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Global Economic Crisis: Impact and Response: A Commonwealth Perspective

Paper by the Commonwealth Secretariat

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Executive Summary

1. Since Commonwealth Finance Ministers met a year ago, the global economy has transited through three phases – mild but escalating deterioration to early-October 2008, thereafter a full-blown and precipitous decline in global output and trade broadly until sometime in the second quarter of 2009 and subsequently a moderation of the pace of decline.

2. The crisis has been without precedent in the Commonwealth's history, with the magnitude of synchronised decline harking back to the Great Depression. Also without precedent has been the scale and coordination of global policy response, led by the G-20 advanced economies and dynamic emerging markets. The Commonwealth's developed economies and emerging markets have contributed significantly, helping to put in place the pre-conditions for global recovery, though at significant cost to fiscal sustainability. The financial and real sectors in these member countries have been severely, though diversely affected.

3. Developing Commonwealth countries have been substantially adversely affected by the crisis. Output, unemployment, fiscal and external balances have all significantly deteriorated, with the crisis being transmitted through three primary channels – declining trade, declining FDI and remittance flows. Aid has held up, but remains well below Gleneagles targets. Critical to a sustained recovery will be a resuscitation in their exports to OECD markets and recovery of market share.

4. Resilience has been eroded and progress on poverty reduction retarded in the Commonwealth's 32 small, vulnerable economies. Responses have varied but have generally been limited by the absence of fiscal space and room for policy manoeuvre.

5. Increasing indebtedness in several Commonwealth member countries, a characteristic emerging before the onset of the crisis, has deepened and require special Commonwealth focus in the period ahead.

6. As Ministers gather for the 2009 Commonwealth Finance Ministers' meeting, the global economy may be entering a new phase, characterised by limited recovery in some OECD economies and several dynamic emerging markets. The downside risks to a sustained and broad-based recovery are substantial, including incomplete reform of financial institutions, continued caution in bank lending, incomplete recovery in some housing markets, and increased concerns for fiscal sustainability and deteriorating unemployment in some advanced economies.

7. The need for continued synchronised fiscal and monetary stimulus, measures to secure global financial stability as well as financial sector reform, has recently been reaffirmed by the G-20 and is expected to be endorsed by the IMF and World Bank at the Annual Meetings in Istanbul. Commonwealth Ministers' views on the importance of continuing stimulus will be valuable; a collective statement to the Annual Meetings could

represent an important contribution to the global discussion on the merit and timing of an exit strategy.

8. Current evidence of recovery has been founded on fiscal and monetary stimulus, rather than a resuscitation of private demand. A key policy question for Ministers going forward will be to identify the factors which will support recovery in the year ahead, if and when the current coordinated stimulus packages begin to be scaled down.

9. The institutional and poverty effects of the crisis suggest that recovery in developing countries particularly the most vulnerable, smallest Commonwealth economies, will substantially lag sustained recovery in global output and trade. Ministers' exchange of views on the impact of the crisis will be useful in determining what if any steps the Commonwealth can take to bolster efforts to accelerate recovery, reduce poverty and put vulnerable developing members back on the path to MDG attainment.

10. Concerted intra-Commonwealth collective action, focused on partnering for sustainable and equitable development, is more clearly needed than at any other time in the Associations' history. This will help speed and make more resilient recovery in member countries. Ministers' views on how partnerships can best be established and taken forward would represent a valuable outcome of the meeting and a springboard for deliberation by Commonwealth leaders at the Heads of Government meeting in November 2009 in Port of Spain, Trinidad.

11. Salient questions for Ministers are identified in the text of this report.

Contents

I The Global Economic Crisis – Evolution and Latest Developments

Introduction

1. The past year has been dominated by the escalation, impact and policy responses to the global financial and subsequent economic crisis. There is no precedent in Commonwealth history for a crisis of this nature. It has represented the first synchronised downturn in global economic output since the Great Depression, has led to the sharpest deterioration in global output and trade since the Second World War, severely impacted all developed and developing countries, precipitated extraordinary, synchronised monetary, fiscal and financial policy responses from advanced and emerging market economies and has altered the structure of both international and national financial regulation and regulatory governance. As Finance Ministers meet in Cyprus in October 2009, much remains work in progress.

2. Frequent and extensive analyses by the IMF, World Bank, OECD, the former Financial Stability Forum, UNCTAD, the ILO and others, have tracked the evolution of the crisis, its escalation, impact and policy responses. The purpose of this paper is not to repeat these analyses, but instead to provide first a brief snapshot of the evolution of the crisis in the past year, its global impact, global policy responses and recent evidence of a potential recovery; and second – and centrally - to focus on the impact that the crisis has had on all Commonwealth member countries. This section focuses particularly on the Commonwealth's low-income and small economies, which have been most vulnerable and least able to respond to the crisis.

3. This is the first of three papers prepared by the Secretariat for FMM 2009 on the impact of the crisis. A second paper (FMM(09)3 considers the short-term policy challenges confronting Commonwealth member countries, notably fiscal and monetary policy choices; and a third paper (FMM(09)5, focuses on the medium-term challenges and opportunities for the Commonwealth, in exiting the crisis and building policies to promote economic and social resilience.

Five key questions may be of particular relevance to Minister's discussion of the global policy response and member country impact:

1. Do Ministers consider the global policy response to have been effective? What more can or should be done to secure comprehensive recovery, within the Commonwealth and by other institutions and fora, including the IMF, World Bank and the G-20?

2. What have been member countries' specific experiences of the crisis and what lessons do these experiences offer for the broader membership?

3. A potential nascent but fragile recovery in the global economy is said to be in sight. Is evidence of this widespread in the Commonwealth? What are the best pathways to exit from the current synchronised and massive global fiscal stimulus; what are the dangers and when should exit strategies be implemented?

4. What opportunities are there for Commonwealth advocacy, pan-Commonwealth partnership and intensified work by the Commonwealth Secretariat, in accelerating recovery, particularly in the smallest and poorest members of the association?

5. Commonwealth Heads of Government will meet in Trinidad and Tobago in November 2009. What specific issues emerging from the experience of crisis in the past year rank as most significant priorities for Leader's consideration?

4. Four distinct phases have characterised the global economy in the past fifteen months: firstly, a period of mild, but escalating downturn through much of last year until shortly before the Commonwealth Finance Minister's Meeting held in St. Lucia in October 2008. Secondly a precipitous global economic and financial sector deterioration from September 2008 through the first quarter of 2009. Thirdly and broadly from April 2009, a period of massive, synchronised and coordinated counter-cyclical fiscal and monetary policy action by the advanced economies and dynamic emerging markets, including several Commonwealth members, in a bid to bring stability to the global financial system, to check the spiralling decline in the global economy and to put in place the pre-conditions for a global recovery.

5. Stimulus measures have been coupled with three major financial sector policy interventions to stabilise the international financial system: massive emergency liquidity support, the unprecedented expansion of financial safety nets and direct government intervention in rescuing failing financial institutions.

6. Finally, from the beginning of the third quarter of 2009, a fourth phase may have been entered, illustrated by the first broad-based signals of a modest and fragile recovery in some advanced economies, as well as stronger recovery in several emerging market economies.

The extent of recovery, its sustainability and its reach beyond a limited number of OECD economies and some emerging markets remain uncertain, although it seems clear that the phase of rapid deterioration which commenced in the month immediately preceding last year's CFMM may well have passed.

7. Consequently Commonwealth Finance Ministers are gathering for their annual meeting in October 2009 in an extraordinary policy environment, one in which the short-term and medium-term outlooks for the global economy are uncertain,[1] are continuously changing[2] and have lurched, in barely a year through several phases. And while Ministers are meeting in a more optimistic and forward-looking environment, they are doing so in the context of a global economy severely damaged in the past year by the economic and financial crisis and with potential global output having suffered a substantial downward correction.[3]

Global Impact and Policy Responses – A Snapshot

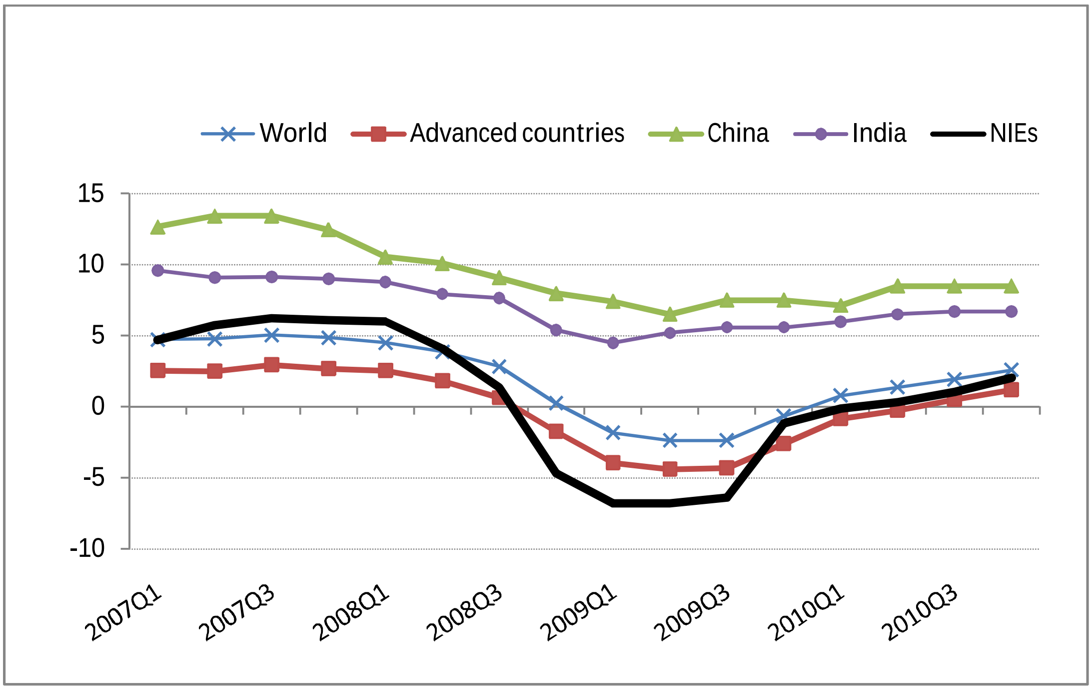
8. The crisis has affected global growth, trade, unemployment, fiscal, financial and external balances in developed and developing countries alike. In developed countries and emerging markets the crisis transmitted initially through the financial sector, with the failure of a systemically important US investment bank in September 2008 and subsequent intervention in a range of other systemic institutions in the US and Western Europe. Developed countries experienced an immediate and massive loss of confidence, prompting a rapid seizing up of inter-bank lending, large-scale bank insolvency, massive deleveraging and fire-sale asset disposal by financial institutions to preserve liquidity and solvency. Trade, working capital and investment finance evaporated and international banks ceased lending.

9. Emerging markets and developing countries which had not been affected suddenly experienced large-scale reversals in capital flows, collapses in financial markets, higher interest rates and exchange rate pressures. In developing countries the crisis has had an acutely damaging impact, eroding resilience, increasing vulnerability and transmitting through three primary channels – declining global trade, remittances and foreign direct investment and aid. In these countries, poverty has increased and progress towards the Millennium Development Goals (MDG's) has been set back significantly.

10. Global output deteriorated sharply, with the most pronounced period of decline occurring in the fourth quarter of 2008 and first quarter of 2009 when global GDP fell at an unprecedented 6 ¼ per cent annualized rate (Figure 1), initially led by declining output in advanced economies and subsequently emerging markets. GDP in emerging Asia for example, excluding China and India, initially plummeted.

[1] For example IMF (2009a); IMF (2009b), World Bank (2009a); OECD (2009), UNCTAD (2009).
[2] An extensive new diagnosis of the short- and medium-term outlook for the global economy is scheduled for release by the IMF immediately prior to the World Bank/IMF Annual Meetings in Istanbul. The WEO is expected to substantially revise the Fund's then-updated outlook of July 2009.
[3] See IMF, July 2009.

Figure 1: Actual and Projected Growth in World Economies (2007 – 2010):



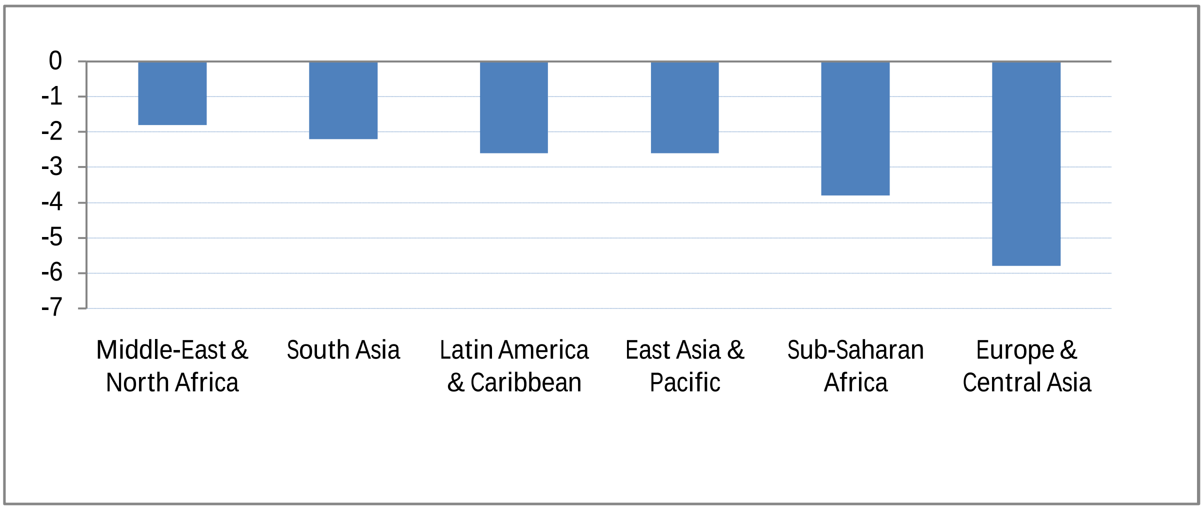
11. **Global growth** estimates for 2009 have varied widely in the course of the year. IMF estimates in April 2009 initially pointed to an estimated decline in global GDP of at least 2 per cent in 2009. In July, the IMF revised its estimate, projecting a global decline of 1.4 per cent for the year, reflecting a moderation of the downturn as the global economy absorbed the early impact of the coordinated fiscal stimulus launched in April 2009.

12. Evidence of a recent slowing in the rate of decline is supported by the World Bank, suggesting that global GDP will have contracted by approximately 1.5 per cent in 2009. The most recently available IMF forecasts for global GDP growth in 2010 suggest a recovery of 2.5 per cent. This is nevertheless substantially below the potential rate of growth of output, with activity in the housing and financial sectors having slumped significantly and with persisting weakness in aggregate demand. Continuing demand weakness has prompted a marked widening of excess capacity; and this, together with the collapse in commodity prices until mid-2009, has led to negative or zero headline inflation in all major economies. Increased economic slack has also dampened measures of underlying inflation and is expected to continue to act as a brake on inflation.

13. **Unemployment** has increased in all parts of the world. Estimates of additional unemployment vary, with the ILO estimating an additional 30 million more persons unemployed, of which 7 million are in developed economies and 23 million are in developing countries. The IMF projects that unemployment rates will reach double digits in some advanced countries, holding back wages and household spending and presenting significant policy challenges.

14. **Fiscal deficits** have increased in advanced economies and developing countries, with fiscal responses varying widely among countries, depending on the availability of fiscal space, extent of discretionary fiscal stimulus and specific national policy choices. Among advanced economies fiscal deficits have increased by 3 per cent on average in 2009, but the deterioration has been most severe in developing countries, with fiscal deficits increasing by an average of 4.4 per cent in 2009. In some instances, deficits have increased very much more significantly. Among regions, the World Bank estimates that the most substantial widening in fiscal shortfall is expected in developing Europe and Central Asia, where contraction in trade and production is severe, the private sector is highly vulnerable, and social safety nets have broad coverage. World Bank estimates also suggest deteriorations in the fiscal deficit in South Asia by 2.2 percentage points of GDP, and in Sub-Saharan Africa by close to 4 percentage points (Figure 2).

Figure 2: Projected Deterioration in Fiscal Balances, 2009 (Percentage of GDP).



Source: World Bank (2009)

15. **Global trade** has declined by approximately 9 per cent in 2009 (WTO, 2009), sharply compounding the real sector impacts of the crisis and serving as a major transmission channel for the crisis to all parts of the world. The contraction in global exports of manufactured products is expected to be much sharper than the decline in overall trade volume (Figure 3). The unprecedented declines in economic activities are reflected in the monthly data of industrial production and merchandise exports of recent months (Figure 4).

Figure 3: World GDP & Export Growth (%)

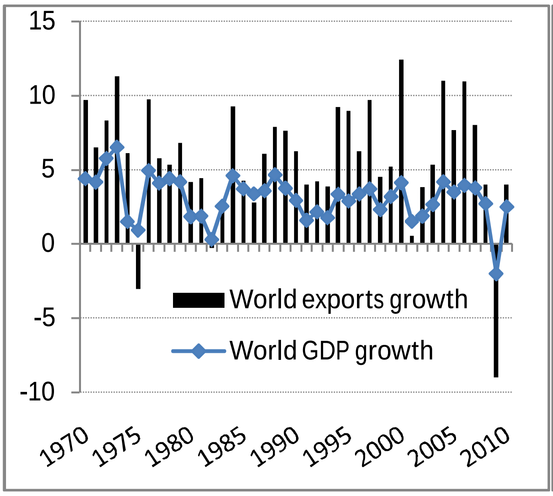
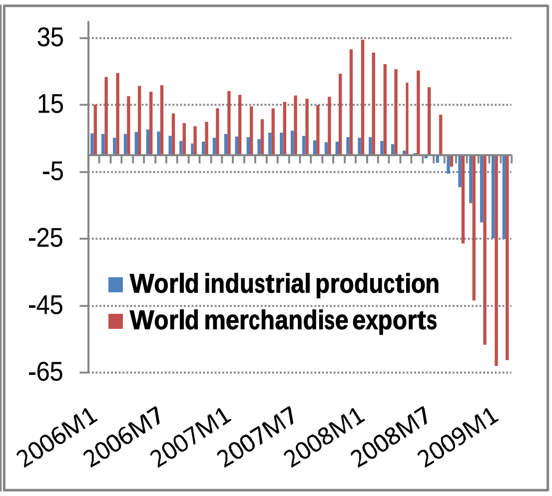


Figure 4: Growth in Industrial Production And Merchandise Exports (%)



16. **Poverty** has increased. While impressive advanced had been made in recent years, progress has been set back by the crisis. Estimates of the impact vary, although at least an additional 55 million persons are considered to have been pushed back into poverty due to the crisis, compounded the poverty effects of the food and fuel crises experienced from 2007-2008. The social consequences have also been substantial with an increase in the number of new infant deaths per year by approximately 200,000- 400,000, representing an estimated increase in infant mortality of between 1.4m and 1.8m to 2015, the end of the MDG period. Similarly, forty four million people are estimated to have suffered permanent health damage, almost entirely in developing countries.

17. Similarly, important progress achieved by developing countries with the **Millennium Development Goals** has been negated, particularly those MDG's focused on human development. A separate report (FMM (09)11) addresses the impact of the crisis on the MDGs in Commonwealth member countries.

18. With tightening fiscal conditions and the deterioration in access to both domestic and external sources of finance, for developing countries the crisis has opened a substantial **financing gap**. World Bank estimates provided in July 2009 have suggested a potential financing gap to be met of between US$352 billion to US$635 billion to return output in developing countries to pre-crisis levels.

Global Policy Responses

19. Global and national policy responses have been unprecedented. The international financial institutions, advanced economies, emerging markets and developing countries including the poorest developing countries have all sought to respond. Several major synchronised global responses have been underway since November 2008.

20. **Interventions to Support Financial Systems and Institutions**: The past year has witnessed historically unprecedented government support to financial systems. These have included large scale interventions in the financial sectors of afflicted countries, provision of liquidity support through easing of access to central bank lender-of-last-resort facilities, lowering of reserve requirements and the establishment of foreign exchange swap facilities; the expansion of financial sector safety nets and the provision of unprecedented levels of government financial guarantees; and the widespread recapitalisation of banking institutions, utilising the full range of resolution mechanisms, including arranged takeovers, closures and nationalisations.

21. Accompanying these have been significant reforms in global financial regulatory policies and in the structure of global financial regulation. These interventions, which commenced in November 2008 and which accelerated strongly from April 2009, have succeeded in stabilising global financial systems, which were in free-fall in the last quarter of 2008 and in early-2009. However bank lending has yet to be restored and bank balance sheets require further strengthening. In addition, public support to financial sectors have yet to be unwound; and have come at extraordinary fiscal cost to the advanced economies which have implemented them.

22. **Coordinated and Synchronised Stimulus**: With the financial crisis in the US and Western Europe impacting global demand severely from the second quarter of 2008, a general consensus emerged in late-2008 that global demand needed to be boosted through a variety of monetary and fiscal policy stimuli. At the G-20 meeting in Washington in November 2008, the IMF suggested that a global fiscal stimulus package in the order of 2 per cent of world GDP might be required to restore global growth to pre-crisis levels. But with aggregate demand plunging through the first quarter of 2009, at the G-20 London Summit in April 2009, G-20 leaders agreed to more substantial monetary and fiscal stimulus, including a substantially larger $1.1 trillion stimulus package.

23. Leaders agreed to treble resources available to the International Monetary Fund (IMF) to $750 billion, to support a new SDR (Special Drawing Rights) allocation of $250 billion, to support at least $100 billion of additional lending by the MDBs (Multilateral Development Banks), to ensure a further $250 billion of support for trade finance, to use additional resources from agreed IMF gold sales for concessional finance for the poorest countries, and overall to constitute an additional $1.1 trillion programme of support of credit, growth and jobs in the world economy. The G-20 also affirmed its commitment to the World Trade Organization (WTO), supporting free trade. It was agreed to make available additional trade finance of $250 billion over the next two years through export credit, investment agencies and MDBs.

24. **Contribution of Commonwealth Members**: Several Commonwealth members have contributed directly to the global, coordinated effort to stabilise the global economy. The following table illustrates the extent of fiscal stimulus pursued by seven Commonwealth members from April 2009.

Table 1: Fiscal Stimulus and Support to the Financial System in Selected Commonwealth Countries (per cent of GDP)

	Fiscal Stimulus	Support for the financial sector	Years to spend fiscal stimulus
Australia	5.4	9.5	3
Canada	4.1	24.8	3
United Kingdom	1.9	81.7	3
India	1.8	6.4	3
Malaysia	2.8	6.3	2
Singapore	8	0	1
South Africa	7.4	0	3

Source: UNCTAD (2009)

25. **Contribution of Other Developed and Developing Countries:** In addition, several other major economies have participated in the globally coordinated effort, illustrated below.

Table 2: Fiscal Stimulus in Selected non-Commonwealth Countries (per cent of GDP)

	Fiscal Stimulus	Support for the financial sector	Years to spend fiscal stimulus
Developed countries			
France	1.5	19.1	2
Germany	3.6	22.2	2
Italy	0.3	3.3	2
Japan	4.7	22.3	3
Spain	3.9	22.9	3
United States	5.5	81.1	3
Developing economies			
Argentina	6.4	0.9	1
Brazil	5.6	1.5	1
Chile	2.8	0	1
China	6.2	0.5	2
Mexico	1.6	0	1
Republic of Korea	6.2	20.5	3
Saudi Arabia	9.2	9.4	3
Turkey	1.1	0.5	2
Russian Federation	5.4	8	2

Source: UNCTAD (2009)

Is A Recovery Emerging?

26. Recent data points to a stronger signs of recovery in several OECD economies, with clear signals of recovery visible in a number of economies including Germany, France, Italy, Japan, Australia, China, India and Russia.[4] In the USA, financial conditions have improved, inventories have corrected, the decline in housing construction may be bottoming out and housing prices appear to have stabilised.

27. The recovery is being driven by a substantial improvement in financial conditions, with declines in the cost of money market funding, a narrowing of corporate bond spreads, a rebound in equity markets and a moderation in the tightening of bank lending standards. Both prices and sales volumes in housing markets in the United Kingdom and the United States have also recently shown some signs of stabilisation. Moreover global trade appears to have reached a trough and is poised to accelerate as the economic recovery gathers strength and broadens in scope.

28. In the large emerging-market economies, recent data revisions suggest that recovery in economic activity is now considered to have commenced earlier in 2009 than had previously been estimated. And in these economies, recovery has accelerated. In China in particular, latest OECD estimates are that GDP has risen by over 14 per cent in the second quarter and activity continues to pick up, supported by the country's substantial fiscal stimulus and rapid increases in bank lending. GDP growth in other Asian emerging-market economies has also strongly rebounded, partly in response to policy stimulus.

29. Recent signs of recovery have prompted consideration of the merit and timing of any exit strategy from the coordinated global monetary and fiscal policy stimulus in the past year. In September 2009 the G-20 agreed that the recovery is too weak to consider an early exit and pointed to several downside risks. First, concerns persist about the overall soundness of banking and financial systems in several countries worst affected by the financial crisis, with bank balance sheets continuing to be impaired, financial institutions requiring further restructuring and bank lending remaining subdued, cautious and below pre-crisis levels. Second many housing markets remain weak. Third, macroeconomic conditions remain weak and in some advanced economies unemployment has continued rising. In addition, the IMF notes that with government debt levels boosted by public support to the banking system and with some countries' fiscal policy constrained by upward pressure on government bond yields, concerns have risen about long-term fiscal sustainability.[5]

30. Consequently, while the impact of the financial crisis, precipitous decline in global trade, and the general increase in uncertainty and collapse of confidence has begun to diminish in the advanced and dynamic emerging markets, supportive forces have remained weak and there has been concern that a premature cessation of stimulus could spark a deflationary episode. As a result at its most recent meeting in September 2009, G-20 Finance

[4] OECD, September 2009; G-20 Communiqué, September 2009.
[5] IMF September 2009.

Ministers opted to maintain and pursue existing stimulus packages, identify opportunities for further monetary easing and accelerate financial institution restructuring.

Have the stimulus measures provided the necessary support to stabilise the global economy and financial system? What additional support measures are necessary?

Do Ministers concur with the decision to continue with stimulus measures currently agreed, including the commitments of the World Bank and IMF?
Are further measures necessary and if so can a consensus position be offered by the Commonwealth to the 2009 IMF and World Bank Annual Meetings?
What constitutes a credible exit strategy and when should this be initiated?

In a coordinated and synchronised exit, what further can be done to help the worst-affected developing countries recover at at least the same pace as developed economies?

II The Impact of the Crisis in Commonwealth Countries

31. All Commonwealth countries have been affected by the crisis, though impacts have varied widely. There have been major impacts on GDP, trade, unemployment, fiscal balances, external debt, FDI, ODA, remittances, poverty and the MDGs, particularly in the smallest and most vulnerable Commonwealth countries.

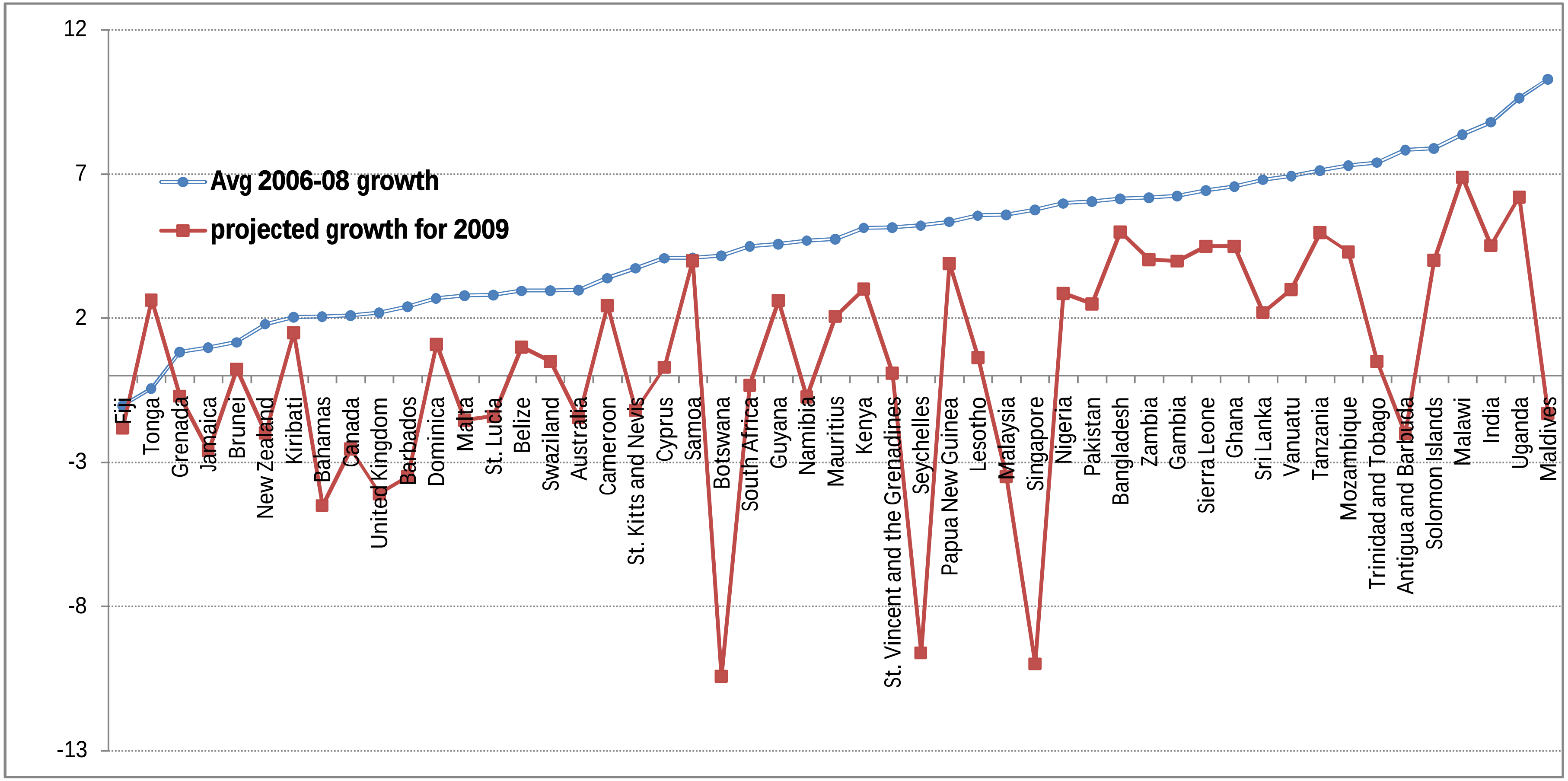
GDP

32. The crisis has delivered an almost universal blow to GDP in Commonwealth countries. This year, 22 Commonwealth members will experience either negative or no growth. In all but one of the Commonwealth's 53 member countries GDP is projected to be well below the average GDP growth rate for the previous two years. (Figure 5).

33. The crisis has been indiscriminate, affecting output in both the largest and smallest economies. The effect on **Commonwealth developed countries** has been clear. This group accounts for over 85 per cent of the total output of the Commonwealth, and for most the scale of the contraction is the highest in at least two generations. Among other developed Commonwealth members, the crisis has had an acutely adverse effect on the most open, dynamic and integrated economies and those with advanced financial services sectors. Several other Commonwealth member countries, including Jamaica, Barbados, St Lucia, Botswana, Seychelles, Malaysia, Singapore, Antigua and Barbuda are also expected to experience similar adverse growth prospects.

34. For many Commonwealth developing countries, the crisis has arrested and reversed significant progress in raising medium-term growth rates, with GDP growth remaining positive in 2009, but far below pre-crisis levels.

Figure 5: Growth in Individual Commonwealth Countries



Note and Source: Average GDP growth figures are from the World Bank World Development Indicators. The projected growth rates for 2009 are from IMF.

Fiscal Balances

35. Fiscal deficits have increased in all Commonwealth member countries. **Commonwealth developed country** members, including those members which contributed to the global fiscal stimulus initiated in April 2009 have seen significant increases, in some cases prompting concern as to the sustainability of the higher levels of deficit. Among **developing country members**, declining output and trade have sharply eroded fiscal balances; and have put significant and unexpected pressure on social sector expenditure across all Commonwealth countries. Among developing countries, where social expenditure and robust social safety nets are crucial in preventing a rapid deterioration in poverty, pressures on social expenditure, brought about by the absence of resources to fill a rapidly expanded financing gap, have been acute. For example as a result of unexpected fiscal pressure brought on by the crisis, in Kenya the 2008/09 budget has reduced spending on core poverty programme funding by nearly 20 per cent. A similar situation has occurred in Zambia, as a result of the global downturn, rapidly deteriorating terms of trade and unexpectedly large fiscal pressure. Similarly in Nigeria, significant reductions have been registered in the level of spending on education and on health.

Trade and Commodity Prices

36. Declining global trade has directly affected output in all Commonwealth members; and has represented the primary transmission channel for the crisis to the Commonwealth's developing countries, which in the past decade have substantially increased their openness to trade.[6]

37. Their high degree of openness and dependence on international trade for growth offered a critical opportunity to accelerate growth and benefit from increased integration in the global economy. But in the current crisis, increasing levels of openness have also meant increased vulnerability. Recent analysis shows that a fall in OECD import growth by 9 percentage points (over a period of a year), which is comparable to current WTO predictions of decline in global trade, leads to a fall in average GDP growth in small and vulnerable economies by 2.4 percentage points. With a long-term average growth rate for these economies of approximately 3 per cent, the revival of global trade will remain critical to the sustainability of any recovery in Commonwealth developing countries.[7]

38. Trade shocks have arisen from several sources including declining commodity prices and commodity price volatility, shocks emanating from reduced export demand for simple manufactures and declining tourism receipts. Commodity prices have exhibited rapid volatility in the past year, with the prices of most commodities declining rapidly from the last quarter of 2009 as global demand plunged; and subsequently exhibiting significant recovery in the second and third quarters of 2009.

[6] UNCTAD notes that developing countries are far more dependent on trade than in the past, with the Export-GDP ratio increasing from 17% (2005) to 45% at present. (UNCTAD, (2009). The contribution of exports to GDP in landlocked developing countries has increased from 23% to 58% over the same period.

[7] Commonwealth Secretariat (2009) Internal Analysis of Small Open Economies' Vulnerability to Trade Shocks.

39. Trade-related impacts have diverged widely across Commonwealth member countries. Vulnerability has been made more acute because many Commonwealth countries depend on export revenues from a single, or a small and concentrated group of commodity and simple manufacturing exports. For example a detailed recent study notes that in Zambia copper contributes 68 per cent of total export revenue, in Nigeria, crude oil contributes 93 per cent, in Bangladesh garment exports contribute approximately 76 per cent, while in Uganda, coffee, gold, flowers and cotton collectively contribute slightly under 40 per cent of export revenue. Elsewhere, in Kenya the export base is more diversified, with flowers, vegetables and coffee contributing 20 per cent of total export revenue.[8]

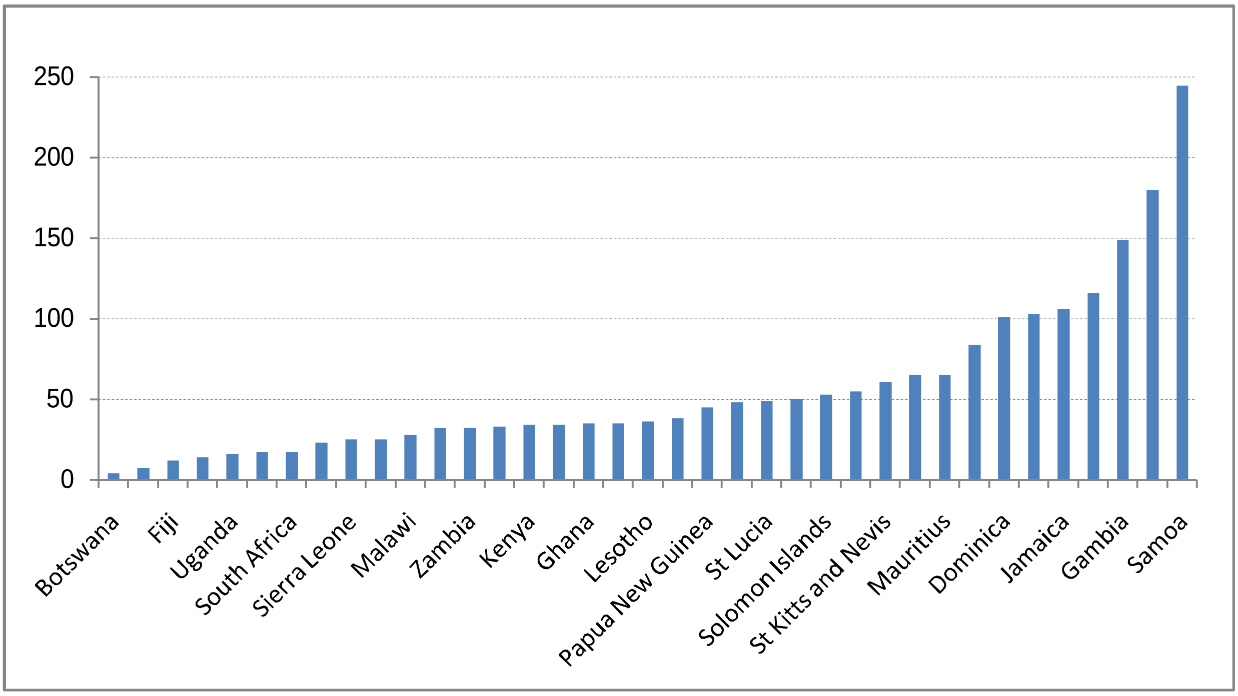
40 Many Commonwealth countries dependent on commodity exports have experienced sharp deteriorations in their balance of payments. Nigeria is projected to have a current account deficit of nearly 9 per cent of GDP in 2009 following a surplus of over 4 per cent in 2008. The deterioration in Botswana is even more substantial: from a 7 per cent surplus in 2008 to a 6 per cent deficit in 2009. It is expected that Botswana's deficit will remain substantial over the medium term and is not currently projected to reduce below 5 per cent of GDP in the period to 2012. As a result of the crisis, Lesotho's deficit is expected to increase from under 3 per cent of GDP in 2008 to over 11 per cent in 2009, one of the key factors in the IMF's assessment of the country as highly vulnerable to crisis.

Increasing Indebtedness in Commonwealth Countries

41. In recent years there has been a significant rise in the indebtedness of several Commonwealth countries. Rising indebtedness commenced prior to the economic crisis and has been severely augmented by it. Indebtedness has risen both among developing countries which have been eligible for the Heavily Indebted Poor Country (HIPC) and Multilateral Debt Relief Initiative (MDRI) programmes, as well as several developing countries which were not granted eligibility and therefore were unable to benefit from these debt relief dispensations. However, the growing debt problem has yet to receive concerted attention, even though higher levels of indebtedness have become an important threat to economic stability in a number of Commonwealth developing countries, including several middle-income countries. Figure 6 below illustrates the extent of indebtedness in selected Commonwealth developing countries. The schedule is neither exclusive nor limited to HIPC and MDRI-eligible members, but is illustrative of the range and extent of indebtedness across developing Commonwealth countries.

[8] ODI (2009). The Global Financial Crisis and Developing Countries. Synthesis of the Findings of 10 Country Case Studies.

Figure 6: Debt-to-GDP Ratios for Selected Commonwealth Countries (%)



Source: Based on data as available in Global Development Finance 2009, IMF, Washington, D.C.

42. Indebtedness is a growing concern among developing country members of the Commonwealth. Of the 40 Commonwealth developing members for which data are available, a substantial 29 members have a debt-to-GDP ratio of 25 per cent or higher. In some populous Commonwealth countries, including Bangladesh, India and Pakistan, debt-to-GDP ratios range from 23 per cent – 33 per cent. The external debt stocks for Dominica, Jamaica, Grenada, the Gambia, Seychelles and Samoa are currently higher than their GDPs. Evidence also suggests that during the last decade the external debts of small states, particularly of some low-income and middle-income Caribbean countries, have been growing faster than others. Several factors may have contributed, including particularly the difficulty in strengthening access to global trade. More recently even for the countries that have benefited from the HIPC and MDRI initiatives, debt sustainability looms as a growing challenge, with many having failed to register improved export response following their debt relief programmes and with challenges compounded significantly by the food, fuel and subsequent economic crisis.

43. Rising indebtedness is hampering growth and development in many Commonwealth developing countries, with debt servicing increasingly diverting resources from health, education, social welfare and physical infrastructure. High levels of indebtedness can also be interpreted by international business as increasing investment risk.

Is further work required to address the emerging challenge of high indebtedness of Commonwealth developing countries, including middle-income countries which were not granted eligibility for the HIPC and MDRI initiatives?
How best can the Commonwealth contribute to addressing this challenge?

Foreign Direct Investment

44. Commonwealth developing countries have historically relied on foreign direct investment inflows as both a key source of capital and as a counter-cyclical impetus to domestic policy. FDI flows to developing countries accelerated significantly in the period 2000 – 2007 and by 2007 had reached a record level of $1.9 trillion. The relative importance of FDI to many low-income developing countries has also grown. The crisis has reversed this trend. Estimates of the deterioration in FDI vary. UNCTAD estimates that FDI declined by approximately 15 per cent in 2008 and has fallen further in 2009; the World Bank projects a 30 per cent fall in FDI flows to developing countries this year; and the IMF anticipates a sharp slowdown in FDI in about a half of all low-income countries and projects a decline in FDI inflows for 2009 of almost 20 per cent from their 2008 levels.

45. Several factors have precipitated reduced FDI commitments, including reduced profit margins, combined with difficult financing conditions and volatile commodity prices. Most recent UNCTAD data reveal that a number of sectors proved immediately vulnerable to the slowdown in FDI from 2008, including financial services, automotive, building materials, intermediate goods and some consumption goods. And while a few sectors proved relatively resilient in 2008, including agriculture, mining, petroleum; food, beverages and tobacco, since early-2009 the crisis has affected all sectors.

46. An upturn in FDI in developing countries will depend on several factors, including continued global fiscal stimulus, improvements in financial sector stability, the speed of recovery in global growth prospects and the extent to which new investment opportunities come to market, including emerging new investment activities arising from environmentally sustainable development, restructuring brought about by the crisis, energy and new technology sector investments.

47. Several Commonwealth developing countries, which have benefitted from rising FDI flows over a sustained period, are now at particular risk to both a protracted downturn in and volatility in FDI flows. Among members considered most vulnerable are Bangladesh, Dominica, Ghana, Grenada, Guyana, Kenya, Malawi, Maldives, Pakistan, Sri Lanka, St Lucia, St Vincent & the Grenadines and Zambia.

Remittances

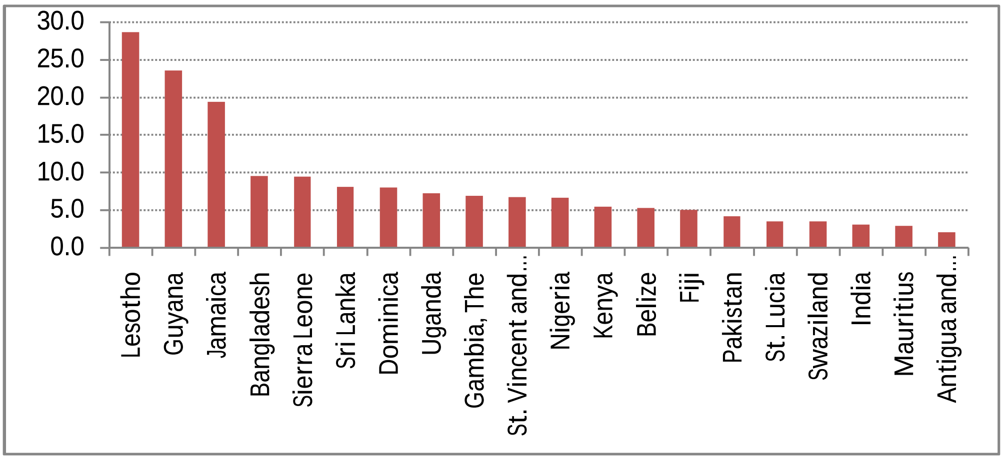
48. Remittances represent an important source of foreign exchange, a key contribution and often a lifeline to households, as well as important counter-cyclical fiscal stimulus for developing countries. In several Commonwealth developing countries, remittances now exceed other types of balance of payments inflows and since 1998 in many countries have exceeded official aid and remaining private capital flows, ranking second only to FDI flows.[9] In the past, remittance flows have tended to remain relatively stable during periods of global economic turbulence. However the recent economic crisis has affected remittances to

[9]Chami, et al. (2009): Fiscal Sustainability in Remittance-Dependent Economies. IMF Working Paper 09/190.

developing countries significantly, including a substantial number of Commonwealth developing countries.

49. Following close to 20 per cent growth during 2006-08, remittance flows to developing countries are expected to decline by 7.3 per cent in 2009, from an estimated $328 billion in 2008 to $309 billion (World Bank, July 2009). Remittances have remained more resilient than private capital flows to developing countries because although new migration flows have declined, the number of migrants living overseas has been relatively unaffected by the crisis. The Bank highlights three short-term risks to the outlook for remittances: uncertainty about the depth and duration of the current crisis, unpredictable movements in exchange rates, and the possibility that immigration controls may be tightened further in major destination countries as a result of rising unemployment in these countries.

Figure 7: Remittances in Commonwealth Developing Countries (% of GDP)



Source: UNCTAD, 2009

50. The largest recipients of remittances among developing countries are India, Mexico and China. Within the Commonwealth, among major recipients of inward flows of remittances are India ($45 billion), Nigeria ($10 billion), Bangladesh ($8.9 billion), Pakistan ($7 billion), Sri Lanka ($2.7 billion), Jamaica ($2.2 billion), and Kenya ($1.6 billion). The extent of dependence on remittance flows varies across the Commonwealth. For more than twenty Commonwealth members, remittances comprise more than 2 per cent of their GDP. Approximately a half of these rely on remittances for between 10 per cent – 15 per cent of GDP; and in case of three members, Lesotho, Guyana and Jamaica, which are most substantially dependent on migrants' earnings, remittances account for over 20 per cent of GDP. Bangladesh, Sierra Leone, Sri Lanka, Dominica, Uganda, the Gambia, St Vincent and Grenadines, Nigeria and Kenya are also particularly vulnerable to adverse shocks in remittances.

51. Remittances have declined significantly in many Commonwealth countries as a result of the crisis. In Kenya remittances have declined by 27 per cent year-on-year in January 2009, while in Bangladesh emigration declined by 38.8 per cent year-on-year in February

2009, putting in jeopardy future remittances.[10] In Ghana flows of remittance through one remittance channel fell 13 per cent in January 2009 compared to a year earlier. There are also reports to suggest that remittance flows from the United States to Latin America and the Caribbean have fallen by precipitously, caused in large part because of a slowdown in the US construction sector. It should be noted that besides the economic crisis, declining remittances have been attributable to other reasons, including sharp fluctuations in exchange rates.

52. As a region, Sub-Saharan Africa is expected to experience a substantial 8.3 per cent slowdown in remittance flows; while flows to South Asia and East Asia, which had been resilient in 2008, are expected to decline in 2009.

Official Development Assistance (ODA)

53. With Commonwealth developing countries experiencing declining FDI and remittances and simultaneously sharply increased fiscal deficits, the maintenance of aid flows has become critical. Aid represents a critical pillar of support for small developing countries and is also known to be pro-cyclical with donor country economic activity. The last decade witnessed a considerable rise in aid flows to developing countries, reflecting debt relief initiatives and increased flows from such emerging donors as Russia, China, and the Gulf Cooperation Council countries. Excluding debt-relief grants, net official development assistance remained broadly unchanged in real terms in 2006–07. In 2008, official development assistance (ODA) from members of the Development Assistance Committee (DAC) of the OECD rose by about 10 per cent in real terms, to slightly under $120 billion, or 0.3 per cent of combined members' GNI. This represents the highest level of ODI recorded.

54. In 2009, evidence suggests that aid has largely held up, despite the acute fiscal challenges confronting OECD economies, with targets for a few donor countries slightly reducing while the bulk of commitments remain in force. However, although aid flows have been largely sustained during the crisis, in real terms ODA from DAC donors in 2008, was about $29 billion short of the Gleneagles target of $130 billion per annum by 2010. And ODA flows to Sub-Saharan Africa were about $20 billion short of the 2010 target of $50 billion per annum.

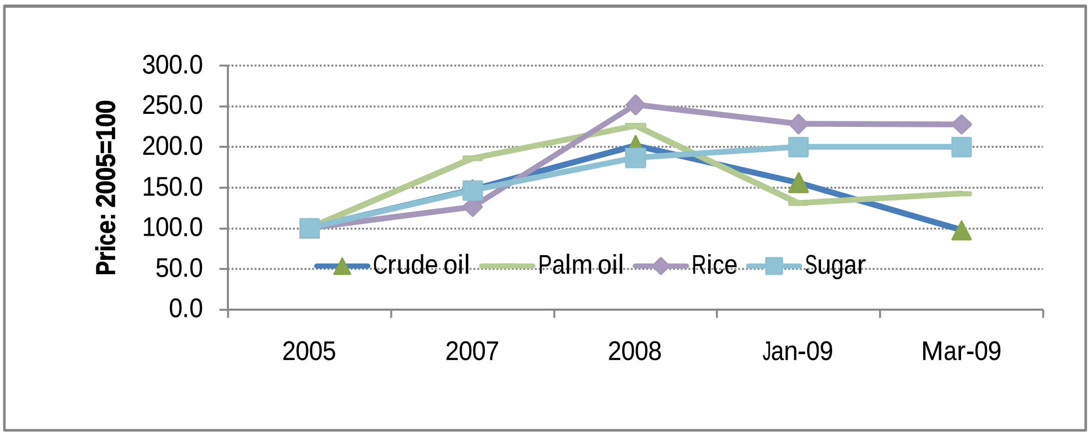
55. Among Commonwealth developing countries the IMF finds several members to be at particular risk to a decline in aid flows during the current crisis. These include: Dominica, Mozambique, Sierra Leone, Bangladesh, Ghana, Grenada, Guyana, Kenya, Lesotho, Maldives, Pakistan, Sri Lanka, St Lucia, St Vincent & Grenadines, Tanzania and Zambia.[11]

[10] ODI (2009).
[11] See IMF (2009).

Poverty, Unemployment and MDG's

56. Strong economic growth in developing countries in the past decade had put the MDGs for poverty reduction within reach at the global level, but successive food, fuel, and financial crises have jeopardised the progress made. Surges in food prices between 2005 and 2008 pushed around 200 million more people into extreme poverty. While food prices have fallen since mid-2008, about half of the newly poor will remain trapped in poverty as food prices, despite falling from their peaks, remain high by historical standards (Figure 8).

Figure 8: Prices of Important Commodities Imported by Developing Countries.



57 Estimates of the poverty impact of the growth slowdown have varied widely in the past year, within the range of 55-90 million more extreme poor in 2009 than expected before the crisis. According to recent estimates by the World Bank, the latest global crisis will add 64 million people to the population living under $2 a day. The Bank predicts that the global poverty rate will fall from 42 per cent to 39 per cent in 2009, while the pre-crisis trajectory would have brought the poverty rate down to 38 per cent. In Sub-Saharan Africa and South Asia, the growth slowdown essentially eliminates the pre-crisis prospect of continued reductions in the poverty count in 2009. Indeed, the poverty count is likely to rise in Sub-Saharan Africa in 2009. The principal transmission channels have been employment and wage effects as well as declining remittance flows. In the Commonwealth, the poverty effects have varied, with several developing country members significantly affected by the crisis, as illustrated below.

Table 3: Projected Poverty Effects of Global Economic Crisis – Selected Commonwealth Countries

Country	Reduced growth due to crisis (% points)	Poverty increase due to reduced growth (in '000)
Bangladesh	-1.2	289.3
Ghana	-2.2	227.7
Kenya	-0.4	57.7
Nigeria	-5.0	5046.8
Uganda	-1.0	233.0
Zambia	-2.4	38.8

Source: ODI (2009).

58. Poverty has been significantly compounded by rising **unemployment**. The International Labour Organization projects that the global economic crisis will lead to unemployment of 30-50 million more people worldwide of which as much as three-quarters could be in developing countries. Effects on Commonwealth countries have been severe. In Bangladesh, for example, incremental job opportunities are expected to be reduced by 500,000 compared to the expected level had the crisis not occurred and if GDP growth declines in 2009 to the level projected by the World Bank.[12]

59. Increased poverty and unemployment have led to a regression in progress towards many **MDG** targets. A separate paper (FMM(09)11 traces the impact of the crisis on MDG achievement in Commonwealth member countries.

The Impact of the Crisis on Small Commonwealth States

60. The severity of the impact has differed widely, depending on initial conditions at the start of the crisis, the degree of interconnectedness with the sources of the crisis, availability of fiscal space and national policy responses. The impact of the crisis has been most acute in many of the Commonwealth's small states. It should be noted as well that data collection and dissemination has lagged and may not adequately capture the rapidly changing economic environment, affecting output, employment, fiscal and external balances in all 32 of the Commonwealth's small states. Small States policymakers and experts, meeting at the Commonwealth Secretariat in London in July 2009, found the following key impacts.[13]

61. The major impacts in the ***Caribbean*** have occurred through indirect income and wealth effects relating to tourism rather than the direct impact on the financial markets. Policy responses to the crisis have included reductions in taxes and interest rates to support industries, initiatives to boost agriculture, SMEs, and tourism, and the expansion of social programmes. A regional task force has suggested expansion in agriculture, a medium term

[12] ODI (2009).
[13] The detailed conference papers presented at the Commonwealth Small State conference can be found at http://www.thecommonwealth.org/sdss09

programme focusing on tourism marketing, strengthening the regulatory and supervisory environment, social dialogue and a regional approach to trade agreements. A regional approach to seeking additional funding is also being pursued.

62. In the ***Pacific,*** the negative impact of the crisis on tourism has been significant though the full impact has yet to be absorbed, since declining tourist arrivals from Australia, the major tourist source market, has lagged the general downturn in global tourism activity. Pacific island countries have also been responding well to the crisis, although policy responses have been limited. To finance budget priorities, some countries have borrowed externally to address the impact of the crisis. Most government borrowing has been sourced from the domestic banking sector, raising concerns regarding the sustainability of these institutions. Some countries, in particular Vanuatu and Fiji, have used agriculture policy to respond. In the long term, trade policy negotiations, including the Pacific Agreement on Closer Economic Relations (PACER plus), can increase the sustainability of Pacific island economies. But there is need to provide funding to compensate for the costs of adjustment, including through a regional adjustment package and a regional development fund.

63. The crisis has affected ***African*** small states through four main channels – banking failures, export earnings, declining tourism and financial aid flows. Botswana has been the most severely affected. This is a result of the country's very substantial reliance on diamond revenue. Botswana's economy is projected to decline by 10.5 per cent in 2009. The crisis has also affected government finances leading to budget cuts, to the closure of mines and subsequently to increasing levels of unemployment. African small states have generally had very limited policy room to respond to the crisis, having entered the crisis with sound macroeconomic policies but with little fiscal space and limited access to external non-concessional finance. Recent analysis from the African Development Bank as well as by ODI indicates that in the face of the crisis, African economies, including small states, have generally responded to the crisis in multiple ways, including by curtailing infrastructure spending, adjusting social expenditure, realigning budgetary priorities and seeking new markets.

64. In the *Indian Ocean* region, the crisis has had a severe impact on the Seychelles, and particularly on the tourism sector on which the economy is heavily reliant. The Seychelles is also in the midst of a debt crisis which began in 2008, and is currently undergoing a substantial IMF reform programme. The initial impact of the crisis on the Mauritian economy has been buffered by the well-diversified nature of the economy and through a fiscal stimulus package initiated at the end of 2008. However since the beginning of 2009 the global recession has impacted all the key sectors. The tourism industry has declined by 9.9 per cent, several textile firms have closed, construction has slowed and an important public enterprise has been rescued from bankruptcy by the Government.

65. In the *Mediterranean* region, membership in the EU has helped reduce the impact of the crisis on Malta and Cyprus. Sound economic policies have also contributed to their economic resilience.

66. Given the substantial reliance of small economies on external markets, trade has been a key transmission mechanism of the crisis across the Commonwealth's 32 small states. This has occurred through deteriorating terms of trade and plunging export demand. The early revival of trade will represent a critical turning point for the Commonwealth's developing countries and small states in recovering from the crisis.

67. In general, in responding to the crisis, Commonwealth small states have applied several policy measures which have included attempts to diversify export markets; pursue new tradeable service opportunities and niche export markets including in the business and professional services sectors; short-term currency devaluation; expansionary fiscal policy where fiscal space has allowed, although in most small states scope for counter-cyclical fiscal policy has been severely circumscribed; efforts to upgrade infrastructure and reduce trading costs; ensuring continued access to credit for firms during the crisis.

Are there opportunities for pan-Commonwealth partnerships and coordinated action to assist Commonwealth small states to recover promptly from the crisis and to build resilience?