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German Development Institute

THE GLOBAL FINANCIAL CRISIS – LESSONS FOR FINANCIAL SECTOR REFORM

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Overview

- Recap: the story so far
- Outlook: how bad will it get?
- Causes of the crisis
- Lessons for financial sector reform

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Recap: the story so far

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Recap: the story so far

- Unlike previous developing and emerging markets crises, the ongoing financial crisis originated in mature economies
- When the sub-prime crisis erupted in the US in 2007, not only Europe but also developing and emerging countries were thought to be immune (*decoupling hypothesis*) on account of:
  - limited exposure to sub-prime market/impaired assets
  - improved fundamentals and policy framework

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Recap: the story so far

- Decoupling hypothesis proved to be a myth
- Even countries whose financial sector was not or hardly exposed to “toxic assets” are hit
- Dependencies on developed markets exist, both in trade and finance, and they are felt now
- Countries with large current account deficits and financing needs, exposure to foreign exchange risk, and high leverage were hit the hardest

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Recap: the story so far

Contagion has been making its way through:

- **Financial market links**
  Deleveraging and heightened risk aversion on the back of existing vulnerabilities → financing in int’l capital markets more difficult and costly
- **Real economy links**
  Global slowdown/contraction → lower trade, falling commodity prices, decline in remittances
  - Indirect impact on bank credit risk/quality of loan portfolio
  - Indirect impact on government revenue and fiscal balance

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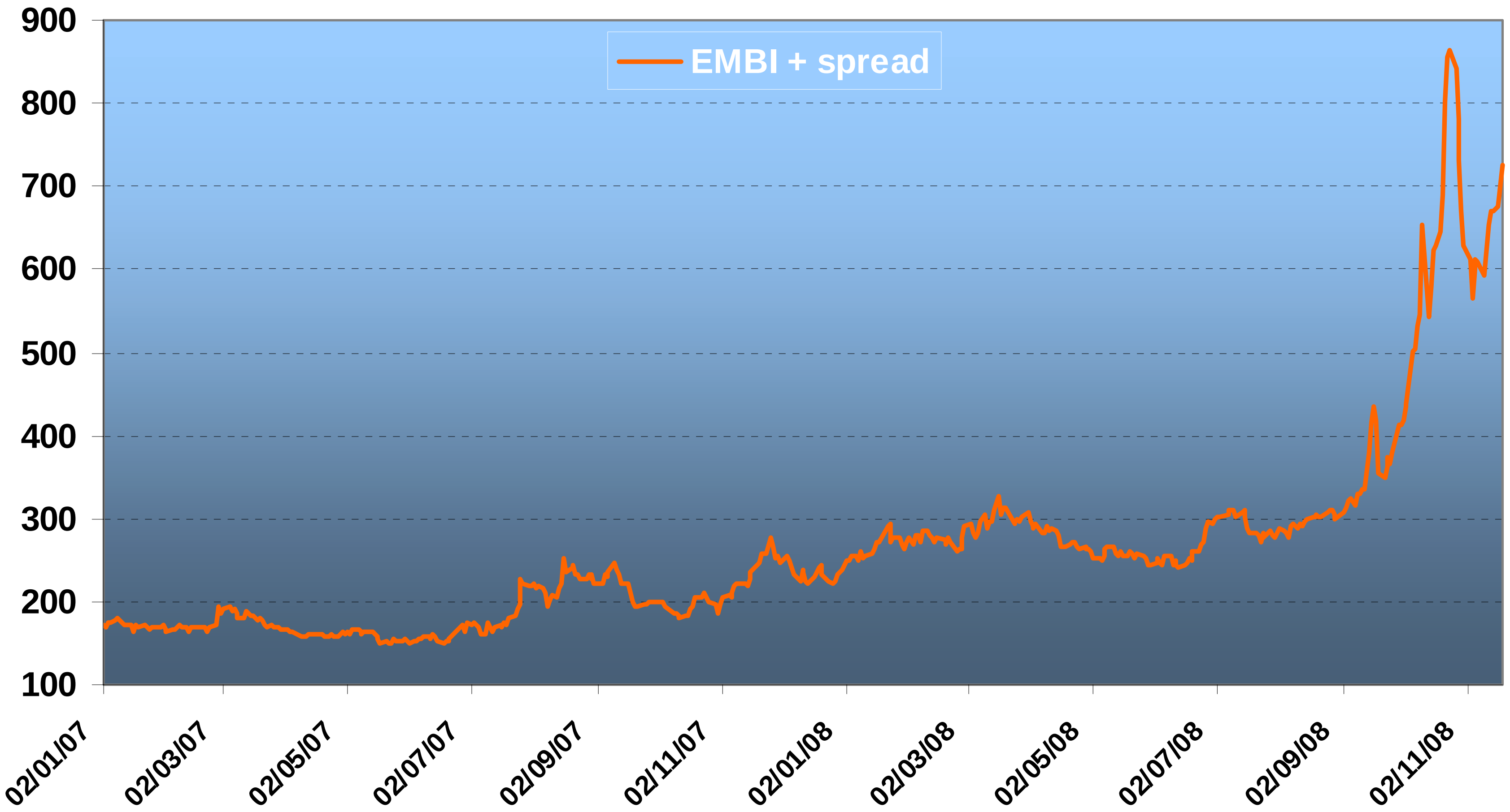
Recap: the story so far

Heightened risk aversion



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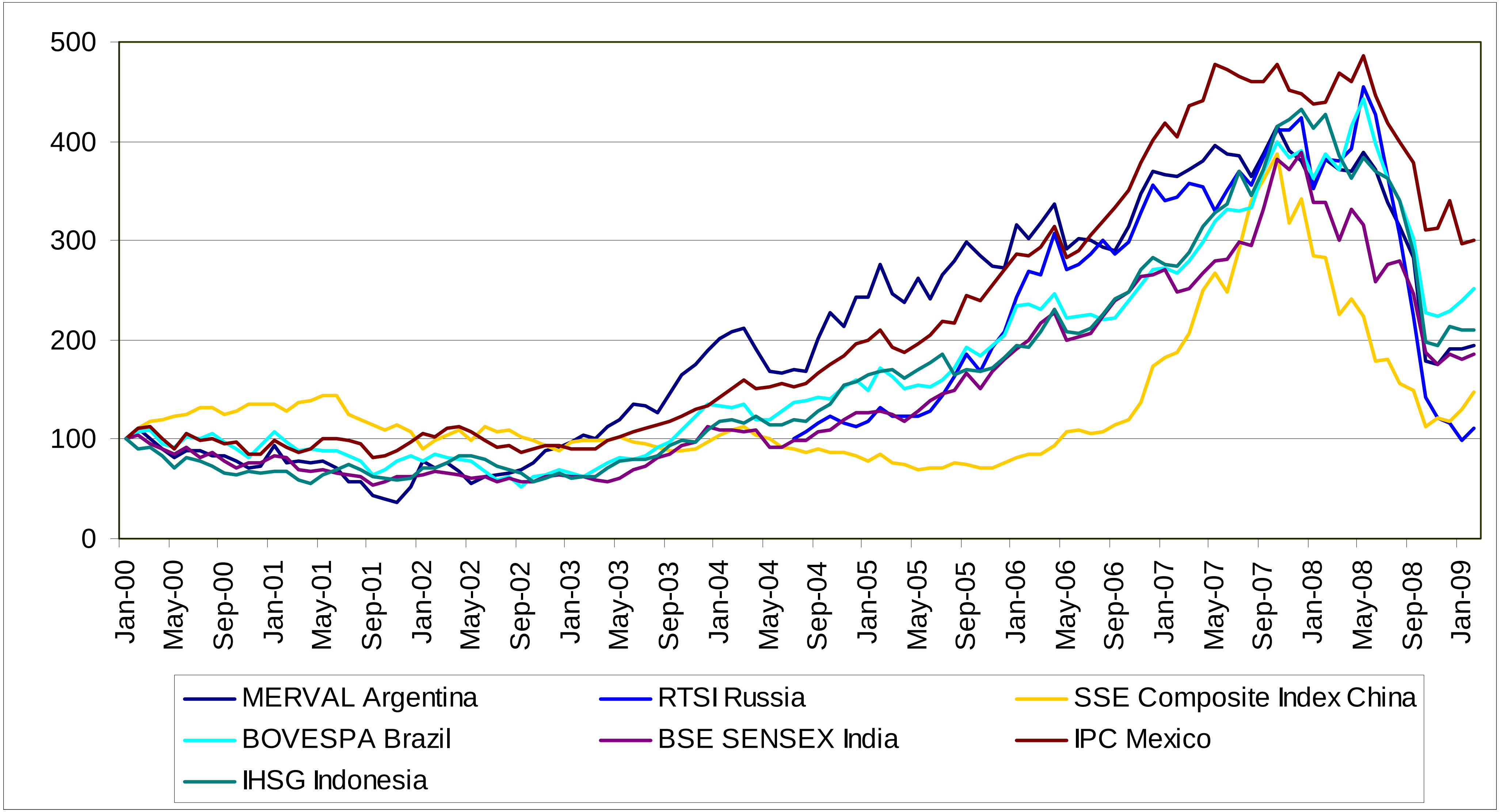
Recap: the story so far

Plunging stock markets



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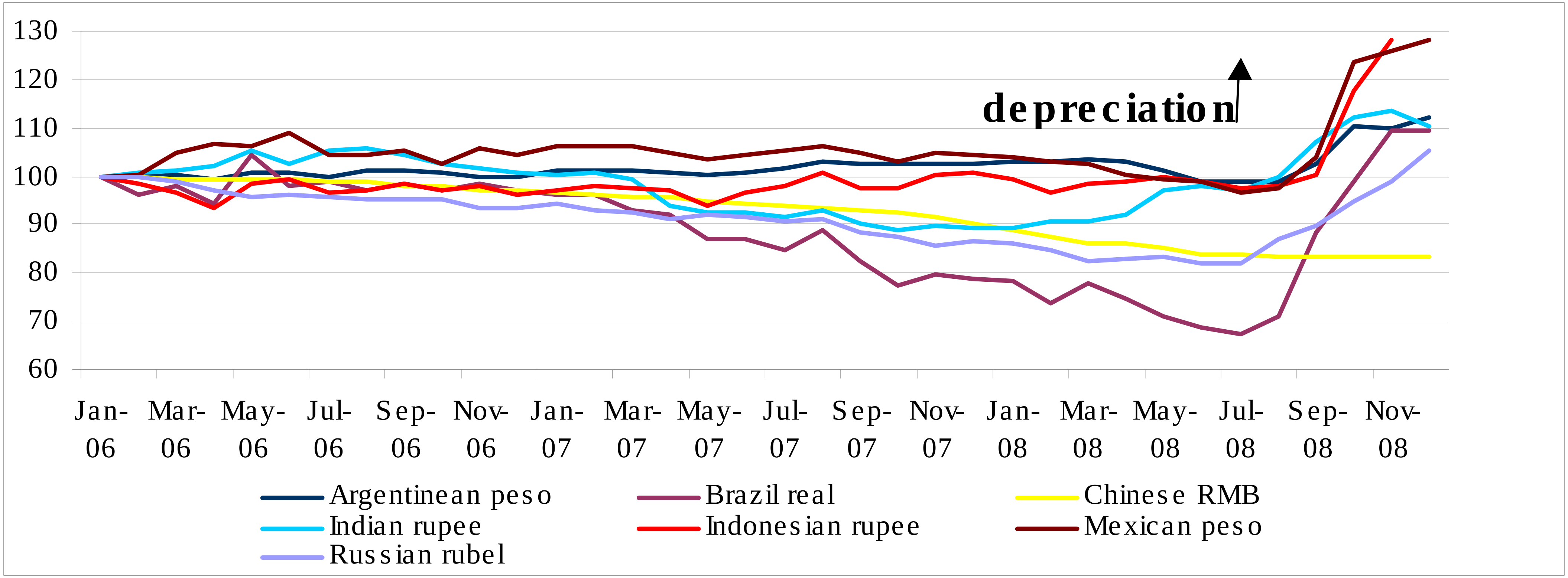
Recap: the story so far

Depreciating currencies



Source: IMF/IFS

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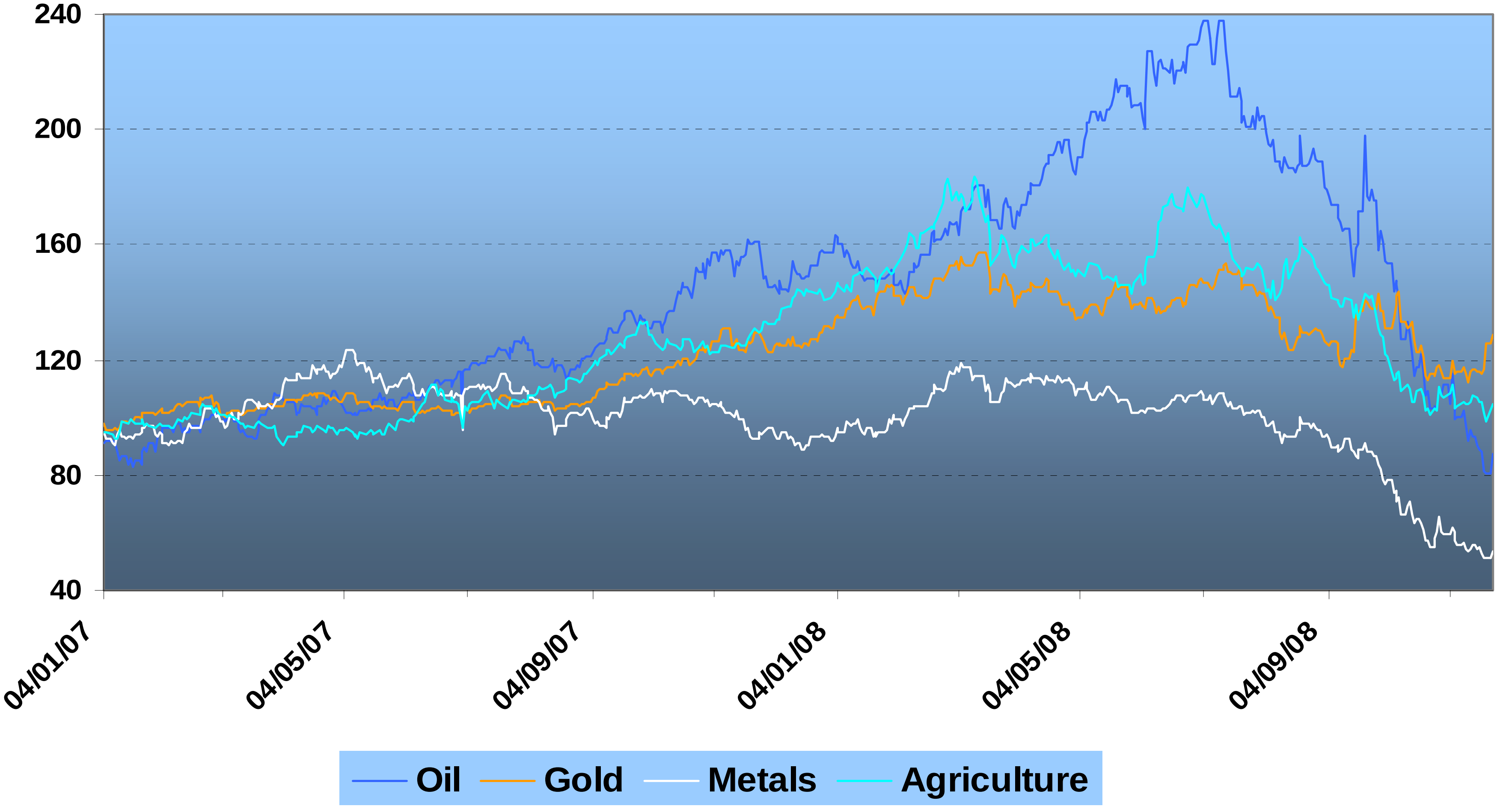
Recap: the story so far

Tumbling commodity prices



Source: Bloomberg and Global Insight

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Recap: the story so far

Other effects

- Decline in foreign direct investment (FDI) by an estimated 10% in 2008 (UN Jan 2009)
- Sharp decline in remittances, which in 2007 amounted to $282 billion worldwide (about 3 times as much as ODA, and about 6% of GDP of LIC; according to the World Bank)
- Global shortfall in trade finance has soared to about $100bn (WTO March 2009)

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Outlook: how bad will it get?

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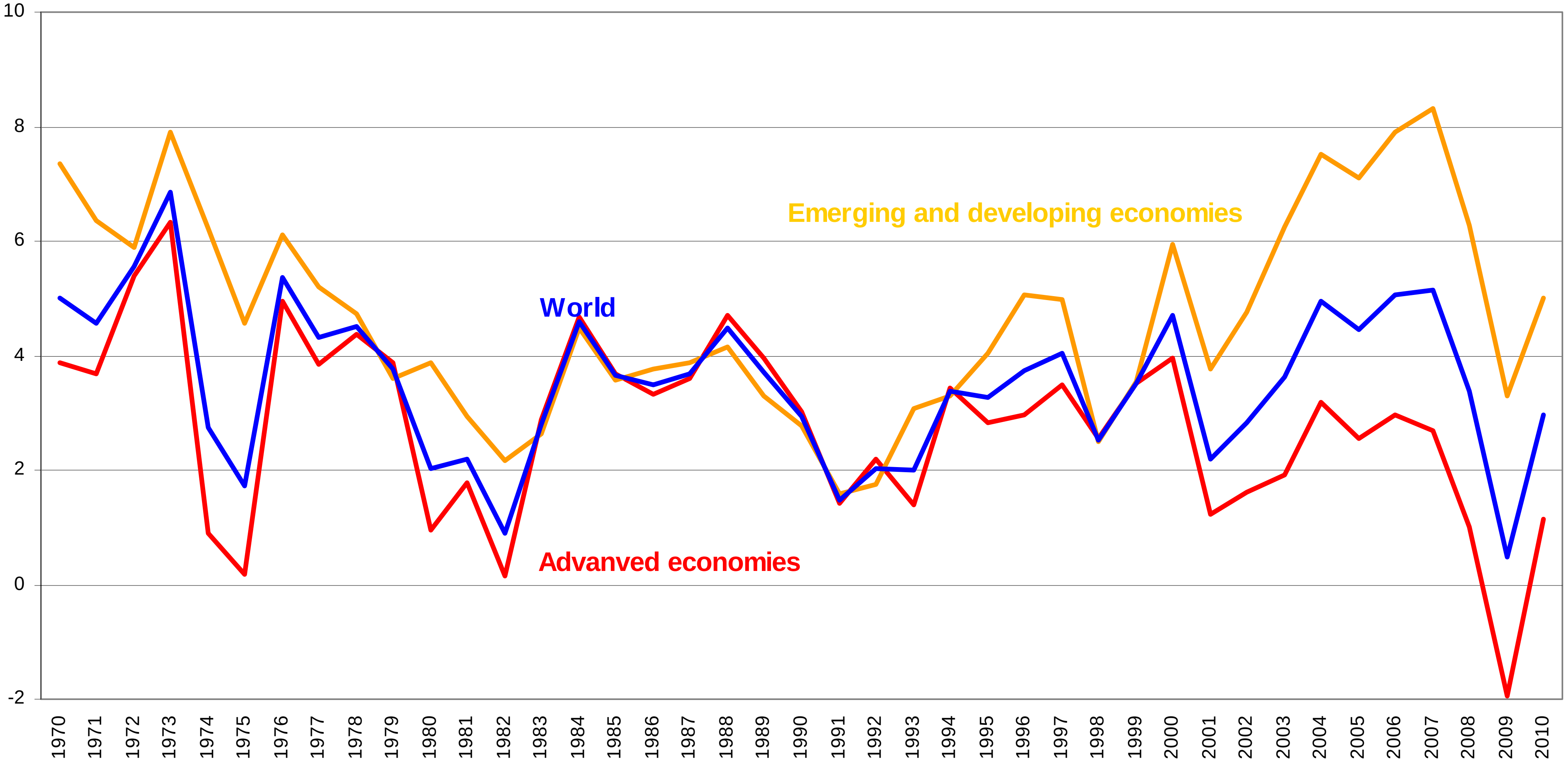
How bad will it get?

GDP growth (% change)



Source: IMF World Economic Outlook Update, January 2009

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How bad will it get?

Growth estimates for developing countries for 2009

	2007	2008	2009		
			Pessimistic scenario	Middle scenario	Optimistic scenario
Transition economies	8.3	6.9	2.7	4.8	6.1
Developing countries	7.2	5.9	2.7	4.6	5.1
Africa	6.0	5.1	0.1	4.1	4.7
East Asia	9.0	6.9	4.6	5.9	6.4
South Asia	7.4	7.0	4.0	6.4	6.6
West Asia	4.7	4.9	1.6	2.7	3.3
Latin America & Caribbean	5.5	4.3	-0.2	2.3	2.7

Source: UN World Economic Situation and Prospects 2009

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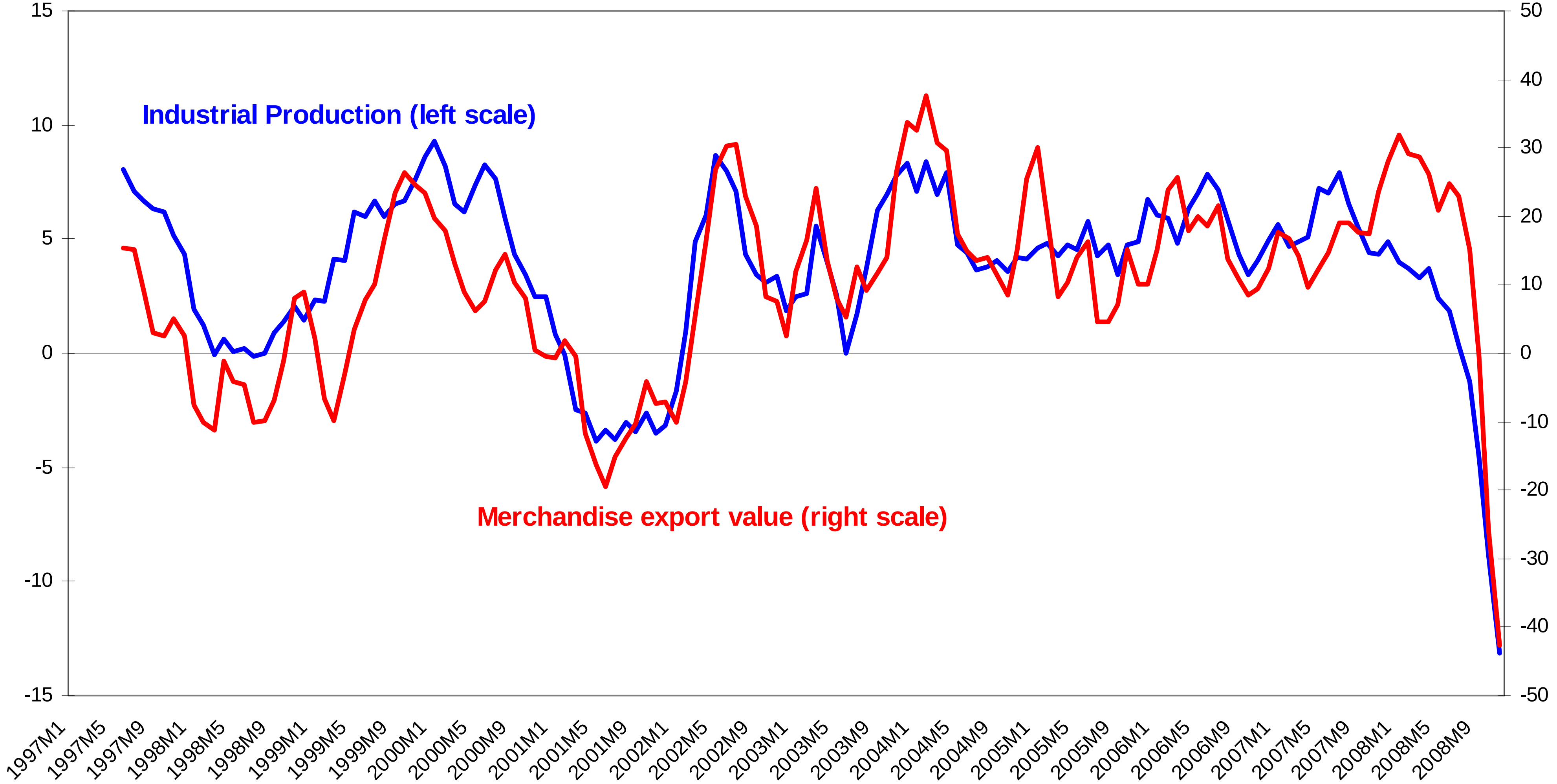
How bad will it get?

Growth in global industrial production and merchandise trade (annualised 3-months %change)



Source: IMF World Economic Outlook Update, January 2009

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How bad will it get?

External financing flows to emerging market economies (millions of dollars)

	2003	2004	2005	2006	2007	2008e	2009f
Private flows, net	236,746	333,311	523,486	564,909	928,553	465,792	165,328
Equity investment, net	138,539	195,006	250,082	222,309	296,131	174,065	194,823
Direct equity investment, net	103,168	154,659	197,322	170,911	304,146	263,358	197,476
Portfolio equity investment, net	35,371	40,347	52,760	51,478	-8,015	-89,293	-2,653
Commercial banks, net	34,994	62,215	163,946	211,915	410,259	166,643	-60,642
Credit flows, net	37,650	64,403	164,223	210,915	408,353	167,620	-60,604
Interest arrears	678	53	-20	0	0	0	410
Discounted debt transactions	-1,350	122	0	0	0	0	0
Other private creditors, net	63,214	76,091	109,459	130,684	222,163	125,083	31,147
Official flows, net	-19,942	-15,397	-65,460	-57,499	11,374	40,971	29,374
International financial institutions, net	-6,133	-14,336	-40,305	-30,436	2,651	16,642	31,013
Official bilateral creditors, net	-13,809	-1,061	-25,155	-27,063	8,723	24,329	-1,639
Resident lending abroad, net	-49,788	-111,301	-247,014	-315,216	-384,407	-421,937	-271,726
Errors and omissions, net	-23,769	27,959	-59,796	-21,222	-41,157	-28,013	0
Monetary gold (- = increase)	709	646	1,069	-81	283	129	139
Reserves excluding gold (- = increase)	-272,503	-400,113	-429,204	-554,838	-948,656	-444,289	-245,860

f = IIF forecast, e = estimate

Source: Institute of International Finance, Capital Flows to Emerging Market Economies, 27 January 2009

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How bad will it get?

Current account balance of emerging market economies (millions of dollars / % of GDP)

	2003	2004	2005	2006	2007	2008e	2009f
Trade balance	204,022	244287.0836	347916.1497	463576.97	491524.4471	510731.3498	477593.8613
Merchandise exports	1,791,942	2327685.424	2822517.832	3418961.577	4076993.526	4857258.109	4488754.343
Merchandise imports	-1,587,920	-2083398.34	-2474601.682	-2955338.826	-3585488.178	-4346527.648	-4011110.571
Balance on services, income & transfers	-75,475	-79392.90324	-70997.72876	-79628.32689	-57515.70383	-123353.7661	-154796.9402
Interest payments	-101,072	-104456.6767	-112834.8724	-131980.925	-155138.0514	-165009.6516	-144929.6947
Private transfers, net	65,838	72701.73124	93435.44981	108486.407	129475.3112	156771.1259	143182.7733
Official transfers, net	6,546	6311.56126	6726.649104	8809.424383	11404.53565	8175.5	10356.73013
Current account balance	128,547	164894.1804	276918.4209	383948.6431	434008.7433	387377.5837	322777.0609
(% GDP)	1.9	2.079248562	2.949246221	3.493216037	3.248071436	2.473000826	2.17308282

f = IIF forecast, e = estimate

Source: Institute of International Finance, Capital Flows to Emerging Market Economies, 27 January 2009

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How bad will it get?

- The World Bank estimates that the slowdown in economic growth will push 53 million people into poverty, in addition to the 155 million already suffering the effects of the food and energy crisis

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How bad will it get?

How bad will it get for India?

- "India is safe from the global turmoil. […] The only fear is fear itself." (Palaniappan Chidambaram, Finance Minister, 6 October 2008)
- "The Indian financial sector has shown resilience and there are no signs of a currency crisis or a banking crisis." (Usha Thorat, Deputy Governor, Reserve Bank of India, 6 March 2009)

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How bad will it get?

Real GDP growth forecasts for India 2009-10

	2007	2008	2009	2010
IMF	9.3	7.3	5.1	6.5
World Bank	9.0	6.3	5.8	7.7

Sources: IMF (WEO Update January 2009) and World Bank (Global Economic Prospects 2009, December 2009)

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Causes of the crisis

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Causes of the crisis

Regulation failure!

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Causes of the crisis

Excessive liquidity as a result of

- Lax monetary policy in the US and elsewhere
- Global imbalances & “global savings glut”

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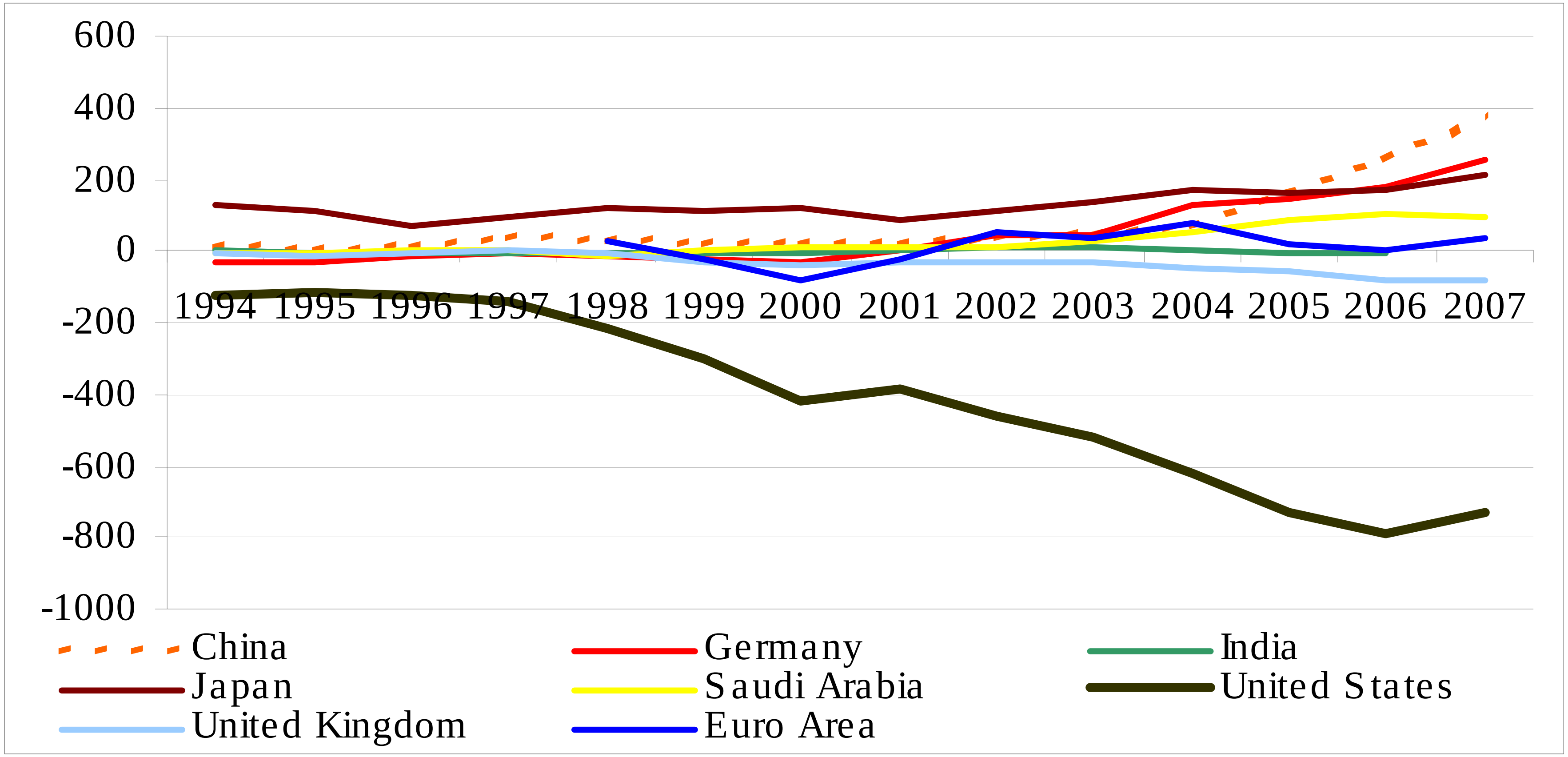
Causes of the crisis

Current account balance (in billion USD)



Source: IMF/IFS

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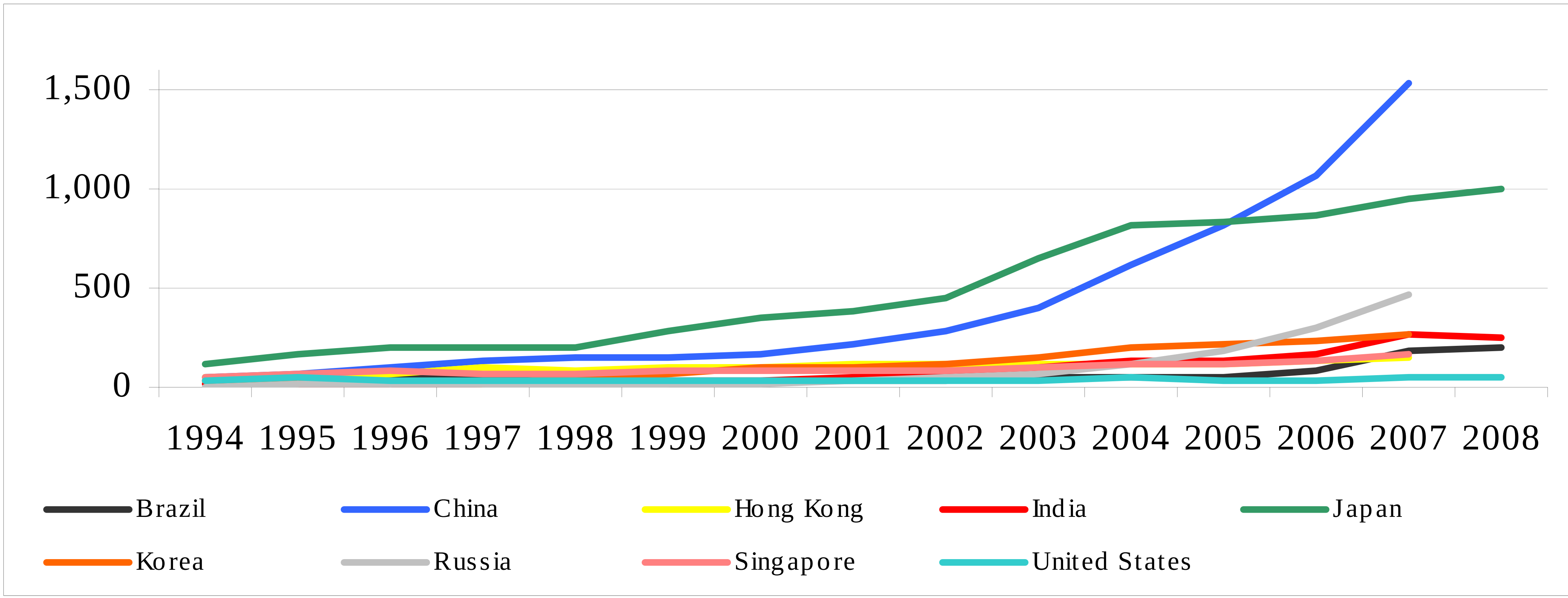
Causes of the crisis

Accumulation of foreign exchange reserves (in billion USD)



Source: IMF/IFS

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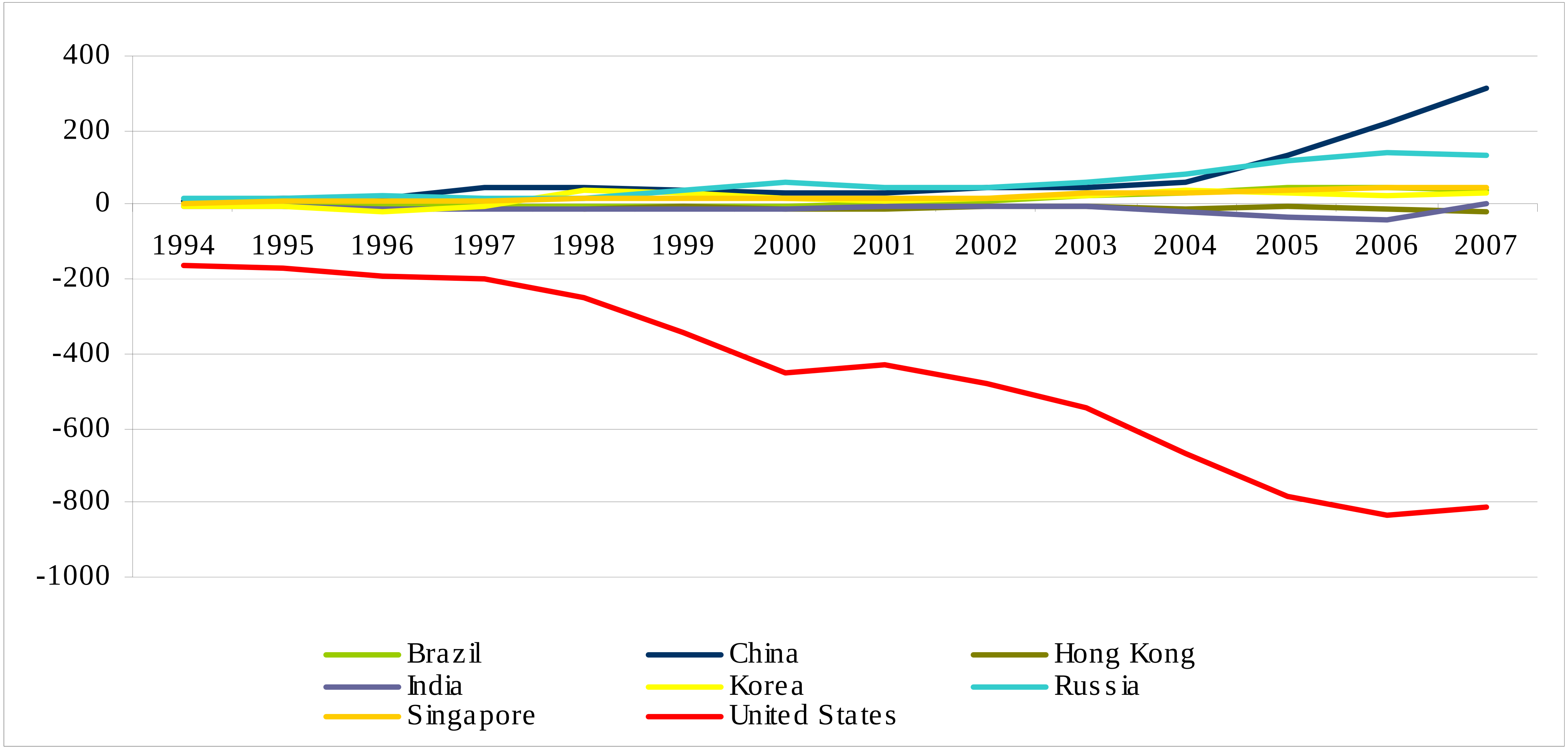
Causes of the crisis

Trade balance (in billion USD)



Source: IMF/IFS

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Lessons for financial sector reform

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Lessons for financial sector reform

Lessons relearned that should guide policy responses aiming at a reform of the int'l financial system:

- Financial stability is a public good on the national, regional, and global level
- International co-operation is needed to ensure financial stability

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Lessons for financial sector reform

Two sides of financial co-operation:

- Crisis prevention
  - Surveillance
  - Exchange of information
  - Cross-border arrangements between financial entities
- Crisis management

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Lessons for financial sector reform

- Better financial regulation and supervision of national AND international financial markets
- WB & IMF FSAPs should be made mandatory for all (systemically) important countries and published
- No tolerance of shadow financial sectors and tax havens
- BUT: desirable forms of financial regulation will inevitably differ across countries, depending on their preferences and level of development

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Lessons for financial sector reform

- Strengthened role of IMF and other IFIs, which requires a more equitable governance structure of these institutions
- Regional financial cooperation and reserve pooling arrangements could complement IFIs

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Lessons for financial sector reform

- Further development of financial markets in developing countries and emerging economies is key
  → More banking and securities markets needed – not less!!!
- Strong rationale for strengthening of national and regional financial markets to better channel developing countries' savings to investments

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