Overview

ALMOST TWO YEARS AFTER PROBlems in the U.S. mortgage market set in motion the biggest financial crisis since the Great Depression, global financial markets remain unsettled, and prospects for capital flows to the developing world are dim. The intensification of the financial crisis in September 2008 dramatically altered the world economic outlook. Global output is now expected to shrink by 2.9 percent in 2009, the first contraction since World War II. International trade is likely to experience the sharpest drop since that time. Unemployment, already soaring in industrial countries, will follow a similar path in the export-dependent economies of East Asia, as high-income countries reel from an unprecedented asset-market bust, and global investors retreat from emerging markets.

The implications of these unfolding events for investment flows to developing countries have already been dramatic: total private capital flows in 2008 dropped to $707 billion (4.4 percent of total developing-country GDP), reversing the strong upward surge that began in 2003 and reached a pinnacle of $1.2 trillion in 2007 (8.6 percent of GDP). For 2009 the most likely scenario is that as global equity markets regain momentum and credit markets heal, net private flows to developing countries will remain positive—barely. But they will drop to $363 billion, approximately the level of 2004 and a decline of 5 percentage points of GDP from 2007. The magnitude of the decline is troubling for its macroeconomic consequences and for vulnerability to further shocks, particularly in countries in which banks and firms have high levels of external debt. Much of the $1.2 trillion external debt raised by emerging market banks and firms between 2003 and 2007 is now maturing, putting pressure on the borrowers' finances at the time when the average cost of external borrowing has increased to 11.7 percent, compared with 6.4 percent in the pre-crisis years when the debt was contracted.

Although extraordinary policy responses by governments around the world have helped save the global financial system from systemic collapse, they have not, thus far, closed the negative feedback loop between financial instability and economic recession. Fragile consumer confidence and a much-diminished appetite for risk among investors in developed countries have all contributed to a plunge in global aggregate demand. Simultaneously, the deepening economic downturn has caused major global banks to scale back domestic and international lending, thereby exacerbating the credit crunch. Actual bank lending in the United States and Europe, as well as surveys of bank intentions and credit terms, point to a slowing in the supply of bank credit to the corporate and household sectors. In recent months, that slowdown has become a decline. Likewise, foreign claims on developing-country residents held by major international banks reporting to the Bank for International Settlements declined by $200 billion between December 2007 and December 2008 (from $4.3 to $4.1 trillion).

To break the cycle and revive lending and growth, bold policy measures, along with substantial international coordination, are needed. In this regard, the joint announcement by the Group of 20 (G-20) leaders at their London summit in April 2009 was encouraging. The leaders vowed to strengthen the capacity of multilateral financial institutions to lend to emerging economies facing traditional balance-of-payments shortfalls or elevated risks from debt rollover and refinancing.

Addressing the various regulatory failures, bank governance shortcomings, and macroeconomic imbalances that contributed to the crisis has been another focus of the international policy response. Bad lending and poor investment decisions stemmed from lax regulation as well as from overconfidence and euphoria associated with low real interest rates and ample liquidity. Therefore, new measures that embrace all systemically important financial institutions (including hedge funds), that strengthen international accounting standards to improve transparency and asset valuation, and that bolster the Financial Stability Board are desirable and timely, even if their immediate success cannot be guaranteed.

In charting the course ahead, policy makers in developed and developing countries should give priority to four tasks: following up on the G-20's promise to restore domestic lending and the international flow of capital, addressing the external financing needs of emerging-market sovereign and corporate borrowers, reaffirming preexisting commitments to the aid agenda and the Millennium Development Goals (MDGs), and, eventually, unwinding governments' high ownership stake in the banking system and reestablishing fiscal sustainability.

Rapid progress on these fronts will make it easier for low-income countries to cope with the crisis. Already under severe strain, low-income countries face increasingly grave economic prospects if the dramatic deterioration in their capital inflows from exports, remittances, and foreign direct investment (FDI) is not reversed in 2010. As it stands, the amount of development assistance available to low-income countries will not fully cover their external financing needs in 2009, while the outlook for donor countries to increase aid significantly is bleak, given the intense fiscal pressures they face because of the crisis.

The global recession has deepened

The tight links between global trade in durable, capital, and high-tech goods, and the closely entwined investment spending that supports economic activity in both high-income and developing countries, can be detected in the vicious circle that now operates between the financial and real sectors of the global economy. The difficulty of obtaining capital, together with uncertainty about future demand, has delayed investments and caused a collapse in demand for durable goods, resulting in a sharp contraction in the production of and global trade in manufactured goods. World industrial production declined by an unprecedented 5 percent in the fourth quarter of 2008 (or 21 percent at an annualized rate). Output continued to decline in the first quarter of 2009, reducing the level of industrial production in high-income countries by 17.3 percent in March 2009, relative to its level a year before, and in developing countries by 2.3 percent relative to March 2008. The collapse in industrial production is truly global, with major producers of advanced capital goods particularly hard-hit—Japan (34 percent, year-on-year) as of March 2009, Germany (22 percent), and the Republic of Korea (12 percent).

GDP growth in developing countries is projected to slow sharply but remain positive in 2009, moving from 5.9 percent in 2008 to 1.2 percent. Nevertheless, developing countries as a whole will outperform by a sizeable margin high-income countries, whose aggregate GDP is projected to fall 4.5 percent in 2009. Two developing regions, Europe and Central Asia and Latin America and the Caribbean, are likely to end 2009 with negative growth. Moreover, when China and India are excluded, GDP in the remaining developing countries is projected to fall 1.6 percent or 0.6 percent in per capita terms, a real setback for poverty reduction. The simultaneous collapse in growth across high-income and developing countries cannot be explained solely by trade links, for the domestic economies of a large number of developing countries have been directly affected by the financial crisis. The reversal of capital flows, the collapse in stock markets, and the general deterioration in financing conditions have brought investment growth in the developing countries to a halt. In many developing countries, investment is falling sharply.

For developing countries that are significant commodity importers, one of the few silver linings of the financial crisis is that commodity prices are down some 35 percent from their record levels of mid-2008, limiting current-account deficits and helping to quell the inflation produced by high food and fuel prices during the years leading up to the financial crisis. Lower commodity prices have also had the salutary effect of mitigating the impact

of the current crisis on the poor. Commodity markets seem to have found a bottom, one that is still nearly 60 percent above the price levels of the late 1990s. In several markets, commodity production is being reduced because the marginal costs of exploiting the least resource-rich or most difficult-to-reach sites now exceed current prices.

While the global economy is projected to begin expanding once again in the second half of 2009, the recovery is expected to be much more subdued than might normally be the case. Global GDP is forecast to increase a modest 2.0 percent in 2010 and 3.2 percent by 2011, as banking sector consolidation, negative wealth effects, and risk aversion continue to weigh on demand throughout the forecast period. Among developing countries, expected growth rates should be higher (given stronger underlying productivity and population growth) but remain similarly subdued at 4.4 percent and 5.7 percent, respectively, in 2010 and 2011. Given the output losses already absorbed and because GDP only reaches its potential growth rate by 2011, the output gap (the difference between actual GDP and its potential) and unemployment are expected to remain high and recession-like conditions will continue to prevail.

Private capital flows are shrinking at an unprecedented rate

While the global economic cycle has always colored the emerging-market asset class, the current downturn has been especially noteworthy in its impact on asset valuation in equity markets and liquidity conditions in primary bond markets. Relative to their peers in mature markets, corporate and sovereign bond issuers in emerging markets have been particularly affected by liquidity concerns and risk aversion among investors. There was virtually no issuance between mid-September and mid-December 2008, in the wake of the collapse of Lehman Brothers. Local stock markets, meanwhile, experienced the worst yearly decline in recent history, as the MSCI Emerging Market Index sank 55 percent during the year, erasing some $17 trillion in market valuation. Investors' flight from perceived danger contributed to the sharp drop in capital flows to the developing countries, a trend that is very likely to persist through the end of 2009.

Although interest-rate spreads in developing countries have not widened by as much as in past crises, the decline in private capital flows to developing countries is expected to set a record. Net private debt and equity flows are projected to decline from a record high of 8.6 percent of GDP in 2007 to just over 2 percent in 2009, exceeding the peak-to-trough drop during the Latin American debt crisis in the early 1980s (3.3 percentage points) and the combined East Asian and Russian crises of the late 1990s (2.4 percentage points). Unlike in these past crises, however, the decline in inflows has hit every developing region. The most affected region is emerging Europe and Central Asia, which also experienced the largest expansion of inflows between 2002 and 2007. Net private inflows to the region were an estimated 6.4 percent of GDP in 2008, down from 15.1 percent in 2007.

Unlike portfolio equity and bond investments, FDI decisions are made with long-term horizons in view. They express the intention to build productive manufacturing facilities, exploit natural resources, or diversify export bases. Thus, FDI flows are less likely to be liquidated or reversed in times of crisis. Driven by the strong momentum of the first half of the year, FDI inflows to developing countries posted a slight increase in 2008, reaching $583 billion, equivalent to 3.5 percent of the aggregate GDP of developing countries. Almost all the increase occurred in middle-income countries, notably the Russian Federation, India, Brazil, and China. In contrast, FDI inflows to high-income countries fell sharply—from $1.3 trillion in 2007 to $827 billion in 2008. Most of the decline was concentrated in Europe; flows to the United States were up slightly compared with previous years.

Financing conditions have deteriorated rapidly

Developing countries will most likely face a dismal external financing climate in 2009. With private capital flows expected to post a dramatic decline, many countries will have difficulty meeting their external financing needs, estimated at $1 trillion, $600 billion higher than in 2003 at constant 2009 prices. Private debt and equity flows will likely fall short of meeting

external financing needs by a wide margin, estimated at $352 billion. Capital flows from official sources, along with drawdowns of foreign reserves, will help fill the gap in some countries. But where countries cannot secure adequate external financing, the external adjustment process will be abrupt—more so than projected for the developing world as a whole, requiring an even greater decline in domestic demand and putting additional pressure on the exchange rate. A number of countries (Belarus, Georgia, Hungary, Iceland, Latvia, Pakistan, Romania, Serbia, and Ukraine) already have received financial support from official sources, primarily the International Monetary Fund (IMF), with additional support from the World Bank, regional development banks, and the European Union (EU) to help alleviate balance-of-payments difficulties. The recent agreement by the G-20 to augment the lending capacity of the IMF and multilateral development banks will help high-income emerging-market and middle-income countries meet their external financing needs. However, little of such financing can be made available to low-income countries that have limited borrowing capacity.

The ability of countries to meet their external financing needs will depend largely on the extent to which firms can roll over their maturing debt. Some 700 corporations based in developing countries issued international bonds during the boom years of 2002–07, and almost 3,000 borrowed in the international syndicated bank loan market. Those corporations account for the bulk of outstanding short-term external debt and around three-quarters of the medium- and long-term private debt coming due in 2009. Two decades ago, corporations accounted for only about 20 percent of maturing medium- and long-term private debt.

Building confidence and strengthening policy coordination are critical to recovery and long-term growth

Among government officials, policy makers, and key market observers, calls to restore confidence in the global financial system have become an international mantra. A quick Web search of major media, for example, shows that the number of occurrences of "restore confidence" in October 2008 was 624 percent higher than the average for the first six months of 2008.

Governments have, by and large, "walked their talk" through a furious combination of unilateral and multilateral actions, drawing on a broad range of conventional and unconventional monetary policy, fiscal stimulus, and government guarantee programs to shore up the banking industry. Such actions have achieved some easing of liquidity conditions in global interbank markets, have supported a narrowing of credit risk premiums, and have underpinned a tentative revival of equity markets. However, the policy agenda for stabilizing financial markets and for global economic recovery is broad and complex, and major challenges remain. Several overarching themes will remain salient for policy makers over the next few years:

The global nature of the financial crisis places a premium on policy coordination

The deep international economic linkages among countries that provide the channels for negative spillovers across borders also enhance the scope for beneficial policy coordination. Indeed, efforts to stimulate aggregate demand through expansionary monetary and fiscal policies, to recapitalize insolvent financial institutions, and to restore the functioning of credit markets through the provision of liquidity are more likely to be taken—and are more likely to be effective—if there is broad agreement among the major governments on policy direction.

Governments' willingness to coordinate their policies can help reestablish confidence by ruling out beggar-thy-neighbor responses to the crisis. The danger of special interests using trade policy to protect particular industries is especially severe in a downturn. As for financial policies, measures taken to recapitalize commercial banks with public funds have introduced pressures for banks to concentrate lending activity on the domestic market (the so-called home bias in lending practices), at the expense of cross-border lending. In the years leading up to the crisis, a defining feature of global finance in developed countries was the escalating integration of the household sector into capital markets. Excessive credit creation, made possible through the technology of asset securitization, yoked

consumer spending to the expansion and profitability of the banking industry, with both serving as engines of economic growth. As household ownership of equities and bonds increased, households' wealth and income became more closely linked to capital markets, forging closer linkages between the real economy and financial markets—and increasing the likelihood of political intervention when trouble appears. In the United States, for instance, almost half of households currently own equities or bonds, up from 39 percent in 1989.

While the case for *fiscal policy coordination* is weak in normal times—because countries normally face very different challenges and priorities—it is called for today, as all countries are facing the same prospect of inadequate global demand. Stimulating aggregate demand through fiscal expansion is in everyone's interest at the moment, but each country will be reluctant to undertake it on the necessary scale because some of the expansionary effects will spill over to other countries, and because any country that acts alone—even the United States—may reasonably fear that increases in government debt will cause investors to lose confidence in its fiscal sustainability and so withdraw financing. Both of these constraints will be lessened by a commitment to coordinate a fiscal expansion globally. A joint international commitment to maintaining open markets for goods and services must be a central feature of governments' policy responses.

A balance must be struck between national and international mechanisms for improved regulation and crisis prevention

In designing and implementing reforms to strengthen financial markets and regulatory regimes, the first line of responsibility lies with national regulators, but greater international financial cooperation among regulators is an unavoidable imperative. Although changes in national regulations have begun to improve transparency and thwart excessive risk taking, today's highly integrated financial markets necessitate close coordination among authorities in order to bolster market confidence and avoid regulatory arbitrage. The international spillovers of the crisis in the financial area presently provide a powerful incentive for harmonization, because concerns over stability temporarily outweigh the urge to seek advantages for the "home team." It should be remembered, however, that regulatory cooperation is often resisted in normal times by policy makers eager to protect or enhance the competitive advantage of financial firms based in their own country.

Analysis conducted for this report suggests that not only the incentive for coordination, but also the gains to be had from it, are largest when there is a large common shock to confidence. But coordination must be in addition to, rather than a substitute for, national action. Because national regulators have the best access to information on their domestic institutions, they must retain principal responsibility for ensuring the stability of their own financial systems—without angling for a competitive advantage for domestic firms.

Over the medium term, governments must reestablish fiscal sustainability

Recent measures by central banks in the Euro Zone, Japan, the United Kingdom, and the United States to purchase private and government debt as a way of unfreezing credit markets have led to a significant expansion of their balance sheets and rapid growth of the monetary base in these countries, a process that has replaced, to a large extent, the accumulation of foreign exchange reserves by other central banks as the main engine of global liquidity.

Rising public debt levels and the rampant expansion of central banks' balance sheets will pose considerable challenges to economic stability once the recovery gets under way. The major industrial countries began the crisis with moderate debt-to-GDP ratios. However, the unprecedented amounts spent to bail out financial firms have already substantially inflated those ratios, and governments have taken on contingent liabilities in connection with various financial guarantees, the potential effects of which on government debt are unknown. Discretionary fiscal stimulus, as well as the operation of automatic stabilizers, will further increase debt ratios, perhaps doubling them in some countries if the downturn turns out to be as severe as is now envisaged. Government commitments will have to be financed, if not through taxation, then through the issuance of debt obligations. As the fiscal implications of such commitments are factored in, interest-rate expectations will be adjusted upward, raising the cost of capital for all borrowers, including those in developing countries.

The damage to low-income countries from the crisis must be mitigated

With so much at stake, there is an urgent need for the international financial community to take a hard look at recent developments, assess the vulnerabilities and risks that are the unintended products of current policy interventions and market changes, and evaluate the likely effects of those interventions and changes on development finance. Most of the available resources to be provided by the IMF and other international financial institutions are likely to be devoted to high-income emerging markets and middle-income countries that are likely to be able to repay the loans they receive.

In this climate, low-income countries that are already under strain deserve special attention. They have had little or no access to private foreign capital even in good times. A combination of policy and market failures has restricted their participation to occasional project finance deals, largely in extractive industries, and to the short-term loan market, mostly bank loans for trade financing.

That sobering fact should reinforce the importance of broad international agreement to mobilize the necessary resources to achieve the MDGs. After several decades of debt rescheduling through the mechanisms of the Paris Club, the sequence of official debt relief programs initiated under the Heavily Indebted Poor Countries measures of 1996 and culminating in the launch of the Multilateral Debt Relief Initiative in 2005 stand out as a remarkable exercise of multilateralism and sound economic sense. With fewer resources now available in low-income countries to service external debt, it is especially important that the world should build on—and certainly not back out of—those agreements.

These are the themes and concerns of this year's edition of *Global Development Finance*.