

Introduction¹

Three pieces of information provide interesting insights into current policy issues related to the global financial crisis.

The first is a quote of Joseph Stiglitz's², *Whither Socialism*, published in 1994 (1990 Wicksell lectures), warning of the problems facing American financial institutions:

- Inadequate capital requirements, which resulted in insufficiently capitalized institutions having an incentive to take excessive risk
- Inadequate incentives for banks not to engage in risk taking
- Inadequate monitoring by regulators

Were we prepared for the 2008 global financial crisis? No. **Was the crisis avoidable if the rules had been right? Most likely, yes.**

The second is the crude observation in October 2008 that developed countries responded to the global financial crisis safeguarding their own banking systems to the tune of \$2-4 trillion, as if only national tax payers mattered with no respect for international linkages (and no common EU position on banking or fiscal issues). **Will the future hold improved global and regional economic co-operation?**

The final piece of news reminds us of how slow some developing countries are to react to the greatest global recession since the 1930, thinking that they might be unaffected. President Kgalema Motlanthe of South Africa moved only last week to mitigate the effects of the financial crisis when the government decided to set up a special task team to look at how best to cope with the knock-on effects of job losses. **How will each developing country cope with and respond to the crisis?**

This note addresses these policy issues and suggests that:

- While some evidence is beginning to become available, individual **developing countries need urgent access to updated research** on country-specific economic, social and political consequences of the financial crisis.
- Each developing country needs to set up a **crisis task force** to consider the best possible policy responses.
- Global financial rules need to allow for new rules to **reduce pro-cyclicality** in international capital flows, to **increase transparency**, and to ensure a **greater voice for developing countries**.
- Developed countries should not amplify the financial mess they pass on to developing countries, and **improve their disbursements on aid and development finance** as the case for aid is stronger now than previously.

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Understanding the effects; do policy makers really know enough?

The global financial crisis is bound to have a major impact on developing countries, with the International Monetary Fund having downgraded its growth forecasts for 2009 by nearly two percentage points in recent months for both developed and developing countries. World growth is expected to be only 2.7% in 2009 (compared to 5% in 2007) and world trade is likely to stagnate. The World Bank is forecasting a drop in world trade in 2009.

There will be significant effects on international financial flows, with private financial flows to developing countries expected to fall rapidly from record highs in 2007. Our latest research (Cali, Massa and te Velde, 2008b)³, based on current updates and forecasts as well as on evidence on what happened in previous slowdowns and in the absence of policy responses, suggests that net financial flows to developing countries may fall by as much as \$300 billion over two years, equivalent to a 25% drop. The World Bank will be forecasting a drop of around \$4-500 billion in two years. Some countries, including successful African countries, are more vulnerable than others (see Massa and Te Velde, 2008)⁴.

The impact of the crisis on developing countries will affect different types of international resource flows: private capital flows such as Foreign Direct Investment (FDI), portfolio flows and international lending; official flows such as development finance institutions; and capital and current transfers such as official development assistance and remittances.

The World Association of Investment Promotion Agencies foresees a 15% drop in FDI 2009. FDI to Turkey has already fallen 40% over the last year and FDI to India dropped by 40% in the first six months of 2008. FDI to China was \$6.6 billion in September 2008, 20% down from the monthly average in year 2008 so far, and mining investments in South Africa and Zambia have been put on hold.

The crisis has led to a drop in bond and equity issuances and the sell-off of risky assets in developing countries. The average volume of bond issuances by developing countries was only \$6 billion between July 2007 and March 2008, down from \$ 15 billion over the same period in 2006. Between January and March 2008, equity issuance by developing countries stood at \$5 billion, its lowest level in five years. As a result, World Bank research suggests some 91 International Public Offerings have been withdrawn or postponed in 2008. There is already financial contagion and stock markets have fallen around the world, with the largest losses since the 1930s. This has triggered etrenchment by investors, with reports that they have withdrawn \$45 billion from Korea, \$6.1 billion from South Africa, and \$16 billion from India this year. Turnover on the nascent stock market in Uganda has fallen 60% this year.

In the first eight months of 2008, remittances to Mexico (which depend almost exclusively on migrants to the USA) have decreased by 4.2%, with the strongest declines in August. Remittances to Kenya (which also depend on the US economy) have been hit even harder, with the Central Bank estimating a 38% year-to-year drop in August.

³ See background paper on <http://blogs.odi.org.uk/blogs/main/archive/2008/11/13/5701.aspx>

⁴ I. Massa and D.W. te Velde (2008), The Global Financial Crisis. Will successful African countries be affected?, forthcoming note

Export revenues are falling rapidly for many countries. Zambia has been affected with the price of copper falling by 40% since July 2009. Tourism bookings are down 40% in Cambodia. And visitor arrivals (and revenues) to Kenya fell 30% over the first 9 months of 2008.

Many developing country policy makers have stood aloof suggesting that the global financial crisis might pass developing countries. However, it is now clear that all countries will be affected, with the effects varying by country (see Cali, Massa and te Velde, 2008a)⁵. The year 2008 was the year of the global financial crisis and the beginning of recessions in the UK, US and Germany. Developing countries will see the fall out in 2009 for which they need to be better prepared. President Kgalema Motlanthe moved only yesterday to mitigate the effects of the financial crisis when the government decided to set up a special task team to look at how best to cope with the knock-on effect of job losses in South Africa. All developing countries need to set up a crisis task force to gain a better understanding of the real and financial effects, followed by urgent action. Developing countries can stand aside and absorb the full impact of the crisis (indeed some countries were unprepared for the fuel and food crisis, which involved protests) or, much better, they can be better prepared and engage in necessary action to deal with the fall out of the crisis.

Policy responses; responsibilities for developing and developed countries.

A crisis of this proportion inevitably opens a window of opportunity to revisit all development models. Changes are needed to avoid the same from happening again, and countries need to act urgently. Of course there is also a risk of overreaction, as in any shock, which would be the case if a cyclical variation was mistaken for structural changes (the noise versus signal debate known to forecasters).

Economic policies in developing countries

Short-term management of economic shocks. One danger is that countries which are affected, cannot or do not want to recognise they are affected. Developing countries are now in a better fiscal position to react and smoothen the impact than a decade ago. However, while many have built up external assets, there are concerns for those countries whose current account deficits have recently ballooned due to the food and fuel crisis (the other two F's of the triple F crisis). Moreover there will also be questions marks about the flexibility of the fiscal and monetary institutions in some countries. Yet countries need to be prepared as they will be hit – e.g. Cambodia's growth will decline from more than 10% in 2007 to less than 5% in 2009.

Short-term policy fixes to the financial system. Few poor countries have such leveraged financial systems as in developed countries, and many do not have a short-term foreign debt which needs financing (such as Pakistan, Iceland and Hungary). But some might. Further, trade finance has become a particular challenge as 90% of trade is financed on short-term credit.

Short-term management of social shocks. The social effects are already visible in developing countries. The key export for Zambia is mining and the industry has seen the copper price reduce by 40% in a few months due to slower demand (even China is now entering a period of "low" growth rates not seen for decades, e.g. 7.5% projected growth in 2009). A result has been a lay-off of workers. How would the social consequences be addressed by economic and social policies, e.g. by promoting short term productive activities or investing in tailored social protection?

⁵ Background paper available on <http://blogs.odi.org.uk/blogs/main/archive/2008/10/15/5668.aspx>

Medium to long-term development policies. An obvious response would be to accelerate reforms and introduce policies to attract investment and promote growth. We know a lot about what policies and factors promote growth (see the Growth Commission report), but less so on what are the most binding constraints in a given country setting. Growth diagnostics aim to examine binding constraints and are underway in several countries. Now that international capital flows and the recession bites, binding constraints to growth over the medium term may shift. For instance, it is likely that the binding constraints in Zambia in a situation of high copper prices and mining investment differ from those in a situation of low copper prices, weak investment and falling exports.

The challenges faced by poor countries include:

- While openness to trade makes countries more vulnerable to downturns elsewhere, openness has frequently increased growth and productivity in developing countries. No country has become rich behind protected borders.
- Openness to financial markets increases the risks of financial contagion, yet openness to foreign banks has over the longer term increases productivity and innovation in the financial sector.
- Some groups will be affected heavily by the current crisis, and helping them may prevent protests, but skewing economic policy responses towards these groups may sacrifice country-wide efficiency over the longer-run.
- It is easier to cut spending on infrastructure and long-run capital intensive projects in the light of the current crisis, but these projects are needed for growth and human development in the long-run.

Some policy choices are urgent. There are already protests in Turkey and Iceland. Would this happen in low-income countries in 2009 when the impact will be felt? There are also some serious governance issues at stake. The ANC treasurer Mathews Phosa suggested that the "outlook for black economic empowerment [BEE] deals and black-empowered companies is bad." Some share prices have collapsed, and these companies are in real trouble." (*Financial Times*, 3 December 2008). More generally, the foundations of state-business relations in each country will be shaken and only those that are most institutionalised (in the formal or informal sense) may continue to act in an effective way.⁶

In order to understand the challenges of the current financial crisis and be able to make the right policy decisions in the short and medium term, it is important to set up country specific task forces to deal with the fall out of the crisis. President Kgalema Motlanthe decided to set up a special task team to look at how best to cope with the knock-on effects of job losses in South Africa as a result of the global financial crisis.

Global Financial Rules

Poor developing countries have a direct interest in global financial stability even though they may not be the main actors. The G-20 summit of 15 October 2008 in Washington (which included the main developed and emerging economies) discussed the global financial crisis and produced a list of 3-4 dozen of action points. The next discussions will take place in London in early April 2009. Over the same period, Joseph Stiglitz will chair a UN Commission on this issue and this includes key stakeholders from a more varied country perspective than the G20.

⁶ K. Sen and D.W. te Velde, *State-Business Relations and Economic Growth in sub-Saharan Africa*, *Journal of Development Studies*, forthcoming.

There are discussions about what exactly are ambitious global financial rules, given that many rules are already adopted e.g. by European regulators, and what is in the interest of developing countries?

- There is a discussion about the introduction of accounting rules to **reduce the pro-cyclicality of international capital flows** and bank lending in particular. The debate is between academic thinkers (Charles Goodhart, Avinash Persaud) who favour a complete rewrite of the current Basle II financial rules versus practitioners and regulators suggesting that anti-cyclical elements could be included in the Basle II principles. It is key that **capital adequacy ratios** vary over the cycle and linked to the growth in banking assets and could be even lower than 8% in bad times) and whether rules can be implemented to **regulate the funding of assets** (the crisis has taught us it matters whether mortgages are financed by deposits or short-term money markets).
- It is completely unthinkable to bail out **tax havens** now. Countries safeguarded deposits and banking systems in their own country only. Transparency is back on the agenda (this could cover capital flight etc) which should cover tax havens some of which are close to "home".
- **IFI reform** has been on the table for some time, but not much is ongoing. Will the current crisis allow a greater voice and participation for developing countries?

New global financial rules need to be supported by global action to provide global public goods (EU publication)⁷. Developed countries can smoothen the impact of the crisis and volatility borne by developing countries by engaging in a co-ordinated fiscal response at home as well as abroad⁸. Some countries are still dragging their feet.

The role of aid and development finance

At Gleneagles 2005, the G8 committed to increase aid to USD 130 billion in 2010 (at constant 2004 prices). Currently it is around \$100 billion. Some countries did reduce aid in a downturn; and France, Spain and Italy may now reduce increases in aid or cut aid. However, predicting a cut in aid is *nihilism* and a *self-fulfilling prophecy*. The case for aid is as strong as it was before, *and* even stronger. Moreover, there is no simple relationship between downturns and changes in aid. For example, there was no decline in global aid in the period 2000-2002 in absolute terms. More aid would be needed in countries to manage the downturn.

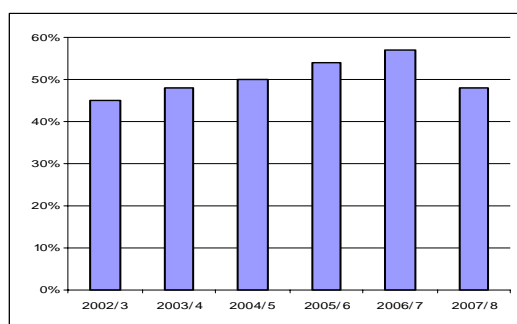
There are also clear implications for development finance and directed credit. The DFI sector (e.g. IFC, EIB, DEG, FMO, CDC, EBRD, AfDB) have had a long experience in using financial instruments (loans, equity positions and guarantees) on the basis of state-backed guarantees or loans. It is important to recognise the contribution of DFIs (worth \$50 bn in 2006/7) as capital may soon become a binding constraint in many countries.

Until recently, DFIs had substantial liquid assets (e.g. cash) in their balance sheets. Capital adequacy ratios have increased dramatically. The IFC reached a level of 57% in 2007 much higher than the 30% recommended (i.e. they could not find enough profitable projects in recent years).

⁷ Morrissey, Oliver, and Dirk Willem te Velde. 2004. "Economic Policy and Global Action." *The Courier ACP-EU* 202. http://www.europa.eu.int/comm/development/body/publications/courier/courier202/pdf/en_28.pdf

⁸ Part of the stimulus abroad would come back to the home country: we estimate that every \$6 of increased (untied) aid would lead to increased exports of \$1

IFC's Capital adequacy ratio (IFC annual reports)



This may now change and DFIs need to ensure that they promote capital flows to developing countries. The IFC has announced a number of schemes (including dealing with trade finance) and the EBRD will be increasing its exposure by 20% to US 7bn. Even though this amounts to only 1-2% of the estimated losses in capital flows it is worthwhile. But at the same time we should not forget that it remains important to safeguard quality as well as quantity over the cycle. Where needed new aid, incentives and regulations would need to ensure that DFI finance is used to overcome market and co-ordination failures (e.g. the current herding behaviour in trade finance, or the mismatch between financial and real rates of return) and promote capital to countries and sectors that are affected by the crisis. Practically, this could include investment targets for countries⁹; incentives for investment officers inside DFIs¹⁰ and the need for new crisis funds that could be linked to DFI operations in a transparent and open way, similar to the global partnership of output based aid¹¹.

Conclusions

While some evidence is beginning to emerge, individual developing countries need urgent access to updated research on country-specific economic, social and political impacts of the financial crisis. This is needed to inform appropriate policy responses which address the current downturn but which will not sacrifice long-term objectives. We suggest that each developing country needs to set up a crisis task force to consider the best possible and urgent policy responses at country level. In addition, developing countries will have an interest in stable global financial rules which allow for new rules to reduce pro-cyclicality in international capital flows, transparency, and a greater voice for developing countries. Developed countries should not worsen the financial mess they pass on to developing countries, and improve their commitments on aid and development finance as the case for aid is stronger now than it was before. They could suggest new investment targets for countries; better incentives for investment officers inside DFIs and the need for new aid funded crisis funds that could be linked to DFI operations in a transparent and open way, similar to the global partnership of output based aid.

⁹ A National Audit Office report of 4 December 2008 discusses CDC's new investment targets

¹⁰ While financial sector bonuses may need to be consistent with sector wide stability, remuneration of investment officers in DFIs could be linked to development impact (and some such as DEG and IFC have begun to introduce development linked remuneration).

¹¹ See D.W. te Velde and M. Warner (2007), "The use of subsidies by Development Finance Institutions" ODI Project Briefing. <http://www.odi.org.uk/resources/odi-publications/project-briefings/2-subsidies-development-finance-institutions-infrastructure-sector.pdf>