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SESRIC REPORTS ON THE GLOBAL FINANCIAL CRISIS



European Debt Crisis and Impacts on Developing Countries



EUROPEAN DEBT CRISIS AND IMPACTS ON DEVELOPING COUNTRIES

July – December 2011

SESRIC Reports on Global Financial Crisis : The financial crisis which started in July 2007, when investors lost their confidence in the mortgage- and asset-based securities in the United States, has deepened during 2008-2009 with a global reach and affecting a wide range of financial and economic activities and institutions in both developed and developing countries around the world. As the crisis deepened, the governments of major developed and developing countries as well as international financial regulators attempted to take some mitigation actions and coordinate efforts to contain the crisis.

Given this state of affairs, the SESRIC has been preparing short reports since May 2009 with the aim of monitoring the developments related to the current global financial crisis at the global, regional and national levels. In particular, these reports focus on the impact of the crisis on the economies of the developing countries, including the OIC Members, and highlight the actions taken by these countries to contain the negative impact of the crisis on their economies.

Introduction

The 2008-2009 financial and economic crisis substantially impacted both the developed and developing countries. In the last quarter of 2008, global industrial production declined by 20% as high-income and developing country activity plunged by 23 and 15 per cent, respectively.¹ The World Bank estimated that developing countries would face a financing gap of \$270-\$700 billion depending on the severity of the economic and financial crisis and the strength and timing of policy responses.² There was the fear that sovereign debt issuance by high-income countries would crowd out many developing countries. The

¹ "Swimming Against the Tide: How Developing Countries Are Coping with the Global Crisis," Background Paper prepared by World Bank Staff for the G20 Finance Ministers and Central Bank Governors Meeting, Horsham, United Kingdom on March 13-14, 2009.

² Ibid.

challenge facing the developing economies was how to protect and expand necessary expenditures on social safety nets, human development, and critical infrastructure.

By late-2010 the concerns seemed to have given way to optimism about the passing of the crisis and start of recovery. Expert organizations such as the World Bank (WB) and International Monetary Fund (IMF) were forecasting that the crisis is over and the recovery is on its way. The April 2011 World Economic Outlook³, IMF's flagship report on the status of world economy, starts with:

"The world economic recovery continues, more or less as predicted ... Earlier fears of a double-dip recession – which we [(the IMF)] did not share – have not materialized."

The WB's June 2011 Global Economic Prospects⁴ highlights that:

"The global financial crisis is no longer the major force dictating the pace of economic activities in developing countries. The majority of developing countries have, or are close to having regained full-capacity activity levels ... Global growth is projected to remain strong from 2011 through 2013."

Yet, not long has passed and the word of the day⁵ is the fear of a Eurozone collapse and a pandemic malaise. Just as the world economy seemed to be entering the recovery phase, the Euro crisis has brought back the gloom.

This has important implications for the developing world. While the earlier crisis made it difficult to protect the process of economic development in these countries, should the current European debt crisis form into a global financial disaster, the current situation could even reverse many of the progresses made during the last decades. Perhaps it is time for developing countries to start planning for developing strategies that puts them less at risk of suffering the most from such financial crises in the high-income countries. The mix of the OIC member countries, with some of the richest countries in the world as member states, give them an exceptionally unique position and opportunity in this regard through forming an emergency development fund between the member countries that provides the least fortunate members with resources to protect their progress until global recovery.

This issue focuses on explaining the evolution of the European debt crisis and shedding light on different conduits through which a financial crisis in Europe could impact the developing economies.



³ <http://www.imf.org/external/pubs/ft/weo/2011/01/pdf/text.pdf>

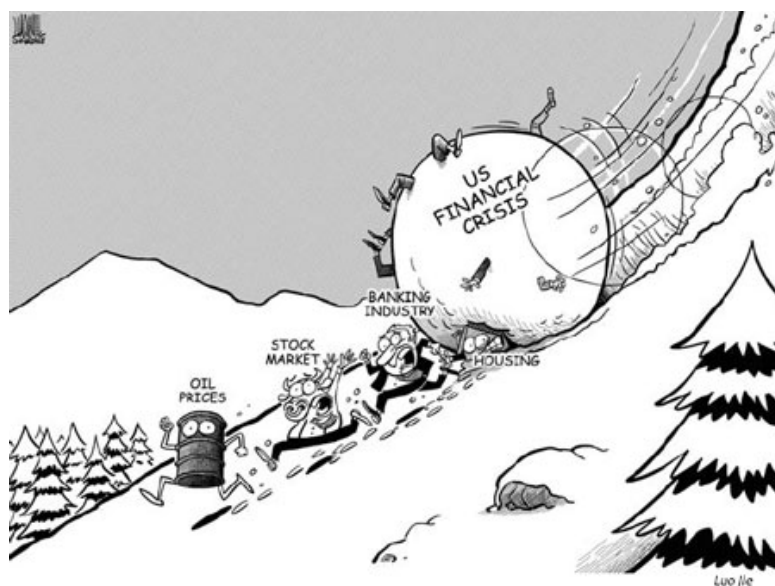
⁴ <http://siteresources.worldbank.org/INTGEP/Resources/335315-1307471336123/7983902-1307479336019/Full-Report.pdf>

⁵ December 2011

The Evolution of the European Debt Crisis

Fears of a sovereign debt crisis in Europe took shape in the late 2009 as it became evident that it is difficult or impossible for Greece, Ireland, Portugal, Italy, and Spain to repay or refinance their debts to Eurozone lenders. Figure 1 below, from the November 2011 Economic Outlook of the Organization for Economic Development and Cooperation (OECD), explains how the problem evolved. The market was lending to Greece, Ireland, and Portugal at the same rate as it did to Germany as recent as 2008, assuming that Euro could never break up and thus every country in its zone is as safe as the safest: Germany. As a result, for instance, Greece accumulated about 145% of its Gross Domestic Product (GDP) as gross debt; more than it can produce (GDP) in almost one and a half years (see Figure 2).

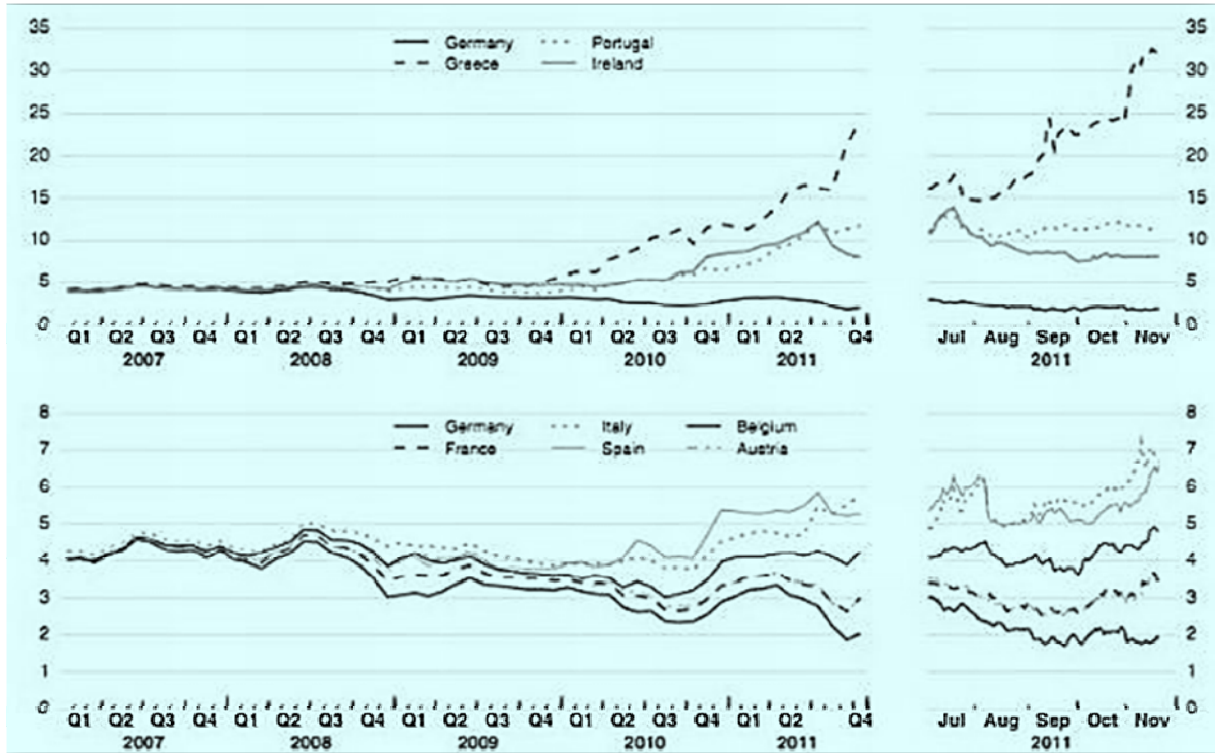
As it became clear that some of the debtor governments in the Eurozone are at the serious risk of default, market attitude changed quickly, making it substantially expensive for the risk countries to further borrow. This exacerbated the likelihood of a debt crisis in the Eurozone as it increased the debtor countries' chance of default and consequently the chance of insolvency of banks in creditor countries. According to the statistics released in the December 2011 Bank for International Settlements Quarterly Review⁶, European banks held close to \$121 billion in foreign claims from Greece at the period ending June 2011, with the highest exposures among the banks in France and Germany. The same number for Ireland is more than \$380 billion, with the highest exposures among the banks in the UK, Germany, and France; for Portugal is more than \$196 billion, with the highest exposures among banks in Spain, Germany, and France; for Italy is more than \$837 billion, with the highest exposure among banks in France, Germany, and the UK; and for Spain is more than \$643 billion, with the highest exposures among the banks in Germany, France and the UK. Banks in Germany, France and the UK also have loans to payback to banks in Greece, Ireland, Italy, Portugal, and Spain, as well as loans from countries outside of Europe such as the US and Japan. Such an interconnected web of finance across countries makes a pandemic in Europe to easily exacerbate and spread outside.



⁶ Table 9E, http://www.bis.org/publ/qtrpdf/r_qt1112.pdf

Figure 1: Investors now discriminating across euro area sovereign bonds

10-year sovereign bond yield, in per cent



Source: November 2011 Economic Outlook, OECD

Figure 2: General Government Gross Debt in the Euro Zone



Source: Eurostat, European Commission

Impacts of a European Financial Contagion on Developing Countries

Should the pessimisms come true, it can substantially impact the economies of the developing countries. While many developing countries are likely to avoid contractions in output seen in advanced economies, they are considerably more vulnerable to an economic slowdown. Major conduits for a renewed financial crisis to impact the developing countries in the short-run are:

- Fall of market capitalization
- Fall of commodities and minerals exports
- Fall of diaspora remittances

Fall of Market Capitalization

In the event of a global scale economic and financial crisis, foreign investors massively withdraw their investments, including from the developing countries fearing that contagion could spread to these countries as well. In 2009, the World Bank estimated that in the aftermath of the 2007-2009 global economic crisis developing countries faced a financing gap of \$270-\$700 billion depending on the severity of economic and financial crisis and the strength and timing of policy responses and indicated that "... should a more pessimistic outcome occur [(such as the current financial turmoil in Europe)] unmet financing needs will be enormous."⁷ Sovereign debt issuance by high-income countries has since increased dramatically and crowded out many developing countries, virtually evaporating financial intermediation for developing countries.

According to the IMF's 2010 Coordinated Direct Investment Survey Database⁸, as of end-2010 and out of close to \$199.5 billion inward direct investment in Sub-Saharan Africa, the European Union had a share of more than 67%; out of \$20.1 billion direct investment in Near and Middle-East economies other than economies of Persian Gulf, the EU countries had a share of 30%; and out of \$1,199 billion direct investment in Central and South Asia, the EU countries had a share of 29%, ranking the first foreign direct investor in all these regions by far. Collapse of the financial system in Europe therefore has major direct repercussions for these regions in terms of market capitalization. Furthermore, as the contagion gets airborne globally, the consequences for developing countries become even more serious.

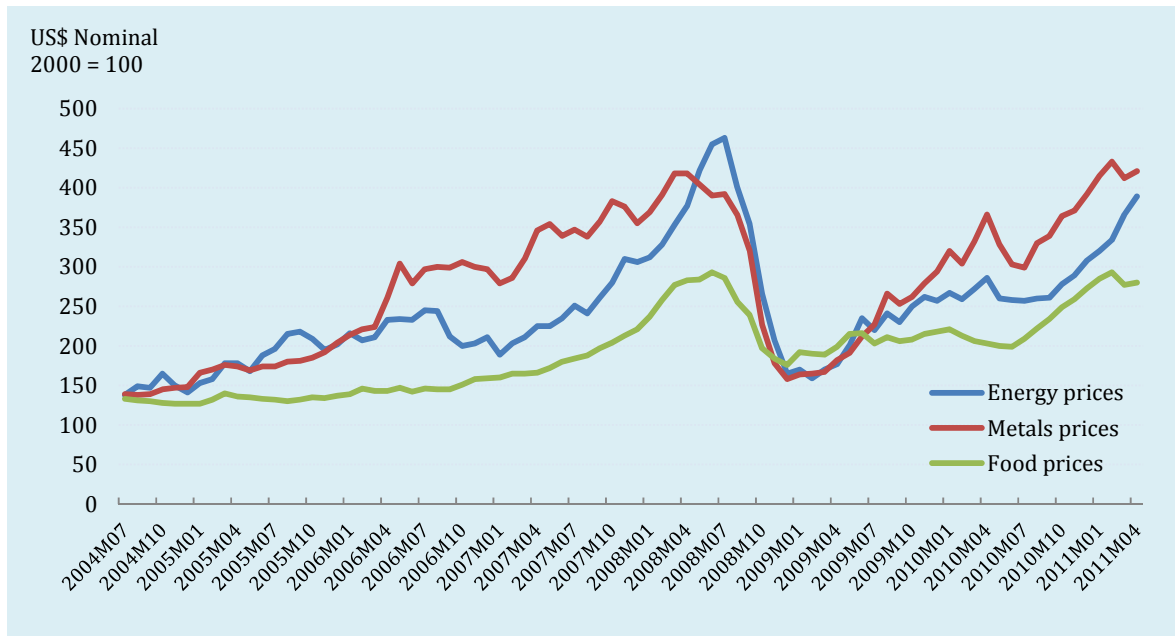
Fall of Commodities and Minerals Exports

A reaction of the developed countries to a global scale economic and financial crisis is to reduce their imports of commodities and Minerals in the international markets, causing drastic reductions in the price of such goods and consequently revenues of the developing countries (e.g., crude oil dropped from \$147 in 2007 to \$47 in 2009). This is essentially dangerous for low income countries given the pre-crisis increases in the share of such export revenues in their gross domestic products (GDP).

⁷ "Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis," World Bank, 2009.

⁸ CDIS Table 7

Figure 3: Global Commodity Prices



Source: Global Economic Prospects, World Bank

According to the European Commission⁹, in 2010 the European Union ranked second in terms of share in total imports from the Least Developed Countries (LDCs) with a share of about 18.3%, in which Primary Products¹⁰ formed 56.7% of the EU imports from the LDCs. With the developing countries, EU ranked also second in terms of share in total imports from the developing countries with a share of about 16.6%, in which Primary Products formed 35.4% of the EU imports from the developing countries. Hence, a deepening of the debt crisis in Europe could have immediate direct impacts on the prices of commodities in the world market and substantial subsequent negative impacts as the crisis spreads to other major trade partners with the developing countries.

Fall of Diaspora Remittances

Rising unemployment in the developed countries in the aftermath of economic and financial crises is affecting employment prospects of existing migrants and hardening political attitudes toward new immigration, making remittances to dry up as migrant workers lose their jobs or are no more able to afford to send as much money back home. According to the World Bank¹¹, even though the officially recorded remittance flows to developing countries are estimated to have reached \$351 billion in 2011, its growth remains slow for the years to come. In the event of a new global crisis sourced by the European debt crisis, the growth rates may become negative once again, especially for flows to countries in Eastern

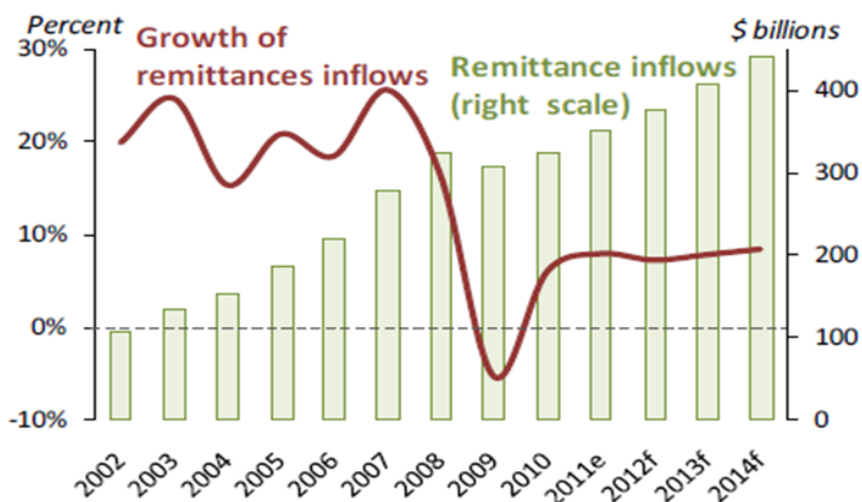
⁹ <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/statistics/>

¹⁰ SITC 1000 Rev.3

¹¹ Migration and Development Brief 17, The World Bank, December 2011.

Europe and Central Asia (e.g. Romania, Bulgaria, Moldova) and North African and Middle-Eastern countries that have a large share of their emigrants in Europe (See Figures 4 and 5).

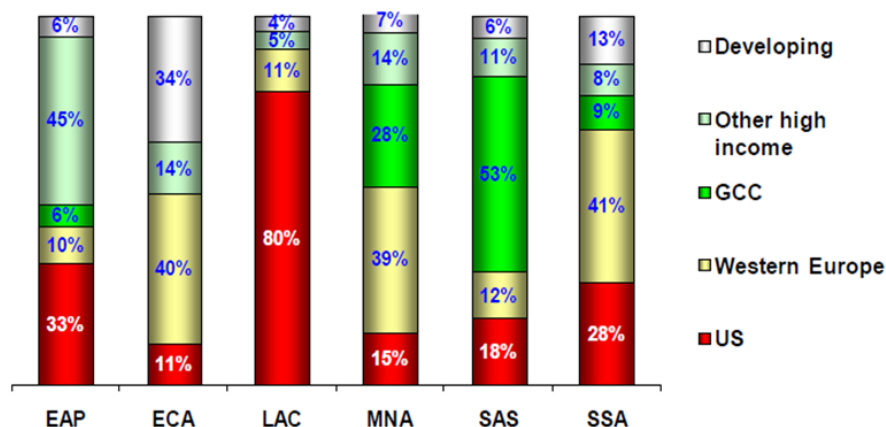
Figure 4: Remittance Flows to Developing Countries



e = estimate; f = forecast

Source: Migration & Development Brief 17, The World Bank, December 2011.

Figure 5: Sources of Remittances for Developing Regions in 2010



EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and Caribbean; MNA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa

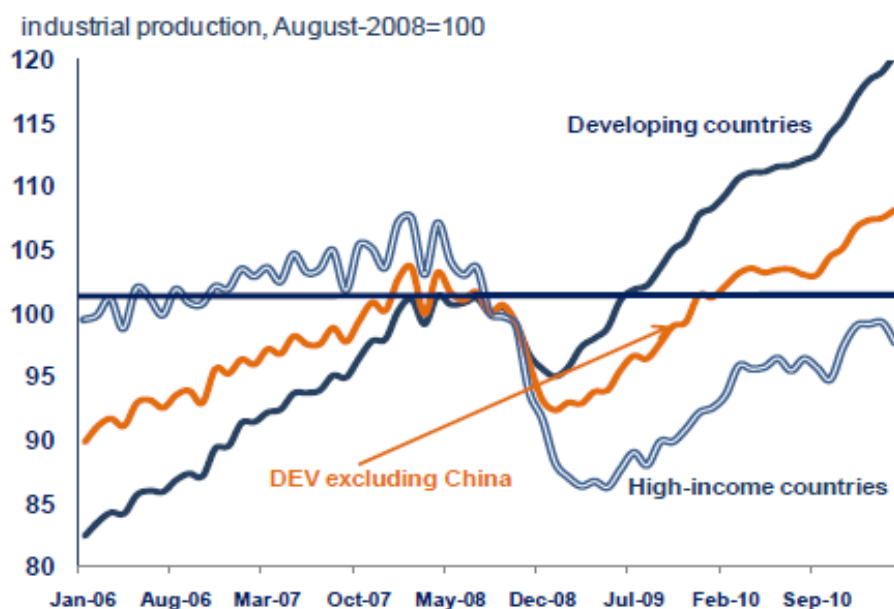
Source: Migration & Development Brief 17, The World Bank, December 2011.

Long Term Effects

In the long-run, with the slow-down of the EU economies there will be less room, appetite, and public support for importing manufacturing goods from developing countries. This will adversely impact the manufacturing sector in the developing countries and further exacerbate their already high unemployment and poverty rates. Unavoidable fall of exports to and foreign investment in the developing countries, due to the slow-down of economies in the high-income countries, would also endanger the transfer of know-how and technology necessary for their medium and longer term growth and development, further impairing and complicating the process of socio-economic development.

According to the European Commission, during 2006-2009, European Union (EU) had an average share of about 18.3% in total imports from developing countries. In 2010 this figure dropped to 16.6%. With “Machinery and Transport Equipment,” “Miscellaneous Manufactured Articles,” and “Manufactured Goods, Classified Chiefly by Material” forming about 63.7% of EU’s imports by value from the developing countries, a financial crisis in Europe translates into loss of the precious manufacturing jobs and considerable rises in unemployment rates across the developing countries. Among the Least Developed Countries, The EU’s share in total export of these countries dropped from an average of 21.5% during 2006-2009 to 18.3% in 2010. “Miscellaneous Manufactured Articles,” “Manufactured Goods, Classified Chiefly by Material,” and “Machinery and Transport Equipment” forms about 46.2% of total EU imports from the LDCs by value.

Figure 3: Pre and Post Crisis Trends in Industrial Production



Source: Global Economic Prospects 2011, World Bank

Conclusion

A renewed global financial crisis stemming from the current sovereign debt problems in Europe can have major repercussions for the developing countries, and especially for the lower income countries in this group. The collapse of the European Union financial systems is capable of severe direct impacts on the process of development in the Least Developed Countries. Further contagions around the world would further amplify the development crisis in the poor countries.

Investment flows to the economies most in-need will evaporate and will be replaced by strong outflows of investments instead. Export revenues from the commodities and minerals, which in many developing countries are among the major sources of revenue for the countries, will evaporate as the prices of these goods fall in the event of a global financial crisis. Remittances, also a major source of revenue especially in the poorest countries, will sharply fall and opportunities for emigration will cease to exist. Economic growth will eventually severely decline and unemployment and poverty rates will soar high, undermining the progress made in the past decade. There will be significant job losses in manufacturing, mining, and construction sectors. These all could well endanger the institutional capacities that were built during the last decades.

The financial resources devoted by high-income countries to support development processes in the least developed countries quickly evaporate in the event of such financial crises at the global scale. Furthermore, the frequency of such events at the global scale appears to be increasing. Perhaps it is time for developing countries to form stronger cooperation, financial alliances, and economic ties among themselves that help them survive when financial resources from high-income countries cease to be available. This would make economic development financially more sustainable at the time of global financial crises.

The OIC member countries have a unique position to make them successful in achieving this goal. While it is a cumbersome task to bring countries of different regions, cultures and backgrounds together for such purposes and keep them committed and loyal, the OIC countries have already passed these difficulties and risen above and beyond. The interesting mix of the OIC member states, with some of the richest countries in the world among them, provides an opportunity for forming the required financial alliance needed for supporting economic development in the low-income member states in such times.

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