



Impact of the Global Economic Crisis on Low Income Countries

Responding to the crisis – What is needed at the international level? What can developing Low Income Countries do?

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June 2009*

How do we understand this crisis?

This crisis is not simply a failure of the financial system but rooted in deeper contradictions in the current development paradigm. Income inequality in the US reached levels last seen only at the precipice of the Great Depression and US households have not been this exposed to debt since 1929. These are structural failures further reflected in persistent imbalances at the global level. The key point is that *global demand has become excessively reliant on overextended US households*. The crisis now provides an opportunity for a paradigm shift away from the narrow efficiency-focus of the Washington Consensus to a new consensus around the need to raise middle-class living standards across developing Low Income Countries (LICs), diversify global demand away from overextended US households and harness productive capacity across the developing world.

How is the crisis affecting Low Income Countries?

The main transmission channels to LICs are trade contraction (in particular volatility in commodity markets), reversal of capital flows (including remittances), and increased vulnerability to debt and macroeconomic crises. The crisis is having a significant impact on already low government capacities; state revenues are falling precisely when vulnerable sections depend on public services the most. A health and malnutrition crisis is underway in many LICs and there is a very real danger of social tensions as the crisis is unfolding at a time of demographic transition with burgeoning young and urban populations.

How long will it last?

There is much talk of 'green-shoots' as credit markets in advanced countries show signs of recovery, equity markets bottom-out and stimulus measures take hold. However *the*

crisis is having a lagged effect in LICs and is still unfolding. While advanced and some emerging economies could experience a 'V' or 'U' shaped recovery in late 2009 or 2010, LIC transmission channels will operate longer. Employment is the key real variable to watch. There are signs of lagged employment impact in LICs and it should be emphasized that employment takes twice as long to recover as output. There is a high probability of an 'L' shaped recovery beginning only in 2011 in LICs, even as advanced economies bounce back faster.

What can be done at the international level?

At the international level we need an enabling environment to diversify global demand away from US households and develop productive capacities in LICs. This entails changes in the conditionality framework of the international financial institutions (Fund and Bank), space for diverse national development strategies, but also a common adherence to respect for human rights, pursuit of low-carbon growth and decent work standards. Key to generating more sustainable global demand is a coherent international monetary system. Articulate proposals for a Global Coordination Council to deal with adjustment of imbalances, adjustment between currency systems and better manage capital flows are currently on the table. Specific to LICs, the crisis has demonstrated the need for a new permanent anti-shock countercyclical financing facility. To champion these proposals LICs need greater voice in international institutions and more engagement with G20. Regional cooperation and integration can play a facilitative role. But perhaps more immediately, we voice support for a moratorium on LIC debt in order to avert another debt crisis and lost decade.

What can developing LICs do?

First is the need for serious rethinking of the role of the state in development. This crisis has shown that whether an economy is developed, middle income, emerging or low income, when crises hit the state has a fundamental role to play. Over the past decade LICs have become increasingly exposed to the global economy via domestic reforms and external liberalization. It is now clear that first and foremost they must protect themselves from the worst effects of external crises, and if necessary employ so called 'blunt' tools such as capital controls and more stringent banking regulation. LICs must argue there is a difference between protection and protectionism; this is clear from the direct intervention by governments across advanced economies to protect the integrity of their financial systems. There is a strong case for greater state involvement in LICs in order to bring about a structural transformation in favor of stimulating domestic demand.

Macroeconomic policies that counteract asset-price bubbles before they form, and are growth and employment oriented can play an important role in this structural transformation. The focus must be on employment generation especially in the agricultural and SME sector. In the medium-to-longer term concerted efforts to enhance domestic resource mobilization are needed to ensure fiscal space, and moves to develop the financial sector must be undertaken with caution. Recent research indicates a greater state role in the financial sector can not only increase efficiency but also stabilize against crises in LICs. Getting governance right is crucial.