ANALYSIS ONE
POLICY OPTIONS

Neil McCulloch

Summary
The debate in rich countries about the impact of the global financial crisis has largely ignored its impact on developing countries. But the instability in financial markets around the world is already spilling over to the ‘real economy’ in poorer countries around the world. It is vital that policymakers from both North and South understand how this crisis may impact developing countries and the implications for development policy.

This briefing examines the causes of the current financial crisis and how it is already affecting developing countries – based on ‘snapshot’ briefings by key thinkers, academics and policymakers in 14 developing countries. It also examines three key policy implications:

- the impact on aid,
- appropriate social protection measures
- a fairer financial architecture.

Causes of Crisis
Although much attention has been focussed on the problems in the sub-prime mortgage market in the US as the trigger of the current crisis, it is important to recognise that the origin of the crisis lies in the interaction between at least three factors:

1. The extraordinary accumulation of reserves in surplus countries (notably China and the Middle East) – mirrored by huge US fiscal and current account deficits. In effect, excessive saving in a set of developing countries has funded excessive consumption in the world’s richest economies.

2. The application of expansionary monetary policies in the OECD, giving rise to low interest rates, helped to create the housing market bubble which has now burst.

3. Financial innovation in developed countries, in the form of securitised mortgages, expanded leverage, and poorly regulated derivative instruments, which allowed some major financial institutions to become dangerously exposed.

While these three factors have played an important role in making the financial system more susceptible to crisis, for many developing countries the seven year period prior to the crisis was one of rapid growth, rising commodity prices, an improved macroeconomic situation and, critically, reduced poverty. The current policy dilemma is how to facilitate a rapid return to this relatively favourable growth pattern, whilst changing global financial governance to minimise susceptibility to crises.

Pathways through which the Crisis affects Developing Countries
The Institute of Development Studies invited key thinkers, academics and policymakers in 19 developing countries to present a brief ‘snapshot’ of the financial crisis from their own country’s viewpoint. Respondents identified seven pathways through which the crisis is affecting developing countries, Table 1 shows how these effects are already being felt throughout the developing world.
THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON DEVELOPING COUNTRIES

Exports: Export growth is already slowing markedly in several developing countries

Foreign Investment: Both portfolio and direct foreign investment have dropped dramatically in several countries as investors shy away from markets that are perceived to be riskier

Exchange rate: Sudden withdrawal of foreign capital from several developing countries has caused dramatic falls in their exchange rates. Companies and governments with substantial foreign-currency denominated debts may contract or even collapse as a result.

Higher interest rates: As foreign investors have withdrawn, risk premiums and interest rates have risen for developing countries on global capital markets

Remittances: A key concern for some countries (e.g. Philippines, Ethiopia) is the decline in remittances from workers in recession-affected rich countries

Declining aid: Many countries expect that aid from rich countries will decline as governments reassess their priorities. This could have particularly negative consequences for Africa

Lower growth: Ultimately the crisis will reduce growth in most developing countries endangering the achievement of the Millennium Development Goals

Impact on Aid

A particular concern is that slower growth and recession in rich countries will slow down or postpone increases in overseas aid. The 2002 Monterrey Consensus on Financing for Development urged developed countries to make ‘concrete efforts towards the target of 0.7 per cent of gross national product (GNP) as ODA to developing countries and 0.15 to 0.20 per cent of GNP of developed countries to least developed countries’. Since then, several countries have set ‘binding’ timetables to achieve this target. In 2005, at Gleneagles, the EU set targets for its 15 established members: 0.51 per cent of Gross National Income (GNI) in aid by 2010 and 0.7 per cent by 2015 (new member states will aim for 0.17 per cent and 0.33 per cent). A few countries have made more ambitious individual commitments (UK 0.56 per cent in 2010 and 0.7 per cent by 2013). The US and Japan have not set targets. Moreover, the Gleneagles Summit saw the G8 and other donors agree on a comprehensive package to double aid by 2010, with an extra $50 billion worldwide and $25 billion for Africa.

Even before the crisis, donors were not on target for achieving these targets. Now with the large additional fiscal costs of rescuing the banking system and additional expenditures to minimise the impact of the downturn, pressure will be placed on these aid commitments. Several developing countries are heavily dependent on aid flows (see Table 2). Almost two-thirds of net capital inflows in Sub-Saharan Africa come from ODA, a significant reduction in these flows would compound the shocks from others pathways forcing the countries concerned to contract sharply. There is therefore a strong case for meeting existing aid commitments to ensure that aid provides counter-cyclical relief to developing countries, rather than pro-cyclical distress. Many countries are already suffering depleted reserves as a result of the global food crisis earlier in the year.
Table 2: Aid matters, particularly to Sub-Saharan Africa

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<th>Developing</th>
<th>Sub-Saharan Africa</th>
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<tbody>
<tr>
<td>Average Percentage of Net Capital Flows (2000-06)</td>
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<tr>
<td>Private flows</td>
<td>84.9</td>
<td>38.4</td>
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<tr>
<td>Overseas Development Aid</td>
<td>19.5</td>
<td>65.4</td>
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<tr>
<td>Other official flows</td>
<td>-4.4</td>
<td>-3.9</td>
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<tr>
<td>Total</td>
<td>100.0</td>
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Designing Appropriate Social Protection

In countries hard hit by the crisis, there is a strong case for the expansion of appropriate forms of social protection to minimise the impact on the poor. An external shock of this nature will have different effects – and therefore require a different response – from policies put in place to tackle drought, disasters, or health shocks. However, the need for a fast response means that adapting existing programs may be more effecting than creating new ones.

Fortunately there is useful experience from the Asian Financial Crisis in 1997/98 to draw on. The key lessons from that experience were:

- Expand established safety net programmes rather than creating new ones.
- Protect pro-poor spending (not only health and education, but infrastructure too)
- Learn from other country experience about how to target social protection
  - a work requirement improved targeting in Argentina post-2001
  - food subsidies can help the poor, but are often poorly targeted and therefore expensive, e.g. Indonesia post-1997
  - unconditional cash transfers can be faster to roll out than more sophisticated conditional cash transfers such as PROGRESA in Mexico
- Macroeconomic stability is important for the poor too. Policies to maintain price stability and employment levels are key

The implementation of social protection programs depends on how the crisis affects aid. Much of Sub-Saharan Africa is heavily dependent on aid-funded social protection programs. Reductions in aid could both contract incomes and make populations more vulnerable. In Latin America – where most social protection programs are tax-funded and tax receipts are likely to reduce – it will be important for governments to prioritise social protection and pro-poor expenditures. However, maintaining infrastructure expenditure can also be pro-poor – during Structural Adjustment in the 1980s many governments attempted to protect social sector expenditure by cutting investment and this resulted in slower growth as the capital stock degraded.

Towards a Fairer Financial Architecture

A new financial architecture is needed to reduce the vulnerability of developing countries to macro-economic shocks. The current crisis may be the worst financial crisis to hit the developed countries in 80 years but crises in developing countries are more common. In the last ten years major financial crises have affected Argentina, Brazil, Russia, and the East Asian countries to name only a few. There is a need for both better regulation in the financial sector and better prevention of the accumulation of large and unsustainable macroeconomic imbalances that give rise to crises.
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If such a new architecture is to work, it must involve developing country governments in its design and implementation. This will clearly involve more rights (and greater responsibilities) for countries generating large surpluses – but it should not stop at this. Poor developing countries have played no role in creating the current crisis but they are likely to be significantly affected by it. A new system of international financial governance that institutionalises a mechanism for hearing the voices of poor countries, as well as larger and more ‘systemically important’ nations, is needed. The G20 grouping, although broader than the G8, includes only one country from Africa (South Africa) and not a single low income country.

Crises will still happen, even with a better framework for global financial governance. It is vital that the international community improves mechanisms for responding to crises when they occur. The US Federal Reserve’s currency swap scheme has played an important role in providing countries with immediate resources to support their currencies and the IMF has a Short-Term Liquidity Facility with similar aims. But the resources which are available under these schemes are limited and only available to a handful of countries.

For low-income countries the situation is even worse. The IMF’s External Shocks Facility provides loans to tackle shocks but resources are limited, there are strict eligibility criteria and high conditionality. The EU’s FLEX program attempts to achieve the same thing, but can take four years to disburse funds. Expanding such programs requires new sources of funding. These might come from a new international tax (such as a Tobin tax, to penalise short-term currency speculation); or they could come from higher contributions from large surplus nations. But to buy into such schemes, nations such as China would require a greater say in setting the agenda and mode of operation of institutions such as the IMF. The international community needs to use this extraordinary crisis as an opportunity to radically rewrite the rules of global financial governance to include the voices of the global poor.

Dr. Neil McCulloch is a Fellow at the Institute of Development Studies at Sussex University. He specialises in the study of the impact of globalisation on poverty and growth in developing countries. As well as his academic work he has lived and worked in both Africa and South East Asia in policy positions within government and international institutions. His current work focuses on the political economy of growth and the impact of the investment climate on firm growth and household poverty.