The global financial crisis: what role for state capacity and political incentives to respond to external economic shocks?

Synthesis of literature review findings

Marta Foresti, Isabella Massa, Dan Harris and Leni Wild

Overseas Development Institute

State capacity and political incentives: why?

- Growing recognition that **governance and institutional set** up likely to influence ability to respond to external economic shocks
- But we don’t know **how in practice** these issues influence response and implementation
- Especially how (political) **incentives and blockages** affect reform as a response to an international driver
- Important to better target donors assistance to country responses.

The questions (November2009)

- How responsive have countries been to the crisis to date, and what are the emerging governance and political-economy implications?

- What are the key political and governance factors affecting state capacity (including incentives) to manage the effects and risks posed by the financial crisis in different country contexts?

- What might this tell us about state capacity and political incentives to manage other external shocks?

- What can donors and other external actors do to support institutions/states in these contexts and to enhance their capacity to respond to external shocks?

Work so far

- Consultations and meetings with DFID and others studying the macro economic effects of the crisis
- **Desk study**
  - ✓ Synthesis of economic effects of crisis
  - ✓ Initial analysis and follow up questionnaires/interview with selected countries affected by crisis to investigate governance dimensions
  - ✓ Literature review on state capacity and state response to previous economic shocks
  - ✓ Draft briefing
- Meetings and discussion with DFID
- A pause
- Initial discussions in way forward

Overseas Development Institute

Forms of state capacity

- Wide range of interpretations
- Capacity to analyse economic problems and identify solutions
- Policy choices but also implementation capacity
- Grindle (1996) institutional, technical, administrative and political : all likely to be affected by economic and political crises

Not only capacity….

- **Flexibility**: capacity to innovate/enterpreneurship and responsiveness . Flexible economic structures adjust more quickly to shocks (Killick 1995)
- **Adaptability**: insulation form short term pressure and responsiveness to long term economic needs (Seddon and Belton Jones 1995)
- **Autonomy** of bureaucracy and civil service: important but needs to be embedded in social networks and ties (e.g. With business community)
- **Factors for 'state insulation'**: rulers views and commitment to reform: technocrats' role in decision making; before –crisis capacity to reform; external influence (e.g. donors) (Callaghy 1990)
- **Regimes**: Authoritarian regimes not necessarily better placed to respond effectively. External shocks do not necessarily increase likelihood of regime change (Nelson 1990)

Still to do…

- Focus on role of political incentives and settlements at play in practice

- Focus on specific institutions and actors' roles

- In general; how in practice state capacity and political incentives influence response in specific countries

- Measures of state capacity?

The effects of the global financial crisis on developing countries (1)

- Developing countries severely hit.
- Economic growth dropped from 13.8% in 2007 to 6.1% in 2008, 2.1% in 2009.
- **Growth effects** vary across developing regions and countries.

- Main transmission belts:

  1. private capital flows;
  2. remittances;
  3. trade;
  4. aid.

The effects of the global financial crisis on developing countries (2)

- **Private capital flows** declined from $1.2tr in 2007 to $363bn in 2009.

  → financially more open countries affected more.

- **Remittances** fell by 6.1% in 2009.

  → countries dependent on remittances from developed countries or informal migrants hit harder (Cambodia, Uganda, Bolivia).

- **Trade** declines visible in a wide range of countries and sectors.

  → countries with high trade openness, exports concentration, dependence on crisis-hit markets affected more.

- Scarce evidence of significant **aid** pullout from developing countries.

  → countries highly dependent on aid more at risk (Benin, Ghana, Cambodia).

The effects of the global financial crisis on developing countries (3)

- **Implications on poverty reduction**:

  89 million people to be living below $1.25 a day by 2010.

- On **employment**:

  → global number of unemployed to increase by 34 million in 2009;

  → effects mostly apparent in garment and mining sectors (Bangladesh, DRC);

  → women severely hit (Kenya, Cambodia).

- On **political stability** through:

  (i) citizen discontent (Mexico, Kenya, Zambia);

  (ii) consolidation of power by governments (Venezuela, Russia).

Policy responses to the crisis

- **Fiscal policies**:

  stimulus packages, most with a focus on infrastructure investments.

- **Monetary policies**:

  interest rates cuts, changes in reserve requirements, etc.

- **Social protection**:

  little evidence of adequate responses.

- **Institutional arrangements**:

  co-ordination mechanisms between governments and Central Banks, consultative mechanisms, social dialogue, crisis task forces.

Economic, political & governance challenges in crisis responses

The ability (and speed) to respond depended on:

- **Fiscal space**:

  three quarters of vulnerable countries have limited fiscal space (Ethiopia, Sudan, Zambia).

- **Governance factors (institutional, administrative and technical capacity)**:

  one quarter of vulnerable countries has weak institutional capacity (Sudan, Uganda, Kenya).

Example 1: Tanzania

- Government initially tried to sell the idea that economy was unaffected by the crisis. With secondary effects authorities **adopted effective urgent policy interventions**.
- Biggest fiscal stimulus package in SSA (6.4% of its GDP), because of **large fiscal space**.
- **Accommodating monetary policy** implemented to facilitate bank financing of the private sector.
- **Social protection**: government has provided cushion by allocating Tsh20 billion in the FY2009/10 budget to ensure food at a reasonable cost.

<u>Governance factors and state capacity</u>:

- **Effective institutional arrangements**: consultative mechanisms between the MoF, Central Bank and other stakeholders in March 2009 leading to a special rescue package.
- **Political willingness, capacity and good institutions**. Only exception a rather weak monitoring system of the impact on the real sector.

Example 2: Bangladesh

- Authorities were **able to respond effectively but sometimes slowly**.
- Three fiscal stimulus packages, notwithstanding **modest fiscal space**.
- Central Bank safeguarded forex reserves by withdrawing 90% of total investment from international banks perceived at risk; appropriate decisions taken on exchange rate and money supply.
- **Social protection** coverage extended.

Governance factors and state capacity:

- **Effective institutional arrangements** implemented:

  → social dialogue;

  → crisis task force suggesting measures to support garments and shipbuilding sectors.

- Slow policy responses because of **technical and implementation constraints** (weak analytical and research capacity of MoF, limited availability of up-to-date data).

Example 3: Sudan

- Government was **slow to respond** (“wait and see” strategy).
- Not able to adopt fiscal stimulus, because of **small fiscal space**.

Governance factors and state capacity:

- **Institutional arrangements** implemented: coordination mechanisms between MFNE and Central Bank to examine possible crisis effects on economy and provide government with policy options.
- Slow adoption and implementation of policy responses because of **weak research and analytical capabilities** within Central Bank, MFNE, presidency.

To sum up

- Crisis effects vary across countries.
- Partly due to different ability to design and implement policy responses.
- Fiscal space matters. So good institutions in managing finances are important.
- Governance factors matter for enacting quick and effective policy measures.
- Flexible institutions are important in dealing with crisis.

Implications

- Governance matters but don’t quite know how...
- What makes flexible institutions?
- Need to consider how far concept of resilience extends to governance and political factors
- Relationship between different forms of capacity (e.g. technical and political) key to better understand how response likely to be affected

The way forward

- **Option 1**
  - ✓ Political economy framework for economic policy making and crises response
  - ✓ Focus on role of key institutions (e.g. Centre of government, central banks) and rules at play in institutional arrangements
  - ✓ 2 country case studies using response to FC as a ‘test’
- **Option 2**
  - ✓ Survey of measurement and diagnostics of state capacity
  - ✓ Political economy framework for economic policy making (if possible including/building on measures of state capacity)
  - ✓ One in depth case study to test the framework and measures, based on crisis response