How the Global Crisis Is Transmitted to Developing Countries

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As the financial crisis spreads out from its crucible in the U.S. and U.K. it has given rise to considerable discussion about its impact on developing countries. The situation itself is novel because previous international financial crises, the Third World Debt Crisis of the 1980s and the emerging market crises of the 1990s, spread from developing or emerging markets, so that developing countries were incriminated and affected from the start.

In the present crisis, the developing countries, for once, were not in the room when the crisis broke. Given the immense range of economic circumstances and exposure to international financial markets among the developing countries, the manner in which they are being affected is inevitably going to be more complex and indirect than in previous crises.

Current economic theory gives little guidance as to how the crisis will impact upon the developing countries. This is partly because the starting point of mainstream economic theory is optimization based on setting policy parameters that will secure internal and external equilibrium for a given country.

It is more realistic to use a stock-flow analysis that places developing countries within a given structure of international economic and financial flows which are largely determined by expenditures in rich countries. Within this framework, assets and liabilities are largely determined by the history of past market disequilibria, rather than saving or portfolio preferences.

U.S. Government Bond Standard
At the start of the twenty-first century, the international financial system is effectively an indirect U.S. Government Bond Standard, in which the U.S. dollar acts as a standard of value for all other currencies, and is held because it is directly convertible into U.S. Government Bonds (Toporowski 2005).

The nearest alternative international currency, the Euro, cannot take over as a reserve currency because a more or less balanced trade account does not allow the Euro-zone to supply the rest of the world with the amounts of ‘free’ (i.e., unencumbered by borrowing) Euros necessary to finance trade. Moreover, the ruling policy doctrine in the European Union remains hostile to government bond issues on a scale and liquidity that would be necessary to back a global reserve currency.

A second key feature of the international financial system is the means of payment for international transactions. These means are not U.S. dollar banknotes, backed by the U.S. Government through the U.S. Comptroller of the Currency who signs those banknotes, but commercial bank credits backed by bank loans to firms and governments. (Private individuals do not borrow in any significant amounts from international banks).

Thus international banking has its counterpart in an international debt system, mostly in U.S. dollars, whose net debtors are largely smaller and poorer countries, because larger and richer countries can finance more of their needs with internal debt rather than borrowing from abroad.

Finally, crucial to the current structure of international trade and finance is the location in the U.S. of the main markets for the commodity exports on which the foreign trade of most developing countries depends. Those commodities are therefore priced in U.S. dollars.

Vulnerability of Developing Countries
These features of international finance and trade combine to make developing countries extraordinarily vulnerable to the financial crisis that is unfolding in the U.S. in particular. As that economy succumbs to debt deflation (reduced expenditure in an effort to repay debt), imports into the U.S. will be reduced, and with that the supply of ‘free’ dollars to the rest of the world. The other industrial countries, which are the main suppliers to the U.S., still have large domestic markets and are therefore less exposed than developing countries to a fall in their exports.

For the developing countries, the reduction in their exports to the U.S. has been exacerbated by the recent fall in commodity prices (see Figure). However, this fall in commodity prices has been to some extent off-set by the almost 30% appreciation of the U.S. dollar in foreign exchange markets since the crisis started.
This wholly unexpected appreciation has surprised many observers still thinking in terms of a foreign exchange market determined by rational portfolio calculations of varying degrees of risk-aversion. But the appreciation was entirely rational in the context of an indirect U.S. Government Bond Standard.

However, that appreciation has been of little benefit to developing countries because they are the principal net debtors in the international financial system. Nearly two thirds of all international debt is denominated in U.S. dollars and its value has therefore risen along with the appreciation of the dollar.

The U.S. is of course the largest net international debtor in the world. But, because the international financial system uses an indirect U.S. Government Bond Standard, the U.S. Government can borrow abroad in dollars, servicing that borrowing in the same way that it finances its domestic debt.

Foreign currency debt (net of foreign currency reserves) is therefore concentrated in developing countries and emerging markets. In this situation, monetary policy does not provide any solutions. Depreciation of the developing country’s local currency against the dollar, which is used to raise the domestic value of exports, increases the domestic cost of external debt financing.

Pegging the local currency to the dollar holds external financing costs constant, but leaves the country exposed to reduced U.S. dollar commodity export prices. Lowering the cost of foreign currency in local currency (i.e., appreciation) reduces export earnings, and encourages imports.

The developing countries did well out of the combination of a weak dollar and high commodity prices. While weaker commodity prices have been to some degree off-set by the appreciation of the U.S. dollar, that appreciation has also driven up the value of those countries foreign debts (relative to the value of their exports), just as exports to the U.S. are falling. This is the point at which the crisis puts significant financial pressure on poorer countries.

Reference: