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Responding to external economic shocks: why state capacity and political incentives matter

Marta Foresti, Isabella Massa, Leni Wild and Dan Harris

Key points

- The effects of the global financial crisis vary between countries, depending on the structure of their economies, historical legacies and government policy responses
- The governance and institutional set up of a country is likely to influence its ability to respond effectively to economic shocks
- Understanding how politics and state capacity shape the response to shocks should inform donor support to affected countries

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The global financial crisis continues to affect prospects for growth and poverty reduction in developing countries. As in previous economic crises, the impact varies between countries. This reflects differences in economic structures, historical legacies and policies, and in the resulting levels of vulnerability to economic shocks. There is, however, growing recognition of the importance of the governance and institutional set up of a country in responding effectively to financial crises and other similar shocks. What is perhaps less clear is how, in reality, these affect policy responses and their implementation. There is a lack of evidence on the incentives for more sustainable and effective reform processes, beyond the immediate crisis, and on the blockages that might prevent such reform.

These issues are key to understanding the dynamics underlying developing countries' policy responses to economic shocks, and to informing both domestic and international priorities in this area. A political economy approach to the analysis of the role of state capacity and incentives to respond to economic shocks would help to fill these knowledge gaps (Box 1).

While more research is needed, this Project Briefing reviews the range of policy responses to the global financial crisis, as a first step. It sets out some useful frameworks and concepts to deepen our understanding of these issues, and to inform more effective assistance for countries affected by similar external shocks in the future.

Box 1: Political economy analysis

Political economy analysis examines interaction of political and economic processes in a society: the distribution of power and wealth between different groups and individuals, and the processes that create, sustain and transform these relationships over time.

Its main features include:

- a focus on the interests and incentives of different groups and how these generate policy outcomes that may promote or hinder development
- an analysis of politics and political processes of contestation and bargaining
- a concern with the role of institutions and of formal and informal 'rules of the game' and how these constrain what is possible
- an exploration of how values and ideas, including political ideologies, religion and cultural beliefs, influence political behaviour and public policy
- an emphasis on the potential for positive change which is politically feasible.

Source: DFID (2009).

The effects of the global financial crisis on developing countries

Globalisation, growing trade and financial links between countries reveal just how interconnected the global economic system has become (Box 2). This explains, in part, how a crisis that originated in late 2007 in a small number of developed countries came to have such far reaching consequences across the world.

Developing economies were hit hard by the crisis through private capital flows, remittances, trade and to a lesser extent aid. Economic growth dropped dramatically from almost 14% in 2007 to just over to 2% in 2009, and these values are expected to remain still significantly below their pre-crisis levels in the next few years (IMF, 2010).

Box 2: Globalisation and state capacity

Globalisation could limit the role and capacity of nation states as national outcomes are increasingly influenced by external actors and events. However, the process of globalisation itself is also shaped and driven by states and the impacts of globalisation depend on the historical and institutional contexts of state capacity in different countries.

From this perspective, states remain active agents, working on their own behalf to manage the challenges of a globalised world. Even as some features of the state are constrained, others, such as policy adaptability and institutions of economic management (i.e. central banks), are increasingly relevant in a complex globalised context.

Source: Weiss (1997).

The impact of the crisis on poverty reduction has been significant. As a result of the crisis, an additional 89 million people are estimated to be living in extreme poverty (below $1.25 a day) at the end of 2010 (World Bank, 2009a), while the global number of unemployed is expected to have increased by 34 million in 2009 compared with 2007 (ILO, 2010).

National governments implemented a number of policy responses including ad-hoc institutional arrangements, crisis task forces as well as fiscal, monetary and social policies. Although there is significant variation in how these responses were designed and implemented, responses specifically targeted at economic management appear to have been well designed in many countries, with no major policy reversals (te Velde et al., 2010). The available evidence on social policy responses is patchier and, in general, less positive.

Institutional and governance dimensions of policy responses

As in developed countries, the ability of developing countries to respond rapidly and effectively to crisis shocks depends not only on the existence of a reasonable fiscal space and macro-economic stability, but also on a number of governance factors including institutional, administrative and technical capacity. This is recognised by the International Monetary Fund, World Bank and many other institutions. According to the World Bank (2009b), one quarter of the developing countries exposed to the impacts of the crisis had institutional capacity that was too weak to increase public expenditure efficiently and effectively, protect vulnerable groups or contain the poverty impacts of the crisis.

ODI's research on the financial crisis to date reveals that weak state capacity and institutions have posed significant challenges for effective and sustainable policy responses to the crisis (te Velde et al., 2010). These issues are key to understanding the dynamics underlying the policy responses of developing countries to the crisis, and to informing domestic and international priorities in this area.

Many African and some Asian countries suffered from weak institutional and technical capacity that hampered the speed and effectiveness of their response. In Kenya, Sudan, Uganda, Zambia, and to a degree in Tanzania, authorities (governments and to a lesser extent Central Banks) lacked the necessary research and analytical capabilities to identify and quantify the effects of the crisis.

In Uganda, for example, the standard analytical tools (such as financial programming) available to the Ministry of Finance, Planning and Economic Development and the Bank of Uganda were inadequate to capture the effects of the crisis. In Sudan, the staff of the Ministry of Finance and National Economy did not have the necessary skills to cope with crisis shocks, and there were no policy centres or think tanks able to produce policy briefs and recommendations to support the decision-making process. In Tanzania, there was no effective monitoring system to assess the impact of the crisis on the real economy. A lack of implementation capacity has also been identified in many of these countries. These capacity gaps had particularly severe implications in countries affected by multiple crises, such as fuel and food crises (Massa, 2010).

However, some countries, such as Kenya and Sudan, have put in place specific institutional arrangements as part of the policy response to the crisis. In general, these are coordination mechanisms to ensure communication and consultation between key government departments (e.g. the Prime Minister's Office and the Ministry of Finance) and with other key institutions such as Central Banks. In Tanzania and Zambia, broader consultative mechanisms or processes have been put in place, involving various stakeholders. Little evidence is currently available on the role and effectiveness of many of these institutional mechanisms, however, in part because their recommendations are rarely made public and may not be implemented.

State capacity and response

This initial analysis of the responses to the financial crisis suggests that it would be useful to further investigate the role of governance and political factors. Much of the analysis of external shocks and of government responses, however, focuses on the specific drivers of the shock and on the economic policy measures taken as a result. As a consequence, issues of political economy and political context have often been overlooked. Yet there is growing recognition that economic policymaking rarely takes place in a vacuum, as it occurs within a political context in which some individuals and institutions hold greater power than others. Understanding how wider political economy factors, including the nature of state institutions and governance, can affect responses to shocks would, therefore, help to fill an existing gap in policy and practice.

To better understand these questions, we need to reflect on some of the different forms of state capacity, and to better understand some of the key variables which shape these different forms of state capacity.

Different forms of state capacity

Discussions of state capacity to respond to external shocks reveal a wide range of potential interpretations. Some have defined state capacity in terms of the capacity to generate analysis of economic policy problems and options, emphasising the role of experienced and trained analytical staff in economic agencies (and the extent to which they can agree on a common analysis), the authority of central economic agencies (for example, in terms of the constitutional and legal framework), and levels of managerial capacity (Nelson, 1990: 21-2).

Implementation capacity is another important component, alongside analysis of policy options. Implementation is more complex than analytical capacity, as it can be affected by the particular dynamics in a state (for example, the level of centralised control or authority) and by the nature of the political settlement and rules of the game (including power dynamics between political interests).

Grindle identifies five key dimensions of state capacity including implementation, institutional, technical, administrative and political capacity. She compares what states ought to have in terms of capacity and how this is likely to be affected by sustained economic and political crises (Grindle, 1996: 8). In seeking to examine state capacity, we need, therefore, to distinguish between different dimensions of capacity.

Economic flexibility and adaptability

There has been some analysis of the extent to which flexibility and adaptability can decrease vulnerability and strengthen responsiveness to external shocks. In general, this has been defined in terms of economic flexibility, but there is some recognition of how this can be shaped and affected by the wider political context. Some argue that economies with flexible structures, which can more quickly adjust, can achieve faster development than those that are rigid (Killick, 1995). The key dimensions of economic flexibility include responsiveness (the ability of governments to respond to external shocks) and the ability to innovate, linked to entrepreneurship. This approach recognises the importance of politics in shaping flexibility and responsiveness. Where a government is insecure, corrupt or repressive, for example, it is unlikely to respond quickly to changes in economic performance. Similarly, in the face of widespread public rejection, governments may respond in ways not previously thought politically feasible.

Linked to flexibility are issues of adaptability. Economic flexibility can depend on policy adaptability, in terms of the need for effective insulation from short-term pressures, such as pressures from special interest groups, combined with responsiveness to the longer-term needs of the economy and of civil society (Seddon and Belton-Jones, 1995: 326). While these factors have clear political underpinnings, there has been little analysis of this in relation to the global financial crisis.

Autonomy and notions of bureaucracy

There is a growing body of evidence that what is key for effective (or 'transformative') state capacity is a combination of internal coherence of the bureaucracy and external connectedness between the state and key parts of society. States cannot, therefore, be completely insulated from society but are embedded in a dense network of social ties that structure the interactions of the political elite, including with social and business actors (Evans, 1992).

Five key factors have been identified by Callaghy (1990: 263) that impact on the ability to 'insulate' the state:

- how the economic crisis is viewed by rulers and how this then affects the commitment to reform
- the extent to which decision-making can be influenced by technocratic staff
- the level of government autonomy from socio-political interests
- the capacity of the state and overall levels of reform before the crisis, and
- external influence, including from donors.

Political settlements and political interests

Beneath these five factors lie notions of political settlements, power dynamics and political interests. These are the least explored in existing analysis, and should be prioritised for future studies.

Authoritarian regimes have, conventionally, been seen as better placed to respond to economic shocks, because of their autonomy from political pressures. However, there is growing convergence that this is not necessarily the case, and that rather than focusing on regime type it may be more helpful to focus on some specific political variables, such as electoral cycles, which may significantly affect the response to shocks (Nelson, 1990).

Similarly, there is increasing debate on the commonly held view that external shocks increase the likelihood of regime change, and a growing focus on the conditions whereby shocks might lead to such political change (Haggard and Kaufman, 1992). This is linked to the nature of the political settlement. Research into crises in the 1980s in Peru and Colombia found that while the weak political settlement in Peru contributed to a change of government and different adjustment policies, in Colombia, the political alliance placed boundaries on the types of policies which could be followed (Stallings, 1990).

Conclusions

There is a growing body of evidence on the impacts of the global financial crisis in developing countries. In some countries, national governments have responded effectively to the crisis and have helped to mitigate some of the worst impacts.

It is important to recognise that the effects of an economic shock are specific to each country, and that the effectiveness of policy responses will depend on a number of different factors, such as the structure of its economy, its historical legacies and resulting levels of vulnerability. However, evidence from the response to the financial crisis and other economic shocks suggests that different levels of institutional and state capacity, as well political incentives, can play a role.

Understanding the dynamics and factors that contribute to state capacity to respond to external shocks requires a multi-faceted approach that unpacks the different forms of capacity and the underlying dynamics and political settlements.

It will be important to test some of these ideas in practice. The aim should be to ensure that the assistance countries receive to respond to external shocks recognises the unique governance and institutional dynamics that underpin their capacity to respond effectively.

Written by Marta Foresti, ODI Research Fellow (m.foresti@odi.org.uk), Isabella Massa, ODI Research Officer (i.massa@odi.org.uk), Leni Wild, ODI Research Fellow (l.wild@odi.org.uk) and Daniel Harris, ODI Research Officer (d.harris@odi.org.uk). To provide feedback on this publication, please visit http://www.odi.org.uk/resources/feedback.asp?id=5163

Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel +44 (0)20 7922 0300

Fax +44 (0)20 7922 0399

Email publications@odi.org.uk

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Useful resources:

ODI on politics and governance: http://bit.ly/ezBYaS
ODI on the global financial crisis: http://bit.ly/gEVDAt

Project Information:

This briefing is based on a literature review conducted as part of a research project funded by the UK Department for International Development. The project aims to increase understanding of the political and governance factors that affect the ability of a state to respond effectively to external economic shocks. It also examines how donors can more effectively support such policy responses. For more information please contact Marta Foresti at m.foresti@odi.org.uk