Global Financial Crisis
Responding Today, Securing Tomorrow

Background Paper prepared by the World Bank Group

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GLOBAL FINANCIAL CRISIS: RESPONDING TODAY, SECURING TOMORROW

Many developing countries are moving into a danger zone. Growth in developing-countries had been expected to reach 6.4 percent in 2009, but has been marked down to 4.5 percent. The economies of high-income countries, many of which have already entered into recession, are now expected to contract by 0.1 percent in 2009, with global growth down to 1 percent. There is much uncertainty and even these scenarios could be optimistic. Some developing countries will be hit much harder than the average – experiencing growth which is negative in per capita or even absolute terms.

Coming on the heels of the food and fuel price shock, the global financial crisis could significantly set back the fight against poverty. Sharply tighter credit conditions and weaker growth are likely to cut into government revenues and governments' ability to invest to meet education, health and gender goals. The poor will be hit hardest. Current estimates suggest that a one percent decline in developing country growth rates traps an additional 20 million people into poverty. Already 100 million people have been driven into poverty as a result of high food and fuel prices.

In an increasingly globalized world, where seemingly distant crises can spread quickly across the globe, the response must be global, coordinated, flexible and fast. Policy challenges need to be addressed at the country level, but it is more critical than ever that the international community acts in a coordinated and supportive fashion to make each country's task easier.

Lessons from earlier crises point to the importance of safeguarding investment in long-term development. As developing country budgets adjust to a new fiscal reality, careful management will be necessary to protect long-run investment in infrastructure and social development, avoid unnecessary cuts in essential public expenditure, and restore high quality economic growth over the longer term – critical steps to restart progress towards the Millennium Development Goals. It is critical that aid flows be maintained, and commitments honored and supplemented where necessary. At some 100 billion per annum, Official Development Assistance volumes are modest in comparison to the sums spent on addressing the financial crisis in developed countries.

Working with partners, the World Bank can help build bridges in what must be a multi-

faceted response – to protect the poorest and most vulnerable from immediate and long-term harm, take actions to help financial and private sectors cope with the crisis, support countries in managing the fiscal challenges, and avoid delays in the long-term investments upon which recovery and long-term development will depend.

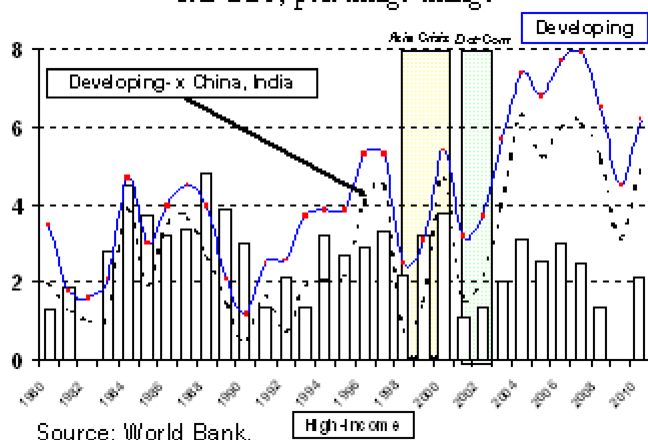
The World Bank Group is in a position to expand its financial support to our clients considerably. IBRD is well capitalized and has the ability to make new commitments of up to $100 billion over the next three years, including a tripling of commitments this year. With a record replenishment, IDA has $42 billion available for the poorest countries for the coming 3 years, with the capacity to front-load a significant amount. IFC is launching 4 new facilities for bank recapitalization, infrastructure financing, trade facilitation and refocused advisory services. Combined with monies mobilized from others, these new facilities could provide more than $30 billion over the next three years. MIGA can also provide much needed liquidity in developing country banking systems.

I. The Challenge for Policymakers

Policymakers must look beyond balance of payments and immediate liquidity financing so as to assist in ways that support recovery, growth, and inclusive and sustainable development. This requires policy steps not just to prevent escalation of the crisis but to ensure a sound foundation for the rebound: banking and regulatory reform which can also encourage innovation and access to financial services - especially for the poor; deposit insurance and guarantees designed carefully and with international coordination to help prevent deposits flowing to countries with more generous deposit insurance; prudent countercyclical lending that will invest in the future; fiscal stimulus packages that can support social development and infrastructure so as to build a platform for growth; access to credit for small and medium sized enterprises through microfinance and SME lending to help boost jobs.

Even as they fight fires today, policymakers must look to tomorrow. The liquidity and credit that is being pumped into the system now, risks a future, larger boom-bust cycle unless the right financial supervision and regulation is in place.

Above all, developed country policymakers must avoid putting in place policies, structures, and norms that undermine or exclude the interests of developing countries. Many governments in developing countries have taken courageous steps in recent years to put in place sound macro and fiscal policies, and now find themselves at the mercy of a crisis not of their making. A retreat to protectionism or economic nationalism by developed countries will undermine their interests even further.



II. Impact of the Global Financial Crisis on Developing Countries1[1]

(a) Revised Global Outlook

The world economic outlook has worsened dramatically. The intensification of the financial crisis in the United States and its rapid spread since the middle of September to both other high-income and developing countries has changed growth projections dramatically. Growth in developing-countries, whose economies had been expected to expand by 6.4 percent in 2009, has been marked down to 4.5 percent and the economies of high-income countries, many of which have already entered into recession, are now expected to contract by 0.1 percent in 2009. Growth rates are projected to recover in 2010, although there is considerable uncertainty and much will depend

1[1]A more detailed discussion is provided in: "Global Financial Crisis and Implications for Developing Countries" A World Bank Background Note for the G-20 Finance Ministers' Meeting, São Paulo, Brazil, November 8, 2008.

2[2]The discussion of the global outlook draws on the forthcoming *Global Economic Prospects: Commodities at the Crossroads* which will be released by the World Bank on December 9, 2008.

3[3]The interbank interest rate spread is defined as the difference between the 3-month Libor and the policy rate. Data as of End-October 2008.

4[4]Of the 128 global currencies for which the World Bank tracks data on a daily basis only Japan has appreciated by more than 1 percent against the dollar since Sept. 15.

5[5]The US Dollar value of developing country stock markets fell by 29 percent between September 15 and October 31, 2008.

6[6]See "Crunch Time in the Developing World Too? Policy options for dealing with the potential poverty and distributional impact of the financial crisis", The World Bank, November 2008.

7[7]See "A Case for Building up Safety-Nets", World Bank policy note, November 2008.

8[8]IDA support for such restructuring initiatives is expected to be more limited given that, as noted earlier in Section II, low-income IDA countries are most likely to be affected primarily through indirect mechanisms such as reduced demand, lower commodity prices and reduced remittance inflows.

on the policy responses in developed and developing countries.2[2]Global trade, which grew by 9.8% in 2006, is projected to fall in 2009 for the first time since 1982.

Virtually no country, developing or developed, has escaped the impact of the widening crisis, although countries that entered the crisis with stronger fundamentals and less integration into the global economy have generally been less affected. The deterioration in financing conditions has been most severe for countries with large current account deficits, and for those that showed signs of overheating and unsustainably rapid credit growth prior to the intensification of the financial crisis. Of the 20 developing countries whose economies have reacted most sharply to the deterioration in conditions (as measured by exchange rate depreciation, increase in spreads, equity market declines and large current account deficits), seven come from Europe and Central Asia, and eight from Latin America.

The poorest countries, including many in Africa, will be significantly affected by the crisis even though the channels of transmission are likely quite different from those operating in emerging markets. Financial sectors in Low-Income Countries are less integrated into global financial markets. As a result, the direct impact of the crisis is likely to be more limited. Nevertheless, the poorest countries will be harmed through slower export growth, reduced remittances, and lower commodity prices (which will reduce incomes in commodity exporters). 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. In this environment, meeting global commitments to provide development assistance to the poorest countries becomes paramount.

(b) Policy Response in Developed Countries

After some hesitation, the financial sector policy response has become increasingly robust. Governments and central banks are stepping in forcefully to guarantee debt, promote interbank liquidity and recapitalize stressed but healthy banks where necessary. Although these efforts have eased credit conditions somewhat, credit flows remain weak and commercial banks wary of lending to one another. At 200 basis points, the interbank interest rate spread, while down from recent highs, remains well above pre-crisis levels of around 30 basis points.3[3]Stock markets throughout the world remain highly volatile after experiencing large losses, and are recording massive day-to-day changes in valuations.

The global outlook in summary

(percentage change from previous year, except interest rates and oil price)

	2006	2007e	2008f	2009f	2010f
Global Conditions					
World Trade Volume	9.8	7.4	5.8	-2.5	6.0
Consumer Prices					
G-7 Countries [a,b]	2.2	1.7	3.3	1.6	2.1
United States	3.3	2.6	4.5	2.5	3.0
Commodity Prices (USD terms)					
Non-oil commodities	29.1	17.0	22.4	-23.2	-4.3
Oil Price (US$ per barrel) [c]	64.3	71.1	101.2	74.5	75.8
Oil price (percent change)	20.4	10.6	42.3	-26.4	1.8
Manufactures unit export value [d]	1.6	5.5	9.0	2.1	1.3
Interest Rates					
$, 6-month (percent)	5.2	5.3	3.3	2.5	3.0
€, 6-month (percent)	3.1	4.3	4.9	4.0	4.5
Real GDP growth [e]					
World	**4.0**	**3.7**	**2.6**	**1.0**	**3.1**
Memo item: World (PPP weights) [f]	5.0	4.9	3.7	2.1	4.0
High income	**3.0**	**2.5**	**1.4**	**-0.1**	**2.1**
OECD Countries	2.9	2.4	1.2	0.2	1.9
Non-OECD countries	5.5	5.6	4.6	3.2	5.4
Developing countries	**7.7**	**7.9**	**6.5**	**4.5**	**6.2**
East Asia and Pacific	10.1	10.5	8.8	6.7	8.0
Europe and Central Asia	7.5	7.1	6.0	3.5	5.4
Latin America and Caribbean	5.6	5.7	4.5	2.1	4.0
Middle East and N. Africa	5.3	5.7	5.7	3.5	5.2
South Asia	9.0	8.4	6.3	5.4	7.2
Sub-Saharan Africa	5.9	6.3	5.4	4.6	5.8
Memorandum items					
Developing countries					
excluding transition countries	7.8	7.9	6.5	4.6	6.3
excluding China and India	6.0	6.1	5.2	3.1	4.9

Note: PPP = purchasing power parity; e = estimate; f= forecast.
a. Canada, France, Germany, Italy, Japan, the UK, and the United States.
b. In local currency, aggregated using 2000 GDP Weights
c. Simple average of Dubai, Brent and West Texas Intermediate.
d. Unit value index of manufactured exports from major economies, expressed in USD.
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
f. GDP mesaured at 2000 PPP weights.
Source: World Bank

Many governments will need to provide fiscal stimulus and rescue packages. The consistency of their approach and the efficiency of their interventions will be crucial in preserving the credibility of the public sector's ability to stem the crisis and continue to act as a lender of last resort. Most important will be rescue plans calibrated to help distressed banks but also to recover taxpayer investments. The need for careful calibration of reforms and assistance also applies to the design of international rescue packages. Fiscal stimulus should be designed to have maximum impact on the critical growth constraint, which may include mortgage support in some countries.

Although the recession is likely to be protracted the elements of an eventual recovery can already be discerned. These include a stabilization and recovery of the housing sector in the United States (housing transactions are already picking up in the Western part of the country even though prices continue to fall). The housing recession hit Europe later and the beginning of recovery of the hardest hit European housing markets may not become apparent for a while longer. A second element is continued progress on debt work-outs and balance sheet strengthening in the

banks as well as adjustments in hundreds of thousands of households some of which could lose their homes. Other elements include a gradual easing of credit conditions as the government bailout packages create the necessary support and investors hesitantly return to purchase heavily discounted equities; lower oil prices as they redistribute incomes towards households with higher spending propensities, and induce lower inflation that will create more room for expansionary fiscal and monetary policy; and exchange rate realignments that will ease the burden of adjustment on countries constrained by external deficits and debt burdens.

(c) Vulnerabilities and Impact on Developing Countries

Developing countries were at first sheltered from the worst elements of the turmoil, but this is no longer the case, as the cyclical downturn that was already under way in September has intensified. Financial conditions have become much tighter, capital flows to developing countries have dried up, and huge amounts of capital have been withdrawn, leading to sharp falls in equity valuations and increases in bond spreads. As of mid-October, developing country equity markets had given up almost all of their gains since the beginning of 2008 and initial public offerings had disappeared. Spreads on sovereign bonds and commercial debt (which until recently had been the most important source of developing-country finance) have risen sharply.

Developing-country interest rate spreads have sky-rocketed and equity prices have plummeted. Spreads on sovereign bonds have reached 650 basis points and those on commercial debt (which until recently had been the most important source of developing-country finance) have jumped to more than 900 basis points – up from levels below 200 basis points as recently as June 2008. Except the Yen and the Yuan, virtually all currencies world-wide have depreciated against the dollar since September 15, with those of 18 developing countries declining by more than 20 percent.4[4] Developing-market equity prices have also plummeted, giving up almost on average 25 percent of the local currency value of their stocks since September 15. 5[5]

Should the freeze in credit markets not thaw quickly enough, then the consequences for developing countries could be severe. Financing conditions would deteriorate rapidly, and otherwise sound domestic financial sectors could find themselves unable to borrow or unwilling to lend both internationally and domestically, and domestic productive sectors would be deprived of working and long-term capital. Such a scenario would be characterized by a long and profound recession in high-income countries and substantial disruption and turmoil. If steps that are being taken to restore the functioning of capital markets and maintain the flow of credit to the productive sector succeed, a milder downturn is possible.

Already, sharp cuts in capital flows to developing countries are expected. Even if the waves of panic that have inundated credit and equity markets across the world are soon brought under control, deleveraging in financial markets and an extended period of banking-sector consolidation is expected to cut sharply into capital flows into developing countries. Private flows into developing countries are projected to decline from $1 trillion in 2007 to around $530 billion in 2009 (or from 7.7 to 3.0 percent of developing country GDP).

The food and fuel price shocks have already imposed large fiscal costs on developing countries, undermining their ability to respond to fall-out from the financial crisis. Policymakers responding to high food and fuel prices made extensive use of tax reductions to offset higher prices and increased spending on subsidies and income support. Data from a recent IMF survey covering 161 countries show that nearly 57 percent of countries reduced taxes on food while 27 percent reduced taxes on fuels. Almost one in five countries increased food subsidies while 22 percent increased fuel subsidies.

Recent declines in food and fuel prices do not imply that pressures and problems have disappeared. Although most of the hike in commodity prices that occurred in 2007 and the first half of 2008 has dissipated, commodity prices remain above their 2004/05 levels, and currency depreciation is raising the local cost for many food and fuel importing countries. For the very poor, reducing consumption from already very low levels, even for a short period, can have important long-term consequences. The poorest households may have had to reduce the quantity and/or

quality of the food, schooling, and basic services they consumed, leading to irreparable damage to the health and education of millions of children. Poor households forced to switch from more expensive to cheaper and less nutritional foodstuffs, or cut back on total caloric intake altogether, face weight loss and severe malnutrition.

In 2008, higher food prices may have increased the number of children suffering permanent cognitive and physical injury due to malnutrition by 44 million. Many of the countries most exposed to rising global food and fuel prices are those with high pre-existing levels of malnutrition. Burundi, Madagascar, Niger, Timor Leste and Yemen are among the ten most affected countries for both stunting and wasting indicators. All of these countries experienced double-digit food inflation in 2007-08.

Despite falling commodity prices, inflation risk remains. Until recently, rising commodity prices and tight capacity in many countries were causing both headline and core inflation to pick up throughout the world, with headline inflation rising by some five percentage points among developing countries. Even as world commodity prices are falling back considerably, and capacity pressures easing, inflation risks remain. In many countries, consumer prices may prove to be less flexible downwards, and upward pressure on prices remains as households seek to recoup the significant real-income losses endured since January 2007 and firms strive to restore profitability.

Investment is expected to suffer as it bears much of the direct impact of the financial crisis. Investment was the main driving force for developing-country growth over the past 5 years. There is a risk that investment in developing countries may be headed for a "perfect storm," with a convergence of slowing world growth, withdrawal of equity and term lending from the private sector, and higher interest rates, as well as lower commodity prices in the medium term will deter new investment in natural resource sectors.

Without adequate coordination and careful policy design, measures taken by crisis-affected developed countries may undermine developing countries' efforts. Some policy interventions or guarantees for severely affected groups in developed countries are aimed at lower borrowing costs and reducing the perception of market risk. Relatively speaking, these policies may inadvertently raise the perceived risks for others, including developing country sovereign governments as well as private firms in both developed and developing economies. If prolonged, such interventions will make it even harder for some to raise the financial resources needed to survive and grow. In addressing the current crisis, it is equally important to consider the transition back to a more normal environment, including limits on the duration of specific interventions and smooth exit strategies. Strengthened multilateral collaboration offers one means of avoiding such undesirable spillovers.

The sharp turn around in commodity prices may require equally dramatic adjustment among commodity exporters. While the terms of trade deterioration faced by food and fuel importers has begun to reverse, exporters of these commodities are facing sharp declines in prices with potentially large implications for their current accounts. At the same time, a large group of developing countries have become heavily reliant on foreign financing in recent years, whether in the form of aid or private capital flows. Around half of all developing countries have current account deficits in excess of 5 percent of GDP and about one third have current account deficits of over 10 percent of GDP.

Remittances from host countries are expected to decline in response to the global slowdown but the impact on flows to recipient countries will depend significantly on exchange rates. In 28 countries, remittances to developing countries were larger than revenues from the most important commodity export, and in 36 countries they were larger than private and public capital inflows. They are also a powerful poverty reduction mechanism. Remittance flows from host to developing countries, which are estimated to reach $283 billion in 2008, began slowing in the second half of 2008 and are projected to slow further in 2009. However, the large exchange rate fluctuations of recent weeks have dwarfed the expected changes in remittances denominated in

host-country currencies. As a result, changes in the local currency value of remittances will likely vary widely by country. Overall, remittance flows into developing countries are expected to decline from 1.8 percent of recipient country GDP in 2008 to 1.6 percent in 2009.

III. Development Challenges and Responses

Multilateral cooperation is essential. Policy challenges need to be addressed at the country level, but it is more critical than ever that the international community acts in a coordinated and supportive fashion to make each country's task easier. The coordinated provision of liquidity by major central banks since last year, the additional efforts made more recently, and the decision of the international community to adopt the Short-term Liquidity Facility (SLF) to more quickly mobilize large scale financing from the IMF, are just some examples. In the wake of the financial crisis it is imperative that donor countries meet their Gleneagles commitments, reach an agreement on the WTO Doha trade round, and follow through on the Bali commitments on climate change.

A vigorous crisis response can set the stage for a new multilateralism. There is a mismatch between 20th century global institutions and 21st century global challenges. The G7 is no longer sufficient. The new approach should not be a fixed or unitary system, but a flexible network of institutions, maximizing the strength of interconnected global actors, including not just the existing institutions such as the World Bank, the IMF and the United Nations, but also private sector firms and civil society organizations. The New Economic Multilateralism must be inclusive and pragmatic, embracing not just trade and finance, but development, climate change, fragile states, and energy. It must look beyond the G7 to include not just the rising economic powers but representatives of the poorer countries as well.

The crisis has highlighted the need for reform of the Bretton Woods Institutions. A modernized World Bank Group must represent the international economic realities of the 21st century, recognize the role and responsibility of growing stakeholders, and provide a larger voice for Africa. Voice and Participation is an issue for resolution by World Bank shareholders. Last month, shareholders endorsed an initial package of reforms. As a second step, shareholders agreed that the Bank should undertake a comprehensive and intensive work program to realign bank shareholding, moving towards an equitable voting power between developed and developing countries. Work on this second stage is beginning now, and should proceed quickly to consensus. The Zedillo Commission, created by President Zoellick to look at World Bank Group governance more broadly, will report back next year.

Preventing a financial crisis from becoming a human crisis is imperative. Working with its partners, the World Bank has a vital role to play in helping to solve this global financial and human crisis. It can help build bridges in what must be a multi-faceted response – to protect the poorest and most vulnerable from immediate and long-term harm, take actions to help financial and private sectors cope with the crisis, support countries in managing the fiscal challenges, and mitigating the risk of delay in the long-term investments upon which recovery and long-term development will depend.

(a) Protecting the Poor

This crisis, just like previous ones, will hit the poorest and most vulnerable groups hardest. It will be a further set back in the fight against poverty, pushing more people into poverty and malnutrition. Current estimates suggest that a one percent decline in developing country growth rates traps an additional 20 million people into poverty. The World Bank Group's first priority in responding to the crisis must therefore be to support programs that help protect the poor from what threatens to be a major human catastrophe.6[6] Worse than the increase in the number of poor people is often the increase in depth of poverty that is experienced by households, pushing them to the edge of survival.

Households left to cope for themselves risk damage to future generations. The poorest households have limited coping mechanisms. Coming on the back of the food and fuel crisis, many poor households have already exhausted their ability to cope with shocks and draw on informal

safety nets. Loss of income and employment opportunities may leave them no choice but to sell productive assets such as livestock or equipment. Households may be unable to feed their children leading to a further rise in malnutrition. There are

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A Case for Building-up Safety-Nets

The food, fuel, and financial crises are the latest in a series of shocks affecting poor people across the world. These shocks can reverse years of painfully slow progress in the global fight against poverty and cause irreversible damage. Well-designed and well-targeted safety nets are a smart investment for now and for the future.

Safety net programs can play four broad roles: (i) redistributed income to the poorest and most vulnerable, with an immediate impact on poverty and inequality, (ii) enable households to make better investments in their future, (iii) help households manage risk, and (iv) allow governments to make choices that support efficiency and growth.

Countries can afford safety nets. On average, safety net expenditures in developing countries fall in the range of 1 to 2 percent of GDP, though some countries spend much less and others much more. Some of the most successful programs, such as Mexico 's *Oportunidades* or Brazil 's *Bolsa Familia*, cost about 0.4% of GDP. Adequate financing of safety nets requires the re-prioritization of public expenditures. Reduction of elimination of general prices subsidies can also free up resources. The increased spending often pales in comparison with other interventions to counter crisis, such as public works programs, increased unemployment insurance, or the cost of financial sector bailouts.

Building blocks for effective safety nets include a targeting mechanism, a payments or in-kind distribution system, and monitoring. These building blocks can be customized to meet the needs in low-capacity environments and fragile states to ensure immediate responses during crises. The World Bank Group is working with countries to help assess, implement, and evaluate Safety Net programs.

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already emerging indications that children are missing school as families cut back on education related spending. These are the mechanisms that transform economic crises into setbacks for future generations.

Aid-dependent countries are particularly vulnerable to disbursement shortfalls and changing donor priorities. Despite recent commitments to improve aid predictability and to scale up official development assistance, progress has been slow and challenges to sustaining these commitments in the current environment are expected to increase. IDA is in a strong position to assist countries in dealing with the impact of the global financial crisis and all the 45 donor countries are expected to fulfill their pledges to the IDA15 replenishment in a timely manner. A majority of donors have already obtained necessary parliamentary approvals and provided written commitments to contribute to IDA15, and others are striving to complete their ongoing processes as quickly as possible.

The World Bank, working with UN agencies, the Regional Development Banks and others, will scale up financing for social protection operations to ensure food access and minimize the nutritional impact of this crisis on the poor and vulnerable. There is a strong case for building-up safety nets now (see Box).7[7] Well-targeted safety nets can help dampen the effects of economic crises and prevent temporary shocks from doing permanent harm. Interventions supported through quick-disbursing Emergency Response Projects and Development Policy Operations will include Conditional Cash Transfer programs and targeted food supplements.

The recent food and fuel crises mean that many such interventions are already underway. In May, the World Bank launched a $1.2 billion Global Food Crisis Response Program. Since then, nearly US$900 million has been committed to finance seeds, plantings and feeding programs, working closely with UN agencies and other partners. The Bank has also started work on the Energy for the Poor Initiative, a new program giving rapid support so that countries can strengthen

their social safety nets. The World Bank's response to the global financial crisis will build on these starts.

The World Bank will also help developing countries secure access to essential public services upon which the poor depend. IBRD and IDA will use quick-disbursing Emergency Recovery Operations, as well as standard Investment Operations, to accelerate and expand investment in basic healthcare and education. For example, school feeding programs will be expanded to ensure that parents have the incentive to keep their children in school and students have the nutrition they need to stay healthy and learn.

(b) Stabilizing the Financial and Private Sectors

The financial crisis has its origins in developed world, but is quickly being transmitted to the financial systems of developing countries. Financial institutions in developing countries are beginning to suffer from a lack of short term liquidity, as retail deposits exit and non-deposit funding dries up. As the effects of the global recession spreads, the impact will be felt on financial sector asset quality, leading to the need for recapitalization of financial institutions. Lack of liquidity will also reveal underlying weaknesses in regulatory frameworks and in the management of financial institutions, requiring regulatory reforms and capacity building. Tight credit markets in developing countries are rapidly affecting the real sector, especially sectors reliant on trade finance and working capital.

The World Bank Group can be part of a coordinated and rapid program of action to avert the collapse of banking sectors in poor countries. Such initiatives will complement and support developed country rescue packages for their domestic financial systems. The World Bank will offer advisory services to help countries prepare for and respond to financial sector crises, assess vulnerabilities and strengthen policy and regulatory frameworks. Currently, the World Bank is responding to requests from some 19 middle- and low-income countries. IFC will provide advisory services to financial institutions to strengthen their capability to withstand crisis conditions and to strengthen their financial position. IFC will support programs to provide short-term finance (including trade finance) to the real sector. IFC and the World Bank will provide capital to vulnerable banking systems – either directly in IFC's case, or indirectly through Development Policy Operations supporting government bank recapitalization programs in the case of the World Bank, not only in the immediate phase of the crisis but as second-round effects take effect.

IFC is also proposing a significant increase in its trade finance interventions as well as mobilization of a Recapitalization Fund (see Box). This fund would include contributions from IFC and other donors and would recapitalize distressed banks which may have a systemic impact. Preliminary discussions have already taken place with potential partners, including governments, other International Financial Institutions and commercial banks.

IFC Crisis Initiatives

Expanding IFC Trade Finance Program

IFC has already boosted its support to its Global Trade Finance Program to $1.5 billion and now **plans to double it to $3.0 billion**. The trade guarantees issued under the program will have an average tenor of six months, thereby **supporting up to US$18 billion for short-term trade finance** over the next three years. The expanded facility would benefit participating banks based in 66 countries, including some of the world's 78 poorest countries. The program offers banks partial or full guarantees covering the payment risk in trade related transactions. IFC is also considering trade support in the form of emergency short-term facilities that would target particular sectors and countries in risk-sharing arrangements with other financial institutions.

Bank Recapitalization Fund

IFC plans to launch a global equity fund to recapitalize distressed banks, as more bank failures would further damage economic activity, thus worsening poverty in developing countries. Preliminary discussions have taken place with potential partners, including governments, other IFIs and commercial banks. IFC expects to **invest US$1 billion over three years with at least US$2 billion provided by other investors**.

Infrastructure Crisis Facility

Reductions in demand and the credit squeeze are putting pressure on existing infrastructure projects, and threatening infrastructure development plans for many countries. A new IFC facility would provide crisis-related infrastructure financing in the short term. It could provide roll-over financing and help recapitalize existing, viable, privately-funded infrastructure projects facing financial distress. It could temporarily substitute for commercial financing for new infrastructure projects, if such funding is unavailable. The funding provided for existing projects would be for three- to six-year maturity, and the intention is that funding for new projects be refinanced commercially after a similar period. IFC expects over three years to **invest a minimum of US$300 million and mobilize between US$1.5 billion and US$10 billion from other sources**. This facility complements public sector financing provided through IBRD and IDA.

IFC Advisory Services

To address the mounting needs of clients, IFC is refocusing and scaling-up existing advisory services programs - SME banking, leasing, microfinance, housing, investment policy & promotion, and business operation & regulation - to support clients in the current crisis. IFC is also designing new crisis-response programs in risk management, loan portfolio work-out, and bankruptcy/insolvency. **IFC estimates a financing need of at least $40 million over three years.**

The World Bank Group's political risk insurance arm, the Multilateral Investment Guarantee Agency, supports developing country financial sectors by providing guarantees to foreign banks that help inject much-needed liquidity into these markets. MIGA's planned support to such projects in Ukraine and Russia is expected to bolster confidence in the financial system in these countries. Similar guarantees are expected in Eastern Europe and Africa.

IBRD and IDA can provide supplementary support to such recapitalization and enterprise restructuring initiatives.8[8] Such support will typically be provided through Development Policy Operations, as part of a strong package of reforms to financial/real sector governance and regulation.

An emerging agenda for Financial Sector Policymaking

The financial crisis is prompting a reassessment of certain principles and practices in financial sector policy making, and could lead to important changes in the structure and oversight of financial systems worldwide. The future agenda is likely to include:

Deposit insurance or guarantees may in some cases be needed, but should be designed carefully. In order to prevent capital outflows or shifts of deposits to state-owned banks which are perceived to be safer, developing countries may need to provide some form of underwriting of banking system deposits. Care should be taken in the design of these measures, because deposit insurance and guarantees require large scale fiscal resources to be credible, and may introduce incentives for excessive borrowing. The long term impact of short term measures need to be considered carefully. International coordination can help prevent competition in introducing measures to prevent deposits flowing to countries with more generous deposit insurance.

Governments will need to find a balance between maintaining financial stability and financial innovation. Governments will need to help the banking system reduce its leverage and recapitalize while minimizing the impact on the real economy. This may involve providing additional domestic liquidity and investing equity in financial institutions. In view of the poor performance of government controlled financial institutions and directed lending in most countries, governments should resist the temptation to take over management of financial institutions or introduce policies to direct their lending, and focus instead on providing the appropriate incentives and regulatory framework for private institutions to lend on a more sustainable basis. Policymakers will need to strike an appropriate balance between ensuring financial stability and encouraging financial innovation, which is badly needed in many developing countries with low levels of financial intermediation and access to financial services, especially by the poor.

minimize the risk of future crises. The current crisis has highlighted a number of weaknesses in current approaches to financial sector regulation, including the tension between rules-based and discretionary regulation, and the ability to regulate effectively over the business cycle – and during asset price bubbles. It has also highlighted the increased risks which regulators face as economies become more integrated internationally, creating new transmission mechanisms for financial contagion. Policymakers will also need to address weaknesses in corporate governance and risk management systems within financial institutions revealed by the crisis.

These financial and private sector reform operations will be underpinned by World Bank and IFC-supported analytical work and selective technical assistance. The goal will be to ensure that the financial and productive sectors of developing countries emerge from the crisis not only intact but strengthened.

(c) Managing Fiscal Challenges

The global financial crisis will pose major fiscal challenges for developing countries. In the coming months, developing countries will see growing fiscal pressures both on the expenditure side (growing demands for social protection, recapitalization, etc) and the revenue side (as exports and economic activity slow). The appropriate response to falling domestic demand may, in some cases, be a measured fiscal stimulus. However, the credit crunch and flight from risk is already reducing the ability of formerly market-access countries to meet their gross financing needs (rolling over amortized debt and financing their net borrowing requirements).

The World Bank Group can play a vital role in ensuring that fiscal adjustment takes into account the poor and the need to investment in recovery. As developing country budgets adjust to a new fiscal reality, careful management will be necessary to protect long-run investment in infrastructure and social development and avoid unnecessary cuts in essential public expenditure. IBRD and IDA financed Development Policy Operations will help partner countries finance their deficits and adjust their expenditure and revenue policies to take account of the priorities and pressures emerging from the crisis. This work will be coordinated with the IMF and other partners.

Careful public expenditure analysis will underpin such operations. Such analytical work will be conducted jointly by IBRD/IDA, development country governments and other partners. It will build on poverty reduction strategies and other national development plans and seek to find ways to reconcile fiscal pressures and development priorities. Such work will go hand in hand with technical assistance to help strengthen management, transparency and accountability in public finances and to ensure that scarce resources are not lost through corruption and graft.

(d) Securing Long-term Development

Lessons from earlier crises point to the importance of safeguarding investment in long-term development. The only way to reverse the income losses imposed upon the poor by the global economic crisis will be to reactivate economic expansion. Developing country governments and their development partners will need to balance immediate crisis response with the imperative to restore high quality economic growth over the longer term and re-start progress towards the Millennium Development Goals. If it leaves out the poor, or is cut short because of inadequate structural reform, such a recovery will not achieve its promise.

One of the most important roles for the World Bank Group over the coming years is to help developing countries minimize disruption of ongoing development programs and projects. This includes helping governments prioritize their own scarce resources sustain external financing of ongoing and planned development projects and programs that are performing well. Crisis-related investments in social protection and recapitalization and post-crisis adjustment must be additional to the current full range projects and programs. Indeed, given the pressures on governments' own resources, IBRD, IDA and IFC will in some cases need to support additional projects and programs in infrastructure and human development.

The unfolding global financial crisis will have major repercussions on the infrastructure development plans of developing countries. Infrastructure remains a top priority for addressing developmental gaps, either in provision of basic services or in reducing impediments to trade and

competitiveness. The financial crisis will cause some existing projects to experience financial distress, and will cause significant dislocations in countries' agendas to address infrastructure deficits. Financial distress in existing infrastructure projects is likely to come from either (i) liquidity issues arising from inability to roll-over market-based funding which may be mismatched with the tenor requirements of underlying cash flows, (ii) reduced demand which is less likely to affect structured projects which rely primarily on contracts, or (iii) failure of governments/off-takers/suppliers to fulfill contracts in structured projects. The first two of these causes of distress could be partially mitigated by the availability of IFI or public sector refinancing or recapitalization facilities. IFC is proposing a facility to provide short to medium-term infrastructure financing, mobilizing funds from other IFIs and governments.

Crisis-related financing must be additional to the planned pipeline if long-term development is to be set back on track. If crisis response spending is at the expense of longer-term investment in physical and human capital, it will set back development by many decades, delaying achievement of the MDGs to well beyond 2015.

IV. Financial Implications for the World Bank Group

Overall, the World Bank Group is well positioned financially to respond to the global financial crisis and considerably expand its financial support to our clients.

IBRD is well capitalized and has the ability to make **new commitments of up to $100 billion over the next three years**, including a tripling of commitments this year **to more than $35 billion.**

Following its record 15th replenishment, **IDA** is in a strong position to assist countries in dealing with the impact of the global financial crisis, with total commitment authority **amounting to nearly $42 billion over the next 3 years**, and scope for front-loading,

In addition to World Bank support to the public sector, **IFC**'s four new facilities for bank recapitalization, infrastructure financing, trade facilitation, and a refocused program of advisory services, could - with money mobilized from others - **total more than $30 billion over the next three years.**

MIGA can also provide much needed liquidity in developing country banking markets. To allow it to scale-up its business, MIGA will continue its discussions with shareholders on amending its Convention and Operational Regulations.

Working through these and other instruments, such as the Energy for the Poor Initiative and the Global Food Crisis Response Facility, the World Bank Group can help protect the poorest and most vulnerable from immediate and long-term harm, support the financial and private sectors hard hit by the crisis, assist countries in managing the fiscal challenges, and build a platform for recovery and long-term development.

The needs are very great. These facilities and instruments have been specifically designed to meet developing country and donor interests. In addition to delivering on their existing aid commitments, we urge donors to supplement these funds through co-financing, grants, loans, and equity investments.

With the careful design of instruments, technical and analytic support, and through its convening power, the World Bank Group can work in partnership with others to catalyze the investment of other public and private partners and help forge a new multilateralism for the 21st century.

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