The Impact of the Financial Crisis on Developing Countries

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Outline

- Why was the global economy so dynamic in 2002-07, especially for the developing countries?
- 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 Countries

- Dot-com bubble burst and expansionary US monetary policy
- Inflation of housing market bubbles in US and other developed economies → consumption boom
- Deregulation and high levels of financial innovation in search of higher yields
- Expansionary US fiscal policy of tax cuts and defense/security spending after 911
Sources of dynamism in 2002-07: Developing Countries

- Past improvements in macroeconomic policies had lain the foundations for rapid growth in this decade
- Investment boom fueled by:
  - Surge in FDI, as well as other private flows
  - High commodity prices, thanks to strong growth in China, India and other developing countries
  - Strong remittances form workers abroad
  - Strong export demand
- Surge increased demand for capital goods from developed countries, fueling virtuous cycle of growth
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
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
  - Exposures to US Subprime mortgage markets
  - Housing bubbles in numerous other countries too

Impacts:
- Availability and Costs of credit
- Wealth effect

Result: Sharp economic slowdown
- Growth in US, Euro area, Japan now all predicted at zero or slightly negative for 2009
Effects of the collapse on developing countries

- Sharp decline in export
- Sharp decline in the sources of financing for investment in developing countries
- Fall in inward FDI and portfolio investment (already seen in 2008), together with higher interest rates on capital
- Fall in commodity prices
- Drop in remittances as developed-country labor markets slacken
- Second-round effects that could exacerbate crisis
- Project incomplete
- Project complete become excess capacity
- Threat: not just slowdown, but crises of their own
**Implications for developing countries**

- **First priority**: Prevent contagion to the financial sector
  
- **Monetary policy**
  - With the declines in commodity price and inflation, the government 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 and to avoid financial crisis to turn into human crisis
Implications for IFIs

- **IMF**
  - Can provide funds to help offset the expected decline in private capital flows for countries with a payment of balance crisis.
  - Japan’s Initiative: Foreign reserve-rich countries could contribute funds to IMF.

- **World Bank**
  - Can finance infrastructure and social investments and provide emergent humanitarian supports outlined above.
  - IDA for low-income countries: Record replenishment of $42 billion over 3 years under IDA-15.
  - IBRD for middle-income countries: Has enough financial headroom to double IBRD lending, from about $13 billion in FY07.
  - IFC could recapitalize the local banks.
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
- Avoiding financial crisis becoming humanitarian crisis