The Impact of the Global Financial crisis on developing countries— lessons and challenges ahead

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- **Dr. Dirk Willem te Velde, Director of Programmes IEDG, ODI** introduced the meeting, noting the positive news recently about the IMF's support for developing nations during the financial crisis.
- **Dominique Desruelle, IMF** noted the theme of the presentation is change in two major areas:
    1) The situation of the low-income countries (LICs) before and during the crisis. The LICs came into this crisis in a better position than at the start of previous crises and were able to react differently as a result, coming out faster and in better shape.
    2) The IMF believes it acted differently, with more finance, quicker, different and more flexible instruments.

- **Christian Mumssen, IMF** discussed past and present crises, and their impact on LICs. In a typical crisis, world GDP drops to a certain amount and quickly recovers within a couple of years. This crisis was notable because the fall was very sharp. In past crises, LICs' GDP tended to fall together with world growth but did not recover as quickly. This time, LICs had a stronger initial position. There was a sharp decline in 2009 but per capita growth remained positive on average, and the projections for the recovery are more optimistic.
- Mumssen noted that LICs were in a much better position in the 2000s compared to the 1990s, in terms of growth, fiscal deficits, debt & inflation.
- He noted that fiscal expenditure increased during this crisis, as opposed to the usual response of cutting it.
- As regards the IMF response, Mumssen brought up:
    1) **2009** very substantial scaling of IMF concessional assistance at $3.8 billion (historical average $1 billion)
    2) Concessional lending capacity doubled to $17 bn through 2014/15
    3) Financed in part by gold sales
    4) SDR allocation
    5) zero interest rates on all concessional credit
    6) Support of countercyclical programmes
- Comprehensive Reforms to IMF financial facilities in 2009
    1) More flexible facilities under Poverty Reduction and Growth Trust to meet diverse LIC needs
        - ECF medium term support
        - SCF short term support
        - RCF emergency support
    2) Access to financing doubled
    3) Zero interest through end 2011
    4) Permanently higher concessionality
- Conditionality, debt policies more flexible
    1) Support country-owned strategies
    2) Explicit safeguards to social spending
    3) Structural conditionality more focused on macro critical areas
    4) Binding structural conditions and wage ceilings abolished
    5) Debt limits more flexible to meet infrastructure gaps

        - Needed to make previously rigid policy more flexible
    6) Improved DSA

- **Roger Nord, IMF** provided a brief overview of how GFC affected Africa and how the continent will emerge from it.
    1) Impact on Africa has shown a lot of heterogeneity among countries. Some heavily affected and some hit far less than the developed world.
    2) Recovery in 2010 will be multispeed but relatively rapid and synchronized with global recovery.
- Growth in Africa 1995-2008 much improved from before
- Lower debt levels, low inflation, and higher levels of foreign exchange reserves in many countries provided them with buffers needed to respond to the crisis
- Past crises—SSA recovered much slower and with a lag after past crises. Current view—shock was less severe in Africa and elsewhere, but also recovery will be synchronized with the rest of the world. Some case studies:
    1) *South Africa*—typical middle income country—very heavy impact on growth, fiscal balances deteriorated as automatic stabilizers kicked in
    2) *Tanzania*—had low levels of debt and had built up significant buffers. While real GDP fell from 7.5% to slightly above 5% in 2009, they were able to respond aggressively by letting the fiscal deficit deteriorate—allowed it to provide a significant cushion to what would've been a significant impact on domestic demand
    3) *Ghana*—already running a significant fiscal deficit before the crisis—up to 15% of GDP up to 2008, provided it with little room to respond. Had no choice but to start fiscal consolidation in 2009, proving to be quite painful and difficult
- Nord addressed the question of why the IMF thinks Africa will recover more rapidly and in synch with the world economy.
    1) Starting positions are significantly stronger—in contrast to past crises, countries did not exit this crisis with unsustainable debt positions
    2) The response that many African countries were able to put in place helped. By maintaining or increasing expenditures, investment in health, education, and public spending was allowed to continue, boding well for growth in the future
    3) Signs of a turnaround already visible since the third quarter of 2009: exports and commodity prices picking up, particularly driven by demand from EMEs, financial flows including FDI resuming, and credit to the private sector growing again.

- **Desruelle** presented the challenges as the LICs move out of the crisis.
    1) Managing Volatility
        - LICs are more exposed to economic shocks, natural disasters and others
        - Exposure will grow further with global integration and climate change
        - LICs generally under-insured
        - But cost of holding reserves high
        - Need 1) policy buffers and 2) concessional shocks support
    2) How to re-build policy buffers?
        - First, do not harm: avoid premature or overly rapid fiscal tightening
        - Then, strengthen fiscal positions: focus on revenue growth; protect social spending, high return investment
    3) Investing for growth

        - Massive infrastructure deficit, esp. in Africa.
        - LIC governments rightly keen to scale up public investment
        - Other (see slide)
4) Evolving Aid Architecture
    - Aid holding up, but not meeting Gleneagles commitments—MDGs?
    - Non-traditional donors, e.g. China as major bilateral donor in Africa
    - Fragile states—weigh risks of engaging against risks of not engaging
        - States that have very little economic or political abilities to handle crisis—how will the IMF engage with this type of country?
    - Special challenge of conflicts and catastrophes
5) Climate Change Financing Needs
    - Global challenge but uneven impact: LICs contributed least but may be most affected
    - Need large-scale, long-term investments for adaptation/ mitigation
    - Appropriate financing terms essential
    - 'Green Fund' idea

Panel Questions

- **Alan Winters, Chief Economist, DFID, who was speaking from a personal perspective,** said the biggest surprise of the last few years has been the transformation of the IMF, which seems to be much appreciated around the world. Questioned what happened to it, asking if the fund itself has changed or if the world has changed. Addressed five main points:

    1. Emphasized the fact that the increased facilities for loans and low interest rates still mean the LICs will eventually have to repay the loans. If this repayment is contingent upon GDP recovery, will they be able to recover enough to eliminate the extra debt? How much is their growth dependent on large industrial countries pulling out of the crisis completely, which is not a given?
    2. Of what did the stimulus packages the LICs overtook comprise?
    3. Noted the presentation did not mention much about capital markets, which the LICs are not as exposed to as the EMEs. However, there is still a connection and dependency. Will the decline in appetite for risk lead to financers pulling out of LICs since they're riskier? Will US borrowing crowd out LICs borrowing?
    4. The developing countries were able to run more compensatory policies, but of course, the fund, lending and the world as a whole—the whole atmosphere of the 2008/2009 crisis has been different. Why was that? Did we feel guilty because it all started over here or have we fundamentally changed?
    5. Noted fund lending programmes means rules of borrowing have been relaxed for developing countries. While the purpose of debt forgiveness is to allow people to borrow again, Winters thinks it's time to start thinking about where all the debt will accumulate. Longer loans, lower interest rates are an encouragement to keep up to your limit, and a situation where every country is holding all the IMF debt it can would be bad. Would it be better to keep rates closer to commercial rates to ensure the debt does turn over?
        - Green Fund, which would be made up of extremely short-term liabilities to issue long-term assets specifically aimed helping developing countries undertake climate change, is very risky and rather troubling.

- **Dr. Ngaire Woods** briefly addressed the reasons behind IMF's transformation:
    - The most influential IMF powers have shifted from the G7 to the G20, including the EMEs and therefore shifting the political parameters.
    - The bureaucratic drivers have shifted away from the Washington Consensus, which fit the purpose of the IMF in the 1980s i.e. enforcing debt repayment. IMF's new task is to stop a global economic seizure, requiring different drivers. The new resources are credit lines rather than capital, meaning an increased influence of the major powers as opposed to internal IMF staff.
    - The relationship with borrowing countries has shifted, partially because of China's explosion.
- She asked several questions:
    1. The extent to which this crisis has prompted institutional responses—where should the new resourcing of the fund go?
    2. The surveillance role and in particular how IMF's focus has shifted from bilateral to regional. What could be learned about regional surveillance and trying to analyze regional risks?
    3. What would a regional reserve fund look like among SSA and other LICs?

IMF response

- **Nord** said the change has been both the IMF and the world. Many countries have a stronger policy framework and the IMF has started to engage with many different actors. Governments have started assuming responsibility for their actions and the IMF acts as an advisor instead of a scapegoat—much more balanced relationship.
- African governments want to be able to manage debt in an intelligent way, and that includes both concessional and non-concessional. Having access to capital markets will be important, but they put an enormous weight on good debt management.
- From the IMF perspective, using the SDRs would be converting it to other currencies. They are allocated, become part of countries' reserves, part of long-term liabilities. Did it allow countries to run looser fiscal position than they otherwise would? For some, yes. For others, simply allowed reserves to increase.

- **Desruelle** noted debt ratios have increased almost mechanically because of more financing and less ability to repay. This said, the debt situation in low-income countries is not expected to result in systemic difficulties.
- Regarding whether countries will be tempted to hold onto IMF liabilities forever, Desruelle said the future will tell but probably not because there's still cheaper financing from the World Bank, et.al. IMF typically set up for quicker financing.
- Regarding regional arrangements, they are useful but likely insufficient if an entire region is hit by a shock. Necessitates insurance across regions. Regional and global arrangements can work together.

- **Mumssen** said IMF's primary purpose is to bridge temporary financing gaps, whereas WB & others aim to shift resources long term to the developing world. Loans mature at 10 years, stand-by credit at 8. The primary reason the interest rate on IMF loans was reduced from 0.5% to 0% was that comparative rates had declined, making IMF financing terms *de facto* less concessional.

- Expects a drop in demand for IMF lending in the next few years. IMF still supports prudent fiscal policies in good times in order to build "policy buffers" for future shocks. The crisis was unusually large and synchronized, and there was strong G20 support for a global fiscal stimulus.
- Regarding capital markets, there needs to be a balance between access to international finance and developing local savings and financial sectors.
- Regarding the Green Fund, Mumssen acknowledged the huge challenges.

- **Desruelle** emphasized the Green Fund does not seek to build a massive pile of long-term assets on short-term liabilities, but rather provide seed money for a transition period until long-term mechanisms such as carbon taxes are put into place.

General Discussion

- What has changed? Why has Africa been able to withstand the crisis a little better? Where did the capacity come from? Brought up the role played by a change in China. During previous crises, China was not nearly as dominant, and its investment flows have coincided with places that recovered quickly. Compared to previous crises, China was not nearly as dominant in Africa previously.
- Sceptical regarding the changes in conditionality, particularly if support of country-owned strategies and explicit safeguards on social spending are actually in place. Also, is focusing on macro critical areas making a difference? Is review-based binding structural conditions really progress?
- What were the other three crisis compared?
- How much of quick recovery projections are simply optimism?
- Some doubt to extent to which LICs improvements were because of individual responses or simply their integration with the world market.
- To what extent has that revenue drop been driven by lapse in imports?

Responses

- **Mumssen:** '75, '82, '91 were the crises years used for the analysis.
- Regarding IMF conditionality, Mumssen emphasized the IMF has changed with global conditions and the shift began in the early 2000s, focusing on streamlining. Review-based conditionality still includes clear benchmarks on the envisaged policies, so there's not any confusion for the countries and simply represents more flexibility. Safeguards on social spending and country-owned strategies have been important in IMF programmes in the past, but are now more transparent in the process. Focus has shifted from wages to overall quality of spending, leaving countries to define what is priority spending and to be transparent about it.

- **Nord** noted many changes in Tanzania since the early 1990s, particularly ownership of strategies by the countries themselves. Time will tell if recovery will be as rapid as projected, but the mid 2009 improvements are promising (exports, imports, commodity markets and financial markets recovering).
- Africa dependent on rest of the world and a double dip recession would be very bad for it.
- Regarding the revenue decline, it was mainly VAT and corporate taxes.
- China is playing a very positive role but needs financing frameworks to make things more transparent.

- **Desruelle** noted most of the global growth this year has come from EME markets, meaning if we were counting only on the developed markets, growth would’ve been much worse.