Financial Crisis and Global Recession: At a Turning Point?

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Main messages

- Recession in the US now appears to be bottoming out, but speed and strength of recovery is uncertain.
- Even though recession will eventually end, several daunting challenges remain, particularly for the poorest countries and vulnerable social groups.
- Domestic policy is critical, but generating a sustained recovery requires new forms of multilateral collaboration.
Causes: Macroeconomic policy and changes in the financial system create conditions for the perfect financial storm

- Excessively easy money after 2001
- Fiscal stimulus as US budget swung from surplus to large deficit
- Expansion of opaque financial innovation
  - Subprime mortgages
  - Home equity lending
  - Consolidated Debt Obligations
  - Credit Default Swaps

Emergence of unregulated borrowing in the *shadow banking system*
  - Mortgage companies
  - Investment banks
  - Hedge funds

...leading to excessive leverage of consumers, corporates, and public sectors

...financed by China and other countries accumulating large reserves
...but the problem goes back to financial deregulation after 1980 and again after 2001
...and the deteriorating global imbalances


Crash of Lehman in September...precipitated financial panic that swept through global markets

MSCI equity price indexes, January 2005=100

So...
- 30% of household wealth wiped out
- $4 trillion of equity worldwide
- Pension funds obliterated
- Unprecedented contraction in consumption

Contracting consumption in rich countries transmits recession to poor countries – as world trade collapses.
Trade plummets in all regions

Export Growth by Region

Source: Datastream, U.S. Commerce Department and authors' calculations. Simple average of growth rates across economies within regions for a balanced sample of 45 economies reporting data.
Terms of trade shocks will compound difficulties in several countries...

Terms of trade impacts
July 2008 to February 2009

Developing, East Asia, Eur/Asia, LAC, MENA, South Asia, Africa

Source: World Bank, DECPG.
...and diminished **capital flows** have deepened recession in the developing world

Net private capital flows / GDP in developing countries

So now the world economy is contracting…. for the first time in the last half-century

Developing countries stand to lose some 4 percentage points of GDP growth

Some 90 million additional workers are expected to be trapped in poverty – with some 47 million in South Asia and 24 million in South-Saharan Africa.

Projected growth of GDP in 2009

Source: World Bank, DEC prospect group, April 2009
Green shoots? Incipient signs of recovery....?

Credit markets have stabilized...secondary markets beginning to reappear

Spread between 3 month $ LIBOR and $ OIS

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Green shoots? Incipient signs of recovery...

- Credit markets have stabilized...secondary markets beginning to reappear
- Equity markets appear to have established a floor
- Personal income in US rose 0.4% in April...household savings hit 5.7% of disposable income (highest since 1995)
- Some life in the real sectors...

Green shoots? Incipient signs of recovery….

…and China’s fiscal stimulus is beginning to take hold

Outlook? Recovery will probably begin later this year or early next year ... but strength is uncertain

Shape of the coming recession depends on responding to several daunting challenges...

Daunting challenge: for rich countries, taking bad debt off the books of the banks


Market Value as of Q2 2007, US$ b.

Source: Bloomberg, Jan 20th 2009
Daunting challenges: Providing adequate financial support to maintain growth in developing countries

Financing gaps range from $200 b to $700 b.

Estimated funding gap in 2009 by region

Daunting challenges: At-risk countries...

Those are at risk:
- export only a few commodities
- have large % in poverty
- have weak fiscal positions
- have low reserves/high debt

Implications of slowdown...
- Crises in Mexico, Argentina, and East Asia increased poverty dramatically
- 200 million likely to be trapped in poverty
- Infant mortality and child mortality rises – 200,000–400,000 infants annually
- Cutbacks in health services

Source: IMF, 2009
Daunting challenges: Providing support to workers and the poor

Widening fiscal deficits will put pressures on social safety nets

Fiscal deficits will widen sharply in 2009

Daunting challenges: Providing support to workers and the poor

- Widening fiscal deficits will put pressures on social safety nets
- Poor households suffer declines in remittances

Remittance flows to developing countries (USD, % change)
Daunting challenges: Providing support to workers and the poor

- Widening fiscal deficits will put pressures on social safety nets
- Poor households suffer declines in remittances
- ...and continued higher food and fuel prices

Source: World Bank, Prospects Group
Daunting challenges: Providing support to workers and the poor

- Widening fiscal deficits will put pressures on social safety nets
- Poor households suffer declines in remittances
- ...and continued higher food and fuel prices
- Firms will face tighter credit conditions and weaker demand, so they will be slow to create new jobs... and unemployment will rise

Daunting challenges: Providing support to the unemployed

- 23 million more workers will be unemployed in 2009 than in 2007
- Recessions with housing busts involve deepest employment cuts and longest period of recovery (Claessens, et al, 2008)
- Jobs are lost more quickly in contraction than are replaced during subsequent recovery (Rijkers, 2009)
- Employment usually takes twice as long to recover as output (Reinhard, et al 2002)
- Poor urban workers often move to agriculture if that is feasible (e.g., in East Asia crisis, 30-40% of displaced workers moved).
Policy options? For developing countries…

- **Counter-cyclical policies:** But only open to countries with access to noninflationary sources of finance and a sound investment climate

- Since trade is a main channel of recession, policies to reduce trade costs can position countries to take advantage of recovery
  - border and customs reforms
  - port reforms
  - improving logistics management
  - Investment in labor-intensive and trade-related infrastructure, such as rural roads
Policy options? For developing countries…

- Counter-cyclical policies: But only open to countries with access to noninflationary sources of finance and a sound investment climate
- Since trade is a main channel of recession, policies to reduce trade costs can position countries to take advantage of recovery
- Policies to support workers and the poor
  - Increase in unemployment benefits
  - Wage subsidies and lowering wage taxes
  - Tariff reductions on food imports
  - Public employment programs
  - Conditional cash transfers programs (stay in school programs)
  - Public investments in labor-intensive and trade-related infrastructure, such as rural roads
Accelerated restructuring of banks and increased regulation
- Pledge to avoid protection
- Fiscal stimulus and expansive monetary policy
- Mobilization of more capital for developing countries
  - IMF – $700- b. New arrangement to borrow (NAB)
  - World Bank MDBs – Capital increase for ADB
- Reform of the IMF and World Bank – Increased capital, new voting, merit selection of leaders

Multilateral collaboration is crucial... and the G20 leaders have begun the process...

G20 Summit
April 2

Agreed:
... but improving the multilateral response requires...

- Fulfilling pledges for development assistance
- Keeping global markets open and resisting pressures for trade protection – and renewing a commitment to the Doha Development agenda
- Improving regulation of financial markets will require careful balancing of national regulatory authorities with international cooperation
- Developing multilateral governance mechanisms to be more inclusive
Conclusion...

- Recovery is near, but its strength is in doubt and it will take many quarters to have full effect on incomes.
- Meantime, assertive policy interventions are needed to protect core social spending and support households – and invest in reforms that will revive growth.
- The G20 process has helped but much remains to be done – in keeping markets open, financial regulation, and providing adequate development assistance.
Acknowledgements and Selected References

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