The Global Economy – From Crisis toward Recovery: A Commonwealth Perspective

Paper by the Commonwealth Secretariat

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Executive Summary

A Global Recession Averted

1. Since Commonwealth Finance Ministers met in Cyprus a year ago the prospect of a prolonged global recession has clearly been averted. Success has been due to the unprecedented coordination of the international policy response to the global financial and economic crisis. The response has been led by the G20, including five Commonwealth G20 members, as well as several emerging and developing countries, including several Commonwealth members. The response has included unprecedented fiscal stimulus, unprecedented liquidity support by the international financial institutions and regional development banks, major steps to reform the international regulatory architecture and very large scale domestic adjustment, across advanced, emerging and developing countries.

Necessitating Deep, Uneven Adjustment

2. The crisis has forced adjustment in all countries. In advanced economies the 2009 fiscal stimulus has given way to large-scale and what for some countries will be likely to be prolonged fiscal consolidation and retrenchment, particularly in the economies whose financial systems were most adversely affected by the financial crises in 2007-2009. In these countries unemployment has escalated significantly and output, while now recovering, remains well below pre-crisis levels. Dynamic emerging markets suffered contagion from the financial crisis, spillovers, though less intense, to their banking sectors, sharply increased funding spreads, a fall off in net inward capital flows and consequent declines in output and unemployment. However, for these countries the crisis has had a less severe impact; and recovery has been far quicker.

3. For the poorest and smallest developing countries, a substantial number in the Commonwealth, adjustment has been deep and costly. Output has declined, unemployment in vulnerable sectors of the labour market has increased, external balances have very considerably weakened and reserves drawn down and fiscal space has been eroded. The crisis has severely tested social safety nets; and has set back progress in achieving poverty reduction goals, most particularly in the poorest and most vulnerable member countries of the Commonwealth. At the same time, sound macroeconomic, financial sector and regulatory policies going into the crisis have helped lessen the impact and contributed to policy capacity in the recovery phase. This has been particularly evident in sub-Saharan Africa.

Uneven Recovery Underway

4. A recovery – though uneven – is underway in global output and trade. The latest available estimates suggest that global output will increase by 4.6% in 2010, following a decline in global output of 2.1% in 2009. Global trade has also rebounded in 2010, following an unprecedented absolute decline in the previous year of more than 12% and a 23% decline in merchandise exports. Trade recovery has also been marked by the relative success of G20 efforts in 2009 to avoid trade protectionism. The recovery is occurring in advanced, emerging and developing countries, but is being led by emerging Asia and the largest economies in Latin America. In these regions, output is now running ahead of pre-crisis levels.

5. Small and vulnerable developing economies, including many Commonwealth members, are also recovering. But the pace of recovery is substantially lagging that in
developing countries as a whole. The longer-term institutional and poverty effects of the crisis are hampering recovery and causing it to lag in these countries. Ministers’ exchange of views on experience of recovery will be useful in determining what if any steps the Commonwealth can take to bolster efforts to accelerate recovery, reduce poverty and put vulnerable developing members back on the path to MDG attainment.

6. There have been accompanying improvements in global regulatory reform. Since Commonwealth Finance Ministers last met, there has been important progress in strengthening the international financial regulatory architecture, including recent proposals to reform prudential requirements for bank capital and liquidity. These proposals have yet to be finalised, but offer the prospect of addressing a major vulnerability exposed by the global financial crisis and limiting public finance exposure to the costs of future banking crises.

Medium Term Impacts and Risks

7. For several advanced economies, the crisis has brought major medium- and longer-term impacts. Unemployment has risen significantly, by some 7 million. In some of these countries, public indebtedness has soared, diminishing confidence and imposing a medium-term constraint on growth prospects and raising the prospect of prolonged fiscal retrenchment and consolidation. In dynamic emerging markets and some developing countries unemployment has increased markedly, with an additional 23 million people unemployed in emerging and developing countries as a whole. The crisis has particularly affected informal economies in developing countries, with the numbers of working men and women unable to keep themselves and their families out of poverty rising sharply.

8. In the smallest and poorest economies, many in the Commonwealth, the crisis has eroded resilience and exposed vulnerability. Limiting the social impact of adjustment has meant stripping away key components of these countries’ resilience capacity in the short term, particularly reserves and sources of fiscal space, so stunting the ability of these countries to quickly recover and return to pre-crisis levels of output and social development. For many small and vulnerable Commonwealth members, escalating external indebtedness has become an important medium-term impediment to the resumption of growth.

9. There are now several significant downside risks to a sustained recovery. Firstly emerging risks to global financial instability, from two sources. One source is the re-emergence of sovereign risk concerns, initially prompted by concern at fiscal sustainability in some Southern European countries from May 2010. This concern quickly escalated in mid-year to broader sovereign risk concerns. Subsequent Eurozone and IMF-supported intervention has moderated the financial stability risks from this source, but significant concerns remain. A comprehensive update is expected at the IMF/World Bank Annual Meetings. A second source of risk to global financial instability and hence a threat to recovery comprises the growing prospect of an erosion in collective policy action across advanced and emerging markets. Concern at a lack of international coordination in fiscal policy consolidation was allayed following the G20 Toronto Summit. But recent developments on currency markets have raised the prospect of potential competitive devaluations which might provoke a return to global financial instability.

10. Fiscal weakness in advanced economies represents a third key downside risk, focused on at length in this report. Fiscal balances in advanced economies have worsened and there has been increased focus on financial markets on fiscal weaknesses, particularly the impact of
high levels of public indebtedness on economic growth in advanced economies. Fiscal weaknesses and the implications for growth in these countries have significant implications for growth prospects in emerging Asia and for dynamic emerging markets more generally, particularly through strong trade and investment channels between these markets and those of advanced economies, particularly in Western Europe.

A Focus on Small States

11. The crisis has exposed the particular vulnerabilities and lack of resilience of many Commonwealth small states. And has highlighted several key challenges if resilience is to be strengthened and growth restored. Among these are the continued need to address institutional and capacity shortfalls, deepen policy implementation, limit shortfalls in external financing gaps of a number of Commonwealth small states and developing countries and reduce the indebtedness of small and vulnerable Commonwealth states - which has deepened during the crisis and stunted prospects for recovery - through the identification and implementation of innovative short- and medium-term options. Lessons from the crisis for Commonwealth small states were addressed at a global Small States meeting held at Marlborough House in July 2010.

Key Questions

12. Commonwealth Finance Ministers are meeting in a period of uncertainty regarding the sustainability of the global recovery, the ability to maintain and implement coordinated global responses to address key downside risks and in the context of an acute need for Commonwealth member countries to achieve a steady-state recovery and resumption of pre-crisis levels of output, employment and social development. Ministers are meeting on the day preceding the meetings of the International Monetary and Finance Committee (IMFC) and Development Committee (DC), presenting an opportunity to provide specific views on issues on which a Commonwealth-consensus might emerge.

13. Among multiple questions for Ministerial consideration and discussion, Ministers may wish to express views on the following:

- What key policy measures are required to best protect and encourage the nascent global recovery?
- How can the emerging downside risks to recovery best be addressed?
- How can recovery be accelerated, resilience built and vulnerability reduced, in the smallest, poorest and most vulnerable members of the Commonwealth? And how can Commonwealth members contribute to these initiatives?
- How can social safety nets be strengthened in Commonwealth member countries, particularly those most impacted by the crisis and where recovery has been weakest?

14. Other relevant questions for Ministers are identified in the text of the report.
I The Global Economy – From Crisis toward Recovery

Introduction

1. Commonwealth Finance Ministers are gathering for their annual meeting in Washington DC in October 2010 in an uncertain global policy environment. A global recession has been averted through multiple domestic and international policy actions over the past eighteen months and a cautious recovery is underway. But the short-term and medium-term outlooks for the global economy are uncertain, with several key uncertainties, including regarding the path and sustainability of fiscal consolidation, particularly in the advanced economies; and heightened concern with sovereign risk, following financial shocks in several Southern European countries in the second quarter of 2010.1 As a result the outlook for the global economy and prospects for a sustained global recovery have undergone sharp corrections in the past six months. And while Ministers are meeting in a more optimistic and forward-looking environment than at any time since late-2006, they are doing so in the context of a global economy severely damaged in the past year by the economic and financial crisis, with potential global output having suffered a substantial downward correction and in the context of an erosion of resilience, built up over many years of consistent policy effort, in many of the Commonwealth’s smallest, poorest and most vulnerable states.2

2. The past year has witnessed a modest recovery from the global financial and economic crisis. Key factors have been the unprecedented scale and immediacy of the G20 members’ collective fiscal policy stimulus from 2009; unprecedented monetary easing, which has continued throughout 2010; extensive and continuous reform of domestic financial systems and of the global financial regulatory architecture; a concerted focus on reviving global trade, including the infusion of new, large-scale trade financing facilities and a commitment by the large advanced economies and emerging markets – largely fulfilled – to avoid trade protectionism during the crisis; an unprecedented financing response by international financial institutions including the International Monetary Fund and the World Bank, coupled with adjustments to these institutions’ access limits, new financing instruments and conditionality policy; and unprecedented domestic adjustment, in advanced, emerging and developing countries.

3. A cautious recovery from late-2009 unravelled in the second quarter of 2010, with new financial shocks precipitating uncertainty regarding the pace and momentum of the recovery Consequently in the past six months there has been increased market sensitivity to sovereign risks, brought about by concern over fiscal positions and competitiveness in Greece and other Southern European countries, resulting in sovereign debt downgrades in these countries. In mid-2010 these concerns spread to the banking sector, precipitating a withdrawal of interbank lending, raising funding spreads and prompting a sell-off of some euro-denominated assets and assets elsewhere, including in emerging markets.

4. The subsequent conclusion of a major Euro-zone and IMF supported programme has helped allay fears of a broader-based deterioration in sovereign risk. But both the pace and prospects for a steady recovery in global output and in the resumption of capital flows to pre-crisis levels have clearly been affected. Prospects for steady global recovery also hinge on the nature of the response to several substantive risks, including fiscal policy, financial sector

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1 For example IMF (2010a; 2010b), World Bank (2010a); OECD (2010a; 2010b), UNCTAD (2010); ILO & IMF (2010).
2 See Marlborough House Small States Consensus, July 2010, Commonwealth Secretariat.
risks and the outcomes to many major ongoing international financial architecture reforms, initiated in the midst of the 2008-2009 financial crisis.

5. As Commonwealth Finance Ministers convene in Washington DC, on the eve of the IMFC and DC meetings, key decisions are needed, to accelerate the pace and quality of recovery and the resumption of growth, particularly in the poorest developing countries and those most adversely affected by the global economic crisis. The purpose of this paper is not to provide a detailed treatment of these risks, which are dealt with substantively elsewhere, particularly in the documentation to be submitted shortly by the IMF and World Bank ahead of the 2010 Bank/Fund Annual Meetings; but to examine the nature and quality of the global recovery, particularly from the perspective of the Commonwealth’s poorest and most vulnerable developing countries and those which have had the most limited capacity both to respond to the crisis and to secure gains from the nascent global recovery. The lessons from the global crisis and from the early stages of the recovery highlight that a wide range of actions are required, to rebuild resilience and safety nets and to restore growth and employment across the Commonwealth.

6. This is the first of two papers prepared by the Secretariat for CFMM 2010 on the aspects of the global crisis and recovery and focuses on the prognosis for recovery across Commonwealth member countries. A second paper (CFMM(10)05) considers the persistent indebtedness of a number of small vulnerable economies, particularly in the Commonwealth. This challenge has been accentuated by the crisis; and has not been allayed by the recovery. The paper outlines the nature of this challenge and the importance of resolving it; and outlines a number of potential innovative solutions to seek to address it.

<table>
<thead>
<tr>
<th>Key Questions in the Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Three key questions may be of particular relevance to Minister’s discussion of the quality, nature of and prospects for global economic recovery:</td>
</tr>
</tbody>
</table>

- What have been member countries’ specific experiences in emerging from crisis toward recovery? Are there specific policy lessons for the broader membership?

- Where consensus exists, how can lessons and recommendations be conveyed to the IMFC and DC, as representing the collective view of Commonwealth Finance Ministers?

- For the smallest and most vulnerable Commonwealth members, what opportunities are there for Commonwealth advocacy, partnership and intensified work by the Commonwealth Secretariat, to help consolidate recovery and address the longer-term impacts of the crisis? |
Global Output and Trade

7. Global output and global trade have recovered significantly in the past year. Yet the global recovery has been uneven, erratic and incomplete, with encouraging evidence of upside prospects, but also substantial downside risks. Global output declined by 2.1% in 2009, reflecting the impact of the global crisis. Table 1 and Figure 1 below highlight extraordinary contractions in output in advanced economies (3.3%) and although many developing countries registered positive growth rates through the crisis, most experienced significantly slower output expansion, with the average GDP growth in emerging and developing countries contracting from 6.1 per cent in 2008 to 1.7 per cent in 2009.

Table 1: Growth in Global Economies

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010(f)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World(^1)</strong></td>
<td>4.0</td>
<td>3.7</td>
<td>1.6</td>
<td>-2.1</td>
<td>3.3</td>
</tr>
<tr>
<td><strong>High-income countries</strong></td>
<td>3.0</td>
<td>2.6</td>
<td>0.4</td>
<td>-3.3</td>
<td>2.3</td>
</tr>
<tr>
<td>United States</td>
<td>2.8</td>
<td>2.0</td>
<td>0.4</td>
<td>-2.4</td>
<td>3.3</td>
</tr>
<tr>
<td>European Union</td>
<td>2.9</td>
<td>2.6</td>
<td>0.4</td>
<td>-4.1</td>
<td>0.7</td>
</tr>
<tr>
<td>Japan</td>
<td>2.4</td>
<td>2.1</td>
<td>-1.2</td>
<td>-5.2</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>Developing countries</strong></td>
<td>7.7</td>
<td>7.9</td>
<td>6.1</td>
<td>1.7</td>
<td>6.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>3.8</td>
<td>5.4</td>
<td>5.1</td>
<td>-0.2</td>
<td>6.4</td>
</tr>
<tr>
<td>Russia</td>
<td>7.4</td>
<td>8.1</td>
<td>5.6</td>
<td>-7.9</td>
<td>4.5</td>
</tr>
<tr>
<td>India</td>
<td>9.7</td>
<td>9.0</td>
<td>5.1</td>
<td>7.7</td>
<td>8.2</td>
</tr>
<tr>
<td>China</td>
<td>11.6</td>
<td>11.9</td>
<td>9.6</td>
<td>8.7</td>
<td>9.5</td>
</tr>
<tr>
<td>South Africa</td>
<td>5.4</td>
<td>5.1</td>
<td>3.7</td>
<td>-1.8</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Sub-Saharan Africa</strong></td>
<td>5.9</td>
<td>6.3</td>
<td>5.0</td>
<td>2.0</td>
<td>5.0</td>
</tr>
</tbody>
</table>

Notes: \(f\) = forecast, \(^1\) = estimates based on purchasing power parity weights.

Figure 1: The Global Economic Crisis: 2008-09
8. Most recent available revised estimates for 2010 point to a significant improvement in comparison with 2009, with global growth for 2010 projected at 4.6%, particularly reflecting stronger activity in the first half of 2010. The recovery has been driven by a return of private demand, growth in industrial production and trade - with both of the latter registering double-digit growth - as well as robust growth in Asia, Latin America and many emerging and developing economies.

9. Output in advanced economies is expected to expand by 2.5% in 2010; and at a similar rate in 2011. Key challenges to sustained recovery in these comprise high levels of public debt, unemployment and the revival of bank lending. Output in emerging and developing countries has recovered far faster. Output in these economies declined to 2.5% last year (2008: 6.1%), but is now projected to exceed pre-crisis levels in 2010, registering an estimated 6.8%. The recovery is being led by emerging Asia and the larger economies in Latin America, with both regions registering strong revivals in private domestic demand and in exports. In China the economy is expected to grow by 10.5 per cent in 2010, slowing to 9.5% in 2011. In India growth in 2010 is forecast at 9.5% in 2010, with strong corporate profits and robust financing conditions promoting investment. Australia and New Zealand are projected to achieve growth of approximately 3% in 2010, driven by strong commodity prices and stronger private domestic demand. Growth is expected to accelerate to 3.5% next year.

10. Global trade has recovered strongly, resulting in a robust and widespread recovery in Latin America and in emerging Asia. The recovery in global trade has also supported recovery in a number of developing countries. One of the most direct and immediate consequences of the global economic crisis was the collapse of international trade. The 2009 global recession resulted in the largest decline in worldwide trade in 70 years. The rate of growth had already slowed down to 2.1% in 2008, but this was followed by an unprecedented absolute decline of more than 12% in 2009 (Figure 2). All product groups that had seen the fastest growth in international trade declined massively. For example, trade volumes of iron and steel declined by more than 45%, automotive products by 32%, and industrial machinery by 29%. Trade in manufacturing declined by 21%, with all major global exporters suffering both in terms of their merchandise as well as service exports (Table 2). Although services trade turned out to be relatively resilient, world commercial services exports declined by 13% in comparison with 23% for merchandise exports.

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3 IMF World Economic Outlook Update, July 2010.
Table 2: Growth of Merchandise and Services Exports of Major Economies (annual percentage change in value terms)

<table>
<thead>
<tr>
<th>Regions</th>
<th>Merchandise exports</th>
<th>Commercial services exports</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007</td>
<td>2008</td>
</tr>
<tr>
<td>World</td>
<td>16</td>
<td>15</td>
</tr>
<tr>
<td>United States</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>European Union</td>
<td>16</td>
<td>11</td>
</tr>
<tr>
<td>Brazil</td>
<td>17</td>
<td>23</td>
</tr>
<tr>
<td>Russia</td>
<td>17</td>
<td>33</td>
</tr>
<tr>
<td>India</td>
<td>23</td>
<td>30</td>
</tr>
<tr>
<td>China</td>
<td>26</td>
<td>17</td>
</tr>
<tr>
<td>South Africa</td>
<td>20</td>
<td>16</td>
</tr>
<tr>
<td>LDCs</td>
<td>25</td>
<td>32</td>
</tr>
</tbody>
</table>

Note: “Not available” is indicated by n.a.

Inflationary Expectations

11. **Inflationary expectations** in the recovery differ widely. In advanced economies, inflation is expected to remain at approximately 1.5% in both 2010 and 2011, contained by continuing low levels of capacity utilisation and low inflationary expectations. As a consequence, monetary policy is expected to remain accommodative for these economies for the foreseeable future. By contrast, inflation in emerging and developing economies is expected to increase to from 5.2% (2011) to 6.2% in 2010 and in the course of 2010, monetary conditions in some of the fastest growing emerging economies have been tightened.

Unemployment

12. **Unemployment** has increased in all parts of the world, as a result of the global crisis. Notwithstanding the use of extensive mechanisms to support labour and to stimulate labour demand during the crisis, including direct job subsidies, wage subsidies and reductions in payroll taxes, all targeted to specific groups most vulnerable to joblessness, unemployment has sharply increased. A most recent joint IMF/ILO report finds that over 210 million people across the globe are estimated to be unemployed at present, representing an increase of 30 million since 2007. An estimated 7 million newly unemployed are in developed economies and 23 million are in developing countries. Within advanced economies there have been severe challenges, despite the operation of automatic stabilisers including unemployment insurance benefits and the use of extensive short-term mechanisms to support those most vulnerable to joblessness. The most severe challenge has been experienced in the US, with an increase in the number of unemployed of some 7.5 million people since 2007. The crisis has resulted in a 3% increase in the unemployment rate in advanced countries; and by 0.25% in emerging economies, with the largest increases occurring in Spain, the US, New Zealand and Taiwan (China). Both youth and long-term unemployment have increased significantly.

13. The joint IMF/ILO report also notes that the human costs of unemployment of the nature experienced during the crisis and through the nascent recovery are also very

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substantial, comprising inter alia lower lifetime earnings, significant costs to health and to children, with loss of schooling achievement and the loss of earnings prospects of children whose parents have become unemployed. These findings support evidence elsewhere (UNESCAP (2010), UNDESA (2009, 2010), pointing to the permanent deterioration of health and welfare through the severe unemployment brought about by the crisis, in developing countries in the Caribbean, Pacific, South Asia and Sub-Saharan Africa. It is estimated that an additional 440 million new jobs will need to be created to absorb new entrants to the global labour market; and multiple policy responses will be needed to support labour market recovery in 2010 and beyond. In the short- and medium-term these include maintaining aggregate demand, through maintaining accommodative monetary policy and avoiding uncoordinated and severe fiscal consolidation.

**Fiscal Deficits and Consolidation**

14. *Fiscal deficits* have significantly increased in 2009/2010, with the global crisis precipitating much weaker fiscal positions, particularly in the advanced economies. As was the case during the crisis, fiscal responses in the recovery have varied widely among countries, depending on the extent of discretionary fiscal stimulus incurred during the crisis, the optimal timing of stimulus withdrawal, specific national macroeconomic, fiscal and other policy circumstances and the speed of recovery. A key development for many of the most vulnerable and poor economies, which started and have endured the crisis with little or no fiscal space, has been the erosion of social safety nets as a result of prolonged periods of crisis and a persistent and very substantial external financing gap.

15. As the nascent recovery has proceeded, an emerging challenge and increasing imperative has been for the G20 countries, which spearheaded the 2009 global fiscal stimulus and particularly the advanced economies within the G20, to commit to credible medium-term adjustment plans, based on national circumstances. A considerable part of G20 discussion at Deputies and Ministerial level during the second half of 2010 has been devoted to achieving this objective. IMF recommendations have included the establishment of legislation including multi-year targets, reforms to pension entitlements and public health care systems, strengthening fiscal institutions and making some planned non-entitlement spending permanent. Progress has been cautious and there has been increased market perception of relatively slow progress. At the G20 Toronto Summit, advanced economies committed to medium-term fiscal plans designed to stabilise or reduce government debt to GDP ratios by 2016, in line with IMF recommendations.

16. The crisis has adversely impacted global progress toward the elimination of poverty. And impressive gains achieved in the pre-crisis period have been eroded. Extreme poverty has continued to fall, declining by 40% since 1990. The sharpest reductions have been recorded in Eastern Asia. In China the rate of poverty is expected to decline to approximately 5% by 2015. In India, poverty rates are expected to decline from 51% in 1990 to 24% in 2015, with the number living in extreme poverty decreasing by 188 million people. Poverty in sub-Saharan Africa has also continued to fall. However poverty rates have fallen more slowly as a result of the crisis, with the World Bank estimating the global poverty rate to be 15 per cent by 2015, instead of 14.1% in the absence of the crisis; and the poverty rate for sub-Saharan Africa (SSA) to decline to 38% by 2015, in contrast to an estimated 36% had the

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crisis not occurred, resulting in 20 million fewer people being lifted out of poverty in SSA. Notwithstanding the erosion of prospects for poverty alleviation, many regions, including SSA, have proved more resilient than first anticipated, to the poverty impacts of the crisis. The World Bank and IMF note five key factors which have cushioned the impact of the latest global crisis. These comprise better policies and institutions, stronger economic performance, higher aid, lower debt and a beneficial external environment.

**Millennium Development Goals and Poverty Reduction**

17. Similarly, the crisis has slowed progress toward the achievement of the **Millennium Development Goals**. A recently released and seminal report on MDG progress finds that progress on poverty reduction is still being made, despite significant setbacks due to the 2008-2009 economic downturn, and food and energy crises. In addition, since the launch of the MDGs a decade ago, there have been major advances in school enrolment in many of the poorest countries, particularly in sub-Saharan Africa. In addition, there have been remarkable improvements in key interventions—for malaria and HIV control, and measles immunization, which have cut child deaths from 12.5 million in 1990 to 8.8 million in 2008. Three important factors are also identified as representing emerging, particularly acute challenges to the achievement of the MDGs. Firstly, climate change, with the most severe impact of climate change being felt by vulnerable populations who have contributed least to the problem. Secondly, the risk of death or disability and economic loss due to natural disasters is increasing globally and is concentrated in poorer countries, setting back progress with several MDGs. Thirdly, armed conflict remains a major threat to human security and to hard-won MDG gains. The recent MDG Report 2010 finds that large populations of refugees remain in camps with limited opportunities to improve their lives, with some 42 million people displaced by conflict or persecution in 2009, four fifths of them in developing countries.

18. Important progress has continued to be made in achieving global goals for extreme poverty and for universal primary education. And recent progress suggests that it will be possible to meet the global target for gender parity (MDG3). At the same time, there has been poor progress towards attaining the MDG for child and maternal mortality, prompting a renewed focus by the G8 at its Muskoka Summit in June 2010 and a revitalisation in both financing and global political will to address progress ahead of the closing date for the MDGs in 2015. Progress in addressing malnutrition and hunger has stalled as a result of the crisis, particularly in Sub-Saharan Africa and South Asia. As foreshadowed at the Commonwealth Finance Ministers’ Meeting in 2009, the crisis has wreaked acute social costs on developing countries. As a result of the crisis, some 265,000 more infants and 1.2 million more children under 5 are expected to die between 2009 and 2015. Progress with the MDGs has been discussed in late-September 2010 at a UN General Assembly Summit to mark ten years of progress since the MDGs were launched in 2000. The Commonwealth Secretariat attended and will incorporate lessons and next steps into the Secretariat’s future work programme.

**Capital Flows**

19. Short to medium terms prospects for capital flows, including overseas development assistance (ODA), private capital flows, and foreign direct investment, remain uncertain in the absence of a solid and sustained recovery in high income countries. Many

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7 Ibid., p10.
Commonwealth developing countries incurred increased government deficits during the crisis and most have exhausted their relatively sound fiscal positions going into the crisis. For governments relying on external assistance for budgetary support, any reduction in aid flows in the immediate future will serve as a severe blow to their economic management and growth prospects.

20. **Net ODA flows** to developing countries, in absolute terms, reached its peak in 2008 at US$ 122.3 billion (Figure 10). Despite the global economic slowdown, official assistance in 2009, estimated to be US$ 119.6 billion, remained relatively resilient. While in absolute terms the net ODA flows in 2009 registered a small decline, in real terms ODA flows grew, by a marginal 0.7 per cent. This compares with an approximately 12 per cent real increase from 2007 to 2008. According to the most recent OECD projections, net ODA to developing countries in 2010 will decline to US$ 108 billion, suggesting that external assistance may already have been affected by the economic slowdown in advanced economies. A recent World Bank study (Dang et al. 2009) suggests that ODA could fall by as much as 20 to 25 per cent in the current crisis and that it could take about a decade for flows to recover. While this might be considered quite unlikely given the renewed donor commitments, it presents a worst case scenario with respect to the effects of the economic slowdown on aid prospects.

**Figure 10: Official and private flows to developing countries**

21. It is important to note that the Gleneagles commitments would have required donors to increase net ODA flows to $128.1 billion a year by 2010. In light of the OECD projection mentioned above, net flows to developing countries would thus fall short by $20 billion. At Gleneagles donors also committed more than doubling aid to Africa (estimated to be an additional $25 billion every year) compared to 2004. According to the latest projection, Africa is to receive just $11 billion a year increase in net ODA by 2010 over 2004, representing underachievement of over a half of the pledged increase.

22. **Net private capital flows** to developing countries fell from $1224 billion in 2007 to $780.5 billion 2008 and then further by another 65% to $454 billion in 2009. Although such flows are expected to recover in 2010 they will not reach 2008 levels. An important component of private capital flows, foreign direct investment (FDI), has also declined drastically during the crisis. Total FDI flows to developing countries declined from $630 billion in 2008 to $478 billion in 2009, representing a decline of 24%. The decline in many individual Commonwealth developing countries has been far worse. Thirty-nine of the 44
Commonwealth members for which data are available witnessed an absolute decline in FDI inflows. Furthermore, 37 of these countries recorded a decline in FDI inflows of in excess of 70%.

**External Financing Gaps**

23. Reduced capital flows to developing countries have had severe adverse implications for their external financing balances precipitating large external financing gaps. Estimates provided by the World Bank show that in 2009 total external financing gaps for developing countries stood at $352 billion. They are expected to decline but will remain substantial for 2010 and 2011, at $210 billion and $180 billion respectively (Figure 11). For low-income developing countries external financing gaps for 2009 were estimated at 8% of their GDP. For this group of countries the gap is expected to reduce slightly to 6.6% in 2010. For lower-middle and upper-middle income countries the financing gaps will be close to 2% of their GDP.

**Figure 11: External financing gaps for developing countries**

![Graph showing external financing gaps for developing countries]

**Key Downside Risks to Recovery**

24. There are several major risks to the sustainability of the current economic recovery. Three risks have proved particularly important. First, the re-emergence of sovereign risk, emerging in Southern European countries in mid-2010. Second, risks associated with perceived slowness and lack of international policy coordination in the global recovery, including coordination in fiscal policy adjustment and in currency alignment. Third, the escalation of fiscal policy risks, with advanced economies required to establish a credible medium-term plan to achieve fiscal policy consolidation and requiring to balance two competing threats to the sustainability of their recovery: the risk that a synchronised and sharp fiscal adjustment across several major economies could adversely affect the recovery; and by contrast the risk that too lax a withdrawal of stimulus and a failure to implement consolidation where necessary will provoke market uncertainty and in turn domestic and potentially wider financial shocks. Recognising the need for country-specific variations, an intensive examination of this issue by the IMF in June 2010 found that the current fiscal consolidation plans for most G20 advanced economies for 2011 – which envisage on average
an adjustment of 1.25 per cent of GDP in cyclically adjusted fiscal balance, are broadly appropriate. And at the G20 Toronto Summit in June 2010, advanced economies reflecting the balance between the above two sets of risks, committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016.

Commonwealth Finance Ministers may wish to comment on the downside risks to the recovery, including their views as to how international policy coordination may be improved; and any key Commonwealth messages to the IMFC and DC.

Progress in Reforming Global Financial Regulation and Architecture

25. The global crisis precipitated extensive review and reform of pre-crisis global financial regulation and regulatory architecture. It spurred major regulatory, institutional and policy changes in advanced, emerging and developing economies. Major changes have been announced in 2010, which strengthen prudential oversight, improve risk management, promote transparency and reinforce international cooperation. At national and regional level, these include the implementation of the European Stabilisation Mechanism and Fund, a decision by the EU to publicly release the results of stress tests on European banks and a US financial reform bill, put forward in mid-2010.

26. The Basel Committee on Banking Supervision has made important progress toward a new global framework for bank capital and liquidity, announcing a proposed new framework for bank capital adequacy, on 12 September 2010. To be known as Basel III, the framework, which will be phased in from 2013, requires banks to hold core capital of 4.5%, representing an increase from current levels of 2%; and to retain further additional capital of 2.5% as a buffer to withstand periods of future stress. Further provisions are expected to be required for systemically important banks. The definition of capital is to be strengthened to exclude certain assets. The proposals are to be put to the G20 Summit meeting in Seoul in November 2010. The proposals, if agreed, are expected to significantly increase prudential capital requirements and significantly improve the quality of capital, enabling banks to withstand future crises of the scale of the recent global financial crisis without recourse to extraordinary government support. Commonwealth Finance Ministers might wish to discuss further details of the emerging capital adequacy framework, a sense of likely response by the G20, as well as any reflections on the validity of and challenges to be considered in implementing the framework in developing countries.

27. During 2010, strong measures have also been agreed to improve transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter derivatives in an internationally consistent and non-discriminatory manner. The Financial Stability Board (FSB) has made important progress over a wide front. It has established standards for sound compensation; and in October 2010 will report to the G20 on recommendations to strengthen oversight and supervision, specifically relating to the mandate, capacity and resourcing of supervisors. At the same time the FSB is expected to provide proposals to effectively address problems associated with and to resolve systemically important financial institutions; and to outline the powers and tools which will be required for this purpose, together with principles for their implementation.

\footnote{For example IMF (2010a).}
28. In addition, as the year has progressed, there has been growing accord among advanced and emerging market economies in the G20 that the financial sector should make a fair and substantial contribution towards paying for the costs incurred by taxpayers when crises occur. At the G20 Toronto Summit in June 2010, leaders agreed that the financial sector should pay for any burdens associated with government interventions, where they occur, in order to repair the financial system or fund resolution, and reduce risks from the financial system. However there has thus far been no universal agreement on the policy approach to achieve this, with some countries calling for and pursuing a financial levy; and with other countries pursuing alternate approaches.

II From Crisis Toward Recovery in Commonwealth Countries

Economic Growth

29. The global economic slowdown severely affected the Commonwealth. Twenty six Commonwealth members had negative growth rate in 2009 (Figure 4). Despite the recovery in the global economy an overwhelming majority of our members (44 out of a total of 54) will have lower GDP growth in 2010 compared to their growth performance immediately before the crisis (e.g. average of 2006-08). Small and vulnerable economies (SVEs) within the Commonwealth have been the worst affected groups in terms of their economic growth performance, with aggregate output declining by 1.3 per cent in 2009 (Figure 5). Because of their inherent economic characteristics associated mainly with small size of the domestic market, SVEs are more dependent on international trade for their growth and economic development. The trade-orientation, as measured by the ratio of exports to GDP, in these countries is much higher than that of other developing countries: the mean export-GDP ratio in small states is about 55 per cent as against 30 per cent for the global economy. This overwhelming outward orientation has meant that they were disproportionately adversely affected. Indeed within the Commonwealth, as shown in Figure 6, there is a strong negative relationship between dependence on international trade, measured by export-GDP ratios; and the impact of global economic crisis, measured by changes in GDP growth. Small states such as Seychelles, Maldives, Antigua and Barbuda, Trinidad and Tobago, Botswana, Saint Lucia, Barbados, and Samoa tend to show far greater response to global economic slowdown than this general inverse relationship.

30. Within the Commonwealth, a particularly important feature of the crisis and recovery has been the performance in 2010 of Sub-Saharan Africa. Despite the global recession Sub-Saharan Africa on average grew by 2% in 2009, with relatively low level integration with the global economy (and thus less dependence on the global markets) and benefits from commodity price increases cited as key reasons for this impressive performance. Sub-Saharan African countries are expected to post a growth of 5% in 2010, although the overall picture masks important differences in country experience during the crisis, with some 10 Sub-Saharan African countries, among them three in the Commonwealth, experiencing an absolute decline in output during the crisis.
Figure 4: Economic growth, crisis and recovery in the Commonwealth
Figure 5: Growth by country groups

![Chart showing growth by country groups]

Figure 6: Relationship between export dependence and the impact of global economic slowdown on GDP growth in the Commonwealth

![Chart showing relationship between export dependence and GDP growth]
Commodity Prices and Inflationary Pressures

31. An emerging challenge comprises potential inflationary pressure for some members. Commodity prices rebounded quickly from early 2009 and the trend has continued as the economic recovery has intensified. In many developing countries there are already signs of inflation picking up driven by rising commodity prices. World Bank estimates show that by early 2010, average inflation in low and middle-income countries rose to 5% from just above 1% in late 2009. While still below the 7% average recorded during the 2006-07, this could be a cause for concern.

32. Apart from energy, prices of other commodities reached close to their pre-financial crisis period peaks. Energy prices also recovered quickly, rising 80% in early 2010 compared to those of early 2009. World Bank projections suggest that average energy prices in 2010 are likely to be 25% higher than that of the preceding year (figure 8). The corresponding figure for non-energy prices would be about 17%. Amongst non-energy commodities, metals and minerals prices are set to rise by a substantial 39% (compared to 2009 prices) followed by a 27% rise for raw materials (Figure 9).

![Figure 8: Energy and non-energy price](image)

![Figure 9: Commodity Prices](image)

Note: Figures for 2010 and 2011 are based on World Bank projections.

33. While rising commodity prices would benefit a number of primary producing and exporting countries, for net food and fuel importing Commonwealth countries they would exert serious challenges in terms of their fiscal and external balances and ensuring food security for their most vulnerable population groups. Rising and volatile commodity prices, particularly staple foods, are already an increasing concern in several Sub-Saharan and South Asian Commonwealth developing countries.

Fiscal Challenges in the Commonwealth

34. In the recovery, managing public debt has become a challenge for countries at all levels of development. Along with high public debt, a large number of countries are also
affected by deteriorations in their fiscal balances. In the immediate post-crisis period, an overwhelming majority of Commonwealth members confront significant fiscal challenges. About half of these countries had a fiscal deficit of more than 5% in 2009. Among developing countries, fiscal deficits in Maldives (26%), Antigua and Barbuda (19%), Jamaica (10.4%), Nigeria (10%), Sri Lanka (9.8%), Ghana (9.7%), Pakistan (9.5%), and Botswana (9.1%), appear particularly high (Figure 12).

35. Of the 46 Commonwealth countries for which data are available, 22 (that is, about 48%) have a public debt to GDP ratio higher than 50%. A ratio of 65% is typically used as a threshold, beyond which the public debt is considered to be unsustainable. Following this yardstick, there are currently as many as 15 Commonwealth countries that need to take immediate measures to address their debt problem. Several are small vulnerable states such as St Kitts and Nevis (185%), Seychelles (131%), Jamaica (130%), Barbados (115%), Maldives (110%), Belize (82%), Gambia (73%), Malta (69%), St Vincent and Grenadines (68%), and St Lucia (69%). Amongst others, the UK, Ghana, and India have both high public debt levels and large fiscal deficits.

Figure 12: Public debt and fiscal balance in the Commonwealth
A number of countries including India and the UK undertook large expansionary fiscal measures to energise domestic demand in the face of the global recession, partly contributing to their current fiscal challenges. Many other Commonwealth developing countries also pursued a similar policy stance. Notwithstanding their consequences, one of the most notable features during the crisis was sub-Saharan African policymakers’ impressive implementation of expansionary and counter-cyclical fiscal policy measures. Almost two-thirds of the SSA states experiencing a slowdown in growth managed to execute countercyclical fiscal measures. This was achieved partly by allowing fiscal deficits to grow. Ten of 19 Commonwealth SSA states maintained positive fiscal balances during 2004-08 (Figure 13). However, the recession implied that most of the countries had to run fiscal deficits in 2009. Deficits for Nigeria, Botswana, Ghana, South Africa, Kenya, Malawi and Uganda in particular were high, exceeding 5 per cent of their respective GDPs. According to IMF projections, all but one Commonwealth SSA country will have negative fiscal balances in 2010; and for several Commonwealth SSA members fiscal deficits in 2010 will exceed 5% of their GDP.

Figure 13: Fiscal balances in Commonwealth Sub-Saharan Africa

A salient feature of the fiscal policy stance in sub-Saharan Africa was that in general these countries could execute pro-poor public expenditure programmes. The spending on social sectors such as health and education, which are generally considered to be pro-poor, actually increased despite the fall the tax-GDP ratio in most SSA states (Figure 14).

37. A salient feature of the fiscal policy stance in sub-Saharan Africa was that in general these countries could execute pro-poor public expenditure programmes. The spending on social sectors such as health and education, which are generally considered to be pro-poor, actually increased despite the fall the tax-GDP ratio in most SSA states (Figure 14).
In the aftermath of the global economic crisis, fiscal consolidation has therefore now become a crucial challenge for most economies. Experience and approach differ widely including in the Commonwealth, with some members focusing on significant deficit adjustment measures, others unwinding stimulus measures more gradually. For Commonwealth developing countries achieving fiscal consolidation is considered a priority. Given their structural characteristics and vulnerabilities, as well as their proneness to shocks, these countries will require the rebuilding of fiscal space and key policy buffers, to address future shocks and to keep space for implementing pro-poor public spending programmes during future crises.

Impending External Debt Crisis

In recent years there has been a significant rise in the indebtedness of several Commonwealth countries. Rising indebtedness commenced prior to the economic crisis and has been augmented by it. Indebtedness has risen both among developing countries which have been eligible for the Heavily Indebted Poor Country (HIPC) and Multilateral Debt Relief Initiative (MDRI) programmes, as well as several developing countries which were not granted eligibility and therefore were unable to benefit from these debt relief dispensations. However, the growing debt problem has yet to receive concerted attention, even though higher levels of indebtedness have become an important threat to economic stability in a number of Commonwealth developing countries, including several middle-income countries.

Figure 15 below illustrates the extent of indebtedness for the Commonwealth developing country members. Of the 46 Commonwealth developing members for which data are available, a substantial 31 members have a debt-to-GDP ratio of 25% or higher. The external debt to GDP ratio for Gambia (170%), Seychelles (163%), Sierra Leone (163%), Cyprus (129%), Jamaica (97%), St Kitts and Nevis (79%), Dominica (75%), and Grenada (74%) are excessively high and appear to be unsustainable. Evidence also suggests that during the last decade the external debt of small states, particularly of some low-income and middle-income Caribbean countries, have been growing faster than others. Several factors may have contributed, including particularly the difficulty in strengthening access to global trade. More recently even for the countries that have benefited from the HIPC and MDRI initiatives, debt sustainability looms as a growing challenge, with many having failed to register improved export response following their debt relief programmes and with challenges compounded significantly by the food, fuel and subsequent economic crisis.
Figure 15: External Debt of Commonwealth Developing Countries

- **Per capita external debt in US$ (left vertical axis)**
- **External debt as % of GDP (right vertical axis)**
41. For large South Asian Commonwealth countries, including Bangladesh, India and Pakistan, it is the sheer volume of their total external debt which might be cause for concern. Amongst developed Commonwealth members, the debt-GDP ratio varies widely.

Figure 16: Debt services to export and debt to export ratios in the Commonwealth

42. Rising indebtedness is hampering growth and development in many Commonwealth developing countries, with debt servicing increasingly diverting resources from health, education, social welfare and physical infrastructure. As expected a strong positive relationship between the size of external debt and debt service charges, both in proportional to respective countries’ exports, is depicted in Figure 16. St Kitts and Nevis has the highest the debt service to export ratio of 18% while for a number of other highly indebted small states such as Gambia, Dominica, Seychelles, Jamaica, Dominica, Belize, and St Vincent and Grenadines, the comparable ratio is also found to be quite high – above 10%. Amongst others, India and Pakistan face relatively high debt service charges despite their external debt as proportion to their GDP being much smaller compared to other countries, as shown in Figure 15 above. Cameroon is another country with relatively low level of external debt but high debt service charges. High levels of indebtedness can also be interpreted by international business as increasing investment risk.

Remittances

43. Remittances represent an important source of foreign exchange, a key contribution and often a lifeline to households, as well as important counter-cyclical fiscal stimulus for
developing countries. In several Commonwealth developing countries, remittances now exceed other types of balance of payments inflows and since 1998 in many countries have exceeded official aid and other private capital flows. In the past, remittance flows have tended to remain relatively stable during periods of global economic turbulence. However the recent economic crisis has affected remittances to developing countries quite significantly. Following close to 20% growth during 2006-08, remittance flows to developing countries are estimated to have declined by 6% in 2009, from US$336 billion in 2008 to US$316 billion in 2009 (Figure 17). Latin America and the Caribbean countries were the worst affected as they on average witnessed a decline of such flows by more than 12% (Figure 18). Only South Asia managed to register a positive and sizeable growth of about 5%.

![Figure 17: Remittance flows to developing country groups](image)

![Figure 18: Growth in remittance flows](image)

Note: Data is from the World Bank. Figures for 2009 are estimates while for 2010 and 2011 are projections.

44. The largest recipients of remittances among developing countries are India, Mexico and China. Within the Commonwealth, among major recipients of inward flows of remittances in 2009 were India ($49 billion), Bangladesh ($10.7 bn), Nigeria ($9.6 bn), Pakistan ($8.7 bn), Sri Lanka ($3.3 bn), Jamaica ($1.9 bn), and Kenya ($1.9 bn). The extent of dependence on remittance flows varies across the Commonwealth. For Nineteen Commonwealth members remittances comprise more than 2% of their GDP. Tonga, Lesotho, Samoa and Guyana are most substantially dependent on migrants’ earnings, as remittances account for over 20% of their respective GDPs. For Jamaica and Bangladesh, the share of remittances in GDP stood at more than 10% in 2009. Gambia, Sierra Leone, Sri Lanka, Belize, Uganda, Kenya, Nigeria, Grenada, Pakistan and India amongst other were also critically dependent on remittance inflows.
Figure 19: Growth of remittances inflows in individual Commonwealth countries

Figure 20: Share of remittances in GDP in the Commonwealth
45. Of the 43 Commonwealth countries for which information is available, more than two-thirds experienced a decline in remittance flows in 2009. Cyprus had the largest decline of 40% while Jamaica and Namibia experienced a 10% fall each. World Bank projections show that remittance flow to recover at a modest pace over the next two years: by 6.2% in 2010 and 7.1% in the following year. Lower than average growth is projected for Latin America and Caribbean, South Asia and Sub-Saharan African regions, while only the East Asia and the Pacific region are expected to achieve higher than the average growth. World Bank highlights three short-term risks to the outlook for remittances: uncertainty about the depth and duration of the current crisis, unpredictable movements in exchange rates, and the possibility that immigration controls may be tightened further in major destination countries as a result of rising unemployment in these countries.

III Conclusions

46. The global economy is recovering. But recovery is uneven, fragile and its sustainability threatened by substantial downside risks. Key challenges for the Commonwealth is to deepen collaboration and mutual support, identify key areas of policy consensus which can contribute proactively to international policy collaboration and find solutions that address the lack of resilience to persistent external shocks in many member countries. With the intensity of the global recession lessening, there is no better time for Commonwealth members to forge deeper partnerships, share and exchange information and skills and strengthen the ability of the association to both effect a faster recovery and to better address together future challenges.

47. Initiatives for learning of lessons about the crisis and their impacts should now be considered in areas such as: strengthening financial regulatory practices and policies; sharing experience of fiscal adjustment; and networking to better address social protection and social safety nets across Commonwealth member countries. Some key areas for further analysis and exploration include: opportunities for mutual benefit, growth and development in Commonwealth developing countries, inter alia through a deepened engagement amongst the Commonwealth’s members; finding innovative solutions to address the debt challenges of the Commonwealth’s small and vulnerable economies; and analysis and implementation of options for financing and managing the development of green economies in Commonwealth countries.