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Financing for Development Series: The Financial Crisis and Developing Countries

Developing countries will be severely affected by the financial crisis. Emerging economies are already suffering from capital outflows and a sudden credit stop. In many low-income countries the financial crisis is exacerbating the ongoing food price crisis, which has already had disastrous effects on the poor.

Given the limited fiscal space for compensatory measures in developing countries, industrialised countries are being asked to mobilise a fraction of their financial rescue packages to compensate for the collateral damage to developing countries caused by the crisis.

The development finance institutions, backed by the assets of industrialised countries, should play a strong countercyclical role by providing credit in areas from which commercial players have retreated, thus helping to finance social safety nets as well as long-term investments in agriculture, infrastructure, and sustainable energy.

The financial crisis has already turned into a global economic crisis and will turn into an employment crisis in the immediate future. Scaling down the credit pyramid of the financial institutions (deleveraging), whose credit losses exceed US$ 2,000bn, is expected to continue beyond 2009, working its way through the real economy. The current forecast of about 2 per cent global growth in 2009, with developing countries at 4.5 per cent, will probably have to be revised further downwards, owing to considerable downside risks that will depend on the severity of the global recession and the slowdown of aggregate global demand. Global trade is projected to decline in 2009, the first time since 1982. Disastrous effects in the real economy are still to come, and even the least integrated countries will suffer.

The response to the crisis is based predominantly on national solutions, which have been no more than loosely coordinated by central banks which are keeping up global liquidity and by the G20 summit on 15 November 2008, where world leaders pleaded for a coordinated fiscal stimulus and avoidance of protectionism. However, to stabilise their financial systems and to keep demand up, some countries are accumulating unsustainable fiscal deficits, while others are trying to defend unsustainable current account surpluses, thus posing a threat of currency crises and provoking protectionist policies in deficit countries. If the global economy is to be prevented from collapsing, a more coordinated approach with a more cooperative stance on the part of the surplus countries is clearly needed.

For the next few years, developing countries, including those which have pursued reasonably good policies in the past, will be victims of the collateral damage caused by the financial crisis. They will be confronted with a volatile economic environment and a high degree of uncertainty, which will threaten the achievement of their development goals.

1. Effects on developing countries

In the past decade many developing countries, particularly the emerging markets, have benefited from the accommodating monetary and financial policies of the industrialised countries. There has been abundant capital seeking profitable investments in emerging countries, and country risk premiums have been low, with even poor countries, such as Ghana being able to access the international capital markets. As a consequence, private financial flows to developing countries have dwarfed official flows, from remittances through foreign direct investment (FDI) to portfolio investments, making official development financing less and less relevant, particularly for the emerging economies.

The bursting of the global credit bubble will hit **emerging economies** first and hardest. While most large developing economies should avoid outright contraction of overall output, sharp deceleration is evident in China and India, as well as in Russia. As economic activity slows and jobs are lost, real income growth will weaken. Owing to the importance of the emerging markets for the global economy, this will have negative repercussions for all.

Emerging-market governments, banks and corporations are feeling the crisis because their foreign loans are no longer being rolled over, or at least not at a reasonable cost. Funding markets are quickly drying up. There is much lower tolerance to risk, as sharply rising rates for credit default swaps by emerging economies

reveal. This is bringing lending to a halt and pushing many who have invested in emerging countries to sell their assets to raise liquidity. As a result, stock market falls in the developing countries have been larger than in industrialised countries. In addition, FDI projects currently being implemented have been delayed or cancelled altogether; new FDI will decline, perhaps dramatically. Portfolio investment will become rare. When capital market conditions change and lenders stop providing finance, long-gestation projects may be left incomplete, new ones are not implemented, real wages and asset prices fall, and the real exchange rate depreciates, spreading turmoil through the rest of the economy. Currently, heavy pressure on exchange rates is to be seen in some developing countries, despite their relatively high reserves.

The full impact of the global financial crisis will hit most **low-income countries** later than higher-income countries, but the development costs will be higher there because the scope and fiscal space for short-term policy responses are very limited and safety nets for the poor are less available. As the financial sector in low-income countries is less integrated into global financial markets, the direct effect on it will be significant only in countries with a high foreign bank presence. The largely indirect impact in other countries will be felt through secondary transmission channels: slower investments, reduced remittances, reduced tourism receipts, reduced availability of credit, such as trade finance, falling terms of trade, contraction of private-sector activity and slower export growth.

The World Bank expects a halving of net private capital flows to developing countries in the year 2009. Mobilising capital for development will thus be very difficult. There are only a few private equity investors in developing countries, among them being the sovereign wealth funds, which are choosing opportunities that have limited macroeconomic effects, but lead to a redistribution of wealth to capital-surplus countries, gambling on the long-term growth prospects of emerging markets and of Africa.

It is possible to predict that the developing countries will undergo a sequence ranging from financial through economic to employment and humanitarian crisis. According to World Bank estimates, a 1 per cent decline in growth will increase the number of people living in poverty by 20 million. The achievement of the Millennium Development Goals is thus at serious risk. Achievements in recent years, based on generally more appropriate and prudent policies in developing countries are similarly at risk. Responses to new challenges, such as the mitigation of and adaptation to climate change, are in danger of being postponed, placing an even greater burden on future generations.

The triple jeopardy: food, fuel and financial crises

The global financial crisis follows hard on the heels of the food and fuel price shock, which, according to World Bank estimates, has already had disastrous effects on the poor: an estimated 100 million people have fallen into poverty in the last two years owing to rising food prices.

In the meantime, energy prices as well as commodity and food prices have fallen as a consequence of the recession. However, commodity prices are tentatively expected to return to a high and volatile medium-term equilibrium, the result of underlying imbalances in commodity markets. The same applies to food prices, which are expected to remain at high levels in the medium term. The long-term challenge of food security remains. Despite the decline in food prices in most developing countries, private real income has been reduced across the board, compounded by a slowdown of remittances. The economic and political situation in several developing countries is very precarious, with more ‘food riots’ and rising public pressure on relatively fragile political regimes likely.

High energy and food costs have depleted public budgets and reduced fiscal space, if only because of high, untargeted subsidies in many countries (see DIE Briefing Paper No 11/2008). This has been compounded by higher financing costs and lower tax income, reducing the scope and volume for development expenditures in developing countries’ budgets.

Against this backdrop there is a need for humanitarian safety nets along the lines of Mexico’s Progresa and Brazil’s “Zero Hunger” programmes. At the same time, high investments in rural development and agro-business are needed, along with continuous investment in low-carbon energy supply, both currently endangered by falling prices.

2. Domestic policy responses

Policies to safeguard financial systems and maintain orderly credit conditions will be key, also in developing countries. While the precise measures will vary from one country to another, they should include the strengthening of crisis management systems and contingency planning, the enhancement of oversight of banks’ liquidity management and the improvement of risk management to enable the likely rise in non-performing loans to be addressed. Temporary credit guarantees may be necessary to ensure the normal flow of credit, and authorities must be ready to recapitalise banking systems if necessary. Otherwise, investment projects with potentially high returns may never be implemented because of the lack of funding.

Particularly relevant are policies to safeguard investment in long-term development, which experience shows is always neglected in times of crisis. Careful management will be necessary to protect long-run investment in infrastructure and social development and to avoid cuts in essential public expenditure.

Since the scope for bail-outs and deficit spending programmes in developing countries is very limited, the required fiscal stimuli must be attained by (1) redirecting public expenditures from across-the-board food and fuel subsidies to targeted cash transfers to prevent

food and hunger crises, and (2) stepping up public investment in infrastructure, with donor support. The crisis could then be a catalyst for more inclusive and pro-poor policies in developing countries.

In addition, private-sector activity needs to be stimulated by targeted lending programmes for small and medium enterprises, supported by donors, and by the further development of domestic capital markets, with domestic savings channelled into domestic investments when external financing conditions are unfavourable.

3. International responses

The major policy challenges need to be addressed at country level, but it is more critical than ever that the international community acts in a coordinated and supportive way to make each country's task easier. Industrialised countries are being asked to mobilise a fraction of the financial rescue packages for their own countries as a humanitarian response to the crisis in developing countries.

For an immediate crisis response it is, first, imperative that the multilateral development banks (MDBs) and bilateral donors provide quick-disbursing funds and play a countercyclical role by providing credit in areas from which commercial players have retreated. Beyond the immediate response, it will be crucial for MDBs and bilateral development banks to act as investors of last resort, to promote public and private investments in support of growth and poverty reduction and to restore investor confidence. In general, there is a strong desire to see the public assets of industrial countries with high credit ratings used to leverage investments in enterprises, infrastructure and agriculture in developing countries.

Second, there is a short-term need to finance more resilient social safety nets in the poorest countries. The programmes of the World Food Programme (WFP) should be fully funded on a long-term rather than an ad hoc basis, a move which would put the WFP in a position to buy food aid locally on a continuous basis.

Third, the crisis should be seen as a catalyst for the conclusion of the Doha WTO trade agreement on the removal of agricultural subsidies and tariffs and the creation of a fairer and more efficient global trade system, particularly with respect to agricultural goods.

New governance structures – towards a modernised multilateralism

The old North-South paradigm no longer fits today's world. It must give way to a broader framework for cooperation and learning, including South-South and South-North collaboration. The G7 framework is no longer sufficient. The new approach should not be a fixed or unitary system, but a flexible and inclusive **network** that includes not only the rising economic powers but also representatives of the poorer countries, links up various international institutions and works on such issues beyond trade and finance as development, climate change and fragile states.

The G20 response has not been effective or inclusive enough, one reason being that G20 members from the South are not regarded by other countries in the regions as their representatives. A new governance structure could be based on a **G13** of the leading economic powers plus a new **UN Economic Council** as a consultative body, integrating all world regions, including Africa. There is no political basis for a World Finance Organisation performing authoritative functions like the WTO, since the powerful countries will not allow any interference in their domestic policies. Any structure therefore has to be consensus-based, relying on peer pressure and joint learning processes.

Consequently, no grand solution for a new financial architecture is visible. The **IMF** has, by consensus, been strengthened as the major agency for global macroeconomic surveillance and **as one of several** providers of rescue funds, with the unconditional short-term facility for satisfactorily performing MICs as a sign that old-style conditionality is dead. But it has no legitimacy and will not gain the power to become the sole multilateral financial agency with a degree of bite vis-à-vis powerful countries.

Coordinated unilateralism has been quite successful as an immediate response to the crisis: cooperation among **central banks**, including the Bank of China, has worked well. Short-term swap lines have been mobilised swiftly, injecting considerable liquidity into the system, which has also benefited large developing countries.

With its fast and focused response, the **World Bank** has taken up the position of leading global development agency. It has responded to the crisis with lending commitments of up to US$ 100bn over the next three years and with a number of new IFC facilities for bank recapitalisation, infrastructure financing and trade facilitation (with a Chinese contribution), which could provide more than US$ 30bn over the next three years. It has established fast-track facilities for low- and middle-income countries, frontloading the existing US$ 42bn IDA commitments to LICs and providing stand-by facilities for MICs who have ruled themselves out of resorting to the IMF (see Box 1).

Box 1: Stand-by facility for vulnerable middle-income countries: Indonesia

The World Bank is coordinating a stand-by donor facility to help Indonesia weather the global financial crisis by enabling it to avoid the expensive bond market. Australia, Japan and the Asian Development Bank are also potential donors, with the list expected to lengthen. Officials have said that a facility of up to US$ 6bn is envisaged at very low interest rates, but discussions are continuing. This would be equivalent to about 6.6 per cent of Jakarta's planned 2009 spending of US$ 90.1bn. Sri Mulyani Indrawati, finance minister, told the Financial Times: "*If the bond market is shut down or totally unrealistic in determining price, we won't take the risk.*" Rates on Indonesian government 5- and 10-year debt are 16.6 and 17 per cent respectively, while the spreads on Indonesian credit default swaps, an indicator of sovereign risk, are 780 basis points over US Treasuries, four times the spread earlier this year.

Source: Financial Times, 27 November 2008

In contrast, the **regional development banks**, expected to be driven by the vision and financing needs of their regional members, have been remarkably cautious in

their response. Although they recognise the need for countercyclical lending in times of declining private financing, their shareholders do not seem to be willing or capable of quickly pushing through the necessary capital increases to speed up their lending. Nor have the envisaged regional responses to the crisis taken off, although there have been a number of bilateral swap agreements in East Asia. Neither the envisaged US$ 80bn Asian currency reserve pool nor other publicly discussed coordinated emergency funds have become operational. There is clearly a need for regional responses, but the political obstacles and the governance issues created by a pooling of reserves have been clearly underestimated. Still, the present crisis will encourage regional currency unions as a long-term answer to the volatility of exchange rates and capital flows.

The Doha Follow-up Conference on Financing for Development

For various reasons the Monterrey Review Conference held in Doha in November/December 2008 did not succeed in achieving anything like a "Global New Deal", linking the MDG agenda to the new issues of fuel-food-finance and climate change. The rich countries obviously did not want to be openly criticised for not fulfilling their commitment to complete the Doha "development" trade round, and although their aid flows have risen, particularly to Africa, as a group they are still lagging far behind their promise to increase aid to 0.7 per cent of GDP. Nonetheless, the Monterrey "compact", under which developing countries committed themselves to more responsible and honest government in return for a commitment from rich countries to provide aid and open trade, in their shared interests in meeting the MDGs, was reaffirmed, and such new issues as the fight against capital flight and tax evasion have been added to the list of policies for mobilising more capital for development (see DIE Briefing Paper No 14/2008). Thus the common goals and the common agenda are still valid.

4. Conclusion

The relevance of development assistance has risen as a result of the crisis. Support for developing countries will be crucial and also extremely important for the global economy.

Public development finance institutions, particularly in current account surplus countries with excess savings (China, Japan, Germany), should increase their capital and co-finance emergency lending, safety nets and long-term investments in developing countries. China is contributing to multilateral initiatives and to bilateral stand-by operations and has already signalled its willingness to keep to its comprehensive investment plans for Africa. Japan has committed US$ 100bn to the IMF as a contribution to its stand-by facilities, while Germany is continuing to pursue a predominantly inward-looking policy, hoping to maintain its status as 'the world's export champion' on the basis of the fiscal stimuli of other countries. Industrialised countries should recognise that, owing to the mutual links between global markets, increases in investment in emerging markets and developing countries are as beneficial to themselves as the envisaged domestic fiscal stimuli on which they are currently concentrating. Global benefits would be further increased if those investments contributed to the prevention of humanitarian crises and to climate change mitigation.

Beyond the immediate crisis response, it is important to note that the financial crisis also reflects the global failure to channel capital to its most beneficial uses. If the German *Landesbanken* had channelled their idle capital into long-term investments in emerging markets and developing countries (with perceived high risks, but surprisingly high profits) instead of buying toxic assets, fuelling unsustainable and wasteful consumption in the USA, the world would be better off today.

For the future this means that globally responsible intermediation of capital should focus, among other things, on investment in clean energy and transport and in sustainable agriculture and agro-business, with the focus on emerging markets and South Asia and Africa as future engines of global growth. After recycling surpluses for consumption in the USA, there should be a process of recycling for investment in countries with large investment gaps and subsequently high returns.

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