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From Economic Crisis to Dept Crisis?

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From Economic to Crisis to Dept Crisis

Bonn, 9 March 2009. As the French author Alphonse Allais once said: “When the rich lose weight, the poor will starve.” Sadly, this appears to be proving true in the current global economic crisis. Since last autumn the crisis spilled over from the US and Europe to the entire world economy, and also developing countries and emerging economies increasingly get to feel the full effects of the crisis. The World Bank estimates that the slowdown in economic growth will push 53 million people into poverty, in addition to the 155 million already suffering the effects of the food and energy crisis.

The crisis hits emerging economies in another way than developing countries. In principle, the more a country has integrated into the world economy by engaging in international trade and finance, the more it now gets to feel the dark side of globalisation.

While most emerging economies were able to refinance themselves cheaply in international financial markets over the past years, financing conditions have worsened dramatically since summer 2008. The collapse of international credit markets has made the access to new credit almost impossible. Moreover, liquidity problems and a “flight to safety” meant that financial firms and investors from industrialised countries withdrew large amounts of capital from emerging economies across the board. This led to crumbling stock markets and strong devaluation pressure on the exchange rates of many countries.

The withdrawal of capital particularly hit economies whose growth over the last years was based on a continuous influx of cheap loans. The list of badly affected emerging economies includes several Central and Eastern European countries, the Baltic states, as well as emerging economies in Asia and Latin America. The Institute of International Finance anticipates a major decline of net private capital flows to emerging economies from $929 billion in 2007 to $165 billion in 2009; a decrease of 82% in only two years. Given that basically all industrialised countries will have to raise large amounts of money in the international capital markets in order to finance their national stimulus packages over the coming months, access to capital is likely to get even more difficult for emerging markets. The International Monetary Fund (IMF) has already had to support Hungary, Ukraine, Iceland and Pakistan with almost $50 billion in emergency credit. Other countries will follow soon. The IMF is now pushing for a doubling of its current resources, which stand at about $250 billion, to be able to respond adequately to the anticipated demand for emergency finance from its most vulnerable members.

The situation is rather different for many of the poorer developing countries that were not able to access the international financial markets even before the crisis. Although their balance of payments had benefited in the last years from increased export earnings, they largely have remained dependent on concessional loans from the World Bank, the IMF and other sovereign lenders. These countries now face the indirect consequences of the crisis such as a decrease in remittances, exports and growth. For instance, in its recent *World Economic Situation and Prospects* report from January, the United Nations projects growth of African developing countries for 2009 at a rate of 0.1% if bad should go to worse. This is significantly lower than the 6.0% recorded in 2007 and the 5.7% in 2008 and will inevitably have detrimental consequences for the already weak budgets of many African countries.

The situation already deteriorated last year for many of the “Highly-Indebted Poor Countries” (HIPC), the group of countries that benefited from the two major rounds of debt cancellation initiated in 1999 and 2005. In September 2008 the IMF and the World Bank observed that there was a mediate to high risk to fall back into debt distress for 14 of the 23 HIPC countries that completed the multi-stage debt cancellation process. These countries are mainly in Sub-Sahara Africa. Seven African countries are threatened by bankruptcy before the end of this year according to the *Debt Report 2009* (available in German only) that erlassjahr.de, a German nongovernmental organisation, released in February this year. An additional six African countries face a high risk of bankruptcy.

It would be expected that these countries should be in a relatively stable fiscal situation after the HIPC debt cancellation. Unfortunately, this is not proving to be the case for two reasons. Firstly, least developed countries are particularly sensitive to a deterioration of their terms of trade. The recent high (and volatile) prices for energy and food were a burden for most of them. The crisis weighs down additionally on these countries as demand for their export products – mainly primary commodities – dwindles and they lack an industrial base to compensate these shortfalls with other exports. Secondly, their liquidity has come under pressure as they took on new loans, the cost of which has increased as new lenders such as China provide many loans on less concessional terms. Moreover, multilateral donors such as the World Bank had increasingly substituted grants by loans.

The situation in many developing countries, especially in Sub-Sahara-Africa, is therefore serious. Without having contributed to the crisis, their development prospects are jeopardised by the crisis. As a consequence, the accomplishment of the Millennium Development Goals – which include the eradication of extreme poverty and hunger, provision of universal primary education and reducing child mortality – is under serious threat and cannot be achieved without external support.

The problems of the poorest countries must not be forgotten as the G-20 devise their policy responses to the crisis. The World Bank and the regional development banks have already increased their lending to the limit of their financial resources. They swiftly need to receive new capital infusions to provide further countercyclical financing to developing countries. For the weakest countries particularly, the financing should take the form of grants. The G-20 can build on long-standing international commitments: donors have agreed both at the level of the EU and the G-8 to substantially increase their official development assistance. Now is the time to cash-in these promises.

Furthermore, it is in the interest of both debtors and creditors to establish a Sovereign Debt Workout Mechanism before the first cases of sovereign bankruptcy actually occur. The mechanism should comprise an independent panel – similar to the courts of the World Trade Organisation’s trade dispute settlement systems. This would decide on a sustainable way out of state bankruptcy while taking into account the interests of debtor country and private and public creditors alike. The advantage would be a timely and rules-based solution to state bankruptcy. This would be in contrast to the haphazard and protracted debt rescheduling of the past. Establishing an Sovereign Debt Workout Mechanism should be part of the reform of global financial governance currently being discussed.

In their Washington Declaration from November 2008, the G-20 members assured us that they will “help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support.” The G-7 finance ministers who met in Rome in February 2009 repeated this promise. Their final communiqué stressed “the need to support emerging and developing countries’ access to credit and trade financing and resume private capital flows”, and expressed their commitment “to explore urgent ways, including through multilateral development banks, to enhance this support.” This is the time to make sure their deeds follow their words.