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Policy responses to economic vulnerability

*Willene Johnson**

BACKGROUND

The present paper was prepared by Ms. Willene Johnson, member of the Committee for Development Committee, as a background paper for deliberations by the Committee at its eighth session. This study reviews policy efforts to advance growth and development in the least developed countries, in particular those efforts aimed at promoting well-being by reducing vulnerability to economic shocks. The paper draws on empirical research analysing the relationships between economic vulnerability, growth and policy. Given that domestic policy efforts are weakened by the shocks that characterize vulnerability, the international community has an important role to play in countries' efforts to cope with economic instability. The present paper begins with an assessment of certain international efforts to mitigate economic vulnerability and focuses on how these efforts may have reduced the likelihood of systemic shocks as well as on how they may have enhanced the resilience of individual countries with regard to shocks. The second part of the study examines how certain countries have used domestic policy instruments to mitigate and contain the economic risk factors that contribute to vulnerability and insecurity. The concluding section draws on the range of international and domestic policy responses with a view to identifying those interventions that have been successful or that show promise for promoting future development. The present paper does not explore issues related to conflict or the environment, yet it is clear that development can only be sustained when war and natural disasters are held at bay. These topics were omitted not because they are unimportant, but because they are too important and would be worthy of a more comprehensive treatment.

JEL Classification: F (International Economics); G (Financial Economics); H (Public Economics); O (Economic Development, Technological Change, and Growth).

Keywords: economic vulnerability, shocks, development.

* Ms. Willene Johnson is an Advisor, Board of Governors, Federal Reserve System and also a member of the Committee for Development Policy.

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Department of Economic and Social Affairs
UN Secretariat, 405 East 42nd Street
New York, N.Y. 10017, USA
e-mail: undesa@un.org
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Policy responses to economic vulnerability

Willene Johnson[1]

International efforts to mitigate economic vulnerability

Vulnerability has been defined as "the risk of being negatively affected by shocks". While some of the most devastating shocks are caused by natural disasters, countries can also be struck by "economic shocks that are outside of their control, such as a rapid decline in the price of their major export, changes in interest rates on international capital markets or reduced access to credit" (United Nations, 1999, para. 38).

The financial crises of the last two decades provide vivid examples of economic shocks. These financial upheavals, notably in Latin America in the early 1980s and East Asia in the 1990s, resulted in dramatic economic downturns, political upheavals and bleaker prospects for longer-term growth and development. The various financial disruptions shared certain characteristics. In each case, countries experienced large inflows of private capital that quickly turned to outflows when creditors' perceptions shifted. During the late 1970s and early 1980s, private capital flows to Latin America took the form of bank loans. While sovereign borrowers often benefited from longer-term credits from bank syndicates, most private-sector borrowing was in the form of short-term loans for trade finance and working capital. With sharp increases in United States dollar interest rates, the costs of servicing these variable-rate loans to both public and private borrowers rose sharply at a time when export earnings faltered.

In part due to these shocks, the Latin American countries faced macroeconomic imbalances, including growing current-account deficits and a large external financing gap. Initially, the international policy response was to treat each country on a case-by-case basis, with the International Monetary Fund (IMF) taking the lead and providing a lending programme to cover the immediate financing shortfall. Donor countries offered to reschedule official-source debt in the Paris Club and private-sector bankers met under the auspices of the London Club to offer debt rescheduling and

[1] The paper benefited from comments by Le Anh Tu Packard.

refinancing with new money. These London Club gatherings recognized the importance of maintaining exports from the borrowing country, and arrangements were often accompanied by commitments to keep trade-financing lines available. Most of the affected countries "muddled along" for some years, facing repeated reschedulings and a shortfall in financing that hampered growth. Programmes with the IMF were extended for years and included conditions related to structural adjustment that Latin Americans viewed as onerous, in large part because constraints on public spending often appeared to have a detrimental impact on the poor and the prescription of devaluing exchange rates and raising interest rates led to business failures and discouraged investment needed for future growth.

The Latin American debt crisis highlighted the need for stronger banking regulation and supervision. Banks in Latin America began a reform process that continues today, but banks in the United States of America and other developed countries also became the focus of efforts to improve risk management and supervisory oversight. The Bank for International Settlements (BIS), which played a coordinating role in the debt restructurings, was also the venue for meetings of the Basel Committee on Banking Supervision that comprised bank supervisors from the Group of Ten industrialized countries. In 1988, the Basel Committee agreed to a framework for measuring capital adequacy and defined a minimum capital standard for internationally active banks. Based on consultations that included supervisors from several large developing countries, the Basel Committee later made recommendations related to banking supervision issues and in 1997 published the *Core Principles for Effective Banking Supervision* (see United Nations, 2001a, p. 145). Despite these efforts to strengthen the financial system, the burden of debt and the demands of serial reschedulings weighed on the economies of Latin America.

The introduction of Brady Bonds in 1989 helped to revive the financial and economic outlook for Latin America. Brady Bonds involved securitizing the outstanding bank loans into instruments that incorporated both debt forgiveness and rolling interest guarantees. These innovations allowed the middle-income countries of Latin America to return to the financial markets and presaged the combination of burden-sharing by lenders and financial innovation that were to be important for later debt-relief efforts aimed at assisting the poorest countries.

However, financial innovations could not prevent future financial crises. Financial difficulties emerged again in the 1990s and, while the precipitating events differed, the extent of the disruptions in various countries, including Mexico, the Russian Federation and several countries in East Asia, pointed to the need for additional financial sector reforms in middle-income countries. These financial crises involving middle-income countries also created economic shocks in poorer countries, in part because recessions in the crisis countries led to a sharp fall-off in demand for least developed countries' exports, but also because the heightened risk awareness slowed capital flows to nearby countries. For example, Cambodia and the Lao People's Democratic Republic, the poorest countries in East Asia, both suffered economic downturns related to the East Asian financial crises that struck Thailand, Indonesia, and the Republic of Korea. The path of contagion was sometimes obvious—the Lao currency was closely linked to the Thai bhat and thus fell more than 70 per cent against the United States dollar between July 1997 and June 1998. The resulting rise in inflation led to dramatic declines in real incomes and purchasing power, especially among the poorest populations (Okonjo-Iweala and others, 1999, p. 49). Other means of contagion were less obvious, such as the pullback in foreign investments. Flows of foreign direct investment (FDI) into the Lao People's Democratic Republic and Cambodia declined sharply during the same period.

In view of the suffering caused by financial shocks, international organizations faced growing pressures to help developing countries design and implement financial reforms that included appropriate regulatory structures. In 1999, the World Bank and the IMF launched the Financial Sector Assessment Program aimed at providing thorough reviews of the domestic financial systems of member countries. The reviews, along with a related exercise of reviewing compliance with international standards and codes, serve to identify vulnerabilities in financial systems, analyse how countries manage the risks that they face and identify needs for technical assistance to develop institutional capacity. Work on standards and codes is being done under the auspices of the Financial Stability Forum, using codes promulgated by several standard-setting bodies.

Efforts at financial reform have also benefited from the work of a new international forum, the Group of 20 (G-20). The G-20 includes central bank governors and finance ministers of several systemically important emerging market countries in addition to representations of the major industrial countries. The G-20 has proven to be a useful forum for discussion on restructuring international financial relations. When others failed to make progress on developing a sovereign debt restructuring mechanism proposed by the IMF, the G-20 advanced action on a related issue, the introduction of collective action clauses in international bond agreements that outlined procedures in the event of payments problems.

The poorest countries are not represented in the groups described above and thus must continue to press for greater influence in the IMF and the World Bank to ensure that their needs are taken into consideration in the ongoing reform initiatives. In late 2005, the major international financial institutions (IFIs) introduced several programmes aimed at lessening the economic and financial vulnerability of the poorest countries. In December 2005, the IMF announced that it would grant 100 per cent debt relief for 19 countries under a new programme, the Multilateral Debt Relief Initiative. This new programme is being conducted jointly with two other IFIs: the International Development Association (IDA), the “soft window” of the World Bank Group; and the African Development Fund (AfDF), the counterpart to IDA in the African Development Bank Group.

The need for substantial debt relief for poor countries is an imperative that was first articulated nearly 20 years ago in the 1987 United Nations Conference on Trade and Development (UNCTAD) Trade and Development Report (see Jolly, Emmerij and Weiss, 2005, p. 56). Early efforts at official reschedulings for poor countries proved insufficient, even though Paris Club reschedulings started in 1956 and half of outstanding developing-country debt was included in reschedulings during the 1960s and 1970s (United Nations, 2005, p. 142). The international community, both at the official and non-governmental levels, long recognized that the debt burden of the poorest countries was a threat to growth and development, but the extent of debt relief was limited by restrictions in the charters of the IFIs, which precluded rescheduling of their loans. The programme of debt relief for the Heavily Indebted Poor Countries (HIPC), introduced in 1996, involved the innovation of creating a trust fund to provide the payments originally due to the IFIs.

The HIPC Initiative also introduced the concept of sustainability as a criterion for determining the amount of relief that a country should receive. The programme assumed that large debt-service payments that drew finances away from essential services were not sustainable. Countries involved in the Initiative were required to develop poverty reduction strategies and to show evidence of making efforts towards improving governance and ensuring macroeconomic stability. Although the HIPC Initiative was path-breaking, the amount of debt relief proved insufficient for true sustainability. In response to repeated pressure from civil society and advocates for the poor, the Enhanced HIPC Initiative was introduced in 1999 to provide broader and deeper debt relief. By April 2005, 27 countries had received debt relief, resulting in a reduction of debt stocks of about two thirds (United Nations, 2005, p. 145), with much of the savings from lower levels of debt servicing being directed towards social sectors and other poverty-reduction activities. Nevertheless, the amounts of debt relief involved in the enhanced Initiative left some countries still short of long-term debt sustainability, in part because commodity price shocks for coffee and other least developed countries' exports had sharply reduced export earnings and related capacity to service external debt.

The Committee for Development Policy called for greater debt relief and an increased share of official development assistance (ODA) in the form of grants, so as to limit the growth of future indebtedness (United Nations, 2004, p. 7). The Committee emphasized that debt relief, though essential, could not be the basis for future development and called for "fresh resources" in the form of higher levels of ODA, and also stressed the need for investments in infrastructure and productive sectors such as agriculture and industry (United Nations, 2004, p. 7).

During the past few years, advocates for more effective development assistance have supported efforts to increase ODA flows and have introduced measures to improve aid effectiveness and build capacity to design and implement policy. Several donors, especially those in Europe, have advocated aid in the form of budget support in order to dampen the volatility of flows and release least developed countries from the burden of time and resources devoted to reporting on donor-funded projects. Others have recommended that aid flows be designed to counter shocks directly, either by tying debt-servicing levels to exports or releasing grants to offset losses related to shocks (Guillaumont and others, 2003, p.8).

The IMF recently announced that it was establishing an Exogenous Shocks Facility designed specifically for low-income countries. The assistance would be provided as a low-interest loan (not a grant, as recommended by Guillaumont) and would be available as insurance against shocks related to changes in commodity prices, natural disasters and conflicts. The programme is designed to disburse quickly and to be repaid within one or two years. An earlier IMF programme, the Compensatory Financing Facility (CFF), had been specifically designed to compensate for commodity price fluctuations, but fell out of use, in part because it was viewed as too expensive. The CFF may also have been too slow, with Guillaumont noting that both the CFF and the European Stabex facility failed to release funds automatically, thus losing the beneficial effect of immediate, counter-cyclical compensation (Guillaumont and others, 2003, p. 5).

International efforts to mitigate economic vulnerability have included various international price-stabilization or commodity agreements. Nearly all of the agreements collapsed because of financial or organizational problems. The best-known arrangements include the International Sugar Agreement (entered into force in 1954; lapsed in 1984 with the expiration of export quotas), the

International Tin Agreement (entered into force in 1954; collapsed in 1985 when resources for buffer stock were exhausted) and the International Cocoa Agreement (entered into force in 1972; suspended in 1989 after export quotas were allowed to expire). The International Natural Rubber Agreement remained active through 1999, and several economists concluded that the relative success of the rubber agreement rests on the fact that this commodity experiences short-lived shocks. According to their analysis, shocks that take a long time to reverse are unlikely to benefit from price stabilization schemes (Cashin, Liang and McDermott, 1999; Cashin and Pattillo, 2000).

The least developed countries continue to receive an array of benefits granted by the international community. The list of benefits from multilateral organizations includes non-reciprocal preferences, exemption from the obligation to reduce trade barriers and favourable treatment for certain least developed countries' exports (for a complete list, see United Nations, 2002, annex II). Certain groups of least developed countries also receive significant benefits defined in bilateral arrangements, such as the benefits of free entry for a wide range of goods offered by the United States to 37 African countries under the African Growth and Opportunity Act (AGOA). In a recent study, the United States identified major challenges to export growth in AGOA countries. Although the focus of the study was on the significant domestic barriers within African countries, the report also noted that international barriers to trade growth include barriers to greater intraregional trade, high tariffs and other trade-distorting measures, and non-tariff barriers that include complex rules of origin (Office of the United States Trade Representative, 2005, pp. 2-3). Thus, despite the significant benefits granted by the international community, most least developed countries have not been able to diversify trade in a way that would increase their export earnings or dampen swings in export earnings.

The failure of programmes designed to dampen the impact of commodity price swings and the failure of countries to diversify export earnings may be critical obstacles to development in the least developed countries. Guillaumont points out the macroeconomic consequences of unstable international prices. When such price swings lead to instability in export earnings, they become an important factor responsible for instability in the real exchange rate, thus disrupting signals about long-term trends and leading to poor resource allocations and lower factor productivity (Guillaumont and others, 2003, p. 3). A study by Frenkel and Taylor (2005, p. 2) lends analytical support to the importance of exchange-rate management for resource allocation and economic development. From a policy perspective, Frenkel and Taylor note that management of a stable real exchange rate, combined with industrial policies, can be used to enhance overall competitiveness and boost productivity and growth. Empirical evidence supporting the use of exchange-rate targeting as a development instrument is presented by Le Anh Tu Packard (2005) in a study of Viet Nam. Packard emphasizes the effectiveness of this macroeconomic policy framework, recommending targeting the real exchange rate rather than targeting inflation because the real exchange rate exerts influence on the allocation of labour and capital and on the composition of domestic output. In Viet Nam, movements in the real exchange rate appear to have a significant impact on the composition of employment, particularly the allocation between low-productivity agriculture and higher-productivity employment in various sectors of formal employment.

The work of Frenkel, Taylor and Packard has furthered our understanding of the challenges of macroeconomic policy management for countries making the transition to market economies. More work is needed to understand the specific challenges faced by least developed countries in developing both the policy framework and instruments to assure macroeconomic stability and growth. While the IMF has demonstrated special efforts in the area of assistance to poor countries, introducing a new non-borrowing programme called the "Policy Support Instrument", the ability of the Fund to support policy management in low-income countries will depend on continued progress in understanding the special challenges of least developed countries and on developing a policy framework and instruments for implementing monetary and fiscal policies that support the process of the structural change critical for the poorest countries to begin a sustainable path to development.

National responses to economic vulnerability

National policy responses to economic shocks are critical instruments in poverty reduction. Following the guidance of Amartya Sen (1999, p. 360), we view poverty as not simply a low income, but rather as "…a serious deprivation of certain basic capabilities". From this perspective, effective policy and planning should enable a country to reduce its vulnerability to the impact that shocks have on growth and development. Within a more immediate timeframe, policy actions and instruments should be designed to mitigate the impact of current shocks. International assistance, though helpful in relieving the immediate impact of a shock, would be viewed as unhelpful if it disrupted community decision-making and collective activity that might provide long-run or future protection from economic risk (Barrett and Maxwell, 2005, p.185).

The range of national policy choice will be shaped not only by international actions such as those described in the previous section, but by the political, social and economic realities of the individual country. Most importantly, the national responses will be conditioned by the impact of economic shocks at the household level and the range of options that households have to mitigate the impact of shocks. Ongoing work on the empirical effect of shocks on poor economies was recently published in the special issue of the *Journal of African Economies* (2005) on “Risk, Poverty and Vulnerability in Africa”. Both theoretical and empirical research on responses to economic shocks at the household level provide useful frameworks for national policy responses (see Dercon, 2005; and the collection of papers on consumption smoothing by Anne Case and others in the *Journal of Economic Perspectives,* 1995).

Understanding the household response to shocks can guide interventions that target poverty reduction. In Mexico, a cash transfer programme has proven effective in encouraging poor families to maintain their children’s school enrolment in spite of economic shocks, thus promising an increase in future growth and development in poorer areas. Recent studies also underscore the importance of maintaining the broad development policy objectives related to health and education. That the death of the head of household or spouse ranked just behind drought as the second most significant cause of loss of assets, income or consumption in rural Ethiopia (Dercon, Hoddinott and Woldehanna, 2005) makes clear that improving public health systems is a critical aspect of development and a way of diminishing shocks and their long-term impact. Better access to health services obviously improves performance on the health-related Millennium Development Goals (child mortality and maternal health), but improved health and its related productivity also have a significant impact on the first and foremost of the Millennium Development Goals--reducing poverty and hunger.

National responses: the experience of least developed countries

Although the least developed countries experience shocks more often than other developing countries, such repeated experiences do not lead to a more effective response. Rather, the experience of a shock can actually weaken capacity for subsequent response and can increase economic vulnerability. Often, the inability to finance the adjustment to a shock leads to additional borrowing, thereby reducing the opportunity to invest in infrastructure or health and education systems. In reviewing the responses of Cambodia and the Lao People’s Democratic Republic to the financial crises of the late 1990s, it was evident that the policy response in each case was halting and painful.

Like many least developed countries, Cambodia and the Lao People's Democratic Republic lacked the range of fiscal and monetary policy instruments needed to ease the adjustment. Expenditure cuts were the primary means of balancing fiscal accounts, and difficulty in controlling inflation extended the erosion of real incomes, especially among the poor (Okonjo-Iweala and others, 1999, p. 50). Restoring macroeconomic balance was particularly difficult in the Lao People's Democratic Republic, where the Government removed direct instruments of monetary control before completing the design and implementation of indirect instruments. Financial-system weakness made the adjustment more difficult and the inflationary pressures further undermined the health of the banking system. Cambodia's adjustment was challenging because the country still felt the impact of the natural disasters of 1994 that destroyed 20 per cent of the rice crop. Although both economies have since recovered, progress on eliminating poverty has slowed or even reversed, with the overall brunt of the shocks being borne by the poorest populations in each country.

Designing and implementing appropriate responses to commodity price shocks have also proven difficult for poor countries. Historically, many developing countries, especially those in Africa, relied on marketing boards to dampen the impact of commodity price swings on incomes of small producers. In West Africa, Mali employs a State-owned enterprise to ease the economic dislocations associated with wide swings in earnings from cotton, a major export. The Government-controlled company is the monopoly purchaser of cotton, providing a base price along with substantial premiums in years when prices are higher. For Mali, the 25 per cent decline in world cotton prices in 1992 resulted in a large loss of export income. Cotton exports had accounted for nearly half of total export earnings prior to the price decline, and prices stayed at the lower level through 1993 before rebounding sharply in 1994. Although cotton accounted for only 6 per cent of gross domestic product (GDP) prior to the shock, about 1.5 million rural residents out of a total population of 9.2 million depended directly on cotton. The cotton-purchasing company estimates that income for cotton farmers fell only 2 per cent in 1992, as producers continued to receive the agreed floor price (but not the premium). However, incomes declined by more than 11 per cent in 1993, and the decline accelerated to 16.4 per cent in 1994 (International Monetary Fund, 2003, Annex I).

The other official response to the deterioration of the Malian current account was a 50 per cent devaluation in the national currency, the Communauté financière africaine (CFA) franc. The devaluation was actually a regional, rather than a national response, since the currency is managed by a regional central bank in coordination with national authorities from West African member countries along with the French Treasury. The devaluation came in response to a widespread deterioration of external accounts throughout the CFA franc zone and, in each case, led to local producers' receiving a higher return in local currency terms for their commodity exports. Nevertheless, the gain in real income for cotton farmers in Mali was wiped out by the sharp rise in consumer prices associated with the devaluation. The lack of local—or even regional—sources for many essential goods meant that the loss of external purchasing power from the devaluation passed through quickly to goods sold on the local market. This difficult adjustment underscores the importance of careful management of a stable real exchange rate as an important tool for assuring macroeconomic stability.

Mali and other cotton-producing countries were recently hit by another economic shock when world cotton prices plunged to record lows during 2004, with the euro price declining by nearly 40 per cent, owing primarily to a record world harvest that had been stimulated in part by production subsidies in higher-income countries. The producer price for the crop was set in April-May 2004, when world prices were still near the peak. In Mali, with ongoing public control of both ginning and marketing, the central Government is absorbing more than half of the projected losses, the total budget subsidy amounting to 1 per cent of GDP. (International Monetary Fund, 2005a, pp. 14-15; International Monetary Fund, 2005b, pp. 13-14). Although donor grants have helped ease the adjustment, there appears to be little improvement from the policy response to the previous price shock. The ability of Mali to diversify exports and other economic activity is limited at least in part by shortages of the skilled labour required for more skill-intensive sectors (Office of the United States Trade Representative, 2005, p. 21-24). The challenges faced by Mali underscore the link between the two dimensions that characterize the least developed countries—a low level of development of human assets and a high level of economic vulnerability. Nevertheless, diversification into other sectors would be easier if Mali and the other least developed country cotton exporters (Benin, Burkina Faso and Togo) were not faced with a market distorted by the generous subsidies given to cotton producers in the United States and other wealthy countries. Although the elimination of all such trade-distorting support is a stated aim of the ministers participating in the Doha Round of trade negotiations, the Sixth Ministerial Conference of the World Trade Organization in Hong Kong Special Administrative Region of China ended in December 2005 with no specific agreement as to the timing and pace of such elimination.

National responses: the experience of middle-income countries

Mauritius was once used as an example of impending economic catastrophe. In the 1960s, economists lamented that rapid population growth and a monocrop economy vulnerable to destruction by storms would combine to produce economic misery. Furthermore, ethnic tensions appeared to threaten social strife. Today, Mauritius is praised as an economic success. Economic growth has averaged nearly 6 per cent a year since the early 1970s. Unemployment—once around 20 per cent—declined rapidly to around 3 per cent by the late 1980s; firms now complain of labour shortages.

What were the keys to success in Mauritius? Some economists credit the policy response. Both trade and industrial policies were combined to reduce economic vulnerability by diversifying to a range of products in export processing zones that promoted FDI in textiles and other labour-intensive industries. Clearly, policy was important, and targeting development in areas where the country had assured market access was critical. However, other countries have tried to establish export processing zones and failed. Perhaps in the case of Mauritius, institutions were important, and widespread literacy helped to support a political process that recognized the need for reconciliation. Some economists (Subramanian and Roy, 2001) think that Mauritius was able to use diversity as a source of strength. Recognizing the potential for conflict, the early independence Government paid special attention to the rule of law, property rights and political consensus-building. And thus a country with many disadvantages, including the geographical disadvantage of a relatively remote location, was able to use strategy and institutions to respond to the new global pressures and the ever-present shocks to sugar production caused by storms and unpredictable weather.

Mauritius will face a new challenge in lower sugar prices because of the preference erosion that is likely to result from the Doha Round, but the country and its private sector are putting in place a strategy to respond to this impeding shock. Mauritian sugar producers are already moving towards specialty sugars that will continue to earn a higher price, and the economy as a whole continues to develop greater employment in service exports, including tourism and information and communications technology. By making secondary education mandatory until the age of 16, the Government of Mauritius hopes to encourage the development of human capital needed for the expanding high-skilled service activities (Office of the United States Trade Representative, 2005, pp.80-81).

Although Mexico is a middle-income country, the marginal rural areas —which are subject to various climatic shocks that reduce income—have many of the characteristics of least developed countries. In these areas, shocks translate into lower future growth and development when families choose to sell productive assets or withdraw their children from school to maintain consumption. Interruptions in school attendance often lead to permanent withdrawal from school and result in lower levels of skills and productivity. The PROGRESA programme provides a cash transfer to poor mothers who can demonstrate regular use of local health facilities and regular attendance of children in school. The transfer increases as children attain the secondary grades. A recent study indicates that the cash transfer programme has been able to serve as a safety net for poor families, with children able to maintain enrolment despite economic shocks related to drought, natural disaster or illness. Moreover, the general health of PROGRESA villages was better than that of other villages, indicating an immediate benefit as well as the longer-term advantage of higher levels of school enrolment (de Janvry and others, 2005).

Domestic resource mobilization is often seen as an essential buffer against the financial shocks that threaten developing countries. On a household level, microfinance institutions that offer savings and insurance (as well as credits) allow families to maintain consumption in the face of shocks, without their having to sell livestock or other productive assets. Providing microfinance through commercial institutions provides a model for financial services to the poor that is sustainable and less subject to swings in ODA or government finance (Robinson, 1998, p. 391). In South Africa, the Government has played a leadership role in encouraging the private sector to supply a range of services to the poor. The South African Government developed a "financial sector charter" that provides a blueprint for inclusion ("deracializing" the financial sector in terms of ownership, employment and procurement practices and setting specific targets for improvement in financial access). The charter was signed in October 2003 by the Government, representatives of financial services, such as banks and insurers, and representatives of the labour movement and other parts of civil society. Banks and insurers made a commitment to provide certain products and services to the poor by 2008. In a first step, the major banks and the Postbank created a new entry-level bank account, drawing in 1.3 million new customers in the first nine months. Participants in the South African arrangement are now encouraging other African countries to develop a strategy for creating an inclusive financial sector and to embed commitment to this strategy by all stakeholders in a formal financial access charter (Napier, 2005, pp. 8-9).

National responses: experiences in transition

Only one country, Botswana, has successfully graduated from the list of least developed countries as defined by the United Nations. Two other countries, Cape Verde and Maldives, have been recommended for graduation, but the transition period for Maldives was postponed for three years because of catastrophic losses associated with the Indian Ocean tsunami of December 2004. The experiences of Botswana and Cape Verde, though limited, are instructive. What were the national policies that allowed these two countries to overcome the structural disadvantage of their vulnerable, unstable environment?

Both Botswana and Cape Verde are countries characterized by high levels of economic vulnerability; the current assessment of Cape Verde, with an economic vulnerability index of 55.5, places it among the top ten least developed countries in terms of vulnerability. In addition to being economically vulnerable, Botswana faced independence with extraordinarily low levels of human assets. At the time of independence in 1966, there were only two secondary schools in the entire country and only one quarter of the 1,000 civil servants were Batswana. The physical disadvantages of Botswana were readily evident: it was a large country (581,700 square kilometres) with only a few kilometres of road and 4 per cent arable land, landlocked, and surrounded by hostile neighbours. Nevertheless, economic progress began almost immediately, owing to the informed leadership of its first President, Sir Seretse Khama, and also because the traditional culture of its major ethnic group was inclusive (absorbing other groups as political and social equals) and open (where debate and discussion were encouraged). Thus, Botswana has functioned as a multi-party democracy throughout its years of independence. Perhaps equally important, civil society has played an active role in policy formation, with civil society organizations "…drafting parallel programmes and implementation methodologies that complement rather than rival those of the state" (Maudeni, 2004, p. 623).

The ability of civil society and opposition parties to play constructive roles in policy formation rests on the relatively high level of education in Botswana. Starting with only a few schools in 1966, Botswana now boasts primary completion rates of more than 90 per cent for both boys and girls. But training and practice in decision-making preceded the expansion of access to formal education. At a speech at Cornell University in October 2005, the second President of Botswana, Ketumile Masire, described the participatory process that led to the decision to share mineral wealth throughout the country. This process involved all of the chiefs in the country and the decision on sharing resources was made before any such resources were identified. By the time mining companies discovered minerals, a social contract on sharing resources was in place. President Masire also described how the Government conducted regular surveys to determine the progress of each crop cycle. Local and national governments work together to create an early-warning system that facilitates a timely response to food shortages and other economic problems associated with the recurrent droughts that characterize the climate of Botswana.

Inclusiveness and openness to criticism have been essential aspects of conflict prevention in Botswana and have fostered a meritocracy and good governance across a broad range of government activities. Several economists conclude that the protection of institutions of private property has been the key to success (Acemoglu, Johnson and Robinson, 2003). There is no doubt, however, that the sound financial management in the Government and the central bank has also been a critical factor, assuring macroeconomic stability with low inflation and a stable, competitive real exchange rate against major trading partners (Commission for Africa, 2005, p. 355-56).

Cape Verde has also demonstrated that political openness and participatory democracy are valuable attributes for formulating and implementing policies to overcome economic vulnerability. This approach is evident throughout the Growth and Poverty Reduction Strategy Paper (GPRSP) that outlines the response of the Government of Cape Verde to the challenges presented by the economic vulnerability of Cape Verde. This vulnerability relates in part to its status as a small island developing economy, but is most evident in the fragile environmental situation of the archipelago. Only 10 per cent of the land in Cape Verde is arable, and planting on hillsides has been done in ways that contribute to greater soil erosion. Rain is limited and sporadic, and the process of desertification, well known in the West African Sahel, is also under way in Cape Verde. Despite the challenges of a harsh environment, Cape Verde has demonstrated high rates of economic growth since independence. Much of the growth has been based on the development of industry and services, with higher levels of productivity supported by widespread access to education. Cape Verde has already achieved 100 per cent enrolment in primary schools, and the current growth strategy calls for refocusing the educational system to provide the skills required in the sectors targeted for future development.

Poverty in Cape Verde is more common in the rural areas and intensifies during periods of drought. The national policy response to economic shocks of this type has been to provide a government works programme that functions as a safety net in the rural areas. While the primary aim of the programme is to provide food security for the rural poor, the projects include work on road construction, soil and water conservation, and reforestation programmes. Such projects aim to limit the consumption effect of the shock while building structures to make future shocks less likely.

The public works programme has been criticized in terms of the design of its projects as well as in the selection of participants. In response to these concerns, the Government has launched an effort to reform the works project, using a community-based targeting system to select recipients. The reform would also restructure the institutional framework responsible for designing, managing and monitoring the activities of the works programme. Participants in the oversight arrangement would include representatives of the central Government, local authorities and civil society representatives, such as farmers groups and non-governmental organizations. The GPRSP recognizes the need to improve the employability of the participants and to forge better links with the labour market.

The other important safety net comes in the form of remittances from Cape Verdeans working overseas. Remittances provide 11 per cent of the total income for rural areas and are an important cushion against drops in consumption when rural areas are hit by drought or other economic shocks. Cape Verde has introduced incentives to encourage deposits by non-residents into the banking system, contributing to intermediation and eventual increases in investment, especially in the construction sector. Additional flows of remittances into the formal financial system would provide multiple benefits by increasing resource mobilization and intermediation. Gaining a better understanding of the incentives that promote remittance flows would provide the Government with greater confidence in its financial management, since the Government currently views both remittances and ODA as significant sources of external financing that remain outside of government control.

Key policy responses to economic vulnerability

How can the least developed countries develop and sustain the capability to provide health and economic well-being for their populations? Can this capability extend to periods of economic shock in ways that lessen the likelihood or impact of shocks (ex ante) and diminish both the immediate impact on consumption and the longer-term impact on development and growth (ex post)?

The individual case studies underscore the importance of partnership—partnerships between individual least developed countries and international organizations as well as partnerships within a country that include Government, civil society and the private sector. The framework for partnership has been well developed in the Programme of Action for the Least Developed Countries for the

Decade 2001-2010 (United Nations, 2001b) and the subsequent progress reports on its implementation.

The Programme of Action also identified factors that contribute to economic growth and development for the least developed countries and a recent study by IMF economists lends support to the belief that these same factors correlate with periods of growth accelerations in African countries (International Monetary Fund, 2005a; Pattillo, Gupta and Carey, 2005). Countries that experienced growth accelerations came from all income levels and include least developed countries with relatively high levels of economic vulnerability. Not surprisingly, growth episodes are correlated with broad measures of good policy as calculated by the World Bank's Country Policy and Institutional Assessment. Rapidly growing countries were more open to trade, and both increases in investment and total factor productivity appear to be correlated with sustained growth. Perhaps more noteworthy is the importance of competitive real exchange rates and democratic institutions, both of which have been illustrated by the experiences of Botswana and Cape Verde. In another study by IMF staff, Rajan and Subramanian (2005) warn that ODA can be counterproductive because it contributes to overvaluation of the real exchange rate. They find that remittances show no evidence of undermining competitiveness, most likely because the flow of remittances is deterred by an overvalued exchange rate (if the home country currency is too strong, workers will send remittances in the form of goods rather than currency). The challenge, then, is to maintain a competitive real exchange rate. Botswana moved quickly to lower inflows of aid once it had sufficient earnings from exports, and Cape Verde is eager to replace ODA with earnings from service exports.

These experiences highlight the importance of developing a fair and open trade system and a strong, but flexible, financial sector. It is hoped that improvements in regulation and management of banks and capital markets can help individual countries and the world financial system avoid the financial shocks of the 1980s and 1990s. The multilateral development banks are now focusing on financial sector development and financial management in the public sector as important prerequisites for economic growth. The African Development Bank in particular has a programme to develop local capital markets in African countries (African Development Bank Group, 2005, p. 14). By strengthening the ability of poor countries to mobilize domestic resources and by assuring that flows of ODA are stable and manageable, least developed countries will increase their capability to avoid shocks and to maintain their growth potential, notwithstanding any shocks that do occur.

Nevertheless, a stable real exchange rate, predictable financial flows and the macroeconomic stability related thereto appear to comprise only one aspect of an effective policy response. The ability to craft a successful response appears to depend on education, though not simply on the set of skills associated with higher levels of production. For Mauritius, Botswana and Cape Verde, educational attainment included the development of the capacity to govern and make decisions that have an impact on future development.

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