The Impact of the Global Financial and Economic Crisis on LDC Economies

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1. Introduction

The current world economic crisis originated in the financial sector of the advanced economies, beginning with sup-prime mortgage problem and the meltdown of mortgage backed securities in the US. The financial crisis had its immediate reverberations in developing countries which were closely linked to the global financial markets, as capital took refuge in safe havens and there was a rapid flight of capital from emerging markets to the advanced economies and particularly the US. This initial impact on the LDCs, however, was less pronounced as they were not integrated into the global financial markets. With the deepening of the financial crisis, freezing of credit, and the sharp fall in the market value of private wealth, the financial crisis turned into a crisis of the real economy beginning in the fall of 2008. The LDCs have been affected more during this later phase of real economic crisis.

The global economic crisis has led to a sharp reduction in world trade and rapid decline in commodity prices. This is one of the main mechanisms through which LDCs have been affected. Foreign direct investment (FDI) flows which achieved their highest level in 2007 have been declining rapidly since the onset of the financial crisis. The decline in FDI is the second channel through which the LDC economies have been affected, particularly the oil and mineral exporting LDCs. A third transmission mechanism, which can be of critical importance for some LDCs, is the slowdown in migrant workers remittance flows. As unemployment in the advanced countries increases and the end of commodity export boom in some of the labour importing developing countries reduces the demand for migrant labour, the labour exporting LDCs may experience noticeable declines in remittance flows. The economic crisis has led to a sharp deterioration in the fiscal position of all advanced economies which is expected to continue past 2010. This can put pressure of ODA budget of the OECD countries, which can potentially have dire consequences for the LDCs.

The impact of the global economic crisis on the LDCs is thus multifaceted, and it will effect different countries in different ways, depending on the mode of integration of the particular LDC in the global economy and the structure of its domestic economy. There is also still a great deal of uncertainty with regard to the depth and length of the economic recession in the advanced countries, and expectations with regard to the real economy continue to be revised downward (see, e.g., OECD, 2009). It is nevertheless clear that the global crisis is likely to have important implications for growth and poverty in the LDCs and for the achievement of the millennium goals. This can be particularly onerous, as the current global crisis has arrived on the heels of the food and fuel crisis of 1977-78 which inflicted a great deal of hardship on non-oil exporting LDCs.

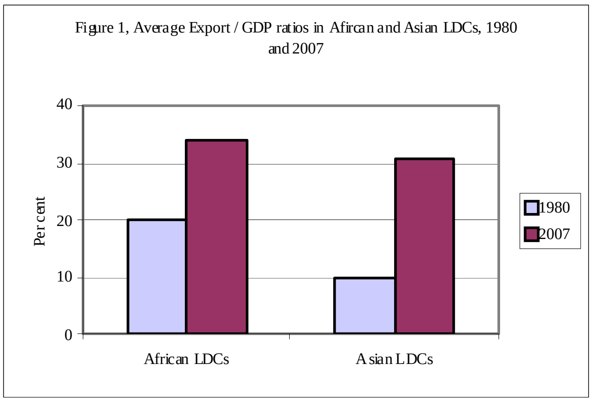
This paper examines the implications of the global crisis for growth and poverty in the LDCs. The next three sections discuss the impact of the crisis on the LDCs through trade, workers remittances and FDI. In Sections 5 and 6 the issues related to the coping strategies and policy constraints facing the LDCs in combating the adverse implications of the crisis are discussed, and projections of the likely effects of the crisis for the poverty levels are provided. Section 7 discusses the likely financing needs of the LDCs resulting from the adverse external shocks due to the global crisis, and Section 8 concludes the paper by discussing the main findings and their policy implications.

2. Trade impact of the global crisis

On the surface the current conditions facing the LDCs may appear similar to those following the end of commodity price boom of the 1970s. The collapse of the commodity boom of the 1970s led to a prolonged period of adjustment and stagnation in the LDCs which lasted up to the latter half of the 1990s. This may create the impression that the collapse of the commodity price boom in the wake of the current global financial and economic crisis may lead to a similarly prolonged and shallow recession in the LDCs. This is not, however, entirely accurate, due to the nature of current global economic crisis and more importantly because of the important structural changes which the LDC economies have undergone during the past two decades. Of course the severity and length of the economic downturn in the LDCs depends on the severity and length of the current global economic crisis which remains uncertain. More importantly, however, the current structures of the LDC economies and their mode of integration into the global economy is very different from those prevailing during the late 1970s.

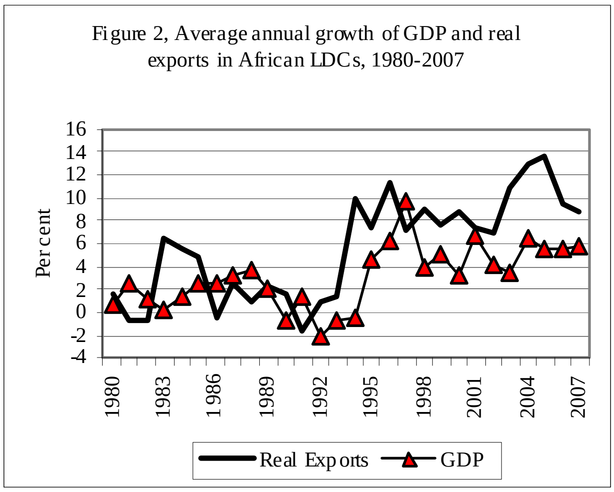
The prolonged period of economic adjustment in the aftermath of commodity price shocks of the 1970s was a result of an initial attempt by the LDCs to preserve income and employment in old industries which were set up during the earlier phase of development by making resort to increased borrowing. Well before the onset of the current crisis, however, the LDC economies had gone far in trade liberalization and were more fully integrated into the global economy.[1] This is also reflected in the rapid increase in export / GDP ratio in Asian and African LDCs since 1980 shown in Figure 1. Island LDCs by their very nature have always had a high degree of trade openness, as indicated by average trade / GDP ratios of close to hundred per cent.

The dismantling of the old protective industrial policies, more liberalized trade regimes, and the much higher ratios of foreign trade to national incomes in the LDCs, imply that the impact of trade shocks are much sharper and more immediate than in the earlier periods, with relatively shorter duration, depending on the length of the global recession and providing there is no sharp policy reversals by the LDCs under economic stress. The importance of external shocks emanating from the international economy for the LDCs is also signified in the close association between growth of real exports and GDP growth, shown for average African LDC countries in Figure 2.[2] As can be seen, during the long commodity boom before the current global crisis, African LDCs managed to maintain relatively high rates of growth, well above those achieved during the 1980s and the 1990s. With the collapse of world trade in the wake of the world economic crisis, these economies are likely to be affected more severely than other countries.



Source: Based on WDI, World Bank

The way the LDCs are affected by the collapse of World trade critically depends on the nature of their trade specialization. Broadly speaking, African LDCs are primary commodity exporters, with more than 90 per cent of their merchandize exports as a group consisting of primary commodities. Manufacturing exports specialization is by and large confined to a few Asian



Notes: Real exports are exports deflated by import prices.
Source: Based on WDI, World Bank.

[1] See, LDC Report 2004 for a detailed analysis trade liberalization in LDCs.
[2] Consistent time series data for Asian and Island LDCs on real exports are not available, except for the case of Bangladesh.

LDCs such as Bangladesh, Bhutan and Cambodia, where over 70 per cent of exports is composed of labour intensive manufacturing products in textiles, clothing and footwear. A finer classification of the LDCs on the basis of their export specialization, conducted by UNCTAD, is shown in Table 1.

Table 1, Classification of LDCs according to their export specialization

(A) Manufacturing Exporters	(B) Oil Exporters	(C) Mineral Exporters	(D) Agricultural Exporters	(E) Service Exporters	(F) Diversified Exporters
Bangladesh	Angola	Burundi	Afghanistan	Cape Verde	Lao PDR
Bhutan	Chad	Central African Rep.	Benin	Comoros	Madagascar
Cambodia	Equatorial Guinea	Congo, Dem. Rep.	Burkina Faso	Djibouti	Myanmar
Haiti	Sudan	Guinea	Guinea-Bissau	Eritrea	Senegal
Lesotho	Timor-Leste	Mali	Kiribati	Ethiopia	Togo
Nepal	Yemen	Mauritania	Liberia	Gambia, The	
		Mozambique	Malawi	Maldives	
		Niger	Solomon Islands	Rwanda	
		Sierra Leone	Somalia	Samoa	
		Zambia	Tuvalu	Sao Tome & Principe	
			Uganda	Tanzania	
				Vanuatu	

Source: Least Developed Countries Report, 2008, p.xiii, UNCTAD, Geneva. Based on 2003-05 trade data.

Manufacturing exporting LDCs such as Bangladesh, Bhutan, Cambodia, and Haiti (Group A, Table 1), are adversely affected by the global slump, as demand for their exports falls, output in export industries contracts and unemployment rises. Without appropriate policy responses, this will lead to further rounds of contraction in the rest of the economy and intensifies poverty. LDC countries in Group E, the services exporters, are similarly affected, as their main source of export revenues are tourism and transport services which are highly income elastic. The falling cost of aviation due to the fall in oil prices can to some extent reduce the impact.

The global slump in the case of primary commodity exporters works mainly through the collapse of the prices of commodity exports. The reason is that in the case of primary commodities the main equilibrating mechanism in the market in the short run is price rather than quantity adjustment. LDC countries in groups B and C in Table 1, namely the oil and mineral exporters, have seen dramatic declines in their export prices since the onset of the global recession. As shown in Figures 3 and 4, crude oil and basic commodity metals witnessed a long period of sustained price increases between 2002 and 2008. Since the onset of the global crisis, however, these price increases have been reversed in a very short period of time. Within a period of six months, between July 2008 and March 2009, crude oil and commodity metal price indexes have fallen by 70% and 59% respectively. Such extreme price shocks, if they persist beyond the current period, will have devastating effects on the development prospects of this group of LDCs. In the short run, however, the extent to which each country can deal with such shocks depends on the manner in which the revenues during the long commodity boom preceding the crisis has been utilized.

Figure 3, Commodity Metals Price Index

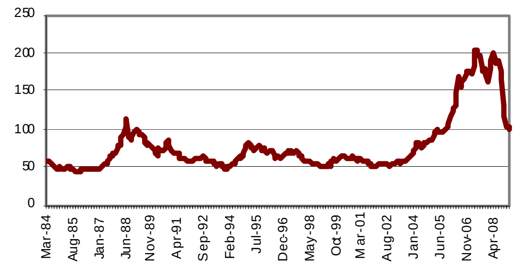
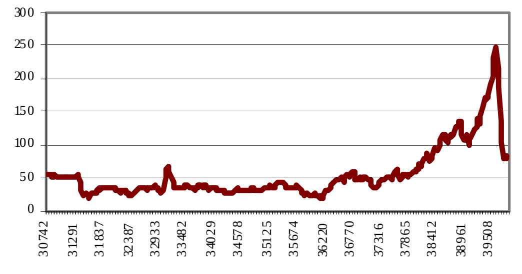


Figure 4, Crude Oil Price Index



Source, IMF

The way the primary commodity collapse affects the domestic economy in these two country groups is different from the case of manufacturing and services exporters, as the main transmission mechanism in oil and mineral export activities is through the government budget. This is more the case for oil exporters where the oil sector employs relatively few workers and has little linkages with the rest of the economy and at the same time generates big sums in the form of taxes and royalties for the government. In fact in the case of some mineral exporting countries in sub-Saharan Africa such generous tax concessions have been given to mining companies that even at the peak of commodity prices in 2007 relatively small tax revenues from the export sector accrued to the government. In such cases, e.g., copper in Zambia, export revenue growth during the boom is normally associated with profit repatriation on a similar scale, and the impact of the export sector on the domestic economy is more linked to the foreign direct investment conducted by the mining companies. Similarly, the impact of the global recession in such mineral exporting countries can be more due to the withdrawal of FDI by the mining companies than the direct effect of the commodity price collapse on government revenue.

The impact of the global recession on Group D countries, namely, the agricultural commodity exporting LDCs, is more immediate as fluctuations in these activities directly effects the livelihood of numerous farmers and traders working in these activities. Price trajectories of agricultural commodity exports from this group of LDCs has been however rather different from oil and mineral exporters. Figures 5 to 8 show price movements between March 1984 to March 2009 for some of the major agricultural commodity exports from the LDCs. A number of features stand out. First is the very high price volatility and the fact that the recent volatility since the onset of the world financial crisis has not so far been more outstanding than other frequent price shocks during the past three decades. Secondly, though some of specific agricultural commodity exports such as coffee showed spectacular price booms during the 2002-08 period, many other agricultural raw materials showed much more moderate price hikes during that period, and at the end of the period items such as fish, cotton, and agricultural raw materials in general stood below their historical peak in real terms.

As shown in Figure 9, oil and food commodity price hikes have overshadowed agricultural raw material prices since 2002. As all the LDCs in this group are net oil importers, and some net food importers as well, the commodity price boom since early 2000s has been costly to these economies, with considerable impact on balance of payments, mounting inflationary pressures, and fiscal constraints. To the extent that the fall in fuel and food prices since the onset of the world financial and economic crisis has helped reduce such pressures,

Figure 5 Commodity Cotton Price Index

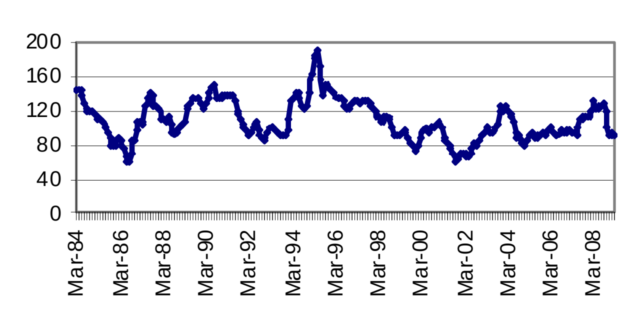


Figure 6, Commodity Beverages Price Index

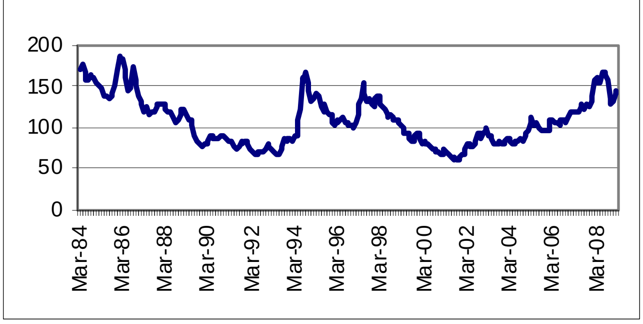


Figure 7, Shrimp Price Index

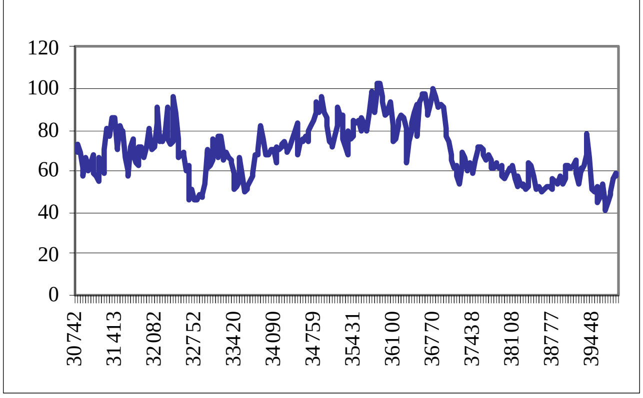
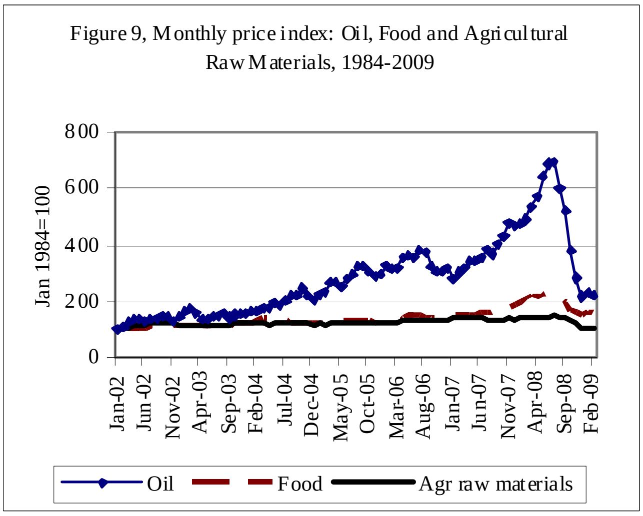


Figure 8, Agricultural raw materials price index

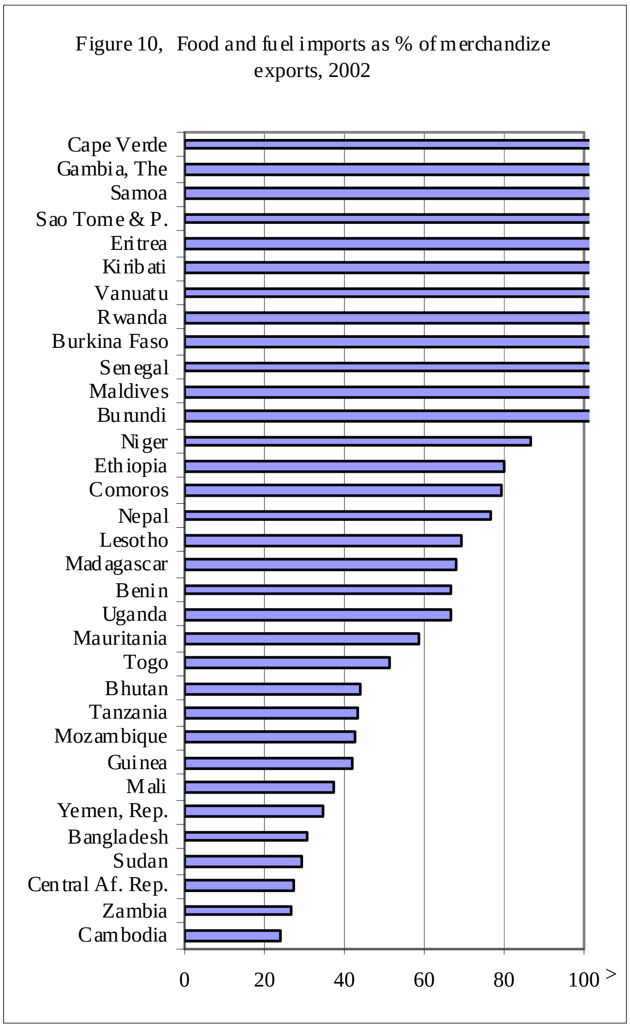
Source, IMF databank

the negative impact of the crisis is somewhat reduced. This is the case in the majority of LDCs with the exception of the oil exporting group.

The combined share of food and oil import bill as a percentage of total merchandize imports in the LDC countries is very high compared to international standards. This is due to the fact that the LDCs finance a large part of their import bill by foreign aid, and hence one or two major items such as oil and food imports constitute a very large share of exports, as the total value of exports is in general much smaller than the import bill. As shown in Figure 10, in the majority of the LDCs for which data is available, the share of food and fuel imports is over fifty per cent of total exports. In the case of twelve countries the combined share of these two items is over 100 per cent.



Source: IMF databank



Source: World Bank, WDI

Considering that these figures do not include fuel costs implicit in the cost of services imports in the form of international transport, it becomes clear that, with the exception of a few oil exporting LDCs, the commodity boom of 2002-08 exerted foreign exchange pressure on the rest of the LDC economies, even those specializing in primary commodity exports. This does not mean that the boom years did not contribute to the growth of the LDC economies. They benefited from fast growth of demand for their export sectors, improved prices and profitability of the export sectors relative to domestic oriented sectors, and growing foreign direct investment in these leading sectors. As noted above the commodity price boom period was associated with accelerated growth in the LDCs, but the food and fuel price hikes are likely to have moderated the impact on rising standards of living and poverty reduction.

The decline in fuel and food prices since the onset of the global crisis has to some extent alleviated the impact of the crisis on the LDC economies, with the exception of oil exporting LDCs. To the extent that oil exporting LDCs have acted prudentially during the boom years by building up foreign exchange reserves and stabilization funds, they will be in a better position than the rest of the LDCs to cope with the impact of the recession, at least in the short run. On the other hand, other LDCs can find more difficult to deal with the global crisis arriving on the wake of the food and fuel price increases of 2007 and 2008 which has led to a diminution of their foreign exchange and fiscal resources. The impact, in any event, is likely to be severe in all the LDCs, particularly if the global recession is prolonged into 2010 and 2011. The global recession has led to drastic fall in export volumes and prices with important implications for balance of payments, government budgets, investment and economic activity in the export sectors and beyond. With the fall in price and profitability of investment in primary producing sectors, this has had important implications on FDI flows to the LDCs as well.

3. The impact on private capital flows and foreign direct investment

In a large number of LDC countries foreign banks dominate the banking system in terms of the ownership of banking assets. In sixteen LDCs for which data are available more than 50 per cent of total banking assets are foreign owned.[3] In ten African LDCs, foreign ownership constitutes more than two thirds of the banking assets.[4] The direct fallout of the global financial crisis on the LDCs as compared to other developing countries, however, has been relatively limited. The foreign banks in the LDCs have been mainly engaged in provision of domestic banking services and private debt flows and portfolio equity flows have formed a very small part of long term capital flows to the LDCs (Table 2). Many LDCs have

[3] Namely, Tanzania, Burkina Faso, Niger, Mali, Senegal, Benin, Cape Verde, Togo, Unganda, The Gambia, Mozambique, Zambia, Guinea, Djibouti, and Lesotho in Africa and Cambodia in Asia. IMF 2009.
[4] These countries are, Benin, Cape Verde, Togo, Unganda, The Gambia, Mozambique, Zambia, Guinea, Djibouti, and Lesotho

maintained their capital controls and domestic banks have not been exposed to complex asset based securities emanating from the industrial countries. Of course, like other developing countries, since the beginning of the global financial crisis the LDCs have found it even more difficult to raise funding in the international markets and the premiums on trade credits that they can procure has substantially increased, with debilitating effect on their export sectors

Table 2, Long term capital flows to the LDCs 2004-06

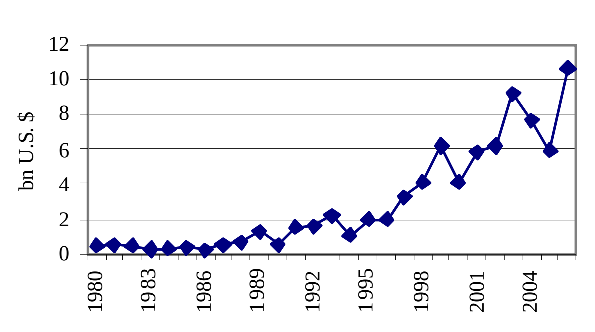
	bn U.S. dolars			Percent
	2004	2005	2006	2004-06
Official flows[1]	**16.3**	**17.6**	**17.6**	**61.8**
Private net flows	**10.8**	**9.8**	**11.2**	**38.2**
FDI	9.3	7.8	12.3	35.3
Portfolio equity	0.0	0.1	0.0	0.1
Private lending	1.4	2.0	-1.6	2.2
Total excluding debt relief	**27.1**	**27.4**	**28.8**	**100**

Notes: (1), excludes debt relief grants Source: LDC report 2008

(IMF, 2009).

The main source of long term private financing in the LDCs has been foreign direct investment. From the late 1990s FDI flows to the LDCs have been growing fast, and particularly accelerating during the commodity boom period, reaching close to 40 per cent of total long term capital flows to the LDCs during 2004-06 (Figure 11, Table 2). About 84 per cent of total FDI to the LDCs during the entire 2000-07 period went to African LDCs, and about 15 per cent to the Asian group. During this period FDI constituted about 3.3 per cent of the gross national income in LDCs as a whole. In African, Asian, and Island LDCs the shares were respectively about 4.8 per cent , 1.2 per cent and 3.2 per cent of the GNI. According to UNCTAD estimates FDI financed about 15 per cent of gross fixed capital formation in the LDCs in 2006 (LDC Report 2008). In African and Asian LDCs this share was about 23 per cent.

Figure 11, Net FDI inflows, total LDC, 1980-2006



Source: World Bank, GDF, December 2008.

The global crisis is likely to undermine the flow of FDI to the LDCs in a major way, as lack of access to funds by multinational companies and the fall in profitability of such investments due to commodity price collapse take their toll. Another important consideration is that about

42 per cent of FDI inflows into the LDCs in 2006 took the form of cross boarder mergers and acquisitions (UNCTAD, 2008), which is likely to shut off as a result of the credit crunch. FDI in the form of greenfield investment in mineral and oil exporting countries may continue under its past momentum, as the gestation period in this type of investment is long and incomplete projects may continue to completion. Investors may also continue investment in such cases due to long term strategic considerations and future access to the resources.

Figure 12, Net FDI inflows and repatriated profits from the LDCs, 1980-2006

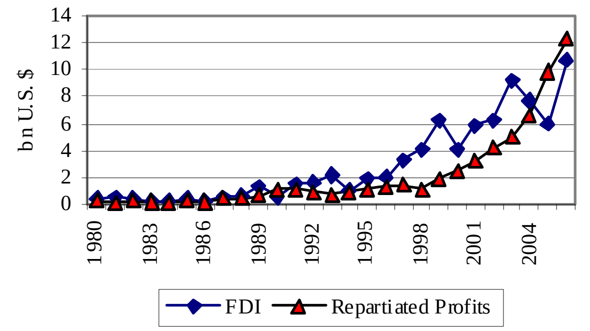


Figure 13, Net FDI inflows and repatriated profits' African LDCs, 1980-2006

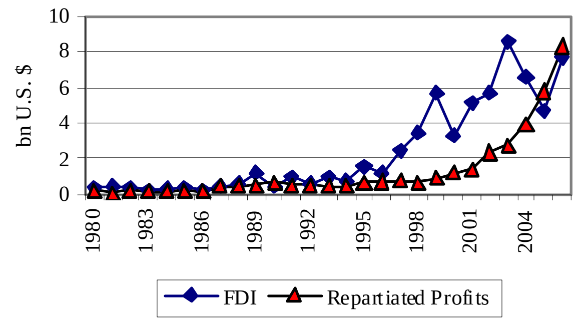
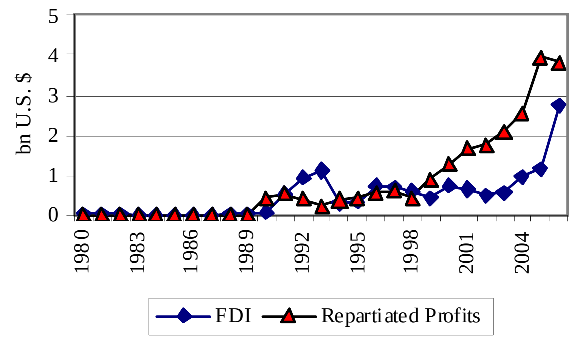


Figure 14, Net FDI inflows and repatriated profits' Asian LDCs, 1980-2006



Source: World Bank, GDF, December 2008.

Along with the growth of FDI since the late 1990s, repatriation of profits by foreign companies has also been growing apace. Since 1994 repatriated profits have overtaken the flow of FDI into the LDCs (see, Figures ?? to ??). In the case of the Asian LDCs this took place early on in 2000, and in African LDCs repatriated profits surpassed FDI only in 2004. To the extent that repatriated profits are derived from domestically oriented industries such as banking, with no direct contribution to exports, the collapse of FDI following the global financial crisis would be particularly serious for the balance of payments. In any event, the collapse of FDI will have a serious debilitating effect on the growth prospects of the LDCs.

4. The impact on Remittances

The contribution of workers remittances to many LDC economies is highly significant. Workers remittances had a rapid growth during the 2000-07 commodity boom years prior to the global financial crisis. In the case of LDC countries where data are available the flow of remittances increased from $6.7 bn in 2000 to $16.6 bn in 2007. In the case of African LDCs remittance flows increased from $2.9 bn in 2000 to $6.4 bn and in Asian LDCs the increase was from $3.6 bn to $10 bn between 2000 and 2007. The total remittance inflows for the LDC as a whole was well over FDI flows in this period. In Asian LDCs labour remittance were over three times higher than net FDI inflows in 2007. Though in the case of Island LDCs remittance flows are relatively low in absolute terms, as a share of GDP some Island LDCs show some of the highest remittance flows amongst the LDCs.

Figure 15, Workers Remittances Received, 2000-07

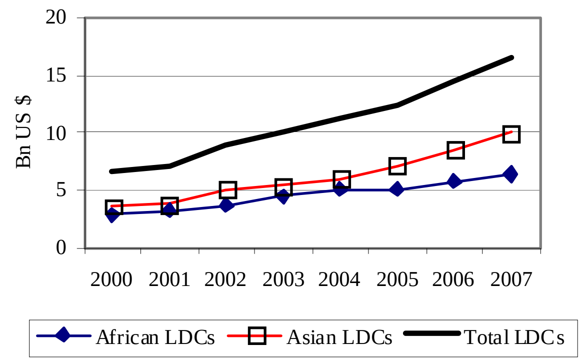


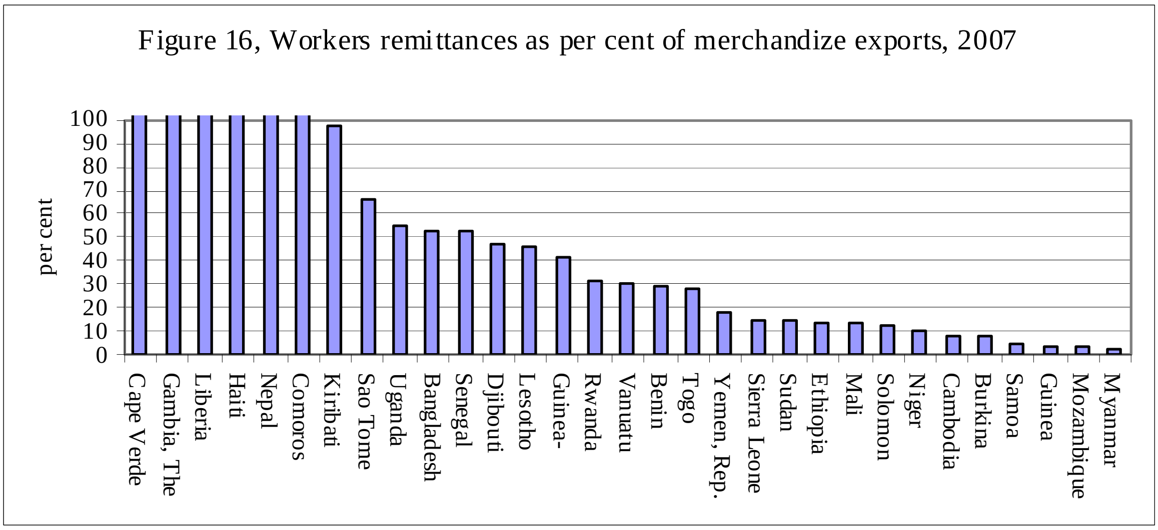
Table 3, Remittance flows to LDCs, 2000-07

(bn US $)

Year	African	Asian	Island	Total LDCs
2000	2.9	3.6	0.2	6.7
2001	3.2	3.8	0.2	7.2
2002	3.7	5.1	0.1	8.9
2003	4.5	5.5	0.1	10.1
2004	5.1	6.0	0.2	11.2
2005	5.1	7.1	0.2	12.4
2006	5.8	8.6	0.2	14.6
2007	6.4	10.1	0.2	16.7

Source: World Bank, WDI

Figure 16 shows remittance inflows as a percent of merchandize exports for 30 LDC countries with available data and where remittances are higher than 1 per cent of the exports. In seven countries remittance flows are close to or well over 100 per cent of merchandize exports, and in more than half of the countries remittance flows constitute over 30 per cent of exports. Workers remittances in the LDCs mainly come from other developing countries in the vicinity that benefited from the commodity boom of the past few years. The collapse of the commodity boom therefore is likely to have a dramatic effect on the remittance flows. According to World Bank projections, remittance flows to developing countries are likely to decline in 2009, possibly by as much as 5 per cent (World Bank, 2009). This will be a further significant negative sock to the LDCs in addition to those arising from the trade and capital markets.



Source: World Bank, WDI.

The significance of workers remittances for the LDC economies goes beyond their macroeconomic role of foreign exchange and income provision. Workers remittances often form a large part of the income of the poor households. Savings by migrant workers are also important sources of funds for investment in small enterprises and can play a significant role in employment generation. In addition, poor households use migration as a source of income diversification and an insurance strategy against frequent internal shocks to which LDC economies are prone. The fact that currently the collapse of remittance income has coincided with a slump in the domestic economy resulting from negative trade and investment shocks undermines this strategy and intensifies poverty. The coincidence of these three major negative shocks in the wake of the world financial crisis also pushes to the limit the coping strategies of LDC economies as a whole.

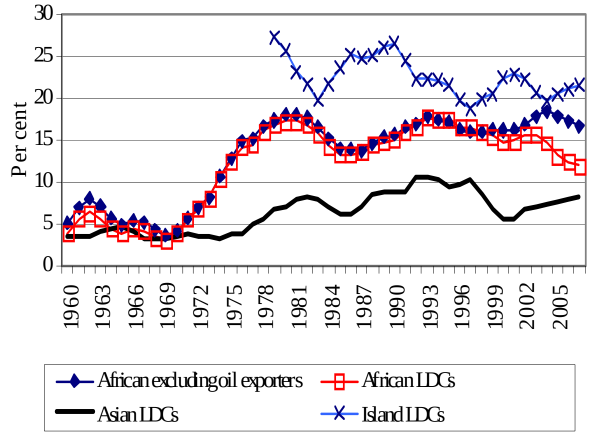
5. Coping strategies and LDC capacities to deal with the global crisis

In advanced industrial countries the reaction to the crisis has been massive fiscal stimulus, drastic reductions in central banks lending rates, and monetary easing through purchase of long term financial assets by the central bank. This has taken place in addition to massive injection of funds into financial institutions and financial assistance to strategic ailing industries. In addition, the industrial countries have inbuilt stabilization mechanisms, such as unemployment insurance, which during the economic downturn to some extent alleviates the easures.

The nature of the economic crisis in the LDCs, however, is different from the industrial countries. Furthermore, the LDC governments and central banks face severe constraints in introducing expansionary fiscal and monetary measures during economic downturn.

The most sever binding constraint for LDC policy makers is the balance of payment constraint, which due to the global crisis is likely to become even more binding. In recent decades the LDCs have been highly dependent on external sources of finance, well above the norms in other developing countries. The external resource gap for Island LDCs has fluctuated between 20 to 25 per cent of the GDP over the past two decades. The same figure for African LDCs (excluding oil exporters) has been between 15 to 20 per cent and for Asian LDCs around 5 to 10 per cent (Figure 17). Only some of the oil exporting LDCs managed to reverse these trends over the past decade to generate sizable current account surpluses.

Figure 17, External resource gap in African, Asian, and Island LDCs as a percentage of GDP, 1960-2007



Source: World Bank, WDI.

Table 3 shows the dominance of external funding in relation to investment and government consumption expenditure in the LDCs. In non-oil African LDCs external resource gap has been on average above 80 per cent of total investment and government expenditure, and in Island LDCs these ratios have been on average above 90 per cent. In average Asian LDCs external resource gap has fluctuated between 30 to 60 per cent of investment and government consumption expenditure (Table 3).

Table 3, External Resource Gap as a per cent of Investment and Government Expenditure 1980-2007

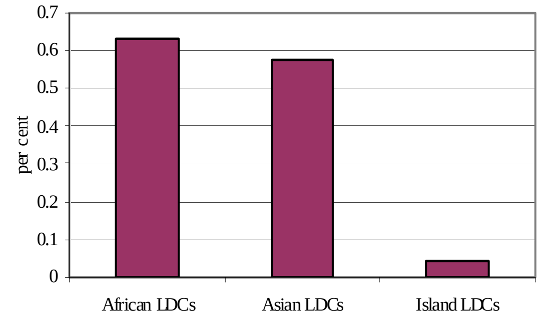
	African LDCs[1]	Asian LDCs	Island LDCs
Percentage of gross domestic investment			
1980-84	94.3	45.1	86.0
1985-89	67.4	48.7	94.7
1990-94	87.7	54.7	92.3
1995-99	80.1	41.9	97.3
2000-04	94.2	29.3	108.9
2004-07	81.0	35.5	97.4
Percentage of government consumption expenditure			
1980-84	96.1	46.4	121.6
1985-89	68.3	49.9	115.6
1990-94	87.6	60.0	103.4
1995-99	82.1	48.8	107.9
2000-04	94.1	32.1	109.1
2004-07	80.8	39.8	98.0

Notes: 1. Excluding African Oil Exporters. Source: World Bank, WDI

The external resource gap in the LDCs has been covered through a number of channels. Workers remittances and FDI, as discussed previously, have made varying degrees of contribution in different LCDs (for the median LDC country the combined contribution of the two has been about 8 per cent of the GDP in recent years). On the negative side, profit repatriation and foreign debt service further add to external resource gap (combined effect of the two for all the LDCs has been about 6 per cent of GNI in recent years). The net effect of these flows for average LDC country is likely to be small, though wide variations exit across individual countries. It is noteworthy, however, that the positive flows such as workers remittances and FDI are negatively impacted during the global crisis, while the outflows such as debt service payments are not affected.

Other sources of financing the resource gap are raising funds from the international capital markets and portfolio financing. As noted above, however, the LDCs have had very little success in procuring this type of long term financing. As shown in Figure 18, at the height of commodity price boom during 2004-06, even including the oil exporting LDCs, African and Asian LDCs on average managed to raise funds equivalent to only about 0.5 per cent of their GDP in this manner. In the post crisis era, at a time when the seizing of private financial flows to many emerging market economies has intensified economic instability in many developing countries, this source of financing will be a fortiori closed to the LDCs.

Figure 18, Financing via international capital markets, % of GDP, 2004-06



Source, World Bank, WDI

Figure 19, Aid as per cent of gross national income, 1980-2006

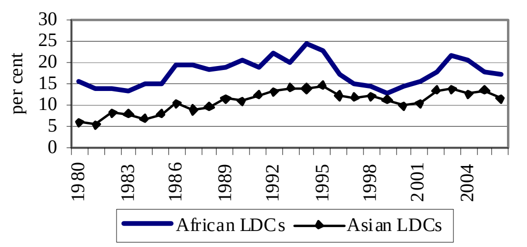
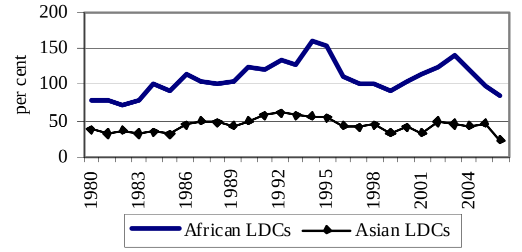


Figure 20, Aid as per cent of gross investment, 1980-2006



Source: World Bank, WDI. Notes: Excluding oil exporters

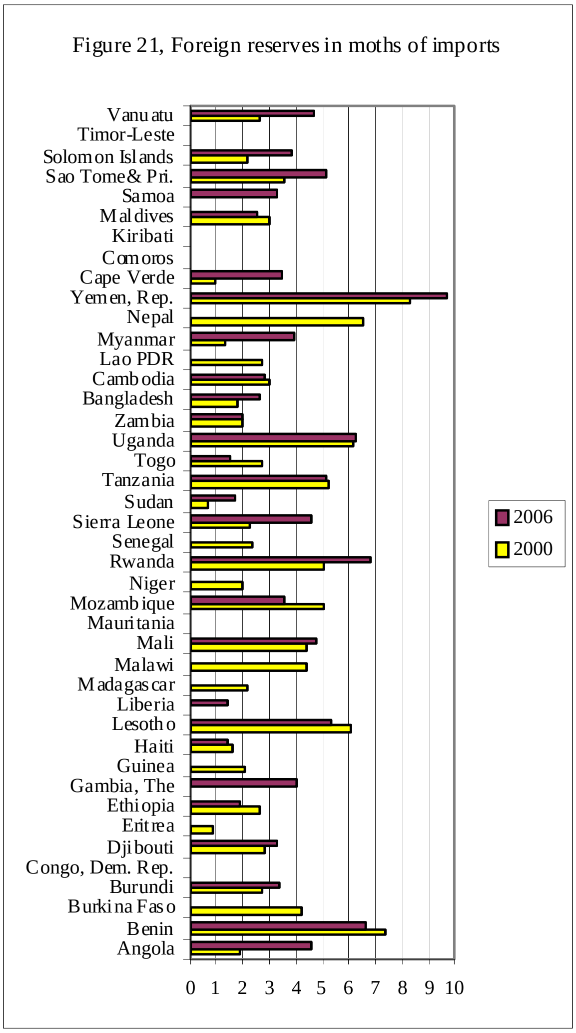
The above highlights the fact that the LDCs are highly dependent on foreign aid in financing their external resource gap. As shown in Figures 19 and 20, foreign aid for average African and Asian LDCs mirrors the external resource gap as a share of GNI and gross investment.

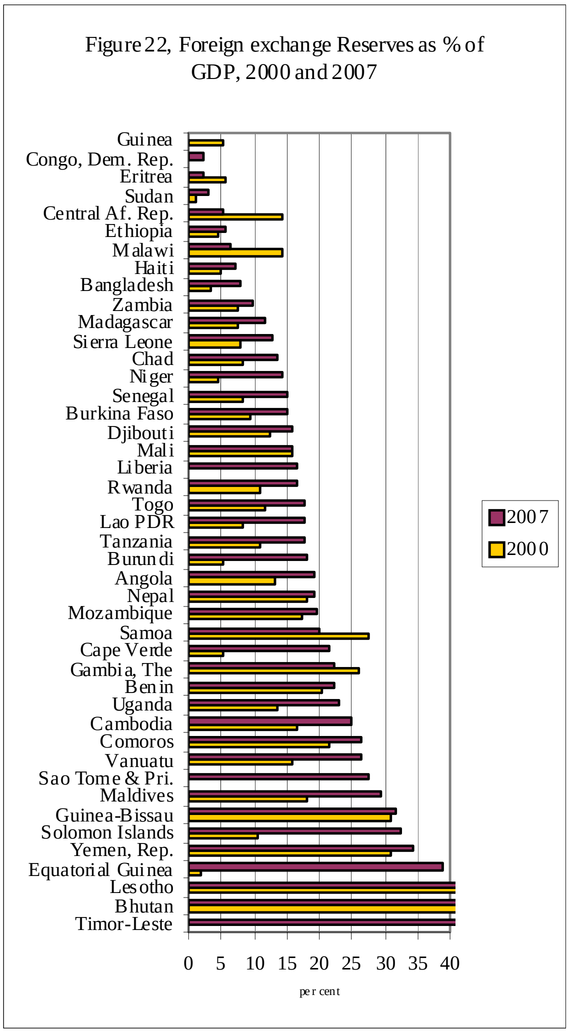
Since the late 1980s in African LDCs on average over 100 per cent of gross investment has been financed by foreign aid, and in Asian LDCs the average figure has been around 50 per cent.

Ideally one would presume foreign aid to be treated as a policy variable, which could be relied upon to pursue counter cyclical policies in the LDCs over the economic cycle. This ideal situation also appears to be the assumption behind various donors pronouncements regarding the magnitude and modality of aid flows; e.g., the programme of action for the LDCs for the decade 2001-2010. But the reality of aid is far from this ideal, as many donors have fallen short of their aid commitments even during normal times. Rather than treating aid as an exogenous policy variable, many analysts have come to the conclusion that aid is best treated as an endogenous variable which has many determinations, amongst which economic conditions in the donor countries are most paramount. Particularly during the current crisis, as the budgets of many donor governments have come under extreme pressure, it is likely that the flow of ODA through conventional channels may be curtailed. According to latest IMF projections, a thirty per cent reduction in ODA is likely in 2009 on the basis of some large donor countries indicating planned reductions in aid. Furthermore, the modalities and time responsiveness of the existing aid channels may not be adequate, even if aid can be increased, given the size and rapidity of the impact of the current global crisis.

One of the paradoxical features of the LDC economies in recent years has been a rapid build up of foreign exchange reserves in economies which are heavily indebted, have large current account deficits, and are aid dependent (Figures 21 and 22). This is sometimes justified on grounds of unreliability and instability of aid flows, which is more a betrayal of the dysfunctional and uncoordinated aid system than a justification for relatively large waste of resources in some of the poorest countries on earth. The question that concerns us here, however, is to what extent the relatively large foreign exchange reserves in some of the LDCs provide a cushion to pursue countercyclical policies during the current crisis.

The answer depends on the relative size of the combined effect of the negative external shocks to the accumulated reserves. Countries like Yemen with foreign exchange reserves equivalent to almost one year of imports can in the short run introduce countercyclical fiscal and monetary policies to somewhat alleviate the effect of the crisis. Whether such policy freedom is worth carrying such large foreign exchange reserves over long periods of time is however another matter. The very neglect of investment in productive capacities in that past can in fact render such expansionary policies ineffectual.





Source: World Bank, WDI

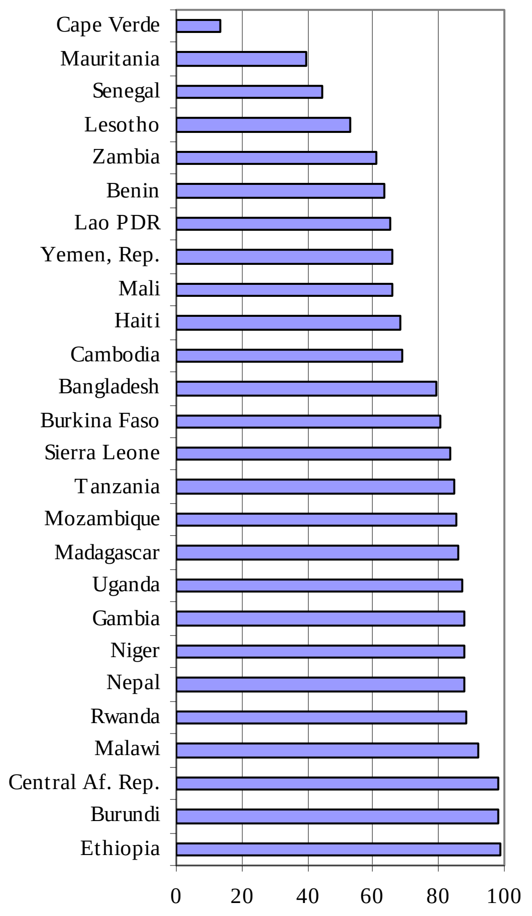
Furthermore, counter cyclical policies through monetary expansion at a time of crisis can lead to fast depletion of the foreign exchange reserves through capital flight. For this reason, amongst others, capital controls and strict supervision of the banking system in the LDCs during the crisis is of utmost importance. Nevertheless, given the size, severity, and multidimensionality of the negative shocks hitting the LDC economies, no credible macroeconomic policy to counter the short term effects of the crisis can work on the basis of the existing reserves and without adequate supply of new external resources (see, Section 7 below). The alternative of letting the economy adjust to external shocks without the injection of new external resources will take a sever toll in terms of economic growth and poverty.

6. Implications for growth and poverty

The impact of the global crisis on economic growth in different LDCs would vary according to the nature of the LDC economy, its mode of integration into the global economy, and of course the policy response by the LDC governments. There are, however, common characteristics amongst the LDCs which limit their policy space and condition their capacities to deal with the impact of the crisis. An important characteristic of the LDCs which limits their policy space is the phenomenon of generalized or mass poverty. This is signified by the fact that the majority of the LDC population lives below the World Bank's global poverty lines of $1 or $2 a day (LDC report 2008). The global poverty lines are defined in 1993 purchasing power parity exchange rates, which translate to 20 to 60 cents in current dollars for each dollar of 1993 PPP rate in various LDCs.

In order to get a better idea of the implications of generalized poverty for the LDCs ability to cope with external shocks, Figure 23 reports the proportion of the population in different LDCs that live below $1 a day in 2005 at current exchange rates. The estimates are based on national accounts consumption data and the latest available income distribution data. It is evident that the majority of the population in LDCs live below $1 a day at current exchange rates. In fact on a population weighted basis, more than 82 per cent of the LDC population consumes less than one dollar a day at current values. Thr $1 a day standard here is of course non-comparable in terms of standards of living across the countries, as price levels vary between countries. But they nevertheless convey the important information that if the entire consumption basket, and a fortiori its tradable component, is exchanged at current international values, for most of the LDC population this will amount to less than $1 a day.

Figure 23, Per cent of populatin living below $1 a day (at current US dollars)



This highlights the extreme resource constraints that the LDCs confront in normal circumstances and the limits that this poses for their ability to adjust to the huge external shocks emanating from the international economy. One indication of this is the relatively low magnitude of what the LDC report 2000 referred to as domestic resources available for finance (DRAF). DRAF is defined as GDP minus household consumption, which in the case of the LDCs can be interpreted as domestic resources potentially available for investment and spending on public services. DRAF is shown in Figure 24 as a share of GDP for average LDC and for 110 other developing countries. Since the early 1980s the LDCs on average have had DRAF rate of about 18 per cent of the GDP, less than half of the 36.4 per cent in the case of other developing countries average (Figure 24). The extreme resource constraints under which the LDC policy makers have to function becomes particularly clear once it is recognized that the low DRAF rates in these countries are combined with extremely low private consumption levels, in the case of the majority of households not very far from the edge of poverty. A comparison with per capita consumption trends in other developing countries, as shown in Figure 25, makes it clear that low DRAF rates in the LDCs are not due high consumption levels, but more a symptom of extremely low productivity levels and lack of productive capacities in the LDCs.

These circumstances severely constrain the policy space in the LDCs even in normal times. The same phenomenon is also the cause of aid dependence of many African and Asian LDCs, which itself can further crowd out the policy space due to the lack of coordination and unreliability of aid flows as well as externally imposed conditionality. The extreme low levels of DRAF in the LDCs is the counterpart of the large external resource gaps and current account deficits discussed in the previous sections. Under the prevailing conditions of the LDC economies, such large current account deficits cannot be treated as simply a matter of overvalued exchange rates. Under the conditions of generalized poverty there may exist no real exchange rate which can maintain current account balance without pushing a large part of the population below extreme poverty levels. This is another example of policy constraints

Figure 24, Domestic resources available for finance (DRAF), LDCs and other Developing countries, 1980-2007

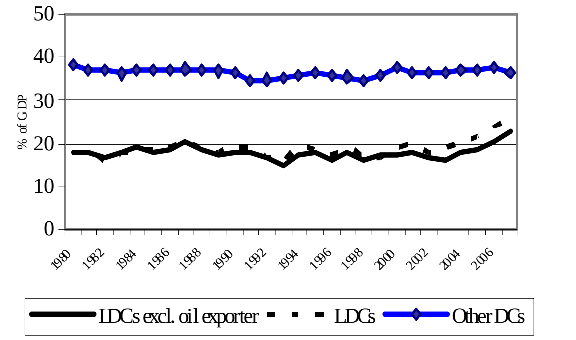
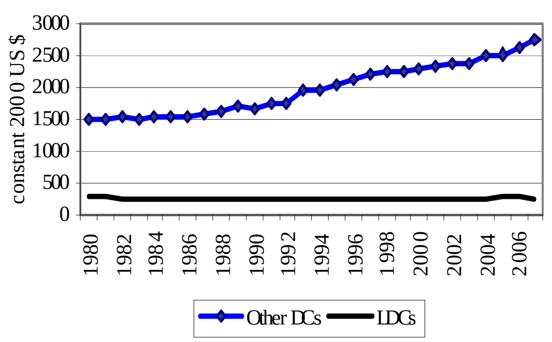


Figure 25, Per capita Household Consumption in LDCs and Other Developing Countries, 1980-2007



Source: Based on World Bank WDI.

facing the LDCs which emanates from the condition of generalized poverty and necessitates reliance on external resources even under normal conditions.

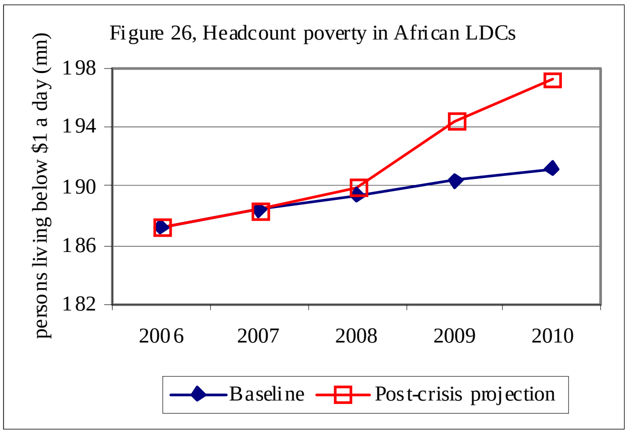
It is significant that during the recent growth episode prior to the global crisis the LDC economies exhibited significant improvement in their DRAF rate, increasing from about 17 per cent of the GDP in 2002 to over 25 per cent in 2007 (Figure 24). This was the case for both the oil exporting and non-oil exporting LDCs, and in fact in 25 out of 39 Asian and African LDCs for which data is available, or seventy per cent of the countries, DRAF rate increased appreciably between 2000 and 2007. The fact that during the same period real per capita consumption remained relatively stable (Figure 25), highlights the serious effort made by the LDCs to mobilize domestic resources for their development. The continuation of this process would in time lead to a situation where the LDCs, having built up enough productive capacities, will no longer be dependent on foreign assistance. The arrival of such major multiple shocks due to the global economic crisis, however, would not only jeopardize this process, but also without additional and appropriately directed external assistance it could lead to the collapse of the growth process and intensified poverty in the LDCs.

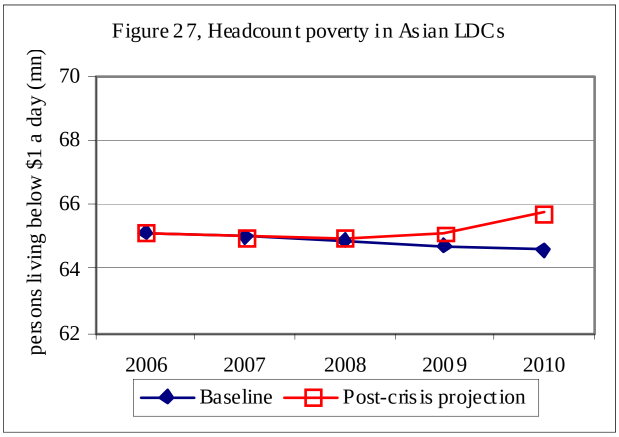
The impact of the global crisis on levels and intensity of poverty in the LDCs works through various direct and indirect channels discussed in the previous sections. The most immediate and direct channel is through its impact on economic growth, employment, and wages. However, some of the transmission mechanisms are more prone to impact the low income groups more than others and hence affect poverty through distributional changes as well. Workers remittances for example form a much higher share of income of the low income families and the decline in remittances is likely to intensify poverty by more than its apparent overall income effect. In addition to income generation, migration also plays an insurance role for low income families by diversifying their income sources. The concomitant negative shock of declining remittances and the slowdown of the domestic economy would hit the poor particularly hard.

Other more indirect mechanisms work through the impact of the crisis on government revenues, by diminishing the provision of social services vital to the poor, particularly at a time when the need for such services has increased. A similar effect will result if the crisis leads to a diminution in ODA directed to such social services. Deficiencies in the provision of health and educational services will have further adverse long term influences on growth and poverty.

To the extent that the global crisis has led to the fall in food and fuel prices it can somewhat alleviate the extent and intensity of poverty, as these are significant items in the consumption basket of the poor. However, if the crisis at the same time leads to abrupt devaluation of the exchange rate, e.g., due to flight of capital from the LDCs to more safe havens, these beneficial effects will not materialize. Similar forces can lead to an increase in interest rates in the LDCs, with negative effects on investment and employment, further hitting the poor. It is unlikely that the LDCs can face these challenges without adequate and well directed external assistance. The alternative is considerable increase in poverty in the short run and a possible derailment of their growth process for some years to come.

The full impact of the global crisis on the poverty in the LDCs, taking into account its direct, indirect and distributional effects, is best assessed by detailed country case studies. There is furthermore a great deal of uncertainty as to the depth and length of the unfolding global crisis, with important implications for LDC poverty. To get some idea of the orders of magnitude involved and assess the sensitivity of poverty to the multiple external shocks emanating from the crisis, projections of the impact of the crisis based on the latest available growth projections for the LDCs are shown in Figures 26 and 27 for the Asian and African LDCs. These estimates are based on the projections of the impact of the crisis on GDP growth in LDCs in 2009 by the IMF and in 2010 by the World Bank.[5]





Baseline projections are based on the assumption that economic growth in the LDCs continues uninterrupted at the same trend growth rate of 2002-07. Under the baseline assumptions,

[5] See IMF (2009) and World Bank (2009). The 2009 projections by the IMF are country specific, but for the 2010 projection of GDP growth we have taken World Bank's aggregate projected growth rates for sub-Saharan Africa and South Asia as proxies for African and Asian LDC growth rates.

in both the Asian and African LDCs headcount poverty, measured as the share of the population living below $1 a day declines.[6] However, in the African LDCs the number of the poor increases even under the baseline projections due to the fact that population grows faster than poverty rates decline.

The impact of the crisis is projected to lead to a considerable increase in the number of the poor in the LDCs. As a result of the crisis, by 2010 the number of the poor in African LDCs will be higher by an additional 6.1 million, and in Asian LDCs by 1.2 million, with a combined effect of 7.3 million. These are conservative estimates, as they do not take into account the impact of the crisis on income distribution and its indirect impact on public service provision for the poor. Furthermore at the time of writing, though the financial crisis in the industrialized countries seems to be abating, unemployment continues to increase and growth of production and trade continues to be revised downwards. Since the main transmission mechanisms of the global crisis for the LDCs is through the real economy effects, this does not bode well for the LDCs and the above poverty projections can turn out to be too optimistic.

7. Financing needs of the LDCs

The poverty estimates for 2009 in the previous section are based on IMF projections of GDP growth resulting from the external shocks and the economic adjustment that will take place in the LDC economies accordingly. Considering the unacceptable poverty outcomes of the projected growth rates from the viewpoint of achieving the Millennium goals of income poverty, and given that the shocks to the LDC economies are external and considered to be temporary, one may approach the question of the financing needs of the LDCs by examining the financial implications of possible alternative adjustments.

The IMF projections of the size of initial balance of payments shock arising from the global crisis is the combined result of the shocks to export volumes, terms of trade, remittances, and FDI flows. This initial shock is combined with other assumptions regarding economic adjustment to arrive at growth projections, estimates of foreign exchange reserve depletion, etc. We start with this initial balance of payments shock, in order to highlight the orders of magnitude of financing needs of the LDCs under other possible adjustments.

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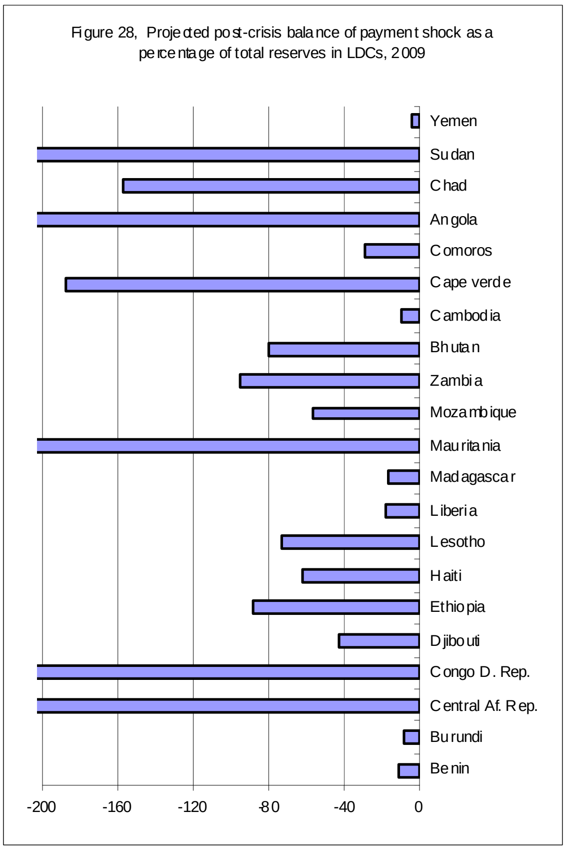
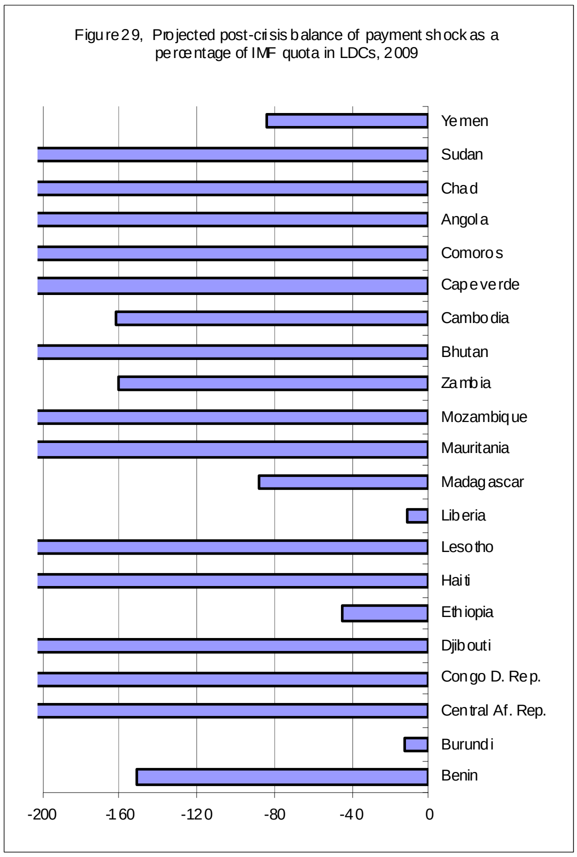
[6] Poverty estimates are based on poverty line $1.08 a day in 1993 PPP rates using the same methodology as in Karshenas (2008).

The size of the balance of payment shock in 2009, as a percentage of total foreign exchange reserves at the beginning of the period, for the LDCs is shown in Figure 28. The LDC economies that are excluded from the Figure have a positive balance of payments shock, presumably due to the fall in fuel and food import prices. As can be seen, for most LDCs experiencing a negative shock, the balance of payments shock is well over 50 per cent of foreign exchange reserves. At this rate foreign exchange reserves will be depleted fast. In fact the rapid depletion of foreign reserves can snowball as adverse expectations may give rise to capital flight and further exacerbating the initial shock.



Source: Based on IMF (2009)



Source: Based on IMF (2009)

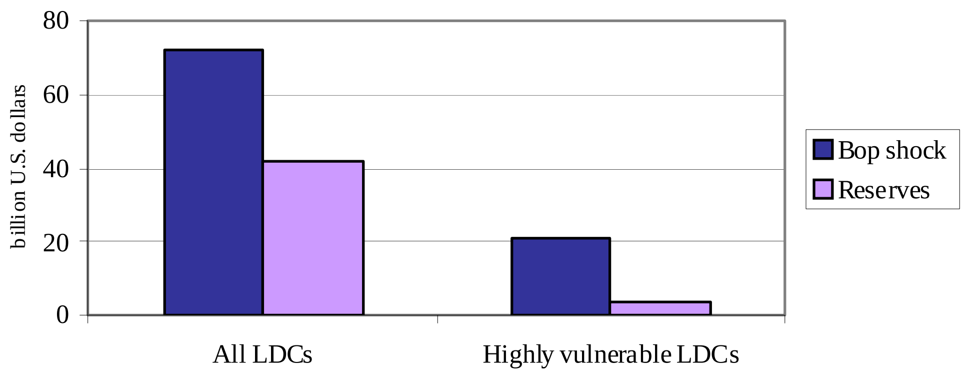
Another way of looking at the relative magnitude of the balance of payment shocks to the LDC economies is to compare them with the IMF quotas of the LDCs. The rapid-access component of the modified Exogenous Shock Facility (ESF) of the IMF provides funding up to 25 per cent of the quota for each LDC, and its high-access component up to 75 per cent of the quota. Figure 29 shows the balance of payment shocks to the LDCs as a percentage of each country's IMF quota. In over 75 percent of the LDCs, the magnitude of the projected balance of payment loss in 2009 is well over 100 per cent of the country's quota. This, apart from showing the inadequacies of the current facilities for low income countries, also demonstrates the large magnitude of the combined external shocks hitting the LDC economies at this time.

Some kind of adjustment in the LDC economies is certainly needed. In fact, the negative external shocks will themselves bring about a great deal of adjustment in the economy through the various deflationary mechanisms discussed in the previous sections. This, however, will not be satisfactory as it will inevitably intensify poverty and can undermine the long term growth prospects of the economies affected as well. Appropriately designed and well directed policies, combined with adequate external assistance can substantially improve the adjustment process and its outcomes. The IMF projections are based on one set of assumptions regarding such policies, taking into account the existing aid commitments and grants. Considering the existing domestic resource constraints facing the LDCs, it is unlikely that they can improve their performance much more than the IMF projections without additional external resources – of course within the bounds of the uncertainties associated with such projections in general.

The combined balance of payments shock to the LDCs due to the global crisis constitutes an immediate income loss to these economies. A measure of such income loss for the LDCs as a whole can put in context the dimensions of the problems faced by these economies in the wake of the global crisis and give some idea of the magnitude of additional external gap that needs to filled one way or another. Figure 30 shows the value of income loss due to adverse external shocks in 2009 for the LDC countries as a group as well as a sub-group of LDCs that the IMF (2009) has classified as highly vulnerable to the global crisis. The value of foreign exchange reserves for the countries in each group is also shown. The total income loss to the LDCs is estimated to be about $71.5 bn dollars in 2009. This compares with $28.2 billion dollars net ODA received by the LDCs in 2006, and is $30 bn dollars, or more than 70 per cent, higher than the combined foreign exchange reserves in the LDCs that are negatively affected by the global crisis. In the case of the highly vulnerable LDCs, the income loss is $20.7 bn which is four times the foreign exchange reserves of the countries in that group, and not far from the entire net average annual ODA to the LDCs as a whole during 2000-05.

These estimates constitute considerable income shock relative to the size of the LDC economies. In both the overall LDC group and the highly vulnerable LDC group, they constitute over 30 per cent of the GDP of the countries included in each group. Even if we allow for half of this to be absorbed by utilizing foreign exchange reserves and possibly front loading some future aid commitments, the LDC economies as a whole will be still faced with an additional deficit equivalent to 15 per cent of the GDP. This is not of course distributed across the countries equally. Some countries are hit harder than others, e.g., oil and mineral exporting countries, and a particular country's burden may not be necessarily proportional to its ability to cope with the shock. It is also important to keep in mind that the existing projections are likely to contain a large margin of error, particularly when based on forecasts of highly volatile items such as commodity prices. Nevertheless, it is clear that any credible macroeconomic framework for poverty reduction in the LDCs has to allow for access to sizable contingency funds to cope with multiple negative shocks of the type confronting the LDCs at this time.

Figure 30, Forein exchange reserves and Income loss due to the balance of payments shock in LDCs and highly vulnerable LDCs, 2009



Source: Based on IMF (2009)

7. Concluding remarks and suggested policies

The impact of the global economic crisis on different LDCs is highly varied, particularly depending on the nature of their trade specialization. The overall shock according to the existing projections, however, appears sizable and requires drastic action, both on the part of the LDC countries themselves and the international donor community. Such action should be guided by the realities on the ground in the LDCs as well as the nature of the shocks arising from the global crisis. Some of these can be identified at a general level, and others need to be worked out on a case by case basis.

At a general level, two important characteristics of the multiple shocks hitting the LDC economies need to be noted. First, the shocks are exogenous and entirely outside the control of the LDCs and not of their making. Secondly, despite the lack of certainty about the intensity and duration of the global crisis, the shocks should be treated as temporary as far as the LDC economies are concerned. These two characteristics imply that any remedial measures taken by the LDCs should not affect the basic strategies of development or the fundamental structural features of these economies. If there are grounds for such changes, they should be justified accordingly and not on the basis of the current conjuncture. Though the current situation can highlight some of the flaws of the existing institutional arrangements and pave the way for bringing about change in the long run.

The third characteristic of the current adverse shocks hitting the LDCs relates to the sheer size of these shocks compared to the resources that the LDCs can muster both internally and in relation to the current ODA budgets. As to the domestically generated resources, we have observed that the LDCs suffering from generalized or mass poverty, even under normal circumstances have to rely on external resources to finance vital public services and investments. As we have also observed in this paper, during the growth episode prior to the global crisis, the LDCs showed considerable effort in mobilizing newly generated domestic resources to finance their development at the expense of current consumption. The promising trends in growing domestic resources available for financing developmental expenditures (DRAF), can be jeopardized due to the adverse shocks arising from the global crisis. As we have shown in this paper, the crisis can also add considerably to poverty in the LDCs.

The financing needs of the LDCs to cope with the adverse shocks due to the global crisis are large relative to the size of the LDC economies, but relatively small (indeed minuscule) in comparison to the fiscal and monetary stimuli provided by the governments in the advanced economies. In fact if all DAC member countries fulfil their Brussels Programme of Action targets for aid for only one year, the funds will be more than sufficient to cover the financing needs of the LDCs resulting from the global crisis in 2009. According to OECD DAC (2009), the total ODA allocation to LDCs during 2006-07 constituted 0.09 per cent of the GNI of DAC member countries. To put things in perspective, it is worth noting that as a result of the financial crisis the public debt of advanced OECD countries is projected to increase to over 100 per cent of their GNI by 2010. A doubling of LDC aid budget in 2009 would increase the national public debt in donor countries to 100.09 of their GNI -- hardly more than a rounding off error for the donors' public debt but vital in the lives of more than 400 million LDC inhabitants.

Of course financing may appear to be the most significant stumbling block, but it is not the most important aspect of policy design to deal with the impact of the global crisis on the LDCs. It is vital that each LDC country produces their own detailed appraisal of the impact of the crisis, their financing needs under different contingencies, and specific policies to deal with the impact within the macroeconomic framework of their PRSP.