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Background Note

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The euro zone crisis: risks for developing countries

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Just as the world was finally showing some signs of recovery from the 2008-09 recession, the global economy is once again on the brink of meltdown. Fears of a sovereign debt crisis are spreading within the euro zone with Greece sliding towards what many analysts think will be a default. A crisis of confidence has emerged with the widening of bond yield spreads and the risk insurance on credit default swaps between euro countries. Global financial markets are in turmoil. Growth prospects in developed countries have been downgraded to just 1.5% this year, and global growth is expected to slow down by more than one percentage point between 2010 and 2012 (IMF, 2011).

Unemployment in Europe is on the rise, reaching its highest level for 17 years in the UK, and prospects are no better in the United States where the Senate has blocked President Obama's jobs bill. On the currency side, the euro has been losing ground against the dollar, while the Chinese yuan has been threatened recently by the US Congress to revalue or face trading sanctions.

What does this mean for developing countries, and in particular for low-income countries (LICs)? What makes the euro zone sovereign debt crisis different from the recent global financial crisis? Through what channels could the European debt crisis spread to the developing world? Are LICs prepared to weather a new global downturn? What policy options may be adopted by developing country policy-makers?

In this Background Note we first explore some of the key characteristics of the euro zone crisis. We then discuss the possible channels through which its effects may be transmitted to developing countries, and identify potential policy responses.

A different crisis? Now and then

The global economy is experiencing a sovereign debt crisis that is spreading rapidly across the euro region and threatening several Western economies including Greece, Ireland, Italy, Portugal and Spain. This is the second time in less than five years that rich countries have been responsible for pushing the world into dangerous waters. However, while the 2008-09 global financial crisis was triggered by the insolvency of US financial institutions, the roots of the current euro crisis can be traced to certain European governments' inability to manage their debt. Indeed, years of excessive government expenditure accompanied by low growth have led to an unsustainable debt burden in Greece, with the risk of a possible domino effect throughout the euro area and beyond.

Sovereign debt problems are not new; previous examples include Argentina in 2001 and the Latin American region in the 1980s. This is, however, the first time that such a crisis has occurred within a monetary union, which implies that – unlike Latin America in the 1980s – devaluation is not an option for Europe. Moreover, the magnitude of the European debts is far greater than that of Argentina in the early 2000s. The Greek debt is more than five times bigger: $483 billion against $95 billion. The Italian debt, the second biggest debt-to-GDP ratio after Greece, is even larger – about $2.5 trillion.

In addition to this, the current world geopolitical context is much more complex than it was a couple of years ago when the global financial crisis struck. At that time the G-20 economies moved quite quickly to coordinate a series of massive stimulus packages, but so far there is no prospect of a clear agreement to deal with the European sovereign debt crisis that risks dragging the world economy back into recession. Policy-makers knew what they had to do to prevent a 1930s style depression as they took action in 2008. But the euro zone crisis is different – there is no textbook response. What's more, the means that policy-makers have at their disposal are more limited as a result of the global financial crisis in 2008 and the stimulus packages launched at that time.

Developing countries in the eye of the storm

Transmission mechanisms

The euro zone sovereign debt crisis is likely to affect developing countries through three main transmission channels: financial contagion, Europe's fiscal consolidation effects, and exchange rate effects.

First, **financial contagion** to developing countries may occur in the form of spillovers through financial intermediaries and stock markets, as well as shifts in investor market sentiment and changes in investor perception of risks.

European banks hold a big share of Greek sovereign debt, with Germany, France and the UK holding $22.6 billion, $15 billion and $3.4 billion respectively. If Greece defaults, European banks may experience significant losses and, as a result, they may need to cut their credit lines in developing countries to restore their capital adequacy ratios. Recent estimates show that in the event of an 80% write-off of Greek debt, euro-area banks would lose over €63 billion. This amount might be even bigger if Greek default extends to other European economies such as Spain and Italy. Growing uncertainty on the full extent of European default may further limit bank liquidity, thereby increasing difficulties for developing countries in securing lines of credit on international markets.

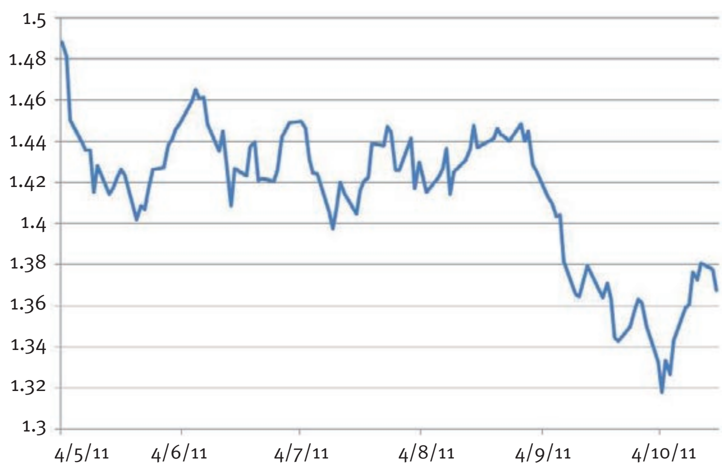
The euro zone crisis is also causing continuous turmoil in global stock markets. Global markets plunged 6.8% in August 2011, with European markets the worst performers: Germany fell 18.7%, Italy 14.9%, France 10.9% and Spain 8.8% (Brandt, 2011). Stock market volatility may have adverse consequences for developing countries. Prolonged sell-off in European equity markets, for example, could lead to fast withdrawals of money in developing countries, generating important adjustment problems.

In addition to this, the European sovereign debt crisis and fears of a new global recession have led to a collapse of investor appetite for risk, as seen in the Credit Suisse's Global Risk Appetite Indicator, which hit panic levels with a 30-year low (JP Morgan, 2011). Such changes in market sentiment may prompt delayed or cancelled investments and reduced portfolio flows in developing countries. Nevertheless, the European debt crisis may also lead investors to reallocate their portfolios from advanced country bonds into more attractive developing country bonds.

Second, austerity packages in several European economies have led to a considerable rise in unemployment and weakened growth that was still recovering from the previous global financial crisis. This may impact developing countries in several ways.

Fiscal consolidation plans, for example, have forced European governments to slash spending. The UK has announced the biggest cuts in state spending since World War II (£83 billion by 2014-15); in France there are plans to cut spending by €45 billion; and Germany has unveiled drastic public spending cuts totalling more than €80 billion. These cuts might lead to declines in aid to developing countries, adding to concerns in a context where several European coun-

Figure 1: US dollars to 1 euro, May-Oct 2011



Source: www.x-rates.com (accessed 19 October 2011).

tries were already struggling to meet aid targets after the global financial crisis.

Slower European growth may also have a severe impact on developing countries by reducing EU demand for commodities, manufactured goods and services. These effects will further undermine already weak EU imports, which have yet to reach pre-global financial crisis levels.

Unemployment in European economies is also on the rise. The euro area unemployment rate reached 10% in August 2011, with Spain leading the way with an astonishing 21%, followed by Ireland (14.6%), Slovak Republic (13.4%) and Portugal (12.3%). The US is also suffering, with an unemployment rate of 9.1%. This will certainly translate into fewer remittances to the developing world as immigrants struggle to maintain or find new jobs.

Third, exchange rate movements may also pose new challenges (and opportunities) for the developing world.

Euro depreciation against the dollar (Figure 1, overleaf) may affect trade flows in developing economies in two opposing directions. On the one hand, those countries with currencies pegged to the euro may actually benefit from a weaker euro that makes their exports more competitive in world markets. This might be the case for crude oil, cocoa, coffee and groundnut exports from the CFA zone countries in West Africa – although these also hold their reserves in euros, which could depreciate in real terms, in terms of months of import cover (Kang et al., 2010). On the other hand, countries with dollar-based exports will suffer from an appreciation of the dollar against the euro.

Trade in services may also be affected by a weaker euro as European tourists travelling to developing economies will have diminished purchasing power.

A weaker euro is also likely to reduce the value of remittances originating in Europe and flowing to developing countries.

Vulnerability to the euro zone crisis

The impact of the European sovereign debt turmoil on developing countries will depend on a number of structural and process factors.

Structural factors refer to exposure and resilience characteristics of developing economies. Poor economies are likely to be exposed to shock waves of the euro zone crisis for a number of reasons.

First, developing countries still have strong trade linkages with Europe (Table 1), even though the importance of the EU as an import and export partner was slightly lower in 2010 than it was in 2007, before the global financial crisis. Increased trade linkages with China has seen this country supplant the EU as the main partner for both imports and exports from Least Developed Countries (LDCs), with a 4.6 percentage point increase since 2007 in its share of LDC imports, and a 7.2 percentage point increase in its share of exports. This may cushion impacts from the euro zone crisis. If China also slows down, however, LDCs will be overly exposed. Over the same period the US has increased its share of LDC imports very slightly but has lost ground as an export market.

Second, developing countries also have strong financial linkages with European countries. Europe is a big investor in the world economy (including LICs), with EU Foreign Direct Investment (FDI) outflows accounting for a 31% share of global FDI in 2010. In

Table 1: Major trade partners for Least Developed Countries, 2007 and 2010

Import partners	2007			2010		
	Rank	euro (million)	%	Rank	euro (million)	%
World (all countries)		103,950	100.0%		145,688	100.0%
China	2	14,932	14.4%	1	27,671	19.0%
EU27	1	20,893	20.1%	2	23,883	16.4%
India	3	5,930	5.7%	3	8,537	5.9%
United States	5	5,019	4.8%	4	7,901	5.4%
Export partners	**2007**			**2010**		
	Rank	**euro (million)**	**%**	**Rank**	**euro (million)**	**%**
World (all countries)		79,291	100.0%		103,211	100.0%
China	3	16,802	21.2%	1	29,303	28.4%
EU27	1	17,923	22.6%	2	18,846	18.3%
United States	2	16,888	21.3%	3	17,855	17.3%

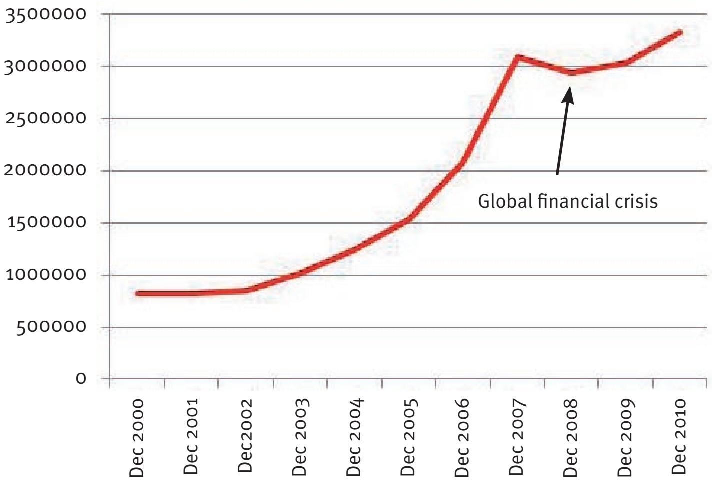
Source: http://ec.europa.eu/trade/issues/bilateral/dataxls.htm addition, the number of European banks in LICs has increased significantly during the past decade. Over the period 2000-06, 56% of foreign-owned banks in sub-Saharan Africa were European (mainly from the UK, France and Portugal; World Bank, 2008). This figure was even higher in Latin America, where 62% of foreign-owned banks in developing countries were European (with Spain leading the way with a 40% share). Cross-border bank lending from European banks to developing countries also increased between 2000 and 2010, despite a slowdown during the global financial crisis in 2008 (Figure 2). In March 2011 it amounted to more than 18% of total claims from European banks.

Third, Europe remains a key source of migrant remittances for the developing world. On average, remittances account for about 8% of LICs' GDP, with notable peaks in countries such as Tajikistan (39%), Nepal (22%), and Gambia (14%).

Finally, developing economies are still heavily dependent on development assistance from Europe. In particular, LDCs receive roughly half of their aid from Europe.

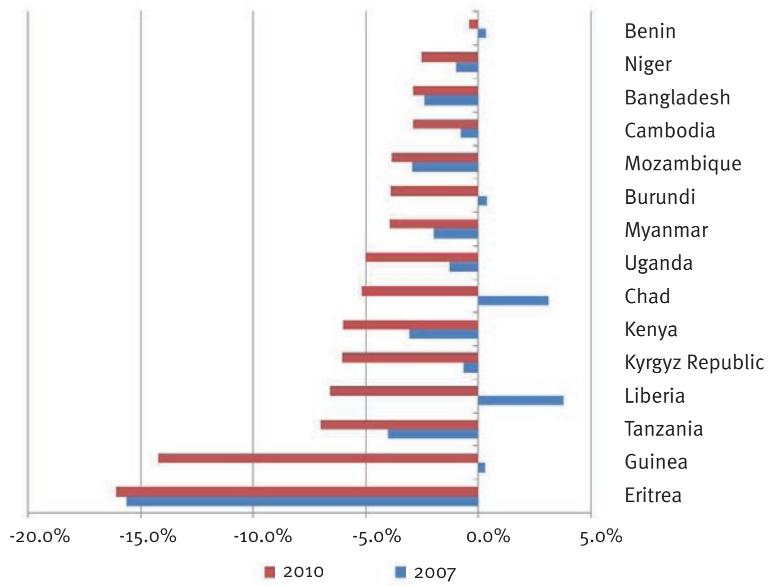
On the other hand, developing countries are likely to be less resilient to the effects of the ongoing debt

Figure 2: Cross-border bank lending to developing countries from European banks ($ millions), 2000-2010



Note: foreign claims on an immediate borrower basis.
Source: Bank for International Settlements Consolidated Banking Statistics, September 2011 (accessed October 2011).

Figure 3: Fiscal balance in 2007 and 2010 in selected low-income countries (share of GDP)



Source: IMF WEO database September 2011 (accessed October 2011).

crisis compared to the previous crisis, as their fiscal policy room is now much more limited. The data in Figure 3 (overleaf) reveal that several LICs have experienced a severe worsening of their fiscal balance as a share of GDP following the global financial crisis.

Looking at selected exposure and resilience indicators, Table 2 highlights the LICs that are relatively more vulnerable to the possible financial and real shocks of the euro zone crisis. Mozambique appears to be among the most vulnerable countries given its high dependence on euro zone trade flows – between 2007 and 2010 it experienced a dramatic increase in exports destined to the EU27 or euro zone countries – and on cross-border bank lending from European banks. It is also highly dependent on aid and has a significant fiscal deficit that has worsened since the global financial crisis. Kenya is also highly vulnerable because of its strong trade and financial linkages with European countries. On the other hand, Burkina Faso, Mali and Niger are likely to feel the effects of the euro zone crisis mainly through depreciation of the euro and lack of adequate fiscal policy space.

In addition to these structural factors, the extent of transmission of the euro zone crisis to developing countries will also depend on process factors, such as the ability of EU countries to coordinate and respond quickly to the crisis and the policy solutions implemented. So far, no agreement has been reached on how to respond to the crisis but three possible solutions are under discussion among euro zone leaders:

- an orderly default with a 50% write-off of Greek debt
- a strengthening of European banks that could be affected by potential government defaults within the euro area
- enhancement of the European Financial Stability Facility (EFSF) from €440 billion to around €2 trillion.

Table 3 (overleaf) summarises the transmission mechanisms and possible effects of the euro zone crisis on developing countries, as well as possible euro zone solutions.

Table 2: Vulnerability of selected low-income countries to the euro zone crisis

Country	Dependence on euro zone trade	Fiscal space in 2010 compared to 2007	Fiscal balance (surplus/deficit)	Remittances dependence	FDI dependence	Aid dependence	Dependence on cross-border bank lending from European banks	Peg to euro
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

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 aid dependence which was calculated using 2009 data, and cross-border bank lending dependence which was computed using the latest figure available (March 2011). Trade dependence: exports to euro zone/total export to world (%). Remittances dependence: 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 3: Transmission mechanisms, possible solutions, effects on developing countries

Channel	Possible euro zone solutions	Broad effects on developing countries, including LICs
Greek default: direct write-off for banks exposed to Greek debt (€109billion bailout)	Orderly bank default and recapitalised banks	• Direct pressure on European banks to hold more capital, and lend less (including to developing countries) • To the extent there will be deleveraging, there will be slower European growth • This will affect world/developing country growth, through trade and investment linkages • Because euro zone debt will need to be reduced, this might affect aid volumes
Contagion and spillover effects through loss of confidence: reductions in stock prices	Ensure banks are stress-tested and recapitalised Bailout fund/ESFS of sufficient amount (€440 billion could be leverage to €2 trillion)	• Loss in confidence will reduce consumption and investment, leading to a real decline in EU activity • This will, in turn, affect developing country growth through its effects on trade, FDI, remittances, etc. • A prolonged sell-off in European equity markets could lead to fast withdrawals of money in developing countries generating important adjustment problems • Changes in market sentiment may prompt delayed or cancelled investments and reduced portfolio flows in developing countries. But may also prompt investors to reallocate their portfolios from advanced country bonds into more attractive developing country bonds
Exchange-rate effects: loss of confidence in euro	Maintain value of the euro and avoid excessive volatility	• Loss of confidence in the euro may mean a depreciation of the euro against the dollar • Countries that operate a currency peg to a weakening euro (e.g. CFA zone countries in West Africa) might benefit through competitiveness effects in world markets, particularly in the case of dollar-denominated commodity exporters. But reserve amounts will depreciate in real terms if held in euros • Trade in services may also be affected by a weaker euro, as European tourists travelling to developing economies will have diminished purchasing power • A weaker euro is also likely to reduce the value of remittances originating in Europe and flowing towards developing countries

Source: Authors' elaboration on different sources.

Possible scenarios

But what might happen to LICs in the case of a Greek default? In line with our earlier discussion, Table 4 (overleaf) shows that several low-income economies have trade linkages with European countries, including those that are currently on the brink of a debt default.

If Greece defaults in an orderly way, with its effects contained within the euro area and European banks properly recapitalised, then the effects on the developing world – especially LICs – would be fairly moderate as trade linkages with Greece are relatively weak (see Table 4, column 2).

If, however, European authorities continue to delay action to counter the euro zone crisis, a disorderly default might become imminent. The magnitude and geographical reach of such a scenario is difficult to assess. However, it is reasonable to assume that a Greek default would knock consumer and investor confidence around the world and that Spain and Italy might be hit by the domino effect soon after. These countries have stronger commercial ties with LICs than Greece (see Table 4, column 3), which means that LICs' export flows could come under pressure.

In addition, the tightening of credit markets could make it harder for developing countries to borrow from international markets. Once this domino effect starts, it is unlikely to stop. Major European economies such as France, Germany and the UK would suffer heavy losses in their banking systems and might experience a contraction in their economies. LICs would then face severe pressures on their export flows, which would be further exacerbated by an inevitable decline in FDI, remittances, and development assistance.

Brace for impact!

Time is running out. Developing countries should not sit and wait for the Europeans to solve the crisis but should start to take steps themselves to limit contagion and encourage alternative drivers for growth.

Maintaining fiscal soundness and macroeconomic stability is a priority for developing economies in times of uncertainty. Furthermore, major efforts should be promoted to diversify trading partners and products, increase capital cushions for banks, and manage capital inflows effectively.

Whilst policy responses in 2008-09 were about preventing further crises, the main strategy now should be to focus on finding long-term solutions. Governments should pass the necessary reforms to improve their domestic business environment and provide the right incentives to start nurturing internal demand.

On their side, developed countries need to demonstrate leadership and coordination in tackling the European sovereign debt crisis as a matter of urgency. The next G-20 meeting in November should set out as its number one priority the achievement of a new international agreement to ease exchange-rate tensions and solve – once and for all – the euro zone crisis before it leads to a new 'Great Recession'.

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Table 4: Trade dependence of low-income countries on selected European countries

LIC exports to:	Greece	Spain, Italy, Portugal	Germany, France United Kingdom	euro zone	EU27	Total exports
	(% of total trade)					(% of GDP)
Burkina Faso	0.03	0.24	5.57	5.87	9.11	14.60
Burundi	0.05	1.00	16.16	17.62	31.00	17.10
Cambodia	0.07	2.74	7.25	11.90	16.68	49.28
Ethiopia	0.32	2.73	15.69	25.60	29.47	8.53
Kenya	0.03	1.39	12.96	13.06	23.92	16.46
Kyrgyz Republic	0.00	0.07	1.04	1.47	2.76	28.11
Madagascar	0.18	6.64	49.15	56.01	60.08	10.80
Malawi	0.72	2.82	11.41	28.59	36.75	20.85
Mali	0.06	6.16	1.74	7.66	8.47	20.87
Mozambique	0.18	6.30	1.09	61.73	62.38	22.91
Nepal	0.03	1.52	7.84	8.52	11.11	5.31
Niger	0.12	4.37	10.28	15.76	15.94	8.71
Rwanda	0.00	1.21	7.24	17.42	22.89	3.56
Tanzania	0.08	2.60	4.73	11.63	12.81	17.01
Uganda	0.32	6.77	10.13	26.05	30.95	6.77
Zimbabwe	0.04	3.61	4.92	7.94	11.24	42.80

Sources: World Bank's WDI, UN COMTRADE database (accessed October 2011).

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