Increasing Resilience to Shocks to Ensure Sustainable Growth

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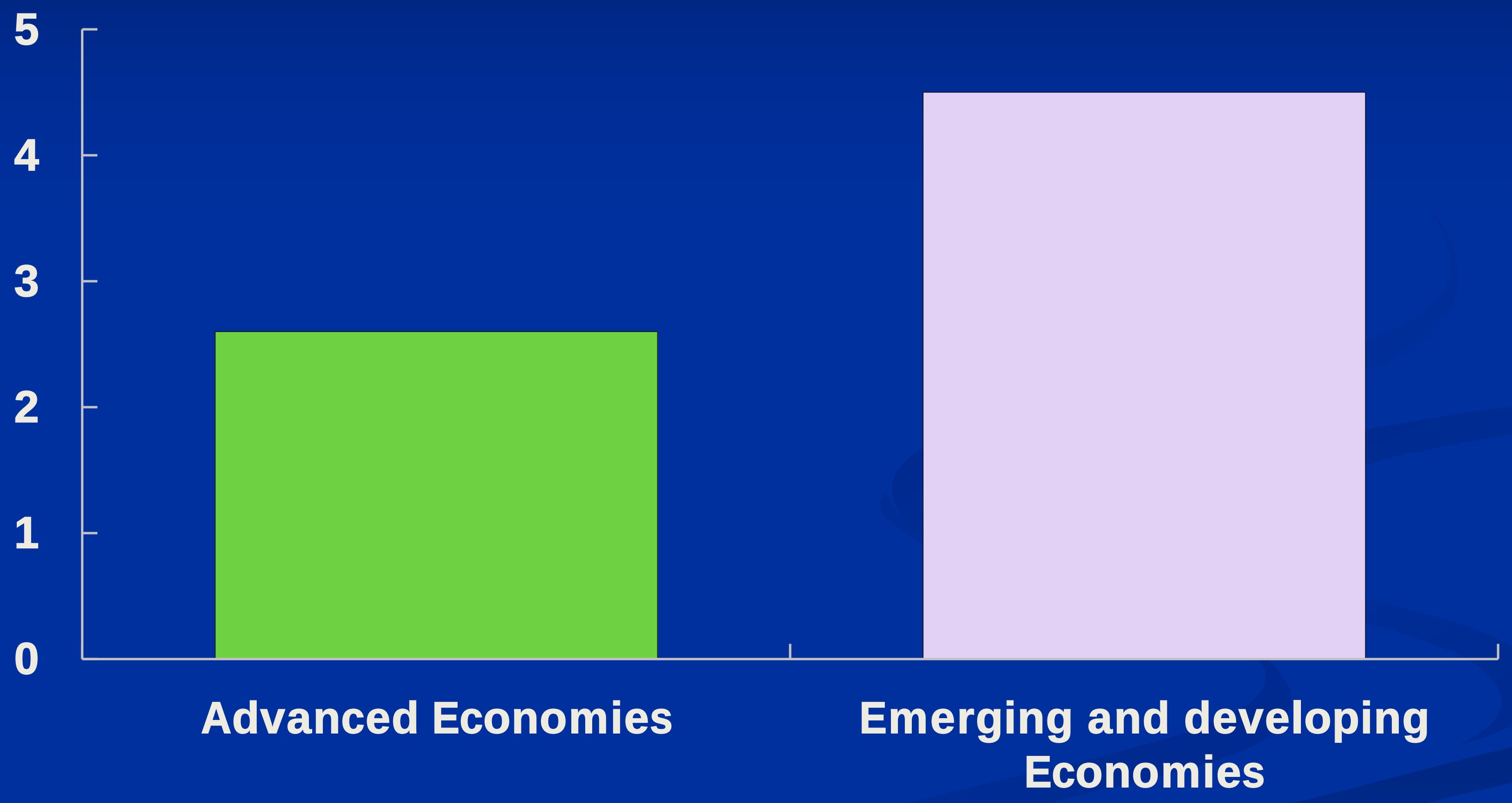
- Three main points:
- Designing macroeconomic institutions and regimes to promote resilience involves a difficult tradeoff between credibility and flexibility.
- Investments in resiliency are costly, but they should be thought of as investments in development.
- Danger that excessive preoccupation with credibility will undermine flexibility.

Start with an empirical observation:

- Growth volatility has historically been much higher among emerging and developing countries than among high-income countries. Episodes of boom and bust have been quite frequent in developing countries.

Standard Deviation of Real GDP Growth
(In percent, 1990-2011)



Sources: IMF WEO database.

- International income convergence has failed to be achieved *not* because rapid growth never starts among poor countries, but rather because it fails to be sustained.

- In other words, high-growth episodes are not at all uncommon, but they tend to fizzle out.

- The convergence challenge that developing countries face, therefore, is to *sustain* growth.

Why is growth so volatile in developing countries?

- Growth collapses tend to be triggered by shocks, either domestic or external in origin.
- But why do such shocks lead to prolonged growth collapses, rather than just to temporary growth slowdowns, as is more commonly the case in high-income countries?

- Two reasons:

- Developing economies have historically been characterized by multiple *fragilities* that have tended to magnify the impact of shocks.

- At the same time, they have lacked mechanisms for ameliorating the effects of shocks.

Fragilities have been of many types. They include:

- Inadequate diversification in the productive sector.
- Precarious fiscal solvency.
- Inadequate capital cushions in the banking sector.
- Currency and maturity mismatches in the banking sector.
- Inadequate monitoring of credit risk in the banking sector.
- Fixed exchange rates with inadequate foreign exchange reserves.
- Widespread indexation.
- Excessive reliance on volatile capital flows.

- Shock amelioration has been prevented by:
  - Weakness of automatic fiscal stabilizers.
  - Procyclicality in discretionary fiscal policy.
  - Inadequate central bank independence.
  - Weak central bank anti-inflationary credibility.
  - Weak and unreliable monetary transmission.
  - "Fear of floating."

- Achieving sustained growth therefore requires measures to reduce fragility as well mechanisms to reduce the incidence of shocks and/or to mitigate their effects when they arrive.

- Unfortunately, some policies correctly intended to *accelerate* growth tend to make the challenge of *sustaining* it more difficult.

- In particular, trade and financial openness, as well as domestic financial liberalization, may have improved developing countries' long-run growth prospects, but they may have done so at the expense of increasing their susceptibility to nonpolicy shocks.

- As faster growth is sought through these means, therefore, the premium on reducing vulnerability to shocks increases.

- So how do we do reduce vulnerability?

Two components:

- Prevent macro policies from themselves being a source of (domestic) shocks.
- Adopt macro institutions and policy regimes that facilitate the flexible use of macro policies to offset (domestic and external) nonpolicy shocks.

Problem: to achieve the first goal we want policy *rigidity*, while to achieve the second we need policy *flexibility* (first point).

How should we make the tradeoff?

No easy answer. But the answer clearly depends on the sources of shocks, and therefore must be country-specific:

- The greater the degree to which they arise from policy, the more attractive is policy *rigidity*.
- The greater the extent to which they arise from nonpolicy factors, the more attractive is policy *flexibility*.

We need macro policy arrangements that:

- *Keep policy on an appropriate path in the long-run* (thereby preventing policy itself from being a source of shocks).

- *Allow it to deviate from that path counter-cyclically in the short-run* (thereby allowing policy to stabilize the economy in the face of exogenous shocks).

- The question is: can this be done?

Lessons from the Great Recession

- The experience of the Great Recession suggests that it can.

- Trade liberalization and financial openness increased the vulnerability of developing countries to the shocks associated with the Great Recession, which originated in high-income countries .

- There was no “decoupling.”

- The most integrated economies proved to be the hardest hit, especially the manufacturing exporters in Asia and Mexico, which is closely tied to the US.

- Based on past experience, the effect of such severe output contractions in emerging and developing economies would have been expected to have been a prolonged period of stagnation, perhaps yet another "lost decade."

- But this time was different.
- Many developing countries affected by these shocks had diversified their trading partners and had undertaken reforms in the fiscal, monetary, exchange rate, and financial areas that dramatically reduced their vulnerability and allowed them to sustain growth.
- What kinds of reforms?

- Fiscal Responsibility Laws and other reforms of fiscal institutions promoted more cautious fiscal policies during the pre-recession boom years. D/Y declined in many developing countries.

- Central banks have been accorded more independence, have taken responsibility for maintaining low and stable inflation rates, and have achieved that goal, enhancing their anti-inflationary credibility.

- Transition to more flexible exchange rate arrangements, substantial reserve accumulation have reduced vulnerability to disruptive discrete exchange rate changes, and have provided an automatic stabilizing effect in response to external financial shocks.
- Financial sector reforms increased bank capital and strengthened regulatory and supervisory mechanisms. Result was banking systems that were well capitalized and not excessively exposed to credit or currency risk.

What did this imply?

- Nominal exchange rates could depreciate, and could cause the *real* exchange rate to depreciate. They did.
- Central banks could lower interest rates without creating fear of reigniting inflation. They did.
- Substantial fiscal expansions could be undertaken without undermining fiscal credibility (in Asian emerging markets, expansions were larger than in the G-20). They were.

Results

- For the first time, international recovery has been led by emerging markets.

- Pattern of recovery followed that of policy response. Asia hit hardest, but recovered most quickly.

But did the policy response really help?

- The IMF estimated that stimulus added 1 3/4 points to growth in Asia in first half of 2009.
- It also estimated that stimulus cut the output cost in the reformed large Latin American economies in half.
- In countries that could not implement countercyclical policies, however, the pace of recovery depended on external environment.

Two Key Lessons

- *Reforms that strike an appropriate balance between macroeconomic credibility and flexibility should be thought of as investments in development.*

- Why? Because they allow growth to be sustained once it starts, and thereby promote convergence.

- *But these reforms are a means to an end, not an end in themselves.*

- The key is to actually *use* the flexibility that credible reforms offer us – i.e., to allow fiscal, monetary, and exchange rate policies to behave counter-cyclically.

- Though knowing when to do so is at present more of an art than a science, the danger is that in not using this flexibility we may lose it.

Thank you!