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**Impact of the global financial crisis on industrial
development in developing countries: UNIDO's response**

Impact of the global financial crisis on industrial development in developing countries: UNIDO's response

Report by the Director-General

Reports on the impact of the global financial crisis on industrial development in developing countries and UNIDO's response to it.

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I. Introduction

1. The present report provides a brief background on the current economic crisis as it evolved from turmoil in the financial markets to a downturn in the global economy. It looks at the initial impacts observed on industry in developing countries and examines the policy responses to the crisis, and the further effects these may have on industrial development. Finally, the report discusses the role of the United Nations system and of UNIDO in meeting the internationally agreed development goals in the context of the current economic environment.
2. The report draws, inter alia, on advance findings from a forthcoming UNIDO study on the impact of the financial crisis, as well as on studies carried out by other United Nations system organizations. It is intended to provide a preliminary assessment of the impact of the current crisis on industry in developing countries and as such may not take full account of the latest developments in a rapidly evolving economic environment.

II. From financial crisis to global economic crisis

3. Considerable advances have been made over the past two decades in bringing prosperity to developing countries through the internationalization of industrial production, trade, investment and technology. By 2008, developing countries accounted for about a quarter of global manufacturing value-added. The economic crisis now threatens to reverse the economic gains made by developing countries and undo progress made to reduce poverty. Between 55 and 90 million of their citizens are expected to join the ranks of the absolute poor, according to the World Bank-International Monetary Fund (IMF) "*Global Monitoring Report 2009: A Development Emergency*". Per capita income is expected to fall in about 50 poor countries, most of them in Africa.
4. The deeper root of the crisis is still the subject of some debate, but it first came to light with the emergence of the sub-prime mortgage crisis in the United States of America during 2007. After years of cumulative increases, prices in this country's housing market reached a peak in 2006, and within a matter of months, defaults on mortgage repayments began to multiply. Rises in interest rates to cover growing bank losses followed, as, eventually, did the insolvency of some lending institutions.
5. Much of the funding for sub-prime mortgages had been obtained from complex and innovative financial products on the inter-bank money market. As these debts began to unwind, a number of financial institutions in the United States became compromised or failed. Lack of information and adverse selection mechanisms led to financial institutions distrusting each other and ceasing to lend, thus aggravating the problem, which was compounded further by the fact that individual investors began to move their assets away from high-yield, higher-risk, money market funds and commercial papers. In September 2008, following the default by a large United States-based investment bank and intervention in a range of financial institutions in the United States and Europe, the situation deteriorated rapidly.

6. In an earlier economic era, any resulting contamination of the real economy might have been relatively limited, especially outside the United States and Europe. But globalization, which has brought immense benefits to developing countries in terms of access to world markets and as recipients of foreign investment and technology, has also entailed a growing integration of financial markets without the corresponding global governance needed to correct imbalances and failures, anticipate disequilibria and regulate international flows of capital.

7. It quickly became evident that the crisis was not limited to the United States or Europe, but was infecting other developed and developing countries. The flow of trade finance and working capital tightened severely across the world, banks constricted lending standards further, and the first clear evidence came to light that the crisis had spread to the real economy.

8. By April 2009, most analysts and commentators had accepted that the current crisis represented the deepest recession since the Second World War, and that its extent reached further than any other experienced since then. What began as a financial crisis has become a broader, global, economic crisis of a depth and severity not witnessed in a generation. While the initial elements of contagion to the real economy were felt deepest of all in a number of developed countries that had gone through housing booms in recent years, the effects were soon felt in the developing world.

9. At the time of writing this document, the World Bank projected gross domestic product (GDP) growth in developing countries to fall to 1.6 per cent in 2009, from an average of 8.1 per cent in 2006-2007. Average growth in Latin America and the Caribbean, as well as in the economies of Eastern Europe and Central Asia, were projected to be negative in 2009. Growth in sub-Saharan Africa was projected to slow to 1.7 per cent, from 6.7 per cent in 2006-07, which represents a significant setback for the region's growth prospects and for the region's achievement of the Millennium Development Goals (MDGs) by 2015.

10. The economic crisis worked its way to the developing countries via a number of transmission mechanisms: trade, remittances, financial flows and official development assistance (ODA).

Trade

11. Global merchandise trade began to falter in mid-2008 as demand fell in countries affected by the first wave of the crisis. 2009 is expected to see the first yearly decline in world trade volumes since 1982. The decline in trade from developing countries is unprecedented, and its impact on industrial production and small and medium enterprises (SMEs) in particular is discussed in section III below.

Remittances

12. Recent estimates suggest that remittance flows, which can account for up to 8 per cent of GDP in some countries, are falling off sharply. The steepest deceleration observed so far has been in sub-Saharan Africa, although South Asia is also particularly vulnerable.

Financial flows

13. Net private capital flows to emerging market economies amounted to \$930 billion in 2007, of which two-thirds was credit. Estimates indicate that this figure halved in 2008, and may drop to about \$165 billion in 2009, the sharpest fall ever recorded.¹

Official development assistance

14. There is evidence of a fall-off in ODA spending since the onset of the crisis, with some countries of the Organization for Economic Cooperation and Development (OECD) confirming substantial reductions in their aid budget for the coming year as well as difficulties in meeting timetables set for reaching the United Nations target of ODA amounting to 0.7 per cent of gross national product (GNP) by 2015. The effect of this, and of a further fall in aid spending, on the achievement of the MDGs is further discussed in section IV below.

III. Impact on industrial development

Global decline

15. Global manufacturing industry slowed markedly in 2008. The world manufacturing output growth rate fell from around 3.5 per cent in the last quarter of 2007 to –15 per cent in the last quarter of 2008. In developing countries as a group, the rate fell from 12 per cent for the first quarter of 2008 to –12 per cent in the last quarter. The fall-out has spread across all industrial sectors and activities in many developing countries, although some industries have been more affected than others. Forecasts for 2009 suggest further slowdowns or outright drops in industrial production, underpinned by lower foreign and domestic demand as well as a continuing lack of access to credit and trade finance. While the fiscal stimulus packages unveiled by advanced economies and by a small group of developing countries, including members of the Group of Twenty (G-20), may to some extent mitigate this contraction in demand, this alone will not suffice to put poorer countries back on a track for adequate pro-poor growth.

Sectors most affected in developing countries

16. The decline in manufacturing industry in developing countries is driven mainly by falling exports. While typically a major driver of economic growth, export-oriented manufacturing industries have along with extractive industries been the most affected. The textile and clothing industry, in which barriers to exit tend to be low, has seen output drop by as much as 50 per cent in some countries. As this industry is among the most labour intensive of all, a reduction in output has a significant effect on employment and a disproportionate effect on poverty, especially among women and unskilled workers. Output in consumer durable industries, which had been on the rise in developing countries, is also declining as worldwide demand contracts.

¹ Institute of International Finance “*Capital flows to emerging market economies*” (January 2009).

17. As industry suffers, a pattern appears to be emerging where workers are moving away from dynamic, export-oriented sectors and into lower productivity activities, as well as from urban to rural areas. Such a trend is likely to have a starkly negative effect on poverty reduction as populations are forced to rely on primary agriculture to meet basic needs. Indeed, crop prices and basic commodity prices, while remaining at historically high levels have recently fallen as a result of the crisis, illustrating the volatility inherent in these sectors.

Small and medium enterprises

18. SMEs linked to the export sector are especially affected by the crisis. While unused capacity is increasing among firms of all sizes and sectors, those with access to credit and foreign links have a better basis from which to survive the crisis. Large domestic and foreign firms are internalizing production and reducing the amount of subcontracting to other firms and SMEs. As a result, some SMEs are turning towards the domestic market, diversifying production and looking for new market niches, as discussed further below.

Effect on operating environment

19. The operating environment of manufacturing firms in developing countries has also become tighter. Levels of unused capacity are very high, and as these grow, so too do unit costs. Furthermore, as factories lie idle or operate at less than full capacity, equipment deterioration and depreciation tend to accelerate. Inventories of raw materials and finished products are also rising dangerously. In addition, business finance conditions are becoming more difficult to adhere to, as suppliers request advance payments or drastically reduce repayment deadlines. Since bank financing of working capital is scarcer than ever before, some companies are forced to borrow elsewhere, frequently at higher costs.

Adjustment strategies and diversification

20. Two types of adjustment strategies are emerging among industrial firms: defensive and proactive. Defensive strategies involve traditional cost-cutting measures while proactive approaches are taking the form of innovation and the search for new alternatives.

21. The more common approach to dealing with the tighter operating environment has been the defensive one. Such traditional cost-cutting measures include shorter working hours, layoffs and temporary closure of plants; improving efficiency through better use of raw materials and energy, increasing the production process yield and output quality; reducing the amount of subcontracting; and, cutbacks in overheads and non-urgent expenditures.

22. There is, however, some evidence of firms in developing countries seeking business opportunities in other areas rather than merely acting defensively. A mechanical engineering company in Cameroon has switched from the production of truck tanks and bodies to making barges, piping and steel plants. Indian auto-component manufacturers have shifted either to the production of oil, gas and railway equipment or to the manufacturing of agro-engines and electrical appliances. Output diversification is accompanied by market diversification in some cases.

IV. Policy responses: risks and remedies for industrial development

23. Responses to the crisis have been prompt, and continue to pick up pace on the global, regional and national levels. Developed countries have, in the main, concentrated on measures to rehabilitate the financial sector through better and more coordinated regulation, and fiscal stimulus packages to encourage liquidity and boost demand.

24. While emerging data suggest that such initial responses are beginning to achieve results, the situation remains unclear. What is certain, however, is that most developing countries outside the G-20 lack the resources to mount any such fiscal stimulus and will, to a large extent, depend on the adequacy of the macroeconomic response of the developed countries. While such an analysis is outside the scope of this report, UNIDO has identified three major risks for industrial development as countries take measures to combat the crisis.

(a) Risk of an exclusive focus on immediate action and of a short-term view of required responses

25. The need for urgent action to release lines of credit and stimulate economies has tended to lead policy responses. While this is understandable, a preoccupation with immediate and short-term responses will pose greater problems in the future. The need for donors to adhere to aid commitments is vital in this context and, while the G-20 Global Plan for Recovery and Reform, agreed at their London summit in April 2009, reaffirms the commitments made on aid, the evidence is that ODA is slipping.

26. For industrial development specifically, there is a risk that, in an era of reduced aid spending, support for building the productive sectors may become marginalized. Yet economic growth remains central to poverty reduction and to the achievement of the MDGs. Even if a successful global fiscal response is mounted, this can only catalyse sustainable economic growth in developing countries if there is a vigorous private sector to take advantage of it. In addition to improving the private sector's access to finance for investment and trade, governments and development partners should ensure that infrastructure is maintained and improved, and that advice and technical cooperation is made available to aid firms in improving their operating efficiency and diversifying production (including into green industries), in the face of rapidly changing consumer demand and export opportunities.

(b) Risk of growing protectionism

27. At the London summit, G-20 leaders pledged to refrain from raising new barriers to trade. While a similar commitment was made by G-20 leaders at their earlier summit in Washington in November 2008, this was not adhered to in practice by many of its members.

28. It is important to guard against protectionism in global trade. Protectionist tendencies were observed in early 2008 in the wake of sharp increases in food prices, and as economic activity decreases, so these have intensified. A number of countries have raised tariffs (albeit still remaining within the strict parameters of

World Trade Organization (WTO) rules), and there has been a rise in “buy national” policies, in particular attached to the stimulus packages of some developed countries.

29. The economic crisis brings into sharp focus the need to conclude the Doha Round of multilateral trade negotiations. Trade has been a powerful engine for growth and poverty reduction in developing countries. Maintaining and improving developing countries’ access to international markets must remain a key element of the global development agenda. A complementary priority that must be maintained is the strengthening of support for trade-related technical assistance.

(c) Risk of declining interest and investments in a low-carbon and sustainable path to industrial development

30. Related to the risk of taking a short-term view in responding, there is a danger that the crisis will upset the momentum toward following a low-carbon, resource-efficient path to industrial development. While the stimulus packages of some developed countries in particular contain a welcome “green” component, in a number of other countries, ambitious investment plans on renewable energy and energy efficiency are being shelved and environmental regulations are being relaxed. This underscores the need to bolster policies on, and invest into, sustainable development and green industries over the longer term, as well as to reach an agreement on the post-2012 framework at the United Nations Climate Change Conference in Copenhagen in December 2009.

V. The role of the United Nations system and of UNIDO

31. As the United Nations system Chief Executives Board (CEB) noted in its communiqué of 5 April 2009, international policy coherence and coordination is crucial in responding to what is a multidimensional and global crisis. While governments must design and implement the right policies to fit their needs, the multilateral system plays a central role in articulating and delivering a coherent response and in translating it into action at the country level.

32. To this end, nine joint initiatives were agreed by the CEB, bringing together the collective mandates and responsibilities of the United Nations system. These initiatives are designed to assist countries and the global community in confronting the crisis, accelerating recovery, and building fair and inclusive globalization allowing for sustainable economic, social and environmental development for all.

33. These CEB initiatives include:

(a) Additional financing for the most vulnerable: advocating and devising a joint World Bank and United Nations system mechanism for common articulation and implementation of additional financing, including through the Vulnerability Fund proposed by the World Bank;

(b) Food security: strengthening programmes to feed the hungry and expanding support to farmers in developing countries;

(c) Trade: fighting protectionism, including through the conclusion of the Doha Round and strengthening Aid for Trade initiatives and finance for trade;

(d) Green economy initiative: promoting investment in long-term environmental sustainability to put the world on a climate-friendly path;

(e) Global jobs pact: boosting employment, production, investment and aggregate demand, and promoting;

(f) Social protection floor: ensuring access to basic social services, shelter, and empowerment and protection of the poor and vulnerable;

(g) Humanitarian, security and social stability: emergency action to protect lives and livelihoods, meeting hunger and humanitarian needs, protecting displaced people and shoring up security and social stability;

(h) Technology and innovation: developing technological infrastructure to facilitate the promotion and access to innovation; and

(i) Monitoring and analysis: strengthening macroeconomic and financial surveillance and implementing an effective early warning system; urgently establishing a United Nations system-wide vulnerability monitoring and alert mechanism to track developments, and report on the political, economic, social and environmental dimensions of the crisis.

34. In addition to taking an active part in the CEB joint initiatives, UNIDO can make a significant contribution to efforts by developing countries to contain and cope with the economic crisis. Through its ongoing collection and analysis of industrial statistics, UNIDO is uniquely equipped to monitor the performance of manufacturing industry in developing countries and raise an alert on actual or potential problems requiring urgent attention.

35. UNIDO can also provide policy and technical advisory services on industrial restructuring, low-carbon and resource-efficient industrial production, institutional infrastructure for conformity with international standards, industrial skills development, energy access for productive uses, technological innovations and improvements and investment promotion. In addition, UNIDO can step up capacity-building support, especially for SMEs adversely affected by the current economic crisis, including by connecting them with international buyers.

VI. Action required of the Board

36. The Board may wish to take note of the information in the present document and provide guidance for further action.
