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Where does it hurt?

The impact of the financial crisis on developing countries

Summary

The global financial system is in crisis, and that crisis is hitting developing countries hard. But the system has never served developing countries well. Those that opened their doors to global finance have seen huge increases in their vulnerability to shocks like the one we are living through now, but little more in the way of improved human development than countries which took a more cautious approach. And the poorest countries have not got the financing they so desperately need. It is becoming increasingly clear that we need a system that actually serves development without the huge risks that are now all too apparent.

Although developing countries didn't make this crisis, it has become all too clear that they are in the firing line when it comes to suffering its effects.

Many descriptions of the current financial crisis have drawn on the metaphor of natural disaster. Storms, earthquakes and floods have all been invoked to describe the scale and destructive power of the financial forces that have been unleashed in the last six months.

But while this gets across the impact of what has happened, it is totally misleading in one respect. The financial crisis is not a natural disaster – it was made by people, and is the product of decisions made by companies and by governments – decisions that could have been made differently, and could have led to very different outcomes.

Although developing countries didn't make this crisis, it has become all too clear that they are in the firing line when it comes to suffering its effects. ActionAid has calculated that Africa will suffer a real drop in income that is predicted to reach US$49 billion between the start of the crisis in 2007 and the end of 2009. This equates to a drop in financial inflows of more than 13%.

The crisis is actually two crises – a **financial crisis** and a **recession**. Africa is predicted to lose US$22 billion due to the financial crisis, on top of a US$27 billion drop in export earnings, aid and income from rich countries that are now themselves in recession.

What determines how different countries are likely to be affected? In this report we look at the very different ways that countries have integrated into the global economy, and how this leads to very different outcomes in the current upheaval. Unsurprisingly, those countries that bought most heavily into the rhetoric of financial liberalisation, and that were big enough to attract significant amounts of capital from rich countries, will be most affected by the financial crisis. For example South Africa, which has been a paragon of neo-liberal economics since the end of apartheid, is likely to suffer a fall in financial flows from abroad equivalent to around a fifth of its entire GDP.

In China the majority of growth to date has been based on expanding exports, which means that the recession is already hitting hard. However the financial crisis is likely to have less impact, since the government has restricted flows of foreign capital and most Chinese investment and other finance comes from within the country.

A major overhaul of the financial system is needed to make it work for development – it needs to be less risky, and to offer more of the types of flows that are good for development.

Although export-led growth has delivered real gains in terms of growth and poverty reduction in many countries, these gains turn out to be less robust than was previously thought. Countries that opened up their financial sectors now find themselves knocked off course by the financial meltdown, and, according to recent research, do not have the consolation of knowing that the gains they made in development terms are any kind of pay-back for the crisis they are now experiencing.

In fact, an increasing number of studies show that the benefits of financial liberalisation for development seem to have been vastly oversold.[1] Those countries that were attracting large inflows of capital weren't necessarily seeing a big increase in their rate of development, and those countries most in need of finance – the poorest – were hardly getting any foreign capital in any case.

Until now many governments have treated the global financial system as an over-indulged teenager. It has been allowed to do what it will without having to take any responsibility for the long-term impact of its actions. Now is the time for the G20 governments to force the system to grow up. Unfortunately, having been spoiled for so long by so many, the scale of the change needed is big. A major overhaul of the financial system is needed to make it work for development – it needs to be less risky, and to offer more of the types of flows that are good for development. And, crucially, developing countries need to be involved in the design of that system.

Introduction

The financial crisis has already become a cliché. Stories of bank bailouts, job losses and company closures that were big news in September are now almost routine.

But one thing we haven't known until now is exactly how the shockwaves from the crisis have travelled around the world, and how big those shocks are going to be. We've had stories of job losses, and the threat of reductions in aid flows, but no systematic look at what this means for the poorest and most vulnerable people on earth.

This new research from ActionAid contributes to the attempts to unpick all the different ways the crisis is affecting the economies of developing countries, and to count the actual cost in dollars lost through reduced financial flows. And we look at how these effects are playing out in some middle and low-income countries such as South Africa, Ghana and Brazil to see how previous policies have affected how exposed countries are to the turmoil currently affecting world markets.

There is much debate about the appropriate level and type of external funding for development. But the fact is that many countries have based their development strategies on attracting various types of external investment in the shape of capital flows. Rather than entering into the debate about which strategies may have been most appropriate in the past, this paper looks at what the different strategies adopted mean right now for how individual countries are affected by the crisis.

The story is not a happy one. Many developing countries have essentially entered into a Faustian pact with the financial markets. Promised funds for development if they opened up their financial sectors, the benefits were oversold and the risks catastrophically underestimated. And now the markets have come to claim their due.

The cost of the crisis

The financial crisis has already led to catastrophic drops in income in 2008, and it's predicted to get worse in 2009. Sub-Saharan Africa as a whole is predicted to see a real drop in financial flows and export earnings of around US$49 billion between 2007 and 2009, or 6% of the entire continent's pre-crisis GDP. The impact relative to GDP is nearly double the impact of the Asian financial crisis of the late 1990s.[2]

Considering that the pre-crisis forecast was that earning from trade and private sector flows should actually rise between 2007 and 2009, the crisis has clearly hit hard and hit quickly. For countries that based all or part of their development strategies on attracting funds from abroad, and for the companies and individuals that were dependent on these flows, this fall is likely to be calamitous.

Throughout this report, the analysis is based on estimates of what has already happened, and predictions about what might happen, to various flows of money between developed and developing countries. The flows, and the way they are defined in this report, are:

Export earnings: what companies in a country earn from trade with companies in other countries.

Foreign direct investment: when a company in one country invests money in a company in another country, or sets up its own subsidiary there.

Bank lending: when a bank in one country lends money to either banks, companies or individuals in another country.

Equities: when individuals, funds or companies from one country buy shares listed on the stock market of another country.

Aid: when governments or official bodies in one country give money to governments, official bodies or NGOs in another country.

Remittances: when expatriate workers send money home to their country of origin.

Bonds (corporate or sovereign): when companies or governments issue promissory notes as a way of raising revenue, which are then bought by companies, individuals or official bodies from another country. The resulting flows are both the initial purchase of the bond (which flows in to the developing country, if it is the issuer of the bond), and then the annual payment of interest from the issuer of the bond (which flows out of the issuer of the bond, the developing country, in this case) to the purchaser.

To see which countries are most affected, and why, we've calculated the estimated financial inflows and export earnings in 2008, and the inflows that are now predicted for 2009, for 16 low and middle-income countries.[3] We then compared them to the inflows in 2007, before the crisis hit, to get an indication of the impact of the crisis so far. The results are in the table below. Every single country in our sample, and sub-Saharan Africa as a whole, is predicted to see a real drop in inflows between 2007 and 2009.

Table 1: Financial inflows and export earnings, 2007-2009 (current US$, millions)

country	total inflows 2007	total inflows 2008	% change 2007-2008	predicted inflows 2009	% change 2007-2009
Sub-Saharan Africa	368,373	371,536	1	319,077	-13
South Africa	118,022	95,203	-19	62,307	-47
Estonia	19,509	16,052	-18	11,200	-43
Korea	391,344	391,437	0	243,458	-38
Turkey	167,316	147,738	-12	109,871	-34
Brazil	255,005	219,845	-14	176,816	-31
Russia	481,195	500,475	4	338,667	-30
India	247,932	222,825	-10	175,344	-29
Nigeria	95,900	115,777	21	71,133	-26
Venezuela	68,934	94,021	36	52,862	-23
China	1,372,763	1,446,750	5	1,075,844	-22
Ghana	6,748	6,698	-1	5,260	-22
Jamaica	5,466	5,282	-3	4,468	-18
Malaysia	193,857	199,362	3	161,791	-17
Uganda	4,650	4,601	-1	4,228	-9
Chile	79,619	75,627	-5	74,591	-6
Mali	2,776	2,782	0	2,600	-6

Source: calculated from data available from WTO, UNCTAD, Bank of International Settlements, IMF, World Bank, IIF

Where do the losses come from?

The crisis is really two crises – a financial crisis and a recession – and although they are of course connected, it is possible to untangle the effects and assess the impact of each.

The financial crisis will affect factors such as bank lending, equities and foreign direct investment, and changes in interest rates will impact on countries and companies that raise money by issuing bonds. While the recession will have the biggest impact on trade flows, it is also likely to affect aid levels and money sent home by relatives working in rich countries.

Losses from the financial crisis

Of all the money that flows into developing countries, it is bank lending that has been hit the hardest. The Institute of International Finance (IIF), the international association of financial institutions, estimates that foreign bank lending to developing countries in 2008 was just 40% of the 2007 level, and by 2009 the IIF forecasts that bank lending will have dropped by more than 100% from its 2007 level. In other words, net flows to developing countries will actually be negative, as more money is transferred to banks overseas than is lent to developing countries.

The turmoil in financial markets has also had an impact on developing country equities markets, in those countries that have them, as international traders have increasingly fled from stocks that look risky – many of which are in developing countries. The IIF has estimated the likely changes in flows to developing countries (see table 2). The exact figures will vary depending on the circumstances of each country, but these estimates give an idea of the scale of the financial cataclysm hitting poor countries. Although foreign direct investment is predicted to be the least affected of all the flows, the IIF still predicts that it will fall by one third between 2007 and 2009.

Table 2: Predicted losses from financial crisis to developing countries[4]

type of financial flow	predicted change for developing countries, 2007-2009 (%)
bank lending	-115
equities	-82
FDI	-34

Source: IIF, *Capital Flows to Emerging Market Economies*, January 2009

As well as the collapse of inflows, the crisis has also pushed up costs for those developing countries that raise money by issuing bonds from the public or private sectors.

As lenders increasingly look for less and less risky places to put their money, the cost of borrowing through bond issues for poor countries in particular has increased. The difference between interest rates charged to the US government when it borrows money by issuing US Treasury bonds – the least risky of all loans – and the rate charged to developing countries when they do the same thing by issuing their own sovereign bonds, has increased from just over 2.5% in 2007 to nearly 7.5% in 2008, and is predicted to stay at around 7% in 2009.[5] In effect, the financial crisis is making borrowing more expensive to those countries that bear least responsibility for the crisis, while reducing borrowing costs in those countries that were actually responsible.

Losses from the recession in rich countries

As if the financial crisis were not devastating enough, developing countries also look likely to be hit hard by the recession to follow. The losses are mainly from trade revenue, and will depend on each country's mix of exports and main trading partners. However for the countries in our sample, the predicted trade losses varied from a fall of up to 25% in export earnings between 2007 and 2009 for Nigeria, to a fall of just under 10% for Uganda.[6] The fall in export earnings is predicted to be between 10 and 20% for over half the countries in our sample.

Although very large, it is notable that these losses are less in percentage terms than those directly attributable to the financial crisis. But the earnings from trade for many of these countries are larger than other types of foreign inflows, therefore the impact of the recession in many countries will prove to be more significant than the impact of the financial crisis.

What is clear is that developing country losses from a crisis that started in the developed world are real and significant, and will be compounded as time goes on by the impact on the domestic economy within developing countries. People earning less from outside will start to spend less within developing countries, investments won't happen and jobs will be lost. Government revenues from aid, taxes and borrowing are also likely to fall. This in turn will have an impact on government spending, which will particularly affect the poorest people who are often most dependent on social spending in areas such as health and social protection. The combination of the impacts on companies, individuals and government budgets is likely to lead to a worsening of poverty, and to terrible consequences for individuals. The World Bank's chief economist for Africa predicts that 700,000 children may well die over the next few years as a result of the financial crisis and the ensuing recession.[7] The fall in financial flows is, for some people, not a matter of abstract economics but a matter of life or death.

Case study

Sixty-five-year-old Felicia Afua Nartey lives in Mafi Sasekpe village, Ghana. In 2002 her son Prosper travelled to the UK to look for work, and was soon earning enough money to send £200 per month back home to provide his mother and four siblings with enough to eat.

Things changed in September 2008 when the money and phone calls from Prosper abruptly stopped. "When I called him and asked why the sudden change, he told me he had lost his job because the company he was working for had made 20 people redundant," says Felicia.

Prosper still has not managed to find another job, and is unable to send any more money home. "Now I have to depend on my little farm and what his poorly paid siblings back in Ghana can salvage from their small pay packets. I also have to resort to selling sachet water to ensure that I am able to eat and take care of four grandchildren living with me. If the situation doesn't change soon, I don't know what would happen."

Which countries are most vulnerable to the crisis?

Devising indices and typologies to show which countries are likely to be most vulnerable to the financial crisis and the recession has become a popular pastime in development circles. The World Bank has produced two typologies, the IMF has one, the *Economist* magazine has an index, and others – including ActionAid together with the New Economics Foundation – are developing their own.[8]

Existing indices and typologies rank countries' vulnerability according to a snapshot incorporating some aspects of their fiscal position, (crudely speaking, how much money they have in the bank) and their exposure to international trade and finance. However, there are a number of gaps in existing attempts to create some measure of vulnerability.

Firstly, all existing measures are based on indicators for a single year, or an average over a single time period. While this provides some indication of vulnerabilities now, it is of limited value in explaining how countries got into this situation and therefore how they might get out of it. Given the huge volatility in financial flows generally, and in export earnings – particularly given the commodity price boom of recent years – it is also more appropriate to define vulnerability over several years.

Secondly, and most problematically, many leave out some of the most important channels of transmission of the crisis and therefore aren't measuring vulnerability accurately. The *Economist*'s index is designed to address only financial and banking variables, but it therefore misses the impact of falling trade flows. One of the World Bank's two typologies looks only at poverty measures and at the fiscal and institutional aspects of the government's ability to cope.[9] It does not address how countries' exposure to the crisis might differ given different levels of dependence on international trade or finance.

The second World Bank typology contains both trade and finance variables, but it still does not reflect how countries are likely to experience vulnerability in the real world.[10] For example, trade vulnerability is only measured according to whether or not a given country is dependent on primary commodity exports. While important to one group of countries, this misses out the huge impact of the fall in demand for manufactured products, which is having such devastating effects throughout Asia. The finance indicator aggregates all finance into one measure – even though, as the estimates from the IIF discussed above show, different types of private flows have been affected very differently by the crisis.

ActionAid and the New Economics Foundation are developing an index that will measure countries' vulnerability along a range of variables over the last ten years. It will allow us to look at how countries became exposed to the risks of the financial crisis by looking at, for example, which countries increased their bank lending from abroad and when, and which relied the most on foreign investors in their stock markets. It will also track countries' vulnerability to the recession in the rich world by looking at, for example, dependence on export earnings and aid flows.[11]

Preliminary results imply that in many developing countries the exposure to international trade – their dependence on export revenues, level of concentration of exports, trade balance and reserves – is the biggest factor in their vulnerability to the crisis. But, together with dependence on aid and other official flows, this indicator has held fairly stable or even been declining over the last few years.

According to the IMF, the impact of financial crises is likely to be more serious, and more long-term, than the impact of recessions that have other causes, such as cyclical slowdowns in the economy.

However, for many countries their openness to and dependence on private sector flows such as FDI and private bank lending from abroad has increased – in many cases dramatically. As the financial bubble grew in developed countries, developing countries were becoming increasingly vulnerable to the bursting of that bubble.

According to the IMF, the impact of financial crises is likely to be more serious, and more long-term, than the impact of recessions that have other causes, such as cyclical slowdowns in the economy.[12] In increasing their vulnerability to financial crises, developing countries have therefore increased their risks of exposure to these more serious recessions.

This is particularly disturbing given several recent studies that have attempted to draw general lessons from the last decades about the relationship between financial integration and growth. Rodrik and Subramanian argue that, "Financial globalisation has not generated increased investment or higher growth in emerging markets. Countries that have grown most rapidly have been those that rely less on capital inflows."[13] Following a comprehensive look at the evidence on financial liberalisation and development, a group of authors including a former chief economist of the IMF concluded, "The majority of empirical studies are unable to find robust evidence in support of the growth benefits of capital account liberalisation." [14]

The impact of the crisis in South Africa, India, Brazil and China

The impact of policy on vulnerability to both financial crisis and recession is starkly illustrated in the differing fortunes of South Africa, India, China and Brazil. All members of the G20, different policy choices in the 1990s and early 21st century mean that the crisis will have a very different impact on each of these four countries. The crucial difference lies in how countries are integrated into the global economy. China and India have historically been less open to the global economy than many other developing countries, and both have retained capital controls. Brazil is more open and South Africa more open still.

While its financial system is relatively closed, China is the most dependent on external trade of all four countries. As a consequence, the total drop in Chinese export earnings between 2007 and the end of 2009 is predicted to be around 18%[15] – an amount equivalent to nearly 7% of China's 2007 (ie pre-crisis) GDP.[16]

The long-term consequences are likely to be dire – and most likely include unemployment, reduced state spending, increased poverty and, eventually, more deaths.

The immediate threat in China is real. A large part of China's economic success over the last 10 years has been based on a strategy of export-led growth. In 2007, earnings from exports accounted for 37% of China's GDP. The financial crisis shows that this was a risky strategy – but it is one that has been key to providing jobs for millions of migrants moving to the cities from urban areas, and has brought China many billions of dollars of export revenue over the years.

But the prediction of hundreds of millions of dollars of lost export revenue is not a death sentence. Export-led growth in China was accompanied by highly controlled engagement with international finance. China's exposure to international financial markets is the lowest in this group of four, and it has been holding steady over the last 10 years. While international inflows are small, the domestic financial sector is moderately large, and most financing for development in China (including for its very high rates of investment) comes from domestic sources. Losses to China's financial system between 2007 and 2009 are predicted to be just over 2% of the country's pre-crisis GDP.[17]

So it's likely that China's financial system will be resilient enough to provide the capital to allow Chinese companies to switch their focus to domestic and regional markets – and China's sheer size means that there is more of a prospect of developing a domestic market, providing the huge and growing inequalities in Chinese society can be tackled.

As mentioned above, recent IMF research indicates that recessions that follow banking crises tend to last longer and cut deeper than other recessions. Whether this general conclusion can predict different countries' experiences of this crisis remains to be seen, but it's a possibility that since the crisis in China is predominantly a trade rather than a banking or financial crisis, the impact will be correspondingly shallower than in countries such as South Africa where the crisis is both a trade and a banking crisis.

If this turns out to be the case, the dire predictions for 2009 and beyond may not come to pass. Already the stimulus package announced by the Chinese government in November seems to be having some effect, for example December saw a five-year high in new bank loans.[18] China is by no means definitively in recovery yet, but it is clear that the government, by virtue of its sheer size and of its relative financial isolation, has choices that others might well envy.

South Africa is at the opposite end of the spectrum. Since 1994, the government has adopted a strategy of extreme openness to the global economy, a strategy that now looks highly questionable – and which, according to recent research, has not been particularly effective in stimulating economic growth.[19] South Africa's financial sector is relatively big compared to other similar emerging economies such as Brazil and India, and particularly dependent on foreign flows. In particular, dependence on foreign buyers in the equities market and in the banking sector has made the country especially vulnerable to the immediate effects of the current crisis.

The value of shares in the South African stock market held by foreign investors, referred to as equities, rose from being equivalent to less than 2% of GDP in 1995, to nearly 20% 10 years later. In 2007, foreign lending accounted for around 20% of total bank credit in South Africa.

By 2009, it's predicted that export earnings in South Africa will be down just under 7% from their 2007 levels, an amount equivalent to just under 9% of pre-crisis GDP, but the fall in flows due to the financial crisis – mainly accounted for by dramatic drops in bank lending and the value of equities – is predicted to be more than 15% of pre-crisis GDP.

Of the four countries, South Africa and China offer the most contrasting experiences of globalisation, and correspondingly are likely to have very different experiences of the financial crisis. While China is already being hit by the recession, its financial system looks resilient enough to survive more or less intact.[20] However South Africa, more integrated into precisely those global financial markets most affected by the crisis, is likely to be hit by both the recession and even more by the financial crisis, as those external sources of development finance on which it is most dependent dry up. The long-term consequences are likely to be dire – and most likely include unemployment, reduced state spending, increased poverty and, eventually, more deaths.

India and Brazil sit somewhere between China and South Africa, though they are quite different to each other. Both are more or less equally exposed to international trade flows. But while Brazil is highly dependent on foreign investment, India funds most of its investment domestically. By contrast, India's banking system is more dependent than Brazil's on foreign loans, and its stock market more dependent on foreign buyers. The losses in the two countries will be similar: a fall in financial flows equivalent to around 5% of pre-crisis GDP, and a fall in export earnings equivalent to around 2% of pre-crisis GDP. However, in the long run India may prove to be more resilient, having a much higher rate of investment, most of which is funded domestically.

Table 3: Patterns of integration into the global economy

country	integration in financial markets	dependence on foreign investment	dependence on rich country economies for aid, trade, remittances
China	low	low	high
South Africa	high	high	medium
Brazil	medium	high	medium
India	medium	medium	medium

Source: calculated from data available from IMF, World Bank, WTO, UNCTAD, Bank of International Settlements, Bloomberg

These four countries show different patterns of integration into the global economy, and how the impact of the crisis will play out through all the different channels of connectedness. The key difference between them is in how dependent they are on foreign capital in their financial sectors and for investment, and how sizeable their earnings from exports. The higher the dependence on external flows, particularly financial flows, the bigger the losses that will result.

However, though there are differences, the crisis will be severe in every country, both for people immediately affected, and for long-term development prospects – the comparisons here are all about degrees of disaster, and capacity to bounce back from disaster, and don't imply that any country can escape the shocks all together.

Vulnerability and the impact of the crisis in Mali, Ghana and Uganda

Mali, Ghana and Uganda are more vulnerable to economic shocks than China, but less so than South Africa. However, what this means in terms of how they are integrated into the world economy is very different. The primary source of vulnerability for these countries is through trade – they are exporters of primary products, a notoriously risky and unstable way of earning a living.

None of these three countries is particularly well integrated into international financial markets. But unlike in China, which has a similarly low level of vulnerability to financial shocks, in these countries this is a sign of weakness rather than strength. China is less vulnerable because it is able to fund development domestically and therefore has a choice about its level of financial integration with the rest of the world. Mali, Ghana and Uganda lack domestic resources, and they are not particularly interesting to foreign capital either.

> The primary source of vulnerability for these countries is through trade – they are exporters of primary products, a notoriously risky and unstable way of earning a living.

The three have taken quite different policy stances toward foreign inflows: while Uganda liberalised its capital account in the late 1990s, in Ghana foreign flows were controlled until steps toward openness began around 2006. But, unlike in China and South Africa, where different policy stances led to different levels of financial flows, in these countries different stances have not led to dramatically different outcomes in terms of financial inflows.

In China, lack of foreign capital is part of a strategy of domestically led development – in Mali, Ghana and Uganda it threatens to mean something quite different. Compared to their colleagues in Brazil, India or South Africa, companies in these countries are stranded on a desert island, watching ships sail past to more profitable shores. There are pockets of interest: in Uganda, nearly 40% of the stocks in the nascent equities market are foreign owned, while in Ghana, nearly one fifth of bank loans come from abroad. But these are investments into tiny markets – and as a proportion of GDP they are very small. The overall picture is grim – these countries are ignored by foreign markets, and in all three the total amount of credit as a proportion of GDP has been falling in recent years. Even before the crisis hit, companies weren't raising money abroad, and they were finding it more and more difficult to borrow it at home.

Mali, Ghana and Uganda all have overall investment rates, relative to their GDP, which are lower than India or China. However, their dependence on foreign direct investment is much greater than in either of these countries. The combination of relatively low rates of investment, but fairly high dependence on foreign investment, reflects the desperate efforts that many African countries have made to increase their attractiveness to external investors as a way of boosting overall investment. This has led to a 'race to the bottom', as companies compete to offer investors more attractive tax breaks, cheap labour and freedom from environmental constraints.

But in development terms this might have been a mistake. Investors might provide jobs, and in some cases tax revenues for the national government, and there might be spillovers for local companies that provide services or components to foreign companies, but it's not the same as growing local companies. A number of studies show that rates of foreign investment are very poorly correlated with job creation, poverty reduction, or other developmental outcomes.[21]

It might be possible to combine foreign flows and domestic companies in more beneficial ways than by simply relying on FDI. Other forms of private flows from abroad, such as equities, bonds or bank lending, could, if properly regulated, allow local business people to get the funding they need to expand and develop, while keeping more control of how their companies are run. In the long run, from a development perspective, this might be a more useful way of getting money from abroad. Unfortunately, it is these markets that have most completely bypassed the poorest countries – and also these markets that, until now, have been dominated by short-termism and volatility. This has meant that, even where they are available, they are of limited – if any – use as sources of funds for development.

Given the small size of their financial sectors, and the low levels of foreign involvement in them, these countries are marginally less vulnerable to the financial aspects of the crisis than to the impact of the recession. The fall in earnings caused by the recession is predicted to be equivalent to between 2 and 5% of these countries' GDP by 2009, and the fall in financial flows caused by the crisis is predicted to be in the order of 2 to 4% of pre-crisis GDP. But their relative lack of vulnerability is not a sign of the strength of their domestic financing, as it is in richer countries. Unlike China, these countries don't have the domestic capital to allow their companies to adapt and seek other markets.

Conclusion

The comparison between the richer and the poorer developing countries in our survey shows how financial markets have failed developing countries on two fronts. Countries like South Africa have bought into the rhetoric of financial liberalisation and the promises of untapped wealth that could be mobilised for development. These countries opened up their markets and now face the consequences – a possible serious reversal in development. This small survey indicates that there was no great pay-off in development terms for the risks countries took in opening up – South Africa's development performance was no better than that of countries that took a more cautious approach – and that openness, which brought dubious rewards, now puts any development gains at risk.

But other countries never had this choice – a financial system organised purely around short-term returns simply didn't register the existence of the poorest countries. At the moment, this might seem like a lucky escape. But in the long run, countries with little domestic capital will need to get money for development from somewhere.

Evidence suggests that domestic capital is the most stable and has the biggest pay-off in development terms. All countries, even the poorest, would be well-advised to look to how they can mobilise more domestic resources through, for example, increasing tax revenues from foreign investors and encouraging citizens to keep their money in local banks. But the very poorest countries face absolute limits on how much domestic capital they can mobilise for development. For them, as for all countries, the question should be how they can engage with international markets to get the development benefits of more capital, without the risks of that capital being of the footloose, extractive and non-productive variety that much foreign investment and financial flows have proved to be.

It is this question that should be at the heart of the attempt to create a better international financial system out of the wreckage of this crisis.

Implications for policy

The development of the vulnerability index over time, and the link to what we know about policy changes, tells a few harsh truths about how global and national economies have been managed over the last 20 years, as this crisis has been slowly building. At the moment, financial globalisation for developing countries is all risk and little benefit. The countries that have done best have primarily used their own resources for development, supplemented with foreign capital as needed, while those whose strategy or circumstances relied on opening up to international markets as a source of resources for development did not see benefits sufficient to compensate for the huge costs they are now experiencing. Others have been left on the sidelines. This has some important lessons for development:

- **The importance of domestically generated development.** It's clear that both from a poverty and a vulnerability perspective, it's better to have a solid domestic base from which to build financial institutions. This means that the ongoing commitment of many rich countries to continued financial liberalisation in poor countries under the guise of 'free trade' agreements needs to be challenged.
- **The importance of diversified financial flows.** Shocks can and will happen, however the economy is designed. It's important that financial flows are as diversified, and as predictable, as possible. A mix of domestically generated and foreign flows is crucial. To raise domestic flows, governments need to increase their tax revenues.
- **The importance of controlling risk in the global economy.** Anyone interested in development should be interested in controlling risk. This means a global economy that is managed to reduce the risks of sudden shocks – to private flows, government flows, and short and long term flows. The regulatory net needs to be spread very wide if the range of shocks that can derail development is to be contained, and both source and recipient countries need to have access to the full array of capital controls needed to control these risks.
- **The importance of transparency.** Those countries that opened themselves up to international financial markets in the 1990s did not have full information about how those markets worked or what the risks were of exposure to them. Like developed countries, they were at the mercy of the ever-more complex financial instruments devised by banks to conceal the functioning of the markets and ensure that they had the upper hand in every transaction.
- **The importance of regulating financial markets so that it becomes thinkable to provide funds in the poorest countries.**[22] At the same time as managing risk, financial markets need to be organised to encourage more long-term investments and investment in countries that lack their own domestic capital but at the moment are ignored by international capital altogether.
- **The importance of involving even the poorest countries in decisions about global financial markets.** The data shows that all countries are affected by the financial crisis, so all countries have a stake in improving the system. It's essential that all countries have a say in how the system is reformed, not just the G20.

Recommendations for the G20

Tinkering around the edges won't help. The extent of global integration, and the way that this crisis has reached deep into the economies of many poor countries, means that anyone interested in reducing poverty needs to be calling for a broad agenda at the G20, where the many and varied sources of risk and vulnerability in the global economy can be addressed. Top of the agenda should be:

Changing how financial markets operate so that they:

- Control risk, so that countries with little option but to build their financial markets from external sources can do so with confidence.
- Improve transparency: on the government side by reforming tax havens to ensure that information is automatically exchanged between them, and on the company side by requiring that companies report their profits and financial transactions on a country-by-country basis.
- Encourage the development of regionally-based financial markets in developing countries, to maximise the possibilities of local resource mobilisation and to increase their global weight with other financial institutions.

Supporting development by:

- Helping in the development of domestic financing. Reducing capital flight, through greater transparency in company accounting and in a reduction in banking secrecy would be an important start.
- Providing assistance to countries affected by the crisis, to ensure that poor people do not suffer the consequences of badly managed markets. In particular, those countries suffering from either the crisis or the recession, but who cannot afford their own stimulus packages, will need extra assistance to cope with the short term impact of the crisis and to restart their economies on a more stable footing in the medium term.
- Ensuring that additional financing is provided in a way that supports longer term, more resilient development, by ensuring that foreign assistance is geared toward developing domestic capacity and resource mobilisation rather than assuming that foreign flows must hold the key to development.

Endnotes

1 Eg Rodrik and Subramanian, *Why did financial globalisation disappoint?*, March 2008; Kose, Prasad, Rogoff and Wei, Financial globalisation: a reappraisal, IMF Working Paper, WP/06/189, 2002

2 28 Jan 09, 'Capital flows to developing world at risk of collapse', www.ft.com/cms/s/0/6fab9488-ecbf-11dd-a534-0000779fd2ac.html

3 Data sources as follows: Export earnings, WTO; FDI and remittances, UNCTAD; Bank lending, Bank of International Settlements; Equities, IMF, overseas development assistance, World Bank World Development Indicators

4 IIF, *Capital flows to emerging market economies*, January 27, 2009

5 EMBI global strip, JP Morgan

6 Calculated from the composition of their exports and predicted changes in demand and prices of different types of products, based on data from the WTO and IMF's *World Economic Outlook* report, January

7 'A sub-prime crisis in the US and infant deaths in Africa', http://africacan.worldbank.org/a-sub-prime-crisis-in-the-us-and-infant-deaths-in-africa

8 Eg The World Bank; *Weathering the storm: economic policy responses to the financial crisis*, PREM network, November 2008; World Bank, *The global economic crisis; assessing vulnerablity with a poverty lens*, Cord, L, M Verhoeven, C Blomquist, B Rijkers, PREM (no date); The *Economist*, Domino theory, 2 March 2009; IMF, *The importance of the global financial crisis for low income countries*, March 2009

9 *World Bank, The global economic crisis: assessing vulnerability with a poverty lens*

10 World Bank; *Weathering the storm: economic policy responses to the financial crisis*

11 Index to be released shortly. More information available from claire.melamed@actionaid.org

12 *World Economic Outlook*, October 2008, Chapter 4: Financial stress and economic downturns

13 Rodrik and Subramanian, *Why did financial globalisation disappoint?*, March 2008

14 Kose, Prasad, Rogoff and Wei, *Financial globalisation: a reappraisal*, IMF working paper WP/06/189, 2006

15 Data sources as above. Predicted reduction in export earnings for all countries was calculated from World Economic outlook predictions for changes in volume and values of manufactures, oil and non-fuel commodities, weighted according to the share of exports for each country

16 Throughout this and the following section, the 'losses' from the crisis are calculated by comparing the actual amount of any given inflow in 2007 with either the estimated value of that inflow in 2008 or the predicted amount in 2009. In most cases, the value of inflows dropped between 2007 and 2008 and is predicted to fall further in 2009. Before the crisis, it was predicted that all of these flows would increase. We are therefore attributing all the drop in flows to the crisis. In order to illustrate the significance of these falls to any given economy, the difference between the actual amount for 2007 and the predicted amount for 2009 (predicted in January 2009) is also compared with 2007 GDP

17 Figures on 2007 flows from UNCTAD, the Bank of International Settlements and the IMF. Forecasts from the IIF, for all countries.

18 IIF, 'Recent developments in Asia', February 12 2009

19 D. Tswamuno, S. Pardee & P. Wunnava; 'Financial Liberalization and Economic Growth: Lessons from the South African Experience', *International Journal of Applied Economics*, 4,2, September 2007, pp.75-89

20 It is possible that the impact of the recession will start to infect the domestic banking system in China as companies default on debts due to falling demand for exports. But the risks of a collapse seem lower than in countries facing both a fall in demand for exports and high levels of exposure to international financial markets

21 Eg UNCTAD, 2005, *Economic development in Africa: rethinking the role of foreign direct investment*

22 Initatives such as the Responsible Finance Charter proposed by the European Network on Debt and Development (Eurodad) might be a good place to start on this

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