Low-income countries are highly vulnerable to exogenous shocks such as sudden drops in the prices of their exports, hurricanes, droughts, shortfalls in aid flows, and volatile private capital flows.

Rich countries and global financial institutions recognise the need to avoid or mitigate the effects of these shocks to poor countries, but they only see a limited role for themselves. Poor countries and their advocates, on the other hand, stress that the international community should do more since shocks cause severe harm to developing country economies and, especially, the poor.

Protecting the Poor: Global Financial Institutions and the Vulnerability of Low-Income Countries brings together in-depth analyses and valuable policy proposals of both officials and critical observers. It spells out what poor countries, rich countries and the international financial institutions can do to address the vulnerabilities of low-income countries.

It also addresses why the governance of the international financial system should be improved. Contributing authors advocate that improvements should go beyond the short-term agenda of policymakers – such as the latest financial crisis or the newest debt relief proposal. “Fundamental” reforms are needed, they say.

Contributors also review the role of the IMF in low-income countries. Some of them see the design of proper “exit strategies” as one of the main future challenges of the IMF, whereas others stress the need for the Fund to recast itself in the role of partner in development rather than macroeconomic master.
Forum on Debt and Development (FONDAD)

FONDAD is an independent policy research centre and forum for international discussion established in the Netherlands. Supported by a worldwide network of experts, it provides policy-oriented research on a range of North-South problems, with particular emphasis on international financial issues. Through research, seminars and publications, FONDAD aims to provide factual background information and practical strategies for policymakers and other interested groups in industrial, developing and transition countries.

Director: Jan Joost Teunissen
Protecting the Poor

Global Financial Institutions and the Vulnerability of Low-Income Countries

Edited by
Jan Joost Teunissen and
Age Akkerman

FONDAD
The Hague

From: Protecting the Poor - Global Financial Institutions and the Vulnerability of Low-Income Countries
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Acknowledgements

This book is yet another result from the Global Financial Governance Initiative (GFGI), which brings together Northern and Southern perspectives on key international financial issues. In this initiative, FONDAD is responsible for the working group Crisis Prevention and Response, jointly chaired by José Antonio Ocampo, under-secretary-general for Economic and Social Affairs of the United Nations, and Jan Joost Teunissen, director of FONDAD.

FONDAD very much appreciates the continuing support of the Dutch Ministry of Foreign Affairs and the stimulating ongoing cooperation with the Economic Commission for Latin America and the Caribbean (ECLAC) in Santiago de Chile, the North-South Institute in Ottawa, the African Economic Research Consortium (AERC) in Nairobi, Debt Research International (DRI) in London, the Korea Institute for International Economic Policy (KIEP) in Seoul and the many other organisations with which it works together.

This is the second volume emerging from a conference held in The Hague on 11-12 November 2004. The previous volume is entitled Helping the Poor: The IMF and Low-Income Countries. A special thanks goes to Ernst van Koesveld at the Dutch Ministry of Finance, who assisted in the organising of the conference in The Hague, and to Adriana Bulnes and Julie Raadschelders, who assisted in the publishing of this book.

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Age Akkerman
September, 2005
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### Abbreviations

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<th>Abbreviation</th>
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<tr>
<td>ACP</td>
<td>Africa, Caribbean and the Pacific</td>
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<td>AfDB</td>
<td>African Development Bank</td>
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<td>AFRODAD</td>
<td>African Forum and Network on Debt and Development</td>
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<td>AFTA</td>
<td>ASEAN Free Trade Area</td>
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<tr>
<td>ATM</td>
<td>automated teller machine (to withdraw money)</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>BWIs</td>
<td>Bretton Woods institutions</td>
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<td>CAR</td>
<td>Central African Republic</td>
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<td>CEPR</td>
<td>Centre for Economic Policy Research</td>
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<td>CFA</td>
<td>Communauté Financière Africaine</td>
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<tr>
<td>CFF</td>
<td>Compensatory Financing Facility (of the IMF)</td>
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<td>CPIA</td>
<td>Country Policy and Institutional Assessment (of the World Bank)</td>
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<td>DFID</td>
<td>Department for International Development (UK)</td>
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<td>DRI</td>
<td>Debt Relief International</td>
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<td>DSA</td>
<td>Debt Sustainability Analysis</td>
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<td>DSF</td>
<td>Debt Sustainability Framework</td>
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<td>DSR</td>
<td>Debt Service Reduction Option</td>
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<tr>
<td>ECLAC</td>
<td>Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)</td>
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<tr>
<td>ECM</td>
<td>External Contingency Mechanism (of the IMF)</td>
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<td>EFTA</td>
<td>European Free Trade Area</td>
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<tr>
<td>EMU</td>
<td>Economic and Monetary Union (of the EU)</td>
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<tr>
<td>ESAF</td>
<td>Enhanced Structural Adjustment Facility</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
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<td>EURODAD</td>
<td>European Network on Debt and Development</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<tr>
<td>FLEX</td>
<td>Fluctuation of Export (EU instrument to compensate ACP countries for fluctuations in export earnings)</td>
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<td>FSF</td>
<td>Financial Stability Forum</td>
</tr>
<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<td>GNP</td>
<td>gross national product</td>
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*From: Protecting the Poor - Global Financial Institutions and the Vulnerability of Low-Income Countries*  
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<tr>
<th>Abbreviation</th>
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<tr>
<td>HIPC</td>
<td>heavily indebted poor country</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IDB</td>
<td>Inter-American Development Bank</td>
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<td>IEO</td>
<td>Independent Evaluation Office (of the IMF)</td>
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<td>IFIs</td>
<td>international financial institutions</td>
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<tr>
<td>IFS</td>
<td>International Financial Statistics (of the IMF)</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>KIEP</td>
<td>Korea Institute for International Economic Policy</td>
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<td>LICs</td>
<td>low-income countries</td>
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<tr>
<td>MCA</td>
<td>Millennium Challenge Account</td>
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<td>MDBs</td>
<td>multilateral development banks</td>
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<td>MDGs</td>
<td>Millennium Development Goals</td>
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<tr>
<td>MICs</td>
<td>middle-income countries</td>
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<tr>
<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
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<td>NEPAD</td>
<td>New Partnership for Africa’s Development</td>
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<tr>
<td>NGO</td>
<td>non-governmental organisation</td>
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<td>NPV</td>
<td>net present value (of HIPC's debt)</td>
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<td>ODA</td>
<td>official development assistance</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
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<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
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<tr>
<td>PPP</td>
<td>purchasing power parity</td>
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<tr>
<td>PRGF</td>
<td>Poverty Reduction and Growth Facility</td>
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<td>PRSC</td>
<td>Poverty Reduction Support Credit</td>
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<tr>
<td>PRSP</td>
<td>Poverty Reduction Strategy Paper</td>
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<tr>
<td>PSI</td>
<td>Policy Support Instrument</td>
</tr>
<tr>
<td>PSIA</td>
<td>Poverty and Social Impact Analysis</td>
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<td>PV</td>
<td>present value (of HIPC's debt)</td>
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<tr>
<td>SDR</td>
<td>Special Drawing Right</td>
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<tr>
<td>SDRM</td>
<td>Sovereign Debt Restructuring Mechanism</td>
</tr>
<tr>
<td>STABEX</td>
<td>Stabilisation of Export Earnings (EU instrument to stabilise ACP countries’ agricultural export revenues)</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>UN</td>
<td>United Nations</td>
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<td>UNDP</td>
<td>United Nations Development Programme</td>
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<td>US</td>
<td>United States</td>
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<td>VAT</td>
<td>value added tax</td>
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<td>WFP</td>
<td>World Food Programme</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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The Dialogue on the Vulnerability of Low-Income Countries: By Way of Introduction

Jan Joost Teunissen

Ask a policymaker of a rich country or a high official of the IMF what their institution is doing to help developing countries overcome the serious problems of a sudden drought or a drop in export prices, and the typical answer will be: “We know that these countries can be hit very hard by exogenous shocks and you can be sure that we do whatever we can to help them. But don’t expect miracles from us. We have to carefully analyse what we can do, and what they can do to better address shocks. We should not act too swiftly or too generously because we run the risk of these countries not doing what they need to do in the first place: follow policies that prevent these shocks from having such a big impact on their economies. The only real, long-term solution will be to help these countries become less vulnerable.”

If you then ask the same official what is being done to help the so-called low-income countries (a group of 59 developing countries with a per capita annual income of less than $765), who are particularly vulnerable to exogenous shocks, the typical answer will be that these countries indeed need special attention. “But again,” the official will hasten to add, “let’s not fool ourselves and come up with all kinds of supportive schemes. In this case too, we need to carefully analyse and discuss what policies low-income countries themselves should follow to better resist shocks.”

Obviously, many officials see it as part of their job to make reassuring statements, and obviously, many observers and critics see it as part of their job to do the opposite: demonstrate what is missing or wrong in
The Vulnerability of Low-Income Countries: By Way of Introduction

The official policies and suggest ways to address these gaps and errors. That’s how the game works in politics, and that’s how it works in economics too – in economic policymaking, I mean. This simple law also applies to the topics of this book: the financial vulnerabilities of low-income countries, what these countries and the rich countries and international financial institutions can do to address them, why the governance of the global financial system should be improved, and what the main future challenges of the IMF in low-income countries will be. This book brings together the views of officials as well as critical observers. But before highlighting a few of their insights, I would like to give you my view of the quality of the debate that has taken place between officials and observers over the last twenty years – just to put things in perspective.

From a Lack of Dialogue to the Fashion of Dialogue

Let’s imagine the above conversation between an observer and a typical high-level official of the IMF taking place twenty years ago – after television and newspapers had shown dramatic images of desperate people in, say, the streets of Kampala or Caracas protesting against “IMF intervention”. In such a case and at that time, the official would have said that these protesters might have good intentions, but they did not really know what they were talking about. Today, however, the typical official would not say that. He or she would listen carefully and engage in what is en vogue today, i.e. a dialogue with “civil society”.

Don’t get me wrong, I am not ridiculing today’s fashion of dialogue between global financial institutions and their critics. I very much welcome this dialogue and hope it will contribute to a better knowledge of developing country problems and a better understanding of differing points of view. But it is always good to remind ourselves of the eventual pitfalls of such a dialogue. Are the officials really listening to the arguments of their critics and considering them seriously? And, vice versa, are the critical observers really listening to the arguments of the officials?

To answer the last question first: Yes, I think the critics are listening to and carefully reading the officials’ arguments and documents – that is what they are doing all the time. The answer to the previous question, however, is less clear-cut. I would say, the answer is yes and no. Yes, because if the officials had not listened to their critics, it would be hard to imagine why they placed debt relief, poverty reduction and
shock prevention high on their agendas. And yes also, because from the moment that FONDAD started organising discussions between academics and policymakers and experts from developing and developed countries fifteen years ago, I have been witness to the seriousness, frankness and open-mindedness of these discussions – our books demonstrate this.

But maybe I should add a footnote here: the typical FONDAD dialogue has not been one between those who see themselves as the masters of wisdom (the officials) versus the nasty outsiders who blame them for all kinds of negative things (the critics). Rather, it has been a dialogue between those who are longing for new insights (the officials) and those who are keen on discussing their analyses and insights with the policymakers (the critical observers). Both groups have always enjoyed the opportunity of learning from each other, and the officials did certainly not see the critical observers as having less wisdom. On the contrary. Often they listened with great interest to the profound analyses and new ideas of the latter. Possibly this has also to do with the fact that quite a few of the critical observers have been officials themselves in previous jobs – as, for instance, the job histories of two contributors to this book, Ariel Buira and John Williamson exemplify – or still are, as the job histories of Stijn Claessens and José Antonio Ocampo illustrate.

Why then, is the answer also “no”? Mainly because I see that the policymakers of rich countries and the officials of global financial institutions have the natural tendency of looking for safety. So when they make public statements or give policy advice, after having listened carefully to critical analyses at FONDAD conferences or other meetings, they easily return to the habit of using the studies that support their policies, rather than those that are critical and suggest alternative policies. One reason for this is that they know it is difficult to get support for alternative policies from management and peer groups. Another is that they don’t want to be seen as supporters of outside views that are not shared by management.

So my experience has also been that officials, after an inspiring exchange of ideas, easily return to the daily routine of limiting their attention to the studies that confirm the views of their peers and superiors – staff reports and “conforming” academic studies. As one of my friends, after a couple of years of working at the World Bank, once jokingly (but with a certain bitterness) asked: “Do you know what IBRD stands for?” “Of course,” I answered, “International Bank for Reconstruction and Development.” “No,” he said, “International Bank
for Rewriting Drafts”. He had had to endlessly rewrite draft reports, until they finally fit into the management’s thinking.

I am not saying that official staff reports merely pay lip service to their masters. Nor am I saying that they do not provide useful insights. I am saying that staff reports are often less critical and contain less innovative ideas than they would if their authors had been stimulated to express themselves freely, without fear of being corrected by their superiors or, anticipating such correction, by exercising self-censorship.

Finally, another reason I think officials may tend not to consider seriously enough the arguments and proposals of critical observers, is that they know it is often not the quality of the ideas that count, but whether they serve certain interests. No matter how good the ideas of critics (and officials) may be, if they do not concur with the dominant views, they will simply be neglected or rejected.

With this sense of reality in mind, let us now look at some of the ideas presented in the chapters that follow.

Better Dealing With Shocks

In his chapter on “Policies to Reduce the Vulnerability of Low-Income Countries” (Chapter 2), John Williamson examines the nature of the balance of payments shocks that hit poor countries, discusses the possibilities of international action in order to reduce the impact of shocks on small developing countries, and suggests what developing countries can do for themselves to reduce their vulnerability to shocks.

Williamson starts by saying that the vulnerability to exogenous shocks has been “the perennial concern of low-income countries”. The best-known of these are terms of trade shocks, which stem primarily from variations in the prices of commodities that still form the staple exports of most low-income countries, but it may also come from variations in import prices (especially of oil). Output shocks, either caused by climatic abnormalities or by political developments (like revolutions or civil wars), have also been important in many countries. Hurricanes and other natural disasters can also cause significant macroeconomic damage in small countries, much of which takes the form of losses to the capital stock.

Before writing the chapter, Williamson’s impression was that interest rate shocks and shocks to the flow of capital would be less important,
“but so far as the flow of capital is concerned this turns out to be a misleading characterisation of the 1990s, and may be even less true in future”.

Williamson’s emphasises what the international community can do. He discusses three mechanisms that can be used to attenuate the impact of terms of trade shocks: (1) commodity stabilisation agreements, (2) a revived IMF’s Commodity Financing Facility, and (3) a HIPC contingency facility. He sees these as “three progressively less ambitious ways in which the international system could help its poorest members deal with shocks”.

Williamson also recommends what developing countries can do themselves to become more shock-resistant. He observes: “The most common problem is that countries run their economies without leaving the slack that is necessary if they are to react to shocks in a stabilising way. … In the best of worlds there is also going to be a role for better economic management.” In his view, countries could improve economic management in various ways. They should, for instance, apply fiscal policies that lower debt/GDP ratios during booms, so that they have the scope to finance borrowing in times of recession. They should also limit their borrowing to such levels that they can service even under unfavourable conditions. And they should borrow in domestic rather than foreign currency (following the “original sin” Eichengreen-Hausmann proposals) to prevent the problem of a so-called currency mismatch.

In Chapter 3, Dutch treasury general Kees van Dijkhuizen enthusiastically embraces Williamson’s notion that a developing country’s vulnerability also depends on its own economic policies. He stresses that these policies “should include structural measures, notably export diversification, but also monetary and fiscal policies as a kind of self-insurance”. He is, however, a bit sceptical about the desirability of the three international mechanisms proposed by Williamson and suggests as an alternative strategy a focus on the microeconomic level. “Governments can promote the development of a financial sector that offers all kinds of insurance or other market-based mechanisms to manage risks.” He also sees many problems with the Eichengreen-Hausmann proposals of lending in domestic currencies. Van Dijkhuizen concludes that through its traditional mechanisms of monitoring, policy advice and temporary finance, the IMF “can assist countries in better anticipating and responding to shocks”.

Matthew Martin and Hannah Bargawi (Chapter 4), who work closely with HIPC countries, turn their attention to how poor African countries
can be better protected against exogenous shocks. They stress that such shocks can reduce GDP by as much as 5 percent, thus causing “dramatic cuts in budget spending on the Millennium Development Goals”. They point to strong evidence that the income of the poor is hit even harder by shocks, “provoking a major setback to progress towards the MDGs”. They observe that even though recent IMF and World Bank Board papers have confirmed the need to avoid or mitigate the effects of shocks, both institutions have tightly limited their own proposed roles in this process. In the view of Martin and Bargawi, current international measures to deal with shocks “fall way short of the scale and frequency of shocks to which African economies are subjected”. They therefore examine in detail how Africa could be better protected against shocks.

The authors first provide an in-depth discussion of the many types of shocks that can be distinguished (predictable or non-predictable, input or output, temporary or permanent, etc.) and conclude that none of these distinctions should be used as an argument to withhold assistance. “If a country is making genuine efforts to promote economic development and reach the MDGs,” they say, “shocks should be foreseen and avoided – and if this is not possible, genuine unforeseeable ‘shocks’, especially those which impact on MDG progress, should be compensated regardless of their source, nature or duration.” Then they identify the key shocks to which African countries are subject, and which countries (especially HIPCs) are most sensitive to the different shocks identified. And finally, they propose a number of measures the international financial community can take, both in preventative and curative terms. The measures they suggest, are: (1) improving analysis to prevent shocks from occurring; (2) taking measures against individual types of shocks; and (3) taking comprehensive measures against Africa’s overall vulnerability to shocks.

With regard to the first measure, they spell out in considerable detail how the IMF and World Bank can improve their baseline forecasts and design comprehensive anti-shock plans. In their view, a “top priority” would be establishing fiscal contingency reserves in all low-income countries linked to the potential scale of shocks, just like such contingency reserves “are normal practice in developed economies, which are much less vulnerable to shocks”.

With regard to measures against individual types of shocks, they report that they can be dealt with in three ways: (1) risk management; (2) insuring low-income countries against shocks; and (3) automatic
adjustment to debt service. Given that these three ways only treat one of the symptoms of an external shock (a high debt burden), rather than its causes or its comprehensive impact, they argue strongly in favour of overall measures against shocks. “Given the frequency of multiple shocks hitting most African countries … the onus is on the official system to implement three main measures to offset and compensate for shocks.”

The first overall measure they propose is adjusting Poverty Reduction and Growth Facility (PRGF) programmes to shocks. The second is providing supplementary financing in the form of highly concessional loans, or preferably grants, as compensatory and contingency financing against shocks. And the third is building overall contingency mechanisms into adjustment programmes. They stress that such anti-shock financing would need to be set aside up front, “as genuine financing against contingencies, rather than after the shock when its negative effects on the economy have already been felt”.

Martin and Bargawi conclude that, “as African HIPC governments have themselves suggested,” there is no better use or higher priority for additional aid funds than immediate, low-cost contingency financing. “Together with measures to prevent shocks by better analysis and improved policymaking, and to offset or compensate specific types of shocks, this could guarantee Africa’s protection against shocks, ensuring that this key factor would no longer disrupt its progress towards the MDGs.”

In Chapter 5, G-24 Secretariat director Ariel Buira broadly agrees with the proposals by Williamson and Martin-Bargawi. He stresses, however, that Williamson’s domestic policy recommendations are easier formulated than applied. For example, Williamson’s recommendation that countries should aim for a redistribution of expenditures over time is difficult, says Buira. First, because capital inflows are pro-cyclical (borrowing increases in good times and falls in bad times), second, because fiscal policy is also pro-cyclical (government expenditure expands in good times and falls in bad times), third, because emerging market monetary policies tend to be pro-cyclical (expansionary in good times and restrictive in bad times), and, fourth, because capital inflows are associated with expansionary macroeconomic policies in good times, as are capital outflows with contractionary policies. “In these circumstances,” stresses Buira, “it is very difficult for countries to pursue counter-cyclical policies. Perhaps the Fund should help them do so, and perhaps they should try harder.”
Changing the Rules of Global Financial Governance

Chapters 6 and 7 of the book deal with the governance of the global financial system.

In their chapter on “The Need for Institutional Changes in the Global Financial System” (Chapter 6), Stijn Claessens and Geoffrey Underhill observe that despite many attempts at the international level to improve the functioning of the system, many developing countries still suffer from high external debt and insufficient development finance, creating “disappointment and scepticism among policymakers and citizens worldwide concerning the contribution of the international financial system to global development”. They advocate a change in the management of the global financial system that goes beyond the topics of immediate interest to policymakers – i.e. the latest financial crisis, the difficult private-public relationship in debt workouts, or the debt problems of low-income countries. Instead, they argue, “fundamental questions” of the nature of the governance of the international financial system need to be addressed.

Rethinking the governance of the international financial system, Claessens and Underhill discuss four sets of interrelated issues. First, how is today’s international financial system different from when it was put in place, and what issues in terms of governance do these changes raise? Second, how do these changes in both markets and governance affect the balance of power between public authorities and private interests in international monetary and financial policies? Third, are the current rules and institutions of the international financial system the right ones to address the global public policy issues and what sorts of changes in governance can be made to improve the international institutional framework, especially with regard to the global development process? And fourth, how might policy processes and institutions at the global level become more accountable and outcomes more legitimate in relation to the policy preferences of citizens of all economies, in particular of the developing world?

After an in-depth discussion of each of these four issues, Claessens and Underhill draw a number of tough conclusions. First, they stress that there is little doubt that the interests of developed countries predominate in current global financial governance processes, and that “private interests of developed country financial institutions are increasingly evident”. Private banks have played a major role in pushing for cross-border liberalisation in both developed and developing countries. In
this way, developing countries now face the power of both public and private agencies of developed countries, “often in coalition with each other”. “In many developing countries, foreign financial institutions from developed economies have had a large role in domestic financial markets and have been able to ‘threaten’ national agencies, thus gaining a stronger voice than the local constituents of the ‘public interest’ behind the national policy agenda.”

Second, they conclude that the failure to deliver on many of the goals set out by the international development community, the debt problems of low-income countries, the setbacks to the development process represented by persistent financial crises, and the continuing difficulties with debt workout and the crisis management framework, “all raise questions about the effectiveness and legitimacy of international financial governance”.

Third, they conclude that the serious deficiencies in the governance of the international financial system clearly point to the need for reform. “Fundamental issues of political economy are at stake: the role of publicly accountable institutions versus the private sector at both national and global levels; the balance of power between core and periphery countries in the global economy; the tensions between national (in particular developmental) and global system-level imperatives; the relative influence of citizens in national and world affairs; and the legitimacy of both national and global institutions. … Solutions will not be easy and may have to be found in building regional coalitions among developing countries and moving away from the assessment of policies by markets and international financial institutions.”

Maybe I should add here that it is remarkable that one of the authors, Stijn Claessens, reaches such strong conclusions since he worked with the World Bank for many years before he became a professor in international finance at the University of Amsterdam. When he started writing this paper with Geoffrey Underhill he was still a university professor, but when he presented it at the FONDAD conference, he had returned to the Bank. This corroborates my earlier point: if World Bank or IMF officials feel they can express themselves freely or are stimulated to do so, they have very interesting things to say. But it also corroborates another point I made earlier: generally speaking, officials do not seem to be encouraged to engage in such endeavour, or lack the interest, self-assuredness or courage to do so.

José Antonio Ocampo (Chapter 7) very much likes the Claessens-Underhill analysis and conclusions, and underlines that the developing
countries will only be able to change global financial governance if they organise themselves into an interest group. Ocampo observes: “Rather than accepting the current rules of the game, developing countries will have to play the game by identifying their collective interests and take these to the international organisations and, hopefully, also to the markets and say: These are the interests that we want to defend. The current international system will only be workable if it is based on stronger regionalism. A stronger regionalism is the only way to balance the huge asymmetries in power that we have in the system.”

Touching on other issues than those presented in the Claessens-Underhill chapter, Ocampo also discusses the so-called ownership issue, the streamlining of IMF conditionality, and the new fashion of rating developing countries by the quality of their institutions. Ocampo stresses that in all three cases it should be the countries themselves that determine what development strategies (ownership of programmes) and economic policies (conditionality) they want to follow, and how they want to improve their institutions. “Trying to build institutions through ranking countries and using that ranking for aid allocation purposes will lead to a loss of legitimacy rather than an improvement in the way of working,” says Ocampo.

The Future Role of the IMF in Low-Income Countries

In the last two chapters of the book the future role of the IMF in low-income countries is discussed. Even though this topic has already been treated extensively by a number of excellent experts (including Amar Bhattacharya, Graham Bird, Stijn Claessens, Louis Kasekende, Ron Keller, Matthew Martin and Mark Plant) in the previous Fondad book Helping the Poor: The IMF and Low-Income Countries, we thought it would be interesting to include two more chapters on this topic – which continues to be intensely debated – in this volume. One is written by Dutch officials and another by a critical Irish observer. The inclusion of these chapters not only provides the opportunity to report on the latest developments, but it also makes it possible to compare what these authors see as the main future challenges for the IMF and what the contributors to the previous volume saw as the main challenges. I will not make that comparison, but you may find it interesting to do so.

In Chapter 8, Dutch Finance Ministry official Ernst van Koesveld and colleagues examine what they see as the main challenges for the IMF.
The first challenge, in their view, is the Fund’s longer-term financial involvement in low-income countries and how a gradual exit to a surveillance-only relationship can be promoted. The second challenge is the role of the Fund in cases where financial assistance is not critical to alleviating balance of payments needs, but where involvement for signaling purposes is important. And the third is the Fund’s approach to debt relief and how debt sustainability can be promoted.

Discussing each of these challenges, Van Koesveld and colleagues observe that the longer-term relationship between the Fund and low-income countries should not be confused with a need for IMF financing being provided over longer periods. “An analysis of whether the economic problems in a country merit financial involvement of the Fund should be made at the end of each Fund programme and include a view on the (protracted) balance of payments need,” the authors stress. They therefore see the issues of “saying-no” and the design of proper “exit strategies” as one of the main future challenges of the IMF. Preventing the build-up of high debt levels in low-income countries is another pressing issue, they say. And third, they hope that the Fund will be able to shift from a direct role in financing balance of payments gaps to a more indirect role in catalysing other sources of funding by providing signals on the macroeconomic and financial developments in countries.

The authors conclude that the three challenges are closely interlinked. “If the Fund is better equipped to design and implement a gradual exit strategy, a country may be better able to shift from IMF financing to other, more concessional funding, which, in turn, reduces the build-up of new, possibly unsustainable debt. This process will be facilitated if the IMF can use the new Policy Support Instrument, providing a strong signal, also on debt sustainability, but without financing.”

Caoimhe de Barra (Chapter 9), the policy and advocacy coordinator of the Irish development NGO Trócaire, observes that in an era where “partnership” is the leitmotif of development discourse, “the IMF stands apart”. The IMF largely continues to talk to a limited group of officials in ministries of finance and central banks, she says. “Tortuous debate” on the role of the IMF in low-income countries has taken place at Board and staff level, and has been “at its most fundamental” when it was about whether the Fund’s role is to have a strictly bilateral relationship with member countries, focused only on macroeconomics, or whether it should position itself as part of a multilateral framework, “with a specialisation in macroeconomic stabilisation but a clearer focus on
poverty reduction”. De Barra examines the role of the Fund in poverty reduction in low-income countries and discusses some of the key issues in the Fund’s review of its role in low-income countries. The issues she reviews include: How should the Fund address poverty? What is its role in mobilising finance for development? What are the changes in policy and practice needed to IMF conditionality? What deeper changes are required in the Fund’s signaling role?

After a discussion of each of these issues, De Barra concludes that the IMF should engage in a partnership model for low-income countries, where the Fund plays an equal role with other donors and supporters of the development efforts of sovereign governments. “This is not an outlandish proposition,” she says, “but it might require an extraordinary effort from the Fund and its political principals to relinquish power, adopt a genuinely multilateral attitude and recast itself in the role of partner rather than macroeconomic master.”

Conclusion

This book is yet another contribution to a dialogue on international finance and development issues in which, as Caoimhe de Barra remarks, there are many partners. It is fashionable to stress that governments and citizens in developing countries should “own” the IMF and World Bank programmes they are engaged in. The following chapters show that while such ownership is indeed crucial, it is rarely put into practice or it is not put into practice in a way preferred by the governments and citizens of developing countries. As José Antonio Ocampo observes when he discusses the evaluations of poverty reduction programmes by the IMF and World Bank: “Ownership will start by evaluations being really done by countries – not by the IMF or the donors, or the World Bank, or the NGOs, but by country teams. That should be the framework for any evaluation”.

Protecting the poor and vulnerable in low-income countries means listening to the voice of the poor. In the chapters that follow, their voice is echoed by the agreement between both officials and observers that the volatility and suffering caused by exogenous shocks are among the pressing problems that the international community needs to address. There is less agreement on what exactly the rich countries and the international financial institutions should do to address these shocks, and if and how the governance of the global financial system should be improved. Nor is there full agreement on what the main
future challenges of the IMF in low-income countries will be. The
debate continues on all of these issues.

In my view, there is only one way that the dialogue between officials
and critical observers can deliver optimal results: serious consideration
of ideas that aim to resolve pressing economic problems and improve
the democratic decisionmaking in both national economies and the
global economic system. A prerequisite for such democratic decision-
making is that all stakeholders become involved and are well-informed.
The following pages not only contribute to enhancing the level of
information, but they also highlight the weak as well as the hot spots in
the current debate.
2

Policies to Reduce the Vulnerability of Low-Income Countries

John Williamson

A perennial concern of low-income countries has been their vulnerability to exogenous shocks. The best-known of these are terms of trade shocks, which stem primarily from variations in the prices of commodities that still form the staple exports of most low-income countries, but may also come from variations in import prices (especially of oil). Output shocks, either caused by climatic abnormalities or by political developments (like revolutions or civil wars), have also been important in many countries. Hurricanes can also cause macroeconomically-significant damage in small countries, much of which takes the form of losses to the capital stock. My impression was that interest rate shocks and shocks to the flow of capital tend to be less important than in middle-income countries, but so far as the flow of capital is concerned this turns out to be a misleading characterisation of the 1990s, and may be even less true in future.

But the reason that countries are vulnerable to shocks is not just because shocks happen: it is also a function of policy reactions. Perhaps the most common problem is that countries run their economies without leaving the slack that is necessary if they are to react to shocks in a stabilising way. Doubtless it would be preferable from the standpoint of developing countries to reduce their vulnerability by creating

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1 Revision of a paper presented to a conference organised by FONDAD in The Hague on 11-12 November 2004. The author is indebted to Jacob Kirkegaard for research assistance and to participants in the FONDAD conference for comments. Copyright Institute for International Economics: All rights reserved.
international mechanisms (like buffer stocks or a revival of the IMF’s Contingency Financing Facility or the Birdsall-Williamson contingency protection mechanism for HIPC countries) that would attenuate the impact of shocks on poor countries, but in the best of worlds there is also going to be a role for better economic management.

The chapter starts by examining the nature of the balance of payments shocks that hit poor countries. It proceeds to look at the possibilities of international action in order to reduce the impact of shocks on small developing countries. The final section focuses on what countries could do for themselves to reduce their vulnerability to shocks.

1 The Nature of Balance of Payments Shocks

Table 1 shows a measure of the relative size of four different shocks to the balance of payments outcomes of developing countries, disaggregated into low-income countries, small low-income countries (the former group excluding countries with a population above 100 million people), and middle-income countries. The boundary line between low- and middle-income countries is the standard World Bank dividing line of a per capita income below or above $735 per annum in 2002, with income converted at market exchange rates rather than PPP.

The measure of the shock is in principle the standard deviation of the dollar value of foreign exchange receipts or payments on the particular item in question, as a proportion of the standard deviation of the average of total current account imbalances. For interest payments and remittances this is straightforward. For capital flows one might ask what sense it makes to express the shocks relative to the size of shocks to the current account; the answer is that this is purely a normalisation, to be able to see how important these shocks are relative to other shocks. The terms of trade shock is more complex. What we did is take the World Bank’s World Development Indicators (WDI) figure for the terms of trade, which is the volume of imports that can be bought with a given volume of exports, expressed in constant local currency terms. This would be the same as the single factoral terms of trade if productivity in the export-producing industry were constant. That figure was converted into dollars by the IFS figure for the average annual dollar exchange rate during the year, and then its standard deviation was calculated. Unfortunately, this procedure produces nonsensical results for a few countries that suffered from hyperinflation.
at some time in the 1990s, presumably because the conversion to dollar terms can produce an answer that is enormously different to the correct one. The second half of Table 1 therefore shows the results excluding those cases in which the calculated standard deviation of the terms of trade exceeded 1,000 percent.

Each entry in the table therefore shows how important the item in question is in producing balance of payments shocks relative to shocks in the current account balance. For example, the table shows that for low-income countries shocks to interest payments average only 16 percent of the size of shocks to the current account balance, while shocks to remittances average 27 percent of the size of shocks to the current account. The dominant source of shocks to the current account turns out to be shocks to the terms of trade, as expected. However, shocks to capital flows are considerably more important, and turn out to be even larger than shocks to the current account. This fact surprised me in regard to the low-income countries (as it did some other participants in

### Table 1  Balance of Payment Shocks to Developing Countries 1990-2002 (Relative to Current Account Shocks)

<table>
<thead>
<tr>
<th>Country Group</th>
<th>Standard Deviation of Total Interest Payments</th>
<th>Standard Deviation of Remittances</th>
<th>Standard Deviation of Terms of Trade Shocks</th>
<th>Standard Deviation of Total Capital Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>LICs¹</td>
<td>16%</td>
<td>27%</td>
<td>120%</td>
<td>132%</td>
</tr>
<tr>
<td>Small LICs</td>
<td>16%</td>
<td>25%</td>
<td>128%</td>
<td>140%</td>
</tr>
<tr>
<td>MICs¹</td>
<td>21%</td>
<td>39%</td>
<td>3102%</td>
<td>116%</td>
</tr>
<tr>
<td>Excluding Outliers²:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LICs</td>
<td>14%</td>
<td>27%</td>
<td>67%</td>
<td>134%</td>
</tr>
<tr>
<td>Small LICs</td>
<td>15%</td>
<td>24%</td>
<td>69%</td>
<td>142%</td>
</tr>
<tr>
<td>MICs</td>
<td>20%</td>
<td>40%</td>
<td>44%</td>
<td>116%</td>
</tr>
</tbody>
</table>

**Sources:**
Terms of trade data from World Bank (2004a); current account data (BN.CAB.XOKA.CD), interest payment data (DT.INT.DECT.CD), remittances data (BX.TRF.PWKR.CD) and total capital flows data (DT.NFA.DLXF.CD) from World Bank (2004b); exchange rate data from IMF (2004).

**Notes:**
¹ LICs: low-income countries; MICs: middle-income countries.
² Outlier identified as having a terms of trade standard deviation denominated in dollar of more than 1,000% of the country’s current account balance. Following outliers excluded; Nicaragua (LIC), Zambia (LIC), Armenia (MIC), Brazil (MIC), Bulgaria (MIC) and Romania (MIC).
the conference) but not in regard to the middle-income countries. But it did not surprise Matthew Martin, whose work for the Commission for Africa (see Chapter 4) had also revealed much volatility in capital inflows – and especially in aid receipts – in low-income countries. Stijn Claessens suggested a possible reconciliation: that perhaps higher moments in the probability distribution than the second are indeed greater in middle-income countries, and perhaps it is these higher moments that are really important in inducing crises.

One might suspect that terms of trade shocks are larger in the small low-income countries than in the large ones, which export a wider variety of goods and therefore have more chance to diversify such variability away. The second row in Table 1 therefore shows the results excluding the large countries, defined as those with a population exceeding 100 million persons. The terms of trade effect is indeed marginally larger, although the results are in any event dominated by the large number of small countries. The result for the middle-income countries is dominated by the hyperinflation cases. After excluding these (the bottom section of the table), it can be seen that terms of trade shocks are much smaller for middle-income than for low-income countries. Indeed, terms of trade shocks are little bigger than shocks to remittances! While the low-income countries suffer rather more instability from capital flows than do middle-income countries (on the measure used), in the middle-income countries – unlike low-income countries – capital-flow instability is the dominant source of balance of payments shocks.

Shocks to the balance of payments are important because they feed through into shocks to the real economy. A loss in export revenue has a multiplier effect on domestic spending. It also causes a loss of tax revenue, often directly but in any event as a result of the slowdown in consumption. Any negative shock to the balance of payments gives a country less to spend abroad, which may result in the government being forced to further restrict demand. It may be able to avoid such a cutback in imports, by either running down the reserves or borrowing more. So a country faced by a negative shock to the balance of payments has a choice between accepting lower activity and more poverty and unemployment, or else seeing both domestic and foreign debt increase. I shall argue subsequently that a country can mitigate the impact of a negative payments shock, but that is by keeping enough reserves that it can afford to lose some and a low enough debt that it can afford to borrow more. In that case shocks will impact even more on debt levels.
2 Possibilities of International Action

Traditionally attention has been focused primarily on stabilising the prices of primary commodities. Variations in these prices are indeed the principal source of terms of trade variability, and as shown above therefore a major source of the exogenous shocks in small countries, so it is a natural reaction.

During the 1970s negotiations to establish a “new international economic order” included an attempt to establish a “common pool” to finance buffer stocks of the principal commodities entering world trade. Insofar as the price fluctuations of those commodities are less than perfectly correlated, a given level of assurance that the buffer stock will not run out of money can be provided with a lower cash outlay by financing the buffer stocks through a common pool rather than individually. Those negotiations ended in failure, and indeed those few buffer stocks that had survived up to the 1970s (like tin) subsequently collapsed. The idea of commodity price stabilisation has nowadays practically disappeared from the international agenda.

Perhaps we have gone too far in abandoning such ideas. Perhaps we have allowed ourselves to be too impressed by the fact that mistakes were surely made in running buffer stock schemes. It was surely a mistake, for example, to try to construct buffer stock mechanisms that would improve the sellers’ average sales price; or that would stabilise prices within a narrow range; or that would stabilise the price around an unchanging mean. Price stabilisation is something different to (and perhaps less difficult than) improving the sellers’ terms of trade, and a mechanism that is intended to stabilise prices should be strictly limited to that task. And it should be obvious that any attempt to stabilise price within a range narrower than that within which it is possible to make a reasonable estimate of the equilibrium price is doomed to failure. Moreover, new techniques and demands are liable to change the equilibrium price over time (just as new information may change our estimate of that equilibrium price), so that a failure to embody a feedback mechanism that changes the estimate of the equilibrium price in response to new facts and new information must doom a commodity stabilisation scheme to failure.

But suppose that the world learnt those lessons, and was suitably unambitious about what it asked of a new scheme. Specifically, consider the feasibility of stabilising the price of oil within a broad band, as has been urged by Fred Bergsten (2004). The argument is that
the price of oil is currently so high because there has been so little investment in the recent past, and that investment has been deterred by the fear of the price of oil collapsing again as it did in the late 1990s. A credible promise of the consumers to cooperate with the producers in preventing a new price collapse could, it is argued, induce a new wave of exploration and investment that would bring the price back down. Bergsten suggests a price zone of $15 to $25 a barrel; I suppose that my instincts would suggest a rather higher range, more like $20 to $30 a barrel initially. (Of course, the range might subsequently be changed, if evidence suggested that the equilibrium price lay outside the band.) The key questions are: What instruments would be potentially available to defend such a range? And: Would producers find the promise to deploy such instruments sufficiently credible to persuade them to change their investment policy accordingly? Obviously any such agreement that started under conditions such as those currently prevailing would not initially attempt to enforce the upper margin as a maximum; that would become feasible only as excess capacity was rebuilt.

Could one defend even the bottom of such a range, and how? To make a minimum price credible, which would be essential to it inducing more investment, one would want membership by all the main producing countries, including the non-OPEC ones, and the main consuming countries, especially those that have a policy of building up strategic stockpiles. The producing countries would have to commit themselves to constraining production in the event of the price threatening to fall through the price floor, to complement the restraint that OPEC tries to exert on its members. One would certainly want participation in such an arrangement by Canada, Mexico, Norway, and Russia, as well as OPEC, all of which would need to agree to cut back production to less than the nationally-optimal level in the eventuality of low prices. The cooperation of the importing countries would be necessary in the first place to give their blessing to such action by the exporting countries, since in the past some of them – most especially the United States – have been sharply critical of any action to restrain production in the interest of keeping prices up. Furthermore, however, those importing countries that manage a strategic stockpile would need to agree to vary the rate of addition to the stockpile with the deliberate objective of price stabilisation. At the very least, they should agree to suspend purchases at a time when the price of oil is being pushed up above the top of whatever price range were established. Conversely, they should be willing to accelerate stockpiling at a time such as 1999.
when an oil glut was pushing prices down below the bottom of the price range. The benefit of a successful oil price stabilisation scheme would be the avoidance of “oil shocks” to the world economy.

In one way it would be exceptionally difficult to stabilise the price of oil, because it would be unlikely that an international authority could be created in order to run a typical commodity stabilisation fund able to sell its holding to depress prices when the price threatened to rise to the top of its permitted range. Because of the strategic importance of oil, one would have to expect that the consuming countries would want to maintain control over the disposition of oil in reserves held on their nation’s territory, which would raise questions as to whether the international agency responsible would be free to sell at its discretion. On the other hand, the strategic importance of oil means that several of the major countries already have strategic reserves, whose rate of acquisition could in principle be varied in the interest of price stabilisation.

It would be simpler to build up internationally controlled stockpiles of most of the other main commodities, even though there would not be available the policy tool of varying the offtake into nationally-managed reserves. The main issues would, once again, be obtaining the finance to buy for the stockpile, and setting the price limits that would govern purchases and sales. In the first instance the stockpile would only be able to post a purchase price, since by hypothesis it would have nothing to sell. That purchase price might be set at, say, 20 percent below the central rate, which should be determined by a formula to ensure that it would respond to changes in the equilibrium price and that no attempt would be made to use it as an instrument for securing a secular improvement in the terms of trade of commodity exporters. The formula should be expressed in SDRs (so that changes in the value of the dollar did not distort real prices significantly) and might be, say, the average price of the commodity over the preceding ten years.

A buffer stock costs money. The question has to be asked whether it is a good use of resources to invest them in building up buffer stocks rather than investing elsewhere. The IMF seems to have decided that the interest and carrying costs of buffer stock schemes outweigh the benefits of price stabilisation. Kees van Dijkhuizen (see Chapter 3) points out that this scepticism had received powerful support from an IMF paper by Cashin, Liang, and Dermott (1999). Their analysis showed that in nearly two-thirds of major commodities (27 out of 44) the price shocks experienced over the 40-year period 1957-98 had lasted on average at least 5 years. Since one can only stabilise price
shocks that are temporary, this suggests that it would be uneconomic, or even impossible, to stabilise the prices of the majority of primary commodities. Thus this sort of scheme is at best one that might work only for a minority of primary commodities.

It was such scepticism which caused the international community, when such schemes were proposed in the 1960s, to create instead (in 1963) a mechanism that allowed a commodity exporting country hit by a terms of trade shock to borrow under a low-conditionality IMF facility, the Compensatory Financing Facility (CFF). This had the advantage of also covering shocks due to output declines, e.g. as a result of climatic factors or natural disasters, which are probably more often temporary than price declines. That Facility was progressively liberalised through the next 18 years, with a Buffer Stock Financing Facility being added in 1969, several liberalisations of access, and the addition of a right to draw in response to an excess in the cost of importing cereals in 1981. However, in 1983 the tide turned and access to the Facility started to be tightened. In 1988 a comprehensive restructuring of the Facility occurred. One element of this was addition of an External Contingency Mechanism (ECM), which added to what a country could draw under the Fund’s regular facilities if certain critical external variables (like export prices and interest rates) turned out to be less favourable to the borrowing country than had been assumed when its programme was drawn up. As a result, the facility was renamed the Compensatory and Contingency Financing Facility (CCFF). But other elements involved cutting back what a country was entitled to draw, and tightening the conditions, under the old compensatory programme. As Figure 1 shows, the net effect of the

![Figure 1: Compensatory and Contingency Financing Facility 1963-99](in millions of SDR)

Source: IMF data.
reforms was to accentuate the reduction in the use of the Facility that had occurred after 1983, interrupted only by a brief surge in use in 1991 as a result of the dislocations caused by the first Gulf War and a large drawing by Russia in 1998. Since 1988 the facility has remained largely unchanged, apart from elimination of the Buffer Stock Financing option and the ECM as a part of the Fund’s post-Asia crisis rationalisation.

The CFF is intended to allow a member country to borrow when it has a balance of payments need and suffers a temporary overall shortfall in the value of exports (or surge in the cost of cereal imports) as a result of factors beyond its control. The member country is required to cooperate with the Fund in resolving its payments problems, but since this phrase is not further defined it amounted in practice to low conditionality. A staff paper issued prior to the 2000 Board discussion of the Facility\(^2\) argued that there is no longer a strong rationale for the Facility. In almost all cases of a need for balance of payments financing, there is also a need for adjustment, which in the Fund view implies a need for high conditionality so as to give reasonable assurance that the required adjustment will actually occur. Second, most middle-income members have access to alternative (private) sources of finance. And third, most low-income countries cannot afford the relatively high interest rates of the CFF, and should instead borrow an increased sum from the highly concessional Poverty Reduction and Growth Facility intended for these countries.

I do not find all these arguments completely convincing. Most countries that have some balance of payments need also need some measure of adjustment: if they don’t, then surely they will find it easy to borrow from the private markets. A key question is whether one agrees that any country that ought to be adjusting also ought to borrow under high-conditionality facilities that give the Fund the right to supervise its adjustment programme. Most countries prefer to manage their own programme, without being “nannied” by the IMF. If they show themselves incapable of managing their own programme, then there is not much option but to bring in the IMF to supervise the adjustment programme, but one can wish for them to be given the benefit of the doubt initially. And even if a middle-income country

would be able to borrow from the private market, doesn’t international solidarity with a country hit by adverse circumstances beyond its control suggest that the international community can reasonably extend it credit on the mildly concessional terms inherent in a regular Fund programme? These arguments would suggest that the CFF should be restored to something like its former state so far as middle-income countries are concerned.

The Fund’s argument is more persuasive where the low-income countries are concerned. It does indeed seem desirable to give them credit on the highly-concessional terms of the PRGF. Admittedly some of us think it would be logical to make the interest charge a country pays dependent on the identity of the borrower rather than the identity of the Facility from which it borrows, but if that is unacceptable to the Fund’s accountant then the solution may be to augment a PRGF loan when an exogenous shock hits. It was suggested by several participants in the FONDAD conference that one advantage of this is that it would permit bilateral donors with grant funds available to buy out such loans, thus combining relatively prompt action by the IMF with grant aid (which most donors can provide only with a lag) in response to a negative exogenous shock. Perhaps the most contentious issue will be whether any such “shocks window” within the PRGF will be subject to high or low conditionality. As with middle-income countries, I favour starting off with low conditionality and tightening this only if the country is failing to adjust.

Another possible mechanism for giving poor countries some protection against exogenous shocks was proposed by Nancy Birdsall and John Williamson (2002) in our study of debt relief. While rejecting the idea of 100 percent debt cancellation for the group of countries that were already in the HIPC Initiative, we suggested three ways in which that initiative could be expanded. One of these was to legislate a ceiling of 2 percent of GDP on the sum that any HIPC should pay in debt service: if it looked to be in danger of breaching that ceiling, additional debt should be forgiven so as to eliminate the possibility. It is not clear, however, that any HIPCs still remain in danger of breaching that ceiling. A second extension was to expand the country eligibility to all poor countries,\(^3\) which meant in practice to allow large countries like Indonesia, Nigeria, and Pakistan to become eligible. It seems that

\(^3\) I.e. those with average income below the IDA threshold then at $735 per annum at market exchange rates.
Indonesia and Pakistan are coping fine without debt forgiveness, but Nigeria is another matter and clearly ought to be allowed to become eligible for HIPC relief. The third proposed extension is the one that is of relevance in this context, since it proposed a contingency mechanism to help countries hit by adverse shocks.

The aim of the HIPC Initiative was to ensure that any qualifying country should have its debt reduced to less than 150 percent of exports, on the argument that history showed that most countries were capable of carrying that much debt, but not too much more, without undermining their ability to manage their economy. To try and ensure that a qualifying country would be in that situation for some years after reaching Decision Point, joint teams from the IMF and World Bank projected key variables like debt, GDP, and exports for 15 years from the base date. These projections, especially for the growth of exports, were widely held to be on the optimistic side. If that is correct – and the number of countries that were forced to take advantage of the possibility of taking an extra bite at the cherry of debt relief between Decision Point and Completion Point suggests that it was – this would imply that many countries are liable to find themselves over-indebted again before many years.

The usual conclusion that has been drawn from this analysis is that indebted countries need more debt relief than they were provided under the HIPC Initiative. We suggested, however, that it would be a more efficient use of resources to provide more debt relief in those specific instances where events showed there to be a need for more relief, rather than universally. In order to avoid distorting incentives, it is important that this relief should be given only where a country suffered an increase in its debt/export ratio as a result of circumstances beyond its control. Similarly, to leave an incentive for export diversification one wants to make this extension of the existing “topping-up” provision of finite duration; we suggested ten years. The programme might be administered by requiring the IFIs agreeing on a HIPC programme to state their assumptions about the price trend of important commodity exports; if a programme country subsequently suffered an export shortfall that could be attributed to a below-projected trend price to an extent that threatened to push debt/exports above 150 percent, it should be entitled to compensation to pay down its debt.

Who would administer such a programme and where would its money come from? We envisaged the IMF as the administrator, for two reasons. First, the IMF has had the experience of administering the
CFF over the years, which has given it expertise – or at least agreement on a set of conventions – needed to estimate whether export shortfalls can be attributed to circumstances beyond a country’s control. Second, the IMF has a potential source of the finance that would be needed to run such a facility. Specifically, we suggested using some of the IMF’s stock of redundant gold, which is presently carried on the IMF’s books at a fraction of the current free market price of gold, for this purpose. It has to be admitted that the authors were not in full agreement on how the IMF’s gold should be mobilised for this purpose: one of us believed in the straightforward technique of selling the stuff, while the other was happy to contemplate a repeat of the financial shenanigans that were used to mobilise part of the IMF’s gold stock in 1999. This involved increasing the price at which a part of the gold was carried on the IMF’s books, and using the increase in the Fund’s net worth to forgive some part of its debts from the HIPCs. (The problem with this technique is that it eats into the Fund’s free currency resources, since some of these are used to pay off the HIPC’s creditors, raising the possibility that to keep the Fund liquid the industrial countries will in due course have to supply it with more resources.)

While economic shocks will never disappear, terms of trade shocks are a sufficiently regular part of economic life that one would have thought that it ought to be possible to attenuate their impact on the poorest countries. That the international community could do a good deal more than it currently does is strongly suggested by one example that Ariel Buira drew to our attention at the conference: the experience of Greece. Here is a country with weak fundamentals that has nevertheless not suffered crises at the hands of the financial markets, presumably because it was assumed that the EU would come to its rescue if necessary. Commodity stabilisation funds, a reinvigorated CFF, and a contingency fund for the HIPCs are three progressively less ambitious ways in which the international system could help its poorest members deal with shocks, if it so chose.

Several participants in the conference also argued that low-income countries could do a fair amount to protect themselves against such shocks, by taking advantage of the risk-sharing techniques already present in financial markets. Producers of primary commodities can, for example, sell their crops forward at planting time (well, the producers of annual crops can, even if those of tree crops cannot). Most producers can buy insurance against climatic disasters. The World Bank is beginning to help low-income countries to access such
facilities. A new study of mine (Williamson, 2005) advocates a number of these techniques, including the sale of growth-linked bonds by sovereign debtors. There is surely scope for a number of these techniques to help, though it is doubtful whether they should displace the mechanisms previously discussed.

3 Domestic Policies for Curbing the Impact of Shocks

While many shocks are external in origin, they have usually had such devastating effects on developing countries because of the policies that these countries have chosen to pursue. Four main lines of policy are at fault. First, countries have often been unable to adopt counter-cyclical fiscal policies designed to prop up demand in the face of a shock because they have more or less exhausted their borrowing possibilities during the good times. It is easy for a country to find itself in this situation because a country’s credit ceiling may well be lowered when it encounters difficulties. So unless it has used the good times to run surpluses and work down the debt/GDP ratio it may easily find it impractical to borrow more under bad conditions. Second, many countries have chosen to use the exchange rate as a nominal anchor in order to reduce inflation when the international capital market was willing to lend freely, and have then found themselves defending an overvalued exchange rate when a sudden stop sets in. Third, countries have borrowed internationally up to the hilt when the opportunity arose, thus building up excessive debt, often of short maturity, in the good times. Fourth, many of those debts have been expressed in foreign rather than domestic currency, thus resulting in a large increase in indebtedness when it was necessary to devalue the national currency.

Reducing the vulnerability of developing countries to adverse shocks means changing these four patterns of behaviour. I propose to discuss them sequentially.

3.1 Fiscal Policy

Standard Keynesian analysis argues that countries should run budget deficits so as to keep activity up when the economy is tending toward recession, and surpluses in the good times. In practice, most developing countries have the fiscal space to run deficits in bad times only if they have previously gone out of their way to run surpluses so as to reduce
the debt/GDP ratio to a level that will not frighten creditors from buying more assets when the economy is in recession. Counter-cyclical policy in developing countries has to start in the boom. (While any country with a non-independent central bank could order the central bank to buy more government debt, this is likely to feed rapidly through into inflation in the absence of a willingness of the public to buy additional interest-bearing debt.) Some might question whether this does not make a counter-cyclical fiscal policy excessively costly, for it implies that a country will have to forego investment and consumption during the boom if it is to be in a position to expand spending during a recession. But what is necessary to run a counter-cyclical policy is a redistribution of spending through time rather than a reduction in the average level of spending. On the contrary, if the policy is successful it will keep production up during the recession and thus increase rather than reduce the average level of spending.

It has been claimed that pro-cyclical fiscal policies may be optimal (Talvi and Vegh, 2000). The logic is that budget surpluses create politically irresistible pressures for increased public spending, combined with the belief that it is economically preferable to cut taxes and thus allow the private sector to spend extra money rather than channel it into inferior public expenditures. However, this is not really a ground for saying that optimal fiscal policy is pro-cyclical so much as to say that the second-best tax policy, given the political unsustainable of budget surpluses, is to cut taxes during booms and thus pre-empt an increase of public expenditure that would otherwise occur.

Keynes got it right: optimal fiscal policy involves a counter-cyclical fiscal policy, running budget surpluses in good times and deficits in bad times. Lags in the operation of fiscal policy may make this difficult even if the government is well-motivated and not subject to populist political pressures of the Talvi-Vegh type. But this does not mean that all thought of a counter-cyclical policy should be abandoned, it simply means that reliance should be placed on the automatic fiscal stabilisers rather than discretionary policy, which is indeed the main mechanism for anti-cyclical fiscal policy in developed countries. Of course, even that may not be possible until a period of fiscal surpluses has strengthened debt positions so that governments can afford to run deficits in bad times without provoking an excessive rise in interest rates. But a fiscal policy that gave unfettered play to the automatic stabilisers would be a vast improvement over the current tendency to cut spending during the recession and cut taxes during the boom. And the automatic
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stabilisers would be enhanced if governments aimed to build up social safety nets over time, as one expects to happen as countries modernise.

What can be done to shift policy in that direction, recognising that the problem is essentially one of political economy? The first step is to recognise, publicly and explicitly, what is desirable. This means not just enunciating the desirability of a counter-cyclical policy, but also a target for the average fiscal balance over the cycle. A natural candidate for this role is the so-called Golden Rule of public finance: at least balance the revenue budget over the cycle, so that debt increases only to the extent that the public sector is building up assets on the other side of the balance sheet. (Naturally these should be assets with a yield at least as high as the interest rate that the government incurs on the liabilities it issues to finance this investment.) If the government starts off with debts that are too large to permit it to run a counter-cyclical policy, then the target for the structural budget surplus should initially be larger than the Golden Rule so as to bring the debt/GDP ratio down over time. (This is the policy that several emerging markets, like Brazil, Jamaica, and Turkey, already seem to have adopted. An obstacle to low-income countries following their lead is the predilection of donors for seeing their money spent on hard projects. Donors need to learn to give programme aid and to like seeing it used to build up contingency reserves and run down debt.) Once such rules had been adopted, those who wished to splurge during a boom would clearly face the onus of making their case. Could one go further in a democracy?

In a recent publication (Kuczynski and Williamson, 2003, especially chapter 4), we argued that it might be possible to create political reinforcement for a prudent counter-cyclical fiscal policy by designing a mechanism for regional peer monitoring of fiscal obligations. The rules might be those spelt out above. The problem would be to find a suitable organisation to undertake the monitoring and apply the peer pressure. It would need to be an organisation that was felt to be under the control of the debtors rather than their creditors: one of the regional development banks rather than the World Bank, for example. It would need to command the technical expertise to give it credibility. None of the existing international organisations seem completely appropriate for the task, but the regional development banks might be

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4 The idea was inspired by the European Growth and Stability Pact, though that is not to endorse the rather primitive (and in some circumstances procyclical) specific rules embodied in that pact.
the most promising place to build the technical expertise that would be needed.

3.2 Exchange Rate Policy

Numerous crises have in the past been sparked by the attempt to hold a fixed exchange rate, especially in recent years when a country had decided to treat a fixed (or predetermined) exchange rate as its nominal anchor. However, those days appear to be over. Nowadays most of the larger countries have adopted a floating exchange rate, and even though they have not abjured all thought of intervention as the purists might hope, the danger of their being forced into offering a one-way bet to the market has vanished. Some of the smaller countries have taken the ultimate step of dollarisation: whatever one may think about the wisdom of this, it at least precludes an exchange rate crisis. Thus this issue no longer has the salience it used to.

3.3 International Borrowing

For some years the flow of financial capital to emerging markets has been highly volatile (see Table 1 above), and these variations have been the principal cause of strong cyclical fluctuations in the middle-income countries. Financial markets generate powerful forces, arising from the incentive that remuneration practices create for managers not to stray far from the market benchmark, plus the fact that a creditworthy borrower is one to whom others are willing to lend, which tend to explain why these variations have been so strong. Moreover, since there is no reason to believe that these forces are being undermined, strong fluctuations in the desire to lend seem likely to persist in future. This suggests that, if the flow of finance is to be stabilised, it will have to occur as a result of changes in the behaviour of borrowers. Since it is impractical to borrow more than the lenders are willing to lend, change will have to result from greater restraint by borrowers when the markets are pushing money at emerging markets.

The public sector can directly control its own borrowing (which in the past was often a major part of the problem). A country that follows the rules for fiscal discipline that were discussed above would find its own borrowing needs were limited. There is also the question of where such borrowing should occur, at home or abroad. In the past many countries have borrowed on the world market and therefore in foreign
currency, partly because this was almost always cheaper (in the sense of requiring a lower interest rate) and usually easier, and partly because they needed the foreign exchange that borrowing on the world market would bring in. However, it will be argued below that there is a good case for terminating borrowing in foreign currency, and that borrowing should be done on the domestic market in domestic currency. Most emerging markets now have domestic bond markets where this would be possible, and of course some foreign funds would be likely to flow in over the exchanges in order to buy debt so this does not amount to refusing to tap the international capital market.

Borrowing by the private sector is not subject to direct policy control in the same way. If a government wishes to limit private borrowing during a boom, then it will have to use capital controls or some substitute, such as a tax, an encaje, or increased reserve requirements on the banking system. The most desirable of the options is a tax or an encaje: they are relatively non-distortive, market-friendly, comparatively difficult to evade, and avoid penalising domestic financial intermediation as an incidental by-product of discouraging capital inflows.

The international community needs to make a collective decision as to what attitude to take to the use of encajes or substitute mechanisms. It looks as though there is a danger of their being ruled out of court as a result of a unilateral decision of a single country to pressure other countries one at a time into excluding their future use. If other countries wish to avoid this, then they need to raise that issue as a policy matter in an appropriate international forum. The IMF is the obvious candidate.

3.4 Currency Denomination

When most emerging markets raise a loan abroad, it is almost always denominated in foreign currency, typically dollars. Implying a belief that these countries have no other way of borrowing abroad, Ricardo Hausmann has dubbed this phenomenon “original sin” (see, for example, Eichengreen and Hausmann, 2003). Most developed countries, like a few emerging markets (such as South Africa and India), borrow primarily in domestic currency, but they do this by floating

\[5\] I refer to the US decision to force the countries with which it has signed bilateral free trade agreements, Chile and Singapore, to virtually renounce use of capital controls even in self-defense during a foreign exchange crisis.
bonds in their domestic markets and allowing foreigners to buy some of them. An increasing number of emerging markets have been adopting a similar path in recent years.

However, when a developing country borrows in dollars (or allows a significant volume of domestic loans to be denominated in dollars) it is liable to create a “currency mismatch” (Goldstein and Turner, 2004). That is, either the financial intermediary that takes a dollar loan and lends in local currency, or the corporation that borrows in dollars and has local currency receipts, acquires a balance sheet that is unbalanced in its currency assets and liabilities. If the corporation is selling abroad then it has some element of a natural hedge, although even then this need not be a very good hedge unless sales are overwhelmingly in the dollar bloc rather than to a diversified world market.

The consequence of this practice is to add an important element of instability to the economies that engage in currency mismatching. In particular, currency devaluation results in an increase in the burden of debt relative to debt servicing capacity. Since currency devaluation is part of the normal and efficient reaction to a wide range of adverse shocks, this results in an increased burden of debt servicing at the worst possible time.

The reason that the practice arose is that foreign lenders were reluctant to lend in a currency that would enable the borrower to inflate away its debts, especially since many of the countries appeared all too willing to resort to inflation in times of difficulty. An obvious solution is to index debt instruments to the country’s own price level, which prevents the issuing country inflating away its debt, unless it is also able and willing to fiddle its statistics, which is normally possible only within rather narrow limits. Unfortunately, financial markets are characteristically conservative, and therefore suspicious of innovative solutions, such as those that would help an economy to function reasonably efficiently despite the absence of assured price stability. Indexation preserves the basic advantage of domestic currency debt: the burden of debt service is eroded, rather than increased, by (real) depreciation. In this crucial way indexation is very different to denomination in dollars. It is only to the extent that the depreciation feeds through into inflation that the lender is protected, but this is sufficient to protect lenders from what really matters, the ability of the debtor to arbitrarily expropriate the wealth of creditors.

One of the major sources of currency mismatch has traditionally been the lending of the multilateral development banks (MDBs), since
these have mostly made loans denominated in dollars. Eichengreen and Hausmann (2003) have argued that it does not have to be this way, and have proposed an ingenious scheme to permit official debt to the MDBs to be transformed into indexed domestic currency debt. The specifics of their proposal were oriented to the World Bank, which they proposed should issue bonds denominated in a basket of indexed emerging market currencies, for sale to international investors (who are known as “Belgian dentists” in the trade). The World Bank would avoid exposure to currency risk by making indexed loans to the countries whose currencies compose the basket, in the same proportions as constitute the basket. Kees van Dijkhuizen raises the issue of how the MDBs would maintain matching assets and liabilities, given that one would want to fix the composition of the currency basket so as to enhance the liquidity of assets denominated in it (see Chapter 3). His own suggestion is that the MDBs might use such bonds for only a part of their portfolios, and keep some debt denominated in foreign currency. An alternative possibility might be for the MDB to cover a part of its liabilities on the forward market, so as to maintain a balanced book.

Another perennial worry about this proposal is whether a basket of emerging market currencies would be sufficiently stable to attract “Belgian dentists”, given that a crisis in one emerging market often spills over into others so that a number of their currencies depreciate simultaneously. This is in fact a question that Eichengreen and Hausmann asked themselves, and they performed what seems to me to be the appropriate test: they ran a simulation of how such baskets would have behaved based on past experience. They concluded that such a basket would have been no more unstable in terms of the dollar than major international currencies like the euro or Swiss franc in which it is perfectly possible to denominate loans.

Emerging markets also sell many bonds to international investors, borrow from international banks, and so on. Governments could start to transform that debt also: partly into assets like the growth-linked bonds referred to earlier, and partly into indexed local currency debt. Investors would doubtless demand a higher real interest rate \textit{ex ante} for holding such debt, but it would be worthwhile for governments to pay

\footnote{Let me make it clear that I am not endorsing the Eichengreen-Hausmann thesis that foreign currency borrowing is unavoidable, but simply their proposal for eliminating the use of foreign currencies in denoting MDB loans.}
a higher real interest rate because of the better risk-sharing characteristics of such debts. And initially investors might refuse to hold long-dated debt, so that any gain in avoiding currency mismatching would be offset by a loss in increased maturity mismatching. One would hope that this would prove an infant-market problem: insofar as investors are better placed to carry these risks than are the governments of the borrowing countries, there would eventually be a real social gain in shifting from foreign currency denominated debt to indexed domestic debt.

It is conceivable that the emergence of a market in government bonds denominated in domestic currency would stimulate an equivalent market for private debt. However, it might also be that such a market – especially for non-indexed debt, as would be needed for the short-term paper that is much more important in private borrowing – would require some additional incentive. If so, a natural instrument would be differential tax rates, in which a tax surcharge would be applied to the interest payments, and/or the interest receipts, on loans denominated in foreign currency. Such a surcharge might be increased gradually to create pressure for a progressive but non-traumatic shift of debt obligations from foreign to domestic currency.

4 Concluding Remarks

Developing countries, and particularly low-income countries, are subject to important shocks emanating from exogenous variations in their balance of payments. Various mechanisms might be used by the international community to attenuate the impact of terms of trade shocks, and three, of progressively diminishing scope, have been examined in this chapter: commodity stabilisation agreements, the revival of the IMF’s Commodity Financing Facility, and a HIPC contingency facility. Any such agreements should be complemented and supplemented by a conduct of macroeconomic policy on the part of developing countries that would enable them to limit the impact of shocks on their economies. Fiscal policy should aim to lower debt/GDP ratios during booms so that countries have the scope to finance borrowing in time of recession. Exchange rates should be maintained at a competitive level rather than used as a nominal anchor. Countries should limit their borrowing to levels that they can service even under unfavourable conditions. And they should borrow in domestic rather than foreign currency and in growth-linked bonds.
References


Insurance as a Tool to Reduce Vulnerabilities

Kees van Dijkhuizen

John Williamson’s excellent chapter addresses one of the core tasks of the Fund. There are various views on the role of the IMF in low-income countries, but there should be little doubt that the Fund has an important role to play when it comes to shocks that result in severe balance of payments problems. Taking the Fund’s Articles of Agreement, this role is at least two-fold. First of all, it includes monitoring economic developments and providing policy advice on how to better prepare for shocks and how to respond once a shock hits. Second, the Fund is to provide countries with resources to correct balance of payments problems without taking measures destructive of national or international prosperity. This rightly puts a shock for one country in a global perspective.

Unfortunately, many shocks are exogenous, that is, beyond the control of a country’s authorities. Although shocks may be exogenous, they are no surprise. We know for a fact that the average low-income country has a major natural disaster every 2½ years and experiences a commodity price shock every 3½ years. As such, it is not beyond, but within the control of a country to anticipate to a shock in order to mitigate its impact. I therefore fully agree with Williamson’s notion that a country’s vulnerability is a function of both the occurrence of shocks and the quality of its policy reactions. I also generally agree with what seems to be a core element in his proposals, that is: matching, for example matching good times with bad times.

1 Special thanks go to Ernst van Koesveld. The usual institutional disclaimer applies.
Insurance Through the Market?

Let me now comment on a number of Williamson’s thought-provoking ideas. His first proposal is to have a fresh look at international commodity stabilisation agreements, especially for non-oil commodities. I have three observations.

First, I agree that many stabilisation schemes in the past had too many objectives. This is contrary to the well-known rule of the first Nobel Prize winner for economics, Jan Tinbergen, implying that one instrument should be employed to reach one goal. Arrangements did not only aim at stable prices, but also at reasonable prices, guaranteeing incomes, protecting vested interests, and so on.

Second, stabilisation schemes not only require excellent early detection systems and timely public interventions, but they also presuppose strong political commitment to save the surpluses in good times to use them in bad times. But from the Nobel Prize winners Kydland and Prescott we have learned that this idea of intertemporal matching bumps into time-consistency problems. Are politicians able to withstand popular pressure and to stick to the rules?

Third, the success of stabilisation schemes hinges on the assumption that the price shock is temporary and will revert itself in the short run. In other words, counter-cyclical interventions require the existence of a cycle in order to smooth prices over time. However, (IMF) research indicates that taking a forty-year period (1957-98), shocks took more than 5 years or were even permanent for two-thirds of all major commodities, i.e. 27 out of 44 (Paul Cashin et al., 1999). The actual lack of matching opportunities over time seems to be the main reason why the various international agreements, for example for sugar, tin and coffee, turned out to be financially unsustainable and broke down. Of course, it is hard to predict the duration of an adverse price shock, but wouldn’t it be wise to err on the side of caution and to focus on adjustment towards export diversification rather than to set up new large-scale stabilisation schemes?

An alternative strategy would be to focus on the micro-level: governments can promote the development of a financial sector that offers all kinds of insurance or other market-based mechanisms to manage risks (microfinance, catastrophe bonds, forward contracts, etc.). Rather than technical constraints, the thin financial markets constitute the main
problem in low-income countries in this respect. During 1985-2000, for example, less than 1 percent of low-income countries’ total losses from natural disasters were covered by insurance. It is estimated that less than 2 percent of the volume of futures and options instruments can be attributed to developing countries (IMF, 2003).

Therefore, advice from international organisations, especially the Fund and the Bank, bilateral donors, and commercial banks will be crucial. In this respect, it is worth mentioning the recently created the Netherlands Financial Sector Development Cooperation, being a concrete example of a public-private cooperation aimed at promoting financial sector development in emerging market economies, transition countries and low-income countries. It is supported by three ministries (Finance, Development Cooperation, Economic Affairs) and four major commercial banks and the FMO (Finance for Development Organisation).³

More specifically, the World Food Programme (WFP) has started an interesting pilot in this area. The objective of the pilot is to contribute to an ex ante risk-management system to protect the livelihoods of Ethiopians vulnerable to severe and catastrophic weather risks. The pilot uses a weather derivative to demonstrate the feasibility of establishing contingency funding for an effective response in the event of low precipitation. The WFP will buy an insurance policy that pays out when the rainfall in Ethiopia is below a certain level. In years of good or mediocre rainfall, the WFP will pay interest, out of its income from donors, but when drought comes, bondholders will lose their principals. Should disaster strike, the WFP will have ready cash to support farmers. This scheme should be up and running by 2007. Similar activities are part of the Commodity Risk Management (CRM) initiative of the World Bank with financial support of a number of donors (Panos Varangis et al., 2004).

Insurance By the IMF?

This brings me to the second of Williamson’s proposals, which relates to the Fund’s role of providing financial assistance. He proposes to restore the Compensatory Financing Facility (CFF), the Fund’s anti-shock facility, in its earlier form in order to facilitate its use. The economic literature seems to make a reasonably strong case for the principle of

³ See www.nfx.nl for an overview of FMO’s activities.
Insurance as a Tool to Reduce Vulnerabilities

providing external finance to help support domestic absorption of a temporary shock and to support policy reforms to smooth adjustment to more permanent shocks. Apart from the technical complication how to distinguish between the temporary and permanent shocks, as noted earlier, practice is understandably more nuanced. Even in the case of a clearly permanent shock, temporary financing may be warranted to smooth the adjustment path to the new equilibrium, as noted in the Fund’s Articles. I expect that in most cases addressing the shock requires both financing and adjustment. The obvious route would then be to augment existing PRGF arrangements, preferably with only marginally increasing conditionality. Since the start of the ESAF and PRGF, one out of four arrangements has been augmented, with an average augmentation of nearly 1 percent of GDP. In 2004, the IMF also decided that either a new PRGF or an augmentation of an existing PRGF could be justified when a country is hit by a shock resulting from a multilateral trade agreement. In my view, this move is welcome and consistent with another purpose in the Fund’s Articles, namely to facilitate the expansion of international trade – in fact, a third reason why the Fund has an important role to play in relation to shocks. More recently, the Fund introduced a new shock facility for low-income countries that do not yet or no longer have a Fund arrangement. It will be important that the actual use of this facility should meet the same criteria as normal PRGF programmes. This will avoid inefficient facility-shopping by members and promote equal treatment.

The practice of the next years will show whether there is still a rationale for a CFF for low-income countries. Let me nevertheless make three other comments on the CFF. First, it might be worthwhile to consider reintroducing an oil-import element, which was added temporarily from November 1990 to December 1991 when oil prices rose sharply as a result of the first Gulf War. Second, a good thing of the CFF is that its eligibility criteria explicitly include that the shortfall should be temporary by calculating the deviation from the trend over a five-year period. Third, the criteria require that the shortfall should be beyond a country’s control. This mitigates what is called the Samaritan’s dilemma: governments may have less incentive to undertake structural reforms when they expect the Fund, with the multilateral and bilateral donors in its wake, to come to their rescue. In addition to addressing the humanitarian needs, it is important that these extra funds are effectively put into use to reduce vulnerability for the medium term. As with all kinds of insurance, moral hazard needs to be minimised.
Insurance Through Further Debt Relief?

Avoiding the Samaritan’s dilemma is also an important element in the Birdsall-Williamson proposal to compensate HIPC countries for exogenous shocks that push their debt burden again above the HIPC norm. In my view, the proposal comes close to what is now happening under the name of topping up, the costs of which are part of the overall HIPC Initiative. Moreover, this exercise is largely, if not fully, overtaken by the recent initiative for multilateral debt relief, as discussed by Brilman, Jansen and Van Koesveld in this volume. Additional debt relief will enlarge a country’s fiscal space to reach the MDGs and comes down to a form of budget support. Finally, for the post-HIPC situation as well as other low-income countries, we should in principle apply the new and forward-looking debt sustainability framework that is being developed by the Fund and the Bank. This framework is meant to prevent debt crises, notably by providing grants, rather than to solve them ex post.

Possibilities for Self-Insurance?

The Samaritan’s dilemma also brings us back to the notion that a country’s vulnerability is a function of both the occurrence of shocks and its own policies. These policies should include structural measures, notably export diversification, but also monetary and fiscal policies as a kind of self-insurance. Regarding fiscal policies, Williamson got inspired by the European Stability and Growth Pact, especially by its peer monitoring mechanism. As part of strengthening and clarifying the Pact, it has been decided to pay more attention to the extent to which countries can and should match good and bad times over the economic cycle. Second, the logic of the Golden Rule is intuitively appealing, as it should safeguard investments during economic downturns. This touches on the new discussion in the Fund and the Bank on what is called creating fiscal space for public investment. A focus on the current balance, however, guarantees neither macroeconomic stability nor debt sustainability, not to mention the quality of investment. At least, the Golden Rule should be accompanied by a debt rule, like in the UK. Additional debt may be compensated by an increase in assets, but we should note that debts are certain, while the value of assets will only be known in the future. In this sense, the Golden Rule may in fact run the risk of creating another kind of balance sheet mismatch. I prefer that investment expenditures are an integral part of the budget and overall priority-setting.
Insurance Through Currency Matching?

The last and potentially most promising idea is Williamson’s support of the Eichengreen-Hausmann proposal. It intends to solve the so-called *original sin*, implying that developing countries are hardly able to borrow in their own currencies, which results in a currency mismatch problem. I have a number of general observations. First, an important issue is the question of whether the new bonds issued by the multilateral banks will gain the interest of private investors. The answer probably depends on the risk and return characteristics of the newly created bond. It seems likely that the required return on new bonds probably has to exceed the return on US dollar bonds in order for investors to buy them. As a consequence, the interest rate that multilateral banks will require for local currency loans to developing countries will also be higher than on dollar loans. This implies a trade-off for governments: either they borrow in their own currency and pay a somewhat higher interest rate or they maintain their exposure to exchange rate depreciations with large potential consequences for financial stability in the long run. The viability of the Eichengreen-Hausmann proposal therefore depends on the question of whether risk-return features can be such that both the lenders and the borrowers of funds will be willing to participate in this new market. Does a basket of developing countries’ currencies provide sufficient opportunities for risk sharing? Recent history has shown that in times of financial distress, developing countries’ exchange rates not seldomly tend to move in the same direction. The transmission of exchange rate shocks throughout the Asian crisis countries and the devaluation of the Brazilian real following the Russian crisis are merely examples of the many episodes in which exchange rate shocks in one or more countries have jumped over to other countries. This limits the degree to which a basket of currencies provides risk-sharing opportunities.

A second and more practical question is how the multilateral banks will maintain the matching of assets and liabilities. To assure a liquid market, it seems preferable to fix the composition of the basket of currencies. But then the portfolio of outstanding loans to developing countries on the asset side should also have a fixed composition in order to assure the matching of assets and liabilities. This implies strict constraints on the provision of loans by the multilateral banks, which seems very undesirable. Indeed, lending policies should be based on countries’ performance and opportunities rather than the banks’ portfolio considerations. This argument does not deny the possibility that the multilateral
banks start with adopting the proposal for only part of their portfolios. For developing countries themselves, keeping some debt denominated in foreign currency would have the advantage of keeping the discipline not to engage in competitive devaluations. Third, Hausmann and Eichengreen propose to use inflation-indexed loans to remove any perverse incentives for governments for creating excessive inflation. The question is which inflation index should be used. To fully eliminate the moral hazard problem, the inflation index should be composed or at least checked by an institution that is independent of all the stakeholders involved. A good starting point could be to include only those developing countries that comply with the Special Data Dissemination Standard (SDDS), which is part of the Fund’s surveillance tool kit.

It seems that this proposal, too, brings us back to the role of the IMF with regard to shocks in developing countries. Through monitoring, policy advice and temporary finance the Fund can assist countries in better anticipating and responding to shocks. John Williamson has put on the table a number of very stimulating proposals to reduce the vulnerability of developing countries. The bottom-line seems to be that when we cannot escape bad luck, we should at least ensure that it is matched by good policies and good instruments! Most of his proposals rightly comprise an element of softening fluctuations over time by a kind of matching or insurance. Since this is the core business of both public and especially private banks and insurance companies, it seems natural that they are closely involved. In my view, this avenue is very much worth exploring further. I am pleased to note that the Fund and especially the Bank have taken up this important challenge as part of their work programmes.

References

For Africa’s future and the reaching of the Millennium Development Goals (MDGs), it is vital to analyse the issue of how to protect the continent against exogenous “shocks”, that is, events beyond the control of African governments. African countries, especially low-income countries, are highly vulnerable to shocks. These may impact directly on the balance of payments – notably exports (commodity price changes, drought and floods) – or the budget – notably budget revenue (import duty shortfalls, devaluation); or less directly by increasing balance of payments or budget financing needs (import price increases, notably for food and petroleum; and erratic donor aid flows). Such shocks can reduce GDP by as much as 5 percent, and cause dramatic cuts in budget spending on the Millennium Development Goals. There is also strong evidence that the income of the poor is hit even harder by shocks, provoking a major setback to progress towards the MDGs. In recent years, the HIPC Debt Relief Initiative has also emphasised the vulnerability of Africa’s debt sustainability to external shocks.

Effective protection against the impact of shocks would therefore be a highly worthwhile investment for international financing and policy.

1 Revision of a paper prepared for the Commission for Africa
2 For more detailed information on the implementation and architecture of an anti-shocks facility and case study evidence of the impact of exogenous shocks in low-income countries, see DRI’s forthcoming report prepared for DFID entitled “Investigation into the International Architecture for Economic Shocks Financing”.
3 Of course, many African countries are frequently subject to shocks arising from conflict and other political factors, which will also make their debt less sustainable, but these are not considered in detail in this chapter.
supporting and encouraging good economic management. Yet it has long been established that the international community is bad at protecting against shocks. African countries and the international financial system have devoted insufficient attention to avoiding the occurrence of shocks through better forecasting and policies, and to counteracting them rapidly with funding that is predictable, sufficient, cheap and free from excessive conditionality.

Recent IMF and World Bank Board papers have highlighted the need to avoid or mitigate the effects of shocks, but have tightly limited their own proposed roles in this process. The IMF (IMF, 2003a and 2004) indicates that it should be responsible only for adjusting macroeconomic policy to prevent and offset shocks, for signaling the existence of a shock, and through providing very limited extra finance by augmenting Poverty Reduction and Growth Facility (PRGF) loans. The World Bank (World Bank, 2004) sees its role as helping with anti-shock structural policies, signaling financing needs to offset a shock, catalysing donor support, and providing limited extra finance by augmenting Poverty Reduction Support Credit (PRSC) loans. The EU is the other main multilateral institution tasked with offsetting shocks but its FLEX (Fluctuation of Export) scheme, though a vast improvement on the earlier STABEX, has provided very little finance during 2000-03.

All of these measures fall way short of the scale and frequency of shocks to which African economies are subjected. In the context of a potential major increase in global grant flows linked to the Monterrey commitments and the International Financing Facility, it is urgent to examine how Africa could be better protected against shocks. In this chapter we will: (i) define what is meant by shocks; (ii) identify the key shocks to which African countries are subject, and which countries (especially HIPCs) are most sensitive to the different shocks identified; (iii) propose possible solutions open to the international financial community, in both preventative and curative terms. The remaining sections of this chapter deal with each issue in turn.

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5 In 2000, the FLEX scheme, the EU instrument to compensate African, Caribbean and Pacific (ACP) countries for short-term fluctuations in export earnings replaced STABEX (Stabilisation of Export Earnings), established in 1975 under the first Lomé Agreement to stabilise ACP countries’ agricultural export revenues.
1 Defining Shocks

What exactly is a “shock”? It is best defined as an event which impacts unexpectedly on an African economy, and which is “exogenous” – beyond the control of the government to prevent – though, as this chapter will show, neither the unexpected nature nor the lack of government control are inevitable. Shocks can be divided in the following categories:

- shocks to international commodity prices (to commodity exports or imports), market conditions, or access to trade partner markets, which can cut exports (and export-related budget revenue) or increase import cost, and cut export-related external financing;
- natural disasters such as earthquakes, cyclones, drought, floods or locust plagues (and diseases hitting crop production), which can hit GDP, exports, budget revenue and food production (increasing import needs), and force increases in budget expenditure;
- conflict-related shocks, notably the negative effects of conflict in a neighbouring country, the impact of terrorist attacks, which can causes extra budget costs for security and refugees, or undermine tourism revenues and related budget taxes;
- global financial market shocks leading to outflows of foreign private capital, either directly for countries which receive large amounts of such capital, or through contagion from neighbouring countries or large regional economic powers, which can provoke domestic financial crises;
- shocks to international interest or exchange rates which can increase debt burdens and destabilise foreign private capital flows, or cut investment returns on reserves;
- shortfalls in external aid flows which can lead to foreign exchange and budget shortfalls;
- shocks of sudden human diseases (e.g. SARS) which can hit tourist revenues;
- changes in host country policies for migrant labour, which can cut remittances.

It is crucial to distinguish between true exogenous shocks and “non-shocks” which are no less important but require different solutions.

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6 This chapter does not discuss positive shocks, because analysis indicates that they have little effect on long-term growth or poverty reduction (see World Bank, 2004).
“Non-shocks” include:

(a) Predictable trends or repeated events at a national, regional or international level. Among the obvious national examples are: repeated droughts, creeping desertification and depletion of water tables to which all Sahelian countries have been subject for more than 20 years; gradual depletion of resources or increases in extraction costs that reduce mineral or timber exports; routine aid shortfalls of disbursements due to disbursement problems; and health epidemics, notably HIV/AIDS, tuberculosis, etc.

International examples include: price falls when many countries increase exports of a commodity simultaneously in the absence of any world demand increase; the secular downward trend in global commodity prices which is now universally acknowledged to have occurred during the last 30 years; commodity – and market-specific factors (for example in bauxite for Guinea and Guyana, phosphates for Togo, and uranium for Niger) which make prospects for traditional exports more bleak than based on global market analysis; changes in regional or global trade policy that lead to reductions in tariff revenues, or in exports due to ending of trade preferences; changes in global climate (e.g. global warming and the impact of El Niño).

(b) Miscalculations of the effects of policy changes. Good examples of these have been: dramatic underestimations of the negative effects on budget revenues of tariff reductions due to regional or international agreements; overprojections of the revenue collections resulting from tax reforms; and overprojections of the positive effects of efforts to liberalise or diversify exports. To these should be added the “shocks” caused by misdesign or misimplementation of policies which produce what seem like perverse “shock” effects (when with more adaptation of policies to the recipient economy, such effects could have been foreseen).8

A large number of “shocks” would therefore not be shocks if more reliable and less optimistic analysis were undertaken before projections

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7 According to commodity market analysts, commodities subject to fallacy of composition and the African low-income countries they affect include: cocoa (Côte d’Ivoire, Ghana, Sierra Leone, São Tomé); coffee (Burundi, Cameroon, Côte d’Ivoire, Ethiopia, Kenya, Madagascar, Rwanda, São Tomé, Sierra Leone, Tanzania, Togo, Uganda); cotton (Benin, Burkina, CAR, Cameroon, Chad, Mozambique, Mali, Senegal, Sudan, Togo and Uganda); gold (Ghana, Mali and Tanzania); and tea (Burundi, Kenya, Malawi, Rwanda, Tanzania and Uganda).

8 These issues have been extensively treated elsewhere: see Killick (1984), Martin (1991), Martin and Mistry (1992).
were made. Many previous authors – including the Bretton Woods institutions (BWIs) – have indicated systematic tendencies to over-optimism in the projections underlying BWI programmes, whether due to optimism over effects of policies in the country, or to over-optimism about global economic trends. With more realistic projections, based on probability and frequency analysis of volatility in key variables, and properly calibrated vulnerability indices, most shocks would disappear from future programmes. However, more “realistic” projections might also carry the risk of reducing projected growth rates up front, and therefore abandoning the MDGs entirely. The aim of “realism” should be to integrate potential shocks into projections, and make sure that growth rates in non-shock years are raised even higher to ensure the attainment of the MDGs even including shocks.

Some would like to define very narrowly the types of shocks against which the international community should take action. They argue that some types of shocks (e.g. commodity price falls, oil price rises) are more valid (because less within the control of government) than others (such as aid shortfalls or domestic financial crises), since the latter can be influenced by recipient government policies. They also argue that shocks are only “real” shocks if they persist over longer periods (e.g. 3-year averages); otherwise, they would not be valid for compensation or for changing adjustment programme targets.

However, more recent analysis shows that it is relatively easy to separate the impact of the exogenous shock – for example, the proportion of aid shortfalls that are due to donor policy and procedural problems, and the scale of domestic financial crisis provoked by other exogenous shocks. It also shows that even short shocks can have persistent long-term effects on growth and poverty.

Others have highlighted a need to distinguish between input shocks (e.g. lack of rain, producing drought) and output shocks (e.g. effect on GDP or exports), and that the two do not always correlate. However, in low-income countries, which are much less resilient in the face of shocks, input shocks almost entirely transform themselves into output shocks, so the distinction is unnecessary.

The largest long-running debate is over whether temporary or permanent shocks should be compensated. Some feel temporary shocks
make the strongest case for compensation, because with rapid financing a country can move back to the correct long-term path immediately; others prefer to compensate permanent shocks, arguing that a country can more easily adjust to temporary shocks and needs more compensation for long-term shocks. However, more recently (IMF, 2004a; World Bank, 2004) the BWIs have acknowledged that even apparently “temporary” shocks will have permanent negative effects; and that there are massive returns from financing against permanent shocks to replace lost capital stock, smooth national adjustment to the new economic situation, or maintain the incomes of the poor. As a result, there appears to be equal support for funding temporary and permanent shocks.

Finally, it is suggested that some shocks are extremely difficult to separate from policy errors, and that providing financing to offset their effects runs a risk of moral hazard. Governments would make less short-term effort to overcome shocks, or less long-term policy measures (e.g. export diversification) that reduce the impact of shocks. This has been true of some past financing mechanisms (e.g. EU STABEX) in which finance was focused on increasing production of the commodity which had received the shock. However, it is now acknowledged that it is very easy to design financial support to avoid such moral hazards and that governments focus more on short-term rather than long-term anti-shock measures because they lack the financing to do both.

This chapter treats all limitations of and distinctions among shocks as spurious. If a country is making genuine efforts to promote economic development and reach the MDGs, shocks should be foreseen and avoided – and if this is not possible, genuine unforeseeable “shocks”, especially those which impact on MDG progress, should be compensated regardless of their source, nature or duration.¹¹

2 Identifying Africa’s Shocks

To prioritise solutions, we need to know which shocks are most important for Africa overall, and which African countries have been most subject to certain types of shocks, so that we can identify the need for solutions to specific or overall vulnerability. In this section we identify: (i) the key shocks that hit Africa, (ii) their impact, and (iii) their probability.

¹¹ This argument could also be applied to domestically-sourced shocks, which are not covered in this chapter.
Table 1  Indicators of Vulnerability by Type of Shock

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**Notes:**

1. Aid: ♦ represents dependency of 10% or more of GDP; volatility ♣ is where the GNP ratio has a standard deviation of 20% or over.
2. Climate: ◆ refers to drought, !!! refers to heavy rains or floods, @ represents a cyclone, ♣ represents locusts and ≡ represents earthquakes.
3. Exports: x refers to export concentration (where commodity provides over 50% of export revenues); ♣ is for countries with a standard deviation of export levels of over 20%; ◆ refers to sudden declines in tourist revenues; R refers to shocks due to shortfalls in migrant worker remittances.
4. Imports: d refers to import dependence (imports to GDP ratio of 30% or over); ♣ is for countries with a standard deviation of import levels of over 20%.
5. Reserves: c refers to import coverage (international reserves under 4 months of imports of goods & services); ♣ is where standard deviation of import coverage is 20% or over.
6. Conflict: N represents a country affected by a neighbouring conflict; ♣ represent a country with its own internal conflict/severe political instability or war.
2.1 Which Shocks Hit Africa?

Table 1 presents in summary form indicators of potential vulnerability of African countries to shocks, as well as the shocks to which they have been subject in the last ten years. It shows:

- **Very high prevalence of natural disasters**: at least 44 countries have suffered natural disasters in the last ten years, including 34 suffering from various types of drought, 22 from other climate shocks (floods, cyclones or hurricanes), 11 from locusts and 3 from earthquakes.\(^\text{12}\)

- **High aid dependency and volatility**: 28 African countries (including 25 HIPCs) are potentially vulnerable to aid shocks, as measured by aid dependency (aid/GNP ratio over 10 percent). In addition, aid flows have been highly volatile, with a mean standard deviation for African HIPCs of 38 percent, and 29 countries suffering a standard deviation over 20 percent in the last ten years. All but 5 of the 34 African HIPCs for which data are available have a standard deviation of aid flows which exceeds 20 percent, and for 12 it exceeds 40 percent. Other analysis (Arellano, 2002; Bulir and Hamann, 2001) as well as almost all ESAF/PRGF Board papers refer to considerable aid shortfalls each year compared to programmed amounts, as one of the most persistent shocks blowing programmes off course. Johnson *et al.* (2004) indicates that aid can frequently fall short of projections by as much as 25-30 percent, with budget support being more volatile but project support falling more consistently short, due to over-optimism about donor pledges being turned into actual disbursements, underestimating delays caused by donor or recipient policies or procedures.

- **High export concentration and volatility**: 24 countries are very vulnerable to export shocks, depending on one commodity for more than 50 percent of export revenues, and within this depending on between 1 and 3 products for more than 70 percent of export revenues.\(^\text{13}\) In addition, African HIPCs have a very high export volatility: standard deviation as a percentage of the mean level averages 23 percent, and exceeds 20 percent for 20 of 34 African HIPCs. Moreover, 10 countries have suffered important shocks to tourist revenues; and 8 to worker remittances. PRGF programme documents also indicate

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\(^\text{12}\) High prevalence of natural disasters is in line with the findings of IMF (2004) and UNDP (2004).

\(^\text{13}\) Export concentration also makes countries more vulnerable to imposition of trade barriers by partners.
persistent shortfalls of exports compared to projections, particularly for non-traditional exports.

- **High import dependence and volatility**: African HIPCs are also highly dependent on imports, with a mean import/GDP ratio of 35 percent and 33 (including 19 HIPCs) having import/GDP ratios exceeding 30 percent, indicating high potential vulnerability to shocks. However, African HIPCs’ imports have been considerably less volatile than exports and aid flows, with mean standard deviation of only 18 percent, and only 12 countries with a standard deviation over 20 percent. Most countries are particularly dependent on food and fuel imports, which are generally the least elastic and flexible types of imports and therefore most subject to international price shocks. Food accounts for more than 20 percent of imports in 15 African HIPCs, and fuel for more than 20 percent in seven African HIPCs. According to PRGF Board papers, the vast majority of HIPCs have also been subject to import excesses over projections. This has been particularly true for oil imports since 1999, given international price rises, but also for wider imports due to over-optimism about their impact on reducing import demand through devaluation or domestic production of alternatives.

- **High prevalence of war and conflict**: no fewer than 26 countries have had their own internal conflicts or been involved in regional conflicts, and 15 have had to cope with severe negative impacts from conflicts in neighbouring countries.\(^\text{14}\)

- **Foreign private capital crises**: another area of persistent shortfalls for almost all countries has been foreign private capital (FDI, portfolio investment, and private sector debt). Data on these flows are very poor in African countries, but at least 13 countries – as well as the whole CFA franc zone before the devaluation in 1994 – have suffered major crises related to surges and slumps of foreign private capital in the last ten years, with particularly severe examples in Ghana, Zambia and Zimbabwe (see also Bhinda et al., 1999; Martin and Rose-Innes, 2004).

Overall, it seems that the most serious shocks for Africa are natural disasters, aid flows, exports, imports and conflict, but most African countries suffer multiple shocks – more than 46 have suffered at least three types – and all have suffered at least one type during the last 10 years.

\(^{14}\) For a good example of analysis of the impact of neighbouring conflict, see Dore et al. (2003).
2.2 The Impact of Shocks

In principle, shocks can impact on the whole economy (GDP), or just one sector or region. Natural disasters and conflict tend to impact economy-wide. However, the other shocks discussed above have their immediate impact on the balance of payments.\textsuperscript{15} For example, the main shocks that impact on exports of goods and services are: price shocks which reduce export earnings; climatic, disease or other shocks to export production; shocks such as tourism, war or disease that disrupt tourism earnings; and changes in host country policies that reduce worker remittances.

In addition, most of the above balance of payments shocks will have two wider impacts. First, they commonly provoke devaluation (if the exchange rate is flexible) unless immediately offset by inflows of external finance. In turn, this devaluation causes problems elsewhere, including inflation, and higher external debt service in domestic currency or budget revenue terms. Second, they will reduce foreign exchange reserves. Reserves have been highly volatile for African HIPC\textsc{'}s, with mean standard deviation exceeding 47 percent of average levels, and exceeding 20 percent for all but two countries. PRGF documents also indicate that most countries have been failing to meet programmed reserves targets, usually due to foreign exchange shortfalls reflecting other external shocks.

The level of reserves measured in months of imports is also commonly used as an indicator of vulnerability to shocks, with a usual objective of having 4-6 months of import coverage. Most African low-income countries have very low reserves: 30 countries have less than 4 months of imports of goods and services, and only six countries reach 6 months.\textsuperscript{16}

However, shocks can also have a major indirect impact on other sectors, of which the most important one is the fiscal sector. Typical impacts are lower budget revenues due to cuts in export (including tourism) or import taxes and related VAT; higher expenditures to combat the impact of shocks (especially natural disasters); lower (especially capital) expenditures if the shocks are not offset by additional financing, or if aid shortfalls lead to cuts in spending. However, the usual impact is pro-cyclical – i.e. cuts in expenditures and revenues

\textsuperscript{15} For more details, see Martin and Alami (2001).

\textsuperscript{16} This presentation probably understates vulnerability because IMF programmes now normally measure reserves in months of the following year\textquoteleft s imports of goods and services.
during negative shocks. In addition, countries tend to try to finance additional expenditures (or offset other shortfalls) by borrowing externally or domestically. This is usually because countries have no fiscal contingency reserve or “fiscal space” to absorb the impact of shocks.

Shocks can also make debt unsustainable. This reflects their impact on the denominators of debt sustainability ratios – exports of goods and services and budget revenue. Shocks can impact on almost every line item of the balance of payments and the budget, thereby increasing financing gaps. Insofar as these gaps are filled by additional borrowing rather than grants, this will also raise debt ratios above sustainable levels.

Shocks also cause major uncertainty in both private and public sectors. This tends to reduce long-term savings and investment plans among all major domestic and foreign actors. Shocks also tend to have major long-term and cumulative effects on the economy. Commodity price shocks tend to be especially “persistent” – they reach their maximum negative effect after 4 years and low-income economies take 5 years to overcome around 50 percent of their effects (see World Bank, 2004). Shocks also have almost irreversible effects such as falls in human capital (deaths), large capital outflows, credit crunches and permanent unemployment.

The most important impact of shocks is on poverty. All of the shocks described above will reduce scope for poverty reduction – for example, by decreasing smallholder export earnings, by reducing imports of goods or aid flows destined for poverty reduction, and by reducing budget expenditure on poverty reduction. A large amount of recent analysis has demonstrated that many different types of shocks – including financial crises – have a dramatic impact on increasing poverty, reversing trends towards the MDGs. The precise impact depends on the degree of prior poverty and on the effectiveness of the national and international counter-measures, but in low-income countries high poverty and lack of adequate safety nets, external reserves cushions or internal stabilisation mechanisms exacerbate the impact. The poor tend to suffer much more during crises, because they lack assets or credit to protect themselves from income falls and unemployment, they are less mobile than the wealthy due to lack of education, skills and health, and they lose sources of income such as transfers from wealthier relatives or communities, or from government, in part because their “voice” is weak. As a result, every 1 percent decline in growth can increase the proportion of the

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17 See Agenor (2001); Aizenman and Pinto (2004); Cline (2002); Lustig (2000); and World Bank (2000).
population in absolute poverty by as much as 2 percent.

In addition, Agenor and Lustig have also argued convincingly that the poor also tend to benefit much less from post-shock recoveries, because shocks cause irreversible damage to their investment in human (education, health, and nutrition) and physical capital. The poor are also constrained in their efforts to get out of poverty by their extreme worry about the risks of future shocks. This makes “economic insecurity” rank very high in their own participatory assessments of factors causing poverty, and leads the poor to invest less for the long-term. As a result, shocks can have a permanent effect of increasing poverty.

Due to the absence of reliable costings for MDG expenditures or country-by-country analysis of the impact of shocks on poverty, it is not possible to quantify the potential impact of shocks on poverty reduction in Africa. However, recent analysis (IMF, 2004a) has indicated that shocks occur at least once every 1.4 years for the average low-income country, and have an average magnitude of 4.25 percent of GDP.\(^{18}\) The UN calculated that to attain the MDGs, countries need 7 percent GDP growth (12 African HIPC s have estimated that the growth rate they need is closer to 6.3 percent), and the average growth rate currently being projected in IMF PRGF programmes in Africa is 5 percent. The impact of shocks would halve the progress to the MDGs, even if governments target 7 percent growth initially. However, given current PRGF projections, which themselves fall short of MDG needs by one-third, shocks could lead to a 75 percent shortfall in the growth needed to reach the MDGs. There is also strong evidence that shocks have a more long-term “drag” effect on economic growth (e.g. Chauvet and Guillaumont, 2001; Collier and Dehn, 2001; Guillaumont and Combes, 2002), and the frequency and severity of shocks for low-income countries has been growing. These factors mean that the above reduction of growth due to shocks is a considerable underestimate.

Analysis of the potential impact of shocks on the long-term path to the MDGs in each African country should be a top priority. Every PRGF Board Paper should ideally contain a 20-year projection of the path to the MDGs and the associated financing which is necessary, and of the key shocks which could derail such progress.

\(^{18}\)This figure represents a combination of natural disasters that occur every 2.5 years with an average impact of 5% of GDP, and commodity shocks which occur every 3.3 years with an average impact of 3.5% of GDP. It does not take into account other types of shocks – notably aid shortfalls and conflict.
2.3 How Likely Are Future Shocks?

To assess the likelihood of future “s hocks” for each country, we have used two methods: (i) recent growth rates in key variables compared to projected trends in HIPC Debt Sustainability Analyses (DSAs). Of course, it is true that past rates might not be repeated in future, where they were due to policy slippages or domestic political/conflict-related events. However, where they were due to commodity prices, climatic events or aid/import shortfalls, there is every reason to believe that past trends might well continue; and (ii) sensitivity assumptions made by HIPC governments, the IMF and World Bank in HIPC DSAs. 19

Recent and Projected Trends

Recent export and GDP growth rates compared to projected trends in the DSAs indicate that projected GDP growth rates are higher than recent averages in all but five cases. 20 The most dramatic increases are for Angola, Central African Republic (CAR), Chad, Côte d’Ivoire, Ethiopia and Madagascar – but most of these large differences are explained by recovery from civil conflict or expansion of petroleum exports. However, the vast majority of countries have projected GDP growth rates well in excess of recent levels, and the overall difference in the recent and projected averages is 2.2 percent. 21 The other striking feature of the projections is the similarity of the GDP growth rates for most countries at between 4 percent and 6 percent. As already discussed above, 5 percent is the minimum real growth needed to make any difference to poverty levels (even though falling some way short of growth rates needed to halve poverty by 2015 in most countries). Therefore the question should be not, how can we make projections more realistic (i.e. bring them down to match past levels), but how can we change policy to increase growth dramatically?

The relationship between historical and projected growth rates for

19 Countries not covered due to lack of a DSA are: Burundi, Comoros, Liberia, Somalia and Sudan.
20 Unfortunately, due to lack of medium-term projections for other variables in DSAs, this analysis has had to be limited to GDP and exports.
21 We also tested periods such as the last five or three years, in order to take into account the fact that many HIPCs have started adjustment programmes only recently, but these made no substantial difference to the growth rates or the conclusion that projected growth rates are much higher than historical rates.
exports is only slightly more balanced, with 24 of 34 countries having projected export growth rates above recent trends, compared to only 10 which are lower. However, the average difference between recent and projected growth rates is much larger than for GDP, at 4.7 percent. The widest disparity and the greatest potential vulnerability to shocks are for 12 countries where projected growth rates are more than 5 percent higher than recent results (Burkina Faso, CAR, Chad, Comoros, the Gambia, Ghana, Madagascar, Mauritania, Niger, Sierra Leone, Togo and Uganda).

In sum, if we expect historical trends to continue, then many countries are likely to be exposed to substantial “shocks” on both GDP and exports. While it is possible to make reasonable arguments that projected trends might be realistic if countries avoid policy slippage and domestically-generated shocks, the scale of rises projected in many countries makes this argument seem much less plausible, raising major worries over whether African HIPCs will reach their GDP growth and poverty reduction targets by 2015.

Potential Shocks Projected in DSAs

A second potential measure of shocks can be derived from sensitivity assumptions about shocks considered likely in HIPC DSAs. Some of these shocks are broadly similar to those forecast by African HIPCs in their own national Debt Strategy Reports compiled with assistance from the HIPC Debt Strategy and Analysis Capacity-Building Programme, for example identifying areas of vulnerability such as commodity prices, drought or aid. Nevertheless, four key characteristics emerge from comparing the types of shocks in sensitivity analysis in DSAs, with those in African government debt service reduction options (DSRs):

- the negative shocks assumed in national DSRs are generally larger than those in DSAs. This is because countries analyse in detail the past effects of shocks on the economy. In contrast, shocks assumed in DSAs are frequently small – limited in many cases to export growth rates which are 2 percent lower (and well above historical trends). Almost all African HIPCs feel that the scale of downside risk assessed in the DSAs is not large enough;
- the shocks calculated in the DSRs are generally fed through and

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analysed for all of their primary (and in some cases secondary) impacts on the balance of payments and budget, therefore producing additional financing gaps, which will also increase debt. In contrast, many tripartite DSAs adjust one line item of the balance of payments or budget and recalculate financing gaps accordingly, without looking at the potential effects of a shock on GDP, and other elements of the balance of payments or budget. African HIPC ministers have often expressed the view that the effects of shocks should be analysed more comprehensively;

- DSAs take virtually no account of potential shocks to the budget. Only one country’s DSA looked at a potential revenue shock, while all DSRs examine alternative revenue shortfalls, particularly related to regional trade liberalisation or slower GDP growth rates. Most DSAs maintain exchange rates at current levels, while DSRs in countries with floating exchange rates tend to adjust exchange rates downwards on a purchasing power parity basis. HIPC ministers have also frequently urged greater attention to potential revenue shocks;
- DSRs take much more frequent account of climate shocks. DSAs included them only for Mali and Mozambique, though Section 2.1 above showed 28 African HIPCs have had recent climate shocks;
- DSAs tend to project one shock at a time, whereas Section 2.1 showed that HIPCs are vulnerable to multiple different shocks.

Overall, which countries are the most vulnerable to shocks? Judging by the scale of impact of the DSA shocks on PV/export ratios: Burkina Faso, DR Congo, Congo Republic, Mauritania, Mozambique, São Tomé and Zambia are the most vulnerable over the medium term (5 to 10 years). The pessimism of the tripartite DSAs might perhaps also be judged by the number of downside risks analysed (though this may simply reflect the amount of time devoted by missions). On this basis, Chad, Ethiopia, Kenya, Mauritania and Senegal might be seen to be more vulnerable.

Obviously, this analysis assumes that national PRSPs and PRGF documents are taking into account all of the "non-shocks" discussed in Section 1 above. Yet this is definitely not the case – apart from a few notable exceptions such as HIV/AIDS in Zambia or bleak prospects for uranium in Niger, occasional analysis of possible aid shortfalls, and somewhat more systematic analysis of the impact of regional trade liberalisation or ending of trade preferences. In particular, most projections in DSAs make highly optimistic assumptions about flows of FDI and other private capital to Africa.
3 Solutions

Based on the above analysis, African governments have been subject to considerable shocks in recent years and are likely to be subject to large shocks in the ten years through to 2015. If nothing is done, such shocks could reduce forecast growth rates by 50 percent, and lead cumulative growth over the 15 years to fall 75 percent short of the level needed to halve Africa’s poverty.

What can be done to prevent such shocks or to offset them if they occur? There are three types of measures: (i) improving analysis to prevent shocks from occurring; (ii) taking measures against individual types of shocks; and (iii) taking comprehensive measures against Africa’s overall vulnerability to shocks.

3.1 Analysing and Preventing Shocks

One fundamental way to prevent shocks is to remove all which are not really shocks. This can be achieved by improving the methodology used in baseline economic projections:

• improve the analytical base of baseline forecasts by enhancing baseline data availability and reliability, notably on imports, aid and private capital flows, by disaggregating projections more, and by analysing historical trends and their causes as the basis for future projections;
• adjust baseline forecasts downwards to include largely predictable events at national, regional or international levels, such as repeated climatic shocks, resource depletion, climate change, HIV/AIDS, capital market shocks and international variables such as interest rates and exchange rates;
• in order to support these baseline forecasts, further refine analysis of predictable country-specific shortfalls and what causes them – notably export volume and budget revenue shortfalls, import excesses and aid disbursement delays;
• take even more account of independent market analysis of country-specific circumstances influencing commodity export prices and prospects, and of global commodity (export and import) markets and world economic trends;
• provide African countries with more “voice” in forecasts. For many countries, long-term forecasts are still designed in Washington with little consultation of African officials who know most about their economic prospects. Donors need to accelerate capacity-building
assistance on macroeconomic forecasting, to avoid Africa’s exclusion from the dialogue due to lack of technical tools. In particular, Africa needs country-specific simple models to forecast MDG progress. In order to forecast the “real” remaining shocks all PRSPs and BWI programme documents need to:

- base projected shocks on historical probability, frequency distribution and scale of all recent shocks, adjusting for (i) any secular long-term changes in commodity prospects or climate and (ii) any African policy changes which might reduce the negative impact of shocks. Ideally, documents would build their baseline economic scenarios on the most probable combination of these trends, and downside scenarios on the most probable extreme negative combinations;
- present considerably larger (though still historically realistic) potential shocks to show the genuine risk of a return to unsustainability of debt;
- analyse the full primary and secondary impacts of shocks on the economy and especially on poverty and the MDGs;
- place far more emphasis on the fiscal effects of shocks, especially on revenue mobilisation and potential cuts in MDG-related expenditures;
- take more notice of aid shortfalls and natural disasters in more countries;
- analyse systematically the scale of shocks that would make debt “unsustainable” after HIPC debt relief, and build into programmes contingency measures to stop this from occurring;
- integrate analysis of shocks fully into the proposed long-term debt sustainability framework for low-income countries, and the grant allocation formulas for multilateral development banks, to tailor Africa’s ability to absorb borrowing to its vulnerability to shocks.

Based on the above analysis, PRSPs and BWI programmes need to contain comprehensive anti-shock plans, containing multiple policies to prevent the most likely multiple shocks for each individual country, in order to reduce their vulnerability. These would include:

- protecting against natural disasters, by for example investing in irrigation and drought-resistant crops, constructing cyclone shelters, and building stocks of anti-locust insecticides;
- improving predictability and stability of aid, by switching to budget support, removing multiple donor procedural restrictions, and improving recipient absorptive capacity;

\[23\text{ For more details of these measures and their potential effects, see Johnson, Martin and Bargawi (2004).}\]
• diversifying sources of export earnings and growth, focusing on non-agricultural sectors which are less shock-vulnerable, and ensuring higher quality and value-added for commodities;\(^{24}\)
• rationalising import use, by promoting competitive local production of imported goods, especially sustainable local production of food and energy;
• promoting domestic savings and investment much more actively, to reduce dependence on aid and foreign private capital, and diversifying and strengthening domestic financial markets to reduce their vulnerability to external shocks;
• increasing reserves to 6 months of imports as fast as possible (6 months of reserves would equal approximately 8 percent of GDP and would allow countries to run down reserves as a first line of defense to buffer against most shocks without reserves disappearing);
• keeping debt levels as low as possible to prevent renewed unsustainability;
• maximise “fiscal space” by diversifying sources of budget revenue, keeping debt levels down and especially by establishing fiscal contingency reserves and anti-disaster funds (see also Happe *et al.*, 2003);
• protecting the poor by designing social safety nets to protect the poor against all types of shocks;\(^{25}\) establishing buffer food stocks; and ensuring that the poor have more access to diversified sources of income, assets, credit, markets, education/training and health care.

However, some measures will take a long time to work, particularly diversifying exports, growth and budget revenue, rationalising imports, promoting domestic savings and investment, and improving the access of the poor. On the other hand, reserve enhancement, debt reduction, more predictable aid, social safety nets, and measures to protect against climate shocks can be more rapidly implemented and have a more immediate preventive effect, and therefore should be given priority.

The top priority is to establish fiscal contingency reserves in all low-income countries, linked to the potential scale of shocks. These are normal practice in developed economies, which are much less vulnerable to shocks, and should become so in more vulnerable low-income countries. Fiscal contingency reserves are preferable to just accumulating

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\(^{24}\) The February 2004 EU action plan on agricultural commodity chains, dependence and poverty is a highly laudable comprehensive programme in this direction (see EU, 2004 for more details).

\(^{25}\) For more details on safety nets, see World Bank (2004).
foreign exchange reserves, because they would make prevention plans focus above all on the fiscal (MDG spending) impact of shocks. However, they would need to be sufficiently well financed to ensure that MDG targets would be met in the baseline scenario without drawing on the contingency reserve.  

3.2 Individual Measures Against Shocks

Even with dramatic improvements in projections and preventive measures, some shocks will still occur due to genuinely unexpected events. They will need to be offset or compensated. Here, it is possible to distinguish between measures which help with only individual types of shocks, and those which are more comprehensive and give greater protection to Africa overall. We first discuss the individual measures.

There already exist many ways of compensating for or offsetting individual shocks. These types of mechanisms tend to fall into three categories: (i) risk management; (ii) insuring low-income countries against shocks; and (iii) automatic adjustment to debt service.

Most discussion of risk management has focused around export commodity risk management through hedging and derivatives (see ITF 1999; UN, 2001; World Bank, 2004). Low-income countries, and particularly their small farmers and producers, are severely under-represented in world derivative and over-the-counter markets, and largely unable to hedge or insure against risk, except a few mineral-producing transnationals. The World Bank Commodity Risk Management (CRM) initiative has been helping commodity producer organisations and financial institutions to access risk management institutions. Hedging instruments could also be used at a more macro level to protect against oil or food import price spikes. Progress in this area will be slow and the impact will be only long-term, but faster action here is a priority.

Risk management has also focused on government asset and liability risk management. There is greater potential for low-income governments to analyse the risks (exchange and interest rate, and maturity) inherent in their liability portfolios and to adjust their assets to match these risks more closely. The World Bank has been leading in building low-income country capacity for integrated asset and liability management.

26 Ghana has recently established such a reserve, albeit to cushion against the impact of future adjustment of domestic petrol prices to match international levels rather than to guarantee MDG spending levels.
However, many low-income countries do not have sufficient assets to be able to manage them proactively, given their low levels of foreign exchange reserves and their vulnerability to shocks – so the first priority is to enhance reserve levels and ensure they are liquid and available to be used as a defense against shocks.

With regard to insuring low-income countries against shocks, it has been argued that countries could take out insurance against virtually all macro shocks. The Commonwealth launched a proposal in 2000 for insurance against the most insurance friendly types of shocks – natural disasters – via a Commonwealth Disaster Management Agency. Yet, while entirely welcome, this has received a firm commitment only from one country (Belize) because the frequency of shocks made the price of insurance prohibitive. Insurance against commodity risks (exports or imports) would be less viable and more expensive, given their frequency and simultaneous impact on a wide range of countries. At a micro level, efforts are being made to improve coverage against shock-related risks in low-income countries, for firms and households. However, this is a very long-term effort and its financial viability for all but the wealthiest client depends on reducing premiums by reducing country vulnerability to shocks.

Proposals have been made to automatically adjust debt service to offset exogenous shocks. Various mechanisms have been suggested. First, by linking debt service obligations to commodity prices. The World Bank (2004b) has indicated that this will not be very useful, and that providing more new grants would be better. Second, by lending new external loans in inflation-indexed local currency instead of foreign currency. This would protect countries against rising debt burdens in the event of a devaluation. However, for countries with fixed currencies (CFA zone) it would not be a good option, as an inflation-indexed local-currency loan would be more expensive than a foreign currency one. The impact of this mechanism would also be felt only through disbursements over the long-term. Third, by deferring debt repayment in the event of a shock. If implemented rapidly this would be helpful but it would also mean accruing additional interest and so adding to the country’s debt.

Most important, all these proposals are treating only one of the symptoms of an external shock (a high debt burden), rather than its causes or its comprehensive impact. As such, and given the low debt service obligations of low-income countries, they would offer only marginal and piecemeal assistance. None of them is therefore considered a high priority by African HIPC ministers (2003).
3.3 Overall Measures Against Shocks

It would be preferable to have comprehensive protection against all shocks. Given the frequency of multiple shocks hitting most African countries, it is impossible to envisage that risk management products, insurance schemes or debt service adjustments would provide comprehensive protection without prohibitive cost. In this light, the onus is on the official system to implement three main measures to offset and compensate for shocks:

The first measure is to adjust PRGF programmes to shocks. It has long been practice for some performance criteria in some PRGF country programmes to be adjustable in light of shocks, but this should be generalised to all programmes, making such targets as fiscal and current account deficits explicitly adjustable according to both positive and negative shocks, or measuring them excluding elements which are vulnerable to such shocks (such as donor grants or interest payments). Alternatively, targets might be regarded as “indicative” and flexibly renegotiated in mid-programme reviews, without the need for requesting formal waivers. However, there is also a case for more fundamental reviews of programmes in order to redouble efforts to reduce poverty. This would include designing measures to accelerate the recovery in growth and pro-poor government spending after the shock through counter-cyclical fiscal policy and specific anti-shock expenditures, to establish permanent anti-shock safety nets, to combat the long-term “downward drag” effects of shocks, and to enhance national mechanisms for monitoring the nature and impact of shocks. At all costs, a reaction to shocks which involves cutting MDG-related spending needs to be avoided.

The second measure is to provide supplementary financing in the form of highly concessional loans, or preferably grants, as compensatory and contingency financing against shocks. Various studies have shown the effectiveness of targeting aid to offsetting shocks. Yet low-income African countries have virtually no access to systematic compensatory financing. There are only two institutions with dedicated anti-shocks facilities. The first, the IMF’s Compensatory Financing Facility (CFF), has been so expensive that low-income countries cannot use it.

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27 For more details on these aspects of policy, see especially Lustig (2000).
28 See for example Collier and Dehn (2001).
29 For more details on these see IMF (2003) and IMF (2004b).
recently, the IMF has proposed the establishment of an anti-shocks window within the PRGF, on cheaper (loan) terms. The second, the EU FLEX facility established in 2000, is a considerable improvement on the previous STABEX, especially since its revision in May 2004 to make access easier (European Commission, 2005). However, the eligibility criteria remain too restrictive and it disburses very slowly (with a lag of 15-24 months between the shock and the receipt of FLEX funding).

However, even the above facilities and amounts fall way short of country needs, largely because they focus only on export shortfalls, which are not the most important shocks for African countries, and do not correlate with GDP or MDG-related budget spending shortfalls which are the key indicators of problems in MDG progress.

The only other current way to compensate for shocks is by ad hoc augmentation of budget support by a lender or donor. Currently the IMF and World Bank play small roles in this area by augmenting PRGF or PRSC loans with extra disbursements, and providing extra disbursements to combat natural disasters. More important players are a few bilateral grant donors, who can provide additional budget support. However, these funds also have major problems (see also IMF, 2004a and World Bank, 2004):

- the amounts available are often inadequate and not frequent enough. Bilateral donors also have limits on the percentage of funds they can use for contingency purposes;
- apart from World Bank anti-disaster funds for IDA-only countries and FLEX, multilateral anti-shock funds are loans, significantly increasing debt burdens. The IMF acknowledges that most anti-shock funds for low-income countries should be in grant form;
- funding is not disbursed fast enough. Typically it requires at least 6 months between a shock emerging and major disbursements of assistance, due partly to slow analysis of the impact of the shock, slow procedures for approving funds, and especially slow procedures for loan effectiveness, procurement and project implementation;
- funding is far too highly conditional, with PRGF programmes often requiring additional measures by the African government to adjust to shocks, partly because of the shortage and delay in anti-shock funding. Anti-natural disaster funding is in general rather more sufficient to the scale of its task – representing 7 percent of global aid – over $6 billion. It is also better coordinated through UN disaster appeals. Dedicated anti-disaster facilities include the EU’s Community Humanitarian Aid
However, the main problems here are delay in disbursement and poor coordination of disbursement through multiple agencies (generally very little via the African government’s budget), as has recently been seen in the late response to the locust plague in the Sahel and the subsequent famines in Niger as well as Southern Africa. Further problems are the overconcentration of funds on large or highly visible disasters such as the tsunami, and high levels of disbursements through tied aid in kind which are overvalued or distort national food markets.

It is not surprising that, in evaluating donor aid policies and practices, African governments gave them the lowest marks for anti-shock funding (see Johnson et al., 2004). As a result, the top priority for the international community should be to establish an anti-shocks facility for low-income countries (Martin et al., forthcoming). This facility would need to be:

- comprehensive, compensating all shock-induced shortfalls in GDP growth, budget spending, or foreign exchange (exports, imports, aid etc.) for IDA-only countries;
- much bigger than current facilities to provide adequate finance;
- grant-financed in order to avoid increasing national debt burdens;
- fast-acting (disbursing within 3 months). To ensure this, contingent funds would be set aside for countries each year (see below);
- not subject to any additional conditionality beyond that of having PRSPs.

It would obviously be desirable to coordinate facilities such as EU FLEX and IMF Trade Integration Mechanism (TIM) with such a facility, in order to provide consistent support to countries – the proposed mid-term review of FLEX would provide an opportunity to increase coordination.

What would be the cost of such a facility? To compensate for commodity (export and import) shocks for all IDA-only countries, which average 1 percent of their GDP a year, and adjusting for 3 percent annual global inflation, the estimated cost of such a facility would be $48-50 billion over the next 11 years – i.e. around $4.5 billion a year.  

Additional funding would be needed to offset aid and foreign private

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30 This figure is calculated for IDA-only countries on the assumption that blend-countries can borrow from other sources, namely PRGF and IDA loans. Of the $48-50 billion over 11 years, less than half (roughly $22.5 billion) would be allocated to African IDA-only countries.
capital shocks, and to implement specific measures to prevent future disasters and protect the poor. Assuming that anti-disaster funding is generally sufficient in amount, the facility could also be used to front-load disbursements of external finance and avoid disrupting government budget plans, with donors reimbursing the facility later.

However, not all this funding would need to be additional or provided as grants. A considerable proportion could be met through the IMF anti-shock facility for less debt-distressed countries, and around $130 million a year could come from FLEX. Donors could also fold their existing grant contingency support into such a facility.

The third measure to be taken by the official system is to build overall contingency mechanisms into adjustment programmes. In order to ensure the effectiveness and speed of anti-shock financing, it would need to be set aside up front, as genuine financing against contingencies, rather than after the shock when its negative effects on the economy have already been felt. It would be relatively easy to calculate the contingency allowance needed for each country, based on historical and forecast vulnerability indices of the types designed by the Caribbean Development Bank, EU, OECD and UN.

In order to provide a basis for such up-front financing, the BWI Boards would be presented with two sets of economic projections at the occasion of each semi-annual PRGF review. Both of these would aim to attain the MDGs: one would be a realistic “base case”, including “likely” shocks such as the impact of HIV/AIDS; the other would be a realistic assessment “low case”, allowing for shocks which would probably hit the economy, and conducting analysis of GDP and budget as well as balance of payments effects of the shock. The anti-shocks facility above would then be committed up to levels to keep MDG-related budget spending on track, and boost reserves to 6 months of imports, in the event of the low case occurring, and the funds representing the extra financing needed for the low case scenario would be put into a blocked fiscal contingency reserve account for the recipient country. Following any evidence of a shock (e.g. a trigger such as a projected shortfall of 2 percent of exports, reserves or budget revenues, or 0.25 percent of GDP), a rapid-response analysis mission (by the BWIs together with the EU and a bilateral donor) would assess

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31 However, some confusion over the data on disaster funding exists, indicating that of the $6 billions allocated per annum, $2 billion is spent on refugees, with $1.5 billion of this being spent in donor countries on action relating to refugees.
its impact and immediately recommend disbursements, which would occur within a maximum of 3 months after the shock. Four questions might be asked about such a fund: First, how do we avoid a “moral hazard” that countries might rely on guaranteed external finance and not take serious steps to prevent or adjust to shocks? While this has been a problem with some past compensatory finance, the use of the funding for MDG-related budget spending and reserves enhancement, as well as to fund specific measures to prevent future disasters and protect the poor, would automatically prevent this moral hazard. No additional conditionality or “pre-qualification” mechanism based on developing comprehensive anti-shock plans in PRSPs should be accepted, as this would merely add to the already heavy burden of conditionality and delay vital funds.

Second, why should we set aside funding up front which might not need to be spent on shocks, rather than spending it on essential immediate needs? It has already been stressed that many OECD countries regard fiscal contingency reserves as essential to efficient budgeting: a case that is all the stronger for low-income countries which are highly vulnerable to shocks. In addition, one crucial lesson of development financing for Africa in the last 30 years has been that insufficient anti-shock action and finance has been a recipe for magnifying economic instability and other distortions, ending up costing donors far more in the long-term because they need to provide more new financing and debt relief. Therefore, adequate contingency finance up front is essential. A small portion of the funding would, in any case, be set aside for guaranteed spending on measures to prevent future shocks and establish systems to protect the poor.

Third, how do we distinguish clearly between shocks that require to be compensated and other reasons for slippages which require more adjustment? The EU, IMF and World Bank do not have problems doing this in the context of FLEX and CFF, or augmentations of PRGF or PRSCs. Nor does the UN have problems distinguishing costs and funding needs of natural disasters It would simply be a question of extending these methods to cover other types of shocks.

Fourth, what would be done with unspent funds? Depending on the assessment of future risks of shocks for the country, and a new assessment of its own ability to protect itself against shocks through budget revenue and foreign exchange reserves, they could be either carried over into the following year’s fiscal contingency reserve or reallocated to be spent on projects to protect the poor against future shocks.
4 Conclusion

Africa is already suffering from large shocks beyond its control, which will continue, and will play a major role in making it impossible for the continent to reach the MDGs. As African HIPC governments have themselves suggested, there is no better use or higher priority for additional aid funds than immediate, low-cost contingency financing. Together with measures to prevent shocks by better analysis and improved policymaking, and to offset or compensate specific types of shocks, this could guarantee Africa’s protection against shocks, ensuring that this key factor would no longer disrupt its progress towards the MDGs.

References


I am in broad agreement with the arguments presented by both John Williamson and Matthew Martin. More than 50 low-income countries are very vulnerable to exogenous shocks as a result of commodity prices changes and the concentration of their exports in one, two, or perhaps even three commodities that account for more than half of their exports.

Many of these shocks are the result of sharp changes in terms of trade. As has been observed, every two or three years terms of trade shocks can reduce their exports by 2.5 to 7 percent of GDP and, when you take the full multiplier effects of this, by as much as 20 percent of GDP. These are estimates of Paul Collier made at the World Bank.

Other exogenous shocks are related to natural disasters, the impact of conflicts in neighbouring countries, sudden reductions in aid, imposition of trade barriers in major markets, and others. The frequency and severity of shocks are closely correlated to growth; their impact on growth is asymmetric and their effects are often irreversible.

High volatility has been demonstrated to be harmful to output and harmful to growth. The volatility of macroeconomic variables tends to have not only high output costs, but tends to lead to the curtailment of investment in infrastructure. There is evidence that half of the total fiscal adjustment efforts in Latin America in the 1990s was achieved through the curtailment of investments in infrastructure and these cuts were not compensated subsequently. So, the pro-cyclical policies resulted in a decline in GDP growth rate of about one percent a year.

1 The views expressed are those of the author and do not necessarily represent those of the G-24.
Dependency on commodities and generally close links between developing countries’ external sectors and demand conditions in the industrial world, make these countries very sensitive to changes in demand and result in a high level of volatility in their export sector, much higher than the variation in export growth in industrialised countries. In fact, three to four times as much.

Advanced countries show much lower volatility. The standard deviation for their exports in terms of trade is 0.97. For the developing countries as a whole it is 3.2, for sub-Saharan Africa it is 3.3 and for Latin America and the Caribbean it is 4.4, which is rather surprising. For the Middle East it is 3.2.

The problem of commodity shocks is very severe in low-income countries because as a norm when your level of per capita income raises above one thousand dollars, the economy tends to become much more diversified. Of course, this is not always the case, you have countries like Chile, which has a very sophisticated economy, but copper continues to account for some 40 percent of total exports and terms of trade shocks may have an impact of 6 percent of GDP. The case of some oil producers with high incomes is very similar.

The problem addressed by John Williamson is a major one for many low-income countries and I too recall the establishment of the CFF in the early 1960s, which was considered very innovative. Going a little over the history of this CFF, by 1983 industrial countries had the feeling that the CFF was often used to postpone what they felt were necessary policy adjustments, so they tightened the access to it and the use of the CFF since then was sharply reduced.

For me, what is surprising in the chapter by John is the importance of capital flow shocks for low-income countries with very limited access to financial markets. These are said to be greater than current account shocks and low-income countries are said to suffer more instability from capital flows than middle-income countries. Perhaps John will provide the data source for this statement and elaborate a little bit on this point, which I found counter-intuitive. I do not know if the standard deviation of capital flows in low-income countries is greater than in middle-income countries. It would seem the size of the flows is small and the impact on the economies is not as large. Thus, I would like to hear his explanation for this.

I agree with John’s comments on commodity agreements. I think that one would have to keep a very clear distinction between price stabilisation and income stabilisation. Probably the attempt to achieve
Curbing the Impact of Shocks

the second hindered the achievement of price stabilisation.

I agree with John also that countries facing balance of payments problems and the need to adjust need not resort to the Fund’s high conditionality programmes, which are usually underfinanced. When countries are hit by adversities through no fault of their own, they certainly deserve support. The CFF would be a very appropriate mechanism for this sort of situations. In fact, I would say one has to enlarge CFF because quotas are so small today, on average less than 1 percent of GDP, and access to resources under the CFF was limited to less than half of a member’s quota.

If the rates of charges are high, well the rates should be adjusted downwards, although I think that today they are at close to 2 percent and that is close to zero in real terms.

Domestic Policies

Let me turn to the domestic policies for curbing the impact of shocks. Since Keynes, one of the main legacies of macroeconomic theory for advanced economies has been the awareness of business cycles and the development of tools to deal with them. The issue has been at the centre of policy debate, as market-oriented economies frequently saw periods of growth interrupted by periods of recession. Such boom-bust cycles have triggered short-term policies in industrial countries that sought to reduce the effects of downturns in income and expenditures. Automatic stabilisers have been built into fiscal policy over the last 70 years and the impact of business cycles in industrial countries is ameliorated through unemployment insurance and automatic tax adjustments that soften the impact of the cycles. This is something that has been happening since the 1970s at least, although the neo-liberal revolution changed the emphasis of policies away from fiscal and monetary policies as instruments of fine-tuning. Counter-cyclical policies have also remained in place. However, in developing countries the space for the pursuit of counter-cyclical actions is much narrower.

What determines the variability to which developing economies are subjected? Are there any hidden reasons for this? Well, in principle one could distinguish at least four. I have already mentioned the much greater dependence on primary commodities and, as a result, the variability of exports, which is three to four time higher for developing countries than for advanced economies. A second element is – of course, there are differences between regions and countries within the
different regions, some have diversified more and so forth but as a whole – a smaller and more volatile access to financial markets. Indeed, the average magnitude of a sudden reversal in capital flows in emerging market countries is about 6.1 percent of GDP, while it is only 1 percent in industrial countries (see Calvo et al., 2004). Additionally, the fragile external and fiscal position of many of these countries has restrained their ability to obtain external financing. Third, there is generally less market confidence perhaps as a result of less reliable macroeconomic policies in the past, and there is, consequently, an inability to pursue counter-cyclical policies. Fourth, the inability to borrow in their own currency beyond a limited extent given the small size of the domestic financial markets and their own history of monetary instability and exchange rate depreciations.

Lacking the capacity to finance counter-cyclical policies, most commodity producers have followed pro-cyclical policies – policies are tight in times of recession and are expansionary in times of the upswing. This has weakened further the growth prospects when external conditions deteriorated. John recommends that countries should aim for a redistribution of expenditures over time. This is of course impeccable, but it is also very difficult to do. First, because capital inflows are pro-cyclical; your borrowing is increased in good times and falls in bad times. I agree, by the way, with John’s remarks on the Chilean “Encaje” and the use of capital controls. Second, because fiscal policy is also pro-cyclical; government expenditure expands in good times and falls in bad times. Third, emerging market monetary policies tend to be pro-cyclical; expansionary in good times and restrictive in bad times. And, fourth, again, capital inflows are also associated with expansionary macroeconomic policies in good times, as are capital outflows with contractionary policies. In these circumstances, it is very difficult, for countries to pursue counter-cyclical policies. Perhaps the Fund should help them do so, and perhaps they should try harder.

John proposes that since there is no real mechanism to support countries faced with contractionary shocks giving rise to cyclical downturns, they should resort to policies of self-insurance. This is perhaps a prudent solution, but I do not know whether it is the right one or whether it is the only one. The increase of reserves, which is something many countries, particularly in Asia, have been doing, has a very high opportunity cost generally. I would say that self-insurance is perhaps the most primitive and costly means of insurance. From self-insurance you move on to group insurance, and from group insurance you ultimately
go to global insurance and you invent the IMF. But if countries do not want to go to the Fund because it does not meet their needs…. Well, this may reflect on Fund policies and will be discussed later.

Nevertheless, group insurance is possible. Laura dos Reis has written a paper for the G-24 that develops the proposal for the implementation of a fiscal insurance mechanism for the member countries of the Eastern Caribbean region and for the African members of the CFA franc zone that works rather well (Laura dos Reis, 2004). Fiscal group insurance can cushion members against transitory shocks. The volatility of fiscal revenues would be reduced for countries that join the fiscal insurance arrangement, which allows cross compensation under a risk-sharing scheme. Their contributions are proportional to the size and the frequency of external shocks and – since regional fluctuations in output and government revenues in these regions are not significantly correlated – the fiscal insurance scheme can take advantage of the asymmetries and lead to welfare gains for all. You can look at the paper in the webpage of the G-24.

You may recall that in some recent studies by the Fund and by other authors as Kaminsky, Reinhart and Beck, they say that countries should avoid crisis by keeping external borrowing at the safe level. This safe level is at times as low as 15 to 20 percent of GDP. This brings to mind the case of the dog that did not bark, that led Sherlock Holmes to the solution of a mystery. We have a very interesting case of a financial crisis that did not happen. I refer to an emerging country with a debt in excess of one hundred percent of GDP, with a very low level of exports to debt and very large fiscal deficits; this country is Greece. Its currency has not been subjected to speculative attacks for a very long time, since well before it adopted the euro as its currency. It was thought by markets to have the protection of being a member of the EU and it was presumed that the EU would come in its support if it would come under a speculative attack. In spite of having poor fundamentals, considerably worse than those of many emerging markets countries that suffered devastating speculative attacks and financial crisis, Greece came through unscathed. Portugal with better fundamentals is in a similar situation.

I think there is a lesson to be drawn from this experience, one that illustrates the role that external support can have in maintaining confidence and in preventing financial crises. This was after all the role assigned to the IMF’s ill-fated Contingency Credit Line; this was what it was supposed to do and unfortunately never did.
International Policies

Like John, I tend to believe that the international community should be more helpful and display more solidarity to assist those countries that undergo external shocks. I also feel that the CFF would deal with not only commodity revenue shortfalls, but impacts of oil prices hikes too. I recall that in the 1970s the IMF had established the low-conditionality facility to deal with exactly these exogenous shocks: the oil facility. Of course, we are in the realm of political economy, with the emphasis on political. At that time, several industrial countries including Italy, UK and Spain, were interested in drawing from it. Since then industrial countries have walked away from the Fund and the chances of such a scheme, although technically quite feasible, are very slim.

The details of how a counter-cyclical facility could be established to support emerging market countries have been worked out in a paper by Claudio Loser, a former head of the Western Hemisphere department in the Fund, in a paper for the G-24, which can be found on the G-24 webpage (Loser, 2004). But if countries in control of the Fund are not prepared to establish a new counter-cyclical facility, could a less ambitious proposal of simply reactivating and expanding this CFF be put forward?

Another question is why governments do not borrow in their own currency. Surely, they realise the risk posed by currency mismatches. Over the last decade a number of emerging market countries have seen a rapid expansion of the domestic financial market, the better-known cases are probably Chile and Mexico. These countries have gone a considerable way to develop their domestic capital market as a means to reduce dependence on external credit. They have done this mostly through a combination of price stability and fostering the growth of fully funded pension funds that would feed long-term capital markets. They have attained a measure of success, but the markets are still not large enough to cope with borrowing needs, perhaps over time they will.

John suggests the issuance of inflation-indexed bonds. Both Chile and Mexico have also issued domestic currency bonds indexed to inflation and, of course, dollarisation is a form of indexation, as was done in Argentina and some other countries, not always with good results. Now, domestic investors fear that a country that is prepared to default on its external debt is probably even more prepared to default on its domestic debt. Countries with a history of domestic debt default are found to be some four times more likely to be dollarised than countries
that have not, curiously. Anyway, the question is, in view of these shocks, should not be the IFIs more helpful?

In keeping with their mandate, we have seen what the Fund could do. But what about the multilateral development banks? First of all, they could lend at the full capacity, most of them are lending well below it. The World Bank is lending at a little above half of its lending capacity. As a minimum, they should avoid running long periods of net negative transfers of resources to the developing world. In the case of the World Bank, this was in the order of 12 to 14 billion in the last couple of years. They could also try to be counter-cyclical in their lending, although I realise that it is not always easy if you are investing and dealing with investment projects and so forth. Amar Bhattacharya had some very good suggestions for expanding lending operations by increasing investment in infrastructure; I hope they are put into effect. Moreover, through resort to portfolio diversification, they can lend to countries in their own currencies. This is technically possible without incurring any losses and, in fact, obtaining higher returns than lending in dollars, according to simulations over a 20-years period, done by Randall Dodd and Shari Spiegel (2004) for the G-24. This is a very recent paper and some people in the IDB and Wall Street are now looking at this possibility.

References


The Need for Institutional Changes in the Global Financial System

Stijn Claessens and Geoffrey Underhill

Since the 1980s, persistent episodes of financial crisis in developed and developing countries have put the international financial system under stress. Efforts to reform the architecture of global finance since the 1990s have failed to prevent severe crises from occurring in middle-income countries, and financial integration remains a contentious aspect of globalisation. Despite many attempts at the international level, many developing countries still suffer from high external debt and a poor match between their development financing needs and the availability and forms of both private and public capital. More generally, there is much disappointment and scepticism among policymakers and citizens worldwide concerning the contribution of the international financial system to global development.

Global financial market integration, debt problems and limited and poorly matched resource transfers are realities, and the issues cannot be avoided. Indeed, discussions on reforms to the international financial

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1 This is a revised version of a paper presented at the FONDAD conference on Developing Countries, Global Finance, and the Role of the IMF: Towards a New Relationship?, The Hague, 11-12 November, 2004. We would like to thank the discussant, José Antonio Ocampo, and the participants for very useful comments. Stijn Claessens also likes to thank the participants in the 2nd EU Development Network Conference, November 25-26, 2004, Paris for comments. The full paper, from which this article is drawn, was originally prepared for the HIPC Unit of the World Bank and we would like to thank Vikram Nehru for commissioning it. The opinions expressed do not necessarily represent those of the World Bank, its Executive Directors, or any of its member countries.
The Need for Institutional Changes in the Global Financial System

Architecture are proceeding, private debt workout mechanisms are being adjusted, (official) debt relief schemes have been put in place, and development assistance is continuously being re-evaluated. Disagreements in policymaking, public and academic circles over the scope, depth, and shape of the reform process remain, however, profound.

The recurrent nature of the debates suggests that deeper reforms to the institutional framework are imperative. The failure of fundamental reform to materialise also suggests that some important blockages in the policy process need to be circumvented if change is successfully to be implemented. Changes for the better will require going beyond the shifting topics of immediate interests among policymakers – i.e. the latest financial crisis, the difficult private-public relationship in debt workouts, or the debt problems of low-income countries – and addressing fundamental questions of the nature of the governance of the international financial system. Furthermore, political strategies to circumvent the current pattern of vested interests in global financial markets and governance will need to be constructed. This chapter’s purpose is to lay out the elements that need to be addressed when rethinking the governance mechanisms of the international financial system.

First, we develop a framework for analysing the tensions between the achievement of global and national development objectives and a world of fragmented governance, multiple institutions, accelerated financial integration and increased private sector roles. We approach the topic by covering four sets of interrelated issues, each of which derives from the other: (i) Forces for change: How do globalisation, increased financial integration and the emerging norms and standards of global governance affect and define the nature and objectives of the international financial system? In other words, how is the contemporary international financial system different today from when it was put in place, and what issues in terms of governance do these changes raise? (ii) Public versus private interests and power: How do these changes in both markets and governance affect the balance of power between public authorities and private interests in international monetary and financial policies? What does this mean for the (shifting) discourses of the “public good/public interest” in financial governance? (iii) The design of the international financial system: Are the current rules and institutions of the international financial system the right ones to address the global public policy issues and what sorts of changes in governance can be made to improve the international institutional framework, especially with regard to the global development process? What sorts of obstacles limit the scope for change?
And (iv) The legitimacy of the international financial system: How might policy processes and institutions at the global level become more accountable and outcomes more legitimate in relation to the policy preferences of citizens of all economies, in particular of the developing world? In addressing these four issues, we highlight the many concerns beyond the immediate or approximate causes and consequences of financial crises, sustained debt overhang, or poor forms of resource transfers.

1 Forces for Change in the International Financial System

In this section, we examine the economic and financial changes that are affecting the global financial system. Globalisation has involved increased financial integration, increased cross-border entry, mergers and acquisitions of financial institutions, and lower formal and de facto barriers between specialised market segments. These changes were triggered by regulatory changes at the domestic level, particularly in the US and the UK, and capital account liberalisation (Helleiner, 1994). Cross-border capital flows have been the most important form of increased financial integration for the last two decades. Furthermore, capital market integration has lowered the cost of raising capital in developed and developing country markets alike. Spurred by governments that have removed entry barriers, the costs of establishing a physical presence have likewise declined in the last decade, resulting in a dramatic increase of cross-border entry of financial institutions and bank consolidation and financial institutions’ mergers and acquisitions across borders and market segments. Finally, in recent years especially, remote delivery of financial services has become much easier; through enhanced communications capability, banking services can now be accessed from anywhere and trading services are no longer restricted to any physical location or exchange.

These structural changes in the markets are a few of the many dimensions of global financial integration over the past two decades. They originated in developed countries as their financial systems and economies matured and they cast off the restrictions of their developmental experience and the heritage of war and depression, and have spread globally. We focus on those dimensions most related to changes in actor preferences in relation to the institutions of governance. One dimension concerns how the changes affect the preferences – financial, political and otherwise – of the public sector, international organisations, private economic actors and citizens. A second dimension concerns the pressures for
The Need for Institutional Changes in the Global Financial System

general economic and policy convergence, that is, those systemic developments that are driving national and local financial systems to search for global or apparently similar solutions. We discuss each in turn.

1.1 Changes in Preferences

Financial integration and globalisation more generally affect the capacities and preferences of different socio-economic actors, interest groups, and constituencies in relation to the nature and objectives of the international financial system. These constituencies and groups include private financial and corporate sector interest groups, state officials, international organisations, non-government organisations, and citizens. The changes are many, and include changes in relation to objectives, tools, and voices.

The end of the cold war removed competition with a rival system and thereby an important anchor to public interventions in national governance and the international system. The demise of a “socialist” alternative and of an active Soviet foreign policy reduced the need to accept social compromises in economic policy as an antidote to unrest and social upheaval in the developing world. As developed economies matured and post-war interventionism lost much of its rationale, models of market-based (or market-friendly) development became central to the policy agenda in western capitals. There was also less tolerance for authoritarian exceptions to more consensual forms of government in emerging markets. The failure of a range of state-interventionist development models to deliver higher income levels in many countries, particularly in Latin America, brought such strategies increasingly under criticism. Despite the successful experience of developmental states in East and South-East Asia, interventionism often appeared to be at the root of problems such as increased inequality, poor environmental performance and other externalities. Chronic inflation and debt burdens induced by state-managed development strategies lent further credence to more market-oriented approaches. At the same time, globalisation introduced more intense competition among countries and firms. All of these trends stimulated changing actor preferences and forms of policy reform.

Correspondingly, the tools of national instances and international agencies changed as policy became aimed at a greater role for local and

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2 Concerning the debate on the “developmental state”, see Underhill and Zhang (2005).
foreign private sectors. It gave the international agencies a smaller voice in the world of global opinion and debates. It left national authorities with fewer means to steer local economies, both in normal times and in times of financial crises. Facilitating private sector market processes became commensurately more important to policymakers. While these developments were the intended outcomes, they also had some unintended consequences: new institutions did not necessarily emerge promptly to compensate for the vacuum or the altered sets of preferences. An important element of these changes had to do with the increased role of the private sector in economic activities, which we take up in detail in the next section. We discuss here the consequences for intellectual leadership and international financial markets.

The liberalisation of media in many countries has given all actors more voice. The intellectual leadership of international agencies has become increasingly challenged by more vocal NGOs, whose analysis and research capacity sometimes rivals the agencies themselves. Technological developments such as the internet have allowed smaller groups to voice their opinions more easily. Policymakers have been searching for new solutions as they interacted with other actors in policymaking processes, but they have found this difficult and bewildering at times.

More importantly, the increase in capital flows has reduced the discretionary room for manoeuvre left to public policymakers in the national and international domains. The capacities of official and international agencies to respond to financial crises were in particular limited, both in terms of resources and effective policy implementation. The dual shift towards greater levels of private sector provision of capital and integration across borders has stimulated internationally mobile capital to opt out of historical relationships with public officials and other players in national level policy processes. The greater emphasis on shareholder value and mobility has given capital more voice relative to labour and the liberalisation of financial markets and capital account has given (internationally mobile) capital more voice. The break-up of national policy networks induces further changes in actor preferences.

Another related aspect of change is the larger scope of markets, greater number of players, and the more decentralised nature of transactions. This diminishes the power of individual entities, whether they are corporations, shareholders, government agencies, etc. Moral suasion by central banks, for example, to stave off a financial crisis by “directing” commercial banks is simply much less effective in (international) financial markets today since there are too many players and investors...
involved. The jurisdiction of public agencies corresponds less and less to
the real domain of the market for which they are responsible. These
changes have also stimulated a search for influence on the rules of the
game, rather than on the market outcomes directly. As such, these
trends increase the motivation of actors to search for (global) norms to
allow some standardisation, which we take up in the next subsection.

1.2 Institutional Environment Convergence

There has recently been an important degree of convergence in national
financial, corporate governance, accounting and many other standards,
including non-financial standards (e.g. labour and environmental regu-
lation). The need for standards has increased as the boundaries of the
markets increasingly cut across national boundaries. In financial services,
increased cross-border presence in financial systems, greater interna-
tional issuance of securities and other forms of globalisation has led to the
spread of similar market practices and “soft” forms of regulations and
laws, such as more harmonised issuing standards for equity and debt.
There is little evidence that this has led to a decline in banking or capital
market standards. If anything, the break-up of national financial policy-
making “clubs” and the institution of market-based regulation have led
to more and in particular more statutory-based enforcement of standards
(Vogel, 1996). As part of the new international financial architecture,
there are now many, somewhat higher standards to which firms and
countries can adhere to or at least to which they may be held accountable.
Examples include the various standards being assessed under the ROSCs
(Reports on the Observance of Standards and Codes). More generally,
globalisation has done away with some institutional differences and led
to more common standards and practices. Cross-border standards imply
some degree of harmonisation of the framework under which govern-
ments and firms (ought to) behave. Over time and to a certain degree,
this convergence will take some of these issues off the global public
policy agenda, although less so for developing countries.

Public agencies seek such standards in order to enhance the efficiency
of their policies through international cooperation. Yet private interests
within developed countries have mostly driven these trends. Private
actors seek standards to lower transaction costs through private sector
cooperation, and public actors respond to their political pressure. The
increased harmonisation of international accounting standards, for
example, has been driven by the two largest markets, the US and EU,
and has been conducted by semi-private agencies, the International Accounting Standards and the Financial Accounting Standards Board (Dewing and Russell, 2004). Similarly, when firms raise capital abroad or list and trade their stocks on international stock exchanges – as firms seek lower cost of financing and investors value the institutional aspects of international environments more than that of local markets, they overcome some of the institutional differences between countries, but again, this is largely due to market forces. Other standards, such as the Core 25 Principles for Banking Supervision, have had a public sector origin but with much private sector input.

While originating in developed countries, the new global standards have the greatest impact on public and private actors in developing countries. The largest impact from the accounting or the Core 25 Principles for Banking Supervision standards, for example, will be in developing countries. There are several reasons for this. Globalisation in financial services industries has been affecting developing countries the most. Crises have been and are likely to remain largely an emerging market phenomenon. The trend in listing abroad and subsequent effects on what type of corporate governance system firms aim for has been more important for developing countries (sometimes more than half of local market capitalisation is listed or traded abroad; Claessens, Klingebiel and Schmukler, 2002).

At the same time, many of these countries are furthest from the frontier of change and their financial and other systems of governance are less adapted to global integration processes. Many practices under the heading of “financial repression” have been integral to the (successful) development strategies of some of these countries, but sit ill with standards developed in countries that now have a more liberal environment. Consequently, the legal and regulatory institutions of developing countries are often poorly adapted to international cooperation and require extensive changes for the implementation of the new standards. And developing countries have been less involved in the formulation of the standards. Despite the informal input of the G-20 since its formation in 1999, few of the standards developed in recent years have had major inputs from developing countries due to the overwhelming representation of developed countries in the various committees designing the new rules. As a result, the speed and extent of changes are greatest for developing countries.

Despite the increased pressure for standards and the very real achievements in terms of convergence, the process remains incomplete. Global
economic space is a long way from the single market of national level economies. The integration process still links often disparate entities at different levels of development or with different sorts of legal and institutional practices. These differences lend volatility to, in particular, the global financial system and they have a differential impact on the various actors and economies involved. Effective convergence and standard setting should put the emphasis more on obstacles to successful implementation and application as opposed to standard setting itself: for example, the focus should be on getting firms to disclose rather than enhancing disclosure rules. Even then, new issues will emerge, global integration will remain imperfect, and standard setting will remain incomplete. Other issues, especially those such as debt workout that are in the main relevant to developing countries, will remain. The deeper issue is whether the political and other constituencies for addressing these questions are in the right place in a globalised world, which is a question on the governance of the international financial system.

In short, both market structures and the preferences of the public and private actors involved have been in considerable flux. As governments sought to promote competition and to loosen the grip of old financial services coalitions on the governance of the sector, cross-border integration was, in part, the result. The most market-competitive financial institutions had long encouraged this process, seeing considerable advantages to a more integrated system and better access to other national markets and other market segments. The structural changes that followed had a dramatic impact on the options for financial institutions, which had to learn to cope with the new environment, as did governments. The impact was not the least for developing countries and their financial sectors. Governments and international institutions alike were confronted with new policy dilemmas that resulted from integration and capital mobility. Crisis and instability led in turn to calls for a reassessment of global financial architecture.

2 Public versus Private Views and Interests

In this section we take increased financial integration as a given and examine the changing balance of power between public authorities and private interests in international monetary and financial policies. This has led, among other things, to shifting discourses of the “public
good/public interest” in financial governance, especially as they relate to the development process. Furthermore, it has led to the institutionalisation of private sector interests in the policy process. The private interests of developed country financial institutions are increasingly evident in public policy outcomes concerning financial governance at the national and global level.

The financial services industry has a long history of self-regulation. In the post-depression, post-war world, however, there was a strong determination by governments to ensure that the market dynamics of the financial sector did not operate contrary to the public interest, especially where stability and crisis were concerned. The emphasis was on constraining market forces and integrating the financial sector into national macroeconomic and economic development strategies: private (sometimes state-owned) finance for profit, but subordinate to the wider public good in a democratic or developmental state context (where many European states were clearly “developmental” as well). Liberalisation, cross-border integration, and associated institutional changes over the past three decades have resulted in a greater role for the private sector, less constrained by public policy priorities, at both national and global levels. Within national financial systems, this increased role has come about through the privatisation of state-owned banks, the deregulation of interest control and credit allocations, the removal of barriers between market segments and products and the general liberalisation of product innovation. The dismantling of regulatory barriers has led to consolidation in the financial sector, making for larger, more transnational players confronting government.

These trends have in general resulted in improved financial sector functioning, more stability and greater access of firms and households to financial services (see, for example, Levine, 2005). More generally, the private sector is accepted as crucial for successful financial sector functioning. More contentious, however, is the debate about to what extent, under what conditions, and for which policy goals public authorities should cede prerogatives to private interests in markets when it comes to financial sector regulation and supervision. This is for at least two reasons: the limits to private sector self-regulation; and the dynamics of institutional change.

There are other arguments, not discussed here, as to what can be best done by the private or public sector related to the general nature and type of public goods.
2.1 Limits to Private Sector Regulation

In all market systems, collective action problems and the possibility of market failure are prevalent. The resolution of these problems requires some form of (private or public) collective provision of regulatory and supervisory authority and policies. Nowhere is this more important than in crisis-prone financial markets. Historically, the public and private sectors have shared the development of regulatory and supervisory functions and institutions. Thus as mentioned above, private sector self-regulation is common in financial services industries. Even where public sector authorities and policies played a dominant role in the post-war period, self-regulation was usually part of the framework, at the very least in terms of implementation.

This is in part because financial services provision is characterised by the use of many and often interlocking networks. The market infrastructure for financial services involves network systems for trading, payment and clearing, distribution (e.g. ATMs), and information. A need for technical expertise and a high level of complexity in the sector plays a role. These networks are often commonly shared and run on a not-for-profit basis by participants themselves, as is often the case for credit registries, or as for-profit organisations, as is the case for many stock exchanges these days. The oversight structures for these commonly-owned network infrastructures often involve self-regulatory arrangements. Sometimes, these are purely private forms of regulation, as in case of many clearinghouses, but often the private forms are mixed with government oversight or delegated mandates. For stock exchanges, for example, typically there will be a division of oversight responsibilities as well as oversight by the public sector of the private sector’s own oversight role. Self-regulation is also common in licensing expertise, as for brokerage houses or for obtaining certified financial analyst licenses.

Self-regulation and self-regulatory organisations and associations are likely to work well when the subsidiary body has more specific information, better resources, a broader range of sanctions and more enforcement powers. Nevertheless, self-regulation has its limits (as does public

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Self-regulation and self-regulatory organisations may be better able to judge the quality of the application for a brokerage license, may have greater insights in what constitutes market manipulation and have more information systems to detect such behaviour. They may also be able to de-license, issue a reprimand (name and shame), and impose financial sanctions, which may be more difficult for a government agency.
sector regulation and supervision) and needs to be coordinated with other aspects of macro and microeconomic governance. Thus self-regulation is typically embedded in the legal and regulatory fabric of national policy communities and networks across a range of sectors.

There have always been limits to self-regulation, just as there are limits to what public sectors can meaningfully do in a private market setting. The main point is, who makes the rules and for whose benefit? This question is highly relevant in a sector where the (short-term) private gains from regulatory laxity or indeed semi-official cartel arrangements can be considerable, and the longer-terms costs for the whole economy likewise. Particularly following recent scandals in developed countries’ capital and financial markets, the limits to private market-based forms of regulation and supervision have become more apparent.

These limits have been in part the result of structural changes in markets, which are in turn linked to liberalisation and cross-border integration. Stock exchanges are losing their monopoly in trading, making it harder to control activities through voluntary and club-type mechanisms. The trend of privatisation and vertical separation of the various parts of the financial market infrastructure, e.g. the demutualisation of stock exchanges, and the separation and privatisation of central counterpart, clearing and settlement functions, have made it more urgent to place certain oversight functions with government agencies. Indeed, the public sector has stepped in to retain more or even to assume some powers previously delegated to the private sector. This happened, for example, with the accounting and audit boards in the US, and earlier with securities markets regulation and supervision in markets like the UK.

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1 There is much evidence that public sector regulation and supervision of banks serve private interests or the interests of the regulators, rather than public policy objectives (Barth, Caprio and Levine, 2005).

2 Why these problems have arisen now in what are otherwise very sophisticated financial markets is less clear, but their emergence appears to correlate to the very market-based liberalisation which is discussed in this section. As public authorities have become more reliant on disclosure practices of firms, and the incentive systems for corporate managers depend increasingly on market performance in a situation of intensified competition (in line with the arguments concerning “shareholder capitalism”), personal reward and the social functions of firms in the economy have become increasingly intermingled.

3 Although it is hard to generalise in this area as many countries, especially emerging markets, coming from more centralised models, are still in the opposite process of giving greater responsibility to the private sector.
The trends are also due to the breakdown in boundaries of once-distinct market segments, particularly the trend known as “securitisation”.

Cross-border market integration and the more decentralised nature of markets have their own dynamics, making the picture more problematic. The coherence and shared norms of national financial services policy communities is taxed by global integration, and the jurisdictions of national agencies are tested. Credit and operational risks, for example, have become more complex to assess across both functional market segments and international boundaries. One can expect less from self-regulation in stock markets when the concept of a stock exchange has become unclear with the advent of new electronic trading systems and participants have become increasingly diverse and international. 

Markets have responded in some dimensions to the increased global nature of financial activities. Clearing and settlement systems that deal with credit risks have emerged (such as the continuous-time linked system for banks), which have also forced coordination in forms of transaction across borders. The increased use of technology has introduced new risks, but private sector groups (such as BITS) assess these risks and propose new approaches. The collective action clauses for bond contracts that countries (both developed and developing countries) under US or UK jurisdictions are increasingly adopting are market mechanisms that have helped as well.

Many international markets and products, however, are too complex to expect purely private forms of coordination to be fully effective. How a handful of commercial banks and the government of major developed countries contained the debt crisis of the 1980s, for example, is no longer feasible. The multiple forms of financing combined with large numbers of creditors and debtor countries make coordination difficult in a crisis, as the events of the fall of 1998 showed, and risk management by individual (national) agencies is insufficient. Financial institutions are also more heterogeneous and are often involved in more activities in multiple market segments. These trends make coordination more difficult and they increase the risk of conflicts of interest (for example, multiple interests, use of privileged information, etc.).

The problems of coordination and the potential for conflicts of

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8 What type of (private or public) arrangements could one expect to cover a trade between, say, a German and Brazilian investor of a French stock listed on a US stock exchange, but traded on electronic trading system owned by a consortium of international investors, but legally incorporated in the UK?
interest have indeed become system-wide. Given the diversity of interests among financial institutions and of national financial systems, it is harder to assemble a coherent coalition of public and private actors for designing new rules. Building institutions of governance at the global level is costly and takes time. In the absence of public forms of governance in which private self-regulation can be designed and then embedded at the global level, one must be modest as to what can be expected from alternative forms of rule-making, such as a Code of Good Conduct, that has been under development for sovereign debt restructuring in recent years.

Despite both private and public inputs, these processes have largely represented creditor countries’ views with considerable deference to the interests of private actors, and developing country issuers have so far been rightly so more sceptical of their benefits. The greater coherence among large-scale, private financial conglomerates, which are simultaneously active in the markets and policy processes of a wide range of states, enhances the risk that the rules may be designed so as to (largely) benefit the private sector, in particular the more globally-active and integrated institutions. Apart from the nature of the rules, to what extent will the private sector have the incentive to enforce or to disclose information concerning (non-binding) arrangements? We must at least expect that developing countries will have more urgent and different needs from either the private sector or creditor countries, and global governance must reflect these needs if the development process is to be a success. In the end, only cooperation among national public sectors or properly global institutions can deal with free riders and enforcement.

2.2 Dynamic Effects

The dynamics of institutional change are complex in any policy domain, particularly where the liberalisation of financial markets is concerned. There are obvious links between the institutional environment and the successful functioning of the financial sector, as the law and finance literature and recent financial crises have shown where weak or missing institutions hamper growth or cause crises. The lessons that the institutional environment needs to be consistent with speed

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9 Developed countries’ market participants are also concerned about the new codes, but more likely because they may lead to legal liabilities and thus costs should they take the form of statutory or regulatory standards.
The Need for Institutional Changes in the Global Financial System

and forms of financial liberalisation and deregulation are now more accepted, although there are still many questions about what constitutes an institutional environment appropriate to a particular type of country at a specific level of development.

Liberalisation by definition cedes prerogatives to the private market forms of interaction at the expense of public agencies seeking to direct the course of economic development. While in many cases liberalisation may accomplish public policy goals better than state intervention, it will not always do so. This is particularly the case where endemic forms of market failure, such as financial crisis, are present. An even more complex issue is the dynamic by which economic reforms (financial liberalisation, capital account liberalisation, and privatisation) affect the balance between private and public interests in shaping the institutional environment. History tells us that a variety of models can work, but that some combinations clearly lead to trouble. These endogenous forms of institutional change are still poorly understood.

These dynamics must be understood in terms of the nature of policymaking in the financial sector, wherein the stability and successful functioning of the financial system is closely linked to state and wider public interests. Economic development and growth requires successful financial intermediation, and states themselves are heavily involved in debt and other financial markets: states thus need and overlap with financial institutions. This situation is accentuated in the case of developing countries. Given their (perceived) systemic importance, commercial banks have traditionally benefited from a large safety net provided through various means (deposit insurance, lender of last resort, etc.). Most financial services markets have some form of more or less intrusive public sector regulation and supervision. Regulation and supervision are unlikely to be successful without at least minimal consent of the sector itself, and where this is largely private, the consent of these private interests. This means that private financial interests become privileged negotiating partners in these crucial policy processes. Their preferences are the most likely to be enshrined as public policy, particularly where states are anxious to attract capital for their own or general development needs.

Furthermore, financial services are characterised by low transparency and central banks have traditionally had close and relatively exclusive relationships with banks and other financial institutions that fostered this. Central banks are, after all, banks, and they certainly think more like banks than they think like ministries of economic development.
Given this closeness of public and private actors and their shared interests in the policy process, the definition of public interest as distinct from the interests of private sector itself is consistently difficult in financial services industries, leaving greater scope for private interests to affect rules and outcomes. Thus although many improvements in the institutional environment have been a response to or codification of market forces, regulatory capture is a persistent threat.

The forms in which the private sector may gain too large a stake will vary by economy. In developed countries, they may take the form of lobbying and regulatory capture, which may not breach formal laws but can undermine public policy objectives. The role of the private sector in lobbying for financial sector regulatory change in the US (say the repeal of the Glass-Steagall act separating investment and commercial banking) and some other developed countries has been well documented. Heinemann and Schüler (2002) conduct a cross-country analysis on supervisory systems and financial structure in Europe and find empirical support for the private interest (Stigler) view on regulation aimed at a “preference for laxity,” and less so for a “barriers to entry” view. At its worst, lobbying for a regulatory framework of “shareholder capitalism” deteriorates into Enron, WorldCom and securities market scandals involving outright crookery.

In developing countries, the dynamics unleashed may, in addition or instead, take the form of more overt corruption, e.g. banking licenses up “for sale”, or a call for more securities markets regulation and supervision being ignored for (too) long as insiders have captured legislators. Alternatively, there may be rampant clientelistic lending in which, for example, industrial concerns are permitted to own financial institutions and thus effectively lend to themselves at will, all of which goes unchecked or is poorly supervised. Importantly, the dynamics can influence the development processes in diverse national economies differently. While in more developed countries, these problems may introduce minor distortions and adverse growth consequences, in emerging markets they can lead to financial crises with large output losses or severe growth costs, and major wealth redistributions (Zhang, 2000).

While corruption and weak governance is not new, these dynamics were not entirely anticipated. The breakdown of financial repression and other institutions of developmental states was bound to be dramatic and to result in a reshuffling of the political as well as the economic cards (Zhang, 2002). Many reform and adjustment programmes still have faltered for reasons of misjudging the dynamics, e.g. few foresaw the
adverse dynamics of mass privatisation in terms of creating no or little constituency for improving the institutional environment in transition economies. While one cannot perfectly assess these possibilities *ex ante*, an assumption of diversity among cases and greater attention to the political dynamics of policymaking and legal institutions in various national settings would be a start. Global financial governance must take such problems as starting points, not afterthoughts.

As an analytical exercise, the respective responses and capacities for adaptation of different (public and private) actors relative to the speed, type, and sequence of deregulation, privatisation, etc. in a dynamic institutional environment need to be assessed. Here aspects such as the expected drain of human capital from regulatory and supervisory agencies or the anticipated rents to be earned from bribing officials once a financial system is liberalised need to be brought into the picture. In addition, in liberalising institutional investors, one should anticipate shifts in regulatory preferences, e.g. preferences for different (better or worse) regulation, supervision, and corporate governance.10 In essence, though difficult to predict, the changes in market structure and institutional and normative framework of governance needs to be plotted against potential changes in actor preferences.

At the international level, evidence is less abundant, but the dynamics are no less troublesome. Private banks have clearly played a major role in pushing for cross-border liberalisation in both developed and developing countries. As liberalisation began, the coherence of private-public sector interactions at the national level was diluted, but the jurisdictions of state agencies remained constrained to the national level. Despite some eventual successes such as the Basel process, cross-border cooperation was, as always, difficult and slow to emerge. Furthermore, it tended to be crisis-led since crises forced national authorities into more supervisory or other cooperation. Private interests (free of cumbersome questions of sovereign or legal jurisdiction) were much quicker to regroup in coherent coalitions at the international level, for example the Institute for International Finance (IIF), and private preferences of globally active institutions tended to converge quickly, as noted above. Once again, the influence of private interests in evolving mechanisms of global governance may have been too strong. It has been

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10 In addition, the effects of changes in regulation on financial institutions’ and financial markets participants’ profitability and franchise value would be analysed, and how that in turn may affect the ability and incentives to manage risk over time.
argued, for example, that the Basel II capital accord reflects private interests to a much greater degree than did Basel I (Soederberg, 2002; Wood, 2004). Supervisory agencies were involved in close relationships with international banks as their essential consultative partners in the negotiations. Banks were particularly effective in making their case in what ended up being very technical discussions (see further Claessens, Underhill and Zhang, 2003 for this argument).

Dynamics at the international level also have implications for developing countries. Again, as for domestic liberalisation, there can be benefits. A process of international liberalisation and greater financial integration can constrain discretionary macroeconomic policies, which can be (more) valuable for inflation and debt-prone emerging markets. As in a domestic context, these beneficial pressures of the private sector can take many forms depending on the individual case (e.g. better standards for credit cards as international lenders enter). On a system-wide basis, there have been many beneficial forms of global self-regulation, such as the various standards mentioned before. But there can be perverse consequences, maybe even more so than for domestic transactions and institutions.

For one, a global system is far from transparent and considerably dilutes the influence of developing countries on financial markets. They face the power of both public and private agencies of developed countries, often in coalition with each other. Lines of authority are far from clear and developing country preferences are difficult to enforce in the light of urgent development needs. Geopolitical and other factors add extra spin to the problem. There are thus more degrees of freedom for the private sector to operate in ways favourable to their own interests rather than in line with broader international or national development goals. In many markets, especially developing countries, foreign players have a large role in domestic financial markets and can “threaten” national agencies, thus gaining a stronger voice than the public interest calls for. This can be done directly, say in case of emerging markets and developing countries in times of financial distress, as the arguments used for (many) bailouts by governments of foreign investors. Or it can be by having international agencies pursue policy conditionality on international aspects more favourable to private interests.

Although it is less likely than it would be in a domestic context to take the form of corruption, the consequences can be equally severe. The financial bailout of crises, for example, seems to have benefited international lenders disproportionately at the cost of domestic investors and
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taxpayers, especially the poor. When these outcomes confront the legitimate and democratically expressed policy preferences of developing countries, the dissonance is considerable, and they find themselves with little influence on the norms and outcomes set by global governance processes.

As noted, global arrangements such as the Basel Committee are characterised not only by low transparency but may have furthered private sector interests to the detriment of developing countries, are even less accountable to their national interests, and may have aggravated matters (see Coleman, 1996). The (long-ongoing) debate on sovereign debt restructuring mechanisms is another example. The private sector, in particular financial intermediaries, has argued against debt restructuring mechanisms since according to them, those would lead to higher costs of debt. More likely, however, their opposition is motivated by the fact that, as investors, they will be worse off since such rules will in part reduce the scope for moral hazard and (unnecessary) bailouts. Private interests resent potential constraints on their freedoms even when it can be clearly demonstrated that debt workout arrangements, which work perfectly well at the domestic level, would be better for all, including the banks, in global crisis situations (Miller and Zhang, 2000).

The issue is not so much that private parties will argue for their own interests, but rather that the institutional framework and the position of all actors do not allow for a proper balancing of private and public views and of various countries’ views. Global level governance is not anchored in the sorts of chains of (democratic) accountability that serve to amplify the voices of weaker actors at the domestic level. Private bondholders or taxpayers, perhaps more interested in clear rules, may be less organised than commercial banks that benefit from less clarity. Countries may face conflicts of interest or time-consistency problems in terms of pushing for solutions. The outcome may not only be unfair, but also inefficient. In many cases, there have been delays and the lack of public regulation has not been filled by global self-regulation, or vice versa.

3 Design of the International Financial System

In this section, we investigate how to analyse the design ofinternational policymaking structures and institutions given the identifiable problems facing the international financial system and preference-setting
in national contexts. Here, the basic question is whether the rules under which the international institutions currently operate are the “right” ones from a first principles point of view. The question can be addressed using several types of approaches, some of which we will discuss.

3.1 A General Public Economics Approach

A general public economics approach can be used to analyse the design of international policymaking structures and institutions, given the identifiable problems facing the international financial system and preferences developed in national contexts. A useful starting point is the definition of global public goods related to the international financial system, fulfilling the criteria of non-excludability and indivisibility (consumption by one or many does not reduce availability for others). These public goods could include: international financial stability and efficiency; adequate reliability of contracts and property rights backed up with the presence of efficient, ex post enforcement mechanisms; a lack of abuse of the international financial system for purposes deemed economically undesirable (e.g. financing of polluting activities or those adding to global warming) and other global merit public goods. Complementary, the potential tools for ensuring the provision of such public goods would need to be identified (e.g. taxes, quantity restrictions, policy harmonisation, disclosure, specific rules or institutions), a far from obvious exercise, but not the focus of our analysis here. (Of course, many of these global public goods do not relate to the international financial system alone, and as such may require other analyses, tools and interventions as well.)

Once the global public goods and potential and necessary policy interventions to achieve such goods have been identified, questions to be addressed include: what global public policy issues should and can be productively delegated to international levels (or sophisticated forms of transnational coordination)? Correspondingly, what forms of representation should exist at the international level, given a set of national

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11 One can further distinguish “merit” goods and other, “welfare” goods. As an example of the latter, citizens of developed countries may well care about the welfare of citizens of developing countries, not just because of their own interests, and therefore a certain design of the international financial system may be perceived as more desirable. Here we focus largely on the question whether the design of the international financial system is best in terms of delivering merit goods.
preferences and a need for national forms of representation? More specifically, many problems in international financial markets have to do with coordination issues, as in times of financial distress or financial crises. What arrangements might lead to the best resolution of the collective action problems inherent in many aspects of international financial governance? As a very specific question, what governance structure is preferable for an international lender of last resort or functional (cooperatively-based) equivalent? Or more broadly, what constitutes a consistent set of national and international forms of representation that effectively provides for necessary public goods at the global level, yet at the same time respects the process of preference formation at a national or regional level?

Obviously, the design and functioning of international organisations is a broad area, on which much research has been undertaken (by political economists, political scientists, and international legal scholars). Questions on the issue of enforcement especially need to be addressed. Countries are notionally sovereign, despite power differentials and the constraints of interdependence, and can always ex post deviate, as has been observed for both developed and developing countries (e.g. the ex post deviations from the EMU Growth and Stability Pact and the many defaults on international contracts). At the international level, the basis for successful governance is clearly an underlying consensus on the tools and objectives of cooperatively-designed policies. Nonetheless, to be effective, agreements and institutions also need to be self-enforcing (including dispute-settlement mechanisms) or to derive their commitment from either clear positive incentive structures for all parties or from political enforcement mechanisms. Given power differentials, this has many implications, among others for representation, and the form and impact of competition among international agencies. Even the powerful must be subject to the rules.

In a domestic context, a majority system may deliver the first best outcome on how to assure the provision of national public goods (although even this is not clear in the context of say information asymmetries or prevalence of interest groups). Even so, provision for minority opinion and rights is an important part of domestic democratic governance. In an analysis of the preferred voting system for international agencies, however, it has been found that under self-enforcement,

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12 The lender of last resort is different from that played by the IMF so far (see Fischer, 2003).
unanimity is most often the optimal system (Maggi and Morelli, 2003). This unanimity principle is not dissimilar to how cooperatives, including financial cooperatives such as rotating savings associations, work in low or weak contracting environments. Whether this result applies to international finance and international financial organisations more generally is, as yet, unclear. Certainly, the general difficulties of unanimity systems in yielding effective decisionmaking and in coping with power differentials are not unknown. The need for speed and efficiency in decisionmaking, important in financial markets, militates against the unanimity principle. Formally, we observe mixtures of unanimity and majority-voting systems in international financial organisations, although in practice unanimity decisionmaking is most commonly, even in majority systems. Thus, decisionmaking in international cooperative environments regularly hinges on broader perceived national interests, not just interests related to the narrower mandate of the specific organisation, e.g. financial stability. Yet, this can clearly sometimes lead to unfair outcomes. In the context of the HIPC debt reduction initiative, for example, relatively poor developing countries like Costa Rica that were creditors to HIPCs were obliged to accept official debt reduction even though they had no say in the design of the HIPC initiative.

Another issue is that the lack of enforcement mechanisms can lead to unwarranted competition among international organisations. Agencies must continuously demonstrate their value to members: that the costs of deviating from the particular arrangement are higher than the benefits of staying in. This creates competition, which may explain the continued flux of private, public and mixed agencies involved in international financial affairs (for example, the G-20 and the Financial Stability Forum are newly established). Since investments are costly and highly specific, especially in financial markets, there are nevertheless limits to competition and switching, thus sustaining international institutions to some degree. Furthermore, legal conventions provide some international agencies with authority in specific areas (e.g. the IMF and World Bank through the Bretton Woods conventions).

The recent changes in international financial markets nevertheless affect the ability of some agencies to sustain themselves, with some declining in importance (for example, the Group of Thirty was more important some years ago) and others increasing. International agencies also adapt, of course, as the BIS/Basel process has done (moving from the interwar role of a bank for settling national debts to a forum for
international monetary policy coordination among central bankers and somewhat of a global financial regulatory body (see Felsenfeld and Bilali, 2004). And the Institute of International Finance has altered its focus from being a depository for and clearing-house on country risk data and analysis concerning the 1980s debt crisis to an advocacy group for international commercial banks. There is some considerable path dependency, of course, and as such it is hard to generalise about how the international financial system will evolve, but one can be sceptical whether, with such dynamics, it will lead to the most efficient outcome. Since little research has been done in this area, however, answers remain elusive for now.

3.2 Agency Approaches

Another approach would be based more on principal-agent, agency perspectives and game-theoretical approaches. Taking thus a more political economy but still rational choice approach, one can try to adopt an agency perspective to the international financial system. Principals in various groups try to pursue their own interests with agents in various forums voting on their behalf. Here one can think of lobbying models where lobbying has rewards for interest groups because it affects decision-making. The “technology” for affecting decisions can be through direct payoffs, through bargaining, or by using informational advantages. Lobbying may have first mover advantages (full competition in lobbying may otherwise lead to degenerate results), treats points may arise from other areas (e.g. international politics), and informational advantages may arise from superior knowledge or resources. This approach has already been applied in case of domestic financial reforms (see for example Pagano and Volpin, 2005; Perotti and von Thadden, 2004). In less democratic countries, lobbying on legislation and enforcement can have a major impact on financial development and thus entry. In highly unequal countries, poorer elected politicians and poorly paid public officials may be more vulnerable to offers of bribery. Then lobbying allows smaller groups to exert a disproportionate political influence on legislation or its enforcement, as first noted by Olson (1965). Olson also observed that collective purposes and action are more easily undertaken by small, single purpose organisations than by broad, multi-purpose coalitions. In short, this literature models legal and financial institutions as the outcome of political choices.

The international context is even more complex. One approach is to
model it as a two-step agency problem, with private principals ("citizens") interacting with governments as agents at the national level, and then, at the international level, governments as principals interacting with international institutional "agents" like the FSF or the IMF, as well as private agents, like IFIs. The risk is that specific private interests, rather than the general public interest, become the main principals and governments/public agencies their agents. Furthermore, power differentials mean that only the more powerful countries can realistically expect international institutions to behave as agents.

One can also analyse the international decisionmaking processes using a game theory approach, again possibly in two steps. Private groups bargain with public agencies and in turn, governments bargain with international agencies, and sometimes international agencies bargain directly with private interests, each having certain strengths and threat points. While these and other types of models have been used and empirics have been conducted on the political economy of domestic financial reform, so far, few of these approaches have been applied internationally. Likely, it will remain difficult to make any statements on what these approaches will teach us about the design of the international financial system since there are so many parameters to consider. Furthermore, antagonistic bargaining models do little to account for the close links between (national or international) public institutions and private sector organisations, including the potential prevalence of capture. Just because we consistently distinguish analytically between public and private sectors does not mean that their interests in governance necessarily diverge.

Related to these approaches would be efforts to identify the principal-agent combinations or coalitions interested in international financial reform. In a domestic context, one can expect, for example, shareholders to be interested in voting on corporate governance reform, or depositors to be possibly interested in better banking system regulation and supervision. Although relationships are very indirect, cross-country analysis has indeed found relationships between financial and ownership structures and the interest in such reform on the one hand, and actual reform on the other (see Pagano and Volpin, 2001 for a review). Some empirical analyses exist of international financial decisionmaking, such as the role of political factors in IMF and World Bank adjustment lending programmes or the allocation of official development assistance (Alesina and Dollar, 2000). But further empirical analysis at the international level is needed.
These rational choice perspectives can provide valuable insights into the likely ways in which different sorts of interests in a given setting are likely to interact. However, the models will at best remain suggestive of correlations between actor preferences, e.g. principal-agent relationships, and actual decision-making outcomes. Models have difficulty demonstrating definitively who or what, with which preferences, led to which outcomes in the sense of causation, particularly where public and private interests interact closely and consistently in a specified institutional environment, yielding a process of socialisation to accepted norms, ideas, and practices which may exclude even demonstrably necessary policy alternatives. In the end, there is likely to be no substitute for detailed empirical research into the preferences and relative resources of actors, the institutional settings in which they interact, and the resulting coalitional politics cutting across national and institutional boundaries that lead to outcomes.

3.3 Lessons from Current and Historic Arrangements

Analysis, theoretical and empirical, is likely to show that many of the current institutional arrangements lack essential economic and political justification. This is surely true of long-existing institutions like the IMF and World Bank where the current percentage representation of shareholders no longer reflects the relative economic or financial importance of countries. Voting processes do not necessarily satisfy any optimal voting model in terms of either representation or decision-making efficiency. There is already a debate underway that can help clarify the preferred structures as well as shed light on the underlying political economy factors.

Similarly, sub-optimal and unrepresentative processes have developed recent reforms to the international financial architecture, with commensurate defects. Which precise policy gap was the Financial Stability Forum intended to fill and why did it emerge with its specific composition of countries (G-7 plus some international organisations)? The various G-groups (G-7, G-8, G-20, etc.) are outside the formal institutional framework, yet they are very important in building coalitions driving specific policy and institutional changes. How might they be conceptualised? What was the anticipated role of the G-20 and why does it include these specific countries? How do these organisations and groups function in practice and how does this relate to their stated objectives, if any? Was the G-20 only an attempt to co-opt the non-G-7
countries into the rules and standards of the G-7, has it been dominated by the United States, or has it led to genuine broader representation? Much can be learned from analysing the political economy of the origins and the effectiveness of these recent and older international institutional arrangements.\footnote{See Soederberg (2002) for an analysis of the FSF and the G-20. Other possible arrangements to analyse include: How did the Basel II process come about? What was the role of the private sector in the design of Basel II? What was the role of various groups of countries, developed/developing countries? (See Claessens, Underhill and Zhang, 2003, for some analysis.) Idem for the SDRM: what was the role of the private sector in affecting the outcome, why was there no eventual agreement? Or what motivated the change in the recent decade at the IMF in terms of more openness and more scrutiny, including having its own independent evaluation department? Has it meant different decisionmaking processes? Or what has triggered the private sector to come up with rules, are these good rules, when does it work and when not? A new Code of Conduct, for example, is being designed on dealing with financial crises. Or regarding global efforts currently underway on having firms from developed countries provide more transparency aimed at reducing corruption, but being resisted by selected interests, e.g. oil companies. What are the political economy circumstances that allow this to happen? Do these efforts reflect private market interests only or do they have a public policy value?}

Lessons can also be learned from the EU/EMU and other regional (financial) integration efforts (NAFTA, EFTA, AFTA, Asian Monetary Fund). The evolution of the EU has been a long political process, and by now it has developed considerable depth to its institutional processes to replicate domestic policy choices and domestic politics, often by integrating EU processes and policies into national politics. While the EU will not be easily replicated and represent the only significantly supranational model so far, it can provide useful lessons in governance and institutional change in international finance. The EMU, for example, has meant member central banks and treasuries had to give up all autonomy in monetary policy. One might set out to determine under which conditions increased monetary and financial integration has been associated with productive institutional changes leading to better regulation and supervision and enhanced stability. Also in other financial services areas, the EU has been debating how best to balance changes and harmonisation in rules with institutional changes, like home supervision. More generally, what has been the impact of the shifts in balance between national and supranational or international agencies and the increased financial integration on national authorities’ decisionmaking in the EU or other regional arrangements? Have substitute arrangements

From: Protecting the Poor - Global Financial Institutions and the Vulnerability of Low-Income Countries
emerged? One of the areas where little progress has been made is in the lender of last resort, which was once the responsibility and in practical terms lay within the capacity of national authorities. The unification of monetary policy and the intensified integration of EU financial markets imply these arrangements no longer apply. Why is it that this area has been so more difficult and what does this suggest for efforts on establishing a lender of last resort at the global level?

There are also historical lessons on some of these issues, including from federalisation in countries such as the US and Mexico. In the US, some have argued that the competition for capital has led individual states of the union to offer relatively strong property rights. The key to the successful race to the top was a common federal structure in which freedom of movement of capital and labour was assured. Lessons from Mexico suggest that a federal structure does not always deliver this, because there also needs to be institutionalised political competition among states (Haber, 2004).

There are similarities here with the debate on race to the top or to the bottom in the context of financial competition among states and countries. It has been argued, for example, that the ability of US corporations to incorporate in the state of their choice (often Delaware) led in some regards to lower standards corporate governance because as it has allowed for more entrenched management by facilitating various takeover protections (Bebchuk and Cohen, 2003). Others have argued that this form of competition has led to improved corporate governance and better firm functioning (Romano, 2005). Yet, others again have argued that only the intervention by the federal state has restrained individual states from offering worse environments and triggering a race to the bottom (Roe, 2003). When does federalism deliver which results?

Of course, if the analogy is to work at the international level, we need to consider competition among sovereign countries rather than units of a federation and how competition for capital among these units compares to the current internationalisation of financial services. Again, the EU might provide some lessons here. In some areas like banking, the EU has chosen a model of minimum harmonisation and subsidiarity, with free competition, whereas in the area of securities markets more uniform standards are being sought. What explains the difference in approaches? Is banking a more local activity than capital markets and thus less in need of uniform rules (unlikely)? Was this indeed the optimal arrangement balancing issues of efficiency and effectiveness? Or is banking less transparent and more subject to
preferential treatment by government of local champions and is full harmonisation therefore less desirable from a political, rather than economic perspective? To what extent do EU members actually compete over policy, or was there a broader, transnational consensus among the associated actors in the process? Is it the case, because competition among individual countries largely takes place in financial markets (e.g. through “beauty contests”), that it leads to the maximisation of private interests? Are there forums where (collections of) countries compete mainly in terms of public interests?

3.4 Towards a More Political Economy Approach?

As pointed out at the outset of this chapter, the tensions between the achievement of global and national development objectives in a world of fragmented governance, multiple institutions, accelerated financial integration and increased private sector roles need to be better understood, and we are just at the beginning of this analysis. To understand these relationships and what to do about them, it is clear though that one needs to more fully consider both the political and economic dynamics at the national and international levels.

One needs to begin by clearly identifying the incentive structures of both markets and policymaking institutions, and how they simultaneously contribute to the integration of financial markets and many of the policy dilemmas we have identified. By beginning with the preferences of actors, one can begin to understand the pressures for change. One then needs to understand how these preferences emerge from particular institutional and market and institutional settings. By setting the preferences of actors in their context of the markets and the institutionalised policy processes of the state and international regimes, one can hope to better understand how actors compete simultaneously for both political and economic resources in order to shape their environment in their own image or interest. This helps to clarify the inherent endogeneity of most variables contributing to the eventual dynamic outcome. While parts of this chain have been analysed, the full process is yet unclear.

4 Legitimacy of the International Financial System

Finally, there are issues of how policy processes and institutions at the global level might become more accountable and outcomes more legiti-
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mate in relation to the policy preferences of citizens of all economies, in particular the developing world. This concerns both the compatibility of any global financial architecture with national economic development aspirations and political processes as well as the bonding value derived from the international system. Here the question of power differentials competes with issues of representation. What is legitimate for the powerful, based on the shareholder principle, is not always representative, and therefore legitimate, for those most likely to be affected by the decisions taken. Furthermore, as was pointed out in Section 3 above, forms of representation should respect preference formation at national and regional levels. If such forms of representation not only stimulate legitimacy, but also serve as catalysts for broader and more successful international development processes, the economic benefits for all are not difficult to demonstrate. Let us remember that the “democratisation” of western European economic development processes in the post-war period was also accompanied by the most astounding improvement in economic performance. Representation and efficiency need not work against each other.

In the eyes of some, the international financial system has been undergoing an identity crisis. The failure to deliver on many of the goals set out by international development agencies, the debt problems of low-income countries, the difficulties in crisis management, among others, all raise questions in the eyes of the general public on the validity of the international organisations involved. The agencies and the system more broadly are seen as failing to prevent or otherwise successfully confront the major challenges they were supposed to address, especially the setbacks to the development process represented by persistent financial crisis. Of course, this is not the only point of view. Where developed countries are concerned, the international financial system has performed relatively well in the last three decades. For example, the system has done well in terms of dealing with large structural changes and has not faced the type of 1971-73 crisis associated with the breakdown of Bretton Woods. Nonetheless if we are to assess outcomes in terms of representation and in relation to fairly simple notions of political legitimacy, clearly the decisions of a minority of the powerful, the shareholder principle, has prevailed and has imposed important costs upon those poorly represented in global financial governance.

The different perceptions can in part be attributed to changes in the world. One can make a case that developments have been forcing
changes on international organisations for which they were not well equipped because their original mandates were different. Institutions like the IMF and World Bank responded to the changes in part by broadening their agendas and taking on issues such as (global) environmental performance, socio-demographic issues, and more generally pursuing a more complex vision of the development process, relying in part more on private sector activities. As part of this, they became more open and participatory in their decisionmaking, making their relationships with client countries, donors and other agents (like NGOs) more complex and risking (greater) client capture. It has also made it more difficult for them to explain their usefulness to their shareholders and other stakeholders, all the more so since they lost their traditional tools in part. A vicious circle of ever more responsibilities and subsequent failure to meet expectations for many of them resulted in even deeper legitimacy crises for some agencies. Furthermore, one might argue, we could not expect IFIs to change faster than their (more powerful) members. But this account fails to bring in the role of private interests in the policy process as discussed above, and how private preferences have considerably reinforced the instincts of the creditor countries in international institutions.

Many of the other international financial agencies and organisations – such as the BIS, the Basel Committees, the FSF, etc. – do not operate in the public eye as the Fund and the Bank do, and as such they do not face similar goal and legitimacy crises in the eyes of their members. It is national authorities in the first instance that address their functioning, including the legitimacy of their policies in relation to domestic political processes. Yet, they are not immune to problems of legitimacy in a broader sense. The lines of accountability to national authorities of an institution such as the Basel Committee, let alone to parliamentary scrutiny, are less clear than their association with their private interest interlocutors. They may appear to redress the balance between self-regulation and sufficient public oversight of the global financial system, but the rules they promulgate are remarkably in line with private sector preferences.

They fail a legitimacy test in another respect. Even if one were to accept that they are fully accountable to national policy processes, the decisions that they take affect a far wider public than their G-7/G-10 “shareholders”. Legitimacy of the international financial system thus needs to be conceptualised more broadly, relative to the often-contrasting interests of the many developed and developing economies.
in the world today. To whom should the system be accountable, and in whose eyes and for what purposes should the system be legitimate? It may be helpful to think in terms of the standard categories of input and output legitimacy (Scharpf, 1999) where input aspects of legitimacy have to do with the legitimacy of the process, and the output side concerns the legitimacy of the outcome. In the developed countries, private interests and public agencies dominate the input side regarding the international financial system. Consequently, it is not surprising that the outcome is relatively satisfactory to developed country governments and (despite some protests) largely to their public. However, the process (input) is singularly unrepresentative of developing country interests, and it is not surprising that such a process leads to an outcome that is often incongruous with the broader objectives of economic development. Why should developing country preferences not be equally well represented, so that international norms are compatible with national political and economic dynamics, and not the other way around?

Solutions may have to be found in building regional coalitions among developing countries and moving away from individual assessment by markets and international financial institutions to representation and assessment of collective interests. One such example was the role of a number of developing countries in the Doha Round of trade negotiations, where they steered towards outcomes much more favourable to developing countries. Another example is NEPAD (New Partnership for Africa’s Development), which relies, among other things, on countries designing their own reform programmes and on extensive peer monitoring. Such mechanisms may discourage downward “policy competition” among countries, increase regional representation and rebalance power away from the “centre”. Another mechanism is the financial support provided by the UK and Dutch development ministries to the executive directors in the IMF and World Bank that will help increase their “voice.”

5 Conclusions

There is little doubt that the interests of developed countries predomi-
nate in current global financial governance processes, via the “share-
holder principle.” Financial globalisation has also involved a change in the balance of power between public authorities and private interests in international monetary and financial policies. This begins at the national
level in developed countries where financial services policymaking is characterised by low transparency and national central banks have traditionally had close and relatively exclusive relationships with banks and other financial institutions at the national level. As national authorities have taken on market liberalising policies closer to private sector preferences, this situation has become increasingly extended to financial governance at the global level, where the private interests of developed country financial institutions are increasingly evident. Given this closeness of public and private actors and their shared interests in the policy process, it is not surprising that private interests are predominant in determining rules and outcomes in domestic financial systems.

How the private sector gains this stake varies by economy. In developed countries, closed-circuit lobbying or even regulatory capture may occur, not breaching formal laws but undermining broader public policy objectives. In developing countries, more overt forms of corruption may be more common, e.g. banking licenses up “for sale.” It is not just the static effects that matter. Many reform and adjustment programmes have faltered because of misjudgements about the dynamics of liberalisation and privatisation, which are related to political economy factors. For example, few foresaw that the dynamics of mass privatisation in transition economies would leave little or no constituency for improving the institutional environment. Few foresaw how private financial interests would commandeer state-initiated liberalisation processes, undermining the necessary adaptation of financial supervision to the new market forces, which was a crucial ingredient of the Asian Crisis. In many countries, a call for more securities markets regulation and supervision was ignored since insiders captured legislators and regulators.

Global financial governance also has faced such issues. At the international level, private banks have clearly played a major role in pushing for cross-border liberalisation in both developed and developing countries. Their influence operated through both national and IFI policies to this effect. As cross-border liberalisation began some two decades ago, the effectiveness of regulation at the national level was diluted, but the jurisdictions of state agencies remained constrained to the national level. Cross-border cooperation and supervision has been, as always, difficult and slow to emerge and tended to be crisis-led. Private interests were much quicker to regroup in coherent coalitions at the international level, pushing their preference for “governance light.” At the level of global financial governance, developing countries face
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The power of both public and private agencies of developed countries, often in coalition with each other. Geopolitical and other factors add extra complications to the problem. The resulting lack of financial and other regulation at the international level in line with broader national development goals has left more space for the private sector to promote its own interests.

In many developing countries, foreign financial institutions from developed economies have had a large role in domestic financial markets and have been able to “threaten” national agencies, thus gaining a stronger voice than the local constituents of the “public interest” behind the national policy agenda. This has been pursued either directly at the local level, or by using the home developed-country state in bilateral negotiations, or indirectly through the conditionality and debt workout terms pursued by IFIs and determined by (home) developed country shareholder power favourable to private interests. Global arrangements such as the Basel Committee and other standard-setting bodies dominated by developed countries have aggravated matters by furthering overseas private sector interests to the potential detriment of local needs in developing countries.

In the eyes of some, and as a reflection of these governance weaknesses, the international financial system has been undergoing an identity crisis. This assessment of course varies according to perspective. The early experiences of developed countries with liberalisation were fraught with difficulty. Most underwent serious national banking crises (e.g. Scandinavia, the US), and the growth of cross-border markets produced international crises such as the Franklin National/Bankhaus Herstatt (1974), Banco Ambrosiano (1982), the post-1982 Latin American debt crisis, BCCI (1992), or the Barings incidents where contagion risked the downfall of the system. Since the early 1990s, the international financial system has performed relatively well for these countries. For the rest of the world, the view is different.

The failure to deliver on many of the goals set out by the international development community, the debt problems of low-income countries, the setbacks to the development process represented by persistent financial crises, and the continuing difficulties with debt workout and the crisis management framework, all raise questions about the effectiveness and eventual legitimacy of international financial governance and of the organisations involved. While some observers may assess the international financial system in a positive light, we nonetheless need to assess outcomes in relation to representation in decisionmaking.
processes and to the legitimacy of the outcomes. Clearly, the shareholder principle has prevailed and has imposed important costs upon those poorly represented in global financial governance. This principle correctly gives voice to the wealthy, but it allows substantially reduced input to those most affected by the decisions themselves.

These serious deficiencies in the governance of the international financial system point to the need for reform. Fundamental issues of political economy are at stake: the role of publicly accountable institutions versus the private sector at both national and global levels; the balance of power between core and periphery countries in the global economy; the tensions between national (in particular developmental) and global system-level imperatives; the relative influence of citizens in national and world affairs; and the legitimacy of both national and global institutions. Many of these questions have been around for a long time (going back to Smith, Marx, or Prebisch), and have been the root of intense past and current debate (e.g. how to avoid a democratic deficit in the EU). They are far from easy to resolve. Nonetheless, if development policies prove consistently ineffective, the legitimacy of national instances will remain impaired, exacerbating the problem and making new initiatives even more difficult. Furthermore, if global level decisions based on the shareholder principle clash systematically with development objectives set in a context of emerging national democratic processes, the legitimacy of global governance will be in question from the ground up.

If the weak are only heard when their opposition can no longer be ignored, it is probably too late to come to a workable compromise solution. Surely, anticipation is not beyond human capacity.

We argue therefore that greater attention to issues of legitimacy and accountability is likely to generate financial governance more in line with broad international development imperatives. Furthermore, a better understanding of the role of private interests in the current process of cooperation in global financial governance will lead to a better understanding of not only the problems of the system, but also of how to resolve them. In each section, we have identified insufficiently addressed research issues, which can be tackled through advances in economic and political economy research tools, and with the benefit of more data.

Our main conclusion though is that one must take problems of governance and legitimacy as starting points, not afterthoughts. The legitimacy of the international financial system needs to be conceptualised more broadly, relative to the often-contrasting interests of the many developed and developing economies in the world today.
whom should the system be accountable, and in whose eyes and for what purposes should the system be legitimate?

Long-run developmental successes such as those in East Asia are, after all, against the interests of no one. Solutions will not be easy and may have to be found in building regional coalitions among developing countries and moving away from the assessment of policies by markets and international financial institutions, toward representation and assessment of collective interests. One such example was the push by a number of developing countries in the Doha Round of trade negotiations towards outcomes much more favourable to themselves. Another example is NEPAD (New Partnership for Africa’s Development), which relies on countries designing their own reform programmes and on extensive peer monitoring among other things. Such mechanisms may discourage downward “policy competition” among countries, increase regional representation and rebalance power away from the “centre”. We hope that more progress like these can be made for which further research can help.

References


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Romano, Roberta (2005), “Is Regulatory Competition a Problem for
The chapter by Stijn Claessens and Geoffrey Underhill lends a lot of support to the thinking of one of my predecessors in ECLAC, Raúl Prebisch, that the current global economic system has become increasingly a centre-periphery system. Second, it lends a lot of support to the ideas of Karl Marx, that private interests can be powerful in determining what sort of regulation they are under. And, third, it lends support to the European discussion on the democratic deficit of international arrangements. Because of these three things I like the chapter very much.

The three basic ideas of the chapter are, first, that changes in the system are too much driven by the developed countries, or actually by the dynamics in the private sector in the developed countries. Second, that the lack of transparency that the rule-making under those international arrangements generates, facilitates the capture of the regulatory authorities. And third, that there are significant “legitimacy” issues in the international system – to put it more gently and more in the terms of the authors.

It is interesting how the dynamics work in the discussion on Basel II, or in the discussion of debt restructuring mechanisms. The chapter by Stijn and Geoffrey points this out very clearly. However, in the case of the Sovereign Debt Restructuring Mechanism (SDRM), it does not mention the important issue that some large or well-organised developing countries can have a powerful role in the debate. Because after all, the only developing countries that have been able to influence the debate are the largest, or the best organised developing countries.
In the case of the SDRM, some powerful developing countries were part of the coalition that killed the initiative.

**Groups versus Institutions**

An important issue that Stijn and Geoffrey stress is the legitimacy of institutional versus ad hoc arrangements such as the G-7, G-20, and G-77. Roy Culpeper has written a paper on this issue and one of the problems of institutional arrangements that he identifies is the fact that we have competition among different institutional arrangements without any clear way of establishing who coordinates the various agencies at the global level. But the main problem is of course that the decisionmaking in institutional arrangements is much tougher than in a restricted group and that this has led to the emergence of the various Gs. The Gs have the basic problem that they are not legitimate and that they will never become legitimate. They are able to rule outside the institutional arrangements and use their coalitions to enter proposals in the institutional arrangements. That is, I think, the best use one can make of Gs.

The Gs exist, they are natural, but they should work within the context of institutional arrangements. However, they also give much power to powerful forces, and especially to one powerful force which is the United States. And they also allow initiatives to be launched of which the costs are not borne by those who have launched them. For example, the US announces debt cancellation for Iraq but then does not incur most of the costs of the cancellation. And when the HIPC Initiative was launched, many of the middle-income countries had to pay for it even though they were not consulted at all. As a proportion of GDP, the highest costs of the HIPC Initiative were incurred by Costa Rica. Costa Rica was never consulted while it had two HIPC countries next to it which were highly indebted to Costa Rica. Also, some of the HIPC countries were indebted to the Central American Bank for Economic Integration (CABEI) without the CABEI ever being involved in the discussions. This shows some of the peculiarities of the current fragmented system of decisionmaking where some of the actors receive merit for something they don’t pay for.

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It should be made clear that we have an international system, not a supranational system. The European Union is the only case where you are really moving from an international system to some elements of a supranational system. But the world as a whole has an international system and that is why I would not use the word “supranational” to characterise the system. And that is why I think Stijn and Geoffrey’s points about how competition among governments plays in the system is so interesting. Whether it leads to a race to the top or a race to the bottom in terms of policy is a very interesting part of the chapter that could be developed further.

In this regard, I would like to mention one of the characteristics of the current system, which you can elegantly call the policy competition, or the beauty contest, between finance ministers of developing countries going to financial markets. I played that game in one of my former duties and I can tell you that it is a very peculiar game. The rules are set by markets, so the only way you can play that game is by presenting yourself as the best player in the game – which creates policy competition between the different actors. Generally speaking, as Stijn and Geoffrey point out, it may be true that sometimes it is a race to the top, as happened with protecting property rights. But one should also recognise that this game maximises the private influence too. Whatever you do under those rules, the outcomes will always maximise the private interest because the system is built, as Stijn and Geoffrey say, around that essential idea.

At the end of their chapter Stijn and Geoffrey discuss the important issue of the organisation of less powerful actors. The less powerful actors, that is, the developing countries, will only have influence if they organise themselves as a group of interest. Therefore, regionalism is essential. There are very interesting developments going on, particularly within the WTO where we have seen organised coalitions of developing countries, including that of ACP developing countries, in the negotiations. Another example is the New Partnership for Africa’s Development (NEPAD). The coming together of African countries that led to NEPAD has made them a stronger coalition. So in the end, the solution to some of the problems that Stijn and Geoffrey pose has to come from the developing countries. Rather than accepting the current rules of the game, developing countries will have to play the game by identifying their collective interests and then go with them to the international organisations and, hopefully, also to the markets and say: These are the interests that we want to defend. The current inter-
national system will only be workable if it is based on stronger regionalism. A stronger regionalism is the only way to balance the huge asymmetries in power that we have in the system – that is the centre-periphery part of Stijn and Geoffrey’s chapter.

**Competition Between International Institutions**

Turning to the role of the IMF in low-income countries, I clearly see the crucial role that the IMF has to play in macroeconomic issues. I am not sure that loosening the dividing line between the IMF and the development banks or between the IMF and development cooperation is a good idea, for the IMF or for development cooperation. I would prefer to keep a clear dividing line, thinking about the national level, where the development functions of central banks were taken away from them and given to specialised development banks.

With regard to the signaling or gatekeeper function of the IMF, my personal judgement is that a world of competitive evaluations is better. We should not rely on one single individual judgement of one single institution, because, among other reasons, we all have made mistakes in the past. Competition in ideas and judgements is a good way to avoid making too many mistakes. We have not talked much about this, but I really think that a world order based on various institutions is better. The competition in the provision of services is actually good, not bad. It is good to have competition between regional and sub-regional development banks and among the bilateral donor community. Similarly, it is good to have various regional monetary funds. Europe has done a good job in taking the monetary problems of Europe out of the IMF. If we have an Asian Monetary Fund and a Latin American Monetary Fund and an African Monetary Fund, the system would be more balanced.

Maybe the future IMF should be more like the European Central Bank or the US Federal Reserve System, and not remain the centralised institution it currently is. That is probably the direction to think about. In the area of development banking, the world has moved in that direction and it should probably go further in that direction, including establishing, in particular, development banks totally owned by developing countries. There are a few cases around that have been successful, why not have more of those? The same may be true for the traditional functions of the IMF; this would make them more balanced.
Ownership

Another important issue is ownership. We continue to discuss the meaning of the concept of “ownership”, which is somewhat unclear. We have to find an operational definition of ownership, we have to have a better idea of what that means. The evaluations of the Poverty Reduction Strategy Papers (PRSP) by both the World Bank and the IMF have tried to assess to what extent PRSPs have contributed to ownership. I have found those two evaluations particularly useful to understanding the problems that are going on. Going back to my previous point, ownership will start by evaluations being really done by countries – not by the IMF or the donors, or the World Bank, or the NGOs, but by country teams. That should be the framework for any evaluation.

This is very closely tied to the issue that capacity building is the best measure of ownership. When you have strong capacity at the national level, and programmes are really done by countries because of strong capacity, you have real ownership of the programmes. Then the international community can give its points of view but such discussions would then take place around a programme that is designed by the countries. Until now, it has too often been the case that programmes do not present the view of the government, and this is part of the distortion generated by the international system.

Diversity of Views and the Streamlining of Conditionality

I feel very strongly about the need to respect the diversity of views. Particularly about growth, poverty reduction and the needed fiscal space there continues to be huge diversions of opinions, even increasingly among professionals. Last year at the Latin American Economists Association meeting, I was struck when in the final panel where I participated, a group of well-known economists reached the consensus that, after all, we did not know what determines growth. That is a huge recognition of the deficiency of professionals. I find it a good recognition. I certainly prefer it to the arrogance of those who pretend they have all the answers. We know much less than we think we do. The economic profession is not a very hard science. It is full of ideological prejudices, on all sides of the debate, all sides. Diversity of views is essential.

I am always struck by the intellectual environments that you see in
different parts of the world. When you go to developing countries, you see a real diversity of views on many things. In New York, in the UN, it is more or less the same: there is a wide variety of views. Washington, however, seems a bit less diverse.

It would be good to leave some things to the judgement of no one else than the countries themselves, particularly on very contentious issues. This is why I think the streamlining of conditionality should really be implemented. The principle of streamlining of conditionality was approved by the Fund, some three years ago. It is a good principle, except that it is left to the Fund’s judgement what are the structural conditions that are relevant for the macro economy. My point of view is that still too many structural conditions are included in IMF programmes and, moreover, I think that the word “structural” is used in a confusing way for that purpose. We have to recognise that we have had stable macroeconomic regimes under very different structural conditions: high interventionist states with very good macro balances and very neo-liberal states with a lot of macro imbalances.

The basic problem is that there is a huge confusion in the use of the term “structural” in most of the literature. For instance, I would probably agree with the Fund that having some structural fiscal balance, or a structurally stable financial system, is a good thing. But does this imply that you have to have privatisation? Maybe yes, maybe no. In some countries, privatisations may help establish fiscal balances, but that does not mean that privatised regimes are always better. It may be the case, it may not be the case. After all, it should be left to the democracies, not to institutions at the international level. If a country wants to have a more privatised regime, that is the country’s choice. If it wants to have more public sector, that is the country’s choice. I do not think we should be judging internationally how large states should be. That is not for international institutions to decide, that should be left to the judgement of nation-states.

Rating of Countries by Quality of Institutions

This brings me to the very contentious issue of judging the quality of institutions of a country on the basis of the so-called Millennium Challenge Account (MCA) and the Country Policy and Institutional Assessment (CPIA). Even though I share the basic concern about institution-building, because transparency and combating corruption are important, and even though I support the basic political principles
behind it, this way of doing it is unlikely to produce good results. These two approaches are likely to be seen as impositions of views that are based on highly imperfect information. Trying to build institutions through ranking countries and using that ranking for aid allocation purposes will lead to a loss of legitimacy rather than an improvement in the way of working. So I think that these MCA and CPIA practices should be discontinued.

I again use the word “ownership”. Ownership here is the critical issue. I do not think that external rating and tying support to the rating of institutions is going to improve the institutions in a country. First of all, two major mistakes, two major things will happen. The first one is that the judgement will be resisted at some point. There will be countries that say: this is not due functioning. But the second thing is that even a country that has received a positive rating, at some point is likely to break the rule and then you have to reclassify this country or make an exception. I really think – and I use a peculiar case – the best idea is to leave the judgement of institutions to developing countries themselves, or to a grouping of developing countries that encourage the implementation of principles they have agreed upon. For example, NEPAD may be a much better place than IMF conditionality to build ownership of better institutions. And the UN convention against corruption is probably a better mechanism, as are many other international processes that are going on. They are better ways to manage some of these institutional issues.

Let me give you another example: the case of democracy in Latin America, which I know very well. The Rio Group, which basically is a grouping of Latin American countries without Cuba, took this issue of helping weak democracies maintain a democratic regime as a conscious effort over the last 10 to 15 years. They took the initiative themselves. So every time you see a problem in a country – a possibility of breaking a democratic rule – what happens is that all the countries try to help the weak country to maintain its democracy. That is much better. I tell you that this was never done through the Organisation of American States (OAS), where the US is powerful. Canada is seen in Latin America and the Caribbean as a more reliable partner than the US. The US has always been seen as too powerful in the game. And of course, the US is seen as having supported some non-democratic regimes in the past. So it is much better to leave it to the countries themselves and try to support this through other, more indirect, means.
Millennium Development Goals

Finally, the issue of the MDG framework. This framework has been a very good one for the political discussions. It has contributed to policymaking in the Bretton Woods institutions. However, there is still a tendency in the Bretton Woods institutions to think of the Fund and the Bank as the centre of the earth. In practice, it would be better for them to build stronger networks, not only with the UN organisations, but also with the regional development banks and the bilateral donors. Such networking should go beyond the practice established at the national level, where the dialogue has improved but nonetheless continues to be distant in many cases. At both the national and the global levels, we have done a lot to improve the dialogue. The Monterrey process was a major advance in terms of dialogue, but we have to strengthen it much more in the future.
Future Challenges for the IMF in Low-Income Countries

Jan Derk Brilman, Irene Jansen and Ernst van Koesveld

When the IMF was established in 1945, a role for the Fund in low-income countries was not foreseen. Its founding fathers envisioned an organisation to guard and help preserve the newly created international monetary stability in a world of fixed exchange rates and the gold-exchange standard. With the collapse of the Bretton Woods system in 1971, the oil price shocks in the 1970s and the debt crises in the 1980s, however, the Fund’s operations geared increasingly towards emerging economies and low-income countries. Moreover, acknowledging that macroeconomic stability as a prerequisite for sustained economic growth and poverty reduction can only be created over a longer term, the Fund’s involvement in low-income countries became much more long-term than the traditional short-term balance of payments support.

In 2003, the IMF started a comprehensive discussion on its role in low-income countries. A first paper was published in July and discussed in the IMF Board in September. A year later, a second paper and discussion followed (IMF, 2004a). Out of these discussions, the consensus emerged that the IMF has an important role to play in low-income countries, and that lending, policy advice and technical assistance should remain the Fund’s main instruments to help low-income countries to achieve the Millennium Development Goals (MDGs). More specifically, we believe that the Fund’s relationship with low-

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Income countries should be aimed at establishing macroeconomic and financial stability, and supporting that, the microeconomic functioning of public finance and the financial sector. A crucial precondition for the Fund to remain effective in low-income countries is its continuing capacity to tailor the mix of policies and instruments to a country’s political and economic realities.

Diverging views emerged however on various more specific issues, including: (i) the Fund’s longer-term financial involvement in low-income countries and how to promote a gradual exit to a surveillance-only relationship; (ii) the role of the Fund in cases where financial assistance is not critical to alleviate balance of payments needs, but where involvement for signaling purposes is important; (iii) the Fund’s approach to debt relief and how to promote debt sustainability.

These three interlinked issues are the key future challenges for the IMF in low-income countries that we will address in the remainder of this chapter. In Section 1, we discuss the issues of “saying-no” and the design of proper “exit strategies”. In Section 2, we argue that when countries have stabilised their economies, the Fund’s direct role in providing balance of payments support needs to change into an indirect, signaling role, i.e. to catalyse other sources of financing. Section 3 discusses how the build-up of too high debt levels can be prevented. Section 4 concludes.

1 Exit Strategies from Fund Financing

One of the consequences of the deep-rooted and complex economic problems in many low-income countries is the high level of longer-term financial engagement of the Fund. The IMF has defined a longer-term programme engagement in the case of low-income countries as having at least two ESAF/PRGF arrangements. On this basis, 45 out of the 78 PRGF eligible countries can be classified as such as of December 2004. Of the remaining 33 countries, 24 are recovering from severe economic and/or political instability and are either not yet engaged in a financial relationship with the Fund, implementing a first PRGF or involved in a programme that went off-track. These countries could therefore enter into a longer-term engagement in the future.

It is important to note that following the IEO “Evaluation of Prolonged Use of IMF Resources 2002” and the conclusions of a Task Force, the IMF Board concluded that, “under proper circumstances, long-term
Fund financial engagement can be an appropriate response to help member countries address deep-seated problems that, by their nature, require many years to resolve. These problems have been particularly prevalent in low-income countries and countries in transition. Thus, a longer-term financial relationship with the Fund is not necessarily worrisome. The Board added however that “at times, prolonged use can also be associated with insufficient progress in dealing with key economic problems and can hinder the development of domestic institutions” (IMF, 2003a).

The question then is whether the longer-term Fund engagement in low-income countries has overall been justified. Elements that are of importance in this respect include: (i) whether the economic problems as well as the level of commitment to reform and institutional capacity justify long-term financial involvement; (ii) whether overall and continuous progress has been made through solid implementation and sound programme design; (iii) whether the Fund has acted if this was not the case, for example by adjusting a programme, delaying a review or declaring a programme off-track, (iv) whether successive arrangements show a declining trend in access; and (v) whether explicit attention is given to an exit strategy as part of an *ex post* assessment.

In June 2004, 19 *ex post* assessments on longer-term engagement in PRGF countries were considered by the Board and became publicly available. Before drawing some conclusions on the basis of these assessments, a few caveats are in order. First, it is always easier to draw conclusions with the benefit of hindsight. Thus, a conclusion that the IMF would have better disengaged in a particular country looking back, since ownership and/or commitment were lacking, does not mean that the decision to agree to a new PRGF was not made with due care and consideration at the time. Secondly, since experience with *ex post* assessments is relatively recent, the documents still evolve in their structure and quality. This makes a comparison between the documents somewhat difficult at times. With this in mind, an analysis of the existing *ex post* assessments according to the above mentioned criteria shows that three different categories can be distinguished: (i) countries where the longer-term programme engagement has overall been successful, (ii) countries where the longer-term engagement can be called into question and which currently still have a Fund programme, (iii) countries where the longer-term programme engagement can be called into question and which currently do not have a Fund programme.
Countries With a Successful Longer-Term Programme Engagement

From the 19 countries analysed, seven can be classified as having a successful longer-term engagement with the Fund. In Albania, Armenia, Benin, Ethiopia, Mali, Mozambique and Cambodia the longer-term engagement of the Fund has been justified considering the existing deep economic problems as well as the level of ownership and the institutional capacity. In Mali and Mozambique, ownership and commitment of the authorities have been consistently strong, leading to continuous progress and solid implementation of reforms. In Albania, Armenia, Benin, Ethiopia and Cambodia episodes of political uncertainty or conflict and low commitment have existed, with temporary deteriorations in programme implementation as a consequence. In all five countries however, the Fund responded appropriately and only renewed its programme relationship when ownership and stability were solidly restored and sound progress could again be expected (and indeed materialised). Only in Ethiopia has programme design been clearly unsatisfactory according to the *ex post* assessments, while in most countries some improvements could have been made in this area.

Despite the overall successful engagement of the Fund, none of the seven countries has of yet fully graduated from Fund resources. With the exception of Cambodia, future graduation is however being properly addressed and low access PRGFs are in place or are being recommended by IMF staff for the immediate future. The signaling role of a Fund programme vis-à-vis donors is mentioned regularly as the reason of why a PRGF is preferable to a surveillance-only relationship. In Cambodia, the IMF staff recommends to raise the question of graduation “at the time of approval of each (future) yearly programme.”

Countries Where the Longer-Term Programme Engagement Can Be Called Into Question

Unfortunately, in the majority of the low-income countries assessed so far questions can be raised with hindsight about the validity of the long-term presence of the Fund. In Bolivia, Chad, Georgia, Guinea, Guinea-Bissau, Kyrgyz Republic, Lesotho, Macedonia, Malawi, Moldova, Niger and Zambia, economic problems were profound enough to merit a longer-term involvement, but lack of ownership, governance problems or capacity constraints and/or political conflict resulted in a political-institutional climate that was not receptive to reforms. As a result, progress
was mixed at best, but more often than not disappointing. The question then emerges why the Fund agreed to continuous new arrangements, knowing that implementation problems would most likely persist. In some of the *ex post* assessments, the Fund explicitly admits that with hindsight more selectivity should have been used in deciding to new programmes, which could have resulted in prolonged disengagement of the Fund. In other cases, the Fund points at pressure from donors to continue the arrangement for signaling purposes or to a change of governments that gave new hope for improved implementation. Often however, new programmes saw similar implementation problems. An interesting case in this respect is Bolivia, where ownership of the national authorities has hardly been an issue, but the high political resistance to reforms from interest groups and the underprivileged majority led to constant implementation failures, irrespective of which government ruled (IMF, 2005). As regards programme design, the *ex post* assessments usually state that more attention should have been given to capacity constraints and the institutional environment, but design flaws have never been a large culprit of the overall disappointing results. Moreover, a few exceptions set aside, the response of the Fund to insufficient progress within arrangements has generally been sound with increases in prior actions, reviews being delayed or not completed and programmes being announced off-track.

Seven out of the 12 countries in this category currently still have a Fund programme. Access has declined in only one of these (Georgia) and *ex post* assessments indicate that a possible exit strategy of Fund resources has not (yet) been properly addressed in four of them. The remaining five countries are no longer involved in a Fund arrangement, even though the Fund foresees a future engagement in most of them, provided that the level of commitment and/or institutional capacity improves. Exit strategies are properly addressed in all of these five countries, while only Guinea has had a declining access of financial engagement of the Fund within this group.

**Lessons for Future Fund Engagement and Exit Strategies**

The *ex post* assessments give a comprehensive and overall candid overview of past Fund involvement in low-income countries. They are highly useful and should therefore be continued and strengthened further. Several lessons can be drawn on the basis of them.

First and foremost, sufficient levels of ownership, commitment,
political stability, good governance and institutional capacity are essential for the success of a Fund programme. Without these, a muddling-through scenario emerges in which limited progress is achieved and the Fund is sooner or later forced to (temporarily) unplug.

Second, it is important that the Fund is able and willing to say “no” at an early stage if warranted. Although it is not and should not become the responsibility of the Fund to improve the overall political and institutional situation in a country, Fund programme design should pay (more) attention to specific capacity constraints. Hence, even if the lack of implementation is beyond the government’s control due to e.g. strong resistance from vested interests, the Fund should consider disengaging when constraints are such that the success of a new programme is highly questionable. When improvements in this area have been made – possibly with the assistance of the World Bank, regional development banks and bilateral donors – the Fund should naturally stand ready to re-engage. The important signaling role of IMF programmes however, makes saying no difficult at times.

A third lesson, therefore, is that more nuanced and textured signals – explaining why a programme goes off-track or why a new programme engagement is unwise – are needed. This issue will be raised into more detail in the next section on the signaling role of the Fund. Fourth, the Fund should adhere more closely to the existing principles on declining Fund exposure. Lastly, the Fund should further strengthen its attention to exit strategies, e.g. in ex post assessments. An analysis of whether the economic problems in a country merit financial involvement of the Fund should be made at the end of each Fund programme and include a view on the (protracted) balance of payments need. Questions concerning ownership and capacity constraints should be properly addressed as well (as is often already the case) and lead to firm suggestions with regard to possible new arrangements (e.g. prior actions). Thought could be given to increasing Board involvement in the case of a longer-term Fund engagement in order to strengthen the focus on exit strategies. Also, precautionary (low access) PRGFs, in which the IMF and a member country agree on a PRGF programme, but the country unilaterally

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2 In this respect, it is a welcome step that the Board decided to reaffirm the essence of declining access and decided to new access norms under PRGF arrangements. The norms are set as follows: 90% of quota for first-time PRGF use, 65% for second-time use, 55% for third-time use etc. Besides these norms, the PRGF also sets a maximum borrowing limit at 140% of quota (185% of quota in exceptional circumstances).
decides not to make use of Fund resources, could serve as a possible exit and are worth considering. The recently approved Policy Support Instrument (see next section) forms a valuable addition to this.

2 The Fund’s Signaling Role in Low-Income Countries

Although episodic IMF financing is often vital for low-income countries, the Fund’s longer-term goal should be to phase out its financial involvement. After countries have sufficiently stabilised their economies, they should rely on, usually more concessional, donor funds to finance their development needs to achieve the MDGs, and ultimately, they should be able to tap international capital markets. In this process, Fund involvement is expected to evolve, with its indirect role, i.e. its role in providing a seal of approval for donors and markets, growing more important. While the Fund’s financial involvement may be relatively limited for countries, the financial implications of its signals are sizeable. This section reviews the recent discussion on this so-called signaling role of the Fund, especially from an EU donors’ perspective, who together account for over half of global ODA with a further rise expected.

IMF interactions with member countries, notably in the context of surveillance and programmes, have an important signaling function to the international financial community. Although signaling is a kind of by-product of the Fund’s core business, it is increasingly considered as one of the main tasks of the Fund in low-income countries. The term “signal” refers to the conveying by the Fund of information that influences the financing decisions of outsiders (such as donors and private market participants). This can be through on/off mechanisms (a typical example of which is a Fund programme, where the signal is given by the approval and continuation of the programme) or through a multi-dimensional picture (a typical example of which can be found in surveillance, where the signal comes from the textured views expressed in the course of surveillance). The Fund also provides assessments of members’ macroeconomic conditions and policies in response to various ad hoc requests from multilateral development banks, creditors or donors. The most recent guidelines on these so-called assessment letters (also known as comfort letters) state that the assessments should be both “sufficiently nuanced” and “written clearly” to inform financial decisions of outsiders. They should be circulated to the Board for information, but this does not imply Board endorsement (IMF, 2003b).
The Risks of an Increased Signaling Role

The Fund’s signaling function appears to have become increasingly important, as reflected by the number of IMF Executive Board discussions that touched upon the issue. Recently, the discussion has focused on the signaling role of the Fund in low-income countries, effectively providing a seal of approval to donors. An important signaling role for the Fund fits in the view that the Fund’s engagement with low-income countries should not be equated with IMF financing being provided over longer periods of time. In particular in the case of so-called mature stabilising countries and pre-emerging market economies, the Fund’s signaling may be more important than its (episodic) financing role. The Fund could rely on catalysing other funding, especially if the latter are provided on more concessional terms to avoid unsustainable debts.

The signaling role of the Fund has also become more important given donors’ gradual shift from project aid to budget support. This shift is based on the belief that national ownership and effective aid allocation are best served by providing direct budget support. Assurances by the IMF that recipient countries’ macroeconomic policies and public finance management are of sufficient quality often guide disbursement of budget support. The Fund is uniquely placed to provide such signals, including information on financing gaps, borrowing capacity and absorptive capacity, to inform donor decisions. Especially in the case of countries with Fund-supported programmes, the Fund is considered to play the role of “gatekeeper”, providing on/off signals on which much donor financing depends.

The Independent Evaluation Office, among others, has pointed out two possible risks of this development (IEO, 2002; see also DFID/HM Treasury, 2004). The first is that the Fund’s actions may result in stop-and-go processes and large swings in official financing, thus further reducing the predictability of aid. The second possible risk is that linking aid to IMF-supported programmes can compromise the quality of these programmes – and hence, the quality of the signal. This is

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1 Bulir and Lane (2002) find that project aid disbursements are more or less independent of the status of an IMF-supported programme. Budget support, being already less predictable than project aid, turned out to be very sensitive to programme interruptions. In fact, the penalty for programme interruptions was 80%: aid disbursements were 80% below the initial commitment level.
because this linkage raises the stakes of programme negotiations to the point of putting strong pressure on both country authorities and the IMF to reach an agreement, even though both parties may have doubts about the programme’s feasibility. This, in turn, may contribute to unduly prolonged use of Fund resources and hinder an effective implementation of exit strategies from the side of the Fund. A third risk would be that the Fund’s financial involvement will add to the often already high debt levels of countries.

The recent historical review by Fund staff (IMF, 2004b) confirms that there are various difficulties in designing a successful signaling mechanism:

- There is a tension between the intention to influence donors (the Fund’s catalysing role) and the intention to leave them to arrive at their own judgement (reducing the negative and unintended consequences of the Fund’s perceived gatekeeper role).
- In order for positive signals to be meaningful, negative signals must also have been a possibility. However, the Fund has been reluctant to send negative signals, to protect the frankness of the dialogue with the authorities and to avoid a sharp reduction in foreign financing;
- On-off signals are open to misinterpretation if they set a standard other than upper credit tranche conditionality, which is the normal standard for IMF-supported programmes (so-called Staff-Monitored Programmes, for example, have a lower policy commitment content);
- The credibility of signals is helped when backed by financial resources, although recourse to Fund resources can be a signal of need as well as strength;
- On/off signals tend to crowd out multidimensional ones, and less intrusive signaling instruments are likely to be less effective.

IMF staff therefore concludes that many attempts to develop new signaling instruments have not stood the test of time or have failed to gain Board support.

**In Search of a New Signaling Instrument: EU Donors’ Perspective**

The US has consistently been a strong advocate for a new instrument. In response to the US proposal for a so-called non-borrowing arrangement, IMF staff decided to put on the table a new signaling instrument in September 2004. The new instrument was tentatively named the Policy Monitoring Arrangement (PMA). The Board did not have a final judgement, but encouraged staff to pursue consultations with potential
users, private market participants and donors to ascertain the usefulness and potential demand for a signaling mechanism (IMF, 2004c).

To this aim, the Fund circulated a questionnaire to recipient countries, other multilateral agencies and donor governments. The following draws some general conclusions on IMF signaling from the perspective of EU donors. Fourteen EU donors (Austria, Denmark, Finland, France, Germany, Italy, the Netherlands, Poland, Portugal, Spain, Slovenia, Sweden, the United Kingdom and the European Commission) filled in the questionnaire. The Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania and Malta indicated that their aid policies are still under development, while Belgium is currently in the process of revising its policies.

All EU donors use Fund signals to inform their development assistance decisions. In line with the economic literature, donors believe that the Fund signals convey three kinds of information: superior information from the Fund about a country’s economy, policies and prospects; assessment of a country’s commitment to sound policies; and information on financing needs and available resources. Given its relationship with the national authorities as well as its competence and expertise, the Fund has an information advantage, at least with regard to macro-economic policies, financial sector issues and public finance management. In effect, the Fund can reduce the information asymmetry of bilateral donors vis-à-vis the recipient countries.

A key issue is whether the approval or presence of an IMF-supported programme is one of the requirements for aid allocation. All EU donors indicate that this is not the case for project aid. The only exception is if the project is in the economic/financial sector and the Fund information brings to light an issue that might affect successful implementation of the project. The picture emerging from the responses of those countries that disburse substantial amounts of budget support varies. Three groups can be distinguished. For the first group of countries, a Fund arrangement being on-track is a strict requirement for budget support. If a programme goes off-track, the donors would directly stop providing budget support. For a second group of donors, the Fund arrangement being on-track is effectively a policy requirement for budget support. Countries in this group, however, clearly state that there is never an automatic or mechanistic use of this IMF signal; there is always room for own judgement based on a variety of other sources of information. If a Fund-supported programme goes off-track, they will reconsider but not necessarily stop budget support. This decision
will also depend on the reasons why the Fund cannot but delay programme reviews. A third group of countries focuses completely on the substantive reasons why a programme goes off-track, and attaches no specific value to the on/off signal. None of the EU donors indicate that a Fund arrangement is a legal requirement. Overall, the perception that donor support is directly linked to the status of a Fund arrangement is not confirmed by the EU responses to the questionnaire. In procedural terms, the link is indirect at best.\(^4\)

Nearly all EU donors attach value to a regular, and mostly also frequent, availability of Fund signals, which help donors improve the predictability of aid. This is particularly relevant if a PRGF review is delayed or if there is no IMF arrangement in place; otherwise the normal PRGF review schedule will more or less guarantee regular Fund signals. In the latter case, some donors suggest to issue assessment letters reports on a more frequent basis, for example twice a year, following a pre-announced schedule. They also indicate that assessment letters should contain up-to-date information and be candid on policy strengths and weaknesses with a clear underpinning of the conclusions reached. In this way, assessments letters could effectively combine an on/off signal with a more textured picture.

Various EU donors need an on/off signal, but others do not believe on/off decisions are a necessary feature of a signal or even oppose on/off signals. Most of the donors that need on/off signals consider upper tranche conditionality and Board endorsement as necessary components of a clear signal, for others they are not. Even more importantly, nearly all donors would also highly appreciate more textured and multidimensional signals as they would enhance insight into the development process and foster well-informed decisionmaking. A recurring issue in the responses to the questionnaire is that donors

\(^4\) This does not deny the fact that the correlation between IMF arrangements and bilateral budget support is and may remain strong, which suggests that donors do not always use the available room for manoeuvre. Besides, only a few EU donors have responded to the question what they do with the committed resources if they decide to discontinue budget support due to the off-signal by the Fund. Normally, these funds will be allocated for other development purposes or become part of a broader budget prioritisation. One donor applies the interesting rule that for IMF/Bank constituency countries, 50% of the budget reserved for macroeconomic support will be allocated to programmes or projects that are instrumental in getting the Fund programme back on track. This promotes flexibility in decisionmaking and predictability of aid flows.
want the IMF to explain especially *why* PRGF reviews are delayed or *why* a PRGF programme is effectively off-track. At present, there is often a lack of information, which may imply ambiguous and mixed signals. The “noise” around the signal may then dominate the signal itself. Is the delay or off-track situation due to macroeconomic or macro-critical structural policy failures? Is it because of temporary circumstances beyond the control of the authorities and for which the Board for some reason is not expected to grant a waiver? Is it due to typical IMF procedures, for example in terms of its safeguard policies? A better explanation would help donors to assess whether the reasons are relevant or critical for the effectiveness of the aid. Such a process may, in turn, mitigate unnecessarily large swings in aid flows.

The recent experience in Vietnam may serve as a good example in this respect. PRGF reviews were delayed, subsequently the programme was curtailed, because the national authorities were not willing to allow an audit of the central bank management of foreign exchange reserves. In addition to the procedural reason for curbing IMF lending, the Fund – especially the Board – criticised the lack of progress in reforms of the state-owned enterprises and state-owned commercial banks. However, at the same time, the Fund signaled in its documentation and briefings that macroeconomic policies were sound. Based on this set of nuanced information, donors expected that aid effectiveness would not be undermined and continued to disburse funds. Vietnam does not intend to renew the PRGF, but the Fund now informs the donor community better during Consultative Group Meetings and in other documentation and briefings. In the case of Mozambique, financial sector reforms caused a bottleneck in the implementation of a Fund-supported programme, but again donors decided to continue to provide budget support, linking this to annual progress in the PRSP. In both cases, “stop and go” processes were prevented thanks to good communication and a sound mutual understanding.

None of the EU donors believes the *volume* of IMF lending to be an important characteristic of an IMF programme. Rather, the mere presence of an IMF programme is the decisive factor for especially budget support. No donor will – necessarily – stop providing budget support if an average PRGF programme is followed up by a low-access PRGF programme, i.e. around 10 percent of a country’s quota. In case a successor programme is not foreseen because the country no longer has a balance of payments need, most donors expect to continue budget support, but effectively need a clear IMF signal to do so. At the
same time, some donors believe that if the Fund puts its money on the line, this adds to the credibility of the Fund on/off signal.

In sum, EU donors, including the Netherlands, generally believe that there was a kind of gap in the IMF instruments available to low-income countries, but thought that this gap could largely be addressed by modifying existing instruments and practices rather than to necessarily introduce a new instrument or mechanism. The following suggestions are the most often given:

- provide regular information on the status of a PRGF programme, especially if reviews are delayed or effectively off-track (e.g. according to the review schedule);
- give regular Fund assessments when a PRGF arrangement is not yet or no longer in place, for example by sending assessment letters to donors twice a year;
- provide better explanation, especially of off-signals, to donors to enable them to assess whether there is substantive reason to suspend or even stop financial support;
- give more textured information in addition to on/off signals, which would contribute to a higher quality of decisionmaking on aid commitments and disbursements.

These suggestions are expected to somewhat loosen the linkage between IMF on/off signals and aid decisions. This allows the Fund to continue catalysing other sources of finance, but with a lower risk of compromising the quality of its seal of approval and a lower risk of unjustifiable stop-and-go processes in bilateral aid flows.

Agreement on a New Signaling Instrument

Most EU donor responses were in line with the general outcome of the questionnaire as far as all donors were concerned. The Fund will therefore intensify and improve its policy on the issuance of assessment letters, providing donors with fuller and more textured information. On the issue as to whether the Fund should extend its present tool kit, many non-EU donors responded more positively. Apart from the donors, the low-income countries were also approached to respond to the questionnaire. They turned out to have similar views on the information issues as donors, but were largely in favour of both better using the existing tool kit and introducing a new instrument to fill the perceived gap between a programme relation and a surveillance-only relation. Subsequently, the issue was taken up again by the IMF. Most
G-7 countries favoured the introduction of a new instrument, while others, including the Netherlands, were ready to support the new instrument, but argued that it should meet the following criteria in order to enhance the Fund’s effectiveness:

- upper tranche conditionality (tailor-made to country circumstances);
- endorsement by the Fund’s Executive Board (adding to the strength of the signal);
- based on a country’s poverty reduction strategy (ensuring national ownership);
- provision on a voluntary basis (truly demand-driven);
- clear focus on mature stabilisers (within the group of low-income countries).

The bottom-line of this approach is that a new instrument should not undermine the existing IMF instruments, particularly low-access PRGFs that have proven to be useful to low-income countries that still face a limited balance of payment problem and precautionary arrangements, that are effectively being used by middle-income countries as a way to signal their graduation towards the financial markets. It is therefore important to confine the new instrument to a subgroup of low-income countries that have fully surmounted stabilisation problems, but still need an IMF programme for signaling purposes. To ensure that existing instruments would not be undermined, the design and procedures of the new instrument should be the same. It would also be important that the instrument would not be “put into the market” as a more attractive instrument than existing ones and that countries were more or less pushed to apply for it. Even if countries belonged to the group of mature stabilisers, they should still be free to choose for a (low-access) PRGF-programme.

After consultations with both donors and potential users of the new instrument and collecting views through the questionnaire, the Fund came with a new proposal under the name of Policy Support Instrument (PSI) and targeted towards so-called mature stabilisers. This group currently is limited to a handful of countries in Africa and Asia, but is expected to grow over time. The characteristics of the PSI are consistent with the abovementioned criteria and thus received overall support among the Fund’s shareholders. A PSI will also provide the basis for rapid access to concessional Fund resources in case of exogenous shocks, similar to a possible augmentation of a PRGF-arrangements for the existing group of members. With the adoption of the PSI in October 2005, a long discussion on the signaling role of the IMF was brought to a successful end.
We will however have to monitor its usefulness and its implication closely. The introduction of the PSI and the better use of assessment letters do not reduce the Fund’s role in low-income countries, but mark a shift in countries that have reached a relatively high degree of stabilisation from direct financing towards indirect support, i.e. advising and catalysing. Together with a more frequent use of low-access PRGF-arrangement for countries that have not fully stabilised yet, this will further help to prevent a build-up of unsustainable debt levels in low-income countries.

3 The IMF and Debt Sustainability

Debt has been a problem for many low-income countries in the past and threatens to be so in the future. There are two sides to the debt problem. First, how to handle unbearably high debt burdens that are already in place, in particular how to decide on debt relief. Second, how to prevent the build-up of unsustainable debt levels. The IMF, together with the World Bank, is playing a leading role in both.

Debt Relief

Twenty-eight countries have already received HIPC assistance and their average debt service has been cut in half. Even though the HIPC process could therefore be called a success, many believe that additional relief is necessary. One of the reasons for this belief is that there are some countries that again reached unsustainable debt positions after receiving HIPC debt relief. An example is Uganda, whose debt-to-export ratio was reduced to less than 150 percent when it reached HIPC completion point in 2000, but had again risen to 288 percent in 2002. There is also discussion on whether a debt of 150 percent of exports is really sustainable, or – if it is deemed so – whether it is bearable in a broader sense since it reduces a country’s resources to reach the MDGs. Against this background, the US launched a “Bold proposal” in 2004 to give 100 percent debt stock relief to HIPCs on International Development Association (IDA), African Development Fund (AfDF) and IMF debt. The proposal was quickly followed by counterproposals from the UK, Canada, the Netherlands, France, Japan, Germany and Norway. Discussions focused mainly on three issues.

The first was whether to give debt stock relief or debt service relief
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(in the latter a country’s debt would not be written off, but its scheduled principal and interest payments would be cancelled on a yearly basis). Debt stock relief will provide the most definite assurance for a country of increased fiscal space in the future, thereby increasing predictability, which facilitates financial planning. Debt stock relief can also be preferred since debt stock is (independently of the current debt service) predictive of the risks of a financial crisis and has a negative effect on economic growth through “debt overhang”, i.e. the knowledge that a debt stock will have to lead to large debt service payments in the future can reduce incentives to invest, thereby reducing growth. Debt service relief has as its main advantage that it allows for ongoing conditionality, which can help guarantee effective use of the resources that are freed up by the relief. As is made clear by some HIPC countries that have had a drop in their policy performance after receiving HIPC assistance, it is not certain that all HIPCs will maintain the policies that are needed to make effective use of the fiscal space that is created through debt relief. Since providing debt relief on an IDA loan comes down to giving budget support over a period of up to 40 years (the maturity of an IDA loan), proponents of debt service relief are of the opinion that donors should be able to stop this form of “unconditional budget support” if policies deteriorate. An additional advantage of debt service relief, also in enabling ongoing conditionality, is that it can be used to mitigate the moral hazard effects of debt relief. Countries may start borrowing at an unsustainable rate after receiving relief under the assumption that the new debt will also not have to be paid back. By making the debt service relief conditional on prudent debt management, this moral hazard effect can be neutralised. Finally, debt service relief will protect the financial solidity of the participating institutions. If debt stock relief is given and donor compensation does not materialise, the institutions can potentially face a large loss. Debt service relief allows the institutions to stop the relief if not enough donor compensation is available.

The second issue on which views varied was how to determine the level of debt relief. Several countries wanted to simply cancel outstanding debt in full. Other countries believed that 100 percent debt relief would unnecessarily undermine a country’s credit culture and that therefore debt relief should only be given in order to reach sustainable debt levels as determined by the new Debt Sustainability Framework (DSF, see below). Basing the amount of debt relief on debt indicators has two drawbacks, however. First, it will result in giving the
highest debt relief to those countries that in the past followed imprudent debt policies, thereby rewarding poor performance. Although this will also be the case if the full debt relief option is chosen (since countries with a higher debt will receive more relief in that case as well), this effect becomes more pronounced by only giving relief on debt above a certain threshold. This problem is exacerbated by the fact that the new DSF applies lower debt thresholds to poor performing countries. Countries that are poor performers are thus more likely to have an unsustainable debt and to receive more debt relief. The second drawback is of a more political nature. Although some HIPCs have again built up an unsustainable debt, many low-income countries are below or only slightly above their debt sustainability threshold. Thus, giving debt relief only up to this threshold would greatly lower the overall amount of debt relief.

The third issue of discussion among the different donor countries related to eligibility. In order to qualify as a HIPC, a country needs to have an income below the PRGF-eligibility threshold (885 dollar a year) and at the same time a debt above 150 percent of debt-to-export. Thus, those countries that became eligible for HIPC debt relief were, at the time, among the poorest and most heavily indebted. Various countries believe that the HIPC countries should therefore again be the countries to profit from the new debt relief. Others, including the IMF, find that the HIPC relief has brought the debt burden of many HIPCs under control and that there are non-HIPCs at least as poor as some of the HIPCs. According to them, it would be unjust to let those countries qualify for debt relief which used to have a debt above 150 percent but have since received HIPC debt relief, while at the same time excluding countries that are just as poor but have debt ratios that are (in some cases only just) below 150 percent. For IMF debt relief this is especially problematic since the IMF is expected to finance relief out of its own resources. The use of IMF resources without applying uniformity of treatment is questionable in principle, but is also in conflict with the IMF’s legal provisions. Under the Fund’s rules, any decision by the Fund to differentiate between members must be based on the application of criteria that are relevant to the objective of the power being exercised. This seems not to be the case for the proposed differentiation between non-HIPCs and post-completion point HIPCs.

In September 2005, a compromise was reached on giving 100 percent debt stock relief, without reference to debt sustainability indicators.
Countries will receive debt stock relief but will at the same time receive a proportional cut in their AfDF and IDA allocations. The net receipts from IDA and AfDF will therefore remain dependent on the quality of a country’s policies and institutions (as measured by the World Bank’s and AfDB’s Country Policy and Institutional Assessment) reducing the reward for poor performers and upholding the incentives for good performance. It was also decided to give debt relief to HIPC only, but equal treatment has been guaranteed to a large extent because donor countries will compensate IDA and AfDF for the debt relief given to HIPC and this additional financing will be distributed among all IDA/AfDF-recipients. This procedure cannot be used for the IMF since it is impossible to reduce IMF allocations in proportion to the relief given (since the IMF does not have a fixed allocation per country, but gives its assistance based on balance of payments need). Uniformity of treatment will therefore be achieved by basing eligibility for relief that will be financed by the IMF’s own resources on an income criterion. IMF relief for HIPC whose income is above this threshold will be financed out of the PRGF Trust, which does not belong to the IMF’s own resources but which is made up of donor contributions. Although it is not yet possible to say exactly how much debt relief will be given under the initiative, it is clear that it will lead to a comparable amount of debt relief as will be granted under HIPC. The Fund’s share amounts to about SDR4 billion, double the amount of debt relief it has committed under HIPC. The initiative will thus provide all low-income countries with a significant boost in resources to support their efforts to attain the MDGs.

How to Prevent the Build-Up of New Unsustainable Debt?

The fact that some HIPC find themselves in an unsustainable debt situation only a few years after receiving significant debt relief increased the call for prevention measures. In response, the IMF and World Bank

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5 The CPIA consists of a set of criteria representing the different policy and institutional dimensions of an effective poverty reduction and growth strategy.

6 Relief countries that currently receive loans from IDA will have the advantage that they will effectively trade in these conditional loans for unconditional grants (the relief). This will result in a NPV advantage of about 40% (IDA loans have a grant equivalent of about 60%). On the other hand, if the debt relief lowers a country’s debt relief under its debt sustainability threshold (see below) IDA will change its grant financing into loan financing.
proposed a new Debt Sustainability Framework (DSF) in February 2004. The DSF determines how much debt a country can have without having the risk of debt becoming too high: its debt threshold. Under the HIPC Initiative, a common threshold of 150 percent of debt-to-exports was used for all countries. This could be defended because of equal treatment considerations (otherwise some countries’ debt would be reduced to lower levels than that of others), but it did ignore important country differences in the ability to service debt. The Fund and the Bank therefore tried to develop thresholds that were more country specific. Further research showed that there are two key determinants of debt levels that a country can sustain.

The first is the quality of a country’s policies and institutions as measured by the World Bank’s Country Policy and Institutional Assessment (CPIA). Thus the IMF and the World Bank set different debt thresholds on the basis of performance. These thresholds can be found in Table 1.

Discussions focused mainly on how high the respective thresholds should be. This choice would have to balance the risk of debt distress with the costs of applying tighter constraints on borrowing. IMF and World Bank eventually chose thresholds that would give a country with a debt ratio at these thresholds an average chance of debt distress (a disruption in debt service payments) in the following three years of about 20 percent. Apart from the wish to be cautious, the concurrent discussions on the IDA grants window also played a role. Since IDA deputies had decided to give IDA grants only to countries with an unsustainable debt, lower debt thresholds would increase the percentage of grants in total IDA allocations, a wish of one important donor, the US. The downside of this relatively low threshold is that the “type I error” is about 60 percent. That is, about 60 percent of the countries that the framework will identify as having an unsustainable debt and

Table 1  Debt Thresholds for Public and Publicly Guaranteed External Debt

<table>
<thead>
<tr>
<th>Country Policy and Institutional Assessment (CPIA)-category</th>
<th>Weak (CPIA&lt;3.25)</th>
<th>Medium (3.25 &lt;CPIA&lt;3.75)</th>
<th>Strong (CPIA&gt;3.75)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NPV/GDP</td>
<td>30%</td>
<td>40%</td>
<td>50%</td>
</tr>
<tr>
<td>NPV/Export</td>
<td>100%</td>
<td>150%</td>
<td>200%</td>
</tr>
<tr>
<td>Debt service/Export</td>
<td>15%</td>
<td>20%</td>
<td>25%</td>
</tr>
</tbody>
</table>
therefore in need of reducing its debt burden, will actually not experience any debt servicing trouble if no further actions are taken.

The second key determinant of the debt levels a country can sustain is its susceptibility to shocks such as adverse movements in key macroeconomic variables or volatility in export earnings. Therefore, the IMF and World Bank will construct a forward-looking debt sustainability analysis (DSA) under the framework in which they project how a country’s debt ratio will evolve given a country’s expected economic performance in the medium to long term and given its exposure to other economic factors such as exogenous shocks. If the projections show that a country is likely to break its debt thresholds or that it will not make enough progress in lowering its debt ratios if they are currently too high, the IMF and World Bank will advise on a change in debt policies.

At the time of writing, only a few of such forward-looking DSAs had been constructed. The IMF therefore still has to show that it can cope with a number of challenges that will result out of the application of the DSF. One such challenge is how flexible the IMF will have to be if countries threaten to break their thresholds. Since low-income countries rely heavily on external assistance, their potential to pro-actively manage their maturity structure and currency composition of their debt is limited and the change in policies in order to adapt its debt structure will thus often have to be a reduction in new borrowing. If not enough grant financing is available, this can only be done by reducing government expenditures.

The IMF and World Bank have decided to apply relatively conservative thresholds but if these thresholds really start to bite, countries may prefer to increase their risk of debt distress in order to maintain government expenditure at current levels. Tension in this regard may be increased by the fact that the DSF will likely work pro-cyclical. Since debt ratios will rise if exports or GDP fall, a reduction in borrowing and therefore possibly in government expenditure will be called for exactly when economic times are rough. Note that the IMF is itself also a provider of credit. Would it be tempted to be less strict in order to be able to continue its own lending? The integration of the debt sustainability assessment into the Fund’s and Bank’s own lending decision is often called the third pillar of the new framework, which will need to be further explored. Another challenge will be how to solve short-term liquidity problems. Since many development assistance loans have a grace period, even shifting from loans to grants will not have much impact on a country’s debt service profile in the short to medium term. The IMF can provide extra liquidity support through an augmentation
of its PRGF if there is an increased balance of payments need due to a shock, but IMF financing would at the same time add to the debt stock. How should smoothing of short-term liquidity problems be weighted against longer-term solvability issues? We look forward to the coming years, in which increased experience with the framework will provide useful insights on how to deal with these issues.

4 Concluding Remarks

We have discussed some of the main challenges related to the Fund’s future role vis-à-vis low-income countries. In many respects, these challenges are closely interlinked. If the Fund is better equipped to design and implement a gradual exit strategy, a country may be better able to shift from IMF financing to other, more concessional funding, which, in turn, reduces the build-up of new, possibly unsustainable debt. This process will be facilitated if the IMF can use the new Policy Support Instrument, providing a strong signal, also on debt sustainability, but without financing.

In general, the recognition of a longer-term relationship between the Fund and low-income countries should not be confused with a need for IMF financing being provided over longer periods. The Fund should phase out its financial involvement when it is no longer effective or no longer needed. The issues of “saying-no” and the design of proper “exit strategies” are among the main future challenges of the IMF. Especially for countries that have stabilised their economies, the Fund’s direct role in providing balance of payments support needs to change into an indirect role, i.e. to catalyse other sources of financing for the achievement of the MDGs.

In order to attain the MDGs, low-income countries need significantly more resources and more fiscal space. One of the most pressing issues is the build-up of high debt levels in most poor member states. The new multilateral debt relief initiative and the application of the new debt sustainability framework should prevent the building up of new unsustainable debts.

In sum, we expect the Fund to remain of vital importance in low-income countries in the decade to come, but the nature of its involvement will change, as it has over the last decades. We hope this change will manifest itself in a shift from a direct role in financing balance of payments gaps to a more indirect role in catalysing other sources of
funding by providing signals on the macroeconomic and financial developments in countries. This would reflect countries’ progress in bettering their predicament.

References

Reviewing the Role of the IMF in Low-Income Countries

_Caoimhe de Barra_

In an era where “partnership” is the leitmotif of development discourse, the IMF stands apart. In a context of increased multdonor initiatives to develop joint assistance strategies with partner governments, the IMF largely continues to operate in strict bilateralism, with a limited group of interlocutors in Ministries of Finance and Central Banks.

Tortuous debate on the role of the IMF in low-income countries has taken place at Board and staff level. At its most fundamental, the debate has been about whether the Fund’s role is to have a bilateral relationship with member countries only, focused on macroeconomics, or whether it should position itself as part of a multilateral framework, with a specialisation in macroeconomic stabilisation but a clearer focus on poverty reduction.

This chapter argues that the Fund has a contribution to make to poverty reduction and sustained growth, but that this is only possible if it operates as a partner with other stakeholders at both international and national levels. The Fund should remain focused on its core areas of competence but change the way it operates. To be effective its contribution needs to be coherent with a broader understanding of the nature of development and the political economy of growth and poverty reduction.

This chapter addresses some ongoing areas for debate around the role of the Fund in low-income countries. How should the Fund address poverty? What is the Fund’s role in mobilising finance for development? What are the changes in policy and practice needed to IMF conditionality? What deeper changes are required in the Fund’s signaling role?
1 The Role of the Fund in Poverty Reduction

The primary role of the Fund in low-income countries should be to highlight to governments the implications of alternative macroeconomic policy paths and encourage governments to decide which path to follow, based on that government’s consideration of the social, economic and political trade-offs involved, after a process of domestic consultation.

However, a narrow interpretation of this role is not tenable. While growth in many low-income countries has stabilised after a disastrous decline over recent decades, inequality and poverty have increased, even in stable performers with a history of social concern, such as Tanzania. Policies for growth and stability are not enough. Policies, including macroeconomic policies, must be expressly designed to achieve reduction of poverty and vulnerability. They should be subject to rigorous testing for their ability to meet those objectives.

The Fund faces a choice therefore, both in policy development and in application of policy at country level: it can take the option for the poor, or it can try to take a neutral position by adopting a minimalist, technical approach to growth and macroeconomic stability in low-income countries. As decades of experience have illustrated, however, there is no such thing as “neutral policy”, economically, socially or politically. Indeed, the political economy of policy change has been a significant blind spot for the Fund.

Taking the “option for the poor” would mean considering vulnerability and inequality as important determinants of potential macroeconomic policy. The operational implications are that the Fund needs to ensure that its macroeconomic analysis is carried out in such a way as to allow multi-disciplinary assessment of the implications of its analysis and recommendations.

The Fund should subject its own work to independent analysis from a poverty-reduction and social vulnerability perspective, in order to ensure that the medium to long-term social and economic implications of its analysis are clear to policymakers and the stakeholders in the Poverty Reduction Strategy (PRS) processes, or its national equivalent. Indeed, the Fund promised no less than this when it included in the key features of the PRGF the promise to subject major reforms to Poverty and Social Impact Analysis (PSIA). To date however, this analysis has proven limited, dealing with a set of discrete structural issues in a small number of programme agreements. Certainly, there is
no sense that PSIAs would routinely be carried out on all major or contentious reforms, in spite of the clear “ownership” imperative of reforms arising from such work, particularly if that is carried out independently of the IMF.

In this chapter, I argue that the Fund should take a partnership approach to its role. This would mean taking a country-by-country approach to policy analysis, stimulating debate among a broad set of stakeholders through increased transparency and being seen to be open to national-level analysis and views. This is further elaborated below.

Institutional resources dedicated to low-income countries should increase, including delegating increased staff and analytical and decision-making capacity to field offices. This is a prerequisite for understanding the country-specific complexities of development in countries for which there are no easy parallels in development history.

2 The Fund’s Role in Mobilising Finance for Development

Low-income countries face a deep finance constraint that compromises their ability: to deliver on basic services; to develop sustainable institutions capable of managing scarce resources; to generate growth sufficient to eradicate poverty; and to plan for and withstand foreseeable shocks (see Trócaire, 2004; Oxfam, 2004a). This logic is broadly accepted, and has resulted in pledges of a doubling of aid to Africa by 2010 over 2004 levels, and an overall increase to $115 billion by 2010, from $78 billion in 2004. However, even this increase – assuming it is delivered – will be insufficient to meet the Millennium Development Goals, which are themselves a minimalist baseline.

The persistently binding financial constraint faced by low-income countries dramatically narrows their range of options both in relatively good times and when they are faced with a balance of payments problem. Chapter 8 deals with the phenomenon of long-term users of the Fund’s resources and argues cogently for a reduction in dependence on Fund resources. These are valid arguments.

However, vulnerability to shocks will invariably lead low-income countries back to the Fund, unless radical solutions can be found, such as those outlined by Martin and Bargawi in this volume. The new IMF shocks instrument will do little to change the fundamental problem of the policy response to shocks, unfortunately. Demand compression tends to be the primary policy response to crises in low-income countries,
Reviewing the Role of the IMF in Low-Income Countries

given the inadequate levels of finance available and the fact that adjustment based on exchange rate devaluation is frequently economically or politically inadvisable.

Demand compression is a highly questionable tool in such circumstances however, given its negative impact on economic growth. Low-income countries can find themselves locked into low-growth scenarios that could be avoided through adequate, early provision of liquidity. Bird (2005) argues in favour of increased finance rather than reducing aggregate demand therefore. And he is right.

Rather than a new Fund facility for shocks, it would have been preferable to establish a donor financed, grants-based shocks facility to deal with shocks as they arise in a manner that would protect progress made on the MDGs and stimulate a fast recovery.

Unfortunately, there is likely to be little movement on this for some time, therefore it is important to look at the Fund’s role in helping to prevent or mitigate shocks and in mobilising the resources promised by donors in recent pledging sessions, including the G-8 meeting in Gleneagles in July 2005.

Aid flows are notoriously fickle; hence, “predictability” has become a central element in the aid effectiveness agenda. The Fund should focus on mobilising higher levels of stable resources through its illustrations of the economic effects of unstable aid flows, and in partnership with other actors, the social effects of chronic resource gaps. In the latest paper reviewing the PRSP approach, the IMF and World Bank (2005) call for alternative scenarios to be included in PRSPs, showing what could be achieved with a different combination of resources, policies and other public actions. There is clearly a mandate for the Fund to use its considerable muscle to advocate for more and better aid.

The Fund has several broad concerns on finance increases however, which may make this difficult. One of the most important is absorption capacity and macroeconomic destabilisation. Recent analysis by the IMF (2005A) highlights the complexity of the absorption issue and in particular shows that aid is not being spent, because countries are fearful of creating exchange rate imbalances and hampering exports. I believe that the answers to this problem are not to be found in limiting aid flows, but in marrying longer-term finance plans with programmes to dramatically develop economic productivity and export capacity.

The implications for the IMF are important. Firstly, it shows that a straightforward cap on the fiscal deficit which limits aid inflows is neither necessary – as countries seem to self-censor for fear of exchange

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rate appreciation – nor advisable. It is not advisable as it forgoes opportunities for investment, growth and poverty reduction.

In practical terms, the Fund research suggests that there should be more flexibility in its policy recommendations, including allowing countries to spend unexpected windfalls and to draw down on reserves when aid shortfalls occur. However, the litmus test of this potential change in Fund thinking will be the content of Fund agreements and in particular the targets which are de facto conditions for an ongoing PRGF agreement.

3 What Are the Changes in Policy and Practice Needed to IMF Conditionality?

The legitimacy and effectiveness of conditionality in general are heavily contested but a number of conclusions are by now axiomatic. For example, excessive conditionality is counter-productive and undermines ownership; conditionality should be streamlined across all donors and particularly the IFIs; all conditionality should be based on benchmarks drawn from governments’ national development plans; and conditionality should be evidence-based and independent PSIAs should be carried out on all major reforms.

Furthermore, it has become widely accepted that policy and process conditionality run counter to normal democratic processes at a domestic level and conditionality should therefore be outcome-based. Conditionality should take the local political economy and potential shocks into account and targets should be stress-tested for realism. Conditionality should be disaggregated so that failure to meet a small number of conditions does not result in aid volatility.

With respect to the Fund’s conditionality, there is particular contention around two issues: firstly, as discussed below, the Fund implements conditions independently of other donors, in spite of the move towards harmonised approaches. Secondly, the assumptions used in the design of fiscal and monetary targets and their links to stabilisation, growth and poverty reduction are contentious. The flexibility granted to countries in meeting programme targets is also highly contested. This is particularly true for “poor” performers (Trócaire, 2004).

For example, Martin and Bargawi (2005a) found that the Fund seems to expect countries to reach 3 percent inflation and a 1 percent budget deficit after grants before allowing any room for flexible policies.
They assert that these levels may be too low to be compatible with the growth needed to reach the MDGs. Oxfam (2004, p. 17) found that out of 20 countries with PRGFs, inflation of less than 5 percent was targeted without any discussion of the trade-off between this reduction and poverty-reducing expenditure.

After many years of such critical comment, Fund research (IMF, 2005a) has recently come to the conclusion that an inflation rate of 5-10 percent is appropriate and that countries should be encouraged to aim to remain within this range, rather than to aim for a specific point. This is significant as inflation is one of the “sacred cows” in the Fund. Nonetheless, it is only a small part of a portfolio of analysis that needs to be radically different if countries are to achieve poverty reduction commensurate with the MDGs.

It is widely acknowledged for example, that growth targets for low-income countries should begin with the MDGs. The use of costed MDG outcomes as the basis for determining growth and poverty reduction strategies has finally influenced IFI thinking, it appears. As noted above, the latest IMF and World Bank paper reviewing the PRSP approach calls for alternative scenarios to be included in PRSPs. This is welcome, but it will nonetheless require a significant shift in culture and practice for the Fund, particularly in relation to the actual development of PRGF programmes at country level. As the IEO (2004) found, average practice in the implementation of good principles under the PRGF, including flexibility, is far removed from best practice. For example, Martin and Bargawi (2005a; p. 106) found virtually no mention of the MDGs in an examination of 72 PRGF-supported programmes.

An approach within the Fund that actively promotes flexibility in PRGFs and alternative scenarios in PRSPs will require changes in the way the Fund does business. Fund staff will have to engage with experts in social and political dimensions of economic growth in order to frame its advice in a context that is squarely focused on poverty reduction and equitable growth. It will require that Fund staff spend more time working in partnership with governments, donors and other stakeholders at a country level, instead of working in isolation, in under-staffed local offices, and interacting almost exclusively with a small cadre of finance officials.

It will need to make its programme advice genuinely transparent and accessible to stakeholders within and beyond government and other donors. It will also need to engage other donors – notably key Board members – to impress upon them the logic of financing development
at adequate levels now in order to reduce poverty, generate growth with equity and build institutions for long-term development.

4 Signaling: Is the Debate Over?

Contrary to the assertion in Chapter 8, I believe the debate on signaling for the IMF is not over. As outlined in that Chapter, the IMF holds a critical, if unsought, role as gatekeeper for budget support, effectively. It is in this position because the broader donor community requires assurance that a country has its macroeconomic situation under control if it is to receive financial assistance. At a general level, this is reasonable. However, there are several problems with the Fund’s role as signal-giver.

First, there is a fundamental difference in the purposes of support given by the Fund and other donors. Hence, the information required to make funding decisions differs substantially. The Fund imposes conditionality on countries in order to ensure that its loans, drawn from a relatively small pool, are repaid as quickly as possible and that a country does not fall into arrears. Its conditions are designed to ensure that countries will not fall into future balance of payments difficulties.

Other donors, on the other hand, need to know whether aid is being used for the purposes for which it was intended, e.g. poverty reduction and long-term development. The interruption of a PRGF programme because of failure to meet IMF targets is not a suitable proxy for judging a government’s capacity to use aid effectively. Arguably, donors are delegating decisionmaking power to the IMF on development issues that are beyond the Fund’s mandate and competence.

Furthermore, while a broad indication of macroeconomic stability is important for donors – particularly in the context of budget support – a PRGF will contain a significant number of conditions that can in theory send a country “off-track” if they remain unmet. These include structural conditions, which continue to proliferate in spite of the streamlining initiative, and micro-conditions. Most budget support donors require an on-track PRGF for disbursement. Countries such as

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1 Structural conditionality has become tighter in recent years, in the experience of HIPC Finance Ministers, in spite of the streamlining initiative. Martin and Bargawi (2005a, p. 97) also highlight the excessive level of micro-conditions in some programmes and note that there is no conceivable link to macro-stability, for example in the condition to issue ID cards for all teachers in Sierra Leone.
Honduras and Zambia have lost $400 million and $50 million respectively in budget support and interim debt relief as a result of going “off-track” in recent years (Oxfam, 2004).

Fund staff sometimes go to significant lengths to keep countries “on-track”, recognising the potential impact of an off-track signal on resource flows. However, such a response is not satisfactory for any of the stakeholders, as highlighted in Chapter 8. Unfortunately, the new Policy Support Instrument (PSI) is probably not the answer either.

The PSI was designed to meet needs of certain mature stabilisers who do not require Fund resources, but for whom the signal of macro-economic integrity is important. This is effectively an instrument of enhanced surveillance, without a lending programme attached. It remains to be seen how this instrument is used and what its impact is on aid volatility in stabilised countries. It is patently clear however, that this latest instrument retains all the hallmarks of the power imbalances between donors, IFIs and “partner” countries that are theoretically being dismantled under the “aid effectiveness” agenda.

The IMF’s role as gatekeeper has to be radically reformed on a deeper level – one that places the countries’ national policymaking processes at its centre. In the context of reasonably rapid movement towards multi-donor assistance strategies for partner countries, this now looks more possible than ever. Specifically, the PRGF “on/off” signal should be replaced by a country-specific agreement between all donors and government on the triggers that would result in aid reduction or suspension. It should be built into a joint government / donor performance assessment and harmonisation matrix.

While such joint performance assessment frameworks are increasingly common, the IMF – and macroeconomic conditionality – remains resolutely outside these frameworks. In a future scenario, jointly agreed performance targets could be based on the main objectives in the PRSP, or an equivalent national development plan, and would also include all the core macroeconomic targets typically negotiated between the IMF and government.

Donors, including the IMF, would commit not to impose conditionality unless they appear in the agreed matrix. The PRGF would be based on the targets emerging from such a government-led Poverty Reduction Strategy process – or national equivalent – on a macroeconomic framework, rather than the reverse. Above all, the PRGF should not predetermine the macroeconomic framework for a country, nor should donors link conditionality in budget support matrices to
existing PRGF conditions.

Civil society and parliament should input to and monitor the implementation of such a performance assessment and harmonisation matrix, under a rights and rule-based system. Such an instrument should be an accountability mechanism both for national governments and for donors.

The obstacles to such a partnership-based system are limited and surmountable. The Fund claims that it cannot legally enter multi-donor agreements. This can be changed. It states that it can only negotiate with governments. The above framework does not require it to strike a deal with actors other than national governments. However, it does require the Fund to contribute as one actor amongst many, in offering advice and support to a government that has the freedom to take its own decisions based on national consultation.

5 Conclusion

The debate on the Fund’s role in low-income countries has been at the heart of policy discussions in the Fund and with external stakeholders for many years. The Fund could try to confine itself to a strictly bilateral relationship with member countries, focused only on macroeconomics, but this option has effectively been rendered obsolete by its commitment to the Monterrey Consensus and the MDGs. The Fund has to position itself as part of a multilateral framework, therefore, and it has to leverage its core competence in macroeconomic stabilisation and growth to help deliver the MDGs.

This chapter notes that there is no such thing as “neutral policy” and that therefore the Fund has to take the option for the poor in its programme design. The Fund has to take responsibility for ensuring that its interventions, whether hard (i.e. conditionality) or soft (i.e. technical assistance and capacity building) are consistent with poverty reduction. It has to ensure that its surveillance and analytic work are rooted in protection of expenditure on poverty reduction and are geared towards mobilising higher levels of grant financing, as opposed to having a default option towards deeper demand reduction, structural reform and excessive fiscal and monetary tightness.

Ultimately, the role of the Fund should be to highlight to government and other stakeholders in a Poverty Reduction Strategy-type process the implications of alternative macroeconomic policy paths and
encourage governments to decide in consultation with those stakeholders, which path to follow. This analysis needs to take on board the political economy of change and in particular the implications for poverty reduction, vulnerability and inequality. This will require a greater partnership-based approach to the Fund’s work and a change in working culture as well as policy orientation.

Furthermore, the Fund’s staff and management need to engage other donors – notably key Board members and Governors – to impress upon them the logic of financing development at adequate levels now in order to reduce poverty, generate growth with equity and build institutions for long-term development.

I would propose a partnership model for the Fund in low-income countries, where the Fund plays an equal role with other donors and supporters of the development efforts of sovereign governments. This is not an outlandish proposition but it might require an extraordinary effort from the Fund and its political principals to relinquish power, adopt a genuinely multilateral attitude and recast itself in the role of partner rather than macroeconomic master.

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From: Protecting the Poor - Global Financial Institutions and the Vulnerability of Low-Income Countries
Helping the Poor? The IMF and Low-Income Countries,
Edited by Jan Joost Teunissen and Age Akkerman

Contributing authors say:

“Above all, the IMF needs to adapt its conditionality to the needs of low-income countries and their wishes for genuinely country-led strategies.”
Matthew Martin and Hannah Bargawi, Debt Relief International

“The IMF should be more flexible in programme design and react as problems reveal themselves, as opposed to setting unrealistic monetary and inflation targets.”
Louis Kasekende, Bank of Uganda

“The recurrent nature of the debt problems, the ongoing debates, and the limited and poor resource transfers are but signs of the need for deeper reforms to the institutional framework for dealing with the financing problems of low-income countries.”
Stijn Claessens, World Bank

“The Bank’s and the IMF’s future role involves… greater empowerment of the borrowing governments and… a move from stabilisation to more pro-poor macroeconomic frameworks.”
William Lyakurwa, African Economic Research Consortium

“Given the lack of scientific consensus about the causes of growth, member countries need to be encouraged to formulate their own development strategies that the IMF can then endorse, monitor and support.”
Graham Bird, Surrey Centre for International Economic

From: Protecting the Poor - Global Financial Institutions and the Vulnerability of Low-Income Countries
Diversity in Development: Reconsidering the Washington Consensus,
Edited by Jan Joost Teunissen and Age Akkerman

Contributing authors say:

“The Washington Consensus is the farce that the development establishment in Washington foisted upon the developing world as universal science...” Wing Thye Woo, University of California

"...the international divergence of income levels and high financial volatility in both the developed and the developing world are increasingly seen as inevitable outcomes of the neo-liberal global order." José Antonio Ocampo, Department of Economic and Social Affairs of the United Nations

"There is strong evidence that trade liberalisation has helped growth and has not worsened inequality...” Anthony Boote, Policy Development and Review Department, IMF

"'The science of economics, the economics profession and international economic organisations cannot continue to ignore the social, political and cultural effects of globalisation and neo-liberal policies." Osvaldo Sunkel, Corporación de Investigaciones del Desarrollo, Chile

“The core of the East Asian crisis was the failure to appreciate the fatal risks of financial liberalisation and globalisation in the context of weak domestic institutions.” Yunjong Wang, Korea Institute for International Economic Policy
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Protecting the Poor: Global Financial Institutions and the Vulnerability of Low-Income Countries

Edited by Jan Joost Teunissen and Age Akkerman

Low-income countries are highly vulnerable to exogenous shocks such as sudden drops in the prices of their exports, hurricanes, droughts, shortfalls in aid flows, and volatile private capital flows.

Rich countries and global financial institutions recognise the need to avoid or mitigate the effects of these shocks to poor countries, but they only see a limited role for themselves. Poor countries and their advocates, on the other hand, stress that the international community should do more since shocks cause severe harm to developing country economies and, especially, the poor.

Protecting the Poor: Global Financial Institutions and the Vulnerability of Low-Income Countries brings together in-depth analyses and valuable policy proposals of both officials and critical observers. It spells out what poor countries, rich countries and the international financial institutions can do to address the vulnerabilities of low-income countries.

It also addresses why the governance of the international financial system should be improved. Contributing authors advocate that improvements should go beyond the short-term agenda of policymakers – such as the latest financial crisis or the newest debt relief proposal. “Fundamental” reforms are needed, they say.

Contributors also review the role of the IMF in low-income countries. Some of them see the design of proper “exit strategies” as one of the main future challenges of the IMF, whereas others stress the need for the Fund to recast itself in the role of partner in development rather than macroeconomic master.