

THE GLOBAL ECONOMIC AND FINANCIAL CRISIS



Regional Impacts,
Responses and
Solutions



The Global Economic and Financial Crisis: Regional Impacts, Responses and Solutions



United Nations

New York, 2009

United Nations publication
Sales No. E.09.II.F.18
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ISBN: 978-92-1-120585-5

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ACKNOWLEDGEMENTS

The report is a joint product of the five United Nations Regional Commissions (Economic Commission for Africa (ECA), Economic Commission for Europe (ECE), Economic Commission for Latin America and the Caribbean (ECLAC), Economic and Social Commission for Asia and the Pacific (ESCAP) and Economic and Social Commission for Western Asia (ESCWA)).

The report was prepared under the overall coordination and direction of Noeleen Heyzer, Executive Secretary of ESCAP and Current Coordinator of the Regional Commissions, assisted by Shigeru Mochida, Deputy Executive Secretary and Officer-in-Charge of the Macroeconomic Policy and Development Division of ESCAP and Tiziana Bonapace, Chief of the Macroeconomic Policy and Analysis Section. Amr Nour, Officer-in-Charge, Regional Commissions New York Office coordinated the preparations and the contributions of the Regional Commissions to the publication.

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The manuscript was edited by Peter Stalker, the layout and printing were provided by TR Enterprise, and Marie Ange Sylvain-Holmgren contributed to the design of the cover page.

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ACRONYMS

ADB	Asian Development Bank
AfDB	African Development Bank
AIDS	Acquired immunodeficiency syndrome
AIG	American International Group
APF	African Partnership Forum
ASEAN	Association of Southeast Asian Nations
AUC	African Union Commission
CAF	Andean Development Corporation
CFA	Communauté Financière Africaine
CIS	Commonwealth of Independent States
CPIA	Country Policy and Institutional Assessment
DSF	Debt sustainability framework
EBRD	European Bank for Reconstruction and Development
ECA	Economic Commission for Africa
ECB	European Central Bank
ECE	Economic Commission for Europe
ECLAC	Economic and Social Commission for Asia and the Pacific
ECOWAS	Economic Community of West African States
EIB	European Investment Bank
ESCAP	Economic and Social Commission for Asia and the Pacific
ESCWA	Economic and Social Commission for Western Asia
EU	European Union

ACRONYMS *(continued)*

EurAsEC	Eurasian Economic Community
FDI	Foreign direct investment
FLAR	Latin American Reserve Fund
G8	Group of eight countries
G20	Group of twenty countries
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GNI	Gross national income
HIV	Human immunodeficiency virus
IDB	Inter-American Development Bank
IIF	Institute of International Finance
ILO	International Labour Organization
IMF	International Monetary Fund
IOM	International Organization for Migration
MDG	Millennium Development Goals
NMS	New member states
ODA	Official development assistance
OPEC	Organization of Petroleum Exporting Countries
SDR	Special Drawing Right
SEE	South-East Europe
SMEs	Small and medium-sized enterprises
SWF	Sovereign wealth fund

ACRONYMS *(continued)*

UNCTAD	United Nations Conference on Trade and Development
UN-DESA	United Nations Department of Economic and Social Affairs
UNDP	United Nations Development Programme
VAT	Value added tax
WGP	World gross product
WTO	World Trade Organization

A CRISIS ACROSS THE REGIONS

The five Regional Commissions come together at a time in which the world's economies face some of the most difficult challenges presented in the past century: from climate change effects to extreme food/fuel price volatility to the worst global recession since the Great Depression. The effects these are having on developing countries' efforts to meet the Millennium Development Goals are worrisome.

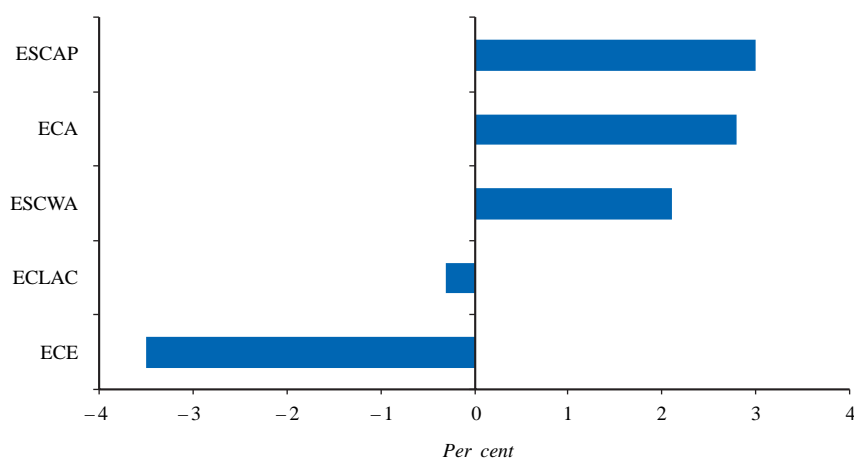
This report focuses on the economic crisis. What started as a financial crisis in the United States has quickly unfolded into an economic crisis that now threatens to roll back the development gains of the last decade and may precipitate a human tragedy in many parts of the developing world. The issues are global: this affects every developing country from every region requiring that each country devise a strategy for addressing the challenges. At the same time, intergovernmental cooperation, both globally and regionally will be central towards ensuring that the solutions are equitable and efficient.

The analysis presented in this report provides a regional perspective on how this crisis is impacting the member states of the five Regional Commissions of the United Nations, and examines the type and adequacy of responses at the national and regional levels. It suggests ways in which the Regional Commissions can use their collective strengths to prevent the economic crisis from becoming a human crisis.

Each region, not to mention each country, has its own unique set of challenges, but the report finds many commonalities and, based on these, it identifies further opportunities for policy coordination and cooperation at the regional and inter-regional levels. The report concludes that the regional dimension provides an important and effective framework – not just for mitigating the impact of the current crisis but also for reducing the chances of similar crises in the future.

All regions have suffered declines in growth

According to World Bank estimates, the global economy is expected to contract by 1.7 per cent in 2009, the first decline on record in world output (World Bank, 2009). The crisis will plague economies all over the world – but the impact will differ in scale and severity from one country and region to another (Figure 1). The epicentre is the ECE region where economic growth in its ad-

Figure 1 – Real GDP growth by region, 2009

Source: Based on data from Regional Commissions.

vanced economies turned negative between late 2007 and 2008. Annual real growth in the region as a whole is forecast to fall from +1.5 to –3.5 per cent between 2008 and 2009. The emerging European economies in particular have been hit hard – suffering from a sudden halt in capital inflows while lacking the policy space to implement expansionary monetary and fiscal policies.

In the ESCWA region, between 2008 and 2009, GDP growth is expected to fall from 6.1 to 2.1 per cent. The Gulf Cooperation Council countries, which are now suffering from large declines in oil prices and depressed real estate markets, will see growth fall from 5.8 to 1.1 per cent. The economies in the ECLAC region are also experiencing falls in commodity prices, which for some countries make up a large part of GDP, as well as from declining flows of remittances. This will depress economic growth across Latin America and the Caribbean where, after six consecutive years of steady expansion, ECLAC estimates GDP is

expected to contract to –0.3 per cent. In the ECA region, preliminary evidence also indicates slower growth. Despite earlier predictions that African economies, with relatively low levels of integration with the global economy, would, to a certain extent, be insulated from the brunt of the crisis, growth forecasts for 2009 are being reduced by between 2 and 4 percentage points. In the ESCAP region the developing economies initially showed resilience since, following the Asian financial crisis in 1997, they had implemented wide-ranging financial and regulatory reforms. Now, however, they are feeling the effects through declining trade, on which the region is heavily dependent. As a result, compared with 5.8 per cent growth in 2008, the ESCAP region is expected to grow in 2009 by only 3 per cent. This is nevertheless faster than in many other parts of the world so, given that the region's developing economies account for 16% of World GDP, Asia and the Pacific is likely to be the locus of global growth in 2009.

Despite banking sector rescue plans, risks remain

When the United States property bubble burst, dramatic increases in mortgage defaults brought insurmountable consequences for the world's banking sector and financial markets. Many banks were over-exposed to bad loans or the complex financial assets derived from them. As a result, market participants became risk adverse and when questions arose about the solvency of major financial institutions; this triggered a severe credit crunch which ultimately affected the real economy.

The IMF estimates that toxic assets held by banks and financial institutions, most of which are in the developed ECE economies, could reach \$4 trillion (IMF, 2009a). Since their exposure is on such scale as to threaten systemic failures in banking systems, governments have been assembling rescue plans – unloading the toxic assets from bank balance sheets as well as recapitalizing the banks so they can resume normal lending operations. This may be essential but it is also risky, for if the plans to 'fix' the banks fail, and require large additional sums, this will continue to absorb funds that are urgently needed for stimulating the real economy and addressing the world's other pressing problems.

A further source of vulnerability in many places, including the emerging European economies, is that foreign capital is drying up. This is not yet a severe issue for the major economies in ESCWA and ESCAP regions, which have relatively low levels of non-performing loans – currently under the 8 per cent threshold. But if the credit crunch gets worse many other enterprises and banks will come under stress. In the ECA region

many of the banks are foreign owned, exposing them to a risk that their owners may choose to offer less support to operations in Africa or sell their assets with serious consequences for Africa's financial sector.

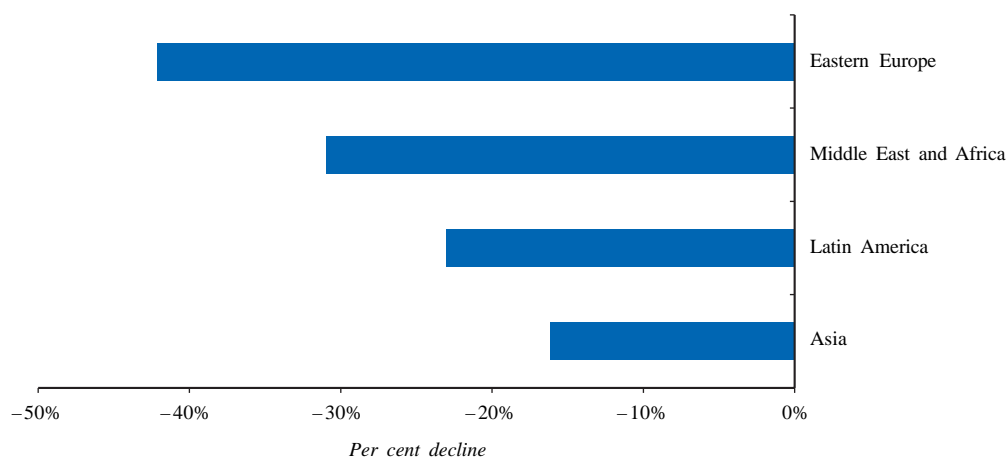
Falling equity prices

All regions first felt the impact of the economic crisis through rapidly declining equity markets – in some cases coupled with massive outward capital flows and an associated depreciation in exchange rates. The ECE region, especially the emerging markets in Eastern Europe, has substantial exposure to foreign capital, and since September 2008 markets have declined by over 40 per cent, while stock markets in the ESCWA region witnessed a sharp decline of nearly 50 per cent in 2008, pushing them to their lowest level since December 2004. Most African countries, on the other hand, with less-developed financial markets and limited links with the global financial markets, have been insulated to some extent from the global financial crisis. Nevertheless, countries like Egypt and Nigeria, with more developed financial markets, have taken a hit: between March 2008 and March 2009, their stock market indices declined by around 67 per cent. Some countries in the ESCAP region have also recorded sharp declines since the crisis, though the losses in Asia and the Pacific have generally been lower than elsewhere (Figure 2).

Capital flows have been drying up

The global economy has seen a reduction in all categories of capital flows including overseas development assistance (ODA),

Figure 2 – Regional emerging markets equity indices, 19 September 2008-16 April 2009

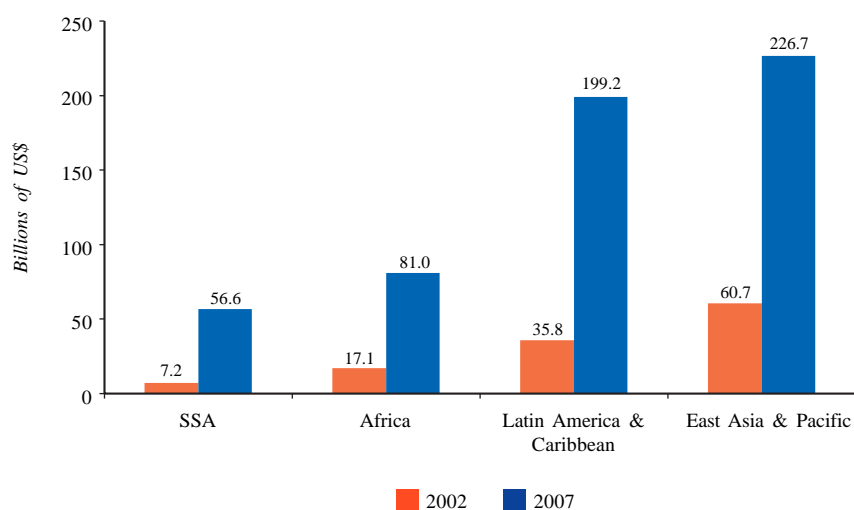


Source: ESCAP calculations based on data from MSCI Barra.

foreign direct investment (FDI) and remittances. This has affected developing countries in all five regions, though to varying extents. Over the past decade, all five regions have seen dramatic increases in capital flows (Figure 3). These are now under threat. Countries in the ECLAC region and the CIS, for example, have already seen a

drop in FDI. Here one of the triggers has been a fall in commodity prices since most of the region’s FDI comprises investment in natural resources. The ESCAP region has also been affected: after rising dramatically during the past decade, FDI inflows have started to decline. The ESCWA region is expected to have witnessed a decrease of

Figure 3 – Net private capital flows to developing country regions, 2002 and 2007



Source: Economic Commission for Africa.

21 per cent in FDI in 2008, largely due to a sharp setback in the last quarter.

Many developing countries also depend heavily on remittances to combat poverty and meet basic needs, such as food, housing, health and education. As migrant workers lose their jobs, remittances are expected to fall. Indeed there are already reports of an increase in the return of unemployed migrants in Asia as well as the ESCWA region. This will affect some of the poorer countries in the ESCAP region as well as countries in the ECLAC, ECA and ESCWA regions.

ODA commitments are increasingly shaky. Pressures are mounting in major donor countries to recapitalize financial institutions, support other ailing industries and revive domestic demand – leaving less available for ODA. Among the recipients likely to suffer most from falling ODA are the least developed countries, of which many are in the ECA region and vulnerable populations in conflict-affected member states throughout the world.

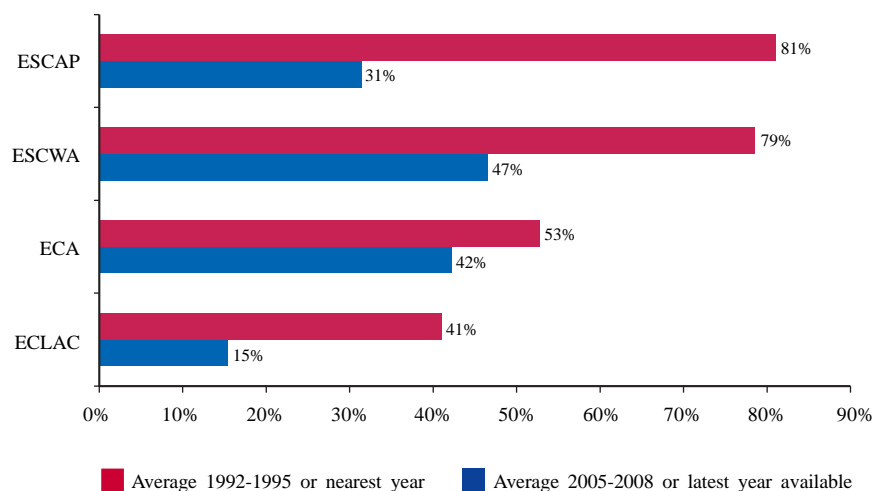
Sharp falls in commodity prices

Following the slump in global demand, the commodity price boom has turned to bust. Since their peak in mid-2008, oil prices, for example, have fallen by more than 70 per cent, energy prices by 60 per cent, and food and metals by nearly 36 per cent. This is hurting many developing countries in Africa and Latin America and the transition economies of the CIS that are heavily dependent on primary exports. OPEC members have now cut production, but oil prices are expected to remain below \$60 per barrel for 2009 with serious consequences for oil exporters, not just in the ESCWA region but also in North and Central Asia (IMF, 2009b).

On the other hand, many non-oil producing countries and regions will benefit from the relatively low prices of oil and other commodities, and a consequent easing of inflationary pressures. The volatility of oil prices in 2007 and 2008 has made it difficult for countries to make the necessary plans for meeting basic energy and subsistence needs.

Contracting global trade

Falling global demand and the drying up of trade finance have dramatically reduced trade. The World Trade Organization projects that in 2009 the volume of world merchandise trade could plunge by 9 per cent (WTO, 2009). The ESCAP region will, given its high trade-orientation, be hit particularly hard – especially in some of the export-oriented South-East Asian economies where, during 2008, exports switched from double-digit growth to double-digit decline. These countries are particularly exposed because they have focused on meeting consumer demand in developed countries. And while in recent years they have also increased exports to developing Asian markets, this is unlikely to serve as much of a cushion because a lot of this intra-regional trade, especially with China, consists of manufactured parts and components which are assembled in China but destined for developed country markets. Many African countries also depend on a few key exports, such as textiles and cut flowers, and have seen their trade income fall. The export declines have also been large even in the advanced economies of the ECE whose exports are extremely diversified in manufacturing, while the ESCWA region will be deeply affected by contractions in oil exports to developed countries.

Figure 4 – Total trade as a percentage of GDP (constant 2000 prices)

Source: IMF statistical databases, <http://www.imfstatistics.org/imf/>, as of 5 May 2009.

Rising protectionism

There are rising concerns that governments in recession-hit countries will give in to protectionist pressures. The pending conclusion of the Doha round of WTO negotiations has left trade more vulnerable to government impulses for protectionist and other trade-distorting measures. Many countries are, to a certain degree, already introducing either covert or explicit forms of protectionism through their fiscal stimulus packages. Since September 2008, countries across the world have implemented 47 trade-related measures and have proposed an additional 33 (Newfarmer, 2009). In the ECLAC region there were five cases of increases in tariffs or import restrictions. Such restrictions have also been seen in the ESCAP region, where, for example, China and India have imposed more stringent import measures while Indonesia requires special licenses for imports of some products. The sectors typically affected are textiles, footwear, toys, electronics, food and beverages.

Protectionism while palatable for dealing with immediate pressures, only exacerbates the downturn and makes it more difficult to achieve strong growth during the subsequent recovery. This makes it all the more important to conclude the Doha round in a manner that institutionalizes the trade and development linkages through a rules-based system of multilateral trade.

Rising unemployment, increasing poverty

Sharp declines in aggregate demand across all five regions are taking their toll on industrial production and leading to rising unemployment. Factory closures and layoffs will hurt the working poor, especially women and youth, as the manufacturing industry employs large numbers of unskilled workers. This will place an enormous economic burden on many developing economies. In the ESCAP region, the 1997 crisis showed that when people are hit by sudden shocks, those most at risk are the poor, the

youngest and oldest people, and socially excluded groups. In the labour force, the main casualties are those with flexible employment- low skilled, temporary, casual workers. Women often constitute the majority of these workers. The damage also lasts much longer than the crisis itself. After the 1997 Asian financial crisis, for example, economic growth resumed relatively quickly, but some countries took up to 10 years to recover the ground they had lost in the struggle against poverty (ILO, 2008a). In 2008, the employment impact was felt most in the export manufacturing sector, including garments, electronics and automobiles, but the crisis is also expected to hit construction, tourism, finance, services and real estate. The least developed countries have less exposure to the financial crisis, since their financial sectors are less integrated into the global markets, but the poor in these countries will nevertheless be affected through lost exports and remittances and reduced donor assistance.

The ILO is predicting that 50 million people will likely lose their jobs during the current crisis as world unemployment increases from 180 million in 2007 to 230 million. Over the next year, 23 million workers in Asia and the Pacific could lose their jobs. In the ECLAC region unemployment in 2008 was 7.5 per cent but in 2009 it is expected to rise to between 8.5 and 9.0 per cent. In the ECE region, by 2010, unemployment rates in the United States, Europe, Turkey and the CIS are likely to reach double digits. In sub-Saharan Africa, ILO estimates that in 2009 as many as 3 million workers could lose their jobs. In Western Asia, it is anticipated that 10 percent of unskilled workers will return home from the Gulf Cooperation Council (GCC) countries, thus worsening unemployment in their home countries in

other parts of Western Asia and beyond. According to the latest ILO estimates, the Middle East and North Africa had the highest unemployment rates – at 10.3 and 9.4 per cent respectively – in 2008.

The crisis is disproportionately affecting the groups that did not benefit much from the earlier expansion of the global economy. In most regions the economic crisis will push a large number of workers into vulnerable employment in the informal sector – which already absorbs a high proportion of workers. Youth, women and migrant workers – groups which already face labour market discrimination – would feel the effects most intensely.

Unemployment can threaten many hard-won social achievements, particularly in education. During times of economic crisis, the poorest families may pull their children from school and require them to work to supplement the family income resulting in losses in human capital that undermine prospects for future economic and social development. The majority of people who become unemployed do not get unemployment benefits. About 80 per cent of the world population is not covered by social protection. Supporting households helps sustain domestic demand and thus acts countercyclically to promote macroeconomic stability, if such systems are in place before the crisis hits. It is clear that effective systems of social protection to make societies more resilient will need to be given higher priority and be implemented with more urgency than in the past.

To meet the employment challenge, the United Nations supports a “Global Jobs Pact” to generate decent work as a mainstay of any global stimulus (United Nations, 2009a, ILO, 2009a). Such an approach

takes account of the interlinkages between the financial, trade, economic, employment and social roots of the global crisis and the required policy responses.

Expansionary monetary and banking policies

Around the world, most countries have responded to the economic crisis by cutting interest rates and injecting more liquidity into financial systems. In the ECLAC region, for example, several central banks, in addition to cutting key interest rates, have lowered reserve requirements. Also in some cases in the ESCAP and ESCWA region guarantees for bank deposits have been provided. Similarly, in the ECA and ESCAP regions, governments have established loan guarantees for domestic firms in order to facilitate lending and improve the flow of credit. But not all countries have the flexibility to implement such policies. In the ESCAP region, some countries have already implemented historically low interest rates. However, for many emerging markets there are concerns that further cuts in interest rates could destabilize their currencies by triggering capital outflows; for example, this would be a risk for Egypt and Lebanon and for many of the emerging European economies.

Moreover, if the downturn deepens and inflation is replaced by deflation, conventional monetary easing will lose its effectiveness. For this reason, the advanced economies in the ECE region that already have near-zero interest rates, such as the United States, the United Kingdom and Switzerland, have found it necessary to increase their money supplies through quantitative easing. In the ESCAP region, developing countries experiencing deflationary

pressures may have to consider similar measures if the macroeconomic environment deteriorates further. Expansionary monetary policies do, however, create the risk that excess liquidity, if left unchecked, may find its way into speculative markets, triggering, once again, volatility in commodity prices and, in the aftermath of the crisis, inflationary pressures.

Combating recession with fiscal stimulus

In light of the relative ineffectiveness of monetary policy caused by already low interest rates and dysfunctional financial markets, much of the attention has focused on fiscal policy. Many governments have concluded that the best way to combat recession is to introduce fiscal stimulus packages that can boost domestic demand and help counteract losses in confidence. To date, the major industrialized countries, and some developing countries, have devised fiscal stimulus plans totalling about \$2.6 trillion, or 4 per cent of world gross product (WGP), to be spent between 2009 and 2011 (UN-DESA, 2009). In some countries this will lead to massive budget deficits, but even so it may still fall short of what is needed. The United Nations estimates that the world needs a stimulus of around 3 per cent of WGP per annum (IMF, 2009c). Also, to maximize the multiplier effects globally, there is an urgent need for policy coordination.

Most agree that the stimulus packages should be front-loaded and commensurate with the size of the crisis, but debate continues over their contents – on whether governments should devote their resources to investment in infrastructure, or to direct trans-

fers or on tax cuts. The packages also have to be tailored to national priorities and circumstances. Some countries, for example, are in a better position to embark on extensive stimulus packages while others are impeded by large existing fiscal deficits. In the ESCAP region, strong macroeconomic fundamentals and high savings rates have enabled some countries to introduce large fiscal stimulus packages. China for example has announced a package amounting to \$586 billion, the second largest in the world (US being the largest) amounting to around 13 per cent of GDP. Overall, fiscal stimulus packages have been focused on macroeconomic stabilization and infrastructure spending, with relatively less attention having been given, particularly at the beginning, to the social consequences, and the disproportionate burden of the crisis on the poor and women. Putting in place social protection systems is a centrepiece of the policy responses required. Not only does it create more inclusive and harmonious societies, it also mitigates the depth of the economic crisis. By increasing income security, the spending power of middle and lower income people is freed up, thus increasing domestic demand and macroeconomic stability.

An uncertain economic outlook

In the second quarter of 2009, the economic situation appears to have plateaued and some countries are showing tentative signs of recovery. However, there is also the risk that the global economy could take another plunge. The uncertainty has been exacerbated by the outbreak of influenza A, and the ongoing uncertainties on how virulent it will turn out to be. It could impose enormous economic costs – as have already been witnessed in Mexico.

Regional responses for early recovery

Most responses to the economic crisis will take place at the national level, while others ideally should be globally coordinated. But many can best be undertaken at the regional level. Even in a globalized world, the strongest links – whether for trade, finance, remittances or migration – are typically with neighbours. Countries in the same region or subregion are also more likely to share common problems and have a clear self-interest in arriving at mutual solutions. Equally important is that policy-making at the regional level promotes consensus that can serve as building blocks for multilateral policy coordination.

In all of this they can take advantage of the expertise and activities of a large number of regional institutions, with Regional Commissions presenting an institutional blend of multilateral and regional approaches that is unique.

Regional financial cooperation

Regional financial institutions have been active in providing support. Many have been extending their credit lines and lending facilities to help member states overcome short-term difficulties, and in certain cases have been providing access to long-term finance. Additionally, regional and sub-regional organizations have been playing an important role in cross-border anti-crisis measures. In the ESCAP region, for example, one of the major regional groups has created a multilateral foreign exchange pool: in May 2009 the ASEAN+3 Finance Ministers reached an agreement which paves the way for converting an existing bilateral fund of \$80 billion to a multilateral pool of \$120 billion (ASEAN, 2009).

Efforts at regional coordination

Across all five regions, governments have been coordinating their responses to the crisis through policy dialogues. For example, following their meeting in Tunis in November 2008, the African Ministers of Finance and Planning and Governors of Central Banks agreed on measures to be taken at the national, regional and international levels to mitigate the effect of the crisis on African countries. Similarly, in Kuwait, in January 2009, the First Arab Economic Summit called for a coordinated policy response among the Central Banks in the region and endorsed several major infrastructure projects to strengthen regional cooperation among Arab states and mitigate the impact of the crisis. The EU leaders have been in close consultations throughout the crisis in attempts to coordinate their countries' fiscal and regulatory responses, while in the first Latin American and Caribbean Summit for Integration and Development, held in Brazil in December 2008, countries agreed to discuss creating a regional and subregional financial architecture for further integration of financial markets in the regional and sub regional sphere, to develop or strengthen regional mechanisms for balance-of-payments stabilization, promote further cooperation between national and regional development banks, and consider the installation of a mechanism for trade payments in local currencies. In the ESCAP region, at the 65th Session of the Commission, held from 23 to 29 April 2009, governments adopted resolution E/ESCAP/65/L.7 (ESCAP, 2008). While expressing concern about the financial crisis which had become a global economic crisis that could complicate efforts to achieve energy and food security in the region, the Commission urged implementation of re-

gional cooperation initiatives. To this end it requested the Executive Secretary to continue to assist countries through indepth analysis, policy dialogue and advocacy and increased capacity-building activities (ESCAP, 2009).

The way forward: the role of regional policy-making

As the Secretary-General of the United Nations said to the leaders of the G20, “a genuine solution of the crisis requires a new international financial and economic architecture that reflects the changing realities in the world and gives greater voice to emerging and developing economies” (United Nations, 2009b).

Developing countries are contributing ever larger shares of economic output in the globalized economy – and are thus deeply affected by decisions taken in developed countries. They must therefore have a greater voice in the global debate, through participation in the bodies charged with economic recovery and regulatory reform.

For this purpose, they could use existing regional platforms, more effectively. The secretariats of the Regional Commissions can support governments and their partners to consider policy options, sharpen their common positions and put in place the building blocks for essential multilateral reforms. They should be able to use these platforms to argue for the most positive long-term solutions – including policies on trade, finance, and overseas development assistance. For finance, the area where policy coordination is still at a nascent stage compared to other areas such trade, this would mean measures to reform the international system to make it more inclu-

sive with developing countries assuming a more influential voice on the reforms needed to avoid the depth of boom-bust cycles and encourage the stable flow of capital to developing countries. For trade, for example, this would mean an expedited conclusion of the Doha Round that would discourage protectionist measures and promote international trade for development. For overseas development assistance, this would mean encouraging developed countries to follow through on their declaration at the G20 Summit in London in April 2009, which reaffirmed all existing commitments to provide more aid and debt relief to the poorest countries and promised \$300 billion in support.

Developing countries will also play a central part in the United Nations global vulnerability monitoring and alert mechanism. This country-driven mechanism will be light in structure and build on existing alert and monitoring capacities and mechanisms across the United Nations system in an inclusive manner. In this regard, the Regional Commissions can support developing countries through their existing well recognized analytical and statistical capabilities. Their distinctive region-specific analysis could make an important contribution in filling the large information gap that exists between when a crisis hits vulnerable populations and when information reaches policy-makers through official statistical channels (United Nations, 2009c). The rapidity and depth of the current crisis underlines the importance of real-time and compelling analysis. Looking forward, what will be needed is faster and improved pre-emptive analysis and advocacy.

Regional Commissions can also provide an important platform for deeper regional eco-

nomic and financial cooperation. In this crisis, the current international architecture has demonstrably failed to respond with sufficient speed or force to the distinctive problems faced by developing countries. Instead regions can work together to marshal their own resources and “insulate themselves from regulatory and macroeconomic failures in systemically significant countries” (United Nations, 2009d). If countries coordinate their policies at the regional level they will gain greater credibility, helping to shore up confidence while enhancing regional and global multiplier effects. This should not, however be regarded as an alternative to full participation in global economic relations but rather as a complement to it, by filling in the gaps in the global system.

Future intraregional financial and economic cooperation can include, for example, pooling funds to respond to balance-of-payments and liquidity crises, cooperating more closely on monetary issues such as exchange rates, integrating equity and debt markets, coordinating financial regulation and supervision, and promoting intraregional trade, such as by providing trade credit. This enhanced cooperation will also mean complementing international financial institutions by upgrading the existing regional financial architecture.

Of particular importance in the current crisis is the coordination of fiscal policies because they provide an excellent opportunity for promoting the idea that economic recovery should be based on a more inclusive and sustainable development paradigm. The Regional Commissions could provide the institutional infrastructure for an inter-governmental fiscal policy regional coordinating mechanism.

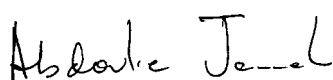
A global crisis demands a global response. But action will be much more effective if it is built on strong regional foundations, as groups of developing countries with similar problems share their experiences and coordinate their activities. Rather than com-

peting with each other they can take complementary and mutually reinforcing actions that re-ignite national economies and enable people all over the world to live free from want, from fear, and from discrimination.



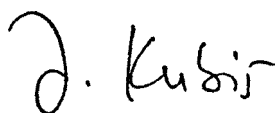
Noeleen Heyzer

Executive Secretary of the Economic and Social Commission for Asia and the Pacific and Coordinator of the Regional Commissions



Abdoulie Janneh

Executive Secretary of the Economic Commission for Africa



Jan Kubis

Executive Secretary of the Economic Commission for Europe



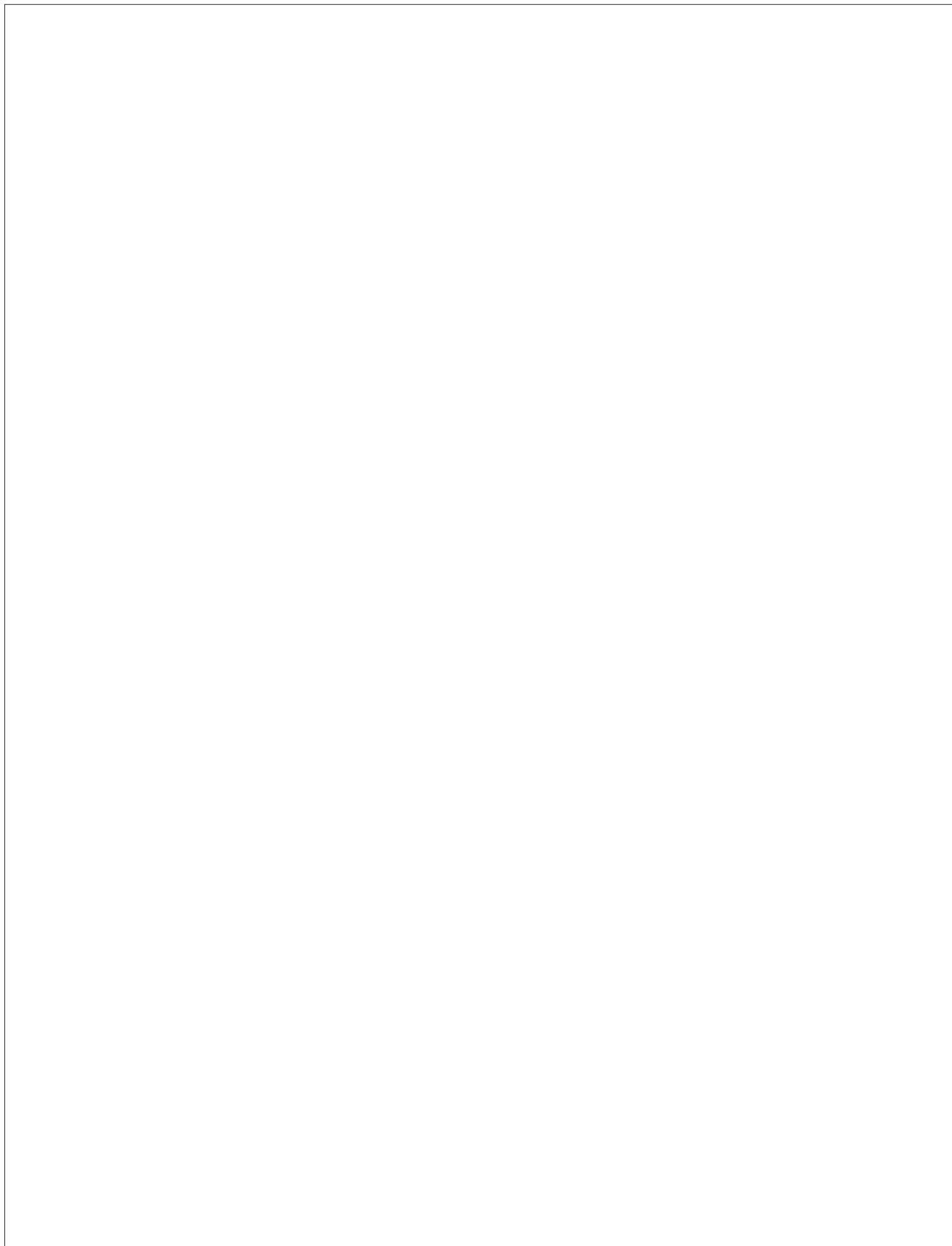
Alicia Bárcena

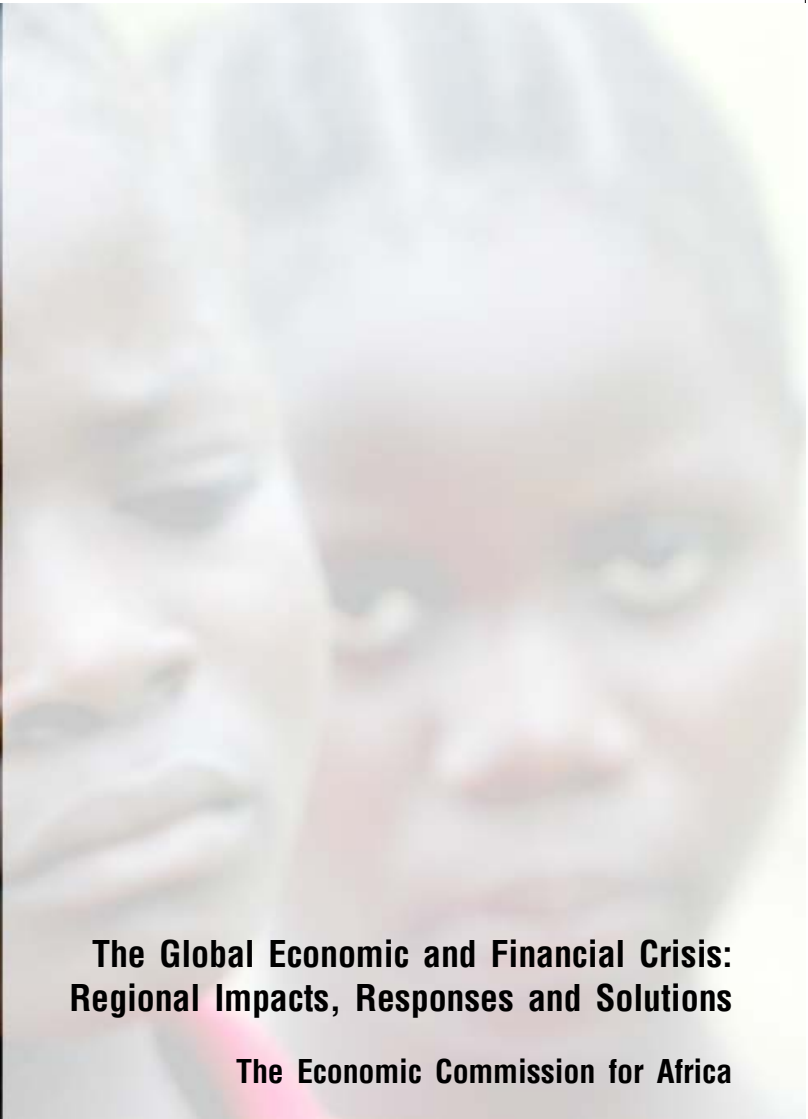
Executive Secretary of the Economic Commission for Latin America and the Caribbean



Bader Al-Dafa

Executive Secretary of the Economic and Social Commission for Western Asia





**The Global Economic and Financial Crisis:
Regional Impacts, Responses and Solutions**

The Economic Commission for Africa

THE ECONOMIC COMMISSION FOR AFRICA

Africa might have expected to be less affected by the crisis, being less integrated into the global economy and having smaller financial markets. But the contagion from the developed countries has already reached most African countries, reducing growth and threatening hard-won achievements in human development. Of great concern is the effect of the crisis on ODA.

The global financial and economic crisis represents a serious setback for Africa, taking place at a time when the region has been making progress in economic performance and management. Since 2000, the Africa region has achieved an average growth above 5 per cent per year and has seen inflation decline to single digits. The region has also made significant improvements in governance and has reduced armed conflicts, making it more attractive to private capital flows. Between 2002 and 2007, net private capital flows to Africa increased from \$17.1 billion to \$81 billion (ECA and APF, 2008). The current crisis is also taking place at a time when the region is slowly recovering from the fuel and food crises.

The global financial and economic crisis threatens these gains. The key challenge facing African countries is to manage the current crisis so as to ensure that it does not reverse progress made since the beginning of the new millennium and reduce the prospects for achieving the Millennium Development Goals (MDGs).

The following sections identify the key channels of transmission of the financial

crisis to Africa, as well as the quantitative impacts. They also consider recent policy measures taken by African governments and regional organizations to cushion the effects of the crisis on regional economies – as well as the policy measures and actions needed at the international level to ensure that in Africa the economic crisis does not develop into a humanitarian crisis.

The impact of the crisis

In the first few months, it was widely assumed that the crisis would have minimal impact on this region. African countries have a low level of integration into the global economy, most have very small inter-bank markets, and several countries have restrictions on new financial products as well as on market entry, which would shield them from the direct effects of the financial turbulence.

Recent developments have shown, however, that the Africa region is after all experiencing the negative effects of contagion. For example, the crisis will reduce economic growth. The extent of the decline will de-

pend on the availability of external finance to the region as well as on the effectiveness of measures taken by the advanced countries to boost global demand, but in 2009 the reduction in growth could be between 2 and 4 percentage points. Given the heterogeneity of African countries, the crisis is certainly going to affect some countries much more than others. For example, the decline will be more severe in Angola, Botswana, Equatorial Guinea, South Africa, and Sudan. These countries are expected to lose more than 4 percentage points of growth. In Cape Verde, Democratic Republic of Congo, Egypt, Ethiopia, Ghana, Kenya, Lesotho, Namibia, Nigeria, Mozambique, Sierra Leone and Tunisia, the decline in growth in 2009 is likely to be between 2 and 3 percentage points.

It is also important to note that the crisis is affecting countries of all categories. It is having an impact on those considered to have good economic policies and governance, as well on those with poor macroeconomic records, and those considered as fragile states. It is affecting both small and large economies, and both oil and non-oil exporting countries. This implies that the real effects of the crisis in the region are not simply due to the nature of macroeconomic policies and governance in particular countries. It will thus be important to provide assistance to countries in the region to enable them to weather the global slowdown and protect vulnerable groups.

Stock markets, banks and exchange rates

The crisis is affecting Africa through both direct and indirect channels. The direct effect has been felt mostly in the financial sector. Since the onset of the crisis, stock

markets have lost value and become more volatile. Between March 2008 and March 2009 the stock market indices in Egypt and Nigeria, for example, declined by about 67 per cent, and there were also significant losses in Botswana, Kenya, Mauritius and Zambia.

The turmoil in African stock markets is beginning to have significant negative effects on the financial sector and on aggregate demand. For example, there is growing evidence that it has been affecting bank balance sheets and, on present trends, the banking sector could see an increase in non-performing loans, with dire consequences for the region's financial stability. Between 2006 and the third quarter of 2008, in Ghana, for example, the ratio of non-performing loans to gross loans increased from 7.9 to 8.7 per cent, and in Lesotho from 2.0 to 3.5 per cent (IMF, 2009d).

So far, the region has not had any bank failures, since few African banks have had any significant exposure to the subprime mortgage market or asset-backed securities. They are however vulnerable to contagion. In several countries in the region a significant number of banks are owned by foreign companies who may decide to reduce their support of local banks, or sell their assets – with serious consequences for Africa's financial sector. Countries that are susceptible to this form of contagion include Botswana, Cape Verde, Central African Republic, Chad, Côte d'Ivoire, Equatorial Guinea, Lesotho and Zambia.

The crisis has also put enormous pressure on African foreign exchange markets. In the first quarter of 2009, the Ghanaian cedi depreciated against the US dollar by 14 per

cent, the Nigerian naira by 10 per cent and the Zambian kwacha by 13 per cent. Table I-1 presents data on expected changes in exchange rates for selected African countries in 2009. Significant depreciations are expected in Ghana (21 per cent), Uganda (22 per cent), Democratic Republic of Congo (23 per cent), South Africa (27 per cent), Nigeria (27 per cent), Zambia (43 per cent), Comoros (45 per cent), and Seychelles (84 per cent). Several of these coun-

tries have high foreign debt so these depreciations will impose serious debt service burdens. They will also increase the cost of imported intermediate inputs, with consequences for production, output and employment. Exchange-rate depreciation will also increase the exchange-rate risk faced by domestic firms and increase the likelihood that they will default on loans owed to domestic banks and thus also make these banks more vulnerable.

Table I-1 – Expected exchange rate depreciation in Africa against the US dollar, 2009

	Currency	Expected depreciation (per cent)
Seychelles	rupee	84.2
Comoros	franc	45.2
Zambia	kwacha	43.4
Nigeria	naira	27.3
South Africa	rand	27.1
Congo, Democratic Republic of	franc	23.7
Uganda	shilling	22.4
Ghana	cedi	21.1
Ethiopia	birr	19.8
Mauritius	rupee	19.5
Madagascar	ariary	17.9
Tunisia	dinar	17.1
Kenya	shilling	16.5
Namibia	dollar	15.0
Sierra Leone	leone	14.7
Mauritania	ouguiya	14.3
Cape Verde	escudo	13.8
Botswana	pula	13.5
Tanzania	shilling	13.3
Guinea	franc	13.1
Lesotho	loti	12.8
Swaziland	lilangeni	12.8
Morocco	dirham	11.4
Mozambique	metical	10.7

Source: Based on data from the Economist Intelligence Unit.

Currency depreciation also has implications for food prices. Several countries in the region are net food importers so currency depreciation will raise prices and reduce access to food by vulnerable groups.

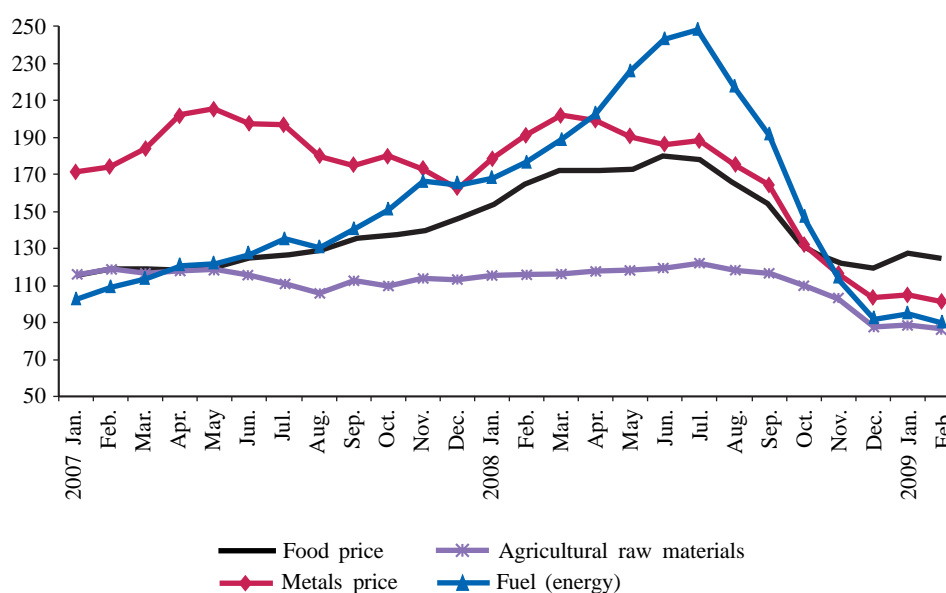
The financial crisis has also increased risk premiums for African countries raising funds in international markets. Indeed there is evidence that several countries in the region are already having difficulties. Kenya, Nigeria, Tanzania and Uganda, for example, have had to cancel plans to raise funds. If international capital markets dry up there would be serious consequences for development in the region because the money raised would have financed infrastructure development and boosted growth. The private sector is also facing challenges in raising funds in international capital markets.

Commodity prices and trade

The financial crisis is also affecting trade. In particular, since the second half of 2008 African countries have seen a significant decline in the prices of key commodity exports. Figure I-1 tracks prices for four major commodity groups of export interest to Africa, showing a downward trend since the second half of 2008. The most affected commodity has been crude oil: between February 2008 and February 2009 the price fell by more than 50 per cent. Over the same period, the prices of copper, coffee, cotton and sugar, also declined by more than 20 per cent.

The crisis has also reduced Africa's export volumes, as a result of the slowdown in economic growth in three key export markets – Europe, the United States and China.

Figure I-1 – Price indices of major commodity groups, 2007-2009^a



Source: IMF online database.

^a Data are up to February 2009.

Between 2007 and 2008 the growth of Africa's exports fell in real terms from 4.5 to 3.0 per cent, while import growth fell from 14 to 13 per cent (Table I-2). Although trade figures for 2009 are not yet available, the World Trade Organization has forecast a drop of 9 per cent in global trade which will certainly harm Africa's exports.

Table I-2 – Africa's merchandise trade, annual percentage change at constant prices, 2006-2008

	Exports	Imports
2006	1.5	10.0
2007	4.5	14.0
2008	3.0	13.0

Source: World Trade Organization.

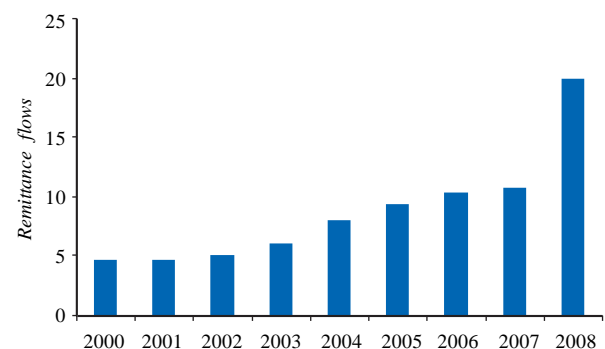
These declines in commodity prices and export volumes have significantly reduced export revenues. In Burundi, for example, between October and November 2008 coffee earnings fell by 36 per cent. Between 2008 and 2009 export earnings are expected to decline in Angola, for example, from \$67 billion to \$23 billion, in Cape Verde from \$90 million to \$84 million, and in Côte d'Ivoire from \$10.4 billion to \$7.7 billion. A reduction in export earnings will make it more difficult for governments to finance the import of inputs necessary for production and limit governments' ability to cushion the negative effects of the crisis on the economy.

Workers' remittances

Since the beginning of the new millennium, development finance in Africa has benefited from increasing flows of remittances – which finance household consumption and help reduce poverty. Between 2000 and

2008, remittance inflows to Sub-Saharan Africa, for example, increased from \$4.6 billion to \$20 billion (Figure I-2). Now however, African migrant workers in Europe, North America and the Gulf States are being laid off and returning home – so the flow of remittances will slow. The World Bank has estimated that as a result of the financial crisis, between 2008 and 2009 remittance inflows to Sub-Saharan Africa will fall by \$1 billion to \$2 billion. Gambia, Lesotho, Liberia, and Seychelles are highly vulnerable to reductions in workers' remittances because these inflows represent more than 10 per cent of their GDPs. North African countries are also vulnerable since they receive a significant amount in remittances though these represent smaller proportions of their GDPs.

Figure I-2 – Remittance inflows to Sub-Saharan Africa (\$ billions), 2000-2008



Sources: Ratha and Zu (2007) and World Bank database.

Private capital flows

The financial crisis has also diminished prospects for private capital inflows. In recent years, there had been significant increases: between 2007 and 2008 foreign

direct investment, for example, increased from \$53 billion to \$62 billion. Now there are indications that FDI flows to the region will decline. But since FDI often responds to growth with a lag, the impact of the crisis will be felt more in 2009 and beyond. Other forms of private capital have also been affected. Prior to the crisis, companies in Ghana and Gabon, for example, successfully issued bonds in international capital markets. Now, as a result of the crisis, this source of external finance has dried up and

firms in several African countries, including Nigeria and Kenya, are finding it more difficult to issue bonds. In Burkina Faso, mining companies have delayed new ventures because of difficulties in obtaining finance. Similarly, in the Democratic Republic of Congo, BHP Billiton, a major foreign investor, has suspended nickel prospecting because of low mineral prices. The drying up of these sources of external finance is thus constraining the region's growth and development.

Table I-3 – Net ODA disbursements to key African recipients, 2000-2007

(Percentage of GNI)

	2000	2001	2002	2003	2004	2005	2006	2007	Average 2000-2007
Liberia	17.4	9.6	11.4	30.4	57.1	55.5	56.2	120.4	44.7
Burundi	12.9	21.4	28.0	39.4	55.5	46.9	47.8	49.5	37.7
Guinea-Bissau	39.5	32.8	30.8	64.6	29.5	22.8	27.6	35.4	35.4
Sierra Leone	29.4	42.9	42.3	35.0	36.1	29.6	24.8	32.7	34.1
Eritrea	27.7	42.0	36.8	55.0	42.4	36.8	11.9	13.0	33.2
Congo, Democratic Republic of	4.5	5.7	22.4	98.8	29.1	26.4	25.2	14.1	28.3
Mozambique	22.5	25.5	55.1	23.5	23.2	21.2	26.1	26.3	27.9
Sao Tome and Principe	29.3	18.0	25.0	24.1
Rwanda	18.7	18.4	22.1	19.2	25.3	24.4	20.5	21.5	21.3
Malawi	26.1	24.1	14.4	21.6	19.5	20.6	21.9	20.8	21.1
Zambia	25.8	15.9	22.3	17.8	22.0	17.3	14.4	9.7	18.1
Mauritania	19.8	25.0	27.8	18.6	11.7	9.6	6.9	12.5	16.5
Uganda	14.5	14.8	12.8	16.3	18.2	14.0	16.7	15.7	15.4
Cape Verde	18.1	14.2	15.2	18.3	15.8	16.7	12.2	11.9	15.3
Gambia	12.4	13.2	17.4	18.0	14.5	13.7	16.1	12.1	14.7
Ethiopia	8.5	13.5	16.8	18.8	18.1	15.6	12.9	12.5	14.6
Niger	11.7	13.1	13.9	17.0	18.0	15.3	13.9	12.8	14.5
Mali	15.0	14.5	15.3	13.2	12.4	13.8	14.9	15.4	14.3
Tanzania	11.6	13.6	13.1	17.0	15.8	10.6	12.9	17.4	14.0
Madagascar	8.4	8.2	8.6	10.1	29.2	18.4	13.8	12.3	13.6
Burkina Faso	13.0	14.0	14.5	12.2	12.6	12.9	15.1	13.9	13.5
Ghana	12.4	12.3	10.9	13.0	16.2	10.9	9.3	7.5	11.6
Djibouti	12.6	9.6	12.8	11.7	8.8	9.8	13.7	12.3	11.4

Sources: OECD (for ODA) and World Bank, African Development Indicators (for GNI).

Official development assistance

To finance government programmes, several African countries depend significantly on official development assistance (ODA). In 2002, the world's governments adopted the Monterrey Consensus, and donors subsequently increased their ODA to Africa; between 2002 and 2007 flows increased from \$21 billion to \$39 billion. Now, however, in response to the financial crisis donors may reduce ODA flows to the region. While there is no evidence yet that donors plan to do so, history and econometric evidence suggest that their ODA flows tend to be procyclical and so it seems likely that donors will reduce them, especially when they face pressures to recapitalize their banking sectors and provide support for their own ailing industries. Table I-3 shows the 23 countries that are most vulnerable – those in which ODA during the period 2000-2007 represented over 10 per cent of gross national income. Burundi, Eritrea, Guinea-Bissau, Liberia, and Sierra-Leone are particularly exposed, with extremely high ratios of ODA to GNI.

Social development and the MDGs

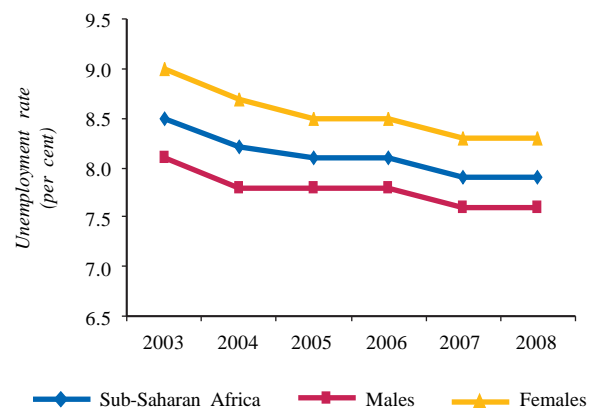
One of the important consequences of the financial crisis for Africa will be the reduction in both internal and external finance – which will reduce the ability of African countries to boost growth and achieve the MDGs. With less fiscal space, they will find it difficult to fund health, education, infrastructure and nutrition programmes.

The expected decline in ODA will have a devastating effect on aid-dependent economies. In several of these, ODA accounts for more than 30 per cent of the government revenue or budget. Across the region many governments are heavily dependant on aid-

funded social protection programmes, so any reduction in aid could harm the poor and make them more vulnerable. Donors will therefore need to honour their existing commitments to enable governments in the region to protect the vulnerable and prevent more people falling into poverty.

The financial crisis will also have an indirect effect on poverty by increasing unemployment. Before the crisis, unemployment in Sub-Saharan Africa was on a downward path: between 2003 and 2008, the unemployment rate fell from 8.5 to 7.9 per cent (Figure I-3). The rates came down both for males and females though generally remain higher for females. There are concerns that, as a result of the crisis, the rate will increase in 2009 as firms cut production or shut factories. Preliminary forecasts by the International Labour Organization suggests that in the worst case scenario the unemployment rate for Sub-Saharan Africa will increase from the 2008 figure by about 0.6 percentage points. This implies that between 2007 and 2009 the number of unemployed people will rise by three million.

Figure I-3 – Unemployment rates in Sub-Saharan Africa, 2003-2008



Source: International Labour Organization.

Country policy responses

African countries have taken several steps to mitigate the economic impact of the crisis. They have, for example, reduced interest rates, recapitalized financial institutions, increased the liquidity available to banks and firms, enacted fiscal stimulus packages, made changes in trade policy, and carried out regulatory reforms. The measures adopted differ from country to country depending on available fiscal space as well as on the degree of vulnerability to the crisis. For example, the region's oil-exporting countries have more fiscal space because during the recent oil price hikes they accumulated huge foreign reserves of which they can take advantage to conduct countercyclical policies. The non-oil exporting economies, however, are less able to adopt countercyclical policies so in these economies fiscal stimulus measures are not widespread. In addition to the above measures, some countries have set up task forces or committees to monitor the financial crisis and advise governments on how to respond. Democratic Republic of Congo, Kenya, Nigeria, and Rwanda, for example, have adopted this approach.

Interest rate changes

Since the onset of the crisis, 18 countries for which information is available have responded by changing interest rates. For example, in December 2008, the central bank in Botswana reduced interest rates by 50 basis points and followed this with a one percentage point reduction on 27 February 2009. In Egypt, the central bank cut its overnight and lending rates by 50 basis points on 26 March 2009. The Central Bank of Nigeria also cut its interest rate,

from 10.25 to 9.25 per cent. Other countries that reduced interest rates include: Kenya, Mauritius, Namibia, South Africa, Swaziland, Tunisia and the six countries that use the CFA franc controlled by the Banque des Etats de l'Afrique Centrale. Democratic Republic of Congo, on the other hand, in an attempt to fight inflation has responded by raising its policy rate – four times since December 2008.

Liquidity injections

Some countries have taken action to increase liquidity both for the banking system and for domestic firms. For example, in Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, and Togo the common central bank – the Banque Centrale des Etats de l'Afrique de l'Ouest – injects liquidity on a weekly basis into the regional money market. In Cameroon and Liberia, a support or guarantee fund has been created for firms. In Tunisia, the central bank has set up new deposit and credit facilities to improve the flow of credit and increase liquidity in the banking system.

Recapitalization of banks and regulatory changes

Some countries have taken specific measures to recapitalize domestic banks. In Mali, for example, in order to increase finance for housing, the government has decided to recapitalize Banque de l'Habitat du Mali. In Tunisia, in order to boost domestic investments, the central bank doubled the capital of the bank that finances small and medium enterprises. In Algeria, the Credit and Monetary Council has issued instructions to commercial banks to increase their capital from 2.5 billion to a minimum of 10 billion Algerian dinars (\$142 million) within 12

months. The council has also put in place a series of banking reforms to strengthen the financial system. The government of Kenya has enacted legislation that would increase the minimum capital requirement for banks from 250 million to 1 billion shillings by 2012.

Fiscal policy measures

In order to cushion the effects of the crisis and boost growth, a number of countries have introduced fiscal stimulus packages. In Cape Verde, for example, to provide a fiscal stimulus the 2009 budget projects a 17 per cent rise in public spending. In Egypt, the government has announced a fiscal stimulus package of 15 billion Egyptian pounds. Gabon, Morocco, Namibia, Nigeria, São Tome and Príncipe, South Africa and Tunisia have also adopted fiscal stimulus measures. Most of these packages emphasize infrastructure development. In Namibia, on the other hand the fiscal measures involve a 24 per cent public-sector pay raise. The South African stimulus plan, announced in February 2009, is quite broad and has four aspects: a \$69 million, three-year public investment programme; expansion of public-sector employment opportunities; an increase in social spending; and assistance to the private sector. Morocco's stimulus plan includes measures to improve access to credit, offer tax incentives, increase vocational training for workers, and reduce red tape and corruption.

Several countries have also responded by exercising fiscal restraint. For example, in Kenya the government plans to cut expenditure by 25 billion shillings. In Benin, in order to free up financial resources, the government plans to cut subsidies on food and oil imports. Botswana has imposed re-

strictions on travel budgets, vehicle purchases and the creation of new posts. In Angola, the government plans to revise its budget downwards to take account of the anticipated decline in oil revenue.

Trade policy measures

For several countries, an important component of their response plans is to try to boost economic growth by encouraging trade. Cameroon, for example, has reduced or waived import taxes on equipment, tools, and goods required for research and oil exploration. In Liberia, the President has announced plans to reduce trade tariffs as well as the ECOWAS trade levy. Tunisia has increased allotments for export business travel, and Mali has introduced measures to refund to mining companies the value added tax and import duty due on 2006/2007 gold operations. In Madagascar, the central bank has devalued the local currency to restore export competitiveness, while the government has also launched a drive to boost exports.

Improving domestic resource mobilization

Some African countries have also used the current crisis as an opportunity to introduce reforms aimed at boosting domestic resource mobilization. In Burkina Faso, for example, the government intends to undertake a comprehensive reform of its tax policy in 2009 so as to increase the tax base and boost revenue collection. Cape Verde, Senegal and South Africa have also taken measures to boost tax revenue. The government of Kenya intends to privatize some state-owned firms. It has also launched an 18.5 billion shillings infrastructure bond in the local capital market.

Regional responses

Coordination and consensus-building

In November 2008, in Tunis, Tunisia, at a meeting jointly organized by the Economic Commission for Africa, the African Development Bank, and the African Union Commission, African Ministers of Finance and Planning and Governors of Central Banks met to discuss the implications of the financial crisis for Africa and identify appropriate policy responses. The Communiqué from the meeting emphasized the need for bold and decisive action through key policy responses which would include:

- *Regulatory reform* – Countries need to undertake comprehensive reviews of their regulatory and supervisory regimes in order to identify areas for further improvement. In particular, all sectors of the financial industry should be subjected to proper regulation and oversight to avoid excessive risk-taking by financial institutions.
- *Macroeconomic policy* – Over the last two decades African countries have implemented macroeconomic policy and structural reforms that have served them well. Now, however, they need to further deepen their economic reforms, to help minimize the effects of crises and lay the foundation for sustainable growth.
- *Social protection* – While governments need to respond with measures to restore growth and financial stability, they also need to take measures to minimize potential social damage. This will mean giving priority to social protection and pro-poor expenditure.

- *Official development assistance* – Across the region, governments are faced with shrinking domestic resource bases arising from falling exports, remittances and tourist receipts. To help offset this they should be able to rely on official development assistance. Donors must therefore, consistent with their Monterrey and G8 summit commitments, increase aid to Africa.
- *International financial institutions* – The increasing globalization of financial markets has made it even more important to reform the governance of the international financial institutions – particularly by strengthening the voice and representation of developing countries.

These recommendations were discussed by African Heads of State and Government at their summit in Addis Ababa in January 2009. At the Tunis meeting, African Ministers and Governors of Central Banks also set up a Committee of Ten to monitor developments, provide regular follow up, advise Ministers and Governors on proposals and contribute to the international discourse in relation to the economic impact of the financial crisis and the necessary mitigating measures. The Committee held its first meeting in Cape Town, South Africa on 16 January 2009 and its second in Dar es Salaam, Tanzania, on 11 March 2009. These coordination meetings have helped build an African consensus on the crisis and on how the international community could help countries in the region to respond.

Research support

In order to design and implement effective policy responses it is vital to assess the

potential impact of the crisis and identify the transmission channels. Since the onset of the crisis, the Economic Commission for Africa (ECA) has therefore been providing African countries with technical and research support. ECA has also played a key role in facilitating an African consensus on the crisis by organizing high-level meetings. For example, ECA organized the Ministerial meeting in Tunis in collaboration with the African Development Bank (AfDB) and the African Union Commission (AUC). ECA, AfDB and AUC are also providing support to the Committee of Ten Ministers and Governors of Central Banks. These technical assistance support and advisory services have played a crucial role in ensuring that African views and concerns are adequately presented to the international community, particularly the G20.

Liquidity support

As credit markets dry up and risk premiums rise, African countries are facing difficulties in accessing international financial markets. The AfDB has therefore taken several measures to help countries in the region gain more access to long-term finance, particularly for essential economic infrastructure. For example, the bank has established a \$1.5 billion Emergency Liquidity Facility to provide fast and exceptional support to AfDB eligible countries. It has also set up a \$1 billion Trade Finance Facility to improve access to trade finance. In addition, in order to improve access to finance it has put in place a number of short-term measures. These include: restructuring portfolios and pipelines in favour of faster disbursement instruments; seeking additional funding through co-financing; reviewing trust funds to direct activities and funds towards countries in need; and, for African Development

Fund countries, supplementing existing resources with a catalytic trust fund.

The way forward

At the national level, African countries have taken many important steps to mitigate the impact of the financial crisis on their economies. But their range of policy measures is limited by financial constraints. The international community will therefore need to provide appropriate assistance to prevent the financial crisis turning into a regional humanitarian crisis. The main areas for international action will involve enhancing the availability of resources and reforming international financial institutions.

Enhancing resource availability

The developed countries have adopted fiscal stimulus packages to boost their own economies, but have paid little attention to the need to boost demand in Africa and how to finance such a boost. In fact, their own fiscal stimulus plans would be a lot more effective if they were accompanied by similar packages in low-income countries. In order to increase global aggregate demand Africa must therefore be fully integrated into the coordinated effort (ECA, 2008). Possible sources of finance for increasing demand and growth in Africa include:

- Ensuring that advanced economies meet existing commitments on aid and debt reduction;
- Improving access to existing finance facilities and accelerating disbursements;
- Urging the IMF, during this crisis, to put in place a new facility with relaxed conditions to support African economies;

- Increasing the capital of the African Development Bank to enable it to scale up its support of African development;
- Selling IMF gold reserves to release additional resources to help developing countries deal with the financial crisis;
- Issuing new Special Drawing Rights.

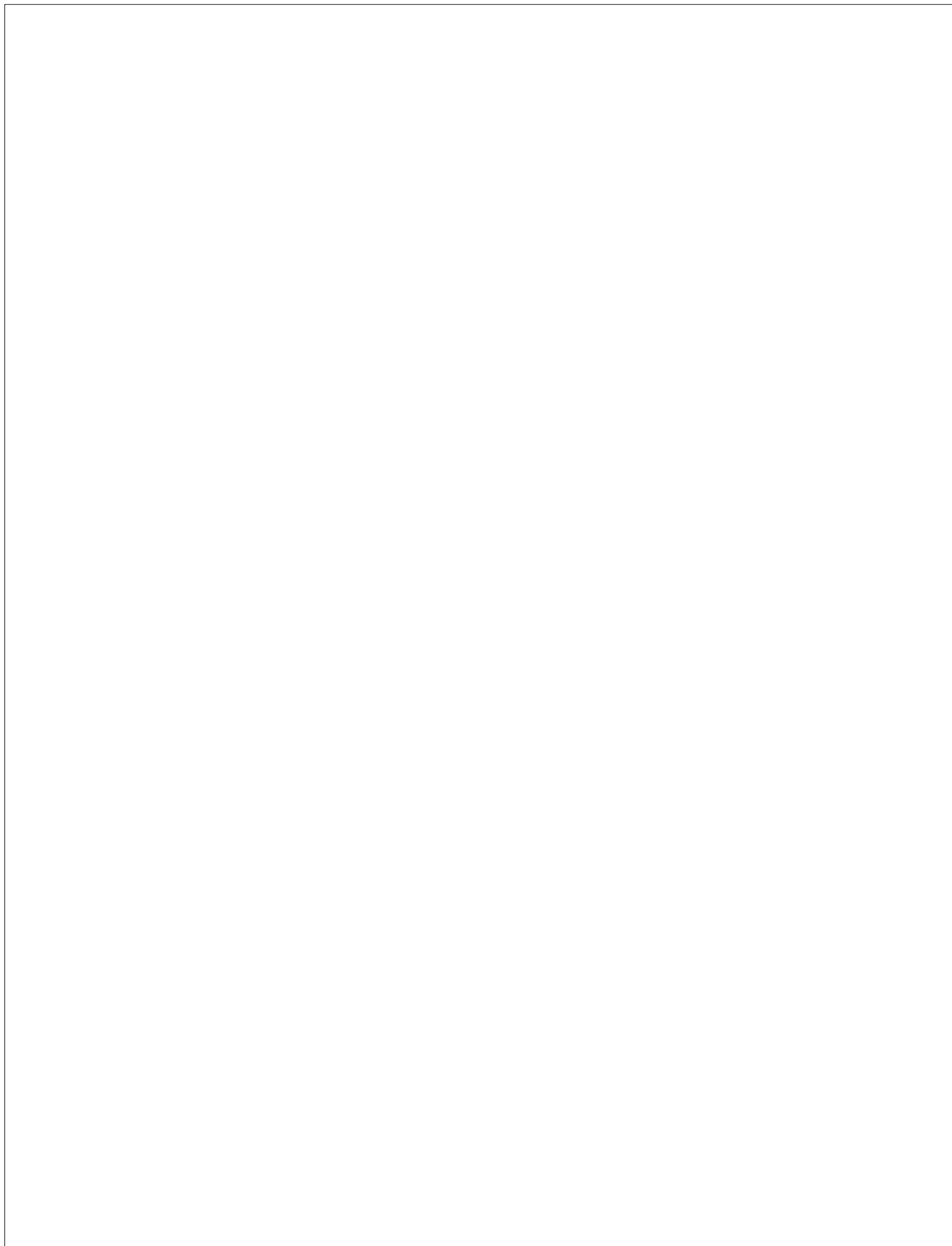
Reforming the international financial system

African countries, and developing countries in general, have long voiced their reservations and criticisms of the existing international financial architecture and of current aid delivery frameworks. Even so, the financial architecture has remained fundamentally the same since the Second World War. With respect to the reform of the Bretton Woods Institutions and of the global financial architecture, African countries would like some key changes.

- *Increasing policy space* – African policymakers have been concerned about aid delivery and the imposition of policy conditionalities that have constrained their freedom to choose their own policy mix and paths. The Country Policy and Institutional Assessment (CPIA) of the World Bank, for example, limits the choices available to African governments, giving a disproportionately high weight to policy performance relative to development outcomes. Under the CPIA, countries are ranked according to the quality of their policies and institutional arrangements. This focus on policies rather than outcomes is problematic because there is no general consensus on what constitutes good policy. African

countries want the CPIA to be redesigned to include a category significantly weighted towards country-specific outcomes and to measure progress in governance using the African Peer Review Mechanism governance indicators.

- *Debt sustainability framework* – Given its methodological limitations, African countries are also concerned about the increasing use in aid delivery of the Debt Sustainability Framework (DSF). The DSF need to be redesigned to address its shortcomings and eliminate the judgmental element of what constitute good policies and institutions.
- *Voice and participation* – African countries are unrepresented in many key forums that taken important decisions that affect their economies. The redesign of the financial architecture should provide an opportunity to address this issue. Africa would like to participate in the Financial Stability Forum and have increased representation on the Boards of the IMF and World Bank. Africa also to have permanent representation in the G20, in addition to South Africa which is there as an emerging economy.
- *Promoting trade* – In Africa, trade is an important source of development finance. The G20 must therefore refrain from trade protectionism and resist the creeping economic nationalism that underpins the developed countries' rescue and stimulus packages. In this regard, Africa would like a speedy conclusion of the Doha Round with appropriate provisions and emphasis on the development dimensions.





**The Global Economic and Financial Crisis:
Regional Impacts, Responses and Solutions**

The Economic Commission for Europe

THE ECONOMIC COMMISSION FOR EUROPE

The ECE region includes the major economies that were responsible for creating the crisis, but many others will also be severely affected. While the richer countries have been able to respond with dramatic bank bail-outs and fiscal stimulus packages, the European emerging economies have had limited options.

In 2009, each subregion of the ECE is experiencing or anticipating negative growth accompanied by rising unemployment and large declines in international trade and capital flows, along with significantly deteriorating government fiscal positions. The declines in economic growth are likely to be greatest in the ECE's emerging economies where there also remains a small possibility of a systemic financial meltdown, along with social and political instability.¹

The 56 economies of the ECE region form a very diverse group that includes advanced, emerging economies along with a few rather poor developing countries. The crisis will enter these countries in different ways and will have different impacts, so the policy options will also vary considerably according to economic circumstances and institutional constraints – making it difficult to generalize about the situation of the ECE economies overall.

The current crisis resulted from a combination of macroeconomic imbalances and microeconomic market failures – both due to inadequate governance and a failure by market participants to properly understand risk. The regulatory failure, however, was not confined to the US. Some of the riskiest behaviour was in European affiliates of US firms outside the jurisdiction of US regulators. The European financial sector thus played an active role in securitizing, distributing, and insuring assets that would later prove to be toxic – and the regulatory failure was not confined to one or two countries but covered a broad spectrum of financial market activities throughout the US and western Europe.

The crisis in Europe has been particularly severe. Many European banks owned a surprisingly large share of the toxic assets and were often more highly leveraged and reliant on international wholesale financing, and had lent more to emerging markets. Moreover, their national regulatory and institutional structures were often poorly designed and unable to deal with financial market turmoil. European policy makers

¹ This chapter relies extensively on a study by R. Shelburne and J. Palacin, *The 2007-2010 Financial Crisis in Europe*.

generally failed to appreciate the need for countercyclical macroeconomic policy. Several European economies also had their own housing bubbles combined with weaker mortgage lending standards.

The impact of the crisis

Although the shock was generally smaller in Europe than in the US, the European policy response was slower and considerably weaker and, as a result, Europe's decline in GDP has been as large as, or even larger than that in the US. Although their levels of unemployment may not reach those of the 1981-1982 downturn, the advanced economies will experience their deepest recessions since the Great Depression of the 1930s.

The countries of emerging Europe experienced a 'sudden stop' in capital inflows – though the shock was different from that than in the advanced economies. Because they were unable to implement countercyclical macroeconomic policies, their economic declines have generally been larger than those in the advanced economies – though they will not be as severe as their transitional recessions of the early 1990s.

Once the value of US mortgage-backed securities began to fall, the crisis moved to the wider European region quite rapidly through a surprisingly large number of channels. In Belgium, Germany, and Switzerland the banks owned large quantities of the toxic US assets. In Ireland, Spain, and the UK – the countries had their own bursting housing bubbles. In the Russian Federation and most of east-central Europe, banks and companies were dependent on global capital markets which seized up. In Austria,

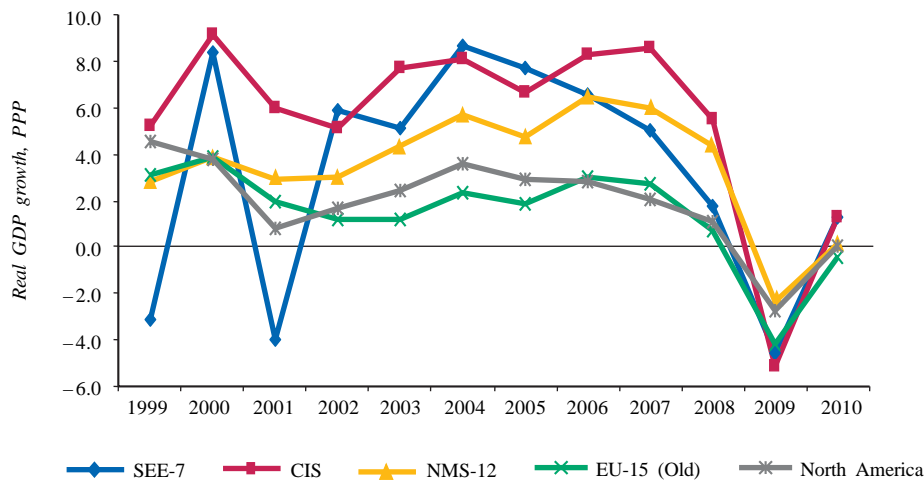
Greece, and Sweden domestic banks had foreign subsidiaries exposed to non-performing loans. In countries such as Armenia, Georgia, FYR of Macedonia, Moldova, Serbia, and Tajikistan there were large declines in remittances which had been a significant component of their GNI, in almost every case, countries suffered from falling exports and from declining tourism.

Key macroeconomic indicators

Prior to the crisis, over the period 2005-2007, annual real growth in the ECE region averaged 3.2 per cent. But in 2008 this dropped by half and in 2009 is forecast to fall to –3.5 per cent before recovering to about one-half per cent in 2010. Previously the European emerging economies had been growing two to three times faster than the advanced economies in North America and western Europe – due to large capital inflows which allowed them to maintain investment at higher rates than would have been possible from domestic savings alone (Figure II-1). During the current downturn, however, this dependence on external finance has proven a major disadvantage as it has provided a channel for importing the crisis.

In each of the ECE's subregions, growth in 2009 is forecast to be between –3 and –5 per cent. This will, however, represent a much greater drop for the European emerging economies – which are also more vulnerable since, compared with the advanced economies, they have weaker social safety nets and a larger percentage of their populations living near subsistence levels.

Growth turned negative in the US from December 2007. But this experience was soon to be repeated in other ECE countries

Figure II-1 – Real growth in the major ECE subregions, 1999-2010

– in the eurozone in the second quarter of 2008, and in the Russian Federation and most of the emerging economies in the last quarter of 2008. In 2009, growth is expected to be –5.1 per cent in the CIS, –5.1 per cent in Turkey, –4.2 per cent in the eurozone, and –2.4 per cent in the EU new member states. The downturn has been most severe in the Baltic economies and Iceland where growth is forecast to be close to –10 per cent. The impact will be less severe in Germany, Ireland, the Russian Federation, and Ukraine. And in 2009 growth may be positive in a few of the smaller ECE economies, including Albania, Azerbaijan, Cyprus, Tajikistan, Turkmenistan, and Uzbekistan – and especially strong in the latter two. For 2010 there could be a slow recovery, with growth positive but low throughout most of the region, however there is still considerable uncertainty around these forecasts and growth in the EU could still be negative.

By 2010, there will also be steep rises in unemployment. In the US, Europe, Turkey, and the CIS, rates are likely to reach dou-

ble digits. But in some countries the situation could be much worse. In Spain, for example, unemployment may reach 20 per cent. By March 2009, employment in the US had reached 8.5 per cent – the highest rate in 25 years. Since approximately half the job losses have been in the male-dominated construction and manufacturing sectors, the rate for men was approximately two percentage points higher than for women. In the spring of 2009, the number of people receiving unemployment insurance benefits in the US reached 5.84 million, the largest number since record-keeping began in 1967. In January 2009, the number of people on food stamps increased to 32.2 million, also the largest in history.

In the EU in February 2009 unemployment had reached 7.9 per cent – 7.8 per cent for men and 8.0 per cent for women. But the rate varied considerably between countries – from 15.5 per cent in Spain, 14.4 per cent in Latvia, and 13.7 per cent in Lithuania to a low of 2.7 per cent in the Netherlands. Currently the EU has 19.2 million unemployed. In the Russian Federation in Febru-

ary 2009 unemployment rose to 8.5 per cent and by the end of 2009 is expected to increase to 12 per cent.

Initially the European emerging markets were sheltered from the first wave of financial instability. Their banks used traditional lending models, with no exposure to the toxic assets. However, the situation deteriorated dramatically in late 2008, as global capital markets came to a standstill. Between 2007 and 2008, private capital flows to the world's emerging markets declined from \$929 billion to \$466 billion and in 2009 are forecast to be only \$165 billion. Many of these flows had gone to the European emerging economies but were rapidly curtailed as market participants became concerned about current account deficits.

Probably the greatest reversal of fortune of any of the world's major economies has been in the Russian Federation. Growth, which had been 8.1 per cent in 2007, is likely to decline to -6.0 per cent in 2009 – a 14 percentage points decline, twice that in the US or the eurozone over the same period. This is all the more remarkable since the Russian Federation owned few of the toxic assets at the centre of the crisis, was running a large current account surplus and had sizeable international reserves, little government debt and a large fiscal surplus. The main causes were steep falls in export revenue and a loss of access to world capital markets. In mid-2008, private capital inflows came to a sudden stop, followed by a sharp reversal as capital started to flood out; net outflows for the whole year were a record \$130 billion. Net outflows have continued in 2009, amounting to \$33 billion in the first quarter. On several occasions, the stock exchanges have been closed.

For the advanced economies, the crisis has moderated inflation – which in early 2008, had begun to exceed target levels. During 2009, these countries may experience a short period of deflation but this is unlikely to persist. For emerging Europe, however, the crisis, by leading to significant currency depreciations, has in some cases increased inflation. In the CIS countries in January 2009 average consumer prices were 14 per cent higher than a year earlier, and in most of south-east Europe in 2009 inflation may be over 5 per cent.

Sectoral impacts

The core of the crisis was in the US housing market, so employment in that sector has been hard hit, declining by 15 per cent since December 2007. Following their peak in January 2006, US housing starts in December 2008 were 76 per cent down. In Europe, however, except in a few markets with housing busts, such as Spain, construction is down only slightly.

The greatest declines were in investment spending on capital goods and consumer spending on non-durables – which hit industrial production and manufacturing. In the US in February 2009, industrial production was down 11.8 per cent from a year earlier; in the eurozone it was down 18.4 per cent and in the EU down 17.5 per cent, a record decline. The largest declines occurred in Estonia (-30.2 per cent), Hungary (-29.0 per cent), Latvia (-24.2 per cent), Spain (-22.0 per cent), Slovenia (-21.2 per cent), Italy (-20.7 per cent), Germany (-20.6 per cent), the Czech Republic (-20.3 per cent), Sweden (-20.3 per cent), and Finland (-19.9 per cent). Industrial production was also significantly lower in the

largest European economies outside the EU – falling by 34 per cent (January year on year) in Ukraine, 21 per cent in Turkey and 16 per cent in the Russian Federation.

The decline in manufacturing activity has been particularly large in the advanced economies. In the eurozone, new orders in January 2009 were 34 per cent lower than a year earlier. Especially hard hit were European exporters of manufactured capital goods such as Germany. In Ukraine, the declines were large in steel and metal production – down 43.3 per cent in the first quarter of 2009, year on year.

Worldwide, one of hardest hit sectors is automobiles – since car purchases are largely discretionary and can easily be postponed, and are often purchased on credit that is now very scarce. In March 2009, sales were 23.5 per cent lower in the US and 47 per cent lower in the Russian Federation than a year earlier. In the EU, automobile production has declined significantly, and some of the governments have provided various types of support. In Germany, by far the EU's largest manufacturer, production in February 2009 was down 65 per cent from a year earlier. By January 2009 automobile production had declined, year on year, by 60 per cent.

Over the last two decades, some economies, such as the UK and the US, had rapidly expanded their financial services sectors, probably at the expense of the manufacturing sector. However, a now-shrinking financial services sector is likely to result in an increase in the importance of manufacturing. This has several implications. Manufacturing is generally dispersed more widely than financial services, which are usually in major cities, so any expansion could reduce

geographical inequality. In addition, manufacturing provides relatively high-wage jobs for non-college educated workers, so this could also reduce education-based inequality.

As in any economic downturn, there has been a fall in world commodity prices, so commodity exporters, many of which are in the CIS, have suffered a large decline in export earnings. The steep decline in energy prices has had large repercussions for the Russian Federation and some countries in Central Asia.

For the ECE economies, trade has declined significantly over the last year, generally by a quarter to a half. This has been due to both the decline in national incomes and consumption, and the collapse of trade financing as credit markets seized up. In February 2009, US merchandise exports were 22.6 per cent lower than a year previously and imports were 30.4 per cent lower. For the same period, merchandise exports of the Russian Federation declined by 47.5 per cent and imports by 36.5 per cent.

The condition of the financial sectors

Since their peaks in 2007, equity markets in the ECE's advanced economies have lost more than one-half of their value, while those in many of the emerging economies have lost three-quarters of their value. A large percentage of the equity capital of the banking sector in the US, western Europe and the European emerging markets has been wiped out, and a significant number of the largest marque banks are either insolvent or close to insolvent. Government attempts to recapitalize the banks have been poorly designed and implemented, and interbank markets in the US and Europe

remain dysfunctional. Domestic credit expansion in Europe and the US has essentially collapsed.

The total global losses from toxic assets during this crisis will ultimately reach an estimated \$4 trillion – \$1.8 trillion in the US, close to \$2 trillion in western Europe and \$150 billion in European emerging markets. Thus the ECE economies will have to absorb over 95 per cent of the global losses resulting from the current crisis. Some \$3 trillion of the total losses resulted from assets originated in the US, while the other quarter originated in Europe and Asia. US bank loan losses will total \$1.1 trillion, of which half have already been written down, while eurozone and UK bank loan losses will be over \$900 billion.

Of the \$4.6 trillion of foreign bank loans to emerging economies, eurozone banks account for 73.4 per cent while US banks account for only 0.3 per cent; UK banks also have exposure. Thus, European banks are being more affected by a global slowdown. By March 2009, EU governments had provided \$380 billion for bank recapitalizations and guaranteed \$3.17 trillion of bank loans.

The Canadian banks largely avoided these problems and have had no failures or bailouts. The Russian Federation and Kazakhstan banks also owned few US subprime assets, but were dependent on external sources of finance which have now dried up and a sizeable number are likely to fail and/or require government support.

The major European banks were much more leveraged than the US banks and as a result were more vulnerable to declining asset values. The European banks had ap-

proximately twice the leverage of their American counterparts and about three times that of Canadian banks. They had compensated for this to some degree by holding less-risky assets and purchasing credit default swaps, though this insurance, purchased to a large degree from AIG which would go bankrupt, was only redeemable because the US government agreed to fund claims with taxpayer funds, without which the situation of western European banks would currently be even direr.

In Europe, banks are very large relative to their home countries' GDP. This is important because in most advanced economies there is some expectation that, should the banks fail, the government will guarantee depositors' funds. In uncertain times, this encourages holders of wealth in emerging market to transfer their funds to advanced economies. This problem was most apparent with Iceland where the banks had assets ten times the country's GDP. In the autumn of 2008, with the potential for global bank runs, European governments were forced to guarantee the liabilities of their banks. In the eurozone there is also an important difference with the US. The US Federal Reserve can act as the lender of last resort if the US government is unable to obtain the needed funds through taxes or borrowing. But eurozone governments have no lender of last resort to monetize their debts. The European Central Bank is not authorized to do this. The European situation has been described quite accurately as one where the banks are too big to fail but too large to save.

Considerable uncertainty remains about the financial condition of US and European banks because the true value of their toxic assets cannot be determined until the price

of US real estate stabilizes. Through the spring of 2009, US housing prices have continued to fall and have probably yet to reach their bottom.

Ultimately, the governments in the US and Europe will have to either nationalize their problem banks, bail them out, or purchase their toxic assets at a premium – with a serious impact on government finances. None of the approaches attempted to date have been particularly effective. The US Troubled Asset Relief Program has been especially chaotic, and financial markets remain largely frozen. Government bailouts of banks have occurred in several European economies – Belgium, Germany, Iceland, Ireland, the Netherlands, and the UK – and west European banks will need to raise \$160 billion to \$300 billion in new capital. Ireland was the first country to set up a “bad bank” patterned after the successful Swedish programme in the early 1990s. The German approach has been to try to distinguish between illiquid and insolvent assets by providing a government guarantee for the former.

The national regulatory and institutional structure of the financial sector in most European economies was inadequate for dealing with financial-market turmoil. After the Great Depression, the US had implemented insurance for bank depositors. In Europe such insurance was largely absent, although it had been implemented in Sweden in 1992 during that country’s real estate-induced financial crisis. As banking solvency issues arose in the fall of 2008, one government after another, in an uncoordinated and somewhat competitive fashion, had to extend government guarantees to bank depositors. In the UK, banking supervision was so separated from the central bank’s lender of last resort facility that the latter had no idea

in its dealings with Northern Rock whether it was insolvent or just illiquid.

Another fundamental weakness in Europe is that banking is regional or global but most regulation is national. More specifically, there is no agreement on how to address financial losses by cross-border banking entities. If a bailout is required, there is no agreement on which government is responsible, leaving unresolved the obligation of a parent bank not to drain liquidity from a subsidiary in order to shore up its own finances.

The banking sectors of the European emerging markets were heavily dependent on external capital markets and when world capital markets froze in 2008, were unable even to roll over existing funds. As their domestic economies began to decline, they also had increasing numbers of non-performing loans which could reach 25 per cent of assets. The new member states of the EU and countries south-east Europe benefited to some degree from the fact that their external borrowing was by local subsidiaries from parent banks in western Europe which were somewhat accommodating. However, parent country governments did not want the assistance they were providing to their domestic institutions to be transferred to subsidiaries abroad. For example, the Greek government warned its multinational banks in January 2009 not to transfer funds provided by them in a \$37 billion support package to foreign subsidiaries in the Balkans. Countries such as the Russian Federation, Kazakhstan, and Ukraine borrowed at arms length in global capital markets and thus received no support from parent banks, and their governments therefore had to take a more active role in supporting their banking systems.

External financing requirements

One measure of a country's need for external financing is how much maturing external debt will need to be rolled over, plus the size of the current account. Overall, the European emerging markets (except the Russian Federation) have an external financing requirement of \$497 billion in 2009 and a somewhat smaller one for 2010. The largest requirement is in Poland (\$190 billion), followed by Turkey (\$180 billion), Romania (\$100 billion), Hungary (\$75 billion), and Ukraine (\$70 billion). A significant percentage of this must come from external public sources. The financing gap is estimated at \$186 billion for the two years. The IMF has calculated it would be able to provide only \$81 billion, so more than \$100 billion will need to be covered by other institutions: presumably the EU or member governments, the European Investment Bank, the European Bank for Reconstruction and Development, or the World Bank.

Effects on achieving the Millennium Development Goals

The crisis will retard or even reverse recent progress in achieving the Millennium Development Goals (MDGs). History has shown that during a crisis those who suffer most are usually the poorest and those socially marginalized, and this pattern is likely to be repeated. For the ECE region, extreme poverty had almost been eliminated by the end of 2007 but with higher food prices, falling employment opportunities, reduced remittances, and strained safety nets it is likely to surface again. UNDP has estimated that another 10 million people in the region have already been pushed back into extreme poverty.

One of the MDGs for which progress in the European emerging economies has been disappointing has been that concerned with controlling HIV and AIDS and tuberculosis. The deteriorating economic situation is likely to exacerbate contributory factors such as poverty, prostitution and drug use, and governments will have fewer health resources. This has global implications since diseases, including antibiotic-resistant tuberculosis, easily spread from one region to another.

Another casualty will be gender equality. Since women are more likely to be in the informal sector, they receive few benefits when laid off, and thus the rate of poverty for them or single-parent households will increase.

Some of the poorest households in many European emerging economies rely significantly on remittances from migrant workers which in the next two years are expected to decline significantly. In Moldova, for example, between 2006 and 2008, remittances fell from 35 to 25 per cent of GDP. The poorest central Asian economies, like Tajikistan, which depend heavily on remittances, have also had climatic and other setbacks which have destroyed infrastructure and farmland.

Country policy responses

North America and Western Europe have concentrated on addressing the meltdowns in their financial sectors and the ensuing recession by providing government support for the financial sector, along with macroeconomic stimulus to minimize the recession. They have also been reforming the governance structure and regulatory appara-

tus of their financial markets. There have, however, been significant differences. The US has focused more on macroeconomic stimulation while continental Europe especially has focused on regulatory reform.

The US reacted quickly with aggressive monetary and fiscal stimulus. But western Europe, except the UK, acted more hesitantly – failing to appreciate the seriousness of the situation and constrained by institutional limitations in using countercyclical macroeconomic policy as well as by inadequate regional coordination. Compared with their American counterparts, European policy makers and academics have traditionally been far more sceptical of countercyclical macroeconomic policies. As a result they were slow to act, and timid when they finally did so.

The European emerging markets have less policy space to expand fiscal and monetary policy to stimulate demand, and have been essentially forced to tighten fiscal and monetary policy to demonstrate to world capital markets that they need not fear defaults or inflation that would destroy asset values. Automatic stabilizers are also weak for these economies. The new member states have additional institutional constraints. A number are committed to fixed exchange rates or currency boards so their monetary policy has had to follow the lead of the ECB. And if they want to stay on track for future euro accession they have to keep budget deficits below 3 per cent of GDP. Finally, a number are under IMF programmes and have to fulfil strict macroeconomic requirements. All in all, there has been a stark difference in the economic policy options available to the region's advanced and emerging economies.

Fiscal policy

Although the US and Western Europe have implemented historically large fiscal expansions, these are currently believed to be only about one-half of what would have been optimal and another round of packages may be required. Comparing the packages is difficult because, for example, there can be differences in how automatic stabilizers (which do not require new legislation) should be counted – they were much larger in Europe. As a result, countries have been able to calculate the size of packages in a manner favourable to their political objectives and thereby deflect criticism from other governments.

Nevertheless, the US has clearly implemented the largest programme in the ECE economies. A \$787 billion-package (about 6 per cent of GDP) was agreed in early 2009, though much of the spending will not actually be until 2010. This was additional to the stimulus package of 2008, which included \$168 billion of tax cuts and spending increases; it was also separate from the \$2.5 trillion-plan for the financial system. Critical to containing the crisis is the need to establish a price for US mortgage-backed securities, so the US government has implemented a number of programmes to support the housing sector and assist mortgage holders experiencing difficulties.

For fiscal policy, the Europeans were much more restrained. Although some European governments, including those of Ireland, Spain, and the UK, readily embraced large deficits, others criticized this approach. In fact, however, the stimulus packages in the major EU economies have been on a similar scale. In the three largest economies, the proposed stimulus for 2009 is slightly over

1 per cent of GDP: 1.1 per cent in the UK; 1.2 per cent in France; and 1.5 per cent in Germany. The non-EU European advanced economies also implemented fiscal stimulus packages; for example, Norway passed a plan worth 2.3 per cent of GDP. The European Commission proposed in late November 2008 a European Economic Recovery Plan which included a fiscal stimulus of €200 billion or 1.5 per cent of GDP.

The European bias against fiscal policy arises from legitimate practical historical experience, anticipated future economic conditions, and ideology. One issue is the size of economies – for a small economy, a fiscal expansion is not particularly effective since much of it will leak out to the rest of the world. Although a coordinated EU-wide fiscal expansion would be more effective, this bias against fiscal policy is nevertheless ingrained into the European policy culture. Also, the European economies have more extensive safety nets and, as a result, the automatic stabilizers are approximately twice the size of those in the United States – reducing the need for discretionary fiscal spending.

The European fiscal packages, like that of the US, consisted of a combination of spending increases and tax cuts. For example, the German plan included about €8 billion in investment projects, €18 billion in income tax cuts, and additional subsidies for health care, child care, and purchases of energy-efficient cars. The French package of €26 billion included €11 billion for businesses, €11 billion for public projects with an emphasis on social housing, and €4 billion for infrastructure improvements in the transport, energy and postal service sectors.

The percentage of the fiscal packages that are allocated to environmentally supportive projects varies from the 10-20 per cent range in France, Germany and the US to only about 5 per cent in Spain and the UK. The need for fiscal stimulus, however, implied that it was not the time for additional taxes – reducing support in the US for a carbon emissions tax.

The fiscal positions of the European emerging economies have also deteriorated – generally as a result of decreasing tax revenues. In the Russian Federation there has been a massive swing in the federal budget, from a surplus of 4.1 per cent of GDP in 2008 to a deficit of 7.4 per cent of GDP in 2009. The new member states not in the eurozone had to cut back government spending to try to keep within the 3 per cent of GDP deficit limit. Several other economies were under IMF programmes that required spending cutbacks.

Monetary policy

Interest rates in the advanced ECE economies have been reduced to historic lows; in the US, UK and Switzerland rates fell effectively to zero, and in the eurozone, although they were still above 1 per cent in early spring of 2009, they are expected to fall further in the coming months. As with fiscal policy, European monetary policy was eased later and more slowly. However, the loose monetary policy of the advanced economies has not proven very stimulative since the financial sector is not functioning properly.

With interest rates near zero, traditional monetary policy has reached its limits. As a result, the US, UK and Switzerland have implemented additional measures, referred to

as quantitative easing, to inject additional liquidity into their financial systems. The ECB currently appears opposed in general to quantitative easing and would face a number of implementation issues not faced by national central banks. For example, it is not clear what assets it should purchase, as there are 16 different types of government bonds from which to choose. This raises questions of the effectiveness of the “one size fits all” monetary policy when economic conditions vary significantly across countries.

Comparison of the monetary policies of the ECB and the US Federal Reserve is complicated because the two regions are in somewhat different economic situations and have different structural characteristics. More specifically, European corporations rely more on bank lending for financing and thus the ECB needs to be more focused on ensuring that the banks have adequate liquidity.

The central banks of the European emerging economies had limited monetary policy options. Given the flight to quality, they had to keep interest rates high to avoid capital outflows, and those that had fixed exchange rates or currency boards had to set monetary policy to maintain the exchange rate. Economies with extensive foreign currency-denominated loans also had to be careful to avoid large exchange rate depreciations that would increase the domestic costs of servicing these debts and increase non-performing loans. Thus interest rates in the emerging economies were often quite high.

Exchange rate policy

One of the standard tools for addressing a financial crisis is a currency depreciation.

The different monetary policies in the advanced economies produced some currency volatility. A significant appreciation in the euro especially in the first half of 2008 harmed the European export sector. However by the spring of 2009, the euro was back to a rate more consistent with its medium-term trend (about \$1.30). In the spring of 2009, the UK pound, because of the UK’s aggressive monetary policy, was about 25 per cent lower versus the US dollar and 15 per cent lower versus the euro; this provided some additional stimulus for the UK economy. The Swedish krona and Danish krone have also depreciated slightly versus the euro.

The European emerging economies, faced with declining capital inflows, came under pressure to depreciate, creating an acute funding problem for those attempting to maintain fixed exchange rates and especially for those with currency boards. Even those with more flexible exchange rates but large volumes of foreign currency-denominated debt worried about the potential effects on debtors’ balance sheets.

At the beginning of the crisis some governments intervened to maintain their currency’s value but ultimately had to let it fall. For example, the government of the Russian Federation tried to support the rouble but, after spending about a quarter of its sizeable foreign exchange reserves, had to adopt a more flexible policy. Some, such as Armenia were forced to return to a flexible exchange regime as part of their IMF agreement, but Latvia, on the other hand, was not required to do so. Those countries that depreciated did get the positive benefit of improving competitiveness for their export industries. Those countries with fixed rates, and even Slovenia and Slovakia which are

in the eurozone, experienced a loss of competitiveness. Nevertheless, being in the eurozone is generally thought to have been helpful since it has eliminated currency speculation.

As the crisis developed in the spring of 2009, the Swiss franc, being regarded as a safe haven currency, appreciated slightly relative to the euro, prompting the Swiss National Bank to lower interest rates close to zero, to intervene on the foreign exchange markets, and to begin a form of quantitative easing by purchasing corporate bonds.

Industrial policy

Some sectors have been hit harder than others, but government attempts to support the more vulnerable sectors have run into objections from foreign governments over the competitive implications. In the EU, the provision of state aid to support domestic industries was largely considered to be a violation of existing EU agreements. On the other hand, provision of EU-wide aid was financially impossible, and coordinated government responses proved to be too complicated and controversial. The European Commission did, however, agree to some emergency measures.

The crisis has had a serious effect on the automobile sector. The US government provided large subsidies to two of its big-three domestic automobile firms. The French government established a €6 billion package of assistance for the domestic automobile industry (Renault and Peugeot) if they agreed not to close any French factories for the next five years. The Italian, Spanish, Swedish and UK governments also provided government aid to their automobile sectors. The German government estab-

lished a €1.5 billion subsidy programme for consumers to buy a new car if their old car was scrapped. The Russian Federation and a number of the CIS, which are not members of the WTO, were less constrained, but the European emerging economy governments generally did not have the financial resources to provide much industrial aid.

Social protection and labour policies

The fiscal stimulus programmes often also provided additional assistance to those most harmed by the crisis – as with extended unemployment insurance in the US. The European emerging economies, on the other hand have been forced into fiscal retrenchments and, as a result, are having to reduce funding for social and safety net programmes. The European emerging economies will also now suffer from having relied on economic growth to trickle down to the poor, instead of aiming for pro-poor growth and redistribution.

Regional responses

A crisis of this severity demands regional cooperation. However there have been a number of problems. The G20 process, for example, required a number of compromises. There have been a surprisingly large number of stresses within the EU, some of which concerned policies of national preference for domestic industries which, rightly or wrongly, were generally characterized as protectionist. The French President suggested that French automobile companies should return car production back to France from their newly established east European plants. This led to a strong public rebuke from officials in the new member states.

In response to these developments, in the spring of 2009 the EU had two “anti-recession” summits to clarify EU rules on industry subsidies, to limit other “protectionist” policies, and to maintain political solidarity. In 2009, the EIB provided about €7 billion in loans to European automobile firms. The US and Canadian governments, on the other hand agreed that each government would contribute to any bailout in proportion to each country’s size of the industry.

In early 2009, EBRD (€6 billion), EIB (€11 billion), and the World Bank (€7.5 billion) put together a €24.5 billion package of support for the European emerging economies, especially their financial sectors. That European institutions should provide such support was not surprising. Even before the crisis there was a well-established pattern of regional assistance to new member states and the EU’s eastern neighbours. The EU enlarged its balance-of-payments assistance fund for non-euro economies to €25 billion in early 2009 and then in March doubled it to €50 billion.

Regional cooperation has been more limited among the CIS countries. Nevertheless, the Russian Federation, despite its own serious economic situation, has increased its financial support for neighbouring economies. In early 2009, it proposed an anti-crisis fund within the framework of the Eurasian Economic Community (EurAsEC) of about \$10 billion, primarily to aid the other CIS economies. Even Ukraine, which had been having rather tense relations with the Russian Federation turned to the Russian Federation for assistance.

The crisis may also encourage the creation of a currency union between the Russian

Federation and Belarus, or the adoption of the rouble in a larger grouping such as EurAsEC. Unfortunately the Russian Federation rouble and all the other currencies experienced significant declines, and the crisis provides no evidence that a larger currency union would necessarily have provided any additional stability.

Multilateral support

Many European emerging markets will probably need some type of multilateral support. By March 2009, six economies (Hungary, Latvia, Ukraine, Belarus, Georgia, and Armenia) already had IMF programmes and others were close to concluding an agreement (Bosnia, Romania, and Serbia). The packages ranged from 5 to 10 per cent of their GDPs. Several of the countries have experienced difficulties in meeting IMF-agreed targets and their disbursements have temporarily been put on hold (Latvia, Hungary, and Ukraine). These are in addition to the IMF rescue of Iceland, a European advanced economy. Several other countries established precautionary new credit lines from the IMF; Poland obtained \$20.5 billion to boost the reserves of its national bank.

Regional participation in global reforms

The economies of the ECE region are well represented – arguably over-represented – in global forums and international organizations that are addressing the crisis. One of the principal ones has been the G20, in which about half of the countries, or half of the people at the table, were from the ECE region – which accounts for slightly over half of the world’s GDP (PPP).

Some of the ECE members of the G20, however, disagreed about what to emphasize. For the US and the UK the most important objective has been to increase the macroeconomic stimulus. The continental Europeans, led by Germany and France, on the other hand, have instead preferred to focus on regulatory reform of the financial sector. At the G20 meeting in London, the US attempted unsuccessfully to get the Europeans to increase their stimulus packages.

Within the ECE region, there is broad agreement on the need to regulate the financial sector. But there remains debate about the details. Most countries agree on the need to tighten mortgage origination procedures, strengthen banking supervision and extend it to a wider range of institutions, ensure greater oversight over hedge funds and derivative markets, regulate credit rating agencies, and reduce bank leverage. They also agree on the need to reduce procyclicality in accounting rules and bank lending practices, and to have central banks consider asset prices when making monetary policy. However, the US and Europe differ on the necessary institutional changes or creations. The Europeans have generally favoured global structures. The US puts more emphasis on national legislation, although this does not eliminate the need for international cooperation and/or coordination.

Although there are unlikely to be significant enhancements in international institutions, it is also unrealistic within the EU to limit reform to separate national responses. Overall, there is general agreement on the need for an EU-level institution that is independent and has authority over national supervisors.

The ECE economies have generally agreed on the need to increase the resources avail-

able to the IMF. The US favoured this as a way to expand world aggregate demand. The western Europeans were initially hesitant but later acquiesced, particularly when it became clear that the alternative was for them to provide the funds. The advanced ECE economies agreed to increase SDR allocations by \$250 billion, though most of that will go to the advanced economies.

Another issue is the representation in the management of the international financial institutions. Europe in particular is over-represented. The eurozone is smaller than the US yet the eurozone economies have 32 per cent of IMF quotas while the US has 17 per cent. Increasing the representation of the emerging economies will require reducing the representation of western Europe. The Europeans appear to agree in principle but have been unwilling to commit to specific changes. None of the major or minor European countries has offered to reduce its strength in international organizations, or give up its seat at the tables of the G7 or G20; nor has the US agreed to give up its IMF veto.

The way forward

Prospects for economic recovery

In the spring of 2009, the economic situation appears to have plateaued, but it remains uncertain whether this represents the bottom from which a recovery can begin – or a temporary landing to be followed by another downward plunge. If there is a shoe left to fall it is probably in the vulnerable European emerging economies. Growth may resume in the US in the second half of 2009, but in Europe the recovery will probably be delayed because of the weaker policy response.

Once the recession is over, it will be necessary to unwind any stimulus quickly in order to avoid inflation and limit the excessive growth of government debt. The timing will be tricky. During the Great Depression in the 1930s macroeconomic policy was tightened prematurely, causing the world to relapse into several more years of depression. The same thing happened in Japan in the 1990s.

Region-specific recommendations for crisis resilience

The crisis has revealed not just inadequacies in the design and regulation of financial markets, but a long list of failures that will require a comprehensive redesign of national, regional and global financial systems. Much of this reform will be at the national level, but it will also be important to increase intergovernmental cooperation so as to harmonize policies, especially in Europe.

The crisis has also exposed the inability of international monetary systems to provide emerging markets with sufficient external finance. This is a particular problem for those in south-east Europe wishing to copy the development model of the new member states. The international financial architecture will therefore need to be redesigned to provide emerging economies with external capital, or prevent large imbalances from developing – a concern that has not been

addressed by the G20 or individual governments.

The European emerging economies have largely been required to implement procyclical fiscal and monetary policies – demonstrating how the current international economic system is fundamentally ‘development unfriendly’ and how the standard macroeconomic tools for addressing crises are unavailable to them. The tripling of IMF resources, however, should help reduce the negative consequences.

The advanced economies of the ECE have responded with unprecedented fiscal stimuli and monetary easing, though with long-run costs in terms of potential inflation and debt repayment. Only time will tell whether the more aggressive US approach or the more cautious European approach was more effective. Whatever the outcome, Europe will need to reconsider its policies and institutions.

The dominance of the advanced economies of the ECE is no longer consistent with the realities of the world economy. If international economic institutions are to be more effective and legitimate, they will require further reform, including reduced European representation. More generally, with increased globalization comes the need for increased global governance; over the long-term the two will either increase or decrease together.



**The Global Economic and Financial Crisis:
Regional Impacts, Responses and Solutions**

**The Economic Commission for
Latin America and the Caribbean**

THE ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

The crisis has been transmitted to Latin America and the Caribbean through a number of channels – including declining exports, low commodity prices, a fall in remittances and tourist income, and a contraction in capital flows. As a result, some of the larger economies are now seeing negative growth.

When the current financial crisis began to spread, initially it seemed possible that it might not affect Latin America and the Caribbean so severely since there might have been a decoupling of global business cycles. By mid-2008, however, and especially after September, it became evident that the crisis would indeed have an impact on the region. The centre of debate then shifted to what would be the intensity of this impact and on what the region's governments could do to mitigate the adverse effects through countercyclical monetary and fiscal policies. There has also been an intense debate on the international financial system and on the reforms needed to enable it to play a countercyclical role and help countries cope with external shocks.

Impact of the crisis

Growth

In a context of contraction in both global and developed countries' GDPs during 2009, Latin America and the Caribbean is facing a negative scenario, characterized by

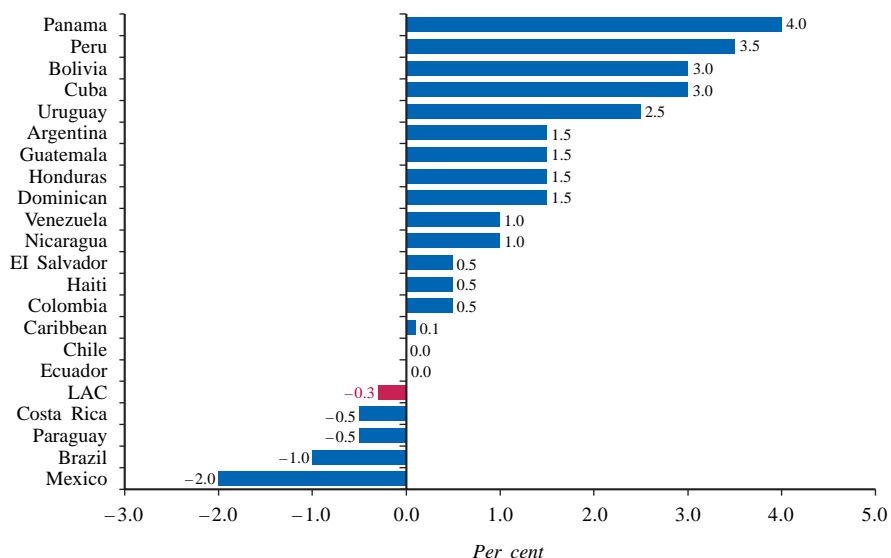
a slowdown of exports, low commodity prices, a drop in remittances and tourist income, and a contraction in capital flows.

ECLAC estimates that the region's GDP will contract 0.3 per cent this year (Figure III-1). The worst performance will be in Mexico (–2 per cent), Brazil (–1 per cent), Costa Rica and Paraguay (both 0.5 per cent), while Chile and Ecuador will have zero growth. On the other hand, Panama will have the best regional performance, with a growth rate of 4 per cent, followed by Peru (3.5 per cent), Cuba and Bolivia (both 3 per cent) and Uruguay (2.5 per cent). The remaining countries will grow between 0.5 and 1.5 per cent (ECLAC, 2009a)

Inflation and exchange rates

As a consequence of the increase in food prices from the second half of 2007, annual inflation in 2008 in Latin America was 8.8 per cent, the highest figure in six years. Inflation in 2009, however, is projected to fall to 6 per cent – as a result of the slowdown in economic activity, with lower internal demand and high unemployment.

Figure III-1 – Countries in Latin America and the Caribbean, estimated growth in 2009

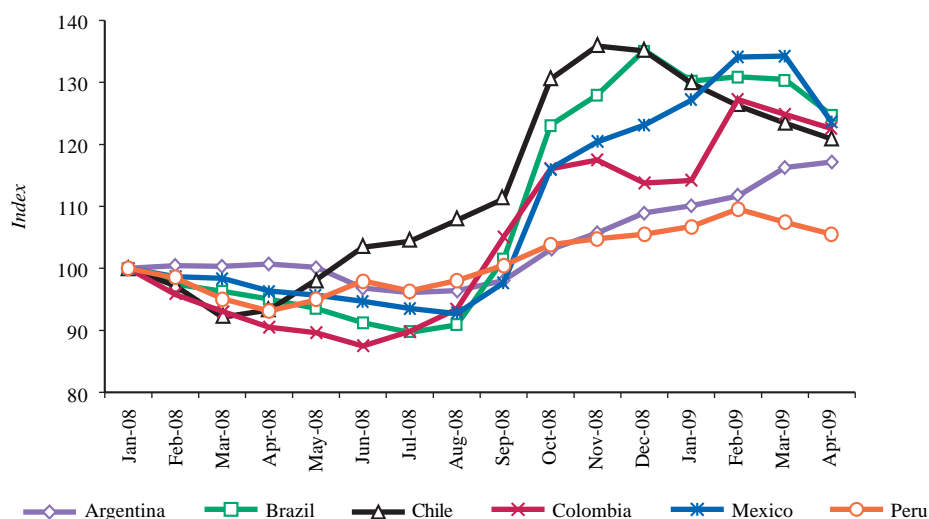


Source: Economic Commission for Latin America and the Caribbean.

Declining inflation rates have given room for Latin American Central Banks to ease monetary policies, in an effort to reactivate economic activity.

Local currencies started to depreciate when the crisis intensified in September 2008, as investors, aiming to protect their wealth, hedged in dollars (Figure III-2).

Figure III-2 – Latin America, monthly exchange rates in six countries, 2008-2009^a



Source: Bloomberg.

Note: Indexed to January 2008 rates.

^a Data are up to April 2009.

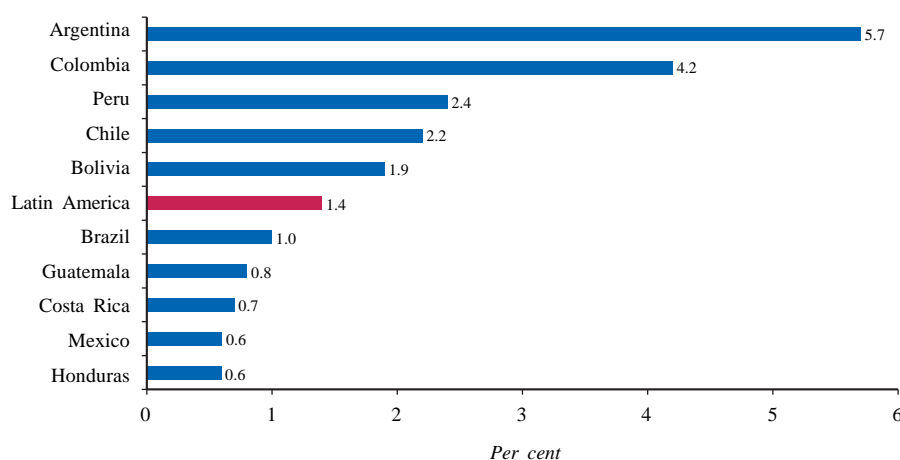
Fiscal accounts

During 2008, primary fiscal surpluses at the central government level in Latin American countries averaged 1.6 per cent of GDP, while for the overall balance there was a deficit of 0.3 per cent (ECLAC, 2008). In the first half of last year, commodity prices were at their historical maximums – allowing countries to reduce government debt/GDP ratios, increase reserves and invest surpluses both abroad and at home. The second half of the year, on the other hand, saw the eruption of the financial crisis, a huge drop in commodity prices and a slowdown in economic activity as a whole. Fiscal surpluses started to decline in the main Latin American countries, and for the

current year it is expected that Latin America and the Caribbean will have a primary fiscal deficit of about 2 per cent of GDP.

Governments have implemented many measures to reduce the impact of the current crisis on domestic economies, including new public infrastructure, tax reductions, credit facilities, and social expenditure. On average, the regional effort in 2009 will cost around 1.4 per cent of GDP, but with differences between countries (Figure III-3). Argentina's fiscal measures account for 5.7 per cent of GDP, and Colombia's for 4.2 per cent. The most limited measures, in terms of GDP are in Mexico and Honduras – 0.6 per cent each (Bárcena, 2009).

Figure III-3 – Increases in public expenditure, percentage of 2008 GDP



Source: Economic Commission for Latin America and the Caribbean.

Unemployment and social indicators

Between 2003 and 2008, unemployment had steadily come down – from 11 to 7.5 per cent – but according to ECLAC estimates, in 2009 unemployment will increase to 8.5-9 per cent. This will increase poverty. In 2007, 34 per cent of the re-

gion's population lived below the poverty line – 184 million people. Poverty rates too had been declining, but the current crisis may cause them to rise again, and also result in an increase in inequality.

Those likely to suffer most from increasing unemployment and poverty are vulnerable

groups, such as women and youth. As a result of job losses in manufacturing, many more women, especially in Central America, will be seeking work in the informal sector. The crisis will also affect the economic security of older people. Many have to keep working because of the limited coverage of social security – as, for example, in Bolivia, Ecuador, El Salvador, Dominican Republic, Guatemala and Paraguay. But now the crisis will reduce their job opportunities (Jaspers-Fajfer, 2009).

Vulnerable groups can be supported in a number of ways, through various forms of social spending, employment creation programmes and schemes for employment insurance. It is imperative that measures and policies adopted to address the crisis do not reduce the existing social rights of vulnerable groups or reduce the coverage and quality of services and benefits.

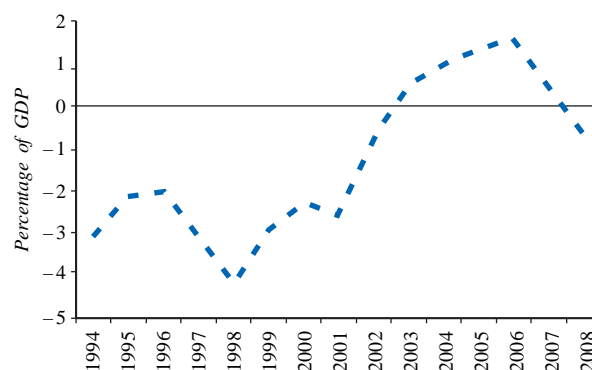
The external sector

After five years of current account surpluses, in 2008 the region experienced a deficit of \$27 billion, equivalent to 0.6 per cent of GDP (Figure III-4). All countries except Argentina, Bolivia, Ecuador and Venezuela recorded a deficit (ECLAC, 2008).

During 2009, the region is expected to have a contraction in international trade. Preliminary figures indicate a slowdown in both exports and imports in Argentina, Brazil, Chile, Mexico and Peru. Mexico and Central America and the Caribbean will also face some difficulties because of their close ties with the US economy where demand has fallen sharply.

Commodity prices have fallen – on average 50 per cent from the maximum levels of mid-2008. Among these, energy prices have

Figure III-4 – Current account balance, percentage of GDP at current prices, 1994-2008



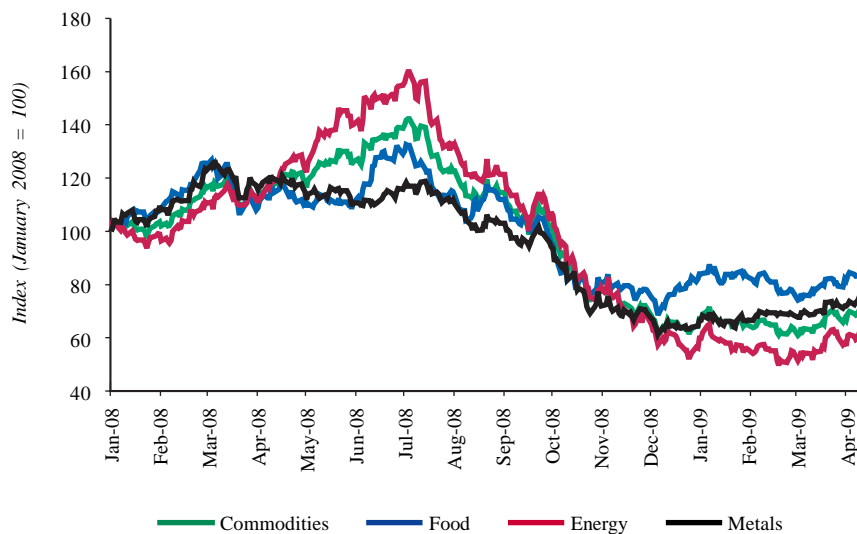
Source: Economic Commission for Latin America and the Caribbean.

fallen 60 per cent, and food and metals, by 36 per cent (Figure III-5). This has affected the main commodity exporters – Venezuela, Ecuador, Colombia, Chile and Peru.

Falling commodity prices have caused a deterioration in the region's terms of trade. In 2008, these had increased by 4.6 per cent, but in 2009 are expected to fall by nearly 15 per cent. The countries most affected are in South America: following a growth of 5.9 per cent in 2008 there will be a decline of 20.6 per cent in 2009. The main losers are Bolivia, Ecuador, Colombia and Venezuela, with an average reduction of 38.8 per cent. For Chile and Peru, the reduction will be 25.4 per cent. Mexico's terms of trade will fall 6.7 per cent this year. In Central America, on the other hand, the situation is likely to improve – from a 3.4 per cent fall in 2008 to a 3.9 per cent rise in 2009.

Workers' remittances

The region is also expecting a fall in migrant workers' remittances. In 2008 these had risen by 0.9 per cent, to \$69 billion,

Figure III-5 – ECLAC region, commodity price index, 2008-2009^a

Source: Bloomberg.

^a Data are up to April 2009.

but in 2009 they will probably decline, as a consequence of recession in major remittance source countries, such as the United States, Spain and Japan. Indeed, even for the last quarter of 2008, remittances had registered their first drop since 2000 – 2 per cent down on the same period in 2007, to \$17 billion. As of January 2009, total remittances in countries that reported data were down by as much as 13 per cent. In households where remittances represent the main source of income, these falls, combined with fluctuations in exchange rates, are making life very difficult (IDB, 2009a).

Capital flows

In late 2008, capital inflows slowed in several countries of Latin America. Excluding net direct investment, financial flows as percentage of GDP dropped in Brazil, Argentina, Mexico and Peru. In 2009, foreign direct investment (FDI) is expected to drop. In the last three quarters of 2008, net FDI

as a percentage of GDP dropped by 0.8 points in Argentina, 2.9 points in Peru and 0.5 points in Mexico. This is as a result of falling commodity prices, which have led to the cancellation of several natural resource projects, as well as of low economic growth in the region. Lower economic activity in the main export markets, such as the United States and Europe, has directly reduced exports from Mexico and the Caribbean Basin. FDI has also been affected by the difficulties that companies are having in obtaining credit.

Banking

From 2003 to 2008, the region experienced a credit boom. In 2009 in some countries, credit has continued to grow, but more slowly (ECLAC, 2008). The financial crisis has caused a decline in liquidity through reductions in domestic and external sources of finance. Country risk ratings and lending and borrowing rates have eased in recent

months, but are still above their levels prior to September 2008. In the seven major Latin American economies, the real credit stock grew in 2008, but at an annual rate around 15 percentage points lower than in 2007.

Country policy responses

Broadly speaking, governments have implemented measures aimed at restoring confidence, unlocking financial markets and bolstering weakened aggregate demand. However, the measures vary considerably from one country to another, according to the extent to which each has been affected and its resources and capacity to respond.

The measures fall into five broad categories: monetary and financial policy; fiscal policy; exchange-rate and external trade policy; sectoral policies; and labour and social policies (ECLAC, 2009b). These are shown in Figure III-6 which indicates the number of countries in Latin America and the Caribbean, out of a total of 33, that have implemented each of the measures.

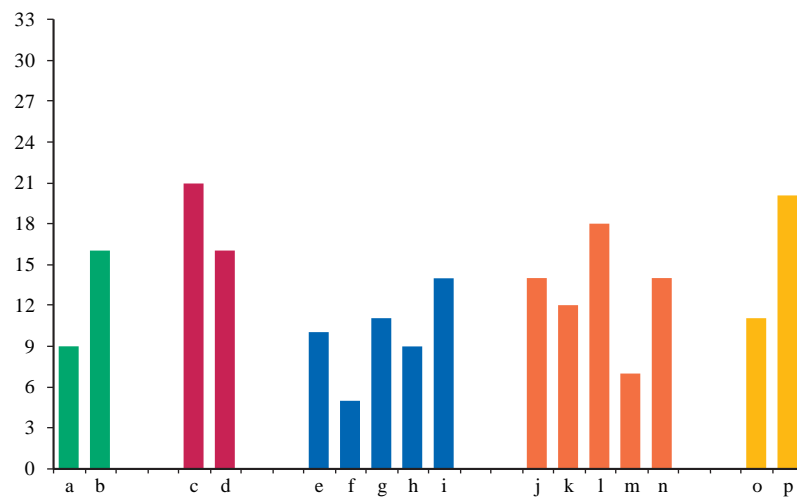
- *Monetary and financial policy* – Countries following an inflation target regime have generally eased monetary conditions, as central banks have lowered benchmark interest rates, in some cases very considerably (Figure III-7). Most countries have also, through various means, been providing liquidity to their financial systems.
- *Fiscal policy* – Almost all countries have implemented fiscal measures – generally reducing taxes or increasing, or bringing forward public spending, or both.

- *Exchange-rate and external trade policy* – Countries have been providing liquidity in foreign currency, while providing export financing. A number of countries have negotiated credits from international financial bodies. Most have also reduced tariffs; only a few have resorted to increasing tariffs or restricting imports.
- *Sectoral policies* – Governments have been supporting specific sectors – particularly agriculture, housing, manufacturing and tourism. They have also given special attention to small and medium enterprises because of their importance for the creation of employment.
- *Social programmes* – Throughout the region, governments have generally put more emphasis on social programmes than on policies to counteract the effects of the crisis on levels of employment.

Regional responses

Regional and subregional financial institutions have been playing a key role in supporting national efforts to mitigate the impacts of the crisis through countercyclical policies. Among them, the Inter-American Development Bank (IDB) has announced it is prepared to approve up to \$12 billion in 2009, compared with \$10 billion in 2008. It has also created a new, fast-disbursing liquidity facility amounting to \$6 billion which “provides funding for countries facing transitory difficulties in accessing international credit markets due to the financial turmoil” (IDB 2008, IDB 2009b). If the total of the new facilities were to be used, then in the course of this year IDB total funds committed to Latin America and the Caribbean could amount to \$18 billion, “the larg-

Figure III-6 – Measures implemented by ECLAC countries



Monetary and financial policy

- a Reduction or relaxation of reserve requirements
- b Provision of liquidity in national currency

Fiscal policy

- c Tax cuts or increased subsidies
- d Spending increased or brought forward (infrastructure)

Exchange-rate and external trade policy

- e Provision of liquidity in foreign currency*
- f Increased tariffs or import restrictions
- g Tariff cuts
- h Financing of exporters
- i Obtaining credit from international financial bodies

Sectoral policies

- j Housing
- k Small and medium-sized enterprises
- l Agriculture
- m Tourism
- n Manufacturing

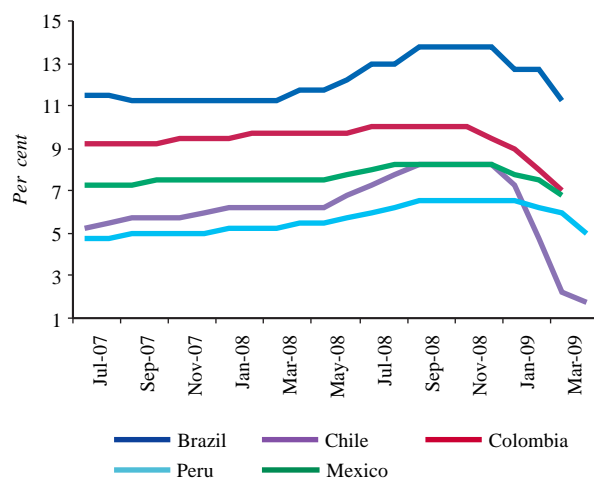
Employment and social policies

- o Promoting job creation
- p Social programmes

* Does not include central bank interventions involving the sale of foreign exchange in currency markets

Source: Based on ECLAC (2009b).

Note: The Y-axis measures the number of countries out of a total of 33 Latin American and the Caribbean countries that implemented each measure.

Figure III-7 – Benchmark interest rates, 2007-2009^a

Source: Economic Commission for Latin America and the Caribbean.

^a Data are up to March 2009.

est and most rapid mobilization of resources in the IDB's 49-year history" (IDB, 2008).

In turn, the Andean Development Corporation (CAF) has extended the credit lines for the financial institutions of its member countries, from \$1.5 billion to \$2 billion. Also in the Andean subregion, the Latin American Reserve Fund (FLAR) has offered liquidity credit lines of \$1.8 billion, and announced last year that it could make available another \$2.7 billion.

The IDB is also coordinating efforts with several other multilateral institutions, including the World Bank, the Caribbean Development Bank, the International Finance Corporation, the CAF, and the FLAR to ensure that resources are provided to countries in a timely manner (IDB, 2008).

Governments of the region have also underlined the importance, during this crisis, of regional integration and cooperation. The

first Latin American and Caribbean Summit for Integration and Development, in Brazil in 2008, recommended that finance ministers consider a strategy for a regional and subregional financial architecture for increasing cooperation. The proposals to be considered include: further integrating regional and subregional financial markets; developing or strengthening regional mechanisms for balance-of-payments stabilization; extending cooperation between national and regional development banks; and installing a mechanism for trade payments in local currencies. This last initiative is also being discussed in the context of the Latin American Integration Association.

The way forward

The international financial system should be able to mobilize and allocate savings to their most productive uses, as well as play a countercyclical role by smoothing out the business cycles across countries (ECLAC, 2009c). Once again, however, it has shown its weakness in reaching these goals, resulting again in demands for deep reform and a more stable and equitable international financial system. This time, however, the demands have a renewed intensity and are coming from a much broader group of people and institutions. This is not only because the current crisis is the most severe since the Great Depression, but also because this episode has shown, more explicitly than ever, that financial crises are global and systemic phenomena that generate large disturbances from small impulses, and that no country is isolated from contagion.

Despite the severe problems that it has created, this crisis also therefore offers a unique opportunity to transform the interna-

tional financial system to enable it to fulfil its fundamental role of mobilizing savings and smoothing out business cycles across countries. At present, the financial system has worked in a procyclical fashion, amplifying rather than smoothing business cycles, and at both macro and micro levels it suffers from weak regulation.

To reduce volatility in global financial markets, the international financial system and regulations need to operate in a countercyclical fashion. Reform is also needed in the international financial institutions, which should benefit from greater surveillance and participation from developing countries – and be complemented by a strong regional financial architecture.

Countercyclical role of the financial system

Traditionally the financial system has accentuated rather than dampened economic fluctuations. Private capital flows; in Latin America and the Caribbean have generally been highly procyclical (Figure III-8) – a source of economic instability. When facing crises, developing countries have had few resources of their own with which to respond and limited access to the international financial system. Developing countries in the ECLAC and other regions have therefore consistently argued for countercyclical instruments and policies that can pre-empt the negative effects of economic and financial crises.

The international financial institutions, such as the IMF, should have the financial and technical capacity to provide the necessary financial resources in a timely manner. This can prevent local crises developing into global ones and ensure that the flow of assist-

ance is not slowed by administrative procedures or conditionality. There now appear to be some steps in this direction, since the IMF has recently created a new Flexible Credit Line “for countries with very strong fundamentals, policies, and track records of policy implementation”. In April, Mexico requested \$47 billion from this credit line.

Regulations to reduce volatility

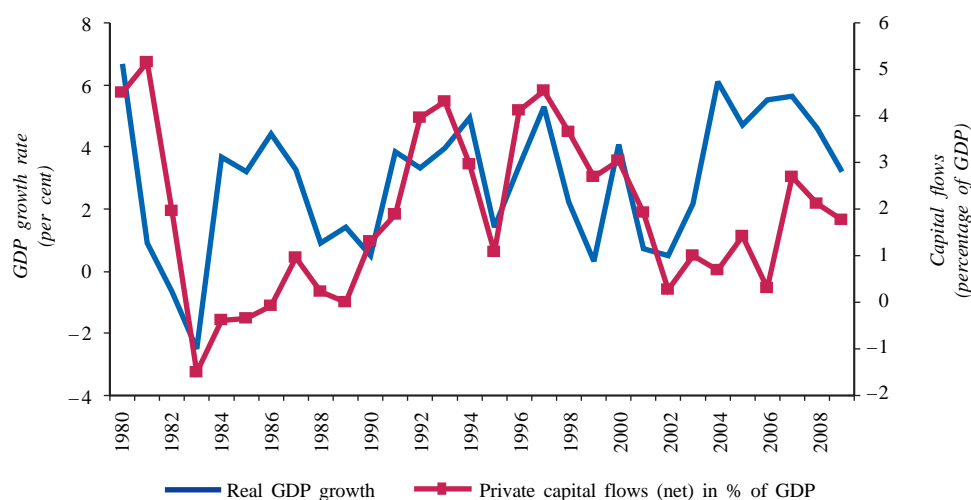
Mechanisms that work in a more countercyclical fashion can reduce the vulnerability of domestic economies to sudden changes in the international financial environment. These can be supplemented by various forms of capital account regulation that enable economic policy to act in a countercyclical fashion, along with other measures to reduce vulnerability to capital outflows by domestic residents.

Prudential counter cyclical regulation

At present prudential regulation largely is procyclical – as with the patterns of credit ratings found in Basle II and the use in United States of mark-to-market accounting in the private sector. One of the most widely cited proposals for prudential countercyclical regulation is the Statistical Provision for Insolvency that has been applied since 2000 in Spain (Férrandez, 2000). In Latin America this type of regulation can be adapted to take into account the specificities of national financial systems.

Surveillance

Currently the international financial institutions fail to provide the level of surveillance needed to enhance the stability of the global system and avoid undue economic

Figure III-8 – ECLAC region – GDP growth and net capital flows as a percentage of GDP

Source: ECLAC, based on IMF data.

imbalances. The developed countries are rarely subject to any surveillance by the IMF, for example, because they do not require the assistance of the IMF to deal with their financial and macro-imbalances. However, distortions in these countries can have global implications, introducing sustained disequilibria in the international financial system. In these circumstances, what is needed is global regulation. The IMF should take on functions similar to those of a global regulator, ruling for all the system's participants, and not only for the developing countries that require its financial assistance. The current crisis has demonstrated how the stability of the system can be threatened by a crisis in financial centres outside the scope of surveillance of international financial institutions.

Regional financial architecture

Regional and subregional financial institutions are playing an increasingly important role in the new international financial archi-

ture by complementing global financial institutions. Subregional development banks and reserve pooling institutions, for example, have helped countries in the region to mobilize financial resources for productive activities. They have been able to provide countercyclical financing and also assist with surveillance and macroeconomic policy coordination.

In addition, regional and subregional development banks have allowed the region to increase its degree of integration in international capital markets while also developing domestic capital markets. They have, for example, been improving their funding conditions and issuing bonds in Latin American currencies. Jointly with international financial institutions, regional and subregional banks have helped countries in the current crisis by providing liquidity.

The region also has a successful experience in pooling foreign currency reserves, as with FLAR, which has been providing

member countries with countercyclical financing when facing balance-of-payments problems. During severe crises this system has given countries access to finance more

rapidly and on a larger scale than provided by the IMF. This could perhaps be extended to new members, in order to enlarge the resource base and help avoid contagion.



**The Global Economic and Financial Crisis:
Regional Impacts, Responses and Solutions**

The Economic and Social Commission for Asia and the Pacific

THE ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

A crisis that arrived from the developed countries is biting deeply in many countries, particularly through plummeting exports. Millions of people are losing their jobs and flows of remittances are declining. Even so, Asia and the Pacific is now more resilient than it was during the 1997 crisis, and though economic growth has slowed it remains higher than other regions. As a result, in 2009 Asia and the Pacific is likely to remain the locus of global growth.

For the second time in a decade, Asia and the Pacific has been hit by a financial crisis. But this time the region is better prepared. It has implemented regulatory reforms that have strengthened the banking system, ensured prudent macroeconomic management which has helped stabilize most macroeconomic indicators, and has improved current-account balances. At the same time, a number of economies in the region have built up protective shields of foreign-exchange reserves.

As a result of these improvements, the region is more resilient, but it has nevertheless felt the impact of the crisis. And despite uniquely aggressive countercyclical fiscal and monetary policy measures – global and regional – since September 2008 the economic outlook has darkened considerably as the crisis has worked its way through the region. There have been deep repercussions for the real economy and employment. Hardest hit is the export sector. In addition, investment and consumer confidence have been shaken by the lack of

credit, poor expectations, corporate losses, a slowdown of remittances and mounting concerns about job security and household income.

Growth has suffered in most countries, but there are nevertheless considerable variations in performance across the subregions. The economies that will be most resilient are likely to be those that rely more on domestic demand than exports, and that have significant room to enact expansionary fiscal and monetary policies. China and India both meet these criteria so are likely to be among the countries that will serve as anchors of global economic expansion in 2009, albeit growing at a much slower pace than in 2008.

Much will hinge on how the region uses fiscal policy in 2009. If the larger economies including China, India and Indonesia, can enact fiscal stimulus packages to keep their domestic demand buoyant this will influence not only the path and speed of the region's economic recovery, but also

help maintain socio-political stability. However, it will also be important to have concerted action at both regional and global levels so that such stimuli and other measures have the maximum impact, and to enable countries to build resistance against future crises.

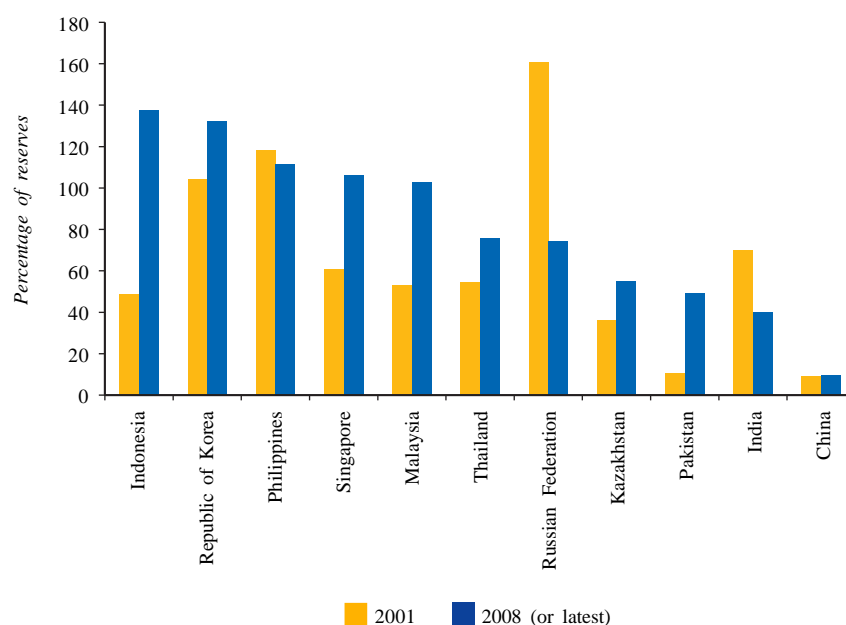
The impact of the crisis

External sector and short-term capital flows

For some economies of the region, the spark that led to immediate macroeconomic difficulties in the third quarter of 2008 was, once again, exposure to short-term portfolio capi-

tal. Figure IV-1 shows that, prior to the eruption of the financial crisis, the Republic of Korea, Indonesia, Singapore, the Philippines, and Malaysia all had stocks of foreign portfolio investments whose value exceeded foreign reserves. When the financial instability hit, there was a flight to safety and capital exited rapidly. For highly leveraged investors, declining equity values abroad had triggered margin calls. In some of these countries, notably the Republic of Korea, currencies came under strain and Central Banks were forced to defend them with reserves. However, over the past decade, regulatory reforms in the financial sector combined with cautious macroeconomic management have improved current-account

Figure IV-1 – Stock of portfolio investments as a percentage of foreign exchange reserves, selected economies, 2001 and 2008 or latest



Source: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., April 2009).

Note: Derived from international investment position of respective economies, including the categories of stock of portfolio investment and financial derivatives investment, excluding direct investments and other investments.

balances (Figure IV-2) and short-term debt profiles (Figure IV-3). To a large extent, the region possessed the resilience to withstand the worst of the deleveraging process.

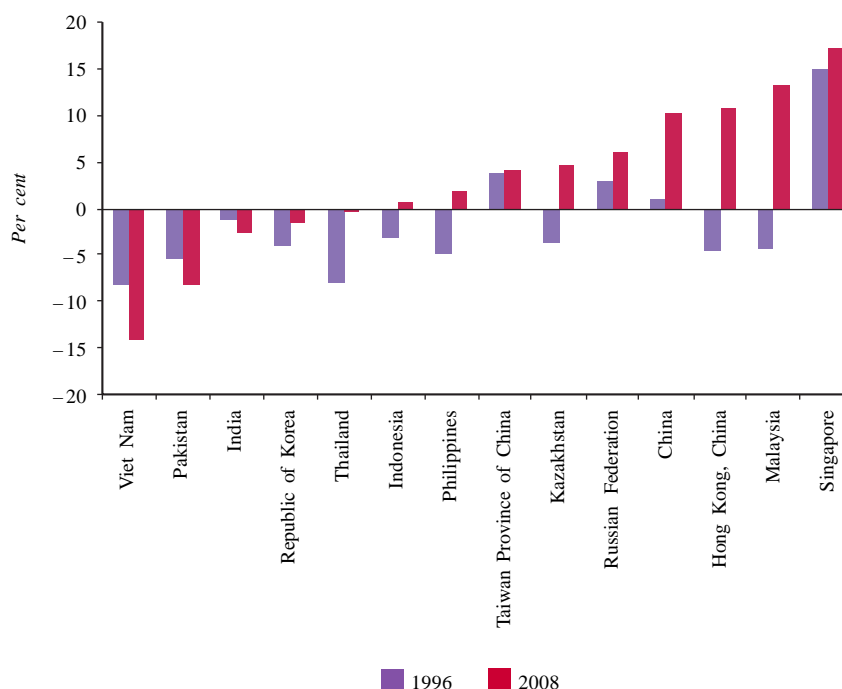
Equity and property markets

Since mid-September 2008, the credit crunch and a worldwide flight to safety by investors have caused the value of the region's equity markets to decline sharply. The global credit crunch, measured by the price of credit, has been more severe than at the peak of the 1997 crisis. This led to particularly sharp falls in markets where, taking advantage of high global liquidity, foreign investors had acquired an increasing

presence. For Hong Kong, China and Taiwan Province of China the declines have exceeded those in 1997 (Figure IV-4).

There is no certainty that the trough has been yet reached and there remains a possibility of further falls. Thus far, however, overall declines have been less than in 1997. Furthermore, as compared to developing countries in other parts of the world, those in the Asia-Pacific region have experienced shallower declines (Overview, Figure 2) – once again underlining the relative resiliency of the region's markets. These declines will lead to lower domestic demand, especially in personal consumption and corporate investment.

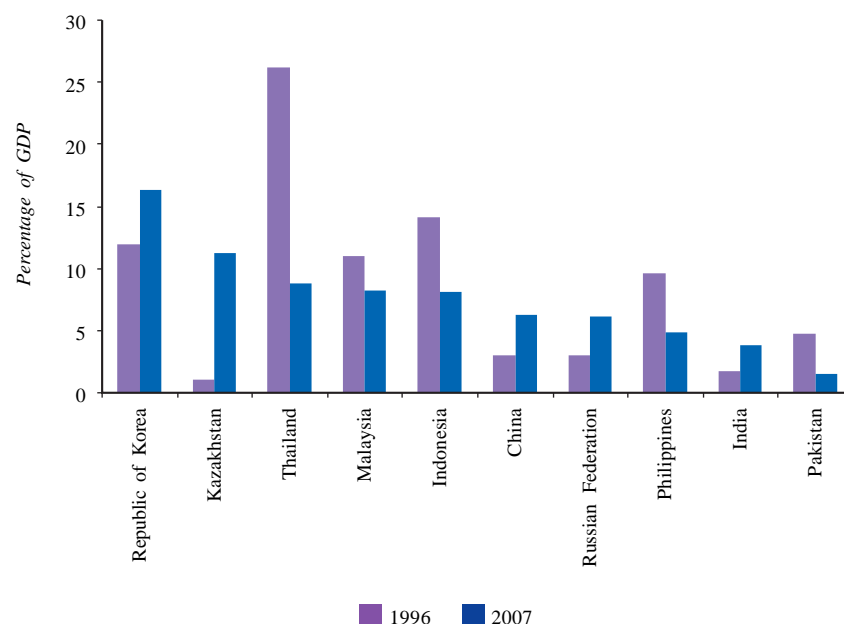
Figure IV-2 – Current account balances as a percentage of GDP, selected developing ESCAP economies, 1996 and 2008



Sources: IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2008), and *World Economic Outlook Database* (Washington, D.C., October 2008); and national sources.

Notes: Figures for 2008 are estimates. Current account balance for Hong Kong, China refers to 1997.

Figure IV-3 – Short-term debt as a percentage of GDP, selected developing ESCAP economies, 1996 and 2007



Sources: ESCAP calculations on the basis of World Bank, *Global Development Finance Database* (accessed 5 May 2009); and ADB, *Key Indicators for Asia and the Pacific 2008* (Manila, 2008).

Note: Short-term external debt has an original maturity of one year or less.

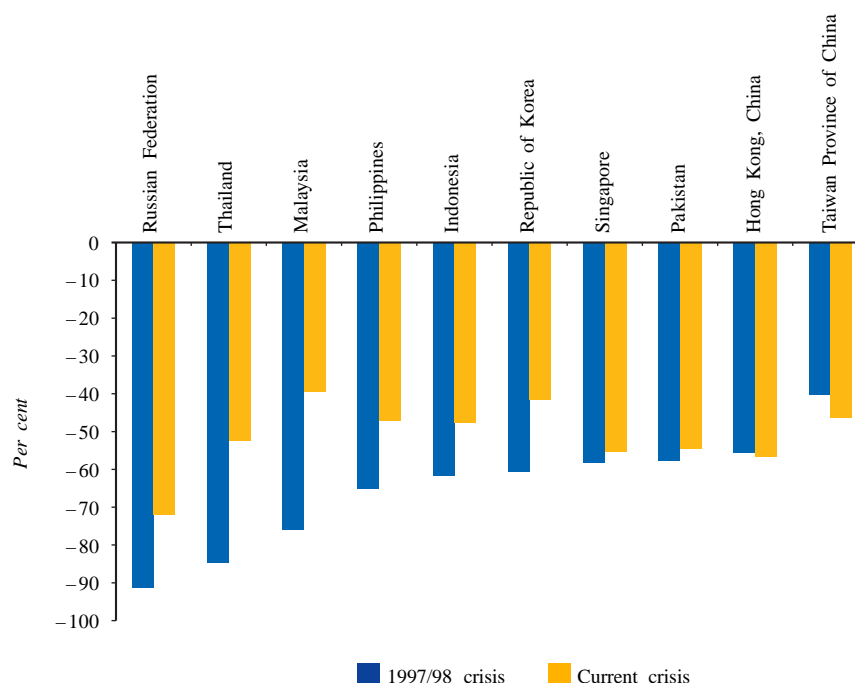
Compared with the developed countries, equity market investments in Asia and the Pacific as a whole constitute only a small proportion of household wealth, and equity financing makes up a relatively small proportion of corporate investment. The declines will, however, be greater in the more advanced economies of the region, such as the Republic of Korea, Singapore, and Hong Kong, China. Domestic demand will also be dampened by the downturn in property prices. As with equity markets, in the property markets foreign capital had increasingly contributed to high price rises. Similarly, home mortgages are much less important in the region than in developed countries. For example, in China they represent 12 per cent of GDP, and in India only 5 per cent, compared to 105 per cent in the

US. The more advanced economies of the region however, are more severely affected.

Banking sector

The region's ability to grow out of the crisis is being hampered by restrained bank lending. Since private funding from developed countries has seized up, Asian companies have either had to delay issuing new external bonds, refinance at shorter maturities, or turn for funding to domestic sources at a time when domestic lenders are also circumspect. Between 2007 and 2008, private capital flows to Asia slowed sharply, from \$315 billion to around \$96 billion (IIF, 2009). Trade credit in particular has been reduced, contributing to a sharp decline of the region's trade flows.

Figure IV-4 – Equity market decline from peak to trough in 1997/98, and in the current crisis from peak to end-March 2009



Source: ESCAP calculations based on data from CEIC Data Company Limited.

Note: Declines for the 1997/98 crisis measure major stock market indices falling from the peak to the trough during that period. Declines for the recent crisis measure the corresponding movement from the recent peak to end-March 2009.

Private-sector debt had increased in recent years, especially in the Republic of Korea, Hong Kong China, Taiwan Province of China, Indonesia, India and Singapore. Now, however, constrained credit is a cause for concern because, during a period of slowing domestic growth, an ailing corporate sector could add a new layer of risk aversion and financial stress to the banking sector.

Small and medium-sized enterprises (SMEs) are particularly vulnerable to a slowdown in credit. With higher risk profiles they are generally less likely to attract funding, and will have a smaller pool of internal funds

to see them through the credit crunch. Their most immediate concerns are the difficulty of rolling over short-term debt positions, and obtaining trade finance. The most-affected SME sectors are export-oriented enterprises, such as textiles, footwear and toys.

Governments have been taking active steps to ease the credit crunch – aiming to break the negative feedback loop between the financial and real sectors, and to mitigate the damage to SMEs. They have, for example, reduced interest rates, injected liquidity to support interbank lending, injected capital directly into banks, temporarily relaxed

banking requirements such as those for collateral, and provided guarantees for working-capital loans to the private sector. To support SMEs specifically they have offered loan guarantees, tax reductions, export credits, and interest subsidies. At present, the level of non-performing loans across major economies in the region is still low, currently below the international threshold of 8 per cent. This, combined with the range of government measures, has created an important buffer for the region's banks, and in the coming months should reduce the systemic risk of increases in non-performing loans.

Trade and growth

The financial crisis has had its most visible impact on trade. Asia and the Pacific is a trade-oriented region. Indeed in 1997 it was able to mitigate the effects of the economic

crisis by boosting exports. This time, however, with the precipitous decline in aggregate demand in developed countries, exports have plummeted. Some of the region's economies have gone from double-digit increases in the previous decade to double-digit declines (Table IV-1). The economies hardest hit are those with enterprises that are most directly linked through vertically integrated production networks that supply US and EU markets – such as China, Hong Kong, China; Republic of Korea, Singapore, Malaysia and Thailand.

This has had a serious impact on economic growth. The economies where growth weakened most in the last quarter of 2008 were the export-oriented ones – owing to the sharp deterioration in exports combined with much weaker domestic demand. The highest negative growth was registered for Taiwan Province of China at 8 per cent,

Table IV-1 – Value of exports, year-on-year, selected ESCAP developing economies

(Percentage change)

	2008			2009		
	Oct	Nov	Dec	Jan	Feb	Mar
China	19.1	-2.2	-2.8	-17.5	-25.7	-17.1
Hong Kong, China	9.4	-5.0	-10.8	-21.3	-22.6	-20.9
Taiwan Province of China	-8.3	-23.3	-41.9	-44.1	-28.6	-35.7
India	-12.1	-9.9	-1.1	-15.9	-21.2	-33.3
Republic of Korea	7.8	-19.5	-17.9	-34.2	-18.5	-22.0
Japan	-6.4	-15.8	-20.0	-35.3	-41.4	-43.9
Malaysia	-6.7	-11.0	-20.1	-33.9	-25.5	..
Philippines	-14.8	-11.4	-40.3	-40.6	-39.0	..
Singapore	-5.0	-15.4	-22.0	-40.2	-29.1	-28.1
Thailand	5.2	-18.6	-12.5	-26.5	-11.3	-23.1

Source: CEIC Data Company Limited.

Note: Derived from figures in US dollar terms.

followed by Thailand at 4.3 per cent, Singapore at 3.7 per cent, the Republic of Korea at 3.4 per cent and Hong Kong, China at 2.5 per cent.

An even greater cause for concern on the trade front is the accelerating decrease in imports. For example, in China in January 2009, the year-on-year decline was 43.1 per cent. South-East and East Asia have regionally integrated production bases so these import declines, consisting to a large extent of manufacturing parts and components, reflect the extent to which vertical production chains are downscaling – and indicate the potential for further export declines in the months ahead. The region is thus in the midst of an industrial crisis, and can expect exports to decline for some time to come.

Foreign direct investment

Over the past decade, following the sharp fall resulting from the 1997 crisis, foreign direct investment (FDI) in Asia and Pacific had increased dramatically. FDI is usually long term, so during a crisis should be a more stable source of inflows, and overall, given the region's positive long-term outlook, Asia and the Pacific should be able to outperform other developing regions in attracting investment. Nevertheless, here too FDI is expected to slow down markedly – as already reflected in estimates of a declining FDI contribution to GDP in 2008. In addition there will be some reorientation, as more of the FDI comes from within the region and is more market- and labour-seeking, aiming to tap into buoyant domestic demand. This reorientation will come at the expense of the more traditional forms of intra-firm FDI between and within East Asian economies and South-East Asian

economies that was used to establish regional production networks supplying parts and components for consumer products destined for developed country markets.

Remittances

Among its 4.1 billion people the Asia-Pacific region has 50 million migrants. Indeed many countries in the region have experienced a surge in labour migration in recent years, with a concomitant increase in remittances. Between 2000 and 2007 remittances more than doubled to \$121 billion. In 2008, among the main remittance – receiving economies five countries in the region were in the top ten – Bangladesh, China, India, Pakistan and the Philippines. Remittances also make up an important proportion of GDP for a number of other economies, especially smaller ones such as Kyrgyzstan and Nepal, and some of the Pacific island countries (World Bank, 2008).

Experience suggests that during times of crisis, remittances in Asia and the Pacific are generally more stable than other capital flows and also tend to be countercyclical in that they increase during economic downturns or following natural disasters in the migrants' home countries. Furthermore, remittances depend not only on flows of migrants but also on the stock of migrants abroad. Thus, although the crisis is likely to reduce the flow of new migrants this may not materially affect remittances since the migrant stock is large. Remittances are thus expected to have a stabilizing effect.

Nevertheless, some sectors are more crisis-sensitive than others. Migrants working in health and domestic care, and education tend to be the most stable, particularly in countries with ageing populations. However,

those employed in tourism, construction and the IT industry are vulnerable to cutbacks or being sent back when their contracts expire. Already there have been reports of an increase in the return of unemployed migrants to India, the Philippines and Indonesia. Some countries in the region now have policies to retrench migrant workers first or to replace them with unemployed nationals, and to speed up the deportation of irregular migrants. Kazakhstan, the Republic of Korea, Malaysia, and Thailand, for example, have also been applying greater restrictions on the issue of new work permits and refusing to renew some existing ones (IOM, 2009).

Livelihoods and vulnerable groups

As the crisis unfolds, it has been estimated that in 2009 unemployment in Asia and the Pacific could increase by as much as 23 million workers (ILO, 2009b). In 2008, the greatest impact was felt in the export manufacturing sector, including garments, electronics and autos which, in many East and South-East Asian economies, employ a large part of the workforce. The crisis also hit employees in construction, tourism, finance, services and real estate. The countries experiencing the greatest impact will be those with slowing economies and rapid growth in the labour force, such as Cambodia, Pakistan and the Philippines (ILO, 2008b). The crisis will also hit wages. Across the region, average wage growth in real terms in 2009 is unlikely to exceed 1.8 per cent, and workers in countries with low economic growth will probably see wage reductions (ILO, 2008c).

Mere unemployment figures mask the full extent of the problem. As the 1997 crisis showed, when people are affected by sud-

den shocks, the ones most at risk are the poor, women who are labourers in the manufacturing sector, the youngest and oldest populations and low-skilled immigrants. When societies are in danger of collapse, such as in the 1997 crisis, there is evidence of significant rises in suicide and crime rates; abuse and violence against women; and ethnic tensions (Heyzer et al, 1999; Knowles et al, 1999). Women bear the brunt, of these social fallouts. The damage of a crisis also lasts much longer than the crisis itself. After the 1997 crisis, for example, economic growth resumed relatively quickly, but some countries took up to 10 years to recover the ground they had lost in the struggle against poverty (ILO, 2008a). Of special concern is youth unemployment, which in some countries is expected to increase from already high levels. In Indonesia, for example, in 2007, youth unemployment was 25.1 per cent, in Sri Lanka it was 25 per cent and in the Philippines it was 14.9 per cent (ILO, 2008b).

Country-specific responses

At the onset of the crisis, for most of the region's economies the first line of defence against economic downturn has been monetary policy. However, many of the developed economies have demonstrated the limits of what can be achieved by the conventional method of aggressive interest rate cuts to inject liquidity into the financial system. If the downturn deepens and inflation moves into negative territory countries in Asia and the Pacific may also need to consider unconventional and untested measures.

Inflation rates have come down markedly in the region since the crisis hit, and for some countries it is forecast at close to zero in

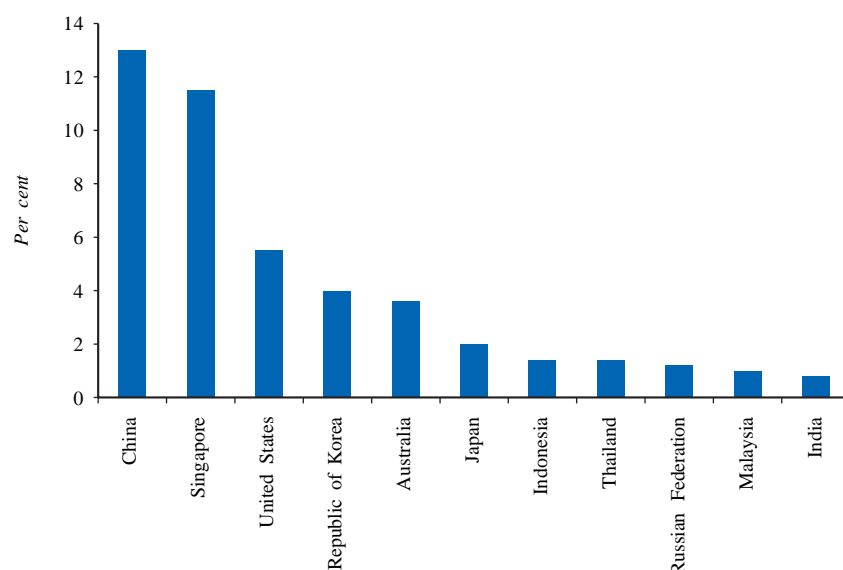
2009. Nevertheless for developing countries, monetary policy remains an important tool – especially in a post-recovery phase when the economy may be ill-prepared to productively employ excess liquidity. Easy liquidity could then find its way into speculative markets, triggering inflationary spikes and commodity price volatility.

To date, however, the key response has been fiscal policy. Many economies have adopted stimulus packages – as documented in the 2009 edition of ESCAP's *Economic and Social Survey of Asia and the Pacific*. At the 65th Session of the Commission in 2009 the ESCAP secretariat was requested to provide a one-stop information and analytical service on the various packages. This information is being regularly updated and shows that while all packages are designed to support aggregate demand, particularly domestic demand, the approaches differ according to each country's level of develop-

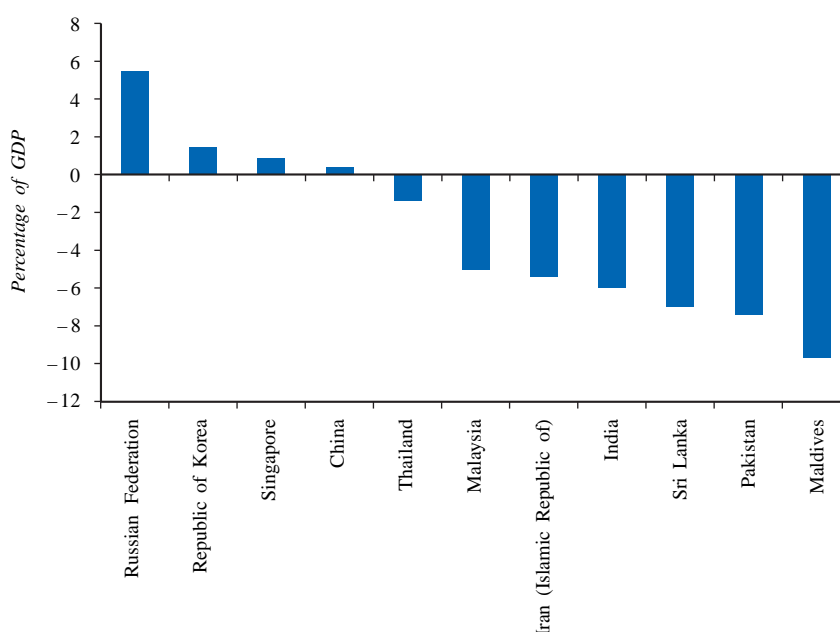
ment and national circumstances (ESCAP, 2009). For example, China and India have made large capital outlays for infrastructure development and activities to create employment. Japan, on the other hand is focusing more on supporting small and medium-scale industries and private consumption. Estimating the true scale of fiscal stimulus can, however, be difficult. Some announcements, for example, may refer to capital outlays that were already in the pipeline. Estimates for a range of countries are shown in Figure IV-5.

The countries best able to introduce large packages are those with strong budgetary positions. China, for example, can afford to enact a fiscal stimulus package amounting to \$586 billion, second only to that in the US. India, on the other hand has less freedom since it is already running a large budget deficit – 6 per cent in 2008 (Figure IV-6).

Figure IV-5 – Selected stimulus packages as a percentage of GDP



Source: *Economic and Social Survey of Asia and the Pacific 2009* (United Nations publication, Sales No. E.09.II.F.11).

Figure IV-6 – Fiscal balance, top surplus and deficit economies, 2008

Sources: ESCAP, based on national sources; ADB, *Key Indicators for Asia and the Pacific 2008* (Manila, 2008); and ESCAP estimates.

Some countries have chosen in their packages to boost private consumption through tax cuts or transfers – measures that usually work faster than public spending on physical or social infrastructure. But in the present circumstances that may not be the case. Given the overall pessimism and uncertainty, many households may decide not to spend these benefits, but to save them. So if the downturn is prolonged, governments may prefer longer-lasting public spending.

One major concern in the region is that fiscal stimulus packages may pay insufficient attention to social protection. Generally they have been confined to job creation programmes and boosting consumption, rather than offering greater protection to those who enter into employment. In Asia and the Pacific the coverage of basic social

protection programmes remains very low: only around 20 per cent of the population have access to health care assistance; only 30 per cent of the elderly receive pensions; and only 20 per cent of the unemployed and underemployed have access to labour market programmes.

Regional responses

As an important first step in regional financial cooperation, the ASEAN+3 Finance Ministers agreed in February 2009 to accelerate the implementation of a multilateral foreign exchange reserves pool, paving the way for converting an existing bilateral fund of \$80 billion to a multilateral pool of \$120 billion. Of the new funds, 80 per cent will be provided by ‘+3’ countries while the remainder will come mainly from the more developed ASEAN economies. Nevertheless

many issues remain unresolved if this agreement is to fulfil its function in the event of a balance-of-payments crisis. One of the main issues concerns the requirements tied to the lending of the funds. This will demand a strengthened ASEAN process of monitoring and surveillance. But as yet this is an issue on which political consensus and thus political will remain fragmented. Another concern is the size of the fund. A contagious financial crisis could result in multi-country requests for assistance that would be difficult to meet. It will therefore probably be necessary to increase the size of the fund and/or expand its membership.

On the trade front, the Government of Japan has announced that it will set up a \$1-billion fund through the Japan Bank for International Cooperation in collaboration with the Asian Development Bank. This will lend to financial institutions in developing countries to help companies gain access to much-needed trade finance.

Additionally, in order to spur economic growth the ADB will expand its lending capacity. In 2009 it will triple its capital to \$165 billion. This measure is in line with the agreement reached by the G20 leaders during the 2009 London Summit to treble IMF resources from \$250 billion to \$750 billion, and to support a new SDR allocation, as well as to boost the capital of multilateral development banks including the ADB.

At the 65th Session of the Commission, held from 23 to 29 April 2009, governments adopted resolution E/ESCAP/65/L.7. While expressing concern about the financial crisis which had become a global economic crisis that could complicate efforts to achieve energy and food security in the

region, the Commission urged implementation of regional cooperation initiatives. To this end it requested the Executive Secretary to continue to assist countries through in-depth analysis, policy dialogue and advocacy and increased capacity-building activities. (ESCAP, 2009).

The way forward

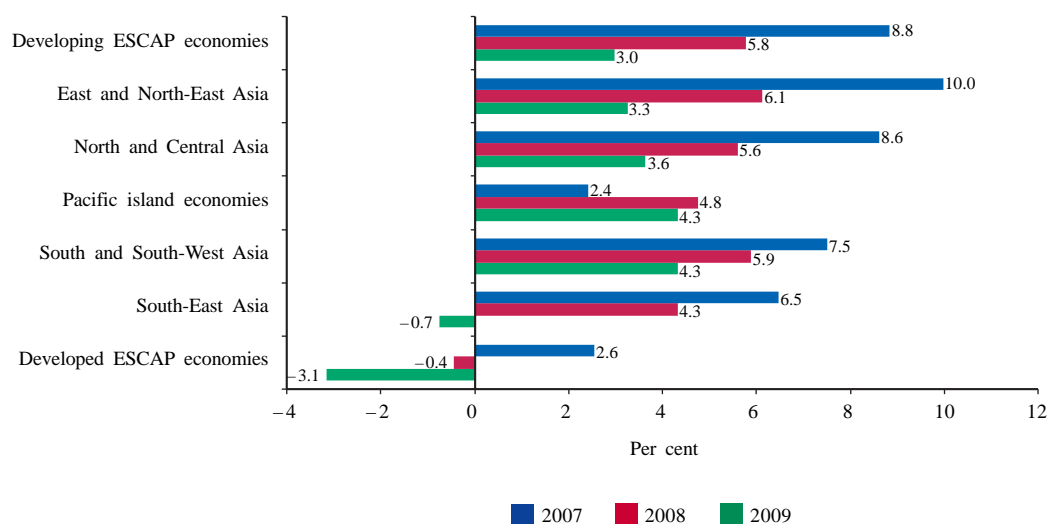
Economic outlook

In 2009, economic growth in developing economies in the region is expected to slow further to 3.0 per cent. All Asia-Pacific subregions will experience a deceleration, but the greatest decline will be in the export-dependent South-East Asian economies (Figure IV-7). Even moderate decreases in growth rates can have enormous social consequences, but the rates in Asia and the Pacific are likely to remain higher than those in other regions which, given the size of the region, will make it the locus of global growth in 2009.

The region will, however, remain vulnerable to further setbacks in the developed countries, and the arrival of new threats, notably influenza A. Figure IV-8 shows a likely scenario based on a severe deceleration in growth in the United States. In this case the Asia-Pacific countries feeling the pinch would be the Republic of Korea, Singapore, Hong Kong, China, and Taiwan Province of China. China, however, even under a downside scenario is expected to achieve relatively robust growth.

Policy recommendations

Urgent action is needed both to emerge from the current crisis, and to prevent similar crises in the future. Some of the most

Figure IV-7 – Economic growth, selected ESCAP economies, 2007-2009

Sources: ESCAP, based on national sources; IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., November 2008); ADB, *Key Indicators for Asia and the Pacific 2008* (Manila, 2008); Economic Intelligence Unit, *Country Reports* and *Country Forecasts*, various issues (London, 2008); data from the Interstate Statistical Committee of the Commonwealth of Independent States, accessed from www.cisstat.com on 30 March 2009; and ESCAP estimates and forecasts.

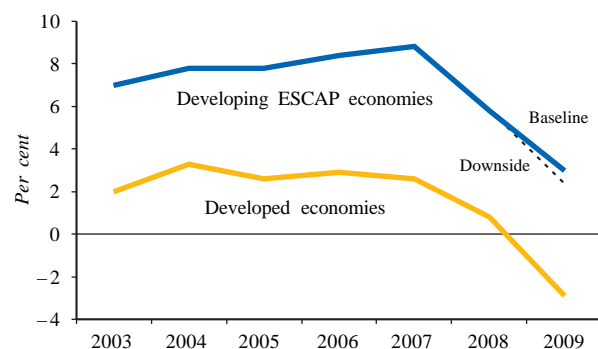
Note: Rates of real GDP growth for 2008 are estimates and those for 2009 are forecast.

important measures can be taken at the regional level – to promote consensus and common policy positions that can serve as building blocks for greater coherence in multilateral economic policy-making and thus result in a truly inclusive multilateral system of economic governance. Compared with global measures, regional ones are also more likely to garner support, since countries appreciate more readily that these are in their own self-interest – and among a smaller group of countries there is less opportunity for “free riding”.

While the Asia-Pacific region has already taken steps in the right direction, with agreements such as those recently reached by ASEAN+3, further concerted action is required. Among other things, this should aim to:

- *Strengthen regional coordination of monetary and fiscal policies.* The current crisis has highlighted the importance of coordinating monetary and fiscal policies, including the design, scale, phasing-in and financing of fiscal stimulus packages so that they can have synergistic multiplier effects across the region. As a guiding principle, the use of fiscal stimulus packages to assist in economic recovery should be based upon a more inclusive and sustainable development paradigm. Key elements are:
 - *Strengthen the social foundation through more effective social protection systems.* Using fiscal stimulus packages to build strong social foundations will make societies more cri-

Figure IV-8 – Real GDP growth, selected developing ESCAP and developed economies, 2003-2009



Source: Calculated based on national sources; IMF, *International Financial Statistics* (CD-ROM) (Washington, D.C., November 2008); ADB, *Key Indicators for Asia and the Pacific 2008* (Manila, 2008); website of the Interstate Statistical Committee of the Commonwealth of Independent States, accessed from www.cisstat.com, 30 March 2009; and ESCAP estimates and forecasts. Figures for developed economies are extracted from World Bank, *World Development Indicators* database and *Global Economic Prospects 2009, Forecast update* (30 March 2009).

Note: GDP growth for 2008 and 2009 are estimates and forecasts respectively. Developed economies refer to high-income economies.

sis resilient, since social protection programmes have consistent counter-cyclical effects. Also, by providing a basic level of income support, protection schemes make individuals feel more secure and less inclined to increase their savings to protect themselves, thereby boosting domestic demand and contributing to macroeconomic stability (Heyzer, 2009a).

- *Utilize the financial crisis as a window of opportunity for addressing climate change.* Climate change is having a severe impact on the Asia-Pacific region; the threats are real

and increasing. Just as countries are coordinating their responses to the current financial turmoil, they also need to work together to galvanize support for action on climate change. The stimulus packages for addressing the financial crisis and economic downturn could incorporate action on climate change for sustainable development. In this regard, the region could consider recent initiatives, such as the “Green New Deal” promoted by the Secretary-General of the United Nations and the ESCAP Green Growth initiative, as a way forward.

- *Engender fiscal stimulus packages.* Gender dimensions need to be incorporated into stimulus packages to address the disproportionate burden of economic crises on women. Large public infrastructure and public work projects are a common feature in all stimulus packages. They are the most effective in reaching a wide range of unemployed workers without regarding their skill mix. However, these jobs are mostly in construction where jobs are held mostly by men. Social services such as health, education, and agricultural extension services that would open equal opportunities for women need to be incorporated into public work programs (Heyzer, 2009b).
- *Strengthen regional contingency and surveillance.* Asia and the Pacific clearly needs a regional mechanism that can respond quickly with sufficient resources to the liquidity and capitalization problems of domestic banks. This would require a strong regional surveillance sys-

tem that can assess systemic financial risk. As a first step, the ESCAP secretariat is working on financial indicators that track the impact of the crisis and analyse its future implications. This will also form part of the regional statistical and analytical contributions that the ESCAP secretariat will provide to the UN Global Vulnerability Monitoring and Alert Mechanism.

- *Establish more durable regional currency arrangements.* In addition to increasing the availability of contingency funds, the region also needs arrangements that can avoid uncoordinated national management of currencies, which can result in competitive devaluations with unnecessary foreign exchange losses, higher debt-servicing costs and balance of payments pressures. The region also needs to consider ways of reducing vulnerability to reversals in short-term capital, such as through introducing deposit requirements on capital inflows or levying financial transaction taxes. There is also an ongoing debate regarding diversifying currency reserves from the US dollar to other currencies, or to a basket of currencies, or to IMF Special Drawing Rights (SDRs). A regional currency arrangement could eventually serve as a building block for an additional reserve currency.
- *Establish a regional trade financing mechanism.* Trade has been curtailed by a lack of trade credit. Somewhat anomalously, given its dependence on trade, Asia and the Pacific is the only region without its own institution dedicated to export credit and export credit guarantees. A regional trade-financing facility would provide risk pooling across countries and scale economies. It would also have more credibility than isolated national initiatives, thus offering countries, particularly those with special needs, greater access to international finance.
- *Strengthening of the regional financial architecture.* The most efficient manner to combine the various regional actions related to financial and monetary cooperation would be through the establishment of an Asian Monetary Fund. Such an initiative, if properly designed, would support and strengthen the evolving global financial architecture. The presence of existing global institutions should not be a constraint to the establishment of a complementary regional setup. The ability of international and regional institutions to work in an integrated manner has already been shown to be effective in the development banking sphere.
- *Strengthen the multilateral trading system.* A particularly worrisome signal on the trade front is growing protectionist pressures. Some recession-hit countries, often via conditionalities on bailout packages or additional subsidies, are giving market-distorting preferences to local producers which could harm Asia-Pacific exporters. This calls for a strengthening of the multilateral trading system in support of trade and development objectives. A conclusion of the Doha Round, in accordance with its development mandate would offer the most stable and transparent environment for conducting global and regional trade.
- *Strengthening South-South trade and investment.* The region can soften the impact of current and future economic cri-

ses by tapping into the potential of South-South trade and investment. To fulfil this potential, governments should

remove non-tariff barriers and accelerate implementation of regional economic integration agreements.



**The Global Economic and Financial Crisis:
Regional Impacts, Responses and Solutions**

The Economic and Social Commission for Western Asia

THE ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA

Western Asia is critical to the world economy as the leading supplier of oil. The current crisis has resulted in a dramatic drop in world oil prices which has reduced the income of oil producers but benefited the region's other economies – and helped offset some of their losses from falling exports to the recession-hit developed countries.

Western Asia can be considered as two groups of countries: those in the Gulf Cooperation Council, which are among the world's major oil producers, and other countries such as Egypt, Syria and Lebanon which have more-diversified economies. All have been seriously affected by the global economic crisis, but in different ways.

The impact of the crisis

As indicated in Table V-1, real GDP growth is expected to decline sharply in the GCC countries, from 5.8 per cent in 2008 to 1.1 per cent in 2009, due mainly to the deep

correction in oil prices, reduced oil production, and tight credit conditions.

Among the GCC economies, the United Arab Emirates (UAE) has been the most affected by the crisis. Between 2008 and 2009, real GDP growth fell from 7.4 to 0.5 per cent. This was due to a severe contraction in domestic demand, notably in Dubai. In the UAE the real estate sector represents 16 per cent of GDP, so the slowdown in this sector is having a severe impact on growth. Around 80 per cent of Dubai's workforce is composed of expatriates and, as many firms downsize their projects and

Table V-1 – Real GDP growth and consumer inflation rate, 2008 and 2009

(Per cent)

	Real GDP growth rate		Consumer inflation rate	
	2008	2009	2008	2009
GCC countries	5.8	1.1	12.0	5.2
More diversified ESCWA members	6.6	4.0	13.9	8.2
ESCWA region	6.1	2.1	12.7	6.3

Source: ESCWA (2009).

start to lay off some of their employees, there is likely to be a significant reduction in consumption (GFH, 2009). Saudi Arabia is also expected to be severely hit: GDP growth in 2009 is forecast at 0.7 per cent, down from 4.2 per cent a year earlier, and the country's lowest rate for many years.

Other countries will also see a decline in real GDP growth between 2008 and 2009: in Bahrain, for example, from 6.3 to 2.0 per cent; in Kuwait, from 6.1 to 0.7 per cent; and in Oman from 6.0 per cent to 1.5 per cent. Qatar has also seen growth fall over this period, from 14.0 to 7.0 per cent, but is likely to remain largely insulated since it depends mainly on gas revenues.

Syria will be affected by the adverse global developments as well as by the slowdown in the GCC countries. Oil output will continue to decline which will reduce government revenues (IMF, 2008). In Egypt too, GDP growth is expected to fall between 2008 and 2009, from 6.5 per cent to between 4.0 and 4.5 per cent. This will take output below its potential, which would leave some scope for a modest policy stimulus to assist the economy through 2009.

In Lebanon, the impact of the global financial crisis has so far been muted. However, the global economic downturn, especially in the GCC countries, will take its toll. Tighter global credit and a pronounced global recession are likely to affect remittances, tourism, foreign direct and portfolio investments, and deposit inflows. As a result, between 2008 and 2009 economic growth is expected to decline from 5.5 to 3.0 per cent.

Inflation

In the GCC countries, the average inflation rate will decline from a peak of 12 per cent in 2008 to 5.2 per cent in 2009. This will be due to a combination of factors. Low demand, for example, will ease pressures on supply bottlenecks. The region will also experience less imported inflation through reduced commodity prices, a significant issue for the very open GCC economies. With the real estate market coming to a halt, rents are also starting to fall, along with house prices. In a number of countries, such as Qatar, rents have recently been one of the main contributors to inflation (GFH, 2009).

In general, in the more diversified ESCWA countries inflation will fall quickly from the 2008 spike that was caused by high food and fuel prices, and remain low (IMF, 2009d). In Egypt, the recent drop in inflation is likely to continue, down to 10 per cent in 2009, followed by a further decrease in 2010. In Syria, inflation started to decelerate in the last quarter of 2008 due to the fall in international food prices, and the figure for 2009 is expected to be about 15 per cent.

Trade

ESCWA countries will undoubtedly be affected by the severe economic slowdown in the developed countries. The extent to which countries in the region are affected will depend on a number of issues including their degree of openness of the economies. This can be assessed using the trade openness index which is the ratio of the sum of exports and imports to GDP. For 13 Arab countries in 2004 the index averaged 71 per cent. In addition, exports accounted for a significant part of the GDP of

ESCWA countries, notably the oil-exporters. The contraction of world trade will thus affect the GCC countries deeply. In addition, ESCWA countries' exports are highly concentrated, as the lion's share is accounted for by oil. The decline in oil prices and production will significantly erode the revenues and growth potential of the major oil-exporting countries.

Another consideration is the degree of concentration of ESCWA countries' exports in terms of products and geographical orientation. The more diversified member countries, particularly Egypt and Jordan, depend significantly on the US market and will therefore suffer as the US recession restrains demand for foreign products. On the other hand, a number of ESCWA countries depend more on European markets. For Syria, for example, between 1997 and 2005, the EU-15 took around 60 per cent of the country's exports. The European market is also important for other countries – taking 35 per cent of Egyptian exports and 19 per cent of those from Lebanon. These countries will therefore be affected by sluggish economic activity in Europe.

Foreign direct investment

In 2008, FDI in Western Asia is expected to fall by no less than 21 per cent – largely as a result of the steep decline in resource-oriented FDI, induced by falling oil prices. (UNCTAD, 2009). Most affected will be the three countries that have secured a high proportion of the region's FDI. In 2007, Saudi Arabia took 33.5 per cent, the UAE 18.3 per cent, and Egypt 18.0 per cent.

For Saudi Arabia in 2007, the largest shares in investment came from the US and Japan (ESCWA, 2008). Most of these flows went

to the oil and gas sector for joint ventures between international energy firms and Saudi Aramco. As oil prices plummet, such investments have become much less profitable and, in the short term at least, the flows are likely to cease.

In the UAE, the bulk of FDI inflows have recently gone to four sectors: oil and gas; financial services; construction; and wholesale and retail trade. The recent turmoil in Dubai's real estate sector is thus expected to sharply reduce investments in both commercial and residential property. However, over the long run, investment prospects in the UAE should remain quite interesting as the country is well equipped in infrastructure and has one of the region's most business-friendly environments.

The fall in FDI flows is also likely to affect a number of small countries. Among the resource-endowed countries, this would be the case for Oman, where recent FDI – originating partly from the US and the UK – was targeted primarily at the oil and gas sector (ESCWA, 2008).

Egypt is one of the region's major recipients of FDI, of which in 2007 around 60 per cent came from the EU and the US. These flows have been invested largely in the energy and construction sectors, but also in the telecommunications and banking industries, where there have recently been large privatizations. Some projected privatizations, as well as cross-border mergers and acquisitions, are likely to be postponed as a result of the current crisis. Lebanon too could witness a severe decrease in investment flows as it is largely dependent on a small number of GCC countries that have been affected by the crisis.

Fiscal balance

In 2009, the GCC countries are expected to witness a steep decrease in their fiscal surpluses. This will be the result of a severe decrease in export receipts induced by the fall in oil prices, as well as by a high level of public expenditure, as governments are forced to boost domestic demand. The IIF expects fiscal surpluses in the GCC countries to decline sharply between 2008 and 2009, from 22 to 5 per cent of GDP (IIF, 2008). In several of the more diversified economies, anticipated increases in public expenditure will exert severe pressure which in some cases will translate into large fiscal deficits.

External balance

Between 2008 and 2009, the GCC external surplus will narrow from \$321 billion to \$48 billion and, as a result, the current-account balance as a percentage of GDP will fall from 29.3 to 4.6 per cent. The more diversified economies, however, will in general benefit from the collapse of oil and commodity prices. This will significantly reduce their import bills and thus lessen, and in some cases offset, the expected decline in their exports (EIU, 2008).

Egypt's trade deficit, for example, is likely to narrow in 2009-2010, due to the decrease in the prices of imported goods and, over the next two years, the current-account surplus is expected to increase. However, the balance of payments will remain vulnerable until the global economy picks up (IMF, 2009b). Moreover, given the ongoing turbulence in the global financial markets there is always the risk of further short-term capital outflows. In Lebanon, too the external current account balance is likely to improve due to the sharp decline in oil prices, but capital inflows may weaken.

Export-oriented sectors

The bulk of ESCWA exports are oil and gas, notably to advanced countries. Over the period 1997-2005, mineral fuels averaged around 64 per cent of total Arab exports to the EU-15, and 81.7 per cent of those to the US. Since oil prices and production are expected to fall sharply in 2009 the region's export income will correspondingly decline (Table V-2).

Plunging oil prices will exert additional pressure on the resources of major ESCWA oil-exporters, notably the GCC countries. Less affected will be those that have been

Table V-2 – Oil market estimations and projections, 2008 and 2009

Expected oil market conditions	2008	2009	Percentage change
OPEC production (millions of barrels/day)	37.2	34.9	-6.6
World oil consumption (millions of barrels/day)	85.9	85.6	-0.3
Dated Brent price (US dollars/barrel)	97.0	35.0	-63.9
West Texas Intermediate price (US dollars/barrel)	98.5	35.7	-63.7

Source: EIU (2008).

making efforts to diversify their economies, such as Bahrain, Oman and the UAE, where exports of machinery and transport equipment have grown significantly.

The more diversified economies are highly dependent on their main trading partner, the

EU, and are likely to witness a decline in exports which are mostly manufactured products. Over the period 1997-2005, manufactured goods and products accounted for 39 per cent of Egyptian exports to the EU-15 and 46 per cent of those from Lebanon (Table V-3).

Table V-3 – Destination of ESCWA exports, 2005-2007

(Per cent)

	2005				2006				2007			
	Asia	EU ^a	North America	Others	Asia	EU ^a	North America	Others	Asia	EU ^a	North America	Others
Oil-exporting countries	54.6	14.3	11.0	20.1	57.6	17.2	15.6	9.6	71.3	3.9	1.2	23.6
Non-oil exporting countries	29.2	48.6	6.2	16.0	29.3	45.8	6.2	18.7	26.8	50.0	3.2	20.0
Arab countries	51.7	18.2	10.5	19.6	53.4	21.5	14.2	10.9	47.6	28.5	2.3	21.6

Source: UN-Comtrade (2009).

^a EU-15.

Banking sector

Despite the global financial crisis, most GCC banks remain well capitalized and profitable, with limited exposure to sophisticated financial products. With few exceptions, the ratio of non-performing loans to total loans is less than 5 per cent. Profits remain strong, with an average return on equity of 21 per cent. Capital adequacy ratios range from 13 to 20 per cent, far exceeding the minimum requirements (IIF, 2008).

Only a few GCC banks and investment firms have been associated with subprime assets and their losses have been limited (IIF, 2008). However, the prospects for 2009 look more difficult. Repatriation of

foreign funds is contributing to large capital outflows that will lead to a credit crunch. In the past few months, the costs of financing have risen sharply. Reduction in bank lending will lead to less investment, lower growth and an increase in unemployment. This will mean a drop in demand which, in turn, will further reduce economic growth.

Between 2005 and 2008, GCC banks increased their foreign liabilities from \$53 billion to \$172 billion – to meet the rise in demand for domestic credit, and in particular to finance the expansion in infrastructure projects and real estate. Between 2005 and June 2008, banks in UAE, especially Dubai, had a sharp increase in foreign liabilities, from \$23 billion to \$93 billion. In 2007 these constituted 40 per cent of GDP. Bank

foreign liabilities had also risen elsewhere: in June 2008 in Oman to \$4 billion; in Bahrain to \$25 billion; in Kuwait to \$24 billion; and in Qatar to \$20 billion. As a result, between 2005 and June 2008 the GCC external debt rose sharply, from \$10 billion to \$358 billion, equivalent to 33 per cent of GDP. However, all GCC countries remain net external creditors. On the other hand, local banks in Kuwait and Saudi Arabia are insulated from the current financial crisis since they have financed the large increase in domestic credit with domestic deposits and local borrowing.

Compared to their GCC counterparts, banks in other ESCWA countries have less exposure to the global financial turmoil. In Lebanon, banks have the region's highest capital adequacy ratio – 24 per cent in 2007. The Lebanese banks have also increased their capital to match the increase in their assets. Further, a great part of the domestic credit is financed through domestic funds: in 2007, the ratio of private sector deposits to assets exceeded 70 per cent, while the ratio of non-residents' deposits to assets was about 16.6 per cent. The Lebanese financial system has no direct exposure to distressed financial products or markets and remains very liquid. However, the political uncertainty following the 2009 elections may cause a substantial drop in deposit inflows, which could complicate government financing.

Similarly in Jordan, the fundamental credit outlook is stable, reflecting the banks' solid fundamentals. Banks in Jordan enjoy a substantial amount of excess liquidity. Nevertheless, Capital Investments forecasts that banks in Jordan will confront challenges in the upcoming years as, in the face of increased uncertainty, most have adopted

tighter lending regulations that will probably affect their profitability. High domestic inflation and falling demand for goods and services will also affect the quality of banks' assets and thus the effectiveness of their credit policies.

In Egypt too, the financial sector has escaped most of the effects of the international financial crisis, reflecting the strengthening of banks' balance sheets, improved banking supervision, and conservative practices with respect to funding, investments, and lending. The Egyptian banking sector is unlikely to face a credit crunch since banks are sitting on excess funds. They have very low ratios of loans to deposits – under 60 per cent – do not depend on foreign credit lines and have little exposure to fluctuations in the prices of equities and other investments. However, domestic liquidity conditions might tighten in response to portfolio outflows; repatriation of banks' overseas assets seems likely, which would give some relief to the balance of payments.

Country-specific responses

Fiscal policies

A number of GCC governments have announced massive programmes of investment in infrastructure and real estate (IIF, 2008) – aiming to boost internal demand and reduce the impact of the crisis on growth. The scale of the stimulus measures ranges from 3 per cent of 2008 of non-oil GDP in Bahrain to 9 per cent in Saudi Arabia. In Saudi Arabia over the next five years the government plans to spend \$400 billion on development projects in addition to the existing plans to invest around \$40 billion in various tourism sites. Kuwait, on the other

hand, appears to be an exception, with draft budget figures for 2009 that show a decline.

Several of the more diversified countries have also announced plans to stimulate domestic demand. In Egypt, the government announced a fiscal stimulus package of 30 billion Egyptian pounds to support industry, exports, tourism, and retail business that are currently feeling the effects of the global financial crisis. The government also intends to direct a great part of the fiscal package towards accelerating existing infrastructure plans. In addition, Egyptian authorities are likely to continue with the programme of economic reform, aiming to create new job opportunities and improve standards of living.

In Lebanon, the government's plans to mitigate the impact of the financial crisis include an acceleration and reprioritization of infrastructure spending, an expansion of interest subsidies for Lebanese lira-denominated bank lending to the corporate sector, various measures to improve the business climate, and incentive programmes to support job creation.

Monetary policies

In many GCC countries, the monetary authorities have recently taken measures to ease credit conditions. Central banks reacted swiftly to the current crisis by injecting funds and providing credit facilities to maintain the liquidity of the banking sector. In an attempt to ease funding pressure, they also cut interest rates and reduced the reserve requirements. The UAE was the first GCC country to provide guarantees for bank deposits; in October 2008 it offered a DH50 billion credit facility which was supplemented by a government deposit of

DH70 billion in banks. The Saudi Monetary Authority reduced reserve requirements on current accounts from 13 to 7 per cent, lowered the repo rate by 150 basis points, and made \$36 billion available to local banks. In October 2008, the Central Bank of Bahrain reduced the one-week deposit rate by 25 basis points and dropped the overnight repo rate by 125 basis points. The Central Bank of Bahrain also plans to raise the guarantee on bank deposits for commercial banks from 15,000 dinars to 20,000 dinars (\$53,200). In October 2008, the Central Bank of Kuwait (CBK) reduced the repo rate by 100 basis points and the discount rate by 125 basis points. Then, in December it made a further cut of 50 basis points to the repo rate. In April 2009, the CBK further lowered its discount rate to 3.5 per cent. It also allowed banks to raise the loan to deposit ratio from 80 to 85 per cent. Further, the CBK injected about \$1.87 billion into local banks. In November 2008, to ease liquidity in the financial sector the Central Bank of Oman reduced its repo rate by 220 basis points.

Sovereign wealth funds (SWFs) have also responded. As an immediate reaction to the crisis, many SWFs started to place more emphasis on injecting liquidity into, and propping up, their home economies. The Kuwait Investment Authority, for example, invested around \$1 billion in the local stock market to stem further declines. In the same vein, the Qatar Investment Authority announced its decision to buy 10-20 per cent shareholdings in local banks to boost their share prices (IIF, 2008).

The situation is different for many of the region's diversified economies that do not have sufficient margin for monetary responses. In Egypt, for instance, a cut in

interest rates could lead to pressures on central bank reserves and the exchange rate. Interest rate cuts are likely to have a greater effect on the exchange rate than on the demand for credit, so there would appear to be room to keep policy rates unchanged until there are clear signs that pressure on the balance of payments has stabilized (IMF, 2008).

The situation in Lebanon too is complex (IMF, 2009e). The economy faces three key risks:

1. The global recession and the slowdown in the GCC region will probably affect capital inflows and economic activity. The most likely outcome is a soft landing, though there is still a significant downside risk.
2. Government financing may be more difficult than anticipated. Slower deposit inflows could complicate government financing and will require contingency plans.
3. Lebanon remains exposed to political and security shocks that would adversely affect economic and financial conditions.

Facing these risks, Lebanon has little room to lower domestic interest rates in the short term since, even during an international financial crisis, interest is essential to maintain strong inflows of deposits. Thus, interest rates should be reduced only gradually when deposit growth can be expected to hold up.

Social protection systems and labour policies

In the ESCWA region the margin for public social expenditure varies significantly from

country to country. Major oil exporting countries can afford to implement measures to protect the most vulnerable segments of the population. Saudi Arabia, for example, has announced plans to extend concessional loans to low-income citizens. But other countries with greater fiscal constraints are more cautious about expanding government spending.

As the crisis unfolds, the more diversified countries will probably have less capacity to support largely publicly funded pension, social insurance and social protection schemes. Indeed the least developed countries might end up cutting expenditures on health, education and social protection. This could have devastating repercussions. The absence of social security programmes, coupled with inadequate educational and health services, would produce inter-generational poverty and lead to vicious cycles of marginalization or exclusion.

Moreover, the crisis is likely to increase unemployment. Across the region, a number of firms in the finance and real estate sectors have already signalled layoffs. The region is still in a stage of demographic transition, with high fertility rates and low death rates. So if both private and public sectors are less able to absorb labour there is likely to be a rapid increase in unemployment.

Regional responses

To confront the current crisis, ESCWA member countries have participated in a number of regional initiatives to coordinate their efforts and strengthen economic ties with developing countries.

Summit meeting

In an unprecedented effort to coordinate measures between the Arab countries, Kuwait hosted the first ever League of Arab States' Economic, Development and Social Summit in January 2009. Recognizing the serious impact of the unfolding crisis on Arab countries, Arab leaders endorsed the following decisions (LAS, 2009):

- Pursuing national measures aimed at strengthening financial institutions and enhancing regulatory frameworks;
- Strengthening the role of the Arab world in international economic relations, notably through an active contribution to the ongoing efforts aiming at stabilizing the world financial order;
- Increasing cooperation between central banks and regional institutions notably in terms of regulatory agencies;
- Supporting regional financial institutions in order to increase intra-Arab investment inflows, notably in projects directly affecting the integration process;
- Facilitating cooperation between Arab ministers of economy and public finance.

In the OPEC meeting in Vienna in March 2009, member countries emphasized their commitment to stabilizing the market and no further cuts are expected in the short term. The stabilization of oil prices at current levels would facilitate worldwide efforts to mitigate the negative impact of the crisis.

As an active regional institution, ESCWA has taken a number of initiatives to mitigate the impact of the financial crisis on mem-

ber countries. It has, for example, prepared a number of technical papers. It has also organized a regional consultative meeting for May 2009 which is expected to shed light on the current financial crisis and analyze its impacts on the ESCWA economies. The meeting will attempt to formulate a joint position on the way forward, as well as a common stand for ESCWA countries at the forthcoming high-level conference on the financial and economic crisis in June 2009 in New York. In addition ESCWA, in cooperation with the International Labour Organization and the World Bank, is preparing a joint publication on the economic and social impact of the crisis.

Another important meeting was the Second Forum for Arab and Latin American Businessmen held during the Doha Summit in March 2009. The Forum emphasized the importance of enhancing Arab-Latin American economic relations as a means of cushioning the impact of the crisis and endorsed a number of decisions, including:

- Eliminating tariffs and non-tariff barriers on Arab-Latin American trade.
- Establishing direct maritime and air transport routes between Arab countries and Latin American countries.
- Granting special visas to businessmen in order to enhance the economic cooperation/transactions between the two regions.

Arab leaders have demonstrated their determination to mitigate the impact of the crisis at other regional meetings, such as the Arab Economic Forum held in Beirut in April 2009 where experts, leaders and private-sector representatives proposed appropriate measures.

Reforms of the global financial architecture

As an active member of the G20, Saudi Arabia participated in the Washington Summit on Financial Markets and the World Economy in November 2008. The Summit stressed the need to enhance international cooperation to restore global growth, and agreed on a number of principles for reforming the financial markets. The 2009 London Summit reiterated the commitment to restore confidence, jobs and growth. In particular, participating countries, including Saudi Arabia, agreed to treble the IMF's financial resources to \$750 billion.

In recent years the GCC's sovereign wealth funds (SWFs) have become important to global financial markets. The SWFs cover a broad range of financial instruments, countries, and currencies. They have, however, created a number of concerns. Some people are worried about the lack of transparency, and the risks of eventual mismanagement that could destabilize the financial system. Others have questioned the decision-making frameworks and hinted that economic incentives might be outweighed by political considerations. These concerns were behind measures recently implemented in the US and some countries in the European Union.

Arab governments have responded to international calls for a regulatory framework for SWF investments. In March 2008, Abu Dhabi's SWFs reached an agreement with the US. This stressed the need for better governance, making investments solely on commercial grounds and ensuring that regulatory measures by hosting countries were non-discriminatory. The Abu Dhabi Investment Authority has also co-chaired

the International Working Group of SWFs.

Although it is still too early to assess the impact of these measures, it is clear that their effectiveness will depend on a number of factors, including the speed with which major developed economies bounce back, the evolution of oil prices and the scope of ESCWA member countries' fiscal and monetary stimulus packages.

The way forward

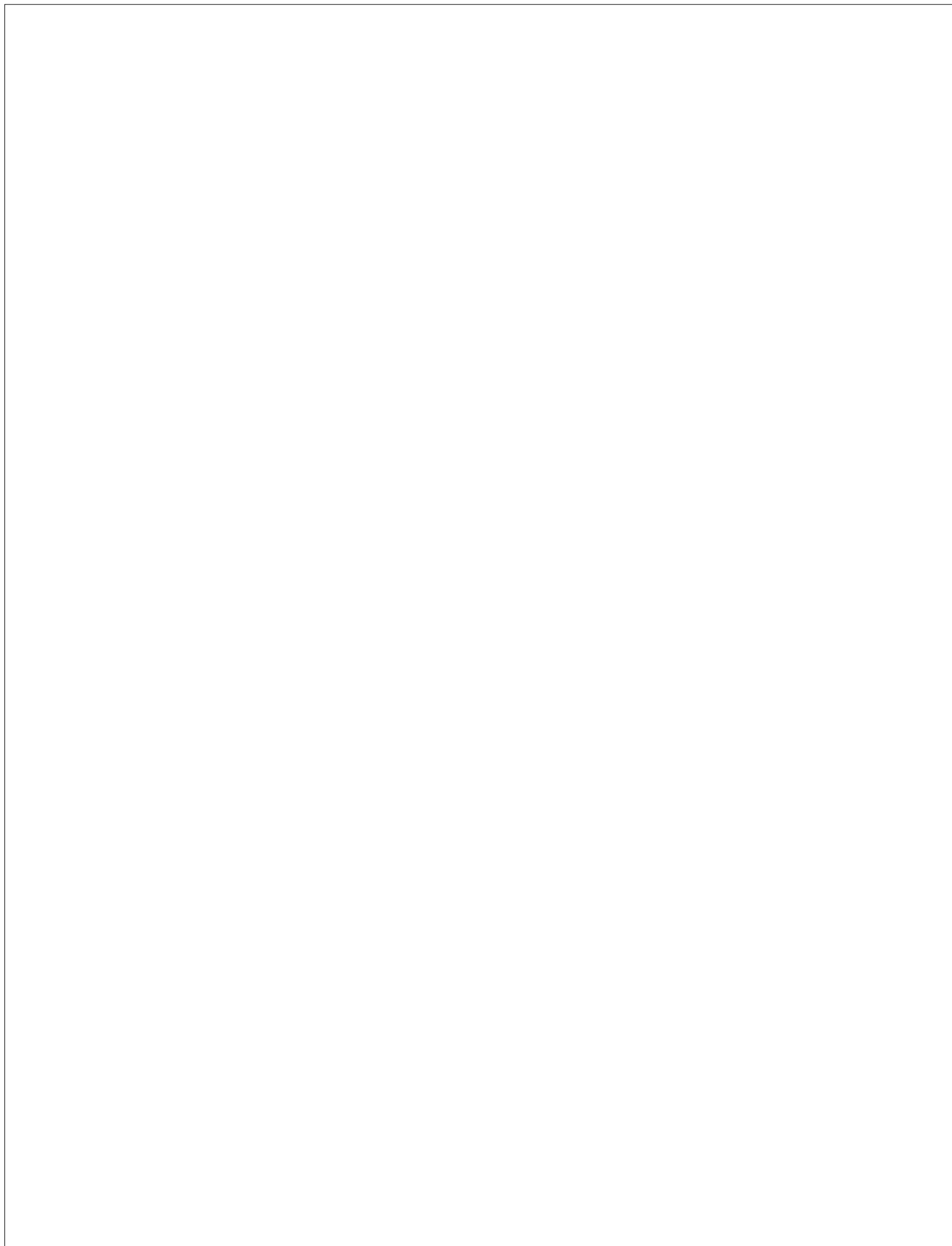
The economic outlook for GCC countries is intimately related to world oil demand. Oil prices are expected to pick up at the end of 2009 and the beginning of 2010. For 2010, forecasts for the average annual price per barrel include \$51 (EIU, 2008) and \$53 (US Department of Energy). These prices would reflect current cuts in production, growth in non-OPEC production, and a small expected recovery in global demand. A recovery in world oil demand in 2010 will then probably result in an increase in GCC production and, consequently, oil receipts.

Recovery for the GCC countries will also benefit the region's more diversified economies, as a result of higher tourism receipts, remittances and investment inflows. However, the export prospects of the more diversified economies will depend largely on an economic recovery in Europe. Inflation is forecast to continue to decline in ESCWA countries, driven mostly by the decrease in commodity prices.

Region-specific recommendations

Among the policy options that can be recommended to mitigate the impact of the financial crisis are:

- Continue to apply expansionary fiscal policies to boost domestic demand especially in infrastructural projects, to stop the recent slowdown and increase the level of economic activity;
- Inject liquidity to the banking sector through rescue packages, thus restoring confidence in the banking and financial sector. Monitor mergers between financial institutions and ease government regulations to encourage the private sector to take an active role;
- Implement more vigilant regulatory measures for the banking sector in the long term;
- Enhance SWF governance standards, in particular those related to transparency and accountability;
- Diversify SWF investments by investing more in the real economy and targeting developing regions, notably in Africa, Asia and Latin America, as an opportunity to increase South-South ties;
- Promote financial integration. ESCWA member countries with major financial surpluses may consider providing loans to other ESCWA member countries – either on a bilateral basis or through the region’s development funds or banks;
- Increase intra-regional investments. Promote investments in sectors in which many ESCWA member countries have a comparative advantage, such as agriculture, clothing and footwear, textile fibres, chemical products, and services such as tourism and research and training centres;
- Ensure the full implementation of the Greater Arab Free Trade Area, in particular by harmonizing production standards, facilitating transborder transit, computerizing customs services, streamlining inspection/control methods and by including services liberalization. Enhance the role of regional institutions, such as the Arab Trade Financing Program;
- Pursue efforts to diversify Arab exports away from oil, and specialize in products with higher added-value, and diversify trading partners;
- Continue efforts to improve the environment for doing business, in particular by enhancing good governance and combating inconsistency in the implementation of laws;
- Promote south-south cooperation by, among other things, increasing investments in, and trade with, other developing countries.

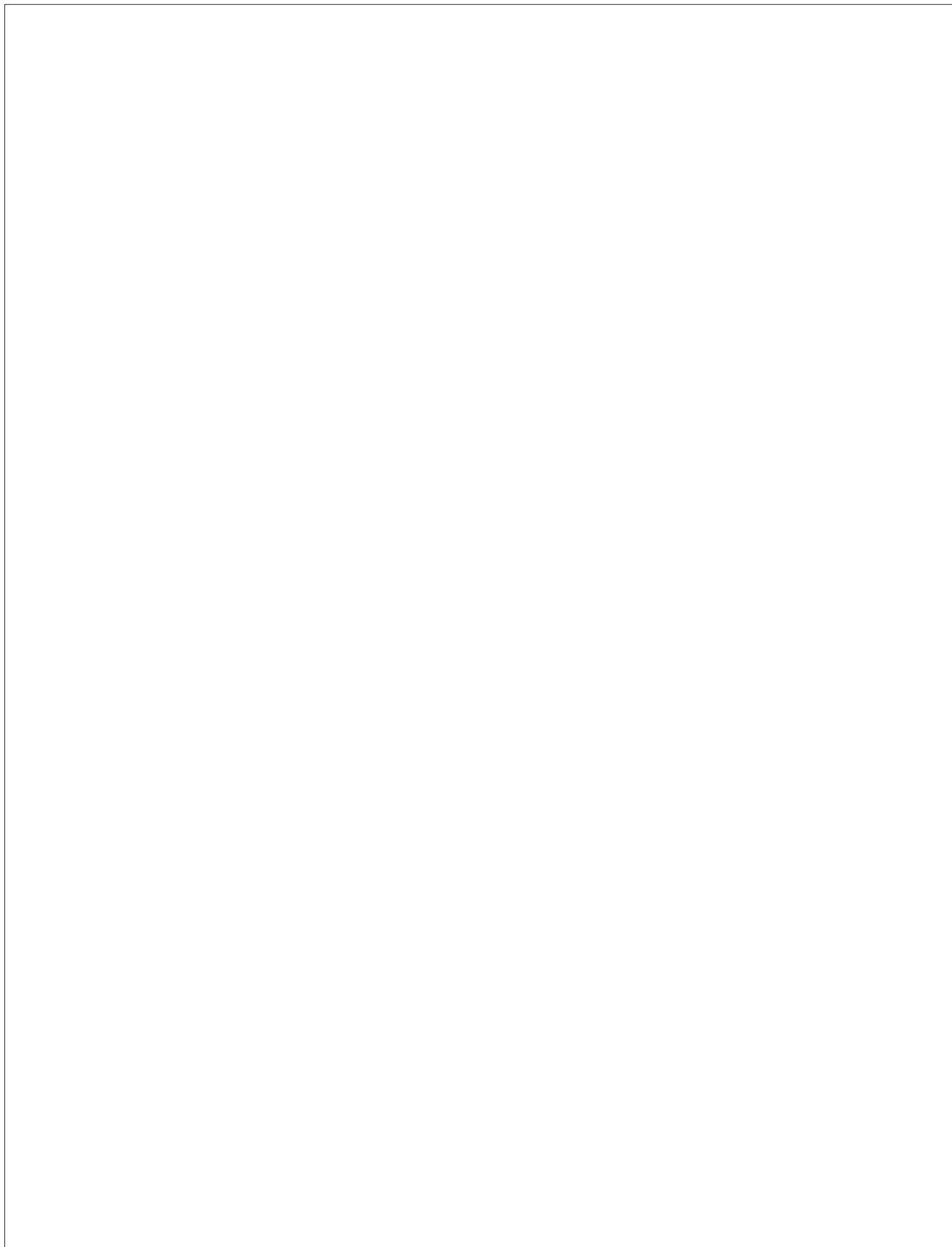


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United Nations publication
Sales No. E.09.II.F.18
Copyright © United Nations 2009
ISBN: 978-92-1-120585-5

Printed in Bangkok
May 2009 – 1,130



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