

The Impact of Recent Global Financial Crisis on the Financial Institutions in the Developing Countries : Global Perspectives

Nida Iqbal Malik¹, Subhan Ullah², Kamran Azam³, Anwar Khan⁴

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 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

I. Introduction

Although they happened several financial crises in the past but the economist still not learn a lesson from them. "We all lived happily for a while — but not for ever after" (Paul Krugman, 2008). The financial crises that started in the mid of 2007 came as a surprise to many people, but not for others. The crisis that shaken the world in the last 18 months, and brought down top names in the

¹ Nida Iqbal Malik is student of Master in Business Administration at the Department of Management Sciences at COMSATS Institute of Sciences and Technology, Attock Pakistan. Email: taurus_nida11@hotmail.com

² Lecturer, COMSATS Institute of Sciences and Technology, Attock, Pakistan, Email: subhan_ullah@comsats.edu.pk

³ Lecturer, COMSATS Institute of Sciences and Technology, Attock Campus, Pakistan, Email: anwar_khan@comsats.edu.pk

⁴ Lecturer, COMSATS Institute of Sciences and Technology, Attock Campus, Pakistan, Email: kamranazamkhan@yahoo.com

Malik, Ullah, Azam & Khan

United States and Europe is the most severe since the stock market crash of 1929. In the last few months we have seen several major financial institutions absorbed by other financial institutions, receive government bailout or completely bankrupt. During the 20th century, the world experienced 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. 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 disorderly while a series of indicators that determine investors' risk aversion are posting all-time highs. The recent financial crisis has 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).

A regular financial crisis reminds us the unreliable financial support on which companies rely for example the "south sea bubble" of 1720, the over end gurney collapse of 1866, the Australian financial crisis of 1893, the wall street crash of 1929, the black Monday of 1987, and the meltdown of high-tech stocks in 2001-02, (Gordon Boyce and Simon Ville, 2002). 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 to 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.

2. 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).

Malik, Ullah, Azam & Khan

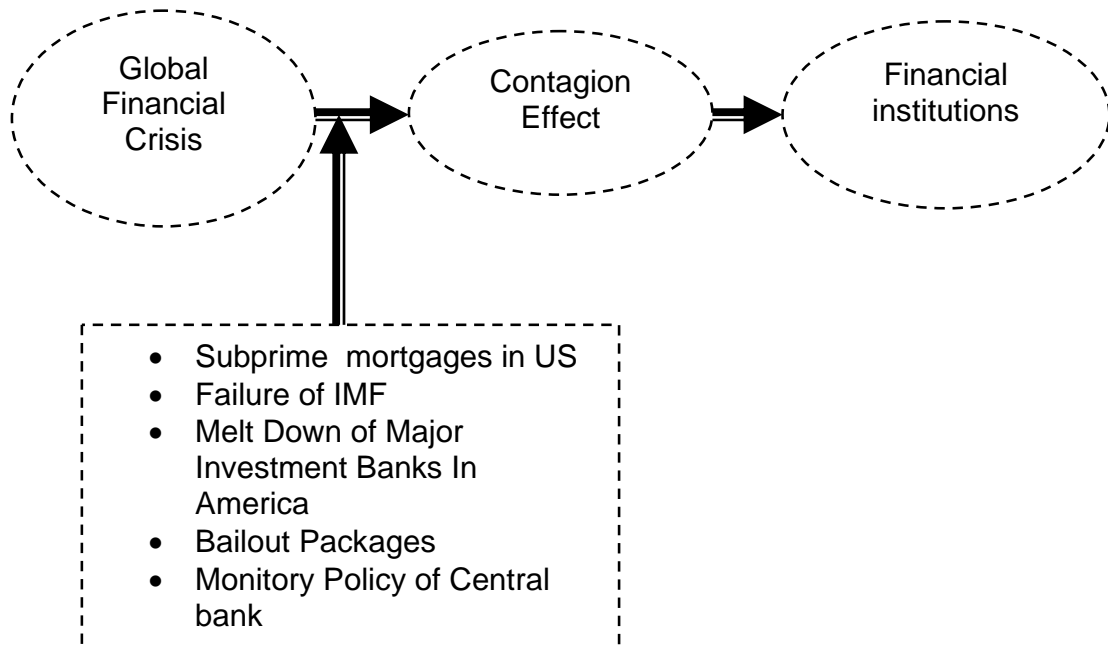
About the cause of current crisis Bartlett (2008) said that crisis was started with the downfall of US sub-prime mortgage industry , the intensity of this collapse was significant; “Mark-to-market losses on mortgage-backed securities, collateralized debt obligations, and related assets through March 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 unfeasible situation, in a rather short, out of hand timeframe”. However Hyun-Soo (2008) argues that it was the “Trust Crisis” which caused this 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.”

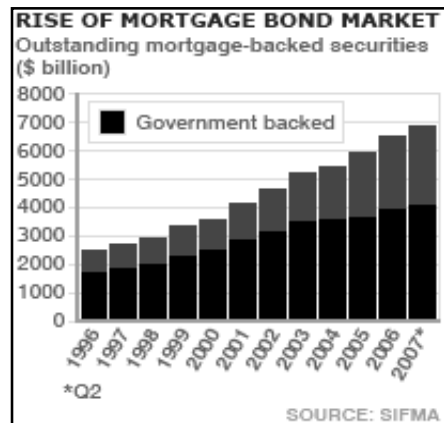
3. Conceptual Framework

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.



4. 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.



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 & loan crisis of 1986-95 (\$380 billion).

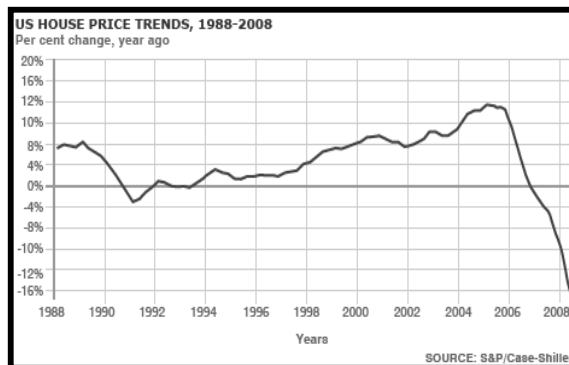
Malik, Ullah, Azam & Khan

- The damage widens across a wide range of investor classes. Commercial banks stand to drop \$440-510 billion, insurance companies \$105-130 billion, pension funds \$90-160 billion, governments \$40-140 billion, and other financial institutions \$110-160.
- An innovation in mortgage securitization in the early- and mid-2000s facilitates 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 sustain \$123 billion in mortgage-related losses. Within the latter group, British institutions features \$40 billion in asset write offs, nearly matching the combined losses of the Euro area (\$45 billion). Financial institutions in Asia and other regions are far less revealed.
- The irresponsible lending practices that precipitated the American subprime collapse are not confined to the United States. The IMF speculates that housing prices in Ireland, Netherlands, and United Kingdom are 30 percent higher than justified by economic fundamentals. British housing prices cut down 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 conventional lending practices (Austria, Canada, Finland, and Germany) are more closely aligned with market fundamentals, underscoring wide country variations in mortgage markets.

5. 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.



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.

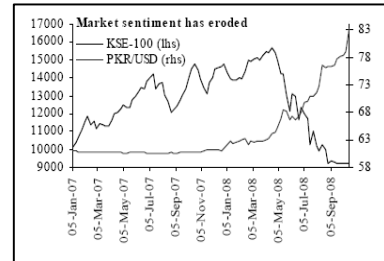
Malik, Ullah, Azam & Khan

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.

6. Effects on Financial Institutions of Pakistan

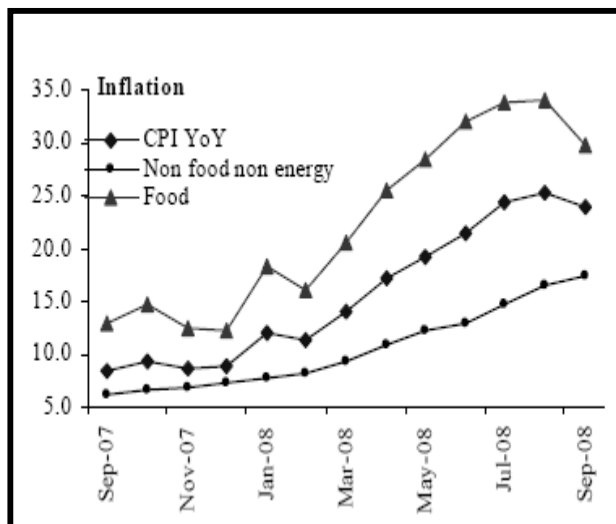
Overview: Pakistan's economic situation has worsened, with capital outflows compounding the impact of a substantial current account deficit. Downward pressure on the rupee has been persistent, making debt financing more costly, while foreign exchange reserves have continued to reduce in size. Inflationary pressures also remain evident, and are being worsened by government borrowing from the central bank. Finally, political tensions are prominent and could be intensified by economic strictness measures, once settled.

Money markets: Domestic money markets have been hit hard by liquidity scarcity. The primary cause has been a sharp reduction in net foreign assets, which has led to a tightening of the money supply. In response, the central bank has injected significant amounts of liquidity, lowered cash reserve requirements by 400 basis points to 5 percent, increased the types of securities suitable for the statutory liquidity reserve requirement and fixed a temporary waiver of SLR on one-year and above deposits. Helped by these actions, overnight rates have come down to about 14 percent, a minor premium over the policy discount rate of 13 percent.



Equities: The Karachi Stock Exchange has been in a severe downward spiral since mid-April, losing more than 40 percent of its value through early October. The government has imposed a floor on the index at 9144 and banned short/blank selling. Since then, the index has hovered around this level, while trading volumes have been extremely thin. The floor is to stay in place for now, while the government will establish an Rs 20 billion 'market stabilization' fund along with an Rs 30 billion sovereign guarantee for foreign investors. Local equity houses are expecting a large downward correction once the floor is removed.

Inflation: Inflation is being driven by on going supply shocks, especially for food. Additional pressures have been generated by policy actions: since January 2008, there has been a 65 percent increase in petroleum product prices, a 60 percent rise in power



Malik, Ullah, Azam & Khan

tariffs, and a 40 percent hike in retail gas prices. Most recent data suggest that food prices and international commodity prices have peaked, indicating softer inflation going forward. Nevertheless, inflation will remain high, given still-strong aggregate demand and a weakening rupee. Inflationary pressures have also been generated by the unprecedented levels of central bank fiscal financing, equivalent to around 2.1 percent of projected 2009 GDP. At the current rate, central bank financing of the fiscal deficit will top last year's 6.9 percent of GDP. The government's failure to adhere to its policy commitment of reducing its reliance on the central bank is not only a reflection of higher financing needs, but also the fall in available external financing and the dominance of fiscal policy over the monetary sphere.

External sector: Much of Pakistan's current financial troubles stem from the balance of payments. The current account balance has turned sharply negative over the past five years, driven by higher deficits on the trade, services and income accounts owing to rising international oil prices, higher profit/interest/dividend repatriation, and greater freight and insurance charges on imports. Until the end of FY08, this deficit was financed quite comfortably from a surplus on the capital account, itself the result of high levels of foreign direct investment, rising portfolio investment and greater borrowing. However, political volatility and mounting security challenges since 2007 have resulted in a sharp slowdown in non-debt creating inflows. This and high oil prices have led to dwindling central bank reserves and a depreciating rupee. The rupee/\$ exchange rate depreciated by 32 percent over this calendar year to October 21, despite substantial intervention by the State Bank of Pakistan, totaling some \$2.0 billion as of end-September. The weakening of the currency has implications for inflation and the fiscal deficit: external debt servicing is expected to amount to \$4.3 billion this fiscal year. Given greater risk aversion amongst investors and donor countries' own domestic financial commitments, an even sharper reversal in foreign currency inflows into Pakistan this fiscal year has led to a pronounced decline in the central bank's foreign exchange reserves. Total foreign reserves, including those held by commercial banks, have fallen sharply from a high of \$16.5 billion in October last year, and stood at \$7.32 billion on Oct. 18, of which the central bank reported for \$4.04 billion. The central bank's reserves indicate about one-and-a-half months of import cover. Indeed, at the current rate of decline, central bank reserves will run out by end-February 2009. Samba calculations indicate that Pakistan's gross external financing requirement (current account deficit plus short-term debt and M/LT amortization payments) will be \$17.2 billion for FY09.

7. 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 guarantee that a country is not susceptible to sudden capital outflows is key. Governments are providing support and doing what so ever they can to prevent

Malik, Ullah, Azam & Khan

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 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 exist? 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

8. 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 number 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 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.

9. 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.

Malik, Ullah, Azam & Khan

First, there might 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 considerably since May 2008. We have seen 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%. These comprises of 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 capable 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 crumple of Iceland. This would bound 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.

10. 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 disproved 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. 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.

References

Bartlett, D., 2008, "Fallout of the Global Financial Crisis"

Davis E.P., Karim, I., 2007, "comparing early warning systems for banking crises" *Journal of Financial Stability* 4 (2008) 89–120

DeBeers, R.D., 2008, "Understanding the Financial Crisis: Origin and Impact."

Erkkilä, M., 2008, "Impact of financial crisis on the Russian economy"

Gurria, A., 2008, "The Global Financial Crisis: Where to next, and what does it mean for OECD countries?"

Hyun-Soo, P., 2008, "Future Direction of the Global Financial Crisis"

Khatiwada S., McGir E., 2008, "Financial Crisis: a review of some of the consequences, policy actions and recent trends."

Nicholson, R., et al, 2008, "Impact of the Financial Crisis on Technology Spending in the Utility Industry"

Rasmus, J., 2008, 'The Deepening Global Financial Crisis: From Minsky to Marx and Beyond', *Journal of Socialist Theory*, 36:1, 5 —29

Warne, K., "Gaining a better understanding of the financial crisis", *Canadian Strategy Report*.

World Economic Forum, 2008, "Network of Global Agenda Councils", *Summit on the Global Agenda, Dubai, United Arab Emirates 7-9 November 2008*

Yilmaz, K., 2008, "Global Financial Crisis and the Volatility Spillovers across Stock Markets"

Zukang, S., 2008, "World economic situation and prospects", *International monetary and financial committee*.

BBC News, 2008, Europe announces 200bn euro plan, [Online], Available: <http://news.bbc.co.uk/2/hi/business/7749382.stm> [26 November. 2008]

BBC News, 2008, IMF head calls for extra funding. [Online], Available: <http://news.bbc.co.uk/2/hi/business/7732631.stm> [26 November. 2008]

Malik, Ullah, Azam & Khan

BBC News, 2008, Rescue plan for UK banks unveiled, [Online], Available: <http://news.bbc.co.uk/2/hi/business/7658277.stm> [26 November. 2008]

BBC News, 2008, US Fed announces \$800bn stimulus, [Online], Available: <http://news.bbc.co.uk/2/hi/business/7748362.stm> [26 November. 2008]

The Times, 2008, World market plunge on US recession fears, [Online], Available: <http://business.timesonline.co.uk/tol/business/economics/article3228186.ece> [22 November, 2008]

Yifu Lin, 2008. "The Impact of the Financial Crisis on Developing Countries," [Online], Retrieved Feb 12, 2009, from crisistalk.worldbank.org/files/Oct_31_JustinLin_KDI_remarks.pdf