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Macroeconomic Vulnerability in Developing Countries: **Approaches and Issues**

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The increasing frequency and severity of financial and economic crises over the past three decades have raised important questions about the risk of economic growth being adversely impacted by crises ('macroeconomic vulnerability') and the appropriate policies needed to withstand and cope with such shocks ('resilience').

The paper (Seth and Ragab, 2012) on which this One Pager is based reviews the literature on macroeconomic vulnerability and finds that there is no single approach to understanding macroeconomic vulnerability in the context of financial and economic crises in developing countries. Broadly though, there are two distinct perspectives on macroeconomic vulnerability. The first addresses vulnerability principally in relation to financial crises. The second approaches macroeconomic vulnerability in the context of both economic and financial crises.

Several studies from the first perspective are concerned specifically with currency crises (IMF, 1998). Currency crises are seen as driven mainly by macroeconomic imbalances in the financial sector of developing economies and by fragile domestic financial systems. Consequently, these studies propose policies that restore macroeconomic balances and strengthen the domestic financial sector as ways to reduce macroeconomic vulnerability. Specific measures such as containing credit growth and the money supply, ensuring flexible exchange rates and guarding against expansionary fiscal policies are proposed. However, the empirical and theoretical assumptions underlying many of these studies have been long questioned—in particular, the assumption that markets are self-regulating and inherently efficient.

Other studies from this perspective are concerned with how the behaviour of international capital flows such as high volatility can trigger financial crises (Ocampo, 2008). Policies recommended by these studies to reduce macroeconomic vulnerability include countercyclical monetary and fiscal policies, prudential regulations, and measures to regulate the volatility of capital flows.

An important limitation of studies from this perspective is that macroeconomic vulnerability in developing economies is understood only in the context of financial crises. However, the rapid integration of developing countries in international trade, coupled with their growing dependence on exports and the increased frequency of commodity price and trade-related shocks, requires that any comprehensive framework on macroeconomic vulnerability also address economic shocks.

The second perspective considers macroeconomic vulnerability in relation to both financial and economic shocks, and most studies from this perspective focus on identifying the structural determinants and transmission channels via which an economy is exposed to such crises (Briguglio et al., 2009; Guillaumont, 2010).

However, different studies emphasise different structural determinants and transmission channels as the primary drivers of macroeconomic vulnerability in developing countries. For instance, some studies focus on size and location as important structural determinants of macroeconomic vulnerability, whereas others identify trade dependency or dependency on international private capital flows as the primary conditions that expose an economy to shocks. Other key factors that determine macroeconomic vulnerability such as rising income inequality are either totally neglected or barely mentioned. Yet, in recent times, rising income inequality has been seen as a major contributor to the greater frequency and volatility of financial crises.

In this literature, there is no disagreement on the need for policies that help economies cope with or counteract the impacts of such shocks. However, many of these studies offer a limited or narrow set of policy options to build resilience. Moreover, the focus of resilience appears to be on short-term adaptive or coping strategies. Less attention is paid to the longer-term policies needed to build systemic resilience.

A comprehensive framework for future assessments of macroeconomic vulnerability in developing countries will require:

- identifying the different types of economic and financial shocks that most frequently impact developing economies;
- mapping comprehensively the structural conditions and transmission channels that are underlying determinants of macroeconomic vulnerability, including those related to income inequality and chronic poverty;
- proposing policies for resilience that (a) build coping capacities to withstand and counteract a shock, (b) reduce exposure to shocks, and (c) reduce the frequency and severity of shocks themselves; and
- advocating for global policies and international coordination mechanisms to minimise the frequency and severity of global economic and financial crises themselves.

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