Financial Crisis and Global Recession: At a Turning Point?

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Main messages

- Recession in the US now appears to be bottoming out, but speed and strength of recovery is uncertain.

- Even though recession will eventually end, several daunting challenges remain, particularly for the poorest countries and vulnerable social groups.

- Domestic policy is critical, but generating a sustained recovery requires new forms of multilateral collaboration.
Causes: Macroeconomic policy and changes in the financial system create conditions for the perfect financial storm

- Excessively easy money after 2001
- Fiscal stimulus as US budget swung from surplus to large deficit
- Expansion of opaque financial innovation
  - Subprime mortgages
  - Home equity lending
  - Consolidated Debt Obligations
  - Credit Default Swaps

- Emergence of unregulated borrowing in the shadow banking system
  - Mortgage companies
  - Investment banks
  - Hedge funds

...leading to excessive leverage of consumers, corporates, and public sectors

...financed by China and other countries accumulating large reserves
but the problem goes back to the unsustainable rise in debt after 1980

Source: Bureau of Economic Analysis (NIPA Table 1.1.5) and Federal Reserve System (Flow of Funds Accounts Table L1)
...and the deteriorating global imbalances


Crash of Lehman in September...precipitated financial panic that swept through global markets

MSCI equity price indexes, January 2005=100

So...
• 30% of household wealth wiped out
• $4 trillion of equity worldwide
• Pension funds obliterated
• Unprecedented contraction in consumption

Contracting consumption in rich countries transmits recession to poor countries – as *world trade* collapses.

**Annual growth of global trade volumes**

Terms of trade shocks will compound difficulties in several countries...
Terms of trade shocks will compound difficulties in several countries...
...and diminished capital flows have deepened recession in the developing world.

Net private capital flows / GDP in developing countries

Remittances may also slacken...

Remittance flows to developing countries (USD, % change)

Source: World Bank data and staff estimates
So now the world economy is contracting... for the first time in the last half-century.

Developing countries stand to lose some 4 percentage points of GDP growth.

Projected growth of GDP in 2009

Some 90 million additional workers are expected to be trapped in poverty – with some 47 million in South Asia and 24 million in South-Saharan Africa.

Source: World Bank, DEC prospect group, April 2009
Green shoots? Incipient signs of recovery...

Credit markets have stabilized...secondary markets beginning to reappear

Spread between 3 month $ LIBOR and $ OIS

Green shoots? Incipient signs of recovery...

- Credit markets have stabilized...secondary markets beginning to reappear
- Equity markets appear to have established a floor
- Personal income in US rose 0.4% in April...household savings hit 5.7% of disposable income (highest since 1995)
- Some life in the real sectors...Retail sales may have hit bottom...new orders up slightly ... and US current account is improving
- EU investor sentiment is turning positive (Germany) and consumers more optimistic (Belgium)
- China’s stimulus is beginning to work... PM survey moved into positive territory
Outlook? Recovery will probably begin in 2010…
but strength is uncertain

Shape of the coming recession depends on responding to several daunting challenges…

Daunting challenge: for rich countries, taking bad debt off the books of the banks


While JPMorgan considers this information to be reliable, we cannot guarantee its accuracy or completeness.

Source: Bloomberg, Jan 20th 2009
Daunting challenges: Providing adequate financial support to maintain growth

Financing gaps range from $200 b to $700 b.

Estimated funding gap in 2009 by region

- All developing countries
- East Asia and Pacific
- Europe and Central Asia
- Latin America and the Caribbean
- Middle East and North Africa
- South Asia
- Sub-Saharan Africa

Daunting challenges: At-risk countries...

Those are at risk:

- export only a few commodities
- have large % in poverty
- have weak fiscal positions
- have low reserves/ high debt

Implications of slowdown...

- Crises in Mexico, Argentina, and East Asia increased poverty dramatically
- 200 million likely to be trapped in poverty
- Unemployment will certainly rise
- Infant mortality and child mortality rises – 200,000-400,000 infants annually
- Health services cutback

Source: IMF, 2009
Daunting challenges: Providing support to workers and the poor

Widening fiscal deficits will put pressures on social safety nets

Fiscal deficits will widen sharply in 2009

Daunting challenges: Providing support to workers and the poor

- Widening fiscal deficits will put pressures on social safety nets
- Declines in remittances will put pressure on poor households
- Firms will face tighter credit conditions, weaker export demand, adversely affecting labor demand

Unemployment likely to increase... and remain high

- ILO: 23 million more workers will be unemployed in 2009 than in 2007
- Recessions with housing busts involve deepest employment cuts and longest periods to recover (Claessens, et al, 2008)
- Jobs are lost more quickly in contraction than are replaced during subsequent recovery (Rijkers, 2009)
- Employment usually takes twice as long to recover as output (Reinhard and Rogoff, 2002)
- Poor urban workers often move to agriculture if that is feasible (e.g., in East Asia crisis, 30-40% of displaced workers moved).
Policy options? For developing countries…

- **Counter-cyclical policies:** But only open to countries with access to noninflationary sources of finance and a sound investment climate.

- **Since trade is a main channel of recession,** policies to reduce trade costs, including border reforms, customs reform, port reforms, and improving logistics management.

- **Policies to support workers and the poor**
  - Increase in unemployment benefits
  - Wage subsidies and lowering wage taxes
  - Tariff reductions on food imports
  - Public employment programs
  - Conditional cash transfers programs (stay in school programs)
  - Public investments in labor-intensive and trade-related infrastructure, such as rural roads.
Conclusion: Improving the multilateral response requires...

- Fulfilling pledges for development assistance, and augmenting these with a “vulnerability fund”

- Keeping global markets open and resisting pressures for trade protection – and renewing a commitment to the Doha Development agenda

- Improving regulation of financial markets will require careful balancing of national regulatory authorities with international cooperation
World Bank Group is increasing financial flows

Increasing financial support for the poorest countries: IBRD and IDA funds:
- Substantially increasing IBRD lending ($100 billion over next 3 years)
- Fast-tracking IDA funds ($42.5 billion over next 3 years)
- Food crisis response

Shoring up the private sector: $30 billion over next 3 years from IFC and:
- Ensure trade flows
- Bolster distressed banking systems
- Keep infrastructure projects on track

Other support:
- Creation of a vulnerability financing facility – to finance social safety nets, infrastructure and SMEs
- Trade Facilitation Facility – $40 m. to as aid for trade
- Technical analysis, advice, and diagnostic tools
Acknowledgements and Selected References

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