5

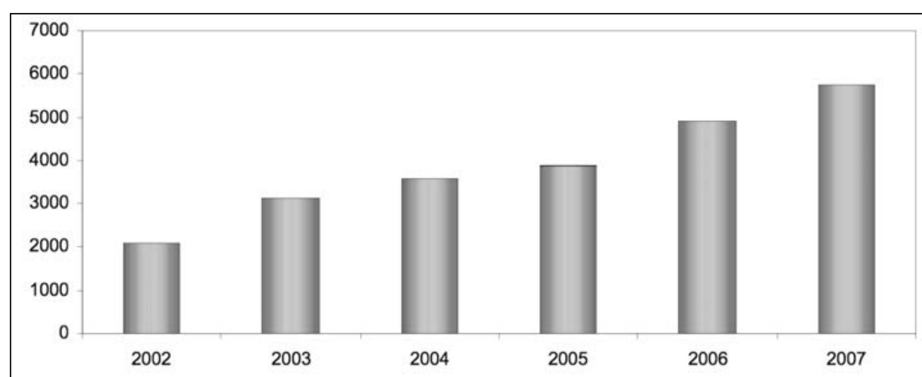
Other Direct Channels of Transmission of the Crisis in Small States

Trade is only one of the channels through which the crisis transmits its effects to developing countries. Given the degree of openness of small states, it is likely to be the most relevant channel in several cases. However, to put the discussion in context, it is worth briefly examining the other direct channels and the way they may impact on small states. Te Velde *et al.* (2009b) identify three areas other than trade where global shocks induced by the crisis may hit developing countries' economies: private capital flows, remittances and aid. We adapt the discussion in te Velde *et al.* (2009b) in what follows.

5.1 Private capital flows

Despite the small size of their markets and limited potential to reap economies of scale in production, most small states have been able to attract a relatively large flow of FDI in the past years. This is mainly due to their potential for tourism and the access to exclusive economic zones that they can offer (this is true of SIDS in particular). Small states are therefore able to attract significant resource-seeking and, to a lesser extent, strategic asset-seeking FDI inflows. Recent trends of FDI inflows to small states show significant increases up to 2007, particularly to SIDS (Figure 25). These have contributed to the large relative size of FDI in small countries, where FDI is often larger than country's entire GDP. However, FDI flows in any given year are usually less than 10 per cent of GDP, which makes a sudden halt in FDI less problematic than a sudden halt in exports for small states. Preliminary evidence gathered by te Velde *et al.* (2009b) suggests that FDI inflows to small states, especially in relation to tourism, financial services and real estate, have already fallen.

Figure 25. FDI inflows to SIDS, 2002–2007 (US$ million)



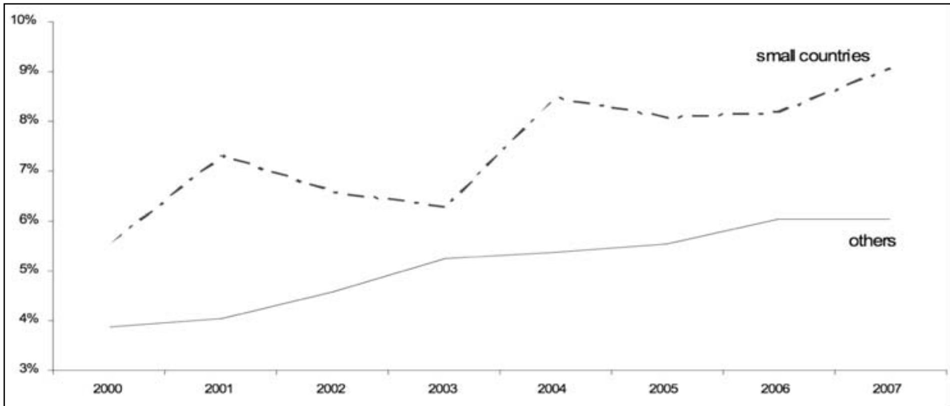
Source: te Velde *et al.* (2009b)

Over the past years, private sector development in small states has been mainly financed through domestic credit. On average, domestic credit to the private sector as a share of GDP has been rising steadily, and in a number of cases it represents over 50 per cent of GDP. The crisis has put at risk access to finance by the private sector. Increased risk aversion in international financial markets has reduced the willingness of banks to lend and has made it more difficult to obtain funds from outside because of the flight-to-quality effect. In a few small states, there have already been the first signs of a contraction in domestic credit as well as of tighter credit conditions. In St Lucia, for example, after three years of rapid growth, in 2008 the expansion in domestic credit slowed to 10.7 per cent, due to a contraction in domestic credit to the private sector, which increased by just 11.6 per cent. In Trinidad and Tobago, lending rates increased as a consequence of the Central Bank's decision to raise its 'repo' rate to 8.75 per cent and to increase the reserve requirements of banks.

5.2 Remittances

The role of remittances in stimulating poverty reduction, private sector development and growth is compounded in small states by their higher level of dependence on remittances as a source of capital than is the case in other developing countries. Figure 26 shows how the share of remittances in GDP has been continuously higher in small states than in other developing countries throughout the last decade. This relatively high remittance-dependence of small states is driven by their larger share of migrants in the population. Docquier and Rapoport (2004) show that net emigration rates per capita in the sending country decrease with sending country size, so that in countries with a population of over 25 million, aggregate emigration rates are less than a fifth of those in countries with a population of less than 4 million.

Figure 26. Remittance dependence: small states compared with other developing countries



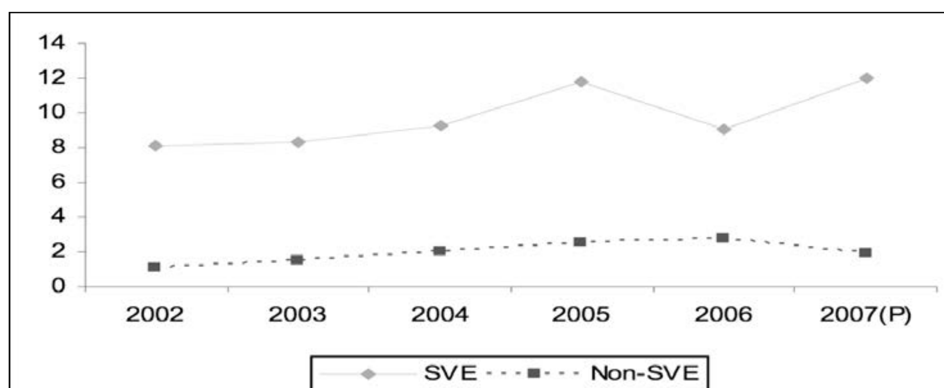
Note: Figures calculated as simple averages across countries.
Source: te Velde *et al*. (2009b)

World Bank (2009) and Calì and Dell'Erba (2009) suggest that remittances may decline by between 4 and 14 per cent (depending on the regions and the source considered). This confirms the resilience of remittances to shocks, such as the current financial crisis, relative to other flows (e.g. private capital flows and trade), but also shows that these flows are unlikely to be immune to the shock. The two most affected regions appear to be East Asia and Pacific and Latin America. As these are also the regions which have the most remittance dependent small states, this may pose some strains to the availability of external capital in a number of those states. In countries like Tonga, Lesotho, Guyana, Samoa and Jamaica remittances represent over one-fifth of GDP. Some preliminary evidence reported in te Velde *et al.* (2009b) suggests that remittance-dependent small states are already suffering substantial reductions in these flows. In Tonga, for instance, remittances are down by about 15 per cent for the 2008/2009 financial year ending in June, increasing the risk of unsustainability of debt. Jamaica experienced a similar drop of 18 per cent in February 2009, which brought the decline to 14 per cent for the first two months of 2009. On the other hand, remittances seem to have held up thus far in Samoa, which saw an increase of 4 per cent in the first nine months of the 2008/2009 financial year.

5.3 Aid

Small states usually receive more aid per capita than other developing countries, and therefore tend to be more vulnerable to falls in aid than other developing countries. Figure 27 shows the relative magnitude of an important category of aid flows (particularly relevant in this context), aid for trade, on a per capita basis in small and vulnerable economies (SVEs) and in other developing countries.

Figure 27. Aid for trade to small and vulnerable economies and other developing countries (US$ per capita)



Note: Preliminary data available for 2007.
Source: Calì and te Velde (2009b) based on OECD/DAC Creditor Reporting System (source and definition of SVE also included)

Whether aid budgets will indeed be squeezed by the increasing pressure of the financial crisis on industrial countries can only be matter of speculation at this time. However, a recent study (Frot, 2009) supports the view that this may be the case if one looks at the effects of previous crises. Past evidence suggests that a crisis reduces aid budgets by 13 per cent and the adverse effects are still felt up to five years after the crisis.