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United Nations Development Programme

POVERTY REDUCTION

# TOWARDS HUMAN RESILIENCE: SUSTAINING MDG PROGRESS IN AN AGE OF ECONOMIC UNCERTAINTY







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# **TOWARDS HUMAN RESILIENCE: SUSTAINING MDG PROGRESS IN AN AGE OF ECONOMIC UNCERTAINTY**

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## FOREWORD

The recent global economic crisis has reinforced significant concerns about the impact of financial and economic shocks in an integrated world economy. Moreover, the increasing frequency and severity of such shocks raise important questions about their systemic character and the ability of individual countries to withstand the most damaging and lasting effects of such economic uncertainty. Perhaps most significantly: How do economic crises affect the world's most vulnerable populations? What structural characteristics make some economies more susceptible to the harmful effects of such shocks? And what policies or strategies can help developing countries grow and prosper in times of profound and unpredictable economic change globally?

The problem of economic vulnerability and the need for policies that make nations more resilient to volatility has a human face. It directly impacts how well households meet basic needs. Responsive strategies, or the lack thereof, affect how many people live in poverty, the overall impact of disease, the educational hopes and expectations of youth, the overall sustainability of housing and food supplies, and the likelihood of meaningful work opportunities for all men and women. Economic shocks have the potential to slow progress towards these and other important Millennium Development Goals. As seen in the wake of the 2007-08 financial and economic crisis, disruptions and unpredictability in world markets exasperate generational cycles of poverty, dash the dreams of hard working families, and unnecessarily squander human potential.

To address the essential questions about economic vulnerability and resilience, UNDP has prepared this detailed report, *Towards Human Resilience: Sustaining MDG Progress in an Age of Economic Uncertainty*. It identifies key determinants that shape how countries experience and adapt to economic and financial shocks while considering policies and practices that minimize susceptibility. This report highlights how an increasingly interdependent and integrated global economy shapes the vulnerability and resilience of developing countries.

Significantly, the research in this report demonstrates that dependence on highly volatile commodity exports not only decreases the ability of governments to predict budget revenue and thus expenditure, but also impacts income in dependent households. In this manner, unpredictability in world markets produces considerable uncertainties at the household level. Additionally, investment and official aid flows can render developing economies particularly vulnerable to economic shocks depending on how reliant they are on these to maintain government spending. Indeed, such flows often trend in a manner that is procyclical, falling during unexpected downturns, precisely when developing countries need financial resources the most.

Increasing income inequalities at the global and country level also play a substantial role in the susceptibility of developing countries to financial shocks. Income inequality is unique in that it contributes to financial instability itself by fostering a political environment that lends itself to risky investment behaviour and the emergence of asset bubbles. Furthermore, such inequality, when it is high and persistent, makes poverty reduction goals particularly difficult to achieve.

Resilience to economic shocks may be dependent on a developing country's ability to maintain spending despite significant losses in revenue and without compromising the overall health of its economy. Functional institutions and governance structures play an important role in shaping resilient responses to change. However, in some of the nations affected, existing high debt levels and international restrictions on deficit spending often constrain the prompt and targeted spending needed to minimize the harm of shocks — harm that for the people affected can be long-term or even permanent in nature.

While there is no one size fits all approach to reducing vulnerability and increasing resilience in developing countries, this report provides many policy recommendations that can be applied to the needs of particular developing economies. With these recommendations as a guide and with support from the international community and global institutions, developing countries can build strong mechanisms to safeguard against economic shocks and protect essential development progress towards 2015 and beyond.



A handwritten signature in black ink, appearing to read 'Olav Kjørven', with a long horizontal stroke extending to the right.

**Olav Kjørven**

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## LIST OF ACRONYMS AND ABBREVIATIONS

A&P	Asia and the Pacific	FAO	Food and Agriculture Organization of the United Nations
AsDB	Asian Development Bank	FDI	Foreign Direct Investment
ADDAC	Asociación para la diversificación y desarrollo agrícola comunal	FTE	Full-time Equivalent
AfDB	African Development Bank	G20	Group of Twenty
CBERA	Caribbean Basic Economic Recovery Act	GCC	Gulf Cooperation Council
CCTs	Conditional Cash Transfers	GDP	Gross Domestic Product
CIS	Commonwealth of Independent States	GFCF	Gross Fixed Capital Formation
CLUSA	Cooperative League United States of America	GNI	Gross National Income
COMESA	Common Market for Eastern and Southern Africa	HIPC	Heavily Indebted Poor Country
CPA	Country Programmable Aid	ICAs	International Commodity Agreements
CPIA	Countries Policy and Institutional Assessment	ICC	International Chamber of Commerce
CSF	Copper Stabilization Fund	IDA	International Development Agency
CSO	Civil Society Organization	IDB	Inter-American Development Bank
DAC	Development Assistance Committee	IDEA	International Institute for Democracy and Electoral Assistance
DC	Developing Countries	IF	Integrated Framework
DCF	United Nations Development Cooperation Forum	IFPRI	International Food Policy Research Institute
DFID	Department for International Development (United Kingdom)	IISD	International Institute for Sustainable Development
DfQf	Duty Free and Quota Free	ILO	International Labour Organization
DSGD	Democratic Strategy and Governance Division	IMF	International Monetary Fund
DTOS	Diagnostic Trade Integration Study	IPA	Investment Promotion Agencies
EAC	East African Community	ITC	International Trade Centre
ECIS	Europe and the Commonwealth of Independent States	LAC	Latin America and the Caribbean
ECR	Export Concentration Ratio	LIC	Low-income Country
EPWP	Expanded Public Works Programme	LDC	Least Developed Country
ESSF	Economic and Social Stabilization Fund	LIIP	Livestock Indemnity Insurance Pool
ETSU	Economic and Technical Support Unit	LLDC	Landlocked Developed Country
EURODAD	The European Network on Debt and Development	LMIC	Lower Middle-income Country
		M&A	Mergers and Acquisitions
		MAF	MDG Acceleration Framework
		MDGs	Millennium Development Goals
		MDRI	Multilateral Debt Relief Initiative
		MECIB	Malaysia Export Credit Insurance Berhad
		MENA	Middle East and North Africa

MIC	Middle-income Country	SWF	Sovereign Wealth Fund
NAFTA	North American Free Trade Agreement	S&P	Standard & Poor's
NEPAD	New Partnership for Africa's Development	TNCs	Transnational Corporations
NGO	Non-governmental Organization	TWN	Third World Network
NPV	Net Present Value	UMIC	Upper Middle-income Country
NRFs	National Revenue Funds	UN OHRLLS	United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States
OCIA	Organic Crop Improvement Association International	UNCOMTRADE	United Nations Commodity Trade Statistics Database
ODA	Official Development Assistance	UNCTAD	United Nations Conference on Trade and Development
ODI	Overseas Development Institute	UNDESA	United Nations Department of Economic and Social Affairs
OECD	Organisation for Economic Co-operation and Development	UNDP	United Nations Development Programme
OHCHR	Office of the High Commissioner for Human Rights	UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
OLICs	Other Low-income Countries	UNNExT	United Nations Network of Experts for Paperless Trade in Asia and the Pacific
OPEC	Organization of the Petroleum Exporting Countries	UNRISD	United Nations Research Institute for Social Development
PAPEP	Prospective Political Analysis and Prospective Scenarios Project	UNU	United Nations University
PCF	Private Capital Flows	VAT	Value Added Tax
PFM	Public Financial Management	WDI	World Development Indicators
PI	Portfolio Investment	WIDER	World Institute for Development Economics Research
PPP	Purchasing Power Parity	WTO	World Trade Organization
PRF	Pension Reserve Fund		
PTA	Preferential Trade Agreements		
R&D	Research and Development		
RCPAR	Regional Centre for Public Administration Reform		
SADC	Southern African Development Community		
SAR	Special Administrative Region		
SIDS	Small Island Developing State		
SMEs	Small and Medium Sized Enterprises		
SSA	Sub-Saharan Africa		
SSC	South-South development cooperation'		
SW	Single Window		
SWAp	Sector-Wide Approach		





## OVERVIEW

Today, we live in a world where the global development landscape is rapidly changing, with newly emerging economic powers, new actors and growing aspirations. Growth poles are shifting, citizen action has assumed new roles and the demand for fair and effective representation is being heard everywhere. Traditional donor-recipient relations are changing, South-South collaboration has taken on a new life and innovative approaches to development are being called for. Yet, development everywhere is facing a series of new challenges, ranging from climate change to the energy crisis, from food insecurity to citizens' insecurity, from financial and economic crises to growing global inequalities. Shocks and crises appear to have become the norm, rather than the exception. And as a result, countries have become ever more vulnerable in the face of such challenges. We now live in a world of uncertainty.

More than ten years have passed since the adoption of the Millennium Declaration and the Millennium Development Goals (MDGs) in 2000 and we have less than five years to go till 2015. Although many countries have made impressive strides towards the achievement of various MDG targets, these achievements have been uneven across regions and nations — and within nations. Significant deprivations and disparities still persist.

*Even as there is a need to accelerate progress towards MDG achievements, it is just as imperative to ensure that the progress already achieved is sustained and protected against risks of reversals.*

Therefore, it is imperative to accelerate MDG progress, especially with respect to lagging MDGs. In 2010, the United Nations Development Group (UNDG) endorsed the MDG Acceleration Framework (MAF) designed by UNDP to assist developing countries address how progress on specific, off-track MDG targets could be accelerated. The MAF was designed to identify those bottlenecks that prevented these targets from being met and to formulate an action plan to bring the lagging MDG target on-course. However, efforts to accelerate MDG achievements and progress towards these targets can be thwarted on account of adverse shocks and crises that emanate from various sources such as conflicts, natural disasters, climate risks and financial and economic collapses. So, even as there is a need to accelerate progress towards MDG achievements, it is just as imperative to ensure that the progress already achieved is sustained and protected against risks of reversals. “Sustaining progress can be just as important as accelerating achievements” (UNDP 2010).

Indeed, reversals in MDG progress have been witnessed in a number of countries in the aftermath of the multiple crises (from food to energy to financial and economic shocks) during the waning years of the last decade. Thus, building resilience to such shocks will be a key aspect of sustaining MDG progress.

At the same time, sustaining progress in health-, hunger- and education-related MDGs builds human capabilities that empower people to actively participate in the economic, political and social arena to affect policies that influence their lives. Sustaining progress on poverty, environmental sustainability and global partnership-related MDGs creates opportunities for people, which contributes to improved livelihoods and lives, lowers environmental stress and contributes to a more equitable global economy, which helps to strengthen resilience. And with greater resilience comes the ability to withstand shocks. Thus, sustaining MDG progress and reducing risks and vulnerabilities for human resilience are mutually synergistic.



As the development landscape is being inexorably altered, no country — not even those on the margins of the global economy — is likely to be insulated from the impacts of such macro-level shocks. In fact, the poorest and most vulnerable households in the very countries that remain on the periphery of the international economy have often paid the heaviest price.

Consider recent global economic developments. Across large parts of the developing world, the world's worst economic recession in 80 years is still showing lag effects. After a year of fragile and uneven recovery, global economic growth started to lose momentum in the middle of 2010, and the slowdown is expected to continue into 2011 and 2012 (UN 2011).

Nor is the longer-term outlook very optimistic. The crisis may have lasting impacts on financial markets and, as a result, the overall level of potential output in developing countries could be reduced by between 3.4 percent and 8 percent over the longer run, compared with its pre-crisis path (World Bank 2010).

Evidently, the crisis that unfolded between 2007 and 2009 will not be the last that the world will see. The frequency of economic and financial crises has increased over the past decade and a half, and they appear to have become a systemic feature of the global economy. "Worldwide, systemic banking crises have been ten times more likely during the 1990s than during the late 1970s, which was hardly a period of calm economic activity" (Ernst and Escudero 2008).

Even as impacts from this last crisis continue to be documented, the havoc caused in just three years is stunning. Between 2007 and 2009, at least 30 million jobs were lost worldwide and the global economy will need to create at least another 22 million new jobs in order to return to the pre-crisis level of global employment. UNESCO estimates a 20-percent drop in per capita income for the 390 million poor people in sub-Saharan Africa (UNESCO 2009) and the crisis could result in 200,000 to 400,000 additional infant deaths per year (World Bank 2009a). Global estimates on poverty indicate that, by the end of 2010, an additional 64 million people will have fallen into extreme poverty. So, even as the world enters the final years of the effort to achieve the MDGs before their 2015 deadline, 2008–2009 will already have seen a reversal of progress on MDG1 (the target of halving extreme poverty).

*Economic and financial shocks have the potential to unravel development gains that have taken years for countries to achieve.*

Clearly, economic and financial shocks have the potential to unravel development gains that have taken years for countries to achieve. And once progress on human development is reversed, the damage can have multiplier effects and be lasting. For instance, deteriorating health and education today can lead to higher mortality rates tomorrow. Lower investments can hamper future progress in sanitation and water supply. The presence of fewer children in school can lead to lower completion rates in later years. And household incomes that fall far below the poverty line can delay escapes from poverty (World Bank 2010).

If crises have become systemic characteristics of the global economy, then it is probable that further waves are likely to break over developing countries in the next few years, jeopardizing even more the progress made towards the MDGs. So, it is against these emerging realities that developing nations will need to protect and sustain development progress and, even as governments attempt to accelerate pace towards the achievement of the MDGs, they will need to safeguard progress already made.



To be sure, crises are triggered by different events: natural and anthropogenic disasters; environmental shocks generated by climate change; the sudden emergence and spread of an infectious disease; unrest in a neighbouring country with a possible flow of refugees; the collapse of demand in a particular industry (such as tourism as a result of real or perceived terrorism threats); or the consequences of a global financial and economic crisis. All such macro-level shocks affect economic well-being in a country. In fact, “a crisis worth the label will have a dramatic negative impact on per capita income. But the precise impact on patterns of income and well-being will depend on the precise origin and nature of the crisis and also on the detail of economic structure in that country” (Kanbur 2010).

While this report recognizes the importance of various sources of vulnerability, it focuses on financial and economic crises to examine how such macro-level shocks impact the sustainability of MDG progress. In that context, the report examines the concepts of vulnerability and resilience, identifies the transmission channels by which such shocks impact the sustainability of MDG progress, and proposes policy options to build resilience to such adverse events.

*This report argues that developing economies are vulnerable to financial and economic shocks on account of specific, structural conditions, which act as drivers of macro-economic vulnerability. And such vulnerability affects the sustainability of MDG progress via two principal channels: fiscal channels and economic growth channels.*

## Main Arguments of the Report

This report argues that developing economies are vulnerable to financial and economic shocks on account of specific, structural conditions, which act as drivers of macro-economic vulnerability. And such vulnerability affects the sustainability of MDG progress via two principal channels: fiscal channels and economic growth channels. Both are critical from the perspective of sustaining MDG progress.

The importance of sustained economic growth for reducing income poverty has long been established, although the extent of poverty reduction in any given country depends on the nature of growth and its distributional impacts. In turn, reductions in income poverty are important for sustaining progress on other MDG targets.<sup>1</sup> “Higher income can reduce undernourishment directly, lower barriers to access basic needs like education and health-care, and facilitate more generally the improvement of living conditions” (Claessens and Feijen 2007).

For many of the other MDGs, a key channel of impact is fiscal: lower levels of GDP, exports and imports sharply reduce tax revenues from income, enterprises, trade and consumption. As a result, a large fiscal hole<sup>2</sup> opens up in many developing countries. For developing countries, such a hole is worrying, because it reduces their ability to allocate resources for reaching the MDGs. Indeed, for most of the poorest households, the impact of the crisis depends on what governments do with their budgets: how much they spend to fight the crisis, protect the poorest, and revive progress towards the MDGs.

However, many developing countries, especially low-income countries (LICs), are not well equipped to deal with the impact of such shocks. The last financial crisis “created a huge fiscal hole in the 56 low-income countries, by reducing their budget revenues (and their ability to spend to confront the crisis and reach the



MDGs) by \$53 billion in 2009 (nearly 10 percent of their pre-crisis revenues) and by \$12 billion in 2010” (Kyrili and Martin 2010).

Still, despite these fiscal constraints, many low-income economies laudably adopted crisis mitigation measures in 2009. But, by 2010, they were cutting budgets. “Two-thirds of the countries surveyed increased their budget deficits in 2009, providing an initial fiscal stimulus to combat the crisis. But only one-quarter continued this stimulus in 2010. Two-thirds of countries cut budget allocations in 2010 to one or more of the priority pro-poor sectors of education, health, agriculture and social protection” (Kyrili and Martin 2010).

*Besides ex post policies aimed at crisis mitigation, national and international policies will need to develop an ex ante approach to dealing with vulnerability to such shocks.*

Policy responses at the national level were mainly focused on crisis-mitigation measures such as the provision of subsidies and cash transfer programmes, food-for-work initiatives and feeding schemes (World Bank 2009b). “By the end of 2008, 48 countries had adopted fiscal stimulus measures. All these measures entailed a combination of spending on income transfers, infrastructure and tax cuts” (UN 2011).

International policy attention remained preoccupied with the question of finance. “More permanent and stable sources of funding for developing countries that could be activated quickly and are not subject to inappropriate conditionality are necessary” (Stiglitz et al. 2009). Though G20 leaders pledged huge external financing rises to help poor countries combat the crisis and reach the MDGs, external loans and grants together filled only one third of LICs’ fiscal hole in 2009–2010. Low-income countries had to fill two thirds of the fiscal hole by borrowing domestically or by running down reserves. Furthermore, the response was very slow, taking between 6 and 18 months for G20 financing commitments to reach the international financial institutions and for them to commit money to LICs.

At present, there is little sign that financing or flexibility on the scale needed will be forthcoming. In fact, recent trends in many donor countries have been to reduce aid pledges, concentrate aid in fewer countries, and focus only on a few MDGs. Moreover, the poorest countries (including those with IMF programmes) are progressively undoing the fiscal stimulus introduced during the crisis, without paying sufficient attention to the longer-term need to stimulate demand and reduce poverty in order to reach the MDGs.

Both national governments and the international development community will need to gear up to face future challenges, and short-term, crisis-mitigation measures will not be up to the task. Besides *ex post* policies aimed at crisis mitigation, national and international policies will need to develop an *ex ante* approach to dealing with vulnerability to such shocks. Indeed, if MDG progress is to be sustained beyond 2015, then it will be necessary to build systemic resilience to such financial and economic shocks. No less important will be the need to build resilience to environmental and climate change-related shocks and to the political drivers of vulnerability.

## Defining Vulnerability and Resilience

The concept of vulnerability is a multi-dimensional concept that relates to risk. Thus, depending on the risk of concern, various disciplines attach different definitions to the concept. In economics, vulnerability is dealt with at the micro and macro levels (UNU-WIDER 2010).



At the micro level, the concept of vulnerability most often refers to the vulnerability to poverty (i.e., the probability that a household or individual will fall into or remain in poverty). Households in developing countries are much more vulnerable and likely to experience acute negative consequences of a crisis in the short, medium, and long terms. This is because poor households have fewer assets, more limited risk-coping mechanisms, and less access to capital markets to help them cope with economic fluctuations. Moreover, vulnerability is greater if governments, having limited fiscal resources and institutional capacity, are simultaneously constrained in cushioning the impacts.

But the degree to which a household is at risk of being harmed by an external shock depends not just on the household's vulnerability, but also on its resilience. A growing body of research studies household resilience.<sup>3</sup> Both *ex ante* and *ex post* coping strategies have been distinguished, where, *ex ante*, households often attempt to diversify their sources of incomes and, *ex post* a negative event, often rely on various forms of insurance.

*The concept of vulnerability is a multi-dimensional concept that relates to risk.*

Significantly, households tend to adjust their behaviour and attempt to deal with external shocks unilaterally. Often, it is effective, but regularly adverse coping strategies are observed, such as dropping out of school or cutting back on health care. Indeed, in the current economic conditions following the global economic crises, a real threat is that households' coping responses will include adverse coping, leaving permanent scars. Therefore, community, government and international measures need to assist households, especially since the impact of shocks often overwhelms individual households. Also, many of the goods needed to strengthen household resilience are public goods. Thus, continued provision of basic goods and services, including education, health services, public infrastructure and protection of property rights are essential in times of crisis if households are to cope with the impacts of macro-level shocks.

Put differently, building the resilience of poor and vulnerable households to economic and financial shocks will necessarily require building systemic resilience to such macro-level shocks. In turn, systemic resilience requires weakening the drivers of macro-economic vulnerability, which are not household-driven, but rather determined by specific, structural economic conditions.

## Drivers of Macro-Economic Vulnerability

From a macro-economic perspective, vulnerability has generally been measured by a variety of indicators related to a country's foreign trade and investment profile,<sup>4</sup> such as trade, tourism, aid, private capital flows and remittances, because these channels expose a country to exogenous economic and financial shocks (Briguglio 2009, World Bank 2009b, UNESCAP 2010). In other words, a country's vulnerability to such shocks depends on the extent of its integration into the global economy.<sup>5</sup>

But, as noted earlier, the extent to which a country is at risk of being negatively affected by an external shock depends not only on that country's level of exposure to shocks, but also on its resilience. In the case of a country, resilience typically refers to the country's ability to cope with or recover from a shock. That is, a country's resilience reflects its ability to counteract (quickly recover from) or withstand (absorb) the impact of a shock. The indicators used to assess a country's resilience typically include some measure of fiscal capacity, institutional strength, and level of social development.<sup>6</sup>



Fiscal capacity is an important dimension of resilience because it reflects the ability of a country to finance programmes that create jobs, ensure the delivery of core services, infrastructure and safety nets. In other words, it denotes the capacity of a country to undertake countercyclical spending. Institutional capacity, in turn, assesses a country's capacity to efficiently and effectively scale up public expenditures and also evaluates its ability to protect vulnerable groups and reduce poverty. Countries with high institutional capacity are better able to direct additional resources to vulnerable groups to help cushion the impacts of a crisis. In short, institutional capacity is the ability to absorb increased spending and to target this at vulnerable groups.

*A country's resilience reflects its ability to counteract (quickly recover from) or withstand (absorb) the impact of a shock.*

Importantly, most studies on macro-economic vulnerability seldom comprehensively address all critical drivers of macro-economic vulnerability. Some focus more on trade, others on finance; still others are concerned primarily with aid flows. However, the critical role played by rising global inequalities is scarcely examined, even though rising inequalities are creating the very conditions that contribute to a crisis and generating an environment that will jeopardize MDG progress.

Indeed, existing work on macro-economic vulnerability can be classified into two groups: on the one hand, work that is primarily focused on financial fragility and on developing indicators that provide an *ex ante* assessment of macro-economic vulnerability (such as the World Bank's Early Warning System of Macro-economic Vulnerability) and, on the other hand, work that addresses macro-economic vulnerability through the prism of structural drivers. However, much of this latter work is largely preoccupied with constructing indexes of macro-economic vulnerability to compare how different countries fare with respect to vulnerability to economic and financial shocks (such as the Economic Resilience Index, Briguglio 2009 and the Global Vulnerability Index, Baritto 2008). Moreover, as noted earlier, most of these studies tend to focus on a limited number of drivers of macro-economic vulnerability.

This report examines all the principal drivers of macro-economic vulnerability rather than just a subset. Specifically, it argues that macro-economic vulnerability is driven by: a) export dependency and export concentration, b) dependency on primary commodities, c) the volatility of private capital flows (particularly, foreign direct investment (FDI) and portfolio investments (PI)), d) the pro-cyclicality and volatility of official development assistance, and e) rising global inequalities.

Although a country's resilience to economic and financial shocks will ultimately depend on adopting longer-term measures to weaken the drivers of macro-economic vulnerability, a country's capacity to cope with such shocks in the short term will depend on its fiscal and institutional capacity.

One clear added value of the report is that, by identifying all the relevant structural drivers of macro-economic vulnerability, it extends the list of drivers that have been typically used to assess a country's propensity to vulnerability. This, in turn, makes it possible to comprehensively diagnose *ex ante* the potential sources of macro-economic vulnerability in a particular country. Moreover, by highlighting policy options that can build resilience over the longer term, the report has the value of indicating to policy makers, initiatives and actions that can be adopted to sustain MDG progress and prevent reversals in the gains made on human development.



## Key Findings

Developing economies have become increasingly reliant on exports for generating growth. Export dependence is even greater than previously imagined and is rising sharply in regions such as Africa and the Commonwealth of Independent States (CIS). As of 2008, exports were more than one third of GDP in Africa, Asia, the CIS and the Arab States, with the most rapid growth taking place in the least developed countries (LDCs) where exports as a share of GDP more than doubled between 1995 and 2008.

Export dependency is an important driver of vulnerability because greater dependency on exports to generate revenues and economic growth leads to greater exposure to global economic shocks. However, the degree of vulnerability to exports is dependent on the degree of export concentration. Not surprisingly, the largest drops in export earnings and growth following the 2008 crisis took place in Africa and the CIS region. In fact, the CIS region witnessed the steepest decline in export revenues and registered the biggest decline in economic growth, whereas regions with below-average declines in export revenues (Asia) witnessed a below-average decline in economic growth. Asia appears to have been relatively less impacted by the crisis because it has a more diversified export portfolio.

*Economic crises impact the principal sources of revenue and economic growth of export-dependent countries. This results in earnings and growth volatility, which is exacerbated if exports are concentrated in too few primary commodities.*

The kinds of products exported by a country are also important drivers of macro-economic vulnerability. The more dependent a country is on primary commodity exports, the more vulnerable it is to international price shocks. Of the 141 developing countries, 95 depend on primary commodities for at least 50 percent of their export earnings (Brown 2008). Three regions or subregions appear to be particularly susceptible to price shocks: Africa, the Pacific Islands and the CIS. In fact, by 2009, the share of primary commodities in total exports was 81 percent in Africa, 79 percent in the Pacific Islands and 72 percent in the CIS region. However, the LDCs remain most dependent on primary commodity exports. As of 2009, their share of primary commodity exports in total exports had reached 92 percent.

Because the vast majority of LICs are dependent on just one or two such primary commodities, their export earnings and growth can be extremely unstable. From the perspective of developing countries, especially those whose principal means of foreign exchange earnings come from the export of primary commodities, erratic price movements generate erratic movements in export revenue, destabilize foreign exchange reserves, and are strongly associated with growth volatility. In short, unpredictable price fluctuations cause fluctuating revenues, thus making fiscal planning extremely difficult; this, in turn, makes it very difficult to plan sustainable social and economic development programmes.

Moreover, the price volatility of primary commodities is of particular concern, since the vast majority of poor households (comprising an estimated two billion people) depend on the production of primary commodities for their livelihoods. At the household level, farmers and workers rely on commodity production for the cash incomes they use to pay for food, school fees and health care. A fall in commodity prices affects the incomes of these households. Thus, international commodity price volatility is closely related to income volatility of commodity-producing households.



It is important to note that (non-oil) commodity prices display varying trends in the short and long terms. The high nominal prices of commodities over the medium term can disguise longer-term trends in real prices. Furthermore, (non-oil) real commodity prices have been falling in the long run, worsening the terms of trade of countries dependent on such exports. The continuous decline of long-term prices also means that producers' incomes dwindle year after year. To maintain the same level of income, producers need to increase the volume of commodities that they trade. But, as more output is put on the market, prices tend to fall even more. In other words, a worsening in the terms of trade has required non-oil primary commodity-producing countries to compensate for losses in unit values by increasing output.

To conclude, economic crises impact the principal sources of revenue and economic growth of export-dependent countries. This results in earnings and growth volatility, which is exacerbated if exports are concentrated in too few primary commodities. Thus, production structures where the key sources of revenue and growth are themselves highly volatile are a principal channel that makes such countries especially vulnerable to economic and financial crises. Add to this the fact that many primary commodity producers

are also highly vulnerable to natural disasters and to the consequences of a changing climate. Put differently, the vulnerability of primary commodity producers is compounded by their added vulnerability to climate-related changes and environmental disasters.

*The procyclicality and volatility of the sources of revenue and the sources of investment effectively trap countries, which is why so many developing nations are beleaguered and unable to adopt countercyclical responses to macro-level shocks.*

But not just revenue and growth sources are subject to volatility and uncertainty. Equally volatile and uncertain are sources of investment. Since the late 1990s, private capital flows<sup>7</sup> have become a significant source of investment in many developing countries. For instance, in countries such as Zambia, foreign private capital stocks as a percentage of GDP reached 75 percent in 2007 and, for many countries in Africa (Uganda, Cameroon, the Gambia, the United Republic of Tanzania), private capital stocks reached 30 percent of GDP (Bhinda and Martin 2009).

Yet, private capital flows (specifically, FDI and PI) are highly volatile. This is well known, as the volatility is reflected in sharp declines and reversals of flows after a crisis. After the 2007–2008 crisis, FDI inflows to developing countries fell by 23 percent in just one year (2009) and portfolio investments crashed in most regions to below zero (more than a 100 percent decline).

The consequences of such volatility for growth are obvious, especially in many of the smaller, lower-income countries where FDI projects are huge in relation to the size of the host economy. Because these countries tend to be much less diversified and depend on one or two large projects or sectors, the volatility of private capital flows has implications for the sustainability of economic growth.

Indeed, there appears to be a worrying and growing trend for developing countries to rely more on foreign capital relative to domestic capital for investment. This trend appears to be more prevalent in those countries that have attracted growing inflows of foreign investments, such as the CIS countries. Another group of countries affected by this trend is LDCs, mainly in Africa. For instance, FDI as a share of total investment is over 100 percent in Angola and Liberia, 66 percent in the Congo and 60 percent in the Central African Republic.

Official development assistance (ODA) is another important source of external finance that many developing countries depend on. In 2008, net ODA flows constituted more than 10 percent of gross national income



(GNI) in 26 developing countries, most of which were LDCs and small island developing states (SIDS). For these countries, a high degree of dependence on aid accentuates macro-economic vulnerabilities. It leaves countries exposed to sharp fluctuations in the overall volume of aid as well as donor preferences for the purposes to which aid is put.

This essentially means that, where countries are heavily dependent on aid, governments remain vulnerable to sharp fluctuations in aid flows. In some cases, countries may not be especially dependent on aid, but certain sectors within a country may rely heavily on aid to function and are thus vulnerable (for example, the health sector). The procyclicality of aid can exacerbate rather than mitigate the impact of financial and economic crises, and much evidence suggests that, on average, aid is indeed procyclical. Where aid is volatile or unpredictable, recipient governments are less able to plan expenditures effectively. Even prior to the current crisis, low-income countries, especially the LDCs, had seen large fluctuations in annual aid flows of up to 2 to 3 percent of GDP on average (UNDESA 2009).

In sum, shortfalls in aid along with aid volatility impact macro-economic balances, potentially generating growth volatility and causing reductions in government spending on poverty reduction and development priorities. This is especially important since studies show that aid shortfalls in aid-dependent countries are frequently followed by reductions in government spending. Since ODA is an increasingly important source for financing public investment in social services, such unpredictability and shortfalls affect the poor households' access to such services.

To conclude, the procyclicality and volatility of the sources of revenue and the sources of investment effectively traps countries, which is why so many developing nations are beleaguered and unable to adopt countercyclical responses to macro-level shocks.

Rising global inequalities are a unique driver of vulnerability in that they are both a cause and effect of the crisis itself. Rising income inequalities create the necessary conditions for a vicious cycle, whereby increasing inequalities contribute to increasing the frequency and volatility of financial crises and financial crises further worsen income inequality.

*Rising global inequalities are a unique driver of vulnerability in that they are both a cause and effect of the crisis itself.*

Indeed, income inequalities have surged in advanced economies since the 1980s and this trend is closely corroborated with the increase in the incidence of financial crises that have rocked the global economy over the same period (Moss 2009). Moreover, in many developing countries too, income inequalities have been rising sharply since the 1990s, which has similarly been strongly associated with the increase in the incidence of domestic financial crises.

Income (and wealth) inequality contributes to financial instability through several interrelated channels: generally, a rise in income inequality reduces the purchasing power of middle- and low-income households, creating a tendency toward reduced levels of aggregate effective demand. Moreover, the search for high-return investments by those who benefit from the increase in inequalities leads to the emergence of asset bubbles. Thus, rising inequalities fuel financial instability because they create a political environment whereby procyclical investment policies (such as poor regulation and loose monetary policy) are more likely to be implemented in order to avoid political instability and lower economic growth.



Even more troubling is the fact that the persistence of inequalities at high levels in many developing countries has made it more difficult to reduce poverty (Birdsall 2005). This relationship appears to be especially pronounced in countries where a large part of the population is trapped in chronic poverty. Moreover, high inequalities also reduce the likelihood that policies fostering inclusive growth and human development will be delivered and implemented. For instance, richer groups may allocate public funds for their own interests rather than for those of the country. And where institutions of government are weak, rising inequality can

exacerbate the problem of creating and maintaining accountable government, thereby increasing the probability of the adoption of policies that inhibit growth and poverty reduction.

*If a country has adequate fiscal capacity, it can maintain public spending, even adopt fiscal stimulus packages and consequently be more resilient in the face of a shock.*

Fiscal and institutional capacity and quality are critical for ensuring the resilience of an economy to macro-level shocks. If a country has adequate fiscal capacity, it can maintain public spending, even adopt fiscal stimulus packages and, consequently, be more resilient in the face of a shock.

However, the evidence points to a very high degree of procyclical bias in the current and fiscal balances, implying that countries will indeed need to engage in countercyclical spending to mitigate and recover from the impact of such shocks. But their capacity to do so is limited on account of chronic and high deficits — trade and fiscal alike. In turn, large deficits cap how much additional debt a country can assume. In other words, just when countries need access to finance, persistent trade and fiscal deficits prevent them from gaining that access.

Apart from the issue of fiscal resources, a key aspect of resilience is the ability of a country to effectively manage a crisis as it unfolds and to anticipate and prepare for such shocks. This, in turn, requires that there be specific technical capacities in organizations and institutions on the front lines of a crisis response and that core country systems (such as procurement, public finance management, and monitoring and evaluation systems) display qualities of performance, stability and adaptability. However, weaknesses in institutional capacity are well known, which is why so many governments have typically resorted to short-term, *ad hoc* arrangements in their responses to crises. But even when institutional capacity is present, political resistance can block or weaken concerted efforts to manage crises.

## Policy Options for Building Systemic Resilience

Building systemic resilience will require a broader perspective and complementary actions by developing countries and the international development community. Such actions will encompass both weakening the drivers of vulnerability and building coping mechanisms. Briefly, policy measures will be needed to:

### *Reduce Dependence on Volatile Sources of Income and Growth*

For many developing economies, this means recalibrating growth strategies to reduce extreme dependence on a narrow range of exports. “In order to protect themselves and the MDGs from exposure to external shocks, countries may want to generate domestic demand in a sustainable way by increasing household incomes and consumption, alongside boosting corporate investment” (Chhibber 2009). Indeed, in the aftermath of the recent economic crisis, countries such as China recalibrated their long-term strategy to focus on domestic demand and took measures to stimulate consumer spending, including in less developed and rural areas.



Measures to boost domestic demand could focus on increasing household consumption and corporate investment. Consumption is likely to increase if a greater share of national income goes to the poor and investing in the poor is also likely to increase their contribution to GDP, thus ensuring a more inclusive pattern of growth. Put simply, reducing poverty by broadening the economic base can unleash potential demand.

Furthermore, providing appropriate incentives to the private sector — through policies on exchange rates, taxation and subsidies — could make it more profitable for companies to invest in sectors that are oriented less towards exports and more towards meeting domestic demand, as could measures that promote the development of rural and underdeveloped areas and create employment.

Moreover, since dependence on a narrow range of exports gives rise to risks associated with the lack of diversification, policies that promote export (and more broadly economic) diversification will be important. Specific measures to promote export diversification could include, *inter alia*, targeted industrial and investment policies that develop potentially new areas of comparative advantage, selective measures such as fiscal and direct credit incentives and local content requirements, trade facilitation, and integration into global value chains.

*Building systemic resilience will require a broader perspective and complementary actions by developing countries and the international development community. Such actions will encompass both weakening the drivers of vulnerability and building coping mechanisms.*

#### *Address the Volatility of Commodity Prices and Stabilize Incomes of Commodity Producers*

Different policies have already been tried to address commodity price volatility at the international and national levels. At the global level, the international community has tried many different ways to stabilize commodity prices and to smooth revenue fluctuations, including quota systems, commodity agreements, compensatory funds and price hedging on futures markets. But international commodity agreements (ICAs) have been progressively dismantled and severe limitations hamper the compensatory funds currently in place. Clearly, this warrants more global policy attention.

At the national level, some countries have adopted income stabilization measures to help commodity producers secure more predictable incomes. Some of these measures include national revenue funds, alternative trade initiatives, supply management mechanisms, and insurance and price-risk management instruments.

#### *Address the Volatility of Private Capital Flows and Leverage Innovative Financing Options*

Developing rapid response and early warning systems to help predict and deal with capital flow-related shocks is especially important. In particular, LICs need to be better equipped to monitor and analyse private capital flows, since very many countries are still not monitoring or analysing flows well.

To contain private capital flow volatility, measures could include paying more attention to the composition of such inflows by encouraging inflows that have higher proportions of genuine equity investments relative to debt, since debt financing is much more volatile.

Furthermore, remittances can be leveraged for development purposes in countries that receive a sizeable volume of them. Remittances are much more stable and even countercyclical in the face of external shocks



and in relevant countries, remittances may potentially become an important tool for economic development and could cushion the impact of external shocks.

### *Address Aid Volatility, Aid Procyclicality and Aid Effectiveness*

Specific policy measures to reduce aid volatility and procyclicality could include mechanisms to save some aid in the form of a reserve accumulation fund. This could serve as a form of 'insurance' to be drawn on in cases of external shocks or cyclical economic downturns. Further, diversifying a country's donor base may help recipient countries to spread risk (that is, the sudden withdrawal of one partner may affect those countries less severely) and may allow recipient countries to shift towards more 'stable' development partners (i.e., those whose aid is more predictable). Finally, much more work will be needed to improve aid effectiveness and aid predictability. As noted, this will be essential, given their relevance for macro-economic stability, and will allow countries to target aid to sectors and for purposes that can secure MDG progress.

### *Address Rising Income Inequalities*

Policy measures to reduce income inequalities have usually been targeted at extremely disadvantaged or disenfranchised populations and vulnerable groups that are often excluded from the growth process. Specific policy measures will be required to promote inclusive growth, productivity, and productive employment and to redistribute assets and incomes. In this context, policies that facilitate the expansion of the sources of growth and efficiently include an increasing share of the labour force in the growth process will be important. Indeed, a focus on productive employment and improving productivity will be especially critical. Employment growth creates new jobs and income for the individual — from wages in all types of firms, or from self-employment — while productivity growth can lift the wages of the employed and the returns of the self-employed. However, the ability of individuals to be productively employed depends on the opportunities to make full use of available resources as the economy evolves. This is why it is important to also look at ways to strengthen the capacity of the individual on the labour supply side as well as at ways to open up new opportunities for productive employment on the labour demand side.

Still, given the vast numbers of 'working poor' households in developing economies, additional and more direct interventions such as social protection and access to assets, as well as regulatory and legislative norms and agreements that secure the rights of assets held by the poor, that legally empower the poor, are needed to reduce inequality and chronic poverty.

### *Create Fiscal Capacity in the Short Term and Mobilize Greater Domestic Revenues over the Longer Term*

The lack of countercyclical finance in times of crisis often risks jeopardizing previous gains in housing, health, education, water and employment (Muchhala and Molina 2010). In short, it jeopardizes the gains towards achieving the MDGs. Protecting MDG achievements will require countries to mobilize adequate fiscal capacity to maintain and/or increase expenditures during economic downturns. Policies that can bolster the fiscal capacity of countries will need to focus on debt relief mechanisms, trade finance, fiscal policy reforms, and, most important, domestic revenue mobilization.

Indeed, over the longer term, the most effective way for countries to fund government spending and reduce aid dependency will be to mobilize domestic resources. In several LICs, an extensive informal economy and a limited tax base result in low levels of tax collection thereby limiting important government expenditures and forcing countries to borrow or depend on aid flows to finance basic development needs. However, given



the volatility of external financing and the important role that public sector investment can play in long-term development, it will be critical for governments to raise domestic revenues. Only with increased tax revenues will countries be able to sustain long-term domestic investments and fiscal policy flexibility (Spiegel 2007).

### *Invest in Building Institutional Capacity and Improve Quality of Institutions and Core Country Systems*

This past crisis has demonstrated many developing countries' institutional weaknesses in coping with the fallout of financial and economic shocks. Capacity deficits in the organizations and institutions responsible for managing a crisis, as well as weaknesses in the overall functioning of core country systems, the absence of inclusive decision-making and consensus-building among key stakeholders, have all been important reasons that crisis response and recovery measures have either been short-lived or unsustainable.

Thus, countries would do better if they took a longer-term view when building their institutions, which include the civil service, oversight bodies (such as the judiciary), public financial management and national procurement systems. By doing so, governments will better sustain their development gains. Indeed, many examples indicate that boosting institutional qualities within systems at the forefront of the crisis response requires continuous and endogenous improvements and changes, especially in risk analyses, upfront investments in critical human resources and the institutionalization of good practices and norms.



## Notes

1. Given the high interdependencies between different MDG targets, income poverty has been found to play a central role. Data show that the correlations of income poverty measures with the measures used for other MDG targets are generally very high and almost always statistically significant (Claessens and Feijen, 2006).
2. A fiscal hole is a fall in the availability of budget revenue to fund spending, caused by unexpected events such as the global economic crisis (DFI and Oxfam 2010).
3. See Adams et al. 1998; Alinovi et al. 2010; Naude et al. 2010; UNU-WIDER special edited volume of *Oxford Development Studies* (Vol. 37, Issue 3, 2009).
4. Various vulnerability indexes at the country-level have been proposed since UN DESA initiated work on the vulnerability of Small Island Developing States (SIDS) in the early 1990s (See, for example: UN 1999, UN 2006, Guillaumont 2008).
5. In Briguglio (2009), the conditions affecting a country's exposure to shocks include economic openness, export concentration and dependence on strategic imports. For UNESCAP (2009), five indicators are used to measure an economy's exposure to economic and financial crises. These include exports, FDI, ODA, inbound tourism, and remittances.
6. In Briguglio (2009), the indicators used to measure resilience include indicators to reflect macro-economic stability, market efficiency, good governance and social development. In UNESCAP (2009), the indicators to measure resilience include external debt, the rate of savings, the level of international reserves, government effectiveness, and the human development index.
7. Private capital flows are the sum of three sources of finance: foreign direct investment, portfolio investment, and workers' remittances. Since remittances are unlike FDI and PI in terms of both function and behaviour, they are treated in a separate chapter.



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# 1

## EXPORT DEPENDENCE AND EXPORT CONCENTRATION



*Economic openness explains the fact that an economy may be vulnerable to external economic shocks (as reflected by losses in export revenues and growth slowdowns), but the scale of impact depends largely on the degree of concentration of a country's export portfolio.*



Photo: Philippe Lissac/ILO



## Introduction

It is widely acknowledged that an economy's vulnerability to exogenous economic shocks is largely determined by its degree of exposure to the global economy — that is, by its degree of economic openness (Rodrik 2010, World Bank 2010, Briguglio 2009). Since economic openness is measured as the ratio of international trade to GDP, the transmission channels by which economic openness impact vulnerability can be import- or export-related.

Economies that are highly import-dependent — especially on strategic imports<sup>1</sup> — appear to be more vulnerable to the availability and cost of such imports. “There is a tendency for small states to be more vulnerable [because of strategic import-dependence] than other groups of countries” (Briguglio 2009).

For economies highly dependent on exports, the volatility in both export earnings and economic growth associated with economic shocks makes them extremely vulnerable. Given that exports constitute a significant and growing share of GDP for most developing economies — over 66 percent of developing countries have an export share exceeding 20 percent — an increased dependence on exports results in significant fluctuations in export earnings. Furthermore, export revenue volatility is strongly linked to growth volatility, so significant fluctuations in export earnings result in fluctuations in economic growth.

From an economic perspective, a country's exposure to external economic shocks generally depends on its reliance on exports because export earnings finance imports and also contribute directly to investment and growth. Production structures primarily oriented towards export-led growth expose countries to external shocks more than production structures reliant on domestic demand (Foxley 2009).

It is important to note, though, that, although the impact of an economic shock is typically registered through losses in export earnings, the size of impact (i.e., the magnitude of trade loss) depends on each country's mix of exports and main trading partners — that is, on its degree of export concentration. In other words, economic openness explains the fact that an economy may be vulnerable to external economic shocks (as reflected by losses in export revenues and growth slowdowns), but the scale of impact depends largely on

the degree of concentration of a country's export portfolio. By all accounts, higher degrees of export concentration are strongly correlated with greater volatility in export earnings and economic growth rates.

Export dependency and export concentration are rising sharply in regions such as Africa and the CIS and in the LDCs. Not surprisingly, these regions and countries have been most affected by the recent global economic crisis, as is evident through the data on export earnings and economic growth.

*Data on the share of exports in GDP indicates that, for developing countries, exports have been growing in relative importance to production for domestic consumption.*

Importantly, though, export dependency does not necessarily have to mean greater levels of export concentration. For instance, Asia, which remains the most export-dependent region in the developing world, is also the region with the most highly diversified exports. So, though the region was affected by the global crisis, evidence shows that it was less vulnerable to external shocks compared to other regions — in part because of highly diversified exports.

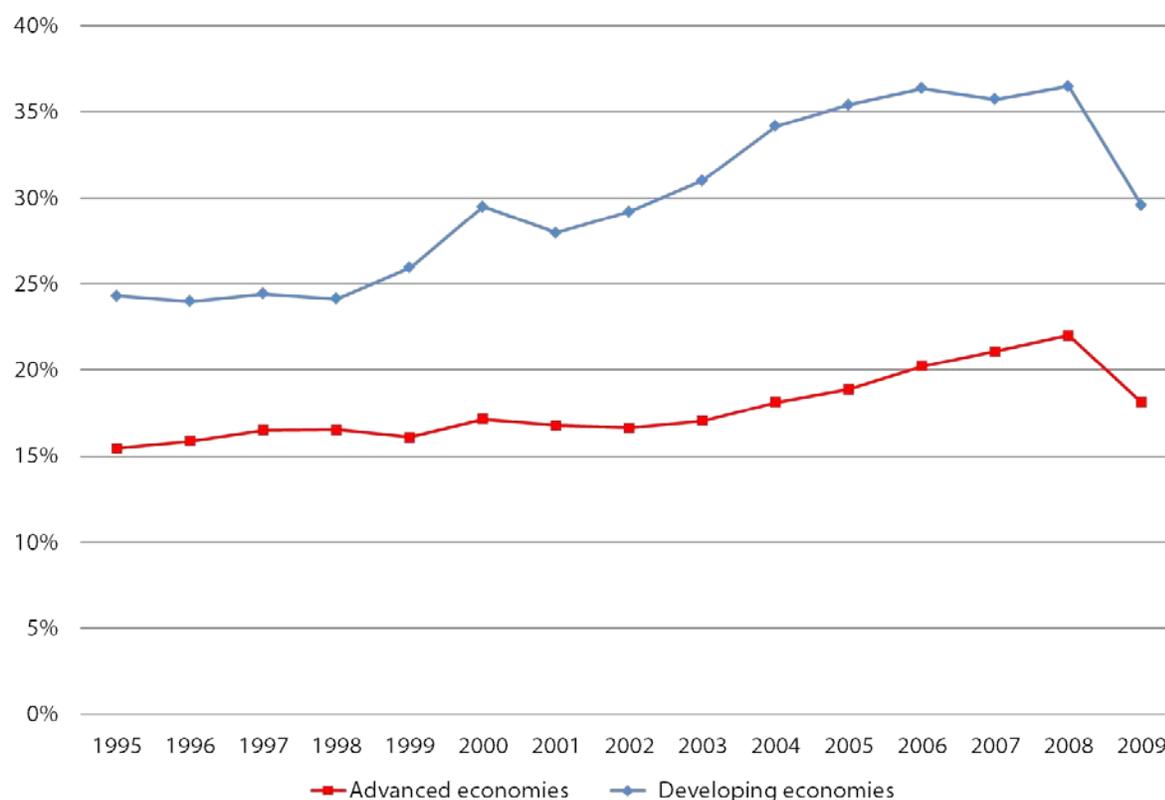


National policy measures focused on building resilience to economic shocks have pointed to the need to recalibrate an export-led growth strategy by strengthening domestic demand and by pursuing a trade agenda focused on export diversification. However, these national efforts need to be complemented by regional cooperation efforts that strengthen export diversification and by an international trade environment focused on trade facilitation and market access for the exports of developing countries –especially for the least developed among them.

## Trends in Export Dependency

Data on the share of exports in GDP indicates that, for developing countries, exports have been growing in relative importance to production for domestic consumption: exports as a share of GDP rose from 24 percent in 1995 to 37 percent in 2008 (Chart 1.1). As of 2008, the share of exports in GDP for developing countries was significantly higher than for the advanced countries, where exports represented only 22 percent of the value of their GDP. With the onset of the global recession in 2009 and the subsequent decline in both export volumes and prices, the export share in GDP fell in advanced and developing economies. In developing economies, the export share fell from 37 percent in 2008 to 30 percent in 2009 and in advanced economies from 22 percent to 18 percent. The share of exports in GDP grew faster in developing countries than in the advanced countries during this period.

**Chart 1.1: Export share in GDP, 1995–2009**



**Source:** Calculated using data from UNCTAD, *Handbook of Statistics 2009*



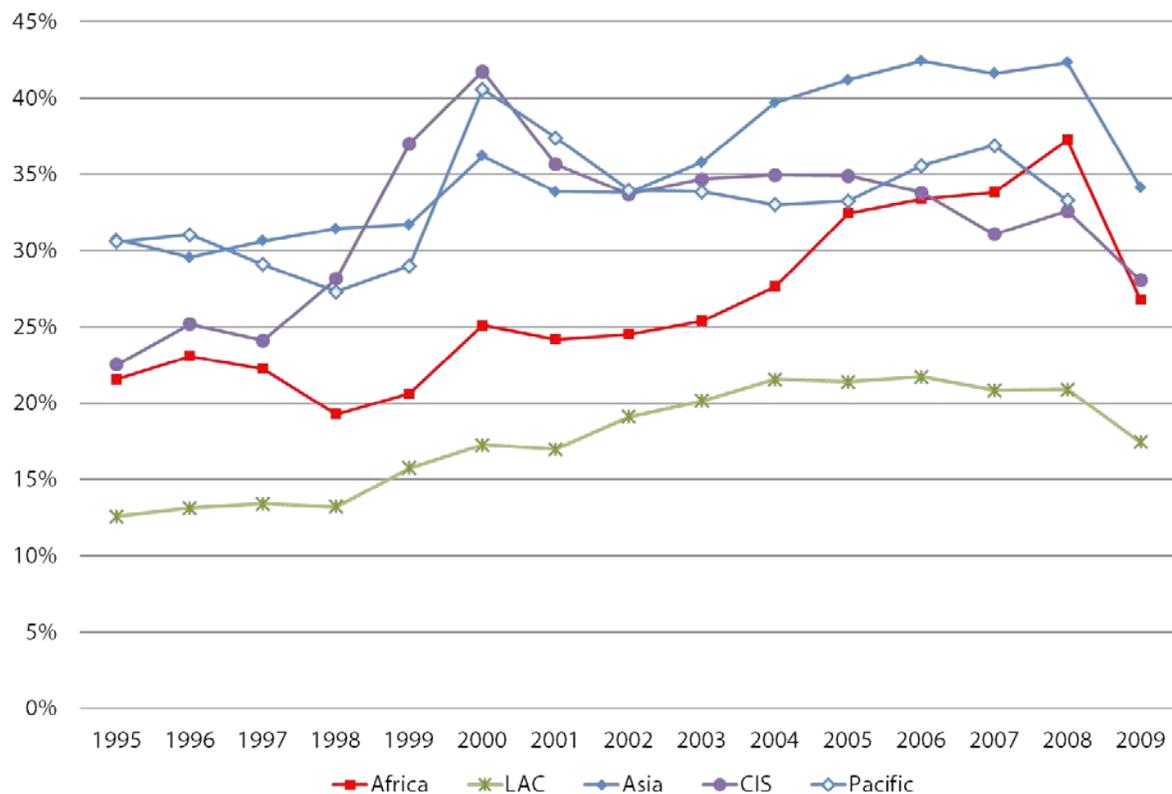
# Export Dependence and Export Concentration

Examining the export-to-GDP ratio by region (Chart 1.2) reveals that the ratio rose across all developing regions, with the fastest increase taking place in African countries, where it grew by 73 percent in just 13 years from 1995 to 2008. In Latin America and the Caribbean, the growth in the share of exports in GDP was next largest at 66 percent over the period. For the CIS countries, exports as a share of GDP grew rapidly in the late-1990s, peaking at 42 percent in 2000 and subsequently declining, reaching 33 percent in 2008. Exports as a share of GDP grew least in Asia, at 38 percent.

As of 2008, the Asia and Pacific region was the most export-dependent region of the developing world (with an export dependency ratio of 42 percent for Asia and 33 percent for the Pacific Islands) followed by Africa (37 percent) and the CIS (33 percent). Latin America and the Caribbean, as of 2008, had the lowest share of exports in GDP (21 percent) as compared to other developing regions.

In other words, the two regions with the lowest export-to-GDP ratios in 1995 had the fastest increase in export dependency (Africa and Latin America) and the region with the highest share of exports in GDP witnessed the slowest rate of increase in export dependency (Asia), suggesting a convergence between regions towards higher levels of export dependency. Moreover, the export-to-GDP ratio shows signs of procyclical behaviour<sup>2</sup> (exports rise more quickly than the growth rate during booms and fall more rapidly than growth during busts). This procyclicality is apparent upon examination of the decline in this ratio in 2009 consequent to the global

**Chart 1.2: Export share in GDP by region, 1995–2009<sup>3</sup>**



**Source:** Calculated using data from UNCTAD, *Handbook of Statistics 2009*



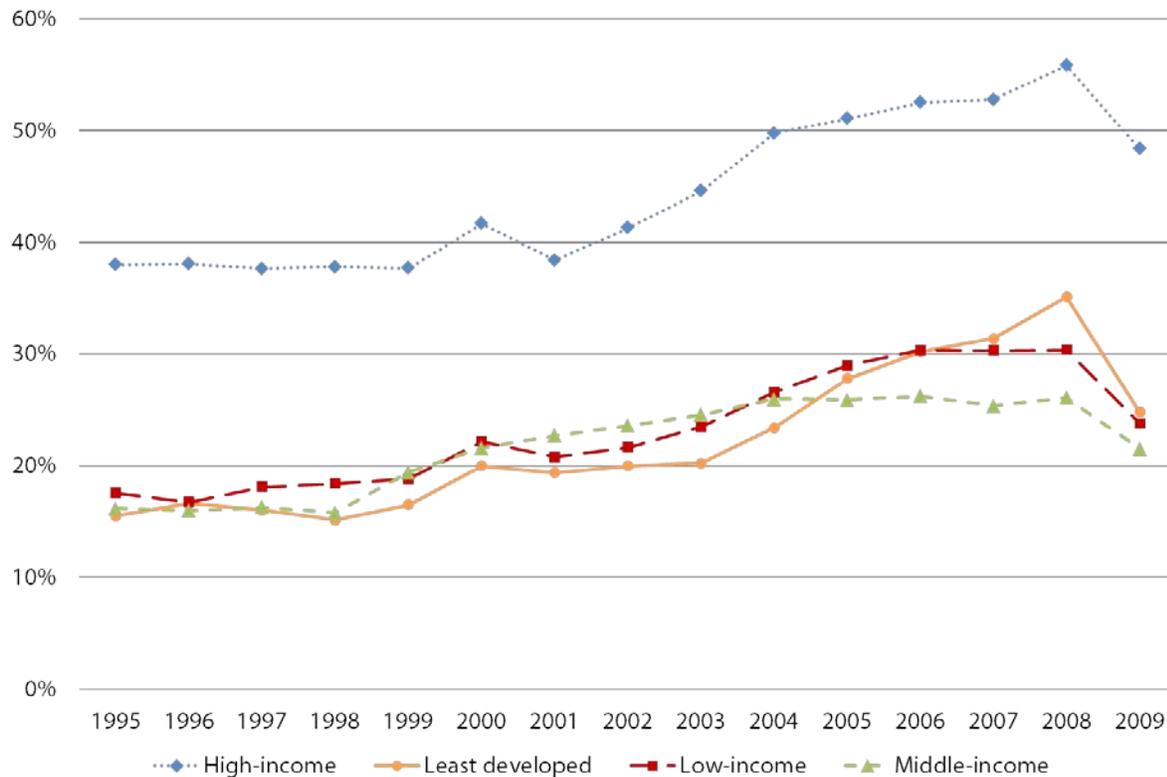
economic shock. The export share in GDP fell in all regions of the developing world. Africa had the biggest fall — from 37 percent in 2008 to 27 percent in 2009 — on account of falling oil prices and oil exports, whereas the CIS had the smallest decline in export dependency in 2009, from 33 percent in 2008 to 28 percent in 2009.

Examining the data on the share of exports in GDP by development status (Chart 1.3) indicates that, as a group, high-income developing countries are significantly more export dependent compared to countries in other income groupings. In 2008, high-income developing countries had an export dependency ratio of 58 percent compared to 30 percent in low-income and 28 percent in middle-income countries (MICs).

The rate of increase in export dependency between 1995 and 2008 reveals interesting trends: as a group, the fastest increase occurred in the LDCs (with a cumulative growth rate of 127 percent for the period) compared to LICs and the MICs (where the cumulative growth rates in the export-to-GDP ratio were 73 percent and 61 percent, respectively, for the period). The high-income developing countries experienced the lowest rate of increase in export dependency, with the export-to-GDP ratio growing by 47 percent.

The slump in trade volumes and revenues in 2009 reduced the degree of export dependency in all development groups. The fall in the export-to-GDP ratio was the largest in LDCs (from 35 percent in 2008 to 25 percent in 2009), followed by LICs (from 30 percent in 2008 to 24 percent in 2009). Next were the MICs, where

**Chart 1.3: Export share in GDP by development status, 1995–2009**



**Source:** Calculated using data from UNCTAD, *Handbook of Statistics 2009*



# Export Dependence and Export Concentration

the export share fell from 26 percent in 2008 to 22 percent in 2009. Interestingly, the development group with the highest degree of export dependency, the high-income development group, had the least fall in export dependency after the crisis in 2009. Export dependency in high-income developing economies fell from 56 percent in 2008 to 48 percent in 2009.

## Trends in Export Concentration

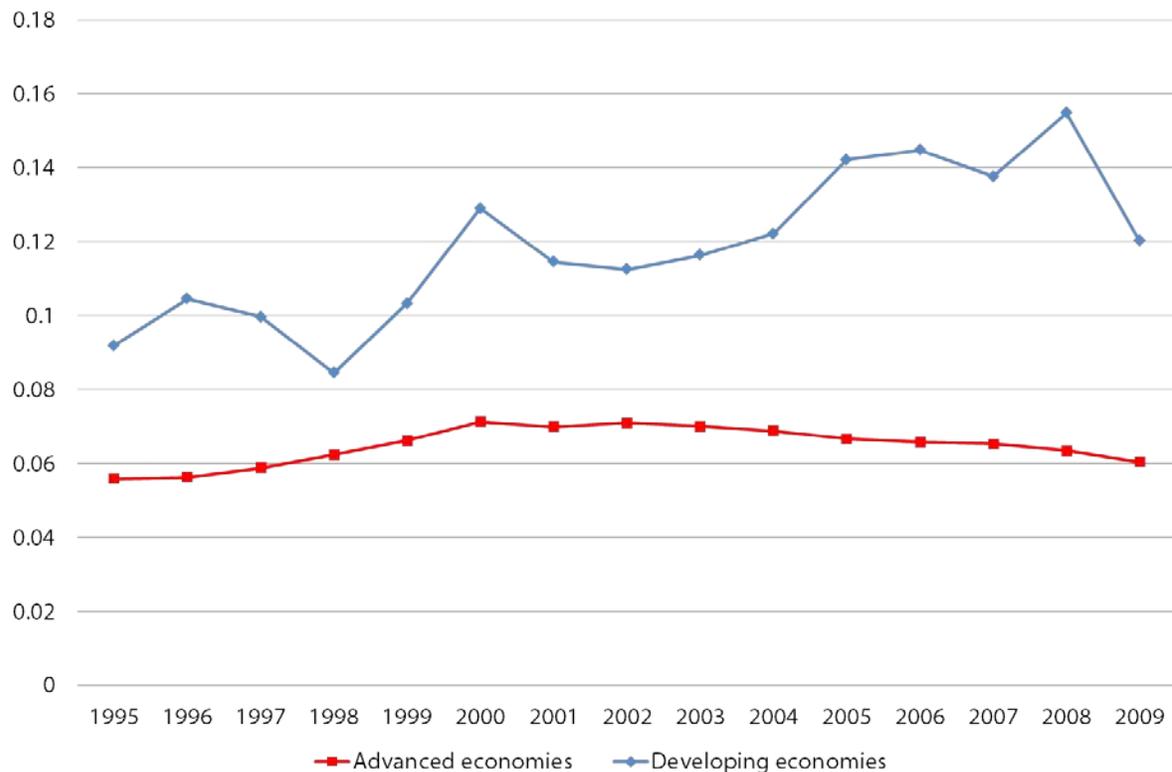
Export concentration<sup>4</sup> reflects the degree to which a country's exports are concentrated on a small number of products or a small number of trading partners. A country that exports one product to only one trading partner has a perfectly concentrated export portfolio. Conversely, a country whose exports are comprised

of a larger number of products and that trades with a larger number of trading partners has a lower export concentration ratio (ECR), i.e., has more diversified exports.

*Export concentration reflects the degree to which a country's exports are concentrated on a small number of products or a small number of trading partners.*

The evidence on export concentration (Chart 1.4) indicates an increasing tendency towards export concentration across developing countries. In 2009, the top 25 countries with the highest concentration ratios were all developing

**Chart 1.4: Export concentration ratio, 1995–2009**



**Source:** Calculated using data from UNCTAD, Handbook of Statistics 2009



countries,<sup>5</sup> with 10 of them LDCs and 10 from sub-Saharan Africa. On the other hand, of the 25 countries with the lowest export concentration ratios, all but three (Brazil, China, Serbia) were advanced economies.

As of 2008, exports from developing countries were twice as concentrated compared to exports from the advanced economies: the ECR was 0.15 for developing countries, compared to an ECR of 0.06 for the advanced economies. The ECR for developing countries increased from 0.09 in 1995 to 0.15 in 2008—an increase of 68 percent, compared to the 14 percent increase in advanced economies. The ECR also appears to be more strongly procyclical in developing countries: it rose prior to the 1997 crisis and then picked up again after 1998, only to decrease thereafter in 2001. This procyclicality appears especially pronounced after the 2008 crisis: the ECR in developing economies fell by 22 percent between 2008 and 2009. On the other hand, the ECR in advanced economies shows no significant fall after 2008.

In other words, although advanced and developing countries witnessed similar increases in their share of exports in GDP, only the developing economies witnessed a pronounced increase in their export concentration ratios. Put differently, despite the growing participation of developing countries in world trade, their exports are increasingly more concentrated in a narrow range of products, compared to the more advanced economies. The tendency towards increased export concentration remains confined mostly to developing countries.

*Despite the growing participation of developing countries in world trade, their exports are increasingly more concentrated in a narrow range of products, compared to the more advanced economies.*

Examining trends in export concentration by region (Chart 1.5) indicates that Africa had the highest export concentration ratio throughout the period 1995–2008 and also experienced the greatest increase in export concentration: the ECR nearly doubled from 0.27 in 1995 to 0.48 in 2008. For the CIS countries, export concentration grew by 69 percent over the period, making it the region with the second highest export concentration ratio. For Latin America and the Caribbean, the ECR rose by 61 percent, whereas the ECR for developing countries in Asia rose by 43 percent. The Pacific Islands did not see any significant change in their ECRs during this period.

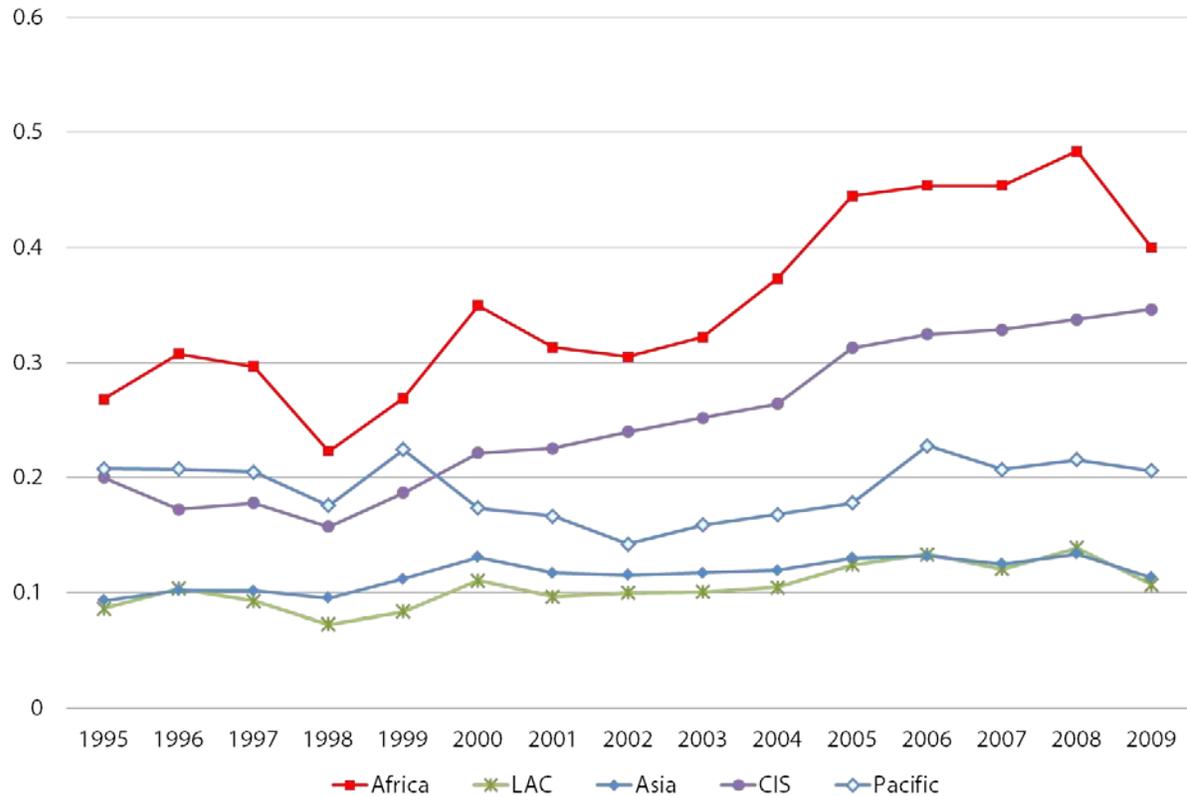
As of 2008, the region with the highest degree of export concentration was Africa (0.48), followed by the CIS countries (0.34) and the Pacific Island States (0.22). For countries in Latin America and the Caribbean, the ECR stood at 0.14 and the lowest degree of export concentration was in Asia (0.13). In 2009, as the economic crisis reduced world trade volume and prices, the ECR fell in all developing regions with the exception of the CIS, where the ECR increased marginally by 3 percent between 2008 and 2009. Latin America and the Caribbean witnessed the biggest decrease in their ECR, which fell by 23 percent, followed by Africa, where the ECR fell by 17 percent. Between 2008 and 2009, the ECR fell by 15 percent in Asia and by 4 percent in the Pacific.

This regional picture reveals extremely interesting trends: although Asia is the region with the highest export dependency, it has the lowest degree of export concentration. In other words, the portfolio of exports from Asia appears to be much more diversified relative to other regions.<sup>6</sup>

Examining the ECR for countries by development status (Chart 1.6) also reveals interesting trends: the LDCs had the largest increase in ECR. In just ten years (from 1998 to 2008), the ECR of the LDCs increased from 0.23 to 0.55. Clearly, the near tripling in the ECR of LDCs along with the doubling of export dependence for these countries renders them excessively vulnerable to external economic shocks.



### Chart 1.5: Export concentration ratio by region, 1995–2009



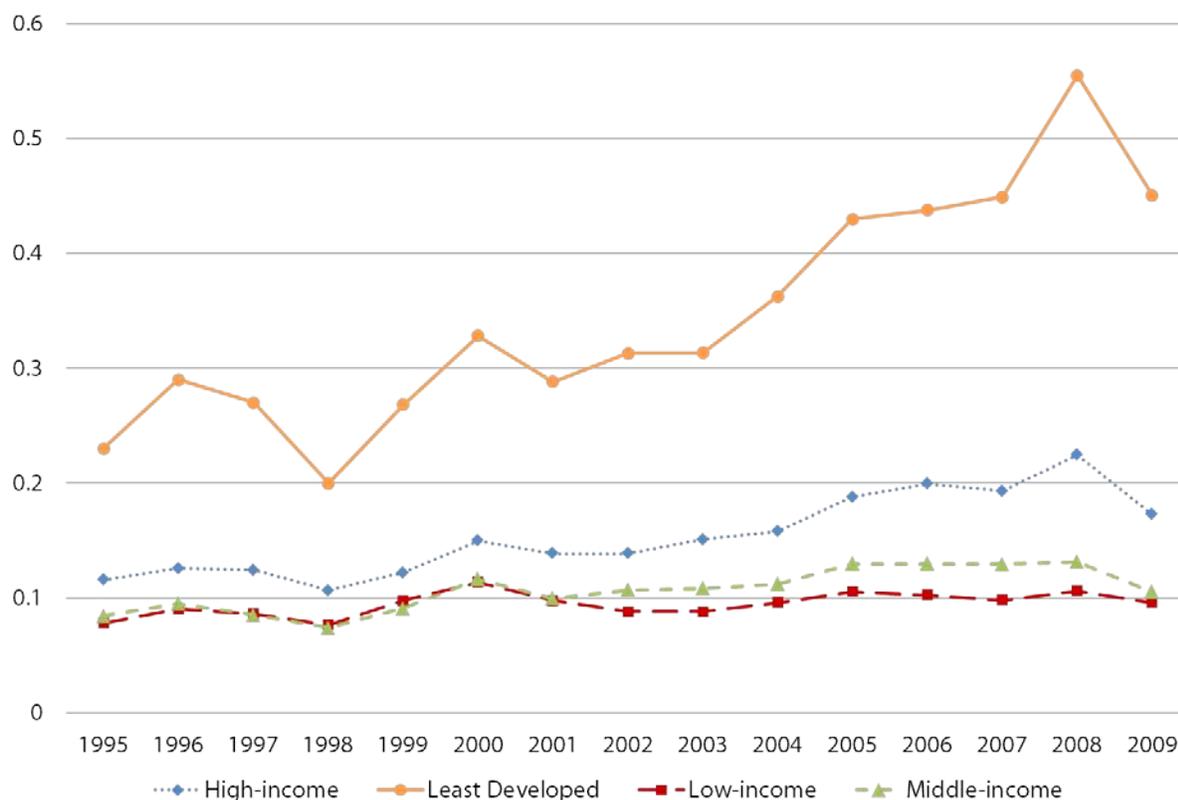
**Source:** Calculated using data from UNCTAD, *Handbook of Statistics 2009*

Although the ECR rose in the MICs, the increase was less than that in the high-income group. Export concentration over the period for MICs rose by 56 percent, compared to 94 percent for high-income countries. Curiously, low-income developing countries witnessed the least increase (36 percent) in their ECRs. This is largely on account of China, which has a very low ECR and a very high share of exports relative to other countries in the group.

As of 2008, LDCs had the highest export concentration ratio (0.55), followed by the high-income (0.22), middle-income (0.13) and low-income group of countries (0.11). The high ECR for the high-income group of countries is due to the fact that the latter includes the oil exporting countries from the Gulf States, which have extremely high concentration ratios. However, the oil exporters witnessed the biggest drop in their ECR as a result of the crisis in 2009. The ECR in high-income developing economies fell by 23 percent between 2008 and 2009. The ECR in the MICs fell by 20 percent followed closely by the LDCs where the ECR fell by 19 percent. In LICs, the ECR fell by 10 percent.



**Chart 1.6: Export concentration ratio by development status, 1995–2009**



**Source:** Calculated using data from UNCTAD, *Handbook of Statistics 2009*

## Economic Shocks, Export Earnings and Growth Volatility

As the 2007–2008 crisis hit developing countries, export earnings declined significantly across all regions. For the developing world as a whole, export revenues fell by 23 percent, but the biggest losses were registered in the CIS region, followed by the Middle East and Africa (Chart 1.7).

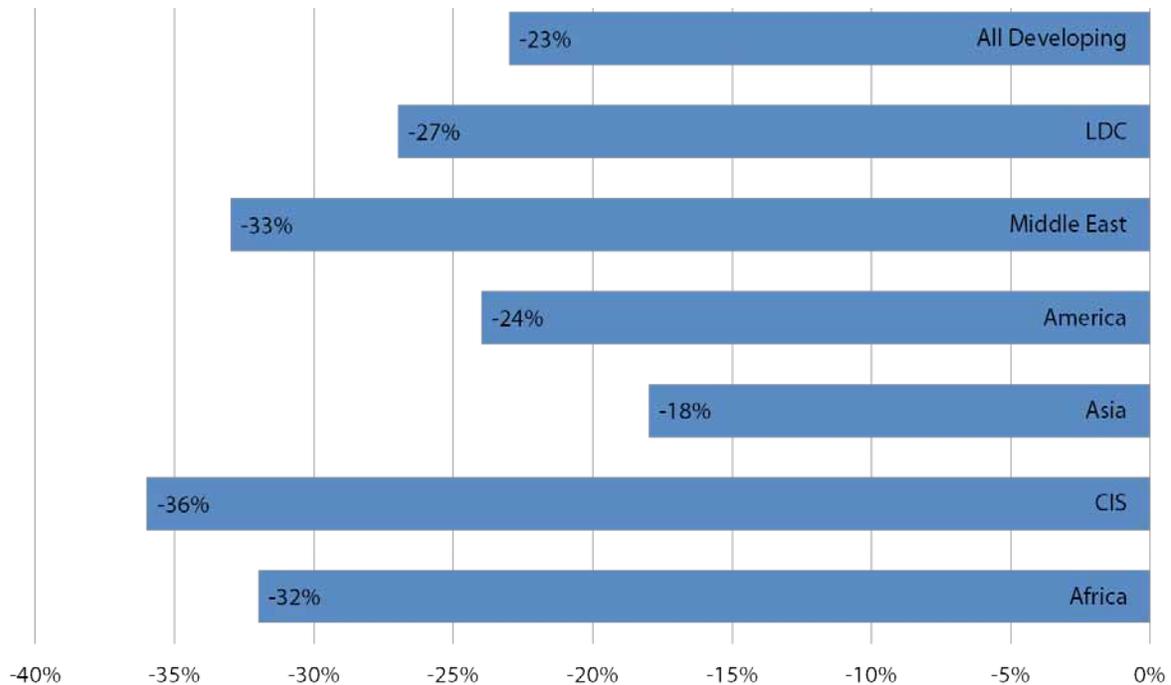
In Africa, export revenues declined sharply as a result of the fall in global demand and in international prices.<sup>7</sup> “Exports from the continent are expected to fall by more than USD 250 billion in 2009” and Africa “will suffer a shortfall in trade taxes to the tune of USD 15 billion, representing 1 percent of GDP and 4.6 percent of government revenue” (African Development Bank Group 2009).

*As the 2007–2008 crisis hit developing countries, export earnings declined significantly across all regions.*

Given the high and growing dependency of so many developing countries on exports, growth rates plummeted as export incomes fell: for developing countries as a whole, as export revenues fell by 23 percent in 2009, the rate of growth dropped from 5.7 percent in 2008 to 1.6 percent in 2009 (Chart 1.8). The CIS region, which witnessed the steepest decline in export revenues, registered the biggest decline in GDP growth, whereas regions with below-average declines in export revenues (Asia) witnessed a below-average decline



**Chart 1.7: Decline in export revenues, 2009**



**Source:** World Trade Organization, *World Trade Report 2010*

in economic growth (growth rates for East Asia and the Pacific fell from 8.5 percent in 2008 to 7.1 percent in 2009); growth rates in South Asia actually rose in 2009.

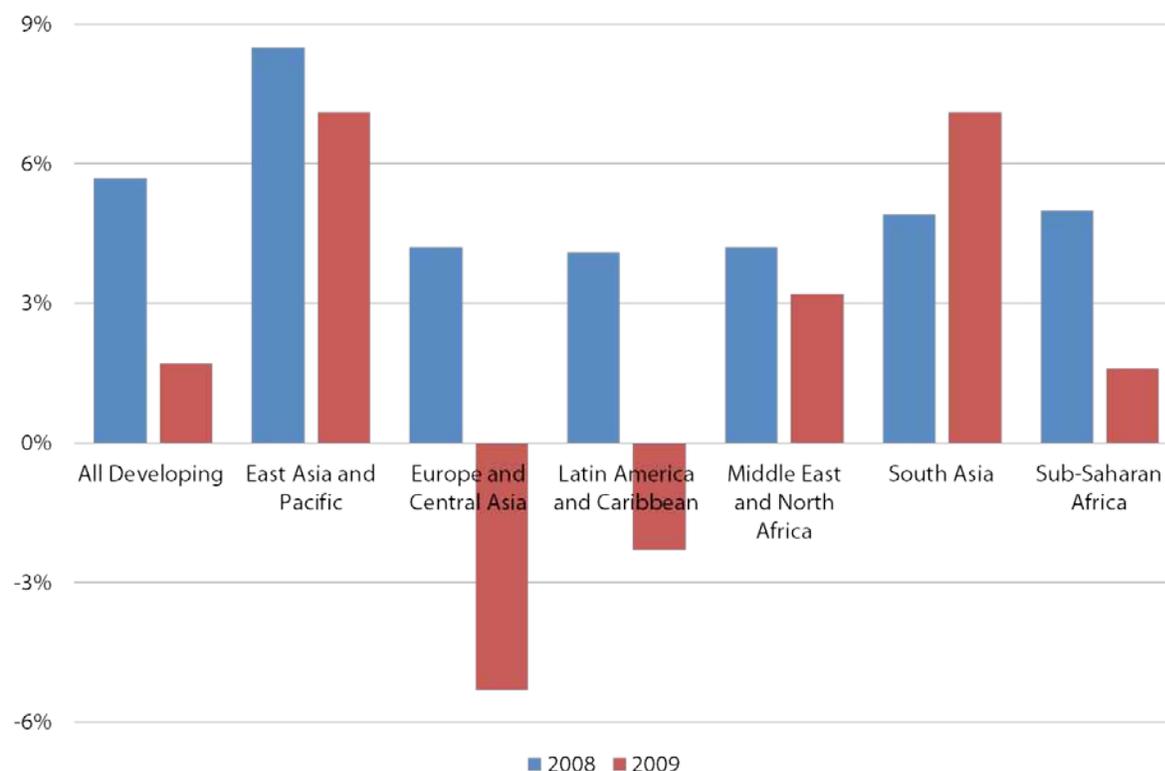
Although, as noted earlier, export dependence increases an economy's susceptibility to external shocks, the size of the loss in trade revenue depends on each country's mix of exports and main trading partners (i.e., on its degree of export concentration). This, then, explains the difference in the size of loss that different countries and regions experienced. It explains why Asia, despite being the most export-dependent region but one with the most diversified export portfolio, lost the least amount in export revenues compared to regions like Africa that, despite being relatively less exposed, had an export basket that was highly concentrated. "The reliance of most countries on a narrow range of commodities as well as a narrow range of markets, makes African export earnings extremely vulnerable to volatility in these markets" (TWN 2010).

More specifically, Asia, with a highly diversified export basket, lost 18 percent of its export revenues in 2009, while regions with higher export concentration ratios (CIS, the Middle East and Africa) lost more than 30 percent of their export earnings in the same year (36 percent, 33 percent and 32 percent, respectively).

Since the loss in export revenues directly impacts economic growth, a greater loss in export earnings causes a greater drop in economic growth. In Asia, for instance, growth rates for the East Asia region declined slightly by 1.4 percent between 2008 and 2009 and, in fact, growth increased in South Asia. On the other hand, regions that lost over 30 percent of their growth revenues in 2009 experienced plummeting economic growth rates. In the CIS region, for example, economic growth plummeted from a growth rate of 4.1 percent in 2008 to a



**Chart 1.8: Economic growth rates by region, 2008–2009**



**Source:** Calculated using data from World Bank, *Global Economic Prospects 2010*

contraction of 5.3 percent in 2009. Likewise, in sub-Saharan Africa, growth decreased from 5 percent in 2008 to 1.6 percent in 2009.

## Export Concentration, Export Earnings and Growth Volatility

If a country's exports are perfectly concentrated, then its export earnings will fluctuate with international price fluctuations. Such fluctuations, especially in the case of commodities, can be very large varying by 30–50 percent on a monthly basis. Countries with a more diversified portfolio will find that price fluctuations in the prices of two or more products will have a smoothing effect on total earnings. The more diversified and unrelated a country's exports, the less volatile its earnings will be. Put differently, a more diversified export portfolio will have a more stable stream of export revenues (Samen 2010).

Examining the relationship between export concentration and export revenue volatility for the period 2002–2008 (Table 1.1) shows that increased export concentration is strongly correlated with higher export earnings volatility: regions with a higher export concentration ratio have a higher relative deviation in export earnings. The LDCs that have the highest export concentration ratio as a group also have the highest relative deviation in export earnings.



**Table 1.1: Export Concentration and Export Revenue Volatility, 2002–2008**

Development Status	ECR 2002	ECR 2008	Change in ECR	Relative deviation of export earnings
Advanced economies	0.07	0.06	-11.6%	26.4%
Developing economies	0.11	0.14	26.7%	38.6%
Least developed countries	0.31	0.54	71.2%	52.6%

*Source:* Calculated using data from UNCTAD, *Handbook of Statistics 2009*

Validating these findings are the results of a quick regression using UNCTAD’s sample of 133 countries for the period 1996–2008, which shows that a 1 percent increase in the ECR results in a 0.5 percent increase in export revenue volatility.

In light of export revenue and growth rate volatility and their ensuing implications for poverty reduction, several studies have argued that export diversification is beneficial for long-run growth.

Export diversification<sup>8</sup> is defined as the change in the composition of a country’s existing export product mix or export destination (Ali, Alwang and Siegel 1991) or as the spread of production over many sectors (Berthelemy and Chauvin 2000).

It has been argued that, by providing a broader base of exports, diversification can lower instability in export earnings, expand export revenues, upgrade value added, and enhance growth through several channels. These include: improved technological capabilities via broad scientific and technical training as well as learning by doing; facilitation of forward and backward linkages within output of some activities that then become inputs of other activities; and increased sophistication of markets, scale economies and externalities. “When exports are more diversified, knowledge spillovers in the form of productivity improvements, efficient management and increased technical, technological and market knowledge tend to be enhanced” (Gutierrez de Pineres and Ferrantino 2000).<sup>9</sup>

Empirical studies testing the relationship between export diversification and growth find that export diversification boosts economic growth (Herzer and Nowak-Lehmann 2006, Al-Marhubi 2000, De Ferranti et al. 2001). For instance, a study using panel data for Latin American countries finds a positive relationship between export diversification and per capita income (Gutierrez de Pineres and Ferrantino 2000) and data from sub-Saharan African countries shows a positive relationship between export diversification and total factor productivity, with increased factor productivity benefiting economic growth (Ben Hammouda et al. 2010).

## Building Resilience: Policy Options

The vulnerability of countries reliant on export-dependent growth and having highly concentrated exports has been amply documented, especially in the aftermath of the recent economic crisis. When foreign demand falters, such countries find themselves with collapsing export prices and depressed growth. This is why a number of development policy makers are focusing on the role of domestic demand. “In order to protect themselves and the MDGs from exposure to external shocks, countries may want to generate domestic



demand in a sustainable way by increasing household incomes and consumption, alongside boosting corporate investment” (UNDP, ADB, UNESCAP 2010, Griffith-Jones and Ocampo 2009, Chhibber et al. 2009).

The growing reliance on exports has not stimulated a process of export and economic diversification. Instead, exports from the poorest regions and from the poorest countries have become even more concentrated. Given the risks associated with export concentration, policies to promote export diversification have also received considerable attention.

### *Boosting Domestic Demand*

In the wake of the recent crisis, many countries introduced measures to boost domestic demand as a way of stimulating their economies (Box 1.1). These, however, were mostly contingency measures — part of a stimulus package introduced by countries to compensate for the fall in foreign demand. Given the vulnerability of so many poor countries to external economic and financial shocks, policy makers may want to look at strengthening domestic demand as a way of lessening export dependence and building more resilient production systems over the longer term.

*Given the vulnerability of so many poor countries to external economic and financial shocks, policy makers may want to look at strengthening domestic demand as a way of lessening export dependence and building more resilient production systems over the longer term.*

## **Box 1.1: Increasing Domestic Demand Cushions Economic Downturn in Asia**

In the global downturn, and especially in 2009, all major economies in Asia experienced declining exports. However, the region’s large developing countries — China, India, Indonesia, Viet Nam and the Philippines — retained positive and (except for the Philippines) high economic growth rates as expanding domestic demand made up for export plunges.

In China, the major driver offsetting the negative impact of falling exports was gross capital formation, spurred by substantial stimulus measures. Private consumption also helped. In India, Indonesia, and Viet Nam, domestic investment and private consumption were equally important drivers of growth. In the Philippines, where investment was sluggish, growth was maintained mostly by a continuing rise in private consumption. India, Indonesia and the Philippines significantly increased government consumption. The latter contributed to growth in all five large economies.

In the contracting Asian economies, internal markets were generally small and thus domestic demand was insufficient to offset the export squeeze. Malaysia and Singapore

retained positive growth of private consumption and increased government consumption, but failed to avoid dramatic falls in domestic investment. Taiwan suffered from both sluggish private consumption and plummeting gross capital formation. In the Republic of Korea, growth of private consumption fell to a critically low level, but remained positive. Investment fell significantly, but the decline of exports was smaller than elsewhere.

Viet Nam was one of the fastest-growing economies in the East Asia and Pacific region both before and after the global economic crisis. After registering a real GDP growth of 5.3 percent in 2009, Viet Nam’s economy expanded an estimated 6.8 percent in 2010. Viet Nam, like China, stands out for achieving not only a higher average growth rate, but also a more stable growth path. The large stimulus package — which took the form of a low base (prime) rate, the injection of liquidity through lower reserve requirements, an interest rate subsidy, acceleration of public investment, reduction in corporate income tax, personal income tax and halving of the value added tax (VAT) in selected items — appears to have provided the necessary boost to private consumption and investment to maintain economic



## **Box 1.1: Increasing Domestic Demand Cushions Economic Downturn in Asia (contd.)**

growth. Real government consumption in Viet Nam also grew rapidly in 2009 (7.6 percent) and 2010 (6.9 percent).

The Government of Viet Nam was, however, slow at responding to the spiraling inflation, which hit 12.2 percent in early 2011. Inflation was driven by external factors, such as the hike in global commodities prices, and internal factors, including increased domestic demand and weather- and disease-related domestic supply shocks. To help tame inflation rate, the government publicly indicated its intention to pursue “tight and prudent monetary and fiscal policy” and approved a wide range of monetary, fiscal and structural policy reforms, intended to cool an overheated economy.

The Asian experience following the recent economic crisis illustrates the key role that domestic demand plays in bolstering economic growth in the face of contracting global demand. The high investment potential of the private sector and expansion of domestic consumption bodes well for future growth. However, in boosting domestic demand, the governments may need to be cautious about inflation as well as to continue support for their exports. In smaller economies with limited internal markets, exports remain a precondition for increased domestic demand and economic growth.

**Source:** Oxford Analytica, 2011, ‘Asia: Domestic Demand Will Lift Asia’, Oxford Analytica Research Daily Brief Service, 5 January, Oxford; World Bank, 2010, *Taking Stock: An Update on Vietnam’s Recent Economic Developments*, World Bank, Hanoi.

Measures to boost domestic demand could focus on:

- Investing in the capabilities and capacities of the poor. Consumption is likely to increase if a greater share of national income goes to the poor<sup>10</sup> and investing in the poor is also likely to increase their contribution to GDP, thus ensuring a more inclusive pattern of growth. Reducing poverty by broadening the economic base can unleash potential demand.
- Providing appropriate incentives to the private sector — through policies on exchange rates, taxation and subsidies — to make it more profitable for companies to invest in sectors that are oriented less towards exports and more towards meeting domestic demand and especially the needs of the poor.
- Adopting specific measures to strengthen small and medium-sized enterprises, which tend to depend heavily on local markets and on the mass market for consumer goods.
- Promoting regional development and employment creation programmes.

## **Box 1.2: Boosting Domestic Demand in China**

In 2009, China announced that it would make domestic demand its long-term growth strategy and take further measures to stimulate consumer spending, including in less developed and rural areas. In the decades prior to this, China’s impressive economic success was driven by an export-led growth strategy. However, the recent downturn in global demand revealed how vulnerable the economy

is to this type of growth strategy and the importance of domestic demand as a buffer against global market fluctuations.

Aggressive measures to bolster domestic demand announced by the Chinese government in 2009 were above all targeted at cultivating areas of high consumer



## Box 1.2: Boosting Domestic Demand in China (contd.)

demand and expanding consumption in new areas. For instance, China sought to improve the policy on automobile consumption, accelerate development of markets for second-hand cars and car rental, and guide and promote rational spending on automobiles. As a result, purchases of cars in 2010 were 92.4 percent higher than in 2008, at least in part reflecting government-financed discounts for traded-in and fuel-efficient cars.

The Chinese government also initiated programmes for bringing home appliances and agricultural machinery to the countryside. It devoted 40 billion yuan in 2009 to subsidizing the purchase of home appliances in rural areas and to trading in old home appliances. It encouraged retailers and commercial chains to open stores in more townships and villages and intensified the development of consumption facilities and service networks in both urban and rural areas, such as safeguarding the legitimate rights and interests of consumers, and developing consumer credit.

In order to increase rural incomes and consumption capacity, China announced that it would continue to improve the distribution of income, raise the proportion of the national income that goes to wages, increase the proportion of government spending dedicated to well-being, and increase subsidies to farmers and low-income urban residents. In 2009, China introduced a rural pension scheme and made it possible to transfer pension accounts across regions. By 2010, the government had invested in projects for developing low-income housing, education, medical infrastructure in rural areas, and other types of infrastructure improvements, including farmland development and water conservancy projects, railways, and freeways.

For example, to develop low-income housing, the government set a target to solve, within three years, the housing problems of 7.5 million low-income urban families

and 2.4 million families living in shantytowns in forests, on reclaimed land and around coalmines. In 2010, work was begun to build low-income housing and renovate run-down areas across the country with a total of 5.9 million units, surpassing the target by 100,000 units. This figure consists of 3.22 million units of low-income housing and 2.68 million units of housing in run-down areas; throughout 2010, work was basically completed on 3.7 million units.

To facilitate an increase in rural incomes, the Chinese government pledged to raise the floor prices for major grain varieties, expand the scale of agricultural subsidies, and raise standards. The latter envisages adjusting agricultural output subsidies with changing input prices on diesel fuel and fertilizers. The government announced strong support to specialized farmer cooperatives, various service organizations in rural areas, and leading industrialized agricultural production enterprises.

Finally, the master strategy for large-scale development of the less developed western region includes measures such as: issuing a list of industries in the western region encouraged by the state; giving greater support to the development of infrastructure and ecological and environmental conservation; promoting the development of industries that can take advantage of local strengths; accelerating the development of key national experimental zones for development and opening up; and launching demonstration projects for ecologically oriented development together with the project to tackle problems in the development of contiguous areas that have high concentrations of poverty and face special difficulties. To energize the development of the central region, the government plans to bring in the industrial production from booming coastal regions and boost city clusters, which are further expected to drive the development of their surrounding areas.

**Source:** Chinese Government, 2009, *Report on the work of the Government delivered at the Second Session of the Eleventh National People's Congress* by Wen Jiabao, March 5, [www.gov.cn/english/official/200903/14/content\\_1259415.htm](http://www.gov.cn/english/official/200903/14/content_1259415.htm); Chinese Government National Development and Reform Commission, *Report on the implementation of the 2010 Plan for National Economic and Social Development and on the 2011 Draft Plan for National Economic and Social Development*, Fourth session of the Eleventh National People's Congress, March 5, ([online.wsj.com/public/resources/documents/2011NDRReportEng.pdf](http://online.wsj.com/public/resources/documents/2011NDRReportEng.pdf))



# Export Dependence and Export Concentration

Studies have pointed out that the potential for boosting domestic demand is evident from the considerable savings in several countries. For instance, in the case of Asia, it has been pointed out that, since 2001, the savings rate in the Asia Pacific region has either remained stable or increased (UNDP, ADB and UNESCAP 2010).

## *Promoting Export Diversification*

Dependence on a narrow range of exports gives rise to risks associated with the lack of diversification, thereby exacerbating a country's vulnerability to economic shocks. Export diversification aims at mitigating these risks, including the volatility and instability in export earnings — which in turn have adverse macro-economic effects on growth, employment, investment planning, export capacity, foreign exchange reserves, inflation, capital flight and, *inter alia*, debt repayment (Samen 2010).

Generally, export diversification takes the following forms: (a) horizontal diversification takes place within the same sector (primary, secondary or tertiary) and entails an adjustment in the country's export mix by adding new products to existing export baskets within the same sector (e.g., production of off-season crops);

(b) vertical diversification entails a shift from the primary to the secondary or tertiary sector (e.g., moving from basic commodity extraction to commodity processing), which typically entails increasing value added in activities such as processing, marketing or other services; and (c) diagonal diversification entails a shift from imported inputs into the secondary and tertiary sector (e.g., using imported goods to produce manufactured products for exports) (Samen 2010).

*Typically, the policy reforms necessary to foster export diversification require a multi-faceted approach spanning trade, investment and industrial policies, and institutional reforms.*

Another objective of export diversification is to reduce the dependence upon one or a limited number of geographical destinations for exports. For instance, 29 of the 84 MICs ship more than 50 percent of their exports to a single market. By 2008, 50 percent of all developing country exports went to just seven destinations (United States, China, Japan, Hong Kong, Germany, the Republic of Korea and the Netherlands). Compared to other developing regions, exports from Latin America and the Caribbean appear to be the most geographically concentrated; the United States alone accounted for 43 percent of the region's exports in 2008 (UNCOMTRADE 2009).

Policies to promote export diversification will clearly depend in the first instance on a comprehensive analysis of the country's specific position in the international division of labour, its position in the global supply chain and the prospects of world demand. Typically, the policy reforms necessary to foster export diversification require a multi-faceted approach spanning trade, investment and industrial policies, and institutional reforms.

Specific measures to promote export diversification should include:

- (A) Targeted industrial and investment policy to develop potentially new areas of comparative advantage** and establish the conditions needed for local firms to access export markets. Increasing market access usually involves a reduction of trade barriers for exporting firms; the setting up of marketing and distribution firms that provide local producers with the necessary know-how to gain access to world markets; an institutional and regulatory framework that supports export diversification; improved communications technology; and infrastructure investments, which increase productivity and enable local firms to compete in global markets.



- **Financing export diversification:** An export diversification strategy should make available financing facilities for export-oriented industries on a priority basis since inadequate trade finance is a major constraint for potential exporters, especially small and medium firms that have no access at all to finance or only at prohibitively high interest rates. For instance, private commercial banks may be persuaded to give loans to exporters at rates of interest fixed by the government. A more developed financial sector will allow more financing opportunities for new and innovative entrepreneurs who might have the potential to develop new export products. It will also allow for the opening of credit lines for export and export-credit insurance. In Malaysia, for example, official schemes are available for the refinancing, insuring and guaranteeing of export credits (UNESCAP 2004). The Malaysia Export Credit Insurance Berhad (MECIB), with an underwriting capacity of up to 125 million Malay dollars, provides commercial banks with coverage of losses against loans to exporters and suppliers. Facilities offered by MECIB include a comprehensive short-term policy, a confirming-bank policy, a banker's export finance insurance policy, a bond indemnity support facility and a buyer credit guarantee facility.
- **Infrastructure development:** Efficient infrastructure is a precondition for good export performance. Infrastructure constraints, like lack of access to adequate power and gas supplies, can limit the ability of new firms to export. Transport infrastructure and port facilities that ensure that goods arrive on time, in good condition and with the least delivery time are a crucial element in any successful export diversification policy. The inadequate functioning of infrastructure may harm enterprises in many ways: by hampering production activities, delaying the movement of goods and passengers, and leading to a delay in the delivery of goods. It adds to business uncertainty and risk and imposes additional costs.

### Box 1.3: Regional Infrastructure Development in Africa

In response to the need to develop regional and trans-African infrastructures, the New Partnership for Africa's Development (NEPAD) has drawn up an infrastructure development plan and has been helping to establish institutions to mobilize financial resources for infrastructure development. Through cooperation, the continent has developed a significant part of the Trans-African Highways Network linking Africa's capitals and major economic production areas, having fixed 75 percent of the highway's missing links.

The option of establishing trade corridors is also being pursued. For example, the North-South Corridor Pilot Aid for Trade Programme is promoted by COMESA-EAC-SADC as a joint initiative. Its objective is to reduce the time, and so the costs, of road and rail travel along two main

corridors: (i) the Dar es Salaam Corridor, which links the port of Dar es Salaam to the Copperbelt; and (ii) the North-South Corridor, which links the Copperbelt to the southern ports of South Africa. In East Africa, the Northern Transport Corridor linking economies of Kenya, Uganda, Rwanda, the Democratic Republic of the Congo and Burundi has been in operation for several years. Discussions are currently underway to transform it from a purely transport corridor to the Northern Corridor Economic Zone that would cover parts of Kenya, Burundi, the Democratic Republic of the Congo, Rwanda, Uganda and the Sudan. Accelerating the implementation of these initiatives and consolidating their achievements would make an important contribution to intra-African trade and trade performance and economic growth more broadly.

**Source:** UNDP, 2011, *Regional Integration and Human Development: A Pathway for Africa*, UNDP, New York.



# Export Dependence and Export Concentration

- **Communication and technological infrastructure:** The development of an adequate and accessible communication infrastructure enhances firm productivity and allows more efficient and speedy communication with the rest of the world. Access to the internet and telecommunications is usually essential for the success of new export firms.
  - **Institutional and regulatory framework:** The regulatory and institutional environment prevailing in an economy can either promote or hinder export diversification (Parketa and Tamberi 2008). Complicated or cumbersome government rules and regulations relating to exports can undermine efforts to diversify exports. For instance, an analysis of trade support services in Africa highlighted how a deficient governance structure in national trade policy had hampered export development. Simplified and harmonized export regulations are thus necessary to promote export diversification (Bonaglia and Fukasaku 2003).
  - **Bonded warehouses:** Special bonded warehouses enable exporters to import and store inputs duty-free with minimal customs formalities. These warehouses are monitored using import and export passbooks and a re-tabulated input-output system, through which raw materials may be imported via an entry in a passbook without paying any customs duty or sales tax. The same value of raw materials is deducted from the passbook upon export of the finished product. Bonded warehouses were established successfully in Bangladesh for garment exporters, but then were extended to all exporters (UNESCAP 2004).
- (B) **Devising selective measures** to stimulate export diversification such as fiscal and direct credit incentives, selective subsidies and local content requirements. Such interventions can help firms improve their export competitiveness and can encourage a more balanced export mix. Many developing economies have used selective measures to stimulate export growth and diversification.
- **Export subsidies:** Countries that do have some sort of export subsidy programme could prioritize subsidies to potential new export sectors. The subsidies can come directly or as a tax incentive or exemption for qualified exporters. These measures reduce the cost of production and allow firms to survive at very low profit margins. For example, Bangladesh Bank provides limited subsidies to garment exporters if their products are locally manufactured using either 100 percent local raw materials or duty-paid imported raw materials (UNESCAP 2004). Bangladesh also exempts exporters from 50 percent of the corporate tax (UNESCAP 2004). In Malaysia, a double tax deduction is allowed for expenses that resident companies exporting manufactured and agricultural products incur. Some of the deductible items are expenditures for overseas advertising, the supply of free samples abroad, market research, the preparation of tenders for the supply of goods overseas, the supply of technical information abroad, public relations work connected with exports, exhibits and participation in trade or industrial exhibitions, the cost of overseas travel and accommodation, and the maintenance of an overseas sales office (UNESCAP 2004). Although these policies might promote export in all sectors, it has a bigger impact on new potential sectors that might be exporting at very slim profit margins. If the tax and subsidy export promotion programmes involve an element of prioritization for new potential export sectors, then they will better promote diversity of exports. However, it is important to note that the design of trade development measures should be carefully crafted and based on rigorous cost-benefit analysis and monitoring. Failure to do so can result in costly exercises with limited impact on the local economy. Subsidies that are likely



to favour rent-seeking behaviours should be limited, while subsidies that provide guarantees on export insurance or for working capital are to be preferred. Under the WTO, the use of export subsidies is regulated under the Agreement on Subsidies and Countervailing Measures.<sup>11</sup>

- **Local content requirements:** Developing countries can impose local content requirements on incoming FDI to ensure that the country realizes the employment and technology transfer benefits of FDI. Local content requirement policy stipulates that multinational firms must use a certain proportion of locally made parts and components. Such a policy can be used to promote export diversification by emphasizing the local procurement of parts and components from nontraditional export sectors. Local content requirement policies need to include specifications on exactly what 'kind' of local content is required. Investors will therefore be required to invest in physical, human and informational capital in the sectors that are targeted for export promotion.<sup>12</sup> Local content requirements were successfully used to diversify exports by a number of Southeast Asian economies in the 1980s and 1990s (for Malaysia, see UNESCAP 2004; for the Republic of Korea, see Chang 2000).

**(C) Investing in Human Capital Development.** Since much research has shown that a diversified export portfolio (and high-value manufacturing) is correlated with a more educated work-force (Carrere, Strauss-Kahn and Cadot 2007) the lack of skilled manpower is a key constraint on the ability of an economy to diversify its export basket (Gullstrand 2000, Parketa and Tamberi 2008). Countries aiming to diversify exports need policies on technology assessment, technology acquisition, adoption, adaptation and development and technology diffusion to raise worker (and firm) productivity in potential export sectors. High worker productivity translates into efficient production and can give the necessary cost edge to succeed in the global market. Private and public sectors can fund skill development training programmes.

**(D) Integration into Global Value Chains.** Technological advances and organizational changes in the global economy and within transnational corporations (TNCs) have fundamentally altered the way goods and services are produced. Global value chains with a high degree of specialization of individual players have become the norm for the production of goods and ever more for services as well. TNCs are increasingly outsourcing parts of their value chains in order to increase efficiency and competitiveness and to avail themselves of the lowest worldwide price options. In many instances, this has entailed the contracting of manufacturing or services to an efficient, low-cost producer in a developing country. As a result, transactions among the various parts of a single corporate system (intra-firm trade) are estimated to account for one third of global trade. Participation in global value chains, however, requires an ability to produce specialized goods or services at a demanding level of quality and quantity and within tight timelines. These demands have made it difficult for most developing countries to integrate into global value chains and to participate at the downstream level as providers of raw materials. In this regard, adequate and timely support from public and donor institutions is vital in order to secure access to open niches. Direct support may take the form of skills development, financial incentives for small and medium sized enterprises (SMEs) to invest in appropriate technologies, the creation of appropriate and effective regulatory frameworks for standards and quality assurance, assistance for establishing sustainable linkages between TNCs and local SMEs, improvement of local investment climate, encouragement and support for local economic development activities including cluster creation, and the strengthening of intellectual property rights protection (UNCTAD 2010).



## Box 1.4: Promoting Business Linkages in LDCs: UNCTAD's Business Linkages Programme

UNCTAD's Business Linkages Programme connects large companies with domestic suppliers in developing countries. It has proven to be a very useful tool for enhancing enterprise development in the LDCs. Recognizing the need to attract responsible FDI, Business Linkages Programmes in LDCs are based on a targeted approach. This approach focuses on attracting FDI that would best contribute to the development of productive capacities and the creation of an environment that fosters the establishment of business linkages between FDI and domestic firms, especially small and medium-sized enterprises (SMEs).

The majority of SMEs in developing countries do not have the capacity needed to benefit effectively from the rise of FDI and the outsourcing of production activities by transnational corporations (TNCs). A major focus of the programme is on empowering project partners to undertake business linkages above and beyond the life cycle of individual projects. Key stakeholders include TNCs,

investment promotion agencies, business associations, local banks and business services providers, relevant government departments, and SMEs.

One of the projects entitled "Building Productive Capacities in Developing Countries to Enhance their Participation in Global Supply Chains" was undertaken in four LDCs between 2008 and 2010: Mozambique, Uganda, the United Republic of Tanzania, and Zambia. Linkages were established not only in the agribusiness sector, but also in mining, tourism and services between 13 TNCs and 137 SMEs. Local business capacity was upgraded and refined through the provision of business development services, which added value to these SMEs, and contributed to improve relations with anchor companies. Sales value between participating TNCs and SMEs went up 15 percent on average and, in some cases, it went up to 50 percent. As a result, more than 1,600 jobs were created and the amount of loans obtained by the SMEs reached \$1.75 million.

**Source:** UNCTAD, 2011, *Foreign Direct Investment in Least Developed Countries: Lessons Learned from the Decade 2001–2010 and the Way Forward*, UNCTAD, Geneva.

- (E) **Designing incentive systems** that, for instance, encourage FDI flows into non-traditional sectors such as manufacturing or the production of new primary commodities or that encourage quality upgrades of existing exports. In this context, ODA can also be used to promote export diversification by supporting capability and infrastructure development in the export sectors of developing countries. Donors can support country efforts to develop a more efficient trade and investment support network by sharing their expertise in these areas and by providing access to trade data and regulations. "Experiences from the trade and investment support network in both OECD and non-OECD countries (such as Mauritius) can be extremely valuable to countries in need of reforming public agencies in charge of trade and investment promotion" (Bonaglia and Fukasaku 2003).
- (F) **Trade facilitation** is essential for export promotion and decreasing the cost of imports. Trade facilitation, as defined by WTO, is the simplification and harmonization of international trade procedures, where trade procedures are the activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade. Excess trade procedures create additional transaction costs incurred by participants in trade. The OECD calculates that each 1 percent of savings in trade-related transaction costs yields a worldwide benefit of \$43 billion (OECD 2003). Keeping that in mind, trade facilitation is increasingly becoming a focus of WTO trade round negotiations, aid for trade programmes, regional integration arrangements and national agendas. It is also important in streamlining global supply chains.



Trade facilitation may cover measures regarding: (a) formalities, procedures and documents and the use of standard and electronic messages for trade transactions; (b) the physical movement of goods through improvements in services (transparent, predictable, uniform), the legal framework, and the transport and communications infrastructure, as well as the use of modern information technology tools by services providers and users; and (c) the timely discussion and dissemination of trade-related information to all concerned parties (government, services providers and the trading community), ideally through an established consultation mechanism, such as a trade facilitation body (UNCTAD 2006).

Although there is a common understanding of the benefits of trade facilitation, its implementation is wrought with obstacles. Considering the trade environment's complexity, many different, often conflicting, interests are at work: trade operators and service providers on the one hand and customs and various ministries and regulatory agencies on the other hand. Institutional limitations add further to implementation difficulties. Policy executives tasked with identifying transaction cost problems, evaluating scope for trade facilitation and implementing trade facilitation programmes require a wide range of experience and skills (Granger 2008).

Thus, concerted efforts by national authorities with assistance from donor organizations are needed to stimulate trade facilitation process. Special efforts could be directed at aligning the interests of various stakeholders involved in the international trade, identifying the baseline and mapping out the scope of trade facilitation measures, capacity building, and fostering public-private partnerships.

## *Strengthening Regional Trade Cooperation*

Export diversification is not only about product diversification, but also about expanding the number of markets that a country exports to. Countries can consider diversifying their export markets to reduce dependence on a few sources of demand or they can boost intra-regional trade by improving transport links and simplifying customs and inspection procedures. Several sub-regions have very little trade between constituent countries, a gap that represents a major opportunity for realizing trade gains and strengthening regional resilience.

Regional cooperation can also be important for small and land-locked countries, since size can be a major constraint on their ability to diversify exports (Briguglio 2009). Such countries can enter into industrial collaboration and production sharing and follow joint trade and industrial policies. As noted by African countries, "the development of regional markets is necessary for African countries to exploit economies of scale, enhance export competitiveness and integrate effectively into the global economy (it is estimated that intra-Africa trade accounts for only 9 percent of Africa's trade" (TWN 2010).

- **Transit Treaties:** For the least developed landlocked countries (LLDCs), the extent of international trade largely depends on their relationship with neighbouring countries. Transit treaties allow landlocked countries to access the ports of neighbouring nations with relative ease and at minimal cost. Transit treaties involve an expedited and simplified treatment of cargo to and from the landlocked country, storage facilities dedicated to the landlocked country's cargo and access to major highways and roads. The transit treaty signed between India and Nepal in December 1996, for example, simplifies procedures to expedite cargo arriving in Indian ports that is destined for Nepal and provides storage facilities for Nepalese cargo (UNESCAP 2004).



## **Box 1.5: Developing a Single Window to Facilitate Trade in Senegal**

Senegal's electronic Single Window (SW) customs clearance system, ORBUS, is regarded as a success story in trade facilitation efforts for introducing electronic techniques to the trade implementation process. ORBUS was launched in 2004 following nearly 20 years of governmental efforts, including by the Ministries of Finance, Commerce, and Customs, to replace onerous paper-based trade processes with computerized exchanges among stakeholders. Its main objectives were to: (a) bring stakeholders of foreign trade into closer contact; (b) improve work processes; (c) simplify and harmonize procedures; (d) reduce trade-related costs and time; and (e) introduce new technologies in the government administration and within the business community.

Prior to the introduction of ORBUS, trade-related regulatory requirements and customs clearance procedures were time-consuming and often not transparent. Traders needed to file separate requests with each public and private agency involved in the clearance process. Typically, it would take more than four days for them to collect the required documents, which then had to be attached to their import declarations for inspection by the customs administration. A meat importer, for example, was required to file an import declaration form with the inspection body along with the invoice and then go to a bank to obtain the payment terms.

At the bank, the importer provided an exchange permit to pay import fees to the consignee. He obtained an insurance policy and then visited the livestock department with his certificate of origin to obtain a phytosanitary certificate and a food product importation permit from the department responsible for quality control.

The SW system replaced the numerous trade-related documents and physical steps previously required in the pre-clearance chain with a single form submitted electronically by the clearing agent through its web-based interface. The system automatically dispatches the single form to the various public and private bodies — banks, insurance companies, and the inspection service — involved in the transaction. Upon submission of a request in the SW, the system proposes a set of electronic documents required for the transaction and the request is automatically forwarded to the relevant stakeholders. Similarly, a separate web-based interface dedicated to customs officers and other agencies connected to the system enables them to receive and process trade requests. Through embedded functions, the interface enables processing officers to validate or reject requests or to ask for modifications. The system has reduced the trade documentation process down to half a day, whereas the previous paper-based system required four days.

**Source:** Diagne, I, 2011, 'Senegal's Transition from a Paper-based System to Paperless Trading System', UNNEXt Briefing paper No. 05.

### *Enabling International Trade Environment*

Given the high degree of export dependency of so many developing countries, it is critical that they be able to access global markets for their products. But, nearly nine years since its launch, the Doha Round of multilateral trade negotiations is at an impasse. Since the last serious push for a breakthrough collapsed in July 2008, no new concrete deadline for the conclusion of the Round has been set, despite recent efforts to revive negotiations and the target announced by the Group of Twenty (G20) to complete the Round in 2010. There has been no significant reduction in the tariffs imposed by developed countries in 2008, and average tariffs on key products from developing countries remain relatively high (UN 2010).

Meanwhile, the removal of tariffs and other trade barriers faced by exports from developing economies (i.e., any measure taken to reduce the cost of entry into the markets of advanced countries) has the potential to increase product diversity. Research has shown that a 10 percent reduction in market entry costs is associated with a 3–4 percent increase in export product diversity and a 5 percent increase in market diversity (i.e., the number of geographical markets served) (Dennis and Shepherd 2007). Import tariffs shape the export basket



of developing countries. A reduction in import tariffs will help developing economies integrate in the world economy and the global supply chain (Dornbusch et al. 1977, Venables 2003, Ruhl 2005, Yi 2003).

The special needs of LDCs, which tend to be highly vulnerable to trade shocks and possess weak exporting capacity, have been left unaddressed. A gap remains in reaching the target to provide duty-free and quota-free (DfQf) market access to at least 97 percent of products originating in LDCs, a target that still falls short of providing full coverage. There are significant regional and country variations and gaps in duty-free access. While many developed countries provide 100 percent DfQf access for LDC exports, there is room for improvement in many of their programmes, especially because the estimated costs of extending full market access to LDCs on production and exports in preference-giving countries are very small. Large developing countries have also made significant contributions by granting DfQf access to LDCs. In view of the increasing role of emerging developing countries as drivers of world trade, this is a positive development that holds potential for expanding LDC exports (UN 2010).

To enable developing countries to repeat greater gains from trade, the international community should:

- Intensify efforts to conclude a development-oriented Doha Round of trade negotiations within a realistic time-frame in order to effectively establish a more open, equitable, rule-based, predictable and non-discriminatory multilateral trading system.
- Ensure that donors accelerate delivery on existing aid commitments, including through renewed technical, financial and political support to the Aid for Trade initiative,<sup>13</sup> as well as through increased support to the Enhanced Integrated Framework, which is the entry point for LDCs in accessing Aid for Trade.
- Accelerate delivery on the commitment made by developed countries in 2005 to eliminate, by 2013, all agricultural export subsidies, and other support measures with equivalent effect, in order to increase the ability of developing countries to produce and export agricultural products competitively.
- Accelerate progress towards the full implementation of the DfQf market access for all products exported by LDCs, which remains a critical aspect for accelerating employment creation in LDC export sectors, and combine this with the creation of more transparent and simplified rules of origin.
- Sign preferential trade agreements (PTAs) that give priority access to developing countries, usually LDCs, to help diversify their exports.<sup>14</sup> For example, Collier and Venables (2007) show that various sub-Saharan African countries have had a large manufacturing export supply response to trade preferences following the African Growth and Opportunities Act, which gives trade preferences to African countries in the United States market. Another example of a successful PTA is the Caribbean Basic Economic Recovery Act (CBERA), which gives preferential treatment to exports from the Caribbean basin countries to the United States. De la Cruz calculates that the CBERA successfully increased the export diversification of Caribbean exports to the United States. Mineral exports from the region used to account for 57 percent of exports in 1983. By 1999, minerals were only 8 percent of Caribbean Basin exports to the United States (De la Cruz 2008). The North American Free Trade Agreement (NAFTA) has actually improved Mexico's product diversification, though at the cost of geographic concentration (Lewis 2004).



## **Box 1.6: Export Diversification Strategy: The Case of Cambodia**

Between 1998 and 2007, Cambodia demonstrated remarkable average annual economic growth of about 10 percent. The expansion was driven largely by rapid export growth, which increased dramatically from 16 percent of GDP in 1993 to 60 percent of GDP in 2009 (World Bank 2011). Cambodia's textile and garment industry has been the cornerstone of this export performance, accounting for 16 percent of GDP in 2007 and 14 percent of GDP in 2009 and representing the largest source of job growth. This expansion in the garment sector has been also complemented by growth in the tourism sector.

Reliance on exports from textile and garment industry is evident in Cambodia's high export concentration ratio (ECR), which equaled 0.415 in 2009.<sup>i</sup> The vulnerability associated with such a high ECR is compounded by a relatively limited export market: Cambodia's traditional export market is comprised of the United States, the European Union, Singapore, Thailand, and Malaysia. The sensitivity of Cambodia's economy to external shocks was revealed during the recent global economic slowdown, which resulted in the contraction of garment exports by almost 20 percent of their value in 2008 and the loss of more than 45,000 jobs in the garment sector by 2010, according to Cambodia's Ministry of Labour. Moreover, economic growth in Cambodia slowed to 6.7 percent in 2008 and the economy contracted by 1.9 percent in 2009.

Rural poverty and inequality pose additional constraints on sustaining the benefits of economic growth in Cambodia. Although there was a substantial reduction in poverty during the last two decades (poverty headcount declined from 47 percent in 1994 to 30 percent in 2007), living standards have increased more rapidly for the wealthier groups and the rural-urban divide remains striking. Furthermore, despite the rapid growth of the garment industry, 59 percent of households depend on agriculture as their primary source of income (ODI 2010).

To help reduce vulnerability to economic shocks and promote the generation of jobs, especially for the poor, the Cambodian government decided to integrate a trade policy into a broader national development and poverty reduction agenda. Cambodia was one of the

first countries to pilot the Integrated Framework (IF) for Trade-Related Technical Assistance to LDCs.<sup>ii</sup> In 2001, a Diagnostic Trade Integration Study (DTIS) was conducted for Cambodia; this was later revised and paved the way for the adoption of Cambodia's Trade Integration Strategy in 2007. A key instrument in implementing the Strategy was a 'sector-wide approach' (SWAp) in the trade sector, adopted by the Government of Cambodia in consultation with development partners.

The 2007 Trade Integration Strategy aimed at: (i) identifying a set of possible priority product or service sectors to serve as a basis for strengthening and diversifying Cambodia's export basket; (ii) identifying bottlenecks, either common to all priority sectors or specific to each, that need to be removed to promote development of those export sectors; (iii) linking trade sector development more clearly with human development and poverty reduction; and (iv) serving as a basis for formulating clear trade sector development priorities shared by the Cambodian government, its development partners, and other concerned stakeholders to be implemented by all through a Trade SWAp.

Nineteen products and services were identified to have export potential, including garments, footwear, rice, cassava, rubber, fish, cashew nuts, silk, soybeans, corn, wood products, light manufacturing, and tourism; sector-specific or cross-sector constraints to the development of these products were also identified. Cross-sector interventions to increase competitiveness of the products focus on trade facilitation, investment facilitation, removing technical barriers to trade, sanitary and phytosanitary measures, and intellectual property rights. The strategy also pinpoints new promising markets in Asia, the Middle East, CIS and Africa. Last, it provides an insight into how human development issues might be looked at in the context of trade development.

Preliminary results from the implementation of this strategy include: discussions by Cambodian rice millers with a Singapore-based company specializing in supply chain management of agriculture products and food ingredients; creation of the Kampong Khlaing Prahoc Orb Association to support production and merchandising of fermented fish



## **Box 1.6: Export Diversification Strategy: The Case of Cambodia (contd.)**

paste; and a needs analysis of the silk industry, pinpointing the areas for improvements in the quantity and quality of mulberry leaves, the breeding and handling of silk worms, and techniques for spinning silk yarn.

Cambodia's example illustrates how a national government, in cooperation with development partners, can build an effective framework for channeling Aid for Trade resources to enable pro-poor growth through trade development.

- i Cambodia is among the top three highly export concentrated developing countries in the region of Southeast Asia after Brunei Darussalam (0.686) and Timor-Leste (0.543), according to UNCTAD's Statistical Database ([www.unctad.org](http://www.unctad.org)).
- ii The IF is a programme of six multilateral agencies — the IMF, ITC, UNCTAD, UNDP, the World Bank, and the WTO — supported by a number of multilateral and bilateral development partners. The IF assists LDCs to integrate more effectively into global trade and turn trade into a driver of national development ([www.enhancedif.org](http://www.enhancedif.org)).

**Source:** Cambodia: Ministry of Commerce and UNDP Cambodia, 2007, *Cambodia's 2007 Trade Integration Strategy: Executive Summary and Action Matrix*, Phnom Penh.; Enhanced Integrated Framework — [www.enhancedif.org](http://www.enhancedif.org); Ministry of Commerce of Cambodia at [www.moc.gov.kh/tradeswap/content/default.aspx?id=14](http://www.moc.gov.kh/tradeswap/content/default.aspx?id=14); ODI, 2009, *An Integrated Approach to Aid for trade: Cambodia Trade Sector-Wide Approach (SWAp)*, ODI, London; UNCTAD, 2011, Statistical Database ([www.unctad.org](http://www.unctad.org)); World Bank, 2011, *World Development Indicators* ([data.worldbank.org](http://data.worldbank.org)).



## Notes

1. Strategic imports are defined as the ratio of imports of energy, food or industrial supplies to GDP.
2. For instance, the export-to-GDP ratio declined for all developing regions from 29.5 percent in 2000 to 28 percent in 2002 on account of the 2001 crisis.
3. 2009 data is unavailable for many Pacific countries.
4. The Export Concentration Ratio (ECR), also known as the Herfindahl-Hirschmann index, is a measure of the degree of market concentration. It has been normalized

$$H_j = \frac{\sqrt{\sum_{i=1}^n \left(\frac{x_i}{X}\right)^2} - \sqrt{1/n}}{1 - \sqrt{1/n}}$$

$$X = \sum_{i=1}^n x_i$$

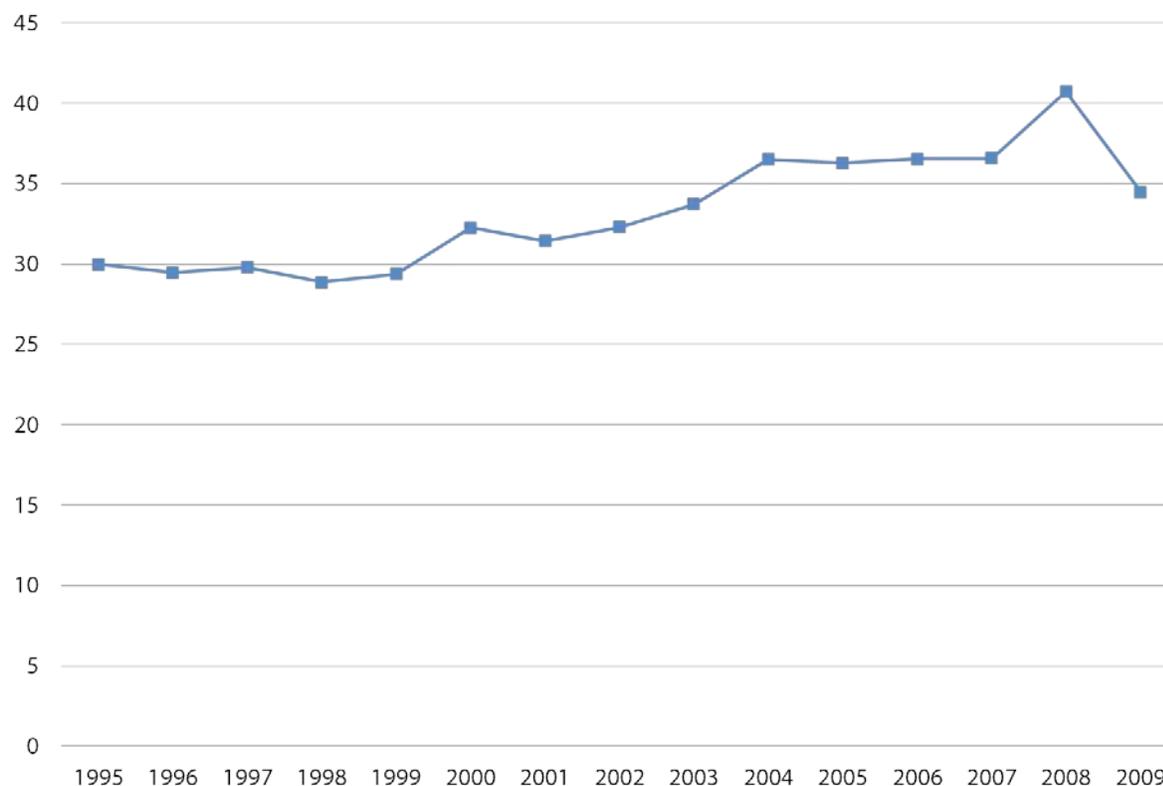
where  $H_j$  is the country or country group index;  $x_i$  is the value of exports of product  $i$ ;  $X$  is the total value of exports; and  $n$  is the number of products. The ECR as defined by UNCTAD only measures merchandise exports and does not include exports of services. The ECR ranges from 0 to 1, with 0 reflecting the least concentrated export portfolio and 1 the most concentrated. See UNCTAD Handbook of Statistics, 2009.

5. The top 25 developing countries with the highest export concentration ratios are: Iraq, Angola, Federated States of Micronesia, Guinea-Bissau, Palau, Chad, Azerbaijan, Nauru, Aruba, Nigeria, Maldives, Yemen, the Sudan, the Libyan Arab Jamahiriya, Saudi Arabia, Islamic Republic of Iran, Mali, Solomon Islands, Equatorial Guinea, Gabon, the Faeroe Islands, Saint-Pierre and Miquelon, the Congo, Kuwait, and São Tomé and Príncipe.
6. UNCTAD's classification of the Asia and Africa regions includes some countries from the Arab States (i.e., the Gulf Cooperation Council (GCC) countries). Disaggregated analysis may well reveal interesting differences in the export portfolios (and export concentration ratios) of GCC countries relative to other Asian exporters.
7. Oil exporters in Africa were especially hard hit in 2009, as their export revenues fell by 40 percent.
8. There are various ways to measure export diversification. The most commonly used measure is the concentration ratio (product or geographic concentration). Other measures used are: the Commodity-Specific Cumulative Export Experience Function (CSCEEF), the Absolute Deviation of the Country Commodity Shares, the Commodity Specific Traditionalist Index (CSTI) and the variance of the CSTI (cf. Samen 2010).
9. Conversely, it has been argued that export concentration limits the productivity spillover into other sectors of the economy, especially when the concentration is in one or two products that have weak linkages to other sectors of the economy (Amin et al. 2000).
10. Since the marginal propensity to consume is higher at lower income levels, economic growth in low-income countries is nearly synonymous with growth in demand.
11. The Arrangement on Guidelines for Officially Supported Export Credits under the aegis of the OECD is also considered as a guiding document for export credit.
12. It should be noted that local content requirements are deregulated under the WTO and many regional trade agreements. While TRIMs and SCM deregulate local content investment measures related to trade in goods, there appear to be no restrictions on the use of local content requirements under the General Agreement on Trade in Services (GATS), although they should be consistent with the national treatment principle. Unlike TRIMs, the basic principles in GATS prohibit any requirement of employment by nationality, unless notified.
13. Aid for Trade commitments to developing countries increased 35 percent in real terms in 2008 to reach a record of almost \$42 billion. However, resources remain concentrated in a few countries: the top 10 recipients account for 45 percent of total commitments, while the LDCs received just 25 percent of total commitments (UN 2010).
14. It has been argued that PTAs that grant preferential access to a narrow range of products can actually limit export diversification. For instance, the preferential treatment for coffee and banana exports from the Caribbean and EU "acted as a disincentive to diversification" (Berezin, Sabehzadeh and Santana 2002). If they are to promote export diversity, PTAs must give preferential access to specific LDCs, with a focus on sectors that LDCs are hoping to promote (e.g., manufacturing; new agricultural products and services) rather than on sectors in which LDCs are already big exporters (namely, primary agricultural or mineral commodities).



## Annex 1.A: Import Dependency

**Chart 1.A1: Imports as a share of GDP in developing economies, 1995–2009 (in percent)**

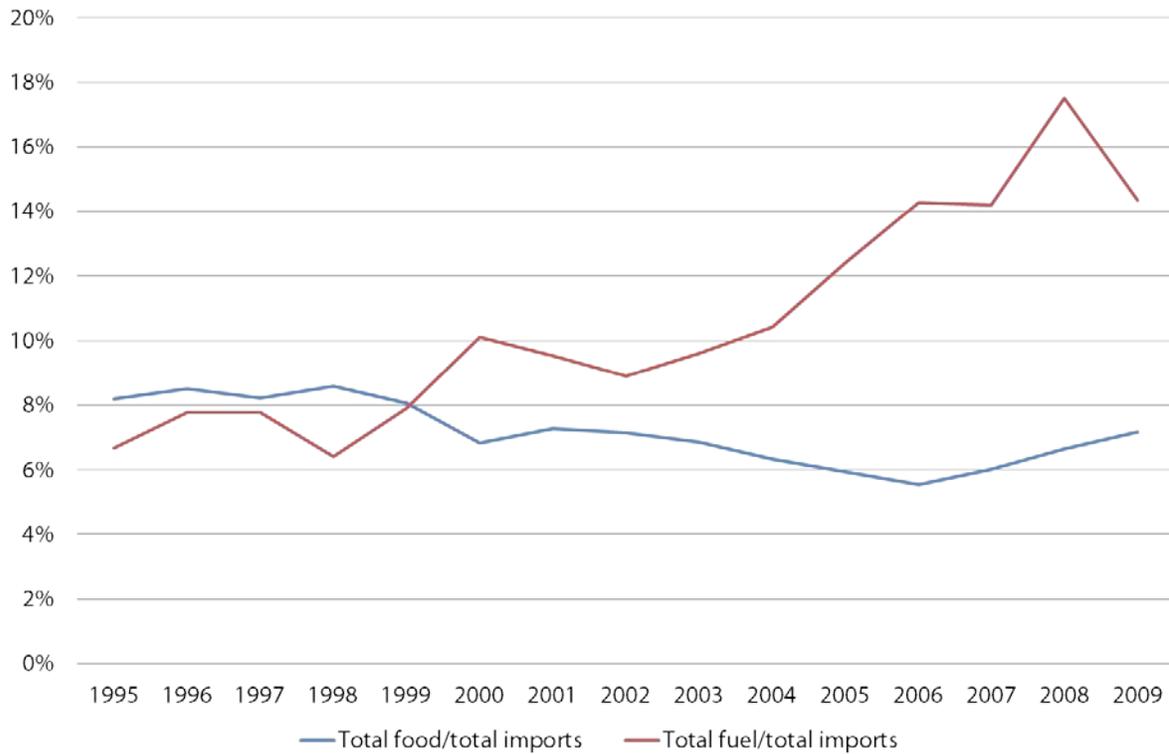


**Source:** Calculated using UNCTAD, *Handbook of Statistics 2011*

Import dependency—measured by the ratio of import values to GDP—increased among developing countries between 1995 and 2008 from 30 percent to 40 percent (Chart 1.A1). The majority of this increase was on account of the growth in dependency on primary commodity imports over the period. However, by 2009, import dependency fell to 34 percent as world trade and commodity prices declined. In 2009, primary commodities accounted for 31 percent of total imports.



**Chart 1.A2: Share of food and fuel imports in total imports into developing countries, 1995–2009**



**Source:** Calculated using UNCTAD, *Handbook of Statistics 2011*

The increased dependency on primary commodity imports is mostly attributed to the growth in fuel imports over the period. Fuel imports as a share of total imports rose from 7 percent in 1995 to 14 percent in 2009 (Chart 1.A2). A combination of rising prices and demand for fuel during the period contributed to this growing “oil-imports dependence.”

Interestingly, food imports decreased as a share of total imports—from 8 percent in 1995 to 7 percent in 2009—as the long-term real price of food has been on the decline. That said, dependence on imports of food remains problematic for some developing economies, such as Small Island Developing Economies, that depend on imports of staple foods. Further, food prices are dependent on climate conditions, which make them particularly vulnerable to short term volatility.

In summary, import dependency among developing countries rose between 1995 and 2009. However, the increase is concentrated in one specific category of commodity imports, namely fuel. Such imports will become increasingly crucial for the health of developing economies, especially with oil prices continuing their steep rise throughout 2010 and 2011.



## Annex 1.B: List of Countries and Territories by Region

Africa			
Algeria	Djibouti	Madagascar	Sierra Leone
Angola	Egypt	Malawi	Somalia
Benin	Equatorial Guinea	Mali	South Africa
Botswana	Eritrea	Mauritania	Sudan
Burkina Faso	Ethiopia	Mauritius	Swaziland
Burundi	Gabon	Morocco	Tanzania
Cameroon	Gambia	Mozambique	Togo
Cape Verde	Ghana	Namibia	Tunisia
Central African Rep.	Guinea	Niger	Uganda
Chad	Guinea-Bissau	Nigeria	Western Sahara
Comoros	Kenya	Rwanda	Zambia
Congo	Lesotho	Sao Tome and Principe	Zimbabwe
Côte d'Ivoire	Liberia	Senegal	
Dem. Rep. of the Congo	Libya	Seychelles	
Latin America and the Caribbean			
Anguilla	Cayman Islands	Grenada	Panama
Antigua and Barbuda	Chile	Guatemala	Paraguay
Argentina	Colombia	Guyana	Peru
Aruba	Costa Rica	Haiti	St. Kitts and Nevis
Bahamas	Cuba	Honduras	St. Lucia
Barbados	Dominica	Jamaica	St. Vincent and the Grenadines
Belize	Dominican Republic	Mexico	Suriname
Bolivia	Ecuador	Montserrat	Trinidad and Tobago
Brazil	El Salvador	Netherlands Antilles	Uruguay
British Virgin Islands	Falkland Islands (Malvinas)	Nicaragua	Venezuela

**Source:** UNCTAD, *Handbook of Statistics 2009*



## Annex 1.B: List of Countries and Territories by Region (contd.)

Asia			
Afghanistan	Iran	Myanmar	Syrian Arab Republic
Bahrain	Iraq	Nepal	Taiwan, Province of China
Bangladesh	Jordan	occupied Palestinian territory	Thailand
Bhutan	Kuwait	Oman	Timor-Leste
Brunei Darussalam	Lao PDR	Pakistan	Turkey
Cambodia	Lebanon	Philippines	United Arab Emirates
China	Macao, SAR of China	Republic of Korea	Viet Nam
Hong Kong, SAR of China	Malaysia	Saudi Arabia	Yemen
India	Maldives	Singapore	
Indonesia	Mongolia	Sri Lanka	
Oceania *			
Cook Islands	Marshall Islands	Northern Mariana Islands	Tokelau
Fiji	Micronesia	Palau	Tonga
French Polynesia	Nauru	Papua New Guinea	Tuvalu
Guam	New Caledonia	Samoa	Vanuatu
Kiribati	Niue	Solomon Islands	Wallis and Futuna Islands
CIS			
Armenia	Kazakhstan	Russian Federation	Ukraine
Azerbaijan	Kyrgyzstan	Tajikistan	Uzbekistan
Belarus	Moldova	Turkmenistan	

\* Also referred to as Pacific Islands in the text.

**Source:** UNCTAD, *Handbook of Statistics 2009*



## Annex 1.C: List of Countries and Territories by Development Status

High-Income Developing Country/ Territory			
American Samoa	Chile	Netherlands Antilles	St. Kitts and Nevis
Anguilla	Cook Islands	New Caledonia	St. Lucia
Antigua and Barbuda	Falkland Islands (Malvinas)	Niue	Taiwan, Province of China
Argentina	French Polynesia	Northern Mariana Islands	Trinidad and Tobago
Aruba	Guam	Oman	Turks and Caicos Islands
Bahamas	Hong Kong, SAR of China	Palau	United Arab Emirates
Bahrain	Kuwait	Qatar	Uruguay
Barbados	Libya Arab Jamahiriya	Republic of Korea	Venezuela
British Virgin Islands	Macao, SAR of China	Saudi Arabia	
Brunei Darussalam	Mexico	Seychelles	
Cayman Islands	Montserrat	Singapore	
Middle-income Developing Country/ Territory			
Algeria	Egypt	Maldives	St. Helena
Belize	El Salvador	Marshall Islands	St. Vincent and the Grenadines
Bolivia	Equatorial Guinea	Mauritius	Suriname
Botswana	Fiji	Micronesia	Swaziland
Brazil	Gabon	Morocco	Syrian Arab Republic
Cape Verde	Grenada	Namibia	Thailand
Colombia	Guatemala	Nauru	Tokelau
Congo	Honduras	occupied Palestinian territory	Tonga
Costa Rica	Iran	Panama	Tunisia
Cuba	Jamaica	Paraguay	Turkey
Dominica	Jordan	Peru	Tuvalu
Dominican Republic	Lebanon	Samoa	Vanuatu
Ecuador	Malaysia	South Africa	Wallis and Futuna Islands
Low-Income Developing Country/ Territory			
Afghanistan	Eritrea	Liberia	Sao Tome and Principe
Angola	Ethiopia	Madagascar	Senegal
Bangladesh	Gambia	Malawi	Sierra Leone
Benin	Ghana	Mali	Solomon Islands
Bhutan	Guinea	Mauritania	Somalia

Source: UNCTAD, Handbook of Statistics 2009



## Annex 1.C: List of Countries and Territories by Development Status (contd.)

Low-Income DC (contd.)			
Burkina Faso	Guinea-Bissau	Mongolia	Sri Lanka
Burundi	Guyana	Mozambique	Sudan
Cambodia	Haiti	Myanmar	Tanzania
Cameroon	India	Nepal	Timor-Leste
Central African Rep.	Indonesia	Nicaragua	Togo
Chad	Iraq	Niger	Uganda
China	Kenya	Nigeria	Viet Nam
Comoros	Kiribati	Pakistan	Yemen
Côte d'Ivoire	Republic of Korea	Papua New Guinea	Zambia
Dem. Rep. of the Congo	Lao PDR	Philippines	Zimbabwe
Djibouti	Lesotho	Rwanda	
LDCs			
Afghanistan	Equatorial Guinea	Maldives	Somalia
Angola	Eritrea	Mali	Sudan
Bangladesh	Ethiopia	Mauritania	Tanzania
Benin	Gambia	Mozambique	Timor-Leste
Bhutan	Guinea	Myanmar	Togo
Burkina Faso	Guinea-Bissau	Nepal	Tuvalu
Burundi	Haiti	Niger	Uganda
Cambodia	Kiribati	Rwanda	Vanuatu
Central African Rep.	Lao PDR	Samoa	Yemen
Chad	Lesotho	Sao Tome and Principe	Zambia
Comoros	Liberia	Senegal	
Dem. Rep. of the Congo	Madagascar	Sierra Leone	
Djibouti	Malawi	Solomon Islands	
Transition Countries			
Albania	Croatia	Montenegro	Tajikistan
Armenia	Georgia	Russian Federation	The FYR of Macedonia
Azerbaijan	Kazakhstan	Serbia	Turkmenistan
Belarus	Kyrgyzstan	Serbia and Montenegro	Ukraine
Bosnia and Herzegovina	Moldova	SFR of Yugoslavia (former)	Uzbekistan

**Source:** UNCTAD, *Handbook of Statistics 2009*



## Annex 1.D: Economic Groupings of Developing Countries and Territories

### *Income Groups*

The country distributions presented are for statistical convenience only and follow those used by the Statistics Division, Department of Economic and Social Affairs (DESA) of the United Nations. The economies are categorized into three groups according to their per capita GDP in 2000. The breakdown is based on GDP and population data available in 2009.

### *2000 per capita current GDP above \$4,500: High-income (41)*

American Samoa, Anguilla, Antigua and Barbuda, Argentina, Aruba, Bahamas, Bahrain, Barbados, British Virgin Islands, Brunei Darussalam, Cayman Islands, Chile, Cook Islands, Falkland Islands (Malvinas), French Polynesia, Guam, Hong Kong (Special Administrative Region of China), Kuwait, the Libyan Arab Jamahiriya, Macao (Special Administrative Region of China), Mexico, Montserrat, Netherlands Antilles, New Caledonia, Niue, Northern Mariana Islands, Oman, Palau, Qatar, the Republic of Korea, Saint Kitts and Nevis, Saint Lucia, Saudi Arabia, Seychelles, Singapore, Taiwan (Province of China), Trinidad and Tobago, Turks and Caicos Islands, the United Arab Emirates, Uruguay, Bolivarian Republic of Venezuela.

### *2000 per capita current GDP between \$1,000 and \$4,500: Middle-income (52)*

Algeria, Belize, Bolivia, Botswana, Brazil, Cape Verde, Colombia, the Congo, Costa Rica, Cuba, Dominica, the Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Fiji, Gabon, Grenada, Guatemala, Honduras, Islamic Republic of Iran, Jamaica, Jordan, Lebanon, Malaysia, Maldives, the Marshall Islands, Mauritius, Federated States of Micronesia, Morocco, Namibia, Nauru, occupied Palestinian territory, Panama, Paraguay, Peru, Saint Helena, Saint Vincent and the Grenadines, Samoa, South Africa, Suriname, Swaziland, Syrian Arab Republic, Thailand, Tokelau, Tonga, Tunisia, Turkey, Tuvalu, Vanuatu, Wallis and Futuna Islands.

### *2000 per capita current GDP below \$1,000: Low-income (63)*

Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cameroon, the Central African Republic, Chad, China, the Comoros, Côte d'Ivoire, the Democratic People's Republic of Korea, the Democratic Republic of the Congo, Djibouti, Eritrea, Ethiopia, Guinea, the Gambia, Ghana, Guinea-Bissau, Guyana, Haiti, India, Indonesia, Iraq, Kenya, Kiribati, the Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mongolia, Mozambique, Myanmar, the Niger, Nigeria, Nepal, Nicaragua, Pakistan, Papua New Guinea, the Philippines, Rwanda, São Tomé and Príncipe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sri Lanka, the Sudan, Timor-Leste, Togo, Uganda, the United Republic of Tanzania, Viet Nam, Yemen, Zambia, Zimbabwe



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# 2

## COMMODITY DEPENDENCE AND INTERNATIONAL COMMODITY PRICES



*Since low-income countries depend mostly on just a few commodities for the bulk share of their export earnings, commodity price fluctuations directly affect the incidence of poverty, as the vast majority of the poor depend on primary commodities for their livelihoods.*



# Commodity Dependence and International Commodity Prices

## Introduction

The types of commodities exported by a country are another important determinant of a country's vulnerability to exogenous economic shocks. The majority of developing countries are dependent on primary commodities<sup>1</sup> for export revenues and, of the 141 developing countries, 95 depend on primary commodities for at least 50 percent of their export earnings (Brown 2008).

However, international commodity prices are notoriously volatile in the short to medium term, sometimes varying by as much as 50 percent in a single year (South Centre 2005). Moreover, price volatility is increasing over time and across a broad range of commodities. "In the past 30 years, there have been as many price shocks across the range of commodities as there were in the preceding 75 years" (Brown 2008).

*Over the longer term, dependence on primary commodities heightens a country's vulnerability because (non-oil) primary commodity prices exhibit a largely declining trend.*

From the perspective of developing countries, especially those whose principal means of foreign exchange earnings come from the exports of primary commodities, unstable commodity prices create macro-economic instabilities and complicate macro-economic management. Erratic price movements generate erratic movements in export revenue, cause instability in foreign exchange reserves and are strongly associated with growth volatility. The more commodity-dependent an economy — that is, the higher the share of primary goods in a country's exports — the more likely it is to be vulnerable to commodity price shocks.

For LICs that depend mostly on just a few commodities for the bulk share of their export earnings, commodity price fluctuations directly affect the incidence of poverty, since the vast majority of the poor are dependent on the production of primary commodities for their livelihoods. It is estimated that, of the roughly 2.5 billion people engaged in agriculture in developing countries, about 1 billion derive a substantial part of their income from the exports of commodities (Common Fund for Commodities 2005). As it stands, most of the countries dependent on commodities already suffer from widespread poverty and have low human development indicators.<sup>2</sup> "Of the 30 countries with the lowest HDI indicators in 2001, 26 were among either the 54 agricultural CDDCs identified by the European Commission or the 25 most mineral-dependent or 25 most oil dependent countries in the world." (Lines 2004).

At the household level, farmers and workers rely on commodity production for the cash incomes they use to pay for food, school fees and health care. Consequently, the poorest producers are hurt most by volatility, since they have fewer resources and social safety nets to fall back on.

In short, unpredictable price fluctuations can significantly reduce national revenue, cost millions of jobs and render farmers' crops nearly worthless in one fell swoop. At the national level, fluctuating revenues make fiscal planning extremely difficult and this in turn makes it extremely difficult<sup>3</sup> to plan sustainable social and economic development programmes.

Importantly, over the longer term, dependence on primary commodities heightens a country's vulnerability. This is because (non-oil) primary commodity prices exhibit a largely declining trend over the long term.<sup>4</sup> When there is a deterioration in the terms of trade for non-oil primary commodity producers over the longer term, increases in volumes must compensate for drops in prices in order for an economy to be able to afford



the same level of imports. Moreover, higher production in world markets leads to a further reduction in price. A continued and sustained decline in commodity prices also jeopardizes the debt sustainability positions of countries, since a drop in commodity prices increases the debt service to export earnings ratio. “Commodity dependent countries are highly vulnerable to debt unsustainability. Thirty seven of the countries classified as a Heavily Indebted Poor Country (HIPC) rely on primary commodities for more than half of their merchandise export earnings” (UNCTAD 2002).

This implies, then, that short- to medium-term upward movements in commodity prices (such as those that occurred during the 2003–2008 commodity price boom) should not be interpreted to mean that the fortunes of primary commodity-producing nations have irrevocably changed for the better. The longer-term deterioration in their terms of trade would caution against such optimism.

To conclude, the excessive instability in export earnings and economic growth rates that primary commodity-producing countries experience is closely associated with highly volatile commodity prices. Price volatility has been increasing sharply — by 175 percent from one decade (1990–2009) to the next (2000–2009) — evidence that commodity-dependent countries are becoming even more susceptible to price shocks. A disaggregated look at the prices of specific commodities reveals even greater volatility. Since most commodity-dependent nations rely on the export(s) of one or a few primary commodities, such volatility explains why these countries are especially vulnerable to price shocks.

*Trends in the share of primary commodities in total exports for the period 1995–2009 show that, despite a contraction between 1995 and 2000, the share of primary commodities in total exports rose rapidly between 2000 and 2009.*

The longer-term trend in (non-oil) commodity prices shows the dual problems of high risk and low returns faced by these countries. Even as prices of their exports decline over the long term, (non-oil) primary commodity producers are producing even larger volumes to maintain current import levels. And as more output floods the market, prices drop further.

Not surprisingly, much policy attention in this area over the years focused on mechanisms to stabilize the prices of primary commodities and provide compensatory finance to commodity producers in the event of extreme price shocks. Although attention has been shifting recently to income stabilization measures (to various instruments that can help commodity producers generate more stable, predictable incomes), measures to diversify away from a dependence on primary commodities will be critical over the longer term.

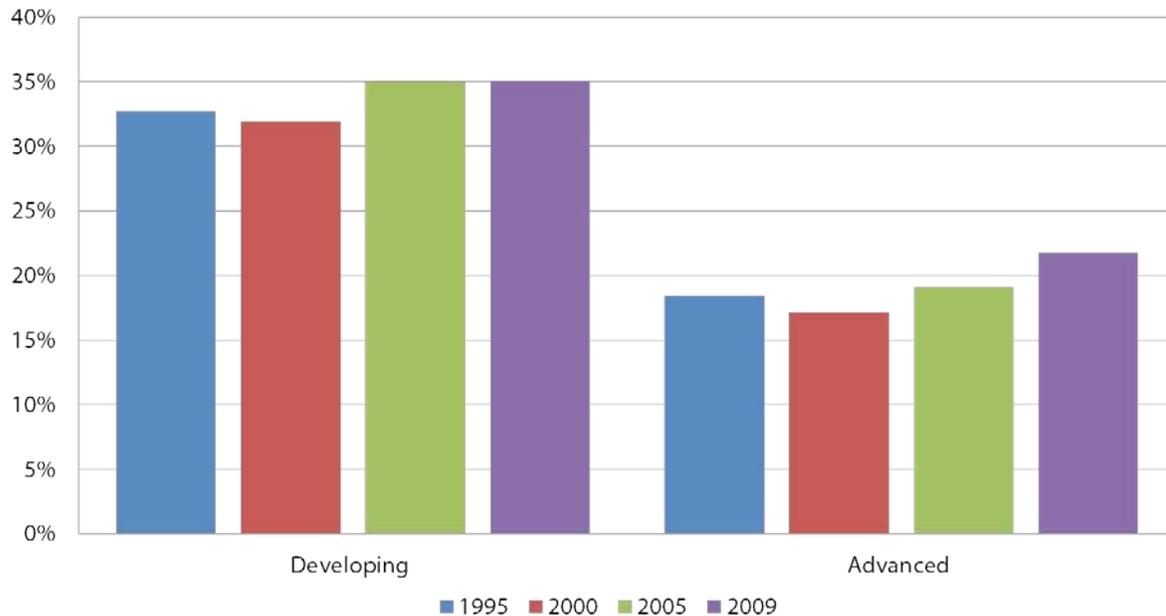
## Trends in Commodity Dependence

Commodity dependence is typically measured by (a) the share of export earnings of the top single commodity (or top three export commodities) in GDP, in total merchandise exports, and in total agriculture exports; (b) the percentage of people engaged in commodity production; or (c) the share in government revenue (South Centre 2005).

Examining trends in the share of primary commodities in total exports<sup>5</sup> for the period 1995–2009 (Chart 2.1) shows that, despite a contraction between 1995 and 2000, the share of primary commodities in total exports rose rapidly between 2000 and 2009. In developing economies, the share of primary commodities in total



**Chart 2.1: Share of primary commodity exports in total exports, 1995–2009**



**Source:** Calculated using data from UNCTAD, *Handbook of Statistics 2009*

exports increased from 32 percent in 2000 to 35 percent in 2009, whereas, in advanced economies, the share of primary commodities rose from 17 percent to 22 percent.

The share of primary commodities in exports increased across all regions of the developing world, albeit at different rates (Chart 2.2). Asian economies, which relied least on primary commodity exports, also witnessed the slowest growth in their share of primary commodities exports (from 25 percent in 1995 to 27 percent in 2009). On the other hand, Africa — the region most dependent on primary commodity exports throughout the period — became even more commodity-dependent (the share of primary commodity exports was 72 percent in 1995 and rose to 81 percent by 2009).

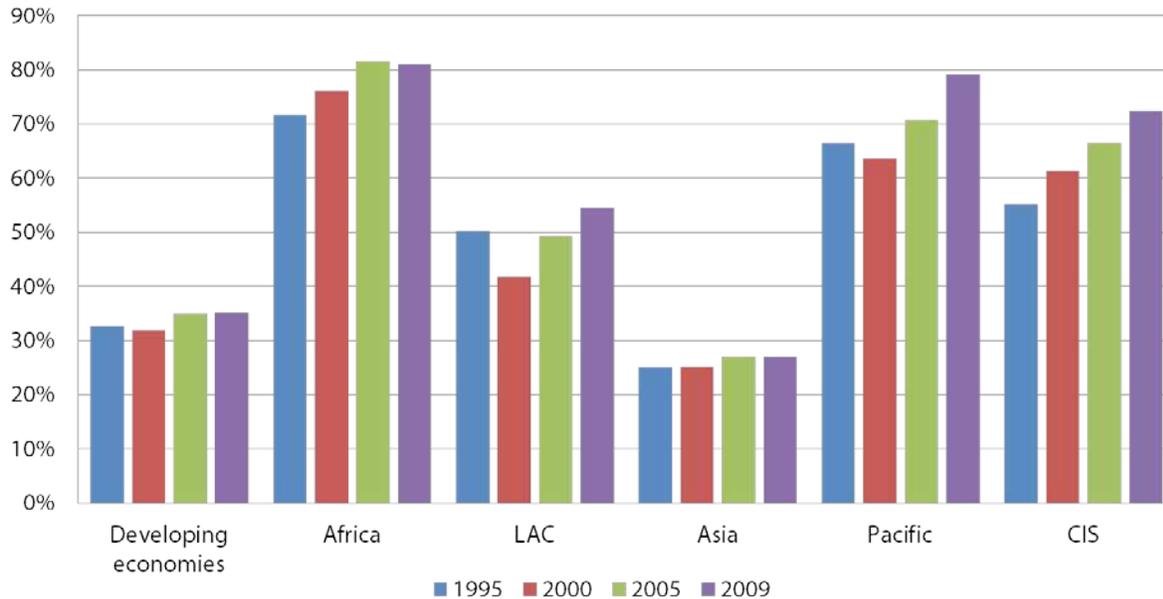
By 2009, the share of primary commodity exports for the Pacific Island states had risen to 79 percent of the region's exports and for the CIS to 72 percent. For Latin America and the Caribbean, the share of primary commodities in total exports rose from 50 percent in 1995 to 55 percent in 2009.

Thus, by 2009, all other developing regions, with the exception of Asia, had become significantly dependent on primary commodity exports (that is, the share of primary commodities in total exports exceeded 50 percent).

By development status (Chart 2.3), high-income developing countries registered a significant increase in their share of primary commodity exports (from 27 percent in 1995 to 37 percent in 2009), although MICs appeared to have the highest share of primary commodity exports: the share of primary exports in total exports increased from 44 percent in 1995 to 51 percent in 2009. Oddly, LICs saw their share of primary commodities in total exports fall from 36 percent in 1995 to 25 percent in 2009. This is mainly accounted for by China, which reduced its dependence on primary commodity exports during this period (from 16 percent in 1995 to 6 percent in 2009).

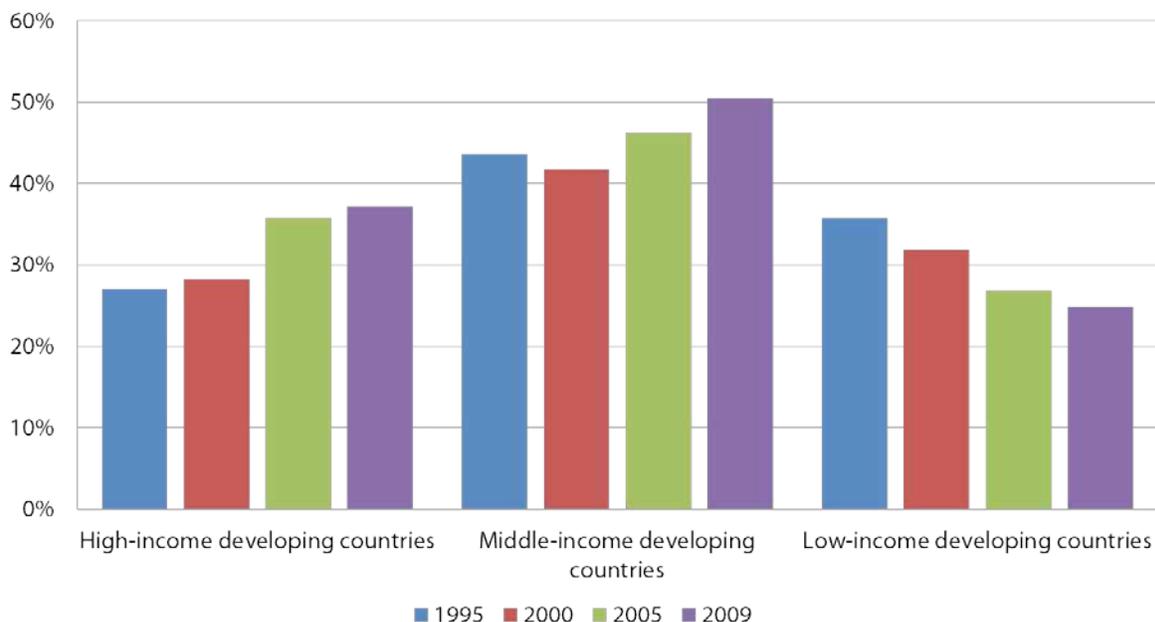


**Chart 2.2: Share of primary commodity exports in total exports by region, 1995–2009<sup>6</sup>**



**Source:** Calculated using data from UNCTAD, Handbook of Statistics 2009

**Chart 2.3: Share of primary commodity exports in total exports by development status, 1995–2009**



**Source:** Calculated using data from UNCTAD, Handbook of Statistics 2009



# Commodity Dependence and International Commodity Prices

It is important to note that, since commodity dependence is defined as the share of primary commodity export revenues to total export revenues, the trends in commodity dependence are a function of both price (value) and quantity (volume) effects. As shown in Chart 2.3, high-income developing economies experienced the largest increase in their share during the period 1995–2009. As expected, this increase was on account of a rise in the price of their exports and an increase in the quantity of exports. Specifically, between 2000–2009, prices rose by 3 percent, whereas total export volumes increased by 42 percent.

Of all country groupings, the group of LDCs has an extremely high dependency on primary commodities. Annex 2.A indicates that the share of primary commodities in total exports of the LDCs rose from 70 percent in 2000 to 78 percent in 2009. The largest increase in primary commodity exports was among the LDCs in the Pacific (increasing from 67 percent in 2000 to 80 percent in 2009). In Africa, the share of primary commodity exports increased from 89 percent in 2000 to 92 percent in 2009, whereas Asian LDCs had the lowest share of primary exports in total exports (41 percent in 2009) when compared to the LDCs from other regions. Overall, the LDCs, especially in Africa, remain extremely commodity-dependent.

## Trends in International Commodity Prices

The aggregate trend in (current) prices for all primary commodities for the period 1995–2010 (Chart 2.4) shows declining prices in the first half of the period (1995–2001). This bottomed out towards the end of 2001 and, from then on, commodity prices started to climb at accelerating speeds until the onset of the global crisis around April 2008. This trend applied to all categories of primary commodities at varying rates (Annex 2.B).

Specifically, by the end of 2001, commodity prices were 33 percent below their January 1995 price level. Commodity prices then went on a 224 percent climb from December 2001 to the peak of the price boom in April 2008. In the crash that followed, commodity prices lost 38 percent of their value from April to December 2008, though they have since rebounded. As of August 2010, commodity prices were 77 percent above their 1995 levels, but there are still high degrees of uncertainty on whether this price rise is sustainable in the long term.

### *Long-term Trends in International Commodity Prices*

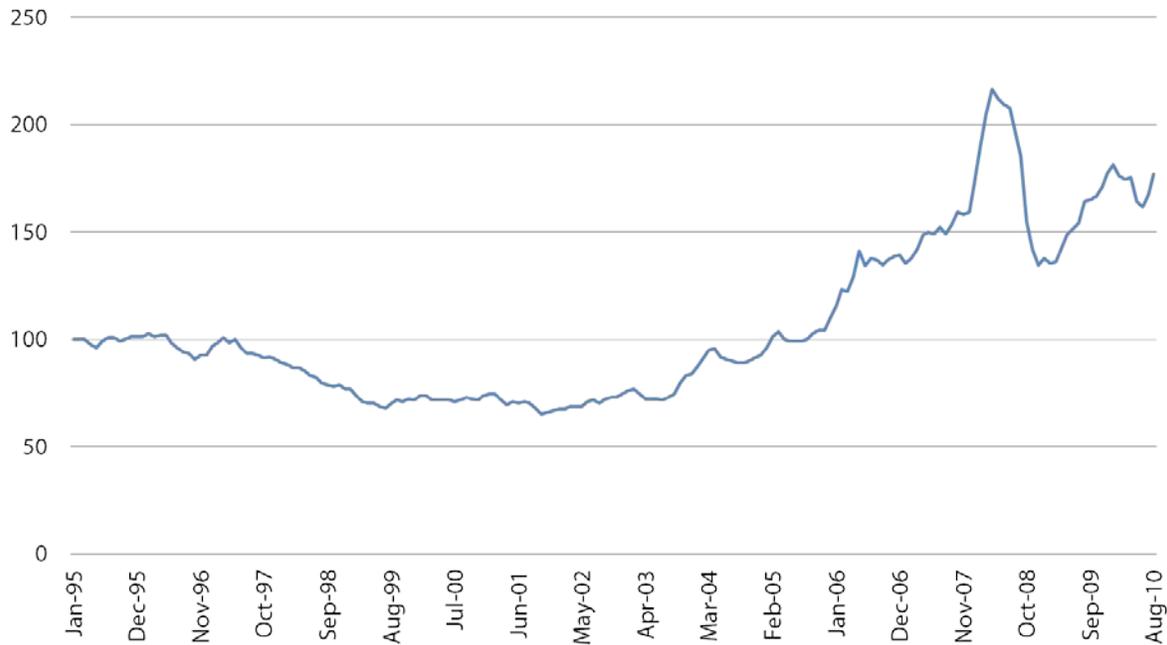
A key feature of international commodity prices is that short- to medium-term price fluctuations take place around declining long-term real price trends for non-oil primary commodities (Brown 2008, South Centre 2005, Page and Hewitt 2001).

Price trends for the last 50 years show that the index of real<sup>7</sup> commodity prices has declined significantly over time (Chart 2.5). Over the 43-year period from 1960 to 2003, the index of real commodity prices declined by 39 percent. This represents a 1.2 percent annual rate of decline.<sup>8</sup> Although commodity prices rose sharply between 2003 and 2008, they began to fall in the second half of 2008 and continued to fall in 2009 by 9 percent. Given continued uncertainties in the global economy and short-term price volatilities, it is difficult to determine if the long-term declining trend in primary commodity prices will reverse course.

Since real prices of commodities exhibit pronounced procyclicality (rising during periods of economic booms and declining during economic recessions and slowdowns), only focusing on medium-term price trends can be misleading and an unreliable indicator of long-term trends. In other words, the five-year commodity price boom (2003–2008) need not necessarily change the long-term trend.

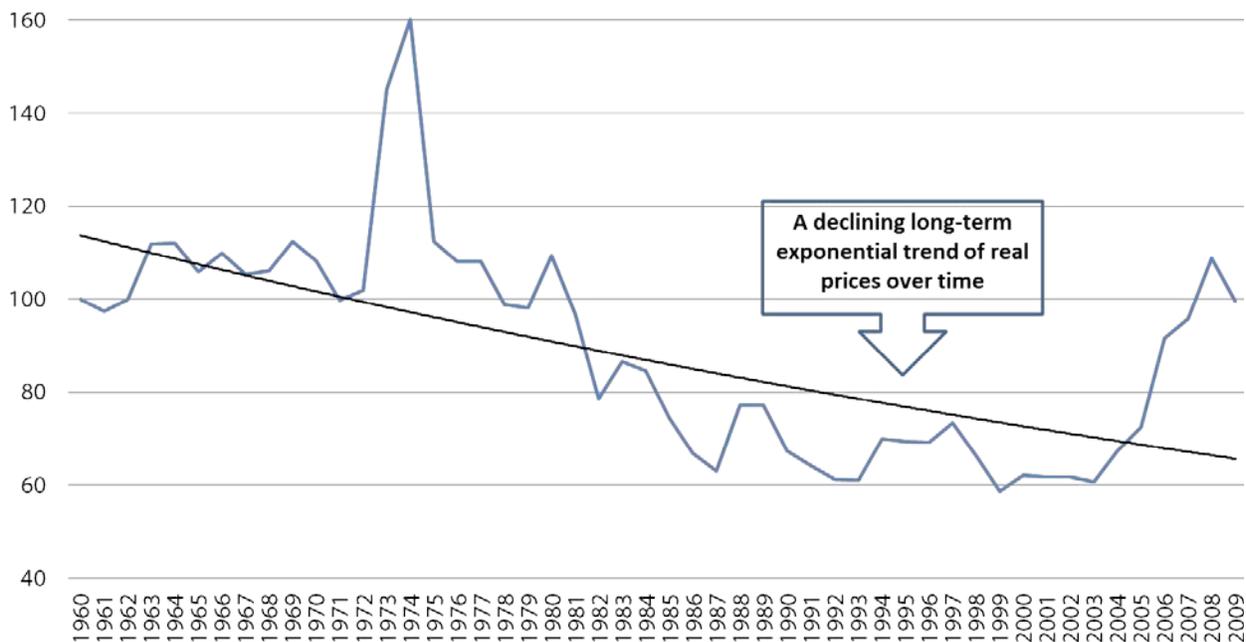


**Chart 2.4: All primary commodities' monthly price index, Jan 1995–Aug 2010 (Jan 1995=100)**



**Source:** Calculated using data from UNCTAD, Commodity Price Statistics 2010

**Chart 2.5: Index of real commodity prices, 1960–2009 (1960=100)**



**Source:** Calculated using data from UNCTAD, Commodity Price Statistics 2010 and International Financial Statistics 2010



# Commodity Dependence and International Commodity Prices

The long-term trends in prices for different types of primary commodities (Annex 2.C) show that, for food and minerals, real price declines have been extremely significant. The decline in real food prices is even more pronounced than that for minerals: between 1960 and 2003, real food prices fell by 42 percent, representing an annual rate of decline of 1.3 percent, as compared to minerals, where prices fell by a total of 27 percent during the period — a 0.7 percent annual rate of decline. Indeed, real food prices were 9 percent lower in 2009 than in 1960. However, the long-term trend in the real price of crude oil differs radically from that of other primary commodities: real prices in 2009 were six times what they were in 1960.

The continuous decline of long-term prices also means that producers' incomes dwindle day by day. To maintain the same level of income, producers need to increase the volume of commodities that they trade. However, as more output is put onto the market, price tends to fall even more. Put differently, a worsening in the terms of

*One of the distinguishing features of commodities is their highly fluctuating prices over the short to medium term, sometimes varying by as much as 50 percent in a single year. Worse, price volatility is increasing over time.*

trade has required non-oil primary commodity-producing countries to compensate for losses in unit values by increasing output (to purchase the same quantity of imports). The terms of trade for developing countries have deteriorated significantly since the mid-1980s. Between 1986 and 1999, the volume of commodity exports from the LDCs increased by 43 percent. However, the purchasing power of their exports increased by only 3 percent. "World Bank estimates suggest that between 1970 and 1997 the terms of trade decline deprived non-oil exporting countries in Africa an equivalent of 119% of their combined annual GDP in lost revenues" (World Bank 2003, FAO 2004).

## Short- and Medium-term Trends

One of the distinguishing features of commodities is their highly fluctuating prices over the short to medium term, sometimes varying by as much as 50 percent in a single year (Brown 2008). Worse, price volatility is increasing over time: the commodity price instability index in current US dollars was 2.8 percent from 1999 to 2002, compared with 1.8 percent 10 years earlier (South Centre 2005).

Furthermore, the amplitude of price fluctuations varies considerably among different primary commodities: for instance, over the past 40 years, the prices of vegetable oilseeds and oils have been much more volatile than those of agricultural raw materials, food or beverages. Among non-agricultural commodities, silver, nickel and crude petroleum have the most unstable prices. Commodity price cycles also appear to be asymmetrical in that "periods of rising prices tend to be shorter as compared to periods of falling prices" (South Centre 2005).

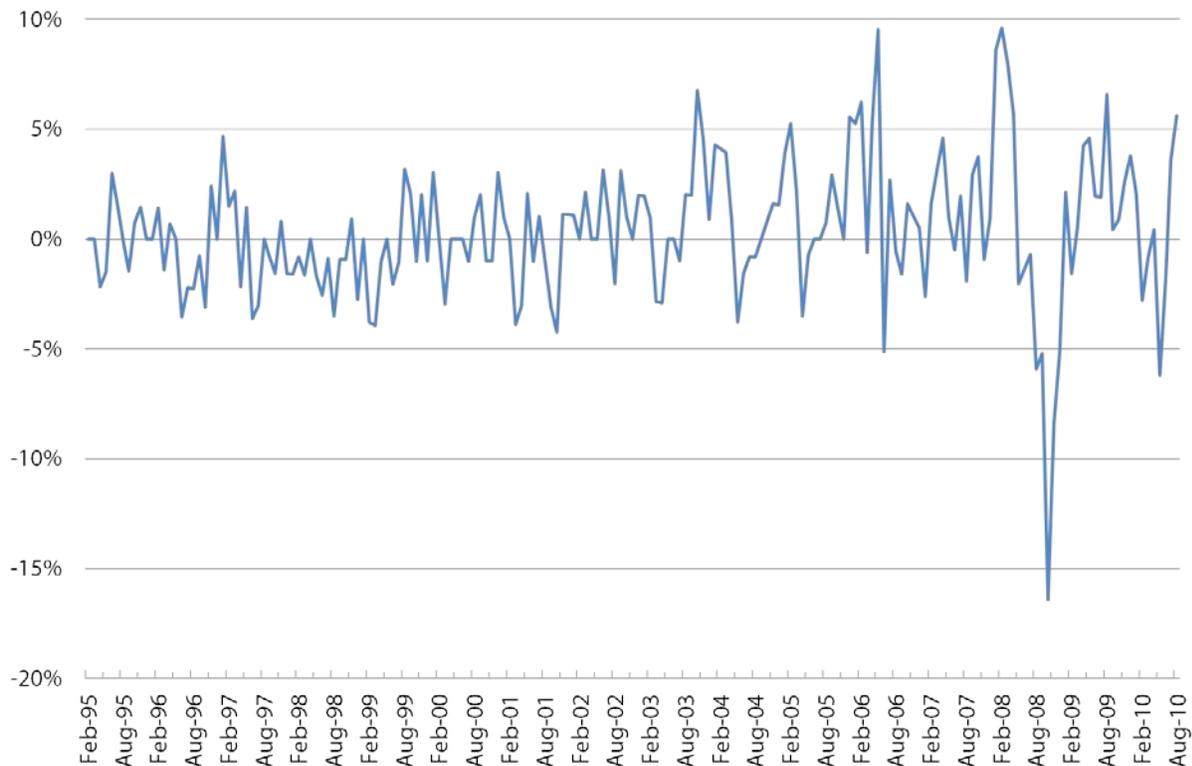
As indicated by Chart 2.6, price fluctuations in the short run are highly volatile even at the most aggregated level of commodity prices.<sup>9</sup> During the period 1995–2010, the maximum monthly decline in the average price level for all primary commodities was 16.4 percent. Not surprisingly, this was in August 2008, at the onset of the global economic crisis.

Monthly data for rates of change in commodity prices show that, in a month of price decline, prices fall by 2.4 percent on average and, in a month of price increases, prices rise by 2.8 percent on average.

Since most commodity-exporting developing countries are generally dependent on a single primary commodity or a few products from the same commodity family (e.g., different types of agricultural products)



**Chart 2.6: Rate of change of commodity prices by month, Feb 1995–Aug 2010**



**Source:** Calculated using data from UNCTAD, *Commodity Price Statistics 2010*

for export income, examining the behaviour of specific commodity prices reflects the magnitude of price variability that different groups of commodity-exporting countries actually experience. For instance, the monthly rate of change of food prices (Annex 2.D) was in decline for 44 percent of the months from February 1995 to August 2010. In a month of decline, the average decline was 2.5 percent and, in the 56 percent of the months when prices increased, the average increase was 3.1 percent. In times of extreme price shocks — for instance, during the global crisis in August 2008 — food prices declined by as much as 14.7 percent in a month.

The minerals price index, which includes all minerals, ores and metals, is even more volatile than the food price index. In the 40 percent of the months when the minerals price index was in decline from February 1995 to August 2010, the average monthly decline was 3.9 percent. During months of price increases, the average monthly increase was 4.1 percent. The maximum monthly decline during the period under examination was 19.7 percent (August 2008) and the maximum monthly increase was 17 percent in a single month (May 2006).

Crude oil prices<sup>10</sup> are even more volatile than either the prices of foods or minerals commodity groups. Between February 1995 and August 2010, in 37 percent of the time when prices declined, the average monthly decline in prices was 7.6 percent. During months of price increases, the price increase was 7.1 percent on average. The maximum decline in a single month was 26.7 percent in a single month. Indeed, more than a quarter of the price of crude oil was slashed in just one month (not surprisingly, August 2008). The maximum price rise in a single month was 23.7 percent.



# Commodity Dependence and International Commodity Prices

Clearly, not only is the volatility of primary commodity prices excessively high, it is also not uniform across different primary commodities. Table 2.1 looks at the average price instability<sup>11</sup> for major primary commodities.

**Table 2.1: Average Monthly Price Instability, 1995–2010**

Commodity Categories	Price Instability
All Primary Commodities	22%
All Food	20%
Minerals, Ores and Metals	34%
Crude Petroleum	31%

**Source:** Calculated using data from UNCTAD, *Commodity Price Statistics, 2010*

For all primary commodities, the average price instability from February 1995 to August 2010 was 22 percent. In other words, short-term price fluctuations on average were 22 percent above or below the long-run trend. The index of all food commodities (which includes foods, beverages, vegetable oils and raw vegetables) was just slightly less volatile than the overall index of primary commodity prices at 20 percent. However, volatility is greater if we examine single food items. For example, the price instability for coffee was 32 percent during the period. For minerals, price instability was 34 percent on average. Thus, minerals as a group are 70 percent more volatile in the short run than food commodities. The prices of specific minerals fluctuated at an even higher rate: for example, the price of phosphate fluctuated by 51 percent and copper by 45 percent between 1995 and 2010. Crude oil price instability was 31 percent during the period.

## Price Instability Over Time

It was noted earlier that not only does the degree of price volatility vary among primary commodities, but volatility has also been increasing over time.

**Table 2.2: Average Monthly Price Instability over Time**

Commodity Categories	1990–1999	2000–2009
All Primary Commodities	9%	26%
All Food	9%	25%
Minerals, Ores and Metals	17%	40%
Crude Petroleum	31%	28%

**Source:** Calculated using data from UNCTAD, *Commodity Prices Statistics, 2010*

As indicated by Table 2.2, the average monthly price instability for all primary commodities was 9 percent in the 1990s. In the first decade of the 21<sup>st</sup> century, this jumped to 26 percent. In other words, price instability of primary commodities increased by 175 percent from one decade to the next. This near tripling of price instability across the board for all primary commodities is further evidence that commodity-dependent countries are becoming even more susceptible to price shocks and volatility. For instance, food price instability rose from 9 percent in the 1990s to 25 percent in the 2000s (190 percent increase). For minerals, price instability rose by 141 percent from the 1990s to the 2000s. When disaggregated further, the instability in prices for specific commodities



shows considerable differentials: for phosphates, price instability rose from 16 percent on average in the 1990s to 67 percent in the 2000s (308 percent increase); and, for copper, price instability was 19 percent in the 1990s and increased to 52 percent in the 2000s (a 171 percent increase). Interestingly, for crude oil, prices became slightly less unstable, dropping from 31 percent in the 1990s to 28 percent in the 2000s.

## Causes of Commodity Price Volatility

It is generally acknowledged that a key reason for excessive price volatility of primary commodities is the inelastic nature of supply and demand of such commodities.<sup>12</sup> In agriculture, for instance, production can be difficult to adjust, since planting and planning decisions must be made far in advance of physical purchases. Thus, situations of oversupply can last for a long time, while it can be difficult to boost production in the case of a shortage.

*It is generally acknowledged that a key reason for excessive price volatility of primary commodities is the inelastic nature of supply and demand of such commodities.*

Other factors that drive price volatility in commodity markets include:

- a) Business cycles in key markets. Advanced economies are the primary consumers of primary commodities. When these economies experience downturns, prices of primary commodities fall.
- b) Changing weather patterns. Extreme weather events in (agricultural) commodity-producing countries can cause price hikes. Moreover, climate change is expected to increase weather-related volatility in the future as extreme weather events become more common and producers struggle to adapt to changing growing seasons.
- c) Conflict in producing countries. Political instability in supplier countries or important transit countries can disrupt commodity supplies, generating sharp spikes in commodity prices.
- d) Price speculation. Investors and funds that use commodity derivatives (e.g., futures and options) as part of their investment strategy can amplify the price effects of true changes in supply and demand. As of January 2007, Wall Street investment funds accounted for 20 to 50 percent of futures contracts for several agricultural commodities, including wheat, corn, cattle and live hogs. These funds, which are not allowed to trade in physical commodities, must 'roll-over' expiring contracts and re-balance their portfolios each month, creating changes in demand for futures contracts that are unrelated to physical demand for the actual goods (Barrionuevo and Anderson 2007).
- e) Export dumping. Farm subsidies in the United States and the European Union have encouraged excess production that brings down world prices when subsidized commodities are exported overseas and sold below the cost of production. However, developing countries have rarely had the capacity to pursue successful anti-dumping actions against these activities.
- f) Exchange-rate fluctuations. Even if international commodity prices are stable, exchange rate fluctuations affect a commodity's value in local currency, since major markets denominate prices in US dollars or in euros, but producers are paid in their local currency. From a producer's perspective, the cost in euros is irrelevant, since the purchasing power he/she gains by selling a product for local currency is what matters.<sup>13</sup>



# Commodity Dependence and International Commodity Prices

## Commodity Price Volatility and Economic Growth

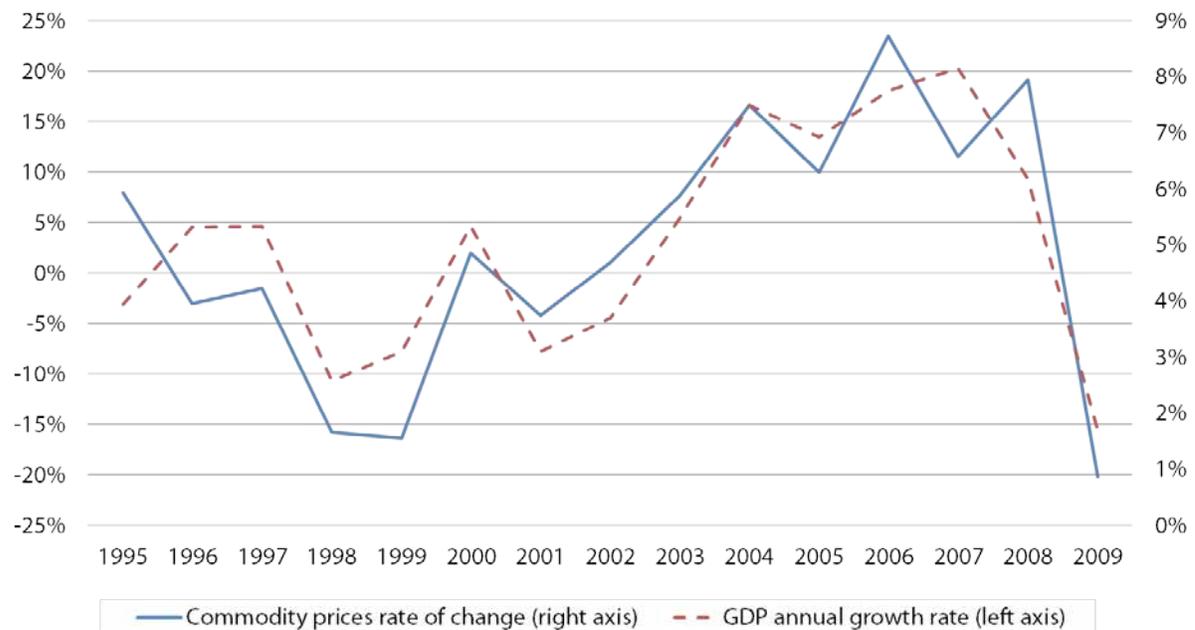
The uncertainty generated from commodity price fluctuations hampers economic growth and is associated with increases in poverty. Indeed, the correlation between changes in commodity prices and economic growth is striking (Chart 2.7). Examining economic growth rates for developing economies against the annual rate of change of commodity prices for the period 1995–2009 finds an 87 percent correlation between the two variables.

In summary, the picture for non-oil primary commodity producers is not rosy. The trends towards increasingly volatile prices, slipping relative prices and shifting power among commodity supply chains have left commodity-dependent countries and producers in a precarious position and grappling with the dual problems of low returns and high risk. Hence, it is important for these countries to reduce their dependence on primary commodities and adopt policies for economic diversification. In this context, policies and measures that focus on both price and revenue (income) stabilization will be critical.

## Building Resilience: Policy Options for Stabilizing Commodity Prices and Incomes of Commodity Producers

Commodity price volatility is not a new problem and different policies have been tried in the past to address it at the global and national levels. At the global level, the international community has tried many different ways to stabilize commodity prices and to smooth revenue fluctuations, including quota systems, commodity

**Chart 2.7: Rate of change in annual commodity prices and GDP growth rate in developing countries, 1995–2009**



**Source:** Calculated using data from UNCTAD, *Commodity Price Statistics 2010*; World Bank, *World Development Indicators 2009*; and World Bank, *Global Economic Prospects 2010*.<sup>14</sup>



agreements, compensatory funds and price hedging on futures markets. Indeed, prior to the 1990s, international attempts to stabilize prices largely focused on International Commodity Agreements (ICAs) and Compensatory Financing Funds (which provide bridging payments to help countries ride out price slumps).

However, starting in the mid-1980s, several international commodity supply agreements (for instance, ones for tin, sugar, and coffee) that previously regulated commodity prices were torn up, reducing international coordination of the production of some key commodities and having immediate impacts on their price.

As noted in Box 2.1, severe limitations have hampered compensatory funds currently in place, such as the European Union's FLEX programme and the IMF's Compensatory Finance Facility. In order to be practically helpful, future compensatory finance instruments need to be more accessible than past programmes, providing support for diversification activities rather than being seen as props for declining or uncompetitive economic sectors. "Less onerous disbursement criteria and fewer conditions would make utilizing CF funds a realistic option for commodity-dependent countries" (Brown et al. 2008).

*The trends towards increasingly volatile prices, slipping relative prices and shifting power among commodity supply chains have left commodity-dependent countries and producers in a precarious position and grappling with the dual problems of low returns and high risk.*

## Box 2.1: Compensatory Finance Mechanisms

Compensatory finance (CF) mechanisms attempt to smooth out revenue flows by providing relief payments to countries when unforeseen events cause export revenues to fall. To date, most CF mechanisms have focused on national balance of payments stability. As currently implemented, grants or loans are directed to governments rather than individual producers, although some of the funding may trickle down in the form of diversification programmes or development projects. Some examples of CF mechanisms include the IMF's Compensatory Finance Facility (CFF) and the EU's STABEX and FLEX schemes.

The benefit provided by these measures to countries so far has been minimal. The IMF's CFF suffered from strict eligibility requirements, onerous application procedures and costly financial terms. Countries were often able to secure better terms elsewhere and, as such, the CFF has gone largely unused since 2000.

STABEX (a CFF) was introduced in 1975 by the European Union as part of the first Lomé Agreement and was available to any African, Caribbean and Pacific country. Eligibility for compensation was based on a drop of 6.5 percent—compared to the four-year average—in export revenues from trade with the European Union in any eligible sector. Such a drop would trigger an automatic compensation payment to the affected government to use for diversification efforts and to benefit producers in the affected sector. In 2000, STABEX was replaced by the FLEX programme, which had more stringent eligibility requirements.

The EU programme too has been hampered by serious limitations. Although the CFF exists, it has been redundant in recent years; the EU's FLEX scheme continues to be used, but does not focus solely on commodity shocks.

**Source:** Brown, Oli, 2008, *From Feast to Famine: After Seven Good Years What Now for Commodity Producers in the Developing World*, International Institute for Sustainable Development (IISD), Manitoba, Canada.



# Commodity Dependence and International Commodity Prices

At the national level, although the best long-term solution is economic diversification away from dependence on a narrow and volatile revenue stream, countries and producers first need some semblance of revenue (or income) stability in order to reduce overall dependence on commodities. In other words, the focus is increasingly shifting to commodity income stabilization for developing countries and producers, where income stabilization refers to the various tools and mechanisms that can help countries and producers generate more stable and predictable incomes.

The basic economic tools necessary to help commodity producers get more predictable incomes are well known: supply management; national revenue management; market-based price risk-management; compensatory finance; and alternative trade initiatives. For instance, recent innovations in risk management insurance allow farmers to buy price insurance along with their fertilizer and national revenue management schemes can help smooth out dips in commodity revenue. Fair trade mechanisms can provide a price floor for producers. However, the bad news is that these mechanisms are not widely available to poor producers in the developing world.

## *Supply Management*

The purpose of supply management is to control the supply of a commodity relative to demand in order to influence its price (e.g., OPEC). Supply management can influence domestic or international markets. In addition to production/export quotas, supply management can take other forms when broadly defined, including buffer stock systems in which a central body is created to buy up a specific product when prices are low and release stocks when prices are high; import tariffs or quotas, which can directly limit the supply of imports or ensure that they do not undercut a minimum price; and minimum purchase price systems in which a government sets the minimum purchase price of a commodity and acts as buyer of last resort.

## *National Revenue Management*

National Revenue Management is a general term for fiscal management laws and institutions set up to smooth national spending and insulate a nation's economy from the harm of volatile revenues. Revenue management often takes the form of national revenue funds (NRFs), commonly known as 'stabilization funds'. Typically, the revenue management legislation specifies a baseline revenue level that represents the average commodity revenue stream at a sustainable production level. During commodity booms, profits in excess of the baseline are funneled into the NRF, which should exist outside of the national budget so that windfalls do not tempt short-term, politically motivated spending. Depending on the parameters of the NRF, the country can then draw on the fund when low commodity prices reduce national revenues (e.g., from royalties and taxes) below the pre-determined baseline.

National revenue management systems do not stabilize commodity prices. Instead, they try to sever the link between volatile commodity revenues and government expenditures by stabilizing the amount of money a government is legally allowed to use. This helps government avoid the temptation to treat booming commodity revenues as if they were permanent and subsidizes government spending when prices are low.

NRFs can help commodity-dependent countries avoid various pitfalls. Often, such funds hold investments outside of the country (in US Treasury bills, for instance) to protect against exchange rate appreciation and an increasing reliance on revenues from a single sector of the economy.

NRFs are most associated with oil-producing countries; similar funds have proven useful to some mineral-dependent countries (e.g., Chile, Botswana) and may be a good idea for countries dependent on



## Box 2.2: Chile's Copper Stabilization Fund

In 2006, the Fiscal Responsibility Law, which created two new sovereign wealth funds, was established. The first of these, the Pension Reserve Fund (PRF), is a savings fund created to cover a future expected public pension liability shortfall. Essentially, its purpose is to ensure the transfer of wealth from one generation to another. The PRF is funded using the first 0.5 percent of GDP of budget surpluses.

The second fund, the Economic and Social Stabilization Fund (ESSF), replaced the original Copper Stabilization Fund (CSF), which was established in 1985. The aim of this fund is to help stabilize the macroeconomy in response to volatility in copper prices. When copper prices are high, a portion of the excess copper revenues are accumulated in the fund and invested in low-risk assets. When the price of copper is low, the accumulated resources are then added to the government budget and used to smooth out public expenditure, particularly for social spending (IMF 2010).

The tripling of the price of copper through the middle of the 2000s enabled the Chilean government to accumulate

large amounts of reserves in the ESSF. Prior to the global financial crisis, the ESSF had accumulated revenues totalling about \$20 billion (Revenue Watch). Given the strength of the economy and high copper prices, the Chilean government had little need to tap into these reserves for much of the 2000s. With the onset of the global economic slowdown in 2008 and the fall in the price of copper, however, the Chilean government used a portion of the ESSF to help support social programmes, including pensions, medical and housing programmes. For example, in November 2008, over \$1 billion was used to improve lending opportunities for middle-income families and small and medium-sized businesses. A \$4 billion package was announced in January 2009 to support public works projects and public support for the most vulnerable Chileans (Revenue Watch). Additionally, the government announced the use of resources from ESSF to support reconstruction following the devastating 2010 earthquake, which caused an estimated \$30 billion in damage (Kraul 2010).

**Source:** IMF, 2008, 'Chile: Selected Issues Paper', Country Report No. 08/239, International Monetary Fund, Washington, DC.; Kraul, Chris, 2010, 'Chile will tap copper fund to pay for quake reconstruction', *Los Angeles Times*, March 17; Revenue Watch Institute, 'How Is the Economic Crisis Changing the Management of Resource Wealth?', Background, Revenue Watch Institute, New York.

agricultural commodities as well. Revenue management funds can be used for a variety of purposes, from broad expenditure stabilization to targeted competitiveness or diversification initiatives (such as Chile's Competitiveness and Innovation Fund).

### Market-based Price Risk Management

Market-based price risk management refers to any strategy that uses financial products to help producers reduce the uncertainty surrounding the prices they can get for their product. In effect, these tools help producers and governments transfer some of the risk they face to investors in commodity markets. As such, these mechanisms offer income predictability, not necessarily income stability, and they become prohibitively expensive after one or two years. However, greater revenue predictability makes it possible for producers to make better decisions and to obtain better credit terms.

Traditionally, risk management tools are based on forward contracts between commodity sellers and buyers and on futures and options contracts available through international and regional commodity exchanges. Futures contracts offer producers the opportunity to lock in a price for a given commodity, while options can either protect producers from downside risks or allow them to benefit from a price increase. However, individual producers can find it quite difficult or even impossible to directly access organized futures and



# Commodity Dependence and International Commodity Prices

options markets. As such, risk hedging requires that a large entity with the appropriate resources and technical expertise serve as an intermediary between the market and individual producers or producer groups.

Multinational buyers and local banks are in positions to offer even more accessible risk-hedging tools. One innovative example is the integration of risk management into contracts for fertilizers and other inputs, which farmers must buy anyway.

## Box 2.3: Index-Based Livestock Insurance in Mongolia

In 2005, the Government of Mongolia asked the World Bank for technical assistance to design and implement a pilot programme for index-based livestock insurance in order to protect herders against major livestock losses caused by harsh winters. The request recognized that smaller, individual livestock mortality risks are better addressed through appropriate household-level risk mitigation strategies.

The product created combines a commercial insurance product (the base insurance product) and a social product (the disaster response product). The base insurance product pays when livestock mortality rates in the local administrative area (soum) exceed 6 percent. Payments are based on estimates of livestock mortality rates in soums from January through May, as estimated by the annual livestock census and, in the future, by a mid-year livestock survey. This is the first time an index insurance product has been used in Mongolia, where traditional indemnity-based livestock insurance proved unsustainable, given the extensive herding practices.

The programme is offered through the Livestock Indemnity Insurance Pool (LIIP), a public-private risk-pooling arrangement, in which participating insurers share underwriting gains and losses based on the share of herder premiums they bring into the pool. The LIIP is protected with a stop-loss reinsurance treaty, currently underwritten by the government and backed by a World Bank credit.

The LIIP has several major advantages:

- It fully insulates this line of business from other lines of insurance (an important feature, given the limited capital of the insurance industry in Mongolia, which is still in its infancy).

- It fully secures the payment of indemnities, thereby eliminating any risk of default on payments.
- It allows insurance companies to pool their livestock insurance portfolio in different regions, which allows them to take advantage of the risk diversification benefits.
- It facilitates the capacity-building of participating insurers.

The risk financing structure of the LIIP follows best practices. Insurance companies retain some portion of the risk, pool risk with other companies, and access public reinsurance for excess losses. It is expected that international reinsurers will provide capacity for the first reinsurance layers, with the government covering only catastrophic risk layers.

The first sales season started in 2006. As of 2009, the programme was being piloted in four provinces (Bayankhongor, Khentii, Sukhbaatar, and Uvs) and four insurance companies were participating. 2,400 policies were sold in 2006, more than 3,700 in 2007, and 4,100 in 2008, representing 14 percent of herders in the pilot provinces.

In mid-August 2008, following high livestock losses, a total of \$340,000 was paid to 1,783 herders. All financing systems worked as planned, with a small amount drawn from the contingent debt facility. Lenders have started offering lower interest rates and better terms for loans to insured herders. Linking index-based livestock insurance to herder loans will be an important next step in reducing delivery costs.

**Source:** Mahul, O. and Stutley, C.J., 2010, *Government Support to Agricultural Insurance Challenges and Options for Developing Countries*, World Bank, Washington, DC., pp. 85–86.



Recognizing the challenges to access that major international commodity exchanges present, national and regional exchanges have begun to develop in commodity-dependent areas. Futures markets for coffee have sprung up in Brazil, India and Indonesia. In India, there are 25 recognized commodity exchanges, three of which are national, multi-commodity exchanges.

## *Alternative Trade Initiatives*

Standards-based, alternative trade initiatives are programmes that allow agricultural producers who meet certain requirements to differentiate their products through a certification mechanism (such as fair trade or organic labels). These programmes are defined by the specification, monitoring and enforcement of sustainable production and trade practices, and are typically identified by a logo, label or certificate. Labeling

### **Box 2.4: Organic Coffee Production Reduces Small-scale Farmers' Vulnerability in Nicaragua**

There are approximately 48,000 coffee farms in Nicaragua. Eighty percent of these are micro-producers (i.e., have less than 3.5 hectares of coffee crops) and contribute only 15 percent to the total coffee harvest in Nicaragua. Organic coffee represents about 4 to 5 percent of Nicaragua's coffee exports, yet comprises a large portion of the coffee produced by small-scale farmers organized in cooperatives, most of which are fair trade-certified. These organic and Fair Trade coffee producers can not only enjoy the economic advantages associated with membership in Fair Trade cooperatives, but also benefit from the environmental factors associated with organic production.

Organic coffee production can provide numerous environmental benefits. Organic standards, for example, require coffee farms to have a structurally and floristically diverse shade cover (e.g., OCIA International, i.e., Organic Crop Improvement Association International, Inc.). This covering provides environmental services that resemble those provided naturally by forests. Coffee fields also store carbon from the atmosphere and protect watersheds by slowing run-off. Moreover, organic coffee production techniques replace inorganic fertilizers, pesticides and fungicides with organic ones, which are less harmful to the environment. Organic standards also prohibit the use of genetically modified organisms. Nicaraguan farmers cite such environmental benefits as motivations for moving

towards organic production, adding that the elimination of agrochemicals is better for their families and children, that organic production lowers expenditures for synthetic inputs, and that it helps protect the water.

While organic methods are less productive than conventional techniques of coffee production (Valkila 2009), organic production provides certain advantages that are particularly beneficial to small-scale and poor farmers. Prices for organic coffee tend to be more stable than those for conventional coffee. Access to organic fertilizers is cheaper and easier. Additionally, fair trade cooperatives provide purchase guarantees, technical assistance, and credit availability through an internal system.

Without support from cooperatives and development organizations, it would be nearly impossible for small-scale coffee farmers to acquire organic certification, due to the high cost of certifying individual small farmers in Nicaragua and the lack of organic trade channels outside the cooperative membership. Organizations such as CLUSA (Cooperative League United States of America), ADDAC (*Asociación para la diversificación y desarrollo agrícola comunal*), Campesino a Campesino, and Solidarity provide such assistance through training and financing, organizing producers in cooperatives, and securing markets for organically certified products.

**Source:** Bacon, C., 2005, 'Confronting the Coffee Crisis: Can Fair Trade, Organic, and Specialty Coffees Reduce Small-Scale Farmer Vulnerability in Northern Nicaragua?', *World Development*, Vol. 33, Issue 3, pp. 497–411; Valkila, J., 2009, 'Fair Trade Organic Coffee Production in Nicaragua: Sustainable Development or a Poverty Trap?', *Ecological Economics*, October.



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helps differentiate the certified product from conventional supply. Ostensibly, each programme's conditions will help counter the economic, social and environmental risks that producers face and offer them a price premium for the certified products. Some of the best-known initiatives are Fair Trade, Organic Certification, and Rainforest Alliance, but there are now sustainability standards and/or labeling initiatives operating in most major agricultural commodities.

Alternative trade initiatives have developed in response to the perceived failure of supply management and risk-hedging tools to address the income and social risks that agricultural commodity producers bear. Although these initiatives address risk factors variously, one of their most important elements is their stabilizing impact on prices. Depending on the criteria associated with a particular label, the price-stabilizing effect can manifest itself in many different ways. Fair Trade, for instance, stipulates that buyers pay a minimum price or a social premium if the market price exceeds the minimum. In return, Fair Trade producers and cooperatives are required to invest a portion of the price premium in community development projects. Eco labels like Organic Certifications require producers to meet ILO labour standards and to reduce or eliminate chemical inputs (e.g., fertilizers and pesticides). While these eco-label programmes do not set minimum prices, their specification of unique production requirements allows them to function as 'differentiated' markets that, due to their higher price elasticity, have reduced price volatility.



## Notes

1. Primary commodities are defined as all foods (includes basic foods, beverages and tobacco, agricultural products and oils); all metals and minerals (ferrous and non-ferrous metals, precious stones, and pearls); and all fuel (crude petroleum, natural gas and other fuel commodities) (UNCTAD, Handbook of Statistics 2009).
2. An extensive literature highlights the relationship between developing countries' dependence on extractive industries and their poor performance on key poverty-related indicators: "overall living standards in oil and mineral dependent states are exceptionally lower than they should be, given their per capita incomes". Further, the mismanagement of natural resources can increase fragility and lead to conflict. Money from oil, gemstones, minerals and timber has fuelled some of the world's most intractable wars (e.g., Angola, Sierra Leone, DRC, Liberia). See Ross 2001, DfID 2009.
3. While low commodity prices create obvious problems, even high prices can create a trap of sorts, forcing countries and producers to choose between immediate profits and future sustainability. For instance, Algeria, Nigeria and Venezuela "have fallen prey to over optimistic spending habits during commodity booms, using current and expected profits to finance social and/or politically motivated projects. Such program can quickly become unsustainable when commodity prices drop, but are typically very tricky for politicians to cut, and so tend to get funded out of borrowed money, adding to a country's debt burden" (Brown et al. 2008).
4. Since many commodity-dependent countries are also net food importers, the changes in their terms of trade have implications for the affordability of food imports and food security.
5. The share of primary commodities in total exports is measured as primary commodity export revenues/total export revenues (in current \$).
6. UNCTAD's classification of the Asia and Africa regions includes some countries from the Arab States (i.e., the GCC countries). Disaggregated analysis may well reveal interesting differences in the export portfolios (and export concentration ratios) of GCC countries relative to other Asian exporters.
7. The price index of exports from advanced economies is used to derive real commodity prices. Real commodity prices are therefore measured in terms of their purchasing power over advanced economies' exports.
8. The compounded annual rate of change in price is calculated by taking the  $n^{\text{th}}$  root of the total percentage rate of change in prices, where  $n$  is the number of years in the period being considered.
9. The indicator of price volatility used here measures the amplitude of monthly variability in price. That is the average decline in price during the months when prices decline, along with the average increase in price during the months when prices increase.
10. Crude oil prices are an average of UK Brent (light), Dubai (medium) and Texas (heavy) equally weighted (UNCTAD 2009).
11. Price instability here is measured as the absolute percentage deviation from the long-run exponential trend for the period. The measure of price instability is equal to  $[ ( | Y_{(t)} - y_{(t)} | ) / y_{(t)} ] * 100$  where  $Y_{(t)}$  is the observed magnitude of the variable.  $y_{(t)}$  is the magnitude estimated by fitting an exponential trend to the observed. The vertical bar indicates the absolute value (i.e., disregarding signs). Accordingly, instability is measured as the percentage deviation of the variables concerned from their exponential trend levels for a given month.
12. See Brown 2008, South Centre 2005, UNCTAD 2009, Page and Hewitt 2001.
13. Recently, there has been new call for reform of the global orientation in exchange rate management. Initiated by China in March 2009 with the eventual endorsement of Brazil, India, Russia, and France, the proposal outlined a reduced role of the US dollar as the world's reserve currency in exchange of a larger role of the IMF's SDRs, the value of which is based on a group of international currencies. The argument is that in today's global economy potential currency fluctuations make using a single currency for international settlements too risky. If the established reserve currency was to change to SDRs, commodity prices would be denominated in that currency and would potentially be more stable if the value of SDRs were more stable. Critics of the proposal argue that global economic insecurity results



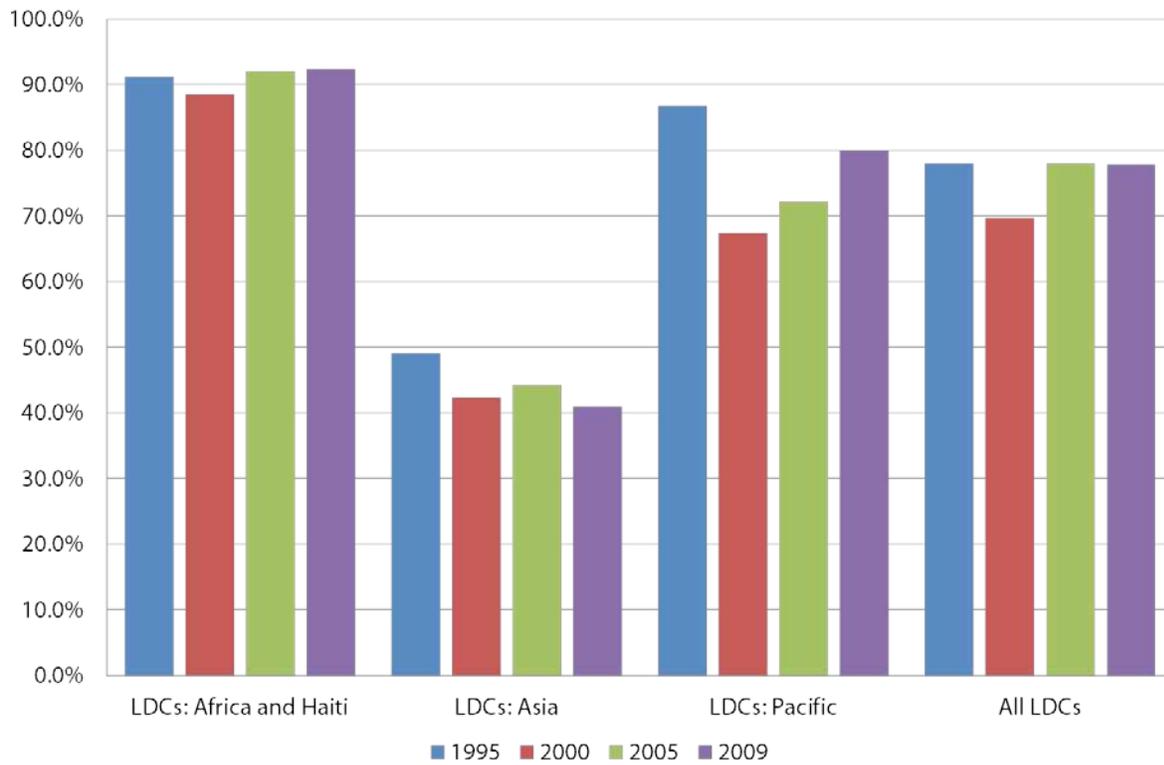
# Commodity Dependence and International Commodity Prices

less from concentration in a single reserve currency and more from countries pegging their exchange rates to this currency. Such action inhibits exchange rates from adjusting to economic conditions, thus correcting imbalances in the global economy. To date, however, little advancement of this proposal has been made on a global level through efforts by the IMF (Anderlini 2009, Bretton Woods Project 2009).

14. Data on GDP growth rate for 2009 taken from Global Economic Prospects (World Bank 2010).



## Annex 2.A: Share of Primary Commodity Exports in Total Exports for LDCs by Region, 1995–2009

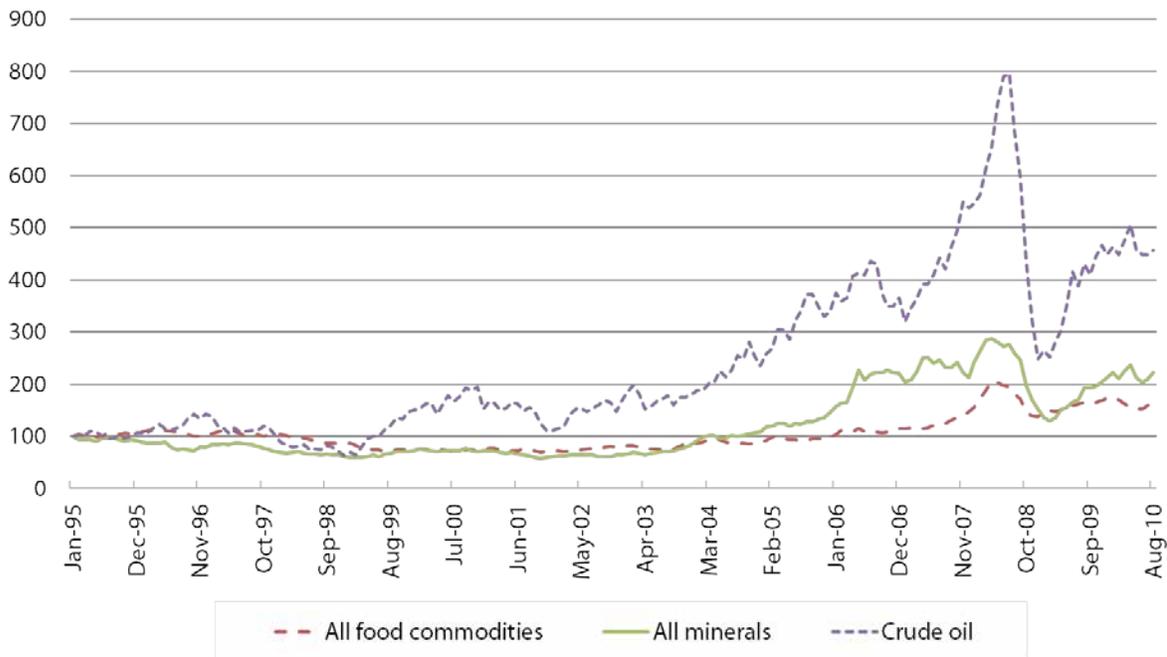


**Source:** Calculated using data from UNCTAD, *Handbook of Statistics 2009*



# Commodity Dependence and International Commodity Prices

## Annex 2.B: Monthly Current Price Index for Major Commodity Categories, Jan 1995–Aug 2010 (Jan 1995=100)



**Source:** Calculated using data from UNCTAD, *Commodity Prices Statistics 2010*

The general price trends of the overall index of commodity prices apply to the foods and minerals commodities groups with varying degrees of intensity and volatility. The food commodity prices index lost 27 percent of its value by December 2001. The price boom that followed increased food prices by 184 percent from December 2001 to April 2008 (closing 108 percent above 1995 price levels in April 2008). The crash that followed the global financial crisis brought prices down by 34 percent from April to December 2008. Food prices rebounded during 2009, closing the year with a 27 percent increase.

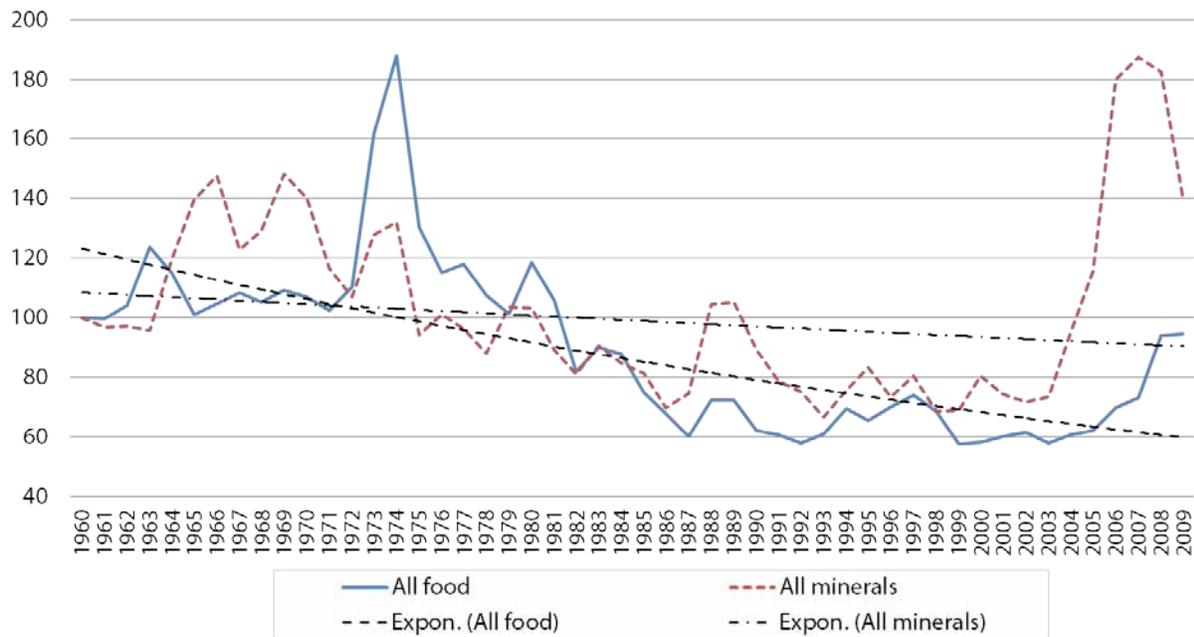
Minerals had similar trends, but with greater intensity. After a period of decline from 1995 to 2001 (minerals prices dropped by 38 percent by December 2001), prices started to rise, peaking in April 2008. From December 2001 to April 2008, mineral prices increased by 365 percent. Mineral prices crashed as a result of the global financial crisis. Mineral prices lost 47 percent of their value from April to December 2008. Prices rebounded in 209 by 39 percent.

During the seven-year period from 1995 to 2001, crude oil prices had risen by only 12 percent. Crude oil prices then started to soar before peaking in July 2008. Crude oil prices increased by 611 percent from December 2001 to July 2008. Prices in July 2008 were nearly eight times what they were at the beginning of 1995. The 2008 global financial crisis brought down oil prices by 69 percent. Crude oil prices rebounded in 2009, increasing by 80 percent before the end of the year. As of August 2010, crude oil prices were 4.5 times what they had been at the beginning of 1995.



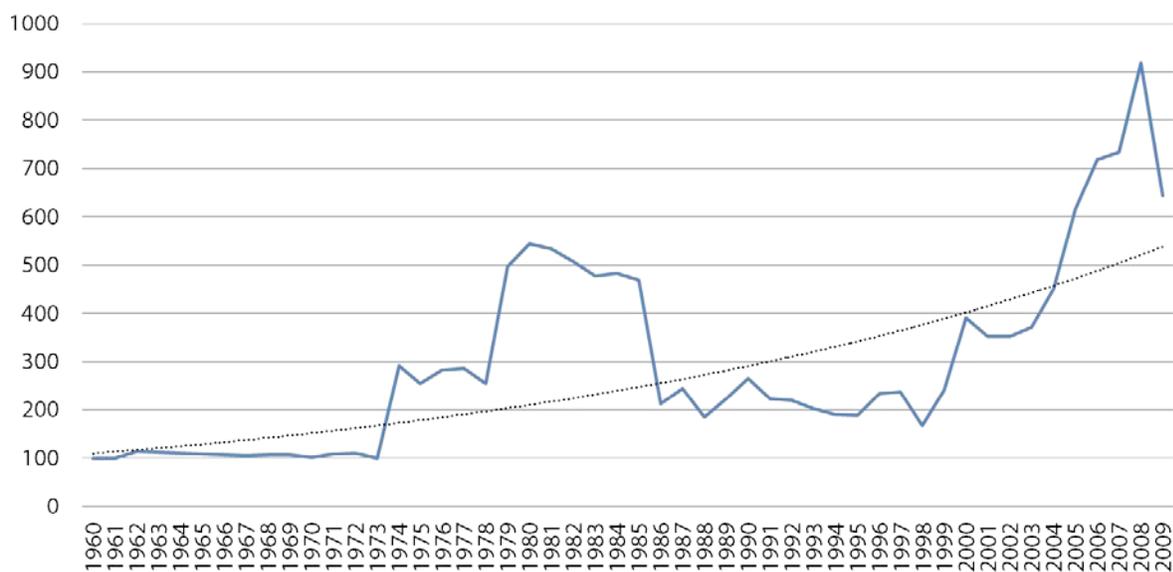
## Annex 2.C: Long-term Trends in Primary Commodity Prices

### Index of real commodity prices for foods and minerals, 1960–2009 (1960=100)



**Source:** Calculated using data from UNCTAD, Commodity Prices Statistics 2010 and United Nations data

### Index of real crude oil prices, 1960–2009 (1960=100)



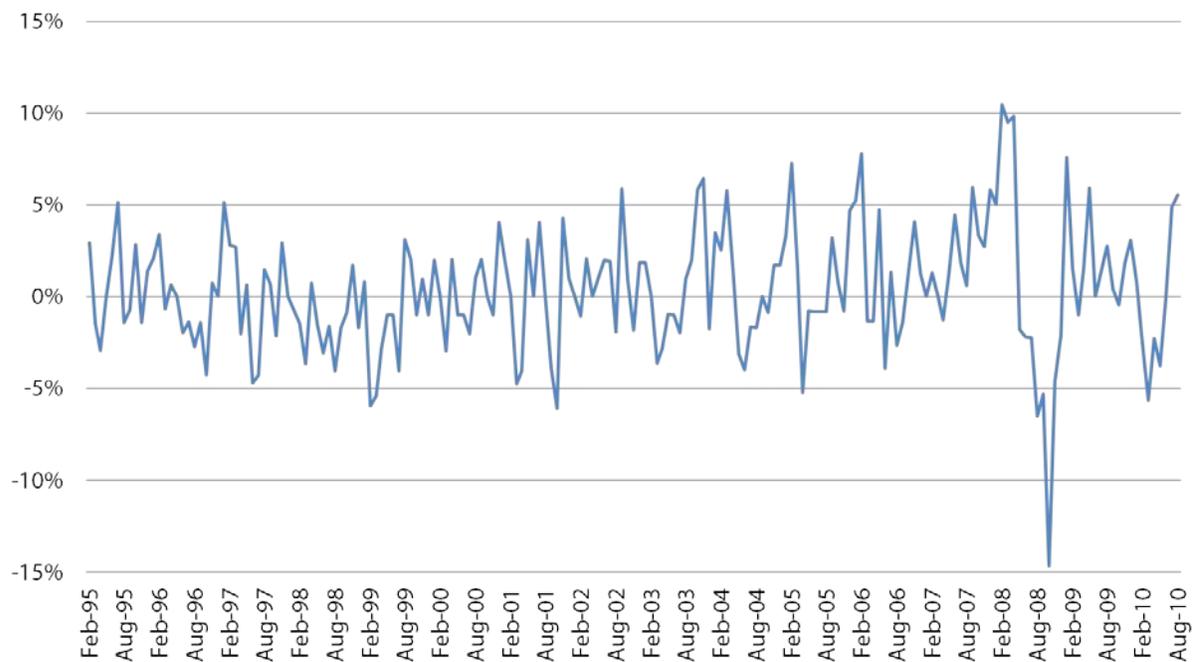
**Source:** Calculated using data from UNCTAD, Commodity Prices Statistics 2010 and United Nations data



# Commodity Dependence and International Commodity Prices

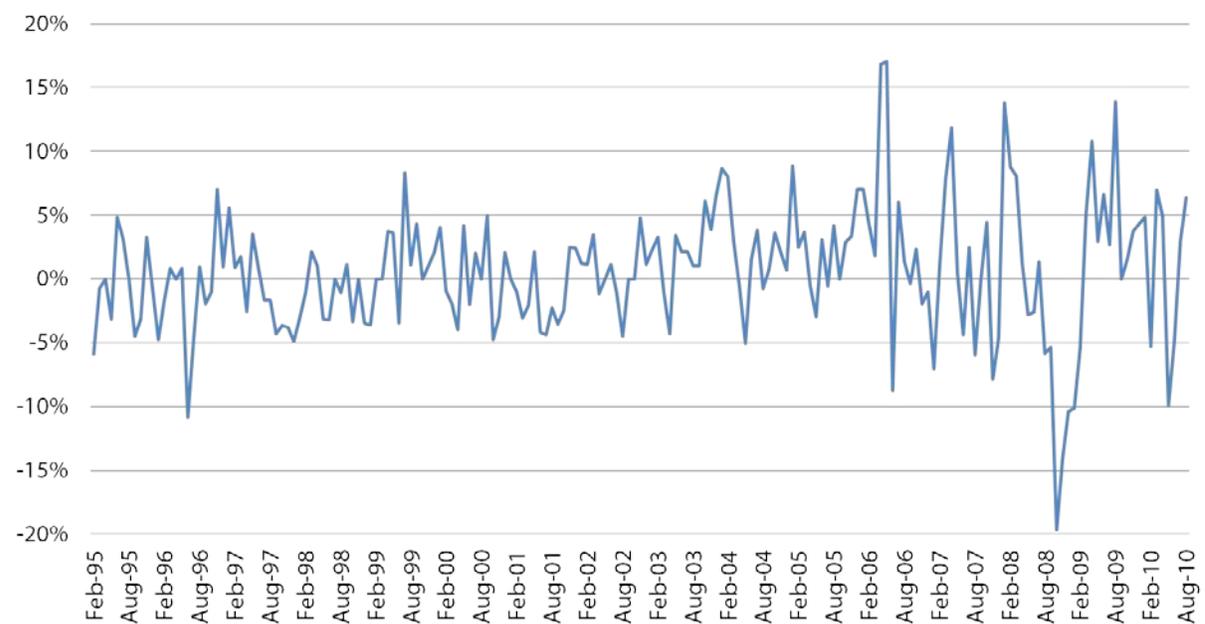
## Annex 2.D: Changes in Prices of Food, Minerals and Oil

### Monthly rate of change of food commodity prices, Feb 1995–Aug 2010



**Source:** Calculated using data from UNCTAD, *Commodity Prices Statistics 2010*

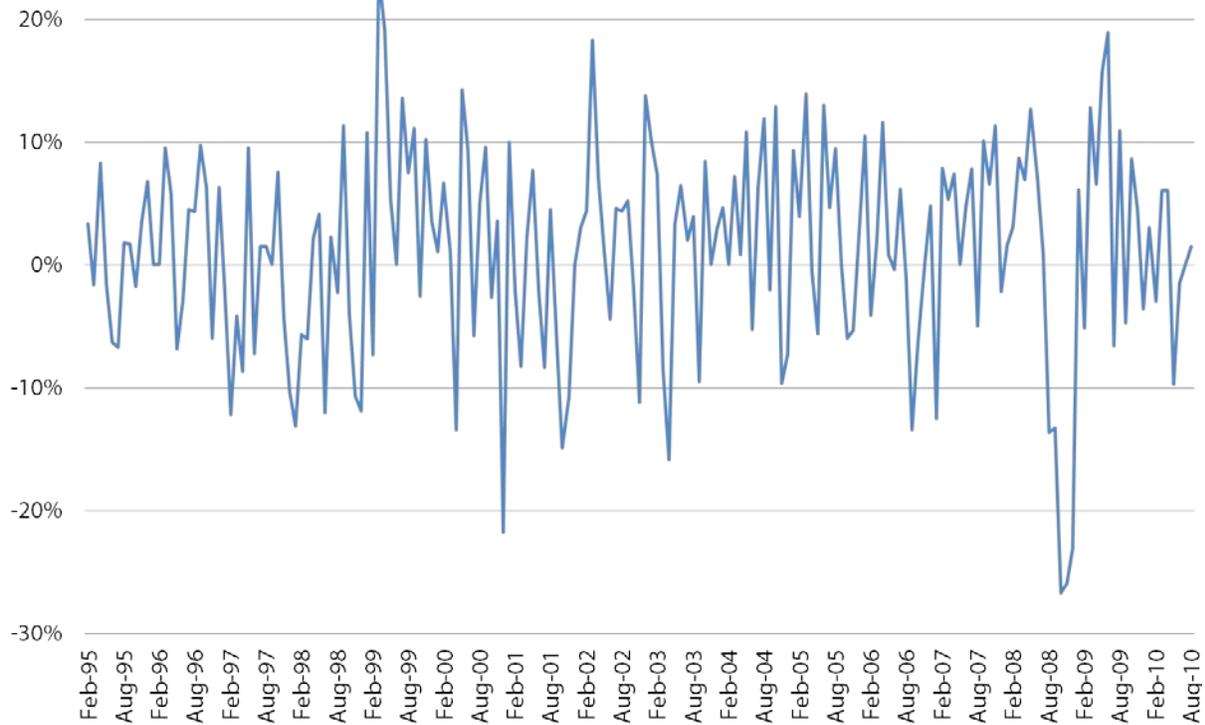
### Monthly rate of change of mineral prices, Feb 1995–Aug 2010



**Source:** Calculated using data from UNCTAD, *Commodity Prices Statistics 2010*



## Monthly rate of change of crude oil prices, Feb 1995–Aug 2010



**Source:** Calculated using data from UNCTAD, *Commodity Prices Statistics 2010*



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# 3

## PRIVATE CAPITAL FLOWS: FOREIGN DIRECT INVESTMENT AND PORTFOLIO INVESTMENT



*Private capital flows have become an increasingly significant source of investment in developing countries, indicating the high degree to which developing countries have become integrated into the global economy and thus how exposed they are to any financial shock.*



Photo: Eskinder Debebe/UN Haiti



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## Introduction

Since the late 1990s, private capital flows (PCF)<sup>1</sup> have become a significant source of investment for many developing countries.<sup>2</sup> Although these flows are still largely concentrated in a few high-income and emerging economies, more PCF are moving into LICs than ever before. In countries such as Zambia, foreign private capital stocks as a percentage of GDP reached 75 percent by 2007 and, for many countries in Africa (Uganda, Cameroon, the United Republic of Tanzania and the Gambia), stocks reached 30 percent of GDP (Bhinda and Martin 2009).

However, as is well-known, PCF tend to be highly volatile — even aid is less volatile and more predictable in most countries. A financial shock can result in the sudden reversal of capital flows and also in sharp declines in inflows. Generally, it is assumed that FDI as compared to Portfolio Investment (PI) is more stable, less prone to volatility and brings significant development benefits to the country, reasons why many developing countries have designed incentive packages to attract foreign capital. “FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development. All of these contribute to higher economic growth, which is the most potent tool for poverty alleviation” (OECD 2002). However, recent evidence highlights the volatility of FDI, laying to rest the idea of FDI’s supposed stability.

The consequences of such volatility for growth are obvious, especially in countries highly reliant on such flows for investment. When investment sources are unpredictable and volatile, so is growth. This is especially the case for the smaller, lower-income countries where many FDI projects are huge in relation to the size of the host economy and because these economies tend to be much less diversified and depend on one or two large projects or sectors (Bhinda and Martin 2009).

Further, the macro-economic effects typical of such volatility also impact poor households through various channels. For instance, sudden and large inflows of private capital have been “associated with inflationary pressures, a real exchange-rate appreciation, a deterioration of the current account and a boom in bank lending” (Calvo et al. 1994). And as is well known, inflation affects poverty through its impact on real wages. Since poor households spend more of their budget, on average, on necessities than on luxuries, the rise in prices of food and essential commodities affects them more than it does non-poor households (Son and Kakwani 2006).

On the other hand, financial shocks that result in a sudden reversal of capital flows can lead to a sharp devaluation of the exchange rate. As imports become more expensive, the prices of imported goods (such as medicine and food) rise and weaken the purchasing power of poor households. Thus, a direct negative impact is on poor people’s purchasing power, caused by the sharp increase in the price of imported goods such as food and medicine.

A devaluation of the exchange rate can also increase a country’s external debt profile, which could result in the government cutting back public spending — including social expenditure — in order to meet increased debt service obligations. Reductions in expenditure on social services during crises have been shown to have both immediate and long-term impacts on poor people. Cutbacks in spending on health and education, for example, can result in a reduction in human capital, thus limiting the capacity of poor people to produce and generate income in the future (Lustig 2000). Further, poor people are often forced to liquidate physical and financial assets during a crisis in order to smooth consumption, but this often serves to limit their capacity



to continue with their livelihoods. Further, renewed employment opportunities during the initial recovery period are often less well remunerated (Fallon and Lucas 2002).

The impact of an exchange rate devaluation on the wider economy can also result in a reduction in demand for labour, with falls in real wages and increases in unemployment, and in less secure forms of employment. Devaluation harms the private sector, as banks and large companies, which have borrowed in international markets, see the value of their dollar liabilities rise. As bankruptcies in the private sector rise, this results in a decline in real wages and job losses (Honohan and Klingebiel 2000, Kimmis 2008).

As noted earlier, efforts to promote PCF have been predicated on the assumption that such investments will have significant and positive development paybacks. It is argued that FDI influences growth by raising total factor productivity and, more generally, the efficiency of resource use in the recipient economy. Further, beyond the strictly economic benefits, “FDI may help improve environmental and social conditions in the host country by, for example, transferring ‘cleaner’ technologies and leading to more socially responsible corporate policies” (OECD 2002). However, a number of studies have questioned the growth and development benefits associated with such flows. “Rates of foreign investment are very poorly correlated with job creation, poverty reduction or other development outcomes” (UNCTAD 2005, Rodrik and Subramaniam 2008, Action Aid 2009, Bhinda & Martin 2009).

To sum up, PCF have become an increasingly significant source of investment in developing countries, indicating the high degree to which developing countries have become integrated into the global economy and thus how exposed they are to any financial shock. Indeed, in some countries, foreign capital is supplanting (rather than supporting) domestic capital as the main source of investment.

*Between 1995 and 2009, total PCF to developing countries increased almost fivefold, with much of the increase taking place in the period 2002–2007.*

Given the volatility associated with capital flows, it is hardly surprising to find that economic growth in these countries is also highly volatile. Such volatility means that governments can scarcely predict how much capital is available to them to plan a sustainable growth strategy, which is ironic, since many LICs are outbidding themselves to attract foreign capital. Moreover, the development paybacks associated with capital flows have so far been less than promising.

For these reasons, policy measures to build a country’s resilience to private capital related shocks have focused on:

- Strengthening domestic resource mobilization in order to reduce dependence on external sources of investment
- Stabilizing the volatility associated with PCF
- Maximizing the development payback of these flows and enhancing their linkages with growth and poverty reduction outcomes



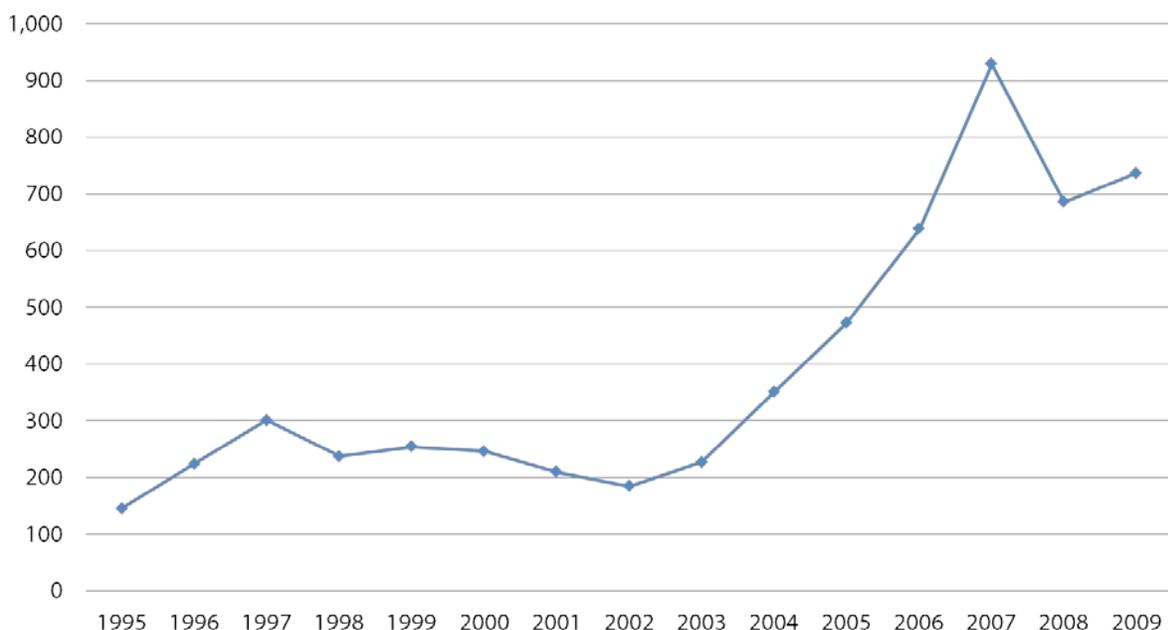
## Trends and Composition of Private Capital Flows

Between 1995 and 2009, total PCF to developing countries increased almost fivefold (Chart 3.1), with much of the increase taking place in the period 2002–2007 (incidentally also the commodity price boom period). Private capital flows increased from \$184 billion in 2002 to \$929 billion in 2007 (a 404 percent increase in 6 years). As the financial crisis began to unfold, these flows fell by 26 percent between 2007 and 2008. Private capital flows began to recover slowly, increasing by 7 percent in 2009 from \$686 billion in 2008 to \$737 billion in 2009.

In terms of composition (Chart 3.2), FDI increased fourfold (a cumulative increase of 395 percent) and was the most important investment channel throughout the period. Between 1995 and 2003, FDI increased from \$111 billion to \$182 billion, soaring thereafter to reach \$704 billion in 2007. The growth in FDI slowed significantly in 2008 due to the global crisis and 2009 saw a 28 percent decline in FDI inflows.

Portfolio investment comprised the smallest share of PCF throughout this period and these flows were significantly more volatile than FDI. After a brief rise from \$33 billion in 1995 to \$120 billion 1997, PIs collapsed on the heels of the Asian financial crisis to reach just \$5 billion by 2001. By 2007, however, PIs had rebounded, reaching \$225 billion — a 44-fold increase. As the most recent crisis unfurled, PIs crashed and, by 2008, registered a reversal of investments of \$80 billion.<sup>3</sup> In 2009, PIs bounced back to \$188 billion. Low return on assets and slow economic growth in advanced economies led to the strong and fast rebound in equity PI inflows to developing economies.

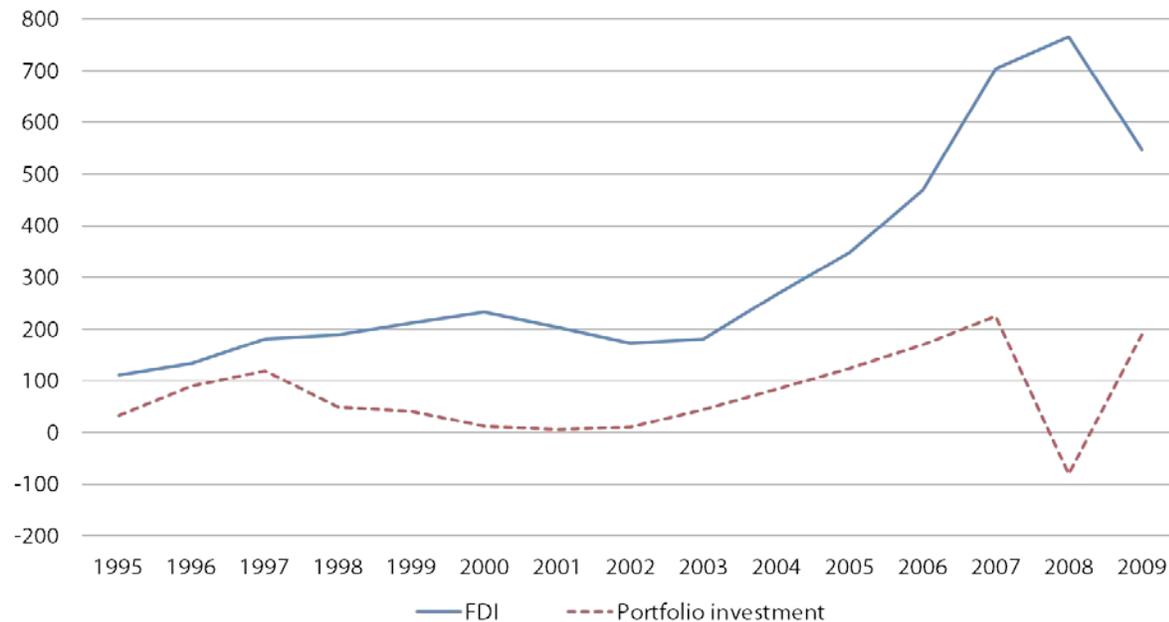
**Chart 3.1: Private capital flows to all developing economies, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from World Bank, *Global Finance for Development*, and IMF, *Balance of Payment Statistics 2009*



**Chart 3.2: Composition of private capital flows, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from World Bank, *Global Finance for Development*, and IMF, *Balance of Payment Statistics 2009*

## Foreign Direct Investment

FDI is by far the most important component of PCF to developing (and transition) economies. By 2009, these economies absorbed almost half of global FDI inflows (UNCTAD 2010a).

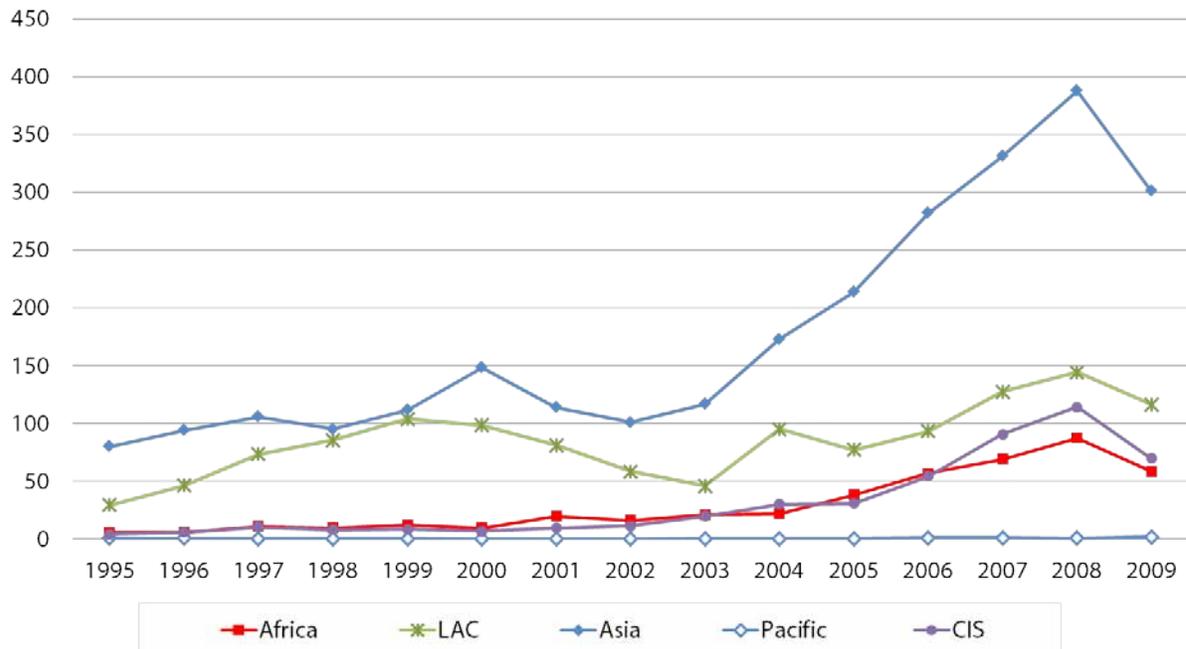
The inflows of FDI by region (Chart 3.3) indicate that the CIS region benefited most from the surge in inflows during the period 1995–2009. FDI inflows to the CIS grew by 1,620 percent in 15 years, increasing from \$4.1 billion in 1995 to \$69.9 billion in 2009. Africa followed with a growth rate of 936 percent, with FDI inflows rising from \$5.7 billion in 1995 to \$58.6 billion in 2009. For Latin America and the Caribbean, FDI inflows grew more slowly (295 percent), increasing from \$29.5 billion in 1995 to \$116.6 billion in 2009. FDI inflows to Asia grew by 276 percent from \$80.1 billion in 1995 to \$301.4 billion in 2009. The Pacific Islands had the slowest rate of FDI growth (170 percent) during the period, rising from \$0.7 billion in 1995 to \$1.9 billion in 2009

Despite the differential in growth rates during the period, as of 2009, Asia received 55 percent of all FDI inflows to developing countries. Latin America and the Caribbean was the second biggest recipient (21 percent), followed by the CIS (13 percent), Africa (11 percent) and the Pacific Islands (0.3 percent). In other words, Asia received over half of all FDI inflows and, within Asia, China and Hong Kong (SAR of China) received 48 percent of the total FDI in 2009.

FDI inflows declined sharply as a result of the latest global crisis. Regions that had the highest growth in FDI during the boom years and were also most dependent on FDI for investment (namely CIS and Africa regions) had the biggest decline in FDI inflows after the crisis. The CIS and Africa regions were the worst affected



**Chart 3.3: FDI inflows by region, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

(39 percent and 35 percent, respectively). In contrast, the decline was lower in Asia and the Latin America and the Caribbean regions (22 percent and 19 percent, respectively).

The Pacific Islands, which represent a very small fraction of total FDI inflows, had an increase in FDI inflows between 2008 and 2009 of 111 percent.

To sum up, despite the increase in FDI across all developing regions, these flows remain quite concentrated. Of all FDI inflows received by developing economies in 2009, 55 percent went to just 10 countries (Table 3.1). China was the single biggest receiver, with 17 percent.

By development status (Chart 3.4), high-income developing economies received more FDI flows than any other development group for most of the period, in part because “new investment is more productive in countries with a skilled workforce and well-developed infrastructure” (Mishra et al. 2001). Inflows to the high-income developing economies increased from \$41.8 billion in 1995 to \$200 billion in 2009 (a growth rate of 379 percent).

For the MICs, FDI inflows increased from \$22.1 billion in 1995 to \$97.3 billion in 2009 (a growth rate of 339 percent), whereas inflows to LICs increased from \$52.1 billion in 1995 to \$181 billion in 2009 (a growth rate of 248 percent). Although the growth in FDI inflows was least for the set of LICs, it is striking that the LDCs — a subset of LICs — recorded the biggest growth in FDI inflows, registering an increase of 1,489 percent (from \$1.8 billion in 1995 to \$28 billion in 2009). The reason for this is that the LDCs account for only 15 percent of total low-income country FDI inflows while China by itself accounts for 52 percent of all inflows to LICs.

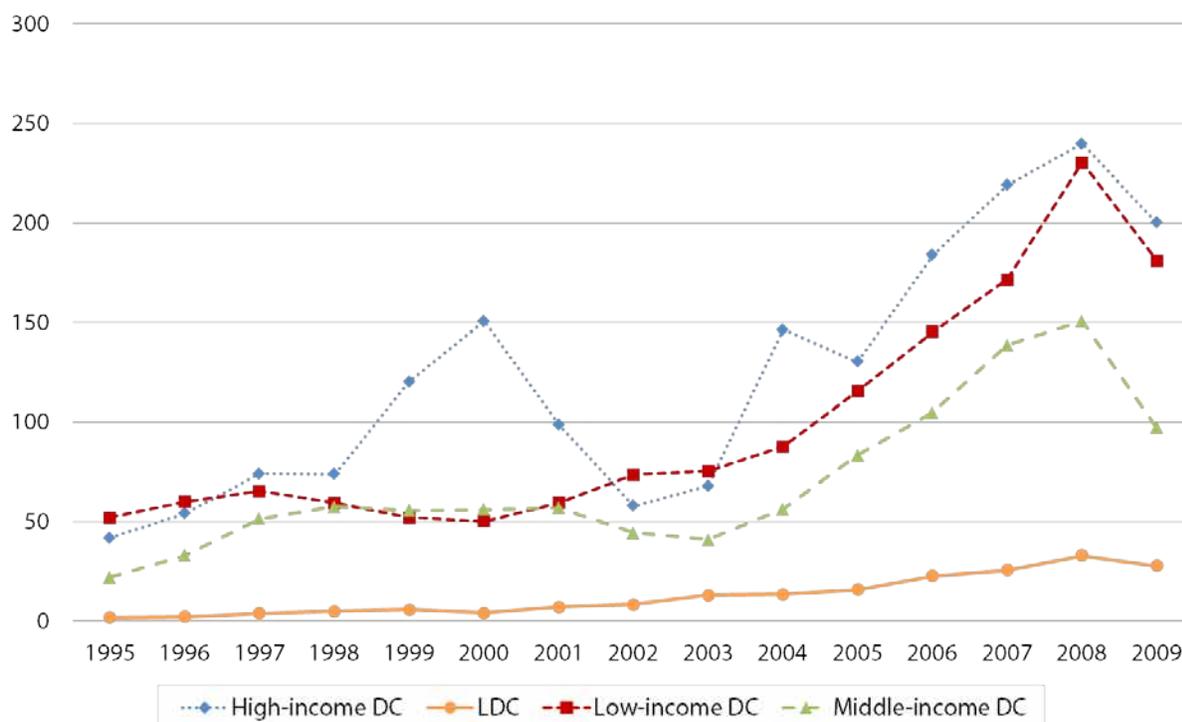


**Table 3.1: Top 10 Recipients of FDI Inflows (2009)**

Rank	Country	Share of FDI
1	China	17.30%
2	Hong Kong, SAR of China	8.80%
3	Saudi Arabia	6.50%
4	India	6.30%
5	Brazil	4.70%
6	Singapore	3.10%
7	Angola	2.40%
8	Chile	2.30%
9	Mexico	2.30%
10	Turkey	1.40%
	<b>Total</b>	<b>55.10%</b>

*Source:* Calculated using data from UNCTAD, World Investment Report 2010

**Chart 3.4: FDI inflows by development status, 1995–2009 (US\$ billions)**



*Source:* Calculated using data from UNCTAD, World Investment Report 2010



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

The most recent global crisis led to a decline in FDI inflows for all development groups. Between 2008 and 2009, FDI inflows declined in MICs by 35 percent, followed by LICs, where FDI declined by 21 percent. For the high-income group of countries, FDI declined by 17 percent and FDI inflows in LDCs fell least (15 percent).

As of 2009, though, both high-income and low-income developing countries recorded significantly higher levels of FDI inflows (40 percent and 38 percent, respectively) than the MICs, where FDI inflows increased by 20 percent.

## *Sources of Foreign Direct Investment*

Development finance has generally been characterized as a one-way flow of capital from the advanced economies to the developing world. Although the majority of PCF are sourced from the advanced countries, significant shares of FDI have more recently been coming from non-OECD countries and this trend has accelerated in the last decade. In fact, overall, “growing FDI between developing countries in recent years has sometimes compensated for reductions in FDI flows from high-income countries” (World Bank 2006).

The growing role of developing economies as sources of FDI is confirmed by investment promotion agencies (IPAs). As of 2009, developing and transition economies account for three of the top ten most promising investors and seven of the top twenty (UNCTAD 2010b). With respect to South-South flows, three trends

appear to be strongly evident: (1) There is rapidly growing intra-regional investment in Africa and Latin America; in Latin America, for instance, Argentina, Brazil and the Bolivarian Republic of Venezuela are investing heavily in Bolivia; (2) some countries are succeeding in attracting non-regional flows; such is the case with the Gambia, which has a 45 percent share of investors from the Middle East and North Africa; and (3) many countries continue to record significant amounts channelled via tax havens (Bhinda and Martin 2009).

*It is important to note that FDI outflows from developing countries have shown less volatility than FDI outflows from advanced economies.*

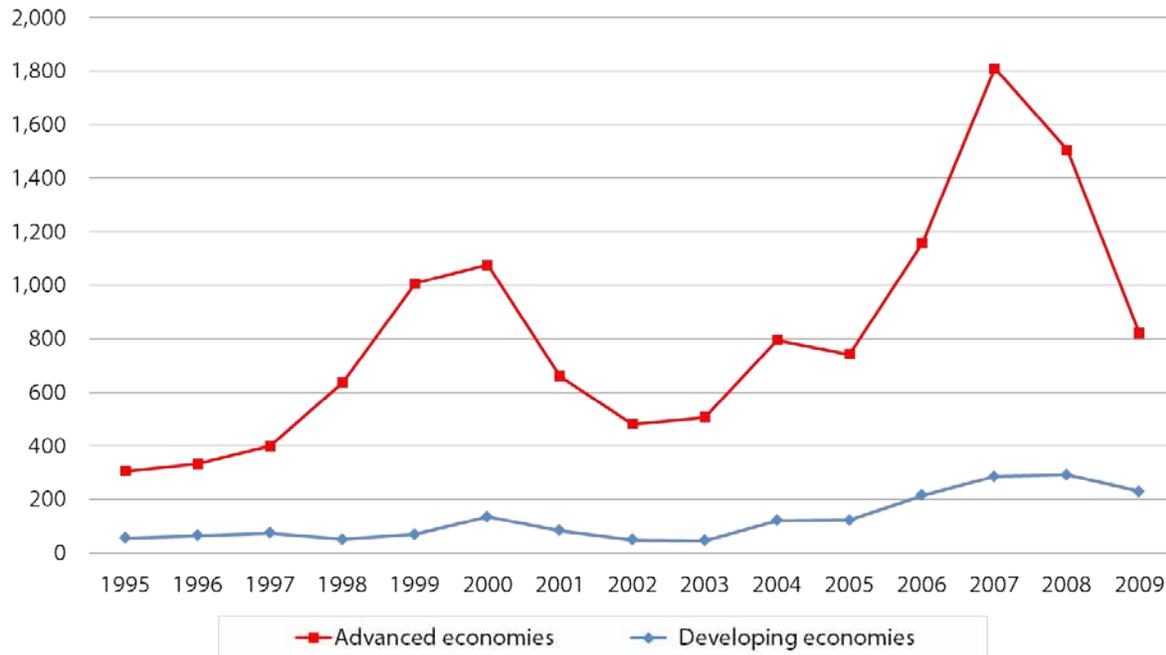
Evidence also shows that TNCs from developing and transition countries have increasingly been investing in Africa over the past few years. “They accounted for 21 percent of flows to the region over the 2005–2008 period, compared to 18 percent in 1995–1999. Investors from China, Malaysia, India and the Gulf Cooperation Council (GCC) are among the most active — although Africa still makes up only a fraction of their FDI” (UNCTAD 2010a). As a result, the share of non-OECD countries in total FDI stock varies from 30 percent in Malawi to as high as 60 percent in the Gambia.

The increase in South-South FDI flows is corroborated by data on FDI outflows (Chart 3.5), which shows that the developing world represented a bigger share of total FDI outflows in 2009 than in 1995. Specifically, total FDI outflows from developing countries in 1995 were only \$55 billion, representing 15 percent of total world FDI. By 2009, FDI outflows from developing countries were \$229 billion, representing 22 percent of total world FDI.

Although advanced countries still account for 78 percent of total FDI outflows, outflows from the developing countries have been growing at nearly twice the rate as that from advanced countries. Between 1995 and 2009, FDI outflows from advanced countries grew by 168 percent, compared to a 317 percent increase in the outflows of FDI from developing countries.



**Chart 3.5: FDI outflows, 1995–2009 (US\$ billions)**



**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

The regional breakdown of FDI outflows (Annex 3.A) shows that Asia has the biggest share of FDI outflows. As of 2009, Asia contributed 63 percent of FDI outflows, followed by the CIS region with 18 percent, and Latin America with 17 percent of FDI outflows from the developing economies.

The biggest increase during the period was in the CIS region, where FDI outflows increased by 80 times, from \$0.6 billion in 1995 to \$49.7 billion in 2009. Latin American FDI outflows grew by 535 percent, from \$7 billion in 1995 to \$47 billion in 2009. Asian FDI outflows grew by 296 percent, from \$45 billion in 1995 to \$177 billion in 2009. Africa had a 69 percent increase in FDI outflows, from \$2 billion in 1995 to \$5 billion in 2009. The Pacific Islands had very negligible amounts of FDI outflows (less than \$1 billion).

It is important to note that FDI outflows from the developing countries have shown less volatility than FDI outflows from advanced economies. Between 2008 and 2009, FDI outflows from advanced economies (where the shock originated and had the biggest impact) declined by 46 percent, while, in the developing countries, the decline was only 22 percent. This trend is different in this crisis when compared to other ‘busts’ of the last 15 years. Between 1997 and 1998 during the Asian crisis, FDI outflows from the developing countries declined by 31 percent, while they continued rising in advanced economies. In the 2001 crisis, all FDI flows fell by 39 percent, regardless of the originating economy.

By development status (Annex 3.B), FDI outflows increased fastest for low-income developing economies, rising by 1,685 percent (from \$4 billion in 1995 to \$67 billion in 2009), mainly because of the growth in Chinese FDI outflows. For high-income developing economies, FDI outflows grew by 242 percent (from \$43 billion in



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

1995 to \$148 billion in 2009), whereas MICs saw a more modest increase of 75 percent in FDI outflows (from \$8 billion in 1995 to \$14 billion in 2009).

Middle-income countries also had the lowest share of total FDI outflows in 2009 (6 percent), while the share for LICs was 29 percent. High-income developing economies accounted for the remaining 65 percent of FDI outflows in 2009.

### *Destination of Private Capital Flows by Sector*

Although it is generally assumed that the bulk of foreign investment, especially in LICs, goes to the primary sector, the evidence (Table 3.2) indicates that there has been considerable diversification into non-primary sectors since the 1990s. During the last two decades, FDI inflows to the services sector have been gaining ground at the expense of FDI inflows into the manufacturing sector: between 1989 and 1991, services accounted for only 35 percent of total FDI flows, while manufacturing accounted for 52 percent of FDI inflows. By 2005–2007, though, the manufacturing sector received only 37 percent of FDI inflows, whereas the services sector recorded the biggest share of FDI inflows (49 percent).

The share of FDI going to the primary sector was 13 percent in 1989–1991 and by 2005–2007, inflows to the primary sector (agriculture and extractive industries) had increased to 14 percent of total FDI inflows.

**Table 3.2: FDI Inflows to Developing Countries by Sector (US\$ billions) <sup>4</sup>**

	Primary	Manufacturing	Services <sup>5</sup>
1989–1991	3.9	16.1	9.3
2005–2007	46.8	121.0	161.4

*Source:* Calculated using data from UNCTAD, *World Investment Report 2009*

In terms of the absolute level of inflows by sector, FDI into the services sector increased the most during the period (nearly seventeenfold), from \$9.3 billion in 1989–1991 to \$161 billion in 2005–2007.

Inflows into primary activities increased elevenfold, from \$3.9 billion in 1989–1991 to \$46.8 billion in 2005–2007. Most of this increase was in the mining, quarrying and petroleum industries (where FDI grew fourteenfold during the period). Mining, quarrying and petroleum represented 93 percent of all FDI in the primary sector. FDI into the manufacturing sector had the lowest rate of increase (sixfold) during the period, rising from \$16.1 billion in 1989–1991 to \$121 billion in 2005–2007.

Country case studies also verify the diversification of FDI away from primary resources. For instance, FDI is going to non-resource-based sectors such as real estate banking and tourism in the Gambia, construction in Ghana, manufacturing in Malawi, new industries in Nicaragua, and telecommunications and commerce in Uganda. In other words, some countries have enhanced the diversification of their FDI or kept it well diversified. A survey of 22 LICs showed that all countries “have identified scope for further diversification into ‘under-invested’ sectors. In all countries these include agriculture, which has suffered from under investment due to lack of credit, infrastructure, inputs and fertiliser, and extension services, poor information for foreign investors on the sector, and land rights issues. Other priorities are tourism in Zambia, manufacturing in the Gambia and Zambia.” (Bhinda & Martin 2009).



## FDI as a Source of Investment

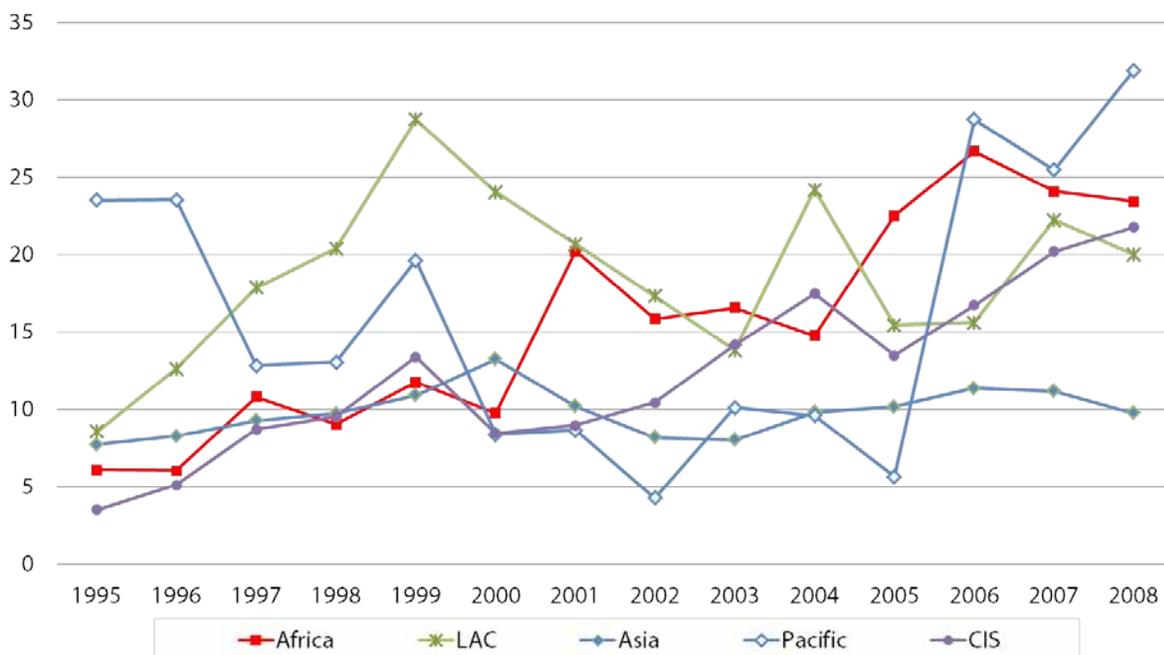
Earlier, it was noted that many LICs are increasingly relying on these sources of capital to finance investment and stimulate economic growth. Examining FDI as a share of gross fixed capital formation (GFCF) (Chart 3.6) clearly shows the growing reliance on such sources of finance for investment — relative to domestic sources — across all developing regions. In short, FDI appears to be substituting for domestic capital as a source of investment in many developing countries.

As of 2008, FDI represented, on average, 20 percent of GFCF in all developing regions except Asia. The CIS region witnessed the biggest rate of increase in FDI as a share of GFCF, from 3.5 percent in 1995 to 21.8 percent in 2008, and, in Africa, where FDI used to represent 6.1 percent of GFCF in 1995, the share increased to 23.4 percent by 2008. Both regions surpassed Latin America and the Caribbean and Asia in terms of FDI as a share of GFCF by 2008. For Latin America and the Caribbean, FDI grew from 8.6 percent of GFCF in 1995 to 20 percent in 2008. FDI inflows as a share of GFCF were by far the highest for the Pacific Islands, rising from 23.5 percent in 1995 to 31.9 percent in 2008.

*Most discussions on volatility have assumed that the PI component of PCF is volatile. FDI is assumed to be relatively stable. Evidence, however, indicates that even FDI is subject to considerable volatility.*

In Asia, FDI inflows as a share of GFCF in 1995 were higher than for Africa and the CIS, but, by 2008, Asian investments became the least dependent on FDI inflows. FDI inflows to Asia as a share of GFCF grew from 7.7 percent in 1995 to 9.8 percent in 2008.

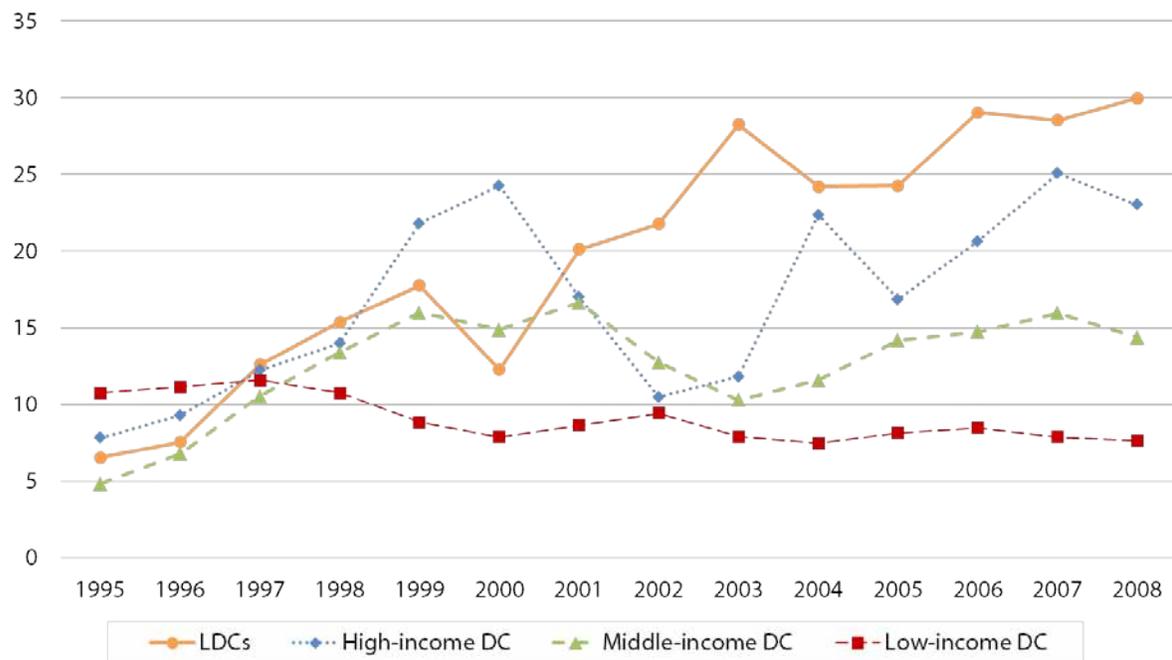
**Chart 3.6: FDI inflows as a share of GFCF by region, 1995–2008 (in percent)**



Source: Calculated using data from UNCTAD, World Investment Report 2010



**Chart 3.7: FDI as a share of GFCF by development status, 1995–2008 (in percent)**



**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

To sum up: the share of FDI in GFCF in 2008 ranged from a high of 32 percent in the Pacific Islands to 23 percent in Africa, 22 percent in the CIS and 20 percent in Latin America. Asia was significantly less dependent on FDI for investment, with the share of FDI in GFCF being just 10 percent.

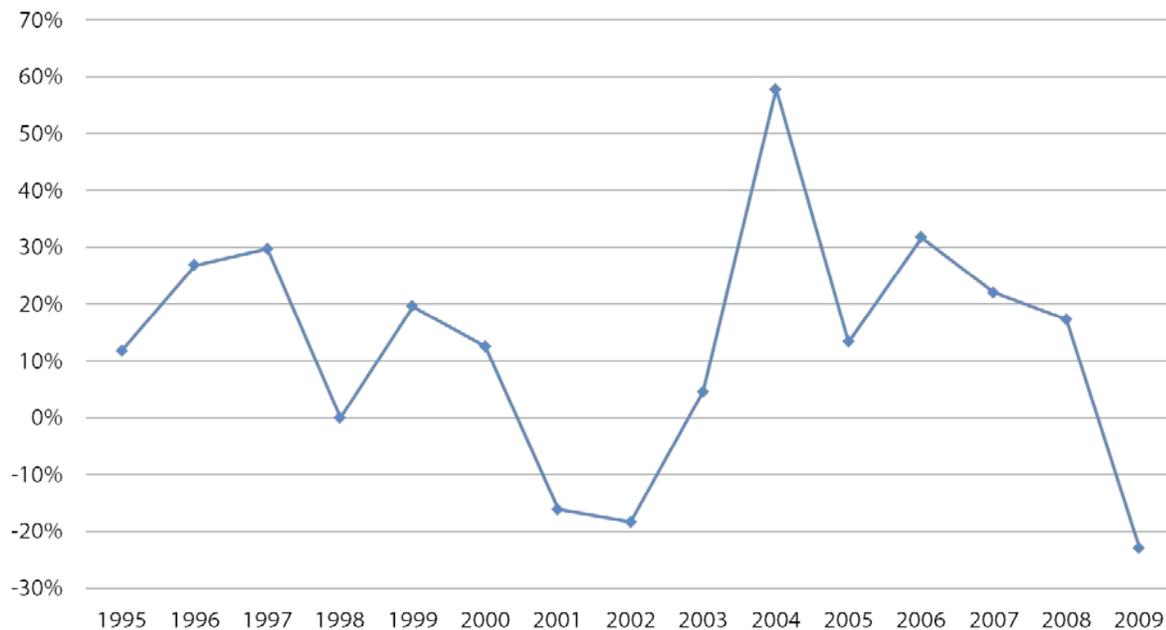
By development group (Chart 3.7), the LDCs experienced the biggest increase in the importance of FDI inflows relative to GFCF during the period. In the LDCs, FDI as a share of GFCF increased by 358 percent, from 6.5 percent in 1995 to 30 percent in 2008. On the other hand, FDI as a share of GFCF in LICs fell by 29 percent, from 10.8 percent in 1995 to 7.6 percent in 2008 (consequent to China's reduction of its FDI-to-GFCF ratio). In high-income countries, FDI as a share of GFCF increased by 194 percent (from 7.8 percent in 1995 to 23 percent in 2008) and, in the MICs, FDI as a share of GFCF increased by 198 percent (from 4.8 percent to 14.4 percent during the same period). As of 2008, FDI as a share of GFCF was highest in LDCs (30 percent), followed by high-income countries (23 percent), the MICs (14.4 percent) and finally by the low-income development group (7.6 percent).

### *Volatility in FDI Flows*

It is well known that PCF tend to be highly volatile; even aid is less volatile and more predictable in most countries (Bhinda and Martin 2009). Most discussions on volatility, though, have assumed that the PI component of PCF is volatile. FDI is assumed to be relatively stable.



**Chart 3.8: Annual rate of change of FDI inflows to developing countries, 1995–2009**



**Source:** Calculated using data from IMF, *Balance of Payments Statistics 2009*

Evidence (Chart 3.8), however, indicates that even FDI is subject to considerable volatility. For instance, even at the aggregate level of all developing countries, FDI inflows can rise by as much as 58 percent in a boom year (such as 2004) and can fall by 23 percent in a bust year (such as 2009).

The actual volatility faced by a single economy can be much higher. On average, the annual rate of change of FDI inflows into any given country was 163 percent (see Annex 3.C). In other words, in a single developing economy, FDI inflows could rise or fall by as much as 163% in a year.

**Table 3.3: Volatility of FDI Inflows by Region**

Region	Average Absolute Annual Rate of Change in FDI Inflows
All Developing	163%
A&P	113%
Africa	204%
Arab States	406%
ECIS	93%
LAC	107%

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

An examination of the volatility of FDI inflows by region <sup>6</sup> (Table 3.3) shows that the fluctuations in FDI inflows from 1995 to 2008 appear to be most volatile for the Arab States, followed by Africa, Asia Pacific, Latin America and the Caribbean, and, finally, Europe and the Commonwealth of Independent States (ECIS). In other words, FDI inflows into Latin America and the Caribbean and the ECIS region appear to be the least volatile.

**Table 3.4: Volatility of FDI Inflows by Development Status**

Development Status	Average Absolute Annual Rate of Change
High-income DC	176%
Middle-income DC	146%
Low-income DC	207%
LDC	300%

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

By development status (Table 3.4), it appears that FDI inflows are significantly more volatile for the LICs compared to the middle-income or high-income developing countries. As a group, the LDCs faced the highest degree of volatility (300 percent) — nearly double the average for all developing countries. In other words, the LDCs — the poorest group of countries — recorded the highest inflows of FDI between 1995 and 2008 and were also those most exposed to the volatility of such flows.

**Table 3.5: FDI as a Share of GFCF and Growth Volatility by Region**

Region	FDI/GFCF	Standard Deviation of Growth
Arab States	15%	4.8
A&P	19%	3.3
LAC	23%	3.3
Africa	24%	4.7
ECIS	28%	5.7
All Developing	22%	4.3

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010* and World Bank, *World Development Indicators 2009*

Given the considerable volatility of FDI inflows, it is hardly surprising that regions most dependent on such external finance for funding investment would experience more growth volatility relative to other regions. The evidence (Table 3.5) corroborates this: regions most dependent on FDI for investment during 1995 and 2008 (ECIS with an FDI/GFCF ratio of 28 percent and Africa with an FDI/GFCF ratio of 24 percent) also had the highest volatility in growth. In contrast, Asia and the Pacific, the region least dependent on FDI for investment, had less growth volatility.



The Arab States, although not highly dependent on FDI, nonetheless experienced considerable growth volatility, mainly on account of the volatility in oil prices during this period.

**Table 3.6: FDI as a Share of GFCF and Growth Volatility by Development Status**

Development Status	FDI/GFCF	Standard Deviation of Growth
Middle-income DC	19	3.5
Low-income DC	21	4.4
LDC	24	4.8
High-income DC	25	4.1
Transition	26	6.6

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010* and World Bank, *World Development Indicators 2009*

An examination of the relation between growth volatility and the FDI-to-GFCF ratio by development status (Table 3.6) clearly shows that the transition economies experienced the greatest growth volatility, whereas the MICs, which, as a group, have the lowest FDI-to-GFCF ratio (19%), also experienced the least growth volatility.

### *Causes of Volatility*

Generally, the volatility of PCF is attributed to the fact that capital is mobile and will move to countries where returns to its investment are likely to be higher. Others have attributed volatility to domestic and international policy shifts: domestic policy shifts, when frequent or unpredictable, will result in high volatility and low growth. Moreover, the volatility of PCF reflects changes in global liquidity conditions and investment behaviour (Mishra et al. 2001).

A closer scrutiny reveals other important reasons for the volatility in flows such as FDI:

#### *(a) Financing of Foreign Direct Investment*

FDI is made up of equity (shares, retained earnings and other capital reserves) and debt (long- and short-term borrowing and supplier credits) from affiliated enterprises.<sup>7</sup> Clearly, a higher debt component produces greater volatility of such flows when there is a tightening in capital markets. Typically, though, it is assumed that FDI is largely equity and hence a stable source of PCF. This is also why most developing countries have encouraged FDI. However, a closer look reveals that equity investors have relied heavily on loan financing contracted overseas (i.e., there is a high degree of debt financing used for what appear to be 'equity' projects). This, in turn, makes countries that are dependent on external finance much more vulnerable to volatility (because debt is the most volatile type of flow) and to a potential debt crisis provoked by the private sector, given that, in many (especially low-income) countries, this debt is between 33 percent and 75 percent of public sector debt levels (Bhinda and Martin 2009).



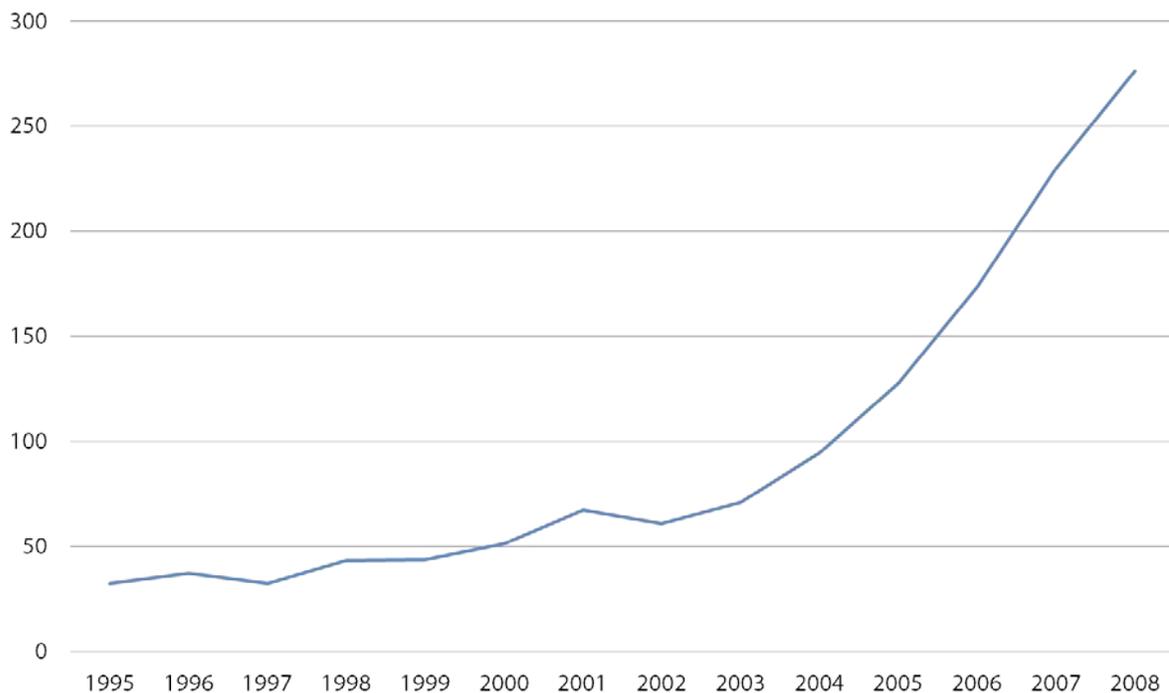
## (b) Profit Repatriation

Nor should it be simply assumed that direct equity is necessarily more stable than loans or portfolio flows. A study of PCF flows to 22 LICs in sub-Saharan Africa and Latin America and the Caribbean found that profits repatriated on FDI were high in most countries; indeed, several countries (Bolivia, Côte d'Ivoire, Mali, Senegal, Cameroon and Gabon) saw income payments in excess of FDI inflows in order to offset economic and political uncertainties or to ensure that projects repaid their investments rapidly. Outflows were lower where investors were confident enough in the investment climate and future opportunities to reinvest their profits (e.g., Nicaragua, Uganda, the United Republic of Tanzania), but even countries with rapid FDI increases in mid-decade saw sharp increases in repatriation in the crisis, as parent companies asked for higher repatriation of profits or dividends or faster repayment of loans.

Rising rates of profit and capital repatriation can generate balance of payment problems, especially if new inflows decline. In Latin America and the Caribbean, for instance, FDI reached record levels by 2007, but, by 2006, repatriated profits equalled the inflows. This indicated that any reduction in new investment might cause problems for balance of payments sustainability. Sub-Saharan Africa also witnessed record FDI inflows, but “these were often exceeded or matched by profits remitted, raising serious questions about the sustainability of FDI” (Bhinda & Martin 2009).

For developing countries as a whole, profits repatriated from FDI investments grew notably between 1995 and 2008 (Chart 3.9). Repatriated income from FDI in the developing world increased 747 percent, from

**Chart 3.9: FDI income repatriated, 1995–2008 (US\$ billions)**



**Source:** Calculated using data from IMF, *Balance of Payments Statistics 2009*



\$33 billion in 1995 to \$276 billion in 2008. In other words, repatriated profits are growing faster than FDI inflows. In 1995, repatriated profits represented 29 percent of FDI inflows, but, by 2008, repatriated profits represented 36 percent of FDI inflows.

(c) *Mode of Entry of Foreign Direct Investment*

Not all FDI inflows constitute Greenfield investments.<sup>8</sup> As of 2008, 20 percent of FDI inflows comprised mergers and acquisitions projects and, as is well known, M&A is much more volatile relative to other forms of FDI. As indicated by the data (Table 3.7), M&A agreements react much faster to global downturns relative to Greenfield projects that usually require long-term planning and commitment. For example, M&A FDI inflows started to decline as soon as the crisis hit in 2008 (4 percent decline relative to 2007), while other forms of FDI continued their growth, although at a declining rate (19 percent increase relative to 2007).

**Table 3.7: Mergers & Acquisitions in Developing Countries**

Year	M&A	Non-M&A FDI	FDI	M&A	Non-M&A FDI	FDI
	US\$ billions			Annual change in %		
2007	130	526	656			
2008	125	628	753	-4%	19%	15%
2009	46	502	548	-63%	-20%	-27%

**Source:** Calculated using data from UNCTAD, *World Investment Report 2010*

Between 2008 and 2009, M&A inflows declined by 63 percent, compared to 20 percent for all other non-M&A FDI inflows.

*Development Impact of FDI*

In order to raise overall investment, many developing countries offer incentive packages to external investors. These incentives range from fiscal incentives (such as subsidies or tax relief) to financial incentives (such as grants, credits, or equity) to subsidized infrastructure, market preferences, labour training and R&D.

However, there appears to be a consensus that these incentives “at most tip the balance in favour of one location among a group of countries that are perceived to have broadly equivalent enabling environments” (OECD 2003). In short, the role of incentives in attracting investment has been limited, yet many countries pay them much attention. It appears “that many of the ‘boom’ sectors for FDI were not—even before the crisis—providing sustainable benefits for growth and poverty reduction, in terms of employment, budget revenue, and transfer of technology and skills” (Bhinda and Martin 2009).

Worse, it has been pointed out that these incentives can also be wasteful if they are ineffective, inefficient (if benefits are not fully realized), have high opportunity cost,

*An increasing number of studies show that the benefits of financial liberalization for development seem vastly overrated and the majority of empirical studies are unable to find robust evidence in support of the growth benefits of capital account liberalization.*



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or trigger competition with other nations. The danger of the latter is a race to the bottom, where countries undercut each other at the cost of lower health, safety, labour or environmental standards. For this reason, regional groupings such as the East African Community are being urged to agree to coordinated codes of conduct to providing incentives (IMF 2008).

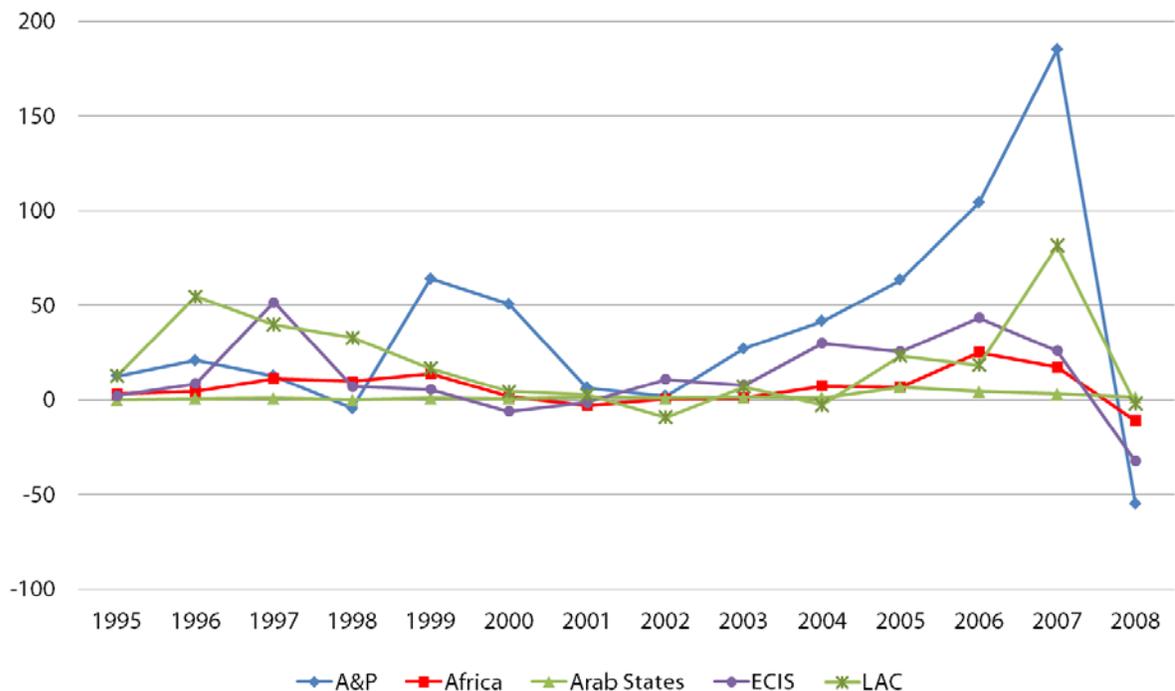
Even worse is the fact that the development paybacks expected from such incentives have failed to materialize. An increasing number of studies show that the benefits of financial liberalization for development seem vastly overrated and the majority of empirical studies are unable to find robust evidence in support of the growth benefits of capital account liberalization (Rodrik and Subramaniam 2008, Kose and Prasad 2002).

## Portfolio Investment

Portfolio investments have long been known to be extremely volatile. In fact, sharp reversals of portfolio flows in times of national or global crisis have underlined earlier lessons about the high volatility of these flows. As increasing numbers of developing countries receive more of these flows, they risk becoming much more vulnerable to financial shocks. Chart 3.10 amply demonstrates the volatility of PI.

Total portfolio inflows (both equity and debt instruments) in all regions except for the Arab States witnessed a very significant decline between 1995 and 2008. In the Arab States, PI inflows actually increased during the period, from \$0.01 billion in 1995 to \$1.4 billion in 2008.

**Chart 3.10: Portfolio inflows by region (US\$ billions)**



**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009



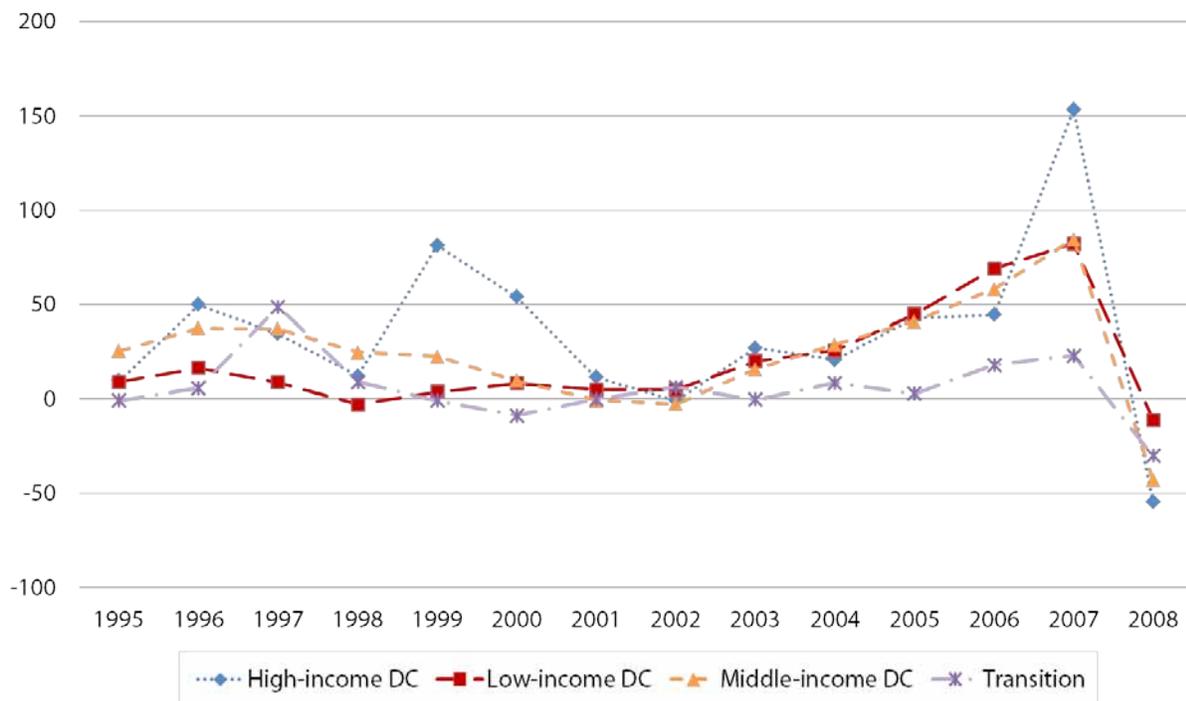
In the Asia and Pacific region, which receives the majority of PI, inflows declined by 535 percent (from \$12.6 billion in 1995 to -\$54.7 billion in 2008), followed by Africa, where PI inflows declined by 441 percent (from \$3.2 billion in 1995 to -\$11 billion in 2008).

For the Latin America and the Caribbean region, PI inflows declined by 116 percent (from \$13 billion in 1995 to -\$2 billion in 2008). The worst affected was the ECIS region, where PI inflows declined by 1,505 percent, from \$2.3 billion in 1995 to -\$32.2 billion in 2008.

As Chart 3.10 indicates, PIs are highly prone to volatility. Portfolio investments increased after the end of the Asian crisis in 1998, only to collapse in 2001 and further in 2002 after the 2001 crisis. During the boom period of 2002 through 2007, PIs increased dramatically in most regions (89 times in Asia and the Pacific, 29 times in Africa, 10 times in Latin America and the Caribbean, 2.8 times in the Arab States, and 1.4 times in the ECIS).<sup>9</sup> But, as the boom ended in 2007, PIs crashed in most regions to below zero (more than 100 percent decline). In the Asia and Pacific region, for example, PIs fell from \$185 billion in 2007 to -\$55 billion in 2008. The ECIS region PI fell from \$26.1 billion in 2007 to -\$32.2 billion in 2008.

The breakdown by development status (Chart 3.11) shows that all groups shared very similar experiences. All development groups saw a decline in inflows from 1995 to 2008. In high-income developing countries, portfolio inflows fell by 667 percent (from \$9.6 billion in 1995 to -\$54.6 billion in 2008). For transition economies, portfolio inflows declined the most — by 4,100 percent (from -\$0.7 billion in 1995 to -\$30.3 billion in 2008). For MICs, portfolio inflows fell by 268 percent (from \$26 billion in 1995 to -\$43 billion in 2008) and for LICs, portfolio inflows fell by 224 percent (from \$9 billion in 1995 to -\$11 billion in 2008).

**Chart 3.11: Portfolio inflows by development status (US\$ billions)**



**Source:** Calculated using data from IMF, Balance of Payments Statistics 2009



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## Volatility of Portfolio Investments

The volatility of PIs is excessively high, with frequent reversals in the direction of flows. Regional averages<sup>10</sup> (Table 3.8) show that the Latin America and Caribbean region has the highest volatility of PIs, followed by the ECIS region, the Arab States, and Africa; the Asia and Pacific region is the least volatile.

**Table 3.8: Change in Portfolio Investments by Region**

Region	Average Absolute Change in Portfolio Investments
A&P	388%
Africa	1,118%
Arab States	2,347%
ECIS	3,176%
LAC	4,524%

*Source:* Calculated using data from IMF, Balance of Payments Statistics 2009

An examination of volatility by development status (Table 3.9) shows that PIs in the MICs seem to be more volatile than in other development groups. Transition economies come second, followed by the high-income and LICs.

**Table 3.9: Change in Portfolio Investments by Development Status**

Development Status	Average Absolute Change in Portfolio Investments
High-income DC	890%
Middle-income DC	5,009%
Low-income DC	561%
Transition	3,428%
All Developing	2,733%

*Source:* Calculated using data from IMF, Balance of Payments Statistics 2009

In conclusion, the evidence points clearly to the substantial increase PCF (largely FDI) received by developing countries; over the past 15 years, this has been particularly true in the ECIS region and in LDCs in Africa. Despite the current concentration of PCF in a few countries, the data point to a clear trend in its diffusion across a larger number of developing countries during this time.

Additionally, the evidence shows starkly the considerable volatility of these flows. Portfolio investment is amply more volatile compared to FDI and the impact of the 2007 financial crisis on these flows was stupendous. Across the board, PIs fell—so much that they almost wiped out any gains made since 1995 in several developing countries. Indeed, as of 2008, PIs were flowing from developing countries rather



than flowing in. In effect, the positive contribution of PI to growth and development appears to have been minimal, if anything. FDI flows also demonstrate considerable volatility. This volatility essentially implies that governments can scarcely predict how much capital is available for them to plan a sustainable development and growth strategy, which is ironic, since so many poorer countries are outbidding themselves to attract such foreign investments.

*Investment volatility essentially implies that governments can scarcely predict how much capital is available for them to plan a sustainable development and growth strategy, which is ironic, since so many poorer countries are outbidding themselves to attract such foreign investments.*

More worrying is the fact that there appears to be a growing trend for developing countries to rely more on foreign capital relative to domestic capital for investment, and this trend appears to be more pronounced in those countries and regions that have attracted growing inflows of foreign investments (i.e., the ECIS region and LDCs mainly in Africa). Although foreign investments at the aggregate level account for approximately 20 percent of total investment, disaggregated information reveals major country differences. For instance, the share of foreign investment in total investment ranges from 91 percent in Tajikistan, 60 percent in the Congo and 89 percent in Trinidad and Tobago.

Significantly, Asia has depended least on foreign investments to drive growth: foreign capital has supported, not supplanted, domestic investments. The evidence is also clear that domestic sources of capital are much more stable relative to foreign sources. “The countries that have done best have primarily relied on their own resources for development, supplemented by foreign capital as needed, while those whose strategy or circumstances relied on opening up to international markets as a source of resources for development did not see benefits sufficient to compensate for the huge costs they are now experiencing” (Action Aid 2009).

This also means that the countries that receive high inflows of foreign capital are not uniquely most vulnerable to financial shocks: countries that received high inflows of foreign capital and relied on these funds increasingly to drive domestic investment and thereby growth are also vulnerable.

## **Building Resilience: Policy Options for Strengthening Domestic Resource Mobilization, Stabilizing Private Capital Flows and Maximizing their Development Benefits**

Not surprisingly, policy recommendations to build a country’s resilience to private capital flow-related shocks have focused on three sets of issues: (1) strengthening domestic resource mobilization to reduce dependence on external finance; (2) stabilizing PCF (i.e., reducing the volatility associated with such flows); and (3) maximizing the development paybacks from such flows.

### *Strengthening Domestic Resource Mobilization*

As noted earlier, the evidence suggests that domestic capital is the most stable and has the biggest pay-off for development. Consequently, countries should try to mobilize additional domestic resources by, for instance, increasing tax revenues from foreign investors and encouraging citizens to keep their money in local banks. Specific proposals include:



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

- Enforcing Corporate Social Responsibility. “Nothing better reflects the corporate responsibility of any company than its payment of taxes” (Kimmis 2005). Under current international accounting standards, TNCs are required to present consolidated accounts. “This makes it impossible to tell which companies are structuring their trade and investment flows through subsidiaries in tax havens, and manipulating intra-company transactions to gain tax advantages (i.e., reduce their tax liabilities)”. This, in turn, limits the capacity of poor countries to raise revenue through taxation on foreign-owned enterprises and deprives them of the revenues they need to sustain investments in infrastructure and fund basic services. A recent study estimated that, if the problems of global tax evasion and avoidance could be addressed, the potential gain for developing countries would be in excess of \$200 billion a year (Cobham 2005).

### Box 3.1: Combating Exploitative Transfer Pricing Practices

Governments in developing countries need strong mechanisms to ensure that Transnational Corporations (TNCs) do not wrongfully shift profits outside of national jurisdictions and that the profits reported by TNCs accurately account for the taxable production that takes place within these borders. One way in which TNCs shift profits and evade tax liabilities is the through the practice of transfer pricing, i.e., using differentiated pricing structures to take advantage of tax policies across national borders. While standard business practice enables TNCs to make transactions with affiliates, these practices can be manipulated to shift taxable profits towards low-tax countries regardless of where the profits were actually generated. Such exploitation of cross-border differentiation in tax policy can deprive development countries of properly generated tax revenues (AEO 2010).

While no global estimates of the tax revenue losses from transfer pricing are available, estimates suggest that exploitative transfer pricing affects nearly two thirds of all trade with African countries. For Latin America, estimates suggest that almost half of all goods and services traded are impacted by exploitative transfer prices (Gurtner 2008).

Awareness of the exploitation of transfer pricing and the potential developmental impact of such tax evasion

practices has grown over the past decade. The Tax Justice Network, for example, has called for better reporting standards from transnational corporations, emphasizing the need for detailed country-level reporting of operations and accounting. In January 2010, the OECD set up an informal task force on taxation and development to help developing countries achieve development goals by improving overall tax systems. Tackling issues related to exploitation of transfer pricing is one area that was pinpointed for attention (OECD 2010).

In April 2010, members of the African Civil Society signed the Nairobi Declaration on Taxation and Development, which “calls on African governments, African regional bodies, the international financial institutions, the UN, the OECD, aid donors and civil society to take steps to strengthen the transparency, accountability and overall integrity of tax systems and to recognise the crucial role played by tax in development processes” (Tax Justice Network Africa 2010). While the Declaration seeks broad reform of the international tax system with emphasis on helping African governments to strengthen their systems and tax codes, a direct appeal was made in this statement for donors to help African countries monitor TNCs, particularly for exploitative transfer pricing.

**Source:** African Economic Outlook, 2010, *African Economic Outlook*, 2010, Issy les Moulineaux, France; Gurtner, Bruno, 2008, ‘Abusive Transfer Pricing is Widespread, Media Orientation ‘Conning the Congo’ of Greenpeace International’, July 30, AllianceSud, Zurich; OECD, 2010, *Co-Chair’s Statement at the Joint Meeting on Tax and Development between the Committee on Fiscal Affairs (CFA) and the Development Assistant Committee (DAC)*, 27 January; Tax Justice Network Africa, 2010, *Nairobi Declaration on Taxation and Development*.



- **Regulating Capital Flight.** Studies of offshore wealth holdings have shown that rich individuals in developing countries tend to hold a far larger proportion of their wealth in offshore tax havens than their North American or European counterparts. For example, over 50 percent of the total holdings of cash and listed securities of individuals in Latin America are estimated to be held off-shore (Kimmis 2005). And again, capital flight can have significant social costs, especially for developing countries. The loss of needed government revenues and foreign exchange often results in lower levels of investment in infrastructure and human capital. Capital flight is also likely to have negative impacts on equality, as wealthy citizens escape taxation while poorer citizens face higher taxes or cuts in social expenditure to make up for shortfalls in government revenue (Epstein et al. 2005).

## *Stabilizing Private Capital Flows*

Policies to stabilize PCF will necessarily depend on country contexts, but will also depend on the specific type of PCF being considered. Specific measures to stabilize PCF could include:

- Focusing on the composition of inflows by encouraging inflows that have higher proportions of genuine fresh equity investments relative to debt. Much more attention should be paid to the composition of finances that developing countries are receiving, since debt financing is much more volatile compared to equity financing. In this context, it has been pointed out that Greenfield investments are not only less volatile than M&A investments, but also more consistent with development objectives.
- Tracking the sustainability of PCF in net terms, which requires looking at which policy measures are most likely to reduce the very high perceptions of risk and therefore rates of repatriation demanded by foreign investors, as well as reducing the scope for unfettered offshore tax evasion through havens, which is sometimes hidden within repatriation.
- Developing rapid response and early warning systems to help predict and deal with capital flow-related shocks. In particular, low-income developing countries need to be better equipped to monitor and analyse PCFs, since very many countries are still not monitoring or analysing flows well. The failure to track and analyse PCFs and to design policies to maximize their contribution to development has forced many of these economies to cope with unexpected booms and busts, disrupting their growth and reducing their prospects for achieving the MDGs. The current financial crisis underlines the need for countries to have timely and accurate data on capital flows in order to track the impact of exogenous shocks on capital flows and to design appropriate policy responses.
- Accelerating the diversification of sources and destinations for FDI. As noted earlier, PCF is increasingly being sourced from non-OECD countries. Yet, there remains a mismatch between the place in which most developing countries promote investment and the place from which investment is increasingly being sourced (i.e., primarily non-OECD countries, especially from within the same region). Some developing countries have been diversifying their promotion efforts to capture these new sources, but others need to make much more effort and international institutions need to encourage this rather than only focus on the OECD. In part, over-concentration of OECD sources may have reflected a perception that OECD investment better contributes to growth or is more socially or environmentally responsible. However, country analysis provides evidence that South-South investment is less volatile than North-South investment and has been especially resilient during the global crisis, partly because it is less dependent on debt financing. It also does not indicate any systematic difference in sectors of investment, tax payments, employment levels, technology transfer or aspects of corporate responsibility.



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

## *Maximizing the Development Payback of Private Capital Flows*

Many country studies have pointed to the absence of a development payback with respect to PCF. To enhance the ability of host governments to maximize the development impact of foreign private capital, efforts to promote investor corporate responsibility must be fostered. These could include spending on environmental protection, human resources and infrastructure. It also entails maximizing efforts to ensure that external investments bolster low domestic savings or weak financial intermediation and realize positive spillovers via technology transfer and enterprise development. To ensure that local firms do not get crowded out, governments also need to invest much more in ensuring that local firms have the capability to invest in absorbing foreign skills and technologies.

Investment promotion authorities, in particular, need to look beyond the quantity of FDI they generate and should receive incentives through more qualitative targets for job creation, exports, budget revenues or technology transfers in their institutional frameworks.

In this context, incentives should be:

- Available to foreign and domestic investors equally
- Offered only under very specific circumstances, where investment makes a demonstrated net contribution to sustainable development efforts
- Cost-benefit reviewed before a project begins and regularly thereafter
- Integrated into a wider national plan and agreed on a regional level

### **Box 3.2: Maximizing the Development Payback of Private Capital Flows**

Many country studies have pointed to the absence of a development payback with respect to private capital flows. To enhance the ability of host governments to maximize the development impact of foreign private capital, efforts to promote investor corporate responsibility must be fostered.

The Yugra charter is one example of a comprehensive effort by local governments to utilize FDI to ensure local communities benefit from investment and resource exploitation. The Khanty-Mansiisk Autonomous Region, also known as Yugra, lies in north-western Siberia. In 1989 and 1990, the regional government passed legislation requiring developers to work closely and in agreement with an indigenous community comprising 2 percent of the population. Such agreements emphasize practices that are

more likely to benefit this population through, for example, the construction of power lines, housing and cultural facilities; the provision building materials; and gas and oil refinement. Moreover, this agreement provides a quarterly financial compensation payment to local households; financing for higher education; health treatment, work training and employment placements; transportation of food to migrating herders; and the shipment of traditional craft products to markets. Many oil and gas companies in Yugra also support foundations that contribute to other local development projects. Last, local communities and regional development in this remote region also benefit from the Black Gold of Yurga, an annual competition that promotes foreign business investment by awarding prizes to companies for their regional community contributions.

**Source:** United Nations, 2007, 'CSR and Developing Countries: What scope for government action?', Sustainable Development Innovation Briefs, Issue 1.



### **Box 3.3: Targeted Domestic Development Promotion**

Some governments in developing countries have sought to promote specified national investment strategies by attracting foreign investors with specific social, environmental, or educational expectations or goals. The Peruvian investment promotion agency, Pro Inversion, is one example of such an agency, recruiting and promoting foreign investment targeted for positive local human capital development.

As an apparatus of national investment and growth policy, Pro Inversion aims to “attract investors able to transfer

state-of-the-art technology and to take responsibilities with respect to the development of their social environment.” The agency is specific and targeted in its assistance to these investors, disseminating and assisting “in the disclosure, among potential investors, of the role and social commitment they have with the environment and people.” Pro Inversion seeks to “to foster competitiveness and sustainable development in Peru to improve the welfare of the Peruvian people.”

**Source:** United Nations, 2007, ‘CSR and Developing Countries: What scope for government action?’, Sustainable Development Innovation Briefs, Issue 1.

Indeed, as PCF to many countries are becoming involved in almost all sectors, it is all the more vital to target incentives, so that FDI investors are encouraged to create joint ventures and backward and forward linkages to local inputs and value-added processes, so that a stronger transfer of technology and employment creation provide a better basis for crowding in domestic private investment rather than crowding it out.

Other ways of maximizing the development impact of such flows is to direct it to underinvested regions in a country. Typically, FDI tends to be concentrated in or around a single centre, usually the capital city and vicinity. The location of major mining and petroleum resources or other natural resources, such as wildlife for tourism, largely determine the more widespread regional distribution of investment. To the degree that FDI generates employment, infrastructure and other services, its absence from the poorer regions of countries can be a potential hindrance to overcoming income inequality and an incentive for greater migration to urban centres. In the absence of countervailing policies, it complicates the implementation of many countries’ national poverty reduction strategies, which include a reduction in income inequality. Much more effort is needed to diversify PCF to underserved regions within countries.

Finally, international policy efforts need to focus on providing:

#### *Contingency Financing*

The unwillingness of the international community to provide financial assistance to countries in crisis can contribute to triggering and deepening a crisis. To reduce poverty and improve equity, the international community in general needs to have adequate financing facilities to prevent crises from occurring, deepening, and spreading through contagion.

One of the key lessons learned from past crises is that emergency financing needs to be on a large scale, rapidly disbursed, and made available to countries that may suffer contagion effects. Indeed, the failure to provide adequate and urgent liquidity is a key reason that many developing countries, especially in Asia, accumulated such high levels of foreign reserves as a form of self-insurance against possible future crisis.



## Box 3.4: Attracting FDI in New Sectors

With a significant proportion of FDI aiding existing large-scale projects and new investments in urban centres in developing countries, there is considerable need for alternative investments and policies that ensure the growth of human capital and other development benefits in remote areas and underserved communities. Rather than relying on investments that continue to focus on mineral and fossil fuel extraction, which contribute minimally to long-term employment or other development goals particularly in LDCs, new efforts are needed to identify and develop sectors of the economy in outlying regions and to promote FDI in these areas (UNCTAD 2011). Such investments could help to reduce income inequality by reducing rural poverty.

By generating employment and encouraging education and transfer of skills, FDI in low-income developing countries directed toward agriculture, tourism, and telecommunications has been found in some cases to have larger development impacts than natural resource extraction (UNCTAD 2008). Telecommunication investment, in particular, comprehensively affects economies of

all sizes by improving the efficiency of commercial business transactions, facilitating access to both lenders and potential markets, enabling the rapid and accurate exchange of information, and improving transportation and delivery chains.

In Africa, for example, policy-guided FDI has helped some remote areas gain access to telecommunications, particularly in places where challenging terrain and poor projected profit margins have traditionally constrained investment. Uganda is an example of a country where government policies, which required companies to provide universal access, attracted FDI in telecommunications even in rural areas. TNCs have also created sub-regional telecommunications markets by removing roaming charges on service. In 2006, for example, One Network in East Africa by Celtel created a borderless mobile network among six countries—the Congo, the Democratic Republic of the Congo, Gabon, Kenya, Uganda and the United Republic of Tanzania—the first such network of its kind (UNCTAD, 2008).

**Source:** UNCTAD, 2011, *Foreign Direct Investment in LDCs: Lessons Learned from the Decade 2001–2010 and the Way Forward*, UNCTAD, Geneva; UNCTAD, 2008, *World Investment Report 2008*, UNCTAD, Geneva.

This policy is not only costly for the countries concerned, but it is also creating huge global imbalances that significantly threaten international economic stability.

### *A Sovereign Debt Workout Mechanism*

Past financial crises have also highlighted the fact that public funds cannot necessarily be relied upon to offset the outflow of private money during a crisis. Economically troubled countries need to be able to reach agreements more quickly with their private creditors. This is important to prevent a crisis from deepening and, over the last decade, more people have become aware of the need to involve or 'bail in' the private sector at a much earlier stage of a crisis. However, the proposal for a sovereign debt workout mechanism has not yet been adopted and debt workout mechanisms have remained informal.

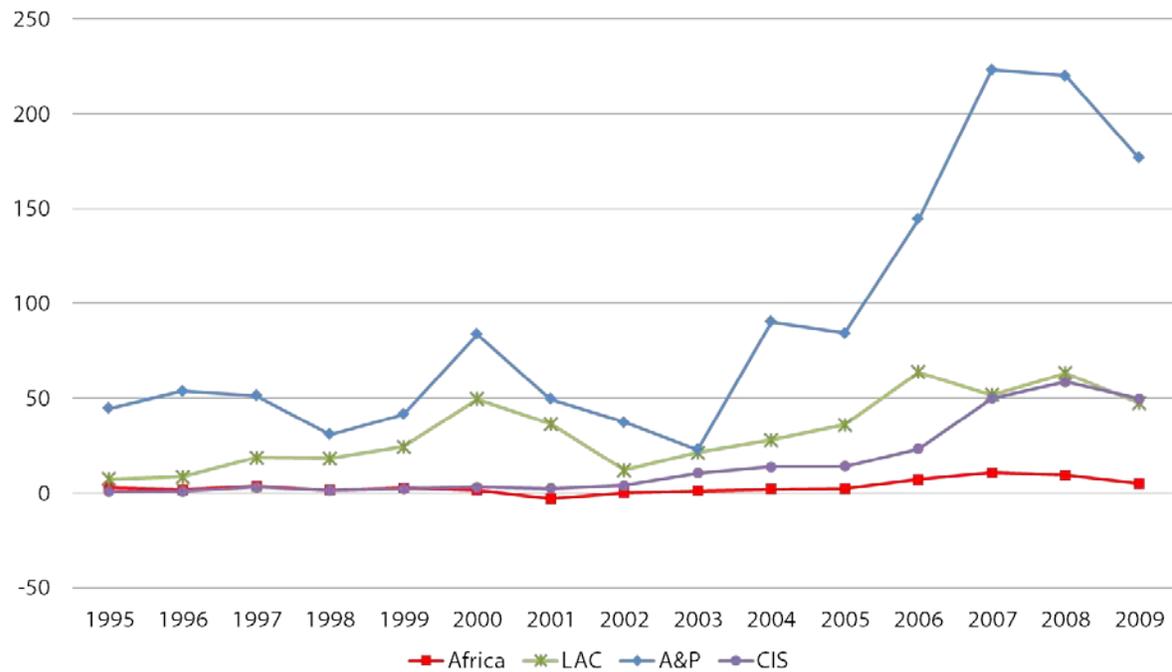


## Notes

1. Private capital flows are the sum of three sources of private capital: Foreign Direct Investment; Portfolio Investment; and Workers' Remittances. Since remittances are unlike FDI and PI both in terms of function and behaviour, they are treated in a separate chapter. The focus of this chapter is on FDI and PI. Foreign Direct Investment is the net inflow of investment so as to acquire a lasting management interest (10 percent or more) in an enterprise, operating in an economy not of the investor. It includes equity capital, reinvested earnings and other long- or short-term capital as shown in the balance-of-payments account of a country. Portfolio Investment includes investment in equity and debt securities. Equity securities cover all instruments and records acknowledging claims to the residual values of incorporated enterprises. Shares, stocks usually denote ownership of equities. Debt securities cover bonds, debentures, notes, money market or negotiable debt instruments, and financial derivatives or secondary instruments, such as options (IMF 1993).
2. Though the share of PCF going to developing countries has grown, the advanced countries still largely dominate PCF. As of 2008, the share of PCF directed to the advanced economies was 78 percent (IMF 2009a).
3. A reversal in PI is the same as outflows of PI. This is because portfolio investments are seen as "portfolio liabilities on the reporting economies by foreign residents" (IMF 2009). In other words, PI records what foreign investors are buying or selling. Hence, a positive number indicates an increase in liabilities for the host country (holdings of foreign citizens increase) and a negative number implies that liabilities have fallen (holdings of foreign citizens decline).
4. Only for developing countries where data was available (see Annex A.I.6 in World Investment Report 2009).
5. 'Business activities' that mostly represent inflows into Hong Kong investment holding companies are not included.
6. The regional classification used henceforth is with reference to UNDP's classification of countries by region. See Annex 3.C.
7. Typically, foreign enterprises tend to favour borrowing from an affiliate because the terms are cheaper and far more flexible. Where this option is not available, they tend to borrow from non-affiliated sources. Foreign enterprises tend also to prefer borrowing from non-affiliated sources abroad rather than from domestic sources. Foreign debt is often cheaper and long-term debt is much more readily available. Further, banks in several LICs may not be geared to the size of borrowing that enterprises require. Even when domestic debt is available, foreign investors may find it difficult to obtain it if certain restrictions exist (e.g., if domestic loans are strictly tied to domestic collateral).
8. Greenfield investments are a form of FDI in which a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up.
9. The surge in PI flows can present substantial risks to developing countries: for instance, surges in PI have been associated with a "dramatic escalation of stock market prices and valuations in many developing countries (for example, in Asia) raising the risk of asset price bubbles" (World Bank 2006).
10. Refer to Annex 3.D for country-specific data on volatility.

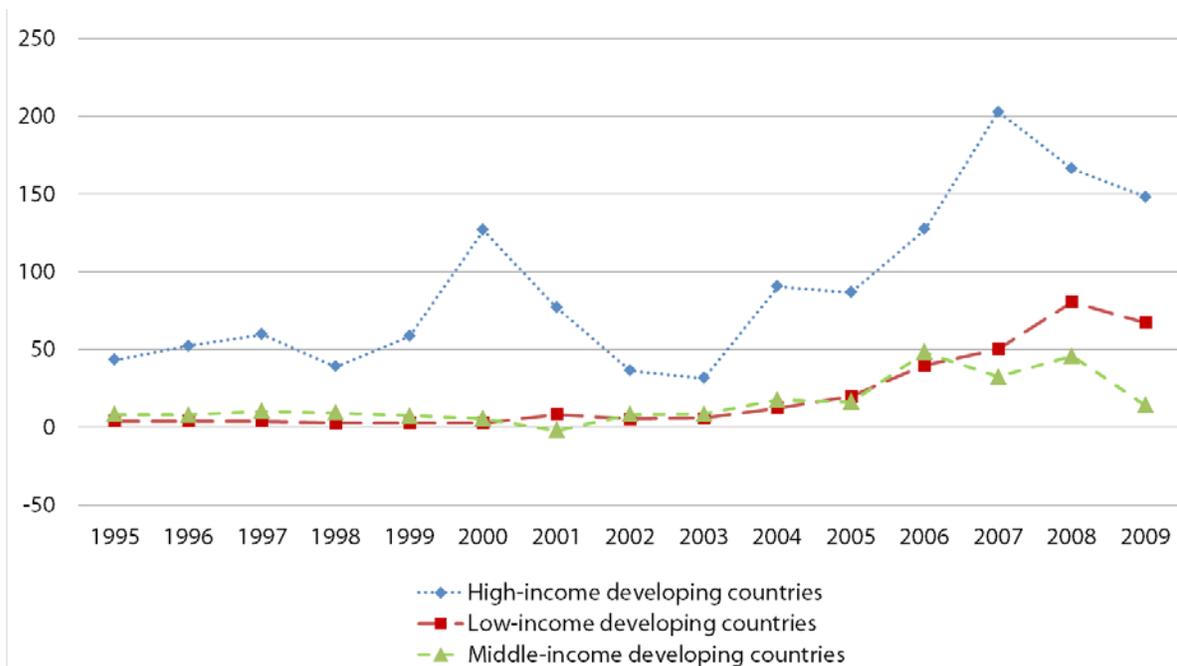


## Annex 3.A: FDI Outflows by Region, 1995–2009 (US\$ billions)



Source: Calculated using data from UNCTAD, World Investment Report 2010

## Annex 3.B: FDI Outflows by Development Status, 1995–2009 (US\$ billions)



Source: Calculated using data from UNCTAD, World Investment Report 2010



## Annex 3.C: Volatility of FDI by Country and Territory

Country/Territory	Development Status	Region	LDC	Average absolute annual rate of change
Albania	Transition	ECIS		57%
Angola	Low-income DC	Africa	LDC	287%
Anguilla	High-income DC	LAC		41%
Antigua and Barbuda	High-income DC	LAC		66%
Argentina	High-income DC	LAC		55%
Armenia	Transition	ECIS		77%
Aruba	High-income DC	LAC		281%
Azerbaijan	Transition	ECIS		157%
Bahamas	High-income DC	LAC		45%
Bahrain	High-income DC	Arab States		106%
Bangladesh	Low-income DC	A&P	LDC	183%
Barbados	High-income DC	LAC		102%
Belarus	Transition	ECIS		140%
Belize	Middle-income DC	LAC		149%
Benin	Low-income DC	Africa	LDC	89%
Bolivia	Middle-income DC	LAC		80%
Botswana	Middle-income DC	Africa		163%
Brazil	Middle-income DC	LAC		48%
Cambodia	Low-income DC	A&P	LDC	45%
Cameroon	Low-income DC	Africa		390%
Cape Verde	Middle-income DC	Africa		87%
Chile	High-income DC	LAC		39%
China	Low-income DC	A&P		16%
Colombia	Middle-income DC	LAC		69%
Congo	Middle-income DC	Africa		670%
Costa Rica	Middle-income DC	LAC		26%
Côte d'Ivoire	Low-income DC	Africa		24%
Croatia	Transition	ECIS		73%
Dominica	Middle-income DC	LAC		45%
Dominican Republic	Middle-income DC	LAC		66%
Ecuador	Middle-income DC	LAC		246%
Egypt	Middle-income DC	Arab States		85%
El Salvador	Middle-income DC	LAC		334%
Fiji	Middle-income DC	A&P		704%
Georgia	Transition	ECIS		53%
Ghana	Low-income DC	Africa		73%

**Source:** Calculated using data from UNCTAD, World Investment Report 2010



# Private Capital Flows: Foreign Direct Investment and Portfolio Investment

Country/Territory	Development Status	Region	LDC	Average absolute annual rate of change
Grenada	Middle-income DC	LAC		35%
Guatemala	Middle-income DC	LAC		98%
Guyana	Low-income DC	LAC		34%
Honduras	Middle-income DC	LAC		39%
Hungary	Transition	ECIS		62%
India	Low-income DC	A&P		44%
Indonesia	Low-income DC	A&P		194%
Jamaica	Middle-income DC	LAC		31%
Jordan	Middle-income DC	Arab States		253%
Kazakhstan	Transition	ECIS		57%
Kenya	Low-income DC	Africa		218%
Kuwait	High-income DC	Arab States		731%
Kyrgyzstan	Transition	ECIS		177%
Libya	High-income DC	Arab States		104%
Malaysia	Middle-income DC	A&P		74%
Mali	Low-income DC	Africa	LDC	347%
Mauritius	Middle-income DC	Africa		158%
Mexico	High-income DC	LAC		25%
Moldova	Transition	ECIS		73%
Mongolia	Low-income DC	A&P		64%
Morocco	Middle-income DC	Arab States		133%
Mozambique	Low-income DC	Africa	LDC	70%
Namibia	Middle-income DC	Africa		105%
Netherlands Antilles	High-income DC	LAC		910%
Nicaragua	Low-income DC	LAC		32%
Niger	Low-income DC	Africa	LDC	351%
Nigeria	Low-income DC	Africa		36%
occupied Palestinian territory	Middle-income DC	Arab States		58%
Oman	High-income DC	Arab States		323%
Pakistan	Low-income DC	A&P		49%
Panama	Middle-income DC	LAC		113%
Paraguay	Middle-income DC	LAC		65%
Peru	Middle-income DC	LAC		42%
Philippines	Low-income DC	A&P		108%
Republic of Korea	High-income DC	A&P		56%
Romania	Transition	ECIS		74%

**Source:** Calculated using data from UNCTAD, World Investment Report 2010

# Private Capital Flows: Foreign Direct Investment and Portfolio Investment



Country/Territory	Development Status	Region	LDC	Average absolute annual rate of change
Russian Federation	Transition	ECIS		55%
Rwanda	Low-income DC	Africa	LDC	113%
Saudi Arabia	High-income DC	Arab States		612%
Senegal	Low-income DC	Africa	LDC	236%
Seychelles	High-income DC	Africa		54%
Sierra Leone	Low-income DC	Africa	LDC	681%
Singapore	High-income DC	A&P		51%
Slovakia	Transition	ECIS		132%
Solomon Islands	Low-income DC	A&P	LDC	170%
South Africa	Middle-income DC	Africa		439%
Sri Lanka	Low-income DC	A&P		47%
St. Kitts and Nevis	High-income DC	LAC		40%
St. Lucia	High-income DC	LAC		56%
St. Vincent & the Grenadines	Middle-income DC	LAC		51%
Sudan	Low-income DC	Arab States	LDC	2,081%
Suriname	Middle-income DC	LAC		206%
Swaziland	Middle-income DC	Africa		210%
Tanzania	Low-income DC	Africa	LDC	30%
Thailand	Middle-income DC	A&P		37%
The FYR of Macedonia	Transition	ECIS		162%
Togo	Low-income DC	Africa	LDC	34%
Trinidad and Tobago	High-income DC	LAC		32%
Tunisia	Middle-income DC	Arab States		72%
Turkey	Middle-income DC	ECIS		70%
Uganda	Low-income DC	Africa	LDC	25%
Ukraine	Transition	ECIS		64%
Uruguay	High-income DC	LAC		43%
Vanuatu	Middle-income DC	A&P	LDC	45%
Venezuela	High-income DC	LAC		98%
Viet Nam	Low-income DC	A&P		29%
Yemen	Low-income DC	Arab States	LDC	312%

**Source:** Calculated using data from UNCTAD, World Investment Report 2010



## Annex 3.D: Volatility of PI by Country and Territory

Country/ Territory	Development Status	Region	Average Absolute Change in Portfolio Investment
Antigua and Barbuda	High-income DC	LAC	302%
Argentina	High-income DC	LAC	151%
Armenia	Transition	ECIS	710%
Aruba	High-income DC	LAC	248%
Bangladesh	Low-income DC	A&P	217%
Belarus	Transition	ECIS	361%
Belize	Middle-income DC	LAC	183%
Benin	Low-income DC	Africa	315%
Botswana	Middle-income DC	Africa	203%
Brazil	Middle-income DC	LAC	186%
Chile	High-income DC	LAC	419%
China	Low-income DC	A&P	258%
Colombia	Middle-income DC	LAC	292%
Costa Rica	Middle-income DC	LAC	236%
Côte d'Ivoire	Low-income DC	Africa	177%
Croatia	Transition	ECIS	1560%
Dominica	Middle-income DC	LAC	1413%
Ecuador	Middle-income DC	LAC	14061%
Egypt	Middle-income DC	Arab States	8169%
El Salvador	Middle-income DC	LAC	230%
Guatemala	Middle-income DC	LAC	848%
Guyana	Low-income DC	LAC	622%
Hungary	Transition	ECIS	180%
India	Low-income DC	A&P	156%
Indonesia	Low-income DC	A&P	96%
Kazakhstan	Transition	ECIS	421%
Kenya	Low-income DC	Africa	262%
Kyrgyzstan	Transition	ECIS	33829%
Malaysia	Middle-income DC	A&P	200%
Mali	Low-income DC	Africa	296%
Mauritius	Middle-income DC	Africa	211%
Mexico	High-income DC	LAC	980%
Moldova	Transition	ECIS	1058%
Morocco	Middle-income DC	Arab States	756%

**Source:** Calculated using data from World Bank, Global Finance for Development, and IMF, Balance of Payment Statistics 2009

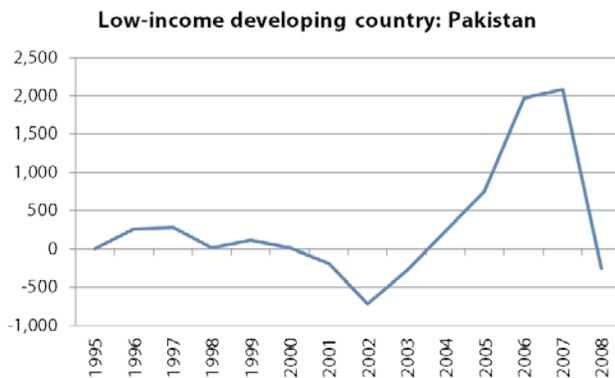
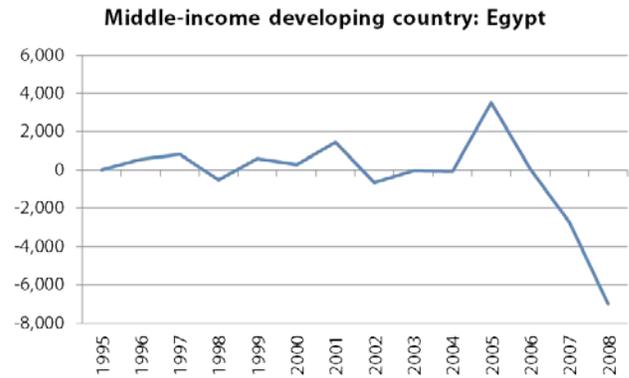
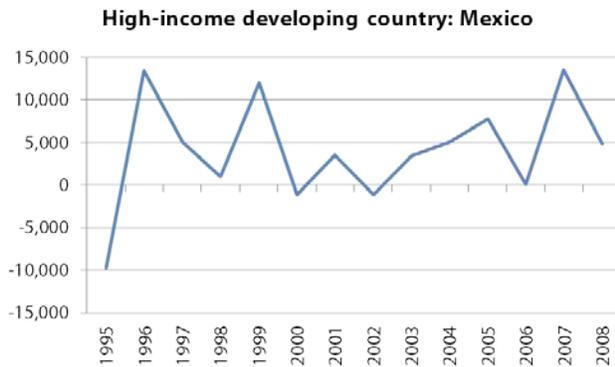


Country/ Territory	Development Status	Region	Average Absolute Change in Portfolio Investment
Namibia	Middle-income DC	Africa	99%
Netherlands Antilles	High-income DC	LAC	526%
Nicaragua	Low-income DC	LAC	234%
Oman	High-income DC	Arab States	322%
Pakistan	Low-income DC	A&P	843%
Panama	Middle-income DC	LAC	81152%
Peru	Middle-income DC	LAC	644%
Philippines	Low-income DC	A&P	235%
Republic of Korea	High-income DC	A&P	164%
Romania	Transition	ECIS	612%
Russian Federation	Transition	ECIS	451%
Senegal	Low-income DC	Africa	4568%
Seychelles	High-income DC	Africa	6594%
Singapore	High-income DC	A&P	1675%
Slovakia	Transition	ECIS	311%
South Africa	Middle-income DC	Africa	158%
Sri Lanka	Low-income DC	A&P	80%
St. Kitts and Nevis	High-income DC	LAC	520%
St. Lucia	High-income DC	LAC	186%
St. Vincent & Grens.	Middle-income DC	LAC	262%
Swaziland	Middle-income DC	Africa	477%
Thailand	Middle-income DC	A&P	124%
The FYR of Macedonia	Transition	ECIS	1334%
Togo	Low-income DC	Africa	55%
Tunisia	Middle-income DC	Arab States	141%
Turkey	Middle-income DC	ECIS	148%
Ukraine	Transition	ECIS	307%
Uruguay	High-income DC	LAC	127%
Venezuela	High-income DC	LAC	240%

**Source:** Calculated using data from World Bank, Global Finance for Development, and IMF, Balance of Payment Statistics 2009



## Annex 3.E: Portfolio Investments for Sample of Developing Countries (US\$ millions)



Source: Calculated using data from IMF, Balance of Payments Statistics 2009



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# 4

## REMITTANCES



*Remittances are largely personal transactions from migrants to their friends and families. They tend to be well targeted to the needs of their recipients.*





## Introduction

Migrant economic remittances<sup>1</sup> are an important and growing source of foreign funds for several developing countries. At present, these flows are more than double the official aid received by developing countries. According to the World Bank and the IMF, if remittances sent through informal channels are included, total remittances could be as much as 50 percent higher than the official record (World Bank 2010, IMF 2009). In 2010, officially recorded remittances to developing countries reached \$334 billion (World Bank 2010).

For many developing countries, remittances constitute a large source of foreign income relative to other financial flows. In 2009, in some countries economic remittances have “become as large as foreign direct investment” and, in a large group of developing countries, remittances represent a resource inflow that often exceeds a variety of other balance of payments flows (IMF 2009).

Although remittances are accounted for as a component of PCF — unlike FDI and PI, which tend to be highly volatile — remittances are much more stable and even countercyclical in the face of external economic shocks (Mohapatra et al. 2010, UNESCAP 2007, Gabel 2008).

Moreover, since remittances are largely personal transactions from migrants to their friends and families, they tend to be well targeted to the needs of their recipients. Their ability to reduce poverty and to promote human development is well documented and often reported as beneficial to overall development: “Remittances directly augment the income of recipient households. In addition to providing financial resources for poor households, they affect poverty and welfare through indirect multiplier effects and also macroeconomic effects” (Ratha 2007).

Regression analyses across countries worldwide indeed show significant poverty reduction effects of remittances. For instance, household survey data show that remittances have reduced the poverty headcount ratio significantly in several LICs: by 11 percent in Uganda, 6 percent in Bangladesh and 5 percent in Ghana. In Nepal, remittances may explain a quarter to a half of the 11 percent reduction in the poverty head count ratio (Ratha 2007).

Furthermore, remittances have been associated with increased household investments in education, health and entrepreneurship — all of which have a high social return in most circumstances. For instance, studies based on household surveys in El Salvador and Sri Lanka find that children of remittance-receiving households have a lower school drop-out ratio and that these households spend more on private tuition for their children. In Sri Lanka, the children in remittance-receiving households have higher birthweight and studies also indicate that remittances provide capital to small entrepreneurs, reduce credit constraints, and increase entrepreneurship.

At the macro-economic level, the relationship between economic growth and remittance receipts has come under renewed scrutiny. Although the empirical evidence on the impact of remittances on economic growth appears to be mixed, it is nonetheless recognized that, since remittance flows are used either to increase consumption or investment, they have the potential to become an important tool for economic development (Fayissa and Nsiah 2008, UNESCAP 2007, Ratha 2007). More recently, it has been noted that “a significant portion of remittance flows are used to service debt, and increase foreign exchange reserves” (Das and Serieux 2010). In other words, such flows can also be used to cushion the impact of external economic shocks.



Given the size and stability of remittance inflows as well as their countercyclical behaviour in the face of external shocks, recent policy attention has focused on mobilizing remittances to leverage growth and poverty dividends as well as utilizing remittances to cushion the impact of economic shocks. Specifically, policy measures have focused on:

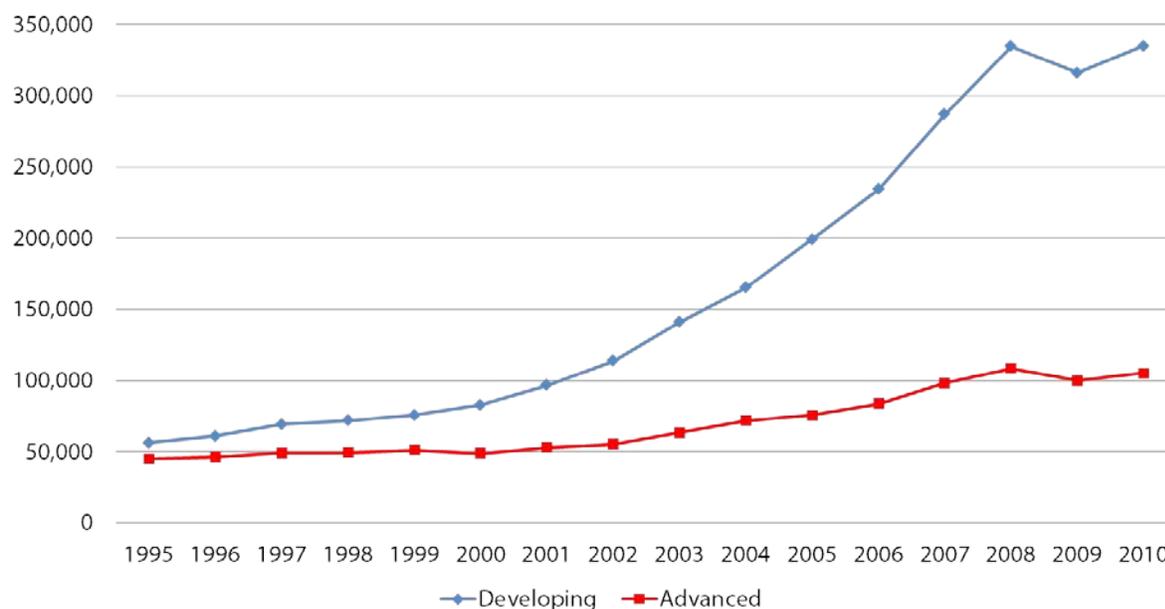
- Monitoring, Analysis and Projection of Remittance Inflows
- Developing Retail Payment Systems for Remittance Transfers
- Reducing the Costs of Remittance Transfers
- Improving Financial Access of Individuals and Households
- Leveraging Remittances for Capital Market Access of Financial Institutions or Countries

### Trends in Remittances

Over the past 15 years, the inflow of remittances to developing economies has grown sixfold, from \$56 billion in 1995 to \$334 billion in 2010 (Chart 4.1). The significant increase in remittance flows also means that it is becoming an increasingly important component of PCF. In 1995, remittances constituted 24 percent of total PCF;<sup>2</sup> by 2008, their share in total PCF had increased to 33 percent (Annex 4.A).

*Over the past 15 years, the inflow of remittances to developing economies has grown sixfold, from \$56 billion in 1995 to \$334 billion in 2010.*

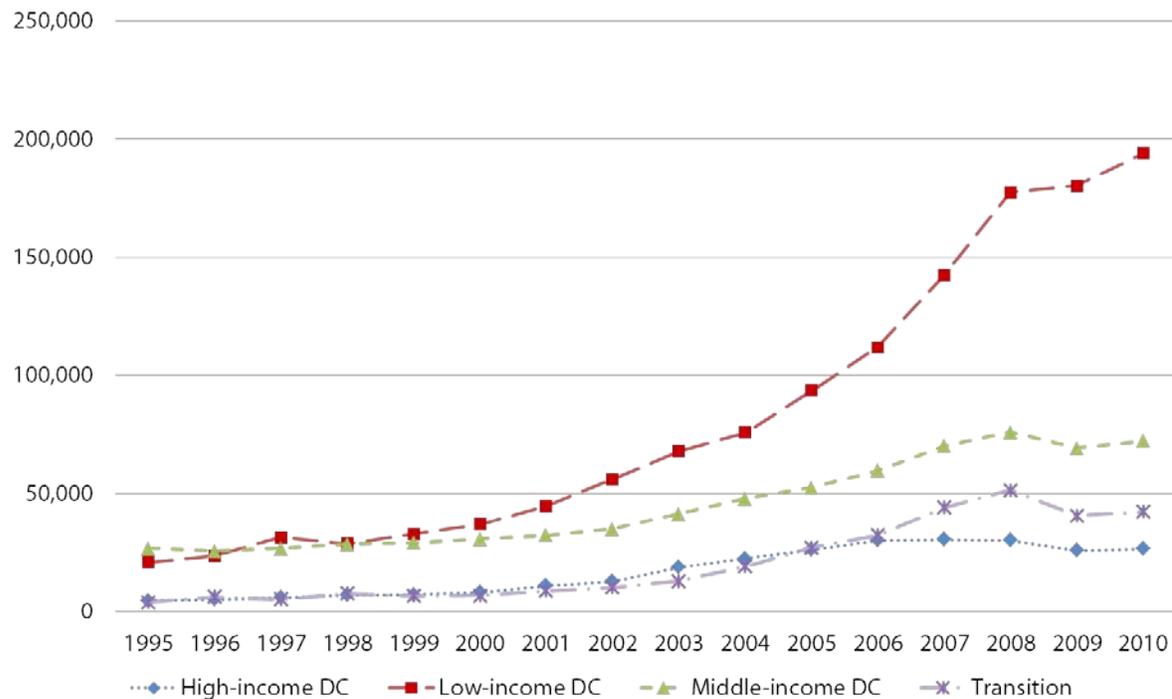
**Chart 4.1: Remittances received by advanced and developing countries, 1995–2010 (US\$ millions)**



**Source:** Calculated using data from World Bank, *Migration and Remittances Fact Book 2011*



### Chart 4.2: Remittances received by development status, 1995–2010 (US\$ millions)



**Source:** Calculated using data from World Bank, *Migration and Remittances Fact Book 2011*

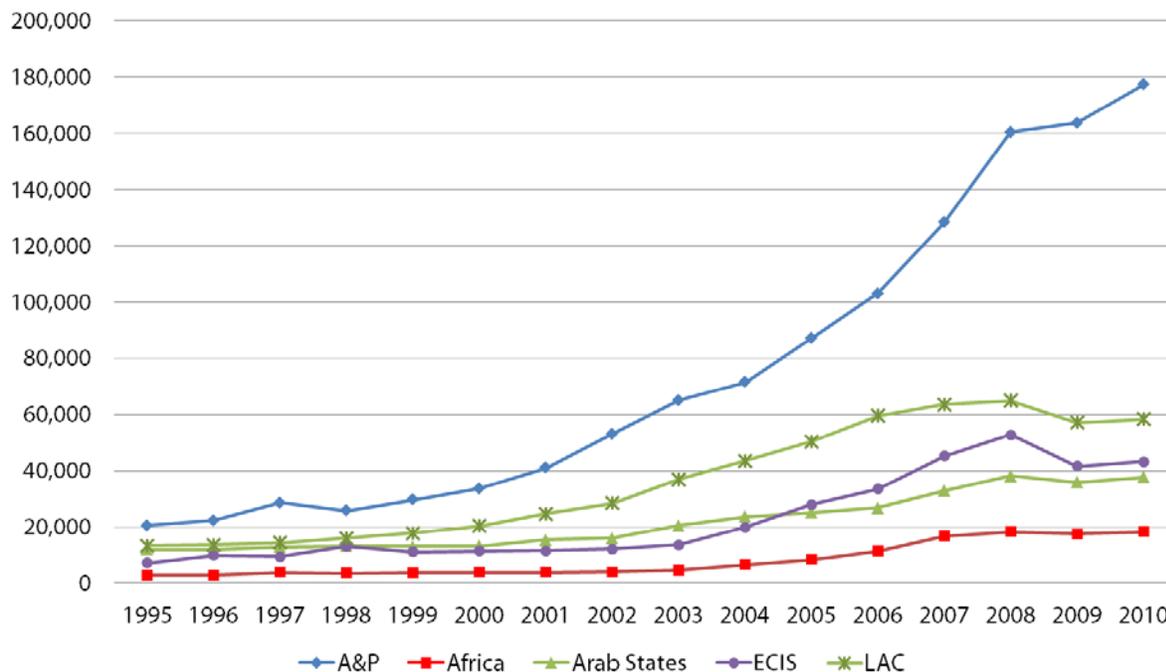
Poorer countries receive relatively larger remittances (Chart 4.2): the lower the average income in a country, the more likely that its citizens will seek to migrate and therefore the higher its remittance inflows will be. As of 2010, LICs received \$194 billion in remittances—that is, 58 percent of total remittances received by all developing countries in that year. Middle-income countries received \$72 billion (or 22 percent of total remittances), followed by transition economies (\$42 billion). High-income countries received only \$26 billion—or 8 percent of total remittances in 2010.

The group of transition countries experienced the biggest increase in remittance inflows during this period: remittance inflows rose from \$4 billion in 1995 to \$42 billion in 2010—a staggering 940 percent increase. The growth in remittances in LICs was also striking, increasing from \$21 billion in 1995 to \$194 billion in 2010 (an 830 percent increase).

By region (Chart 4.3), it appears that all developing regions received higher remittances between 1995 and 2010. The largest recipient region was Asia and the Pacific. In 2010, the region received \$177 billion (or 53 percent of total global remittances received by developing economies that year), followed by Latin America and the Caribbean, which received \$58 billion (or 17 percent of total global remittances to developing economies). The ECIS region received \$43 billion (13 percent of total global remittances) and the Arab States \$38 billion (11 percent of total global remittances). Africa received only \$18 billion (5 percent of total global remittances) in 2010.



**Chart 4.3: Remittances received by region, 1995–2010 (US\$ millions)**



**Source:** Calculated using data from World Bank, *Migration and Remittances Fact Book 2011*

The growth in remittances between 1995 and 2010 has been the fastest in Asia and the Pacific. From 1995 to 2010, remittances to the region increased by 763 percent, from \$21 billion in 1995 to \$177 billion in 2010. The second fastest growing region in terms of remittances inflows is Africa. Despite their relatively small share in total remittances, remittances to Africa increased by 545 percent from 1995 to 2010. The Arab States had the slowest growth in remittances among all developing region. Remittances to the Arab States increased by 213 percent, from \$12 billion in 1995 to \$38 billion in 2010. As a result, the Arab States region's share in total remittances was nearly halved during the period, from 21 percent in 1995 to 11 percent in 2010.

## The Growing Economic Importance of Remittances

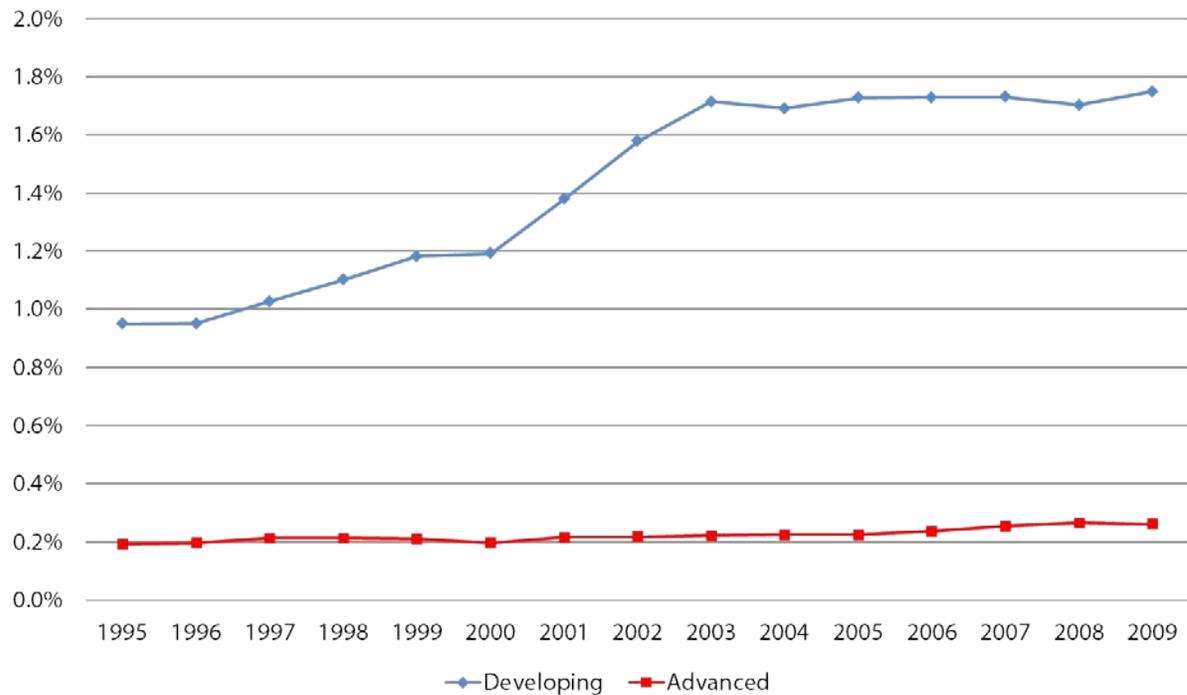
Not only have economic remittances increased in importance as a source of PCF, but they have also grown in importance relative to the size of the economy. As a share of GDP, remittances rose from 0.95 percent in 1995 to 1.75 percent in 2010, with much of the increase occurring between 1996 and 2003 (Chart 4.4).

Moreover, remittances as a share of GDP nearly doubled in all regions except for the Arab States (Annex 4.B). The biggest increase was in Africa, where remittances as a share of GDP increased from 0.9 percent in 1995 to 2 percent in 2009.

The Arab States had the highest remittance-to-GDP ratio during this period. As of 2009, remittances as a share of GDP were 3.1 percent in the Arab States region, 2 percent in both Africa and Asia and the Pacific and 1.4 percent in the ECIS region. In Latin America and the Caribbean, remittances represent only 1 percent of GDP.



### Chart 4.4: Remittances received as a share of GDP for advanced and developing countries, 1995–2009



**Source:** Calculated using data from World Bank, *Migration and Remittances Fact Book 2011*

The relative importance of remittances to the receiving economies is strongly correlated with the development status of each country. As Annex 4.C shows, low-income developing countries are more dependent on remittances, while high-income developing economies are less dependent. As of 2009, remittances represented 2.2 percent of GDP in low-income developing countries, 1.5 percent in MICs and 0.8 percent in high-income developing countries. In transition economies, remittances represented 1.7 percent of GDP.

*The relative importance of remittances to receiving economies is strongly correlated with the development status of the country. Low-income developing countries are more dependent on remittances, while high-income developing economies are less dependent.*

Remittances continued to increase in importance throughout the period in all developing groups, with the smallest increase in MICs and the biggest increase in transition economies. In transition economies, remittances as a share of GDP increased from 0.6 percent in 1995 to 1.8 percent in 2009; they were followed by the high-income countries, where remittances as a share of GDP increased from 0.3 percent to 0.8 percent in 2009. In low-income developing countries, remittances as a share of GDP increased from 1.3 percent in 1995 to 2.2 percent in 2010.

MICs are the only exception to the trend. After a period of rising relative importance of remittances from 1.4 percent in 1995 to 2 percent of GDP in 2003, remittances as a share of GDP declined to 1.5 percent in 2009.

**Table 4.1: Remittances as a Share of GDP, 2009**

Country	Region	Development Status	Remittances as a share of GDP, 2009 (%)
Tajikistan	ECIS	Transition	35.1%
Tonga	A&P	Middle-income DC	27.7%
Lesotho	Africa	Low-income DC	24.8%
Moldova	ECIS	Transition	23.1%
Nepal	A&P	Low-income DC	22.9%
Lebanon	Arab States	Middle-income DC	22.4%
Samoa	A&P	Middle-income DC	22.3%
Honduras	LAC	Middle-income DC	19.3%
Guyana	LAC	Low-income DC	17.3%
El Salvador	LAC	Middle-income DC	15.7%
Jordan	Arab States	Middle-income DC	15.6%
Kyrgyzstan	ECIS	Transition	15.4%
Haiti	LAC	Low-income DC	15.4%
Jamaica	LAC	Middle-income DC	13.8%
Bosnia and Herzegovina	ECIS	Transition	12.7%
Serbia	ECIS	Transition	12.6%
Bangladesh	A&P	Low-income DC	11.8%
Philippines	A&P	Low-income DC	11.7%
Albania	ECIS	Transition	10.9%
Togo	Africa	Low-income DC	10.3%

**Source:** Calculated using data from World Bank, *Migration and Remittances Fact Book 2011*

Since 2003, the share of total remittances in GDP of all developing countries has stabilized at around 1.75 percent. Yet, data at the national level reveals the extent to which several economies are highly dependent on such inflows. In 2009, remittances exceeded 10 percent of GDP in 21 developing economies (Table 4.1).

### The Stability and Countercyclicity of Remittances in the Context of External Economic Shocks

Historically, remittances have been stable and even countercyclical, tending to rise during times of financial crisis and natural disasters because migrants living abroad send more money to help their families back in places of origin.<sup>3</sup> “There is unambiguous, plentiful evidence that remittances function as a shock-absorber in low-income countries by providing critical income support after economic shocks, natural disasters and civil conflict” (Kapur 2004, World Bank 2006).



Indeed, much evidence points to the fact that remittances are less volatile to economic downturns as compared to FDI or Portfolio Equity. For instance, during the 2001 economic downturn, only remittances kept growing, whereas both FDI and portfolio equity declined. Evidence from Asia and the Pacific indicates that remittances in the region are relatively stable sources of external finance, compared with exports and non-FDI private capital inflows. “Throughout the 1990s, the standard deviation of the ratio of remittances to GDP is around 0.88 while that of exports and non-FDI PCF are 7 and 13 respectively” (UNESCAP 2007).

*Historically, remittances have been stable and even countercyclical, tending to rise during times of financial crisis and natural disasters because migrants living abroad send more money to help their families back in places of origin.*

Country-specific evidence validates these findings. For instance, remittances to Philippine households increased after the 1997 financial crisis (Yang 2003). They rose as a share of personal consumption in response to the financial crisis in Mexico in 1995 and in Thailand in 1997 and continued to rise as a share of personal consumption after natural disasters in Bangladesh, the Dominican Republic, Haiti and Honduras (Gabel 2007). They increased in Albania shortly after the economic and political crisis of 1997 and fuelled a recovery in the economy by 1998 (Korovilas 1998). Remittances also increased during Hurricane Mitch in Central America, and they were a critical means of support for the vulnerable during Lebanon’s civil war (Ratha 2007, Kapur 2004).

In fact, for the first time since the 1980s, remittances to developing countries declined in 2009.<sup>4</sup> In the aftermath of the global economic crisis, remittances declined by 5.5 percent in 2009 from their 2008 peak of \$324 billion. Still, the decline in remittances during the global financial crisis was modest, compared to a 40 percent decline in FDI between 2008 and 2009 and an 80 percent decline in private debt and portfolio equity flows from their peak in 2007 (Mohapatra et al. 2010). According to World Bank estimates, remittances were expected to totally recover by 2010.

Strikingly, the recession in 2009 did not cause a decrease in remittances to Asia and the Pacific. Despite the overall 5.5 percent decline in remittances between 2008 and 2009, remittances to Asia and the Pacific actually increased by 2 percent. On the other hand, remittances to Latin American and Caribbean countries declined by 12 percent between 2008 and 2009. The degree of resilience to the crisis is dependent on the source countries that the migrants are sending money from. Most Latin American and Caribbean remittances come from migrants in the United States, where the crisis originated and was most severe. On the other hand, migrants from Asia and the Pacific are sending remittances from many source countries, including countries from the rich oil exporters of the GCC, Europe and North America.

Another example of concentration in the source of remittances can be found in the ECIS region, where remittances declined by 21 percent between 2008 and 2009 on account of the crisis. Most ECIS remittances came from the Russian Federation and Europe, the economies of which were disproportionately affected by the economic crisis of 2007–2008. In other words, a diversification in the destination of migrants increases the resilience of remittances to economic downturns.

The relative resilience of remittance flows in the context of economic crises has also been noted for Africa. “The crisis threatens to reverse the continent’s recent progress in attracting public and private capital inflows. While private financial flows held their ground in 2008, the continent will see a substantial decline in 2009



due to the economic downturn. The one relatively bright spot in this picture is that remittances appear to be relatively more resilient to the economic downturn” (AfDB 2009).

## Remittances, Economic Growth and Poverty Reduction

Given the growing importance of remittances as a source of PCF, these flows could potentially become an important tool for economic development, especially if they can be channelled into productive investment (Ratha 2007).<sup>5</sup> From a macro-economic perspective, it is increasingly accepted that remittances can generate output growth either by increasing consumption or by increasing investment.<sup>6</sup> In this context, the positive multiplier effects of remittances may well promote growth, as, for instance, when remittances are used to purchase domestically produced goods and services (Stahl and Arnold 1986, Stahl and Habib 1989, Glytsos 1993, Das and Serieux 2010).<sup>7</sup> The ability of households to spend on health, housing and nutrition can also enhance their productivity and spur economic growth over the longer term.

Other studies have shown that remittances have been important in generating output growth by increasing investment in countries with less developed financial sectors. The reason for this is that many migrants invest their savings in small businesses, real estate or other assets in their own countries and therefore support local markets. In economies where the financial system is underdeveloped, remittances may alleviate credit constraints and act as a substitute for financial development (Giuliano and Ruiz-Arranz 2006, UNESCAP 2007). In other words, remittances in these countries have provided an alternative means for financing investment and reducing liquidity constraints. “Remittances make a significant contribution to savings and investment in island economies such as Samoa and Tonga” (Brown 1994); in Tunisia, workers who have limited access to the financial market tend to use such remittances to invest (Mesnard 2004). In short, to the extent that economic remittance transfers finance health, education and increase investment, they could have a positive effect on economic growth.

*Given the growing importance of remittances as a source of private capital flows, these flows could potentially become an important tool for economic development, especially if they can be channelled into productive investment.*

However, large remittance inflows, like any other foreign currency inflows, can cause an appreciation of the real exchange rate and raise the price of traditional exports, while making imports more expensive. Although empirical evidence of such ‘Dutch Disease’ effects of remittances is still lacking, the impact is likely to be large in small economies. For instance, some countries, including El Salvador, Kenya and Moldova, are worried about the effects of large remittance inflows on currency appreciation. Several studies have suggested that, since workers’ remittances are mainly used for consumption purposes, they have a minimal impact on investment.

To date, the empirical evidence of the impact of remittances on economic growth appears mixed and is difficult to predict *a priori*. For instance, results for a sample of 39 developing countries covering the period 1980–2004 indicate a positive impact on economic growth (Pradhan et al. 2008). A study examining the aggregate impact of remittances on the economic growth of 18 Latin American countries for the period 1980–2005 found that remittances positively and significantly affected the growth of Latin American economies where the financial systems are less developed by providing an alternative way to finance investment and helping overcome liquidity constraints (Fayissa and Nsiah 2010). There were similar results for 37 African countries for the period 1980–2004 (Fayissa and Nsiah 2008).



On the other hand, empirical assessments on the impact of workers' remittances on growth and poverty reduction in developing Asia-Pacific countries for the period 1993–2003 found that, “while remittances do have a significant impact on poverty reduction through increasing income, smoothing consumption and easing capital constraints of the poor, they have only a marginal impact on growth operating through domestic investment and human capital development” (UNESCAP 2007). While not denying the poverty-alleviating and consumption smoothing effects of remittances on recipient households, other studies find no impact on economic growth (IMF 2009).

More recently, it has been suggested that, by boosting foreign exchange receipts, remittances have allowed LICs to maintain adequate foreign reserves and service debt.<sup>8</sup> “Remittances have helped to build up international reserves and have contributed to reducing current account deficits in many developing countries. This has provided a cushion against external shocks during the global crisis. In LICs, the current account deficit as a percentage of gross domestic product (GDP) would have more than doubled in the absence of remittances in recent years. For some large remittance recipient countries such as the Philippines, Bangladesh, Nepal, remittance flows have offset large trade deficits and enabled these countries to maintain a current account surplus” (Mohapatra et al. 2010).

Further, remittances are now factored into sovereign ratings in MICs and in the debt sustainability analysis<sup>9</sup> for LICs. For instance, in large remittance recipient countries, country creditworthiness analysis by major

## **Box 4.1: Diaspora Bonds as a Source of Financing during Difficult Times**

In the current environment of a severe crisis of confidence in debt markets, several developing countries are encountering great difficulty in obtaining private financing using traditional financial instruments. This scarcity of capital threatens to jeopardize long-term growth and employment generation in developing countries, many of which have limited access to capital even in the best of times. Official aid alone will not be adequate to bridge short- or long-term financing gaps. Ultimately, it will be necessary to adopt innovative financing approaches to target previously untapped investors. Diaspora bonds are one such mechanism whereby developing countries turn to borrowing from their expatriate (diaspora) communities. A diaspora bond is a debt instrument issued by a country — or potentially, by a sub-sovereign public or private entity — to raise financing from its overseas diaspora. In the past, diaspora bonds have been used by India and Israel to raise over \$35 billion of development financing. The proceeds from these bonds were used to support balance of payments needs and finance infrastructure, housing, health,

and education projects. Several countries — for example, El Salvador, Ethiopia, Nepal, the Philippines, Rwanda and Sri Lanka — are considering (or have issued) diaspora bonds recently to bridge financing gaps.

Diaspora bonds are a stable and cheap source of external finance for countries, especially in times of financial stress. For the diaspora investors, these bonds offer the opportunity to help their country of origin while at the same time offering an investment opportunity. In addition to being motivated by patriotism, diaspora members are usually more interested than foreign investors in investing in the home country. However, in countries that have weak governance and high sovereign risk, diaspora bonds may require support for institutional capacity-building and/or credit enhancement from multilateral or bilateral agencies. Compliance with securities and exchange regulations overseas can also be cumbersome in some migrant-destination countries.

**Source:** Mohapatra, Sanket, Dilip Ratha and Anil Silwal, 2010, ‘Outlook for Remittance Flows 2011-12: Recovery after the crisis, but risks lie ahead’, Migration and Development Brief 13, Migration and Remittances Unit, World Bank, Washington, DC.



rating agencies such as Standard & Poor's (S&P) and Moody's often cite remittances as a factor in their rating decisions. The stability of remittances to the Philippines was an important factor in its ability to issue a \$750 million bond despite the global financial crisis. Bangladesh was rated for the first time in 2010, receiving a BB rating from S&P, similar to that of many emerging markets. Again, the rating agencies cited the high share of remittance flows in GDP and their high growth rate as one of the important factors for their rating decisions.

As countries have become aware of remittances functioning as a stable source of foreign currency earnings, many countries have started looking at their diaspora for potential sources of capital that could be tapped through the issuance of diaspora bonds. Countries such as El Salvador, Ethiopia, Nepal, the Philippines, Rwanda and Sri Lanka have issued or are considering the issuance of diaspora bonds (Ratha 2007, Mohapatra et al. 2010).

## Policy Options for Building Resilience: Leveraging Remittances for Development

Given the size and stability of remittance inflows as well as their countercyclical behaviour in the face of external shocks, recent policy attention has focused on mobilizing remittances to leverage growth and poverty dividends and also to cushion the impact of external shocks. Specifically, the focus has been on policies to monitor and analyse the impact of remittance receipts, to develop retail repayment systems, to reduce transactions costs for remittance transfers, and to develop strategies to intermediate these resources through the formal financial system and channel them into productive investment.

### *The Monitoring, Analysis and Projection of Remittance Inflows*

Monitoring and analysing remittance inflows includes understanding the size, corridors, channels and costs of remittance flows and the cyclical behaviour of these flows, analysing remittances' impact on poverty, inequality,

### **Box 4.2: Monitoring Remittance Inflows**

Governments in every geographical region face increasing pressure to better monitor the transfer of economic remittances from and into their countries. On the one hand, it is ever more important to impede the flow of money that may be laundered or used to fund terrorist activities. On the other hand, flows of foreign funds should be facilitated to reach impoverished communities and protected from undue restrictions, high fees, and delays. Central banks across the world have invested in making the process more transparent and ensuring that proper channels exist for all communities to increase the ability of remittances to promote development and to save families from extreme poverty.

For instance, examples from Malaysia show that opening the banking system to immigrants and implementing legislation that protects consumers and banks is good policy in legalizing transfers from the country and therefore preventing money-laundering. At the same time, Indonesia has created legislation to help banks to receive remittances and to discourage the use of money-changers, who may not act fully within the law or may charge high fees. Similarly, the United Republic of Tanzania has started to monitor remittances more carefully while making the process more transparent and making the information available to the public in order to ensure that there is sufficient collaboration between different parts of national



## Box 4.2: Monitoring Remittance Inflows (contd.)

administration; consequently, the system is more reliable and secure for all. In October 2010, the Bank of Tanzania released information for the 2005–2008 fiscal years.

Elsewhere in Africa, the Bank of Uganda, in partnership with the Uganda Bureau of Statics, announced in 2011 that it has started the third national household survey to collect data on money and other items remitted from workers in the diaspora. In 2006 and 2008, Uganda also conducted comprehensive National Household Workers' Remittances Surveys on money sent home by Ugandans living and working outside the country. The survey, published in 2009 with information from the previous year, covered 4,080 households located throughout the country. The Surveys measure remittances with regard to, *inter alia*, value, type (cash or kind), amounts, source countries, transmission channels and flow patterns. "The latest survey found that

remitters cut across all age groups, but are mainly in the 20–49 years age range. The majority of remitters (69.6%) have lived abroad for periods of 10 years and less. The bigger proportion of remitters (64%) was married, while 29.6% were in the never married category. Most remitters (86.2%) attained a qualification of secondary school level and beyond. The bigger proportion of households (36.9%) indicated that remitters were based in Europe, which was followed by Africa (29.0%) and North America (24.5%). 93.0% of remitters are in the 'working' category." Already in 2010, the Bank of Uganda had forecasted an increase of over 16 percent in remittances into the country, most of them specially coming from immigrants in the United Kingdom, the United States and South Africa, in which the World Bank has denominated the strongest remittances corridors into Uganda.

**Source:** Hernandez-Coss, Raul, 2008, 'The Malaysia-Indonesia Remittances Corridor: Making formal transfers the best option for women and undocumented migrants', World Bank Working Paper No. 149, World Bank, Washington, DC.; Information on Uganda's household level surveys can be found online on the Bank of Uganda website: [www.bou.or.ug/bouwebsite/opencms/bou/rates\\_statistics/statistics/trade\\_remittances.html](http://www.bou.or.ug/bouwebsite/opencms/bou/rates_statistics/statistics/trade_remittances.html); World Bank, 2010, *Uganda's Remittance Corridors from United Kingdom, United States and South Africa: Challenges to Linking Remittances to the Use of Formal Services, 2010*, World Bank, Washington, DC.; Bank of Uganda, 2008, *Uganda: Workers' Remittances Report, Inward Remittances 2008*, p. iv.

education, health care and investment in remittance recipient countries and analysing policy factors that affect remittance costs, such as entry barriers and exclusivity contracts affecting market competition.

### Developing Retail Payment Systems

Changes in the payment system relating to personal remittances impact all retail or small-value payments. Items in this category include new payment platforms or instruments (including card-based, cell phone-based, or internet-based remittance instruments), prudential capital requirements and regulations governing access of remittance agents to clearing and settlement systems, and the disclosure of remittance fees. Interestingly, Africa is now at the forefront of mobile money transfer technologies. For instance, Kenya's M-Pesa now has more than 9 million subscribers. While M-Pesa is mostly focused on domestic money transfers in Kenya, with a small pilot scheme for UK-Kenya remittances, a Kuwaiti mobile operator Zain has expanded to 15 African countries and now has 42 million subscribers. It offers Zain Zap, or mobile remittance service, which offers, in addition to money transfers, other services such as payment for bills and groceries (Mohapatra et al. 2010).

New remittance technologies are also being adopted in South Asia. In Bangladesh, Banglalink, the second largest mobile operator in Bangladesh, is launching a mobile remittance services in partnership with several



### Box 4.3: Developing Retail Payment Systems

Partnerships between banks and telecommunication companies have the potential to give millions of mobile subscribers access to national banking systems. The development of more secure, faster and reliable technologies increases the capacity of companies to provide services to people who previously have been disenfranchised due to inflexibility in the banking system. By bringing the bank into the mobile device, it is possible to integrate rural residents as well as urban customers who otherwise have no access to a bank.

Since 2010, Banglalink, the second largest mobile operator in Bangladesh, has partnered with banks, providing services to immigrant Bangladeshi nationals in Europe, the Gulf States, the United States and Australia to send remittances back home for easy access by family members at one of the company's thousands of 'cash points' in Bangladesh. The service reduces the transfer time from the current four to five days to just one day.

This example of partnership extends beyond the use of new technologies and has the potential to curtail money-

laundering and other illicit activities, such as the need to use informal channels for exchange of foreign currency. The money that is remitted back to Bangladesh is conveniently stored in an e-wallet that can then be accessed to withdraw cash or be used for online payments.

Bangladesh is one of the largest exporters of manpower resources, with an expatriate population of 7 million people as of 2010. Money remitted back home by migrants is one of the largest sources of foreign currency. Barriers to financial services for the rural population, who are the major beneficiaries of the migrant workers' earnings and who constitute 90 percent of the population, hinder remittance inflows through formal money transfer channels. In 2010, remittance inflows contributed \$10 billion in foreign exchange annually, or 9 percent of Bangladesh's GDP. However, 40 percent of remittance inflows bypass formal channels primarily because of asymmetries in access to retail payment infrastructure.

**Source:** Rahman, Atiur, 2010, *Inauguration of Dhaka Bank-EBL-Banglalink: Mobile Phone Based Remittance Service*, 13 April, Bangladesh Bank.

Bangladeshi banks. These banks will offer 'mobile wallet' accounts through Banglalink and Banglalink distribution outlets will be used as remittance disbursement cash points.

### Reducing Transactions Costs for Remittance Transfers

Reducing remittance fees would increase the disposable income of migrants, boost their incentives to send money home, and encourage the use of formal remittance channels. The cost of sending remittances tends to be high and regressive. Although a typical poor migrant sends about \$200 or less per transaction, the average cost through the top three money transfer operators (such as Western Union) can be as high as \$18. In other words, these fees are highly regressive because the smaller remittances sent by poor migrants cost more per dollar sent. Although remittance costs have been declining in recent years, they have remained sticky since 2006. However, the recent global crisis has intensified efforts to reduce remittance costs and leverage remittances for improving financial access. As a result, many banks and operators are cutting fees (Ratha 2007).

Furthermore, South-South remittance costs are higher than North-South remittance costs, even though nearly half of the migrants from the South live in the South. Yet, South-South remittances remain costly due to capital and exchange controls or because currency conversion charges are payable at both ends.



## Box 4.4: Lower Transactions Costs for Remittances

The call to lower fees for monies being remitted has been at centre stage of discussions on South-South migration. This is to be expected, as costs of South-South remittances are even higher than those of North-South remittances because of a lack of competition in the remittance market, a lack of financial development in general, and high foreign exchange commissions at both ends of the transaction.

On average, the cost of sending money to Latin America and the Caribbean has been cut in half since 2000 due to greater competition and the adoption of new technologies for this

service. The average total costs for migrant remittances are higher than the global average in countries in East Asia and Pacific, sub-Saharan Africa, and the Middle East and North Africa (MENA) regions.

While countries such as China, Nicaragua, Bangladesh and Costa Rica have established mechanisms to target these issues, the vast majority of remittances from migrants residing in other countries of the global south still face onerous charges on their transactions.

**Source:** World Bank, 2001, *Migration and Remittances Factbook 2011*, World Bank, Washington, DC.; Monge-González, Ricardo, Oswald Céspedes-Torres and Juan Carlos Vargas-Aguilar, 2009, *South-South Remittances: Importance of the Costa Rica-Nicaragua Corridor*, Academia de Centroamérica, San Jose, Costa Rica.

### *Financial Access of Individuals and Households*

While financial intermediaries like banks, credit unions and savings banks can help deliver remittances, they can also benefit by offering remittance services that may attract new customers and then encourage them to save and invest. Besides encouraging savings from remittances, these financial intermediaries can develop remittance-linked consumer or housing loans and insurance products.

Encouraging remittances through banking channels can improve the impact of remittances on development by encouraging more savings (cash remittances are less likely to be saved than direct bank deposits) and enabling better matching of savings with investment opportunities. For many poor households, remittances are the only point of contact with the formal financial sector. Both sending and receiving countries can give migrants more access to banking by allowing country of origin banks to operate overseas and by providing identification cards (such as the Mexican Matricula Consular) that are accepted by banks to open accounts. Access to remittance services in rural and remote areas can be improved by encouraging the participation of savings banks (including postal savings schemes) and credit unions in the remittance market. Existing regulations may need to be amended to allow these institutions to more fully participate in the provision of remittance services.

### *Leveraging Remittances for Capital Market Access of Financial Institutions or Countries*

Large and stable remittance inflows undoubtedly improve a country's creditworthiness and thereby the creditworthiness of sub-sovereign entities as well. Hard currency remittances, properly accounted, can significantly improve country-risk rating and thereby lower the cost of borrowing money in international markets. The ratio of debt to exports of goods and services (a key indicator of indebtedness) would increase significantly if remittances were excluded from the denominator.



#### Box 4.5: Access to Financial Services

In the last 20 years, it has become increasingly important to improve access to financial services for migrants abroad while ensuring that their remittances are captured within the national financial systems to impede money-laundering and other illegal activities. Governments in countries of origin and destination have set up regulations that give migrants access to savings and banking systems. Innovative examples can be found around the world, but practices involving countries of origin that help their migrants abroad to better navigate host country institutions are particularly noteworthy.

Since 1969, the Government of Morocco, in conjunction with the Banque Centrale Populaire, increased its presence abroad, particularly in France, to give Moroccan migrants access to financial services. Under the scheme of 'Bancarization' — to engage the diaspora and provide better options abroad — the bank opened branches in the suburbs of Paris and also institutionalized the use of 'post office checks' that were easily accessible in French post offices for the transmission of remittances to the migrants' communities of origin.

Most recently, the governments of Mexico and other Central American countries have also initiated programmes to ensure that their migrants abroad, especially in the

United States, have access to the banking systems of the host countries. The Government of Mexico, through its vast network of consulates in the United States, has been issuing high-security identifications to its nationals for the past 10 years. This identification, known as *Matricula Consular*, is a means of identification for a population that otherwise may not have any proof of citizenship, name, age, or address.

Some financial institutions recognize the *Matricula Consular* as a valid form of identification to open checking and savings accounts. This gives Mexican nationals access to banking services and enables them to benefit from financial instruments that cater especially to migrants. It also increases the potential of those new customers to build credit histories and eventually benefit from loans to open businesses and/or to buy property. The Mexican *Matricula Consular* has also benefited migrants by giving them a means of identification that is widely recognized by law enforcement, government institutions, and businesses as a secure and reliable document backed by the Mexican government.

Other governments, including El Salvador, have created similar identification cards that can be used in the country of destination, but also in El Salvador, as a proof of foreign residency.

**Source:** Délano, Alexandra, 2011, *Mexico and its Diaspora in the United States: Policies of Emigration since 1848*, Cambridge University Press, New York; Iskander, Natasha, 2010, *Creative State: Forty Years of Migration and Development Policy in Morocco and Mexico*, Cornell University Press, New York.

Banks in many countries have used future remittances as collateral for raising significant bond financing from international markets. The interest spread on these bonds was lower and the tenor was higher than comparable plain sovereign bonds. Some estimates show that the potential for such bond financing remains untapped, especially in many poor countries that also receive significant remittances. The funds raised from these bonds can be targeted to specific development projects.

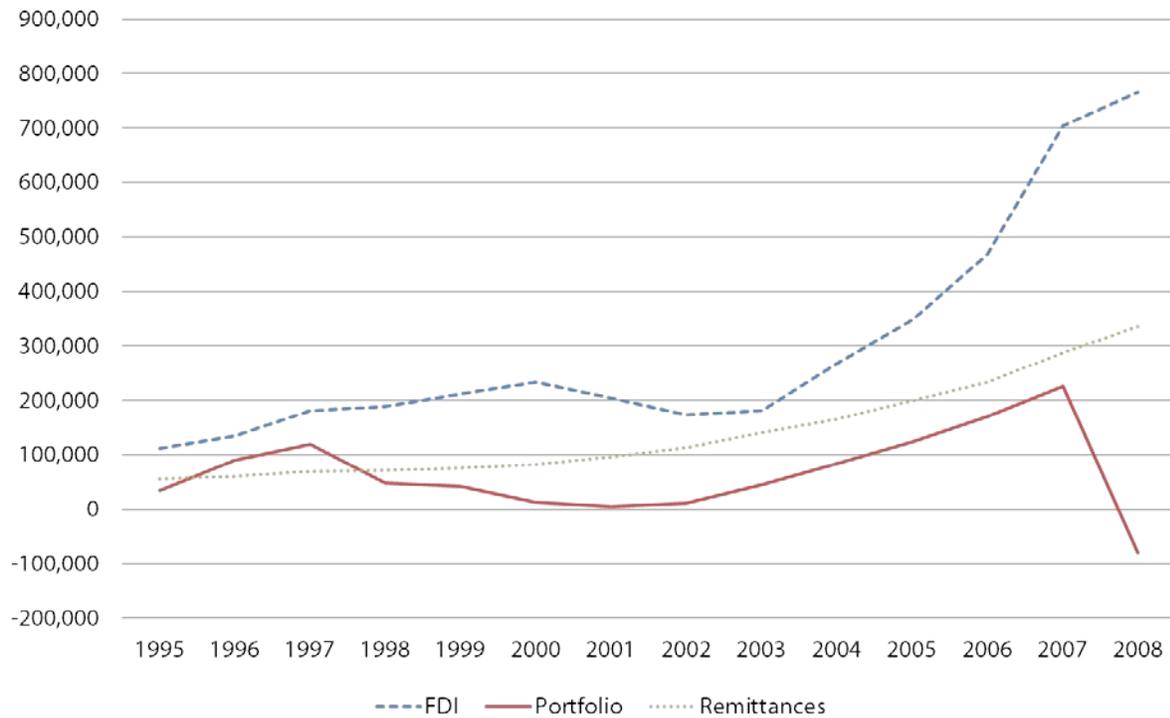


## Notes

1. Remittances are the sum of workers' remittances, compensation of employees and migrants' transfers. They are classified as current private transfers from migrant workers resident in the host country for more than a year, irrespective of their immigration status, to recipients in their country of origin; compensation of employees is the income of migrants who have lived in the host country for less than a year; migrants' transfers are defined as the net worth of migrants who are expected to remain in the host country for more than a year (IMF 1993).
2. Defined as the sum of FDI, PI and remittances.
3. Remittances tend to rise when the recipient economy suffers a downturn in activity, an economic crisis, natural disaster or political conflict, as migrants may send more funds during hard times to help their family and friends.
4. It has been argued that the decline in remittances has both short- and longer-term effects on poverty and growth. Over the longer term, a fall in workers' remittances has an adverse direct influence on domestic demand. For instance, in LDCs, "the average income of families whose source of income is remittances is often higher than the average family income of workers who are engaged in the domestic sector or are unemployed. Thus, the reduction in remittances directly affects the domestic demand for manufactured goods" (Shaffaeddin 2009).
5. The traditional 'sterilization' techniques used to prevent currency appreciation due to natural resource windfalls, however, is not appropriate for addressing currency fluctuations due to remittances. The reason for this is that, unlike oil windfalls, remittances persist over long periods. Trying to sterilize their impacts year after year can be very costly.
6. However, large outflows of workers (especially skilled workers) can reduce growth in the country of origin; remittances may also induce recipient households to choose more leisure than labour, with adverse effects on growth. Since the effects of remittances on human and physical capital are realized over a longer period of time, in the short to medium run, the effect of remittances on growth may be mixed.
7. On the other hand, if remittances are used to purchase imported goods, the impact of remittances on economic growth may be limited.
8. However, remittances that are used to finance reverse flows are no longer available for consumption or investment. This would appear to limit the potential growth effect.
9. The joint WB/IMF low-income country Debt Sustainability Framework now allows for a more explicit consideration of remittances in evaluating the ability of countries to repay external obligations and their ability to undertake non-concessional borrowing from private creditors. The debt-to-export ratio, a key factor in sovereign ratings, would be lower if foreign exchange revenues from remittances were factored into calculations. Many IMF Article IV assessments of countries' economic performance now include remittances as a variable alongside FDI and portfolio flows.



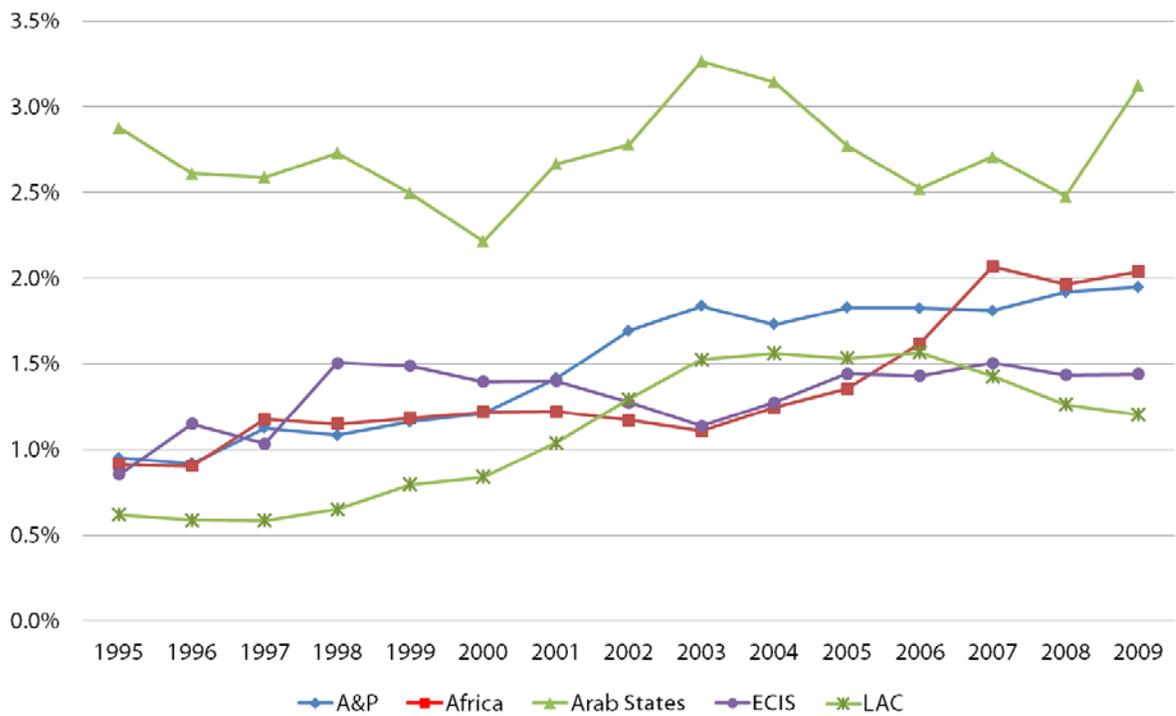
**Annex 4.A: FDI, Portfolio and Remittances Inflows to Developing Countries, 1995–2008 (US\$ millions)**



**Source:** Calculated using data from World Bank, *Migration and Remittances Factbook 2011*



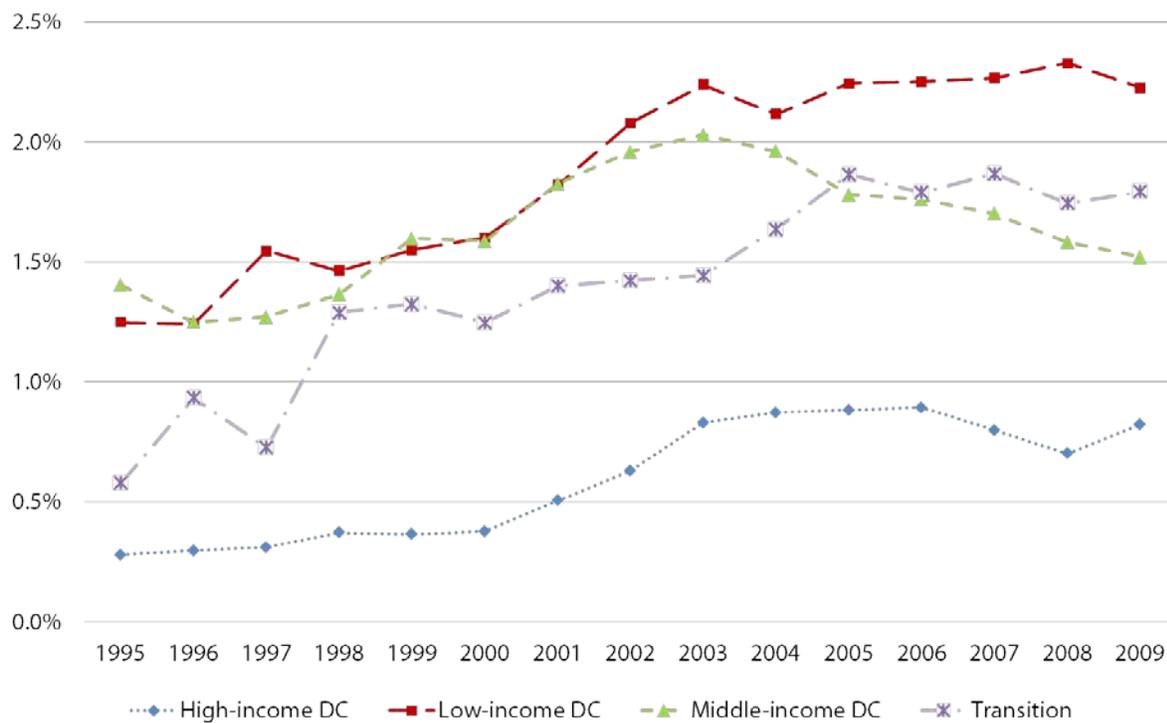
## Annex 4.B: Remittances Received as a Share of GDP by Region, 1995–2009



**Source:** Calculated using data from World Bank, *Migration and Remittances Factbook 2011*



**Annex 4.C: Remittances Received as a Share of GDP by Development Status, 1995–2009**



**Source:** Calculated using data from World Bank, *Migration and Remittances Factbook 2011*



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# 5

## OFFICIAL DEVELOPMENT ASSISTANCE



*Interest in Official Development Assistance has increased markedly over the last decade. This has been generated in large part by international attention towards the MDGs.*



Photo: Quocnguyen/UNDP, Viet Nam



## Introduction

Interest in Official Development Assistance (ODA) has increased markedly over the last decade. This has been generated in large part by international attention towards the MDGs. The United Nations Millennium Declaration explicitly recognized the role of ODA in the development process and committed industrialized countries to “grant more generous development assistance” (UN 2000). The International Conference on Financing for Development held in Monterrey, Mexico in 2002 reiterated this view and recognized that “a substantial increase in ODA”, *inter alia*, would be required to achieve the MDGs (UN 2002). These international agreements have helped to increase the political momentum for aid following a substantial weakening during the 1990s. In 2010, net ODA flows from members of the Development Assistance Committee (DAC) of the OECD reached \$128.7 billion, the highest level ever in nominal terms (OECD-DAC 2011).<sup>1</sup>

For some developing countries, especially the LDCs and some SIDS, ODA is a major source of external finance when measured as a percent of GNI, on a per capita basis or as a proportion of the government budget; for other developing countries, ODA is of little significance. For instance, in 2008, net ODA flows constituted more than 10 percent of GNI in 26 developing countries.<sup>2</sup> Most of these are either LDCs or SIDS. Several

post-conflict countries are also recipients of substantial amounts of aid. For 31 countries, mostly middle-income, net ODA flows represented less than 0.5 percent of GNI in 2008 (author calculations based on data in World Bank, World Development Indicators 2010). Some of the poorest resource-scarce countries, as well as some small islands, attract little FDI and are not able to access finance on international capital markets in the same way as many other developing countries can. Thus, aid flows become all the more important as a source of foreign exchange and development finance.

*A dependence on aid is akin to ‘putting all one’s eggs in the same basket’ and leaves countries exposed to sharp fluctuations in the overall volume of aid as well as donor preferences in terms of the purposes to which aid is put.*

For a subset of developing countries, a high degree of dependence on aid accentuates macro-economic vulnerabilities and may also be a contributory factor in the overall sustainability of the MDGs. A dependence on aid is akin to ‘putting all one’s eggs in the same basket’ and leaves countries exposed to sharp fluctuations in the overall volume of aid as well as donor preferences in terms of the purposes to which aid is put.

There are four broad avenues through which dependence on aid can influence sustainability of the MDGs:

- 1. Degree of dependency on aid:** Where countries are heavily dependent on aid (measured as a proportion of government revenues, on a per capita basis or as a percent of GNI), governments remain vulnerable to sharp fluctuations in aid flows. In some cases, countries may not be especially dependent on aid, but certain sectors within a country may rely heavily on aid to function and thus are vulnerable (e.g., the health sector).
- 2. The procyclicality of aid:** Where aid is procyclical, it can exacerbate rather than mitigate the impacts of business cycles and/or extreme weather-related shocks. Where aid is countercyclical, it can have an important smoothing or insurance function. The empirical evidence suggests that, on average, aid is procyclical.



3. **The volatility of aid:** Where aid is volatile or unpredictable, recipient governments are less able to plan expenditures effectively. This raises the costs of financial management and can worsen the composition of government spending (e.g., divert resources from capital investment towards recurrent expenditure). However, it should be noted that not all volatility in aid is necessarily negative; volatility in aid can be associated with aid shortfalls and aid windfalls.
4. **The uses of aid:** While the headline ODA figure suggests substantial increases in aid over the last decade, this masks the extent to which relatively little aid actually reaches recipient countries overall. Some sectors (e.g., the social sectors) have seen larger increases in aid than others (e.g., agriculture and the productive capacities). However, the evidence shows that much aid has had little meaningful impact on development outcomes and the MDGs.

These problems are well known and have inspired a number of international efforts aimed at addressing them, such as the Paris Declaration on Aid Effectiveness of 2005 and the Accra Agenda for Action of 2008, both under the auspices of the Organisation for Economic Co-operation and Development (OECD).<sup>3</sup> These international agreements, endorsed by many donors, recipient countries and international organizations alike, aim to improve the effectiveness of aid through a pre-defined set of actions to be undertaken by both donors and recipients. Progress, however, has so far been mixed.<sup>4</sup>

Policy responses to secure sustainability of the MDGs in aid-dependent countries must therefore seek to address the concerns cited above. This will necessarily involve actions by aid recipient countries and aid providers.

This chapter provides a broad overview of current dynamics in international development cooperation. It continues with an analysis of the specific avenues through which aid influences sustainability of the MDGs. The chapter concludes with a series of policy recommendations at the donor-and recipient-country levels to improve aid's contribution to the development process, with a particular focus on measures to safeguard MDG progress.

### Setting the Scene: Aid at a Glance

The ODA landscape has changed markedly over recent years in relation to how much aid is provided, by whom, to which countries, through which modalities, as well as the purposes to which it is put. In 2010, net ODA from members of DAC of the OECD reached \$128.7 billion, the highest real level of ODA ever (OECD-DAC 2011). Since 2000, ODA from OECD-DAC members has increased from \$53.9 billion (current prices), an increase of almost two and a half times (OECD-DAC 2010).

Non-OECD-DAC donors have also increased aid levels significantly. Indeed, 'South-South cooperation' (SSC) has become much more prominent over the last decade, as rapid economic growth by many major developing countries has led to a greater role in international affairs. Estimates of total South-South cooperation stand at about \$15.3 billion in 2008 (in current prices), or 9.5 percent of total development cooperation (UN DESA International Development Cooperation Report 2010). The largest developing country providers of development aid are China, Saudi Arabia and the Bolivarian

*The ODA landscape has changed markedly over recent years in relation to how much aid is provided, by whom, to which countries, through which modalities, as well as the purposes to which it is put.*



Republic of Venezuela (at about \$2 billion each in 2008) and India (\$750 million in 2008). In 2008, the top three providers accounted for about 75 percent of total South-South development cooperation (UN DESA 2010).

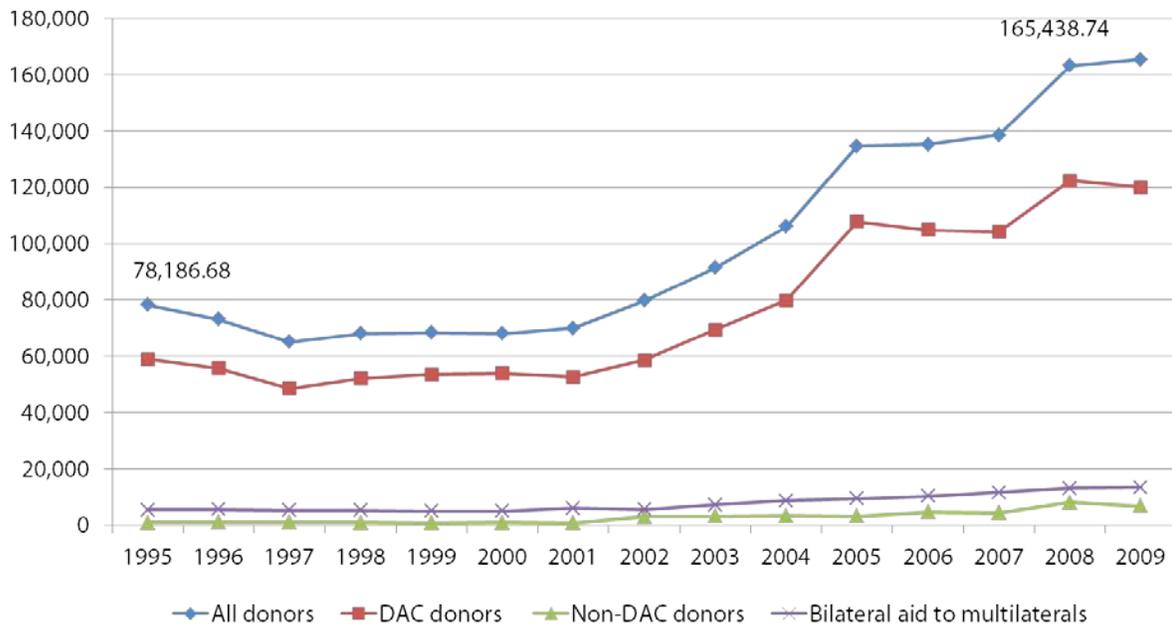
When measured as a proportion of donors' GNI, however, a somewhat different picture emerges. ODA from OECD-DAC donors has increased only marginally since 1995, from 0.26 percent in 1995 to 0.32 percent in 2010 (OECD-DAC 2011). ODA as a percent of GNI was at its lowest in 1997, at just 0.22 percent (OECD-DAC 2010).

Indeed, only a handful of international donors have reached the longstanding UN target of 0.7 percent ODA/GNI (Denmark, Belgium, Luxembourg, the Netherlands, Norway and Sweden in 2011) (OECD-DAC 2010). Although a number of other more 'modest' commitments to increase aid also exist (e.g., by the G8 in 2005 to increase ODA by "around \$50 billion per year by 2010, compared to 2004" and the EU commitment to a collective EU target of 0.56 percent ODA/GNI by 2010), these have been squarely missed. The OECD-DAC reported that, in 2010, total ODA fell approximately \$18 billion short of the commitments made at the G8 Summit in 2005 (in 2004 prices and exchange rates); \$125 billion was committed, but only \$103 billion was actually delivered (OECD-DAC 2010).<sup>5</sup> When measured against the UN target of 0.7 percent ODA/GNI, ODA fell short by \$153 billion in 2009 (in 2004 dollars) (UN MDG Gap Task Force 2010).

Although much lower in absolute terms, ODA provided by so-called 'emerging' donors has increased sharply over the last decade, and especially the last five years. The chart below illustrates the sharp rise in development cooperation from the following emerging donors: the Czech Republic, Hungary, Iceland, Poland, Slovak Republic, Turkey, Taiwan, Israel, Slovenia, Thailand, United Arab Emirates.

For 'traditional' OECD-DAC donors, the OECD recently projected slower aid growth ahead.<sup>6</sup> Global CPA is predicted to grow at a real rate of 1.3 percent per year for DAC countries from 2011 to 2013, compared to

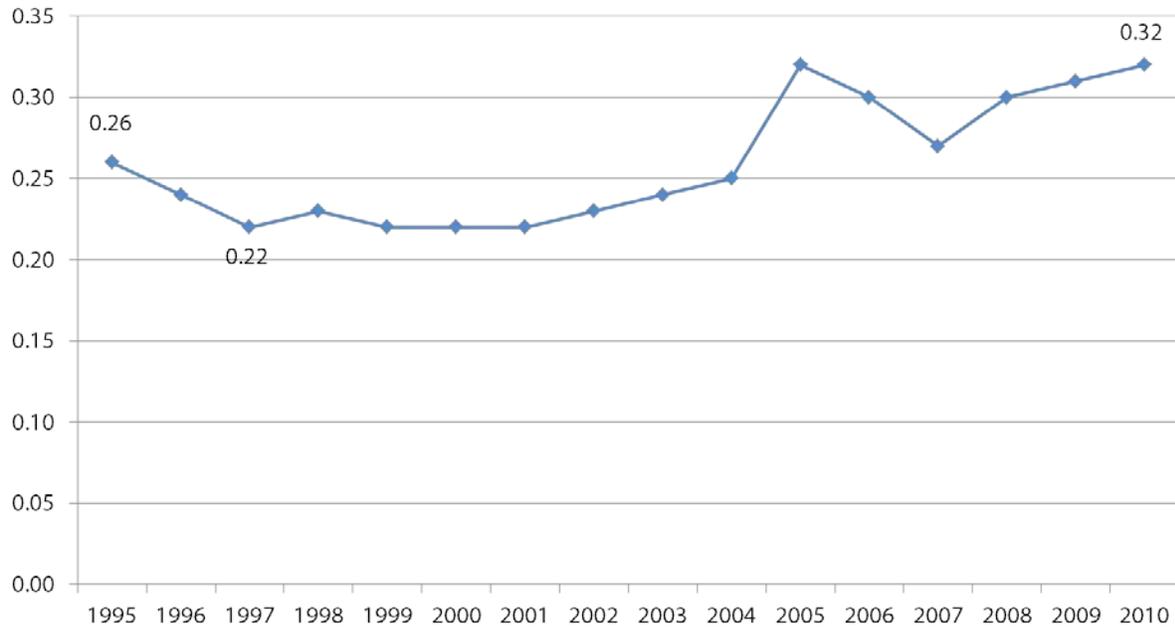
**Chart 5.1: Total ODA, all recipients and all donors, 1995–2009 (US\$ millions)**



Source: OECD-DAC 2010

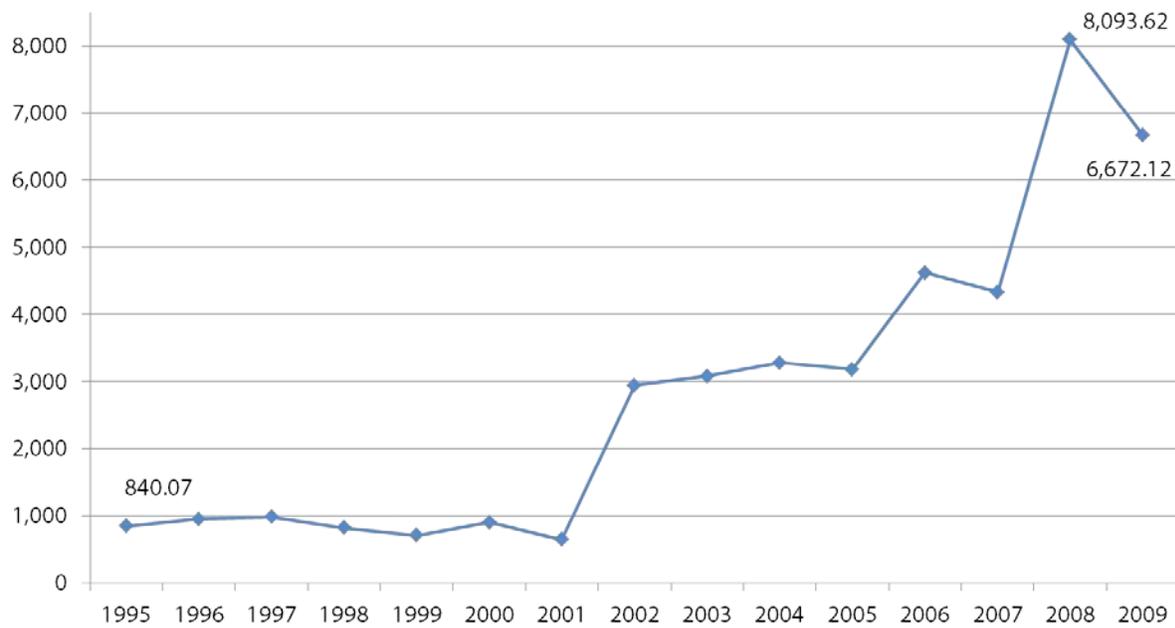


**Chart 5.2: ODA as a percent of GNI, OECD-DAC donors, 1995–2010**



Source: OECD-DAC 2011

**Chart 5.3: Non-OECD-DAC donors' total ODA (current US\$ millions)**



Source: OECD-DAC 2010



*The recent slowdown in development cooperation funds from so-called 'traditional' donors is indicative of the fragility of international aid and of internationally agreed promises to increase it.*

8 percent per year on average over the past three years. Projected increases in population in many recipient countries will outpace the growth in aid from traditional donors.

On the other hand, South-South cooperation is on a sharp upward trajectory with respect to volume and the emergence of new players. Assistance from private voluntary organizations and the development of a number of innovative finance schemes must also be added to this mix. Both have increased considerably over recent years. Estimates of the amount of

development assistance provided by private philanthropy from developed to developing countries stood at around \$52.6 billion in 2008 (Hudson Institute 2010). South-South philanthropy also has a longstanding tradition and is increasing sharply, especially in the Arab world. Innovative financing schemes have so far generated around \$4 billion in resources for development, mainly to support interventions in the health sector.<sup>7</sup>

The current picture is thus one of a significantly more diversified donor landscape over the last decade and particularly the last five years. For recipient countries, more donors mean more resources and also more competition among them. This can be viewed positively. On the other hand, it may lead to greater fragmentation in the delivery of aid and can place large administrative burdens on the governments of recipient countries.

**Table 5.1: ODA and Other Aid Flows: An Overview**

Funding Source	Monies Contributed, US\$ million (2009, current prices)
ODA (OECD-DAC)	120,000.63
ODA (non-DAC countries that report to OECD-DAC)	6,672.12
South-South Cooperation (donors that do not report to OECD-DAC)	15,300.00 *
Bilateral aid to multilaterals	13,443.66
Innovative finance mechanisms	4,000.00 <sup>8</sup>
Private philanthropic initiatives	52,600.00 *

\* 2008, current prices

Source: OECD 2010, Leading Group, Hudson Institute 2010, UN DESA 2010.

The recent slowdown in development cooperation funds from so-called 'traditional' donors is, however, indicative of the fragility of international aid and of internationally agreed promises to increase it. Prospects for most industrialized countries reaching 0.7 percent ODA/GNI any time soon are not promising. And although recent increases in South-South cooperation offset this somewhat, the volume of aid overall is still far from sufficient when compared to the amounts needed to support the MDGs. A key question for the future is whether the current political momentum for increased aid will be sustained beyond the 2015 MDG target date.



## ODA as a Source of Vulnerability to Sustaining MDG Progress

ODA can influence sustainability of the MDGs. However, the transmission channels will vary from one recipient country to the next. A country's overall dependency on aid is perhaps the most important consideration, but the extent to which aid actually matters in terms of sustainability of the MDGs also depends on whether aid makes (or has made) any meaningful contribution to development outcomes. This, in turn, is influenced by the ways in which aid is delivered and the extent to which it supports or undermines macro-economic stability and resilience to shocks in recipient countries.

A large body of research has attempted to provide some insight as to why aid is not especially effective in recipient countries. Some of this research has emphasized recipient countries' characteristics to explain the poor performance of aid; other research has focused more on donor behaviour as the main determinant.

On the recipient country side, research has explored the roles of, *inter alia*: policy and institutional quality (Collier and Dollar 2002); institutional quality alone (Burnside and Dollar 2004); civil conflict and war (Collier and Hoeffler 2002, Collier 2006); the 'nature' of the regime in place (i.e., totalitarian, democratic, etc.) (Islam 2003); geographical characteristics (e.g., being landlocked or a small state) (Collier 2006, Commonwealth Secretariat); degree of economic openness of the economy (Burnside and Dollar 2000); degree of vulnerability to external shocks, such as export price shocks and/or extreme weather events (Collier and Dehn 2001, Guillaumont and Chauvet 2001 and 2002); the degree to which aid is fungible (Petersson 2004); and the extent to which the scaling-up of aid leads to 'Dutch Disease' (Rajan and Subramaniam 2005).

On the donor side, the research has looked at: the volatility of aid relative to other sources of government revenues (Bulir and Hamman 2003 and 2006, Chauvet and Guillaumont 2008); donor motivations for aid (e.g., political, strategic or economic interests of donors) (Alesina and Dollar 2000); and the destination of aid, i.e., what aid is actually spent on and the proportion that actually reaches beneficiary countries (e.g., technical assistance, direct budget support, social or productive sectors, debt cancellation, humanitarian crises, etc.) (OECD 2007, EURODAD 2006, 2007, 2008 and 2009).

The research that finds that aid is most effective in those countries with strong policies and institutions has been enormously influential in policy circles over the last decade. Donor agencies have embraced the implication that more aid should be channelled to countries with stronger policies and institutions, but have been more reluctant to embrace the implication that aid should be eliminated, or at least substantially reduced, in the countries with the weakest policies and institutions (Clemens, Radelet and Bhavnani 2004). This research has prompted some major donor agencies and multilateral institutions to be more 'selective' with their aid allocations and to allocate larger shares to countries with supposedly 'stronger' policies and institutions (as judged by donors), where it will presumably have a bigger impact on development and economic growth. This has helped contribute to the phenomenon known as 'donor darlings' and 'donor orphans'.<sup>9</sup>

Other research has pointed to the heterogeneity of aid flows themselves rather than to the heterogeneity of aid recipients. All aid is not alike and the extent to which aid is 'effective' depends on the objective of that aid. For instance, with politically motivated aid, economic development may be a welcome side-effect of aid, but it is not the metric by which policy makers would evaluate the effectiveness of that aid (Clemens, Radelet and Bhavnani 2004). Supporting economic growth is the clear objective of some aid (e.g., aid to support the development of productive capacities), while, in other cases, it is not the objective at all (e.g., aid in humanitarian crisis situations). Aid to build infrastructure (such as roads, ports, irrigation systems, etc.) may



be expected to have a fairly rapid impact on economic growth. However, aid provided to halt environmental degradation, improve education and health systems or to build political systems may have economic growth as only secondary objectives. Moreover, the impact of these interventions will take a much longer time to become apparent and it will also be harder to attribute the positive development outcome directly to a particular aid intervention (Clemens, Radelet and Bhavnani 2004). The heterogeneity of aid flows explains the mixed results of aid.

Fears over so-called 'Dutch Disease', which posits that a sizeable inflow of ODA will exacerbate macro-economic instability by raising inflation and appreciating the real exchange rate, has also been influential in some policy circles. Under such a scenario, it is assumed that growth will be impaired because exchange rate appreciation will hamper the competitiveness of a country's export sector (Rajan and Subramaniam 2005). Thus, the scaling-up of aid as called for in the UN Millennium Declaration may be counter-productive to countries' development efforts. While it is broadly accepted that an ill-advised use of an ODA surge can pose macro-economic problems (e.g., where it fuels a consumption boom), concerns over 'Dutch Disease' should be manageable and ODA can contribute to sustainable development if ODA is used wisely to prioritize public investment and boost net imports (UNDP 2005). Thus, aid can and should be scaled up significantly in support of the MDGs.

At the same time, much concern has also been raised about the proportion of ODA that ever reaches recipient countries at all (EURODAD 2006, 2007, 2008 and 2009). The broad headline figure conceals the reality that a significant proportion of development cooperation funds are never available for in-country spending. For instance, technical assistance (which represented 12.7 percent of ODA in 2009) typically involves a contract between a donor agency and a consultant in its own country. The aid recipient receives a service (the consultancy report, training, etc.), but the valuation of the service is beyond its control and no cash transaction takes place with the developing country. On the other hand, volatility associated with this form of aid may be less problematic than that by which funds are channelled directly to recipient countries' budgets.

### *The Determinants of Aid-related Vulnerability*

This section explores the four main avenues through which aid can influence sustainability of the MDGs, namely:

1. Overall dependency on ODA
2. Procyclicality of ODA
3. Volatility of ODA
4. Uses of ODA

#### *1. Dependency on ODA*

Two sets of countries emerge as most heavily dependent on ODA: the LLDCs and some SIDS. Dependence on ODA can be measured in a variety of ways: aid as a percent of GNI; aid per capita; aid as a proportion of government revenues; aid as a percent of gross capital formation; and aid relative to other external capital flows such as loans, remittances and FDI.

The region that receives the largest volume of ODA relative to other regions is sub-Saharan Africa. This is also the region where most LDCs are located and where most countries 'off-track' towards the MDGs can be found.



Thus, at a very simplistic level, the poorest region in the world receives the highest volume of aid relative to other regions. Given large increases in aid levels since 2000, sub-Saharan Africa and the LDCs now receive historically unprecedented volumes of aid.

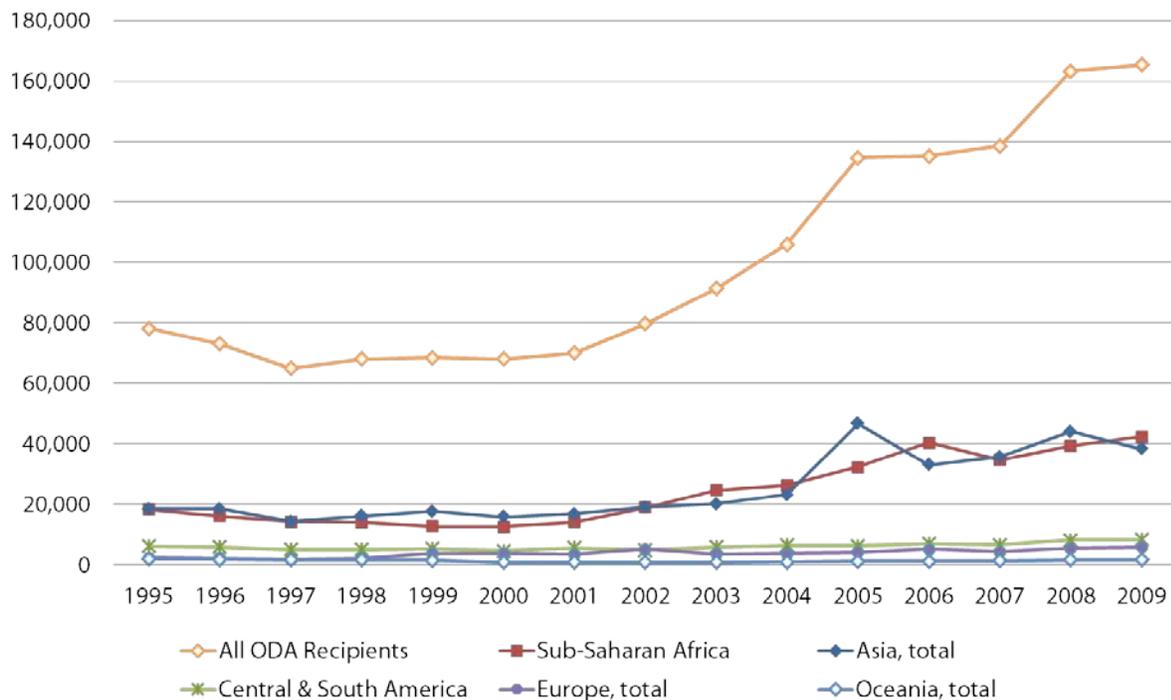
Of a total ODA envelope of \$165.4 billion in 2009 (current prices), sub-Saharan Africa received \$42.2 billion (25.5 percent). As a proportion of total ODA, sub-Saharan Africa receives roughly the same amount of development aid today as it did in 1995 (23.4 percent in 1995), although this amount did decline in 1999 and 2000 to approximately 18.5 percent of total ODA allocations (OECD-DAC 2010).

Asia receives the next largest aid allocation relative to other regions. In 2009, 23.1 percent of ODA was received by Asia (\$38.3 billion). Europe, Central and South America, North Africa and Oceania each received less than 4 percent of total ODA allocations in 2009 (OECD-DAC 2010).<sup>10</sup>

The Least Developed Countries received almost \$40 billion in ODA in 2009 (24.1 percent of total ODA), more than any other income category both in volume terms and as a proportion of total aid (OECD-DAC 2010).<sup>11</sup> That said, the LDCs still receive far less aid than donors have committed to provide them. The United Nations target for aid to the LDCs is between 0.15 percent and 0.2 percent of industrialized countries' GNI. Between 2000 and 2008, OECD-DAC ODA to the LDCs rose from 0.05 percent to 0.09 percent of GNI, a substantial increase, but still well below the lower bound target of 0.15 percent (OECD-DAC 2010 and MDG Gap Task Force 2010).

The United Nations has formally recognized that the LLDCs and SIDS need special assistance from the international community, in part due to geographical characteristics that accentuate their development

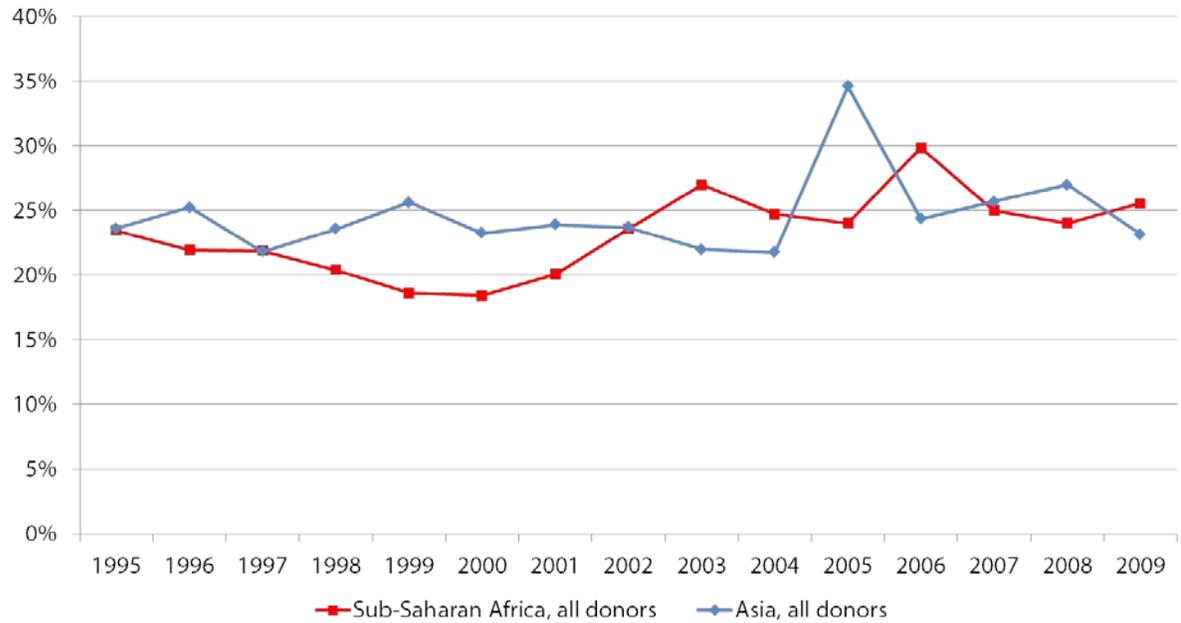
**Chart 5.4: Total ODA by region, 1995–2009 (current US\$ millions)**



Source: OECD-DAC 2010

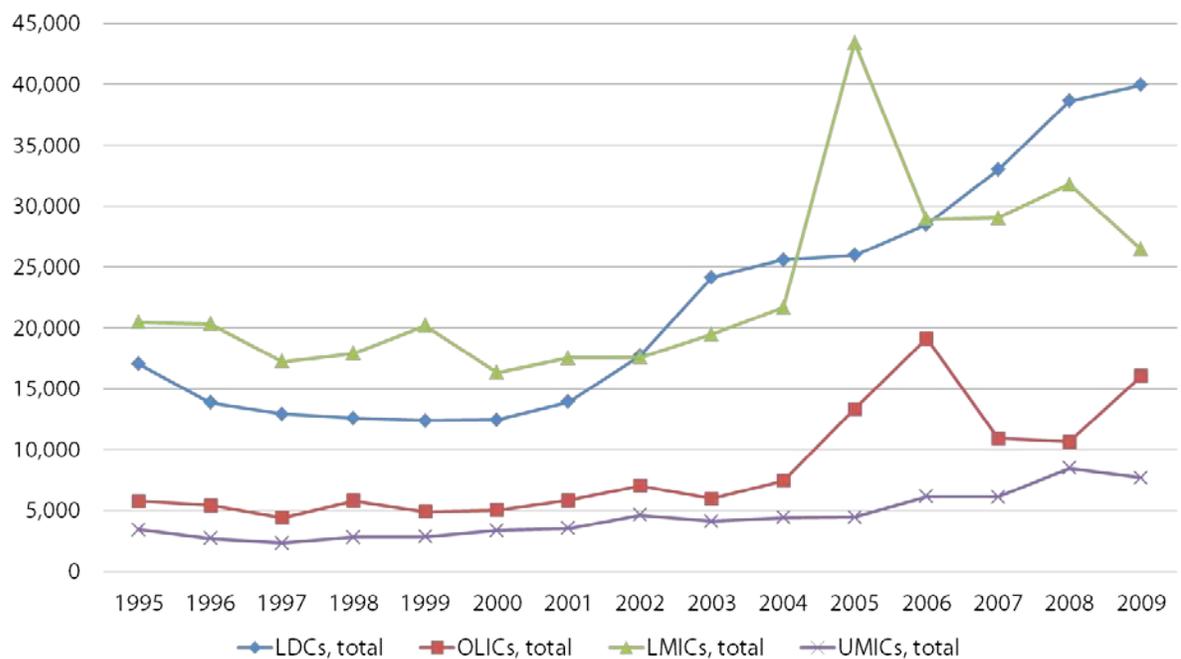


Chart 5.5: ODA to Asia and sub-Saharan Africa as a percent of total ODA



Source: OECD-DAC 2010

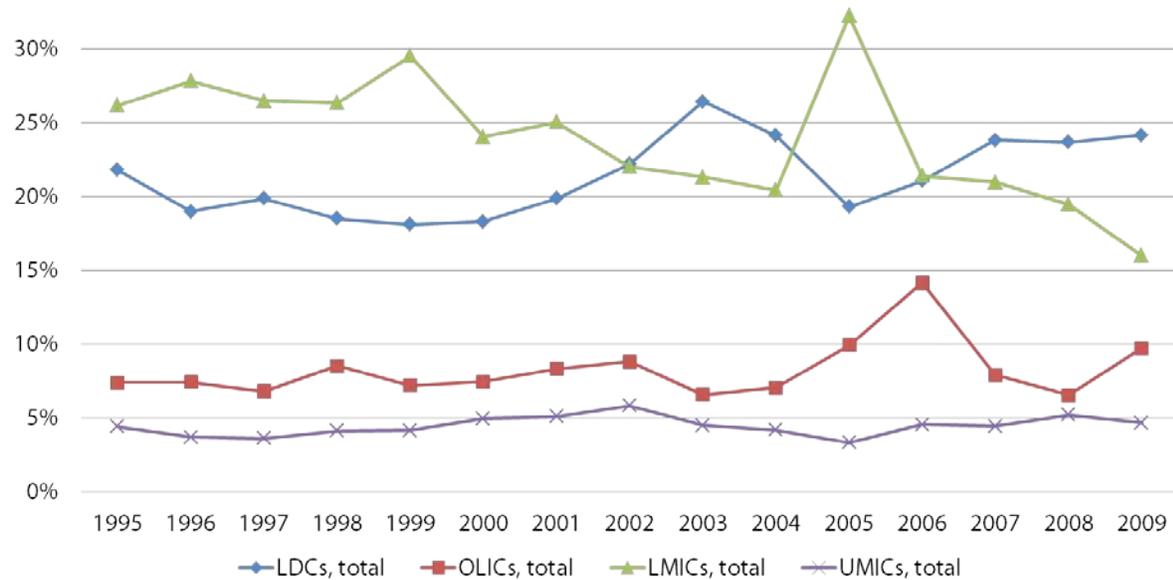
Chart 5.6: ODA to income groups, all donors (current US\$ millions)



Source: OECD-DAC 2010

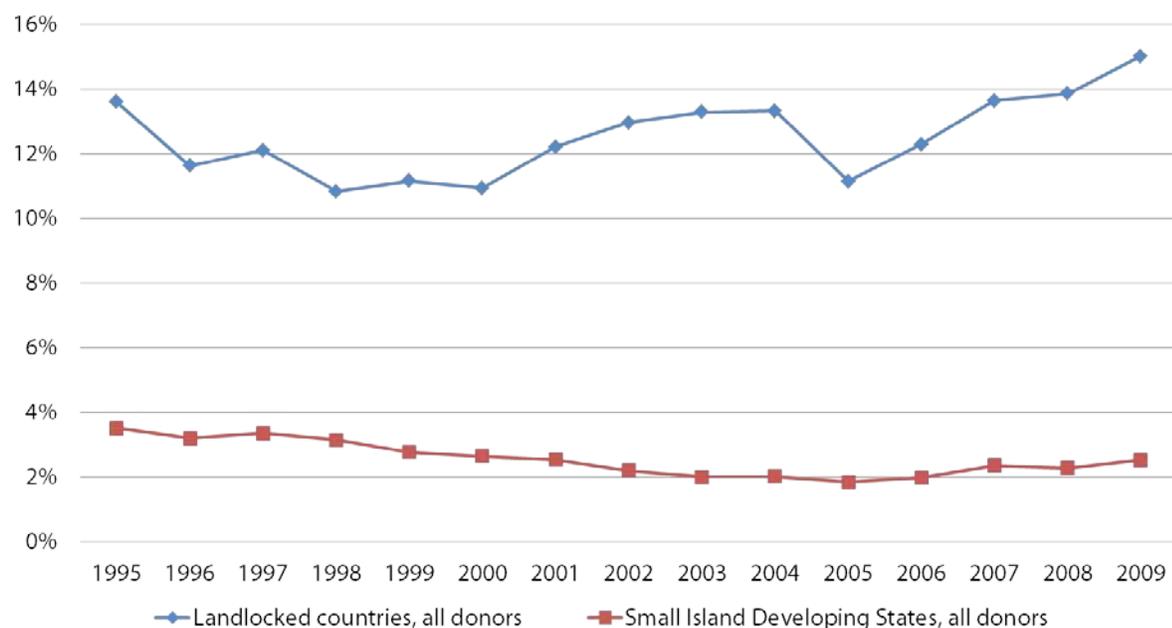


**Chart 5.7: ODA to different income groups as a percent of ODA, all donors**



Source: OECD-DAC 2010

**Chart 5.8: ODA to recognised vulnerable country groups as a percent of total ODA**



Source: OECD-DAC 2010



challenges (UN OHRLLS). ODA to the LLDCs actually decreased between 1995 and 2000 (OECD-DAC 2010). Recent increases to this group as a whole (from 11 percent of total ODA flows in 2005 to 15 percent in 2009) reflect significant aid directed towards two countries only — Afghanistan and Ethiopia — and the fact that both countries are landlocked was not the primary motivation for these aid increases (MDG Gap Task Force

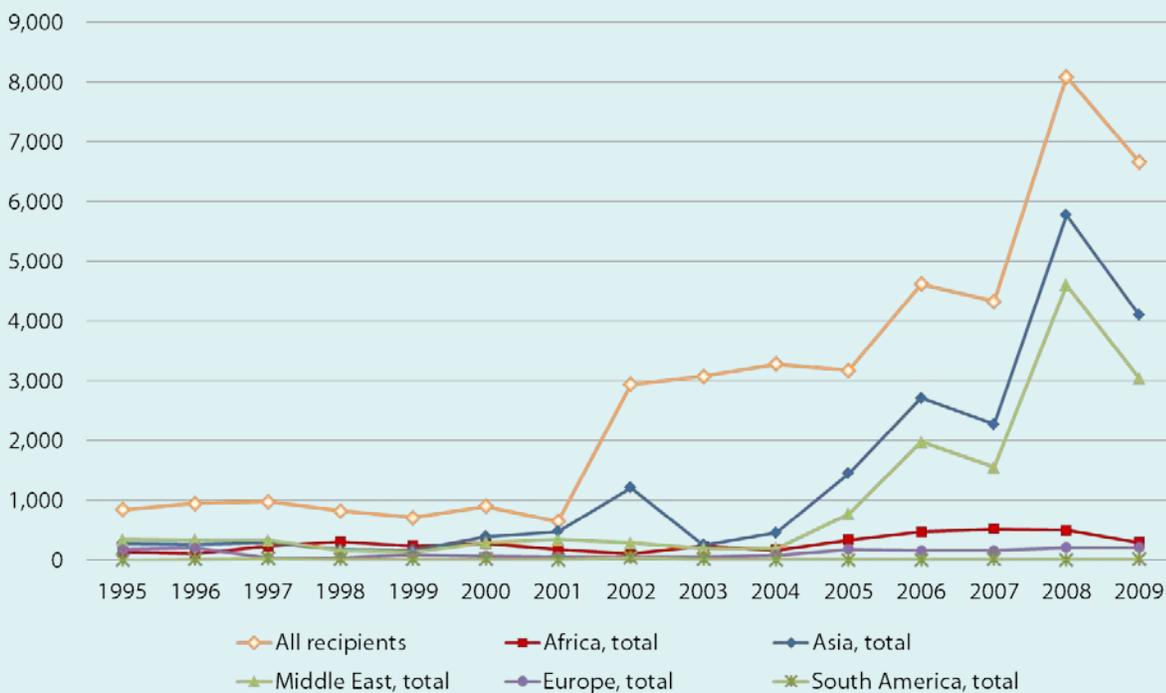
### Box 5.1: South-South Cooperation Traditionally Has a Large Intra-regional Component

Much South-South development cooperation has traditionally been intra-regional. Thus, the major beneficiaries of South-South development cooperation so far have been countries in Asia and the Middle East where several of the major South-South aid providers are found (see chart below). China provides around 40 percent of its ODA to Asia (Schueller 2010). As of December 2007, Arab donors had channelled 59 percent of their cumulative commitments to other Arab countries. India channels much of its assistance to Afghanistan, Bhutan, Maldives, Myanmar, Nepal and Sri Lanka (UN DESA 2010).

Venezuelan cooperation also has a strong Latin America and Caribbean bias.

This is now changing, though. For instance, China pledged in November 2009 to provide \$10 billion in concessional loans to Africa between 2010 and 2012, double the pledge for the previous three years (UN DESA 2010). Overall, it appears that geographical, cultural, language, political or other ties may be just as important—if not more important—in ('old' or 'new') donors' decisions about aid allocation and considerations of countries' relative levels of need for donor assistance are often secondary.

### Non-DAC donors' ODA to different geographical groups (current US\$ millions)



Source: OECD-DAC, 2010, 'Development aid reaches an historic high in 2010'; [www.tinyurl.com/oecd2010](http://www.tinyurl.com/oecd2010)



2010). ODA to SIDS declined between 1995 and 2005 from 3.5 percent of total ODA to a low of 1.8 percent. It has recovered slightly over the last few years to reach 2.5 percent of total ODA in 2009 (OECD-DAC 2010).

In summary, large increases in development aid over the last decade have translated into increased resources for sub-Saharan Africa, Asia and the LDCs. But when measured as a proportion of the total ODA envelope, ODA allocations to different geographical regions and income categories have not changed very much over the last 15 years. ODA to lower-middle-income countries is, however, currently on the decline as compared to previous years (from approximately 24 percent in 2000 to 15.9 percent in 2009) (OECD-DAC 2010).

The largest proportions of ODA are channelled to sub-Saharan Africa, the world's poorest region, and to Asia, the region in which the largest number of the world's poor are found. These regions are also the beneficiaries of unprecedented amounts of aid. This implies that sub-Saharan Africa and Asia (and the LDCs) would be more vulnerable to any eventual sharp decreases in development aid. However, this picture in the aggregate masks the extent to which aid flows have in reality been skewed towards just a few countries.

### Box 5.2: ODA Concentration

ODA is heavily concentrated in a much smaller number of countries and this degree of concentration has increased over the last decade, as indicated by the chart. This indicates that donors provide aid for a variety of reasons not necessarily related to poverty reduction and the MDGs.

In 2008, the top 20 aid recipients received almost 54 percent of all country-allocable aid for that year. The top 10 aid recipients received 37.6 percent (UN MDG Gap Task Force 2010). Donor priorities also change over time. So while Iraq received almost \$9 billion in ODA in 2008, the figure was just \$174 million almost a decade earlier (UN MDG Gap Task Force 2010). Of the top 20 ODA recipients in 2008, only nine are classified as LDCs (marked with an asterisk). These facts remind us that being a major beneficiary of aid in dollar terms does not necessarily imply dependency on aid *per se*.

#### Top 20 ODA recipients, 2008

Country	2000 ODA receipts (current US\$ millions)	2008 ODA receipts (current US\$ millions)
Iraq	174	9,880
Afghanistan *	232	4,865
Ethiopia *	1,065	3,327
occupied Palestinian territory	986	2,593
Viet Nam	2,104	2,552
Sudan *	359	2,384
Tanzania *	1,601	2,331
India	1,867	2,108
Bangladesh *	1,716	2,061
Turkey	502	2,024
Mozambique *	1,488	1,994
Uganda *	1,362	1,657
Dem. Rep. of the Congo *	299	1,648
Pakistan	907	1,539
China	2,256	1,489
Kenya	745	1,360
Egypt	1,927	1,348
Ghana	864	1,293
Nigeria	252	1,290
Liberia *	102	1,250
<b>TOTAL</b>	<b>20,808</b>	<b>48,994</b>
<b>TOP 20's share of total aid</b>	<b>37.5%</b>	<b>53.9%</b>

Source: United Nations, 2010, *MDG Gap Task Forced Report 2010*, United Nations, New York

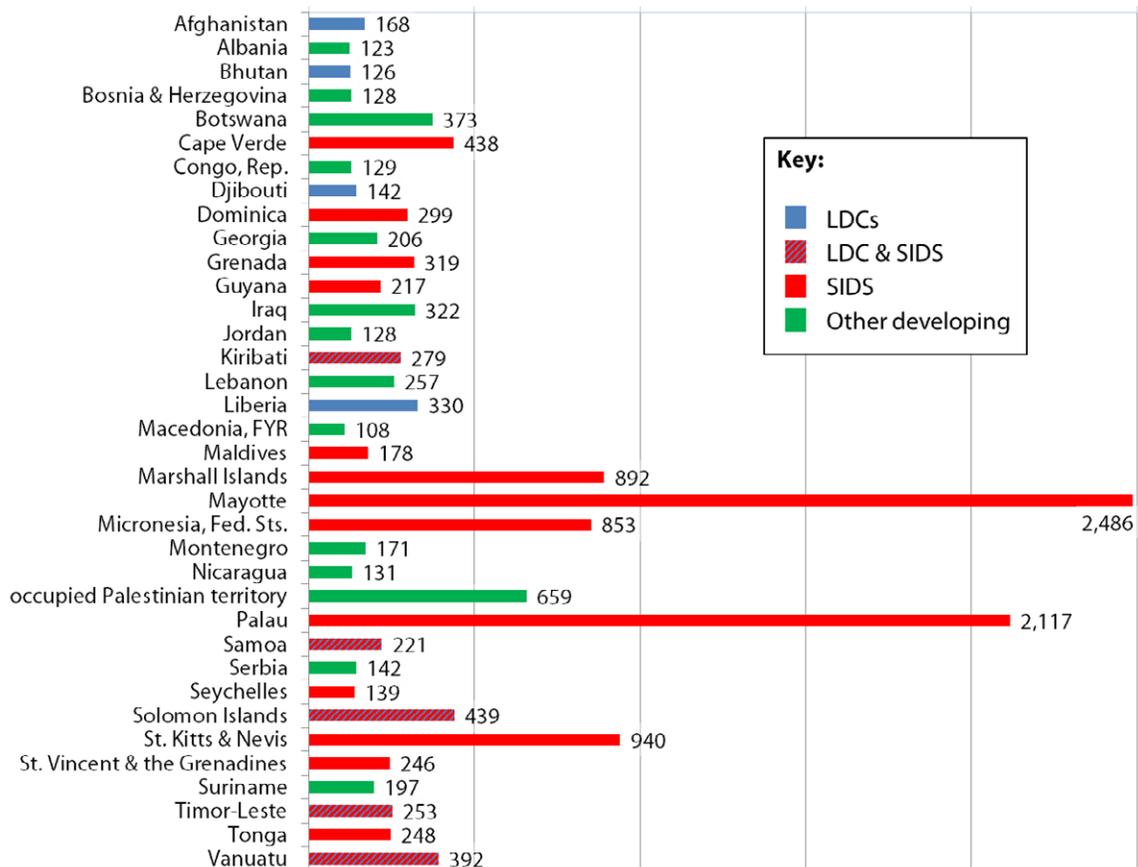


## ODA PER CAPITA

The amount of aid that developing country governments have available to spend per head of population is an important issue. When measured on a per capita basis, a different picture of the major beneficiaries of development cooperation emerges. Not surprisingly, countries with relatively small populations receive more ODA per capita on average than other developing countries. Having larger populations, many LDCs receive smaller amounts of aid per capita. In 2008, 36 countries received more than \$100 in aid per capita (author calculations based on data in World Bank, World Development Indicators 2010). Eighteen of these countries (50 percent) were SIDS and nine were LDCs (only four of which were non-SIDS LDCs).<sup>12</sup> Several post-conflict countries (e.g., Liberia, Timor-Leste, etc.) also receive substantial sums of aid on a per capita basis.

On a per capita basis, Oceania receives more than five times more aid than sub-Saharan Africa (OECD-DAC 2010). These findings imply that, on a per capita basis, a significant number of LDCs is heavily dependent on official development aid.<sup>13</sup> This, in turn, increases their vulnerability to sharp swings in ODA. However, it should also be pointed out that some of the small island states that receive substantial sums of aid on a per capita basis are not necessarily the poorest *per se*.

**Chart 5.9: Countries and territories that receive more than \$100 in ODA per capita (2008)**



**Source:** Author calculations based on data in World Bank, World Development Indicators, 2010



## ODA AS A PROPORTION OF CENTRAL GOVERNMENT EXPENDITURE

The extent to which governments rely on external aid as a proportion of their budget is also important, since governments need to plan expenditures effectively on the basis of detailed projections of inflows, both internal and external. Where aid is a large proportion of the government budget, sudden decreases (and increases) in aid must be carefully managed so as not to seriously undermine expenditure plans.

Relatively little current information on aid as a percent of central government expenditure is available at the aggregate level. This may be for a number of reasons. For instance, aid flows can sometimes be unpredictable, so governments have to frequently adjust their budgets to account for shortfalls (or windfalls) in aid receipts. There is also a lag between budget years and the time this information is passed on to relevant multilateral bodies such as the World Bank.

In 2007, 15 of 48 developing countries that provided data to the World Bank on ODA as a percent of central government expenditure relied on ODA for at least 25 percent of that expenditure (World Development Indicators 2009). These countries are: Afghanistan, Armenia, Bangladesh, El Salvador, Ghana, Kenya, Kyrgyzstan, Lao PDR, Madagascar, Mali, Mongolia, Nicaragua, the Niger, Togo and Zambia. Seven of these countries—almost half of the total—are located in sub-Saharan Africa, while five are in Asia and the CIS, two are in Latin America, and one is in Europe. The two aid-dependent countries in Latin America, El Salvador and Nicaragua, are very small countries next to their larger (non-ODA dependent) regional neighbours. Eight countries are classified as LDCs, again underscoring the high degree of aid dependency of this category of countries.

The countries that stand out as most heavily dependent on aid as a proportion of government expenditures are Afghanistan, Lao PDR, Madagascar, Mali, Nicaragua and the Niger, although this probably gives only a partial picture due to lack of data availability.

ODA will be especially important in resource-scarce countries. In countries rich(er) in natural

*The largest proportions of ODA are channelled to sub-Saharan Africa, the world's poorest region, and to Asia, the region in which the largest number of the world's poor are found.*

**Table 5.2: Most Heavily Aid-Dependent Countries as a Proportion of Central Government Expenditures (2007)**

Country	ODA as a % of Central Government Expenditure (2007)
Afghanistan*	167.7
Armenia	23.0
Bangladesh*	21.7
El Salvador	22.1
Ghana	26.0
Kenya	24.0
Kyrgyzstan	39.8
Lao PDR*	89.7
Madagascar*	108.1
Mali*	97.4
Mongolia	23.2
Nicaragua	76.4
Niger*	108.4
Togo*	27.6
Zambia*	39.9

\* Also an LDC

**Source:** World Bank, World Development Indicators, 2009.

Note that many countries do not report this data to the World Bank and therefore could not be analysed.



resources, governments may be able to extract sizeable resource rents and thus aid will become less important as a source of revenues and foreign exchange, even though the country may otherwise be extremely poor.

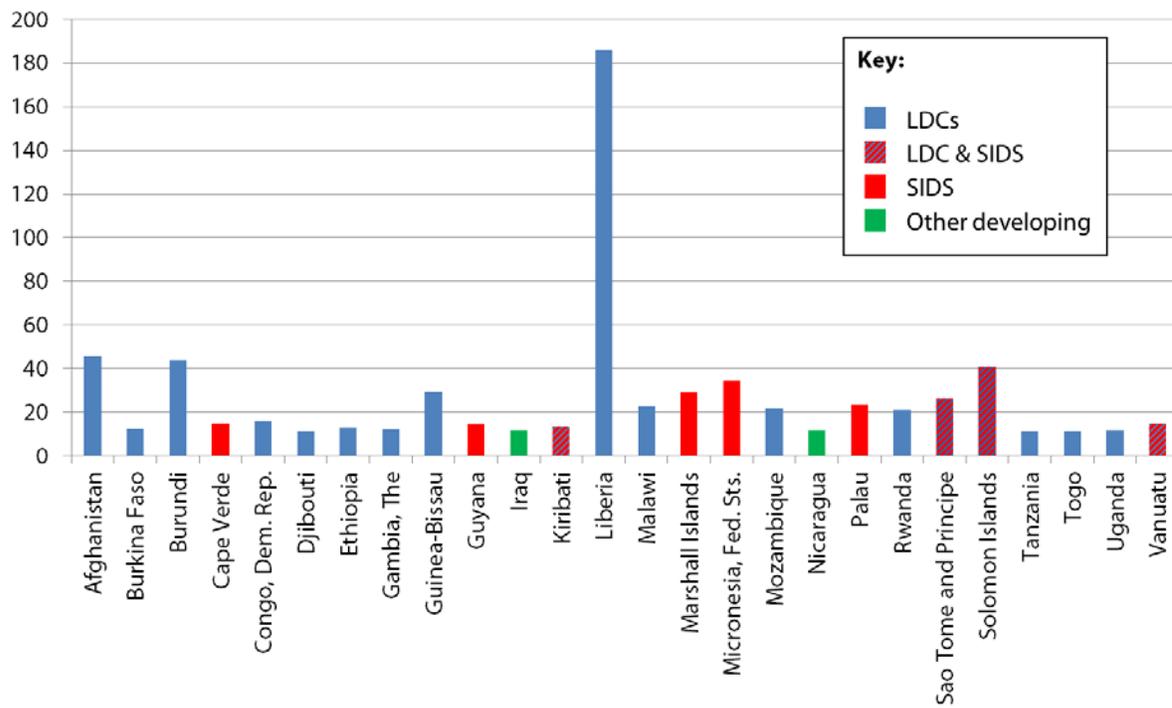
### ODA AS A PERCENT OF GNI

ODA as a percent of GNI shows official aid as a share of the country's overall national income in a year. In 2008, 26 countries registered ODA levels in excess of 10 percent of GNI. Of these 26 countries, 17 are LDCs (16 of which are in sub-Saharan Africa) and 9 are SIDS (4 countries are both LDCs and SIDS) (author calculations based on World Bank, World Development Indicators 2010). This leaves two further countries, one of which is low-income (Nicaragua), the other middle-income (Iraq). At the extreme end of the scale, Liberia's ODA/GNI ratio exceeded 185 percent in 2008 (World Development Indicators 2010). Relative to the size of their economies, the data shows that, once again, LDCs and SIDS are most dependent on ODA.

For 31 developing countries, net ODA flows represented less than 0.5 percent of GNI in 2008. Eleven of these countries are in Latin America and the Caribbean, eight are in Asia, five are in the Middle East and North Africa, and three are in sub-Saharan Africa (author calculations based on data in World Bank, World Development Indicators 2010).

It is interesting to note that several countries in the category of 'not especially dependent on aid' (China, India and Turkey) actually keep significant amounts of aid dollars in *volume* terms relative to other countries and, indeed, feature in the 'top 20' ODA recipients for 2008. However, because these countries' economies are very

**Chart 5.10: Countries with ODA in excess of 10 percent of GNI (2008)**



Source: World Bank, World Development Indicators 2010



large (and growing), aid flows as a proportion of GNI are of little significance overall. Put simply, some of the countries that receive the most aid dollars are also among the least aid-dependent. For most countries in Latin America, ODA is also small as a percent of GNI.

#### *ODA AS A PERCENT OF GROSS CAPITAL FORMATION*

Reliance on ODA to support gross fixed capital formation (i.e., new value added in an economy) indicates the extent to which governments need external rather than domestic resources to fund growth-enhancing investments. The region most heavily dependent on net ODA as a percent of gross capital formation is sub-Saharan Africa.

At least 27 countries in the region relied on ODA to finance more than 10 percent of gross capital formation in 2009.<sup>14</sup> However, many have ratios in excess of 50 percent or more: Central African Republic at 111 percent, Comoros at 76.2 percent, Democratic Republic of the Congo at 74.5 percent, Côte d'Ivoire at 90.4 percent, the Gambia at 67.3 percent, Georgia at 69.9 percent, Haiti at 63 percent, Kosovo at 52.7 percent, Malawi at 65.6 percent, Mozambique at 98.1 percent, Nicaragua at 53.6 percent, Rwanda at 82.3 percent, and Sierra Leone at 148 percent (World Bank, World Development Indicators 2010).<sup>15</sup>

These figures are probably underestimated, since some countries have not reported this data to the World Bank. The other countries also heavily reliant on net ODA to finance gross capital formation are mostly small vulnerable economies (e.g., LDCs such as Comoros, Dominica, Grenada, Haiti, Seychelles, St. Lucia, St. Vincent and the Grenadines, Tonga, etc. or non-island small economies such as Bhutan, Kosovo, Lesotho, etc.).

#### *ODA RELATIVE TO OTHER EXTERNAL CAPITAL FLOWS*

The degree to which a country is dependent on aid also depends on how important aid is relative to other external capital flows, such as loans, FDI and/or migrant remittances. For many of the LDCs and some SIDS, ODA is important because they have little or no access to international capital markets. They also attract little FDI, which is the major source of external finance for the developing world as a whole. In addition, the World Bank and the IMF impose limits on the amounts of non-concessional loans that LICs may assume under the debt sustainability framework for LICs (World Bank and IMF 2006). This also increases the importance of grants and concessional loans for certain countries.

Developing and transition economies attract half of all global FDI inflows, estimated to have been \$1.2 trillion in 2010 (UNCTAD 2010). While FDI remains heavily concentrated in a number of emerging economies, more private capital flows than ever before are moving into LICs, especially those rich in natural resources.

Between 1995 and 2009, FDI inflows to Africa increased by 936 percent. In 2009, FDI to Africa reached \$58.6 billion (UNCTAD 2010); ODA levels to the region in the same year stood overall at \$47.6 billion, which means that, as a whole, FDI is slightly more important than ODA to Africa as a source of external finance. Of course, this hides the extent to which FDI and aid flows are heavily concentrated in certain countries. While Africa's overall FDI share remains small, the rate of growth is such that it is conceivable that FDI could increasingly substitute aid. Indeed, even though ODA and FDI typically have very different objectives (FDI for the most part does not have 'development' as its aim), the literature suggests that there is a shift from aid to FDI as an economy moves to a higher per capita income level, i.e., FDI tends to substitute aid (Kristjansdottir 2007).



## Box 5.3: 'Sectoral' Aid Dependency

Some countries that are not especially dependent on development aid overall may, however, rely heavily on aid to finance one or more sectors within their economies. This is especially the case with the health sector. The recent upswing in donors' and philanthropists' interest in health issues such as HIV/AIDS, child immunization and others has created many new initiatives to fund health interventions in developing countries. A significant proportion of these funds has been channelled to developing countries via so-called 'vertical' funds.<sup>16</sup> Indeed, the relative share of vertical funds in health is much higher than in other sectors with more than 25 percent of ODA delivered through such mechanisms (Goodwin 2008).

Because of the increased prominence of vertical funds, coupled with the tendency for donors to 'herd' around 'fashionable' sectors, a particular sector within the country — HIV/AIDS, for instance — may be almost entirely externally financed even if a country is not particularly dependent on ODA overall. From the perspective of sustainability of the MDGs, it will be important to consider not only a country's overall level of aid dependence, but also the dependence of specific sectors on donor resources. The sudden withdrawal of donor funding could be hugely disruptive at best and catastrophic at worst. Consequently, recipient country governments in such situations should have realistic 'contingency' plans to prepare for any such eventuality.

**Source:** Goodwin, Frazer, 2008, 'European Public Health Alliance', *Vertical Funds in the Health Sector*, July.

For some countries, migrant remittances are a major source of foreign exchange. At present, these flows are more than twice as large as the volume of ODA. Official recorded remittance flows to developing countries reached \$325.5 billion in 2010, although it is likely that billions more were transferred through non-official channels (World Bank 2010). Poorer countries receive relatively larger remittances: the lower the average income in a country, the more likely its citizens will seek to migrate for economic motives. Many SIDS also register large migrant remittances, in part because many of their citizens are living abroad in the absence of economic opportunities at home. This helps to offset, at least in part, the vulnerability derived from a high degree of dependency on ODA. Indeed, the data shows that some SIDS (e.g., Dominican Republic, Haiti, Jamaica, Mauritius, etc.) and some other small vulnerable economies (e.g., Lesotho) are also equally, if not much more, dependent on migrant remittances than on aid.

As a whole, the LDCs and some SIDS are heavily dependent on ODA. Many, but certainly not all, are also in receipt of significant amounts of aid dollars relative to the size of their economies, as a proportion of the government budget and/or on a per capita basis.

Dependency on ODA is accentuated by limited access to other forms of external capital, such as bond finance or FDI (although this is now changing for some countries); a limited ability to tax also fosters dependency. In some countries, though, large migrant remittances mitigate dependency on ODA to some extent. In dollar terms, however, many relatively much wealthier countries receive far higher levels of development cooperation, which indicates that donors provide aid for a variety of reasons not necessarily related to poverty reduction and economic growth.

### 2. *The Procyclicality of Aid*

The world's poorest countries are among those with the least diversified economies. Many LDCs typically rely on a few commodity exports to generate most of their foreign exchange. The prices of these commodities on world markets are, in turn, extremely volatile. A similar picture is true for many SIDS, which depend



heavily on 'industries' such as tourism or financial services coupled with a handful of commodity exports. As a consequence, these countries are more exposed to external shocks than many other countries, such as terms of trade shocks or recessions in the developed world. This vulnerability was manifested most recently with the concurrent food, fuel, and financial crises, which led to sharp increases in many countries' food and fuel import bills and then by sharp decreases in the prices of many commodity exports and in numbers of tourists. Some countries also experienced extreme weather events over the same period.

The poorest countries and aid-dependent countries are among those least able to cope with external shocks and other crises due to their pervasive liquidity constraints and lack of effective countercyclical policy tools combined with weak institutions. In such circumstances, aid is most effective when it is countercyclical. Where aid is countercyclical, it can be an important smoothing device or insurance function and can help to mitigate the worst effects of the external shock. It can thus enhance macro-economic stability in recipient countries.

While the empirical evidence is mixed as to whether aid tends to be countercyclical or procyclical, the literature suggests that, on average, aid tends to be procyclical, i.e., countries tend to receive more in years when economic activity is on the rise and less when it is on the decline (Gemmell and McGillivray 1998, Bulir and Hamann 2003). Bulir and Hamann (2003 and 2006) find that aid inflows are more volatile than fiscal revenues and that shortfalls in aid and domestic revenues tend to coincide, i.e., aid tends to be procyclical.

*Increases and decreases in aid are frequently a manifestation of economic conditions in donor countries; thus, aid increases when times are good and falls when times are bad.*

Increases and decreases in aid are frequently a manifestation of economic conditions in donor countries; thus, aid increases when times are good and falls when times are bad. Consequently, between 2008 and 2009, when the effects of the financial crisis took hold, 10 OECD-DAC donors decreased their aid levels as a proportion of GNI (Australia, Austria, Canada, Germany, Greece, Ireland, Italy, Japan, New Zealand and Portugal) (OECD-DAC 2010).

Where aid is procyclical, it can exacerbate rather than mitigate the business cycle. This undermines macro-economic stability in recipient countries and, in turn, impedes economic growth and development. Procyclicality also undermines countries' resilience to shocks. This undermines the development effectiveness of aid and may jeopardize sustainability of the MDGs.

### 3. The Volatility of Aid

A large body of evidence points to a very high degree of volatility associated with aid flows. This volatility not only reduces the value of aid, but can contribute to macro-economic instability in recipient countries (Bulir and Hamann 2003 and 2006, Chavet and Guillaumont 2008, Kharas 2008, Markandya, Ponczek and Yi 2010).

Bulir and Hamann (2003 and 2006) find that aid inflows are more volatile than fiscal revenues. Pallage and Robe (2001) find that aid is twice as volatile as real output. Meanwhile, Kharas (2008) shows that aid volatility is five to six times as large as volatility in GDP and three times as large as export volatility. It has also worsened in recent years. It is also possible that aid volatility could worsen further as donors increase their aid commitments while stepping up coordination among themselves and choose aid recipients more selectively. In addition, some donors are shifting away from project aid to programme aid (given in the form of direct



budget support or sector-specific support). While this can substantially reduce transaction costs in recipient countries and increase the effectiveness of aid, programme aid tends to be more volatile than project-based aid (Eifert and Gelb 2005). There is minor support for the notion that weaker states have slightly more volatile aid, but this is not statistically significant, and geographic region, income level and degree of aid dependency do not appear to have sizeable impacts on levels of aid volatility (Kharas 2008). Finally, some volatility can also be linked to exchange rate fluctuations. Because donors typically provide programme aid in their own currencies, large fluctuations in exchange rates between donor and recipient can negatively (or positively) affect what recipient countries are able to 'buy' with their aid.

The literature systematically suggests that volatility in aid flows is extremely costly, particularly in the LDCs. Both donors and recipients tend to overestimate aid disbursements (Bulir and Hamann 2003, Desai and Kharas 2010). Aid volatility can cause harm in three ways: 1) by raising the cost of financial management; 2) by worsening the composition of investment; and 3) by amplifying the fiscal effects of business cycles (Desai and Kharas 2010). For developing countries, aid can be uncoordinated and fragmented. Donors are unaware of each other's activities and often duplicate analytical work. This leads to volatility, waste and overlap of activities (Kharas 2008). Aid volatility can worsen the composition of investment. For instance, unexpected shortfalls in aid lead governments to shift expenditures away from growth-enhancing long-term investment to short-term consumption (Celasun and Walliser 2008, Desai and Kharas 2010).

Not all aid volatility is alike, however. Aid volatility comprises both aid shortfalls and aid windfalls. Thus, in some circumstances, volatility in aid can be viewed as positive rather than negative. For example, when aid responds to disasters such as the earthquake in Haiti in January 2010 or the Indian Ocean tsunami in December 2004, aid volatility is generally regarded as positive. Many donors also regard the ability to reduce aid to corrupt governments (or in the event of war or conflict) as a good thing.

However, the effects of aid windfalls and aid shortfalls are typically asymmetric; while aid windfalls are associated with increases in government consumption, aid shortfalls typically lead governments to slash investments (Desai and Kharas 2010). Moreover, aid windfalls in response to external shocks are unlikely to come anywhere close to compensating governments sufficiently for the loss in output and other associated damages.

There are many other reasons why aid is volatile, some associated with donor behaviour and others associated with recipient country behaviour. The major sources of aid volatility are summarized in Table 5.3.

The costs associated with aid volatility are extremely high. Kharas (2008) places the deadweight loss associated with aid volatility at 15 percent to 20 percent of the total value of aid in recent years. At 2009 ODA levels, this equates to an annual loss of approximately \$24 billion to \$33 billion (author calculations based on OECD-DAC 2010).

Even though some aid volatility can be regarded positively (for instance, in response to a natural disaster), in the overall long run, aid volatility is, on average, negatively correlated with economic growth (Markandya, Ponczek and Yi 2010). However, the effect varies, depending on the level of aid absorption of the recipient country. For economies with full (or close to full) aid absorption, aid volatility appears to lead to a negative impact on growth over the medium and long terms; for those economies with low aid absorption, the relationship is negligible (Markandya, Ponczek and Yi 2010). One could expect aid volatility to affect the LDCs with high levels of aid absorption more severely.


**Table 5.3: The Determinants of Aid Volatility**

Recipient country reasons	Donor country reasons
<p><b>Domestic political turmoil:</b> Internal conflicts and political instability may negatively affect aid flows. Post-conflict countries, on the other hand, may be the beneficiaries of sudden large increases in aid. Democratic governments and non-democratic governments do not experience differing levels of aid volatility, although democratic withdrawal is associated with increased aid volatility (Desai and Kharas 2010).</p>	<p><b>Donor ‘herding’ behaviour:</b> Herding occurs when donors, lacking information, respond to the publicly observed actions of other donors (Desai and Kharas 2010). This can lead to cascades of money towards some countries (or sectors) or the abrupt withdrawal of resources from others (‘donor darlings’ and ‘donor orphans’). Thus, this behaviour is associated with both positive and negative consequences for individual countries. Brief periods of sustained increases in official development aid tend to be followed by secular declines (Bulir and Hamman 2006; Desai and Kharas 2010).</p>
<p><b>Emergency aid:</b> This sort of aid, which responds to shock situations, is by its very nature difficult to predict and may enhance rather than hinder aid effectiveness.</p>	<p><b>Bureaucratic and administrative procedures in donor countries:</b> Donors are often unable to make long-term commitments to recipient countries due to domestic budget procedures. Aid budgets are frequently set annually. ODA often requires parliamentary approval and an explicit discussion of aid strategies, which can lead to abrupt changes in aid allocations. The OECD reports that donor commitments are often a poor indicator of actual donor outturns (disbursements) for a particular year.</p>
<p><b>Policy performance:</b> Major shifts in a recipient country’s policy performance can lead to aid shortfalls. The OECD-DAC shows that recipient countries with more stable relationships with donors — as signaled by a sustained track record of implementing an IMF programme — receive, on average, more predictable aid (Alesina and Dollar 2000; OECD 2005).</p>	<p><b>Donor conditionality:</b> If recipient countries do not comply with donor conditionalities, aid can be reduced or delayed. This is linked to the issue of policy performance in recipient countries. Countries with ‘sound’ policies and institutions as defined by donor agencies may be ‘rewarded’ with increased aid flows, although the empirical evidence on this point is mixed. Donors tend to ‘herd’ behind IMF and the World Bank conditionalities, i.e., aid can be reduced or delayed where countries fail to comply with the conditionality imposed by these two institutions even though these conditionalities may not be directly relevant to the donor activities being funded. Some donors link aid more closely to conditionality than others.</p>
<p><b>Corruption:</b> Recipient country mismanagement of aid — or donors’ perception of the recipient country’s commitment to use aid for the intended purposes — can lead to aid shortfalls.</p>	<p><b>Donor prerogatives:</b> This includes donor responses to domestic events (e.g., overall economic situation, fiscal pressures, public opinion, etc.) or global events (e.g., 9/11). This can have positive or negative consequences for aid in general and individual countries in particular.</p>
	<p><b>Donor specific volatility:</b> Desai and Kharas (2010) show that the United States is the donor whose aid allocations tend to fluctuate the most; the European Union the least. But this volatility in United States aid is mainly due to unexpected increases in aid (to allies and countries dependent on the United States) (Desai and Kharas 2010).</p>



For the sustainability of the MDGs, this means that countries heavily dependent on aid (e.g., some LDCs and SIDS) could in principle have a greater challenge coping with aid volatility than dealing with commodity price volatility (Bulir and Hamann 2003). A notable exception is those developing countries that receive a large amount of export income from fuel exports; they appear to be more shielded from aid volatility than other commodity-exporting countries (Kharas 2010). For others, large fluctuations in aid flows — coupled with uncertainty about future aid flows — can result in changes in government budgets, the composition of spending and instability in employment, i.e., macro-economic instability. All of this affects poverty.

#### 4. What ODA is Used For

##### *HOW MUCH AID REACHES RECIPIENT COUNTRIES?*

Aggregate aid data masks the extent to which large amounts of development aid never actually reach developing countries. This includes, for instance, aid that is spent in donor countries on assistance to refugees, development awareness-raising and research in donor countries, scholarships for developing country nationals, support to non-governmental organizations (NGOs), technical assistance, food aid, humanitarian aid and debt relief. Some NGOs have dubbed these forms of aid ‘phantom aid’ (ActionAid 2005, EURODAD 2006, 2007, 2008 and 2009). In 2007, the OECD developed the concept of ‘country programmable aid’ (CPA) or ‘core aid’ in response to these concerns; it includes only the portion of aid that is actually available to developing countries in-country to plan and spend on national development priorities.<sup>17</sup> CPA is thus much closer to the aid numbers reported in many developing country budgets.

Over the past five years, CPA has comprised about 53 percent of OECD-DAC donors’ gross bilateral aid (OECD-DAC 2010). In 2009, total CPA amounted to \$91.7 billion of a total aid envelope of over \$170 billion in 2008 prices and exchange rates. Africa and Asia receive the largest absolute volumes of CPA: in 2009, Africa received approximately \$36 billion in CPA, while Asia received \$37.5 billion (in 2008 dollars). CPA allocations to Africa — the region farthest off-track on many of the MDGs — have increased at an annual rate of approximately 9 percent over the last five years, 4 percentage points higher than the global CPA increase over the same period. On a per capita basis, Oceania receives the highest proportion of CPA, at over \$200 per person in 2009, compared to approximately \$38 for Africa (value as of 2008). While CPA has increased considerably over the last five years, the OECD-DAC recently forecast a slowdown in this growth. Additionally, increases in CPA have been crowded out by population increases in some regions, e.g., sub-Saharan Africa (OECD-DAC 2010).

The share of CPA in bilateral ODA varies widely among donors, however, from a low 10 percent (Austria) to a high 81 percent (the Republic of Korea and Portugal) (OECD-DAC 2010). Moreover, recent studies have shown that developing country providers deliver a much higher proportion of their ODA in ‘country programmable aid’, at around 90 percent in 2009. About three quarters of this is in the form of project finance (UN DESA 2010).

CPA has been shown to have a positive causal relationship on recipient countries’ economic growth and development over the short term (Clemens, Radelet and Bhavnani 2004). CPA is thus critical to the overall MDG effort. From the perspective of a recipient country, the donor base affects how much CPA that the country can expect; some deliver (much) more than others. If CPA is a more desirable form of aid, one strategy would consist in vigorously engaging with those donors who provide larger proportions of it. On the downside, however, volatility in this form of aid may be more problematic than that associated with other forms of external support.

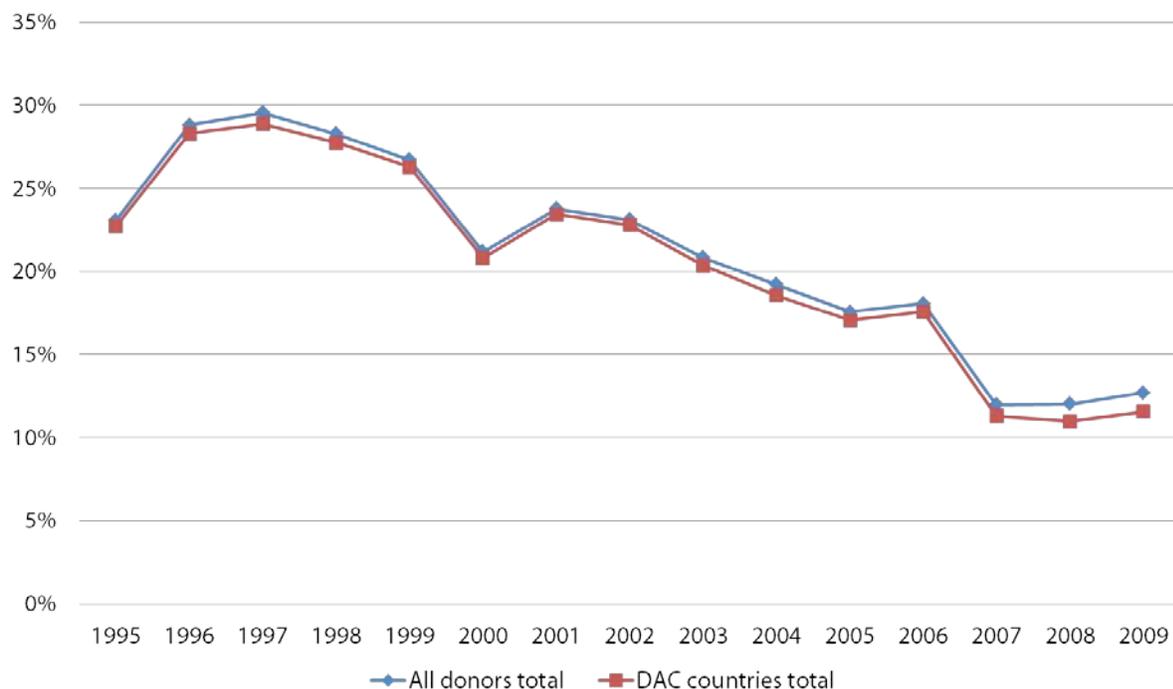


CPA is not a perfect measure of the quality of donors' ODA, however, since it still includes technical assistance, which has a mixed record with respect to its contribution to development. A significant proportion of ODA continues to be spent on technical assistance, although the figure has declined considerably over the last decade, from 21 percent in 2000 to 12.7 percent by 2009 (OECD-DAC 2010).

Additionally, a considerable amount of development aid has been used to cancel the debt of the Heavily Indebted Poor Countries (HIPC) and a number of other developing countries, especially in 2005 and 2006. The large 'spikes' in aid flows in 2005 and 2006 evident in Charts 5.5, 5.6, 5.7, and 5.8 reflect the large debt cancellation operations for Iraq and Nigeria.<sup>18</sup>

Debt relief as a proportion of ODA jumped from just 8 percent in 2004 to 21.3 percent in 2005 and 17.2 percent in 2006. Since then, it has declined steadily and was just 1.8 percent of total ODA in 2009 (OECD-DAC 2010). The claim that this form of 'aid' has contributed to development remains controversial. Debt relief can help release additional resources in recipient countries' budgets for poverty reduction and development expenditures. Additionally, some studies have shown that excessive debt can be detrimental to economic growth (Reinhart and Rogoff 2010); thus, in some cases, debt cancellation could help boost economic recovery and growth, thereby indirectly supporting the MDGs.<sup>19</sup> Nevertheless, the extent to which debt relief has actually released additional resources for MDG expenditures is questionable, since, in any event, many governments had not been able to service these debts for many years. Instead, debt relief is no more than a formal recognition by the creditor that the debt will not be recovered (EURODAD 2006, MDG Gap Task Force 2010). Because debt cancellation is counted as ODA, it has enabled some donors to increase their aid levels in certain years, while,

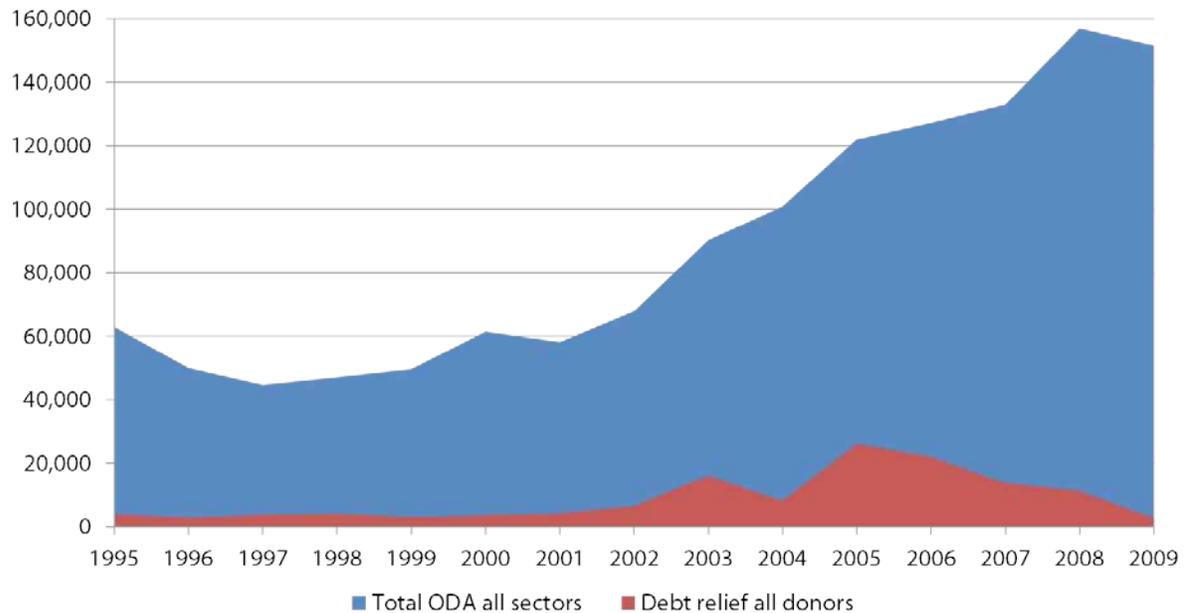
**Chart 5.11: Technical assistance as a percent of total ODA, 1995–2009 (US\$ millions)**



Source: OECD-DAC 2010



### Chart 5.12: Debt relief as a proportion of total ODA (US\$ millions)



Source: OECD-DAC 2010

in subsequent years, it has fallen again. Hence, OECD-DAC donors' ODA levels increased from 0.25 percent GNI in 2004 to 0.32 percent in 2005 and 0.3 percent in 2006, thanks to the large debt cancellation operations for Iraq and Nigeria, before declining to 0.27 percent GNI in 2007 (OECD-DAC 2010).

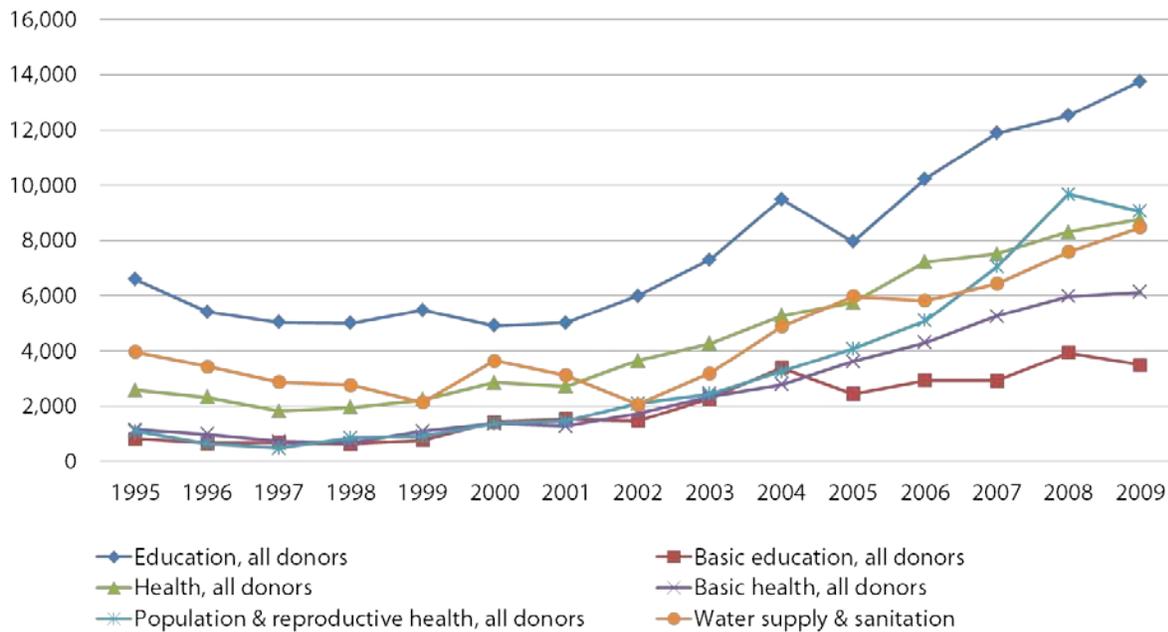
#### DEVELOPMENT SECTORS THAT BENEFIT MOST FROM AID

Although investments in infrastructure, agriculture and the productive capacities are important to countries' overall development strategies and the MDGs, the MDG agenda has to some extent re-oriented donor preferences toward the social sectors. Increases in the overall aid envelope over the last decade have tended to go towards the social sectors, while aid to agriculture, forestry, fisheries and the productive sector has remained largely stagnant, increasing only over the last couple of years.

The data show that ODA to social infrastructure and services has more than tripled in nominal terms over the last decade, from \$20.7 billion in 2000 to over \$64 billion for all donors in 2009.<sup>20</sup> ODA to the health sector has more than quadrupled between 2000 and 2009, from \$2.8 billion in 2000 to \$8.7 billion in 2009, while ODA to education as a whole has almost tripled over the same time period, from \$4.9 billion in 2000 to almost \$14 billion by 2009. In dollar terms, the volume of resources now channelled into the social sectors is unprecedented. ODA to agriculture, forestry and fisheries has also tripled over the last decade, from \$3.5 billion in 2000 to \$9.7 billion in 2009 (OECD-DAC 2010). However, unlike health and education, where the rate of increase has been more or less steady year-on-year, the growth in aid to agriculture, forestry and fisheries is only evident from 2007 onwards; between 2000 and 2007, ODA to this sector remained relatively stagnant and, indeed, declined in some years, even though overall aid levels were on the increase. ODA investments in industry, mining and construction have only nearly doubled over the last decade, from \$1.2 billion in 2000

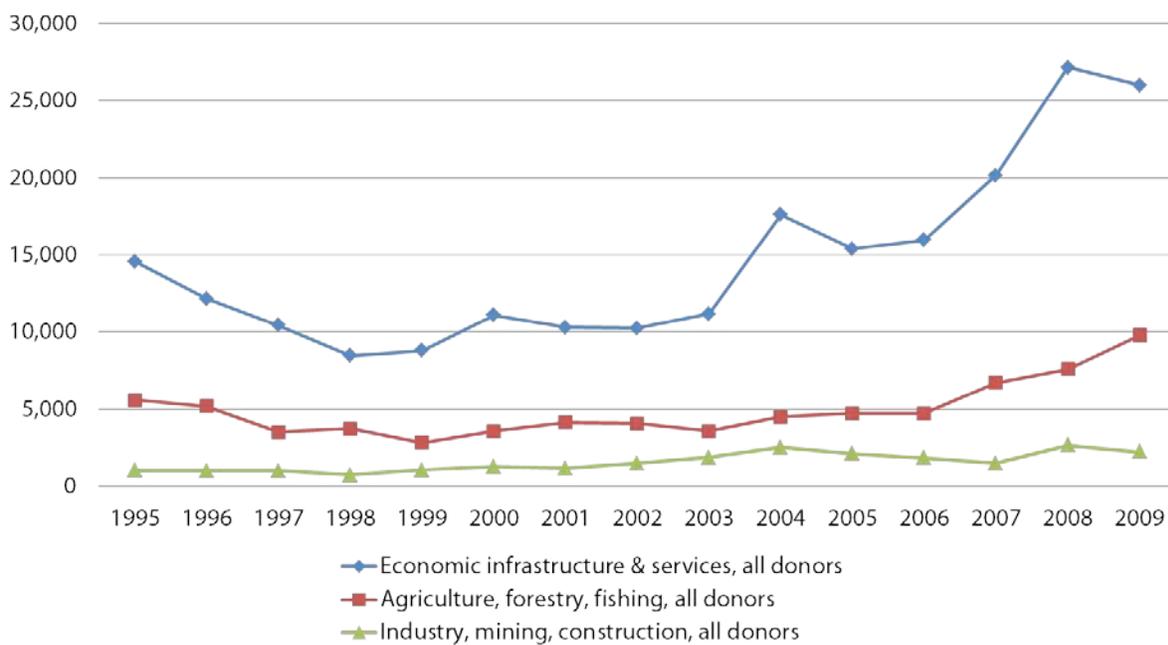


**Chart 5.13: ODA to social sectors (current US\$ millions)**



Source: OECD-DAC 2010

**Chart 5.14: ODA to economic infrastructure and agriculture (US\$ millions)**



Source: OECD-DAC 2010



to \$2.2 billion in 2009 (OECD-DAC 2010), and remain far from the amount needed to support development in the world's poorest countries.

When measured as a proportion of total ODA, however, a slightly different picture emerges. Sectoral allocations have, in fact, changed little over the last decade. ODA to education as a whole has increased little, if at all, since 2000 and has remained steady at around 8 percent of total ODA allocations. ODA to basic education has also remained steady at around 2.5 percent over the same time period. ODA to health as a proportion of total ODA

has increased slightly, from 4.6 percent to 5.7 percent between 2000 and 2009. Only ODA allocations to basic and reproductive health have increased substantially over the last decade. In 2000, basic health captured a 2.2 percent share of total ODA, rising to over 4 percent by 2009. Population and reproductive health also received a 2.2 percent share of total ODA in 2000, almost tripling to 6 percent by 2009. Despite poor progress on MDG7, which pertains to sanitation and drinking water, aid allocations to this sector significantly decline between 2000 and 2002 and have since been fairly constant at around 5 percent of total ODA (OECD-DAC 2010).

*Increases in the overall aid envelope over the last decade have tended to go towards the social sectors, while aid to agriculture, forestry, fisheries and the productive sector has remained largely stagnant, increasing only over the last couple of years.*

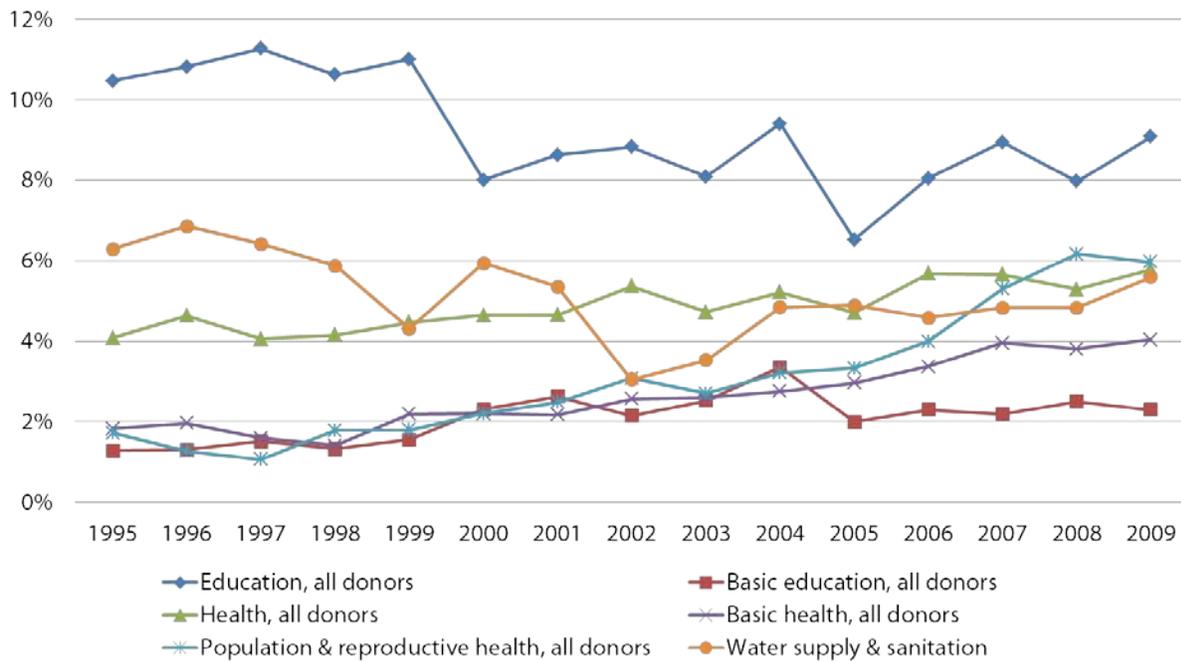
ODA to the productive sectors and agriculture progressively declined between 1995 and 2007 and has only just begun to reverse. ODA allocations to agriculture, forestry and fisheries declined from approximately 10 percent of total ODA in 1995 to 3.8 percent a decade later. Only over the last couple of years have there been small increases in aid to agriculture. In 2009, ODA to this sector reached 6.4 percent of total ODA (OECD-DAC 2010). However, this still remains well below the levels seen in 1995 and far from the United Nations target of 10 percent of ODA to agriculture. Meanwhile, economic infrastructure (roads, ports, etc.) declined from 23 percent of total ODA in 1995 to a low of 12.3 percent in 2003. In 2008 and 2009, ODA allocations to economic infrastructure increased to around 17 percent, but the scale of this trend should not be overemphasized; aid to infrastructure has only just recovered the share it held a decade ago (OECD-DAC 2010). As a result of this limited progress, some developing countries have turned to more expensive market-based finance to meet their large infrastructure gaps. This has contributed, in turn, to increased public debt burdens in some developing countries.

Many developing country aid providers have demonstrated more 'openness' to funding large-scale economic infrastructure than 'traditional' donors. While South-South cooperation focuses on all sectors in national development plans, infrastructure and the productive sectors have featured prominently. Economic infrastructure is often a priority for many developing countries, and several Southern donors (notably China, India, Kuwait, Saudi Arabia, Islamic Development Bank, OPEC Fund, etc.) have extensively supported infrastructure development, industry and agriculture (UN DESA 2010).

This form of development aid is more closely correlated with economic growth in recipient countries in the short run. Clemens, Radelet and Bhavnani (2004) find a "strong, positive and causal relationship between 'short-impact aid' and economic growth (with diminishing returns) over four years". This basic result does not depend on quality of policies or institutions; this type of so-called 'short-impact aid' causes growth, on average, across recipient countries regardless of these characteristics, although the impact on economic growth is even greater in those countries that have stronger institutions and better health (Clemens, Radelet

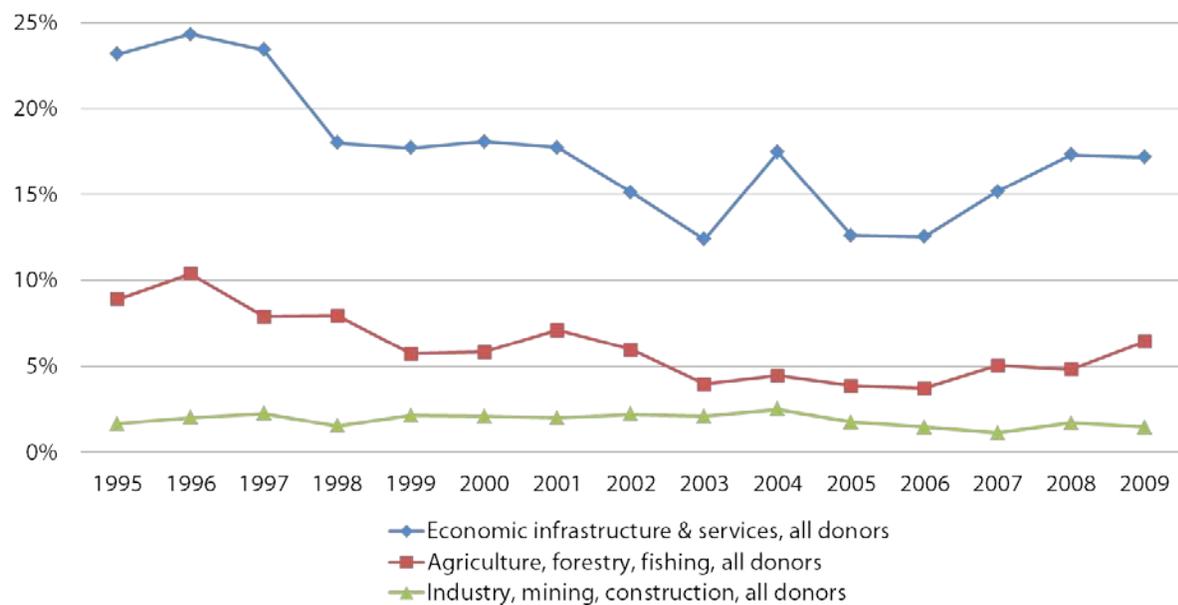


**Chart 5.15: ODA to MDG sectors as a percent of total ODA**



Source: OECD-DAC 2010

**Chart 5.16: ODA to economic infrastructure and agriculture as a percent of total ODA**



Source: OECD-DAC 2010

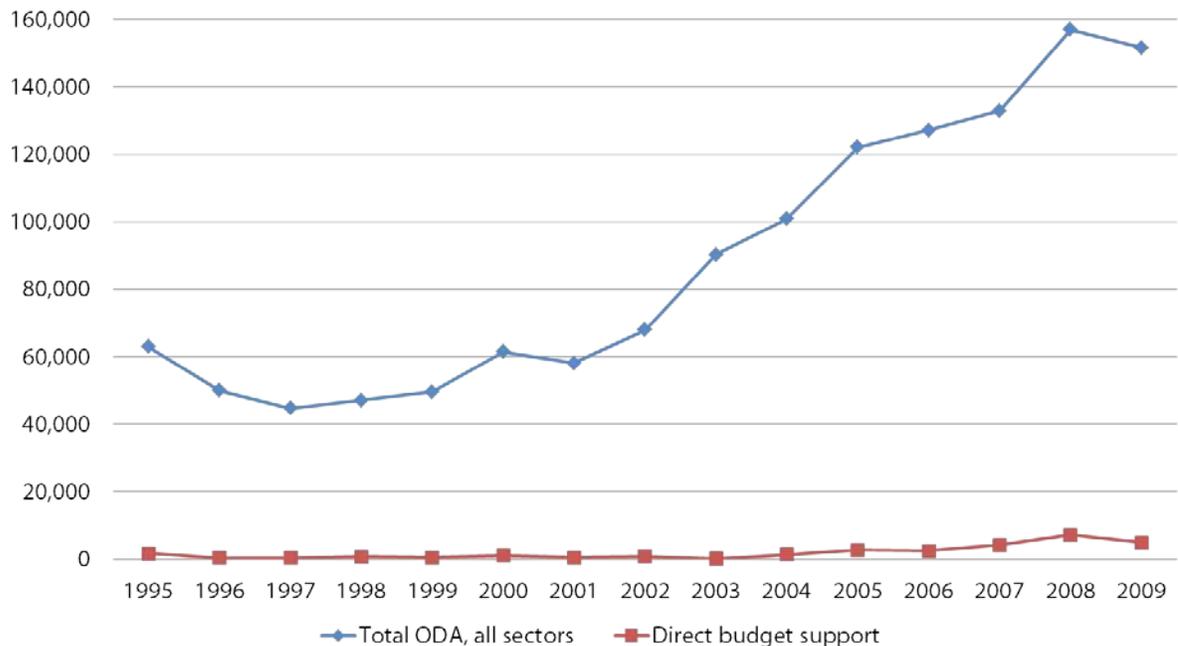


and Bhavnani 2004). They find that a \$1 increase in short-impact aid raises output by \$1.64 in present value in the typical country. While there are limits as to the amount of short-impact aid a country may be able to absorb, the turning point is well above the current amount of aid that most countries receive. Whereas the average country receives short-impact aid flows of about 2.7 percent of GDP, Clemens, Radelet and Bhavnani (2004) estimate that many developing countries could absorb up to 8 percent to 9 percent of GDP in short-impact aid.

'Short-impact aid' may be positively correlated with economic growth in recipient countries, but many studies continue to show that direct general budget support — and sector budget support — is the most efficient, effective and sustainable form of aid for promoting development (see Dom 2007, Gerster 2007, European Commission 2008, Oxfam 2010, UKAN 2010, UNDP 2010).<sup>21</sup> Yet only a fraction of aid is channelled to recipient countries in this way.

While the amount of ODA allocated to budget support has more than quadrupled over the last five years (from \$1.3 billion in 2004 to almost \$5 billion in 2009 in current prices), just 3.2 percent of ODA in 2009 was in the form of direct budget support (OECD-DAC 2010). Larger increases have so far proven politically difficult in many donor countries that are keen to report 'visible development results' to their electorates. Concerns about corruption in recipient countries compound this. Again, Southern donors have a better record on this front; recent estimates of the amount of balance of payments support and direct budget support provided by Southern donors stands at approximately 15 percent of Southern ODA. Much of this has been intra-regional, e.g., the Bolivarian Republic of Venezuela has provided oil financing to the Caribbean region and India has provided budget support to Afghanistan, Bhutan, Maldives and Nepal (UN DESA 2010).

**Chart 5.17: Direct budget support (US\$ millions)**



**Source:** OECD-DAC 2010



In conclusion, there is little rhyme or reason behind many donors' aid allocation decisions. Despite much empirical evidence that direct budget support and/or sector budget are more effective, much more aid is channelled via other modalities, such as technical assistance, that have a mixed record on development results. A wider trend in 'earmarking' of aid is evident, especially by OECD-DAC donors. This is achieved by allocating resources to so-called 'vertical' funds, global funds or trust funds in multilateral institutions. The health sector has so far been the major beneficiary while climate change looks set to benefit from significant earmarked resources in the future. However, despite vertical funds' solid track record on immediate and tangible development results, this approach can undermine country ownership of the development process and many of these funds are highly fragmented and possibly unsustainable. This may have implications on the sustainability of the MDGs in certain sectors. A trend in smaller and smaller development projects is also becoming evident. Coupled with the proliferation in the number of development actors, this stands to increase administrative burdens and challenge efficiency unless recipient countries have sufficient capacities to effectively coordinate and manage the incoming resources.

Some Southern ODA providers have a better track record on, for instance, direct budget support and the financing of economic infrastructure projects, which can be expected to contribute to economic growth in the short run. However, anecdotal evidence also points to the use of 'tied aid' by some developing country donors that may undermine the value and effectiveness of some of their aid.

That said, overall increases in aid have indeed translated into increased aid allocations (in dollar terms) to key MDG-related areas such as education, health, reproductive health and sanitation over the last decade.

## Policy Conclusions and Recommendations

ODA is at unprecedented levels in dollar terms. With the recent rapid rise in South-South Cooperation combined with commitments to increase aid from 'traditional' donors, aid is projected to rise further still over the next couple of years. This is largely due to the MDG agenda. Nevertheless, the importance of aid relative to other financial flows should not be exaggerated for many developing countries; for others, however—especially the LDCs and some SIDS—aid will remain a critical source of external finance for some time to come.

The empirical evidence has shown that, despite large increases in aid, the contribution of this aid to development outcomes relative to the size of the increase in aid has been disappointing. This can be attributed to both donor and recipient country behaviour, although the relative importance of one over the other will vary considerably from country to country. The procyclicality of aid has undermined many countries' resilience to external shocks and has exacerbated rather than mitigated macro-economic instability in recipient countries. Further, the lack of predictability and volatility in aid flows has also undermined macro-economic stability and worsened the composition of government spending. Thus, managing aid flows can be extremely challenging for many governments. This is combined with a tendency to channel substantial amounts of development aid via modalities that have a mixed record of development results (e.g., technical assistance) or that suit donor interests as much as, or more than, recipient country interests.

ODA can have a direct impact on the MDGs (e.g., through support for specific health, education, sanitation interventions, etc.) or an indirect impact on the MDGs (e.g., through supporting economic growth more broadly via direct budget support or the development of specific productive capacities). This means that



abrupt swings in aid in one area can have a knock-on impact in many other areas. As the United Nations Development Programme has shown, progress (or reversal) in one MDG area often translates into MDG progress (or reversal) in other areas (UNDP 2010).

What does this mean for the role of ODA in sustaining MDG progress? From the perspective of an aid recipient country, several considerations are important:

1. The extent to which the country is dependent on aid overall (measured in terms of aid per capita, aid as a proportion of government revenues, aid as a percent of gross capital formation and aid as a percent of GNI).
2. The extent to which certain sectors within the country are heavily dependent on aid to function (this may be a particular issue in the health sector).
3. How aid is delivered in the country, for instance, how much is received through direct budget support, project aid, 'vertical' funds, etc.? How much does the country never actually 'see'? Volatility associated with some forms of aid is perhaps more harmful than others, e.g., volatility in direct budget support or sector support may be worse than volatility in technical assistance.
4. The overall level of aid absorption in the country (on the assumption that countries with low levels of aid absorption are less likely to be more severely negatively impacted by aid shortfalls than those with full aid absorption).
5. The diversity of the country's donor base (under the assumption that a more diversified donor base will help the recipient country to spread risk in the event of aid shortfalls).<sup>22</sup>
6. The particular characteristics of a recipient country's major bilateral aid donor(s), for example, the donor's record on predictability, responsiveness to business cycles or external shocks, commitment to the implementation of conditionalities, etc.
7. Conditions prevalent in the recipient country (e.g., potential for political turmoil, strength of institutions, level of exposure to external shocks, level of political commitment to implement donor conditionalities, etc.). This can also affect the levels of aid received in particular years, as well as its overall volatility (for better or worse).
8. Access to other sources of external and domestic finance to substitute for or complement ODA, with particular consideration of whether these sources of capital are procyclical or countercyclical, i.e., the extent to which they could be drawn down in the case of economic shocks or other cyclical downturns.
9. The overall record of aid on development results in the country (this will include the track record of particular donors as well as the record in particular sectors).

The preceding analysis suggests some possible policy responses for aid recipient countries and particularly for those more heavily dependent on aid. In some cases, however, there may be certain opportunity costs or other difficulties associated with these policy measures; these must be carefully weighed up against the potential benefits. Possible policy responses include:



- 1. Save some aid:** Where aid is volatile and/or typically procyclical (and taking this as given), some savings of aid in the form of reserve accumulation may be useful to some recipient countries. This would serve as a form of ‘insurance’ to be drawn on in cases of external shock or cyclical economic downturns. Aid would thus act as a useful smoothing device. There are some difficulties and costs associated with this strategy, however. How much aid a country is able to save will depend on its overall level of aid absorption. Those countries most dependent on aid and with full or close to full aid absorption may be able to save less aid than other countries (even though they may benefit most from this sort of strategy). The opportunity cost of saving aid rather than spending it must also be carefully considered, i.e., one should ask what the alternative uses of these aid resources are. Could these uses support rapid economic growth and human development? Additionally, with the ‘earmarking’ of aid on the increase by donors, the extent to which recipients may have the leverage to save some aid may also be restricted.
- 2. Diversify your donor base:** A more diverse donor landscape entails more resources and more competition between donors. Some developing countries may be able to use this to their advantage. Increasing the number of development cooperation partners may help aid recipient countries to spread risk, e.g., the sudden withdrawal of one partner may affect them less severely. It may also allow recipient countries to shift towards supposed ‘more stable’ or ‘desirable’ development partners, i.e., those whose aid is more predictable or those which offer the types of aid in which the country is most interested (for example, direct budget support or other forms of country programmable aid, or those donors who impose less conditions, etc.). Again, this strategy may have some costs. A larger number of donors may lead to greater fragmentation in the delivery of aid and coordination problems and could place large administrative burdens on recipient country governments. Thus, the capacities of indigenous institutions would need to be evaluated and/or combined with a strategy to rapidly develop institutional capacities.
- 3. Reduce reliance on aid:** A primary objective of aid-dependent countries should consist in defining a way to ‘exit’ from aid at some point in the future. The development of a realistic ‘exit’ strategy may help recipient country governments to focus attention on how they will raise revenues in the future and the development areas that ODA should be used to support today. Over the longer term, the ability to raise more resources domestically will increase policy space and country ownership of the development process. Governments should explore ways to mobilize more external and internal resources for development. Again, some policy options have both advantages and disadvantages. Possible policy measures include: issuance of sovereign debt on international and/or domestic capital markets; increased taxation of multinational corporations (or, conversely, tax breaks to attract more FDI);<sup>23</sup> strengthening and broadening the domestic tax base; and implementing measures to catalyse remittance flows and curtail illicit outflows of capital. These measures can be successful only if they are implemented within the framework of a broader development strategy.
- 4. Ensure that aid supports the development process:** Much aid has not, in fact, supported positive development outcomes, so recipient country governments may wish to be more aggressive concerning the aid that they will and will not accept. The national development strategy should guide this. Of course, the extent to which this is a realistic prospect for some countries is debatable. Moreover, some donors may just offer their aid to someone else in retaliation. This must be weighed against the possibility that a recipient country may receive less, but better, aid. Lower amounts of aid may, in turn,



be easier to coordinate and the results easier to attribute. Governments may be particularly interested in exploring ways in which aid can be used as a catalyst for the mobilization of private sector resources and investment. Additionally, the development of a clear aid policy and the implementation of an aid information and management system to capture aid and other external financial flows may also help to ensure that the government of recipient country governments uses aid transparently and effectively. UNDP has helped many recipient governments to implement and use such systems.

There are also policy recommendations for donors. Many donors have already committed to increase the quantity and quality of their aid. This is essential to ensure mutual accountability for development results. Pledges by some donors to increase the quality of their aid are contained in the Paris Declaration and Accra Agenda for Action endorsed in 2005 and 2008, respectively.<sup>24</sup> These international agreements commit donor and recipient countries to a range of measures to improve the effectiveness of development aid.<sup>25</sup> Despite these commitments, however, progress has been slow.

In 2008, the OECD, which has responsibility for monitoring OECD-DAC donors' progress on key aid effectiveness principles, reported mixed results. For instance, progress on increasing the predictability of aid — critical to macro-economic stability in some recipient countries — has been slow. Progress on improving coordination among donors and increasing the use of recipient country systems has also been slow.<sup>26</sup> In addition, many donors — especially the emerging donors — do not adhere to the Paris Declaration and Accra Agenda for Action. Many emerging donors were not involved in the development of the Paris Declaration and, as a consequence, feel no ownership over it and no need to be bound by the principles contained in the document. Some emerging donors have also developed their own aid effectiveness principles, which they believe are more suited to their cooperation activities. Some see the United Nations Development Cooperation Forum (DCF) as an alternative international forum in which issues concerning aid effectiveness may be debated more inclusively.<sup>27</sup>

These considerations suggest several policy measures that donors would do well to take:

- 1. Increase the quantity of development aid:** Developed country donors should recommit to the UN target of 0.7 percent ODA/GNI and set clear timetables for meeting this aid commitment. Consideration should be given to appropriate targets on aid quantity for emerging donors. The target will undoubtedly vary between donors.
- 2. Improve development effectiveness of aid:** All donors should make every effort to improve the effectiveness of their development cooperation. The IV High Level Forum on aid effectiveness in Busan, the Republic of Korea, in November 2011 provides an opportunity for a renewed commitment to aid effectiveness. However, over the long-term, there needs to be more consideration about the most appropriate and inclusive forum for debating aid and issues of development effectiveness. The DCF has been cited as one opinion in this regard. Much more aid needs to reach recipient countries than is currently the case, as too much is still spent within donor countries or on services that donor countries provide and much more aid could be channelled via direct budget support, which is the most efficient and effective form of resource transfer.
- 3. Better target aid:** ODA needs to be better targeted to reach those who need it most. This includes the poorest countries, the poorest communities within countries, and those countries with recognized structural constraints to development (e.g., the LDCs and SIDS). The degree of aid concentration has



worsened over the last decade and needs to be reversed. More aid needs to be allocated on the basis of objective need and structural vulnerabilities.

- 4. Enhance the role of aid in macro-economic stabilization:** There needs to be more use of aid as a smoothing device to counter the fiscal effects of business cycles or external shocks. On average, aid tends to be procyclical, which can amplify the negative effects of economic downturns. ODA should be countercyclical in order to make the biggest contribution possible to macro-economic stability.
- 5. Increase transparency and accountability in aid:** Donors must publicize more information about their development cooperation activities. Increased transparency will help to support greater accountability for aid decisions in both donor and recipient countries. This recommendation applies equally to 'old' and 'new' development cooperation partners; currently, very few emerging donors publish clear and systematic data about their aid activities, an omission that leads to much speculation about what they do 'well' and what they do 'badly'. More information will lead to a range of better outcomes, *inter alia*: more effective oversight, the ability to learn from other donors' experiences, better coordination between donors, and improved development outcomes.

A key question for the future is whether the current political momentum for increased aid will be sustained beyond the 2015 MDG target date, especially given the mixed track record of aid on tangible development outcomes. Another essential issue is that some countries (mainly LDCs and SIDS) are likely to need sustained external support for many years due to structural constraints to development. How the international community responds to these challenges and how it apportions responsibilities for helping to finance these countries' development will also be crucial.

Climate change adds another critical element to the equation. Climate change is already magnifying many developing countries' development challenges. Furthermore, it is increasing the cost of development. The international community has pledged much climate finance (\$100 billion per year by 2020) to support adaptation and mitigation in developing countries. How this finance will be raised still remains unclear. How this finance will relate to traditional forms of development aid is also unclear, and one might question the extent to which climate finance will represent a truly 'additional' source of finance and how climate finance and ODA will be 'counted' when many sources of funds are simultaneously designated to address climate and development issues. These are critical issues for ODA in the coming few years.



## Notes

1. OECD-DAC 2010, Development Aid Reaches an Historic High in 2010: [www.tinyurl.com/oecd2010](http://www.tinyurl.com/oecd2010)
2. These countries are: Afghanistan, Burkina Faso, Burundi, Cape Verde, Democratic Republic of the Congo, Djibouti, Ethiopia, the Gambia, Guinea-Bissau, Guyana, Iraq, Kiribati, Liberia, Malawi, the Marshall Islands, Federated States of Micronesia, Mozambique, Nicaragua, Palau, Rwanda, São Tomé & Príncipe, Solomon Islands, the United Republic of Tanzania, Togo, Uganda and Vanuatu.
3. See OECD: [www.tinyurl.com/oecd-PD-AAA](http://www.tinyurl.com/oecd-PD-AAA)
4. As reported by the OECD in its annual 'Monitoring Survey'. For more information, see: [www.tinyurl.com/PD-AAA-progress](http://www.tinyurl.com/PD-AAA-progress)
5. Refers to OECD-DAC donors only.
6. See: OECD-DAC, Development Aid Reaches an Historic High in 2010: [www.tinyurl.com/oecd2010](http://www.tinyurl.com/oecd2010)
7. Some of the more established and well-known schemes include the international solidarity levy on air tickets and the International Finance Facility for Immunisation (IFFIm), both of which were launched in 2006. The international solidarity levy on air tickets has so far raised over \$1 billion for HIV/AIDS, malaria and tuberculosis (UNITAID 2009) and the IFFIm has raised over \$3 billion for immunization programmes (IFFIm 2010). The resources raised through innovative finance schemes have generally supported interventions in the health sector and have been channelled to recipient countries via so-called 'vertical funds'. A note of caution: some of these initiatives are donor-funded (and therefore are not additional to the ODA totals mentioned above); others raise revenues privately and therefore represent additional sources of development cooperation.
8. Innovative finance schemes have raised a total of \$4 billion since 2006 (Leading Group).
9. Recent estimates indicate that 'donor orphans' are underaided by around \$12 billion per year (UNDESA 2010).
10. Europe was allocated 3.5 percent of ODA in 2009; North Africa received 1.7 percent of ODA in 2009; Central America received 2.6 percent; South America received 2.2 percent; and Oceania received 1 percent (OECD-DAC 2010).
11. When measured next to other low-income countries and middle-income countries.
12. Note that Kiribati, Samoa, Solomon Islands, Timor-Leste and Vanuatu are classified as both LDCs and SIDS.
13. Note that a small number of LDCs are both SIDS and LDCs.
14. Net ODA.
15. All figures refer to 2009.
16. 'Vertical funds' focus 'vertically' on specific issues or themes, in contrast with the 'horizontal' approach of the country-based model of aid. Such funds have their advocates and their critics. Many vertical funds have a stronger record on clear, measurable development results than other donors, in part because of the nature of their interventions (e.g., numbers of children immunized across a certain number of countries). However, the extent to which vertical funds are aligned with national development priorities has been called into question, as well as whether they undermine rather than strengthen the development of indigenous health systems. The use of vertical funds has become so prevalent that coordinating mechanisms for the sector have been developed, i.e., initiatives coordinating the initiatives (Goodwin 2008). This has increased transaction costs further still. Some vertical funds are heavily dependent on donor contributions to carry out their activities (e.g., Advance Market Commitments, etc.). Thus, given current fiscal pressures in several major donor countries, the sustainability of some funds over the longer term may be legitimately questioned. The Global Alliance for Vaccines and Immunisation (GAVI) has been funded through the mechanism known as the International Finance Facility for Immunisation (IFFIm), launched in 2006. This mechanism 'frontloads' future aid commitments for development spending today via the issuance of bonds by donor countries in international capital markets. Donor governments' future aid will be used to repay these bonds and there is some concern that future aid levels will decline as a result.



17. OECD, Getting Closer to the Core – Measuring Country Programmable Aid: [www.tinyurl.com/CPA-measure](http://www.tinyurl.com/CPA-measure)
18. In Chart 5.8, the decline in ODA levels registered in 2005 and 2006 by LLDCs and to a lesser extent by SIDS reflects the exceptional debt relief operations in those years for Iraq and Nigeria. Almost all donors count these operations as ODA. As a consequence, some donors register a ‘one-time spike’ in annual aid flows relative to previous years before returning to previous levels. In other cases, donors may reduce aid to other developing countries in a particular year. For further information, see the Paris Club: [www.clubdeparis.org](http://www.clubdeparis.org)
19. Reinhart and Rogoff (2010) show that, while the relationship between government debt and real GDP growth is weak for debt/GDP ratios below 90 percent, above the threshold of 90 percent, median growth rates fall by 1 percent and average growth falls considerably more (in advanced and emerging economies). Emerging and developing countries face lower thresholds for total external debt (public and private), which is usually denominated in a foreign currency. When total external debt reaches 60 percent of GDP, annual growth declines about 2 percent; for higher levels, growth rates are roughly cut in half.
20. ODA to social infrastructure and services was relatively stagnant in nominal terms between 1995 and 2000 (OECD-DAC 2010).
21. There are various reasons for this: it contributes to national ownership, increases the accountability of recipient governments to their citizens and parliaments, helps build the capacities of local institutions, reduces transaction costs, increases predictability and ensures a greater proportion of aid is spent directly on the intended beneficiaries.
22. Donor ‘herding’ behaviour may mean, however, that a greater number of donors may not necessarily entail reduced risk. On balance, however, it probably will help slightly.
23. The evidence on the effectiveness of tax breaks or tax holidays as a means to attract FDI is not particularly strong, although some multilateral financial institutions have long advised this policy.
24. See OECD, Paris Declaration and Accra Agenda for Action: [www.tinyurl.com/PD-and-AAA](http://www.tinyurl.com/PD-and-AAA)
25. These commitments include: ownership—developing countries set their own strategies for poverty reduction, improve their institutions and tackle corruption; alignment—donor countries align behind these objectives and use local systems; harmonization—donor countries coordinate, simplify procedures and share information to avoid duplication; results—developing countries and donors shift focus to development results and results get measured; mutual accountability—donors and partners are accountable for development results; predictability—donors will provide information on their planned aid to partner countries three to five years in advance; country systems—partner country systems, rather than donor systems, will be used to deliver aid as the first option; conditionality—donors will switch from reliance on prescriptive conditions about how and when aid money is spent to conditions, based on the developing country’s own development objectives; untying—donors will relax restrictions that prevent developing countries from buying the goods and services they need, allowing countries to get the best goods and services at the lowest price from whomever and wherever they can.
26. For a full summary of results, see: [www.tinyurl.com/PD-AAA-progress](http://www.tinyurl.com/PD-AAA-progress)
27. The DCF brings together developing and developed countries, parliamentarians and civil society organizations, local governments and the private sector for a frank dialogue on development cooperation. It reviews trends in development cooperation and promotes greater coherence among the activities of various actors. The next DCF will be held in June/July 2012 in New York. See: United Nations Development Cooperation Forum: [www.un.org/en/ecosoc/dcf/index.shtml](http://www.un.org/en/ecosoc/dcf/index.shtml)



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# 6

## INCOME INEQUALITY AND THE CONDITION OF CHRONIC POVERTY



*Although the adverse effects of financial crises on growth and poverty are well documented, the fact that financial crises also tend to worsen income distribution in developing economies is less frequently considered. As this happens and inequalities worsen, they create the very conditions that provoke the next crisis.*



Photo: Kibae Park/ UN Bangladesh



# Income Inequality and the Condition of Chronic Poverty

## Introduction

By all accounts, income inequalities in advanced economies have surged since the 1980s. This trend is closely correlated with the increase in the incidence of financial crises that have rocked the global economy over the same period (Moss 2009, Stiglitz et al. 2009, Rajan 2010). “Worldwide, systemic banking crises have been ten times more likely during the 1990s than during the late 1970s, hardly a period of calm economic activity” (Ernst and Escudero 2008). As developing economies become ever more integrated into international financial markets, they are increasingly exposed to the negative effects that such shocks typically have on poverty and growth. Evidence from the financial crises in Asia in 1997, in Mexico in 1994, in the Russian Federation in 1998, and in Argentina and Brazil in 2001 and 2002 has amply documented this (Gonzalez-Hermosillo and Hesse 2009).

There is a similar pattern in many developing countries, where inequalities have risen sharply largely due to the adoption of financial liberalization and adjustment policies. Moreover, as in advanced economies, the rise in income inequality appears strongly associated with more frequent domestic financial crises (Cornia 2004, Vandemoortele 2009, Woo 2005, van der Hoeven 2008). In other words, there appears to be a strong link between the rise in income inequality and the increasing frequency of financial crises across the world.

Although the adverse effects of financial crises on growth and poverty are well documented, the fact that financial crises also tend to worsen income distribution in developing economies is less frequently considered. As this happens and inequalities worsen, they create the very conditions that provoke the next crisis. For these reasons, rising income inequality, be it in advanced or developing economies, has become a principal driver of vulnerability in recent times.

Furthermore, the persistence of inequality at high levels in many developing economies has made it more difficult to reduce poverty. It is well known by now that greater inequality makes it less likely that economic growth can reduce poverty—regardless of the rate of economic growth. Moreover, there is a growing consensus that excessive inequality can stunt growth itself (Birdsall 2005).<sup>1</sup>

High inequality can also have undesirable political and social consequences (Alesina and Perotti 1996).<sup>2</sup> “Where the institutions of government are weak, inequality exacerbates the problem of creating and maintaining accountable government, increasing the probability of economic and social policies that inhibit growth, and poverty reduction and where social institutions are fragile, inequality further discourages the civic and social life that undergirds collective decision-making which is necessary to the functioning of healthy societies” (Birdsall 2005). Put differently, high inequality is associated with higher crime rates, lower life expectancy and conflict.

This relationship between high inequality and weak growth appears to be particularly strong in countries where a large part of the population is ‘trapped’ in poverty. One reason that poor countries find it so difficult to grow is that all income in an impoverished household goes for consumption. There are no taxes and no personal savings. “Yet, depreciation and population growth continue relentlessly. The result is a fall in capital per person and a negative growth rate of per capita income. That leads to still further impoverishment of the household in the future” (Johnston 2010).

Thus, at the macro-economic level, extensive poverty leads to low savings rates and, in the absence of external sources of finance, low rates of investment. Low investment results in low growth, which, in turn, is insufficient to make a dent in poverty. Put differently, high initial levels of poverty can set into motion a vicious cycle



“through which the high incidence and severity of poverty act as constraints on economic growth, thus perpetuating all-pervasive poverty” (Gore 2002).

Chronic poverty and high and rising income inequality have important consequences for sustaining MDG progress:

- High and rising inequality can slow and even stall progress towards the reduction in poverty, given the growth, inequality and poverty linkages in a country.
- Rising inequality is a key driver of domestic financial instability that is typically associated with adverse growth, poverty and distribution impacts. As the conditions of the poor deteriorate and inequalities worsen amidst depressed growth, budgetary outlays to sustain MDG investments may be difficult to maintain.
- Income inequalities are linked to and can reinforce other inequalities. For instance, the supply of publicly subsidized education is likely to be limited where the rich resist a large tax burden to finance services they can purchase privately (Behrman and Birdsall 1983). Likewise, one of the key messages of the Commission on Sustainable Health was that there is a need to tackle the inequitable distribution of income, since a major determinant of health inequality is income inequality (van der Hoeven 2008).
- For countries with chronic and extensive poverty and long-term anaemic growth, policies that address poverty reduction at the margins will be grossly inadequate. If growth is unable to generate domestic resources or make a dent in poverty, the prospects for MDG progress will be very uncertain. Further, low growth is unlikely to generate the resources needed for measures that can protect economies against the effects of external or domestic shocks.
- High and rising inequality also reduce the likelihood that economic and social policies fostering inclusive growth and human development will be delivered and implemented. For instance, richer groups may secure economically inefficient advantages such as regressive taxes or an allocation of public funds for their own interest rather than for that of the country (Vandemoortele 2009).
- Finally, in developing countries, where the institutions of government are often weak, inequality exacerbates the problem of creating and maintaining accountable government, thereby increasing the probability of the adoption of economic and social policies that inhibit growth and poverty reduction (Birdsall 2005).

*This relationship between high inequality and weak growth appears to be particularly strong in countries where a large part of the population is ‘trapped’ in poverty.*

For the most part, policy measures to reduce income inequalities and poverty have mainly focused on the latter. Yet, given the centrality of income (and wealth) distribution for poverty reduction, it is essential that countries pursue an inclusive growth agenda and squarely address the issue of inequality and poverty reduction in tandem. Specifically, policy measures should focus on:

- Promoting inclusive growth and creating productive employment
- Redistributing assets and incomes
- Adopting pro-poor macro-economic policies



# Income Inequality and the Condition of Chronic Poverty

## Trends in Income Inequality

### *Income Inequality in Advanced Countries*

In most advanced and emerging economies, the rise in income inequality during at least the past two decades has been unprecedented (IMF 2007, OECD 2008, Krueger et al. 2010). In most advanced economies, the average wage stagnated, while inequalities surged in favour of the upper quintile of the distribution.

Chart 6.1 shows a redistribution of income from the lowest earning 80 percent to the highest earning 20 percent of income earners in OECD countries as a whole.<sup>3</sup> The real income of the lowest earning quintile in

*The increase in inequality within advanced countries fuels financial instability because inequality creates a political environment whereby procyclical investment policies (such as poor regulation and loose monetary policy) are more likely to be implemented with the objective of avoiding political instability and reductions in economic growth.*

OECD countries grew by 0.8 percent less than the average growth in income. This means that the share of the bottom quintile in total income fell from the mid-1980s to the mid-2000s. The middle three quintiles suffered a similar fate during the period: growth of the real income of the middle three quintiles was 0.2 percent less than the growth in average income. Only the real income of the top quintile grew faster than average income. In the OECD countries, the real income of the top quintile grew by 0.5 percent above the average growth in income. With the exception of France, the same patterns hold for individual OECD countries (Germany, Italy, United Kingdom, and the United States of America).

### *Rising Inequality in Advanced Economies and Global Financial Fragility*

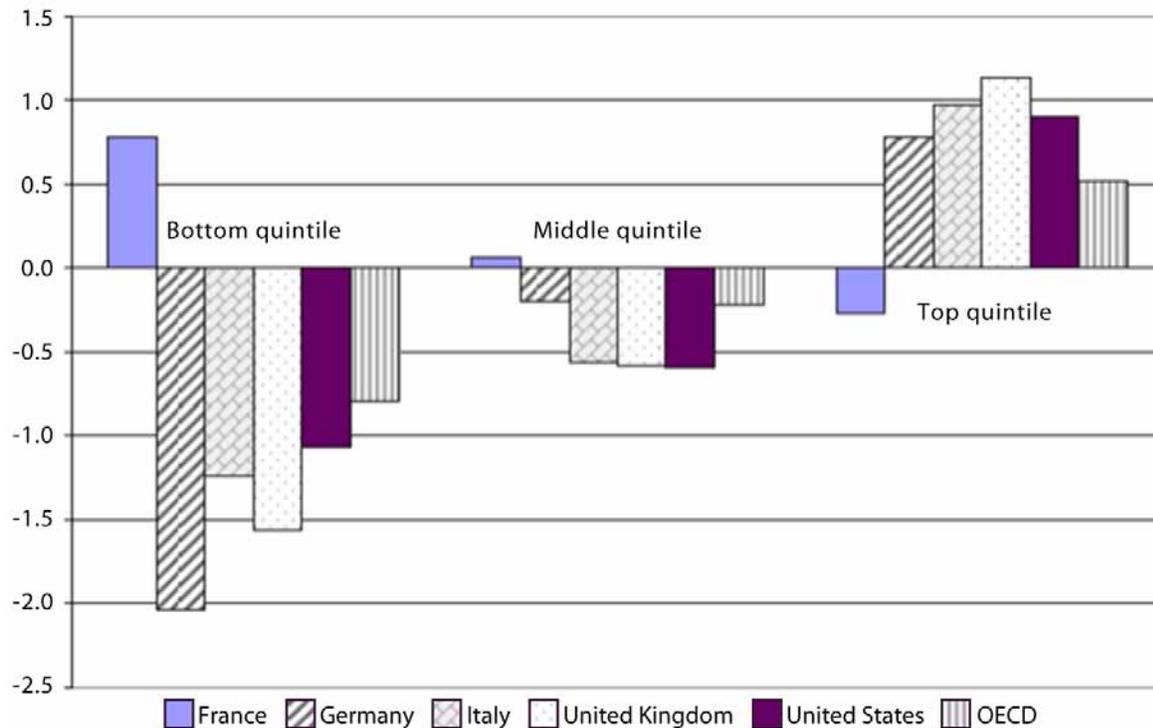
Sharply rising inequalities in advanced economies have come under greater scrutiny since the 2007/08 crisis and are increasingly seen as a primary determinant of global financial fragility. "Although the crisis may have emerged in the financial sector, its roots are much deeper and lie in a structural change in income distribution that had been going on for the past three decades." (Rajan 2010, Fitoussi and Saraceno 2010, Vandemoortele 2009, Stiglitz et al. 2009).

Inequality contributes to financial instability through several interrelated channels. Generally, a rise in income and wealth inequality reduces the purchasing power of middle- and low-income groups. From a macro-economic perspective, this triggers a redistribution away from households with a higher propensity to consume to households with a lower propensity to consume. If propensities to consume differ, then income distribution affects the overall propensity to consume, and an increase in inequality causes it to decrease. The consumption demand then puts downward pressure on aggregate demand and on income (Kalecki 1942, Fitoussi and Saraceno 2010). Put simply, people who would spend money do not have it. "As inequality rose, money was transferred from those who would spend it to meet basic needs to those who had far more than they could easily spend. This created a tendency toward reduced levels of aggregate effective demand" (Stiglitz et al. 2009).

In other words, concentrations of wealth sap the overall demand for goods and services from the economic system, leading to a lack of aggregate effective demand. To circumvent the consequences of rising inequality, policy makers in the advanced countries allowed, even encouraged, policies that fuelled financial instability



**Chart 6.1: Average annual growth of income minus growth of average wage, mid-1980s to mid-2000s**



**Source:** Reproduced from Fitoussi and Saraceno 2010

(Vandemoortele 2009). These included lax legislation and loose monetary policy — manifest in the easy credit for poor consumers and complex financial instruments and practices to maximize profit, such as derivatives and swaps.<sup>4</sup> Coupled with the search for high-return investments by those who benefited from the increase in inequalities, this led to the emergence of bubbles. “Net wealth became overvalued, and high asset prices gave the false impression that high levels of debt were sustainable.” (Fitoussi and Saraceno 2010).

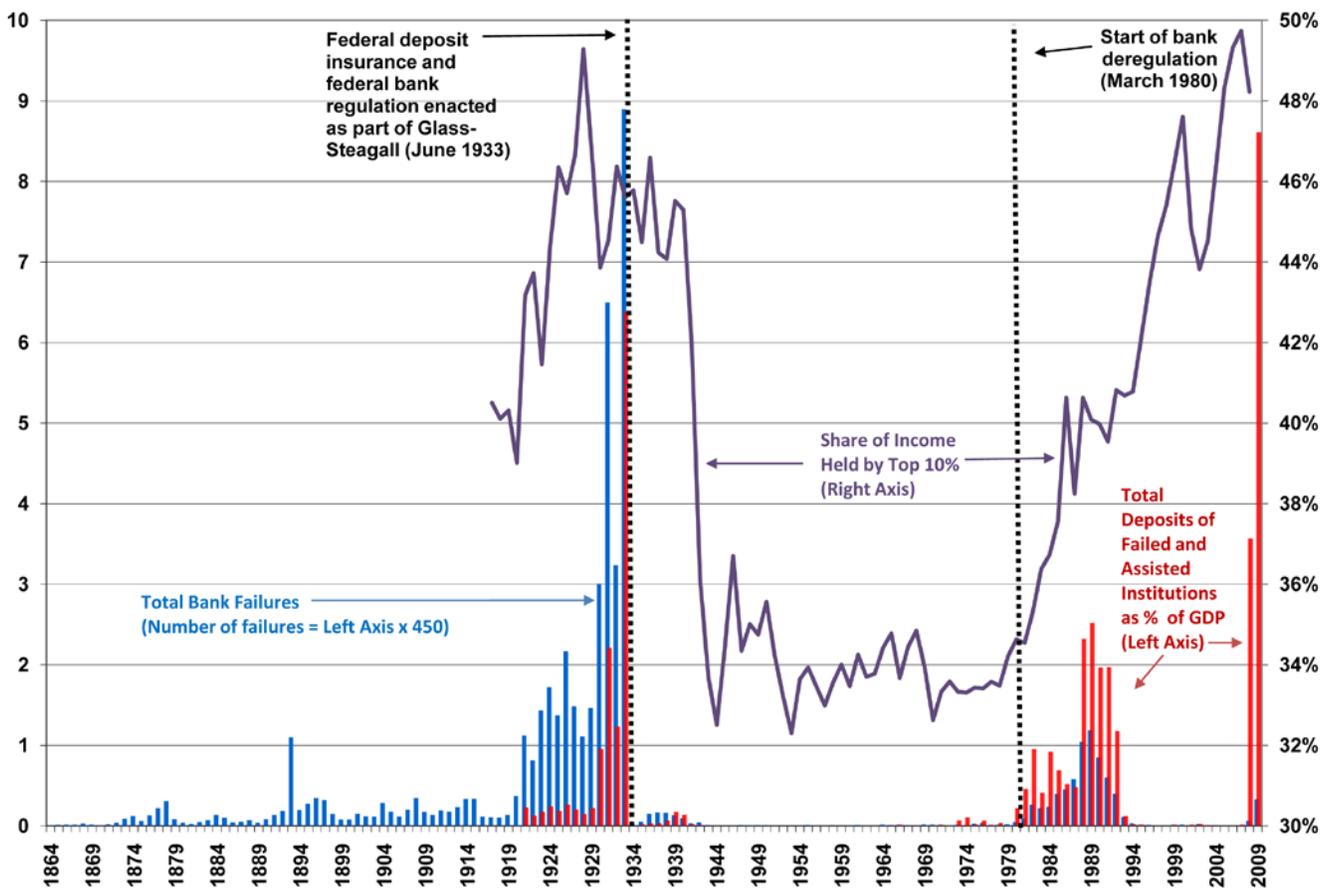
To sum up, the increase in inequality within advanced countries fuels financial instability because inequality creates a political environment whereby procyclical investment policies (such as poor regulation and loose monetary policy) are more likely to be implemented with the objective of avoiding political instability and reductions in economic growth.<sup>5</sup> Concentrating wealth within a small portion of the population reduces risk aversion among investors and generates excessive risk-taking, particularly where regulation is weak. Together, these phenomena result in endogenous financial fragility. In other words, if wealth is concentrated within a small portion of the population, those at the top of the income distribution find themselves with a large pool of excess capital and search for profitable opportunities to invest. When these large investments enter the financial sector, they — in the absence of effective management and regulatory controls — have the potential to generate excessive risk-taking by market agents. Where this takes place, the result is endogenous financial fragility (Milanovic 2009, Minsky 1982).<sup>6</sup>



# Income Inequality and the Condition of Chronic Poverty

The relationship between rising income inequality and financial fragility appears to be borne out by evidence for the United States (Chart 6.2), which shows that “disparities between rich and poor widened as government regulations eased and bank failures rose” (Moss 2010). It is also striking that the two peaks in inequality occurred in 1928 and 2007 — in each case, immediately before a major financial crisis. “Although correlation is not causation, the patterns across American history are sufficiently striking that further investigation of possible connections seems merited” (Moss 2010).

### Chart 6.2: Bank failures, regulation, and inequality in the United States



**Source:** Reproduced from Moss, 2010. Original source: *Historical Statistics of the United States: Colonial Times to 1970* (Washington, DC.: Government Printing Office, 1975), Series X-741,8 (p. 1038); “Federal Deposit Insurance Corporation Failures and Assistance Transactions United States and Other Areas,” Table BF01, FDIC website (<http://www2.fdic.gov/hsob>); Richard Sutch, “Gross domestic product: 1790–2002.” Table Ca9-19 in *Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition*, eds. Susan B. Carter et al. (New York: Cambridge University Press, 2006); Bureau of Economic Analysis, “Gross Domestic Product.” NIPA Table 1.1.5. (<http://www.bea.gov/national/nipaweb/SelectTable.asp>); Thomas Piketty and Emmanuel Saez, “Income Inequality in the United States, 1913–1998,” *Quarterly Journal of Economics*, 118(1), 2003, pp. 1–39, with updated data available at: <http://elsa.berkeley.edu/~saez/TabFig2008.xls>. For an earlier version of this chart, without the inequality overlay, see David Moss, “An Ounce of Prevention,” *Harvard Magazine*, September-October 2009. Note: David Moss prepared this chart with the assistance of Darin Christensen and Arthur Kimball-Stanley and is deeply indebted to Mitchell Weiss for his insightful observation about the pattern of inequality.



## *Rising Inequality in Advanced Countries and its Impact on Developing Economies*

If the increase in income inequality in advanced economies is associated with more frequent financial crises, this has implications for developing economies, especially those that are more exposed to global financial markets. “Countries that have experienced banking and financial crises have also experienced an average reduction in GDP growth of 1.3% over the subsequent five years compared with countries that did not experience such crises” (Szekely 2003, as quoted in Cornia 2006).

As mentioned, the negative growth and poverty impacts of financial shocks in emerging and developing economies that are highly exposed to global financial markets have been extensively documented. More recently in the context of the 2007/08 financial meltdown, studies for Bangladesh, Mexico and the Philippines predict an increase in the level and depth of poverty for all three countries as a result of the crisis, with the extent of increase largely depending on the size of the macro-economic shock. “In Bangladesh and the Philippines, where the crisis led to a slowdown but not a reversal in GDP growth, poverty is expected to decline at a slower pace due to the crisis. In 2010, the poverty rate is expected to be 1.2% and 1.5% higher than what it would have been without the crisis in Bangladesh and the Philippines respectively, which translates to approximately 1.4 and 2 million additional poor” (Habib et al. 2010).

In Mexico, GDP actually contracted by nearly 9 percent in 2009 and is expected to grow by just 3 percent in 2010. As a result, the poverty rate is expected to rise by nearly 4 percent between 2008 and 2010 (Habib et al. 2010). Additional evidence shows that financial crises are associated with an increase in poverty in emerging and transition economies (Baldacci et al. 2002).

Financial crises adversely affect not only growth and poverty, but also typically income distribution. In developing countries, they do this through various channels, including by causing a slowdown in economic activity, relative price changes, fiscal retrenchment, and a change in assets (Balducci et al. 2002). Evidence from Mexico, Bangladesh, and the Philippines indicates that, in all three countries, the impacts are relatively large in the middle part of the income distribution. “Between 15% and 20% of households in the fourth to seventh decile of the income distribution group in Mexico and the Philippines, and 10% of this group in Bangladesh, suffer income losses that push them to a lower income decile. In Mexico, where the crisis has been more severe, significant impacts are also likely for the bottom of the distribution. The poorest 20% of Mexican households suffer an average per capita income loss of about 8% compared with 5% for the entire population — even after existing safety net transfers that benefit many of the extreme poor are taken into account. The impact on the middle of the distribution can be attributed to significant shocks to employment and labour earning in the manufacturing sector, which employs a large number of workers from middle-income households” (Habib et al. 2010).

Evidence from the financial crises of the late 1990s that affected the Republic of Korea, Mexico and Thailand also show that the income share of the bottom 80 percent of households fell compared to the top 20 percent (Table 6.1). In Mexico in 1995, many children of the poor dropped out of school — with many never returning (Szekely 1999).

To conclude, rising inequality in advanced countries is a key factor that accounts for heightened financial fragility in international markets. Financial shocks typically worsen inequality, growth and poverty in

*Addressing growing income inequalities in advanced countries is as important as addressing the same trend within developing nations.*



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developing economies.<sup>7</sup> Thus, addressing growing income inequalities in advanced countries is as important as addressing the same trend within developing nations.

**Table 6.1: Financial Crises and Changes in Income Shares in East Asia and Latin America**

Country	Pre-crisis		Post-crisis	
	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)
Rep. of Korea	61.2	38.8	58.3	41.7
Philippines	48.0	51.9	45.2	54.8
Thailand	39.2	60.8	38.2	61.8
Brazil	35.1	64.8	34.4	65.6
Mexico	42.0	58.0	41.5	58.5
Country	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)	Income share of poorest 80% of population (%)	Income share of richest 20% of population (%)
Rep. of Korea	19.3	38.8	15.9	41.7
Philippines	13.7	51.9	12.3	54.8
Thailand	8.2	60.8	7.8	61.8
Brazil	8.2	64.8	8.0	65.6
Mexico	11.2	58.0	10.7	58.5

**Source:** WIDER WIID 2.0a (2005) and author's calculation – Reproduced from Birdsall (2005). Notes: East Asian Financial Crisis 1997/98, Brazil crisis 1999, and Mexico crisis 1994/95. Pre-crisis data for Thailand, the Republic of Korea, and Brazil are from 1996, for the Philippines from 1994 and Mexico 1992. Post-crisis data are from 1996 for Mexico, 1998 for the Republic of Korea, 1999 for Thailand, 2000 for the Philippines, and 2001 for Brazil

## Trends in Income Inequality Within Developing Countries

Income inequality within the majority of developing countries has been rising — in some cases, sharply. “The last two decades have witnessed a widespread and symmetric rise in within-country inequality in developing countries” (Cornia 2004, Birdsall 2005, Van der Hoeven 2008).

Examining the change in the Gini coefficient of income distribution for a sample of 70 countries<sup>8</sup> from the mid-1990s to the mid-2000s indicates that, although the trends in income inequality were not uniform across developing economies, income inequality rose in the majority of countries (38 of the 70 countries). Since these 38 countries represent 75 percent of the population covered by the sample, the rise in inequality affected the vast majority of households living in the developing world. For one country in the sample, there appears to have been no change in income inequality, while inequality declined in 31 of the 70 countries during the decade (Annex 6.A).



By the mid-2000s, Latin America and the Caribbean remained the region with the highest levels of income inequality (Gini coefficient of 51), followed by Africa (Gini coefficient of 42). In Asia and the Pacific and the Arab States, the Gini was 37, and the lowest level of income inequality was found in the ECIS region, which had a Gini of 32.

As of the mid-2000s, high-income developing economies and MICs had the highest level of inequality among development groups. Low-income economies followed and the lowest level of income inequality was found in transition economies (Table 6.2).

**Table 6.2: Gini Coefficient of Income Distribution by Region and Development Status, mid-2000s**

Region or Development Status	Gini Coefficient (*100 )
LAC	51
Africa	42
A&P	37
Arab States	37
ECIS	32
High-Income Developing Economies	48
Low-Income Developing Economies	40
Middle-Income Developing Economies	48
Transition Economies	32

*Calculated using data from World Bank, World Development Indicators 2009*

Disaggregating trends in income distribution by region (Chart 6.3) shows that, in the Asia and Pacific region, ECIS, and Latin America and the Caribbean, more countries saw income inequality rise than fall. Africa was the exception to this pattern, with only four countries registering an increase in income inequality, whereas 12 countries showed a decrease in income inequality. In the Arab States, which are represented by only four countries in the sample, two countries saw income inequality rise and two saw inequality fall between the mid-1990s and mid-2000s.

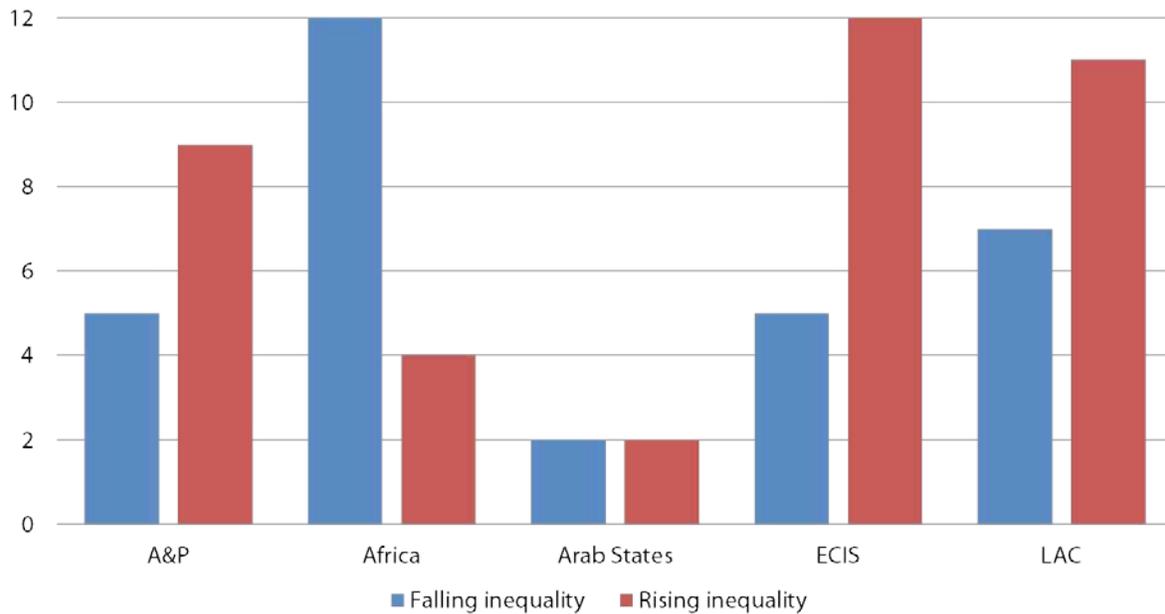
The ECIS saw the largest number of countries experience rising inequality. Income inequality rose in 12 of the 17 countries in the sample, with the average rate of increase in inequality standing at 14 percent during this period (Chart 6.4). In Latin America and the Caribbean, 11 of 18 countries experienced rising inequality, with the increase averaging 13 percent. A similar pattern was observed in Asia and the Pacific, with nine of 14 countries experiencing rising inequality, which averaged 13 percent. Included in the latter group are China, India and Indonesia, the three most populous countries in the developing world. Only two Arab countries (Egypt and Morocco) witnessed increasing inequality during the period. Income inequality increased by 4 percent in Morocco and by 0.4 percent in Egypt.

*Although the trends in income inequality were not uniform across developing economies, income inequality rose in the majority of countries.*



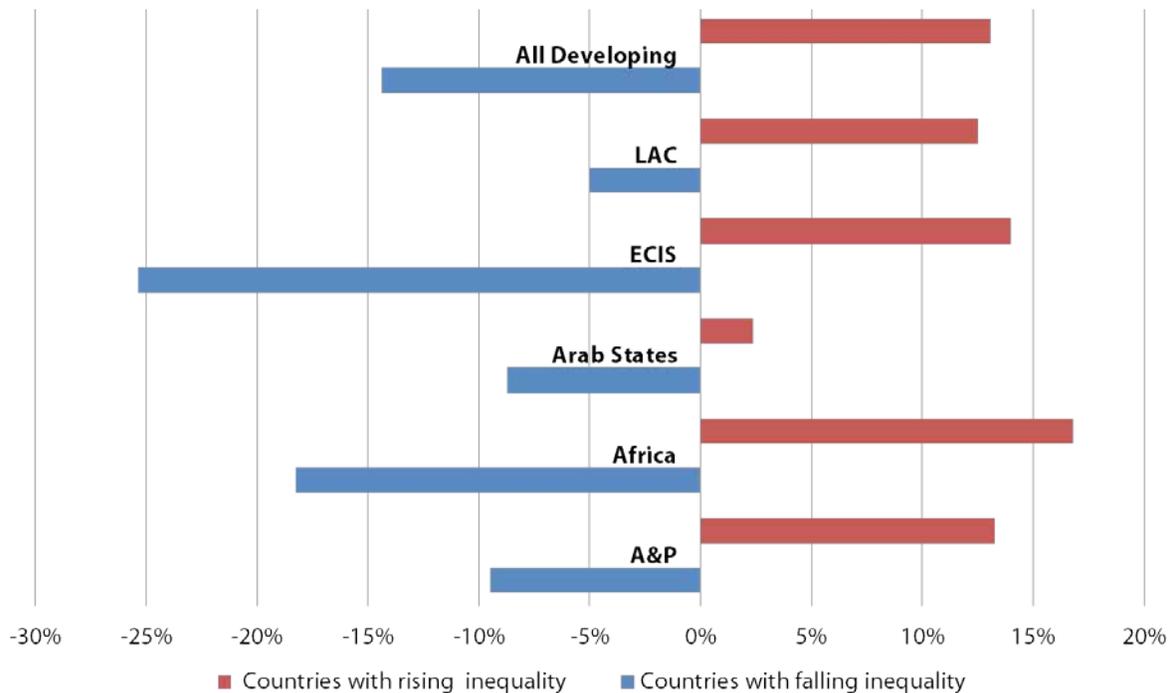
# Income Inequality and the Condition of Chronic Poverty

**Chart 6.3: Number of countries with rising and falling income inequality by region, mid-1990s to mid-2000s**



**Source:** Calculated using data from World Bank, World Development Indicators 2009

**Chart 6.4: Average change in income inequality by region, mid-1990s to mid-2000s**



**Source:** Calculated using data from World Bank, World Development Indicators 2009

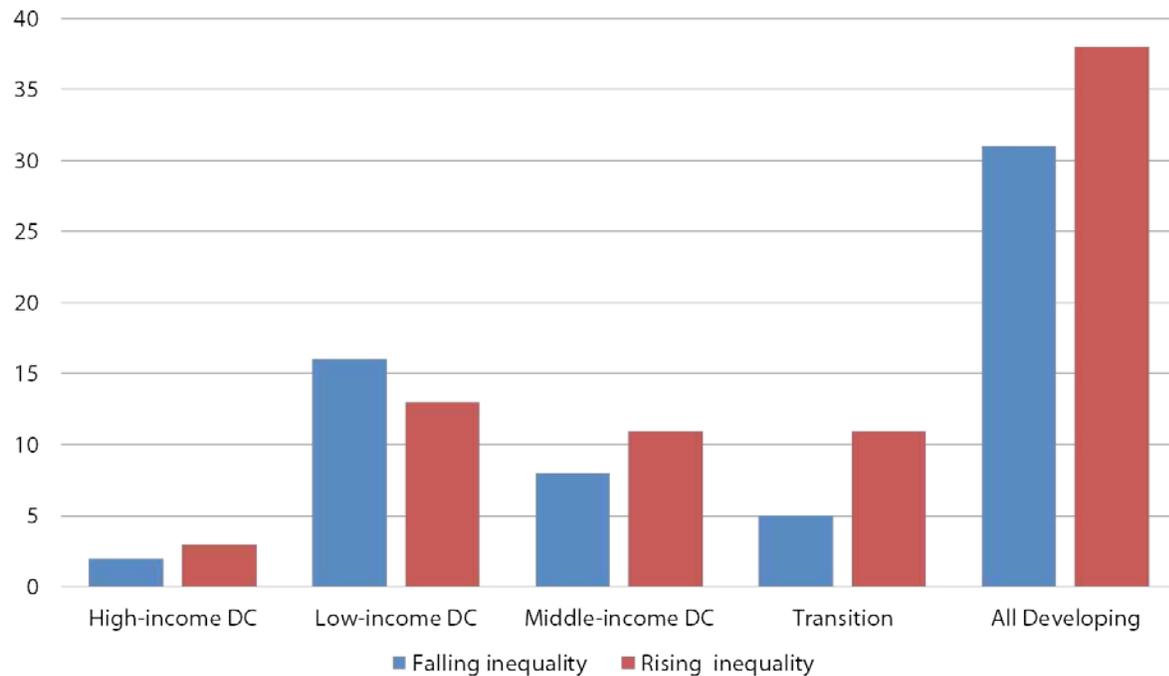


Africa had the lion's share of the number of countries with falling inequality during the period. Twelve African nations of the 17 covered by the data had declining income inequality at an average rate of 18 percent during the period.<sup>9</sup> Seven of the 18 Latin American and Caribbean countries in the sample experienced falling inequality, with an average rate of 5 percent. This group of countries includes countries that traditionally have had very high levels of inequality (Brazil, Chile, Nicaragua and Panama). The five countries (of 14) in the Asia and Pacific region with declining inequality managed to reduce inequality by 9 percent on average during this period. The most successful was Malaysia, where inequality fell by 20 percent.

The majority of countries in each development group (Chart 6.5) saw inequality rise, except for countries in the low-income development group. Nearly 70 percent of the transition economies in the sample experienced rising inequality, a trend true of high-income developing economies as well, although only five countries represent the group of high-income developing countries. Still, three of the five high-income developing economies had an increase in inequality. Middle-income developing economies, with a more representative sample of 19 countries, also display the same trend. Eleven of the 19 MICs in the sample had an increase in income inequality during the period.

Among countries with rising inequality (Chart 6.6), transition economies showed the greatest increase, with an average rate of increase of 15 percent during this period. Low-income economies followed closely, with a 14 percent average increase in inequality. For the MICs with rising inequality during the period, inequality

**Chart 6.5: Number of countries with rising and falling income inequality by development status, mid-1990s to mid-2000s**

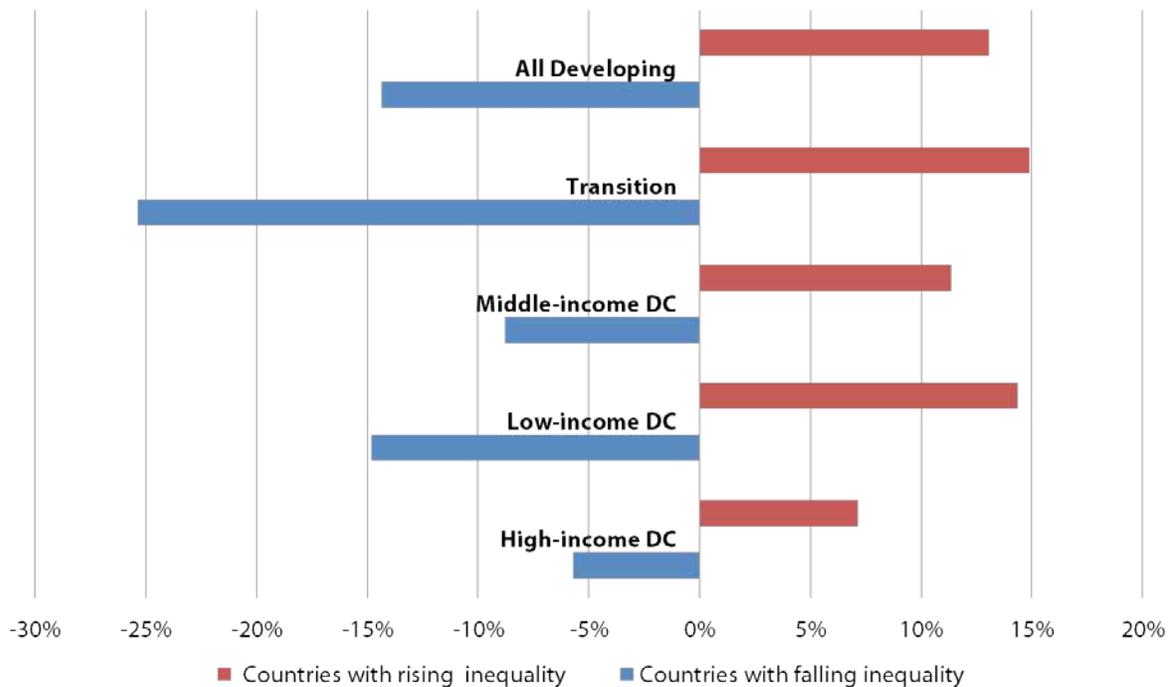


**Source:** Calculated using data from World Bank, *World Development Indicators 2009*



# Income Inequality and the Condition of Chronic Poverty

**Chart 6.6: Average change in income inequality by development status, mid-1990s to mid-2000s**



**Source:** Calculated using data from World Bank, World Development Indicators 2009

rose by an average of 11 percent. Income inequality in the three high-income developing economies with rising inequality rose by 7 percent on average.

Significantly, the majority of countries with falling inequality were low-income economies. Sixteen of 29 low-income economies had an improvement in the distribution of income by an average of 15 percent. Only five of 16 transition economies had a decrease in income inequality, averaging 25 percent — the highest average decline among all development groups. In the MICs, eight of 19 countries had falling levels of income inequality, averaging 9 percent over the period. Only two high-income countries had a fall in inequality: Chile and Mexico both managed to reduce their levels of income inequality by 6 percent during the period.

To conclude, despite mixed trends, more countries are moving towards higher levels of income inequality than towards more equality.

### *Explaining the Rise in Income Inequality in Developing Countries*

Making generalizations about the causes of income inequality in developing countries must be done with care. The situation in each nation depends on country-specific circumstances and policy mixes. Yet, it is clear that there are some common factors behind the widespread surges in inequality around the world. It has been noted that a worsening situation in the ‘traditional’ causes of inequality such as land concentration, urban bias and inequality in education has not caused the recent increases in inequality in developing countries,<sup>10</sup>



although these factors still do explain most of the variation in cross-country inequality (Cornia 1994).<sup>11</sup> Rather, the evidence points to ‘new’ causes associated with neo-liberal policy reforms that have increasingly been adopted in transitional and developing countries (Cornia and Court 2001, Birdsall 2005, van der Hoeven 2008, UNRISD 2010). The most important of such policy reforms are macro-economic reforms including, *inter alia*, financial and labour market liberalization, privatization, and reforms in the tax and transfer systems.

*Stabilization and Adjustment Programmes:* The 1980s and 1990s witnessed a sharp increase in the number of stabilization and adjustment programmes. Since a key objective of stabilization is inflation targeting, “the sharp demand compression undertaken by such programmes to reduce inflation to single digits led to sharp recessions and poverty surges” (Cornia 1994). Furthermore, “in developing countries, the standard approach to stabilization has not been distributionally neutral” (Cornia 1994). This is because wages in LICs and MICs are downwardly flexible and social safety nets are much less developed. Thus, wages (especially wages for unskilled labour) fall faster than GDP per capita and profits, the wage share declines, and inequality of income distribution increases. The rise in wage share during recovery then tends to be smaller than the fall during the crisis period.

*The evidence points to ‘new’ causes associated with neo-liberal policy reforms that have increasingly been adopted in transitional and developing countries.*

*Domestic Financial Liberalization:* Many MICs in Asia and Latin America adopted financial liberalization policies in the 1990s. In addition to spurring financial crises, the liberalization of the domestic financial system has apparently “caused an increase in income inequality much greater than that caused by other policy changes such as trade and labour market liberalization” (Cornia and Court 2001). Increases in real interest rates, a result of the liberalization of domestic financial markets, benefited lenders and rentiers at the expense of borrowers, including governments. Consequently, interest payment on public debt has risen rapidly and a large part of the government budget in many MICs now goes for interest payments rather than for social expenditure.

*Privatization and Distribution of Industrial Assets:* The mass privatization of industrial assets in transition economies has almost invariably increased income inequality and created severe incentive problems. In some African countries like Guinea-Bissau and Mozambique, there has been some confusion in land titling following de-collectivization, with poor communities least able to protect their rights.

*Changes in Labour Market Institutions:* It seems likely that changes in labour market institutions have contributed significantly to rises in wage inequality and overall inequality, especially in middle-income and transition economies. “As employment became more informal, wage shares declined and the difference between skilled and unskilled wages increased in many countries” (Cornia and Court 2001).

*The State Tax and Transfer Systems:* Governments can significantly influence levels of income inequality through taxes and expenditures. Indeed, this is why it is important to look for changes in government budgets — particularly taxes and transfers — in order to help drive the distribution of disposable income towards greater equality. Progressive tax and pro-poor expenditure will reduce poverty.<sup>12</sup> Yet, over the past two decades, the main policy trend has been in the opposite direction: tax systems appear to have evolved towards greater use of indirect taxes (VAT) and lower progressivity in developing countries; very few tax systems in developing countries are progressive and, over time, the progressivity of tax systems has declined in most developing countries. More troubling, the level and composition of public expenditure in



# Income Inequality and the Condition of Chronic Poverty

some countries appear to have become less redistributive. In other words, the tax and transfer policies in developing and transition economies were not effective in limiting the rise in inequality of the distribution of national incomes, while the declining progressivity of tax systems may have worsened inequality during the 1980s and 1990s (Roy and Heuty 2009).

## *Within-Country Inequality and Domestic Financial Fragility*

Rising income inequality is associated with endogenous financial fragility in developing economies just as it is in advanced economies, although the transmission channels vary:

- Domestic financial liberalization in many developing countries has tended to raise the interest rate, which, in turn, has increased the cost of servicing the public debt. This, in turn, usually requires an increase in taxation. However, in many countries, the tax incidence is regressive or proportional, while ownership of financial assets is highly concentrated. And higher interest rates have rewarded the owners of financial assets, thus increasing income inequality. “Generally, financial deregulation has led to a substantial increase in the rate of return to financial capital, a rapid accumulation of public debt, an increase in the share of GDP accruing to non-wage incomes, the emergence of a new class of rentiers, and the redistribution via the budget of labour incomes to holders of state bonds” (Cornia and Court 2001).<sup>13</sup>
- If wealth is concentrated within a small portion of the population, those at the top of income distribution find themselves with a pool of excess capital and search for profitable opportunities to invest. In the absence of effective management and regulatory controls, these large investments have the potential to generate excessive risk-taking by market agents when they enter the financial sector. In other words, inequality generates procyclical investment behaviour.<sup>14</sup> Where this occurs, the result is often endogenous financial fragility (Vandemoortele 2009). Indeed, such excessive risk-taking accounts for the emergence of asset bubbles in sectors such as real estate in developing economies, leading to financial fragility.
- Further, societies with higher degrees of income polarization will be more prone to fiscal instabilities because, when politicians disagree on how to use public funds, each will have an incentive to overexploit the common pool of resources, with negative effects on fiscal balance and the ‘national project of development’. This behaviour is more likely to occur and be more severe in societies with higher degrees of polarization (Woo 2005).

## *Inequality, Economic Growth and Poverty Reduction*

It is well known that economic growth and inequality play a major role in generating changes in poverty. Indeed, high, sustained growth is essential for poverty reduction if the distribution of income remains more or less constant (Deininger and Squire 1996, Ravallion 2002). Likewise, much evidence suggests that greater inequality tends to increase poverty (Bourguignon 2004, Birdsall 2005, UNRISD 2010, van der Hoeven 2008). For these reasons, “although poverty reduction is correlated to growth in per capita income, this effect appears low in countries where income inequality has been rising” (Jantii and Sandstrom 2005, Lopez 2006).

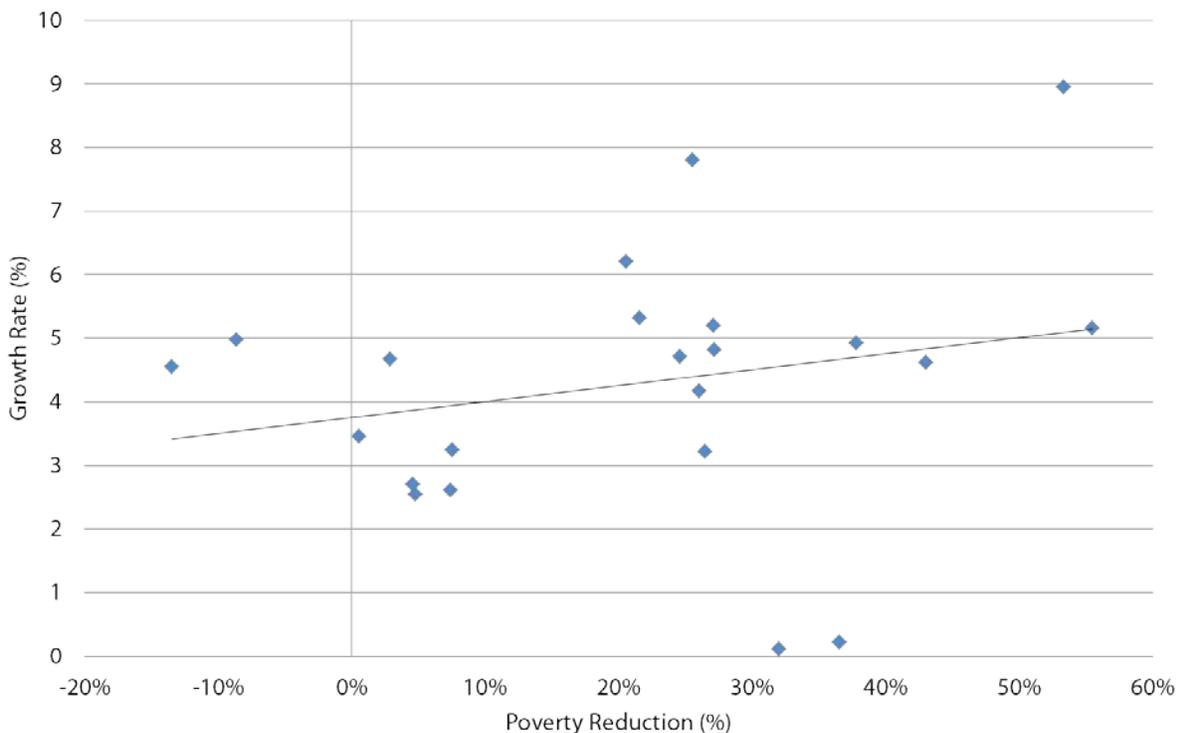
What, though, is the relationship between distribution and growth? Does faster growth in a country reduce or increase inequality? Or does excessive inequality in a given country slow or accelerate growth?



The dominant perspective today is that inequality plays a central role in determining the rate and pattern of growth and that high initial levels of inequality seem to be associated with lower economic growth rates (Alesina and Rodrik 1994, Alesina and Perotti 1996, Birdsall 2007, Rodrik 1998).<sup>15</sup> The evidence appears to support this perspective with cross-sectional studies showing that inegalitarian countries tended to grow more slowly over the last 20 to 30 years,<sup>16</sup> whereas countries with an initially relatively egalitarian distribution of assets and incomes grew faster (Birdsall 2005).

If this is indeed generally the case, then its implication for policy is that progressive redistribution would enhance growth. In other words, it is possible to reduce inequality through redistribution or through promoting inclusive growth for a sustainable poverty reduction strategy. In short, a more equal distribution of assets matters. It can reduce poverty indirectly by accelerating economic growth and directly by enhancing income growth of the poorest groups. The long-standing inattention to the distribution of assets, both in terms of physical and human capital, has been costly as it otherwise would have called attention to a fundamental constraint on poverty reduction: the lack of access by the poor to the assets necessary for increased productivity and income (Birdsall 1997). Additionally, it is not only the lack of access to assets that holds the poor back; equally important is the fact that the poor's assets tend to be insecure, unprotected and less productive than they could be.

**Chart 6.7: Relationship between economic growth and poverty reduction, mid-1990s to mid-2000s**



**Source:** Calculated using data from World Bank, World Development Indicators 2009



# Income Inequality and the Condition of Chronic Poverty

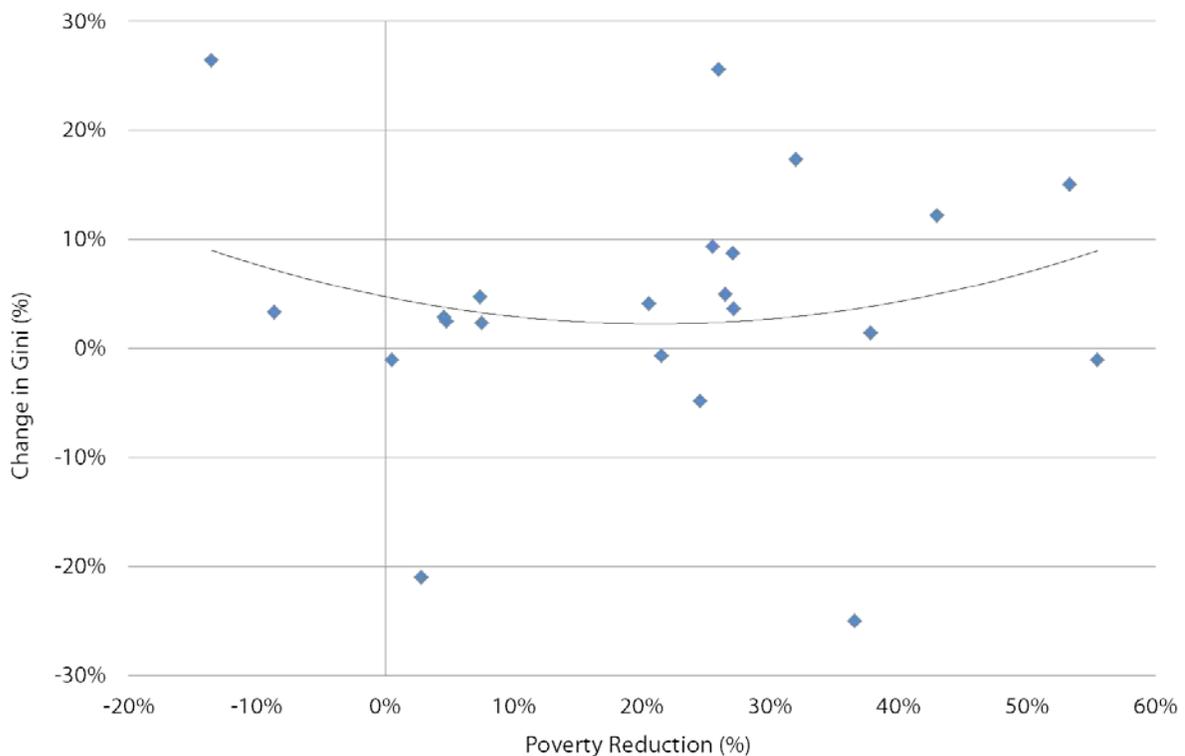
In summary, it is important to consider both growth and income (wealth) distribution simultaneously and to recognize that distribution matters as much as growth for poverty reduction. However, the impact of these phenomena depends on the initial level of income and inequality, and the relative effects of both phenomena may differ quite significantly across countries.

Evidence on poverty reduction, economic growth and inequality for a sample of 22 countries from the mid-1990s to the mid-2000s (Annex 6.B) indicates that, although there is a direct correlation between economic growth and poverty reduction, specific countries nonetheless demonstrate great variance in the precise nature of this correlation (Chart 6.7).

Some countries, despite low growth rates, appeared to have lowered their poverty incidence significantly. For instance, El Salvador reduced poverty by 26 percent, with an average rate of growth of 3.2 percent, whereas, in Indonesia, with relatively low rates of growth (2.5 percent), poverty was reduced by only 5 percent. Clearly, country-specific conditions explain some of these results: El Salvador emerged from conflict, while Indonesia suffered from the East Asian crisis in 1997.

On the other end, high-growth countries, like China and India, significantly lowered their poverty incidence, whereas Costa Rica, Ethiopia and Sri Lanka, despite high growth, saw an increase in poverty (Costa Rica's poverty rose by 9 percent, Sri Lanka's poverty rose by 14 percent) or a negligible reduction in poverty

**Chart 6.8: Relationship between change in poverty and change in income inequality, mid-1990s to mid-2000s**



**Source:** Calculated using data from World Bank, World Development Indicators 2009



(Ethiopia's poverty fell by 3 percent). Many other countries with moderate rates of growth showed minimal reduction in poverty (Mongolia, the United Republic of Tanzania).

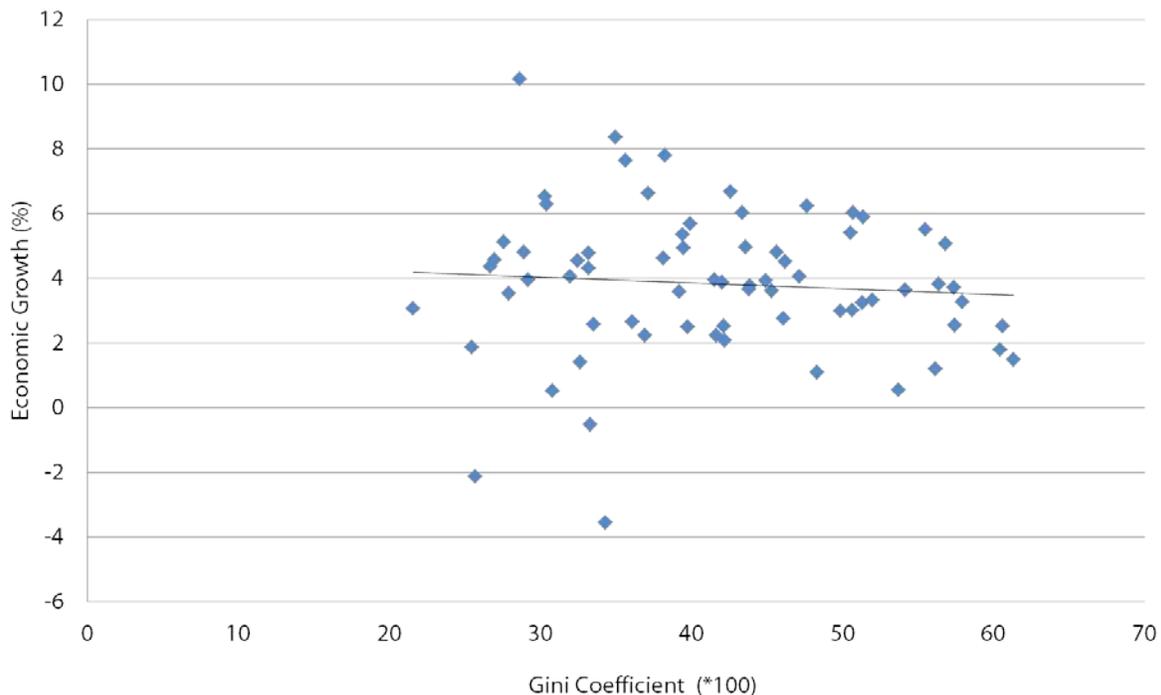
Earlier, it was noted that, though growth has the potential to reduce poverty, this potential is more strongly realized when it is accompanied by falling inequality. Indeed, the sample of 22 countries shows not a single case where reductions in income inequality were associated with an increase in poverty.

The relationship between changes in poverty and changes in inequality (Chart 6.8) shows that, although the relationship is not linear, a worsening of income inequality is typically associated with a lesser reduction in poverty. Moreover, the relationship between changes in inequality and changes in poverty generally appear to be significantly weaker at very high rates of poverty reduction.<sup>17</sup>

Apart from the impact of changes in income inequality on poverty, the initial levels of income inequality also matter for growth and poverty reduction. Countries with higher initial levels of inequality tend to have a lower growth path than countries with low initial inequality. Chart 6.9 shows the relationship between growth from the mid-1990s to mid-2000s and the initial level of inequality in the mid-1990s for a group of 70 developing countries. The evidence shows that countries with a lower initial Gini coefficient were generally able to achieve higher levels of growth.

To sum up, countries that had the most success with poverty reduction were those where income inequality fell and growth remained robust.

**Chart 6.9: Relationship between initial level of income inequality and economic growth, mid-1990s**



**Source:** Calculated using data from World Bank, World Development Indicators 2009



# Income Inequality and the Condition of Chronic Poverty

## Poverty Traps

The concept of poverty traps has long been used to explain the persistence of chronic poverty and long-term growth failure (i.e., growth with low levels of income per capita) in the poorest of economies. “The persistent failure to break the cycle of stagnation and poverty in the poorest countries is perhaps the most striking exception to the otherwise remarkable economic achievements of the twentieth century” (IMF 2000, OECD/World Bank 2001).

The trap<sup>18</sup> stems from the fact that the condition of poverty itself has effects that cause poverty. In other words, not only does economic growth affect the incidence of poverty, but, where the majority of the population is very poor, the incidence of poverty also affects economic growth. “In societies where the majority of the population live at or below income levels sufficient to meet their basic needs, and the available resources even where equally distributed are barely sufficient to meet the basic needs of the population, this all-pervasive poverty itself acts as a major constraint on economic growth” (Gore 2002).<sup>19</sup> For instance, between 1995 and 1999, the average per capita income in LDCs, when measured in terms of current prices and official exchange rates (rather than in 1985 PPP dollars) was \$0.72 a day and the average per capita consumption was \$0.57 per day. This implies that, on average, there was only \$0.15 a day per person to spend on private capital formation, public investment in infrastructure and the running of vital public services, including health, education, administration, and law and order. The low rate of per capita expenditure on essential public services, such as health and education, in the LDCs results not from different expenditure priorities, but from the extremely low overall resource availability amidst all-pervasive poverty.

*When poverty is extant, low income leads to low savings, low savings leads to low investment, and low investment leads to low productivity and low incomes.*

It has been pointed out that the extreme poor lack six kinds of capital: human capital, business capital, infrastructure capital, natural capital, public institutional capital, and knowledge capital.<sup>20</sup> So “the poor start with a very low level of capital per person, and then find themselves trapped in poverty because the ratio of capital per person actually falls from generation to generation. The amount of capital per person declines when the population is growing faster than capital is being accumulated” (Sachs 2005).

In short, poor nations remain poor because of a vicious circle of low savings and few investment opportunities. When poverty is extant, low income leads to low savings, low savings lead to low investment, and low investment leads to low productivity and low incomes.

## Policies for Reducing Chronic Poverty and Inequality

Although policies to address poverty reduction have been around for a long while, policies to address inequality have received much less attention. Yet, addressing both in tandem will be critical for sustaining MDG progress. Specifically, policy measures in three areas will be critical:

- (a) Inclusive growth and the expansion of productive employment
- (b) Redistribution of incomes and assets
- (c) Pro-poor macro-economic policies



## *Promoting Inclusive Growth and the Expansion of Productive Employment*

Although rapid growth is necessary for substantial poverty reduction, it should, in order to be sustainable over the long run, be broad-based across sectors and include<sup>21</sup> much of a country's labour force, where 'inclusiveness' refers to equality of opportunity of access to markets and resources and an unbiased regulatory environment for businesses and individuals (The Commission on Growth and Development 2008).<sup>22</sup>

More specifically, growth that raises average household incomes and household consumption is necessary. "Increases in overall GDP per capita will not necessarily do the trick" (Gore 2002). Indeed, evidence indicates that there is a major opportunity for the rapid reduction of extreme poverty through a form of economic growth that raises average household incomes. This, of course, requires an expansion of employment opportunities and increasing output per worker (World Bank 2009b).

In other words, sustained high growth rates and poverty reduction can only be realized when the sources of growth are expanding and an increasing share of the labour force is efficiently included in the growth process. Thus, the main instruments for inclusive growth are growth in productive employment and growth in productivity (OECD 2009).

*Although policies to address poverty reduction have been around for a long while, policies to address inequality have received much less attention. Yet, addressing both in tandem will be critical for sustaining MDG progress.*

Employment growth creates new jobs and income for the individual — from wages in all types of firms, or from self-employment — while productivity growth has the potential to lift the wages of those employed and the returns to those who are self-employed.<sup>23</sup> However, the ability of individuals to be productively employed depends on the opportunities to make full use of available resources as the economy evolves. This is why it is important to also look at ways to strengthen the capacity of the individual on the labour-supply side as well as ways to open up new opportunities for productive employment on the labour-demand side.

Thus, specific policy measures to promote inclusive growth will need to:

**Identify the sources of growth and employment-intensive investments affecting different sectors and types of firms and also the bottlenecks to economic transformation in the long run.** For instance, although it is well known that SMEs and cooperatives can be important sources of growth and employment creation, the growth and productivity of these firms are often constrained by their lack of access to finance, markets and inputs (Birchal and Ketilson 2009).

It is also important to review whether employment-intensive investments can be effectively adopted and the trade-offs are involved. Although the idea of employment-intensive investment evokes a perceived trade-off with productivity and efficiency, there is evidence that this need not be the case with respect to every investment decision. Choosing an employment-intensive option for a given investment could be cost-effective while also generating much-needed employment opportunities (Islam and Majeres 2001). Infrastructure and construction are common investments that can be made employment-intensive, but there are other options such as agriculture, forestry, environmental services and protection or even the provision of social services (Islam and Majeres 2001, Lieuw-Kie Song and Philip 2010).

**Devise strategies to raise the pace of growth by more fully using parts of the labour force trapped in low-productivity activities or completely excluded from the growth process.** Integrating the poor



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and excluded into the growth process can be undertaken through various measures. For instance, public employment schemes and employment guarantee programmes have been identified as initiatives by which underemployed, marginal and vulnerable populations can be included in local economic growth processes while receiving income support and skills training. Cash-for-work and temporary employment programmes could also fit into this category, provided they contain skills-building components and they focus on the creation or rehabilitation of basic infrastructure.

**Adopt policies that build the human capital and productivity of labour.** As has been noted so often, policies in education, health and nutrition make a difference in the possibilities and conditions of entry into the labour market (McKinley 2008).

- Skills training can help enhance productivity and earnings of workers in the informal economy (OECD 2009, Dreschler et al. 2008).
- Enabling access to basic education and health services across regions and socio-economic groups can “not only stimulate economic growth and reduce inequality simultaneously, but also play an important role in determining a country’s ability to cope with technological and economic changes” (Vandemoortele 2009).

## Box 6.1: South Africa’s Expanded Public Works Programme

The Expanded Public Works Programme (EPWP) is one of numerous government programmes to provide poverty and income relief through temporary work for the unemployed to carry out socially useful activities. It was launched in April 2004 to promote economic growth and create sustainable development. The immediate goal of the EPWP Phase 1 was to help alleviate unemployment by creating at least 1 million work opportunities, of which at least 40 percent of beneficiaries will be women, 30 percent youth and 2 percent people with disabilities. As part of the contribution to the income of the poor, the target for 1 million work opportunities through the Expanded Public Works Programme was reached in 2008, a year earlier than envisaged in the 2004 electoral mandate.

The Expanded Public Works Programme Phase 2 was launched in April 2009 at the University of the Western Cape. The goal of EPWP Phase 2 is to create 2 million full-time equivalent (FTE) jobs for poor and unemployed

people in South Africa to help halve unemployment by 2014 through the delivery of public and community services. (This will scale up from 210,000 FTE jobs per year in 2009/10 to 610,000 FTE jobs in 2013/14.) This translates to 4.5 million (short and ongoing) work opportunities. The average duration of employment is assumed to be 100 days. This will scale up from 500,000 work opportunities in 2009 to 1.5 million in 2014.

Public bodies from all spheres of government (in terms of their normal mandates and budgets) and the non-state sector (supported by government incentives) are expected to deliberately optimize the creation of work opportunities for unemployed and poor people in South Africa through the delivery of public and community services. Training and enterprise development will be implemented in sector specific programmes to enhance service delivery and beneficiary well-being.

**Source:** Adapted from Department of Public Works, Republic of South Africa, *Welcome to the Expanded Public Works Programme (EPWP): Phase 2*, available at [www.epwp.gov.za](http://www.epwp.gov.za)



## *The Redistribution of Incomes and Assets*

Although the focus of inclusive growth is generally on productive employment rather than on direct income distribution as a means of increasing incomes for excluded groups, it is also clear that employment, by raising the incomes of workers, can contribute to reductions in inequality. “High employment levels reduce inequality and, especially, high employment levels in the industrial sector reduce inequality” (Angeles-Castro 2006). Thus, targeting for employment and for reduction of income inequality can be combined objectives in policy making.

Still, given the vast numbers of ‘working poor’ households,<sup>24</sup> additional and more direct interventions such as social protection and access to assets are needed to reduce poverty and inequality. Providing social protection and social services to those who cannot work can also shoehorn many of those who care for them — usually women — into the labour market.

## *Social Protection*

Social protection has been conceptualized in many ways, from safety net approaches that help households respond to sudden shocks in their incomes, to a set of policies that support the poor to find an exit from poverty. More comprehensive approaches include transformative or promotional aspects aimed at helping the poor to enhance their income and capabilities and transforming enabling environments in regulatory and cultural dimensions (Lal et al. 2010). Whatever the approach, they all try to ensure a minimum level of consumption so that the poor are sufficiently nourished and have enough health care even when their income is compromised.

Social protection encompasses a wide variety of interventions. These include cash transfers such as conditional cash transfers (CCTs), non-contributory old age pensions, child-care pensions, social insurance or in-kind transfers such as school feeding programmes, nutritional supplements or subsidized foods. They can also include workfare programmes such as cash-for-work (common in post-crisis or post-disaster settings) and temporary public employment programmes. In more comprehensive systems, social protection can also include support for child and elder care and unemployment benefits (Table 6.3).

**Table 6.3: Social Protection in the Developing World**

Programme	Country	Type	Coverage	Impact
Progres- Oportunidades	Mexico	Conditional cash transfer	25% of the population	Reduced poverty gap in rural areas by 19% and contributed 18% to the decline in Mexico’s income inequality between 1996 and 2006. Educational attainment of beneficiaries: estimated increase 0.7–1.0% per year.
Bolsa Familia	Brazil	Conditional cash transfer	26% of the population	Reduced the poverty gap by 12% between 2001 and 2005 and contributed one third to the decline in income inequality over the last decade.

**Source:** European Communities, 2010



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**Table 6.3: Social Protection in the Developing World**

Programme	Country	Type	Coverage	Impact
Plan Jefes y Jefas	Argentina	Conditional cash transfer (public works)		Poverty among participants dropped from 80% to 72%; an extra 10% of participants would have fallen into extreme poverty in the absence of the programme.
Red de Protección Social	Nicaragua	Cash transfer	3% of the population	Contributed to an 18% decline in poverty gap among beneficiaries.
Old Age Pension	South Africa	Social Pension	80% of elderly	Combined direct effects of both programmes are to reduce poverty incidence by 6 percentage points, and a much larger effect on poverty depth.
Child Support Grant	South Africa	Social Grant	70% of children	
Productive Safety Net Programme	Ethiopia	In cash and in kind transfer	10% of the population	Modest but relevant average impacts, improving food security (by 11%), livestock holdings (by about 7%) and households' ability to cope with emergency. Larger effects on asset accumulation for those receiving substantial and complimentary support.
National Health Insurance Scheme	Ghana	Social insurance	67% of the population	Reduced out-of-pocket expenditures for health up to 50%.
Vision 2020 Umurenge Programme	Rwanda	Public works and cash transfers	About 36,000 households	Ongoing evaluations. The programme has contributed to the fall of the percentage of extreme poor among beneficiaries from 40.6% to 9%.

**Source:** European Communities, 2010

Although there is evidence of success of certain social protection interventions aimed at the poorest (such as CCTs or employment guarantee schemes), the sustainability of the results of these programmes will depend largely on how social protection strategies interact and intersect, *inter alia*, with labour market policies and the ability of the economy to absorb 'graduates' of social protection programmes into the labour market. Particular care must be taken to ensure that social protection interventions do not generate perverse incentives for the poor to avoid earning income or accumulating assets. Obviously, the ultimate success of these interventions in helping people get and stay out of poverty will also depend on the sustainability of financing and the priority given to this policy area in budgetary allocations (European Communities 2010).

### *Asset-Building and Protection*

Asset-building and protection are important mechanisms for poor households to address vulnerability and generate and protect their incomes. The poor have limited access to formal insurance mechanisms to protect their income when faced with a shock. Thus, assets can help the poor to engage in productive activity, invest in human capital development and stabilize their income more sustainably.



## Box 6.2: Assessing and Establishing a Social Protection Floor

Despite the benefits of a comprehensive and well-articulated system of social protection at the micro and macro levels, according to the latest estimates, up to 80 percent of the world's population is without any sort of social security protection. Since 2009, the UN system agreed on a set of initiatives in response to the global economic crisis. The Social Protection Floor Initiative (SPFI), led by ILO and WHO, is an integrated approach to social protection that minimally includes:

A basic set of essential social rights and transfers, in cash and in kind, to provide a minimum income and livelihood security for all and to facilitate effective demand for and access to essential goods and services.

The supply of an essential level of goods and social services such as health, water and sanitation, education, food, housing, life- and asset-saving information that is accessible for all (UN 2010).

In this way, the SPFI seeks to address the demand and supply sides of social protection. The specific characteristics of this social protection floor and the subsequent building blocks towards more comprehensive protection systems will depend on the specific context at the country level in terms of the initial levels of poverty and inequality, vulnerabilities, demographic trends and structure of the economy.

There is some evidence that establishing such a floor is an affordable enterprise for many countries. According to ILO calculations based on two regional studies in Africa and Asia, as little as 2 percent of the global Gross Domestic Product (GDP) would be enough to provide a social security floor to all of the world's poor and 6 percent would cover all individuals that currently have no access to social protection. Domestically, the initial annual cost of a basic social protection package could be between 3.7 percent and 10.6 percent of GDP.

**Source:** ILO, 2010, *Global Employment Trends*, ILO, Geneva.

Many social protection programmes can harm or foster asset-building even if they do not explicitly seek to do either. Therefore, it is important to consider how social protection and asset-building interact. For example, social protection programmes could conceivably dissuade programme beneficiaries from accumulating assets because beneficiaries might fear that, by having assets, they might no longer be eligible for the programme. There is some encouraging evidence, though, that some social protection interventions, such as CCTs, can encourage savings, as in the cases of Mexico and Paraguay (Zimmerman and Moury 2009), and they can open the door for the financial inclusion of the poor if transfers make use of the banking system or other models for setting up accounts for the beneficiaries. There is also evidence that the cash transfer given to CCT beneficiaries in Mexico has been used for productive investments. Beneficiaries use 88 cents of every peso they receive for household consumption and they invest the remaining 12 cents (Gertler et al. 2006). CCTs, or cash transfers in general, are meant to smooth consumption and, therefore, the transfer should ideally be spent to satisfy the basic needs of the household. Nonetheless, the potential to facilitate savings or other types of asset-building could be an interesting area to explore (de los Rios and Tivelli 2011).

Social protection can also play a critical role for the accumulation and use of assets. If poor households have predictable consumption-smoothing mechanisms, they do not have to resort to undesirable strategies to cope with shocks. For example, poor households, in an attempt to 'self-insure', could forgo more productive, but less liquid, investments in favour of more liquid assets that they can quickly sell if necessary. This generates a loss of efficiency and affects potential for future income (Dercon 2003).



## Box 6.3: Five Emerging Success Stories

**Ghana's National Health Insurance Scheme** is an intermediate form of health insurance involving social insurance financed by contributions from formal (and to a lesser extent informal) sector employees and by government coverage for those unable to contribute. The programme, now covering about 67 percent of the population, successfully includes informal workers by building on elements of community-based health insurance, thanks to the strong government commitment to guarantee health care for everyone.

**Lesotho's Old Age Pension** is a universal non-contributory scheme including all registered citizens over 70 not receiving any other form of pension benefit. The programme shows that, with strong political commitment, building a universal pension to reduce household vulnerability and enhance health and human capital might be feasible and affordable under certain preconditions, even in low-income countries.

**Rwanda's Vision 2020 Umurenge Programme** consists of three core initiatives to redirect social protection programmes to vulnerable populations: (1) public works; (2) the Ubudehe credit scheme; and (3) direct support

through an unconditional cash transfer. The programme underlines the importance of framing social protection as part of national development strategies and shows that decentralized administrative structures can improve targeting, avoid resource mismanagement, and increase local ownership and accountability.

**Ethiopia's Productivity Safety Net Programme** is a conditional transfer in cash and/or in kind based on public works. It also includes a small component of unconditional direct transfers to those unable to work. It is Africa's largest public works programme and one of the most effective social protection programmes in sub-Saharan Africa, reducing poverty and increasing food security in the short run while offering the potential for asset growth in the long run.

**Kenya's Home Grown School Feeding programme** is a conditional cash transfer to schools for local purchase of food, involving half a million children of primary school age. The programme shows that home-grown school feeding can spread the benefits of social protection to children while boosting local agricultural productivity.

**Source:** European Communities, 2010, *Social Protection for Inclusive Development: A New Perspective in EU Co-Operation With Africa*, The 2010 European Report on Development, Robert Schuman Centre for Advanced Studies, European University Institute, San Domenico di Fiesole.

### *Supporting Micro-finance Services*

Beyond micro-credits for micro and small enterprises, other micro-finance services, particularly savings and micro-insurance (Zimmerman and Moury 2009), can promote the acquisition and protection of assets. Developed countries have long had financial instruments that promote savings among the poor, such as individual development accounts in the United States and Canada. These accounts are set up to receive deposits from the beneficiary that are then matched by public or private subsidies (OECD 2003). The uses of the funds of these accounts are normally restricted to investments in human capital, such as education, or the acquisition of assets such as land or housing. Recently in Mexico, the Oportunidades CCT programme included a similar approach for young people reaching the age at which they are no longer eligible for the educational benefits of the programme. Oportunidades established accounts for these young people and gave them financial help to pursue technical or higher education (Mexican Federal Government 2010).

### *Pro-poor Macro-economic Policies*

A sound macro-economic framework is the basis for supporting growth and employment creation. Macro-economic policies can contribute to raising domestic productive activities and thus create new employment



opportunities, but they also need to be sustained by structural and institutional changes in order to be effective. While many developing economies have achieved macro-economic stability in the recent past, major challenges in facilitating a more robust and pro-employment growth pattern remain.

In this context, coordinated macro-economic policies are key instruments for a structural anti-cyclical fiscal policy, since they can help smooth out economic fluctuations, raise investors' confidence, and contribute to growth and employment creation in periods of economic downturn. However, in many developing countries, monetary policies only include inflation targets. More attention should be given to growth and employment, without jeopardizing macro-economic stability.

### *Macro-economic Stability and Growth and Employment Creation*

It has been noted that the key goals of any anti-poverty strategy should be the minimization of output volatility and the avoidance of sharp recession-induced rises in inequality. However, the typical focus of macro-economic policies remains stabilization, not economic growth. "At a time when the boundary between monetary and fiscal policy becomes fuzzy, when the control of asset prices becomes a major objective for macro-economic stability, we have to accept the sheer fact that monetary policy should also have several objectives and instruments and should strengthen its cooperation with fiscal policy" (Fitoussi and Saraceno 2010).

### *Careful Domestic and International Financial Liberalization and Regulation*

In addition to spurring financial crises, the liberalization of domestic banking and international financial flows, including short-term flows, has also allowed income inequality to rise. Policies regarding domestic financial liberalization and capital account liberalization thus need to be reconsidered. "Capital controls can be, under certain conditions, an effective mechanism to insulate developing countries from the contagion effects of a financial crisis and can help reduce financial fragility" (Cozzi and Niskanke 2009). Further, institutional reforms, stronger regulation and an early warning system signalling financial distress can help mitigate the impact of such shocks.

Indeed, given the increased openness of most developing economies, exchange rate policy can also powerfully influence the competitiveness of the domestic economy, with all its consequences for employment.

### *Tax and Transfer Policies*

By increasing tax revenues and progressive pro-poor expenditure, governments can directly and significantly affect income inequality. A progressive income tax system, in which tax rates increase as an individual's income increases, is a traditional way of redistributing income. Those with higher incomes pay taxes that are then used to finance government priorities, among which poverty reduction is often included. This is redistribution through the expenditure side of the public finance equation. However, on the revenue side, there are also ways to address inequalities. Specific policy options can include:

### *Prioritizing Poverty Reduction Expenditures*

Given the overrepresentation of the poor in the informal labour market and their income levels, they often fall outside the tax net, so redistributing income through social expenditure often makes sense. Social expenditure can be directed at those in the formal and informal labour markets through, for example, spending on education, health, pensions, cash transfers and subsidies, for example.



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## *Extending tax exemptions and zero tax rates for basic products*

Many developing countries are not able to effectively collect direct income taxes. They thus rely heavily on indirect taxation, which tends to be regressive, since it is not related to a person's income level. However, there are also ways of addressing inequality through indirect taxation, such as zero-rating or exempting basic products such as certain foods, edible oils, fuels for cooking and heating, and clothing that are often consumed by the poor. At this level, there are important opportunities for promoting gender equality, since women are not only overrepresented among the poor, but are also the ultimate consumers of these types of goods in their roles as caregivers (UNDP 2010).

## *Policies conducive to employment creation*

Taxation systems are also relevant for the promotion of employment and income generation. Taxation should not be so onerous that it discourages investment and the creation and formalization of firms that can offer better quality employment. Likewise, at the household level, they should not discourage the entry and retention in the formal labour market. If taxation systems are such that the added income from a family member leads to a higher, unaffordable the tax rate, that family member will often exit the formal labour market (Grown and Valodia 2010). In this sense, countries can analyse their tax codes and try to minimize the tax costs for poor households to engage in paid employment.

## *Include social expenditures in fiscal stimulus packages in times of crisis*

During times of crisis, such as the recent global economic crisis, governments also rely on fiscal stimulus packages; this is a good opportunity to invest in often-needed social protection measures. As discussed above, social protection can have positive macro-economic effects, such as protecting domestic aggregate demand. During the recent crisis, at least 48 countries (developed and developing) announced fiscal stimulus packages (Zhang et al. 2010). However, the content of these stimulus packages is important in terms of their relevance for reducing poverty, vulnerability and inequality. An analysis of 48 countries by the Office of Development Studies at UNDP in 2010 (Zhang et al. 2010) revealed that at least 35 of those countries included some measures related to social protection (broadly understood). The percentage of the package devoted to social protection measures varied considerably, ranging from 1.5 percent in Turkey to 55.7 percent in South Africa. The social protection measures included spending in public housing construction and maintenance, as in China, Honduras, Malaysia and Viet Nam. There were also fee waivers for education and health services and a lowering of VAT for medications. Some also included some labour market measures such as investing in job-creating infrastructure projects, increasing vocational training options, or generating temporary employment. Aside from the macro-economic benefits, including such measures can help avoid the poor from bearing a disproportionate burden during economic downturns.



## Notes

1. According to Cornia (2004), very low and very high levels of inequality can depress the rate of economic growth. The turning point seems to be at a Gini coefficient of 40. Beyond this point, growth seems to suffer.
2. High inequality is linked with conflict and political instability because it creates incentives for people to engage in activities outside the market (e.g., illegal drug trafficking, crime) that contribute to political and social instability. Such instability generates disruptions in the current economy and uncertainty about the future, thereby discouraging the accumulation of wealth, savings and investment (Alesina and Perotti 1996).
3. Chart 6.1 examines the difference between the growth of real income by quintile (or group of quintiles) and the growth in average income from the mid-1980s to the mid-2000s. Less-than-average growth of a given quintile (or group of quintiles) indicates a decrease in the share of that quintile in total income. And if a quintile's income is growing above average, then that quintile's share in total income must be growing.
4. As Rajan (2010) notes, "The political response to increasing inequality — whether carefully planned or the path of least resistance — was to expand lending to households, especially low-income households."
5. Procyclicality is accelerated in more unequal societies because, during economic booms, investors' net wealth increases. As net wealth rises, so does the borrowing capacity in the economy. "Greater availability of credit (perpetuated by policy makers and complex financial instruments) led to higher asset prices, which in turn served as collateral for more borrowing. Investors therefore accumulated debt during the boom, increasing demand for investible funds. As the interest rate rose (as it tends to during the boom), the credit-fuelled boom enabled the middle class to continue consuming, and temporarily offset potential tensions arising from increasing inequality. It collapsed, however, when ordinary borrowers started defaulting on their debts" (Vandemoortele 2009).
6. According to Minsky (1982), endogenous financial fragility is more likely to develop in a situation of rising inequality, where it becomes necessary for borrowers to increase indebtedness in order to face previously undertaken financial commitments (largely because expected income is insufficient to service the debt). In such a situation, borrowers and lenders are both speculating that it will be possible to finance the debt in the future. In the context of a growing economy, borrowers and lenders are rational in that their expectations are continually fulfilled. Thus, financial agents looking for larger profits will undertake riskier decisions as long as prosperity continues engendering endogenous financial instability in the market (See also Mendonca and Deos 2009).
7. "International financial deregulation in turn has caused growing instability as signalled by the rise in the frequency and severity of crises in recent years. In Latin America and Asia, for instance, financial crises raised inequality 73% and 62% of the time respectively" (Cornia and Court 2001).
8. Country level on Gini data is not available for every country in each year. To overcome this issue, we have selected countries that have Gini information for two years approximately a decade apart from the World Bank's World Development Indicators database (World Bank 2009a). Specifically, only countries that had Gini data for any year from 1991 to 1996 (the earliest year if there is more than one reported) and data for any year from 2002 to 2007 (the latest of years reported) were included in the sample. Also, countries with inequality data that covers less than a 10-year span were excluded. Moreover, the income definition used to compute the Gini coefficient can also vary by country. Most income distribution data in developing economies were calculated using household expenditure studies/surveys.
9. This impressive decline in income inequality recorded by countries in Africa is only exceeded by the group of five ECIS countries where inequality declined (Azerbaijan, Bulgaria, Estonia, Kyrgyzstan and the Russian Federation). These five countries managed to reduce income inequality by 25 percent on average during this period.
10. Land concentration: Land ownership inequality is widely considered to be the reason for high levels of income inequality in agriculture-dominated countries. However, even for countries that remain agriculture-dominated, there have been few major changes in the agrarian structure of developing countries that could directly explain the recent



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rises in income inequality. Evidence also shows that countries well endowed with mineral resources (oil, diamonds, etc.) tend to have a higher asset and income inequality than other types of economies. This is due to the capital-intensive nature of the production process and concentration of ownership in this sector. Yet, dominance of natural resources does not appear to explain the recent rise in inequality in resource-rich countries (Cornia 2004).

11. According to Cornia (1994), traditional causes of inequality (land concentration, urban bias, dominance of a highly concentrated mining sector, inequality of education) do explain most of the variation in cross-country inequality (i.e., these factors explain the level of inequality between regions), but, with the exception of inequality in education in Latin America, they do not explain the recent surges in inequality within countries.
12. This is why it is important to look for changes in government budgets — particularly taxes and transfers — in order to help drive the distribution of disposable income towards greater equality.
13. The rapid growth in the FIIRE sector (finance, insurance, internet and real estate) — in which financial rents and the wages for a few highly skilled workers absorb most of the value added — has been critical in many countries.
14. It has also been noted that procyclical policies and lax regulation of the financial sector are more likely to occur in more unequal societies. Typically politicians will seek to avoid implementing policies to address structural failures where they are controversial, and will support policies that both expand the purchasing power of the middle class and sustain growth, whether or not they are sustainable in the longer term (Vandemoortele 2009).
15. Alesina and Rodrik (1994) were the first to point out that initial inequality seemed to be empirically associated with lower growth rates. The literature has proposed several hypotheses to explain why progressive redistribution may be growth-enhancing: for instance, redistributing capital from capital-rich enterprises or individuals to capital-poor or credit-constrained people increases efficiency, investment and growth; too much inequality may lead to social tensions, which, in turn, adversely impact growth (Rodrik 1998).
16. It has been noted that these results depend very much on the sample and quality of data being used (Bourguignon 2004). Still, recent models focus on the likelihood that inequality exacerbates the effect of capital and other market failures on growth. “When credit-worthy borrowers cannot borrow because they lack collateral to comfort lenders, then their lack of income or wealth limits their ability to invest — in their own farms, small businesses, and in the health and education of their children” (Birdsall 2005).
17. However, some developing countries were able to reduce poverty considerably, despite rising inequality consequent to persistently high economic growth, which more than compensated for the rise in inequality in these countries (for instance, China and Ghana).
18. It is important to note that poverty traps do not explain why poor people remain poor in countries with sustained economic growth. That is a different kind of chronic poverty than that found in countries where poor people stay poor because of long-term growth failure. The former type of poverty is not irrelevant to LDCs, but it becomes important only once a process of economic growth is started and sustained (Gore 2002).
19. One mechanism through which this occurs is the negative feedback effects of generalized poverty on domestic resources available to finance investment and public goods, including governance.
20. Additional factors that contribute to a poverty trap include: limited access to credit and capital markets, extreme environmental degradation (which depletes an area’s agricultural production potential), corrupt governance, capital flight, poor education systems, disease ecology, lack of public health care, war or poor infrastructure.
21. The relationship between concepts of inclusive growth and pro-poor growth are explored in the note on Inclusive Growth, World Bank, 2009. “IG is in line with the absolute definition of pro-poor growth, not the relative one” (Ianchovichina et al. 2009).



22. According to the Report of the Commission, “persistent, determined focus on inclusive long-term growth by governments is one of the ingredients of a successful growth strategy. Yet, there is limited analytical work integrating the literature on growth and productive employment” (Ianchovichina et al. 2009).
23. Since the problem in many LICs is not unemployment, but underemployment, inclusive growth requires not only employment growth, but also productivity growth. Further, it concerns not only wage employment, but also self-employment, so that returns to capital, labour, land and assets matter to the income potential of the focus group. Here, it should be noted that there is no preconception or bias in favour of labour-intensive industry policy. Indeed, the self-employed poor need improvements in productivity and leveling of the business environment in order to raise their incomes (see World Bank 2009b).
24. According to the ILO (2010), approximately 850 million workers might have been living in extreme poverty—i.e., below \$1.25 a day—in 2009.



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## Annex 6.A: Change in Inequality

Country	Beginning Year	End Year	Years	Region	Development Status	Gini*100 (1991–1996)	Gini*100 (2002–2007)	Change in Gini (%)
Argentina	1992	2006	15	LAC	High-income DC	45.4	48.8	0.1
Azerbaijan	1995	2005	11	ECIS	Transition	35.0	16.8	-0.5
Bangladesh	1992	2005	14	A&P	Low-income DC	27.6	33.2	0.2
Belarus	1993	2005	13	ECIS	Transition	21.6	27.9	0.3
Bolivia	1991	2005	15	LAC	Middle-income DC	42.0	58.2	0.4
Brazil	1990	2007	18	LAC	Middle-income DC	60.6	55.0	-0.1
Bulgaria	1992	2003	12	ECIS	Transition	30.8	29.2	-0.1
Burkina Faso	1994	2003	10	Africa	Low-income DC	50.7	39.6	-0.2
Burundi	1992	2006	15	Africa	Low-income DC	33.3	33.3	0.0
Cambodia	1994	2004	11	A&P	Low-income DC	38.3	41.9	0.1
Central African Rep.	1993	2003	11	Africa	Low-income DC	61.3	43.6	-0.3
Chile	1990	2006	17	LAC	High-income DC	55.5	52.0	-0.1
China	1991	2002	12	A&P	Low-income DC	28.7	37.1	0.3
Colombia	1991	2006	16	LAC	Middle-income DC	51.3	58.5	0.1
Costa Rica	1990	2005	16	LAC	Middle-income DC	45.7	47.2	0.0
Côte d'Ivoire	1993	2002	10	Africa	Low-income DC	36.9	48.4	0.3
Dominican Republic	1992	2006	15	LAC	Middle-income DC	51.4	51.9	0.0
Ecuador	1994	2007	14	LAC	Middle-income DC	52.0	54.4	0.0
Egypt	1991	2005	15	Arab States	Middle-income DC	32.0	32.1	0.0
El Salvador	1995	2005	11	LAC	Middle-income DC	49.9	49.7	0.0
Estonia	1993	2004	12	ECIS	Transition	39.5	36.0	-0.1
Ethiopia	1995	2005	11	Africa	Low-income DC	40.0	29.8	-0.3
Georgia	1996	2005	10	ECIS	Transition	37.1	40.8	0.1
Ghana	1992	2006	15	Africa	Low-income DC	38.1	42.8	0.1
Guinea	1991	2003	13	Africa	Low-income DC	47.2	43.3	-0.1
Guinea-Bissau	1991	2002	12	Africa	Low-income DC	56.2	35.5	-0.4
Honduras	1990	2006	17	LAC	Middle-income DC	57.4	55.3	0.0
Hungary	1993	2004	12	ECIS	Transition	27.9	30.0	0.1
India	1994	2005	12	A&P	Low-income DC	30.3	32.6	0.1
Indonesia	1990	2005	16	A&P	Low-income DC	28.9	32.6	0.1
Iran	1990	2005	16	A&P	Middle-income DC	43.6	38.3	-0.1
Jamaica	1990	2004	15	LAC	Middle-income DC	42.2	45.5	0.1
Jordan	1992	2006	15	Arab States	Middle-income DC	43.4	37.7	-0.1
Kazakhstan	1993	2003	11	ECIS	Transition	32.7	33.9	0.0
Kenya	1992	2005	14	Africa	Low-income DC	57.5	47.7	-0.2

**Source:** Calculated using data from World Bank, World Development Indicators 2009

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Country	Beginning Year	End Year	Years	Region	Development Status	Gini*100 (1991–1996)	Gini*100 (2002–2007)	Change in Gini (%)
Kyrgyzstan	1993	2004	12	ECIS	Transition	53.7	32.9	-0.4
Lao PDR	1992	2002	11	A&P	Low-income DC	30.4	32.6	0.1
Latvia	1993	2004	12	ECIS	Transition	27.0	35.7	0.3
Lesotho	1993	2003	11	Africa	Low-income DC	57.9	52.5	-0.1
Lithuania	1993	2004	12	ECIS	Transition	33.6	35.8	0.1
Madagascar	1993	2005	13	Africa	Low-income DC	46.1	47.2	0.0
Malaysia	1992	2004	13	A&P	Middle-income DC	47.7	37.9	-0.2
Mali	1994	2006	13	Africa	Low-income DC	50.6	39.0	-0.2
Mexico	1992	2006	15	LAC	High-income DC	50.7	48.1	-0.1
Moldova	1992	2004	13	ECIS	Transition	34.3	35.6	0.0
Mongolia	1995	2005	11	A&P	Low-income DC	33.2	33.0	0.0
Morocco	1991	2007	17	Arab States	Middle-income DC	39.2	40.9	0.0
Nicaragua	1993	2005	13	LAC	Low-income DC	56.4	52.3	-0.1
Niger	1992	2005	14	Africa	Low-income DC	36.1	43.9	0.2
Nigeria	1993	2004	12	Africa	Low-income DC	45.0	42.9	0.0
Pakistan	1991	2005	15	A&P	Low-income DC	33.2	31.2	-0.1
Panama	1991	2006	16	LAC	Middle-income DC	56.8	54.9	0.0
Paraguay	1990	2007	18	LAC	Middle-income DC	39.7	53.2	0.3
Peru	1990	2006	17	LAC	Middle-income DC	43.9	49.6	0.1
Philippines	1991	2006	16	A&P	Low-income DC	43.8	44.0	0.0
Poland	1992	2005	14	ECIS	Transition	26.7	34.9	0.3
Romania	1992	2005	14	ECIS	Transition	25.5	31.5	0.2
Russian Federation	1993	2005	13	ECIS	Transition	48.3	37.5	-0.2
Senegal	1991	2005	15	Africa	Low-income DC	54.1	39.2	-0.3
Slovenia	1993	2004	12	ECIS	Transition	29.2	31.2	0.1
Sri Lanka	1991	2002	12	A&P	Low-income DC	32.5	41.1	0.3
Thailand	1992	2004	13	A&P	Middle-income DC	46.2	42.5	-0.1
Turkey	1994	2005	12	ECIS	Middle-income DC	41.5	43.2	0.0
Uganda	1992	2005	14	Africa	Low-income DC	42.6	42.6	0.0
Ukraine	1992	2005	14	ECIS	Transition	25.7	28.2	0.1
Uruguay	1992	2006	15	LAC	High-income DC	42.2	46.2	0.1
Venezuela	1993	2006	14	LAC	High-income DC	41.7	43.4	0.0
Viet Nam	1993	2006	14	A&P	Low-income DC	35.7	37.8	0.1
Yemen	1992	2005	14	Arab States	Low-income DC	39.5	37.7	0.0
Zambia	1991	2004	14	Africa	Low-income DC	60.5	50.7	-0.2

**Source:** Calculated using data from World Bank, World Development Indicators 2009



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**Annex 6.B: Poverty Reduction, Growth and Inequality (mid-1990s to mid-2000s)**

Country	Region	Development Status	Beginning Year	End Year	Poverty Rate (mid-1990s)	Poverty Rate (mid-2000s)	Poverty Reduction	Gini (mid-1990s)	Gini (mid-2000s)	Change in Gini (%)	Growth
Azerbaijan	ECIS	Transition	1996	2001	68.1	49.6	27%	35.22	36.50	4%	4.8
Bangladesh	A&P	Low-income DC	1996	2005	51.0	40.0	22%	33.46	33.22	-1%	5.3
Cambodia	A&P	Low-income DC	1994	2004	47.0	35.0	26%	38.28	41.85	9%	7.8
Cameroon	Africa	Low-income DC	1996	2001	53.3	40.2	25%	46.82	44.56	-5%	4.7
China *	A&P	Low-income DC	1996	2004	6.0	2.8	53%	32.34	37.05	15%	9.0
Costa Rica	LAC	Middle-income DC	1992	2004	22.0	23.9	-9%	46.95	48.50	3%	5.0
Egypt	Arab States	Middle-income DC	1996	2000	22.9	16.7	27%	30.13	32.76	9%	5.2
El Salvador	LAC	Middle-income DC	1995	2002	50.6	37.2	26%	49.86	52.32	5%	3.2
Ethiopia	Africa	Low-income DC	1996	2000	45.5	44.2	3%	37.97	30.00	-21%	4.7
Ghana	Africa	Low-income DC	1992	2006	50.0	28.5	43%	38.13	42.76	12%	4.6
India	A&P	Low-income DC	1994	2000	36.0	28.6	21%	30.32	31.56	4%	6.2
Indonesia	A&P	Low-income DC	1996	2004	17.5	16.7	5%	30.55	31.31	2%	2.5
Jamaica	LAC	Middle-income DC	1995	2000	27.5	18.7	32%	38.87	45.59	17%	0.1
Kazakhstan	ECIS	Transition	1996	2002	34.6	15.4	55%	35.32	34.95	-1%	5.2
Mauritania	Arab States	Low-income DC	1996	2000	50.0	46.3	7%	37.29	39.04	5%	2.6
Mongolia	A&P	Low-income DC	1995	2002	36.3	36.1	1%	33.20	32.84	-1%	3.5
Nepal	A&P	Low-income DC	1996	2004	41.8	30.9	26%	37.67	47.30	26%	4.2
Poland	ECIS	Transition	1993	2001	23.8	14.8	38%	32.39	32.84	1%	4.9
Russian Federation	ECIS	Transition	1994	2002	30.9	19.6	37%	47.61	35.70	-25%	0.2
Sri Lanka	A&P	Low-income DC	1991	2002	20.0	22.7	-14%	32.48	41.06	26%	4.6
Tanzania **	Africa	Low-income DC	1991	2001	38.6	35.7	8%	33.84	34.62	2%	3.2
Turkey	ECIS	Middle-income DC	1994	2002	28.3	27.0	5%	41.53	42.71	3%	2.7

Poverty rate measured as the poverty headcount ratio (using the national poverty line)

\* China poverty data for 2002

\*\* United Republic of Tanzania Gini data are for 1992 and 2000

Source: Calculated using data from World Bank, World Development Indicators 2009



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# 7

## ECONOMIC RESILIENCE AND FISCAL CAPACITY



*If a country has adequate fiscal capacity, it can maintain public spending, even adopt fiscal stimulus packages and consequently be more resilient in the face of an economic shock.*



Photo: Partha Pratim Saha/ UNDP India



## Introduction

Fiscal capacity determines a country's ability "to finance larger fiscal deficits *without jeopardizing macro-economic stability and debt sustainability*" (emphasis added, World Bank 2009a).<sup>1</sup> As such, this measure assesses whether a country can afford to take on additional debt as a means of coping with or counteracting the impact of economic crises. If a country has adequate fiscal capacity, it can maintain public spending, even adopt fiscal stimulus packages and consequently be more resilient<sup>2</sup> in the face of an economic shock.

This concept of fiscal capacity focuses principally on the ability of a country to run larger fiscal deficits. A country could, of course, address tight fiscal constraints by increasing the efficiency of spending or raising additional revenues, but it is generally difficult to carry out such measures in the short term. In this sense, fiscal capacity as defined here is narrower than the concept of fiscal space.<sup>3</sup>

From the perspective of sustaining MDG progress, fiscal capacity is simply critical. It is well known that fiscal accounts are highly procyclical in the developing world: tax revenues rise during periods of economic growth when incomes rise, and fall during recessions when incomes fall. Yet, many countries find it difficult or expensive to borrow the funds necessary to finance government spending during economic downturns (which is when they should engage in deficit spending). And, in the absence of external finance, they are forced to cut spending, which exacerbates the recession, delays recovery and impacts the sustainability of MDG progress.

*Fiscal capacity determines a country's ability "to finance larger fiscal deficits without jeopardizing macro-economic stability and debt sustainability".*

The evidence is clear: During crises, growth decelerations and budget cuts tend to risk, if not reverse, progress made towards different goals. For instance, estimates for countries in Asia and the Pacific indicate that a 1 percent fall in per capita GDP growth translates on average, depending on the country, into a 0.5–0.7 percent decrease in the growth of per capita public health expenditure and a 0.3–0.5 percent decrease in the growth of per capita public education spending (Wan and Francisco 2009).

In order to understand what accounts for varying fiscal capacities among countries, one must consider the indicators that collectively reflect the potential fiscal capacity of a country. Most measures of fiscal capacity include the fiscal deficit, external debt, current account balance, international reserves, and level of savings. These indicators reflect the solvency and reserve position of countries and hence are indicators of whether a country can afford to take on more debt and/or rely on its own reserves to maintain or increase expenditures during a crisis.

Trends on these different indicators of fiscal capacity<sup>4</sup> for the period 1995–2009 indicate:

A high degree of procyclical bias in both the current account and fiscal balances, implying that developing economies do need to engage in countercyclical spending if they are to mitigate the impact of economic shocks. However, for the most part, their capacity to do so appears to be restricted on account of chronic and persistent deficits — both trade and fiscal. Large deficits cap how much additional debt a country can assume.

Although the external debt picture of many developing countries had been improving steadily in the run-up to the crisis, this does not necessarily mean that the poorest of them have greater latitude to carry additional debt, in part on account of: (a) conditionality associated with multilateral loans that impose tight fiscal deficit



targets, including during downswings of the economy, (b) the limited access of developing countries to trade finance, and (c) the preoccupation of policy makers with short-term macro-economic stabilization over long-term economic growth. All of these factors reinforce the procyclical bias of fiscal accounts, limiting the fiscal capacity of countries.

In the poorer developing economies, the rate of savings is low and, though international reserves have been growing since 1995, they are by no means sufficient and cannot be relied upon to finance countercyclical expenditure. Although this appears to be the aggregate trend in fiscal capacity, there are clear differences between regions and countries. For instance, it is evident that, at the outset of the last global crisis, countries that had saved fiscal surpluses and had low levels of external debt, and relatively high rates of savings and international reserves, were in a better position to finance expenditures during the crisis. The fiscal capacity of several countries in Asia and in the Arab States was clearly better positioned than that of ECIS or African countries. “Towards the end of 2008, in response to the crisis, a number of Asia Pacific economies announced stimulus packages, some of which were quite large in relation to GDP” (UNESCAP 2009).<sup>5</sup> However, “the widening twin deficits [trade and fiscal] severely limit the ability of African governments to undertake needed crisis response initiatives and to sustain their development programmes” (African Development Bank 2009).

*Most measures of fiscal capacity include the fiscal deficit, external debt, current account balance, international reserves, and level of savings.*

Although efforts to support developing countries’ access to external finance were central policy concerns during the last global shock, much of the focus centred on the need for providing contingency financing to countries that the crisis had badly affected. However, building the fiscal capacity of countries, especially that of LICs, will require much more. Policy attention will need to focus on: (a) tackling the chronic and persistent current account deficits; (b) providing relief on debt servicing payments and designing sovereign debt workout mechanisms; (c) relaxing the conditionality on the fiscal deficit, especially during crises; (d) reassessing the presumed trade-offs between macro-economic stability and long-term economic growth; and (e) adopting policies to mobilize additional domestic revenues. In short, countries need to redress the procyclical bias of fiscal accounts as far as possible.

Moreover, policies that bank on national savings and foreign reserves to cushion the impact of the crisis will need to review the short-term advantages of these instruments vis-à-vis their longer-term opportunity ‘costs’ and development objectives. For example, the opportunity costs of holding foreign reserves may be quite high for many developing countries and some countries may wish to promote domestic demand by encouraging consumption and investment; consequently, they may not wish to target savings as a policy objective for the longer term. In the end, though, financing countercyclical spending will depend crucially on mobilizing greater domestic revenues for investment.

## Fiscal Capacity Indicators

Typically, studies on fiscal capacity use a number of indicators to assess whether a country can afford to incur higher deficits without jeopardizing macro-economic stability or debt sustainability.<sup>6</sup> These indicators include:



*The Fiscal Balance:* The government's budget position is suitable for inclusion because it reflects 'resilience of a shock-counteracting nature'. Countries with high fiscal deficits would have difficulties in implementing countercyclical measures, while countries with strong fiscal positions could use discretionary expenditures or tax cuts to mitigate the crisis (UNESCAP 2009).

*External Debt:* This is considered to be a good measure of resilience because a country with a high level of external debt may find it more difficult to mobilize resources to offset the effects of external shocks. This variable also "indicates resilience of a shock-counteracting nature" (Briguglio et al. 2008).

*The Current Account Balance:* The current account balance is the sum of the balance of trade (net earnings on exports minus payment for imports), factor income (earnings on foreign investments minus payments made to foreign investors) and cash transfers. It is an important indicator of fiscal capacity because any current account deficit (a trade deficit) would need to be financed. It would thus place limits on how much additional debt a country could assume, thereby limiting the capacity of a country to introduce countercyclical measures.

*Gross Savings Rate:* The level of savings is a useful indicator of a country's fiscal capacity. This is because a high level of savings can increase available domestic funds and provide a country with sufficient internal resources to engage in countercyclical spending.

*Official International Reserves:* International reserves (which include foreign exchange and gold, Special Drawing Rights, and IMF reserve positions) are assets of the central bank and are held in different reserve currencies, mostly the US dollar, and, to a lesser extent, other currencies. These reserves are used to back the liabilities of governments or financial institutions. Thus, foreign exchange reserves are important indicators of the ability to repay foreign debt and are used to defend currency and to determine the credit ratings of nations; at the same time, though, other government funds that are counted as liquid assets can also be applied to liabilities in times of crisis (such as stabilization funds, also known as sovereign wealth funds).

## Trends in Fiscal Capacity

### *External Indebtedness*

The degree of external indebtedness in developing economies, as measured by the ratio of external debt to GDP,<sup>7</sup> declined substantially between 1995 and 2009 (Chart 7.1). The external debt ratio fell from 86 percent in 1995 to 40 percent by 2009, with a big part of this improvement taking place during the last business cycle boom from 2003 (74 percent) to 2007 (39 percent).

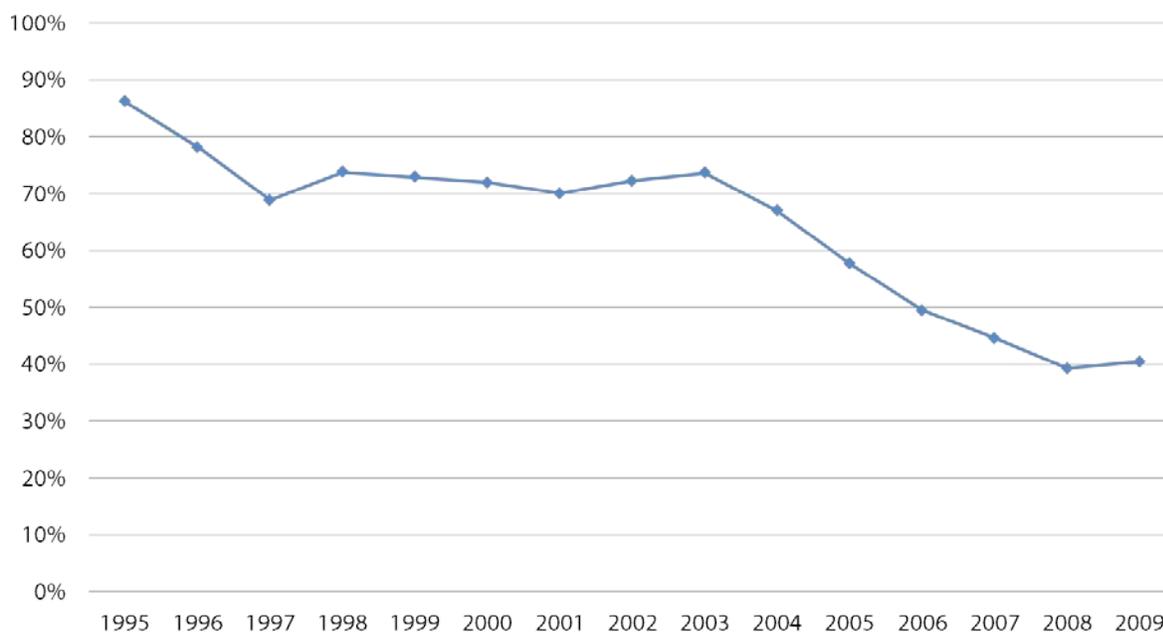
Another aspect of improved indebtedness across the developing world is that a larger proportion of countries have an external debt ratio below 50 percent. In 1995, 49 percent of developing countries had external debt ratios below 50 percent; by 2009, that proportion had increased to 73 percent.

The external debt ratio demonstrates clear countercyclicality — not surprising, since the need for external finance is especially acute during economic crises. External debt to GDP increased during both the 1997 and 2001 global slowdowns as well as during the latest global meltdown; in the latter instance, the external debt ratio increased by 3 percent in just one year (between 2008 and 2009).

The longer-term reduction in the degree of indebtedness was not uniform across regions (Chart 7.2). Africa had the lion's share of debt reduction, mostly due to the Heavily Indebted Poor Countries (HIPC) debt

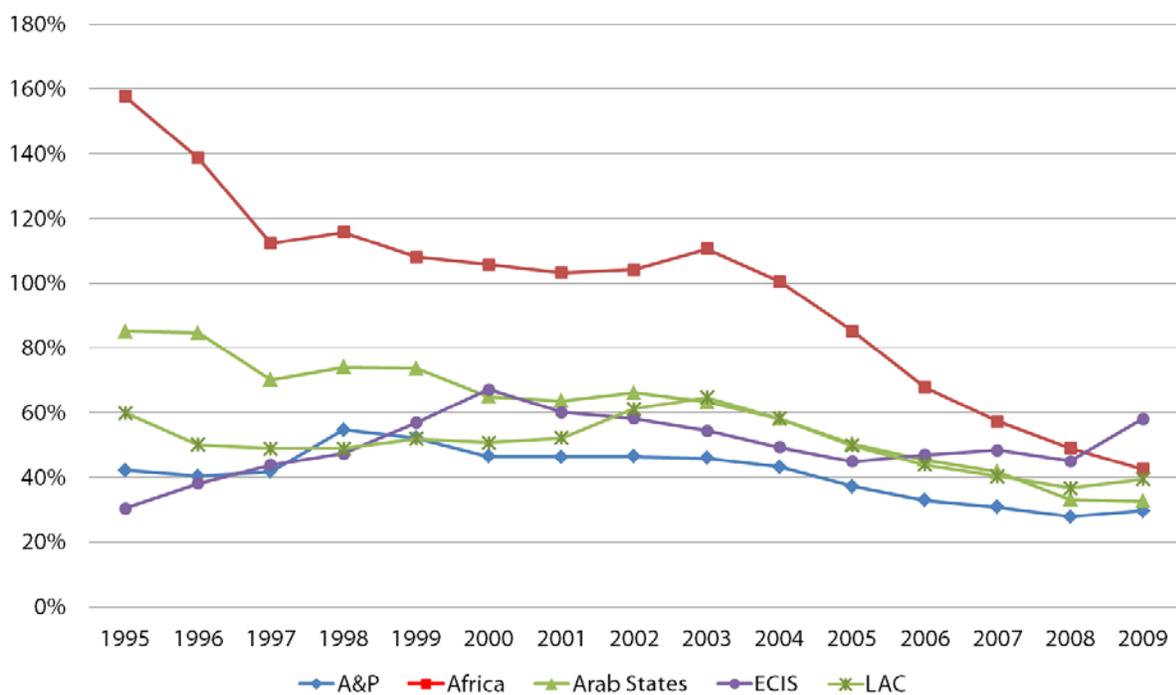


**Chart 7.1: External-debt-to-GDP ratio for developing economies, 1995–2009**



**Source:** Calculated from World Bank, World Development Indicators 2011

**Chart 7.2: External-debt-to-GDP ratio by region, 1995–2009**



**Source:** Calculated from World Bank, World Development Indicators 2011



## Box 7.1: The Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI)

The IMF and the World Bank introduced the HIPC initiative in 1996 and enhanced it in 1998 in order to reduce the multilateral debt of LICs to sustainable levels. The eligibility requirements for the HIPC initiative entail that countries: be low-income as determined by eligibility criteria for concessional loans from the International Debt Association and the IMF's Extended Credit Facility; have levels of indebtedness above the HIPC initiative thresholds;<sup>1</sup> commit to an approved poverty reduction and growth strategy; and have previously undergone a successful IMF assessment (IMF 2011a). In 2006, the World Bank, IMF, and African Development Fund made the MDRI operational, which expanded the goals of HIPC by providing full debt relief on eligible debt owed to participating multilateral financial associations in selected LICs.

As of 2010, 40 countries had been deemed eligible for HIPC and MDRI relief. Of these, 32 reached the completion

point and thus received full HIPC and MDRI debt relief. Four countries reached the decision point by 2010, which allows them to benefit from HIPC debt relief on a provisional basis.<sup>2</sup> The remaining four countries have met only the initial income and indebtedness requirements. Of the 36 countries that have reached the completion or decision point, 30 are located in Africa, 32 are low-income developing countries, and 28 are LDCs.

Between 1999 and 2010, the combined impact of HIPC and MDRI brought down the debt stocks in HIPC completion and decision-point countries by \$77 billion. Combined with other forms of traditional and bilateral debt relief, the debt stock in the 36 post-decision HIPC countries fell from \$142 billion to \$19 billion between 1999 and 2010 (World Bank 2011b).

1. In 1999, the HIPC debt thresholds were lowered with the goal of expanding the coverage of the initiative. The enhanced HIPC thresholds were set at: net present value (NPV) of external-debt-to-exports ratio greater than 150 percent; NPV external debt/domestic budget revenue greater than 250 percent; external-debt-service-to-export ratio greater than 15 percent to 20 percent by completion point.
2. These countries must implement an approved poverty reduction strategy for at least one year, maintain macro-stability, and implement structural and social reform proposals in order to reach the completion point.

**Source:** IMF and IDA, 2009, *HIPC Initiative and MDRI: Status of Implementation*, 15 Sept.

initiative and the Multilateral Debt Relief Initiative (MDRI) (Box 7.1) and the region's external debt ratio fell from 158 percent to 43 percent. In the Arab States, indebtedness was reduced from 85 percent in 1995 to 33 percent in 2009,<sup>8</sup> largely on account of their above-average growth rates during the period. In Latin America and the Caribbean, the external debt ratio fell from 60 percent in 1995 to 39 percent in 2009. Asia and the Pacific had the least reduction in relative indebtedness with the external debt ratio, which fell from 42 percent in 1995 to 30 percent in 2009.

Interestingly, ECIS was the only region to increase its indebtedness over this period. The external-debt-to-GDP ratio nearly doubled from 30 percent in 1995 to 58 percent in 2009. As a result, among development regions, the ECIS region went from having the lowest external debt ratio in 1995 to having the highest ratio by 2009.

As of 2009, Asia and the Pacific had the lowest levels of external debt ratio (30 percent), followed by the Arab States (33 percent), Latin America and the Caribbean (39 percent), Africa (43 percent), and the ECIS (58 percent).



As noted earlier, the external debt ratio moves countercyclically. The last economic crisis increased indebtedness across most regions. The ECIS region was most affected, with its external-debt-to-GDP ratio rising by 29 percent between 2008 and 2009. Indebtedness grew by 8 percent in Latin America and the Caribbean and by 6 percent in Asia and the Pacific.

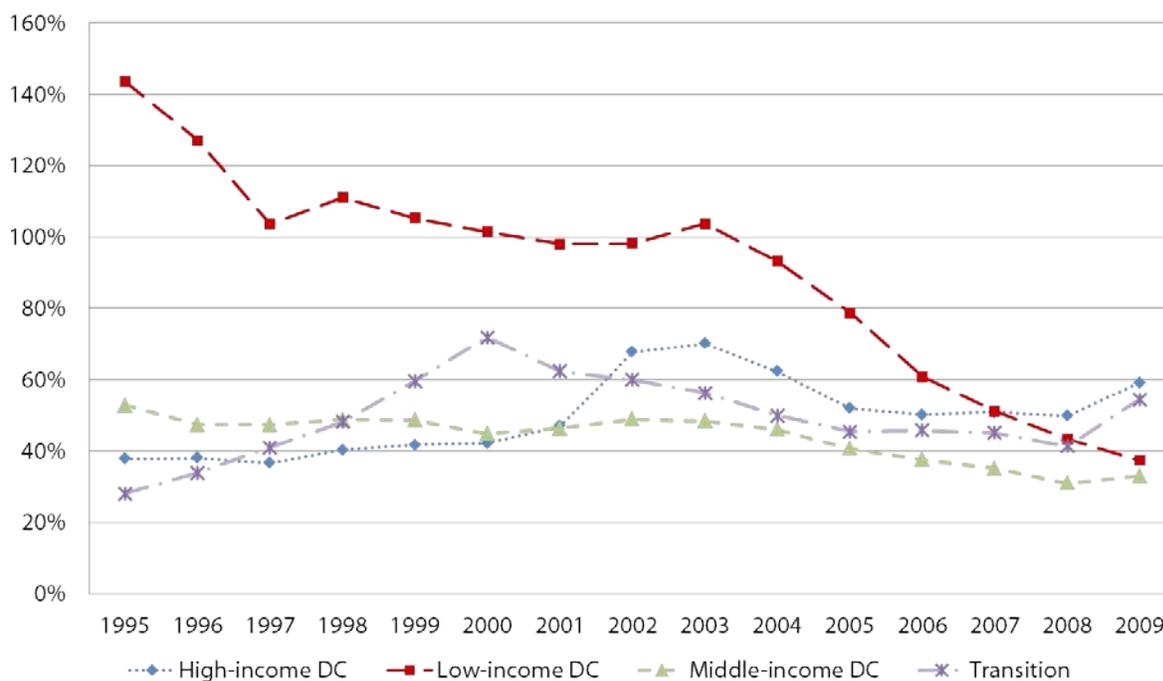
In the Arab States, the external debt ratio did not change much consequent to the global downturn, largely on account of their above-average growth rates through 2009 (while the average growth rate was 1 percent for all developing countries, it was 3.4 percent for the region in 2009). Surprisingly, the external debt ratio continued to fall in Africa during 2009.

Disaggregating the external debt ratio by development group (Chart 7.3) reveals interesting trends. The low- and middle-income countries had a pronounced reduction in their external debt ratio during the period. However, the external debt ratio rose in transition and high-income countries during the same period.

High-income countries increased their indebtedness from 38 percent in 1995 to 59 percent in 2009 and transition economies posted an even larger increase, from 28 percent in 1995 to 54 percent in 2009. On the other hand, the external debt ratio fell for low-income countries from an extremely high 144 percent in 1995 to just 37 percent by 2009. Middle-income countries started the period with an external debt ratio of 53 percent, but by 2009, that ratio had fallen to 33 percent.

Significantly, the external debt ratio for LDCs fell from 167 percent in 1995 to 41 percent in 2009 (Annex 7.B) because, as LICs, many of them qualified for debt relief under the HIPC debt initiative and the MDRI.

**Chart 7.3: External-debt-to-GDP ratio by development status, 1995–2009**



**Source:** Calculated from World Bank, World Development Indicators 2011



To conclude, developing economies as a whole made steady progress in reducing their external debt burden in the run-up to the crisis. The exceptions to this trend were countries in the ECIS region. “Prior to the crisis, the debt situation of many countries had improved, reflecting strong economic growth and less need for new borrowing. Some developing and transition countries, however, entered the crisis with debt situations that were still weak, in particular a number of small island developing States and low-income countries” (UN 2010).<sup>9</sup>

Four key factors are said to account for the improvement in external indebtedness during this period.

First, the HIPC debt initiative and the MDRI (Box 7.1) sought to provide debt relief to LICs on the debt owed to participating multilateral financial institutions. By the spring of 2011, 32 of the 40 countries that were eligible for debt relief under the HIPC had reached ‘completion’ point and were accorded the full relief programmed for them. They then also qualified under the MDRI for additional relief from remaining multilateral obligations owed to participating institutions. So far, 36 countries have received at least some relief under the initiative. The expectation is that the debt burden of all 36 countries will be reduced by 80 percent compared to pre-decision point levels.

Although significant debt relief has been provided to a number of countries, not all creditors have delivered on their commitments, and a number of commercial creditors have initiated litigation against some of the HIPCs, aiming to collect fully on the original obligations. Moreover, since the ‘sunset clause’ of the HIPC was introduced, countries that are currently not listed as eligible or potentially eligible may not be added under current policy. This means that no low-income country with debts that subsequently become unsustainable, owing to the recent crisis, for example, will be able to draw upon HIPC/MDRI debt relief.

Second, the (sovereign) debt difficulties of individual MICs, mainly involving obligations to private creditors, were being resolved through debtor-organized market swaps of new bonds for old debts. Regardless of whether relief was adequate to return the countries to sustainable situations, the countries did regain access to financial markets.

**Table 7.1: Average Fiscal Budget Balances and GDP Growth Across Developing Regions, 1995–2009**

Region	Average Fiscal Balance (% of GDP)	Average GDP Growth (% of GDP)
A&P	-1.5	5.2
Africa	-1.6	4.3
Arab States	-2.5	4.8
ECIS	-1.9	5.0
LAC	-1.6	3.5
All Regions	-1.7	4.5

*Source:* Calculated from World Bank, *World Development Indicators 2011* and IMF, *World Economic Outlook 2011*



Third, the external debt burdens of many developing and transition economies eased in the middle of the decade, helped by favourable trends in world trade and commodity prices and low interest rates. The importance of economic growth in reducing the overall indebtedness of countries should not be underestimated. Evidence indicates that, despite an increase in total external debt stocks, the growth of GDP outstripped the growth in external debt stocks, thus improving the ratio of external debt to GDP between 1995 and 2009. Moreover, the average economic growth (growth rate of GDP) during the period was 4.5 percent while the average fiscal deficit was 1.7 percent of GDP (Table 7.1). This differential between the rates of growth of GDP and the fiscal deficit as a share of GDP contributed to the decline in external debt ratio.<sup>10</sup>

Fourth, fiscal balances have, despite pronounced cyclicity, improved during the period across developing economies. Lower fiscal deficits translate into lower debt growth rates, since the majority of new debt goes to finance the budget deficit. Average fiscal deficits from 1995 to 2002, the first half of the period under consideration, were 2.3 percent of GDP, while fiscal deficits averaged 1.3 percent of GDP from 2003 to 2009, the second half of the period. In other words, the rate of debt accumulation fell during the period on account of improving fiscal balances.

This trend of declining external indebtedness changed course as a result of the global financial and economic crisis. All development groups, except for LICs, increased their levels of indebtedness between 2008 and 2009<sup>11</sup> (Chart 7.3). In transition economies, the external-debt-to-GDP ratio increased by an astounding 32 percent in 2009. Similarly, an increase in indebtedness occurred in high- and middle-income countries in 2009, where the external-debt-to-GDP ratios increased by 19 percent and 7 percent, respectively.

*The conclusion that some countries may need sovereign debt restructuring in the coming years underscores the fact that the world lacks a comprehensive mechanism with which to treat sovereign debt crises adequately.*

Clearly, since some countries had entered the crisis in less robust conditions than others, the risk of debt distress in those weaker countries grew. “Transition economies of Eastern Europe and Central Asia were the most severely hit regions” (UN 2010). Developing countries across the board suffered credit downgrades from major international ratings agencies. This, in turn, further increased the cost of borrowing and weakened many countries’ fiscal positions.

With many countries facing balance-of-payments financing problems, the IMF was approached for support. The Fund responded with additional resources and new flexibility in its lending arrangements, following the initiative of the G20. In 2007, just before the outbreak of the crisis, IMF gross lending commitments stood at just \$1 billion. By 2009, they had risen to \$120 billion and, by the end of April 2010, 57 countries, 30 of which were low-income, had an IMF arrangement. Other multilateral financial institutions also sharply increased their lending. The World Bank increased its gross commitments from \$36.5 billion in 2007 to \$65 billion in 2009 to help countries cope with the crisis. The main regional development banks together increased their lending from \$30 billion to \$50 billion over the same period (UN 2010).

According to the IMF and the World Bank, two groups of countries seem to be facing potentially difficult public debt scenarios: LICs and small, vulnerable MICs that have not been eligible to receive concessional resources from the major financial multilateral financial institutions. Results from the IMF/WB debt sustainability



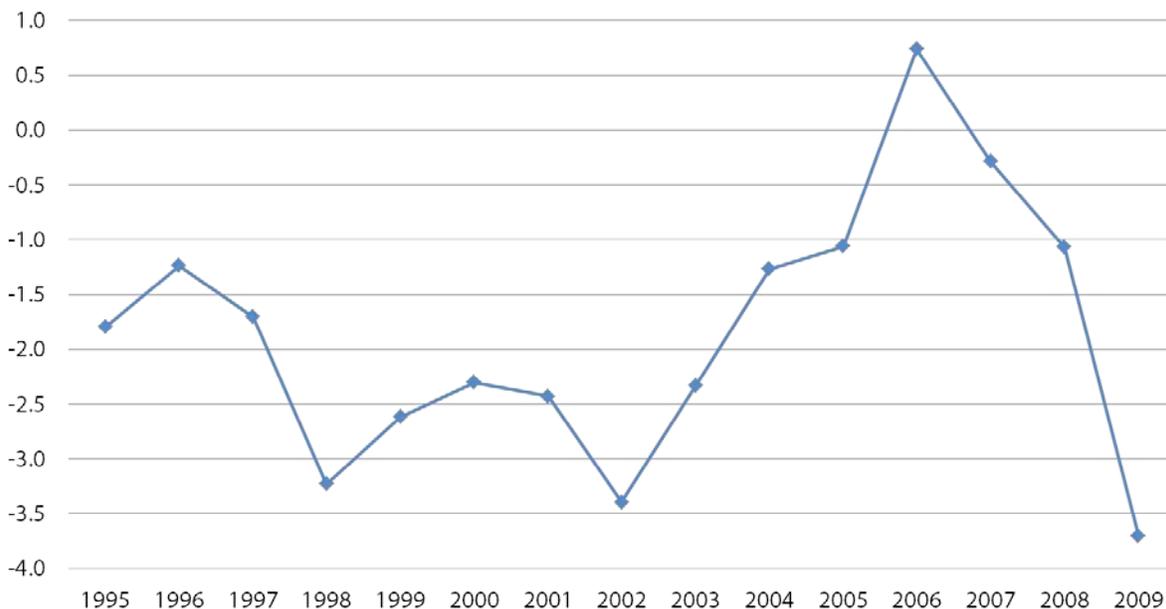
framework for the sovereign debt of LICs<sup>12</sup> indicate that, since May 2009, 11 of 39 LICs were classified as being in 'debt distress' and 16 of them as being 'at high risk of debt distress'.<sup>13</sup> It is noteworthy that six post-completion HIPC were identified as being at high risk. In short, the need for debt relief for some of these countries should not be ruled out. Moreover, these might not be the only countries that potentially need debt restructuring (IMF and IDA 2009).

The conclusion that some countries may need sovereign debt restructuring in the coming years underscores the fact that the world lacks a comprehensive mechanism with which to treat sovereign debt crises adequately.<sup>14</sup> Although countries may apply to the Paris Club under the Evian Approach,<sup>15</sup> most Paris Club members have already written off or reduced their claims against these countries and are unlikely to be their creditors at this point.

### The Fiscal Balance

The trend in the fiscal balance as measured by the share of the fiscal deficit or surplus in GDP<sup>16</sup> reveals that, despite evident procyclicality, the fiscal position for developing countries as a whole improved between 1995 and 2007 (Chart 7.4).<sup>17</sup> In 1995, developing countries had an overall budget deficit of 1.8 percent of GDP. By 2007, they were running a deficit of 0.3 percent of GDP. The majority of improvement occurred from the early- to mid-2000s. Furthermore, the proportion of developing countries with a deficit larger than 3 percent declined from 1995 to 2007.<sup>18</sup> In 1995, 40 percent of developing countries had a budget deficit greater than 3 percent. By 2007, 22 percent did. Despite the improvement, however, it is evident from the data that developing countries ran a deficit for much of the period. These averaged 1.8 percent of GDP between 1995 and 2007.

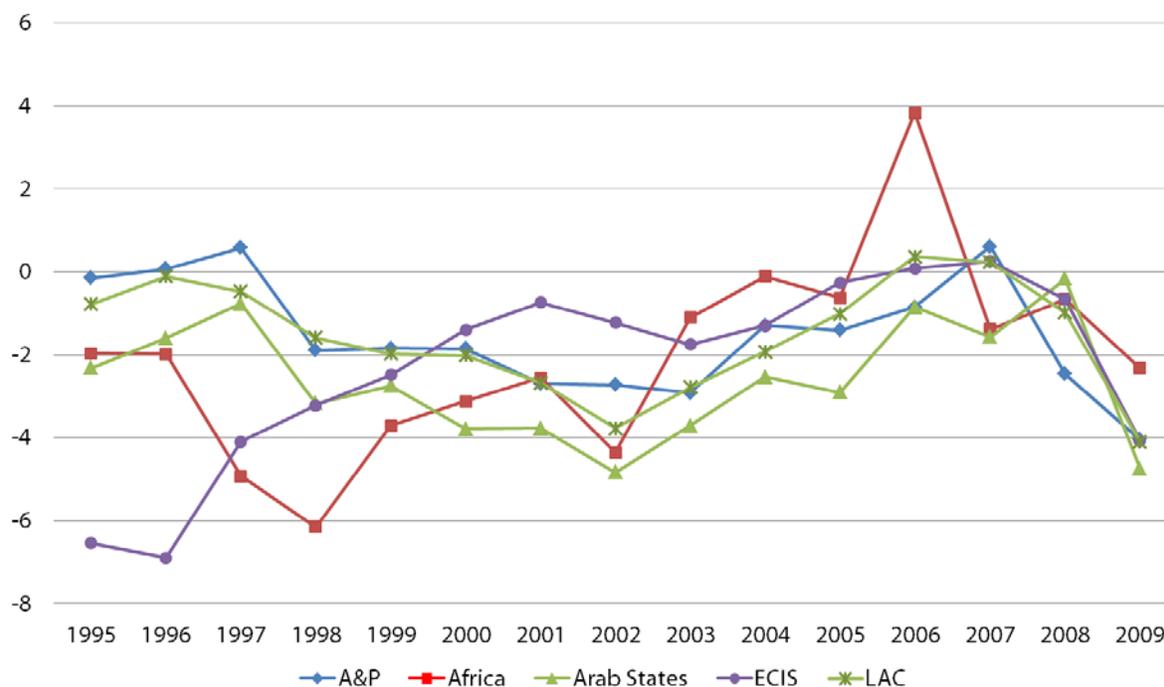
**Chart 7.4: Fiscal balance in developing countries, 1995–2009 (percent of GDP)**



**Source:** Calculated from World Bank, *World Development Indicators 2011*



**Chart 7.5: Fiscal balance by region, 1995–2009 (percent of GDP)**



**Source:** Calculated from World Bank, *World Development Indicators 2011* and IMF, *World Economic Outlook 2011*

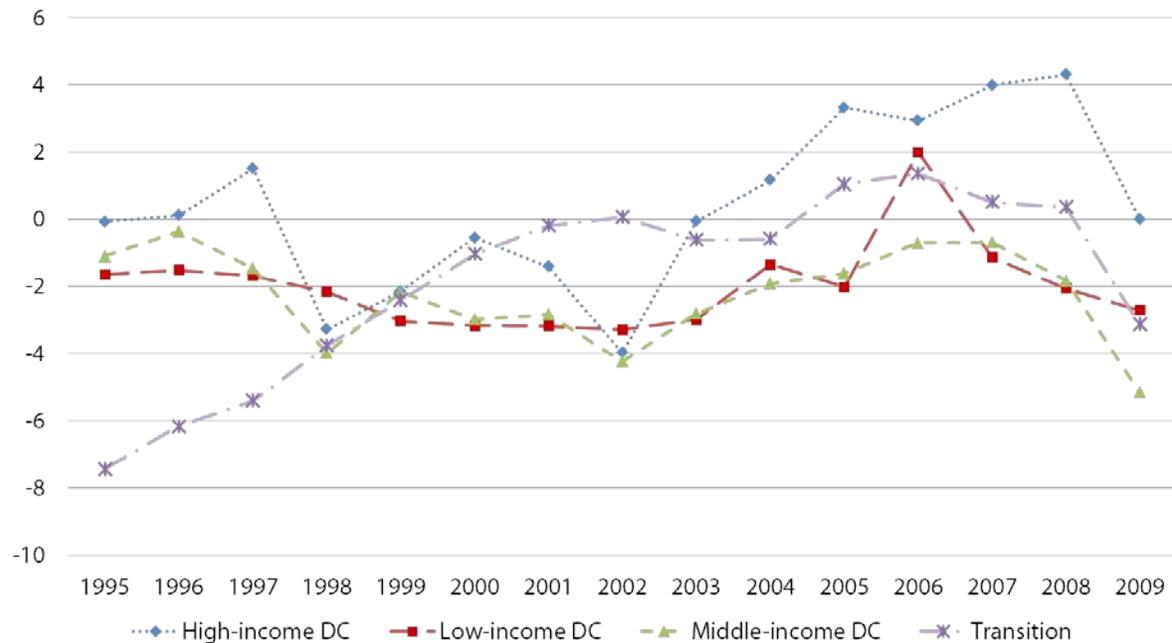
By region, it appears that the ECIS region experienced the largest overall improvement in its fiscal balance between 1995 and 2007. In 1995, it ran a deficit of 6.5 percent of GDP — nearly three times larger than any region in that year. By 2007, it had a fiscal surplus of 0.3 percent of GDP (Chart 7.5). Latin America and the Caribbean experienced the next largest improvement in its fiscal balance. In 1995, the region ran a deficit of 0.8 percent of GDP. By 2007, it ran a surplus of 0.2 percent of GDP. Asia and the Pacific had a deficit of 0.3 percent of GDP in 1995 and a surplus of 0.6 percent in 2007. In 1995, Arab countries had a fiscal deficit of 2.0 percent of GDP. Their deficit decreased to 1.6 percent of GDP by 2007. Africa experienced the smallest improvement in their fiscal deficit over the period: from 2.0 percent of GDP in 1995 to 1.4 percent in 2007.<sup>19</sup>

Even though every development group spent most of the period in deficit, the overall fiscal balance increased in each group between 1995 and 2007 (Chart 7.6). The mid- to late-2000s are unique in that high-income and transition countries sustained fiscal surpluses over this period. Transition economies started the period in 1995 with the largest deficit — 7.4 percent of GDP — of any development group. Yet, through 2007, these economies had the largest and most consistent overall improvement in their fiscal balance, which registered a surplus of 0.5 percent of GDP. High-income countries experienced the second largest improvement in their fiscal balance, running a deficit of 0.1 percent of GDP in 1995, but enjoying a surplus of 4.0 percent of GDP by 2007.

Low- and middle-income countries saw an overall improvement in their fiscal balances between 1995 and 2007, with most of the improvement occurring during the boom years of the early-2000s. Low-income countries ran an overall deficit of 1.7 percent of GDP in 1995. By 2007, they had a fiscal deficit of 0.8 percent.



### Chart 7.6: Fiscal balance by development status, 1995–2009 (percent of GDP)



**Source:** Calculated from World Bank, *World Development Indicators 2011* and IMF, *World Economic Outlook 2011*

Middle-income countries had the smallest improvement in the fiscal balances of any development group. Their deficit decreased from 1.1 percent of GDP in 1995 to 0.7 percent of GDP in 2007.

Following the global economic crisis, the fiscal position of every region deteriorated. The deterioration was largest in Asia and the Pacific, at 4.6 percentage points.<sup>20, 21</sup> The deterioration in the fiscal position was next largest in both the ECIS and Latin America and Caribbean regions, where the fiscal deficit increased by 4.3 percentage points, respectively. Between 2007 and 2009, the fiscal deficit increased by 3.2 percentage points among the Arab States and by 0.9 percentage points in Africa.

The external shock of the global economic crisis harmed the fiscal balance of all development groups without exception. Between 2007 and 2009, the average fiscal balance in all development groups deteriorated by 3.5 percentage points. The biggest deterioration was in middle- and high-income countries, where fiscal balances deteriorated by 4.5 and 4 percentage points of GDP, respectively. Between 2007 and 2009, the fiscal balance worsened by 3.7 percentage points in transition economies and by 1.6 percentage points in LICs.<sup>22</sup>

By 2009, the deficit was largest for MICs (5.2 percent of GDP). In transition and low-income countries in 2009, the deficit was 3.1 percent of GDP and 2.7 percent of GDP, respectively. High-income economies had the strongest fiscal balance in 2009, with a balanced fiscal budget.

In sum, in the run-up to the economic crisis, the fiscal balance improved across the developing world. However, the most recent crisis had a considerable impact on the fiscal balances of countries. Fiscal positions began to



deteriorate in 2007 and had their biggest fall during 2009. The average fiscal deficit in developing economies increased from 0.3 percent of GDP in 2007 to 4.2 percent of GDP in 2009 and the proportion of countries with deficits above 3 percent of GDP increased from 22 percent in 2007 to 62 percent in 2009.

## *Procyclical Bias of Fiscal Accounts*

An increasing number of empirical studies for developing countries affirm the procyclicality in fiscal balances so evident in the data for this period. “There is widespread evidence that fiscal accounts are highly procyclical in the developing world” (Kaminsky et al. 2004). In Latin America, for example, there were 45 episodes of cyclical swings between 1990 and 2001, 12 of which were neutral, 25 of which were procyclical and only eight of which were countercyclical. In the region, “total expenditure and its components are highly pro-cyclical, with recessions being associated with exaggerated collapses in public spending”<sup>23</sup> (Gavin and Perotti 1997). Data from 35 developing countries for the period 1970–1998 also indicate that government expenditure is procyclical (Braun 2001).

However, as many note, the costs of such procyclicality are high: “During upswings, abundant financing may lead authorities to start some projects that have low social returns. During downswings, cuts in spending may mean that investment projects are left unfinished or take much longer to execute than planned, thereby raising their effective cost. In turn, extended cuts in public sector investment may have long-term effects on growth. In general, stop-go cycles significantly reduce the efficiency of public sector spending” (Ocampo 2005).

*One reason for the procyclical bias of fiscal balances is simply that revenues are tied to incomes, rising during upswings of the business cycle and falling during economic downturns.*

One reason for the procyclical bias of fiscal balances is simply that revenues are tied to incomes, rising during upswings of the business cycle and falling during economic downturns. So, if countries are to maintain spending during a downturn, they need to borrow — thereby incurring a deficit. However, this procyclical bias of fiscal accounts has been unmistakably promoted by additional factors with the result that fiscal policy is oriented towards maintaining financial solvency in recessions while during booms it tends to expand with the business cycle (Kaminsky et al. 2004).

## *Procyclicality of ODA:*

In aid-dependent countries, the procyclicality of aid flows compounds the procyclical bias of fiscal accounts. As noted in the chapter on ODA, aid financing is like other foreign inflows: it affects exchange rates, interest rates, and domestic prices. The injections of liquidity, through the conversion of donor flows into domestic currency, can cause gyrations in interest and exchange rates, especially when flows are volatile.

Furthermore, aid flows are highly volatile. The gap between commitments and disbursements exacerbates this volatility. Indeed, empirical work suggests that the volatility of aid flows exceeds that of other macro-economic variables, such as GDP or fiscal revenue. Hence, “when aid falls, it leads to costly fiscal adjustments in the form of increased taxation and spending cuts that reinforce the cyclical impact of declining aid flows” (Spiegel 2007).



## *Tight IMF Fiscal Deficit Targets:*

Typically, the IMF imposes a high degree of fiscal austerity with its policy conditionalities, generally requiring that deficits be 3 percent or below (Kovach 2008). The conditionality is generally attached to multilateral loans. This means that, during recessions, when tax revenues fall, countries are forced to cut expenditures to meet these targets. Thus, such conditionalities create and indeed reinforce procyclical behaviour.

For the IMF, the concern with deficits arises because “deficits financed by borrowing can prove a source of inflationary pressure, crowd out credit to the private sector, engender imbalances in a country’s external accounts and lead to a higher public debt that cannot be financed sustainably, thereby hurting growth, and ultimately, undermining efforts to reduce poverty” (Heller 2004).<sup>24</sup>

Indeed, this view has been dominant for some time in fiscal policy debates. However, as various studies have pointed out, crowding-out (and inflationary) arguments are persuasive when the economy is operating at full capacity. Then, increased government expenditures must come at the expense of reduced consumption or reduced investment elsewhere in the economy. On the other hand, crowding-out is not inevitable when the economy is below full employment. Here, the size of the pie can increase so that government expenditures can rise without private investment decreasing. Or, in the case of tax cuts, consumption can increase without a decrease in investment. In fact, higher government expenditures may actually result in a crowding-in of private investment. For instance, higher government expenditures might stimulate the economy and improve the economic situation so much that there is room for more investment. Similarly, an increase in government investments that complement private investment (for example, spending on infrastructure) can increase returns in the private sector and stimulate private investment and the economy as a whole (UN 2010).

Moreover, the impact of tight fiscal policy on investor confidence largely depends on the type of investors that a government hopes to attract. Short-term investors and creditors are often more interested in the size of the fiscal deficit than in other variables. The most important issue for these investors is government’s ability to repay its debt in the near future. To the extent that government saves money by cutting the fiscal deficit, it will have more funds to pay back investors in the short run — even if this hampers long-term growth. But these are precisely the investors who stoke market volatility rather than sustain long-term growth.

On the heels of the recent global crisis, the IMF stated that it has changed its traditional stances on tight fiscal and monetary policy advice and lending conditions and has become ‘more flexible’.<sup>25</sup> Although assessments of recent IMF programmes in some developing countries show that there has been some easing of fiscal targets compared to historic IMF positions, “this only allows for slightly higher budget deficits on a temporary basis” (TWN 2009, Rowden 2009, CEPR 2009). Often, the IMF expects a country to bring down deficits to pre-crisis levels as soon as 2011, as is the case for Ethiopia and Latvia (TWN 2009). In short, the IMF “seems to be strictly focused on tight fiscal and monetary policy (balanced fiscal positions and rebuilding the reserve buffers) to increase resilience of these economies in the future” (Rowden 2009). In other words, the IMF is still imposing inappropriate, procyclical conditions on many borrowers that may unnecessarily exacerbate economic downturns in a number of countries.

## *Prioritizing Macro-economic Stability over Long-term Economic Growth:*

As already noted, fiscal capacity is defined as the ability to incur deficits without compromising macro-economic stability. This definition makes two assumptions, though. First, it assumes “that the short-medium term is an appropriate time-frame to assess the financing needs of developing countries. Second, [it assumes]



that what is being financed through borrowing and the manner in which the deficit is to be financed are not especially important” (Roy et al. 2009). This is the case despite the existence of evidence showing that, when disaggregated by sector, public expenditure (especially in infrastructure) has positive and statistically significant effects on economic growth (Barro 1991, Aschauer 2000, Milbourne et al. 2003). In fact, many empirical studies for developing countries find that capital expenditure as well as spending on health, education, transport and communications can be favourable to economic growth (Bose et al. 2005, Haque and Kim 2003, Adam and Bevan 2005). Put differently, the “longer run macro-economic stability implications of a scaling up in public spending are rather different from what emerge in a short run analysis” (Roy et al 2006, Gupta, Powell and Yang 2006, Goldsbrough 2007).

Giving overriding importance to short-term fiscal stability (measured through the annual fiscal balance) and solvency (measured by the debt-to-GDP ratio) can underestimate the long-term real impact of spending on development objectives. In short, the positive endogenous effects of additional public investment on solvency and stability are ignored. If fiscal policy is to incorporate longer-term growth objectives, it is hard to see why the short-term macro-economic impact of public expenditures is the primary consideration in deciding whether those expenditures are appropriate.

This thus means that the concept of fiscal capacity itself, as currently defined, limits the ability of countries to mobilize adequate fiscal capacity during a crisis. If the objective is to maintain price stability in the context of long-term growth, then short-term fiscal targets and tight fiscal policy should not serve to limit borrowing, especially if the development payback from such borrowing can compensate for deficits over the short term.

To conclude, the focus of macro-economic policy appears to be solely on price stabilization and not on ensuring price stability in the context of delivering long-term growth while being sensitive to the risks to financial stability, capital flows and exchange rates.

## *The Current Account Balance*

Current account positions are integral to building a comprehensive picture of fiscal capacity. If it is in a surplus (export revenues exceed imports), it can be a source of foreign currency. Conversely, it can be a drain on foreign currency reserves if it is in deficit. Current account balances are especially important for developing economies, where the availability of foreign funds is crucial to financing the imports of necessary goods such as food, fuel, and capital equipment necessary for economic development.

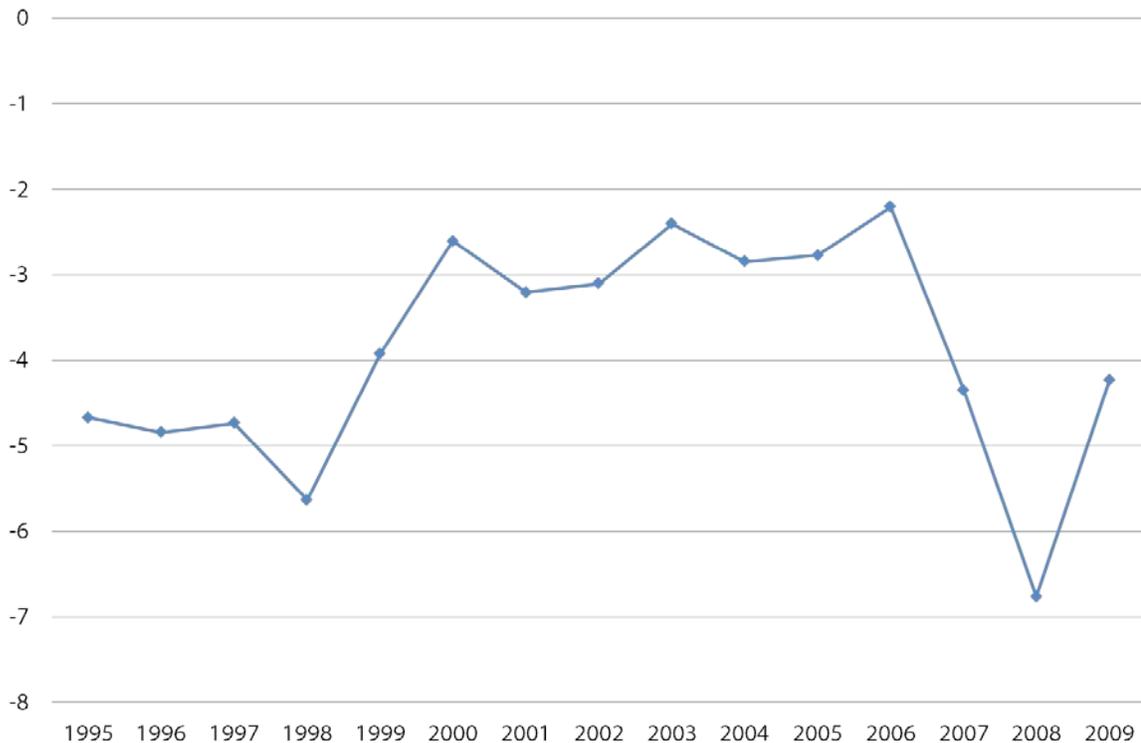
On average, the current account balance as a share of GDP in developing economies was in deficit (imports exceeded exports) for the entire period (Chart 7.7). As such, the current account balance was a drain on foreign funds for most developing economies over the period.

Nonetheless, developing economies were able to use the expansion in world trade over the period to improve their current account position. The average current account deficit as a share of GDP in developing economies between 1995 and 1998 was 5 percent, compared to an average of 2.9 percent between 1999 and 2006.

On account of the economic slowdown and decline in world trade between 2007 and 2009, current account deficits in the developing world more than tripled, from 2.2 percent of GDP in 2006 to 6.8 percent by 2008. Despite some improvement in the current account position in 2009, current account deficits stood at 4.2 percent of GDP, a slight improvement from the average current account deficit of 4.7 percent in 1995.



**Chart 7.7: Current account balance for developing countries, 1995–2009 (percent of GDP)**



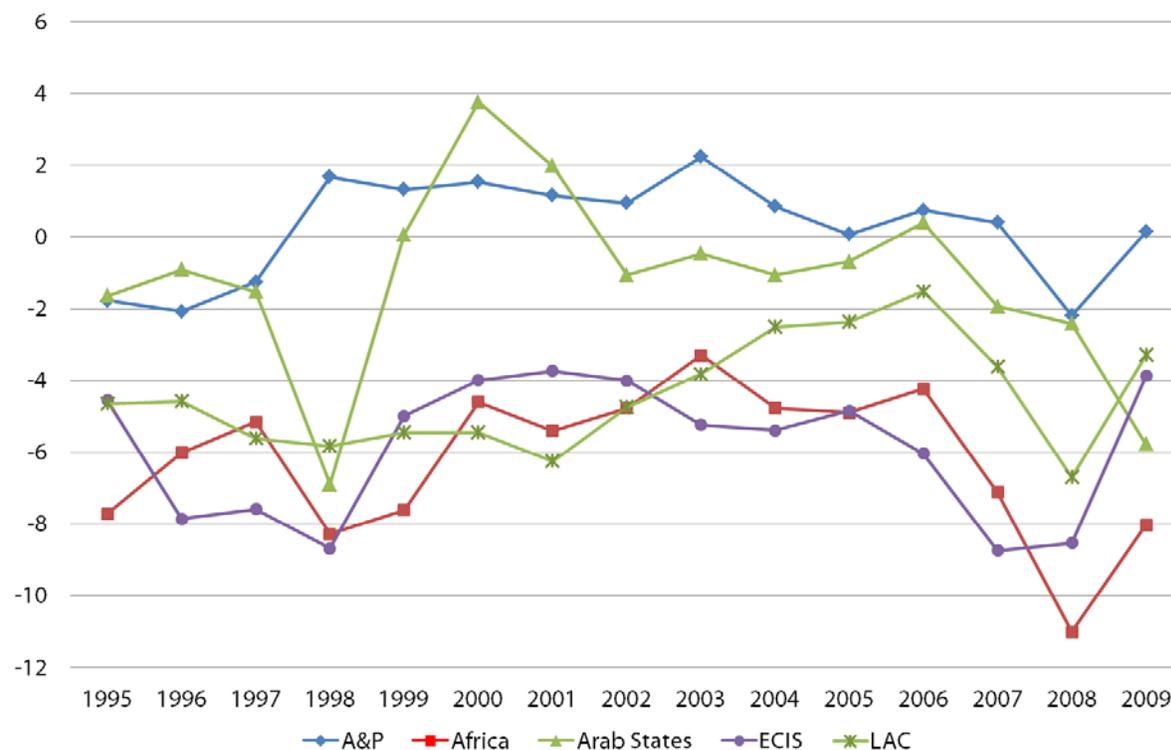
**Source:** Calculated from World Bank, *World Development Indicators 2011*

Most regions ran current account deficits for the majority of the period (Chart 7.8). The only exception to this was the Asia and Pacific region, which had a current account surplus from 1998 to 2007. Still, all regions, except for the ECIS, improved their trade balance between 1995 and 2006. Africa had an average current account deficit of 7.7 percent in 1995, but, by 2006, it had improved to 4.2 percent of GDP. Similarly, in the Latin America and Caribbean region, the deficit improved from 4.7 percent in 1995 to 1.5 percent in 2006. Even Asia and the Pacific showed an improvement in its current account balance, moving from a deficit of 1.8 percent in 1995 to a surplus of 0.75 percent in 2006. For the Arab States, the current account deficit moved from 1.65 percent in 1995 to a surplus of 0.4 percent in 2006.

Despite this improvement in current account balances, these balances remain highly procyclical. The volatility of current account balances was most apparent during the most recent global economic downturn. From 2006 to 2008, current account balances deteriorated in all regions without exception. The biggest loss was in Africa, where the trade deficit increased by an average of 6.8 percentage points. The Latin America and Caribbean region suffered the second largest deterioration in its trade deficit (5.2 percentage points). The current account balance in the Asia and Pacific region deteriorated by 2.9 percentage points, followed closely by the Arab States, where the trade balance deteriorated by 2.8 percentage points. The ECIS region had the least deterioration in current account balance, at 2.5 percentage points.



**Chart 7.8: Current account balance by region, 1995–2009 (percent of GDP)**



**Source:** Calculated from World Bank, World Development Indicators 2011

Current account positions improved across the developing world in 2009 as commodity prices began to recover and world trade started to grow again. Still, all developing regions' current accounts are in deficit. The only region that managed to return to a surplus, though a very slight one, was Asia and the Pacific, which showed a surplus of 0.2 percent of GDP in 2009.

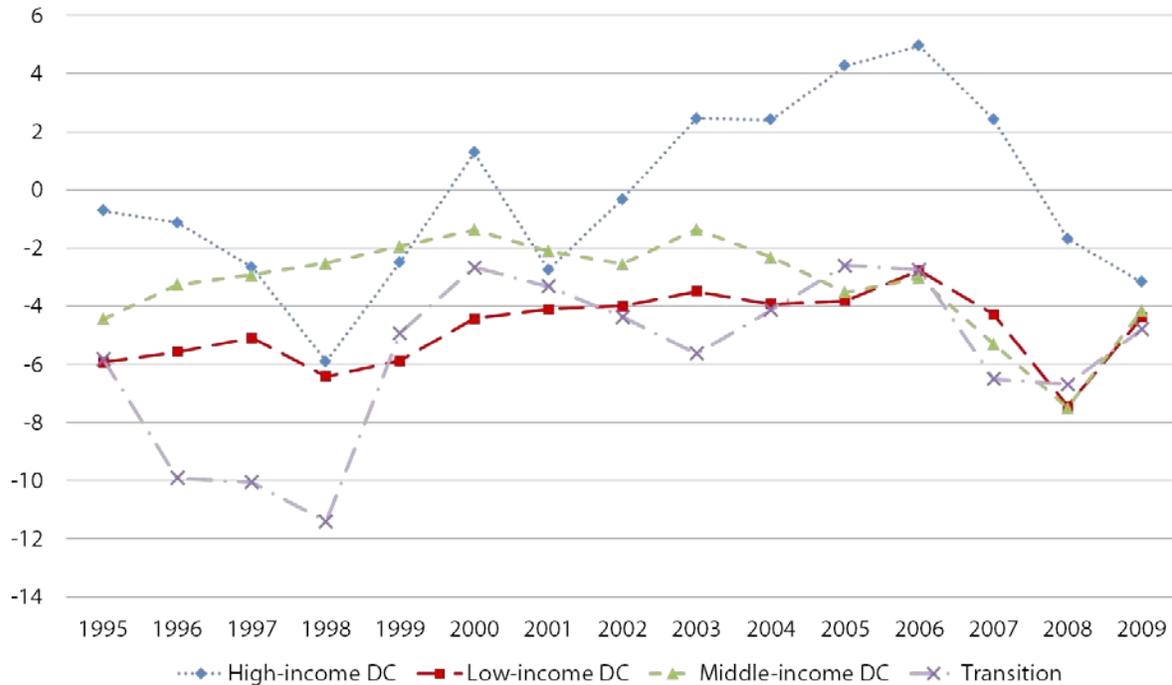
As of 2009, Africa had the largest trade deficit (at 8 percent of GDP), followed by the Arab States (5.8 percent). In the ECIS region, the average current account deficit stood at 3.9 percent of GDP in 2009, whereas, for the Latin America and Caribbean region, the deficit was 3.3 percent of GDP in 2009.

The current account balance improved across all development groups between 1995 and 2006 (Chart 7.9). However, after peaking in 2006, trade balances deteriorated across the board, bottoming out in 2008.

High-income developing economies were the only group that had current account surpluses for at least six of the 15 years in the period under consideration. Their average deficit was 0.7 percent of GDP in 1995, and, by 2006, they had a trade surplus of 5 percent of GDP. However, the crisis affected their fortunes and the current account reached a deficit of 3.2 percent of GDP in 2009. Middle-income economies did not exhibit any strong trend in their average current account balances. Their current account deficit was 4.5 percent of GDP in 1995. By 2006, their current account positions improved slightly, to a deficit of 3 percent of GDP. But, as the crisis hit, their balances deteriorated from a deficit of 3 percent of GDP in 2006 to 4.2 percent of GDP in 2009.



### Chart 7.9: Current account balance by development status, 1995–2009 (percent of GDP)



Source: Calculated from World Bank, World Development Indicators 2011

For LICs, the deficit improved significantly, from 6 percent of GDP in 1995 to 2.8 percent of GDP in 2006. After peaking in 2006, and as the economic crisis took its toll on international trade, the deficit rose to 4.4 percent of GDP. Transition economies followed the same general trend. Their current account deficit improved from 5.8 percent in 1995 to 2.8 percent of GDP in 2006. After the crisis, the deficit deteriorated, reaching 4.8 percent of GDP in 2009.

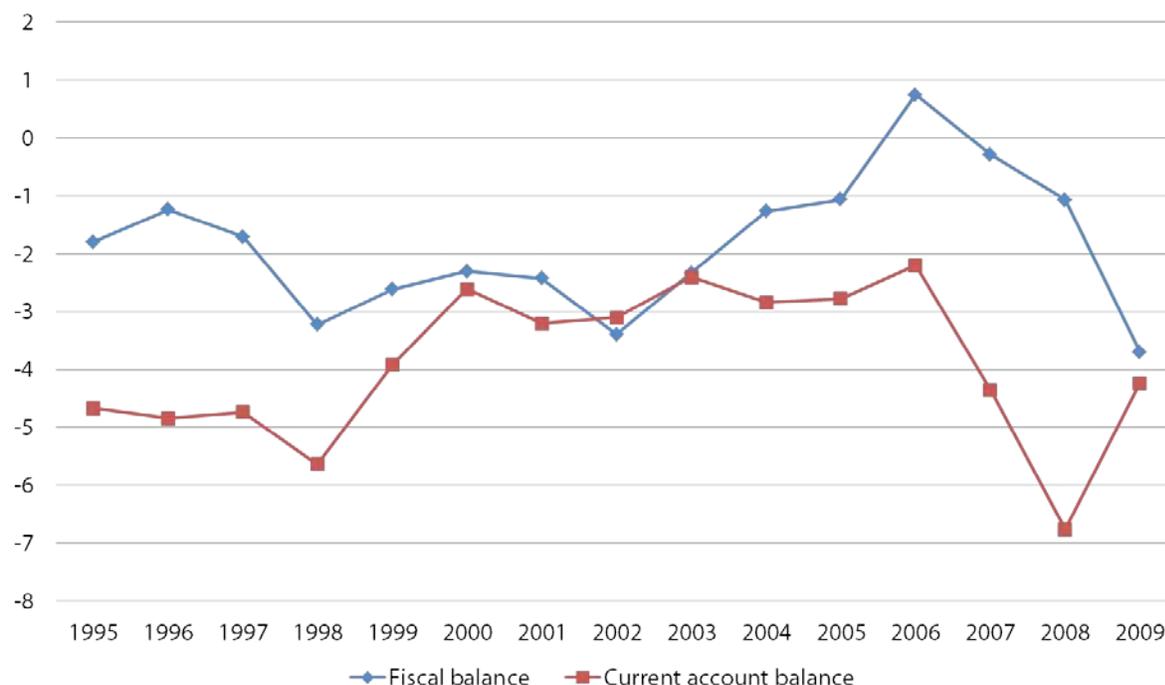
#### The Relation between Current Account Deficits and the Fiscal Deficit

There appears to be a strong correlation between current account and fiscal balances during this period. The evidence indicates that a 1 percent improvement in the current account deficit would improve the fiscal deficit by 0.75 percent (Chart 7.10). This is consistent with the conclusions of other studies, which indicate that fiscal deficits may respond to, rather than cause, changes in external accounts: “Causality runs from the external to the internal deficit” (Taylor 1991). This is especially true for countries that are relatively more open and where trade plays a relatively important role. In other words, a heavy reliance of corporate income taxes on exports may explain the strong link between the foreign and the fiscal sector.<sup>26</sup> This is reinforced by data indicating that “more than 50% of the tax revenues of developing countries may be directly related to the foreign sector” (Tanzi 1986).

In other words, these studies suggest that economies that are relatively more open and in which trade plays a relatively more important role are probably more likely to have their domestic developments dictated by the



**Chart 7.10: Current account balance and fiscal balance for developing countries, 1995–2009 (percent of GDP)**



**Source:** Calculated from World Bank, World Development Indicators 2011

foreign balance (Anoruo and Ramchander 1998, Arize and Malindretos 2008, Islam 1998, Kouassi et al. 2004, Mansouri 1998, Onafowara and Owoye 2006). It also means that current accounts can potentially reinforce the procyclical bias of fiscal balances and put additional pressure on governments to borrow. Indeed, current account deficits can variously harm the fiscal position of an economy, thereby increasing the procyclicality and volatility of fiscal deficits.

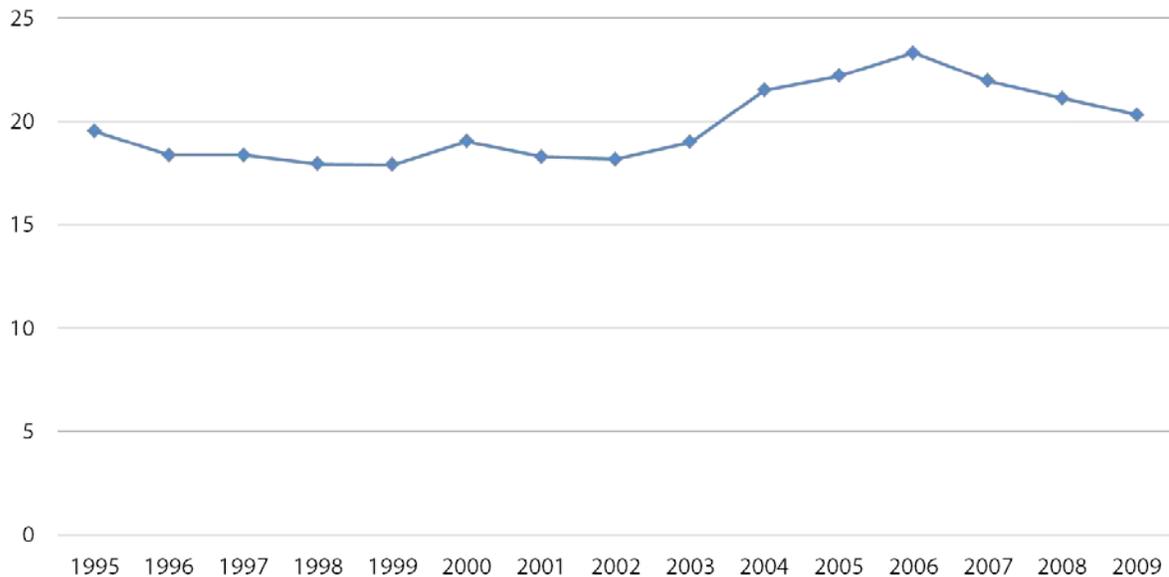
First, current account deficits need to be financed by an inflow of foreign funds. For many low-income developing economies, external debt is the only source of current account deficit financing because those economies do not have access to foreign direct investment or other private capital flows. Rising debt on account of current account deficits can lead to higher interest expenses, thereby worsening the fiscal balance.

Moreover, deteriorations in the current account balance, especially during global economic downturns, happen as the result of declining exports. Declining exports affect the fiscal position in two ways. First, tax revenues from export industries fall and worsen the fiscal balance. Second, exports also contribute directly to economic growth. A decline in the pace of economic growth on account of declining export revenues leads to an increase in the ratio of external debt to GDP.

*Indeed, current account deficits can variously harm the fiscal position of an economy, thereby increasing the procyclicality and volatility of fiscal deficits.*



**Chart 7.11: Gross savings rate for developing countries, 1995–2009 (percent of GDP)**



**Source:** Calculated from World Bank, *World Development Indicators 2011*

Thus, it is hardly surprising that, for developing countries, episodes of deteriorating current account balance are often accompanied with deteriorations in the fiscal budget balance.

### Gross Savings

The average gross savings rate<sup>27</sup> in developing countries was fairly constant between 1995 and 2009, averaging about 20 percent of GDP, although there was some growth during the early- to mid-2000s (Chart 7.11).

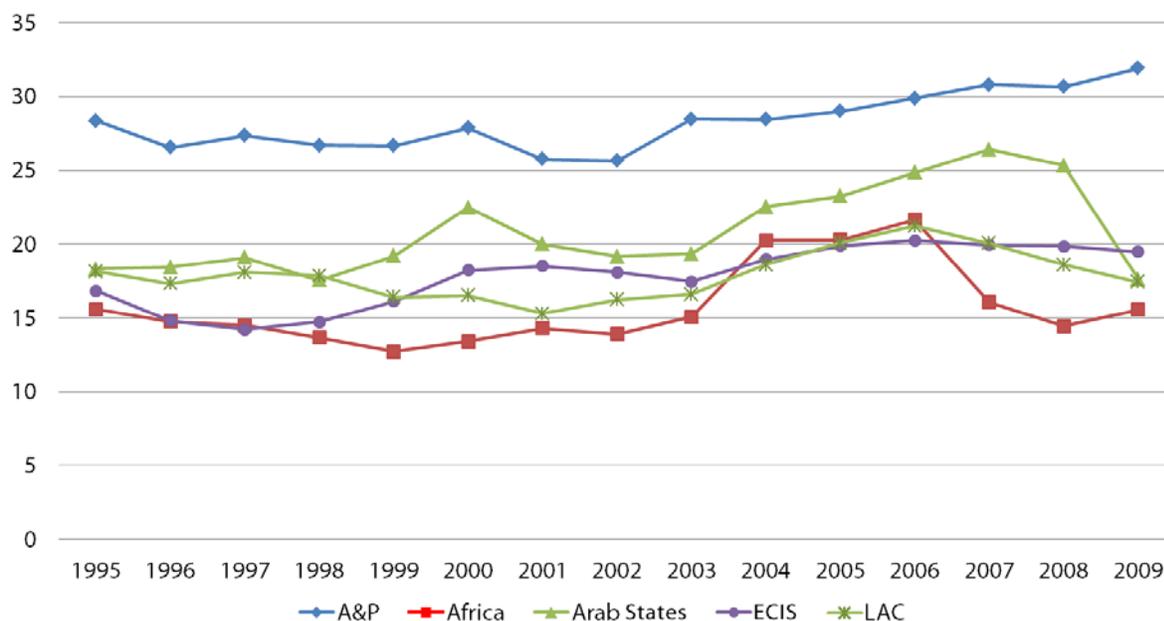
Between 1995 and the onset of the global recession in 2007, the gross savings rate increased at different rates in every region (Chart 7.12). The Arab States had the largest increase, from 18 percent of GDP in 1995 to 26 percent of GDP in 2007, reflecting the impact of rising oil export revenues on gross savings. In the ECIS, the savings rate rose from 17 percent in 1995 to 20 percent in 2007 and, in the Asia and Pacific region, by 2.5 percentage points to 31 percent of GDP in 2007. In Latin America and the Caribbean, the rate grew by 1.9 percentage points to 20 percent of GDP in 2007, and in Africa by 0.5 percentage points, to 16 percent of GDP in 2007.

The global crisis led to a fall in the savings rate in all regions except for Asia and the Pacific, where the savings rate increased by 1 percentage point, to 32 percent of GDP. The Arab States experienced the largest fall (8.8 percentage points), to 18 percent of GDP in 2009.<sup>28</sup> The Latin America and Caribbean region experienced a 2.6 percentage point decline, to 17 percent of GDP. The savings rate fell by 0.5 percentage points between 2007 and 2009 for ECIS and Africa, to 19 percent and 16 percent of GDP, respectively.

By 2009, the Asia and Pacific region had by far the highest savings rate among developing regions (32 percent). ECIS region is a distant second, with a savings rate of 19 percent of GDP. This is followed closely by the Arab



**Chart 7.12: Gross savings rate by region, 1995–2009 (percent of GDP)**



**Source:** Calculated from World Bank, *World Development Indicators 2011*

States (18 percent), Latin America and the Caribbean (17 percent) and Africa, which had the lowest savings rate (15 percent).

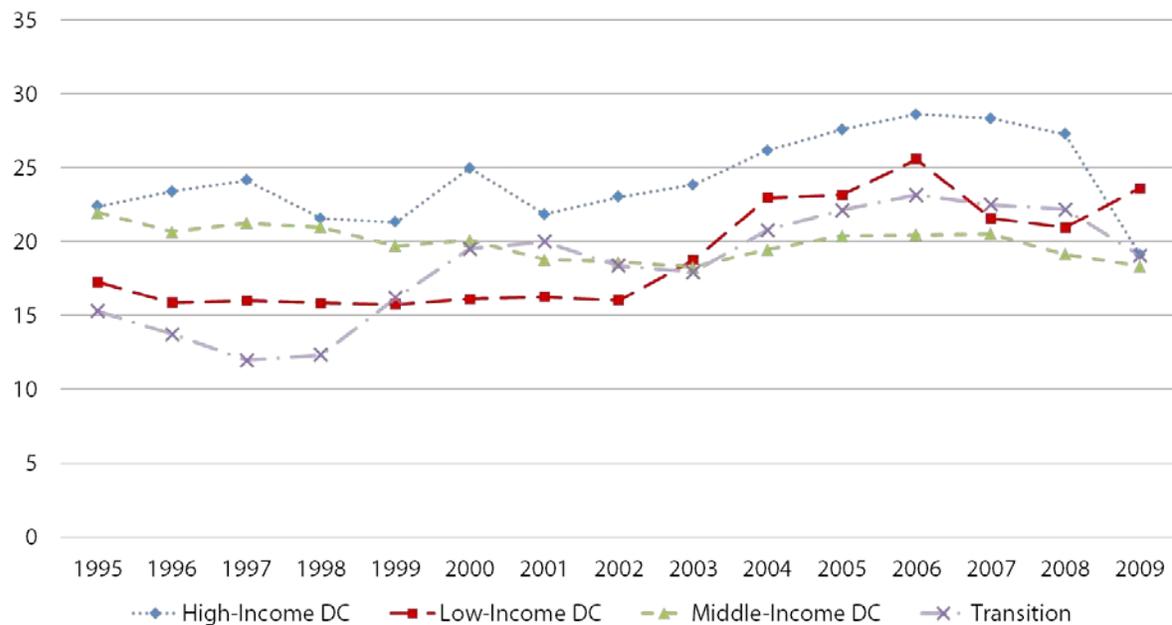
By development group, the evidence indicates that the savings rate increased in each group with the exception of MICs, where it fell marginally from 22 percent in 1995 to 21 percent in 2007 (Chart 7.13). In transition countries, the savings rate rose from 15 percent in 1995 to 23 percent in 2007; in high-income countries, it rose from 22 percent to 28 percent between 1995 and 2007. The increase in the gross savings rate was least for LICs (from 17 percent in 1995 to 22 percent in 2007).

Interestingly, LICs were the only group in which the gross savings continued to increase following the global economic slowdown beginning in 2007.<sup>29</sup> Its gross savings rate grew by 2 percentage points to 24 percent, the highest rate of any development group in 2009. The global economic crisis seems to have most affected the gross savings in high-income countries, where it fell by 9 percentage points to 19 percent of GDP in 2009,<sup>30</sup> largely reflecting the decline in the savings rate of Arab countries. Among transition countries, the savings rate fell by 3.5 percentage points to 19 percent of GDP in 2009 and the fall in the savings rate was least in MICs (where the rate fell by 2.1 percentage points).

By 2009, LICs had the highest rate of savings, which stood at 24 percent of GDP. Despite having the highest savings rate over the entire period until 2008, high-income countries by 2009 had the second highest rate of gross savings (19 percent). Transition economies and MICs had comparable levels of savings, at 19 percent and 18 percent, respectively.



**Chart 7.13: Gross savings rate by development status, 1995–2009 (percent of GDP)**



**Source:** Calculated from World Bank, *World Development Indicators 2011*

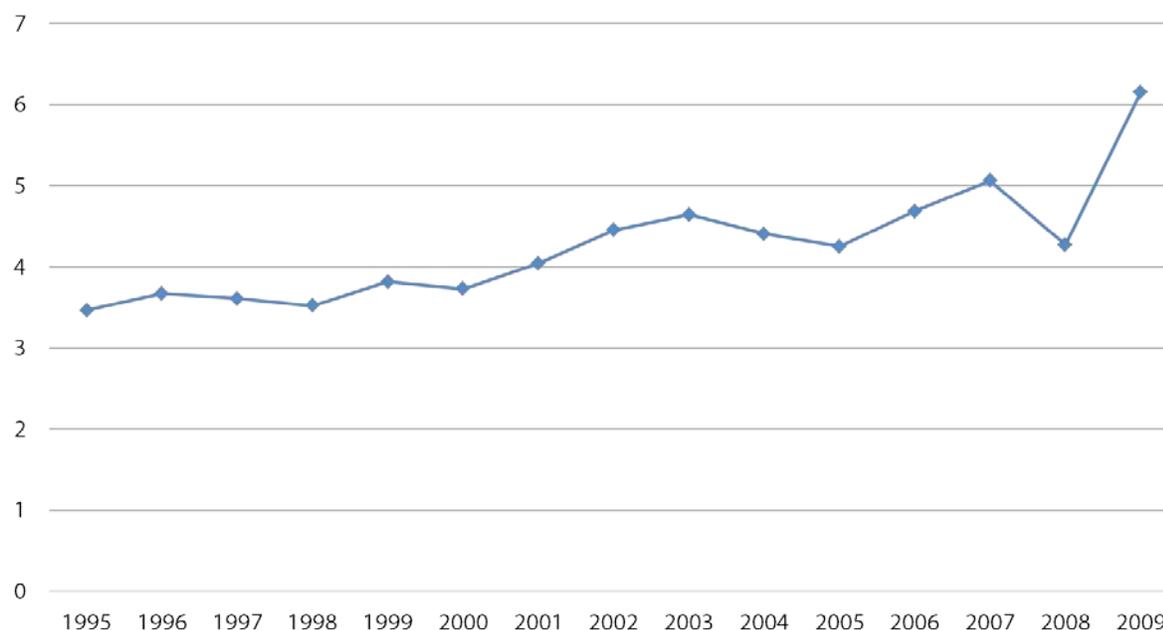
The LDCs had the lowest average gross savings rate (17 percent) of any development group between 1995 and 2009 (Annex 7.C). However, gross savings as a share of GDP grew among LDCs over the entire period. Even though they began the period with the lowest gross savings rate of any development group (15 percent), they ended the period with a higher rate than high-income, middle-income, and transition countries (20 percent). The global economic slowdown does not appear to have harmed their savings rate. Rather, between 2007 and 2008, gross savings grew from 17 percent of GDP to 20 percent.

Earlier, it was noted that the level of savings is a useful indicator of fiscal capacity because a high level of savings can increase available domestic funds and provide a country with sufficient internal resources to engage in countercyclical spending. From the evidence on regional trends in the gross savings rate prior to the crisis, it is clear that some regions, such as Asia and the Arab States, were in a better position than others and could rely more on domestic funds for countercyclical spending during the economic downturn. For instance, in several Asian countries, “savings exceeded investment by 5% or more of GDP. These represent quite a turnaround. Before the 1997–98 Asian financial crisis savings were far smaller: most countries invested more than they saved, or ran only small surpluses of savings over investment. But the crisis taught a harsh lesson and many countries resolved to protect themselves in the future by building up their own savings” (UNESCAP, ADB, UNDP 2009).

Within the Arab States, the GCC oil exporters were in the best position to absorb the economic shocks, as they had entered the crisis in exceptionally strong positions that largely protected them against the global downturn. For instance, Saudi Arabia announced an investment spending plan and provided capital to the



**Chart 7.14: Total reserves in developing countries, 1995–2009 (in months of imports)**



**Source:** Calculated from World Bank, *World Development Indicators 2011* and IMF, *World Economic Outlook 2011*

Saudi Credit Bank to secure credits to low-income households<sup>31</sup> (World Bank 2009b). On the other hand, in Africa, “many low-income countries and fragile countries with limited fiscal space and international reserves have lacked resources to implement countercyclical measures” (Kasekende et al. 2010).

### Foreign Reserves

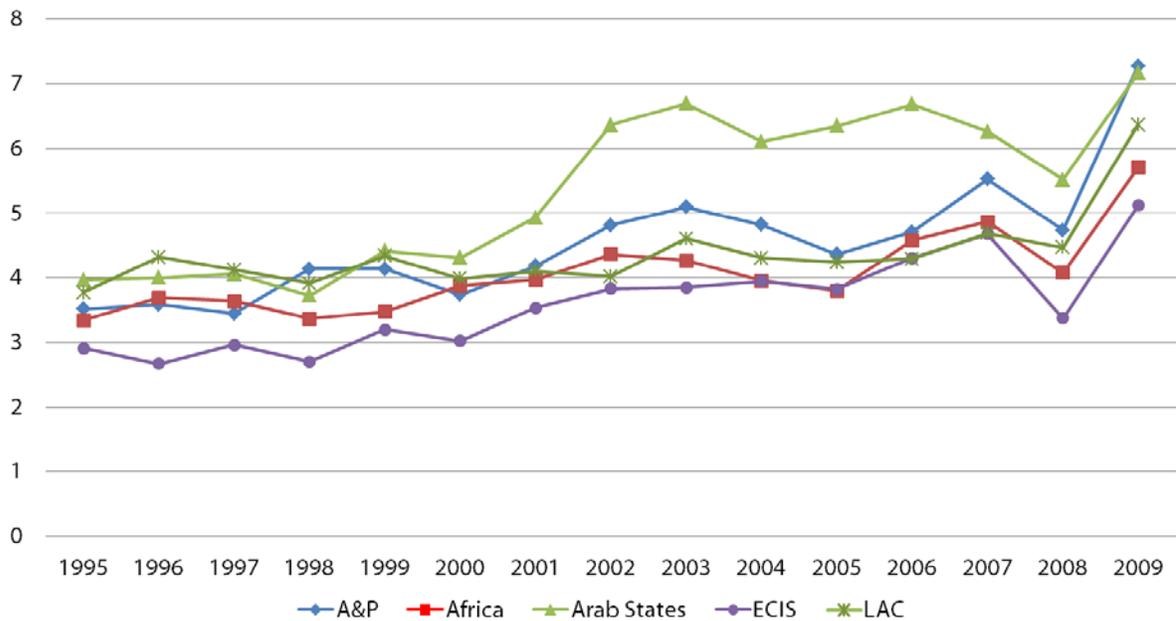
The stock of foreign reserves held by central banks and monetary authorities in developing countries is a strong measure of the liquidity of their economies. Foreign reserves indicate that countries can pay for their short-term foreign finance obligations, namely, debt obligations and import financing.

Since 1995, all developing economies sought to increase their total reserves. Total reserves held by monetary authorities in developing countries had a ninefold increase from 1995 to 2009. This trend is uniform across all development regions and groups. In 1995, total reserves covered an average of 3.5 months of imports; by 2009, this number had increased to 6.2 months.

Although rising reserves obviously improve a country’s liquidity position, reserve ratios are prone to procyclicality. Interestingly, the reaction of reserves in months of imports to each of the two global economic slowdowns during the period under consideration (the Asian Crisis 1997 and the Global Financial Crisis 2008) showed varying degrees of volatility (Chart 7.14). Total reserves in months of imports fell only slightly after 1997 (3 percent) before they were able to quickly pick up again. In 2008, as the global financial crisis took its toll, total reserves stocks in the developing world shrunk by 20 percent. This led to a 16-percent drop in the value of total reserves in months of imports, from 5.1 in 2007 to 4.3 in 2008. In the following year, total reserves in months of imports jumped by 44 percent, from 4.3 in 2008 to 6.2 in 2009. This increased volatility can be attributed to the financial nature of the

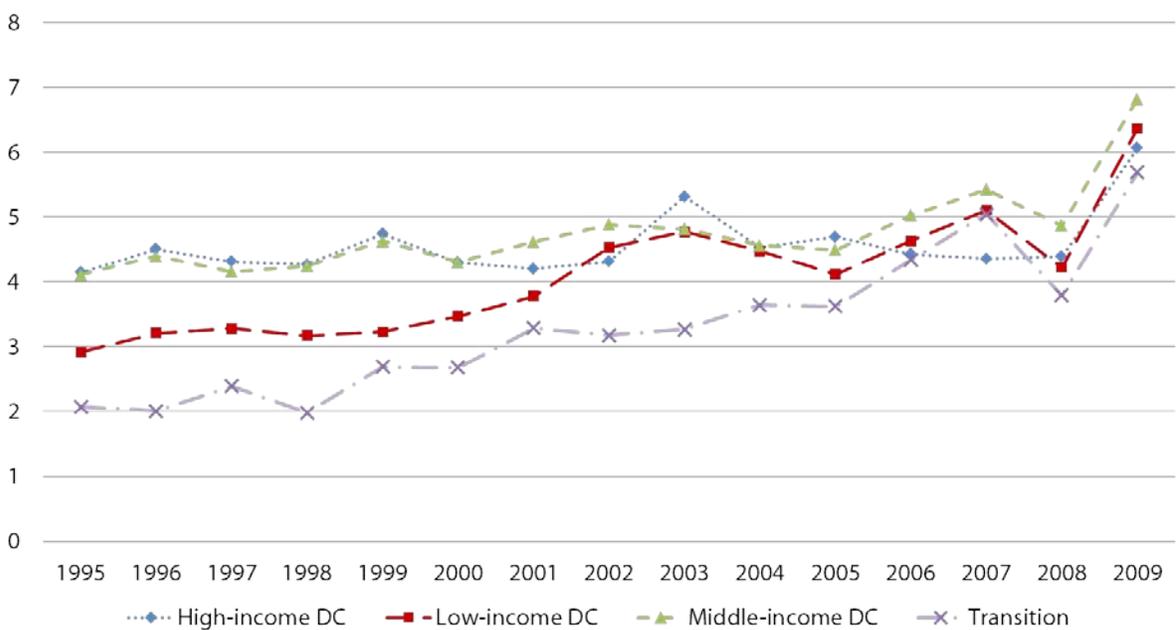


### Chart 7.15: Total reserves by region, 1995–2009 (in months of imports)



Source: Calculated from World Bank, World Development Indicators 2011

### Chart 7.16: Total reserves by development status, 1995–2009 (in months of imports)



Source: Calculated from World Bank, World Development Indicators 2011



most recent global economic recession in 2008. Initially, the recession that started in the financial sector led to a 20-percent contraction in reserves held by developing countries as capital flew back to 'safer' advanced economies. In 2009, as central banks responded to the crisis by raising their levels of required reserves in all financial institutions across the globe, central banks in developing economies increased their reserve holdings. Imports to developing economies also declined by 19 percent during 2009 as world trade declined. These two factors contributed to the big spike in the value of total reserves in months of imports in 2009.

In sum, developing economies, on account of their reserves, are more liquid now than they were in 1995, but this has come at the expense of higher volatility.

The regional trends in reserves in months of imports are not different from the aggregate trend (Chart 7.15). The Asia and Pacific region had the largest increase in total reserves in months of imports (107 percent) during the period. The second biggest increase was in the Arab States region, which increased its reserves as a share of imports by 81 percent. The ECIS, Africa, and Latin America and Caribbean regions also increased their reserve positions substantially during the period (76 percent, 71 percent and 69 percent, respectively).

As of 2009, the Asia and Pacific region had the highest level of reserves (7.3 months of imports), followed closely by the Arab States region (7.2 months of imports). Latin America and the Caribbean had 6.4 months of imports as of 2009. Africa came in next, with 5.7 months of imports. The ECIS had the lowest level of reserves in months of imports (5.1).

Reserves grew across all development groups (Chart 7.16). The biggest increases occurred in transition economies and low-income developing economies. In low-income developing economies, total reserves in months of imports increased by 118 percent, from 2.9 in 1995 to 6.4 in 2009. By 2009, low-income economies had reserve levels in months of imports that inched higher than that of high-income developing economies. Low-income economies were able to get much closer to the average level of reserves holdings in other development groups.

By 2009, middle-income developing economies had the highest level of reserves in months of imports (6.8), followed by low-income developing economies (6.4), high-income developing economies (6.1) and, with the lowest level of reserves, the transition economies (5.7).

To conclude, it is amply evident that developing economies have been steadily building up their international reserves since 1995 (two thirds of international reserves are currently held in developing countries). Indeed, the "stockpiling of international reserves has been seen as the central policy option that a country can pursue to avoid a financial crisis" (Bird and Rajan 2003). And though the accumulation of international reserves was seen initially as a source of protection or insurance, it has more recently been viewed as a permanent buffer stock against the total or overall vulnerability of the balance of payments position. In other words, the strategy of reserve accumulation has been linked to the pursuit of financial stability.<sup>32</sup>

This strategy of reserve accumulation is not, however, without costs. For instance, holding reserves incurs an opportunity cost, which is the difference between what the reserves could have earned or what they actually earn. This has been "estimated to be of the order of 8 percent of GDP" (UN 2001). Furthermore, the accumulation of international reserves seems unrelated to any clear notion of what might constitute an optimal level of reserves (Cruz and Walters 2008).



## Box 7.2: Sovereign Wealth Funds

The term 'sovereign wealth fund' (SWF) was coined in 2005 in *Central Banking Journal* in 2005 and refers to state-owned investment funds that are financed through the accumulation of foreign reserves (Rozano 2005). SWFs have existed since the 1950s with the establishment of the Kuwait Investment Authority. SWFs serve a variety of purposes, including fiscal stabilization and savings. Stabilization funds reduce the volatility of government revenues. This type of fund is particularly important for resource-rich countries where government revenues are thus tied to the volatility of the commodity markets. Savings funds, on the other hand, help build up sources of wealth that can be used in the future or by future generations. SWFs may also be used to sterilize liquidity or for domestic economic or social development.

SWFs have grown recently as a result of large accumulation of foreign reserves, particularly in Arab and Asian countries. In Arab countries, this reserve accumulation is linked to rising oil revenues. Among Asian countries, the

accumulation of reserves is tied to large trade surpluses (particularly with advanced economies) and high domestic savings rates, which cannot be absorbed by their generally weak domestic financial markets. The accumulation of reserves has been particularly sharp in China, whose foreign reserves are estimated to be three times more than necessary to cover its short-term debt obligation and three months of imports (Reisen 2008).

While measuring the size of SWF assets is difficult due to issues with disclosure, estimates suggest that since 1999, the magnitude of assets in SWFs increased roughly fivefold between 1999 and 2007 (Weiss 2008). In 2011, SWF assets reached \$4 trillion — an 11 percent increase from 2010 (Sakoui 2011). Forecasts predict that, given the current pace in foreign reserve accumulation, SWFs may reach \$12 trillion in assets by 2015. Of this, about two thirds are expected to be financed from oil and gas revenues, with the remainder coming from current account surpluses in Asian economies (Weiss 2008).

**Source:** Reisen, Helmut, 2008, 'How to spend it: Sovereign wealth funds and the wealth of nations', VoxEU, London, [www.voxeu.org](http://www.voxeu.org); Rozano, Andrew, 2005, 'Who holds the wealth of nations?', *Central Banking Journal*; Sakoui, Anousha, 2011, 'Sovereign wealth fund assets rise to \$4,000bn', *Financial Times Online Editions*, Published March 8; Weiss, Martin A., 2008, 'Sovereign Wealth Funds: Background and Policy Issues for Congress', CRS Report for Congress, Congressional Research Service, Washington, DC.

Thus, although foreign reserves do provide a cushion against economic shocks in the short term, the wisdom of relying on such a strategy over the longer term would have to be squared with the costs of pursuing the same.

## Policy Options for Building Fiscal Capacity

The lack of countercyclical finance in times of crisis often risks jeopardizing previous gains in housing, education, health, water and employment (Muchhala and Molina 2010). In short, it jeopardizes the gains made with respect to MDG achievements. Protecting MDG achievements will require countries to mobilize adequate fiscal capacity to maintain and/or increase expenditures during economic downturns. Policies that can bolster the fiscal capacity of countries will need to focus on debt relief mechanisms, trade finance, fiscal policy reforms, and, most important, domestic revenue mobilization.

### External Debt

Given the procyclical bias of fiscal balances, developing countries would need to accumulate additional debt if they were to mobilize fiscal capacity in the event of a crisis or shock. Given the consequent rise in external



indebtedness, it will be necessary to have debt workout mechanisms for countries that may fall in debt distress or would be at high risk of debt distress. More fundamentally, there will be a need for the revision of debt sustainability frameworks that take account of the impact of rising indebtedness over the course of business cycles and that consider the impact of debt obligations on sustaining MDG achievements.

It has been noted that, although the external debt positions of many developing countries had improved in the run-up to the crisis, several were still in debt distress or at high risk of debt distress—including some that had received debt relief under the HIPC initiative and MDRI. In short, many countries are likely to need sovereign debt restructuring in the coming years. Yet, the world lacks a comprehensive and adequate mechanism with which to treat sovereign debt crisis. The international community needs to consider establishing enhanced approaches to sovereign debt restructuring as outlined in the Monterrey Consensus and reiterated in the Doha Declaration on Financing for Development (UN 2010). Pending the creation of such a mechanism, innovative forms of debt crisis resolution could be considered, including:

*Protecting MDG achievements will require countries to mobilize adequate fiscal capacity to maintain and/or increase expenditures during economic downturns.*

- Setting up schemes of independent arbitration or mediation or providing further support in organizing *ad hoc* meetings of a debtor with its creditors
- Extending the ‘sunset clause’ of the HIPC to extend and re-open eligibility to participate in HIPC and adapt criteria for potential inclusion of any low-income and lower-middle-income country vulnerable to debt distress

Measures to reduce the unsustainable external debt burdens of LICs can also consider:

- Revising debt sustainability frameworks to take account of the impact of debt obligations on progress towards the achievement of the MDGs (as proposed in the Monterrey Consensus)
- Offering moratoria on debt-service obligations based on agreed, standardized criteria to countries seriously affected by financial crises, shocks, conflicts and natural disasters
- Concluding all country arrangements under the HIPC initiative and ensuring that all creditors deliver their share of debt relief promptly
- Impeding the efforts of private holders of HIPC debt to collect unethical, if not illegal, claims
- Providing bilateral and multilateral aid in grant form to LICs that have significant debt burdens

## *Trade Finance*

For developing countries, trade finance is critical, since international trade accounts for a significant portion of overall economic activity. As such, developing countries can be particularly vulnerable to shifts in the availability of trade finance, especially when local financial and insurance markets are weak, governmental support is lax, or export credit agencies do not exist or lack significant lending resources. Moreover, current account deficits in many developing countries make access to other types of capital for imports particularly



critical. Thus, persistent shortages in trade finance can prolong recovery following an economic crisis, limit fiscal capacity, and hinder progress towards development goals.

Commercial banks, public export credit agencies, multilateral development banks, insurance firms, suppliers, and purchasers all supply trade finance. In developing countries, especially where financial markets are not fully formed, letters of credit are the most common instrument for financing trade (ICC Banking Commission 2009b). These instruments provide exporters with important cash guarantees for the eventual delivery of goods, reducing demand-side risks associated with production. Other mechanisms for trade finance include bank guarantees, buyers' and sellers' credit, open accounts, shipment finance, and leasing.

The recent global financial crisis precipitated a significant decline in developing countries' access to trade finance,<sup>33</sup> with estimates attributing from 10 percent to 30 percent of the fall in global trade between 2008 and 2009 to growing constraints on trade finance (Cornford 2010).

The recent crisis prompted the adoption of various policy responses to alleviate the decline in trade finance. These included a G20 package, formulated in 2009, that pledged significant trade finance support for two years. Funding amounted to roughly \$50 billion to cover the estimated \$250 billion gap in short-term financing.<sup>34</sup> The World Bank also joined to address the short-term financing gap, supporting up to \$50 billion in trade (World Bank 2009). Several regional banks also contributed to this effort, including the Asian Development Bank, which offered support up to \$15 billion until 2013 (UNESCAP 2009).

Central banks in several countries responded to the crisis by offering commercial banks additional foreign reserves. For example, the Brazilian central bank provided \$90 billion to local banks and the central bank of the Republic of Korea announced an injection of \$10 billion in foreign exchange reserves. Export credit agencies also played a role in helping to mitigate the shortfall in trade finance by providing credit and credit insurance. However, these programmes were mostly limited to developed and relatively strong developing countries, such as China and the Republic of Korea (Auboin 2009a).

The combined impact of these measures appears to have helped ease the crunch in trade finance. Since the second half of 2009, trade finance has experienced a modest, but mixed rebound, with emerging markets registering the largest improvement in trade finance access. Asian countries — especially China, India, and the Republic of Korea — gained in the second half of 2009. Among Latin American and Middle Eastern countries, the results were mixed, with some countries receiving additional finance. African countries, in contrast, continued to experience significant constraints in accessing global trade finance (WTO 2010).

In June 2010, however, the G20 decided not to use the remaining funds in their package because the utilization rate of the additional capacity provided by the package declined from 70 percent to 40 percent between the first half of 2009 and second half of 2009 (WTO 2010). The long-term impact of this decision, though, has been questioned, with suggestions that this fund would do more good if it were part of a long-term strategy to ease access to trade finance generally while targeting the specific regions and nations where the gap persists (UN 2010).

Various measures have been suggested to improve access to trade financing in developing countries over the medium and long terms. These include:

1. International organizations and national governments can establish policies on pool risks that private creditors face when lending for trade finance. Such measures can safeguard private lenders against



economic shocks and smooth access to trade finance over the business cycle. These policies could include the establishment of trade finance funds at the international and national levels that would be accessible during crises. Additionally, national governments could establish or strengthen state-backed or private export credit banks and insurance agencies.

2. Methods of collecting and distributing information on trade finance need to be better, especially in countries that are technologically less advanced. These measures can entail a collaborative effort between the international community and national agencies to improve information availability. Accurate and timely information for creditors to assess lending risks can minimize the type of creditor 'herd behaviour' that can limit trade finance within developing countries. Moreover, access to information can increase efficiency in markets for trade finance by making it easier for importers and exporters to obtain funding. This function can become increasingly important as new trade finance instruments develop in financial markets and as trade increases.
3. Reserve requirement regulations for trade finance that acknowledge the lower risk and higher collateral associated with this type of lending should be reviewed (Auboin 2009a). Lower reserve requirements can provide critical liquidity to the market, which is particularly crucial during economic crises.
4. The overall, long-term financial and insurance sectors in developing countries need to be strengthened in order to ensure that exporters and importers have access to trade finance (UNESCAP 2009).

## *Fiscal Policy Measures*

It was noted earlier that the procyclical bias of fiscal balances and the debt and fiscal sustainability indicators as currently defined leave little room for countries to undertake fiscally expansive measures to promote growth, to adopt countercyclical policies, or to finance measures that will sustain MDG achievements.

Thus, a primary aim of economic policy in developing countries should be to minimize, if not avoid, the procyclical bias in fiscal policy. This, in turn, will require: (a) the elimination of countercyclical conditionalities and 'benchmarks' for deficit limits, (b) reliability of the delivery of external assistance, and (c) review of macro-economic policies that focus on short-term economic stability at the expense of long-term growth.

It has been noted that the focus on tight nominal fiscal deficit targets is clearly inappropriate during depressed economic conditions, especially for countries that depend on multilateral loans and foreign aid for financing. Most conditionality includes nominal fiscal targets, meaning that, when tax revenues fall during recessions, countries are forced to cut expenditures to meet their targets. Hence, donors and the IMF will need to be more flexible in granting developing countries 'policy space' to pursue countercyclical policies. Some of the measures that can be adopted include:

- Eliminating countercyclical conditionalities and 'benchmarks' for deficit limits (inflation rates and foreign exchange holdings), since countercyclical expenditures will require a modest increase (Weeks 2010)
- Strengthening the reliability of donors to deliver assistance, since late — let alone shirked — assistance could reinforce the procyclicality of fiscal balances and provoke macro-economic instability



- Introducing automatic stabilizers, such as Fiscal Stabilization Funds,<sup>35</sup> that can provide ‘self-insurance’ against sudden interruptions in external financing (such as the National Coffee Fund of Colombia and the copper and petroleum funds of Chile)
- Adopting policies that focus not simply on price stability, but also on containing output volatility. As noted earlier, procyclical macro-economic policy aimed at price stability and fiscal balance has been one of the causes of increased output growth volatility. Yet, it is well known that policies targeting price stability cause excessive fluctuations in output, as the burden of adjustment falls only on one variable (output), especially in the face of shocks

## *Domestic Revenue Mobilization*

The most effective way to fund government spending and reduce aid dependency, though, is to mobilize domestic resources. The low levels of tax collection in many poor countries limit important government expenditures and forces countries to borrow or depend on aid flows to finance basic development needs. Given the volatility of external financing and the important role that public sector investment can play in long-term development, it will be critical for governments to raise domestic revenues. Only with increased tax revenues will countries be able to sustain long-term domestic investments and fiscal policy flexibility (Spiegel 2007).<sup>36</sup>

*The most effective way to fund government spending and reduce aid dependency is to mobilize domestic resources.*

Poor countries, on average, collect only about two thirds of the tax revenues as a percentage of GDP that richer countries collect. Even some of the wealthier emerging market countries, like India, still have relatively low ratios of tax revenue to GDP. In most developing countries, direct taxes, such as income taxes, contribute only a small percentage of total tax revenues.<sup>37</sup> For example, tax collection on income, profits and capital gains in Latin America and Asia is one third to one half that of collection levels in OECD countries.

Further, most developing countries rely on indirect taxes for revenue. Many of the reforms of the 1990s and 2000s shifted taxation to VAT from other indirect taxes such as tariffs and other trade taxes. VAT is a tax on consumption, rather than on investment. VAT is also a tax on the formal sector and is therefore not as effective in countries with large informal sectors, where it operates like a tax on sales rather than a tax on value added. Since it is a highly regressive tax, the poor pay more as a share of income than the wealthy. Multiple rates (such as higher taxes on luxury goods and lower or no taxes on food and medicine) can be used to make VAT less regressive, though this requires additional administrative capacity. Overall, the shift to VAT has resulted in a net reduction in revenues: VAT replaced less than 30 percent of the revenues lost through the elimination of trade taxes (Baungsgaard and Keen 2005).

Rather than relying on one indirect tax, such as VAT, countries should try to diversify sources of tax revenues simply and transparently. Further, to reduce tax evasion, countries can also try to design more ‘corruption-resistant tax structures’ that rely on non-discretionary and readily observable tax instruments. One such measure is a tax on financial transaction. Countries such as Argentina, Brazil, India and the Republic of Korea imposed this type of a tax on bank debits. In Brazil, for example, the financial transaction tax collects 1.5 percent of GDP. These taxes have the added benefit of providing information about firm transactions that can help authorities increase collection and find evading firms. The Republic of Korea has also implemented



a similar programme to reduce the attractiveness of cash by offering a subsidy for credit cards. The goal is to shift transactions from cash to a medium that is traceable. In countries where banking services are relatively well developed, these taxes have been effective. Furthermore, they play a countercyclical role by slowing financial transactions during financial booms and bubbles.

Other examples of non-discretionary 'corruption-resistant taxes' include taxes that target consumption items, such as luxury cars and homes. Taxes on luxury items would, again, enhance countercyclical policy-making during boom periods.

Improving tax administration is also important for increasing collections. For instance, the United Republic of Tanzania's tax reform raised tax revenues by 47 percent from 1998 to 2003 and the Province of Buenos Aires's administrative reforms succeeded in increasing collection of direct taxes, such as car license fees (from 50 percent to 90 percent), real estate taxes (from 40 percent to 70 percent) and company income taxes.



## Notes

1. “Macroeconomic stability relates to the interaction between an economy’s aggregate demand and aggregate supply. If aggregate expenditure in an economy moves in equilibrium with aggregate supply, the economy would be characterized by internal balance, as manifested in a sustainable fiscal position, low price inflation and an unemployment rate close to the natural rate, as well as by external balance, as reflected in the international current account position or by the level of external debt” (Briguglio et al. 2008). The ability of a country to adequately manage its debt burden determines its debt sustainability (IMF 2011a).
2. Resilience refers to the capacity of an economy to absorb (withstand) and/or counteract (quickly recover from) an economic shock. Shock counteraction is associated with the flexibility of an economy (such as having fiscal surpluses which will enable countercyclical policy-making) and shock absorption is associated with having mechanisms to reduce the impact of shocks (Briguglio et al. 2008).
3. The term ‘fiscal space’ is hotly debated. According to the IMF, the term essentially refers to the room in a government’s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy (Heller 2005). The crucial point of debate is in how resources that ‘define’ fiscal space should be viewed and thus calculated. Hence, UN agencies advocate defining it in relation to the extent to which a government can mobilize resources (over the longer term) to combat poverty and achieve the MDGs (Roy and Heuty 2009).
4. Data from 102 developing economies (see Annex 7.A) was used to generate trends for each indicator of fiscal capacity from 1995 to 2009.
5. In many instances, the stimulus packages aimed to boost economic growth by reviving aggregate demand. Often, they involved expanding public expenditure on infrastructure, such as roads and power supplies, combined with cuts in taxes on goods and services, especially fuel, along with subsidies for exports (UNESCAP 2009).
6. In Briguglio et al. 2008, principal indicators that define fiscal capacity include deficits, inflation and external debt. According to UNESCAP (2009), the capacity to cope with a crisis is assessed using external public debt stock/GDP, total reserves in months of imports/GDP, and gross savings/GDP. For the World Bank (2009), the fiscal capacity measure averages standardized indexes of debt/GDP, the fiscal deficit, the current account balance, international reserves, and reversible capital flows.
7. Total external debt is debt owed to nonresidents and repayable in foreign currency, goods, or services. It is the sum of public, publicly guaranteed, and private non-guaranteed long-term debt, use of IMF credit, and short-term debt. Short-term debt includes all debt having an original maturity of one year or less and interest in arrears on long-term debt.
8. The reduction in the indebtedness of Arab States is likely an underestimation, since external debt figures for a number of oil-exporting countries (Kuwait, the Libyan Arab Jamahiriya, Qatar and Saudi Arabia) are not included in the Global Development Finance database of the World Bank.
9. A number of LICs were already in debt distress before the crisis erupted, including some countries eligible for debt relief under the HIPC initiative.
10. Since the fiscal balance is the biggest contributor to changes in debt from year to year, developing countries increased their stock of external debt. Still, all regions had economic growth rates that exceeded their average fiscal deficits during this period.
11. This increase in indebtedness was also reflected in the increase in the ratio of external debt servicing.
12. The debt sustainability framework addressing sovereign debt of LICs identifies benchmarks to signal low, medium and high risks of debt distress according to the quality of a country’s economic policies and institutions. For instance, in the



case of countries deemed as having 'medium policy' quality, the benchmark level of the ratio of external public debt (measured in present value terms) to exports is 150 percent, while the ratios relative to GDP and government revenue are 40 percent and 250 percent, respectively. In addition, debt servicing obligations should be less than 20 percent of exports and under 30 percent of government revenue. Countries assigned with weaker institutions are assigned lower benchmarks and stronger countries are assumed to be able to manage higher debt burdens (World Bank, IMF, IDA 2009).

13. Debt distress is defined as having debt and debt service ratios that are significantly beyond the thresholds, as being in or close to having debt restructuring negotiations, or as being in the process of accumulating arrears. High risk is defined as having a protracted breach of thresholds, but not yet facing difficulties in making debt payments as they fall due (IMF 2010).
14. It should be noted that HIPC and MDRI do not provide such comprehensive sovereign debt relief, but were designed to provide one-time external debt relief only to eligible LICs.
15. The Evian Approach is an initiative established by the Paris Club in 2003 that provides sovereign debt relief to non-HIPC and MICs. As such, it addresses the need for a broader treatment of debt relief than that provided by HIPC. Eligibility for debt relief is determined by the Paris Club and by creditors on a case-by-case basis. By 2009, 11 countries had received some sort of debt relief under the Evian Approach (Paris Club 2010).
16. Cash surplus or deficit is revenue (including grants) minus expense, minus net acquisition of nonfinancial assets. In the 1986 GFS manual, non-financial assets were included under revenue and expenditure in gross terms. This cash surplus or deficit is closest to the earlier overall budget balance (still missing is lending minus repayments, which are now a financing item under net acquisition of financial assets).
17. The peak in 2006 is driven by large fiscal surpluses relative to GDP in several African countries (Lesotho, Mali, and the Niger). In the absence of these three countries, developing countries would have experienced a fiscal deficit of 0.5 percent of GDP in 2006.
18. A 3 percent fiscal deficit target is generally assumed to be the upper bound of fiscal sustainability (Kovach 2008).
19. In 2006, Africa experienced large fiscal surplus (3.9 percent of GDP). The magnitude of this surplus, however, is driven by Lesotho, Mali, and the Niger. In the absence of these three countries, African countries would have experienced a fiscal deficit of 1.2 percent of GDP in 2006.
20. The Asia and the Pacific region was unique in that the deterioration in the fiscal balance represents a shift from a surplus of 0.6 percent of GDP in 2007 to a deficit of 4.0 percent of GDP in 2009.
21. The percentage point change refers to the absolute difference in the value of the measure between the two years.
22. Fiscal balances are highly sensitive to the time period being considered. For instance, in LICs, the fiscal balance started deteriorating sharply in 2006. So, if the deterioration in the fiscal balance for the period 2006–2009 is considered, LICs had the worst deterioration of all development groups.
23. Procyclical fiscal policy accounts for 15 percent of excess volatility in Latin America compared to East Asia.
24. Recent studies (UNRISD 2010, Vera 2009, Spiegel 2007) indicate that there is considerable latitude on what levels of inflation, budget deficit and reserves are needed to achieve stability, particularly in relation to achieving growth.
25. Due to the crisis, the IMF has "altered its fiscal policy generally by factoring in higher deficits and spending in 2009 and 2010. It claims to have made financial assistance programmes more flexible, to have loosened fiscal targets in close to 80% (18 of 23) of African countries that have an active IMF programme" (Rowden 2009).
26. Moreover, unexpected changes in foreign earnings, changes in major import prices, changes in the cost of borrowing, changes in the availability of foreign credit, and changes in general in the external accounts may affect not just the incomes of countries but also their fiscal variables.



27. Gross savings are calculated as GNI less total consumption, plus net transfers (World Bank 2011).
28. The absence of gross savings figures for Bahrain and Oman in 2009 may be artificially depressing the trend from 2008 and 2009, especially given the high gross savings rates in these two countries (44 percent and 39 percent, respectively). Further, many Arab States had accumulated savings in Sovereign Wealth Funds (SWFs).
29. In the absence of China, the growth of gross savings in LICs would have been moderately smaller, from 16 percent of GDP in 1995 to 22 percent of GDP in 2009.
30. The sample size in high-income developing countries fell to 8 in 2009 from an average of 11 for the period 1995–2008. The missing data may be biasing the figure for 2009 downwards, as the missing countries (Bahrain, Oman, and Singapore) had high gross savings rates in 2008 (44 percent, 39 percent, and 45 percent, respectively).
31. Other Arab States also introduced fiscal stimulus packages: for instance, Tunisia introduced a package with measures to support employment creation and support for domestic SMEs. Egypt announced a fiscal stimulus package geared towards job creating infrastructure investments (World Bank 2009a).
32. There may be additional reasons to accumulate foreign reserves, such as mercantilist concerns and the need to protect policy space. Further, large stocks of reserves may reduce the volatility of the foreign exchange rate and the cost of foreign borrowing may also be reduced (Cruz and Walters 2008).
33. Nearly 80 percent of all global trade transactions involve some form of credit (Auboin 2009b).
34. International institutions and governments provided 40 percent of the contributions to this fund, with commercial banks providing the balance (Lynn 2009).
35. The point of a stabilization fund is to put funds aside during an economic boom for use when the economy is in recession.
36. Low levels of domestic resource collection limit the government's ability to use fiscal policy; the government cannot afford to lower tax rates during a recession and is unable to raise them during a boom.
37. The low rate of direct taxation in many developing countries implies that there is room to improve direct tax collection. This would also have the added benefit of increasing the progressiveness of tax collection, since, in many countries, income taxes are not currently progressive in practice because the wealthy are able to take advantage of loopholes and other forms of tax evasion. An increase in income tax collection could start by focusing on these issues.



## Annex 7.A

### Note on Data

Using data from the World Bank, World Development Indicators 2011, empirical evidence on fiscal capacity was collected for 28 advanced economies and 102 developing economies. Only countries with data on their fiscal balances, current account balances and external debts were included. Table 7.A1 below gives a full list of countries included in the empirical study, classified by region and development group.

Data for China's budget balance were obtained from the IMF, World Economic Outlook 2011.

**Table 7.A1**

Country	Region	Development Status	LDC
<b>Advanced Economies</b>			
Australia	(advanced)	Advanced	N
Austria	(advanced)	Advanced	N
Belgium	(advanced)	Advanced	N
Canada	(advanced)	Advanced	N
Czech Republic	(advanced)	Advanced	N
Denmark	(advanced)	Advanced	N
Estonia	(advanced)	Advanced	N
Finland	(advanced)	Advanced	N
France	(advanced)	Advanced	N
Germany	(advanced)	Advanced	N
Greece	(advanced)	Advanced	N
Iceland	(advanced)	Advanced	N
Ireland	(advanced)	Advanced	N
Italy	(advanced)	Advanced	N
Luxembourg	(advanced)	Advanced	N
Netherlands	(advanced)	Advanced	N
New Zealand	(advanced)	Advanced	N
Norway	(advanced)	Advanced	N
Poland	(advanced)	Advanced	N
Portugal	(advanced)	Advanced	N
Slovenia	(advanced)	Advanced	N
Spain	(advanced)	Advanced	N
Switzerland	(advanced)	Advanced	N
United Kingdom	(advanced)	Advanced	N
United States of America	(advanced)	Advanced	N



# Economic Resilience and Fiscal Capacity

Country	Region	Development Status	LDC
<b>Advanced Economies</b>			
Bulgaria	ECIS	Advanced	N
Latvia	ECIS	Advanced	N
Lithuania	ECIS	Advanced	N
<b>Developing Economies</b>			
Afghanistan	A&P	Low-income DC	LDC
Bangladesh	A&P	Low-income DC	LDC
Bhutan	A&P	Low-income DC	LDC
Cambodia	A&P	Low-income DC	LDC
China	A&P	Low-income DC	N
Fiji	A&P	Middle-income DC	N
Hong Kong, SAR of China	A&P	High-income DC	N
India	A&P	Low-income DC	N
Indonesia	A&P	Low-income DC	N
Iran	A&P	Middle-income DC	N
Malaysia	A&P	Middle-income DC	N
Maldives	A&P	Middle-income DC	LDC
Mongolia	A&P	Low-income DC	N
Myanmar	A&P	Low-income DC	LDC
Nepal	A&P	Low-income DC	LDC
Pakistan	A&P	Low-income DC	N
Papua New Guinea	A&P	Low-income DC	N
Philippines	A&P	Low-income DC	N
Singapore	A&P	High-income DC	N
Sri Lanka	A&P	Low-income DC	N
Thailand	A&P	Middle-income DC	N
Vanuatu	A&P	Middle-income DC	LDC
Benin	Africa	Low-income DC	LDC
Botswana	Africa	Middle-income DC	N
Burkina Faso	Africa	Low-income DC	LDC
Burundi	Africa	Low-income DC	LDC
Cameroon	Africa	Low-income DC	N
Cape Verde	Africa	Middle-income DC	N
Central African Republic	Africa	Low-income DC	LDC
Congo	Africa	Middle-income DC	N
Côte d'Ivoire	Africa	Low-income DC	N
Dem. Rep. of the Congo	Africa	Low-income DC	LDC
Ethiopia	Africa	Low-income DC	LDC



Country	Region	Development Status	LDC
<b>Developing Countries</b>			
Ghana	Africa	Low-income DC	N
Guinea	Africa	Low-income DC	LDC
Kenya	Africa	Low-income DC	N
Lesotho	Africa	Low-income DC	LDC
Liberia	Africa	Low-income DC	LDC
Madagascar	Africa	Low-income DC	LDC
Mali	Africa	Low-income DC	LDC
Mauritius	Africa	Middle-income DC	N
Niger	Africa	Low-income DC	LDC
Nigeria	Africa	Low-income DC	N
Senegal	Africa	Low-income DC	LDC
Seychelles	Africa	High-income DC	N
Sierra Leone	Africa	Low-income DC	LDC
South Africa	Africa	Middle-income DC	N
Swaziland	Africa	Middle-income DC	N
Togo	Africa	Low-income DC	LDC
Uganda	Africa	Low-income DC	LDC
Zambia	Africa	Low-income DC	LDC
Zimbabwe	Africa	Low-income DC	N
Algeria	Arab States	Middle-income DC	N
Bahrain	Arab States	High-income DC	N
Egypt	Arab States	Middle-income DC	N
Jordan	Arab States	Middle-income DC	N
Lebanon	Arab States	Middle-income DC	N
Morocco	Arab States	Middle-income DC	N
Oman	Arab States	High-income DC	N
Sudan	Arab States	Low-income DC	LDC
Tunisia	Arab States	Middle-income DC	N
Yemen	Arab States	Low-income DC	LDC
Albania	ECIS	Transition	N
Armenia	ECIS	Transition	N
Azerbaijan	ECIS	Transition	N
Belarus	ECIS	Transition	N
Bosnia and Herzegovina	ECIS	Transition	N
Cyprus	ECIS	Advanced	N
Georgia	ECIS	Transition	N
Hungary	ECIS	Advanced	N
Kazakhstan	ECIS	Transition	N

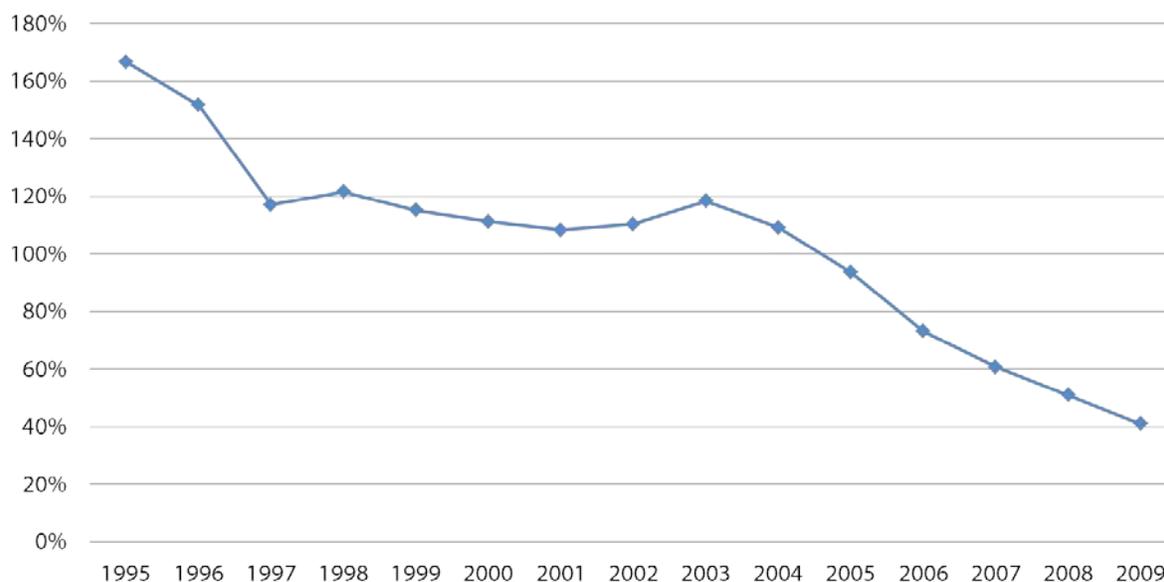


# Economic Resilience and Fiscal Capacity

Country	Region	Development Status	LDC
<b>Developing Countries</b>			
Kyrgyzstan	ECIS	Transition	N
Malta	ECIS	Advanced	N
Moldova	ECIS	Transition	N
Romania	ECIS	Advanced	N
Russian Federation	ECIS	Transition	N
Serbia	ECIS	Transition	N
Slovakia	ECIS	Advanced	N
Tajikistan	ECIS	Transition	N
The FYR of Macedonia	ECIS	Transition	N
Turkey	ECIS	Middle-income DC	N
Ukraine	ECIS	Transition	N
Argentina	LAC	High-income DC	N
Belize	LAC	Middle-income DC	N
Bolivia	LAC	Middle-income DC	N
Brazil	LAC	Middle-income DC	N
Chile	LAC	High-income DC	N
Colombia	LAC	Middle-income DC	N
Costa Rica	LAC	Middle-income DC	N
Dominican Republic	LAC	Middle-income DC	N
El Salvador	LAC	Middle-income DC	N
Guatemala	LAC	Middle-income DC	N
Honduras	LAC	Middle-income DC	N
Jamaica	LAC	Middle-income DC	N
Mexico	LAC	High-income DC	N
Nicaragua	LAC	Low-income DC	N
Panama	LAC	Middle-income DC	N
Paraguay	LAC	Middle-income DC	N
Peru	LAC	Middle-income DC	N
St. Kitts and Nevis	LAC	High-income DC	N
Uruguay	LAC	High-income DC	N
Venezuela	LAC	High-income DC	N

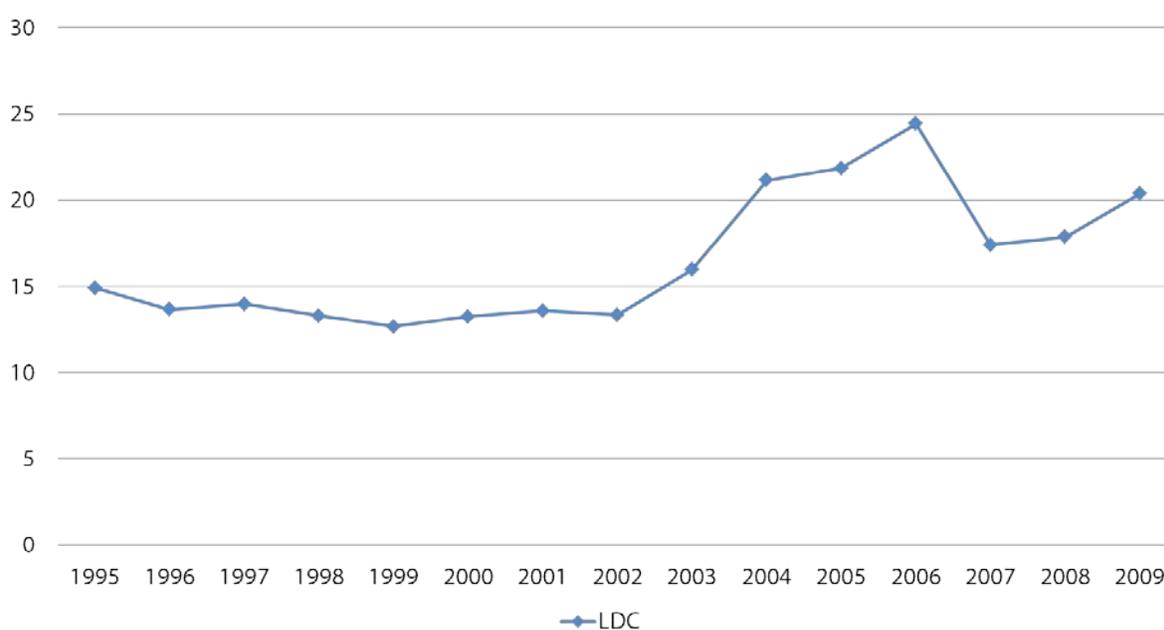


## Annex 7.B: External-Debt-to-GDP Ratio for LDCs, 1995–2009



**Source:** Calculated from World Bank, World Development Indicators 2011

## Annex 7.C: Gross Savings Rate in LDCs, 1995–2009 (percent of GDP)



**Source:** Calculated from World Bank, World Development Indicators 2011



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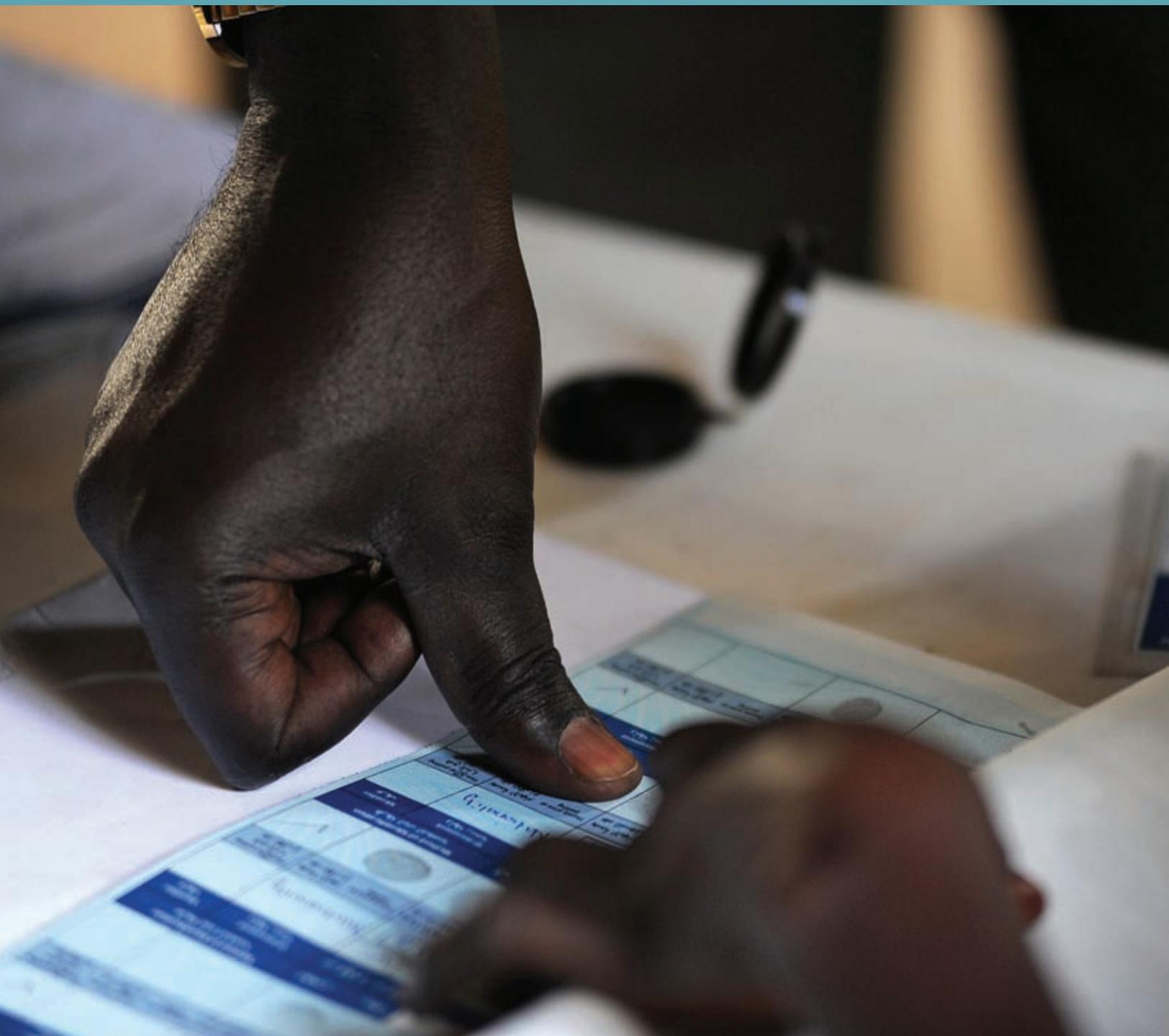
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# 8

## GOVERNANCE PRINCIPLES, INSTITUTIONAL CAPACITY AND QUALITY



*The resilience of nations is manifest in their ability to anticipate and prepare for shocks, which, in turn, depends on the technical capacities of organizations and institutions at the front lines of crisis response, the overall functioning of country systems, and the governance structures that 'set the rules of the game'.*



## Introduction

During times of economic crisis, the resilience of nations is manifest in their ability to anticipate and prepare for shocks and effectively manage crises as they unfold. The ability of governments to design and implement the right combination of short- and long-term policy measures is thus critical for sustaining MDG progress and building greater resilience over time. Determining the appropriate policy measures is complex, though. On the one hand, it requires specific technical capacities in the organizations and institutions at the front lines of the crisis response. On the other hand, it depends on the overall functioning of country systems and institutional qualities, including decision-making processes and consensus building among key stakeholders, the broader political economy dynamics, and governance structures that largely set ‘the rules of the game’.

This chapter identifies the institutional qualities and governance principles that are critical for developing and implementing effective and equitable policy measures to mitigate the impact of economic crises. These institutional qualities are performance, adaptability, and stability; the main governance principles are participation/inclusion, non-discrimination/equality and rule of law/accountability. Moreover, the key country systems that are involved in a crisis response, such as the civil service, procurement mechanisms, public financial management systems and monitoring and evaluation systems, need to incorporate and display these qualities and principles when responding to economic shocks. Otherwise, the policy measures implemented will be either short-lived or unsustainable.

When individual institutions or entire systems adopt a combination of these governance principles and institutional capacities, governments boost their ability to formulate and implement effective anti-crisis measures that are also legitimate in the eyes of their citizens. These qualities and principles are mutually supportive: the governance principles set the overall enabling environment and drive the capacity of institutions to perform better and respond to crises, while the key institutions involved in realizing these principles need to be effective, adapt to changing circumstances and priorities, and sustain results and efforts. These key qualities and principles, when adopted by core country institutions, can help countries design and implement more inclusive policies and avoid implementing recovery measures that could erode social protection (such as cash transfers) and social services (such as health and education) (Sepulveda 2011).

Determining the ‘right’ policy recommendations for improving governance structures and institutional capacities so that countries are better equipped to respond to crises is complex. Depending on the extent of their development, countries require differing investments in capacities. In the absence of institutional capacities and effective governance, though, countries have relied on *ad hoc*, short-term measures to contain the impact of economic crises.

Countries would do better to take a longer-term view when building their institutions, which include the civil service, oversight bodies (e.g., judiciary systems), public financial management and national procurement systems. By so doing, governments could better sustain their development gains, regardless of their political and historical backgrounds. Without investments in such core structures and systems, countries may employ short-term measures (such as the establishment of task forces, coordination mechanisms and other similar institutional arrangements) that bring about quick gains, but that, not being systemically incorporated, leave countries ill-prepared in the (inevitable) event of future crisis.



## Institutional Capacities and Qualities

Countries that strive to respond effectively to crises and to build resilience need adaptable, capable institutions. A better understanding of how institutional capacities within countries form a building block for effective responses to economic shocks is essential for sustaining human development gains, including progress towards the MDGs. This section discusses the qualities necessary for institutions at the forefront of the crisis response, provides country evidence, and proposes measurements and recommendations. Institutions mentioned in this chapter are defined as formal organizations of government and public service, including government ministries and agencies, sub-national governments and other organizations of states responsible for public services, the design and implementation of policies, and the administration of the state's functions.<sup>1</sup>

### *Defining Institutional Qualities*

Performance, adaptability and stability are the three qualities critical for any effective response to a crisis. While institutional performance is the foundation of state capacity to function and fulfil its obligations towards its citizens, it is not a sufficient condition for countries that need to respond to shocks and deal with a changing environment. Building resilience also requires institutions that are stable, yet adaptable.

*While institutional performance is the foundation of state capacity to function and fulfil its obligations towards its citizens, it is not a sufficient condition for countries that need to respond to shocks and deal with a changing environment. Building resilience also requires institutions that are stable, yet adaptable.*

*Performance* — Performing institutions, with the capacity to deliver basic public services and to design and implement policies, are critically important to countries' efforts to achieve their development goals, and even more so during crisis. For example, the quality of governance, as measured by the level of corruption and the quality of bureaucracy, can explain differences in the ability of public spending to improve health and education (Rajkumar and Swaroop 2008). Measured by effectiveness and efficiency, institutional performance is the foundation of the state's capacity to manage its executive, legislative and judiciary functions, to administer the economy, to deliver social services, to use natural resources sustainably, to ensure protection of human, economic and social, civil and political rights, and to provide security (UNDP 2010). Effectiveness is the degree to which an institution's objectives are achieved, and an understanding of where and how an institution is more or less effective can help people to design programmatic responses to develop capacities in these particular areas. Efficiency is the ratio of produced outputs (or what has been achieved) to the resources used to create them (money, time, labour, etc.). The effects of improved efficiency extend beyond obvious cost-saving factors, and recent research shows a direct relationship between public sector operational efficiency and economic growth (Public Choice 2008). Furthermore, higher efficiency in public sector organizations improves the image and public legitimacy<sup>2</sup> of the government.

*Adaptability* — In times of crisis, countries need institutions with the capacity to anticipate, adapt and respond to changing needs and shifting priorities. Adaptability is thus an ability to perform in future conditions and to innovate to meet future needs (UNDP 2010). Adaptable institutions are flexible and able to continuously invest in endogenous improvements, while anticipating and responding to crises with innovative solutions (UNDP 2010 and Killick 1995). Such institutions form a foundation for building longer-term resilience.



# Governance Principles, Institutional Capacity and Quality

Investments in innovation<sup>3</sup> comprise cutting-edge changes to policies, processes, practices and behaviour that would lead to better and more sustainable performance (UNDP 2010). Some *ad hoc* changes can be introduced in reaction to external factors (e.g., the establishment of crisis response task forces within ministries of finance or central banks). Most changes, though, require preparation to adapt to anticipated changes in external and internal environments (e.g., up-front investments in human resources, including incentive mechanisms able to attract capable new graduates to government institutions). Such continuous and endogenous improvement can ensure adaptability.

*Stability* — Stability is the degree to which an institution can decrease volatility of performance through institutionalization of good practices and norms and can identify and mitigate internal and external risks through risk management (UNDP 2010).

Institutional innovations need to become routine, not just a temporary improvement in an institution's performance that might be followed by larger setbacks (e.g., when a crisis response task force is dismantled after the crisis). The reasons for this are compelling: Stable institutions are able to decrease the volatility and unpredictability of their performance and resource utilization through the institutionalization of good practices and innovative norms. When innovative procedures, institutional arrangements, mechanisms, and other interventions that have proven effective are systematized, they ensure continuous and consistent institutional performance.

A stable institution should be able to design and implement proper risk identification, analysis and management (UNDP 2010). An institution with an overall risk management strategy that addresses risks holistically, rather than with a loose patchwork of plans from various departments or teams, is often better able to mitigate risk and is less susceptible to major threats, thereby ensuring stability. An example of this would be the establishment of a permanent economic analysis/surveillance and policy advisory unit within a government's ministry of finance.

## *Measuring Change in Institutional Performance, Adaptability and Stability<sup>4</sup>*

Improvements in institutional qualities can be measured by an institution's ability to: a) convert inputs into productive use (performance); b) adapt to changing realities and demands (adaptability); and c) seek resolution to problems and remove barriers (stability). Annex 8.A provides a summary of measurements and indicators to track changes in institutional performance, adaptability and stability.

*Performance* — As defined earlier, performance consists of the effectiveness and the efficiency with which an institution fulfils its purpose. Indicators of increased effectiveness could be quality (e.g., through definition of quality standards or a quality assurance mechanism) or adequacy of output quantity (e.g., the quantity of the products and services required to meet the needs of beneficiaries). For example, programmatic responses may contribute to increased effectiveness by:

- improving the quality of policy (e.g., by better analysing the crisis and formulating an adequate and effective response in times of crisis)
- improving the implementation of programmes (e.g., by having better talent management systems that attract and retain top talent in policy advisory and development units, with the capacity to analyse crisis situations and develop policy responses).



Indicators of increased efficiency could be the degree of clarity of roles and responsibilities, client needs and values, or expected outcomes; degree of alignment between teams, budget allocations, or monitoring and evaluation systems; or efficient business processes that reduce the time required to identify, develop, and deliver outputs. A programmatic response may contribute to increased efficiency by:

- aligning organizational structure to the mandate in order to reduce overlapping roles and responsibilities (e.g., establishing a crisis response task team with a clear mandate, role and responsibilities in times of crisis)
- streamlining business processes by reducing the time required to complete tasks or the number of people whose approval is required, as the introduction of fast-track procedures is critical in time of crisis
- improving the policy formulation process by involving more stakeholders (e.g., by coordinating the responses of government ministries in times of crisis).

*Adaptability* — Measures of institutional adaptability are levels of/investments in innovation, and the existence of systematic reviews of policies, procedures and business processes. A programmatic response could involve the design and implementation of a built-in mechanism for continuous improvement, such that an institution's effectiveness and efficiency are examined, redefined and realigned continuously in response to changing realities (by offering, *inter alia*, training to staff that addresses specific needs within the institution, including skills for complex data analysis and policy development).

*Stability* — While measures of performance provide a static image of how well an institution uses its resources, measures of stability provide a dynamic representation of how well an institution performs over time through its incorporation of good practices and policies (e.g., its use of standard operating procedures and adherence to regulations) and risk mitigation mechanisms (e.g., reduced staff turnover and measures to improve transparency and accountability). Identifying and analysing areas that are particularly subject to variable performance — due to, for instance, changes in political or organizational leadership or high staff turnover — can reveal which areas need programmatic responses. Possible interventions that may foster institutionalization of good practices include:

- documentation of business processes
- alignment of business processes, competency requirements and performance management, such as by hiring people with the needed skills, having them do the right things, and rewarding them for doing it well
- development of a knowledge-sharing mechanism to share good practices and retain institutional memory.

Programmatic responses may contribute to better risk mitigation by:

- designing and implementing participation mechanisms
- drafting and implementing best practice policies and practices
- developing information management systems to ensure fact-based decision-making.



# Governance Principles, Institutional Capacity and Quality

## *Application of Institutional Qualities to Core Country Systems and Country Evidence*

The qualities defined above — performance, adaptability and stability — are critical to country systems, which are at the forefront of crisis response, and are responsible for ensuring that the available capacities, assets and resources are used as efficiently and effectively as possible. The country systems comprise legislation, policies, procedures and organizational structures needed for the functioning of the state and include human resource management/civil service, public financial management (PFM), procurement and monitoring and evaluation systems.<sup>5</sup> This section focuses on four core systems: civil service, PFM, procurement, and monitoring and evaluation. These are critical for an effective response to a crisis and for the sustainability of MDGs and other development goals. The examples and evidence below demonstrate, especially in light of the recent economic crisis, how the key institutional qualities of performance, adaptability and stability have been applied to these core systems in times of crises.

### *Civil Service*

Of the many institutions that are mobilized to respond to a crisis, the civil service<sup>6</sup> at the national and local levels is a key system on which the state relies to fulfil its obligations towards its citizens. Thus, to function effectively and reach its development agenda, a country must prioritize investments in a professional, merit-based civil service and strengthen local governments responsible for overseeing or delivering basic social services, especially to the poor and other vulnerable groups (Kohli 2004).<sup>7</sup> The experience of countries in responding to the recent economic shock has shown that the capacity of institutions to provide evidence-based analysis of the situation and sound policy options to address the crisis is critical. This fundamental capacity is grounded on the continuous availability of experienced and well-trained staff in key government institutions and central economic agencies, such as ministries of planning, finance and central banks (Nelson 1990, ODI 2010).

The lack of a predictable, coherent and functioning bureaucracy undermines the ability of developing countries to respond to crises (Evans 1992). The World Bank found that one quarter of developing countries could not contain the effects of poverty secondary to the economic crisis due to weak underlying capacities (World Bank 2009). Recent Overseas Development Institute (ODI) research also pointed out weak state and institutional capacities that impeded the ability of states to establish effective and sustainable policy responses to the economic crisis (ODI 2010). Prolonged underinvestment in the civil service, including education policies that neglect investments in specialized tertiary education,<sup>8</sup> can lead to a failure to produce a cadre with the skills and competencies to build an effective and ethical civil service or to the crowding out of skilled talent from the public sector (to the private sector).

A recent study on the 2008 economic crisis response, conducted by the UNDP-supported Regional Centre for Public Administration Reform (RCPAR), found that ineffective and inconsistent responses in some countries in Eastern Europe and Central Asia have exposed underlying weaknesses within their public sectors. Underinvestment in the professional civil service system has affected their capacity for strategic and evidence-based policy-making and coordination, effective public finance management, budget planning and execution, and effective delivery of public services. The same study also revealed that the economic crisis halted, or at least stunted, reform processes that were underway in many countries to modernize the state apparatus, including civil service and public administration reforms, decentralization processes, and others. Countries in which reform processes were still underway and that had only been able to lay the foundations of a modern state, were unable to implement effective measures to mitigate the impact. This is particularly



true for their sub-national governance structures, which have suffered from a cessation of efforts to improve their ability to fulfil their increasing responsibilities for the delivery of basic services to local communities.<sup>9</sup>

In time of crisis, particularly in countries where chronic underinvestment in the civil service has failed to build competent bureaucracies, institutions need to be able to quickly adjust to the new challenge and to establish workable mechanisms and arrangements that boost their capacities to design and implement effective counter-crisis policies. While each country context requires its own specific set of interventions and policy options, all countries can enhance their institutional capacity by introducing short-term measures, such as offering incentives to attract competent and educated members of the diaspora to support their country's response to the crisis. Sometimes, the skills and the competencies might already be within the country, but might be scattered across different state institutions or working in the private sector. In these countries, the establishment of task forces and committees and the promotion of public-private partnerships would allow institutions at the forefront of the crisis response to temporarily draw on these resources. Faced with a lack of strong performing systems, and especially with a lack of a vital civil service, states have resorted to short-term, *ad hoc* responses to contain crises. Examples of these are detailed below.

In Bangladesh, the government formed a number of multi-sectoral task forces and committees to monitor the crisis and articulate policy adjustments.<sup>10</sup> These task forces included a committee, headed by the minister of finance and comprising competent public and private sector experts, such as cabinet ministers and policy makers, researchers and analysts. Nigeria established the Presidential Steering Committee on the Global Economic Crisis as well as the Presidential Advisory Team to propose measures to reverse the declining trend in its capital markets. Kenya and the Sudan established coordination mechanisms to ensure communication and consultation between key government departments (i.e., the Prime Minister's office and the Ministry of Finance) and other key institutions (central banks). Kenya also set up a taskforce, comprised of officers from the Ministry of Finance and Planning as well as the Central Bank, to look into ways of cushioning the economy from the adverse effects of the crisis. The United Republic of Tanzania and Zambia, instead, established broader multi-stakeholder consultative mechanisms and processes.

*While each country context requires its own specific set of interventions and policy options, all countries can enhance their institutional capacity by introducing short-term measures, such as offering incentives to attract competent and educated members of the diaspora to support their country's response to the crisis.*

While the degree of effectiveness of such task forces and other institutional arrangements established within ministries of finance and central banks to respond to the crisis is not clear, examples from Bangladesh, the United Republic of Tanzania and Mauritius show that, where these mechanisms for policy development and coordination have been institutionalized, countries have had greater capacity to develop and implement more coordinated policy responses to the 2008 economic crisis (ODI 2009 and 2011).

For instance, the experience of Lebanon in responding to the recent economic crisis attests to the effectiveness of past investments in capacity to reform its Ministry of Finance. Staffed with well-trained and highly skilled Lebanese professionals, the Ministry's Economic and Technical Support Unit (ETSU) played a critical role in the aftermath of the financial crisis by providing high-level policy advice to the government to address short-term effects of the crisis. Formed (with support from UNDP) at the beginning of the 1990s as a temporary



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economic advisory body and staffed with Lebanese diaspora, ETSU is the main body in charge of providing up-to-date economic analysis, research and policy advice to the government. The progressive integration of its staff into the Ministry and the institutionalization of ETSU have been ensuring consistency in institutional performance and retention of capacity.<sup>11</sup>

While putting in place short-term measures, such as task forces or policy advisory units equipped with high-calibre professionals, provides institutions with the short-term capacity to respond to a crisis, institutionalizing such measures allows countries to remain responsive. Thus, countries that would like to deal more effectively with future shocks and become more resilient should implement, in tandem with short-term and *ad hoc* measures, medium- and long-term strategies that address underlying institutional weaknesses.

## *Public Financial Management Systems*

The adequate performance of PFM systems — which comprise, *inter alia*, institutions in charge of developing and executing national and local budgets, setting fiscal frameworks, collecting taxes, and performing financial accounting and reporting (Renzio 2010) — is necessary for an effective response to an economic crisis. The World Bank (2009) broadly identifies country resilience with the capacity to promptly scale up

public expenditures and to protect vulnerable groups through poverty reduction programmes. According to the Country Policy and Institutional Assessment (CPIA), one of the primary indicators for assessing a country's resilience is its institutional abilities to manage the budget process, design and implement policies, provide services, and deliver accountable and transparent government.<sup>12</sup> Well-performing PFM systems become particularly relevant during an economic downturn, when countries' — and particularly developing countries' — fiscal positions deteriorate (i.e., declining government revenues, including lower ODA

*Well-performing PFM systems become particularly relevant during an economic downturn, when countries', particularly developing countries', fiscal positions deteriorate.*

(i.e., declining government revenues, including lower ODA predictability, declining tax collection, contracting trade, etc.). Experience from previous crises indicates that budget constraints harm the quality of budget management and implementation (as when, for instance, activities are moved off-budget, spending is determined by unplanned decisions, regular budget and control procedures are circumvented, the credibility and reliability of budget planning are reduced, etc.) and lead to increased corruption and mismanagement.<sup>13</sup> These weaknesses compromise the design, execution and monitoring of countries' responses to crises. Investing in reforms aimed at strengthening PFM systems, including budget management, is therefore critical to prepare countries for an effective and efficient response to future economic crises.

While the specifics of PFM reform depend on the degree of robustness, or weakness, of a country's PFM systems, key elements of such reforms may include, but need not be limited to, strengthening mid-year budget and macro-fiscal framework reviews to align annual budgets to the new fiscal situation; strengthening the capacity for developing and costing capital projects to ensure that they adequately address the needs of the crisis response; improving the capacity for cash forecasting and debt management for sound budget financing; introducing more robust and transparent budget execution procedures, ensuring that budget rationing is based on pre-defined expenditure priorities that have been established by clear political processes (i.e., cabinet sub-committees) rather than arbitrarily by finance ministries; introducing more rigorous expenditure review processes to eliminate inefficiencies; and establishing contingency funds for emergencies. Since



a country's response to a fiscal stress (e.g., stimulus packages, tightening of social spending, etc.) affects current and future generations, countries must also include more transparent budget processes in their PFM reforms.<sup>14</sup> Policy decisions on budget spending need to be clearly articulated and communicated to citizens.

A cross-country study conducted by the ODI finds a positive and significant correlation between countries' income levels and the quality of their PFM systems (de Renzio 2009). Although it is not possible to determine either the existence of a causal relationship or (if there is one) its direction, one can nevertheless strongly argue that investments in PFM systems eventually lead to higher income levels and thus to increased capacity to respond to economic shocks (i.e., because more resources are available). De Renzio's contention, though, is that income levels generate the necessity and pressure for governments to improve PFM systems while governments also invest in capacities to sustain such improvements. The study also finds a significant and positive relationship between aid dependency and the quality of PFM systems (measured through the PFM Performance Measurement Framework).<sup>15</sup> Here again, though, it is not possible to determine either the existence of a causal relationship or (if there is one) its direction, and so it is not possible to draw policy conclusions: while higher levels of aid dependency may lead to donor-supported PFM reform programmes, countries with relatively better PFM systems are able to attract more aid and thus to increase their capacity (fiscal space) to respond to crises.

As described earlier, the establishment of social protection mechanisms to protect the poor requires more money. Yet, many countries, especially poor and aid-dependent ones, have very limited resources, as short-term budget balancing or tight deficit control often outweighs longer-term considerations.

*Building good national procurement systems or strengthening existing ones is especially important for countries that are dependent on imports of essential goods and services, such as foodstuffs, at times of soaring food prices.*

## *Procurement*

Public procurement accounts for most of government budgets; indeed, in Africa, it accounts for as much as 70 percent of government budgets.<sup>16</sup> The performance of procurement systems is especially important for aid-dependent countries that seek to develop countercyclical measures during economic crisis and/or that rely on timely imports of essential goods and services, such as basic foodstuffs, to protect their vulnerable citizens. In this respect, good national procurement systems play a pivotal role in preventing misuse and leakages of public resources, in curbing corruption, and in ensuring that public investments in goods and services are of standard quality and quantity.<sup>17</sup> For example, responding to crises by creating labour- and capital-intensive works, such as large public infrastructure programmes, requires the availability of robust procurement systems capable of delivering large infrastructure projects transparently and effectively. In developing countries, where systems are weak, these projects are particularly subject to resource leakages and rampant corruption. Building robust procurement systems and reforming them is most needed, not only to minimize the effects of the crises by supporting the implementation of countercyclical programmes (i.e., public procurement of foodstuffs), but also to restore the levels of economic growth and development gains that the crises have eroded. For example, since recovering from the Asian financial crisis of the late 1990s, the Government of Indonesia identified weaknesses in its procurement and services delivery as a contributing factor to worsening the effect of the crisis, and thus embarked on a large-scale reform of its national public procurement system, to better prepare for future shocks.<sup>18</sup>



Building good national procurement systems or strengthening existing ones is especially important for countries that are dependent on imports of essential goods and services, such as foodstuffs, at times of soaring food prices. Least-developed landlocked countries (LLDCs), such as Malawi and the Niger, need robust procurement systems to import food and other essential goods. The underlying cause for increased dependence on imports in the Niger is the structural adjustment programmes, such as trade liberalization, that were implemented beginning in 1994 and have caused the gradual depletion of food reserves and been replaced by monetized equivalents (Deotti 2006). Capacity deficits within national procurement systems, compounded by inefficient domestic and regional markets, contributed to the overall worsening of the

impact of the recent food price crises on the nutritional level of the poor and on the availability of food, even when Malawi and the Niger were able to take relatively strong anti-poverty and social protection measures.<sup>19</sup>

Procurement policies also play a pivotal role during crises when they economically empower the poor and other vulnerable social groups by, for instance, promoting local hiring practices or by opening procurement and contract opportunities to SMEs, women- and minority-owned businesses, and community-based organizations.

*Reliable data and monitoring and evaluation systems at the national and local levels are critical for designing evidence-based responses and targeting interventions.*

### *Monitoring and Evaluation*

The complexity and scope of the recent global economic crisis have affirmed the need for accessing real-time data on the impact of economic (and other) shocks. Reliable data and monitoring and evaluation systems at the national and local levels are critical for designing evidence-based responses and targeting interventions.

When the economic crisis unfolded in 2008, some Eastern European and Central Asian countries did not have up-to-date and policy-relevant statistical data to collect baseline information necessary for evidence-based policy formulation, implementation, and impact assessments. Weak monitoring and weak analysis of economic trends left countries such as Kazakhstan, Hungary, and Serbia without a deeper understanding of the effect of the crisis on their populations and industries; consequently, such countries were unable to sufficiently mitigate the impact (RCPAR and UNDP 2011).

Statistical systems that provide consolidated socio-economic information about households, such as Brazil's single registry system (Mostafa and da Sliva 2007), proved useful in expanding existing social protection programmes through top-ups or in identifying new vulnerable households. In contrast, institutions in Kenya, the Sudan, Uganda, Zambia and the United Republic of Tanzania lacked the necessary research and analytical capabilities to identify and quantify the effects of the crisis (ODI 2011). In Uganda, the analytical tools available to the Ministry of Finance, Planning and Economic Development and the Bank of Uganda were inadequate to capture the full impact of the crisis. In the Sudan, the Ministry of Finance and National Economy did not possess the trained staff with the skills to analyse the extent and depth of the economic crisis. In addition, these countries did not have policy centres or think tanks capable of producing sound policy recommendations to support an informed decision-making process (ODI 2010). Countries that want to better prepare for future shocks thus need to invest in long-term reform processes that build or address underlying weaknesses of country systems, including PFM, procurement and monitoring and evaluation systems.



## Governance Principles

Core values and principles of democratic governance<sup>20</sup> are important means of achieving and maintaining development goals as recognized by UN member states in the Millennium Declaration in 2000 and include: participation; equity, non-discrimination and inclusiveness; gender equality; rules-based; transparency; and accountability and responsiveness. They are congruent with key human rights principles set out in a variety of UN declarations and conventions and can be summarized in three core principles:<sup>21</sup> participation and inclusion,<sup>22</sup> accountability and rule of law<sup>23</sup> and equality and non-discrimination (UNDP 2010b).<sup>24</sup>

### *Definition of Core Governance Principles and Country Examples*

#### *Participation and Inclusion*

Participation and inclusion include empowerment through representation in government and through other (e.g., administrative and local) mechanisms facilitating free, active and meaningful participation in decision-making processes. In economic crises, the participation of civil society in the formulation and adoption of crisis responses has been recognized as being particularly useful in providing alternative sources of information — and thus in framing policy debates (IDEA 2010) — as well as in increasing citizens' ownership of results (RCPAR and UNDP 2011). Some argue that democratic mechanisms such as civic participation in political processes lead to political instability, but the evidence shows that the reverse is often true: even though socio-political unrest and handovers of power do occur more often in democracies than in dictatorships, they do not disrupt the overall development process as they do in dictatorships (UNDP 2000).

Further, participatory political regimes generally deliver better growth because they produce 'superior institutions' better-suited to local conditions for a number of reasons: participatory political regimes yield more predictable long-term growth rates and have more stability, since the wider range of decision makers results in greater diversification and lower risk in an environment rife with imperfect information (Rodrik 2000). Participatory political regimes also deliver better distributional outcomes by producing greater equality (Rodrik 2000).

Better development outcomes, especially in times of crisis, can be explained through the core characteristics of representative government: shared power, openness, and adaptability. Shared power fosters a climate of innovation and entrepreneurship, reflective policy-making, and thus steady growth; openness promotes the exchange of information and ideas, and greater efficiency (e.g., in the allocation and use of resources); and adaptability (i.e., the flow of ideas among public, private and civic sectors) promotes greater versatility, timeliness and flexibility in the adoption and implementation of policies, while the legitimate regular renewal of political leadership avoids conflict and allows for innovation (Halperin et al. 2010).

Meaningful and free participation of citizens and stakeholders in decision-making processes during times of crises contributes to the overall adaptability and stability of institutions and promotes innovative policy dialogues. In the Asian financial crisis of the 1990s, mechanisms of participation, consultation, and bargaining in Thailand and the Republic of Korea enabled policy makers to fashion the consensus needed to undertake the necessary policy adjustments decisively and thus to handle the crisis significantly better than Indonesia (Rodrik 2000). Generally, the hardest hit countries in an economic crisis tended to be those with few political liberties, such as Syrian Arab Republic, Algeria, Panama, and Gabon, while countries with open political regimes, such as Costa Rica, Botswana, Barbados, and India, fared much better (Rodrik 2000).



## Box 8.1: Moldova's National Participation Council

Following the July 2009 elections in Moldova, the government in February 2010 established the National Participation Council as an advisory body and a liaison between the government, civil society, and the private sector. The Council consists of 30 members representing Civil Society Organizations (CSOs) from various fields whose primary task is 1) to participate in policy-making through providing expert opinions on draft policies and strategic

documents and conducting and presenting independent assessments of policies' impacts; and 2) to contribute to establishing the institutional framework for consultation. The government involved the Council in the consultation process when developing the anti-crisis legislation, which allowed for the measures to better reflect the needs and concerns of the public.

**Source:** United Nations Development Programme/Bratislava Regional Centre and Regional Centre for Public Administration Reform, 2011, *Economic Crisis Responses from a Governance Perspective in Eastern Europe and Central Asia: Regional Report*; Asipovich, H., 2010, 'Country Report: Moldova', *The International Journal of Not-for-Profit Law*, Vol. 12, Issue No. 4..

Using a methodology called the called Prospective Political Analysis and Prospective Scenarios Project (PAPEP, for its Spanish acronym) that provides a political economy analysis in highly political decision-making processes in the face of an economic crisis,<sup>25</sup> UNDP contributed to consensus building in various countries, particularly in Latin America, that faced tough decisions because of economic crisis.<sup>26</sup> For example, the PAPEP methodology was employed in El Salvador during 2008–2009 when that country was embroiled in the global economic crisis and a new government was in power there. The process helped build a consensus with the opposition party about the best policies to adopt for economic recovery and contributed to the smooth transition of power.<sup>27</sup>

### *Accountability and Rule of Law*

Participation hinges on effective accountability and rule of law. With regards to the current crisis, it has been recognized that, "[as] governments assume a broader, more significant role in response to the crisis, it becomes even more important that they are effective and accountable — otherwise, they would compound the severity of the problems" (Peters et al., n/d). Empirical research has substantiated this more and more. For example, research shows that, when opposition parties draw attention to the effects of a crisis, governments will have greater incentive to prevent crises such as famines (Sen 1999 and UNDP 2000). Thus, greater accountability on the part of leaders and the ability of the system to advance popular demands and negotiate distributive pressures can lead to more concerted and effective policy responses to a crisis such as an economic downturn and thus provide a source of resilience (IDEA 2010).

Where the rule of law exists, it is easier to manage potential conflicts during crisis. In the Republic of Korea and Thailand, for example, democratic processes facilitated a smooth transfer of power from a discredited set of politicians to a new government through institutionalized mechanisms of 'voice'; consequently, the Korean and Thai institutions obviated the need for riots, protests, and other kinds of disruptive actions by affected groups (Rodrik 2000).

An effective rule of law can also support reforms or adaptation processes within state functions and overall government performance. Some countries, such as Kenya and the Sudan, have specific institutional arrangements to ensure communication and consultation between key government departments (e.g., the



Prime Minister's office and the Ministry of Finance) and with other key institutions such as central banks (ODI 2011). Other countries, such as Kazakhstan and Latvia, have tried to merge state assets and optimize expenditure (UNDP 2011).

### *Non-Discrimination and Equality*

Equality addresses power inequalities (be they political, economic, legal, or cultural) and requires the extension of development gains to the most excluded groups and individuals (OHCHR 2008). Institutions that ensure non-discrimination and equality can mitigate the effects of a crisis on the most vulnerable, such as through the facilitated ring-fencing of social expenditure and the prevention of the erosion of normative standards in times of crisis. Some countries have strong governance mechanisms that can be used to this end during an economic crisis, for example, the judiciary system (see Box 8.2).

An increasing body of literature on states in fragile situations refers to principles such as those discussed above and stresses that they generate an important driver for organizational legitimacy.<sup>28</sup> The argument is that an organizational legitimacy, understood as a societal acceptance of regimes and institutions, affects the effective exercise of power and authority. This will be further discussed below in the section on linkages.

### *Measures of Governance Principles*

There have been numerous efforts to develop indicators for governance. Many focus strongly on measuring political freedoms and the rule of law. A recent World Bank study, summarized below, contains a useful discussion of indicators for measuring the three core governance principles discussed in this paper (World Bank 2010).<sup>29</sup> These indicators are meant to be descriptive and illustrative, not prescriptive or comprehensive:

- Regarding equality and non-discrimination, the study suggests indicators that target exclusion, discrimination, and inequality in general, and that can be developed through disaggregation of data not only by gender, but also by age, citizenship, etc. In general, indicators related to equality should focus more on the most excluded and vulnerable groups.
- Regarding accountability, the study proposes indicators that capture mechanisms of monitoring and independent oversight (such as establishment of ombudsmen's offices, and human rights monitoring

## **Box 8.2: Role of the Judiciary System in Crisis Response**

In Latvia, the Parliament voted in December 2009 to further shrink the 2010 budget through spending cuts and tax increases, including a 10 percent decrease in pensions and a 70 percent decrease for working pensioners. Later that month, the Constitutional Court ruled the pension cuts unconstitutional on the grounds that they violated residents' right to social security. As a result, the cuts had to be reversed.

In Romania, 15 percent pension cuts proposed in May 2010 were declared unconstitutional the following month. Although pensions partly funded by worker contributions are constitutionally protected, the government had circumvented this protection on the grounds of a separate constitutional article allowing the temporary limitation of certain rights in order to defend national security.

**Source:** United Nations Development Programme/Bratislava Regional Centre and Regional Centre for Public Administration Reform, 2011, *Economic Crisis Responses from a Governance Perspective in Eastern Europe and Central Asia: Regional Report*.



# Governance Principles, Institutional Capacity and Quality

at the domestic level), institutionalization of complaints facilities that are anchored in national institutions or in specific parts of the executive branch, as well as access to formal and informal justice (such as local and community dispute resolution mechanisms and those that link formal and informal systems).

- Regarding participation, the study proposes indicators that can capture civil society involvement in policy processes such as the poverty reduction strategies, processes of advocacy and empowerment (e.g., dialogues, collaborative activism, and community participation by specific groups), and legal outcomes, such as the establishment of laws allowing the flourishing of an independent civil society.

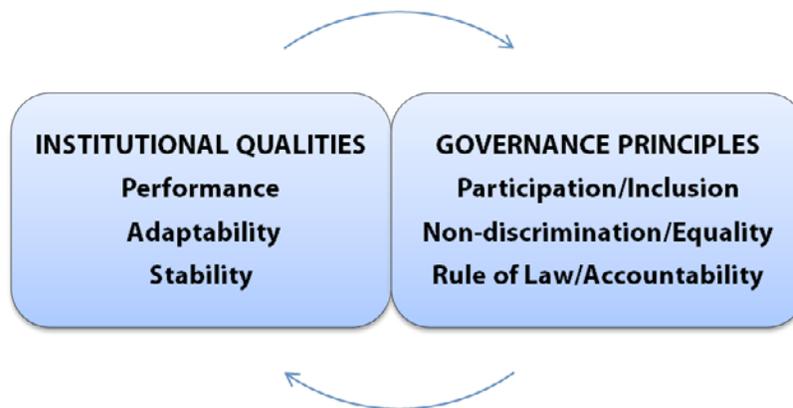
UNDP’s Governance Assessment Programme has compiled another useful report presenting an overview of 35 sources of governance indicators (UNDP 2007).<sup>30</sup> Based on this study, the most common categorizations of governance indicators are:

- Input/rights/commitment/*de jure* — at this level, the indicators might typically cover commitments made by countries, including national constitutions and commitment to international treaties.
- Process/responsibility/*de facto* — these would include the existence of functioning institutions to ensure that obligations are fulfilled and would typically look at processes documenting the fulfilment of these responsibilities and commitments.
- Output/outcome/enjoyment/performance/*de facto* — this type of data would typically look at the number of people enjoying or not enjoying their economic, social and civic rights, and would include indicators of the results of commitments, for example, the percentage of government spending for the poor and vulnerable, as verified by an independent audit.

## Linkages Between Institutional Qualities and Key Governance Principles

The institutional qualities and governance principles mentioned above are interlinked and mutually supportive, as Chart 8.1 illustrates.

**Chart 8.1: Linkages**





On the one hand, governance principles provide the environment that enables institutions to perform, adapt and remain stable, especially in a crisis. For example, ensuring that state institutions account for decisions, actions and results (accountability) makes these institutions more efficient and effective in addressing the changing needs and demands of a society (performance). Another example that illustrates the enabling effect of governance concerns participation: as described earlier, involving people in decision-making processes (participation) helps institutions become more responsive and to gain more legitimacy, especially when faced with tough choices amidst resource scarcity (adaptability).

On the other hand, institutions responsible for realizing and upholding these governance principles need to perform, adapt and be stable. This means that institutions responsible for ensuring accountability (e.g., anti-corruptions commissions, judicial bodies, ombudsmen's offices, parliaments) also need to perform well to fulfil their mandates and to gain legitimacy. With regard to participation, institutions and mechanisms that ensure participation (such as town hall meetings of local governments and local boards for service provision) also need to be able to adapt to better respond to beneficiaries' needs.<sup>31</sup>

The interrelationship between these governance principles and institutional qualities as described above is valid in any development situation. Nevertheless, as country examples in this report show (and as highlighted below), these linkages between institutional qualities and governance principles seem to be particularly important to ensure governments' effective response to an economic crisis:

- Where task forces and mechanisms for policy development and coordination have been institutionalized (rule of law), countries have had greater capacity to develop and implement more coordinated policy responses to an economic crisis (adaptability), as in the cases of Mauritius, Bangladesh, the United Republic of Tanzania and Lebanon.
- The effective rule of law can also support adaptation processes within state functions and government performance under distress. For example, in a country with a clear system of checks and balances and institutional arrangements, it is easier to introduce complementary or alternative mechanisms needed to boost the effectiveness of a response to a crisis, including the ability of the country to respond to citizens' demands and to negotiate distributive pressures (IDEA 2010).
- Broad stakeholder participation ensures innovation and policy dialogue and thus adaptability of institutions. For example, realizing the centrality of innovation for building greater resilience to respond to shocks, Chile has been investing in the past decade in strengthening its capacities to develop innovative policies and to move away from ineffective *ad hoc* development interventions (IDB 2010).<sup>32</sup>

The concept of organizational legitimacy mentioned above similarly demonstrates the linkages between institutional qualities and governance principles. Much of the current literature mentions several sources of legitimacy.<sup>33</sup> For state institutions in the process of responding to an economic crisis, two sources seem particularly relevant: 1) input or process legitimacy, when the legitimacy of the organization or institution is tied to agreed rules and procedures that govern decision-making processes, including the organization of participatory measures; and 2) output or performance legitimacy that is defined in relation to the performance, effectiveness and quality of services and goods that the state delivers. Thus, organizations that adhere to societal expectations about their mandates, actions, structures, and performance and that build an ongoing reputation for their relevance, appropriateness and correctness are viewed as trustworthy and reliable, especially during sensitive decision-making processes as part of a response to a crisis.



## Policy Recommendations and Conclusion

Developing countries, especially the LDCs, would do better to take a longer-term view when responding to crises, as the successful implementation of inclusive and equitable countercyclical measures largely depends on the countries' core systems, such as merit-based civil service, oversight bodies (such as judiciary systems), public financial mechanisms, and national implementation mechanisms (such as procurement). Not having

strong institutional capacities, countries may be forced to resort to *ad hoc* measures that may not be sustainable in the long run. If forced to resort to these measures, though, countries should nevertheless make continued investments to address underlying institutional weaknesses.

*Developing countries, especially the LDCs, would do better to take a longer-term view when responding to crises, as the successful implementation of inclusive and equitable countercyclical measures largely depends on the countries' core systems.*

Country examples indicate that boosting of institutional qualities within systems at the forefront of the crisis response requires continuous and endogenous improvements and changes, especially in risk analyses, upfront investments in critical human resources, and the institutionalization of good practices and norms. The main recommendations are:

- Improve the quality of implementation of anti-poverty and social protection programmes by attracting and retaining skilled national talent and by generally investing in merit-based civil service
- Frontload investments such as data collection, information and risk management systems in order to increase, relatively quickly, the core capacities needed to forecast and analyse the impact of crises, implement targeted social protection measures
- Prioritize investments to improve capacities of services delivery mechanisms at the sub-national and local levels to enable the provision of direct benefits for citizens' livelihoods
- Systematize innovative, proven and effective procedures, institutional arrangements, mechanisms, and other interventions to ensure continuous and consistent institutional performance, even during times of crises
- Invest in reforms to strengthen PFM systems, including budget management, in order to prepare countries for an effective and efficient response to future economic crises
- Strengthen national procurement systems to prevent misuse and leakages of public resources during crises (especially in countries dependent on foreign aid and/or imports of basic foodstuffs).

When key institutions involved in crisis response uphold governance principles such as inclusion/participation, rule of law/accountability and non-discrimination/equality, greater consensus, wider public support and sustainable results are more likely. Contrary to opposing claims, these can reduce transaction costs down the road. Important recommendations for the use of the governance principles identified in the report are:

- Strengthen oversight institutions (e.g., constitutional courts, national human rights institutions) in order to protect the rights of the vulnerable groups



- Improve the ability of a system or institution to negotiate, through inclusive and transparent processes, distributive measures, which can lead to more concerted and effective policy responses and thereby bolster the legitimacy of state institutions
- Institutionalize and/or strengthen participatory decision-making and consultation processes at the national level (e.g., establish civil society councils or inclusive policy round tables)
- Invest in effective ‘voice mechanisms’ that allow for the free, active and meaningful participation of citizens and stakeholders in the decision-making processes at the local level (e.g., establish local service delivery boards)
- Invest in institutions that ensure non-discrimination and equality
- Facilitate the ring-fencing of social expenditure and prevent the erosion of normative standards during crisis.

*Development partners need to support countries through longer-term investments to improve the functioning of key institutions, even in the face of crisis.*

While the discussed governance principles and institutional qualities are always important for the basic functioning of the state, they are particularly critical during economic crises, especially if states hope to take countercyclical measures and to protect the welfare and livelihoods of their poorest and most vulnerable citizens. Taking this route, countries can avoid implementing recovery measures that could erode social protection measures and gains in human development, including the achievement of MDGs.

Development partners need to support countries through longer-term investments to improve the functioning of key institutions, even in the face of crisis. In the case of countries heavily dependent on aid, development partners need to support the development of greater institutional and fiscal space to design and implement countercyclical measures. Partners can also provide alternative policy advisory options that put human development first. This requires a careful consideration of the dynamics of political economy (power) in order to ensure that decisions ultimately support the rights of the poor and disenfranchised.



## Notes:

1. Institutions can also be defined as “the rules of the game in a society. [...] [T]hey structure incentives in human exchange, whether political, social or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change” (North 1990:3–5, in UNDP Arab Human Development Report (2002)).
2. See further deliberation on the concept of legitimacy under Governance Principles section.
3. Innovation is usually driven by capable and visionary leaders, and entails investments in capacities requiring a longer gestation period (i.e., the introduction of new institutions), such as investments in skills development and education, R&D and new technologies, and forward-looking reforms (UNDP 2010).
4. This section is a summary of UNDP (2010), *Measuring Capacity*.
5. The OECD-DAC defines country systems as national arrangements that are established in national legislation, including public financial management, procurement, audit and monitoring and evaluation, social and environmental assessments. The IDB defines procurement country systems as incorporating all policies, procedures, instruments, controls, and organizational structures that govern the acquisition of goods, works, and consulting services required by public sector institutions.
6. Civil service is part of the public human resource management system (HRM). This chapter discusses civil service only, without detailing other components of the HRM.
7. Kohli finds a high degree of correlation between superior bureaucracy and high rates of economic growth (e.g., the Republic of Korea, Taiwan, Malaysia, India), and poor quality bureaucracy and low rates of economic growth (e.g., Nigeria, the Congo, Argentina and Syria).
8. For example, Zambia no longer has a civil service academy, where newly recruited and career civil servants are trained.
9. Local governments play a critical role in addressing disparities and, by virtue of their mandate, are pivotal in identifying and delivering locally relevant social protection and MDG measures to protect vulnerable populations from the effects of crises. For more information, see UNDP (2010) *Scaling Up Support for the MDGs at the Local Level*.
10. These examples are summaries from te Velde, D. W. et al. (2009) and Foresti, M. et al. (2011).
11. Anecdotal evidence gathered by UNDP CDG. For other country stories on institutions, visit [www.undp.org/capacity/publications.shtml](http://www.undp.org/capacity/publications.shtml)
12. According to the World Bank study *The Global Economic Crisis: Assessing Vulnerability with a Poverty Lens* (2009), ‘the capacity of governments to cope with the impacts of the crisis’ depends on 1) fiscal capacity to absorb an increased fiscal deficit and 2) institutional capacity to implement programmes aimed at mitigating the poverty impact of the crisis. Institutional capacity in this paper is measured by a country’s capacity to efficiently and effectively scale up public expenditures and by its ability to protect the poor. The indicators to assess such capacities are derived from the World Bank’s Country Policy and Institutional Assessment (CPIA) questions 13–16, quality of budget and financial management, efficiency of revenue mobilization, quality of public administration, transparency, accountability and corruption in the public sector, and questions 10a, d, e — the quality of social protection policies and equity of public resource use.
13. IMF: [www.tinyurl.com/pfm0903blog](http://www.tinyurl.com/pfm0903blog)
14. *ibid.*
15. The Public Financial Management (PFM) Performance Measurement Framework, an indicator-based assessment tool, is developed by the Public Expenditure and Financial Accountability (PEFA) initiative: [www.tinyurl.com/pfm-pefa](http://www.tinyurl.com/pfm-pefa)
16. AfDB: [www.tinyurl.com/AfDB2009nov](http://www.tinyurl.com/AfDB2009nov)
17. *ibid.*



18. Snapshot Assessment of Indonesia's Public Procurement System as of June, 2007 Piloting OECD/ DAC Procurement JV Baseline Indicator (BLI) Benchmarking Methodology.
19. For further details, see Cornia Giovanni (2011) *Food Security under Price Volatility*, presentation to UNDP RBA March 2011. Publication forthcoming.
20. Governance is the system of values, policies and institutions by which a society manages its economic, political and social affairs through interactions within and among the state, civil society and private sector. It is the way a society organizes itself to make and implement decisions — achieving mutual understanding, agreement and action. It comprises the mechanisms and processes for citizens and groups to articulate their interests, mediate their differences and exercise their legal rights and obligations. It is the rules, institutions and practices that set limits and provide incentives for individuals, organizations and firms. Governance, including its social, political and economic dimensions, operates at every level of human enterprise, be it the household, village, municipality, nation, region or globe. See further *UNDP Strategy Note on Governance for Human Development*, 2000.
21. As agreed in the UN Common Understand Understanding of a Human Rights Based Approach to Development Cooperation (UNDG 2003).
22. Every person and all peoples are entitled to active, free and meaningful participation in, contribution to, and enjoyment of civil, economic, social, cultural and political development in which human rights and fundamental freedoms can be realized (UNDG 2003).
23. States and other duty-bearers are answerable for the observance of human rights. In this regard, they have to comply with the legal norms and standards enshrined in human rights instruments. Where they fail to do so, aggrieved rights holders are entitled to institute proceedings for appropriate redress before a competent court or other adjudicator in accordance with the rules and procedures provided by law (UNDG 2003).
24. All individuals are equal as human beings and by virtue of the inherent dignity of each human person. All human beings are entitled to their human rights without discrimination of any kind, such as race, colour, sex, ethnicity, age, language, religion, political or other opinion, national or social origin, disability, property, birth or other status as explained by the human rights treaty bodies (UNDG 2003).
25. Political economy analysis is not a new concept, but is emerging with renewed interest and recognition from policy makers, especially given the recent political changes in the Middle East. Political economy analysis is 'concerned with the interaction of political and economic processes in a society, the distribution of power and wealth between different groups and individuals, and the processes that create, sustain and transform these relationships over time.' Such power relationships 'ultimately underpin the social contract that both enables and applies pressure on the state to be responsive, capable and inclusive' (p. 5) UNDP Political Economy Guide, 2011 (forthcoming) and OECD-DAC [www.oecd.org/dac/governance/politicaconomy](http://www.oecd.org/dac/governance/politicaconomy).
26. According to PAPEP, the following three factors contribute to the successful implementation of policies and reforms, especially in times of crises: political agreements, stakeholder consensus, and political timing.
27. UNDP Political Economy Guide, forthcoming, p. 53.
28. 'State legitimacy is the basis for rule by consent rather than coercion.' For further details, see OECD (2010) *The State's Legitimacy in Fragile Situations* and Brinkerhoff (2005) and *Organizational Legitimacy, Capacity and Capacity Development*, ECDPM. [www.tinyurl.com/3jg2vgk](http://www.tinyurl.com/3jg2vgk)
29. World Bank (2010), McInerney-Lankford, S. and Sano, H.-S., Human Rights Indicators in Development.
30. [www.gaportal.org/sites/default/files/undp\\_users\\_guide\\_online\\_version.pdf](http://www.gaportal.org/sites/default/files/undp_users_guide_online_version.pdf)
31. An interesting example for this comes from the application of UNDP's MDG Acceleration Framework (MAF) in Belize, where the government is now adapting the composition of local water boards to ensure better representation of rural populations, particularly indigenous peoples, who were previously left out from the process (and consequently were



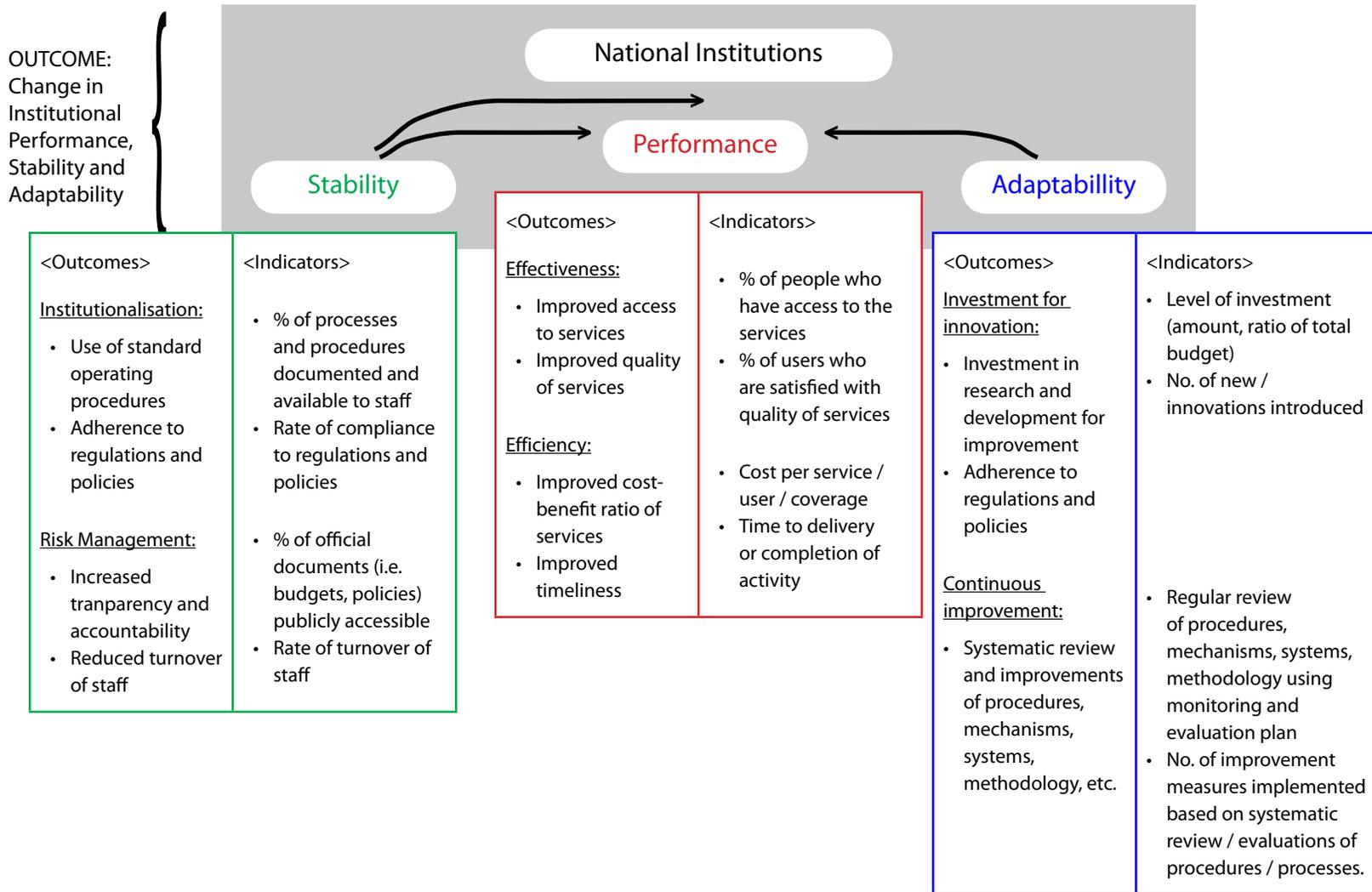
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not receiving adequate water and sanitation services). See UNDP (2010), *Unlocking progress: MDG acceleration on the road to 2015*.

32. Chile established the National Council for Innovation and Competitiveness (NCIC) and well as the Committee of Ministers of Innovation (CMD) as the national institutions in charge of developing a strategy for innovation. Regional development agencies have also been established as the institutional referent for innovation policy in the regions. Broad stakeholders' participation also ensures long-term support for innovation. As innovation takes place in networks, which have local, national and international constituencies, the agencies in charge of strategic planning and coordination of innovation policy (i.e., the NCIC and CMI) have been entrusted with promoting policy dialogue across different levels of governments and institutions, as well as civil society (IDB 2010).
33. These sources can be: input or process legitimacy, when the legitimacy of the organization or institution is tied to agreed rules of procedure through which the organization or institution takes binding decisions and organizes people's participation; output or performance legitimacy, defined in relation to the performance, effectiveness and quality of services and goods that the state delivers; shared beliefs, including a sense of political community, and beliefs shaped by social practices and structures, political ideologies, religion and tradition that allow people to see the state or other form of public authority as the overarching, rightful authority (marriage is a typical example of a legitimate institutions based on shared beliefs, even though same-sex marriage in many countries has not yet reached that level of legitimacy due to lack or weakness of shared beliefs); and international legitimacy, which is recognition of the state's sovereignty and legitimacy by external actors (this, in turn, affects its internal legitimacy). Organizations and institutions can also gain international legitimacy (e.g., the manner in which a drug enforcement agency or an anti-corruption commission gains international legitimacy through its handling of issues (e.g., drugs and corruption) that are high on the international agenda). [www.tinyurl.com/ECDPM2005jun](http://www.tinyurl.com/ECDPM2005jun)



## Annex 8.A: UNDP Framework for Measuring Change in Institutional Performance, Adaptability and Stability



Source: Developed by UNDP CDG.



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