The Chain Reaction

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There doesn't seem to be respite to the global economic downswing as the latest reports show another 651,000 jobs lost in the United States in February, bringing its unemployment rate to 8.1%, the worst in 25 years.

Although much of the global news of the crisis has focused on the West, it is the developing countries which are suffering more. The GNP fell by 3% to 4% in the US in the last quarter of 2008. But the fall was sharper in many Asian countries such as Japan, South Korea, Taiwan and Singapore.

The crisis began as a financial crisis in the US and Europe, and then this affected the West's real economy as the credit crunch led to job losses and a fall in consumer spending. There was a lag time before the effects reached developing countries late last year. Now the effects are really being felt. *The global crisis is like a train wreck in slow motion.*

The two main ways in which the Western crisis is being transmitted to developing countries are through finance and trade. In the finance route, some countries have been hit through investing in toxic or depreciating assets. The sovereign wealth funds in Singapore and Middle East oil-producing states invested in some of the big US, Swiss and British banks whose stocks have lost much of their value. China has also lost value in investments turned sour, or in some toxic assets.

Some individuals in Hong Kong and Singapore invested in funds that in turn invested in Lehman Brothers that went into bankruptcy. Latin Americans invested in funds of the US-based Stanford Bank that is now mired in fraud charges.

Secondly, there has been a big drop in funds flowing to developing countries. Net capital flows to emerging markets are estimated to fall from US$929bil in 2007 to US$466bil in 2008 and further to US$165bil this year, according to the Institute of International Finance.

Of these capital flows, portfolio investment which surged into developing countries has been flowing out, especially from the sale of shares in the stock markets.

There is also a severe reverse flow in bank credit. The IIF expects that this year the banks will take out more in debt repayment in emerging markets than they provide in new loans.

Thirdly, the flow of foreign direct investment (FDI) worldwide fell by 21% to US$1.4 trillion last year, according to UNCTAD (UN Conference on Trade and Development) data. So far, developed countries have been affected more by this. The FDI flow to developing countries still grew by 4% in 2008, but this was much slower than 21% in 2007.

In the trade transmission route, developing countries are also affected in many ways. Firstly, their exports to the US and Europe have dropped sharply as consumers cut spending.

It was reported that Malaysia's exports fell by 28% in January, the fourth straight month of decline. Some other Asian countries fared worse. In the latest month where figures are available, exports fell by 46% for Japan, 44% for

Taiwan, 48% for the Philippines, 38% for Singapore and 34% for South Korea, compared with the 12 previous months.

In China, exports in January fell by 17.5% which has caused thousands of factories to close, with 20 million losing their jobs, according to official estimates. But China's imports fell by 43% and this has hit many Asian countries which export manufactured parts used in making the products meant for exports to the West.

Besides the fall in demand for developing countries' manufactured exports such as electronic products and components and textiles and clothing, many countries have also seen a sudden drop in the demand and prices of export commodities. The most publicised fall is in the oil price which dropped from its peak of US$140 a barrel to around US$40 at present. This is a blow to oil producing countries.

Prices of a wide range of other commodities have also dropped sharply. In Malaysia, for example, the palm oil price fell from a peak of US$1200 a tonne in March 2008 to a low of US$386 in October. It has since recovered to about US$527.

On Feb 24, *The Economist's* commodity-price dollar index for all items had fallen by 42% compared to a year ago. The index for food was 30% down, for non-food agricultural products 45% down and for metals 60% down.

Trade in services is also affected. For example, global tourist arrivals fell by 1% in the second half of 2008. In the Caribbean, which depends heavily on tourism, arrivals are expected to fall by one third this season.

Countries like India that have benefited from outsourcing by US multinationals (for services ranging from accountancy to being call centres) are expected to be affected as the business of the Western firms shrink.

Thirdly, developing countries are facing a worsening of trade financing as banks have tightened their supply of credit even for routine import and export business. It was reported at a World Trade Organisation meeting that there is a US$25bil shortfall in trade financing that now needs to be filled.

The reduced flows or outflows in finance and the fall in exports of goods and services have led to the deterioration in the balance of payments and the stock of foreign reserves in many developing countries. Some have also seen their currencies devalued, making it more difficult to service their external loans.

Thus the transmission through the finance and trade routes is working its way through to the real economy of output, trade and jobs. And this is only the beginning, as the recession in the US and Europe is now expected to last at least two years. □

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