Global crisis and developing countries

By Martin Khor

THE world is in crisis the sources of which lie in financial and other policies of the developed countries, especially the United States. Though not responsible for the crisis, developing countries are being seriously affected by it.

Coming through various transmission routes--mainly finance and trade-- the western economic downturn has impacted balance of payments and foreign reserves of some developing countries, a few of whom are facing a new debt crisis. The output, jobs and social development in many states have been hit. There was a lag time before the effects reached developing countries, in the few months before the end of last year.

Finance route: In the finance route, developing countries are affected in at least four ways:

First, some countries have been hit through investing in toxic or depreciating assets. The sovereign wealth funds in Singapore and Middle East's oilproducing states invested in some of the big US, Swiss and UK banks whose stocks have now lost much of their value. China also lost value in investments turned sour, or in some toxic assets.

Second, there has been a big drop in funds flowing to developing countries. Net capital flows to emerging markets are estimated to have fallen from $929 billion in 2007 to $466 billion in 2008 and further to $165 billion this year, according to the Institute of International Finance (IIF).

Of these capital flows, portfolio investment which earlier surged into developing countries, has been flowing out. Bond business in the emerging markets fell from $50 billion in the second quarter of 2008 to only $5 billion in the last quarter.

Third, there is also a severe reverse flow in bank credit. The IIF expects that this year banks will take out more in debt repayment in emerging markets that they will provide in new loans.

suddenly, mainly because of a drop in consumer demand in the US and Europe. In the latest month, for which figures are available, export value (compared to 12 months previously) fell in Japan by 46 per cent, Taiwan 44 per cent, the Philippines 40 per cent, Singapore 38 per cent, South Korea 34 per cent and Malaysia 28 per cent.

In China, exports in January fell by 17.5 per cent. The fall in exports there caused thousands of factories to close down, with 20 million losing jobs, according to official estimates.

But China's imports fell more sharply (43 per cent) and this has hit many Asian countries, exporting manufactured parts used in the products China exports to the West.

The sudden drop in manufactured exports such as electronic products and components, textiles and clothing have led to a fall in industrial production in developing countries that have relied on such exports for their economic growth.

Developing countries that export commodities have also been hit by the sudden drop in demand and prices.

The sharp decline in the price of oil from its peak of $140 a barrel to around $40 is a blow to oil-producing countries, but has benefited oil-importing countries.

Prices of a wide-range of other commodities also dropped sharply. For example, in Malaysia, the palm oil price fell from a

mechanism by which global crisis was transmitted to them. In the past 4-5 years, the rising prices of commodities fuelled economic growth and raised hopes of a structural shift in the commodities situation. However, such hopes have been dashed in a deepening recession.

Second, trade in services is also being increasingly affected by the crisis. For example, global tourist arrivals fell by one per cent in the second half of 2008. In the Caribbean, which depends heavily on tourism, arrivals are likely to fall by one third this season.

Countries like India that benefited from outsourcing by US multinationals (for services ranging from accountancy to call centres) are being affected as the business of western firms shrink. India has also protested against the move announced in President Obama's recent budget speech to remove the tax exemption of foreign profits made by American firms that outsource their business.

Many developing countries depend on the remittances of the migrant workers. So far the migrants' flow of money home has been resilient to the crisis, with the World Bank estimating that remittances to developing countries actually rose from $281 billion in 2007 to $305 billion in 2008. The bank however predicts a fall of six per cent in 2009, as migration flow slows down or as workers are sent back home.

> Developing countries are facing a worsening of trade financing as banks have tightened supply of credit even for routine import and export businesses. It was reported at a World Trade Organisation meeting that there is a $25 billion shortfall in trade financing.

balance of payments and the stock of foreign reserves in many developing countries. Some also see their currencies devalued, making it more difficult to service their external loans.

A few countries (such as Pakistan and Sri Lanka) have had to go to the IMF for loans to avoid debt defaults. More countries may join them in the near future.

The developing countries have also experienced slower GDP growth (China, India, Brazil), zero growth (Malaysia) or a decline in GDP (Korea, Taiwan, Singapore). Unemployment is rising as factories get closed and the labour force chase scarce jobs.

All these will have adverse social effects, including an increase in poverty and the inability to meet social goals of health care, education, water supply and environmental protection, if people's incomes and governments' budgets are shrunk by the crisis.

Suggestions: It would be useful for developing states to prepare to deal with the crisis at the national, regional and international level. Some options which can be explored are: At the national level, the collapse in export demand may be countered through expanding domestic demand.

At the regional level, developing countries could pool their funds and lend to one another.

At international level, they can advocate the types of cooperation required to assist them to face the crisis they did not create but of which they have become the worst victims.

- For countries that have fallen into new debt crisis, a new round of debt relief and cancellation is required.
- To prevent countries from falling in debt default, an international debt arbitration system is required, with debt standstill and orderly workout and continuation of working capital.
- Mechanisms to deal with the instability of demand and prices of exportable commodities.
- An international framework that

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Fourth, the FDI flow worldwide is slowing down. It fell by 21 per cent to $1.4 trillion last year, according to UNCLAD data. So far the developed countries have been affected more by this. The FDI flow to developing countries still grew by four per cent in 2008, but was much slower than 21 per cent in 2007.

Trade route: First, exports of many developing countries fell drastically and

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Prices of a wide-range of other commodities also dropped sharply. For example, in Malaysia, the palm oil price fell from a peak of MR4,300 a tonne in March 2008 to a low of MR 1,390 in October. It has since recovered to about MR1900.

On 24 February 2009, The Economist's commoditydollar index for all items fell by 42 per cent compared to a year ago. The index for food was 30 per cent down, for nonagricultural products 45 per cent and for metals 60 per cent.

For poorer countries such as Africa, the fall in commodity prices was the main

firms that outsource their business.

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Third, developing countries are facing a worsening of trade financing as banks have tightened supply of credit even for routine import and export businesses. It was reported at a World Trade Organisation meeting that there is a $25 billion shortfall in trade financing that needs to be filled.

The reduced flows or outflows of finance and the fall in exports of goods and services have led to a deterioration in the

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- To prevent countries from falling in debt default, an international debt arbitration system is required, with debt standstill and orderly workout and continuation of working capital.
- Mechanisms to deal with the instability of demand and prices of exportable commodities.
- An international framework that would assist the developing countries in regulating capital flows and to prevent/minimise speculative flows and would enable them to undertake regulation of capital flows.
- Reform of the international financial and economic organisations, for giving developing countries a fair voice and representation in the policies of the global institutions. *(edited and abridged)*

Courtesy: South Centre, Geneva.