Financial Crisis and the Developing Countries

Farah Naaz Gauri and Riyazuddin Qureshi

Abstract: This paper critically focuses that as far as the developing countries are concerned with financial crises, particularly countries that will be adversely affected. There might be countries that are less affected, and they may avoid recession, and recover sooner than expected. Prospects for the world’s rich countries would be much bleaker. Some options are available to the developing countries for minimizing the impact of crisis. The urgent need for accelerating financial development in developing countries is through domestic financial deepening, domestic resource mobilization, and reform of international financial system.

Keywords: Developing countries, economic development, global markets, mobilization, banking

1. Introduction

It is clear from the past few years that the developing countries are far away from financial crisis originating in the West. The developing world experienced an impressive economic boom, growing at a rate of 7% per year. The boom was fueled by global markets: exceptional financing, high commodity prices and, for a significant number of countries, large flows of remittances. They have shown high volatility, going sharply up and down on a daily basis. Around an overall declining trend, that the pattern is reminiscent of the behaviour of stock indices. This factor, together with high foreign exchange reserves, helped to attract capital to emerging markets even after the outburst of the subprime crisis. However, both have now joined the downturn. Asia and China’s growth served as the basis for world economic growth. The statement given by the IMF in 2007 that the developing world would “de-couple” from weak economic conditions in industrial countries was essentially wrong.

2. Impact on developing countries

Failures of Banks: Banks in developing countries had affected to the extent to which they hold assets. Many developing – country banks had limited inter-relationship with international banks. Foreign owned banks are not significant players in most countries. China, where the financial sector is largely governed, controlled, exposure to subprime mortgage of united states origin in minimal. More serious threat is through decline in stock market prices and housing prices. This has reduced the capital of bank and other big firms, as they do no hold sufficient level of capital in cash. In such cases it is likely that banks will reduce lending in order to shore up their capital. In worst case scenario, banks may face solvency problems and may require their governments’ to recapitalize them, lower growth and an increase in unemployment.
**International Transmission:** The key channel for transmission of the crisis from developed to developing countries has been via private capital flows. The financial liberalization policies across the developing world that have made capital markets much more integrated directly through mobile capital flows, and similar forms of financial fragility everywhere. The international transmission of turbulence is one of the way in which the global financial crisis can and will affect developing country. The impact on private capital flows to developing countries which reduce credit crunch and reduced appetite for risk among investors. The last five years witnessed an unprecedented increase in gross private capital flows to developing countries.

**Remittances:** There is strong evidence of reduced dynamism of remittances, for e.g.: in case of Latin America remittance grow very slowly both in the year 2007 and 2008, falling GDP in both years. The direct sensitivity of migrant incomes to construction activity, which has been falling for three years now, is an important explanation for the absolute reduction of remittance from US to Mexico in the year 2008. Remittances from Europe had experienced a similar pattern of strong reduction in the growth e.g.: Case of Spain, one of the economies hit the hardest by a construction crisis. On the other hand, particularly the gulf countries continued to boom until the third quarter of 2008, and have experienced no significant slowdown in remittance year. But it is likely to change as a result of the steep fall in oil prices. The World Bank has estimated that remittances to the developing world experienced a lower, but still positive and fairly strong growth in 2008.

**Decline in Export Earnings:** Most developing countries had significant damage to their own financial systems. The developing countries have been basing their economic growth in recent years on export e.g.: China, India, Japan, Malaysia and others. The crisis had substantially declined in the country’s export earnings. The expected decline came through combination of decline in commodity price, decline in demand for their goods from advanced economies and decline in tourism. Decline in commodity price will be detrimental to the export earnings for large number of countries those are major exporters of commodities. It is not just commodity – dependent countries that will be adversely affected. Even in USA and other G7 countries reduced the demand in their export, as these markets are important destinations of developing-country exports. Significant proportion of US imports is from developing countries. Many of these imports of services, not just of goods e.g.: India’s software sector which exports IT services to the US. Another important source of foreign currency earning in many developing countries is tourism. The tourism and hospitality sector which had emerged as an important employer in many developing countries is facing cancellation and decline demand across both luxury and middle class segments. Since September 2008, number of air passengers in the world has dropped sharply.

**Decline in financial flows to developing countries:** Developing country requires financial flows from rest of the world to facilitate and accelerate economic growth, trade and development, include – official development assistance (ODA), Investment flow (both Portfolio and FDI), Trade credits and flows of remittances. All these are set to be affected negatively during current financial crisis.

**Global financial crisis and emerging markets:** Second private investment flows to developing and emerging countries had declined as more risks adverse investors more their funds to perceived safer havens, include portfolio and FDI. Decline in portfolio flows will affect government borrowings. The costs of sovereign bonds and commercial debts are important sources of finance for developing countries.
While FDI to developing countries grew tremendously over the past seven years, there was a slight decline of 10% in the year 2008. International trade depends on trade credit being extended: around 90% of trade is traditionally financed by short-term credit. Consequently there is dual pressure on developing country trade: reduced demand for their export and reduced trade credit. As far as remittance are concerned there are already indications from countries with large number of migrant workers that remittance flows are declined. Remittance in recent years was one of the most important financial flows for developing countries.

3. Policy responses

From past experiences of financial crisis, developing countries would need to include immediate, short-term (stabilization) and long-term (structural) policy responses. More research should be done on the implications of the financial crisis for greater global coordination of responses. This is not only hugely important for developing countries, but also for developed countries. Immediate and short-term policy responses are required to ensure that (i) the financial crisis contained, (ii) that confidence in financial systems is restored and that (iii) the impact on the real economy is minimized. Over the longer term, countries should focus on strengthening their financial systems within the context of reforming the global financial scenario. Domestic financial development depends on a better global financial architecture and vice versa. Developing countries’ responses will depend on their own unique circumstances, and approaches on issues of bank nationalization, bailouts, expansionary monetary policies and financial openness.

### Policy responses to the financial crisis

<table>
<thead>
<tr>
<th>Timeframe</th>
<th>Objective</th>
<th>Policy options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediate</td>
<td>Containment of financial panic</td>
<td>• Guarantee bank deposits&lt;br&gt;• Guarantee interbank loans&lt;br&gt;• Provide liquidity to banks&lt;br&gt;• Forbearance on regulations</td>
</tr>
<tr>
<td>Short term</td>
<td>Resolution measures</td>
<td>• Recapitalize banks&lt;br&gt;• Mergers and acquisition in financial sector</td>
</tr>
<tr>
<td></td>
<td>Monetary expansion</td>
<td>• Reductions in the costs of borrowing&lt;br&gt;• Raise inflation targets</td>
</tr>
<tr>
<td></td>
<td>Fiscal expansion</td>
<td>• Increase in spending on social safety nets, including conditional and unconditional grants and public works</td>
</tr>
<tr>
<td></td>
<td>Trade expansion</td>
<td>• Lowering of protective measures&lt;br&gt;• Maintain competitive exchange rates</td>
</tr>
<tr>
<td>Longer term</td>
<td>Domestic financial development</td>
<td>• Increase the access to finance&lt;br&gt;• Improve domestic resource mobilization&lt;br&gt;• Improve efficiency of banking sector&lt;br&gt;• Avoid financial repression&lt;br&gt;• Improve supervision and regulation&lt;br&gt;• Strengthen property and contract rights, judiciary and rule of law&lt;br&gt;• Proceed, but with caution, with financial openness</td>
</tr>
</tbody>
</table>
Reform of international financial architecture

- Move to a more inclusive system of global financial governance
- Improve the share, efficiency and management of global aid system
- Reform Bretton Woods Institutions

Source: Compiled by authors

3.1. Immediate responses

Table 1 lists immediate responses to the crisis as including (i) containment and resolution measures to stop the crisis, restore confidence in banks and improve their health, and (ii) measures to reduce the fall-out on the real economy. Containment measures typically include guarantees on deposits and interbank loans, provision of liquidity to financial institutions. Resolution measures aim to redress the balance sheet difficulties of banks and typically consist of direct cash. Allowing mergers and acquisitions, and may include bank nationalization. These measures were applied in the present crisis wherein, the United States government nationalized their two largest mortgage lenders, Fanny Mae and Freddie Mac, and governments from the UK, France, The Netherlands, Belgium and Germany recapitalized failing banks and extended guarantees on bank deposits and interbank loans.

Developing countries should avoid, where possible, following the example of the US or EU in nationalizing banks if their collapse can otherwise be prevented. An essentially a strong private sector financial system, characterized by sufficient competition but with strong oversight and sufficient capital adequacy, remains the best option for developing countries. In contrast, while nationalizing banks may be a short-term emergency measure to prevent banks from failing, it creates a number of longer-term difficulties such as moral hazard, opportunities for rent-seeking, and directed/distorted lending, all of which compromise economic efficiency. The current crisis has already shown some of the fault lines of too rapid or too early financial liberalization, as well as re-emphasized the importance of the correct sequencing and monitoring of financial liberalization.

3.2. Short-term responses

Safety programmes should include both unconditional and conditional cash transfers to poor households, and public works programmes. But given the need to attract finance and encourage the profitability of their domestic banking sectors, many developing countries will probably not have the leeway for expansionary monetary or fiscal policies such as are being followed in the EU and US.

Many developing countries are facing much higher inflation rates, pressure on the exchange rates to depreciate, and an outflow of international capital. Under such circumstances, and in view of the imperative not to repress domestic financial development, these countries would need to take care to maintain positive real interest rates. Indeed, with historically low interest rates in the US and EU, developing countries face an opportunity to attract external funds. Countries facing balance-of-payments constraints could need to make use of the IMF’s short-term liquidity facilities, and those with difficulties meeting investment and social spending, the various World Bank and International Finance Corporation (IFC) facilities. A liquidity trap is said to exist when households and banks hoard cash, so that expansionary monetary policy becomes ineffective (even if interest rates are zero, no one wants to borrow or spend). Heinemann (2008) points to a number of ways to get out of liquidity trap in the midst of a credit
crunch. The essence is to strengthen the balance sheets of banks and consumers. One way is to prevent further declines in stock market prices and in fact encourage the buying of stocks.

3.3. Long-term responses – financial development

Financial development refers to the deepening in the financial sector, providing greater access to credit, as well greater efficiency of the financial system. There are many ways in which financial sector development matters for growth. Over the past decades many developing countries have seen much progress in financial development, such as improvements in banking regulations since the 1998 Asian crisis, improvements in micro-credit provision, and in finance friendly reforms in legal systems, contractual and property rights, and rule of law. In order to manage the risks of financial openness, countries ought to proceed gradually with the opening of their financial systems, while simultaneously strengthening their domestic financial sectors and institutions. These include the rule of law, an independent judiciary, and contractual and property rights but also extending and strengthening bank supervision and regulation.

3.4. Longer-term responses: reform of the international financial system

Finally, the reform of the Bretton Woods Institutions, the IMF and World Bank. These institutions have been largely marginally in the response to the financial crisis, despite the fact that this was what they were initially designed to prevent and cure. The IMF, for instance, does not have the resources to bail out the US. Another is IMF conditionality, a reason why many developing countries have been self-insuring against balance-of-payments problems by accumulating such massive foreign exchange reserves since the 1998 Asian crisis. In a more equitable and efficient global financial system, developing countries ought not to be over-accumulating reserves, and rich countries ought not to be running-up unsustainable deficits. More attention now needs to be paid to designing a better system. The inadequacies of the system have been raised unsuccessfully many times. But hopefully now, given that the current crisis takes place during the transition from a unito multi-polar world, coincides with political change in the US, and will largely be resolved by developing-country money, this will spur developing-country governments to use the crisis as a window of opportunity for change.

4. Conclusion

The likelihood of an economic slowdown in the world economy will mean a slowdown in economic performance in most developing countries during 2009. developing countries will be affected in the form of lower growth, higher unemployment and poverty, and changes in inequality, it has been argued in this paper that there are many and various channels for the impact to affect countries differently, depending on the extent to which they are vulnerable to particular channels.

Many developing countries, Africa and the large emerging markets of Brazil, China and India, will continue to grow at relatively strong rates. The financial crisis has occurred at a time when many developing economies have been enjoying years of good growth, and this together with improved macroeconomic management (many countries have learned important lessons during the previous financial crises) have resulted in more robust economies in the developing world. With this more
optimistic prognosis, it may be possible for many individual developing countries to manage the impact of the crisis through appropriate policy responses.

This crisis has shown how important credit and risk-management institutions are to economic growth, and it has shown how important appropriate institutions (including appropriate regulation) are for the correct functioning of the financial sector. It has also shown how important the international financial architecture, including international cooperation, is for mitigating financial crises. Therefore, financial development in developing countries should begin to focus urgently on both domestic financial deepening as well as reform of the international financial architecture. Countries, like China, have a particularly important role to play, given their substantial international reserves as well as their own need to reform and improve their own financial institutions.

References


Financial Crisis and the Developing Countries


**About the Authors**

Dr. Farah Naaz Gauri, Associate Professor, Department of Business Administration, Jazan University, Jazan, K.S.A.; Dr. Riyazuddin Qureshi, Assistant Professor, Jazan Community College, Jazan University, Jazan, Saudi Arabia

**Contact Information**

Email: fngjob@yahoo.co.in, riaz_quraysh21@yahoo.com