



## **GLOBAL FINANCIAL CRISIS AND IMPLICATIONS FOR DEVELOPING COUNTRIES**

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# GLOBAL FINANCIAL CRISIS AND THE CHALLENGES FOR DEVELOPING COUNTRIES

## *Introduction*

**The current financial crisis has evolved differently from other major crises that have hit the developing world in recent decades.** Not only is it occurring in a world of unprecedented financial globalization, where the financial sector plays a historically large role in economic activity, but it is also an “imported” crisis, with origins outside the developing world. The crisis also comes on the heels of a major global shock from high food and fuel prices that has imposed a heavy economic burden on many countries and significantly increased the incidence of poverty and vulnerability.

**The uniqueness of the current configuration of economic challenges has important implications for the nature and effectiveness of the policy options available to developing country governments.** It implies that the policy responses of individual developing countries are unlikely to measurably affect the depth and length of the global crisis. However, their actions can affect the impact of the crisis on their own economies. Policymakers need to be ready to react forcibly and quickly at the first signs of domestic weakness, including the rapid involvement of external assistance as necessary. More generally, countries need to maintain sound macroeconomic and financial-sector policies, while focusing on mitigating the potential negative impacts of the crisis on those living at the margin. The unprecedented scope of the crisis calls for innovative solutions to complement those more traditional policies that have a sound record of success under similar circumstances.

**Many developing countries are moving into a new danger zone, with heightened risk to exports, investment, credit, banking systems, budgets, the balance of payments, and the most vulnerable.** With this latest financial crisis, growth is slowing and is likely to weaken even more sharply. Developing country exports to developed countries are falling, capital is being withdrawn from emerging markets and short-term credit is drying up. This could trigger a fall in production and investment by the productive sector. Sharply tighter credit conditions and weaker growth are likely to cut into government revenues and governments’ ability to invest to meet education, health and gender goals. Countries dependent on exports, remittances or foreign investment, exhibiting high current account deficits or rising inflation, and those with extensive fuel/food subsidies are most vulnerable to a sharp slowdown—especially if accompanied by a significant tightening of financial market conditions. Coming on the heels of the food and fuel price shock, the global financial crisis could significantly set back the fight against poverty.<sup>1</sup>

## *Economic Context<sup>2</sup>*

**The global financial crisis that emerged in September 2008, following more than a year of financial turmoil, will have serious implications around the globe.** Developing countries were at first sheltered from the worst elements of the turmoil, but this is no longer the case, as the cyclical downturn that was already under way in September has intensified. Financial conditions have become much tighter, capital flows to developing countries have dried up, and huge amounts of

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<sup>1</sup> The World Bank estimates that a one percentage point reduction in growth could trap 20 million more people into poverty.

<sup>2</sup> The discussion of the global outlook draws on the forthcoming *Global Economic Prospects: Commodities at the Crossroads* which will be released by the World Bank on December 9, 2008.

capital have been withdrawn, leading to sharp falls in equity valuations and increases in bond spreads. As of mid-October, developing country equity markets had given up almost all of their gains since the beginning of 2008 and initial public offerings had disappeared. Spreads on sovereign bonds and commercial debt (which until recently had been the most important source of developing-country finance) have risen sharply. Bank lending is also down and foreign direct investment inflows are expected to decline in the final quarter of the year.

**Virtually no country, developing or industrial, has escaped the impact of the widening crisis,** although those countries with stronger fundamentals and less integration into the global economy going into the crisis have generally been less affected. The deterioration in financing conditions has been most severe for countries with large current account deficits, and for those that showed signs of overheating and unsustainably rapid credit growth prior to the intensification of the financial crisis. Of the 20 developing countries whose economies have reacted most sharply to the deterioration in conditions (as measured by exchange rate depreciation, increase in spreads, equity market declines and large current account deficits), seven come from Europe and Central Asia, and eight from Latin America. And as a knock-on effect, with the crisis taking its toll on even the most well off countries, there is a serious risk that some donors might consider stepping back from aid commitments when they are most needed.

**Consensus growth projections for developed countries in 2009 are being slashed and world trade volumes may fall for the first time since the 1982 recession.** The consequent downturn in developing country exports will be the most widespread shock generated by the crisis and private capital flows to developing countries are likely to fall significantly in 2009, led by pull-backs in portfolio flows and international bank lending. On the positive side, improvements in macroeconomic policies in developing countries over the past decade (e.g., more sustainable fiscal policies, build-up of large foreign exchange reserves) especially in large countries, suggest that unsustainable levels of sovereign debt are likely to be less of an issue in the initial stages than in previous crises. But if fiscal positions deteriorate under the impact of the crisis, sovereign debt burdens may increase rapidly, and access to international capital markets may become more of a constraint.

**Earlier concerns about rapid credit growth in some developing countries have been proven valid.** Large portfolio and foreign bank lending flows have contributed to rapid growth in credit to the private sector and large private-sector driven current account deficits in a number of countries. The sudden deceleration of inflows will force a sharp adjustment in private-sector activity. There is a high probability of balance sheet deterioration and possible banking crises where banks and non-bank financial institutions have expanded credit to the private sector most rapidly. There may be an especially direct channel in economies where there has been substantial borrowing from foreign banks, either through branches in the domestic market or through borrowing by local banks. Central and Eastern European economies, which have experienced especially rapid credit increases, with foreign banks playing a dominant role in the domestic market, could be most at risk.

**Investment is expected to suffer as it bears much of the direct impact of the financial crisis.** Investment was the main driving force for developing-country growth over the past 5 years, contributing almost half of the increase in domestic demand. For 2008, investment is expected to increase only moderately in middle-income countries, compared with 13 percent growth in 2007. There is a risk that investment in developing countries may be headed for a “perfect storm,” with a convergence of slowing world growth, withdrawal of equity and term lending from the private

sector, and higher interest rates, with a further risk that lower commodity prices in the medium term will deter new investment in natural resource sectors.

**Should the freeze in credit markets not thaw quickly enough, then the consequences for developing countries could be severe.** Financing conditions would deteriorate rapidly, and otherwise sound domestic financial sectors could find themselves unable to borrow or unwilling to lend both internationally and domestically, and domestic productive sectors would be deprived of working and long-term capital. Such a scenario would be characterized by a long and profound recession in high-income countries and substantial disruption and turmoil, including bank failures and currency crises in a wide range of developing countries. Corporates with high leverage or reliance on trade finance, swaps and other financial instruments are particularly vulnerable. Sharply negative growth in a number of developing countries and all of the attendant repercussions, including increased poverty and unemployment, would be inevitable. If steps that are being taken to restore the functioning of capital markets and maintain the flow of credit to the productive sector succeed, a milder downturn is possible, with the economic dislocation contained mainly within the financial sector.

**Remittances from host countries are expected to decline in response to the global slowdown but the impact on flows to recipient countries will depend significantly on exchange rates.** In 28 countries, remittances to developing countries were larger than revenues from the most important commodity export, and in 36 countries they were larger than private and public capital inflows. They are also a powerful poverty reduction mechanism. For example, in Nicaragua remittances reduce poverty incidence by four percentage points on average, and five percentage points in urban areas. In Albania, households with migrants to Italy and Greece have an incidence of poverty that is half the national rate (i.e., 15 and 19 percent compared to an average of 32 percent). Remittance flows from host to developing countries, which reached an estimated \$295 billion in 2008, began slowing in the second half of 2008 and are projected to slow sharply in 2009. The global slowdown is also expected to lead to a sharp reduction in employment opportunities in the developed world, especially in sectors with a high concentration of migrants (e.g., construction, retail, catering). This, plus lower oil revenues in Gulf countries, will lead to a decline in migrant earnings. However, the large exchange rate fluctuations of recent weeks have dwarfed the expected changes in remittances denominated in host-country currencies. As a result, changes in the local currency value of remittances will likely vary widely by country. Overall, remittance flows into developing countries are expected to decline from 2.0 to 1.7 percent of recipient country GDP.

**Low-income countries (LICs) will be significantly affected by the crisis even though the channels of transmission are likely quite different from those operating in emerging markets.** Financial sectors in LICs are less integrated into global financial markets. As a result, the direct impact of the crisis is likely to be more limited. Nevertheless, LICs will be impacted through slower export growth (global trade is projected to decline in 2009), reduced remittances, lower commodity prices (which will reduce incomes in commodity exporters) and the potential for reduced aid from donors. The crisis may also lead to a reduction in private investment flows, making weak economies even less able to cope with internal vulnerabilities and development needs.

### ***Impact of the Food and Fuel Price Shocks***

**Earlier this year, amidst historically high food and fuel prices, the global community's attention was focused on the impact of these shocks on poor countries and populations.** The rise in food prices between 2005 and early 2007 was estimated to have increased the share of

the population of East Asia, the Middle East, and South Asia living in extreme poverty by at least 1 percentage point, a setback equivalent to seven years of progress toward meeting the poverty MDG. The impact on the urban poor was particularly acute, increasing the incidence of poverty by more than 1.5 percentage points in East Asia, the Middle East, South Asia, and Sub-Saharan Africa.

**As a result of the food and fuel crises, the number of extremely poor was estimated to have increased by at least 100 million.** The poverty deficit (the annual cost of lifting the incomes of all of the poor to the poverty line) rose by \$38 billion or 0.5 percent of developing country GDP. The increase in the *number* of poor due to the food crisis was only part of the story. Equally worrisome was that many of those already poor are slipping even more deeply into poverty. Recent estimates of poverty depth (i.e., the gap in consumption between the average poor household and the poverty line) show that poverty is deepening, with the extreme poor being hit hardest. Eighty-eight percent of the increase in urban poverty depth from rising food prices is from poor households becoming poorer and only 12 percent from households falling into poverty.

**Recent declines in food and fuel prices do not imply that pressures and problems have disappeared.** For the very poor, reducing consumption from already very low levels, even for a short period, can have important long-term consequences. The poorest households may have had to reduce the quantity and/or quality of the food, schooling, and basic services they consumed, leading to irreparable damage to the health and education of millions of children. Poor households forced to switch from more expensive to cheaper and less nutritional foodstuffs, or cut back on total caloric intake altogether, face weight loss and severe malnutrition. Already during 2008, higher food prices may have increased the number of children suffering permanent cognitive and physical injury due to malnutrition by 44 million. Regardless of recent declines in global food and fuel prices, this represents a tragic loss of human and economic potential. Many of the countries most exposed to rising global food and fuel prices are those with high pre-existing levels of malnutrition. Burundi, Madagascar, Niger, Timor Leste and Yemen are among the ten most affected countries for both stunting and wasting indicators. All of these countries experienced double-digit food inflation in 2007-08.

**Second round impacts on inflation remain a concern.** Until recently, rising commodity prices and tight capacity in many countries were causing both headline and core inflation to pick up throughout the world, with headline inflation rising by some five percentage points among developing countries. However, even with world commodity prices falling back considerably, and capacity pressures easing, inflation risks remain. In many countries, consumer prices may prove to be less flexible downwards, and upward pressure on prices remains as households seek to recoup the significant real-income losses endured since January 2007 and firms strive to restore profitability. The combination of these price pressures with slowing growth and rising unemployment raises the specter of stagflation.

**The food and fuel price shocks have already imposed large fiscal costs on developing countries, undermining their ability to respond to fall-out from the financial crisis.** Policymakers responding to high food and fuel prices made extensive use of tax reductions to offset higher prices and increased spending on subsidies and income support. Data from a recent IMF survey covering 161 countries show that nearly 57 percent of countries reduced taxes on food while 27 percent reduced taxes on fuels. Almost one in five countries increased food subsidies while 22 percent increased fuel subsidies. The reliance on “across the board” tax reductions and subsidies is unfortunate because these measures are often more regressive, more costly, and more difficult to

reform once in place. Fuel subsidies are usually much more regressive than food subsidies and often have further adverse environmental consequences. Reliance on inefficient fiscal measures such as untargeted subsidies is also regrettable given the need to create the fiscal space to accommodate a permanent increase in the size of targeted safety nets.<sup>3</sup> Careful fiscal planning is needed to protect critical growth-enhancing spending, prune low-priority expenditures and ensure fiscal sustainability in the medium term. These pressures will only increase as the global financial crisis takes its toll.

**The sharp turn around in commodity prices may require equally dramatic adjustment among commodity exporters.** While the terms of trade deterioration faced by food and fuel importers has begun to reverse, exporters of these commodities are facing sharp declines in prices with potentially large implications for their current accounts. At the same time, a large group of developing countries have become heavily reliant on foreign financing in recent years, whether in the form of aid or private capital flows. Around half of all developing countries have current account deficits in excess of 5 percent of GDP and about one third have current account deficits of over 10 percent of GDP. Should the current extreme liquidity squeeze persist, it is bound to have repercussions for global growth and the capacity of countries to obtain external finance. There is evidence of this already.

### *Policy Challenges from the Financial Crisis*

**The challenges faced by developing countries earlier this year are now compounded by the pressures emanating from the global financial crisis.** Policymakers need to respond to the short-term crisis while remaining cognizant of the implications for longer-term growth. With policymakers making critical policy decisions on a near daily basis, there is an enormous premium on learning from experience as quickly as possible. Without question, current circumstances have revealed important weaknesses in crisis preparedness arrangements both within and across countries, including the need for much greater international policy coordination that recognizes the collective character of the crisis and avoids beggar thy neighbor policies.

**Major industrial country governments have provided extensive assurances to bank depositors and creditors** (and, in a few cases, non-bank financial institutions such as mutual funds) that have sometimes included blanket guarantees, prompted by systemic stability and (in a few cases) competitive concerns. The scale of these arrangements has no historic parallel. These guarantees will probably be maintained until financial stability is consolidated and credit flows resume on a sustained basis, which may well take several years in some cases.

**Some emerging countries are matching these arrangements to prevent capital outflows and/or a shift of deposits to state-owned banks, which are perceived to be safer.** However, before moving in this direction, policymakers need to be sure that the state guarantee backing these arrangements is credible, which requires consideration of the state's overall indebtedness and the

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<sup>3</sup> The fiscal costs of a well-targeted safety net for the poorest need not be high. Even such large and generous CCT programs as those in Mexico and Brazil are only around 0.5 percent of GDP. For a large share of developing countries, spending on overall safety nets has been on the order of 1 to 2 percent of GDP in recent years. The cost of safety net responses will differ according to the scope, generosity, and degree of targeting. For example, in Chile, where the response so far has been a very time-limited increase in targeted transfers, the cost has been a mere 0.04 percent of GDP. In Ethiopia, the total additional costs of lifting the value-added tax on food grains, raising the wage on the cash-for-work program, and distributing wheat to the urban poor at a subsidized price are likely to exceed 1 percent of GDP.

size of the banking system. That said, given systemic crises of confidence, government actions become inevitable and good governance indispensable.

**Many of the lessons from the current crisis are equally relevant for both industrial and developing economies.** While the crisis has reaffirmed some fundamental tenets of financial-sector policymaking, such as the need for a solid financial infrastructure, it is also prompting a reconsideration of several aspects of financial sector regulatory frameworks and supervision. For example, regulators need to ensure that financial innovation does not destabilize financial markets. Over time, we may see a more fundamental reappraisal of regulation. In particular there will be new approaches to the scope of regulation (who and what products), greater emphasis on systemic risks (macro-prudential regulation) and an attempt to deal with the pro-cyclical effects of current policies.

### *Policy Priorities*

**The financial crisis and the resulting abrupt slowing of global growth occur as many developing countries have become more vulnerable.** Higher commodity prices have raised the current account deficits of many oil-importing countries to worrisome levels (they exceed 10 percent of GDP in about one-third of developing countries), and after having increased substantially, the international reserves of oil-importing developing countries are now declining as a share of their imports. Moreover, inflation is high, and fiscal positions have deteriorated both for cyclical reasons and because government spending has increased to alleviate the burden of higher commodity prices.

**The countries that are likely to perform better are those that have managed to reduce macro-financial vulnerabilities, increase investment rates, diversify export markets, and restore productivity growth.** At the same time, a number of developing countries are likely to be subjected to substantial strains, until the rapid equity declines seen in September and October end and until credit begins to flow again as recent policy actions improve financial market confidence. In these very uncertain circumstances, policymakers must place a premium on reducing the impact on their domestic economies by reacting swiftly and forcefully to emerging difficulties. They must also protect the real sector by taking measures to maintain the flow of short-term and trade credit necessary for economic activity.

**The challenge for policymakers is not just to prevent the escalation of the crisis and to mitigate the downturn, but also to ensure a good starting position once the rebound sets in.** This means responding rapidly and forcefully to signs of weakness in their financial sectors, including resorting to international assistance where necessary. It also means pursuing a prudent counter-cyclical policy, relying on automatic stabilizers, social safety nets, and infrastructure investments that address bottlenecks that have become binding constraints on long-term sustainable growth. In the current circumstances of heightened risk aversion and investor skittishness, policymakers need to be especially wary of taking on excessive levels of debt or creating the conditions for an inflationary bubble by too aggressive a reaction to the global slowdown. It also means continuing to improve the investment climate for private investment, to increase the flexibility of the private sector to adjust to changing market conditions (business entry and exit) and to generate new jobs and tax revenues.

### *Protecting the Most Vulnerable*

**Aid-dependent countries are particularly vulnerable to disbursement shortfalls and changing donor priorities.** Despite recent commitments to improve aid predictability and to scale up official

development assistance, progress has been slow and challenges to sustaining these commitments in the current environment are expected to increase. IDA is in a strong position to assist countries in dealing with the impact of the global financial crisis and all 45 donor countries are expected to fulfill their pledges to the IDA15 replenishment in a timely manner. Some donors have raised their pledges further in recognition of the financing needs of low-income countries. Many donors have already obtained necessary parliamentary approvals and provided written commitments to contribute to IDA15, and others are striving to complete their ongoing processes as quickly as possible.

**At the micro level, even as pressure from high and volatile food and fuel prices appears to have begun to abate, the poor will now have to contend with the repercussions of slowing growth.** Efforts to expand and improve the targeting of social safety nets, which received renewed impetus and importance under the Bank's Global Food Crisis Response Program (GFRP)<sup>4</sup> and will also figure prominently in the proposed Energy for the Poor Initiative (EFPI)<sup>5</sup> which the Bank is in the process of discussing with donors, must therefore be sustained. This is particularly crucial if the fiscal impact of a slowing global economy is to be contained. Of the options available, targeted cash transfers tend to succeed best because they have relatively low administrative requirements and minimize the diversion of benefits toward less needy population groups. However, in countries where there are no targeted programs in place, setting one up from scratch could take four to six months. In-kind programs, such as school feeding and the distribution of fortified weaning food for toddlers, can be effective; that is especially the case for the distribution of in-kind food aid in fiscally constrained countries. Subsidies, even targeted ones, tend to be much less efficient and costly and be politically difficult to eliminate once introduced. Public works programs rarely provide sufficient coverage to meaningfully target poor families. Whatever policies are adopted, it is critical that the offsetting income support be clearly presented as temporary to avoid creating an unnecessary and unsustainable fiscal burden.

### *Importance of Multilateral and Coordinated Actions*

**Multilateral cooperation is essential to address major global challenges and prevent sudden and disorderly market reactions from creating pressure for protectionist and inward-looking policies.** The recent situation in food markets has features of a classic "prisoner's dilemma". The introduction of export bans restricted global supply and aggravated shortages. Unilateral actions by exporting countries prompted others to follow suit. Actions by rice importers who organized large

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<sup>4</sup> Under the GFRP, which was approved by the Board in May 2008, the World Bank is providing technical advice and \$1.2 billion of financial support to countries affected by the food crisis (including \$200 million of grant financing from the Bank's own income). GFRP-funded projects to date (Board approved and pipeline) amount to almost \$1 billion in Bank funds. The \$1.2 billion ceiling will be reached before the GFRP's first anniversary in May 2009. The WBG is also committed to increasing new annual lending to food and agriculture to \$6 billion over the next year, including through support to smallholder farmers on irrigation, fertilizers, and crop diversification, the development of agribusiness activities and supply chains, and safety nets and other forms of social protection for the poor. The Bank is also working with the World Food Program (WFP) to help improve their financial and operational management in an effort to increase the amount of humanitarian food aid that can be derived from each dollar of donor financing.

<sup>5</sup> Following on ideas formulated at the June 2008 Jeddah Energy Conference, the Bank began work on an *Energy for the Poor Initiative* (EFPI) which is intended to provide rapid support to social safety nets to alleviate the impact of higher fuel prices on the budgets of poor households to prevent an irreversible erosion of household and human capital. It would also provide co- or parallel financing, in partnership with other donors, for energy-sector projects intended to reduce countries' longer-term vulnerability to high and volatile fuel prices. A technical meeting with donors to discuss the framework is scheduled for mid-November.



tenders to obtain needed rice imports against a backdrop of shrinking traded supplies, aggravated the problem. It should not be forgotten that many of the distortions that led to the food crisis in the first place can be traced back to the protectionist trade and agricultural policies of rich countries and poorly conceived ethanol subsidies.

**Multilateral cooperation is needed if we are to meet the internationally-agreed development goals (MDGs) and ensure inclusive and sustainable globalization.** The MDG challenge remains daunting and the environment for achieving poverty reduction has become more difficult. Global coordination efforts must therefore focus on the features of the current situation that are most problematic or disruptive, and which are most conducive to concerted action. To justify public intervention, it is also important to understand the nature and causes of the underlying market failure, the channels through which the proposed remedies will operate, and the consequences—both intended and unintended—that can result from application of those remedies. Initiatives must balance the need for a blend of short- and long-term actions, both at the global and country level, to prevent, mitigate and resolve such crises.

**Neither individual governments nor international agencies alone are in a position to offset entirely the costs of financial crisis and high and volatile food and fuel prices.** These policy challenges need to be addressed at the country level, but it is more critical than ever that the international community acts in a coordinated and supportive fashion to make each country's task easier. The coordinated provision of liquidity by major central banks since last year, the additional efforts made more recently, and the decision of the international community to adopt the Short-term Liquidity Facility (SLF) to more quickly mobilize large scale financing from the IMF, are just some examples of how important it is to work together during times of stress in the global economy.

**Mutual support must extend beyond the provision of balance of payments financing to encompass areas critical for longer-term development and stability.** In the wake of the financial crisis it is imperative that donor countries meet their Gleneagles commitments, reach an agreement on the WTO Doha trade round, and follow through on the Bali commitments on climate change. Developing countries must ensure that resources are put to their best and most efficient use, including by putting in place well-targeted social safety nets and improving the targeting of resources provided to the poor.