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Macroeconomic Volatility and Development

Reducing volatility in developing countries calls for a three-pronged strategy, including stronger shock absorbers

By any measure, developing countries always have the most macroeconomic volatility. The connection between volatility and lack of development is undeniable, making volatility a fundamental development concern. What is behind this relationship? Is volatility a source or a reflection of underdevelopment? And what characteristics of underdevelopment put poor countries more at risk?

Macroeconomic volatility in developing countries has particularly large welfare costs. The direct welfare loss of deviating from a stable consumption path reaches up to 5–10 percent of annual consumption in some Latin American countries, compared with less than 1 percent in industrial countries. No less important, macroeconomic volatility has an adverse impact on output growth and thus on future consumption. This is worst in countries that are poor, financially and institutionally underdeveloped, or unable to conduct countercyclical fiscal policies. The average effect of a one-standard-deviation increase in macroeconomic volatility (the distance between the output gap variance of Indonesia and the United Kingdom) is a loss of 1.28 percentage points of per capita GDP growth.

The greater volatility in developing countries stems from three sources. First, developing countries receive bigger exogenous shocks. These may come from financial markets, taking the form of, for example, “sudden stops” of capital inflows. Or they may come from goods markets, especially as abrupt and large changes in the international terms of trade.

Second, developing countries seem to experience more domestic shocks. These are generated by a combination of the intrinsic instability of the development process and self-inflicted policy mistakes. Governments often instigate mac-

roeconomic volatility by conducting erratic fiscal policy and, even worse, sometimes financing it through similarly volatile inflationary monetary policy. In low-income countries especially, domestically induced shocks—related to social conflict, economic mismanagement, and political instability—account for most of the fluctuations in GDP per capita. For these countries external shocks—linked to terms of trade, foreign aid, international finance, and climatic conditions—contribute a significant but small share of macroeconomic volatility.

Third, developing countries have weaker “shock absorbers,” so external fluctuations have larger effects on their macroeconomic volatility. Economists have traditionally identified shock absorbers with two elements: financial markets to diversify macroeconomic risk and stabilization policies to counteract aggregate shocks. Both are deficient in developing countries. Financial markets are shallow, drying up in times of crisis when they would be most useful and failing to provide adequate instruments to diversify away the risk posed by external shocks. Similarly, macroeconomic policies often tend to amplify volatility in developing countries. Fiscal policy is generally procyclical, expanding in booms and contracting in recessions.

Mainstream analysis of shock absorption has traditionally focused on macroeconomic policy. More recently, microeconomic policy also has been found to play an important role. In particular, the high levels of microeconomic regulation in developing countries hamper the adjustment to shocks by restricting the ability to reallocate resources. There is evidence that tighter barriers to microeconomic reallocation—particularly related to regulation of labor markets—make countries more vulnerable to economic shocks.

The three main sources of macroeconomic volatility suggest a need for a three-pronged strategy to manage it. The first element of such a strategy is to reduce domestic policy-induced

volatility by controlling the level and variability of fiscal spending, by keeping a stable monetary and financial policy, and by avoiding price rigidity (including that of the exchange rate), which eventually leads to drastic adjustments.

The second element is to strengthen the economy’s shock absorbers. Creating room for countercyclical fiscal policies is essential. This depends on the ability of the authorities to reduce public debt to internationally acceptable levels, establish a record of saving in good times, and develop credibility against perceptions of wasteful spending and default risk. The financial sector can also play a role as a shock absorber. Governments can help by reducing financial fragilities and deepening financial markets through the elimination of implicit contingent liabilities and insurance schemes (such as fixed exchange rate regimes) and through the proper protection of creditor and shareholder rights. Finally, firms and other microeconomic agents should have the flexibility to adjust to shocks by reallocating resources across plants, areas, and sectors. Competition and trade provide the basic incentives and mechanisms for effective resource reallocation, but governments can help by reducing the burden of regulations.

The third element is to manage external shocks. Governments have traditionally had three options: self-protection (reducing the exposure to risk through, for example, low trade and financial openness), self-insurance (transferring resources across time by, for example, accumulating foreign reserves during tranquil times), and full hedging and insurance (transferring resources across “states of nature” by, for example, securing contingent credit lines or trading commodity-linked options).

An optimal strategy would typically combine all three options to different degrees. But hedging and insurance, the option that potentially entails the smallest costs in forgone investment

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and access to the advantages of integration, is currently unfeasible for developing countries. They have therefore relied excessively on self-insurance as a compromise solution between the extremes of isolation and no protection, and have started to accumulate massive foreign reserves. Although this may be a sensible temporary solution, the focus for the future should be on developing hedging instruments. There are hopeful signs that some of these instruments—linked, for example, to world financial indicators—are becoming available to developing countries.

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