The Impacts of the 2008 Global Financial Crisis on Developing Countries:
The Case of 15 Most-Affected Countries

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Structure

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Guiding questions

The popular perception regarding developing countries is that they weathered the crisis relatively well.

However, the heterogeneity among developing countries in their ability to cope with the crisis is often disregarded.

The aim of our paper is…

→To explore the transmission mechanisms through which the recent global crisis affected these countries

→To reveal the common characteristics of these countries that made them vulnerable to the crisis

Method

- Our focus is on the big developing countries hit hardest by the crisis in terms of *GDP growth* in 2009.

- 15 relatively big countries which had the lowest growth rates were selected among all developing countries (according to the IMF and World Bank definitions).

- Countries with very small economies that experience frequent fluctuations are excluded.

Countries in our set

- **Transition economies (Former Eastern Block)**

  Armenia, Bulgaria, Croatia, Hungary, Latvia Lithuania, Moldova, Ukraine, Russia and Romania

- **Others**

  Kuwait, Botswana, Paraguay, Turkey and Mexico

Performances of developing countries prior to the global crisis

- The exceptional growth performance of developing countries was significantly related to the positive global outlook after 2001.

→High global demand

→Exceptional financing

→High commodity prices

→Large flows of remittances

Global Economic Outlook Prior to the Crisis

- Financial innovations mainly taking place in the US
- The US current account deficit
- Outstanding performances of China and India

Performances of Developing Countries in 2009

Table 2: Countries which were affected by the global crisis most severely

	2002-06average	2007	2008	2009
Latvia	8.99	9.6	-3.27	-17.72
Lithuania	8.01	9.79	2.91	-14.84
Ukraine	7.44	7.6	2.3	-14.8
Armenia	13.32	13.74	6.94	-14.15
Botswana	5.18	8.68	3.90	-7.84
Russia	7.03	8.53	5.24	-7.8
Kuwait	9.74	5.99	2.48	-7.07
Croatia	4.71	5.06	2.08	-6.94
Hungary	4.20	0.11	0.89	-6.76
Romania	6.16	6.31	7.34	-6.57
Moldova	6.80	2.99	7.8	-6
Bulgaria	5.95	6.44	6.19	-5.47
Turkey	7.21	4.66	0.65	-4.82
Mexico	2.76	3.13	1.21	-4.52
Paraguay	3.83	5.422	6.35	-3.96
Developing Countries	6.86	8.701	5.87	3.11
World	4.31	5.348	2.705	-0.381

Source: IMF, WEO, October 2013

Transition Economies

- Credit growth
  Domestic credit to private sector was higher in the majority of these countries than the upper middle income, middle income countries and world averages.
- Consumption growth
  In connection with large financial inflows and rapid credit growth, there was a rapid rise in consumption expenditures.
- Investment growth
  Rise in investment expenditures and asset prices (especially in Baltic countries)

Transition Economies

- Increase in vulnerabilities

  →Rise in credit growth

  →Real appreciation of exchange rates

  →Worsening of current account deficits

  Bulgaria (25.2%), Latvia (22.4%), Moldova (15.2%), Lithuania (14.4%), Romania (13.42%), Croatia (7.3%), Armenia (6.4%), Ukraine (3.7%)

  →Rising dependency on financial inflows

Transition Economies

- Increase in vulnerabilities (cont'd)

→High levels of debt accumulation by private sector, majority of which was denominated in foreign exchange

→Dependency on rising commodity prices (Russia, Ukraine and Armenia)

→Narrow spectrum of industrial products

Transition Economies

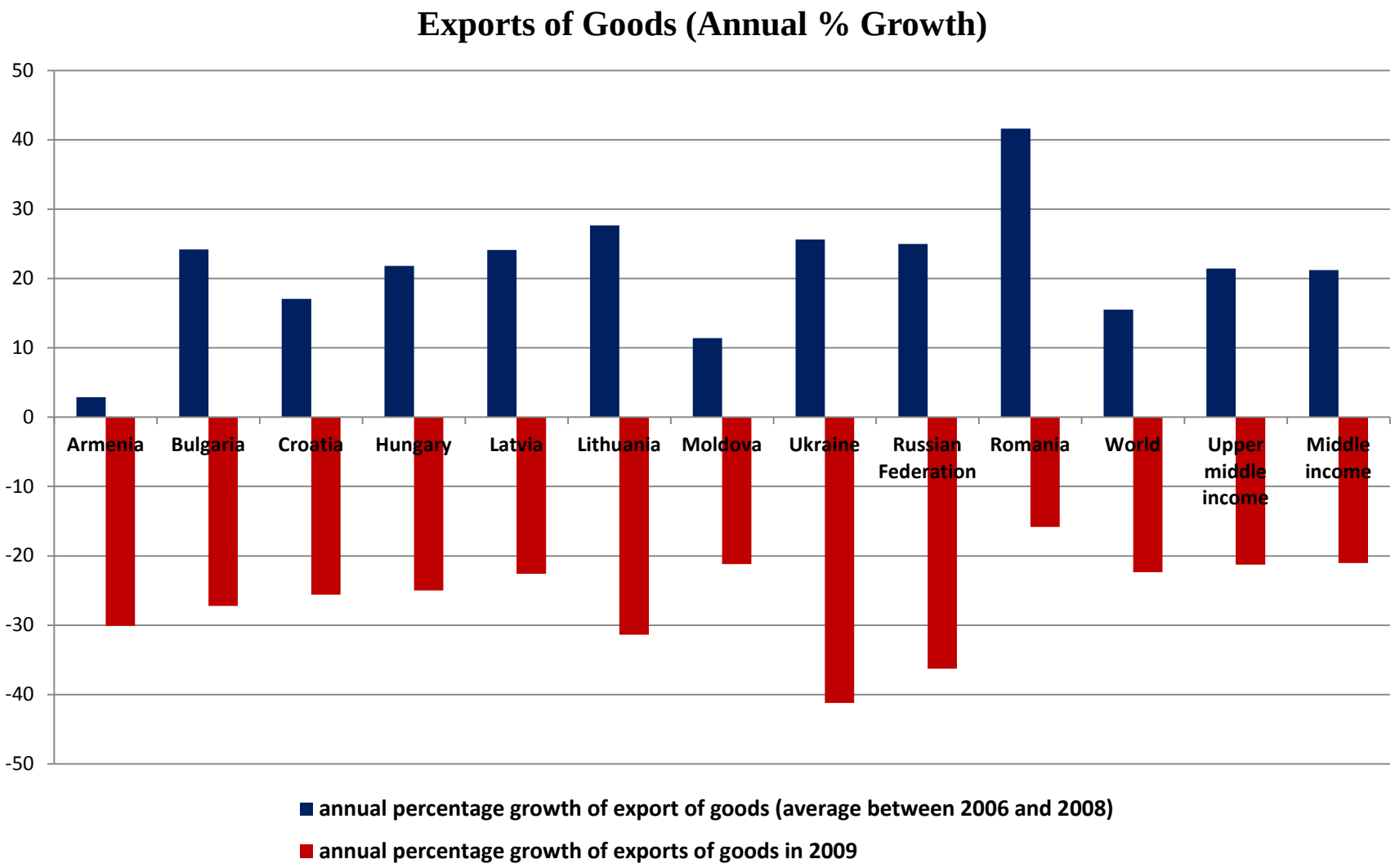
- **Trade Channel**

  Firstly, the demand for goods and services plummeted in 2008. Immediately after, the prices of commodities began to fall. The first mechanism was valid for all of the transition countries whereas the latter hit only commodity exporting countries (Ukraine, Russia and Armenia)

- Geographical Concentration

  Although it is difficult to reach a conclusive verdict, the contagion effect might have been weaker if these countries had diversified trading routes prior to the crisis.

- Restrictions on the Euro zone candidate countries / the choice of exchange rate regimes



Source: WDI, World Bank

Transition Economies

❖ **Financial Channel**

- The loans taken in foreign currency were central for the transmission of the financial crisis

→ With the emergence of a global turmoil, borrowing in foreign currency opportunities decreased as foreign banks reduced their net assets. As asset holdings were reduced, credit to these countries also dried up.

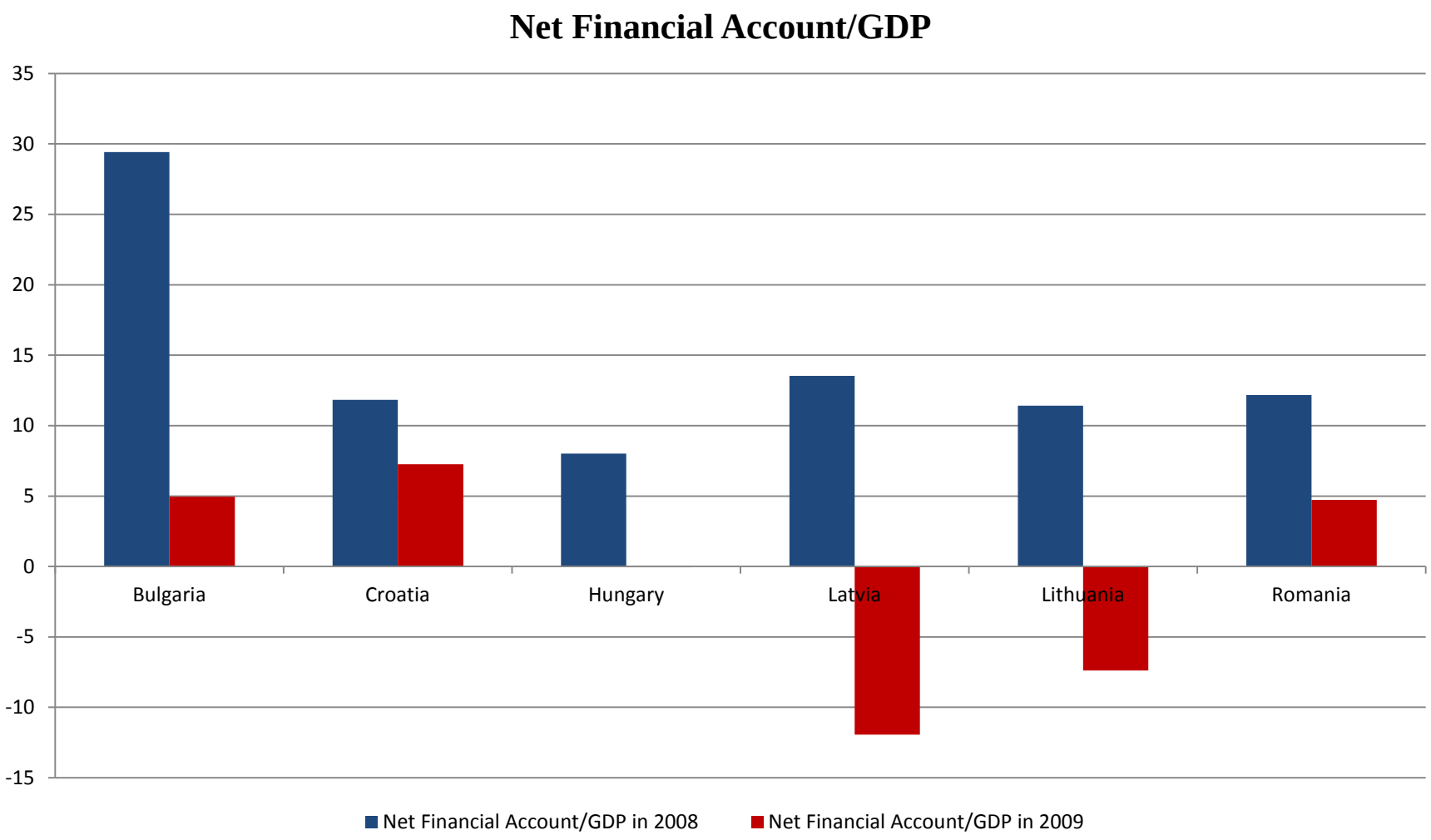
→ This has created significant stress in these countries since they ran up dangerously large current account deficits [except for Russia] and took on substantial international debt.

→ In other words, countries with large current account deficits were disproportionately hit by the crisis as foreign investors deleveraged and capital flows dried up.

Transition Economies

❖ **Financial Channel (Cont'd)**

- Stress in the banking sector due to lack of liquidity (especially in Latvia, Ukraine and Russia)
- Increased foreign ownership of developing country banks, in some cases, turned out to be a source of fragility as these banks withdrew lending to their subsidiaries from developing and transition countries in order to strengthen their very weak positions in developed countries. (For instance, Parex in Latvia)
- 47 Russian banks failed after September 2008 (Fidrmuc and Süß, 2009)



Source: IMF, IFS & Authors' calculations

Other Countries

- Mexico & Turkey

  -Pre-crisis conditions in these countries were relatively better than in the first set of countries (although Turkish case demonstrates some characteristics of transition economies such as high current account deficits)

  - Reforming macroeconomic policy framework in line with neoliberal agenda

  -The Mexican economy did not experience a rapid credit boom accompanied by high investment and consumption increases. Its vulnerability laid in Mexico's limited diversity and high dependency on export revenues and financial flows coming from the US (trade with the US made up 78 percent of Mexico's total trade)

Other Countries

- Mexico & Turkey

  -Stagnating investment rates (both in Turkey and Mexico)

  - They did not devote enough resources to investment in machinery or technology, which play important roles in terms of productivity and sustainable growth paths in developing countries

  -In Turkey, significant worsening of current account deficit (capital inflows → appreciation of exchange rate → worsening of current account deficit

  (+ the role structural problems such as strong dependency on imported intermediate goods)

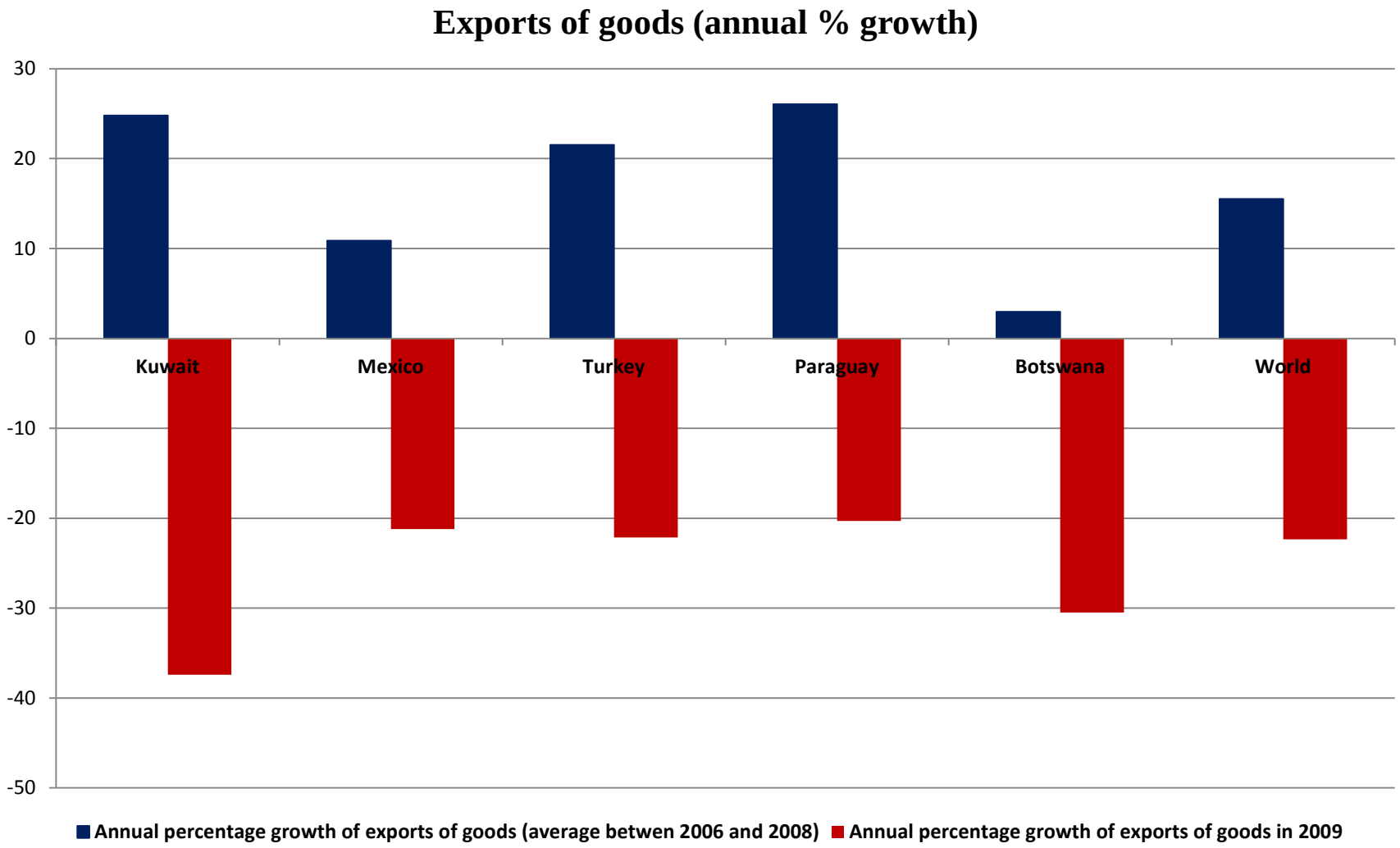
Other Countries

- Kuwait, Botswana and Paraguay

  -They benefitted from high commodity prices

❖ **Trade Channel**

It was mainly the limited number of export partners and high dependency on commodity prices that exacerbated the effects of external shocks in these countries.


Exports of goods (annual % growth)
30
20
10
0
-10
-20
-30
-40
-50
Kuwait
Mexico
Turkey
Paraguay
Botswana
World
Annual percentage growth of exports of goods (average betwen 2006 and 2008)
Annual percentage growth of exports of goods in 2009

Other Countries

- **Financial Channel**

  Turkey, Mexico, Kuwait, Botswana and Paraguay also experienced a decline in the amount of net financial flows. However, compared to the shock that advanced economies and the countries in the first group faced, the magnitude of the decline in net financial flows was relatively small in these countries.

Policy responses

- Developing countries in general

  - Monetary policy

  Contrary to past crisis experiences, developing countries in general were able to conduct countercyclical policies by slashing policy interest rates and pumping liquidity to the financial markets.

  - Fiscal policy

  Developing countries as a group improved their fiscal positions prior to the crisis. Improved fiscal stances across many developing countries allowed them to acquire enough fiscal space to design and implement packages to counteract the contraction in the world economy.

Policy responses

- The majority of the countries we analyze in our paper could not utilize fiscal policy or/and monetary policy relative to many other developing countries.

  -The lack of fiscal space / political will

  -The Euro zone entry requirements

  -Ineffective and/or insufficient monetary policy responses

Policy responses

- **Monetary policy responses**

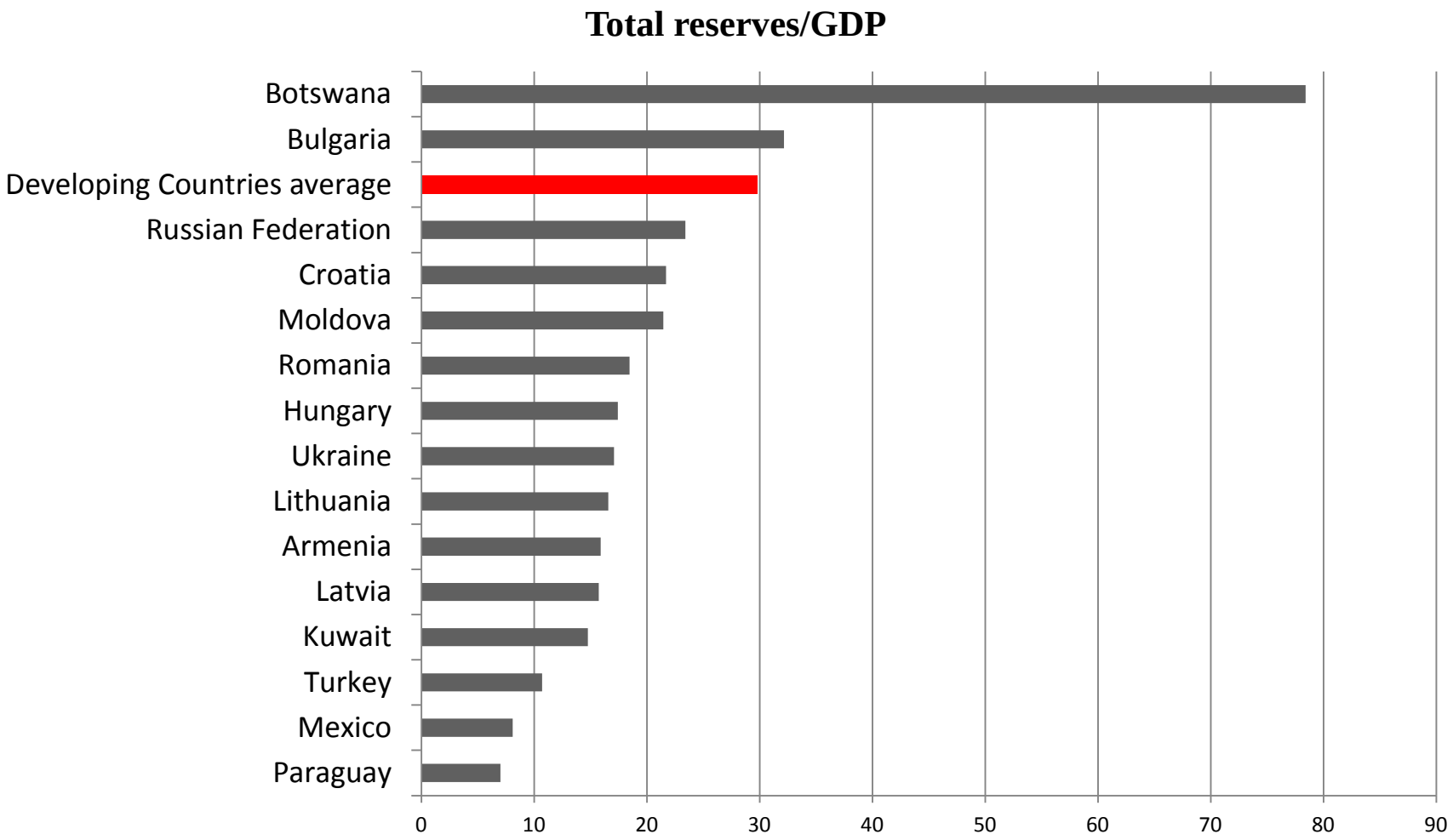
  - Early and a significant reduction in policy rates did not take place in any of the countries that we consider.

  - Balance of payment related fragilities might have prevented some countries from implementing expansionary monetary policies due to fear of financial reversals.

  - Concerns about international reserves

  - Risks about financial stability associated with exchange rate depreciations (the share of outstanding foreign currency loans to the private sector)

Policy responses



Source: WDI & Authors' calculations

Policy responses

❖ **Fiscal Policy Responses**

- Limited fiscal space (measured by the level of deficits in relation to the government revenues)
- The growth of total government expenditure in all countries in our set **<** the average growth of total government expenditures in developing countries
- 5 of 6 Central and Eastern European countries faced a tradeoff between their commitment to the Euro adoption and taking countercyclical measures.
- Conditions linked to the IMF and EU financial support programs

Conclusions

- The trade channel was the most important mechanism in the transmission of the crisis from advanced economies to developing countries.
- The most affected countries in our set are the ones which experienced both a dramatic decline in their exports and financial reversals
- Although almost all these countries experienced spectacular growth performances from 2002 to 2008, they also accumulated significant vulnerabilities such as domination of foreign exchange debt or current account deficits.
- Those countries which were unwilling or unable to conduct considerable countercyclical fiscal and monetary policies were among the most affected ones.

Conclusions (Cont'd)

- Economies which experienced very hasty trade and financial flows integration without much institutional capacity accumulated huge vulnerabilities during the "Great Moderation".
- Those countries with more reliance on certain export markets and commodity exports are very vulnerable to the cycles in advanced countries. Therefore, it seems that developing countries would be less exposed to external shocks by choosing a strategic integration to the world economy rather than embracing full-fledge integration.

Thank you for your attention