

trade hot topics

Small States in Global Economic Slowdown

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Background

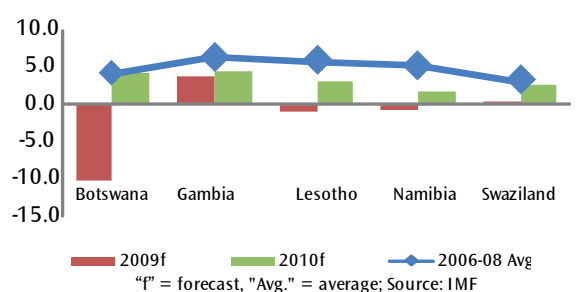
The current economic downturn is affecting all countries, rich and poor, and large and small, demonstrating the greater interconnectedness of the global economy in recent decades. Most small developing countries lack the capacity and resources to implement effective countercyclical policies as has been adopted by many developed countries to cushion the impact of the economic shock. The global crisis is having serious implications for the small vulnerable economies that comprise the bulk of the Commonwealth's membership (with 32 of the 53 members being classified as small states). The transmission channels have included declines in commodity prices, exports, remittances, tourism revenues, foreign direct investment (FDI) and capital flows. These effects have resulted in shrinking fiscal revenues, increased demand for social safety nets and higher levels of unemployment. This issue of Commonwealth Trade Hot Topics assesses the impacts of the economic downturn on small Commonwealth economies, and discusses some of the macroeconomic challenges they face in dealing with shocks emanating from the global slowdown.

Effects of the global economic downturn on Commonwealth small states

Africa

The five Commonwealth African small states - Botswana, The Gambia, Lesotho, Namibia and Swaziland - have been affected by the crisis mainly through the declining demand for exports, and dwindling remittances and tourism receipts. Figure 1 shows the impact of the crisis on growth for 2009 which is projected to dip well below the average attained over the 2006-08 period, with slow recovery expected in 2010.

Figure 1: Annual growth rates for Commonwealth small states in Africa



Of these economies, Botswana is likely to be worst affected, with growth expected to contract by 10.3 per cent as a result of the declining revenues from diamond sales. Lesotho's growth is expected to decline from 3.5 per cent in 2008 to -0.1 per cent in

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2009. Namibia is also expected to contract by 0.7 per cent in 2009. For Swaziland and The Gambia, growth is forecasted to decline but remain positive at 0.4 per cent and 3.6 per cent respectively in 2009.

The International Monetary Fund (IMF) estimates that between 2007 and 2008 Sub-Saharan exports of all goods declined by 8 per cent, owing to low demand from major importers such as the USA. Lesotho has been affected by a drop in textile exports to the United States. Swaziland has also witnessed a decline in textile exports, but sugar and agro-based exports (which are income inelastic) are likely to compensate. Revenues from the Southern African Customs Union (SACU), upon which the Lesotho and Swazi Governments are heavily dependent, have decreased due to a reduction in imports. Between 2008 and 2009, the world prices of copper, coffee, cotton and sugar declined by more than 20 per cent. As a major exporter of sugar, Swaziland experienced major reduction in revenue.

The Gambia's tourism sector has been hardest hit though the demand for groundnut is less likely to be affected, given low levels of inflation. Remittances from the Lesotho and Swazi diaspora have declined due to reduction in labour demand in South Africa's mineral sector in response to lower demand for its mineral exports. A number of African countries are highly dependent on official development assistance (The Gambia's ODA levels in 2000-2007, for example, were 14.7 per cent of GNI), and there are signs that donors will be reducing ODA levels as the downturn continues to place pressure on their national budgets. Also, a decline in FDI into Sub-Saharan Africa is expected in 2009 and beyond.

The crisis has impacted on the foreign exchange market and led to the depreciation of most SACU currencies against the US dollar. This will raise debt servicing costs and increase the cost of imported

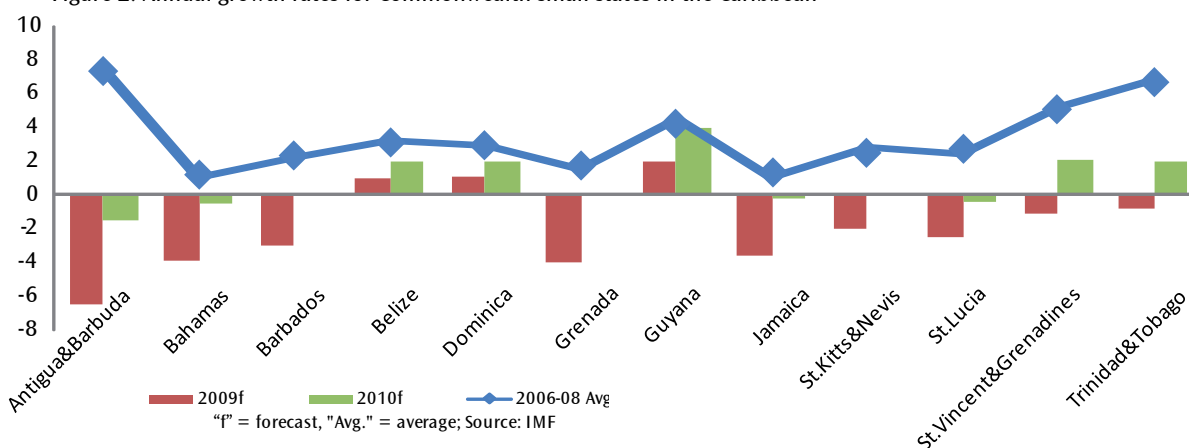
inputs, resulting in increased production costs and likely higher unemployment. On a positive note, the global downturn has reduced inflation in Botswana from a high of 15.1 per cent in August 2008 to 6.1 per cent in August 2009, despite currency depreciations. The Gambia, Lesotho, Namibia and Swaziland are experiencing similar trends in inflation, and this is expected to continue into the near future. Declining government revenues are weakening fiscal balances (percentage of GDP) across the Sub-Saharan Africa region which declined from 0.5 per cent in 2008 to -5 per cent (projected) in 2009.

In response to the crisis, policies adopted by different countries often vary quite remarkably while in other instances there are similarities. Botswana, for example, froze civil service salary increases, and cut its budget by 7 per cent. Other countries have adopted expansionary policies – Namibia, for example, allowed a 24 per cent salary increment in January 2009. Botswana and Namibia used their energy funds to subsidise petrol and oil prices. In terms of monetary policy, most countries have been cutting interest rates, recapitalising financial institutions, and increasing liquidity to banks and firms. In Botswana, for example, the Bank of Botswana rate fell from 15 per cent in December 2008 to 11.5 per cent in July 2009; Namibia and Swaziland either reduced interest rates or kept them unchanged while South Africa increased its interest rates.

The Caribbean

Growth in the Caribbean region has declined sharply, with most economies expected to contract or slowdown in 2009 (Figure 2). World Bank estimates show that average growth in the region declined from 8.7 per cent in 2006 to 3.5 per cent in 2008 and is expected to fall to -0.9 per cent in 2009. The main impacts of the economic slowdown have come

Figure 2: Annual growth rates for Commonwealth small states in the Caribbean



through the negative effects of falling household income and wages in main developed country markets, mainly the USA, UK and Canada. These effects are being felt through declines in export demand (especially for bauxite, tourism and offshore finance), remittances, FDI, and capital inflows; reduced access to credit (with some Caribbean bonds being downgraded); depreciation in exchange rates; increased unemployment; and deterioration of the internal and external balances.

The main tourist destinations – The Bahamas, Barbados, and St Lucia – have seen a decline in tourist arrivals. Between 2008 and 2009 (for the corresponding months as shown in Figure 3), tourism arrivals to these three destinations fell by about 10 per cent, while Jamaica and Guyana recorded small increases. Tourism-related construction has declined as occupancy rates have dropped. Tourism receipts are expected to decline further in 2009.

Between 2008Q1 and 2009Q1, the rate of growth of remittances to the region slowed considerably. Remittance-dependent economies such as Jamaica and Guyana, where remittances account for more than 15 per cent of GDP, have been hard hit. Foreign direct investment in St Vincent and the Grenadines, which used to be a stable source of financing its current account deficit, is projected to decline by about 7.9 per cent of GDP in 2008-09. The decline in FDI across the region is putting further pressures on construction work in The Bahamas, while such activity in Trinidad and Tobago has been hurt by the cut-backs in government infrastructure projects. Small businesses in Barbados and St Vincent and the Grenadines are under pressure as consumers cut down spending. In Jamaica, the recession has been hitting the mining and quarrying sectors. In the June 2009 quarter, crude bauxite production and alumina production fell by 52.7 per cent and 63.6 per cent respectively. The Caribbean region has witnessed

a collapse of two major financial institutions, CL Financial and the Stanford Financial Group.

In 2008, unemployment rose in The Bahamas, Barbados, Jamaica, and Trinidad and Tobago after a period of steady decline in unemployment to below 10 per cent in 2007, and is expected to rise further in 2009. Inflation rates throughout the Caribbean, which rose over the 2007-2008 period due to increase in oil prices up to mid-2008, are now declining. Fiscal positions have been worsening with the crisis. For example, amongst others, Barbados experienced a rise in fiscal deficit to 5.9 per cent of GDP in 2008 from 2.5 per cent in 2007. The use of countercyclical policy measures in these countries is expected to cause further deterioration in 2009.

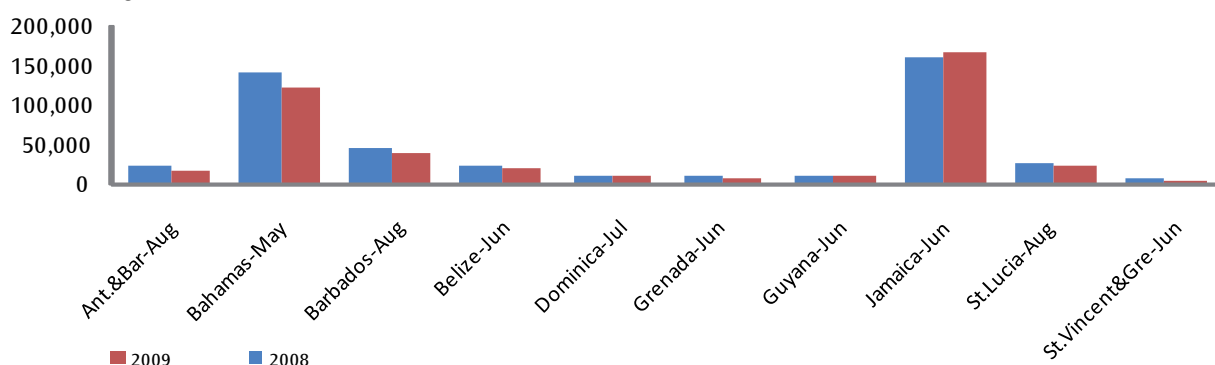
Policy responses to the crisis have included expansionary fiscal and monetary policies to keep employment at high levels, fiscal support for key sectors such as tourism, increased support for safety nets, and sourcing of external funds. In Barbados, for example, the central bank cut the minimum deposit rate by 50 basis points to 4 per cent in October 2008, but the intensity of the downturn since then signals a need for further easing. Antigua and Barbuda is currently seeking IMF support to meet its significant financing gap.

Pacific Islands

The Asian Development Bank estimates that growth in the Pacific region will decline from 5.2 per cent in 2008 to 2.8 per cent in 2009. Figure 4 shows that for most countries growth forecasts for 2009 are below the average for the 2006-08 period, despite the history of poor growth performance in the Pacific.

Only Papua New Guinea and Vanuatu are expected to grow above 3 per cent in 2009, the former a mining exporter and the latter a key reformer. Fiji Islands, Samoa and Tonga are expected to contract

Figure 3: Tourist arrivals in selected Commonwealth small states in the Caribbean



Data is in thousands; Source: Caribbean Tourism Organisation

Table 1: Fiscal and current account balances for selected Commonwealth small states in the Pacific

Fiscal Balance (% of GDP)				Balance on Current Account (% of GDP)			
	2007	2008	2009f		2008	2009f	2010f
Fiji	-1.8	-1.5	-3.0	Fiji	-25	-25.9	-27.9
Kiribati	-3.4	-13.0	..	Kiribati	-0.9	-3.1	-6.3
Nauru	4.8	0.6	0.0	Nauru
Papua New Guinea	2.5	0.0	..	Papua New Guinea	2.8	-6.7	-4.7
Samoa	1.1	-3.2	-5.5	Samoa	-6.2	-2.1	-5.2
Solomon Islands	-0.3	-5.6	-3.7	Solomon Islands	-18.7	-11.1	-18.2

"f" means forecast; Source: Asian Development Bank, IMF

mainly due to declining tourism receipts and remittances.

The export of logs from Solomon Islands has declined significantly, contributing to the meagre growth of 0.4 per cent expected for 2009. The declining trend of commodity prices (with the exception of cocoa) might have negative implications for Papua New Guinea, Fiji, Solomon Islands and Vanuatu. The declining prices of other commodities (such as oil) will affect Papua New Guinea and Fiji Islands in terms of export earnings, with negative knock-on effects on the incomes of rural households. As in the case of the African and Caribbean regions, lower food and fuel prices have been reducing inflation from the high average of 9.5 per cent in 2008 to projected rates of 6.1 per cent and 5.2 per cent for 2009 and 2010 for the region as a whole, although figures have remained high for some countries due to the flooding in early 2009.

Tourism appears to be holding up, with the exception of Fiji. The political climate in Fiji is discouraging donor support, and the January flooding has contributed to declining tourist numbers. Fiji's exports of textile, water and sugar have declined. In April 2009, the government devalued the Fijian dollar by 20 per cent in an effort to boost exports and hence reserves. Although reserves increased, the amount still remains below target. Devaluation

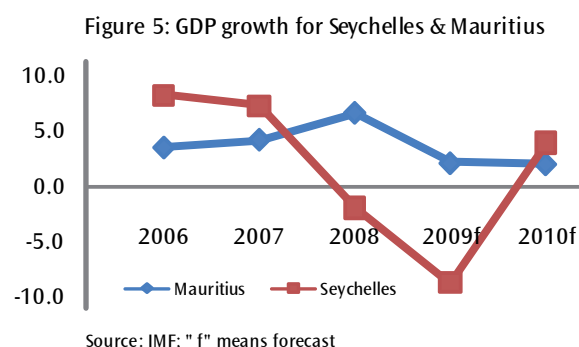
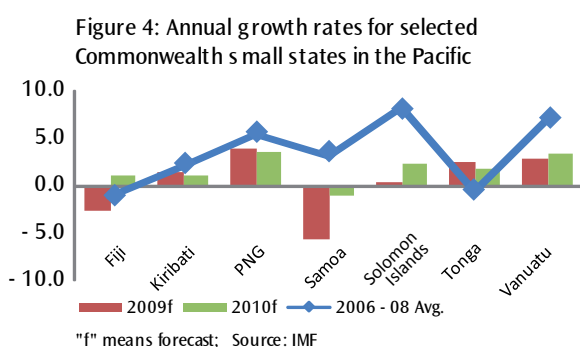
has increased inflation and the already high cost of serving public debt.

Remittances for the smaller countries - Tonga and Samoa - show a declining trend due to the recession in major markets - USA, New Zealand and Australia - and this may have serious impacts on foreign exchange earnings and external balances. Furthermore, an increase in bad loans is reducing bank lending in Tonga.

Declining revenues are placing pressure on budget commitments. Table 1 shows that the budget and current account balances (% GDP) have been deteriorating. As a result, much-needed development spending is at risk. Policy responses have included the boosting of spending in the agricultural sector in Fiji; careful short-lived monetary expansion in Papua New Guinea; and the establishment of an agricultural development bank in Vanuatu.

The Indian Ocean region: Seychelles and Mauritius

When the crisis hit, the Seychellois economy was still recovering from the food and oil crisis of 2007, and being highly dependent on tourism, the economy has been badly affected. Growth fell from 8.3 per cent in 2007 to -1.9 per cent in 2008, and the economy is expected to contract further with GDP growth for 2009 projected at -8.7 per cent due to



huge reductions in government spending as a result of ongoing economic reforms and a forecast 25 per cent drop in tourism earnings in 2009.

In 2008, Seychelles sought IMF assistance after defaulting on the repayment of sovereign bonds and facing the near exhaustion of its foreign currency reserves. The IMF granted an emergency stand-by agreement and the government started implementing a radical macroeconomic reform programme. The manufacturing sector contracted by approximately 20 per cent in the first quarter of 2008 compared to 2007. Foreign investment is expected to fall to less than US\$200million in 2009, compared to a record high of US\$350million in 2008. In 2007 total public debt was approximately 122.8 per cent of GDP, reaching about 175 per cent in December 2008.

Following the flotation of the exchange rate as part of the economic reform programme, there has been a sharp depreciation of the Seychelles rupee. As a result, the rate of inflation increased by more than 60 per cent, aggregate demand has declined sharply, costs of production have increased, and some businesses face bankruptcy. Interest rates were liberalised in early 2009 and this led to an increase in real rates (on treasury bills) from below 5 per cent in February 2008 to approximately 30 per cent in February 2009, a level above the lending and savings rates. The higher return on government bonds has led to the crowding out of private sector investment. Seychelles is hoping for an improved global economic climate to boost tourism figures and FDI in 2010, leading to a recovery in real GDP growth to 4 per cent.

The initial impact on Mauritius, on the other hand, was not as severe as that in Seychelles, largely due to the well diversified structure of the Mauritian economy and the stimulus package put in place by the government at the end of 2008. Almost all the key sectors of the economy, however, are now contracting; and real GDP is projected to grow between 2.1 per cent in 2009 as against the rate of 6.6 per cent achieved in 2008.

There has been a decline in exports and tourism activity, and closure of textile firms, and a slowing down of the construction industry. Demand in the crucial export sectors is expected to drop by almost 15 per cent. The overall budget deficit is expected to be at 3.9 per cent of GDP, with fears that it could reach up to 7 per cent by the end of 2009.

In the tourism sector, the growth in visitor numbers

declined by 9.9 per cent during the first quarter of 2009 and the outlook is expected to be worse. The national carrier, Air Mauritius, ran into financial crisis and was on the verge of collapse until the government stepped in to provide a huge bailout. FDI for the first quarter for 2009 was about ten times lower than the level in 2008. Unemployment rose from 6.2 per cent to 8 per cent in the first quarter of 2009 despite the large fiscal stimulus of some US\$310million. Inflation has declined, leading to fears of possible deflation.

In response to the falling external demand for Mauritian products, there is pressure on the government to devalue the local currency by a further 30 per cent to make exports more competitive (the Mauritian rupee already having depreciated by almost 20 per cent against the US dollar between June 2008 and May 2009). The government is in discussions with the IMF, World Bank and African Development Bank for financial assistance to guard against the possibility of a budget overrun. It has cut interest rates to stimulate aggregate demand and to reduce the cost of investment; unfortunately these actions have not had a significant impact on the economy.

Macroeconomic policy challenges of the global economic downturn

Governments in small economies have sought to manage the impact of the crisis, but many have tight policy space and face liquidity constraints to deal with shocks of this magnitude. It is important though that, over the longer term, steps are taken to improve their development prospects by adopting resilience building strategies and diversifying into new economic activities. With respect to the short term:

Fiscal policy

The policy responses implemented are needed to provide vital stimulus to aggregate demand and support to key sectors, but tight fiscal space is constraining governments' ability to respond more effectively. African small states, for example, are struggling to maintain previous spending levels (without even considering increased spending), forcing them to use pro-cyclical measures. Countries with debt problems and macroeconomic instability also have much less scope to accommodate fiscal deterioration. In the short term, countries must focus fiscal policy on protecting or increasing priority spending, including for infrastructure and the Millennium Development Goals. Governments should work with regional and multilateral

development banks to protect spending plans from the impact of the downturn.

Monetary policy

The effectiveness of monetary policy is somewhat limited given the combination of deflationary pressures, below zero growth and near zero interest rates. In the short term, countries need to maintain macroeconomic stabilisation, despite the difficulties in doing so amidst deteriorating terms of trade. Countries with flexible exchange rates should allow real exchange rates to adjust; using the rates as shock absorbers in response to the negative external shocks, but needing to be wary of the possibility of fuelling inflationary pressures. For countries with fixed exchange rates, competitiveness and availability of sufficient external reserves will need to be considered carefully given the reduction in exports.

Financial sector

Governments should monitor risk levels, take actions to reduce uncertainty and boost confidence. At this stage, there is no need to rush to implement regulatory reforms, given the possibility of further liquidity problems. Governments should still however maintain an agenda for financial reforms to be advanced in the medium term.

At the global level

Policy responses implemented by small states seem to be proving insufficient, if not inadequate, due to the limited capacity of governments and the challenging policy environment. Larger and more developed economies must recognise the potential negative effects of their crisis-response efforts on the economic recovery and growth prospects of smaller

economies. The adverse implications of domestic policy efforts to resuscitate demand and address drying up of credit (e.g. the considerable easing of monetary policy), and the rising protectionism including increased pressures on tax havens and mounting social aversion to immigration of service providers, need to be critically addressed. There are also regulation 'externalities' arising from the increased demand for tougher (and costly) regulation and supervision, putting further pressures on the severely constrained capacity of governments in small states.

Conclusion

Small states have felt the consequences of the global economic downturn more significantly through the real sector via declining external demand. Advanced economies need to recognise the adverse implications of their policy efforts on small states as, if growth is to be realised through trade in these small vulnerable economies, demand for their goods and services will need to be generated in importing country markets. The international community should continue to play its role in assisting these economies - by providing financial and technical assistance which must be put to effective use in order to accelerate recovery and reduce the effects of the crisis on poverty. International efforts are also needed in addressing any potential risks that may result in marginalisation of small states when recovery takes place. Consistent with these efforts, small economies should protect their financial systems and follow prudent macroeconomic policies that provide countercyclical buffer to the extent possible, mindful of the need for these policies to be sustainable.

International Trade & Regional Co-operation Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth - an association of 53 independent states, comprising large and small, developed and developing, landlocked and island economies - facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITRC is entrusted with the responsibilities of undertaking policy-oriented research and analysis on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITRC approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on two highly vulnerable Commonwealth constituencies - least developed countries (LDCs) and small states.

Scope of ITRC Work

ITRC undertakes activities principally in three broad areas:

- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development-friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research and consultations that increase understanding of the changing of the international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance the more beneficial participation of Commonwealth developing country members, particularly small states and LDCs.

ITRC Recent Activities

ITRC's most recent activities focus on assisting member states in the WTO Doha Round and the Economic Partnership Agreement (EPA) negotiations involving the African, Caribbean and Pacific countries (ACP) and the European Union (EU), undertaking analytical work on a range of trade policy and development issues, and supporting workshops/dialogues for facilitating consensus-building on issues of Commonwealth members' interest, exchange of ideas, and disseminating results from informed analysis.

Selected Recent Meetings/Workshops supported by ITRC

7-8 July 2009: Conference on Managing Regional Integration in South Asia, held in Dhaka, Bangladesh

24 June 2009: Conference on Political Economy of Competition and Regulation in Developing Countries, held in Jaipur, India

23-24 June 2009: ACP Preparatory Meeting for the WTO Second Global Review of Aid for Trade, held in Geneva, Switzerland

15-17 June 2009: Workshop on Strengthening Skills of Government Officials in Sub-Saharan Africa on Commercial Diplomacy and Trade Policy Issues, held in Nairobi, Kenya

10 June 2009: Prime Ministerial Caribbean Banana Policy Review Meeting, held in Castries, St Lucia

10 June 2009: Discussion meeting on Challenges to Small States in the Multilateral Trading System, organised during the World Trade Week, UK (8-12 July 2009), held in London, UK

9-10 June 2009: Commonwealth Investment Experts' Meeting, held in London, UK

18 May 2009: Seminar on Preference Erosion: How Much and What To Do About It?, held in London, UK

22-23 May 2009: Workshop on Trade Policy and Trade Agreements for the Members of the Parliament of Bangladesh, held in Dhaka, Bangladesh

31 March-1 April 2009: Brainstorming Workshop - The Doha Round: Securing Development Outcomes for Small Economies and LDCs, held in Hampshire, UK

6-7 February 2009: High-Level Conference on Financial Crisis, Global Economic Governance and Development, held in New Delhi, India

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ISSN: 2071-8527 (print) **ISSN: 2071-9914** (online)

Series editor: Dr Mohammad A Razzaque
Produced by the Economic Affairs Division of the Commonwealth Secretariat

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