

## **Panel Discussion for the Volatility and Growth Conference (Barcelona) <sup>1</sup>**

Let me first thank the organizers of this conference for inviting me at this panel discussion, which deals with a theme that is certainly of critical importance for the IMF.

I will not dwell on why (at least excessive volatility) is regarded as a problem. I would just like to underscore that macroeconomic volatility is regarded as something to be avoided even in advanced countries, hence the focus on countercyclical policies. This desire to “fine tune” the economy in countries, where the welfare costs of volatility should be lower is something of a puzzle. But it points at one shortcoming of volatility that has not perhaps been underscored enough. Namely that shocks, if sufficiently strong, may affect price and demand expectations, and hence have prolonged effects. If we were sure that a cycle is just a cycle, we could ignore it, particularly in advanced countries. But what starts as a cycle may turn out to have cumulative effects if it affects expectations. Hence a premium for policies oriented at stability.

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<sup>1</sup> These notes were prepared together with Mr. Mumtaz Hussain and Ms. Lupin Rahman.

In any case, for one reason or another, in all countries volatility seems to be regarded as a problem. Today, I will focus on the role of the international community and of the Fund in particular in reducing volatility.

My main point is that volatility has also a multilateral dimension. Because of spill-over effects, volatility is not just a problem for the volatile country. It is also a problem for its economic partners. Indeed, it may be more of a problem for its partners. For example, the welfare costs of volatility may be low for an advanced country. But if the advanced country is big, its volatility creates problems for other countries.

This importance of spillover effects from volatility is indeed the key rationale for the existence of the IMF. The IMF was the response of the international community to the volatility of the interwar periods and to the acknowledgment that, because of spill-over effects, each country had an interest in reducing economic volatility not only in its own country but also in other countries. In the minds of the founding fathers of the post-war international financial system, and admittedly with some simplification, the World Bank's focus was to promote growth. The Fund was to promote stability.

Given this mandate, the Fund plays two distinct roles. The first has to do with alleviating the cost of shocks, through its lending. The second has to do with reducing the probability of shocks, through its surveillance activity.

Let me first focus on lending. You know the theory. Through its lending the Fund allows countries to respond to shocks more gradually than in the absence of external financing. In addition, the policies under a program, particularly its structural policies, aim at reducing the structural weaknesses that lead to future vulnerability. So, Fund-supported programs reduce vulnerability for two reasons. First, because they reduce the output impact of shocks, and, second, because the policies implemented under the program reduce the likelihood of (or the vulnerability to) future shocks.

This is the theory. Does it work? As you know, a lot has been written on the macroeconomic effects of Fund-supported programs, and the results are mixed.

I will report the result of recent studies by three Fund economists (Uma Ramakrishnan, Juan Zaldendo, and Jun Kim)<sup>2</sup> that provide comfort to the theory that Fund-supported programs are indeed effective in reducing the

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<sup>2</sup> “The Role of IMF Support in Crisis Prevention,” and IMF-Supported Programs and Crisis Prevention: An Analytical Framework,” (forthcoming IMF working papers).

probability of crises, but with important qualifications. In particular, the paper's econometric results show that the initiation of a Fund-supported program *before* the start of a crisis can reduce significantly the probability of a crisis. The paper also shows that the probability of the crisis declines with the size of Fund financing. Money matters, not just the Fund's catalytic stamp of approval. Thus, the bottom line—supported also by the case study analysis published in IMF Occasional Paper (No. 241)<sup>3</sup> on the design of Fund-supported programs—is that lending in the appropriate amounts and at the right time helps avoiding crises, and reducing volatility.

The question, then, is whether the international community is willing to allow taxpayers' money to be used to prevent crises. The crises of the 1990s have shown the willingness to intervene with a lot of money *ex post* after a crisis has erupted, and even this has often happened in “installments,” with the initial provision of support being inadequate. There are fewer examples of preemptive actions involving a large financial package to prevent a crises, Brazil in 2002 is perhaps the most important example.

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<sup>3</sup> Atish Ghosh, and others, 2005, *The Design of IMF-Supported Programs*, IMF Occasional Paper No. 241 (Washington: International Monetary Fund).

One possible reason for the reluctance to put together large packages—unless they can be seen as absolutely necessary to bring a country out from a crisis that is already become quite painful for the country itself—is moral hazard. I will not have time to discuss moral hazard issues. I will just note that this is a specific aspect of a more general issue related to volatility, namely whether the existence of institutions that aim at reducing the costs of shocks, may lead to increased volatility because it leads to imprudent behavior by economic agents.

Let me now focus on volatility in low income countries. What is the role of the Fund in this area? In addition to our regular standby arrangement, the Fund has three tools to support low income countries affected by shocks:

- First, we have an emergency assistance facility for natural disasters, featuring rapid-disbursing low-conditionality loans, at subsidized terms, resource permitting.
- Second, we can augment our PRGF arrangements for countries hit by exogenous shocks, providing subsidized long-maturity financial support.
- Finally, for countries hit by an exogenous shock but that do not have a PRGF arrangement, the Fund recently established an exogenous shocks

facility at concessional terms. The new facility covers the full range of exogenous shocks experienced by low-income countries.

If we look at the range of these shocks, one peculiar issue relates to aid volatility. Aid volatility is a problem in its own right. Fluctuations in aid can occur in response to changes in economic policies and governance in the recipient country. But they can also occur because of shifts in donor preferences.

In this respect, one open issue that is worth mentioning is whether the Fund could consider providing financing to offset aid shocks under the new shock facility if an aid shock is determined to be purely exogenous. This raised difficult questions. It would be, for example, critical to avoid undermining donor conditionality and accountability.

Let me turn to the role of IMF surveillance in ensuring that economic policies of its member countries are managed in a way that reduces the probability of shocks.

This key issue in international monetary cooperation was addressed in the Bretton Woods system through the establishment of a system of fixed exchange

rates, which provided the anchor to the policies of each member. While it eventually collapsed, the Bretton Woods system did provide some 20 years of stability. That system is now gone. It was replaced in 1977 by the approach that emerged from the Jamaica amendment of the Fund's articles of agreement.

The new approach is based on two pillars. First, the commitment that each country undertook in 1977 to conduct domestic policies oriented to stability. Article IV of the IMF's Articles of Agreement lists these constraints. Regarding domestic policies, they include the commitment to "endeavor to direct ... economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability" and to "seek to promote stability by fostering orderly economic and financial conditions and a monetary system that does not tend to produce erratic disruptions". Clearly stability is at the core of these commitments. The second pillar is the mandate to the Fund to oversee the observance of these commitments by countries through the process of Art. IV consultations. This is the essence of what is called Fund surveillance.

Does it work? Has this new approach to international cooperation helped reduce volatility? It is hard to prove this one way or another, taking into account the difficulty of any counterfactual analysis. For example, let's look at the current

emergence of the largest external current account imbalance ever recorded, that of the US. Clearly, this is a challenge for Fund surveillance. Has Fund surveillance, helped the recognition by the US policy-makers that the imbalance is unsustainable? Frankly, at best one can hope that this has been the case, and that, in the absence of Fund surveillance, the imbalance would be even larger. However, it is in addressing these issues of international cooperation—in which action by a number of countries is needed but no country is willing to act on its own—that surveillance can potentially play a useful role.

This said, the fact remains that the surveillance approach, as a soft-law approach, faces considerable challenges in getting traction vis-à-vis sovereign countries. In recent years, the Fund has tried to boost this traction, for example through public outreach and transparency. But this more open approach may irritate policy-makers, and its viability is reduced by the fact that the Fund is not independent from political forces (unlike many central banks). Calls for an independent IMF are resurfacing from time to time, most recently in the words of Mervyn King, the Governor of the Bank of England.

I think it is fair to say that the Fund's surveillance can only be effective in so far as sovereign countries are willing to let it work, This means, first, giving

surveillance sufficient resources. It is worth underscoring a paradox here, namely that, in the current budgetary structure of the Fund, surveillance is expected to be financed by revenues from lending that is from the failure of surveillance to prevent crises, which does not make much sense. Second, the Fund should be allowed to use those surveillance resources with sufficient independence.

For all this to become reality, it will be necessary to revitalize the idea, that was behind the birth of the IMF, the idea that economic multilateralism has a key role to play in avoiding economic volatility.