



# Policy Brief

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## Overview

One year into the global economic crisis, it has become clear that the paradigm for international development has changed irrevocably. With leadership, moral authority and the capacity of the West in international development diminishing, developing countries' recovery and future growth will critically hinge on their own initiatives, solutions and leadership. This policy brief summarizes the global responses to the crisis over the past year, points to their shortcomings and argues that a new paradigm for recovery in developing countries is emerging.

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## *The Global Economic Crisis after One Year: Is a New Paradigm for Recovery in Developing Countries Emerging?*

**T**HE ECONOMIC DOWNTURN AND RECESSION, WHICH spread across the globe following the US sub-prime mortgage crisis in September 2008, has become the dominant news topic of the past year. One year into the crisis it has become clear that the paradigm for international development has changed irrevocably. With leadership, moral authority and the capacity of the West diminishing, developing countries' recovery and future growth will critically depend on their own initiatives and solutions.

This is made all the more pertinent given that by mid-2009 there were some weak signs of recovery in the advanced economies, while in many developing countries the situation continued to deteriorate, with the impact of the crisis turning out worse than expected. Figure 1 shows the collapse in (expected) GDP growth across the developing world.

Recovery will be difficult. For many developing countries it will be characterized by rising food and fuel prices and sluggish demand. Recovery will be bedevilled by a combination of inadequate co-ordination, insufficient assistance from rich countries and the detrimental long-term consequences of policies with immediate appeal. This policy brief takes stock of the crisis after one year and asks how the paradigm of international development has changed, what developing countries can do, on their own, to recover from the crisis and suggests how to avoid the detrimental long-term consequences of short-term policy choices.

### **Global Responses to the Crisis**

The global economic crisis has been caused by more than just greed and inadequate banking regulations; it was caused by fundamental inequities in the structure and

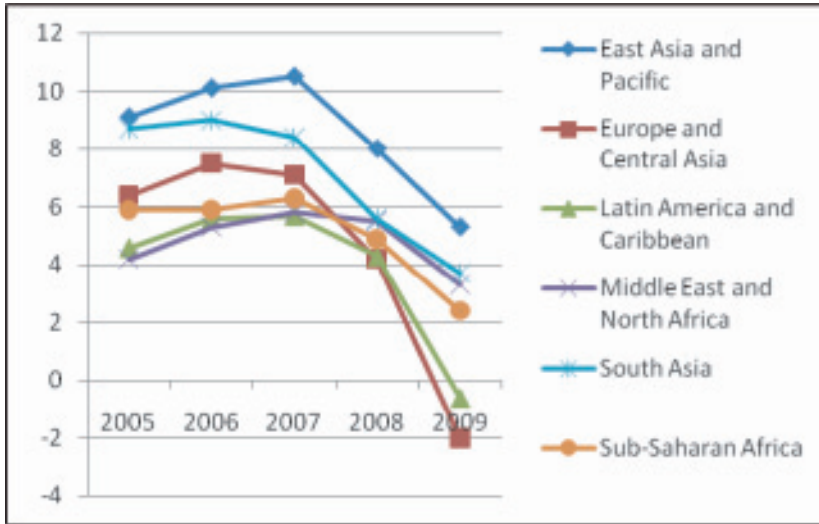


Figure 1: Expected Impact of the Global Economic Crisis on Developing Countries and Expected GDP Growth

Source: Compiled by the author using data from *World Bank Global Economic Prospects 2009, Forecast Update*, 30 March 2009

governance of the global economic and financial system. Consequently, fiscal stimulus packages can only be a short-term response to declining demand. More drastic interventions are required for sustainable growth in global demand. As Professor Joseph Stiglitz<sup>1</sup>, speaking at a United Nations University Lecture early in 2009, put it:

Some people have acted as though this is a problem in our financial system. A problem you might say, in the plumbing. So we fix the plumbing and we can go on. But the problems are much deeper and are problems of the modern version of capitalism, at least of the American style... I think we are coming to a realization that the institutions that were created sixty years ago are not up to the task, and we need to begin re-thinking these institutions. We are also realising that some of the ideologies that prevailed over the last quarter century are greatly flawed. So I think that the next few years will be a really exciting time as we begin to discuss a new global architecture.

What Stiglitz is referring to here is the need to reform the global economic system, including the International Monetary Fund (IMF) and the World Bank, which were created around 60 years ago. There is now widespread agreement that global economic reform should at least include (1) addressing global imbalances in savings and consumption; (2) moving away from the US dollar as the major reserve currency; (3) reforming the Bretton Woods institutions and in particular giving more say to developing countries; and (4) reforming the international aid architecture. Calls have also been made for a rethink of global trade agreements.

The global responses to the crisis over the past year acknowledged the need for such reform, but failed to make much progress. The two major global responses took place around the G-20 meeting in London in April 2009 and at the United Nations Conference on the World Financial and Economic Crisis and its Impact on Development in New York in June.

At the G-20 meeting in London, the plight of and challenges facing developing countries were certainly recognized. However, the meeting failed in many fundamental respects: it did not seriously set in motion the reform of the IMF and World Bank; did not address the reserve currency issue; nor did it address related global imbalances in trade, savings and consumption.

At the G-20, the main focus was on short-term measures, including bank bailouts, to stabilize the US and Europe's battered banking systems. These measures are not popular, and have been described as 'financial protectionism', whereby the US, as issuer of the world's reserve currency, can pump sufficient money into its banking sector to guarantee its stability, thereby

attracting funds from other countries without this ability.

Furthermore, only about US\$50 billion of the amount pledged at the G-20 has been directly allocated to the 'poorest' developing countries. This amount should be put in to context.

on below, the conference reflected a paradigm shift towards international development. Although not explicitly described as such in the conference outcome document (which was endorsed by the General Assembly in resolution 63/303 on 9 July 2009), the

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Many have already remarked on the fact that huge amounts of money have been found at short notice to bail out banks, but that money to bail out the world's 'bottom billion' is always in short supply. Contrast the US\$50 billion with the estimated US\$8.4 trillion allocated in total so far to bail out the banks. As Oxfam has pointed out, the latter amount is sufficient to end extreme poverty worldwide for 50 years.

The UN conference in June 2009 differed significantly from the G-20. It was largely marginalized by rich countries. The world media generally ignored it. What was reported portrayed the conference as though it were another 'hat-in-hand' forum for poor countries to demand aid from rich countries. Unlike the G-20, the UN conference did not directly commit monetary assistance for developing countries. Although it stressed the plight of developing countries and recognized the need for short-term stabilization measures, liquidity, and for the strengthening of financial regulations and longer-term structural changes in the global economic system, it did not come up with novel or immediate solutions to the current challenges facing developing countries. But in many respects, which I will elaborate

precariousness of placing too much hope on aid and on expecting aid commitments to be kept or protectionism to be avoided was acknowledged along with the recognition that changing the global economic system will take a long time (the establishment of working groups and *ad hoc* panels to explore possibilities further were proposed, perhaps indicative that no consensus on reform is yet near). It is therefore meaningful that the conference saw a major and enhanced role for the United Nations development system in this crisis. The main recommendations coming out of the conference and adopted by the General Assembly were to (a) "Strengthen the capacity, effectiveness and efficiency of the United Nations; enhance the coherence and co-ordination of policies and actions between the United Nations, international financial institutions and relevant regional organizations"; and (b) "[to] further develop the United Nations development system's comprehensive crisis support of national development strategies through a co-ordinated approach".

The support and co-ordination of the United Nations may be an important dimension of the emerging new paradigm for the recovery of the poorest countries.

### About the Author



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### **A New Paradigm for Developing Country Recovery?**

Global responses to the crisis over the past year have brought home the realization that developing countries should not expect too much assistance from the rich world. The West is facing an unprecedented economic crisis of its own. Money thrown at bailing

We have already witnessed over the past year brave and even imaginative efforts by many developing countries in order to cope. Developing countries with the largest and strongest economies, such as China, India and Brazil, have shown encouraging early signs of recovery after implementing timely countercyclical policies. In many

## Developing countries should not expect too much assistance from the rich world

out banks and struggling firms, and as a result of fiscal stimulus initiatives, will require spending cuts in the future as these countries manage their high debt and try to steer away from new debt crises. This is already clear by the fact that the rich countries have actually so far done very little for developing countries during this crisis. Commitments of monetary assistance seem inadequate and doubtful. Aid budgets are being cut and aid is declining despite commitments otherwise. And despite the pledges made at the G-20, murky forms of trade protection continue to be implemented. Despite promises made, very few concrete steps have been taken to start the reform of the IMF and World Bank.

Consequently, if developing countries want to recover from this crisis they need to do so without relying primarily on Western aid, assistance or growth. This may sound like a tall order, but is perhaps not as impossible as it would first seem. Indeed, the crisis may herald a new paradigm in international development whereby the dependence of the developing world on the assistance, example and leadership of the West is substantially lessened (but not eliminated) and the UN's role is enhanced.

African countries governments have been proactively attempting to protect their economies. In many (including Botswana, Mauritius and South Africa) governments have increased their expenditure. Ghana, facing a large budget deficit, is negotiating assistance from the IMF. Kenya and Tanzania are carefully monitoring their economies. The African Development Bank reacted quickly by identifying the most vulnerable countries and making emergency finances available. Many long-term investment projects in Africa, many in critical infrastructure, seem to remain in place.

The fact that many developing countries can now act in this way is quite in contrast to their actions during previous global recessions, such as those in the early 1980s, 1990s and in 1998. Then, developing countries, especially those in Africa, were much less well-managed. Deficits were high and reserves were low. Consequently, when global growth declined, these economies shrunk substantially. This time around, with a few exceptions, developing countries have, on average, had more leeway: deficits are lower and reserve holding is much better. In Asia, valuable lessons were learnt after the 1998 financial crisis, the actions



implemented in response to this have resulted in their economies becoming less vulnerable to financial shocks. Many countries here, such as China and South Korea, accumulated large foreign exchange reserves in order to insure themselves against such crises. While this reflects poorly

countries is also becoming abundantly clear. Demand in the West will be low and sluggish for years to come. Global growth depends now more than ever on growing demand in developing countries. The days of the USA as a 'consumer of last resort' (as described by Joseph Stiglitz) are over.

## Developing countries can and will act in their own best interests

on an international financial system that is not trusted by developing countries, it does show that developing countries can and will act in their own best interests.

It also needs to be pointed out that improvements in macro-economic management in many developing countries have resulted in improvements in governance – including improvements in many African countries. These improvements, including more robust democracies; more frequent elections; initiatives to reduce corruption and end conflicts; and to empower women, are largely home-grown. It would be very difficult to argue that they were the outcome of Western aid or pressure. This means that better governance, which leads to better resilience in the case of financial and economic shocks, have most often been achieved without, or even in spite of, Western aid.

If this crisis can ever be said to have a positive outcome, it may be that of developing countries showing that they can and should manage by themselves and collaborate with regional institutions and the UN development system. They still are – and this is another lesson from the crisis – very dependent on global economic growth, but unlike in the past, the extent of the rest of the world's, in particular the West's, dependence on developing

### The Road Ahead

The first challenge for the road ahead is for the rich world to do no further harm. This means that rich countries should continue to restore order in their financial systems and that they should put in place proper regulations to prevent excessive risk-taking and other factors which contributed to the financial 'bubble'. It is often said that it was rapid financial 'innovation' that caused this financial bubble and encouraged excessive risk-taking. One should object, since the term 'innovation' should have a more positive connotation. What we have seen in the subprime meltdown has been greed, predatory lending, skewed incentives and fraud – by no stretch of the imagination should this be confused with 'innovation'. Now the world does indeed need real financial innovation in order to restore trust in banks and create strong financial systems that do effectively what financial systems are supposed to do. Moreover, an important lesson from the current crisis is that finance matters for growth; millions of people in the developing world are subject to a daily 'credit crunch'. Financial innovation is needed to extend financial resources across the world, in particularly to the poorest households, to support consumption smoothing by households, business cre-



ation by entrepreneurs and sources of funding for governments' investment in infrastructure. Rich countries can play an important role in such true financial innovation.

after the crisis started that counter-cyclical policies are having a positive effect. Business confidence in many EU countries has improved, and forecasts for growth in OECD countries have

## Rising food and energy prices coupled with poor growth in rich countries will pose a deadly combination for poor countries' development prospects

Can rich countries go beyond the 'do no more harm' challenge to positively assist poorer countries through the crisis? As it is clear that developing countries cannot pin their hopes on more or faster aid, all that would seem to remain for rich countries to do is to stimulate their own economies and get their own growth going again. This will benefit developing countries through the recovery of global demand. The good news is that there is already some indication one year

picked up. The downside is that there is still much concern as to whether these 'green shoots' will wilt and as to the true nature of recovery. Some fear that recovery will be slow with deflation, while others fear sluggish growth with inflation – stagflation. Rising food and energy prices coupled with poor growth in rich countries will pose a deadly combination for poor countries' development prospects.

Ultimately, high growth requires deep-seated structural changes in the global economic system as described earlier. But as was remarked, these reforms would take many years if not decades to be put in place. In the meantime, developing countries must find a way forward – without substantial Western aid, without strong Western growth, and within a very imperfect global economic system. What are their options?

There is no single magic formula or a 'one-size-fits-all' approach for countries to foster recovery. But while many countries have been trying to find their own means to cope with the immediate impacts of the crisis as mentioned, there has so far been little consideration of the approach to the crisis that should be taken in view of the longer-term scenario sketched here. For instance, making use of their greater fiscal space is a policy option used by many (but not all) developing coun-

### About this Policy Brief

This policy brief is published as part of UNU-WIDER's ongoing work on the global economic crisis within its project 'New Directions in Economic Development' directed by Augustin Kwasi Fosu. More detailed findings are set out in a series of WIDER research papers and WIDER Angle newsletter articles (available to download free at [www.wider.unu.edu](http://www.wider.unu.edu)):

Wim Naudé (2009), *The Financial Crisis of 2008 and the Developing Countries*, UNU-WIDER Discussion paper, DP2009/01.

Augustin Kwasi Fosu and Wim Naudé (2009), *The Global Economic Crisis: Towards Syndrome-Free Recovery for Africa*, UNU-WIDER Discussion paper, DP2009/03.

Augustin Kwasi Fosu and Wim Naudé (2009), *Africa's Recovery from the Global Economic Crisis*, WIDER Angle, June 2009.

Imed Drine (2009), *Impact of the Global Economic Crisis on the Arab Region*, WIDER Angle, June 2009.

Wim Naudé and James C. MacGee (2009), *Wealth Distribution, the Financial Crisis and Entrepreneurship*, WIDER Angle, March 2009.



tries. The problem is that fiscal stimuli are only feasible for a short period. And to retreat behind tariff protection and direct state intervention in business would be fatal over the longer-term. So, many short-term measures now being

to continue to be a viable development strategy. Some see a greater importance and need for South-South trade, and for progress in regional integration and co-ordination. Here, an enhanced role of the UN, in collaboration with

## The way forward for most developing countries may hinge on whether or not exports can continue to be relied on to fuel growth

implemented by developing countries may soon run out of steam or become counter-productive.

The way forward for most developing countries outside of China, India and perhaps Brazil (countries with large domestic markets) may hinge on whether or not exports can continue to be relied on to fuel growth. Some believe that this is no longer possible. That countries should now, with sluggish prospects for Western growth and rising protectionism, stop relying on exports. Calls for countries to stimulate import replacement production, and to reduce for instance production of commodities for exporting, are being widely heard. But others are less pessimistic about the potential of exporting

regional development agencies and regional integration initiatives, is likely to have an important impact. Even if developing countries are on their own in this crisis, the mechanisms and tools which UN and regional level assistance can provide will be indispensable for the effectiveness of individual level responses. A historic challenge now faces the UN's Economic and Social Council in addressing the requests made to it by the General Assembly in Resolution 63/303 on 9 July 2009.

### Note

- 1) Watch Professor Joseph Stiglitz's UNU lecture online at <<http://www.ony.unu.edu/events-forums/events/2009/emerging-thinking-series-expla.html>>.



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UNU World Institute for Development Economics Research (UNU-WIDER) is a research and training centre of the United Nations University. UNU-WIDER was established by the United Nations University (UNU) as its first research and training centre and started work in Helsinki, Finland in 1985. The Institute undertakes applied research and policy analysis on structural changes affecting the developing and transitional economies, provides a forum for the advocacy of policies leading to robust, equitable and environmentally sustainable growth, and promotes capacity strengthening and training in the field of economic and social policy making. Work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

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