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## Curbing the Impact of Shocks

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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.

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<sup>1</sup> 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

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

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