Canada's funding for the International Monetary Fund's "Exogenous Shocks Facility" is an important contribution to dealing with a problem that warrants greater international attention and more creative solutions.

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As the events of the past few weeks have shown, even strong economies like Canada’s can take a beating from sudden fluctuations in commodity prices. But in emerging and transitional economies, the effect is magnified, with a sudden plunge in the value of a key commodity being enough to trigger a crisis. Add to this the impact of natural disasters (think of the long-term economic fallout from the Tsunami) and the trade disruption caused by regional conflicts, and it becomes clear that many developing countries’ economies can be brought to a grinding halt by forces they have no control over.

That’s why a small detail in Canada’s latest federal budget (tabled in May 2006) — a CA $25 million contribution to the “Exogenous Shocks Facility” (ESF), a little-known fund managed by the International Monetary Fund (IMF) — is significant. The IMF isn’t widely loved by development NGOs, but this is the kind of thing that even critics of the IMF believe it can and should do more of.

The Facility is designed to help poor countries weather unforeseen and largely uncontrollable events that can buffet their economies. The idea is to free up fast-disbursing balance of payments support to allow countries to adjust to the shock, and combine this with policy advice from the IMF to improve macroeconomic policies and provide a reassuring signal to other, longer-term sources of development finance.
Hardly the stuff of front-page news, but it’s important. Poorer countries, of course, are particularly vulnerable to these kinds of shocks. New research supported by Canada’s International Development Research Centre (IDRC) has shown that those economies are particularly volatile. Private consumption (and hence individual well-being) fluctuates even more wildly than overall economic activity, and ‘exogenous shocks’ often cause the dramatic fluctuations that are observed.

In April 2006 in Ottawa, researchers supported by IDRC presented the results of a major study that examined these issues in eight developing and transition countries. The initiative, spearheaded by Dr José M. Fanelli of Argentina, involved local experts in South Africa, Nigeria, Thailand, China, Russia, Brazil, Chile, and Argentina. They have taken a closer look at the impact of those ‘exogenous shocks’ on macroeconomic performance, and it seems to be big.

Moreover, macroeconomic volatility can have a double effect on these countries. Not only does it force short-term adjustments that can be costly in economic and human terms, but it also undermines the institutions of macroeconomic policy themselves, which are supposed to be the guardians of stability. The result is a vicious cycle in which volatility breeds institutional failure, which in turn breeds further volatility. And so on, and so on, and … you get the picture, as does anyone who has taken a serious look at macroeconomic policy in Argentina, or Nigeria, or Russia.

All of this underscores the importance of the kind of emergency support that the Exogenous Shocks Facility can provide. Early, concessional funding can help developing countries weather initial shocks, and can “crowd in” longer-term funding from donors and development banks as a result of the IMF seal of approval on macroeconomic policies. But equally importantly, this kind of finance can help stem the pressures that can lead to failures in domestic macroeconomic policies and institutions, and with luck help reverse the vicious cycle described above. Or, as Fanelli puts it, “policies to reduce macroeconomic instability (can and) should be considered part of the institutional upgrading efforts.”

What’s encouraging is that the IMF seems to be listening to criticisms of earlier programs — which too often sit idle because of limited concessionality and complicated procedures for accessing loans. In this case, funds would be provided well below market rates, with funding from Canada and other donors used to cover the interest rate subsidy. Equally importantly, the Facility would be fast-disbursing — with a kind of “lend first, ask questions later” approach that makes sense in emergency situations.

Clearly, however, more is needed. The CA $25 million contribution from the Canadian government is a drop in an awfully big bucket, and even if the IMF is successful in raising the targeted US $700 million for the Facility as a whole, it couldn’t possibly meet the full scale of funding required. And funding is only open to 78 countries with a per capita annual income below US$895, which means that many middle-income countries that desperately need emergency support wouldn’t qualify (think Guatemala after the 2005 mudslides, or Indonesia in the wake of the Tsunami). These countries might be willing to pay closer attention to market rates for emergency loans, if some of the rapid response promised by the ESF could be maintained.

There’s also a need to think about other measures that could be taken to deal with volatility. The IDRC-funded project provides a number of suggestions in this regard. If, for example, Nigeria could be as successful at diversifying its export base away from a single commodity as Chile has been, commodity price shocks would be less destabilizing. Similarly, countries such as Brazil, South Africa, or Thailand would feel more comfortable in relaxing their monetary policies to stimulate growth if they could be less concerned with sudden capital flow reversals. But all these require domestic policy changes as well as international coordination and coherent reforms to the...
institutions governing global economic relations. Canada, other developed countries, and the IMF have various responsibilities in allowing these to happen.

Providing funding to the ESF isn’t a dramatic measure and it is, at best, only part of what needs to be done to help developing countries deal with the far-reaching effects of macroeconomic volatility. But it’s a good step nonetheless, and Canada can claim some leadership as being one of the early contributors to the Facility.

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