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The global financial crisis and developing countries: taking stock, taking action

The global financial crisis, grim as it is, paves the way for major changes

Key points

- The global financial crisis presents a unique opportunity to reshape the world's financial and economic systems, and rethink growth strategies
- A rainbow recovery would combine the best of the blue of conservatism, the red of interventionism and the green of sustainability
- A 'new compact for crisis-resilient growth' to ensure that the recovery is sustainable, avoids volatility and includes the interest of the poorest countries

A year on from the collapse of Lehman Brothers and talk in developed countries has moved from recession to recovery. Recent OECD and International Monetary Fund reports suggest that financial conditions in developed countries have improved: there has been a boost in business confidence, export orders are growing, the US housing market has bottomed out and industrial production in emerging markets has begun to increase. Bolstered by successful implementation of fiscal stimuli and collective action to support financial markets, there is a new belief in the role of the state to correct market failures. But just as the financial crisis engulfed the world, affecting those who played no part in the original causes, it is crucial that any recovery from the crisis has the same global reach.

The crisis itself stems, mainly, from poorly regulated financial markets which allowed risky and complex financial products to develop, skewing financial flows and creating unsustainable global imbalances. The consequence was that world trade volumes plummeted and industrial production fell drastically. The economic crisis affected developing countries through declining private financial flows, trade, and remittances. By the end of 2009, developing countries may have lost incomes of at least $750 billion – more than $50 billion in sub-Saharan Africa. The human consequences include rising unemployment, poverty and hunger, and an additional 50 million people trapped in absolute poverty, with the number expected to rise to 90 million by December 2010 (DFID, 2009).

Politicians, under pressure from angry voters, may be veering towards protectionism and migration controls. Such responses undermine the prospects for sustainable recovery, increasing the risks of a double dip. But the crisis itself may have created a rare opportunity to reshape the financial

Left behind – the poor face even greater challenges as a result of the financial crisis.

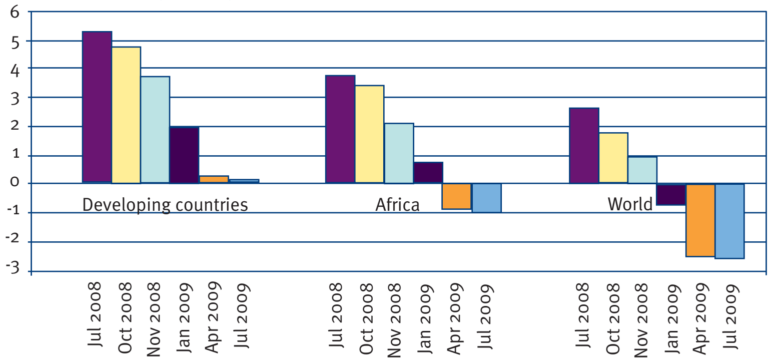
and macro-economic systems that have failed poor countries, and to rethink growth strategies so that they are more resilient to future crises.

ODI led case studies in ten developing countries in early 2009 – Bangladesh, Benin, Bolivia, Cambodia, Ghana, Indonesia, Kenya, Nigeria, Uganda and Zambia – working with local researchers to see how the financial crisis is being felt on the ground; we are now extending this work to Sudan, Ethiopia, Democratic Republic of Congo, Mozambique and Tanzania. The research suggests that poor countries have been hit harder than was originally predicted, and 2009 is likely to be worse than 2008 (te Velde et al., 2009a).

The economic impact

Some countries are seeing strong economic growth transformed into negative growth in 2009 (Figure 1), others see significant slowdowns of 3-7 percentage points, though some have hardly been affected. The ODI research found a slowdown throughout 2008, with sure signs that 2009 will be worse, in general, for low-income countries. Growth forecasts have been revised downward in all ten countries, in stark contrast to the excellent economic

Figure 1: GDP per capita forecasts for 2009



Source: IMF forecasts and author's own calculations.

growth in developing countries overall in recent years. Growth in Cambodia, for example, is set to slide from more than 10% in 2007 to close to zero in 2009. Kenya may achieve only 3-4% growth in 2009, down from 7% in 2007. Key sectors are suffering: tourism in Kenya and Cambodia; manufacturing in Asian countries in general; and commodities in Bolivia, DRC, Sudan and Zambia.

Trade values declined rapidly, in part due to rapid rises in stock building, but also because trade prices fell sharply. The value of garment exports from Cambodia has been slashed, from $250 million per month in 2008 to $100 million in January 2009, although Bangladeshi garment exports did not suffer the same fate. Coffee exports, which have a strong correlation with poverty in Uganda, fell by a third in the year to March 2009, though fortunately an increase in Uganda's regional trade of maize and beans cushioned the impact somewhat.

Prices of commodities, including copper and oil, fell, affecting countries such as Nigeria, Zambia and Bolivia, but have rebounded in recent months, adding to an already volatile situation. Declining oil exports have lowered government revenues threatening fiscal transfers to Southern Sudan. Mining exports collapsed in DRC where reserves had reportedly dwindled to only a few days worth of exports until the IMF intervened.

ODI research suggested that net financial flows to all developing countries could fall by as much as $300 billion over 2007-2009, equivalent to a 25% drop (Calí et al., 2008).

Portfolio investment fell in most of the countries studied in 2008, with many seeing large net outflows, and no recent signs of reversals. Stock markets plunged, with tighter credit conditions for bank lending in Cambodia, Ghana and Zambia. Bond issuances were put on hold in Ghana, Kenya and Uganda.

Foreign Direct Investment (FDI) is one of the most stable external resources for developing countries, reaching a record $500 billion in 2007. Even so, the impact on FDI varies across countries, and worsened in 2008. FDI in garments halved in Cambodia in 2008, raising fears that investors, mainly Chinese, will not return when the recovery kicks in. FDI plans in mining exploration in Tanzania were halted with potential long-term consequences.

Around 80% of remittances to developing countries come from high-income countries, making this often vital source of household income vulnerable to economic crises. Such remittances reached a record $251 billion in 2007, but have fallen in many of the countries studied. Remittances to Kenya, largely from the US, fell by 12% in the first six months of 2009 compared to the same period in 2008. Overall, remittances to developing countries are set to fall by between $25 and $66 billion in 2009 (see Table 1) (Calí and Dell'Erba, 2009).

Additional research by ODI suggests that small and economically open states are particularly vulnerable to the crisis. They are experiencing falling remittances and FDI, especially in sectors that fuelled their earlier economic growth: tourism, financial services and real estate (te Velde et al., 2009b). In St Lucia, where many people depend on tourism, hotels were 80% empty during the peak tourist period in late 2008 and early 2009. Remittances to Tonga fell by 15% between June 2008 and June 2009 (Matanga Tonga Online, 2009); Jamaica experienced a drop of 14% in the first two months of 2009 (Jamaica Observer, 2009).

There was no evidence of an aid pull out at least

Table 1: Prospects for remittances to developing countries

	World Bank forecasts, March 2009					ODI forecasts, March 2009			
		Base case		Low case		Base case		Low case	
	2008e*	2009f	2010f	2009f	2010f	2009f	2010f	2009f	2010f
US$ billion									
Developing countries	305e	290	299	280	280	272[A]; 282[B]	312	239[A]; 270[B]	315
SSA	20	19	20	18	18	19	21	18	21
Growth rate (%)									
Developing countires	8.8	-5	2.9	-8.2	0.2	-8[A]; 8[B]	5	-12[A]; -22[B]	8
SSA	6.3	-4.4	3.5	-7.9	0.0	-6	7	-9	10

Notes: * World Bank data based on March 2009 data on remittances. ODI estimates based on February 2009 data on remittances; A: estimates based on outflows' predictions; B: estimates based on inflows' predictions; e: estimated; f: forecast.

until now. Countries such as DRC and Zambia benefited from timely support by the IMF.

The human impact

Calculations suggest that more households will fall into poverty than would otherwise have been the case – as many as 300,000 in Bangladesh; 233,000 in Uganda; and 230,000 in Ghana (1% of the entire population) (te Velde et al., 2009a). The number of those employed as a result of FDI in Ghana, for example, dropped by around one third between the last quarter of 2007 and the last quarter of 2008. In Kenya, the labour-intensive horticultural industry has suffered a 35% drop in exports of flowers, with inevitable knock-on effects on its workers, and in Zambia, nearly one in four of the workers in the mining sector lost their jobs in 2008 (ibid.). In Cambodia, more than 63,000 garments jobs were lost by March 2009 (a fifth of the total). Further increases in unemployment are anticipated. Research confirms that it is the poorest – who had least responsibility for the global financial crisis – who are paying the highest price. However, the poorest could be part of the solution.

Possible policy responses

The crisis, grim though it is, could be an opportunity to re-shape the global economic institutions and rethink growth strategies. A 'new compact on crisis-resilient growth' between rich and poor countries is needed to ensure that the system works for both, that global growth is more resilient to crises and that it does not fail the poorest. The G-20 leaders and poor country governments have a joint responsibility to ensure that the recovery is sustainable, that volatility is dampened and that poor countries have a growing role in the recovery as it comes.

Ensuring a sustained rainbow recovery for all:

- Good policy is based on good information. As suggested by ODI (2009), we need a Global Poverty Alert System to monitor the economic and social impact of the crisis. A United Nations that works 'above' the smaller groupings of the G-20 and G-8 is ideally placed to pioneer the systematic monitoring of the crisis, and to host the global debate on the response. The Commonwealth Secretariat could take a lead in monitoring the particular challenges facing small states.
- A global recovery assumes current fiscal stimuli are not withdrawn. Poor countries hit by fewer trade revenues will see their deficits increase, and some may have scope for additional stimuli. Indeed, a sizeable share of the (inadequate) $50 billion in additional lending pledged at the G-20 in London in April, plus new grant aid, should be channelled to a 'rainbow' stimulus in poorer counries, bringing together the best of the blue of conservatism and market forces to increase growth; the red of state interventionism directed at liquidity constrained consumers and the increasing unemployed; and the green of environmental sustainability ahead of the Copenhagen summit later this year. This would help to address the medium-term impact, and foster a rainbow recovery. The poor and poor countries are most liquidity constrained, so additional funding to these groups may have the largest marginal effect and can therefore be part of the solution to the crisis.
- Developing countries need national crisis task-forces (ODI, 2009) and their own 'rainbow' policies to grow themselves out of the crisis. Too many poor countries have been in a state of denial about the crisis – a year on, this is no longer acceptable. Our current monitoring suggests that countries that are not competitive or have not responded are not well positioned to gain from any global recovery. Thus, much of the responsibility lies within developing countries themselves.
- A new kind of trade package is needed which should concentrate on preventing 'beggar-thy-neighbour' protectionism in labour, trade and financial markets, which has hardened recently as evidenced by new restrictions on temporary workers and new import duties. Funding for Aid for Trade should be brought forward, especially for infrastructure, to bring long-term prosperity to African countries and their suppliers (Barrel et al., 2009).

Reducing global volatility by solving market and co-ordination failures:

- Better financial regulation and new financial rules are needed in developed countries to increase the transparency of capital flows, curb illegal transfers, and reduce the pro-cyclicality of financial flows to developing countries, for example, by adjusting capital adequacy ratios over the business cycle, or promoting capital flows to developing countries using innovative financing mechanisms. The vexed question of bonuses could be resolved by rewarding efforts to pursue sustainable global growth and responsible investment abroad, drawing on lessons from the use of incentives in development finance. Bonuses should reward economic not just financial rates of return.
- Global imbalances need to be curbed. Many rich and emerging countries – including oil exporters – have surplus capital. Rather than investing such surpluses in risky financial products in other rich countries, better returns could be gained from greater investment in low-income countries, benefiting investors and helping to kick-start a global recovery. The International Financial Institutions could, for example, leverage sovereign wealth and other funds as a useful second-best policy to address the crisis along side appropriate financial regulation.

A global compact for crisis-resilient growth could help developing countries cushion the impact of crises:

- The international community needs to provide the global public goods to foster growth that is more resilient to crises. This means effective reform of the global governance systems with a new voice for emerging and developing countries. The UN needs to establish its role in leading global debate on issues of worldwide concern. The crisis has undermined the reputation of pre-crisis development models, as well as any belief that the West knows best (Evans and te Velde, 2009). In global terms, the UN is the 'last man standing', but it must be stronger in coordinating debate and action on country-development models.

- The IMF needs sufficient resources for low-income countries – beyond the $50 billion pledged at the London summit which pales in comparison to the total of $1.1 trillion of increased liquidity destined mainly for middle-income countries. It had sufficient resources to triple lending to low-income countries this year, but what about the next crisis when countries are still repaying the debts of this one? Additional and flexible grants funding is also needed through the IMF and World Bank (e.g. through an enhanced IDA crisis facility) and other institutions. ODI (2009) calculated the effects for a $50 billion grant increase and showed that increased support for poor countries makes us all better off. The IMF's technical assistance is valuable, but its forecasts need refinement at the country level.
- The World Bank needs new approaches to risk and crisis, based on better analysis and partnerships, allowing it to be faster, stronger and more flexible. And it needs to work more closely with regional development banks, and more effectively with the private sector, to support climate change initiatives, entrepreneurship and job creation in the poorest countries (Evans, 2009). An IDA crisis facility could replace the myriad of approaches so far and reduce specific conditions and buttress growth when the next crisis hits.
- A new deal on climate financing in Copenhagen can 1) help to promote growth in developing countries which is more resilient to climate change, and 2) ensure that developing countries gain from, and are not compromised by, a drive to a low-carbon world. Aid is normally provided for development objectives, so climate finance should be additional to ensure the provision of environmental global public goods. Development finance institutions could leverage non-aid sources. The private sector will have an interest in promoting energy efficiency as well. Climate finance provides insurance against climate risks.
- Developing countries could be encouraged to diversify their economic base, spreading their reliance on more than a few export sources. For example, it makes sense for small and landlocked countries to stimulate knowledge-intensive sectors, which have fared better during the current crisis, away from reliance on manufacturing and concentrated commodity exports which face stiffer competition, extreme volatility and large transport cost challenges.

Taken together, these measures would provide a new global compact for crisis-resilient growth, providing a better response to today's global economic meltdown and putting developing countries in a stronger position to address unknown challenges in the future.

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