

Impact of the Crisis on Poverty and Access to Finance in Developing Countries

Ishrat Husain

1. The purpose of this paper is to examine the impact of the global financial crisis on emerging and developing economies (EDEs) in two dimensions. First, the impact on poverty, inequality and human development and second the impact on access to finance by small and medium firms, small farmers and low income households. In this assessment, a distinction is made between the relatively strong Asian economies and low income countries affected by civil wars, conflicts, natural disasters, geographical and location challenges. Finally, recommendations are made by EDE country type about required reforms.

2. Transmission channels through which global economic downturn influenced EDEs are remittances, aid disbursements, bank lending, private capital flows and international trade. Each channel had different effects and consequently the impact of this global financial crisis differed across countries and regions. However, a few generalizations can be made:

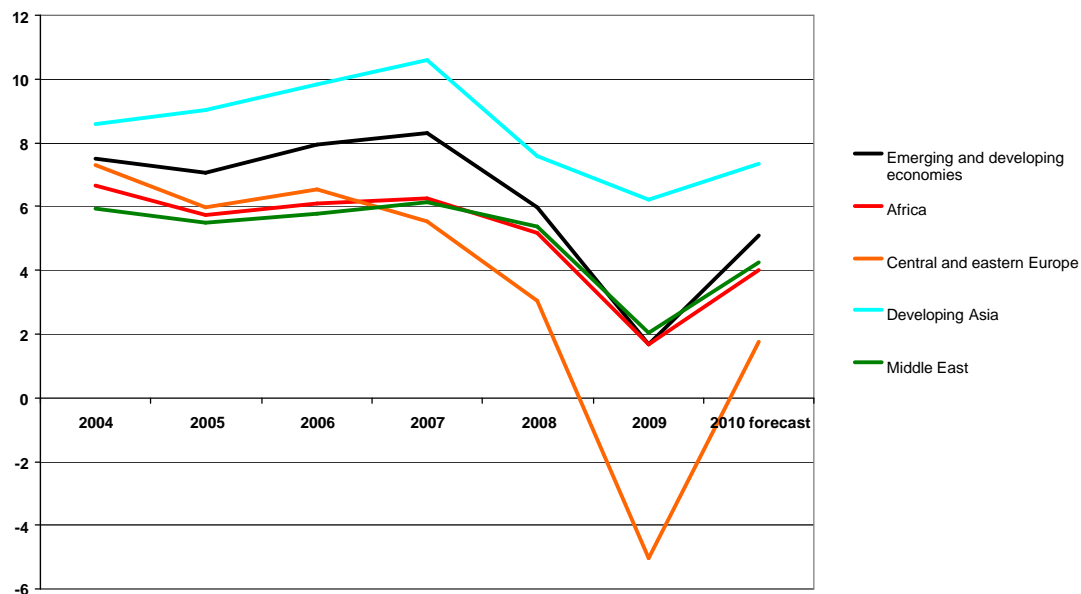
- i) **Correlation exists between EDE and advanced economies (AE) mainly through the real economy** (foreign direct investment, international capital flows and trade) and also through the financial sector for some countries especially in Eastern Europe. Adverse impact on EDEs' real sector was substantial for a limited period despite domestic financial sectors' resilience.
- ii) **Prudent fiscal, monetary and regulatory policies put many EDEs in a strong position at the onset of the crisis.** EDEs that had undertaken financial sector reforms prior to the crisis were able to insulate themselves better from the adverse impact. EDEs who had (i) reduced indebtedness, (ii) accumulated foreign exchange reserves, (iii) strong macro-economic policy frameworks and management in place and those who responded quickly to the crisis fared well. Inflation remained low as inflation targeting and appropriate monetary policy helped anchor price expectations.
- iii) Advanced financial integration, capital account convertibility, and foreign ownership of domestic banks proved a double edged sword that caused high damage.
- iv) Food and fuel prices that escalated between 2007 and mid 2008 had more adverse impacts on most low income countries than the financial crisis.
- v) EDEs with large domestic markets and export diversification such as China, India, Indonesia, and Brazil proved crisis resilient and recovered quickly. This underscored the importance of large emerging economies as the world economy rebalances itself. Low income countries that have more diversified export earnings seem to have borne the shock well.
- vi) Policy response to the recession by governments, the IMF and other multilateral organizations was rapid, better coordinated, and much larger compared with previous crises in EDEs.

EDE regional recovery

3. The following graph illustrates the collapse of EDEs' GDP growth and forecasted modest recovery after a long period of growth. Among EDEs, 20 of 25 middle income countries experienced real GDP declines during the fourth quarter of 2008 and 24 of 26 during the 1st quarter of 2009. In the remaining period of 2009 recovery of EDEs proved

more robust particularly in Asia. Structural reforms carried out for the last two decades have made Latin America and Asia much less vulnerable to external shocks. Only economies linked closely to the U.S. such as Mexico, and Central American states and Eastern and Central Europe those integrated in the European Union markets suffered massively.

Graph 1: EDE GDP Growth 2004-2009 (in % p.a. at constant prices)



Source: International Monetary Fund, Global Economic Outlook Database accessed 24 February 2010

Asia

4. East Asia's GDP growth (except Taiwan, Korea, and Singapore) exceeded that of other regions. While China suffered some temporary setback it is now again poised to lead the recovery with GDP growth expected to exceed 8% in 2009. Its strong fiscal position allowed massive public spending to cushion a slowdown.

5. Thailand, Malaysia, Indonesia and the Philippines have withstood the financial crisis well and had been better prepared after the Asian crisis in 1997-98. Macroeconomic stability was high at the onset of the 2008/09 crisis despite a sharp export decline, which is now reversing. Governments have also cushioned the impact on the most vulnerable citizens through appropriate cash transfers and other social safety nets. However recovery will not be uniform across East Asia.

6. South Asia's terms of trade suffered from the exceptional hike in world market prices of commodities, food and fuel. The region was at the verge of recovery from the commodity price shock when the financial crisis struck. The nature of the financial markets, the relative insulation of domestic banks from the dominance of the global banks, and strong prudential regulation and supervision ring fenced them somewhat from contagion in the first round. But when the world economy slowed down and the advanced economies came to a grinding halt, the adverse impact was transmitted through the channels of exports, remittances, foreign capital flows and tourism earnings.

7. India and Bangladesh did not suffer much from the financial crisis while the subsequent recession has lowered the demand for their exports. India has shown a remarkable resilience being a large domestic market, having a large burgeoning middle class with rising purchasing power and well regulated capital flows. Recent estimates

indicate that India's GDP growth in 2009 was 7 %. Exports have suffered but the contribution of exports to GDP is low. Macro-economic stability is threatened by rising inflation and growing fiscal deficit. The risks from India's exposure to the international financial markets have been offset by strong foreign exchange reserves, prudent debt levels, high savings rate, sound financial sector and a pro-active monetary policy management. The Central Bank responded by injecting liquidity into the financial system and allowing a depreciation of exchange rate, helping in arresting capital outflows.

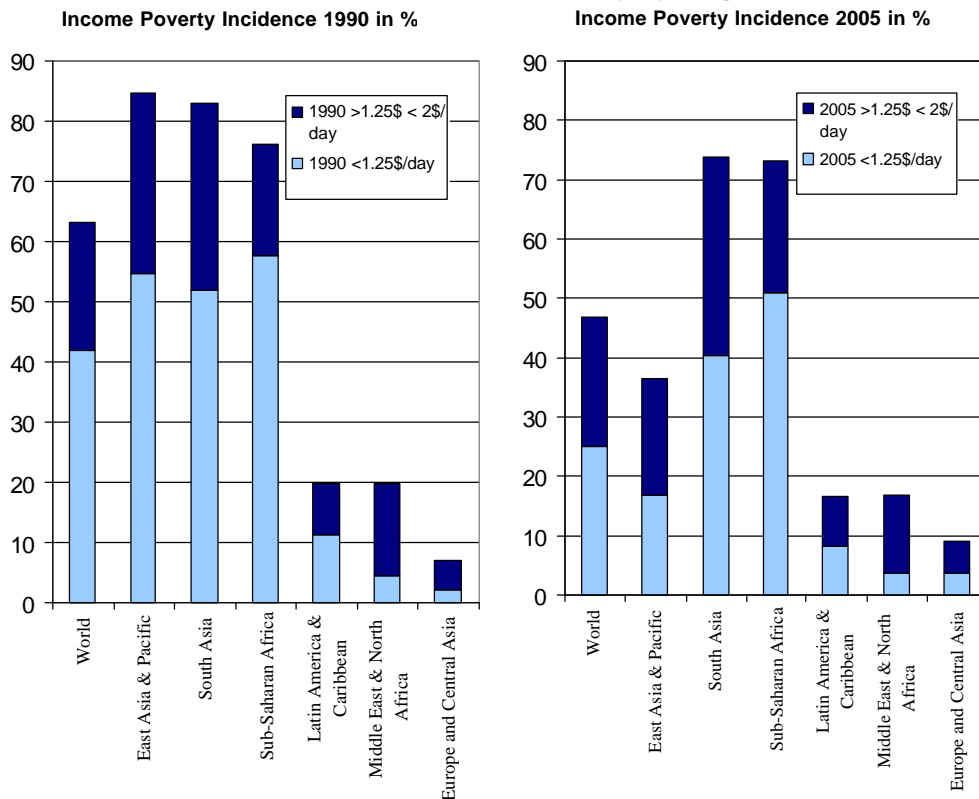
8. Workers' remittances to South Asia are a major source of foreign exchange earnings and have kept up momentum despite the slow down in the oil exporting countries. Bangladesh has been resilient as its foreign exchange reserves have reached an all time high, exports are on an upward incline and the remittances are rising steadily.

9. Pakistan faced an economic and political crisis that had little to do with the global crisis. Pakistan's high growth rates of 7 % over much of the 2000s tumbled to about 2% within only two years. It is undergoing a macro-economic stabilization program with the assistance of the IMF. Pakistan's cumulative terms of trade losses from the world price increases in fuel and food is estimated by the World Bank to be around 11 %. The postponement of key policy decisions to pass on the price hikes to consumers, neglect of economic management during the transition from the military to the democratic elected government and internal security problems arising from its role as a front line state in the war against terrorism exacerbated the situation.

Poverty impact of the crisis

10. Income poverty has showed an impressive decline across the world over the past two decades. However progress has been uneven as presented in the graphs below:

Graph 2 - Incidence of Income Poverty by Region 1990- 2005

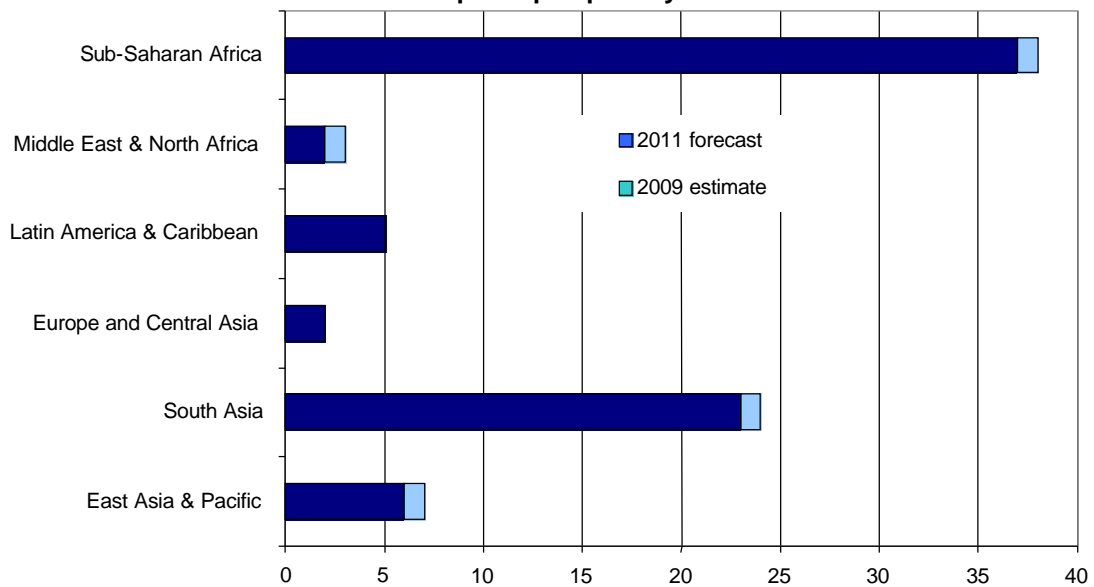


Source: World Bank Global Economic Prospects, January 2010 database accessed 24 February 2010

11. Most impressive is the progress in East Asia thanks to the large growth of China and other East Asian economies, whereas progress in South Asia, especially India has been steady but more subdued. Africa’s decline has been and is expected to continue on a much slower pace compared to other developing regions. Middle income regions still display significant levels of poverty which showed moderate decline over the past decades. Another important observation is that the reduction in poverty is largely attributed to the most vulnerable groups (defined with per capita incomes of up to USD 1.25 per day) while those less vulnerable (between USD 1.25 and USD 2 per capita per day) remained more stable.

12. How has the crisis impacted on the incidence of poverty? The World Bank estimates that an additional 64 million people will move into poverty in 2010 after about 50 million in 2009. While the secular trend of poverty reduction has in some regions come to a standstill, the robust growth, especially in Asia suggests that the overall trend of decline in income poverty will continue as indicated in Graph 3 below:

Graph 3 - Incidence of Poverty Headcount Index by Region in % at less than 1.25USD per capita per day



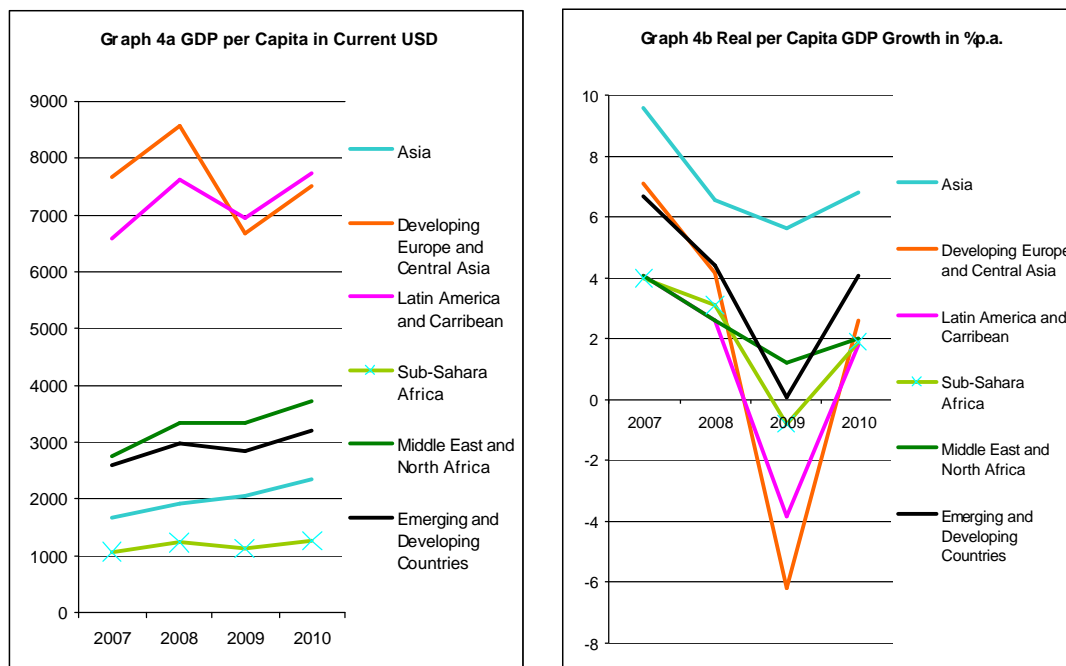
Source: World Bank Global Economic Prospects, January 2010 database accessed 24 February 2010

13. Unemployment has soared from 5.6% in 2007 to a high since the Second World War reaching 8.5 % in 30 high income OECD countries. Job losses have particularly affected the disadvantaged groups such as young people, low skilled workers, immigrants, ethnic minorities and temporary staff. The IMF warns that there is likely to be a ‘jobless recovery’ with high unemployment and companies waiting a long time before hiring new staff. Rising job losses can depress real sector demand posing a threat to recovery. The loss of migrant workers jobs in high income countries adversely affected labor exporting EDEs. ODI estimates that developing countries may have lost at least USD 750 billion incomes in 2009. ILO estimates that 20 million jobs will disappear by the end of 2010 as a result of the impact of the financial crisis on the global economy. The aggregate number of unemployed will rise from 190 million to 210 million.

14. The IMF estimated in October 2009 the total financial sector losses at \$2.8 trillion between 2007 and 2010 in the U.S., Europe and Asia. This is equivalent to 5 % of the value of the world GDP in 2009. Across G20 countries, the average public deficit is expected to increase from 1.1 % of national income in 2007 to 6.9 % in 2010. Public debt in advanced G20 countries is expected to rise from 75 % of national income to 115 % by 2014. This permanent loss of output will hit households hard through rising unemployment.

15. As the poor are less able to insulate themselves against shocks, it is possible that they have become more vulnerable to future shocks. In absence of effective social safety nets in most of EDEs those marginally above the poverty line may have fallen back below the line after the crisis.

16. Graph 4a below illustrates high volatility of GDP per capita before and after the crisis in middle income regions of Eastern Europe and Central Asia and to a lesser extent Latin America. Low income developing countries GDP per capita showed an upward moving pre-crisis and stable trend in the crisis, whereas Asia showed an almost unabated upward moving trend. Graph 4b shows that real per capita GDP growth in all developing regions had tumbled in 2008 and 2009, however differentiates sharply between Asia at the high end and middle income and oil exporting developing regions of Europe and Central Asia, Latin America and Middle East and North Africa at the lower end. Sub-Saharan Africa also declined significantly however from more moderate levels.



Source: World Bank Global Economic Prospects, January 2010 database accessed 24 February 2010

Asia

17. An ADB conference in Hanoi discussed the crisis impact on the Asian poor in September 2009 and reached the following conclusions:

- (a) So far, the crisis did not trigger mass unemployment or poverty in Asia.

- (b) The crisis has affected the income poor classified at an income of up to 2 USD per capita per day whereas the most vulnerable group classified at less than 1.25 USD per day appears to be less affected
- (c) The urban educated youth, women in export sectors, migrants (international and rural-urban) and children were affected, while the overall picture was diverse by country and social groups.

18. Governments in East Asia cushioned the impact on the most vulnerable citizens through cash transfers. But due to the crisis 10 million more people are projected to remain in poverty.

19. Despite buoyant growth in China, an estimated 25 million migrant workers were laid off lowering remittance flows to rural China. Unemployment is expected to reach about 23.6 million. As many as 670,000 small firms went out of business in China in 2008 and 2009.

20. India's social safety nets and social transfers (see Para. 25) did play an important role in protecting the poor. Recent estimates do not show serious increases in the number of the poor in India although India's gems and jewelry industry laid off 200,000 workers since the onset of the crisis.

21. Bangladesh's and Pakistan's low income groups are protected through overseas workers' remittances. But low growth and high inflation are expected to increase the incidence of absolute poverty in Pakistan.

Sub Sahara Africa, Developing Europe and Middle East

22. There are 43 Low Income Countries (LIC) mostly in Africa who limited room to maneuver during the crisis. This group consists of smaller, poorer countries, countries in conflict, weak and fragile countries that depend heavily on aid and remittances. In that group GDP growth slowed in 2008 and 2009 also witnessing high commodity price volatility prior to 2007. Food prices in August 2009 were still about 60% above 2005 while energy prices are 28% above their average in 2005. Terms of trade have somewhat improved in 2009 due to lower oil prices while oil exporters saw their incomes fall by 5.4% of GDP. Export values from LICs dropped by 14 % in 2009 prompting layoffs in exporting industries. The aggregate trade deficit rose from 6.3 % to 9.2 % of GDP. Current account deficits are up from 8.7 % to 11.7 % of GDP while the world wide tourism revenue declined by 8 % in 2009. Net private flows continuously dropped sharply to \$13 billion in 2009 from \$30 billion in 2007 while remittances, an important source of foreign exchange, fell moderately by 5-7% in 2009.

23. As the Governments are forced to reduce public expenditure, households are pushed into poverty, health conditions deteriorate and school attendance declines. Similar effects were observed from declining remittances from overseas workers. In thin domestic credit markets Government borrowing crowds out the private sector as the domestic banks prefer less risky assets. Poverty should increase significantly in Sub-Saharan Africa as real GDP contracted in 2008 and 2009 the first decline in a decade. Unemployment has risen and the region lacks extensive social safety nets.

24. In Eastern and Central Europe, forecasts suggest that unemployment will remain high for some time and some of the increase in unemployment will become structural. Labor market policies continue to focus on protecting other groups that are mostly at risk. Unemployment in the Middle East is quite high and youth unemployment is a matter of concern as it may cause social and human crisis.

Mitigating Poverty - Experience of social safety net programs

25. India is a successful example where the social impact of the financial crisis had been marginal. Its regularly operating social safety net programs cushioned the transient population that was adversely affected by the global crisis. The National Rural Employment Guarantee Program (NREG) is designed to provide 100 days of guaranteed employment at the minimum wage of Rs.100 per day (equivalent to US \$2 per day) to one member of each household. For example urban workers who became unemployed as a result of the decline in jewelry and gem exports were able to migrate back to their villages and secure employment under the NREG program. At its peak 50 million registered under the program and as the economy is on the path to recovery registrations have been dropping to pre-crisis levels. This government-financed program proved an excellent vehicle for temporary absorption of unskilled, retrenched and other low income vulnerable groups into the work force.

26. Similarly, an agriculture loan waiver program proved effective in relieving the vulnerable rural population from the high level of debt servicing obligations and enabling them to cope with the dislocations caused by the crisis.

27. These examples and conditional cash transfer programs show that no exceptional measures are required to temporarily alleviate the burden on the poor during an economic downturn if existing social protection programs are well designed with built-in flexibility. Counter cyclical social transfer mechanisms, where funding access expands during the crisis and contracts during good times, is commendable for other EDEs.

Impact on EDEs' Financial Sector

28. Access to finance is much determined by country specific conditions of the domestic financial sector. However, the crisis has provided some useful general insights:

- (a) Regulation of banks was well focused with commercial banks and standard banking products forming the bulk of financial intermediation. The weight of non-bank entities such as investment banks, hedge funds, private equity firms, insurance companies, off-balance sheet exposures and special purpose vehicles that triggered the crisis was almost negligible.
- (b) Except for Eastern Europe and a few other countries regulators insisted that credit expansion should be mainly funded by domestic deposits. Regulators were also (i) adverse towards exotic foreign derivatives, such as collateralized debt and loan obligations and high leverage and (ii) hesitant in promoting large scale securitization. Banks were not allowed to follow the "originate and distribute" business model through securitization and retained relationship with the borrowers throughout the credit cycles. This policy stance supported bank system resilience in many EDEs.
- (c) Excessive risk taking by the banks was kept under active vigilance by the regulators. Although resented at the time as too much intrusion and micro-management this approach proved to be an ultimate savior of the system. Banking systems were relatively well capitalized. Quality of bank portfolios had improved as regulators took prompt corrective actions to clean the balance sheets by getting rid of chronic non performing loans. Substantial improvements have taken place in the quality of banking supervision in the EDEs since the Asian crisis.

- (d) Adequate liquidity support by the central banks proved decisive in boosting market confidence.
- (e) In the context of market panic pricing quotations and mark to market valuation proved unreliable for determining asset values. Temporary regulatory forbearance in enforcing mark to market accounting, loan loss provisioning, and capital infusion strengthened the banks.
- (f) In most EDE markets the share of large foreign financial conglomerates was limited and therefore direct exposure of the significantly important financial institutions to global financial markets was low. The damage to EDEs' domestic financial systems except for Eastern European and some Latin American countries was consequently not significant.
- (g) Capital Controls and limited capital convertibility in China, India, Pakistan, and Bangladesh effectively limited exposure to foreign currency assets.

Asia

29. Asia's banking system came out largely unscathed as the banks were by and large sound, well capitalized and liquid. The period after the Asian crisis had witnessed significant reforms in the financial and capital markets. Notably most banks, the dominant force in financial intermediation, had their restructuring and consolidation completed. Non-banking equity and bond markets have made some headway but remain underdeveloped, thin and shallow. Asian capital markets particularly are more volatile, the investor base is narrow and market infrastructure and governance is still not well developed. However the weight of non-banking activity in the financial sectors and its systemic risks are insignificant. Asian financial institutions' share in the global financial meltdown since July 2007 was limited so far at USD \$39 billion or only about 2.7 % of global losses.

30. The corporate sector that suffered enormously during the Asian crisis had been restructured and therefore was relatively well positioned. Household debt and mortgages extended by the banking system were low.

31. Asian countries that highly depended on the inflow of short term portfolio investments in stocks, bonds and loans from international banks were most affected. The repatriation of capital by foreign investors created temporary liquidity problems in some Asian countries. Korea, Taiwan, Hong Kong and Singapore were worse off. Governments in these countries responded by injecting capital and liquidity, guarantees for deposits and other liabilities, intervening in foreign exchange and stock markets and making swap arrangements to restore confidence in the banking system. Regulatory forbearance or easing prudential requirements was not the norm and was exercised by only a few countries such as Indonesia, Korea and the Philippines.

Eastern and Central Europe

32. In Eastern and Central Europe, financial institutions were vulnerable to deterioration in asset quality because losses in the corporate sector had risen while capitalization remained low. Large cross-border exposures by advanced countries' banks added to the risk of the portfolios held by the domestic banking system. Credit conditions therefore remained tight while public support was not commensurate with the gravity of the problem. The existence of distressed assets and the quality of assets did impair the capacity for external financial intermediation. Stress tests have revealed the need for bank recapitalization to rebuild lending capacity.

33. In Russia, dependence on foreign investment, long term debt and equity capital along with fear of arbitrary and capricious decision making accentuated unpredictability. Massive capital flight by the residents and foreigners led to a drop of more than 50 % in Russia's stock market value. As Russia's fiscal health depends on oil revenues, the falling oil prices further alienated investors. However, large foreign exchange reserves and sovereign wealth funds have helped weather the credit crisis. Russia's banking system is not as large relative to the rest of the economy but borrowing interest rates for small and medium sized enterprises and private households remain extremely high. The volatility of the stock and credit markets point to an immature market coping with one of the biggest challenges it has ever faced.

Latin America

34. In Latin America, domestic financial systems have endured the global crisis well. In particular, the banking systems generally remained sound, reflecting important regulatory and supervisory enhancements introduced before the crisis. Accumulation of large foreign exchange reserves by the leading developing countries also shielded against financial market contagion. However, the foreign investors' and parent banks' flight to quality and liquidity away from the developing countries equity and debt markets and to cover losses elsewhere left a significant financing gap. As credit growth in the private sector slowed, public banks increased their lending to the private sector.

35. Latin America's strong monetary policy instruments included relatively independent central banks, flexible exchange rates and developed local currency debt markets have helped Mexico, Brazil, Chile, Peru and Colombia. Central banks in inflation-targeting economies have cut their policy interest rates by between 375 and 775 basis points since September 2008 while allowing their currencies to float. Monetary policy was eased and complemented by some central banks with liquidity support including lower bank reserve requirements and expanded use of discount windows.

Middle East and Africa

36. The Middle East was hit hard by global recession and growth has decelerated sharply through the collapse in oil prices, sharp contraction in foreign direct investment and excessive borrowing by companies in Dubai. The banking systems of several oil exporting countries could come under severe stress if global financial conditions remain tight. However, sovereign wealth funds in Abu Dhabi, Qatar and Kuwait can come to their rescue if needed. Some economies have reduced policy interest rates as inflation has fallen. Some central banks intervened in the banking systems by injecting liquidity, providing guarantees for private deposits and/or increasing own deposits at commercial banks.

37. In Africa the effect of the global recession was initially felt most strongly in middle income economies such as South Africa which is highly integrated into global markets. The impact then extended to oil and commodity exporters as global trade collapsed. This includes large countries such as Nigeria and Angola, bestowed with sufficient fiscal balances to use as shock absorbers for stimulating domestic demand. Other countries that depend on commodity exports were adversely affected by falling prices. Most African countries have limited access to foreign private and bank financing and as such were not much affected.

38. However, as advanced countries mire in severe recession aid flows to the region may be affected. China has become a major source of financing particularly for resource development and infrastructure in Africa. Chinese manufacturers are also beginning to

relocate some of their production facilities in Africa. As Chinese aid and investment flows have no correlation with advanced countries' aid, the aggregate decline of aid flows to Africa may be negligible.

Conclusion

39. **EDEs that relied on domestic savings for investment proved more resilient than those that relied more on foreign capital.** Short-term foreign inflows seem to increase the volatility and adverse consequences of boom-bust cycles magnifying the risk of destabilization. This suggests that short term financial flows and financially mobile capital can prove highly disruptive to an economy as they can be reversed fairly quickly triggering contagion as well as erosion of public confidence.

40. **International trade remains an important channel for expanding EDEs and raising its peoples' living standard.** The best example is China which has now overtaken Germany as the world's largest exporting nation. The revival of trade is therefore crucial. As the global economy contracted, world trade also fell but proportionately more sharply. As supply chains have become more global and complex a shock to demand is multiplied through the multitude of trading relationships. Once world output recovers to its capacity world trade will grow and EDEs' broad participation in world trade will improve their prospects.

41. **Global banks' ownership in local subsidiaries often resulted in drying up of offshore funds.** Weakness at global banks' home base resulted in (i) increasing NPLs (ii) tightening liquidity due to reduced trade credit flows (iii) withdrawal of liquidity from local subsidiaries of foreign banks, and (iv) contagion risk for regional banks. For example South African Banks own 24% of Africa's banks.

42. **Financial sectors in EDEs have not been particularly responsive to the credit needs of small farmers, small scale entrepreneurs, low income housing and micro-enterprises.** Tighter borrowing conditions, rising borrowing costs and increased risk aversion have further reduced the funds to the poor and vulnerable groups. Finance has traditionally remained limited to the corporate sector, large size businesses export-import trade and high net worth individuals. Microfinance started to penetrate in some countries but it remained peripheral to the mainstream financial sector.

43. Providing access to these excluded groups would help in diversifying assets of financial institutions, increase the client base and provide opportunities for economies of scale. The correlation between corporate asset class and finance to low income groups is low as the crisis does not affect the activities of small businesses, retail shops, and small farm agriculture as severely as it does in the formal and large businesses. Luxury, semi-luxury and other income elastic goods are on the top of the line when a recession hits. The relative demand for cheaper goods at the low-end spectrum increases during bad times.

Beneficiaries of this demand are informal small businesses. If provided with adequate access to finance, it is possible that production, distribution and trading are scaled up by financial resources. This can further lower the end-user prices, which is badly needed in hard times to align with the reduced purchasing power of the customers.

44. Central banks and governments in EDEs can act as catalysts in promoting financial inclusion by imaginative and innovative use of the policy instruments. For example the central bank in Pakistan brought microfinance under the ambit of its regulation and supervision. Microfinance regulations were light and user friendly and were quite different from those applicable to the commercial banks. Dedicated

Microfinance institutions have sprung up while the commercial banks now extend wholesale lines of credit to these institutions. Also the regulators recognized the need to differentiate between corporate and SME bank customers and separated the prudential regulations for these business types as well as microenterprises, agriculture financing and consumer financing. SME prudential regulations called for credit appraisals based on cash flow of the firms as most small enterprises did not possess tangible collaterals and securities. In agriculture financing, revolving lines of credit by which the farmers were not forced to sell their produce at distressed prices soon after the harvest were introduced.

Outlook

45. Prospects for the EDEs will depend on whether the world economy will return to its pre-crisis pace of growth or will grow at much lower rates. Financial sector problems are yet to be addressed. Strong policy implementation remains essential and premature withdrawal of stimulus could jeopardize the recovery.

46. However, the room for policy maneuvers for the advanced countries is limited. Budget deficits of G20 countries that account for 80% of the world economy have risen to 8.1 % of GDP. Indebtedness has already reached an alarming level 100 % of GDP and is projected to reach further to 120 % by 2014. This group of economies would have to generate a fiscal surplus of 4.5 % of GDP every year to contain this debt burden. Fiscal retrenchment of this magnitude will likely slow down economic growth of G-20 countries below that of the pre-2007 period. The probable outcome therefore is that global recovery will remain subdued at low growth rates.

Conclusion

47. Asian countries had learnt the hard way from their 1997-98 Asian crisis and developed a number of shock absorbers that made them more resilient to crises:

- (a) Pre-crisis macro conditions were favorable. Prudent macro-economic management, sound economic policies, open trade and investment regimes, accumulation of sufficient foreign exchange reserves, and an enabling environment for business promoted stability and growth. .
- (b) Social safety nets and social transfer mechanisms effectively absorbed income shortfalls of the poor and those who became unemployed through the crisis.
- (c) The regulatory and supervisory capacity and the enforcement of the prudential norms and regulations were strong. Bank supervision was vigilant on excessive risk-taking and leveraging and transparency, disclosure and enforced market discipline across all types of FIs.
- (d) A shadow system with a massive build up of assets and liabilities that escaped the regulator's watch was discouraged.

48. **The outstanding challenge for financial sector policies in other EDEs is therefore the resumption of credit growth.** The shaken confidence has stirred a culture of risk aversion among lenders and bank credit to the private sector has dried up.

49. The IMF Global Financial Stability Report (GFSR) issued in October 2009 concluded that financial markets have rebounded, emerging market risks have eased, banks have raised capital and wholesale funding markets have reopened. However the report warns that *"credit channels are still impaired and the economic recovery is likely to be slow."* *The GFSR analysis shows that deeper financial reform, the resolution of*

weak banks increase in bank capital and bad debt resolution are ways to enhance lending and supporting economic recovery.

50. **To provide clarity and boost confidence governments must ensure transparency and contain the risks of financial institutions.** Large financial institutions showed a massive concentration of risk and their collapse harmed not just shareholders and employees but a host of other innocent by-standers. While the spreading of risk is generally stabilizing for a system, this does not hold for extreme circumstances such as for the global loss of confidence. The assumption that free markets produce a superior outcome does not work in practice because lending is more pro-cyclical and downturns are more severe.

51. **Regulations on capital ratios force greater prudence in booms and cushion de-leveraging during a bust.** A strong body responsible for regulating and supervising systemically important financial institutions irrespective of their business is needed. The US and Europe have commenced a reassessment of their financial regulatory systems but reforms had limited success so far. If the influence of the EDEs is expanding the G-20 has to consider ways for better coordination among the regulators. Risk management in financial institutions is still driven largely by the pro-cyclical capital adequacy frameworks.

52. **Greater reliance on stable deposits** by the banking systems permitted maturity transformation, provided ample liquidity and preserved confidence among the investors.

53. **Capital account liberalization has been a highly contentious issue.** Before the Asian Crisis in 1996 a number of leading economists and institutions such as the IMF had advised the emerging and developing countries to liberalize their capital accounts. However, this enthusiasm waned after the crisis badly hit the countries with fully convertible currencies such as Indonesia and Thailand. At that time countries such as China, India and Pakistan did not suffer much and it was argued that they were insulated because of partial capital convertibility. The same parallel is being drawn for the 2008/09 crisis when the capital liberal economies of Eastern and Central Europe suffered relatively more compared to China and India which still maintain partial convertibility.

54. **The EDEs should avoid that high financial liberalization compromises on financial stability.** Jagdish Bhagwati, a renowned proponent of trade liberalization, has openly voted against financial liberalization. However in practice the two are bundled.

55. **Global imbalances have emerged as a consequence of slow progress in the EDEs financial sector development.** Foreigners bought U.S. assets because of lack of financial development at home. Size, liquidity, efficiency and transparency of US financial markets attracted \$2 trillion of overseas capital in 2007 in form of direct investment, purchase of bonds, equities and loans. This was more than enough to cover the \$730 billion current account deficit and leave enough to finance \$1.3 trillion of investments by Americans overseas. As a consequence financial sector development in EDEs should be accelerated. Debt Capital Markets and Equity Capital Markets are not that well developed and local currency borrowing and IPOs on a large scale remain limited. These markets should be opened up to the foreigners also to provide depth and liquidity.

56. **The future of financial innovation is currently under intense debate.** "Most financial innovations have favored instruments and intermediaries that promise large returns in the short term. This leads to herding behavior in which risk control becomes a secondary issue." There is ample evidence that few investors understood how exotic

contracts worked, and the extent of their risk exposure. Balancing prudential regulation with financial innovation to support entrepreneurial activity in the real sector, and expand and include low income households within the purview of the formal financial sector, while improving for internal control and risk management within the financial institutions as well as improving international coordination are the challenges for policy makers in the coming years.

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