Preparing for the Next Shock

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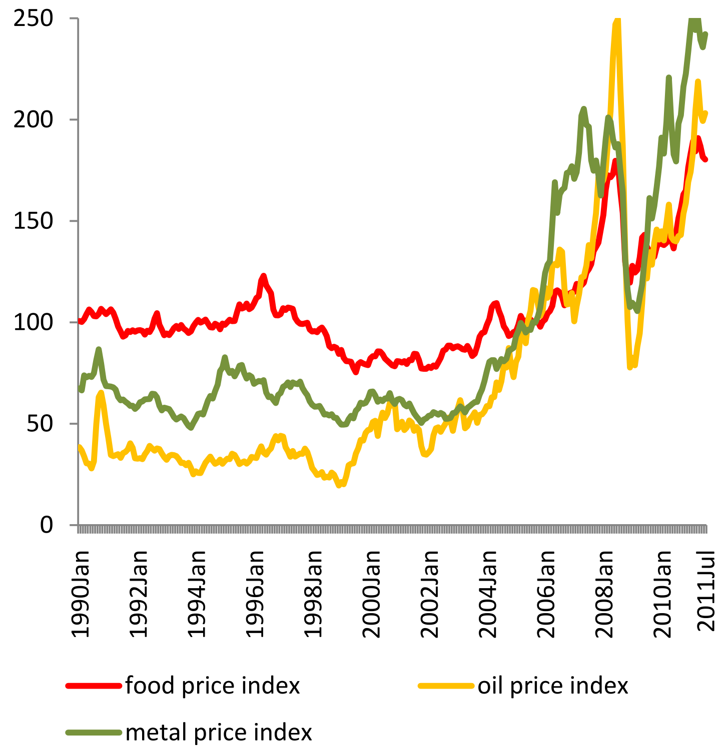
Where could the next fiscal shocks come from?

- External shocks
  - Commodity price shocks
  - Spillover of growth shocks (global growth slowdown)
- Domestic shocks
  - Policy shocks
  - Weather related shocks

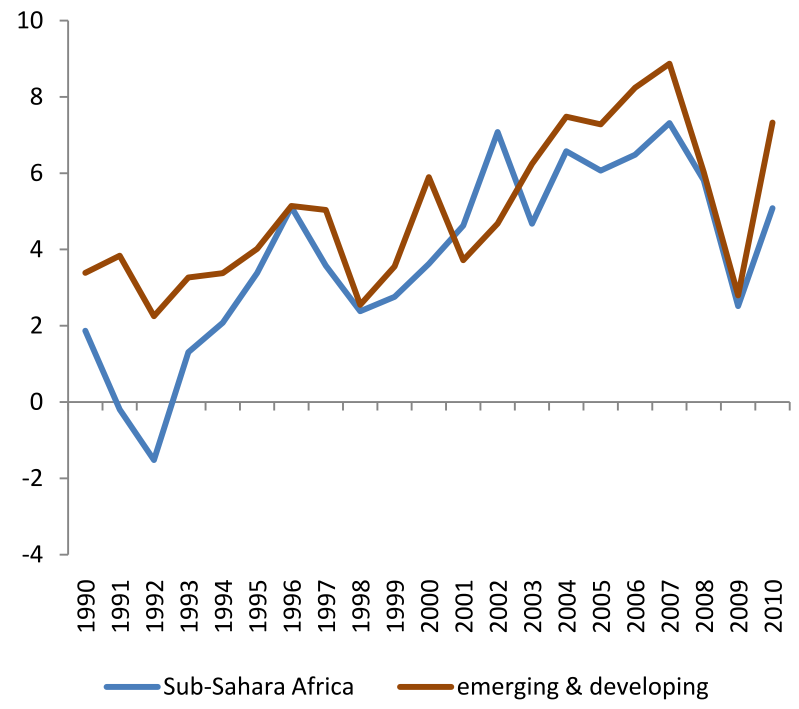
External and domestic volatility is high

Commodity and fuel prices are volatile



- **Commodity price indices (2005=100)**

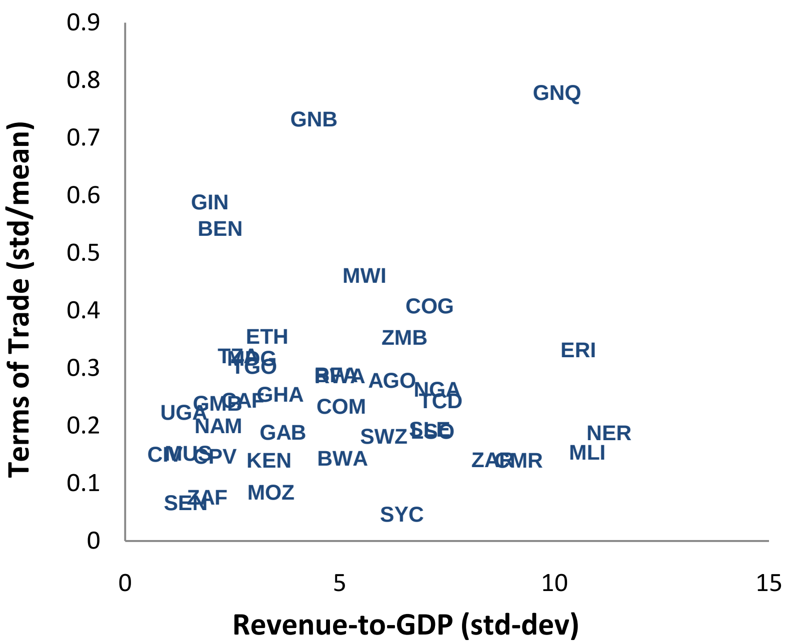
Domestic growth is volatile



Real GDP growth rate (%)

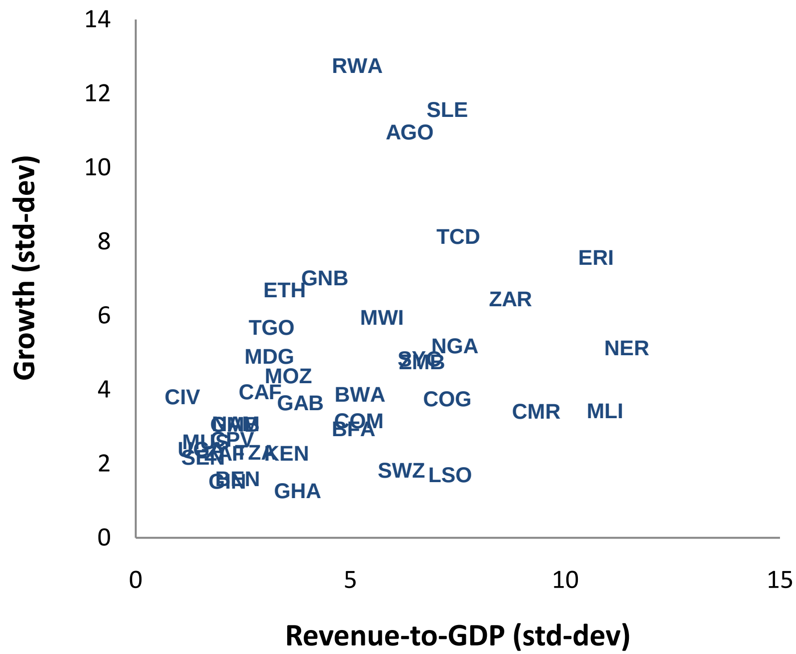
Economic volatility spills over on the budget

Revenue volatility tends to be higher in countries where the terms of trade is volatile…



Revenue volatility vs. terms of trade volatility (1990-2010)

…and where the domestic growth rate is volatile

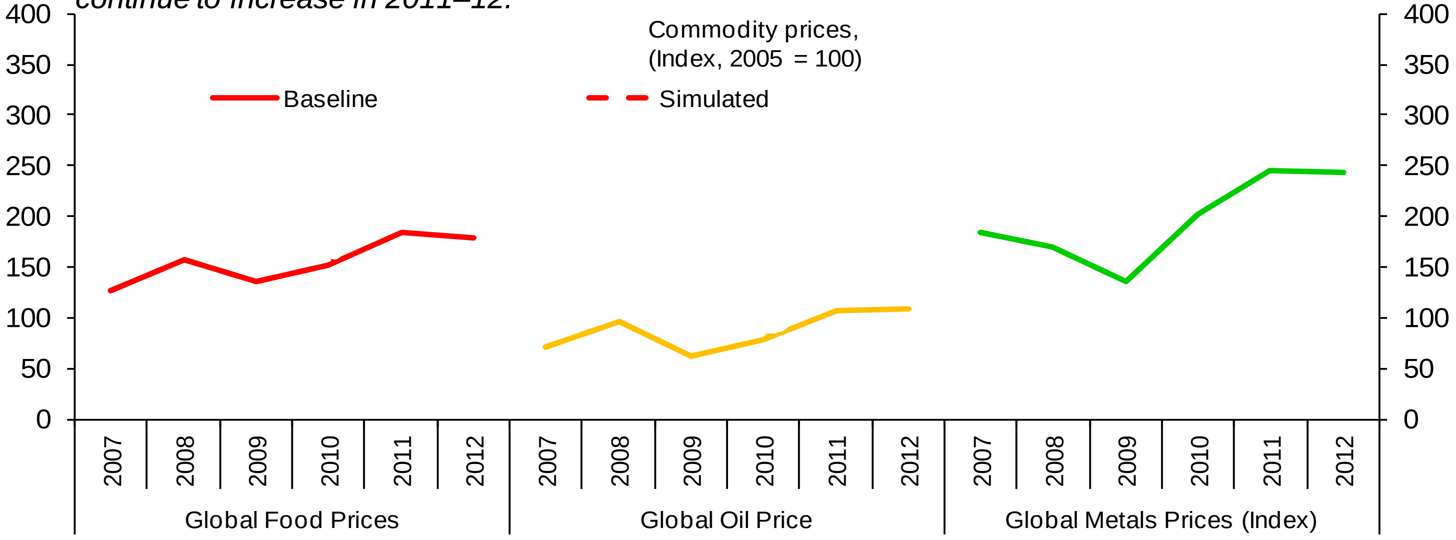


Revenue volatility vs. growth volatility (1990-2010)

We assessed the impact of two kinds of shocks on LICs

Another spike in global commodity prices

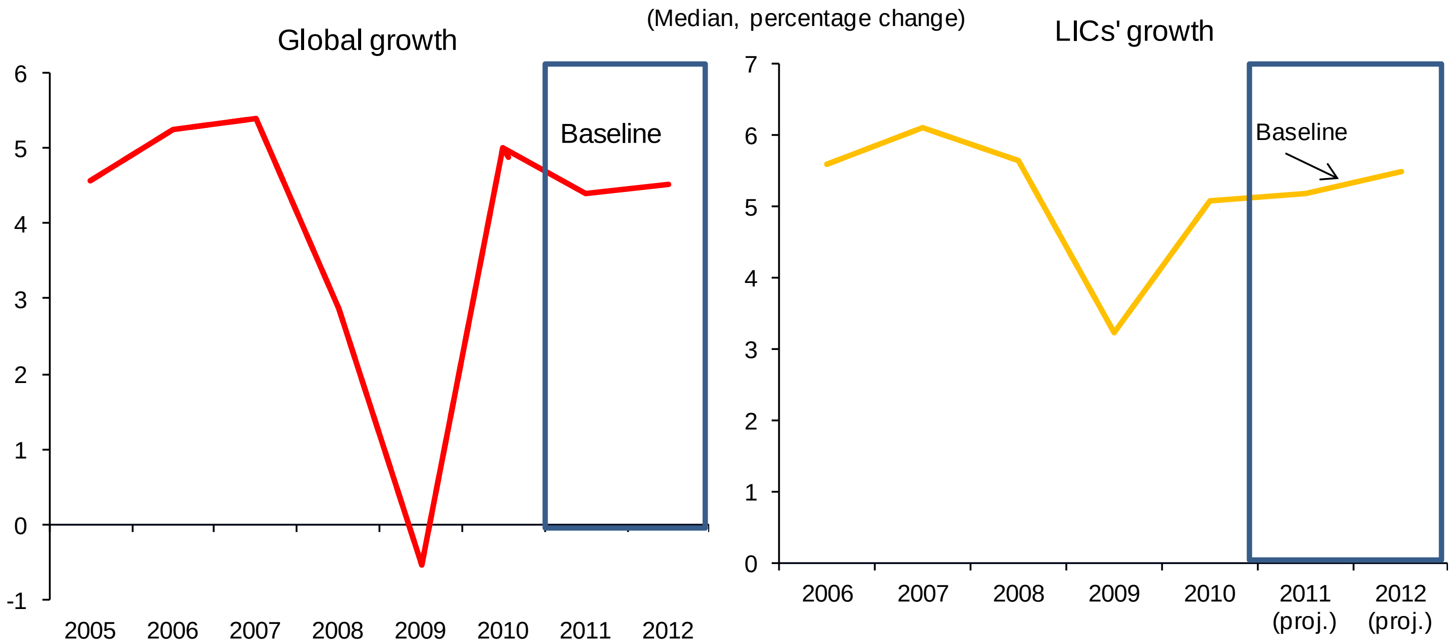
Based on market expectations, embedded in commodity future options, commodity prices would continue to increase in 2011–12.



Sources: WEO, and IMF staff estimates.
Note: Global food prices are assumed to increase by 28% in 2011, 47% in 2012, relative to the baseline; global oil prices by 23% in 2011 and 47% in 2012; and metal prices by 23% in 2011 and 46% in 2012.

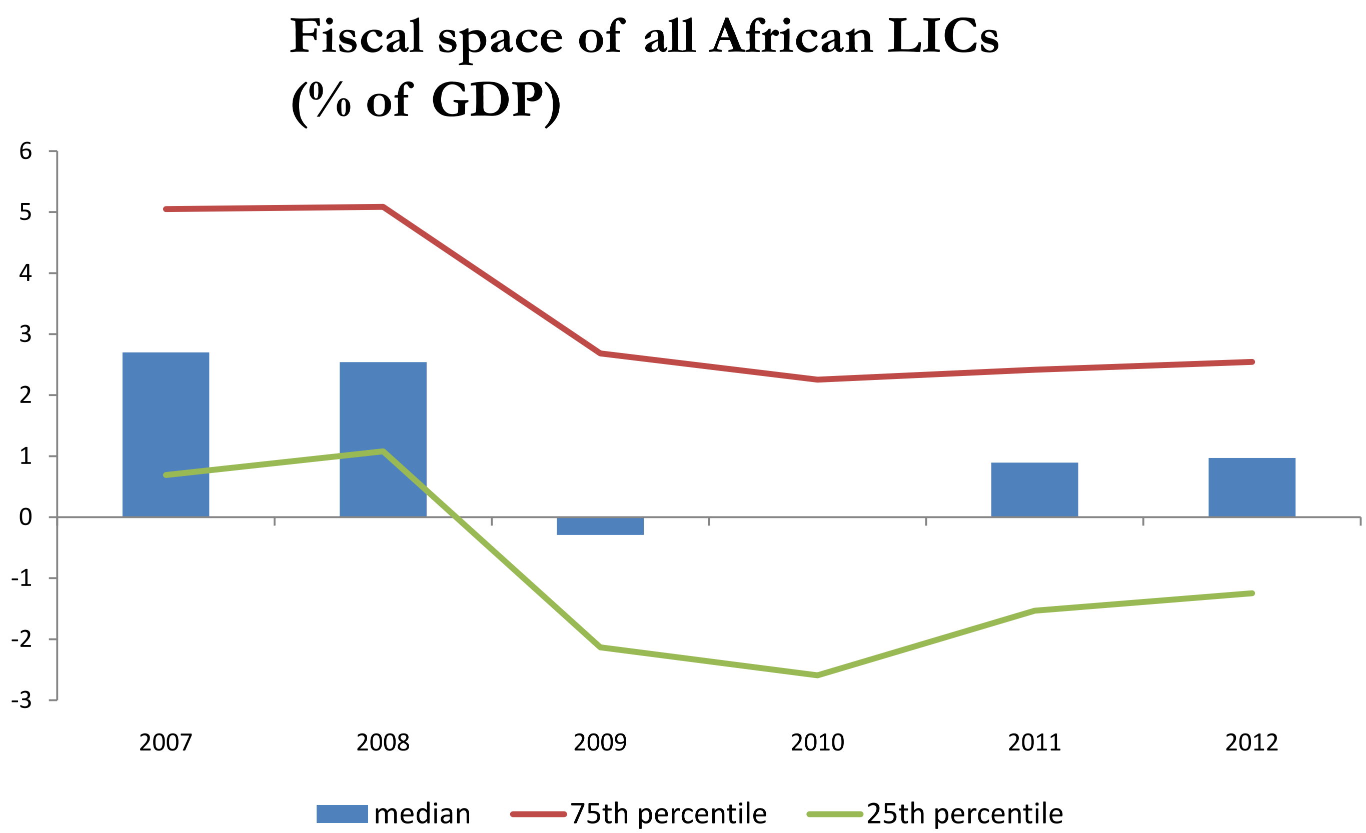
And a downturn in global growth

A 1½ percentage point decline in global growth in 2011–12 would shave off an estimated 1 percent from LIC growth.



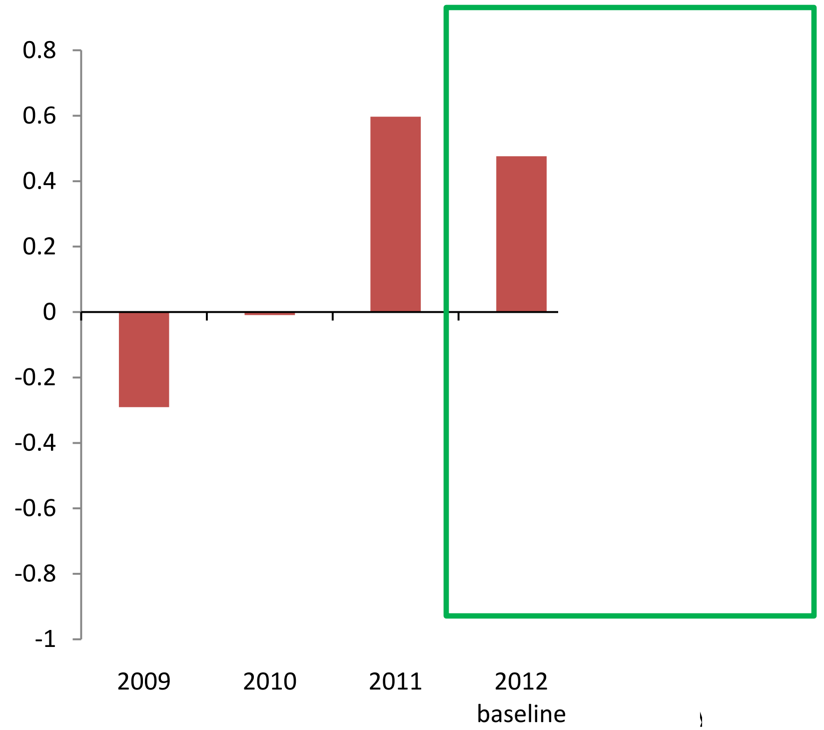
Sources: WEO, and IMF staff estimates.

A recap from yesterday: the recovery of fiscal space is still lagging



African LICs are less prepared to respond to further shocks compared to 2009

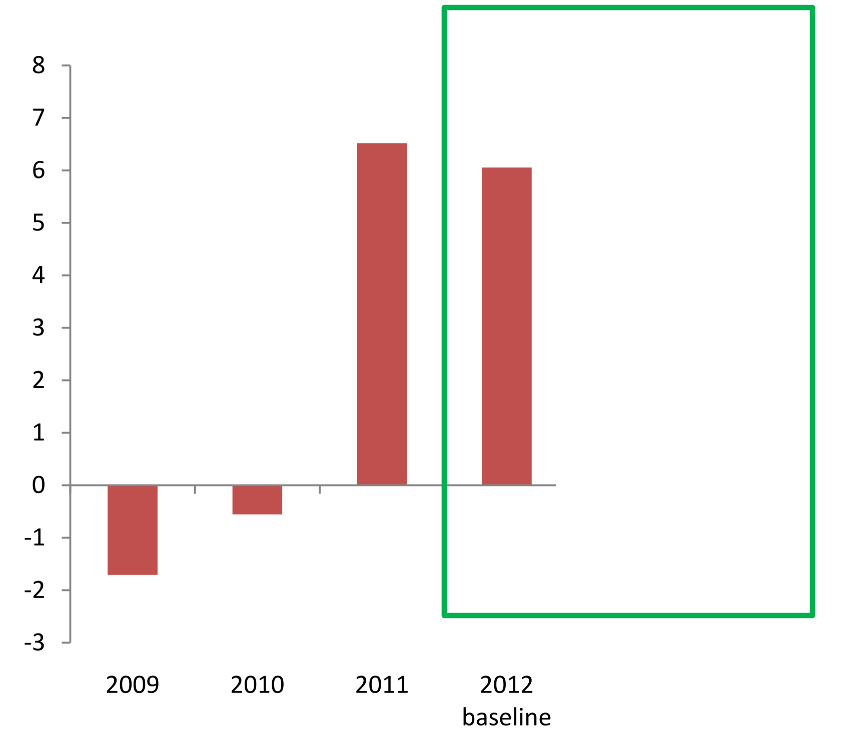
- Fiscal balances would deteriorate in LICs eroding fiscal space if the shocks materialize
- The fiscal impact of the growth shock is higher



Fiscal space (% of GDP, African LICs, non-oil exporters, median)

Oil exporting LICs in Africa have greater fiscal buffers, but more volatile

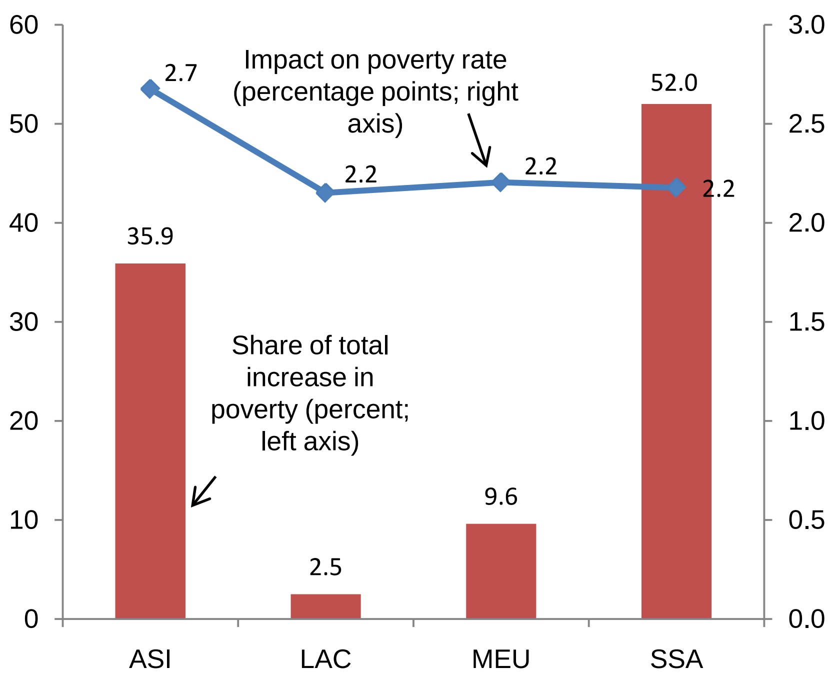
- While oil exporting LICs have more room to accommodate the shocks…
- …and would benefit from higher fuel prices…
- …the fiscal space can quickly be eroded if oil prices drop



Fiscal space (% of GDP, African LICs, oil exporters, median)

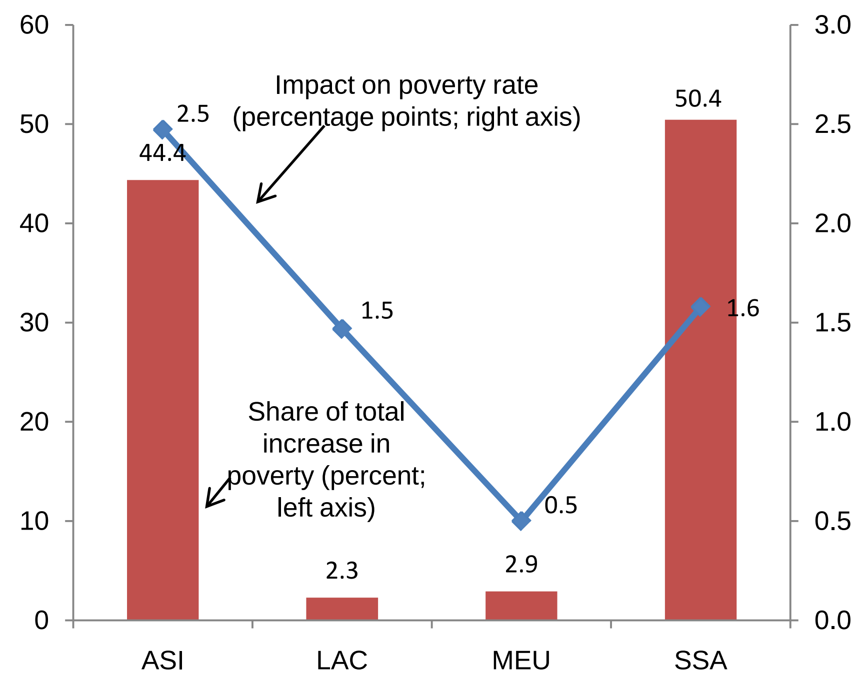
Poverty would increase if the shocks were to materialize

Higher food and fuel prices would leave an additional 31 million people in poverty in 2012, more than half in Sub-Saharan Africa.



Sources: WEO, and IMF staff

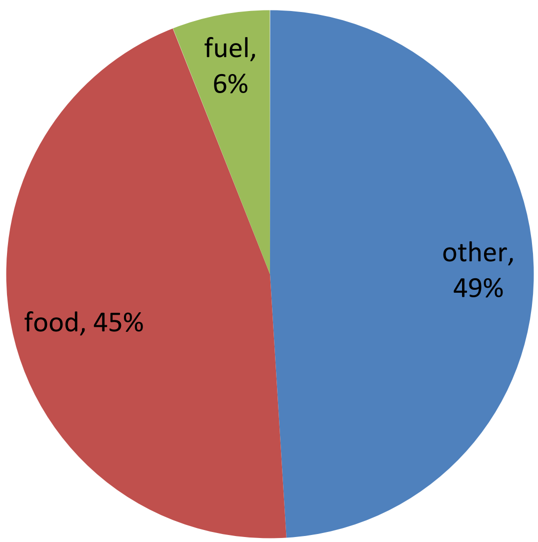
A double dip growth shock would leave an additional 23 million people in poverty by 2012, more than half in Sub-Saharan Africa.



Sources: WEO, and IMF staff

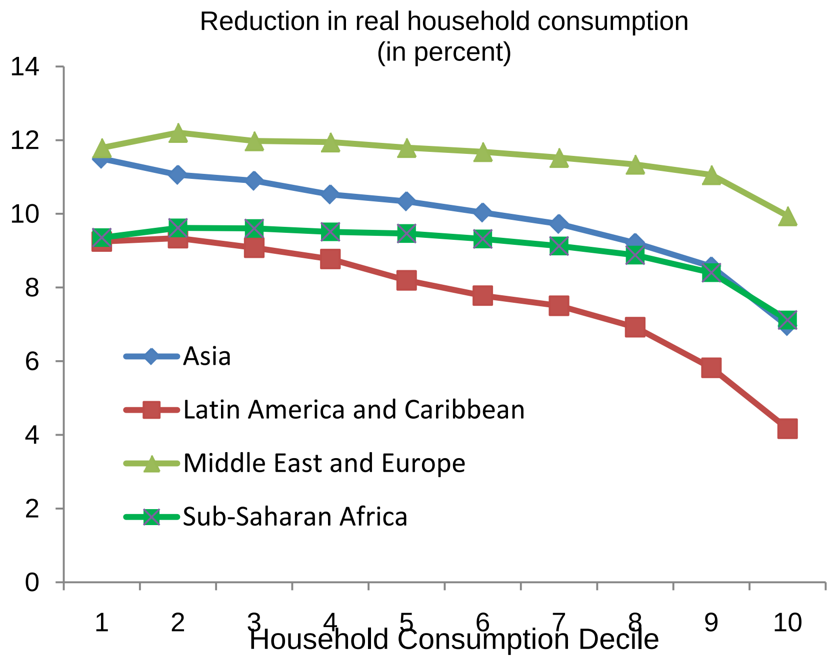
Households are especially sensitive to fuel and food price shocks

Food and fuel make up half of the consumer basket in LICs



Composition of CPI basket (LICs, median)

Higher food and fuel prices affect the poorest most, but middle-income households also impacted



Sources: WEO, and IMF staff estimates.

How should countries respond to a commodity price surge?

- LICs face inflation and social pressures → tough choices for fiscal and monetary policies
- Fiscal policy: need a pragmatic response, but avoid generalized tax decreases or subsidies
  - First best: full pass-through of international prices while relying on an effective, well-targeted social safety net
  - Second best:
    - Well-targeted price subsidies on specific commodities mostly consumed by the poor
    - Import tariff reductions on selected food items
    - Social support schemes: school based feeding, food voucher programs and proxy-targeting
    - If well-designed and targeted, agricultural input subsidies can help stimulate small-holder agricultural production

How should countries respond to a double dip growth shock?

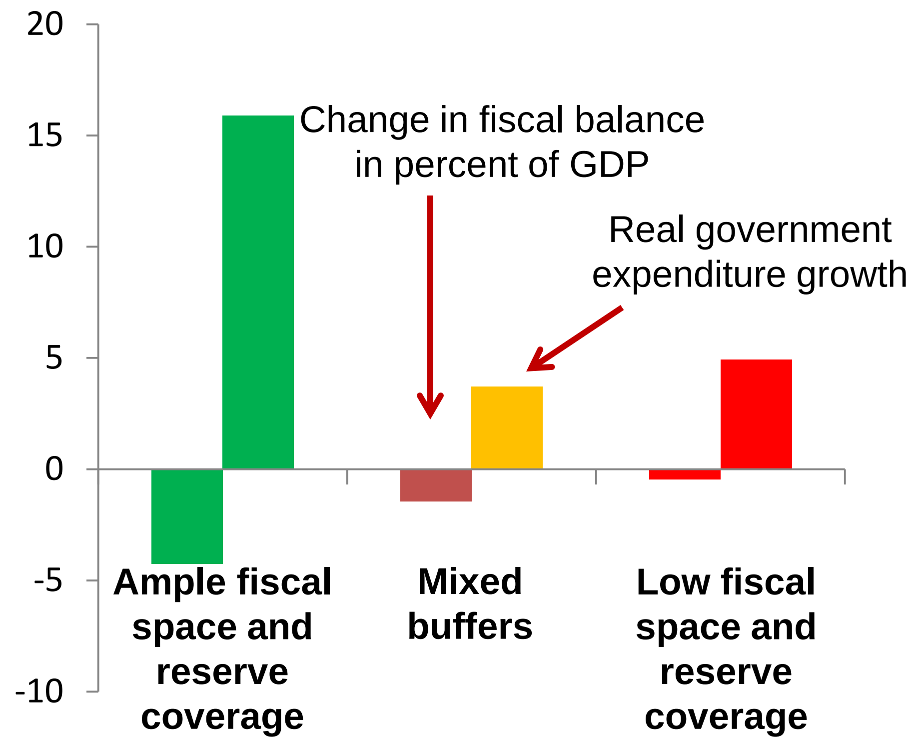
- Countries with fiscal space and financing can maintain, or even scaling up, expenditure to soften the economic and social impact
  - Investment spending for growth and employment
  - Social spending soften the impact on the poor
- Countries with inadequate fiscal space should limit revenue decline and prioritize spending
- Where there is no comprehensive social safety net, ad hoc social programs can help
- Avoid poorly targeted measures such as public wage increases

Anticipating future shocks: balance the rebuilding of buffers against spending needs

- **Policy buffers are key for building resilience against shocks**

- **But building buffers has an opportunity cost**

  ⟶ trade-off



How can countries become more resilient by increasing fiscal space?

- Strengthen the fiscal balance…
- …by revenue increases… Link
- …and public expenditure reforms Link
- Other reforms that strengthen growth and economic diversification

Scaling up capital expenditure has benefits but also risks

- Increasing capital expenditure is important for growth
- But requires better public investment management…appraisal, project selection, implementation, and evaluation
- Non-concessional borrowing needs to be handled prudently
  - Debt sustainability
  - Fiscal risks including from off-budget liabilities

Thank you !