# The financial crisis and its impact on developing countries

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## I. Introduction

The developing world experienced in 2003-07 an impressive economic boom, growing at a rate of 7% per year. The boom was fueled by a mix of three conditions prevailing in global markets: exceptional financing, high commodity prices and, for an important group of countries, large flows of remittances. The first two had coincided for the last time in the 1970s, while the mix of the three had never been experienced before. The rise of an alternative Asian engine, with China at the center, is a fourth element, which has had a strong influence on world trade and commodity prices.

These conditions have been replaced since mid-2008 and, particularly, since September 2008 by the effects of financial turmoil that erupted in mid-2007 in the US and has now become the worst global financial crisis and the worst recession since the Great Depression. For a year since the crisis erupted, commodity prices continued to boom. This factor, together with high foreign exchange reserves, helped to attract capital to emerging markets even after the outburst of the subprime crisis. However, both have now joined the downturn. There are signs that the third source of the boom, remittances, have experienced a significant slowdown or are even falling. We will see in the immediate future whether the Asian and, particularly, the Chinese engine, can serve as the basis for world –and not only Chinese—economic growth, but recent events are not very promising in this regard, as the data for the fourth quarter of 2008 seems to indicate. More broadly, these events indicate that the view exposed by the IMF in 2007 that the developing world would "de-couple" from weak economic conditions in industrial countries was essentially flawed.

## II. Channels of transmission of the crisis

The crisis can be seen as being driven by the reversal of the three positive shocks that developing countries experienced during the recent boom. We start with a short look at remittances, where the information is not abundant. Then we deal more extensively with capital flows and trade.

### A. Remittances

For some regions, there is strong evidence of reduced dynamism of remittances. In the case of Latin America, in particular, remittances grew very slowly both in 2007 and 2008, falling as a proportion of GDP in both years, in sharp contrast with the rapid growth earlier in the decade. The direct sensitivity of migrant incomes to construction activity, which has been falling for three years now, seems to be an important explanation for the absolute reduction of remittances from the US to Mexico in 2008, but absolute reductions are still an exception. Remittances from Europe may be experiencing a similar

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pattern of a strong slowdown or reduction (see, for example, the case of Spain, one of the economies hardest hit by a construction crisis).

In contrast, other areas destination of migrants, particularly the Gulf countries, continued to boom until the third quarter of 2008, and have possibly experienced no significant slowdown in remittances yet. This effect seems to have prevailed so far, but seems likely to change as the result of the large fall in oil prices. Overall, the World Bank has estimated that remittances to the developing world experienced a slowdown but still fairly positive growth in 2008 (7% growth vs. 16% in 2007), but will face either a small (-1%) or large (-6%) reduction in 2009 (Ratha et al., 2008).

Overall, therefore, remittances are likely to show resilience and are, therefore, unlikely to be a major channel of transmission of the crisis. However, should the recession become deep and prolonged, the effects on remittances could deepen.

## B. Capital Flows

In contrast, one of the key channels for transmission of the crisis from developed to developing countries is via private capital flows. The effects take place both via volumes and cost of flows. Vulnerability of developing countries to rapid deterioration in capital flows has been diminished by the fact that, as a result of their good policies, many of these countries have far higher levels of foreign exchange reserves and lower levels of external debt than in the past. As we will see below, this can help to cushion a deteriorating international environment, but the space it provides for counter-cyclical macroeconomic policies remains to be seen. Emerging market investors (both public and private) have also become an important source of capital and other flows to other developing countries. We return to this issue below, in our policy section.

On the other hand, new sources of vulnerability have opened up, such as the volatility of portfolio investments into the growing domestic capital markets of developing countries and the carry trade and its rapid unwinding (this trade was mainly done using instruments from the rapidly growing derivative markets). Also, increasing foreign ownership of developing country banks has not proven to be a source of strength, and in some cases may have been a source of fragility, as these banks have withdrawn lending to their subsidiaries in developing and transition countries in order to strengthen their very weak positions in developed countries.

As regards volumes of flows, foreign direct investment continued to grow through 2008. Private financial flows peaked from mid-2006 to mid-2007. After a short weakening during the third quarter of 2007 due to the sub-prime crisis, they recovered and boomed again during the first semester of 2008 but dropped very sharply since the third quarter of 2008 and became negative in some cases during the last quarter of the year. Emissions in bond markets came to a halt, bank lending was severely hit, and there was a sharp reversal of flows from mutual funds and an unwinding of the carry trade (further details below). On annual terms, financial flows peaked in 2007 and fell in 2008.

They are widely expected (e.g. by the IMF, the United Nations and IIF) to fall further in 2009.[1]

In terms of the cost of financing, although spreads for emerging market bonds have been increasing since mid-2007, this effect was largely counteracted by the reduction of reference interest rates (generally the 10 year US Treasury bond), so that yields did not show a strong upward trend.. It was only in June 2008 that yields increased substantially and exploded after the global financial meltdown of mid-September 2008.

This behavior of the quantity and price of financial flows has been a major mechanism transmitting movements in stock markets from industrial to developing countries. On average, and measured in dollar terms, stock markets have experienced a stronger contraction in emerging markets since their peak in late October/early November 2007 than stock markets in industrial countries.

This impact of the global financial crisis has been more severe for emerging markets than for low-income countries, which are less integrated into international private capital markets. Indeed, capital flows to low-income Africa have been relatively limited. It is unfortunate, furthermore, that the bond issuance that some Sub Saharan African countries had begun to make has also stopped. Hardest hit were the transition economies of Central and Eastern Europe, where the combination of adverse expectations generated by large current account deficits, high vulnerability of the domestic financial system, or both, led to rapid withdrawals of private capital flows. The reversal of portfolio flows in East and South Asia was large and even surprising in several cases. For South Korea, for example, the Institute of International Finance estimates that foreign investors withdrew a massive net $45 billion in 2008. Countries like India and Taiwan POC also saw negative portfolio investment flows. In Latin America, Brazil and Mexico were hit by losses in derivative markets and, in the first case, by the unwinding of the carry trade. South Africa was also severely hit.

Concerning categories of private flows, a major source of problems in late 2008 was the interruption of bond issues in international capital markets (some were done, though in limited quantities, in early 2009) and the severe slump in inter-bank lending, as part in the both cases of a worldwide freeze in financing. Trade credit has been an important casualty of this. Some countries, like Brazil, have been able to put their foreign exchange reserves to good use by supporting exporters that have no access to international private trade credit lines. However, the IIF and others rightly fear that net bank lending to emerging markets will remain lower for some time, as bank capital will restrain banks' ability and willingness to lend. According to IIF figures, bank lending to emerging markets fell from a peak of $401 billion in 2007 to $245 billion in 2008; even more worrisome, they project a fall to $135 billion in 2009, but fear that the fall may, in fact, be greater.[2]

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[1] United Nations (2009), Chapter III. For annual figures by region, see in particular Table III.2.
[2] See the latest Capital Market Monitor of this organization in www.iif.com

A second source of problems is the high level of aggregate amortizations due by private sector borrowers, which are projected to reach $130 billion in the first half of 2009 and $250 billion for the whole of 2009, if both loans and syndicated bonds are added. More significantly, some emerging countries greatly increased their short-term borrowing in 2007 and 2008, which seems to leave them very vulnerable to a reversal of these short-term flows. South Korea and Russia had particularly large short-term inflows, and their reversal has been a source of serious problem for their economies.

The other category of capital flows that is highly problematic are net flows from non-bank sources such as mutual and hedge funds. Withdrawals from mutual funds in industrial countries and the unwinding of carry trade since July 2008 led to a massive reversal of currency positions out of high-yielding assets in emerging economies into developed countries' currency. This has had a major negative impact on exchange rates of developing countries, even in countries with significant current account surpluses. This shows how some categories of private firms are almost totally driven by internationally-determined factors (e.g., global risk aversion) and far less by country fundamentals.

The IIF estimates that short-term speculative carry trade positions are much reduced (in contrast to bank exposures that remain substantial), and, for this reason, they project non-bank private debt flows to rebound in 2009. However, the transparency of these positions and firms is quite limited, as most of these transactions do not operate over the exchanges and have no or limited reporting requirements (see, for example, Griffith-Jones and Dodd, 2008).

Foreign direct investment flows have been relatively more stable. However, the most recent UNCTAD Investment Report (UNCTAD, 2008) estimates that FDI to emerging markets declined by 10% in 2008, whilst the OECD estimates a far sharper decline. The decline in real estate and, especially, commodity prices seem to make it more likely that FDI flows into those sectors will fall sharply. This could have particularly strong negative impacts on FDI to Latin America and Africa.

Official capital flows show a very different pattern. On the one hand, official development assistance (ODA) increased since the Monterrey Conference on Financing for Development, from $57 billion in 2002 to a peak of $107 billion in 2005 (including debt relief), but declined since then, to an estimated $104 billion in 2007. A key challenge is for aid flows to augment at the very least according to existing commitments, and there is a strong argument to increase them further. This is especially necessary given that poor developing countries will be hit by a number of external shocks related to the crisis, which will endanger their growth and their ability to meet poverty reduction targets. Nevertheless, if the recession in the developed countries is very serious, there is a risk that aid budgets may not increase enough, or could even fall, with negative effects on poor countries and poor peoples.

Other forms of official capital flows stand in open contrast to this trend in ODA. First, some developing countries with active sovereign wealth funds and/or public sector firms have been actively investing abroad, thus generating net negative official flows to developing countries. This is particularly true of the oil-exporting countries of Western Asia. An even larger negative flow is, of course, associated with foreign exchange reserve accumulation, which is generally reflected in investments in safe assets from reserve currency countries. Finally, major multilateral development banks have been experiencing in recent years difficulties in finding a demand for their lending, and some countries have actually paid back some of their debts to these institutions. The crisis has generated a large demand for these flows. This reflects the counter-cyclical role that this type of financing should have. However, the magnitudes involved are relatively small, more in the order of billions rather than the tens and hundreds billions that characterize net changes in private sector financing. This indicates the need for much larger official funds that those currently available.

## C. Trade

World trade has shown in recent decades two important characteristics. First of all, it has tended to expand more rapidly than world production, a process that has been accompanied by a rapid diversification in the trade structure. Thus, during the recent boom, in 2003-2006, world trade grew at an annual rate of 9.3%, more than twice the rate of growth of world output (3.8%). Secondly, these rates of growth have been highly elastic to world output through the business cycle and have, therefore, been more volatile than world production. A major implication of this is that, although trade enhances world business cycle upswings, it equally tends to multiply downswings. Trade volumes contracted in 2001 and will again contract in 2009. The growth of trade volume experienced a strong slowdown since mid-2007, to a rate of around 2% by September 2008. This rate turned negative in November and December if we are to judge from reports that indicate that even the most dynamic world exporter, China, experienced negative export growth in those months, and even sharper negative import growth.

While this recession in trade volumes will be the main channel of transmission of the crisis to exporters of manufactures and services (tourism being a major service export for many developing countries), price developments will dominate the export performance of exporters of primary goods.

In recent years, the world economy experienced the most impressive commodity boom in more than a century, both in terms of duration (five years), intensity and product coverage (World Bank, 2009, chapter 2). The boom was more impressive, however, for minerals, including energy products, than for agricultural goods. This is reflected in the fact that whereas, at the peak, generally around the second quarter of 2008, the real prices of minerals exceeded the average of the 1970s by considerable margins (more in the case of energy products but also significantly so in that of metals), real agricultural prices just went briefly back to the level of the 1970s. It was, in other words, a boom of mineral, not agricultural prices (Ocampo and Parra, 2008). A major reflection of this fact is that, whereas the terms of trade of mineral exporters improved significantly, those of agricultural exporters remained flat and those of manufacturing exporting countries deteriorated (United Nations, 2009, Figure II.6).

This difference seems to reflect diverse determinants behind the associated price trends among commodity groups. For mineral exports, the dominant issue has been the underinvestment generated by a long period of low prices over the last two decades of the twentieth century. Given the higher demand generated by rapid growth in the developing world, and the specific high Chinese demand for metals, prices boomed. Investment increased but there were significant lags in the transformation of new projects into increased supplies. In the case of agriculture, the disproportion between supply and demand was more moderate, though the growing demand for biofuels operated as major mechanism of transmission of high energy into agricultural prices, particularly in the last phase of the commodity price boom, during the second semester of 2007 and the first semester of 2008.[3]

Additional factors affecting commodity prices during the latest phase of the boom were dollar exchange rate volatility and financial speculation. This resulted in an unprecedented level of price volatility. The turnaround of price trends took place since July for most commodities and August for energy products, and therefore preceded the financial collapse of mid-September. But the worldwide credit freeze that followed led to a free fall of most commodities. Energy products and metals, which had experienced the most impressive price boom, were also hit more severely.

Prospects for commodity prices remain poor. They are already below (and, in some cases, including oil, well below) the most recent projections released by the World Bank, which forecasted a 25% reduction in energy prices in 2009 and 23% fall in non-energy commodity prices (World Bank, 2009, Table 1.4). The fact that many oil exporting countries and some metal exporters have stabilization funds in place will serve as an important cushion. For agricultural exporters, such a cushion does not generally exist.

Falling energy prices generate a major benefit for a significant number of developing countries which are energy importers. Indeed, one reason behind the generally large number of developing countries with growing current account deficits had been the effect of high energy prices. So, falling energy prices will affect energy exporting countries but benefit a relatively large number of developing countries, which are energy importers.

Falling prices will be reflected in reduced investment and economic activity in the still relatively large number of developing countries that are commodity-dependent, particularly in Africa, the Middle East and North Africa region and in Latin America. Indeed, low commodity prices will be the major mechanism of transmission of the world crises to poor countries. For these countries, a major opportunity ahead is to redesign their trade strategy to reduce their commodity dependence.

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[3] See, on the latter, von Braun (2007).

## III. Policy Responses

### A. National responses

Given the fact that there has been a worldwide trend towards external opening in recent decades, the ongoing crisis will have severe effects on developing countries. As indicated, remittances will show some resilience. Financial turmoil will have stronger effects on middle income countries more integrated into world financial markets, whereas low-income countries dependent on official flows will remain less affected by the capital flows channel. Given the magnitude of the collapse of commodity prices, the trade channel will affect all countries but is likely to be stronger for commodity-dependent economies, many of which are low income ones; those with stabilization funds (generally energy and some metal exporters) will be able to use past savings to cushion the effect of commodity price downswings.

National responses should aim at trying to mitigate the contractionary effects coming from abroad and to rethink their trade strategies. The room to maneuver to adopt expansionary fiscal and monetary policies will depend on balance of payments constraints. In the case of fiscal policy, it also depends on the room to maneuver provided by recent fiscal stances, inherited public sector debts and the existence (or not) of a well developed domestic bond market where the public sector can finance in non-inflationary ways its current imbalances. Given the dependence on balance of payments constraints, the availability of external financing will be critical.

The enclosed table summarizes the evolution of three major external variables during the recent boom –the current account balance, external debt and foreign exchange reserves—in 90 developing and transition economies[4] with a population of over 5 million in 2007. The table shows the simple average of associated ratios of the external variable to GDP for each region, as well as the proportion of countries showing improvement in the indicator over the boom.

**External Indicators of Developing and Transition Economies with Population Over 5 Million**

| | Number of countries | Current Account Balance | | | | External Debt | | | Foreign Exchange Reserves, excl. gold | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | % of GDP 2003 | % of GDP 2007 | % with deficit, 2007 | % with improvement | % of GDP 2003 | % of GDP 2006 | % with improvement | % of GDP 2003 | % of GDP 2007 | % with improvement |
| Africa | 31 | -5.6 | -4.2 | 87% | 45% | 89.7 | 43.0 | 97% | 12.8 | 18.1 | 78% |
| Central and Eastern Europe | 8 | -5.4 | -9.1 | 100% | 38% | 56.4 | 57.3 | 57% | 21.0 | 23.2 | 63% |
| CIS | 8 | -1.0 | 3.1 | 63% | 25% | 56.1 | 44.5 | 88% | 12.9 | 21.3 | 100% |
| Latin America and the Caribbean | 16 | -0.7 | -0.9 | 50% | 38% | 63.7 | 37.6 | 100% | 11.7 | 14.8 | 69% |
| Middle East, incl. Egypt | 7 | 7.2 | 6.5 | 43% | 43% | 54.0 | 28.6 | 100% | 41.1 | 50.1 | 40% |
| Asia, incl. NICs | 20 | 2.2 | 3.0 | 30% | 45% | 52.6 | 36.9 | 100% | 27.2 | 32.7 | 69% |
| Total | 90 | | | 63% | 41% | | | 94% | | | 72% |

[4] Comparable information is available for the 90 countries in the case of the current account, for 80 in the case of external debt and 78 for foreign exchange reserves.

Current account deficits and, indeed, increasing current account deficits were the dominant pattern. This was matched, however, by broad based and, in many cases, large improvement in debt ratios and, to a lesser extent, by foreign exchange reserve accumulation. Debt improvements were associated both to domestic policies and to the major debt relief initiatives for low-income countries (the Multilateral Debt Relief Initiative but also major debt relief granted individually by the Paris Club). Foreign exchange reserve accumulation underestimates the magnitude of the improvement, as it does not include fiscal funds held abroad by either sovereign wealth or stabilization funds.

In regional terms, the Middle East, Asia and the CIS show the best performance in the three dimensions (less so in the case of debt in the CIS). Africa shows large current account deficits but significant improvements in the two other dimensions. Latin America and the Caribbean stand out for its avoidance of current account deficits and, particularly, large improvements in debt ratios. Central and Eastern Europe stands for its weakest stance: large current account deficits with limited or no improvements in debt and foreign exchange reserves.

Unfortunately, no equivalent picture can be drawn for fiscal indicators. However, for those countries for which data are available, weak stances are generally infrequent. Again, Central and Eastern Europe and major South Asian countries stands out as having the weakest stance, but there are individual countries with large central government deficits mixed with high levels of public sector debt in other regions, such as Colombia and El Salvador in Latin America, and Egypt and Jordan in the Middle East.

The picture that stands is, therefore, one in which developing countries do have larger room to maneuver to adopt counter-cyclical policies than in the past. The major regional exception is Central and Eastern Europe, where the traditional mix of weak external and fiscal indicators that has led to frequent macroeconomic crisis prevails. That mix is infrequent elsewhere, though there are two notable cases in South Asia (Pakistan and Sri Lanka). These countries will have to undergo some traditional macroeconomic adjustment. It is essential, however, that in these cases the fiscal adjustment is done in such a way as to avoid the worst of pro-cyclical fiscal adjustments of the past, and is able in particular to maintain good levels of public sector spending in the social sector and in infrastructure. Fiscal reform packages that focus on strengthening government revenues have in the past shown to be preferable to sharp spending reduction packages.

The nature of the policy packages to be adopted depends on the current policy stance. For those countries with a strong debt and foreign exchange reserve position but weak fiscal stance (India and Colombia are two important examples), the room to maneuver lies more in monetary than with fiscal policy. More generally, most emerging economies have the capacity to avoid the traditional pro-cyclical monetary policies of past crisis and follow the expansionary policy stance of industrial economies. Most have actually adopted policies to ease domestic financing and facilitate access of private sector companies to foreign exchange and, to a lesser extent, to reduce domestic interest rates. They should move also in that direction. A similar rule of easing monetary policy should be followed by other developing countries.

In the fiscal area, there is significant room to maneuver in a relative large group of developing countries. They should use this to mitigate the effects of the external shock. Infrastructure investment and social spending should be the focus of these programs. The strategy will depend on each country's social policy framework. Universal social policies in the areas of nutrition and basic education and health should be the major policy focus, but targeted programs for the poor, such as conditional cash transfers, make sense in middle-income countries (in poorer countries, by definition poverty is widespread and universal programs are clearly superior). Special emergency employment programs should be the essential complement, as the traditional automatic stabilizer of industrial countries, unemployment insurance, is generally absent. Within the available mix, experience indicates that tax reduction policies are unlikely to have the best effects and, rather, strengthening the tax base should be a persistent preoccupation of authorities.

Although trade opportunities are not generally viable, trade policy can play a role in the recovery in at least three different ways. First, non-traditional exports can be encouraged, particularly in commodity-dependent economies through a mix of exchange rate depreciation and sectoral incentives. Second, the possibility of strengthening domestic linkages of existing manufacturing export activities can also play a role. Third, more active South-South cooperation can play a role, by encouraging trade through existing integration processes. Payments agreements among central banks can also play a role in facilitating such trade without the need for hard currencies.

Finally, and very importantly, the crisis provides an opportunity to think again the role of domestic markets, largely set aside as a major preoccupation of authorities during the reform period. Indeed, a major implication of expansionary macroeconomic policies is that all countries can contribute to the global economic recovery by focusing on their domestic demand. Protection policies would be clearly counter-productive, generating beggar-thy-neighbor effects. But policies that focus on the mass market for consumer goods and on strengthening small and medium sized enterprises, which tend to depend heavily on local markets, can play a role in policy packages that place domestic demand again at the center preoccupation of economic policy.

## B. Multilateral Financing

A particularly urgent issue is the need for the IMF to lend during balance of payments crises rapidly, at sufficient scale, and without overburdening conditionalities of the past, particularly when the sources of the crisis are exogenous, such as a rapid reversal of capital flows and/or a sharp deterioration in the terms of trade. The recent approval (October 2008) of a quickly-disbursing fairly large facility by the IMF seems positive; the new Short-Term Liquidity Facility (SLF), creates a quick-disbursing financing mechanism for countries with strong economic policies, yet are facing temporary liquidity issues.

To qualify for a loan under the SLF, countries must have sound macroeconomic policies and sustainable debt burdens. Additionally, the last annual country assessment by the IMF must have been positive. The IMF stated that "Given this strong emphasis on past performance, financing is made available without standard phasing, performance criteria, monitoring, and other conditionality of a Fund arrangement." Countries will be allowed to borrow up to 500% of their quota.

The U.S. Federal Reserve simultaneously announced the establishment of temporary swap lines with the Central Banks of Brazil, Mexico, Korea, and Singapore.

The IMF SLF plans to keep the results of countries rejected confidential, as to not increase market instability in rejected countries. However there is a concern that the SLF is "essentially dividing developing countries into an A-list of nations that qualify for loans without strings, and a B-list of everyone else." As Kemal Dervis (*Washington Post*, November 2, 2008) put it: "Emerging markets cannot be easily and simply divided into two categories: those with good and those with bad policies." It would seem far better to enlarge access to SLF to a fairly large number of countries with reasonably good policies (Bhatttacharya, Dervis and Ocampo, 2008).

There should also be a major and quick reform and more active use of compensatory financing to reduce the large cost of adjustment for developing countries hit by exogenous shocks linked to their terms of trade. This has become urgent, given the sharp fall in commodity prices, with highly negative effects, especially for low-income countries. The IMF Compensatory Financing Facility has not been used since 2000 due to very high conditionalities. For low-income countries the Poverty Reduction and Growth Facility (PGRF) enhancement to compensate for the adverse terms of trade shocks and the Exogenous Shocks Facility (compensatory financing without a PRGF) are clearly insufficient, especially as regards the scale of the lending. An expansion of this facility is urgent, given the severity of the current crisis and the potential damage it could do to low-income countries growth and poverty reduction, which could set them back for meeting the MDGs. More broadly, especially in the light of recent sharp falls in commodity prices the following broad suggestions for compensatory financing seem especially relevant (see, for more details, Griffith-Jones and Ocampo, 2008).

*i) Scaling up:* The scale of existing facilities, and of resources—including for grants and for subsidies to allow concessionality financing of loans—are too small, in proportion to the shocks. This seems perhaps the most important point. This would need to be linked to fewer restrictions (e.g. higher per cent of IMF quota for access) on the scale of facilities.

*ii) Both loans and grants are valuable*: In the case of low-income countries, grants are more useful for more permanent shocks, or shocks (e.g. natural disasters) with more permanent effects. However, official lending has an important role to play as potentially speedy, and may provide incentives for changes in the economy, to reduce its vulnerability.

*iii) IMF lending for trade shocks needs far-reaching changes*: There should be significant simplification of IMF facilities as they are too many (e.g. enhanced PRGF, ESF and others) and too complex. Indeed, an option to consider may be to merge all these IMF trade compensatory financing facilities for low-income countries into one low-conditional facility at the IMF.

iv) *Lower conditionality* is clearly needed, especially for external shocks. There is no justification for upper credit conditionality for external shocks, for countries with reasonable policies.

A large increase in official development assistance to low income countries can play an important role, to both combat poverty and contribute to the generation of aggregate demand at the global level. Additional ODA, and highly concessional lending with low conditionality (e.g., from IDA) is particularly important to avoid contractionary policies in the poor countries suffering a deterioration of their terms of trade due to the collapse of commodity prices or other external shocks. This will significantly help poor countries avoid setbacks in their aim to meet MDGs.

Past crises have also shown that multilateral development banks can play an essential role as lenders when private financing dries up. One particularly problematic issue during crises in developing countries is the curtailment of commercial credit available to exporters, limiting an essential mechanism through which countries can recover from crises. So, the launching by multilateral and/or regional development banks of a large program of commercial lending and/or guarantees should be at the center of the crisis response efforts. No conditionalities should be attached. To expand lending these banks should do so rapidly, to substitute for the sharp reduction in private flows. Unfortunately, however, as pointed out in our diagnosis, the scale of official lending is small relative to the magnitude of contraction of private flows. Scaling up the size of MDBs may therefore become essential if the credit freeze persists.

## C. Regional responses funded by developing countries

Developing countries are in an excellent position to create or strengthen their own regional institutions, given their large foreign exchange reserves, and can use those reserves more actively. Developing countries as a whole had, in mid-2008, a level of reserves approaching $5 trillion. Additionally, many developing countries have created sovereign wealth funds, which have an additional level of assets of more than $3 trillion. Swap arrangements among central banks, pooling them in reserve funds or to support the development of regional bond markets, are mechanisms to multiply the room to maneuver that they provide. These reserves and existing sovereign wealth funds could also be used to increase the role of regional development banks owned by developing countries, by investing in the capital of existing institutions and creating new ones.

Multilateral development banks should maintain their central function in the international development architecture and, in particular, in financing human development, infrastructure and clean energy investment. But regional and sub-regional financial institutions owned by developing countries should play an important complementary role, as they give a greater voice and sense of ownership to developing countries. Moreover, regional and sub-regional development banks are particularly suited to provide regional public goods.

If developing countries allocate 1% of their foreign exchange reserves to the paid-in capital of regional and sub-regional institutions, this would amount to $50 billion at current levels of reserves. Assuming a ratio of loans-to-capital of 2.4 times –an estimate based on the ratio of the successful and financially sound Andean Development Corporation– the expanded regional and sub-regional development banks or new ones could generate additional annual lending of approximately $120 billion. This additional lending could be very valuable in the current context.

By expanding or creating new regional and sub-regional financial institutions, developing countries could lay the basis for their own current and future lending capacity, which would eventually help them meet their development goals. Given their large foreign-exchange reserves, we believe the time to begin such an initiative is now. A network of regional development banks is already in place, though unevenly developed in different regions of the developing world. The multiplication and growth of these institutions is highly desirable.

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