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How Does the **Financial Crisis Affect** Developing Countries?

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The global economy is in crisis as a result of inadequate regulation and supervision of banks and financial markets. The prudential regulation and supervision recommended to developing countries was largely ignored in the developed nations. No country, however, is spared from the consequences of the downturn. The impact on developing countries is even greater.

The crisis is driven by the reversal of the three factors that fuelled the economic boom of 2003–2007. This period saw exceptional levels of financing (private flows to some countries and overseas development assistance to others), high commodity prices and large flows of remittances. The continuing decline in capital flows and exports is hurting the developing countries, despite their having adhered to stringent macroeconomic frameworks.

The accumulation of international reserves and lower levels of external debt allow some developing countries to protect themselves from the rapid deterioration of capital flows. But the contraction of credit, its high cost and the volatility of portfolio investments have already led to a contraction of financial flows. Bank lending to emerging markets fell from a peak of US$410 billion in 2007 to US$167 billion in 2008, and is projected to fall to US$60 billion in 2009 (Griffith-Jones and Ocampo, 2009).

Lower trade volumes will be the main channel of transmission to exporters of manufactures and services (including tourism). The volatility of commodity prices will also affect exporters of primary goods. In countries like Congo, Equatorial Guinea, Gabon and Nigeria, oil provides more than 50 per cent of government revenues from commodity exports. In Côte d'Ivoire and Guinea, cocoa and minerals account for a fifth of revenues. Cotton and aluminium exports provide a fifth of tax revenues in Tajikistan. In Trinidad and Tobago, and in Bolivia, commodities account for 22 and 12 percent of GDP, respectively. The prospects for commodity prices remain poor. Recent projections by the World Bank forecast a 25 per cent reduction in energy prices in 2009 and a 23 per cent fall in non-energy commodity prices (World Bank, 2009).

Remittances often provide a safety net in recipient countries. Income from migrant workers helps stabilise consumption levels when recipient economies contract. But remittances have been falling since 2008 in the range of -1 per cent to -6 per cent.

The decline in remittances will be devastating to countries that largely depend on them. For instance, remittances make up 45 per cent of Tajikistan's GDP. Guyana relies on remittances for a quarter of its income (see table).

Remittances as a Proportion of GDP

Tajikistan	45
Moldova	38
Tonga	35
Lesotho	29
Honduras	25
Lebanon	24
Guyana	24

Source: World Bank (2009).

What should be done to mitigate the impact of the crisis? In most developing countries, macroeconomic indicators, including the accumulation of reserves, have improved in the last five years.

Those countries are much better placed to adopt expansionary fiscal and monetary policies. Infrastructure investments and social spending on nutrition, basic education and health care are essential. There is also an opportunity to expand non-traditional exports through a mix of exchange rate policies and sectoral incentives.

Concerted international action is also needed. A new system of financial regulation should be built upon two broad principles: the need to incorporate counter-cyclical mechanisms in order to correct for the boom-bust nature of financial markets; and effective regulation whereby the domain of the regulator is the same as the domain of the market to be regulated, which is global in nature.

Reforms are needed in three areas. First is the creation of a meaningful and truly global reserve currency with a substantial expansion of resources to provide counter-cyclical liquidity to developing countries. Second, with greater voice given to developing countries, the International Monetary Fund (IMF) can be instrumental in coordinating global macroeconomic policy. Third, IMF lending has to come without the overly burdensome conditionality of the past. It must have quick-disbursing facilities for countries with strong economic policies facing temporary liquidity problems.

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