

EVENT SUMMARY

The Causes and Impact of the Global Financial Crisis: Implications for Developing Countries

Justin Lin, Chief Economist of the World Bank

February 9, 2009

Justin Lin Urges Investment in Developing Countries Akin to Marshall Plan

The financial crisis has spread to developing countries through trade linkages, a reduction of FDI and remittances, and a collapse in commodity prices, said Justin Lin, Chief Economist of the World Bank, at an event at the Peterson Institute for International Economics on February 9. While the world economy is still projected to recover in 2010, the downside risk is high. Recovery depends on two factors: whether world leaders can overcome growing popular protectionist pressure, and whether leaders enact a decisive, coordinated fiscal stimulus. Coordination will be key, as stimulus enacted by only one or two countries will be rendered ineffective by international diffusion.

Governments will face two major challenges. First, low-income countries suffer from limited fiscal space. Many already have large current account deficits; a third have deficits that exceed 10 percent of GDP. Foreign reserves are limited. Developing countries thus lack the means to stimulate their own economies. Second, in order to raise money, countries must issue bonds or raise taxes. The latter will lead to less available private money in the short run; the former will require increased saving in the short run in order to pay off debt in the long run. Unless a stimulus pays for itself, Ricardian equivalence will hold, and such a stimulus will be ineffective.

The solution to both problems is to follow China's example and invest in the infrastructure of developing countries. Infrastructure already tends to be adequate in developed countries, so domestic infrastructure investments will likely not provide a high return. In contrast, infrastructure "bottlenecks" to growth in developing countries are relatively easy to identify and profitable to exploit. The return on these investments would spread throughout the globe through international trade linkages. For this reason, Lin called for developed countries to invest 1 percent of GDP into a fund administered by the World Bank to finance infrastructure stimulus in low-income countries, an effort he compared to the Marshall Plan.

As domestic consumption and profits drop, politicians will be tempted to turn to protectionism. While leaders have thus far committed to maintaining open markets, public pressure to enact trade barriers is growing. Such a move would cause massive job loss and exacerbate the current crisis, just as it did during the Great Depression.

Discussion

Marc-Olivier Strauss-Kahn of PIIE asked how Lin intended to address regulation and the structural problems of the global financial system, and Jamaican Ambassador Anthony Johnson asked how to get rid of toxic assets. To these questions, Lin stressed that that government and international institutions need to step in immediately to create private demand for funds. He added that toxic assets are toxic because prices are too low; the solution is to increase demand for these assets. Herbjorn Hansson of Nordic American Tanker Shipping Ltd. argued that the cause of the crisis was a “borrowing binge” and that we must extend massive tax cuts in order to induce people to save money as well as spend it, recapitalizing the banking system. Lin countered that a tax cut alone would not take care of toxic assets or create sufficient short-run demand for bank loans.

Bob Davis of the *Wall Street Journal* questioned whether stimulus should go to countries that the crisis did not originate in, and whether there was a drop-off in the effectiveness of financial stimulus between developing and developed countries. Lin answered that high-income countries do not have as much space as low-income countries for return on investments in basic infrastructure, such as roads and electricity. Because this recession is global and because the economy remains open, developed countries as well as developing countries will see the benefits of this high return.

Institute Director C. Fred Bergsten asked whether China could revalue its exchange rate, reduce energy subsidies, and reduce its savings rate in order to help fuel a global recovery. Lin argued that improving income distribution could accomplish this by putting money in the hands of poor people likely to spend rather than save. Regarding Asia’s undervalued currencies, Lin stated that while undervalued exchange rates were a long-term, structural issue, increasing consumer confidence was the most important objective in the short run.

Thea Lee of the AFL-CIO asked whether there was a distinction between trade barriers and procurement policies when eschewing protectionism, and whether in the absence of coordinated stimulus countries would be better off restricting the benefits of their stimulus packages within their own borders in order to prevent diffusion internationally. Lin responded that if countries contributed to the proposed fund, protectionism would not be necessary. Regarding the Buy American provision in the US stimulus package, Lin argued that the provision could lead to further protectionism and was thus inadvisable, while C. Fred Bergsten pointed to a recent Institute study conducted by Gary Hufbauer and Jeff Schott that showed a negligible gross positive impact on jobs as a result of the provision.

Jo Marie Griesgraber of the New Rules for Global Finance Coalition criticized Lin’s presentation for failing to touch on the environmental component of fiscal stimulus. Lin agreed that environmental initiatives must be built into projects. Finally, Zhen Yu asked Lin’s opinion of the US stimulus bill; Lin expressed his hope that the bill would pass soon so that the United States could lead the world in restoring confidence to the private sector.