



UNITED NATIONS CONFERENCE ON THE WORLD FINANCIAL AND ECONOMIC CRISIS AND ITS IMPACT ON DEVELOPMENT

ANATOMY OF THE CRISIS

From the Report of the Secretary-General on the Economic and Financial Crisis and its Impact on Development

The world is currently faced with the worst recession since the 1930s. Though the crisis did not originate there, developing countries are being severely hit through, inter alia, weaker trade, tighter global financing conditions and lower remittances. Poverty and hunger are increasing and major reversals in hard-won gains towards the Millennium Development Goals (MDGs) will likely be seen. Children, women, the working poor, migrants and people already at a disadvantage are the most vulnerable. There is an increased risk of accelerated environmental degradation and social tensions are on the increase.

Origins and Causes

The years prior to the crisis were characterized by high global growth and relatively stable and low inflation in most countries. Growth was driven by substantial increases in productivity in many countries which, combined with the increased integration of developing countries into the global economy and a strong expansion in trade, also allowed prices to remain relatively flat for several years.

This pattern of growth, coupled with deficient regulation, eventually led to over-leveraged financial institutions, businesses and households, which proved unsustainable. Persistently low interest rates caused investors to search for higher yields in equities, housing and basic commodities, as well as progressively riskier financial instruments. Asset prices were driven up across a broad range of industrialized and emerging economies, and many developing countries benefited from high commodity prices. In publications such as the World Economic Situation and Prospects and the Trade and Development Report, the UN has warned against mounting household, public sector and financial sector indebtedness in the United States and elsewhere.

The global search for higher yield was accompanied by mounting international financial imbalances. High rates of saving in Asia and oil surplus countries financed high rates of consumption in the United States and some other industrialized countries. When global confidence in over-leveraged financial institutions and complicated asset structures began to break down in 2008, these imbalances began to unwind. In a highly integrated global economy without adequate regulation, a breakdown in one part of the system has huge repercussions elsewhere, as we are witnessing today.

Response to the crisis

The global economic crisis presents an opportunity for strengthened multilateralism. A global crisis requires concerted, global solutions.

Member States have mobilized resources on a massive scale, including \$18 trillion (almost 30 per cent of world gross product, or WGP) to recapitalize banks, nationalize financial institutions and provide guarantees on bank deposits and other financial assets; and fiscal stimulus plans that by April 2009 amounted to \$2.7 trillion (about 4 per cent of WGP), to be spent over 2009–2011.

Leaders of the Group of Twenty (G20) also pledged US\$1.1 trillion in financing at their London Summit in April, of which \$50 billion is for social protection, trade and development in low-income countries.

Policy directions gaining broad international support include:

- early warning surveillance systems to identify and respond to finance-sector risks, as well as monitoring of Member States' debt sustainability;
- strengthened international tax cooperation, to rein in tax evasion and to boost governmental fiscal capacities;
- reforms related to the credibility, accountability and efficacy of the international financial institutions;
- commitments to fight protectionism and to reach agreement on the Doha development round of trade negotiations.

The UN system is pooling its multiple assets to assist countries and vulnerable populations through:

- additional financing through jointly designed World Bank-UN system mechanisms, including the World Bank's Vulnerability Fund;
- strengthened programmes to feed the hungry and expand support to farmers in developing countries;
- aid for trade and finance for trade;
- promoting investment in long-term, climate friendly environmental sustainability;
- a global jobs pact to boost employment and decent work for all; and
- emergency action on humanitarian, security and social stability.

A new UN Global Vulnerability Alert will work to make sure that the international community does not overlook the fate of the poorest and most vulnerable while formulating its response to the crisis.

Developing countries are particularly adversely affected by the systemic flaws in the global financial system, but most are not in a position to respond with countercyclical measures. At lower levels of development, they are less resilient and thus more vulnerable to fluctuations in world markets. With fewer resources, they are typically forced to pursue pro-cyclical monetary and fiscal policies, adversely affecting economic performance and long-term growth.

Impact of the Crisis on Development

External financing for developing countries has dried up. Net private capital flows to developing economies declined by more than 50 per cent during 2008, dropping from the peak level of more than \$1 trillion registered in 2007 to less than \$500 billion. Another significant decline of 50 per cent is expected for 2009.

External financing costs for emerging economies and developing countries have surged. The risk premium on lending to these countries soared, on average, from 250 to about 800 basis points within the space of a few weeks in the third quarter of 2008. Even though spreads narrowed to 500 basis points in April 2009, they remain very high relative to normal market conditions.

The shortage of affordable financing could have major repercussions for infrastructure spending, which is critical for longer-term growth. Investments in public and private infrastructure projects in sub-Saharan Africa and Latin America declined substantially after various crises and fiscal adjustments in the

1980s and 1990s, while infrastructure investment also dropped substantially after the financial crisis of the late 1990s in East Asia and had not recovered to pre-crisis levels by 2008.

The increased cost of external borrowing will also affect debt sustainability in many countries. Some \$3 trillion of external sovereign debt, together with well over \$1 trillion of external private-sector debt, will mature in 2009. These debts will need to be rolled over at much higher costs than those that prevailed on the original financing. Debt sustainability for many developing countries will be affected further by falling growth rates and reduced export earnings. As foreign debt is denominated in major currencies, the debt-servicing ability of countries is highly sensitive to exchange-rate shifts. Deteriorating external conditions and the appreciation of the United States dollar since August 2008 have put downward pressure on the currencies of many developing countries. Depreciations have made external debt service much more expensive in terms of local currency and are already affecting budget positions of governments and businesses. These factors are putting debt sustainability under severe stress in low-income as well as middle-income countries.

Trade flows worldwide sharply declined from the end of 2008 and have continued to decline in the first quarter of 2009 at an annual rate of more than 40 per cent in the three months up to February 2009. The World Trade Organization (WTO) projects that the volume of world merchandise trade could plunge by 9 per cent for 2009 as a whole, while the United Nations World Economic Situation and Prospects expects an even steeper fall of 11 per cent, the largest decline since the Great Depression of the 1930s.

Sharp declines in commodity prices are compounding the adverse impact for many developing countries, especially economies heavily dependent on primary exports. From 2002 to mid-2008, many countries gained from the upward, albeit volatile trend in the prices of oil and non-oil commodities. The intensification of the global financial crisis since mid-2008 has led to a sharp reversal in this trend. Oil prices have plummeted by more than 70 per cent from their peak levels of mid-2008. Prices of metals dropped by 50 per cent, while prices of other commodities also declined significantly. Among net exporters of commodities, low-income countries are being hit hardest by plunging world market prices as primary exports comprise, on average, 70 per cent of their total exports and also a high share of government revenue comes from these exports.

Remittance flows to developing countries appear to be moderating. Totalling more than \$300 billion in 2008, almost three times the amount of annual official development assistance (ODA) to developing countries, remittance flows have become an important source of income support to sustain household consumption and investment in many developing countries. In earlier crises, remittances tended to be counter-cyclical, rising to compensate for economic downturns in home countries, but the parallel declines during the current global crisis appear to be limiting such remittances.

Remittance flows are also at risk because of rising immigration controls, forced expulsions of migrant workers and further reduced job security for such workers. With rising unemployment, many host countries have tightened immigration controls and introduced tougher requirements for migrant workers. Also, migrant workers tend to lose their jobs more quickly than other workers as a consequence of national policies or public pressures.

Aid flows may come under pressure in view of declining incomes in the major donor countries. The global economic slowdown of the early 1990s produced large fiscal deficits in donor countries that led to deep cuts in ODA, which fell from 0.30 per cent of their gross national incomes (GNI) in 1992 to 0.22 per cent in 1997. Many donors target annual aid flows as a share of GNI, such that the value of aid will fall with national income even if the share stays fixed.

Most developing countries are likely to experience severe balance-of-payment problems. The World Bank estimates that 98 of 104 developing countries are expected to fall short of covering external financing needs, with an estimated external financing gap that could rise to \$268 billion in 2009 alone, but may well be as high as \$700 billion under an envisaged scenario of further declines in private capital flows and increased capital withdrawal. For low-income countries alone, the IMF estimates that the balance-of-payments shock could amount to \$140 billion in 2009.

One of the biggest risks is that of a prolonged labour market recession. The ILO estimates that, because of the crisis, at least 50 million more people worldwide could become unemployed and hundreds of millions may join the ranks of the working poor. Higher unemployment rates may persist for some time.

The global economic and financial crisis comes on top of the 2008 food crisis, which is not over. According to the FAO, higher food prices pushed an estimated 115 million people into hunger in 2007 and 2008, raising the global total to close to one billion people. Moreover, prior to the current crisis, two billion people already suffered from micronutrient deficiencies.

Previous economic and financial crises have shown that economic downturns put a disproportionate burden on women. Women, especially in developing countries, have a higher probability than men of finding themselves in vulnerable employment situations or of being unemployed. Existing evidence also shows that the various economic and financial crises in Latin America, South Asia and Eastern Europe of the 1990s increased women's domestic burdens. In many cases, women were forced to absorb the impact of cuts in public spending on healthcare and education that were made in response to those crises. Cuts in social spending also tend to disproportionately affect women's and girls' access to education and health services.

Reduced investments in environmental protection, energy efficiency and renewable energy, water and land management, and forestation measures could slow efforts to make development more sustainable and to address climate change. Investments in low-carbon infrastructure and technologies may weaken along with the global decline in investment. Lower oil prices have also reduced the incentive to substitute cleaner technologies for fossil fuels.

Prolonged recession and insufficient attention to social needs could cause problems of social unrest, rising criminality and weakening governance. Failing to adequately address expected setbacks in achieving poverty reduction targets and the other MDGs.