Factors influencing inclusive economic resilience in middle-income countries

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Research Question

What are the key threats to the resilience of middle-income countries (MICs) and their at-risk population groups? How can MICs promote inclusive economic resilience in the face of these challenges through policies and systems, specifically including those related to:

- Revenue mobilisation
- Management of investment flows and financial system risks
- Crisis management

Empty streets during COVID-19 in New Delhi

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Terminology

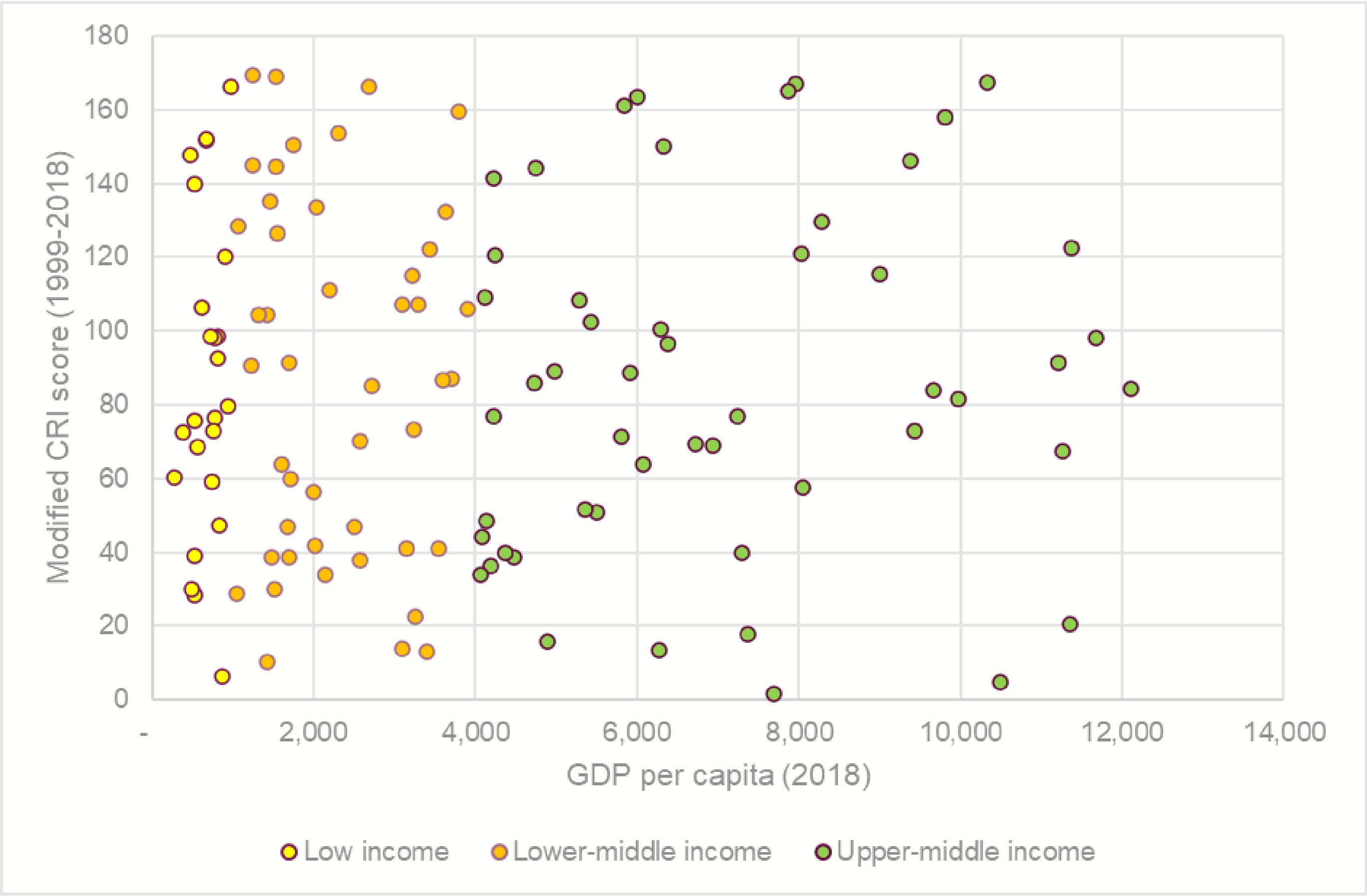
- **Economic vulnerability**. Inherent "susceptibility to being harmed" by economic shocks.
- **Economic resilience.** Ability of an economy to withstand or cope with the negative effects of exogenous shocks.
- **Inclusive economic resilience.** Protecting the interests of everyone in society:
  - ***Vertical:*** vulnerability: disabled; women; the poor; etc.
  - ***Horizontal:*** different regions and areas are frequently differentially affected by shocks.

Sources of economic shocks

Numerous and often hard to predict:

- Financial crises
- Currency crises
- Price shocks (e.g. oil prices)
- Public health issues
- Ecological degradation and climate change
- Natural disasters
- Trade wars
- Civil unrest, terrorism and conflict
- Technological shocks (e.g. artificial intelligence)

MIC vulnerability 1: Climate change risks



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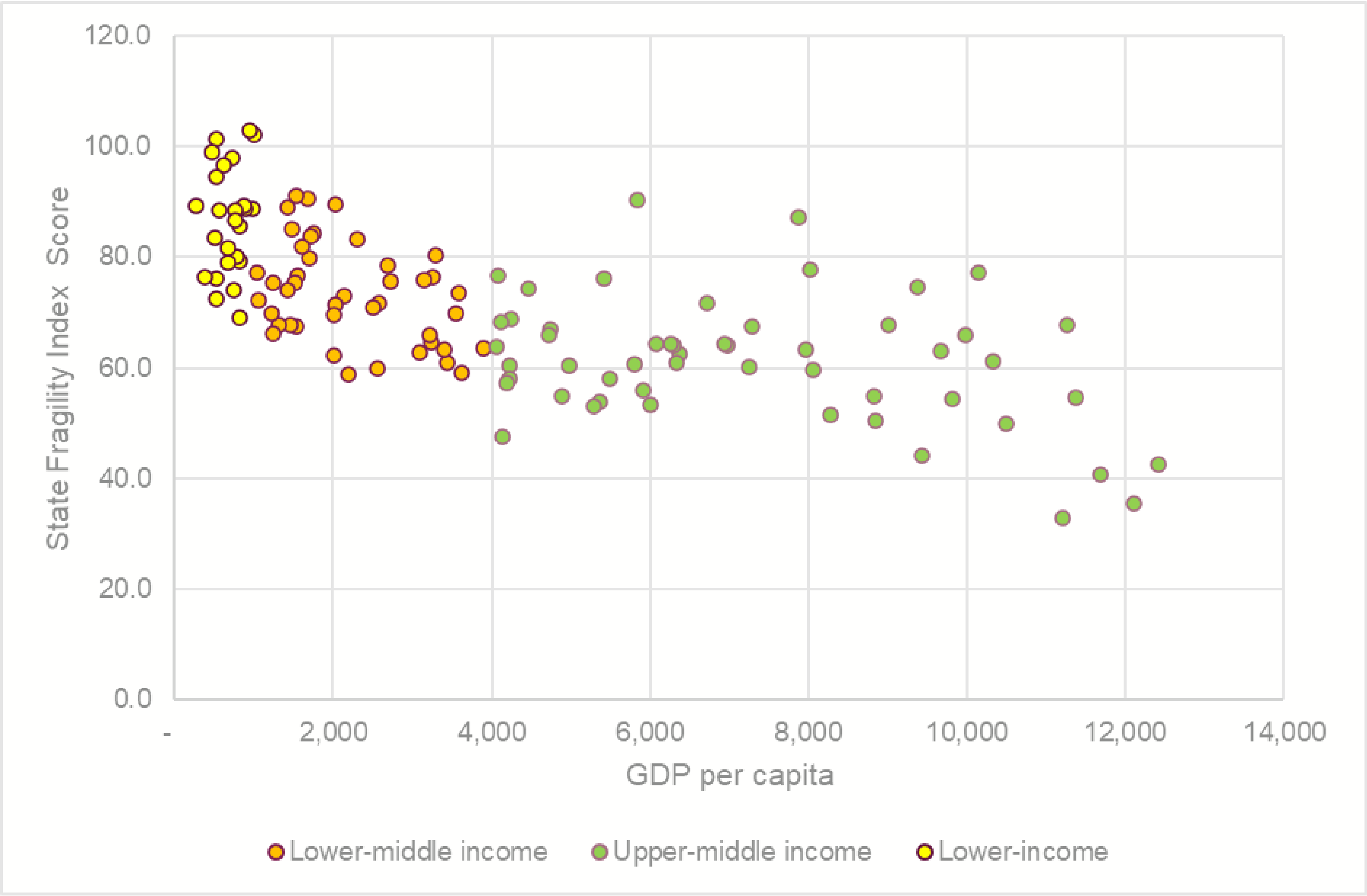
MIC vulnerability 2: state fragility



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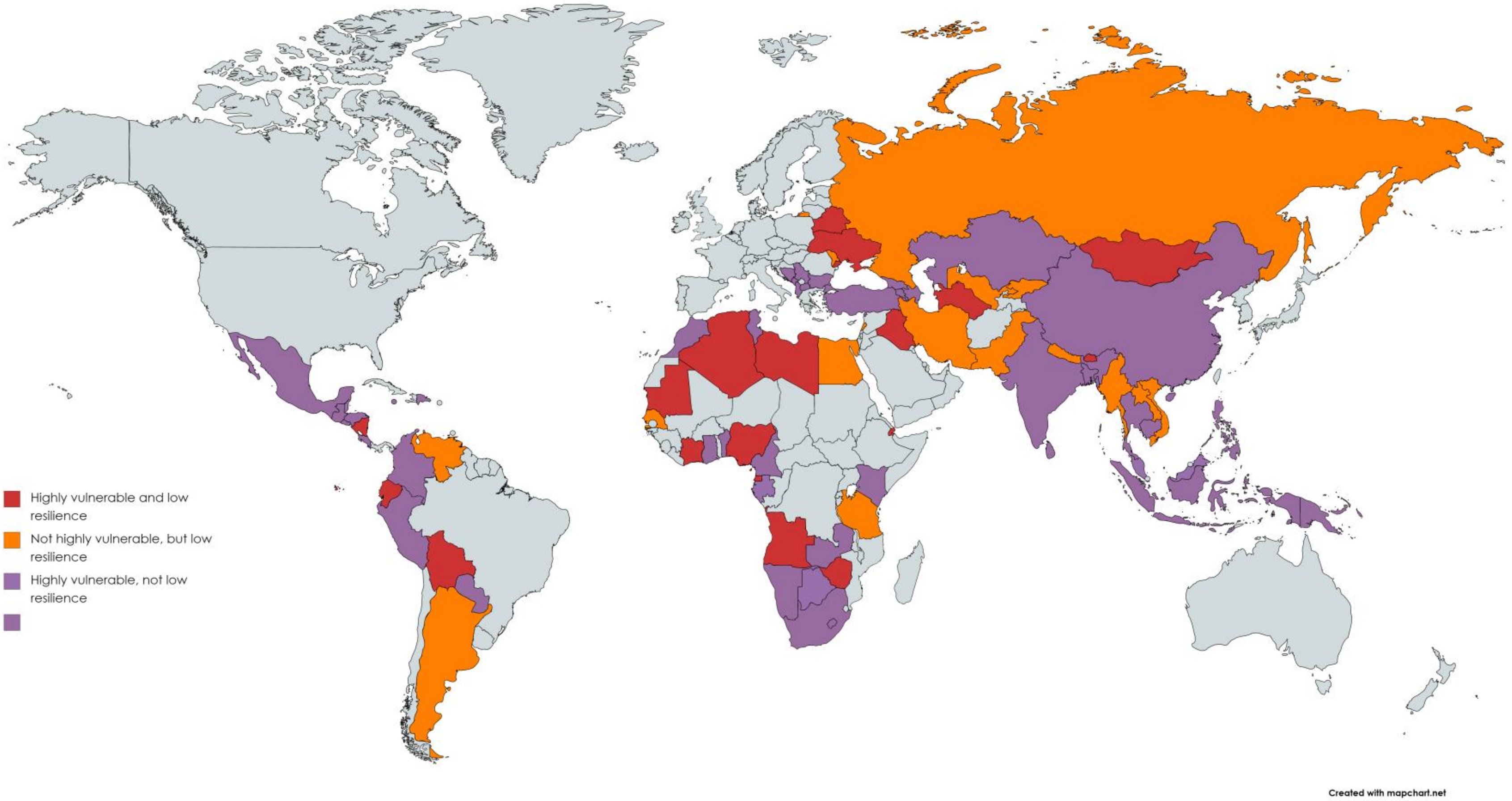
MIC vulnerability & resilience (Briguglio, 2016)



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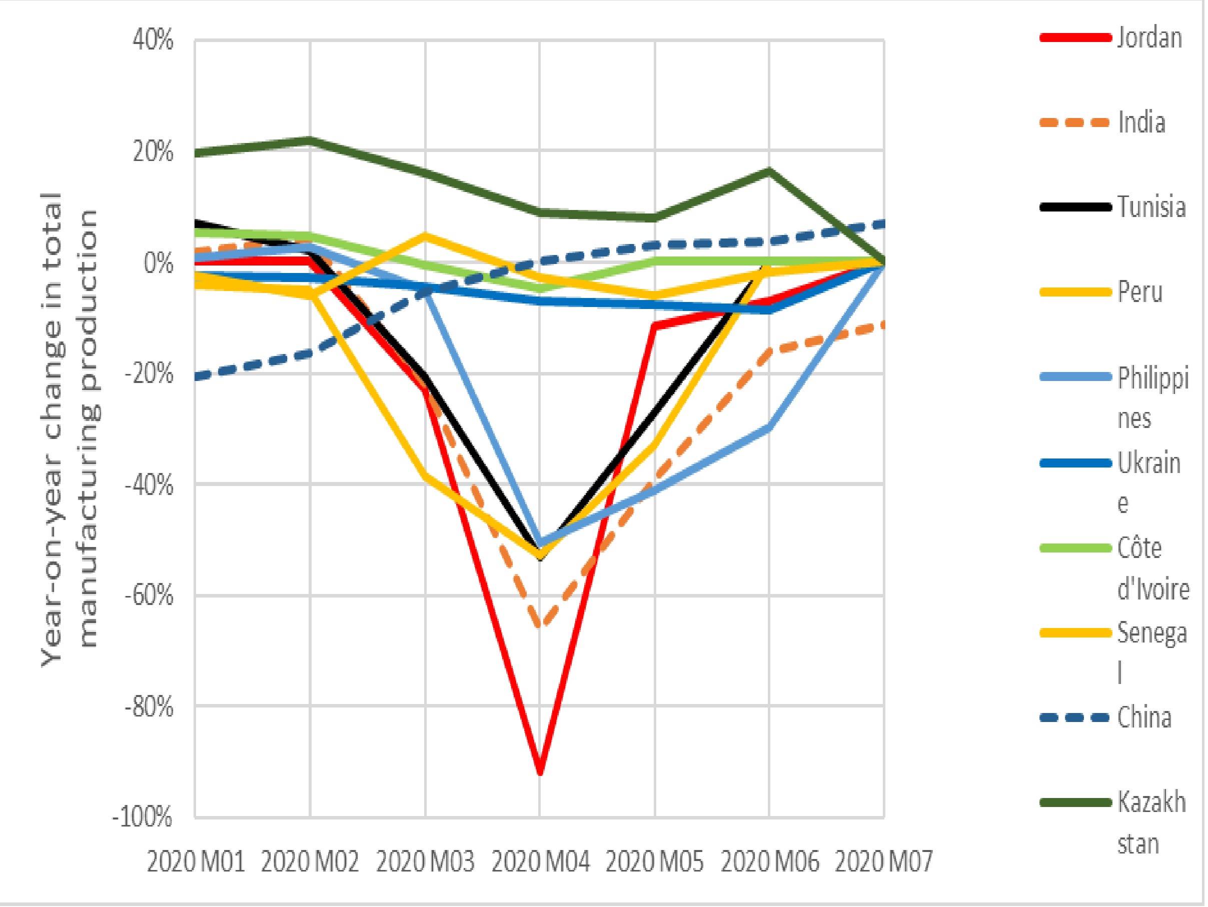
Economic resilience in MICs early in COVID-19

April 2020 year-on-year manufacturing output decline (UNIDO) :

- **35 MICs = 28%**
- **34 advanced economies = 19%**



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Fiscal policy

- Key to smoothing demand and protecting the vulnerable
- Requires fiscal space:
  - Expenditure control

  23/30 MICs scored C+ or below for PEFA payroll controls.
  - Revenue raising capacity

  +30 MICs government revenue <15% GDP.
  - Ability to borrow cheaply

  Moody’s: 13/53 MICs lower-medium grade or above.

Revenue priorities in MICs

Junquera-Varela, et al., 2017

- Improving taxation of self-employed professional income and capital income of the very wealthy
- Enhancing taxation of natural resource production
- Increased revenue from 'sin taxes' (e.g. alcohol & cigarettes) and 'green taxes'
- Encouraging business formalisation in order to enhance corporation tax and VAT revenue
- Reducing tax exemptions and incentive schemes
- Improving tax administration performance

Financial sector

- Major source of economic shocks.
- Liberalisation can increase vulnerability by allowing banks to hold more risky assets, increasing competition, & exposure to interest-rate or exchange-rate risk.
- Particular risk for MICs with under-developed financial sectors or strong implicit guarantees.
- Pre-COVID ~20% of MICs had a +10% NPL rate

Foreign investment flows

- Unclear if foreign investment is important for growth.
- Large foreign portfolio investment flows can increase the risks of economic shocks, particularly if the financial sector is under-developed.
- Capital controls:
  - Can reduce economic volatility.
  - Don’t necessarily damage growth
  - Are challenging to implement
  - Can have unintended consequences (e.g. corruption)

Crisis management

- Negative association between state effectiveness and COVID mortality rate.
- No clear authoritarian advantage in managing COVID – anocracies have performed badly
- Crisis management systems are useful
- BUT government effectiveness is what really counts

Limits to our understanding of resilience

- Standard measures of resilience haven't proven great predictive tools – notably in relation to COVID-19
- Crisis response highly affected by hard to quantify factors:
  - Political culture
  - Social attitudes
  - Personality and priorities of key political leaders.
- Every shock is unique.
- Importance of learning from prior experience

Inclusivity and resilience

- Potential tensions between resilience & inclusivity – e.g., labour market flexibility
- However, lack of inclusion can also undermine resilience (e.g. Singapore migrant workers)
- Importance of social protection schemes – often lacking in middle-income countries
- Need to be thinking about horizontal inclusivity (left-behind regions) as well as vertical inclusivity

Efficiency-resilience trade-offs

- Efficiency is good
- BUT so is resilience
- Sometimes there are trade-offs between them
- Systems that contain "slack" in normal times are less likely to buckle in the face of unprecedented demands following severe negative shocks.

Conclusion

- Economic resilience is not just a COVID-19 issue: threats to economic stability are varied, numerous and hard to quantify
- MICs are generally more vulnerable and less resilient than high-income countries
- State effectiveness and fiscal space are key to resilience
- Horizontal and vertical inclusivity need to be considered when assessing resilience
- FCDO and other donors need to take seriously potential trade-offs between short-term growth and resilience

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