African Fiscal Forum

Managing Fiscal Risks with Limited Policy Space

Todd Mattina
Fiscal Affairs Department
International Monetary Fund

March 14, 2013

Plan of Presentation

I. Fiscal risk management

II. Illustrative risk scenarios

III. Debt sustainability framework

IV. Summary

I. Fiscal risk management

I. Improving the fiscal risk management process

A key lesson of the global financial crisis is the importance of managing fiscal risks

- Fiscal risks are factors that lead to differences between government forecasts and actual fiscal outcomes
- Examples include shortfalls in expected aid, guaranteed debt and the cost of bank recapitalization
- Traditional reporting often does not cover fiscal risks
- Ministries of Finance should have the authority and capability to manage fiscal risks supported by accounting, budgeting, auditing and disclosure rules

I. Improving the fiscal risk management process

Strengthening fiscal transparency can improve awareness and prompt action to manage fiscal risks

- Strengthening fiscal transparency implies greater clarity, reliability, frequency and relevance of reporting

- Expanding the coverage of fiscal reporting is a key step:

  - While some progress has been made in extending coverage to the general government sector, the quasi-fiscal activities of public corporations remains a risk

  - Broadening fiscal coverage reduces the incentive to undertake quasi-fiscal activities off-budget through creative accounting and budgeting

I. Improving the fiscal risk management process

Greater transparency requires timely fiscal reporting, credible forecasts, effective monitoring and auditing

- Timely fiscal reporting allows for in-year corrective actions: the goal should be consolidated monthly reporting
- Assess the quality and reliability of Budget forecasts to ensure the credibility of the Budget
- Publish audit reports to highlight weaknesses in financial controls and prompt corrective action
- Monitor public corporations and off-budget public entities

I. Improving the fiscal risk management process

A fiscal risk matrix can be a useful tool to report and identify the largest fiscal risks

	Direct risks	Contingent risks
Explicit risks	Public debt; public sector wages; tax base erosion	Govt. guarantees, indemnities, legal action against the state
Implicit risks	Rising social expectations	Possible fiscal support to SOEs, SNGs, banks and PPPs

- Risks can be quantified in various ways, such as the maximum possible loss and expected loss based on probabilities.
- How risks have been mitigated and the impact on the overall balance should also be included.

I. Improving the fiscal risk management process

Consider fiscal risks in the Budget and medium-term fiscal planning

Potential actions to manage fiscal risks:

- Contingency appropriation in the annual Budget
- Include statement of fiscal risks in the Budget
- Regularly monitor SOEs, sub-national governments and other sources of contingent risk. Focus on mitigating the biggest risks.
- Sensitivity and scenario analyses can be included in the Budget to assess the fiscal impact of specific risks

II. Illustrative risk scenarios

II. Illustrative risk scenarios

Low income countries are more susceptible to shocks

Macro volatility imposes large welfare costs given under-developed safety nets and shallow financial markets

Narrow and volatile domestic tax bases are vulnerable to shocks

Liquidity-constrained governments can amplify shocks

Stop-go public investment imposes long-term costs

II. Illustrative risk scenarios

Underlying vulnerabilities

- Increasing trade and financial integration with the rest of world
- Reduced fiscal buffers after 2009

Exposure to specific risks

- Some countries without large underlying vulnerabilities can still be exposed to specific risks, such as higher energy prices

Scenario analyses

- Quantify underlying vulnerabilities and the impact of specific macro-fiscal shocks

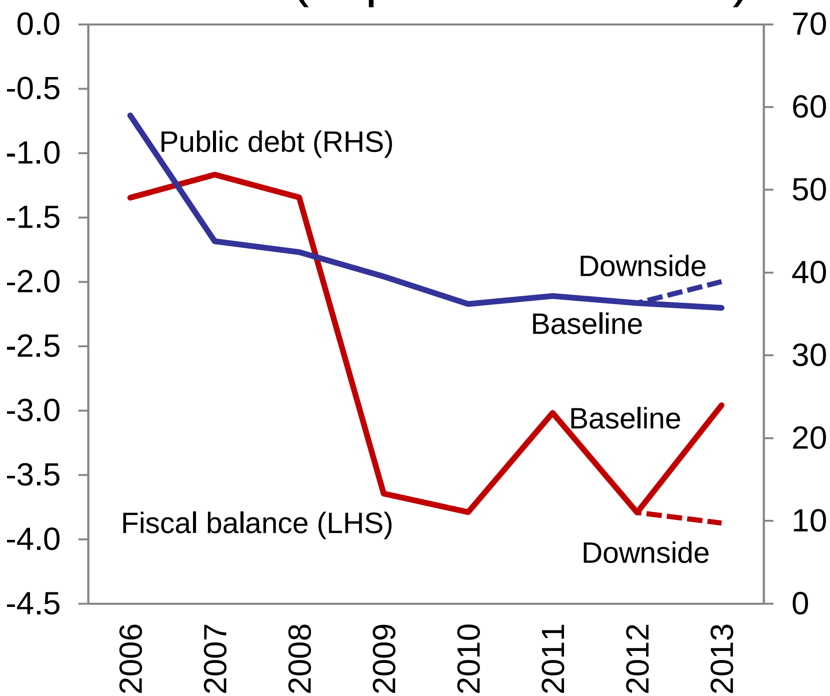
II. Illustrative risk scenarios

Scenario 1: Sharp global growth decline	Scenario 2: Protracted global growth decline
This scenario involves a sharp decline in global growth by 2% in 2013 relative to the WEO baseline projection.	A protracted global growth slowdown reflects slower potential output growth in advanced and emerging economies.
The epicenter of the simulated shock is the Euro Area, assuming an intensification of sovereign and bank stress.	Hysteresis in high unemployment rates, slower technological advancement and greater caution by households and firms slow growth.
Countries with the largest trade relationships and openness would be the hardest hit.	Oil prices decline by 30% and non-oil commodity prices fall by 20% after three years.

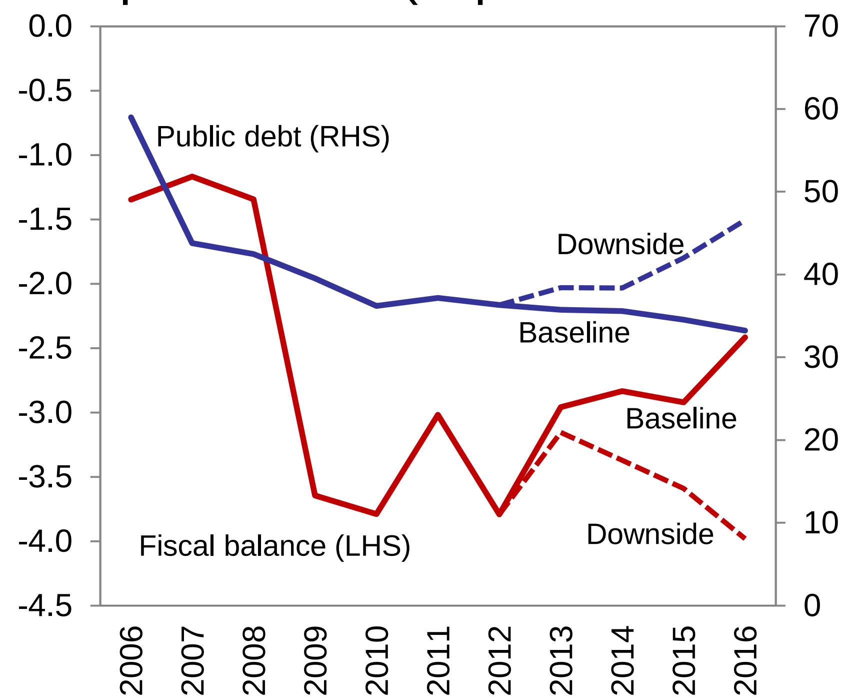
II. Illustrative risk scenarios

Scenario analyses suggest that the region remains exposed to global downside risks

Impact of a Sharp Global Output Decline (in percent of GDP)



Impact of a Protracted Global Output Decline (in percent of GDP)



Sources: VE-LIC (October 2012); IMF staff estimates

III. Illustrative risk assessment based on a debt sustainability framework

Large fiscal adjustment needs to stabilize the public debt ratio implies greater exposure to adverse shocks

- The debt-stabilizing primary balance, “DSPB”, would hold the debt ratio constant over time given average growth, g, and the average real borrowing rate, r

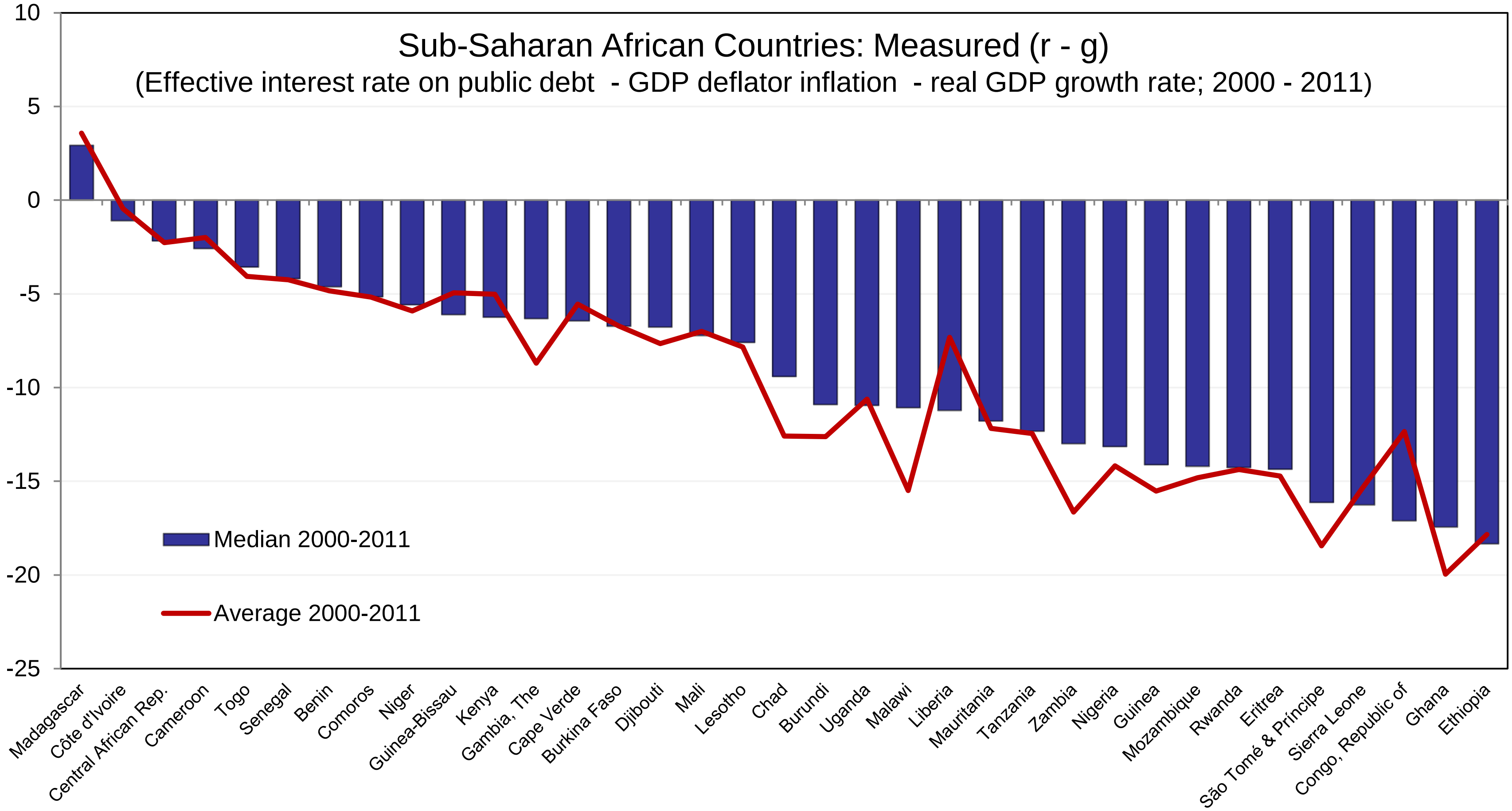
$$\frac{D_{t+1}}{GDP_{t+1}} = \left(\frac{r-g}{1+g}\right)\frac{D_t}{GDP_t} + \frac{PD_t}{GDP_t}$$

$$\frac{DSPB^*}{GDP} = \left(\frac{r-g}{1+g}\right)\frac{D^*}{GDP}$$

- The adjustment in the primary balance required to achieve the DSPB level provides a broad measure of fiscal space

III. Debt sustainability framework

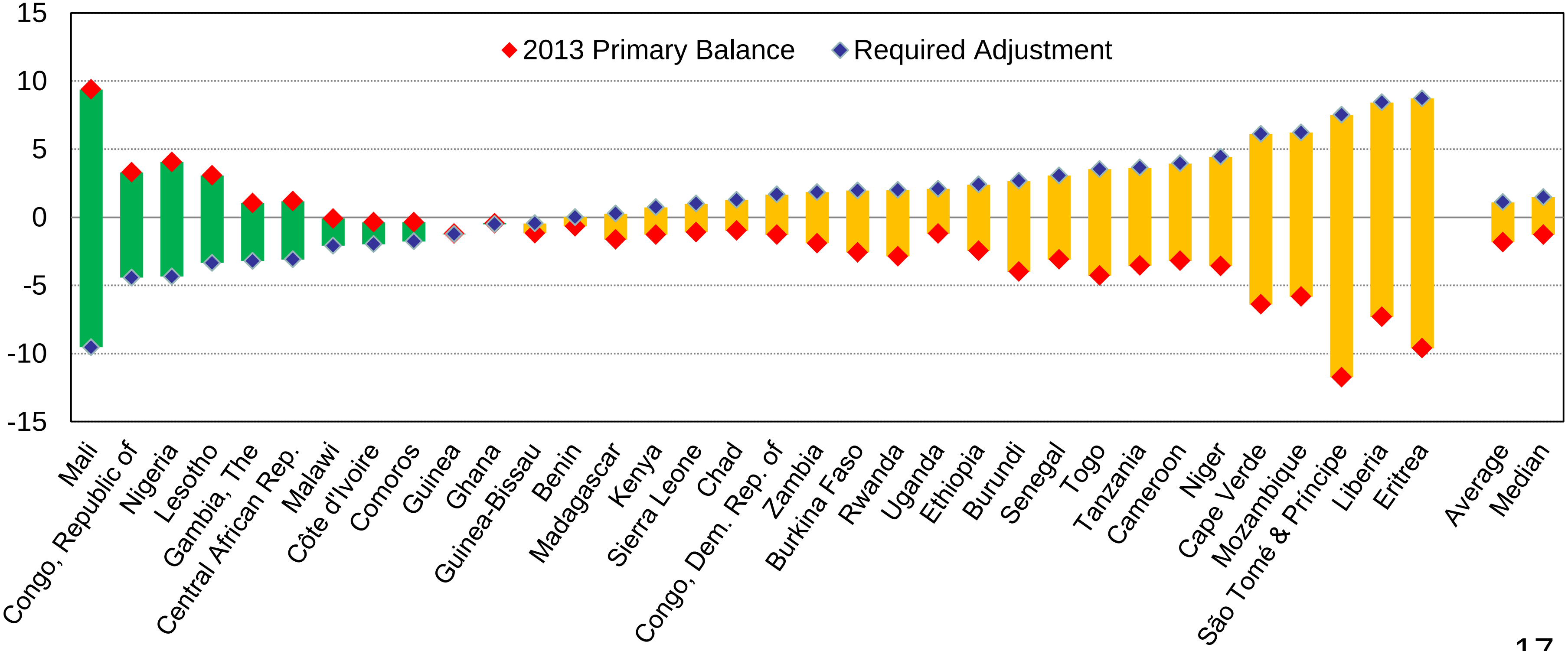
Attractive debt dynamics stemming from persistently negative (r-g) have been an important factor in reducing debt ratios



III. Debt sustainability framework

Fiscal adjustment needs differ across the region based on estimates of the debt-stabilizing primary balance

Fiscal Adjustment to Reach the Debt-Stabilizing Primary Balance
(in percent of GDP)



Sources: VE-LIC (October 2012); IMF staff estimates

III. Debt sustainability framework

The composition of fiscal consolidation should include both increased domestic revenues and expenditure adjustment

- A balanced approach involving revenue and expenditure measures is needed for rebuilding fiscal buffers without compromising on development objectives.

- Higher domestic revenues would mitigate the need for reducing productive areas of expenditure.

- More growth-friendly expenditure policies and enhancing the efficiency of public investment could support domestic demand and productivity growth.

IV. Summary

IV. Summary

Strengthening fiscal risk management can help to raise awareness and prioritize corrective actions based on expected impact

Illustrative risk scenarios can help quantify the fiscal impact of specific global and local risk exposures

An illustrative debt sustainability framework suggests varied adjustment needs in the region to stabilize public debt

Fiscal consolidation should combine domestic revenue mobilization with improved targeting and more growth-friendly expenditures

THANK YOU

Presentation is based on:

Fiscal Monitor, *Taking Stock: A Progress Report on Fiscal Adjustment*, October 2012. Fiscal Affairs Department, IMF. Available at: *www.imf.org/external/pubs/ft/fm/2012/02/pdf/fm1202.pdf*

Global Risks, Vulnerabilities, and Policy Challenges Facing Low-Income Countries, IMF, October 12, 2012.

Available at: http://www.imf.org/external/np/pp/eng/2012/101012a.pdf

Fiscal Transparency, Accountability, and Risk, August 2012, Fiscal Affairs Department, IMF.

Available at: http://www.imf.org/external/np/exr/facts/fiscal.htm