

TC Document RG-T4055

I. Basic Information for TC

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| ▪ Country/Region: | REGIONAL |
| ▪ TC Name: | Fiscal risks analysis, ALC monitoring and policy options with inclusive growth |
| ▪ TC Number: | RG-T4055 |
| ▪ Team Leader/Members: | Valencia Arana, Oscar Mauricio (IFD/FMM) Team Leader; Astudillo, Karen (IFD/FMM) Alternate Team Leader; Alejos Marroquin, Luis Alejandro (IFD/FMM); Andrian, Leandro Gaston (CAN/CAN); Calderon Ramirez, Ana Cristina (IFD/FMM); Canillas Gomez, Mariana Belen (IFD/FMM); Carmen Montesinos Ibanez (IFD/FMM); Juan Carlos Cardenas Valero (INE/ENE); Manzano, Osmel Enrique (CAN/CAN); Sara Vila Saintetienne (LEG/SGO) Team Leader; Astudillo, Karen (IFD/FMM) Alternate Team Leader; Alejos Marroquin, Luis Alejandro (IFD/FMM); Andrian, Leandro Gaston (CAN/CAN); Calderon Ramirez, Ana Cristina (IFD/FMM); Canillas Gomez, Mariana Belen (IFD/FMM); Carmen Montesinos Ibanez (IFD/FMM); Juan Carlos Cardenas Valero (INE/ENE); Manzano, Osmel Enrique (CAN/CAN); Natalia Almeida (LEG/SGO) |
| ▪ Taxonomy: | Research and Dissemination |
| ▪ Operation Supported by the TC: | .N/A |
| ▪ Date of TC Abstract authorization: | 09 Aug 2022 |
| ▪ Beneficiary: | Ministries of Finance in LAC |
| ▪ Executing Agency and contact name: | Inter-American Development Bank |
| ▪ Donors providing funding: | OC SDP Window 2 - Institutions(W2C) |
| ▪ IDB Funding Requested: | US\$350,000.00 |
| ▪ Local counterpart funding, if any: | US\$0 |
| ▪ Disbursement period (which includes Execution period): | 24 months of disbursement period, and 24 months of execution period |
| ▪ Required start date: | January 10,2023 |
| ▪ Types of consultants: | Individuals |
| ▪ Prepared by Unit: | IFD/FMM-Fiscal Management Division |
| ▪ Unit of Disbursement Responsibility: | IFD/FMM-Fiscal Management Division |
| ▪ TC included in Country Strategy (y/n): | No |
| ▪ TC included in CPD (y/n): | No |
| ▪ Alignment to the Update to the Institutional Strategy 2020-2023: | Institutional capacity and rule of law |

II. Objectives and Justification of the TC

2.1 Objective. The general objective of this technical cooperation (TC) is to evaluate and improve existing tools for macro-fiscal risk analysis in Latin American and Caribbean (LAC) countries, so that they can be integrated fiscal discipline frameworks, such as fiscal rules and councils, and with energy transition strategies to strengthen institutions to contribute to mitigating existing macroeconomic risks and promote fiscal sustainability. The specific objectives of the TC are to: (i) develop analytical tools for identifying the main macro-fiscal variables that may affect the fiscal sustainability of countries; (ii) improve the early warning model with accurate information and integrate

institutional and climate change indicators that will allow countries to assess current macro-fiscal risks thoroughly; and (iii) promote regional dialogue among countries to share lessons learned and promote best practices in identifying and mitigating risks to fiscal sustainability.

- 2.2 **Justification.** The economic and social impact of the COVID-19 crisis profoundly affected LAC's macro-fiscal position. During 2020, the region's average public debt increased by 15pp to 72.5% of GDP, the fiscal deficit increased by 4pp to 7.5% of GDP, and economic growth contracted by 6%. Although, the economy showed a strong recovery of 7.4%, in 2021 the fiscal deficit continues to be 1.5pp of GDP above pre- pandemic levels (3.4% of GDP), and the debt only corrected by 3.5pp to 69% of GDP. Additionally, macroeconomic risks are increasingly persistent. By 2022, new supply shocks have affected the stability of value chains and boosted inflationary pressures, affecting growth dynamics that depend to a large extent on fiscal adjustment capacity. The effects on LAC are heterogeneous. Energy subsidies, which represent a significant component of fiscal inefficiency, could increase by 2pp of GDP in 2022, revenues from commodity exports would increase by 1.2pp of GDP by 2023, and higher interest rates could make debt service more expensive (Pineda et al.,2022)¹. Consequently, the uncertainty and fiscal efforts needed for countries to return to their fiscal consolidation paths have been amplified in the face of this new fiscal policy normality.
- 2.3 The pandemic also exposed the need to reinforce institutional schemes supported by regulatory frameworks of fiscal discipline, which play an essential role in designing mechanisms to guide policy decisions towards fiscal sustainability. In this sense, fiscal rules and councils are an appropriate strategy to strengthen the monitoring and evaluating compliance with medium and long-term fiscal commitments by constructing institutional indicators. In addition, it is also relevant to quantify the risks associated with climate change through the early warning system, which could facilitate economies' efforts to transition to renewable energies and harmonize green transition strategies within fiscal policy formulation.
- 2.4 The Fiscal Sustainability for Latin American and Caribbean Countries (FISLAC) is a digital real-time analytical solution developed by IDB² that allows finance ministries to better analyze macro fiscal risks, considering international financial market conditions, helping them design credible fiscal policies during periods of great uncertainty. Currently, FISLAC allows the creation of an early warning system in three dimensions: macroeconomic, fiscal, and institutional, including: (i) making projections about macro-fiscal variables at the level of country, regions or groups of countries, taking into account respective levels of uncertainty; (ii) calibrating fiscal rules, which in the current context is very useful given the high levels of indebtedness and the need for countries to re-design their macro-fiscal institutional framework; (iii) analyzing key macro fiscal indicators through dashboards, allowing comparison with peers both in LAC and in other emerging market countries as well as against projections of credit rating agencies; and (iv) preparing heatmaps and interactive risk, fiscal and macroeconomic maps that allow countries to analyze evolution of key indicators over time.

¹ Pineda, E; Valencia, Ó; Nicaretta, R; & Arellano, M. (2022). *The Fiscal Puzzle of the Ukraine War for Latin America and the Caribbean*. IDB's Fiscal Management Division Blog.

² IDB borrowing member countries are part of the FISLAC platform.

- 2.5 This TC enables the improvement of FISLAC's early warning tool that allows LAC countries to assess and identify the main macro-fiscal risks that could affect their fiscal sustainability and, thus, respond on time through the appropriate design of the fiscal policy. It also facilitates the integration of fiscal discipline regulatory frameworks (fiscal rules and councils) with these tools, contributing to institutional strengthening for risk mitigation and monitoring and evaluating compliance with their fiscal commitments. In addition, the TC promotes the analysis and quantification of risks associated with climate change. In this sense, governments can act appropriately and reduce the probability of seeing their fiscal results and growth dynamics affected by materializing these sources of risk.
- 2.6 **Strategic alignment.** This TC is consistent with the Second Update of the Institutional Strategy 2020-2023 (AB-3190-2) aligning the cross-sectional area of Institutions and the State of Law, by means of strengthening the Ministry of Finance through the development of models and tools that allow to identify them areas of macro-fiscal vulnerability to prioritize the resources allocated during the pandemic. The TC is aligned with the Ordinary Capital Strategic Development Program (GN-2819-14) though the objectives of the Priority Area No. 3: "Effective, Efficient and Transparent Institutions"³ by strengthening institutions to contribute to mitigate existing macroeconomic risks and promote fiscal sustainability. This TC is also aligned with Sectorial Framework for Fiscal Policy and Management (GN-2831-8) which emphasizes the importance of strengthening institutional capacity in the public sector to design and implement fiscal policies with a sustainable path and economic development by evaluating and improving existing tools for macro-fiscal risk analysis in LAC Countries. Finally, the TC will contribute to the Corporate Results Framework (GN-2727-12) through the indicator "countries with strengthened tax and expenditure policy and management".
- 2.7 **Contribution to the Bank's operative program.** This TC will coordinate with other on-going projects that support activities aimed at strengthening macro fiscal institutions. For example, with ATN/OC-18398-RG (Macro-Fiscal Monitoring for LAC in the Pandemic and Post-Pandemic, RG-T3751) that provides technical support for Ministries of Finance to build macro fiscal frameworks and more robust fiscal strategies. On climate change, the TC will contribute with other on-going projects that support activities related to developing methodologies, standards, and capacity to integrate and mainstream climate action into fiscal policies and management such as ATN/OC-19028-RG (Fiscal Policy for Climate Change: Support to the Ministries of Finance of Latin America and the Caribbean) and ATN/AC18114-RG; ATN/OC-18115-RG; and ATN/OC-18116-RG (Fiscal Policy and Climate Change). This TC will expand these results by developing complementary knowledge products to further support the analysis of the macroeconomic associated to climate change mitigation strategies.

III. Description of activities/components and budget

- 3.1 **Component I: Improvements to the current early warning methodologies for identifying macro-fiscal risks (US\$ 125,000).** The objective of this component is to strengthen the identification of fiscal risks by improving the early warning system tools

³ The main objectives of Priority Area 3 include, but are not limited to (i) contribute to public policies and institutions that are more effective, efficient, transparent, and citizen-centered; (ii) improve service delivery to citizens; (iii) reduce constraints for business growth and productivity; and (iv) strengthen enforcement of the rule of law, and the fight against corruption, including fostering transparency and integrity and citizen security and justice

of the FISLAC Platform, so that countries can place them promptly and design appropriate policy strategies to mitigate them. Specifically, this component will finance: (i) integration of signaling methodologies and machine learning models within the FISLAC platform, contributing to correct out-of-sample prediction problems; (ii) design and implementation of the leading indicator module of the early warning system, at the country level; and (iii) improvement of the platform's registration system to protect user data and to secure the information.

- 3.2 **Component II: Integrating of the fiscal discipline frameworks and climate change mitigation strategies into the early warning system (US\$ 125,000).** The objective of this component is to complement the tools of the early warning system of the FISLAC Platform through systematic integration with the institutional strengthening of fiscal rules and councils and with energy transition strategies. Specifically, this component will finance: (i) strengthening of the institutional component of the model by incorporating indicators of compliance with fiscal rules and other dimensions of fiscal management; and (ii) building the climate change module to include indicators that reflect fiscal vulnerability in the face of these sources of risk.
- 3.3 **Component III: Dissemination of results (US\$ 100,000).** The objective of this component is to disseminate the results of the knowledge products financed in Components I and II above. This component will finance the following activities: (i) publication and communication about the products that are prepared with this TC, this will allow to create more awareness about the program among IDB member countries; (ii) an event⁴ to present and foster collaboration among IDB specialists, public officials, academia, civil society, and other international organizations interested in this topic.
- 3.4 All knowledge products derived from this TC will be the Bank's intellectual property. Any studies report or other knowledge products (e.g., material, graphic, software or otherwise), prepared as stated in the Procurement Plan (Annex IV) will be the Bank's intellectual property. All intellectual property rights in the outputs produced under this TC are vested in the executing agency, the Fiscal and Municipal Management Division (IFD/FMM). Knowledge products will be published through the Bank's web page and other official communication channels, providing long term outreach and sustainability to the TC's results and products.
- 3.5 **Expected results.** At the end of the execution period of this TC, it is expected that the products financed with the operation will make it possible to identify the main macro-fiscal risks that could affect the fiscal sustainability of LAC's countries. In addition, it will enhance countries' institutional capacity by providing them with tools for macro-fiscal risk analysis that integrated fiscal discipline frameworks, such as fiscal rules and councils, and with energy transition strategies.
- 3.6 The total cost of this TC will be US\$350,000, which will be financed by the Bank through OC SDP Window 2- Institutions (W2C). The execution period of this TC will be 24 months, and the disbursement period will be 24months.

Indicative Budget

| Activity/Component | Description | IDB/Fund Funding | Total Funding |
|--------------------|-------------|------------------|---------------|
|--------------------|-------------|------------------|---------------|

⁴ This event could be virtual, hybrid, or in person.

| | | (US\$) | (US\$) |
|---|---|------------|------------|
| Component I. Improvements to the early warning methodologies for identifying macro-fiscal risks. | The objective of this component is to strengthen the identification of fiscal risks by improving the early warning system tools, so that countries can place them promptly and design appropriate policy strategies to mitigate them. | 125,000.00 | 125,000.00 |
| Component II. Integration of the fiscal discipline frameworks and climate change mitigation strategies into the early warning system. | The objective of this component is to complement the tools of the early warning system through systematic integration with the institutional strengthening of fiscal rules and councils and with energy transition strategies. | 125,000.00 | 125,000.00 |
| Component III. Dissemination of results. | The objective of this component is to disseminate the results of the knowledge products financed in Components I and II | 100,000.00 | 100,000.00 |

- 3.7 The Fiscal Management Division (FMM) at the IDB HQ will be responsible for the supervision, monitoring and evaluation of the TC. It will also be responsible for the financial execution of the operation. The project will be monitored and evaluated according to the annual goals and indicators of the results and products that make up the TC results matrix.

IV. Executing agency and execution structure

- 4.1 **Executing agency.** Given the regional dimension of this TC and the lack of a regional entity with the capacity to implement it, the Bank will be the executing agency through the Fiscal Management Division (IFD/FMM) in close coordination with FMM country specialists. The activities of this TC will be executed in accordance with the procurement methods established by the Bank, namely: (i) Hiring of individual consultants, as set forth in the AM-650 standards; (ii) Contracting of consulting firms for intellectual services in accordance with GN-2765-4 and its related operating guides (OP-1155-4) and (iii) Contracting of logistics services and other services other than consulting, in accordance with policy GN-2303-28.
- 4.2 In line with the criteria established in Annex II of the Procedures for the Processing of TC Operations (OP-619-4), the Execution by the Bank is justified by the regional nature of this program, that this is a Bank initiative, and because which will allow effective coordination of the work to be carried out with the ministries of finance. The Bank's execution is justified by the fact that this program involves strengthening the design of fiscal policies to reduce poverty and increase equity. The technical capacity and experience that the Bank has through the Fiscal Division in matters of fiscal management and policy, will allow the expected result of this TC to be achieved, which is to provide the ministries of finance with tools to reduce poverty and inequality through sound fiscal policy.
- 4.3 **Procurement.** The activities to be executed under this operation have been included in the Procurement Plan (Annex IV) and will be executed in accordance with the Bank's established procurement methods, namely: (i) Hiring of individual consultants, as established in AM-650; and (ii) Contracting of logistics services and other services other than consulting, according to policy GN-2303-28.

V. Major issues

- 5.1 Risks for this project are low but the major risk is related to the availability of quality information from the Ministries of Finance or similar agencies for the development of the different products of the TC. To mitigate this risk, the models' data will be based on public and official sources that allow the replicability of the estimates and the maintenance of the models. In addition, the data and the model will be used in the future for continuous monitoring analysis of the countries.
- 5.2 Because the beneficiaries of TC are all Ministries of Finance in Latin America and the Caribbean, the political risk for the implementation of this TC in specific countries is considered low, so it is not included in the EC document. The political risk is mitigated because the execution of the TC will be done in prior coordination with the representatives and their team of each country that is chosen at the time to carry out studies and / or analysis.

VI. Exceptions to Bank policy

- 6.1 This TC does not involve exceptions related to the Bank's policies.

VII. Environmental and Social Strategy

- 7.1 This TC will not finance feasibility or pre-feasibility studies of investment projects with associated environmental and social studies; therefore, it is excluded from the scope of the Banks's Environmental and Social Policy Framework (GN-2965-23).

Required Annexes:

[Results Matrix - RG-T4055](#)

[Terms of Reference - RG-T4055](#)

[Procurement Plan - RG-T4055](#)