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Swimming Against the Tide: How Developing Countries Are Coping with the Global Crisis

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SWIMMING AGAINST THE TIDE: HOW DEVELOPING COUNTRIES ARE COPING WITH THE GLOBAL CRISIS

Background Paper prepared by World Bank Staff for the G20 Finance Ministers and Central Bank Governors Meeting, Horsham, United Kingdom on March 13-14, 2009.

Swimming Against the Tide:
How Developing Countries Are Coping with the Global Crisis

I. Key Messages

The sharp global contraction is affecting both advanced and developing countries. Global industrial production declined by 20 percent in the fourth quarter of 2008, as high-income and developing country activity plunged by 23 and 15 percent, respectively. Particularly hard hit have been countries in Eastern Europe and Central Asia and producers of capital goods. Global GDP will decline this year for the first time since World War II, with growth at least 5 percentage points below potential. World trade is on track to register its largest decline in 80 years, with the sharpest losses in East Asia, reflecting a combination of falling volumes, price declines, and currency depreciation.

Financial conditions facing developing countries have deteriorated sharply. The World Bank estimates that developing countries face a financing gap of $270-$700 billion depending on the severity of the economic and financial crisis and the strength and timing of policy responses. Even at the lower end of this range, existing resources of international financial institutions would appear inadequate to meet financing needs this year. Should a more pessimistic outcome occur, unmet financing needs will be enormous.

The financial crisis will have long-term implications for developing countries. Sovereign debt issuance by high-income countries is set to increase dramatically, crowding out many developing country issuers (private and public). Many institutions that have provided financial intermediation for developing country clients have virtually disappeared. Developing countries are likely to face higher spreads, and lower capital flows than over the past 7-8 years, leading to weaker investment and slower growth in the future.

The challenge facing developing countries is how, with fewer resources, to pursue policies that can protect or expand critical expenditures, including on social safety nets, human development and critical infrastructure. This will be especially difficult for LICs: the slowdown in growth will likely deepen the degree of deprivation of the existing poor, since large numbers of people are clustered just above the poverty line and particularly vulnerable to economic volatility and temporary slowdowns. Many of the most affected LICs are heavily dependent on official concessional flows, which will be under pressure in donor countries facing their own fiscal challenges.

There is a therefore a strong need to expand assistance to LICs to protect critical expenditures and prevent an erosion of progress in reducing poverty. Attention must be directed to protecting the poor through targeted social spending, including expanded safety nets, and to maintaining and expanding the infrastructure assets that will be critical to restoring growth following the crisis. A concerted effort is also needed to support the private sector, especially SMEs, which are essential to a resumption of growth and job creation in developing countries. Creation of a global Vulnerability Fund, financed with a modest portion of advanced country stimulus packages, could go a long way to providing the resources necessary for these efforts.

II. The Impact of Deteriorating Global Conditions on Developing Countries

Overall Impact

What began as a collapse of the US sub-prime mortgage market quickly spread through the financial system, eroding the value of capital, undermining the creditworthiness of major global financial institutions, and triggering massive de-leveraging.[1] Efforts to restore capital adequacy and uncertainty about the underlying value of assets held in the form of sub-prime mortgage backed securities resulted in capital hoarding, causing liquidity to dry up, ultimately compromising the ability of borrowers to finance transactions in both the real and financial sectors. This in turn reduced demand and employment, undermining consumer and business confidence, and triggering a further contraction in demand. According to the IMF's latest World Economic Outlook Update,[2] output in advanced economies is expected to contract by 2 percent in 2009, a sharp downward revision from expectations just a couple of months ago. Forthcoming forecasts by the World Bank and the OECD will likely show a further deterioration in the outlook.

Evidence of the toll that the financial crisis is having on middle-income countries is mounting. Growth prospects for emerging market and developing countries have been revised downward by a similar magnitude as for advanced economies. Central and Eastern Europe and the CIS countries are particularly hard hit given their reliance on external borrowing to fuel high credit growth in recent years. Latin America's prospects are closely tied to those of the United States, with the impact being felt through a variety of channels including declining remittance flows. For East Asia, the decline in external demand is partially offset by lower commodity prices and a large fiscal package in China, but the region's export dependence makes adjustment more difficult. In the Middle East, at least until recently, government spending in oil-producing states has been sustained despite a decline in oil prices. For those countries with capital market access, there has been an across-the-board increase in spreads since June 2007, with some countries facing increases of more than 2000 basis points.

Box 1: ***Food and Fuel Crisis Hangover: The Case of Malawi***:

Conditions in Malawi at the onset of the global financial crisis were less than propitious, making the economy particularly vulnerable to fallout from the global financial crisis. Foreign reserves had been seriously depleted by the food and fuel crisis (having fallen to less than one month of imports in the first quarter of 2008). The deterioration in the terms of trade in 2007 and much of 2008 increased the trade deficit (in constant volumes) by more than 4 percent of GDP while the sharp decline in fertilizer and oil prices since September 2008 and rising tobacco export prices have only offset a small part of this. These conditions led the authorities to agree to a program supported by the IMF's Exogenous Shocks Facility in December 2008 in an amount equivalent to 1.7 percent of GDP despite the "generally solid performance" under the 3-year PRGF-supported program which had been completed in July 2008. Fallout from the food and fuel crisis earlier in the year, and high fertilizer price subsidies in particular, also caused Malawi's fiscal situation to deteriorate (the overall fiscal deficit excluding grants increased from 13.6 percent of GDP in 2007/08 to a projected -16.9 percent in 2008/2009). This has left the government with little fiscal space should the fallout from the crisis begin to manifest itself more starkly. Further undermining the fiscal situation is a sharp depreciation of the British Pound against the Kwacha, which has reduced the budget support from its largest bilateral donor (DFID) from 2 to 1.5 percent of the budget.

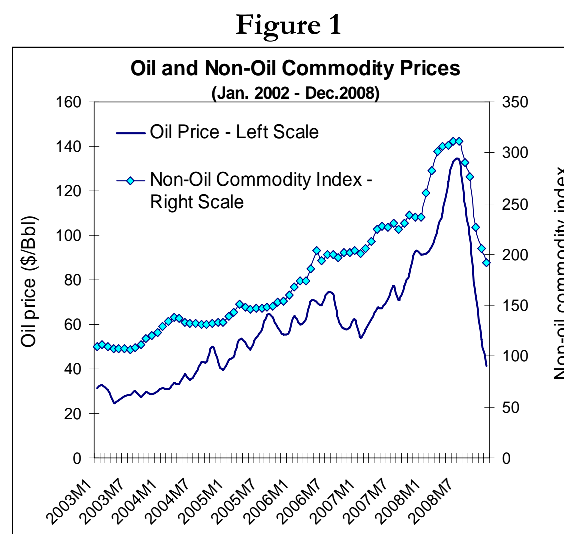
Most low-income countries were shielded from the direct impact of the sudden stop in private capital market flows because they have lower access to such flows. In Sub-Saharan Africa, for example, banks are largely financed domestically or regionally and do not rely significantly on external borrowing to finance operations. But while slower to emerge, the impact of the crisis on LICs has been no less significant as the effects have spread through other channels. Many LIC governments rely disproportionately on revenue from commodity exports, the prices of which have declined sharply along with global demand. These countries have subsequently come under intense fiscal pressure, particularly those with no access to private capital markets which must, if they are to protect core spending, look to ODA and concessional borrowing to fill financing gaps. Foreign direct investment is falling, particularly in the natural resource sectors, as financing becomes scarcer and as declining commodity prices lead to delays or cancellation of major projects. Remittances, which represent a major source of foreign exchange for many LICs, and an important income support for many households, are expected to contract in 2009 after years of rapid growth. In response to their own domestic fiscal pressures, some donors may find themselves under pressure to scale back concessional assistance on which LICs rely for balance of payments and budget support. For other donors, the challenge of meeting their commitments to increase aid has become much more difficult.

While many LICs will likely avoid the outright contraction in output seen in advanced economies,[3] they are considerably more vulnerable to an economic slowdown. The slowdown in growth will likely deepen the degree of deprivation of the existing poor. In many LICs, large numbers of people are clustered just above the poverty line and are therefore particularly vulnerable to economic volatility and temporary slowdowns. Many of the LICs most affected by the crisis have weak institutional capacity, limited fiscal space and high existing levels of household vulnerability which present additional challenges in coping with the growth, fiscal and poverty impacts of the crisis.

Declining Commodity Prices

Part of the fallout from the financial crisis has been a precipitous decline in the prices of a large number of basic commodities,[4] and the weakness in global demand, is expected to keep commodity prices low for a prolonged period. During the second half of 2008, non-energy commodity prices plunged 38 percent, with most indices ending the year well below where they started. In December, non-energy prices fell 6.8 percent, down for the fifth consecutive month on weak global demand. Primary commodity prices continue to display extraordinary volatility, falling swiftly as the downturn in global activity has intensified. Oil prices fell 69 percent between July and December 2008, reversing the oil price increases of the previous 3½ years. Non-oil commodities also fell 38 percent on average over the same period, with substantial declines in the dollar prices of food commodities, beverages, agricultural raw materials and metals and minerals (Figure 1).

Figure 1



Source: DEC Prospects Group, World Bank

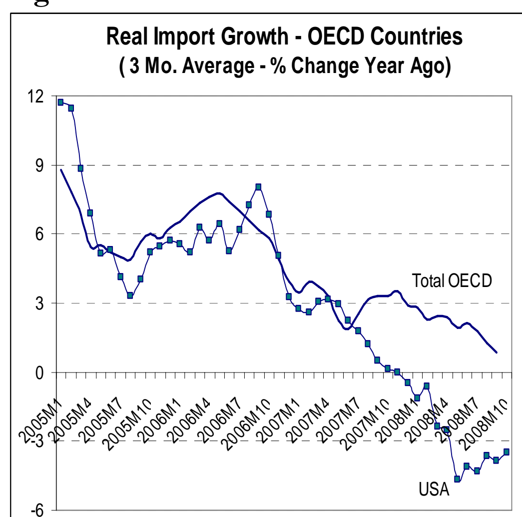
The dramatic fall in commodity prices is affecting different developing countries differently. Just as the *increase* in food and fuel prices between early 2007 and mid 2008 created both winners and losers among developing countries,[5] the sharp *decline* in commodity prices has done the same. Of the 68 developing countries with available data which experienced deteriorating terms of trade during the first three quarters of 2008, all but eight saw a partial reversal of the deterioration in the final quarter of the year. Of the 39 countries for which the terms of trade improved in the first three quarters, all but two saw a partial reversal in the final quarter. Oil-importing emerging market countries—including many Asian countries—were the top gainers from the oil price decline, receiving an income boost of some 2 percent of GDP, on average.[6] Many oil exporters, faced with a sharp drop in prices, have been able to draw on savings and reserves accumulated when prices were at historically high levels and indeed many of the countries that gained from recently high prices have been prudent in saving more of their gains than in previous commodity price booms (e.g., Nigeria). Such expenditure smoothing may help mute the impact of extremely volatile commodity prices on the real economy. Nevertheless, for some low-income commodity producers, the cumulative windfall was not large, particularly relative to their development needs. And for some commodity producers, the high prices from 2007 and into 2008 followed on the heels of a prolonged period during which their terms of trade declined.[7]

In many countries, commodities generate a large share of government revenue. This is particularly the case for major oil exporters and many LICs. In Africa, for example, oil is responsible for generating more than half of all revenues for Congo, Equatorial Guinea, Gabon and Nigeria; cocoa generates almost one-fifth of Cote d'Ivoire's revenue as do minerals in Guinea.[8] On average between 1999 and 2004, cotton and aluminum accounted for almost one-fifth of tax revenues in Tajikistan.[9] For at least nine Latin American countries, commodity revenue was, on average, at least 2 percent of GDP between 2002 and 2007.[10] For Trinidad and Tobago and Bolivia, respectively, this share has recently been as high as 22 and 12 percent of GDP. Respondents to a survey of Bank country teams in LICs have indicated that commodity-based revenues have already started to decline in many LICs. Careful monitoring of this trend is needed, while at the same time, it is essential that donors increase budget and other financial support to vulnerable LICs to avoid long-lasting setbacks to poverty reduction efforts.

Collapsing Global Trade

Falling demand in advanced economies has had serious implications for global trade, with 2009 expected to experience the first yearly decline in world trade volumes since 1982, the largest decline in 80 years. Advanced country imports are projected by the IMF to contract by 3.1 percent in real terms compared to earlier expectations of no change in volumes, and further downward revision is likely. The counterpart to this is the expectation of a virtually unprecedented decline (of close to 1 percent) in exports from emerging and developing economies. Figure 2 gives some indication of the magnitude of the slowdown in OECD country imports. Although 70 percent of global trade is between advanced countries, developing economies are highly dependent on advanced country markets for their exports. South-South trade only represents about 10 percent of global trade.

Figure 2:



Source: World Bank data and staff estimates.

Table 1

US Imports from Developing Countries October-November 2008

	US$ Billion	% Ch.*
All Developing	170.8	-3.2
Middle Income	155.0	-2.9
Low Income	15.8	-5.8
Sub Saharan Africa	11.4	-11.5
East Asia & Pacific	2.4	13.4
Eastern Europe & Central Asia	0.1	-17.7
Latin America & Caribbean	1.1	-2.4
Middle East & North Africa	0.0	38.2
South Asia	0.8	11.6

Source: US Commerce Department and World Bank staff calculations. Excludes small economies.

* % change from year ago.

Deteriorating growth in global trade has been underway for some time. In the last quarter of 2008, trade growth turned negative, raising fears in many corners of a protectionist backlash (Annex 1). Of the 51 economies reporting fourth quarter data for 2008, 36 show double-digit declines in nominal exports relative to a year ago. Many European countries, including the United Kingdom and Spain, as well as developing countries such as Indonesia, Philippines and Turkey registered a drop in exports of 20 percent or more. In October, India registered its first every year-over-year decline in exports (of 15 percent), following growth of 35 percent in the previous five months. In December, Brazil reported its first trade deficit in almost eight years, as exports plunged 29 percent. Data for January are available for only a handful of countries but show a sharp drop in exports relative to levels a year ago. Longer data lags make it difficult to evaluate what is happening to LIC exports, but a partial picture can be obtained by looking at import data from advanced countries. Table 1 suggests that LIC exports are already being seriously impacted, with US imports from LICs in October-November 2008 down almost 6 percent from a year earlier.

Weak global demand is compounded by a drying up of trade finance. Traditionally, some 80 percent of world trade is financed through open account transactions, leaving about US$2.8 trillion to be financed using various trade finance instruments. But with no comprehensive data available, an overall assessment of developments in trade finance is difficult. Emerging evidence suggests that the demand for traditional instruments such as letters of credit is strong as international traders, including in advanced economies, are increasingly requiring means of payment that are more secure than open account transactions.

Small and medium enterprises (SMEs) are especially challenged by the deteriorating risk landscape and are being crowded out by large firms who had previously financed international sales on "open account."[11] At the same time, the collapse in the supply of trade finance has been compounded by a sharp increase in capital requirements associated with the move to Basel II capital adequacy standards. As a result, the cost of trade finance has increased across the board.

According to Dealogic,[12] global trade finance shrunk by about 40 percent in the last quarter of 2008 relative to 2007.[13] In total, only 116 trade finance loans (excluding aircraft and shipping) were signed in the last quarter of 2008, the lowest quarterly deal count since 2004. Preliminary results from a recent IMF survey of 40 advanced economy and emerging market banks indicate that there was a widespread increase in pricing of all trade finance instruments relative to banks' costs of funds toward the end of 2008, with major traders paying 100 to 150 bps over trend.

Disappearing Private Capital Flows

Nowhere is the impact of the financial crisis more evident than in the global capital markets on which emerging markets and many developing countries rely. According to the Institute for International Finance, net private capital flows to emerging markets are estimated to have declined to US$ 467 billion in 2008, half of their 2007 level.[14] A further sharp decline to US$165 billion is forecast for 2009, with just over three-quarters of the decline due to deterioration in net flows from commercial banks. The Bank estimates that in 2009, 104 of 129 developing countries will have current account surpluses inadequate to cover private debt coming due. For these countries, total financing needs are expected to amount to more than $1.4 trillion during the year. External financing needs are expected to exceed private sources of financing (equity flows and private debt disbursements) in 98 of the 104 countries, implying a financing gap (i.e., not taking into account flows from official sources) in 98 countries of about $268 billion. Should rollover rates come in lower than expected, or capital flight significantly increase, this figure could rise to almost $700 billion.

There is a growing recognition that the rollover of maturing debt constitutes a key risk to emerging markets, especially banks and corporates, for which the lack of access, combined with limited domestic capital markets, will put additional financial pressure on governments who themselves are foreign capital constrained. Preliminary estimates suggest that well over $1 trillion in EM corporate debt and $2½-3 trillion in total EM debt matures in 2009, the majority of which reflects claims of major international banks extended cross-border or through their affiliates and branches located in emerging markets. Most of this lending is in foreign currency, and for relatively short terms, meaning that the currency and maturity risks are primarily on the balance sheet of EM banks, corporate and households. There is mounting evidence of growing pressure on interbank lines, particularly those extended to the corporate sector. Recent evidence of rollover efforts on public debt of major corporates indeed suggests that even stronger corporates in key emerging markets are struggling.

While small in global terms, Africa has been relying increasingly on private capital inflows (Figure 3). But given the small size of domestic securities markets, even a small decline in these flows could have a sizeable impact on securities prices. In terms of market borrowing, there have been no international bond issues by African countries in 2008, compared with US$6.5 billon in 2007.[15]

With credit conditions tightening, foreign direct investment is expected to decline in all regions (Figure 4) and will be particularly pronounced in those sectors (e.g., mining, oil) for which price declines have been particularly large. The impact of sharply lower oil prices and cuts in production is also having a negative impact on FDI in non-oil producers, particularly in the Arab world, as GCC countries cut their investments abroad. The World Bank's Public-Private Infrastructure Advisory Facility (PPIAF) reports that the value of PPI projects that reached financial closure between August and November 2008 was down 40 percent compared to a year earlier. A recent survey of World Bank economists suggests that concerns about the adverse

impact of the crisis on FDI are widespread, affecting three-quarters of LICs, particularly those in Sub-Saharan Africa and Central Asia. Numerous projects are being cancelled, delayed or at risk of being delayed on account of significantly lower commodity prices.

Figure 3: Sub-Saharan Africa Capital Inflows

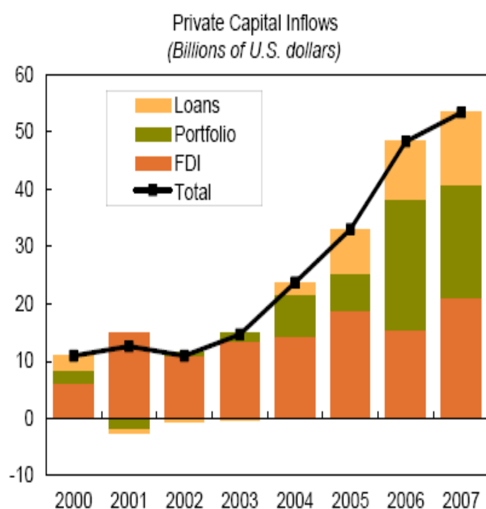
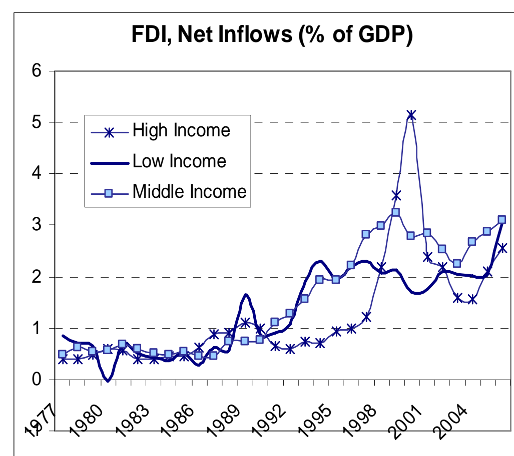


Figure 4: Foreign Direct Investment

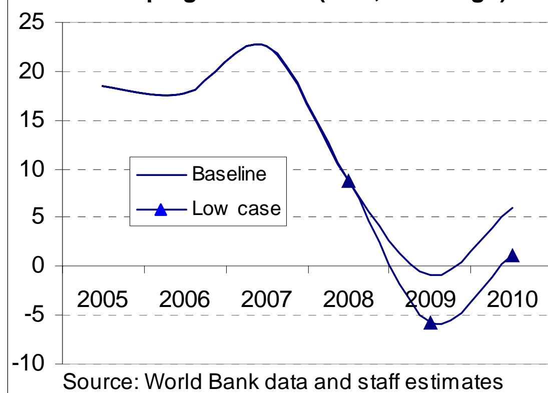


World Bank World Development Indicators.

The shortage of affordable financing will have major repercussions for infrastructure spending, which is critical for longer-term growth. New private activity in developing countries between August and November 2008 was about 40 percent lower than the same period in 2007, reflecting the impact of the financial crisis on the availability of financing. In several developing countries, major depreciations against the dollar have made foreign currency denominated debt too expensive. About one quarter of projects surveyed by IFC have been delayed, canceled, or are at risk of being canceled. A similar trend was experienced after previous financial crisis. Investments in private infrastructure projects in East Asia and Latin America declined substantially after the late 1990s crises in developing countries and had not recovered their pre-crisis levels by 2007. Maintaining, constructing or rehabilitating much needed public infrastructure such as roads, water supply and sewerage systems, drainage canals, and urban infrastructure (including slum upgrading) is critical to sustained development and growth, including by influencing the location of new private sector activities.

Dropping Workers' Remittances

Remittance flows are estimated to have reached $305 billion in 2008, an increase of around 9 percent from 2007, but with a sharp deceleration in the second half of 2008. World Bank projections suggest that remittances to developing countries will fall in 2009 (Figure 5). The steepest decelerations in 2008 have been for Sub-Saharan Africa and Europe and Central Asia, although moving into 2009, South Asia is particularly vulnerable given the importance of the GCC countries as a source of remittances. In the past,



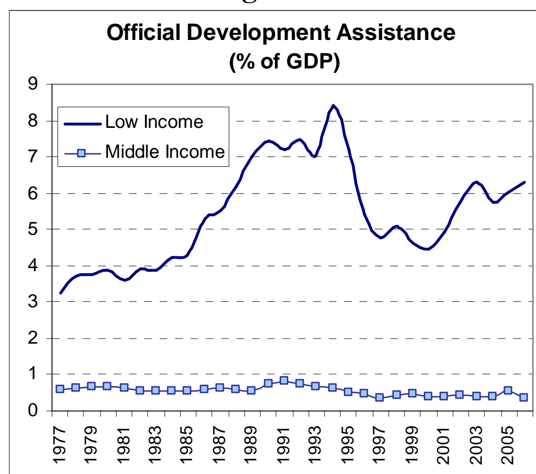
remittances have been stable, or even counter-cyclical, during an economic downturn in the recipient economy. This time, however, the crisis has affected remittance source as well as recipient countries. Since workers' remittances traditionally help finance consumption and SME investment in recipient countries, the deceleration in growth and possible decline is of great concern.

The situation is particularly problematic for those countries for which remittance inflows are large relative to GDP. The top recipients in terms of the share of remittances in GDP included many smaller economies such as Tajikistan (45 percent), Moldova (38 percent), Tonga (35 percent), Lesotho (29 percent), and Honduras (25 percent), Lebanon (24 percent), Guyana (24 percent). For a number of countries, declines in remittance inflows have been compounded by unfavorable exchange rate movements. Particularly problematic is the situation of countries like Tajikistan, Moldova, Kyrgyz Republic, and Armenia for which Russia is the main source of remittances. Many of these workers are employed in the oil and gas industry, sectors which are suffering from the precipitous decline in prices. Compounding this is the sharp depreciation in Russia's currency in the second half of 2008 and into early 2009 (falling about 35 percent against the US$), significantly reducing the local currency value of ruble-denominated remittances.

Squeezing Aid Flows

Budget support needs are increasing, but ODA commitments are uncertain. Historically, ODA to low income countries has been quite volatile, falling by around 3 percentage points of LIC GDP between the early and mid 1990s (Figure 6). Even before the onset of the financial crisis, developed countries as a group were falling short (by around $39 billion a year) of their Gleneagles commitments to significantly increase their aid and double aid to Africa. The concern now is that official aid flows could become even more volatile in the wake of a widespread global financial crisis and recession. Evidence of the impact of the crisis on donor budgets is mixed. While a few donors have signaled their intention to scale back their ODA budgets others have reaffirmed earlier commitments to increase ODA, at least for the upcoming fiscal year. For many low-income countries, there are few alternatives to development assistance when faced with crisis-related declines in export and fiscal revenues. Moreover, the channels through which the crisis is affecting them threaten recent progress in increasing social and core infrastructure spending, pointing to a growing need for quick disbursing budget support. With revenue expected to decline significantly, particularly in LICs, the ability to protect core development spending will depend heavily on receiving increased budget support from donors. On the positive side, almost three-quarters of developing countries are deemed to have the institutional capacity to effectively absorb at least some scaling up of budget support.

Figure 6:



Source: World Bank World Development Indicators.

III. Impact on the Poor and Most Vulnerable

What does this mean for the poor? The economic crisis is projected to increase poverty by around 46 million people in 2009. The principal transmission channels will be via employment and wage effects as well as declining remittance flows. While labor markets in the developing world will take a while to experience the full effects of the on-going global contraction, there is already clear evidence of the fall-out. The latest estimates from the Ministry of Labor in China show 20 million people out of work. So far, the most affected sectors appear to be those that had been the most dynamic, typically urban-based exporters, construction, mining and manufacturing. The **garment industry** has laid off 30,000 workers in Cambodia (10% of workforce) where it represents the only significant export industry. In **India,** over 500,000 jobs have been lost over the last 3 months of 2008 in export-oriented sectors—i.e., gems and jewelry, autos, and textiles. ILO forecasts suggest that global job losses could hit 51 million, and up to 30 million workers could become unemployed.

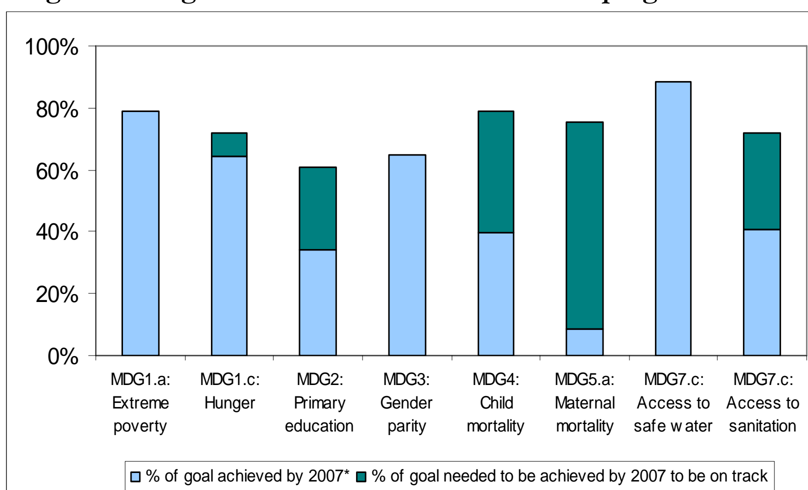
Workers are increasingly shifting out of dynamic export-oriented sectors into lower productivity activities (and moving from urban back into rural areas). These trends are likely to jeopardize recent progress in growth and poverty reduction resulting from labor shifting to higher return activities. For instance, nearly half of the increase in GDP per capita experienced in Rwanda between 2000 and 2008 is explained by movement of labor away from agriculture into the secondary and tertiary sectors.[16]

Declining remittances and migration opportunities are also undermining poverty gains and depressing wages. Remittances are a powerful poverty reduction mechanism, so that the current forecasts for a significant decline in remittances in 2009, will have strong welfare impacts in some countries.[17] Estimates for Tajikistan suggest that halving of the remittance flows would raise the poverty headcount from 53% to 60% and would deepen poverty and inequality.[18] According to recent projections in Bulgaria and Armenia, two countries heavily dependent on migration, a decline of 25% in remittances would increase poverty rates among recipients from 7% and 18% respectively to nearly 23% and over 21% respectively.[19] The international return flows of migrants as well as reduced new departures will reinforce the shortage of employment opportunities and further strain tight labor markets in the developing world.

Falling real wages and employment impede households' ability to provide adequate food and necessities to their members, particularly given their already stretched coping mechanisms from the 2008 food and fuel crises. Compounding this is the very real risk that, in many countries, fiscal pressures will result in reduced services to the poor, which is particularly problematic at a time when people are switching from private to public education and health services. Absent assistance, households may be forced into the additional sales of assets on which their livelihoods depend, withdrawal of their children from school, reduced reliance on health care, inadequate diets and resulting malnutrition. The long-run consequences of the crisis may be more severe than those observed in the short run. When poor households withdraw their children from school, there is a significant risk that they will not return once the crisis is over, or that they will not be able to recover the learning gaps resulting from lack of attendance. And the decline in nutritional and health status among children who suffer from reduced (or lower-quality) food consumption can be irreversible. Estimates suggest that the food crisis has already caused the number of people suffering from malnutrition to rise by 44 million.[20]

Experience from past crises suggests the potential for a slowdown in progress towards the MDGs (Figure 7). Even prior to the crisis, most human development MDGs—especially for child and maternal mortality but also primary school completion, nutrition, and sanitation—were unlikely to be met. Until recently, stronger progress in reducing income poverty had put the MDG for poverty reduction within reach at the global level, but the combination of food, fuel, and now, financial crises, has raised new obstacles. While the magnitude of the setback is difficult to assess at this point, countries that suffered economic contractions of 10 percent or more between 1980 and 2004 experienced, for example, more than one million excess infant deaths. Evidence suggests that growth collapses are costly for human development outcomes, as they deteriorate more quickly during growth decelerations than they improve during growth accelerations. The average GDP growth rate of developing countries is now projected to fall in 2009 to less than half the pre-crisis rate. The projected lower growth path will sharply slow the reduction in infant mortality. Preliminary analysis shows that, as a result, infant deaths in developing countries may be 200,000 to 400,000 per year higher on average between 2009 and the MDG target year of 2015 than they would have been in the absence of the crisis. Unless reversed, this corresponds to a total of 1.4 to 2.8 million excess infant deaths during the period. Progress towards the MDGs is expected to pick up when growth recovers, but achievement of the goals will be further delayed.

Figure 7: Progress towards MDGs --- all developing countries



IV. Policy Challenges in Responding to the Crisis

In responding the global economic crisis, developing and emerging market countries will face three main challenges:

- *Stabilization:* The crisis threatens growth, employment, and balance of payments stability even in those countries that have made significant improvements in macroeconomic management in recent years. Give the unprecedented severity of the crisis, few countries will be able to avoid heavy pressures on their fiscal and external positions. The challenge for policymakers in this environment is to assess their ability to undertake countercyclical policies given the resources available to them as well as their institutional and administrative capacity to rapidly expand and adapt existing programs. [21]

- *Protecting Longer-Term Growth and Development*: An important lesson learned during the Asian crisis is that neglecting core development spending during a major crisis can have large long-run costs. Responding to immediate fiscal pressures by putting off maintenance of existing infrastructure essential for economic development, for example, can lead to costly rehabilitation over the longer term and also hold back economic recovery. The same can be said of reduced public spending on human capital development, such as basic education.

- *Protecting the Vulnerable.* Inevitably, the crisis will impact social and human development objectives. Declining growth rates combined with high levels of initial poverty leave many households in developing countries highly exposed to the crisis. The Bank estimates that of 116 developing countries, 94 have experienced decelerating growth, of which 43 experience high levels of poverty. This implies new spending needs and may warrant a re-prioritization of existing public spending. While impacts are country specific, the crisis entails real risks for future poverty reduction and exposes poor and vulnerable households to potentially severe welfare losses. Households in the poorest countries are the most in danger of falling back into poverty and have less access to safety nets to cushion the impact. To some extent, countries that established or improved the efficiency of social safety nets during the food and fuel crisis can utilize these channels to protect the poorest and most vulnerable. Critical to protecting households in exposed countries will be the ability of governments to cope with the fallout and finance programs that create jobs, ensure the delivery of core services, and provide safety nets. However, given the scarcity of resources, the challenge remains to continue to improve the targeting and effectiveness of social support.

Pursuing these objectives can require significant resources. But in an environment characterized by rising needs and scarce resources, policymakers face difficult challenges of setting spending priorities and maximizing the development impact of their spending. These challenges are particularly daunting for debt-distressed countries for which the resources constraints are often greatest. Even if a country's public debt is low, it may find it difficult to finance a large fiscal stimulus package.

There is also considerable uncertainty with respect to both the severity and length of the economic downturn, further complicating the task of policy makers. A less protracted slowdown would suggest a focus on shorter term measures that are easily reversible, emphasizing (where possible) the acceleration of pre-existing spending plans rather than new initiatives. A more protracted slowdown would lengthen the horizon over which it would be desirable to implement countercyclical polices. With no clear sense of the length and depth of the crisis, contingency planning and enhanced monitoring of evolving economic and fiscal conditions will be critical.

V. Limiting the Damage from the Crisis

To date, all advanced economies and a majority of developing countries in the G-20 have announced plans for some level of fiscal stimulus. As of end January, this amounted to almost US$1 trillion for 2008 and 2009[22] combined, with a further US$650 billion in 2010. Of these amounts, the major portion—more than four-fifths—is being undertaken by advanced economies. With virtually all countries expected to be affected by the crisis, many will be looking to cushion the impact on their citizens. Yet, according to Bank analysis, only one quarter of vulnerable developing countries are in a position to expand their fiscal deficit to undertake significant countercyclical spending.[23] Moreover, one-third of these countries is aid dependent and will require additional external support to finance increased spending.

At the same time, there is a clear need for countercyclical fiscal stimulus in response to the contraction in global demand. However, many countries, particularly LICs, lack the resources to undertake the types of measures that could make a real difference in the lives of those impacted by the crisis. To a significant extent, a country's ability to respond to the needs of its people is a function of its fiscal and external positions leading into the crisis, with countries

that have a more favorable starting position more likely to have room to implement countercyclical fiscal policy.[24] Countries with large accumulated reserves and fiscal surpluses, for example, may be able to offset some of the drag on the domestic economy through discretionary expenditure and tax measures. But many governments, particularly in LICs and countries negatively impacted by the earlier food and fuel crisis, have found it increasingly difficult—if not impossible—to cushion the effects of the crisis on their populations, as weak revenue performance puts budgets under additional pressure, placing the delivery of basic services at risk and precluding the adoption of a stimulus packages without external assistance. Many of the countries most affected by the crisis, and those at the lower end of the development scale, also have weak institutional capacity and high existing levels of household vulnerability, which will make it very difficult for them to cope with the growth, fiscal and poverty fallout from the crisis.

Box 2: India's Infrastructure Response

In response to rapidly deteriorating growth, the central government has allowed the India Infrastructure Finance Company Limited (IIFCL) to raise r400 billion (0.7 percent of GDP) to help with the financing of projects (largely for road and ports) that were being implemented as public-private partnerships (PPPs). The infrastructure projects that are eligible for financing (mainly in the roads and port sectors) were well-advanced in their design and many were near financial closure prior to the crisis and had been, or were at the risk of being, delayed on account of the global credit crunch. The additional resources being made available through the IIFCL will refinance loans originally provided by commercial banks. This will ensure that these projects, which will help address some of the infrastructure bottlenecks that have been a huge constraint on India's long-term growth, are able to proceed, and help support aggregate demand and protect jobs during the economic downturn.

With the expectation of falling revenues and a scarcity of affordably-priced capital, protecting core social and infrastructure spending will become more difficult. And with the likely increase in demand for social safety nets, particularly as unemployment rises, the cost of existing social support programs can be expected to increase. But as noted previously, the long-term cost of neglecting either social support or infrastructure maintenance can be significant,[25] suggesting a critical need to protect spending in these areas.

In many cases, the drying up of liquidity will threaten the viability of developmentally-important public-sector or public-private capital projects. The disappearance of financing could be the result of a fundamental shift in market conditions making it difficult for governments to follow through on previous plans to borrow from markets or, in the case of public-private partnerships, the inability of a private-sector partner to finance its originally agreed participation. Projects of this type that are well advanced could favorably impact domestic demand quite quickly if completed. Were they delayed or even cancelled due to the evaporation of expected financing, an important part of the foundation for future growth in output, employment and productivity would be lost. Recognizing this, policymakers in a number of countries are working to put in place alternative arrangements to replace financing no longer available from private partners (Box 2).

Getting the "biggest bang" for the stimulus "buck" will be key to limiting the damage caused by the crisis. Augmenting or accelerating the implementation of existing public works or investments may be one option that is open to policymakers in developing countries**.** Assuming both financing and implementation capacity are available, bringing forward future spending to a time when labor market conditions are particularly weak can help preserve jobs and head off a potential burden on social safety nets. Augmenting spending on, for example,

maintenance of existing infrastructure, particularly when it is in disrepair, may also provide a rapid channel for generating employment consistent with enhancing longer-run growth and development.

New spending initiatives (including on infrastructure) are also an option, if appropriate financing can be mobilized, particularly if they can be implemented quickly and are expected to contribute to a country's long-run growth potential. Investments in clean technology could conceivably fall into this category. However, uncertainty about the length of the crisis, and the difficulty in obtaining longer-term financing commitments in current market conditions, suggests the need for caution in approaching ambitious projects for which a significant share of spending may not take place for several years. Besides the opportunity cost in terms of forgoing a more immediate fiscal stimulus, there is the risk that such spending ends up being pro-cyclical.

To lay the ground for recovery, it will also be important that small and medium-sized enterprises are able to obtain the financing necessary to create and develop opportunities for growth and employment. SMEs play a critical role in economic recovery, often acting as the "best safety net". This highlights the importance of protecting access to financing for this particular vulnerable segment of the private sector. A number of initiatives are underway, including through the use of public guarantees to private financial institutions to support the ongoing provision of finance to SMEs Using newly gathered data for 91 banks from 45 countries, research by World Bank staff finds that banks in developing countries perceive the SME segment to be highly profitable, but see (in descending order) macroeconomic instability, high interest rates, and exchange rate risk as the main obstacles to continued lending.[26] This underlines the importance assigned by policymakers to macroeconomic stability in creating an environment conducive to recovery.

VI. Responding to the Crisis—How the World Bank is Helping

The World Bank Group has an important role to play in helping developing countries assess and respond to the challenges presented by the global economic crisis. The Bank is well positioned to play a role in helping its clients stabilize their economies, preserve and enhance the foundations for longer-term economic growth, and protect the most vulnerable against fallout from the crisis. Because of the magnitude of the crisis and the heterogeneity of its impact on individual developing countries, the Bank is mobilizing a wide range of support, which will be tailored to country and community needs, including through technical assistance and policy advice, direct financing, and by helping to leverage financial support from a variety of public and private sources. The Bank is actively working with other IFIs and MDBs to design, develop and implement many of the new approaches and instruments it is proposing

Taken together, financial needs are considerable. The World Bank Group is stepping up its financial assistance to its clients on a number of fronts. There is scope to almost triple lending to around $35 billion in FY2009, and lending volumes could potentially reach $100 billion over the next three years. Following its record 15th replenishment, IDA is positioned to assist LICs in dealing with the impact of the global financial crisis, with commitments amounting to nearly $42 billion over the next 3 years, and scope for front-loading this support over the next year. The Bank is at the forefront of global efforts to mobilize resources for developing countries, particularly those without the means to cushion the impact of a crisis not of their making.

Central to this effort is a World Bank proposal for an umbrella Vulnerability Fund to

which developed countries could dedicate 0.7 percent of their planned economic stimulus. The Vulnerability Fund, which could channel resources not only through the Bank but also through the UN or other MDBs, would help countries without the resources to respond to the crisis by funding investments in three key areas:

- **Infrastructure projects** that would help put people in developing countries back to work while building a foundation for future growth and productivity.

- **Safety net programs**, such as conditional cash transfers that make it possible for people to keep their children in school, get adequate nutrition and seek health care.

- **Financing for small and medium-sized businesses and microfinance institutions** to help the private sector create jobs.

The Bank continues to adapt its financial instruments to the specific needs of its clients. The World Bank Group is also establishing a comprehensive IBRD/IDA Vulnerability Financing Facility (VFF) to streamline its support to protect the poor and vulnerable during global and systemic shocks. The VFF could be one option for countries wishing to contribute to the Vulnerability Fund. Along with its support to the private sector and to sustain infrastructure investment, the VFF is part of an emerging framework for addressing developing country vulnerability to crises. The VFF currently incorporates three initiatives: (i) the Global Food Crisis Response Program (GFRP); (ii) the IDA Fast-Track Facility, which will fast-track up to $2 billion of financial assistance, with potential to increase this amount in future; and (iii) the Rapid Social Response Fund to help protect the poor and vulnerable in middle and low-income countries affected by different dimensions of the global crisis. These initiatives focus respectively on three key areas of vulnerability response: (i) agriculture, which is the main livelihood for the majority of the world's poor, (ii) programs to protect investments in longer-term development in the poorest countries, and (iii) employment, safety nets and protection of basic social services to help the poor and vulnerable groups cope with crisis.

To respond to the challenges the current crisis presents for the infrastructure sector, the WBG is also launching an Infrastructure Recovery and Assets (INFRA) Platform. The objectives of the three-year INFRA Platform are to: (i) stabilize existing infrastructure assets by restructuring current portfolios, covering maintenance costs, and advising clients on currency and interest rate risk management; (ii) ensure delivery of priority projects through Public Expenditure Reviews and government capacity building, by accelerating disbursements and/or identifying additional financing, and by seizing the opportunity for "green infrastructure" through access to leveraging facilities, (e.g. Carbon Partnership Facility, Clean Technology Fund); (iii) support Public Private Partnerships (PPPs) in infrastructure through advisory and restructuring support, use of Bank Group guarantees, innovative instruments, and in coordination with the IFC Infrastructure Crisis Facility; and (iv) support new infrastructure project development and implementation by providing financing and advice to governments launching growth and job enhancement programs, as well as new infrastructure projects.

IBRD/IDA aims to support the achievement of the INFRA Platform objective through.

- Direct IBRD and/or IDA funding of infrastructure projects of up to $15 billion per year

- Diagnostic and advisory support to identify countries most at risk and projects most appropriate for INFRA support

- Technical assistance to governments in the development of fiscal stimulus packages
- Providing parallel financing to ensure collaboration and complementarity among bilateral and IFI financing for priority projects
- Providing concessional financing for project preparation and financing for priority projects to mobilize additional funds for infrastructure development

In addition to direct financial support, the Bank continues to provide developing countries with access to diagnostic and capacity-building instruments like Public Expenditure Reviews (PERs) and Debt Management and Performance Assessments (DEMPA)—the former to help improve budget management and identify priority expenditures to be protected should financing shortfalls persist, the latter as a critical tool for assuring essential fiscal sustainability. The value to developing countries of these instruments has increased in a resource constrained environment, as will the usefulness of technical assistance to improve revenue and customs administration. A number of client countries are also looking for assistance in building bank supervisory capacity to enable them to more effectively monitor developments and respond to weaknesses in domestic financial sectors as they emerge.

The IFC Private Sector Platform will provide support to the private sector in LICs and vulnerable MICs for crisis-related activities. The International Finance Corporation (IFC) has launched or expanded five facilities to address problems experienced by the private sector. Financing for the new facilities is expected to total about US$30 billion over three years, combining IFC funds and externally mobilized resources, including from governments, export credit agencies, and international financial institutions. Among the efforts underway are:

- **Expansion of the Global Trade Finance Program (GTFP).** The existing program, which offers banks partial or full guarantees on the payment risk in trade transactions, was doubled in size and can now support up to US$18 billion in short-term trade finance over the next three years. Since its inception in September 2005, US$3.2 billion in trade guarantees have been issued in support of 2,600 transactions. Of these, 48 percent were for banks in Africa, 70 percent involved small and medium enterprises, half supported trade with the world's poorest countries, and 35 percent facilitated trade between emerging markets. The expanded facility is expected to benefit participating banks in more than 65 developing countries.

- **Creation of a Global Trade Liquidity Pool (GTLP).** While expansion of the GTFP greatly increases the potential to support trade finance through the use of guarantees, the severe shortage of liquidity has made it difficult for many companies to line up the basic financing to be guaranteed. IFC is therefore working with a number of partners to create a funded Global Trade Liquidity Pool and will seek Board approval for its adoption at the end of March. With the involvement of a number of global or regional banks active in trade finance, the GTLP will fund trade transactions for up to 270 days and will be self liquidating once conditions for trade finance improve.

- **Bank Recapitalization Fund.** IFC recently approved a US$3 billion Bank Recapitalization Fund to provide Tier I and Tier II capital to distressed banks in emerging markets which lack alternative sources of financing. It will also provide advisory services to strengthen private sector development and improve economic and financial performance. IFC expects to invest US$1 billion of its own money. Japan has announced its intention to become a key founding partner and provide the remaining US$2 billion in financing.

- **Infrastructure Crisis Facility.** This IFC facility, which is part of the WBG's broader Infrastructure Recovery and Assets (INFRA) Platform, will help ensure that viable, privately-funded infrastructure projects in emerging markets have access to the funding they need to weather the financial crisis by providing temporary financing to private or public-private partnership infrastructure projects in emerging markets. Among other things, it will roll-over financing and temporarily substitute for commercial financing for new infrastructure projects, if funding is unavailable. IFC expects to invest a minimum of US$300 million and mobilize between US$1.5 billion and US$10 billion from other sources.

- **Microfinance Liquidity Facility.** As one of the top three international investors in microfinance, IFC has designed a liquidity facility to help ensure availability of adequate refinancing for Microfinance Institutions amidst the market turmoil. The US$500 million facility is a joint effort with Germany's KfW. Using three of the industry's largest fund managers, the facility will provide refinancing options of up to 70 percent of the microfinance market. IFC expects to invest up to $150 million.

In addition, IFC will contribute up to €2 billion in a coordinated effort (with the EBRD and the EIB) to finance assistance to businesses hit by the crisis in Central and Eastern Europe. It will be disbursed through IFC's various crisis response initiatives in sectors including banking, infrastructure, and trade as well as through its traditional investment and advisory services. This is part of a broader €24.5 billion joint effort to support the banking sectors in the region and to fund lending to businesses hit by the global economic crisis, of which the World Bank Group will provide support of about €7.5 billion.

The Multilateral Investment Guarantee Agency (MIGA) continues to focus its guarantee activity in higher risk/low income countries and on difficult structured finance transactions. During December of 2008 and January 2009, MIGA approved US$675 million in guarantees in support of loans to three foreign-owned financial institutions operating in Ukraine. A US$95 million guarantee was provided to a subsidiary of foreign-owned financial institution operating in Russia. Similar guarantees are being explored for banks operating in other Eastern Europe countries and in Africa, in collaboration with IFC. MIGA is in the process of proposing changes to its operational regulations to allow it to respond more rapidly to emerging needs.

VII. Urgent Priorities

By any standard, the magnitude of challenge faced by policymakers is massive and minimizing the impact of the crisis on vulnerable populations and households is going to require concerted and coordinated action. On the positive side, there is a growing recognition of what needs to be achieved to put all countries—advanced and developing—back on the path to sustained growth and poverty reduction:

1. **Restore confidence**: Only by restoring confidence in the global financial system will the financing needed for growth—including through short-term trade finance, medium-term debt rollovers, and long-term FDI, including via public-private partnerships—resume at the level required to restart growth.

2. **Restore aggregate demand**: Without restoring aggregate demand, job prospects will remain poor and unemployment will continue to rise, creating its own cycle of economic, social and political pressures. Key to this will be renewed growth in global trade, with the

provision of trade finance a high priority. But one of the greatest threats to increased trade flows is protectionism and beggar-thy-neighbor policies, which need to be resolutely resisted.

3. **Increase concessional flows**: With needs mounting, and progress to the MDGs under increasing threat, now is not the time to cut pull back from commitments to increase both the quantity and quality of ODA. Indeed, under current circumstances, donors should make a concerted effort to enhance the share of assistance that is untied and provided in the form of budget support.

4. **Enhance the counter-cyclical impact of lending from the IMF and parallel financing from the MDBs**: Responding to the perils implied by the current economic situation will require that the IFIs become more nimble, innovative and flexible to ensure that resources are mobilized quickly and used to their greatest effect.

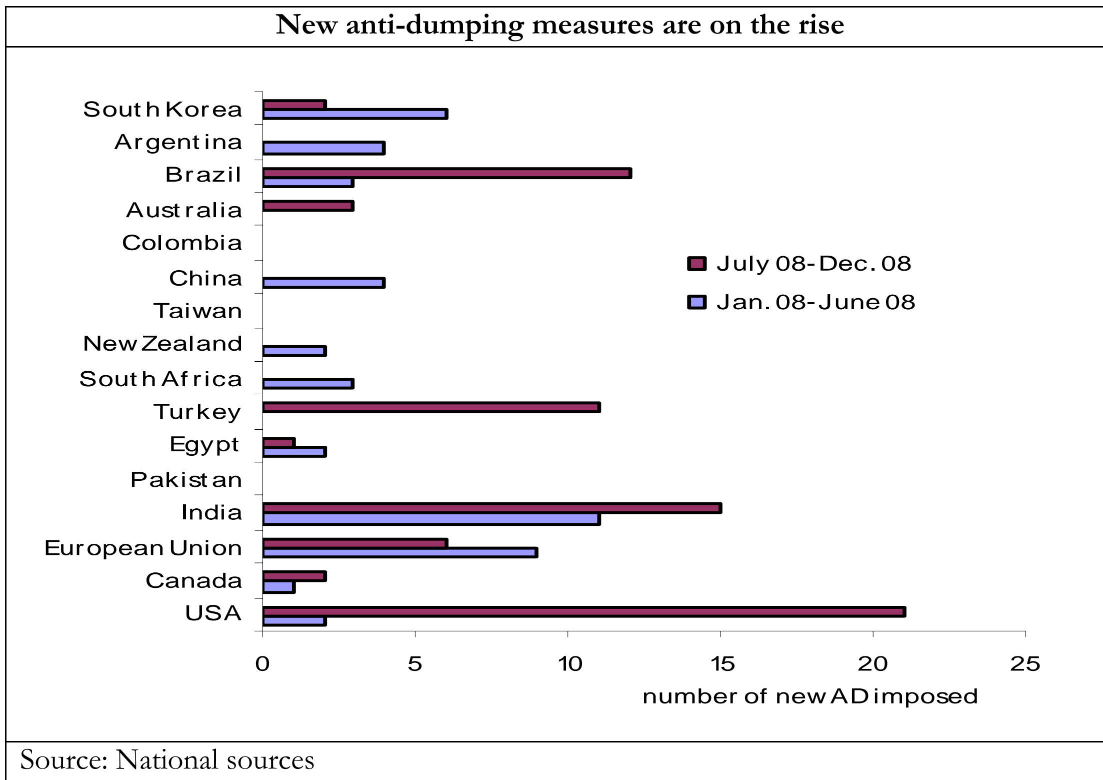
5. **Provide additional support to the private sector, particularly in emerging market economies**: With the risks of doing business having increased across the board, the official sector, through institutions like the IFC, will play an increasingly valuable role by sharing these risks. Increased collaboration and partnership between these facilities will be key to making the best use of available resources.

Annex 1: The Protectionist Tide

Protectionism remains a serious threat in the current environment. Many countries are contemplating, or have already implemented, increased protection, which may be difficult to reverse and will slow the recovery. Since the beginning of the financial crisis, roughly 78 trade measures have been proposed or implemented, of which 66 involved trade restrictions. Of these, 47 measures were actually implemented, including by 17 of the G20. In addition, anti-dumping claims and actions increased 20 percent in 2008 relative to 2007; and 55 percent in the second half of 2008 relative to the first half of 2008.

Agricultural subsidies, not counted in these numbers, have increased automatically with the recent fall in commodity prices. In addition to changes in tariffs, nontariff barriers, such as licensing requirements and tighter application of product standards, are also being introduced. Governments are also taking measures to support specific industries through potentially trade-distorting measures, including by increasing subsidies as part of fiscal stimulus packages. While government financial support packages do not necessarily distort trade, public intervention targeted at specific export-oriented industries or competing import industries are akin to protectionism and run the risk of starting a subsidy race among nations. In addition, there is a risk that governments providing "bailouts" to domestic banks may exert pressure on those banks to use those resources within their countries rather than to provide trade finance that would go to foreign countries.

New anti-dumping measures are on the rise



Source: National sources

Endnotes

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[1] For a discussion of the origins of crisis, see Jaffe, D.M., *The U.S. Subprime Mortgage Crisis: Issues Raised and Lessons Learned*, Commission on Growth and Development Working Paper 28, June 2008.

[2] World Economic Outlook Update, International Monetary Fund, January 28, 2009

[3] The IMF's January WEO forecast for Sub-Saharan Africa predicts growth in 2009 will slow to 3.5 percent from an estimated 5.4 percent in 2008. However, there is considerable variation around this average, with several countries particularly vulnerable.

[4] There have been a few exceptions. For example, gold prices remain above their historical average, reflecting, in part, the status of gold as a haven in times of turmoil.

[5] See, for example, *Double Jeopardy: Responding to High Food and Fuel Prices*, World Bank, 2008.

[6] For countries that had previously been subsidizing food and fuel prices, this will provide a welcome respite. That said, the net impact on the terms of trade of the respective declines in commodity prices is still expected to be negative in 2009 for between 25 and 30 LICs.

[7] Bower, Geis and Winkler (2007) report that between 1999 and 2005, at least 10 West and Central African countries experienced terms of trade declines of at least 10 percent.

[8] Marinkov and Burger, "The Various Dimensions of Commodity Dependence in Africa", South African Journal of Economics, Volume 73:2, June 2005

[9] Kumah, F. and J. Matovu, "Commodity Price Shocks and the Odds on Fiscal Performance: a Structural VAR Approach", IMF Working Paper WP/05/171, August 2005

[10] Vladkova-Hollar, I. and Jeronim Zettelmeyer, "Fiscal Positions in Latin America: Have They Really Improved?" IMF Working Paper 08/173; May 1, 2008

[11] In Africa, as a result of a drying up in trade finance, there has been an increased use of "cash in advance" transactions.

[12] Dealogic is a leading provider of global investment banking analysis and systems and one of the few sources of information on trade finance developments.

[13] Trade finance data reported by Dealogic covers structured trade finance operations such as syndicated loans or commodity trade finance operated by banks. It does not include private bilateral deals which actually make up the bulk of the estimated US$2.8 trillion of trade finance.

[14] Institute for International Finance, *Capital Flows to Emerging Market Economies*, January 27, 2009. these estimates are consistent with an assumption for 2009 global growth of -1.1 percent, considerably more pessimistic than the recent IMF WEO forecast of 0.5 percent. The IIF's increased pessimism concentrated in their forecasts for Latin American and Emerging Europe growth in 2009.

[15] Ghana and Kenya recently postponed planned sovereign bond issues totaling US$800 million.

[16] World Bank (2009) "The Role of Employment and Earnings for Shared Growth: The Case of Rwanda."

[17] Ratha, 2009, low-case scenario.

[18] World Bank (2009) *Simulation of the impact of reduced migrant remittances on poverty in Tajikistan*, 2009.

[19] World Bank (2009) *Bulgaria, The impact of the Financial Crisis on Poverty*, World Bank (2009) *Armenia, Implications of Global Financial Crisis for Poverty.*

[20] World Bank (2008) *Rising food and fuel prices: risks to future generations*

[21] As measured by a country's ability to manage the budget process, design and implement policies, provide services, and deliver accountable and transparent government as well as capacity to quickly enhance support for poverty reduction programs

[22] Excludes banking sector support measures.

[23] The classification of a country as "vulnerable" is based on an assessment of its overall level of exposure to the fallout from the crisis and its government's ability to cushion the impact of the crisis on exposed households. The capacity of governments to cope with the impacts of the crisis on poverty depends on: (1) fiscal capacity to incur an increased fiscal deficit (i.e., which is linked to the ability to raise additional funding domestically and from abroad without jeopardizing macroeconomic stability or debt sustainability); and (2) institutional capacity to implement programs aimed at mitigating the poverty impact of the crisis.

[24] World Bank/PREM, *Weathering the Storm: Economic Policy Responses to the Financial Crisis*, November 2008, available at http://siteresources.worldbank.org/NEWS/Resources/weatheringstorm.pdf

[25] For example, see Jorge Arbache and John Page, *More Growth or Fewer Collapses? A New Look at Long Run Growth in Sub-Saharan Africa*, World Bank Policy Research Working Paper No.WPS4384, November 11, 2007. The authors find that, for instance, child mortality rises during growth decelerations, but hardly falls during accelerations. Primary school completion rates are substantially lower in countries experiencing growth decelerations, as is life expectancy.

[26] Beck, Thorsten; Demirguc-Kunt, A., Martinez, P., and Maria Soledad, *Bank Financing for SMEs Around the World: Drivers, Obstacles, Business Models, and Lending Practices*, World Bank Policy Research Working Paper No. 4785, November 2008