УДК 336:330.33.01 (100)
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THE GLOBAL FINANCIAL CRISIS: FINANCIAL FLOWS TO DEVELOPING COUNTRIES

Розглянуто основні аспекти та наслідки світової фінансової кризи. Наведено аналіз руху фінансових потоків та їх вплив на стабілізацію економіки країн, що розвиваються. Виявлено вплив фінансової кризи на банківський сектор України, а також зарубіжних країн.

Ключові слова: *світова фінансова криза, фінансові потоки, фінансова інтеграція, новий економічний порядок, подвійна криза, криза глобального капіталізму.*

Actuality of the problem. The global financial crisis that has spread around the world has caused a considerable slowdown in most developed countries and has already affected financial markets and growth prospects in developing countries. Governments around the world are trying to contain the crisis, but some suggest the worst is yet to come. House prices in the USA have collapsed with losses of up to $2,4 trillion in the eight months to July 2013 (Lin, 2013), hitting the balance sheets of banks exposed to the housing sector, which affected the entire US financial sector, and then, in turn, other developed and developing countries. Leading indicators of global economic activities, such as shipping rates, have declined at alarming rates. Asian markets are also slowing down, while orders for Chinese exports are falling.

Analysis and results of the study. Authors Jaseviciene F. Bakladgi H., Vardar G., Cherkashina K., Liakhov O., Nanavov A. providing of competitive advantages of banking sector development under conditions of financial market, but not been fully considered. Global financial contagion is already upon us. Stock markets in both developed and developing countries are down 50–75 % from their recent peaks. The USA has lost equities worth $16,2 trillion this year. Investment banks have collapsed and high street banks have been rescued, with government sponsored packages worth more than one trillion US dollars. The International Monetary Fund (IMF) has begun to support countries such as Hungary, Iceland and Ukraine. On 8 October, interest rates were cut around the world in what looks like a coordinated response, and have fallen further in a number of countries.

The financial crisis will also have major negative implications for the real economy. The IMF has revised its growth forecasts downward twice in recent months. The world economy is expected to grow by 3,7 % in 2013 and 2,2 % in 2014 – nearly 2 % less than its July forecast for 2014 – after growth of 5% in 2012. While China is expected to maintain growth rates of more than 8 % this year, developing countries (and also Sub-Saharan Africa as a group) are expected to grow at 5,1 % in 2014 (both groups had a two percentage point downward revision in growth rates), whilst advanced economies are expected to contract by 0,3 %. The IMF expects world trade growth to slow down from 9,3 % in 2012 to 2,1 % in 2014, broadly consistent with the World Bank's forecast of stagnant trade. The impact of the crisis on developing countries will vary depending on their direct and indirect trade links to crisis affected countries, the structure of trade, the share of remittances and private financial flows from crisis affected countries, and the extent to which their fiscal and

trade balance allow governments to respond.

This background note discusses a number of critical questions for those interested in development. What does the global turmoil mean for financial resources to developing countries? What are the channels through which the crisis spreads to developing countries and how are they feeling the effects? What evidence is already available? And what does this mean for the upcoming Doha conference on Finance for Development and G20 crisis meeting?

The remainder of the note is structured as follows. The second section examines how the current financial crisis affects development finance resource flows to developing countries. The third section describes the evidence so far on the effects of the financial turmoil on flows and indicators of development finance resources, and includes a summary table on the potential effects of the financial crisis on developing country financial resources. Finally, the fourth section presents policy implications. This section focuses on the capital and financial account of the Balance of Payments (which records transactions between residents and non-residents), acknowledging that the fallout of the crisis may also be explained through effects on the current account such as export revenues, aid flows, and remittances. In conceptual terms we distinguish between different types of resource flows:

1. Private capital flows: Foreign Direct Investment (FDI), portfolio flows and international bank and non-bank lending;

2. Official flows: finance by development finance institutions (DFIs);

3. Capital/current transfers: aid (ODA or official development assistance) and remittances;

4. Other relevant finance flows for development include **domestic resources** such as domestic public and private spending (which enters the national accounts, not balance of payments statistics).

The developing world has become more closely integrated with the global financial system especially over the past two decades. This integration is due to both pull and push factors; ‘pull’ factors include continuous liberalisation of capital accounts and domestic stock markets as well as large scale privatisation programmes, while ‘push’ factors include the increasing importance of institutional investors (mutual funds, hedge funds, etc.), and the spread of depositary receipts (negotiable receipts that represent a company’s publicly traded debt or equity), and cross-listings. Thanks to all of these factors, as well as an improvement in emerging market economies’fundamentals, foreign investors have gained confidence in the potential of the developing world leading to a remarkable surge in cross-border capital flows between developed and developing countries.

Increased financial integration of developing countries can increase economic growth rates, but may also potentially increase the speed and the number of channels through which financial crises in general, and the current financial turmoil in the specific case, may propagate across the developing world. Indeed, crossborder capital flows between developed and developing countries are sensitive to macroeconomic and financial conditions not only in developing economies but also in mature markets, and the transmission of shocks through these financial channels is much quicker than through real channels. For example, a shock in income growth in a developed country may have a gradual impact on a developing country through trade channels, but could have a much quicker effect on economic activity of that country through correlations in stock market fluctuations.

There are two main financial channels through which the recent turmoil, triggered by the subprime crisis in the USA since mid-2013, has spread to developingcountries:

- *Net private equity flows*: this includes foreign direct investment (FDI) aimed at acquiring a long lasting stake in developing country entities and portfolio equity inflows.

- *Net private debt flows*: this includes short, medium, and long-term debt flows.

The developed country financial crisis affects private capital flows to developing countries in a number of ways:

- *Solvency Effect.* During the current financial crisis, several financial institutions in developed countries experienced a strong deterioration in their balance sheets due to huge losses in subprime mortgages. This deterioration caused a substantial fall in the amount of bank capital and, because of risk based-capital requirements, banks have restricted asset growth by cutting

back on lending. As a consequence, cross-border syndicated loans to developing countries and intra-bank lending have been curtailed.

- *Liquidity Effects.* The financial crisis increased the pressure of liquidity constraints on bank and non-bank intermediaries (i.e. institutional investors like mutual funds and hedge fund) in developed economies with adverse consequences for developing countries. Indeed, the increased uncertainty about counterparty risk in the banking sector caused a surge in demand for short-term financing thus putting banks' liquidity under pressure and making fewer resources available for cross-border bank lending. Moreover, hedge fund investors in mature economies, who had faced margin calls and redemption orders at home, have been forced to liquidate some of their foreign equity positions thus intensifying the sell-off of risky assets in the developing world.

- *Investor perceptions.* The uncertainties on the global economic outlook created by the current financial turmoil have reduced investors' appetite for risk, thus causing a flight to quality. International investors have become more risk averse and have preferred to flee to high quality assets (e.g. government bonds) from large economies like Europe and, ironically the USA, rather than continuing to invest in risky emerging markets' assets. This phenomenon has been exacerbated by investors' concerns about the existence of some overvaluation in emerging markets and about the risk of a sudden slowdown in their economic growth. Consequently, bond issuance and net private equity flows in developing countries have declined. In particular, the lack of investors' confidence has led to a reduction in the number of initial public offerings (IPOs), as foreign investors have become less willing to invest in equities issued by companies going public in developing countries.

- *Asymmetric information and herding.* Because of the opacity of the structured products market, the subprime mortgages crisis has led to a high degree of asymmetric information among banks about the distribution of losses and counterparty risk. Banks have, therefore, become reluctant to lend even to developing countries and have increased the cost of borrowing. The presence of information asymmetries among investors have also led to the herding phenomena, where uninformed investors decide to sell-off risky assets in developing countries just following the behaviour of perceived informed investors.

- *Real economy effects*. Given the strong links between global growth and net private capital flows to developing economies, the projected reduction in global growth mainly driven by developed countries may lead to a further reduction in net private capital flows to developing countries.

- *Liability Management Effect.* The absence of a prudent liability management by financial institutions may have additional negative effects on capital flows to developing countries, because of increasing uncertainty of whether developing countries will be able to roll over short-term debt as well as medium and long-term debt. On the other hand, the overall amortisation payments of debt due by private sector borrowers are expected to amount to $90 billion in the last quarter of 2013, and to $130 billion in the first half of 2014. Brazil and Russia are among the countries with the largest debt close to be due in the next months.

Trade and development finance are important sources of external finance for developing countries. Export credit is short term finance that enables trade to take place. Recently, developing country firms have funded themselves in developed countries by issuing bonds and arranging loans which means that the financial crisis affects such firms. These effects are also felt through the lack of export credits as these are important for countries heavily dependent on exports.

The family of multilateral and bilateral DFIs have substantial resources backed by guarantees and capital endowments from governments in developed countries.

The mandates of DFIs require them to leverage such liquidity to invest in emerging markets, and for some, low-income and frontier markets. When emerging markets are doing well, DFIs will be able to obtain high returns on equity investments and developing country firms will be able to repay loans. Until recently, there have been very high levels of income across the main DFIs. At the IFC, in 2012/2013 total capital (capital stock plus designated and undesignated retained earnings) was close to total commitments of loans, equity and debt securi-

ties. CDC's (UK DFID) rate of return outpaced emerging markets stock market indices.

The current crisis is likely to reduce the growth (and possibly the size) of total remittances substantially as it would (negatively) affect both the size of the migrants'population and the amount remitted per capita. Economic theory suggests that migration is driven by the difference between the expected wage obtained in the destination country and the actual wage earned in the source country. The current crisis would reduce wages in developed countries, squeezing the difference in wages, and reducing the level of migrant flows. But the migration stock may also be affected as some migrants may lose their jobs, thus increasing the rate of return migration or the level of unemployed migrants. Moreover, the downturn may force even those who maintain their job to reduce the amounts remitted, due for instance to a reduction in real wages (if these are linked to firms' profitability) and to a depreciation in the exchange rate of the country of destination. For instance a currency depreciation (vis-a-vis that of many developing countries) is currently occurring in the UK.

A large enough reduction in growth in remittances could turn into a reduction in the *absolute* level of remittances. Recent evidence suggests that the decrease in remittances can be substantial for certain countries. For example, in the first eight months of 2013 remittances to Mexico (which rely almost exclusively on the US market) have decreased by 4,2 % (at annual level). And the drop has been strongest in the last two months of data: remittances fell by 12,2 % in August and by 9,6 % in the July-August period. Remittances to Kenya (which depend on the US economy) have been hit even harder, with the Central Bank estimating a 38 % year-to-year drop in August.

Conclusions

Not all countries and sectors are likely to be affected in the same way. First, certain sectors may be less affected than others. The health sector for instance is likely to be among those less affected. As a primary need, the demand for health services has a low elasticity with respect to income. Therefore health expenditures may remain fairly stable even in a period of deep crisis. According to the Philippines' Central Bank, this seems to be the case of Philippines, whose inflow of remittances is expected to experience a less drastic drop than other countries in the aftermath of the current crisis. Second, to the extent that the crisis is localised to certain regions, the more concentrated a country's migrant population is in those regions, the more adverse the potential consequences of the crisis on remittances. Third, the more reliant a country is on remittances to fund its imports or its public budget, the more exposed it is to the potential reduction in remittances.

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