

CIGI Task Force on Developing Countries

The Effect of the World Financial Crisis on Developing Countries: An Initial Assessment



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Addressing International Governance Challenges

About the Task Force

The Centre for International Governance Innovation (CIGI) based in Waterloo, Ontario, consistent with its mandate to contribute to global debate on contemporary world problems, has formed a task force of eminent economists to study and offer solutions for the devastating effects of the current financial crisis on developing and transition economies. Reminiscent of the 1930s, when most Latin American countries were in default, several countries recently have experienced a sharp reduction of their international trade, a rapid decline in inward investment flows and, in many cases, repatriation of prior foreign investment and a fall in remittances. This first statement by the task force briefly outlines the nature of the crisis for developing countries and suggests in general terms a strategy for a way forward.

Summary

- The current financial crisis started in developed countries, but reduced foreign investment and reduced demand for imports of commodities and labour-intensive products are having profound effects on developing countries.
- Growing protectionism and massive budget deficits in developed countries that threaten to pre-empt much of the world's savings will exacerbate problems for developing countries.
- The many developing countries that lack large foreign-exchange reserves and have balance-of-payments difficulties will be able to implement expansionary fiscal policies only with augmented assistance from the World Bank and the International Monetary Fund and a relaxation of the conditions under which these institutions lend money.
- Continuing lack of demand in developed countries implies that developing countries need to enhance trade and finance linkages among themselves in order to foster economic growth.
- The developed world needs to acknowledge the severity of the effects of the current financial crisis on developing countries, to resist new protectionist measures that would further harm their growth and development, and to maintain and even increase current aid and investment flows.

A Brief Outline of the Crisis

The origins of the current world financial crisis are now well known. They lie in the worldwide financial excesses of the past few years and even decades; the bursting of the housing and oil price bubbles; excessively low interest rate policies; massive trade surpluses in some countries and trade deficits in others; and savings rates that are too low in some parts of the global economy and too high elsewhere. The cumulative effect is a financial and liquidity crisis that threatens to become a global macroeconomic upheaval, with significantly negative world GDP growth, perhaps for two or three years, sharply increased unemployment, pressures on public revenues and deflation.

Although the crisis originated in the economies of North America and Europe, its effects are now global, with particularly serious implications for the economies of the developing countries. Indeed, the nature of the crisis is very different for developed and developing countries, and among the latter there is also a considerable diversity of effects.

In developed countries, the crisis stems from a drying up of credit

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flows as financial institutions are no longer able to assess the credit-worthiness of other enterprises, whether financial or nonfinancial. For instance, the inability of some companies to obtain insurance for orders they have placed with suppliers has caused them to curtail or shut down their production and sales activities. This problem has been aggravated by developments on the demand side, with households compelled to increase their savings to compensate for the fall in the value of their financial and real estate assets. Rising fears of unemployment have also led households to curtail consumption. In this sense, the crisis differs from most of those in the past in that the problem is not a lack of demand for credit but a lack of supply of credit.

For the developing countries, which have become increasingly integrated into global trade and finance over the past few decades, the crisis is not one of credit but of falling demand in the markets of developed countries. The financial crisis in the developed countries did not initially affect developing and transition economies as the crisis did not originate within their financial systems. It was even hoped that the real economy in the developing countries would escape unscathed and even that growth in developing countries would help to buoy the world economy, as it did in the recession at the beginning of this century. But when demand fell in developed countries, volumes and prices of exports from developing countries declined. This initial severe contraction of output and employment in the export industries of developing and transition countries in turn has spread to other industries in these countries, causing economy-wide declines in output and employment.

The extent of the effects of the global crisis on developing countries depends on the importance of exports and capital inflows in their economies. In South Asian countries, for example, exports of goods and services average 22 percent of GDP, while in Latin America and the Caribbean the share is 26 percent, in sub-Saharan Africa 35 percent, in eastern Europe and central Asia 40 percent and in East Asia almost 50 percent. For the large developing countries, exports as a proportion of GDP vary from 15 percent in Brazil to 23 percent for India, 28 percent for Turkey, 30 percent for South Africa, 31 percent for Indonesia, 32 percent for Mexico, 34 percent for Russia and 40 percent for China. Exports from both China and South Korea have dropped, and although GDP growth remains positive in China, it is sharply negative in South Korea. Russia has been severely affected, with industrial output falling by more than 10 percent in the last quarter of 2008 and GDP posting a 27 percent year-on-year decline in the first quarter of 2009; Russia's financial reserves have also declined substantially.

Countries that depend on exports of primary commodities other than oil have also been hit hard because of the sharp decline in prices of export commodities. Prior to the onset of the crisis, the economies of sub-Saharan Africa had been growing strongly, buoyed by higher commodity prices after a prolonged period of stagnation caused, in part, by terms-of-trade losses. The recent fall in prices now threatens a return to the conditions through which these countries struggled during the

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1980s and 1990s. But even the oil exporters have seen a sharp drop in tax revenues, on which these economies depend heavily.

The increasing integration of world finance also means that the crisis is having a serious effect, both directly and indirectly, on investment in developing countries. Not only is foreign direct investment (FDI) declining, but foreign financial institutions are withdrawing their investments in developing countries' stock exchanges and repatriating the proceeds, resulting in sharp declines, often of more than 50 percent, in stock prices and large devaluations, often of more than 25 percent, in their currencies. The drop in stock prices further hurts investment in developing countries; the effect of currency devaluation, however, depends on the share of imported inputs in production or in the consumption basket of workers. Policies in developed countries, because of their linkage with developing countries, will influence the outcome in the latter and so need to be discussed in studying the policy choices for the developing countries.

Policy Responses in the Short Term

As a short-term response to the financial crisis, governments in all the developed countries and in many developing countries have undertaken measures, including partial public ownership, to shore up their financial systems. To counter the decline in economic activity, they have also implemented expansionary monetary policy leading to sharp falls in interest rates charged by central banks, often to very close to zero, supplemented by expansionary fiscal policy that has led to ballooning budget deficits. In itself, such a policy response to an economic downturn is not unusual; central banks typically attempt to counter falling demand for credit by reducing interest rates. In crisis situations, however, the supply of credit dries up because of developments on the liability side of banks' balance sheets. In the past, this usually happened when there was a large-scale withdrawal of deposits — a possibility that deposit insurance has almost eliminated.

Most recent financial crises have occurred in developing countries and have been caused by the withdrawal of international credit, to which the International Monetary Fund (IMF) has responded by injecting money. In the current crisis, however, the problem has arisen in the developed countries from the liability side of the balance sheets, and has occurred because financial institutions have been able to borrow from international capital markets to finance their lending, thus snapping the link between deposits and loans (banks in Iceland provide an extreme example).

The crisis in the developed countries is likely to be long-lasting. The traditional instrument of lowering interest rates is likely to work only after a significant time lag, as it did in Japan in the 1990s. Governments have been reluctant to take stronger actions to bolster confidence in

the viability of banks. For instance, banks could have been made more forcefully to increase their capital, or more public capital injected into banks or bad assets transferred to separate entities. The effectiveness of expansionary fiscal policy could also be enhanced if government expenditures were coupled with credit guarantees on behalf of those meeting government demands. Direct help to those who are the primary holders of toxic assets also might be needed to enable them to service their debt. The situation would be helped by an independent evaluation of the balance sheets of financial institutions and perhaps of major companies.

In developing countries, policy responses to the current financial crisis will depend on each country's fiscal and balance-of-payments positions. Countries such as China, with ample foreign-exchange reserves and small fiscal deficits, will be able to undertake effective expansionary fiscal policy. India, with ample reserves but large fiscal deficits, has relied more on monetary policy, particularly in making more and easier credit available to producers. Russia and other oil exporters, which depend largely on oil revenues that are now declining, are experiencing a worsening of their governments' fiscal position, which limits their ability to undertake expansionary fiscal policy. Still other countries, particularly in Africa, that lack large reserves or whose balance-of-payments situation is precarious might not be able to adopt expansionary fiscal policy unless they are assured of financing on easy terms if they end up with balance-of-payments deficits. For such countries, the confidence of their governments to engage in expansionary policies could be increased by expanding the resources of the World Bank and the IMF and loosening the conditions under which these institutions lend.

In the Longer Term

This crisis has revealed serious shortcomings in the current system of supervision and regulation of the international financial system, and clearly some significant changes will need to be made. But there are more deep-seated causes for the current problems stemming from the nature of international money and adjustment. In the 1970s, creditworthy developing countries borrowed from international banks, but the resolution of the resulting debt crisis in the 1980s ground growth to a halt in many of them. In response, many developing countries became reluctant to borrow from the IMF and borrowed only limited amounts in international capital markets. In doing so, they built up their reserves, denominated in US dollars, often by following conservative monetary and fiscal policies that kept their economic growth rates low. Now, however, the growth of massive deficits in the United States and the decline in the relative value of the US dollar, as well as the possible emergence of the euro and perhaps other currencies as rivals for the role of an international reserve currency, could create instability in the international financial system. This could be avoided by agreement on new rules for international money.

John Whalley

John Whalley is a CIGI distinguished fellow and a fellow of the Royal Society of Canada. The author or coauthor of dozens of scholarly articles, he is one of Canada's preeminent experts in the field of global economics. His current academic positions include professor of economics and codirector of the Centre for the Study of International Economic Relations, Department of Economics, University of Western Ontario; research associate, National Bureau of Economic Research in Cambridge, MA; and coordinator, Global Economy Group, CESifo, University of Munich. Dr. Whalley is a former visiting fellow at the Peter G. Peterson Institute for International Economics, Washington, D.C. He holds a BA in Economics from Essex University (1968), and an MA (1970), M.Phil (1971) and a PhD (1973) from Yale University.

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Since demand from developed countries is likely to remain low for some time and the fiscal needs of their governments are likely to absorb a substantial part of the world's savings, developing countries will have to take some actions on their own to foster economic growth, including accelerating the trade and financial linkages growing among themselves. Some developing countries have high levels of savings that could be used for investment in those with a scarcity of savings, while intra-developing country trade could be enhanced by tariff cuts and the encouragement of preferential trade agreements among them.

Who We Are

The Centre for International Governance Innovation is an independent, nonpartisan think tank that addresses international governance challenges. Led by a group of experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate, builds capacity, and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events, and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

CIGI's work is organized into six broad issue areas: shifting global order; environment and resources; health and social governance; international economic governance; international law, institutions and diplomacy; and global and human security. Research is spearheaded by CIGI's distinguished fellows who comprise leading economists and political scientists with rich international experience and policy expertise.

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