The Effect of the Global Financial Crisis on Emerging and Developing Economies

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Summary

- The global financial crisis has hit emerging and developing economies extremely hard. Output, exports, remittance flows, aid and capital inflows have all been lower than expected.
- For some people in the poorest economies this has been disastrous. Lower employment rates and a lack of social safety nets mean that poverty is higher than it would otherwise have been. Around 120 million more people may now be living on less than US$2 a day, and 89 million more on less than US$1.25 a day.
- It is impossible to measure exactly the effects of the financial crisis because we can never know for certain what would have happened if it had not occurred. But reasonable estimates of its effects can be derived by looking back to the second half of 2007 and comparing forecasts made then for 2008, 2009 and 2010 with actual developments over the last three years.
- On this basis, it is clear that the financial crisis has knocked emerging and developing economies onto a lower trajectory for output, exports and remittances. Nominal GDP for this group of countries will be around US$1.3 trillion lower in 2010 than was expected in 2007, and the cumulated loss over the three years 2008 to 2010 will amount to US$2.6 trillion. Lost remittances over the same period will amount to more than US$100 billion.
- Private portfolio flows to emerging and developing countries fell sharply as the financial crisis deepened, but they were clearly at an unsustainable level in the lead-up to the crisis. Direct investment flows have held up much better.
- Aid flows to low-income countries will be lower than hoped. The money value of aid targets has been reduced and some countries will choose to fall short of their targets because of pressures on their public finances. African countries will see only US$11 billion of the US$25 billion in increased aid promised for 2010 at the Gleneagles G8 and Millennium +5 meetings in 2005.
- Although the worst of the crisis appears to be in the past, its effect on emerging and developing economies will be sustained well into the future. Poverty will be higher than it would otherwise have been and achieving the Millennium Development Goal of halving poverty by 2015 will be that much harder.

1 Comparable figures for the group of ‘advanced countries’ are US$3.1 trillion and US$6.7 trillion
Introduction
The aim of this paper is to set out estimates of the cost of the global financial crisis to emerging and developing economies. The financial collapse of 2008 and 2009 produced the worst global recession since the 1930s. Demand in advanced economies slumped, despite efforts by governments and central banks to support it through easier fiscal and monetary policies. Inevitably, this has had severe negative consequences for emerging and developing countries.

We would like to catalogue the human costs of the crisis, in terms of lost jobs, lost income, reduced consumption levels, increased poverty and reduced education opportunities, but much of the data needed to do so is not yet available. So we focus instead on macroeconomic indicators. There have already been some attempts to estimate the effects of the crisis, particularly on output, but we extend that analysis to encompass its effects across a range of variables: output, exports, remittances, aid and capital flows.

One problem with this type of analysis is that we can never be sure what would have happened had the financial crisis not occurred. In some cases, such as output growth, it might be reasonable to assume that the rates recorded immediately prior to the crisis would have been sustained. In others, this will not do; some reasonable estimate has to be made of the underlying trend ahead of the crisis. The fact that some developments in the global economy prior to the financial crisis were unsustainable also has to be taken into account.

It is also the case that the effects of the financial crisis will probably linger for several years, so current estimates of its impact on emerging and developing economies rely to some extent on forecasts of the future. These appear, for the most part, optimistic. Should they prove wrong – for example, if the advanced economies experience a ‘double-dip’ recession or an extended period of little or no output growth – then estimates of the severity of the effect of the crisis on emerging and developing economies will need to be revised upwards.

Lost output
As a result of the global financial crisis, emerging and developing economies across all regions experienced a sharp slowdown in output growth. In aggregate, real GDP growth in emerging and developing economies fell from 8.3 per cent in 2007 to 6.1 per cent in 2008 and just 2.4 per cent in 2009 (IMF 2010a). The real GDP of countries in the Commonwealth of Independent States (CIS), central and eastern Europe (CEE) and the Western Hemisphere contracted in 2009, while in developing Asia, sub-Saharan Africa, and the Middle East and North Africa (MENA) real GDP growth in 2009 was well below its average rate in the years leading up to the crisis. 

2 Appendix 1 sets out in more detail the effects of the crisis on sub-Saharan Africa, as the region that is potentially most vulnerable to negative shocks.

3 See Appendix 2 for lists of the countries in each of these regional blocs.
One simple way to gauge the effect of the crisis on emerging and developing economies is to compare GDP growth over the period 2003–07 with growth in 2008, 2009 and 2010. This suggests a shortfall of 1.3 per cent in 2008, 5 per cent in 2009 and 1.1 per cent in 2010 – or a cumulative loss of around 7.5 per cent by 2010.

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
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<td>6.1</td>
<td>2.4</td>
<td>6.3</td>
<td>-1.3</td>
<td>-5.0</td>
<td>-1.1</td>
</tr>
<tr>
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<td>4.0</td>
<td>-0.6</td>
<td>-6.6</td>
<td>-0.9</td>
</tr>
</tbody>
</table>

Source: IMF 2010a

A better approach is to compare what actually happened with what leading forecasters thought might happen, because this will abstract from any anomalies in the 2003–07 period. For example, the IMF’s forecasts for real GDP growth published in October 2007 – while global growth was still strong and only a moderate slowdown was expected – can be compared with their latest forecasts, published in April this year. These show massive shortfalls in growth in 2009, compared to expectations, and smaller shortfalls in 2008 and 2010 through to 2012.
In aggregate, GDP growth for these economies was 1.3 per cent lower than expected in 2008 and 4.9 per cent lower in 2009. Based on the latest forecasts, it will also be 1 per cent lower in 2010, 0.8 per cent lower in 2011 and 0.7 per cent lower in 2012. Similar results are obtained if World Bank forecasts are used rather than IMF forecasts (World Bank 2008).

This suggests that, as result of the crisis, emerging and developing economies’ nominal GDP in 2010 is likely to be about US$1.3 trillion lower than was being forecast in October 2007, and that the cumulative loss of output over the period 2008–10 will be US$2.6 trillion.

Two further implications should be emphasised. First, the output that was lost as a result of the crisis, particularly in 2009, has gone forever. There is no compensating period of above-trend growth, as Figure 3 clearly demonstrates.
Second, the trend growth rate for these economies appears to have been reduced by between 0.5 and 1 per cent. The IMF believes that potential growth in the advanced economies has been permanently lowered as a result of the crisis, principally because weakened financial systems will take many years to mend, and while this is occurring there will be fewer funds available for investment and innovation (IMF 2009a: 68).

**Lost exports**

The main channel through which the crisis affected emerging and developing economies is trade. The sharp fall in demand in advanced economies led to a collapse in world trade and substantial declines in exports.

<table>
<thead>
<tr>
<th>Region</th>
<th>Export Growth</th>
<th>Difference from 2003–07</th>
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<tr>
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<td>-1.4</td>
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<tr>
<td>Developing Asia</td>
<td>16.2</td>
<td>6.2</td>
</tr>
<tr>
<td>MENA</td>
<td>7.0</td>
<td>2.4</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>6.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Western Hemisphere</td>
<td>8.3</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: IMF 2010a

In October 2007 the IMF expected emerging and developing countries to record export growth of 9–10 per cent throughout the period 2008–12. The latest estimates show exports grew by only 4 per cent in 2008, fell by over 8 per cent in 2009, and are now expected to increase at an annual rate of 8–9 per cent between 2010 and 2015. In aggregate across all regions, exports from emerging and developing economies in 2010 are expected to be some 20 per cent lower than was being forecast in 2007. This goes a long way to explaining the output losses suffered by these countries.
All regions were badly affected. Countries in developing Asia, central and eastern Europe and the Commonwealth of Independent States suffered the biggest falls in exports in 2009, both in absolute terms and relative to expectations, but even sub-Saharan Africa, which is less well integrated into the global economy, experienced a fall of 7 per cent in exports in 2009.  

Lost remittances

The effect of lost remittances varies from region to region. Parts of the Caribbean and Latin America have been very badly affected, as well as those CIS countries that previously enjoyed high levels of remittances from Russia. On the other hand, most of East and South Asia has suffered much less severely. Trends within Africa have varied, with North Africa being more heavily affected than many of the sub-Saharan countries (World Bank 2010).

The depth of the financial crisis is the key factor explaining these different regional trends. The more heavily a ‘destination’ country and sector of work has been affected by the crisis, the greater the drop in remittances (Glennie and Chappell 2009, Latorre and Chappell 2009). So remittances from workers in North America and Europe and in industries such as construction have been worst hit. This is illustrated in the figure below for Bangladesh. It shows that remittances sent from the Gulf Cooperation Council (GCC) countries to Bangladesh dropped much less dramatically than those sent from the United States.

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4 There is no space here for comprehensive analysis of the effects on individual countries. The Overseas Development Institute has examined the impact of the crisis on selected economies (ODI 2010).
Overall, the World Bank estimates that remittances to low-income countries fell by about 6 per cent in 2009. This marks ‘a decisive break from the past’, as remittances had previously been growing at double-digit rates (IMF 2009b: 12). Indeed, both the IMF and World Bank estimate that remittances in 2009 may have been over 20 per cent lower than they would have been had there been no financial crisis.

Moreover, the World Bank forecasts only a relatively shallow recovery of around 6 per cent in 2010 and 7 per cent in 2011. By the end of the current year, in other words, lost remittances will have amounted to US$109 billion compared to an assessment that they would have increased by 15 per cent per annum (a fairly conservative assumption) if there had been no financial crisis.

Lost aid

The latest figures from the OECD’s Development Assistance Committee (DAC) suggest aid has been less hard hit by the financial crisis than output, trade and remittances. The DAC reported a 0.7 per cent real-terms increase in official development assistance in 2009, lifting it to US$119 billion, or 0.31 per cent of its members’ gross national income (GNI) (OECD 2010a). It expects a further increase in aid in 2010 to US$126 billion.

However, the financial crisis has had the effect of reducing the dollar value of the commitments made for 2010 at the Gleneagles G8 and Millennium +5 meetings in 2005 (because these commitments were expressed in terms of a proportion of GNI and GNI will turn out to be lower than expected). The DAC believes this represents lost aid flows of US$4 billion (in 2004 dollars). In addition, aid in 2010 is likely to fall US$14 billion short of even the reduced target.

African countries will feel the impact particularly badly, with the continent estimated to receive only about US$11 billion of the US$25 billion increase envisaged at Gleneagles (ibid). In part, this is attributable to the financial crisis, though some European countries were already falling behind their targets.
Lost capital inflows

The global financial crisis caused private capital flows to emerging and developing economies to slump in 2008 – but from levels that had clearly been artificially boosted by the very types of behaviour that helped to bring about the crisis. Judging what might have happened if the financial boom and bust had not occurred is extremely difficult. Although inflows are below their levels in 2004–06, they are well above what was seen from 2000–02.

The effect of the crisis on private capital flows varied considerably from region to region. The biggest immediate effect was on CIS countries, which saw large inflows in 2007 replaced by large outflows in 2008 and 2009. Developing Asia experienced a big fall in inflows in 2008, though they remained positive, whereas the effect in central and eastern Europe was delayed until 2009.
The biggest increases and subsequent declines in capital flows were in portfolio and other financial flows. Direct investment flows were boosted in 2007 and 2008, probably due mainly to extraordinary increases in some commodity prices. They have subsequently fallen back, but look set to remain above their 2006 level.

The regions most badly hit by the freezing of credit markets and a consequent drying up of capital inflows were the CIS countries and central and eastern Europe. This led to what are best described as depressions in the Baltic States, where GDP contracted by between 14 and 18 per cent in 2009, and to severe recessions in many other economies. Several countries – including Bosnia, Hungary, Latvia, Romania and Serbia – were forced to resort to balance of payments support from the IMF.

There is little prospect of growth in this region returning to its pre-crisis level any time soon and unemployment will remain high for many years. This is almost certain to lead to hysteresis effects – for example, if some displaced workers drop out the labour force altogether – but it is too early to be able to make a sensible estimate of their likely scale.

Russia also experienced a sharp fall in capital inflows in 2008 and 2009. These had been boosted ahead of the crisis by the high price of oil but fell away as the crisis developed. This had a very significant effect on the Russian economy, but also on the economies of many other countries in the CIS which had come to rely on exports to and remittance flows from Russia.

However, particular caution is needed before attributing the problems of central and eastern Europe and the CIS to the financial crisis alone. The exceptionally strong growth rates recorded there in the mid-2000s were, with the benefit of hindsight, unsustainable and only achievable because of

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5 When economists refer to ‘hysteresis effects’, they mean the risk that some cyclical effects – such as an increase in unemployment during a recession – become more permanent, or structural. For example, workers who are unemployed for any length of time may lose the skills they need to find employment or find it difficult to acquire new skills that may be needed to find a job. As a result, they may settle for employment that is less productive than what they are capable of, or they may drop out of the labour force altogether. The economy’s productive potential is, therefore, diminished.
some of the activities that ultimately caused the crisis. That said, output in Latvia (for example) is expected to be only 30 per cent higher in 2011 than it was in 2001 – an annual growth rate of 2.7 per cent, which is some way below what it should be capable of achieving.

**Lost revenues (and other fiscal effects)**

The immediate effect of the financial crisis on low-income countries would have been much greater had they not, as a group, made enormous efforts to improve their economic situation in the years before 2008. Lower inflation, reduced debt and stronger fiscal positions meant that many countries were able to adjust policy in response to the crisis in a way that would have been impossible 10 years earlier (ODI 2010). In particular, fiscal policies were eased to offset some of the negative effects of the crisis on economic activity. According to the IMF around one-third of low-income countries introduced some discretionary fiscal stimulus, while many others allowed the ‘automatic stabilisers’ to operate, and the overall fiscal balance of low-income countries deteriorated by 2.7 per cent of GDP in 2009 (2010a).

While these actions will have mitigated the effect of the crisis in the short-term and prevented much worse outcomes for poverty, there is likely to be a price to pay when the stimulus is reversed. Just as the UK government is now having to act to reduce its deficit over the medium-term, so fiscal consolidation, when it takes place, will be a drag on the economies of low-income countries. But, just as in the UK, there is a risk that it takes place too rapidly. Already, senior figures at the IMF are talking about the need to return fiscal positions to a more sustainable state.

Katerina Kyrili and Matthew Martin have analysed the effects of the economic crisis on the budgets of low-income countries. Their concern is that efforts by these countries to improve their budgetary positions could lead to cuts in spending that would directly affect their ability to meet the Millennium Development Goals (2010). They argue that the crisis has created a ‘fiscal hole’ of $65 billion in total (taking 2009 and 2010 together) for low-income countries, as a result of lost revenues and increased spending, mainly on anti-poverty programmes. This fiscal hole has been filled one-third by external financing and two-thirds internally.

Closing this financing gap is likely to mean spending cuts. Kyrili and Martin’s analysis of the individual budgets of 56 countries shows many are already taking action in 2010, and that as a group these countries are acting faster than advanced countries to reverse the fiscal easing that took place in 2008 and 2009. They note: ‘Two-thirds of countries are cutting budget allocations in 2010 to one or more of the priority pro-poor sectors of education, health, agriculture, and social protection, just at a time when they need to massively increase such spending.’ (ibid: 4).

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**Figure 10**

Total fiscal and revenue holes in low-income countries (US$ billion)

Source: Kyrili and Martin (2010: 9)

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6 That is, allowing tax revenues to fall and welfare spending to increase without taking offsetting action to increase taxes or to cut other areas of spending.
It is impossible to put a figure on the ultimate effect of fiscal consolidation on the economies of low-income countries (as the debate about the possible effect of public spending cuts on the UK economy makes clear). However, it is very likely that economic growth will be held back somewhat over the next few years as countries seek to bring spending more closely into line with revenues.

**Increased poverty and lost lives**

So far, this report has focused on attempting to gauge the macroeconomic effects, across a range of indicators, of the financial crisis. But we should remember that behind the large economic numbers are the lives of people and that it is these lives that are ultimately affected by the crisis. It is beyond the scope of this paper to look at all the human dimensions, but we are able to include a brief comment on poverty and mortality.

The financial crisis put a severe dent in the economic growth of developing countries and caused output to contract in many of them. As a result, poverty levels, which had been falling steadily, will have risen in most low-income countries. The effects will be uneven. At greatest risk will have been those economies that are relatively well integrated into the global economy because, for example, they will have seen the biggest falls in exports or large drops in remittances. Some of the very poorest countries, and regions within countries, will have been insulated by the very factor that caused them to be poor in the first place: their isolation from the global economy and markets.

Poverty counts are generally based on surveys, so hard evidence of the effect of the crisis will not be known for some time. For now we have to rely on projections. In 2009, Martin Ravallion at the World Bank suggested that: ‘the crisis will increase the 2009 count of people living below US$1.25 a day by 50 million’ and ‘another 64 million will be added to the number living under US$2 a day’ (2009: 17). He expects these numbers to increase further in 2010, to 89 million and 120 million respectively. Our own calculations, using more recent data, support these projections.

Increased poverty, particularly in low-income countries, will inevitably lead to higher mortality rates. Estimating the scale of these effects is fraught with difficulties, but analysts at the World Bank have attempted to gauge the effect of the global financial crisis on infant mortality in sub-Saharan Africa (Friedman and Schady 2009). Their estimates, based on regression analysis, suggest that the crisis will result in between 30,000 and 50,000 additional infant deaths in sub-Saharan Africa.

**Conclusion**

The global financial crisis has hit low-income countries very hard.

By the end of 2010, emerging and developing economies as a group may have lost output equal to around US$2.6 trillion. Exports will be 20 per cent – or over US$1 trillion – lower in 2010 than was being forecast before the crisis began. And remittances in 2009 and 2010 have been more than US$100 billion short of what might have been expected if there had not been a crisis. Official aid in 2010 is also set to fall some US$20 billion short of the levels targeted in 2005.

As a consequence of the crisis, there may now be 120 million more people living on less than US$2 a day and 89 million more living on less than US$1.25 a day.

It is hoped that the worst phase of the crisis is in the past, though recent signs of renewed economic weakness in the United States and Europe have sparked fears of a ‘double-dip recession’. However, even if the global economy continues to recover, the effects of the crisis on low-income countries will be long-lasting. Output, exports and remittances from overseas are all on lower trajectories than was expected three years ago. As a result, achieving the Millennium Development Goal of halving poverty by 2015 will be harder than previously anticipated. An urgent task for the international agencies and advanced economies is to recalculate the amount of aid that will be needed to help low-income countries achieve this aim.
Appendix 1: Sub-Saharan Africa

The effect of the financial crisis on sub-Saharan Africa has not been as great as was initially feared. In part, this is due to the limited integration of many of the region’s economies and financial systems into the global economy. But it also reflects the stronger macroeconomic position of the region in 2008, when compared to its position ahead of earlier crises.

Table A1 summarises the main effects. It also gives some indication of how the effect of the global financial crisis on sub-Saharan Africa has varied quite widely. The largest effects have been on countries that are integrated into the global economic and financial system, whether through their financial systems (such as South Africa), their trade (particularly the oil exporters) or for other reasons (for example, the reliance of the Seychelles on tourism).

<table>
<thead>
<tr>
<th></th>
<th>GDP</th>
<th>Consumer prices</th>
<th>Overall fiscal balance</th>
<th>Current account balance</th>
<th>Stock of reserves</th>
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<tr>
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<td>(per cent change)</td>
<td>(percentage of GDP)</td>
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<tr>
<td>Sub-Saharan Africa</td>
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<td>-14.1</td>
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<td>2.9</td>
<td>-1.2</td>
<td>0.4</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: IMF 2010b: 5

The IMF also notes that ‘job losses and reduced employment opportunities have affected millions of households’, pointing out that around 900,000 jobs were lost in South Africa alone in 2009 (ibid: 4). The absence of social safety nets means that these employment losses will have had devastating effects on the people affected. They will have resulted in increased poverty and will set back efforts to achieve the Millennium Development Goal of halving poverty by 2015.

Analysis by staff members at the IMF suggests African countries that are relatively heavily dependent on remittances, such as Morocco and Tunisia, could have lost up to 2 per cent of GDP in 2009 due to the fall in remittances (Barajas et al 2010: 10), though they go on to note that, with the exception of countries in North Africa, the impact of the financial crisis on African GDP through reduced remittances is small. This is largely because most African countries do not receive large remittances from outside the continent.

The IMF also looked at the effect of the crisis on private capital flows to sub-Saharan Africa. It found that foreign direct investment, which before the crisis was focused on oil-exporting countries, fell back in 2009 due to the fall in the oil price, while portfolio inflows, concentrated on South Africa, went into reverse in 2008. It also said that remittance flows fell by US$0.5 billion (3 per cent) in 2009 – in no case did the fall in remittances exceed 0.5 per cent of GDP, though it noted that a ‘jobless recovery’ in advanced economies might mean that remittances fall further and are slow to recover (ibid: 51).

Lastly, the IMF expressed a concern that reduced bilateral aid flows were a serious risk once donor countries began to address the serious deterioration in their fiscal deficits (ibid: 52).
## Appendix 2: Emerging and developing countries by region

**Central and eastern Europe**
- Albania
- Bosnia and Herzegovina
- Bulgaria
- Croatia
- Estonia
- Hungary
- Latvia
- Lithuania
- Macedonia
- Montenegro
- Poland
- Romania
- Serbia
- Turkey

**Commonwealth of Independent States**
- Armenia
- Azerbaijan
- Belarus
- Georgia
- Kazakhstan
- Kyrgyz Republic
- Moldova
- Mongolia
- Russia
- Tajikistan
- Turkmenistan
- Ukraine
- Uzbekistan

**Developing Asia**
- Afghanistan
- Bangladesh
- Bhutan
- Brunei Darussalam
- Cambodia
- China
- Fiji
- India
- Indonesia
- Kiribati
- Lao People’s Democratic Republic
- Malaysia
- Maldives
- Myanmar
- Nepal
- Pakistan
- Papua New Guinea
- Philippines
- Samoa
- Solomon Islands
- Sri Lanka
- Thailand
- Timor-Leste
- Tonga
- Vanuatu
- Vietnam

**Middle East and North Africa**
- Algeria
- Bahrain
- Djibouti
- Egypt
- Iran
- Iraq
- Jordan
- Kuwait
- Lebanon
- Libya
- Mauritania
- Morocco
- Oman
- Qatar
- Saudi Arabia
- Sudan
- Syrian Arab Republic
- Tunisia
- United Arab Emirates
- Yemen

**Sub-Saharan Africa**
- Angola
- Benin
- Botswana
- Burkina Faso
- Burundi
- Cameroon
- Cape Verde
- Central African Republic
- Chad
- Comoros
- Congo, Democratic Rep. of
- Congo, Republic of
- Cote d’Ivoire
- Equatorial Guinea
- Eritrea
- Ethiopia
- Gabon
- Gambia, The
- Ghana
- Guinea
- Guinea-Bissau
- Kenya
- Lesotho
- Liberia
- Madagascar
- Malawi
- Mali
- Mauritius
- Mozambique
- Namibia
- Niger
- Nigeria
- Rwanda
- Sao Tome and Principe
- Senegal
- Seychelles
- Sierra Leone
- South Africa
- Swaziland
- Tanzania
- Togo
- Uganda
- Zambia
- Zimbabwe

**Western Hemisphere**
- Antigua and Barbuda
- Argentina
- Bahamas, The
- Barbados
- Belize
- Bolivia
- Brazil
- Chile
- Colombia
- Costa Rica
- Dominica
- Dominican Republic
- Ecuador
- El Salvador
- Grenada
- Guatemala
- Guyana
- Haiti
- Honduras
- Jamaica
- Mexico
- Nicaragua
- Panama
- Paraguay
- Peru
- St Kitts and Nevis
- St Lucia
- St Vincent and the Grenadines
- Suriname
- Trinidad and Tobago
- Uruguay
- Venezuela
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