Overseas Development Institute

Background Note
October 2008

The global financial crisis and developing countries

Which countries are at risk and what can be done?

By Dirk Willem te Velde

The global financial crisis is already causing a considerable slowdown in most developed countries. Governments around the word are trying to contain the crisis, but many suggest the worst is not yet over. Stock markets are down more than 40% from their recent highs. Investment banks have collapsed, rescue packages are drawn up involving more than a trillion US dollars, and interest rates have been cut around the world in what looks like a coordinated response. Leading indicators of global economic activity, such as shipping rates, are declining at alarming rates.

What does the turmoil mean for developing countries? Many developing country economies are still growing strongly, but forecasts have been downgraded substantially in the space of a few months. And for how much longer can growth persist? What are the channels through which the crisis could spread to developing countries and how are the effects being felt in developing countries? Which developing countries will be able to withstand the international macro economic challenges created by the downturn in developed economies, and which are most at risk? What is the role for development policy and what do developing country policy-makers need to know?

This note discusses recent growth performance in developed and developing countries, the channels through which the global crisis affects developing countries, which countries might be most at risk, and possible policy responses.

Growth in developed and developing countries; decoupling or delayed coupling?

With a recession already underway in the UK, Germany, France, the USA and other developed countries, it is quite startling to hear the Malawian finance minister argue that Malawi's economy is projected to grow by more than 8% this year. Yet this is today's stark reality. The USA is going through the greatest financial crisis since the 1930s, but, as the *Financial Times* has reported, Lagos is not Lehman. Nigeria, held back by decades of economic mismanagement, is growing at nearly 9%. Leaders in China suggest that they can help the world by offering growth rates of up to 10%, and many African countries still gain significantly from this (they are growing at 6-7%).

Growth performances vary substantially among developed and developing countries. African growth exceeds OECD growth by margins not seen for 25 years; East Asia's growth is diverging as much as it did during the last significant global economic downturn in the early 1990s (see Figure 1).

The relationship between OECD GDP and Africa's GDP has weakened as a result of the emergence of countries such as China, as well as structural changes in African economies. According to the IMF World Economic Outlook report in April 2008, a decline in world growth of one percentage point would lead to a 0.5 percentage point drop in Africa's GDP, so the effects of global turmoil on Africa (via trade, FDI, aid) would be quite high. The correlation between African GDP and World GDP since 1980 is 0.5, but between 2000 and 2007, it was only 0.2. As there have been significant structural changes (and a move into services that were able to withstand competition much better) as well as the rise of China, African growth has temporarily decoupled from OECD GDP.

The Overseas Development Institute is the UK's leading independent think tank on international development and humanitarian issues. **ODI Background Notes** provide a summary or snapshot of an issue or of an area of ODI work in progress. This and other ODI Background Notes are available from www.odi.org.uk

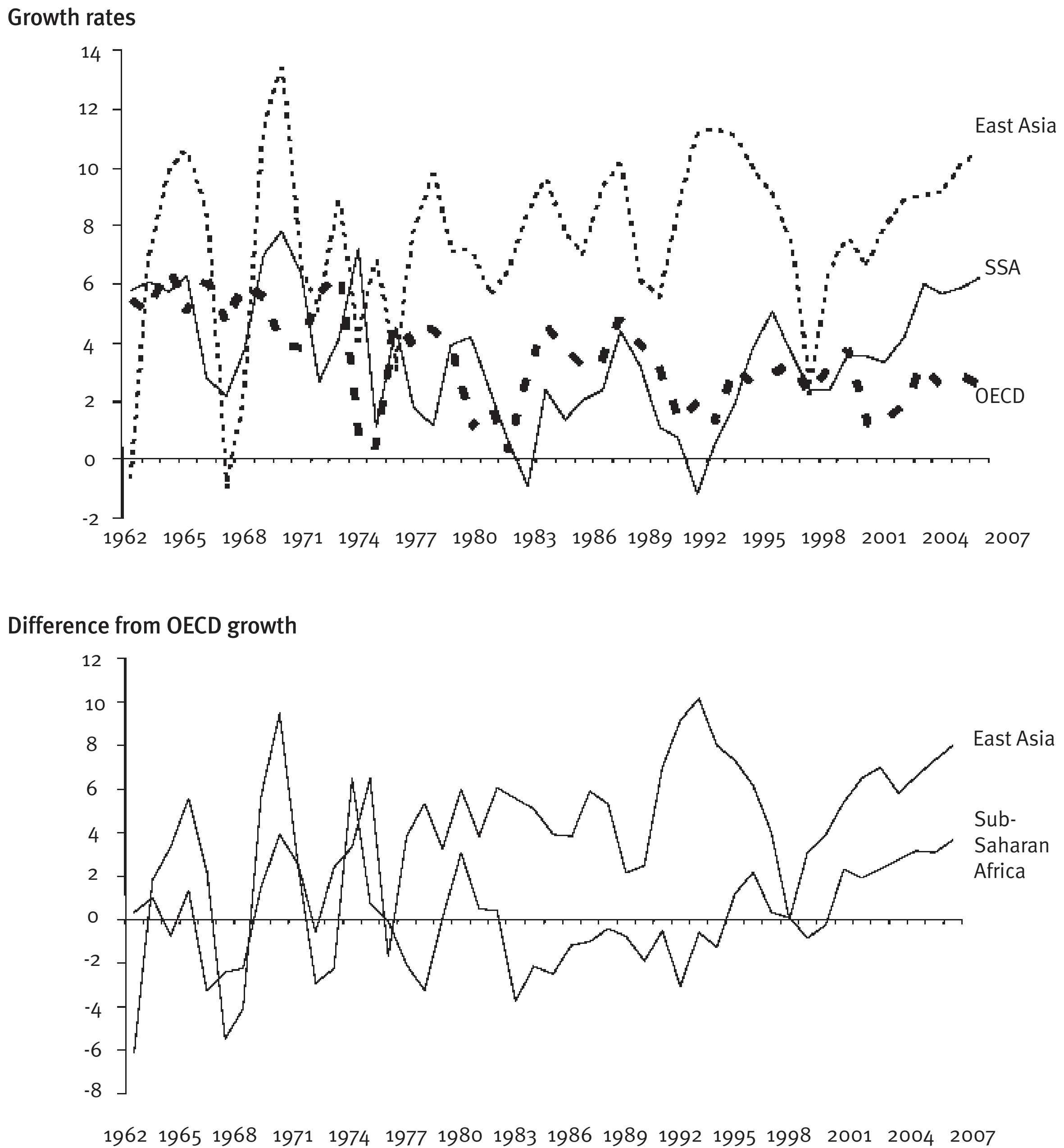

Figure 1: Growth rates have been diverging, but for how long?

Source: World Development Indicators.

Several Asian countries have built up healthy government reserves, and solid export performance has helped their strong current account position. Latin American countries are currently in a much better fiscal and external position compared to the 1990s, the decade in which several financial crises struck.

However, there are also several worrying signs. The combination of high food prices and high oil prices has meant that, while the current account of oil and food importers was in balance by 2003, it was in deficit by 4% in 2007. Inflation has also doubled. Many developing and especially small and African countries are, therefore, in a bad position to face yet another crisis. The terms of trade shock tend to be highest in small importing countries such as Fiji, Dominica, Swaziland. However, African countries such as Kenya, Malawi, Tanzania are projected to have faced terms of trade shocks of greater than 5% of GDP (World Bank paper for the October 2008 Commonwealth Finance Ministers meeting).

Table 1: World Economic Outlook projections

			Projections		Difference from July 2008 WEO projections	
World	2006	2007	2008	2009	2008	2009
USA	5.1	5.0	3.9	3.9	-0.2	-0.9
Euro area	2.8	2.0	1.6	0.1	0.3	-0.7
UK	2.8	2.6	1.3	0.2	-0.4	-0.1
Brazil	2.8	3.0	1.0	-0.1	-0.8	-1.8
Russia	3.8	5.4	5.2	3.5	0.3	-0.5
China	7.4	8.1	7.0	5.5	-0.7	-1.8
India	11.6	11.9	9.7	9.3	-	-0.5
Sub-Saharan Africa	9.8	9.3	7.9	6.9	-0.1	-1.1
Middle East	6.6	6.9	6.1	6.3	-0.5	-0.5
ASEAN-5	5.7	5.9	6.4	5.9	0.2	-0.1
World trade volume*	5.7	6.3	5.5	4.9	-0.1	-1.0
APF/MRDE	9.3	7.2	4.9	4.1	-1.2	-1.9

Source: IMF.

And there are also signs of a slowdown in Asia, the engine of recent world growth. In the space of a couple of months, the Asian Development Bank has revised its forecast for Asian countries downwards by 1-2 percentage points. The IMF growth forecasts have been revised significantly, especially for the UK (-1.8 percentage points down from the last forecast for 2009), but also India (-1.1 percentage points down to 6.9% real GDP growth), and China and Africa (both down by -0.5 percentage points to 9.3% and 6.3% respectively).

The magnitude of the crisis will depend on the response of the USA and EU. Trillion dollar rescue packages are launched around the world, but while the markets may eventually respond, the UK is already in a recession. Its magnitude will depend, in part, on how accommodative monetary policy can be, with the recent interest rate cut a sure sign the authorities are concerned more about the financial crisis than recent inflationary pressures. There is less scope for expansionary fiscal policy – in fact these rescue measures have increased public debt.

Impact of the current financial crisis on developing countries

The current financial crisis affects developing countries in two possible ways.

First, there could be **financial contagion** and spillovers for stock markets in emerging markets. The Russian stock market had to stop trading twice; the India stock market dropped by 8% in one day at the same time as stock markets in the USA and Brazil plunged. Stock markets across the world – developed and developing – have all dropped substantially since May 2008. We have seen share prices tumble between 12 and 19% in the USA, UK and Japan in just one week, while the MSCI emerging market index fell 23%. This includes stock markets in Brazil, South Africa, India and China. We need to better understand the nature of the financial linkages, how they occur (as they do appear to occur) and whether anything can be done to minimise contagion.

Second, the economic downturn in developed countries may also have significant impact on developing countries. The channels of impact on developing countries include:

- **Trade and trade prices.** Growth in China and India has increased imports and pushed up the demand for copper, oil and other natural resources, which has led to greater exports and higher prices, including from African countries. Eventually, growth in China and India is likely to slow down, which will have knock on effects on other poorer countries.
- **Remittances.** Remittances to developing countries will decline. There will be fewer economic migrants coming to developed countries when they are in a recession, so fewer remittances and also probably lower volumes of remittances per migrant.
- **Foreign direct investment (FDI) and equity investment.** These will come under pressure. While 2007 was a record year for FDI to developing

countries, equity finance is under pressure and corporate and project finance is already weakening. The proposed Xstrata takeover of a South African mining conglomerate was put on hold as the financing was harder due to the credit crunch. There are several other examples e.g. in India.

- **Commercial lending.** Banks under pressure in developed countries may not be able to lend as much as they have done in the past. Investors are, increasingly, factoring in the risk of some emerging market countries defaulting on their debt, following the financial collapse of Iceland. This would limit investment in such countries as Argentina, Iceland, Pakistan and Ukraine.
- **Aid.** Aid budgets are under pressure because of debt problems and weak fiscal positions, e.g. in the UK and other European countries and in the USA. While the promises of increased aid at the Gleneagles summit in 2005 were already off track just three years later, aid budgets are now likely to be under increased pressure.
- **Other official flows.** Capital adequacy ratios of development finance institutions will be under pressure. However these have been relatively high recently, so there is scope for taking on more risks.

Each of these channels needs to be monitored, as changes in these variables have direct consequences for growth and development (see e.g. Te Velde, 2008, on pro-poor globalisation). Those countries that have done well by participating in the global economy may also lose out most, depending on policy responses, and this is not the time to reject globalisation but to better understand how to regulate and manage the globalisation processes for the benefit of developing countries. The impact on developing countries will vary. It will depend on the response in developed countries to the financial crisis and the slowdown, and the economic characteristics and policy responses, in developing countries.

Which countries are at risk and how?

The list of channels above suggest that the following types of countries are most likely to be at risk (this is a selection of indicators):

- Countries with significant **exports to crisis affected countries** such as the USA and EU countries (either directly or indirectly). Mexico is a good example;
- Countries exporting products whose **prices are affected or products with high income elasticities.** Zambia would eventually be hit by lower copper prices, and the tourism sector in Caribbean and African countries will be hit;
- Countries **dependent on remittances.** With fewer bonuses, Indian workers in the city of London, for example, will have less to remit. There will be fewer migrants coming into the UK and other developed countries, where attitudes might harden and job opportunities become more scarce;
- Countries heavily **dependent on FDI, portfolio and DFI finance** to address their current account problems (e.g. South Africa cannot afford to reduce its interest rate, and it has already missed some important FDI deals);
- Countries with sophisticated stock markets and banking sectors **with weakly regulated markets for securities**;
- Countries with a **high current account deficit** with pressures on exchange rates and inflation rates. South Africa cannot afford to reduce interest rates as it needs to attract investment to address its current account deficit. India has seen a devaluation as well as high inflation. Import values in other countries have already weakened the current account;
- Countries with **high government deficits.** For example, India has a weak fiscal position which means that they cannot put schemes in place;
- Countries **dependent on aid**.

While the effects will vary from country to country, the economic impacts could include:

- Weaker export revenues;
- Further pressures on current accounts and balance of payment;
- Lower investment and growth rates;
- Lost employment.

There could also be social effects:

- Lower growth translating into higher poverty;
- More crime, weaker health systems and even more difficulties meeting the Millennium Development Goals.

Possible policy responses

The current macro economic and social challenges posed by the global financial crisis require a much better understanding of appropriate policy responses:

- There needs to be a better understanding of what can provide financial stability, how cross-border cooperation can help to provide the **public good** of international financial rules and systems, and what the most appropriate rules are with respect to development;
- There needs to be an understanding of whether and how developing countries can **minimise financial contagion**;
- Developing countries will also need to manage the implications of the current economic slowdown – after a period of strong and continued growth in

developing countries, which has promoted interest in structural factors of growth, **international macro economic management** will now move up the policy agenda. Do countries have room to use fiscal and monetary polices?

- Developing countries need to understand the social outcomes and provide appropriate **social protection schemes;**
- There will also be implications for **development policy:**
  - There will be limits to financial solutions if the problems lie in the real economy, but **development finance institutions** may be able to take some risks and support investment flows to developing countries, counteracting reductions in other financial flows. Whether DFIs can take higher risks might be informed by past experience, for example by looking at what happened during the Asian financial crisis of the late 1990s. During this period DFI portfolios were riskier, loan losses higher and returns lower than they are at present. And yet this poorer financial performance has not had an adverse affect on institutional credit ratings. The EBRD argued in 2007 that is able to withstand the impact of a major shock with an impact equivalent to 3.5 times the magnitude of the financial crisis in 1998, without a need to call capital;
  - **Aid volumes** will come under pressure,[1] but there may also be implications for the composition of aid. Should aid be provided to countries with high risks, and how should this be channelled? Are existing IMF and World Bank schemes sufficient for this, as they already need to address balance of payment problems in countries due to high food and oil prices?

For further information, contact Dirk Willem te Velde, ODI Research Fellow (dw.tevelde@odi.org.uk).

Endnotes

1 There are several reasons why developed countries provide aid during a downturn to promote development in developing countries. This includes the need to reduce poverty in developing countries (the traditional case for doing development), the desire to promote global public goods (see ODI Opinion 5 by Dirk Willem te Velde on aid financing of global public goods) and self-interest to promote the interests of the UK (see ODI Opinion 104 by Simon Maxwell on a poll indicating the interest of UK nationals in providing aid).

Overseas Devlopment Institute, 111 Westminster Bridge Road, London SE1 7JD, Tel: +44 (0)20 7922 0300, Fax: +44 (0)20 7 922 0399, Email: publications@odi.org.uk.
Readers are encouraged to quote or reproduce material from ODI Background Notes for their own publications, but as copyright holder, ODI requests due acknowledgement and a copy of the publication. This and other ODI Background Notes are available from www.odi.org.uk.
© Overseas Development Institute 2008.
ISSN 1756-7610.