Testimony by George Soros

Senate Foreign Relations Committee

Hearing on "Foreign Policy and the Global Financial Crisis"

Washington DC

Dirksen Senate Office Room 419

March 25, 2009

WRITTEN VERSION

The current financial crisis is different from all the others we have experienced since the end of World War Two. On previous occasions, whenever the financial system came to the brink of a breakdown, the authorities got their act together and prevented it from going over the brink. This time the system actually broke down when Lehman Brothers was allowed to fail on September 15, 2008. That event transformed what had been a mainly financial phenomenon into a calamity that affected the entire economy.

Within days the financial system suffered what amounts to cardiac arrest and had to be put on artificial life support. That came as a shock to the business community and the general public. Everybody retrenched. International trade was particularly hard hit and is now down nearly $4 trillion from a year ago. The decline in employment has not yet hit the bottom, and the International Monetary Fund (IMF) estimates that globally more than 50 million people could loose their jobs by year end.

The countries on the periphery of the international financial system are even more severely affected then those at the center. The rich countries could effectively guarantee their financial institutions against default but the less developed countries, ranging from Eastern Europe to Africa, could not extend similarly convincing guarantees. As a result, capital is fleeing the periphery and it is difficult to roll over maturing loans. Exports suffer from the lack of trade finance. Deutsche Bank estimates that $1,440 billion of bank loans are coming due in 2009 alone.

The capital flight is abetted by national regulators intent on protecting their own financial systems by tacitly encouraging banks to repatriate funds. When history is written, it will be recorded that – in contrast to the Great Depression – protectionism first manifested itself in finance rather than trade. To stem the tide, the International Financial Institutions (IFIs) must be reinforced and reinvigorated. Unless effective measures are taken to protect the periphery countries against a storm that originated at the center, the international financial and trade system is liable to fall apart.

The primary responsibility lies with the United States, both because it is the originator of the crisis and because it enjoys veto rights in the IMF. It is not just a moral issue but a matter of self-interest. We have derived great benefits from being at the center of the global financial system and we ought to do whatever we can to preserve that position. If the multilateral system falls apart, every country will pursue its interests unilaterally. Then China will be much better situated than we are. While we are, regrettably, still lagging behind the curve in dealing with the crisis, China is ahead of the curve. Its banking system is in relatively good shape and it can activate its large stimulus program faster than we can ours. The leadership realizes that it must ensure economic growth in order to avoid social unrest and it is both willing and able to apply additional stimulus if the current program is not sufficient. To support its export industries it will extend credit to periphery countries just as it did to the United States. As things stand at present, China and the United States have a common interest in protecting the periphery countries from a storm that originated at the center. We must seize this opportunity even as we address our own recession.

While the primary responsibility is ours, we cannot act without the support of the European countries which carry a disproportionate weight on the governing board of the IMF. Unfortunately the IMF is ill-suited to the novel task with which it is now confronted. It is used to dealing with the failures of government policy, especially at the periphery; now it is confronted with the failure of the private sector at the center. To make matters worse, the IMF is deeply unpopular with public opinion both at the periphery and at the center – and that includes Congress. Moreover, there is a profound disagreement between the United States and Europe, particularly Germany, about the nature of the problem and the right remedies to apply.

The United States has recognized that the collapse of credit in the private sector can be reversed only by using the credit of the State to the full. Germany, traumatized by the memory of hyperinflation in the 1920s that led to the rise of Hitler in the 1930s, is reluctant to sow the seeds of future inflation by incurring too much debt. Both positions are firmly held and can be supported by valid arguments. In the case of Germany's opposition to the use of the German state's credit for the rest of Europe or the rest of the world, they are valid only from a narrow German point of view. Be that as it may, the controversy has dominated the preparations for the forthcoming G20 meetings on April 2.

That meeting is a make or break event. Unless it comes up with practical measures to support the countries at the periphery of the global financial system, markets are going to suffer another sinking spell just as they did on February 10, 2009 when the authorities failed to produce practical measures to recapitalize the United States banking system. To put it in an oversimplified and exaggerated form, the United States wants to re-inflate, Germany and Europe want to regulate. It should be possible, however, to find common ground in the need to protect the periphery countries from a calamity that is not of their own making. Actually, we need to both re-inflate and regulate but reinflation is urgent and regulatory reforms will take time to implement. The urgent task has to be carried out mainly by the IMF, imperfect and beleaguered as it is, because it is the only institution available. The regulatory reforms will involve reforming the IMF and establishing other institutions.

Periphery countries need to protect their financial systems including trade finance, and to enable them to engage in countercyclical fiscal policies. The former requires large contingency funds available at short notice for relatively short periods of time. The latter requires long-term financing.

When the adverse side effects of the Lehman bankruptcy on the periphery countries became evident, the IMF introduced a new short-term liquidity (STL) facility that allows countries that are otherwise in sound financial condition to borrow five times their quota for three months without any conditionality. But the size of the STL is too small to be of much use, especially while a potential stigma associated with the use of IMF funds lingers. That is now being remedied, but even if it worked, any help for the top-tier countries would merely aggravate the situation of the lower-tier countries. International assistance to enable periphery countries to engage in countercyclical policies has not even been considered.

The fact is that the IMF simply does not have enough money to offer meaningful relief. It has about $200 billion in uncommitted funds at its disposal, and the potential needs are much greater. As things stand now, the G20 meeting can be expected to produce some concrete results: the resources of the IMF are likely to be effectively doubled, mainly by using the mechanism of the New Arrangements to Borrow (NAB) which can be activated without resolving the vexing question of reapportioning voting rights in the IFIs. NAB will require Congressional approval.

The capital increase will be sufficient to enable the IMF to come to the aid of specific countries in difficulties, but it will not provide a systemic solution for the developing world. Periphery countries are reluctant to apply to the IMF for support as seen from the fact that the recently introduced short-term liquidity facility that allows qualified countries to borrow without any conditionality has had no takers. A more radical solution is needed. Such a solution is readily available in the form of Special Drawings Rights (SDRs). The mechanism exists and has already been used on a small scale. There is a pending issue of SDR 21.4 billion ($32.2 billion), which only requires approval by the United States to become effective.

SDRs are highly complicated and difficult to understand but they boil down to the international creation of money. Countries that are in a position to create their own money do not need them but the periphery countries do. The rich countries should therefore lend their allocations to the countries in need. This would not create a budget deficit for them. The recipient countries would have to pay the IMF interest at a very low rate: the composite average treasury bill rate of all convertible currencies. They would have free use of their own allocations, but the IFIs would supervise how the borrowed allocations are used. (The World Bank, which has devoted a lot of resources to developing poverty alleviation programs, would be better suited for this task than the IMF). This should ensure that the borrowed funds are well spent. It is difficult to think of a scheme where the cost / benefit ratio is so favorable.

In addition to a one time increase in the IMF's resources there ought to be substantial annual SDR issues, say $250 billion, as long as the global recession lasts. To make the scheme counter-cyclical, the SDR issues could be callable in tranches when the global economy overheats. It is too late to agree on issuing SDRs at the April 2 G20 meeting, but if it were raised by President Obama and endorsed by others, it would be sufficient to give heart to the markets and turn the April 2 meeting into a resounding success.

The SDR proposal, arcane as it is, makes eminent sense. The United States and Europe are actively engaged in creating money to replace credit. SDRs would provide money to less-developed countries which cannot create their own – at no cost to those who make their allocations available.

One of the obstacles standing in the way is the well-known negative attitude of Congress towards anything connected with the IMF. The SDR issue does not require legislation. Nevertheless, it would be very helpful if Congress expressed a willingness to authorize the NAB, which does require Congressional approval and supported the SDR issue in principle.

As we have seen, the IMF is far from perfect, but it is more needed than ever. It has a new mission in life: to assist the less-developed countries to protect their banking systems and enable them to engage in countercyclical fiscal polices. How well it fulfills that mission will have a major impact both on the survival of the international financial and trading system and on our leadership position within that system.

While my testimony focuses mainly on the role of the IMF, we also need to dramatically expand foreign assistance. President Obama pledged to double United States foreign assistance and the proposed budget moves us toward that target, if not as quickly as I would like. I urge you to do no less than he requested and to look to supplemental appropriations to meet more ambitious goals. We need to help countries deal with the immediate impact of the financial crisis and help ensure that we continue to make progress on critical areas such as HIV/AIDS. Now is the time to do more, not less.

One particularly innovative funding instrument is the Global Fund to Fight AIDS, Tuberculosis and Malaria. It has demonstrated remarkable results in the last seven years, working to fill a gap not met by our bilateral programs. But for the first time, it faces a funding shortfall – there are more qualified proposals than there is financing available. Historically, the United States has provided one-third of the financial needs, and we should recommit to that goal. A particular benefit here is that the United States contribution mobilizes new money from other donors, increasing our impact.