Narrowed fiscal buffers: A vulnerability in emerging and developing economies

Fiscal positions in many emerging market and developing economies have weakened since the global financial crisis of 2008. Emerging market and developing economies built fiscal space in the run-up to the crisis, which was then used for stimulus. As a result, fiscal space has shrunk and remains narrow as these economies have taken advantage of historically low interest rates. A lack of fiscal space can undermine the effectiveness of fiscal policy by reducing fiscal multipliers. In this talk, Franziska Ohnsorge, Manager in the Development Prospects Group, defines fiscal space, how it has evolved in emerging market and developing economies since the financial crisis, the implications for diminishing fiscal space should another fiscal downturn occur, and ways to rebuild it.

Story | Presentation | Video

Measuring fiscal space and understanding what it means

Fiscal space can be broadly defined as the availability of budgetary resources for a government to service its financial obligations. A comprehensive cross-country database covers 200 countries during 1990-2016, and includes 28 indicators of fiscal space grouped into four groups: debt sustainability, balance sheet vulnerability, external and private debt as potential sources of contingent liabilities, and market access. Fiscal space had improved in many countries before the global financial crisis. In advanced economies, following severe deteriorations during the crisis, many indicators of fiscal space have virtually returned to their mid-2000s levels. In contrast, fiscal space has shrunk in emerging market and developing economies since the crisis. Financial crises and, in energy-exporting emerging markets, oil price plunges typically coincide with deteriorations in fiscal space, but they are often followed by reduced short-term borrowing and a restoration of fiscal space.


Fiscal space is necessary for effective fiscal policy and can be rebuilt

Developing economies may need to undertake fiscal stimulus should there be an economic slowdown. A chapter in the January 2015 Global Economic Prospects report argues that fiscal space—the availability of budgetary resources for a
government to service its debt—is essential for fiscal policy to be effective. The chapter describes how fiscal space has shrunk since the Great Recession and has not returned to pre-crisis levels. Developing economies need to rebuild fiscal space at a pace appropriate to country-specific circumstances. Implementing oil subsidy reforms may be appropriate for some countries. Credible and well-designed institutional arrangements such as fiscal rules, stabilization funds, and medium-term expenditure frameworks can also help build fiscal space.


Rebuilding fiscal space to prepare for the next downturn

Emerging and developing economies have faced downside risks to growth and the prospects of rising financing costs. Should these cause a sharp cyclical slowdown, policy makers may need to employ fiscal policy to stimulate economic activity. Given that these governments’ abilities to service their debt has shrunk since the Great Recession and not returned to pre-crisis levels, priorities for rebuilding fiscal space include strengthening institutional frameworks such as fiscal rules, stabilization funds, and medium-term expenditure frameworks.


Deteriorating debt dynamics in emerging market and developing economies

A chapter in the World Bank’s semi-annual global economic outlook report argues that since the global financial crisis, rising private sector debt and deteriorating government debt dynamics have made some emerging market and developing economies more vulnerable to financial shocks than before. As economic growth becomes more durable and inflation rates move closer to central bank targets, the prospect of monetary policy normalization in advanced economies becomes more likely, raising the possibility of financial market volatility. Although many emerging market and developing economies have strengthened their monetary policy frameworks and accumulated significant reserve buffers, they are urged to shore up their fiscal positions to prepare for the possibility of sudden spikes in financing costs, which could force fiscal tightening.


The relationship between fiscal multipliers and the fiscal positions of governments

The fiscal position of a government can have considerable bearing on whether and how much government spending boosts growth. A study of advanced and developing economies shows that the magnitude of fiscal multipliers depends on the fiscal positions of governments and tends to be larger when government fiscal positions are strong, for example, where government debt and deficits are low. At the same time, a fiscal multiplier can be negative if a fiscal position is weak. The study also shows that the effect of the fiscal position is distinct from the impact of the business cycle on the fiscal multiplier. Finally, it shows that the fiscal multiplier can be affected when increased perception of risk due to a weak fiscal position crowds out private investment or when households reduce spending in anticipation of higher taxes in the future.


Estimating government spending multipliers for developing countries

Policy discussions often assume the government spending multiplier is above one—a dollar of government spending raises GDP by more than one dollar. Evidence from a large sample of developing countries suggests that the government spending multiplier is much smaller. This study estimated spending multipliers using loan-level data from official creditors, who typically
finance multiyear public spending projects, with disbursements linked to the stages of project implementation. Given the long lags between approval and eventual disbursement of these loans it is possible to isolate a predetermined component of public spending associated with past loan approval decisions taken before the realization of contemporaneous shocks. In 102 developing countries over the period 1970–2010, the one-year spending multiplier is estimated to be around 0.4. Although the estimated multiplier is much smaller than the conventional wisdom would suggest, there is still a role for a fiscal response to economic downturns. For example, expanding social protection to the most vulnerable during economic crises may be warranted even if this spending does not stimulate aggregate economic growth.


**Procyclical fiscal policy for commodity exporters can sometimes be optimal**

The conventional wisdom among policymakers is that fiscal policy for commodity exporting countries should be countercyclical or acyclical—governments should save rather than spend windfall revenue from commodity price booms. This research questions that wisdom for countries with highly persistent commodity export prices where price shocks can last many years. In these countries, a country’s current income is close to their permanent income, and so Milton Friedman’s Permanent Income Hypothesis suggests that the windfall should be spent rather than saved. That is, procyclical balanced budget fiscal rules can outperform acyclical structural surplus rules, with the latter leading to rapid and unsustainable increases in debt or assets. Quantitatively, it is optimal to spend around two-thirds of windfall revenues for highly persistent commodities like oil. But for other commodities with less persistent shocks, like bananas or sugar, the optimal rule involves spending less than half of above-average commodity revenues.


**BRIEFS/TOOLS**

**Long-Term Growth Model – Excel-based Tool**

The Long-Term Growth Model (LTGM) is an Excel-based tool to analyze long-term growth scenarios building on the celebrated Solow-Swan Growth Model. The tool can also be used to assess the implications of growth (and changes in inequality) for poverty rates. The tool is simple, transparent, and easy to use: there are no macros, and the very low data requirements mean the tool can be applied in almost any country. The tool is useful for planning/vision documents and country reports, but is not designed for short-term forecasting. The building blocks of growth are savings, investment and productivity, but the model also analyzes human capital, demographics, the external sector (external debt, FDI, CAB) and labor force participation by gender. The tool can be downloaded here: [www.worldbank.org/LTGM](http://www.worldbank.org/LTGM)

**Land tenure and the agricultural estate sector in Malawi**

Most of the agricultural estates in Malawi (totaling 1.5 million hectares) have expired lease contracts and are underperforming smallholder farmers in yield, productivity, and land use intensity. Data from digitized agricultural leases, a georeferenced farm survey, and satellite imagery show the government is losing over 70 percent of ground rents on expired estate leases, leading to tenure insecurity for estate holders. Overlapping claims affecting 9 percent of total area under estates is also contributing to tenure insecurity. Clarifying boundaries and lease statutes for estates should come before any systematic demarcation and preparation of customary estates under the recently enacted Land Acts. Failure to follow this sequence could add another layer of unconnected rights, exacerbate tenure insecurity, and discourage investment in productive performance.

**Performance of large farms and benefits for smallholders: Challenges and opportunities in Malawi’s estate sector** by Klaus Deininger and Fang Xia.

**Usefulness of returning to projects long after the intervention ended**

Between 2008 and 2010, a leading global consulting company attempted to improve management in Indian textile firms. The randomized experiment involved 28 plants in 17 firms in the woven cotton fabric industry. These were large firms, with an average of 270 employees, and a median of two plants per firm. Researchers interviewed the directors and plant managers about each of the 38 management practices to understand why practices were adopted or dropped over time. They find the
treated firms that received the intervention are using more looms and fewer workers over time, although neither is statistically significant. Finally, the results provide an illustration of the usefulness of returning to projects long after the intervention has ended.


EVENTS

- **February 27, 2018**: Policy Research Talk: Machine Learning Algorithms and Poverty Prediction
- **March 1, 2018**: Artificial Intelligence for Economic Development
- **March 5, 2018**: Policy Research Talk: Exporter Dynamics, Superstar Firms, and Trade Policy
- **March 13, 2018**: DEC Lecture: The Backlash Against Globalization
- **March 19–23, 2018**: Land and Poverty Conference 2018: Land Governance in an Interconnected World
- **April 23, 2018**: Policy Research Talk: Fintech and Inclusion
- **June 12–15, 2018**: Disruptive Innovations, Value Chains, and Rural Development

All upcoming events

BLOGS AND ARTICLES

Cash Transfers Increase Trust in Local Government
*Development Impact, 14 February 2018*

Cash transfers seem to be everywhere. A recent statistic suggests that 130 low- and middle-income countries have an unconditional cash transfer program, and 63 have a conditional cash transfer program. We know that cash transfers do good things: the children of beneficiaries have better access to health and education services (and in some cases, better outcomes), and there is some evidence of positive longer run impacts. (There is also some evidence that long-term impacts are quite modest, and even mixed evidence within one study, so the jury’s still out on that one.)

In our conversations with government about cash transfers, one of the concerns that arose was how they would affect the social fabric. Might cash transfers negatively affect how citizens interact with each other, or with their government? In our new paper, “Cash Transfers Increase Trust in Local Government” (can you guess the finding from the title?) —which we authored together with Brian Holtemeyer—we provide evidence from Tanzania that cash transfers increase the trust that citizens have in government. They may even help governments work a little bit better.

Read the blog by David Evans and Katrina Kosec.

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The Toyota way or Entropy? What did we find when we went back 8-9 years after improving management in Indian factories?
*Development Impact, 20 February 2018*

Between 2008 and 2010, we hired a multinational consulting firm to implement an intensive management intervention in Indian textile weaving plants. Both treatment and control firms received a one-month diagnostic, and then treatment firms received four months of intervention. We found (ungated) that poorly managed firms could have their management
substantially improved, and that this improvement resulted in a reduction in quality defects, less excess inventory, and an improvement in productivity.

Should we expect this improvement in management to last? One view is the “Toyota way”, with systems put in place for measuring and monitoring operations and quality launch a continuous cycle of improvement. But an alternative is that of entropy, or a gradual decline back into disorder – one estimate by a prominent consulting firm is that two-thirds of transformation initiatives ultimately fail. In a new working paper, Nick Bloom, Aprajit Mahajan, John Roberts and I examine what happened to the firms in our Indian management experiment over the longer-term.

Read the blog by David McKenzie.

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Edutainment changes the way we do development

Voices, 16 February 2018

Improving people’s lives is more than offering services. It requires people to be active participants in development, demanding services and products that add value to their lives and engaging in behaviors that are conducive to increasing their own welfare. Health prevention is a case in point.

At our HIV Impact Evaluation Workshop in Cape Town, South Africa in 2009, I listened to Nancy Padian, a medical researcher at the Women’s Global Health Imperative, presenting a systematic review of random control trials testing the effectiveness of HIV prevention campaigns.

The study she presented explained how three dozen HIV prevention campaigns had failed to change sexual behavior and reduce HIV incidence.

A closer look revealed that the campaigns lacked inspiring narratives, and were communicated through outdated and uninteresting outlets such as billboards and leaflets. The question we asked ourselves was: Can we do this differently?

In 2016, the World Bank Development Impact Evaluation group (DIME) launched “Narrating Behavior Change”, a new research program on entertainment education that aims to scale up evaluation research in the main entertainment hubs. Since then, DIME has launched new randomized control trials in Mexico, Brazil, Nigeria and India to prevent addictions, increase aspirations and reduce teenage pregnancies, help send girls to school, and reduce gender-based violence.

Read the blog by Arianna Legovini.

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In search of fiscal space: A new database

VoxEU, 12 February 2018

The availability of fiscal space has been at the centre of recent debates on the effective use of fiscal policy. This column introduces a new cross-country database of fiscal space indicators and applies it to the analysis of the evolution of fiscal space over the past quarter century and during oil price plunges. Fiscal space has weakened materially in many emerging and developing economies since the Global Crisis. Fiscal space tends to deteriorate in energy-exporting emerging and developing economies during oil price plunges but later improves, often because of procyclical fiscal tightening.

Read the article by M. Ayhan Kose, Franziska Ohnsorge, and Naotaka Sugawara.

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Wrong criticisms of Doing Business
While I welcome criticism and comments on the Doing Business (DB) report—or any other data and research product of the World Bank, for that matter—I find Justin Sandefur’s and Divyanshi Wadhwa’s (SW) recent blog posts on DB in Chile and India neither enlightening nor useful.

In 2013, an external assessment of DB recommended, among other things, that the set of indicators be broadened to better reflect the challenges that entrepreneurs face and make DB a more comprehensive benchmarking tool for business regulation. In particular, indicators reflecting gender differences, reliability of electricity, and “trading across borders” were either introduced or significantly revamped. These changes were adopted after extensive consultations with academics, country officials, and Bank staff, management, and members of its Executive Board. Because of these significant changes to the methodology, we discourage comparisons of rankings across the year of the change because it would be like comparing apples with oranges. Even if you wanted to compare the same set of indicators across two years, the data simply don’t exist. For example, prior to 2015, DB’s trading across borders indicator set also measured the volume of documentation needed to comply with border controls. This is no longer part of the indicator set and, hence, the relevant data are no longer collected.

Read the blog by Shanta Devarajan.

What works to reduce child marriage?

Development Impact, 7 February 2018

Child marriage, despite being against the law in a lot of places, is still fairly common. One estimate, cited in a new paper by Nina Buchmann, Erica Field, Rachel Glennerster, Shahana Nazneen, Svetlana Pimkina, and Iman Sen, figures there will be 142 million new child brides between 2011-2020.

So what might a policymaker do? One option would be to empower girls. Another would be to give the household (specifically the girls’ parents) a transfer conditional on waiting until they’re older. Buchmann and co. work with Save the Children in Bangladesh (the country with the second highest child marriage rate in the world) to try these out.

Read the blog by Markus Goldstein.

International migration’s long-term impact: Evidence from a lottery

VoxDev, 5 February 2018

The vast wage differences across countries suggest sizeable economic distortions due to limits on immigration. At the individual level, these offer the possibility of large gains through international mobility. We find that randomly selected workers moving from a poorer country to a richer country appear to be immediately more productive and that the observed wage gains are stable over time. These findings support the idea that cross-country wage differences are due to better institutions, higher quality capital and other factors in rich countries that serve to raise the productivity of all workers, rather than attributes that are embedded in native workers and take time for migrants to accumulate.

Read the article by John Gibson, David McKenzie, Halahingao Rohorua, and Steven Stillman.

Upgrading outputs means upgrading inputs

VoxDev, 2 February 2018
Probably the most important implication is that success in world markets (where most demand is from rich countries) requires upgrading the quality of both products (outputs) and inputs. If firms cannot source high-quality inputs locally, they face an uphill climb in upgrading outputs. The policy challenge is to foster upgrading of entire complexes of producers and suppliers, not just of individual leading firms. Tax incentives and other inducements may attract foreign firms temporarily, but sustained industrial development requires a broader base of upgrading firms.

Read the article by Paulo Bastos, Joanna Silva, and Eric Verhoogen.

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What’s new in education research? Impact evaluations and measurement: January 2018 round-up
Development Impact, 31 January 2018

Here is a selected round-up of recent research on education in low- and middle-income countries, with a few findings from high-income countries that I found relevant. This is mostly but not entirely from the "economics of education" literature. If I’m missing recent articles that you’ve found useful, please add them in the comments!

Read the blog by David Evans.

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Depression and its links to conflict and welfare in Nigeria
Nasikiliza, 31 January 2018

Chronic depression affects about 20 percent of Nigerian heads of households, according to the most recent results of the Nigerian General Household Survey (GHS) Panel, which measures indicators from agriculture, welfare, and other areas of life in Nigeria once every two to three years. This statistic is linked to an additional finding that nearly 2 out of 5 Nigerian respondents have been affected by at least one negative event, such as conflict and/or the death of a household member.

We worked with Julian Jamison and Renos Vakis to explore the nexus between mental health, negative incidents, and economic investment. Our findings show that poor mental health is strongly associated with having experienced shocks, conflicts, and/or deaths (which we define as “adverse events”). Our findings also show that depression is associated with lower labor participation, and lower investment in human capital.

Read the blog by Julie Perng, Kevin McGee, Gbemisola Oseni, Ryoko Sato, and Tomomi Tanaka.

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Future Development Reads: Migration, global growth, gender inequality, and 12 charts reviewing 2017
Future Development, 30 January 2018

A few recent development economics articles and papers that caught my attention this past week should be on the top of anyone’s reading list who is interested in inequality, economic growth, or migration.

Economist Branko Milanovic has written a blog post quantifying the share of global inequality that can be attributed to where people live: The answer is two-thirds. The “citizenship premium” can be as high as 300 percent in some areas. The calculation is reminiscent of development economist Lant Pritchett’s measurement of the wage gap between migration-sending and -receiving countries, with migration-receiving countries providing wages 200-400 percent higher than sending countries. Both these articles make the point that migration may be the most powerful means of reducing global inequality.

Read the blog by Shanta Devarajan.
The revaluation of international banks following the crisis
VoxEU, 30 January 2018

Banks that internationalise can enjoy additional profit opportunities and diversification benefits as national business cycles are not perfectly synchronised. This column uses an international sample of banks in 113 countries during 2000-2015 to show that the relative valuation of international banks from high-income countries rose following the Global Crisis as they experienced lower increases in loan losses, adjusted their international asset allocations, and received generous ‘too-big-to-fail’ subsidies. International banks headquartered in developing countries experienced no such revaluation following the crisis.

Read the blog by Ata Bertay, Asli Demirgüç-Kunt, and Harry Huizinga.

Pakistan is home to the most frenetic education reforms in the world
Economist, 4 January 2018

The outsourcing of schools to entrepreneurs and charities is on the rise across the country. It is too early to judge the results of this massive shake up, but it seems better than the lamentable status quo. If this wholesale reform makes real inroads into the problems of enrolment, quality and discrimination against girls that bedevil Pakistan, it may prove a template for other countries similarly afflicted.

Read the article.

Whither international banking?
All About Finance, 24 January 2018

Strong regional and global integration have been central to countries’ rapid growth and reduced poverty. Few economic sectors can better illustrate integration’s potential benefits—and its significant risks—than the banking sector.

The period prior to the 2008 global financial crisis was characterized by a significant increase in financial globalization, which coincided with dramatic increases in bank sizes. This was manifested both in a rise in cross-border lending and in the growing participation of foreign banks around the world, especially in developing countries. These trends resulted in: additional capital and liquidity; efficiency improvements through technological advancements and competition; and, eventually, greater financial development.

Read the blog by Mahmoud Mohieldin.

List of New Policy Research Working Papers

- 8324. Why Are More Sovereigns Issuing in Euros? Choosing between USD and EUR-Denominated Bonds by Antonio Velandia and Rodrigo Cabral
- 8325. Investment in ICT, Productivity, and Labor Demand: The Case of Argentina by Irene Brambilla and Dario Tortarolo
- 8326. Digital Technology Adoption and Jobs: A Model of Firm Heterogeneity by Irene Brambilla
• 8327. Tobacco Price Elasticity and Tax Progressivity in Moldova by Alan Fuchs and Francisco Meneses
• 8328. Informal Sector Heterogeneity and Income Inequality: Evidence from the Democratic Republic of Congo by Franck M. Adoho and Djeneba Doumbia
• 8329. South Caucasus in Motion: Economic and Social Mobility in Armenia, Azerbaijan and Georgia by Sailesh Tiwari, Cesar Cancho, Moritz Meyer, and Alan Fuchs
• 8330. Redistribution and Group Participation: Experimental Evidence from Africa and the UK by Marcel Fafchamps and Ruth Vargas Hill
• 8332. Effect of Climate Policies on Labor Markets in Developing Countries: Review of the Evidence and Directions for Future Research by Marc Hafstead, Roberton C. Williams III, Alexander Golub, Siet Meijer, Badri G. Narayanan, Kevin Nyamweya, and Jevgenijs Steinbuks
• 8333. Cash Transfers Increase Trust in Local Government by David K. Evans, Brian Holtemeyer and Katrina Kosec
• 8334. Human Capital Outflows: Selection into Migration from the Northern Triangle by Giselle Del Carmen, and Liliana D. Sousa
• 8335. The Price Elasticity of African Elephant Poaching by Quy-Toan Do, Andrei A. Levchenko, Lin Ma, Julian Blanc, Holly Dublin, and Tom Milliken
• 8336. Structural Change in West Africa: A Tale of Gain and Loss by Fiseha Haile
• 8337. Unlocking India’s Logistics Potential: The Value of Disaggregated Macroscopic Freight Flow Analysis by Bernard Aritua, Jan Havenga, Zane Simpson, and Esther Woon Lyn Chiew
• 8338. Love the Job . . . or the Patient? Task vs. Mission-Based Motivations in Health Care by Sheheryar Banuri, Philip Keefer, and Damien de Walque
• 8339. Do Management Interventions Last? Evidence from India by Nicholas Bloom, Aprajit Mahajan, David McKenzie, and John Roberts
• 8340. Migrants, Towns, Poverty and Jobs: Insights from Tanzania by Luc Christiaensen, Joachim De Weerdt, Bert Ingelaere, and Ravi Kanbur
• 8341. Urban Transport Infrastructure and Household Welfare: Evidence from Colombia by Tobias Pfutze, Carlos Rodríguez-Castelán, and Daniel Valderrama-González
• 8342. Finding the Poor vs. Measuring their Poverty: Exploring the Drivers of Targeting Effectiveness in Indonesia by Adama Bah, Samuel Bazzi, Sudarno Sumarto, and Julia Tobias
• 8343. The Role of Social Ties in Factor Allocation by Ulrik Beck, Benedikte Bjerge, and Marcel Fafchamps
• 8344. Hit and Run? Income Shocks and School Dropouts in Latin America by Paula Cerutti, Elena Crivellaro, Germán Reyes, and Liliana D. Sousa
• 8346. Distribution-sensitive multidimensional poverty measures by Gaurav Datt
• 8347. Psychic vs. Economic Barriers to Vaccine Take-up: Evidence from a Field Experiment in Nigeria by Ryoko Sato and Yoshito Takasaki
• 8348. A Skills-Based Human Capital Framework to Understand the Phenomenon of Youth Economic Disengagement by Diego F. Angel-Urdinola and Renata Mayer Guvkas
• 8349. The Roots of Inequality: Estimating Inequality of Opportunity from Regression Trees by Paolo Brunori, Paul Hufe, and Daniel Gerszon Mahler
• 8350. Wider Economic Benefits of Investments in Transport Corridors and the Role of Complementary Policies by Martin Melecky, Siddharth Sharma, and Hari Subhash
• 8351. Governing the Commons? Water and Power in Pakistan’s Indus Basin by Hanan G. Jacoby and Ghazala Mansuri
• 8352. Decentralization and Redistribution: Irrigation Reform in Pakistan’s Indus Basin by Hanan G. Jacoby, Ghazala Mansuri, and Freeha Fatima


8355. The State of Jobs in Post-Conflict Areas of Sri Lanka by David Newhouse and Ani Rudra Silwal

8356. India's Internal Labor Migration Paradox: The Statistical and the Real by Gaurav Nayyar and Kyoung Yang Kim