The Global Financial Crisis: Reflections on Impact on Developing Economies

Shyam Sunder, Yale School of Management
Nevsehir University, Nevsehir, Turkey
November 28, 2008
Difficulties of Generalization to Diverse Developing Economies

• Some 120 developing economies show great economic and structural diversity, making it difficult to find propositions that apply to them all
  – Oil exporting-importing
  – Manufacturing-agricultural
  – Financial sector developed-under-developed
  – Food importing-exporting
  – Capital importing-exporting

No Longer Sheltered from the Crisis

• In the initial stages of the crisis, the developing countries were relatively sheltered from the worst elements of the crisis
• This is no longer the case
• The crisis has intensified the cyclical downturn that was already underway in September
• Financial conditions have become much tighter—capital inflows dried up and huge withdrawals of capital
• Drop in equity values, sharply increased bond spreads—higher cost of sovereign and commercial debt
• Drying up of initial public offerings
Higher Interest Spreads and Lower Equity Valuations

- Sovereign bond spreads reached 650 basis points
- Commercial debt spreads at 900 basis points (up from 200 in June 2008)
- Depreciation of virtually all currencies relative to U.S. dollar (except Yen and Yuan) since September 15 (20 % on average for 18 developing currencies)
- Equity valuations dropped by an average of 25 percent (in local currencies), more in dollar terms
Severe Consequences of Continued Freeze in Credit Markets

• Unavailability of financing will choke off otherwise sound financial sectors
• Domestic productive sectors will be deprived of working and long-term investment capital
• A long and deep recession in high income countries is likely
• If these countries restore the flow of capital to productive sectors of the economy, the downturn could be milder
Sharp Cuts in Capital Flows to Developing Economies Expected

• If we assume that the waves of panic in the world’s credit and equity markets are controlled
• Still, the financial markets are undergoing significant deleveraging and banking consolidation; both these will cut capital flows to developing economies sharply
• Private flows are expected to decline from $1 trillion (7.7% of GDP) in 2007 to $530 billion (3 percent of GDP of the developing countries)
Impact of Food and Fuel Price Shocks

• The preceding rise in food and fuel costs imposed large fiscal costs on developing countries, limiting their capacity to respond to the financial crisis

• 57 percent of the countries cut taxes and 20 percent raised subsidies on food

• 27 percent of the countries cut taxes and 22 percent raised subsidies on fuel
Recent Drops in Food and Fuel Prices

• Most of the food and fuel price rises of 2007 and 2008 dissipated but prices remain much higher than in 2004-5
• Depreciation of local currencies raised the local costs even more
• At subsistence level families, this can lead to long term effects of health and education of children
• Reduction in caloric intake, weight loss, malnutrition
Permanent Damage from Malnutrition

- 44 million increase in the number of children suffering permanent cognitive and physical injury from malnutrition
- Burundi, Madagascar, Niger, Timor Leste and Yemen most affected
Commodity Prices Fall, Inflation Risk Persists

• The 2007-8 inflation picked up by about 5 percent and capacity tightened

• Now commodity prices and capacity constraints have eased

• But the risk of inflation remains because consumer prices may be less flexible downwards, and firms try to restore their profitability
Investment Will Suffer

• Investment was the main driving force in growth of developing economies in the recent years
• With slowing world growth, withdrawal of equity and term lending from the private sector, and higher interest rates combined with lower commodity prices will deter investment in the natural resource sector of the developing economies
Coordination and Careful Policy Design Needed

- Intervention in specific countries and their sectors tend to have undesirable and unintended spillovers other countries and sectors, necessitating careful consideration.
- How long should the interventions last?
- How to get back to “normal” from the intervention mode—exit strategies?
Dependence on High Commodity Prices

• Some developing economies that benefited handsomely from rise in commodity prices (and raised their spending accordingly) have a difficult adjustment ahead of them
• Many developing countries rely heavily on foreign financing
• Half of the developing countries have current account deficits of more than 5 percent of GDP
• One third of the developing countries have current account deficits of more than 10 percent of GDP
Consequences for Remittance Dependant Developing Countries

- 28 countries had remittances exceeding the most important commodity export
- 36 had remittances exceeding private and public capital inflows
- Estimated at $283 billion in 2008, beginning to slow down in second half, more in 2009
- Benefits of local currency depreciation
- Overall, expected to drop from 1.8 percent of local country GDP in 2008 to 1.6 percent in 2008
Multilateral Cooperation Essential

- Policy response necessary at individual country level
- Coordination at multilateral level necessary
- Coordinated provision of liquidity by major central banks
- Short term liquidity facility to mobilize large scale financing from IMF
- Donor countries to mean their Gleneagles commitments
- Reach agreement of Doha trade round
- Follow through on Bali commitments on climate change
Rethink Domestic Policies

• The financial crisis calls for some basic rethinking of their financial policies and regulation by developing economies
• Degree of integration and insulation from the global system
• Control of risk in the banking system
• Risk exposure of investment banks
• Ownership of the banking sector—public private
• Balance of total capital convertibility
Dealing with the Externalities

• How big is too-big-to-fail in the financial sector and what to do about it?
• Invisibility of a large part of the financial sector (credit default swaps market of $60 trillion); need a central registry/clearinghouse
• Opaque regulatory jurisdictions (tax haven) need to be subjected to the rules of the international community
• Do not forget regulatory competition
A Vigorous Crisis Multilateral Response

• The 20th Century global institutions (WB, IMF, UN) need reform in the 21st century
• Create a flexible network of interconnected institutions
• Bring in private enterprises as well as civil society organizations
• Create an inclusive and pragmatic new economic multilaterism to deal with trade, finance, development, climate change, energy, and fragile states
Thank You!

• Shyam.Sunder@yale.edu
• www.som.yale.edu\faculty\sunder