IDS IN FOCUS POLICY BRIEFING

Research and analysis from the Institute of Development Studies

ISSUE 07
POLICY RESPONSES TO THE GLOBAL FINANCIAL CRISIS
MARCH 2009

The Global Financial Crisis, Developing Countries and Policy Responses

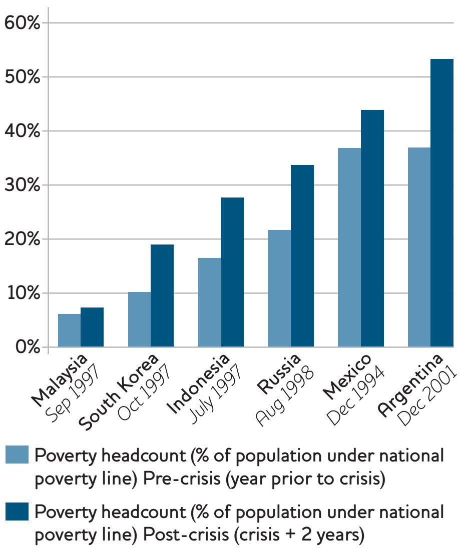
How will the global financial crisis affect developing countries and what should policy responses be? To address the development dimensions of the current crisis, the Institute of Development Studies (IDS) undertook a set of rapid research projects. This brief summarises the conclusions from those projects. See www.ids.ac.uk/go/infocus7

The impact of the crisis on poverty

Previous financial crises have increased poverty – sometimes dramatically (see In Focus Policy Briefing 7.2)

Sadly, the world has a lot of experience of financial crises. Figure 1 shows poverty rates before and after the major crises that have occurred since 1990. In each case, the poverty headcount increased. Non-income measures of poverty, including malnutrition, schooling drop-outs, and infant mortality have also often worsened.

Figure 1: Poverty impacts of selected financial crises



Source: Gottschalk (2004) – see *In Focus Policy Briefing 7.2*

Poor households are still reeling from the fuel and food price shocks of last year (see 7.3)

To try and assess the impact of this crisis on poor households now, researchers in Bangladesh, Indonesia, Jamaica, Kenya and Zambia undertook a rapid appraisal of the impacts in one rural and one urban community in each country. Often, households are still suffering from the large increases in food and fuel prices during 2007/2008. Many have exhausted their assets and are already in a weaker position. Crime, violence and other forms of insecurity and social division also appear to be increasing. Food riots and violent protest occurred in all of the countries.

The crisis represents an opportunity to expand the scope of social protection in many poor countries (see 7.4)

Current systems of social protection in developing countries are often fragmented and incomplete. Yet a substantial body of evidence shows that social protection programmes can have a significant positive impact. For example, the Oportunidades Program in Mexico provides cash and in-kind transfers conditional on school attendance and regular visits to health centres. In rural areas, Oportunidades increased educational achievement by

Policy recommendations on poverty impacts of the crisis

- Invest in better early warning poverty and vulnerability data systems for rapid release of quantitative and qualitative indicators of the impacts of the crisis on poor people.
- Seize on opportunities to strengthen and implement social protection systems and programmes and develop long-term programmes through global partnerships.
- Aid-led finance is urgently needed to expand social protection in poor countries lacking fiscal space.
- Support vulnerable businesses, particularly in rural areas coping with shortages of credit and reduced demand in export markets.

14 per cent and children on the scheme have higher growth on average and lower levels of anemia than children not on the scheme.

Differences in fiscal space (see 7.5)

Developing countries vary enormously in their ability to expand government spending on social protection or infrastructure to compensate for the negative impacts of the crisis on the real economy. Some have strong fiscal positions and substantial international reserves, others have high debt, low reserves and substantial current account deficits. For such countries, aid-led financial packages can have a critical role in avoiding severe hardship. To be effective, such resources need to be delivered quickly and with flexibility.

The crisis impact on trade and investment

Policy recommendations on trade and investment

- Reform the IFIs and regional development banks to give more funds, more flexible funds and new social protection financing mechanisms.
- Understand China's strategic interests and motivations in order to enhance collaboration in the goals of renewed but sustainable growth, poverty reduction and achievement of the MDGs.
- Identify and address shortages in trade credit where they exist.
- Account for changes in world prices when considering impact.
- Understand people's differing policy narratives on the causes of the crisis and responses to it, to create more sustainable solutions.

Recession in the rich countries hurts developing countries' exports… but it also lowers the price of oil (see 7.7)

The GLOBE model of the world economy was used to simulate the impact of major recession in the developed countries on world trade (a five per cent reduction in the GDP of the OECD was simulated). The results suggest that world trade will shrink by over five per cent and the prices of developing country exports will fall. However, the price of oil also falls significantly. Developing countries lose US$71 billion in export revenues, as the prices of their exports decline, but for oil importers, the losses are partially offset by the declining oil price.

Access to trade credit is NOT a major problem for established horticulture and garment exporters in Africa … but exchange rate volatility and buyer power are (see 7.8)

A rapid survey of 25 horticulture and garment exporters in sub-Saharan Africa showed that the capacity of these firms to continue exporting was not being affected by cutbacks in credit, either from their customers, the international banking system or domestic banks. This appears to be because established horticulture businesses remain a good risk for domestic banks and are operating in well-established value chains, whilst Asian-owned garment firms rely on credit from their parent companies. However, firms exporting to the UK are suffering from exchange rate changes when their inputs are priced in US dollars. Nevertheless, there are substantial problems with trade credit for horticulture firms in Latin America. The well-established businesses covered in the survey may still have access to domestic credit, but others – such as business start-ups and cooperatives – may be more vulnerable.

China's state enterprises are using the crisis as an opportunity to increase investments in Africa, particularly in the energy sector (see 7.6)

China's need for natural resources, combined with its infrastructure-focused stimulus package, should maintain demand for key commodities such as oil, cotton, and copper. This contrasts with some South East Asian countries who provide intermediate products for China's export manufacturing and are seeing falling demand. Moreover, intensifying competition between private sector firms in China may accelerate investment in Africa, as Chinese companies seek new markets to compensate for falling demand from Europe and America.

Developed country policymakers need to understand the way in which the crisis is being viewed within developing countries (see 7.9)

Efforts to put in place effective new mechanisms of global financial governance will require the participation and agreement of a range of developing country governments. Achieving such agreement will only be possible if policymakers understand the way in which the crisis is viewed in different parts of the world and how these perspectives shape the types of solutions which are likely to be acceptable. Tracking of national-level debates in a select set of emerging economies suggest that the crisis, while demonstrating global economic interdependence, simultaneously increases distrust of Western models.

Credits

This *In Focus Policy Briefing* was written by **Neil McCulloch**, **Anna Schmidt** and **Andy Sumner** at the Institute of Development Studies. The series editor is **Clare Gorman**. For other briefs on the crisis see: **www.ids.ac.uk/go/infocus7**

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IDS Institute of Development Studies

DFID Department for International Development

Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk

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What are the Likely Poverty Impacts of the Current Crises?

This brief is about the likely poverty impacts of the current crisis. It asks, what does the evidence from previous financial crises tell us about the possible impacts on poverty of the current crisis?

Estimates of the poverty impact of the current crisis are becoming numerous and varied. The World Bank (2008) puts the number of new poor people from the crisis at 46–53 million. This is on top of the 130–155 million new poor people as a result of 2008 food and fuel price increases. These are estimates. What does the evidence from previous financial crises say?

How does a financial crisis transmit to household poverty?

Financial crises impact poverty through several transmission mechanisms (see box, right). Baldacci *et al.*, (2002) argue that 60–70 per cent of the poverty impacts of a crisis are due to four factors: unemployment, inflation, reduced public expenditure and GDP contraction. Those households that are adversely hit may respond by trying to increase income. They may do this via family members seeking new or additional work and/or drawing upon savings, credit (if available) and/or selling assets. Or they may try to reduce household expenditures via changes in quantity and quality of diet or the costs of health and children's education (see *In Focus Policy Briefing* 7.3).

How does a crisis transmit to poverty?

A crisis may transmit to poverty through the following:

- Changes in labour demand
- Changes in prices
- Changes in public spending
- Changes in the value of economic, human, social, environmental and financial assets
- Long-term impacts on capabilities (i.e. effects of malnutrition, schooling drop-outs, etc.).

Source: Lustig and Walton (2008)

Evidence from previous crises

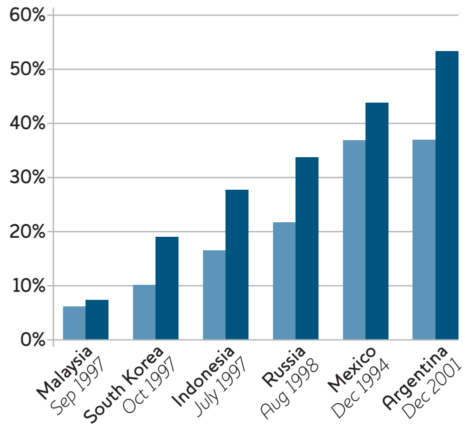
Income poverty impacts

The total number of poor people and the severity of poverty rise dramatically during a crisis (figure 1; World Bank, 2008). Cline (2002) puts the average poverty impact of a crisis at a seven per cent increase in the poverty headcount per country. The IMF (2009) estimates every one per cent contraction in developing countries GDP leads to an increase in poverty of two per cent.

Inequality and non-income poverty impacts

The distributional impacts of crises are highly uneven and income inequality often worsens during a crisis, adding further pressure to poverty levels (Ravallion, 2008). Gendered impacts are particularly evident via labour markets and school drop-outs (World Bank, 1999). Further,

Figure 1: Poverty impacts of selected financial crises



Poverty headcount (% of population under national poverty line) Pre-crisis (year prior to crisis)

Poverty headcount (% of population under national poverty line) Post-crisis (crisis + 2 years)

Source: Gottschalk (2004)

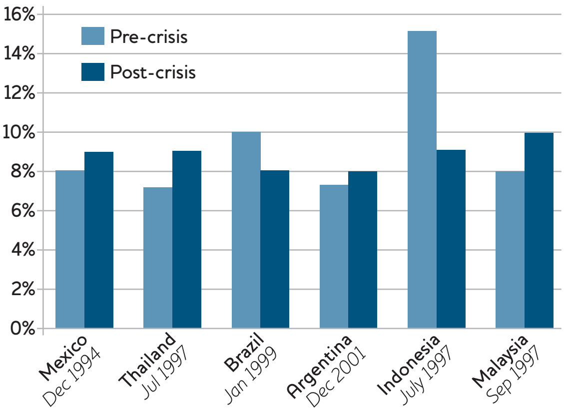
major rural and urban variations are often evident because of different impacts on different production and consumption patterns (World Bank, 2008).

Nutrition, health and education impacts have been evident in previous crises (World Bank, 2008). Such impacts may be long term too because household coping mechanisms typically include decisions related to children and expenditures on food, education and health (see figure 2 overleaf; Mendoza, 2008). There is also

"The total number of poor people and the severity of poverty rise dramatically during a crisis"

strong cross-country evidence of psychological distress, mental health problems and community and intra-household conflict as a result of crises (World Bank, 2008).

Figure 2: Changes in low birth weight babies as per cent of all births during selected financial crises, 1990–present



Source: World Development Indicators (Dec 2008)

However, governments can and do successfully intervene to prevent these kind of impacts (see 7.4). There is evidence in some middle income country crises that education indicators are unaffected or might actually improve (table 1; World Bank, 2008).

Table 1. Primary school completion rate (per cent of relevant age group) during selected financial crises, 1990–present

Country (date crisis began)	Pre-crisis	Post-crisis
Mexico (Dec 1994)	92 (1994)	97 (1996)
Malaysia (Sept 1997)	92 (1995)	94 (1999)
Indonesia (July 1997)	97 (1997)	95 (2001)
South Korea (Oct 1997)	98 (1996)	92 (1999)

Source: World Development Indicators (Dec 2008)

Responses to the current crisis

From the past, we know that the better our ability to track and understand the shifts in poverty at a micro level, the better we are able to respond. Therefore, we suggest two actions:

1. Invest in better poverty and vulnerability early warning tracking systems

Tracking poverty alone is not enough. For each poverty indicator we can propose a corresponding vulnerability indicator. For example, for income and nutrition poverty we need to track the population immediately above the income and food poverty lines. We also need rapid qualitative appraisals of poverty impacts (see 7.3).

2. Explicitly link these new tracking systems to the following:

- Planning of responses, social protection and pro-poor public expenditures;
- Indicators of the underlying causes of vulnerability such as the indicator sets we have for food security and social protection;
- The Millennium Development Goal (MDG) framework by developing corresponding vulnerability indicators for each MDG.

Ongoing tracking and evaluation becomes particularly important given that the poverty impacts of the current crisis may be worse than previous crises because of the global nature of the crisis (thus export-led poverty reduction will be difficult); because the current crisis follows household shocks in food and fuel prices (with major poverty impacts already); and because aid and public expenditures are under threat (with major poverty implications). Poverty and vulnerability must be carefully tracked and interventions made using this as an evidence base to mitigate the poverty impacts of the current crisis.

Credits

This *In Focus Policy Briefing* was written by Andy Sumner and Sara Wolcott from the Vulnerability and Poverty Reduction Team at IDS. The series editor is Clare Gorman. For other briefs on the crisis see: www.ids.ac.uk/go/infocus7

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Institute of Development Studies

DFID Department for International Development

Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk

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Voices of the Poor in the Current Crises

Findings from a participatory study on the impacts and responses to the food, fuel and financial crises indicate poor communities have been hit hard by high food and fuel prices, while the effects of the global financial crisis are beginning to be felt.

This brief reports on field research undertaken in February 2009 in poor rural and urban communities in Bangladesh, Indonesia, Kenya, Jamaica and Zambia. The research findings are illustrative rather than representative of the wider impact, and are intended to offer insights into the processes, institutions and relationships through which poor people are experiencing the crises. The study was designed to test a methodology for fast but systematic participatory monitoring, and aims to complement economic impact assessment.

Table 1. Prices of basic goods reported in Focus Group Discussions in rural Bangladesh and Kenya, February 2009

Naogaon, Bangladesh (in taka; US$1=Tk66 (March 4, 2009)	2009	2007-8	2006
Rice/kg	23/24	36	18/20
Red lentils/kg	100	112	80/85
Diesel/litre	45	50-58	38-40
Malindi, Kenya US$1=Ksh 80 (March 4 2009)	**2009**	**2008**	**2007**
Maize flour (2kg)	140	75	50
Water (20l)	2	1.5	1
Paraffin (250ml)	35	25	20
Beans (250g)	30	15	10

Source: Focus Group Discussions in Dhamuirhat, Naogaon and Bango Laya, Malindi

Perspectives on the crises from poor communities: Complex compound crises

The global financial crisis is coming at a time when the shock of high food and fuel prices continues to reverberate. People have yet to recover from the peak of the food and fuel crisis, many prices remain unaffordably high, and fluctuation has created uncertainty (see table 1). Food and fuel crises are compounded by national crises – violent political transitions or natural disasters – and localised crises such as floods (Indonesia) and drought (Kenya). Poor households continue to face shocks related to their personal circumstances, from ill-health, deaths or job losses.

Local economies

The impact of the global crisis is already being felt. In peri-urban Jakarta, migrant export sector workers started to return home late in 2008 when their contracts were not renewed; others have had their working hours reduced. The wider impacts of the downturn in export manufacturing are being felt by local businesses that depend on the export sector. By contrast, garment factory workers in Dhaka report that new jobs are available, but in poor quality, unsafe sub-contractor sweatshops, rather than in the labour standards-compliant factories.

Fluctuating agricultural prices have created uncertainty. In rural Kenya, food prices continue to rise as a result of drought, but farmgate prices have dropped sharply. In Bangladesh and Zambia, farmers report high fertiliser and diesel costs are constraining efforts to increase production. Credit is being squeezed, including in Jamaica, where the January 2008 crash of the investment company Cash Plus has meant investment capital losses for many low-income people. In rural Bangladesh, a microfinance NGO reported local lending was down and bad loans were up.

> Eating less frequently, and less diverse and nutrient-rich foods was commonly reported across all ten communities

Naomi Hossain

Export sector workers facing job losses talking about their experiences in Gandasari, Jakarta

Livelihood adaptation has been swift, but into low-yield or dangerous activities. Women have been prominent in developing new forms of retail for low-cost food items, in small quantities and on convenient terms (see picture). Men from Kalimantan, Indonesia, were travelling to another island to mine gold, and cross-border smuggling was reportedly rising in rural Bangladesh – both illegal and dangerous but potentially lucrative activities.

How people are coping

Eating less frequently, and less diverse and nutrient-rich foods was commonly reported across all ten communities. The worst conditions were in Nairobi, where signs of acute malnutrition in children were reported by teachers and mothers.

Health-seeking behaviour was found to have changed in a small number of cases, with people resorting to self-medication and avoidance of expensive procedures. More common was the sense that education was at risk. There were many cases of children being withdrawn from school or college. In Indonesia and Bangladesh there was one case each of children being moved to (cheaper) madrasahs from general schools. Children were reported to be entering work, including unconfirmed reports from Kenya and Zambia of growing numbers of children and young girls selling sex.

The response

Apart from in Indonesia, community-based support was widely deemed inadequate. In some contexts, middle-class people had been hit hard and were reportedly less helpful to poor neighbours than before. Faith-based support was prominent in Bangladesh and Kenya, but in Zambia, community and church-based support was declining and inadequate. NGO programmes were not prominent in any of the communities, other than a Catholic Church-backed school feeding programme in Nairobi.

Government programmes were similarly felt to be insufficient: public safety nets for the poor in Kenya and Bangladesh were roundly criticised for the small amounts disbursed. In Jakarta, migrant workers who had lost their jobs were not able to access government rice for the poor, which typically goes to longer-term residents. There were widespread concerns that even the limited public resources available to support people through crisis were not necessarily reaching the poorest.

Social impacts

Stress levels have been rising in many households, and there are signs of rising domestic violence, as well as incipient signs of inter-group tensions. Minority groups have been criticised for taking advantage of the crisis, but are typically disadvantaged compared to the majority in terms of access to official resources. Petty crime, drug and alcohol abuse were reportedly on the rise. In Jakarta rising crime was dated to the last three months, backed by local police statistics.

Conclusions and key messages

The global recession is coming on the back of an ongoing food and fuel crisis. Prices have declined, but not all prices, not everywhere, and not enough for people to return to 2007 living standards. As the direct impacts of crisis begin to be felt, many people in the ten poor communities in this research were aware of a new impending crisis, and were keen to understand what was happening and to share their experiences. Tracing the impacts of global financial crisis on people's lives and wellbeing is complicated by the interaction of compound crises on capacities to adapt, cope and respond. The complexity of these processes underlies the value of qualitative participatory research into how people experience and understand the crises as they unfold.

Credits

This *In Focus Policy Briefing* was written by Naomi Hossain from the Participation, Power and Social Change Team at IDS. The series editor is Clare Gorman.
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Social Protection Responses to the Financial Crisis: What do we Know?

Over the last decade there has been significant growth in the number of social protection programmes around the world. In times of financial crisis it is not a question of whether we can afford to support social protection initiatives; rather whether we can afford not to.

What is Social Protection?

Social protection describes a group of policy initiatives that transfer income or assets to the poor. They protect vulnerable people against livelihood risks, and seek to enhance the social status and rights of the marginalised.

Social protection programmes have generated a substantial body of evidence about *what* social protection can do and *how* it can do it. Costs associated with the absence of social protection in developing countries are now well documented (Dercon, 2005; Morduch, 1998).

The emerging consensus and evidence base on social protection indicates that it underpins other investments in development. For example, the Oportunidades Human Development Programme in Mexico (formally PROGRESA) provides cash and in-kind transfers conditional on school attendance and regular visits to health centres. In rural areas, Oportunidades has increased education achievement by 14 per cent and children on the scheme have a higher growth average and smaller levels of anaemia than children not on the scheme (Garcia, 2004). Seventy-five per cent of the 8 million beneficiaries on the Ethiopian Productive Safety Net Programme (PSNP) reported that they had consumed more and better quality food as a result of the initiative (Devereux *et al.* 2008). In Bangladesh productive assets (e.g. livestock or land) provided through the BRAC Challenging the Frontiers of Poverty Reduction programme resulted in an estimated 85,000 women graduating up from their 'ultra poor' status (Young *et al.* 2003).

What are the impacts of this crisis and how can social protection respond?

When people struggle to cope, there is an increased need to support them more formally through national – state run social protection programmes. Social protection programmes can play four roles – *Protection*, *Prevention*, *Promotion* and *Transformation*. Each has a set of policy instruments associated with it and each can play a different role in the current crisis (see table 1).

Table 1. Social protection categories and instruments

Type of Social Protection	Social Protection instruments	Role in this crisis
Protective **(social assistance)**	• social transfers • disability benefit • pension schemes • social services	Immediate protection and relief from poverty and deprivation
Preventive **(insurance and diversification mechanisms)**	• social transfers • social insurance • livelihood diversification • savings clubs; funeral societies	Prevents damage to coping strategies
Promotive **(economic opportunities)**	• social transfers • access to credit, transfers/protection, common property resources • school feeding • agricultural starter packs • public works programmes	Promotes resilience through livelihood diversification and improves security
Transformative **(addressing underlying social vulnerabilities)**	• promotion of minority rights • anti-discrimination campaigns • social funds	Transforms social relations to reduce exclusion

> Starting out on a modest scale, by 2002 the Oportunidades programme in Mexico was reaching over 25 million people and is now the centrepiece of the country's poverty reduction strategy

What have we learnt from previous crises?

The lessons learnt from responses to previous crises in Indonesia and Mexico are informative. In Indonesia it was a case of rapid *action and learning by doing*. In 1997 the Government of Indonesia (GoI) quickly introduced a National Safety Net Programme as the financial crisis doubled the poverty rate in a year. The results of the programme have been impressive with the poverty rate reducing from 33 per cent in 1998 to 12 per cent in 2002. Without the programme, evidence suggests that recovery in this timeframe would not have been possible. It demonstrates the importance of responding quickly and boldly. The GoI, without previous experience of implementing a safety net programme, had improved the programme as they went along (Sumarto *et al* 2008).

In contrast, Mexico provides a case of *building a strong constituency for social protection through evidence*. Although starting out on a modest scale, by 2002 the Oportunidades programme was reaching over 25 million people and is now the centrepiece of the country's poverty reduction strategy. The key to its expansion and success was the use of evidence of its impact to persuade donors and politicians from all sides to support the programme. A strong constituency for social protection was developed and was led from the front by high-level political leadership in successive governments (de Britto 2008).

What should be done?

In the current crisis we can do two things:

1. Seize on opportunities to implement social protection programmes

Historically, moments of crisis also result in social and political unrest. In some circumstances, where political leadership is strong, this has proven to be a key driver in the development of social protection schemes (for example, the New Deal in post-depression USA); in others it can provoke political paralysis and the shrinkage of state protection which triggers a spiral of long-term decline. A key lesson from recent responses is that the crisis can represent a window of opportunity and that it is important to seize these moments for progressive social protection initiatives.

2. Develop long-term programmes through global partnerships

As we respond to the immediate impacts, the longer-term impacts of the crisis must not be overlooked or underestimated. Social protection programmes that are national in coverage and provided over the long term are therefore required. Recent discussion of financial support to develop them through a 'global vulnerability fund' is encouraging since they represent recognition of a sense of global responsibility and cooperation. Social protection should follow this path with cooperation in the development of national programmes that transcend national boundaries.

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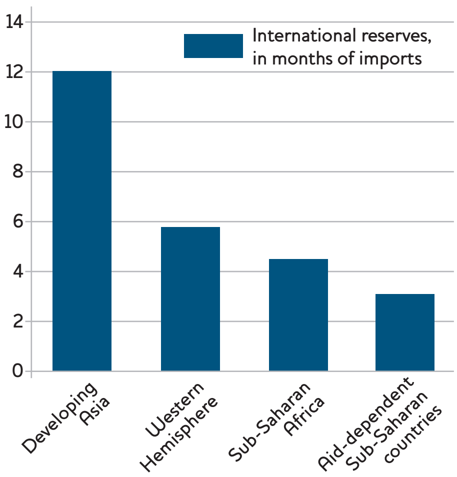
Macroeconomic Policy, Stimuli, Aid, and Budgeting: What Options?

Developing countries are being severely hit by the global financial crisis. However, the ability of different countries to respond varies considerably. This briefing finds that developing country governments should use a range of economic and financial policy instruments to combat the downturn. The availability of external resources is critical.

Many emerging economies in Latin America and Asia, which have suffered from volatile international capital flows, have learned to reduce their exposure to shocks and build capacity response by undertaking cautionary fiscal policy, reducing public debt and accumulating foreign reserves. In Latin America, Chile and Peru benefited from the recent primary commodity boom and saved a substantial portion of the windfall. In Asia, countries such as Malaysia and Thailand have historically maintained fiscal balance and are in sound positions to respond to the crisis. Despite a good record in recent years, other countries such as Brazil still have somewhat limited space for expansionary fiscal policy, because of initially large public debt.

In contrast, low-income countries do not have their own resources to cushion the macroeconomic shock. For instance, levels of international reserves, especially among aid-dependent countries in sub-Saharan Africa, are very low (see Figure 1).

Figure 1: **Level of international reserves, for different groups of developing countries**



Source: Author's elaboration, based on IMF World Economic Outlook (2008) and various IMF country reports

Although less exposed to international capital flows, they are most likely to be affected by reduced external demand, falling commodity prices and declining remittances which in some cases are larger than their export values and account for a large portion of their external financing needs. Moreover, many of these countries are aid dependent.

Fiscal space is the existence of fiscal room for increased spending, without jeopardising government's fiscal sustainability (Heller, 2005). World Bank (2008) categorises countries as having 'low fiscal space', 'some fiscal space' and 'more fiscal space' by averaging standardised indexes of debt/GDP, fiscal deficit, current account balance, international reserves and reversible capital inflows. The World Bank study indicates that of 18 countries that we identify as aid-dependent in sub-Saharan Africa, ten have 'low fiscal space', while the other eight are considered either as having 'some fiscal space' or 'more fiscal space'.

This may give a false sense of space, as it assumes aid will be forthcoming, which is far from guaranteed in the current crisis context.

Macroeconomic Policy, Stimuli, Aid, and Budgeting: What Options?

> "The global nature of the current crisis implies that external demand for developing country exports is declining. Therefore, these countries need to find alternative stimulus to support recovery"

How important is fiscal space in this crisis?

In the 1990s and early 2000s, crisis-hit countries suffered massive currency devaluations, which caused severe balance sheet problems within their economies. Devaluation also encouraged exports and thereby helped countries recover relatively fast. However, the global nature of the current crisis implies that external demand for developing country exports is declining. Therefore, these countries need to find alternative stimulus to support recovery. In this context, fiscal space becomes critical. Where it is limited, monetary easing should be pursued, especially where inflationary pressures are receding (UN-DESA, 2009). Moreover, the limited resources available need to be used more effectively and geared to protect the poor (Ravaillon, 2008). Indeed, we have learned from previous crises that counter-cyclical mechanisms can be used to protect the poor and the most vulnerable (see social protection brief). Maintaining public investment is also very important for sustained recovery. In previous crises these were drastically reduced, thereby undermining post-crisis long-term growth. Research by the National Institute of Economic and Social Research shows that fiscal stimulus spent on productive investment raises the level of output by 1.5 per cent in the long run (Barrell *et al.*, 2009). IMF-led large-scale financial packages can also play a critical role in helping avoid too deep a crisis and supporting rapid recovery, (as in Mexico's crisis of 1994–5 and Brazil's in early 1999) but resources have to be frontloaded and with little conditionality attached.

What should be done?

Given the scale of the crisis, developing country governments should use not one but a range of economic and financial policy instruments, in addition to social protection mechanisms to combat the downturn and protect the poor. But availability of external resources is critical. Therefore, at the international level four responses are needed:

- The IMF role as provider of official liquidity should be enhanced – its recently created Short-Term Liquidity Facility (SLF) should be made available to a larger number of countries, as should the revamped Exogenous Shocks Facility (ESF), with conditionality relaxed.
- The IMF role should be complemented with that of regional development banks, in providing counter-cyclical lending. Also at the regional level, initiatives such as those from the East Asian countries to create a large pool of funds to combat the crisis should be expanded and replicated in other regions, where large financing capacity for pooling reserves exist.
- Donor countries should meet their commitments to increased aid, and efforts made to link new financing to social protection mechanisms to improve effectiveness of resources for poverty reduction.
- Coordinated policy action among the larger world economies is needed to avoid protectionism and support macroeconomic policies that are coherent with sustainable growth and reduced global economic imbalances.

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IDS Institute of Development Studies

DFID Department for International Development

Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk

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China and the Global Financial Crisis: Implications for Low-income Countries

How the financial crisis affects China has implications that extend well beyond its domestic economy. As the world's third largest economy, China's ability to maintain growth and restructure its domestic economy is critical for addressing global macroeconomic imbalances. How the financial crisis affects China will also affect many low-income economies, whose recent growth has in part been stimulated by China's demand for commodities and intermediate inputs, and its expanding overseas investments.

China's financial institutions are relatively well insulated from the direct impacts of crisis. Its export dependence has however resulted in a sharp downturn in the real economy. The government has responded with an extensive package of measures aimed at stimulating the economy, raising domestic demand and maintaining stability. Given the continued decline in both exports and imports, growth rates for 2009 continue to be revised downwards, possibly to as low as six per cent.

What are the implications for low-income economies?

China affects other low-income economies both indirectly and directly. Indirectly, the increased price of commodities in response to China's demand has benefited many low-income economies in Latin America and sub-Saharan Africa. A fall in demand from China, on top of collapsing commodity prices, will negatively affect these countries.

The main direct channels of economic influence are trade, investment and, to a lesser extent, aid, all of which have increased significantly in recent years. These are closely related and, particularly in the case of Africa, reflect China's political and strategic interests as well as long-term economic objectives. It is therefore unlikely that there will be any significant downturn in China's direct engagement with Africa in these three areas, at least in the short to medium term.

In terms of trade, China's inelastic demand for natural resources, combined with a heavily infrastructure-focused stimulus package, should maintain demand for key commodities such as oil, cotton and copper at a time of otherwise falling global demand and deteriorating terms of trade. By contrast, those countries providing intermediate products for China's export manufacturing (particularly in South East Asia) will see demand fall. In 2008 total China-Africa trade increased by 45 per cent to US$107 billion, exceeding the US$100 billion target set in 2006 when trade was US$55 billion, and giving Africa a trade surplus for the first time.

Given this past growth, China's exports to Africa may shrink, but African demand for light industrial and consumer products is unlikely to be seriously affected. Potential problems arising from the increased value of China's currency should be offset by a corresponding drop in the price of Chinese imports. So trade in the next three years will probably continue to increase but at a slower rate than over the past two years.

In terms of investment, there is little reason to expect significant reduction in China's public and private investments in Africa. State enterprises are clearly taking advantage of opportunities created by the crisis to increase investments, especially in the energy sector. New deals are being made, and China is seeking investments in commodities that are important for its long-term food and energy security, and growth.

"Increased competition during a downturn may accelerate investment in Africa"

Private sector investment in Africa is driven primarily by competition between firms in China's domestic market. Increased competition during a downturn may accelerate investment in Africa. Furthermore, Chinese companies exporting to Europe and America have to adjust to falling demand by seeking new markets: already Africa has been called the 'best refuge for sunstroke prevention from the financial crisis' by the Chinese media. In a new trend, entrepreneurs also state their intention to move from low towards middle-to-high value-added products that they believe have a sustainable demand in African and other markets.

Aid flows to Africa will remain stable or may even increase. China has reiterated commitments made at the Forum on China-Africa Cooperation (FOCAC). During his recent visit to Africa, President Hu Jintao announced increased assistance and a reduction or cancellation of debts. Furthermore, Chinese aid is provided on a multi-annual line of credit of at least three years. While aid has increased significantly and may be important to some African countries, it remains small as a share of China's GDP. It is valued for associated political relationships and economic opportunities. China is therefore likely to take this chance to increase its influence in the region and secure its long-term interests.

Key messages

Ultimately, how African countries fare will be determined more by relations with their main trading partners – the US and Europe. While benefiting from their relationship with China, most countries remain more dependent on other sources of income, including remittance flows, tourism and OECD development assistance. However, during the downturn, China's continued trade, investment and aid, may act as a buffer for some economies.

If China can steer its own economy through crisis, it may become a development partner of choice with increasing 'soft power' influence in the developing world. It may appear as a steadying factor in trade and investment compared to the West.

We conclude with two key messages:

1. A multi-faceted response to Chinese state and private activities is required

Low-income countries are dealing with both Chinese state and private sectors. Private entrepreneurs are transferring part of their value chain to Africa, providing Africa with an opportunity to push up the value chain. These developments require a multi-faceted African response involving government, the private sector, unions and NGOs.

2. The development community needs to understand and work with China

The development community should take this opportunity to understand China's strategic interests and motivations to enhance collaboration in the pursuit of renewed but sustainable growth, poverty reduction and achievement of the Millennium Development Goals. The transnational dimensions of the financial crisis require a multilateral response. The development community should develop a common framework for a 'global development partnership', creating a network for bi-, tri- and multi-lateral dialogue and cooperation at various levels.

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DFID Department for International Development

Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk

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The Impact on Developing Countries of an OECD Recession

The global financial crisis and evolving recession in the developed countries and emerging economies will affect developing countries through two major channels: changes in international trade flows and world prices; and movements in global capital flows and foreign investment away from developing countries.

Through the first channel, the demand for exports from developing countries will fall and the beneficial terms-of-trade trends that have recently favoured net exporters of primary commodities will turn negative. The demand for oil will fall, lowering the world price, helping oil importers while hurting oil exporters. In addition to the trade channel, the crisis in financial institutions is causing movements in global capital flows and foreign investment away from developing countries, forcing them to make difficult macroeconomic adjustments. While both channels are potentially important, this briefing focuses on the first: changes in international trade flows and world prices.

The GLOBE model

We use a global model of world production and trade to simulate the impact on developing countries of a recession in the rich countries, focusing only on changes in commodity trade and prices, and ignoring impacts that work through financial markets and investment flows. Even with this narrow focus, the results indicate that: (1) world trade shrinks significantly and the prices of developing country exports fall; (2) the price of oil falls significantly; (3) developing countries generally lose, but the losses are partially offset for oil importers by the price fall, and overall losses from commodity trade changes alone are modest.

How these trade shocks affect economic performance and welfare in low-income countries depends on country-specific characteristics, especially initial trade patterns, and requires a differentiated analysis across countries. Our study uses a multi-country, multi-sector model that simulates the impact of a slowdown in economic activity in the developed countries on world trade, prices, production, demand, and welfare across the globe, with a focus on the least developed countries in sub-Saharan Africa and Asia. The model, called GLOBE, distinguishes 32 regions including 28 developing countries and regions.

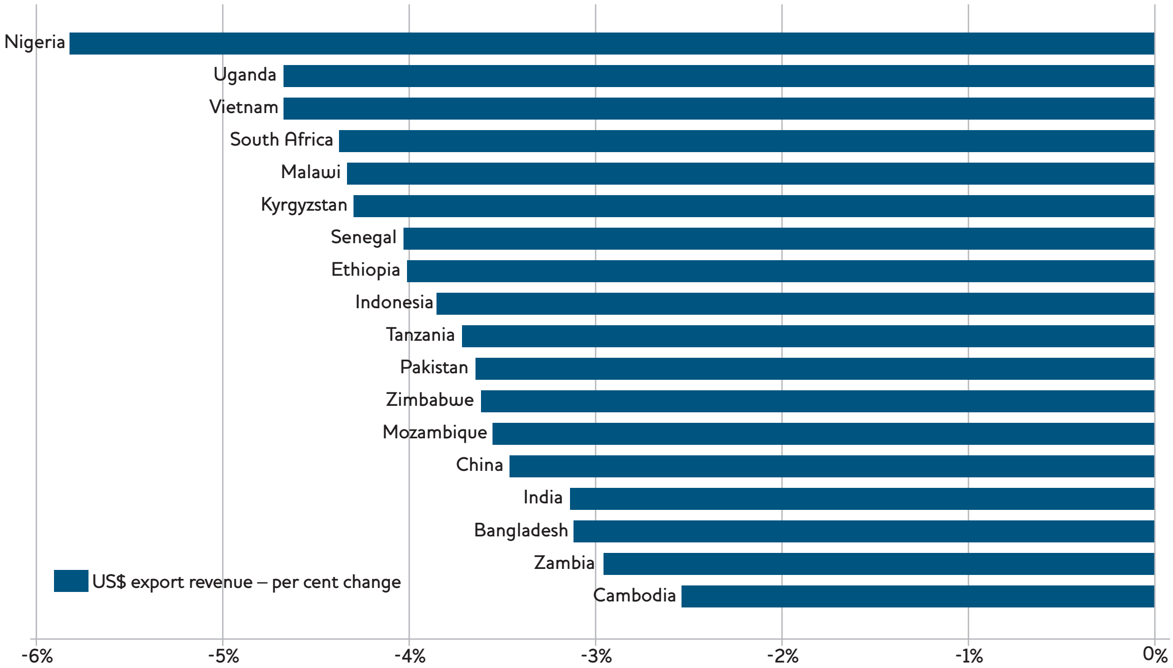
A number of simulations were done to measure the impacts on world trade and welfare in poor countries of a recession in the rich countries. We report the results of a single simulation with a decline of five per cent in gross domestic product (GDP) of the high-income countries. In designing the simulation we focused only on changes in trade and world prices, assuming no changes in capital flows, foreign investment, or current account balances. The simulation captures the causal chain operating through changes in trade alone, leaving aside effects working through financial flows and macro adjustment.

Findings

The fall in GDP in high-income regions reduces their demand for goods and services from all regions and generates a terms-of-trade deterioration for all other countries. The value of world trade contracts by 5.6 per cent, and exports from all developing countries fall by about US$71 billion. The average world market price of fuels drops markedly, and the prices of other primary commodities exported by developing countries also fall.

Figure 1 (overleaf) indicates the impacts on the export earnings of developing countries and regions in the model, with the countries ranked by the size of the impact. The largest impact is on oil exporters, but export earnings of non-oil exporters also fall. A 5 per cent decline in

Figure 1: Per cent change in export earnings by developing countries



Source: Robinson and Willenbockel (2009)

rich-country GDP generates a decline in export earnings of non-oil exporters of about -3 to -7 per cent, a response elasticity of -0.3 to -1.4. Even ignoring financial flows, global trade is very responsive to changes in income in the rich countries and the poorest countries are exposed to the shock.

The effects on aggregate welfare (measured by the total supply of goods and services available in the country or region) follow the changes in export earnings, with oil exporters losing the most. The impact on oil-importing developing countries is mixed, with the loss of export markets partially offset by the gain from importing cheaper oil. The welfare declines are large for oil exporters (-3 to -5 per cent) and smaller for oil importers with a diversified export structure.

What should we do?

Even focusing only on commodity markets, ignoring credit and investment shocks, the simulation results indicate that world trade volumes and exports from developing countries are sensitive to a recession in the rich countries. The impacts on welfare are mixed, depending critically on the composition and volumes of country exports and imports. In particular, oil prices decline with the fall in demand in the rich countries and the gains to oil-importing developing countries partially offset the losses in their export markets.

Given the heterogeneity of initial conditions in the developing countries, designing good policy responses to adapt to the trade changes requires detailed country knowledge.

While significant, the shocks that work only through the trade channel appear to be manageable for the poor countries. Modest increases in foreign aid would suffice to compensate them for the net losses in welfare arising only from shocks to global commodity markets. However, this optimistic conclusion assumes no increase in protectionism in the rich countries, which would exacerbate the impact on global markets from a recession in the rich countries and lead to steeper declines in world trade.

In addition, many developing countries are potentially sensitive to changes in financial flows and investment arising from the global financial crisis. Analysis of these potential impacts is beyond the scope of our study, requiring macro analysis of differing exposure and response to changes in global financial markets.

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Institute of Development Studies

Department for International Development

Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk

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Trade Credit

Accessing trade finance is not the most serious problem for established horticulture and garment exporters in sub-Saharan Africa – exchange rate fluctuations and falling demand are more important. But trade credit is a major problem for new exporters and small cooperatives as well as for Latin American horticulture exporters.

In October-November 2008, the World Trade Organisation, International Trade Centre and International Chamber of Commerce all raised serious concerns about trade finance (ICC, 2008; WTO 2008). They highlighted declining trade, substantial falls in trade credit, increasing lending costs and credit rationing. Shortly after, the governments of Brazil and India stepped in to guarantee trade finance for exporters. In this situation, will African exporters find that neither their customers nor their banks provide them with trade finance?

How unprecedented is this problem?

Trade credit is far removed from the exotic financial products that have undermined global banking, but previous financial crises that hit developing countries (such as Argentina, Brazil and Indonesia) were all associated with rapid and significant cutbacks in trade credit. Short-term finance dried up as financial institutions reduced their risk exposure. Finance for trade can be cut back in three ways (see box right).

Evidence from the financial crises of the 1990s shows that credit lines for trade fell more rapidly during financial crises than had been the case in the 1980s. Wang and Tadesse (2005) attribute this to banks increasing their leverage and having increased risk exposure. Since then, leverage has increased and, given the current freeze on credit globally, and fears about recession worldwide, trade credit may be greatly reduced. Nevertheless, the likely impacts on capacity to export are far from clear. Ronci (2005) notes that in previous financial crises substantial declines in short-term capital availability in crisis countries was very weakly associated with declines in exports.

How might trade finance be harder to obtain in the current crisis?

- Banks in developing countries cut lending to exporters.
- Letters of Credit (LCs) become harder to obtain.
- Trade credit offered by importers to their developing country suppliers may be restricted if the importers themselves cannot borrow from their banks (see Love *et al.* 2007).

In these circumstances, firms in developing countries that have been encouraged to target export markets find themselves unable to trade.

Are cutbacks in trade credit hurting exporters in sub-Saharan Africa?

IDS arranged for researchers in the UK and Kenya to telephone 25 firms in sub-Saharan Africa and inquire about how they financed their exports and whether the availability of trade finance had changed. They also contacted international trade experts and UK importers. The focus was on horticulture and garments – two sectors that have seen big export increases in the past decade. The overall findings were clear. The capacity of these firms to continue exporting was not being affected by cutbacks in credit, either from their customers, the international banking system (LCs) or domestic banks. Why not?

- Established businesses remain good risks for domestic banks. The horticulture sector in sub-Saharan Africa was considered a good risk by local banks and lending continued. However, in Latin America, the trade finance crisis is much more severe and horticulture exporters are having serious problems. So far, sub-Saharan Africa has escaped the worst problems.
- Firms are operating in well-established value chains. Even horticulture firms supplying wholesale markets in Europe have well-established relationships with their importers and established lines of trade finance. Very often, these transactions involve no credit from financial institutions.

> The trade finance problem varies greatly between sectors and countries. Governments and multilateral development banks should step in, as in previous financial crises, to sustain trade finance

- Garment-exporting companies in sub-Saharan Africa are predominantly Asian-owned. LCs for exporting to the United States (the main export destination) are usually arranged by the parent company. None of the firms interviewed indicated that this had been affected. These firms did not use domestic credit lines for export finance, and availability of domestic credit for working capital has not changed.
- Trade finance shortages and restrictions on domestic credit are affecting new exporters, small-scale cooperatives and other enterprises that do not have established relationships with their banks and with their customers.

Nevertheless, clear and substantial impacts from the global financial crisis were found. In particular:

- Exchange rate volatility. In particular, firms exporting to the UK are suffering as revenue is priced in British pounds, but airfreight and many inputs are priced in dollars.
- Falling demand. In garments, the exporters from Africa are still completing orders negotiated in mid-2008, but the companies reported that buyers were delaying new orders and pushing for much lower prices. Horticulture producers were concerned about possible falls in demand and downward pressure on prices.

Policy responses

In the short term, the availability of trade credit needs to be monitored. The trade finance problem varies greatly between sectors and countries. Governments and multilateral development banks should step in, as in previous financial crises, to sustain trade finance.

In the longer term, the crisis highlights new sources of risk for exporters. In both garments and horticulture, African exporters have done well from linking up to large customers in dynamic market segments. In the crisis, these customers are transferring the risks and consequences of turbulence and unpredictable markets to their suppliers. Prices and quantities are adjusted rapidly because of the power of retailers in increasingly concentrated retail markets. The problem is not trade finance, but rather the profitability of exporting.

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Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk

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From Crisis Management to Institutional Reform

As the financial crisis deepens, policymakers are focused on responding to the immediate impact of the crisis. However, there is also a strong interest in prevention, so that future crises can be better contained and managed. Here, economic considerations about tools and mechanisms are inevitably tied to political institutions, and the shifting nature of global interdependence and power-effective reform is not a merely technical exercise. This brief outlines the importance of understanding the diverging understandings of the crisis and their likely influence on options for reshaping global economic governance.

The crisis has triggered a shift in power from the G8 to the G20

The current situation is unique in its magnitude and origins: caused in developed countries, its rapid spread demonstrated a qualitatively new level of global interdependence. Politically, it resulted in the high profile institutional outreach to emerging powers through the G20 forum rather than reliance on the G7/8 forum. The G20 consists of the G7 + the European Union, the World Bank and the International Monetary Fund, Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, and Turkey. This expansion promises adaptation to fundamental changes in the importance and interests of some developing countries in the last 50 years.

Is the shift from G8 to G20 grand gesture or real change? The organisational principles of the G8 are based on its role as an informal club regime with self-selected membership (concerted power and constricted participation) and largely informal structures, including a focus on leadership. Previously, the combined economic strength of its members could sometimes have a decisive influence on markets or worldwide practice. But on the many other issues it tackled, its power rested in its capacity to exercise leadership within multilateral fora.

Shifting global realities have undermined this role. Today China is a key contributor to world growth and has overtaken the US as the top importer of emerging market exports. China and India may well have contributed more to reducing world poverty than the G8. Other actors (i.e. vertical funds, private foundations) play an ever increasing role in North-South relations

The G20's institutional authority is weak

The G20 was constituted after the Asian crisis of 1997–98. Its constitution is rather loosely based on the notion of 'systemic importance' i.e. countries who have the potential to affect the system as a whole. Its role so far has been small. Its members perceive it as a forum for informal dialogue. However, they also believe that G20 support for global initiatives has had 'only a modest effect on members' behaviour, and even less impact on the behaviour of non-member countries' (G20, 2008). If the G20 is to assume a major role in global economic governance, its authority will have to increase.

Institutional authority has many potential sources: it can be based on output and the ability to propel change, as well as the recognition of representativeness and adherence to the principles of the constitution. Both also depend on the ability to forge a shared diagnosis of the problems at hand.

There are various competing understandings of the crisis (Weber, 2008). For example,

- The crisis is due to regulatory failure in the main capitalist economies
- The crisis is a manifestation of an enduring 'stability-instability' paradox inherent in capitalist markets that includes cyclical panics
- The crisis results from 'exploitative hegemony' in which the US acted as an irresponsible great power (see Arrighi, 2005)
- The crisis represents a deep and fundamental catastrophe of Western financial capitalism, which originates in a fatal flaw in the US system.

A team of IDS researches tracked such frames in national debates in selected G20 countries (India, Japan, Indonesia, Mexico, Brazil, South Africa, and South Korea as well as Europe and the United States). This served to identify elite-level debates and the positions of some key domestic actors between October 2008 and February 2009. The box below illustrates how elements of the above narratives were expressed in national media.

Narratives from national media in G20 countries

- An 'unhealthy relationship' between Asia and the West, sometimes framed in terms of a culture clash (India, Korea, and Indonesia)
- Notions of Western 'greed' and arrogance and US/Western arrogance (India and South Korea)
- A general irresponsibility of western capitalist economies (Brazil)
- Chinese currency manipulation (US)
- 'Immoral capitalism' (France)
- Foreseeable regulatory failure (Canada)

Alongside geopolitical weight, these competing narratives influence views on participation and positioning in global fora. Developing country experts seem to prefer a global rather than a national approach to the crisis (Coupe, 2009). Yet, in national debates distrust in current processes appears widespread, as illustrated in the following box.

National narratives about institutional solutions to the crisis

- Resentment of western institutions for treatment received during the Asian crisis of 1997–99 (Indonesia)
- Open and latent distrust of the role of the IMF in any solution and concerns that its 'ideology' has not changed (India, Indonesia, Japan, Mexico and South Africa)
- There can be no return to the pre-crisis status quo (India and Japan)
- Wariness of G20 symbolism as well as potential mechanisms to make others share the responsibility for the 'mess' created by the G8 (South Korea)
- Value of G20 for information-gathering or diplomatic reasons (India, South Africa)
- Willingness to engage with new US leadership via the G20 and to reinforce multilateralism (Brazil, Indonesia and South Korea)

Key messages

The review of competing narratives reinforces that just expanding representation is not a solution. Policymakers' understanding of the different framings of the crisis may be as important to create institutional authority. For example, trust in current or future supervisory institutions will be essential given the difficulty to conclusively assess 'systemic risk' in financial markets. Any pre-designed approach, in which those who are to blame for the crisis are seen as devising its solution for others to implement, is unlikely to be successful.

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This *In Focus Policy Briefing* was written by **Anna Schmidt**, a research fellow of the Governance Team at the Institute of Development Studies, and edited by **Louise Stoddard**. The series editor is **Clare Gorman**. For other briefs on the crisis see: **www.ids.ac.uk/go/infocus7**

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Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk

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Will the Global Financial Crisis Change the Development Paradigm?

The global financial crisis may change the face of development as we know it. This is no ordinary crisis. Its origin, depth and severity and the speed with which it has spread around the globe are likely to lead to profound changes in the way that policymakers throughout the world think about development policy.

Exploring new development models

IDS's research about crisis narratives suggests that developing country policymakers may have less respect for, and less interest in, policy prescriptions from the West (see *In Focus Policy Briefing* 7.9). In particular, many countries are looking East for new models of development. IDS's research on China shows the need for greater understanding of China's evolving role in development (see 7.6). A greater tendency for developing countries to explore new development models and to rely on their own analysis and knowledge to fashion solutions to the problems they face, could be a positive outcome of the crisis. But the focus on national solutions should not forget the gains from openness and the benefits of global cooperation that have been achieved.

A new era for international development policy

The reductions in poverty that have happened over the last 20 years have largely been fuelled by export-led growth. Yet in a global recession, this past engine is an unlikely route for recovery. It is also clear that more open countries are increasingly vulnerable to the economic downturn (see 7.7). As a result, analysts and policymakers across the world are questioning the effectiveness of global integration as a pathway towards prosperity. The next decade could see a repeat of the de-globalisation experienced in the early twentieth century, including restrictions on the international movement of capital and greater protectionism. We may also see significant increases in both government regulation and the direct role of the state in the economy.

Whether these shifts are positive or negative depends on how policy responses tackle today's problems and learn from the lessons of the past. It is likely that developing countries will demand greater flexibility within international fora to implement policies that they feel are appropriate for their situation.

A new era for global economic governance

The crisis has demonstrated the extraordinarily high level of inter-dependence of economies around the globe. This has placed in sharp relief the inadequacy of today's international institutions to identify and respond to the crisis. The failings are manifold.

First, there is a lack of international financial regulation and institutions capable of monitoring and enforcing such regulations. The weaknesses of relying on national financial regulators to deal with global financial markets are only too apparent in the current crisis.

> The crisis presents an opportunity to institutionalise social protection in sub-Saharan Africa

Second, there is an urgent need to broaden representation in the institutions of global economic governance. The crisis has resulted in the high profile institutional outreach to emerging powers through the G20 forum rather than the reliance on the G7/8 forum. This grouping includes some 'systemically significant' countries – but still excludes the voices of almost all African countries and the large majority of developing nations. In the long run, the effectiveness of global economic institutions depends not only on their ability to engage major new powers such as China, India and Brazil, but also on the perceived legitimacy of those institutions by the rest of the developing world.

Third, current institutions lack the funds and the ways of operating which are needed to respond to a crisis of this kind. Efforts are underway to bolster the resources of the IMF and the World Bank, but are still a long way from the level of resources that might be needed to tackle the problems. At the same time, the flexibility and speed with which resources can currently be used is limited and the range of instruments available not always appropriate (see 7.5). Looking forward, these institutions will need to be closer to their client countries to deliver support that is better tailored to their priorities and needs.

A new opportunity to protect the poor and the planet

Moments of crisis also present windows of opportunity. Just as the depression in 1930s USA gave birth to the New Deal, there is much talk now of a Global New Deal. One way to make this a reality would be to take this opportunity to institutionalise social protection in sub-Saharan Africa. IDS Research shows that the most vulnerable people in the world's most vulnerable continent still lack effective, systematic social protection. The last ten years have seen extensive experimentation with mostly donor-funded social protection schemes. Developing country policymakers need to seize this opportunity to build political support for widening the coverage of such schemes and embedding them within national budgets. The proposed new Global Vulnerability Fund should support this process and help to create new global partnerships to share experience, evidence and ideas on how to effectively extend social protection (see 7.4).

The large coordinated fiscal stimulus also presents a major opportunity to achieve a step-change to a lower carbon growth path. The potential damage that global warming may cause is immense. The costs of significantly slowing down the process are small in comparison – and similar to the size of the fiscal stimulus being undertaken to address the crisis. There is therefore a strategic opportunity to use a part of the stimulus to promote a shift to lower carbon technologies. To be effective this will require the participation of major developing countries. This will depend on finding accountable forms of international environmental governance which strike the right balance between the responsibility of all to reduce the harm to future generations and the right of all to development.

Credits

This *In Focus Policy Briefing* was written by **Neil McCulloch, Anna Schmidt** and **Andy Sumner** at the Institute of Development Studies. The series editor is **Clare Gorman**. For other briefs on the crisis see: **www.ids.ac.uk/go/infocus7**

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Institute of Development Studies

DFID Department for International Development

Institute of Development Studies at the University of Sussex Brighton BN1 9RE UK
T +44 (0) 1273 606261 F + 44 (0) 1273 621202 E ids@ids.ac.uk W www.ids.ac.uk