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How Will the Financial Crisis Impact on the Developing World and What Can Be Done About It?

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Following the US subprime mortgage crisis of 2007-2008, the world is now staggering from financial to economic crisis as many high-income economies are officially in recession. Now, having decimated Wall Street and then crippled Main Street, the financial crisis seems like a hurricane about to sweep across the developing world.

In this article, which is based on a more substantial UNU-WIDER Discussion Paper, I look at how the financial crisis may sweep across the developing world. I also ask what can be done to overcome the worst of the crisis and alleviate the impact thereof on the poor.

Impact on the Developing World

There are three main channels through which the financial crisis can affect the economies of developing countries.

Banking failures and reductions in domestic lending

Financial institutions in developing countries could be negatively affected depending on the extent to which they hold assets contaminated by subprime mortgages. At the time of writing, this does not appear to be a significant concern although the 'location' of all of these 'toxic' securitized assets still seems to be causing concern. Many banks in developing countries only have weak links with international banks. In China, where the financial sector is largely government controlled, exposure to subprime mortgages of United States origin is limited.

There is, however, a more serious indirect threat through declines in stock market prices and housing prices. These reduce the capital of banks (and of other big firms), which in particular causes problems where they do not hold sufficient levels of their capital in cash. In such cases it is likely that banks will reduce lending in order to shore up their capital. Reductions in bank lending will reduce investment, lower growth and increase unemployment.

Reduction in export earnings

Even if most developing countries are spared significant damage to their own financial systems, the fact that the advanced economies are entering a recession is likely to hurt them. The impact may be significant, given that most developing countries have been basing their economic growth in recent years on exports. The International Monetary Fund (IMF) expects growth in world trade to decline from 9.4 per cent in 2006 to 2.1 per cent in 2009. The expected declines will come through a combination of lower commodity prices, a reduction in demand for their goods from advanced economies and less tourism.

International trade depends on short-term credit. At the time of writing, the trade finance gap has been estimated at US$25 billion by the World Trade Organization (WTO). Although this seems relatively small, it has important knock-on effects. Consequently, there will be dual pressures on developing country trade: reduced demand for their exports and reduced trade credit.

Reduction in financial flows

Financial inflows from the rest of the world to developing countries include official development assistance (ODA), investment flows - both portfolio and foreign direct investment (FDI), trade credits and flows of remittances. All of these are likely to be affected negatively during the current crisis. Estimates put the decline in financial resources to developing countries from around US$300 – 400 billion.

Limiting the Damage to Developing Economies

The World Bank and IMF forecast that developing country growth as a whole will slow to 4.5 and 3.3 per cent respectively in 2009. The International Labour Organization (ILO) predicts that unemployment could rise by 20 million across the world and that the number of people working for less than the US$2 per day poverty line will rise by 100 million.

Avoiding or limiting these outcomes, and facilitating recovery would require immediate and appropriate responses from developing country governments and the international development community.

But there is no one size fits all policy response. Some countries will suffer more, especially those dependent on trade with the United States, those with balance of payments difficulties and large fiscal deficits, and those with poorly regulated financial sectors. Countries with the latter constraint(s) may even experience their own financial crises in 2009. In essence, the crisis will expose countries with poor macroeconomic management and poor financial institutions. A number of countries have either already received short-term IMF assistance to alleviate balance of payments crises or signalled the possibility that they may need such support in the near future.

Generally though, countries should, where possible, consider a combination of short-term and long-term measures. Immediate and short-term policy responses are required to ensure that (i) the financial crisis is contained (ii) that confidence in financial systems are restored, for instance by providing guarantees, strengthening the balance sheet of banks and by sharpened supervision, and that (iii) the impact on the real economy is minimized.

In the latter regard, some countries may wish to engage in countercyclical fiscal and monetary policies to cushion the fall in external demand and reductions in credit. Here it may be encouraging that countries such as China, South Korea and India are reported to have announced substantial fiscal stimulus packages. Various calls have also been made for official development assistance (ODA) to developing countries to remain at existing levels despite the crisis. Following the recent Doha Declaration on Finance for Development, most developed countries recommitted themselves to maintaining, and even accelerating where possible, their aid commitments. Despite the possibility of reductions in ODA, I remain optimistic that such reductions may be avoided or minimized. This is because aid budgets are relatively small compared to the huge sums being spent on bailing out the US financial system and key industries throughout the developed world. In addition, there is no more room for fiscal expansion in traditional donor countries, and 'new' donor countries such as China and India are rapidly emerging.

It is necessary that countries coordinate these responses as far as possible. Areas for greater cooperation include: coordination of bailouts to avoid a 'race to the bottom', as different countries all rush to provide subsidies to their different ailing industries; better coordination of the responses of central banks; and coordination and cooperation to ensure that countries do not retreat into economic nationalism or trade protectionism.

Over the longer term, countries should prioritize a number of measures for further domestic financial sector development. A recent two-year research project by UNU-WIDER on 'Financial Sector Development for Growth and Poverty Reduction' conducted a careful study of these. These measures should however be implemented within the context of reforming the global financial architecture—specifically improving ODA and the Bretton Woods Institutions. The current crisis has dramatically exposed the serious shortcomings in the latter and illustrated the importance of having access to credit for economic growth. Indeed, domestic financial development will depend on improved global financial architecture and vice versa.

Conclusion

The financial crisis is a setback for the developing world, but one which I am confident they can survive and overcome. There are a number of reasons to be optimistic and we should not lose sight of these in these challenging times. Thankfully many developing country economies are currently quite resilient as a result of good growth, better policies and having learned hard lessons during the 1998 Asian crisis. Also, the largest emerging markets, China and India, will continue to grow (albeit at slower rates) and this will benefit many other developing counties. Finally, given the huge fiscal and monetary expansion programmes now being undertaken in the advanced economies, and the efforts at the G20 to address the root causes of the crisis within the context of the global financial architecture, developing countries could very well start to pluck the fruits of renewed vigour in the global economy in the near future.

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