François Villeroy de Galhau: What responses to terms of trade shocks in poor and vulnerable countries?

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Bank of France-FERDI (Fondation pour les Etudes et Recherches sur le Développement International) conference, Paris, 24 January 2017.

* * *

Good morning and welcome to all in the auditorium of the Banque de France.

It is a great pleasure to welcome you here with Patrick Guillaumont, President of FERDI and co-organiser of this conference, to whom I extend my warmest greetings. I would also like to welcome Jan Gunning, Professor Emeritus at the Free University of Amsterdam, as well as all the speakers who honour us with their presence.

The Banque de France has established research partnerships with several foundations and universities: the Paris School of Economics, the Toulouse School of Economics and the Fondation nationale des Sciences politiques. The partnership with FERDI (Fondation pour les études et recherches sur le développement international), which we are pleased about, focuses on extending and enriching discussions and research on monetary and financial issues related to development, including:

- the financing of development, in particular the mobilisation of domestic and international savings,
- the competitiveness of African countries and exchange regimes and strategies,
- regional integration in Africa, which was the theme of our first conference in 2014,
- the "curse" of commodities in low-income countries, and the management of the Dutch syndrome and the terms of trade cycles, i.e. changes in the relative prices of exports compared to imports: this is the theme of today's conference.

The subject chosen is highly topical, following the very sharp drop in commodity prices, in particular oil prices, between mid-2014 and early 2016, the effects of which on exporting countries had been underestimated, both by the countries themselves, but also by the international financial community. Thus, the economic growth forecasts for sub-Saharan Africa made by the main international organisations were revised downwards only very late. In January 2016, the IMF still expected Sub-Saharan Africa to grow by 4% in 2016 and by 4.7% in 2017, but the forecasts in the October 2016 global economic outlook were only 1.4% for 2016 and 2.9% for 2017, almost solely as a result of the recession in the oil economies. The Ivorian economy is another illustration of the importance of the terms of trade for economies focused on commodities. After experiencing exceptional growth over the last three years, partly driven by the good performance of cocoa prices, contrary to that of other commodities, activity appears to have slowed down, in the wake of the downturn in prices.

The subject is also of major importance for central banks because the challenge here is to find how to implement appropriate counter-cyclical policies in the face of large-scale shocks that monetary policy cannot deal with either on its own or in the long run.

In this spirit, I would like to share with you this morning some thoughts on two issues: how important are the terms of trade cycles for the economic and financial situation of the exporting poor countries and their neighbours? And how to mitigate shocks?

1. How important are terms of trade shocks for poor and vulnerable countries?

To illustrate my point, I will take the example of sub-Saharan Africa. The super cycle of commodity price growth has coincided with over a decade of strong economic growth in sub-Saharan Africa. The degree of causality between these two developments is the subject of debate. Before the cyclical downturn, a large majority of observers emphasised the endogenous nature of African growth and minimised, or even denied, the role of the terms of trade appreciation.

However, the current terms of trade shock has led to a reversal of the perception of the African outlook. For oil-exporting countries, the twofold decline in prices between mid-2014 and early 2016 resulted in large budget and external deficits, calling for a rapid adjustment, due to the weakness or lack of countercyclical leeway. The savings accumulated during the upswing in oil prices proved largely insufficient and the borrowing capacity of the countries concerned remains very limited, although some benefited from debt cancellations under the Heavily Indebted Poor Countries initiative.

In poor and vulnerable countries where financial development is weak and sovereign indebtedness with the banking sector is predominant, the feedback effects between the deterioration in public accounts and rising debt, on the one hand, and liquidity, or even solvency of the banking system on the other, also foster the propagation and amplification of shocks.

The current terms of trade shock thus highlights the excessive dependence of vulnerable and poor countries on commodities.

2. How to mitigate terms of trade shocks?

On this subject, it seems essential to distinguish two types of objectives: the objectives of economic and financial stabilisation on the one hand, and the objectives of prevention and better resilience to terms of trade shocks on the other.

As regards economic and financial stabilisation, macroeconomic policies, in particular fiscal policies, play a central role in this field. Of course, in order for these to be implemented, it is necessary to have sufficient countercyclical room for manoeuvre. Consideration should also be given to how fiscal consolidation policies can preserve investment priorities for sustainable development, based on the development of infrastructure and human capital (health, education). The effects of fiscal consolidation can thus be mitigated by changes in the composition of government revenue and expenditures, more favourable to long term growth.

As regards the exchange rate, the optimal policies to be put in place in developing countries facing exogenous shocks are the subject of debate. While exchange rate flexibility cushions a terms of trade shock, it is also associated with risks of amplification, via the triggering of inflationary spirals or the foreign exchange losses that economic agents must bear. Fixed exchange rate regimes have the advantage of anchoring the expectations of economic agents and thus providing a favorable framework for investment. They will of course be all the more credible if they benefit from a convertibility guarantee, as is the case of the Franc Zone monetary unions.

Furthermore, for poor and vulnerable countries with limited access to international financing and sometimes dependent on official development assistance, the coordination of national public authorities and international development partners is an important issue.

The effective implementation of macroeconomic stabilisation policies is conditional on the financing of their balances of payments, often under the aegis of the IMF. In this regard, I would like to welcome the commitment, announced simultaneously by the CEMAC member countries on 23 December, to open and rapidly conclude bilateral negotiations with the IMF in order to better structure their adjustment efforts.

At the same time, the IMF should adjust its intervention tools and the conditionalities associated with its programmes in poor and vulnerable countries in order to fully respond to the scale of commodity price shocks. First, the IMF should provide, directly or indirectly, a volume of financing commensurate with the shock. Second, the objective of the IMF should be to find ways of making the least costly fiscal adjustment in terms of growth, while strengthening its recommendations on the prevention of this type of shock.

This brings me to focus on the second type of objectives: the objectives of prevention and better resilience to terms of trade shocks.

The first priority to improve prevention and resilience is to create sufficient countercyclical fiscal leeway, by limiting public debt, or even by accumulating budgetary reserves. In this regard, controlling the public payroll, which is the most dynamic item of expenditure in times of growth in many poor and vulnerable countries, as well as improving the efficiency of public spending, are essential.

Consideration should also be given to setting up fiscal rules on the basis of deficits excluding commodity-related receipts, adopting stricter debt ceilings for the public sector and creating an adequate savings buffer for countercyclical purposes, taking into account the scale and length of commodity price cycles. In countries exporting non-renewable commodities, in particular oil, this savings buffer must be even more substantial since it must aim to cover not only the decline in the value of receipts but also part of the decline in the value of reserves.

The second priority concerns the diversification of the economy. Industrial policies based on sectoral subsidies or tax expenditures are not viable in the event of a fall in commodity prices and make the policy of diversification pro cyclical. Public action should instead focus on improving the business climate, which is the only way to promote entrepreneurship in the formal sector and ultimately improve the country's international attractiveness. Diversification is only sustainable if one avoids the Dutch syndrome, characterised by an excessive appreciation of the real exchange rate, restricting the growth of other export sectors. The accumulation of external savings contributes to this objective. Finally, the third priority concerns the robustness of the financial sector. I will emphasise the importance of measuring, via stress tests, the potential effects of a sharp drop in commodity prices on the solvency of the banking system. These stress tests make it possible to determine the adequate level of bank capital needed to withstand shocks.

* * *

Allow me to conclude briefly by expressing once again my gratitude to all the speakers and participants who came here today to share their thoughts on these crucial issues. I wish you fruitful exchanges and now give the floor to Patrick Guillaumont. Thank you for your attention.