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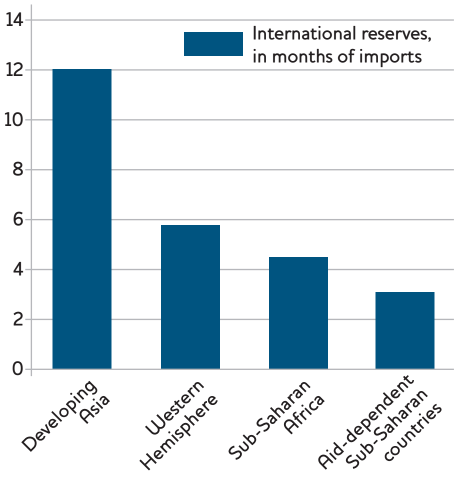
Macroeconomic Policy, Stimuli, Aid, and Budgeting: What Options?

Developing countries are being severely hit by the global financial crisis. However, the ability of different countries to respond varies considerably. This briefing finds that developing country governments should use a range of economic and financial policy instruments to combat the downturn. The availability of external resources is critical.

Many emerging economies in Latin America and Asia, which have suffered from volatile international capital flows, have learned to reduce their exposure to shocks and build capacity response by undertaking cautionary fiscal policy, reducing public debt and accumulating foreign reserves. In Latin America, Chile and Peru benefited from the recent primary commodity boom and saved a substantial portion of the windfall. In Asia, countries such as Malaysia and Thailand have historically maintained fiscal balance and are in sound positions to respond to the crisis. Despite a good record in recent years, other countries such as Brazil still have somewhat limited space for expansionary fiscal policy, because of initially large public debt.

In contrast, low-income countries do not have their own resources to cushion the macroeconomic shock. For instance, levels of international reserves, especially among aid-dependent countries in sub-Saharan Africa, are very low (see Figure 1).

Figure 1: **Level of international reserves, for different groups of developing countries**



Source: Author's elaboration, based on IMF World Economic Outlook (2008) and various IMF country reports

Although less exposed to international capital flows, they are most likely to be affected by reduced external demand, falling commodity prices and declining remittances which in some cases are larger than their export values and account for a large portion of their external financing needs. Moreover, many of these countries are aid dependent.

Fiscal space is the existence of fiscal room for increased spending, without jeopardising government's fiscal sustainability (Heller, 2005). World Bank (2008) categorises countries as having 'low fiscal space', 'some fiscal space' and 'more fiscal space' by averaging standardised indexes of debt/GDP, fiscal deficit, current account balance, international reserves and reversible capital inflows. The World Bank study indicates that of 18 countries that we identify as aid-dependent in sub-Saharan Africa, ten have 'low fiscal space', while the other eight are considered either as having 'some fiscal space' or 'more fiscal space'.

This may give a false sense of space, as it assumes aid will be forthcoming, which is far from guaranteed in the current crisis context.

> "The global nature of the current crisis implies that external demand for developing country exports is declining. Therefore, these countries need to find alternative stimulus to support recovery"

How important is fiscal space in this crisis?

In the 1990s and early 2000s, crisis-hit countries suffered massive currency devaluations, which caused severe balance sheet problems within their economies. Devaluation also encouraged exports and thereby helped countries recover relatively fast. However, the global nature of the current crisis implies that external demand for developing country exports is declining. Therefore, these countries need to find alternative stimulus to support recovery. In this context, fiscal space becomes critical. Where it is limited, monetary easing should be pursued, especially where inflationary pressures are receding (UN-DESA, 2009). Moreover, the limited resources available need to be used more effectively and geared to protect the poor (Ravaillon, 2008). Indeed, we have learned from previous crises that counter-cyclical mechanisms can be used to protect the poor and the most vulnerable (see social protection brief). Maintaining public investment is also very important for sustained recovery. In previous crises these were drastically reduced, thereby undermining post-crisis long-term growth. Research by the National Institute of Economic and Social Research shows that fiscal stimulus spent on productive investment raises the level of output by 1.5 per cent in the long run (Barrell *et al.*, 2009). IMF-led large-scale financial packages can also play a critical role in helping avoid too deep a crisis and supporting rapid recovery, (as in Mexico's crisis of 1994–5 and Brazil's in early 1999) but resources have to be frontloaded and with little conditionality attached.

What should be done?

Given the scale of the crisis, developing country governments should use not one but a range of economic and financial policy instruments, in addition to social protection mechanisms to combat the downturn and protect the poor. But availability of external resources is critical. Therefore, at the international level four responses are needed:

- The IMF role as provider of official liquidity should be enhanced – its recently created Short-Term Liquidity Facility (SLF) should be made available to a larger number of countries, as should the revamped Exogenous Shocks Facility (ESF), with conditionality relaxed.
- The IMF role should be complemented with that of regional development banks, in providing counter-cyclical lending. Also at the regional level, initiatives such as those from the East Asian countries to create a large pool of funds to combat the crisis should be expanded and replicated in other regions, where large financing capacity for pooling reserves exist.
- Donor countries should meet their commitments to increased aid, and efforts made to link new financing to social protection mechanisms to improve effectiveness of resources for poverty reduction.
- Coordinated policy action among the larger world economies is needed to avoid protectionism and support macroeconomic policies that are coherent with sustainable growth and reduced global economic imbalances.

Further reading

Barrell, R., Holland, D. and Velde, D. (2009) *A fiscal Stimulus to Address the Effects of the Global Financial Crisis on sub-Saharan Africa*, Draft paper, London: NIESR and ODI

Heller, P. (2005) *Understanding Fiscal Space*, IMF Policy Discussion Paper Number 05/4, Washington DC: IMF

Ravaillon, M. (2008) *Bailing out the World's Poorest.* World Bank Policy Research Working Paper 4763. Washington DC: World Bank

UN-DESA (2009) *World Economic Situation and Prospects 2009*, New York: The United Nations

World Bank (2008) *The Global Economic Crisis: Assessing Vulnerability with a Poverty Lens*, Washington DC: World Bank

Credits

This *In Focus Policy Briefing* was written by **Ricardo Gottschalk** from the Globalisation Team at IDS. The series editor is **Clare Gorman**. For other briefs on the crisis see: **www.ids.ac.uk/go/infocus7**

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