

THE FINANCIAL CRISIS AND ITS IMPACT ON DEVELOPING COUNTRIES

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ABSTRACT

This working paper has been commissioned by the Poverty Group, Bureau for Development Policy at UNDP, to identify the transmission mechanisms of the financial crisis from developed to developing countries and to provide broad policy recommendations at the national, global and regional level. The paper identifies three mechanisms that play a key role in spreading the consequences of the financial crisis to the developing world: remittances, capital flows and trade. The policy responses take MDG achievement and poverty reduction as the central policy concern. The paper indicates that a fair number of countries have policy space to protect vulnerable groups in the short run as well as to undertake investments to build resilience and reach these goals in the longer term. Other countries will need additional development assistance to protect development achievements. The authors point to a number of factors that need to be taken into account in determining what mix of policies to deploy including the macroeconomic, fiscal and policy stance of countries and their dynamics. The paper also proposes far-reaching reforms to address the global financial crisis, which would help to put the global macroeconomic, fiscal and financial coordination mechanisms on a firmer footing.

EXECUTIVE SUMMARY

The current economic and financial crisis was driven by the reversal of the three positive 'shocks' that developing countries experienced during the recent boom period: exceptional financing, high commodity prices and, for a significant number of countries, large flows of remittances. The initial trigger that contributed to the reversals of these trends was the impact of the bursting of the U.S. housing bubble. However, it was the reversal in commodity prices in mid-2008 and, particularly, the severe world financial crisis that started in September 2008 that led to significant reversal of favorable global conditions for developing countries. The emerging recession in the United States and other developed countries further multiplied the negative impact of the crisis for developing countries.

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TRANSMISSION MECHANISMS

One of the key channels for transmission of the crisis from developed to developing countries has been *via private capital flows* though the impact of this has been more severe for emerging markets than for low-income countries, which are less integrated into international private capital markets. In several countries, there has been a massive reversal of currency positions out of high-yielding assets in emerging economies into developed countries' currency with a negative impact on the exchange rates of developing countries, even in countries with significant current account surpluses. While FDI flows have not been significantly affected to date, with the decline in commodity prices, FDI flows into those sectors will likely fall sharply. Official Development Assistance (ODA) is estimated at \$104 billion in 2007. A key challenge is for aid flows to augment at the very least according to existing commitments, though if the recession in the developed countries is very serious, there is a risk that aid budgets may not increase enough or could even fall, with negative effects on poor countries and poor peoples.

The main channel of transmission of the crisis to exporters of manufactures and services is through a decline in trade volumes; while exporters of primary goods have been more affected by declining prices. Falling energy prices will benefit energy importing countries but they will also lead to reduced investment and economic activity in commodity-dependent developing countries, particularly in Africa, the Middle East and North Africa, and Latin America. For these countries, a major opportunity ahead is to redesign their trade strategy to reduce their commodity dependence.

NATIONAL RESPONSES

Countries with stabilization funds (generally, energy exporters and some metal exporters) will be able to use past savings to cushion the effect of commodity price downswings. Broadly, national responses should aim to mitigate the contractionary effects coming from abroad and to rethink their trade strategies. The nature of the policy packages to be adopted will vary. For those countries with a strong debt and foreign exchange reserve position but weak fiscal stance the room for maneuver lies more in monetary than with fiscal policy. Most emerging economies have the capacity to avoid the traditional pro-cyclical monetary policies of past crises and follow the expansionary policy trajectories of industrial economies. In the fiscal area, there is significant room to maneuver in a relatively large group of developing countries. They should use this space to mitigate the effects of the external shock. Infrastructure investment and social spending should be the focus of these programs.

The strategy will also depend on each country's social policy framework. Universal social policies in the areas of nutrition, basic education and health should be the major policy focus, but targeted programs for the poor, such as conditional cash transfers, make sense in middle-income countries (in poorer countries, by definition, poverty is widespread and universal programs are clearly superior). Special emergency employment programs should be the essential complement, since unemployment insurance, the traditional automatic stabilizer of industrial countries is generally absent in developing countries. Tax reduction policies are unlikely to have the best effects. Trade policy can play a role in the recovery in at least three different ways: i) non-traditional exports can be encouraged through a mix of exchange rate depreciation and sectoral incentives; ii) strengthening domestic linkages of existing manufacturing export activities can also play a role; and iii) more active South-South

cooperation may encourage trade through existing integration processes. Payments agreements among central banks can also play a role in facilitating such trade without the need for hard currencies.

GLOBAL RESPONSES

The magnitude of the current crisis is clearly associated with inadequate regulation and supervision of banks and financial markets. The new regulatory governance needs to be based on a well-functioning network of national and regional authorities and include truly international supervision of financial institutions with a global reach. The institutional structure that responds to this challenge should have adequate representation from developing countries to ensure not just greater legitimacy, but also greater efficiency. There are a number of broad principles on which future financial regulation needs to be built: the first is counter-cyclicality, in order to correct the main market failure of banking and financial markets– their boom-bust nature. The second key principle for modern, effective regulation should be comprehensiveness; for regulation to be effective, the domain of the regulator has to be the same as the domain of the market to be regulated.

The global recession now under way calls for a coordinated policy response. It means expansionary monetary, credit and fiscal policies in all industrial countries. Developing countries should adopt equally expansionary policies, individually and in a coordinated way. Countries that have accumulated large amounts of foreign exchange reserves and have limited external debt ratios do have a larger room for maneuver to adopt these policies. For others it is essential to avoid the IMF conditionalities of the past, which forced developing countries to adopt contractionary macroeconomic policies.

Four essential reforms of the IMF should be part of the reform agenda: i) the creation of a meaningful and truly global reserve currency, ii) the need to place the IMF at the center of global macroeconomic policy coordination giving greater voice to developing countries; iii) the need for the IMF to lend during balance of payments crises rapidly, at sufficient scale, and without overburdening borrowers with conditionalities of the past, particularly when the sources of the crisis are exogenous.

REGIONAL RESPONSES FUNDED BY DEVELOPING COUNTRIES

In all of the areas of reform, the IMF should collaborate more closely with regional institutions, such as the Chiang Mai¹ Initiative or the Latin American Reserve Fund.² Developing countries are also in an excellent position to contribute to this task, given their large foreign exchange reserves. Additionally, many developing countries have created sovereign wealth funds with an additional level of assets of more than \$3 trillion. Further, swap arrangements among central banks, pooling them in reserve funds or for support of the development of regional bond markets, are mechanisms to multiply the room to maneuver that they provide.

While multilateral development banks should maintain their central function in the international development architecture, regional and sub-regional financial institutions owned by developing countries should play an important complementary role. If developing countries allocate even 1 per cent of their foreign exchange reserves they could create or expand existing regional institutions by \$50 billion at current levels of reserves, laying the basis to meet their development goals more efficiently.

1 INTRODUCTION

In 2003-2007, the developing world experienced an impressive economic boom, growing at a rate of 7 per cent per year. The boom was fueled by a mix of four ingredients prevailing in global markets: exceptional financing, high commodity prices and, for a significant number of countries, large flows of remittances. The first two conditions had coincided for the last time in the 1970s, while the mix of the three had never been experienced before. The rise of an alternative Asian engine, with China at the center, is a fourth element, which has had a strong influence on world trade and commodity prices.

These conditions have been replaced since mid-2008, particularly since September 2008, by the effects of financial turmoil that erupted in mid-2007 in the U.S. which has now become the worst global financial crisis and the worst recession since the Great Depression. For a year since the crisis erupted, commodity prices continued to boom. This factor, together with high foreign exchange reserves, helped to attract capital to emerging markets even after the outburst of the subprime crisis. However, both have now joined the downturn. There are signs that remittances, the third source of the boom, have experienced a significant slowdown or are even falling. We will see in the immediate future whether the Asian and particularly the Chinese growth engine can serve as the basis for world economic growth, but recent data for the fourth quarter of 2008 are not very promising in this regard. More broadly, these events indicate that the view espoused by the IMF in 2007 that the developing world would “de-couple” from weak economic conditions in industrial countries was essentially flawed.

2 CHANNELS OF TRANSMISSION OF THE CRISIS

The crisis can be seen as being driven by the reversal of the three positive shocks that developing countries experienced during the recent boom: rapid growth of remittances, capital flows and trade. We start with a short look at remittances, where the information is not abundant. Then we deal more extensively with capital flows and trade.

2.1 REMITTANCES

For some regions, there is strong evidence of reduced dynamism of remittances. In the case of Latin America, in particular, remittances grew very slowly both in 2007 and 2008, falling as a proportion of GDP in both years, in sharp contrast with the rapid growth earlier in the decade. The direct sensitivity of migrant incomes to construction activity, which has been falling for three years now, seems to be an important explanation for the absolute reduction of remittances from the U.S. to Mexico in 2008, but absolute reductions are still an exception. Remittances from Europe may be experiencing a similar pattern of either a strong reduction in the growth rate or absolute reduction (see, for example, the case of Spain, one of the economies hit the hardest by a construction crisis).

In contrast, other areas of destinations of migrants, particularly the Gulf countries, continued to boom until the third quarter of 2008, and have experienced no significant slowdown in remittances yet. This effect seems to have prevailed so far, but is likely to change as a result of the steep fall in oil prices. Overall, the World Bank has estimated that remittances to the developing world experienced a lower, but still positive and fairly strong growth in 2008

(7per cent in 2008 vs. 16per cent in 2007). However, in 2009 they will face a reduction – either small (-1per cent) or large (-6per cent) (Ratha et al., 2008).

Overall, remittances are likely to show resilience and are, therefore, unlikely to be a major channel of transmission of the crisis. However, should the recession become deep and prolonged, the effects on remittances could deepen.

2.2 CAPITAL FLOWS

In contrast, one of the key channels for transmission of the crisis from developed to developing countries is via private capital flows. The effects take place both through volumes and associated costs of such flows. Vulnerability of developing countries to rapid deterioration in capital flows has been diminished by the fact that, as a result of their good policies, many of these countries have far higher levels of foreign exchange reserves and lower levels of external debt than in the past. As we will see below, they can help to cushion countries from a deteriorating international environment, but the space it provides for counter-cyclical macroeconomic policies remains to be seen. Emerging market investors (both public and private) have also become an important source of capital flows to developing countries. We return to this issue below, in our policy section.

At the same time, new sources of vulnerability have opened up, such as the volatility of portfolio investments made into the growing domestic capital markets of developing countries and the rapid unwinding of carry trade³ (this trade was mainly done using instruments from the rapidly growing derivative markets). Also, increased foreign ownership of developing country banks has not proven to be a source of strength, and in some cases may turned out to be a source of fragility, as these banks have withdrawn lending to their subsidiaries in developing and transition countries in order to strengthen their very weak positions in developed countries.

As regards volumes of flows, foreign direct investment continued to grow through 2008. Private financial flows peaked from mid-2006 to mid-2007. After a short weakening during the third quarter of 2007 due to the sub-prime crisis, they recovered and boomed again during the first semester of 2008 but dropped very sharply since the third quarter of 2008 and became negative in some cases during the last quarter of the year. Emissions in bond markets came to a halt, bank lending was severely hit, and there was a sharp reversal of flows from mutual funds and an unwinding of the carry trade (further details below). On annual terms, financial flows peaked in 2007 and fell in 2008. They are widely expected (e.g. by the IMF, the United Nations and the Institute of International Finance - IIF) to fall further in 2009.⁴

In terms of the cost of financing, although spreads for emerging market bonds have been increasing since mid-2007, this effect was largely counteracted by the reduction of reference interest rates (generally the 10-year U.S. Treasury bond), so that yields did not show a strong upward trend. It was only in June 2008 that yields increased substantially and exploded after the global financial meltdown of mid-September 2008.

This behavior of the quantity and price of financial flows has been a major mechanism transmitting movements in stock markets from industrial to developing countries. On average, when measured in dollar terms, stock markets have experienced a stronger contraction in emerging markets since their peak in late October - early November 2007 than stock markets in industrial countries.

This impact of the global financial crisis has been more severe for emerging markets than for low-income countries, which are less integrated into international private capital markets. Indeed, capital flows to low-income Africa have been relatively limited. It is unfortunate, nonetheless, that the bond issuance that some Sub-Saharan African countries had begun to make has also stopped. Hardest hit were the transition economies of Central and Eastern Europe, where the combination of adverse expectations generated by large current account deficits, high vulnerability of the domestic financial system, or both, led to rapid withdrawals of private capital flows. The reversal of portfolio flows in East and South Asia was large and even surprising in several cases. For South Korea, for example, the Institute of International Finance estimates that foreign investors withdrew a massive net \$45 billion in 2008. Countries like India and Taiwan (PRC) also saw negative portfolio investment flows. In Latin America, Brazil and Mexico were hit by losses in derivative markets and, in the first case, by the unwinding of the carry trade. South Africa was also severely hit.

Concerning categories of private flows, a major source of problems in late 2008 was the interruption of bond issues in international capital markets (some were done, though in limited quantities, in early 2009) and the severe slump in inter-bank lending, both phenomena being part of a worldwide freeze in financing. Trade credit has been an important casualty of this drop. Some countries, like Brazil, have been able to put their foreign exchange reserves to good use by supporting exporters that have no access to international private trade credit lines. However, the IIF and others rightly fear that net bank lending to emerging markets will remain lower for some time, as bank capital will restrain banks' ability and willingness to lend. According to IIF figures, bank lending to emerging markets fell from a peak of \$410 billion in 2007 to \$167 billion in 2008. Even more worrisome, it is projected by the IIF to fall to minus \$60 billion in 2009.⁵

A second source of problems is the high level of aggregate amortizations due by private sector borrowers, which are projected to reach \$130 billion in the first half of 2009 and \$250 billion for the whole of 2009, if both loans and syndicated bonds are added. More significantly, some emerging countries greatly increased their short-term borrowing in 2007 and 2008, which seems to leave them very vulnerable to a reversal of these short-term flows. South Korea and Russia had particularly large short-term inflows, and their reversal has been a source of serious problem for their economies.

The other category of highly problematic capital flows is net flows from non-bank sources such as mutual and hedge funds. Withdrawals from mutual funds in industrial countries and the unwinding of carry trade since July 2008 led to a massive reversal of currency positions out of high-yielding assets in emerging economies into developed countries' currency. This phenomenon has had a major negative impact on exchange rates of developing countries, even in countries with significant current account surpluses. It also shows how some categories of private firms are almost totally driven by internationally-determined factors, such as the global risk aversion, and far less by the economic fundamentals of countries.

The IIF estimates that short-term speculative carry trade positions are much reduced (in contrast to bank exposures that remain substantial) and, for this reason, it projects non-bank private debt flows to rebound in 2009. However, the transparency of these positions and firms is quite limited, as most of these transactions do not operate over the exchanges and have no or limited reporting requirements (see, for example, Griffith-Jones and Dodd, 2008).

Foreign direct investment flows have been relatively more stable. However, the most recent UNCTAD Investment Report (UNCTAD, 2008) estimates that FDI to emerging markets declined by 10 per cent in 2008, whilst the OECD estimates a far sharper decline. The decline in real estate and, especially, commodity prices seem to make it more likely that FDI flows into those sectors will fall sharply. This could have particularly strong negative impacts on FDI to Latin America and Africa.

Official capital flows show a very different pattern. Official Development Assistance (ODA) increased since the Monterrey Conference on Financing for Development, from \$57 billion in 2002 to a peak of \$107 billion in 2005 (including debt relief), but slightly declined since then, to an estimated \$104 billion in 2007. A key challenge is for aid flows to augment at the very least according to existing commitments, and there is a strong argument to increase them further. This is especially necessary given that poor developing countries will be hit by a number of external shocks related to the crisis, which will endanger their growth and their ability to meet poverty reduction targets. Nevertheless, if the recession in the developed countries is very serious, there is a risk that aid budgets may not increase enough or could even fall, with negative effects on poor countries and poor peoples.

Other forms of official capital flows stand in open contrast to this trend in ODA. First, some developing countries with active sovereign wealth funds and/or public sector firms have been actively investing abroad. This has led to net negative official flows to developing countries. This is particularly true of the oil-exporting countries of Western Asia. Second, an even larger negative flow is associated with foreign exchange reserve accumulation, which is generally reflected in investments in safe assets from reserve currency countries. And third, in recent years major multilateral development banks have experienced difficulties in finding a demand for their lending, and some countries have actually paid back some of their debts to these institutions. The crisis has generated a large demand for these flows, reflecting the counter-cyclical role that this type of financing should have. However, the magnitudes involved are relatively small, in the order of billions rather than the tens and hundreds billions that characterize net changes in private sector financing. This gap indicates the need for much larger official funds than those currently available.

2.3 TRADE

In recent decades, world trade has shown two important characteristics. First of all, it has tended to expand more rapidly than world production, a process that has been accompanied by a rapid diversification in the trade structure. Thus, during the recent boom, in 2003-2006, world trade grew at an annual rate of 9.3 per cent, more than twice the rate of growth of world output (3.8 per cent). Second, these rates of growth have been highly elastic to world output through the business cycle and have, therefore, been more volatile than world production. A major implication of this characteristic is that, although trade enhances world business cycle upswings, it equally tends to multiply downswings. Trade volumes contracted in 2001 and will again contract in 2009. The growth of trade volume experienced a strong slowdown since mid-2007, to a rate of around 2 per cent by September 2008. This rate turned negative in November and December if we are to judge from reports that indicate that even China, the most dynamic world exporter, experienced negative export growth and even sharper negative import growth in those months.

While this recession in trade volumes will be the main channel of transmission of the crisis to exporters of manufactures and services (tourism being a major service export for many developing countries), price developments will dominate the export performance of exporters of primary goods.

In recent years, the world economy experienced the most impressive commodity boom in more than a century, both in terms of duration (five years), intensity and product coverage (World Bank, 2009, chapter 2). The boom was more pronounced for minerals, including oil and other energy products, than for agricultural goods. This is reflected in the fact that whereas at the peak around the second quarter of 2008 the real prices of minerals exceeded the average of the 1970s by considerable margins (more in the case of energy products but also significantly in the case of metals), real agricultural prices went only briefly back to the level of the 1970s. It was, in other words, a boom of mineral, not agricultural prices (Ocampo and Parra, 2008). A major reflection of this fact is that, whereas the terms of trade of mineral exporting countries improved significantly, those of agricultural exporters remained flat and those of manufacturing exporters deteriorated (United Nations, 2009, Figure II.6).

This difference seems to reflect diverse determinants behind the associated price trends among commodity groups. For mineral exports, the dominant issue has been the underinvestment generated by a long period of low prices over the last two decades of the twentieth century. Given the higher demand propelled by rapid growth in the developing world and specifically, the high demand of China for metals, prices boomed. Investment increased, but there were significant lags in the transformation of new projects into increased supplies. In the case of agriculture, the disproportion between supply and demand was more moderate, though the growing demand for biofuels operated as a major mechanism of transmission of high energy prices into higher agricultural prices, particularly during the second semester of 2007 and the first semester of 2008 - the last phase of the commodity price boom.⁶

Additional factors affecting commodity prices during the latest phase of the boom were dollar exchange rate volatility and financial speculation. These factors resulted in an unprecedented level of price volatility. The turnaround of price trends took place since July for most commodities and since August for energy products and therefore preceded the financial collapse of mid-September. But the worldwide credit freeze that followed led to a free fall for most commodities. Energy products and metals, which had experienced the most impressive price boom, were also hit more severely.

Prospects for commodity prices remain poor. They are already below (and, in some cases, including oil, well below) the most recent projections released by the World Bank, which forecasted a 25per cent reduction in energy prices in 2009 and 23per cent fall in non-energy commodity prices (World Bank, 2009, Table 1.4). The fact that many oil exporting countries and some metal exporters have stabilization funds in place will serve as an important cushion. For agricultural exporters, such a cushion does not generally exist.

Falling energy prices bring a major benefit for a significant number of energy importing developing countries. Indeed, one reason behind the large number of developing countries with growing current account deficits had been the effect of high energy prices. So, falling energy prices will affect energy exporting countries but benefit a relatively large number of energy importing developing countries.

Falling prices will be reflected in reduced investment and economic activity in commodity-dependent developing countries, the number of which is still relatively large, particularly in

Africa, the Middle East, North Africa, and Latin America. Indeed, low commodity prices will be the major mechanism of transmission of the world crises to poor countries. For these countries, a major opportunity ahead is to redesign their trade strategy to reduce their commodity dependence.

3 POLICY RESPONSES

3.1 NATIONAL RESPONSES

Given the fact that there has been a worldwide trend towards external opening in recent decades, the ongoing crisis will have severe effects on developing countries. As indicated, remittances will show some resilience. Financial turmoil will have stronger effects on middle income countries more integrated into world financial markets, whereas low-income countries dependent on official flows will remain less affected by the capital flows channel. Given the magnitude of the collapse of commodity prices, the trade channel will affect all countries, but is likely to affect commodity-dependent economies more, many of which are low income countries. Countries with stabilization funds (generally, energy exporters and some metal exporters) will be able to use past savings to cushion the effect of commodity price downswings.

National responses should aim to mitigate the contractionary effects coming from abroad and to rethink their trade strategies. The room for maneuver to adopt expansionary fiscal and monetary policies will depend on balance of payments constraints. In the case of fiscal policy, it also depends on recent fiscal stances, inherited public sector debts and the existence (or the absence) of well-developed domestic bond markets where the public sector can finance its current imbalances in non-inflationary ways. Given the dependence on balance of payments constraints, the availability of external financing will be critical.

The enclosed table summarizes the evolution of three major external variables during the recent boom – the current account balance, external debt and foreign exchange reserves – in 90 developing and transition economies,⁷ each with a population of over 5 million as of 2007. The table shows the simple averages of ratios of these variables to GDP for each region, as well as the proportion of countries showing improvement in the indicator over the boom.

External Indicators of Developing and Transition Economies with Population Over 5 Million

| | Number of Countries | Current Account Balance | | | | External Debt | | | Foreign Exchange Reserves, excl. gold | | |
|---------------------------------|---------------------|-------------------------|---------------|----------------------|--------------------|---------------|---------------|--------------------|---------------------------------------|---------------|--------------------|
| | | % of GDP 2003 | % of GDP 2007 | % with deficit, 2007 | % with improvement | % of GDP 2003 | % of GDP 2006 | % with improvement | % of GDP 2003 | % of GDP 2007 | % with improvement |
| Africa | 31 | -5.6 | -4.2 | 87% | 45% | 89.7 | 43.0 | 97% | 12.8 | 18.1 | 78% |
| Central and Eastern Europe | 8 | -5.4 | -9.1 | 100% | 38% | 56.4 | 57.3 | 57% | 21.0 | 23.2 | 63% |
| CIS | 8 | -1.0 | 3.1 | 63% | 25% | 56.1 | 44.5 | 88% | 12.9 | 21.3 | 100% |
| Latin America and the Caribbean | 16 | -0.7 | -0.9 | 50% | 38% | 63.7 | 37.6 | 100% | 11.7 | 14.8 | 69% |
| Middle East incl. Egypt | 7 | 7.2 | 6.5 | 43% | 43% | 54.0 | 28.6 | 100% | 41.1 | 50.1 | 40% |
| Asia, incl. NICs | 20 | 2.2 | 3.0 | 30% | 45% | 52.6 | 36.9 | 100% | 27.2 | 32.7 | 69% |
| Total | 90 | | | 63% | 41% | | | 94% | | | 72% |

Source: Own estimates based on IMF, International Financial Statistics.

The dominant pattern over this period was an increasing number of countries with current account (and indeed larger size) deficits. This trend was matched, however, by broad-based and, in many cases, large improvements in debt ratios and, to a lesser extent, by foreign exchange reserve accumulation. Debt improvements were associated both with domestic policies and with the major debt relief initiatives for low-income countries (the Multilateral Debt Relief Initiative and a major debt relief granted individually by the Paris Club). Foreign exchange reserve accumulation underestimates the magnitude of the improvement, as it does not include fiscal funds held abroad by either sovereign wealth or stabilization funds.

In regional terms, the Middle East, Asia and the CIS show the best performance in the three dimensions (less so in the case of debt in the CIS). Africa shows large current account deficits but significant improvements in the two other dimensions. Latin America and the Caribbean stands out for its avoidance of current account deficits and large improvements in debt ratios. Central and Eastern Europe shows the weakest stance: large current account deficits with limited or no improvements in debt and foreign exchange reserves.

Unfortunately, no equivalent picture can be drawn for fiscal indicators. However, for those countries for which data are available, weak fiscal positions are generally infrequent. Again, Central and Eastern Europe and major South Asian countries stand out as having the weakest positions, but there are individual countries with large central government deficits mixed with high levels of public sector debt in other regions as well, such as Colombia and El Salvador in Latin America, and Egypt and Jordan in the Middle East.

The picture, therefore, is one in which developing countries do have larger room for maneuver to adopt counter-cyclical policies than in the past. The major regional exception is Central and Eastern Europe, where the traditional mix prevails of weak external and fiscal indicators that has led to frequent macroeconomic crises. That mix is infrequent elsewhere, though there are two notable cases in South Asia (Pakistan and Sri Lanka). These countries will have to undergo some traditional macroeconomic adjustment. It is essential, however, that in these cases the fiscal adjustment is done in such a way as to avoid the worst of pro-cyclical fiscal adjustments of the past, and is able in particular to maintain good levels of public sector spending in the social sector and in infrastructure. In the past, fiscal reform packages that focus on strengthening government revenues have shown to be preferable to sharp spending reduction packages.

The nature of the policy packages to be adopted depends on the countries' current stance. For those countries with a strong debt and foreign exchange reserve position but relatively weak fiscal stance (India and Colombia are two important examples), the room for maneuver lies more in monetary than with fiscal policy. More generally, most emerging economies have the capacity to avoid the traditional pro-cyclical monetary policies of past crises and follow the expansionary policy trajectories of industrial economies. Most have actually adopted policies to ease domestic financing, to facilitate access of private sector companies to foreign exchange and, to a lesser extent, to reduce domestic interest rates. They should continue to move in that direction. A similar rule of easing monetary policy should be followed by other developing countries.

In the fiscal area, there is significant room to maneuver in a relatively large group of developing countries. They should use this space to mitigate the effects of the external shock. Infrastructure investment and social spending should be the focus of these programs. The strategy will depend on each country's social policy framework. Universal social policies in the areas of nutrition, basic education and health should be the major policy focus, but

targeted programs for the poor, such as conditional cash transfers, make sense in middle-income countries (in poorer countries, by definition, poverty is widespread and universal programs are clearly superior). Special emergency employment programs should be the essential complement, since unemployment insurance, the traditional automatic stabilizer of industrial countries is generally absent in developing countries. Within the available mix of policies, experience indicates that tax reduction policies are unlikely to have the best effects and, rather, strengthening the tax base should be the focus of policy makers.

Although trade opportunities are not generally viable, trade policy can play a role in the recovery in at least three different ways. First, non-traditional exports can be encouraged, particularly in commodity-dependent economies, through a mix of exchange rate depreciation and sectoral incentives. Second, the possibility of strengthening domestic linkages of existing manufacturing export activities can also play a role. Third, more active South-South cooperation can play a role, by encouraging trade through existing integration processes. Payments agreements among central banks can also play a role in facilitating such trade without the need for hard currencies.

Finally, and very importantly, the crisis provides an opportunity to rethink the role of domestic markets, which were largely left out from the radar of policy makers during the reform period. Indeed, a major implication of expansionary macroeconomic policies is that all countries can contribute to the global economic recovery by focusing on their domestic demand. Protection policies would be clearly counter-productive, generating beggar-thy-neighbor effects. But policies that focus on the mass market for consumer goods and on strengthening small- and medium-sized enterprises, which tend to depend heavily on local markets, can play a role in policy packages that place domestic demand again at the center of economic policy.

3.2 GLOBAL RESPONSES

Given all the channels through which financial contagion spreads across the world, the present financial crisis has shown again how dysfunctional the current international financial architecture is. Whereas previous crises have demonstrated the deficiencies of this architecture for managing the financial vulnerability of developing countries, the current crisis has made patently clear the major financial regulatory deficit that characterizes the global system. Unfortunately, although deep flaws were identified during previous crises in developing countries there was little progress on any significant reform of the international financial architecture (Griffith-Jones and Ocampo, 2003). The fact that this time the crisis started in developed countries provides a hope for action though also the risk that action would focus on industrial rather than developing countries. Within the G-20, the call by several countries to engage in a serious reform and the prospects of the Commission of Experts of Reforms of the International Monetary and Financial System convened by the President of the UNGA are most commendable.

3.2.1 Correcting the Regulatory Deficit of Global Finance

The magnitude of the current crisis is clearly associated with inadequate regulation and supervision of banks and financial markets. Since the Asian crisis, it became widely accepted that financial liberalization must be accompanied by stronger prudential regulation and supervision. This lesson was applied in many parts of the developing world but, paradoxically,

was largely ignored in the United States and the United Kingdom, where liberalization was accompanied by deregulation and weak supervision of financial intermediation (Stiglitz, 2008).

The new regulatory governance should be based on a well-functioning network of national and regional authorities and include truly international supervision of financial institutions with a global reach.

First of all, the institutional structure that responds to this challenge should have adequate representation from developing countries. This arrangement will ensure not just greater legitimacy, but also greater efficiency, given the growing role of developing countries in the global economy. Secondly, it should have real power to influence decisions of national regulators, especially in the largest countries, including industrial countries. Thirdly, it should take macro-prudential concerns clearly into account. Finally, it should consider the potential costs of financial instability on the real economy. For this purpose, it could include representation not just from different financial regulatory bodies across sectors and countries, but also from those concerned with growth and equity. For that reason, the United Nations should have a place in the new institutional structure.

The current deep crisis and numerous previous ones that hit developing countries seem to demonstrate that crises are inevitable in deregulated financial systems. There is, therefore, ever-growing consensus that more complete and more effective financial regulation is required. Its main objective must be to help avoid future build-up of systemic risk.

There are two broad principles on which future financial regulation needs to be built (D'Arista and Griffith-Jones, 2008). The first is counter-cyclicality, in order to correct the main market failure of banking and financial markets - their boom-bust nature. The key idea is that provisions and/or capital required should increase as risks are incurred, that is, when loans are disbursed. In this way, provisions and capital requirements should increase during periods of rapid credit growth and decrease when lending expands at slower rates (Ocampo, 2003). This would strengthen banks in boom times and discourage them then from excessive lending. It would also make it easier for them to continue lending in difficult times.

The second key principle for modern, effective regulation should be comprehensiveness. Economic theory tells us that for regulation to be effective, the domain of the regulator has to be the same as the domain of the market to be regulated. There is need for comprehensive and equivalent transparency, as well as regulation of all financial activities, instruments, and actors. Both minimum liquidity and solvency requirements need to be regulated. Indeed, if banks had stronger liquidity, as in the past, their solvency problems could have been smaller in the current crisis.

Developing countries need to make sure that new regulatory standards allow enough flexibility, so they can be adapted to their needs and characteristics. Also developing countries should advocate for regulatory changes in developed countries (e.g., derivatives markets) to ensure their economies will not be harmed by disruptions caused elsewhere.

3.2.2 IMF Reform

Four essential reforms of the IMF should be part of the reform agenda (see South Centre, 2008). The first long-term reform is the creation of a meaningful and truly global reserve currency,

which could be based on the IMF Special Drawing Rights (SDRs). This currency would overcome both the inequities but also the instability that are inherent in a global reserve system based on a national, or a few national currencies (Ocampo, 2007-8). SDRs can also be used to provide counter-cyclical official liquidity to developing countries.

The second issue is the need to place the IMF at the center of global macroeconomic policy coordination. This is the only way to give developing countries a voice on the issue.

The third, particularly urgent issue is the need for the IMF to lend during balance of payments crises rapidly, at sufficient scale, and without overburdening borrowers with the conditionalities of the past, particularly when the sources of the crisis are exogenous, such as a rapid reversal of capital flows and/or a sharp deterioration in the terms of trade. The recent approval (October 2008) of a fairly large and rapidly-disbursing facility by the IMF seems positive. The new Short-Term Liquidity Facility (SLF) is a quick-disbursing financing mechanism for countries with strong economic policies, which are yet facing temporary liquidity issues. To qualify for a loan under the SLF, countries must have sound macroeconomic policies and sustainable debt burdens. Additionally, the last annual country assessment by the IMF must have been positive. The IMF stated that "Given this strong emphasis on past performance, financing is made available without standard phasing, performance criteria, monitoring, and other conditionality of a Fund arrangement." Countries will be allowed to borrow up to 500 per cent of their quota.

The U.S. Federal Reserve simultaneously announced the establishment of temporary swap lines with the Central Banks of Brazil, Mexico, Korea, and Singapore.

The IMF SLF plans to keep the results of countries rejected confidential, as to not increase market instability in rejected countries. However there is a concern that the SLF is "essentially dividing developing countries into an A-list of nations that qualify for loans without strings, and a B-list of everyone else." As Kemal Derviş, UNDP Administrator (*Washington Post*, November 2, 2008) put it: "Emerging markets cannot be easily and simply divided into two categories: those with good and those with bad policies." It would seem far better to enlarge access to SLF to a fairly large number of countries with reasonably good policies (Bhattacharya, Derviş and Ocampo, 2008).

There should also be a major and quick reform and more active use of compensatory financing to reduce the large cost of adjustment for developing countries hit by exogenous shocks linked to their terms of trade. Compensatory financing has become urgent, given the sharp fall in commodity prices, with highly negative effects. The IMF Compensatory Financing Facility has not been used since 2000 due to very tight conditionalities. For low-income countries, the enhancement of the Poverty Reduction and Growth Facility (PRGF) to compensate for the adverse terms of trade shocks, and the Exogenous Shocks Facility (compensatory financing without a PRGF) are clearly insufficient, especially as regards the scale of the lending. An expansion of this facility is urgent, given the severity of the current crisis and the potential damage it could do to low-income countries' growth and poverty reduction, which could set them back for meeting the MDGs. Especially in the light of recent sharp falls in commodity prices, the following broad suggestions for compensatory financing seem especially relevant (see, for more details, Griffith-Jones and Ocampo, 2008):

- i. *Scaling up*: Perhaps the most important point is that the scale of existing facilities and the amount of resources in each facility are too small in proportion to the shocks. This includes resources available for grants and for the subsidies that allow concessional financing of loans. There should be fewer restrictions on the scale of facilities (e.g. higher per cent of resources that can be accessed in relation to IMF quotas).
- ii. *Both loans and grants are valuable*: In the case of low-income countries, grants are more useful for shocks with more permanent effects, such as natural disasters. However, official lending has an important role to play as it is potentially speedier and may provide incentives for changes in the economy to reduce its vulnerability.
- iii. *IMF lending for trade shocks needs far-reaching changes*: There should be significant simplification of IMF facilities as they are too many (e.g. enhanced PRGF, ESF and others) and too complex. Indeed, an option to consider may be to merge all these IMF trade compensatory financing facilities for low-income countries into one low-conditional facility at the IMF.
- iv. *Less conditionality* is clearly needed. For countries with reasonable policies there is no justification for tight credit conditionality especially when imbalances result from external shocks.

3.2.3 Coordination of Global Macroeconomic Policy for Growth and Poverty Reduction

The global recession now under way calls for a coordinated policy response. It means expansionary monetary, credit and fiscal policies in all industrial countries. Many are now adopting such policies. Developing countries should also be part of the solution, and should adopt equally expansionary policies, individually and in a coordinated way. As we have pointed out above, countries that have accumulated large amounts of foreign exchange reserves and have limited external debt ratios do have a larger room for maneuver to adopt these policies, compared with previous crises. For those who do not have this policy space, it is essential to avoid the IMF conditionalities of the past, which forced developing countries to adopt contractionary macroeconomic policies. It is important to make available sufficiently large-scale and rapidly disbursing IMF facilities.

Some large developing countries can actually have a strong influence on world economic activity. Given its size, large reserves and strong fiscal position, China plays a particularly crucial role in this regard. China needs to boost its domestic demand significantly, along the lines announced in late 2008,⁸ and increase financial support to other developing countries, which will benefit both China and the world economy.

A large increase in official development assistance to low income countries can play an important role for both combating poverty and contributing to the generation of aggregate demand at the global level. Additional ODA and highly concessional lending with low conditionality (e.g., from World Bank's IDA) is particularly important to avoid contractionary policies in the poor countries suffering a deterioration of their terms of trade due to the collapse of commodity prices or other external shocks. This will significantly help poor countries to avoid setbacks in their aim to meet MDGs.

Past crises have also shown that multilateral development banks can play an essential role as lenders when private financing dries up. One particularly problematic issue during crises in developing countries is the curtailment of commercial credit available to exporters, limiting an essential mechanism through which countries can recover from crises. So, the launching by multilateral and/or regional development banks of a large program of commercial lending and/or guarantees should be at the center of the crisis response efforts. No conditionalities should be attached. To substitute for the sharp reduction in private flows, these banks should expand lending rapidly. Unfortunately, as pointed out in our diagnosis, the scale of official lending is small relative to the magnitude of contraction of private flows. Scaling up the size of MDBs may, therefore, become essential if the credit freeze persists.

3.2.4 Regional Responses Funded by Developing Countries

In all of the areas of reform, the IMF should collaborate more closely with regional institutions, such as the Chiang Mai Initiative or the Latin American Reserve Fund.

Developing countries are in an excellent position to contribute to this task, given their large foreign exchange reserves and their ability to use those reserves more actively. In mid-2008, developing countries as a whole had a level of reserves approaching \$5 trillion. Additionally, many developing countries have created sovereign wealth funds, which have an additional level of assets of more than \$3 trillion. Swap arrangements among central banks, pooling them in reserve funds or to support the development of regional bond markets, are mechanisms to multiply the room to maneuver that they provide. These reserves and existing sovereign wealth funds could also be used to increase the role of regional development banks owned by developing countries, by investing in the capital of existing institutions and creating new ones.

Multilateral development banks should maintain their central function in the international development architecture and, in particular, in financing human development, infrastructure and clean energy investment. But regional and sub-regional financial institutions owned by developing countries should play an important complementary role, as they give a greater voice and sense of ownership to developing countries. Moreover, regional and sub-regional development banks are particularly suited to provide regional public goods.

If developing countries allocate 1 per cent of their foreign exchange reserves to the paid-in capital of regional and sub-regional institutions, this would amount to \$50 billion at current levels of reserves. Assuming a ratio of loans-to-capital of 2.4 times⁹ the expanded regional and sub-regional development banks could generate additional annual lending of approximately \$120 billion. This additional lending could be very valuable in the current context.

By expanding or creating new regional and sub-regional financial institutions, developing countries could lay the basis for their own current and future lending capacity, which would eventually help them meet their development goals. Given their large foreign-exchange reserves, we believe the time to begin such an initiative is now. A network of regional development banks is already in place, though unevenly developed in different regions of the developing world. The multiplication and growth of these institutions is highly desirable.

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NOTES

1. The Chiang Mai Initiative (CMI) is an initiative under the ASEAN+3 framework. After 1997 Asian Financial Crisis member countries started this initiative to manage regional short-term liquidity problems.
2. The Latin American Reserve Fund, is a multilateral organization formed by the central banks from Bolivia, Colombia, Costa Rica, Ecuador, Peru and Venezuela.
3. The phrase "carry trade" became widely popular in the context of currency speculation. The search for yield implies that the excess liquidity surging out of the low-interest currencies is invested into high-yielding currencies. When the process reverses, investors pull out high-yielding currencies, which they fear would depreciate and retreat back to the "safe haven" of the low-interest-rate currencies (Frankel, 2008).
4. United Nations (2009), Chapter III. For annual figures by region, see in particular Table III.2.
5. See the latest Capital Market Monitor of this organization in <www.iif.com>.
6. See, on the latter, von Braun (2007).
7. Comparable information is available for the 90 countries in the case of the current account, for 80 in the case of external debt and 78 for foreign exchange reserves.
8. In November 2008 China announced a fiscal stimulus package in the amount of 585 billion U.S. dollars to be spent over the next two years to finance programs low-income housing, rural infrastructure, water, electricity, transportation, the environment, and technological innovation among other priority areas. (Note from the editor).
9. This estimate is based on the ratio of the successful and financially sound Andean Development Corporation.

ACRONYMS

| | |
|--------|---|
| CIS | Commonwealth of Independent States |
| ESF | Exogenous Shocks Facility |
| FDI | Foreign Direct Investment |
| IDA | International Development Association, a World Bank lending arm to low-income countries |
| IIF | Institute of International Finance |
| IMF | International Monetary Fund |
| MDBs | Multilateral Development Banks |
| MDGs | Millennium Development Goals |
| NICs | Newly Industrialised Countries |
| ODA | Official Development Assistance |
| OECD | Organisation for Economic Cooperation and Development |
| PRC | People's Republic of China |
| PRGF | Poverty Reduction and Growth Facility |
| SDRs | Special Drawing Rights |
| SLF | Short-Term Liquidity Facility of IMF |
| UNCTAD | United Nations Conference on Trade and Development |
| UNDP | United Nations Development Programme |
| UNGA | United Nations General Assembly |



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