G-24 Research Program
A Counter-Cyclical Financing Mechanism for Developing Countries: Wishful Thinking or Policy Requirement?

Claudio M. Loser[1]
The Inter-American Dialogue

Abstract

Developing countries face serious obstacles to economic growth and experience high volatility in their foreign exchange earnings, closely linked to the variability of exports and capital. They have little ability to carry out the type of counter-cyclical policies that developed countries use to counter shocks. The IMF and other IFIs have been in charge of providing financing at times of cyclical Balance of payments crises, but their role has been constrained by limited availability of resources. This paper proposes a Counter-cyclical Financing Mechanism (CCFM), managed by the IMF. Emerging and developing countries would qualify for the facility, intended to offset the effect of cyclical declines in GDP, exports and private capital flows. With adequate cooperation and macro-policies, access would be automatic and based on shortfalls calculated for one year and up to two years. Charges would be the same as at present, with lower interest charges applied to low-income countries. Excluding China, a total amount of some US$120-140 billion would cover significant deviations on an annual basis (about one third of total loans by the IMF and World Bank/IDA, and only 1 percent of total international debt securities outstanding). The financing would be raised through an extraordinary increase in IMF quotas and special bond issues by the IFIs.

1. Introduction

The global economy over the last 20 years has grown significantly. However, the picture for many developing countries does not look good. Their debt has increased in relation to GDP, and high volatility in foreign exchange earnings and incomes has limited their capacity to maintain high levels of employment and income.

While domestic polices often have contributed to a poor performance, the real culprit appears to have been the variability of exports, which is some three times higher for developing countries than for advanced economies. Moreover, whenever the fragile economic position of many of these countries has restrained their ability to obtain financing, they had to follow pro-cyclical policies (tightening at times of recession and expansionary at times of upswing) that further aggravated their prospect when external conditions deteriorated.[2] This paper explores the impact of counter-cyclical actions--a key component of the modern macroeconomic toolbox aimed at offsetting short-term cyclical downturns and ensuring growth over the medium term. The paper focuses

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[1] This paper draws to a significant extent on my experience at the IMF. I want to thank the Inter-American Dialogue for encouraging and accommodating this project in our work plan. I am extremely grateful in particular to Cecilia Carro, Research Associate, as well as Ramiro Gonzalez, intern and other members at the Dialogue for their hard work and invaluable support during this project. I also want to thank Ariel Buira, Director, and Azizali Mohamed of G-24 Secretariat for their substantive and very useful comments on an earlier draft. Of course, this paper reflects my personal views, and all existing errors are mine.

[2] For examples of pro-cyclical policies see World Economic Outlook IMF, 2002, and 2003.

specifically on a financing mechanism to help developing countries pursue those counter-cyclical policies, particularly in the presence of external trade and financing shocks.

The paper is organized as follows: Section 2 provides a brief description of analytical issues related to counter-cyclical macroeconomic policies, and discusses the experience of advanced and developing countries. Section 3 discusses the role of International Financial Organizations. Section 4 reviews the need for counter-cyclical financing and Section 5 presents a proposal for a possible Counter-cyclical Financing Facility. Section 6 provides a summary and conclusions to the paper.

2. The nature of counter-cyclical polices in advanced and developing economies

One of the main legacies of modern 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 center of debate since Keynes developed his macroeconomic theories[3]. Market-oriented economies frequently saw periods of growth, interrupted by periods of recession.[4] These cycles have triggered short-term policies in industrial countries, which have sought to reduce the effect of downturns on income and expenditure[5]. However, there have been important changes over time. Recessions have become generally less severe and less frequent and there has been considerable synchronization among developed countries, suggesting a clear link among them.

- Automatic stabilizers have been built into fiscal policy over the last seventy years or so to help in the process. Today, the impact of business cycles is ameliorated through the workings of unemployment insurance and tax adjustments that take into account the impact of these cycles. Such policies were the established paradigm through the mid 1970s. Even when the neo-liberal revolution changed the emphasis of policies away from fiscal and monetary policy as instruments for economic fine-tuning,[6] counter-cyclical policy remained in place in recent decades.
- Over time it became clear that counter-cyclical policies, which were relevant in the short-term management of the cycle, could not be extrapolated to the long term. Counter-cyclical policies just seek to stabilize income and expenditure around the cycle. They cannot in themselves generate long-term growth, which will be dependent on the investment decisions of economic agents. Accordingly, governments have focused on a dual agenda of stabilization and creation of conditions for growth in investment and income. In advanced economies, characterized by developed financial markets and generally strong confidence in the ability of governments to deal with their debt, counter-cyclical policies have been accommodated with little difficulty.
- Finally, as interdependence has remained strong and capital mobility has risen at a fast pace, counter-cyclical policies also had to include exchange rate management.

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[3] Keynes, John Maynard. The General Theory of Employment, Interest and Money. London: MacMillan, 1936.
[4] Chatterjee, Satyajit. "Real Business Cycles: A Legacy of Countercyclical Policies." Federal Reserve Board of Philadelphia Business Review, Jan/Feb 1999. Page17-27. Espinosa-Vega, Marco and Jang-Ting Guo. "On Business Cycles and Countercyclical Policies." Federal Reserve Board of Atlanta Economic Review, IV Quarter 2001.
[5] IMF World Economic Outlook, April 2002. Chapter III: "Recessions and Recoveries" provides a thorough analysis of the behavior of advanced economies regarding recession recoveries from a long-term historical perspective.
[6] Palley, Thomas. From Keynesianism to Neo-Liberalism: Shifting Paradigms in Economics. Forthcoming in Johnston and Saad Filho, Neoliberalism: A Critical Reader. 2004.

Exchange rates have become increasingly sensitive to capital flows, with countries generally depreciating their currencies at times of weakness in the cycle relative to other countries, and appreciation at the time of recovery.[7]

The experience of **developing countries** is different. The variability of output is high, and that of consumption even higher, as illustrated by studies of the IMF.[8] Furthermore, the volatility of external conditions is much higher in developing countries than in advanced economies, as is shown in Table 1.[9] These issues have been discussed extensively by international organizations, including the IMF, World Bank, UNCTAD and ECLAC.[10]

Generally, advanced economies showed a much lower volatility (as measured by the standard deviation of output growth) for the period 1990-2003. Furthermore, certain regions--particularly Latin America and the Caribbean--had higher volatility and lower rates of growth. The same is true in terms of inflation and trade variables. The effects of high volatility on the level of output has been demonstrated to be harmful, thus strongly suggesting that the high volatility of macroeconomic variables tends to have high output costs over the longer run.[11]

What determines the degree of variability to which developing economies are subjected? Are there any inherent reasons for it? In principle, one could distinguish three: a greater dependence on primary commodities, a small and volatile access to financial markets, and generally less reliable macroeconomic policies, in large part a consequence of the inability to pursue counter-cyclical policies.

- Developing countries have been characterized by a large dependence on commodities. This varies by region and country, with Asia--particularly East Asia--Mexico, Chile, and some Central American countries having increased the proportion of manufactured goods. In Sub-Saharan Africa and the rest of Latin America, by contrast, most countries depend to a large extent on a few commodity exports. As a consequence, export earnings are subject to considerable variability.
- Dependence on commodities and the generally close link between developing countries' external sector and demand conditions in the industrialized world makes exports particularly sensitive to these changes in demand, and, as noted earlier, results in a high level of volatility of the export sector. Table 1 above shows the high deviation for export growth, in relation to industrialized countries.

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[7] IMF, WEO, April 2002. Chapter III

[8] *Ibid.*

[9] Loser, Claudio and Cecilia Carro. "Gestión Macroeconómica, Comercio Internacional y Crecimiento Económico." CEPAL Seminar on Latin American Growth: Why So Slow? Santiago, Chile, December 2003.

[10] UNCTAD, Trade and Development Report, various issues. *Op.Cit*. The 2003 issue includes a thorough analysis of developments in Latin America (See Chapter VI). Jose Antonio Ocampo, Developing Countries' Anti-cyclical Policies in a Globalized World, in D.A.Krishnaed, R. Jaime Eds. Development Economics and Structuralist macro-Economics: Essays in Honor of LanceTaylor, Chetwick Edwin Elgar, 2003, pg. 374-405.

[11] Ramey, Gary and Valerie A. Ramey "Cross-Country Evidence on the Link Between Volatility and Growth." American Economic Review, Vol. 84. December 1995. Gavin and Perotti, "Fiscal Policy in Latin America", NBER Macroeconomics Annual 1997, Cambridge, Mass, Talvi and Vegh"Tax Base Variability and Pro-cyclical Fiscal Policy", NBER Working paper 7499, 2000; Calderón, Easterly and Serven "Infrastructure Compression and Public Sector Solvency in Latin America" Central Bank of Chile 2002, and other authors estimate than more than half of the total fiscal adjustment effort in Latin America in the 1990s was achieved through the curtailment of investment in infrastructure. Because those cuts were not compensated subsequently, pro-cyclical policies resulted in a decline in GDP growth of one percentage point a year.

Table # 1 GDP, Inflation, and International Trade: Selected Averages and Standard Deviations (1990-04)

	Average Growth (in %)	Standard deviation
Global Economy		
GDP	3.23	.88
Inflation	14.22	12.70
Exports (volume)	5.94	3.60
Developed Economies		
GDP	2.54	.89
Inflation	2.54	1.16
Terms of Trade	.11	.97
Exports (volume)	5.53	3.83
Developing Countries		
GDP	5.25	1.10
Inflation	7.69	4.39
Terms of Trade	.15	3.20
Exports (volume)	8.32	3.59
Sub-Saharan Africa		
GDP	2.59	1.73
Inflation	29.00	19.32
Terms of Trade	.57	3.27
Exports (volume)	3.84	3.51
Developing Asia		
GDP	7.09	1.67
Inflation	6.71	4.45
Terms of Trade	-.34	1.57
Exports (volume)	11.46	5.64
Latin America and the Caribbean		
GDP	2.64	1.79
Inflation	85.91	131.76
Terms of Trade	-.41	4.37
Exports (volume)	7.31	4.14
Middle East		
GDP	4.05	1.73
Inflation	25.1	1.73
Terms of Trade	.15	3.21
Exports (volume)	5.71	4.08

Source: International Monetary Fund; and own calculations

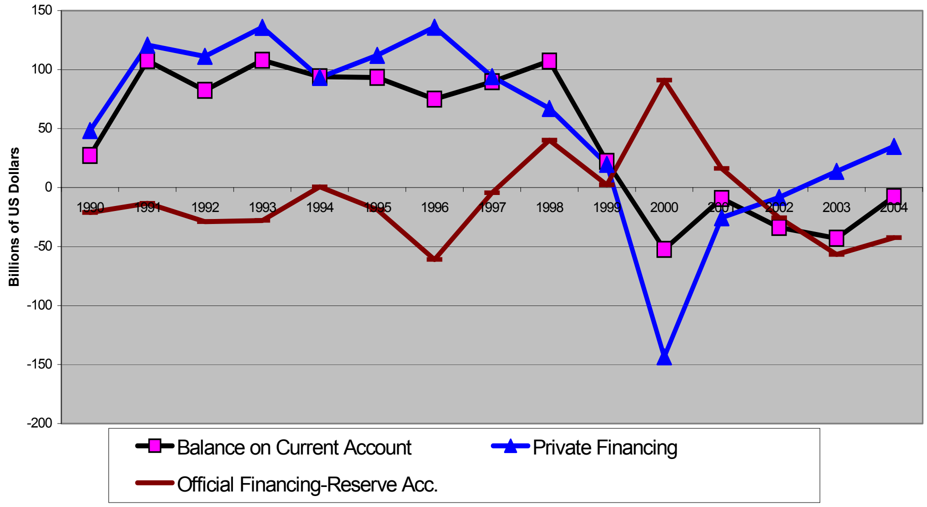
- High volatility in exports is also closely linked to growth of output. This phenomenon is associated very closely to the inability of developing countries to isolate themselves from the fluctuations of external demand, particularly because of the high level of protection of agricultural commodities by developed countries. This handicap is a consequence of the limited possibilities of emerging economies to apply counter-cyclical policies, because of the lack of financial protection and highly volatile private capital flows.
- Developing economies depend directly on two sources of financing: official flows and market-related financing. Poorer countries depend heavily on the support of official institutions. As net aid to poorer countries has diminished, and donors have increased conditionality on structural reforms, net disbursements have slowed, imposing major adjustment costs at a time when the debt burden remains high. Countries with access to market-related borrowing, in turn, have been subject to high volatility, as funds have moved swiftly in and out of borrowing countries. Furthermore the IFIs have not been able to act counter-cyclically because of limited resources.[12]
- With limited official financing from institutions like the IMF, private lenders have tended to perceive a greater risk of debt problems and have therefore sought to reduce their exposure to countries in difficulty. As a consequence, the burden of adjustment has fallen increasingly on borrowing countries. High external volatility and generally pro-cyclical flows has made it virtually impossible to apply the type of industrial country policies to counter external volatility. What is more, while developed countries have the required depth in their financial markets and external access to obtain the necessary resources to follow expansionary fiscal and monetary policies, this has not been the case in developing countries.

When developing countries are confronted with an external shock, they have little choice but to adjust their external accounts. In the case of a fall in external demand or terms of trade, exports will decline. With little ability to obtain financing in adverse times, the current account adjusts through declines in imports, and possibly restrictions on other current transactions (although limited by their IMF Article VIII status). In order to attain this adjustment, fiscal, monetary and/or exchange rate policies are used, with contractionary effects on output and employment. Today, only through the process of foreign reserve accumulation can countries moderate the impact of cyclical shocks. However the accumulation of reserves will usually entail significant costs to the country in terms of resources forgone and higher quasi-fiscal deficits.

The close link between financing and the external current account is illustrated in Chart #1 for all developing countries, excluding China and India. The chart shows private capital flows and the external current account during the period 1990-04. Even with no clear causality, it suggests the high correlation between the two, with very few exceptional years, and gives a clear indication of the cyclical external nature of domestic developments. All these adjustments cannot be considered neutral in the medium term. Periods of rapid growth, followed by periods of reversal--frequently associated with difficulties in servicing debt--make developing countries a subject of greater risk, and

[12] Loser, Claudio. "External Debt Sustainability Guidelines for Low- and Middle-Income Countries." G24 Technical Papers. Geneva, Switzerland, 2003.

Chart #1 Developing Countries Excluding China and India-External Variables



thus reduce the prospects of additional investment, financed either domestically or abroad.[13]

3. International Mechanisms of Financial Support

As the main multilateral institution in charge of providing financing at times of crisis, the International Monetary Fund has been given the role of the lender of last resort within the existing international financial architecture. This role is supplemented by the financing provided by the World Bank, the regional financial institutions, as well as some key countries

This lending role, however, has been sharply constrained by the slow growth of available resources to these institutions. The International Financial Institutions (IFIs) are owed only about 19 percent of total debt outstanding by developing countries, and only 13 percent among middle-income countries. In the past, the reactions of the markets could be ameliorated as countries started negotiations with the IMF in order to obtain financial support. In today's world, with many more participants in the market, it appears increasingly more difficult to help control these outflows, unless the negotiation between the country and the IMF is accompanied by large commitments on the part of banks and governments. The catalyst role of the IFIs has declined markedly and the vulnerability of debtor countries has increased as the amounts of possible support on the part of the official community have stagnated. Private domestic and foreign lenders see a greater risk of debt defaults or forced restructurings, and therefore seek to reduce quickly their exposure to countries in difficulty.[14]

[13] The experience with external shocks in the case of Latin America is described in more detail in Appendix I, including a comparative study of Argentina and Chile.

[14] Loser. "External Debt Sustainability…"

a. **IMF Lending**

As stated in its Articles of Agreement,[15] a main function of the IMF is to provide loans to countries experiencing balance-of-payments problems so that they can restore conditions for sustainable economic growth. Unlike development banks, the IMF does not lend for specific projects. IMF loans are usually provided under an "arrangement," which stipulates the conditions the country must meet in order to gain access to the loan. The Executive Board approves all arrangements, and based on economic programs formulated by countries in consultation with the IMF. Loans are released in phased installments as the program is carried out.

Table # 2: IMF Lending (December 31, 2003)	
Loanable funds	$85 billion
Of which: For concessional loans	$4 billion
Loans outstanding	$107 billion to 87 countries
Of which: loans on concessional terms	$10 billion to 60 countries

[15] IMF; information obtained from website www.imf.org; IMF; Selected decisions of the IMF, vs. issues; Margaret Garritsen de Vries: The International Monetary Fund 1972-1978, IMF, Washington D.C. 1985.

Box 1.:IMF Facilities

Poverty Reduction and Growth Facility (PRGF). The IMF for many years provided assistance to low-income countries through the Enhanced Structural Adjustment Facility (ESAF). In 1999, a decision was made to strengthen the focus on poverty, and the ESAF was replaced by the PRGF. Loans under the PRGF are based on a Poverty Reduction Strategy Paper (PRSP), prepared by the country in cooperation with civil society and the World Bank. The interest rate on PRGF loans is 0.5 percent, and loans are to be repaid over a period of 5½-10 years.

Stand-By Arrangements (SBA). The SBA is designed to address short-term balance-of-payments problems and is the most widely used facility of the IMF. The length of a SBA is typically 12-18 months. Repayment is expected within 2¼-4 years. Surcharges apply to high levels of access.

Extended Fund Facility (EFF). This facility was established in principle to help countries address more protracted structural balance-of-payments problems. Arrangements under the EFF are longer (3 years). Repayment is expected within 4½-7 years unless an extension is approved. Surcharges apply to high levels of access.

Supplemental Reserve Facility (SRF). The SRF was introduced in 1997 to meet a need for very short-term financing on a large scale. The sudden loss of market confidence experienced by emerging market economies in the 1990s led to massive outflows of capital, which required loans on a much larger scale than anything the IMF had previously been asked to provide. Countries are expected to repay loans within 2-2½ years, but may request an extension by up to six months. All SRF loans carry a substantial surcharge of 3-5 percentage points.

Compensatory Financing Facility (CFF). The CFF was established in the 1960s to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports caused by fluctuating world commodity prices. The financial terms are the same as those applying to the SBA.

Emergency assistance. The IMF provides emergency assistance to countries that have experienced a natural disaster or are emerging from conflict. Loans are subject to the basic rate of charge and must be repaid within 3¼-5 years.
A recently approved *IMF Trade Integration Mechanism* (TIM) aims to mitigate concerns that implementation of WTO agreements might give rise to temporary balance of payments shortfalls. A balance of payments need might result from the erosion of tariff preferences in important export markets, adverse changes in food terms of trade, or the expiration (in 2005) of quotas under the WTO's textiles agreement. Shortfalls could be significant in the short run for some countries. It is not a special facility. A similar mechanism was established for Debt and Debt Service Reduction . Operations in the context of the Fund's support of the Brady Plan in the 1980s.

Oil Facility. The Oil Facility was established in 1974 and expired in 1976. It was set up to offset the effect of higher oil prices in the wake of the Oil Crisis of 1973. 55 countries made use of the facility, for a total of SDR 6.9 billion. It was based on a special financing mechanism provided by oil producing and developed countries. Access was automatic, on the basis of the increased cost of oil to individual countries, and the determination of balance of payments need and cooperation with international organizations. The amount of access was reduced by a relatively small proportion of the shortfall. A subsidy account helped poorer countries pay for the lending.

The current proposal for a CCFM is based on the Oil facility and the currently under-utilized CFF.

b. World Bank Lending[16]

The Bank has two basic types of lending instruments: investment loans and adjustment loans. Investment loans have a long-term objective (5 to 10 years), and finance goods, works, and services in support of economic and social development projects. Adjustment loans have a short-term focus (1 to 3 years), and provide quick-disbursing external financing to support policy and institutional reforms. Both investment and adjustment loans are used flexibly and are occasionally used together in hybrid operations.

Adjustment Lending provides quick-disbursing assistance to countries with external financing needs to support structural reforms in a sector or the economy as a whole. Over the past two decades, adjustment lending has accounted, on average, for 20 to 25 percent of total Bank lending. Originally designed to provide support for macroeconomic policy reforms--including reforms in trade policy and agriculture--adjustment operations now generally aim to promote competitive market structures, correct distortions in incentive regimes, aid financial sector and judicial reforms, advance the adoption of a modern investment code, encourage private sector activity, carry out civil service reform, and mitigate short-term adverse effects of adjustment. Eligibility for an adjustment loan requires agreement on policy and institutional reform actions that can be monitored in practical ways, and satisfactory macroeconomic management. Funds are disbursed in several stages, based on agreed release conditions.

Table 3: World bank Group, Financial Operations 2003 (US$ billion)

	IBRD	IDA	Total
Commitments (FY03)	11.2	7.3	18.5
Oustanding Loans	116.2	106.9	223.1

Source: World Bank

4. The need for adequate cyclical financing mechanisms

While the existing mechanisms within the international financial institutions should aim at providing sufficient resources for counter-cyclical support, the evidence shows that these have been limited. As discussed earlier, for most of the emerging market economies the external current account is dominated mainly by movements in private capital, with a very limited role for official lending and with only limited availability of international reserves for most countries. For those countries that have accumulated significant reserves, in fact this constitutes an expensive self-insurance mechanism. This insurance is usually not required by developed countries, which have access to financial markets. Accordingly, there is a need for the development of more relevant financing mechanisms within the existing official financing structure.[17]

[16] IBRD; information obtained from website, www.worldbank.org

[17] In a recent Policy Document, the World Bank analyzes the way exogenous shocks affect Low Income Countries, and what mechanisms could be applied within the World Bank/IDA framework. While its scope is different than that of this proposal, there are many coincidences as to the type of mechanism that should be developed in the presence of cyclical shocks. World Bank: Exogenous Shocks in Low Income Countries. Policy Issues and the Role of the World Bank, Washington DC, March 8, 2004.

Any such mechanisms should be based on three principles: the pursuit of adequate macroeconomic policies, adjusted for the cycle; prompt access to financial resources in sufficient amounts; and use of automatic rules for access. This can be supplemented by a contingent mechanism for the containment of capital outflows, in case of exceptional and emergency situations. The pursuit of counter-cyclical policies needs to be based on a mix of financing and **adequate macroeconomic policies, adjusted for cyclical factors.** The cyclical factors have to include mechanisms to support the unemployed, an increase in some types of government spending, and only limited compensatory measures to counteract tax revenue declines. Even within their fragility, countries cannot expect that the financing is a full substitute for consistent macroeconomic policies. There should be an understanding that there will be a repayment of counter-cyclical financing in the recovery phase.

A simple counter-cyclical view suggests that countries would build self-financing reserves during the boom periods, to be set-aside in a special fund that could then be drawn at times of recession. In practice, such an approach has proven of limited practical applicability for many countries. With limited availability of financing there would be a downward bias in adjustment for these countries. Under these circumstances, the IFIs--and the IMF in particular--need to establish a mechanism that can quickly provide financing (assuming that the debt dynamics are sustainable initially) on the basis of track record, and clear triggering rules of access, with financing well in excess of the amounts currently available. Triggering should be based on indicators related to international economic activity, commodity prices, and indicators of capital movement. The facility would work much like the ill-fated Contingent Credit Line (CCL), within the IMF. That facility was heralded as an insurance mechanism that could provide financing to "well-behaved countries" that subsequently might have entered into problems because of exogenous shocks.[18] Any new mechanism would need to be based on more flexible and automatic rules than the CCL. An appropriate macro-economic management framework with assurances of sufficient access to automatically triggered financing would be the basis for effective counter-cyclical policies.[19]

[18] The IMF created the CCF in 1998 in the wake of the Asian crisis. However it was never utilized due to the hard prior conditionality involved, and the "club membership" syndrome, which precluded countries from sign onto the facility given a concern that they would be marked by doubts for signing for the type of security implicit in the facility. Furthermore, countries that could have qualified were also concerned that if they signed to be considered for the facility, there would be a significant confidence risk if they wanted to opt out of the facility, as it could have been read as an indication of policy weakness.

[19] An additional element is needed in circumstances of large and volatile capital flows, namely a **mechanism for an orderly resolution for private debt**. In those exceptional instances where countries amass unsustainable debt burdens, they must restructure their obligations. Currently, the international financial system lacks a strong legal framework for the predictable and orderly restructuring of sovereign debt, which drives the cost of default even higher. The IMF tried to create a framework for an equitable debt restructuring--including incentives that unintentionally increase the risk of default, under the Sovereign Debt Restructuring Mechanism (SDRM)--but was unable to convince its share-holders about its benefits.[19] Of course, such mechanism can only be seen as a contingent mechanism, to be accessed under limited circumstances, mainly related to longer-term issues and not those associated with the cycle. Otherwise, there would be a real danger of "moral hazard" during the cycle for countries that depend heavily on market financing.

5. A Proposal for a Counter-Cyclical Financing Mechanism

As noted, the CCFM would be based on three principles: adequate macroeconomic policies, a mechanism for quick and automatic disbursements, and sufficient financing. All these principles could be framed within existing or previously utilized institutional arrangements.

a. Policy Objective

The CCFM would provide cyclical financing to developing countries, in response to real and financial shocks. The group of countries that can have access to the facility would be those defined by the World Economic Outlook as "Other Emerging Markets and Developing Countries".[20]

b. The Financing and Management of the CCFM.

The IMF would centralize the management of the CCFM--with financing from the World Bank and the regional financial institutions--as it focuses on the broad macro-economic developments of individual countries at a regional and global level, thus making it the most relevant institution to serve that purpose. Other financial organizations with expertise on specific aspects and institutional developments may be required to determine need and access to the facility.

c. Individual Country Access to the CCFM

All individual countries included as developing countries would have access to the facility, subject to the customary conditions for access to multilateral lending, namely cooperation with the IFIs, including (a) the regular process of discussion, e. g. Article IV consultations; (b) absence of arrears with the lending organizations; and (c) broadly appropriate macroeconomic policies, as discussed below. Countries would apply for eventual consideration on the basis of these conditions.[21]

d. Macroeconomic Policy Framework

Countries would pursue appropriate macro-economic policies adjusted for the cycle. Fiscal, monetary and exchange rate policies would be assessed under the normal standards applied in IMF consultations. A country in an operative IMF program, other than for deviations that occur because of cyclical reasons, will be eligible. While a degree of judgment will always be required to determine the quality of policies, the core criterion must be sustainability, i. e. whether the country could continue with its policies without recourse to IFI resources, other than for cyclical factors. The facility itself would not deal with other objectives that may be "close to the heart" of the IFIs, like specific structural reforms. The facility would not be intended for long-term changes, which

[20] World Economic Outlook, April 2004, Statistical Appendix.

[21] The Mechanism could include incentives for early application for eventual access, on the basis of the three conditions noted. A possible instrument would be an application deadline that would allow for additional financial resources, for example a 20 percent access augmentation.

should be dealt within the more traditional facilities.[22] However, in order to apply for the facility, countries would need to set in motion a process that would help set-up a counter-cyclical fiscal and monetary mechanism, although its completion would not be a prior condition. The IFIs would provide technical assistance to that effect.

e. Eligibility for Access

- Drawings under the CCFM should be based on deviations with regard to long-term trends for the world economy. The key factors on which the drawings should be based are GDP, exports and private capital flows. These trends would be projected on the basis of the World Economic Outlook (WEO) exercises, and those of other institutions like the OECD and World Bank as supporting material. The long-term trend projections would need to be revised frequently. Deviations from trend would provide the framework for the use of the mechanism (very much along the lines of the existing Compensatory Financing Facility).Trend calculations would be needed also at a regional level, again on the basis of WEO estimates.

- Individual countries would qualify on the basis of shortfalls for the variables noted above for a specific period, normally one year. The shortfalls would be calculated as deviations with regard to a seven-year trend centered in the shortfall year, and would not distinguish between national, regional or global shortfalls. Because of the diverse set of circumstances, it would be impractical to work on highly specific projections for individual countries, as described below.

- Drawings will be made in an amount equivalent to the smaller of: (a) the sum of the deviation of exports of goods, non factor services, and remittances, and of the deviation of private capital flows; (b) one quarter of the decline in GDP for the year of the deviation; or (c) 150 percent of quota at the IMF, on annual basis, and a maximum of 250 percent over two years.[23]

- In order to avoid compensation for small deviations, and to account for the availability of foreign reserves, the deviations in (a) and (b) above will be reduced by 20 percent of net international reserves as of the beginning of the shortfall year.[24]

- The deviation for each variable will be calculated as a seven year average, centered in the year of shortfall. The **projection of GDP** for the three years in the future will be based on the relevant trends for the region, or "ad-hoc" export composition. The **projection of exports** would have the same basis, with the exception of countries with high concentrations of exports, where a separate projection could be made for individual commodities. Finally, in the case of **private capital flows,** the most

[22] One of the most difficult tasks for this facility will be the determination of the appropriate parameters for the key macroeconomic variables. In practice the presence of a program, and the absence of major imbalances in the economy, relative to the average performance of the general constituency of the IMF/World Bank should be sufficient. In some exceptional cases, where imbalances are well identified, access to the facility may need to be supplemented by an adjustment program. However , contrary to other recent IMF facilities, this association would need to be the exception to the rules of access.
[23] Access equivalent to 150 percent of IMF quota may be too small, and may need to be revised upward.
[24] In order not to penalize countries that have high levels of reserves, the adjustment can be the smallest of 20 percent of international reserves, or 2 percent of the sum of exports and private flows, as defined above.

practical assumption would be to estimate the values for the projection years as equivalent to the values for the three years of historical data.[25]

- The IMF, together with the World Bank and other organizations, will produce periodic exercises about developments and prospects for key commodities, possibly two to three times a year. On the basis of the specific patterns for these commodities, projections will be made for most developing countries, to determine possible deviations from trend. The list of countries that would register a shortfall on that basis , will be made available to these countries, directly and through the respective Executive Board. This procedure would increase both the transparency and automatic nature of the mechanism. The information will allow countries to decide about their borrowing plans, and will give the international official community a broad idea about prospective financing requirements.

- Access may extend for up to two years if the cycle is of a somewhat longer-term nature. In such case, total access would not exceed 250 percent of quota. If deviations regarding previous projections in the second year or subsequently were associated with changes in long-term trends, the more traditional types of financing (Stand By, EFF, or Adjustment Lending) would kick in.[26]

f. Conditionality

Access to the Mechanism would be automatic if the principles of adequate macroeconomic management and cooperation with international organizations are respected. It might be possible that under special circumstances approval of a loan may be subject to conditional approval, if there were serious questions about the underlying situation. However, these occurrences should be exceptional. The principle of Balance of Payments need[27] will be covered by the adjustment of the calculated shortfall by 20 percent of net international reserves.

g. Borrowing Terms

- There would be an expectation of repayment over a minimum period of five years, with a grace period of three, and exceptionally a maximum repayment schedule of ten years. It would be possible to design a repayment schedule associated with the recovery itself, but this would complicate the facility unnecessarily.

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[25] In exceptional cases adjustments could be made to projections, by eliminating easily identifiable and large one-time loans or investments.

[26] In its document on Exogenous Shocks, the World Bank suggests several measures for IDA countries that suffer from external events: (a) reduce the debt service burden, including linking debt service to commodity shocks, issuing inflation-indexed local currency bonds, and deferring repayment schemes; (b) augmenting financing in response to a shock; and (c) use of market-based mechanisms for risk management, including hedging and insurance. Hedging, insurance, and domestic currency bonds are not contemplated in this proposal, but are compatible with it. All other aspects are similar to those proposed for the CCFM.

[27] Lending by the IMF is based on the principle of balance of payment need, namely that without the financing an individual country would have serious difficulties in maintaining normal external operations, without applying restrictive policies detrimental to international trade.

- Interest rates on the amounts borrowed would be linked to the normal lending rates of the institutions providing the resources, namely, the normal rate of charge for the IMF, and the equivalent interest rates for the World Bank and the Regional Lending Organizations. A service charge of 0.25 percent would be applied at the time the loan is granted, to be counted toward interest and charges when the loan is disbursed.

- IDA countries would be charged a lower rate than countries which normally have access to market financing, on the basis of a subsidy account, as explained below. IDA countries would have an extended repayment schedule of five years of grace and a maximum of 10 years maturity.

The distribution of lending for an individual country among different organizations will be proportional to the exposure of each organization, relative to the total exposure for all organizations. In the case of the IMF, exposure will be set equal to 250 percent of quota for each country at the IMF.

The CCFM may be supplemented by additional official lending to allow for adequate rollover mechanisms regarding multilateral and bilateral loans. For example, repayment terms for official financing could be extended when a country complies with the conditions for access to the facility. This type of refinancing would be useful, if it does not detract from the automatic nature of the facility. Multilateral and bilateral lending terms could be extended on the basis of the expected length of the cyclical downturn, although interest payments may continue to be effected. In turn, the private sector could be incorporated into this mechanism. Loan contracts could provide for an automatic extension, on the basis of the shortfall calculated and announced by the IMF. In order to make this rollover more attractive; a premium of up to 100 basis points may be added to the amounts subject to and for the period of the extension. Such mechanism would eliminate some of the debt rollover risks at the periods of the downturn.

h. Sources of Financing

Financing for the mechanism would be obtained from different sources: an extraordinary increase in quotas within the IMF, special bond issues by the World Bank or the regional financial institutions, and supplemented by subsidy account for poorer countries, financed by all other members including emerging economies. As background to the latter part of the initiative, subsidies were granted successfully in the past with regard to the oil facility, PRGFs and HIPCs.

The magnitude of available funds for the Facility needs to be commensurate with the financial problem for developing countries. However, the amounts need to be realistic in terms of mobilization of resources from surplus to deficit countries. Table 4 provides a simple calculation of possible amounts made available under the facility. It shows the magnitudes for developing countries equivalent to 2 percent of GDP (twice the level of the standard deviation for the rate of economic growth), 5 percent of the value of exports (somewhat less than one time the standard deviation for export growth), and of 30 percent of private flows. The table suggests that under the assumption that China does not have an interest in the facility (in light of its high level of reserves) a total amount of some US$120-140 billion would be sufficient to cover most deviations on an annual basis. The amount is somewhat more than 40 percent of total IMF quotas, and about one third of total outstanding loans by the IMF and World Bank/IDA. From that perspective, the magnitudes seem high. However, it would be equivalent to only 1 percent of total international debt securities outstanding; .25 percent of total world debt securities outstanding; and about 5 percent of total debt outstanding of developing countries.[28] In such light the facility is not an excessive burden for the international financial system.

Table No 4: Counter-cyclical Financing Facility (GDP and Exports, 2003, Private Flows, 2002))

	GDP (US$bill)	2%of GDP	Exp (US$bill.)	5% of Exp.	Private Flows	30%of PrFl
World	36163	723.26	9228	461.4	…..	
Advanced economies	29056	581.12	6822	341.1	…..	
Developing Countries	7107	142.14	2406	120.3	135.6	41
of which excl. China	5698	113.96	1871	93.6	130.6	39

Sources: Global Financial Stability Report, and WEO, IMF, Sept. 2003/April2004

It is clear that all parties will likely not use the facility concurrently. Only countries that experience a sharp deceleration or an actual decline in growth of exports, capital flows and/or GDP will make the use of the Facility. On the basis of the statistics noted above, the probability of a decline of the GDP growth rate by 2.6 percentage points--that is, by one half relative to the average for the period 1990-2003 for all developing countries--would be 1.1 percent, and for an actual decline in exports, 9 percent[29]. Accordingly, the prospects for full use of the amounts noted would be very unlikely. It would be possible to make adjustments on account of the response of advanced economies to their own cyclical problems, to avoid double compensation for the cyclical events impacting borrowing countries. However, such adjustment would be extremely cumbersome. Thus, this paper proposes the simpler solution of adjusting access for available reserves and, possibly, having a minimum threshold to make use of the facility.

i. Three hypothetical cases

In order to illustrate how the CFM could be used; this section presents three examples of countries that could have been considered for use of the proposed financing. The countries are Colombia, for 1999, Mexico for 2002, and Uruguay for the period 2002-2003, when they experienced output declines, and a deceleration in their exports. The three countries had broadly appropriate policies at the time. In the case of Colombia, the country confronted a slowdown in investment and eventually entered into an extended Arrangement with the IMF. Mexico was directly affected in 2002 by the slowdown in the US economy, with declines in exports and a slowdown in capital inflows, except for the sale of Banamex to Citibank. Uruguay in turn, was within a program with the IMF, but

[28] IMF. World Financial Stability Report, April 2004.

[29] These estimates are made on the basis of an expected normal distribution, as a simplifying assumption.

was heavily hit by contagion from the Argentine crisis of 2002. In the latter case the IMF provided significant amounts of money, but with tough and detailed conditionality.

Table 5 provides a calculation of the available amount of financing for the three cases. The table provides some simplifying assumptions, but includes estimates of the GDP shortfall on the basis of current US dollars and a Purchasing Power Parity (PPP) calculation. The private capital account calculations exclude FDI, which could be expected to behave differently than financial flows, in terms of its impact on the balance of payments. The calculations are corrected for 20 percent of the level of reserves, and include what the availability would be, adjusted for minimum deviations in GDP and exports. In the case of Colombia, the estimates of shortfall are in the order of US$0.8 to 1.7 billion, the maximum allowed under the 150 percent of quota limit. In the case of Mexico the high level of international reserves limits access. Even when corrected for deviations in GDP or exports, the amounts are small, in large part because of the relatively small size of the deviation. Finally, in the case of Uruguay, give the size of the shortfall, and the low level of reserves, the constraint to access is imposed strictly by quota (in this specific case 250 percent over two years, a large amount according to international financial institution's standards).

i. Critical Considerations about a CCFM

The mechanism described above would represent a quantum improvement over existing procedures to deal with cyclical crises. For many countries options actually do not exist at present. It would constitute a predictable and significant source of financing, thus generating much greater certainty both with respect to external shocks and the possibility to preserve domestic sustainability, because financial markets would not be subject to uncertainties that at present can lead to runs. In light of the close link between volatility and poverty in developing countries, there would be additional advantages to the counter-cyclical mechanism. To that extent, the facility would constitute a true public good, as it would improve overall world welfare.

However, there are many obstacles to attain prompt progress. Most important is the general unwillingness of larger shareholders of international organizations to authorize increased capital contributions or higher levels of lending for cyclical problems. In addition, there would be a general reluctance to develop rules-based automatic disbursements, as the larger shareholders would fear losing control on the decision-making process. Even though incorrectly, automatic rules of access and disbursement may be seen by some of these countries as reducing discipline to implement appropriate policies.

Furthermore, there may be difficulties in developing acceptable rules regarding what can be considered cyclical, what should be the right balance between adjustment and financing, and to what extent countries should make a financial "down-payment" toward a stabilization fund, ahead of difficult times. These are all relevant and complex issues, but none of them can be considered intractable in practice, if there is a willingness to act. The proposed mechanism can be easily incorporated within the financing schemes now in place in various IFIs. Developing countries, in a positive sign of self-help, could contribute to finance the scheme. However, the political difficulties of such an initiative cannot be underestimated, particularly regarding the support of the developed countries.

Table 5 .: Potential Access under the CFM for Three Latin American Countries
(Colombia 1999; Mexico 2002; and Uruguay 2002-2003; in US$ billion

	GDP PPP	GDP, in current US1/	Exports of Goods and Services	Net Private Flows2/	Export and Capital Flows	Availability based on excess over 0.25% GDP, or 2% Exports
Colombia						
1.Average1996-98	243.2	81.5	13.6	3	16.6	
2.Shortfall Year 1999	243.3	79.3	13.8	-3.4	10.4	
3.Average2000-2002	264.5	84.9	15.1	-1.2	13.9	
4.Average for historical and projected years	253.8	83.2	14.4	0.9	15.3	
5.Shortfall (4-3)	10.5	3.9	0.6	4.5	5.1	
Adjusted shortfall 3/	2.6	1			5.1	
20 percent of Gross Reserves	1.6	1.6			1.6	
150 percent of Quota at IMF	1.68	1.68			1.68	
Smaller of .25% GDP, 2 %Exports, or 20%Reserves						0.2
Maximum Available Financing	1	0			1.68	0.8-1.68
(In percent of GDP)	*0.4*	*0*			*0.4*	*1.0-2.1*
Mexico						
1.Average1998-00	849.6	562	166.5	6.3	172.8	
2.Shortfall Year 2001	902.4	599	173.4	8.3	181.7	
3.Average2002-2004	976.2	682.4	190.9	9.4	200.3	
4.Average for historical and projected years	912.9	622.3	178.7	7.9	186.6	
5.Shortfall (4-3)	10.5	23.3	5.3	-0.4	4.9	
Adjusted shortfall 3/	2.6	5.8			4.9	
20 percent of Gross Reserves	8.9	8.9			8.9	
150 percent of Quota at IMF	5.625	5.625			5.625	
Smaller of .25% GDP, 2 %Exports, or 20%Reserves						1.5
Maximum Available Financing	0	0		0		0.9-1.1
(In percent of GDP)	*0*	*0*		*0*		*0.001*
Uruguay (two year shortfall)						
1.Average1999-01	43.2	19.8	3.47	0.51	3.98	
2.Shortfall Years 2002-03	38.8	15.8	2.71	-4.3	-1.59	
3.Average2004-06	45.1	18.5	3.45	0.51	3.96	
4.Average for historical and projected years	44.1	19.2	3.46	0.51	3.97	
5.Shortfall (4-3)	5.3	3.4	0.75	3.81	4.56	
Adjusted shortfall 3/	2.65	1.7			4.56	
20 percent of Gross Reserves	0.155	0.155			0.155	
150 percent of Quota at IMF	1.112	1.112			1.112	
Smaller of .25% GDP, 2 %Exports, or 20%Reserves						0.03
Maximum Available Financing	1.112	1.112			1.112	1.112
(In percent of GDP)	*5.6*	*5.6*			*5.6*	*5.6*

1/GDP in US dollars adjusted for changes in the real exchange rate

2/Private flows, net of direct foreign investment

3/ 25 percent of shortfall in GDP, or full amount for external transactions

Source: International Monetary Fund published data and own estimates

6. **Summary and Conclusions**

The last quarter century has witnessed major events that have revolutionized the economy of the world. At the end of this period, however, even with booming trade and capital flows, developing countries continue to face serious obstacles to economic growth and experience high volatility in their foreign exchange earnings and incomes. While domestic polices may have contributed to this outcome, the problems of developing countries are closely linked to the variability of exports and volatile capital flows. Moreover, the fragile economic position of many of these countries has restrained their ability to obtain financing, forcing them to follow pro-cyclical policies that aggravated their prospects.

This circumstance is in stark contrast with one of the main legacies of modern macroeconomic theory: the development of tools to deal with business cycles. Automatic stabilizers have been built into the structure of developed economies over the last seventy years, becoming part of these countries' policy arsenal.

The experience of developing countries is considerably different than that of advanced economies, mainly because of a much higher external volatility. In principle there are three reasons for this high volatility: a greater dependence on primary commodities, a small and volatile access to financial markets, and generally less reliable macroeconomic policies.

High external volatility and generally pro-cyclical capital flows make it virtually impossible to apply the type of policies developed countries use to counter external volatility. When developing countries are confronted with external shocks--and with little ability to obtain financing in adverse times--they are required to adjust the external accounts through declines in imports, higher exports, and possibly restrictions on other current transactions. In order to attain this adjustment, contractionary macro-policies are used, with adverse effects on domestic and world output and employment.

The International Monetary Fund, together with the World Bank and the Regional Financial Organizations, has been in charge of providing financing at times of cyclical crisis. However, the role of the IFIs has been sharply constrained by the slow growth of available resources. Consequently, the catalyst role of the IFIs has declined and the vulnerability of debtor countries has increased.

In this context, there is a need for the development of more relevant financing mechanisms, based on three principles: the pursuit of adequate macroeconomic policies, adjusted for the cycle; flexible and prompt access to financial resources in sufficient amounts; and automaticity of use.

This paper proposes a Counter-cyclical Financing Mechanism (CCFM), broadly consistent with existing institutional arrangements:

- Individual countries, defined as "Other Emerging and Developing Countries" by the WEO, would qualify for the facility, intended to offset the effect of cyclical declines in GDP, exports and private capital flows. The facility would be managed by the IMF, with support and financing from the World Bank and the Regional Financial Organizations.
- Access to the facility will be based on adequate cooperation with the IFIs, absence of arrears and broadly appropriate macro-economic policies. The macroeconomic policy framework would be deemed appropriate if a country is engaged in an IMF program,

or considered to be pursuing sustainable policies, as determined in Article IV consultations.

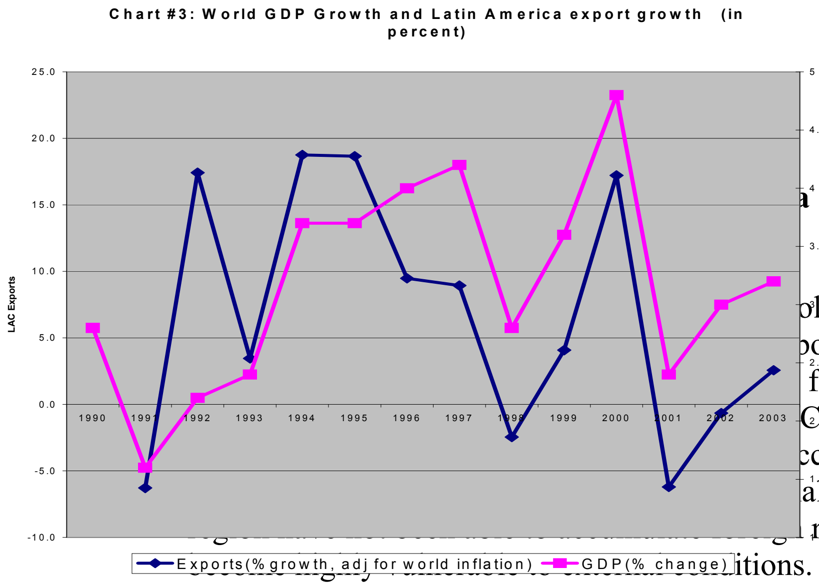
- Drawings would be based on deviations with regard to long term trends in regional and world economies. Access would be normally based on shortfalls for one year and up to two years, based on seven-year projections, centered on the shortfall period. The drawings would be the equivalent of the smaller of the sum of exports and private capital flows; one fourth of the decline in GDP; or 150 percent of IMF quota (or a total cumulative 250 percent for a maximum two-year period. The shortfall would be reduced by 20 percent of the value of net international reserves at the time of the shortfall.

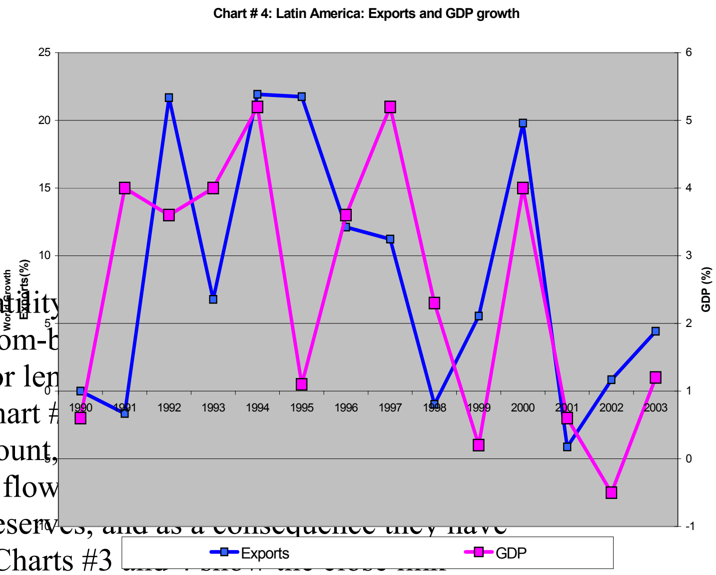
- Access would be automatic, if the principles of adequate macroeconomic policy and multilateral cooperation are maintained. Repayments would be linked to the recovery under the cycle, with a maximum repayment period of ten years. Lower interest charges would be applied to low-income, defined as IDA, countries.

- Financing for the mechanism could be obtained from an extraordinary increase in quotas within the IMF, special bond issues by the World Bank or the Regional financing Organizations, and with a special subsidy account for poorer countries.

Under the assumption that China does not have an interest in the facility, a total amount of some US$120-140 billion would cover significant deviations on an annual basis. Such amount is about one third of total outstanding loans by the IMF and World Bank/IDA, but only 1 percent of total international debt securities outstanding. All parties will likely not use the facility concurrently, with a very low probability of full use of available resources. Adjustments could be made on account of the response of advanced economies to their own cyclical problems, to avoid double compensation.

The pursuit of appropriate domestic policies, together with the financial support provided by the CCFM, would create a strong basis for sustainable growth. Under those conditions, the multilateral financial system will fulfill the objectives of their founding elders, with strong assurances for a reduction in poverty and inequity, so pervasive under current conditions among developing countries.

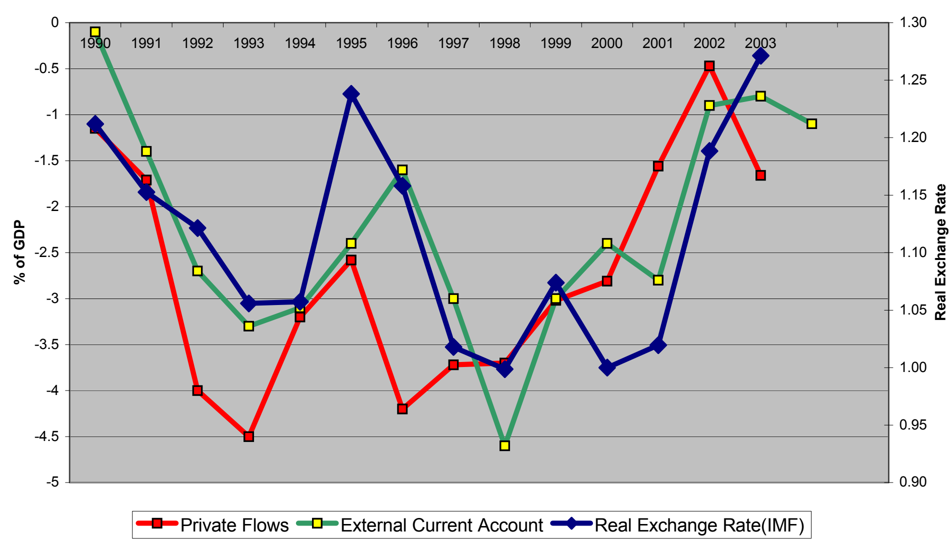




... reserves, and as a consequence they have ...itions. Charts #3 and 4 show the close link between external events on Latin American exports, and, in turn, the link between regional GDP to exports. The only possible exception is 1995, which shows the effect of the Mexican crisis on regional growth, without a commensurate change in world GDP.

In Latin America, **trade liberalization and other reforms explain,** in part, **capital account behavior**. Increased openness generated more investment, and widened the current account deficit—both phenomena that were eventually reverted. [31] Monetary policy helped sterilize capital movements and export volatility in the short-term by playing a counter-cyclical role in both times of boom and crisis. Nevertheless, with low levels of resources, the impact was limited and exchange rate and fiscal policy had to absorb medium-term adjustment.

Chart #2- Latin America: Private Flows, External Current Account and Real Exchange Rates



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[30] Loser and Carro. "Gestión Macroeconómica…"

[31] It is important to note that, even with these shocks, openness was not reverted in Latin America, measured in terms of trade as a percentage of GDP, which has grown in recent years.

The link between trade movements, the capital account and foreign reserves can be observed in Chart #5. International reserves have tended to grow in times when capital inflows were strong, playing a narrow counter-cyclical role and reflecting a monetary policy, which sought to sterilize capital movements, but with only partial success. With slower capital inflows, a reverse sterilization took effect, causing international reserve losses for a period of time, until reserves were exhausted and policies had to become pro-cyclical.

Chart # 5: LA: Trade Account, Capital Flows and Foreign Reserves

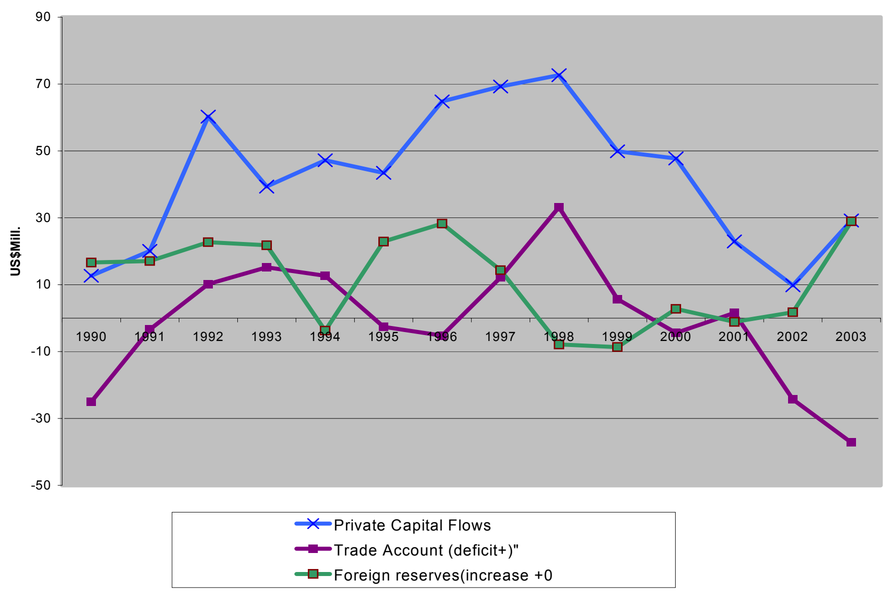
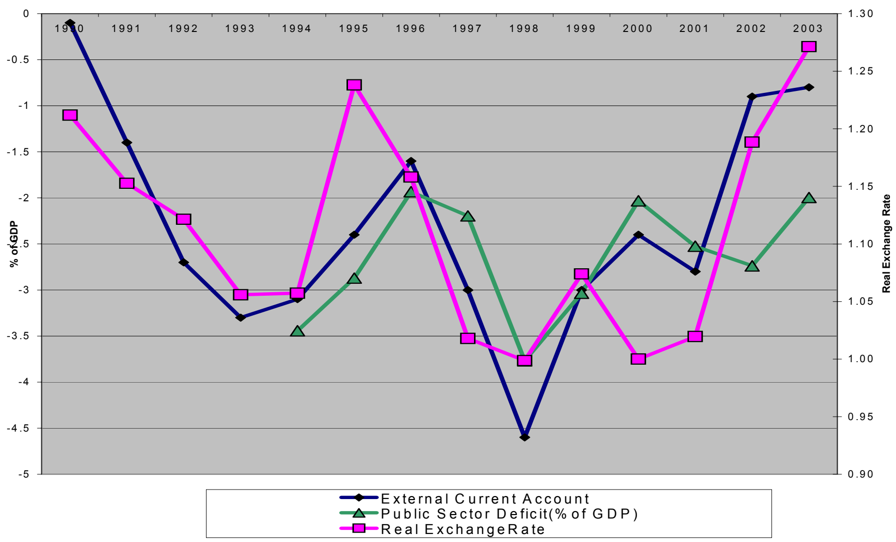


Chart #6: LA:, Curent Account, Fiscal Deficit and Real Exchange Rates



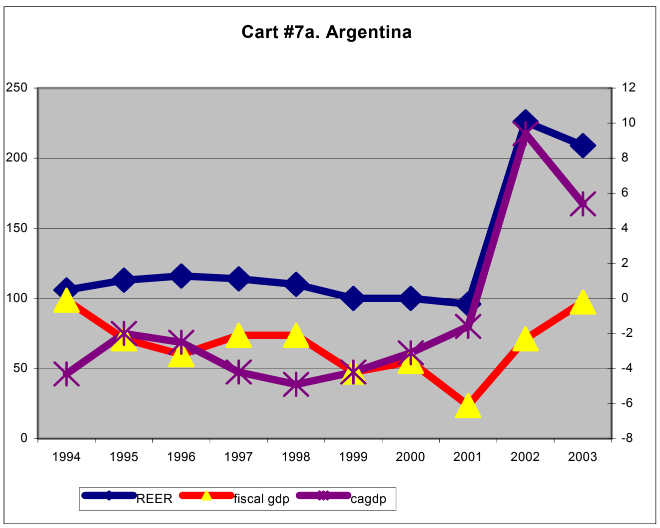
Finally, fiscal policy has been clearly pro-cyclical in the Latin America, as seen in Chart # 6. It has been expansionary in times of growth, taking advantage in part of better capital market access. The growth in public sector indebtedness—and the loss of confidence that ensued—led to the reversal of private capital flows, forcing major adjustments. These adjustments, along with the changes necessary to improve balance of payments, have also led to a strong private adjustment in times of crisis. In the absence of compensatory financing, these swings have been inevitable.

A high correlation between the current account and the fiscal deficit strongly suggests the pro-cyclical nature of fiscal policy, one of the greatest weaknesses in the region's macroeconomic management. This can be explained, in part, as a result of circumstances where a strong privatization effort and openness accompanied liberalization processes to international capital markets. Thus, the public sector could expand its expenditures, allowing somewhat of a reduction in its tax income. The slowing down of privatization and reversal of private capital flows caused a sharp adjustment in the public sector, leading to adjustments in the current account.

Of course, this stylized analysis is not applicable to all cases at all times. In some countries, the correlation was more marked—as was the case with Argentina and Mexico—but it is less so in Brazil, where the 1998-99 crisis was alleviated in great part through an effort to maintain access to capital markets. Moreover, the case of Chile demonstrates that greater credibility allowed the exercise of anti-cyclical policies, enabling the avoidance of strong fiscal and exchange rate cycles.

b. The tale of two countries

The experience of Argentina and Chile may well illustrate the differences that macroeconomic policies might show on account of the underlying conditions in the respective economies. The case of Argentina reveals a high degree of vulnerability, while that of Chile a much greater capacity to respond to a slowdown in external conditions. Charts # 7 and #8 illustrate the sensitivity of economic growth to external conditions. Specifically, Chile's rate of growth seems to be more closely associated with external trade events, while Argentina more directly affected by private capital movements (not shown in the graphs). What is remarkable is the behavior of fiscal policy in light of changes in the current account.



Cart #7a. Argentina

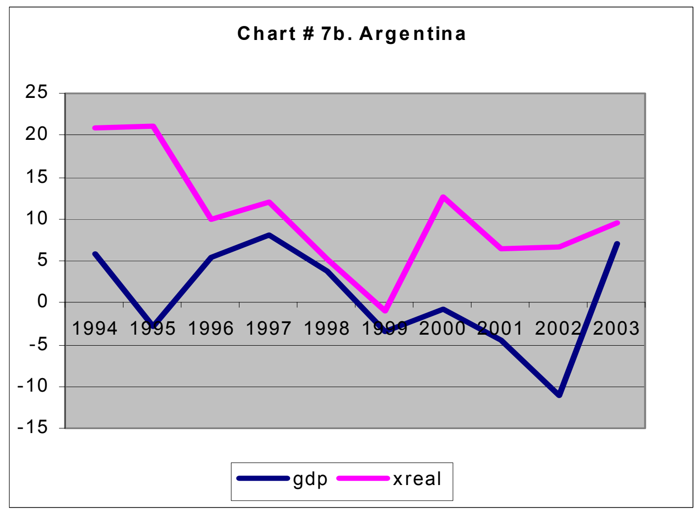
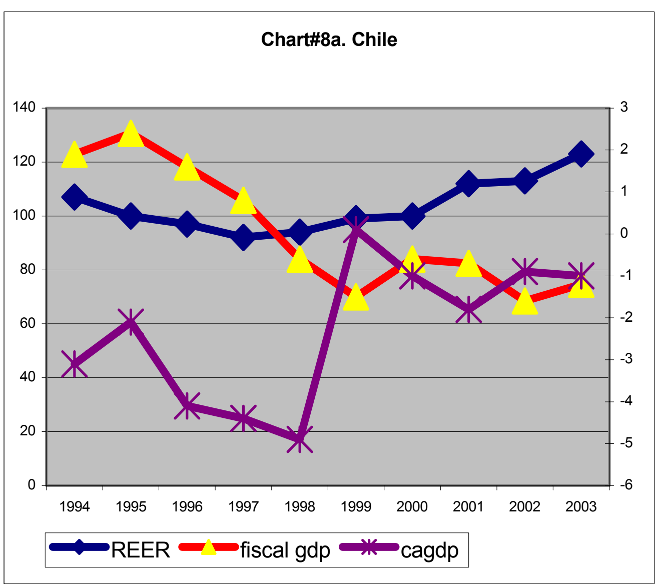


Chart # 7b. Argentina



Chart#8a. Chile

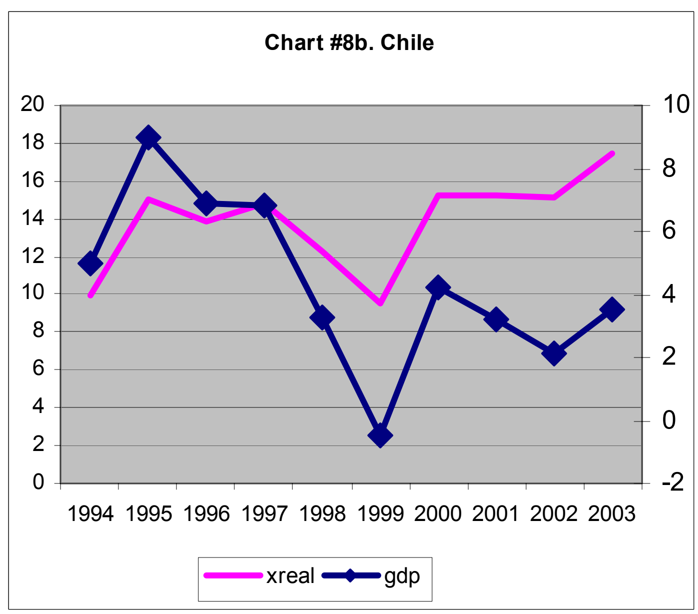


Chart #8b. Chile

In the case of Argentina, with a much more vulnerable internal and external position, the fiscal policy needed to adjust strongly, given the limited ability to obtain financing or use reserves. Accordingly, the external current account responded to a sharp downturn through exchange rate adjustments and a fiscal effort.

In Chile, on the other hand, even in the presence of external vulnerability, the fiscal policy did not have to follow suit. While the reasons for the different behavior are complex, it is possible to mention some stylized facts for the different conditions:

- A more flexible exchange rate regime in Chile, that eventually developed into a full-fledged freely floating exchange rate, while Argentina followed a strict fixed exchange rate policy under convertibility;
- A lower public sector deficit in Chile, with lower levels of public debt;
- A well-established Copper Stabilization Fund in Chile, which was intended to absorb resources at times of boom and use them in times of price falls;
- The establishment of a central structural fiscal outcome, entailing a baseline budget, adjusted for cyclical factors. In Argentina, the corresponding law was a fiscal responsibility law, with maximum deficit levels but with little consideration for cyclical factors, and without serious penalties;
- Initial mechanisms of short-term capital control in Chile, which reduced private capital flow volatility, compared to a system in Argentina based on prudential regulations for the financial system;
- Both countries had well-developed financial systems with good supervision, and prudential regulations that helped deepen financial intermediation, although Chile had gone through a deeper process of reform in the early 1980s; Even though Chile had a much more vulnerable external sector, in terms of exports (greater dependence on copper as a single export), because of the lower level of debt it had greater degrees of freedom, helped by a good use of the proceeds form the boom years. Argentina followed a pro-cyclical fiscal policy, at the federal and provincial levels, at the times of boom, on the basis of the use of privatization proceeds and access to increased domestic and foreign borrowing.[32]

Accordingly, Argentina was not able to absorb the external shocks resulting from financial contagion and weakening conditions in international financial markets. Increasingly complicated debt dynamics under the convertibility regime resulted in growing vulnerabilities in the fiscal and monetary conditions that made counter-cyclical policies impossible to pursue. Eventually, these developments led to the declaration of default on private debt, the break with convertibility, and highly pro-cyclical policies, in the context of the worst economic crisis in recent Argentine history.

By contrast, Chile--even in the presence of deteriorating external conditions because of lower commodity prices and a decline in demand from Asia-- was able to withstand the shock, making use of reserves, and permitting a wider public sector deficit, counteracting the impact of lower demand on output and employment.

While Chile had a clear advantage over Argentina in terms of its underlying policies, Argentina confronted extremely small sources of financing, given the limitations on official multilateral lending, and in addition had to deal with its external debt problems without clear rules of the game, aggravating its position.

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