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The Dialogue on the Vulnerability of Low-Income Countries: By Way of Introduction

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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

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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,

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"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."

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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.

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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.

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