Fiscal Policy in Developing Countries: Implications from the Current Crisis

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A Two-fold Message

1. Aggressive counter-cyclical fiscal policies are among the factors differentiating the current global economic crisis from the Great Depression.

2. Setting aggressive fiscal policies as a cornerstone of crisis response is an idea that may not travel well to many developing countries.
Part I

Why the current global economic crisis differs from the Great Depression

- Larger weight of developing countries
- Larger share of services in global activity
- Changes in the structure of world trade
- Different policy responses: monetary, financial sector, and fiscal policies

Stylized scenarios for the recovery

Part II

Fiscal policies in developing countries

- Channels of transmission of the crisis on developing countries
- Fiscal policy responses to the crisis: constraints and options
Source: Eichengreen, B. & O’Rourke, K. – “A tale of two depressions”, VoxEu, (updated) 06/04/09
Larger weight of developing countries

China and India: Share of World GDP (%)
(Constant 2000 Market Prices and Exchange Rates)

World Output Growth 1961 - 2011
(% Change)

Source: World Bank WDI and GDF.

Larger share of services in global activity

World export growth appears to be bottoming
exports, ch % seasonally adjusted annual rates (saar)

Bulk freight rates starting to recover from extreme lows

Source: World Bank data

Source: Datastream and DECPG Commodities Group
Policy Responses (1): Central Banks’ Total Assets
(Index, 12/29/06 = 100)

Source: IMF – World Economic Outlook, 2009
Policy Responses (2):
Fiscal Stimulus and Financial Sector Support

1/ In percent of 2009 GDP. Excludes below-the-line operations that involve acquisition of assets.
2/ As of Apr. 15, 2009, in percent of 2008 GDP. Consists of capital injection, purchase of assets and lending by Treasury, and central bank support provided with Treasury backing.
Source: IMF
Stylized scenarios for the recovery

Part I

Why the current global economic crisis differs from the Great Depression
• Larger weight of developing countries
• Larger share of services in global activity
• Changes in the structure of world trade
• Different policy responses: monetary, financial sector, and fiscal policies

Stylized scenarios for the recovery

Part II

Fiscal policies in developing countries
• Channels of transmission of the crisis on developing countries
• Fiscal policy responses to the crisis: constraints and options
Channels of Transmission of the Crisis on Developing Countries

- Lower and more selective private capital flows
- Declining migrant remittances
- Squeezing aid flows
- Lower and more volatile commodity prices
- Smaller world trade volumes
First-half volumes halved from a year earlier

<table>
<thead>
<tr>
<th>Gross capital flows to emerging markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ billion</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Bonds</td>
</tr>
<tr>
<td>Banks</td>
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<tr>
<td>Equity</td>
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<tr>
<td>Bonds</td>
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<td>E. Europe</td>
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<tr>
<td>Bonds</td>
</tr>
<tr>
<td>Asia</td>
</tr>
<tr>
<td>Bonds</td>
</tr>
<tr>
<td>Others</td>
</tr>
</tbody>
</table>

Source: DECPG Finance Team
Changing composition of private capital flows to developing countries

$ billions

Percent of GDP (right axis)

Debt
Port Equity
FDI inflows

Source: DECPG/GDF 2009
Cross border bank flows remain well below the levels seen in previous years
(billions USD, 3-month moving average)

Source: Loanware and Bondware
EM assets rebound from recent corrections

MSCI equity index, USD [left]; EM bonds spreads, bps [right]

Source: Morgan-Stanley and JPMorgan-Chase.
Potential declines in remittances & ODA

Remittance Flows to Developing Countries (USD, % Change)

Source: World Bank data and staff estimates
Oil prices and OECD oil stocks

Source: IEA and DECPG Commodities Group.
Food prices edged higher in June

Source: DECPG Commodities Group
Metals prices ease following large gains in first-half 2009

Source: LME and DECPG Commodities Group
Fiscal policy responses to the crisis in Developing Countries: constraints and options

1. Macroeconomic Constraints
   - Fiscal sustainability
   - External constraints
   - Domestic financing options
   - World Bank Fiscal Survey results

2. Institutional Constraints

3. Protection of “Core Spending”
G20 Government Debt: medium term prospects

- Significant expansion of public debt in G20 economies may shrink the space available for riskier sovereign debt

### Public Debt/GDP Ratios

<table>
<thead>
<tr>
<th>Country</th>
<th>2007</th>
<th>2009</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advanced G20</td>
<td>77.6</td>
<td>97.7</td>
<td>114.1</td>
</tr>
<tr>
<td>Emerging G20</td>
<td>37.8</td>
<td>38.7</td>
<td>35.0</td>
</tr>
<tr>
<td>USA</td>
<td>63.1</td>
<td>87.0</td>
<td>106.7</td>
</tr>
<tr>
<td>Japan</td>
<td>187.7</td>
<td>217.2</td>
<td>234.2</td>
</tr>
<tr>
<td>UK</td>
<td>44.1</td>
<td>62.7</td>
<td>87.8</td>
</tr>
<tr>
<td>Korea</td>
<td>33.0</td>
<td>40.0</td>
<td>51.8</td>
</tr>
<tr>
<td>Brazil</td>
<td>67.7</td>
<td>65.4</td>
<td>54.1</td>
</tr>
<tr>
<td>China</td>
<td>20.2</td>
<td>19.8</td>
<td>17.9</td>
</tr>
<tr>
<td>India</td>
<td>80.4</td>
<td>86.8</td>
<td>76.8</td>
</tr>
</tbody>
</table>

(Source: IMF, WEO, 2009)
How different factors impact a country’s scope for fiscal stimulus

Quality of counter-cyclical fiscal policy matters

- Timeliness
- Delays in implementation
- Reversibility (ring-fenced from entrenched interest groups)
- Implications at the sub-national level
- Growth-enhancing measures
- Administrative capacity to provide short-run assistance to vulnerable groups
- Bail outs
- “Bang from the buck” (especially in cases of “low fiscal space”)
Additional fiscal spending for protecting core priorities in developing countries, 2009

Source: PREM, World Bank, “Protecting core public spending during the global economic crisis”, 2009
Fiscal Trends in Developing Countries, 2008–09

(Median change on the previous year, in % of GDP)

Source: PREM, World Bank, “Protecting core public spending during the global economic crisis”, 2009
The World Bank Group response

✓ Increase in IBRD lending (mix of Development Policy Loans (budget financing/fast disbursing: financial sector restructuring; contingent source of liquidity...) and Investment Loans (preserving infrastructure spending; support for clean technology; social safety nets...)) + fast-tracking IDA funds + Vulnerability Financing Facility + INFRA (support for infrastructure) + guarantees via MIGA + new IFC facilities (support for trade; recapitalization of banks; refinancing of microcredit institutions).

World Bank Group Commitments

Fiscal years 2009 and 2008 (in U.S. billions)

<table>
<thead>
<tr>
<th>World Bank Group</th>
<th>FY09*</th>
<th>FY08</th>
</tr>
</thead>
<tbody>
<tr>
<td>• IBRD</td>
<td>32.9</td>
<td>13.5</td>
</tr>
<tr>
<td>• IDA</td>
<td>14.0</td>
<td>11.2</td>
</tr>
<tr>
<td>• IFC</td>
<td>10.5+</td>
<td>11.4+</td>
</tr>
<tr>
<td>• MIGA</td>
<td>1.4</td>
<td>2.1</td>
</tr>
<tr>
<td>TOTAL</td>
<td>58.8</td>
<td>38.2</td>
</tr>
</tbody>
</table>

*Unaudited numbers as of July 1.
+Own account only. Excludes $4.5 billion in FY09 and $4.8 billion in FY08 mobilized through syndications and structured finance.
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