GLOBAL LINKS

In a more integrated world the financial crisis reaches more economies faster

Although high-income economies remain the principal source and destination of international trade and investment, globalization has allowed more developing countries to participate in the growth of the global economy. They now account for almost 30 percent of world trade, and their share has been increasing. Developing economies attracted 20 times more foreign direct investment in nominal terms in 2007 than in 1990 and raised 40 times more net portfolio equity. The 12 largest developing economies, which produce 70 percent of developing country output, accounted for 67 percent of developing country exports in 2007. They also received 69 percent of the net private financial inflows to developing economies.

The financial crisis that originated in high-income economies has spread rapidly to developing economies through the same channels that connect them to the global economy: trade, investment, aid, and the movement of people. Although developing economies have previously encountered financial and economic crises, the current one is larger and may last longer. And because the world is more integrated, the crisis will affect more economies and more people.

Even before the current crisis many developing economies' finances suffered from hikes in commodity prices in the first half of 2008, while net exporters of commodities gained. Since then, the prices of primary commodities have declined rapidly. While the net effect is difficult to measure, some developing economies have benefited from improved terms of trade, but price volatility undermines investment in the commodity-producing and exporting sectors—and reduces government revenue.

Export revenues constitute about a third of developing country GDP. But global demand is declining, as economies in recession import less and less. Economies that benefited from growing exports in the past decade will be hurt as export revenues decline.

Weak prospects for international capital markets, foreign investments, and aid flows pose an immediate danger for developing economies. Equity prices plunged during the financial crisis, and developing country asset values declined. Credit conditions have tightened, and cross-border lending has become more expensive. Foreign direct investment is likely to decline as businesses around the world suffer from shrinking profits and growing pressure to raise cash. Lower financial flows affect countries differently, depending on their integration with capital markets and their dependence on foreign capital. In the past, as donor economies entered recession, their aid to developing economies fell. Countries dependent on official flows are likely to face fiscal difficulties if donors fail to keep their aid commitments.

High-income economies are the primary destination for migrant workers. The financial crisis has distressed labor markets in many high-income economies, and millions of workers—including many migrants—are losing their jobs. This may diminish workers' remittances, an important source of foreign capital in many developing economies.

Data in this section provide snapshots of the world's integration and a framework for measuring it, to show how developing economies are likely to be affected by the recent financial crisis. Figures 6y–6vv illustrate just how quickly the financial crisis has spread.

Global trade slows

The importance of trade to low- and middle-income economies can be seen in the ratio of trade (imports plus exports) to GDP, which has risen rapidly, from 47 percent in 1990 to 70 percent in 2007 for low-income economies and 39 percent to 64 percent for middle-income economies, surpassing the share of high-income economies (figure 6a). Increased exports drove many developing economies' GDP growth in the past few years.

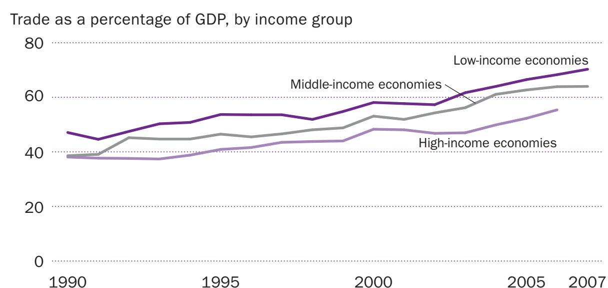
Developing economies' share of world trade increased from 18 percent in 1990 to 28 percent in 2007. The 12 largest developing economies— China, India, Russian Federation, Brazil, Mexico, Turkey, Indonesia, Islamic Republic of Iran, Poland, Argentina, Thailand, and South Africa—accounted for 67 percent of developing economies' exports in 2007, a share that has increased over time (figure 6b). China alone accounted for 27 percent. Low-income economies' share of global exports in 2007 was a mere 1.8 percent, but export revenues constituted 33 percent of their GDP.

Although trade between developing economies increased in the last decade, trade with high-income economies still accounts for the largest portion of developing economies' total merchandise exports. In 2007 about 70 percent of middle-income economies' merchandise exports went to high-income economies (figure 6c). Low-income economies exported 67 percent of their goods to high-income markets. And some of the exports to other developing economies are primary goods, which are in turn used for manufactured goods destined for high-income markets.

Since the onset of the financial crisis, the output of high-income economies has fallen and with it global trade. In the third quarter of 2008 the volume of imports by Group of Seven industrial economies declined 1.4 percent over the same quarter in 2007. The sharpest reductions were in Italy (7.1 percent), the United Kingdom (5.2 percent), the United States (3.6 percent), and Japan (1.3 percent) (figure 6d).

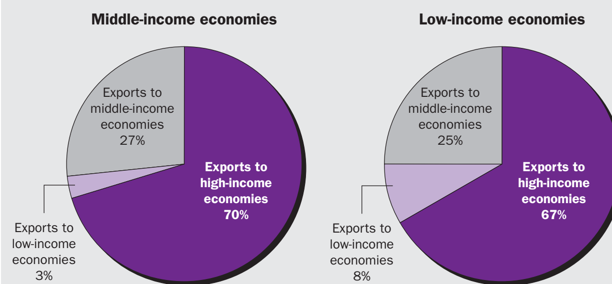
Developing economies' exports fell sharply starting in the last quarter of 2008. Merchandise exports in January 2009 fell 17 percent over exports in January 2008 for China, 31 percent for Mexico, and 43 percent for the Russian Federation. Imports by large developing economies from other developing economies have also declined, and the ripple effect is likely to hurt the low-income economies whose main exports are primary commodities such as fuels, metals, minerals, and agricultural raw materials.

The importance of trade to developing economies has increased **6a**



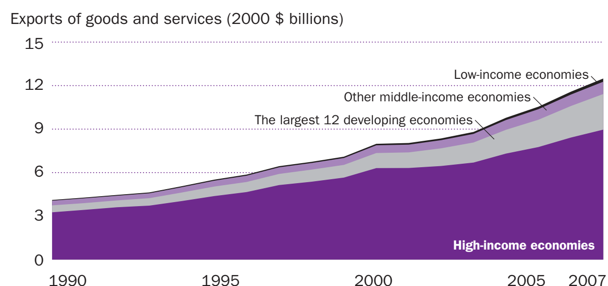
Source: World Development Indicators data files.

Most developing economy exports were directed to high-income economies in 2007 **6c**



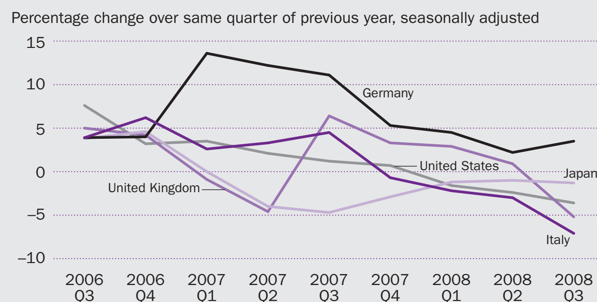
Source: World Bank staff calculations based on data from IMF's Direction of Trade database.

High-income economies and a few large middle-income economies account for a majority of world exports **6b**



Source: World Development Indicators data files.

Merchandise imports of Group of Seven industrial economies have declined, reflecting slowing demand for imports **6d**



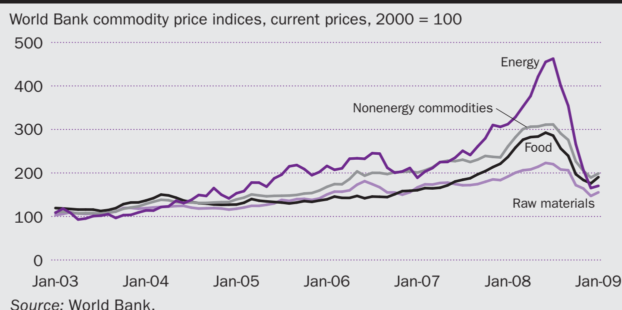
Source: Organisation for Economic Co-operation and Development.

Primary commodity prices have been volatile

Commodity prices rose rapidly in early 2008 before collapsing in the second half of the year (figure 6e). Oil prices rose 48 percent between December 2007 and July 2008 and then plunged 69 percent by December 2008. Prices of nonenergy commodities increased an average of 32 percent then dropped 39 percent over the same period. Food, fertilizers, and metals and minerals have been among the most volatile.

The price hikes in early 2008 threatened to impoverish around 200 million people. They also weakened the fiscal positions of developing economies that import large quantities of food and fuel (table 6f), as governments spent more on subsidies and safety nets to offset higher costs. The sharp price decline in the second half of 2008 eased the pressure on net importers of fuel and other commodities, but hurt the export revenues of economies that export mostly oil. Net importers of food and fuel may temporarily benefit from lower prices, but producers of export commodities are likely to suffer. Low prices and uncertain long-term prospects may diminish further investment in primary commodities.

Primary commodity prices have been volatile over the past year **6e**



Source: World Bank.

For some economies food imports were equivalent to more than 7 percent of household consumption, 2005–07 average **6f**

	Merchandise imports		Food imports	Fuel imports
Economy	Value ($ millions)	Share of PPP GDP (percent)	Share of PPP household consumption (percent)	Share of PPP GDP (percent)
Namibia	3,003	30.1	11.3	1.9
Botswana	3,419	14.3	9.4	2.2
Gambia, The	270	14.1	9.4	2.4
Jordan	11,852	45.9	9.1	10.5
Mauritius	3,560	26.7	8.5	4.6
Senegal	3,694	19.0	8.0	5.2
Swaziland	2,461	47.5	7.6	3.5
Jamaica	5,430	32.8	7.3	9.9
Gabon	1,815	9.6	7.0	0.3

PPP is purchasing power parity.
Source: World Development Indicators data files.

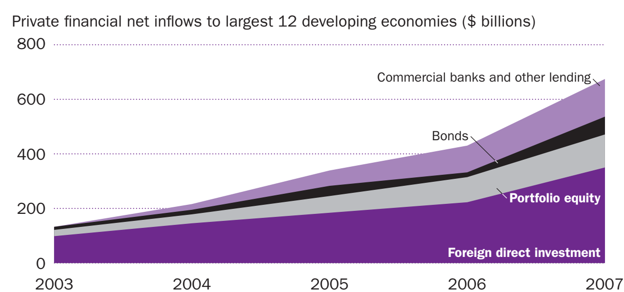
Private financial flows—greater access for some

Developing economies now have greater access to international capital markets and attract more foreign direct investment (FDI). In nominal terms private capital flows to developing economies increased from $208 billion in 2003 to $961 billion in 2007, but 70 percent of that went to the 12 largest economies.

FDI was the source of 55 percent of private financial flows to developing economies in 2007. The 12 largest economies, with greater access to international capital markets, also received large amounts of portfolio equity investment, at 18 percent of total private flows in 2007 (figure 6g). For developing economies with limited or no access to international capital markets, borrowing from private creditors was the second largest source of private flows, at 25 percent in 2007 (figure 6h).

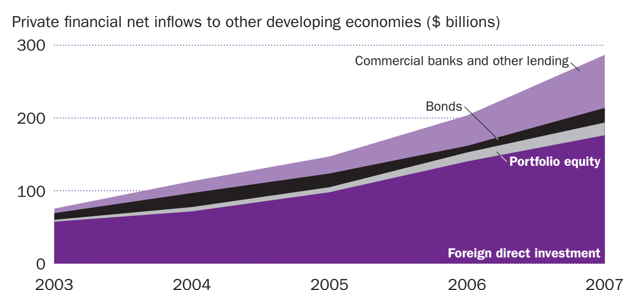
Larger middle-income economies were directly hit by falling equity prices. Sovereign and corporate bond spreads widened, indicating more costly borrowing terms. Cross-border lending by private creditors also slowed, restricting credit to developing economies, especially to the least creditworthy borrowers.

Large middle-income economies received increasing amount of portfolio equity flows in recent years **6g**



Source: Global Development Finance data files.

Other developing economies borrowed increasing amounts from private creditors **6h**



Source: Global Development Finance data files.

Foreign direct investment—largest source of private financing

In 2007 high-income economies received about 75 percent of global FDI inflows. The 12 largest developing economies received more than 66 percent of the remainder (figure 6i), with China alone receiving nearly 26 percent. Low-income economies received a mere 1.5 percent of global FDI.

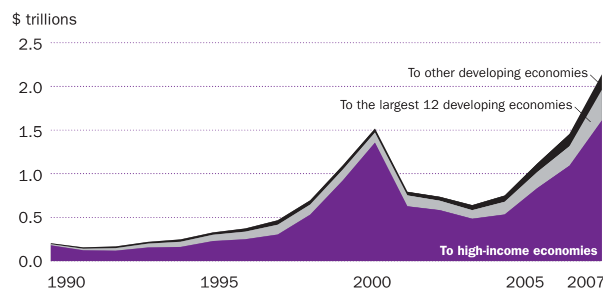
Despite accounting for a small part of global flows, FDI is the largest source of private financing for many developing economies, especially important for low-income economies with limited or no access to international capital markets. Between 2000 and 2007 FDI net inflows to low-income economies more than doubled, from 1.7 percent of GDP to 4.2 percent of GDP (figure 6j). The increase was due partly to increased investments in oil, mineral, and other primary commodity production sectors driven by high commodity prices and partly to an increase in infrastructure projects (many through public-private partnerships). In 2007 FDI net inflows were more than 20 percent of GDP for nine small economies—Republic of Congo, Seychelles, St. Kitts and Nevis, St. Lucia, Montenegro, São Tomé and Principe, Djibouti, Grenada, and Bulgaria.

Foreign direct investment—stable source of financing?

FDI is considered a fairly stable source of external financing, but in past financial crises it declined, sometimes sharply. During the East Asian financial crisis net inflows of FDI fell 105 percent between 1997 and 1998 to Indonesia and 58 percent to Malaysia in parallel with falling output (figure 6k). For Thailand and the Republic of Korea FDI net inflows remained resilient for two to three years (figure 6l).

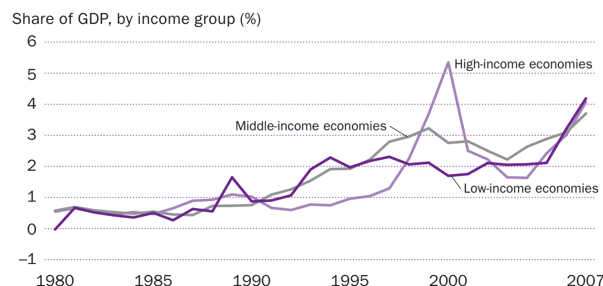
The current financial crisis originated in high-income economies, so the effect on FDI flows to developing economies may be more drastic than in past crises originating in developing economies. Businesses around the world are lowering their capital spending in response to tighter credit and weaker global demand. And reinvested earnings, which have accounted for a rising share of FDI net inflows, have started to plunge as profits weakened. Likewise, weak commodity prices are likely to undermine new investments in commodity-producing industries, and low real estate prices will weaken FDI in the construction sector. For countries already running current account deficits, a shortfall in FDI may further undermine their ability to manage their balance of payments.

Much global FDI is directed to high-income economies and a few large middle-income economies . . . 6i



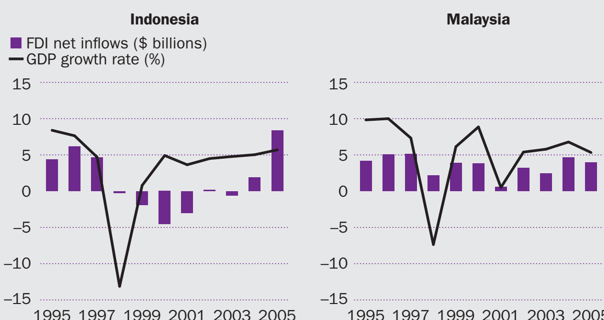
Source: World Development Indicators data files.

. . . But as a share of GDP, FDI net inflows are a large source of private financing for low-income economies 6j



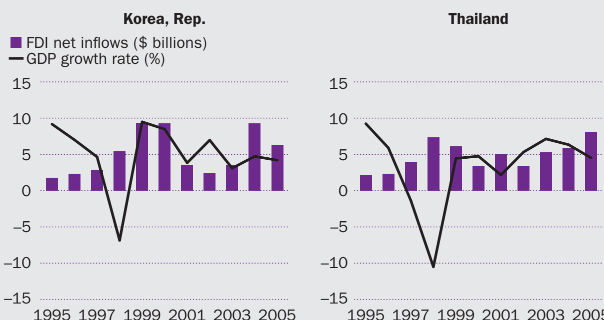
Source: World Development Indicators data files.

FDI net inflows to Indonesia and Malaysia declined immediately after the East Asian financial crisis hit 6k



Source: World Development Indicators data files.

FDI net inflows to the Republic of Korea and Thailand remained resilient for several years after the plunge in GDP 6l



Source: World Development Indicators data files.

Declining portfolio equity flows

In 2007 high-income economies received $577 billion—more than 80 percent of global portfolio equity flows. Developing economies received nearly $140 billion, more than 87 percent of it going to the 12 largest developing economies (figure 6m). And low-income economies received only 1.7 percent of global equity flows.

For larger middle-income economies with developed capital markets, portfolio equity flows are the second largest source of private financial flows. Equities from these economies (emerging market equities) became an attractive investment for high-income investors with appetites for risk, and their prices soared after 2005. Equity markets, declining since October 2007, fell sharply in the last quarter of 2008; investors became more risk averse and were pressed to liquidate their holdings.

Developing economies now play a bigger role in international capital markets. Stock market capitalization of listed companies from developing economies accounted for 23 percent of global market capitalization in end-2007, up from 6 percent in end-2000. In more mature developing markets the stock market capitalization to GDP ratio, at its peak, approached that of high-income economies, around 120 percent. But the ratio has been volatile over the past few years and may be unsustainable for some countries (figure 6n). By December 2008 the stock market capitalization in 42 developing economies where data are available had fallen to 52 percent of GDP, down more than 59 percentage points from its October 2007 peak.

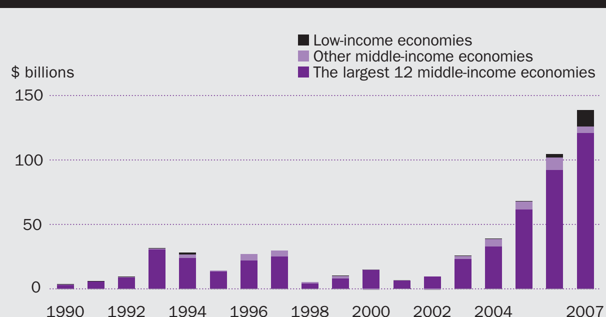
Private debt flows have become more costly

Developing economies raised net capital of $85.4 billion through bond issuance in 2007, up from $20.4 billion in 2003. The five largest bond issuers (Russian Federation, Kazakhstan, India, Turkey, and Ukraine) accounted for 74 percent. Nearly 90 percent of the bond issuance by low-income economies in 2007 was public and publicly guaranteed, while almost 70 percent by middle-income economies was private nonguaranteed. Following the financial crisis, sovereign bond spreads (the spread over 10-year U.S. Treasury notes) widened for most developing economies, raising the cost of borrowing. Corporate bond spreads jumped even more (figure 6o). By January 2009 sovereign bond spreads in 15 developing economies exceeded the “distressed debt” threshold of 1,000 basis points.

Borrowing from private creditors is (after FDI) the second-largest source of private financial flows to developing economies. It is especially important for low-income economies with limited or no access to global equity markets. The financial crisis has made cross-border borrowing more costly. And trade finance tightened in the last quarter of 2008.

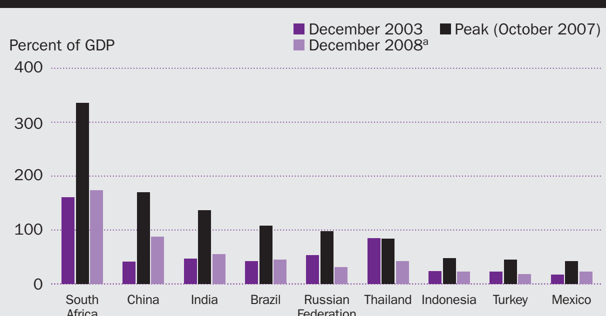
Most affected by the slump in debt flows is Europe and Central Asia, where net borrowing from foreign private creditors rapidly increased during the last few years, from $14.5 billion (1 percent of GDP) in 2003 to $131.2 billion (4 percent of GDP) in 2007 (figure 6p).

Net portfolio equity flows to large middle-income economies increased considerably **6m**



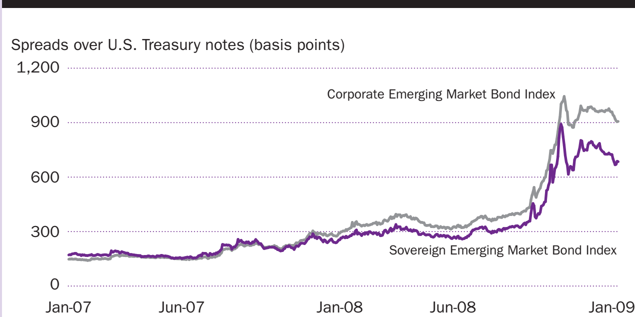
Source: World Development Indicators data files.

Stock market capitalizations declined after the financial crisis **6n**



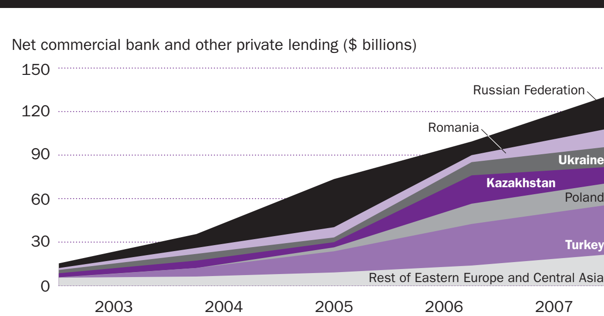
a. Data are as a percentage of 2007 GDP.
Source: World Development Indicators data files and Standard & Poor’s.

Spreads on emerging market sovereign and corporate bonds have widened, increasing the cost of borrowing **6o**



Source: JP Morgan Chase, Bloomberg, and Thomson Datastream Advance.

Private lending to Europe and Central Asia increased ninefold between 2003 and 2007 **6p**



Source: Global Development Finance data files.

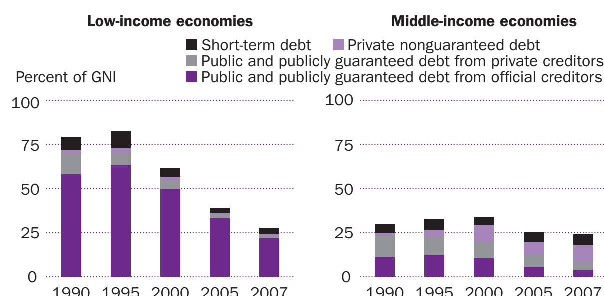
External debt declined but the share of private debt has increased

External debt of low-income economies declined from 65 percent of GNI in 2000 to 29 percent in 2007, partly due to debt relief (figure 6q). Public debt from official creditors accounted for nearly 90 percent of the long-term external debt of low-income countries in 2007, and public debt from private creditors for 7 percent. Private nonguaranteed debt was less than 1 percent of GNI.

External debt of middle-income economies declined from 36 percent of GNI in 2000 to less than 25 percent in 2007. More than half their long-term external debt was private nonguaranteed debt, which amounted to 10 percent of GNI in 2007. Public debt from private creditors was 6 percent of GNI and short-term debt 5 percent of GNI, putting some middle-income economies at greater risk from tightening global credit markets.

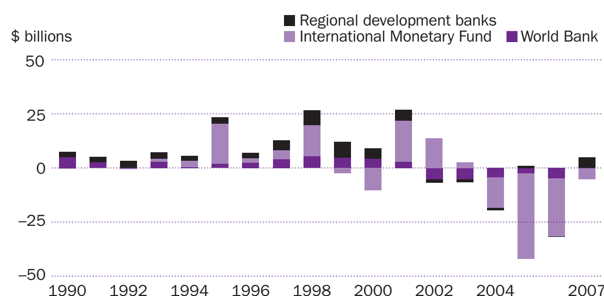
Net lending of international financial institutions to middle-income economies had been declining since 2002 (figure 6r). But with private capital flows drying up, middle-income economies are again turning to the major international financial institutions. The International Monetary Fund made new commitments to several countries totaling $45 billion as of February 2009. The World Bank created a $2 billion fast-track fund to assist the poorest countries affected by the crisis and plans to increase commitments to all eligible countries in the next few years.

For middle-income economies nearly 80 percent of long-term debt was from private creditors while for low-income economies 90 percent was from official creditors **6q**



Source: Global Development Finance data files.

Net nonconcessional lending to middle-income economies from international financial institutions, declining since 2002, recently increased **6r**



Source: Global Development Finance data files.

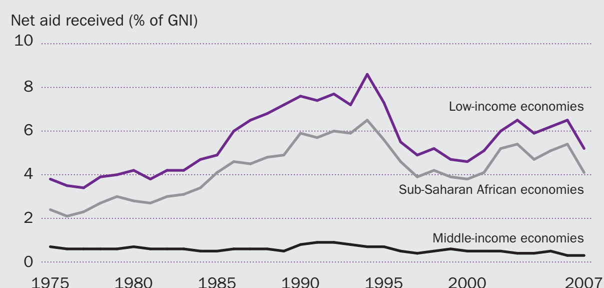
Official development assistance— a lifeline to poor countries

Official development assistance is the main source of external financing for low-income economies (figure 6s). For some countries (Liberia, Burundi, Micronesia, Solomon Islands, Afghanistan, Guinea-Bissau, and Sierra Leone) it is equivalent to more than 30 percent of GNI.

Official development assistance has risen 38 percent in constant prices since 2000, but most of the increase was for debt relief, technical assistance, and emergency relief, which do not provide long-term investment to raise productive capacity. Official development assistance to finance long-term development projects has not increased much since the 1970s (figure 6t). After reaching a record $107 billion in 2005—mainly driven by one-time debt relief—aid declined by 13 percent in 2007.

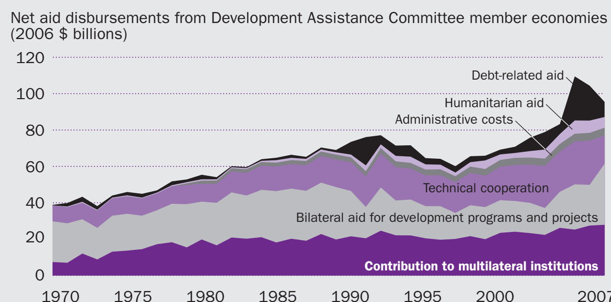
Official development assistance is a small part of the budgets of the Development Assistance Committee members of the Organisation for Economic Co-operation and Development, averaging only 0.28 percent of their GNI, a small fraction of what they will spend on bailouts and fiscal stimulus in their domestic economies. But for low-income economies that depend on aid for their development, even a small decline can be devastating. To counter the financial crisis and progress toward their development goals, the poorest countries will need more assistance from external donors.

Aid is equivalent to 5 percent of the GNI of low-income economies **6s**



Source: Organisation for Economic Co-operation and Development, Development Assistance Committee International Development Statistics database and *World Development Indicators* data files.

Aid for long-term development has remained about the same as in the 1970s **6t**



Source: Organisation for Economic Co-operation and Development, Development Assistance Committee International Development Statistics database.

Official development assistance—in historical perspective

Aid flows usually decline after an economic crisis in the donor economy. After Japan's bubble economy burst in 1990 aid flows declined continually through 1996 by 24 percent. After the U.S. savings and loan crisis in the 1980s aid flows dropped 46 percent over the next 10 years. After the Nordic banking crisis in 1991 net aid flows fell 61 percent from Finland, 14 percent from Sweden, and 7 percent from Norway (figure 6u). In Norway aid flows recovered immediately, while Sweden's aid flows continued to decline through 1998.

But donor economies can increase aid flows to developing economies even with difficult conditions at home. After the dot-com bubble burst in 2000, the United States—despite significant economic difficulties—increased its aid flows continually through 2005 (figure 6v). The increase was partly a response to international pressure to increase aid following the 2000 UN Millennium Summit and the 2002 Financing for Development Conference and partly a response to the humanitarian needs of countries at war, such as Afghanistan and Iraq.

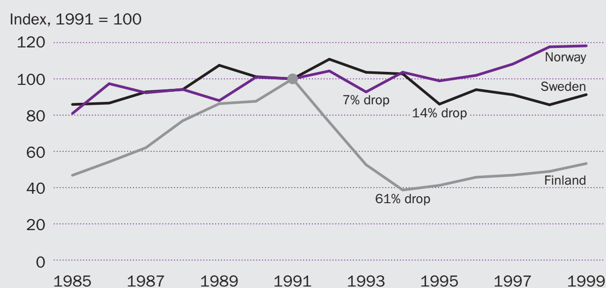
Migration and remittances—of increased importance for developing economies

Net migration to high-income economies totaled 18.5 million people during 2000–05, almost twice the number for 1985–90 (figure 6w). Global flows of workers' remittances and compensation of employees also increased, from $68.6 billion in 1990 to $371.3 billion in 2007, more than 75 percent of it received by developing economies, up from 45 percent in 1990 (figure 6x).

Remittances have become an important source of foreign exchange earnings for developing economies, at 2 percent of their GDP in 2007. For low-income economies remittances equaled 7 percent of GDP in 2007, up from 3 percent in 2000. And for Guyana, Lesotho, Liberia, Moldova, Seychelles, Tajikistan, and Tonga remittances accounted for more than 25 percent of GDP in 2007.

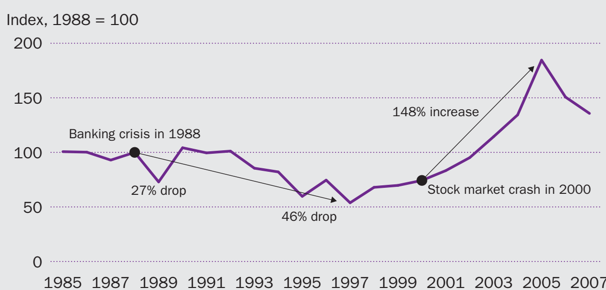
The deepening global recession has reduced demand for migrant workers. As labor markets tighten, thousands of workers are losing their jobs, and some migrants are returning home. After a final surge associated with the repatriation of savings and capital assets, remittances are expected to decline, leaving many families with fewer means of support.

Aid flows declined after the Nordic banking crisis in 1991 **6u**



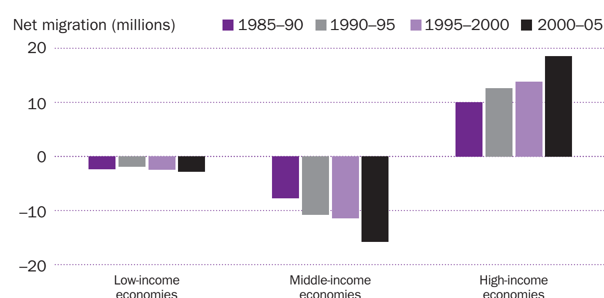
Source: Organisation for Economic Co-operation and Development, Development Assistance Committee's International Development Statistics database.

Two U.S. financial crises in the late 20th century—aid down, then up **6v**



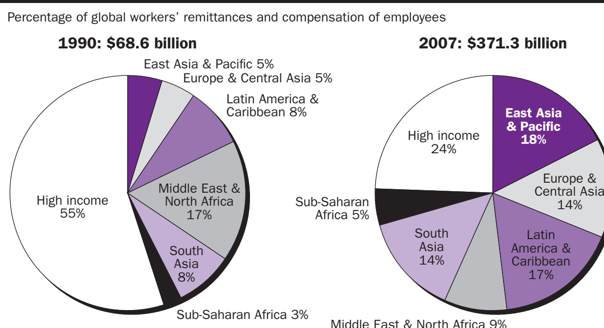
Source: Organisation for Economic Co-operation and Development, Development Assistance Committee's International Development Statistics database.

Migration to high-income economies has increased **6w**



Source: United Nations Population Division and *World Development Indicators* data files.

More remittance flows are now going to developing economies **6x**



Source: World Development Indicators data files.

Merchandise trade

Goods make up 70–90 percent of most countries' total exports and imports. Since 2006 Brazil, China, and the Russian Federation have been running current account surpluses, while Egypt, India, and South Africa have had deficits. In the last quarter of 2008 merchandise exports and imports in absolute values and as a share of GDP declined for China, India, the Russian Federation, and South Africa (figures 6y–6dd). Merchandise exports and imports also declined for Brazil, but its GDP declined more.

Equity price indices

Equities of large developing economies had become attractive investments, and their prices soared through October 2007. But equity prices fell back in late 2007 and plunged in the last quarter of 2008 (figures 6ee–6jj). Declines in equity prices undermine the values of developing country assets.

Bond spreads

Following the financial crisis, sovereign bond spreads have widened. Corporate spreads have jumped even more. Bond spreads, measured by J.P. Morgan's Emerging Markets Bond Index Global (EMBI Global) and Corporate Emerging Markets Bond Index (CEMBI) and benchmarked against the yield of 10-year U.S. Treasury notes, indicate that the cost of external borrowing for developing countries is rising (figures 6kk–6pp).

Financing through international capital markets

In 2007 developing economies received increasing amounts of gross private debt and equity flows. But in 2008, even before the intensification of the financial crisis, credit conditions tightened, and transactions slowed. Since October 2008 there has been virtually no new equity issuance, and only a limited amount of new bond issuance and syndicated bank loan commitments (figures 6qq–6vv).

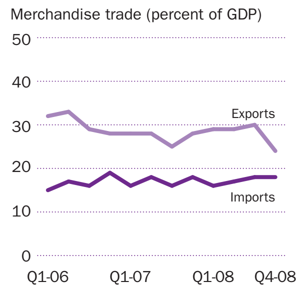
Arab Republic of Egypt 6aa

Source: Haver Analytics.

India 6bb

Source: Haver Analytics.

Russian Federation 6cc

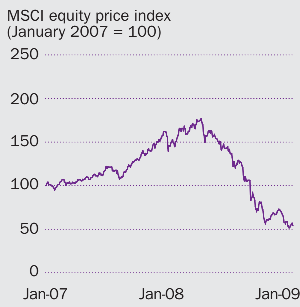


Source: Haver Analytics.

South Africa 6dd

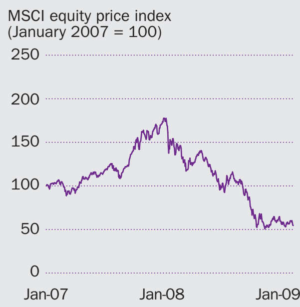
Source: Haver Analytics.

Arab Republic of Egypt 6gg



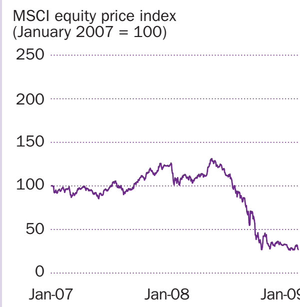
Source: MSCI Barra and Thomson Datastream Advance.

India 6hh



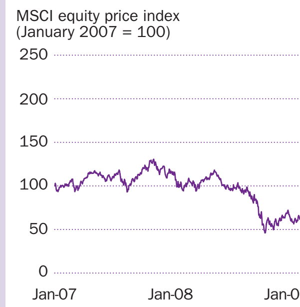
Source: MSCI Barra and Thomson Datastream Advance.

Russian Federation 6ii



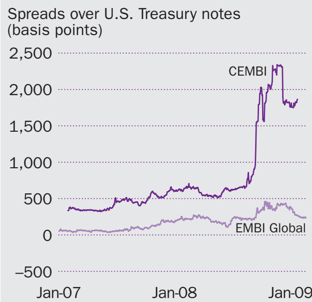
Source: MSCI Barra and Thomson Datastream Advance.

South Africa 6jj



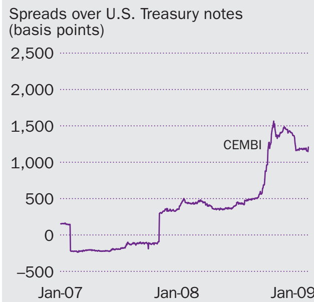
Source: MSCI Barra and Thomson Datastream Advance.

Arab Republic of Egypt 6mm



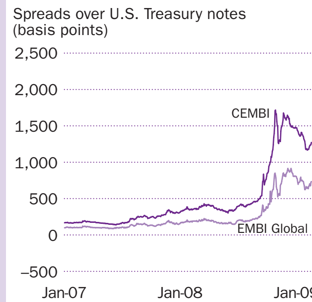
Source: JP Morgan Chase, Bloomberg, and Thomson Datastream Advance.

India 6nn



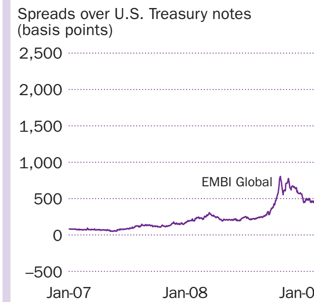
Source: JP Morgan Chase, Bloomberg, and Thomson Datastream Advance.

Russian Federation 6oo



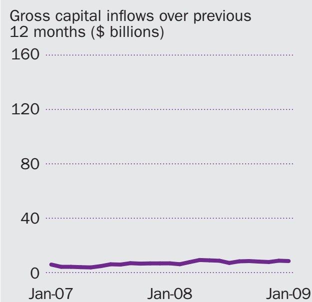
Source: JP Morgan Chase, Bloomberg, and Thomson Datastream Advance.

South Africa 6pp



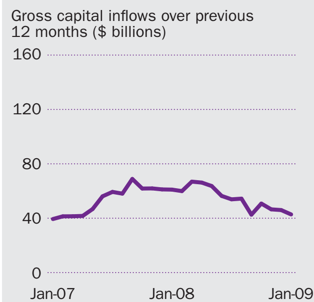
Source: JP Morgan Chase, Bloomberg, and Thomson Datastream Advance.

Arab Republic of Egypt 6ss



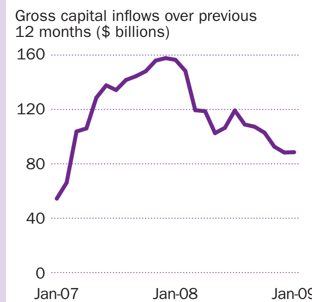
Source: Dealogic.

India 6tt



Source: Dealogic.

Russian Federation 6uu



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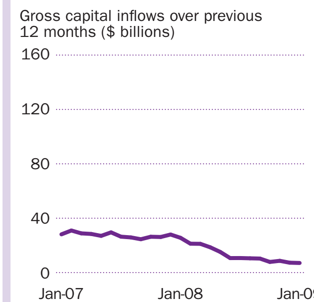
South Africa 6vv



Source: Dealogic.