SM/08/154
Correction 1

June 13, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Fiscal Risks—Sources, Disclosure, and Management**

The attached corrections to SM/08/154 (5/22/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 14, first bullet, line 4: amount of bailouts for Thailand corrected and text moved to footnote 13.
third bullet, line 6: for "Italy, 1 percent" read "Italy, initially estimated at 1 percent"
line 8: "copyright protection (Poland);" removed
footnote 13, line 1: for "Additional examples" read "Examples"

Questions may be referred to Mr. Mauro (ext. 37712) and Mr. Velloso (ext. 37156) in FAD.

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15. **Changes in commodity prices also have important fiscal implications, especially for commodity producers**. For example, a US$20 decline in oil prices would lead the overall fiscal balance to worsen by 10 percentage points of GDP in a sample of oil producing countries.[11] As seen above, the magnitude of the impact is also apparent in the large negative forecast errors for the debt/GDP ratio of oil-producers during years characterized by oil price increases. Commodity price changes affect the fiscal sustainability of commodity importers primarily through economic growth, though their direct fiscal impact may be considerable for countries with energy subsidies.

16. **For low-income countries, volatile aid flows and the need to cushion the poor from external shocks present special challenges**. In some highly aid-dependent countries, aid is more volatile than fiscal revenues, and shortfalls in aid and domestic revenues tend to coincide. More generally, uncertainty about aid disbursements is large and the information content of commitments made by donors is limited (Bulír and Hamann, 2003). Moreover, sharp increases in staple food prices may unexpectedly require incurring sizable fiscal costs.

17. **However, some of the largest fiscal costs have arisen from contingent liabilities**. Examples include:

- **Banking crises**. A review of the fiscal costs of systemic banking crises identified 24 episodes in which cumulative costs exceeded 5 percentage points of GDP, based on a sample of 117 banking crises that occurred in 93 countries during 1977–98. It estimated costs at 30–55 percent of GDP in Argentina, Chile, and Uruguay in the early 1980s, 25–50 percent of GDP in Indonesia, Korea, and Thailand in 1997–98, and about 20 percent of GDP in Japan in the 1990s (Honohan and Klingebiel, 2000).[12] Such costs arise primarily from depositor and debtor bailouts, open-ended liquidity support, and repeated recapitalization programs—and are often larger when incurred after years of implicitly subsidized lending by state-owned financial institutions.

- **Natural disasters**. Direct economic losses from natural disasters have often exceeded 10 percentage points of GDP in developing countries and amounted to a few percentage points of GDP in some advanced countries (Freeman and others, 2003); such losses are unevenly distributed across countries, as disasters usually revisit the same geographic zones. The fiscal implications are clearly substantial, though

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Ecuador (1999), Mexico (1995), and Russia (1998). The debt/GDP ratio jumped by more than 30 percentage points of GDP on average during these crises.

[11] "The Role of Fiscal Institutions in Managing the Oil Revenue Boom" (SM/07/88).

[12] In a number of cases, Honohan and Klingebiel's (2000) method does not fully reflect recoveries and may thus be considered an upper bound on the net present value of the fiscal and quasi-fiscal costs. At the same time, banking crisis interventions were often financed with central bank debt that remained on the central bank's balance sheet for many years (Stella and Lönnberg, 2008).

estimates are available for a limited sample; a study on Latin American and Caribbean countries found several episodes when the fiscal deficit rose substantially in the aftermath of natural disasters (Caballeros Otero and Zapata Martí, 1995).

- **State-owned enterprises**. Public enterprises have often been a significant source of contingent government liabilities, especially as a result of political interference, mismanagement, or irresponsible borrowing. Losses or excessive debt have resulted in costly government bailouts, especially in the aftermath of crises.[13]

- **Subnational government bailouts**. Subnational government defaults or bankruptcies have often led central governments to provide rescue packages, occasionally with large costs: examples include Brazil (7 percent of GDP in 1993 and 12 percent of GDP in 1997; Bevilaqua, 2002), Argentina (1 percent of GDP, cumulative, in the mid-1990s; Nicolini and others, 2002), and Mexico (1 percent of GDP in the aftermath of the Tequila crisis; Hernández-Trillo and others, 2002).[14]

- **Legal claims**. Governments have paid compensation in legal cases related to disparate claims; the amounts, often difficult to predict prior to a ruling, can be sizable. Examples include war claims and frozen foreign currency deposits (Bosnia and Herzegovina, 12 percent of GDP); litigation on domestic arrears (Chad, 9 percent of GDP); company car VAT refunds (ruling by the European Court of Justice against Italy, initially estimated at 1 percent of GDP); claims related to privatization (Brazil); liquidation of SOEs (Brazil, Indonesia); personnel management (Brazil, France); compensation for real estate and other property losses (Lithuania and Poland); tax refunds (Indonesia); bank restructuring guarantees (Czech Republic); and environmental cleanup (e.g., related to defense or nuclear power; Canada and United States).

- **Guarantees**. Although systematic information on actual calls on guarantees is limited, it is clear that potential risks from guarantees are substantial. Information on exposure is available for explicit guarantees legally binding the government to take on an obligation should a specified event occur (e.g., price guarantees, loan guarantees, or profit guarantees): these amounted to 12 percent of GDP on average in

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[13] Examples relate to the power sector (Indonesia, where during the 1998 crisis the central government paid for the electricity company's fuel costs, amounting to 4 percent of GDP; and the Philippines); airlines (e.g., subsidies/bailouts averaging US$2 billion each for several airlines in Europe); railways/metro (Colombia, Hungary, Japan, Malaysia, and Thailand; 1–5 percent of GDP); and water authorities (Jordan, 3 percent of GDP).

[14] In Italy, central government bailouts of subnational government health units ranged between 0.2–0.6 percent of GDP yearly over the past five years.