

Financial crisis in the New Independent States (NIS) countries: its possible impact and challenges for development

5th Annual Summer Public Management Institute
Latvia, August 17–21, 2009

Foreword

- The global financial system is in crisis, and that crisis is hitting developing countries hard...
 - The system has never served developing countries well. Those that opened their doors to global finance have seen huge increases in their vulnerability...
 - With little more in the way of improved human development than countries which took a more cautious approach...
 - And the poorest countries have not got the financing they so desperately need...
 - It is becoming increasingly clear that we need a system that actually serves development without the huge risks that are now all too apparent.

Plan of presentation

- I. Governments are responding
- II. Understanding crises
- III. Channels of transmission of the crises
- IV. Possible consequences
- V. The cost of the crisis
- VI. Countries case studies
- VII. Development Challenges and Responses
- VIII. Concluding remarks

Governments are responding (I)

“We have to do more than just fix the current financial disorder. We have to improve governance so that globalization produces fairer results and promotes social justice. And we have to make sure that it is environmentally, economically, socially and politically sustainable.”

Ban Ki-moon, Secretary-General of the
United Nations

Governments are responding (II)

- ▶ Governments should give high priority to monitoring and responding to the financial and economic crisis.
- ▶ In some cases, governments have been very proactive:
 - injected huge resources from the reserve and national welfare funds, as well as from budgetary surpluses;
 - looked for providing short-term economic stimuli to revive demand; and
 - in other cases, the special priority was given to agriculture, to ensure food security and to support livelihoods.
- ▶ However, in a majority of countries, action is still only at the level of discussion and debate.

Understanding crises (I)

- ▶ Lessons learned about the causes of past financial crises
- ▶ It is crucial to evaluate different potential causes of the crisis, and identify the political and bureaucratic incentives that undermine the effectiveness of financial regulation and supervision
- ▶ An important lesson from past experience is that the short-term responses to a crisis – macroeconomic stabilisation, trade policies, financial sector policies and social protection – cannot ignore longer-term implications for both economic development and vulnerability to future crises.
- ▶ The process of globalisation and financial development has been prone to crises
- ▶ Even relatively mature financial systems are vulnerable to systemic banking crises, cycles of booms and busts, and financial volatility
- ▶ As countries become more open to capital flows, crises are more easily transmitted across borders
- ▶ Crises reflect systemic risk.

Understanding crises (II)

- ▶ There are undoubtedly many further interesting and important dimensions to the crisis worth pursuing further.
- ▶ For present purposes, however, the above shows that the anatomy of the crisis is rather simple:
 - ⇒ easy credit; bad loans; weak regulation and supervision of complex financial instruments; debt defaulting; insolvency of key financial institutions; a loss of credibility and trust; financial panic and mass selling-off of stocks; and a hoarding of cash by banks and individuals.
- ▶ With the interconnectedness of financial markets, especially amongst the developed countries, the panic spread rapidly, causing a widespread 'credit crunch' and sharp declines in consumption, investment and trade in initially all of the G7 countries.

Channels of transmission of the crisis

- ▶ Despite of the fact that financial sectors in developing countries are less integrated into global financial markets, the poorest countries will be harmed through slower export growth, reduced remittances, and lower commodity prices.
- ▶ The crisis may also lead to a reduction in private investment flows, making weak economies even less able to cope with internal vulnerabilities and development needs.
- ▶ The developing countries will be significantly affected by the crisis even though the channels of transmission are likely quite different from those operating in emerging markets.

Possible consequences

While the effects will vary from country to country, the economic impacts will include:

- ▶ Weaker export revenues;
- ▶ Further pressures on current accounts and balance of payment;
- ▶ Lower investment and growth rates;
- ▶ Lost employment;
- ▶ Lower growth translating into higher poverty;
- ▶ Remittances are expected to decline;
- ▶ More crime, weaker health systems and even more difficulties in social protection.

The cost of the crisis

- ▶ The financial crisis has already led to catastrophic drops in income in 2008, and it's predicted to get worse in 2009.
- ▶ The impact relative to GDP is nearly double the impact of the Asian financial crisis of the late 1990s.
- ▶ Considering that the pre-crisis forecast was that earning from trade and private sector flows should actually rise between 2007 and 2009, the crisis has clearly hit hard and hit quickly.
- ▶ For countries that based all or part of their development strategies on attracting funds from abroad, and for the companies and individuals that were dependent on these flows, this fall is likely to be disastrous.

Countries case studies

- ▶ Kazakhstan
- ▶ Latvia
- ▶ Moldova
- ▶ Russia
- ▶ Ukraine

Kazakhstan

- ▶ Kazakhstan is the leading economy in Central Asia and the third largest among the CIS. It was the first country in the CIS affected by the global financial crisis.
- ▶ The substantial involvement of Kazakh banks in retail and construction sectors and high dependence on foreign loans in light of worsening credit crisis and declining oil prices have put the country at serious risk.
- ▶ The crisis was expressed also in extreme financial deterioration in terms of exchange rate depreciation, increase in spreads, and equity market declines. The equity market was down by 70% (in Iceland, for instance, is down by 85%, in Russia by 76%).
- ▶ The Government implemented a series of measures to stabilize the market, in particular using money from National Oil Fund, and this seems to be effective.

Kazakhstan (cont.)

Causes of the crisis and implications	Measures undertaken
<ul style="list-style-type: none">▪ Since autumn 2008, the Kazakhstan's stock exchange have continued to drop, in which the financial sector has been the most seriously hit;▪ The banks borrowed more than 50% of their total borrowings from foreigners (in Russia – 18%);▪ The banking crisis inclines deeply on the real estate market;▪ The share of bank credits, subjected to stress, was equal to 35–40%;▪ According to official data, in May 2008 the inflation was 19%, while non-official sources report 40%;▪ The financial crisis has also hit the country industrial production;▪ Housing sector has also suffered.	<ul style="list-style-type: none">▪ Some 10 billion USD has been injected into the financial market;▪ The Government has assumed controlling stakes in two of the country's largest banks;▪ The Central Bank announced in February a 25-percent devaluation of the country's currency (Tenge);▪ The Government decided to spend 1 billion USD on agricultural development in the next three years;▪ The Government has scrapped the export tax on all oil companies registered in the country in a bid to support exports and drive the economy;▪ Measure to secure socials ability and the people's livelihood.

Latvia

- ▶ The country's economic decline is accelerating: GDP fell 10,5% in the last quarter of 2008 from the same period a year earlier. By the end of 2009, the economy is projected to shrink a devastating 12 %.
- ▶ Manufacturing output fallen down 11,3% in the quarter in comparison with a year ago, while the retail trade sector fell 15,6% and hotel and restaurant business plunged 24,8%.
- ▶ The unemployment rate reached 9,5% in February 2009 (in some country's district – 21,2%), with predictions set around 50% unemployment by the end of year.
- ▶ Political and social tensions exploded in January 2009 into a riot and forces Latvia's Government to resign.
- ▶ International lenders, including the EU, the IMF and Nordic countries, have pledge Euro 7.5 billion (US\$9.5 billion) to help the Baltic country recover from its economic predicament.

Moldova

- ▶ In October 2008, the National Bank's Governor says there is no financial, neither economic crisis in Moldova, and there are no factors that could generate it in the near future.
- ▶ In 2008 the economic growth in Moldova was 4, 5% (in 2009 is projected to be 6%); the annual rate inflation was among the smallest in the region – 7% and the Moldovan currency strongly appreciated because the remittances increased significantly, the foreign investment grew (2,4%), as well as the export.
- ▶ Even if the crisis could influence on the real sector (i.e. the realty market), the banking sector feels safe. A factor positively describing the Moldovan banking system, is the very low percentage of the non-performing loans – up to 4.5%.
- ▶ However, the Moldovan economy is very open and therefore seriously exposed to foreign factors.
- ▶ The global economic crisis will lead to a decline of the labor demand in the European countries and will affect Moldovan citizens working abroad; consequently the volume of money transferred to Moldova will reduce, respectively, it could lead to lower consumption and lower economic growth too.
- ▶ The recent political crisis in Moldova after Parliamentary elections has brought some concerns about the security and geopolitical implications of the economic crisis into reality.

Moldova (cont.)

The Banker, Risers and fallers

Published: 05 January, 2009

- ▶ The results, based on 25 indicators of financial and economic health, are shocking. According to The Banker's new financial risk model, **Moldova**, Chile, Bolivia and Peru are less likely to be affected by the current financial crisis than the US, UK or Japan. These countries may be poorer, but with a far lower reliance on credit and just a fraction of the leverage of developed markets, they are more isolated from financial meltdown than any developed country, according to the ranking.
- ▶ The big surprise is **Moldova**, a small eastern European country with a gross domestic product (GDP) per capita of just \$1830, ranks fifth. **Moldova** has very low levels of debt (\$763 per capita, compared with the UK's \$171,000 per capita), and its banks have high capital-to-asset ratios of more than 17% and low levels of lending.
- ▶ According to the World Bank, banks in **Moldova** have extended loans worth just 35% of GDP, compared with the US, where domestic bank lending has reached 230% of GDP. **Moldova** pays just 2.8% of public sector revenues to service government debt but Italy, for example, spends 11.9% of government revenues on interest payments.

Russia

- ▶ Russia is a major exporter of commodities such as oil and metals, so its equity market has been hit hard by the decline in the price of many commodities.
- ▶ After studying the country case, a few conclusions are pertinent:
 - (1) Western investors began fleeing the Russian markets even before the global crisis hit;
 - (2) Russia passed through the first stage of the financial crisis more easily than the US or the countries of the EU simply because its banking sector is much smaller and only a tiny portion of the population is dependent on it;
 - (3) In order to protect the banking sector and problematic sectors of the real economy from collapse, the Government injected huge resources from the reserve and national welfare funds, as well as from budgetary surpluses;
 - (4) The main factor is the burden of foreign corporate debt, which amounts to more than \$500 billion. This sum equals the country's entire hard-currency reserves;
 - (5) Another problem is the rise in global prices for foodstuffs and medicines. Russia imports about 46 percent of its food and about 80 percent of the most crucial medications are imported.

Russia (cont.)

- ▶ In November 2008, Government announced package of tax reforms: corporate profit tax rate is to be reduced to 20% (24% in 2008). There will be no changes in VAT rates (maximum 18%), but the government considered changing accrual rules in favor of the taxpayers.
- ▶ The crisis has been partially mitigated by the enormous reserves accumulated by the Government (Stabilization Fund) on the wave of high prices worldwide for raw materials and energy resources.
- ▶ However, there are increasing signs that the main problems for Russia lie ahead and that the efforts of the country's leaders to present Russia as an island of calm and stability have failed.

Ukraine

- ▶ Ukraine has been badly hit by the global economic crisis with a slide in the value of its currency and falling prices for metals, its main export, which have caused thousands of lay-offs in the country's industrial east.
- ▶ Inflation peaked in May 2008 at 31 percent before dropping to a less alarming 16 percent in September. The value of the local currency, the hryvna, depreciated significantly, forcing the Central Bank to intervene and sell dollars at an artificially low rate.
- ▶ A global recession would also have a dramatic impact on remittances for Ukraine's large migrant workforce. Ukraine is second only to Russia in remittances in Central and Eastern Europe, sending home nearly \$8.5 billion a year -- an estimated 8 percent of the country's GDP.
- ▶ Then there is the critical factor of the price Ukraine will pay for Russian gas in 2009.
- ▶ Other channels of influence: Foreign trade; Banking system; Debt (See slide 18).
- ▶ Ukraine's economy is expected to shrink 9% in 2009 amid the global economic crisis.
- ▶ The situation has been compounded by protracted infighting between President and Prime Minister, which has cast doubt on country's ability to carry out an anti-crisis programme.

Ukraine (cont.)

- ▶ **Foreign trade**. Since the Ukrainian economy is highly dependent on exports making up more than 47% of the country's GDP, the above trends in the global markets will be harmful for the development of export-oriented sectors, with subsequent repercussions on industries relying on exports directly and indirectly.
- ▶ **Banking system**. The penetration of foreign capital into Ukraine's financial institutions is considerable. The financial sector is one of the national leaders in attracting foreign direct investments (19% of total accumulated foreign capital). The share of foreign capital in the banking sector amounts to 37.2% of total capital, which exceeds the threshold of economic security established at 30%; in the insurance sector it approaches the threshold value, currently constituting 28.1%.
- ▶ **Debt**. In June 2008, gross foreign debt made up 59.9% of GDP at USD 100.06 billion. Almost 85% of this debt was that of the private sector. According to IMF data, the maximum limit of foreign debt for low and middle income countries is set at 49.7% of GDP; once this limit is exceeded, the probability of financial crisis increases to 70%.

The survey results

Sociologists of three countries – Russia, Ukraine and Byelorussia – explored at the beginning of the 2009 Year how the crisis influences the citizens of these countries:

	Byelorussia	Russia	Ukraine
Shrinkage of income of their family	n/a	n/a	7%
Renouncement of certain commodities and services	n/a	n/a	10%
Surrounding panic and depression	n/a	n/a	9–10%
The wage arrears	11%	21%	25%
Started to save:			
– on food stuff	45%	30%	56%
– on apparel and shoes	39%	42%	56%
– on leisure and entertainment	25%	30%	43%
Ready to participate in protest actions	38%	43%	62%

Development Challenges and Responses (I)

The current macro economic and social challenges posed by the global financial crisis required a much better understanding of appropriate policy responses:

- ▶ **Fiscal and monetary policies face difficult tradeoffs in a crisis:** Developing countries that enter the crisis with large balance-of-payments and fiscal deficits will be the most vulnerable to these effects.
- ▶ **Trade policies pose further challenges:** Global trade can be an important part of the adjustment process in response to a crisis.
- ▶ **Early response is crucial, but political economy plays a role:** Because financial crises tend to be systemic, government intervention is unavoidable. Though the fiscal cost of interventions can be quite large, and with corresponding political costs, the cost of an eventual collapse of the financial system is even larger. Well-designed policies implemented at the early stages of crises tend to be less costly.

Development Challenges and Responses (II)

- ▶ **Financial sector responses need to consider incentives and longer-term impacts:** Crisis resolution is a very important component of the safety net, and how the current crisis is resolved may sow the seeds of future crises.
- ▶ **Crises have led to some of the best social protection, and some of the worst:** Social policy needs to respond flexibly to differing needs. If it is to provide effective insurance, it is crucial that the safety net responds to the needs of the poor, and does not rely heavily on administrative discretion.
- ▶ **A crisis calls for a pro-poor fiscal response:** If the country concerned has the option of an aggregate fiscal stimulus (possibly helped by foreign aid) then there is a long-standing macroeconomic argument in favor of assuring that the composition of the extra public spending, or tax cuts, favors programs that immediately benefit poor people.

Development Challenges and Responses (III)

- ▶ **A crisis can be an opportunity for introducing better social programs:** Universal social policies in the areas of nutrition, basic education and health should be the major policy focus, but targeted programs for the poor. Special emergency employment programs should be the essential complement, since unemployment insurance, the traditional automatic stabilizer of industrial countries is generally absent in developing countries.
- ▶ **Public works can combine a safety net with infrastructure development in poor areas:** Public spending on labor-intensive public works projects, such as building rural roads, can combine the benefits of an aggregate fiscal stimulus with those of income support for poor groups.
- ▶ **Good data are crucial:** Sound information and monitoring and evaluation systems are important for an effective social policy response. Various types of data are needed, including household and enterprise surveys and data on public spending.

Concluding remarks (I)

- ▶ Understanding of past crises and their impacts provides the foundation for appropriate policy responses, with a leg on each side of macroeconomic policy, the financial sector and social protection.
- ▶ Even if developing countries will be affected in the form of lower growth, higher unemployment and poverty, and changes in inequality, it has been argued that there are many and various channels for the impact to affect countries differently, depending on the extent to which they are vulnerable to particular channels.

Concluding remarks (II)

- ▶ This crisis has shown how important credit and risk-management institutions are to economic growth, and it has shown how important appropriate institutions are for the correct functioning of the financial sector.
- ▶ The likely responses required in developing countries would need to include immediate, short-term (stabilization) and long-term (structural) policy responses.