DEVELOPMENT CENTRE

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TAKING STOCK OF THE CREDIT CRUNCH: IMPLICATIONS FOR DEVELOPMENT FINANCE AND GLOBAL GOVERNANCE

By Andrew Mold, Sebastian Paulo and Annalisa Prizzon
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PREFACE

Although at the outbreak of the current financial crisis the issue was largely ignored, it is becoming increasingly accepted that low-income countries are especially vulnerable. They are heavily dependent on external finance — which is under stress as the crisis deepens — and have poorly developed networks of social protection. This paper argues that the channels of transmission of the crisis will not necessarily be the obvious ones. Moreover, it is suggested that the prospects for the developing world depend not only on how the financial crisis evolves in high-income countries but also increasingly on how growth holds up in the rest of the developing world. In this sense, the paper discusses the possibility that South-South linkages are strengthened in the wake of this crisis, an outcome which would be in line with the ongoing research at the Development Centre on the theme of “Shifting Wealth”.

Of course, all analyses on the impact of the financial crisis are at present tentative and raise as many questions as they answer. But this paper provides a good overview of the issues, both in terms of the sources of risk for low-income countries and also the governance issues which will undoubtedly arise over the coming months and years. The paper examines how the different forms of development finance for low-income countries are likely to be affected by the global financial crisis. Pointedly, it is noted that the crisis may have major consequences for the external debt sustainability of many low-income countries as they struggle with falling export revenues and rising fiscal deficits. Aid flows, on which the poorest developing countries are still heavily dependent, are also likely to come under pressure as governments in donor countries face tough fiscal decisions. In sum, over the short-to-medium term the panorama for the developing world, and low-income countries in particular, is bleak.

A major consequence of the crisis is that existing governance and regulatory structures will be challenged. Some of the most enduring principles of global economic management are being overturned, though we are uncertain as yet of what will be put in their place. As a result, low-income countries might find their policy space, one of their long-standing revindications, opened up in a way that was unimaginable just a few months ago. The irony is that at the same time they are being battered by falling commodity prices and higher borrowing costs, and thus may be less able to take advantage of their new-found policy space. Last but not least, the crisis — having its roots in global economic imbalances and deficient regulations and supervision — brings home the point that better representation of the developing world in global governance is not simply an issue of “equity” and “fairness”; it is a necessary condition for efficient economic
Taking Stock of the Credit Crunch: Implications for Development Finance and Global Governance

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...governance in tune with the new global realities. Low-income countries need to be engaged in the rethinking of the global financial architecture. In all these debates, our intention is to ensure that the Development Centre, with its OECD and non-OECD membership, is active as an interlocutor or “honest broker” of policy dialogue and governance solutions.
RÉSUMÉ

Ce Document examine l’impact de la crise financière mondiale sur les différentes formes du financement du développement pour les pays les plus pauvres, principalement à travers les transferts d’argent, l’aide au développement, et les investissements directs étrangers. Il montre que les canaux de transmission des effets de la crise ne sont pas nécessairement ceux auxquels on s’attendrait. La crise aura ainsi des conséquences majeures pour la soutenabilité de la dette extérieure des pays les plus pauvres — en dépit des initiatives de réduction dont ils bénéficient de la part de leurs créanciers — puisqu’ils sont affectés par une diminution des revenus d’exportation, des dépréciations monétaires et des déficits budgétaires croissants. La crise représente néanmoins une opportunité pour mettre en œuvre certaines réformes. Ainsi, des budgets plus serrés pourraient stimuler les efforts d’amélioration de l’efficacité de l’aide publique au développement. Le Document souligne également que les perspectives pour les pays en voie de développement ne dépendent pas seulement de l’évolution de la crise financière dans les pays de l’OCDE, mais aussi de plus en plus des perspectives de croissance dans le reste du monde. A cet égard, les liens économiques entre les pays du Sud pourraient sortir renforcés de la crise. Enfin, étant donné le discrédit dont souffrent les structures de régulation existantes, le Document insiste sur la nécessité de mieux tenir compte des pays en voie de développement dans les réformes à venir de la gouvernance mondiale.

Mots clés: financement du développement, finance internationale, crise financière, gouvernance mondiale, liens sud-sud.

Classification JEL: F3, F5, O1, O2.
ABSTRACT

This paper examines how the different forms of development finance for low-income countries are likely to be affected by the global financial crisis, principally through reductions in remittances, aid flows and FDI. It argues that the channels of transmission of the crisis for particular countries will not necessarily be obvious ones. Despite initiatives to lower the debt burden for low-income countries over recent years, the crisis will also have consequences for the external debt sustainability as they struggle with falling export revenues, currency depreciations and rising fiscal deficits. In other senses, however, the crisis represents an opportunity for reform. With regard to aid, for instance, it is suggested that a hard-budget constraint on aid budgets may help focus attention on increasing aid efficiency. Moreover, it is argued that the prospects for the developing world depend not only on how the financial crisis evolves in the OECD countries, but also increasingly on how growth holds up in the rest of the developing world. In this sense, the paper discusses the possibility that South-South linkages are strengthened in the wake of this crisis. Finally, the paper looks at the global governance issues that arise from the crisis. In many areas, existing policy frameworks have been discredited by the crisis. It is argued that future reforms in global governance and regulatory structures need to take into account more fully the developing world to be effective.

Keywords: development finance, international finance, financial crisis, global governance, South-South linkages.

JEL Classification: F3, F5, O1, O2.
I. INTRODUCTION

It is always extremely difficult to assess the consequences of an event or series of events which are still unfolding. However, such is the importance of the current financial crisis to the developing world that a first approximation is clearly merited. This working paper provides some early insights on the current financial crisis for:

- the channels of crisis contagion
- the future of the major sources of private and official development finance and
- global governance.

The working paper focuses in particular on the implications for the poorer developing countries, as these are often overlooked, particularly in a time of severe crisis as markets and policy makers in OECD countries tend to direct their attention to large industrialised countries and emerging markets, where the consequences of financial contagion could be disastrous. For policy makers, this is of course a quite legitimate — indeed, imperative — concern.

Yet the poorest countries are arguably more vulnerable to the vicissitudes of the global economy — they are heavily dependent on external finance and trade, and have poorly developed networks of social protection. While it is true that subsistence agriculture continues to play a major role in their economies, insulating them to some extent from the downturn in the global economy, in recent decades there have been some notable successes in promoting niche export sectors (e.g. textiles, cut-flowers, vegetables, tourism). These industries have become an important source of foreign exchange for some countries and are now at risk.

Moreover, the fact that some of the poorest developing countries, particularly in Africa, do not have sophisticated financial markets, and so are not susceptible to direct financial contagion, does not obviate the dangers arising from pure contagion: the overall collapse in confidence in the financial system world-wide will raise borrowing costs, sharply curtail revenues and threaten the solvency of domestic financial systems even in low-income countries that are poorly integrated into the international market. Even a major developing country like India, widely considered to be immune from the financial fallout due to its highly regulated domestic financial markets, is finding that it cannot escape the consequences of the crisis, and is

suffering serious problems of liquidity. An added dimension to this problem is that the banking sector in some low-income countries is largely under foreign ownership. This gives rise to concerns that decisions taken by foreign banks to withdraw credit might compound difficulties caused by deleveraging, as banks sharply curtail lending activities and focus on consolidating the financial accounts of the parent company.

Another major focus of this paper is the existing governance and regulatory structures, both at the national and international level. These have shown themselves to be woefully inadequate. The industrialised countries are being forced to intervene massively to prop up their banking systems and key strategic industries such as automobile manufacturing. According to one recent estimate (Furceri and Mourougane, 2009), the financial resources committed to these interventions already amounted to USD 4.157 trillion by December 2008.

The irony of the situation has not been lost on many people in the developing world. On the one hand, it is hard to reconcile the speed with which USD 4.157 trillion funds have become available for the bail out, while the Gleneagles’ commitments on the scaling-up of aid have remained largely unfulfilled. On the other hand, poor countries have been lectured by multilateral institutions and industrialised countries on the importance of not intervening to prop up their own domestic industries or financial sectors. To some authors, that advice has always smacked of double-standards. It will now become decidedly more difficult to defend arguments against interventionism (even the good ones).

As a consequence of all this, existing global governance structures will be challenged, and perhaps some of the most enduring principles of global economic management will be overturned. Of course, there may be legitimate concerns that the balance will swing too far in the other direction, and countries will contemplate adopting short-term policy measures that will damage their long-term growth prospects. But for developing countries the crisis does mean that their policy space, one of their most enduring revindications during recent decades, is being opened up in a way that was unimaginable just a few months ago. By policy space, we mean their capacity to experiment with policies outside the range of those considered “acceptable” by mainstream opinion. Again, the irony is that, just as policy space is opened up, low-income countries are being battered by falling commodity prices and higher lending costs. Thus they may be in no position to take advantage of that new-found freedom to use their policy space.

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2. The Reserve Bank of India has responded vigorously by boosting liquidity and loosening monetary policy, but the Government’s announced fiscal stimulus package in response will put its fiscal consolidation plan completely off-track (EIU, 2009).

3. A recent econometric study by Cull and Peria (2007) shows that countries that experienced a banking crisis tended to have higher levels of foreign bank participation than those that did not.

4. When the first rescue packages were being announced in the UK and US, the African Business journal “Les Afriques” noted on its cover page that Western countries were about to indulge in practices which had long been forbidden to African countries themselves through multilateral and bilateral pressure (Fall, 2008).

5. See, inter alia, Chang (2002).

6. See, for instance, the collection of essays in Gallagher (2005).
The working paper is organised as follows. Section 2 sets out the distinctive features of the current global financial crisis. Section 3 outlines possible consequences on current accounts, focusing on the trade balance, before examining in more depth whether and how external debt sustainability, aid budgets, finance from multilateral donors’ and foreign direct investment are likely to be affected. Section 4 investigates the challenges for the current structure of global governance and the opportunity for making it more inclusive and efficient. Section 5 concludes.
II. WHY THIS CRISIS IS DIFFERENT

“To some of us, the financial market turmoil that started in the summer of 2007 reflects the secular transformation of the global economy. There are now economic and financial forces in play whose impacts are of great consequence but that cannot as yet be adequately sustained by the world’s current policy and market infrastructures.”

Mohamed El-Erian (2008: 4)

As the words of the Egyptian economist Mohamed El-Erian (above) suggest, the current global financial crisis is perhaps symptomatic of some underlying, deeper changes that are occurring in the global economy — a “Shift in Wealth” towards the emerging markets, or what some analysts have called the “Rise of the Rest”. The current crisis was provoked essentially by two simultaneous phenomena — a combination of a massive accumulation of global macroeconomic imbalances and the poor regulation of financial markets. Its severity brings to light the high degree of instability in the contemporary global financial system. Though experts began to recognise it some time ago (Kaminsky and Reinhart, 1999; Bordo and Eichengreen, 2002), it will no longer be possible to ignore the fact that financial failure has been more extensive and pervasive in the last thirty years than in any previous period in history. Something is seriously amiss with a system of international finance that generates crises with such regularity. Addressing the underlying problems that cause this instability should now be a priority for governments and policy makers.

This time around, however, it is increasingly apparent that we are not confronted by a run-of-the-mill crisis. Earlier financial crises in developing countries usually had a regional concentration — as in the case of the East Asian crisis of 1997-98 or the Latin American “tequila” crisis of 1995. The difference now is that the epicentre of the current crisis lies deep inside the developed economies (Lin, 2008).

This has implications for the strategies that low-income countries should adopt to mitigate the impact of the crisis — traditional policies of fiscal adjustments and sitting tight until the storm has passed will not suffice. The predictions about how the emerging economies had decoupled themselves from the business cycle in the industrialised countries have been shown to be excessively optimistic. The rapidly contracting demand in OECD countries continues to have an impact elsewhere, even though the extent of this is under debate (see Section III.6). Some of the most successful globalisers are being hit the hardest — Singapore’s economy shrunk at an

7. See, for instance, Amsden (2001).
annualised rate of 17 per cent in 2008, and Chinese Taipei may see its economy contract by as much as 11 per cent in 2009. Similarly, in the last quarter of 2008, the German and Japanese economies (two particularly open industrialised economies) fell at an annualised rate of 8 and 13 per cent respectively (The Economist, 2009). Strategically, therefore, low-income countries may be forced to reconsider the way they have integrated into the global economy. Ever-greater degrees of trade and financial liberalisation reveal vulnerabilities that are now coming into sharp relief. More nuanced pragmatic policy options will clearly be warranted in the future.

Globally, financial sector losses have already been massive, and the knock-on effects on the real economy are only just beginning to become visible. In some areas, developing countries have been hit even harder than OECD countries. The MSCI Emerging Market Index, designed to measure equity market performance of emerging markets using data from 23 emerging economies, fell some 57 per cent between 31st December 2007 and 28th January 2008, compared to drops of “only” 41 per cent for the Standard & Poors 500 and 34 per cent for the FTSE100. Real economy indicators in the emerging markets are also falling fast. For instance, the Indian authorities reported a year-on-year decline of trade of 15 per cent for October 2008. Such figures reflect a very serious decline in real economic activity and employment.

Private finance to developing countries is also rapidly drying up. The Institute of International Finance (IIF, 2009) estimates that net capital flows to emerging economies will be just USD 165 billion in 2009, down from USD 466 billion in 2008. This 2009 estimate would represent a decline of 82 per cent from the boom year of 2007, when net capital flows amounted to USD 929 billion. Even though the developing and emerging economies are still forecast to achieve positive growth rates in 2009 (currently estimated at 3.3 per cent by the IMF thus maintaining the growth rate differential with the advanced economies, where GDP is expected to contract by -2.0 per cent), this is hardly cause for celebration in the current context. Moreover, no one can discount at this stage the possibility of further revisions downwards in the forecasts.

What is particularly worrying is the intangible nature of the crisis — in recent years there has been an explosion in the use of new financial instruments (“derivatives”), and nobody knows exactly who is exposed to risk of default and insolvency. Fear and uncertainty are powerful drivers of financial crises and the odds are that it will take a considerable length of time until confidence is restored in the economic system. A prolonged crisis is therefore a distinct possibility — policy makers need to take this possibility into account and plan accordingly.

8. For an engaging discussion of some of these issues, see Kaplinsky (2005), especially Chapter 8. A recent paper by Eichengreen et al. (2009) finds that while financial openness has positive effects on the growth of financially-dependent industries, these growth-enhancing effects evaporate during financial crises. Moreover, the positive effects of capital account liberalisation are limited to countries with relatively well-developed financial systems, good accounting standards, strong creditor rights and rule of law. This latter point suggests that countries must reach a certain threshold in terms of institutional and economic development before they can expect to benefit from capital account liberalisation.
III. HOW WILL COUNTRIES BE HIT? THE CHANNELS OF CRISIS CONTAGION

In setting the scene in the introduction, we have discussed very briefly some of the major themes that are arising from the current crisis. The more immediate question is, however, which countries will be most affected, and through which channels? Some solid tentative explorations of this issue have already been published by the World Bank and the IMF (World Bank, 2008b; Demirgüç-Kunt and Servén, 2009; IMF, 2009). But just as the crisis is changing some of the most entrenched ideas on global governance and the financial architecture, some of the key parameters of crisis management may also behave in ways which are unfamiliar. This section of the working paper explores some of these issues.

The global nature of the shock means that it would be reasonable to expect all developing regions to be damaged by the shocks to some extent (though some countries will undoubtedly be better positioned to take advantage of the subsequent recovery, thus speeding up the reconfiguration of the global economy which was underway prior to the crisis). It also needs to be borne in mind that the channels of contagion are often unexpected ones — thus, for instance, Ethiopia is vulnerable to a slowdown in international air-traffic (Ethiopian Airlines is one of the country’s main earners of foreign exchange), and Mozambique could be adversely affected by the worldwide decline of the automobile industry (its leading export is alumina). As mentioned in the introduction, despite the low level of financial integration with the rest of the world in low-income countries, it is similarly not unthinkable that the banking sector could be a source of transmission, especially bearing in mind that in countries like Tanzania, Côte d’Ivoire, Rwanda, Madagascar, Botswana, Mozambique and Uganda over two thirds of the banking sector assets are in the hands of foreign banks (World Bank, 2008a). In terms of the channels of transmission of the crisis, then, expect the unexpected is probably a good rule of thumb.

On the standard indicators of the probability of a crisis, there are five variables that merit particular scrutiny (Edison, 2003; Agénor, 2004): real exchange rate overvaluation, a high ratio of short-term debt to official reserves, a high ratio of broad money to reserves, substantial losses of foreign assets and sharply declining equity prices. These indicators are easily analysed, but it is important to point out that they can also be easily misinterpreted (Reisen and von Maltzhan, 1999). For instance, both debt and fiscal deficits may be at low levels during the boom, but can rise sharply during the crisis. Tax collection flourishes when exports and raw material prices boom but can tumble during the subsequent bust. Currency appreciation during the boom reduces foreign currency-denominated debt ratios but gives way to an endogenous rise in debt ratios as currencies and GDP growth weaken during the recession. There are similar difficulties in trying to determine equilibrium real exchange rates, as studies tend simply to extrapolate from
previous trends. Equally troubling is the perennial problem of data availability; for many low-income countries, data only becomes available with a significant delay, of up to 6 months (or even more) for GDP data. Formulating timely policy advice during a crisis based on such data is Thus extremely problematic.

Despite this overall panorama of uncertainty, there are some stylised facts to keep in mind when evaluating the prospects for low-income developing countries. One is the pervasive lack of social safety nets and the lack of capacity to adopt counter-cyclical policies to compensate for the fall in demand for exports from abroad. Another is the high degree of dependence on foreign savings. Of UNCTAD’s classification of 49 Least Developed countries, 15 (mostly small) countries had negative domestic savings rates in 2006, and so were relying on capital inflows to finance not only domestic investment but also their domestic consumption 9. Indeed, only one third of LDCs had gross domestic savings rates above 15 per cent and savings rates remained low in a number of African LDCs which have had relatively sustained growth performances over recent years, including Burkina Faso, Ethiopia, Uganda, Tanzania and Senegal (UNCTAD 2008: 9). The upshot of all this is that low-income countries are still highly dependent on external financial flows. And, as we saw earlier, the expectations are that these flows will all be seriously reduced in 2009. How then will governments manage?

III.1 Consequences on the current account

In an early analysis of the countries likely to be affected by the crisis, the World Bank (2008b) uses a simple but illustrative taxonomy of fiscal deficits vis-à-vis the current account balance, the idea being that countries displaying simultaneously large fiscal and current account deficits being most at risk during the coming crisis. And although for many developing economies the current account balance might not be the most important source of risk, the prevalence of the trade balance as the main source of unexpected disturbances may be an acceptable assumption for low-income developing countries that are characterised by export specialization in a narrow range of staple goods (Wyplosz, 2007). This obviously still includes many of the low-income countries of Africa, Asia and Latin America.

Some developing countries, buoyed up by strong commodity prices, have enjoyed positive current account balances over recent years (Figure 1). But the average masks a more complicated reality: in many cases surpluses have been small, and even prior to the crisis many were already converting into deficits (especially in Latin America, but also in Sub-Saharan Africa). Many developing countries were particularly adversely affected by the combination of exceedingly high food import bills and oil prices in 2007-8, which led to a rapid deterioration in the current account balances and reserves. By the summer of 2008, about half of all developing countries already had a current account deficit. According to the IMF (2009:4), 33 out of 78 low-income countries now have reserve holdings equivalent to less than 3 months of imports.

9. These included five very high growth “fragile states” – Afghanistan, Burundi, Malawi, Liberia and Sierra Leone.
This leads us to the next question which is how vulnerable are low-income countries through trade? As part of the ongoing process of globalisation, in recent years the “openness ratio” (i.e. imports plus exports as a share of GDP) of LDCs has increased substantially from 23 per cent in 2000 to 31 per cent in 2007. Openness should be a positive attribute during periods of economic boom. But obviously a high degree of openness to international trade becomes a liability when the world economy is suffering a serious recession. Reflecting the sharp contraction in international trade, the Baltic Exchange Dry Sea Index (a standard measure of international trade costs) had declined by over 90 per cent between June 2008 and the end of January 2009. Many of the burgeoning export industries in low-income countries are already at risk (e.g. the cut flower industry in Ethiopia, or the textile industry in Cambodia, for example, where reportedly orders are 60 per cent down) (Lamy, 2009).
In recent years some low-income countries have decreased their dependence on developed country markets and their trade has been reoriented towards the emerging markets. For instance, African LDCs (plus Haiti) now export more to China than to the European Union (24.2 per cent vis-à-vis 18 per cent of total exports). If growth remains positive in the emerging markets (as IMF predictions seem to suggest), then there are chances for some developing countries to avoid a complete collapse in export volumes. Nevertheless, this will not avoid losses through falls in their terms of trade (i.e. prices) — which could be large.

Some pressure on current accounts and government budgets will be relieved by the drop in commodity prices (particularly oil and food) for net commodity importers. Government budgets could benefit as costly price subsidies for fuel and food prices are reduced (though this positive effect may be mitigated by currency depreciation) (see Figure 2). At the same time, however, there are legitimate concerns that the price level in many poor countries has suffered a ratchet-type effect, with prices being quick to rise, but very slow to fall. Rising food prices in particular are still a source of concern in many African countries, such as Ethiopia, Kenya and Rwanda.

Another important dimension to the crisis is the foreseeable reduction in remittances and its impact on the current account and on household income. According to World Bank data remittances are now larger than commodities as a foreign exchange earner in 28 developing countries. For Sub-Saharan Africa, the total income from remittances has been put as high as USD 19 billion for 2008, higher than estimates for either FDI inflows or country programmable aid (i.e. aid budgets which are available for development projects and programmes in poor countries). During disasters or post-conflict situations, there is usually a counter-cyclical dimension to remittance flows. However, there is no guarantee that this is the case during an economic downturn that is global in nature.

Tourism receipts, another major source of income for some developing countries, will also be affected by the crisis. Some low-income countries that have met with considerable success in attracting an increasing number of visitors in recent years, such as Uganda, Cape Verde, as well as the more well-established destinations (e.g. Kenya), can expect to see their earnings from this source decline. Tourism bookings are already reportedly down 40 per cent in Cambodia, while visitor arrivals (and revenues) to Kenya fell 30 per cent over the first 9 months of 2008 (Willem te Velde, 2008).

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10. For Ethiopia, for instance, the sharp increase in oil and fertilizer price led to a doubling of the oil and fertilizer import bill in 2007/08 to almost USD 2 billion (about 8 per cent of GDP). Similarly, in 2007 total subsidies in Egypt reached 30 per cent of the entire government budget (IFPRI, 2008).

III.2 Impact of the crisis on external debt sustainability

The crisis is likely to have major consequences for the external debt sustainability of many low-income countries. According to the IMF and World Bank classification, only nine Heavily Indebted Poor Countries (HIPC) are rated as enjoying a low risk of debt distress (IDA and IMF, 2008). The latest data available show that about one third of low and lower-middle Sub-Saharan African countries have an external debt-to-GNP ratio greater than 50 per cent and a debt service-to-GDP ratio greater than 2 per cent (Figure 3), still within a range which these countries could be considered vulnerable to external shocks. Clearly, some economies are more vulnerable than others — their share of short-term to total debt has been rising and is not sufficiently covered by foreign exchange reserves (e.g. Democratic Republic of Congo, Côte d’Ivoire, Liberia), while the average maturity of their debt has been declining (e.g. Bangladesh, Cambodia, Kyrgyz Republic and Yemen)\textsuperscript{12}. In times of economic crisis, this is always a potentially dangerous combination.

\textsuperscript{12} In the case of HIPC that benefited from debt relief, a shorter average maturity may result from a lower share of official debt characterized by longer maturity \textit{vis-à-vis} private debt (with on average shorter maturities) such as in Benin, Burundi, Chad, Ghana, Guinea, Madagascar, Mali, Mauritania, Mozambique, Niger, Senegal, Sierra Leone and Zambia.
The financial crisis will further compromise external debt sustainability for many developing countries, affecting endogenous debt dynamics, as growth rates and export earnings fall. Moreover, foreign debt is denominated in hard currencies, making repayment ability highly sensitive to shifts in exchange rates. And with the collapse in commodity prices and the recent appreciation of the dollar, exchange rates in many low-income countries have already been falling in commodity dependent economies such as Zambia (a -40 per cent depreciation to the US dollar from June 2008 to February 2009), Uganda (-20 per cent), Ghana (-24 per cent) and Nigeria (-25 per cent). Such depreciations obviously make it much harder to service foreign debt.

At the same time, fiscal deficits are expected to worsen not only because of the drop in export revenues but also because of the need to increase social spending and safety nets and to provide the fiscal stimulus required to mitigate the worst consequences of the financial crisis. Another source of potential concern is that the debt relief process — which still involves 17 countries — may slow down because of unforeseen cuts in donors’ pledges and commitments. It is pertinent to ask whether HIPCs will even be able to meet existing goals and objectives to be eligible for debt relief in the new harsher international environment. In addition, new channels of financing for low-income countries, such as sovereign bond issues, will be closed down and export credits to developing countries are drying up as financial markets tighten.

13. Several countries have recently issued or planned to issue sovereign bonds, among them Ghana, Cameroon, Kenya, Mongolia and Uganda.
III.3 Challenges and opportunities for bilateral aid budgets

Despite the enormous increase in private flows to the emerging markets in recent years, the poorest developing countries are still heavily dependent on aid flows (Table 1). Africa is most at risk on this score where aid averages around 9 per cent of GDP (compared for instance with South Asia which has reduced its dependency on aid flows to only 1 per cent of GDP). There are, however, wide variations across countries even within Africa, with some like South Africa receiving only a small amount of aid as a share of GDP, while others are still highly aid dependent (e.g. Mali (13 per cent), Malawi (20 per cent), Sierra Leone and Burundi (over 30 per cent)) (Glennie, 2008:22).

Table 1: The Relative Importance of Aid for SSA

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<th>Developing Countries</th>
<th>Sub-Saharan Africa</th>
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<tr>
<td>Private flows</td>
<td>84.9</td>
<td>38.4</td>
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<td>Overseas development aid</td>
<td>19.5</td>
<td>65.4</td>
</tr>
<tr>
<td>Other official flows</td>
<td>-4.4</td>
<td>-3.9</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
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</table>


Since the Gleneagles G8 Summit in July 2005, the major debate within donor circles has been about the scaling up of aid, especially for Africa. In reality, however, progress has not lived up to expectations. In real terms, aid in 2007 was only 15 per cent higher than in the 2004 Gleneagles base year, compared to the 60 per cent required by 2010 to meet the Gleneagles commitments (DCD/DAC, 2008). Roodman (2008) has argued that in the aftermath of the financial crisis even existing aid budgets are at risk. He points to some particular examples (Finland, Japan, Norway, and Sweden) of sharp falls in aid during previous financial crises. For instance, Japan’s aid (measured as net disbursed ODA in USD at 2006 constant prices) fell 12 per cent between 1990 and 1996. In Finland, according to Roodman’s figures, the fall was even more dramatic; during its banking crisis between 1991 and 1993 when GDP dropped by nearly 11 per cent, development aid fell by 60 per cent (OECD-DAC figures showing a smaller, but still major drop of nearly 30 per cent). On the basis of national data, historical evidence does indeed seem to show that during sharp economy-wide contractions, aid budgets are vulnerable.

In the light of these examples, are all hopes of scaling-up now dashed? And are Roodman’s case studies generalisable? What do we know about the impact of economic cycles in the donor countries themselves on the scale of aid disbursements? Despite the fall of aid during the Finnish financial crisis in the early 1990s, Figures 4 and 5 reveal no clear pattern between GDP growth and aid. In the case of Japan (Figure 4), the negative growth of -2 per cent in 1998 was actually accompanied by a 40 per cent increase in aid flows. For the United States, the trends between economic growth and the size of the aid budget seem to be similarly ambiguous —
while aid dropped in 1990 during the recession of 1990-91, in the 2000-1 recession aid was accompanied by a sharp increase. The simple correlation between aid flows and GDP growth in the US case is just 0.06 over the period 1960-2007. Decisions on allocations to the aid budget do not appear to be strongly affected by the business cycle\footnote{More rigorous empirical evidence based on aggregate data for all DAC donors on this point is rather thin on the ground. But the aggregate studies that do exist (e.g. Round and Odedokun, 2004; Chong and Gradstein, 2008) contradict one another sufficiently to confirm that there is no trenchant evidence on the nature of the relationship between GDP growth and aid flows.}.

* The grey-shaded areas highlight years characterized by a systemic banking crisis as in Laeven and Valencia (2008).

One important dimension to this question is the fiscal balance — one would expect, ceteris paribus, that governments with large deficits would be more prone to cut aid. And by massive intervention to prop up the banking and credit system, OECD governments are currently taking on huge financial commitments, already amounting to several trillion US dollars. For example, the Emergency and Economic Stabilization Plan in the United States alone is currently worth USD 700 billion. As Robert Zoellick, President of the World Bank, has recently affirmed, “at USD 100 billion a year, the amount spent on overseas aid is a drop in the ocean compared to the trillions of dollars that are now being spent on financial rescues in the developed world.” Clearly governments are going to have to take some tough fiscal choices in the coming years. Against this backdrop, the a priori reasons for expecting significant aid cuts during a recession are strong ones — after all, the recipients of ODA are not members of the domestic political constituency — and maintaining the aid budget during a crisis is not necessarily a vote-winner. Under pressure to reduce

\begin{figure}[h]
\begin{center}
\includegraphics[width=\textwidth]{Figure4_5.png}
\end{center}
\caption{Japan}
\caption{United States}
\end{figure}

Sources: OECD (2008a) and World Bank (2008d).
expenditures, it would therefore seem logical to expect aid flows to be one of the first areas to be affected by cuts.

Once more, however, the empirical evidence on this point is mixed. According to a study by Faini (2006), countries with a healthy fiscal situation tend to be more generous donors. Bertoli et al. (2008), on the other hand, come to exactly the opposite conclusion — that donors with larger fiscal deficits deliver larger aid flows. The findings of both studies can be plausibly interpreted — Faini’s study implies that countries with a better fiscal stance are likely to be more generous in their allocations to development aid, while the Bertoli et al. (2008) study could reflect the fact that fiscally more conservative governments might be less likely to give to development aid! Again, the analysis of individual donors seems to support the viewpoint that there is no systematic relationship between fiscal position and aid allocations. In the case of the United States, for instance, there is no statistical relationship between net bilateral ODA and either tax receipts, deficits or total government expenditures (Kharas, 2008).

To sum up, then, the existing evidence lends support to a rather agnostic interpretation of trends for aid budgets during the course of the current crisis. Severe depressions and financial crises have sometimes been accompanied by aid cutbacks in the past, but at the present time, without knowing how deep the recession will be, it is difficult to be sure. Nevertheless, it is not encouraging that countries such as France, Ireland and Italy have already announced cutbacks in their bilateral aid programmes. We are, at present, in uncharted waters.

III.4 Finance from multilateral donors

What will almost certainly happen during the crisis, however, is a notable shift in the composition of resource flows towards multilateral contributions as more funds are channelled through the IMF, the World Bank and the regional banks. At a time of economic crisis, finance which carries an implicit or explicit government-backed guarantee is likely to be privileged over other kinds of capital flows, hence the renewed interest in providing finance via the Bretton Woods institutions. However, despite ongoing discussions to increase their financial firepower, the resources available to the IFIs are so far quite limited in comparison with the scale of the global downturn. The IMF had USD 265 billion lending capacity before the crisis broke; but its interventions in Eastern Europe and Iceland have already consumed a lot of that lending capacity. The potential liquidity needs of any major emerging economies might deplete these resources very rapidly. Likewise, the World Bank cannot extend its lending capacity to low-income countries quickly beyond the roughly USD 50 billion negotiated within the IDA15 replenishment.

In September 2008, the IMF launched a modified Exogenous Shocks Facility (ESF) targeted to low-income countries — economies which are eligible for a Poverty Reduction and Growth Facility Program (PRGF) but currently without a programme in place. Several low-income countries have already obtained access to this facility (Comoros, Ethiopia, Kyrgyz Republic, Malawi and Senegal), though some analysts remain critical about the terms on which the funds are disbursed (e.g. Birdsall, 2009:2). At present negotiations are underway to double (or perhaps even triple) the IMF’s overall funding capacity. In December 2007 the World Bank
approved the 15th IDA replenishment of the amount of USD 42 billion. These flows are channelled to low-income countries that are not creditworthy enough to borrow at market terms. At the same time, the World Bank hard-loan window, IBRD, could make new commitments of up to USD 100 billion over the next three years but eligibility is limited to middle-income and creditworthy low-income countries\(^{15}\). A new facility has also been set up to speed USD 2 billion to help the poorest countries by expediting approval for IDA 15 funding. The resources are to be used for safety nets, infrastructure, education and health.

Despite these initiatives, there is still a danger that the new funds will largely bypass the poorer most vulnerable countries and instead be destined principally for emerging markets and middle-income countries. There is, to be sure, some logic and justification in such an allocation of resources — considerable concern exists that contagion may spread to the emerging markets with serious implications for the rest of the global economy. It is also true that many of the new flows made available through the multilaterals are not accounted for as development aid (there is little or no grant component).

Nevertheless, the essential point is that many of the poorest countries are still vulnerable in the context of the current crisis. In this sense, Robert Zoellick has made a proposal for a new “Vulnerability Fund”, destined for low-income countries which would amount to 0.7 per cent of the rich countries’ stimulus packages, or about USD 15 billion. But bearing in mind the rapidly deteriorating fiscal situation in many low-income countries and the possible decline in bilateral aid, it is questionable whether such funds are sufficient. A major challenge for both bilateral and multilateral donors is therefore to maintain their existing commitments to low-income countries, in particular by making sure that country programmable aid does not suffer from cutbacks.

Finally, the financial crisis could (or should) give a new impetus to governments’ efforts to improve aid effectiveness, as set out in the Paris Declaration and the Accra Agenda for Action. Even in the face of the possible stagnation of aid budgets, there might be a pay-off to the crisis if donors react in a way that is pro-poor. Indeed, a hard-budget constraint may even help reduce some of the inefficiencies that have become inherent in the international aid system. Significant portions of aid budgets have grown enormously over the last 10-20 years — particularly technical cooperation — and yet the rationale for supporting such a large expansion of these expenditures, in terms of aid effectiveness, is more doubtful\(^{16}\). Now, more than ever, policy makers need to protect aid volumes and allocate them in a way that is pro-poor.

### III.5 Will FDI inflows turn out to be pro-cyclical? Evidence from past experience

FDI has been one of the principal beneficiaries of the liberalisation of capital flows over recent decades and now constitutes the major form of capital inflow for many developing countries (Figure 6), including some low-income ones like Chad, Mauritania, Sudan and Zambia. According to UNCTAD (2009: 6), for instance, FDI flows to Africa have been estimated at USD 62

\(^{15}\) The International Financial Corporation (IFC), the private sector branch of the World Bank, is expected to allocate around USD 30 billion over the next three years.

\(^{16}\) See Riddell (2007), Chapter 12.
billion in 2008, up from USD 53 billion in 2007, despite the slowdown in global economic growth and its negative consequences for the region. The year 2008 was also good for Mergers and Acquisitions (M&As) in Africa, which rose by an estimated 157 per cent to USD 26 billion.

Figure 6: **Net Capital Inflows to SSA, 1999-2007** (USD billion)

![Net Capital Inflows to SSA, 1999-2007](image)

*Source: World Bank (2008c).*

While there are reasons to celebrate this success, the current financial turmoil does not bode well for the sustainability of these flows in 2009. Global FDI inflows fell by about 21 per cent in 2008 and the prediction is that they will likely fall further in 2009 (UNCTAD, 2009). It will be difficult for low-income economies to buck these global trends in 2009. Resource seeking FDI projects in particular could suffer from the decline in world demand and consequently in prices. It is often argued that countries are less vulnerable to external financing difficulties when current account deficits are financed largely by FDI inflows, rather than debt-creating capital flows. It is true that FDI inflows generally provide a more stable source of external financing than private debt and portfolio equity flows. And there is no gainsaying the importance of FDI both for its contribution to sustaining current account imbalances and for its contribution to broader economic growth, through technological spillovers and competition effects. But this is only part of the story.

There are several reasons for adopting a more cautious stance regarding the potential contribution of FDI finance during the current crisis. Firstly, approximately 30-35 per cent of current flows are accounted for by M&As and much of this activity is likely to dry up, as corporations have increasing difficulty in getting access to credit (though there may be examples of “opportunistic” FDI as multinationals with stronger cash balances take advantage of low “fire sale” prices to buy up assets of insolvent companies). M&A activity in developing economies has
so far held up well, but its global value had already declined by 28 per cent during the first nine months of 2008 and is likely to decline further (Sauvant, 2008).\(^{17}\)

Secondly, if profit remittances are taken as a proxy for its “price”, FDI can be an “expensive” form of financing, especially for low-income countries. In Zambia, for instance, profit remittances ran at an average of -4 per cent of GDP between 2004-7 (UNCTAD, 2008: 30). On average World Bank data shows profit remittances exceeding new FDI inflows for every year in low-income countries between 1999-2005. Moreover, although profits will be squeezed because of the crisis, it is not inconceivable that in some cases the rate of profit remittances accelerates, as parent companies try to strengthen their own balance sheets.

Thirdly, the ease with which multinational enterprises can shift financial resources from one country to another may add to the current instability. For instance, FDI investors often use derivative products such as currency forwards and options, which may put local currencies under pressure and increase instability (Griffith-Jones and Persaud, 2008). Similarly, some components of FDI are more pro-cyclical than others. In particular, reinvested earnings and intra-company loans are likely to be curtailed sharply during the current crisis, as companies repatriate financial resources towards parent companies. This was very much the case during previous crisis, such as the Thai crisis (1997) and the Argentinean crisis (2001) (See Figure 7).

Figure 7: Decline of intercompany loans versus equity component of FDI during financial crises (per cent)

![Figure 7: Decline of intercompany loans versus equity component of FDI during financial crises (per cent)](image)

**Source:** World Bank (2004: 87).

17. Some M&As in developing countries are already being cancelled. For example, the recent proposed takeover of a South African mining conglomerate by the Anglo-Swiss firm Xstrata was abandoned due to financing difficulties.
Finally, although not to the same extent as other private capital flows, FDI itself is still pro-cyclical. This was particularly evident during the downturn in 2000-01 when global FDI outflows fell by almost 50 per cent. The implications are clear: as the credit crunch starts to bite and capital becomes scarcer and more expensive, so multinational corporations will scale back their investment plans. FDI inflows are also highly contingent on local growth as a “pull factor” which entices foreign investors. In so far as the prospects for growth in developing countries deteriorate, so too will FDI inflows. This is particularly important to the extent that much FDI in the developing world is directed towards local markets.

Once the crisis is over, FDI might actually be one of the forms of cross-border flows that will be privileged (as it has been in the aftermath to previous crises). Indeed, there are some early signs that South-South investments may come out of the crisis strengthened over the long term. In a deleveraged world, FDI could become one of the few ways in which low- and middle-income countries can access capital for development. But in the meanwhile policy makers in developing countries need to monitor trends carefully and adapt policy accordingly. FDI is in itself no panacea and can sometimes compound problems during times of financial crisis. It is certainly no substitute for enlarging tax bases and promoting better mobilisation of domestic resources.

III.6 Can South-South Linkages Compensate for the Economic Slowdown in the North?

Much attention has been focused on the idea that the prospects for the developing world, and low-income countries in particular, hinge on what is happening in OECD countries. However, in a context of “Shifting Wealth” (see Section 2), how true is this nowadays? For several of the transmission channels to which we have drawn attention in this paper, such as migration, south-south linkages are becoming increasingly important. And southern trade and investment linkages have grown enormously too over the last decade.

How deep are real channel linkages between the developing world and industrialised countries? Some suggestive findings are provided by Akin and Khose (2008). Their analysis is based on a comprehensive database of macroeconomic and sectoral variables for 106 countries over the period 1960–2005. They distinguish between a Northern world of industrialised economies and a developing world composed of two groups of countries, the Emerging South and the Developing South, based on the extent of their integration into the global economy. Using a panel regression framework, they find that the impact of the Northern economic activity on the Emerging South has declined during the globalisation period (1986–2005). In contrast, the growth linkages between the North and Developing South have been rather stable over time.

18. Two recent examples: firstly, the Liberian Government has recently signed a USD 2.6 billion agreement with a Chinese company, China Union, to excavate for iron ore, in what is one of the single largest ever investments in SSA. http://www.voanews.com/english/Africa/2009-01-23-voa8.cfm. Secondly, the Brazilian company Petrobras has announced a massive expenditure plan for the period 2009-2013, reaching USD 174 billion, of which USD 2 billion are planned for Nigeria and USD 800 million for Angola. “Brésil: La crise, quelle crise?”, Jeune Afrique No. 2508, From 1st to 7th February 2009, page 58.
Such exercises are crude approximations to what in reality are a complex set of linkages. But should their findings be right, the conclusion could be that the poorer developing countries, still heavily dependent on the markets of the North, will be more seriously hit by the financial crisis in the north than the emerging countries.

Table 2: **Sub-Saharan Africa: Real GDP Growth Correlations — 1980-2007**

<table>
<thead>
<tr>
<th>Region</th>
<th>Correlation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rest of the World(1)</td>
<td>0.60</td>
</tr>
<tr>
<td>European Union</td>
<td>0.32</td>
</tr>
<tr>
<td>United States</td>
<td>0.01</td>
</tr>
<tr>
<td>Developing Countries(1)</td>
<td>0.54</td>
</tr>
<tr>
<td>Asia</td>
<td>0.30</td>
</tr>
<tr>
<td>Latin America</td>
<td>0.32</td>
</tr>
</tbody>
</table>

*Note: (1) Excluding Sub-Saharan Africa. Source: IMF (2008b).*

Other evidence does not necessarily concord with these findings however. An IMF (2007) study estimates that, on average, a 1 percentage point decline in GDP growth in the euro area is associated with a slowing in GDP growth of about 0.25 percentage point in SSA. In the case of the US, these negative spillover effects would be limited to 0.1 percentage point. A subsequent IMF (2008b) study carried out an analysis of the simple correlation of growth rates in SSA with growth rates in other regions of the world over the period 1980-2007 and finds that the correlation with Latin America and Asia is just as high as the correlation with its traditional trading partners in Europe. Pointedly, despite initiatives like African Growth and Opportunity Acti (AGOA) intended to intensify trade and investment links with SSA, the simple correlation of growth in SSA with the United States is near to zero. The upshot of all this is that how well low-income countries will withstand the crisis has become increasingly more contingent on the fortunes of the rest of the developing world, rather than on the prospects for the OECD. If growth rates remain positive in the main southern “drivers” (countries like Brazil, China and India), one long-term consequence of the current crisis may be an accelerated reconfiguration of the global economy in favour of the developing world.
IV. GLOBAL GOVERNANCE AND THE FINANCIAL CRISIS — FINDING A VOICE FOR THE POOR?

From the point of view of global financial architecture, the prospects are particularly sombre. We are confronted with a disorderly unwindning of the unsustainable imbalances in the global economy, against which some of the more prescient analysts have been warning for some time (Roubini, 2008; UNCTAD, 2007; Izurieta and McKinley; 2006). Again the roots of the problem are longstanding ones. Since the early 1980s, current account imbalances at the global level have been growing very significantly. As Glyn (2006:66) points out, there would have been nothing intrinsically wrong with this if larger deficits had reflected borrowing by poorer countries or those particularly well-endowed in natural resources to invest in productive investment. But deficits have generally tended to favour consumption in high-income countries and have often been associated with falling savings ratios, as has been the case in various economies since the 1990s (e.g. the USA, UK, Netherlands, Sweden, Italy, Finland, Canada and Australia). This all led to the perverse situation whereby developing countries were making an enormous net outward transfer of resources to developed countries, reaching an all-time high of USD 933 billion in 2008, according to DESA estimates (UNDESA, 2009:61). The implications for development finance have not been difficult to gauge. As Izurieta and McKinley (2006:17) put it:

“Current resource flows are inequitable because the world’s largest rich country is consuming significantly beyond its domestic income. In order to do so, it is cornering the lion’s share of global excess savings. Instead, these resources could be re-cycled to poorer countries badly in need of development finance. Even an MDG-inspired doubling of ODA to poor countries could only modestly redress this massive imbalance.”

These global imbalances are unwinding now, but in a way which will be extremely damaging to the prospects for growth and poverty reduction in low-income countries. It is clear that there is a tremendous need for urgent reform of policy instruments, macroeconomic frameworks and regulatory institutions. The challenge for the international community is to design an international financial architecture which in the future avoids such perverse outcomes, by providing a framework for sufficient stability and sustainability for long-term investment and growth, for the industrialised and developing countries alike. But how? Martin Ravallion (2008:5) puts the challenges most succinctly:
“As in past crises, there is a risk of myopic policy responses. The scale, visibility and potential political costs of the 2008 crisis could well prompt short-term responses that neglect longer-term implications for economic development...The right policies could go a long way toward mitigating the welfare impacts on the world’s poorest families. An effective response package should be consistent with restoring economic growth, and may even help promote more rapid growth in the future, by helping to redress some of the inequalities of opportunity that constrain both growth and poverty reduction. By contrast, the wrong policies could actually make things worse in the longer term.”

IV.1 How Far is Reform likely to go?

The current crisis could represent an opportunity for developing countries to become more independent from long-held policy prescriptions and to increase the Southern voices in global governance. Such an outcome is not assured, of course; history is replete of failed attempts to improve the position of developing countries within the international economic hierarchy, such as the 1970s’ Declaration for the Establishment of a New International Economic Order (NIEO)\(^{19}\). According to Narlikar and Tussie (2004), for example, in international trade negotiations developing country coalitions have persistently been undermined by a combination of a lack of their economic clout, internal disagreement and the divide-and-rule-tactics adopted by rich countries. Such negotiating weaknesses plague developing country coalitions in other fora too (Mold, 2007).

The Voices of the South face an uphill battle to be heard in international rule and regulation setting. The fact that the current crisis, in contrast to other recent crises, has its origins in regulatory and policy failure originating in the developed world, has not prevented developing and emerging economies from being affected. Emerging countries have been severely hit and, as we have argued here, low-income countries might be even more vulnerable. This is despite the more fundamental and long-term shift of economic and financial power from developed to developing countries. Existing governance structures created in the international system are in many cases ill-adapted to the political and economic realities of the 21st century.

Yet International Relations theorists, especially from the realist school, are generally sceptical about the possibility of major governance reforms in the context of an emerging multipolar world order. The protracted, tortuous negotiations in the 1940s during the Bretton Woods negotiations (which stretched out for two years prior to the conference itself) tend to support this view; even then, reaching agreement was difficult, despite the shared experiences of the Great Depression, the Second World War, the concentration of economic and political power in the hands of a few countries and, above all, the willingness of one power (the United States) to take on a role of global leadership. The neorealist theory of hegemonic stability argues that leadership by a dominant power is always necessary for sustaining the global governance architecture and an open world economy. According to neorealist theory, the increase in

\(^{19}\) The Declaration for the Establishment of a NIEO was adopted by the United Nations General Assembly in 1974. It contained a set of demands aimed at restructuring the international economic system in favour of the “South” (the “periphery”).

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multipolarity in the system would intensify rivalries, conflict and protectionism since growing uncertainty impedes cooperation. Institutionalists, however, argue that existing institutions can evolve and facilitate cooperation even when the conditions under which they were created have changed (see Keohane, 1984).

A dramatic overhaul of existing institutions may not be on the cards, then, but the crisis may provide an opportunity for pragmatic changes within the existing institutional framework, making it more efficient and inclusive by involving emerging and developing countries. The depth of reform might also increase depending on how severe the downturn turns out to be. These pragmatic changes are most likely to result in more influence for the usual suspects: Brazil, China, India and South Africa. This leaves open the question how smaller and poorer developing countries can voice their interests and concerns in the new “G20-world”. The G20 includes Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States of America and the European Union represented by the rotating Council presidency and the European Central Bank.

McCulloch (2008) refers to the financial crisis “as an opportunity to radically rewrite the rules of global financial governance to include the voices of the global poor”. Though the idea of giving developing countries more say in global governance is commonly accepted, the way to achieve this is less clear-cut. The existing governance models provide a possible spectrum ranging from the Bretton Woods institutions (the “Washington-model”) to the UN-General Assembly (the “New York-model”). Both are criticised — the former for lacking legitimacy, the latter for lacking decision-making capacity. The crux will be to find a formula which allows the inclusion of new players, while not impeding decision making.

Maxwell and Messner (2008) highlight the possible usefulness of the EU-model of a qualified (double) majority. The EU offers an example of how countries of different size and with different income levels can be integrated into decision-making procedures. Clearly, the European “model” is not universally lauded as a paragon of effective, consensual decision making, but could Brussels provide a compromise model between Washington and New York? The example of the EU suggests that global governance institutions require a mix of principles of representation. A range of principles are possible: one member one vote, differentiated representation according to wealth and population, the “shareholder principle” (based on who provides resources), the principle of the most affected (users of services provided by institutions) (Underhill, 2007: IV-V). Until now, the shareholder principle has been dominant in global financial institutions. But in a context of a changing distribution of power in the world economy and deep global financial crisis its legitimacy is increasingly being questioned.

IV.2 The Evolving Global Governance System and the Role of Small Low-Income Countries

Though the probability of a substantial governance reform is low over the short term, this should not prevent urgent and pragmatic changes to the main building blocks of the global financial architecture. The Group of Eight (G8) industrialised countries has in fact already kicked off a reform process by “reaching out” to emerging economies. This process has been
institutionalised under the “Heiligendamm process” initiated at the 2007 G8 summit in
Heiligendamm (Germany) and hosted by the Heiligendamm Dialogue Support Unit within the
OECD. The initiative aims at enhancing dialogue on issues like innovation, energy and
development between the G8 and five emerging countries (Brazil, China, India, Mexico and
South Africa).

The Washington summit in November 2008 on the financial crisis took place in the G20
format. Clearly, this reflects concerns that, without a wider legitimacy, actions to counter the
global credit crisis are likely to be ineffective. However, though the G8 may be outdated, the new
format has not yet been confirmed for future summits and the debate about the “right”
composition continues. While some see in the G20 “a step in the direction of a more participatory
system of global governance, others question [its] very legitimacy”20. On the one hand, it could be
argued that the G20 is too big — the difficulties of negotiating the Lisbon Treaty for the EU-27 is
a good illustration of the problems of decision making in a body with 20 or more members. On
the other hand, it might be maintained that the G20 is an exclusive ad hoc structure leaving more
than 170 countries unrepresented. Then again, those twenty constitute roughly 90 per cent of
world GDP, 80 per cent of world trade and two thirds of the world population. From the
perspective of representation of the interests of the poor, the G20 format also represents a
fundamental change. Within the borders of the developing countries present in the G20 are about
54 per cent of the world’s poor21. India alone accounts for 36.5 per cent of the global poor which
is more than that of the whole of Sub-Saharan Africa.

The reform of the Bretton Woods institutions is at the heart of the current discussion on
global governance. After a period in which its role was much diminished, the IMF is likely to
regain protagonism in the context of the crisis. However, the Fund is in urgent need of financial
resources to live up to its mandate. Liquidity can only be provided by countries with sufficient
reserves and this may be in exchange for substantial changes in the Fund’s governance. Though
proposals on reforming the IMF and the World Bank are abundant, the process remains
piecemeal (mostly ad-hoc reforms like the 2006 increase in quota shares for China, Korea, Mexico
and Turkey). The debate on the IMF focuses very much on the issue of “shares and chairs”, in
terms of the formula by which quota shares are distributed or the composition of the Board of
Executive Directors. Other issues discussed are the arguments in favour of more transparent,
qualification-based selection procedures for presidents of both institutions and a possible
physical relocation of at least one of the institutions to the emerging economies.

The balancing of power within the IMF is not only a question of representation and the
distribution of voting rights. Prasad (2008) criticises the rights-without-responsibilities principle
inherent in the system of IMF governance22. Economically powerful countries can ignore policy

20. See, for example, the Global Crisis Debate on www.voxeu.org. Quotation from Biagio Bossone’s
commentary Debating global financial governance on Vox: where do we stand, 18th February 2009. Available
21. This figure is based on the less than USD 1 per day measure at Pursaching Power Parity of the World
Development Indicators 2007.
22. See also Mold (2009 – forthcoming).
advise even though mismanagement in large economies can be much more dangerous for the world economy. Prasad proposes to set up a system of mutual responsibilities by imposing conditions not only on loans, but also on voting rights (e.g. lower budget deficits or more flexible exchange rates) much in the spirit of the Maastricht criteria for European budget deficits. Such a proposal is reminiscent of the ideas proposed by John Maynard Keynes in terms of reciprocal responsibilities for resolving global imbalances. Though controversial, they clearly merit being revisited in the light of the scale of global imbalances.

Above all, the global credit crisis has highlighted the need for better financial regulation and supervision. Mattli and Woods (2008) suggest that this has to involve greater developing country participation in the relevant fora. They ascribe the failure in financial regulation to limited membership and a lack of transparency and accountability in the Basel Committee on Banking Supervision and the Financial Stability Forum (FSF)\(^23\). Mattli and Woods see a direct link between the absence of inclusiveness in financial standard setting and oversight and the failure of regulation responsible for the outbreak of the crisis: “Effective new regulation thus requires participation by a broader range of countries and stakeholders in rule-making. The recent crisis shows that some of the costs of poor regulation fall on emerging and other economies whose voice would add a different and balancing set of stakes into rule-making.” Similarly, the unrepresentative structure of the Basel Committee is often referred to as a reason why Basel II does not sufficiently take into account financial realities and needs of the developing world (Griffith-Jones and Persaud, 2008: 264-5). In March 2009, both the Basel Committee and the FSF took action for more inclusiveness in international financial regulation by inviting emerging and middle-income countries as members\(^24\).

Finally, the OECD is an organisation where governments compare policy experiences, seek answers to common problems, identify standards of good practice and coordinate domestic and international policies. As such, it represents a major forum for resolving problems related to the global financial crisis. The fact that the OECD is also in the process of enlarging its membership (Chile, Estonia, Israel, Russia and Slovenia) and has an Enhanced Engagement process with emerging countries (Brazil, India, Indonesia, China and South Africa) makes it well placed as a “honest broker” or “interlocutor” against a backdrop of “Shifting Wealth”.

Although the inclusion of large emerging countries already accounts for a majority of the world’s poor, the reform process threatens to ignore the voices of many of the poorest countries.

23. Members of the Basel Committee are: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Switzerland, the United Kingdom and the United States (represented by their central banks or by an authority with formal responsibility for the prudential supervision of banking business). The FSF is composed of senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. Countries represented by national authorities are: Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, the United Kingdom and the United States.

24. The Basel Committee invited Australia, Brazil, China, India, Korea, Mexico and Russia; the FSF has decided to broaden its membership to include the G20 countries that are currently not in the FSF.
Africa might end up (or rather is likely to remain) the blank spot on the map of global governance. Despite its economic puissance, South Africa, the only African country at the November 2008 G20 summit, clearly does not represent the entire continent. As a consequence, finding ways how to integrate smaller developing countries into global decision making processes without encumbering their effectiveness excessively is an essential question in the current reform debate. A small step in the right direction is the invitation of non-G20 developing countries to the London Summit, which will take place on 2nd April 2009, with Ethiopia attending in the capacity of chair of the New Partnership for Africa’s Development (NEPAD) and Thailand representing the Association of South East Asian Nations (ASEAN). The Chairperson of the African Union Commission will also attend the summit.
V. CONCLUSIONS

This paper argues that the current financial crisis has more serious implications for low-income countries than previously thought. Moreover, the channels of transmission are likely to be rapid and unexpected. Developing countries are vulnerable through trade; many export industries in low-income economies are at risk and low-income countries may be affected by a sharp deterioration in their terms of trade. Workers’ remittances are expected to fall. Despite improved macroeconomic conditions in recent years, some low-income countries are still vulnerable through external debt. Expected FDI inflows may also fail to materialise. While aid may not suffer major falls in 2009, the prospects for the 2010 budget cycle are not at all encouraging.

In the face of declining development finance, it is self-evident that developing country policy makers need to focus much more attention on domestic resource mobilisation. At the same time, bilateral donors should deliver on their commitments to increase aid efficiency. But it is also clear that the multilateral development agencies need to enlarge their lending capacity and resource availability. On this point, Birdsall (2009) has made what might at first sight seem an outlandish proposal for USD 1 trillion to be made available for developing countries to weather the current crisis. But in the context in which we are living, it is no longer so outlandish. The figure, to be sure, is ten times larger than existing aid flows. Yet put in perspective of the first major crisis of the globalised age, the proposal is perhaps not so extreme. It is less than 25 per cent of the commitments already made by OECD countries to counter the recession in their own economies. A coherent case could indeed be made that global reflation needs to be done not on the basis of individual countries or even among groups of industrialised countries but to include the whole of the developing world too. From a Keynesian point of view, it makes sense to rebalance the global economy in a way which includes the poorest consumers (with a higher marginal propensity to consume). To be sure, all kinds of questions could be raised about how such large financial resources could be channelled towards the developing world in an efficient way. But given the gravity of the crisis, there is an emerging consensus in favour of greater coordination and bold measures25.

One important consequence of the global crisis might be that in future the prospects of low-income economies will become increasingly reliant on the fortunes of the rest of the developing world. If growth rates remain positive in the main southern “drivers” (countries like

Brazil, China and India), the current crisis may accelerate the reconfiguration of the global economy in favour of the developing world.\footnote{See OECD Development Centre Global Development Outlook (GDO), http://www.oecd.org/dev/gdo}

Finally, the global financial crisis arguably opens a unique window of opportunity for making global financial governance more inclusive and efficient. Such is the severity of the crisis that old consensuses are breaking down and policy space is increasing: capital controls, industrial policy, regulation/deregulation, exchange rate policy — all these debates will be revisited in the coming months. Inequality too has become a major challenge for both industrialised and developing countries, not just for its own sake, but for the problems of social and political instability that it causes.\footnote{The OECD (2008b) has recently released a study which traces changes in income inequality and poverty over the period from the mid-1980s to the mid-2000s, covering all 30 developed countries of the OECD. The statistics show that few OECD countries have reduced inequality over the past 20 years, and that the past five years saw growing inequality and poverty in no less than two-thirds of OECD countries.} A failure to address these problems and issues could lead the developing world to turn its back on the global economy, in what John Williamson once termed an “implosion into autarchy” (cited in Kaplinsky, 2005:250). In responding to the current crisis, the reform of the international financial system must take into account the concerns and interests of previously marginalised players, especially the low-income countries, involving them in the rethinking of global governance and financial systems, and not merely as side-players who are finally consulted on the outcome of negotiations. Otherwise, the “new world order” will remain the old, only with some new faces at the table.
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