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The Financial Crisis of 2008 and the Developing Countries

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Abstract

Following the financial crisis that broke in the US and other Western economies in late 2008, there is now serious concern about its impact on the developing countries. The world media almost daily reports scenarios of gloom and doom, with many predicting a deep global recession. This paper critically discusses this 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. Six major reasons for this conclusion are discussed. Without this resilience in the developing world, prospects for the world's richer countries would be much bleaker. 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.

Keywords: financial crisis, developing countries, development finance, financial development

JEL classification: F34, F35, G14, O16

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1 Introduction

Sales of Karl Marx's *Das Kapital* are reported to have soared in recent months as financial markets collapsed like dominos and the US government, traditionally a bastion of capitalism, rushed in to nationalize banks.[1] Marx, on the face of it, seems particularly prescient in having expected financial crises to occur regularly in capitalist economies. There have been at least 124 systemic financial crises since 1970 (Laeven and Valencia 2008). Despite this, unlike Marx, most latter-day economic forecasters seem to have been unprepared for the present debacle. As Giles argues (2008), 'there is no doubt that the credit crisis, which has morphed into recession across advanced economies, leaves most economic forecasters with ample egg on their face'.[2]

Indeed, the crisis that by October 2008 had erased around US$25 trillion from the value of stock markets, seems largely to have been unexpected.[3] Partly this was because it came on the heels of a seven-year period of high growth and originated in the USA; many had expected a global slowdown to start in the emerging markets.

Both the initial destruction of financial wealth as well as the psychological shock of seeing many elite Wall Street firms on their knees, prompted numerous commentators to initially raise the spectre of the great depression. Although not the great depression, it is indeed true that the world is staggering from financial to economic crisis as the US, EU, Japan and other high-income economies entered the recession at the end of 2008. Having decimated Wall Street and then crippled Main Street, the financial crisis seems like a hurricane about to sweep across the developing world. As Evans and Maxwell (2008) suggest, it may be time for these countries 'to start nailing shutters on the windows'.

This paper investigates the consequences of the 2008 financial crisis on the developing countries. It is structured as follows. Section 2 provides a brief outline of the causes of the crisis. This is the necessary background for understanding the likely impact and the required responses. The remainder of the paper examines the likely magnitude and duration of the crisis, identifying the channels through it will exert its impact on developing countries. In this regard the main conclusion is more optimistic of the prospects faced by the developing world, although at the time of writing, many uncertainties remain. As discussed in section 3, there are at least six major reasons for a more upbeat prognosis for developing countries. These are that (i) the epicentre of the crisis is in the developed countries, not the developing world as in many of the previous crises; (ii) developing-country financial sectors have not been as directly affected; (iii) there has been a measure of decoupling of growth rates between developing and developed countries in recent years; (iv) many developing-country economies are currently quite resilient as a result of good growth, better policies and having learned lessons during the 1998 Asian crisis; (v) the largest emerging markets, China and India, will continue to grow, albeit a bit slower; and (vi) the extent of fiscal expansion

1 See, e.g., www.news.bbc.co.uk/1/hi/world/europe/7679758.stm

2 As put by Naím (2009: 1), 'As much as Wall Street and Main Street, the economics profession needs a bailout of its own'.

3 See Giles (2008). In its October 2007 *World Economic Outlook*, for instance, the IMF, although concerned about the subprime crisis in the US and its potential negative impact on slowing down growth, still assumed in its baseline forecasts that, 'market liquidity is gradually restored in the coming months and that the interbank market reverts to more normal conditions' (2007: xv).

programmes now being undertaken is likely to cushion the extent and duration of growth declines.

Section 4 discusses the options for developing countries to minimize the impact of the crisis, arguing that the crisis makes it imperative to accelerate financial development in developing countries through both domestic financial deepening and reform of the international financial system. Section 5 concludes by commenting on some of the shortcomings in the current responses of the developed countries, referring to the dangers of moral hazard, the continued availability of cheap credit, and of the disturbingly widening inequalities in wealth. In the context of a world where the 'poor are bailing out the rich' and the reckless are rewarded at the expense of the thrifty, these dangers should not be dismissed lightly.

2 A brief background

The causes of the crisis have by now been widely analysed and dissected.[4] But many volumes and theses will no doubt appear over the coming years to explain why the crisis was actually inevitable, and why it should have been foreseen, had the world only taken note of these prior warnings. These will be accompanied by the inevitable airport blockbusters offering secrets on how individuals can prosper amidst global doom and gloom. Without mentioning new editions of *Das Kapital* nor wanting to rob the reader from discovering these insights for her or himself, this section will, therefore, be very brief.

Following the burst of the 'dotcom' bubble in 2000 and the 2001 terror attacks on the United States, the US and most other advanced economies embarked on a period of sustained expansionary economic policies to ward off recession. The Federal Reserve, for instance, lowered its discount rate no less than 27 times between 2001 and 2003 (Lin 2008). Low interest rates, facilitated by the huge trade surpluses which China and other countries used to purchase US Treasury Bonds, stimulated rapid growth in credit. Accompanying rises in house prices further fuelled credit growth, especially through mortgage lending. In the US, subprime market mortgage lending, to households without the essential means to repay loans, took on huge proportions; according to Lin (2008) about US$1.3 trillion was lent in subprime mortgages. US mortgage lenders, most infamously the institutions known as Fanny Mae and Freddie Mac, securitized these subprime loans, which were then sold throughout the financial system as assets. They were able to issue and securitize these bad loans due to a combination of inadequate regulation and financial innovation. The latter made it difficult for other institutions to assess the risks of these securitized mortgages and led to increased subprime mortgages (Bicksler 2008). Thus in spite of their underlying risk, they were taken up by financial institutions. As put by Krugman (2007),

> the innovations of recent years—the alphabet soup of C.D.O.'s and S.I.V.'s, R.M.B.S. and A.B.C.P.— were sold on false pretences. They were promoted as ways to spread risk, making investment safer. What they did instead—aside

4 For recent overviews of the causes and nature of the financial crisis, see Barth (2008), Felton and Reinhart (2008) and Taylor (2009).

> from making their creators a lot of money, which they didn't have to repay when it all went bust—was to spread confusion, luring investors into taking on more risk than they realized.

Two factors in particular have encouraged asset managers to throw caution to the wind: the growing global economy and their pay incentives. Risk-management tools now seem to have been inadequate in properly assessing risk during the upswing in the global economy. Rating agencies in particular seem to have been awarding high ratings much more easier under favourable growth conditions. Barth (2008) shows that 45 per cent of all new securities rated by Standard and Poor's in 2007 were rated AAA. As far as pay incentives are concerned, Bicksler (2008) describes the overpayment of CEOs of many financial firms as a serious breach of good corporate governance. The *New York Times* points out that,

> Wall Street has been the top tier of the corporate pay range, with executives earning eight-figure salaries. Its bonus system, which rewards short-term trading profits, has been singled out as an incentive for Wall Street executives to expand their highly profitable business in exotic securities and ignore the risks.[5]

By the summer of 2007 increasing defaults on mortgages and growing numbers of foreclosures in the US signalled that the subprime market was in crisis. House prices and financial stock prices started to plummet. This reduced the value of household wealth in the US by trillions. The solvency of Fanny Mae and Freddie Mac, as well as of a number of wellknown international financial institutions was threatened by these defaults and the drops in house and stock prices. On 7 September 2008, the US government nationalized Fanny Mae and Freddie Mac. Then, on 15 September 2008, the firm of Lehman Brothers filed for bankruptcy; with US$639 billion in assets, it was the largest in the history of the US.[6] This resulted in widespread financial panic, with large-scale selling of stocks. The investment banking industry in the United States was wiped out. Central to the sudden reductions in availability of credit, particularly in the interbank market, which precipitated the collapse of many firms, is what Taylor (2009: 12) describes as the 'Queen of Spades problem'. This refers to the fact that securities containing bad subprime mortgages were distributed across the financial system and institutions did not know where they were. This created a counterpart risk, which according to Taylor (2009: 15) meant that 'the turmoil in the interbank market was not a liquidity problem of the kind that could be alleviated simply by central bank liquidity tools. Rather it was inherently a counterparty risk issue...'.

When the US House of Representatives on 29 September 2008 first rejected a US$700 billion bailout proposal for the financial firms adversely affected by the credit crunch (albeit later adopted), Wall Street's Dow Index experienced its largest one-day point loss in history.[7]

Banks in Europe were soon affected due to their exposure to United States financial markets. On 8 October the UK government recapitalized eight of the country's banks,

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5 See www.nytimes.com/2008/09/24/business/24pay.html).

6 See www.financialpost.com/news/story.html?id=790965.

7 See www.etftrends.com/2008/09/dow-jones-loses-nearly-800-points-volatile-session.html.

followed by an agreement amongst the Euro-zone countries on 15 October on injecting further capital into distressed banks and providing guarantees for interbank loans, at the cost to the taxpayer of more than US$1.3 trillion.[8]

There are undoubtedly many further interesting and important dimensions to the crisis worth pursuing further (see, e.g., Taylor 2009). For present purposes, however, the above shows that the anatomy of the crisis is rather simple: easy credit, bad loans, weak regulation and supervision of complex financial instruments, debt defaulting, insolvency of key financial institutions, a loss of credibility and trust, and financial panic and mass selling-off of stocks and a hoarding of cash by banks and individuals. With the interconnectedness of financial markets, especially amongst the developed countries, the panic spread rapidly, causing a widespread 'credit crunch' and sharp declines in consumption, investment and trade in initially all of the G7 countries.

3 The impact on developing countries

3.1 The main channels

How will the above be transmitted to and affect the developing countries? Three main channels are discussed here: (i) banking failures and reductions in domestic lending, (ii) reductions in export earnings, and (iii) reductions in financial flows to developing countries.

3.1.1 Banking failures and reductions in domestic lending

In the wake of the crisis in the US, the biggest initial fear in the rest of the world was that of financial contagion. This is the danger that financial institutions in developing countries will be negatively affected. There are both direct and indirect ways in which this can happen.

Directly, banks in developing countries may be affected to the extent to which they hold assets contaminated by subprime mortgages. At the time of writing, this does not appear to be a significant concern. Many developing-country banks had limited inter-relationships with international banks. Foreign owned banks are not significant players in most countries in Latin America and Africa (although they are in the transition economies of eastern and central Europe). In China, where the financial sector is largely government controlled, exposure to subprime mortgages of United States origin is minimal.

There is, however, a more serious indirect 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. In a worst-case scenario banks may face solvency problems and may require their governments to recapitalize them. 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.

8 See www.news.bbc.co.uk/1/hi/business/7644238.stm.

Bearing in mind that government revenue depends on growth, this will translate into less government revenue, and consequently less means for governments to fight poverty.

3.1.2 Reduction in export earnings

Even if most developing countries are spared significant damage to their own financial systems, the fact that the advanced economies are entering a recession is likely to hurt them. How much this will hurt depends on a number of factors, which are evaluated in section 3.2 below. For now though, it should be noted that the potential may be significant, given that most developing countries have been basing their economic growth in recent years on exports. Notable cases include China, India, Japan, Korea, Malaysia, and others. The crisis is likely to lead to a substantial decline in the countries' export earnings. The IMF expects growth in world trade to decline from 9.4 per cent in 2006 to 2.1 per cent in 2009.[9] 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. These are briefly assessed.

Declines in commodity prices will be detrimental to the export earnings of a large number of countries that are major exporters of commodities. Non-energy commodity prices are predicted by the World Bank to decline by 19 per cent in 2009.[10] 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. The price of oil fell by more than 70 per cent in the second half of 2008. Other prices followed suit. The dilemma facing many such commodity exporting countries is well illustrated by the case of South Africa, a major exporter of the platinum group of metals (PGMs). As the price of these declined, the country, already with a large balance-of-payments deficit, faced further pressure on its trade account, and saw the value of its currency, the rand, declining precipitously further—by almost 40 per cent—against the US dollar. PGM mining companies have recently announced the retrenchment of around 10,000 workers. Significant foreign investments in the country's mining industry have also been put on hold (Te Velde 2008).

But it is not just commodity-dependent countries that will be adversely affected. A recession in the United States and other G7 countries will in general reduce the demand for their exports, as these markets are important destinations of developing-country exports. A significant proportion of US imports are from developing countries. Many of these imports are also imports of services, not just goods. Thus, there are already signs that India's software sector, which exports IT services to the United State, for instance, and other advanced economies are registering slower growth.

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

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9 See www.imf.org/external/pubs/ft/weo/2008/update/03/.

10 See the World Bank (2008) at www.worldbank.org/external/default/main?contentMDK=0666027&menuPK=612515&theSitePK=612501&pagePK=2904583&piPK=2904598 .

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, such as Mauritius, 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. But for many other countries again, the crisis comes at a time when their own foreign reserves are at historically high levels. Such countries include China, Russia, Korea and others. In total, developing countries' foreign reserves now amount to over US$6 trillion. This will play an important role in cushioning the impact of the crisis.

3.1.3 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. Cali, Massa and Te Velde (2008) estimate the decline in financial resources to developing countries to be around US$300 billion. ActionAid gives a higher estimate of US$400 billion on the decline.[11]

With regard to ODA, although most advanced countries committed themselves to the 2002 Monterrey Consensus on Financing for Development to provide at least 0.7 per cent of GNP as aid to developing countries, it was clear at the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus in Doha in December 2008, that few countries could meet this commitment. 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. Following the Doha Declaration on Finance for Development, most developed countries recommitted themselves to maintaining, and even accelerating where possible, their aid commitments. As will be argued below, despite the possibility that total aid may decrease, this may in fact be avoided, given that aid is relatively small compared to the money spent on bailing out the US financial system, given that there is no more room for fiscal expansion in the donor countries, and given the rise of 'new' donor countries such as China and India[12] (McCormick 2008).

Second, 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. The costs of sovereign bonds and commercial debt—both important sources of finance

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[11] See www.actionaid.org.uk/101543/press_release.html.

[12] It has recently been reported that India has committed itself to extend credit lines to Africa by US$5.4 billion, to donate US$1 billion to Africa's satellite and fibre-optic network and to work towards tripling trade by 2014 with Africa (currently worth around US$35 billion per annum) (Majumdar 2009).

for developing-country governments—have risen sharply.[13] Similarly, FDI is declining. While FDI to developing countries grew tremendously over the past seven years to a record high of over US$500 billion by 2007, it is expected that FDI flows to these countries will decrease by 10 per cent in 2008 (UNCTAD 2008: 33). Cali, Massa and Te Velde (2008) document that FDI to countries such as Turkey and India declined by 40 per cent in 2008, greatly adding to their balance-of-payments constraints. In many parts of Africa the decline in commodity prices is likely to compound the reduction in FDI, as most FDI to the continent is resource-motivated.

Third, 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. At the time of writing, the trade finance gap has been estimated at US$25 billion (WTO 2008).[14] Although this seems relatively small, it has important knock-on effects. Consequently, there will be dual pressures on developing-country trade: reduced demand for their exports and reduced trade credit.

Fourth, 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 (for example Mexico and the Caribbean) and small states such as Lesotho, Haiti and Nepal (where remittances contribute in excess of 10 per cent to GNP) 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 (Ratha et al. 2007).

3.2 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 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. Given that there are still around 1.4 people billion living in extreme poverty (Chen and Ravallion 2008), and that progress towards the Millennium Development Goals (MDGs) has been slow, it is clear why the possible impact of the factors described in section 3.1 is a rising concern. Consequently, various predictions have been made as to the possible outcome of the current economic crisis for developing economies. In section 3.2.1 these are reviewed, and in section 3.2.2, the impact is evaluated, leading to a more upbeat conclusion.

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13 Hostland (2008) records that average sovereign bond spreads increased from 325 base points in August 2008 to 660 by October 2008.

14 See www.wto.org/english/news_e/news08_e/gc_dg_stat_12nov08_e.htm.

3.2.1 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? The IMF forecasts average world growth to decline to 3.0 per cent in 2009, down from 5 per cent in 2007 (IMF 2008). The United Nations baseline forecast for world growth projects a decline from 2.5 per cent in 2008 to 1 per cent in 2009. Their worst-case scenario sees a contraction of 0.4 per cent in the world economy in 2009 (UN-DESA). 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 2009 (World Bank 2008). 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, as Harsch (2009) shows, many of these countries are more resilient than before, and expectations are that African countries will continue with good growth in 2009, of around 4.7 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 7 to 8 per cent in 2009. Some commentators, though, have expressed concern that if Chinese growth should dip below 8 per cent, it could contribute to internal dissent, as high growth rates are needed to absorb the growing waves of labour market entrants (see, e.g., Brown 2009). Whether or not this will materialize, what is important to note for present purposes is that future developments in China will be important for the eventual extent of the impact on developing countries. China (and also other large emerging markets such as Brazil, India, Russia and to a more regional extent, South Africa) plays an increasingly important role as a catalyst of growth in many developing economies, through the demand for commodities and other goods, and also as a new source of development aid and finance. Continued growth in China could, therefore, cushion the impact of the reduction in demand from the US and EU.

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 20 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.[15] According to reports, the World Bank expects 40 million people to fall into poverty as a direct result of the crisis.[16]

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

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15 See www.ilo.org/global/About_the_ILO/Media_and_public_information/Press_releases/lang-en/WCMS _099529/index.htm.

16 See www.guardian.co.uk/business/2008/nov/12/world-bank-poverty-developing-nations .

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. Ravallion (2008), for instance, argues that, 'not all of the poor will be affected. Indeed, some will be protected by the same things that have kept them poor in the first place—geographical isolation and poor connectivity with national and global markets'. One implication is that the urban poor in developing countries may be disproportionately affected. More research is clearly needed in this regard.

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.

3.2.2 Discussion

In evaluating the impact of the financial crisis on developing countries, I have first set out the channels through which the impact can be driven, and then reviewed the expectations of how substantial these impacts will be. Now I 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. In essence, the crisis will expose countries with poor macroeconomic management and poor financial institutions. But having said this, many large emerging countries could overcome the crisis in a relatively short period of time. There are various reasons for this belief.

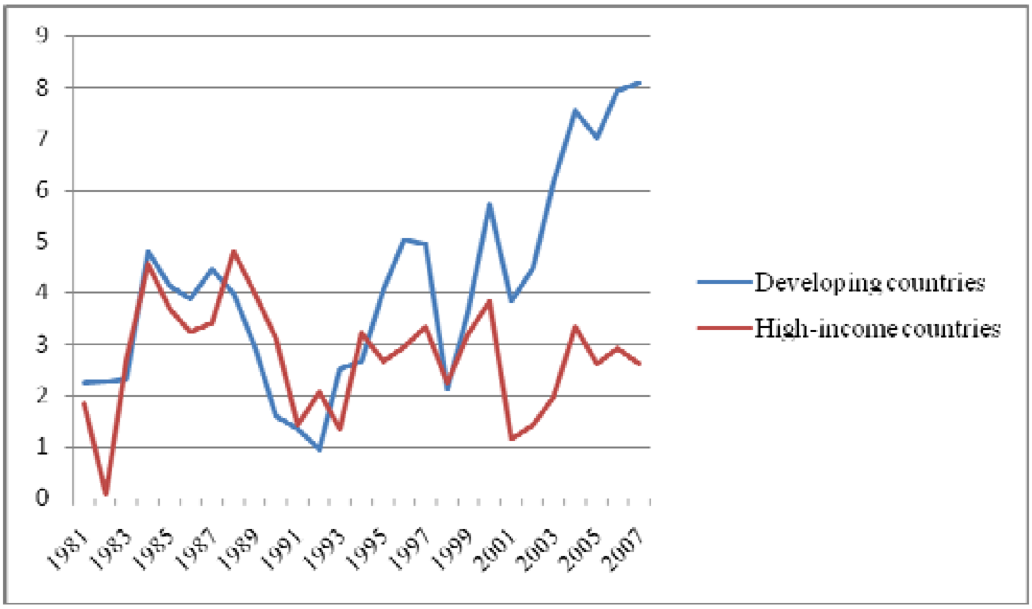
First, the epicentre of the crisis is in the developed countries. The crisis is unlike many of the previous 123 financial crises in that it comes as an exogenous shock and not because of inappropriate domestic policies, as in the past.

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. Te Velde (2008) and Lin (2008), for instance, 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.

Figure 1 shows that since the 1990s, there has been a decoupling of growth rates between developing countries and high-income countries. It also shows that by 2007, the growth rate of developing countries as a group reached 8 per cent—a historical high—after an almost uninterrupted acceleration since 2001. Although the total growth

Figure 1
GDP growth in developing and high-income countries, 1981-2007



Source: Authors' calculations based on World Bank Development Indicators Online.

rate does not give an indication of individual countries' growth rates, it is also true that growth in some of the poorest countries, most notably of those in Sub-Saharan Africa, also accelerated over this period. Although the financial crisis and the recession in the rich countries will slow this growth momentum, it will not stop growth, and at the time of writing it seems that a full-out recession in the developing countries may be avoided in general. Accordingly, the World Bank's *Global Economic Prospects* forecasts growth in developing countries to average around 4.5 per cent in 2009.

Fourth, many developing-country economies are much more resilient as a result of good growth, better policies, and having learned lessons during the 1998 Asian crisis. To take a few examples; after its financial crisis in the 1980s, Chile improved its supervision of banks and limited banks' risk taking. Consequently the country's banking system has not been seriously affected, and in fact its central bank had already started accumulating reserves in April 2007. After the 1998 Asian crisis, affected countries in the region adopted the Economic Review and Policy Dialogue, the Chiang Mai Agreement, and the Asian Bond Markets Initiative, all of which contributed to financial development and stabilization in the region (see Kuroda 2008). Moreover, after the Asian crisis the IMF's financial sector assessment programme (FSAP) was launched and many developing countries benefited from its evaluation of the friskiness and regulation of their financial systems. It is telling that the USA, until very recently (when it was already too late), refused to be subject to the FSAP process.

Five, despite the slowdown in the G7, all predications are that the largest emerging economies, China and India, will continue to grow, as expected.

Six, both advanced economies and a number of developing countries have introduced significant countercyclical fiscal expansion packages. Barack Obama, as US President-elect, proposed a fiscal stimulus package intended to create 2.5 million jobs mainly through public infrastructure investment.[17] 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. As part of the latter the EC encouraged members states to facilitate the start-up of new firms through regulatory reform such as reducing the regulatory requirements for new firms, minimum capital requirement for a start-up to be set at zero, to enable new firms to be registered within three days, and to limit the paperwork to one procedure.[18]

The largest developing countries are following suit. China, Korea and India, for instance, are reported to have announced fiscal stimulus packages of respectively US$586 billion, US$11 billion and US$60 billion. 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 favour 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

There is no 'commonly accepted theory of financial crisis' to provide fail-proof advice on the correct policies that each particular country should adopt in the wake of the crisis (Jonung 2008: 566). However, 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.

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17 See www.cnn.com/2008/POLITICS/12/06/obama.jobs/ .

18 See www.ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf .

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. Areas for greater coordination in the latter include, for instance, coordination in bailouts to avoid a 'race to the bottom', as different countries all rush in to provide subsidies to their different ailing industries, as well as for better coordination of the responses of central banks.[19]

Immediate and short-term policy responses are required to ensure that (i) the financial crisis is contained, (ii) that confidence in financial systems is restored and that (iii) 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.

Table 1
Summary of responses to the financial crisis

Timeframe	Objective	Policy options
Immediate	Containment of financial panic	• Guarantee bank deposits • Guarantee interbank loans • Provide liquidity to banks • Forbearance on regulations
Short term	Resolution measures	• Recapitalize banks • Mergers and acquisition in financial sector
	Monetary expansion	• Reductions in the costs of borrowing • Raise inflation targets
	Fiscal expansion	• Increase in spending on social safety nets, including conditional and unconditional grants and public works
	Trade expansion	• Lowering of protective measures • Maintain competitive exchange rates
Longer term	Domestic financial development	• Increase the access to finance • Improve domestic resource mobilization • Improve efficiency of banking sector • Avoid financial repression • Improve supervision and regulation • Strengthen property and contract rights, judiciary and rule of law • Proceed, but with caution, with financial openness
	Reform of international financial architecture	• Move to a more inclusive system of global financial governance • Improve the share, efficiency and management of global aid system • Reform Bretton Woods Institutions

Source: compiled by the author.

19 As James (2009: 2) remarks, 'the failure to find a supranational mechanism for dealing with Europe's large and internationally active banks is rapidly developing into the Achilles' heel of the continent's ambitious project to build a monetary union. The European Union's governing bodies can only leave bank bailouts and their fiscal implications to national authorities'.

Table 1 summarizes the key policy responses in a highly stylized manner. Apart from the longer-term policy imperative of financial development, other measures, where possible, should take cognisance of the current approaches followed in the affected rich countries—although they need not, or should not, be the same. As will be argued here, developing countries' responses will depend on their own unique circumstances, and should approach carefully on issues of bank nationalization, bailouts, expansionary monetary policies and financial openness.

4.1 Immediate responses

Table 1 lists immediate responses to the crisis as including (i) containment and resolution measures to stop the crisis, restore confidence in banks and improve their health, and (ii) 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 ('lender of last resort' facilities) 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. Thus the United States government nationalized their two largest mortgage lenders, Fanny Mae and Freddie Mac, and governments from the UK, France, The Netherlands, Belgium and Germany recapitalized failing banks and extended guarantees on bank deposits and interbank loans. In total, almost US$3 trillion was allocated for the support of financial institutions in these countries.

Developing countries should avoid, where possible, following the example of the US or EU in nationalizing banks if their collapse can otherwise be prevented. An essentially private sector-based financial system, characterized by sufficient competition but with strong oversight and sufficient capital adequacy, remains the best option for developing countries. In contrast, while nationalizing banks may be a short-term emergency measure to prevent banks from failing, it creates a number of longer-term difficulties such as moral hazard, opportunities for rent-seeking, and directed/distorted lending, all of which compromise economic efficiency. It is also difficult to assess risk in a nationalized bank, which will make adherence towards the Basel Accord more difficult. It is useful to consider that whereas the present crisis was triggered by defaults on mortgage lending by the private sector and by 'toxic' assets securitized by private sector firms, the 1998 Asian crisis was triggered by defaults on state-directed credit to nonperforming firms. State-ownership of banks, therefore, does not guarantee that crises can be avoided and brings problems of its own.

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. An example here is Hungary, where like in many other new European Union member states, a sizeable (more than 50 per cent) share of its banks is in foreign ownership. When these were affected by the September credit crunch, they stopped lending operations in Hungary, resulting in knock-on effects on its currency and the balance of payments to such an extent that the country required an IMF bail-out. 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, as was mentioned. 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. Indeed, it may be argued that now is the opportunity for many countries to implement and/or strengthen their social safety-nets. Safety-net programmes should include both unconditional and conditional cash transfers to poor households, and public works programmes (Ravallion 2008).

But given the need to attract finance and encourage the profitability of their domestic banking sectors, many developing countries will probably not have the leeway for expansionary monetary or fiscal policies such as are being followed in the EU and US. For one, there are a number of countries, particularly amongst the least developed countries, with little fiscal or current account leeway (Hostland 2008). 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. A number of countries, such as Belarus, Hungary, Iceland, Pakistan, Serbia and Ukraine, have already requested IMF assistance or indicated that they may require this in the future. South Africa and Turkey may need assistance in the future. Both the World Bank (US$100 billion) and the IMF have announced increases in the amount of funds they will make available to countries. 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 (especially important now in China), 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). Heinemann (2008) points to a number of ways to get out of a liquidity trap in the midst of a credit crunch. 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. Heinemann (2008) favours a proposal for the US Federal Reserve (or analogously central banks in large developing countries) to temporarily guarantee a lower limit on stock prices. This could protect banks' balance sheets from further declines in value. Another option would be for China and other developing countries (with their US$6 trillion in foreign exchange reserves) to invest in stock markets across the world.

4.3 Longer-term responses: financial development

As indicated in Table 1, 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. It is also important for economic diversification, the growth of entrepreneurship, and for the efficient application of fiscal and monetary policies. Over the past decades many developing countries have seen much progress in financial development, such as improvements in banking regulations since the 1998 Asian crisis, improvements in micro-credit provision, and in finance-friendly reforms in legal systems, contractual and property rights, and rule of law. Countries should build on these and avoid this crisis from derailing their progress—any action that limits financial development, such as capital controls, low/negative real interest rates, government ownership of banks and directed lending for instance, is likely to be costly for developing countries.

Moreover, countries should prioritize a number of measures for further financial sector development. A recent two-year research project by UNU-WIDER on 'Financial Sector Development for Growth and Poverty Reduction' made a careful study of these. Three recent books from this project contain important policy guidance in this regard (see Addison and Mavrotas 2008; Guha-Khasnobis and Mavrotas 2008; Mavrotas 2008).

As is summarized in Table 1, countries should proceed, but with caution, with financial openness (liberalization). This is because financial openness, which is a distinct and necessary part of financial development, can increase a country's vulnerability. Jonung (2008) gives a good discussion of the Nordic countries' financial crisis of 1992-93 and shows that policymakers here fundamentally misunderstood financial deregulation and liberalization as 'minor technical adjustments of no major consequence for economic performance' (ibid.: 582). More generally though, there is little empirical evidence in the literature that financial liberalization and openness have strong positive effects on economic growth (Obstfeld 2008). However, financial openness is a requirement—and an outcome—as countries' openness to trade increases. Therefore, 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 (Obstfeld 2008) but also extending and strengthening bank supervision and regulation. There is also a good case now to be made for regulations and supervision to extend to all institutions involved in leveraging—not just banks.

4.4 Longer-term responses: reform of the international financial system

As Table 1 indicates, 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. Now, as described by UN-DESA (2009: 28):

> Developing countries as a group are net creditors to the rest of the world, and their savings will quite likely provide, directly or indirectly a major source of funding to cover the costs of the multi-trillion dollar bailouts of financial institutions in the United States and Europe.

Currently the G7/G20 groups of countries are coordinating responses—but these countries are hardly representative (James 2009). 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.

Table 1 also suggests that the system of global aid needs to be reformed. A large literature has emerged in recent years on proposals to improve aid effectiveness, which include, *inter alia,* finding innovative sources of development finance (such as a carbon tax), increasing the share of multilateral aid (most current aid is bilateral), improving the management of aid, pushing forward with aid for trade initiatives and facilitating mechanisms for encouraging private sector aid. The UNU-WIDER projects on 'Development Aid: A Fresh Look' and 'Innovative Sources for Development Finance' resulted in a number of publications which contain detailed suggestions on these and others aspects related to aid (see Atkinson 2004; Mavrotas and McGillivray 2009).

Finally, there are widespread calls for the reform of the Bretton Woods Institutions, the IMF and World Bank. These institutions have been largely marginally in the response to the financial crisis, despite the fact that this was what they were initially designed to prevent and cure (James 2009). One reason is the lack of sufficient funding—the IMF, for instance, does not have the resources to bail out the US. Another is IMF conditionality, a reason why many developing countries have been self-insuring against balance-of-payments problems by accumulating such massive foreign exchange reserves since the 1998 Asian crisis.

The IMF is widely seen not to have any influence over the US (see, for instance, the United States' long refusal to submit to the FSAP), nor to have the mandate to address developing countries' concerns about speculation being the driver of food and oil price hikes. A full discussion of these calls and their merits fall outside the scope of this paper, but nevertheless, what is clear is that, at a minimum, IMF's lending capacity and resources need to be increased, its mandate broadened, its facilities simplified and its multilateral surveillance improved.

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 Concluding remarks

The likelihood of an economic slowdown in the world economy will mean a slowdown in economic performance in most developing countries during 2009. The epicentre 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, it has been argued in this paper that there are many and various channels for the impact to affect countries differently, depending on the extent to which they are vulnerable to particular channels. Smaller, highly indebted countries significantly dependent on the US economy will be most severely affected. However, many developing countries, from many in Africa to the large emerging markets of Brazil, China and India, will continue to grow at relatively strong rates, cushioning the impact for others.

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 (many countries have learned important lessons during the previous financial crises) have resulted in more robust economies in the developing world (there are, of course, exceptions). So this analysis suggests a more optimistic prognosis of the current situation. 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 in all likelihood reverse further declines in stock and housing prices, and that will boost investment and growth. In line with this more optimistic prognosis, it may be possible for many individual developing countries to manage the impact of the crisis through appropriate policy responses.

Just as fundamental as the need for appropriate short-term crisis management is the need for developing countries to further their financial development. Despite progress over the past decade, much remains to be done. This crisis has shown how important credit and risk-management institutions are to economic growth, and it has shown how important appropriate institutions (including appropriate 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. Countries, like China, have a particularly important role to play, given their substantial international reserves as well as their own need to reform and improve their own financial institutions. Here, as in many other countries around the world, a growing middle class is demanding more sophisticated financial products such as credit cards, internet banking, and flexible mortgages to name but a few which, without doubt, will result in an expansion of credit, mortgage lending as well as further financial innovation. Indeed, future financial innovation may largely by 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.

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