Development Finance and the Macro Economic Impact of COVID-19

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Authors

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Stevan Lee is Acting Chief Economist at Oxford Policy Management. He has extensive in-country advisory experience, including a nine-year residency in African countries and in the Middle East. He has spent a large part of his career shaping academic work into a useful form for policy advice with the UK Department for International Development and the World Bank.

Christopher Adam has over 20 years' experience as an academic economist working principally on the macroeconomics and public finance of low-income economies. He is Professor of Development Economics for the Department of International Development, University of Oxford, and a Fellow of the European Development Network (EUDN).

Yasmina Yusuf led the in-country engagement component of this study, where she interviewed key decision makers and stakeholders who are working on alleviating the economic impact of COVID-19 their countries. She has been an international development consultant for over six years and worked on a range of topics within economic and urban development.

Aaron Templeton is an Assistant Consultant at Oxford Policy Management. He primarily focuses on economic analysis and mixed methods evaluations of program effectiveness. He has a Master's degree in Economic Development and Policy Analysis.

Mark Henstridge is Chief Executive Officer at Oxford Policy Management, having joined OPM as Chief Economist in 2012. In his capacity as Chief Economist, Mark was responsible for setting the strategic direction of OPM's work in development economics.

Oxford Policy Management Limited
Registered in England: 3122495

Level 3, Clarendon House
52 Cornmarket Street
Oxford, OX1 3HJ
United Kingdom

Tel: +44 (0) 1865 207 300
Fax: +44 (0) 1865 207 301
Email: admin@opml.co.uk
Website: www.opml.co.uk
Twitter: @OPMglobal
Facebook: @OPMglobal
YouTube: @OPMglobal
LinkedIn: @OPMglobal

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Registered in England: 3122495
Level 3, Clarendon House
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Oxford, OX1 3HJ
United Kingdom

Tel: +44 (0) 1865 207 300
Fax: +44 (0) 1865 207 301
Email: admin@opml.co.uk
Website: www.opml.co.uk
Twitter: @OPMglobal
Facebook: @OPMglobal
YouTube: @OPMglobal
LinkedIn: @OPMglobal

Executive summary

The research

The research takes stock of the experience of COVID across 15 countries in 2020, and looks ahead to the medium-term challenges from 2021. Needless to say, the crisis causes a deep economic recession, with long lasting impacts and a drawn out recovery.

By comparing pre-COVID forecasts from the International Monetary Fund (IMF) and World Bank, with the most recent ones, and using further modelling to explore scenarios and deviations from these central projections, and where possible adding observational data, the research surveys health, economic, poverty and financial impacts of the crisis at its apex in 2020. On the basis of further forecasts and information about choices already made, the report explores the constraints for countries going forward, the options for continued support from global financial institutions, and the implications for bilateral development actors.

Three types of country experience

The research distinguishes three country groupings which define the experience of the COVID economic and financial shocks and its further impacts in the medium term. The immediate impact of COVID on gross domestic product (GDP) is not that varied across the 15 countries, although India and the closely linked economies of Nepal and Bangladesh are more severely hit than others. The groupings are not defined by characteristics of economic production, but are largely based on public finance conditions: a *lower income, acute impact* group of countries (Democratic Republic of the Congo (DRC), Ethiopia, Kenya, Nepal, Uganda); a *middle income, partially delayed impact* group (Ghana, India, Nigeria, Pakistan, South Africa); plus a *resilient but affected* group (Bangladesh, Burkina Faso, Indonesia).

The *lower income, acute impact* group were financially constrained at the start of 2020, only managed a very weak fiscal response to the crisis, were helped by International Financial Institutions (IFIs) but continue to need concessional finance, if not debt cancellation, going forward.

These countries were financially constrained because loose fiscal policy in the good times, pre-COVID, and because of limited access to international financial markets. They suffered a severe economic setback in the apex of the crisis (April–September 2020), but mounted little or no counter-cyclical fiscal response – several cut expenditure. They cut public investment and also cut routine public programmes in order to finance COVID-related packages, although there was much less support for business or households compared with most better off countries. The accelerated financing provided by the IMF and Multilateral Development Banks (MDBs) in mid-2020 was very important for this group, limiting public expenditure cuts and reductions in investment and consumption in the economy. It seems that these countries are likely to have experienced significant scarring (damage to capital) during the apex of the crisis and will experience increased poverty and weak public revenue even as growth rates recover pre-COVID levels. There will be a continuing need for concessional finance and in some cases, debt distress suggests a need for debt cancellation (although grant support is also useful to these countries).

The *middle income, partially delayed impact* countries had unhealthy public finances, and sometimes weak economic performance, even before COVID. They manage a fiscal response mid-2020, protecting against the worst of the impacts – but unfortunately this leaves this group in unsustainable or deeply unsustainable positions with the need for quite severe adjustment and stabilisation in the years following the crisis.

This group of better-off middle-income countries (MICs) had weak economic performance in some cases, and less sustainable public finances than the lower income countries in early 2020. They were more active and counter-cyclical in 2020, mainly reducing public investment but boosted recurrent spending for COVID-related packages. Official finance helped but was less important for these countries mid-2020. They managed a short-term fiscal stimulus despite failing to build 'buffers' pre-crisis, and the consequence was even greater imbalances by the end of 2020: high debts and unsustainably large fiscal deficits which won't be closed just by winding down COVID-related packages. This leaves these countries with significant medium-term challenges, in effect, delaying and prolonging the impact of the crisis. Non-concessional official finance can be of some use but cannot remove the need to stabilise.

Three *resilient but affected countries* are Bangladesh, Burkina Faso and Indonesia. This is a diverse group but what they had in common was strong public finances prior to the crisis, such that they are able to finance a fiscal stimulus to limit damage to public services, consumption and investment, without emerging with unsustainable public debt or fiscal deficits.

These countries are very deliberately not referred to as 'unaffected'. The economic damage in Bangladesh would be seen as a disaster in most years and will cause lasting poverty increases – but at least the scarring is not compounded by unsustainable public finances. The impact is less in Indonesia but still constitutes a major recession by the standards of normal times. In Burkina Faso the relatively mild COVID impact is still serious and is compounded by economic pressures caused by political and security problems.

Global financial institutions did well at taking action in the apex of the crisis in 2020, although decisions need to be made about what happens in the medium term

Multilateral organisations mobilised very quickly in April and May 2020, even while high-income countries were distracted by their own crises, with new IMF finance, special COVID-related loans from the World Bank and other MDBs and faster disbursements on existing policy-related lending and project loans. Across the 15 countries studied, these organisations and humanitarian agencies are together estimated to disburse an additional US$ 23 billion in 2020, that is, an increase in foreign financial flows of US$ 23 billion compared to what was planned for 2020 before the crisis struck. Critically, however, the MDBs achieved this disbursement by accelerating lending which would otherwise have flowed in future years. They cannot keep up this level of finance into the medium term unless soft windows are replenished and/or non-concessional windows are recapitalised.

The challenges for development finance from 2021

The economic and financial impacts of the COVID crisis will last well beyond 2020. The groups of countries defined above face different challenges and different development finance needs in the medium term. There is an array of options in the development finance toolkit which can help address these challenges and needs.

A new Special Drawing Rights (SDR) allocation, with High Income Country (HIC) quota repurposed to fund concessional replenishments, is a somewhat unorthodox but feasible way to meet the need for extra official and concessional resources in the medium term, given the global crisis conditions

Serious scarring and the absence of a rapid return to pre-COVID output levels means many countries will have a high medium-term need for external finance. Because of the frontloading in 2020, however, multilaterals need an additional replenishment just to keep up the lending levels they would have managed in 2021–2023 in the absence of COVID. The standard way of financing replenishments is from the budgets of HICs, and this remains an option, although these budgets are already stretched. A new SDR allocation from the IMF, like that which followed the 2008 Global Financial Crisis[1], would offer some help to larger MICs and enable HICs to fund US$ 50–100 billion of replenishment to the IMF's Poverty Reduction and Growth Trust (PRGT) soft window. It is more complicated but theoretically feasible to use the same resources for other soft windows like International Development Association (IDA). This would be enough to make a significant difference to IDA-eligible countries, equivalent to several years of the 'accelerated finance' provided in 2020.

Country engagement suggest that debt cancellation is needed and wanted, although MDB soft windows providing grants for countries with liquidity problems might be faster to organise and a good complement

Several of the countries studied are so financially constrained and near to debt distress that even their ability to access highly concessional finance (e.g. IDA) is compromised. Debt cancellation to restore liquidity is popular in these countries, and more widely. In the medium term, there is scope for innovation – for example, in combining debt relief and climate finance to accelerate progress on low-carbon investment. However, some forms of debt cancellation would only back-load disbursement of a given lump sum of concessional finance. Debt cancellation always takes time to negotiate and administer. Targeting grants on the least-liquid countries, rather than soft loans, would be a way to overcome liquidity constraints more quickly.

In any concessional replenishment (e.g. an early IDA 20 replenishment as has been discussed by the World Bank), country allocation is designed to meet several objectives – it is not obvious that any new allocation weighting would be superior to the standard IDA performance and income-based criteria.

[1] The 2009 issuance of SDRs was US$ 283 billion, so allowing for inflation and growth, US$ 600 billion is similar in scale for 2021. Most of these SDRs are allocated to high income or upper middle income countries and a portion could be offered back to the IMF to fund their soft window or repurposes to IDA or other MDBs in a similar way

Regular IDA allocations are based largely on a country's population, GDP, and governance score, and there is an argument for allocating 'extra' COVID crisis resources more closely based on COVID impact. The normal allocation weightings (including GDP *per capita* prior to the crisis) are almost completely uncorrelated with COVID's GDP and poverty impacts, but they are favourable to the poorest countries. This means that allocations that bring in the GDP impact of COVID, or alternatively the poverty impact of COVID, both tend to skew resource allocation away from the poorest IDA countries to lower-middle income countries such as Nigeria and Bangladesh that have borne significant hits to GDP following the COVID-19 crisis, which would be in tension with the rationale for the main performance-based allocation criteria.

The political calculus on reform may change including in larger MICs which had problematic public finances and/or external positions before COVID, and now face a stabilisation challenge that SDR allocations or International Bank for Reconstruction and Development (IBRD[2]) re-capitalisation will not solve

Development finance cannot remove the need for stabilisation in economies such as India or Pakistan – they need to move to a more sustainable footing. On the road to that, they require financing that is too large for the IBRD or IMF without significant recapitalisation. However, in some larger MICs, the financial system is so globally integrated that non-concessional official finance is not so different from domestic capital markets. What may be most important is for the IMF, World Bank and others to signal to creditors (domestic or international) where they think a credible stabilisation plan is in place. In smaller MICs, such as Ghana, they may need to step in if non-concessional financing becomes too expensive due to lack of a credible plan to stabilise.

Bilateral donors need to be flexible, reassessing the usefulness of continuing to tie resource transfers rigidly to projects or conditions set before the crisis

Even if the great majority of additional resources for COVID come via multilaterals, nimble bilaterals could make themselves more relevant in the wake of the COVID crisis by quickly switching support from pre-COVID priorities to new priorities. Overly rigid bilaterals could inadvertently waste resources or effectively 'punish' countries for the inevitable fallout of COVID. Ideally, bilaterals would be able to help poorer countries access the multilateral resources which their capitals have helped authorise.

[2] The non-concessional finance arm of the World Bank.

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1 Introduction

This study was commissioned to review the economic and public finance impacts of COVID-19, countries' development financing needs and the options for action using available instruments. This synthesis draws on more extensive research and analysis of 15 countries across Africa and Asia (Bangladesh, Burkina Faso, DRC, Ethiopia, Ghana, India, Indonesia, Kenya, Nepal, Nigeria, Pakistan, Sierra Leone, South Africa, Tanzania and Uganda), selected to represent a range of pre-COVID conditions and COVID experiences. Interviews and group discussions were held to gather perspectives in several country engagement exercises.

The first part of the synthesis looks at the impact of the crisis in the middle part of 2020. The scale of the shock varied across countries, and was not a direct function of death and morbidity. Countries' ability to mount economic stimulus efforts to counteract the adverse shock varied highly, and partly determined the short-term impact. In the poorest, most financially constrained countries, development finance has already been vital for enabling some level of counter-cyclical policy.

The second part of the synthesis looks forward. While an end to the health crisis is now realistically anticipated, it has been much too prolonged to permit a 'V'-shaped recovery (i.e., one involving a rapid return to pre-crisis levels of income and consumption.)In most countries, output will be below the pre-crisis forecasts for years unless recovery can be accelerated by additional finance and impactful reform.

The expected speed of the recovery depends partly on expansionary fiscal policy, which in poorer countries relies in turn on continued concessional development finance. Countries which had relatively weak public finances before the crisis – not necessarily the poorest ones – now face an even less sustainable situation, and tough choices about how to stabilise and grow.

The synthesis concludes with views from three perspectives. First, from a multilateral finance policy perspective, what level of support is required? And how is it best allocated, through which instruments and to which countries? Second, from a national perspective, what choices realistically face governments for macro-fiscal and financing strategy and spending priorities? Third, from the perspective of bilateral agencies, what are the risks and opportunities to add value? While most additional official financing is expected to be mobilised through multilateral channels, bilateral donors and specialised global programmes (e.g. the Global Fund) remain significant sources of support in poorer countries.

2 What happened?

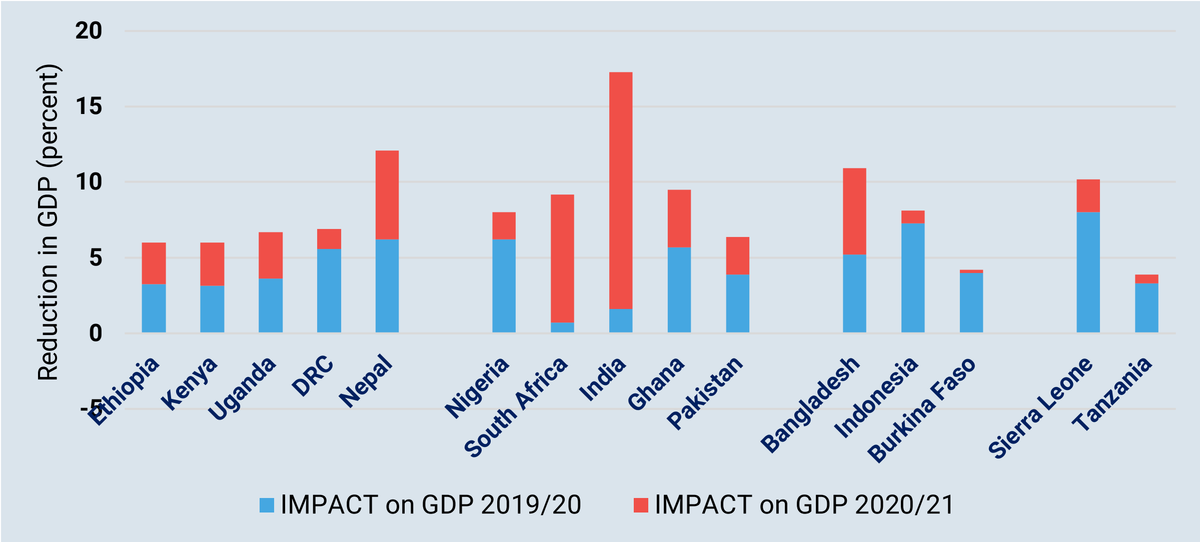
We can now look back on the apex of the COVID-19 health crisis and the associated macroeconomic crisis in 2020, although the data is not yet complete: most of the information on the economic and financial impact derives from comparing IMF and World Bank, pre-COVID forecasts (what would have happened) with post-COVID forecasts, which are updated at high frequency – at least quarterly – as information allows.

2.1 The COVID-19 crisis and the short-term economic shock

The COVID-19 pandemic has caused two million premature deaths at the time of writing, and still has the potential to cause many more. Yet these deaths are not directly responsible for the main economic impacts on individual countries, which vary as a result of lockdowns and other public health measures; voluntary behaviour changes; the international recession; governments' overall fiscal response; and shifts in development finance flows, including remittances and foreign direct investment (FDI). Many of the initial government responses assumed that the impact of COVID-19 would unfold as it did in Europe and the USA; however, the pandemic played out differently across Africa and Asia, which led some key informants in the country engagement exercise (see Appendix 2) to question the strict lockdowns and other measures put in place to stop the spread.

The World Bank's Global Economic Prospects and IMF's forecasts currently suggest global economic output will have shrunk by 4.3% in 2020, and will grow back in 2021 to be very close to the level in 2019. In effect, that means two years of global growth will have been lost – about 7% of global GDP. This is a very bad recession: although there is substantial variation between countries, most regions will permanently lose 6 to 7% of GDP (compared to pre-COVID forecasts, GDP will be 6 to 7% less even when normal growth resumes). In most of the 15 countries studied, the domestic recession is the worst not just in a generation but a lifetime. Most will come out of the crisis with much more public debt than they started with, and their public and private capital stock at least somewhat depleted. This is a bigger problem for some countries than others.

Figure 1: Combined economic impact of COVID-19 shocks (% of GDP)



Source: compares pre-COVID forecasts from IMF Article IV consultations and World Economic Outloook with post-COVID forecasts in World Bank Macro-Poverty Outlook October 2020.

The GDP impact varies substantially across the 15 countries, as measured across the 2019/20 and 2020/21 financial years. It is particularly severe in the South Asian countries of India, Bangladesh and Nepal, and middle-income countries in Africa: Nigeria, Ghana and South Africa. The pattern of impact seems to have more to do with the impact of public health restrictions than with particular characteristics of production.

2.2 Fiscal response in the short run

The 15 countries varied substantially before COVID in the health of their public finances and available 'buffers', meaning some were more constrained than others in their fiscal response. Some had large fiscal and trade deficits even in good years; others combined unsustainable deficits with poor economic performance; a few seemed more robust, with low debt giving greater potential fiscal space to act financially in the crisis – although a key question (from country engagement) is how much is trickling down to the household and business level, and how quickly.

In every country, the crisis put pressure on revenue and generated demands for public resources to fight the disease and protect businesses and households. Looking at their pre-crisis financial constraints and their fiscal response, it is possible to pick out three main groups in the 15 countries.

(i) **Lower-income, acute-impact countries.** The first group are on the left in Figure 2 below: Ethiopia, Kenya, Uganda, DRC and Nepal.

Kenya and Ethiopia were close to debt distress at the end of 2019. In Uganda, DRC and Nepal, fiscal deficits and debt did not appear so unsustainable before the crisis, but these countries also turned out to be significantly financially constrained even in the short run, unable to mount more than a small or technically negative fiscal stimulus.

In this group of countries, fiscal stimulus was insufficient to protect public expenditures. In most cases, investment spending – that is, capital spending with a future economic return – was cut back severely. However, this was barely enough to protect recurrent spending (public consumption, such as service delivery) at pre-crisis planned levels. When we take into account that COVID-related expenditures are also recurrent, it becomes clear that normal current programmes have also been cut back during 2019–2021.

The information in Figure 2 is extrapolated from macro-forecasts – but actual budgetary information[3], where available, reinforces the picture. The fiscal stimulus in Kenya, Ethiopia and DRC, for example, is not sufficient to prevent real cuts in overall expenditures including recurrent expenditures.

On average, health spending *per capita* is expected to be flat in sub-Saharan Africa in 2019–2021 – but as this includes temporary COVID-related spending, it likely represents around a 33% decline in non-COVID health spending. Even including COVID-related spending, Kenya cut recurrent health expenditure during the COVID crisis.

Cutting investment in a downturn is contractually and politically less difficult than cutting recurrent spending but will slow the speed of recovery unless it can rapidly be restored.

(ii) **Middle-income, partially delayed impact.** Nigeria, South Africa, India, Ghana and Pakistan were vulnerable to shocks pre-COVID and have faced a severe initial impact. All had big deficits, the economies of Nigeria and South Africa were performing weakly, and India was also facing what now seems like a relatively minor domestic downturn at the end of 2019.

Unlike the first group of countries, this second group had the financial credibility to mount a significant counter-cyclical fiscal response in 2020. However, this left their public finances in an even worse state, and they face a mountain of fiscal adjustment in the medium term.

As shown by Figure 2, most countries in this group switched resources from investment to recurrent spending and pushed up spending overall. In a crisis, switching from investment to temporary recurrent programmes (e.g., for COVID-related expenses) is sensible if it can be rapidly reversed post-crisis, but permanently reducing public investment is likely also to reduce private investment, slowing the recovery. In Ghana and South Africa, especially, post-crisis fiscal pressures may require not only that the temporary programmes are ended but also that the cuts to investment remain.

India appears from the figures to have increased investment, but this happened mainly in 2019, before the crisis struck – an effort to escape the lesser recession

[3] This report was prepared in parallel with a number of Bill and Melinda Gates Foundation Macro-Fiscal Briefs, which contain more granular fiscal information based on publicly available sources. For example, Kenya had three supplementary budgets in 2019/20, as well as the annual 2020/21 budget, in the period under review, and these are public.

then being experienced. It will be very difficult for India to keep up this level of investment after 2021. Meanwhile, investment is at very low levels in Nigeria. Pakistan is also included in this group, although its problems are perhaps much less to do with the COVID crisis.

In countries which had unsustainable deficits in 2020, there is a risk that COVID-related health spending will be cut back in 2021 or after vaccination programmes are complete, and that core health spending does not recover in the medium term.

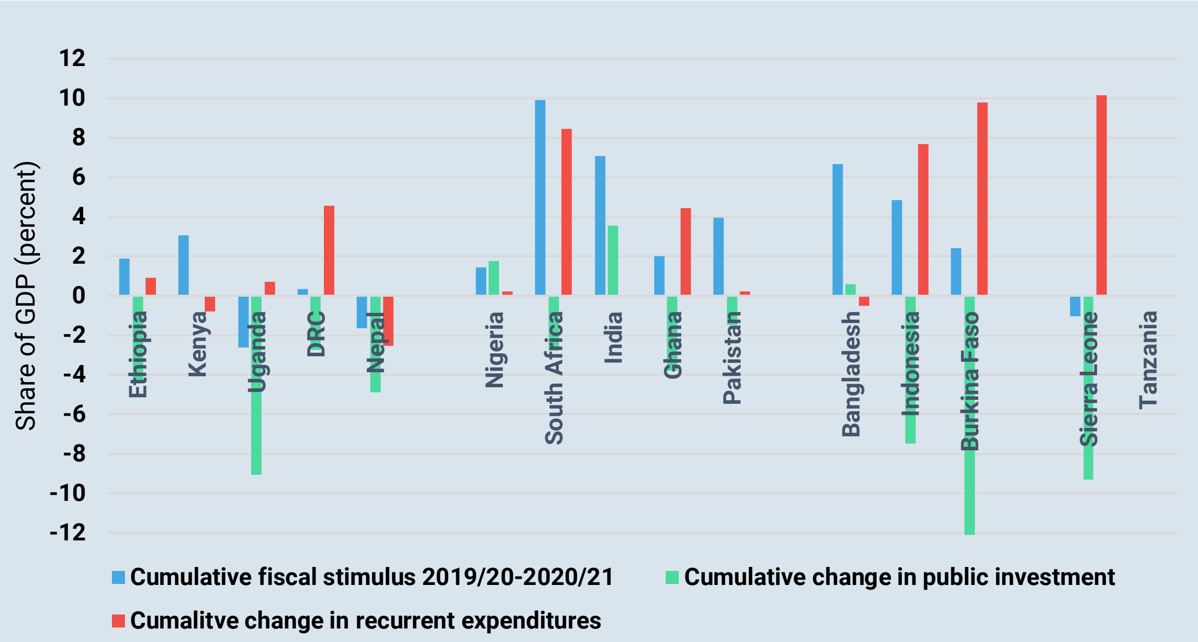
(iii) **Resilient but affected countries.** The pre-COVID finances of Bangladesh, Indonesia and Burkina Faso were in a state that created ‘buffers’ – room to borrow more in a sustainable way. As a result, they were better placed to finance an appropriate counter-cyclical response from domestic and/or external sources.

While forecasts and estimates vary, it seems Bangladesh will be quite badly impacted. Like India, it managed a large technical stimulus, although this was mainly used to maintain existing programmes; unlike India, its finances remain sustainable. As shown by Figure 2, Indonesia and Burkina Faso appear to have cut back public investment strongly – but unlike Ethiopia, Uganda, South Africa or Ghana, this seems to be a reversible switch from investment to temporary recurrent spending for COVID-related expenses. In both cases, their stronger public finances make a post-crisis recovery of public investment more achievable.

Burkina Faso is a special case. Figure 1 suggests it experienced a relatively mild impact from COVID, but the economic damage in 2019–2021 is expected to be greater due to other causes including the threat of conflict – as indicated by its ‘COVID package’ of temporary measures largely covering security and other election-related expenditures. Like Kenya, Burkina Faso cut recurrent health expenditure during the crisis.

It was very obvious from the country engagement exercise that the quality as well as the quantity of COVID mitigation activities was variable – everywhere this was done in a rush.

Figure 2: Net fiscal stimulus, investment/recurrent trade-offs



Source: compares pre-COVID forecasts from IMF Article IV consultations and WEO with post-COVID forecasts in World Bank Macro-Poverty Outlook October 2020. Inadequate data for Tanzania.

2.3 Development finance in the short run

In the short run, the COVID crisis is causing a reduction in economic activity, expenditures and public revenue. Development finance can allow governments to protect and increase spending even as revenue dips. More fundamentally, it can fund a current account deficit and allow the sum of consumption and investment (public plus private 'expenditures') to be larger than current output (GDP). If an economy is forced to adjust to the GDP *and* external shocks without development finance, deep reductions in consumption will create poverty and lasting economic damage – and if adjustment is through reduced investment, the economy will not be able to recover at all.

The financing channels available differ per country. Those in the second group have access to more sources of development finance than those in the first, although non-concessional finance may be expensive because their credit-worthiness is wearing thin. Of the final group, Indonesia has access to foreign financial markets which it doesn't even need to use, whereas Burkina Faso is dependent on official financing but is far from debt distress.

In our country engagement interviews, there was much discussion about the G20's Debt Service Suspension Initiative (DSSI). Much of the feedback was critical: there were complaints about the unclear framework, short time frame and uncertainty about whether participation for G20 countries would be mandatory. The consensus across both the first two groups was that this support was insufficient and unattractive. Lower-income countries were not interested in expanding non-concessional finance, and even interviewees in Pakistan disliked the idea of resorting to foreign concessional finance for such a short time.

The receptiveness towards receiving aid depends on the current state of finances. Interviewees in the most financially constrained countries highlighted eagerness to receive aid. Those in in larger MICs thought that aid is unlikely to alleviate the financial burden brought on by COVID-19: while a broad range of sectors and organisations are affected, COVID-related aid is likely going to support only immediately affected sectors such as health or education. One Ministry of Finance official said, '*If we were facing a huge financial deficit in terms of medical requirements than I would've said tied aid is better'.*

The exogenous shifts in foreign financing associated with the crisis do not appear to have been as strongly adverse as was feared in early 2020. Indications are that remittance income – a major source of foreign finance, worth between 3% and 5% of GDP in Kenya, Uganda, Ghana, 6% in Bangladesh and 9% in Pakistan – will not fall, year on year, by as much as following the global financial crisis in 2008[4]. In Bangladesh, Kenya and Pakistan, remittance income seems to have increased during the COVID crisis, possibly due to returning migrants.

Early in 2020, there were also expectations of a severe drop-off in FDI: UNCTAD predicted a global decrease year on year of 40%. In reality, the focus countries seem to have experienced lesser reductions. The decreases in Ethiopia, Ghana, Kenya, Uganda, Bangladesh and Pakistan are more uniform than following the global financial crisis, and mostly closer to 20% than 40%, according to recent World Bank estimates. Except in Ethiopia[5], this is in the order of 1% of GDP and therefore a significant share total financing.

At the apex of the crisis, the multilateral organisations mobilised significant official development finance resources. Across the 15 countries, the IMF mobilised US$ 13.3 billion, the World Bank US$ 4.6 billion, and regional development banks and humanitarian agencies US$ 4.9 billion in addition to the disbursement that had been expected in December 2019.

Figure 3 shows that for the first group of countries, this accelerated disbursement was critical in enabling fiscal stimulus and protecting public expenditures. Without it, the cuts would have been even more damaging. In the middle-income countries with less immediate financial constraints, official finance was less important.

The Centre for Disaster Protection[6] note that the countries experiencing the highest increases in poverty have received fewer dollars *per capita* than richer countries in COVID-related official financing. However, it is difficult to estimate poverty impact. Also, the distribution of concessional resources is more favourable for poorer countries than the distribution of non-concessional resources. Figure 3 shows that resources received by poorer countries constitute a larger share of their GDP and will be predominantly from soft windows and grants, such as the IDA.

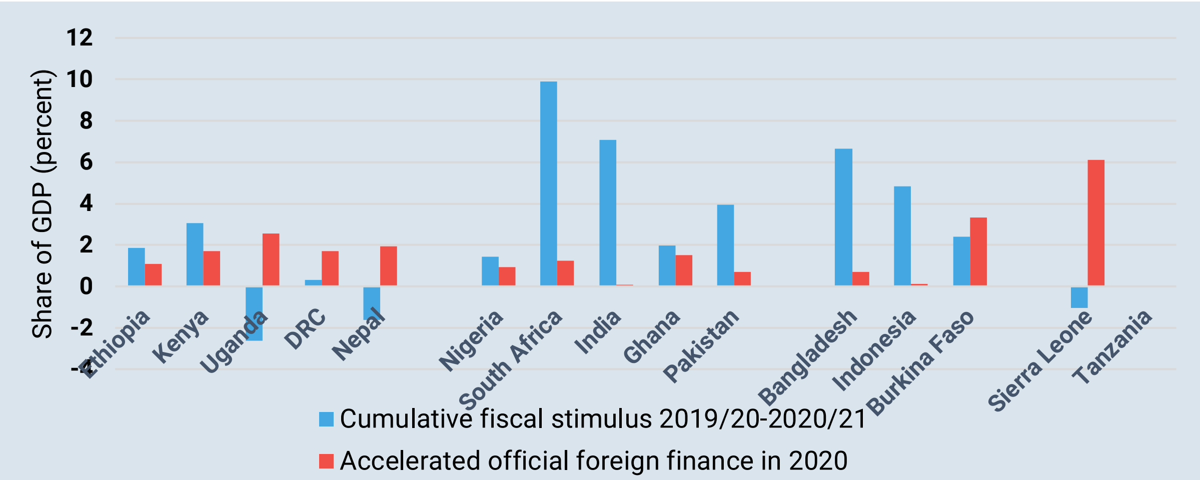
Overall, the international system has done quite well at reacting quickly to the COVID crisis given how distracted the governments of industrialised countries have been with their own handling of the pandemic. The distribution of the resources made available could be criticised, but it is not clearly flawed. Though the level of finance was limited by the supply available to the IMF and MDBs – even more would have had a greater smoothing impact – it

[4] World Bank Migration and Remittances Data, updated October 2020
[5] Apparently low levels of remittances in Ethiopia are, almost certainly, to do with underreporting of informal flows
[6] https://www.disasterprotection.org/latest-news/what-have-we-learned-after-six-months-of-tracking-covid-19-funding

was still greater than in a normal year and was sufficient to make a substantial difference to the fiscal response especially in the poorer countries.

Critically, however, the levels of financing mobilised were made possible by bringing forward resources from future years. Unless these are topped up, there will be a shortage of official finance during the recovery from the COVID shock.

Figure 3: Net fiscal stimulus and accelerated[7] official financing



Source: compares pre-COVID forecasts from IMF Article IV consultations and WEO with post-COVID forecasts in World Bank Macro-Poverty Outlook October 2020. Accelerated official financing is taken from credit and loan agreements from IMF, World Bank, Asian Development Bank and African Development Bank, plus press releases about accelerated disbursements from existing agreements, and also from the UNOCHA financial tracking system. Inadequate data for Tanzania.

[7] 'Accelerated' means achieving a higher rate of disbursement in 2019/20–2020/21 than previously expected pre-COVID. For MDB soft windows this means faster disbursement out of a finite replenishment intended, originally, for a longer period. For non-concessional windows and IMF this is also from a finite pool of resources.

3 What happens next?

In the medium term, information about the economic and financial impacts of COVID still rely on a comparison of pre-COVID and current IMF/World Bank forecasts but are supplemented by modelling (see Appendix 1) which is explores scenarios that diverge from the central forecasts based on known criteria – for example, what happens if there is more development finance?

3.1 Economic recovery and fiscal conditions in the medium term

Most economies have lost around two years of growth. As returning to trend growth is not the same as returning to trend consumption or investment, this will set back incomes below their previous expected path for years to come. Global Economic Prospects forecasts the world's economy shrinking by 4.3% in 2019/20 then growing by 4% in 2020/21, taking it almost back to the 2019 level of output, before resuming something like normal growth from 2021/22.

Prospects are similar in every region, with somewhat deeper recessions in some than others. For sub-Saharan Africa, the recovery takes a little longer and two years' growth represents more lost output – about 7% of GDP – than the global average. In South Asia, the recession is deeper and recovery of 2019 levels of output takes until the end of 2021/22; by the time growth resumes the reduction in output will be more like three years' of South Asian growth – over 15% of GDP. *Per capita* GDP will be set back even more, given that the population grows during the recession.

The speed of recovery from the COVID shock will have lasting implications. The state's ability to crowd in investment and support poverty-reducing programmes is reduced compared to pre-crisis expectations, and because of the financial obligations taken on during the crisis: if GDP is 7–15% below pre-crisis levels and there is extra debt, then debt sustainability and the relative burden of debt service will both be worse.

In our country engagement interviews, concern had mainly shifted from the disease to the medium-term recovery, in the expectation that some sense of normality will resurface in the coming months (this may have been too optimistic at the time of interviews but this shift is still expected during 2021). Not all countries suffered terrible health consequences nor economic damage – one interviewee noted: '*Things seem to be very comfortable – almost miraculous*'. No interviewee was concerned about a second wave, with most expecting 'smart' localised lockdowns to contain any surge in cases. Concern about the enduring economic impact was almost universal.

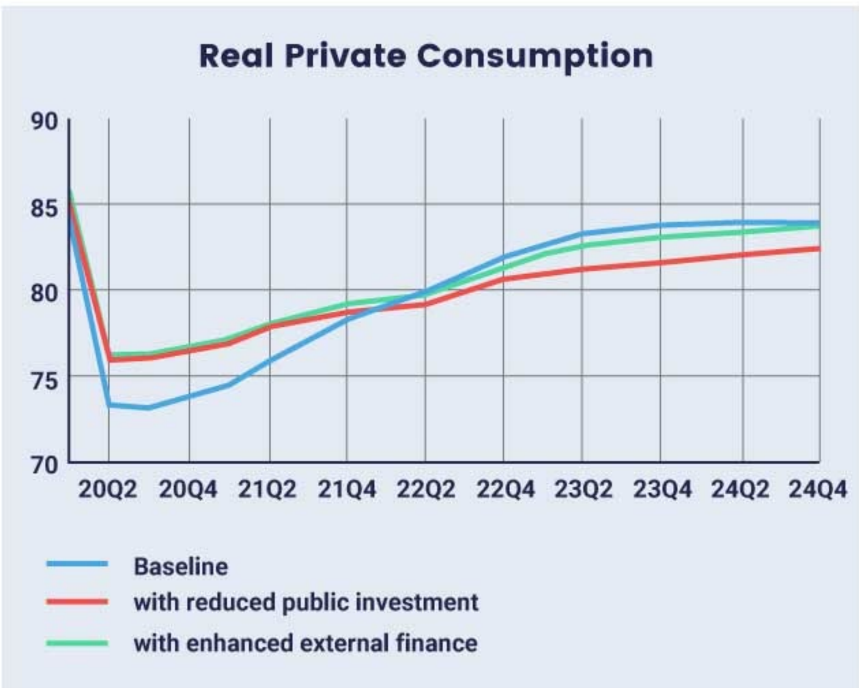
IMF and World Bank forecasts have been revised on a quarterly basis through 2020 and have altered substantially for different countries due to uncertainty over the determinants of the depth of the recession and the speed of the recovery. These include the severity of lockdowns, exposure to the international recession, initial fiscal conditions, the burden of debt taken on during the crisis, and mitigating measures, including the detail of policy and the (re)distribution of impact.

The central projection of IMF and World Bank forecasts is merely the scenario considered most likely at the time, and our research has included modelling[8] to explore the variability implicit in these forecasts. Known factors can make a substantial difference to outcomes in a particular country, from a normal pattern of growth resuming after anything from one year to more than three years.

Figure 4 shows that in the first group of highly financially constrained countries, the combination of a small fiscal stimulus and deep cuts to public investment is likely to produce a deeper, longer recession and more lasting impact (red line), which accelerated official development finance can help to mitigate (green line). Figure 5 shows that in any country with a substantial shock, the degree of 'scarring' (dotted line is less, dashed line is more) makes a substantial difference to the duration of the recovery and how long the impact lasts. As outlined in Box 1 below, scarring refers to impacts of the destruction of capital and livelihoods that last beyond the crisis itself.

Note that these figures show consumption, not GDP. Consumption is hit worse than GDP, with strong implications for poverty and welfare. Development finance makes a lot of difference to consumption, but not GDP.

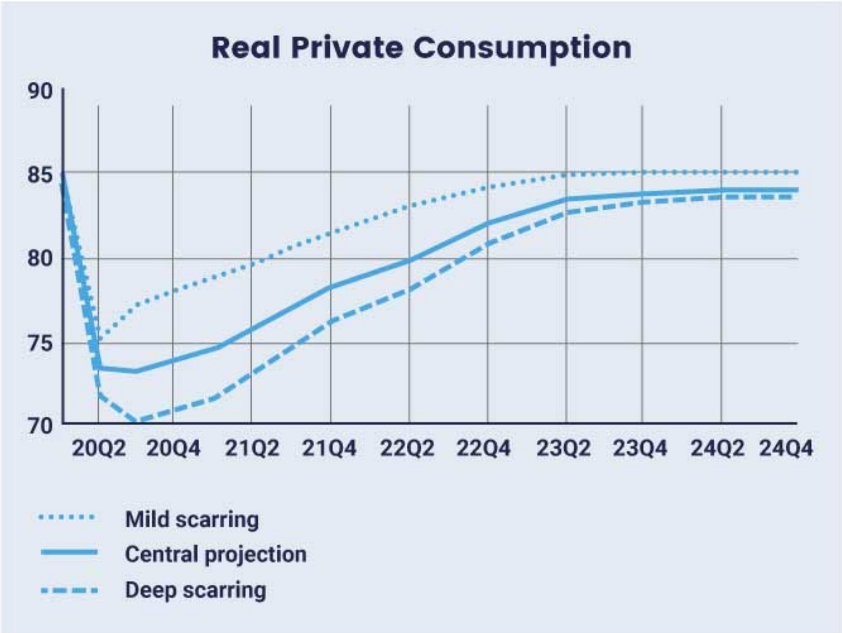
Figure 4: Adjustment via public investment, with/without accelerated external finance



Source: see Appendix 1

[8] This is a reference to work covered in Appendix I.

Figure 5: The impact of 'scarring'



Source: see Appendix 1

3.2 Medium-term impact in each group of countries

Lower-income acute-impact countries did least to mitigate the short-term impact of COVID-related economic shocks because they were so financially constrained: expenditure cuts were common, especially in public investment but also in non-COVID service delivery. The scale of protection offered to households and businesses was smaller than in other countries. This makes these economies vulnerable to scarring.

For this group, accelerated official finance helped to protect public programmes in the short run and most likely keep the lasting impact of COVID to around a 7% reduction in GDP. But if the flow of finance reduces before the end of 2021/22, it will feel like a secondary shock because alternate sources do not exist. Without a replenishment of the soft windows of multilaterals, notably IDA, the accelerated disbursement in 2020 will lead to reductions from 2021. For Kenya and especially Ethiopia, debt cancellation may be necessary to permit continuing access even to concessional finance in the coming years.

For the *middle-income partially delayed impacts*, the lasting impact of the COVID crisis is likely to exceed the two-year impacts described in Figure 1. In India, a mixture of private sector scarring and severe cuts to public programmes seem likely to bring down average growth rates in the 2020s compared to the 2010s. The initial shock and scarring issues are not so bad in Nigeria and South Africa, but their public finances were less sustainable in late 2019: growth looks likely to be sluggish until this is put right, which will take years. Ghana's debt is very costly, has mounted during the crisis, and might become even harder to re-finance without a credible strategy for stabilisation. Pakistan also needs to take major steps to stabilise, although this is less to do with COVID.

Box 1: Economic scarring

Scarring is damage to physical and financial assets and skills which occurs during a sharp downturn (or lockdown) and takes time to repair. It is hard to collect evidence about scarring so soon after the apex of a crisis, but leading indicators in some countries are consistent with the hypothesis that there is cause for concern.

There is ex-ante evidence that informal enterprises across the 15 countries have been offered little support from government, despite being smaller and less financially resilient than formal businesses. They are especially exposed to COVID-related shocks in urban areas. This has potentially serious implications not only for the speed of recovery but also for welfare, as the informal sector employs 70–90% of workers in most countries despite having a much smaller share of GDP.

Exports are recovering much more quickly than imports, according to high-frequency trade statistics from central banks in countries such as Kenya and Bangladesh. Exports reflect the performance of agriculture and formal-sector firms, while imports reflect consumption and investment in the wider economy. Across South Asia the informal sector has been much more vulnerable to loss of employment, with around twice as much new unemployment in urban areas as rural[9].

As Figure 5 suggests, scarring of this nature is likely to deepen the economic setbacks in affected countries for at least two more years.

In the *resilient but affected* group, Bangladeshi public finances and export performance are strong but there appears to have been scarring in the non-traded part of the economy, which employs even more people than the garments sector. This seems less of an issue in Indonesia, which has a much more diversified economy that was hit less hard by COVID.

COVID might not be the most serious problem in 2020/21 in Burkina Faso, given its security crisis. Ethiopia experienced a greater impact from COVID, and the government’s choices are constrained by an inter-reginal dispute that has led to fighting. COVID could also make the management of disputes more fraught in Kenya, Nigeria and elsewhere.

[9] World Bank South Asia Economic Focus | Fall 2020 ‘Beaten or Broken?’

4 What difference can development finance make in three types of countries?

This research simplifies the full range of instruments in the development finance toolkit to focus on the most relevant qualities for the COVID crisis. There are three sources of financial resources: non-concessional and private; monetary; and concessional and grants. There are important options for allocation of concessional resources, in particular, between countries. These are linked to decisions about allocation of resources to development finance instruments, ideally according to what best suits the COVID-related needs of different countries.

4.1 Sources of finance

The main policy decision is whether to generate concessional resources from high-income country budgets, or to innovate and use international monetary financing

Private investment and non-concessional official flows are grouped together in this analysis, although shifts in private flows are a reaction to events rather than a matter of policy. COVID disrupted private-to-private flows, notably FDI and remittances, that are important to many countries – but that disruption was part of the crisis, not part of the response. Private-to-public flows, such as Eurobonds, are a significant share of financing in some countries but unavailable to others. The same goes for non-concessional official finance such as IBRD loans, though these are routinely much cheaper than Eurobonds and it is worth considering whether they are being mobilised as effectively as possible. There is some headroom to allow an expansion in IBRD lending, which could be helpful to middle-income countries, though perhaps this needs to be expanded in the medium term.[10]

Concessional finance – including bilateral grants and global programmes, and very soft loans from IDA and others – are the only finance many countries can take advantage of, other than limited borrowing in the domestic market. This is in more finite supply than non-concessional official lending. Although there were great efforts to accelerate disbursement in 2020, there is a risk that this will depress flows in the coming years.

The obvious source of additional concessional financing is an increase in budgetary commitments from high-income countries, but there is an important alternative: an increased allocation of SDRs from the IMF. A new SDR allocation is global monetary financing – it permits the IMF to create money, which cannot sensibly be done without limit, but is a way of pooling the inflationary risk across nations and currencies when there is a substantial hit to global production. From a fiscal perspective there are only technical differences between this and pure grant funding, and it can alleviate financing constraints in two main ways:

[10] Analysis, e.g. from ODI, suggests that IBRD has been much less responsive in the crisis than IMF, IDA or other MDBs. This could be because IBRD headroom is not what it was. If the sustainable lending level for IBRD is US$ 25–35 billion per year, this is small compared to the extraordinary financing needs of middle-income countries during the crisis and in the recovery.

i. Central banks in low-income countries (LICs) and MICs can draw down their SDRs and use them as a basis for financing governments, cancelling debts etc.

ii. Central banks in HICs can use their (much larger) SDR allocation as a basis for financing further concessional financing for LICs and MICs, for example through an accelerated replenishment of PRGT or IDA.

In Figure 6, below, HIC grants and repurposed HIC SDR allocations are almost interchangeable as a source of resources for a range of concessional instruments. The idea of using SDRs to replenish concessional MDB windows like IDA is somewhat unorthodox, although the principle of funding an IDA replenishment from repurposed SDRs is not much different to financing an IMF PRGT replenishment. **International monetary financing, that is, repurposed HIC SDRs, should not become the default way to replenish MDB soft windows but it could be a good expedient given that COVID-19 has created an economic crisis in almost every economy**. SDRs are certainly not the only option, and HICs could fund a replenishment from budgetary resources as they typically do.

4.2 Allocation across countries and instruments

On allocation across countries and between development finance instruments, the policy decisions are mainly about concessional resources, which are the most finite and policy-sensitive type of finance. *Lower-income, acute-impact* countries are in severe need of new concessional financing until at least 2022. *Middle-income, partially delayed impacts* would be helped by a new allocation of SDRs and access to concessional or non-concessional official financing – although, realistically, the scale of concessional finance available may not be significant for the larger economies in this group.

Resilient but affected countries face their own medium-term challenges, and are in no shape to cross-subsidise the worse-affected developing countries. There is a strong argument against penalising these countries for good management of their public finances pre-COVID.

If new concessional finance is mobilised, options for allocating it include:

(i) Debt cancellation – which may or may not be biased in favour of big debtors. This would remove the immediate financing constraints from countries such as Ethiopia, which is near debt distress, limiting even its concessional borrowing levels. Country engagement interviewees stressed the importance of debt cancellation and the unsuitability of non-concessional finance (which would worsen indicators of debt distress). What might make this unrealistic is that debt cancellation takes time to organise, whether it is a non-concessional creditor 'haircut', or a concessional debt write-off, and certainly does not produce the most immediate relief, in a crisis, from a given scale of concessional resources.

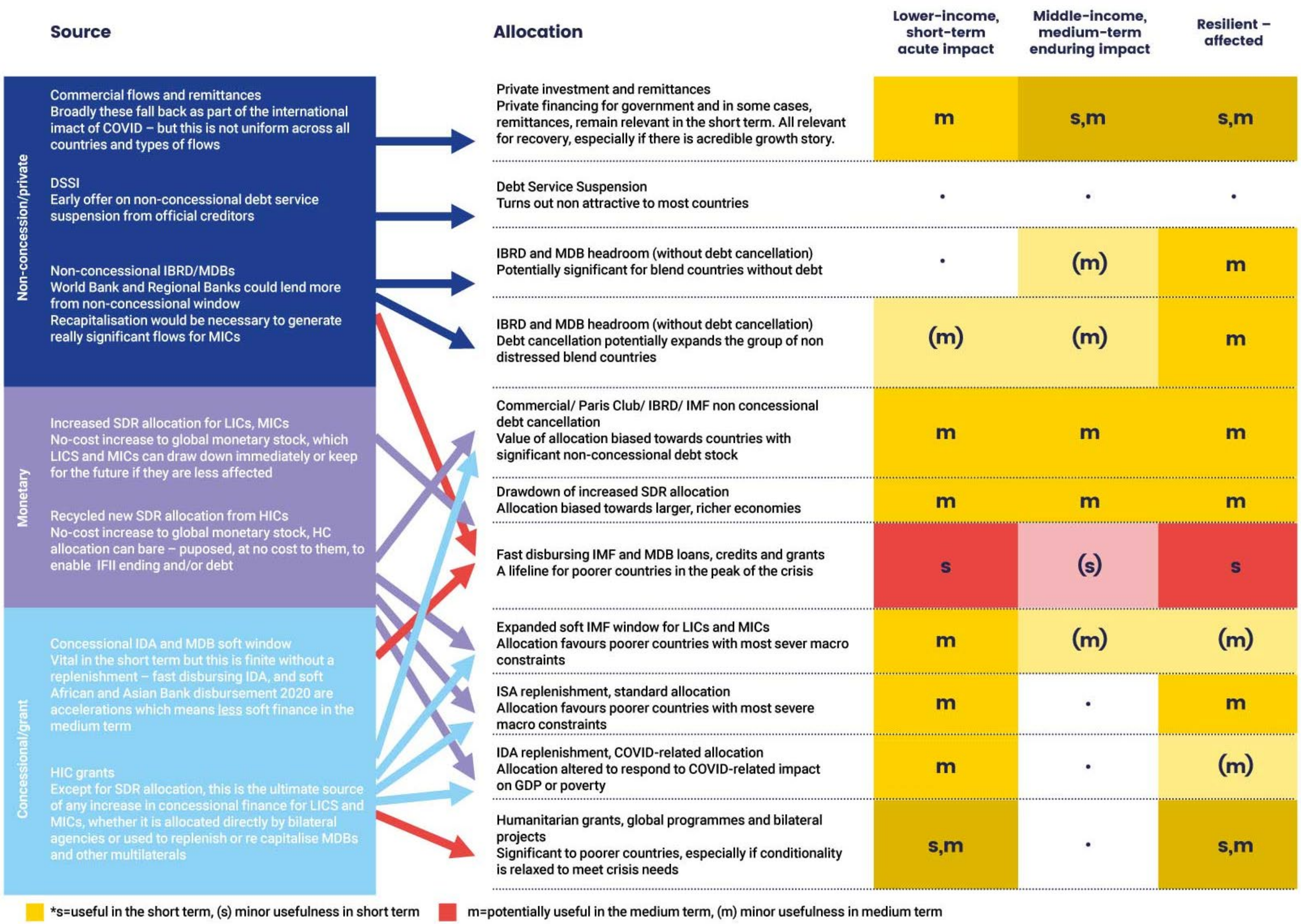
(ii) Grants or concessional loans distributed through the IMF and/or MDBs – allocation can target poorer countries and those worst hit by COVID. For example, a portion of an early IDA replenishment could be allocated to countries on the basis of the two-year loss of GDP compared to forecasts, or the increase in poverty, alongside the normal IDA performance-based allocation. Some countries are too indebted to take advantage even of concessional loans, but grants may make sense as an alternative or a complement to concessional debt cancellation.[11]

(iii) Bilateral grants and grants through global programmes can also assist – but will be inefficient if resources are directed at donor-only priorities instead of shared objectives in core government programmes, which have been or face being cut.

Figure 6 below summarises the main sources of private, non-concessional, monetary and concessional finance, how they can be allocated using different development finance instruments, and how they are differently useful in the short and medium term, across the three groups of countries.

[11] Debt cancellation needs funding and its benefits are slow-disbursing, compared to new lending or grants. For example, US$ 1 billion in concessional debt cancellation may create a stream of value of over decades, whereas a loan or grant could disburse in one year. Grants are a way of financing countries which are near debt distress – Ethiopia already received a mix of grants and soft loans from IDA. In country engagement, the idea of cancelling (repaying) domestic debts or non-concessional foreign debts was popular but this would have to be fully funded, with a direct trade-off between funded grants now and the same face value of debt repayment.

Figure 6: Sources of finance, key instruments for allocation and transfer, and short–medium-term suitability across three groups of countries



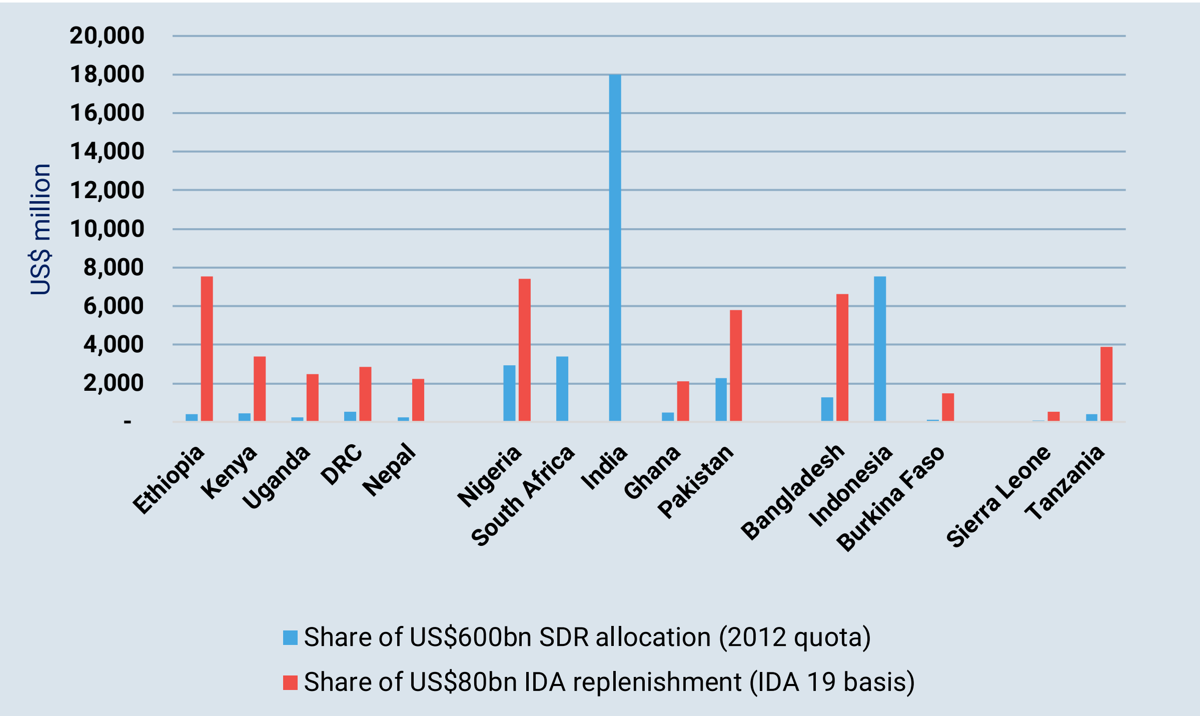
4.3 IDA allocation issues

Both an SDR allocation and a smaller, more targeted replenishment of multilateral soft windows – specifically an IDA replenishment – are realistic possibilities for 2021 and beyond. An earlier IDA 20 replenishment can achieve a similar effect and is now under active discussion. There are important questions – with no easy answers – about how any IDA replenishment, or other multilateral soft window, should be allocated. IDA allocation is just one lever and may be subject to tension between competing objectives.

For the *lower-income, acute-impact* countries, an IDA replenishment allocated on an IDA 19 basis would be much more important financially than an SDR allocation of US$ 600 billion. Figure 7 shows that the SDR allocation would be similar in scale to the accelerated official finance mobilised in 2020 (as shown in Figure 3 above), but IDA replenishment would support economies and public finances for several years at a similar level.

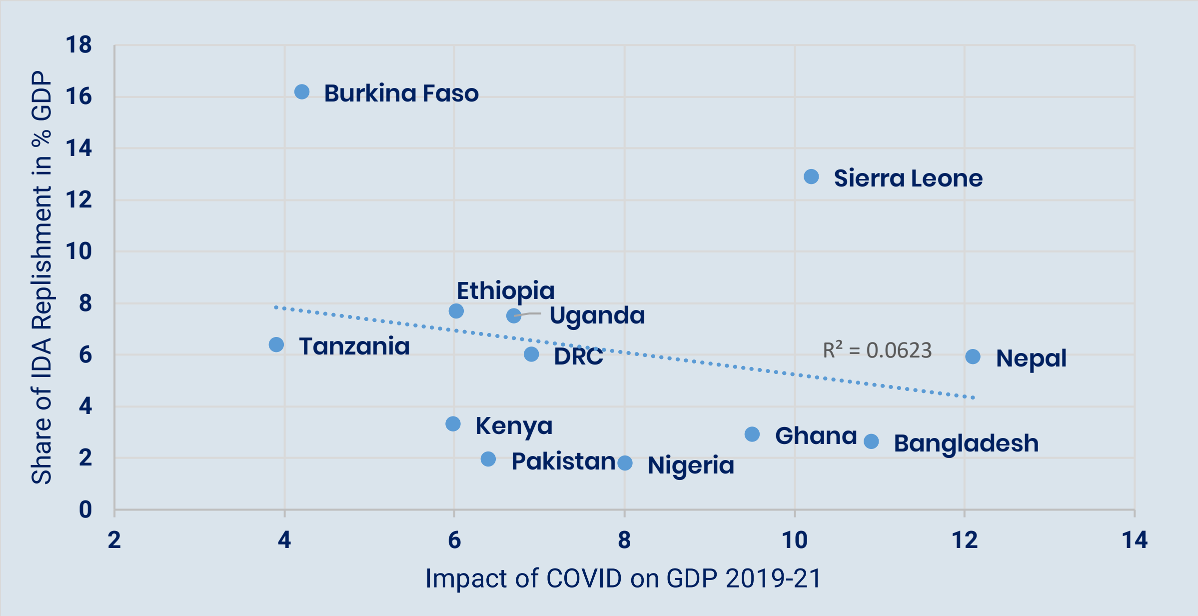
For the *middle-income, partially delayed impact* countries, the SDR allocation would be much more important than any IDA allocation even though as a share of GDP it is similar to the SDR allocation for poorer countries. It could provide some very useful liquidity in 2021/22 as these countries embark on difficult adjustment. An innovative re-allocation of G20 or G7 SDRs to IDA replenishment could accelerate recovery from the crisis.

Figure 7: A possible US$ 600 billion SDR allocation and US$ 80 billion IDA replenishment



Source: The hypothetical US$ 600 billion is divided according to 2012 quota shares published by the IMF. The hypothetical US$ 80 billion IDA allocation is divided according to IDA 19 country shares.

Figure 8: Allocation of US$ 80 billion IDA replenishment, on IDA 19 basis, is not correlated with COVID impact



Source: Impact is based on comparing pre-COVID forecasts from IMF Article IV consultations and WEO with post-COVID forecasts in World Bank Macro-Poverty Outlook October 2020; share of IDA replenishment is based on IDA 19 country shares.

Figure 8 compares the same allocation of a potential US$ 80 billion IDA replenishment with the COVID impact for IDA countries in our group, both in percent of GDP. There is a slight inverse correlation, indicated by the dotted line, but it is very weak: essentially, the allocation based on IDA-19 is independent of COVID impact. This creates an argument for a COVID-related IDA replenishment to be more strongly allocated on the basis of COVID-related impact.

The economic impact of COVID-19 in 2019–2021 forms quite a good criterion for allocation as it rewards ‘good’ and ‘bad’ policy choices ex post in a way that does not create strong perverse incentives and cannot be gamed. As noted above, this impact is a function of factors including the magnitude of the COVID disease threat, exposure to the international recession, seriousness of anti-COVID measures, and strength of financial buffers pre-COVID.

Would the poverty impact of COVID-19 be a better criterion for allocating IDA resources? The result would be to allocate less to a relatively well-off country such as Ghana, where the GDP impact has been greater than the probable poverty impact, and more to Burkina Faso where GDP impact is less but poverty impact is more. GDP impact is not strongly correlated with poverty impact, as estimated in the World Bank’s Macro-Poverty Outlook (MPO), but estimating the impact on poverty has even more uncertainties than estimating the impact on GDP. For example, the World Bank’s MPO figures estimate a huge poverty impact in Bangladesh and Nigeria compared with other IDA-eligible countries, despite being much richer. This might be because poverty impact has been estimated differently for these countries.

The basic, performance-based IDA allocation criteria have merit, too. They are partly based on GDP but are quite well correlated with the estimated poverty impact of COVID-19, excluding Nigeria and Bangladesh. The countries which do less well in Figure 8 are mostly in the *middle-income, partially delayed impact* category, while some *lower-income, acute-impact* countries – including Ethiopia, Uganda and DRC– do quite well, though Kenya less so.

Any alteration to IDA allocation linked to COVID GDP impact is likely to skew resources towards less-poor countries which took strong measures against COVID and perhaps had unsustainable public finances before COVID. Such countries probably do need extra help in the medium term, but this would create a relative penalty for the poorest IDA countries, especially those that did little to combat COVID.

If there is an early IDA 20 instead of a special COVID-IDA, it may come in 2022/23 rather than 2021/22, with IDA 19 being further accelerated in the interim. The objectives for an early IDA 20 will be mixed, making allocation even more fraught. The smaller *middle-income, medium-term enduring-impact* countries which are eligible for IDA will still need help by then, so an allocation skewed to COVID-related economic impact in 2019–2021 could work well. But there are difficult trade-offs.

5 Critical policy choices in the three types of countries

Countries made constrained choices about their policy mix during 2020, including the level of fiscal stimulus, the financing of that stimulus and the management of public expenditure adjustments. This includes trade-offs among public investment, temporary packages to combat COVID and support enterprises and households, more permanent poverty-reducing programmes, and – in some cases – parallel pressing crises.

A government's choice of macro-level and qualitative policies has implications for the quantity of financing it might seek, and the finance that might be available: if there are large financing gaps and less than fully credible plans for stabilisation, creditors can exert a lot of pressure.

In the medium term, the parameters of these choices are summarised by the two dimensions in Figure 9. There is a choice between financial responsibility and fiscal short-sightedness – and a grey area between the two, which has recently been occupied by several of the 15 counties. The second dimension is a conservative versus reforming approach towards the policy levers of raising revenues, expenditure choices, and the business environment.

Fiscal short-sightedness characterised countries in the first two groups – especially those in the second group, plus Kenya and Ethiopia – leading up to the COVID crisis. Fiscal short-sightedness means pursuing an unsustainable fiscal policy, running large deficits using unsustainable sources of finance at an increasing cost, and without a credible plan for altering this course. COVID has made fiscal short-sightedness less feasible because debts are higher and economies are weaker – but it also makes the shift to financial responsibility more difficult, including politically, because they have moved further away from it.

A conservative policy approach is the natural path, for the same reasons that led to the pre-COVID status quo – few interviewees expected a radical change in policy. However, when countries are forced onto a more financially responsible path, there can be greater impetus for reforms: a conservative approach loses it political appeal if it is a way of sharing pain rather than sharing gains. An alternative, reforming approach will inevitably create some losers – which spells political difficulties – but should also create some winners, and speed up the recovery.

In 2019 Kenya and Ethiopia were already moving from fiscal short-sightedness towards financial responsibility. The COVID crisis will force the pace, but it remains to be seen whether policies continue to be conservative or become more reforming in areas such as revenue generation and tax efficiency, expenditure prioritisation and redistribution, regulation and the investment climate. In Kenya, for example, a costly public sector wage bill reduces fiscal space for other priorities. In Ethiopia, the very low level of revenue mobilisation constrains fiscal space.

Figure 9: Critical policy choices

	Conservative	Reforming
Financially responsible	Aim to maintain or return to debt sustainability by controlling deficits via expenditures. Access finance which is compatible with financial goals and improve credit-worthiness with a credible medium-term plan. Maintain the broad patterns of expenditure, taxation and business environment policies from the pre-crisis period.	Aim to maintain or return to debt sustainability by controlling deficits and accessing finance which is compatible with these goals. Use the crisis as a basis for reforms: for example, close deficits with efficient revenue-side reforms, not just spending cuts; engage in zero-based spending reviews to cut waste and refresh the public programme; and reduce protection to significant groups in the economy to promote efficiency and investment.
Fiscal short-sightedness	Ignore debt sustainability and access all available finance. Avoid severe expenditure adjustment in the short term, deepening fiscal sustainability issues for the medium term as a result.	

Tough expenditure decisions will be faced most immediately in the first group, and later in the second. Figure 10 illustrates estimates of reductions in priority spending, compared to pre-COVID plans, in *lower-income, acute-impact* countries. These countries have cut public investment most, but Figure 10 shows it is unlikely that infrastructure is the only sector affected: health, education and agriculture also seem likely to lose resources compared to pre-COVID plans, especially when COVID-specific elements are excluded. These estimates are confirmed in early information from supplementary budgets: for example, Kenya has already cut health expenditure. Resources to support these priority programmes will not simply bounce back when the COVID crisis is over, so a less conservative approach to generating fiscal space may be needed.

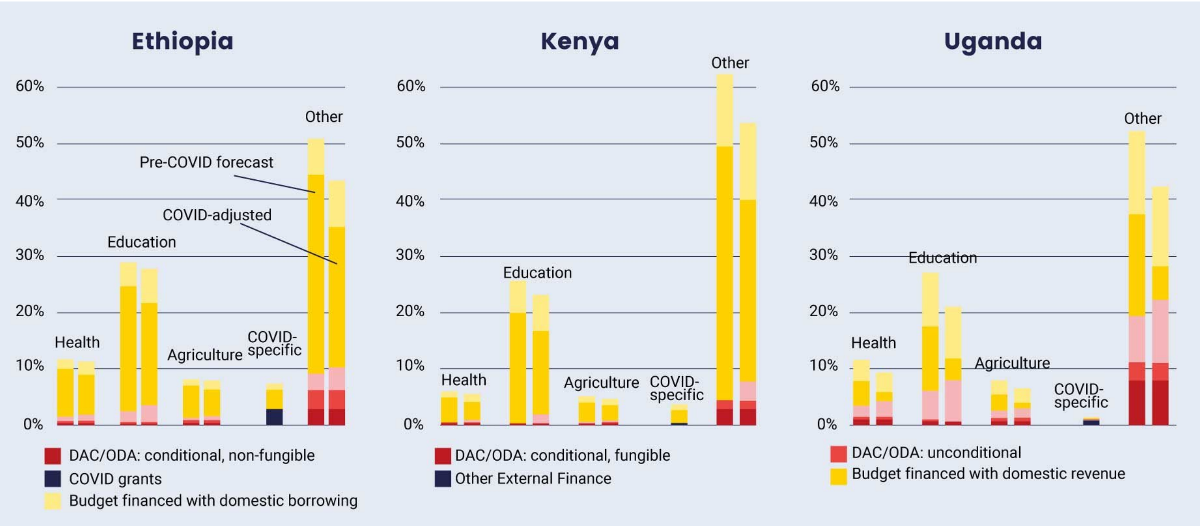
Figure 10 also shows that bilateral aid, including off-budget or very projectised aid, is significant in scale compared to total spending and likely cuts in these priority areas. That means bilaterals can make a difference, or not, depending on how they behave – managing relations with bilateral agencies will be important in reducing the disruption caused by COVID-19.

National governments should be able to persuade international donors to help support priority poverty reduction programmes, but they need to manage the risk that donor support is lost when cuts are made to national funding for such programmes (see next section).

In the *middle-income, partially delayed impacts*, rhetoric about shifting towards financial responsibility will need to become reality and, again, there is a choice about whether this is accompanied by accelerated reforms. There was a strong indication in country engagement that reformers were emboldened by the crisis, but this may work out differently depending on local political conditions. South Africa has planned a fiscal consolidation that is so rapid that it lacks credibility: it has a record of solid revenue mobilisation, but may be in need of a reset after a decade or more of excessive deficits, low public investment and unaffordable support programmes. Nigeria's fiscal malaise is clearly linked to its failure to mobilise revenue in the non-oil part of the economy, now a huge majority. In India, a fiscal imbalance which could have been dealt with in an incremental way pre-COVID may now require more radical steps.

For *resilient but affected* countries, and a couple of others, financial responsibility was the norm pre-COVID so will be easier to sustain post-COVID. Other things being equal, these countries might want to use more of their available fiscal space in the economically depressed years that will follow the crisis. But they need to be ready for the next crisis, too.

Figure 10: Recurrent and development spending on 'priority sectors' pre-COVID and COVID-adjusted by country



Source: Macro-fiscal shift is taken from comparison of pre-COVID forecasts from IMF Article IV consultations and WEO with post-COVID forecasts in World Bank Macro-Poverty Outlook October 2020; expenditure shares are taken from national budgets and/or national/World Bank public expenditure reviews from 2018–2019. Further research mentioned in the text links to budgets and supplementary budgets for Kenya.

5.1 Implications for financing

Policy choices and financing options are linked.

Macro-fiscal policy choices have strong implications for access to finance, so development finance limits the policy options available. Many of the 15 countries have demonstrated, pre-COVID, that it is possible to occupy a grey area close to 'fiscal short-sightedness' for quite a few years before things come to a head. The COVID-19 crisis brings forward the point where this position cannot be sustained.

In the *lower-income, acute-impact* countries – and others, such as South Africa – which have moved very close to debt distress as a result of COVID-19, access to any kind of finance is limited. This includes domestic and foreign commercial credit, which fiscal short-sightedness is likely to make expensive as perceived risks increase, as well as official and concessional finance such as IDA. For these countries, a policy of ignoring debt sustainability and accessing all available finance in the short term would quickly exclude concessional finance other than grants.

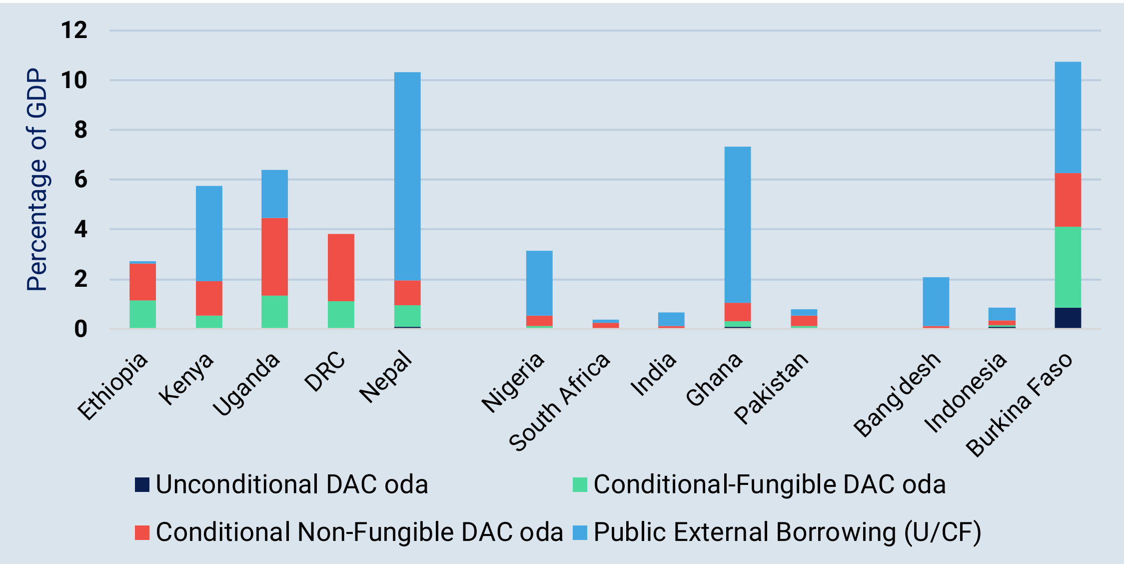
A transition to financial responsibility can be accelerated with the right reforms, and commitment to reform can buy some time with creditors.

On the expenditure side, countries dependent on grants and concessional loans from bilateral donors and global programmes need to manage risks. For lower-income countries these can be significant streams of development finance, but sharp cuts to priority programmes can push away access to this finance even if it aids stabilisation.

5.2 Bilateral donors and lower-income countries

Figure 11 illustrates how bilateral grants, including off-budget grants and grants tied to very specific uses and projects, are much more important to the first group of countries than to the others. Figure 10 showed that these amounts are significant compared to spending and especially compared to possible spending cuts in priority sectors linked to COVID-19.

Figure 11: Bilateral ODA and other development finance 2018[12]



Source: OECD data on ODA flows in 2018 plus pre-COVID observations in IMF Article IV consultations.

[12] Figure 11 maps the many DAC categories of official development assistance/ODA into 'unconditional', i.e. fully fungible budget support; conditional-fungible, which is finance for sector budget support or on-budget projects; and conditional non-fungible, which includes technical assistance and off-budget projects, possibly run by NGOs. Other public external borrowing is from commercial sources or MDBs.

Bilateral aid is important in *lower-income, short-term acute-impact* countries but issues need to be addressed to keep it effective as conditions change post-COVID. These countries have started making cutbacks in public investment and current programmes (see Figure 10 above) and will need to sustain these cuts in the medium term. Bilateral grants, including off-budget grants for donor projects, are worth several points of GDP in each case. Conditions on the use of grants may be intended to protect priority sectors with a focus on the Sustainable Development Goals, but if the conditions reflect pre-COVID objectives they may be ineffective in a situation where health, education and agricultural service delivery systems are experiencing cuts.

Governments and donors both have sector priorities. Official development finance is often linked to priority sectors, through conditional non-fungible grants for specific projects or more loosely – though development financers may not prioritise the same sectors as governments. There can be a clear rationale for these arrangements, but a significant economic shock such as COVID-19 can create unintended consequences unless funders are flexible.

Policy commitments can lose relevance in a crisis. For some countries, part of the government response to COVID has been a fiscal stimulus which funds new COVID-related expenditures and protects pre-COVID spending plans even as the economy and revenue base has shrunk. In several countries, new, fast-disbursing official development finance has been instrumental in enabling this counter-cyclical response. Ghana, for example, managed a counter-cyclical response only because of external development finance. In other countries, however – including Ethiopia, Kenya and Uganda – the net fiscal stimulus has been small to non-existent despite new official development finance. This is policy, but it is principally because other channels of finance are so restricted and there is pressure to reduce spending on all public sector activities, to meet the new expenditure limits and fund the extra COVID-related activities.

An issue is most important for *lower-income acute impact* countries is that the crisis forces policy, and cuts across pre-crisis policy commitments. This is true of expenditure commitments but also true of reforms. For example, revenue reforms become more vital in the post-crisis recovery but may have to be frozen during the apex of the crisis. In the country engagement exercise, several interviewees noted substantial bilateral for enhancing tax compliance, but queried the timeliness of increasing taxes during 2020, given the impact of COVID-19 on household and business income.

Bilateral donors need to guard against inadvertent pro-cyclical behaviour. It is possible for principled rules aimed at transparency and predictability to lead, inadvertently, to pro-cyclical outcomes. When financially constrained lower-income countries cut back on key sectors and miss performance targets, this can lead to grant providers retreating almost automatically from supporting ‘on-budget’ government programmes to off-budget or less-aligned projects. This reaction is designed to cope with a collapse of trust in the partner government but can be counter-productive when the cutbacks are triggered by an exogenous shock and the programmes are more in need than ever of grant providers’ assistance.

Bilateral donors can support reforms in the medium term. As explained in the previous section, for most of the 15 countries COVID-19 has increased the need to move away from unsustainable macro-fiscal positions and face some hard trade-offs. That the status quo is no longer an option strengthens the political and technical incentives to reform revenue policy and expenditure allocation, reduce corruption and waste and create better conditions for business investment. Whereas the bulk of additional post-COVID financial assistance may come through multilaterals, smaller and/or more specialised agencies can be nimble and help governments wishing to take a new tack on various aspects of policy.

There is scope for innovation and leverage of bilateral donor priorities. It might not be necessary to abandon longer-term objectives like climate and biodiversity in order to help with the COVID-recovery – fast disbursing resources for the crisis and recovery can still be linked to forward commitments of action, for example, providing debt relief – which is an inherently multilateral action – can be linked to ring-fencing at least part of the fiscal space it offers for public investment in low-carbon or other green initiatives. Given that a significant proportion of national wealth in many low-income countries is held as natural assets, such as rainforests, a deal which exchanges debt relief for sustaining natural assets could accelerate recovery as well as protect the climate and biodiversity.

A bilateral donor can also combine multilateral influence on re-purposing an SDR issuance towards IDA replenishment with its own agenda to support accelerated recover, such as reforms in public finances and systems for service delivery. In combination with focused technical assistance and other bilateral support, this can serve its own foreign policy priorities as expressed in bilateral ODA programmes, whether explicit or implicit depending on the overtness of its soft power agenda.

Overall the COVID 19 crisis presents an opportunity for bilateral donors to be more relevant and useful. More countries will be in need of grant support, with fewer alternative forms of affordable finance. But to realise the opportunity, donors must change their own behaviour to recognise how the facts have changed in particular countries. Bilaterals which stick to rigid agreements made pre-COVID will make themselves less relevant. But this does not mean abandoning all influence on forward actions as long as they are compatible with post-COVID recovery. And there is more than one instrument which can be used to advance an agenda. As bilateral donor capitals authorise the SDR allocations and soft window replenishments that will support LICs and MICs post-COVID, they can ensure that multilateral financial flows are conducive to reforms to which they can then offer complementary support.

Appendix 1: Insights from model simulations

Introduction

In this appendix we use a simulation model to explore the possible effects of alternative fiscal policy responses to the economic impact of the COVID-19 pandemic in low-income countries. The simulations represent various domestic and international dimensions of the shock associated with the pandemic and examine how private sector outcomes, principally consumption and investment, and key fiscal and debt aggregates are shaped by the authorities' fiscal policy choices in the short and medium term. The simulations show how different forms of external finance may ameliorate or exacerbate outcomes. Given its design, the model focuses only on aggregate macroeconomic and fiscal behaviour rather than explore outcomes at the firm or household level. We focus on private sector aggregate consumption as an overall proxy measure of well-being.

The simulations presented in the appendix are generated by a standard macroeconomic model of a small open economy operating in a highly constrained environment where it has limited influence over the impact of global economic conditions on domestic economic conditions. The economy is dependent on external demand for traditional commodity and merchandise exports and services such as tourism, and heavily reliant on imports and – critically – foreign capital flows. Policymakers face the direct effects of the pandemic on domestic production and employment and the public health policy responses, and are also confronted by the effects of disruption to the global economy such as the effects on commodity and other prices, the temporary closure of key sectors such as tourism and hospitality, and the slowdown or reversal of private capital flows including FDI and remittances. These spill-over effects constitute the principal transmission mechanism between the global pandemic and the economic conditions of developing countries.

In the simulations presented below, the model is calibrated to data from Kenya. The model is described in detail in our Working Paper from July 2020.[13] It is not a forecasting model designed to project how any specific economy will progress over the coming years, nor does it seek to emulate hybrid projection frameworks such as the IMF's *World Economic Outlook*. Rather it is used to conduct counterfactual analysis to examine how outcomes may be ameliorated or worsened by different fiscal and financing strategies.

[13] Christopher Adam, Mark Henstridge and Stevan Lee. After the lockdown: Using epidemiological and macroeconomic models to set out the adjustment to the aftermath of the Covid-19 pandemic in Sub-Saharan Africa OPM Working Paper (https://www.opml.co.uk/files/Publications/ahl2020-opm-working-paper-16-july-2020-final.pdf?noredirect=1)

Scenarios

1. External finance and financially constrained low-income economies

Figure 12 and Figure 13 compare how variations in the fiscal and financing response affect private welfare. To establish a baseline, Figure 12 shows the response of the economy to the domestic and international spill-over effects of the pandemic where the government implements an initial fiscal stimulus but holds public investment at its pre-shock level. The purposive fiscal stimulus totals 2.85% of initial GDP disbursed over the first eight quarters, starting during 2020Q2.[14] In this scenario no additional external financing is secured. The initial supply-side shock to the economy through to the end of 2020Q2 is assumed to be already baked in to all simulations, but given that there are no comparable experiences in recent history, it is extremely difficult at this stage to determine how quickly these effects will unwind. We therefore run the model forward under different assumptions about the depth and persistence of the reduction in domestic productive capacity, commonly referred to as ‘scarring’ (see Box 1 above). The range is shown by the dotted lines around our central projection.

To simplify the counterfactual analysis, all changes are measured on a quarterly basis and relative to an underlying trend rate of growth which in this case is assumed to be 3% per annum *per capita*. With a median population growth rate in the region of around 2 to 2.5%, this corresponds to recent pre-COVID trend growth rates of around 5 to 5.5% per annum.

If scarring turns out to be limited, GDP is projected to return close to trend early in 2022 – but if the dislocating effects of the lockdown are more severe, GDP may not return close to its trend level until the end of 2023. The same is true for consumption expenditure. As we show in the following simulations, while the shock has already destroyed output and subjected populations to a severe loss of income, judicious policy – especially supported by external finance – can accelerate this recovery.

Multiple adjustment mechanisms are at work. First, the real exchange rate and real interest rate adjust to reduce domestic absorption, consistent with the tighter balance of payments position and the reduction in domestic supply. Second, the real wage adjusts to clear the labour market.[15] Finally, the fiscal balance is satisfied by adjustments in taxation and short-term domestic borrowing, conditional on exogenously determined levels of public investment, recurrent spending and external official flows.

The ‘required’ fiscal response and consequent path for private consumption are shown in the bottom row of the figure. The required fiscal adjustment is measures by the latent fiscal gap which is the excess fiscal financing that has to be mobilised beyond that generated at initial

[14] The plots express the fiscal stimulus (and the latent fiscal gap) in terms of actual GDP, which means the initial spike in both plots – as with the initial jump in debt – reflects in part the fall in GDP. The scale in these share-of-GDP plots are the annualised values (i.e. a point value of 10% corresponds to 2.5% of annual GDP).

[15] The assumption of labour market clearing is a strong assumption, especially if one element of the lockdown is the complete closure of individual sectors. Outside the small, government-dominated formal sector, the labour market in most low-income countries is characterised by significant wage flexibility so that layoffs in sub-sectors are absorbed elsewhere, primarily in agriculture and the informal service sector. In our simulations we reflect the inefficiencies from skills mis-matching or increased under-employment that result from this reallocation by assuming a deterioration in total factor productivity during the lockdown and its aftermath.

tax rates and domestic borrowing. It takes as given the existing fiscal programme, amended by any programmed adjustments to either recurrent or development expenditures; plus statutory debt service costs on external and domestic debt where, in both cases, debt stocks are pre-determined, interest rates are endogenous and any identified financing flows consist of grants plus flows of concessional and non-concessional sovereign borrowing. In this baseline we assume that the gap is financed on a pro-rata basis between domestic borrowing and increases in domestic tax rates.

Even if there were no new spending commitments, the authorities would still need to undertake a fiscal adjustment as a result of the increased cost of existing expenditure commitments, including on debt service, and the contraction of the tax base from lower domestic output and employment and reduced imports.

The first point to make is that the decline in private incomes and consumption following the outbreak of the pandemic is larger and more persistent than the hit to domestic production. This reflects the fact that for small, low-income countries, the reduction in consumption reflects both the reduction in domestic production and income and the reduction in external inflows from lower net export earnings, reduced remittances and reduced FDI inflows.

Figure 13 examines how outcomes are affected by variations in the fiscal programme. We consider two alterative paths to reducing the latent fiscal burden associated with adjustment. The first entails an aggressive but temporary reduction in public infrastructure investment – in effect, a crowding out of public investment (Figure 13 panel d) to finance the required fiscal stimulus programme (panel c). In the second case, the authorities are able to scale back the reduction in public investment by accessing enhanced external financing (half in the form of unrequited grants and half on IDA terms). The two programmes are calibrated to deliver the same fiscal saving in the short run.

In both cases the fiscal adjustment is substantially reduced (panel e) in the short run, and the required crowding out of private consumption is substantially ameliorated. However, the two strategies play out very differently in later years. Because of the complementarity between public and private capital – in that the provision of infrastructure raises the return to private investment – the strategy of cutting back public capital leads to a significant slowdown in the recovery of domestic output and GDP following the initial shock (panel a). As a result, while the reduced burden of taxation on the private sector initially supports the recovery in private consumption (panel f), this quickly peters out.

The situation is much more favourable when external finance is made available, even in the form of concessional debt finance. While this strategy leads to a rise in the concessional debt-to-GDP ratio from an initial value of 18% to around 24% by the end of 2022 (panel b), this finances a more rapid recovery in GDP (panel a) and private consumption.

The fact that private consumption is still marginally lower than the baseline here reflects the combination of the still-slower recovery in GDP, because of the reduction in public investment, and the fact that the government is now required to finance a higher debt service burden than before. Although not shown here, it follows that if a larger share of the external finance were in the form of grant financing and the public investment programme was not cut back at all, the consumption path with enhanced external finance would dominate the baseline and private welfare would be unambiguously higher.

2. External finance for countries with market access

Countries with market access may be able to tap Eurobond or other commercial debt markets as these begin to re-open.[16] However, despite the historically low world interest rates, likely yields on Eurobonds for low-income countries remain elevated at between 8% and 10% per annum in US dollar terms, rendering this source of financing relatively unattractive, certainly compared to concessional finance. Figure 14 shows how the substantially higher debt service cost associated with market finance serves to sharply elevate fiscal costs, even for an initially modest non-concessional debt-to-GDP ratio of 10%. As with Figure 13 we focus exclusively on the central projection for scarring. In this case, while the output recovery is faster than under the domestic adjustment programme, the higher debt service costs mean the prospects for the recovery of private sector consumption are no better than under the pure domestic adjustment strategy.

3. External finance and domestic fiscal reforms

Even with external financing, countries face a substantial fiscal challenge just to return to trend growth within two-to-three years, even assuming there is not a second wave, second domestic lockdown or further dip in the global economy. A natural question is whether current circumstances offer the opportunity for domestic fiscal reforms to accelerate the recovery process.

Figure 15 considers the gradual implementation of public financial management (PFM) reforms concerned with the efficiency of government expenditures designed to improve the operation and maintenance of the public capital stock, which, as noted earlier, is complementary with private capital. Strengthened public expenditure procedures in this area are designed to improve the productivity of private investment and would be expected to allow the economy to sustain a higher level of *per capita* GDP. In the post-pandemic period, the payoff of an accelerated recovery may be expected. Panels a and f of Figure 15 tell the story here. For a fiscal programme that is only marginally more expensive (the green line in panel 4 is initially higher than the blue and red lines), the output gains from improved ring-fencing of operating and maintenance expenditures accelerates the GDP recovery and supports a faster consumption recovery. In this instance improved recurrent cost management is equivalent to higher (counterfactual) investment in public capital.

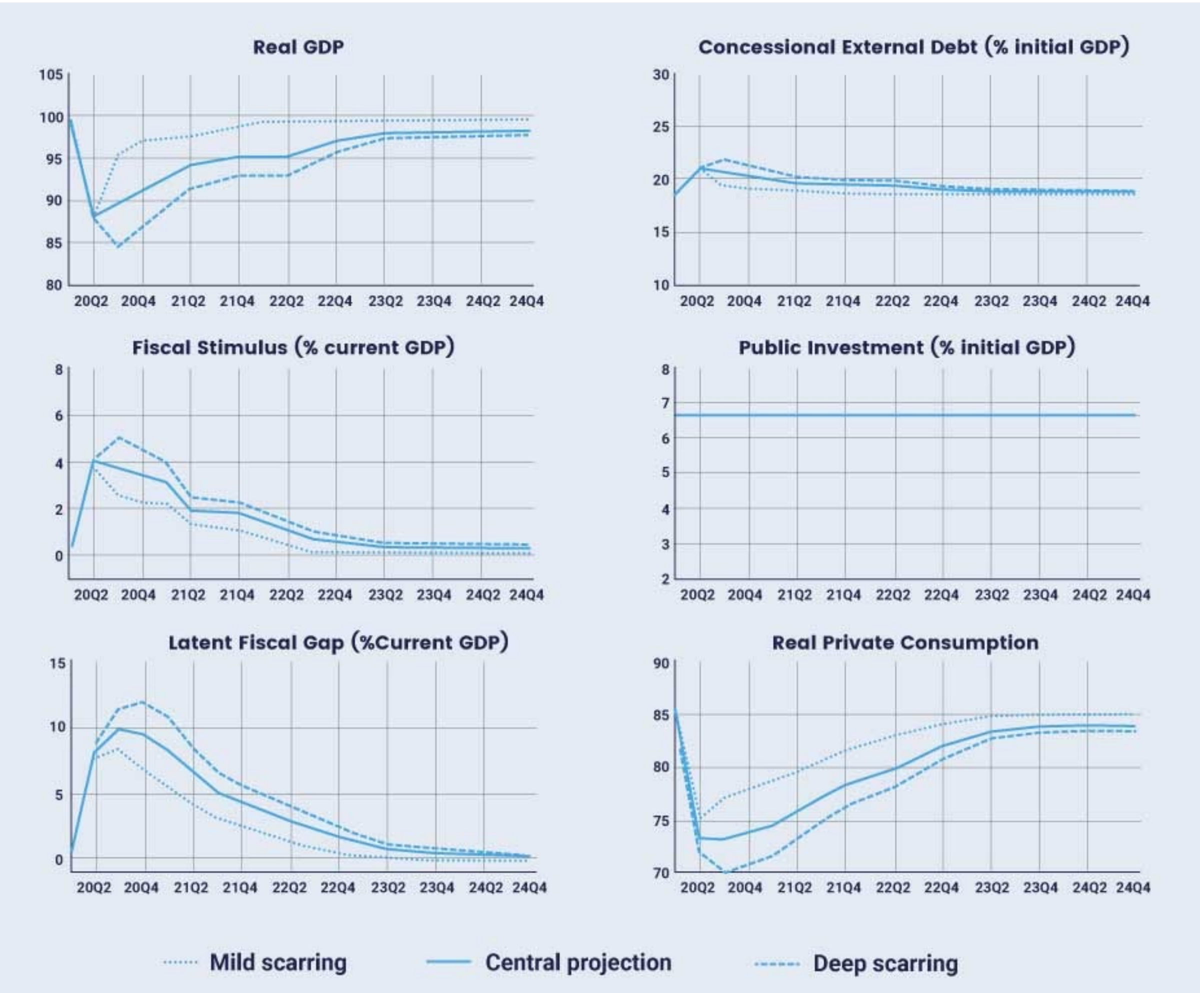
It follows, of course, that to the extent that these PFM reforms are combined with external finance that allows for the initial contraction in public investment to be curtailed, the recovery in output and consumption may be even more rapid: in the case shown in Figure 16, both have returned above their trend *per capita* level by the end of 2023.

A second set of reforms consists of those targeted at removing administrative loopholes and hence reducing leakages in the tax system. Improved compliance allows for higher revenues, enabling higher expenditure or lower domestic borrowing. Alternatively, improved compliance allows the same level of revenue mobilisation at lower marginal tax rates; to the extent that lower rates imply lower tax distortions, through reduced deadweight losses from

[16] See https://www.fitchratings.com/research/sovereigns/debt-markets-re-open-for-sub-saharan-issuers-29-11-2020

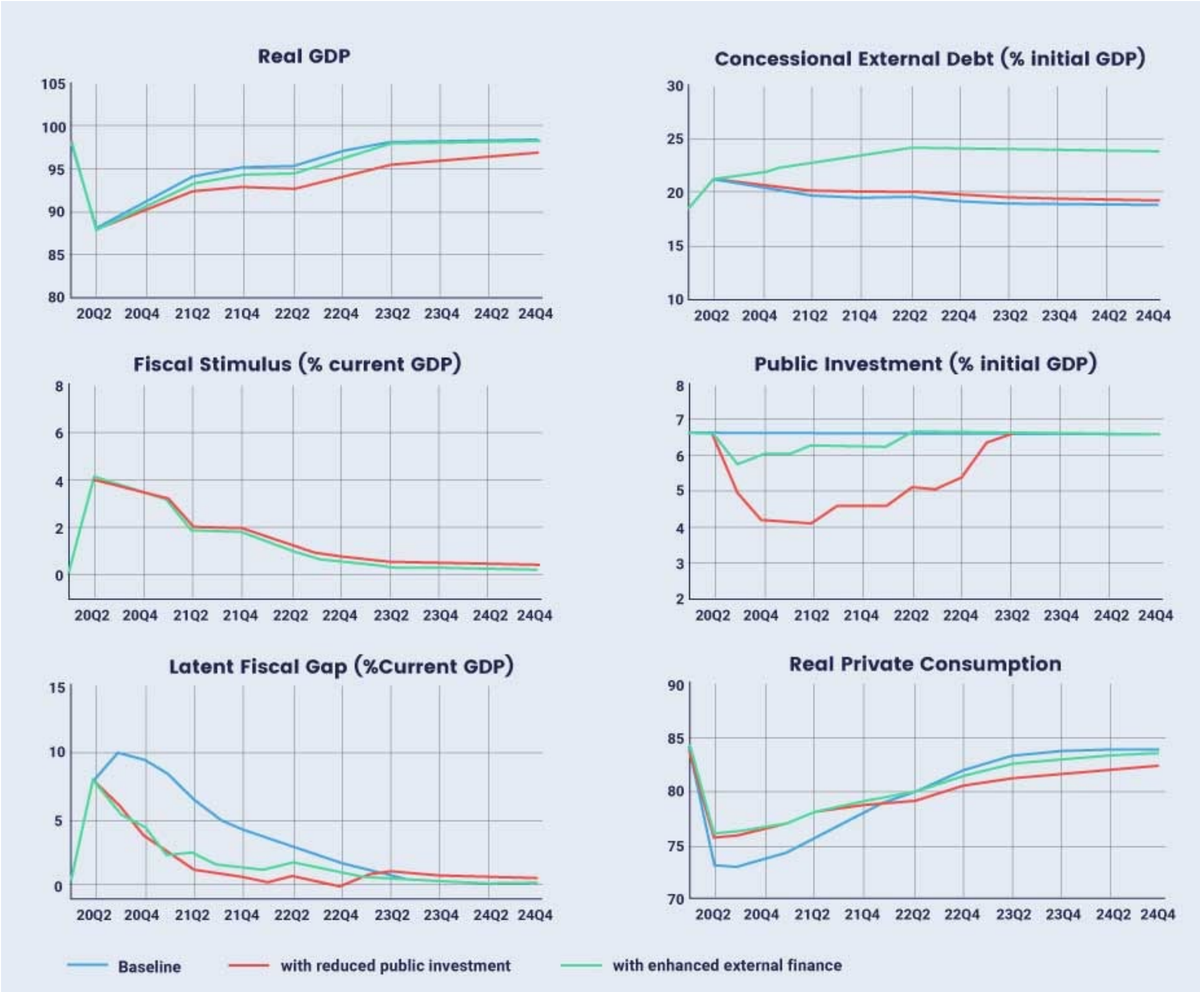
taxation, this improves resource allocation. For example, lower taxation on profit incomes will, at the margin, encourage higher saving and investment, which in turn will support higher real wages and GDP in the long run. There are reasons to believe, however, that these effects are likely to be modest in the short run since the main effect of closing tax loopholes is redistributive between the private and public sector, as notional tax revenues that were previously leaking directly into private sector expenditures now accrue to government. This direct redistributive effect is first order in the short run, while the gains from lower tax distortions are second order and feed through in the longer term. These longer-term gains are non-trivial but, unless pre-existing levels of leakage are large, they do not play a significant macroeconomic role over the recovery horizon we are looking at here.

Figure 12: Baseline simulation for financially constrained economy [public investment ring-fenced and no additional external financing]



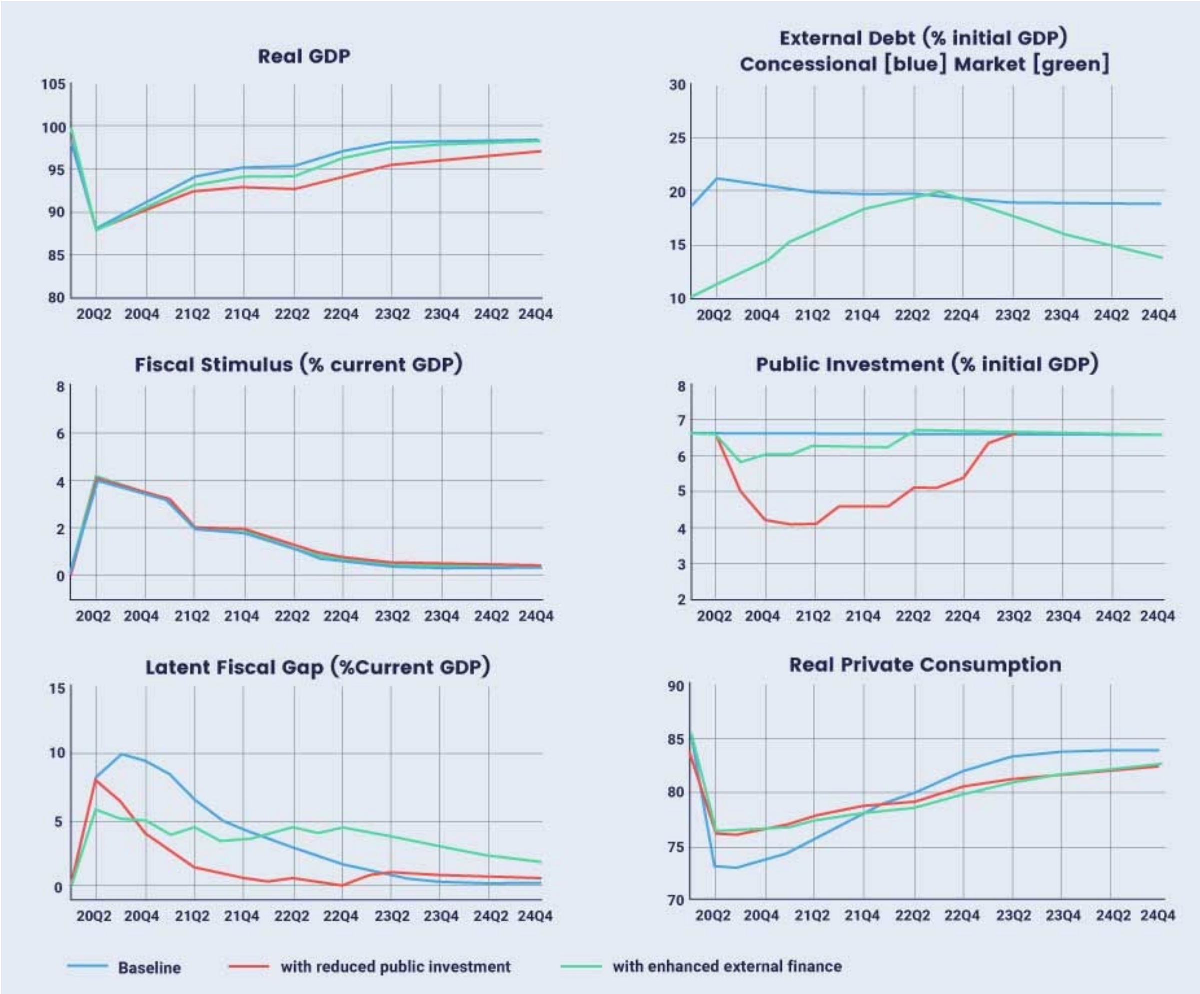
Notes: Simulations Ken_02_20bAx.m; Ken_02_26bAx.m; Ken_02_32bAx.m

Figure 13: Alternative fiscal adjustment paths for financially constrained economy



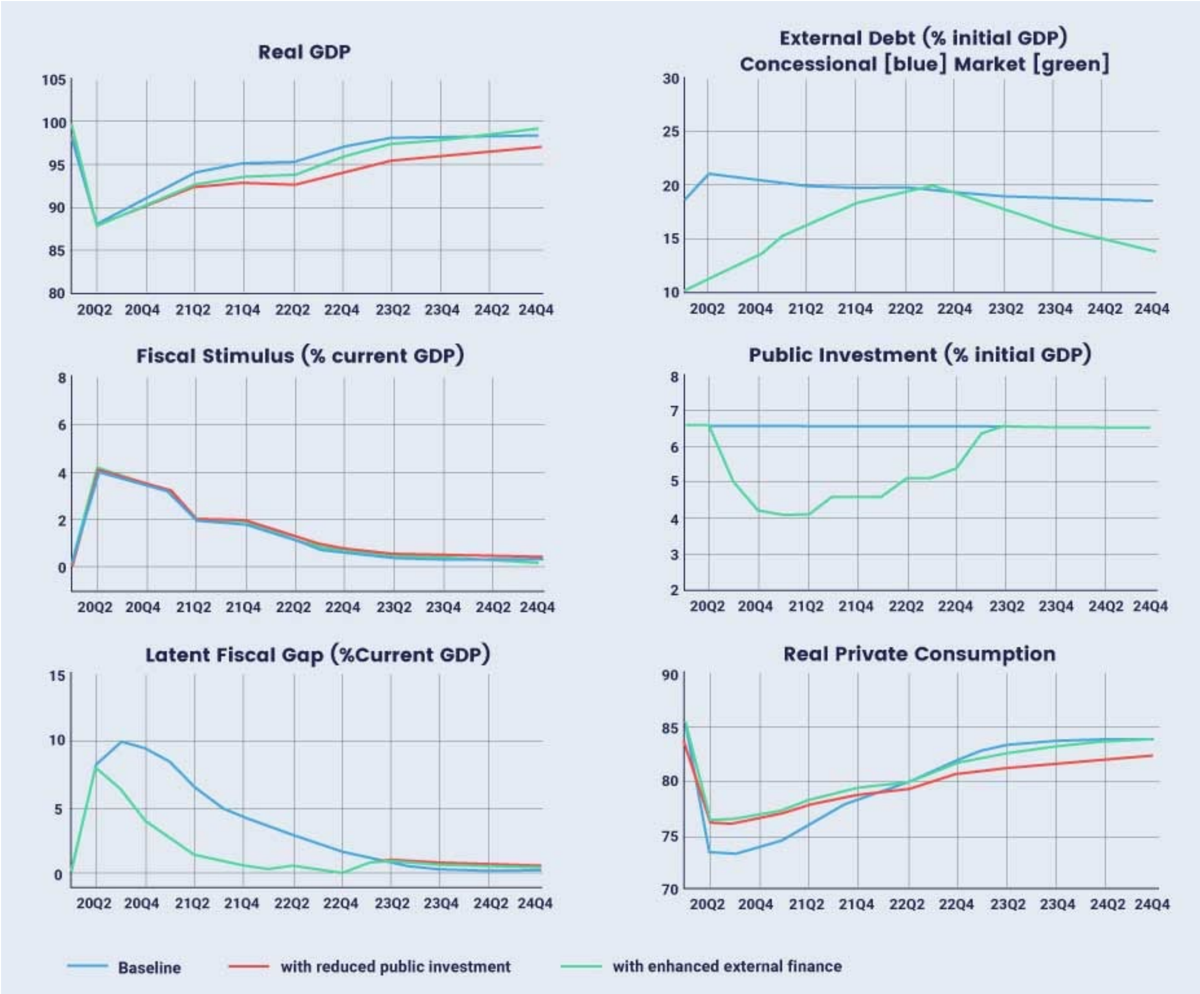
Notes: Simulations Ken_02_26bAx.m; Ken_02_26bBx.m; Ken_02_26bCx.m

Figure 14: Adjustment with market financing



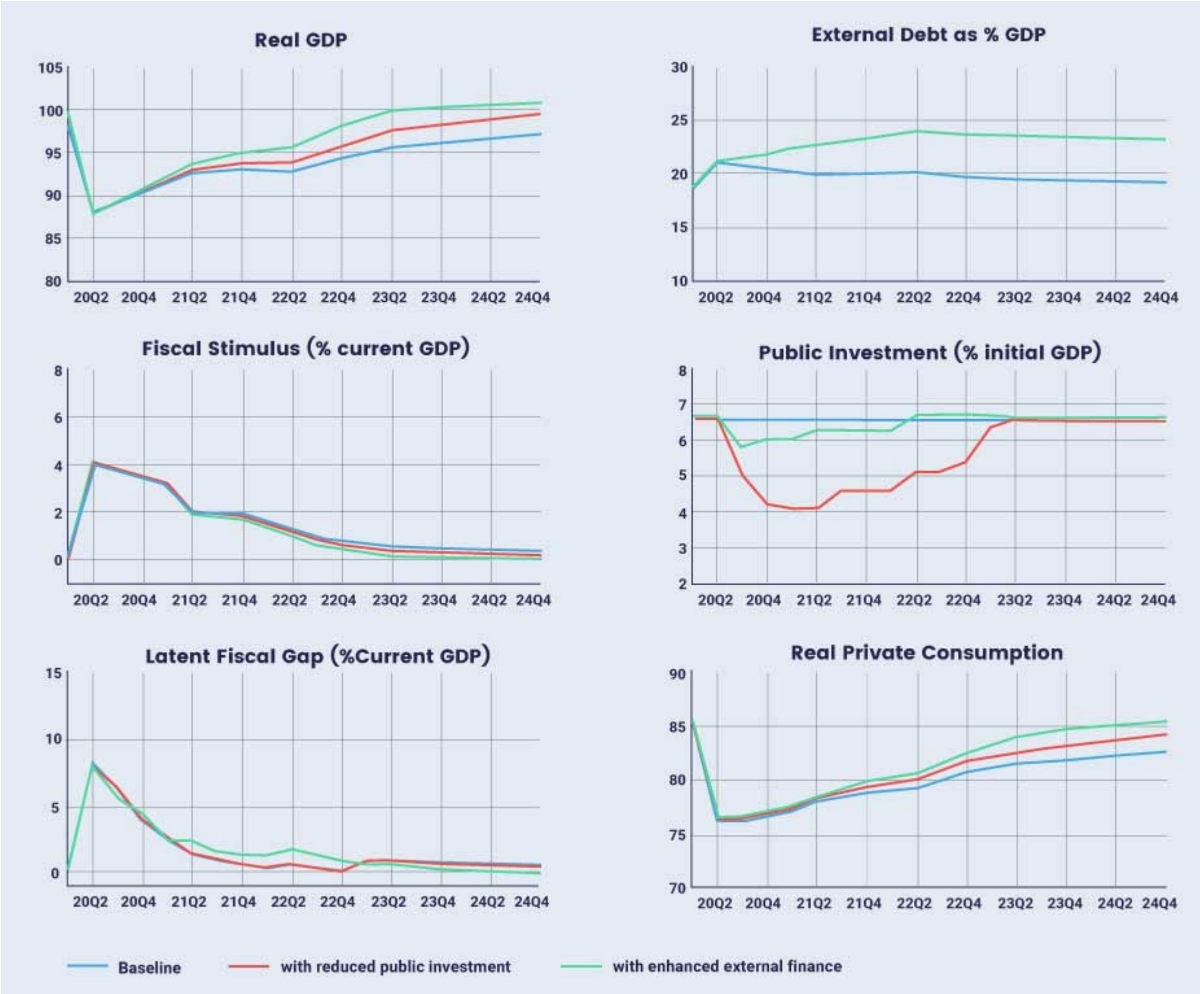
Notes: Simulations Ken_02_26bAx.m; Ken_02_26bCx.m; Ken_02_26bEx.m

Figure 15: Adjustment with PFM



Notes: Simulations Ken_02_26bAx.m; Ken_02_26bBx.m; Ken_02_26bFx.m

Figure 16: Adjustment with PFM and concessional external finance



Notes: Simulations Ken_02_26bBx.m; Ken_02_26bFx.m; Ken_02_26bHx.m

Appendix 2: In-country consultation report

Objective

The country engagement exercise ensures that the modelling is not done in a vacuum. It acts as a sense check and provides the team with the on the ground realities that are unfolding in country on the impact of COVID-19 on the economy. In particular, the interviews and workshop probed into the government response to COVID-19, the design and impact of fiscal stimulus packages, the fluctuation in remittances and the country's priorities for leveraging external financing.

The aim of this report is to highlight the key findings from the country engagement process in Ethiopia, Kenya, Uganda, Ghana, Pakistan and Bangladesh to date.

Approach

To identify suitable individuals to speak to, the team leveraged their existing network. One key point of contact was identified in each country through which the team was able to snowball other interviews.

An email template and interview guide was developed (see Annex A), which was used to structure all conversations. In some cases, the interview commenced with a short presentation on the research findings so far, which provided an entry point for conversation. Due to time constraints it wasn't always possible to cover all interview questions, however the team ensured that the most relevant areas were probed in to.

List of people interviewed

Given the short time period to arrange interviews and the fact that those we were most interested in are key decisionmakers or their advisers in country who are currently involved in response efforts, it was challenging to schedule interviews. Furthermore, in some countries such as Kenya it is more difficult to get access to government officials due to their being a more formal process of engagement. Given the limited availability of the people interviewed, the conversations were limited to 30 mins each.

Table 1: List of people interviewed

Name	Position	Organisation	Country
Faisal Rashid	Senior Consultant in PFM	Subnational Government Programme (SNG) II	Pakistan
Kamran Ali Afzal	Additional Secretary	Ministry of Finance	Pakistan
Nohman Ishtiaq	Independent Consultant	SNG II	Pakistan
John Nyangi	Head of Research	Institute of Public Finance	Kenya

Name	Position	Organisation	Country
John Kinuthia	Lead Researcher	International Budget Partnerships	Kenya
Wangari Muikia	Lead Economist	Expertise Global Consulting	Kenya
Haron Ngeno	Research Analyst	Expertise Global Consulting	Kenya
Richmond Commodore	Research Associate and Southern Voices Network for Peacebuilding Scholar	African Center for Economic Transformation (ACET) for Africa	Ghana
Ed Brown	Senior Director, Research and Advisory Services	ACET for Africa	Ghana
John Asafu Adjaye	Senior Fellow and Head of Research	ACET for Africa	Ghana
Selim Raihan	Associate Professor and Executive Director	Dhaka University and SANEM	Bangladesh
Ann Bartholemew	Independent Consultant		Bangladesh
Gabi Elte	Consultant	OPM	Bangladesh
Dr Fouzul Kabir Khan	University Professor and former Secretary to the Government of Bangladesh	Dhaka University and Government of Bangladesh	Bangladesh
Rezauddin Chowdhury	Independent Consultant		Bangladesh
Tadele Ferede	Professor in Economics	Addis Ababa University	Ethiopia
Dawit Ayele	Adviser to the Minister	Ministry of Finance	Ethiopia
Fantahun Belew Asfaw	Independent Consultant	Building Resilience in Ethiopia	Ethiopia
Firehiywot Handamo	Director of Fiscal Policy	Ministry of Finance	Ethiopia
Mezgebu Terefe	Advisor to the Minister	Ministry of Finance	Ethiopia
Kokeb Misrak Workeneh	Director of Bilateral Cooperation Directorate	Ministry of Finance	Ethiopia
Roberto Tibana	Chief Economist	ACET for Africa	Mozambique

In addition, there have been email exchanges with a range of relevant stakeholders, with the anticipation that these will be scheduled in the coming months.

Workshop

In addition to Key Informant Interviews (KIIs) a virtual workshop was held on 9 December 2020 which allowed for discussion and comparisons between countries. The two-hour workshop was structured in a way that allowed the OPM team to probe into certain areas and themes that had emerged from the desktop research and KIIs. To start the workshop the OPM team presented their initial findings. After a brief discussion on the presentation itself two key topics were discussed. The first was on the allocation of concessional finance for COVID-19. The second on what type of development finance for which country and when A subset of those interviewed in the KII process participated in the workshop. For a full list see Table 2.

Table 2: List of workshop participants

Name	Position	Organisation	Country
Faisal Rashid	Senior Consultant in PFM	SNG II	Pakistan
Kamran Ali Afzal	Additional Secretary	Ministry of Finance	Pakistan
Nohman Ishtiaq	Independent Consultant	SNG II	Pakistan
Wangari Muikia	Lead Economist	Expertise Global Consulting	Kenya
Richmond Commodore	Research Associate and Southern Voices Network for Peacebuilding Scholar	ACET for Africa	Ghana
Selim Raihan	Associate Professor and Executive Director	Dhaka University and SANEM	Bangladesh
Rezauddin Chowdhury	Independent Consultant		Bangladesh
Roberto Tibana	Chief Economist	ACET for Africa	Mozambique
Usman Khan	Consultant	SNG	Pakistan

Key findings from the in-country consultation process

I. Economic impact of COVID-19

All interviewees commented on the economic standstill brought on by COVID-19, in particular in April, May and June 2020, although the effects of travel restrictions and the global recession were already felt in March 2020. The majority of sectors faced unemployment and lay-offs. Deficit are ballooning to 5–10% of GDP. Agriculture is one of the few sectors that continued to function in all countries, according to the interviews. For Bangladesh, the impact of COVID-19 has not been as expected. While the ready-made garment (RGM) sector suffered, the stimulus package provided substantial support. Even during the peak of lockdown, one interviewer speculated that an estimated 50% of factories were still operating. Compliance and enforcement in the country were problematic, despite the strict measures.

Interviews in Pakistan and Bangladesh noted that there was urban to rural migration, which has been difficult to reverse, as factories are now reopening, and workers are opting to stay in agriculture.

In Ethiopia, an important impact that was highlighted in the interviews is that the country has been classified as high risk, affecting their ability to stimulate the economy.

Despite all interviewers highlighting this standstill for the formal economy, the informal economy still seemed to be active in many places, with markets places and street vendors still operating, albeit with less traffic coming through.

Key to note is that all interviewees were concerned about the long-term effect of COVID-19 on the budget.

II. Government response and stimulus packages

The impact of COVID-19 has played out differently in each of the case studies, yet there are still some commonalities across all the countries. Primarily, COVID-19 was expected to unfold similarly as it did in Europe and the USA. However, Pakistan, Ghana, Bangladesh and Kenya all put into question the extreme measures were taken, which followed in the footsteps of more developed economies.

The stimulus packages supported a range of sectors, including micro and small businesses, hospitality and services industry as well as infrastructure. At the core they were about job retention. In Ethiopia these stimulus packages were co-funded by government and international organisations. In Pakistan and Bangladesh they largely came from the central government.

For stimulus packages to be effective, they require quick disbursement. In the case of Bangladesh, 20,000 crore Thaka (US$ 2 billion) was made available to support SMEs. However, to date only 10–15% have been dispersed. The concern is that this will have long-term effects. In Ghana US$ 100 million was offered to SMEs – however one interviewer noted ‘the jury is out whether this was effective’. This line of thinking was echoed for other countries.

COVID-19 has in many cases led to a shift in government priorities. The current government in Pakistan has strongly supported social sectors and was less focused on infrastructure. Since COVID-19 the focus has been back on construction, in part because of the anticipated backward linkages. Furthermore, COVID-19 has also led to a focus on income support and a reduction in untargeted subsidies (these are to be means tested).

In Kenya, it was noted that being classified as middle income has created constraints. Kenya is going through a debt crisis and has little room for additional financing. Some of the tax relief will further reduce the ability for the country to recover.

When asking about preparation for a second wave, as can be seen in more developed economies one interview in Pakistan noted: ‘*Things seem to be very comfortable – almost miraculous*’ and noted that the expectation is that some sense of normality will resurface in the coming months. No interviewee was concerned about a second wave, but they did note that the ‘smart’ lockdown approach that many countries have adopted (i.e. having lockdowns in areas where there has been a surge in cases) will likely be part of the government response. In Ethiopia one respondent noted: *‘It looks like we’re going for herd immunity’.* Finally, Ethiopia has confirmed the elections for summer next year, thus further demonstrating that the expectation is that normal life will resume.

Scaling up social protection has been a key part of response efforts, which have been supported through a mix of external and internal financing.

III. Remittances

All interviewees noted that remittances were affected. Pakistan and Bangladesh noted that informal channels of remittances had been restricted due to COVID-19 resulting in there being an increase in the official figures on remittances. Ethiopia reported a decline in remittances with concerns that this trend will continue.

In Bangladesh one interviewee noted, that there are two drivers of growth – remittances and RGM. When there is an export shock as was seen due to the cancellations of orders in the RGM sector, the expectation is that this shock will spill-over into other sectors. There is some speculation that the positive growth in remittances might counter this export shock. However, because of COVID-19 all sectors were affected this positive growth in remittances is likely to have a minimal impact on other sectors.

IV. External support

The interviews were critical of the DSSI support that the G20 was providing arguing that this didn't provide *'sufficient financial space*'. In particular, there were complaints of the unclear framework, the short time frame and the fact that this wasn't mandatory for G20 countries to provide this support. Furthermore, even when countries did indicate that they were providing this support, they didn't make this mandatory for private institution. The consensus among the countries we interviewed was that this support was insufficient and did not meet the needs of their economies. While some countries like Bangladesh and Kenya have decided to not pursue this relief, other countries like Ethiopia and Pakistan are continuing to negotiate with the G20 countries, although Pakistan noted that they are likely to only engage if the terms change for example extending the debt relief to December 2021. This is supported by an interviewee in Kenya who noted: '*More financing after 2020 could ease the recovery faster'*. Ethiopia noted that they are now working bilaterally in order to restructure their debt.

The receptiveness towards receiving aid depends on the current state of finances. Interview in Ethiopia highlighted that they are willing and eager to receive aid. Currently the Ministry of Finance is also seeking non-traditional forms of finance. Countries like Bangladesh and Pakistan on the other hand, noted that aid is unlikely to alleviate the financial burden brought on by COVID-19. The Ministry of Finance in Pakistan noted: '*If we were facing a huge financial deficit in terms of medical requirements than I would've said tied aid is better'.* However, as a broad range of sectors and organisations are affected, COVID-19 related aid is likely only going to support the immediately affected sectors such as health or education.

There has been a push from the IMF for increasing taxes but given the current COVID-19 climate this 'puts policymakers in a difficult position'.

Assuming there will be additional resources, how should they be allocated?

Among workshop participants there was consensus that external debt cancellation would go a long way to supporting governments in the Global South. In Pakistan overall debt is 5% but currently domestic debt is occupying 75% of the fiscal space. In Kenya, external debt and domestic debt are about equal. In Ghana, debt to GDP was about 71%, which with the upcoming elections is likely to have increased as there have been substantial expenses. While debt cancellation or restructuring of debt is the preference softer loans were also noted as alleviating some of the burden.

In Pakistan, the government is pushing for a restructuring the IMF loan by the central bank to be at 2–3% interest over 50 years. This restructuring the government already attempted

18 months ago but was rejected. They are now seeking this again however there are some challenges: this loan is contingent on increasing electricity prices and increasing taxes, which are both exceptionally difficult in the current domestic climate. In Kenya, on the other hand an IBRD seems like one of the few options available to them. However, any loan would have to be a concessional relief. In Ghana, debt cancellation would give more fiscal space but there aren't many options for restructuring. Currently the government is looking to go back to the Eurobond market, which might create substantial fiscal space. However, it will also be very expensive. For Ghana it was noted that the DSSI option is not attractive due to the risk of the credit rating being lowered.

Reflections

- Pertinent issues in the report: the development financing provided in the short term have been useful and that the future will be difficult. All countries have struggled across the board.
- All countries noted that they are concerned about the long-term impact of COVID-19 on the budget. In many cases the money that is being used for the response is not new money, but simply funding that has been pushed forward and reallocated. There is a real concern on the potential economic consequences of this.
- Agreement that it was good to give development financing quickly, but there are still many challenges ahead, which development finance can help with. However, concern with countries in the Global North cutting aid budget e.g. UK.
- For the African context the biggest thing to watch is that people are coming home (migrant workers) to a contracted job market.
- COVID-19 has enabled policymakers to be much more brave and innovative. This should be capitalised on. Stakeholders including political stakeholders are now much more receptive.

Annex A Cover email for KIIs

Dear [NAME]

[NAME] suggested I reach out to you as we at Oxford Policy Management are working on a project that is looking at how and which types of development financing can help combat the impact of COVID-19 on developing economies across the world.

We are looking at the impact of the pandemic on [COUNTRY] as a case study, in part by developing a dynamic macroeconomic model founded on a baseline assessment of the impact of the pandemic, lockdowns, and the international recession, and so enabling us to also look at changes in financing flows. The model will allow us to make some estimates of the impacts on [COUNTRY], which we hope you will find of interest.

As part of this process, we are conducting in country consultation to gain a deeper understanding on how COVID-19 has affected different sectors, what the impact of the government response has been, and the ways external financing instruments can be leveraged to accelerate recovery.

Given this, I would very much welcome to speak to you or your colleagues over the next week as part of our consultation process. We would happily share our modelling results with you, if they think they could be of interest.

Do let me know when you are available.

Best Wishes,

[NAME]

Interview guide

1. Lockdown & Mobility: In country perception of lockdown & mobility
    a. Our data shows that …. What have the in-country perceptions been of lockdown & its impact on economic activity?
    b. Supply & Productivity shock?
    c. Is there concern about a second wave?
    d. What would this mean for government response?
2. Impact of government response: Both short and long term
    a. What has government response been aside from lockdown?
    b. What are the long-term consequences of government response?
    c. Will there be additional measures?
3. Stimulus Packages: Getting a good grasp on the stimulus packages helps us to create more accurate models
    a. To what extent does this cushion the impact of the economic shock?
    b. What impact does this have on public finances?
    c. Debt?
    d. Current account deficits?
    e. Liquidity?
    f. How extensive have the stimulus packages been? What have they covered?
    g. Who has provided the funding?
    h. Is there a sector that has been particularly supported? How was money reallocated?
    i. What do you think the long-term impact of the stimulus package will be? What can we expect to see 2 or 5 years down the line?
4. Remittances
    a. How have remittances been affected so far?
    b. Given the latest COVID-19 situation, what would your prediction be for remittances?
5. External support: What should DAC group be doing?
    a. What are the remaining challenges for development financing instruments?
    b. Support in what format? What tools are available/make sense?

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Oxford Policy Management is committed to helping low- and middle- income countries achieve growth and reduce poverty and disadvantage through public policy reform. We seek to bring about lasting positive change using analytical and practical policy expertise. Through our global network of offices, we work in partnership with national decision makers to research, design, implement, and evaluate impactful public policy. We work in all areas of social and economic policy and governance, including health, finance, education, climate change, and public sector management. We draw on our local and international sector experts to provide the very best evidence-based support.

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Oxford Policy Management Limited

Registered in England: 3122495

Registered office: Clarendon House,

Level 3, 52 Cornmarket Street,

Oxford, OX1 3HJ, United Kingdom