

Chapter 5. The impact of the financial crisis on fragile countries

When the current crisis broke out in the summer of 2007, there was a widespread perception that Sub-Saharan Africa was going to be affected only to a limited extent, with fragile countries making no exception in this respect (see for instance IDS, 2008 on Ethiopia). The limited depth and low integration of their financial systems with the US and European capital markets appeared to be sheltering them – so the reasoning went - from a direct transmission of the worst effects of the crisis. But, as events continued to unfold, this perception appeared to be regarded as unsound, and there are now mounting concerns that the impact of the crisis on fragile countries in Africa could actually be substantial. As African countries have a limited formal and informal financial system (Allen et al., 2008), the real effects of the crisis on firms and individuals will be difficult to avoid with such a limited ability to borrow and smooth shocks. It is not easy to track the set of effects of the current financial and economic crisis on fragile countries, as these are most likely to be indirect.¹ Furthermore, given the marked differences across countries, the impact will be uneven.

It has been estimated that negative spillover effects arising from a 1 percent slowdown in global growth may reduce SSA countries growth by 0.3-0.5 percent (Bredenkamp, 2008). In addition, after almost a decade of a steady increase in the flow of financial resources to Sub-Saharan Africa - excluding South Africa - (Ratha et al., 2008), there is a concern that the deterioration in the global economy due to the crisis will reverse the positive trends in Foreign Direct Investments and migrants' remittances (World Bank, 2008). Exports are also likely to fall in response to the reduction of global demand.

Furthermore, as the funds devoted to official development assistance tend to follow donor countries' economic cycle (Bertoli et al., 2007), aid to fragile countries is likely to decrease in coming years. Moreover, as emphasized in Chapter 4, fragile countries have been exposed to serious adverse macroeconomic effects, due to the surge of the prices of oil and food, and this entails that the sharp decrease in food and oil prices that has been observed over the last two quarters of 2008 can bring some relief to the Balance of Payments of food and energy-importing fragile countries.

Conversely, the fall in the prices of other commodities could have a serious negative impact on the resource-rich fragile countries.

Leaving aside the macroeconomic impact of the current financial crisis on fragile countries, it is important to flag a further issue: the crisis could also expose other countries to the risk of entering a situation of fragility, because – as Chapter 2 emphasized – sudden falls in the income level of a country represent a potential trigger for the outbreak of social unrest or of armed conflicts.

The remaining part of this chapter is going to explore the aforementioned channels through which the current financial crisis could have an impact on countries in a condition of fragility.

Foreign Direct Investments

Countries in a situation of fragility are likely to face serious problems to enforce contracts, and this represents a serious discouraging factor for foreign investors.² OECD (2008) signals that FDI to non-fragile African countries amounted to \$24.5 billion in 2005, compared to \$6.4 billion to fragile countries in the same year.³ Though this figure is higher than the \$4.2 billion recorded in 2000, FDI to fragile African countries have been declining since 2003, and they are highly concentrated: four resource-rich countries, namely Angola, Chad, Nigeria and Sudan, received 70 percent of total FDI over the period 2000-2005 (OECD, 2008). As these four countries are all oil producers, whether they are going to experience a decline in the level of incoming FDI or not depends largely on the extent to which the investment decisions of large extracting companies are influenced more by the current sharp decline in the oil price or by its expected long-term increase due to a rising global demand. As the crisis is expected to substantially reduce the flow of FDI to developing countries, it is at best unlikely that other fragile countries will begin to receive significant investments from abroad over the next few years.

The ERD 2009 will try to provide a theoretical framework, emphasizing the problems of contract enforcement in “weak” states. It is difficult to enforce a contract if players are not well identified, and have no – or a bad – reputation, as has been already discussed in Chapter 3. This of course means that some commitment devices have to be imposed. A related issue that will also be discussed in the ERD 2009 concerns the

absence of capacity to manage public resources, which can lead to substantial problems of corruption.

One solution is the implementation of a mechanism that creates external controls on revenue generating entities, as it has for instance been undertaken in Liberia with GEMAP, Governance and Economic Management Assistance Programme; natural resource concessions and contracts; management of the central bank, finance ministry, state-owned enterprises; procurement processes; and anti-corruption and judicial reform. Accompanying the proposed controls were plans for capacity development in all these areas of governance. While GEMAP allocates monitoring and oversight authority to international experts, it also provides a variety of technical advisors, who are supposed to develop capacity for an eventual hand-off to national actors. The "exit strategy" terms though are unspecified and the success of GEMAP in terms of capacity development will depend upon an effective transition from an international staff doing the job to effective training and skills transfer, coupled with sustained national commitment to the principles of good governance (Dwan and Bailey, 2006; UNDP, 2006).

Remittances

Sub-Saharan Africa is not one of the main recipient of migrants' remittances in absolute terms, as the official flows of remittances amounted to an estimated \$19 billion, out of approximately \$265 billion directed to the whole set of developing countries.⁴ Still, there are solid-grounded reasons that suggest that this figure could substantially underestimate the official flows, and all the more so for countries in a situation of fragility. Freund and Spatafora (2008) recently found that high transaction costs represent a powerful factor in diverting remittances towards informal channels that are not captured by the Balance of Payments statistics, and the limited financial development of fragile countries clearly contributes to drive transfer fees up. Furthermore, as Ratha and Shaw (2006) emphasize, most African migrants tend to move intra-regionally, and transfers between neighboring countries offer significant opportunities to resort to informal channels.

Though the level of remittances to Sub-Saharan African countries fell well below the funds that these countries receive through official development assistance, Gupta et al. (2009) recently provided evidence that remittances contribute to poverty reduction, and to the financial development of these countries. Furthermore, there is

evidence that remittances still play a critical role in Somalia, and contribute to shelter recipient households from some of the worst economic consequences due to state failure.

Against this background, the ERD 2009 will discuss the extent to which the flow of remittances to fragile countries is going to be affected by the current economic crisis. A factor of concern is represented by the concentration of migrant workers in sectors – such as construction, services and tourism – that usually magnify the fluctuations of the business cycle. This entails that migrant workers are particularly exposed to the risk of losing their jobs, and this could have a negative impact on remittance transfers. Moreover, destination countries could react to the crisis with the introduction of tighter immigration policies, and it is often politically convenient to blame the immigrants for the adverse effects of the crisis, through the ill-grounded claim that immigrants “steal natives’ jobs”.⁵ Although these factors of concern should not be downplayed, Ratha et al. (2008) argue that remittances are going to be resilient, and fall only modestly even in the worst case scenario that they have depicted.⁶ This is in line with historical experience, which has shown that remittances tend to respond modestly to an economic slowdown or recession in the countries of destination.⁷

Aid

While remittances to fragile countries may be only modestly affected by the current financial crisis, the outlook seems to be worse with respect to official development assistance. David Roodman of the Centre for Global Development argues that a substantial fall of aid over the next five years is not just possible, but actually probable.⁸ This grim prediction is based on the analysis of how Sweden, Finland and Norway reacted to the crisis that hit the Nordic countries in 1991; the real value of the aid given by these countries fell by 10 percent for Norway, 17 percent for Sweden, and 62 percent for Finland.

At present, public interventions in support of the financial sector and the demands for huge fiscal stimulus to sustain the falling aggregate demand are most likely to put aid under the strain of competing budgetary allocations

The reduction in aid flows could be gradual, because of the time lag between the commitments and the actual disbursement of the funds, and it can be expected to be

less pronounced for those donor countries which have an independent development agency, as this institutional design has been found to reduce the pro-cyclicality of aid disbursements (Bertoli et al., 2007). The ERD 2009 will map current aid flows, and – if possible – attempt to predict the extent to which aid to fragile countries is likely to fall over the next few years. If the predicted fall is significant, then we shall investigate and discuss its consequences.⁹

Fragile countries could be affected not only via a reduction in the total amount devoted to official development assistance by donor countries, but also by their choices with respect to the composition and allocation of aid.

With respect to the first point, donors may be tempted to shift away from actual disbursements, and to increase their efforts for debt cancellation,¹⁰ which sometimes has a dubious development impact. As far as the allocation across countries is concerned, the OECD Development Centre has recently argued that the crisis will induce donors to channel their funds to multilateral institutions, so that “much of the new resources will bypass the poorer and most vulnerable countries, and instead be destined almost exclusively for the emerging and middle income countries, in order to reduce systemic risks” of a worsening of the financial crisis (Mold et al., 2008).¹¹ The need to prioritize the flows of resources to fragile countries cannot be detached from a broader discussion relating to how these aid flows need to be employed. More specifically, this is connected with the topic of “State versus non State” service provision, addressed in Chapter 3. As a matter of fact, a practical solution to the dilemma rests on how donors’ capacity building support can be articulated with public-sector agencies to: capitalize on existing sources of capacity as starting points to visibly demonstrate coordination; create incentives for local capacity-building and partnership between NGOs and state actors; develop linkages to community groups to build their capacity for oversight and expression of voice.

Although funds from DAC donors may be declining, it has to be recalled that during the last few years a group of ‘emerging donors’ is making its way into Africa (World Bank, 2007; Kragelund, 2008). China, in particular, is expanding its role in Africa through a comprehensive strategy that includes also the provision of aid, especially in a concessional form (CCS, 2008)¹². During the last multilateral forum of FOCAC, Forum on China-Africa Cooperation, held in Beijing in 2006, the Chinese president Hu Jintao committed to double international aid to African countries by 2009. Chinese international aid activities are nowadays spread all over the African continent,

including those fragile countries where severe internal political conditions have pushed traditional donors to reduce their commitment. The ERD 2009 will explore the determinants and the effects of the Chinese engagement with fragile countries.¹³

Trade and terms of trade

Trade, and especially exports, will be affected by global slowdown. Declining world demand from developed countries are likely to lead to a reduction of developing countries' exports. In addition, the financial crisis is likely to affect the capacity to finance world trade. This is true especially for the part which is financed by documentary credits, due to banks' unwillingness to carry foreign risks and, to rising bargaining power of international buyers in extending/reducing credits into their global supply chains (Hoekman, 2008).

Massa and te Velde (2008) include also African countries exporting high income elastic services such as tourism in the list of possible 'losers'. In addition, exporters facing declining world prices will be at risk.

After having historically worsened, over the last decade terms of trade of developing countries have started to improve substantially (Kaplinsky, 2006). Though this has had unexpected positive effects on commodities exporters, developing countries that are net importers of natural resources and - more recently - food, have been severely affected by high prices.

An analysis of the International Monetary Fund released in June 2008, when the prices of food and oil were at their peak, suggested that African countries in a situation of fragility were exposed to severe macroeconomic effects due to this negative terms of trade shock.¹⁴ IMF (2008) identified 18 African countries for which this adverse shock exceeds either 2.5 percent of GDP or 50 percent of the foreign reserves, and 11 of these countries had been classified by the World Bank as being "low income countries under stress" in recent years. In other words, as discussed at length in Chapter 4, fragile countries are likely to be more affected than others by the food price crisis.

The world price of food items and of oil has been however declining sharply after the International Monetary Fund released its analysis.¹⁵ World Bank (2008) traces back the abrupt change in the price of food and oil to the substantial slowdown due to the financial crisis, and this represents a significant indirect channel through which the

financial crisis could give some relief to fragile countries, mitigating the pressure of the adverse terms of trade shock on their Balance of Payments.

Needless to say, the macroeconomic implications of the global economic slowdown are the opposite for those fragile countries for which the proceedings from the exports of natural resources represent an important revenue item. Besides the aforementioned oil-exporting countries, other countries could be influenced as well. Emilie Mushobekwa, from the World Bank, recently emphasized the widespread implications for the Democratic Republic of Congo due the fall in the price of copper.¹⁶ Besides the direct impact on the Balance of Payments, this is likely to influence also infrastructural investments in the country.¹⁷ The Democratic Republic of Congo had agreed upon a \$5 billion deal with China in 2007: China proposed to finance massive infrastructural investments in the country in exchange for the establishment of joint ventures for the exploitation of Congolese natural resources, including copper.¹⁸ Emilie Mushobekwa argues that the proposed infrastructural investments will have to be downsized or postponed, as the fall in the price of copper is going to reduce the profits that China will get from these newly-established joint ventures. Something similar has already happened in the Republic of Congo and in Zambia, where Chinese mining companies have left local mines in correspondence with the slowdown in the prices of raw materials (Herbst and Mills, 2009). This is just an example of how the ERD 2009 will attempt to address these issues with specific case studies.¹⁹

The need for a country-by-country assessment

The effects of the current financial crisis on African fragile countries are most likely to be indirect, but their potential relevance should by no means be overlooked, as we have argued in this chapter.

The variety of indirect channels through which fragile countries could be affected suggests that it is necessary to move towards a more tailored approach, where we analyze the exposure of each single country to the effects of the crisis.

The recent research of Massa and te Velde (2008), for instance, has shown that even some of the most successful among the SSA countries are likely to face a slowdown. The magnitude of the slowdown, in turn, depends upon a combination of factors, including terms of trade shock, the degree of the economies dependence upon

external financial flows, the performance of macroeconomic indicators²⁰ and the degree of interrelation of the financial system with the international markets. Another relevant issue has to do with the opportunity to adjust exchange rate downward and on the consequences for balance of payments.

In order to do so, we aim at publishing on the ERD website detailed country profiles. Though, fragile countries represent a top priority for donors, we need to emphasize that the analytical relevance of this categorization is somehow shaky, and broad generalizations on this set of countries may end up hiding more than they reveal.

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Endnotes to Chapter 5

¹ Philippe Martin will present a paper where he will analyze the transmission channels of the financial crisis upon fragile countries in the Accra conference, with a special focus on how trade with developed countries is going to be adversely

² Ramon Marimon is going to present a paper on this topic in the Accra conference.

³ Starting from 2005, Africa has experienced a significant surge in its inflows of FDI; data from the last World Investment Report (UNCTAD, 2008) estimate a total \$53 billion received (the highest amount ever for the continent), which contributed to increase the inward stock to \$393 billion.

⁴ Some fragile countries, such as Sierra Leone, Guinea-Bissau and Nigeria, receive substantial remittances inflows, which are estimated to exceed 5 percent of their gross domestic products (Ratha et al., 2008).

⁵ In this respect, it is important to recall that European countries began to introduce substantial restriction to immigration flows in the 1970s, when their economic systems suffered from the adverse effects of the two oil crises.

⁶ It is important to note that the local currency value of remittance transfers is going to be significantly influenced by the influence that the crisis will exert on the exchange rate of the various currencies with the euro and the dollar.

⁷ Philippe Fargues will attempt to analyze this issue in the Accra conference, although the poor reliability of official statistics published by these countries might represent a binding constraint to the analysis.

⁸ See http://blogs.cgdev.org/globaldevelopment/2008/10/history_says_financial_crisis.php.

⁹ We are aware of the statistical difficulties that will arise, as sometimes – especially as far as non DAC donors are concerned – it is difficult to disentangle aid flows from other transactions.

¹⁰ Note that most fragile African countries are deemed as eligible for the Highly Indebted Poor Countries Initiative.

¹¹ Such an outcome could be potentially disruptive in the path towards the achievement of the MDGs, as an allocation of aid that is less favourable to low-income countries would be matched by the little relevance that MDGs seem to have in influencing donors' allocation choices with respect to the sectors of intervention (Thiele et al., 2007).

¹² In the ERD 2009 we shall compare the aid programs of China in Africa with those of the US and EU and address carefully the issue of conditional versus unconditional aid; a paper by Marco Sanfilippo and Simone Bertoli which will be presented in the Accra conference analyzes the determinants of Chinese engagement in fragile countries, to assess whether China filled a gap left by DAC donors.

¹³ Note, however, that Chinese aid is often closely intertwined with trade and investment policies, and the global slowdown could actually lead to a reduction in the actual disbursements of aid funds, as it is argued below in the case of the Democratic Republic of Congo.

¹⁴ Alexander Sarris will analyze in the Cambridge workshop the effects of the so called "double squeeze" on African countries.

¹⁵ The FAO Food Price Index was down to 148 in December, from 219 in June 2008, while the oil basket price of the OPEC was down from \$131.2 to \$38.6 over the same period.

¹⁶ The price of copper fell from \$4 per pound in June 2008 to \$1.20 in December 2008.

¹⁷ See <http://africacan.worldbank.org/blogs/emilie-mushobekwa>.

¹⁸ See <http://www.iht.com/bin/print.php?id=7595719>.

¹⁹ The ERD will rely on the AERC, African Economic Research Consortium, to access the network of African economists who have studied these issues.

²⁰ The authors find for instance that in terms of reserves held, although SSA countries as a group are healthy, the group of fragile countries is seriously lagging behind (Massa and te Velde, 2008).