Briefing note 4

Slowing down the pendulum of volatile economic swings

Macroeconomic volatility can be deadly for developing economies. Volatility needs to be contained through counter-cyclical policies, but these countries often either lack the capability or are discouraged from doing so.

The overwhelming share of investment in all countries – developed, developing or in transition – comes from domestic sources. One focus of last year's International Conference on Financing for Development was on how developing and transition economies can better mobilize resources, through macroeconomic and regulatory policies, broad institutional strengthening and strengthening of their financial sectors. Developed countries agreed in Monterrey to support capacity-building in these areas, as well as to provide financial assistance to bolster stability and growth.

Volatility poses a major threat to these efforts – whether in the form of rapid currency or interest rate fluctuations or sudden outflows of foreign investment. In the Secretary-General's follow-up report to the Monterrey conference [A/58/216], it is argued that macroeconomic volatility is so damaging and discouraging that it needs to be better contained through counter-cyclical policies – cooling off monetary expansion and excessive borrowing during upswings; stimulating economic activity during downturns.

The ability to combat economic downturns requires precautionary measures during booms, such as avoiding substantial currency appreciation and excessively expansionary fiscal and monetary policies. Failing to take these steps effectively narrows room to manoeuvre during the backward pendulum swings. This principle became evident in the global economic downturn in 2001-2002, when only countries with strong fiscal positions were able to counter the forces of contraction through the use of expansionary fiscal and monetary policies.

Debt difficulties

Countries with a high level of public debt and debt service, on the other hand, were forced to pursue fiscal consolidation, aggravating their economic slowdowns.

"After the widespread economic downturn, the weakness or strength of the fiscal position was the key to the ability of Governments to implement counter-cyclical macro-economic policies in 2002-2003," the Secretary-General's report says.

Reinforcing national fiscal positions is especially important because, in the past, portfolio investors, aid donors and international lenders have been unforgiving of countries with bad balance sheets during times of difficulty. But the effort to return to the good graces of lenders and investors by cutting back on government expenditure and raising taxes and interest rates has proven to be bad medicine for domestic economic recovery.

The extent of the debt problem is indicated in statistics released in September of this year by the International Monetary Fund (IMF). As a share of gross domestic product, the average public debt of emerging market countries has risen from under 60 per cent in 1997 to over 70 per cent in 2002. Coping with this debt is especially difficult, as the effective tax rate in the developing countries is about 10 per cent, roughly one-third of that in the developed economies. As a result, interest expenditures on debt in the developing world is nearly twice that of developed countries.

Policy reforms are urged in the Secretary-General's report. These include expanding the use of medium-term fiscal frameworks in the budget process and adopting the goal of "structural" budget balance (surpluses in strong years and deficits in weak ones). Besides providing a counter-cyclical capability, these moves can help to better align the budget process with poverty reduction and development strategies, and make the delivery of essential public goods and services more stable.

The report also stresses the importance of strengthening tax systems and tax administration, which an increasing number of countries are undertaking, especially in the follow-up to Monterrey.

In addition, countries with economies that are highly dependent on natural resource exploitation and have a strong management regime are urged to consider establishing reserve funds, which in the past have helped smooth large swings in public revenues in a number of countries.

SDRs

The IMF was established because even well managed economies sometimes need and warrant international financial support. The Contingent Credit Line (CCL) was created by the IMF in 1999 to help meet these requirements, but it has never been used. With the imminent expiration of the CCL, the Fund is exploring other ways to achieve the same objectives. In this regard, the Secretary-General calls on the Fund and other financial bodies, including regional ones, to further develop their loan facilities and credit lines, including those for low-income commodity dependent countries that cannot carry significant additional debt on standard terms.

The Secretary-General also asks the IMF to keep under review the need for new allocations of "special drawing rights" (SDRs), a special type of liquidity used by central banks for balance-of-payments financing. The Secretary-General notes proposals already advanced for temporary, counter-cyclical SDR allocations during times of exceptional need, and suggests further serious consideration of future usages of the SDR.

Building the banking sector

Prompted by the series of crises in the 1990s and their global repercussions, the international community has sought to strengthen the capacity of the financial systems of all the world's economies to face potential volatility. The Monterrey Consensus emphasized as well keeping attention focused on the development dimension of the financial sector, including provision of appropriate financial services to enterprises of all sizes and households in poverty as well as wealth, and in rural as well as urban areas, particularly for women. Governments moreover are cautioned about issuing local-currency debt that is linked to the exchange rate. It has the appearance of domestic debt because it is in local currency, but it is just as difficult to service as foreign debt. This is because the local-currency burden rises with devaluation just as if the debt were denominated in foreign currency.

A multifaceted approach to financial development is recommended. The financial sector in developing and transition economies requires a variety of institutions, ranging from development banks to micro finance. Donor assistance remains decisive in helping with the initial set-up and operation of new institutions, such as in microfinance. Multilateral organizations, organizations in donor countries, public/private partnerships, civil society organizations and business at the country level are encouraged to contribute to developing such services.

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