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Protecting Developing Country Growth from Global Shocks

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The global financial crisis as well as food and fuel price increases have had a great effect on developing countries. Even though there is a common perception that poor countries were relatively unaffected by the 2008-2010 financial crisis, we estimate that sub-Saharan Africa lost around 5% of Gross Domestic Product (GDP) (compared with forecasts prior to the onset of the crisis). Contrary to perceptions, sub-Saharan Africa is a net oil importer (although there are of course some major exporters), and small and vulnerable countries (as a group) are net food importers, so high and vulnerable food and oil prices have very negative effects.

Sudden external shocks can involve sudden net capital outflows, sudden declines in export revenues, increased costs of essential imports such as food and oil products or declines in remittances. These will affect growth and government revenue. This can lead to increased poverty in the short term, as well as a reduction in critical expenditures, which can have long-lasting negative development effects. Donors and international financial institutions have designed shock facilities to cushion the impact of shocks on the poor and protect critical spending categories, so as to sustain growth. Given that global shocks are expected to increase in frequency and magnitude (see, e.g., the World Economic Forum Global Risk Reports), it is important that the growth prospects of the poorest countries are safeguarded.

The European Commission (EC) has put in place various shock-absorbing schemes, most recently the FLEX, Vulnerability FLEX (V-FLEX) and Food Facility initiatives. Past schemes have a number of strengths and weaknesses. The EC Communication suggests the European Union (EU) 'can help partner countries make use of market-based insurance mechanisms, like the commodity futures market, to hedge against revenue shortfalls. Building on the V-FLEX set up in 2009 to help mitigate the effects of global food and financial crises on African, Caribbean and pacific (ACP) countries', the EU 'will work to set up a new shock-absorbing scheme focusing on broader exogenous shocks with a cross-country dimension'. We argue the EU should be ambitious, building on the effective V-FLEX scheme, and reform its shock facilities to include resilience and resilience building.

Economic shocks have become more important ...

Shocks have become more important in today's globalising world. Te Velde et al. (2011) review the evidence showing shocks can have a large effect on growth, poverty reduction and government expenditure and development. The global community has responded. The Group of 20 (G20) development agenda was explicitly about growth and resilience and the International Monetary Fund (IMF) has been enhanced during the crisis to focus on balance of payments support. A European angle is key to protect critical spending such as on social and infrastructure projects.

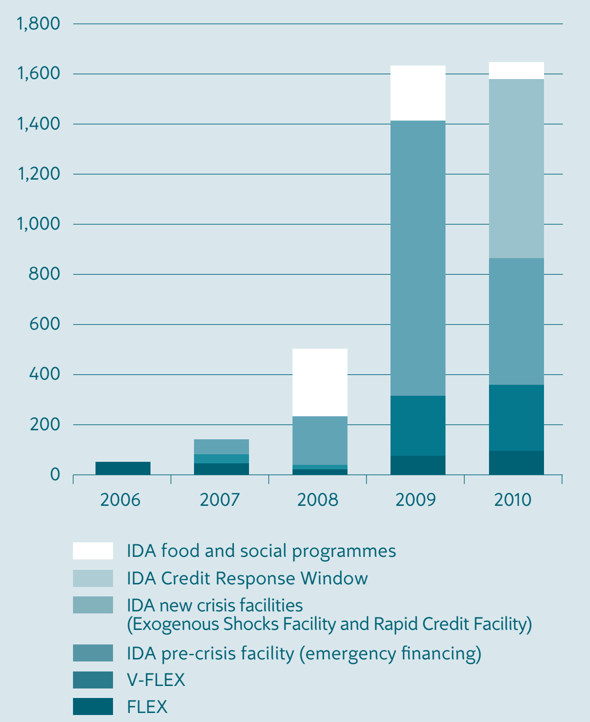
... Therefore it is important to devote attention to dealing and coping with shocks

There are various ways of dealing with economic shocks, including: (1) resilience building to improve dealing with shocks; and (2) providing finance in case shocks affect critical spending. Large donors such as the EC could lead the way in two ways: (1) they are large donors on their own, with development and shock components in their indicative programmes; and (2) they can coordinate and pool loan and grant resources for a large European shock facility, which could incorporate resources from other donors.

Scale and speed are particularly important criteria for shock absorber schemes, including those of the EU, so they can have a genuinely counter-cyclical and significant effect on developing countries facing external shocks. It would seem desirable to increase the proportion of donor resources going to shock absorber schemes, as shocks seem to be a major cause of lower growth in developing countries and have become more frequent, because of both more frequent financial crises and the impacts of climate change. Furthermore, even for liquidity facilities (e.g. those of the IMF), greater emphasis on significant low conditionality lending in the face of shocks seems highly desirable.

Of course, developing countries themselves need to improve their resilience to shocks by building up financial buffers and diversifying their economic activities. However, donors can coordinate efforts and support these activities, especially in countries that are inherently more exposed to crises. One lesson from the recent global financial crisis is that donors and the IMF were able to support developing countries at a meaningful scale and speed (see Figure). In this sense, the V-FLEX was successful in delivering finance to those in need and in a coordinated way.

Shock financing by crisis facility, 2006-2010 (€ millions)



Source: te Velde et al. (2011).

The next multiannual financial framework will cover the period 2014-2020. If some €22 billion is found, we assume at least €1.1 billion or 5% (adding FLEX and V-FLEX amounts in the previous period) will need to be reserved for a shock facility, and more could be pooled from EU bilateral states. The World Bank's International Development Association (IDA) crisis facility reserves a similar proportion from all IDA resources to deal with crises. However, we feel €3 billion is a better approximation of what would be needed to deal with another big shock such as the global financial crisis, now extended as a European sovereign debt crisis.

So what might be the key elements in a new European approach?

Access to the new shock facility needs to be simple and flexible, yet also predictable. There should be a set of clear *trigger variables*, for example using forecasts such as those on GDP and the current account as elements, because this allows for faster allocation of resources (in the past, EU shock facilities were notorious for disbursing funds four years after the shock, with V-FLEX a positive exception). A case can be made for spending some resources on monitoring shocks, for example supporting a team of researchers at the EC or IMF and doing this in collaboration with partner countries. Such a team could monitor categories of variables more closely related to preserving critical spending but which might not be readily available on international databases, including data on government spending. If a new shock absorber scheme needs to address shocks quickly and at sufficient scale to protect critical spending, it needs to have up-to-date information on the underlying financing situation, and this can facilitate *ex-ante* engagement with countries to ensure an optimal impact from the shock facility. A further decision is required on the threshold used for each trigger variable. The tighter the *threshold*, the fewer countries are eligible.

Our study in May 2011 (te Velde et al., 2011) examined the pros and cons of different trigger variables and suggested using country-specific GDP shocks (or fiscal shocks if data were available) on the basis of IMF forecasts, verified by in-country examination with partner countries, initially using a 3% threshold (or changed to the median GDP shock). The trigger value of 3% reaches around half of the countries in the first instance (at least based on the 2009 shock). In other years, such a trigger may not be sufficient, so one could consider changing the trigger threshold to the median shock, closer to 1% (too high a threshold might make the shock system too inflexible). The trigger threshold would be country specific (and not group specific or necessarily as high as in the IDA Crisis Response Window (CRW), whose thresholds are considered too tight).

Current shock facilities such as FLEX and V-FLEX are for *ACP countries*, but a new scheme could be for all developing countries (the Food Facility was one such example), all Least Developed Countries (LDCs) or all Low-Income Countries (LICs). Given that the EDF is unlikely to be budgetised for the period 2014-2020, and following the Cotonou Partnership Agreement, it might be useful to remain focused on the ACP for now, but to begin to extend shock facilities into all developing countries (and finding new resources) by the next period from 2020 onwards. This means preparations could start now by extending the new FLEX scheme to all developing countries while bringing in additional resources from the EU budget.

Our report suggested an innovation which could be introduced into future EU shock facilities: the incorporation of the concept of resilience and resilience building. We argue that resilient countries are better able to withstand shocks, hence less resilient countries should receive more funding *ex-post*, while (to counteract the moral hazard problem) *ex-ante* more funding should be devoted towards resilience building. If we accept the argument that resilience is a good criterion for funding, we might conclude that small, poor and vulnerable economies are most likely to receive funding in the case of shocks. Thus, EU shock absorber payments should take into account whether countries are resilient to shocks.

We also examined channels of delivery. The EC specialises in grant resources, and we suggest this would continue to be relevant for LICs. V-FLEX paid resources through budget support, which could be continued for those countries ready to receive this and in coordination with other development institutions. We also argued that the EC could use its coordinating role and bring in other funders, for example loans from the European Investment Bank (EIB) and/or bilateral lenders such as the German Development Bank (Kreditanstalt für Wiederaufbau, KfW). In addition, critical spending, which needs to be maintained in the face of shocks, is often related to large infrastructure projects that require project financing; this could be provided by the EIB, including by using blending schemes, financed from EC resources. The EC could also liaise with other institutions such as the World Bank and Regional Development Banks (RDBs) in the delivery of project finance. Working with others could also help to improve additionality and the leveraging effect of the EU's interventions, as well as providing sufficient scale to deal with large shocks.

References

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