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## **Economic Vulnerability and International Development Assistance: Aid Allocation in 2020–2022<sup>1</sup>**

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### ***Abstract***

The COVID-19 pandemic and sanctions against Russia greatly influenced the global economy, including developing countries. The first part of this article explores the main macroeconomic trends in emerging economies, including the decline of economic growth rates after the shocks of 2020–22, dynamics of external debt, government deficit, unemployment, and inflation.

The hugely increased financing needs of developing countries against the background of financial constraints requires a fine adjustment of the development assistance allocation system, especially from multilateral agencies. The second part of this article highlights the current situation in terms of usage of economic vulnerability as one of the criteria for allocation of concessional finance. This includes the most relevant experience of the Caribbean Development Bank and its concessional body, the Special Development Fund. The absence of economic vulnerability as one of the criteria for aid allocation in most of the institutions increases risks for the global economy as a number of vulnerable countries have an increasing financing gap. The third part of article evaluates potential financing allocation based on economic vulnerability and brings to a conclusion that most of the vulnerable developing countries are underfinanced by multilateral organizations.

**Key Words:** Vulnerability, EVI, COVID\_19, Sanctions, International Development Assistance, Multilateral Development Banks

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## **Introduction**

The shocks of 2020-22 disrupted the course of economic development and cemented high-level risks [Grigoryev, 2023]. Based on the results of studies dedicated to prior pandemics, researchers anticipated a quick V-shaped recovery in 2021 [Brodeur, 2021, p. 1019], bearing in mind that restrictions and government support greatly affected the extent of recess in the developed and developing countries [Brodeur, 2021, p.1032; Grigoryev et al., 2021]. Due to a particularly strong effect on long-term economic growth in the least developed countries caused by to the loss of human capital in 2020 [Buffie et al., 2022] and less extensive government support compared with world leaders [Grigoryev et al., 2021], the issue of economic vulnerability of developing and least developed countries' economies to external economic shocks and methods for measuring this vulnerability becomes particularly relevant.

Development assistance from the developed countries may insure its recipients against macroeconomic shocks [Pallage et al., 2006], but empirical research indicates that real-life scenarios can vary greatly. For example, during the 1997-98 Asian crisis, donors provided almost \$100 billion to affected countries in loans and grants through multilateral and bilateral channels [Dang, 2009, p. 2]. Similarly, official development assistance facilitated Mexico's recovery after the 1994-95 crisis. At the same time, evidence from other crises indicates that when recipients are in recession, the volume of provided assistance may not increase, and in some cases may actually decline. A study on assistance provided to 76 recipients over 1975-2003 shows that the likelihood of getting additional assistance for a recipient with a falling GDP ranges from 5 to 30%, whereas the probability of getting less assistance under similar circumstances is commensurate and ranges from 10 to 20% [Bulir, Hamann, 2008, pp. 2060-2061]. In other words, a significant increase in assistance coincides with periods of a decreasing GDP virtually as often as with a growing GDP. As for multilateral institutions, the nature of their financial assistance is countercyclical [Griffith-Jones, 2016; Griffith-Jones and Gottschalk, 2012; Morozkina, Grigoryev, 2024].

The need to provide countercyclical assistance and increase its effectiveness during shocks makes researchers engage in active discussions on allocation criteria that multilateral institutions have not revised for quite some time. For example, the International Development Association has considered the possibility of incorporating vulnerability into its allocation system, but studies showed a lack of data and information on the effectiveness of this criterion for assistance allocation [IDA, 2010].

This study seeks to determine how economic vulnerability of the developing countries factors into the existing system that promotes international development and to assess potential effects of applying vulnerability indicators to the provision of funding. The first part of the study determines the effect of the latest shocks on developing countries' main economic indicators and identifies channels that exert this effect. The second part discusses the existing vulnerability indicators and their inclusion in the system which development institutions use to assess projects and priorities in the provision of funding. The third part establishes the correlation between the size of development assistance and developing countries' vulnerability and provides recommendations that would boost the

effectiveness of development assistance through greater inclusion of vulnerability indicators into the system for the allocation of funding.

### Impact of 2020-22 Shocks on Developing Countries

In 2020-22, the world economy experienced a series of shocks, including lockdowns and stimulating fiscal and monetary policies in 2020, disruption of supply chains and price increase in 2021, and rising geopolitical tensions, sanctions and price increase in 2022.

The crisis of 2020 had the strongest adverse effect on economic growth and consumption of the developing countries in general. The GDP dropped in all groups, except low-income countries, which experienced a dramatic slowdown of economic growth. The majority of the developing countries also recorded a drop in their final consumption. The crisis mostly affected the developed countries that suffered a large drop in consumption and also introduced extensive fiscal measures. Table 1 shows that the share of stimulating measures in the GDP goes down along with a decrease in the average income and for the developing countries is generally lower than for the world at large (Table 1). At the same time, it is worth noting that the recovery of the least developed countries was also less pronounced [Medzhidova, 2024]. For example, 28 out of 46 least developed countries exhibited lower economic growth rates in 2022 than their 2017-19 average before the shocks. After 2022, the IMF downgraded its forecasts for the developing economies by 1 percentage point and for the low-income countries in aggregate by .5 percentage point compared with January 2022 [IMF, 2022b; IMF, 2024]. This adjustment serves as additional evidence of the 2021-22 external shocks' negative effect.

Table 1. GDP growth, final consumption and fiscal measures in 2019-2022

<i>Group</i>	<i>GDP Growth (annual per cent)</i>				<i>Final consumption, bln USD.</i>				<i>Fisc. Measures in 2020 (% to GDP)</i>
	2019	2020	2021	2022	2019	2020	2021	2022	2020
<i>Upper-Middle Income Countries</i>	4.1	-0.7	7.6	3.1	16 001	15 258	17 490	18 427	5.0
<i>Lower-Middle Income Countries</i>	3.5	-3.2	6.1	5.2	5 347	5 237	6 019	6 410	4.5
<i>Low- Income Countries</i>	3.8	0.1	1.8	3.4	406	398	420	495	3.6
<i>LDCs</i>	4.8	-0.2	2.6	4.5	911	923	1 016	1 169	4.5
<i>World</i>	2.6	-3.1	6.2	3.1	64 092	62 574	70 054	72 536	6.0

Source: author's calculations based on [World Bank, n.d.; IMF, 2022a]

The GDP of some least developed countries dropped after the 2020 shock as well, but in most cases it was caused not by the general economic vulnerability, but by unstable political situation and military conflicts (Afghanistan, Myanmar, Sudan, Solomon Islands) or natural disasters (Haiti).

Studies on fluctuations in the developing countries show that approximately 70% of them are caused by changes in the demand of industrially developed countries [Kouparitsas, 2001]; therefore, channels that affect the economies of the developing countries are primarily external and linked to their participation in the global trade and financial relations. Economic openness measured as the ratio of external trade to the GDP is an indicator of economic vulnerability for the developing countries. On the one hand, economic openness

attests to participation in international markets and may be a source of solid economic growth and basis for more effective regulation; but, on the other hand, external demand may have a negative effect unrelated to the national economic policy and, therefore, may become a source of vulnerability [Briguglio et al., 2008, p. 4]. The table below shows trade indicators as percentage of the GDP in 2019-22. It demonstrates the developing economies' growing involvement in the global trade and a drop caused by lockdowns in 2020. But it is the concentration of trade on a certain product and, consequently, dependence on global conditions in this market that is an important source of vulnerability. This indicator highlights a particularly vulnerable position of the least developed countries and low-income countries, especially in comparison with the global average (Table 2).

Table 2. Openness indicators for developing countries, 2019-2022

<i>Group</i>	<i>Trade (%to GDP)</i>				<i>Trade concentration index</i>			
	2019	2020	2021	2022	2019	2020	2021	2022
<i>Upper-Middle Income Countries</i>	45	43	48	50	0.13	0.09	0.10	0.12
<i>Lower-Middle Income Countries</i>	53	48	54	60				
<i>Low- Income Countries</i>	48	46	51	50	0.15	0.19	0.19	0.17
<i>LDCs</i>	50	48	52	53	0.20	0.19	0.18	0.20
<i>World</i>	56	52	57	63	0.07	0.06	0.06	0.07

Source: author's calculations based on [UNCTAD, n.d.; World Bank, n.d.]

When hit with negative external shocks, the developing countries have a limited range of stimulating policy measures, primarily due to high levels of state budget deficit and state debt, which – unlike the developed countries – they typically cannot raise given the overall instability of their national economies. During shocks, state budget deficit increased in all groups of the developing countries and has not yet rebounded to its 2019 levels. Similarly, all else being equal, higher level of debt translates into fewer opportunities for the implementation of a stimulating budget and fiscal policies, i.e., prompt anti-crisis measures. Growing external debt typically reflects the deterioration of budget balance and a decrease in funds available for the implementation of budget policy, including anti-crisis measures. At the same time, this indicator has its particularities, especially for the poorest countries. It is during crises that debt relief initiatives may be implemented, as was the case after the G20 resolution in 2020 [G20, 2020], which could explain lower levels of debt recorded by the low-income and least developed countries in 2022. High inflation and unemployment, which comprise the so-called misery index, also yield less opportunities for the implementation of stimulating policies<sup>2</sup>. When inflation is high, central banks have limited ability to pursue stimulating monetary policies and apply them to boost economic growth [Podrugina, Lysenko, 2023]. Disruption of global supply chains had a negative effect on the number of jobs and, albeit the situation somewhat improved in 2021, sanctions and geopolitical

<sup>2</sup> Misery index introduced by Arthur Okun is the sum of the inflation and unemployment rates and an economic vulnerability indicator (Nessen, 2008, <https://www.brookings.edu/opinions/the-brookings-institutions-arthur-okun-father-of-the-misery-index/>).

tensions cemented risks and slowed down recovery in 2022. That is why the misery index remains high for all groups of the developing countries (Table 3).

Table 3. Macroeconomic stability indicators in developing countries (state budget deficit, debt level, misery index), 2019-2022

<i>Group</i>	<i>Budget deficit (% to GDP)</i>				<i>Debt (% to GDP)</i>				<i>Misery index</i>			
	2019	2020	2021	2022	2019	2020	2021	2022	2019	2020	2021	2022
<i>Upper-Middle Income Countries</i>	-2.2	-6.3	-4.6	-2.5	24	26	24	21	9.2	10.2	14.6	18.6
<i>Lower-Middle Income Countries</i>	-3.5	-5.3	-3.9	-3.7	29	32	30	29	20.8	21.6	18.7	25.0
<i>Low- Income Countries</i>	-3.4	-5.5	-4.8	-4.9	42	47	47	42	13.0	28.6	29.5	20.8
<i>LDCs</i>	-2.2	-4.6	-4.1	-3.3	40	43	43	39	11.8	20.2	21.7	19.5
<i>World</i>	-3.0	-5.5	-4.0	-3.5	48	52	48	45	9.4	9.5	12.4	14.2

Source: author's calculations based on [ILO, n.d.; IMF, 2023]

Thus, the shocks of 2020-22 had a negative effect on the developing countries, primarily as a result of more prominent macroeconomic challenges and higher vulnerability caused by high concentration of trade, high level of debt, and, consequently, fewer opportunities for the implementation of stimulating fiscal and monetary policies. In order to assess the need for providing support to countries after shocks and mitigate risks associated with future shocks, it is particularly important to conduct regular assessment of developing countries' vulnerability.

### **Economic Vulnerability of Developing Economies in the System of International Development Assistance**

Due to the developing economies' dependence on external market conditions, research on the developing countries defines economic vulnerability as "the likelihood that a country's economic development process is hindered by external shocks" [Cariolle, 2010, p. 5]. The best known developing countries' economic vulnerability index is calculated by the UN Committee for Development Policy. It is used along with other indicators [UN, 2021] to determine the least developed countries and includes the following aspects:

- share of agriculture, forestry, and fishing in the GDP;
- remoteness and landlockedness;
- merchandise export concentration;
- instability of exports of goods and services.

Bilateral development assistance primarily takes into account commercial and political interests of donors [Morozkina, 2019; Degterev, 2011], which is why this study focuses on multilateral institutions, as they typically have clear criteria for the allocation of resources.

Multilateral development banks predominantly rely on performance-based allocation criteria because – among other things – research on aid allocation effectiveness shows that countries with quality results and high level of governance exhibit greater effect of concessional financing [Burnside and Dollar, 2000]. But when multilateral development

institutions assess the effectiveness of a country's policies, they do not take into account external and starting conditions, which puts countries with different economic abilities on par as regards the allocation of resources. That is why researchers have been increasingly dissatisfied with the existing formula and demand that vulnerability and need for assistance factor more prominently in assistance allocation [Guillarmont et al., 2017].

Presently, only the Caribbean Development Bank (CDB) accounts for the economic vulnerability index as one of its criteria for allocating assistance to member countries from the concessional Special Development Fund [Ram et al., 2019]. The Fund's allocation formula is provided below:

$$\begin{aligned} \text{Allocation score} &= (\text{country need}) * (\text{country performance}) \\ &= (\log\text{Pop} * \text{GNPpc}^{-0,9} * \text{Vul}^2) * (0,7 * \text{Pres} + 0,3 * \text{Port}) \end{aligned}$$

where *logPop*- logarithm of population

*GNPpc* – gross national product per capita;

*Vul* – country vulnerability;

*Pres* – country performance on policy and institutions (similar to the World Bank CPIA)

*Port* – performance of the country's portfolio of CDB loans (SDF, 2007)

The economic vulnerability index calculated by the CDB is somewhat different from the UN index and comprises the following indicators:

- peripherality and accessibility (freight and insurance costs for imports);
- dependence upon imported energy (percentage of total energy consumption);
- export concentration by product;
- convergence of export destination;
- reliance upon external finance (overseas development assistance and foreign direct investment as a proportion of annual gross fixed capital formation).

Other development institutions account for economic vulnerability in an indirect way. The World Bank provides the most vulnerable small countries with special access to the International Development Association's concessional resources, even though the vulnerability index does not directly factor into its allocation. The need to establish minimum and maximum thresholds in order to even out assistance volumes for small and large countries warrants a separate discussion [Guillaumont, Wagner, 2015]. In its Strategy for Addressing Fragility and Building Resilience in Africa (2022-2026), the African Development Bank considers broader application of vulnerability indicators in the allocation of concessional resources, particularly through the Transition Support Facility [AfDB, 2023]. Research on African countries shows the need for further development of the vulnerability index that would increase the effectiveness of development assistance in the region and break the vicious circle when vulnerable countries' weak performance awards them less funding [Guillaumont et al., 2021]. The use of vulnerability indicators is particularly relevant during shocks [Sembene, 2021].

## **International Development Assistance in 2020-22**

During shocks, international development assistance could serve as a safety net for the developing countries because it is de facto meant to bridge the ability gap for different countries. For some economies, especially low-income countries as defined by the World Bank, the majority of which are also on the UN's least developed countries list, international development assistance is the main source of capital inflow (Figure 1). Financial systems of such countries are characterized by low levels of development and, consequently, low levels of savings and access to capital, apart from foreign direct investment (FDI) [UNCTAD, 2023]. But FDI typically targets the mining segment and rarely facilitates active development of recipient countries.

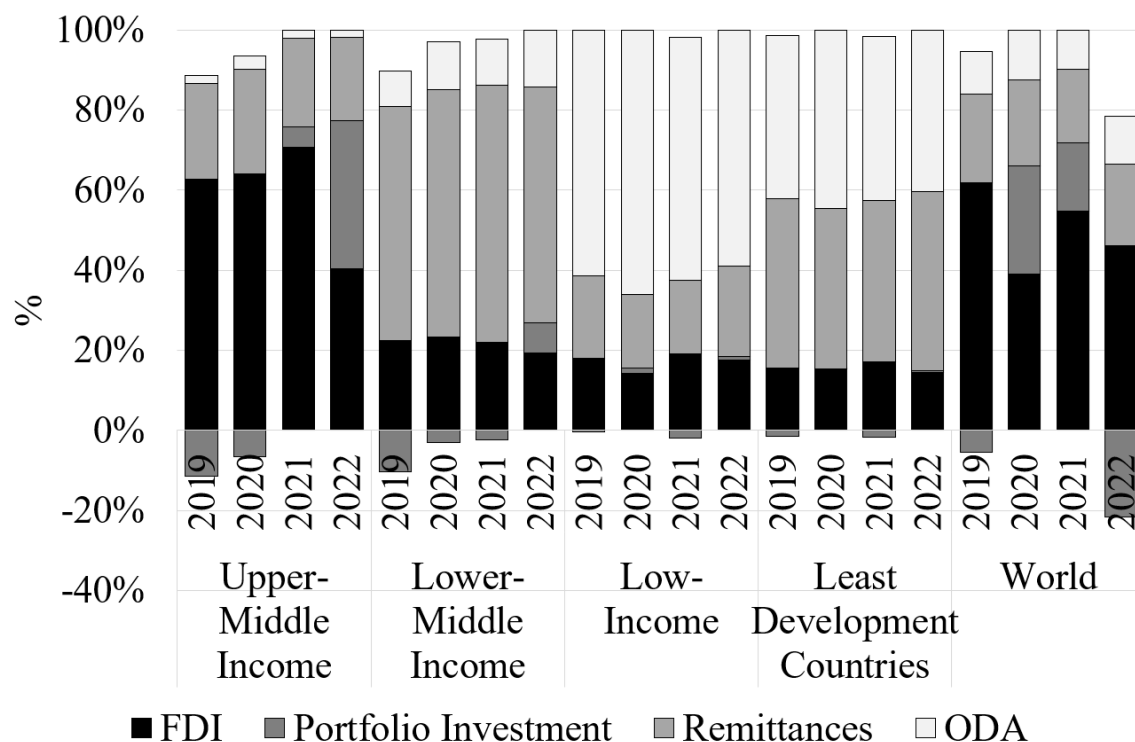


Figure 1 – Structure of capital inflow to developing countries and world, 2019-2022, % to total inflow

Source: author’s calculations based on [World Bank, n.d.; OECD, n.d.]

2020 saw a significant increase in development assistance, both from all donors in general and from multilateral institutions, whereas aid increase from the latter was more even and went up by approximately 40-60% across all groups of recipients. If we look at bilateral flows, the situation is going to be more uneven, with a higher relative increase in financial flows to groups of countries with higher income. For example, assistance to the upper-middle income countries grew by 50% against a 20% increase for the least developed countries in 2020 compared with 2019. As for 2021-22, aggregate assistance for the least developed countries did not see an increase – it actually dropped (Table 4). We should also pay attention to formats in which development assistance is provided because reallocation of funds from programmable aid to short-term projects in times of crisis lowers allocation effectiveness [OECD, 2023, p. 24].

Table 4. Official Development Aid, including from multilateral institutions, breakdown by recipient groups, bln USD, 2019-2022

<i>Group</i>	<i>Official Development Aid, bln USD</i>				<i>Official Development Aid from multilateral institutions, bln USD</i>			
	2019	2020	2021	2022	2019	2020	2021	2022
<i>Upper-Middle Income Countries</i>	13.3	20.3	19.2	19.2	3.5	5.5	5.6	5.3
<i>Lower-Middle Income Countries</i>	48.8	61.4	63.6	86.2	18.7	29.8	24.2	32.8
<i>Low- Income Countries</i>	45.9	53.0	51.7	46.2	14.8	21.5	18.3	16.6
<i>LDCs</i>	53.0	64.5	61.7	57.2	21.7	31.3	25.9	24.6
<i>World</i>	317.2	379.9	396.6	448.9	33.7	50.4	44.9	53.6

Source: [OECD, n.d.]

The allocation of resources between recipients is a particularly important issue. At the moment, five out of 46 least developed countries get more than 35% of all funding. These recipients are as follows: Afghanistan, Bangladesh, Democratic Republic of Kongo, Ethiopia, and Yemen. When allocating resources, even more neutral multilateral development institutions have already been shown to rely primarily on performance and not take into account vulnerability indicators. That becomes rather obvious if we examine the correlation between development assistance and the economic vulnerability index shown below (Figure 2). Even though there may generally be an upward trend, the correlation between development assistance and vulnerability index is .36 for multilateral development institutions and .55 if we exclude Tuvalu and South Sudan that have an extremely high ratio of concessional funding to the GDP. In case of Tuvalu, this situation stems from its low GDP and major climate problems (sea level rise). The resolution of these issues is financed using funds of Development Assistance Fund members (Australia, New Zealand, Japan) and multilateral development institutions (World Bank, Asian Development Bank, UN Green Climate Fund). As for South Sudan, almost half of assistance is provided as humanitarian aid due to the military conflict with Sudan. The U.S. and Great Britain are the main donors on bilateral basis.



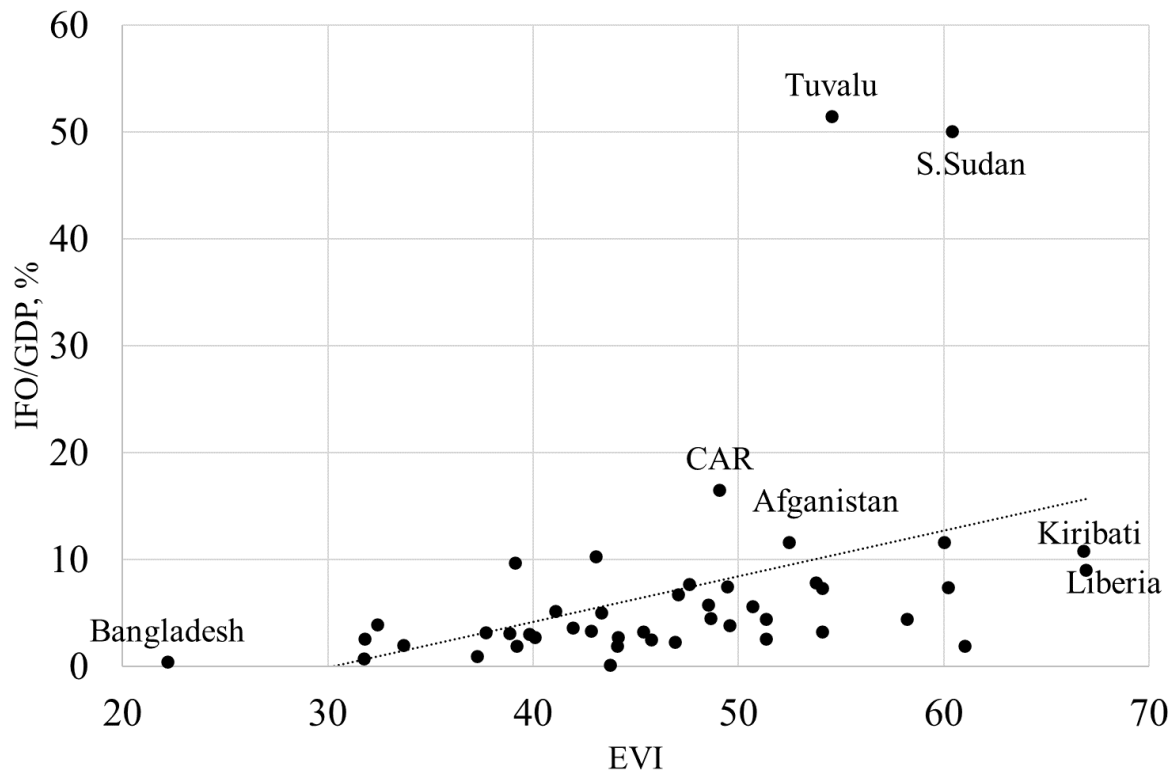


Figure 2 –EVI and ODA from multilateral financial institutions (IFO) to GDP for least developed, average for 2020-2022

Source: author’s calculations based on [UN, n.d.; OECD n.d.]

In order to determine the effect of changes in the allocation system and incorporation of economic vulnerability therein, we performed a detailed calculation of model allocation of assistance provided by multilateral institutions. The calculation consisted of three stages:

1. First, calculate the allocation score using the aforementioned country need formula used by the Caribbean Development Bank;
2. Second, use allocation score values obtained at Stage 1 to calculate model assistance allocation in 2020-22 based on aggregate value of development assistance provided by multilateral development institutions to the least developed countries;
3. Third, compare obtained model values with actual development assistance provided.

Model values were calculated for 46 least developed countries for the years 2020-22. Calculations were limited by available data on the vulnerability index.

The table below shows model calculation results (Table 5). As expected, South Sudan (which has the highest economic vulnerability index, according to the UNCTAD) showed the highest discrepancy between vulnerability and allocated resources, in spite of high volumes of actual assistance received. Indeed, South Sudan is a vulnerable region with high export concentration, logistical limitations on international trade, military conflict in the neighboring Sudan, and, consequently, a large number of refugees, which exacerbates South Sudan's unresolved social tensions. Other most underallocated countries also have

high vulnerability due to high inflation (Burundi, Sierra Leone), humanitarian crisis, and dependence on international assistance (Somalia, Liberia). Countries with the highest surplus of actual assistance received over their estimated needs are predominantly large countries with low economic vulnerability.

Table 5. Model calculation of need in official development aid for several countries, average for 2020-2022

	<i>EVI, 2020-2022</i>	<i>Population, mln</i>	<i>GNP per capita, USD</i>	<i>Index of need in ODA</i>	<i>Est. ODA, mln USD</i>	<i>Real ODA, mln USD</i>	<i>Difference, mln USD</i>	<i>Ration of real to est. ODA, %</i>
<i>Top-5 countries with real ODA flows lower than estimated</i>								
<i>S.Sudan</i>	67.7	11	94	145.5	5 583	505	5 078	9
<i>Burundi</i>	48.6	13	265	46.0	1 764	340	1 424	19
<i>Somalia</i>	50.0	17	575	33.8	1 296	722	574	56
<i>Liberia</i>	60.6	5	676	20.9	804	309	494	38
<i>Sierra-Leone</i>	52.3	8	603	24.2	927	479	448	52
<i>Top-5 countries with real ODA flows higher than estimated</i>								
<i>Bangladesh</i>	24.5	169	1764	3.0	116	1 779	-1 663	1 534
<i>Ethiopia</i>	38.7	120	830	22.0	842	2 170	-1 327	258
<i>Tanzania</i>	34.7	64	1024	12.5	478	1 345	-867	281
<i>Sudan</i>	30.8	46	1683	6.8	260	1 076	-816	414
<i>Uganda</i>	35.8	46	903	17,2	660	1 311	-651	199

Source: author's calculations based on [World Bank, n.d.; UN, n.d.; OECD n.d.]

This model calculation definitely has a number of major flaws, i.e.:

- uses only eligibility calculations without performance assessment. That is due to limited data availability since portfolio's performance assessment requires calculations from development institutions;
- uses EVI UNCTAD index in the Caribbean Development Bank's formula, which is also related to limited data access. The model calculation uses EVI data that are open access;
- does not have a threshold, which results in an extremely high value for small countries, such as South Sudan. When providing development assistance, it is necessary to account for recipient's ability to absorb financial resources, otherwise assistance will just lead to high inflation and will not have a positive effect on the economy.

Thus, this study cannot serve as a guide for assistance allocation, but it can be used as grounds for looking into the possibility of incorporating vulnerability indicators into donors' – including multilateral institutions' – system for allocation assessment.

Prioritizing the most vulnerable countries in assistance allocation may boost its effectiveness. First, it will ensure more even access to international markets (through building infrastructure and developing diversified production) and various social

services (by developing healthcare and education). Second, it will promote more sustainable economic development of potentially vulnerable countries, i.e., lower sovereign debt and budget deficit, through grants, which will translate into lower risks for the global economy in general.

## Conclusion

This study explores the correlation between economic vulnerability and international development assistance allocation in 2020-22. Peculiarities of the latest shocks and their effect on the developing countries prompt us to reconsider grounds for development assistance allocation and ensure that economic vulnerability indicators factor more prominently into the decision making process, i.e., by using best practices, such as the allocation system used by the Caribbean Development Bank's Special Development Fund.

Prospective ways for incorporating economic vulnerability into the assistance allocation system are as follows:

- include economic vulnerability index directly into the eligibility formula, as is the case with the allocation formula used by the Special Development Fund of the CDB;
- use the vulnerability index to establish the threshold for access to concessional resources;
- provide concessional terms to recipients based on their economic vulnerability index, including reduction of administrative barriers, softer loan terms or special conditions for the provision of funding.

Such measures will increase opportunities for pursuing sustainable development goals in some most vulnerable countries, as well as mitigate risks for the onset of unfavorable economic conditions and the need to provide assistance after the risks have realized.

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