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# **The Impact of Recent Global Financial Crisis on the Financial Institutions in the Developing Countries – the need for Global Solutions**

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## **Abstract**

*The purpose of this paper is to examine the recent impact of financial crisis on the financial institutions in the developing countries. This study contributes to the knowledge of investors and market practitioners to be well aware of the risks attached with investments in developing countries. The global financial crisis set off by the sub-prime credit crisis in the US. This has destabilized the financial markets of the developed world causing the fall down of prominent names in the banking business. Primary cause of this crisis can be Banks and other financial institutions in the United States of America have gone through a long period of inappropriate lending. Another cause of this crisis as according to latest studies may be the effect of the global financial crisis was worsened by rising global energy and commodity prices which pushed up inflation. Developing countries have mainly faced strong rises in prices. In order to study the impact of this*

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*financial crisis content analysis of various articles and research papers related to development literature was carried out. Our findings are in line with the previous research done by Eichengreen et al., (2008) and Yifu Lin (2008) which support the fact that the Banks in the developing economies will see their credit lines from foreign banks squeezed and the increasing financial flows that these economies have been experiencing are going to dry up. Based on this study certain recommendations can be made such as role of loss sharing and the policies of developing countries regarding stabilization and crisis management as well as rule of law and good governance. The government should introduce programs to recapitalize banks, guarantee bank liabilities, and provide liquidity to banks by funding markets and in some cases support troubled asset markets. Asset price inflation should be made under the control of monetary policy authorities by government. Responses to global crises must be methodical, inclusive, decisive, and organized. As Global problems may require global multilateral solutions. If the crisis will continue for long period, state and local governments may begin to restrict as they try to shore up new financing arrangements for their operations.*

**Field of Research: Banking**

**Keywords:** *Emerging markets, fiscal policy, monetary policy, Development economics, IMF, Asian development bank.*

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## Introduction

During the 20<sup>th</sup> century, the world experience two major financial crises. The first global financial crisis was seen during 1929-30, which affected the developed nations, Europe and America. While the second crisis came in 1997 and remained till 1999 and was experienced by emerging economies of Asia Pacific.

The recent financial crisis has taken the attention of the world in current months; it was seen with serious anxiety as it falls outwards from the regions originally affected. Alan Greenspan recently called it a “once-in-a-century credit tsunami”, born of a collapse deep inside the US housing sector. On the other hand the discussions from the other previous or recent disaster come to mind too, as it was seen that the great wave of the financial crisis overtop one economic levee after another. Instability has rushed forward from sector to sector, firstly from housing into banking and other financial markets, and then into all parts of the real economy. The recent financial crisis has also been rushed across the public-private boundary, which has hit the private firms and the financial statements has forced the new heavy demands on the public sector's finances. The crisis has surged across national borders within the developed world, and now there are some reasons which has alarmed that the crisis will swamp other developing countries, affecting the significant economic progress of recent years. (Yifu Lin, 2008)

According to Hyun-Soo., 2008, anxieties have augmented over the global financial crisis, which began from the US sub prime mortgage disaster with the help of the governments of major countries which are coming up with measures such as provision of liquidity and bailout packages for distressed banks, the fear that has gripped financial markets shows little signs of abating. Major stock exchanges are tumultuous while a series of indicators that gauge investors' risk aversion are posting all-time highs.

The developing world – what it has recently achieved, how these achievements are now at risk, and what it must now do – is the focus of this paper. Understandably, perhaps, until now the focus of policymakers has mostly been on the actions of the governments at the epicenter of the crisis, as well as those of other developed countries like Japan and Korea. But now we must also focus on the developing world, as it faces the surge of instability. The 1.4 billion people who live in or on the verge of extreme poverty are all in the developing world;

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given their slim margin for survival, any economic crisis will have its most severe human consequences in the developing countries. So there are altruistic reasons for concern about the developing countries in the crisis. But there are also strong reasons of self-interest. As I will argue, demand from the investment-led booms in developing countries did much to drive the rapid global economic expansion of this decade, and preventing deflation and depression could very well depend on keeping that growth going.

This study begins with a brief discussion of the dynamics of global growth in 2002-07, which mainly focused on strengthening of the booms in the developed and developing world. This study then discusses that how global recession crises begin due bad mortgages in 2007-08, starting with the US housing crisis. At the end, it discusses that how government can respond to the crisis to guarantee that the costs to the developing world are as small as possible.

## **Literature Review**

As Nikolson, 2008 recognized that financial crisis which initiated in United States has now become a global phenomenon. At present, not only in United States but across Asia and Europe, stock exchanges crashed; collective losses of the London, Paris and Frankfurt markets alone amounted to more than 350 billion Dollars. Stock Exchange 100 index closed more than 323 points down in January 2008 (Times online 2008). This crisis apart from affecting the capitalist economies has distressed the Socialist economy like Russia as well; in May 2008 Russian stock market was fallen by 50% and the Russian central bank had to buy rouble in massive amount to prevent the severe falling against US Dollar and Euro (Erkkilä, 2008). About the cause of current crisis Bartlett (2008) said that crisis was started with the downfall of US sub-prime mortgage industry , the intensity of this collapse was significant; “Mark-to-market losses on mortgage-backed securities, collateralized debt obligations, and related assets through March 2008 were approximate \$945 billion.” He further stated that it is “The largest financial loss in history”, as compared to Japan’s banking crisis in 1990 about \$780 billion, losses stemming from the Asian crisis of 1997-98 approx \$420 billion and the \$380 billion savings and loan crisis of U.S itself in 1986-95. Yilmaz (2008) charged U.S subprime mortgage industry to be the major reason of current global financial crisis, he also stated that the total loses estimated initially up to \$300 to \$600 billion are now considered to be around \$1 trillion.

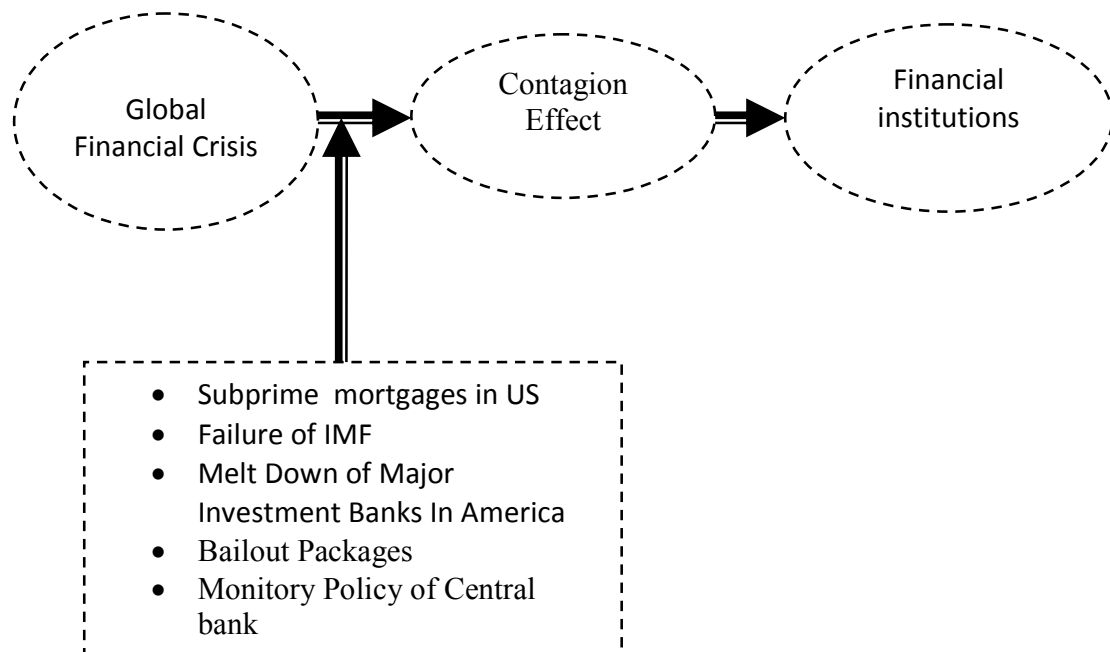
While enlightening the factors that why this US sub-prime mortgage crisis turn into global banking crisis, Khatiwada and McGirr (2008) stated “Many of these sub-prime mortgages actually never made it on the balance sheets of the lending institutions that originated them”; and they were made attractive to foreign banks by high investment grading, “when sub-prime borrowers failed to repay their mortgages, the originating institution needed to finance the foreclosure with their own money, bringing the asset back on its balance sheet. This left many banks in a financially unviable situation, in a rather short, unmanageable timeframe”. However Hyun-Soo (2008) argues that it was the “Trust Crisis” which caused this

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global predicament. DeBoer (2008) believes that it was series of events which caused the crisis; it begins with the collapse of currencies in East Asia in 1997 and became edgy due to the financial crisis of Russia in 1998. Next, in USA was the “dot-com” stock collapse in 2001, and the final stroke was again in USA, when after a swift decline in housing prices and “rapid contraction in credit, it fell into recession. Rasmus (2008) has the same thoughts; he, while discussing the reasons of economic recession of U.S said “The ‘real’ ailments afflicting the US economy for more than a quarter-century now include sharply rising income inequality, a decades-long real pay freeze for 91 million non-supervisory workers, the accelerating collapse of the US postwar retirement and healthcare systems, the export of the US economy’s manufacturing base, the near-demise of its labor unions, the lack of full time permanent employment for 40 per cent of the workforce, the diversion of massive amounts of tax revenues to offshore shelters, the growing ineffectiveness of traditional monetary and fiscal policy, and the progressive decline of the US dollar in international markets.”

## Conceptual Framework

According to this study the proposed model which explains various variables which explains the impact of the Global recession on the financial markets in developing countries, is as follows.



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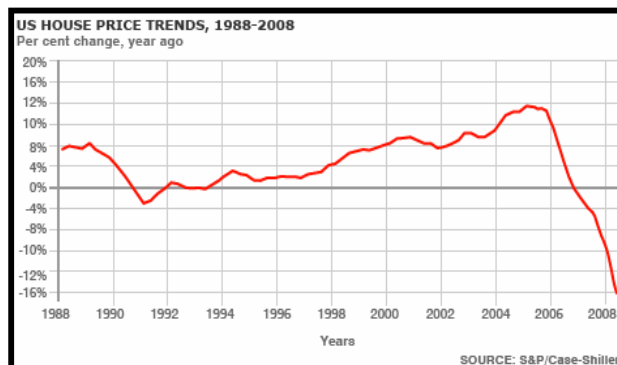
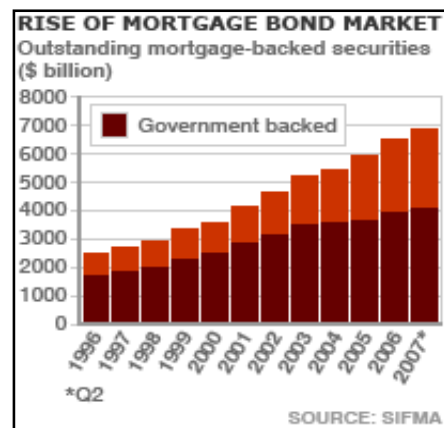
## Global financial Crisis

The causes behind the recent global crisis are complex, and are linked to the financial market decline of the last 20 months or so.

In US economy, Banking industry has been badly hit due to mortgages backed by sub-prime mortgages fallen in value. Due to bad debts financial institutions were reluctant to lend money and thus firm especially construction industry's output faced contractions in credit lines which contributes 15% of US output. (Mvula, 2008)

On April 8, 2008 the International Monetary Fund released information regarding the magnitude of the Global financial crisis:

- Mark-to-market losses on mortgage-backed securities, collateralized debt obligations, and related assets through March 2008 approximate \$945 billion. In absolute terms this represents the largest financial loss in history, exceeding asset losses resulting from Japan's banking crisis in the 1990s (\$780 billion) and far surpassing losses emanating from the Asian crisis of 1997-98 (\$420 billion) and the U.S. savings and loan crisis of 1986-95 (\$380 billion).
- The damage extends across a wide range of investor classes. Commercial banks stand to lose \$440-510 billion, insurance companies \$105-130 billion, pension funds \$90-160 billion, governments \$40-140 billion, and other financial institutions \$110-160.
- Innovations in mortgage securitization in the early- and mid-2000s enabled loan originators to sell high-risk assets to downstream financial institutions around the world, thereby globalizing the American subprime crisis. Against U.S. bank losses of \$144 billion, European financial entities stand to incur \$123 billion in mortgage-related losses. Within the latter group, British institutions face \$40 billion in asset write offs, nearly



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- matching the combined losses of the Euro area (\$45 billion). Financial institutions in Asia and other regions are far less exposed.
- The imprudent lending practices that precipitated the American subprime collapse are not confined to the United States. The IMF estimates that housing prices in Ireland, Netherlands, and United Kingdom are 30 percent higher than justified by economic fundamentals. British housing prices fell by 2.5 percent in March; the sharpest monthly fall in that country since 1992. Australia, Belgium, Denmark, France, Norway, Spain, and Sweden also face sizable housing bubbles.
  - Housing prices in OECD countries with more conservative lending practices (Austria, Canada, Finland, and Germany) are more closely aligned with market fundamentals, underscoring wide country variations in mortgage markets.

### ***Effects on Financial Institutions in Developing countries***

The financial institutions in developing countries haven't been effected by financial crisis in developing countries due to of usage of traditional financial system where unlike US, individuals and groups need to have good track record in order to gain credit or loans and therefore risk is minimal.

As according to Fitch Ratings, the international credit rating agency with head offices in New York and London, 'the Pakistani banking system has, over the last decade, gradually evolved from a weak state-owned system to a slightly healthier and active private sector driven system', Pakistan's banking sector has not been as prone to external shocks as have been banks in Europe.

However, banks in developing economies have to suffer contractions in credit lines and reduced financial flows. Due failure of leading financial institutions such as IMF. IMF failed to response to Asian crisis during second great recession. IMF recommended contracted fiscal policies as economies were going into recession. IMF failed to predict banking crisis coming due to currency crisis. Indonesia suffered bank runs courtesy of IMF and Malaysia pulled back IMF conditionality. (Stiglitz., 2002)

### ***Government's Role***

*World of Work Report 2008* argues, governments need to take into account the social impact of financial globalization while allowing financial institutions to benefit from the global capital markets. Having institutions and structures in place to ensure that a country is not vulnerable to sudden capital outflows is key. Governments are providing support and doing what so ever they can to prevent their economical structure; US government injected \$800 billion in the economy to support the structure, UK government has announced a package of \$692 billion, European Union is about to start an economic recovery plan and IMF has called for minimum financial support of \$100 billion (BBC news, 2008). Also on the research part, E. Philip Davis and Dilruba Karim suggested an "Early warning

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System” to cope better with such crisis; the proposed two models “Logit” as a global early warning system and “Signal Extraction” for country specific early warning system. DeBoer (2008) believe that such bailout programs and other supporting packages from governments is like offering protection from a negative outcome which is more appropriate to be called as “moral hazard”; this trend could increase the possibility of future bad upshots.

*How long the crisis will prevail?* It is indeed very difficult to answer this question; Warne (2008) believes that it’s the matter of confidence of investors, as long as it is restored, crisis will be over; but it cannot be done when we daily hear news about the abandonment of financial institutions, it needs some financial stability. OECD Secretary General, Gurría (2008) hopes that the effective macroeconomic policies and vital financial reforms will turn down the heat and normal financial conditions as well as the growth rates will return to normal in 2009. Yılmaz (2008) acknowledged that the worst part of the crisis is already over and the markets are suffering from what can be called ‘the after shocks’. Sha Zukang (2008) says that normalization of economic activities need “global and symentic” solutions, he stated that current “global Economic Governance System” is derisory for the prevention of such crisis

## **Research Design**

This study is an explanatory study which is aimed at explaining the impact of global crisis and what effect it will have on the financial institutions of developing countries. For this purpose content analysis was technique was used and several research papers and articles related to development economics were examined. As in conceptual analysis, a concept is chosen for examination, and the analysis involves quantifying and tallying its presence. Also known as thematic analysis. A specific no and set of concepts were examined such as “effects of global financial crisis”, its “contagion effect” on “financial institutions” of “developing countries”. In this content analysis the existence of a concept e\was examined. Set of rules were defined in this research regarding the existence of concepts and the linkages between these concepts. As Weber, 1990 suggested irrelevant data was also decided. By applying above stated content analysis process the researcher is able to generalize the concepts and to form results of the study.

## **Results**

Data from various sources was examined thoroughly and conclusive evidence was formed that current global crisis has significant impact on the financial institutions of developing countries The current financial crisis affects developing countries in two possible ways.

**First**, there could be financial contagion and spillovers for stock markets in emerging markets. The Russian stock market had to stop trading twice; the India stock market dropped by 8% in one day at the same time as stock markets in the USA and Brazil plunged. Stock markets across the world – developed and developing – have all dropped substantially since May 2008. We have seen

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share prices tumble between 12 and 19% in the USA, UK and Japan in just one week, while the MSCI emerging market index fell 23%. This includes stock markets in Brazil, South Africa, India and China. We need to better understand the nature of the financial linkages, how they occur (as they do appear to occur) and whether anything can be done to minimize contagion.

**Second**, Commercial lending. Banks under pressure in developed countries may not be able to lend as much as they have done in the past. Investors are, increasingly, factoring in the risk of some emerging market countries defaulting on their debt, following the financial collapse of Iceland. This would limit investment in such countries as Argentina, Iceland, Pakistan and Ukraine. Means Banks in the developing economies will see their credit lines from foreign banks squeezed and the increasing financial flows that these economies have been experiencing are going to dry up

## **Conclusion**

This study confirms that the global financial crisis has a significant effect on the financial institutions of developing countries. Our findings are in line with the previous research done by Eichengreen et al., (2008) and Yifu Lin (2008) which support the fact that the Banks in the developing economies will see their credit lines from foreign banks squeezed and the increasing financial flows that these economies have been experiencing are going to dry up. As developing countries Asia and Latin America are at a crossroads, and the next twelve to eighteen months will be very difficult. The perception that they had broken the links with the larger economies has been painfully refuted by the hard facts of the last 18 months. Financial markets of the world are closely interconnected, and the impact of the world financial collapse on Emerging Economies is a witness to this fact.

## **Recommendation**

The government should introduce programs to recapitalize banks, guarantee bank liabilities, and provide liquidity to banks by funding markets and in some cases support troubled asset markets. Asset price inflation should be made under the control of monetary policy authorities by government. Responses to global crises must be methodical, inclusive, decisive, and organized. As Global problems may require global multilateral solutions. If the crisis will continue for long period, state and local governments may begin to restrict as they try to shore up new financing arrangements for their operations.

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