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Where the Financial and Economic Crisis *Does* Bite: Impact on the Least Developed Countries

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Abstract

This paper looks beyond the comparatively good performance of the large emerging economies that gave rise to the mainstream narrative of decoupling.

I discuss the negative economic and social impacts of the financial and economic crisis on the Least Developed Countries that the mainstream narrative hides below the veil of well performing large countries. The negative macroeconomic consequences are directly observed in a reduction of the foreign contribution to capital formation in LDCs and a deceleration of the growth of per capita Gross Domestic Product. Official Development Aid does not offer recourse contracting in real terms in 2011 and falling short by US$ 51 billion over 2008-2011.

The potential implications for human development are important. The paper indicates that Millennium Development Goals (especially in the fields of poverty, child mortality and universal primary education) will be more difficult to attain in the Least Developed Countries.

Keywords

Crisis, Least Developed Countries, official development aid, foreign direct investment.

Where the Financial and Economic Crisis *Does* Bite: Impact on the Least Developed Countries

1 Introduction

The current mainstream narrative about the impact of the financial and economic crisis in developing countries is a rather positive story. In contrast to the developed world, where the impact of the crisis obviously deteriorates growth and public finances, developing countries and emerging markets are seen as the poles of global growth. This hypothesis of decoupling emerged early on in the financial and economic crisis also because banks in developing countries had not been involved in irresponsible financial innovation (see Kose and IMF 2007, World Bank 2008, Prasad 2009, Vos 2011a). The implications of the main narrative are clear: the levels of economic activity of countries located outside the OECD area apparently continue to be well in positive territory. Growth perspectives attract foreign capital flows and – since these flows towards the developing and emerging economies predominantly consist of Foreign Direct Investment and remittances – debt ratio's are on a downward trend. Table 1 and Figure 1 illustrate the positive mainstream narrative numerically on the basis of the most recent IMF *World economic outlook* database and UNCTAD's *World Investment Report 2011*. By and large the global financial and economic crisis thus (according to he mainstream narrative) would seem to have bypassed the emerging and developing countries.

TABLE 1
Key economic indicators emerging and developing economies
(period averages 1990-2017, percentages)

	1990-2000	2001-2006	2007-2011	2012-2017 IMF forecast
Real GDP growth	3.8	6.3	6.3	6.1
Investment share in GDP	25.6	26.2	30.5	32.8
Gross national savings to GDP	23.7	28.7	33.1	33.8
Real import growth	10.1	9.8	8.0	7.9
Real export growth	9.0	9.4	5.7	7.4
General government gross debt to GDP	49.0	36.5	36.0	27.3
Current account balance to GDP	-1.5	2.9	2.6	n/a
Total external debt to GDP	37.1	32.7	25.6	n/a

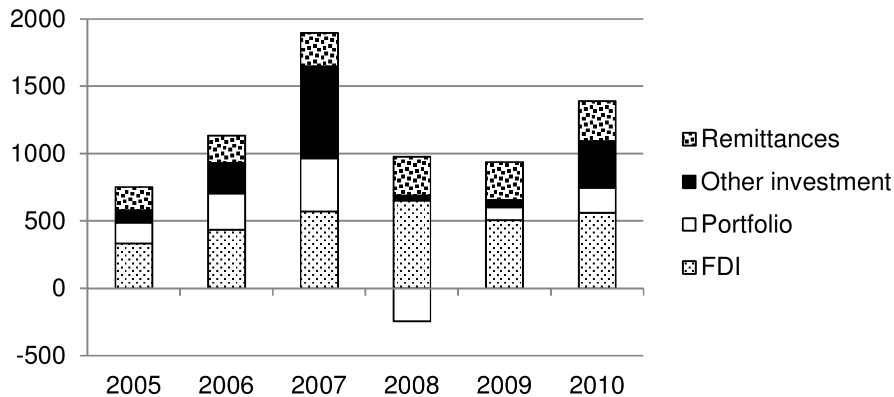
Source: IMF World Economic Outlook data base, April 2012, accessed May 8, 2012

Note: [a] end of period

Against the background of cuts in the volume of Official Development Assistance (DAC, 2012) of -2.7% in 2011 for Developing Countries and of even -8.9% for the group of Least Developed Countries, I will argue that the positive mainstream narrative is too good to be true, at least for the most vulnerable group of developing countries. The present mainstream discourse analyses economic development through a specific lens that focuses on the

aggregate or average performance of a heterogeneous group of countries that is being dominated by a very few, very large, very fast growing countries, in particular China, India, Indonesia and Brazil. This lens obscures the costs of the crisis that are increasingly borne by smaller and less successful developing economies.

Figure 1
Capital flows to developing countries
(2005-2010, Billions of Dollars, current prices and exchange rates)



Source: UNCTAD (2011a), Table 1.4 p. 21

One important contribution of this paper is thus that it looks behind the smokescreen of the continued good performance of the big emerging economies as I focus on the negative economic and social impacts of the financial and economic crisis in the Least Developed Countries.[1] These negative macroeconomic consequences of the crisis are directly observed in a reduction in the foreign contribution to capital formation in the Least Developed Countries and by a concomitant deceleration of the growth of their (per capita) GDP. The second contribution of this paper is that it discusses the shortfall of Official Development Aid since the start of the crisis. Obviously these two issues are closely linked: the mainstream discourse neglects the plight of the 850 million people that live in the Least Developed Countries, as the development narrative of the mainstream is the continued success of the big emerging economies that do not depend on foreign aid. This sets the stage for a seemingly 'painless' reduction of aid flows to the poorest and most vulnerable countries.

The remainder of this paper is organized as follows. Section 2 discusses some of the difficulties of observing economic developments during times of crisis and in particular in countries with low levels of development. Section 3 focuses on the direct economic impact in LDCs. This section documents the growth deceleration of per capita GDP since the onset of the financial and

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[1] The Appendix lists the Least Developed Countries

economic crisis as well as the reduction in foreign direct investment since the start of the crisis. This section also argues that the outlook for Official Development Assistance is bleak and that preservation of remittances as a stable flow of funds may become difficult if the global unemployment situation deteriorates. Therefore a further reduction of savings and investment rates and consequently of growth (potential) is a realistic scenario for the Least Developed Countries. Section 4 additionally discusses the potential impact of lower growth on health, life expectancy and gender issues. Section 5 draws some conclusions.

2 Measurement and identification

It is always difficult to see where you are sailing in the midst of a storm. An economic depression is not different. In general the statistical measurement tools are designed for normal conditions, but once business fluctuations become exceptionally large the normal statistical procedures may no longer yield unbiased estimates. This is true both for developed and for developing countries although the latter will probably encounter more severe problems. In addition to the problem of inaccuracy in measurement, the timeliness of the construction and publication of statistics can be problematic and this is especially so at lower levels of development. So it should not come as a surprise that many early analyses on the impact of the financial and economic crisis outside the OECD start with a warning that we do not yet know what has actually happened in many countries – and especially for segments of the population – simply because reliable real time data are unavailable (see, for example, Van Bergeijk, de Haan and van der Hoeven. 2011, p. 3). Although we are now five years into the crisis many data are still not available. One way to deal with this uncertainty is to use, combine and triangulate indicators, methods, historical experiences and theory in order to get at a reliable assessment of current conditions in the Least Developed Countries. This article follows this approach sometimes resorting to basic social science detective work, but always making good use of the most recently available information from different international databases, such as those of UN/DESA, UNCTAD, World Bank and the IMF. (Note that the IMF does not report aggregates or averages for the LDC category and that the construction of LDC-group data can only be roughly approximated; I will often resort to median observations for this group.[2])

In addition to recent hard data, historical lessons are important, for example to discharge the argument that the financial crisis would not hit the developing countries as the banks in these countries did not have toxic assets or because there was no detachment between the real and the financial valuation of transactions (see for an example of this line of argumentation Moro Visconto 2009). History tells that the world crisis of the 1930s also started in the center, but later spread to the periphery with ultimately a strong impact on the informal capital markets in the periphery (see Kindleberger,

[2] Islam (2011) follows a similar approach.

1973 and Rothermund, 1996). There is no reason to expect that the current financial and economic crisis is different from the 1930s in this respect and that in itself questions the decoupling narrative.[3] More recent history can provide light on important policy question as it can help to point out how the crisis will influence donor country behaviour (Roodman 2008, Frot 2009; see also Gravier-Rymaszewska, 2012) and how economic distress influences human development including gender issues, education and health (World Bank 2010, Sumner et al. 2010, Annex, pp. 35-50). On the former issue this article already reports concrete empirical evidence that the lessons from the past were valid also in this crisis; on the latter the statistics are not yet available since the most recent data at the international organizations still are for 2009. With these caveats in mind we can now proceed to the discussion of current developments and the impact of the financial and economic crisis on the Least Developed Countries.

3 The economic impact of the crisis

The crisis impacts on growth and finance. Although growth and finance are closely linked I will deal with these aspects in different sections, because finance also involves behavior at the origin of international capital flows, thus bringing the economic conditions in developed countries into the picture as well. Section 3.1 thus first takes a look at recent macroeconomic developments in the Least Developed Countries and section 3.2 discussed developments and outlook of Foreign Direct Investment, Official Development Aid and remittances.

3.1 Macroeconomic developments in the Least Developed Countries

Table 2 provides a snapshot of macroeconomic developments in the Least Developed Countries, giving economic evidence for their slow-down in per capita GDP growth since the start of crisis. Actually the period average for 2007-2011 sketches to rosy a picture since the average hides the extent to which the annual growth rates follow a downward trajectory (see Figure 2). UNCTAD (2011, pp. 5-7) notes two other kinds of heterogeneity hidden under with important implications. Firstly, although the average growth rate remains positive about one fifth of the countries fell into a recession and GDP per capita contracted in 18 out of 48 countries in 2009. Secondly, only 10 of the 48 LDCs would in the UNCTAD forecasts grow fast enough to reach the targets of the Istanbul 'Programme of Action for the Least Developed Countries for the Decade 2011-2020'. As will become clear even that assessment may seem to be too optimistic given the current trends.

Indeed, from Table 2 it becomes clear that important drivers of the growth slow down are the reduced external demand for median LDC exports and the steady decline in median gross domestic savings rate that has a negative

[3] See also Adams-Kane et al. 2011.

impact on capital formation. Importantly, IMF forecasts indicate a trend of continued and increasing current account deficits and this offers an additional indication that foreign capita will be necessary to increase saving and investment.[4] So let us turn to the relevant question about the availability of foreign capital for the Least Developed Countries.

TABLE 2
Key economic indicators Least Developed Countries
(period averages 1990-2013)

	2001-2006	2007-2011	2012-2013 Forecasts
Real GDP per capita growth	4.5	4.0	2.7
Gross national savings to GDP[a]	15.7	14.5	13.8
Real import growth[a]	7.0	8.9	6.6
Real export growth[a]	7.4	4.8	6.0
General government gross debt to GDP[a]	83.5	39.0	35.9
Current account balance to GDP	-5.1	-8.1	-9.4

Sources: UN/DESA data base for per capita growth and IMF World Economic Outlook database, April 2012, accessed May 8, 2012

Note: [a] based on median calculated from the IMF World Economic Outlook database (which does not always report on all LDCs)

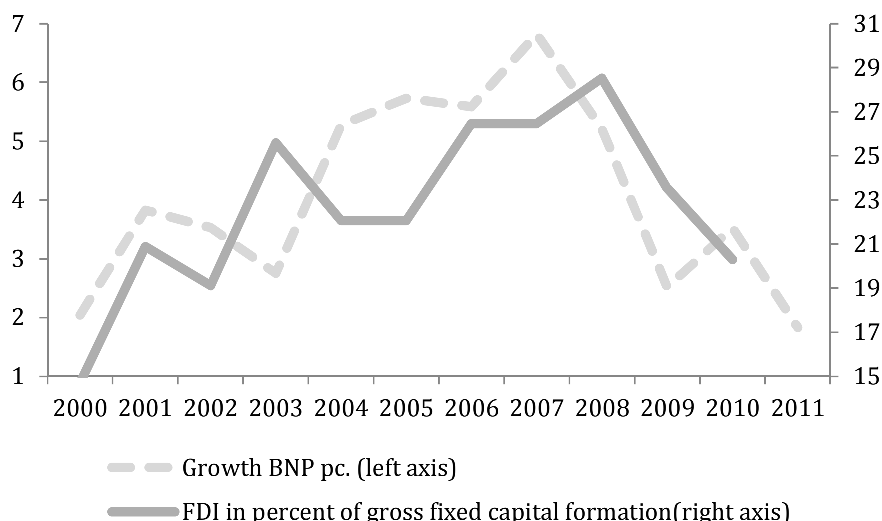
3.2 Capital flows to the Least Developed Countries

Foreign Direct Investment is not only relevant because it provides foreign capital, but also because of the spillover effects on productivity to domestic sectors (Mebratie and van Bergeijk 2013). Changes in incoming Foreign Direct Investment thus increase and improve the capital stock. Foreign investment into the developing and transition countries fully recovered after the crisis reaching a new record high in 2011 (UNCTAD 2012). However, according to UNCTAD (2011b, pp. 56-61), Foreign Direct Investments in the Least Developed countries in 2010 were still one fifth smaller than in 2008 while it remained unclear if and when these flows would regain their pre-crisis level.[5] Figure 2 illustrates the development of Foreign Direct Investment pointing out that its share in gross fixed capital formation in the Least developed Countries almost halved since the start of the crisis. Figure 2 relates this development to the growth rate of per capita GDP, both because this is the only available indicator for the general productivity level and because GDP per capita is an important basic indicator of the economic activity level in the Least Developed Countries.

[4] Note again that Table 2 reports median developments for the group of 48 Least Developed Countries.

[5] UNCTAD (2012) reports that the African continent continued its decline in FDI flows in 2011.

Figure 2
Foreign capital and LDC growth 2000-2011



Sources: UNCTAD 2011a, p. 74 and UN/DESA

The outlook for private capital flows to the Least Developed Countries thus is bleak; the outlook for public capital flows, unfortunately, is not better. Table 3 shows the changes in Official Development Aid since the start of the crisis. In line with fears expressed early on in the crisis (Roodman 2008, Frot 2009, van Bergeijk 2009) many donor countries reduced real levels of Official Development Aid.

TABLE 3
Growth and Contraction of ODA 2008-20011

	2008	2009	2010	2011
Real growth at constant exchange rates and prices	11%	1%	6%	-3%
Number of DAC donors that reduced real ODA	2	11	6	16

Sources: OECDstat.extracts accessed May 9, 2012 and DAC (2012)

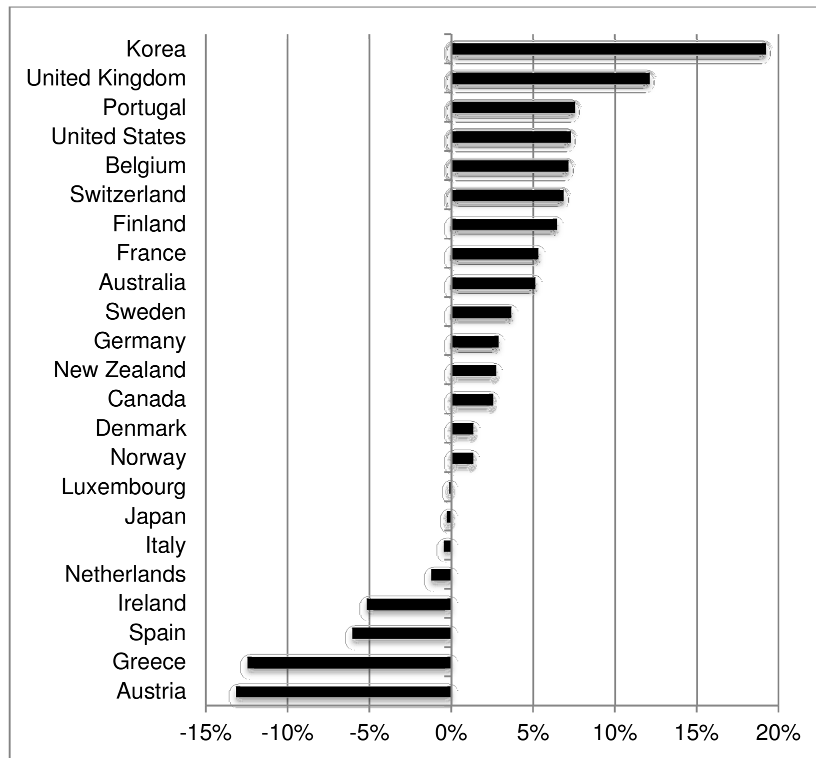
In 2009 11 donor countries trimmed down their aid bringing ODA to a virtual stand still as the amount of aid increased by a mere 0.7 per cent.[6] In 2011 the majority (16!) of the donors cut ODA and often from already reduced levels reducing total ODA by -2.7% and average country effort decreased from

[6] Importantly this was not the result of increased spending but solely due to exchange rate movements that contributed more than 4 percentage points. Also note that recent revisions of ODA for earlier years put the growth rate now at 1.0% in 2009 (*OECDstat.extracts* accessed May 9, 2012).

0.49% to 0.46% of Gross National Income (14 countries reduced their effort; DAC 2012). The contrast with the OECD (2009) estimates that the underlying trend growth rate of the volume of official development aid (ODA) needed to increase to 11 per cent per year in order to achieve the Millennium Goals is painful, to say the least.[7] According to the OECD (2009, p. 103-104),

> *At the time of the Gleneagles G8 and UN Millennium +5 summits in 2005, donors committed to increase their aid. These commitments would raise ODA by USD 50 billion in 2010 compared with 2004 (at 2004 prices and exchange rates). Excluding debt relief and humanitarian aid, which are expected to return to their historical levels by 2010, the annual growth required to reach the target is 11%.*

Figure 3
Average annual real growth rate of ODA 2008-2011 by donor



Sources: OECDstat.extracts *accessed May 9, 2012 and DAC (2012)*

Figure 3 illustrates how the different donors have fared during the crisis. Only Korea and the United Kingdom meet the OECD's estimated requirement of an annual real 11% growth in Official Development Assistance. The clear

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[7] Many recent policy documents appear to have considered the possibility of a real reduction in ODA as an unrealistic scenario and were mainly seeing the 2010 increase as a return to normal pre-crisis aid relations. An example is World Bank 2011, pp. 126-128.

implication is that the public funds made available to the Least Developed Countries fall significantly short of the levels that are required to reach the Millennium Development Goals. The average real annual compound growth rate over 2008-2011 is 3.8% p.a.

Table 4 estimates the shortfall and compares actual and target growth rates in order to assess annual and cumulative growth surpluses and deficits (the percentage gap between target and actual growth rate). Since the target is to reach the preset level of ODA at the end of 2010, the target rate for 2011 is set at zero. The table starts in 2008, the first crisis year, in order to focus on the impact of the crisis proper (the year 2008, registered a real growth rate for ODA in excess of the 11% target). The next step is to confront these growth rates with actual ODA flows valued at 2010 prices in order to make the annual amounts comparable and allow for aggregation. The final column of Table 4 gives the ODA shortfall (in 2008: a surplus) per year. The total ODA shortfall over 2008-2011 can thus be estimated at US$ 51 billion and for the year 2011 at 22 billion US dollar (10.3% of actual flows over the period).

TABLE 4
Shortfall of net ODA during 2008-2011 (at constant 2010 prices)

Year	Growth rates		Annual surplus or deficit	Cumulative surplus or deficit	ODA in billion US$	
	Target %	Actual %	%	%	Actual flow	Shortfall
2008	11	11.3	0.3	0.3	119.5	0.4
2009	11	1.0	-10.0	-9.0	120.9	-11.4
2010	11	6.3	-4.7	-13.3	128.5	-18.4
2011	0	-2.7	-2.7	-15.5	125.1	-21.8
Total		3.8			493.9	-51.1

Sources: OECDstat.extracts accessed May 13, 2012 and DAC (2012)

With little hope for a recovery of Foreign Direct Investment and with no recourse from Official Development Aid, the only remaining relevant capital flow consists of remittances. Remittances have been very resilient during the crisis and continue to be an important capital inflow for the Least Developed Countries. In fact this is a very hopeful stylized fact (and one that, incidentally, contradicts pessimistic views that prevailed at the start of the financial and economic crisis). The big, and as yet unanswerable, question, however, is whether remittances will be able to continue to play their useful role in the foreseeable future, not so much because emigrants would not like to send money to their home countries anymore, but because they may not be able to do so if unemployment abroad and return migration were to increase. An indication that it may become increasingly realistic to consider this risk is provided by observations by central bankers in Burundi, Tanzania and Uganda who, as reported by Barak Harif and Richardson (2012), note a reduction of remittances in particular from the euro region.

The conclusions of this section are sobering. The crisis has certainly not passed the Least Developed Countries: capital formation is no longer supported by private investment and public aid; a further reduction of savings and investment rates and consequently of growth (potential) is a realistic scenario. The decoupling hypothesis is *not* relevant for the Least Developed Countries.

4 Expected impact on human development and MDGs

It is still difficult and probably to early to ascertain the full impact of the financial and economic crisis on human development, but it is clear that the 2007-2011 growth deceleration, the reduced availability of public and private foreign capital over this period in combination with the quite limited prospects for LDC export growth in the near future reduce the probability of achieving Millennium Development Goals. Indeed, the outlook contrasts with the rather optimistic analyses prepared when observers were counting on a quick and sustained return to the pre-crisis conditions and suggested that the Millennium Development Goals remained well in reach. Sumner et al. (2010, p. 2) rightly observe "The MDGs comprised an approach born of a benign era of relative stability, stronger economic growth and fairly buoyant aid budgets. We now face a very different world". Under the current conditions it is not pessimistic, but realistic to take a close look at assessments of growth decelerations.

The *Global Monitoring Report 2010* (World Bank, 2010, pp. 107-113) presents instructive analyses with the World Bank's Maquette for MDG Simulations that deal with two types of low income countries (resource rich and resource poor) and develops a number of possible scenario's.[8] The base case in the scenarios assumes that the real growth rate of GDP recovers to pre-crisis values in 2011, steady growth of foreign aid and weak remittances and FDI until 2015. The worst case scenario ("low aid") describes a two thirds reduction of the GDP growth rate and a three quarters reduction in the rate of growth of development aid. The previous sections uncovered a reduction in the growth rate of GDP by some forty per cent and of aid by about sixty five percent. This is a little bit better than the low-aid-low-growth scenario, but far worse than the World Bank's base case. With this information in mind, World Bank scenarios clarify that the MDGs will be difficult to reach in this environment (only the target for primary school completion rates remain attainable). The scenarios acknowledge that the improvements that can be reaped from better domestic policies (so the internal efforts of the Least Developed Countries), although relevant, can presently not by themselves achieve the required base-case levels of MDG indicators: "better development outcomes hinge critically on … improve(d) export conditions, terms of trade and capital flows for low-income countries" (World Bank 2010, p.113). That conclusion was drawn in 2010; it gains significant credibility if we consider the subsequent experiences of the Least Developed Countries.

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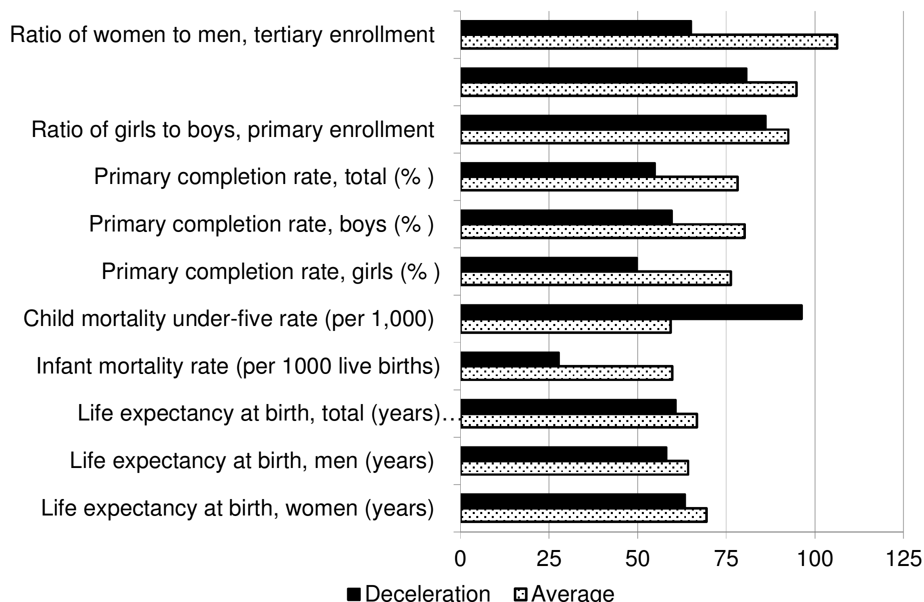
[8] This tool has also been used to investigate the impact of the financial and economic crisis on MDGs for a number of individual countries. See for example Vos (2011b).

Figure 4
Comparative impact of growth decelerations on indicators related to MDGs



Source: World Bank 2010, Appendix 2.1

The *Global Monitoring Report 2010* also reports research findings regarding growth accelerations and decelerations in 163 countries and the years 1980–2008 (World Bank, 2010). Figure 4 summarizes the most important findings related to key aspects of human development comparing human development indicator values achieved on average in normal years and during growth decelerations. It is true that the developments that were discussed in the previous section do not completely meet all the strict requirements that World Bank analysts have formulated for a growth deceleration, but recent events come very close to qualifying for a truly significant growth deceleration.[9] Therefore the general lessons of earlier episodes of growth deceleration are informative for current debates on the impact of the crisis on human development. As before the empirical evidence clearly suggests that many human development targets, in particular the targets for the primary completion rate and child mortality, become much more difficult to attain as a consequence growth decelerations.

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[9] See World Bank (2010), Box 2.1, p. 30. In particular, the four-year forward-moving average growth rate exceeds as required both the four-year backward-moving average growth rate and the average growth rate over 2000-2013 for four consecutive years, but average GDP per capita during the four-year forward-moving period exceeds the average during the four-year backward-moving period so that only two out of the three requirements of the World Bank definition are met.

TABLE 5
Least Developed Countries that (can) achieve MDGs

	Achieved	On Track	Total
Poverty	2	3	5
Universal Primary Education	2	0	2
Gender parity in primairy education	9	11	20
Gender parity in secundairy education	2	5	7
Under-five mortality	0	3	3
Safe drinking water	6	4	10
Access to Sanitation	2	1	3

Source: calculations based on Go and Quijada, (2011), Table 1, page 8
See also the appendix to this working paper

Table 5 provides an overview of the prospects that Least Developed Countries will be able to achieve the Millennium Development Goals. The table reports the number of countries that had already achieved the targets in 2011 and the number of countries that in 2011 was on track to meet the criteria in 2015. The counts confirm that many key targets are not attainable for the majority of Least Developed Countries.[10] It is relevant that the MDGs that were identified by World Bank (2010) to be the most endangered by the crisis also show up in low numbers of Least Developed Countries that can be expected to meet the MDGs in 2015. Likewise the largest numbers of successful countries are identified for the MDG areas that appear to be least vulnerable in the World Bank analyses. Triangulation of the results of time series analyses, economy wide simulation models and descriptive statistics points out the common finding that it has become extremely difficult to reach the Millennium Development Goals for the vast majority of Least Developed Countries.

5 Concluding Remarks

The debate on the impact of the economic and financial crisis in non-OECD countries all too often is based on summary data for emerging and developing countries. These aggregate observations and their development over time are dominated by the relatively good performance of a very few, very large, very fast growing countries.

This lens keeps the costs of the crisis for the Least Developed Countries and their subdued prospects outside the picture. The growth slowdown and

[10] Ironically, the research from which Table 5 derives its evidence illustrates the lens through which researchers at the global institutions look at the Least Developed Countries. This is how Go and Quijada, (2011, p. 7) introduce their evidence: "A look beneath the aggregate global statistics shows not just middle-income countries doing well, but many low-income countries, too … This confirmed that progress in individual African and poor countries was indeed strong".

foreign capital decline in the Least Developed Countries have major implications. The potential impact on human development is important. The previous section clarified that Millennium Development Goals (especially in the fields of poverty, child mortality and universal primary education) will be much more difficult to attain (if at all) in the Least Developed Countries. These costs should be included in the mainstream narrative, because the neglect of this information so to say enables policy makers to overlook the negative impact of the crisis on development issues that are relevant for the 850 million people that live in the Least Developed Countries. This neglect of their difficulties in the mainstream narrative may very well explain why Official Development Aid is lagging so significantly behind the commitments of the 2005 Gleneagles G8 and UN Millennium +5 summits.[11]

It is hoped that this paper can contribute to refocusing the discourse so that the costs of the policies in the centre that are borne by the periphery become part of the mainstream narrative.

[11] See for an alternative explanation Fialho (2012) who critically analyses the reasons behind the LDC category and its apparent lack of success.

Appendix: LDCs and MDGs

Country	Poverty	Universal primary Education	Gender parity prim. education	Gender parity sec. education	Under-five mortality	Safe drin-king water	Access to Sanitation
Afghanistan						A	
Angola							
Bangladesh			A	A	O		
Benin			O			O	
Bhutan							
Burkina Faso			O			A	
Burundi			O				
C.Afr.Rep	O						
Cambodia	A		O			O	
Chad							
Comoros			O			A	
Congo Dem. Rep (Zaire)							
Djibouti							
Eq. Guniea							
Eritrea					O		
Ethiopia	O		O				
Gambia	O		A	O		A	
Guinea			O			O	
Guinea-Bissau							
Haiti							
Kiribati							
Lao People's Dem. Republic					O		A
Lesotho							
Liberia							
Madagascar			A				
Malawi				O		A	
Mali						A	
Mauritania	A		A	O			
Mozambique							
Myanmar		A	A	A			A
Nepal			O	O			
Niger							
Rwanda			A	O			O
Samoa							
Sao Tome and Prinicipe							
Senegal							
Sierra Leone			O				
Solomon Islands			O				
Somalia							
Tanzania		A	A				
Timor-Leste							
Togo			O				
Tuvalu							
Uganda			A			O	
Vanuatu							
Yemen							
Zambia			A				

Source: calculations based on Go and Quijada, (2011), Table 1, page

Note: A = Achieved; O = On track

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