# The Current Financial Crisis

## Implications and Issues for less Developed Countries

Andersen, Thomas Barnebeck; Jones, Edward Samuel; Tarp, Finn

*Publication date:*
2008

*Document version*
Early version, also known as pre-print

*Citation for published version (APA):*
Andersen, T. B., Jones, E. S., & Tarp, F. (2008). *The Current Financial Crisis: Implications and Issues for less Developed Countries*. Danida.

# The current financial crisis: implications and issues for Less Developed Countries

31 October 2008

Thomas Barnebeck Andersen, Sam Jones & Finn Tarp

Development Economics Research Group (DERG)
Department of Economics, Faculty of Social Sciences
University of Copenhagen

## INTRODUCTION

1. The objective of this note is to identify the principal short- and longer-term issues for less developed countries arising from the current global financial crisis. Focus is on the channels through which the ongoing financial crisis can undermine progress on poverty reduction and the policy challenges this situation presents for both developing and developed countries. While the discussion relates broadly to less developed countries (LDCs), particular attention is given to low income economies and principally those in **sub-Saharan Africa**.

2. The main message is that while the **immediate risks to low income countries are modest**, **over the medium and longer terms there may be considerable downside effects if the crisis provokes a sustained downturn in advanced economies** and a corresponding reduction in private capital flows to LDCs. At the same time, the crisis suggests the need for a reconsideration of the risk-reward trade-offs associated with financial integration for all developing countries.

## BACKGROUND

3. **The current financial crisis forms part of a period of major stress faced by the banking sectors in advanced economies.** Increasing stress in the financial sector has been driven by the poor performance of assets associated with domestic real estate markets (so-called structured products). To date, the **effects of the crisis have been felt primarily within the financial sector**, most specifically institutions with a heavy exposure to the real estate market either as mortgage originators or as investors in structured products.

4. The scale of problems has become apparent gradually since mid-2007 as the number and size of reported losses has grown.[1] Most recently **the crisis has entered a more critical phase**. Although this was sparked by the collapse of Lehman Brothers and the rescues of AIG, Freddie Mac and Fanny Mae, these events only underlined the depth of losses facing the banking sector; also, consistent reports have emerged of growing problems in the real sector; put differently, **the crisis is spreading from Wall Street to Main Street.** With mounting uncertainty, equity markets have plunged and inter-bank markets are completely frozen. This has prompted the search for large public sector interventions in order to calm markets and restore liquidity.

5. With respect to the causes of the crisis, both longer- and shorter-term factors can be identified. With respect to the former, **financial innovation as well as extensive deregulation of the financial industry** in advanced countries since the 1980s has resulted in **increased leverage** as well as rapid growth in highly complex **securitized products** (based on an originate-and-distribute model; see Eichengreen, 2008). Shorter-term factors are also crucial. Recessionary pressures evoked by the dotcom crash of 2001 prompted the US to cut taxes and interest rates. At the same time, the emergence of massive current account (trade) surpluses in China and the oil-exporting countries added **considerable liquidity to international capital markets**, much of which was recycled to industrialized countries. This **provoked a rapid credit boom across the advanced economies** (especially in the US), taking the form of a pronounced real estate bubble. This was pricked, however, by significant interest rate hikes from 2005 driven by concerns over rising inflation, partly associated with global commodity price rises.

6. The extent to which this crisis differs from previous ones is the subject of debate (e.g., Reinhart and Rogoff, 2008). Two points can be highlighted, however: (i) given the conjuncture of financial deregulation, large capital inflows and rapid increases in equity prices, **the current situation bears considerable resemblance to previous post-war banking crises in the industrialized countries**; (ii) contrary to the most recent global financial crises, **current problems emanate from advanced rather than less developed economies**. In fact, many low income and emerging market economies have been enjoying favourable external balances with sizeable international reserves, low external debt ratios and low inflation.

7. It should be emphasised that **many economies in SSA also report favourable macroeconomic and external positions**. This is illustrated in Figures 1 and 2, which show that external debt and international reserve positions have improved considerably across the region since 2000. As a whole for the region (excluding South Africa and Nigeria), average external debt levels have fallen from around 75% of GDP in 1997-2000 to around 20% for 2005-2008. However, as is evident from differences in the figures (e.g., fragile vs. middle income states), the extent of external vulnerability varies considerably across countries indicating that a nuanced view must be taken.

[1] For a chronology of events from early 2007 see: http://news.bbc.co.uk/2/hi/business/7521250.stm. One source estimates that to date around 290 mortgage providers in the United States have taken emergency measures such as filing bankruptcy proceedings, accepting public support or making a firesale of the business (see: http://ml-implode.com/).

**RISKS FOR LDCs**

8. **Immediate risks to financial sector stability in LDCs** associated with the present crisis could, in principle, come from three main sources, namely: (i) write-downs on exposures to illiquid or downgraded assets in the advanced economies; (ii) infection of foreign-owned domestic banks by a crisis in their foreign parent (head office); and (iii) general liquidity problems where domestic banks are dependent on short-term finance in international inter-bank markets. Our view is that **these risks are low**, **primarily because low income LDCs face highly restricted access to (short-term) international capital markets** such that their exposure to international securities are extremely small, if not non-existent. Also, although foreign banks do have considerable operations in low income countries, especially in SSA, these operate principally as subsidiaries and therefore must meet capital adequacy requirements at the domestic level.[2]

9. An additional **immediate threat is to domestic capital markets**, especially where these are important sources of domestic funds (private and public) and where foreign investors play a significant role. Risk aversion and demands for liquidity could prompt investors in advanced countries to unwind (speculative) positions in LDCs; also, recessionary fears may prompt significant asset price corrections. Together, these tendencies would act to increase the costs of capital for both private and public entities. However, **for the majority of low income LDCs these risks are modest**. This is primarily because domestic capital markets tend to be small, illiquid and have little foreign involvement. Even so, for a few countries in SSA such as Ghana, Zambia, Nigeria and Kenya, domestic capital markets have grown substantially over recent years and, therefore, may merit closer examination.[3]

10. **The medium term implications of the crisis refer principally to its real sector effects**, including the possibility of a recession in the advanced economies which extends to major emerging markets such as the BRIC countries. **Financial sector stress is also likely to lead to an extended period of de-leveraging and risk aversion** on the part of financial institutions in advanced economies. Thus, even though interest rates in advanced countries may fall, a widening of the interest spread between advanced and developing countries is likely to lead to a rise in the cost of credit (capital) over the medium-term, especially for higher-risk emerging market and low income countries (i.e., countries with vulnerable macroeconomic stances).

11. The main channels through which LDCs may be affected by these medium-term developments include: (i) a reduced demand for exports; (ii) a fall in commodity prices; (iii) a contraction of both short- and longer-term private capital flows to LDCs across all financial instruments (i.e., foreign

---

[2] For example, the only major US banking group operating in SSA (Citigroup), operates through subsidiary operations. Moreover, it should be noted that foreign-owned banks in SSA typically are retail and commercial banks (e.g., Barclays, Stanbic) rather than investment-only banking operations. As such, they are more robust to the current crisis as they have larger retail financing bases. Additionally, on-lending to the head office can be expected to be very low due to the tendency for low savings rates in lower income countries relative to middle and advanced economies.

[3] For discussion of African capital markets see IMF (2008), Jones (2007). Also note that as of September 12th 2008, the Central Bank of Nigeria has increased restrictions on foreign repatriation of investments in local government securities (see: www.firstbanknigeria.com/mc/pressrel/pr_17092008.asp)

direct investment, portfolio and debt flows); and (iv) downward pressure on, or freezing of overseas aid (ODA) flows from advanced countries.[4]

12. **Identifying countries that are most vulnerable to these effects is not straightforward**. Significant diversity in country circumstances, such as depth of financial markets and reliance on external (private) capital flows, means that generalizations should be avoided. In our view, however, the following factors might be employed to assess the extent to which downside medium-term risks from the present crisis are material for a given country. They are:
    - degree of integration in (reliance on) global capital markets;
    - depth of domestic capital markets and, particularly, the influence of foreign investors;
    - structural position in the global economy (as net creditor or debtor via the current account); and
    - overall macroeconomic stance.

13. Figure 3 illustrates the **diversity of access to different global private capital flows for a selection of SSA countries**. While foreign direct investment (FDI) is important for many countries, its volume varies between 1% of GDP (Cameroon) to around 7% (Zambia). Greater variability is indicated for portfolio and debt-creating flows, with Ghana showing a recent increase in portfolio flows reflecting its raising of a $750m 10-year dated Eurobond in September 2007.[5]

14. The **longer-term implications of the current crisis are largely a matter for speculation**. Even so, three broad policy areas may undergo significant changes. At a global and domestic level, the financial crisis may engender a period of enhanced financial sector regulation and stricter controls over banking risks. More conservative financing practices are likely to reduce the availability of private capital to lower income countries. Finally, increasing protectionism may emerge as a consequence of recessionary pressures in the advanced countries as well as a reaction to the (potentially) growing role of cash-rich sovereign wealth funds. These factors all indicate the likelihood of a more hostile external environment for LDCs.

## SUMMARY AND KEY POLICY ISSUES

15. It is important to note that there is **significant uncertainty as regards the scale and likely outcomes of the present crisis**. In particular, the duration and depth of liquidity difficulties in advanced economies, as well as the extent and scope of any ensuing economic downturn, are unknown.

[4] While such flows typically are not large relative to overall public sector budgets, fiscal constraints associated with the crisis plausibly may reduce the scope for any expansion of aid budgets and/or development of new financing instruments. In this regard US Senator Joe Biden recently argued that, as a consequence of the crisis "… the one thing we might have to slow down is a commitment we made to double foreign assistance." (Vice-Presidential Candidates debate, 2 October 2008; see http://www.reuters.com/article/politicsNews/idUSTRE4920SZ20081003). Equally, aid flows funded by private sector contributions (e.g., emergency aid, corporate sponsorship) may well be more severely affected in a recessionary environment.

[5] See: www.newtimesonline.com/index.php?option=com_content&task=view&id=11518&Itemid=203

16. Absent a complete meltdown (worst-case scenario), the main implications of the current crisis for LDCs derive from its impact on the real sector as well as reduced access to private capital inflows. Particularly **for low income countries in SSA this does not represent a fundamentally new set of circumstances**. Rather, the crisis is likely to aggravate pre-existing challenges, including gaining access to export markets, attracting external investment financing and ensuring access to domestic sources of capital on reasonable terms. As such, a general worsening of growth prospects for LDCs may be expected. Under certain circumstances the combination of lower (export) growth, reduced investment inflows and tighter local credit conditions plausibly could evolve into local financial sector difficulties. To date these are the principal concerns raised by major emerging market economies such as China and India and merit careful ongoing monitoring at the domestic level across LDCs.[6] For this reason, **strengthening of banking supervision and efforts to increase transparency in domestic financial markets should be prioritised in LDCs.**

17. An important distinction between low income countries concerns their external vulnerability. Countries with (large) current account deficits that rely on private or volatile sources of external funding may be at most risk if global credit conditions remain tight and investors become highly risk averse. However, **as many low income LDCs rely on foreign aid to finance their current account deficits, it is imperative that these sources of funding remain in place and commitments are honoured**.

18. Given current liquidity and fiscal challenges facing the advanced economies, the large international reserves managed by China (as well as sovereign wealth funds) could come to represent more important sources of development financing over the long-term. As such the current crisis may act to **further China's influence in the African continent**.

19. At a more general level, it is clear that the crisis brings into question the suitability of extensive financial deregulation in LDCs and the developmental contribution of financial globalization (at least in its present form).[7] This is obviously more pertinent for economies with weak regulatory capacities and shallow domestic financial markets. Consequently, **greater attention must be given to the risk-reward trade-offs associated with extensive financial deregulation and integration in LDCs**. Importantly, mobilization of domestic savings should take greater priority as part of a sustainable development strategy in contrast to excessive reliance on external financing.

20. Finally, it is necessary to recognise that **DANIDA programme countries are highly diverse, meaning that the potential effects of the current crisis are not identical**.[8] Consequently, case-by-case consideration of financial sector characteristics and the nature of external vulnerabilities is necessary in order to evaluate material risks and identify relevant policy interventions.

[6] For example see: 'Indian banks may weather market turmoil better than China', *Times of India*, 23 September 2008

[7] This is the subject of controversy; a number of scholars have raised theoretical and empirical concerns regarding the beneficial impact of financial deregulation in developing countries (e.g., Andersen and Tarp, 2003).

[8] These are: Bangladesh, Benin, Bhutan, Bolivia, Burkina Faso, Egypt, Ghana, Kenya, Mali, Mozambique, Nepal, Nicaragua, Tanzania, Uganda, Vietnam, Zambia

## REFERENCES

Andersen, Thomas Barnebeck and Finn Tarp (2003), Financial liberalization, financial development and economic growth in LDCs, *Journal of International Development*, 15: 189–209

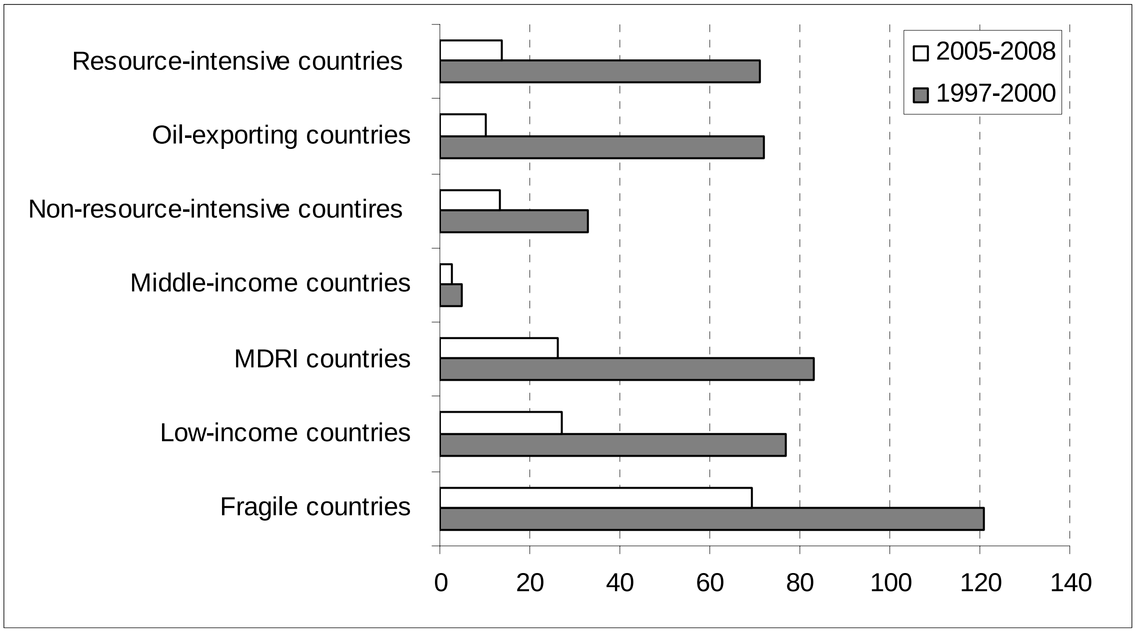
Eichengreen, Barry (2008), 'Anatomy of the financial crisis', Project Syndicate, 23 September

IMF (2008), 'Private Capital Flows to Sub-Saharan Africa: Financial Globalization's Final Frontier?', chapter 3 in *Regional economic outlook: Sub-Saharan Africa*, World Economic and Financial Surveys, April, Washington, D.C.: International Monetary Fund

Jones, Sam (2007), Sub-Saharan Africa and global capital markets: Past and present, *DIIS Working Paper*, 2007:28

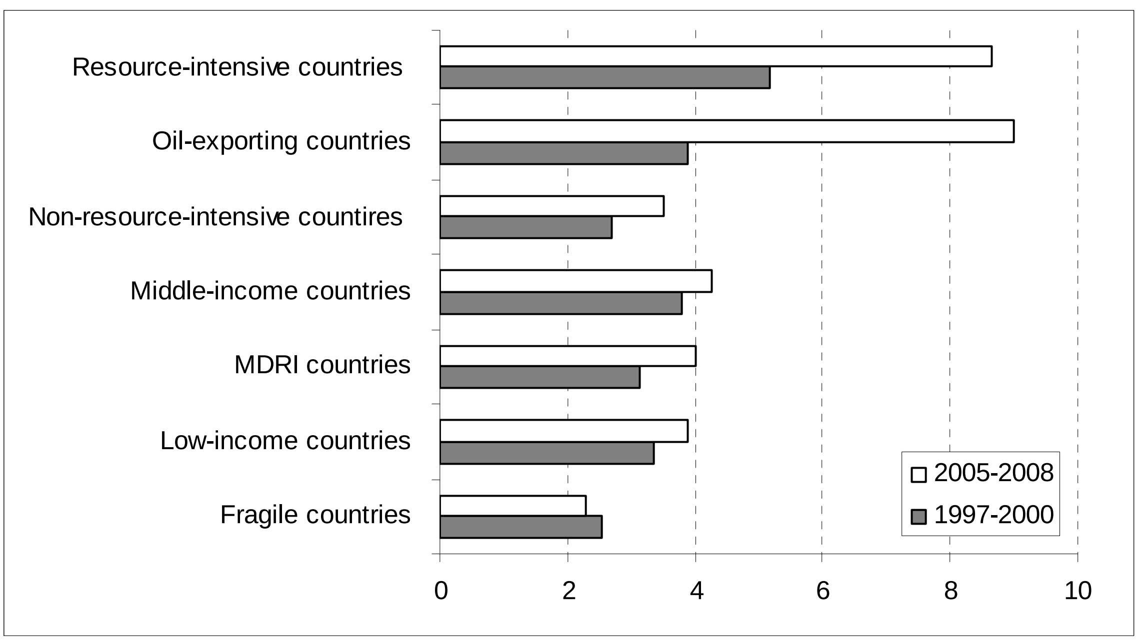
Reinhart, Carmen M. and Kenneth S. Rogoff (2008), Is the 2007 U.S. Sub-prime financial crisis so different? An international historical comparison, *NBER Working Paper*, 13761, January, http://www.nber.org/papers/w13761

**Figure 1: External debt to official creditors as % GDP, selected SSA regions**



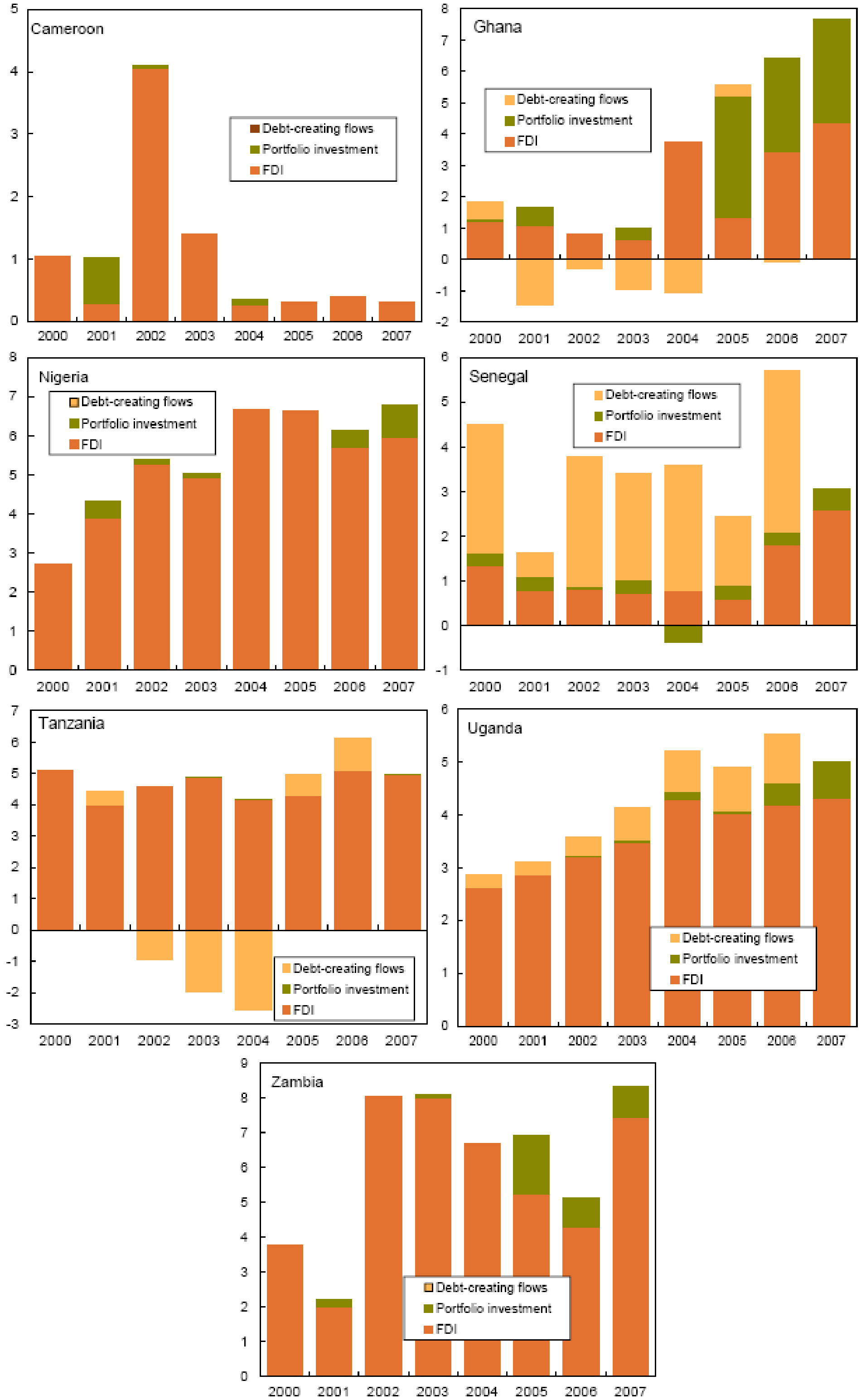

Source: authors' calculations from IMF Africa Regional Economic Outlook April 2008 database

**Figure 2: International reserves in months of imports of goods and services, selected SSA regions**




Source: authors' calculations from IMF Africa Regional Economic Outlook April 2008 database

**Figure 3: Composition of private capital flows (as % GDP), selected SSA countries**




Source: IMF (2008: Figure 3.6, p.58)