INTERNATIONAL FINANCIAL CRISIS AND POLICY RESPONSES TO THIS NEW CHALLENGE IN THE EMERGING COUNTRIES

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Abstract:
The rapid spread of the financial crisis from a small number of developed countries to the global economy provides tangible evidence that the international trade and financial system needs to be profoundly reformed. While it is important to introduce structural changes to adapt the international system, this cannot be achieved without significant immediate measures to promote recovery from the current crisis: protectionist trade policies must be unwound, better coordination of additional fiscal stimulus, restoration of credit flows to productive sectors, regulatory reforms, international financial support. This paper presents the causes of the present crisis, measures needed for the recovery of the emerging markets and the support of the international financial institutions, especially IMF, for the developing countries.

***Key words**: financial crisis, emerging markets, international financial supports, measures.*

***JEL classification**: E52, E58, E62, E61, G01, G12, G21, O23*

I. Introduction

The rapidly unfolding global financial and economic crisis has severely disrupted economic growth worldwide and is setting back progress towards achievement of the internationally agreed development goals. If effective policy responses are not implemented in a timely fashion, unemployment rates could rise to double digits in some developed countries, and tens of millions of people in developing countries could become unemployed, while hundreds of millions of people could join the ranks of the working poor.

The outbreak of the financial crisis in 2008 originated in the advanced developed countries, but it has spread quickly to become a world economic crisis affecting all countries, including the emerging economies and less developed countries. Short-term measures to stabilize the current situation must ensure the protection of the world's poor, while long-term measures to make another recurrence less likely must ensure sustainable financing to strengthen the policy response of developing countries.

The paper is divided into the following sections: section II considers the origins and causes of the crisis, as well as the mechanisms by which it has been transmitted to developing countries; section III reviews the current and potential impact of the crisis on development; section IV presents the IMF's implication in the crisis and section V is the conclusion of the paper.

The analysis is based on data released by UNCTAD, World Bank and IMF regarding the emerging countries during the crisis period.

II. Causes of the present crisis

Growth was driven by substantial increases in productivity in many countries which, combined with the increased integration of developing countries into the global

economy and a strong expansion in trade, also allowed prices to remain relatively flat for several years.

Persistently low interest rates caused investors to search for higher yields in equities, housing and basic commodities. Asset prices were driven up across a broad range of industrialized and emerging economies, and many developing countries benefited from high commodity prices. Relatively low volatility and excessive optimism driven by years of strong growth led investors to move into ever-riskier assets. Deficient regulation allowed financial systems to develop new structures and instruments that appeared to offer increased risk-adjusted returns, but were often far riskier — and systemically more dangerous — than they appeared.

High rates of saving in Asia and oil surplus countries financed high rates of consumption in the United States and some other industrialized countries. Capital flows from saving-surplus countries — including many emerging market countries — to the United States were further supported by perceptions that United States assets were both less risky and more liquid than other assets (Whalen C., 2008).

The large imbalances between Asia and industrialized economies are being unwound through a compression in industrialized country demand as credit is curtailed, the real economy is squeezed, and housing prices drop.

Massive public funding, amounting to $18 trillion or almost 30 per cent of gross world product (GWP), has been made available to recapitalize banks, nationalize financial institutions and provide guarantees on bank deposits and other financial assets. Recognizing that monetary and financial measures will not be enough to stave off a recession, many countries, mostly developed but also some developing, have elaborated fiscal stimulus plans amounting, by April 2009, to about $2.7 trillion to be spent over the period 2009-2011. This stimulus spending is intended to halt the slide into deeper recession and to provide new jobs.

These bold policy responses are not expected to gain sufficient traction to prevent an economic downturn in 2009, but they could allow for some recovery in 2010-2011. Yet the risk of a more prolonged global recession remains: At lower levels of economic development, countries are generally more vulnerable to fluctuations in world markets. Developing countries typically have small reserves and have borrowed in foreign currency to finance their progress.

III. Transmission mechanisms and the impact of the crisis on development

A. Impact of declining trade, finance and remittances

Even though many developing countries were not directly exposed to the financial turmoil, they are being hurt through a variety of channels, including collapsing trade, volatile commodity prices, capital flow reversals, increased borrowing costs, declining remittance incomes and strains on official development assistance.

The poorest countries are more vulnerable to the vicissitudes of the global economy. They are heavily dependent on external finance, including aid, and trade. Furthermore, their foreign-exchange earnings and Government revenue tend to rely on a small number of commodities.

Private capital flows to developing countries have dropped sharply, accompanied by a surge in risk premiums for external financing. While declines in net private capital inflows are expected for all emerging market economies and developing countries, the most substantial fall from previous levels is likely to occur in emerging Europe (Acemoglu D., 2009).

Deteriorating external conditions and the appreciation of the United States dollar since August 2008 have put downward pressure on the currencies of many developing

countries. Numerous middle- and low-income countries have seen strong currency depreciations over the past six to nine months, sometimes as strong as from 20 to 50 per cent. These depreciations have made external debt service much more expensive in local currency terms that are already affecting the budget positions (Wolf M., 2009).

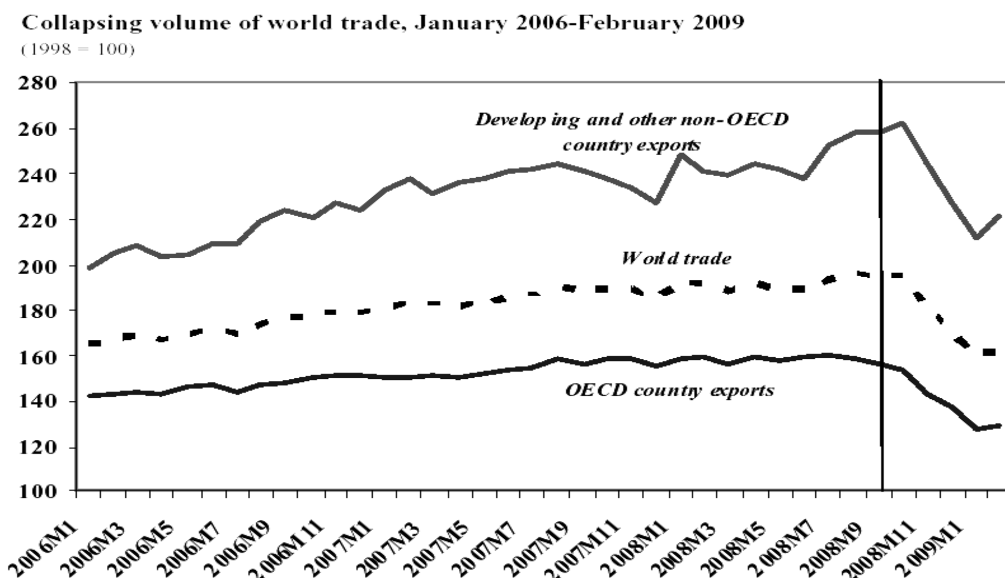


Figure 1

Trade flows worldwide sharply declined from the end of 2008 and have continued to decline in the first quarter of 2009 at an annual rate of more than 40 per cent in the three months up to February 2009 (Fig. 1). The World Trade Organization projects that the volume of world merchandise trade could plunge by 9 per cent for 2009 as a whole, while, according to the United Nations an even steeper fall, of 11 per cent, is expected, the largest decline since the Great Depression of the 1930s.

The sharpest declines in trade have been observed among Asian economies, in some cases at annualized rates of 50 per cent or more. Some countries have been successful in promoting niche export industries, including textiles, cut flowers, fruit and vegetables. These sectors have become important sources of foreign exchange and government revenue in many low-income countries and are now at risk because of the global downturn. Similarly, tourism is one of the main export sectors for many developing countries and it has declined substantially.

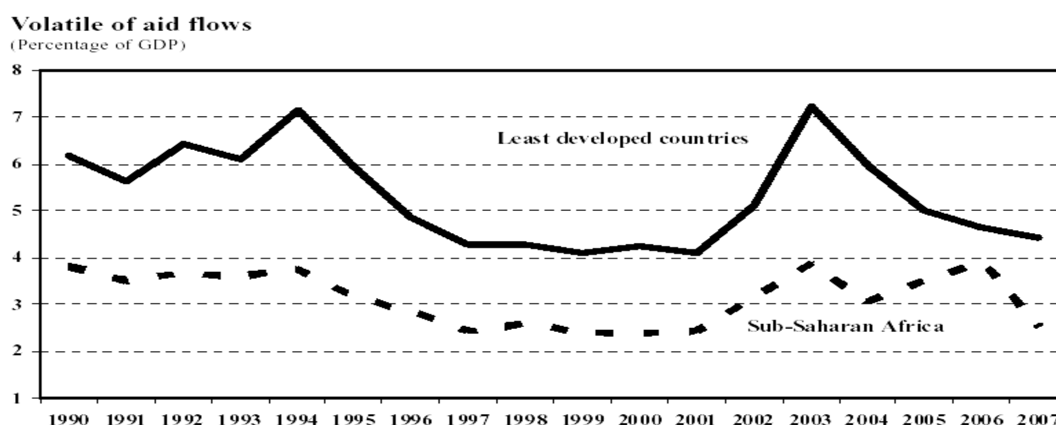
From 2002 to mid-2008, many countries gained from the upward, albeit volatile, trend in the prices of oil and non-oil commodities. The intensification of the global financial crisis since mid-2008 has led to a sharp reversal in this trend. It is likely that export earnings and government revenue will continue to be depressed in many developing countries. Food- and energy-importing countries may see their terms of trade improve, although in most cases these gains may be more than offset by the collapse in export demand, the increased cost of borrowing and/or falling remittance flows. Among net exporters of commodities, low-income countries are being hit hardest by plunging world market prices because primary exports comprise, on average, 70 per cent of their total exports. In addition, a high share of government revenue comes from taxes on these exports (UNCTAD, 2008).

With rising unemployment, many host countries have tightened immigration controls and introduced tougher requirements for migrant workers. In addition, migrant workers tend to lose their jobs more quickly than other workers as a consequence of national policies or public pressures. As a result, migrant workers' home countries may

be deprived, through reduced remittances, of the resources needed to cushion the impact of the crisis. Remittance flows to middle-income countries may see the largest absolute declines, as they currently account for the largest individual country flows. In relative terms, however, remittance flows are even more important for a number of small countries, both middle- and low-income countries.

The crisis is already putting downward pressure on aid flows. Although donor countries have repeatedly reaffirmed their commitments, timely delivery on those targets may still be disrupted if the present crisis is protracted. Before the crisis, low-income countries, especially the least developed countries, saw large fluctuations in annual aid flows equivalent to up to 2 to 3 per cent of GDP (Fig. 2).

For many low-income countries there are few external financing alternatives to development assistance when faced with crisis-related declines in exports, fiscal revenues, remittances and private capital flows. Uncertainty about the expected level of aid inflows further complicates the formulation of macroeconomic policies in response to the crisis.



Source: Organization for Economic Cooperation and Development/Development Assistance Committee and Department of Economic and Social Affairs databases.

Figure 2

The World Bank estimates that most of the developing countries are expected to fall short of covering their external financing needs, if there will be further declines in private capital flows and increased capital repatriation to industrialized countries. For low-income countries alone, IMF estimates that the balance-of-payments shock could rise very much. While some developing countries have accumulated vast amounts of international reserves, these are unequally distributed — that is, most are held by a handful of countries. Most developing countries have insufficient reserves to cope with the magnitude of the external shock caused by this crisis. An increasing number of countries have had to turn to IMF for large sums of emergency funding to limit further destabilization of their economies.

B. Implications for growth and employment

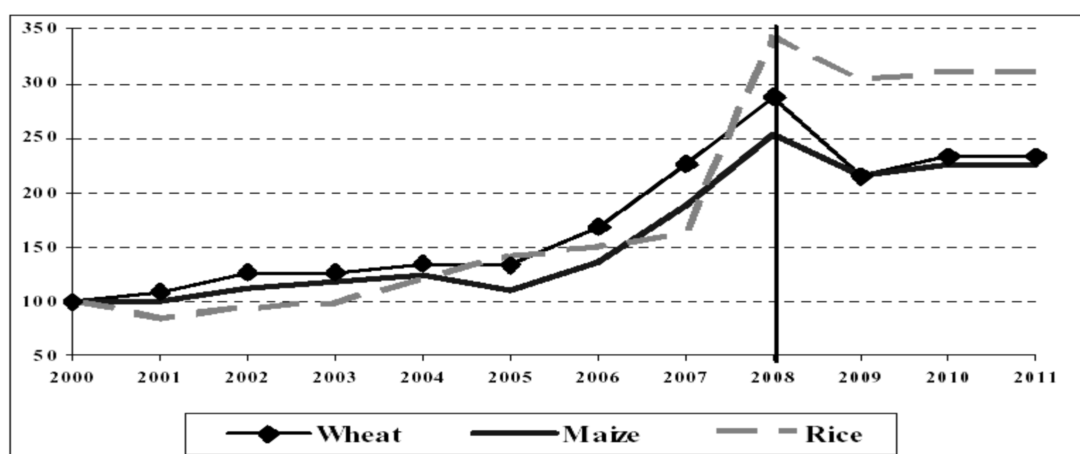
Growth of GDP per capita is expected to drop to zero on average for developing countries, down from 4 per cent in 2008 and almost 6 per cent on average per year during 2004-2007. The expected setbacks are across the board, though strongest in sub-Saharan Africa and Latin America and the Caribbean. Those regions are also expected to suffer the severest actual declines in per capita income during 2009. At least 60 developing countries are likely to suffer negative per capita income growth in 2009. The least developed countries, including the small island developing States among them,

could also be severely affected, with growth decelerating by five percentage points from the robust growth they have witnessed in recent years (UNCTAD, 2009).

Lessons from past financial crises indicate that it typically takes four to five years for unemployment rates to return to pre-crisis levels after economic recovery has set in. This is because massive rises in long-term unemployment and greater labor market “informalization” — exacerbated by returning migrants and large-scale reverse migration from urban to rural areas — are very difficult to reverse. Most countries will need to achieve strong growth acceleration during the period 2011-2015 to offset the job destruction and displacement of workers caused by the crisis.

Even though food prices have declined significantly from their peaks early in 2008, they remain above recent historic trends. Moreover, the recent exchange-rate depreciations have increased the domestic cost of processed imported food in many developing countries, most of which are net food importers. Many experts predict that food prices will be significantly higher over the next 10 years than the low levels that persisted during the late 1990s (Fig. 3). The full impact of the crisis on global poverty is difficult to project. By most estimates, the world has not yet reached the bottom of the crisis, countries are affected in varying degrees that depend on their specific circumstances and their capacity to respond with social protection measures varies significantly (Von Braun J. and Torero M., 2008).

Food prices: declining, but still high
(2000 = 100)



Source: United Nations Conference on Trade and Development and Department of Economic and Social Affairs.

Figure 3

The crisis has already hit major exporting industries in developing countries that are dependent on North American and European markets, including the labor-intensive clothing, footwear, processed foods, and electronic products sectors. Since women often make up the majority of the workforce in these sectors, initial indications imply that their labor market position has worsened considerably in countries where these sectors account for a significant share of production.

IV. IMF’s response to crisis

Within emerging markets, eastern European economies have been the hardest hit. The linkages between Western Europe and emerging European banking systems make the region particularly vulnerable. Western European banks may reduce the funding of their eastern European subsidiaries and losses from emerging Europe may damage western European balance sheets. Fortunately, there are promising regional

initiatives in which some western banks have agreed to keep credit flowing to the subsidiaries.

Financial policies must work constructively with other macroeconomic policies—both are needed to short-circuit the adverse feedback loop between the financial system and the economy through which deteriorating financial conditions lower economic activity, which in turn makes it harder for companies and individuals to repay borrowings, with an adverse impact on financial conditions. It is essential to stabilize the financial system—without which a robust and sustained economic recovery will be difficult to attain.

Hungary: The IMF, the European Union (EU), and the World Bank announced a joint financing package for Hungary totaling $25.1 billion to bolster its economy, hit by recent financial market turbulence. Subject to agreement by the IMF's Management and Executive Board, the IMF is ready to lend Hungary $15.7 billion (12.5 billion euro) under a 17-month Stand-By Arrangement. The proposed package could be reviewed by the Board under the Fund's emergency procedures in early November, the IMF said in a press statement.

The EU stands ready to provide a loan of €6.5 billion ($8.1 billion), and the World Bank has agreed to provide €1.0 billion ($1.3 billion). The IMF is moving quickly to help emerging markets battered by fallout from global financial turmoil and the sharp slowdown in the economies of advanced industrialized countries. The 185-member institution has more than $200 billion of loanable funds and can draw on additional resources through two standing borrowing arrangements with groups of IMF member countries.

The planned financing package for Hungary follows within days earlier announcements of tentative loan agreements with both Iceland and Ukraine. The IMF is also in discussions with several other countries about possible new lending programs.

The IMF said in the statement that the Hungarian authorities have developed a comprehensive policy package designed to restore investor confidence and alleviate the stress experienced in recent weeks in the Hungarian financial markets. It will bolster the economy's near-term stability and improve its long-term growth potential, the IMF said.

Core measures under the program are designed to improve fiscal sustainability and strengthen the financial sector. Specifically, the package includes measures to secure adequate domestic and foreign currency liquidity, as well as strong levels of capital for the banking system.

Important measures in the fiscal area will reduce government financing needs and ensure longer term debt sustainability. These strong policies justify the exceptional level of access to Fund resources—equivalent to around 1,020 percent of Hungary's quota in the IMF—and deserve the support of the international community.

The success of the policy package will be a shared responsibility between all stakeholders in the country and the international community. The IMF has worked in close coordination with the European Union, the European Presidency, and the World Bank on the issue. We will continue assisting the Hungarian authorities on how to adapt to the current global financial turmoil and to catalyze financing as needed.

With Hungary's commitment to strengthened economic policies, we expect that banks and other financial institutions operating in the country will continue to provide adequate financing.

Ukraine: The IMF said it has reached a tentative agreement with Ukraine to lend the Eastern European country $16.5 billion to help it combat a series of economic problems tied to the international financial turmoil and announced broad agreement with Hungary on a set of policies designed to bolster near-term stability.

Ukraine has developed a comprehensive policy package designed to help the country meet the balance of payments needs created by the collapse of steel prices, and

the global financial turmoil and related difficulties in Ukraine's financial system. The authorities' program is intended to support Ukraine's return to economic and financial stability, by addressing financial sector liquidity and solvency problems, by smoothing the adjustment to large external shocks and by reducing inflation. At the same time, it will guard against a deep output decline by insulating household and corporations to the extent possible.

The IMF is moving expeditiously to help Ukraine, and this program is focused on the essential upfront measures needed to maintain confidence and economic and financial stability. The strength of the program justifies the high level of access, equivalent to 800 percent of Ukraine's quota in the Fund.

Island: The IMF announced an initial agreement with Iceland on a $2.1 billion two-year loan to support an economic recovery program to help the island restore confidence in its banking system and stabilize its currency.

Following review by the IMF's management, the agreement could be presented to the IMF Executive Board for approval in early November. Iceland would be able to draw $833 million immediately after Board approval.

Iceland has put together an ambitious economic program, which aims to restore confidence to the banking system, to stabilize the krona through strong macroeconomic policies, and to help the country achieve medium-term fiscal consolidation following the collapse of its banking system. I believe these strong policies justify the high level of access to Fund resources—equivalent to 1,190 percent of Iceland's quota in the IMF—and deserve the support of the international community.

The authorities' program is focused on the essential upfront measures needed to restore confidence and economic and financial stability. The overarching goal is to support Iceland's effort to adjust to the economic crisis in a more orderly and less painful way.

Latvia: Higher social spending and better targeting. In the December 2008 IMF-supported program, Latvia’s expenditure adjustment departs significantly from typical fiscal consolidations by protecting social spending and capital outlays. Social spending is targeted to increase by 1.5 percent of GDP between 2008 and 2009, moving closer to EU/OECD averages. That said, targeting could be improved and social safety net spending is about ½ percent of GDP below European average. This is largely due to income inequalities between local governments, which will be partially addressed under a planned local administration reform. The program also includes health sector reform, and additional measures to improve the targeting of the social benefits system.

Romania: The Fund-supported program provides room for additional spending of RON 250 million (amounting to 0.05 percent of GDP) in 2009 and RON 500 million (0.1 percent of GDP) in 2010 to improve social protection for the most vulnerable groups during the economic downturn.

The IMF is fighting at the front lines of the financial crisis. In recent months, it has provided loans worth more than $50 billion to emerging market countries hit by faltering demand for their exports, the drying up of capital in financial markets, overextended banks, and wary consumers.

V. Conclusions

In the face of the world economic and financial crisis, the multilateral system must deploy all its resources and capacities for rapid, coordinated and effective responses. The international community should consider how to coordinate better additional fiscal stimulus measures, giving due consideration to global imbalances, destabilizing exchange-rate movements and the need to allow counter-cyclical responses by developing countries.

Financial sector rescue operations should prioritize the restoration of affordable credit flows to productive sectors through more adequate bank capitalization and regulatory reforms.

A much larger share of the new international liquidity for emergency financing should be made available to developing countries through flexible responses to country needs that support counter-cyclical policies.

Development lending and official development assistance need to be scaled up substantially to ensure reliable financing for developing countries that will enable them to respond swiftly to the crisis while making long-term investments in human development and a sustainable global economy. This will require new capital replenishments for the multilateral development banks and accelerated delivery on existing aid commitments.

Protectionist trade policies must be unwound and any further increase in protectionism must be resisted. Additional aid for trade flows should be significantly increased, not least for trade financing. Full access to global markets should be provided immediately to exports from the least developed countries to help their recovery. Discrimination against migrant workers must be stopped. Such workers should be enabled to earn incomes that can fund remittances to help economic recovery in their home countries.

The international community should continue to review the need for comprehensive and significant financial sector reforms, and should be especially cognizant of the impact such reforms may have on developing countries.

Debt sustainability should be closely monitored. The flexibility of the debt sustainability framework should be reviewed, and the international community should consider whether it would be appropriate to establish an international mechanism for sovereign debt restructuring and relief.

The process of reforming the international institutions should continue in order to increase their capacity to prevent and manage future crises and to enhance their legitimacy. The international financial architecture should not only ensure greater financial stability but should also create the conditions for sustainable development, more decent employment, more effective investment, better technology policies and financial inclusion at both the national and the international level.

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