

TC ABSTRACT

I. Basic Project Data

| | |
|--|---|
| ▪ Country/Region: | REGIONAL/IDB |
| ▪ 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; CANILLAS GOMEZ, MARIANA BELEN (IFD/FMM); NATALIA ALMEIDA (LEG/SGO); MANZANO, OSMEL ENRIQUE (CAN/CAN); ALEJOS MARROQUIN, LUIS ALEJANDRO (IFD/FMM); ANDRIAN, LEANDRO GASTON (CAN/CAN); CARMEN MONTESINOS IBANEZ (IFD/FMM); CALDERON RAMIREZ, ANA CRISTINA (IFD/FMM) |
| ▪ Taxonomy: | Research and Dissemination |
| ▪ Number and name of operation supported by the TC: | N/A |
| ▪ Date of TC Abstract: | 09 Aug 2022 |
| ▪ Beneficiary: | Ministries of Finance of LAC |
| ▪ Executing Agency: | INTER-AMERICAN DEVELOPMENT BANK |
| ▪ IDB funding requested: | US\$350,000.00 |
| ▪ Local counterpart funding: | US\$0.00 |
| ▪ Disbursement period: | 24 months |
| ▪ Types of consultants: | Individuals; Firms |
| ▪ 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 2010-2020: | Institutional capacity and rule of law |
| | |

II. Objective and Justification

- 2.1 This Technical Cooperation (TC) project aims to evaluate and improve existing tools for macro-fiscal risk analysis in Latin American and Caribbean countries. Additionally, to integrate these tools with 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 promoting fiscal sustainability. In the aftermath of the COVID-19 crisis, the region's fiscal position deteriorated significantly, four countries defaulted, and most had to abandon the fiscal sustainability paths they were on before the pandemic. In this context, the TC proposes to improve early warning tools so that governments can promptly mitigate the different sources of risk and respond with appropriate policies that will allow them to return to their fiscal consolidation processes. The specific objectives of the TC are: (i) to develop analytical tools for identifying the main macro-fiscal variables that may affect the fiscal sustainability of countries. (ii) To 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. (iii) To promote regional dialogue among countries to share lessons learned and promote best practices in identifying and mitigating risks to fiscal sustainability.

- 2.2 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 in 2021, the economy showed a strong recovery of 7.4%, 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 levels of 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. On the one hand, 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). 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 has also exposed the need to reinforce institutional schemes supported by regulatory frameworks of fiscal discipline, which can 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 This TC enables the improvement of the early warning tool that allows LAC countries to assess and identify the main macro-fiscal risks that may 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.

III. Description of Activities and Outputs

- 3.1 **Component I: Improvements to the current early warning methodologies for identifying macro-fiscal risks.** Improve existing tools to analyze main macro-fiscal risks so that countries can design appropriate policy strategies to mitigate them. This component will improve early warning system tools by: (i) integrating signaling methodologies and machine learning models in FISLAC platform; (ii) leading indicator module of the early warning system designed and implemented at the country level; and (iii) improving the platform's registration system to protect user data and information more securely.
- 3.2 **Component II: Integrating fiscal discipline frameworks and climate change mitigation strategies into the early warning system .** Complement early warning system tools with institutional strengthening of fiscal rules and councils. This component will provide: (i) institutional indicators of fiscal rules compliance to monitor governments' fiscal responsibility objectives; and (ii) standardized indicators to reflect the vulnerability of fiscal stress in the face of climate shocks.
- 3.3 **Component III: Dissemination of results and regional dialogue of lessons learned in adopting best practices for macro-fiscal risk mitigation .** This

component will finance the dissemination of results through seminars, regional dialogues, and workshops that facilitate the adoption of the tools developed through doing learning doing schemes. In addition, documents and working guides will be prepared to show the analyses and results for the pilot countries, comparability between countries, and detailing the methodological development of the tools used so that they can be shared and applied by other countries in the region.

IV. Budget

Indicative Budget

| Activity/Component | IDB/Fund Funding | Counterpart Funding | Total Funding |
|---|-------------------------|----------------------------|-----------------------|
| Improvements to the current early warning methodologies for identifying macro-fiscal risks | US\$150,000.00 | US\$0.00 | US\$150,000.00 |
| Integrating fiscal discipline frameworks and climate change mitigation strategies into the early warning system | US\$150,000.00 | US\$0.00 | US\$150,000.00 |
| Dissemination of results and regional dialogue of lessons learned in adopting best practices for macro-fiscal risk mitigation | US\$50,000.00 | US\$0.00 | US\$50,000.00 |
| Total | US\$350,000.00 | US\$0.00 | US\$350,000.00 |

V. Executing Agency and Execution Structure

- 5.1 The Bank will be the executing agency through the Fiscal Management Division (IFD/FMM) in close coordination with the fiscal specialists of the countries.
- 5.2 In line with the criteria established in Annex II of the Procedures for Processing TC Operations (OP-619-4), execution by the Bank is justified by the regional nature of this program, which will allow effective coordination of the work to be done with the ministries of finance. The Bank's choice as EA is due to: (i) FMM's technical capacity and experience in systematization, exchange of experiences, and facilitation of regional policy dialogue on management and fiscal policy issues; (ii) FMM's experience in establishing and maintaining digital solutions and platforms for internal use and that of our clients; (iii) the Bank's experience in organizing events and knowledge dissemination activities; (iv) the regional nature of the project, the execution of which requires a specialized technical body to carry out coordination tasks at the regional level, facilitating dialogue between the beneficiary countries and, in turn, monitoring and reporting on the results and products achieved in the framework of the project; (v) the relationship and experience of the FMM with relevant regional networks for dissemination issues of this TC (for example, the results-based budgeting and public investment networks of LAC).

VI. Project Risks and Issues

- 6.1 Risks for this project are low but the major risk is related to a possible delay in TC implementation activities given the current restrictions of the ongoing pandemic such as travel restrictions. This risk will be mitigated by maintaining an open and fluid dialogue with our counterparts in each participating country, consultancies that can work remotely will be hired, and virtual events will be organized to facilitate the exchange of information.

- 6.2 Another risk associated with this TC 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 project team will collect extensively existing information, databases, and secondary sources to execute this TC. However, considering the type of this operation is research and dissemination (R&D), the TC should consider a potential slow response from counterparts in collecting primary source of information, likewise it will focus on beneficiary entities that show interest in solving specific problems to face the economic, fiscal and social crisis, COVID-19, and will seek synergies with operations already approved by the IDB's Fiscal Management Division that allows for updated information.

VII. Environmental and Social Classification

- 7.1 The ESG classification for this operation is "undefined".