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Special Issue on
the Financial Crisis

Lessons from World Bank Research on Past Crises

Crisis have been much studied, including at the World Bank. Entering *financial crisis* in the search engine for the Bank's Policy Research Working Papers brings up more than 650 research papers issued since 1990. Of course, not all these papers are relevant to a particular crisis. And others that do not mention the word *crisis* may be relevant; the literature on famines and natural disasters, for example, contains insights for social protection policy responses to a financial crisis. The Bank does not have a monopoly on crisis research. Nonetheless, as the world enters what is clearly a major financial crisis, it is worth taking stock of the lessons that might be drawn from the Bank's past research on crises.

Arguably, greater openness in such areas as trade and migration helps countries deal with domestic shocks, but may well increase vulnerability to external shocks. Globalization has probably facilitated contagion of the 2008 financial crisis, though some economies and some people are likely to be more vulnerable than others.

Even an economywide crisis can have diverse, heterogeneous impacts that warn against simple generalizations and also point to the need for a flexible social policy response. It should not be presumed that the poorest will be hit hardest; indeed, some of the same (undesirable) factors that have kept a significant share of the developing world's population in deep and persistent

poverty—including a lack of connectivity to markets and a consequent lack of opportunity for economic advancement—will protect the poor from the crisis to some degree. But significant welfare impacts can be expected, notably in countries—and in regions within countries—that have benefited from market-oriented development.

Poverty is very likely to rise in a crisis, though by how much will depend on the extent of the aggregate economic contraction and the rise in inequality (if any). An aggregate poverty measure cannot tell the whole story, however. There are likely to be both gainers and losers at every level of living, including among the poor. And there may well be adverse impacts on important nonincome dimensions of welfare, including the nutrition and schooling of children.

Even a short-lived crisis can have longer-term impacts for some of those affected, most notably through the nutrition and schooling of children in poor families. And deficient crisis responses can plant the seeds of longer-term vulnerability to crises. The extent to which these adverse outcomes materialize will depend in part on the policies adopted by developing country governments. The record of past policy responses to crises contains both successes and failures.

A new paper by the Development Research Group reviews lessons from the Bank's past research on the causes of past crises and the

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How Should Developing Countries Respond to the Current Crisis?

Developing countries considering a fiscal response to the financial crisis should heed the lessons of the past

The prospect of a deep global slump has brought attention to discretionary fiscal policy as a potential tool for mitigating the severity of the slowdown. Developing countries, however, have a decidedly mixed record in using fiscal policy to stabilize fluctuations in output. Institutional weaknesses, the limited role of automatic stabilizers, and limited access to financing for expansions have often led to mistimed or ineffectual fiscal measures in the past. A recent paper by Servén and Kraay identifies some key lessons that have emerged from these experiences, and suggests that policy makers should take these into account before initiating a fiscal response.

- *Any fiscal response should be commensurate with the shock experienced.* The speed and magnitude of the growth slowdown will differ greatly across developing economies, varying with their dependence on trade, foreign investment, and remittances. Thus each country should first carefully assess its expected exposure to the crisis to avoid an unnecessary or excessive fiscal response.

- *Monetary policy options should also be considered.* Policy makers need to coordinate monetary and fiscal interventions. In many developing countries the central bank's policy interest rates are still high and inflation is modest, suggesting that there may be room for traditional easing measures. Yet decision makers need to recognize that relaxing monetary policy also entails risks, including downward pressure on exchange rates and the loss of anti-inflationary credibility in countries with a history of monetary recklessness.

- *Fiscal expansions need to be sustainably financed.* Otherwise, stimulus measures can backfire and lead to

high inflation, if fiscal deficits are monetized, or a debt crisis, if developing countries borrow excessively at high sovereign spreads. Only governments with strong fiscal positions and large reserve stocks are well placed to undertake a successful fiscal response to the crisis.

- *Fiscal policy responses to the crisis should be either reversible or likely to yield long-term productivity gains.* This is crucial to ensure that long-run fiscal and debt sustainability is not jeopardized by a countercyclical spending increase. Projects that act as automatic stabilizers are one way to achieve this. For example, workfare programs with below-market wage offers will attract participants in downturns but will not be appealing once the economy recovers. Another way of reducing the risk of unsustainable public debt accumulation is to increase spending in areas with reasonable expectations of long-term growth benefits. For example, China's successful fiscal expansion in response to the East Asian financial crisis of 1997–98 spent heavily on infrastructure projects for which there was strong local demand. Similarly, spending on social safety nets is particularly crucial in areas in which short-term coping mechanisms (such as selling assets or cutting back on caloric intake) can reduce productivity and well-being in the long run (through an inability to produce or through stunting and reduced cognitive abilities).

- *Fiscal expansion must be timely but not rushed.* To minimize the potential for waste and fraud, policy makers should not rush into new and untried public spending projects. They should first consider expanding existing and well-functioning programs and financing preappraised and "shovel ready" new projects. This is particularly true in developing countries in which the capacity to appraise and adequately oversee untried projects is limited. But while it is important to act circumspectly, policy makers should keep in mind that fiscal interventions need to be timely

to be effective and can be counterproductive otherwise. In Argentina, for example, a mistimed fiscal impulse in 1996–98 spent public resources when a recovery boom was already under way, undermining the state's room for maneuver in the crisis that followed.

- *The success of a fiscal expansion depends greatly on how it is delivered.* In a deflationary environment, increases in spending on public projects will generally be more effective at stimulating aggregate demand than tax cuts or direct transfers to households, which tend to be saved rather than used for consumption. In developing countries with large informal sectors there is the additional problem that tax cuts and social insurance transfers will fail to reach many of the poorest households and firms, thereby increasing inequality and social tension. Yet public spending programs can be wasteful, captured, and hard to reverse if institutions are weak. Fiscal policy should factor in such constraints and choose delivery channels tailored to the characteristics of the economy.

For most developing countries, expansionary fiscal policy has not been an effective tool for responding to economic downturns in the past. This does not mean that fiscal policy can play no role in mitigating the effects of the current crisis. Instead, it implies that countercyclical fiscal measures should take into account the lessons from past experience to provide successful short-term relief without undermining long-term development.

Luis Servén and Aart Kraay. 2008. "Fiscal Policy Responses to the Current Financial Crisis: Issues for Developing Countries." World Bank, Development Research Group, Washington, DC.

Financial Market Failures: Searching for Lessons, Not Scapegoats

Good regulatory design requires attention to incentives

The current financial crisis, occurring during a period of strong world macroeconomic growth and low interest rates, appears to have surprised financiers and regulators alike. The turbulence was triggered by a sudden and widespread loss of confidence in securitization and financial engineering and by the failure of respected statistical models for assessing and pricing credit risk. These now-doubtful techniques had previously been hailed as the cornerstones of modern risk management. Moreover, the turbulence proved greatest in countries whose supervision of credit risk had been thought to be the best in the world. Indeed, these countries' regulatory standards and protocols were being emulated worldwide.

As the crisis unfolded, the world witnessed a series of unprecedented events, including a previously unthinkable rate of default on AAA instruments, the first run on a U.K. bank in 150 years, and an explicit extension of the U.S. safety net to cover a major insurance company, the entire investment banking industry, and two giant government-sponsored housing finance enterprises (Fannie Mae and Freddie Mac). These events were followed by the demise of a number of commercial and investment banks and a sharp, worldwide plunge in equity stock prices that was especially pronounced for the financial sector.

Inquiring minds yearn to know how this financial crisis could have occurred in the 21st century and, especially, how it could have originated in the United States, home to arguably the most sophisticated financial system in the world. Promptly uncovering the true roots of the crisis is important because false explanations are quick to gain a foothold. Policy makers and pundits often latch onto simplistic theories of what happened, why,

and what should be done to prevent similar events.

A recent paper by Caprio, Demirgüç-Kunt, and Kane seeks to make it clear that the main source of financial instability is not the aberrant behavior of a few greedy individuals or a sudden weakening of important institutions of a particular country at a particular time. Systemic financial fragility stems instead from a web of contradictory political and bureaucratic incentives that undermines the effectiveness of financial regulation and supervision in every country. Weaknesses in supervisory incentives encourage modern safety net managers not only to tempt financial institutions and their customers to overleverage themselves in creative ways, but also to close their own eyes to the unbudgeted costs of the loss exposures that excess leverage passes on to financial safety nets until it is too late to control the damage that results.

These incentive conflicts explain how securitization went wrong, why credit ratings proved so inaccurate, and why it is superficial to blame the crisis on mark-to-market accounting, an unexpected loss of liquidity, or trends in globalization and deregulation in financial markets.

The analysis also finds disturbing implications of the crisis for Basel II and its implementation. Since authorities will be reforming the architecture of financial regulation, how this reform should proceed and what lessons developing countries ought to draw from this crisis are focal issues. The paper proposes reforms that would improve incentives by increasing transparency and accountability in government and industry alike. Perhaps most important are the proposals for enhancing accountability of government officials, through better crisis preparedness, greater use of market information to track risks and subsidies, the publicizing of estimates of safety net subsidies, and deferred compensation schemes.

First, crisis preparedness is important to avoid short-termism in crisis management. Accountability would be greatly improved by requiring that regulators establish and regularly test a well-publicized benchmark plan for crisis resolution. Second, regulators need to draw on market signals to overcome information problems and improve their ability to track risk in and out of crisis. Requiring the largest banks to regularly issue a series of credit default swaps or uninsured subordinated debt would provide such signals, since the holders of these instruments would apply the market discipline that pillar three of Basel II seeks to harness.

Third, the safety net needs to be strengthened by making authorities more accountable for its cost. This requires developing a system of fair-value accounting for intangible safety net subsidies, to establish political accountability for controlling them. Important institutions and their supervisors must be required to model, estimate, and expose to outside review the value of this intangible source of income—at individual institutions and in the aggregate. Finally, the decision-making horizons of government officials could be lengthened if employment contracts included a deferred compensation fund that heads of supervisory authorities would have to forfeit if a crisis occurred within a couple of years of their leaving office.

The discussion of how best to reform regulation and supervision of financial institutions is likely to continue. But it is important to keep in mind that ultimately the goal of financial regulation and supervision is not to reduce financial institutions' risk taking but to manage the safety net so that private risk taking is neither taxed nor subsidized. This goal implies that supervisors have a duty to see that risks can be fully understood and fairly priced by investors. No one should expect that, in a risky world, risk-neutral regulation and supervision can eliminate the risk of financial crises; what it can do is to reduce their frequency and cost.

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Bailing Out the World's Poorest

A significant share of the poor can be protected in a crisis without damaging longer-term prospects of escaping poverty

As the financial crisis emanating from the U.S. housing and financial markets spills over to the developing world in 2008/09, many governments and citizens are asking what can be done to help protect the poorest. There is a compelling case for believing that the composition of public spending and taxation should change in favor of the poor. But the evidence on past performance is not encouraging; too often it is spending on the nonpoor that is protected.

If an adequate safety net exists, it should of course be supported to protect the poor in the crisis. If no such safety net exists, a crisis may well create the political space for building one. But crises have given birth to some of the worst social protection policies as well as to some of the best. Governments have sometimes been drawn into introducing generalized food and fuel subsidies that have come at a huge fiscal and economic cost and are not easily reversed, yet have had at best a modest impact on poverty. But some developing countries have been able to turn a crisis into an opportunity for dismantling inefficient subsidies in favor of more effective safety net programs.

The starting point for many developing countries will be a weak safety net, with limited potential for protecting the poor from an economy-wide crisis. There will also be limited information on the likely profile of welfare impacts, though an effort should still be made to anticipate the types of households and places that will be most vulnerable, using the best available data and analytic tools. Crises have often presented opportunities for setting up better information systems for monitoring progress and for future preparedness.

A recently popular class of transfer programs requires the recipient family to demonstrate adequate school attendance by its children (and, in some versions, adequate child health

care). There is evidence from impact evaluations that such conditional cash transfer programs bring nonnegligible benefits to poor households—in terms of both current and future incomes—through higher investments in child schooling and health care.

A common drawback of targeted cash transfer schemes is that they tend to be relatively unresponsive to changes in the need for assistance. A previously ineligible household that is hit by (say) unemployment of the main breadwinner may not find it easy to get help from such schemes. While a temporary increase in the transfer payments to existing beneficiaries can help in a crisis, a temporary expansion in coverage will probably also be needed, and this can be harder to achieve.

One way to ensure that the safety net provides effective insurance—a genuine “safety net”—is to build in design features that encourage only those in need of help to seek out the program *and* encourage them to drop out of the program when they no longer need help because of better options in the rest of the economy.

The classic example of such self-targeting is a workfare program (variously called relief work or public works programs; food-for-work programs also fall under this heading). Workfare has been widely used in crises and by countries at all stages of development. These programs, if well designed and implemented, can be responsive to differences in need—both between people at a point in time and for a particular person over time.

An ideal workfare scheme guarantees low-wage work on community-initiated projects. The low wage rate ensures that the scheme is self-targeted because the nonpoor will rarely want to participate. The federal or state government announces that it is willing to finance up to (say) 15 days a month of work on community projects for any adult at a wage rate no higher than the market wage rate for unskilled manual labor in a normal year. The work is available to any adult at any time, crisis or not. This would extend the coverage of the public works schemes often found in

current relief efforts to include normal times at which demand would be much lower but almost certainly not zero. It would also relax the eligibility restrictions often found on relief work. It would rely very little on administrative discretion in access to the program (either in turning it on and off or in determining who gets help). As long as the guarantee is credible, it would also help reduce the longer-term costs of risk facing the poor. Thus it can help in fighting chronic poverty as well as transient poverty in a crisis.

It is possible to protect a significant share of the poor in a crisis without damaging longer-term prospects of escaping poverty. This would probably require a combination of relief work with transfers (in cash or food) targeted to specific groups that either cannot work (because of physical incapacity, including poor nutritional status) or should not be taken out of other activities (notably school).

Martin Ravallion. 2008. “Bailing Out the World’s Poorest.” Policy Research Working Paper 4763, World Bank, Washington, DC.

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Financial Market Failures: Searching for Lessons, Not Scapegoats

Early statements by policy makers have tended to label the securitization meltdown as purely a “market failure.” But the market’s failures were embedded in a parallel failure in government supervision. Giving more power to regulators without first improving their incentives will not fix anything important. Even in countries whose markets are unsophisticated, good incentives and reliable information can produce effective regulation. That bad incentives generate misinformation and painful losses is the cumulative lesson that this and other crises impart.

Gerard Caprio, Asli Demirgüç-Kunt, and Edward Kane. 2008. “The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats.” Policy Research Working Paper 4756, World Bank, Washington, DC.

Are All the Sacred Cows Dead?

Policy responses to the financial crisis have shaken the confidence of the development community in the financial and macroeconomic policies underpinning Western capitalist systems

The current financial crisis has shaken the confidence of developed and developing countries alike in the very blueprint of financial and macroeconomic policies that underlie the Western capitalist systems. In an effort to contain the crisis, U.S. authorities and many European governments have taken unprecedented steps of providing extensive liquidity, giving assurances to bank depositors and creditors that include blanket guarantees, and structuring bailout programs that include taking large ownership stakes in financial institutions. Few developing countries have even reintroduced capital controls to prevent capital outflows. It is not surprising that many analysts are already declaring capitalism dead, along with the mainstream policy view associated with it.

A new paper by Demirgüç-Kunt and Servén argues otherwise. Keeping in mind the importance of incentives and tensions between short-term and longer-term policy responses to crisis management, the paper addresses several questions about the implications of this crisis for financial and macroeconomic policies going forward:

- Are blanket guarantees inevitable to halt a systemic crisis?
- Should governments bail out and own financial institutions?
- Should governments regulate finance much more aggressively given the failures in market discipline?
- Should monetary policy target asset prices?
- Should countries resort to capital controls to contain the crisis?

Crises recur in part because people forget the lessons from the previous ones. While every crisis is different, past crises provide important lessons that need to be learned so that policy makers need not reinvent the wheel every time a new one erupts.

The paper draws on a large body of analytical research, econometric evidence, and country experience to argue that the “sacred cows” of financial and macro policies are still very much alive. For the most part the confusion arises from an inability to recognize incentive conflicts and trade-offs inherent in short-term and long-term responses to a systemic crisis. Policies employed to contain a crisis—often in a rush to reestablish confidence and without regard to long-term costs—should not be interpreted as permanent deviations from well-established policy positions. While governments may end up providing blanket guarantees or owning large stakes in the financial sector in an effort to contain and deal with the crisis, this does not negate the fact that generous guarantees over the long term are likely to backfire or that government officials make poor bankers.

Financial crises often do expose weaknesses in the underlying incentive frameworks and the regulation and supervision systems that are supposed to reinforce them. But finance is risky business, and it is naive to think that regulation and supervision can—or should—completely eliminate the risk of crises, though they can make them less frequent and less costly. An often overlooked point is the importance of incentives. To be effective, regulatory reforms must improve the chain of incentives under which market discipline and official supervision operate. Reform proposals usually address the structure of regulation but not the incentive structure of regulators, which is likely to limit the effectiveness of the reforms.

Neither monetary policy nor capital controls can substitute for well-designed prudential regulation. While most observers agree that lax monetary policy in the United States in the early 2000s helped fuel the housing bubble, trying to use monetary policy to prick asset price bubbles may do more harm than good because identifying and bursting bubbles in a timely manner is very difficult.

More broadly, monetary authorities in most countries face two objectives:

price stability and financial stability. Attempting to achieve two objectives with one instrument is not a promising strategy. A second instrument is needed for financial stability, and the best option is a prudential regime capable of dampening financial cycles of boom and bust. This is primarily a task for financial regulation. An important pillar of such regulation is the establishment of capital requirements that can automatically be adjusted over the business cycle, providing incentives for financial intermediaries to hold more liquid assets in good times so that they can be run down in bad times. Provisions, leverage ratios, and additional capital buffers can all be designed to be countercyclical. By switching the basis of capital adequacy requirements from levels of risk-weighted assets to their rates of growth, these measures require additional capital and liquidity when bank lending and asset prices are rising fast, and relax such requirements in the downturns.

These proposals can be seen as alternatives or complements to monetary policies intended to prevent asset bubbles and their bursting. Nevertheless, while it is politically feasible to apply these policies and relax requirements in downturns, it is questionable whether they will be as easily tightened in upturns, without greater accountability and appropriate incentive reforms for the authorities.

Despite their inherent fragility, financial systems underpin economic development. The challenge for financial sector policies is to align private incentives with public interest without unduly taxing or subsidizing private risk taking. Public ownership or overly aggressive regulation would simply hamper financial development and growth. But striking this balance is becoming increasingly complex in an ever more integrated and globalized financial system.

Aslı Demirgüç-Kunt and Luis Servén. 2009. “Are All the Sacred Cows Dead? Implications of the Financial Crisis for Macro and Financial Policies.” Policy Research Working Paper 4807, World Bank, Washington, DC.

Beyond Doha

The current Doha agenda cannot adequately deal with all the challenges in trade. Is it time to aim for a broad agenda?

The recent G-20 summit communiqué included a commitment by world leaders not to impose protectionist measures. The ink was barely dry before several countries took measures to protect domestic firms. The Russian Federation imposed a number of import tariffs. India slapped restrictions on steel. Indonesia introduced licensing to regulate a wide range of imports. France created a fund to protect French firms. The United States and the European Union are in the process of providing state aid for the domestic auto industry. Earlier, China had increased its value added tax rebate for exports and is now publicly worrying that the renminbi is, yes, overvalued.

As the financial crisis has morphed into a crisis in the real economy, the world is facing a sharp and perhaps prolonged economic slump. In these circumstances resurgent protectionism is a real threat, especially since preexisting anxieties about globalization are widespread. Restrictions on trade and investment would deepen the recession and undermine efforts to reduce poverty.

Recognizing these dangers, and to head off protectionist pressures, leaders at the G-20 summit called for completing the Doha Development Agenda of trade negotiations at the World Trade Organization (WTO). But the current Doha agenda cannot adequately deal with all the challenges facing the trading system.

First of all, any likely Doha deal would deliver little by way of new market opening. It would also provide only limited insurance against future reversal of trade policies. The recent trade restrictions attest to the fact that the WTO does not bind developing countries' policies effectively. Even if the Doha talks had not stalled in July 2008 and had resulted in a deal, the outcome would not have

seriously changed that. Doha also would do little to tighten disciplines on contingent protection in the form of antidumping and safeguard actions. Such instruments, which some industrial countries adopted in past recessions, are now employed by many developing countries.

Moreover, pressures for protection are coming from new areas. Concerns have already been expressed in the United States and the European Union about undervalued currencies that tax imports and subsidize exports, hurting the profitability of industries in other countries. Capital can relocate to escape these adverse effects, leaving immobile, generally low-skilled labor to bear the brunt of these states' declining competitiveness. New multilateral rules are needed to address genuine trade distortions arising from such exchange rates while precluding unilateral action.

As the pace of climate change quickens, there is increasing talk of using trade as an instrument for furthering environmental objectives. The most prominent climate bills in the U.S. Congress envisage some form of trade-restrictive action against imports from countries not deemed to be taking "comparable action" to that of the United States. The European Union has been contemplating similar action. Without multilateral rules, environmental concerns could easily become an excuse for trade restrictions.

Similarly, the industrial countries are going to be under pressure to subsidize declining industries, starting with cars and trucks. Such support, regardless of its merits, will adversely affect competitive conditions and distort trade. A fresh look at multilateral rules will become necessary to discipline the granting of such subsidies.

Finally, there are challenges for collective action from agricultural and oil markets. Prices in these markets have dropped sharply recently, but we should not forget that only a few months ago we saw a new and dangerous form of protectionism in agriculture—on the export side—and

a cartelized oil market interacting with high demand to deliver unprecedentedly high prices. The global trading system does not effectively regulate export restrictions in agriculture and, most strikingly, no mechanisms exist for blocking collusive government action in the most important traded commodity—oil. Multilateral rules will have to address these gaps.

Is it realistic for the trading system to aim for a broad agenda that includes exchange rates, the environment, state aid, and oil and agricultural markets? Ironically, a bigger agenda that addresses the new concerns would improve the prospects of success because there would be greater scope for give-and-take between the major trading countries. China will have to recognize that its exchange rate policies can provoke a protectionist reaction; the United States and the European Union will have to refrain from excessive recourse to contingent and environmental protectionism and to subsidies; and emerging market economies such as India will have to appreciate that keeping markets open will require an effort on their part to lower their significant trade barriers.

In the wake of the financial crisis, the challenges on trade are becoming more urgent. The new Bretton Woods process is an opportunity to rethink not just the architecture for international finance but also that for international trade. How much a successful Doha would deliver can be debated, but the importance of issues that Doha does not address is becoming glaringly evident. It is in this sense that the world must now look beyond Doha.

Aaditya Mattoo and Arvind Subramanian. 2008. "Multilateralism beyond Doha." *Policy Research Working Paper 4735*, World Bank, Washington, DC.

———. Forthcoming. "From Doha to the New Bretton Woods: A New Multilateral Trade Agenda." *Foreign Affairs*.

The Impact of the Financial Crisis on the Developing World

Growth is forecast to decline across developing regions in 2009, though effects of the financial crisis differ greatly

Throughout the developing world, growth is forecast to decelerate in 2009—as a result of falling exports and remittances, stock market declines caused by capital flight, widening sovereign spreads, and depreciating local currencies—though a recession is not expected. The reversal of the rise in fuel and food prices is shifting terms of trade and helping to ease inflationary pressure. The size and implications of these effects differ greatly across developing regions, depending on the structure of regional economies and their integration into world markets.

East Asia and Pacific. The rapid trade and investment growth that has supported economic development in this region has also made it vulnerable to the downturn in global demand. Most affected will be the smaller, heavily trade-dependent economies such as Singapore. China has a more solid domestic demand base and was able to build up considerable buffers: \$1.9 trillion in international reserves, a \$400 billion current account surplus, and a balanced budget in 2008. The government has announced a \$586 billion stimulus program. Fiscal and monetary intervention in the region is helped by an easing of inflation due to commodity price declines. Terms of trade are improving for China, though not for the region's hydrocarbon, food, and raw materials exporters. Thanks largely to China, growth is expected to remain robust, though GDP per capita growth is forecast to fall below 6 percent in 2009.

Europe and Central Asia. Tight links with Western Europe leave this region directly exposed to the financial crisis. Outside the Russian Federation, banking is dominated by Western institutions, many of them severely troubled. Industrial production is heavily reliant on demand from Western Europe. A slowdown in remittances will hurt

poorer countries (Bosnia and Herzegovina, the Kyrgyz Republic, Moldova, Tajikistan). Large external financing needs are creating debt rollover risks for Bulgaria, Hungary, Romania, Serbia, Ukraine, and the Baltic states. Five countries have concluded or are negotiating deals with the International Monetary Fund for emergency financing. The decline in commodity prices poses particular problems for oil and gas exporters such as Russia, whose budget balance and currency are exposed to major downward pressure. GDP per capita growth is expected to fall below 3 percent in 2009.

Latin America and the Caribbean. Close integration with the United States through trade and capital flows makes this region particularly vulnerable to the crisis. The worsening U.S. contraction is having a strong, direct impact on exports, foreign investment, and remittances. With net commodity exporters accounting for more than 90 percent of the region's GDP and population, food and fuel price declines are hurting terms of trade and fiscal revenues. Deteriorating current account balances and soaring sovereign spreads have made it more difficult to meet foreign debt obligations, as shown by the recent default of Ecuador. On the upside, inflation, previously a major policy concern, has eased in most countries, though imported inflation may increase as currencies depreciate further. GDP per capita growth is expected to fall to 2 percent in 2009.

Middle East and North Africa. The region is relatively well positioned to weather the financial aspects of the crisis but will suffer from commodity price declines. Banks and investment companies had few toxic assets, equity markets have fallen somewhat less, and sovereign spreads have risen less than in emerging markets as a group. Oil-rich countries have built up international reserves in recent years. But with the collapse of oil prices, current account and fiscal balances are projected to decline steeply. The more diversified, non-oil-exporting economies—Jordan, Morocco, and Tunisia—

may gain from lower commodity prices on the trade side (and will likely see lower inflationary pressures), but links with European economies in recession put their industrial production at risk. The declining oil prices also mean risks of lower foreign direct investment and remittances from Gulf countries. For the region, even if oil prices recover to \$65–75 a barrel, GDP per capita growth is expected to fall below 4 percent in 2009.

South Asia. Governments' ability to respond to the decline in aggregate demand is constrained by the terms-of-trade shocks of 2003–08. Large net losses from food and petroleum prices have led to a sharp deterioration in current account and fiscal balances, allowing little scope for countercyclical policies. Pakistan is particularly vulnerable, with large fiscal and current account deficits, rapid inflation, low reserves, weak currency, and deep political tensions. India is better placed, having a large and dynamic domestic market, high savings rate, solid financial sector, and proactive monetary policy. Commodity price declines may help terms of trade and create fiscal space for governments. The region's banking sector has been relatively insulated from the financial crisis thanks to limited exposure to toxic assets. But there was a significant correction in equity markets and a falloff in bank borrowing and equity and bond issuance. GDP per capita growth is expected to decline to 4 percent in 2009.

Sub-Saharan Africa. While the region's lack of integration into the world economy insulates its banks from the crisis, its economies are vulnerable to the drop in commodity prices and slowdown in private capital flows, remittances, tourism, and aid. An estimated 80 percent of the region's exports are primary or semiprocessed commodities. The rapid price decline will drastically curtail fiscal and export revenues, particularly in Angola, Chad, Mozambique, and Nigeria. Economies

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strengths and weaknesses of past policy responses. The lessons span financial sector policies, macroeconomic stabilization, external trade policies, education and health care, and social protection. Many specific lessons emerge, but there is space here only to point to some generic lessons. (Other articles in this issue elaborate on some specific areas.)

The generic lessons include the importance of an early response. The fiscal cost of interventions can be quite large, but the cost of inaction can be even larger. Other generic lessons include the importance of an understanding of incentives in designing policy responses, the importance of spending composition in designing a fiscal stimulus or adjustment program, and the importance of sound information on what is happening on the ground as the crisis unfolds.

If there is one lesson that stands out, however, it is this: that the short-term responses to a crisis cannot ignore longer-term implications for development in all its dimensions. The macroeconomic stabilization response must be consistent with restoring the growth process and thus the pace of poverty reduction. Financial sector policies need to balance (understandable) concerns about the fragility of the banking system with the needs for sound longer-term financial institutions. And the social policy response must provide rapid income support to those in most need—giving highest

priority to the poorest among those affected—while preserving the key physical and human assets of poor people and their communities. Difficult choices will be faced in addressing the inevitable trade-offs between rapid crisis response and these longer-term development goals.

Development Research Group. 2008. "Lessons from World Bank Research on Financial Crises." Policy Research Working Paper 4779, World Bank, Washington, DC.

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The Impact of the Financial Crisis on the Developing World

relying heavily on tourism—Kenya, Mauritius, the Seychelles—can also expect a sharp drop in earnings. Remittances to Africa, 77 percent of which come from the United States and Europe, may also suffer. Foreign direct investment inflows are highly concentrated, primarily in Nigeria and South Africa. Even these larger economies are susceptible to greater risk aversion by investors. The last quarter of 2008 saw a drop in portfolio investments and a 40 percent decline in stock market values. While aid tends to be more stable than private investment, a cutback is possible.

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