

THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON DEVELOPING COUNTRIES

ANALYSIS TWO

VIEWS FROM THE SOUTH: AN OVERVIEW

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Summary

The global financial crisis is already beginning to have an impact on the 'real economy' in poorer countries around the world. However, the debate in rich countries about the impact of the crisis has largely ignored its impact on developing countries, and the voices of thinkers from these countries are rarely heard.

This briefing represents snapshots of the financial crisis as seen by 21 thinkers, academics and policymakers in 14 developing countries – brought together by the Institute of Development Studies. As growth in these countries begins to slow their key concerns include reductions in exports, aid, remittances and foreign direct investment. They also explore three possible responses to the crisis: counter-cyclical spending, social protection and the creation of a new financial architecture.

The Impact of the Crisis Varies from Country to Country

Contributors from developing countries with relatively developed financial markets – India, Pakistan, Nigeria, Thailand, Brazil, South Africa, and the Philippines – have seen large falls in their stock markets. The Nigerian stock market has lost one third of its market capitalisation since the beginning of March; the Bombay Stock Exchange index is less than half of its previous peak; and the Sao Paulo Stock Exchange dropped by 60 per cent during October.

This has partly been caused by foreign investors attempting to repatriate their funds and a general flight to safety away from developing country markets which are perceived to be riskier. The Philippines has seen a reversal of net portfolio inflows of \$500 million between January and September of this year, compared to a net inflow of US\$ 3.4 billion in the same period last year. Sudden stops and reversals of external funding have affected exchange rates, leading to strong depreciations of domestic currencies: the Rand lost 35 per cent of its value between mid-September and mid-October; the Indian rupee hit a record low to the dollar.

However, despite this turmoil in the financial markets, many contributors state that the impact on their country so far has been remarkably limited to date – particularly those from the poorest countries. The relative lack of development of the financial sector in some countries may shield them from the worst of the crisis. For example, the Prime Minister of Ethiopia, one of the least monetised economies in the world, told Parliament '...we don't expect drastic effects on our economy, [because] our financial structure is not as liberalized as those of affected countries...'. Even some countries with well developed financial markets, such as South Africa, have been able to weather the storm because their government finances and international reserve positions are healthy.

The issue is complicated by the declining price of oil and other commodities. Contributors from Ghana, Sri Lanka, and Kenya – countries dependent on commodity exports – express concern about the impact that this will have on growth. However, the decline in oil prices is seen as a positive factor in most countries, providing space for the authorities to expand domestic demand because of the weakening threat of inflation.

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Almost all contributors point to a significant and sometimes a drastic slowing of growth. Brazil was expected to grow 5.2 per cent in 2008, its forecast for 2009 has been repeatedly revised downwards to 2-3 per cent; South Africa's growth rate will fall by slightly less than half; even Vietnam is only predicting growth of 6-6.5 per cent. This is particularly unfortunate since several developing countries had been experiencing their highest rates of growth for a decade prior to the crisis.

Four Common Concerns

Despite the variety of country circumstances, four concerns emerged strongly from almost all contributors.

The concern that exports will decline, or, in many cases already have begun to decline, due to slow growth or recession in the US and some European countries. In Bangladesh, where ready-made garments account for two-thirds of the country's total annual export income, orders from Europe and the US dropped 7 per cent in September, even before the worst of the crisis hit. The weakening performance of electronics and garments industries is a key concern in the Philippines, with year on year exports to the US down by 15 per cent. In Kenya, the cut flower industry is suffering as European customers are hit by the crisis.

Declining revenue from tourism is also a key concern. Both Kenya and Thailand's earnings from tourism have declined sharply in the past year. Political instability may be contributing, but the crisis is likely to exacerbate this trend. The crisis will also impact on the price of exports – the private sector in Sri Lanka is concerned about the falling prices of rubber, tea, coconuts and garments. Vietnamese producers are concerned that price competition will intensify, as large producers such as China increase exports to other developing country markets.

The concern that aid will decline. Contributors, from African countries in particular, anticipate a fall in aid receipts from donor countries as they reprioritise expenditure. Private foundations are already scaling down their budget allocations and contributors from Kenya, Ghana and Ethiopia all expect a decline in official aid.

The concern that remittances will decline. There is strong concern about the impact of the crisis on remittances. The Philippines' target for remittance income was US\$15 billion in 2008 – this may be missed as Filipino workers abroad lose their jobs. In Kenya, orders for *Mbuzi ya Jamii* (goat for the family) are down sharply at online stores that allow Kenyans abroad to pay for products and services for their families back home. But location matters – Bangladesh's 5 million expatriates are mostly based in the Middle East and Muslim countries less affected by the crisis, although this also may change as the oil price declines.

The concern that foreign direct investment will decline. In a few countries, the impact of the crisis on Foreign Direct Investment (FDI) is a significant concern. The Ethiopian Electric Power Corporation has indicated that its investment plans will be severely affected due to the crisis and in Vietnam, where FDI accounts for over a fifth of total investment, there is concern that planned investments may be postponed or cancelled.

Responses to the Crisis

Counter-cyclical spending will be key – but not always affordable. A noteworthy aspect of the responses was what was *not* said. Very few developing country governments appear to have given significant thought to how to respond to the impact of the crisis in the real sector, either in the form of fiscal stimulus, or the implementation of appropriate forms of social protection for those most affected. This is not surprising – attention has been focussed on responding to the extreme volatility in the financial and currency markets. But contributor's concerns make it clear that effects on the real economy are likely to be felt soon.

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Several respondents call for more government spending on infrastructure, health and education. In South Africa, the accumulated fiscal surplus may allow the government to increase social expenditure whilst continuing to invest in infrastructure. But most countries are not in a position to do this. Data from the Philippines suggests that the deficit is being reduced rather than expanded, and the contribution from Pakistan expresses concern about the implications of receiving IMF financing. From India, there are concerns that increases in social expenditure in the last budget (including the National Rural Employment Guarantee scheme) may not be sufficient to prevent recession in the future.

Developing countries need to implement appropriate social protection mechanisms now. Worryingly, not one of the 19 respondents pointed to efforts by their governments to implement social protection mechanisms to respond to the crisis. It is likely that in each country some groups will be affected by the crisis more than others. From the East Asia crisis in 1997/1998, countries can learn about the types of social protection which are most effective in responding to macroeconomic shocks. But adapting existing social protection mechanisms to tackle a macroeconomic shock takes time, developing country governments need to start this process soon. This may be an area where donors can provide valuable support.

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 financial crises affecting developing countries are far from uncommon. 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 clearly a need, not only for better regulation in the financial sector, but also for improved ways of preventing the accumulation of large and unsustainable macroeconomic imbalances that give rise to crises. If such a new architecture is to work, it must involve developing country governments in its design and implementation. We hope that this report by compiling views from a wide range of thinkers from developing countries, can contribute to building a more sustainable architecture for sustainable growth and development.

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