Overseas Development Institute

The euro zone crisis and developing countries

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Working Paper 345

Results of ODI research presented in preliminary form for discussion and critical comment

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May 2012

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Acknowledgements

ODI gratefully acknowledges the support of DFID in the production of this Working Paper. The authors are also grateful to Prof. Stephany Griffith-Jones and Dr Dirk Willem te Velde for valuable comments and suggestions.

ISBN 978-1-907288-66-1
Working Paper (Print) ISSN 1759 2909
ODI Working Papers (Online) ISSN 1759 2917

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Acronyms

BIS	Bank for International Settlements
BRIC	Brazil, Russia, India and China
CBK	Central Bank of Kenya
CDDC	Commodity-Dependent Developing Country
CEMAC	Economic and Monetary Community of Central Africa
CFA	*Communauté Financière Africaine*
DAC	Development Assistance Committee
ECB	European Central Bank
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
LDC	Least Developed Country
LIC	Low-Income Country
LMIC	Lower-Middle-Income Country
MIC	Middle-Income Country
NSE	Nairobi Security Exchange
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PDR	People's Democratic Republic
SITC	Standard International Trade Classification
SIDS	Small Island Developing States
SSA	Sub-Saharan Africa
US	United States
WAEMU	West African Economic and Monetary Union

Executive summary

This paper analyses the vulnerability of developing countries to the euro zone crisis, looking at differences across countries and groups of countries. In addition to this, it simulates the potential effects of trade shocks due to the crisis on lower-income economies, and establishes a set of stylised facts on the actual impacts of the European debt crisis on poor countries. Policy responses at the country and international level are also discussed.

From the analysis it emerges that the developing countries likely to be more at risk from the euro zone crisis are those which:

- direct a significant share of their exports to European crisis-affected countries
- export products with high income elasticities
- are heavily dependent on remittances, foreign direct investment, cross-border bank lending and aid flows from European countries
- have limited policy room to counter the effects of the crisis.

Significant differences in the degree of vulnerability to the euro zone crisis exist among countries as well as across developing regions and groups of countries.

The European debt crisis is likely to hit poor countries hard through the trade channel. Our simulation results show that a drop of 1% in export growth could reduce growth rates in low- and lower-middle-income countries by an average of 0.4% and 0.5% respectively.

The impact of the crisis on developing countries is already visible in the form of reductions in exports, declining portfolio flows, cancelled or postponed investment plans, and falling remittances and aid flows. In Mozambique Portuguese public investments have been reduced; in Nigeria remittances have declined; in Kenya the stock exchange has suffered heavy sell-offs; and in Rwanda foreign investments have been delayed. Nevertheless, the effects of the euro zone crisis so far (at least from a trade and finance perspective) seem to be less severe than those of the 2008–9 global financial crisis. The slow-down in China's growth may, however, increase the risks for developing countries, thus leaving them overly exposed to the trade- and finance-related adverse impacts of the euro zone crisis.

In order to weather the crisis, developing countries should, whilst maintaining fiscal soundness and macroeconomic stability as long-term targets, spur aggregate domestic demand, promote export diversification in both markets and products, improve financial regulation, endorse long-term growth policies, and strengthen social safety nets. For their part, multilateral institutions should ensure that adequate funds and shock facilities are put in place in a coordinated way to provide effective and timely assistance to crisis-affected countries.

1 Introduction

Since the last quarter of 2011 the euro zone crisis has entered a new and dangerous phase. This is despite repeated interventions by the European Central Bank (ECB) to shore up investor confidence and recapitalise the banking system within crisis-affected countries, in particular Italy, Spain, Ireland, France and Greece. Concerns about banking sector losses and fiscal sustainability have widened sovereign spreads for many euro area countries. Bank funding dried up in the euro area in the first quarter of 2012, prompting the ECB to offer a three-year long-term refinancing operation to inject capital into the system. These developments meant that bank lending conditions deteriorated across a number of advanced economies, and affected capital flows to emerging economies and developing countries in general. Currency markets have been volatile, as many emerging market currencies depreciated significantly (IMF, 2012a).

There remain concerns regarding the ECB's refinancing operations to recapitalise the banking system within crisis-affected euro zone economies. There are risks involved in the continuation of the provision of easy credit to institutions that need to change their behaviour rather than continue business as usual. Although some commentators posit that the latest cash injections may have prevented a bank run across euro zone economies, or a Lehman-style collapse, the measures still do not resolve the sovereign debt crisis.[1] In the short term it is unclear if ECB's interventions, even though massive, are enough, as fears grow over the impact of a possible Greek withdrawal from the Euro. The implementation of bail-out measures within individual countries, for example Ireland, poses the risk of further increasing fiscal deficits and hence increasing pressure on fiscal stability pacts within the region.

There are also political difficulties to resolve. There is stiff opposition to continued austerity in Greece. Italy is currently under a state of emergency. Spain and France are still grappling with the design and implementation of reforms. Tensions are running high between some euro zone members. Germany's economy, on the other hand, continues to outperform others, and voters there are opposed to any further interventions and contributions to the euro zone stabilisation fund which is required to assist weaker economies to adapt.

This view was also previously shared by agencies such as the International Monetary Fund (IMF), as well as other members of the G20, which have argued that euro zone members need to increase their own contributions in order to resolve the crisis rather than rely on additional external resources. That is, euro zone members need to increase their firewall so as to defend their currency before external resources are allocated via the IMF.[2] However, this view has now changed since the gravity of the euro zone crisis has accelerated into 2012. Some G20 members, notably Japan, have committed to making additional resources available to the IMF in order to assist 'innocent bystanders' who might be affected by economic and financial spill-overs from Europe.[3]

In summary, these developments mean that the outlook for the global economy remains gloomy, with economic recovery being patchy both globally and within the euro zone economies. The break-up of the euro zone – which could result from the default of Greece and its exit from the euro zone unless it is able to implement its austerity measures or Germany and other governments reduce the pressure on excessive austerity – remains a major risk. A Greek exit from the euro is likely to have contagion effects in the euro region. Bank runs could occur in Portugal, Ireland, Italy and Spain; the prices of financial and other assets could collapse; and flight to safety to Germany or beyond the euro zone could accelerate (Wolf, 2012). Moreover, the already weak macroeconomic conditions of several European countries could worsen substantially (*ibid.*). On the other hand, the new emphasis on growth, spurred by the victory of France's new president, may help if crisis is managed. So what are the implications of

1 See Wilson (2011).
2 What has been agreed is that any loans made by the IMF will be on a bilateral rather than a regional basis.
3 See http://www.reuters.com/article/2012/04/17/us-imf-japan-idUSBRE83G03L20120417.

these developments for lower-income countries highly dependent on the European Union (EU) as a market and source of finance?

This paper examines the vulnerability of developing countries to the euro zone crisis, looking at differences across countries and groups of countries, and undertakes scenario analyses to assess the potential effects of the crisis on lower-income economies. A set of stylised facts on the actual impacts of the crisis on poor countries is established, and policy responses at the country and international level are also discussed.

The paper is organised as follows. In Section 2 we assess poor countries' vulnerability to the euro zone crisis and its transmission channels (direct and indirect). We outline the economic and financial transmission mechanisms and review exposure and resilience indicators. In Section 3 we go on to highlight which developing countries within a selected sample are relatively more vulnerable to the possible financial and real shocks of the euro zone crisis, and undertake scenario analysis of the possible effects on poor countries of trade shocks due to the crisis. This is followed, in Section 4, by an analysis of the impacts already visible in the developing world. In Section 5 we discuss in more detail country-specific effects through the use of a number of country case studies. Finally, in Section 6 we conclude with reference to specific policy recommendations.

2 Poor countries' vulnerability to the euro zone crisis

In this section we focus on the vulnerability of poor (low- and lower-middle-income) countries to the effects of the euro zone crisis. We first identify the main channels of impact and then investigate which countries or groups of countries are most susceptible to the effects transmitted through these channels based on their exposure and resilience characteristics.

2.1 Channels of impact

The major channels of impact from the euro zone sovereign debt crisis identified by Massa et al. (2011) include:

- Financial contagion effects: These occur in the form of spill-overs through financial intermediaries (e.g. bank lending) and stock markets, as well as in the form of shifts in investor market sentiment and changes in investors' perception of risks.
- Fiscal consolidation effects: The series of austerity packages enacted in several European economies has led to a considerable rise in unemployment and weakened growth which had still not fully recovered after the 2008–9 global financial crisis. This may affect demand for developing country exports, leading to changes in trade flows between the EU and developing economies. It may also affect foreign direct investment (FDI) and remittance flows as well as aid flows from European countries.
- Exchange rate effects: A depreciation of the euro may affect trade flows in developing economies in two opposite ways. On the one hand, countries whose currency is pegged to the euro may benefit from a weaker euro which makes their exports more competitive in world markets. On the other, countries with dollar-linked exchange rates will suffer from an appreciation of the dollar against the euro.

With regard to financial contagion effects, IMF (2012a) highlights how low interest rates in the advanced economies – including among euro zone countries – can lead to increased capital flows into developing countries, which in turn strengthen exchange rates, fuel expansions in domestic liquidity and credit, and therefore asset prices, potentially increasing financial vulnerabilities. On the other hand, a loss of risk appetite amongst investors can lead to a rise in funding costs and reduced credit lines for domestic banks. This suggests that financial vulnerabilities for emerging and developing economies have increased despite a generally positive growth outlook. Unless further backstops for sovereign financing are agreed, a further round of bank deleveraging may occur which could be disorderly and exacerbate an already risky and uncertain situation.

The euro zone entered a mild recession in 2012 and overall is expected to register -0.3% growth this year, with Italy and Spain experiencing the most severe contractions (of -1.9 and -1.8 respectively).[4] As a result of this slow-down and the adverse spill-over effects arising from the transmission channels outlined above, growth in emerging and developing economies is expected to continue moderating (IMF, 2012c). Global output is projected to expand by 3.5% in 2012, down from close to 4% in 2011 (IMF, 2012b). This revision is largely a result of the slow-down in euro zone economies, itself a result of the rise in sovereign yields, the effects of bank deleveraging on the real economy, and the effects of fiscal consolidation.

According to the IMF (2012a), the overarching risk remains an intensified global 'paradox of thrift' as households, firms, and governments around the world reduce demand. This risk is further exacerbated by fragile financial systems, high public deficits and debt, and already low interest rates in the developed world which limit the policy space of governments to provide further stimuli.

Developing economies will feel the effects of the euro zone crisis to a greater or lesser extent, depending on their degree of vulnerability to its transmission channels. The gravity of its effects will therefore depend on countries' exposure and resilience characteristics. In the following section, we look at a number of selected exposure and resilience indicators in order to identify the countries and groups of countries which are most exposed to the euro zone crisis.

2.2 Vulnerability indicators

The EU is the major trading partner for low-income countries (LICs) and the Least Developed Countries (LDCs). It is a key donor for developing countries – for example, LDCs receive roughly half of their aid from Europe. It is also an important source of remittances and one of the largest investors in the global economy. Poor countries (or groups of countries) which are likely to face higher risks in the context of the euro zone crisis are those characterised by the following exposure and resilience factors:

- a significant share of exports to crisis-affected countries in the EU
- exports of products with high income elasticities
- heavy dependence on remittances
- heavy dependence on FDI and cross-border bank lending
- dependence on aid, and
- limited policy room (e.g. high current account deficit, high government deficit, low reserve level).

2.2.1 Exposure indicators

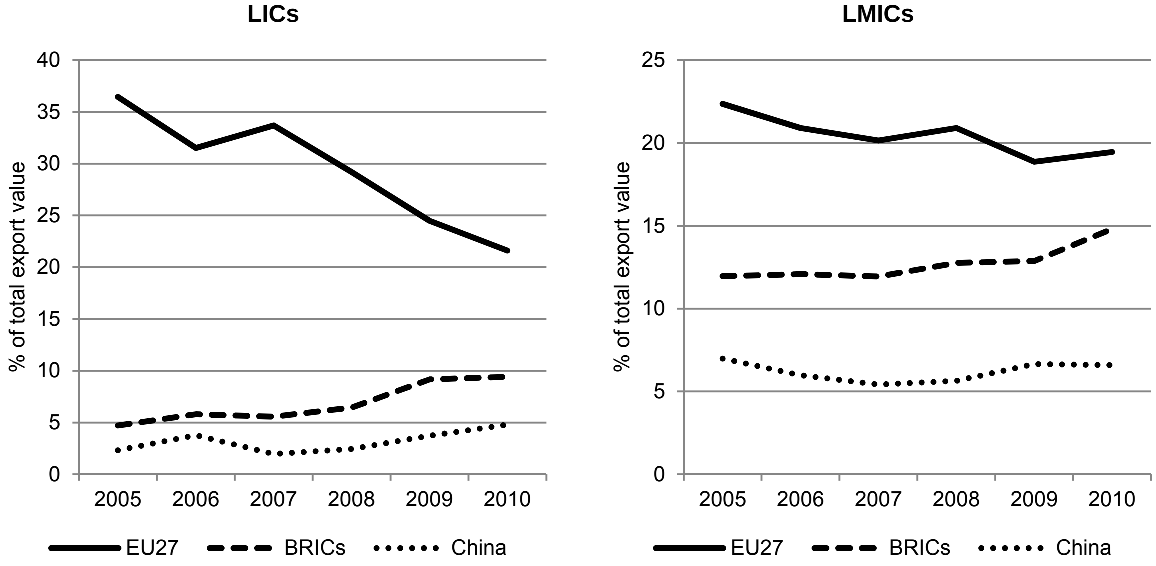
The degree of exposure of developing countries to the shock waves of the euro zone crisis depends on the extent to which these economies depend on trade flows, remittances and private capital flows (e.g. FDI and cross-border bank lending) as well as aid flows.

Dependence on trade

On the export side, the EU remains the largest single trading partner for LICs as a group and lower-middle-income countries (LMICs), even though its relative importance has been declining over time: export shares to Brazil, Russia, India and China (the BRICs) have increased in recent years (Figure 1).

[4] See IMF (2012b), which does not include projections for Greece.

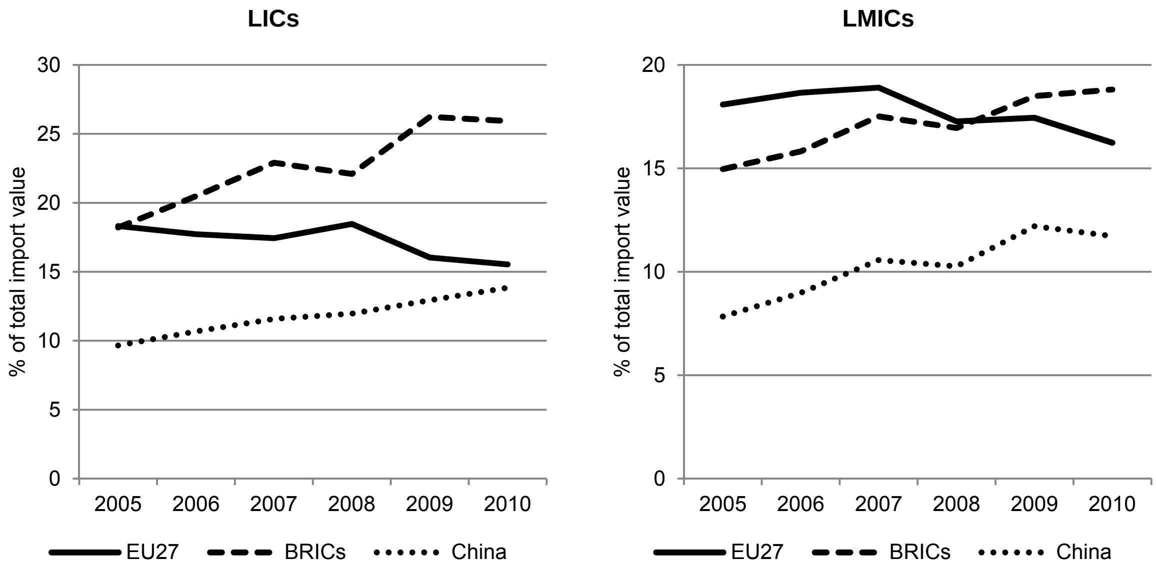
Figure 1: Share of LIC/LMIC exports destined for the EU, BRICs and China, 2005–10



Note: The number of countries included in each category, and year, varies according to data availability.
Source: UN COMTRADE database.

On the import side, the value of imports from BRIC countries already exceeds that of those from the EU. However, the decline in the relative importance of the EU as an import partner has been particularly pronounced since the global financial crisis of 2008–9 (Figure 2).

Figure 2: Share of LIC/LMIC imports sourced from the EU, BRICs and China, 2005–10



Note: The number of countries included in each category, and year, varies according to data availability.
Source: UN COMTRADE database.

Despite these aggregate structural shifts in trade patterns, which have become more apparent in recent years, a number of LICs and LMICs have an extreme dependence on the EU as both an export destination and an import source, as shown in Table 1. These countries include Cameroon, Cape Verde, Egypt, Morocco, Mozambique and São Tomé and Príncipe, amongst others.

Most of the countries presented in Table 1 with a high dependence on the EU market – defined as an export or import share of more than 30% – are LMICs. In addition to this category, a number of LDCs as well as small and vulnerable economies also feature. Figure 3 presents those countries where the total value of exports to the EU accounts for more than 1% of Gross Domestic Product (GDP). These include

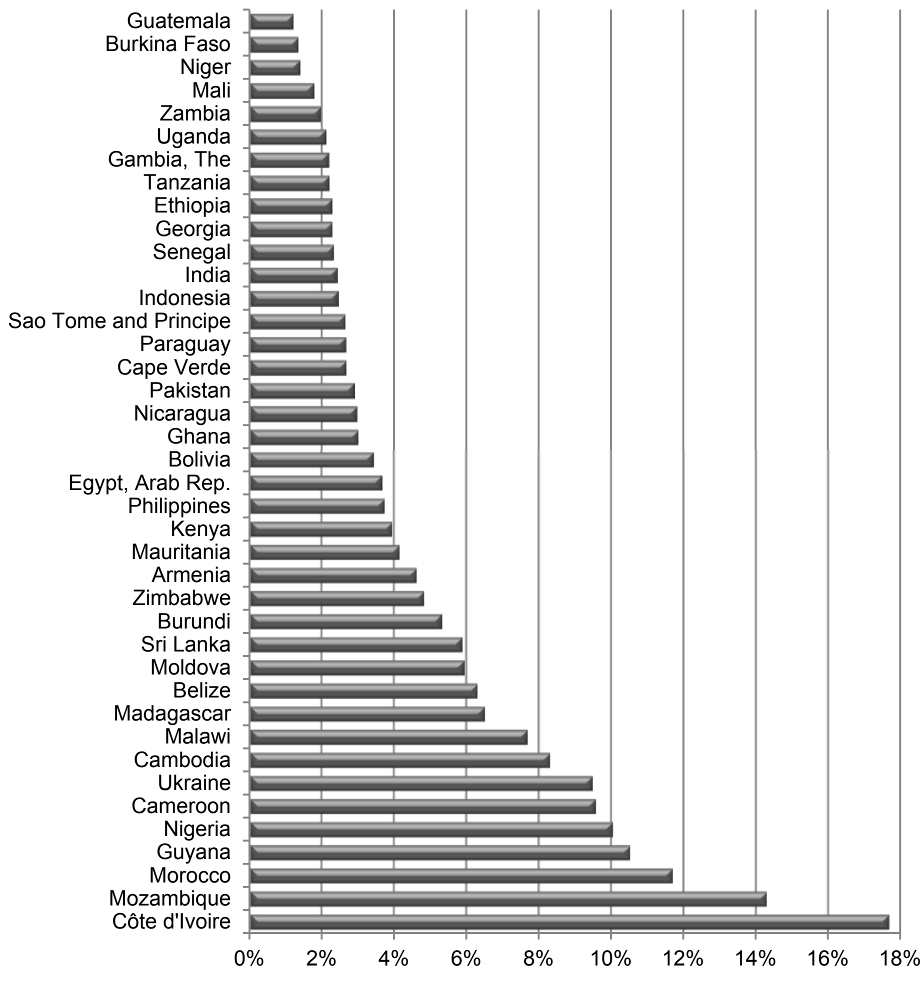
Côte d'Ivoire, Mozambique, Morocco, Madagascar and Malawi, as well as Cape Verde and São Tomé and Príncipe, which also feature in Table 1.

Table 1: LICs and LMICs with a high trade dependence on the EU

Reporting country	Group	% of total exports to EU27, 2010	Reporting country	Group	% of total imports from EU27, 2010
Cape Verde	LMIC	94.1	Cape Verde	LMIC	78.1
São Tomé and Príncipe	LMIC	81.5	São Tomé and Príncipe	LMIC	66.8
Mozambique	LIC	62.4	Morocco	LMIC	49.2
Madagascar	LIC	60.1	Mauritania	LMIC	46.5
Morocco	LMIC	59.7	Moldova	LMIC	44.2
Cameroon	LMIC	55.2	Senegal	LMIC	43.6
Gambia, The	LIC	50.0	Togo	LIC	39.9
Armenia	LMIC	49.8	Egypt, Arab Rep.	LMIC	32.3
Côte d'Ivoire	LMIC	39.1	Cameroon	LMIC	31.6
Moldova	LMIC	36.8	Ukraine	LMIC	31.4
Malawi	LIC	36.8	Ghana	LMIC	30.8
Sri Lanka	LMIC	35.0	Mozambique	LIC	30.6
Belize	LMIC	31.3	Burkina Faso	LIC	30.2
Burundi	LIC	31.0	Gambia, The	LIC	28.4
Uganda	LIC	31.0	Georgia	LMIC	28.2
Egypt, Arab Rep.	LMIC	30.3	Burundi	LIC	26.8
Ethiopia	LIC	29.5	Armenia	LMIC	25.6

Source: UN COMTRADE database.

Figure 3: Value of exports to the EU (% GDP), 2010



Source: UN COMTRADE database; World Bank, World Development Indicators.

As we saw during the global financial crisis of 2008–9, some types of product are more vulnerable than others to a slow-down in consumer demand, which we expect to occur as a result of fiscal consolidation in the euro zone countries. In particular, products with a low degree of elasticity to consumer demand, such as necessities, may experience less of a slow-down relative to more luxury types of good which have a higher elasticity. In all cases, however, it is generally recognised that trade has become more sensitive to changes in levels of income and consumer demand: merchandise trade has become more responsive to income over time, and particularly so since the mid-1980s (Irwin, 2002). These increases are a result of the degree of the fragmentation of production across countries which has occurred in recent years. Countries – including commodity exporters – have become increasingly integrated into global value chains and production networks since the most recent phase of globalisation began, with each specialising in a particular stage of production. These changes in the structure of global trade mean that the subsequent effects of a slow-down in consumer demand in developed country markets may be transmitted with immediate effect to producers in developing countries.

Furthermore, some products, such as commodities, may be more susceptible to financial contagion as well as exchange rate effects. There has been an increasing involvement of international traders and investors in the use of commodities as a specific asset class, particularly since 2002 when a number of commodity hedge funds were launched (Nissanke, 2010). This process, which began in the 1980s, has meant that financial and commodity markets have become closely intertwined. As investors become risk averse some types of commodity may be perceived to be a safer bet, hence fuelling price increases if speculative demand is not managed accordingly. The management of exchange rate regimes, in addition to the regulation of finance, therefore becomes important. The challenge for commodity exporters relates to the ability to manage such dramatic price increases which tend to result in an exchange rate appreciation, potentially reducing the competitiveness of other sectors.

Since the global financial crisis of 2008–9 it has become more apparent that commodity prices are key in driving (trade) effects for LICs (Meyn and Kennan, 2009). At that time there was a precipitous decline in commodity prices as the crisis hit. Since then prices have been fairly volatile, with some products, notably gold, experiencing increases as a result of the global flight to security. Oil prices rose sharply in 2010 and early 2011, to around $115 a barrel; they then experienced a decline as the euro zone crisis hit. However, as a result of geopolitical risks, prices are now back up to around $115 a barrel.[5] Overall commodity markets lost some of their momentum – in terms of following an upward trajectory – towards the end of 2011 (except crude oil).

On an annual basis, although there was something of a rebound in 2011, generally prices remain below their levels at the end of 2010.[6] Annex Figures 1–3 index nominal price developments across commodities since 2005 in order to provide an overview of trends both prior to and since the beginning of the uncertainty that now exists regarding the global economic outlook. As can be seen clearly, further to the decline in prices experienced during the global financial crisis, overall across all commodities levels remain considerably higher than in the years prior to the onset of uncertainty.

We present and discuss recent price developments for commodity exporters in more detail in Section 4. The reasons for the more recent price developments – since the start of the euro zone crisis – posited by the IMF (2012b) are as follows:

- higher than usual uncertainty about near-term global economic prospects
- the greater than expected slow-down in emerging and developing economies, and
- supply-side responses further to the broad-based boom in commodity prices which began about a decade ago, notably in the case of major grains and base metals.

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5 See IMF (2012b).

6 *Ibid.*

In terms of exchange rate management, the majority of LICs and LMICs operate conventional fixed-peg arrangements, against the United States (US) dollar or the euro (see Table 2). The challenge for developing countries at the current time is to battle against a number of opposing forces. These include increases in some commodity prices, a strengthening dollar, and a potentially depreciating euro. Depending on the degree of market dependence on the euro zone countries, both as a source of imports and a destination for exports, and overall commodity dependence there will be different implications for macroeconomic management.

Table 2: Exchange rate regimes

	Exchange rate anchor				
	US dollar		Euro	Composite	Other
Exchange arrangement with no separate legal tender	Ecuador El Salvador Marshall Islands Micronesia	Palau Panama Timor-Leste	Montenegro San Marino		Kiribati
Currency board arrangement	Antigua and Barbuda Djibouti Dominica Grenada	Hong Kong SAR St Kitts and Nevis St Lucia St Vincent and the Grenadines	Bosnia and Herzegovina Bulgaria Estonia Lithuania		Brunei Darussalam
Other conventional fixed peg arrangement	Angola Argentina Aruba Bahamas Bahrain Bangladesh Barbados Belarus Belize Eritrea Guyana Honduras Jordan Kazakhstan Lebanon Malawi Maldives Mongolia Netherlands Antilles Oman	Qatar Rwanda Saudi Arabia Seychelles Sierra Leone Solomon Islands Sri Lanka Suriname Tajikistan Trinidad and Tobago Turkmenistan United Arab Emirates Venezuela Vietnam Yemen Zimbabwe	Benin Burkina Faso Cameroon Cape Verde Central African Republic Chad Comoros Congo, Republic Côte d'Ivoire Croatia Denmark Equatorial Guinea Gabon Guinea-Bissau Latvia Macedonia, FYR Mali Niger Senegal Togo	Fiji Kuwait Libya Morocco Russian Federation Samoa Tunisia	Bhutan Lesotho Namibia Nepal Swaziland
Pegged exchange rate, horizontal bands			Slovak Republic	Syria Tonga	
Crawling peg	Bolivia China Ethiopia	Iraq Nicaragua Uzbekistan		Botswana Iran	
Crawling band	Costa Rica			Azerbaijan	

Source: Adapted from IMF *de facto* classification of exchange rate regimes (http://www.imf.org/external/np/mfd/er/2008/eng/0408.htm).

As discussed by Massa et al. (2011), *Communauté Financière Africaine* (CFA) zone countries in West Africa – which comprise the West African Economic and Monetary Union (WAEMU) and Central African Economic and Monetary Community (CEMAC)[7] – may in fact in this aspect gain competitiveness from Europe's debt crisis, due to the currency peg to a weakening euro. This is because the depreciation of the euro could help to make CFA zone exports of crude oil, cocoa, coffee and groundnuts more competitive in world markets – especially in the case of the region's dollar-based exports. On the other

[7] These countries include: Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Côte d'Ivoire, Democratic Republic of the Congo, Equatorial Guinea, Gabon, Guinea-Bissau, Mali, Niger and Senegal, Togo.

hand, however, the fact that the currency is pegged to the euro also implies that most of the CFA zone countries have their reserves in euro, which could depreciate in real terms, in terms of months of import cover.[8]

We focus on the current effects of the euro zone crisis being experienced in some West African countries in more detail in Section 5, where we introduce and discuss specific country case studies. However, briefly, Table 3 summarises actual and potential trade effects across developing regions.

Table 3: Potential and actual trade effects reported

Region	Potential and actual trade effects	Exchange rate movements
Sub-Saharan Africa (SSA)	Growth in exports (predominantly commodities) has been supported by strong demand from other developing countries, in particular China. The share of high-income countries in total sub-Saharan exports is falling. For instance in 2002, the EU accounted for some 40% of all exports from SSA, but by 2010 that share had fallen to about 25% – while China's share has increased from about 5% to 19% over the same period. For the first seven months of 2011, growth in exports destined for China from SSA was 10 percentage points higher than those destined for high-income countries.	During the downturn in 2009, a third of local currencies in the region depreciated by over 10% because of a fall in commodity prices.
South Asia	The EU27 countries account for a significant share of South Asia merchandise export markets. It represented about one fourth of South Asia's merchandise export market, of which Germany and France account for 40% and 20%, respectively. At the country level, Bangladesh, the Maldives and Sri Lanka are particularly exposed to a downturn in European demand for merchandise. With respect to services, tourism sectors could be especially hard hit in Sri Lanka and the Maldives. However, there could be some countercyclical benefits for goods exporters ('Walmart effect') for some sectors (e.g., for Bangladesh's garment industry).	Local currencies depreciated sharply against the dollar in the second half of 2011, as investors retreated into safe-haven assets, prompting some monetary authorities in the region to defend their currencies and draw down international foreign exchange reserves. For Bhutan and Nepal, with local currencies pegged to the Indian Rupee, sustained high inflationary pressures in India have been an important driver of local inflation.
Latin America and the Caribbean	In the first eight months of 2011 tourist arrivals were up 4% in Central America and the Caribbean, following growth of 4% and 3% in 2010. But performance in these two regions has been weaker than the rest of the world. Growth in tourist arrivals to South America has benefited in part from strong income growth in Brazil, where expenditure on travel abroad surged 44%, following on the heels of a more than 50% expansion in 2010. By contrast spending by the US on travel abroad grew at a much weaker 5% pace. The EU27 accounts for almost 15% of total Latin American and Caribbean exports. Exports to the euro area amount to nearly 20% of the total in Brazil and Chile, and almost 15% in Argentina and Peru.	Regional equity markets suffered substantial capital outflows in September, forcing the depreciation *vis-à-vis* the US dollar of several currencies and causing Central Banks to rapidly switch from being concerned about the volatility and competitiveness effects caused by unwarranted appreciations to the risks that might be associated with an uncontrolled depreciation. The Mexican peso, Chilean peso, and the Brazilian real lost more than 10% of their value, and the Colombian peso nearly 8%, between 1 September and 13 December 2011.
East Asia and the Pacific	Vietnam, and the region's low-income to lower-middle income economies (Cambodia and Lao PDR), as well as the small island economies are less well positioned than the major countries of the region, with limited space for policy change and less reserves to stem financial disturbances. Despite the erstwhile continued growth of regional exports (excluding China), exporters in the Philippines, Malaysia, Indonesia and Thailand and Vietnam are vulnerable to slowing import demand growth in the EU. For example, 48% of the Philippines' exports are destined to three markets: Europe (20%), the US (18%) and China (10%), the latter in part representing demand from production chains serving Europe and the US. Already, external demand for manufactures has weakened significantly (the dollar value of imports of the US, the euro area and China declined 10% in the third quarter of 2011).	In September 2011 a spurt of capital flight towards safe haven‖ assets in the US tied to the unfolding events in Europe, caused the currencies of a number of developing countries to depreciate *vis-à-vis* the dollar. In general, East Asian declines were modest compared with those of other large middle-income countries such as South Africa and Brazil. Only the Indonesia rupiah and the Malaysian ringgit came under moderate pressure, falling 5.8 and 5.4% respectively during the second half of 2011.

Source: Adapted from World Bank (2012a).

6. In fact, the currency peg actually requires that more than 80% of the foreign reserves of these African countries are deposited in the 'operations accounts' controlled by the French Treasury (Kang et al., 2010).

Trade in services comprises a large share of GDP for LDCs – the highest across the country groups presented in Table 4. These services include tourism, which comprises the highest share of total exports for LICs, as shown in Table 5. This implies that LDCs are particularly vulnerable to any slow-down that might be induced by the effects of the euro zone crisis.

Table 4: Trade in services (% of GDP)

	2005	2006	2007	2008	2009	2010
Least developed countries	13.4	13.6	14.1	15.3	14.0	..
Low income	13.1	13.7	14.1	14.6	13.1	..
Lower middle income	13.8	13.8	13.5	14.7	12.6	12.3
Low & middle income	9.9	9.7	9.7	9.8	9.0	8.3
Middle income	9.8	9.7	9.6	9.7	9.0	8.3
Sub-Saharan Africa	12.5	13.2	14.1	14.6	13.6	11.2

Source: World Bank, World Development Indicators.

Table 5: International tourism, receipts (% of total exports, goods and services)

	2005	2006	2007	2008	2009	2010
Least developed countries	6.7	5.7	6.5	5.9	7.2	5.5
Low income	12.0	11.3	13.5	13.1	13.8	7.6
Lower middle income	6.9	6.7	7.0	6.5	7.2	5.3
Low & middle income	6.3	5.9	5.9	5.5	6.3	5.0
Middle income	6.3	5.9	5.8	5.4	6.2	4.9
Sub-Saharan Africa	7.7	7.4	7.4	6.4	7.6	6.9

Source: World Bank, World Development Indicators.

Dependence on remittances

Workers' remittances comprise the largest share of GDP for LICs, as shown in Table 6. Figure 4 presents some of the countries for which data are available most highly dependent on remittances. For some of these, notably Cape Verde, the Gambia, the Philippines and Nigeria, the EU is the main source of these remittances.

Table 6: Workers' remittances and compensation of employees, received (% of GDP)

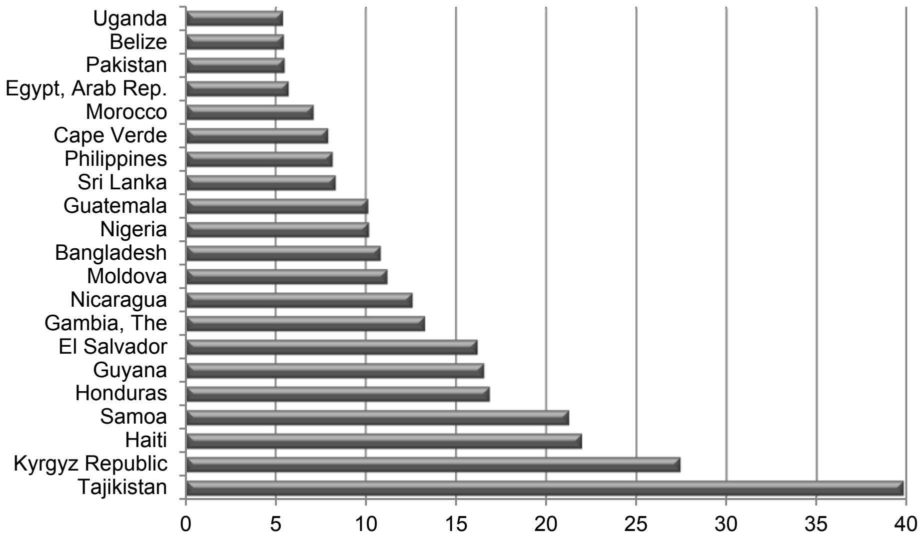
	2005	2006	2007	2008	2009	2010
Least developed countries	5.4	5.8	6.0	5.3	6.5	6.4
Low income	5.4	6.6	7.3	8.1	7.9	8.0
Lower middle income	4.1	4.1	4.2	4.4	4.3	3.9
Low & middle income	2.0	2.0	2.0	1.9	1.9	1.7
Middle income	1.9	1.9	1.9	1.8	1.8	1.6
Sub-Saharan Africa	1.6	1.9	2.5	2.3	2.5	2.2

Source: World Bank, World Development Indicators.

As noted by the World Bank (2012a), in terms of share of GDP Cape Verde, Senegal and Guinea-Bissau are the most dependent countries in SSA on remittance flows from the high-spread euro area countries and are thus likely to be the most vulnerable to a slow-down in growth in the EU27. The World Bank's report also notes that:

- a deepening of the euro area crisis would lead to weaker worker remittances (as well as exports and capital inflows) to South Asia
- countries where remittances represent a large share of GDP – such as El Salvador, Jamaica, Honduras, Guyana, Nicaragua, Haiti and Guatemala – could be at risk from a growth slow-down in the EU
- remittance receipts are potent drivers for growth in countries from the Philippines to the small island economies; and these flows, as well as tourist arrivals could slow because of sluggish labour market and growth developments in the EU.

Figure 4: Dependence on remittances (% GDP), 2010



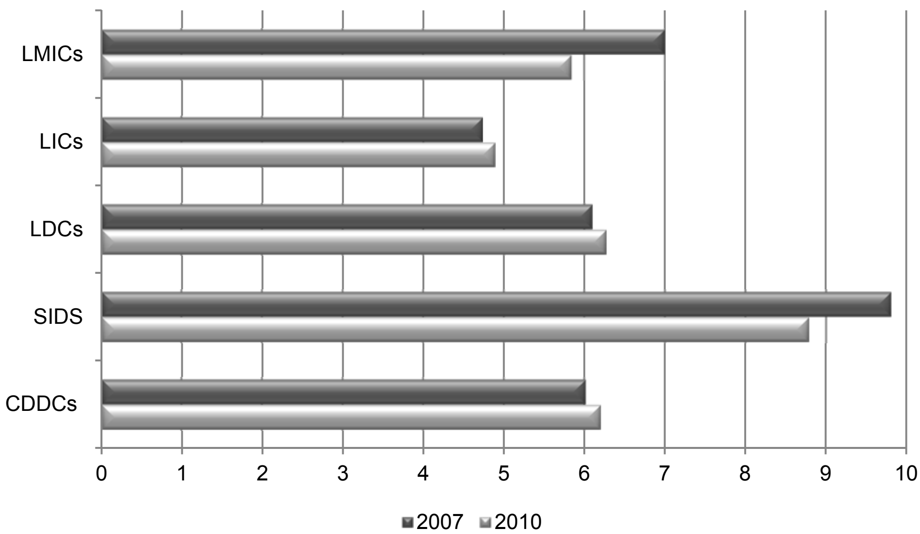
Source: World Bank, World Development Indicators.

Dependence on Foreign Direct Investment (FDI)

A key variable to be taken into account when assessing the exposure of poor countries to global shocks such as the euro zone crisis is their dependence on FDI. Indeed, countries and groups of countries heavily dependent on FDI are more exposed to a sudden contraction in or interruption of such flows. Dependence on FDI can be measured by the ratio between a country's FDI inflows and its GDP.

Figure 5 shows that among the different groups of developing countries considered in this study, small island developing states (SIDS) are the most exposed to possible FDI shocks due to the crisis in the euro area, with inward FDI accounting for about 9% of their GDP in 2010. LDCs and commodity-dependent developing countries (CDDCs) follow, with FDI inflows representing in both cases a 6% share of GDP over the same year. Note that compared to 2007, the year before the outbreak of the global financial crisis, in 2010 both LDCs and CDDCs were in a slightly worse situation being more exposed to possible FDI shocks. The exposure of SIDS and LMICs diminished between 2007 and 2010, but it is still particularly high for SIDS.

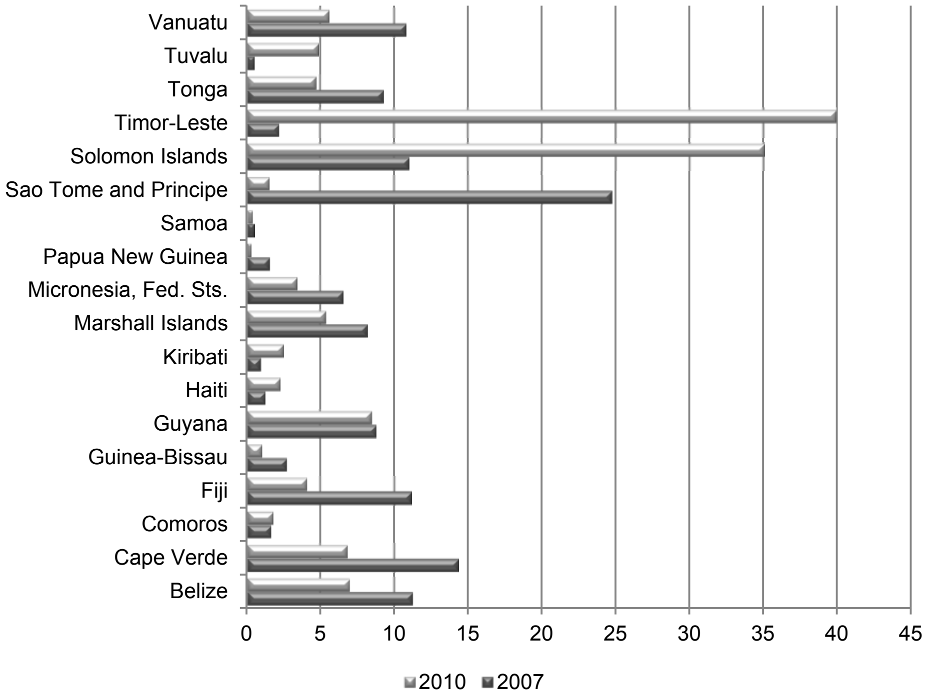
Figure 5: Average inward FDI flows by country groups (% GDP), 2007 and 2010



Source: UNCTAD, UNCTADstat database.

There are, however, important differences to be noted at the country level. For example, among lower-income SIDS in 2010 Timor-Leste and Solomon Islands appeared to be particularly exposed to FDI shocks since FDI inflows represented shares of 40% and 35% respectively of their GDP (Figure 6). On the other hand, countries such as Samoa, Papua New Guinea and Guinea-Bissau were much less exposed to FDI shocks. Figure 6 also confirms that in 2010 most of the SIDS were characterised by a lower degree of exposure to FDI shocks than in 2007. Notably, in São Tomé and Prı́ncipe FDI flows as a share of GDP dropped from about 25% in 2007 to less than 2% in 2010.

Figure 6: Inward FDI flows in lower-income SIDS (% GDP), 2007 and 2010



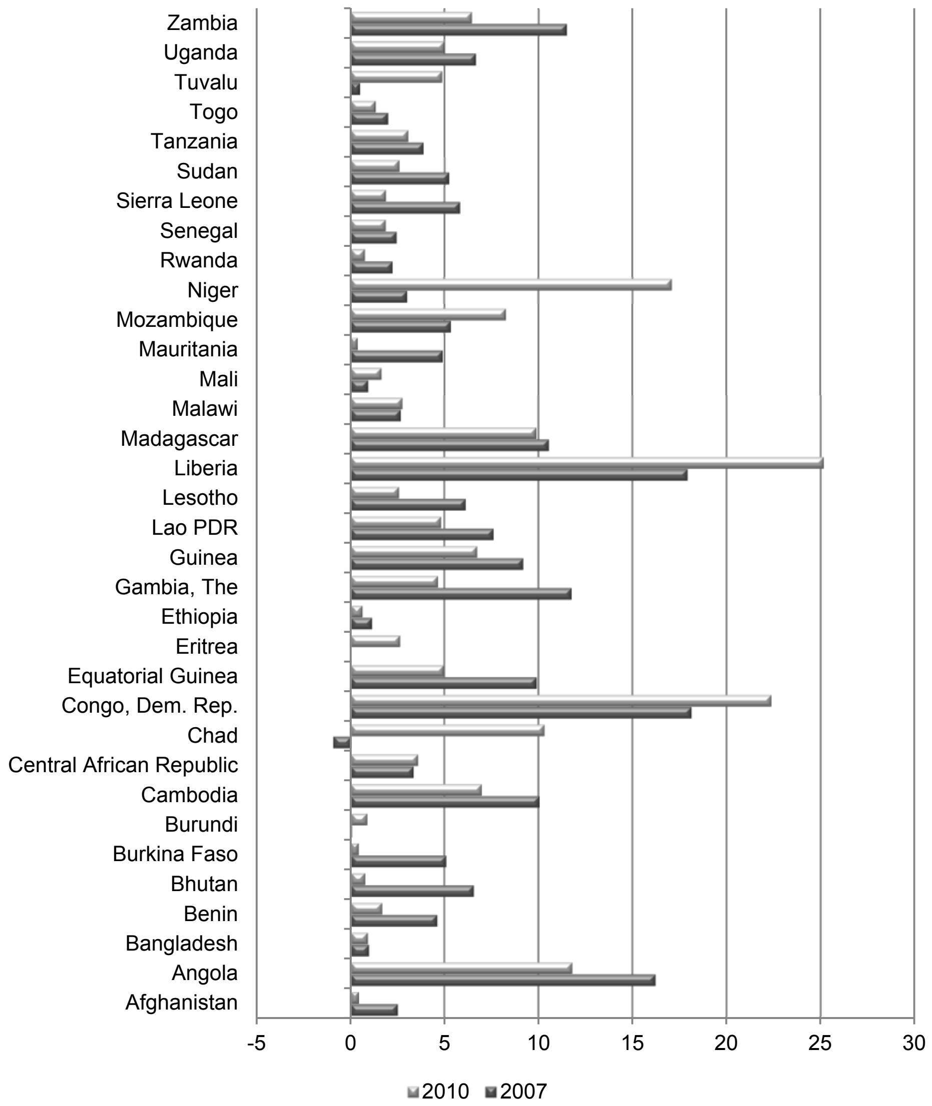
Source: UNCTAD, UNCTADstat database.

Among LDCs (excluding those which are SIDS), the countries characterised by the highest degree of exposure to FDI shocks in 2010 were Liberia and Democratic Republic of the Congo, which both had a ratio between FDI inflows and GDP higher than 20% (Figure 7). Niger followed, with a value of inward FDI as a share of GDP equal to 17%. Much less exposed were countries such as Burkina Faso, Burundi and Ethiopia. Notably, Tuvalu, Niger, Mozambique and Chad were, among others, more exposed to FDI shocks in 2010 than in 2007.

Taking a geographical perspective, Figure 8 highlights that in 2010 the developing regions more exposed to shocks in FDI were East Asia and the Pacific, followed by SSA. Note that the exposure of the former has increased considerably compared to 2007. This is partly due to the fact that after the drop experienced in 2009, FDI inflows to the East Asia and Pacific region picked up markedly, surpassing their pre-crisis level and outperforming all other developing regions (Figure 9), some of which continued to experience a decline in FDI inflows – e.g. the Middle East and North Africa (also because of the Arab Spring), Europe and Central Asia, and to a minor extent SSA.[9]

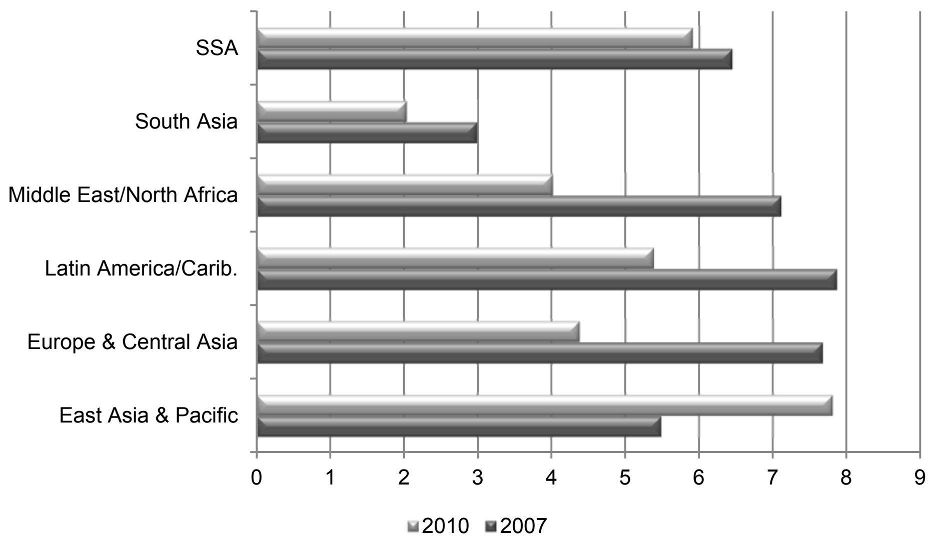
[9] However, those countries within the region with high saving rates may be able to mitigate the impacts of a sudden drop in FDI by making use of domestic sources.

Figure 7: Inward FDI flows in LDCs, excluding SIDS (% GDP), 2007 and 2010



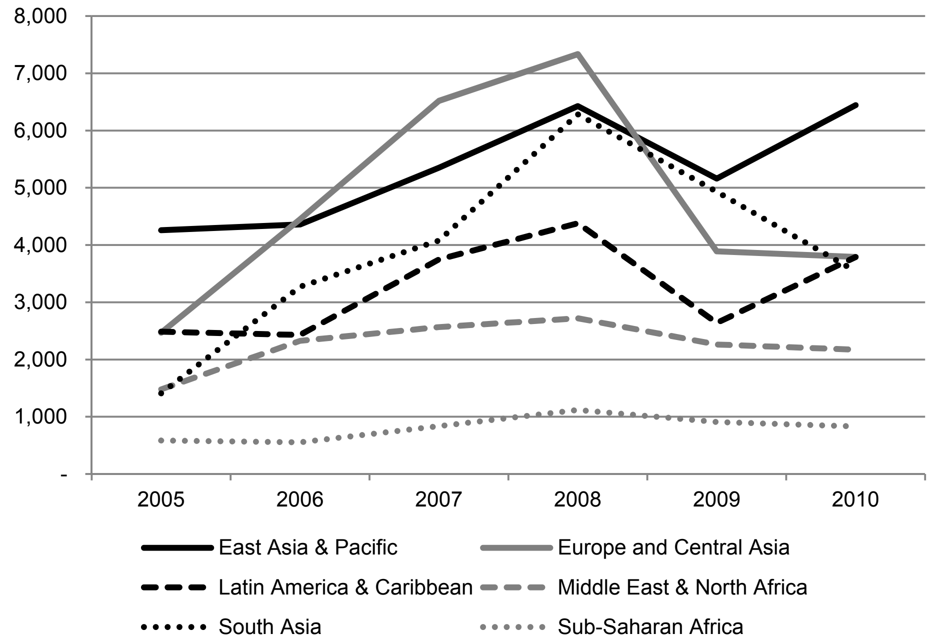
Source: UNCTAD, UNCTADstat database.

Figure 8: Average inward FDI flows by geographical regions (% GDP), 2007 and 2010



Source: UNCTAD, UNCTADstat database.

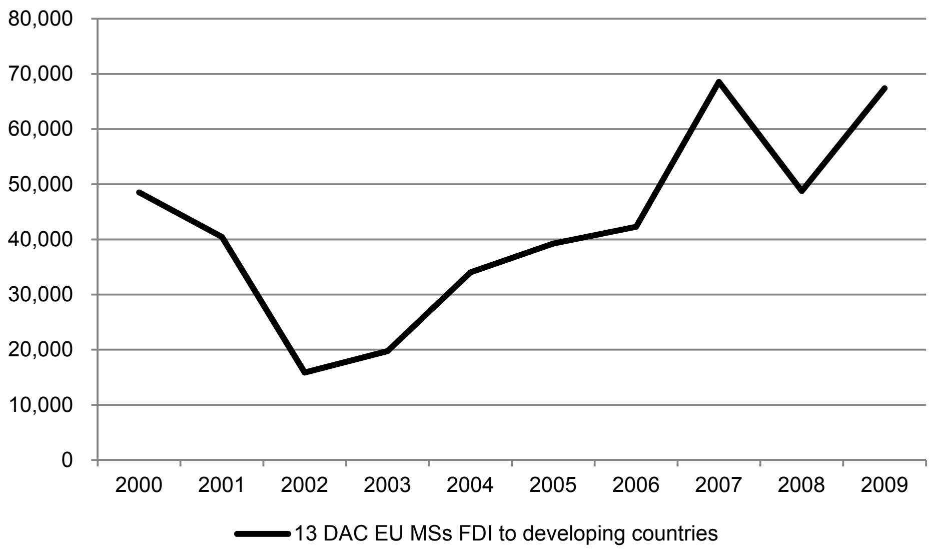
Figure 9: Average inward FDI flows by geographical regions (US$ million), 2005–10



Source: UNCTAD, UNCTADstat database.

A shock in FDI from European countries could produce severe adverse impacts on developing countries. The latter, indeed, are big recipients of European FDI. Figure 10 shows that FDI flows from Development Assistance Committee (DAC) EU Member States to developing countries increased significantly up to 2007 when they peaked at €68,562 million. In 2008 they declined sharply due to the global financial crisis, but in 2009 they recovered to a value very close to the pre-crisis level.

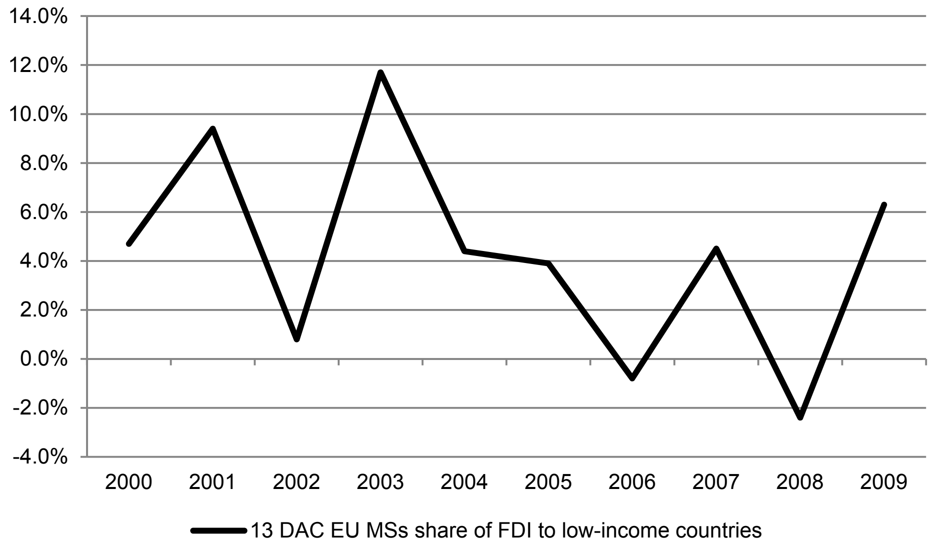
Figure 10: 13 EU Member States FDI in developing countries (million euro), 2000–9



Sources: OECD, Eurostat.

European investors are particularly active in LDCs. According to UNCTAD (2011b), indeed, they account for the largest share of FDI flows from developed countries to LDCs, with about 20–30% of the world total. Figure 11 also shows that FDI from DAC EU Members in the two poorest groups of developing countries (including LDCs) as a share of total FDI to developing countries increased moderately between 2000 and 2009, from 4.7% to 6.3%, although it varies considerably across years (and notably declined sharply from positive values in 2007 to negative values in 2008 due to the global financial crisis). Furthermore, FDI flows are very important for LDCs since they are a major contributor to capital formation in such economies. Therefore, a sudden stop or decline in FDI flows due to the euro zone crisis is a matter of grave concern for LDC economies.

Figure 11: DAC EU Member States share of FDI to LDCs and other LICs (%), 2000–9



Sources: OECD, Eurostat.

FDI flows from developing and transition economies (South–South FDI) such as China, India, Malaysia and South Africa may play an important role for poor countries in off-setting the adverse impacts of a shock in FDI from developed countries due to the euro zone crisis. Indeed, over the past decade South–South FDI flows have been on the rise in relative and absolute terms and proved to be more resilient to global shocks such as the 2008–9 global financial crisis (UNCTAD, 2011). Section 2.2.4 analyses in more detail the importance (but also associated risks) of increased FDI flows from China to developing countries.

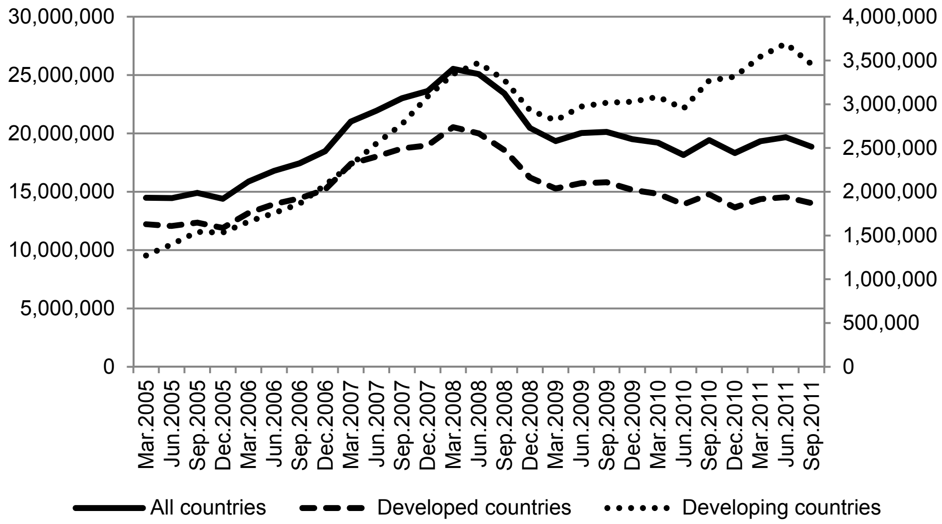
Dependence on European banking activity

The vulnerability of developing countries to the European debt crisis also depends on the extent to which they are dependent on foreign – and in particular European – private bank activity through both cross-border lending and local market activity (i.e. lending through local affiliates).

Cross-border bank lending from European banks to the rest of the world had increased significantly up until the outbreak of the 2008–9 global financial crisis, when it experienced a severe drop (Figure 12). Then, while claims on developed economies continued to slow, claims on developing countries recovered, increasing to levels higher than the pre-crisis ones. As of September 2011 (the latest available data), European banks had total claims of US$ 3,458,577 million on developing economies, compared to US$ 1,541,625 million in September 2005. As a consequence, the current challenges in Europe may have severe repercussions on developing countries through the cross-border bank lending channel.

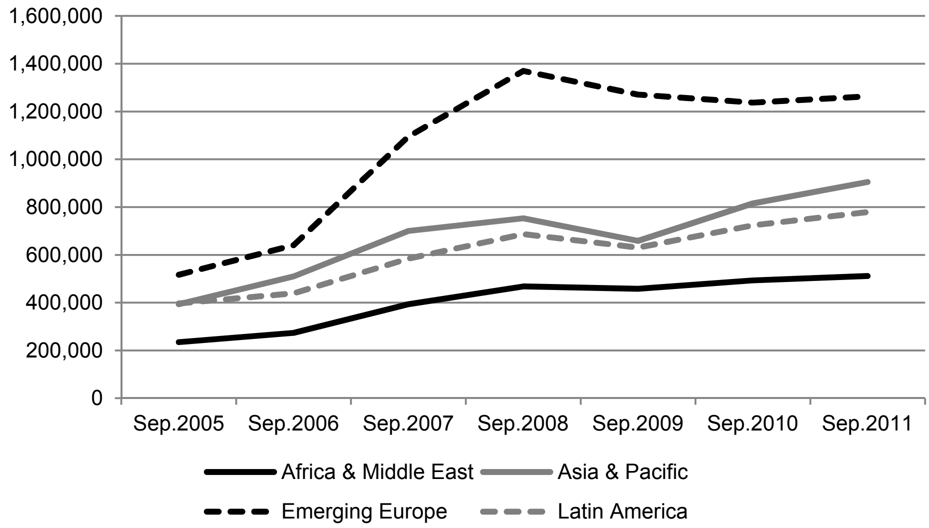
There are however relevant differences between developing regions. As shown in Figure 13, Emerging Europe and Asia and the Pacific have experienced the most significant increases in cross-border bank lending from European banks over time, and so are the two most exposed regions. The Africa and Middle East regions are less exposed to drops in European international bank lending. Indeed, Fuchs (2012) reports that the importance of European bank lending in Africa is rather limited since cross-border lending from European banks accounts for less than 25% of total credit to the African private sector.

Figure 12: Cross-border bank lending from European banks (US$ million), March 2005–September 2011



Note: Consolidated foreign claims of reporting banks, by nationality of reporting banks, immediate borrower basis. Developing countries data on secondary axis.
Source: BIS Consolidated Banking Statistics.

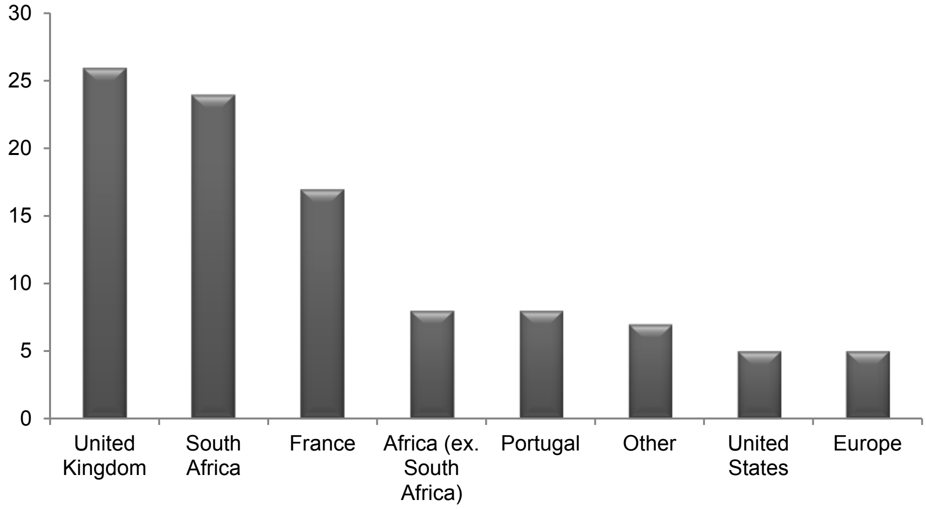
Figure 13: Cross-border bank lending from European banks by region (US$ million), September 2005–September 2011



Note: Consolidated foreign claims of reporting banks, by nationality of reporting banks, immediate borrower basis.
Source: BIS Consolidated Banking Statistics.

European banks have a strong presence in several developing economies. This implies that if European banks face funding difficulties because of the debt problems within the euro area they may start to sell off foreign subsidiaries, or pull out accumulated profits, thus negatively affecting developing countries' domestic financial sectors. The presence of European banks is very heterogeneous within developing regions. In Africa, for example, European banks have a limited presence overall (Figure 14), but they represent over half of total bank assets in countries such as Mozambique, Ghana, Cameroon, Rwanda, Zambia and Tanzania, which are therefore particularly exposed to euro zone crisis spill-overs through the banking system (Ancharaz, 2011). In Mozambique and Angola there is a very strong presence of Portuguese banks (Fuchs, 2012).

Figure 14: Home countries of foreign banks in SSA, 2000–6



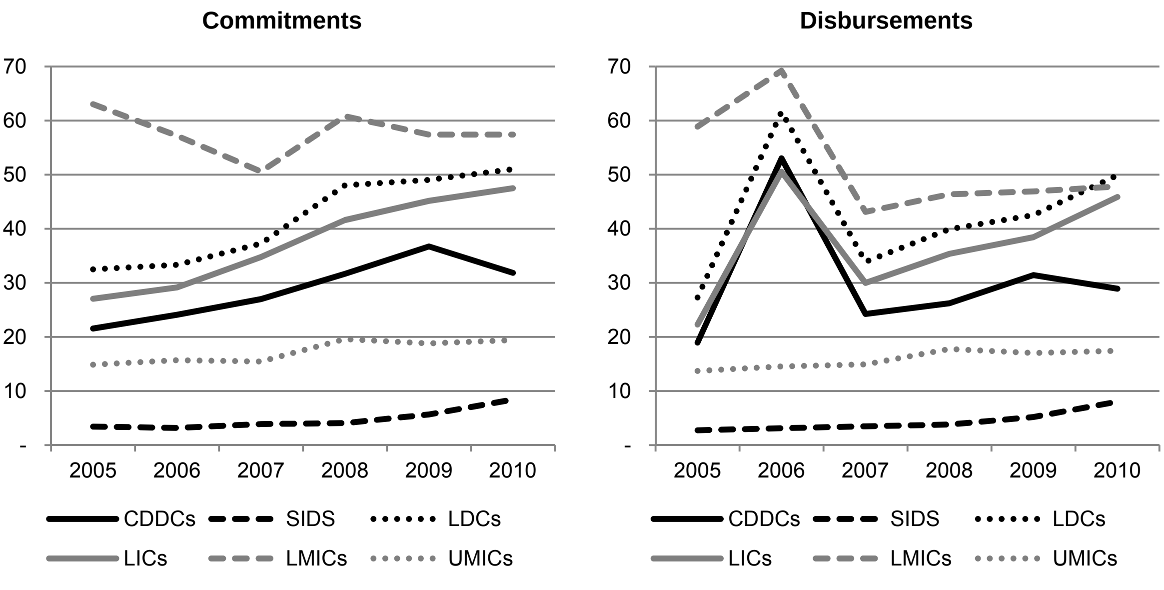
Note: Percentage of foreign banks on vertical axis.
Source: World Bank, Global Development Finance (2008).

Finally, it is also important to highlight that certain sectors in developing countries are more exposed to shocks in European bank funding. Fuchs (2012), for example, reports that in Africa regional telecom operators and the commodities sector are large borrowers of European bank lending and therefore more exposed to a sudden drop in cross-border lending.

Dependence on Official Development Assistance (ODA)

At an aggregate level, ODA commitments across all donors are highest for LMICs (Figure 15). In absolute terms commitments for LDCs and LICs have, however, grown rapidly – and this growth appears to have held up in spite of the global financial crisis. In terms of disbursements, LMICs, LDCs and LICs are the major recipients, and growth has similarly been maintained (more strongly in the latter two groups) despite the effects of the global financial crisis.

Figure 15: ODA commitments and disbursements (all donors, current US$ billion)



Source: OECD Creditor Reporting System dataset.

At a more disaggregated level, ODA commitments and disbursements from all donors towards LICs and LMICs comprise a large share of GDP. On average, both commitments and disbursements to LICs amounted to more than 20% of GDP in 2010; this is compared to around 10% for LMICs. The relative importance of the EU27 as a donor to LICs compared to LMICs is highlighted in Table 7, which shows that on average ODA from the EU (commitments and disbursements) amounts to around 5% of GDP in LICs compared to 1–2% in LMICs.

Table 7: ODA commitments and disbursements, % of GDP

Recipient	ODA current $ commitments from all donors						ODA current $ commitments from EU27					
	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
LIC average	18.6	17.3	19.0	20.3	19.1	21.1	5.4	5.3	4.8	6.6	5.4	4.9
LMIC average	13.5	10.8	10.9	10.5	10.4	11.4	3.3	2.2	2.1	1.9	1.6	1.5
	ODA current $ gross disbursements from all donors						ODA current $ gross disbursements from EU27					
LIC average	16.0	28.3	19.3	19.8	19.6	22.2	4.7	4.5	4.7	6.4	4.6	5.3
LMIC average	12.2	13.6	11.6	8.8	9.1	10.0	3.0	2.1	2.1	1.9	1.5	1.5

Source: OECD Creditor Reporting System dataset.

ODA is therefore a potential channel through which LICs and LMICs may be affected by the crisis. It is also related to the ability to govern and maintain public expenditures. This is because ODA flows support public expenditure needs in LICs and LMICs, and therefore contribute to their overall level of resilience and ability to mitigate exogenous shocks, as seen during the global financial crisis.

2.2.2 Resilience indicators

The capacity of countries to mitigate the effects of the euro zone crisis depends also on their resilience: that is, their ability to respond to shocks. In this section we analyse the following resilience indicators: current account balance, fiscal balance, external debt and reserve levels, as well as related social and governance indicators.

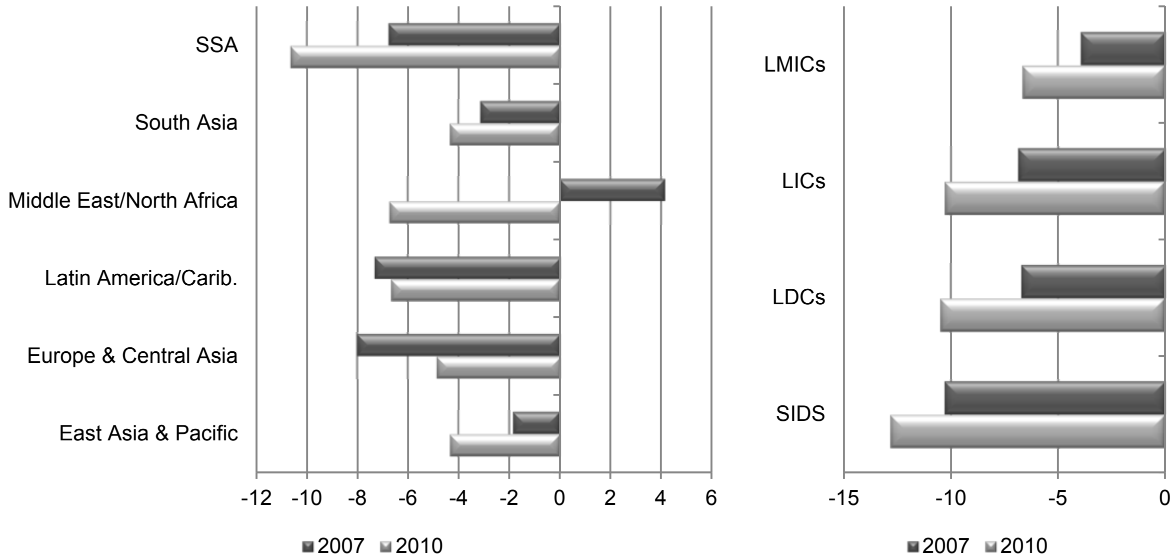
Current account balance

The current account balance is a key indicator which reflects to a large extent the strength of exports in a country. Although there are many thresholds, a 3% deficit is generally accepted as a healthy equilibrium, especially in countries in the early or middle stages of development, since they invest heavily in, or import, capital goods to sustain and enhance their exports and growth more generally.

In Figure 16 we compare current account balances in 2007 and 2010. What emerges is that in general the situation has deteriorated over time and most developing countries will have to face the euro zone crisis in a much worse position than they were in prior to the 2008–9 global financial crisis. From a regional perspective, the Middle East and North Africa shows the biggest change, going from a healthy surplus in 2007 to the second-biggest deficit among developing regions in 2010. This is due not only to the global financial crisis, but also to the social and political upheaval following the Arab Spring. Moving to SSA, it is worth highlighting that in 2007 the region had more or less the same deficit as Latin America and Europe and Central Asia (around 7%), but in 2010 it accounted for by far the biggest regional current account deficit, above 10%. This leaves the region particularly vulnerable to trade shocks that may originate because of the crisis in the euro area, which is the region's biggest trading partner.

Looking at groups of countries, the picture is very similar, suggesting a general deterioration between 2007 and 2010. SIDS showed the highest deficit (12.8%) in 2010, followed by LDCs and LICs with deficits of 10.5% and 10.3% respectively (Figure 16). This reflects the dependence of these countries on exports and evidences the difficulties that SIDS and LICs will face during the euro zone crisis.

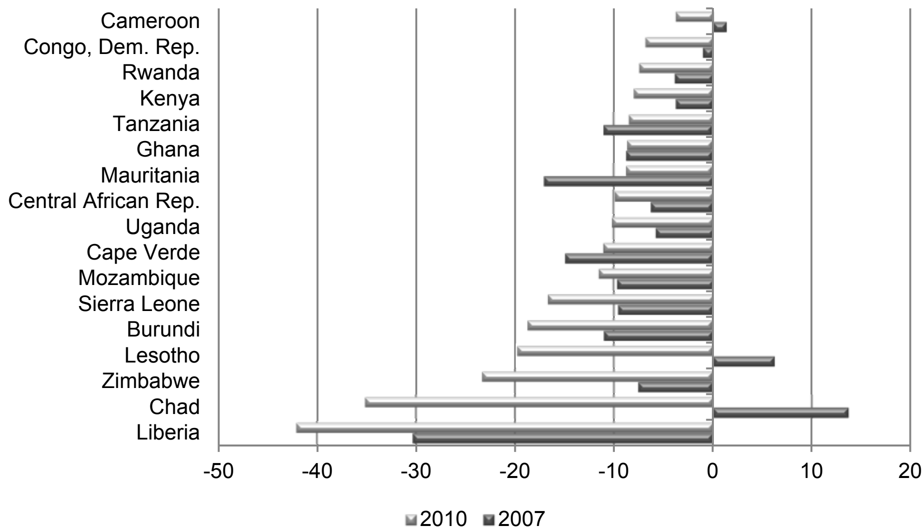
Figure 16: Average current account balance by region and by group of countries (% of GDP), 2007 and 2010



Sources: World Bank, World Development Indicators; IMF, World Economic Outlook (September 2011).

From a single-country perspective, in Africa, Chad, Lesotho and Cameroon had comfortable surpluses prior to the 2008–9 global financial crisis while in 2010 they had to face the euro zone crisis with huge deficits, which are likely to severely limit their manoeuvre space (Figure 17).

Figure 17: Current account balance in selected African countries (% of GDP), 2007 and 2010



Sources: World Bank, World Development Indicators; IMF, World Economic Outlook (September 2011).

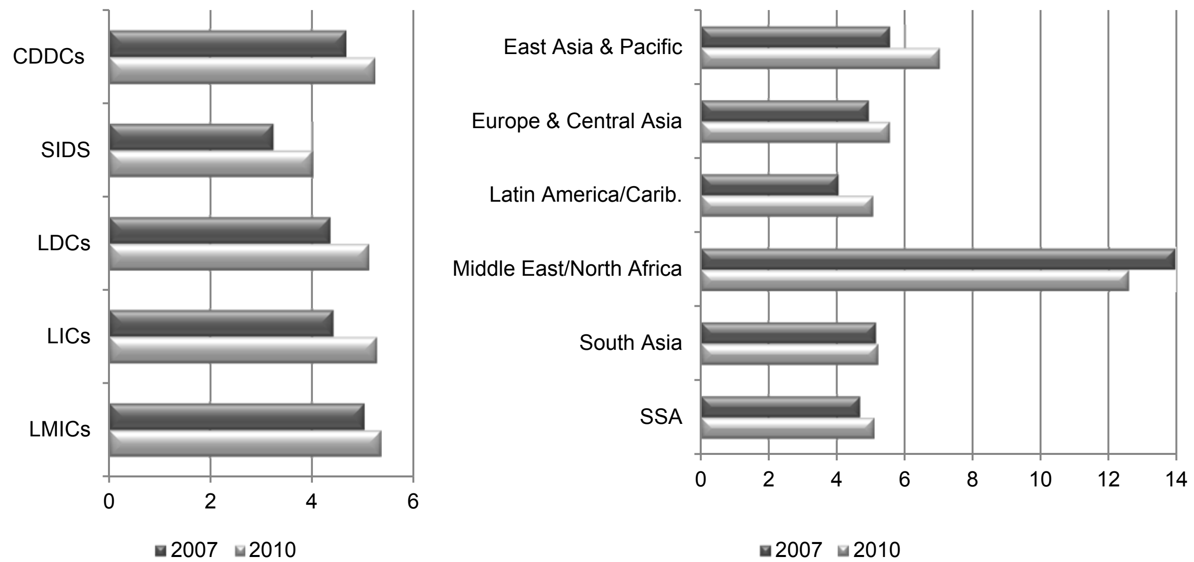
Overall, at both the regional and country levels, current account balances presented a sombre picture in 2010 compared to 2007. Before the 2008–9 global financial crisis developing countries were enjoying strong and sustained growth rates supported by strong exports and high commodity prices. This allowed many of them to enact expansionary policies to counteract the effects of the global crisis. Today most developing countries, in particular the poorest ones, are in a worse position. Recovery was still weak when the shock waves of the euro zone crisis hit the markets, so their policy space is currently more limited than in 2007.

Foreign currency reserves

Reserves are considered an essential cushion against economic shocks. Therefore, developing countries backed by strong exports tend to store huge amounts of reserves. In particular, emerging markets alone have accumulated more than US$ 5 trillion. This has benefits, but it also carries costs for the holding country and the rest of the world economy by creating macroeconomic imbalances.

Traditionally, a healthy threshold is considered to be three months' worth of imports. However, developing countries tend to stock double this amount, usually an average of six months of imports. Figure 18 summarises the level of reserves in months of imports that developing countries held in 2010 compared with 2007. It shows that, both by region and by groups of countries, reserves in the developing world have increased slightly in 2010 compared to 2007 – remaining in all cases above the three months of imports threshold. By groups of countries reserves increased on average by around a half to one month of imports; while by regions, SSA and South Asia remained stable at five months of imports, Latin America increased by one month, and Europe and Central Asia and East Asia and Pacific by half a month and two months respectively. The only decline occurred in the Middle East and North Africa – by almost two months of imports, but still leaving reserves well above the three-month threshold.

Figure 18: Average reserves in months of imports by group of countries and by region, 2007 and 2010

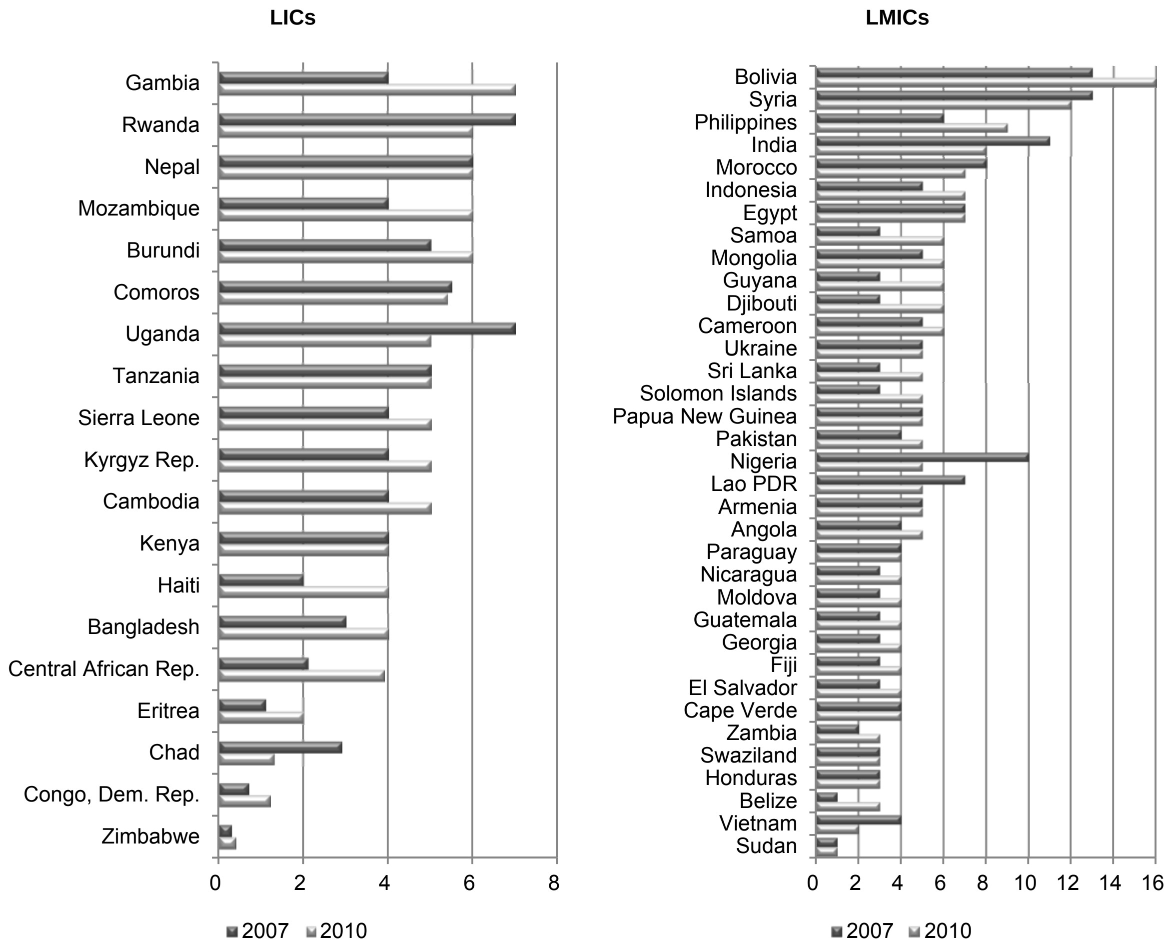


Sources: World Bank, World Development Indicators; IMF, World Economic Outlook (September 2011).

The above increases are not surprising, since after the 2008–9 global financial crisis poor countries (and in particular LICs) were more cautious and made an effort to build up their reserves, exploiting the recovery of exports and the subsequent return of capital flows. On the risk side, the euro zone crisis and the consequent turmoil in exchange rates (euro and dollar) risks eroding quickly the value of international reserves. Nevertheless, reserve levels seem adequate, and in most cases they are still well above the required or suggested levels. However, the fact that the euro zone crisis is not only affecting demand for LICs' products but also reducing private capital inflows and generating uncertainty in the exchange rate markets will pose significant challenges for these countries in the near future. LICs will need to make effective use of their reserves if they want to weather the current crisis successfully.

From an individual-country perspective the trend is confirmed: most countries increased their reserves in terms of months of imports in the period 2007–10 (Figure 19). A few exceptions can be found among LICs, such as Rwanda, Uganda and Comoros, as well as among LMICs, such as Nigeria, Lao People's Democratic Republic (PDR), and India, which saw their reserves declining in 2010, but still staying above the three months of imports threshold. The only exceptions are Vietnam, which saw its reserves going from four months of imports in 2007 to two months in 2010, and Sudan, which maintained the same low level of reserves (one month).

Figure 19: Reserves in months of imports by country, 2007 and 2010



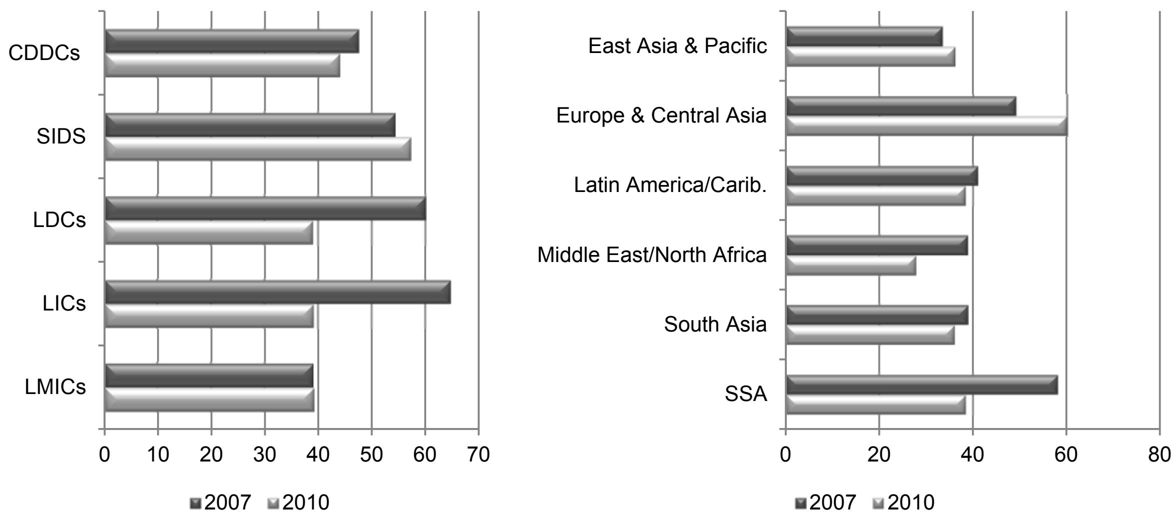
Sources: World Bank, World Development Indicators; IMF, World Economic Outlook (September 2011).

External debt

Issuing external debt is an essential tool for governments to finance their activities. Although there is still no consensus on a particular ‘sustainable’ threshold, the IMF and World Bank suggest that a burden of a 30 to 50% ratio of debt to GDP is within manageable limits. In the case of developing countries, heavy debt burdens limit the potential growth of their economies. In particular, poorer countries are required to service their debts and drain resources from their economy that otherwise could be allocated to boost growth. Before the 2008–9 global financial crisis most developing countries carried a heavy burden of external debt. In LICs and LDCs external debt averaged around 60% of GDP, while other groups of countries (LMICs, CDDCs) were below the 50% threshold (see Figure 20). In 2010 the situation remained relatively stable, with improvements for LICs and LDCs mainly due to debt relief efforts.

From a regional perspective, external debt burdens also remained stable in 2010, with the exceptions of Europe and Central Asia and East Asia and Pacific, which witnessed an increase in their debt to GDP ratios (Figure 20).

Figure 20: Average external debt by group of countries and by region (% GDP), 2007 and 2010



Source: World Bank, World Development Indicators.

Looking separately at specific LICs and LMICs there is a mixed picture: some countries have improved compared to 2007, while others experienced minor external debt increases during 2010 (Figure 21). SSA countries showed the greatest improvements in debt to GDP ratios, although this might be more related to debt relief programmes such as the Heavily Indebted Poor Countries Initiative than to particular government policies. On the other hand, Papua New Guinea and Armenia saw their debt burden jump from 22.6% and 31.5% respectively to more than 60%. However, the risk of debt distress remains small in both countries.

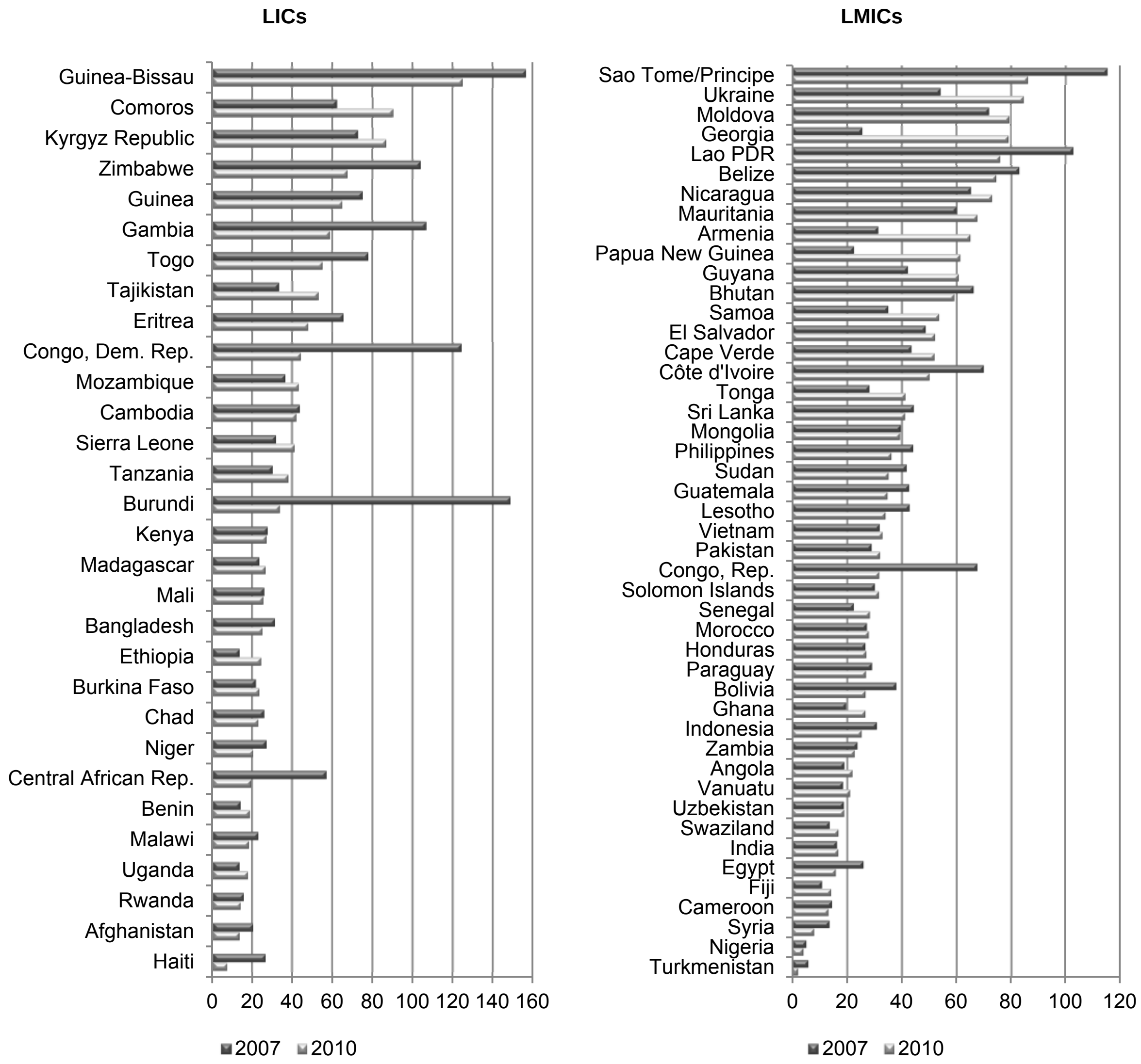
Overall, developing countries are facing the euro zone crisis with relatively stable external debt burdens, but further consolidation and fiscal discipline may be needed to preserve their debt sustainability over the long term, though on the other hand the need for stimulating growth may require higher borrowing.

Fiscal balance

The comfortable fiscal surpluses that many developing countries had before the 2008–9 global financial crisis allowed them to enact expansionary policies to cushion the negative effects of the crisis. This is clear from Figure 22, which shows how the bonanza of the years before the global financial crisis propelled an increase in government revenues (mainly through export income) which was however followed by a sharp decline during the crisis period. Consequently, developing countries have to face the euro zone crisis with diminished fiscal surpluses or even deficits.

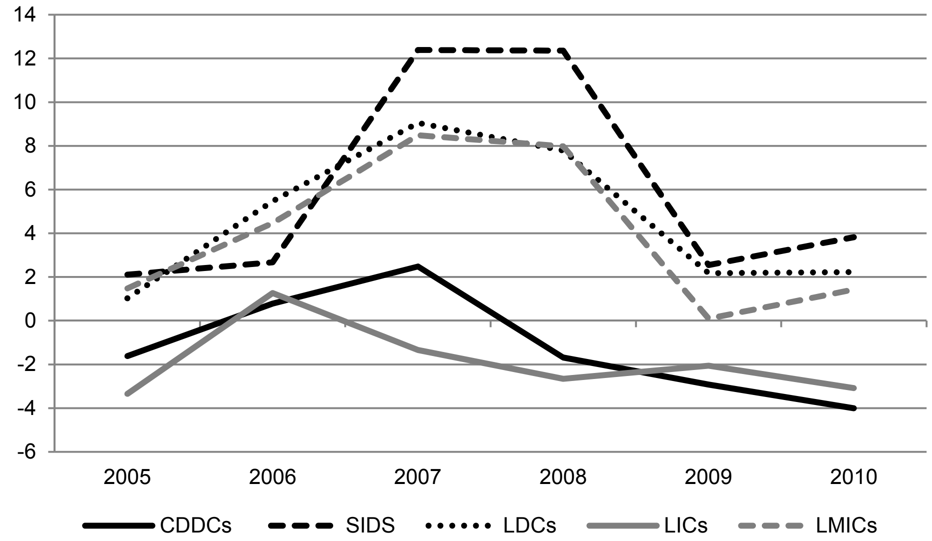
If we examine the situation regionally the comparison is even more striking, with all regions but East Asia and Pacific running a fiscal deficit in 2010 (Figure 23). What is more worrying is that those regions on the negative side are all below the -2% threshold recommended to maintain a sustainable fiscal balance. This constrains the policy options available to developing countries to respond to the shock waves of the euro crisis, since it limits governments' ability to enact countercyclical measures.

Figure 21: External debt by country (% GDP), 2007 and 2010



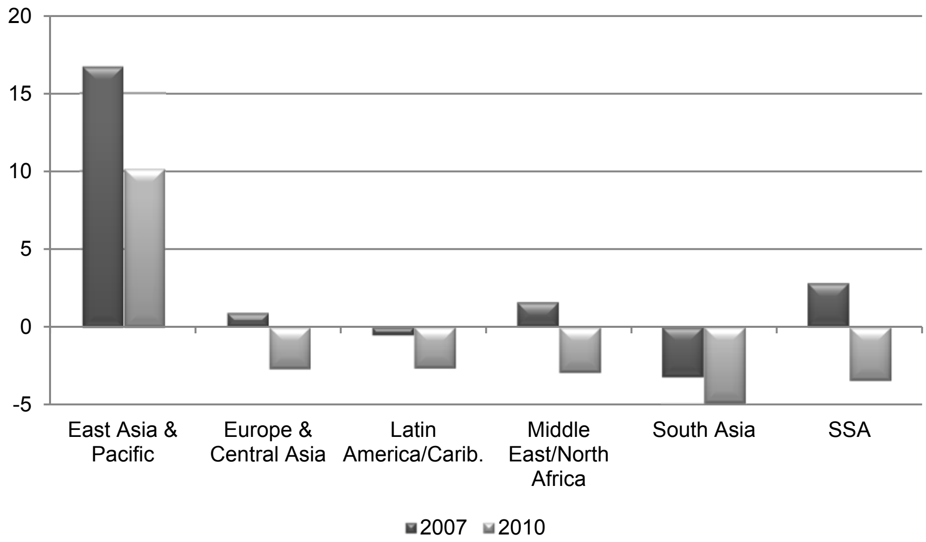
Source: World Bank, World Development Indicators

Figure 22: Average fiscal balance by group of countries (% GDP), 2005–10



Source: IMF, World Economic Outlook (September 2011).

Figure 23: Average fiscal balance by region (% GDP), 2007 and 2010



Source: IMF, World Economic Outlook (September 2011).

To sum up, economic resilience indicators in the developing world (and in particular in LICs and LDCs) present a weaker scenario overall in 2010 than prior to the 2008–9 global financial crisis. This is due in part to the fact that, unlike in 2007 when the developing world was coming from a very favourable situation, in 2010 developing countries were hit by the euro zone crisis just in the middle of a very feeble recovery from the previous financial crisis.

2.2.3 Human capital indicators

Countries with a high level of poverty that are subject to an external shock may experience threshold effects and may have a low degree of resilience given limited human capital and capacity to adapt. Table 8 summarises poverty indicators for the exporters most highly dependent on the EU market (those for which exports to the EU account for 5% or more of GDP). As can be seen clearly, the countries with the most acute levels of poverty are located in SSA, which suggests that these economies may be the least resilient and able to cope with an external demand shock which emanates from the EU. Most importantly, countries with high levels of poverty may, if hit by an exogenous shock which results in an economic slow-down, experience further increases in those levels of poverty, which is unacceptable from a human welfare perspective.

Governance indicators

As the experience of the global financial crisis suggests, the overall level of openness of countries to trade and finance may mean not only that they are more exposed to global shocks but also that they have a lower degree of resilience because shocks may be transmitted with immediate effect with little by way of mediation. This is unless, of course, structures are designed in such a way as to be able to adapt quickly to adverse external circumstances.

Indicators of the capacity to adapt to a trade or financial shock, as well as to mitigate it, may include investment climate indicators. Although clearly an imperfect proxy, they provide some indication of the ability of a country to continue stimulating investment even in the face of global shocks. Indicators related to government effectiveness, such as the World Bank's governance indicators, may also provide an indication of the institutional capacity to adapt to a given shock.

Table 8: Poverty indicators for exporters highly dependent on the EU market

Country	Poverty line (PPP$/month)	Mean ($)[1]	Headcount (%)[2]	Gini index[3]	Survey year
Côte d'Ivoire	38	87.64	23.75	41.5	2008
Guinea	38	56.81	43.34	39.35	2007
Mozambique	38	46.53	59.58	45.66	2007
Iraq	38	109.33	2.82	30.86	2006
Morocco	38	161.17	2.52	40.88	2007
Guyana	38	180.14	8.7	44.54	1998
Nigeria	38	39.9	67.98	48.83	2009
Cameroon	38	115.47	9.56	38.91	2007
Ukraine	38	301.29	0.06	26.44	2009
Vietnam	38	85.31	16.85	35.57	2008
Syrian Arab Republic	38	135.38	1.71	35.78	2004
Cambodia	38	78.11	22.75	37.85	2008
Malawi	38	34.12	73.86	39.02	2004
Bangladesh	38	51.67	43.25	32.12	2010
Madagascar	38	28.02	81.29	44.11	2010
Belize	38	191.4	12.21	53.13	1999
Moldova, Rep.	38	186.37	0.39	33.03	2010
Sri Lanka	38	119.03	7.04	40.26	2006
Burundi	38	28.96	81.32	33.27	2006
Armenia	38	126.86	1.28	30.86	2008

Notes:
1. $ the average monthly *per capita* income/consumption expenditure from survey in 2005 PPP.
2. % of population living in households with consumption or income per person below the poverty line.
3. A measure of inequality between 0 (everyone has the same income) and 100 (richest person has all the income).
Source: World Bank PovcalNet.

In both cases, however, it is important to recognise that general governance indicators at a point in time may not be able to account for the fact that sudden policy changes may arise as a result of measures taken to address crises. This may include the adoption of different policy measures, such as, for example, the imposition of capital controls. This matters since as a result of the global financial crisis of 2008–9 it is now increasingly recognised that policies previously considered unorthodox may actually be more welfare enhancing and necessary to cope with new uncertainties and vulnerabilities as a result of instability within the global economy.[10] However, general governance indicators that assume that all countries should aspire to a similar type of governance, regardless of their level of development, do not at the current time reflect these policy shifts.

Statistics on the investment climate of country income groups are available. Table 9 presents the results for LICs. We have highlighted in this table those countries that also feature in Figure 3 as highly dependent on the EU as a market for their exports. There is a wide range in terms of the ease of doing business for these countries: Rwanda and the Kyrgyz Republic have the highest rankings for the overall ease of business within country, whilst Zimbabwe and the Central African Republic have the worst. However, the ease of trading across borders for Rwanda and the Kyrgyz Republic is not as high as it is for other countries such as the Gambia and Madagascar, for which the EU is a more important trading partner.

[10] See Massa (2011) and Ostry et al. (2010).

Table 9: Investment climate indicators for selected LICs: rankings, 2011

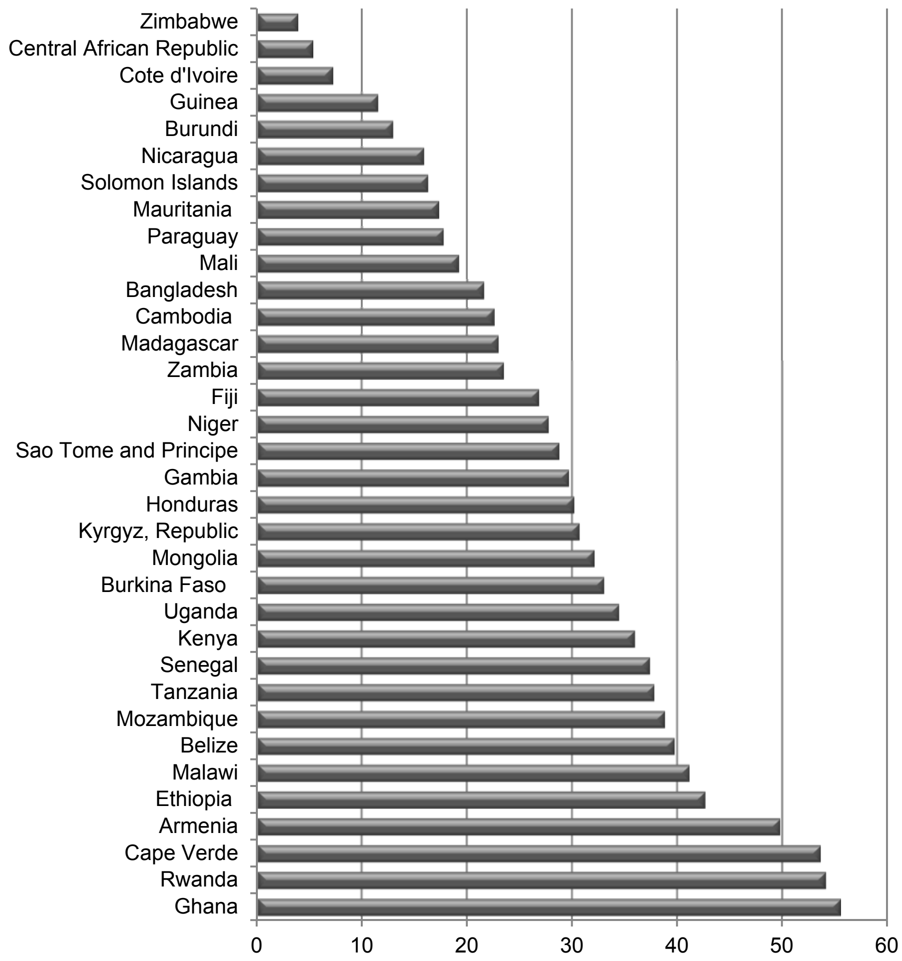
Economy	Ease of doing business	Protecting investors	Trading across borders	Enforcing contracts	Resolving insolvency
Rwanda	1	3	17	2	25
Kyrgyz Republic	2	1	24	5	20
Nepal	3	9	20	17	10
Kenya	4	12	14	13	4
Ethiopia	5	15	18	6	3
Bangladesh	6	2	5	32	8
Uganda	7	17	19	11	1
Tanzania	8	12	2	1	11
Madagascar	9	7	4	24	18
Cambodia	10	9	8	20	19
Mozambique	11	5	12	15	17
Sierra Leone	12	3	11	19	22
Malawi	13	9	21	12	16
Mali	14	21	16	16	9
Tajikistan	15	7	29	3	2
Gambia, The	16	30	1	7	14
Burkina Faso	17	21	28	9	6
Liberia	18	21	6	27	23
Comoros	19	17	13	23	27
Afghanistan	20	32	31	25	7
Togo	21	21	3	22	5
Burundi	22	5	27	29	27
Zimbabwe	23	15	25	10	21
Niger	24	25	26	18	12
Haiti	25	29	15	8	24
Benin	26	25	9	31	13
Guinea-Bissau	27	17	7	20	27
Congo, Dem. Rep.	28	25	23	28	26
Guinea	29	30	10	13	15
Eritrea	30	14	22	4	27
Central African Republic	31	17	32	30	27
Chad	32	25	30	26	27

Note: Highlighted countries are those that also feature in Figure 3 as highly dependent on the EU as a market for their exports.
Source: http://www.doingbusiness.org/rankings

Figure 24 presents the World Bank's ranking of government effectiveness indicators across those countries for which exports to the EU market accounted for more than 1% of GDP and which fall within one or more of the following country groups: LICs, LDCs, SIDS or CDDCs. This indicator first estimates the strength of countries' governance systems, which ranges from estimates of between -2.5 (weak) to 2.5 (strong). It is based on a combination of both survey data and quantitative data and is intended to capture the perceptions of relevant stakeholders regarding the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

As can be seen from Figure 24, African states such as Ghana, Rwanda, Cape Verde, Ethiopia and Malawi achieve a higher rank of government effectiveness than states in Latin America, Asia and the Pacific. In summary, it is difficult to distinguish any clear pattern across the different categories of countries (related to income, or region) which suggests that governance capabilities are highly country specific.

Figure 24: Rank of government effectiveness, 2010



Source: http://info.worldbank.org/governance/wgi/mc_countries.asp

2.2.4 Vulnerability to China's slow-down

Growth in China, which is an export-dependent economy, is expected to slow down because of the debt crisis in Europe. According to the latest IMF projections, China's growth rate declined to 9.2% in 2011 from 10.4% in 2010, and is projected to lower further to 8.2% in 2012 before increasing slightly to 8.8% in 2013 (IMF, 2012b). This may have severe impacts on poor countries for which China represents a key trading partner as well as a key investor. The World Bank (2012a) defines the possible 'China effect' in two ways: first, as a slow-down of China's import demand which could be grounded in a quicker-than-expected slow-down in China's domestic demand; or second, a fall-off in orders from China's production chains due to slower high-income country demand.[11]

These developments could constitute a double hit on shipments from a number of East Asian export-intensive economies.[12] As shown in Table 10, Association of South East Asian Nations trading partners such as Indonesia and the Philippines feature amongst the LICs/LMICs with the highest value of trade with China, and could therefore be vulnerable to any China effect which affects intra-regional production networks. However, a number of countries in SSA also feature, including Zambia, Nigeria and Ethiopia.

[11] Data show that the value of China's imports from the world was 24.8% higher in 2011 than in 2010, down from an increase of 38.8% in 2010 over 2009.

[12] WTO and IDE-JETRO (2011).

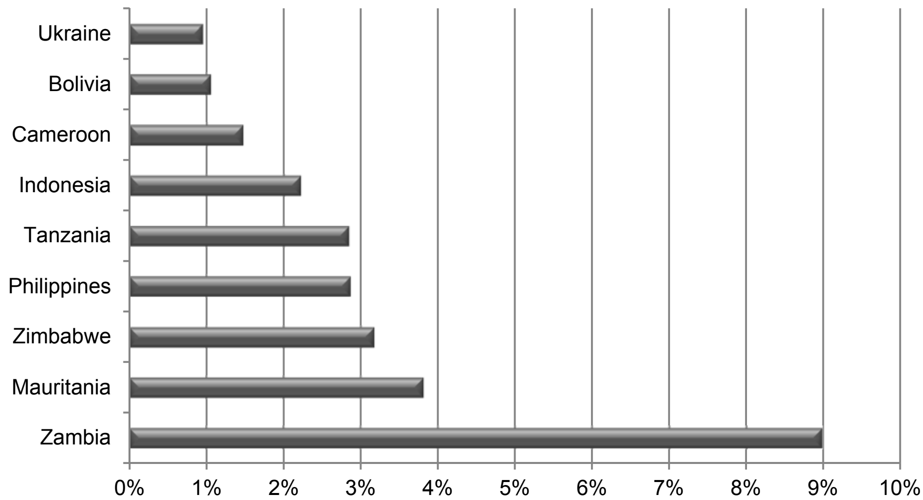
Table 10: Highest-value LIC/LMIC traders with China (2010)

LIC/LMIC	2005	2006	2007	2008	2009	2010	Avg. ann. change
	Value ($000)	*Value ($000)*	*Value ($000)*	*Value ($000)*	*Value ($000)*	*Value ($000)*	
Exports to China							
India	7,184	7,829	9,492	10,094	10,370	17,440	19.4%
Indonesia	6,662	8,344	9,676	11,637	11,499	15,693	18.7%
Philippines	4,077	4,628	5,750	5,469	2,934	5,724	7.0%
Zambia	38	257	189	287	483	1,455	106.9%
Nigeria	n/a	4	873	268	717	1,441	332.1%
Pakistan	432	506	603	724	980	1,375	26.0%
Ukraine	711	545	432	548	1,434	1,317	13.1%
Tanzania	99	149	156	270	387	657	46.1%
Egypt	109	108	130	342	975	432	31.6%
Cameroon	68	122	96	465	292	330	37.0%
Imports from China							
India	10,167	15,639	24,576	31,586	30,613	41,249	32.3%
Indonesia	5,843	6,637	8,558	15,249	14,002	7,324	4.6%
Nigeria	n/a	3,161	4,911	4,292	6,000	5,248	13.5%
Pakistan	2,338	2,915	4,164	4,737	3,780	4,954	16.2%
Philippines	3,134	3,869	4,233	4,561	4,060	4,902	9.4%
Egypt.	915	1,197	1,633	4,432	3,911	4,700	38.7%
Ukraine	1,810	2,310	3,308	5,600	2,734	3,433	13.7%
Paraguay	642	1,268	1,623	2,471	2,051	2,968	35.8%
Morocco	1,061	1,260	1,856	2,407	2,568	2,062	14.2%
Ethiopia	517	640	1,139	1,750	1,920	1,523	24.1%

Source: UN COMTRADE database.

Figure 25 shows those countries for which exports to China accounted for 1% or more of GDP in 2010. Clearly, Zambia has the largest degree of exposure to a slow-down in demand from China; its principal export – copper – is also likely to be affected by financial contagion effects, as discussed previously. Other commodity exporters such as Mauritania, Zimbabwe and Tanzania also exhibit a relatively high degree of exposure, with exports to China accounting for around 3% of GDP in 2010. This is also the case for other Asian exporters integrated within regional production networks such as the Philippines, which has a similar degree of exposure to any China effect induced by the spill-over effects from the euro zone crisis.

Figure 25: Exports to China as share of GDP, 2010



Note: Countries for which exports to China accounted for more than 1% or more of GDP in 2010.
Source: UN COMTRADE database

On the other hand, over the last decade China has rapidly become a key investor in developing economies thanks to its rapid economic growth, abundant financial resources and strong motivation to acquire resources and strategic assets abroad (UNCTAD, 2011).

Table 11 shows that FDI flows to LDCs increased from US$ 234 million in 2005 to US$ 2,742 million in 2010. Notably, China's FDI outflows to LDCs continued to grow during the 2008–9 global financial crisis, when FDI inflows from developed countries weakened. This suggests that at that time investments by China helped developing countries to counteract the effects of the global shock.

Table 11: China's outward FDI flows to LDCs, 2005–10 (US$ million)

Country	2005	2006	2007	2008	2009	2010
Afghanistan		0.25	0.10	113.90	16.39	1.91
Angola	0.47	22.39	41.19	-9.57	8.31	101.11
Bangladesh	0.18	5.31	3.64	4.50	10.75	7.24
Benin	1.31		6.32	14.56	0.09	1.76
Bhutan						
Burkina Faso						
Burundi					0.69	
Cambodia	5.15	9.81	64.45	204.64	215.83	466.51
Central African Republic						25.81
Chad	2.71	1.61	0.75	9.47	51.21	2.13
Comoros						-0.01
Congo, Dem. Rep.	5.07	36.73	57.27	23.99	227.16	236.19
Djibouti			1.00		3.40	4.23
Equatorial Guinea	6.35	10.19	12.82	-4.86	20.88	22.08
Eritrea		0.01	0.45	-0.49	0.23	2.94
Ethiopia	4.93	23.95	13.28	9.71	74.29	58.53
Gambia, The						
Guinea	16.34	0.75	13.20	8.32	26.98	9.74
Guinea-Bissau						
Haiti						
Kiribati						
Lao PDR	20.58	48.04	154.35	87.00	203.24	313.55
Lesotho	0.60			0.62	0.10	0.56
Liberia	8.65	-7.03		2.56	1.12	29.89
Madagascar	0.14	1.17	13.24	61.16	42.56	33.58
Malawi			0.20	5.44		9.86
Mali		2.60	6.72	-1.28	7.99	3.05
Mauritania	0.36	4.78	-4.98	-0.65	6.53	5.77
Mozambique	2.88		10.03	5.85	15.85	0.28
Myanmar	11.54	12.64	92.31	232.53	376.70	875.61
Nepal	1.35	0.32	0.99	0.01	1.18	0.86
Niger	5.76	7.94	100.83	-0.01	39.87	196.25
Rwanda	1.42	2.99	-0.41	12.88	8.62	12.72
Samoa			-0.12		0.63	98.93
São Tomé and Príncipe						0.02
Senegal			0.24	3.60	11.04	18.96
Sierra Leone	0.49	3.71	2.85	11.42	0.90	
Solomon Islands						
Somalia						
Sudan	91.13	50.79	65.40	-63.14	19.30	30.96
Tanzania	0.96	12.54	-3.82	18.22	21.58	25.72
Timor-Leste						
Togo	0.31	4.58	2.70	4.20	8.91	11.77
Tuvalu						
Uganda	0.17	0.23	4.01	-6.70	1.29	26.50
Vanuatu						
Yemen, Rep.	35.16	7.61	43.47	18.81	1.64	31.49
Zambia	10.09	87.44	119.34	213.97	111.80	75.05
Total	**234.10**	**351.35**	**821.82**	**980.66**	**1,537.06**	**2,741.55**

Source: Ministry of Commerce of the People's Republic of China (2011).

Such an offsetting impact may be at risk in the context of the euro zone crisis since China's growth is slowing down, thus leaving poor countries overly exposed to the adverse impacts of a possible shortfall in FDI flows. The biggest recipients of FDI flows from China are likely to be the biggest losers. A few natural resource rich countries in Africa and a number of Asian economies where Chinese FDI outflows have been highly concentrated are particularly at risk. These include Angola, Democratic Republic of the Congo, Niger, Myanmar, Cambodia and Lao PDR, which together accounted for 80% of China's FDI flows to LDCs in 2010.

3 Scenario analysis

On the basis of the analysis of exposure and resilience indicators described in Section 2 it is possible to identify which countries within a selected sample of LICs and LMICs seem relatively more vulnerable to the possible financial and real shocks of the euro zone crisis. Table 12 shows that, across LICs, Mozambique is among the most vulnerable countries owing to its high dependence on euro zone trade flows and cross-border bank lending from European banks. It is also highly dependent on aid and has a significant fiscal deficit which has worsened since the global financial crisis. Kenya is also highly vulnerable because of its strong trade and financial linkages with European countries. Burkina Faso, Mali and Niger, on the other hand, are likely to feel the effects of the euro zone crisis mainly through depreciation of the euro and lack of adequate fiscal policy space.

Looking at the LMIC sub-sample, it emerges that Cape Verde and Moldova are particularly vulnerable to the shock waves of the euro crisis. Both countries have strong trade linkages with the euro area, and are heavily dependent on aid and cross-border bank lending from European economies. Moreover, both countries experienced deterioration in their fiscal balance between 2007 and 2010, and thus have limited policy space to counter the effects of the euro zone crisis. Moldova is also likely to feel the effects through shocks in remittance flows, while Cape Verde may be affected by depreciation of the euro. Guyana and Samoa, like Moldova, are vulnerable because of their high dependence on remittances and aid. Cameroon is likely to be affected mainly through depreciation of the euro and contractions in cross-border bank lending from European banks.

It is worth noting that almost all countries, within both the LIC and LMIC groups, are likely to feel the effects of the euro zone crisis because of their high dependence on trade with European countries. This confirms that trade is a key transmission channel through which the crisis is likely to spread across the developing world. For this reason – together with the fact that, according to WTO (2012), growth in world exports dropped from 13.8% in 2010 to 5% in 2011 and is forecast to slow further to 3.7% in 2012 – we decided to simulate the potential effects that a decline in export growth may have on output growth in developing countries.

In order to do this, the shock was set at a uniform decrease of 1% in export flow growth. Table 13 summarises the simulation results. The first thing to notice is that the average growth effect is higher in LMICs than in LICs: the export shock reduces growth rates in LICs by an average of 0.4%, whereas the corresponding figure for LMICs is 0.5%.

Within the LIC sub-sample, Uganda appears to be the most vulnerable to export shocks, accounting for a staggering -2.2% growth effect. Zimbabwe and Cambodia are found to be likely to experience a growth contraction of 0.8% and 0.6% respectively. Burkina Faso, Ethiopia, Malawi, and Rwanda, however, would suffer just a 0.1% reduction in growth as a result of a 1% export decline.

Moving to LMICs, some of the Latin American countries appear to be the most vulnerable to export flow shocks. Paraguay is the hardest hit, with a 2.2% drop in economic growth, followed by Bolivia (1.3%), Guyana (1.1%) and Belize (0.7%). On the other hand, the fall in output growth in Guatemala, Nicaragua, Pakistan, and Zambia is a more moderate 0.1%.

Table 12: Vulnerability of selected LICs and LMICs to the euro zone crisis

Country	Dependence on euro zone trade	Fiscal space in 2010 compared to 2007	Fiscal balance (surplus/deficit)	Dependence on remittances	FDI dependence	Aid dependence	Dependence on cross-border bank lending from European banks	Peg to euro
LICs								
Burkina Faso	medium	improved	**deficit**	low	low	medium	medium	**yes**
Burundi	**high**	**worsened**	**deficit**	low	low	**high**	low	no
Cambodia	**high**	**worsened**	**deficit**	medium	medium	medium	low	no
Ethiopia	**high**	improved	**deficit**	low	low	medium	low	no
Kenya	**high**	**worsened**	**deficit**	medium	low	medium	**high**	no
Kyrgyz Republic	low	**worsened**	**deficit**	**high**	medium	medium	medium	no
Madagascar	**high**	improved	**deficit**	n.a.	medium	medium	**high**	no
Malawi	**high**	improved	surplus	n.a.	low	**high**	low	no
Mali	medium	improved	**deficit**	medium	low	medium	medium	**yes**
Mozambique	**high**	**worsened**	**deficit**	low	medium	**high**	**high**	no
Nepal	medium	same	**deficit**	**high**	low	medium	low	no
Niger	**high**	**worsened**	**deficit**	low	**high**	medium	low	**yes**
Rwanda	**high**	improved	surplus	low	medium	**high**	low	no
Tanzania	**high**	**worsened**	**deficit**	low	low	medium	medium	no
Uganda	**high**	**worsened**	**deficit**	medium	medium	medium	medium	no
Zimbabwe	medium	improved	**deficit**	n.a.	low	**high**	medium	no
LMICs								
Armenia	**high**	**worsened**	**deficit**	low	medium	medium	medium	no
Belize	**high**	same	surplus	medium	medium	medium	**high**	no
Bolivia	medium	same	surplus	medium	medium	medium	low	no
Cameroon	**high**	**worsened**	**deficit**	low	low	medium	**high**	**yes**
Cape Verde	**high**	**worsened**	**deficit**	medium	medium	**high**	**high**	**yes**
El Salvador	medium	**worsened**	**deficit**	**high**	low	low	medium	no
Georgia	**high**	**worsened**	**deficit**	medium	medium	medium	medium	no
Ghana	**high**	**worsened**	**deficit**	low	medium	medium	**high**	no
Guatemala	medium	**worsened**	**deficit**	**high**	low	low	low	no
Guyana	**high**	improved	**deficit**	**high**	medium	**high**	low	no
Indonesia	**high**	**worsened**	**deficit**	low	low	low	medium	no
Moldova	**high**	**worsened**	**deficit**	**high**	medium	**high**	**high**	no
Morocco	**high**	**worsened**	**deficit**	medium	low	low	**high**	no
Nicaragua	**high**	**worsened**	**deficit**	**high**	medium	medium	low	no
Nigeria	**high**	**worsened**	**deficit**	**high**	medium	low	medium	no
Pakistan	**high**	**worsened**	**deficit**	medium	low	low	medium	no
Paraguay	**high**	**worsened**	**deficit**	low	low	**high**	**high**	no
Philippines	**high**	**worsened**	**deficit**	medium	low	low	medium	no
Samoa	low	**worsened**	**deficit**	**high**	low	**high**	n.a.	no
São Tomé and Príncipe	**high**	**worsened**	**deficit**	low	low	**high**	**high**	no
Sri Lanka	**high**	**worsened**	**deficit**	medium	low	low	**high**	no
Ukraine	**high**	**worsened**	**deficit**	low	medium	low	**high**	no
Zambia	medium	**worsened**	**deficit**	low	medium	medium	**high**	no

Notes: country selection made on the basis of 2010 data availability. Low <3%; Medium =>3%–<10%; High =>10%. All data refer to 2010 with the exception of cross-border bank lending dependence, which was computed using the latest figure available (September 2011). Trade dependence: exports to euro zone/total exports to world (%). Dependence on remittances: total remittance inflows/GDP (%). FDI dependence: total FDI inflows/GDP (%). Aid dependence: total DAC countries' aid/GDP (%). Dependence on cross-border bank lending from European countries: foreign claims from European banks/GDP (%). Fiscal space: fiscal balance/GDP (%).
Source: Authors' elaboration on different sources.

Table 13: Potential growth impact in LICs and LMICs of a -1% export growth shock

LICs		LMICs	
Uganda	-2.2	Paraguay	-2.2
Zimbabwe	-0.8	Bolivia	-1.3
Cambodia	-0.6	Guyana	-1.1
Burundi	-0.5	Belize	-0.7
Kenya	-0.3	Cape Verde	-0.5
Kyrgyz Republic	-0.3	Moldova	-0.5
Mali	-0.3	Nigeria	-0.5
Madagascar	-0.2	Philippines	-0.5
Mozambique	-0.2	Ghana	-0.4
Nepal	-0.2	Ukraine	-0.4
Niger	-0.2	Cameroon	-0.3
Tanzania	-0.2	Georgia	-0.3
Burkina Faso	-0.1	Indonesia	-0.3
Ethiopia	-0.1	Morocco	-0.3
Malawi	-0.1	Armenia	-0.2
Rwanda	-0.1	El Salvador	-0.2
		Sri Lanka	-0.2
		Guatemala	-0.1
		Nicaragua	-0.1
		Pakistan	-0.1
		Zambia	-0.1

Notes: The simulations were carried out using the World Bank DECPG's experimental global macro model, which is a platform for performing economic simulations available to World Bank Staff, partner institutions and authorised users.
***Source*: Authors' calculations.**

4 Current impacts of the euro zone crisis on poor countries

4.1 Trade

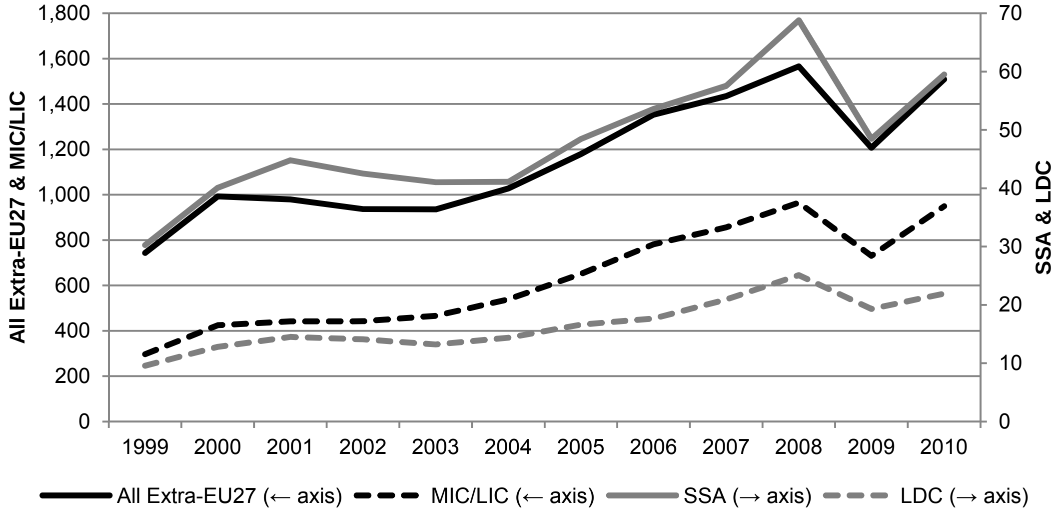
On an annual basis, and on aggregate across all EU27 members, although there has been growth since 2009, trade values remain below their levels prior to the global financial crisis (Figure 26). However, this is not the case for those goods supplied from middle-income countries (MICs) and LICs, whose value in 2010 exceeded that of 2008. Imports sourced from LDCs, in comparison, on an annual basis appear to remain depressed.

This situation however appears to be reversing if we look at higher-frequency data. The value of imports from LDCs experienced considerable growth on a monthly basis (Figure 27) in 2011, although by the end of the period had reverted to 2010 levels. In comparison growth in the value of imports from LICs and MICs in 2011 was far less pronounced.

Essentially the aggregate trade patterns of the 17 euro zone countries mirror those of the EU27 as a whole (Figure 28). For individual euro zone members, in the case of Greece the value of imports from all trade partners was mostly lower in 2011 than in 2010 (Figure 29).

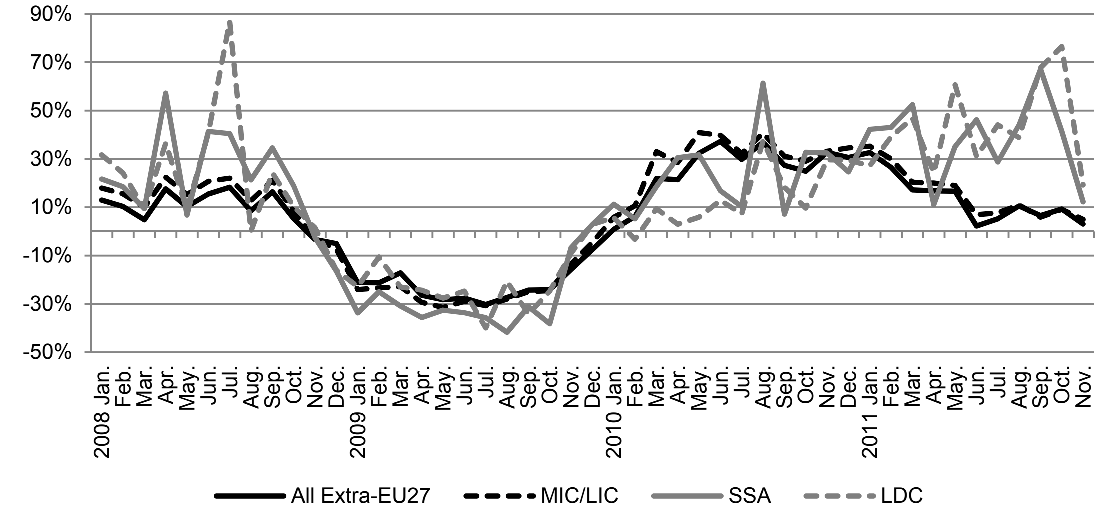
We expect there to be differences in how types of trade – manufactures and commodities – are affected by the euro zone crisis. Because different types of countries – LDCs, SIDS, CDDCs – specialise in these types of trade, we distinguish between the effects apparent on their major exports to the EU market. Table 14 provides an overview of the different types of countries. As can be seen, most of the highly dependent exporters to the EU market (identified in Figure 3) fall within the category of CDDCs.

Figure 26: EU27 imports: annual, 1999–2010 (€ billion)



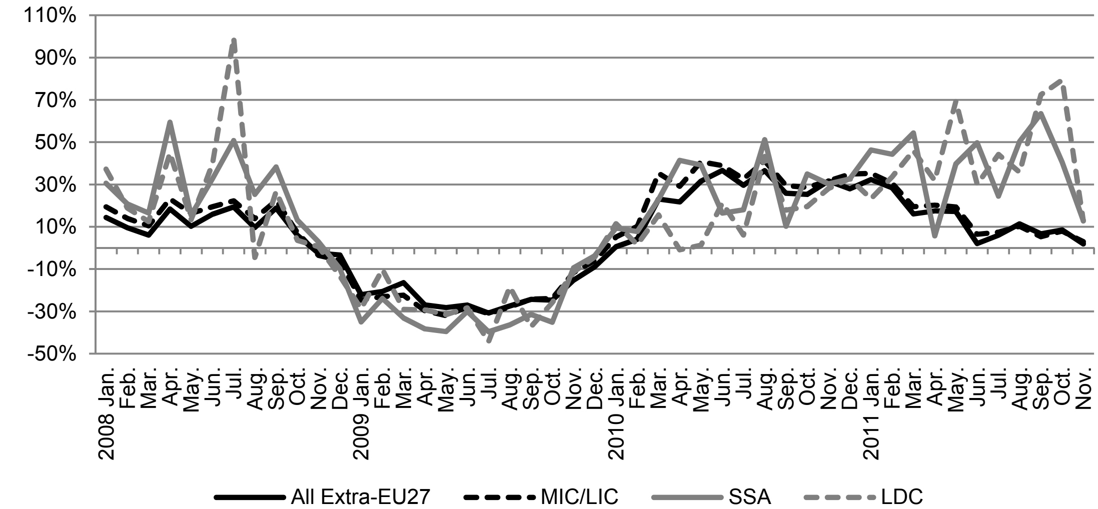
Source: Eurostat COMEXT database.

Figure 27: EU27 imports: monthly year-on-year change, Jan. 2007–Nov. 2011



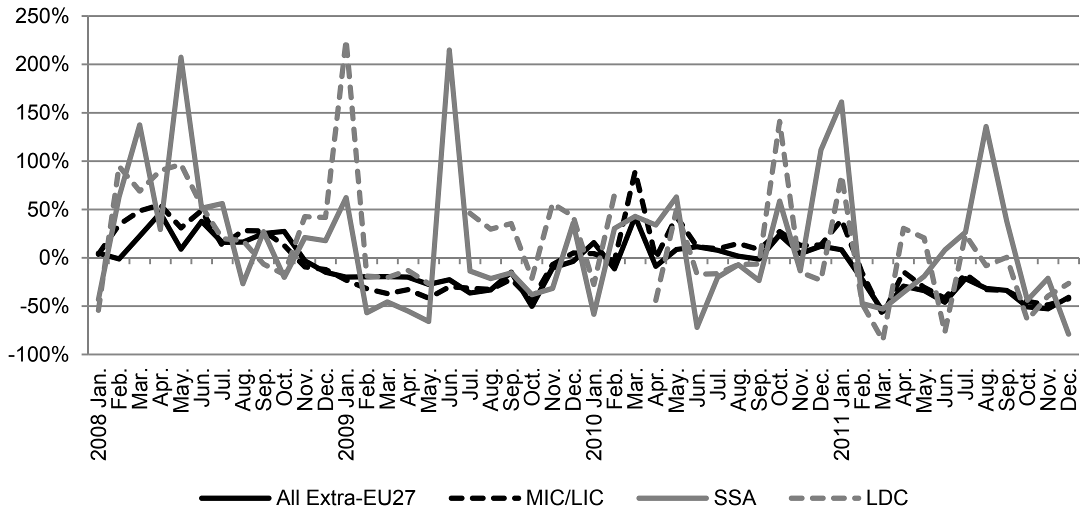
Source: Eurostat COMEXT database.

Figure 28: Euro zone (17) imports: monthly year-on-year change, Jan. 2007–Nov. 2011



Source: Eurostat COMEXT database.

Figure 29: Greek imports: monthly year-on-year change, Jan. 2007–Dec. 2011



Source: Eurostat COMEXT database.

Table 14: Country groups of countries highly dependent on the EU market

Country	LIC	LMIC	LDC	SIDS	CDDC	Exports to EU, % of GDP
Côte d'Ivoire	✓				✓	18
Mozambique	✓		✓		✓	14
Malawi	✓		✓		✓	8
Madagascar	✓		✓		✓	6
Belize		✓		✓	✓	6
Burundi	✓		✓		✓	5
Zimbabwe	✓				✓	5
Armenia		✓			✓	5
Kenya	✓				✓	4
Ghana		✓			✓	3
Nicaragua		✓			✓	3
Paraguay		✓			✓	3
São Tomé and Príncipe		✓	✓	✓	✓	3
Mali	✓		✓		✓	2
Uganda	✓		✓		✓	2
Ethiopia	✓		✓		✓	2
Tanzania	✓		✓		✓	2
Niger	✓		✓		✓	1
Burkina Faso	✓		✓		✓	1
Cambodia	✓		✓			8
Mauritania		✓	✓			4
Senegal		✓	✓			2
Gambia, The	✓		✓			2
Zambia		✓	✓			2
Cape Verde		✓		✓		3
Nigeria		✓				10
Cameroon		✓				10
Ukraine		✓				9
Moldova		✓				6
Sri Lanka		✓				6
Philippines		✓				4
Egypt, Arab Rep.		✓				4
Bolivia		✓				3
Pakistan		✓				3
Georgia		✓				2
Indonesia		✓				2
Guatemala		✓				1

Note: The countries included are taken from Figure 3.

Table 15 presents year-on-year change in monthly export values to the EU for the countries classified as CDDCs. The steepest year-on-year declines are apparent for Kyrgyz Republic, Burkina Faso, Belize, Mongolia, and Côte d'Ivoire. By contrast, the most dramatic price increases are apparent for Niger, Ghana, Mali, Burundi and Zimbabwe.

Table 15: Trends in CDDC exports to the EU (monthly value, year-on-year growth rate %)

Country	2011 Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.
Côte d'Ivoire	34	26	-24	-59	-25	-3	44	4	-12	1	-22
Guinea	-7	26	44	23	-1	-30	-8	22	161	3	-57
Mozambique	41	-22	84	-21	55	-26	0	-33	108	-25	-14
Malawi	-18	1	-16	-26	4	8	-9	53	-22	-9	101
Madagascar	27	13	19	15	36	3	28	25	12	25	16
Belize	-12	-22	61	-9	-3	-5	-35	-8	-10	-55	-74
Burundi	54	114	137	46	243	-16	12	106	123	37	26
Zimbabwe	101	-7	230	4	47	-7	31	12	54	-25	243
Armenia	-2	-21	-35	36	36	-4	-9	61	102	33	38
Kenya	41	57	-4	15	26	27	-2	-14	-6	3	27
Honduras	36	59	92	51	62	29	39	54	40	7	16
Central African Rep.	-5	5	58	-16	12	113	136	0	53	33	-24
Ghana	89	151	78	93	176	146	123	292	63	207	149
Nicaragua	65	59	13	46	22	15	58	100	6	-1	-1
Paraguay	76	158	-46	-49	20	95	-38	84	0	41	38
São Tomé/Príncipe	-22	-58	0	-70	-5	-55	21	371	-55	213	30
Mali	-39	-21	1199	-1	-12	-38	0	42	-16	-8	-2
Mongolia	-19	-50	-56	-54	-13	-27	55	12	115	-50	10
Uganda	3	-1	-9	6	10	17	32	16	21	39	52
Ethiopia	109	47	58	69	76	15	33	54	25	40	11
Tanzania	32	10	27	40	40	42	76	25	79	45	72
Niger	35	16520	1410	-27	37	42	39	156	-65	218	290
Burkina Faso	-58	-13	-75	3	-46	-62	18	-26	-30	0	16
Rwanda	1	220	175	129	49	-33	-33	-39	-2	17	33
Kyrgyz Republic	-7	143	54	-41	-61	-95	-90	8	-96	-91	-86

Source: Eurostat COMEXT database.

In relation to recent changes in the value of exports from SIDS to the EU, there does not appear to be a decline; most months of 2011 have registered an overall increase compared to 2010 (Table 16). This also appears to be the case for exports from other LDCs (Table 17).

Table 16: Trends in SIDS exports to the EU (monthly value, year-on-year growth rate %)

Country	2011 Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.
Solomon Islands	123	18	84	5	-11	94	7330	14	403	0	103
Fiji	-17	2294	-89	-77	52	82	-37	40	3465	59	-90
Cape Verde	-15	14	122	-20	77	199	-57	35	92	-3	124

Source: Eurostat COMEXT database.

Table 17: Trends in other LDC exports to the EU (monthly value, year-on-year growth rate %)

Country	2011 Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.
Cambodia	50	52	65	40	50	52	29	28	44	28	68
Bangladesh	48	58	52	29	44	32	32	25	19	11	17
Mauritania	160	40	25	69	33	52	-1	80	110	48	-42
Senegal	44	27	21	111	40	-13	24	84	28	143	-22
Gambia	-94	218	-15	-57	49	-21	61	37	37	75	-42
Zambia	79	6	187	172	65	267	234	507	124	197	87

Source: Eurostat COMEXT database.

These data, along with those presented at the more aggregate level across country income groups, suggest that the category of countries hardest hit by declines in demand in the EU market is MICs. Table 18 presents recent trends in the value of exports to the EU for, among others, the most highly dependent LMICs identified in Table 1 which do not fall within the categories of CDDC, SIDS or LDC (i.e. Cameroon, Moldova, Sri Lanka and Egypt). Out of this group of countries, Syria and the Philippines experienced a decline in the value of their exports to the EU in 2010 compared to 2011. Growth in the value of exports from Sri Lanka, Cameroon and Bolivia was relatively low compared to all other LMICs included in Table 18. In the case of Swaziland there are almost as many months of relative declines compared to 2010 as there are increases, and in the case of Bolivia there are more.

Table 18: Trends in LMIC exports to EU (monthly value, year-on-year growth rate %)

Country	2011 Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.
Iraq	-19	-40	-35	-22	42	31	95	36	54	110	23
Nigeria	104	113	131	12	47	144	20	119	135	47	12
Cameroon	14	23	1	-5	-10	21	-16	-17	54	33	14
Ukraine	64	102	55	67	25	39	19	28	10	-2	8
Viet Nam	43	46	27	20	36	16	12	34	33	56	57
Syrian Arab Rep.	-10	43	57	60	-5	-7	27	14	-12	-82	-85
Moldova	67	47	65	74	51	43	33	37	39	44	33
Sri Lanka	18	13	11	3	16	-1	6	-3	14	14	6
Philippines	8	12	13	-22	5	-11	-8	-13	-3	-5	-32
Egypt	77	41	47	61	50	89	39	33	-2	15	-24
Swaziland	263	-92	154	-70	137	8	-7	19	-4	84	-54
Bolivia	84	-24	27	-1	-35	-6	-28	-12	14	106	0
Pakistan	39	43	44	31	26	17	14	21	17	5	-5
Georgia	100	74	-52	9	238	-52	-59	-1	8	43	2
Indonesia	44	35	41	3	28	25	8	33	3	8	-5
Guatemala	-3	68	9	97	45	-8	2	31	4	0	-15
El Salvador	21	76	46	94	75	38	15	76	16	78	91

Source: Eurostat COMEXT database.

In relation to the types of product that have experienced the most dramatic declines in demand in the EU27 and the euro zone (and more specifically in the Greek and Italian markets) it is clear that since the last quarter of 2011 there have been reductions in exports in the following product categories across the EU27 and in particular in Italy (see Annex Figures 4–9):

- manufactured goods classified chiefly by material
- machinery and transport equipment
- miscellaneous manufactured articles
- crude materials, inedible, except fuels.

Demand for the following product categories, across markets, appears to be more stable:

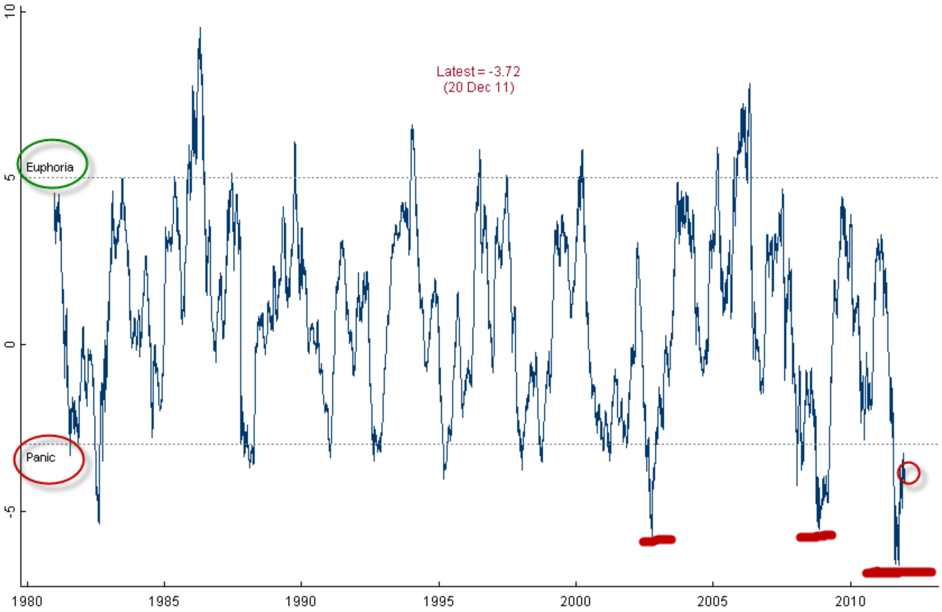
- chemicals and related products, not elsewhere specified
- animal and vegetable oils, fats and waxes
- commodities and transactions not classified elsewhere
- beverages and tobacco
- food and live animals.

In the case of mineral fuels, lubricants and related materials, although demand within the EU27 has held up, Greece has reduced demand considerably since the impact of the euro zone crisis (see Annex Figures 10–12). Overall, recent trends in exports to the EU27 suggest that the euro zone crisis is beginning to affect production networks operating within the EU for manufactured goods. The trade related impacts of the crisis could therefore escalate as a result of the China effect, as discussed in Section 2.

4.2 Private capital flows

Financial contagion effects from the euro area debt crisis to developing countries started to become visible in 2011, in particular in the second half. Risk aversion among global investors increased at levels higher than during the global financial crisis, as shown by the Credit Suisse Risk Appetite Index that in 2011 reached an absolute low (Figure 30).

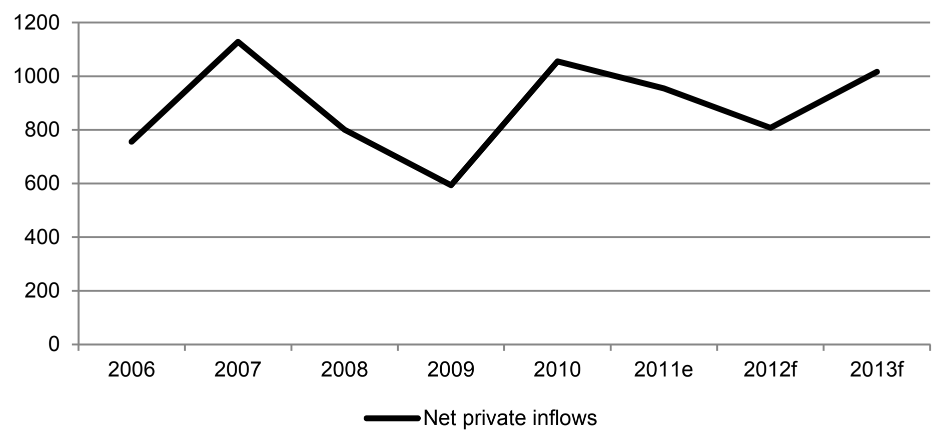
Figure 30: Credit Suisse Risk Appetite Index, 1981–2011



Source: Kurtz (2011).

As a consequence, net private capital flows, which in 2010 had partly rebounded from the lows of the 2008–9 global financial crisis, declined again to US$ 954 billion in 2011 (i.e. 4.3% of GDP, which is about half of their peak values of 2007 as a share of GDP) (Figure 31). This trend is expected to continue in 2012, when capital flows are projected to drop further by 18% to US$ 807 billion, before recovering in 2013 even though at a level still lower than the 2007 peak value (Figure 31). Given current uncertainties, such projections are particularly tentative. However, the positive outlook for private capital flows in the medium term could be explained by three main factors: (i) real interest rates are expected to remain higher in emerging markets than mature economies; (ii) despite the recent downward revision, developing countries are projected to grow at higher rates than developed countries; (iii) several developing countries are improving their credit quality against an increasing number of developed countries experiencing sovereign rating downgrades.

Figure 31: Net capital flows to developing countries (US$ billion)



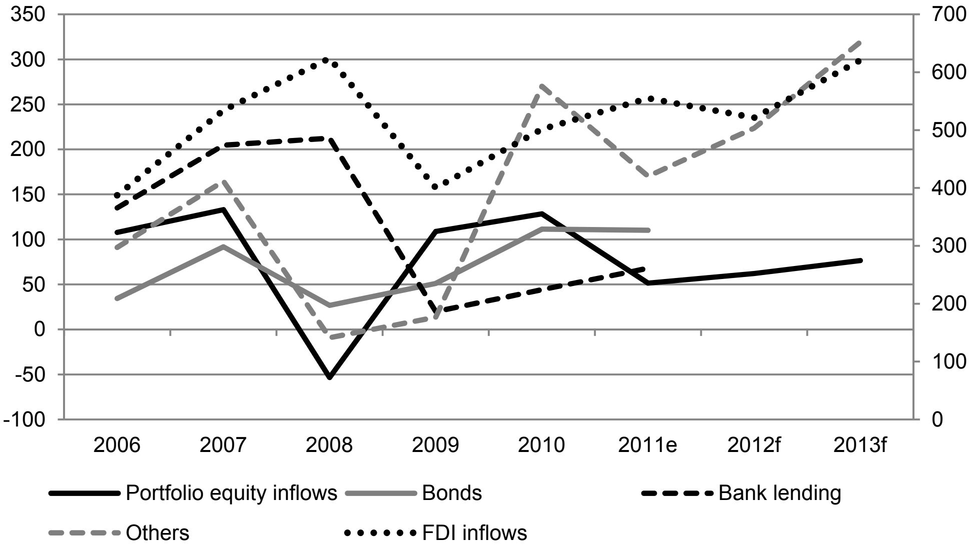
Note: e=estimate, f=forecast.
Source: Adapted from World Bank (2012a).

Nevertheless, aggregate data mask important differences between different types of private capital flow (Figure 32). Portfolio equity flows were hit hard: between 2010 and 2011 they declined by 60% to US$ 51 billion. Note, however, that such a drop was much less marked than that experienced in 2008, when net portfolio equity inflows actually reversed because of the global financial crisis. In 2011 developing country equity markets experienced significant sell-offs in line with price declines.[13] Moreover, the volume of equity issuance declined by 80% between September and December 2011 compared to the same period in 2010 (World Bank, 2012a).

On the other hand, bond flows were more resilient than portfolio equity flows to the shock waves of the euro zone crisis, experiencing a decline of just 1% over the period 2010–11 (Figure 32). Therefore, compared to the 2008–9 global financial crisis, when several bond issuance plans were put on hold in developing countries (Brambila Macias-Massa, 2010), so far the crisis in the euro area seems to have affected bond flows much less. Indeed, in 2011 some developing countries such as Namibia and Senegal were still able to issue bonds successfully for the first time (Fuchs, 2012).

FDI inflows to developing countries, after the 2009 sharp decline, recovered strongly in 2010 when, according to UNCTAD (2011), for the first time they absorbed more than half of global FDI flows. This rebound occurred thanks to their relatively fast economic recovery, the strength of domestic demand, and growing South–South flows. The rise of FDI continued in 2011, when inflows reached an estimated value of US$ 555 billion. Nevertheless, they are projected to decline by 6% in 2012 before recovering in 2013 to a value close to their peak level of 2008 (Figure 32). There is already some evidence of investment plans cancelled or postponed in a few developing countries. In Rwanda, for example, two foreign investments (one of US$ 300 million in the Kigali Convention Centre and one of US$ 325 million in a methane gas energy project) have been delayed due to financing gaps.[14] Note, however, that the expected decline in FDI to developing countries in 2012 is much less significant than the 36% drop experienced in 2009 due to the global financial crisis (Figure 32).

Figure 32: Net capital flows to developing countries by type of flow (US$ billion)



Note: FDI inflows on secondary axis. e=estimate, f=forecast.
Source: Adapted from World Bank (2012a).

Finally, World Bank (2012a) data show that after increasing by 123% in 2010 from the US$ 20 billion low experienced in 2009, international bank lending to developing countries is expected to continue to rebound, albeit at a much slower rate of 54%, and to reach an estimated US$ 68 billion in 2011 – which

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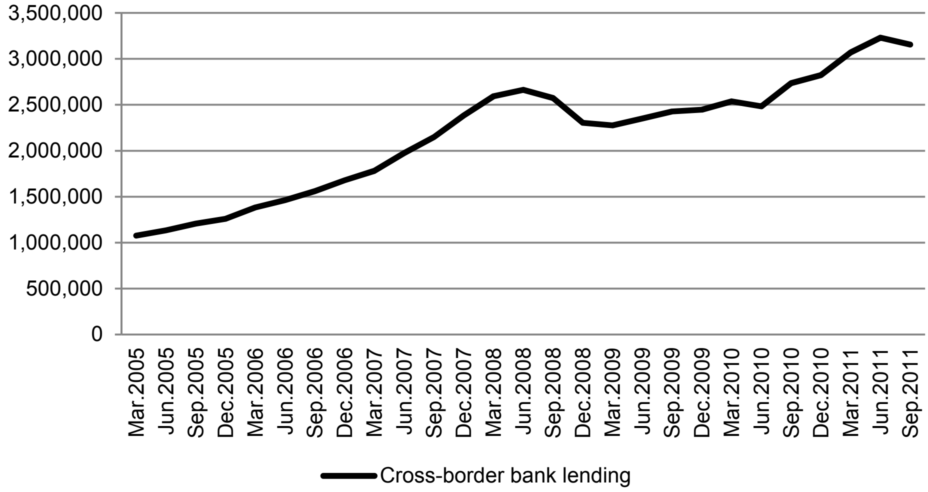
[13] According to the World Bank (2012), in 2011 developing country equities fell about 16% compared with an 8% drop for mature markets.

[14] See http://www.theeastafrican.co.ke/business/Key+projects+in+Rwanda+delayed+as+investors+cut+back+on+funding+/-/2560/1298400/-/wjwo3v/-/index.html

is still below its pre-crisis level (Figure 32). A slightly different picture emerges from recent high-frequency data released by the Bank for International Settlements (BIS). According to these data, international bank lending directed to developing countries after the drop experienced during the global financial crisis continued to increase until the second half of 2011, when it suffered a decline of 2% between June and September (although remaining well above its level before the global financial crisis) (Figure 33).

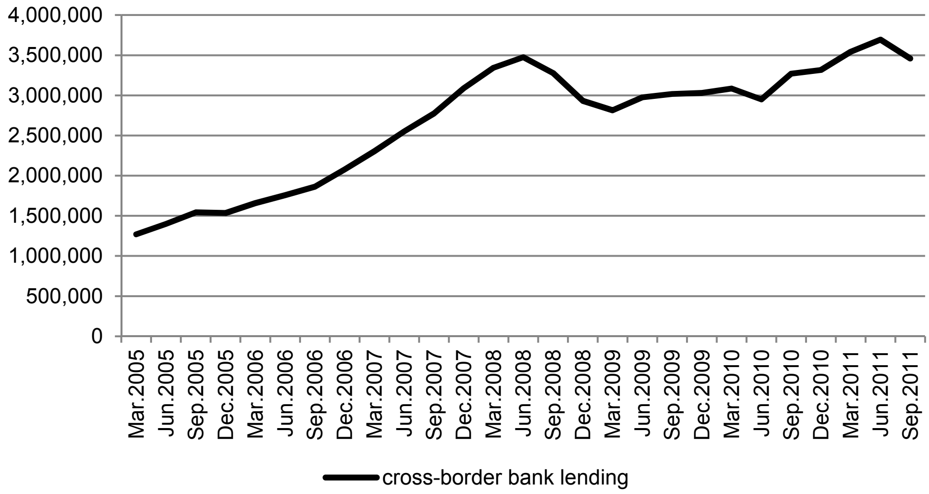
Figure 33: Cross-border bank lending to developing countries (US$ million), March 2005–September 2011



Note: Total international claims, immediate borrower basis.
Source: BIS Consolidated Banking Statistics.

It is also important to highlight that BIS data reveal that a liquidity squeeze in European banks is restricting lending from European institutions to developing countries. Indeed, Figure 34 shows that after a period of slow recovery from the 2008–9 global financial crisis, cross-border bank lending to developing countries from European banks declined by 6.4% between June and September 2011. Interestingly, the US$ 3,474,253 million value reached in September 2011 was slightly lower than the peak value reached in June 2008, before the onset of the global financial crisis.

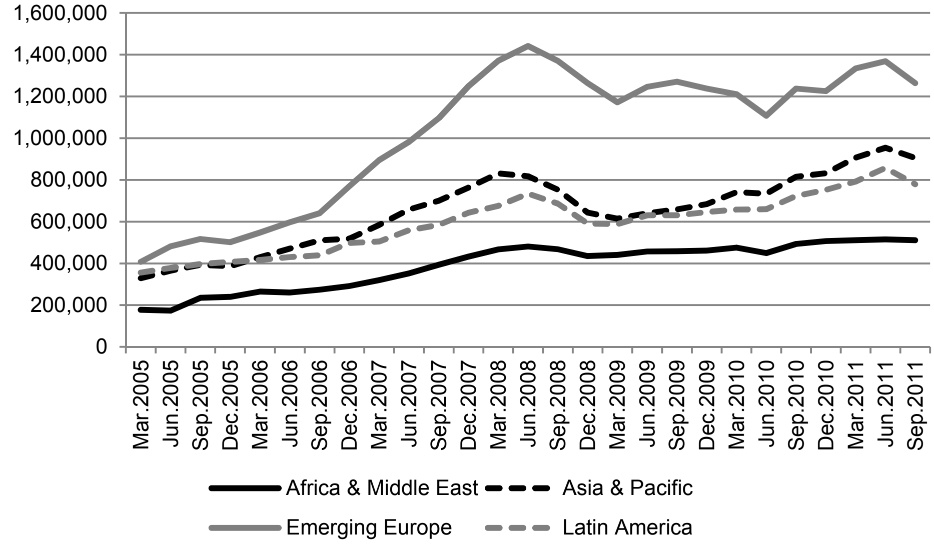
Figure 34: Cross-border bank lending to developing countries from European banks (US$ million), March 2005–September 2011



Note: Consolidated foreign claims of reporting banks, by nationality of reporting banks, immediate borrower basis.
Source: BIS Consolidated Banking Statistics.

All developing regions experienced a decline in cross-border bank lending from European banks in the second half of 2011, albeit to varying extents (Figure 35). Latin America and Emerging Europe were the hardest hit, experiencing declines of 9.2% and 7.7% respectively between June and September 2011. The Asia and Pacific region followed, with a decline of about 5% over the same period. The Africa and Middle East region has so far been less affected. Notably, Emerging Europe is the only region in which cross-border bank lending from European banks has not yet fully recovered from the severe drop experienced during the 2008–9 global financial crisis.

Figure 35: Cross-border bank lending to developing countries from European banks by region (US$ million), March 2005–September 2011



Note: Consolidated foreign claims of reporting banks, by nationality of reporting banks, immediate borrower basis.
Source: BIS Consolidated Banking Statistics.

Important differences emerge within regions. In Africa, for example, some countries with a strong presence of European banks, such as Angola, Rwanda, Ghana and Cameroon, experienced cross-border banking declines in the second half of 2011 (Figure 36). In other countries, such as Mozambique, Niger, Tanzania and Zambia, on the other hand, cross-border bank lending from European banks increased notwithstanding the euro zone crisis.

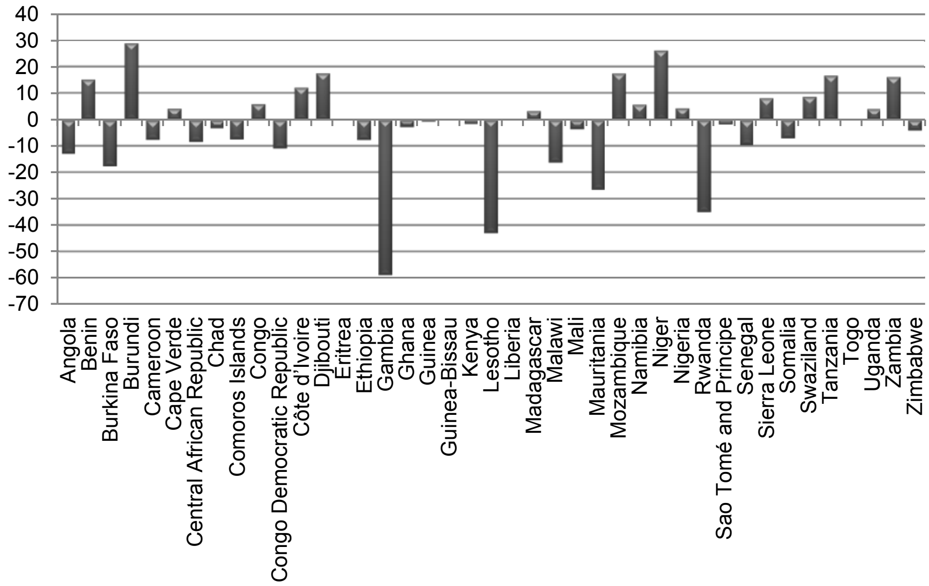
4.3 ODA

Although it is difficult to obtain high-frequency data on ODA flows, latest reports suggest that levels of aid are under threat from the effects of the euro zone crisis.[15] Indeed, the World Bank (2012a) reports that the ongoing fiscal crises in Greece, Ireland, Italy and Spain have already led to significant drops in their ODA. The latest country to announce declines is the Netherlands. Moreover, recent Organisation for Economic Cooperation and Development (OECD) surveys show that bilateral aid from DAC members to core development programmes in developing countries will grow at a mere 2% over the period 2011–13, compared to the average of 8% per year over the past three years (World Bank, 2012).

According to the OECD (2012), major donors' aid to developing countries fell by nearly 3% in 2011 because of the global recession. Within total net ODA, aid for core bilateral projects and programmes fell by 4.5% in real terms, while bilateral aid to SSA fell by 0.9% in real terms compared to 2010 (*ibid.*). LDCs also experienced a fall in net bilateral ODA flows of 8.9% in real terms in 2011 (*ibid.*). The reasons for these differentiated effects across country income groups are not presently clear. However, what is clear is that there are differentiated effects across donors: among DAC EU countries, ODA volume in real

15 For example, see http://news.sky.com/home/business/article/16151671.

Figure 36: Change in cross-border bank lending from European banks in African LICs and LMICs (%), June–September 2011



Note: Consolidated foreign claims of reporting banks, by nationality of reporting banks, immediate borrower basis.
Source: Authors' elaboration on BIS Consolidated Banking Statistics.

terms fell by 39% in Greece, 33% in Spain, 6% in France, and 3% in Ireland between 2010 and 2011 (*ibid.*).

Since the EU is its largest donor, the euro zone crisis is expected to weigh heavily on ODA to SSA (where the most LDCs are located). Among the EU countries most severely affected by the crisis, Ireland and Portugal channelled over 80% and 60% respectively of their ODA to Africa in 2007–9.[16] There are reports that public investments from Portugal to development partners in SSA have slowed.[17]

4.4 Growth

The severity of the previous and on-going global crisis is evident in Figure 37. Before 2007 growth rates in the developing world were on average above 4%. Once the financial crisis struck developing economies suffered a huge slow-down, with Europe and Central Asia the worst hit developing region with average growth collapsing below -6%, closely followed by Latin America which reached almost -2% in 2009. Then, a weak recovery was under way until the euro zone crisis cooled down most of the world economy.

The smooth recovery of the developing world between the global financial crisis and the early stages of the euro zone crisis can be appreciated from Figure 38, which shows regional growth rates in 2007 compared to 2010. In the early days of the euro zone crisis growth rates in SSA and East Asia and Pacific almost reached 2007 levels, whilst in South Asia and Latin America 2007 levels were reached or surpassed.

Unfortunately, when the euro zone crisis spread the inherent uncertainty and reduction in the trade flows so crucial for developing countries disrupted growth rates. This translated into a downward forecast revision by international organisations.

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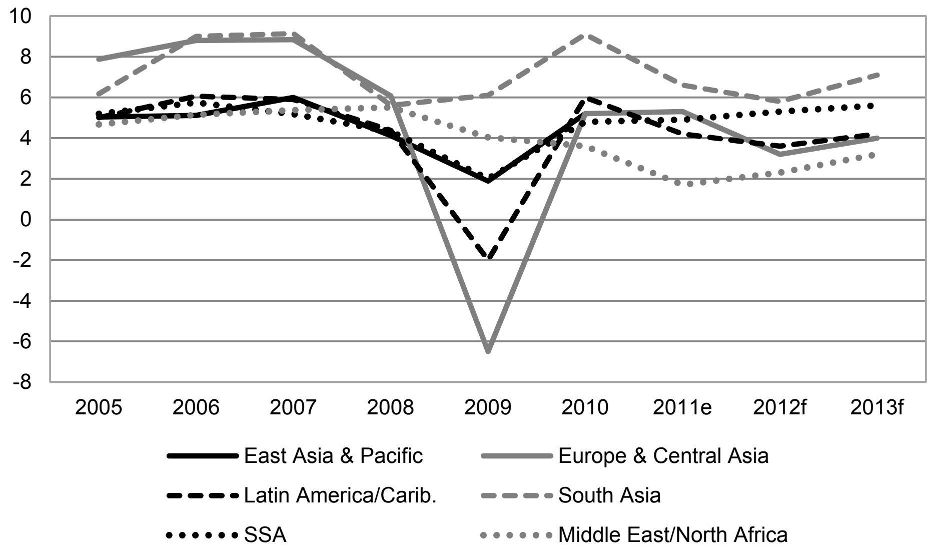
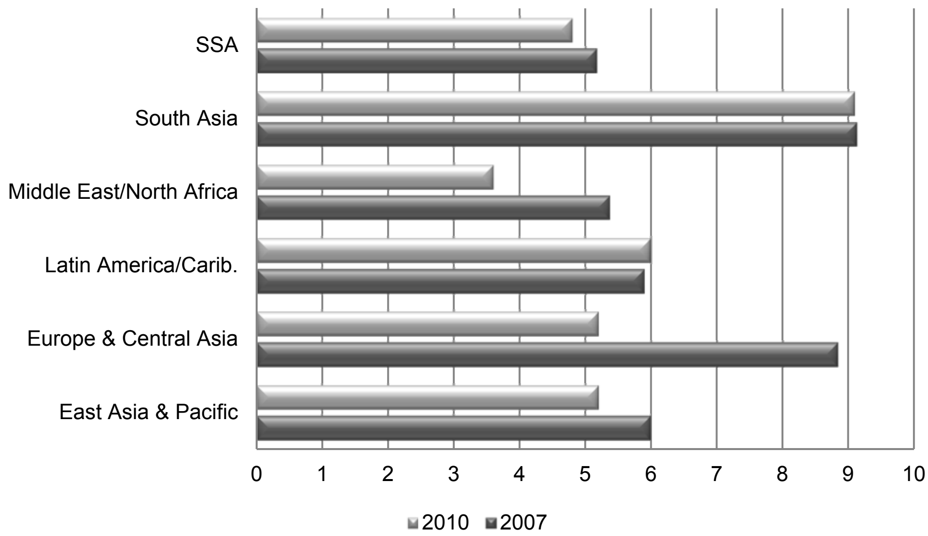
16 See http://www.afriquejet.com/development-africa-euro-crisis-to-impact-heavily-on-oda-to-africa-2012032735838.html.
17 See http://allafrica.com/stories/201112191948.html.

Figure 37: Growth rates by region (%), 2005–13



Note: e: expected; f: forecast.
Source: World Bank, World Development Indicators.

Figure 38: Comparison of regional growth rates between 2007 and 2010 (%)



Source: World Bank, World Development Indicators.

In January 2012 the IMF expected global output growth to be around 3.3% in 2012, as opposed to its earlier forecast of 4%. This downward revision reflects the deceleration of the euro area, which has suffered from bank deleveraging, and additional tightening of internal demand as a result of further fiscal consolidation. In April 2012, the IMF's forecast has been revised slightly upwards to 3.5%, reflecting signs of improvement in the United States and the emerging economies remaining supportive. The developing world is expected to suffer the crisis shock waves. The most recent IMF figures put the emerging and developing economies growth rate for 2012 at 5.7%, down from a healthy 6.2% in 2011 (IMF 2012b).

The World Bank has also downgraded its forecasts for global growth, which is now expected to be 2.5% in 2012 as opposed to the 3.6% predicted in June last year. This is due mainly to euro area economies falling into recession with a deceleration of -0.3% this year. For developing countries this means an overall slow-down to 5.4% in 2012 as opposed to the previous forecast of 6.2%. Of particular concern for poor countries, world trade is also slowing down. While in 2011 it was growing back to pre-crisis levels at 6.6%, new projections estimate that trade flows will slow and achieve an increase of only 4.7% by the end of this year. This will severely affect developing countries' growth.

The latest African Development Bank outlook expects continental growth rates for Africa to average 5.8% in 2012, showing some signs of recovery. But uncertainty remains high. It is also important to highlight that according to World Bank forecasts SSA will be the only developing region to maintain a steady trend of growth during the next couple of years, allowing it not only to reach but to surpass pre-crisis growth levels. The other regions will experience a recovery, but will stay below pre-crisis levels at least until early 2014.

In Asia there are signs of deceleration, with the Asian Development Bank expecting growth in Developing Asia to slow from 9.1% in 2010 to 7.2% in 2011, and 6.9% in 2012 (ADB, 2012). Among its sub-regions, East Asia and the Pacific appear to be the most affected by the crisis, though maintaining very high growth rates, experiencing respectively a slow-down from 8% to 7.4%, and from 7% to 6% in the period 2011–12 (*ibid.*). A light recovery to 7.3% is projected in Developing Asia in 2013 (*ibid.*).

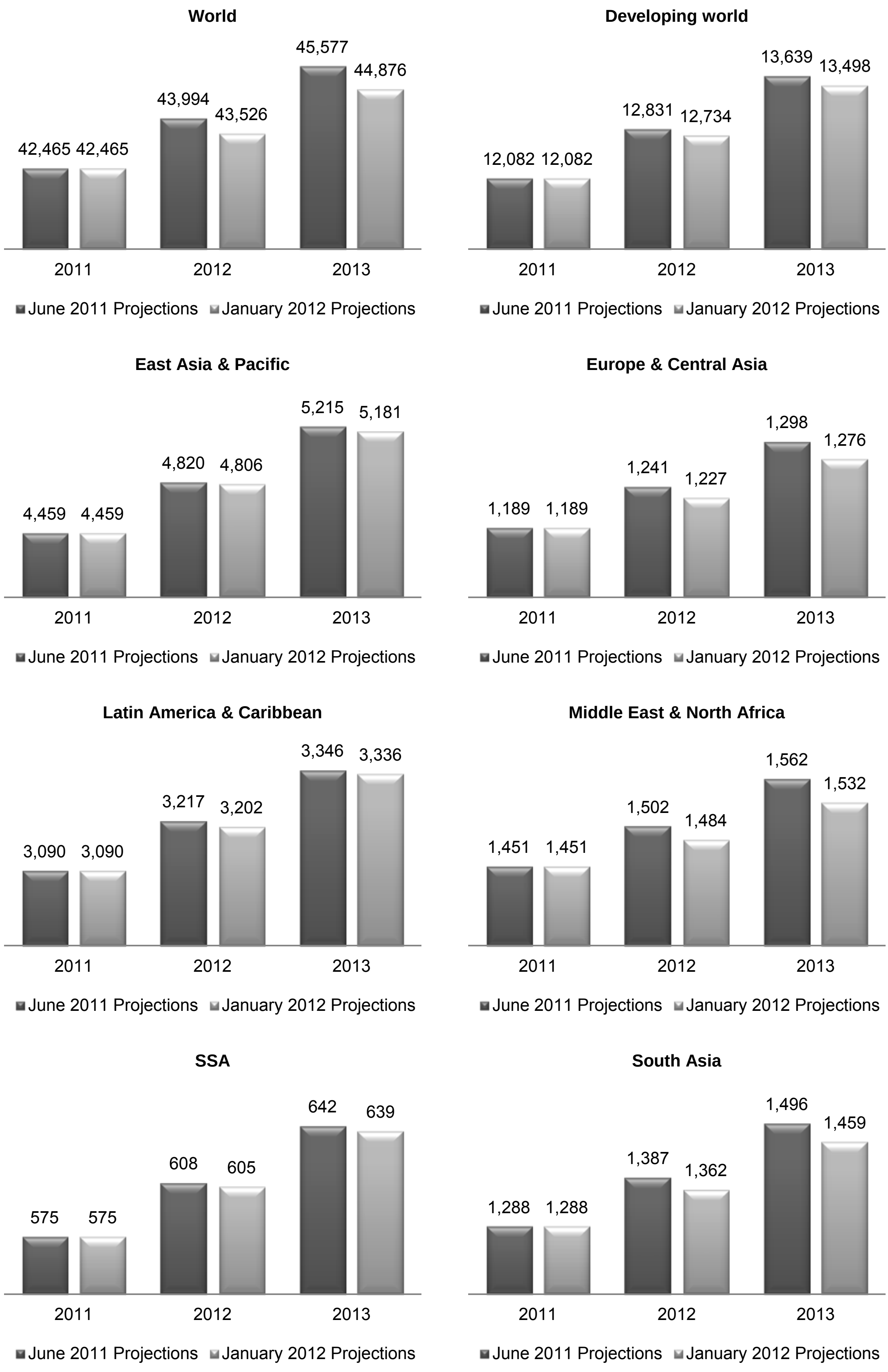
From a regional perspective the Middle East and North Africa is behind its developing world peers in terms of growth rates (Figure 37). Euro zone hurdles, together with domestic civil unrest, are hindering the region's potential, putting downward pressure on its economies. South Asia, on the other hand, has proven the most flexible and resilient region. Still, a slow-down is evident and a clear double-dip 'deceleration' can be appreciated from Figure 37, with regional growth rates peaking in 2007 at 9.1%, falling to 5.6% in the middle of the global financial crisis, and then recovering at astonishing pace to regain pre-crisis levels in 2010, before falling back to 6.1% in 2011 because of the euro zone crisis.

The magnitude of the euro zone crisis impact can be assessed by looking at the potential output loss for the world economy. Using the latest World Bank forecasts (June 2011 and January 2012), it is possible to estimate possible output losses over the period 2012–13, expressed in 2011 US dollars. In Figure 39 we show projected output in constant prices for the world, developing countries and the various developing regions.

Table 19 indicates that the output loss for the global economy over 2012–13 is expected to be close to 2011 US$ 1.2 trillion; almost the same impact that the 2008–9 global financial crisis was forecast to have on the world economy (US$ 1.4 trillion – see ODI, 2009), suggesting that indeed we are experiencing a double-dip recession. Unfortunately, the euro zone crisis is far from settled, and projections might prove to be optimistic. Consequently, cumulative output loss could be even greater. So far, the developing world is expected to bear a loss equal to 2011 US$ 237 billion due to the effects of the euro zone crisis.

From a regional perspective, output losses present a heterogeneous picture, with South Asia leading the way potentially loosing US$ 61.8 billion, followed by Middle East and North Africa and East Asia and Pacific, with US$ 47.4 and US$ 47.1 billion respectively. Then we have Europe and Central Asia with US$ 36.5 billion, followed by Latin America and SSA with US$ 25.1 and US$ 5.3 billion respectively. It is important to highlight that the regions which include Asian developing countries cumulatively lose around US$ 145 billion. This is particularly worrying, since the Asian region is one of the most dynamic in terms of trade and during the past global financial crisis allowed other developing regions to weather global uncertainties better through increased South–South trade flows. A slow-down in Asia will therefore definitely have an impact on the other less developed regions of the world, in particular SSA, which is so reliant on Europe for its exports.

Figure 39: June 2011 and January 2012 GDP projections (2011 US$ billion)



Sources: World Bank, World Development Indicators, Global Economic Prospects Report (June 2011 and January 2012) and authors' calculations.

Table 19: Cumulative output loss

Region	Period of cumulative output loss	Estimated output loss US$ billion, 2011
World	2012–13	-1,168.7
Developing World	2012–13	-237.6
East Asia & Pacific	2012–13	-47.1
Europe & Central Asia	2012–13	-36.5
Latin America & Caribbean	2012–13	-25.1
Middle East & North Africa	2012–13	-47.4
Sub-Saharan Africa	2012–13	-5.3
South Asia	2012–13	-61.8

Sources: World Bank, World Development Indicators, Global Economic Prospects Report (June 2011 and January 2012) and authors' calculations.

5 Country-specific effects

In this section we focus on the country-specific effects of the euro zone crisis that are apparent across some of the countries most highly dependent on the EU market, as identified in the previous sections of this report. We do this across indicators related to trade, remittances, finance, aid, governance etc. Table 20 (in Section 5.5) summarises these effects, which are drawn from a variety of sources. We briefly discuss each country case study in turn in the following sub-sections.

5.1 Mozambique

There are mixed reports regarding the effects of the euro zone crisis on ODA flows to Mozambique. On the one hand, the IMF's Third Review of Mozambique's performance under the Policy Support Instrument (2012d), published recently, notes that EU aid commitments to Mozambique for 2012 have largely been confirmed. Moreover, it states that although most European countries face intense budget constraints, any future change in aid volume or modalities is more likely to be the result of ongoing policy re-orientations among donors or their concerns on governance and the implementation of the poverty reduction plan than a direct impact of the sovereign debt and banking crisis.[18] However, on the other hand, it is reported that Portugal has reduced its economic ties with Mozambique, which includes public investments. For example, the first disbursement under the non-concessional Portuguese credit line to build road infrastructure was delayed; disbursements under the credit line's concessional window have also occurred at a slower pace than initially envisaged.[19]

The IMF (2012d) therefore warns that overall Mozambique is likely to face a levelling-off in net aid flows. At an aggregate level it is noted that net aid flows have already significantly declined from the global crisis-related peak of 14.5% of GDP in 2009 to 12.5% in 2010, and are projected to level off to below 10% from 2011 onward. These trends are however reflective of a reorientation among some donors but also the rapid growth of Mozambique's GDP (*ibid.*).

In relation to trade, Mozambique is reported to have achieved solid growth, reflecting rising mining output and strong global demand for minerals, including aluminium.[20] The current account deficit is projected to remain at around 11% of GDP in 2012; overall foreign exchange reserves and import cover are expected to remain robust into 2012 (*ibid.*). In relation to exchange rate developments, because South Africa is Mozambique's major import partner this bilateral exchange rate is considered the key determinant of price developments in Mozambique, particularly for food products. At present exchange rate developments have been stable – although it is noted by the IMF (2012d) that risks remain.

[18] *Ibid.*
[19] *Ibid.*
[20] See http://www.afriquejet.com/development-africa-euro-crisis-to-impact-heavily-on-oda-to-africa-2012032735838.html.

In relation to finance, the two largest Mozambican banks (which account for 60% of the banking system's assets) are owned by the three major Portuguese financial institutions that experienced funding pressures through their exposure to European sovereign risks. Even though it appears that Mozambican banks have generally remained resilient to the crisis, there is evidence that because of tight liquidity conditions and funding pressures from parent banks, they were forced to reduce their risk taking and curtailed credit growth. Moreover, analysis of aggregate intra-group cross-border flows suggests that large Mozambican banks which traditionally maintained substantial deposits in parent banks have curtailed their intra-group exposure over the past few months, in order to reduce vulnerabilities (IMF, 2012d).

5.2 Nigeria

There are concerns regarding the potential effects of the euro zone crisis on Nigeria's economy given that the euro area accounts for about 23% of the country's crude oil exports.[21] A drop in crude oil demand could have adverse effects on the country's export earnings. Furthermore, the non-oil sector may also be negatively affected as the euro zone accounts for around 25% of these total exports.[22] Remittances from Nigerians have already declined from US$ 12 billion to about US$ 5 billion in 2011 according to recent reports.[23] There is ongoing pressure on the Naira and foreign exchange reserves.

So far, overall the euro zone crisis has translated into volatility in prices for the commodities and products that Nigeria exports, and also volatility in the currency and the stock market.[24] The Central Bank of Nigeria is reconsidering its strategy of pegging its exchange rate to the US dollar which is running down their reserve capacity.[25]

The Nigerian Stock Exchange lost about 20% of its capitalisation in 2011.[26] The bulk of FDI in Nigeria is held by EU investors. The stock of FDI was estimated at US$ 75.7 billion in 2011, while the FDI inflow in 2011 was estimated at US$ 6.29 billion, representing 2.3% of GDP. There are concerns that project finance deals could suffer from shortfalls; Nigeria is not likely to tap the Eurobond market, a loss of enthusiasm for emerging market debt could impact Nigeria.[27]

Some of the European banks, such as the Union de Banques Suisses and the Royal Bank of Scotland, which have been downgraded by ratings agencies, act as correspondent banks for Nigerian banks. A squeeze on liquidity could therefore consequently affect lending conditions in Nigeria.[28] This has not occurred yet but there are concerns regarding the current outlook. In order to ensure the resilience of Nigerian banks to an increasingly uncertain and hostile macroeconomic environment a number of stress tests are being undertaken to ensure that institutions have adequate capital and assets to respond to various adverse scenarios. This is part of a general process intended to improve corporate governance.[29]

5.3 Kenya

According to a recent report by the Central Bank of Kenya (CBK), the debt crisis continues to have a significant impact on the Kenyan economy through its effects on exchange rate volatility.[30] Because of

[21] See http://allafrica.com/stories/201111300809.html.
[22] See http://nationalmirroronline.net/business/business-and-finance/31234.html.
[23] See http://saturday.tribune.com.ng/index.php/features/32959-moaning-as-remittances-from-abroad-decline.
[24] See http://www.bbc.co.uk/news/business-15968984.
[25] See http://thenewsafrica.com/2011/11/07/nigeria-not-insulated-from-euro-debt-crisis/.
[26] See http://triumphnewsng.com/article/read/1588.
[27] See http://www.thisdaylive.com/articles/anxiety-grows-over-spillover-of-eu-debt-crisis-in-nigeria/102671/.
[28] See http://thenewsafrica.com/2011/11/07/nigeria-not-insulated-from-euro-debt-crisis/.
[29] See http://allafrica.com/stories/201204020922.html.
[30] Central Bank of Kenya (2011).

continued pressure on Kenya's current account balance additional support was requested from the IMF in 2011. A foreign exchange bond was also launched by the government in 2011, targeting Kenyans in the diaspora. In addition, a sovereign bond has been programmed for issuance in 2012. In order to address liquidity shortages for commercial banks the CBK has adjusted cash reserve ratios, which will be monitored by the monetary policy committee in terms of effectiveness.[31]

Remittances jumped to KSh. 75.7 billion (US$ 891.1 million) thanks to CBK's aggressive marketing of the diaspora-targeted treasury bonds in 2011.[32] The CBK revised its investment procedures to allow Kenyans abroad to open accounts for buying treasury securities. In sum, the diaspora-targeted infrastructure bond sold last year attracted KSh. 13.5 billion, while a savings bond raised KSh. 19.5 billion. Reduced money transfer charges also encouraged more Kenyans to send remittances through formal channels, helping data collection (*ibid.*). These actions have been taken to avoid the adverse effects experienced during the global financial crisis of 2008–9, during which remittances dropped steadily from US$ 61 million in October 2008 to US$ 39 million in January 2009.[33]

Remittances are the fourth-largest source of foreign exchange in Kenya after export revenue from tea, horticulture and tourism.[34] According to recent estimates, the US is now the major source of most remittances to Kenya and other SSA countries.[35] These measures have boosted Kenya's foreign exchange reserves; however, despite these interventions, since 2010 Kenya's official forex reserves have not been able to cover the statutory four months of imports, even though they are at a level above what the authorities have agreed on with the IMF.[36]

Tea, tourism and horticulture together make up more than a third of Kenya's total exports. The EU is the major market for these products.[37] As a result of the euro zone crisis, in 2011 Kenya halved its earnings growth forecast for horticultural exports; 82% of which are destined for the EU, and for which cut flowers are the highest-value export. The price of cut flowers is reported to have fallen in 2011.[38] This is a result both of reductions in external demand and the recent depreciation of the Kenyan shilling. Between May and December 2011 the Kenyan shilling depreciated against the dollar by 13% as a result of a shift by investors from euro- to dollar-denominated assets. This subsequently increased the cost of imports, depleted foreign exchange reserves and widened Kenya's trade deficit.[39]

The euro zone crisis has also affected the stock market in Kenya. Indeed, there is evidence that the Nairobi Security Exchange (NSE) suffered heavy sell-offs. Foreign investors, for example, divested more than KSh. 715 million of their equity investments on the stock market in the 11 months to November 2011, setting the NSE on course to recording the first net sell-off by international participants in three years.[40]

Overall, the World Bank projects a growth rate of 5% for 2012 – if Kenya is successful in managing risks; if not, growth could drop to 3.1%.[41] It is noted that 2012 will be a defining year for Kenya. The establishment of a new system of devolved government, coupled with the possible deterioration of global economic conditions, will make the next twelve months extremely challenging. The bulk of the

31 Central Bank of Kenya (2011). .

32 See http://www.connection33.com/index.php?option=com_content&view=article&id=548:kenyans-in-diaspora-increase-remittances-to-cushion-relatives&catid=35:demo2.

33 Agbor and Kamau (2011).

34 See http://www.reuters.com/article/2012/01/30/kenya-remittances-idUSL5E8CUoM420120130.

35 See http://www.businessdailyafrica.com/Corporate+News/Europe+fiscal+woes+force+Kenya+export+market+into+lean+times/-/539550/1327616/-/l25jsm/-/index.html.

36 *Ibid.*

37 Fengler (2012).

38 See http://www.kenyalondonnews.co.uk/index.php?option=com_content&view=article&id=9190:eurozone-crisis-impact-on-kenya&catid=41:kenya-headlines&Itemid=44.

39 Agbor and Kamau (2011).

40 Bank of Ghana (2012).

41 See World Bank (2011).

decentralisation reforms will be implemented in 2012 and will impact Kenya's social stability, service delivery, and fiscal health for years to come. In responding to the euro zone crisis, Kenya's policy makers will need to find the fiscal space required to deliver on the promise of devolution, while protecting public investment.[42]

5.4 Cameroon

Over half of Cameroon's total exports in value terms are destined for the EU. Receipts from oil exports are the country's predominant source of foreign exchange earnings, as well as a substantial source of its government revenue: on average between 2000 and 2010 oil accounted for 46% of total exported goods and for 30% of total government revenue (World Bank, 2012b). The transmission channels to Cameroon's economy are expected to be similar to those observed during the 2008–9 global financial crisis (*ibid.*). These include through: deteriorating terms of trade; slower world demand for oil, timber, rubber, cotton and aluminium, resulting in a reduction in export volumes; tighter international liquidity conditions that lead to reductions in capital inflows and the postponement of some investments; and a decline in remittances.

The global linkages of the financial system of the CEMAC countries are still limited and the banking sector remains sufficiently liquid to meet the credit needs of the government and the private sector (Singh, 2012). The economic slow-down in the euro zone is expected to result in a reduction of exports and remittances. Some of the mitigating actions taken by the government so far in Cameroon so as to spur domestic demand include a simplification of the tax regime for small and medium sized enterprises. However, although these measures are expected to reduce the tax burden faced by such enterprises, and therefore to support their growth, they will result in a revenue shortfall for the government.

The budget in Cameroon does not rely heavily on aid, hence any adverse impact from lower aid following fiscal austerity measures in the euro zone should be limited (Singh, 2012). However scenario analysis has been undertaken by the World Bank country office in Cameroon of the minimum fiscal deposits required to cover about nine months of current spending. This is with a view to ensuring that Cameroon is sufficiently protected against shocks affecting fiscal oil revenues. At the end of 2010, however, net government deposits (measured as government deposits minus liabilities to the regional central bank) were sufficient to cover only 1.9 months of current spending.

Like the EU, the CFA zone – of which Cameroon is a member – encompasses a diverse group of countries in terms of GDP and economic productive structures. It has been in existence for more than 60 years, following its creation after the Second World War as part of the Bretton Woods agreement. Cameroon is a member of CEMAC, one of the two regional economic communities that make up the CFA zone (the other being WAEMU). CEMAC countries, which are mostly oil exporters, have been posited as benefiting from the euro zone crisis as a result of the recent depreciation which makes exports more competitive (Songwe and Moyo, 2012). For example, between July 2008 and December 2011 the euro depreciated by over 14% against the US dollar and by 20% against the Chinese Renminbi. Since the CFA franc is pegged to the euro, its depreciation should lead to increased competitiveness of CFA zone exports to the US, China and other regions. In 2010 about 41% of all exports from CFA countries went to the US (27%) and China (14%).[43]

However, because Cameroon is a member of the CFA franc zone it is obliged to deposit a large share of its foreign exchange reserves at the French Treasury. These resources are subsequently pooled across CFA countries, which means that individual members have no recourse to them. The long-term impact of the CFA peg to a depreciated euro, therefore, is a loss in the value of reserves held by CFA countries, as well as continuing constraint on monetary policy (UNECA, 2012).

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[42] *Ibid.*

[43] *Ibid.*

Given this, there are valid concerns regarding the adjustment to the currency peg arrangement, according to which the CFA pegged to the euro at an exchange rate of CFA 655.59 to €1, would fall to a rate of CFA 1,000.00 to €1. The last time this occurred, in 1994, there were adverse consequences for some members. In this sense the challenges of CFA countries are in many respects similar to those of the euro zone, with members unable to devalue so as to ensure competitiveness and adapt to adverse market conditions on an individual and country-specific basis.

5.5 Summary of country case studies

Table 20 summarises the effects apparent across the country case studies. These are rather diverse, although the trade and investment channels seem to be the major transmission mechanisms at the current time, as a result of reductions in demand in the EU market (fiscal consolidation effects) and financial contagion and exchange rate effects.

Table 20: Summary of current effects across country case studies

Country	Trade effects	Finance effects	Exchange rate effects	ODA effects
Mozambique	Solid growth reflecting strong demand for commodities	Evidence of tight liquidity conditions as parent banks (in EU) reduce risk and limit credit growth	Stable since the bilateral rate with South Africa is the key determinant of price movements	Portugal reported to have reduced and slowed flows
Nigeria	Decline in remittances. Reduction in demand in EU expected to affect oil and other non-traditional exports	Heavy sell-offs in stock market as a result of global flight to safety	Volatile exchange rate movements, reconsideration of *de facto* peg *vis-à-vis* US dollar	None apparent
Kenya	Decline in major exports destined for EU: horticulture, tea, tourism. Increase in remittances	Heavy sell-offs in stock market as a result of global flight to safety	Volatile exchange rate movements	None apparent
Cameroon	Decline in oil exports destined for EU anticipated	None apparent	CFA peg devaluation	None apparent

6 Conclusions and policy implications

The global economy has entered a new and dangerous phase. On the heels of the 2008–9 financial and economic turmoil the global economy is experiencing a sovereign debt crisis which is spreading across the EU region, weakening the moderate economic recovery in the developed world and raising fears of a double-dip recession. This poses important challenges for developing countries, which risk being affected by the euro zone crisis through three transmission channels: financial contagion, Europe's fiscal consolidation effects, and exchange rate effects.

From our analysis of a number of vulnerability indicators it emerges that:

(i) developing countries have a significant degree of exposure to a contraction in trade flows, capital flows, and ODA from the EU;
(ii) their ability to respond to the euro area crisis shock waves (resilience) is more limited than in 2007, before the outbreak of the global financial crisis.
(iii) the most vulnerable countries include Mozambique, Kenya and Niger among LICs, and Cape Verde, Moldova, Cameroon, Paraguay, and São Tomé and Príncipe among LMICs.

The exposure indicators assessed show that the EU remains the largest single trading partner for LICs and LMICs, even though its relative importance has been declining over time compared to BRIC countries. European countries are also among the largest investors in the developing world, although emerging economies, and in particular China, are increasing significantly their investment activities in poor countries. The EU is particularly active through FDI (especially in LDCs), as well as through cross-border bank lending (in particular in Emerging Europe and Asia and the Pacific), and bank lending through local affiliates (in Africa particularly in countries such as Mozambique, Ghana and Cameroon, among others). The EU Member States are also a key source of remittance flows and a key donor in several developing economies. A shock in trade flows, FDI, bank lending, remittances and aid from Europe is therefore likely to have a severe impact on poor economies. Our simulations show that a drop of 1% in export flows may reduce growth rates by an average of 0.5% in LMICs and 0.4% in LICs. Uganda, Zimbabwe, Cambodia, Paraguay, Bolivia, Guyana and Bolivia are likely to be among the countries hardest hit by export flow shocks.

The economic resilience indicators suggest that in the developing world, and in particular in LICs and LDCs, the policy space available to cushion the adverse effects of the euro zone crisis was narrower in 2010 than it had been prior to the 2008–9 global financial crisis. This is partly due to the fact that, unlike in 2007 when developing countries were in a very favourable situation, the onset of the euro area crisis in 2010 came at a time of only feeble recovery after the significant outlays made to introduce stimulus packages to respond to the previous financial crisis. Between 2007 and 2010, in several poor economies the fiscal account balances and current account balances deteriorated and external debt burdens remained fairly high. Moreover, although the level of reserves tended to increase, their value risks erosion by the exchange rate turmoil caused by the euro zone crisis, so that diversification of reserves by currencies seems urgent. As a consequence, the ability of developing countries to respond to the shock waves emanating from the euro area crisis is likely to be constrained if international finance dries up and global conditions deteriorate sharply.

Impacts of the euro zone crisis on developing countries became visible in 2011, particularly in the second half of the year. Since the last quarter of 2011, for example, there have been reductions in EU Member State imports from LICs and MICs in a number of product categories such as manufactured goods, machinery, and crude materials, among others. From a financial perspective, portfolio equity flows to developing countries declined considerably between 2010 and 2011, a number of investment plans were cancelled or postponed in a few poor countries such as Rwanda, and cross-border bank lending to developing economies (especially in Latin America and Emerging Europe) declined in the second half of 2011. Furthermore, major donors' aid to developing countries fell.

Nevertheless, it is important to highlight that the impacts of the euro zone crisis so far (at least from a trade and finance perspective) seem to be less severe than those of the 2008–9 global financial crisis. What makes the current situation really worrying for developing countries is that growth rates in emerging economies, including the BRIC countries (and China in particular), which have been the engine of the global recovery after the 2008–9 financial crisis, are now slowing down. So poor economies cannot rely on emerging markets to mitigate the effects of the European debt crisis and sustain their economic growth. Also, at the time of writing, the euro zone crisis is at serious risk of worsening.

What can policy makers do to help developing countries to weather the euro zone crisis? Even though there are no one-size-fits-all prescriptions for developing countries, given their high degree of heterogeneity, some general policy recommendations can be provided. At the country level, it is important to maintain fiscal soundness and macroeconomic stability, whilst encouraging growth to compensate for falling external demand, and to take actions aimed at limiting financial contagion, encouraging alternative drivers of growth, and protecting the most vulnerable parts of the population.

- Diversification in both markets and products should be promoted to reduce developing countries' vulnerability to economic shifts within rich economies as well as to commodity price shifts and market speculation. To this end, intra-regional trade and South–South trade should be enhanced, and appropriate incentives to start shifting from commodities to services and more processed products should be pursued.

- Domestic demand should be stimulated, since it may represent a buffer against international economic upheavals, particularly in countries with fiscal space.
- Financial regulation should be improved, and the operation of foreign banks as well as of their links with domestic banks should be closely monitored.
- Long-term growth policies should be promoted, focusing for example on adequate investment in infrastructure, health and education.
- Stronger and better targeted social safety nets should be put in place.

At the international level, multilateral institutions should ensure that adequate funds and shock facilities are in place to provide assistance to crisis-affected countries. In January 2012 the IMF said it would need US$ 600 billion in new resources to help 'innocent bystanders' who might be affected by economic and financial spill-overs from Europe. The agreement reached by the G20 in April 2012 to increase the funds available to the IMF by US$ 430 billion is therefore welcome. Although the euro zone crisis seems to emphasise the vital role of the IMF as a global lender of last resort, the actions of other multilateral institutions remain key for supporting poor economies in weathering its effects. The US$ 27 billion funding pledged in January 2012 by the World Bank to crisis-affected countries of Emerging Europe and Central Asia, for example, will allow these economies to support the private sector in keeping investment, incomes and jobs growing and to strengthen protection of the most vulnerable through social safety nets.

The 2008–9 global financial crisis also showed that short-term measures such as the Vulnerability FLEX mechanism (compensating for fluctuations in export earnings) put in place by the EU may be usefully extended in reducing the financial gaps in crisis-affected countries and helping them maintain priority spending in a context of deteriorating fiscal balances. Sufficient grants and concessional loans when countries are hit by external shocks need to be expanded in the light of increased frequency of such external shocks and growing evidence of their damaging effects (te Velde et al., 2011).

It is important that coordination between multilateral institutions remains a high priority. Adequate assistance and the avoidance of duplication of effort are essential in delivering an efficient and effective response to global shocks.

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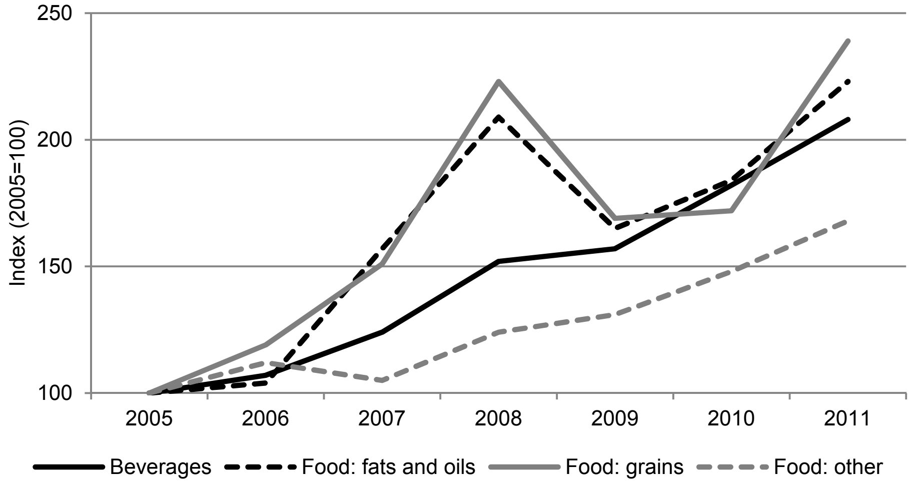
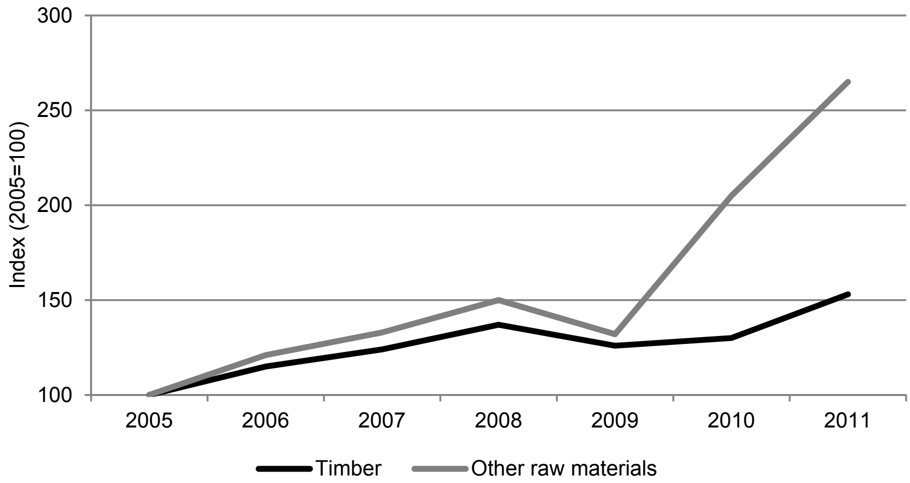
Annex

Annex Figure 1: Food and beverage prices (index, nominal US$)



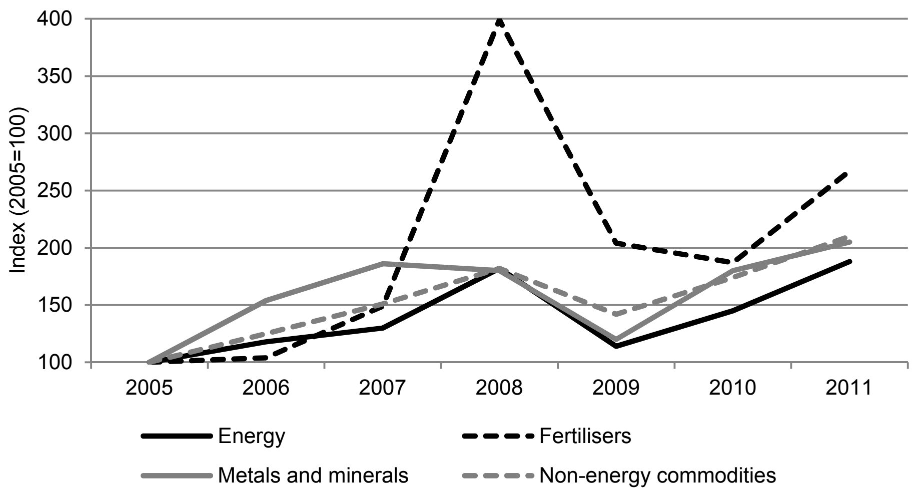
Source: World Bank, Global Economic Monitor Commodities.

Annex Figure 2: Raw materials prices (index, nominal US$)



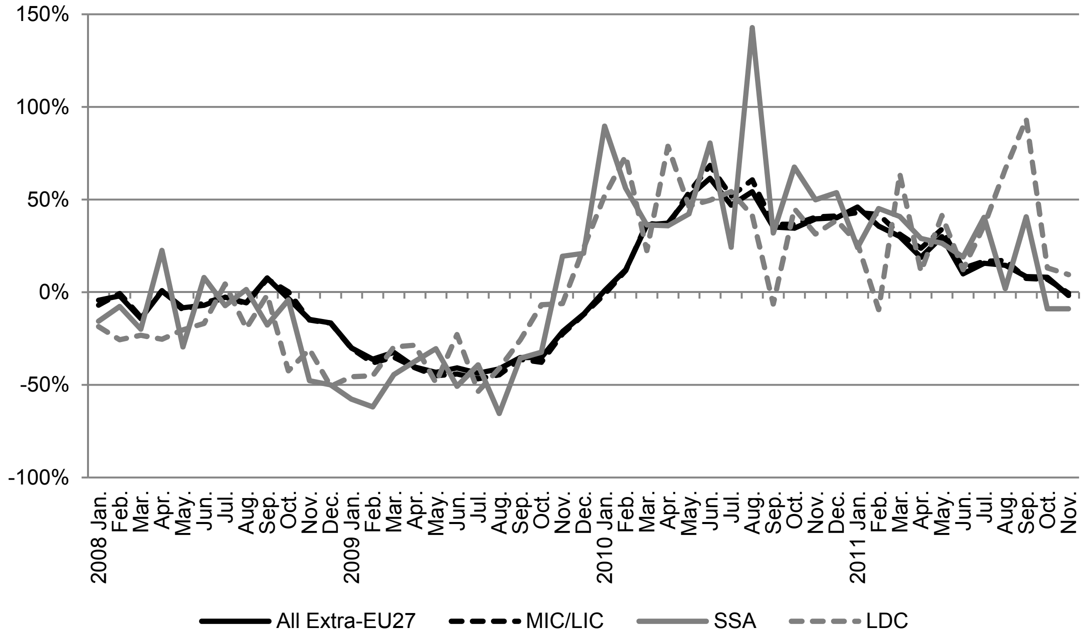
Source: World Bank, Global Economic Monitor Commodities.

Annex Figure 3: Other commodity prices (index, nominal US$)



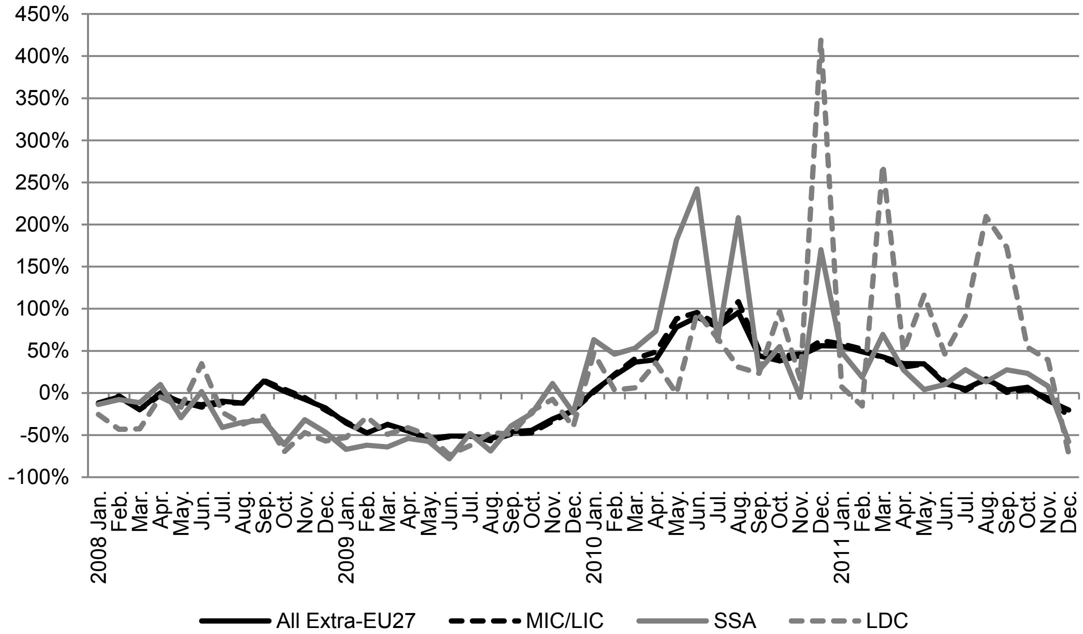
Source: World Bank, Global Economic Monitor Commodities.

Annex Figure 4: EU27 imports of manufactures classified chiefly by material (SITC 6): monthly year-on-year change, Jan. 2007–Nov. 2011



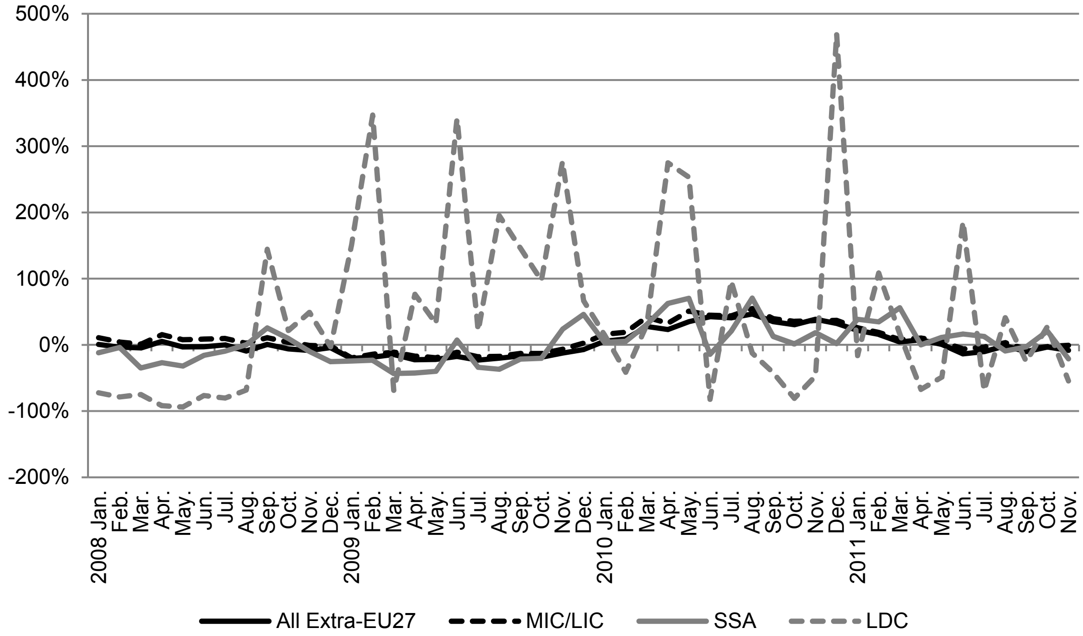
Source: Eurostat COMEXT database.

Annex Figure 5: Italian imports of manufactures classified chiefly by material (SITC 6): monthly year-on-year change, Jan. 2007–Dec. 2011



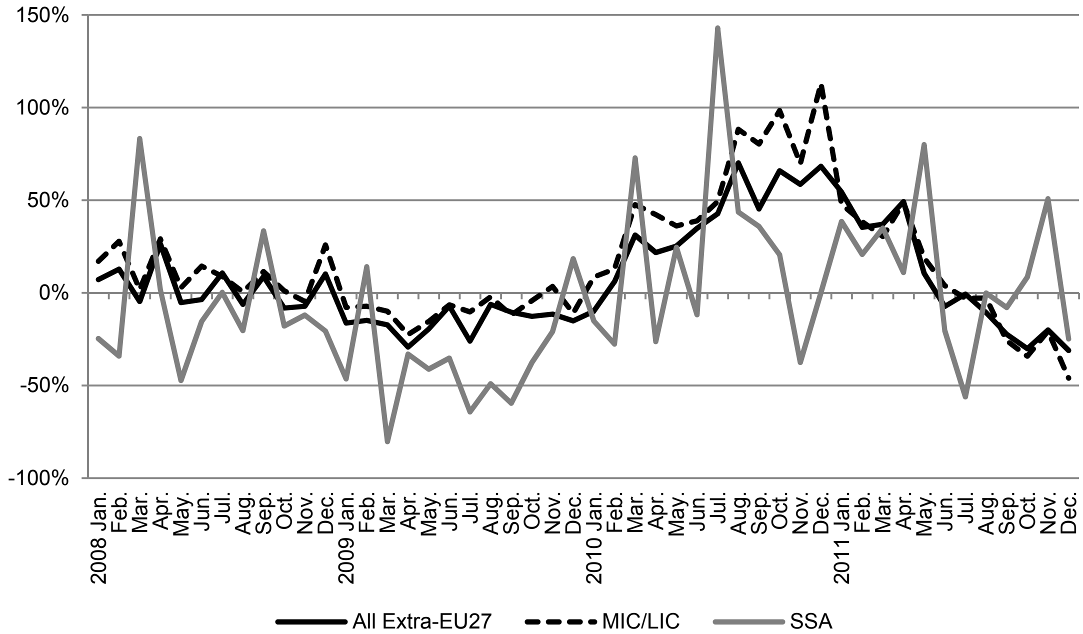
Source: Eurostat COMEXT database.

Annex Figure 6: EU27 imports of machinery and transport equipment (SITC 7): monthly year-on-year change, Jan. 2007–Nov. 2011



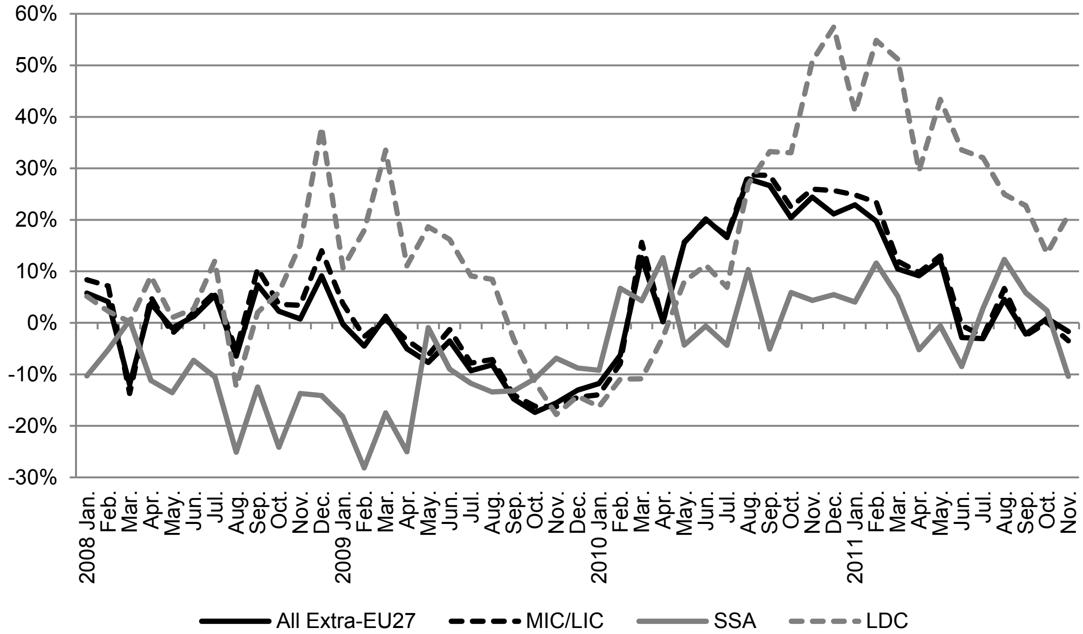
Source: Eurostat COMEXT database.

Annex Figure 7: Italian imports of machinery and transport equipment (SITC 7): monthly year-on-year change, Jan. 2007–Dec. 2011



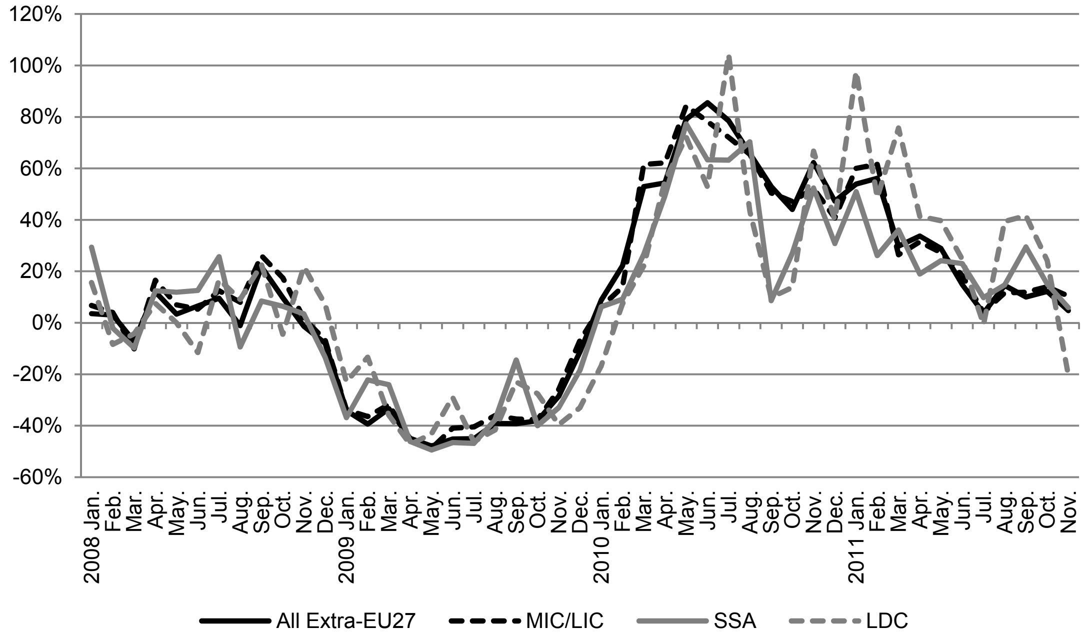
Source: Eurostat COMEXT database.

Annex Figure 8: EU27 imports of miscellaneous manufactures (SITC 8): monthly year-on-year change, Jan. 2007–Nov. 2011



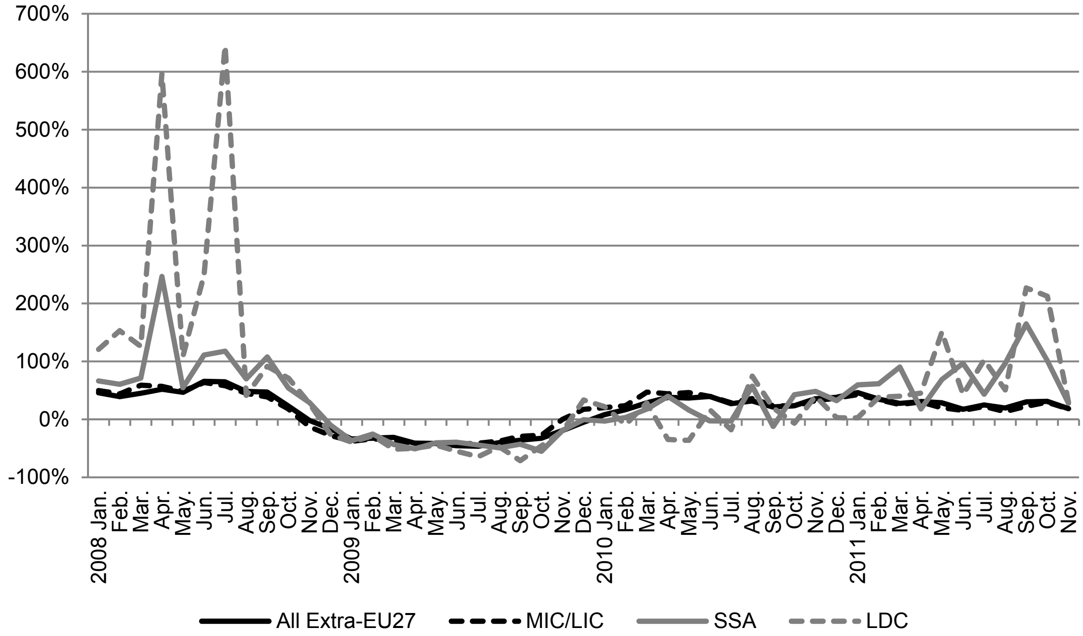
Source: Eurostat COMEXT database.

Annex Figure 9: EU27 imports of crude materials, inedible, excl. fuels (SITC 2): monthly year-on-year change, Jan. 2007–Nov. 2011



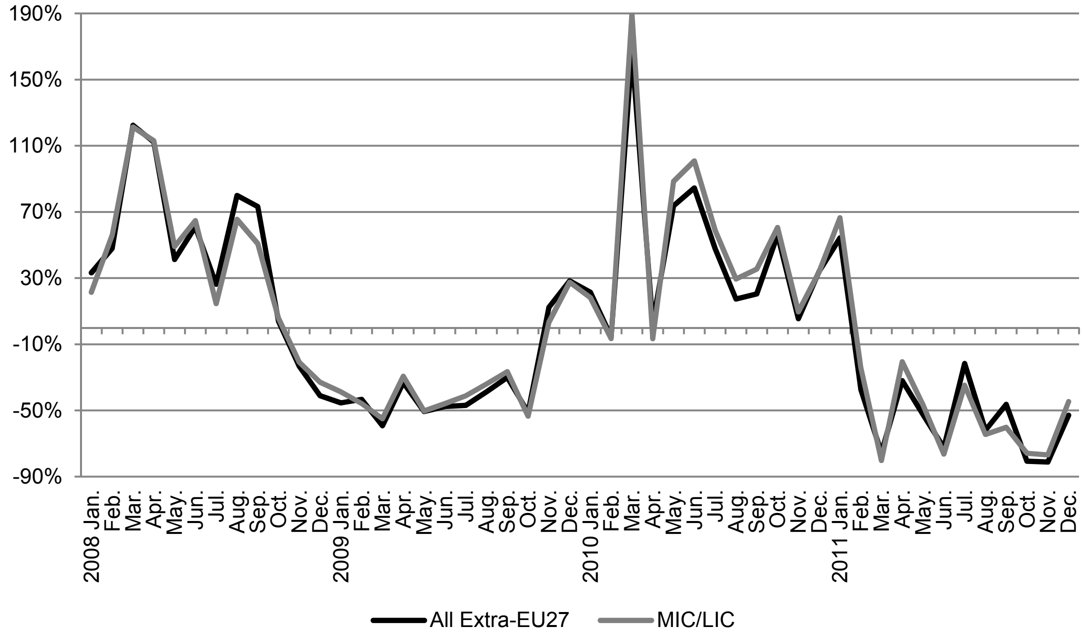
Source: Eurostat COMEXT database.

Annex Figure 10: EU27 imports of mineral fuels (SITC 3): monthly year-on-year change, Jan. 2007–Nov. 2011



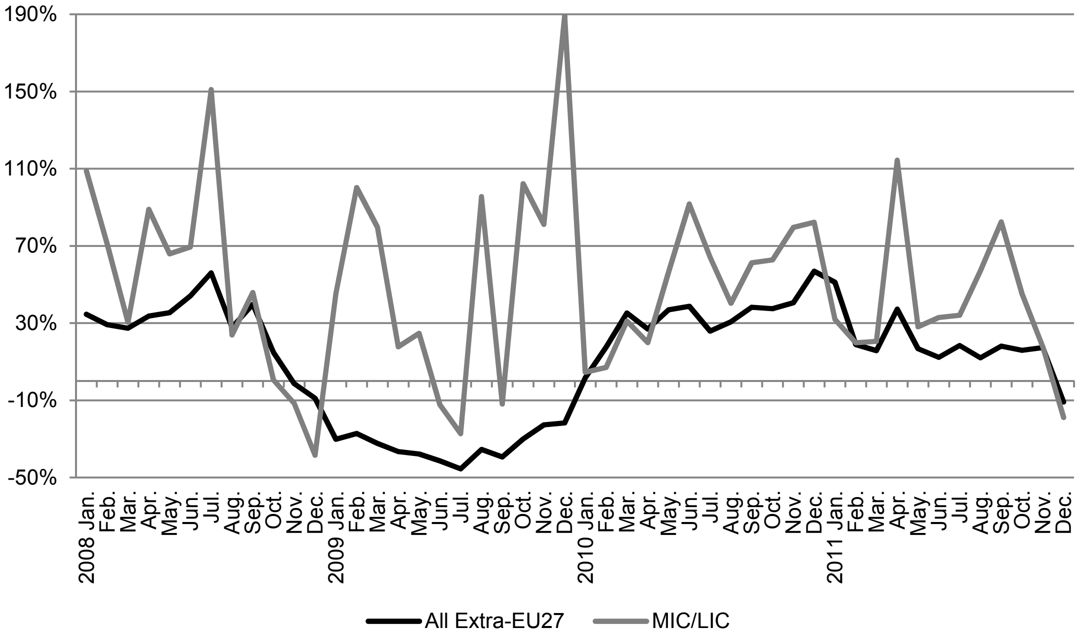
Source: Eurostat COMEXT database.

Annex Figure 11: Greek imports of mineral fuels (SITC 3): monthly year-on-year change, Jan. 2007–Dec. 2011



Source: Eurostat COMEXT database.

Annex Figure 12: Italian imports of mineral fuels (SITC 3): monthly year-on-year change, Jan. 2007–Dec. 2011



Source: Eurostat COMEXT database.

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ISBN 978-1-907288-66-1
Working Paper (Print) ISSN 1759 2909
ODI Working Papers (Online) ISSN 1759 2917