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INTERNATIONAL MICROECONOMICS - The impact of the current global financial crisis on developing economies

By Sean Crowley

Governments around the world are trying to contain the current financial crisis although many fear the worst is not yet over. Stock markets are well down from their recent highs, investment banks have collapsed, rescue packages worth more than a trillion US dollars have been drawn up and interest rates have been cut globally. Leading indicators of global economic activity, such as shipping rates, are declining at alarming rates.

What does this turmoil mean for developing countries? Many such economies are still growing strongly, but forecasts have been downgraded substantially in the space of a few months.

Agenda asked Wim Naudé, Senior Research Fellow and Project Director at the United Nations University World Institute for Development Economic Research (UNU-WIDER) for some answers. Based in Helsinki since 1984, UNU-WIDER is the first research and training centre of the United Nations University and undertakes applied research and policy analysis on global development and poverty issues.

Does globalisation mean that we are we likely to see a major slowdown in developing economies that mirrors what is happening in places like the USA, Britain, Iceland and elsewhere?

Yes we are likely to see a slowdown in growth in developing economies – although not all developing economies will be affected in the same manner and some will recover faster than others.

What are the channels through which the crisis could spread to other economies and how are the effects being felt in developing countries?

There are at least six channels. One direct effect is that financial institutions in developing countries may fail, to the degree that their assets were contaminated by their holdings in failing US and UK banks. The second is that people in developing countries may lose trust in their banks and save less in the formal banking system. A third, more indirect, effect is that declining wealth and rising interest rates in the USA and EU will reduce the demand for exports from developing countries, which will slow down these countries' growth. Fourth, export contracts are underpinned by trade credits, and as these become harder to obtain, export volumes will fall further. Five, with the huge financing need in the USA and EU pushing up interest rates, developing country governments will find it more expensive to borrow/issue debt for expenditure on infrastructure, education and



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health, for instance. Six, as governments in the USA and EU face growing pressure on their finances; less money is likely to be made available in the form of aid to developing countries.

Which developing countries will be able to withstand the challenges created by the downturn in developed economies, and which are most at risk?

Most at risk are small, highly-indebted countries with weak public finances, current account difficulties/deficits and exposed banks. Larger countries, such as China and India are likely to be less seriously affected, as these countries' banking systems have held less of the bad assets from the US mortgage lending market, and they have large reserves of foreign currency. The continued, albeit slower, growth of China and India is likely to support growth in many other developing countries.

What kind of macroeconomic strategies could be beneficial for countries like China, India and Brazil to weather the current financial storms? Are there actually real opportunities here for such economies when most of the more developed countries are suffering the effects of recession?

The financial storms have by now largely passed – it is now more a question of limiting contagion, speeding up recovering, and avoiding a similar crisis in future. In developing countries, where it is possible and balance of payments constraints do not pose a crisis, governments could support domestic demand through more expansionary policies. Especially in China, where savings rates are traditionally very high, growth in consumption expenditure could revive growth. Given that China is a big importer of commodities from developing countries, this would also be good for these countries. Elsewhere, governments should adopt policies which signal stability, and encourage investment, including foreign investment. Some countries will inevitably require assistance to overcome balance of payments problems – such as that offered by other central banks or the International Monetary Fund (IMF). These should however be seen as short-term measures to restore macro-economic stability.

As for opportunities, we have already seen in recent years growing South-South trade between countries such as Brazil, China, India, South Africa and others. Perhaps the recession in the USA and EU will have the side effect of increasing the growth in this trade. Also, many financial institutions in developing countries have withstood the global financial storms remarkably well – as for instance those in South Africa. With their reputations now enhanced, these institutions may even come in future to be more noted global players.

What should the very poorest countries, resource-rich or otherwise, be doing during these uncertain economic times?

The most fundamental challenge remains to reduce poverty and create jobs. The financial crisis has the very real possibility of putting back efforts in this regard by years. Therefore, in the very poorest countries, comprehensive measures should be taken to ensure that the effects of the crisis are not permanent. Of course, if these countries were able to do so effectively and on their own, they would not be poor in the first place. Poverty increases the vulnerability of countries. Because of this vulnerability, the very poorest countries should be supported by the international community. The latter should ensure as far as possible that aid volumes and effectiveness are not compromised, and that the advanced economies do not close their economies to goods and services from the developing world.

Of course, what the crisis has illustrated powerfully in the West is the important role of finance in the economy. Hundreds of millions of people in developing countries

have to do without access to finance. Let us hope that the current crisis will have the positive outcome that more effort will in future go into extending access to finance for people in the poorest countries.

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