The Impact of the Financial Crisis on Developing Countries

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Outline

- Why was the global economy so dynamic in 2002-07?
- Why has that dynamism collapsed in developed countries, and what will be the effect on emerging markets & poorer countries?
- What policy responses – by developing countries, IFIs, and developed countries – will limit the damage?

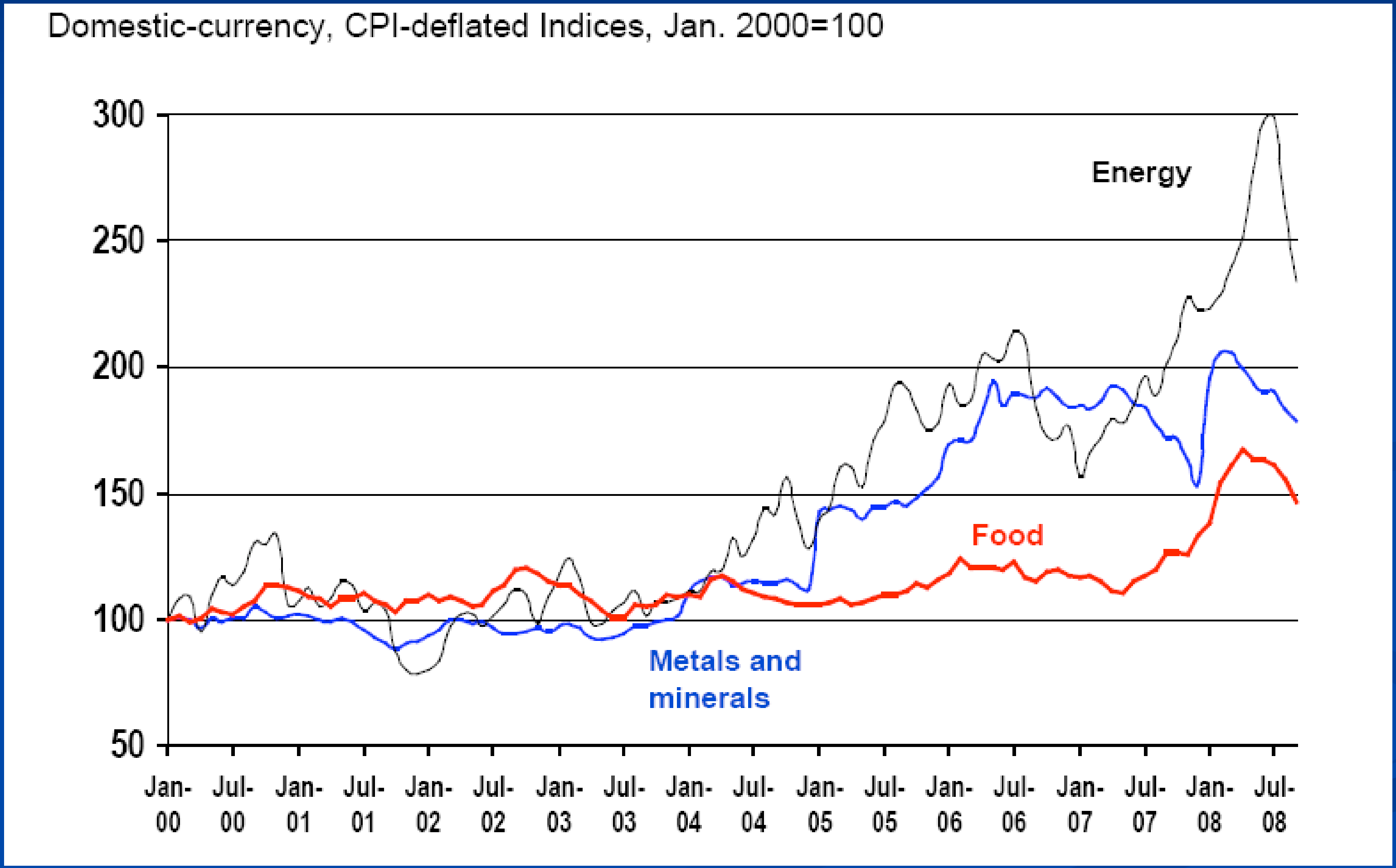
Sources of dynamism in 2002-07

- Developed economies
  - Expansionary US monetary policy and very low interest rates in the wake of dot-com bubble burst
  - Expansionary US fiscal policy of tax cuts and defense/ security spending
  - Inflation of housing market bubbles in US and other developed economies → consumption boom
  - High levels of financial innovation in search of higher yields

Sources of dynamism in 2002-07 *(continued)*

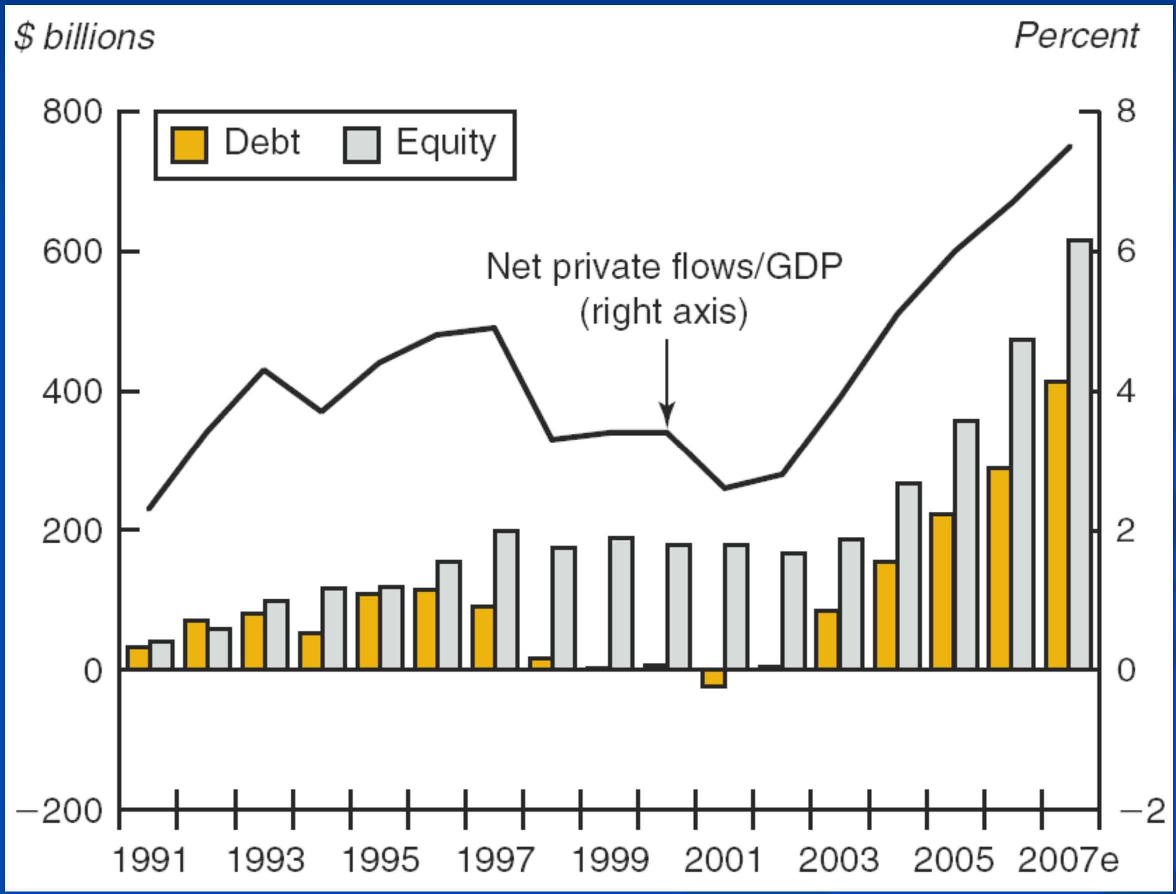
- Developing economies
  - Past improvements in macroeconomic policies had lain the foundations for rapid growth in this decade
  - Investment boom fueled by:
    - Strong export demand and high commodity prices, thanks to large US CA deficit and strong growth in China and India
    - Surge in FDI, as well as other private flows
    - Strong remittances form workers abroad
  - Investment surge increased demand for capital goods from developed countries, fueling virtuous cycle of growth

Real commodity price indices, 2000-08



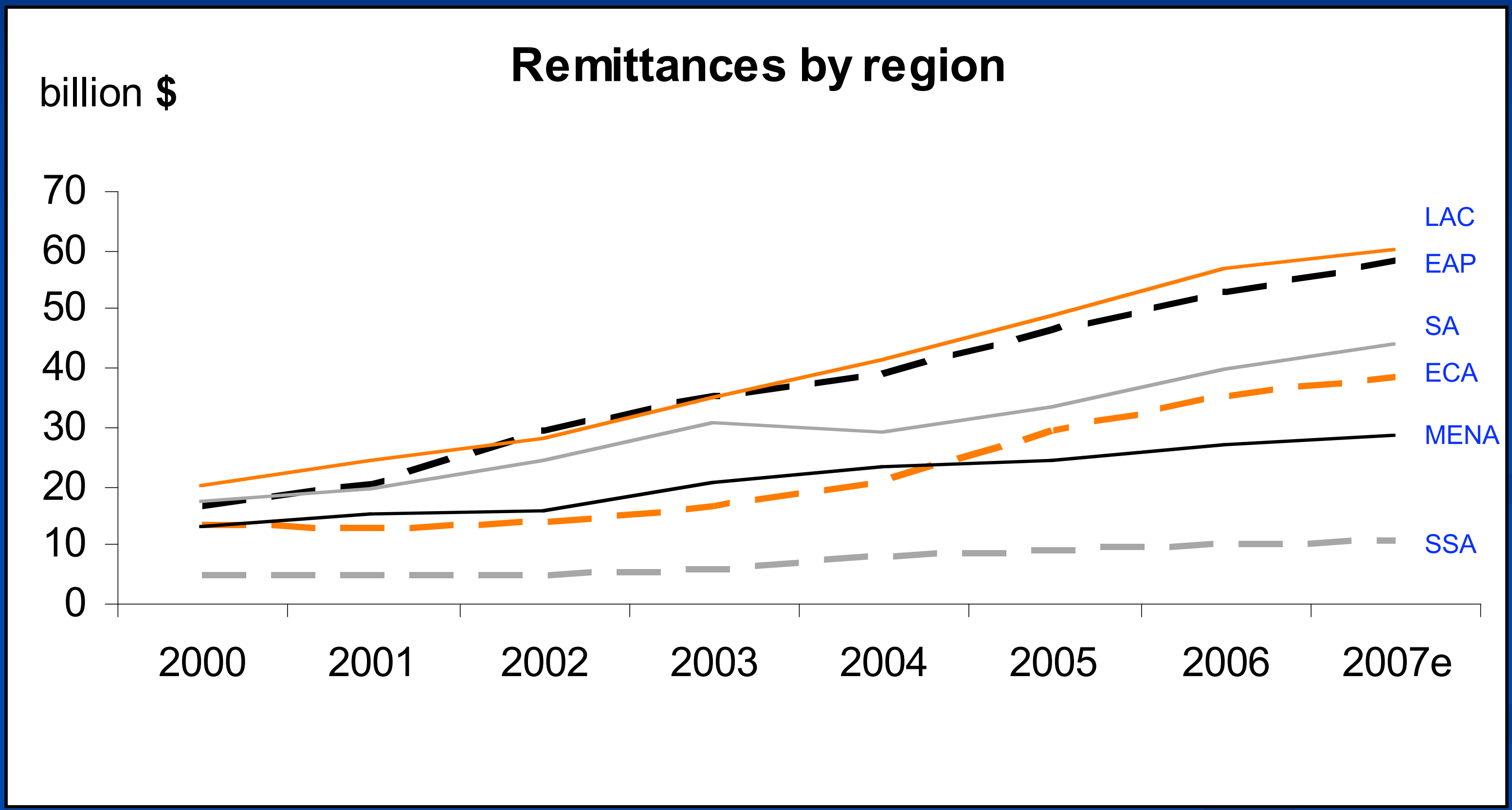
Source: World Bank data

Private capital flows to developing countries, 1991-2007



Source: World Bank, *Global Development Finance 2008*

Remittances to developing countries, 2000-07

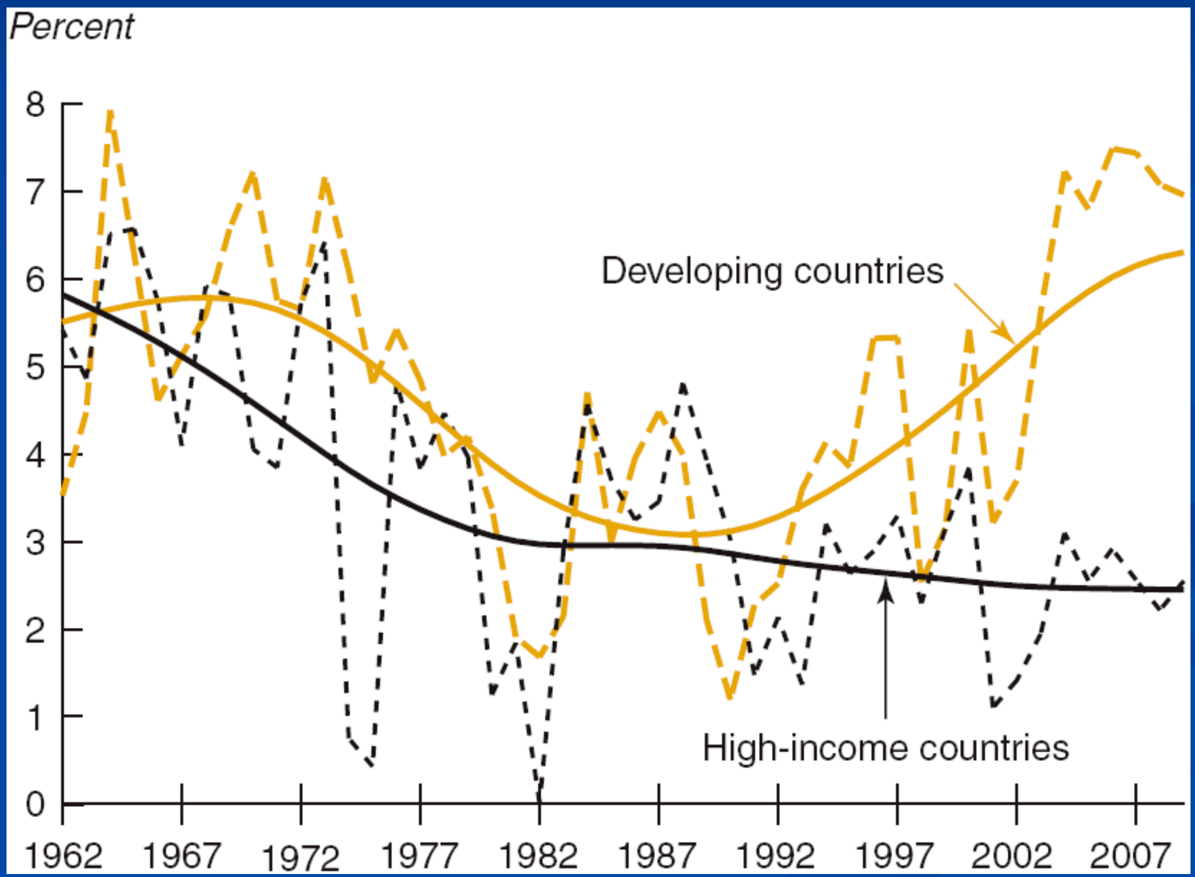


Source: World Bank, *Global Development Finance 2008*

Rapid growth with growing vulnerabilities

- Result was rapid global growth, especially developing countries
  - From 2003 to 2007, developing-country growth exceeded 5 percent every year, peaking at 7 percent
  - Most rapid growth in more than 4 decades
- But also large and growing vulnerabilities, especially in developed countries
  - Unsustainable double-digit increases in housing prices
  - Twin deficits in US, including large balance-of-payments deficit
  - Financial innovations also created vulnerabilities

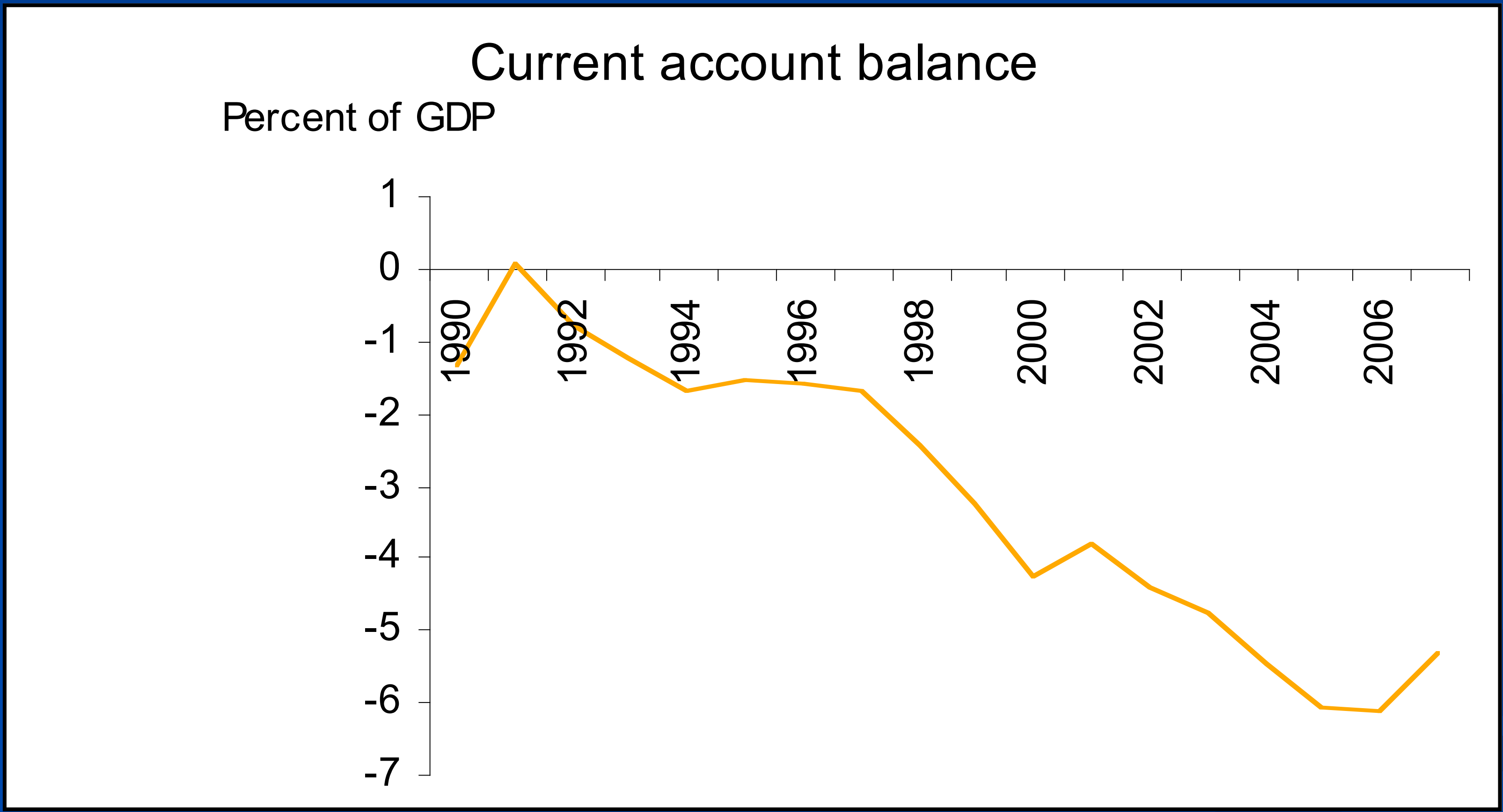
GDP growth of developed and developing countries, 1962-2007



Source: World Bank, *Global Development Finance 2008*

Note: Solid lines show smoothed trend

US current account balance, 1990-2007

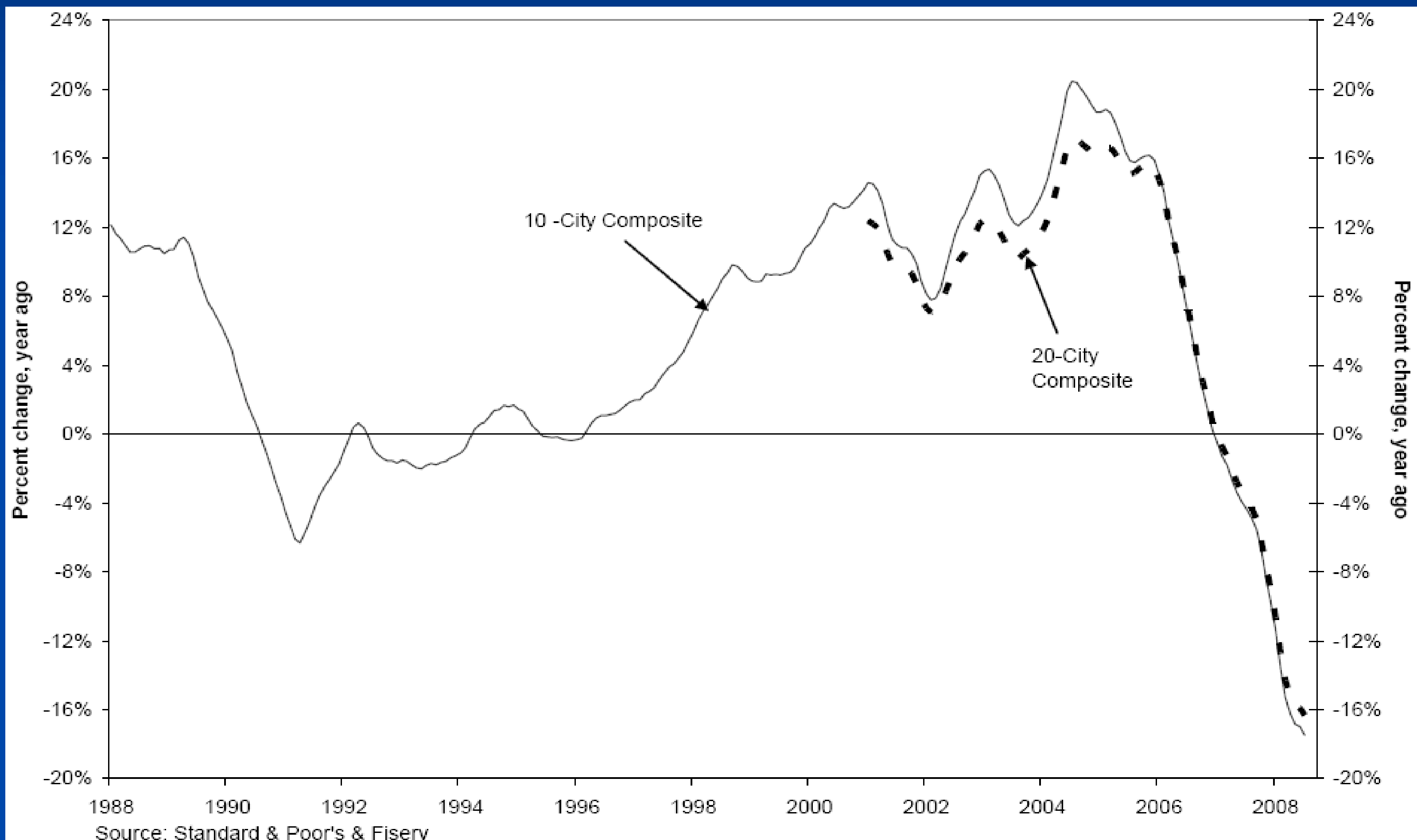


Source: World Development Indicators

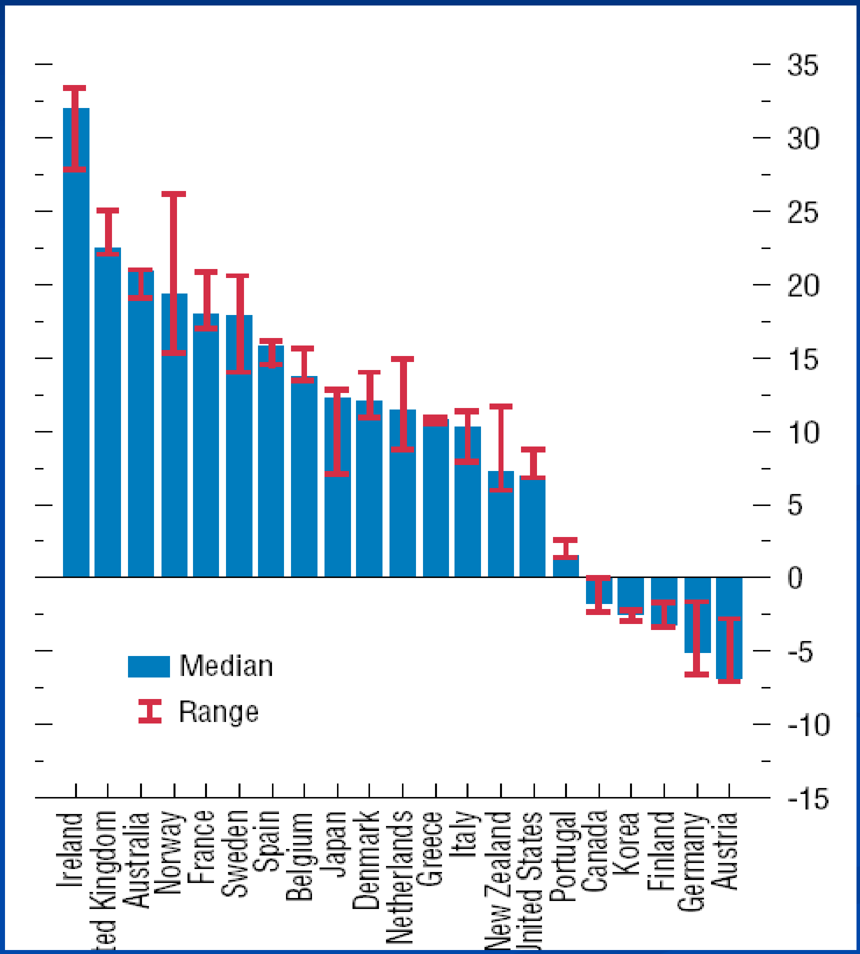
Causes of the collapse

- Sources of dynamism became causes of collapse
  - Bursting of the housing bubble → crisis in subprime mortgage market
  - Financial innovations amplified risk rather than sharing and dampening it
- Problems originated in the US, but with parallels and repercussions in other developed economies
  - Housing bubbles in numerous other countries too
- Result: Sharp economic slowdown
  - Growth in US, Euro area, Japan now all predicted at zero or slightly negative for 2009

Changes in US housing prices, 1988-2008
(S&P/Case-Shiller Home Price Indices)



Housing price gaps (as of end-2007)



Source: IMF *World Economic Outlook* (October 2008)

Effects of the collapse on developing countries

- Sharp decline in the sources of financing for investment in developing countries
  - Possible decline in world trade volumes in 2009, combined with further fall in commodity prices
  - Fall in inward FDI and portfolio investment (already seen in 2008), together with higher interest rates on capital
  - Drop in remittances as developed-country labor markets slacken
- Second-round effects that could exacerbate crisis
- Threat: not just slowdown, but crises of their own

Implications for developing countries

- First priority: Prevent contagion to the financial sector
- Monetary policy
  - Little potential for developed economies to use it; but
  - Developing economies can use monetary easing to promote industrial upgrading in sectors with comparative advantage
- Fiscal policy
  - Finance creation and upgrading of infrastructure – useful to catch up, after period of rapid private-sector growth
  - Fund social safety nets and investments in education and health – investment in future productivity of the economy
- Key: increase demand counter-cyclically to the extent that is consistent with protecting fundamentals

Implications for IFIs

- IMF
  - Can provide balance-of-payments to help offset the expected decline in private capital flows
- World Bank
  - Can finance infrastructure and social investments outlined above
  - IBRD for middle-income countries: Has enough financial headroom to double IBRD lending, from about $13 billion in FY07
  - IDA for low-income countries: Record replenishment of $42 billion over 3 years under IDA-15

Implications for developed countries

- Not my main focus, because much has been written about developed-country policy already
- But a development perspective offers some lessons:
  - Countries must move quickly to reach consensus on sharing of costs of adjustment *(e.g., as in Korea in 1980 and 1998, vs. the lost decade in Latin America)*
  - Developed countries must not exacerbate crisis effects on developing countries by blocking trade or reducing aid

Lessons for economic management

- Governments should consider carefully whether to use monetary policy also to control asset price inflation
- Financial supervision should be based on the recognition that innovations can do damage
- Responses to global crises must be systematic, comprehensive, decisive, and coordinated
- Global problems require creativity and a willingness to try new multilateral solutions