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The Eurozone Crisis and Developing Countries

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Overview

- **What is the Eurozone crisis?**
  - Transmission channels
- **Degree of Developing Country Exposure**
  - Analysis of dependency on trade, remittances, finance, and aid
- **Resilience Indicators**
- **Effects apparent**
- **Conclusions**
  - Policy implications

1. What is the Eurozone crisis?

- Sovereign debt crisis - contractions in growth
- The Euro zone entered a mild recession in 2012

- General slowdown and spillover effects across the following transmission channels:
  - **Financial contagion effects**: These occur in the form of spill-overs through financial intermediaries (e.g. bank lending) and stock markets.
  - **Fiscal consolidation effects**: Effects of austerity measures employment and demand in Euro zone.
  - **Exchange rate effects**: A depreciation of the euro may affect trade flows.

The Eurozone Crisis and Developing Countries

- **Increased risks for developing countries**
  - Overarching risk: Global 'paradox of thrift'
    - Households, firms, and governments around the world reduce demand.
    - Fragile financial systems, high public deficits and debt.
    - Limited policy space of governments to provide further stimuli to the real economy.
- **Financial contagion effects**
  - Low interest rates can lead to increased capital flows into developing countries.
    - Strengthens exchange rates, fuel expansions in domestic liquidity and credit, and therefore asset prices.
    - Loss of risk appetite amongst investors can lead to a rise in funding costs and reduced credit lines for banks.

The Eurozone Crisis and Developing Countries

- **Vulnerability Indicators**
  - The EU is the major trading partner for low-income countries (LICs) and the Least Developed Countries (LDCs).
  - It is a key donor for developing countries – for example, LDCs receive roughly half of their aid from Europe.
  - It is also an important source of remittances and one of the largest investors in the global economy.
- **Groups of countries most at risk include those with:**
  - Large shares of exports to crisis-affected EU countries.
  - Exports of products with high income elasticities.
  - Heavy dependence on remittances.
  - Heavy dependence on FDI, cross-border bank lending, aid
  - Limited policy space (e.g. high current account deficit, high government deficit, low reserve level).

- **Exposure indicators**
  - The degree of exposure of developing countries to the shock waves of the euro zone crisis depends on the extent to which these economies depend on:
    - trade flows;
    - remittances;
    - private capital flows (e.g. FDI and cross-border bank lending); and
    - aid flows.

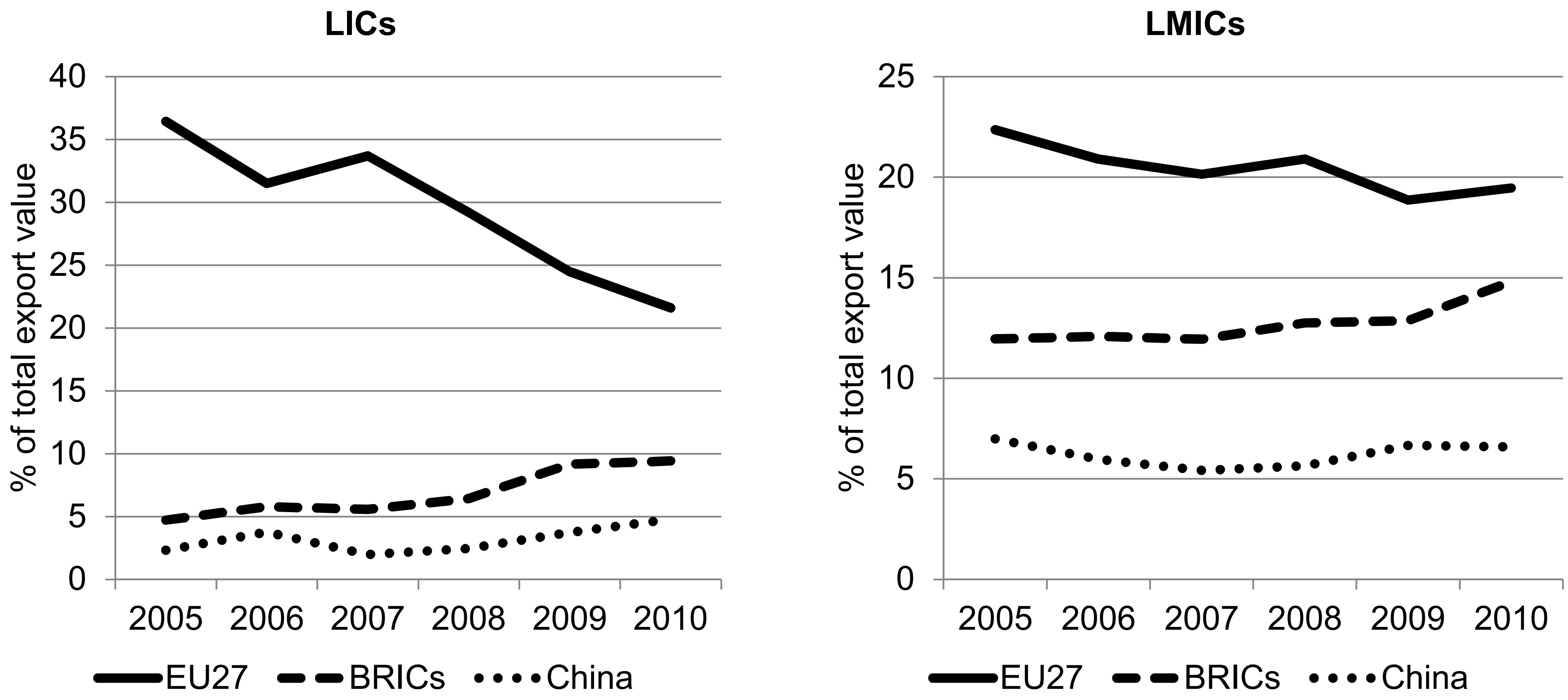
Dependency on EU Trade

- The EU remains the largest single trading partner for LICs and LMICs.

- Our simulations show that a drop of 1% in export flows may reduce growth rates by an average of 0.5% in LMICs and 0.4% in LICs.
  - Uganda, Zimbabwe, Cambodia, Paraguay, Bolivia, Guyana and Bolivia are likely to be among the countries hardest hit by export flow shocks.

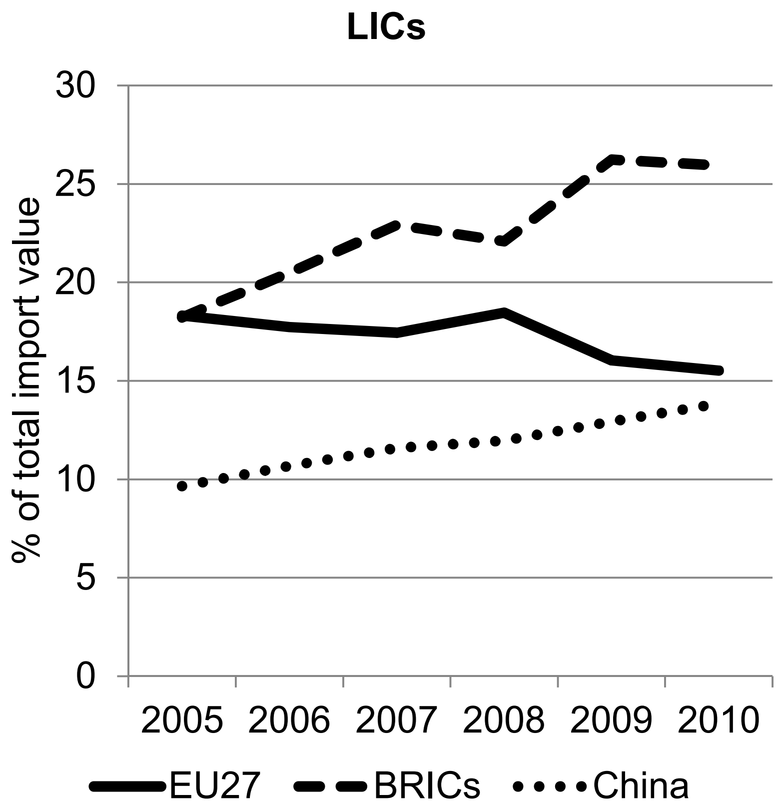
- During the last quarter of 2011, there were reductions in EU Member State imports from LICs and MICs in a number of product categories:
  - manufactured goods, machinery, and crude materials, among others.

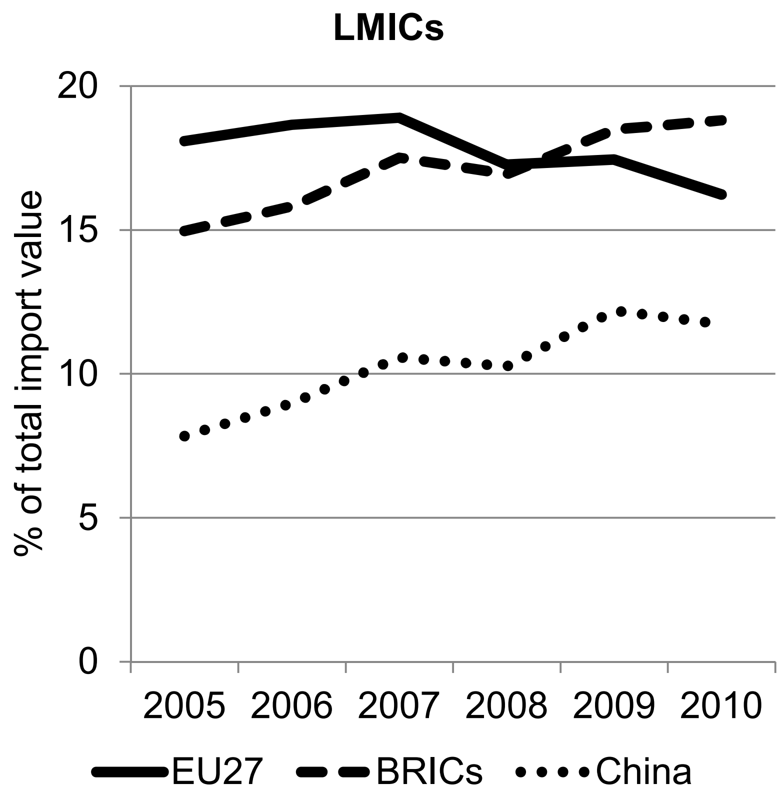
Figure 1 & 2: Share of LIC/LMIC exports destined for the EU, BRICs and China, 2005-10



Note: The number of countries included in each category, and year, varies according to data availability; *Source*: UN COMTRADE database.

Figure 2 & 3: Share of LIC/LMIC imports sourced from the EU, BRICs and China, 2005-10





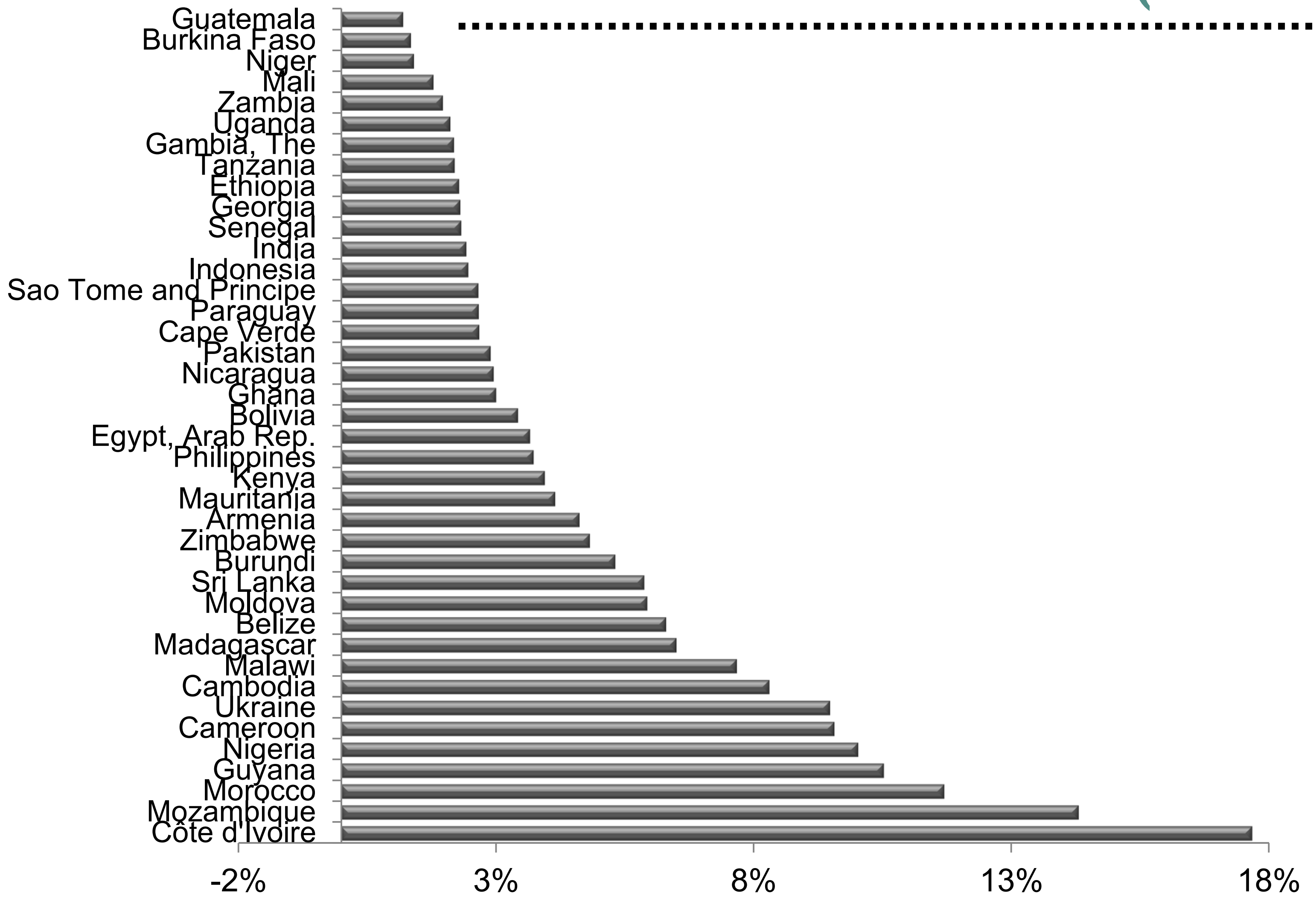
Note: The number of countries included in each category, and year, varies according to data availability; *Source*: UN COMTRADE database.

Table 1: LICs and LMICs with a high trade dependence on the EU

Reporting country	Group	% of total exports to EU27, 2010	Reporting country	Group	% of total imports from EU27, 2010
Cape Verde	LMIC	94.1	Cape Verde	LMIC	78.1
São Tomé and Príncipe	LMIC	81.5	São Tomé and Príncipe	LMIC	66.8
Mozambique	LIC	62.4	Morocco	LMIC	49.2
Madagascar	LIC	60.1	Mauritania	LMIC	46.5
Morocco	LMIC	59.7	Moldova	LMIC	44.2
Cameroon	LMIC	55.2	Senegal	LMIC	43.6
Gambia, The	LIC	50.0	Togo	LIC	39.9
Armenia	LMIC	49.8	Egypt, Arab Rep.	LMIC	32.3
Côte d'Ivoire	LMIC	39.1	Cameroon	LMIC	31.6
Moldova	LMIC	36.8	Ukraine	LMIC	31.4
Malawi	LIC	36.8	Ghana	LMIC	30.8
Sri Lanka	LMIC	35.0	Mozambique	LIC	30.6
Belize	LMIC	31.3	Burkina Faso	LIC	30.2
Burundi	LIC	31.0	Gambia, The	LIC	28.4
Uganda	LIC	31.0	Georgia	LMIC	28.2
Egypt, Arab Rep.	LMIC	30.3	Burundi	LIC	26.8
Ethiopia	LIC	29.5	Armenia	LMIC	25.6

Source: UN COMTRADE database.

Figure 4: Value of exports to the EU (% GDP), 2010



Source: UN COMTRADE database; World Bank, World Development Indicators.

Dependence on EU Trade and Marketing Structures

- Global trade has become more sensitive to changes in levels of income and consumer demand.
  - Merchandise trade has become more responsive to income over time, and particularly so since the mid-1980s (Irwin, 2002).
  - Countries increasingly integrated into global value chains and production networks since the most recent phase of globalisation began.
- Commodity and financial market developments
  - Increasing involvement of international traders and investors in the use of commodities as a specific asset class. Since 1980s, financial and commodity markets have become closely intertwined.
  - As investors become risk averse some types of commodity may be perceived to be a safer bet, hence fuelling price increases.
  - The management of exchange rate regimes, in addition to the regulation of finance, therefore becomes important.

Workers' remittances comprise the largest share of GDP for LICs

Table 2: Workers' remittances and compensation of employees, received (% of GDP)

	2005	2006	2007	2008	2009	2010
Least developed countries	5.4	5.8	6.0	5.3	6.5	6.4
Low income	5.4	6.6	7.3	8.1	7.9	8.0
Lower middle income	4.1	4.1	4.2	4.4	4.3	3.9
Low & middle income	2.0	2.0	2.0	1.9	1.9	1.7
Middle income	1.9	1.9	1.9	1.8	1.8	1.6
Sub-Saharan Africa	1.6	1.9	2.5	2.3	2.5	2.2

Source: World Bank, World Development Indicators.

- Cape Verde, Senegal and Guinea-Bissau are the most dependent countries in SSA on remittance flows from the high-spread euro area countries and are thus likely to be the most vulnerable to a slow-down in growth in the EU27.

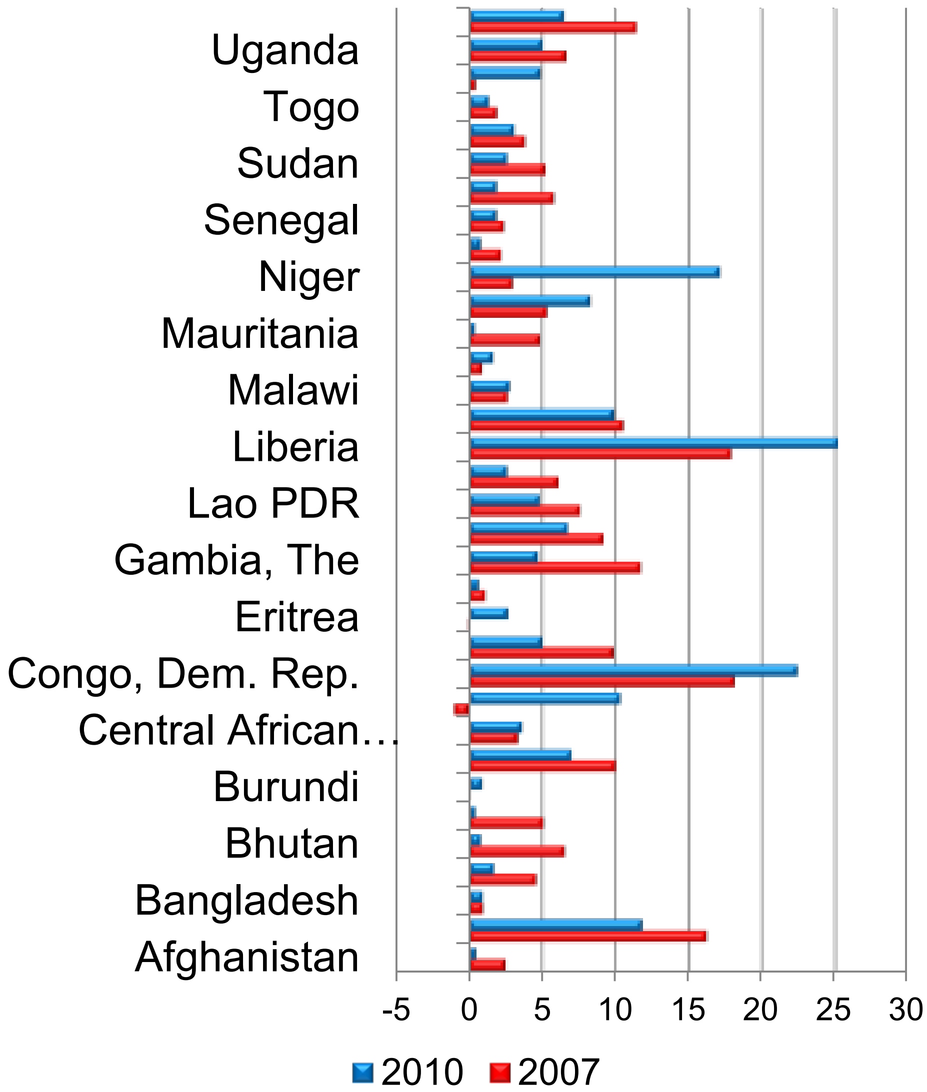
Dependency on EU Sources of Finance

- European countries are also among the largest investors in the developing world.
  - Although emerging economies, and in particular China, are increasing significantly their investment activities.

- The EU is particularly active
  - FDI (especially in LDCs)
  - Cross-border bank lending (in particular in Emerging Europe and Asia and the Pacific)
  - Bank lending through local affiliates (in Africa particularly in countries such as Mozambique, Ghana and Cameroon)

- Portfolio equity flows to developing countries declined considerably between 2010 and 2011;
  - Investment plans were cancelled or postponed;
  - Cross-border bank lending to developing economies declined.

Figure 5: Inward FDI flows in LDCs, excluding SIDS (% GDP), 2007 and 2010



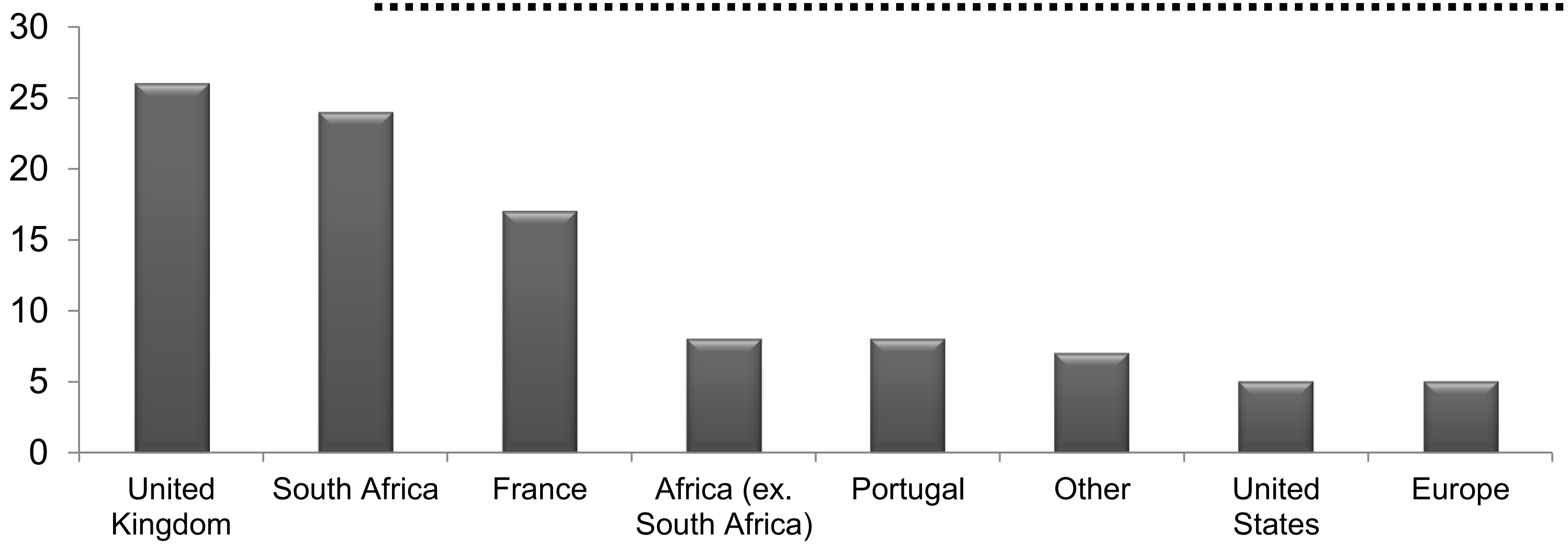
- Among LDCs the countries characterised by the highest degree of exposure to FDI shocks in 2010 were:
  - Liberia and
  - Democratic Republic of the Congo
- Both had a ratio between FDI inflows and GDP higher than 20%.

Dependence on European banking activity

- Cross-border bank lending from European banks to the rest of the world had increased significantly up until the outbreak of the 2008–9 global financial crisis, when it experienced a severe drop.
  - If European banks face funding difficulties because of the debt problems within the euro area they may start to sell off foreign subsidiaries.
  - pull out accumulated profits.
  - thus negatively affecting developing countries' domestic financial sectors.

- European banks represent over half of total bank assets in countries such as:
  - Mozambique, Ghana, Cameroon, Rwanda, Zambia and Tanzania
    - exposed to euro zone crisis through spillover effects.

Figure 6: Home countries of foreign banks in SSA, 2000-6



- Note: Percentage of foreign banks on vertical axis; *Source*: World Bank, Global Development Finance (2008).

- Certain sectors in developing countries are more exposed to shocks in European bank funding. Fuchs (2012), for example, reports that in Africa regional telecom operators and the commodities sector are large borrowers of European bank lending and therefore more exposed to a sudden drop in cross-border lending.

Table 3: ODA commitments and disbursements, % of GDP

Recipient	ODA current $ commitments from all donors						ODA current $ commitments from EU27					
	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
LIC average	18.6	17.3	19.0	20.3	19.1	21.1	5.4	5.3	4.8	6.6	5.4	4.9
LMIC average	13.5	10.8	10.9	10.5	10.4	11.4	3.3	2.2	2.1	1.9	1.6	1.5
	ODA current $ gross disbursements from all donors						ODA current $ gross disbursements from EU27					
LIC average	16.0	28.3	19.3	19.8	19.6	22.2	4.7	4.5	4.7	6.4	4.6	5.3
LMIC average	12.2	13.6	11.6	8.8	9.1	10.0	3.0	2.1	2.1	1.9	1.5	1.5

The relative importance of the EU27 as a donor to LICs compared to LMICs is highlighted in Table 3, which shows that on average ODA from the EU (commitments and disbursements) amounts to around 5% of GDP in LICs compared to 1–2% in LMICs.

Resilience of Developing Countries to Weather the Storm

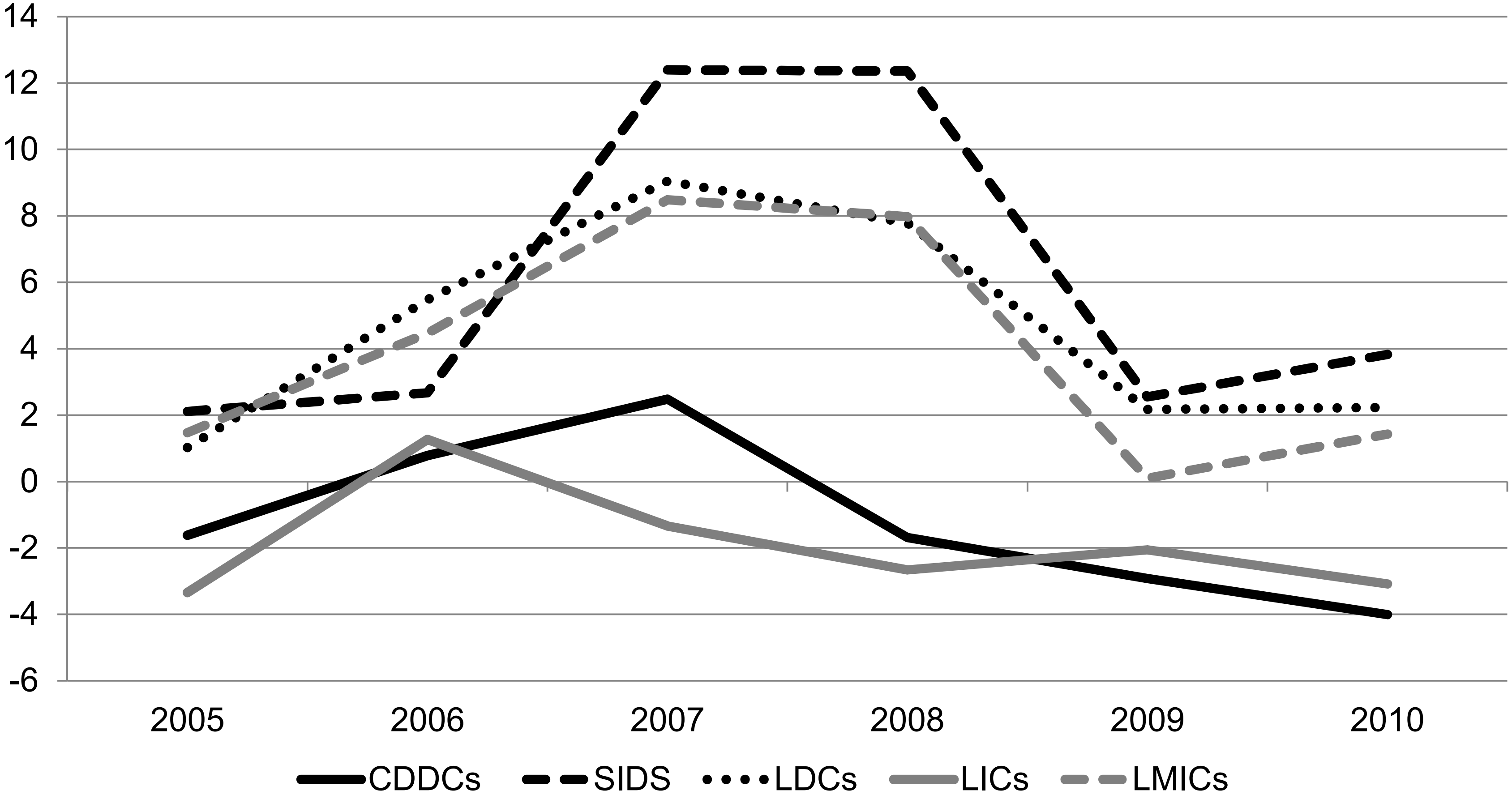
- Policy space available to cushion the adverse effects of the euro zone crisis was narrower in 2010 than it had been prior to the 2008–9 global financial crisis (GFC).
  - Unlike in 2007 when developing countries were in a very favourable situation, the onset of the euro area crisis in 2010 came at a time of only feeble recovery.
  - …after the significant outlays made to introduce stimulus packages to respond to the GFC.
- Between 2007 and 2010, the fiscal and current account balances deteriorated and external debt burdens remained fairly high in many developing countries.
  - Reserves have tended to increase, but value risks erosion by the exchange rate turmoil caused by the euro zone crisis.
  - Ability of developing countries to respond to the shock waves emanating from the euro area crisis is likely to be constrained if international finance dries up and global conditions deteriorate.

Resilience of Developing Countries to Weather the Storm

- **Fiscal Balances**
  - The comfortable fiscal surpluses that many developing countries had before the 2008–9 global financial crisis allowed them to enact expansionary policies to cushion the negative effects of the crisis.
  - The bonanza of the years before the GFC propelled an increase in government revenues (mainly through export income):
    - followed by a sharp decline during the crisis period;
    - consequently, developing countries have to face the euro zone crisis with diminished fiscal surpluses or even deficits.

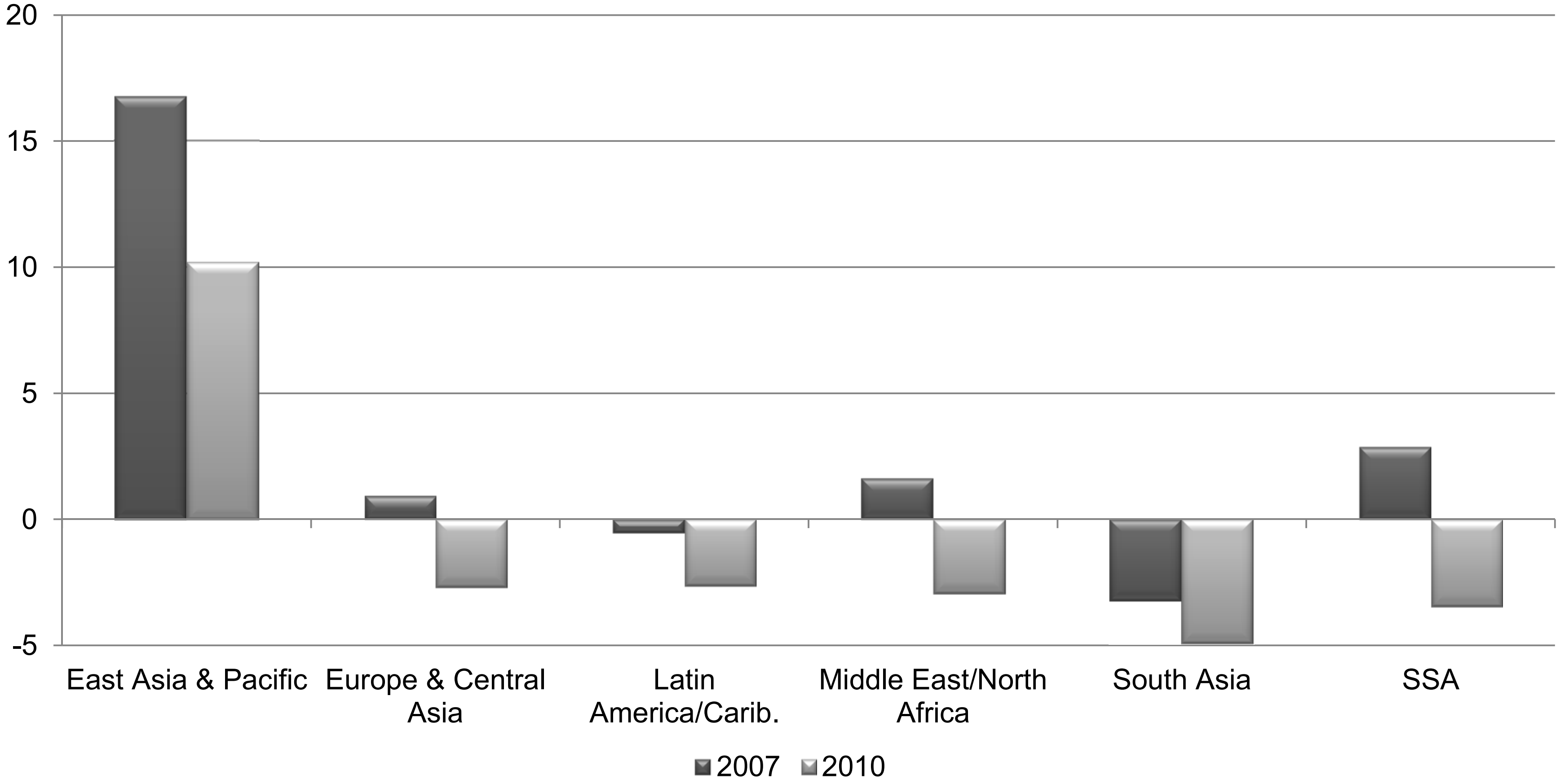
- **Some regions running a fiscal deficit in 2010.**
  - Below the -2% threshold recommended to maintain a sustainable fiscal balance.
  - This constrains the policy options available to developing countries to respond to the shock waves of the euro crisis, since it limits governments' ability to enact countercyclical measures.

Figure 7: Fiscal balance by group of countries (% GDP), 2005-10



Source: IMF, World Economic Outlook (September 2011).

Figure 8: Fiscal balance by region (% GDP), 2007 and 2010



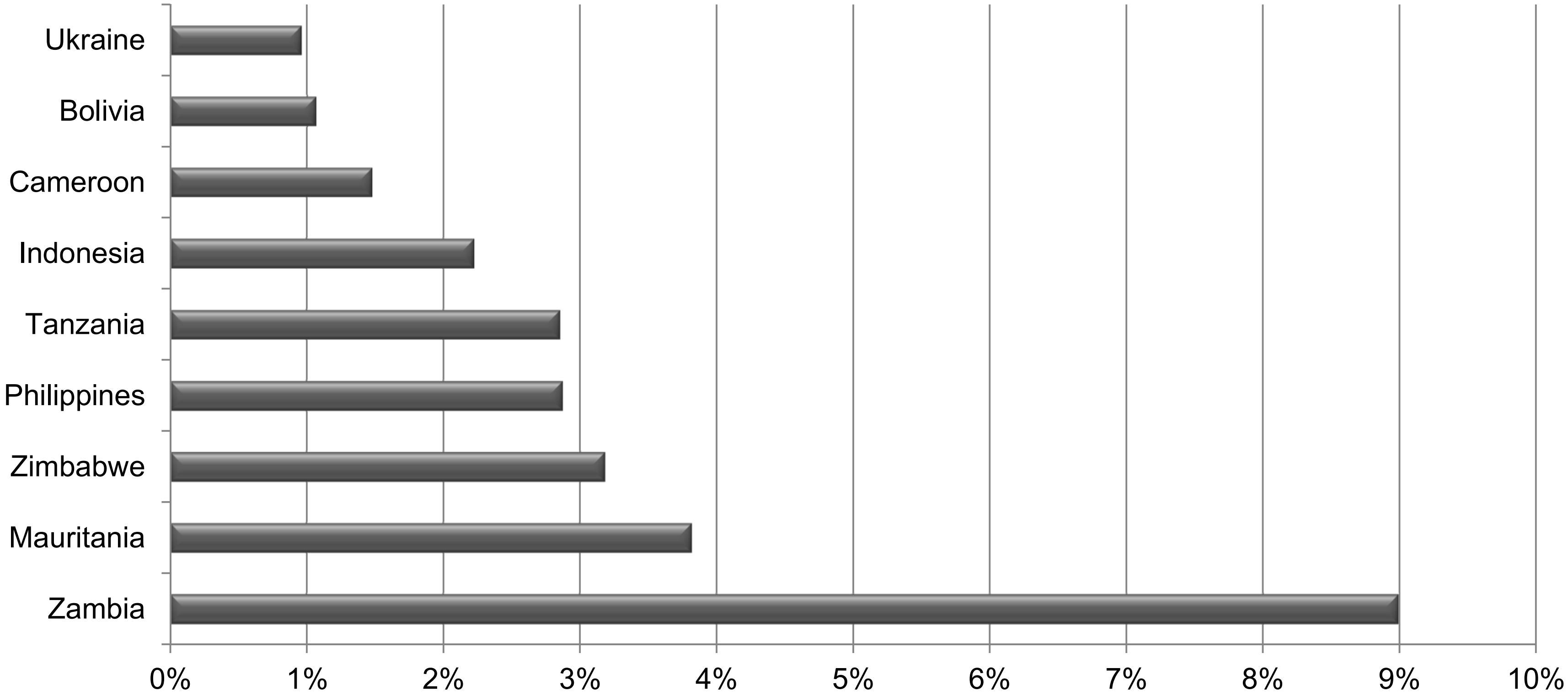
Source: IMF, World Economic Outlook (September 2011).

Resilience of developing countries to weather the storm

- Economic resilience indicators in the developing world (and in particular in LICs and LDCs) present a weaker scenario overall in 2010 than prior to the 2008–9 global financial crisis.
  - Unlike in 2007 when the developing world was coming from a very favourable situation, in 2010 developing countries were hit by the euro zone crisis
  - In the middle of a very feeble recovery from the previous financial crisis.

- Growth in China, which is an export-dependent economy, is expected to slow down because of the debt crisis in Europe.
  - The 'China effect':
    - a slow-down of China's import demand which could be grounded in a quicker-than-expected slow-down in China's domestic demand;
    - a fall-off in orders from China's production chains due to slower high-income country demand.

Figure 9: Exports to China as share of GDP, 2010



Note: Countries for which exports to China accounted for more than 1% or more of GDP in 2010; *Source*: UN COMTRADE database

Effects Apparent

- Focus on Country-Specific Effects

Country	Trade effects	Finance effects	Exchange rate effects	ODA effects
Mozambique	Solid growth reflecting strong demand for commodities	Evidence of tight liquidity conditions as parent banks (in EU) reduce risk and limit credit growth	Stable since the bilateral rate with South Africa is the key determinant of price movements	Portugal reported to have reduced and slowed flows
Nigeria	Decline in remittances. Reduction in demand in EU expected to affect oil and other non-traditional exports	Heavy sell-offs in stock market as a result of global flight to safety	Volatile exchange rate movements, reconsideration of *de facto* peg *vis-à-vis* US dollar	None apparent
Kenya	Decline in major exports destined for EU: horticulture, tea, tourism. Increase in remittances	Heavy sell-offs in stock market as a result of global flight to safety	Volatile exchange rate movements	None apparent
Cameroon	Decline in oil exports destined for EU anticipated	None apparent	CFA peg devaluation	None apparent

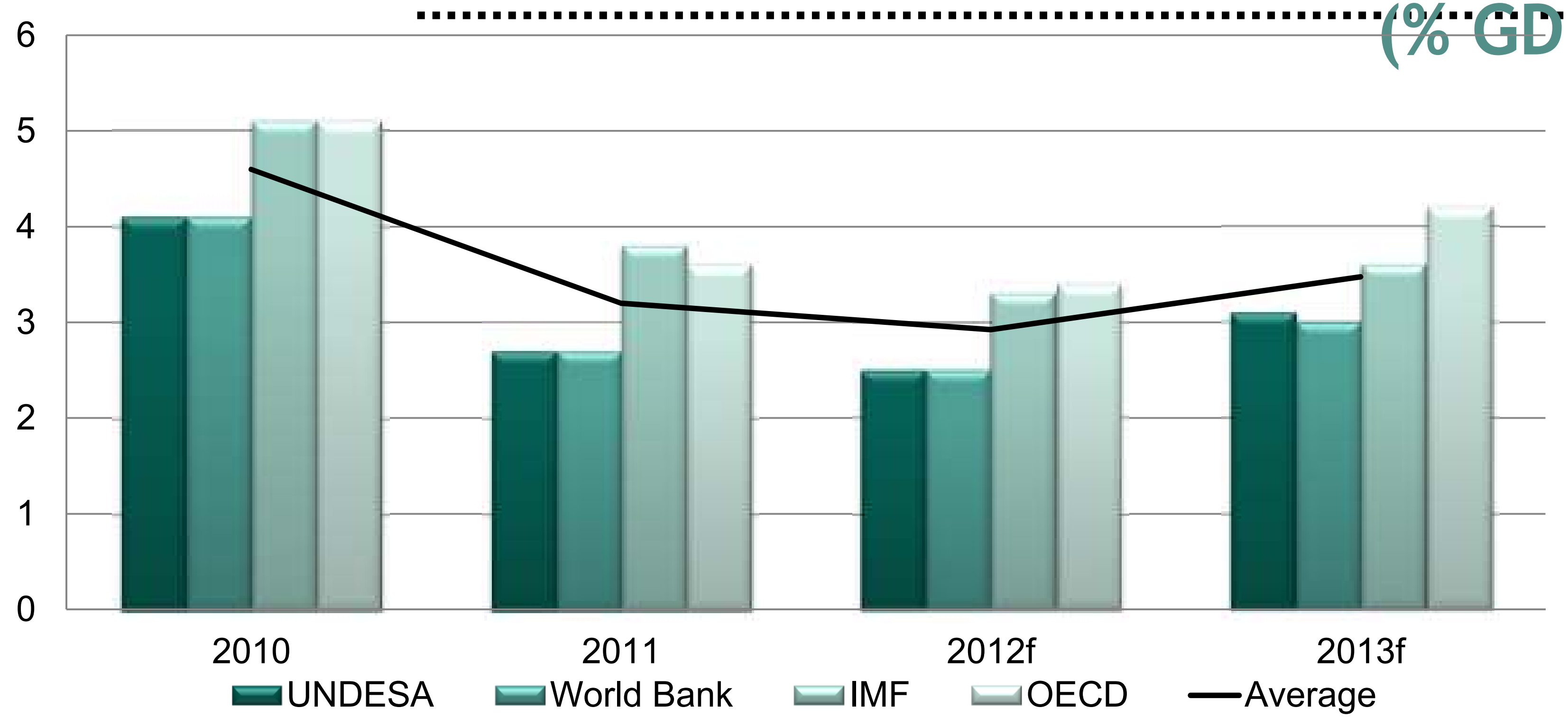
Risks Apparent

- The global economy has entered a new and dangerous phase.
  - On the heels of the 2008–9 financial and economic turmoil the global economy is experiencing a sovereign debt crisis which is spreading across the EU region,
  - weakening the moderate economic recovery in the developed world.
- From our analysis of a number of vulnerability indicators it emerges that:
  - developing countries have a significant degree of exposure to a contraction in trade flows, capital flows, and ODA from the EU;
  - their ability to respond to the euro area crisis shock waves (resilience) is more limited than in 2007, before the outbreak of the global financial crisis;
  - the most vulnerable countries include Mozambique, Kenya and Niger among LICs, and Cape Verde, Moldova, Cameroon, Paraguay, and São Tomé and Príncipe among LMICs.

Key differences between the Eurozone Crisis and the GFC

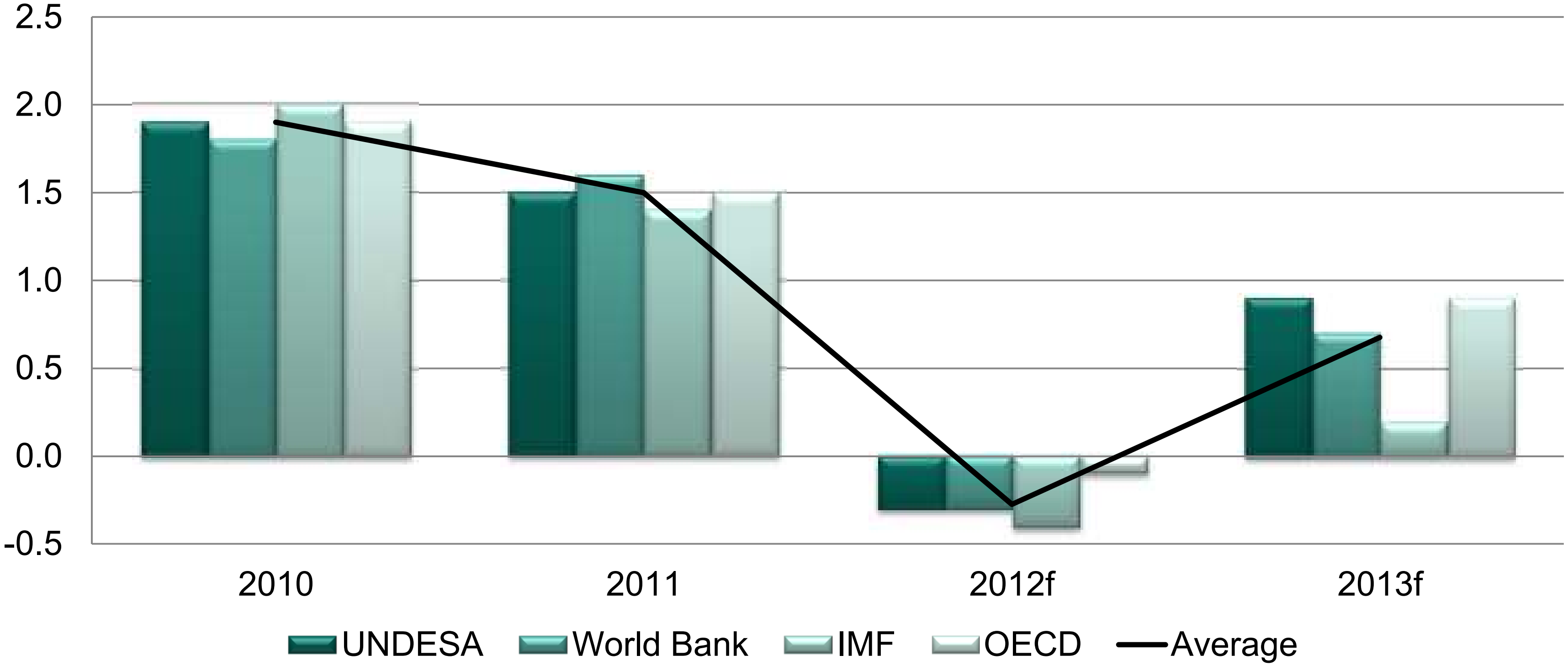
- New challenges for developing countries.
  - The impacts of the euro zone crisis so far (at least from a trade and finance perspective) seem to be less severe than those of the 2008–9 GFC.
  - What makes the current situation most worrying is that growth rates in emerging economies, including the BRIC countries (and China in particular), which have been the engine of the global recovery after the 2008–9 financial crisis, are now slowing down.
  - Countries cannot necessarily rely on emerging markets to mitigate the effects of the European debt crisis and sustain their economic growth.

Figure 10: World Growth Prospects (% GDP)



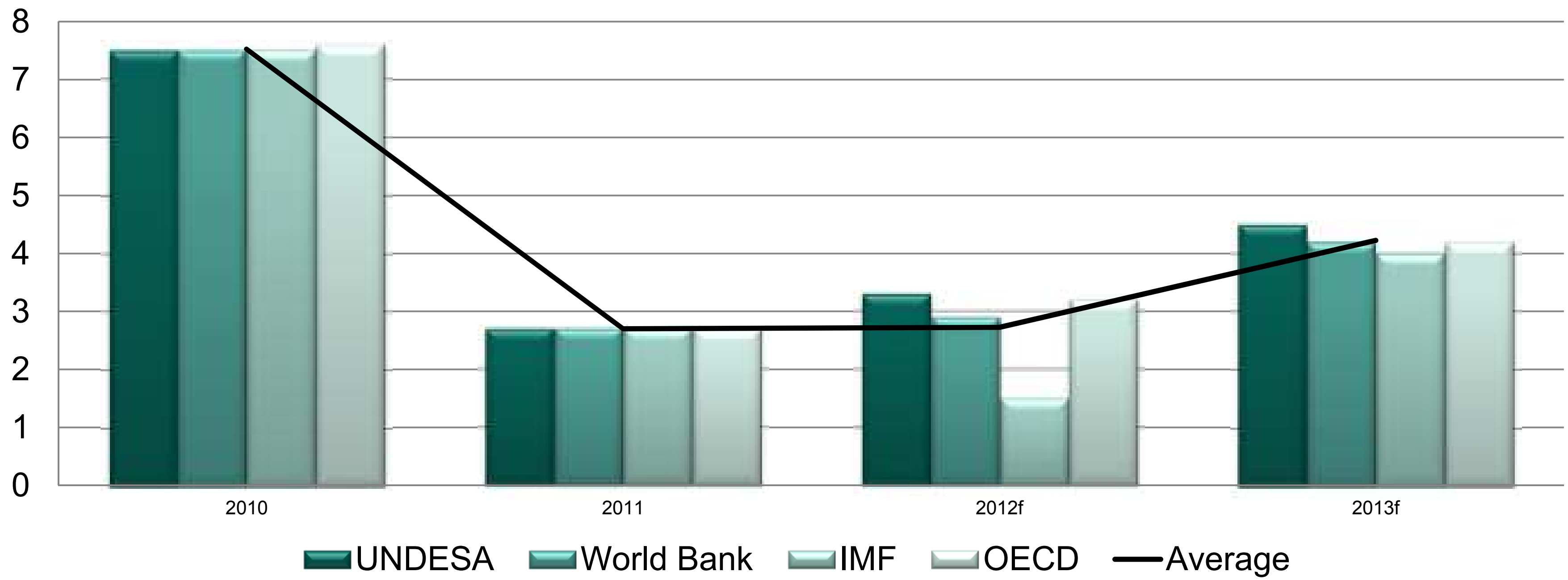
Notes: units represent percentage changes with respect to previous year. The IMF and OECD use purchasing power parity rates. f=forecast. *Source:* Authors' calculations based on IMF (2012a), World Bank (2012b), OECD (2012), and UNDESA (2012).

Figure 11: Euro area GDP growth (%)



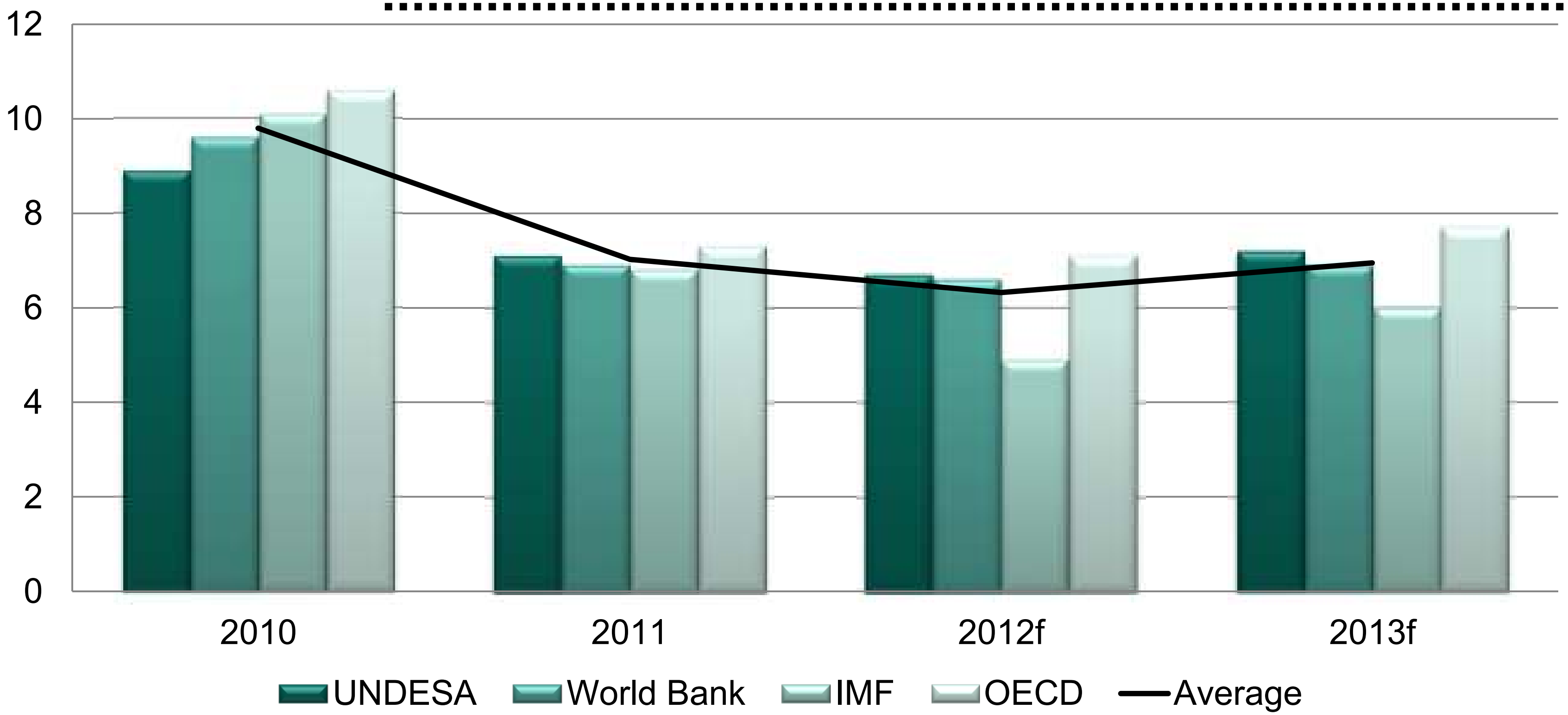
Notes: units represent percentage changes with respect to previous year. f=forecast.
Source: Authors' calculations based on IMF (2012a), World Bank (2012b), OECD (2012), and UNDESA (2012).

Figure 12: Brazil GDP growth (%)



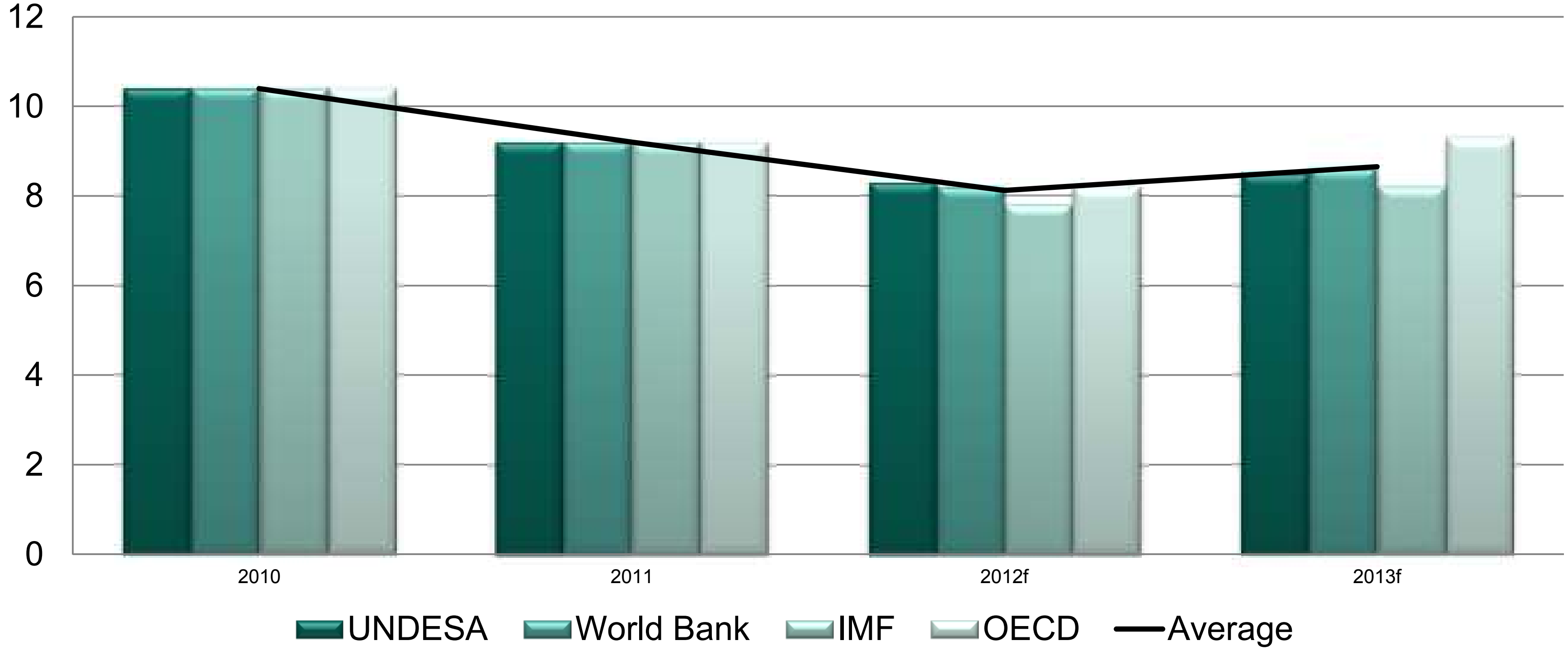
Notes: units represent percentage changes with respect to previous year. f=forecast.
Source: Authors' calculations based on IMF (2012a), World Bank (2012b), OECD (2012), and UNDESA (2012).

Figure 13: India GDP growth (%)



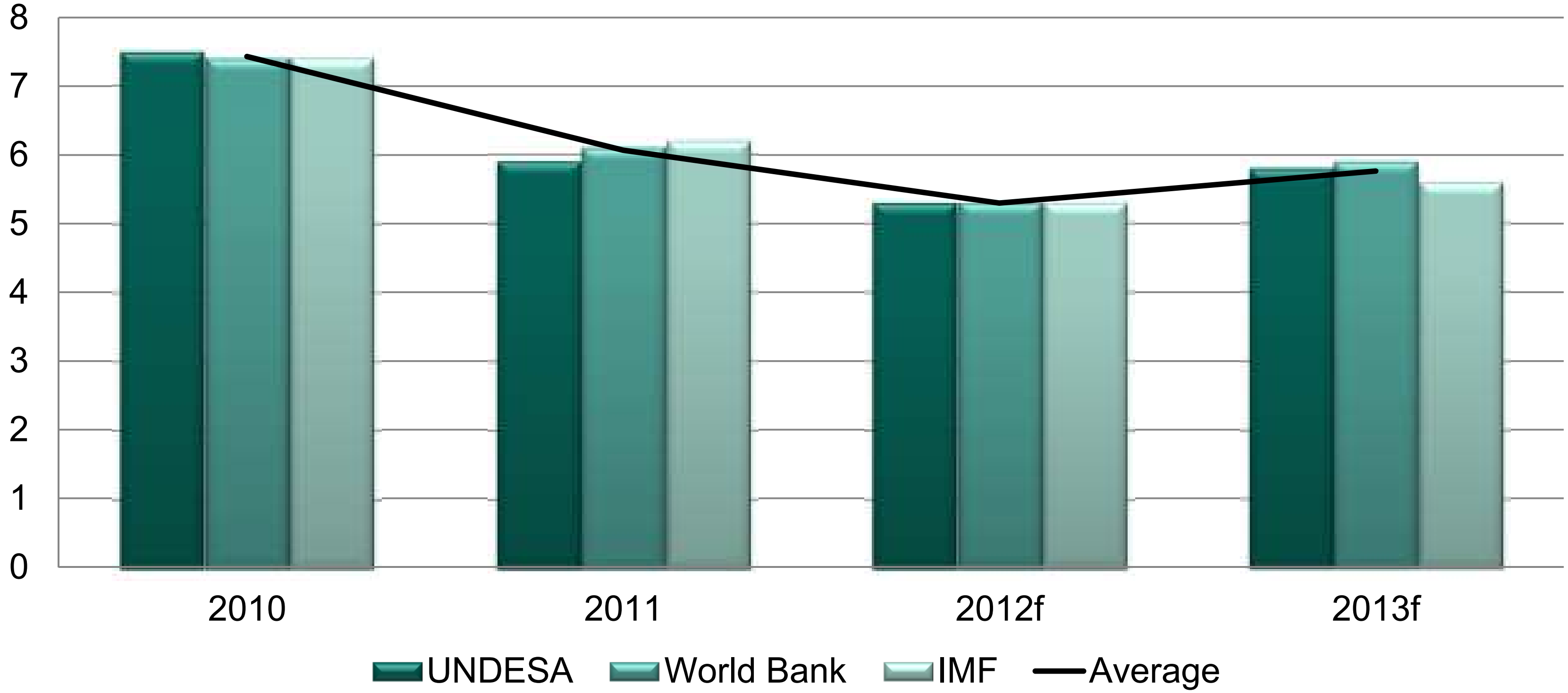
Notes: units represent percentage changes with respect to previous year. f=forecast.
Source: Authors' calculations based on IMF (2012a), World Bank (2012b), OECD (2012), and UNDESA (2012).

Figure 14: China GDP growth (%)



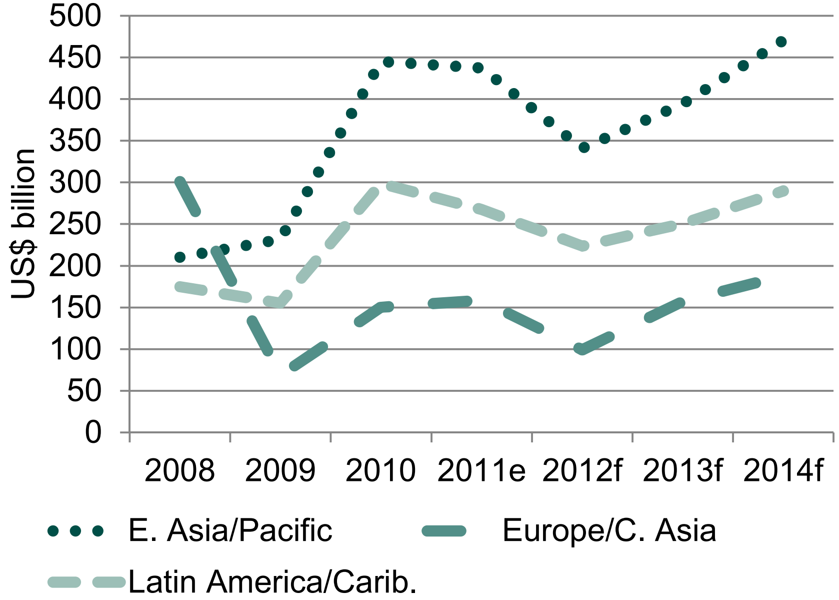
Notes: units represent percentage changes with respect to previous year. f=forecast.
Source: Authors' calculations based on IMF (2012a), World Bank (2012b), OECD (2012), and UNDESA (2012).

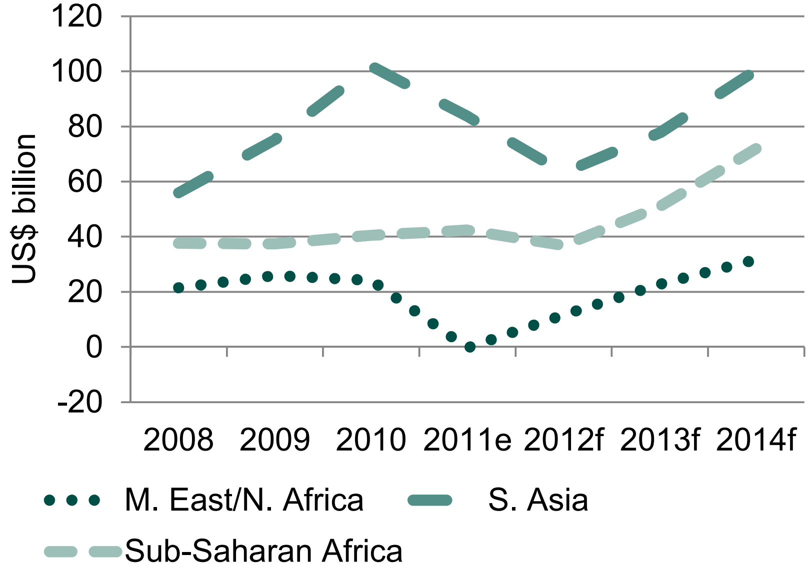
Figure 15: GDP growth in developing countries (%)



Notes: units represent percentage changes with respect to previous year. f=forecast.
Source: Authors' calculations based on IMF (2012a), World Bank (2012b), OECD (2012), and UNDESA (2012).

Figure 16: Net private capital inflows to developing countries by region, 2008-14

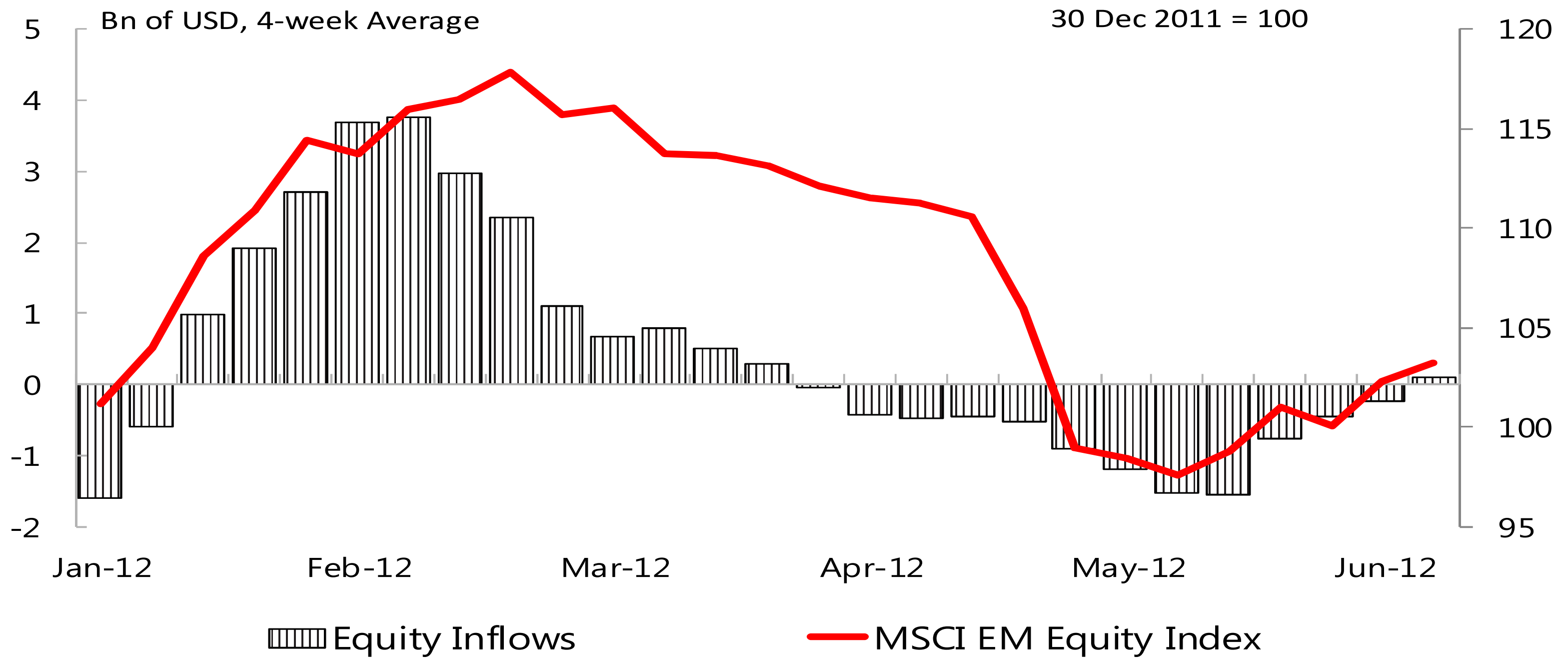




Notes: e=estimate, f=forecast.
Source: Adapted from World Bank (2012b).

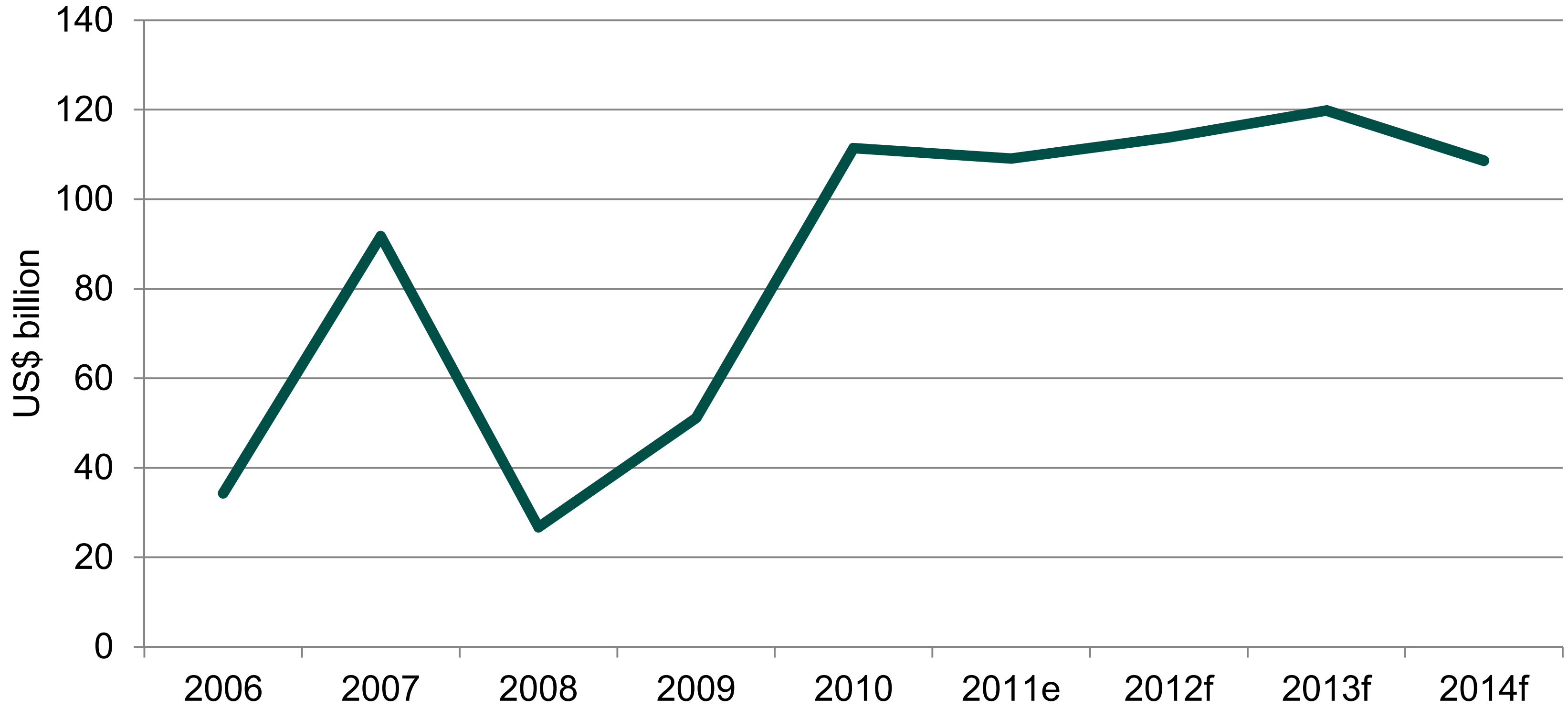
Some shifts in flows apparent

Figure 17: Emerging markets: equity inflows (US$ billion) and price, January–June 2012



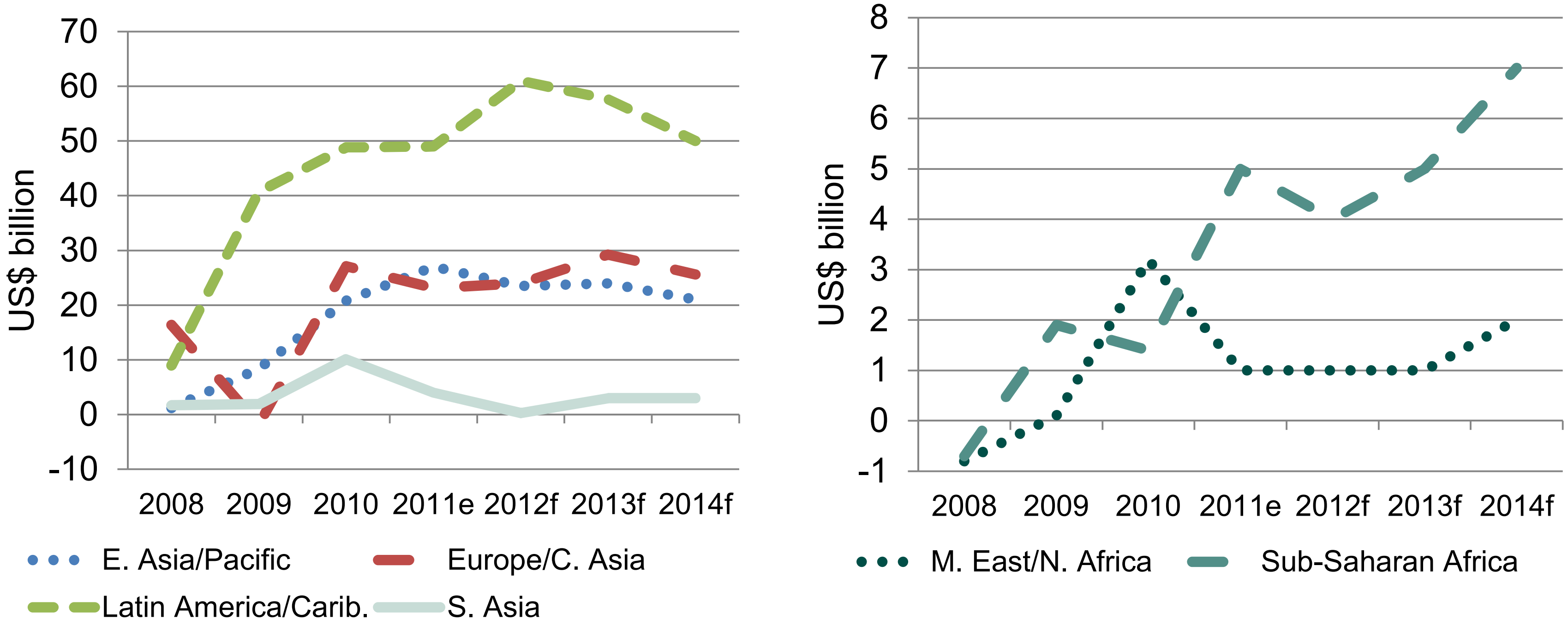
Note: MSCI Emerging Market Equity Index on secondary axis.
Source: Adapted from IMF (2012b).

Figure 18: Bond flows to developing countries, 2006-14



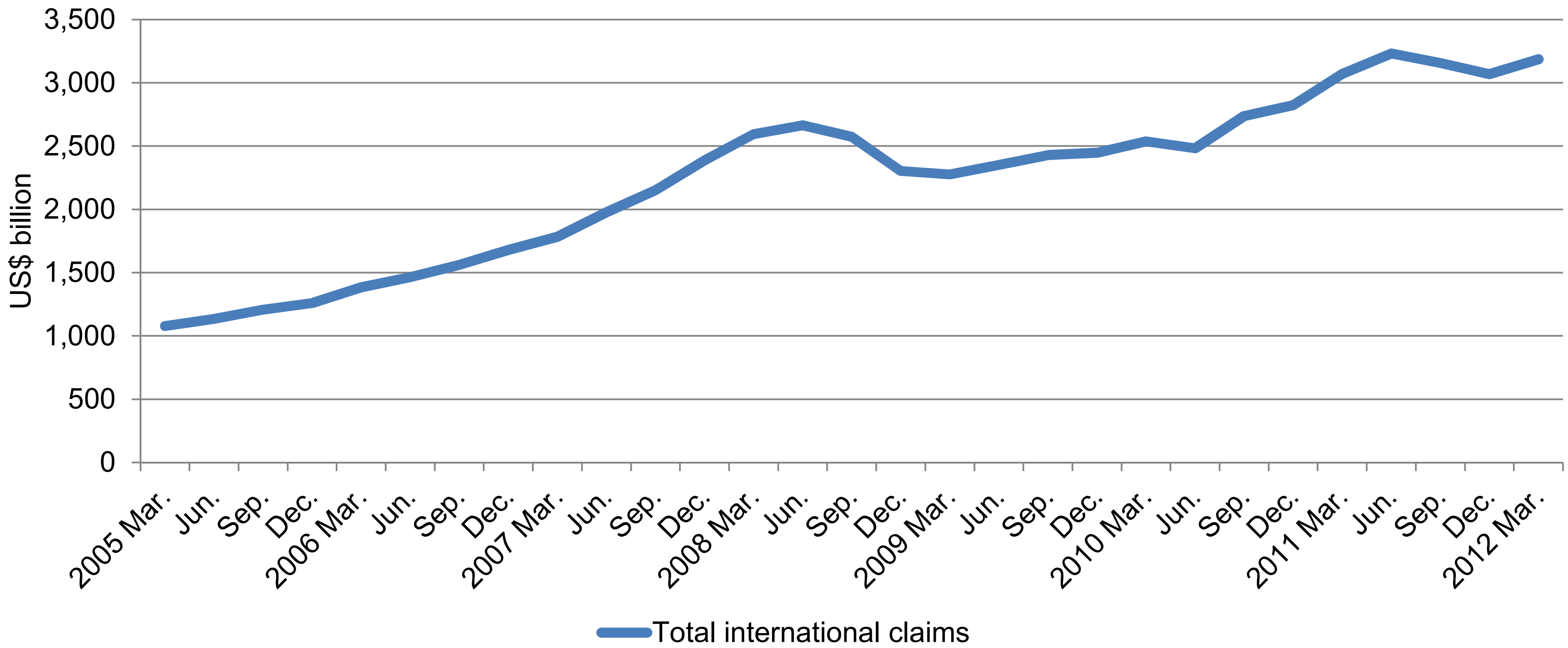
Note: e=estimate, f=forecast.
Source: Adapted from World Bank (2012a; 2012b).

Figure 19: Bond flows to developing countries by region, 2008-14



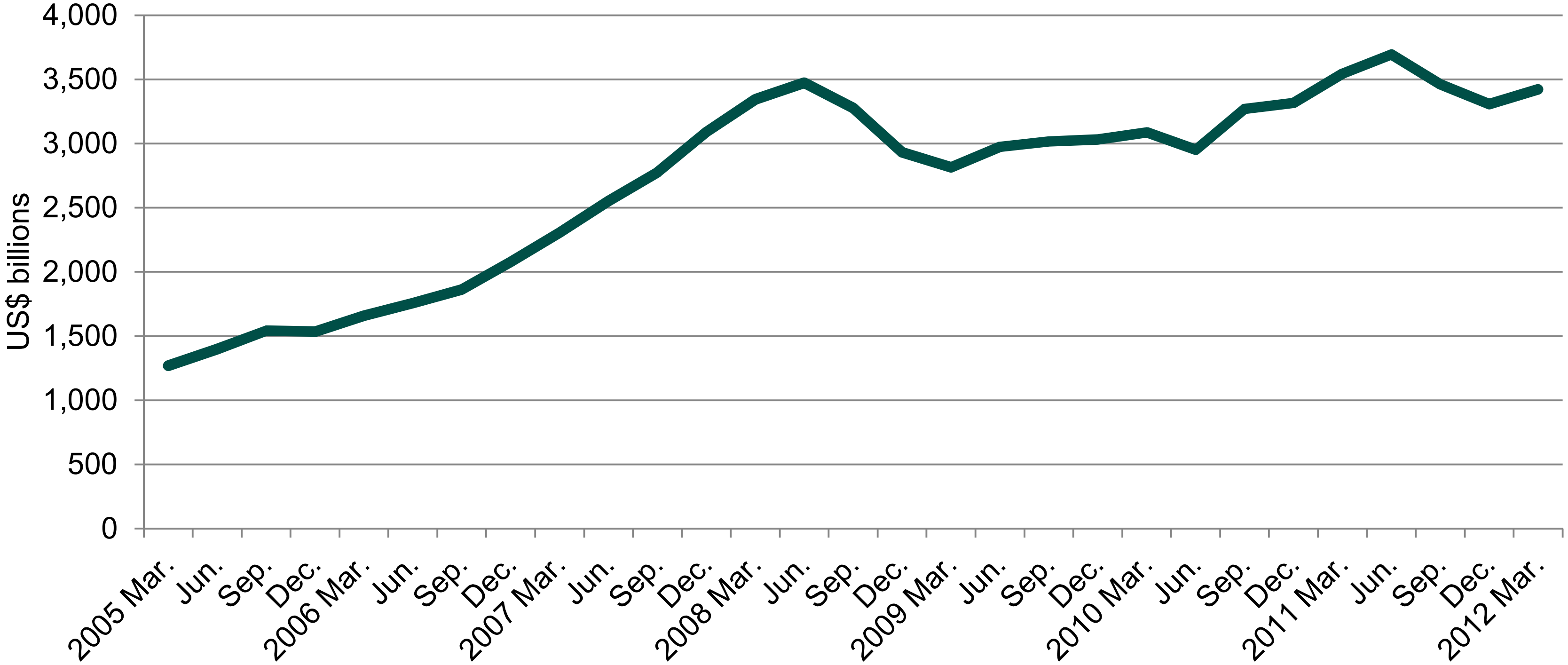
Note: Middle East and North Africa, and Sub-Saharan Africa on secondary axis. e=estimate, f=forecast
Source: Adapted from World Bank (2012b).

Figure 20: Cross-border bank lending to developing countries, Mar 05-Mar 12



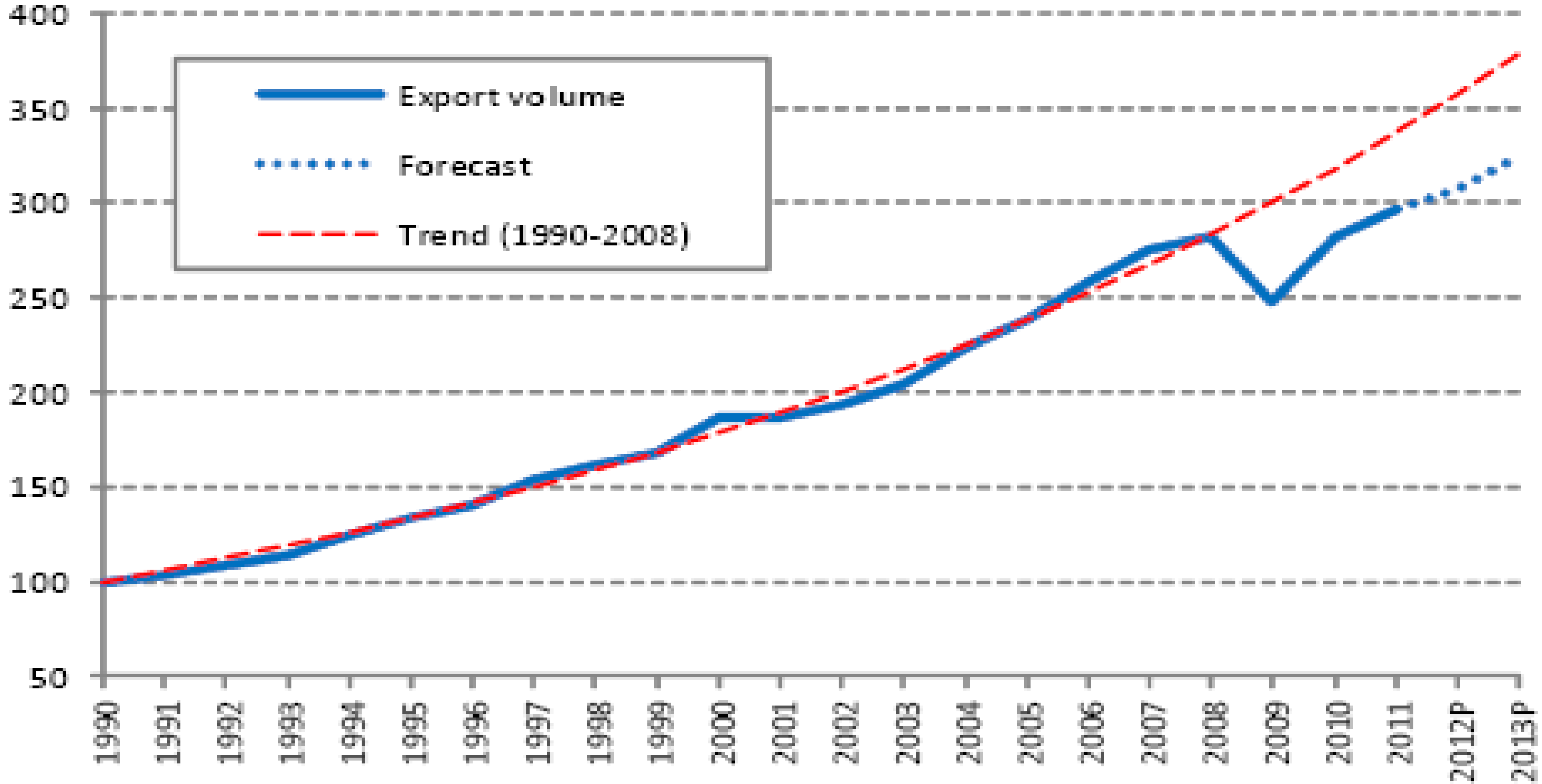
Note: total international claims, immediate borrower basis.
Source: Authors' calculations based on BIS Consolidated Banking Statistics.

Figure 21: Cross-border bank lending to developing countries from European banks, Mar 05-Mar 12



Note: consolidated foreign claims from reporting banks, immediate borrower basis.
Source: Authors' calculations based on BIS Consolidated Banking Statistics.

Figure 22: Forecasts of global trade volumes



Source: WTO (2012).

Table 4: Forecasts on the global economic outlook (percent change from previous year, except oil price)

Global conditions	2010	2011	2012e	2013f	2014f
World trade volume (goods and non-factor services)	13.0	6.1	5.3	7.0	7.7
Non-oil commodities price (US$ terms)	22.5	20.7	-8.5	-2.2	-3.1
Oil price (US$ per barrel) [a]	79.0	104.0	106.6	103.0	102.4
Oil price (percent change)	28.0	31.6	2.5	-3.4	-0.6
Manufactures unit export value [b]	3.3	8.9	0.9	1.2	1.5

Notes: e = estimate; f = forecast;
(a) Simple average of Dubai, Brent and West Texas Intermediate;
(b) Unit value index of manufactured exports from major economies, expressed in US$.
Source: World Bank (2012b).

Concluding Remarks

- The global outlook is generally pessimistic, with international organisations such as the IMF predicting a reduction in world output growth from 5.1% in 2010 to 3.3% in 2012. A rapid growth slow-down is projected in the euro area in 2012, and emerging economies are also slowing down.
  - According to the IMF, growth in developing countries is projected to decline from 6.2% in 2011 to 5.3% in 2012.
  - Net private capital flows to developing economies are expected to decline by more than 20%, from US$ 989 billion in 2011 to US$ 775 billion in 2012.
  - Growth in world merchandise trade is projected to be 2.5% in 2012, less than half the 6% long-term annual average for the period 1990–2008.
  - Remittances to developing countries could decline by 5% or more this year because of reductions in growth in developed countries such as the EU.
  - Growth in aid flows is expected to remain below pre-crisis levels in 2012.

Concluding Remarks

- **What can policy makers do to help developing countries to weather the euro zone crisis?**
  - No one-size-fits-all prescription, but some general recommendations:
    - Maintain fiscal soundness and macroeconomic stability, whilst encouraging growth to compensate for falling external demand.
    - Limit financial contagion.
    - Protect the most vulnerable.

- **Examples**
- Diversification in both markets and products should be promoted to reduce developing countries' dependence on the EU.
- Domestic demand should be stimulated, since it may represent a buffer against international economic upheavals, particularly in countries with fiscal space.
- Financial regulation should be improved, and the operation of foreign banks as well as of their links with domestic banks should be closely monitored.

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