



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, lower 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).

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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.¹ “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 hole² 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.³ 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,⁴ 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.⁵

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 vulnerability, 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.⁶



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 flows⁷ 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.

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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.

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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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