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How Bad is Bad? The Prospects for Development Finance in the Light of Credit Crisis

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1. Introduction

Access for developing countries to external finance has become much more difficult since the beginning of the international financial crisis that began in the second half of 2007. Low-income countries are particularly dependent on external finance from official sources. The policy options for developing countries are thus two-fold: maximize remaining sources of external finance and put them to optimal use; and generate more and wider sources of internal development finance. Donors alike have serious challenges to meet on this score. If not in the 2009 budget cycle, by 2010 donors are most likely going to face some difficult decisions regarding ODA commitments. It will be of utmost importance to deliver on commitments made under the Paris Declaration to increase aid efficiency.

While there are some reasonable hopes that some of the emerging markets may recover relatively quickly from the downturn in economic activity, the poorest countries are arguably far more vulnerable to the vicissitudes of the global economy – they are heavily dependent on external finance and trade, and have poorly-developed networks of social protection. While it is true that subsistence agriculture continues to play a major role in their economies, isolating them to some extent from the downturn in the global economy, in recent decades there have been some notable successes in promoting niche export sectors (e.g. textiles, cut-flowers, vegetables, tourism) - industries which have become an important source of foreign exchange and are now at risk. Moreover, the fact that some of the poorest developing countries, particularly in Africa, do not have sophisticated financial markets, and so are not susceptible to direct *financial contagion*, does not obviate the dangers arising from *pure contagion*: the overall collapse in confidence in the financial system world-wide will raise borrowing costs, sharply curtail revenues and threaten the solvency of domestic financial systems even in poor countries that are poorly integrated into the international market.

2. The channels of crisis contagion

The global nature of the current crisis means that it would be reasonable to expect the growth prospects for all developing regions to be damaged to some extent, though some countries will undoubtedly be better positioned to withstand the economic slowdown than others. Indeed, some emerging markets may even be strengthened over the long run, being well placed to take advantage of the subsequent recovery. This will speed up the ongoing long-term process of reconfiguration of the global economy in favor of the emerging markets (what we term at the OECD Development Centre as "*the Shift in Wealth*"). It also needs to be borne in mind that the channels of contagion are often unexpected ones – thus, for instance, Ethiopia is vulnerable to an slowdown in international air-traffic (Ethiopian Airlines is one of the country's main earners of foreign exchange), and Mozambique could be adversely affected by the world-wide decline of the automobile industry (its leading export is alumina). As mentioned in the introduction, despite the low level of financial integration with the rest of the world in low-income countries, it is similarly not unthinkable that banking sector could be a source of transmission, especially bearing in mind that in some countries, such as Tanzania, Ivory Coast, Rwanda, Madagascar, Botswana, Mozambique and Uganda, over two thirds of banking sector assets are in the hands of foreign banks. In terms of the channels of transmission of the crisis, then, expect the unexpected is probably a good rule of thumb.

Implications for the current account

Although some developing countries, buoyed up by strong commodity prices, have enjoyed positive current account balances over recent years, in many cases such surpluses have been small, and even prior to the crisis many were already converting into deficits. Many developing countries were particularly adversely affected by the combination of exceedingly high food import bills and oil prices in 2007/ 2008, which led to a rapid deterioration in current account balances and reserves. By the summer of 2008, about half of all developing countries already had a current account deficit. According to the IMF (2009:4), 33 out of 78 low-income countries now have reserve holdings equivalent to less than 3 months of imports.

This leads us to the next question which is how vulnerable are low-income countries through the trade channel? As part of the process of globalization, in recent years the "openness ratio" (i.e. imports + exports as a share of GDP) of LDCs has increased substantially from 23 per cent in 2000 to 31 per cent in 2007. Such a high degree of openness should of course be a positive attribute during periods of economic boom but openness to international trade becomes more of a liability when the world economy suffers a serious recession. Many of the burgeoning export industries in low-income countries are already at risk (e.g. the cut flower industry in Ethiopia, or the textile industry in Cambodia, for example, where reportedly orders are 60 per cent down).

One particular area of concern raised by many economists is the rapid drying up of trade finance. While this is has some serious implications for developed and emerging economies, on the whole we consider the impact on low-income countries to be modest – their principal exports (commodities) are not usually dependent on trade finance. It may, conversely, affect their capacity to import capital goods from the industrialized and emerging markets, but during a time of deteriorating balance of payments, some constraints on imports and indebtedness through trade credits might actually be beneficial in re-establishing the macroeconomic balance.

On the positive side, in recent years, as part of the shifting wealth phenomenon, many low-income countries have decreased their trade dependence on developed-country markets in favor of the emerging markets. This is even true for African least developed countries, which now export more to China than to the European Union (24 per cent of total exports vis-à-vis 18 per cent). If growth remains positive in the emerging markets (as IMF and OECD predictions seem to suggest), then there are chances for poorer developing countries to avoid a complete collapse in export volumes.

A final point regarding the trade impacts are the current trends regarding commodity prices. Though the phenomenon has not affected all commodities, there are some signs that prices are rebounding quickly. Prior to the crisis, there was much talk of a ´commodity super-cycle´. One manifestation of that may well be a quick recovery in prices – if not to pre-crisis levels, at least to levels which will mitigate the initial loss of foreign exchange. The key issue for many low-income countries is whether this will affect soft commodities (e.g. agricultural exports, tropical beverages, etc.) as much as hard ones (e.g. oil, iron ore, copper, etc.), and whether the beneficial impact on the export side is offset by the high cost of food imports, which have not fallen as much as was hoped in the wake of the crisis. It is important to bear in mind the fact that, according to the FAO definition, 82 countries are classified as low-income countries dependent on food imports.

Another dimension to the crisis through its impact on the current account and on household income is the foreseeable reduction in remittances. In fact, according to World Bank data remittances are now larger than commodity exports as a foreign exchange earner in 28 developing countries. For Sub-Saharan Africa, the contribution of remittances to the current account has been put as high as USD 19 billion for 2008 - higher than estimates for either FDI inflows or country programmable aid (i.e. aid budgets which are available for development projects and programs in poor countries). In the current climate of a global crisis and reduced employment, especially for migrant labor in the industrialized countries, remittances are expected to decline. World Bank estimates in March 2009 indicate that remittances towards developing countries are expected to fall by 5 to 8 per cent in 2009.

Tourism receipts, another important source of income for some developing countries, will also be affected by the crisis. Some low-income countries that have met with considerable success in attracting an increasing number of visitors in recent years, such as Uganda, Cape Verde, as well as the more well-established destinations (e.g. Kenya), can expect to see their earnings from this source decline. Tourism bookings are already reportedly down 40 per cent in Cambodia, while visitor arrivals (and revenues) to Kenya fell 30 per cent over the first 9 months of 2008.

The sustainability of external debt

The G20 leaders have included the review of the flexibility of the debt sustainability framework as one of the key issues in the development agenda. The financial crisis will further compromise external debt sustainability for many developing countries, as growth rates and export earnings fall. Moreover, foreign debt is denominated in hard currencies, making repayment ability highly sensitive to shifts in exchange rates. With the fall in commodity prices and the strengthening of some reserve currencies, exchange rates in many low-income countries have already weakened significantly in commodity-dependent economies such as Zambia (40 per cent depreciation to USD from June 2008 to February 2009), Uganda (about 20 per cent), Ghana (24 per cent) and Nigeria (25 per cent). Such depreciations make it obviously much harder to service foreign debt.

At the same time, fiscal deficits are expected to worsen not only because of the drop in export revenues but also because of the need to increase social spending and safety nets and to provide the fiscal stimulus required to mitigate the worst consequences of the financial crisis.

Another source of potential concern is the slowing down of the debt relief process – which still involves 17 countries – because of unforeseen cuts in donors' pledges and commitments. It is pertinent to ask whether HIPC countries will even be able to meet existing goals to be eligible for debt relief in the new, harsher international environment. In addition, new avenues of financing for low-income countries, such as sovereign bond issues, have been closed down.

That said, donors may have an incentive to *increase* the share of debt relief in ODA, rather than commit fresh aid resources, to meet the targets set at Gleneagles 2005.

Challenges and opportunities for bilateral aid budgets

Despite the enormous increase in private flows to the emerging markets in recent years, the poorest developing countries are still heavily dependent on aid flows. Africa is most at risk on this score where aid now averages around 9 per cent of GDP (compared for instance with South Asia which has decreased its dependency on aid flows, with aid now contributing only about 1 per cent of GDP).

The key question is, of course, what will happen now in the wake of the most serious economic recession since the 1930s? Are all hopes of scaling-up now dashed? At the country level, historical evidence seems to be ambiguous. For instance, during the stagnation of its economy in the 1990s, Japan's aid budget (measured as net disbursed ODA in USD at 2006 constant prices) fell 12 per cent between 1990 and 1996. But negative economic growth of -2 per cent in 1998 was actually accompanied by a 40 per cent increase in Japanese aid flows. For the United States, the trends between economic growth and the size of the aid budget seem to be similarly ambiguous: while aid dropped during the recession of 1990/ 1991, in the 2000/ 2001 recession the aid budget experienced a sharp increase. Aid flows and GDP growth in the US case show no correlation (0.06) over the period 1960-2007. Thus decisions on allocations to the aid budget do not appear to be strongly affected by the business cycle.

The difference this time is of course that the recession has affected simultaneously nearly every single donor country in the OECD DAC grouping. One important dimension to this question is the fiscal balance – one would expect that governments with large deficits would be more prone to cut aid. By their massive intervention to prop up the banking and credit system, OECD governments are currently taking on huge financial commitments, already amounting to several trillion USD. Clearly governments are going to have to take some tough fiscal choices in the coming years. Announced cuts by March 2009 in aid budgets by several donor countries do not bode well. It would be wise, therefore, to anticipate at least a failure to scale up ODA, if not an actual cut.

Finance from multilateral donors

At their meeting in April 2009 in London, the G20 leaders sharply increased the resources available to the multilateral development banks up to USD 1.1 trillion. The International Monetary Fund in particular benefited from this new injection of resources, tripling its overall lending capacity. Nevertheless, funds specifically targeted to low-income countries only amount to an estimated USD 50 billion. Thus there is still a danger that much of the new resources will bypass the poorer, most vulnerable countries – and instead be destined principally for the emerging markets and middle-income countries. To be sure, there is some logic and justification in such an allocation of resources. Considerable concern has been raised that the emerging markets may reveal their vulnerability and so the multilaterals will need to step in, in order to reduce systemic risks, because – at the present juncture – no one wants to see a major emerging economy go under. It is also undoubtedly true that many of the new financing capacity made available through the multilaterals are not accounted for as development aid (there is little or no grant component).

Finally, the financial crisis could (or should) give a new impetus to governments' efforts to improve aid effectiveness, as expressed in the Paris Declaration and the Accra Agenda for Action. Even in the face of the possible stagnation of aid budgets, there might be a pay off if donors react in a way that is pro-poor. Indeed, a hard-budget constraint may even help reduce some of the inefficiencies that have become inherent in the international aid system. Significant portions of aid budgets have grown enormously over the last 10 –to 20 years – particularly technical co-operation – and yet the rationale for supporting such a large expansion of these expenditures, in terms of aid effectiveness, is more doubtful. Now, more than ever, policy makers need to protect aid volumes and allocate them in a way that is pro-poor.

What about FDI? Evidence from past experience

FDI has been one of the principal beneficiaries of the liberalization of capital flows over recent decades and now constitutes the major form of capital inflow for many developing countries. Nevertheless, the current financial turmoil does not bode well for the sustainability these inflows in 2009.

There are several reasons for adopting a cautious stance regarding the potential contribution of FDI finance against the backdrop of the current recession. Firstly, if profits repatriation is taken as a proxy for its "price", FDI has proved to be an extremely "expensive" form of financing in recent years, especially for low-income countries, with, profit repatriation actually surpassing new inflows of FDI in many low-income countries. Such outflows need to be financed and add to pressure on the exchange rate.

Secondly, the presumption that FDI finance is intrinsically more stable than other kinds of financial flows has perhaps been exaggerated, especially in view of the ease with which multinational enterprises can shift financial resources from one country to another. For instance, FDI investors often use derivative products such as currency forwards and options, which may put the local currency under pressure and increase instability. Similarly, some components of FDI are more pro-cyclical than others. In particular, reinvested earnings and intra-company loans are likely to be curtailed sharply during the current crisis, as companies repatriate financial resources towards the parent companies. This was very much the case during previous crisis, such as the Thai crisis in 1997 and the Argentine crisis of 2001.

Finally, and perhaps more importantly, FDI is still pro-cyclical. In recent years, outflows of FDI from OECD countries - the major source of investment flows - have been quite clearly correlated with economic growth. The implications are clear: as the credit crunch starts to bite and capital becomes scarcer and more expensive, so multinational corporations will scale back their investment plans. FDI inflows are highly contingent on local growth as a "pull factor" which entices foreign investors. In so far as the prospects for growth in the developing countries deteriorate, so too will FDI inflows. This is particularly important to the extent that much FDI in the developing world is directed towards local markets.

Notwithstanding these points, once the crisis is over FDI might actually be one of the forms of cross-border flows that will be privileged (as it has been in the aftermath to previous crises). There are some early signs that South-South investments may indeed come out of the crisis strengthened over the long term. FDI could become one of the few ways in which low and middle-income countries can access capital for development.

3. South-South linkages: a chance for low-income countries to cope with the crisis?

When the financial crisis struck, much attention was focused on the idea that the prospects for the developing world (and low-income countries in particular) hinged on what was happening to the OECD countries. However, how true is this nowadays? For several of the transmission channels discussed here, such as migration, trade, and investment patterns, south-south linkages are becoming increasingly important over the last decade.

How deep are real channel linkages between the developing world and industrialized countries? For instance, Akin and Khose (2008) find that the impact of the Northern economic activity on the Emerging South has declined during the globalization period (1986–2005). In contrast, the growth linkages between the North and Developing South have been rather stable over time. Such exercises are crude approximations to what in reality are a complex set of linkages. But should their findings be right, the conclusion could be that the poorer developing countries, still heavily dependent on the markets of the North, will be more seriously hit by the financial crisis in the north than the emerging countries.

Other evidence does not necessarily concord with these findings however. An IMF (2007) study estimates that, on average, a 1 percentage point decline in GDP growth in the euro area is associated with a slowing in GDP growth of about 0.25 percentage point in Sub-Sahara Africa (SSA). A subsequent IMF (2008) study carried out an analysis of the simple correlation of growth rates in SSA with growth rates in other regions of the world over the period 1980-2007 and finds that the correlation with Latin America and Asia is just as high as the correlation with its traditional trading partners in Europe. Pointedly, despite initiatives like African Growth and Opportunity Act (AGOA) intended to intensify trade and investment links with SSA, the simple correlation of growth in SSA with the United States is near to zero. Such studies need to be treated with some caution – correlation does not imply causality, and it could well be that the growing synchronization of economic cycles is due to common external factors (e.g. shifts in commodity prices) rather than reflecting real economic links between southern countries. Nevertheless, the fact that, for instance, Chinese-African trade increased by 40 per cent in 2008, up to USD 107 billion, suggests that real South-South economic links are indeed deepening.

The upshot of all this is that how well low-income countries will withstand the crisis has become increasingly more contingent on the fortunes of the rest of the developing world, rather than on the prospects for the OECD. If growth rates remain positive in the main southern "drivers" (countries like Brazil, China and India), one long-term consequence of the current crisis may be an accelerated reconfiguration of the global economy in favor of the developing world.

4. Conclusions

In contrast to many previous crises, this time the countries of the developing world have been caught out as innocent bystanders rather than protagonists. Yet arguably the developing world and the low-income countries in particular have as much at stake during this economic crisis as the industrialized countries.

The global crisis has brought into sharp relief the vulnerability of emerging and developing countries to the vagaries of globalization. They need external finance to continue to develop, but the spigot seems to be tightening. At the same time, the markets for their products, commodities and services in the OECD world are shrinking. This good news for no-one; global interdependency is a reality and the wealthier countries cannot and must not seek to resolve the crisis in a vacuum that excludes the rest of the world. At the international level, policies that leave poorer countries exposed and fiscally weak need to be looked at again, and in forums that include the developing countries themselves. Similarly, developing countries need to make a more determined push in favor of the domestic mobilization of resources. Finally, the donor community needs to grasp the nettle and deliver on its commitments to improve aid efficiency.

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Further Reading

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