

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 laid 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 from 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

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- 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