Summary of the conference of 24 January 2017

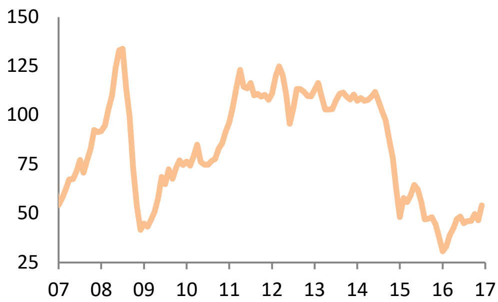
« What responses to terms of trade shocks in poor and vulnerable countries?»

Poor and vulnerable countries face significant shocks to their terms of trade, in particular because of their strong reliance on imports and exports of commodities. Depending on whether they are net importers or exporters, the volatility of international commodity prices may result either in windfall effects, for example due to falling food and energy costs, or in difficulties achieving a fiscal and external balance. Terms of trade shocks can also have a significant impact on the activity, liquidity, and even the stability of banking systems, which in turn can dampen or amplify the effects.

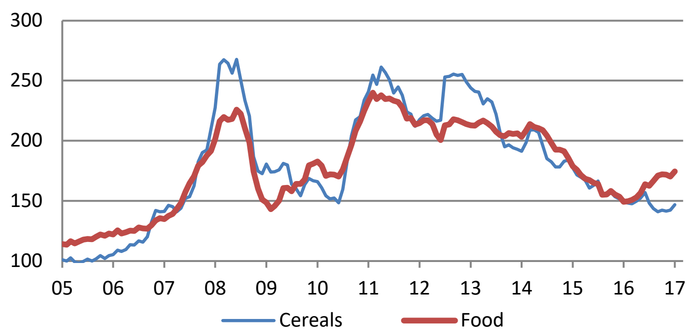
The purpose of this symposium organised by the Banque de France in the framework of its partnership with FERDI was to determine what public policies can be put in place to mitigate or prevent these shocks that particularly affect poor and vulnerable countries. The discussions at the conference made it possible to combine the contribution of recent academic knowledge on the subject and the experience of practitioners, both public and private, from four different angles: macroeconomic policies, the role of financial systems, regulation, support from the international financial community.

François Villeroy de Galhau, Governor of the Banque de France, started by stressing the pertinence of the topic, after the sharp drop in commodity prices, particularly oil prices, between mid-2014 and early 2016 (see charts below), whose effects on exporting countries had been underestimated, both by the countries concerned and by the international financial community. The magnitude of the effects of this shock which has hit a majority of African countries may also change the perception of the continent's prospects by paving the way for Afro-pessimism. Faced with these shocks, public policies have two objectives: ex post economic stabilisation and the prevention and improvement of resilience to terms of trade shocks (ex ante). Finally, the Governor noted the need for the international community, in particular the IMF, to adjust its instruments of intervention in poor and vulnerable countries to the scale of the current commodity price shocks.

Brent (USD per barrel)
Monthly data



Cereal and food price indices
Monthly data; 100 = 2002-2004 average



Source: World Bank

Patrick Guillaumont (President of FERDI) recalled that this terms of trade crisis had been preceded by other crises and that the lessons learned had not been sufficiently exploited in public policy. According to him, there are two key principles: on the one hand, managing price shocks is not only a policy of reacting to negative shocks, it is first of all a policy of managing positive shocks, on the other, international policies to deal with shocks, in particular external compensatory financing, are not a substitute for national policies, but rather a complement and must be articulated with them.

Ian Gunning (Professor Emeritus, Vrije Universiteit Amsterdam) highlighted the importance of commodity price instability for low-income countries, whose negative impact can be heightened by inappropriate economic policies, in particular those designed to provide full coverage of producer price risk. According to him, the Stabex[1] compensatory instrument was an appropriate instrument for managing these shocks and its transformation was not justified. Its effectiveness was inadvertently reduced by the introduction of conditionalities linked to structural adjustment programmes. He noted that the quality of spending during the positive shocks had been improved, but that the share of saved revenues remained insufficient. He stressed the importance of taking into account not only the shocks (ex-post), but also the changes in the behaviour of agents linked to the ex-ante exposure to shocks. He concluded that it is important and difficult to distinguish in the risk analysis what was related, on the one hand, to exposure to shocks and, on the other, to the weak shock management capacity.

1 - What role for macroeconomic policy in shock management?

Alexander Sarris (Professor, University of Athens) pointed out that after a period of decline in commodity price instability between the 1970s and the end of the 1990s, instability has picked up since the 2000s.
He highlighted the scientific finding that developing countries' growth variations can be explained largely by external Terms of Trade (TOT) shocks. The ability of a country to adjust to a change in its TOT is limited and this is because of the presence of structural constraints. Negative TOT shocks inevitably lead to negative growth impacts and declines in welfare. Policy responses to external TOT shocks are limited and not without side effects. Finally the same negative TOT shocks would produce substantially smaller impacts in an economy that has efficient markets.

Pierre Jacquet (President of the Global Development Network) stressed the crucial importance of two factors in ensuring the effectiveness of policies: their adjustment to the context of each country, the implementation procedures (the question of "how?"). He highlighted several key points regarding commodity prices for low-income countries: (i) high short-term volatility and no general long-term price trend, making price forecasts relatively unreliable; (ii) a major impact on fiscal policies; and (iii) an impact on economic dynamics that depends on the quality of management of these resources. He then pointed out that the theoretical literature on the subject is little conducive to policy guidance, since it is difficult to determine the temporary or permanent, expected or unexpected nature of shocks. Finally, he concluded by reaffirming the need to combine three issues with different temporalities: (i) managing resource depletion, (ii) strengthening the capacity to invest effectively, (iii) managing short-term volatility.

[1] System for the Stabilisation of Export Revenues.

Guillaume Chabert (Head of Multilateral Affairs and Development, Directorate General of the Treasury) stressed that the countries hardest hit by the terms of trade shock were facing a new debt situation, linked to the activity of new lenders (non-DAC members) and to the access of certain countries to international financial markets. He pointed out that while the international institutions had taken time to react to the current shock, their reaction had been more appropriate in recent months. He concluded that a preventive arm was essential to increase the resilience to future shocks, in particular by developing local currency debt, diversification, and the constitution of public savings funds.

Gilles Noblet (Deputy Director General for International and European Relations, European Central Bank) noted that, despite the magnitude of the shock and the unusual length of the decline in commodity prices, sovereign defaults have so far been limited. He recalled the diversity of situations between countries with a fixed exchange rate regime and those with a flexible exchange rate regime. The former were able to absorb part of the shock when they had large foreign exchange reserves or a guarantee of convertibility, but a significant fiscal adjustment could not be avoided. The latter mitigated the shock via a nominal depreciation, but had to manage the inflationary consequences of this depreciation. He concluded by emphasizing the importance of controlling the debt path, conducting countercyclical fiscal policies in expansion phases, but also adopting adequate legal regimes for the recovery, resolution and insolvency of banks and companies.

After recalling that CEMAC was one of the regions most affected by the terms of trade shock, **Paul Tasong** (Commissioner of the Economic, Monetary and Financial Policy Department, CEMAC Commission) stressed that this crisis was also an opportunity to launch long-term reforms strengthening the growth potential of the area. He also stressed the importance of a concerted response from the different countries, based on the Community Reform Programme, and of a regional monitoring of the programmes of each country.

Albert Zeufack (Chief Economist Africa, World Bank) noted that the sharp slowdown in African growth was largely attributable to a few large countries (Nigeria, South Africa, Angola), while many countries still showed strong growth, but that the most preoccupying development was the rapid increase in public debt. He stressed the importance of being transparent about resources derived from commodities, in order to promote their efficient use during periods of high prices, but also on the necessary extension of tax bases, in particular land taxation. He concluded by urging States to adopt a strategy of economic diversification, without counting on a lasting rise in the price of commodities.

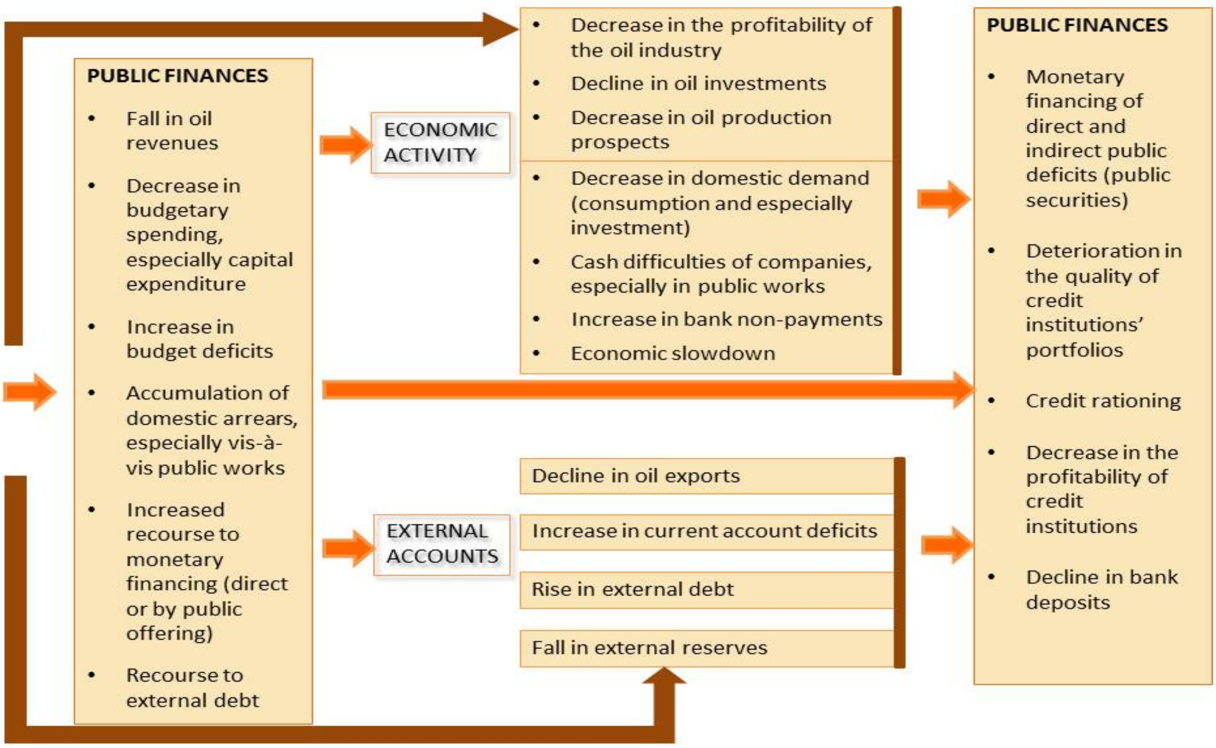
2 - What financial systems to cushion shocks?

Having noted the growing integration of low-income countries in a context of weak financial development, **Roland Kpodar** (Senior Economist, International Monetary Fund), questioned the ability of financial systems to cushion the terms of trade shocks or amplify them. The empirical study that he conducted shows that banking development has stabilising effects, thanks to the effects of leverage, smoothing, risk diversification and enhanced monetary policy effectiveness. In less developed countries, the expansion of financial markets appears to be less a source of macroeconomic instability than in more developed countries.

Pedro de Lima (Head of Division, Economic Studies, Economic Department, European Investment Bank) also noted that a recent study by the EIB shows that financial systems dominated by financial markets favour innovation and higher productivity gains, at the cost of a higher volatility of the economic cycle, while financial systems dominated by banking sectors favour macroeconomic stability.

Stephany Griffith-Jones (Financial Markets Program Director for the Initiative for Policy Dialogue at Columbia University) emphasised the pro-cyclicality of capital movements. These flows, which are high in periods of strong growth, rapidly turn around in times of economic crisis, with poor and vulnerable countries facing either a loss of market access or excessively high risk premia. Negative terms of trade shocks are also associated with significant banking costs, resulting from the growth of bad debts, contagion and systemic risks, and credit rationing. Given that poor and vulnerable countries require macro-prudential policies as much as developed countries, they should be represented on the Basel Committee and the FSB. To limit the financial risks and pro-cyclical nature of bank financing, Ms Griffith also recommends a diversification of banks and an increased role for public development banks.

After noting the importance of the shock induced in CEMAC by the fall in oil prices between mid-2014 and 2016, **Dominique Bida Kolika** (Deputy Director for Studies and Financial Stability, Banque des Etats de l'Afrique Centrale), pointed out that the main transmission channel for terms of trade shocks is the fiscal channel (see illustration below): sharp fall in revenues resulting in a sharp reduction in investment and public consumption, recourse to monetary and debt financing, accumulation of arrears. Given the weak development and segmentation of banking systems, the feedback effects between the real and financial spheres can be particularly important. While there is a decline in profitability due to an increase in bad debts, the CEMAC financial system nevertheless appears to be overall sound.



Source: Presentation by Mr Bida Kolika[2]

[2] https://www.banque-france.fr/conferences-et-medias/seminaires-colloques-et-symposiums/conferences-de-recherche-et-symposiums/conference-banque-de-france-ferdi-quelles-reponses-aux-chocs-des-termes-de-lechange-dans-les-pays

After noting that the macroeconomic impact depends on the level of development (threshold effects affecting developed countries), **Ousmane Samba Mamadou** (Director General for Financial Stability and Inclusion, Banque Centrale des Etats de l'Afrique de l'Ouest) argued that in countries like WAEMU, the effects of production volatility, in particular due to climatic variations, are as destabilising as commodity price shocks. The financial system can play a crucial role in terms of economic stabilisation through a variety of channels: insurance and coverage mechanisms, SME-SMI financing, financial inclusion, and financing of economic development along the value chain. Mr Samba also stressed the threshold at which the impact of financial development on growth is expected to become negative in low-income countries. In this regard, he questioned the relevance of the levels generally put forward in the studies on developed and emerging economies (thresholds between 90% and 135%) when we know that for African countries the credit / GDP ratio rarely exceeds 30%.

3 - What financial regulation to avoid the propagation of shocks?

Samuel Guérineau (Lecturer, Cerdi, University of Auvergne) recalled the diversity of instruments that contribute to financial stability: microprudential supervision, capital controls, macroprudential policy, crisis resolution and guarantee mechanisms, but also budgetary rules. He asked the speakers about the combination of these instruments adapted to the situation in each country.

Jérôme Héricourt (Professor, Lille University (LEM-CNRS), Scientific Adviser, CEPII) focused on the regulation of international capital movements, which depend above all on an overall financial cycle, and in particular on the differentiated yields induced by US monetary policy, to which poor and vulnerable countries are particularly sensitive as it is correlated with the commodity cycle. This dependence is all the more strong as internal capital markets, whose main issuers are the States, are underdeveloped and as only international aid and migrant remittances constitute substantial counter-cyclical financing. It is thus necessary to be prudent in opening up the capital account, in particular by limiting short-term capital flows, by adopting appropriate macro-prudential policies, by limiting foreign currency debt, and by setting up international insurance mechanisms to increase the attractiveness of these countries for investors.

Abdallah Boureima (Commissioner for Economic Policies and Internal Taxation, WAEMU Commission) stressed the need to adapt banking supervision to improve the resilience of banking systems, by taking the example of WAEMU. Migration to a prudential framework derived in particular from Basel II and Basel III by 2018 should, in developed countries, lead to a substantial increase in banks' capital, in particular a better provisioning of sovereign risk. Several mechanisms have also been put in place to increase the resilience of the WAEMU banking system to crises: the creation of the Financial Stability Board, the implementation of stress tests, the monitoring of financial soundness indicators, and since 2013, the establishment of information offices on credit. The insurance and guarantee mechanisms are also important: bank crisis resolution fund, deposit guarantee, agricultural insurance programmes.

Ingrid Ebouka-Babackas (Minister for Planning, Statistics and Regional Integration, Republic of Congo) distinguished the specifically national effects of the current crisis and the risks of regional contagion. In addition to the deterioration in the quality of bank portfolios and the liquidity of credit institutions, the current crisis highlights the need to ensure the financial stability not only of the pan-African institutions that have developed over the past decade, but also of the microfinance institutions, and even electronic money institutions. Responses to the crisis include the setting up by States of countercyclical financial cushions, and for banks a regional approach to banking supervision: consolidated supervision, cooperation agreements between supervisors.

Ivan Odonnat (Deputy Director General for Financial Stability and Operations, Banque de France) stressed the importance of the work of the FSB and its regional groups in conveying to the FSB the specific concerns of a geographical area (bottom-up approach), informing non-members of FSB decisions and thereby contributing to the implementation of standards (top-down approach). He then illustrated various macroprudential approaches for managing foreign exchange risk and real estate risks in emerging countries. Lastly, he highlighted the importance of effectively monitoring (i) the effects of financial reforms on poor and vulnerable countries, in particular the decline in correspondent banking, (ii) the development of digital finance, and finally (Iii) climate risk management.

4 - What support from international financing following the shocks?

Ingrid Ebouka-Babackas stressed the need to provide technical support for building capacity, particularly in the area of information systems. She recalled the importance for the programmes to take into account the priorities set by the countries themselves.

Viwannou Gnassounou (Assistant Secretary-General for Sustainable Economic Development and Trade, African, Caribbean and Pacific Group of States) noted that the transition from Stabex to Flex[3] had shifted the principle of the mechanism from compensation to mitigation. He stressed that countries were confronted with other risks than terms of trade shocks (natural disasters, food crisis, etc.), which it was useful to address. He pointed out the difficulties in establishing eligibility criteria and allocation points (in particular the appropriateness of using budget support).

After briefly describing the AFD's counter-cyclical lending mechanism, **Gaël Giraud** (chief economist, AFD) recalled that the objective of this loan was to address the incompleteness of the markets by integrating an insurance mechanism in the financing. He stressed the importance of assessing the effects of each new financial product (in particular trigger clauses) since the correction of a single market failure does not guarantee an improvement in the efficiency of the markets. He concluded by recalling that some of the shocks are not exogenous, but stem from inadequate economic policies with foreseeable effects.

Ugo Panizza (Professor, Graduate Institute of International and Development Studies, Geneva) presented his proposal for a GDP-indexed debt, allowing an ex-post adjustment of the concessionality. Given the very low precision of GDP forecasts over long horizons (10 to 30 years), the capacity of the borrowing countries is very uncertain. He went on to explain why this proposal had not been adopted to date. As regards borrowers, the main obstacle seems to be the gap between the immediate cost of insurance and the more distant benefits derived from this insurance resulting from a failure of the political system to emphasise long-term measures. As for lenders, especially international institutions, the difficulty lies in convincing the main shareholders of the value of this instrument.

[3] Flexibility instrument developed by the European Union. A Flex-V programme has also been developed for vulnerable countries.

Joerg Stephan (Deputy Director General, G20 Policy, Ministry of Finance, Germany) described the principles of the "Compact with Africa", an initiative led by Germany in the framework of its presidency of the G20 and which seeks to exploit the growth opportunities on the continent. This involves relying on private investment to meet the constraints of internal and external public financing. Three dimensions are highlighted: (i) the quality of the macroeconomic framework (macroeconomic stability, debt sustainability, mobilisation of tax resources); (ii) improving the business environment (in particular investor protection and failure resolution mechanisms); (iii) financing, through the use of risk mitigation instruments and the development of financial markets.

Joel Toujas-Bernate (Deputy Director, Africa Department, IMF) recalled the changes in IMF instruments to respond rapidly to the various shocks affecting developing countries (natural disasters, health crises). They take the form of a debt forgiveness. Other instruments are used to address terms of trade shocks. Precautionary agreements are also proposed, which provide for economic policy reforms without immediate funding, but with funding available very quickly in the event of a shock. These funds are hardly used by countries, as their political cost seems too high compared to available funding. The IMF has become aware of this problem and has started improving access for low-income countries.

Patrick Guillaumont concluded by recalling the importance of preventively reinforcing the resilience to shocks, in particular by integrating structural vulnerability into the criteria for allocating development aid.

In his conclusion, Bruno Cabrillac (Deputy Director General for Studies and International Relations, Banque de France) highlighted four concrete measures to prevent / mitigate the effects of terms of trade shocks:

- Promote contingent debt instruments adapted to low-income countries, producers of commodities, in the form of loans including automatic rescheduling in the event of a terms of trade shock, such as AFD countercyclical loans or debt instruments directly linked to the price of exported commodities or to GDP in value terms.

- Promoting new forms of production sharing contracts with mining companies smoothing out budgetary revenues: these contracts would be less favourable for producer countries when commodity prices increase, but they would offset the decline in revenues when prices decrease. The objective of limiting the pro-cyclical effects of the exploitation of commodities, besides being part of the social responsibility of the mining companies, also ensures the continuity of the exploitation which could be threatened by a socio-political crisis.

- In order to limit the feedback effects between the State and the banking systems that depend on it (large customer base of public servants, issuance of government securities), examining capital requirements determined by stress tests to proportionate them to the risks incurred in such economies. Financial institutions should also be encouraged to diversify their portfolios, in particular on foreign assets or through financial inclusion.

- Lastly, strengthening the international or regional safety nets, which must offer appropriate instruments, to complete the self-insurance of producer countries, but also to reinforce the incentives for self-insurance.