Global Development Finance

Charting a Global Recovery

I: Review, Analysis, and Outlook

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Foreword

THE CRISIS OF THE PAST TWO YEARS is having dramatic effects on capital flows to developing countries, and the world appears to be entering an era of lower growth. This edition of *Global Development Finance* revisits the genesis of the turmoil—which began in a relatively small segment of the U.S. credit markets and mutated into a major worldwide financial and economic crisis—and explores the broad approach needed to chart a global recovery.

This year, global output is projected to fall by 2.9 percent; global trade by 10 percent. Growth in the developing world is expected to slow to 1.2 percent. Excluding China and India, GDP in other developing countries will fall at a rate of 1.6 percent. Meanwhile, private investment flows to developing countries plummeted by more than 40 percent in 2008 as access to international debt markets dried up and portfolio equity inflows all but ceased.

Unprecedented situations call for unprecedented policy responses. Through ambitious unilateral and multilateral actions, both conventional and unconventional, governments have drawn on monetary policy, fiscal stimulus, and guarantee programs to shore up the banking industry, which lay at the epicenter of the crisis. Those actions are beginning to have a positive impact on financial markets, where liquidity conditions in global interbank markets have begun to ease, credit risk premiums have narrowed, and equity markets have staged a tentative revival. However, the policy agenda for stabilizing financial markets and fostering global economic recovery is broad and complex. Major challenges remain.

Greater integration of the global economy and the increasing importance of private actors in international finance over the past three decades have brought enormous benefits to developing countries, but they also have widened the scope for economic turmoil. Consider trade and flows of private capital. The share of international trade in developing countries' output grew from 35 percent in 1980 to 57 percent in 2007. New markets opened for producers in the developing world, and prices lowered for consumers. But rising trade also widened channels through which a slowdown in economic activity in one group of countries could spread to other countries. Capital flows have grown with trade, and developing countries today are much more dependent on flows of private capital than they were at the peak of the boom of the 1970s. Once dominated by bank lending to sovereign governments, most capital now flows through a variety of transactions between private entities—and those flows respond rapidly to financial disruptions. Thus, even though most developing countries maintain better policies and have stronger institutions than they did at the onset of previous crises, more of them are nevertheless vulnerable to external disruptions. Emerging-market equities and investments have always been sensitive to the global economic cycle, but the current downturn has hit developing countries especially hard. Emerging-market borrowers, both private and public, will encounter increased competition from developed countries as the latter dramatically expand government deficit debt financing as well as government-guaranteed bank debt issuance.

The crisis has affected the external financing position of all developing countries—but not equally. Those that have high levels of external debt, large current-account deficits, and shallow foreign reserves are more likely to encounter difficulties in obtaining the finance they will need to avoid a more severe contraction in growth. Many private firms in the developing world will be hard pressed to service their foreign-currency liabilities with revenues earned in depreciating domestic currencies while confronting declining global export demand. The likelihood of balance-of-payments crises and restructurings of corporate debt in these countries warrant special attention. Countries that pursued prudent macroeconomic policies in the years preceding the crisis have more flexibility than others to respond to short falls with expansionary fiscal and monetary policies and so keep their domestic industries afloat.

Low-income developing countries, initially cushioned from the direct impact of the financial crisis, are now feeling effects that have spread through other channels. Net private capital flows will be insufficient to meet the external financing needs of many of these countries, and in view of the intense fiscal pressures triggered by the crisis, the prospects for large increases in aid flows are dim. The bulk of new commitments by international financial institutions will go to middle-income countries in 2009, and workers' remittances to low-income countries are projected to decline by 5 percent. Such sobering facts reinforce the importance of broad international agreement to mobilize the necessary resources to achieve the MDGs.

The financial crisis in today's integrated global economy has underlined the importance of coordinating policy so that measures taken in one country complement, rather than defeat, those taken in another. The economic channels through which nations trade goods and services also serve to propagate crisis when countries resort to protectionism. For that reason, it is imperative that countries coordinate policies to provide adequate financing for trade and resist the politically tempting tactic of protectionism—either in the trade or financial arena.

Recent actions by the world's central banks illustrate the utility of concerted action. With international banks operating in a multiple-currency world, central banks need ready access to several major currencies to fulfill their role of providing liquidity to their banks. Thus, the swap facilities that were created by the U.S. Federal Reserve and the People's Bank of China in response to the crisis are likely to be reinforced by other central banks acting in concert. Central banks in many countries, including some developing countries, also have acted together to reduce interest rates, expand their lending, provide guarantees to encourage more private lending, and take other action to jump-start credit markets stalled by the crisis.

Today's crisis constitutes a triad of tight credit, diminished confidence, and global recession, set in the context of an interconnected world economy. The world is transitioning from an extended credit boom and economic overheating to an era of slower growth. Looking to medium-term developments, participants in the international financial system—consumers, investors, traders, and firms—must adapt their behavior to the new realities of tightened credit conditions, a prominent role of the state in financial affairs, large excess capacity in many industrial sectors, and more closely coordinated regulatory policy. Governments, for their part, must support emerging signs of recovery in financial markets with persistent, robust policy efforts to transform the adverse feedback loop between the financial sector and the real economy into a positive one. In a world of global financial institutions, effective oversight of the financial system can be achieved *only* through coordinated efforts, because lax regulation in one jurisdiction makes it more difficult to enforce adequate standards elsewhere. Greater international cooperation in sharing information and establishing broad standards for regulation is important to making national regulators more effective and thus the global financial system more stable.

Global Development Finance is the World Bank's annual review of global financial conditions facing developing countries. The current volume provides analysis of key trends and prospects, including coverage of the role of international banking in developing countries. A separate volume contains detailed standardized external debt statistics for 128 countries, as well as summary data for regions and income groups. Additional material and sources, background papers, and a platform for interactive dialogue on the key issues can be found at http://www.worldbank.org/prospects. A companion online publication, "Prospects for the Global Economy," is available in English, French, and Spanish at http://www.worldbank.org/globaloutlook.

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The principal author was Mansoor Dailami, with direction from Hans Timmer. The report was prepared under the general guidance of Yifu Justin Lin, World Bank Senior Vice President and Chief Economist. The principal authors of each chapter were:

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Selected Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
BIS	Bank for International Settlements
CDSs	credit default swaps
CIS	Commonwealth of Independent States
DAC	Development Assistance Committee
DRS	Debtor Reporting System
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	foreign direct investment
G-7	Group of Seven
G-20	Group of 20
GDP	gross domestic product
GTFP	Global Trade Finance Program
GTLP	Global Trade Liquidity Program
HIPC	heavily indebted poor country
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFI	international financial institutions
IMF	International Monetary Fund
IPO	initial public offering
LIBOR	London interbank offered rate
M&A	mergers and acquisitions
mb/d	million barrels per day
MDB	multilateral development banks
MDGs	Millennium Development Goals
MIGA	Multilateral Investment Guarantee Agency
NIE	newly industrialized economy
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PRGF	Poverty Reduction and Growth Facility
REER	real effective exchange rate
saar	seasonally adjusted annual rate
SADC	Southern African Development Community
SDR	special drawing rights
WTO	World Trade Organization