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The Impact of the Global Financial Crisis on the Least Developed Countries

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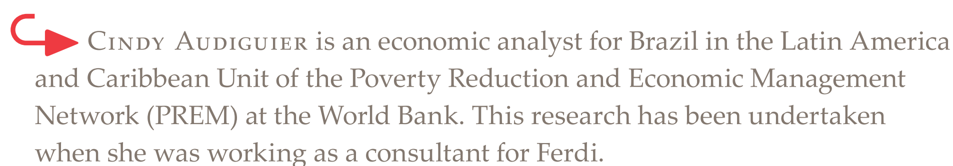

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Abstract

This paper investigates the short-run effects of the 2007–09 global financial crisis on GDP growth in least-developed countries (LDCs) compared to the effects on other low income countries and lower middle income countries. This paper shows that for many individual LDCs, 2009 was not extraordinarily bad. The output shock following the financial and economic crisis was less than expected and hit LDCs less than other developing countries. Moreover, the growth declines are on average well explained by the collapse in export demand. In two years, the volume of world trade fell by a third. Finally, there are few robust relationships between the annual cross-country growth variation between 2007 and 2009, and the variables reflecting policy and structural environment. The main exception is foreign aid that has mitigated the negative impact of external shocks on economic growth in LDCs.

policy brief
59
February
2013
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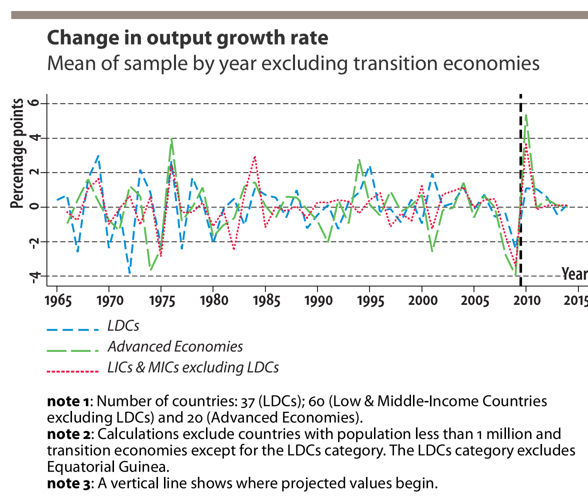
Introduction

In recent research (Audiguier 2012), we argue that for many individual LDCs 2009 does not stand out as an extraordinarily bad year. LDCs showed unexpected growth resilience during the 2007-9 global crisis and their average growth rate remained high by historical standards. What differs from past crises was that output declines across LDCs and other countries were unusually synchronized. LDCs, less open and less financially integrated in the global economy were thus less affected than expected due to the nature of the crisis by itself. The global financial crisis that started in 2007 raises three important questions for LDCs. First, what have been the short-run effects on growth in LDCs and are the effects different from those in other LICs? Second, what are the key transmission mechanisms? Third, how do the effects depend on policies and country characteristics?

Figure 1: Change in output growth rate (percentage points)



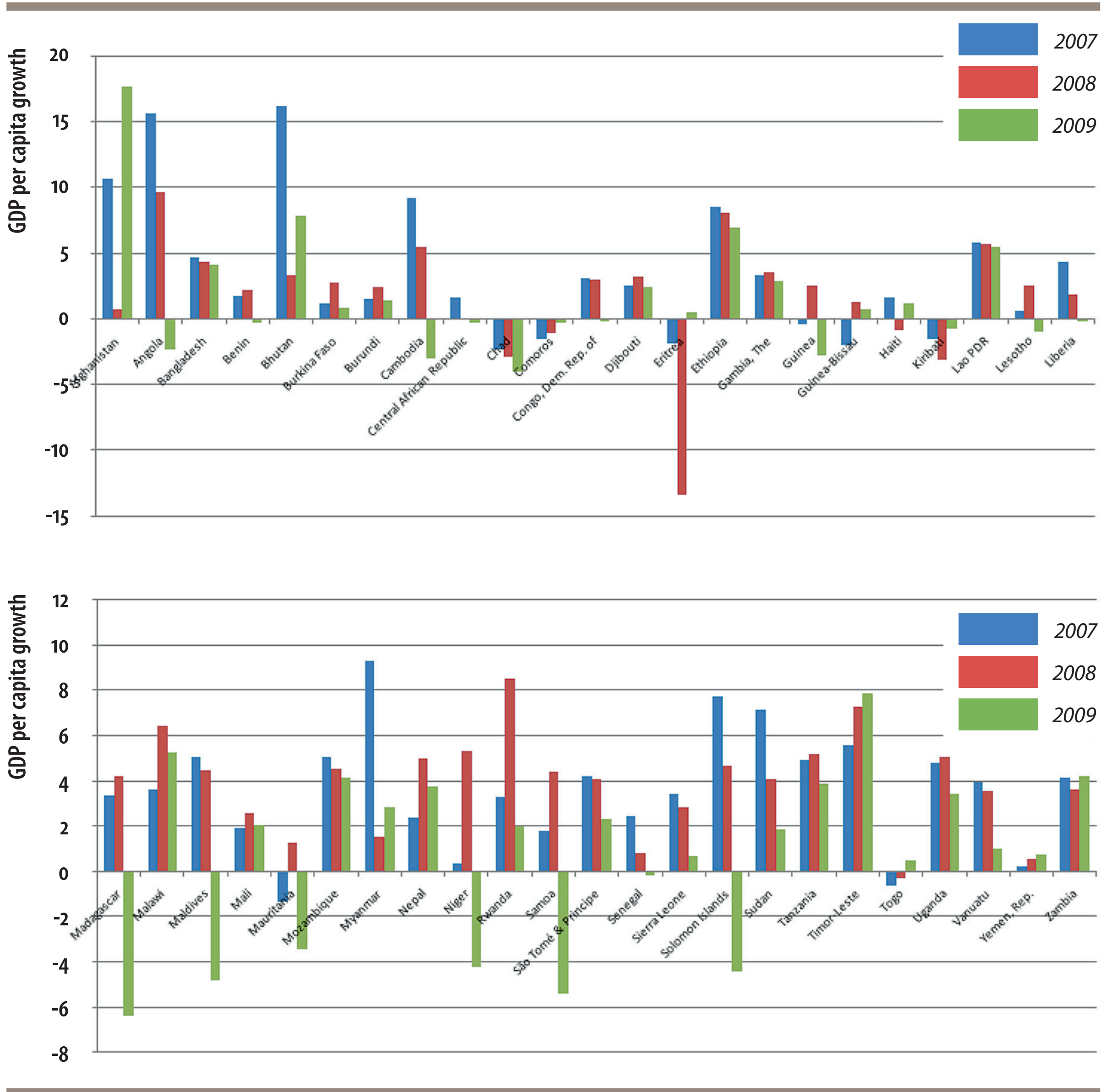
Note: Figure 1: Change in output growth rate (percentage points). For each group of countries, the annual change in output growth is computed.

A lower impact of the global financial crisis on LDCs as a group

Output responses to the financial crisis have been quite heterogeneous across countries. Although the global crisis has substantially slowed growth in LDCs, other LICs and MICs were more severely hit (Figure 1). Indeed, 2009 represented the biggest shock to growth since the 1970s for LICs as a group but this is not the case for LDCs. Among developing countries, MICs and oil economies were the most adversely affected. The crisis also caused a dramatic collapse in advanced economies, the most severe since the 1970s.

In contrast to past crises and to other groups of countries in the world, growth remained positive for LDCs as a group and in two-thirds of individual LDCs; the median growth equals to 3.3 % for LDCs and 1 % for low and lower-middle income countries in 2009 (Figure 2). Finally, even at the peak of the crisis, LDCs showed a higher resilience than expected and their average growth rate remained rather high by historical standard. For most individual LDCs economies, 2009 does not stand out as an extraordinarily bad year as pointed out before.

Figure 2: Economic growth in LDCs



Note: No data available for Somalia /// Source: WEO October 2010

The trade channel as a driver of the output decline

The output shock following the financial and economic crisis was less than expected and hit LDCs less than other developing countries. This seems to be the result of a lower integration into the global economy than upper-middle income countries, advanced economies and fuel exporters, and then a lower sensibility to contractions of external demand and foreign investments. Unlike precedent crises, the transmission of the recent worldwide crisis mainly occurred through the trade channel in developing economies. A sharp fall in international trade affected all countries in the world in 2009 but LDCs to a less extent. LDCs that are less dependent on external markets, saw a relatively smaller decline in their global external demand. In contrast, when examining the changes in

the external terms of trade, the period 2007–09 does not stand out as exceptionally negative. Meanwhile, foreign direct investment (FDI) into LDCs and LICs & MICs declined in 2009 on average by amounts that were large by historical standards, but still fairly small relative to GDP. In LDCs, private investment rates remained at low levels but were resilient during the crisis.

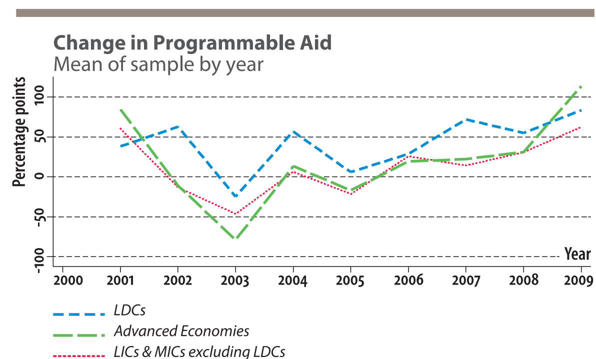
Responses of the LDCs

LDCs group benefited from a high growth rate from 2000 to 2007 and thus entered the crisis with a stronger macroeconomic position than in the past. Benefiting from the boom period, LDCs' pre-crisis macroeconomic policy buffers have played an important role in mitigating the impact of the crisis. From 2000 to 2007 LDCs as a group achieved some improvements: stronger international reserve coverage, a reduction in current account deficit, lower inflation and lower fiscal deficits and public debt. International reserves in particular increased since 1980 to reach record levels in 2007 in LDCs. However, despite stronger policy buffer than in the past, LDCs continue to lag behind average developing countries. The situation differs across LDCs for which performance strongly depends on their export specialization.

LICs and LDCs adopted a countercyclical fiscal response in response to the global shock. LICs and LDCs as a group did not curtail spending and thus increased expenditures. As a result, the median fiscal deficit widened in 2009 and 2010. This was possible due to higher coverage of international reserves and external financing.

We also examined the external policy response to the crisis, mainly the role of foreign aid and remittances during the crisis. LDCs described as the most vulnerable developing countries are traditionally highly dependent on foreign aid. On average in 2007, aid disbursements represented more than 9% of GDP for non-fuel LDCs and went up to 12.7% for commodities LDCs. As a result, foreign aid might have helped to cushion the impact of the financial crisis. However, since the crisis affected most of donor countries, there was a risk of an aid budgets' decrease which would have dampen LDCs recovery. But programmable aid[1] has been on an upward trend since 2000 and did not fall during the crisis (Figure 3). Moreover, programmable aid growth rate has been higher for LDCs since 2006 than other developing countries. Nevertheless, aid targets are not expected to be respected since, due to the crisis and the pressure on their budgets, advanced economies only plan a marginal increase in their aid commitments in the coming years.

Figure 3: Programmable aid



note 1 Number of countries by group: 42 (LDCs); 71 (Low & Middle-Income Countries excl. LDCs); 39 (Low & Lower Middle-Income Countries excluding LDCs).
note 2 Calculations exclude fuel exporters Note 3: Programmable aid is measured as the total volume of aid received by each country in constant prices.

Source: OECD-DAC

1. Programmable aid is a measure of aid computed by OECD-DAC that only includes "real" transfers of funds to recipient countries. It thus excludes flows to the recipient countries in the form of administration fund, student costs and refugees' costs as well as humanitarian aid and debt relief that are considered as unpredictable. This measure also does not net out loan repayments. Programmable aid is now available since 2000 and is roughly a little over a half of their gross bilateral official development aid.

Cross-Country and Panel analyses

Cross-country analysis shows that the sharp growth declines observed in LDCs in 2008–09 are on average well explained by the magnitude of the external shocks which they faced over the period. LDCs were affected by the global crisis through a decline in the global demand rather than adverse terms of trade as it occurred in past shocks.

Econometric analysis also suggests the role of foreign aid to dampen the effect of external shocks. Foreign aid which has been on an upward trend since 2000 did not fall during the crisis in LDCs and buffered the impact of external shocks. The cross-country analysis indicates a negative association between the share of aid in GDP and the decline in domestic growth: countries with a higher share of aid experienced a smaller growth decline. LDC economies that are heavily dependent on foreign aid (with an average of aid representing 9% of GDP in 2007) saw growth decline by less. Interestingly, net flows of FDI were also not severely affected by the global financial crisis.

By exploiting within-country variation, a panel approach can yield additional insights. First, external demand and terms of trade to a bigger extend for LDCs are highly significant determinants of output growth for LICs. Foreign aid is found to buffer the impact of large negative shocks to terms of trade and external demand in LDCs. As seen before, the 2007-09 global crisis has been defined as an external demand shock and aid appeared to dampen the negative impact of this large external demand shock to growth. In the context of the global downturn, foreign aid allocated to LDCs increased and helped LDCs avoid growth collapse. This result is in line with the argument that aid dampens the effect of structural vulnerability. Indeed it was argued that aid is more effective in countries which are more vulnerable to external shocks. Aid can reduce their negative impact on economic growth through its stabilizing impact. More precisely, aid helps to dampen the negative impact of export volatility shocks. However, developing countries are facing other types of shocks (climatic instability, external demand shocks …) to which aid can also respond.

Case studies: How three LDCs limited the negative impact of the global crisis?

The research paper also presents three case studies (Mali, Uganda, and Zambia), which highlight the roles of targeted policies to counter the effects of the 2007-2009 financial crisis in a variety of country circumstances. These three countries all experienced a limited negative impact of the global crisis. While Mali and Uganda registered a higher growth in 2008 compared to 2007 before dropping in 2009, Zambia's GDP growth rate declined in 2008 before increasing again in 2009. More precisely, Mali succeeded in stabilizing its real GDP growth despite the weakening of external demand and lower exports. Uganda's high dependence on remittances made it exposed to the global crisis. However due to policy space for responding to the impact of the financial turmoil, the economy was only marked by a relatively modest dip in growth. Zambia was highly vulnerable to the global crisis mainly because of a sharp decline in the price of copper, their primary export commodity, and a reduction in foreign direct investment. Nevertheless, the crisis did not materialize into a drop in GDP growth per capita, supported by an increase in foreign aid disbursements. The paper develops further the impact of the global crisis in those three countries and the policy space for responding to the impact of the financial turmoil.

Conclusion

LDCs showed resilience during the peak of the crisis, and were able to recover quickly in 2010, registering a higher growth rate of 5.7 percent. After this episode of sustained and higher economic growth interrupted by the global crisis, challenges for LDCs are then to implement sound macroeconomic policies to retrieve their pre-crisis economic growth rate. In a context of a dire state of the global economy reflected by commodity prices weakness, LDCs major buffers will be needed to face other large negative external shocks. For instance, a deterioration of the terms of trade will remain a central issue in LDCs and might dampen their abilities to build up their international reserves which were clearly used as an adjustment factor in 2007-9.

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