ISLAMIC DEVELOPMENT BANK

IMPACT OF GLOBAL FINANCIAL AND ECONOMIC CRISIS ON OIC MEMBER COUNTRIES

Paper distributed at the 25th Session of COMCEC Senior Officials Meeting
Istanbul, Turkey

17 Dhul Qa'da 1430H (5 November 2009)

IMPACT OF GLOBAL FINANCIAL AND ECONOMIC CRISIS ON OIC MEMBER COUNTRIES[1]

I. INTRODUCTION

1. The global financial and economic crisis has been the most serious crisis after the Great Depression of the 1930s. The crisis has gone far beyond the financial sector and has seriously affected the real economy. Despite wide-ranging policy actions at international, regional, and national levels, financial and economic strains remain acute in 2009.[2] Virtually no country, developing or developed, has escaped from the impact of economic crisis, although countries that were relatively less integrated into the global economy have generally been less affected. However, policy actions taken in the second half of 2008 and in 2009 cushion the impact of economic crisis and are expected help to recover global economic growth and enhance volume of world trade in the short-term, through the shape of medium-term global recovery (whether V-, U-, or W-shaped) is uncertain yet.

2. Like other developing countries, the impact of the crisis has also been increasingly felt in OIC member countries. They have been affected both directly and indirectly, although the channels of transmission are different from those in relatively more developed member countries. Some OIC member countries had already been affected by the high food and fuel prices and the global financial and economic recession has added to economic strains seriously affecting their socio-economic development. Consequently, they have been affected by slowing down in economic growth, deteriorating current account balances, shrinking remittances and development assistance, and rising unemployment and poverty. However, timely fiscal stimulus, money injections, interest rate cuts, and rise in oil- and non-oil commodity prices have helped spurred recovery in OIC member countries.

3. The human cost of the economic crisis has also imperiled the social stability and future economic emancipation of the people in OIC member countries. In particular, the Millennium Development Goals (MDGs) appear to suffer a serious setback as the decade-long gains achieved by member countries are under stress.

4. The analysis focuses on OIC 57 member countries (as a group) disaggregated into oil-exporting and non-oil exporting member countries. Since the impact of economic crisis varies across regions, the analysis also focuses on four regional economic groupings of OIC member countries namely Middle East and North Africa (MENA), Asia, Sub-Saharan Africa (SSA), and Countries in Transition (CIT). The paper presents key external and domestic factors affecting economic outlook of OIC member countries and its various regions. In particular, it focuses on the impact of economic crisis on economic growth, current account balances, and inflation.

---

[1] The Paper has been prepared by Zafar Iqbal, Senior Economist, Economic Policy and Research Department under the supervision of Ifzal Ali, Chief Economist, Islamic Development Bank. Abdullateef Bello, Director, Data Resources and Statistics Department is gratefully acknowledged for his constructive comments and data support.

[2] For detail, see IDB (May 2009), Issue Paper on "Shaping the Post-Crisis World: Regional Implications and Coordinated Responses by Member Countries".

Further, it also highlights some social aspects of the crisis. Finally, the paper suggests a number of medium- and long-term measures to be considered by member countries.

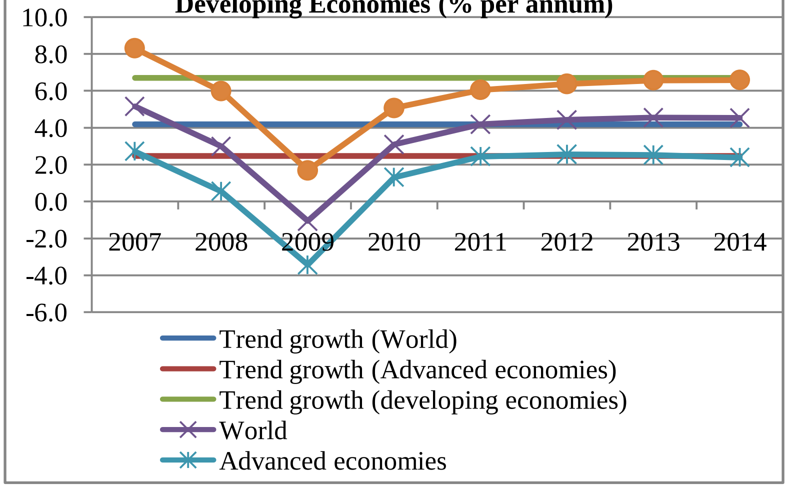
II. KEY GLOBAL FACTORS AFFECTING ECONOMIC OUTLOOK OF OIC MEMBER COUNTRIES

5. The major global factors that have affected the economic performance of OIC member countries include sharp drop in world output; collapse in the volume of world trade; highly volatile oil-and non-oil commodities prices; and cost and availability of external financing.

6. ***World real GDP growth dropped sharply but is expected to recover in the short-term.*** In 2009, the world economy recorded an unprecedented contraction. According to the IMF World Economic Outlook (October 2009), global output growth is likely to fall from 3 percent in 2008 to negative 1.1 percent in 2009 - for the first time in 60 years. The most serious and immediate impact of the financial turmoil has been on the advanced economies, whose real output growth is estimated to decline from 0.6 percent in 2008 to negative 3.4 percent in 2009. The global economic downturn also resulted in the deceleration of growth in developing economies, which is estimated to drop from 6 percent in 2008 to 1.7 percent in 2009 (Figure 1).

7. In the medium-term (2010-2014), the global economy as well as advanced economies are projected to achieve the pre-crisis level of growth (trend growth of 2002-2006) by 2011 and will resume thereafter. However, the recovery of trend growth of developing countries may take a little longer time as they are projected to achieve it by 2013 (Figure 1). The medium-term recovery will very upon the movement in oil and non-commodity prices, exchange rates, cost and availability of external financing, and the policies adopted by the national authorities.[3] Therefore, the shape of medium-term recovery of world economy (V-, U-, or W-shaped) is uncertain yet.[4]

Figure 1. Real GDP Growth in World, Advance and Developing Economies (% per annum)



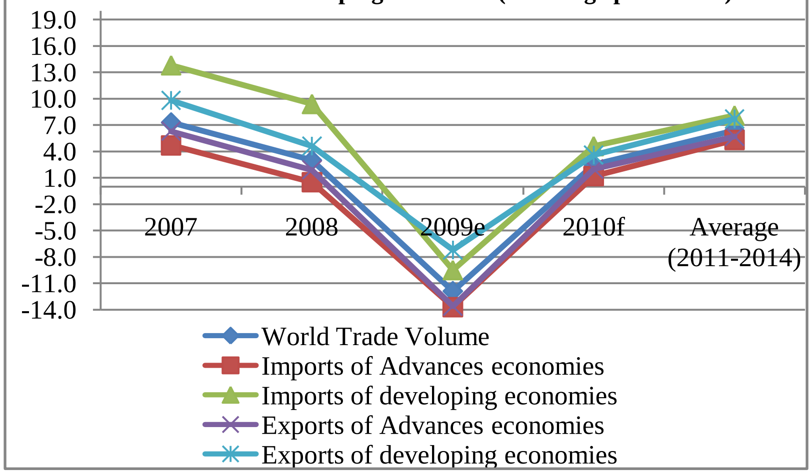
Data Source: IMF World Economic Outlook October 2009

[3] IMF World Economic Outlook (October 2009) is based on a number of assumptions such as: (i) Real effective exchange rates will remain constant at their average levels during July 30–August 27, 2009; (ii) Established policies of national authorities will be maintained; (iii) Average price of oil will be $61.5 a barrel in 2009 and $76.5 a barrel in 2010, and will remain unchanged in real terms over the medium-term; and (iv) The six-month London Interbank Offered Rate (LIBOR) on U.S. dollar deposits will average 1.2 percent in 2009 and 1.4 percent in 2010; the three-month euro deposit rate will average 1.2 percent in 2009 and 1.6 percent in 2010; and the six-month Japanese yen deposit rate will yield an average of 0.7 percent in 2009 and 0.6 percent in 2010.

[4] For more detail on this issue, see Economist (20 August 2009)

8. ***The impact of the economic crisis on world trade is even more pronounced.*** The year 2008 and 2009 witnessed collapse in the volume of world trade as both advanced and developing economies were badly affected by the global financial and economic crisis. The growth in volume of world trade declined from 7.3 percent in 2007 to 3 percent in 2008 and negative 11.9 percent in 2009. Both imports and exports of advanced economies declined by 13.7 percent and 13.6 percent, respectively, in 2009. Similarly, imports of developing economies dropped by 9.5 percent and exports by 7.2 percent in 2009. In the medium-term, in line with the global economic recovery, the global trade is also projected to recover (Figure 2).

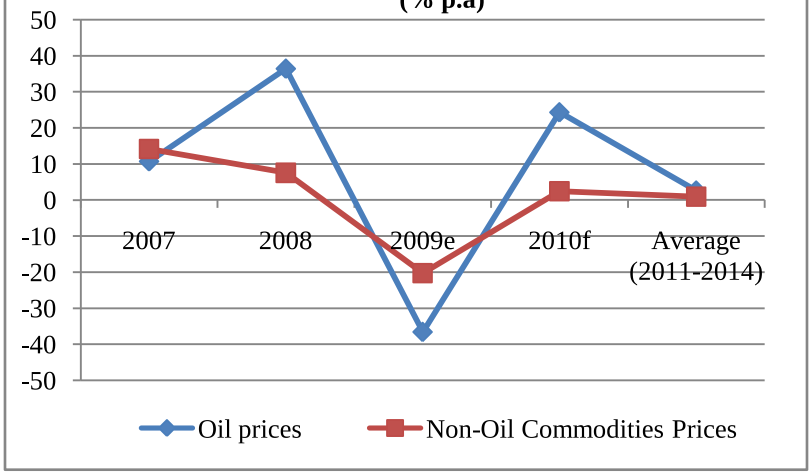
Figure 2. Trade (good and services) Volume of Wolrd, Advanced and Developing Countries (% change per annum)



Data Source: IMF World Economic Outlook October 2009

9. ***Economic recovery has reversed plunging prices of oil- and non-oil commodities.*** The oil price, which increased by 36.4 percent in 2008, is estimated to decline by 36.6 percent in 2009. Similarly, weakening global demand is depressing commodity prices and creating deflationary conditions around the globe. The non-oil commodity prices, which increased by 7.5 percent in 2008, are estimated to fall by 20.3 percent in 2009. With the moderate global economic recovery and increasing demand, the oil prices are expected to rise by 24.3 percent and non-oil commodity prices by 2.4 percent in 2010. In the medium-term, the movement in oil- and non-oil commodity prices will depend upon the speed and scale of global economic recovery (Figure 3).

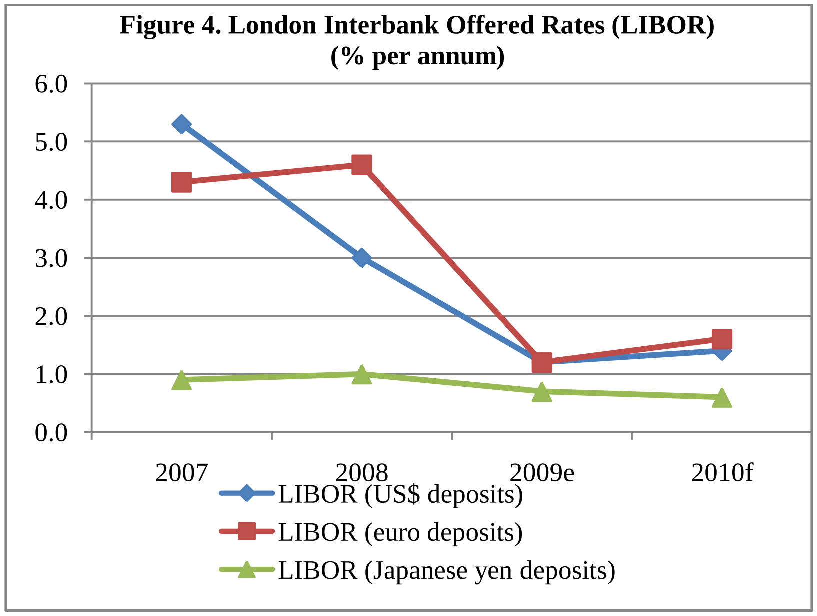
Figure 3. Oil and Non-Oil Commodities Prices (% p.a)



Data Source: IMF World Economic Outlook October 2009

10. ***Low policy interest rates also help to recover global economy.*** In order to stabilize economies in the face of global economic crisis, monetary authorities reacted quickly with exceptionally large interest rate cuts in 2008 and 2009 as well as unconventional measures to inject liquidity and sustain credit. In particular, policy interest rates have been brought down considerably in many advanced economies. In particular, LIBOR on US$ deposits has declined

from 5.3 percent in 2007 to 3 percent in 2008 and further to 1.2 percent in 2009. Similarly, LIBOR on euro deposits has declined from 4.6 percent in 2008 to 1.2 percent in 2009, while the LIBOR on Japanese Yen deposits has declined from one percent to 0.7 percent during the same period. In the short-term, policy interest rates are expected to remain lower. However, in the medium-term, the large increases in fiscal deficits and public debt are likely to put upward pressure on long-term interest rates as the global recovery is sustained (Figure 4).

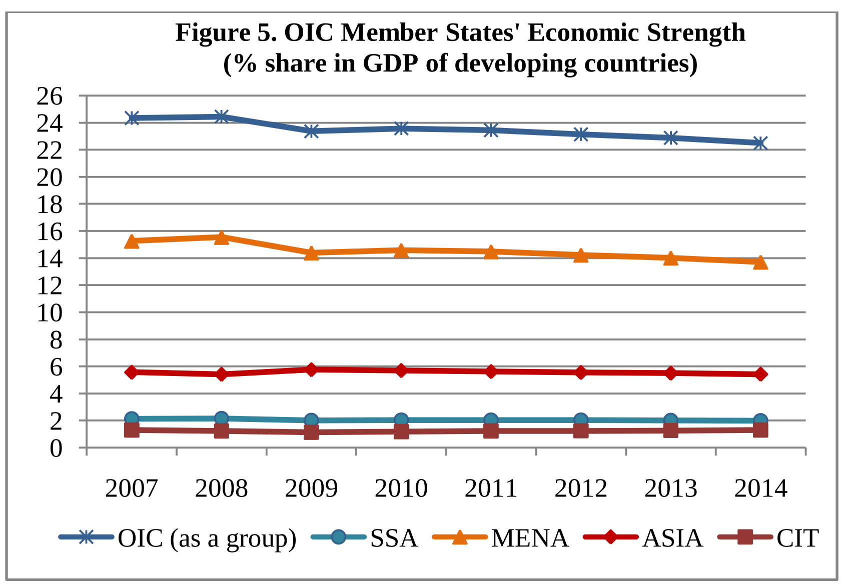


Data Source: IMF World Economic Outlook October 2009

III. ECONOMIC PERFORMANCE AND OUTLOOK OF OIC MEMBER COUNTRIES

11. Due to the above mentioned external factors, economic performance of OIC member countries has been adversely affected in terms of weakening economic strength, slowing down real output growth, and deteriorating current account balances of both oil-exporting and non-oil exporting member countries as well as in its four regions.

12. ***Global economic recession has weakened economic strength of OIC member countries.*** It appears that global financial and economic crisis has permanently damaged economic strength of OIC member countries. The share of these countries in developing countries' GDP has declined from 24.4 percent in 2008 to 23.4 percent in 2009 and is projected to decline further to 22.5 percent by 2014. In particular, MENA's share is projected to decline from

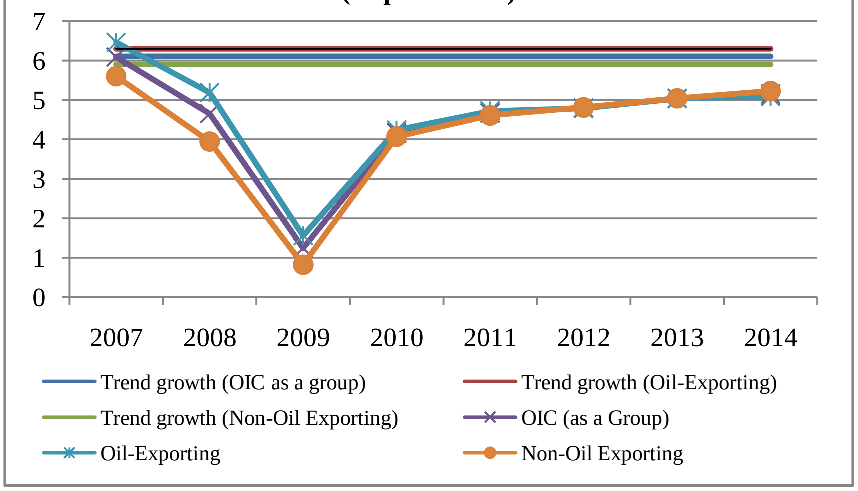


IDB estimates based on data from the IMF WEO database of October 2009

15.5 percent in 2008 to 14.4 percent in 2009 and 13.7 percent by 2014, while shares of other regions will remain more or less unchanged (Figure 5).

13. ***Recovery in OIC member countries faces major downward risks.*** OIC member countries (as a group) had experienced impressive real GDP growth of above 6.1 percent during the pre-crisis period (2002-2006), while oil-exporting member countries[5] trend growth remained 6.3 percent and non-oil exporting member countries[6] 5.9 percent during the same period. Due to spillovers first from the food crisis and later from global financial and economic crisis, the real GDP growth in OIC member countries (as a group) is likely to drop to 1.2 percent, oil-exporting 1.6 percent, and non-oil exporting member countries 0.8 percent in 2009. With the global recovery and positive trends in commodity prices, growth is expected to pick up in 2010. However, both oil-exporting and non-oil exporting member countries will not be able to achieve the pre-crisis level of growth by 2014**.** It appears that the economic crisis has permanently damaged the potential output of OIC member countries as a group (Figure 6).

Figure 6. Real GDP Growth Rate in OIC Member States (% per annum)



IDB estimates based on data from the IMF WEO database of October 2009

14. Although strong public policies have supported OIC member countries' economic recovery, the short-term V-shaped recovery through economic painkillers (i.e. stimulus packages and money injections) appears to be fragile. A number of major risks are also associated with medium-term recovery, and whether V-, U-, or W-shaped recovery will depend upon the underlying factors mentioned above.

15. Among various regions of OIC member countries, Middle East and North Africa (MENA)[7] was hit hard by the economic crisis as its real GDP growth dropped from normal growth rate of 5.9 percent to 0.3 percent in 2009. The MENA region has been adversely affected mainly due to

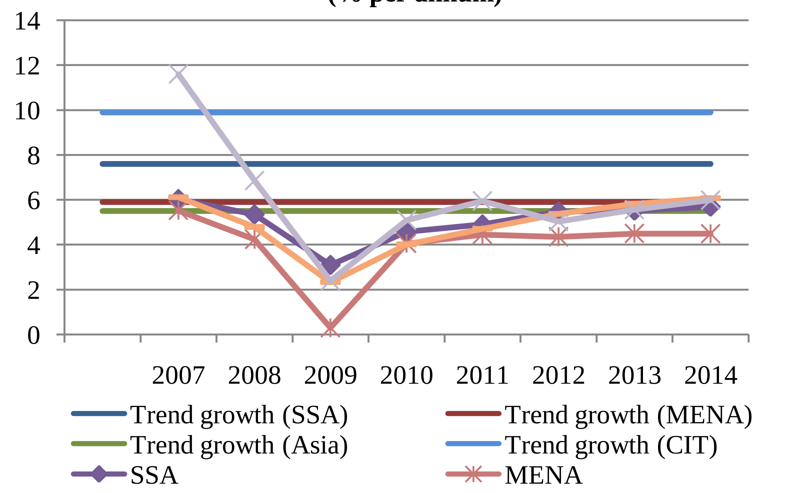
[5] Oil-exporting member countries include Algeria, Azerbaijan, Cameroon, Chad, Cote d'Ivoire, Egypt, Gabon, Iran, Iraq, Kazakhstan, Kuwait, Libya, Malaysia, Nigeria, Qatar, Saudi Arabia, Sudan, Syria, Turkmenistan, U.A.E, Uzbekistan and Yemen.

[6] Non-oil exporting member countries include Afghanistan, Albania, Bahrain, Bangladesh, Benin, Brunei, Burkina Faso, Comoros, Djibouti, Gambia, Guinea, Guinea-Bissau, Guyana, Indonesia, Jordan, Kyrgyz, Lebanon, Maldives, Mali, Mauritania, Morocco, Mozambique, Niger, Oman, Pakistan, Palestine, Senegal, Sierra-Leone, Somalia, Suriname, Tajikistan, Togo, Tunisia, Turkey and Uganda.

[7] MENA region includes Algeria, Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Syria, Tunisia, Turkey, UAE, and Yemen.

collapse in oil and asset prices, significant decline in domestic demand and sharp drop in FDI flows. The second region affected badly by the economic crisis is Countries in Transition (CIT)[8], whose output decelerated sharply from 9.9 percent in 2008 to 2.3 percent in 2009. The fallout of the economic crisis on CIT member countries has been immense mainly due to sharp drop in demand, currency devaluations, decline in foreign capital inflows, workers' remittances, and lower energy prices. The growth in Sub-Saharan Africa (SSA)[9] has dropped from 7.6 percent in 2008 to 3.1 percent in 2009, mainly due to collapse of global trade, decline in capital flows (FDI, ODA, and remittances), and sharp decline in oil- and non-oil commodity prices. Economies of member countries in Asia[10] were relatively less affected as their growth decelerated from 5.5 percent to 2.3 percent during the same period. In particular, drop in global domestic for durable goods, and a decline in investment in the export-oriented emerging economies in the Asia region hurt manufacturing exports. However, the expansionary fiscal and monetary policies and rebound in the financial markets and capital inflows are helping the region's fast recovery.

Figure 7. Real GDP Growth by Regions of OIC States (% per annum)



IDB estimates based on data from the IMF WEO database of October 2009

16. In the medium-term scenario, only Asia is projected to achieve normal growth by 2013 as the region appears to be more resilient shock absorber due to sound macro reform adopted during the Asian crisis of late 1990s. While other MENA, SSA, and CIT do not seem to achieve pre-crisis level of economic growth by 2014 (Figure 7).

17. With regard to individual member countries, it appears that potential output in 21 out of 57 member countries has dropped permanently as they are projected to remain far behind from their normal trend growth path by 2014, while four countries' recovery will be W-shaped. The other countries are projected to achieve their pre-crisis growth before 2014 (Table 1).

[8] CIT region includes Albania, Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

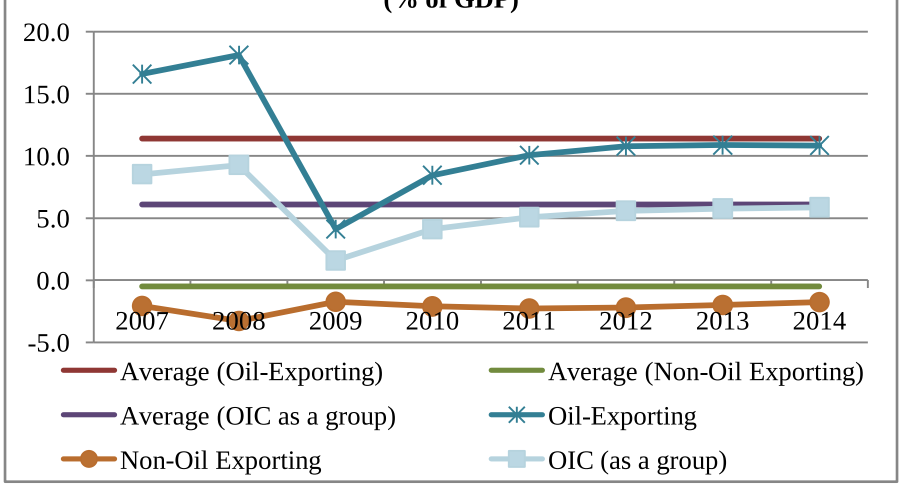
[9] SSA region includes Benin, Burkina Faso, Cameroon, Chad, Comoros, Côte d'Ivoire, Djibouti, Gabon, Gambia, Guinea, Guinea Bissau, Mali, Mauritania, Mozambique, Niger, Nigeria, Senegal, Sierra Leone, Somalia, Sudan, Togo, and Uganda.

[10] Asia region includes Afghanistan, Bangladesh, Brunei, Indonesia, Malaysia, Maldives, Pakistan, and Suriname.

Table 1. Status of Member Countries of OIC for Achieving Trend/ Pre-Crisis Growth (2002-2006)						
Already achieved/ will maintain	**2010**	**2011**	**2012**	**2013**	**Not achievable by 2014**	**W-Shaped Recoveries**
Côte d'Ivoire	Gabon	Albania	Burkina Faso	Malaysia	Afghanistan	Oman
Djibouti	Guinea	Bangladesh	Indonesia		Algeria	Qatar
Egypt	Niger	Benin	Libya		Azerbaijan	Turkmenistan
Guinea-Bissau	Syria	Cameroon	Mauritania		Bahrain	Uzbekistan
Iraq	Togo	Comoros	Morocco		Brunei	Yemen
Lebanon		Gambia	Saudi Arabia		Chad	
Oman		Kyrgyz	Suriname		Iran	
		Mali			Jordan	
		Senegal			Kazakhstan	
		Tunisia			Kuwait	
					Maldives	
					Mozambique	
					Nigeria	
					Pakistan	
					Sierra Leone	
					Sudan	
					Tajikistan	
					Turkey	
					Turkmenistan	
					Uganda	
					U.A.E	
Data source: IMF World Economic Outlook database of October 2009						

18. ***By 2014, both oil- exporting and non-oil exporting member countries will not be able to achieve the pre-crisis level of current account balances (CABs).*** Current account balances of OIC member countries are hit hard by the economic crisis. The CAB surplus of OIC member countries (as a group) dropped from 9.3 percent in 2008 to 1.6 percent of GDP in 2009. In particular, CAB surplus of oil-exporting member countries dropped from 18.1 percent of GDP in 2008 to 4.1 percent in 2009. In contrast, the current account deficit of non-oil exporting member countries improved from 3.3 percent to 1.7 percent of GDP during the same period (Figure 8).

Figure 8. Current Acvcount Balance of OIC States (% of GDP)



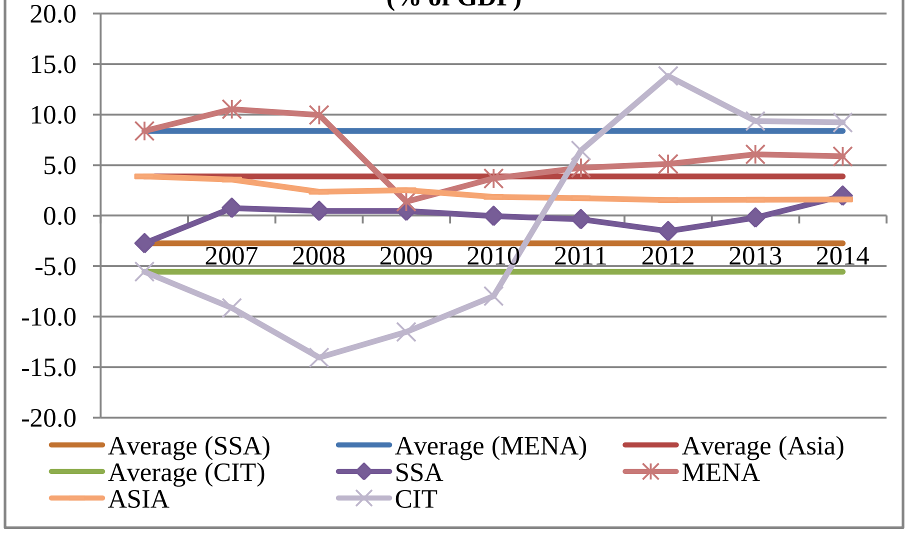
IDB estimates based on data from the IMF WEO database of October 2009

19. However, with the expected revival of the

global economy and increase in oil and non-oil commodity prices, current account surplus of OIC member countries (as a group) and oil-exporting countries is projected to improve but they will not be able to achieve the pre-crisis level of CAB surplus by 2014. In the medium-term, improvement in CAB will mainly depend upon the movement in oil and non-oil commodity prices and their exchange rates.

20. The impact of the economic crisis is not uniform across all four regions of the OIC member countries. They are experiencing a marked deterioration in their current account balances. Among four regions of OIC member countries, CAB deficits of SSA and CIT regions are projected to improve faster and they are expected to achieve normal CABs after 2010. In particular, in the medium-term, the increasing trade links with the European Union, China, India and other emerging markets are likely to help the SSA region in economic recovery and achieving sustainable growth. However, MENA and Asia will not be able to achieve the normal CAB surpluses by 2014. Their medium-term recovery in CABs will depend upon the movement in oil prices, global oil demand, and volume of trade (Figure 9).

Figure 9. Current Account Balance by Regions of OIC States (% of GDP)



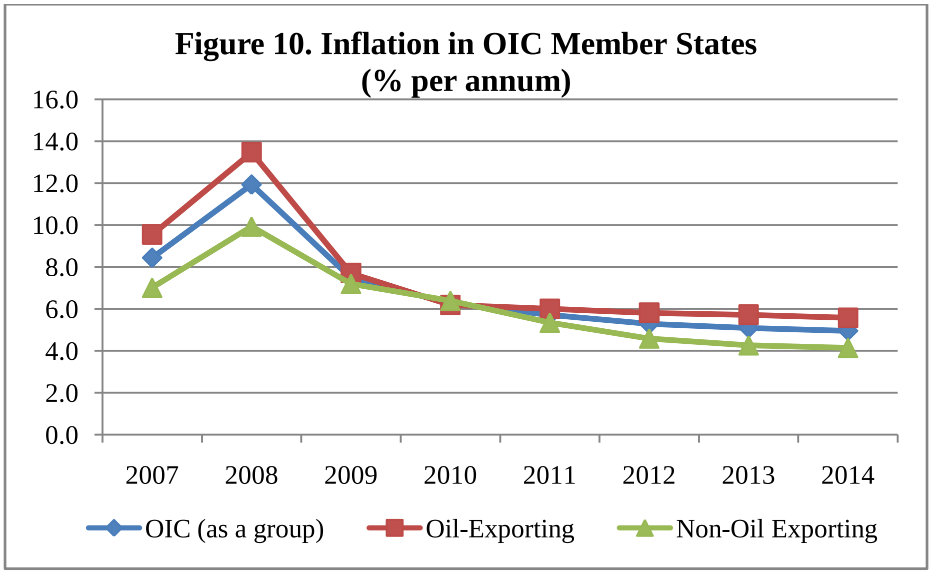
IDB estimates based on data from the IMF WEO database of October 2009

21. Although, the global financial and economic crisis appears to have adverse impacts on exports of OIC member countries, it has also created an opportunity for them to reconsider their trade and investment strategies and learn how to cope with a dramatically transformed international financial landscape. For instance, member countries need to enhance intra-trade through additional measures aimed at providing greater access to their markets. The OIC Ten-Year Programme, adopted in December 2005, called on member countries to expand the scope of intra-trade in order to achieve greater economic integration by raising its level to 20 percent of the overall trade volume by 2015. The intra-trade performance of member countries (as a group) has improved overtime, reaching 16.3 percent in 2008 and the 20 percent intra-trade target can be achieved through strengthening and expanding the scope of OIC-Trade Preferential System (TPS) in its full spirit. The OIC-TPS has been signed so far by thirty-one member countries but ratified by twenty-two members, having the required number of ratifications for its enforcement.[11] Another opportunity is in the area of encouraging investments by the Sovereign Wealth Funds in long-term infrastructure projects in member countries with adequate and competitive risk-return profile. Further, enhancing intra-trade and intra-investment also require

[11] Report on "Twenty Fifth Meeting of the Follow-up Committee of the COMCEC, 12-14 May 2009.

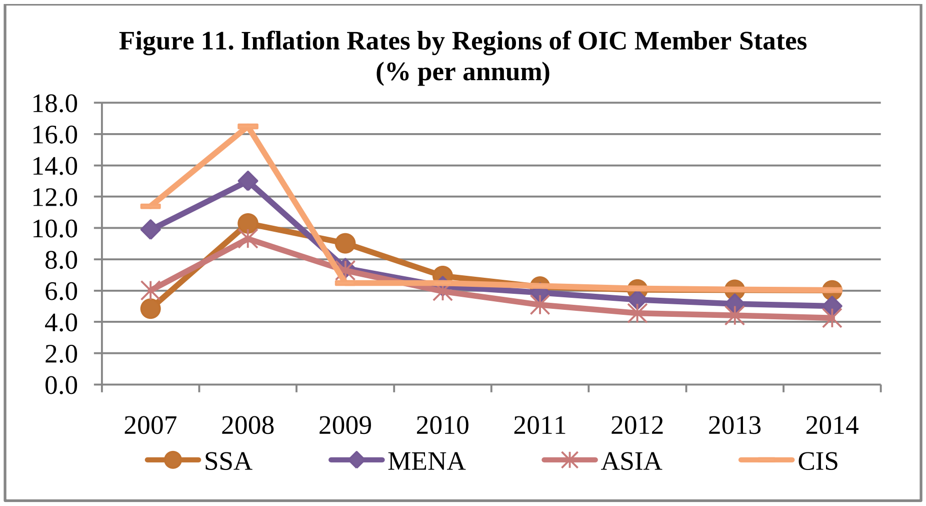
to remove tariff and non-tariff barriers, particularly free movement of labour and capital across regions.

22***. Inflationary pressure has been significantly released in OIC member countries.*** The sharp decline in domestic economic activities and wide gap between actual and potential output in OIC member countries have released inflationary pressures in both oil-exporting and non-oil exporting member countries. At the OIC level, inflation rate has declined from 11.9 percent in 2008 to 7.5 percent in 2009. The oil-exporting member countries experienced relatively sharp drop in inflation (from 13.5 percent to 7.7 percent) and non-oil-exporting member state from 9.9 percent to 7.2 percent during the same period (Figure 10).



IDB estimates based on data from the IMF WEO database of October 2009

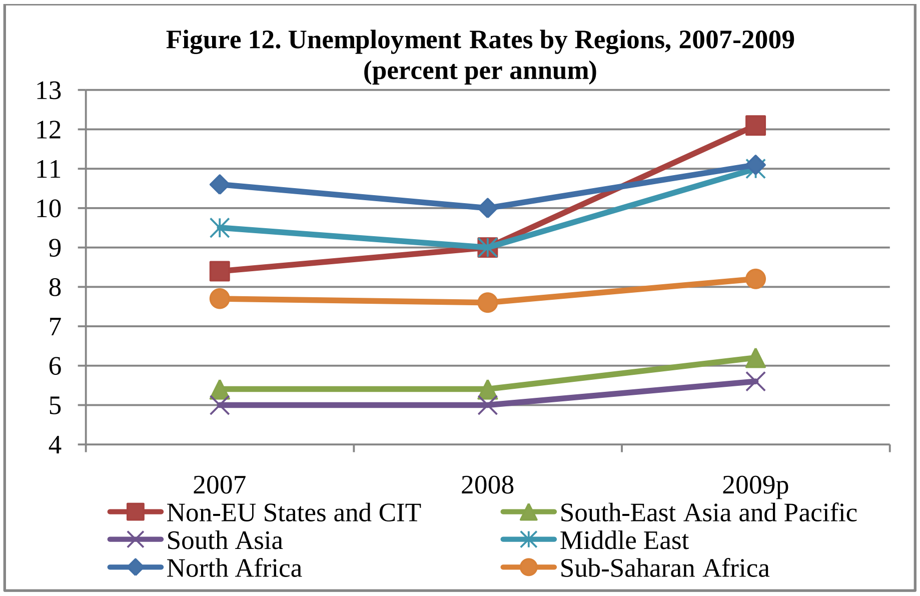
23***. The drop in inflation remained uneven across various regions.*** In CIT, inflation rate fell from 16.5 percent in 2008 to 6.5 percent in 2009, followed by MENA (from 13 percent to 7.4 percent), SSA (from 10.3 percent to 9 percent) and Asia (9.3 percent to 7.3 percent). Due to excess capacity and slow economic recovery, the inflationary pressure is expected to remain moderate in the medium-term (Figure 11).



IDB estimates based on data from the IMF WEO database of October 2009

IV. SOCIAL INDICATORS

*24. **Rising unemployment is posing a major challenge for OIC member countries.*** The current speed of economic recovery is insufficient to decrease unemployment. The impact of global economic recession on unemployment varies across regions of the globe. The latest estimates by the ILO (May 2009)[12] indicate that all regions are projected to experience higher unemployment rates in 2009 compared to 2007. Region-wise unemployment trends show that Non-EU States and Countries in Transition are projected to experience the highest increase in unemployment rate from 8.4 percent in 2007 to 12.1 percent in 2009, followed by the Middle East from 9.5 percent to 11 percent; North Africa from 10.6 percent to 11.1 percent; Sub-Saharan Africa from 7.7 percent to 8.2 percent; Southeast Asia and Pacific from 5.4 percent to 6.2 percent and South Asia from 5 percent to 5.6 percent during the same period (Figure 12). Creation of jobs requires new investment, the pre-requisites of which include political and economic stability, existence of proper legal and regulatory framework, appropriate policy environment, existence of basic infrastructure, and adequate economic incentives.



Data source: ILO (May 2009), Global Employment Trends Update.

25. While most OIC member countries were already facing the negative effects of food and fuel crises, the economic recession further compounded their socio-economic problems; in particular, it made the unemployment situation more serious. However, there is no easy and short-term solution to fix this problem.

26*. **The economic crisis has also led to rise in poverty in OIC member countries.*** The global economic slowdown threatens to reverse the gains made in terms of poverty and human development indicators. Recent estimates suggest that the food crisis has caused 130-155 million people to fall back into poverty and global financial and economic crisis will trap 53 million more people in poverty in developing countries, which will need an additional $38 billion to lift the incomes of the poor to the poverty line.[13] The sharp slowdown in economic growth in 2009 will substantially expand the resource requirements to put hard hit member countries back on track. According to the latest estimates by the UN (May 2009), between 73 and 103 million more people would fall into poverty due to financial crisis. Most of this setback will be felt in East and South Asia, with between 56 million and 80 million likely to be affected. The crisis could keep 12 million to 16 million more people in poverty in Africa, another 4 million in Latin America and the Caribbean, and about one million more in Economies in Transition. If the economic

[12] ILO (May 2009), Global Employment Trends Update.

[13] World Bank, Global Economic Prospects, 2009.

crisis has translated into a human crisis in the developing world, it will have a severe impact on the poor people in various regions of OIC member countries in the medium-term.

27. ***The adverse external factors have been compounded by a number of domestic factors resulting in weak socio-economic performance of OIC member countries.*** These domestic factors include:

- Resistance to macro reforms (i.e. generalized subsidies instead of targeted subsidies) and micro reforms (i.e. poor business climate for firm-level investment)
- Lack of focus on inclusive growth (i.e. lack of productive employment opportunities, unequal access to opportunities, and inadequate social safety nets)
- Weak linkage between the financial sector and real sector
- Weak corporate governance in the financial institutions
- No common policy to improve OIC regional imbalances

28. ***There are a number of risks to medium-term socio-economic outlook of member countries.*** These risks include:

- As accommodative fiscal, monetary, and financial policies have played a critical role in mitigating the adverse effects of economic recession, their premature exit may reverse V-shaped recovery into U-shaped or W-shaped.
- Long-lasting stimulus packages and money injections may result in higher fiscal deficit and unsustainable public debt.
- Oil price risk due to geopolitical situation may increase the risk to current account balance.
- Increase in domestic and foreign cost of financing may discourage much needed private investment activities and reduce private consumption.
- A strong return of H1N1flu (Swine flu) may slow growth through affecting tourism industry, travel, and business sector.
- With regard to achieving intra-OIC trade target and enhancing intra-investment, not removing barriers on mobility of labour and capital across regions.

V. PROPOSED MEASURES TO IMPROVE SOCIO-ECONOMIC OUTLOOK OF OIC MEMEBR COUNTRIES

In order to mitigate the adverse impact of economic recession and improve socio-economic outlook of OIC member countries, following medium-and long-terms measures are suggested.

Medium-term Measures

- **Rescue** through stimulus packages and money injections, which need to be continued until private domestic demand/consumption fully recovers but in a fiscally sustainable way with keeping the inflation under close check by the monetary authorities. In this context, policymakers need to choose the right time for starting tightening the fiscal and monetary policies.

- **Recovery** is expected from 2010 but the question remains whether V-, U-, or W-shaped recovery, therefore, the member countries need to adjust their policies accordingly.
- **Rebalancing** regional imbalances of OIC member countries is essential (i.e. shifting resources from resource-rich regions to resource-deficient regions through enhancing intra-trade and intra-investment).

Long-Term Measures

- **Re-regulation** of the financial sector in order to make it stable and respond to the needs of the priority economic sectors and support economic recovery.
- **Expanding** Islamic financial institutions would be a best alternate as Islamic financial structure creates clear link between the financial sector and real sector and contributes more to the development of an economy.
- Adopt **macro reform** (i.e. targeted subsidies instead of generalized subsidies) and **micro reform** (i.e. improve the efficiency of firm-level investment through improving business climate).
- **Re-assure inclusive growth** The economic recession is also fueling rising unemployment and poverty in OIC member countries. Therefore, increasing employment opportunities, providing equal access to opportunities and adequate social safety nets will be essential.