DCED
The Donor Committee for Enterprise Development

BER to Improve Economic Resilience to Global Shocks

Policy Brief

This policy note draws on the DCED Business Environment Working Group's research report: Business Environment Reforms to Improve Economic Resilience to Global Shocks, authored by James Lloyd. The DCED Business Environment Working Group produces policy notes to provide short, relevant insights and guidance on specific topics related to donor and development agency support for business environment reform in emerging and developing economies.

/01 Key messages

Low- and middle-income countries (LMIC) face a broader range of acute exogenous shocks than advanced economies, and the incidence of these shocks is expected to increase. Policy space in LMIC is now constrained and if there is not an effort to improve resilience, the achievement of the Sustainable Development Goals will be hampered.

To improve resilience, authorities in LMIC, with donor support, should:

- Adopt the principles of Risk Informed Development in future development decisions
- Urgently address external and internal imbalances, while progressing structural change
- Better balance the joint priorities of macro-economic stability and inclusive development during exogenous shocks, and maintain and accelerate improvements in regulatory quality during normal business cycles
- Support, but adapt, approaches in debt finance, employment support, tax measures, business cost measures and business

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environment reforms, among others, to be more suited to the shock and the needs of MSMEs

- In adapting and supporting approaches put more emphasis on measures to effectively recover from shocks, alongside measures to weather the immediate crisis
- Strengthen the complementarity of support to formal businesses with efforts to prepare to formulate, and then implement, horizontally and vertically expanded social safety nets, to provide support to workers, the self-employed and entrepreneurs of informal and smaller MSMEs
- Improve the availability of data on economy wide and business specific resilience
- Improve the institutional context, especially inclusive social dialogue, to enable effective preparation and response.

/02 Introduction

LMIC are vulnerable to a wide range of acute exogenous shocks, and they are less resilient. [1] Each shock is different. It is therefore challenging to categorise types of shocks definitively across the dimensions of i) acuteness and ii) exogeneity. Some categories of shocks, such as extreme weather and cyber security events, are likely to increase in frequency and impact. Shocks often overlap and their stresses interact.

Stresses are the crises that the primitive exogenous shock places on a business ecosystem. These emanate from supply induced or demand induced stresses, either of which can lead to messy stresses. The overlapping of stresses results in complex causal chains; from shocks to impacts in LMIC.

The vulnerability of smaller firms originates from a complex set of, often self-reinforcing, reasons. Further, the heterogeneity of MSMEs, requires Government support to be better tailored to the needs of different segments of MSMEs. Among these, are informal businesses, which generate 35% of Gross Domestic Product (GDP) in LMIC. Informal enterprises are creating jobs, but these are precarious jobs without the safety of social security systems or labour regulations. Another criterion is the gender of entrepreneurs, and workers. There are significant gender disparities in business cycles, across unemployment, income risk and hours worked.[2] Exogenous shocks, however, lay bare deep gender inequalities that are to the detriment of women entrepreneurs and workers.[3]

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[1] OECD, 2021, Fostering economic resilience in a world of open and integrated markets: Risks, vulnerabilities and areas for policy action, online, available at: https://www.oecd.org/newsroom/OECD-G7-Report-Fostering-Economic-Resilience-in-a-World-of-Open-and-Integrated-Markets.pdf
[2] Gomes D, 2024, Gender and Business Cycles, IMF Gender Notes, online, available at: https://www.imf.org/-/media/Files/Publications/GNS/2024/English/GNSEA2024001.ashx
[3] ILO, 2020, A Gender Responsive Employment Recovery: Building Back Fairer, Policy Brief, online, available at: https://www.ilo.org/media/396926/download

/03

What determines macroeconomic resilience?

Macroeconomic resilience comprises of two dimensions.

1. The capacity to withstand the immediate impact of an adverse economic exogenous shock:
   - External financing needs
   - External solvency
2. The capacity to promptly respond to the effect of an adverse economic exogenous shock:
   - Fiscal balance as a ratio of GDP
   - Government indebtedness
   - Deviation of inflation from target
   - Institutional and regulatory quality (as a proxy for the business environment).

Four country case studies are considered against these dimensions in the report. Brazil, Egypt, Ethiopia and Malaysia are all large economies, with varying Gross National Income per capita, regulatory quality and public finance positions. The four case study countries, hence, have varying scores in this resilience indicator. This is displayed in Table 1. Only Malaysia scored positively on the scale of -1 to 1. There is a close ordering of country scores in the resilience indicator discussed, with the World Bank's assessment of countries' risk of default in the aftermath of shocks.[4]

Table 1: Resilience indicator scores in 2019[5]

Brazil	Egypt	Ethiopia	Malaysia
- 0.27	- 0.46	- 0.84	0.33

The adoption of effective counter cyclical policies across LMIC is constrained by policy space. This constraints resilience. The debt position, particularly short-term external debt, has deteriorated in many LMIC. These positions are now out of balance with balance of payments positions, and forecasted growth rates. Funds that could be used to finance the Sustainable Development Goals, and build resilience, are directed to financing debt.

There is a need for regulations to be more cognisant of the needs of MSMEs, and for macroeconomic managers to be guardians of both economic stability and inclusive development. Across case study countries progress to improve regulatory quality is slow, and seems to reverse

[4] World Bank, 2024, Debt Sustainability Analysis, online, available at: https://www.worldbank.org/en/programs/debt-toolkit/dsa
[5] Rojas Suares, L, 2023, Identifying macroeconomic resilience to external shocks in emerging and developing economies, Centre for Global Development, https://www.cgdev.org/publication/identifying-macroeconomic-resilience-external-shocks-emerging-and-developing-countries

between acute crises. There is a need to accelerate, and maintain improvements, in regulatory quality during normal business cycles.

With exogenous shocks expected to increase in incidence and severity, concerted action must now be taken to increase resilience. This is particularly pressing given multiple concurrent threats. All countries should now adopt the principles of Risk Informed Development, to build their resilience.[6]

/04

Which business reforms respond well to acute global shocks?

There are a broad range of tools that are available to be deployed to acute global shocks. These tools cover monetary and fiscal policy and business environment reforms. The challenge is to deploy the right tool to the task. Policymakers need to rapidly diagnose the channel of stresses and identify the segments to focus on Be they priority sectors, or particularly vulnerable targets such as young and women entrepreneurs and informal firms, for reforms to perform well.

While correlation between measures and impacts during the COVID 19 pandemic has been partly determined across LMIC, causation has not been determined. In LMIC, monetary transfers and access to credit, which relax short term credit and liquidity constraints, were found to be correlated with higher future expected sales growth. Causation was not determined. Meanwhile wage subsidies were negatively correlated with laying off workers, but did not affect expected future sales growth. Tax support, meanwhile, was found to be positively correlated with future expected sales growth, but does not influence the likelihood of falling into arrears nor reducing the likelihood of insolvency. Tax payment deferrals were the least effective policy. [7]

The effectiveness of measures directly supporting MSMEs, is driven by how they are relevant to the needs of businesses and how efficiently they are delivered. Business Pulse Surveys demonstrated that the demand for policy support differed across country income groups, firm size, formality status, exporting status and transmission channels. Half of all surveyed businesses demanded access to finance (deferral of credit payments, suspension of interest payments, rollover of debt, new credit and loans with subsidised rates) and tax reductions and deferral measures.[8] Tax reductions and deferrals were more in demand in low-income countries, but also less possible because of fiscal space. Monetary transfers, payment deferrals and access to credit were in more demand in middle income countries. There was found to be a mismatch between the needs of

[6] UNDP, 2022, The UNDP approach to risk-informed development, online, available at: www.undp.org/publications/undp-approach-risk-informed-development

[7] Xavier, C, 2021, Policies to support businesses through the COVID 19 shock: A firm level perspective, online, available at: https://documents1.worldbank.org/curated/en/188461610547807479/pdf/Policies-to-Support-Businesses-through-the-COVID-19-Shock-A-Firm-Level-Perspective.pdf

[8] Cirera, X, et al, 2021, Policies to support businesses through the COVID-19 shock, online, available at: https://documents1.worldbank.org/curated/en/188461610547807479/pdf/Policies-to-Support-Businesses-through-the-COVID-19-Shock-A-Firm-Level-Perspective.pdf

businesses, and support provided, in payment deferrals and access to credit.

During the COVID-19 pandemic, debt finance interventions were deployed in all case study countries. They were more in demand in middle income countries, where financial access is more prevalent.[9] Malaysia deployed the greatest number of debt finance interventions, followed by Brazil. Ethiopia, with constrained policy space, deployed one measure.

- + Debt finance is most appropriate during short term demand shocks, and only for formal businesses.
- + Debt financing will be more effective where firms have ready access to finance.
- + Debt finance allows for the self-selection of firms or behaviours with desirable characteristics, such as viability- if loans are appropriately assessed.[10]
- - Debt finance measures would not be available for informal businesses, nor those facing challenges in accessing finance.
- - Data is often not available to assess solvency nor future viability, challenging targeting.[11].
- - Rapid increases in interest rates, post-acute shocks, results in burdens to MSMEs.
- - Guarantee schemes may deliver longer term budgetary costs.

During the COVID-19 pandemic, employment support measures were more in demand in middle income countries, than low-income countries.

- + Wage subsidies could only be directed towards formal businesses, with registered workers.
- + Wage subsidies are most relevant to short term demand shocks, and natural resource shocks.
- + Wage subsidies were in particular demand in middle income countries, where informality is lower.
- + Wage subsidies can be particularly effective during economic recovery, to tilt the incentives of firms towards restarting.[12]

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[9] Cirera, X, et al, 2021, Policies to support businesses through the COVID-19 shock, online, available at: https://documents1.worldbank.org/curated/en/188461610547807479/pdf/Policies-to-Support-Businesses-through-the-COVID-19-Shock-A-Firm-Level-Perspective.pdf

[10] World Bank, Crisis and recovery: Learning from COVID 19's impacts and policy responses in East Asia, online, available at: https://www.worldbank.org/en/events/2023/07/11/crisis-and-recovery-learning-from-covid-19-s-economic-impact-and-policy-responses-in-east-asia-report-launch

[11] World Bank, 2021, Supporting firms in restructuring and recovery, online, available at: https://documents1.worldbank.org/curated/en/306401616131450724/pdf/Supporting-Firms-in-Restructuring-and-Recovery.pdf

[12] Blanchard, O, 2020, A new policy toolkit is needed as countries exit COVID lockdown, Petersen Institute for International Economic Policy Brief no. 20-8

- Wage subsidies can not reach informal enterprises, nor their entrepreneurs or workers. Social safety nets must be expanded effectively, vertically and horizontally, to provide support to these workers.
- Wage subsidies, used in isolation, can encourage employment retention, at the expense of the efficient reallocation of labour.

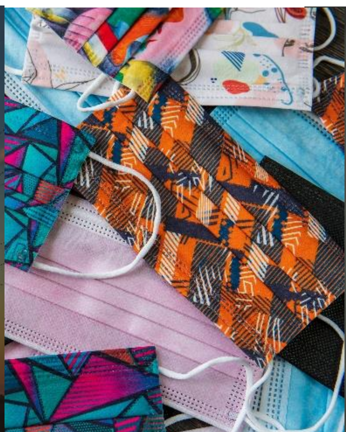
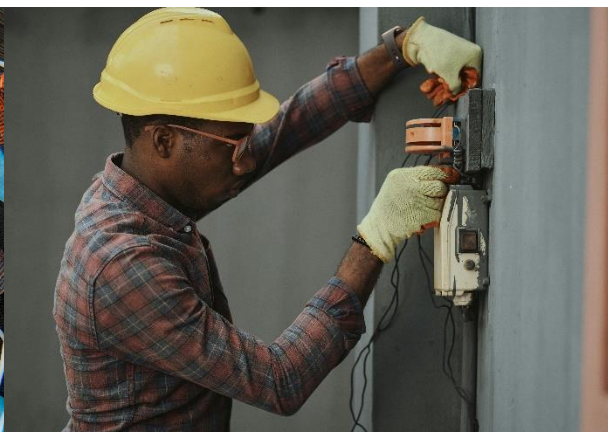
During the COVID-19 pandemic, social safety nets were adapted to support informal workers. Effectiveness was challenged by the availability of finance to scale up support, and the uniqueness of the stresses. The case load affected by COVID-19 was different than the case load affected by other shocks. Steps should be taken to enable the rapid adaption of social safety nets.

All case study countries deployed tax measures during the COVID-19 pandemic. Tax measures were particularly in demand in lower income countries, where access to finance is limited. Tax measures were less likely to be deployed in these countries, however. Ethiopia deployed tax measures, that were limited in scope. Tax measures could not reach those unregistered for tax.

+ Tax measures are relevant to short term demand shocks and natural disasters and can assist with managing liquidity in formal firms.
+ Tax measures can use financial information to target tax relief.
+ Tax relief measures can be rapidly designed and deployed.
+ Tax based measures can allow for an immediate response, while better enabling building back better through deploying incentives.

- Tax measures will not reach informal MSMEs.
- Corporate tax deferrals only assist those firms that make a profit,
- The common requirement for two years' worth of past information reduces the efficiency of this measure, as solvency and viability changes rapidly during crises.

Blanket energy pricing subsidies can lead to unintended, sometimes longer term, consequences. The International Monetary Fund suggests that pricing subsidies should not be deployed, during acute energy price increases. The use of energy price subsidies rebounded during the COVID-19 pandemic. While politically attractive, particularly during energy price shocks, subsidies have distributional and longer-term consequences, including hampering the transition to renewable energy. When used,

energy subsidies are best targeted towards certain categories of businesses. In Malaysia, smaller benefited more from pricing subsidies than larger firms.

No case study countries supported business entry, hibernation or exit reforms during the COVID-19 pandemic. These measures do provide opportunity for countries with limited monetary or fiscal policy space, to enable business dynamism during shocks, thereby furthering structural change. In the initial stages of a shock, introducing extraordinary time bound adjustments to insolvency frameworks, can stop viable firms being pushed into bankruptcy. Designing and implementing regulations that allow MSMEs hibernation, will also further resilience. Despite this opportunity, during the COVID-19 pandemic, regulatory flexibility in LMIC centred on trade related regulations. This aimed to secure cross border value chains, and reduce demand and supply stresses. Reduced customs duties were most prevalent, followed by streamlined customs procedures and the elimination of import licensing.[13]

/05

Which institutional conditions favour resilience?

Institutions establish the rules of the game for authorities in LMIC, and formal and informal MSMEs. Responses by Governments show that formal rules can change rapidly during exogenous shocks. While informal norms change more slowly in normal times, shocks do provide space for their rapid adaptation, to the benefit of MSMEs.

Governments in LMIC face tough choices when economic crises eventuate. This challenge is often worsened by political divisions, insecurity, and social unrest. In particularly acute and severe shocks, Governments face public pressure in rapidly responding, often with very limited resources.

Whether autocratic or democratic, the perception of the ability of Government to formulate and implement sound policies, that permits and promotes MSME development, matters for building resilience.[14] Only Malaysia shows gradual improvements in regulatory quality. Estimations for Brazil, Egypt and Ethiopia all worsened between the Global Financial Crisis and the onset of the COVID-19 pandemic. They then improved slightly during the COVID-19 pandemic.

The risks of unequal state business relations have been born out in past crises. Across East Asia, strong business government relations contributed to fast growth rates before the Asian Financial Crisis. State owned, and strategic businesses, are more likely to receive support- to the detriment of MSMEs. Egypt's system for state business relations has created influential state-owned enterprises. The military also plays an important role in the economy.

[13] OECD, 2023, Regulatory flexibility, online, available at: https://www.oecd.org/trade/resilient-supply-chains/regulatory-flexibility/#:~:text=Regulatory%20flexibility%20does%20not%20mean,or%20services%20can%20be%20accelerated.
[14] World Bank, Regulatory quality, online, available at: https://www.worldbank.org/content/dam/sites/govindicators/doc/rq.pdf

Smaller firms in Latin America have been challenged in concentrating their influence. Here, small firms (fewer than five employees) and informal firms were less aware of existing programs, less likely to apply for aid and less likely to receive aid.

In Ethiopia, government industry relations differ within industries.[15] These have influenced policy outcomes. Trust and collective learning have been established in floriculture, and logistical privileges have been established. However, in leather, path dependency and internal fragmentation has undermined collective learning. Overall, there is a system of mutual suspicion that has been exacerbated by a lack of dynamism in business associations and short termism in the private sector.

Governments face challenges in coordinating their actions. Enhanced coordination among agencies is instrumental to the provision of efficient and effective crisis support. However, case study countries relied on existing coordination mechanisms during the COVID-19 pandemic.[16]

Coordination bodies should be inclusive of organisations representing MSMEs Experience from case study countries, suggests that greater emphasis should be given to communicating the support available to smaller businesses. Coordination mechanisms should also design mechanisms to ensure that support is accessible to MSME. Early evaluations from advanced economies, support this view.

Public private and social dialogue can lift the profile of the needs of different segments of MSMEs. Across economies, the is opportunity for Government to involve civil society, the private sector and local actors in deliberations to increase transparency in decision making, as well as the relevance, efficiency and effectiveness of support.[17] This is especially pressing when rapidly designing and deploying measures to support businesses during shocks.

/06

What data can evidence resilience?

Despite the relevance of economic resilience, resilience remains inconsistently theorised. Achieving consistency in theory is confounded by the heterogeneity of shocks and contexts. Since the Global Financial Crisis, concepts of fiscal and monetary policy space have risen in prominence.[18]

During the Global Financial Crisis, a resilience indicator was formulated that aimed to measure the effect of shock absorption and counteraction policies.[19] This included measures of i) macroeconomic

[15] Oqubay, A, 2018, Industrial policy and late industrialisation in Ethiopia, African Development Bank, Working Paper no. 303
[16] ILO, 2023, A framework to support small firms in developing countries navigate crises and build resilience, online, available at: https://www.ilo.org/publications/framework-support-small-firms-developing-countries-navigate-crises-and#:~:text=Report-,A%20framework%20to%20support%20small%20firms%20in%20developing%20countries%20navigate,small%20firms%20during%20such%20conditions
[17] OECD, 2022, First lessons from government evaluations of COVI9 responses: A synthesis, online, available at: https://read.oecd-ilibrary.org/view/?ref=1125_1125436-7j5hea8nk4&title=First-lessons-from-government-evaluations-of-COVID-19-responses
[18] Strauss-Kahn, Dominique. 2008. "The Case for a Global Fiscal Boost." Financial Times, January 30
[19] Briguglio, L, et al, 2009, Economic vulnerability and resilience: Concepts and measures, UNU WIDER, https://www.wider.unu.edu/publication/economic-vulnerability-and-resilience-0

stability, ii) micro economic market efficiency, iii) good governance and iv) social development. This was updated in 2016 to account for the increasing relevance of environmental governance and increased exposure of the real sector to financial markets instability.

Another composite indicator attempts to capture vulnerability to disasters, and macro and micro economic resilience. The latter was captured at the household level, to account for welfare changes. Household level data could be replaced with data capturing the resilience of MSMEs.

Innovations in the measurement of economic resilience continue. An innovation in upper income countries, reduces the emphasis on fiscal and monetary policy space and increases emphasis on investment in research and development, the contribution of services to GDP and social progress, among others. These have relevance to LMIC.

Information asymmetries between firms and policymakers during a shock, are extremely pervasive. To measure resilience as an outcome and target support, it would be necessary to track firms over time. This will allow for the identification of firms that were able to recover from disruptions. International organisations have not yet embarked on a global effort to build a resilience index for businesses, although empirical work has begun. The International Labour Organisation has recently deployed principal component analysis and least absolute shrinkage and selection operator analyses.

The timeliness of data matters, as do assessments of future viability. Despite the attraction of debt finance to policy makers, assessing solvency and viability is extremely challenging during a shock. Viability can be determined by establishing if the discounted value exceeds the recovery value of assets through forced sale. This can be calculated through tax returns and calculations of future earnings before interest, taxes, depreciation and amortization. This data is often not available, especially for smaller businesses.

When considering data to target firms, authorities could consider utilising (in declining order of capability requirements):

- Solvency measures- where the discounted value exceeds obligations to banks and government.
  - As this changes during crises, government arrears should be cleared to allow for insolvency to be determined.
- Vulnerability- Declines in revenue have been used to identify vulnerable firms.
  - This can be complemented with a notion of solvency to avoid channelling funds to firms who do not need support or who are unlikely to survive anyway.
- The segmentation of firms, as exporters, young firms and start-ups may experience acute financial distress while being particularly important for the recovery.

- At minimum these firms should be identified early, and should not be excluded from support programmes.
- Size/informal status- There is less rationale in using public funds to support informal firms where entry and exist costs are lower, and intangible capital rests with the entrepreneur.
  - Identifying a cut-off point relating to size can allow social security systems to support informal businesses.

For links to more resources on this topic see the DCED's Business Environment Reform webpage.

This policy brief was written by James Lloyd for the DCED Business Environment Working Group and edited by Ella Duffy of the DCED Secretariat. Please provide feedback to admin@enterprise-development.org