B.1. Fiscal response and debt

The developing East Asia and Pacific (EAP) entered the pandemic reasonably prepared with a strong track record of growth and more robust monetary and fiscal policy frameworks than in previous crises. However, several structural weaknesses, including high overall debt, and low revenue generating capacity have limited the scope of fiscal policy support. Fiscal positions are expected to deteriorate considerably across the developing EAP this year, owing to additional fiscal outlays and lower revenues amid output contraction in much of the region. Future policies in support of economic recovery should be framed around the long-run growth and debt sustainability objectives.

Initial conditions

In some dimensions, major developing EAP economies have demonstrated better preparedness to cope with this crisis than in the past. They have a strong track record of growth, more robust monetary, prudential, and fiscal policy frameworks, relatively moderate public debt levels, reduced dependence on foreign sources of financing, and greater exchange rate flexibility. These improvements in economic fundamentals have been reflected in market perceptions which improved overtime. During the latest financial stress episode, the increase in borrowing costs in EAP has been generally less pronounced than in other emerging market and developing economies (EMDEs), and all major developing EAP economies enjoyed better market access and lower borrowing costs to finance higher fiscal deficits than during the previous crises (Figure B.1.1).

\[\text{This analysis was conducted to inform the October 2020 East Asia and Pacific Economic Update.}\]
Figure B.1.1. Improved economic fundamentals have been reflected in better market perceptions.

A. EMBI spreads

Source: Haver Analytics; J.P. Morgan; World Bank.
Notes: A.B.C. EMBI Global and associated sub-region aggregates are weighted using market capitalization. ASIA=China, India, Indonesia, Malaysia, Mongolia, Pakistan, Papua New Guinea, Philippines, Sri Lanka, and Vietnam. EMDE excl. China refers to a median of all EMDEs excl. EAP region.

Better macroeconomic and fiscal policy frameworks than in previous crises have resulted in improved fiscal positions compared to other EMDEs (Figure B.1.2). The overall government debt-to-GDP ratio in developing EAP, excluding China, had declined significantly from its peak levels in the aftermath of the Asian financial crisis to 39 percent of GDP on average in 2019, about two-thirds of the average level seen in other EMDEs. The average fiscal deficit in the region other than China was also relatively low at 2.3 percent of GDP in 2019, compared to an average of 4.2 percent of GDP in other EMDEs.
Figure B.1. The developing EAP entered the pandemic with relatively strong fiscal positions than other EMDEs.

A. Government gross debt

B. Government overall fiscal balance

Source: Fiscal Monitor, International Monetary Fund; World Bank staff calculations and projections.

Many countries in the region have also reduced reliance on external and volatile sources of financing in the aftermath of the Asian financial crisis (Figure B.1.3). While the overall debt level in the region is higher than it was in 1997, many countries have become less dependent on short-term foreign borrowing and have accumulated substantially higher foreign exchange reserves to meet their external debt obligations. This general trend notwithstanding, considerable foreign holdings of domestic debt remain a source of potential volatility in several large economies, including Indonesia. In addition, some small economies stepped up external borrowing in recent years and thus increased their vulnerability to external shocks.
Figure B.1.3. Many developing EAP countries have reduced reliance on external and volatile sources of financing since the Asian financial crisis.

A. Domestic and external debt

B. Short-term external debt to reserves

Source: International Monetary Fund; World Bank.

Notwithstanding generally stronger fiscal positions, there were notable differences across countries (Figure B.1.4). Some regional economies entered the crisis with relatively high government debt and fiscal deficits. Notably, Lao PDR and Malaysia’s government debt levels were close to 60 percent of GDP in 2019, nearing the average level of the EMDEs and almost 20 percentage points higher than most other developing EAP countries. In China, overall deficit and government debt-to-GDP ratio reached 6.4 and 41.9 percent of GDP last year, up from 1.8 and 34.6 percent in 2009, partly reflecting higher borrowing by local governments and state-owned enterprises (SOE).
Figure B.1.4. Government fiscal balance and debt levels vary considerably across developing EAP countries.

A. General government gross debt

B. General government overall balance

Source: Fiscal Monitor, International Monetary Fund; World Bank staff calculations.

Notes: B. The overall fiscal balance refers to net lending (+)/borrowing (−) of the general government. The red lines represent EMDE averages in 2009 and 2019, computed with current U.S. dollar GDP weight.

The region is also characterized by several structural weaknesses, including weak revenue generating capacity. Revenue mobilization is comparatively low in the developing EAP region excluding China—only 18 percent of GDP on average, compared to 25 percent in other developing economies and 36 percent in advanced economies. Many commodity-exporting developing EAP countries with relatively high shares of volatile resource revenues have also seen their government revenues decline sharply over the past decade following the commodity price plunge in 2012. Meanwhile, most commodity-importing countries have continued to rely heavily on indirect taxes, including value added and trade taxes, which are expected to shrink as the COVID-19 pandemic and the necessary public measures to contain its spread have resulted in substantial reductions in household consumption and trade (Figure B.1.5).
Figure B.1.5. Revenue mobilization is comparatively low in developing EAP region

A. General government revenue

B. General government revenue in developing EAP

C. Resource revenue in selected developing EAP economies

D. Indirect taxes as a share of total government revenue, 2018


Notes: B. Commodity exporters are Indonesia, Lao PDR, Mongolia, Myanmar and Papua New Guinea. Commodity importers are Cambodia, China, Malaysia, Philippines, Thailand and Vietnam. Unweighted averages are computed.
Comparatively low revenue mobilization in the region is also reflected in low government spending, especially on social safety nets. Overall government expenditure in the developing EAP countries other than China, averaging at 19 percent of GDP in 2018-2019, is lower than all other EMDE regions, and is roughly half of the average level seen in high-income economies. Public social spending on education, health and social protection as a share of GDP is also relatively low in developing EAP, with cash transfers and social pensions accounting for the bulk of government social spending in most countries (Figure B.1.6).
C. Government expenditure on social sectors by region

D. Government spending on social assistance programs in developing EAP

Source: Atlas of Social Protection, International Monetary Fund: Indicators of Resilience and Equity (ASPIRE), and Pensions databases; OECD Social Expenditure database; Betcherman and Moroz 2018; World Bank.

Notes: A. Averages computed with current U.S. dollar GDP weight. AEs = Advanced economies; Pre-COVID-19 = 2018 to 2019; Post-COVID-19 = 2020f and 2021f. B. 2019 or latest available year. Capital expenditure refers to net acquisition of non-financial assets. Data refer to general government for Cambodia Indonesia, Mongolia, Thailand and Vietnam; central government for Lao PDR, Malaysia, Philippines, PNG and Timor-Leste; and consolidated public sector for Myanmar. C. Circa 2010s. Shares of social spending shown are simple averages across country groups. D. 2016 or latest available year. Other social expenditure includes food and in-kind, school feeding, public works and other social assistance.

In contrast to government debt, indebtedness of the private sector in developing EAP has increased across the region (Figure B.1.7). This ratio varies widely by country, ranging from around 70 percent in Indonesia to around 260 percent of GDP in China. Total private sector debt in developing EAP was, on average, 151 percent of GDP at the end of 2019. High private sector debt could be a source of additional liabilities that governments have to take on as a result of potential defaults of some portions of its high stock, potentially resulting in significantly larger fiscal deficits and higher public debt in the future.
Figure B.1.7. Indebtedness of the private sector in developing EAP has increased across the region.

A. Total debt

B. Private sector debt

Source: Bank of International Settlements; Institute of International Finance; International Monetary Fund; World Bank staff calculations.
Notes: Averages computed as non-weighted averages with current U.S. dollar GDP. Total debt includes government and private debt. Last observation is Q4 2019.

Policy response

Fiscal policy response to the pandemic-induced shock has been swift but varied considerably in size and breadth across the developing EAP countries. The average size of fiscal measures announced to date in developing EAP, estimated at 4.9 percent of GDP including liquidity support, was comparable to the other developing regions but was about one-fourth of fiscal policy support announced in advanced economies (Figure B.1.8). A narrower fiscal policy space, weaker revenue generating capacity, restricted market access, and larger informal sectors have contributed to limited fiscal response in some economies.

Additional spending and revenue measures to lessen near-term disruptions to vulnerable households and businesses accounted for the bulk of the direct fiscal support. Additional government spending (including temporary cash transfers, wage subsidies and unemployment benefits) and revenue measures (such as tax cuts, credits and exemptions) to individuals and firms, estimated at 2.6 percent of GDP on average, constituted nearly two-thirds of all budgetary
measures announced to date in the developing EAP region. About 65 percent of these income support and revenue measures were directed at individuals to cushion the fall in household incomes, while the remainder were channeled to businesses to mitigate revenue losses, reduce layoffs and limit bankruptcies. In most countries, additional allocations for the income and revenue support programs in response to COVID-19 are estimated to be significantly higher than the amounts spent on social assistance programs prior to the crisis.

By contrast, additional health-related spending only amounted to 0.2 percent of GDP on average, a small fraction of government health-related spending during the pre-COVID-19 period in most countries. This partly reflects the relatively low incidence of COVID-19 infections in the region. Only a few countries (Thailand, China, Cambodia, Malaysia and the Philippines) have increased public investment spending. In addition to budgetary measures, several developing EAP countries (notably Thailand, Malaysia, and Cambodia) provided sizable liquidity support (including equity injections, loans, asset purchases and sovereign guarantees) to businesses with cashflow difficulties, which may increase public debt if these interventions incur losses.
Figure B.1.8. Fiscal policy responses varied considerably in size and breadth across the developing EAP countries

A. Fiscal measures by country group

B. Fiscal measures in developing EAP

C. Additional spending and revenue measures

D. Additional spending on income support and revenue measures by beneficiary
E. Government spending on social assistance programs

F. Government health-related spending

Source: International Monetary Fund June 2020 World Economic Outlook Update; World Bank staff estimates.

Notes: GDP data for 2020. A. Data are as of June 12, 2020. AE s = advanced economies; EM = emerging markets; G20 = group of twenty; LIDC s = low-income developing countries. Country groups are weighted by GDP in purchasing power parity-adjusted current international dollars. B. C. D. Data refer to general government, except for Indonesia, Malaysia and the Philippines which refer to central government only. Income and revenue support measures include direct transfer payments, reduction or deferral of payment commitments, foregone revenue from tax cuts, credits and exemptions, and other financial assistance to individuals and firms. E. Pre-COVID-19 = 2016 or latest available year. F. Data refers to domestic general government health expenditure. Pre-COVID-19 = 2015 – 2017 average.

Fiscal outlook

Fiscal positions are expected to deteriorate significantly across the developing EAP this year, owing to substantial revenue losses combined with sizable fiscal outlays. Government revenues are projected to decline more sharply than output reduction in most developing EAP countries, especially those with greater reliance on tourism, trade and oil-related receipts. Meanwhile, government expenditures are expected to increase sharply to accommodate the necessary increases in large-scale fiscal measures implemented during the crisis (Figure B.1.9).

Fiscal deficits and government debt are projected to increase by around 5 and 7 percentage points of GDP on average in 2020, with large variations across the region. For the majority of the developing EAP economies, the deterioration in fiscal positions is expected to be larger.
than during the Asian Financial Crisis and much worse and more prolonged than for the global financial crisis in 2009. An analysis of past pandemics and financial stress episodes suggests that in the aftermath of diseases, economic growth declines and fiscal positions deteriorate.

**Regional governments have implemented a wide range of measures to finance large fiscal deficits.** Most governments will continue to rely on domestic and external (both concessional and non-concessional) borrowing to finance the bulk of the considerable budget deficits projected for this year. In addition to sovereign debt issuances, several regional central banks (in Indonesia, Myanmar and the Philippines) have been directly purchasing government bonds, and hence increasing credit in the domestic banking systems, to cover government financing requirements.

**Some governments have turned to fiscal savings to finance higher fiscal deficits.** In Cambodia, approximately half of the projected fiscal deficit this year is expected to be funded through government savings accumulated over the past few years, which stood at 20.2 percent of GDP in 2019. Similarly, part of the projected fiscal deficits in China and Mongolia will be financed via drawdowns of reserve funds, limiting the buildup of sovereign debt. In Timor-Leste, withdrawals of oil-related savings from the Petroleum Fund (PF) will continue to be the primary source of financing for the fiscal deficit of 33 percent of GDP projected for this year.

**Figure B.1.9. Fiscal positions are expected to deteriorate markedly across the developing EAP**

**A. General government revenue**

**B. General government expenditure**
C. Fiscal balance

D. Contribution to projected change in fiscal balance

E. Government gross debt

F. Financing of fiscal deficit

Source: International Monetary Fund; World Bank staff estimates.
Notes: A. B. C. D. E. Estimates refer to general government, except for Indonesia and Malaysia which refer to central government only. Malaysia’s government expenditure in 2019 includes a one-off refund of tax arrears in 2019 of 2.4 percent of GDP. F. The Philippine government borrowing is expected to exceed its estimated deficit in 2020. Information is not available for Lao PDR.
The crisis will likely hit hardest the commodity-exporters and tourist-dependent island economies, despite generally lower incidence of COVID-19 infection cases. Government tax revenues have fallen precipitously across many island economies, owing to a sharp contraction in trade and tourism activity amid supply chain disruptions and stringent international travel restrictions (Figure B.1). Revenue losses have been less pronounced in some North (RMI and Palau) and Central Pacific Island countries (Nauru and Tuvalu), which depend more extensively on grants and non-tax revenues, although substantial declines in tourism and external trade are still expected to result in steep downturns this year.

Governments in PICs have also provided fiscal support of varying scale to lessen the near-term economic ramifications of the pandemic, with additional spending and revenue measures ranging from 2.7 to 18.7 percent of GDP. Health-related spending and support for vulnerable households and firms, amounting to 6.8 percent of GDP on average, accounted for the vast bulk of the direct fiscal support measures implemented across the island countries. The scale of fiscal response in countries with more favorable fiscal positions – notably FSM and RMI – has been significantly greater than in those constrained by narrower fiscal space, including PNG and the Solomon Islands.

The adverse impact of the COVID-19 pandemic on fiscal deficits and debt has varied considerably across PICs, given the marked differences in cyclical sensitivity of government revenues to external shocks. In RMI and Tonga, overall fiscal deficits are estimated to be relatively low at 1-2 percent of GDP in 2020, as development grants and non-tax revenues - which account for at least half of government revenue in these economies - are mostly unaffected by the ongoing crisis. Meanwhile, the Government of Nauru is expected to achieve a fiscal surplus of 9.4 percent of GDP this year, largely driven by higher-than-expected fishing license fees and Regional Processing Center (RPC) revenues.

In most other island economies, however, precipitous declines in domestic revenue combined with additional fiscal spending in response to the pandemic are expected to result in considerable widening of fiscal deficits in 2020. The average fiscal deficit in the PICs is expected to reach 8 percent of GDP this year, with particularly pronounced deficit increases projected for Fiji, Kiribati and Palau. To cover these additional financing needs, some governments will likely rely extensively on concessional borrowing (Fiji, Palau), while others are expected to draw on sovereign reserves (Samoa, Vanuatu), or a combination of both (Kiribati, Solomon Islands), to contain the buildup of government debt and associated vulnerabilities.
Figure B.1.10 The pandemic will likely have a devastating fiscal impact on many Island economies.

A. Government revenue

B. Fiscal measures in response to the COVID-19 Crisis (2020)

C. Fiscal balance (percent of GDP, 2020f)

D. Government gross debt (percent of GDP, 2020f)
Policy considerations

The financing needs are likely to be exceptionally high and persist over the medium term. The need for boosting health expenditures and interventions to stimulate aggregate demand will leave most countries with limited and difficult policy choices. Domestic revenue mobilization will remain subdued and income from commodity resources, trade and tourism will be curtailed for the near future. Public sector financing needs will be significantly above pre-crisis levels with expenditures on mitigation and higher debt service. Private sector financing needs are expected to increase as many firms and financial institutions may need restructuring and recapitalization. Increasing foreign financing increase vulnerabilities.

Broad-based international action is needed. Countries with large fiscal deficits or large debt burdens are particularly vulnerable. New bouts of debt distress and/or financial instability are possible and will become more likely in the absence of stepped-up external support. The WBG and other MDBs are providing positive net flows for urgent interventions that impact the poor and vulnerable, including highly concessional financing for poor countries. The G20 Debt Service Suspension Initiative for poor countries announced in April could defer up to $12 billion in debt service due in 2020 (Error! Reference source not found.). While these constitute important steps, more will be needed. There is merit to extending the DSSI into 2021 and all PPG bilateral debt should be covered. Private sector creditors need to participate, voluntary approach has not produced a result. DSAs will be undertaken jointly by WB/IMF to look at longer-term sustainability concerns. Enhanced transparency of public debt is critical to successful outcomes.
The Debt Service Suspension Initiative can have significant benefits for some EAP countries. Potential DSSI savings (USD million) and potential DSSI savings (% 2019 GDP) are shown in the figure. The savings are based on estimated debt service payments owed as of the end of 2018 for public and publicly guaranteed debt outstanding and disbursed. The savings are projected for May-December 2020.

In the near term, governments should continue to focus on providing lifelines and promoting economic recovery. For economies facing disruptive balance of payments pressures and without access to private external financing, official financing and swap lines can help provide economic relief and preserve critical health care spending. Foreign exchange intervention, where needed and where reserves are adequate, could help alleviate disorderly market conditions. Countries with flexible exchange rates would benefit from continuing to allow them to adjust in response to external conditions, where feasible.

In economies where excess current account surpluses that existed before the crisis persist, prioritizing reforms that encourage investment and discourage excessive private saving are warranted. In economies where larger-than-desirable fiscal deficits exacerbate current account deficits and where such imbalances persist, fiscal consolidation over the medium term would promote debt sustainability, reduce the excess current account gap, and facilitate raising international reserves (Table 1). In economies with remaining fiscal space, a growth-oriented fiscal policy would strengthen economic resilience and narrow the excess current account gap.
surplus. In some cases, reforms to discourage excessive precautionary saving may also be warranted (as in Thailand and Malaysia) including by expanding the social safety net.

Table 1. The region’s economies have been fiscally prudent, but existing vulnerabilities coupled with the size of the shock are a cause for concern

<table>
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<tr>
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<th>Government gross debt % of GDP</th>
<th>Fiscal balance % of GDP</th>
<th>Government revenue % of GDP</th>
<th>Domestic credit to private sector % of GDP</th>
<th>External debt, % of GDP</th>
<th>Gross external financing needs % of reserves</th>
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Source: International Monetary Fund, Fiscal Monitor, Global Financial Stability Report and International Financial Statistics; World Development Indicators; World Bank staff calculations

Notes: Gross external financing needs is defined as short-term debt, plus the amortization of medium and long-term debt, minus the current account balance. External debt data refers to 2018 for Lao PDR, Myanmar, Timor-Leste and Vietnam. Colors refer to comparisons with EMDEs: shows that country is in the bottom 25th percentile of the global distribution; shows that country is between the 25th and 50th percentile; shows that country is between the 50th and 75th percentile; shows that country is between the 75th and 90th percentile; and shows that country is in the upper 10th percentile of the world distribution.

Initiating fiscal reforms could allow greater spending on relief without sacrificing public investment. The budget constraint bites hard because revenue mobilization is exceptionally low in the EAP countries other than China – only 18 percent of GDP on average, compared to 25 percent in other developing economies and 36 percent in advanced economies. And the greater reliance on indirect taxes, which represent more than 50 percent of government revenue in several countries, has amplified the revenue loss in a crisis in which consumption has contracted sharply. Large fiscal deficits in EAP are projected to increase government debt on average by 7 percentage points of GDP in 2020. High and growing private debt constitutes an additional indirect risk for government finances. Widening the tax base with more progressive taxation of income and profits and less wasteful spending on regressive energy subsidies, in some cases over 2 percent of GDP, could make recovery more inclusive and sustainable.
References


