

**FISCAL VULNERABILITIES IN DEVELOPING COUNTRIES  
AND THE TWIN OIL-FOOD SHOCKS**

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**Poverty Reduction and Economic Management (PREM) Network**

**THE WORLD BANK**



# FISCAL VULNERABILITIES IN DEVELOPING COUNTRIES AND THE TWIN OIL-FOOD SHOCKS<sup>1</sup>

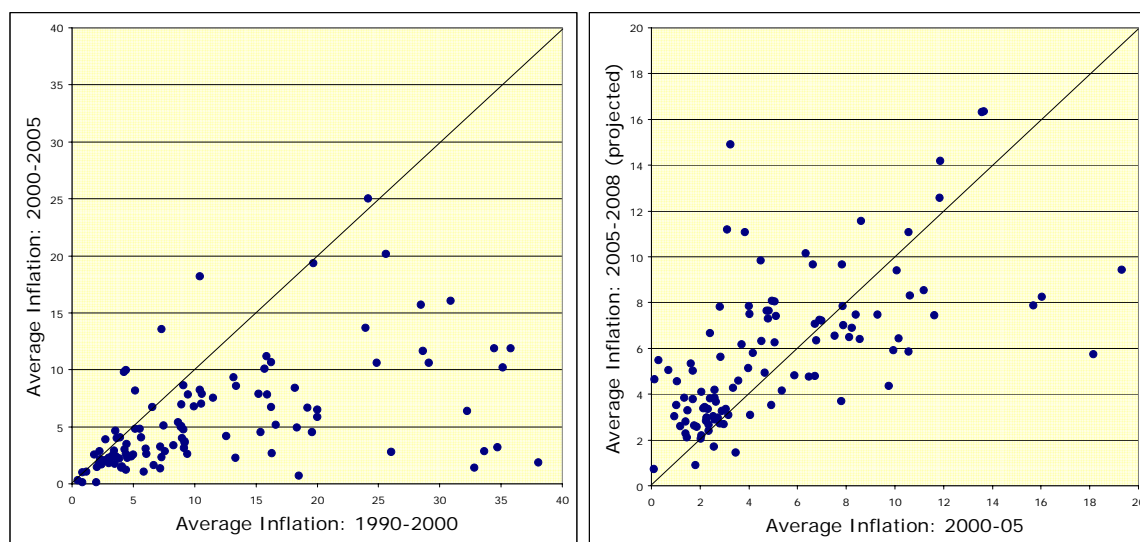
## I. PRICE SHOCKS AND MACROECONOMIC MANAGEMENT

- 1. As documented in several recent IMF-World Bank reports, the twin food and fuel price hikes are impacting world macroeconomic stability.** For net importers, the average terms-of-trade impact of the oil and food price shock (as a percent of GDP) is almost twice as large since 2005 as between 2003 and 2005. This large impact exacerbates already high current account deficits in many developing countries. Resource-rich developing countries have been able to cushion the current-account impact of food and oil price increases, but inflation is on the rise and they face the threat of Dutch disease stemming from appreciating real exchange rates.
- 2. Commodity prices appear to have peaked and have moderated in the second half of this year, but they are expected to stay at historically high levels in real terms.** In addition, they are expected to remain volatile as they are highly sensitive to changes in perceptions about demand and supply trends. **It is also important to recognize that there has been a significant increase in financial strains stemming from the U.S. housing and subprime crises.** Severe challenges lie ahead in restoring confidence in the financial system, and addressing the interplay between tighter credit conditions for developing countries and economic growth.
- 3. Inflation is mounting in both advanced and emerging economies, despite the global slowdown.** According to the IMF's World Economic Outlook, core inflation in emerging markets has climbed to 4.2 percent and headline inflation to 9 percent. The *first-round effect* of these price shocks provides only a partial picture of their macroeconomic impact. The recent experience has been characterized by a *sequence* of price increases in international markets instead of a single shock. The policy responses to the initial price shock have been complicated by the fact that, while the shocks were happening there was no consensus among policymakers as to whether these shocks were permanent or transitory. Moreover, the sequential nature of the price rise has also influenced inflationary expectations, and second-round inflationary effects, through increases in wages or prices in other sectors, merit special attention.
- 4. Figure 1 documents the resurgence of inflation following a period of successful inflation moderation. The left panel** displays inflation rates for developing countries, comparing the average inflation for the period 1990–2000 *vs.* the average inflation for 2000–05. The success in lowering inflation during the early 2000s shows up by most countries being below the 45° degree line—implying lower inflation in 2000–05 than in 1990–2000. **The right panel** plots average inflation rates for the same period 2000–2005 *vs.* 2005–2008 focusing on those developing countries that managed inflation below 20 percent in the initial period (note the different scale in the axes with respect to the left panel). Now most countries lie above the 45° degree line implying higher inflation—especially those that managed to achieve single-digit levels earlier.

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<sup>1</sup> This brief is a product of the Poverty Reduction and Economic Management (PREM) Network. It relies on substantive inputs of the Development Economics Vice Presidency (DEC) and other networks and regions of the World Bank. Questions/comments should be addressed to C. Braga ([cbraga@worldbank.org](mailto:cbraga@worldbank.org)), S. Gooptu ([sgooptu@worldbank.org](mailto:sgooptu@worldbank.org)), and E. Ley ([eley@worldbank.org](mailto:eley@worldbank.org)).

**Figure 1. Developing Countries Are Now Facing a Resurgence of Inflation**



## II. FISCAL VULNERABILITY

5. **Policy responses to higher food and fuel prices are generating fiscal pressures in many developing countries.** Fiscal measures have been used to address the cost-of-living issues emanating from the twin shocks. So far, the first-round fiscal responses have included: fuel and food tax rate reductions; increases in fuel and food subsidies; income or corporate tax relief to individuals or businesses facing hardship due to higher energy prices; under-pricing of electricity generated from oil and gas; and increases in social transfer programs to cope with higher energy/food prices. **These responses have exacerbated fiscal imbalances for countries whose fiscal and debt management policies (and institutions) are already weak.**

6. **This note identifies fiscal risks arising from higher fuel and food prices,** using information from: (i) the first-round terms-of-trade (ToT) impact of the recent price shocks (January 2007 through August 2008) based on the Bank's Development Prospects Group (DECPG) estimates; (ii) the IMF survey (conducted in June 2008) of 147 countries on the fiscal costs of policy measures undertaken by their governments to deal with the higher fuel and food prices;<sup>2</sup> and (iii) the Bank's Country Policy and Institutional Assessment (CPIA) ratings for Fiscal and Debt Policy reflecting the situation mostly as of mid- to late-2007. Finally, it goes on to address the special challenges faced by aid-dependent countries.

7. **Figure 2 combines information on the ToT impacts estimated by DECPG with a measure of fiscal vulnerability derived from the World Bank's CPIA.**<sup>3</sup> The ToT impact is measured as the first-round effect of commodity price changes between January 2007 and

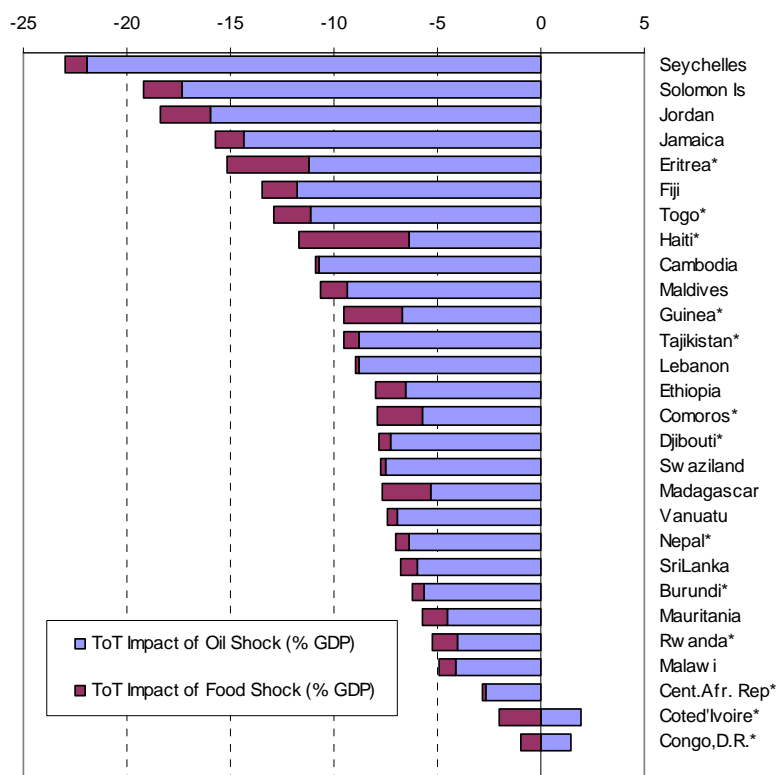
<sup>2</sup> See IMF (2008), "Food and Fuel Prices—Recent Developments, Macroeconomic Impact, and Policy Responses," June and its update (September 2008) that now encompasses 161 countries.

<sup>3</sup> The CPIA ranks countries on 16 criteria of which two—those related to fiscal policy and debt policy—are used here. Rankings are based on the quantitative levels of the fiscal balance, the level of debt and the quality of fiscal and debt management institutions. Using these rankings countries are classified as having a low, moderate, or high *fiscal vulnerability*.

August 2008. These estimates represent the impact of price changes alone and do not take into account the corresponding changes in quantities in response to the higher prices.<sup>4</sup> The ToT impact also reflects potential pressure on government budgets, as they absorb a share of the shock.

**8. The countries presented in Figure 2 are highly fiscally vulnerable and their respective government budgets have very limited capacity to help absorb shocks.** Moreover, the countries marked by an asterisk (“\*”) face debt sustainability issues, as defined by the LIC debt-sustainability framework (DSF).

**Figure 2. Fiscally Vulnerable Countries**  
(ToT impact due to 2007-2008 price developments)



Note: An asterisk (\*) denotes countries in debt distress or at high risk of debt distress.  
Food includes rice, wheat, maize, sorghum, soybean, groundnuts and edible oils.  
Source: DECPG and staff estimates.

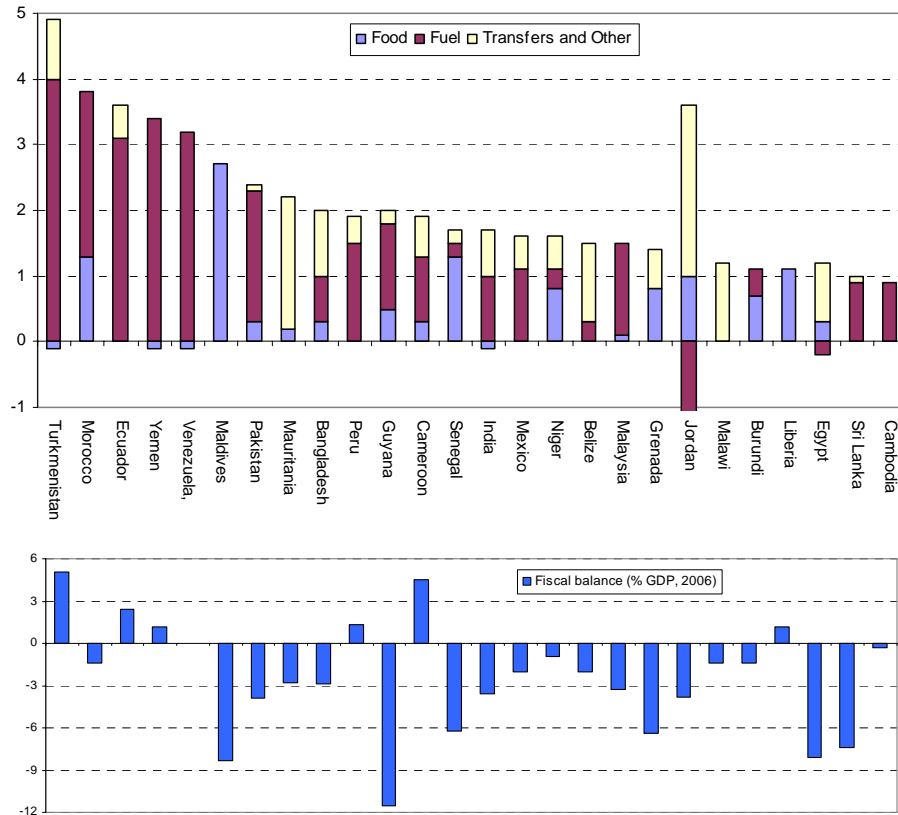
### 2.1 Policies Adopted

**9. In addressing high food prices, tax reduction measures have been more prominent—** according to the latest update of the IMF survey, 57 percent of the countries have reduced food taxes and 18 percent have increased subsidies. **In addressing high fuel prices** only 27 percent have reduced taxes, while 22 percent of the countries have employed fuel subsidies. Over one-

<sup>4</sup> The estimates are likely upper bounds to the true cost of the price change since they are calculated by maintaining constant the shares of food, oil and imports and exports in GDP. Nonetheless, these estimates provide useful benchmarks to identify countries severely affected by the terms of trade shock.

quarter of the countries surveyed spent more on targeted transfer programs in 2008. The total fiscal cost of the measures introduced has been substantial in several countries—over 1 percent of GDP for most of the countries shown in Figure 3, and close and above to 2 points of GDP for half of the countries.

**Figure 3. Reported Increase in Fiscal Costs Since 2006**  
(Percent of GDP)



Source: IMF (2008), IMF World Economic Outlook database, April 2008, and World Bank staff estimates.

Note: For **Jordan**, the overall fiscal cost of the policy response was equivalent to 1.3 percent of GDP since 2006.

This reflects reduction in fuel subsidies (of 2.4 percent of GDP) that were accompanied by an increase in social transfers (of 2.6 percent of GDP) and an increase in food subsidies combined with food tax rate reductions (a fiscal cost of 1 percent of GDP).

10. It must be noted that **the costs reported in the Fund’s survey are actual costs and may underestimate the needs in the countries most severely impacted by higher food and fuel prices**, which tend to be poorer on average and where food expenditures are a larger share of GDP.<sup>5</sup> Thus, several of the countries identified in Figure 2 as fiscally vulnerable *ex-ante* and with severe potential ToT impacts, do not appear in Figure 3. For example, countries such as Togo, Guinea, or Haiti may just lack the fiscal room to respond, and therefore report no

<sup>5</sup> The impact of food inflation could increase urban poverty alone by more than 3 percentage points in the worst affected countries. See S. Dessus, S. Herrera, R. de Hoyos (2008) “The Impact of Food Inflation on Urban Poverty and its Monetary Cost: Some Back of the Envelope Calculations” World Bank WPS4666, forthcoming *Agricultural Economics*.

incremental fiscal costs associated with higher food and fuel prices. On the other hand, oil or gas exporters such as Venezuela, Ecuador, and Turkmenistan are not under equally serious fiscal pressure even though they face high fiscal costs due to their policy responses, which involve untargeted universal subsidies.

**11. Other countries such as the Maldives, Mauritania and Jordan are identified by both approaches as countries that may face severe stress.** Jordan, in particular, merits mention because it reduced fuel subsidies while increasing transfers by a similar amount. Finally, it is also important to keep in perspective the initial fiscal position of the countries being analyzed. For example, Maldives, Guyana, Egypt, Sri Lanka, Grenada and Senegal had fiscal deficits already above 5 per cent of GDP in 2006.

**12. Support of the expansion of safety net programs in poor and capacity-constrained governments is often required to dampen the worst effects of the crisis on vulnerable populations.** Several hard-hit small countries require emergency food aid, nutritional supplements, and budget support in order to protect the vulnerable. Many of the poorer countries that are more exposed to international food and fuel price shocks are also constrained in their fiscal capacity to cope with these shocks, and they possess limited means to respond to inflationary pressures. In this regard, the Bank paper to the 2008 G8 Summit “Double Jeopardy: Responding to High Food Fuel Prices” highlighted the need for governments to review the scope for reducing their lower priority public expenditures and for adopting more efficient taxation policies, in order to help accommodate the additional fiscal costs generated by the need to respond to rising food prices. Efforts by the monetary authorities to lower inflation may prove difficult, as persistently high food and energy prices place further pressure on wages and other costs, and untargeted fuel and food subsidies add to fiscal spending.

### III. CHALLENGES FOR AID DEPENDENT COUNTRIES

**13. Several other low-income countries, while being fiscally vulnerable, are somewhat less so than those identified in Figure 2—in part because they are major recipients of grants.** In many instances these grants reflected donor support for progress on reforms aimed at promoting growth and poverty alleviation. For these countries’ fiscal positions to remain sustainable in the face of the twin shocks, as well as for their reforms to continue progressing, donor support will need to continue at least at levels achieved in recent years, if not more.

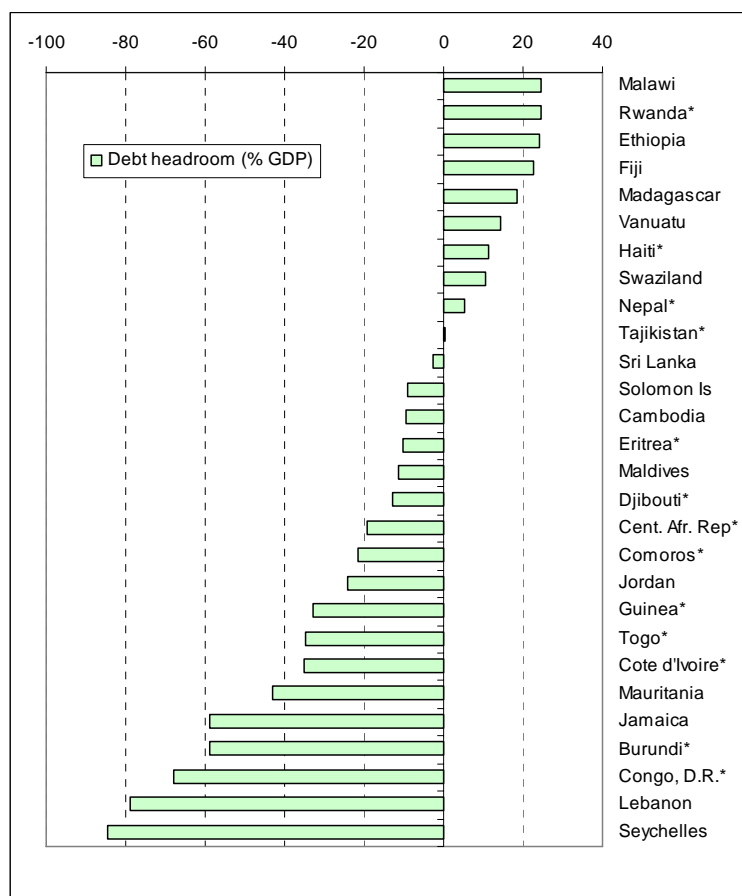
14. As noted above, **the total fiscal cost of the actual measures introduced so far has been substantial in several countries, but may still fall short of the needs** of the low-income countries that are most severely impacted by higher food and fuel prices. **These countries may not have the fiscal space to adequately respond to the crisis.** *Fiscal space* refers to availability of budgetary resources for a specific purpose without jeopardizing the sustainability of the government’s financial position, or the macro stability of the economy.

**15. There are four ways to obtain additional fiscal space:**<sup>6</sup> (1) improving efficiency in government spending and reallocating expenditures; (2) raising more revenue; (3) increased borrowing; and (4) additional aid. **In the short term, however, only aid and debt are feasible alternatives to drastic budget reallocation to quickly expand fiscal space.**

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<sup>6</sup> See papers prepared for the Development Committee regarding fiscal space (DC2006–3 and DC2007–4).

**Figure 4. Headroom to Increase Debt Is Unavailable to Most Countries**



Note: An asterisk (\*) denotes countries in debt distress or at high risk of debt distress.

Source: IMF, World Bank GDF data, DECPG estimates, and staff calculations.

16. **Figure 4 shows that many countries have little or no debt headroom to meet the fiscal costs from the twin shocks.** *Debt headroom* estimates measure the maximum increase in debt that a country can withstand before reaching the indicative LIC debt-sustainability framework (DSF) debt-sustainability threshold for countries considered to display “weak” policy frameworks.<sup>7,8</sup> Most countries have negative entries (bars to the left of the axis), which indicate no room to increase borrowing, and aid is these countries’ only remaining option. Even several of the countries—e.g., at the top of the graph: Malawi, Rwanda, Ethiopia and Madagascar—that show positive headroom have recently received debt relief, so the apparent headroom for

<sup>7</sup> An indicative debt burden threshold of 30 percent of debt-to-GDP was used to determine the degree of headroom, in line with the measure stipulated by the LIC Debt Sustainability Framework for countries displaying “weak” macroeconomic, fiscal, and debt policy frameworks, as assessed by the World Bank CPIA scores. See IDA and IMF “Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries” (May 2007).

<sup>8</sup> Figure 4 includes several non-IDA-only countries identified as fiscally vulnerable. The LIC DSF threshold is applied to these countries for comparability with other countries in the sample, though some of them would remain vulnerable even if a higher threshold were employed.

increasing debt levels in such countries may be misleading, especially if debt is non-concessional.<sup>9</sup> Another caveat is that being solvent by this measure (positive headroom) does not guarantee that their current liquidity needs will be met, especially in an environment of tighter credit to developing countries.

**17. Many of these countries, however, are already heavily dependent on ODA flows.** Table 1 displays recent trends in *actual* ODA flows. Countries such as the Solomon Islands, Burundi, DRC, Rwanda, and Malawi all received aid in excess of 20 percent of GNI in 2006.<sup>10</sup> Moreover, several of these countries have seen large increases in aid over the past 5 years—e.g., the Solomon Islands, Haiti, Burundi, the Central African Republic, Sri Lanka, and Madagascar have all seen aid flows increase by over 40 percent from 2002–2006. However, nine of the countries listed below have seen aid flows decline by more than 10 percent in real terms from 2002–2006.<sup>11</sup> The special circumstances of highly-indebted poor countries vis-à-vis the twin price shocks are described in Box 1.

**18. While ODA flows in the recent past are an important indicator of the availability of assistance, a focus on current and planned aid is also informative.** Looking specifically at programmable aid<sup>12</sup>—disbursements available for budget support and projects—reveals that for these highly-vulnerable countries, the planned increase in flows for 2008 (as reported by the OECD in May 2008)<sup>13</sup> will not be sufficient to offset the costs of the combined oil and food shocks (see Figures 4 and 5).

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<sup>9</sup> For example, countries that have received debt relief under the HIPC Initiative and, where applicable MDRI, before end-2006 include Malawi, Rwanda, Ethiopia, Madagascar, Haiti, Guinea, Cote d'Ivoire, Mauritania, Burundi, and Congo DR.

<sup>10</sup> World Bank GDF data and staff calculations.

<sup>11</sup> In addition, there is a set of countries with weak policies and institutions, which make for some of the most difficult environments for aid programs, although they are amongst the poorest nations. Dollar and Levin (2005) suggest that these *Difficult Partnership Countries (DPCs)* typically receive less aid than their stronger-performing peers. Such countries, sometimes described as “aid orphans”, include both large countries and small countries and badly governed countries. The plight of these countries that have been adversely affected by the rise in food and fuel prices cannot be ignored.

<sup>12</sup> Data on programmable aid is based on OECD surveys regarding planned allocations, as data on actual disbursements is released with a two-year lag. This represents real financial resources available for budget support or projects, which excludes items such as humanitarian aid, debt relief and technical assistance. Surveys cover all OECD DAC countries and multilateral agencies, and assume constant flows for USA and Japan, which do not provide this data.

<sup>13</sup> OECD, “Scaling Up: Commitments and Performance”, May, 2008. Estimates for 2007 flows, and planned disbursements for 2008, adjusted for inflation and relative to 2007 GDP.

**Table 1. ODA Flows to Highly Fiscally Vulnerable Countries (2002–2006)**

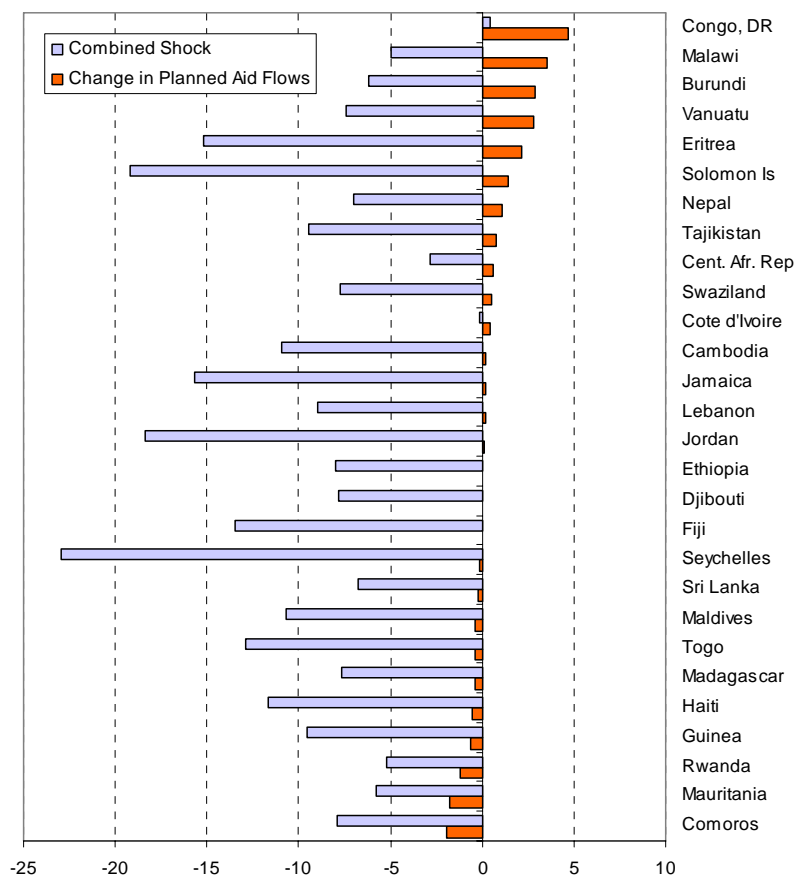
	(Net ODA Flows excluding Net Debt Relief)						Percent Change (2002-2006)	Nominal change in Programmable Aid Flows (2007-2008)
	Constant Prices (2006 USD millions)							
	2002	2003	2004	2005	2006	Average (2002-2006)		
Solomon Islands	42	85	134	203	205	134	392%	4%
Haiti	197	242	280	522	565	361	188%	-6%
Burundi	233	264	327	366	405	319	73%	11%
Central African Rep.	75	57	114	97	128	94	70%	12%
Sri Lanka	430	754	516	1191	731	724	70%	-7%
Madagascar	475	533	765	635	692	620	46%	-5%
Fiji	43	57	66	65	56	57	31%	2%
Malawi	484	578	524	586	581	551	20%	28%
Lebanon	590	259	278	251	707	417	20%	21%
Swaziland	29	39	23	45	35	34	20%	31%
Nepal	439	520	446	428	511	469	16%	20%
Togo	67	56	67	84	77	70	16%	-10%
Djibouti	103	90	66	78	117	91	14%	1%
Maldives	34	23	28	77	39	40	13%	-14%
Seychelles	11	11	11	15	12	12	12%	-15%
Ethiopia	1636	1797	1788	1932	1823	1795	11%	1%
Rwanda	469	384	510	575	513	490	9%	-6%
Jordan	639	1346	622	677	568	770	-11%	4%
Congo Dem.Rep.	1380	677	1092	1355	1181	1137	-14%	78%
Cambodia	620	573	502	548	529	554	-15%	3%
Jamaica	36	8	83	34	30	38	-16%	30%
Comoros	43	28	26	25	30	31	-31%	-19%
Guinea	300	266	239	193	161	232	-46%	-16%
Mauritania	356	225	187	200	163	226	-54%	-20%
Eritrea	303	363	282	366	129	289	-57%	27%

Source: OECD data and Bank staff calculations.

**19. For these highly vulnerable countries, the median ToT estimated impact is -8 percent of GDP, while on average, there is no increase in programmable aid.** Even for the **five net oil and food importing countries** with the highest projected increase in programmable aid flows as a share of GDP —Malawi, Burundi, Vanuatu, Eritrea, and Solomon Islands (see Figure 5)—the estimated shock averages -10.6 percent of GDP, while the average increase in aid is only 2.6 percent of GDP.<sup>14</sup> While it is not expected that such programmable aid would cover the entire gap, and even though these figures are preliminary, the fact that they are based on donor intentions as of early 2008 indicates that **donor response to countries' additional requirements due to the price shocks needs to be adjusted.**

<sup>14</sup> As noted in footnote 3, the cost figures are likely upper bounds and need not be those actually incurred.

**Figure 5. Planned Changes in Programmable Aid Fall Short of Cost of Shocks (2007–2008 in percent of GDP)**



Source: IMF, OECD and World Bank DECPG estimates, and staff calculations.

20. In addition to these trends in current and planned aid flows, **developing countries continue to suffer from the impacts of aid volatility and the lack of predictability.** The predictability of aid flows over the short- and medium-term is critical if recipients are to successfully manage public finances, undertake realistic planning, and fully implement development projects. Aid-dependent countries are particularly vulnerable to disbursement shortfalls and changing donor priorities. As discussed during the 2008 High Level Forum on *Aid Effectiveness* in Accra, despite donor commitments to improve aid predictability at the Paris Forum in 2005, there has been slow progress in this area, including towards achieving the agreed target of halving the proportion of aid commitments not disbursed by 2010.<sup>15</sup> In this context, the Accra Agenda for Action calls on donors to provide additional information on commitments, actual disbursements, and their three- to five-year forward expenditure implementation plans. It also calls on aid recipients to strengthen budget planning processes and the linkages between expenditures and results.

<sup>15</sup> As outlined in the “Aid Effectiveness: Progress Report on Implementing the Paris Declaration”, prepared for the High Level Forum in Accra, progress towards achieving Indicator 7 of the Paris Declaration—to halve the incidence of under-disbursement within the fiscal year—by 2010 has been slow, including because of legal and financial obstacles to medium-term ODA budgeting in donor countries.

**21. Donors will have to make a concerted effort to increase the availability of resources to those countries most affected by the food and oil price shocks.** In light of the limited ability of these countries to take on additional debt and the difficulties in using scarce domestic resources to finance adjustment to the price shocks—implying a diversion of spending away from priority development. On the other hand, recipient countries will have to make efforts to ensure that resources are put to their best and most efficient use, including by putting in place well-targeted social safety nets and improving the targeting of resources provided to the poor.

**Box 1. COMMODITY PRICES AND PROGRESS OF THE HIPC INITIATIVE**

There are 18 remaining pre-completion-point heavily-indebted poor countries (HIPC):<sup>1</sup> (1) ten interim HIPCs and (2) eight pre-decision-point countries (see listing below). **The recent increase in commodity prices is imposing fiscal pressure and creating external imbalances in 12 of these 18 HIPCs, posing challenges to their macroeconomic stability.** For the pre-decision-point HIPCs, the commodities' recent price hikes engender unanticipated financing needs, which may lead to further accumulation of arrears on external debt. For the interim countries, additional fiscal needs associated with the increase in commodity prices may decrease resources available to reaching their HIPC Initiative completion point triggers.

Preliminary analysis shows that **eight of the 12 negatively affected pre-completion-point HIPCs are making substantial efforts toward reaching their HIPC Initiative decision or completion points.** Two of the remaining four—the Democratic Republic of Congo, and Eritrea—face challenges in advancing through the HIPC Initiative process not directly related to the commodity price increases. These challenges are of a political or security nature, and pre-existent to the recent hikes of commodity prices.

**Five pre-completion-point HIPCs benefit from the commodity price increase:** Rep. of Congo, Chad, Côte d'Ivoire and Sudan are oil producers, while Guinea-Bissau is a net food exporter. These five countries, especially the oil producing ones, have the opportunity to use their revenue windfall to attain their economic and social development targets. However, only two of these five countries are on track in the HIPC Initiative process: Côte d'Ivoire and Guinea-Bissau.<sup>2</sup>

<sup>1</sup>The **ten interim HIPCs** are Afghanistan, Chad, Dem. Rep. of Congo, Haiti, Burundi, Republic of Congo, Liberia, Central African Republic, Guinea, and Guinea-Bissau. The **eight pre-decision-point** countries are: Côte d'Ivoire, Kyrgyz Republic, Sudan, Comoros, Nepal, Togo, Eritrea, and Somalia. For **Somalia** there is no data available.

<sup>2</sup>The **Kyrgyz** authorities indicated in early 2007 that they did not wish to avail themselves of the HIPC initiative, but they subsequently expressed interest for the MDRI. At end-2007, however, the Kyrgyz Republic debt indicators were estimated to be below the HIPC Initiative thresholds, while income levels were estimated to be above the IMF MDRI thresholds.

#### IV. ROLE OF THE WORLD BANK

**22. The countries whose fiscal vulnerability has increased as a result of these shocks would be eligible to access additional budget-support operations from the World Bank.** These budget-support operations can support specific reform measures to help governments move away from untargeted and increasingly unsustainable energy or food subsidies, rationalize energy pricing while establishing or strengthening social safety nets for the most vulnerable population, and supporting energy efficiency measures.

Budgetary support could also be provided to vulnerable countries with limited fiscal means to directly alleviate the oil and food prices shock. In addition, the World Bank Group's *New Deal on Global Food Policy* has been endorsed by 150 countries. The New Deal embraces short, medium and long-term responses, including safety nets such as school feeding, food for work, and conditional cash transfers; increased agricultural production; a better understanding of the impact of biofuels; and action on the trade front to reduce distorting subsidies and trade barriers.

**23. A new \$1.2 billion rapid financing facility—the Global Food Response Program (GFRP)—has been created in the World Bank to speed assistance to the neediest countries.**<sup>16</sup> As of September 25, the value of total approved projects and those in the pipeline for approval under this facility amounts to \$851 million. An Energy Price Crisis Response window is also being established to provide short term assistance to adversely-hit economies by combining resources under the GFRP to top up and extend the social protection component of these operations. Medium-term support is also being extended to energy supply diversification, energy efficiency programs and policy support for severely affected countries. In addition, co-financing and parallel financing is being sought to scale up assistance to energy access programs including fuel supply diversification, energy efficiency.

**24. On the analytical side, it is critical for the World Bank, in collaboration with the IMF and others, to continuously examine the potential risks to these economies with a view to assess the appropriateness of their macroeconomic policies to counter such risks.** Stronger analytical work would also provide a better grounding for budget support operations. In addition, *Public Expenditure Reviews* could look into the creation of fiscal space for strengthening or developing social protection programs that are now being considered by many governments. In the energy sector, a better understanding of the fiscal and quasi-fiscal impact of energy subsidies that are being considered in response to the recent price hikes needs to be carefully examined as well.

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<sup>16</sup> In addition to the GFRP, the World Bank has also approved additional lending outside fast-track procedures, bringing its overall response to the food crisis to \$1.3 billion.

## V. OTHER SOURCES OF POTENTIAL ECONOMIC VULNERABILITIES

25. **As noted, the complexity of coping with the twin price shocks is being compounded by unfolding developments in the global economy.** The recurrent nature of the price shocks has complicated the management of inflation expectations, and there are risks of second-round effects. Until recently, there have been also demand pressures stemming from the large capital inflows into developing markets. With inflation on the rise and slower growth in high-income countries, monetary policy developments must be closely watched—for their spillover effects for developing countries.
26. **A tightening of credit could lead to a “flight to quality”** by portfolio investors that may, in turn, lead to a “sudden stop” or reversal of portfolio investment to developing countries with capital market access. Assessing and managing the downside risks from the drying-up of such capital inflows needs to become a key priority for policymakers in these countries.
27. **More generally, spillover effects from weaknesses in global financial markets constitute another very important potential source of fiscal vulnerability.** As financial weaknesses originating from the developed world continue to unfold, key issues going forward are how significant will be the spillover effects to the rest of the world, and which countries are likely to be most affected. Stock markets in several emerging market economies have already been impacted by the financial turbulence in developed countries. Authorities will need to keep a close watch on their financial systems and corporate debt, make contingency plans, and maintain a readiness to swiftly tackle any stress that may be spilling over their borders.
28. **Countries with high current account deficits, rising or high inflation, and those with extensive fuel/food subsidies could be particularly vulnerable to a sharp slowdown**—especially if accompanied by a significant tightening of financial conditions. The strong growth that many developing countries had experienced in recent years is weakening, which could expose or exacerbate macroeconomic imbalances that may have been built-up. Industrial production has already slowed sharply in several developing countries. Policymakers need to focus their attention on the most vulnerable groups and prepare internal vulnerability assessments, including threats to the progress on MDGs.
29. **There is a danger that scarce fiscal resources may be diverted away from growth-enhancing expenditures.** The need to finance adjustment to the price shocks in the short-term, may lead to a diversion of spending away from priority development programs in health and education, much needed public infrastructure investment or operations and maintenance expenditures. While these expenditures may be relatively “easier” to hold back they could adversely impact growth in the next 5–10 years. It would be more prudent to gain resources, for example, through improving the efficiency and targeting of subsidies, supported by higher aid inflows to the most vulnerable countries.
30. **Meanwhile, in response to their own inflationary pressures, several countries are already tightening monetary policy.** For those with significant debt stocks, this could also be a source of emerging fiscal pressure. If, in addition, a significant slowdown in activity in advanced economies materializes, the trade-off between inflation and unemployment (or growth) will become more pronounced.