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.
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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). 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 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.

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.

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 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). 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).

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. These indicators include:
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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, 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
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Source: Calculated from World Bank, World Development Indicators 2011


Source: Calculated from World Bank, World Development Indicators 2011
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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; commit to an approved poverty reduction and growth strategy; and have previously undergone a successful IMF assessment. 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. 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.

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).²

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>
<thead>
<tr>
<th>Region</th>
<th>Average Fiscal Balance (% of GDP)</th>
<th>Average GDP Growth (% of GDP)</th>
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<tbody>
<tr>
<td>A&amp;P</td>
<td>-1.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Africa</td>
<td>-1.6</td>
<td>4.3</td>
</tr>
<tr>
<td>Arab States</td>
<td>-2.5</td>
<td>4.8</td>
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<tr>
<td>ECIS</td>
<td>-1.9</td>
<td>5.0</td>
</tr>
<tr>
<td>LAC</td>
<td>-1.6</td>
<td>3.5</td>
</tr>
<tr>
<td>All Regions</td>
<td>-1.7</td>
<td>4.5</td>
</tr>
</tbody>
</table>

*Source: Calculated from World Bank, World Development Indicators 2011 and IMF, World Economic Outlook 2011*
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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.10

Fourth, fiscal balances have, despite pronounced cyclicality, 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 200911 (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.

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

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.
framework for the sovereign debt of LICs\textsuperscript{12} 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’.\textsuperscript{13} It is noteworthy that six post-completion HIPCs 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.\textsuperscript{14} Although countries may apply to the Paris Club under the Evian Approach,\textsuperscript{15} 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\textsuperscript{16} reveals that, despite evident procyclicality, the fiscal position for developing countries as a whole improved between 1995 and 2007 (Chart 7.4).\textsuperscript{17} 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.\textsuperscript{18} 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)](chart)

\textbf{Source:} Calculated from World Bank, World Development Indicators 2011
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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 2007.19

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.

*Source: Calculated from World Bank, World Development Indicators 2011 and IMF, World Economic Outlook 2011*
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Chart 7.6: Fiscal balance by development status, 1995–2009 (percent of GDP)

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. 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.

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...
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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”23 (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. 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).
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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).24

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’.25 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 macroeconomic 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.
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**Chart 7.7: Current account balance for developing countries, 1995–2009 (percent of GDP)**

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.

*Source: Calculated from World Bank, World Development Indicators 2011*
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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.
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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. 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
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**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.
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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 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. 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 States.
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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 2007.29 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 2009,30 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.
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Chart 7.13: Gross savings rate by development status, 1995–2009 (percent of GDP)

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

Source: Calculated from World Bank, World Development Indicators 2011
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**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 households31 (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
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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
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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.32

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).
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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 counties, 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).


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 (Muchhal 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:

- 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,33 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.34 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
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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
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- Introducing automatic stabilizers, such as Fiscal Stabilization Funds, 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).

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. 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 (Baunsgaard 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. Pro-cyclical 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.
Economic Resilience and Fiscal Capacity

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

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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
References


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