Weathering the Storm: Economic Policy Responses to the Financial Crisis

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The World Bank
1. Introduction

The world economy is entering a major downturn caused by the most dangerous shock in mature financial markets since the 1930s. Current World Bank growth projections for high income countries have been slashed from 2.5 percent in 2007 to a contraction of 0.1 percent in 2009. World trade volumes are expected to actually contract in 2009, the first time since the 1982 recession. A distinctive feature of the coming global downturn is that it is a crisis emanating from advanced economies rather than from bad policies in developing countries. On the contrary, economic policies and macroeconomic positions in developing countries are generally stronger than 10 years ago. Nevertheless, the approaching advanced world recession will pose a severe test for the quality of economic policies and institutions in developing countries and will likely generate a sharp slowdown in their growth in 2009 through a variety of channels. Bank projections are for developing country growth to tumble to 4.5 percent in 2009 from 7.9 percent in 2007.

Developing country export growth will experience a dramatic deceleration as a result of the recession in the advanced economies. A fall in remittances to developing countries has already begun. At around $250 billion in 2007, recorded remittances to developing countries were larger than revenues from the most important commodity export in 28 countries, and in 36 countries they were larger than private and public capital inflows. Primary commodity prices have plunged at the prospect of falling world demand. This reversal, while providing a ray of light for commodity importing countries in the wake of the huge commodity price increases of the past 1-2 years, also poses the need for adjustment in public and private expenditures in commodity exporters which, until just a few months ago, were enjoying extraordinary boom conditions.

Private portfolio and bank lending flows to developing countries have fallen sharply, combined with

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extraordinary declines in stock prices, sharp increases in external borrowing costs for both sovereign and private sector borrowers. Trade finance, which underpins around 90 percent of world trade and which is especially important for low income countries, has been disrupted. Over a slightly longer horizon, foreign direct investment flows may also be expected to weaken in response to weaker global growth and tougher corporate financing conditions. Overall the Bank projects private capital flows to developing countries will fall from $1 trillion in 2007 to around $600 billion in 2009. Over a somewhat longer horizon there is also a significant risk that ambitious targets for increased official aid flows will fall by the wayside and that actual aid flows may stagnate or fall as developed economies face a more constrained budget environment in the wake of various enormous financial rescue packages. Political pressures towards more protectionist and generally more inward-looking economic policies may gather momentum in both developed and developing countries.

2. Developing country vulnerabilities today and going forward

Developing countries’ ability to undertake policies to protect growth and poverty reduction will depend in part on their initial macroeconomic positions and their vulnerability to potential shocks, as well as their access to official financing. This section provides a brief overview of the macroeconomic position of developing countries in 2007, going into the global financial crisis, focusing on their external and fiscal positions. The situation is changing rapidly, however, and countries may find their significant currency depreciation and macroeconomic circumstances and policy options greatly affected by the shocks generated by the global financial crisis. We evaluate countries’ vulnerability to three such shocks: a sudden stop in private capital flows to emerging markets, large volatility in primary commodity prices, and the emergence of stress in the domestic financial systems of developing countries. We suggest some broad typologies of countries according to their macroeconomic position and vulnerability to shocks2 (Annex Table 1 provides more detailed country information).

2.1. Current account and fiscal positions

Figure 1 shows the current account and general government fiscal balances of IBRD and IDA Blend countries in 2007 (both as a percent of GDP). A current account deficit is here defined by convention as “large” if it exceeds 3 percent of GDP, and a fiscal deficit if it is over 2 percent of GDP. Figure 1 shows that there is a significant positive association between fiscal and current account balances: countries with small fiscal deficits or fiscal surpluses also tend to have small current account deficits or current account surpluses.

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2 To determine the appropriate policy stance for any individual economy going forward, this initial broad cross-country evaluation would of course need to be supplemented with more detailed individual assessments for each economy, taking into account its unique characteristics and a wide range of additional data: short and long term external debt, foreign exchange reserves, public sector debt, public contingent liabilities, financial system indicators, and so on.
- **Low external and fiscal deficits:** Close to 40 percent of the countries are in the upper right quadrant, with both good fiscal and current account positions, reflecting in part the widely commented upon improvement in economic policies in developing countries in recent years, as well as - in many cases - the recent strength in primary commodity prices. This group includes many of the larger economies in East Asia (China, Indonesia, Philippines, Thailand), Latin America (Chile, Colombia, Ecuador, Mexico, Peru, Uruguay) and other regions (for example, Morocco and Russia). These are economies whose sound initial position would, other things being equal, allow them to weather the shock of the global downturn relatively well, including the ability to undertake somewhat more stimulative macroeconomic policies or more generous poverty alleviation policies, although, as noted below, this judgment may need to be qualified when other vulnerabilities are taken into account.

![Figure 1. Macroeconomic Sustainability and Private Capital Inflows](image-url)

- **High external and fiscal deficits:** About a quarter of the economies shown were in the lower left corner of Figure 1, with both large current account and fiscal deficits. These include several economies in the
Europe and Central Asia region (including Turkey and various economies in Eastern Europe and the Caucasus), Latin America and the Caribbean (Jamaica), and the Middle East and North Africa (Jordan, Lebanon), as well as economies such as Pakistan. Here, unless they have access to large and stable external official financing, governments are likely to be under significant pressure to undertake both fiscal and external adjustment.

- **High external and low fiscal deficits:** The upper left corner of Figure 1 shows countries – about a quarter of the total - with relatively prudent fiscal balances, where however, low savings and high borrowing by the private sector have contributed to a large external deficit. Here much of the adjustment will likely occur through cuts in overextended private consumption and investment, although, due to its relatively prudent fiscal stance, the public sector may be in a position to expand poverty alleviation measures and to protect key public expenditures that will contribute to longer term growth, especially when it can be buttressed with expanded official financing. This group includes, among larger economies, countries like South Africa, Bulgaria, Poland and Ukraine, as well as a number of smaller European and Central Asian and Latin American economies.

- **Low external and high fiscal deficits:** About 10 percent of countries are in the lower right of Figure 1, with low external deficits, but fiscal deficits over the 2 percent line. This group includes India, Egypt and Malaysia, as well as Argentina and Brazil, although the last two are only marginally over the 2 percent line. This group will likely need to undertake fiscal adjustment, but, given reasonable private saving and comfortable initial current account positions and strong reserves, may have more leeway to follow their own timetable.

### 2.2. Vulnerability to Sudden Stops in Private Capital Inflows

One of the immediate impacts of the financial crisis on developing countries has been a sudden fall in private capital market flows to developing countries, reaching, in October 2008, the level of a financial panic, accompanied by extraordinary increases in offshore emerging market spreads. Figure 1 provides one view of vulnerability to this sudden stop by distinguishing between countries with net private capital market inflows (the total of portfolio and bank debt inflows) greater than 3 percent of GDP in 2007 (marked with a circle) and those with less (triangle).³ Figure 1 shows that most of the countries with large inflows are also those with large current account deficits. The sudden stop will therefore tend to enforce the need for substantial adjustment in current account deficit countries, whether this is by both public and private sectors (bottom left quadrant) or mainly by the private sector (upper left quadrant). A fuller assessment of vulnerability to the sudden stop would of course also take into account the availability of foreign exchange reserves and short term liabilities in the months ahead.

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³ This threshold lies between a median of 1.4 percent and a third quartile of 3.8 percent.
2.3. Vulnerability to High Volatility in Primary Commodity Prices

The plunge in primary commodity prices in recent months is also likely to have a significant impact on the macroeconomic context and room for maneuver available to policymakers. Annex Figure A highlights countries according to whether a majority of exports are primary commodities (circle) or not (triangle). Such countries will likely see a fall in export revenues in the months ahead, as well as increased pressure on government fiscal revenues that are based on commodity exports. The Figure shows that many commodity-dependent exporters are among the ‘strong’ countries with low current account and fiscal deficits in 2007, including large oil exporters such as Iran, Iraq and Russia. Declining export prices will suggest the need for a more cautious ‘wait-and-see’ approach for policymakers in this group contemplating more expansive policies. However countries that prudently saved a significant part of commodity windfall gains in recent years may now be in better shape to undertake such policies. There are also quite a few commodity dependent countries among those with large current account deficits and here falling prices will further sharpen the need for adjustment. (Needless to say, countries that are mainly exporters of manufactures and importers of commodities will experience terms of trade based income gains. These include the large Asian manufacturers such as China, India, Malaysia, Philippines and Thailand that already have comfortable current account balances, but also economies like Bulgaria, Romania, Jordan and Lebanon that are under pressure because of large external deficits).

2.4. Vulnerability to Domestic Financial System Stress

Financial systems in developing countries may be shielded from direct involvement in the financial crisis because of their limited exposure to sophisticated securitized instruments in developed country markets. They may be affected via more indirect routes, however. Developing country banks could face funding difficulties if they have short term liabilities to liquidity-starved banks in developed countries. Credit quality may already have been deteriorating in countries where credit growth has been very rapid in recent years, and may now be further compromised by the deterioration in macroeconomic conditions caused by the global crisis. Governments could end up with unexpected fiscal liabilities for recapitalizing banking systems. To evaluate this risk, Annex Figure B highlights countries that experienced an annual average increase in bank credit to the private sector (as a percent of GDP) of 7.5 percent or more in 2002-07. A significant number of countries with rapid domestic credit growth are those with small fiscal deficits or with fiscal surpluses. Looking at countries’ fiscal balances alone may thus understate the fiscal risks emanating from a deteriorating financial sector.

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4 This threshold lies between a median increase of 5.8 percent and a third quartile of 11.4 percent.
5 For more on financial sector risks see “The Unfolding Crisis: Implications for Financial Systems and Their Oversight.” World Bank
3. Policy Responses in Developing Countries

3.1. Protecting the vulnerable

The global financial crisis may soon become the latest, and possibly the most severe, in a series of shocks that have hit the poor across the world over the last year, most recently due to sharp increases in food and fuel prices. The combined impact of these shocks could pose a substantial set-back in the fight against poverty and further jeopardize the already slow progress towards achievement of the Millennium Development Goals. Prompt and well-targeted policy responses can substantially reduce the depth, length and long term impact of sudden economic shocks. Here we identify the channels through which the financial crisis is likely to affect household welfare, outline policies that can help mitigate its negative impact in the short and long term, and, finally, discuss which policies would be most appropriate in different country circumstances.

3.1.1. Impact of the crisis: transmission channels and coping mechanisms

The impact of the financial crisis can be viewed in the main as a large negative shock to both aggregate demand and the demand for labor in developing countries, putting downward pressure on wages and employment. Household welfare will also be affected by a fall in migrant remittances and other private transfers from abroad. Households will take a variety of actions to cope with the immediate crisis, but some of these may have harmful long term consequences, especially for women and children.

- Impact on wages and employment. Labor markets will adjust to the shock of the crisis through some combination of reduced employment and reduced earnings. Historically, labor market adjustment in developing countries has occurred predominately through real wage declines – often facilitated by sharply higher inflation during the crisis – and changes in the composition of employment (for example, shifts from the formal sector into the informal sector and subsistence agriculture), rather than through sharp reductions in total employment. Adjustment through earnings is more likely if labor markets are flexible and the absorptive capacity of the agricultural and informal sectors is high. Increased joblessness is likely to be more important in countries with rigid labor markets, comprehensive unemployment benefits and a large share of the workforce in salaried employment.

cuts tend to concentrate the burden of adjustment on the unemployed, suggesting more specific labor market policies such as payroll tax holidays and public works programs.

○ **Intersectoral transmission of shocks.** Experience from recent financial crises shows that even if the impacts are first felt in only a few sectors (e.g., construction or exports), the recession quickly flows out to the wider economy and labor markets via declines in demand and movement of workers between sectors. Such movements are an important channel through which earnings are driven down across the economy, as workers move from highly paid sectors to already low pay small scale sectors, such as agriculture or the informal economy. The economy-wide transmission of shocks suggests that policy responses should be comprehensive rather than trying to target only the initially affected sectors.

○ **Falling remittances.** The financial crisis has already triggered a fall in remittance flows to developing countries by reducing employment opportunities in the developed world, especially in sectors with many migrant workers such as construction, retail and catering. The fall in remittances will affect both macroeconomic stability and household welfare in developing countries with large migrant outflows. Remittances are a powerful poverty reduction mechanism. For example, in Nicaragua they reduce poverty incidence by 4 percentage points on average and by 5 points in urban areas.

○ **Long term costs of coping mechanisms.** To mitigate negative income shocks poor households may have to take steps with pernicious long-term consequences, such as to sell productive assets (e.g. livestock or household inventories), thereby sacrificing longer term future income. They may also pull children out of school, with a much higher chance of pulling girls than boys. The poorer the country, the more likely there will be adverse schooling impacts. Poor households may also have to cut back on calorie intake, leading to weight loss and malnutrition, with ample evidence that gender disparities in food consumption increase during times of shortage.

### 3.1.2. Policy Responses for Protecting the Vulnerable

Good policies should provide short-run assistance against income shocks, facilitate economic adjustment, and nurture investments in human and physical capital to minimize long-run crisis costs. Good safety nets require workable systems for enrolling beneficiaries, making payments, and monitoring. Since establishing a sound safety net program from scratch usually requires at least four to six months, the initial focus should be on expanding existing interventions that have a proven track record. The most effective interventions will be those that target people who are the most vulnerable to income declines and most exposed to the crisis, not an easy task ex ante and one which will differ across countries. One approach is to develop practical poverty proxies, derived from household level data which are readily obtainable for
most countries. We consider policy options under four broad categories.

- **Supporting household income via public transfers.** Direct cash transfers have low administrative costs and do not distort prices. Provided they have adequate coverage and generosity, this is the single best option. Scaling up non-earnings-linked social pensions, disability pensions, unemployment benefits and the like can be helpful. Recipients are often poorer than average, and their incomes will be more thinly stretched as the crisis affects family members. However, the coverage of such programs in poor countries is typically modest and, for most, limited to the middle class. They are therefore unlikely to be an effective means for poverty reduction. Conditional cash transfer (CCT) programs may be an improvement on unconditional cash transfers in one respect, by channeling help to the most vulnerable. CCTs on school enrolment can enhance children’s educational outcomes while those conditioned on female labor market participation can boost women’s intra-household bargaining position. However, when starting from scratch, conditional transfer schemes take longer to implement than unconditional ones. Poorly designed schemes may actually exclude the most vulnerable (e.g., if they do not have access to the public services upon which transfers are conditioned). As a crisis response, then, targeted, unconditional cash transfers may yield better results.

- **Labor market interventions to support employment and earnings.** Such measures include payroll tax holidays and wage subsidies, which reduce the cost of employment for firms without reducing workers’ take-home pay. These measures may be appropriate when a crisis is short-lived, but in the longer-run may not be fiscally sustainable. Evidence also suggests that long term gains in employment have been only modestly positive at best, while deadweight losses and substitution effects (for example of subsidized workers for unsubsidized ones) have been large. Public works programs are likely to have lower net costs than direct transfer programs since they could be used to improve infrastructure and provide public goods, thereby improving long-run growth prospects. Self-targeting should ensure that the program benefits the poorest. Public sector employment and wage increases may also be a tempting way of bolstering labor market demand. However, increases in public sector wages are typically not pro-poor, as the majority of civil service workers are above the poverty line. And since public sector wages typically constitute a large share of public expenditures, fiscal costs will be high and will tend to crowd out better targeted programs. In summary, most prominent labor market interventions are unlikely to provide sufficiently comprehensive, adaptive or progressive means of tackling the present crisis. They risk introducing significant labor market distortions and fiscal costs, often have negative unintended consequences, and may be difficult to eliminate once vested interests in their continuation have been created
(notably amongst formal sector employers).

- **Supporting private transfer flows.** Reducing fees on remittances services and providing fiscal and in-cash incentives to remit may be ways of counteracting the potential drop in remittances, although this is an area where there is relatively little research or evidence to inform policy.

- **Supporting household investments in human capital.** Measures to support household investment in human capital by keeping public services affordable or providing incentives for their use may represent a “quick win”. Lower school and health care fees could keep children in school and support family health, potentially mitigating the long-run impacts of sudden income declines. The effectiveness of such measures will however depend on the extent to which vulnerable households actually use such services, and on the extent to which these services can be increased in response to increased demand. Use of cash transfers conditional on utilization may be a more effective way of reaching the poor.

### 3.1.3. What policies should be adopted?

The distributional impact of the financial crisis and the choice of the most appropriate policy responses will depend to a large extent on how the economy adjusts to the shock. The fiscal cost of poverty alleviation is also a major consideration, especially during an economic slowdown, when revenues are falling and there are even more demands than usual on government spending.

- If adjustment occurs through generalized wage reductions, the burden of adjustment will be spread more evenly. But the working poor will be less able to cope with wage declines, a problem that can be addressed by income support or by policies that boost the productivity and earnings of the poor.

- Adjustment through increased joblessness places the burden of adjustment on the unemployed. Policymakers may either attempt to reduce joblessness by stimulating labor demand in the formal/waged sector through payroll tax holidays or public works programs, or provide protection for the unemployed through unemployment benefits.

- If transmission occurs through people switching jobs, job movers are likely to suffer most of the losses. It may be feasible to support labor demand in the sectors most affected, using payroll tax holidays or wage subsidies. Alternatively, one may attempt to maintain earnings in the lower-pay sectors. Here microcredit programs may be helpful in maintaining the earnings of the self-employed in times of crisis, while public work programs and increased coverage of unemployment benefits may help reduce the increase in labor supply to low-pay sectors.

- The fiscal implications of public interventions may seem daunting, particularly given the public spending stresses already experienced by food and fuel-importing countries. But the fiscal costs of well-targeted interventions for the poorest need not be unduly
high, especially compared to the present and future costs of not having them in place. Even such large and generous CCT programs as those in Mexico and Brazil are only around 0.5 percent of GDP. For a large share of developing countries, spending on overall safety nets has been on the order of 1 to 2 percent of GDP in recent years. Critically, the future costs associated with not taking action are likely to be many times higher than the savings from inaction.

3.2. Fiscal policy challenges

The unfolding crisis will sharply increase the range of demands on fiscal policy in developing countries. The fiscal policy response must address both short-term risks to macroeconomic stability and long-term fiscal sustainability. And it also needs to be formulated in a way that protects the vulnerable segments of society and longer term investments that sustain economic growth and human development. While investments in physical capital can be put on hold if necessary and restarted later when resources become available, the same intertemporal substitution does not apply to human-development programs – increases in child malnutrition and student dropout rates may have more permanently damaging effects on development than the postponement of a public works project.

3.2.1. Overall fiscal stance and design of the fiscal package

Policy makers need to determine the right overall fiscal stance in the wake of the global crisis, as well as the design and composition of the fiscal package.

- A practical approach is to first analyze the size of the needed overall fiscal adjustment—given the initial conditions—and then turn to the design of the fiscal policy response. The overall size of the adjustment should be determined against the need for macroeconomic stability and debt sustainability. The composition of the fiscal policy response should then be designed in a way that is sustainable and, to the extent possible, supports longer term growth and human development. A completely clean separation between overall size of adjustment and its design is unlikely. The overall adjustment may not be sustainable if it is simply too large to receive political support, or if its composition is felt to be inequitable on political or social grounds.

- The appropriate fiscal stance in crisis-affected countries depends on their initial position, how they are likely to be affected by the crisis going forward and the availability of official financing. There are several considerations that are relevant.

- As the discussion in Section 2.1 indicated, the direction and size of the necessary fiscal adjustment will depend in part on the country’s initial fiscal and external position. Countries with strong initial fiscal and external positions may have room to undertake a more expansive fiscal policy while, conversely, countries with a poor starting point will likely have to undertake a substantial adjustment. This analysis should take into account not only the current year’s flow balances but
also longer term fiscal and external debt sustainability considerations and the availability of official financing.

- It will also be necessary to assess the country’s fiscal and external position in the light of foreseeable external shocks – for example a sudden stop in capital inflows or a sharp fall in export prices – and of new domestic contingencies – for example potential fiscal liabilities due to deterioration the in domestic financial system or likely social spending needs.

- Other aspects of a country’s macroeconomic policies can also be relevant. For example a country with a fixed exchange rate or a highly dollarized economy will have to rely much more heavily on fiscal policy for adjustment.

3.2.2. Issues in implementing countercyclical fiscal policy

- **Countries that have a more favorable starting position may have policy room for implementing countercyclical policy.** Countries with large accumulated reserves and fiscal surpluses could have the ability to offset some of the drag on the domestic economy from the financial crisis by undertaking countercyclical fiscal policy. Such a policy may work through automatic stabilizers or through discretionary expenditure and tax decisions. The evidence suggests that automatic stabilizers have a more prompt and consistent countercyclical effect than discretionary policies. However they play a more limited role in developing than in developed economies. (It is worth noting that social safety nets act as automatic stabilizers and that this provides another reason to consider introducing or expanding them as part of the crisis response.)

- **Achieving the right timing and size for a discretionary fiscal stimulus is not easy and requires careful contingency planning and disciplined execution.** Discretionary fiscal packages often cannot be delivered quickly enough and their effect is then only felt after the crisis has eased, adding to the procyclicality of the economy. Expenditure may be targeted to wasteful projects, especially when subject to political pressure, and may not be withdrawn once the economy recovers. Resources and policy room may be quickly depleted in a long-lasting crisis. Governments can address some of these problems through advance planning to identify expenditures that can be quickly implemented and are likely to have a large stimulative impact – e.g. poverty alleviation measures or identified infrastructure projects that can be quickly implemented. Reforms to improve fiscal policy governance could also improve the efficiency and credibility of discretionary fiscal packages.

3.2.3. The composition of the fiscal policy response is a key determinant of its success.

High-quality reforms reduce the burden of taxation by making it more efficient and broad-based and allocate spending toward highly productive areas, such as effective education and public investment. Whereas the size of
the fiscal adjustment is the key fiscal instrument for macroeconomic stability, its composition is critically important for sustainability, economic growth, and human development.

- **Expenditure adjustment should be politically and economically durable, shield the most vulnerable and protect long term growth.**
  - Countries should clearly identify the elements of spending that they wish to protect, such as core social spending, key infrastructure projects and reform initiatives that are important for long term growth.
  - Fiscal adjustment is more durable when associated with protecting capital expenditure and reducing selected current expenditures. Across-the-board expenditure cuts can result in arrears, add to long-term costs (e.g., by postponing maintenance), and lead to inefficiencies (e.g., by reducing travel budgets for tax inspectors). Such cuts are often quickly reversed.
  - The recent large falls in world oil and food prices create an opportunity for countries to reduce reliance on untargeted, expensive and generally regressive fuel and food subsidies, replacing them well-targeted modern safety net programs.

- **A key factor in analyzing the composition of public spending is its import component.** The import content of different types of public expenditure varies, and so the composition of the fiscal policy response may affect the viability of overall fiscal adjustment via its impact on imports and the balance of payments. Spending that lifts domestic demand and has little impact on import growth (e.g., road construction in many countries) could be increased even if the balance of payments is precarious.

- **Short term revenue adjustments should avoid undermining the efficiency and longer-term viability of fiscal revenues.** Increases in broad-based taxes such as the VAT may be important elements in a fiscal package. Similarly, countries can use tax measures to provide an economic stimulus. However, when stimulus is desired, tax cuts in specific sectors or specific investment exemptions may be politically popular, but risk degrading the tax system over time. Rather than aiming for selectivity, stimulus measures should be broad based as well as aimed at having an immediate demand response—lowering VAT, sales tax or payroll tax rates could have this effect; (the impact of lowering income tax rates would typically only be felt in the next fiscal year, when tax payments are due).

- **The financial crisis may provide an opportunity for countries to shift their tax base toward consumption and away from income.** This would broaden the tax base and support the outlook for growth in the long term. At the same time it would strengthen short-term automatic stabilizers (because of the lag in income tax collection). In principle, a shift from income toward consumption taxation that is revenue neutral in the long term would have a stimulating impact in the short term. Consumption taxes are more likely
to fall in the near term because of the economic downturn than are income taxes. Consequently, such a shift in the structure of taxes could be part of a short-term fiscal stimulus

3.3. Monetary policy, inflation and exchange rate issues

Compared to previous crises, developing countries appear to be targeting monetary policy more generally towards domestic economic conditions than towards defending specific exchange rate levels. One indication is that, while short term domestic interest rates in developing countries have risen over the course of the year, especially in the August-October period, their level generally remains well below and the increase has been more gradual and smaller than in earlier emerging market crises. The rise in domestic rates has also been less than the recent surge in offshore foreign currency interest rate spreads. Currencies, on the other hand, have depreciated sharply in August-October. (These recent trends are not uniform, of course. In some cases central banks have intervened heavily to slow depreciation, incurring large reserve losses in the process.)

3.3.1. While there is no ‘one size fits all’, targeting monetary policy at domestic inflation and activity seems appropriate for many developing countries at present.

- The achievement of substantially lower inflation was one of the major improvements in developing country macroeconomic outcomes and policies over the past decade. More recently, however, inflation has picked up significantly in most developing countries, rising from an average 6.4 percent in 2007 to an estimated 9.4 percent in 2008. (IMF WEO, 2008). In most countries a significant part of the surge in inflation over the last 12 months was imported via rising food and fuel prices. The standard policy prescription in this situation is to accommodate a temporary rise in inflation due to changes in global relative prices (for food and fuel) and to tighten monetary policy only to the extent needed to prevent the price shock from becoming embedded in domestic inflationary expectations. However there were also indications of rising domestic inflation pressures in many countries due to increasing capacity constraints in the wake of several years of rapid growth. Thus a number of countries had already begun to tighten monetary policies in 2006-07.

- Looking forward, however, the inflation outlook is changing quickly. The steep recent fall in world food, oil and other commodity prices will contribute to lower headline inflation, while the downturn in global and developing country economic activity will defuse domestic excess demand pressures, although there will be some offsetting inflation pressure from recent currency depreciations. Indeed, the focus is increasingly shifting from concerns about global inflation to those about deflation.

- Targeting monetary policy towards domestic conditions will help underpin macroeconomic stability and a more supportive environment for growth in the present turbulent

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global environment. Recognition of the severe social and economic costs of high inflation has led a growing number of developing countries to adopt some form of strict or flexible inflation targeting in recent years (the latter entailing concern not only with pressures are likely to be abating for exogenous reasons, a flexible inflation targeting approach will allow policy makers to avoid large interest rate increases in defense of the exchange rate, and, if domestic inflation expectations are well under control, to adopt a monetary policy more supportive of domestic activity.

3.3.2. More flexible exchange rate management will allow many countries to adjust to fundamental shocks more
smoothly, reduce speculative pressure and conserve valuable foreign exchange reserves.

Many developing countries have moved towards more flexible management of exchange rates in the period since the 1997-98 emerging market crises and in their responses to the present global financial crisis. Countries have tended to move away from systems of exchange rate pegs because such pegs have often proved fragile in a world of high capital mobility and unstable capital movements, and which in some cases have also contributed to the build up of vulnerabilities before the onset of a currency or financial crisis. This will also help developing economies adjust to the serious fundamental external shocks they have been or will be hit by as a result of the present crisis: declining exports and remittance inflows, plunging export prices (for commodity exporters) and a sharp pullback in foreign financing. Greater flexibility will assist current account adjustment, reduce speculative pressure and allow countries to conserve valuable foreign exchange reserves as well as to make the best use of any swap arrangements or other valuable sources of liquidity support.

It is also worth stressing that the recent depreciations are in many cases only reversing sharp appreciations against the dollar in 2007 and early 2008. As Figure 2 shows, the median depreciation in developing country exchange rates versus the dollar between the start of August and the end of October was a relatively modest 8-10 percent, although of course there were much larger depreciations of 30-50 percent in specific economies such as Brazil, Chile, Colombia, Hungary, Mexico, Poland, Turkey and South Africa. However, as Figure 2 shows, median exchange rates after the depreciation were still about the same as at the start of 2006. Even in several cases of countries with large recent depreciations – for example Brazil, Colombia, Hungary, Poland -- exchange rates at the end of October were still about the same as at the start of 2006.

Of course the suitability of a more flexible exchange rate regime will ultimately depend on country circumstances. Small economies which are deeply integrated with a larger economy through trade and which experience similar macroeconomic shocks with that partner may find it superior to adopt the partner’s currency or maintain some form of fixed exchange rate regime with it. Many emerging European economies value stability relative to the euro as important for deeper integration with the Eurozone economy. Countries whose banks, corporations or households have accumulated large net foreign currency debts may also hesitate to let their currency depreciate, for fear of the financial impact on those bodies. Monetary policy faces a serious dilemma in these economies, which may only be partially overcome via access to substantial foreign official financing or liquidity support.

3.4. Growth analysis, structural and institutional policies

Countries need to retain focus on key reforms that can relax longer term constraints to growth and unlock new
sources of productivity. Conversely, they also need to ensure that immediate crisis management policies do not compromise longer term growth prospects. Careful growth diagnostic study can help pin down key constraints to growth. Some of these constraints may relate to fiscal policy – for example the contribution of fiscal sustainability to overall macro stability, the availability of key growth enhancing public expenditures and public goods, and ensuring that the overall tax burden is not excessive and that the structure of taxes is efficient. Thus there should be a close interface between growth diagnostic and fiscal analysis. There is also a range of structural and institutional policy reforms that arise at the interface between near term crisis management and longer term growth prospects. We address three: governance and political economy considerations, financial sector and macro-financial linkages and trade policy and facilitation.

3.4.1. Governance and political economy

The present global financial crisis will likely have profound impacts on governance and the political economy of economic reforms in developing countries. Addressing the crisis will change incentives and constraints faced by decision makers, in some cases threatening sustainable reform efforts, in others creating new opportunities. It will be particularly important for policy makers to ensure that short term measures aimed at addressing immediate macroeconomic and social pressures do not jeopardize longer term growth and development prospects, for example by creating costly new distortions that become difficult to remove because they have come to be supported by powerful vested interests, or by short-changing social safety net and human development expenditures.

- **The crisis will likely create momentum for greater government ownership of economic assets.** Policy makers may be under pressure to take over troubled bank assets and bail out troubled nonfinancial firms. Plans for privatization may be delayed or suspended. The example set by *de facto* bank nationalization in the US and Western Europe will tend to reduce resistance to expanding government ownership, particularly of banking assets.

- **Governance concerns related to rising state ownership can be addressed through clear rules for acquisition, management, reporting and disposal.** Government ownership of banks and firms opens the possibility of political intervention in lending and employment decisions, which could imply considerable costs for the budget and the economy in the long term. The elements of policies to deal with these issues are well known -- clear criteria for assets to be taken over; appointment of an independent and capable management with a mandate to minimize the cost to the budget from ownership of the assets; accurate accounting of the fiscal cost of the intervention, and transparent reporting to parliament, the public, donors, and financial markets; and establishment of a time-bound plan for disposing of the assets. It is particularly important for decision makers to understand that
discretionary interventions in the management of government-owned assets to address concerns about employment, credit creation, or inflation are generally counter productive. They are difficult to time and subject to high risk of unintended adverse consequences. Other policies (monetary and fiscal policy, economic regulation, and social safety nets) are more cost-effective in addressing these targets.

- **The government footprint on the economy may also increase as more people become dependent on the public sector for protection of their livelihoods.** Increasing unemployment and the erosion of real incomes may increase the dependency on social safety nets, social insurance and public employment. Governments may be tempted to adopt ad hoc and poorly targeted social protection measures such as generalized food and fuel subsidies or expansion of public employment if scalable interventions (e.g., unemployment insurance and easy-to-administer means-tested cash transfer) are unavailable or inadequate. However, this raises concerns about how such ad-hoc and fiscally costly safety net measures will be phased out, especially since they will be defended by broad constituencies that derive benefits from them.

- **Social safety net programs should be designed with political economy aspects in mind.** Preference should be given to scalable programs that are well targeted. If they are not available, efforts should be made to adopt them after recovery has set in and before the next crisis hits. In the short term, consideration should be given to expanding existing programs that have features of scalable social safety nets—for example, eligibility requirements and duration of unemployment benefits could be relaxed (as Korea did during the East-Asian crisis) and public works programs could be replicated in new areas. In so far as broad-based untargeted programs are deemed necessary, their cost to the budget should be made transparent and they should be subject to sunset provisions and continuous monitoring and review.

### 3.4.2. The financial sector and macro-financial linkages

Financial systems in developing countries have tended to be shielded from direct involvement in the current global financial crisis because of their limited exposure to the sophisticated financial instruments that have brought low their counterparts in the US and Europe. Nevertheless they are subject to growing risks through other channels, for example the sudden stop and pullback in lending by banks in developed countries and the impact of sharply increased macroeconomic volatility on the quality of their assets. As these risks have increased, policy makers in developing countries increasingly need to undertake contingency planning and other preparation for managing growing stress in the domestic financial sector. Some emerging economies have followed developed countries in extending deposit insurance and guarantees on new bank debt.

Policy questions related to financial crisis management and broader financial sector policy are addressed in
ingoing work by the World Bank’s Financial Sector Network. Here we focus on key two-way linkages between the economy and the financial sector that policy makers need to evaluate and take into account as they set macroeconomic policies in the increasingly turbulent global environment.

- **Policy makers should monitor and, if necessary, act to contain increased financial stress caused by lower growth and increased macroeconomic volatility.** Experience shows that systemic financial sector crises are generally preceded by a general economic slowdown and large shocks to interest rates, exchange rates, asset prices and capital flows which result in rising defaults and non-performing loans. The likelihood of problems is also higher if the shocks have been preceded by a boom or bubble in asset prices and domestic credit. The quality of developing country financial supervision will now be tested as countries try to assess the impact of the downturn and other shocks on the financial system. Macro-prudential surveillance based on monitoring of financial system indicators (FSIs) and the conducting of stress tests can help determine the size of potential problems and decide on the measures needed to contain financial stress or a potential crisis. Early intervention with a comprehensive and credible plan can avoid a systemic crisis, minimize adverse effects and limit overall losses. The types of strategies followed can make a large difference to the fiscal and other costs of a crisis.

- **Policy makers also need to evaluate and minimize the adverse impact from financial sector instability on fiscal sustainability and on the economy as a whole.** The realization of contingent liabilities in the event of a banking crisis can generate enormous fiscal costs and deterioration in longer term fiscal sustainability, reducing the government’s ability to undertake necessary social expenditure or long term growth enhancing expenditures. The fiscal costs of cleaning up the banking system in banking crises in the period 1970-2007 averaged 15 percent of GDP. Fiscal liabilities can also suddenly emerge when the government is obliged to take over liabilities of private pension plans that have been compromised by plunging stock market prices. The design of containment and restructuring programs can however make a large difference to the fiscal and other costs of a crisis.  

3.4.3. Trade policy, finance and facilitation

The global financial crisis is already having a substantial impact on world trade flows. Export growth is slowing fast as recession in developed countries curbs demand. High volatility in exchange rates will create more uncertainty about the profitability of international trade transactions, at least for a time. There are increasing signs of disruption in trade finance. Over a

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7 There is for example a long standing debate as to the value of large scale liquidity support and unlimited deposit insurance guarantees during the containment stage. There is a good deal of evidence suggesting that such accommodative measures significantly increase the ultimate fiscal costs of banking crises.
slightly longer term one may expect special interest groups to exploit the global financial crisis as an opportunity to press for greater protectionism in both developed and developing countries.

- **The financial crisis is having an impact on developing country access to trade financing of imports and exports.** Although comprehensive data on the supply of trade finance are not readily available, there is much other evidence of significant disruptions to trade finance. The Brazilian Central Bank sounded the alarm when it indicated that export credit available to Brazilian companies dropped by 50 percent during the second half of September. Bank charges to confirm letters of credit have risen sharply and shipping and commodity markets are rife with talk that banks are refusing to honor letters of credits from other banks and holding back guarantees that commodity buyers and sellers need to ship their commodities. As market confidence erodes, there is a risk of resurgence of barter trade between countries.

- **There are a variety of national and international actions that can help alleviate the disruption in trade finance.** Brazil’s government announced that it would use its foreign reserves to increase credit lines for exporters and countries such as India, Korea, and Russia are also reported to be looking at ways to extend official trade credit lines. Coordinating and expanding these efforts – for example by central banks collaborating to offer currency swap facilities along the lines of the recent facility provided by the US Federal Reserve to Brazil, Korea, Mexico and Singapore -- would send a powerful signal to market participants, help restore confidence, and eventually lower the overall cost of public intervention. Such initiatives could be undertaken by central banks on a regional basis and regional development banks may also help extend guarantee facilities to international banks confirming local banks' letters of credit. IFC has already decided to increase its trade financing program by US$500 million to US$1.5 billion. Export credit agencies from developed countries could also help provide short-term insurance for bilateral trade credits. The WTO has convened a meeting with leading commercial banks to review conditions for trade finance and could provide a forum to press for more coordinated action.

- **Policy makers need to remain vigilant and proactive in heading off a drift towards greater protectionism.** Since trade protection is mostly a means to favor one set of (mostly import-competing) domestic industries at the expense of other (mostly export-oriented) domestic industries, there is little reason to think that it is a useful instrument to alleviate the kind of aggregate demand shock created by the financial crisis. It does however lead to some costly waste of resources and is likely – unless these distortions are offset by other policy measures – to inhibit the efficiency of export sectors. And unilateral protectionist measures also threaten to set off competitive ‘beggar-my-neighbor’ protectionist actions by trading partners that result in all countries being worse off. The framework of rules provided by the
WTO provides a key insurance policy against such collective action failures and a vital resource for governments in warding off protectionist trends. It is also important – if more difficult – for governments to avoid taking unilateral protectionist actions in areas where multilateral rules do not exist or are not fully developed. While resisting protectionist pressures, countries should instead strive to use the crisis as an opportunity to invest in trade-related infrastructure and implement measures to facilitate trade, which, research suggests, can yield significant economic benefits and help offset the effects of the global recession on trade.
## Annex Table 1: Countries by typology of fiscal position, external position and vulnerabilities, 2007

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### Notes

**Fiscal and Current Account Positions, 2007**

1. **Low Fiscal/Low Current:** Fiscal Balance > -2% of GDP and Current Account Balance > -3% of GDP.
2. **High Fiscal/High Current:** Fiscal Balance <= -2% of GDP and Current Account Balance <= -3% of GDP.
3. **High Fiscal/Low Current:** Fiscal Balance <= -2% of GDP and Current Account Balance > -3% of GDP.
4. **Low Fiscal/High Current:** Fiscal Balance > -2% of GDP and Current Account Balance <= -3% of GDP.

**Vulnerabilities**

1. **Private Capital Market Net Inflows > 3% of GDP in 2007.**
2. **Annual Average Growth in the ratio to GDP of Bank Credit to the Private Sector in 2002-07 >7.5 percent.**
3. **Primary Commodity Exports as a Share of Total Exports in 2007 >50%.

- √ = Country meets Vulnerability Criterion.
- • = Data Not Available

**Sources:** IMF World Economic Outlook, 2008 and World Bank data and staff estimates.
Annex Figures

Annex Figure A. Vulnerabilities - Primary Commodity Dependence

Current Account Balance vs Government Balance 2007
By Ratio of Primary to Total Exports (Threshold > 50 percent; circle)

Source: IMF World Economic Outlook 2008 and World Bank data and staff calculations.

Annex Figure B. Vulnerabilities - Growth in Bank Credit

Current Account Balance vs Government Balance 2007
By Criteria on Net Credit Growth 2002-2007 (Threshold = 7.5 percent)

Source: IMF World Economic Outlook 2008 and World Bank data and staff calculations. Increase in bank credit to the private sector as a share of GDP between 2002 and 2007.