IMPACT OF FINANCIAL CRISIS ON DEVELOPING COUNTRIES

Ph.D Luminita Horhota,
Ph.D Cristina Nicoleta Matei
Romanian American University
Faculty of Commerce, Finance and Banks
Bucharest, Romania

Abstract: This paper aims to discusses in a critically manner the crisis and concludes that as far as the developing countries are concerned, a bit more optimism may be warranted. Although without doubt there are particular countries that will be adversely affected, there will also be countries that may be less affected, may avoid recession, and may recover sooner than expected. Finally, some options available to the developing countries for minimizing the impact of the crisis are discussed. The crisis accentuates the urgent need for accelerating financial development in developing countries, both through domestic financial deepening, domestic resource mobilization, and reform of the international financial system.

JEL classification: G01, G17

Key words: financial crisis; developing countries; financial development

1. Introduction

The higher cost of credit, the decline in export earnings and weak stock markets are likely to affect the confidence of investors, both domestic and foreign. There is thus enough reason to expect that the short and medium term impact on developing countries will be a slowdown of growth. The extent of the slowdown depends on how deep the recession in the rich countries is going to be and on how quickly financial markets can return to normal operations. Those developing countries that have current account surpluses and large stocks of international reserves can stimulate domestic demand to compensate for the fall in exports. The cost of restoring the financial system will be considerable and this will have effects on the real economy as well through the loss of wealth, the higher cost of borrowing and through fiscal stress.

2. The impact on developing countries

2.1. Banking failures and reductions in domestic lending. There are both direct and indirect ways in which financial institutions in developing countries would be negatively affected. Directly, banks in developing countries may be affected to the extent to which they hold assets contaminated by subprime mortgages. Indirectly, there is a threat through declines in stock market prices and housing prices. These reduce the capital of banks (and of other big firms), which in particular causes problems where they do not hold sufficient levels of their capital in cash. In such cases it is likely that banks will reduce lending in order to shore up their capital. Reductions in bank lending will have the impact of reduced investment, lower growth, and an increase in unemployment. The latter will lead to reductions in demand which, in turn, will reduce economic growth further.

2.2. Reduction in export earnings. Most developing countries have been basing their economic growth in recent years on exports. The expected declines will come through a combination of a decline in commodity prices, a decline in demand for their goods from advanced economies and a decline in tourism. Declines in commodity prices will be detrimental to the export earnings of a large number of countries that are major exporters of commodities. A large proportion of countries dependent on commodity prices are in Africa. Over the past seven years, prices of many commodities, including copper, nickel, platinum and petroleum, have risen to record highs, and contributed significantly to good growth in these countries. However, since September 2008 commodity prices have been declining. Another important source of foreign currency earnings in many developing countries is tourism. Since September 2008 the number of air passengers in the world has dropped sharply. Although a good part of this drop is due to reduced travel for business purposes, it would also include less tourist travel, as households generally reduce consumption on luxury goods, and second mortgages for overseas holidays are becoming more difficult to obtain. Many small island states dependent on tourism have already registered a decline in hotel bookings. For many countries, primarily commodity-importing countries, the reduction in export earnings will come at a time when their balance of payments is already under pressure due to rising food and fuel prices in 2007 and 2008. Such countries may be in particular need of balance-of-payments assistance from the IMF and other sources.

2.3. Reduction in financial flows to developing countries. As a group, developing countries require financial inflows from the rest of the world to facilitate and accelerate economic growth, trade and development. These flows include official development assistance (ODA), investment flows, both portfolio and foreign direct investment (FDI), trade credits and flows of remittances. All of these are set to be affected negatively during the current crisis. Moreover, even if countries were to maintain their share of GNP as aid contributions, with the falling GNP the absolute volume of aid will also fall, although currency depreciations may counter this effect. First, private investment flows to developing and emerging countries will decline as more risk averse investors move their funds to perceived 'safer' havens. This includes both portfolio and FDI. Reduced portfolio flows will also affect government borrowing. Second, international trade depends on trade credit being extended; around 90 per cent of trade is traditionally financed by short-term credit. With the credit crunch starting to bite, trade finance has also been reduced as banks limit their risk exposure. Consequently, there will be dual pressures on developing-country trade: reduced demand for their exports and reduced trade credit. As far as remittances are concerned, there are already indications from countries with large numbers of migrant workers that remittance flows are declining. Countries with migrants predominantly in the US or EU and small states, have already started to feel the pinch. Remittances in recent years have grown to be one of the most important financial flows to developing countries, exceeding US$240 billion in 2007, more than twice the volume of aid flows.[1]

2.4. Possible outcomes. A valid global concern is that the possible combination of banking failures and reductions in domestic lending, reductions in export earnings, and reductions in financial flows to developing countries will end up reducing private

[1] Ratha et al. 2007

sector investments and household consumption. This in turn will lead to reduced government expenditure, as governments will now face the higher cost of raising funds coupled with less tax income. Together, low investment, consumption and government expenditure could spell higher unemployment and poverty across the developing world.

2.5. Current expectations. Given the concerns about the impact of the financial crisis on economic growth and poverty, the current predictions are now reviewed. First, what are the expectations regarding growth? As far as developing countries are concerned, the World Bank has revised its estimate for growth downwards from 6.4 to 4.5 per cent for 2010. For Africa, home to many of the least developed countries, growth expectations are also down, given the continent's dependence on exports and commodities. However, many of these countries are more resilient than before, and expectations are that African countries will continue with good growth in 2010, of around 4.5 per cent according to the IMF forecasts and 4.1 per cent according to UN-DESA forecasts. Expectations of GDP growth in two of the largest emerging economies, China and India, are also down, although these countries are still expected to continue growing at high rates of around to 8 per cent in 2010.

Second, what are the expectations regarding poverty? It is likely that both absolute and relative poverty (inequality) will increase. For instance, as far as absolute poverty is concerned, the International Labour Organization (ILO) predicts that unemployment could rise by 22 million across the world and that the number of people working for less than the US$2 per day poverty line will rise by 100 million[2]. As far as inequality is concerned, it is worrisome to note that the issue so far has been largely neglected. But the crisis has the potential to increase inequalities between countries, as the developing world's financial resources are diverted to the rich world's financial system (the poor bailing out the rich). Within countries it is still unclear whether the net effect of the crisis will be to increase or decrease inequality. It could decrease wealth inequality to the extent that owners of assets are more adversely affected. But it may possibly also worsen inequality within countries due to the fact that not all people within countries will be affected in the same manner. One implication is that the urban poor in developing countries may be disproportionately affected. While the general expectation is that the crisis will overwhelmingly have a negative impact on poverty, it is also the case that the group of least developed countries in particular will benefit from declines in oil and food prices, which had particularly affected these countries since 2007. In addition, many countries will have the fiscal resources (at least the means, if not the will) to minimize the impact on the poor.

3. Discussion

We will attempt to critically evaluate the extent of the impact. The overall impact will undoubtedly be negative. Some countries will be more negatively affected, especially those dependent on trade with the United States, those with balance-of-payments difficulties and large fiscal deficits, and those with poorly regulated financial sectors. Countries with the latter constraint(s) may even experience their own financial crises in 2009-2010. In essence, the crisis will expose countries with poor macroeconomic management and poor financial institutions. But anyway, many large emerging countries could overcome the crisis in a relatively short period of time. There are various reasons for this belief.

[2] UN-DESA

First, the epicenter of the crisis is in the developed countries. The crisis is unlike many of the previous financial crises in that it comes as an exogenous shock and not because of inappropriate domestic policies, as in the past.

Second, as was discussed, developing-country banks have not been directly impacted as badly. Most developing-country banks were only marginally exposed to the US subprime crisis, so that a direct impact on their banking systems has been largely avoided.

Third, there is evidence of a measure of decoupling of growth rates in recent years. Specialists show that in the case of Africa and developing countries as a group, economic growth rates have decoupled from those of the richer countries from the early 1990s. The proportion of African and Latin American exports to the United States and EU has declined significantly in recent times, while their trade with Asia has increased substantially.

Fourth, both advanced economies and a number of developing countries have introduced significant countercyclical fiscal expansion packages. Barack Obama, US President, proposed a fiscal stimulus package intended to create 2.5 million jobs mainly through public infrastructure investment. In Europe, the European Commission (EC 2008) urged a Euro 200 billion fiscal stimulus plan, and emphasized the importance of improving Europe's competitiveness through encouraging employment security and entrepreneurship. Having a number of large developing countries adopt such fiscal stimulus packages in a coordinated fashion will have an even larger aggregate impact on demand in these countries.

The above, therefore, suggests that the crisis need not be another great depression as far as the developing countries are concerned. However, this conclusion, as well as the current predictions of decline, needs to be qualified by adding that at the time of writing there is still much uncertainty as to the eventual impact. This is partly reflected in that IMF and World Bank forecasts of future growth continue to be revised (downwards) as time goes by. There are uncertainties due to the extent of the decoupling of developing country and OECD growth, uncertainties as to the impact on China, uncertainties as to the resilience and robustness of developing-country economies, and uncertainties as to the extent and duration of the downturn in the US and EU. Regarding the latter, questions remain as to whether the actions taken by the US and EU will have the desired effect, or how long it will take for confidence to recover. Another area where there is uncertainty is the impact of the crisis on income and wealth inequality. While there is a likelihood that it will have an adverse impact on inequalities between countries and also within countries, it is uncertain what the size of the impact will be and how it would affect different groups. Many of these uncertainties will be resolved by the manner in which individual countries make use of the factors in their favor to minimize the impact. So individual country choices, good leadership and good management will make a difference. But these are difficult to forecast, and need to be accompanied by considered policy responses.

4. Policy responses

From past experiences of financial crises and given the analysis of the origin and likely impacts of the current crisis, the likely responses required in developing countries would need to include immediate, short-term (stabilization) and long-term (structural) policy responses. It is desirable that countries coordinate these where possible. Indeed, an area where much future research is now needed, is on the implications of the financial crisis for greater global coordination of responses. This is not only hugely important for developing countries, but also for developed countries. Immediate and short-term policy responses are required to ensure that:

- the financial crisis is contained,
- that confidence in financial systems is restored and
- that the impact on the real economy is minimized.

Over the longer term, countries should focus on strengthening their financial systems within the context of reforming the global financial architecture. Domestic financial development depends on a better global financial architecture and vice versa.

4.1. Immediate responses. Immediate responses to the crisis include:

- containment and resolution measures to stop the crisis, restore confidence in banks and improve their health, and
- measures to reduce the fall-out on the real economy.

Containment measures typically include guarantees on deposits and interbank loans, provision of liquidity to financial institutions and forbearance on meeting regulatory requirements. Resolution measures aim to redress the balance sheet difficulties of banks and typically consist of direct cash injections, allowing mergers and acquisitions, and may include bank nationalization. All of these containment and resolution measures were applied in the present crisis. Moving towards an essentially private sector-based financial system does not mean the approach of unbridled liberalization and de-regulation, however. The current crisis has already shown some of the fault lines of too rapid or too early financial liberalization, as well as re-emphasized the importance of the correct sequencing and monitoring of financial liberalization. Many countries should thus be considering slowing down the rate of financial liberalization, and of imposing controls of the movements of capital.

4.2. Short-term responses. Both advanced economies and a number of developing countries have introduced significant countercyclical fiscal expansion packages. Where countries have the scope for expansionary fiscal policy, and even where they do not, the challenge is to ensure that spending on social protection is not compromised. For one, there are a number of countries, particularly amongst the least developed countries, with little fiscal or current account leeway. Two, many developing countries are facing much higher inflation rates, pressure on the exchange rates to depreciate, and an outflow of international capital. Under such circumstances, and in view of the imperative not to repress domestic financial development, these countries would need to take care to maintain positive real interest rates. Indeed, with historically low interest rates in the US and EU, developing countries face an opportunity to attract external funds.

Countries facing balance-of-payments constraints could need to make use of the IMF's short-term liquidity facilities, and those with difficulties meeting investment and social spending, the various World Bank and International Finance Corporation (IFC) facilities. Nevertheless given that IMF and World Bank resources may be limited and need to be repaid, countries would need to undertake reforms to improve their domestic resource mobilization by strengthen microfinance, increase access to savings facilities, and improve the efficiency of the financial sector through encouraging competition and providing more instruments for saving. Developing countries, in any case, should consider expansionary monetary policies carefully, due to the combination of a credit crunch and liquidity trap. A liquidity trap is said to exist when households and banks hoard cash, so that expansionary monetary policy becomes ineffective (even if interest rates are zero, no one wants to borrow or spend). The essence is to strengthen the balance sheets of banks and consumers. One way is to prevent further declines in stock market prices and in fact encourage the buying of stocks.

4.3. Longer-term responses: financial development. Over the longer term countries should promote financial development more vigorously, and press for reform of the international financial system more urgently. Financial development refers to the deepening in the financial sector, providing greater access to credit, as well greater efficiency of the financial system. There are many ways in which financial sector development matters for growth:

- it allows a more efficient allocation of capital throughout an economy;
- is important for economic diversification, the growth of entrepreneurship, and
- for the efficient application of fiscal and monetary policies.

Developing countries should build on these and avoid this crisis from derailing their progress -any action that limits financial development (capital controls, low/negative real interest rates, government ownership of banks and directed lending). Moreover, countries should prioritize a number of measures for further financial sector development. To manage the risks of financial openness, countries ought to proceed gradually with the opening of their financial systems, while simultaneously strengthening their domestic financial sectors and institutions. These include the rule of law, an independent judiciary, and contractual and property rights but also extending and strengthening bank supervision and regulation.

4.4. Longer-term responses: reform of the international financial system A more inclusive international system for governance of the global financial architecture is a prerequisite for any progress in reform. When much of the current financial architecture was first set up after the Second World War, the developed countries of the north were the net creditors to the rest of the world. Whether the UN is the appropriate forum is certainly a topic worthy of discussion, but one that falls outside the scope of the present paper. Suffice to note that there are both pros and cons for the UN to coordinate the discussions on a new global financial architecture. The system of global aid needs to be reformed. In a more equitable and efficient global financial system, developing countries ought not to be over-accumulating reserves, and rich countries ought not to be running-up unsustainable deficits. More attention now needs to be paid to designing a better system. The inadequacies of the system have been raised unsuccessfully many times. But hopefully now, given that the current crisis takes place during the transition from a uni to multi-polar world, coincides with political change in the US, and will largely be resolved by developing-country money, this will spur developing-country governments to use the crisis as a window of opportunity for change.

5. Conclusions

The economic slowdown in the world economy will mean a slowdown in economic performance in most developing countries during 2009-2010. The centre of the financial crisis is in the US and EU, and this is also where the most substantial economic slowdown will be experienced. Although developing countries will be affected in the form of lower growth, higher unemployment and poverty, and changes in inequality. The financial crisis has occurred at a time when many developing economies have been enjoying years of good growth, and this together with improved macroeconomic management have resulted in more robust economies in the developing world. It is unlikely to turn out to be a crisis of the same magnitude as the great depression. Indeed, the US and EU countries have introduced - and will continue introduce - appropriate countercyclical policies that will reverse further declines in stock and housing prices, and that will boost investment and growth. Just as fundamental as the need for appropriate short-term crisis management is the need for developing countries to further their financial development.

This crisis has shown how important credit and risk-management institutions are to economic growth, and it has shown how important appropriate institutions and regulation are for the correct functioning of the financial sector. It has also shown how important the international financial architecture, including international cooperation, is for mitigating financial crises.

Therefore, financial development in developing countries should begin to focus urgently on both domestic financial deepening as well as reform of the international financial architecture. Future financial innovation may driven by developing countries. By continuing to build appropriate financial systems and working towards reforming the international financial system, the developing world may limit the potential for future financial crises of their own.

REFERENCES

1. Addison, A., Mavrotas, G. (eds) — Development Finance in the Global Economy: The Road Ahead. Basingstoke: Palgrave Macmillan for UNU-WIDER, 2008
2. Dollar, D., Wei, S.-J. — 'Das (Wasted) Kapital: Firm Ownership and Investment Efficiency in China'. NBER Working Paper 13103. Cambridge, MA: National Bureau of Economic Research, 2007
3. European Commission — 'A European Recovery Plan', 2008. ww.ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf
4. Evans, A., Maxwell, S. — 'Financing Development: from Monterrey to Doha',OpenDemocracy, 26 November, 2008.
5. Giles, C. — 'The Vision Thing'. Financial Times, 26 November, 2008
6. Guha-Khasnobis, B., Mavrotas, G. (eds) — Financial Development Institutions, Growth and Poverty Reduction. Basingstoke: Palgrave Macmillan for UNUWIDER, 2008
7. Hostland, D. — 'The Impact of the Global Financial Crisis on the Development Finance Prospects for LDCs'. WB Presentation, 18 November. Washington, DC: World Bank, Development Economics Prospects Group, 2008
8. IDS — 'Voices from the South: The Impact of the Financial Crisis on Developing Countries', 2008. Available at www.ids.ac.uk/go/financial-crisis-impact.

9.	IMF	World Economic Outlook: Globalization and Inequality. Washington, DC, 2007.
10.	IMF	World Economic Outlook: Housing and the Business Cycle. Washington, DC, 2008
11.	James, H.	'The Making of a Mess: Who Broke Global Finance, and Who Should Pay for It?', 2009. Foreign Affairs, January/February.
12.	Jonung, L.	'Lessons from Financial Liberalization in Scandinavia'. Comparative Economic Studies, 2008, 50: 564-98.
13.	Obstfeld, M.	'International Finance and Growth in Developing Countries: What have we Learned?'. WB Working Paper 34. Washington, DC: Commission on Growth, 2008
14.	UNCTAD	World Investment Report 2009. Geneva: United Nations.
15.	World Trade Organization	'Lamy Warns Trade Finance Situation Deteriorating'. WTO News, 12 November, 2008