Analysis of instruments to help countries cope with unforeseen shocks; the case of the CCL

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I Introduction

This paper will examine the development of proposals for new or modified lending instruments to help countries cope with unforeseen exogenous shocks, not caused by domestic policy mistakes. Typically, such shocks are caused by variations in the value of exports or imports, linked to events in the international economy (such as financial crises, volatility in the price of commodities) or due to natural disasters. One important feature is that such external shocks have become more frequent in recent years. There seem to be two main causes: firstly, financial crises, including in the developed world, have become far more frequent; one could almost say that having major crises has become the "new normal"; it is to be feared that if financial regulation is not significantly improved in developed countries and financial sectors are not meaningfully restructured, such crises may continue to occur; secondly, continued climate change seems to cause more frequent and severe natural disasters, such as hurricanes, floods and droughts.

Furthermore, there is growing empirical evidence that external shocks cause significant slowdowns or reversals of growth and poverty reduction; for LICs in particular, there is clear evidence that negative growth in some years is a major cause of slow growth and development for long periods (see for example, Winters et al, 2010).

The focus of this study is the development of lending mechanisms that will help countries better cope with external shocks, without unnecessarily interrupting their development process. Particular focus will be placed on counter-cyclical lending contracts, in which it is agreed ex-ante that debt servicing will automatically be allowed to fall, or become zero, in periods when external shocks (measured in a particular way, eg fall in value of exports, hit a country.

This study deals with an issue raised and discussed at a joint meeting of the Commonwealth Ministerial Debt Sustainability Forum (CMDSF) and Organisation Internationale de la Francophie (OIF) in April 2009 and by Commonwealth Ministers in October 2010, as well as the Ministers of the Francophonie, meeting in April 2011 in Chad. Commonwealth Ministers recognised the need for new or modified lending instruments to help vulnerable countries cope with large unforeseen exogenous shocks and accordingly urged the international community to develop new instruments to promote the counter-cyclical management of debt service. Ministers noted that this approach would allow LICs automatic access to contingency financing when they are affected by adverse unforeseen events. It would also have the benefit of making protracted, time-consuming negotiations for ex-post debt restructuring unnecessary and better align the incentives of borrowers and lenders.

Special focus will be placed in this study to the analysis of a concrete lending instrument adopted by the Agence Francaise de Development, (AFrD), that gives the option of debt servicing holidays on their concessional loans to low income countries (LICs) when these are hit by an externally determined external shock.

However, before doing that we will briefly put (in section II), this analysis in the context of the broader shock absorbing architecture, that also includes major facilities for new lending and grants in the face of shocks, that has existed for a long time but was developed significantly in the light of the global financial crisis (for a recent discussion, see for example, Te Velde, Griffith-Jones et al 2011). Though having different features, (for example of conditionality),new lending and debt servicing holidays can have short term cash equivalent effects for LICs; therefore it is appropriate to bear in mind a comparative dimension, when analysing counter-cyclical lending.

The paper will then in section III, examine in some detail the Counter –Cyclical Loan (CCL) of the Agence Francaise de Development (AFrD), both in terms of its basic principles, its main features, existing experience, benefits and potential costs, as well as some possible improvements and broadening of the French instrument itself; the possibility of wider implementation, by other bilateral donors as well as by multilateral and regional banks, will then be examined. In section IV we will examine possible improvements to, and broadening, of, the CCL

Section V will examine the views, as well as appetite of borrowing countries for counter-cyclical loans. We will then examine in Section VI the appetite amongst bilateral donors, as well as MDBs, for counter-cyclical lending.

II The broader shock absorbing architecture

Before starting the analysis of counter-cyclical lending, which is the aim of this paper, it seems to be useful to put this in the broader context of the compensatory financing or shock absorber financial architecture, of which counter-cyclical loans form part.

Since 1963, when the IMF created the Compensatory Financing Facility, the international community has created a number of lending and grant instruments to help developing countries deal with shocks, with the aim of allowing them to maintain their growth, as well as their priority development spending. These instruments relate to liquidity provision for Balance of Payments support (typically through the IMF), concessional development financing (through the World Bank/IDA) and grants (via the European Commission). When shocks have increased (like with the large increases in oil prices in the seventies, and particularly with the global financial crisis that started in 2007), new shock absorbing mechanisms-often on a temporary basis- have been created or existing ones have been expanded. Current existing mechanisms, at the

European Commission, the IMF and IDA, as well as their main features, are summarized in Table 1; the key characteristics of current IMF facilities are outlined in Table 2. We provide some general features immediately below.

The European Commission has for many years had the Flex grant facility available to all ACP countries. Whilst Flex had the virtue of being grant money, one major problem was insufficient scale in proportion to external shocks; as a result, in the wake of the 2008 global financial crisis, when the scale of external shocks increased significantly, V-Flex was created initially on a temporary basis, on a far larger scale. Flex also suffered from long delays, which diminished its counter-cyclical effect, as it relied on ex-post data. The criteria for triggering V-Flex were also changed, so as to allow use of projected data, which implied far quicker approval and disbursement. This increased the countercyclical impact of V-Flex. Both Flex and V-Flex are, if possible, disbursed as budget support. The European Commission is now defining its new shocks facilities for ACP countries, though it is also considering broadening it to non-ACP countries.

The IMF has frequently changed its counter-cyclical financial architecture. For many years it had a Compensatory Financing Facility (CFF), which was used by middle income countries; this has now unfortunately been abolished. It has however two concessional loan shocks facilities that can be used by low income countries: a) the small low access Rapid Credit Facility (RCF), that provides fairly quickly disbursing emergency loans both in cases of external shocks and/or natural disasters and b) a Stand By Credit Facility(SCF), that provides high conditionality loans for meeting short term balance of payments need, whether these are originated in domestic policy factors or external shocks. IMF facilities are provided with the aim of Balance of Payments support.

IDA created, also as a response to the global financial crisis, the IDA Crisis Response Window; this provides concessional loans for countries, whose GDP falls by 3% or more, criterion which several observers consider as too restrictive. The aim of the CRW is to help maintain core development spending

Table 1

Overall Comparison of EU and IFI emergency financing facilities (Excluding food and social response programs)

Facility*	EU Flex and V-Flex	IMF (ECF, SCF & RCF)	IDA Crisis Response Window
Country Eligibility	ACP subject to trigger criteria; "fragile states" on case-by-case basis for V-Flex	IMF eligible countries with concessional funds for LICs	IDA eligible countries
Trigger	Drop in export earnings for FLEX, past data basis: broadened to deterioration in government revenues, foreign reserves & fiscal deficit, forecast data	No fixed quantitative trigger: Case by case assessment of short & long term Bop problems and emergency needs	3% GDP decline to be *considered only*; Then case by case assessment with board approval
Level & length of support	Trigger determined level of support; Maximum of 4 consecutive years	Scale as a factor of IMF quota; Maximum 10 year term	5% of IDA16 replenishment resources; Variable length of term
Degree of concessionality	Grant	Concessional interest rates (Including 0%)	Various levels
Delivery	Budget support; or, if not feasible due to capacity, via existing social mitigation programs	Balance of payments; natural disasters support	Focus on core development spending; implemented largely through existing programs

Source: Authors.

(Source: TeVelde, Griffith-Jones, op cit.)

All these facilities, whilst clearly helpful, have a number of limitations, including especially insufficient scale and excessive conditionality, as discussed for example in Griffith-Jones and Tyson, 2010.In particular it seems very

inappropriate that significant IMF lending for external shocks to low income countries requires upper credit tranche conditionality, given that the deterioration in the country's Balance of Payments is not caused by policy mistakes.

After the global financial crisis started, and especially when it started hitting developing countries, existing facilities were expanded and new ones created.

Table 2

Summary of Key Features of the IMFs new LIC financing facilities. (Source: IMF)

Facility	**ECF** **Extended Credit Facility**	**SCF** **Standby Credit Facility**	**RCF** **Rapid Credit Facility**
Function	Long term balance of payments problems	Short term balance of payments needs	Low-access, emergency funding
Replaces	PRGF (Poverty Reduction & Growth Facility)	Exogenous Shock facility (High Access Component)	Exogenous Shock facility (Low Access Component), Emergency Post-Conflict Assistance & Emergency Natural Disaster Assistance
Term	3 years	1-2 years	Outright disbursement
Repayment	5-10 years	4-8 years	5.5-10 years
Extendable	Yes	No	No
Repeatable	Yes	Limited to 2.5 out of any 5 years	Yes
Precautionary	No	Yes (Subject to maximum of 50% of quota)	No
Interest Rates*	0.25%	0.25% plus commitment fee	0.25%
Upper Credit Tranche	Yes	Yes	No
PRSP required	Yes	No	No
Limit on scale	Annual limit of 100% of quota; Limit of 300% cumulative basis; Limits decline with outstanding	Annual limit of 100% of quota; Limit of 300% cumulative basis; Limits decline with outstanding	Sub-limits of annually 25 & cumulative 75% of quota
Trigger	On a case-by-case basis examining balance of payments and macro-economic policy		

Plus concessional zero-interest rate for all facilities to the end of 2011 as part of the IMFs crisis response.

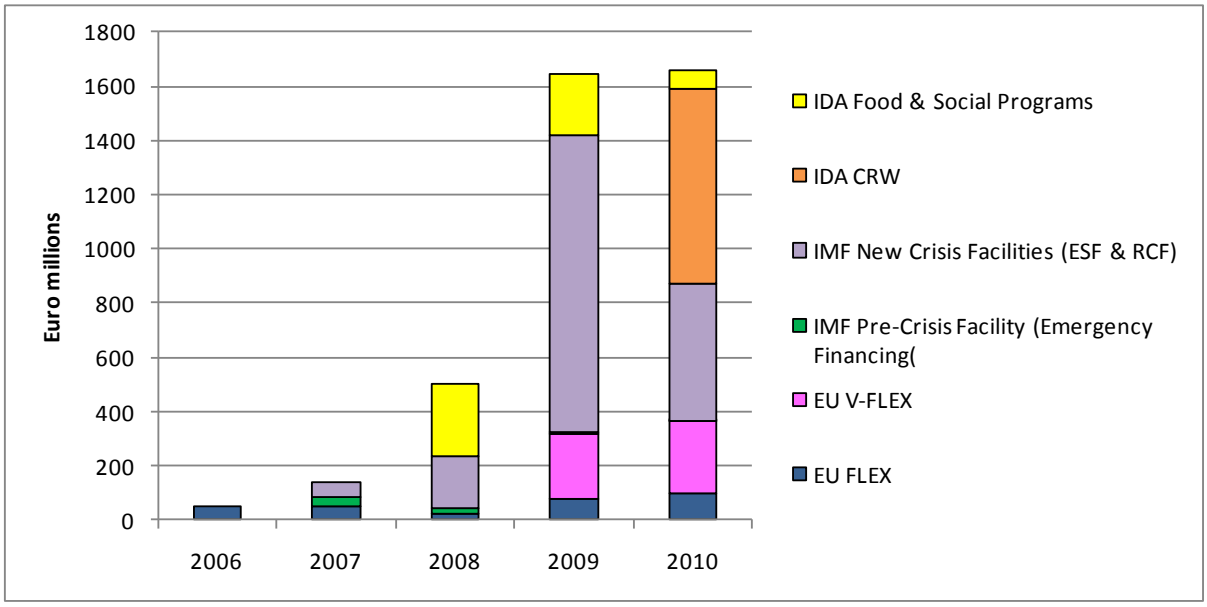
(Source: TeVelde, Griffith-Jones, op cit.)

Table 3 shows the significant increase in shock absorber financing between 2006 and 2010, which was very valuable for sustaining growth and development spending in the face of the global financial crisis; also, the

coordination between institutions seemed to increase significantly, which was also welcome. However, even at these increased levels, shock facilities financed only about a third of the total export shocks hitting developing countries, which was insufficient (TeVelde and Griffith-Jones, op cit); furthermore several of the facilities used were temporary, as were resources provided to them.

In the light of the continued sovereign debt crisis in Europe, and the slowdown of the world economy, it would be particularly important and timely to expand the battery of instruments that help developing countries, when they are hit by shocks, as well as increase their scale. Counter-cyclical lending of the type discussed in this paper, if far more widely applied, could be an important instrument, that complements existing shock absorber mechanisms

Table 3: Shock financing in million Euros (2006-2010)



III French Counter-Cyclical loans (CCL)

Background for the CCL

As pointed out, in the light of the high level of inherent structural vulnerability to external shocks of many LICs, the international community has started to explore new modalities of debt contracts, which would make debt servicing counter-cyclical. In particular the Commonwealth Secretariat has received a mandate to explore desirability of broad implementation of such an instrument, supported by Commonwealth Finance Ministers as well as by the Francophonie. The International Monetary Fund and the World Bank have also been studying counter-cyclical instruments, in the context of a broader analysis of instruments to deal with shocks.

The idea of counter-cyclical lending is to have concessional loans to LICs,that include an ex-ante mechanism, which would allow automatic suspension of debt servicing, for years when the LIC is hit by an external shock, such as decline of value of exports, or increase of price of imports. Such an instrument would build flexibility ex-ante, thus reducing the likelihood of a debt crisis; this would help avoid need for costly ex-post debt restructuring; it would also reduce need for negotiations for new liquidity facilities in the face of external shocks. For the debtor country it would thus have the important advantages of automaticity (implying no additional conditionality, which can be problematic for example with IMF loans) and predictability, (as the conditions under which debt servicing can be suspended are established ex- ante). There are some limitations of these instruments, which we discuss below. Furthermore, as also discussed below, there is short experience with this instrument, so its effectiveness cannot yet be evaluated. However, its advantages seem clear.

Indeed, as stated by Pierre Jacquet, Chief Economist at the AFrD, (interview material),the purpose of counter-cyclical lending , via the CCL , is to allow post HPIC borrowing in a more responsible way, by both lenders and borrowers. For lenders, it implies creating an instrument which helps protect borrowers against external shocks. A key aim is to build flexibility of debt servicing ex-ante, before shocks hit; this would help prevent possible build-up of debt that could later lead to a debt crisis, in the aftermath of a shock, which deteriorates a country's capacity to pay.

The concept of counter-cyclical lending, often called GDP linked bonds, has been supported by many well-known economists, such as Joseph Stiglitz, Jose Antonio Ocampo, Robert Shiller, John Williamson, Andres Velasco and others; there are precedents, for example in the loan from the United States that Keynes negotiated for the United Kingdom, which included a so called bisque clause, implying a de facto debt servicing holiday, when certain conditions were met(see for example, UN Stiglitz Commission, for a discussion of this bisque clause).

Main features of the Counter-Cyclical Loan

More importantly in the LIC context, the idea has begun to be applied in an innovative way since 2007 by the Agence Francaise de Development, (AFrD) via its Counter-Cyclical loan, the CCL. The CCL replaces 30 years concessional loans at 1% interest, with a fixed grace period (of 10 years) for similar concessional loans, but with a shorter fixed grace period (5 years) and a floating grace period, (also of 5 years) ; the latter debt holiday on capital repayments can be used automatically if the debtor country choses to do so, allowing suspension of debt servicing , by the debtor country if its merchandise exports fall by 5% or more in relation to the moving average of the previous

five years; this shock was estimated to be equivalent to 1.5% of GDP , for a sample of HPIC countries.

The choice of merchandise exports as a trigger variable, (rather than total exports) is linked to the fact that this indicator is available at most with four months lag in the Global Trade Atlas, which implies that the debt service suspension holiday can be triggered quickly (Cohen et al., 2008); speed is essential as it ensures genuine counter-cyclicality.(see again, Te Velde and Griffith-Jones, op cit). Furthermore, the fact that mirror statistics (not based on the data of the country itself, but of its trading partners) are used ensures data objectivity.

These counter-cyclical loans provide unconditional, automatic(if requested by country and thus optional) debt service holiday , equivalent in cash terms to conditional new compensatory financing, for THOSE countries that have borrowed previously. Lack of conditionality for debt holiday is seen as an attractive feature for developing countries, but the facility is only relevant for countries that have borrowed fairly significantly in the past.

There is short experience with this instrument, as first loans were made in 2007, when the scheme was created by the AFrD; therefore the effectiveness of these loans cannot yet be evaluated, as countries are still in the five year standard grace period. Therefore, till 2012, it is not yet possible to know if countries will use extra debt service holidays, and how much it will contribute to alleviate their foreign exchange situation, in the light of external shocks. However, according to research commissioned by AFrD (reported in Cohen et al., op cit), if a sample of 24 HPIC countries had hypothetically borrowed a CCL in 1975, they would have been able to suspend on average debt service at least five times in the 1975-2004 period.

The total of CCL lending done by AFrD is equal to approximately 200 million Euros; this is a fairly small percentage of AFrD total loans, of around Euros 6.7 billion. CCL loans have been made by the AFrD to Mali, Tanzania, Mozambique, Senegal (four) and Burkina Faso. The total of CCL loans made is eight. The fact that not more CCL loans have been made is, according to the AFrD, due to lack of demand for such loans by countries. Examples of the type of projects for which CCL loans have been used include: smoothing price fund for cotton in Burkina Faso, investment in drinkable water in Mali, build highway in Senegal, recapitalize Senelec, (Senegal utility), fight pollution in Dakar.

Indeed, the AFrD report that there is not too much demand for this type of loans from potential borrowing countries; one reason AFrD give is that maybe their loans are not a significant share in total bilateral and MDB/RDB lending. They pose the hypothesis, which seems very likely to be correct, that if all official concessional lenders created a CCL, borrowing through this instrument could become an important proportion of LIC countries' debt, and debt holidays could become a valuable and desirable source of foreign exchange and fiscal expenditure savings in the light of shocks. LIC countries agree with this point. However, as discussed below, several LIC countries also say they have not evaluated the possibility of using even the AFrD CCL (which they find in principle very attractive) because they did not know about it. AFrD seemed unaware of this lack of knowledge in LICs, as reportedly they have made efforts to disseminate information about it. This would increase the value of a Commonwealth Secretariat workshop organized for the purpose of discussing how to expand CCL type lending to other actors, as well as helping disseminate knowledge of what exists.(see discussion below)

If countries do not use debt capital repayment holiday, within the first 10 years, they get equivalent cash. Thus, the net present value of loan servicing is not

affected by whether countries use the holiday or not. Furthermore, there is financial neutrality from the creditors and debtors viewpoint, between normal AFrD loans and CCL loans. This avoids penalizing countries not experiencing export shocks, or experiencing one and not taking debt holidays, as well as avoiding possible moral hazard, that would imply countries deliberately export less (though the latter seems unlikely)

A more ambitious scheme, that is being studied in a preliminary way by the AFrD (see also below) is to link the degree of concessionality of loans to variations of the terms of trade, so loans could become more concessional when LIC economies are hit by severe or repeated shocks.

Under the CCL, a country can have debt holidays (cease servicing of capital amortization repayments in a particular year) if merchandise exports are projected to be equal or less than 95% of previous average. In the current modality of operation, there is no provision for debt holidays if there is an increase in imports value, linked to higher prices of these imports, which is an important issue, both for fuel and food. However, AFrD seems open to widen its coverage to also include in CCL external shocks that affect the cost of imports. We will return to this issue below.

One of the reasons AFrD perceives there is not more appetite is the mentioned supply problem, for example no IDA or African Development Bank loans with CCL like features exist till now. One possible explanation for this is that variable maturity could be problematic for liquidity management for other institutions, for example if loans are funded in the markets(see also discussion for IMF and IDA below); this is not so much the case with AFrD, as they have special resources for this purpose, funded by the French Treasury(interview material). However, this could become a problem even for AFrD if a substantial part of their portfolio would not pay due to debt holidays, in case

there CCL loans were significantly scaled up and there was a major external shock.

Potential bilateral donors who could do counter-cyclical loans, are those who make significant concessional loans: these include the Japanese, the Germans,(KfW), and the Spanish. IDA, African Development Bank, Asian Development Bank, Inter-American development Bank, as well as the European Investment Bank could also do such lending.

IV Possible improvements to, and broadening of, CCL

The AFrD loan is currently specified in terms of a shock on the borrowing country's export receipts. It seems more desirable to frame such an instrument in broader terms to deal with a number of situations that can translate into financing problems for the borrowers. For example, the trigger for such a flexible loan could be re-specified in terms of variation of trade balance in goods and services, so that both a shortage of export receipts and/or an increase in the import bills would be covered. Including variation in the capacity to import seems a good innovation, as it is far more precise analytically, as countries are affected by both exogenous shocks that affect imports, as well as exports; furthermore, extreme variability in the price of both food and fuel prices, that are key imports for many LICs, has increased in recent years and can be very damaging to LICs growth prospects.

It is encouraging that AFrD is very open to the idea of expanding coverage of its CCL loans to include shocks that cover variations in imports, as this is also an idea supported by debtor countries interviewed (see below). It is also encouraging that these ideas have been presented to the G20, and have reportedly received a positive reaction (interview material). It is important to find an appropriate trigger that can reflect changes on the whole balance of trade in a timely manner, so as to allow speedy debt suspension to be used by LIC

countries for a modified CCL, in the same way as CCL can be quickly activated at present. It may be desirable theoretically to include other relevant variables, such as fluctuations of workers remittances, but in practice may not be achievable if this would delay obtainment of data for calculating trigger in a speedy way and therefore allow quick suspension of debt. There may be a case for institutions like the Commonwealth Secretariat or others to provide technical support for better and timely monitoring and reporting of remittance flows

One possible further improvement that could be considered is to maintain the initial number of years for the fixed grace period (10 years), and to add for the CCL, an additional period of a flexible grace period of five years. This innovation would make the loan more attractive to debtors, (see interviews below) and could be clearly justified in economic terms, as a longer guaranteed grace period may be more appropriate, in particular to fund infrastructure projects, whose revenues often start accruing only after a long time, given long periods of construction and slow build – up of revenue (eg in motorways). This would slightly change the current practice of financial neutrality applied by the AFrD between CCL and their equivalent more traditional loans, but this could actually provide a welcome additional incentive for countries to use the CCL, as it would tailor the loan better to their needs, even if it would have some cost implications for the AFrD.

In this broader context, it is interesting that AFrD is rather ambitious conceptually, and is in a preliminary way exploring interesting ideas to vary the level of concessionality to external shocks, and have reportedly even presented such ideas to the G20. This would suggest to donors to consider bearing part of the risks involved in some exogenous events (if this is conceived symmetrically, it may not imply net additional budgetary transfers, as donors could put in more resources if the state of nature is unfavorable, but would receive more repayments when it is favorable). This would imply going

beyond the liquidity management mechanism of the deferred repayment options of the CCL to adjusting also the level of concessionality to the exogenous situation facing the borrower, and to do this in a symmetric way. (see also below for IMF/WB discussion of this issue).The suggested innovation, implies to further explore the design and use of flexible loans, that incorporate variable concessionality (for example, in case of exporters, low concessionality when prices are high, and high concessionality when prices are low, if the magnitude of the shocks is large and/or persistent). Such steps would represent a significant departure from traditional approaches to ODA and would also require new ways to account for ODA.

A previous issue in this context is whether it is desirable for donors to move along the spectrum from providing more grants towards providing concessional loans, as for example the French authorities have done, but also the Japanese, German, Spanish and others have; IDA and RDBs have of course always provided concessional loans to LICs. Clearly this approach has the advantage of greater leverage of grants, which may be especially valuable when aid levels from Western donors may not grow during the crisis, whilst needs of developing countries may expand, as a result of the same crisis; therefore blending loans and grants has the advantage of "doing more with less". However, the risk is that there could be a build-up of excessive future debt servicing needs, that could lead to new future debt crises. These risks can be reduced by two mechanisms. One is that the replacement of grants by concessional loans should be done, or done more, for relatively richer and less vulnerable developing countries, and less , or not at all, for poorer more vulnerable economies. Indicators of vulnerability, (such as the very good one developed by the Commonwealth Secretariat) rightly need to include not just existing debt burdens, which is important, but also variables such as economy size and diversification of exports. Secondly, the risk of debt crises should be

moderated by counter-cyclical lending mechanisms, such as the AFrD CCL but spread to a variety of donors as well as MDBs and RDBs; in that context, introducing variable and symmetrical changes in concessionality to loans could be a welcome addition, though it seems important this is done in ways that are relatively simple, both for donors and particularly for recipients/borrowers.

Going back to counter-cyclical lending as a mechanism that defers debt payment in the face of exogenous shocks, the main limitation seems to be (as expressed by LIC debtors, please see below) that the scale of debt contracts , which have this modality, as proportion of the total debt of these countries is currently so small. Indeed, for the country now having the largest volume of AFrD CCL debt, the share of CCL debt servicing in the total of debt servicing is estimated to be less than 3%(interview material), which implies that the benefit of this mechanism, though valuable is somewhat marginal.

It would of course be welcome if a greater share of AFrD concessional loans were in the form of CCLs; however, by far the main challenge is for other bilateral donors, that make concessional loans to LICs to adopt the counter-cyclical lending modality; particularly important would be also for institutions like IDA, African Development Bank, Asian Development Bank and the European Investment Bank- in its external lending to LICs- to also adopt counter-cyclical loans.

Provided a substantial portion of the external debt of LICs incorporates such a provision, the borrowing country would have **an automatic, unconditional and optional** access to financial resources in case of being hit by external shocks. This would be a valuable instrument for helping LICs sustain development, in the current very volatile international economy, whilst not requiring any additional grant resources.

It should be mentioned however, that though counter-cyclical lending is very valuable, it is not a panacea for dealing with shocks. Because so many LICs have benefited from HPIC, as well as making efforts-encouraged by the IMF-to avoid excessive new borrowing, levels of debt servicing are currently not so high; as a result, if major shocks hit, debt service holidays may not be enough, on their own, to provide necessary additional liquidity to deal with the shock, without unnecessary compression of imports. This is truer for LIC countries with lower levels of concessional debt. As a result, other counter-cyclical lending mechanisms, like those currently provided by the IMF, World Bank and European Commission, (see again Tables 1 and 2 above, and description there) would continue to play an important role; a significantly expanded and improved CCL would be a valuable and significant complement, but not a substitute, for those other shock absorber mechanisms.

Furthermore, LIC countries themselves need to increase their efforts to increase resilience to external shocks by for example trying to have bigger macroeconomic buffers, eg in terms of foreign exchange reserves and fiscal space, as well as attempting to have a productive strategy that tries to diversify their economy, and particularly their exports. Naturally macroeconomic buffers have high opportunity costs for LICs; therefore, a good international shocks architecture, particularly including counter-cyclical lending, can reduce those opportunity costs, allowing such resources to be used for development

V The Borrowers' Perspective

A number of senior officials from Finance Ministries (including one Finance Minister) from borrowing countries were interviewed: they were mainly from Sub-Saharan Africa, but also one was from Central America.

Overall, when the counter-cyclical loan(CCL) was explained, senior officials all thought it was a very good mechanism and liked its' general features; they

were very interested in adopting it, particularly as could be especially valuable in the context of a relatively gloomy likely global context. They particularly welcomed the automaticity of the CCL as well as the speed of the deferred debt servicing, and the fact that the borrowing country could chose to use the deferred payment or not, at its' own discretion.

The strong advantage of a broader use of a CCL or CCL type loan was illustrated by a dramatic story told by Dr Garner, from Honduras. At the time Hurricane Mitch hit his country, he was a senior official in the Finance Ministry; he had to wade into his office, through high mud, to get the numbers and ciphers so he could instruct the bank to make debt servicing payments to IADB and WB, to avoid Honduras defaulting; some automatic postponement at the time of the catastrophe would have been very helpful, and he was therefore very enthusiastic about the CCL.

One unexpected finding of the interviews was the lack of knowledge about the CCL instrument. Either the interviewees, all very senior officials who had been sent a questionnaire, did not know at all about the instrument or they had lack of knowledge of any specifics. They believed because the publicity amongst potential borrowers was bad, the CCL was either not known at all or was not properly understood.

These senior officials, including one Minister, were very interested in obtaining additional information about the CCL; they were very keen on further dialogue about this instrument; they also strongly supported the desirability of a seminar , either in Africa itself, which they would like to attend (with Ghana informally even offering to host it) or in Paris, jointly with the AFrD, but also including WB/IDA and the African Development Bank, as well as other bilateral donors, who make concessional loans. In later conversation with AFrD, they were interested in co-organizing such a seminar, either in Paris on in SSA, jointly

with the Commonwealth Secretariat, suggesting the subject could be broader, ncluding not just the CCL, but also other possible counter-cyclical instruments, as well as issues such as analysing costs and benefits of possible greater use of concessional loans versus grants by bilateral donors.

One specific point that emerged in the interviews was that LIC Finance Ministry senior officials did not like the fact that the fixed grace period of the CCL loans was only five years, as opposed to the standard AFrD fixed grace period of ten years; this was especially the case when funds were used for infrastructure projects, that would take a long time to bring revenue in. They would therefore appreciate a modification of the CCL that could grant ten years fixed repayment, plus five years variable grace period. Especially oil importing countries, highlighted the desirability that the instrument would not just apply to export shortfalls, but also to increases in imports, caused by external shocks

A broader point made in the interviews was a concern about limits imposed on non- concessional borrowing, which they require for infrastructure financing; reportedly the World Bank for example is urging countries to do large investment (which they themselves would like to do), but they argued IMF conditionality puts too low a ceiling for the non-concessional borrowing permitted for HIPIC countries, even though such borrowing is necessary to finance this infrastructure investment.

VI The lenders' perspective

Bilateral agencies; the German interest in counter-cyclical lending

Overall the German Development Ministry (BMZ) is very interested in possible use of counter-cyclical lending instrument, including by them, probably through KFW, which is reportedly also interested. German Ministry did quite an in depth study of it some time ago, spurred by AFrD presentations, but have not yet moved forward on it, though they seem open to doing so. Like borrowers,

(see above) they are very interested to see result of Commonwealth Secretariat study, and suggested organizing a meeting, possibly in Paris, where the Paris Club could also be invited. They would be keen to attend and actively support such a meeting.

German Development Ministry(BMZ) officials made the broad point that , given restrictions on aid budgets, linked to sovereign debt crisis in Europe, it may be a good time to re-evaluate the issue of concessional loans versus grants, and within that context the use of CCL like instruments may become particularly interesting.

According to the German BMZ position, the use of CCL is justified by the considerable macroeconomic impact expected of the instrument (avoidance of debt crises and their negative impact on development).

This macroeconomic impact can, according to BMZ, come into play if:

Major donors join together to make a binding commitment to this mechanism. For the expected macroeconomic effects (avoidance of debt crises) to materialise, it is important that a large proportion of the country's official debt service be agreed on a CCL basis;

It is suggested by BMZ that application concentrates on countries in which a large proportion of external debt is persistently made up of ODA loans; according to BMZ, CCLs are applicable mainly to countries that have, on the one hand, an economic structure that is vulnerable to shocks and relatively high foreign debt (which would apply to many HIPC countries) .That makes this instrument attractive primarily to HIPC countries that have been given green light status under the Debt Sustainability Framework but are still heavily dependent on ODA loans. This would, according to BMZ, only apply to a relatively small group of countries. The author of this paper thinks the scope for country coverage could be wider.

In order to ease the situation more rapidly in countries experiencing export shocks, the triggers applied by the various lenders (regarding the timing and the factual conditions to be fulfilled) should be harmonised, according to BMZ. This would require a coordination body or access to World Bank/IMF data. The advantage, compared to ex-post coordination via the Paris Club, would be that debt repayment difficulties would, from the outset, not arise.

There were some potential concerns in BMZ that in operational terms, the instrument takes more time and effort to manage (e.g. agreement on and monitoring of when mechanism is triggered, management of the compensation fund). This, however, did not seem to be a concern in AFrD, when we discussed it in Paris. BMZ, however, also had some worries because the uncertainty regarding the ultimate maturity of the loan, which could make managing liquidity somewhat more difficult. This concern may be worth exploring further.

It is interesting however that BMZ notes that "in the commercial financial sector, it is already possible to form compensation funds through the use of debt service reserve accounts so as to cover short-term payment difficulties. Experience has shown that this instrument, too, is seldom used. When the KfW grants major loans that are decided on in the Board of Supervisory Directors and the credit approval committee, this is, however, a security measure that is often agreed on with the recipient of the loan, particularly where infrastructure funding is concerned." This may show a way out is feasible for any liquidity management problems of CCL instruments, at least in Germany.

The multilaterals

Discussions were held with the International Monetary Fund, which was, simultaneously to the writing of this report, preparing an IMF/World Bank Report on a related subject, which made the dialogue very fruitful. The IMF/World Bank report (2011) looks more broadly at all concessional lending,

as well as private insurance and hedging mechanisms to help counties deal with external shocks. As regards the latter two, there are important concerns about the desirability of widespread use of these instruments, by the authors of this report, linked to the high cost of private insurance and hedging, as well as the risk that insurers can go bankrupt, with the risk that coverage against risk could be lost.

As regards loans like the AFrD CCL, the IMF/World Bank document, 2011, op cit (which we quote in some detail here, given the importance of IMF and WB/IDA lending to LICs) says that it provides some liquidity support in the face of temporary shocks, while preserving the present value of the loan. The latter feature can make resource allocation more predictable for the creditor as the total amount of relief is known in advance. However, while this may be the case for some creditors, it is not the case for some revolving credit institutions like IDA.

Indeed, one of the main issues raised in the IMF and World Bank Report is the issue of liquidity management, which such instruments would apparently pose to institutions like IDA and the IMF. Thus the IMF/WB Report , op cit argues that:

"Floating grace periods present serious challenges for revolving credit institutions, due to their reliance on reflows to finance new credit. Given that an exogenous shock hitting one LIC is likely to simultaneously affect other LICs, delayed repayments in response to a shock have the potential to introduce uncertainty into the institution's ability to make additional long-term comitments. To manage the liquidity risk that would be generated, a revolving credit institution would need to hold additional liquidity to replace the credit reflows if borrowers invoke the floating grace period". More generally the IMF/World Bank document argues that because deferred repayment loans

require long loan maturities and the possibility of several grace periods, their applicability to the IMF and IDA, that lend with relatively short or medium-term maturities, may be limited. This point seems more relevant for the IMF than for IDA, as the loans of the latter tend to have longer maturities.

Also, deferred repayment loans with discrete triggers are only weakly targeted in two respects, according to the IMF/WB document: (i) a shock that reduces exports by 5 % triggers the same relief as one that reduces exports by 50 %, and (ii) a series of moderate shocks that exhausts the floating grace periods would leave the country vulnerable to a larger shock later.

For a hypothetical loan issued to Haiti in the early 1980's, for example, floating grace periods would have been exhausted by 1994, leaving Haiti vulnerable to the sharp export decline of the early 2000's. In Benin, sustained export declines would have triggered floating grace periods in two periods, covering a total of four years. In the latter case the CCL would have been appropriate, but not in the former case.

Mitigating potential problems with contingent debt instruments, according to IMF/WB

Contingent debt instruments can help address liquidity or long-term debt sustainability problems, but they have limitations. The main advantage of these instruments is that they can offer an element of automaticity relative to standard instruments and therefore make financing for shocks more predictable. The main drawback is that they do not necessarily deliver relief in the amount needed.

Various possible design features could help mitigate these drawbacks, however:

To reduce the risk that relief is delivered in circumstances where the country does not need it, LICs could be given the *option* of exercising their right to relief in the qualifying events or periods. Countries would have an incentive not to take the financing when there is limited need if they could save the relief for potential future shocks. **This is already the case with the AFrD CCL, though the IMF/WB document does not acknowledge that!**

Making relief proportional to the size of the shock could enhance tailoring, and could be combined with the "option" feature, according to the IMF/WB document. For example, if exports fell by, say, 1 % within a quarter, an option to defer repayment of 2 % of debt service could (but need not) be exercised. For further specified declines in exports, additional options to defer a share of debt service could be granted

Making the instrument symmetrical, with incentives for early debt repayment in the event of favourable shocks (say through additional deferral options contingent on early repayments), could also tighten the link between debt service and repayment capacity and promote countercyclical policies.

In the case of instruments that are intended to mitigate long-term debt sustainability risks, where the appropriate size of PV transfer is difficult to determine *ex ante*, one avenue could be to design the instrument such that it provides only liquidity support at the time of the shock, but then converts part of this support into a permanent transfer if and when it becomes clearer over time (during the life of the loan) that the shock is more permanent. For example, the instrument could provide that a specified proportion of the contingent loan (or of the debt service being deferred) would be waived if the negative shock persists for more than 5 years.

The IMF/WB document, 2011, op cit, concludes that:

"While the likelihood that the contingent liquidity support would be limited is a concern, the instruments could still be worth considering. The current debt outlook indicates that debt service is generally low in most LICs, suggesting that these instruments would not be able to deliver significant liquidity in the event of shocks. Contingent debt instruments could still be worthwhile, however, for LICs with relatively high debt service ratios."

As of September 11, 20 of the 70 LICs for which there is debt sustainability analysis, fall in the high risk/debt distress categories, according to the IMF/World Bank.

Contingent debt instruments to address debt sustainability concerns also have potential. Some donors (particularly MDBs) extensively use mechanisms geared to preserving debt sustainability, which adapt their financing terms to the level of debt distress. There may be, nonetheless a case for bilateral creditors that do not have the kinds of debt-mitigating mechanisms used by the MDBs to consider such mechanisms.

A more general conclusion of the IMF/WB document, in relation to contingent instruments such as the CCL is positive; specifically it says that

"Contingent instruments cannot match the targeting of *ex post* instruments, but are one way to provide for related financing that is quick-disbursing (and thus more likely to be counter-cyclical) and predictable. When well-designed, contingent instruments can mitigate the budget uncertainty, policy pro-cyclicality, and debt risks that otherwise arise from exogenous shocks. And

while there are important constraints on their use, several of these constraints can be addressed. There is substantial scope for …development of official sector contingent debt instruments."

One issue discussed in interviews with the IMF was why LIC policy-makers might prefer standard AFrD loans, with 10 years grace to those with 5 years fixed grace plus 5 years of movable grace if exports shocks occur. A reason given by the IMF was the possible short time horizon of politicians in debtor countries; if longer grace period, they are more sure debt payment are more likely to start with the next administration. However, the reason, given by debtor countries themselves in interviews with them seems more important-that the period for the projects to start generating revenue (eg infrastructure) could be longer than 5 years, and there is therefore an economic case for using a longer grace period loan. As pointed out above, an ideal solution may be therefore for the CCL loan from AFrD, and from other possible official lenders, to have a fixed 10 year grace period, and a variable one for 5 years.

Though they have produced a joint document quoted in some detail above, reportedly the International Monetary Fund seems very supportive of counter-cyclical loans, whilst reportedly the World Bank argues there is not much need for counter-cyclical loans. This is a source of concern, as the participation of IDA in counter-cyclical lending would be crucial for making that instrument meaningful. Further dialogue with the World Bank and specifically IDA on this issue seems desirable.

IDA has a traffic light system; if a country has low debt service, for example post HPIC, it can have loans; if medium to high debt service burden, it could have all grants or high proportion of grants. Also in IDA there is the newly created CRW (Credit Response Window mentioned above), which has the

ability to front-load lending in the light of external shocks. However, the CRW is quite restrictive, in the sense that several countries need to be hit by a shock simultaneously, and there has to be quite a high forecast decline of 3% of GDP, for the CRW to be activated.

Concerns raised by the IMF related to the fact that the volume of concessional loans by bilateral donors may not be sufficiently meaningful in total debt, to provide the necessary debt relief, if a big external shock hits. Further calculations may be required for this purpose; the essential issue is that for such a counter-cyclical loan to be effective, it should include major bilateral donors, as well as IDA and the regional development banks.

The argument was made by the IMF that counter-cyclical lending does have advantages, such as automaticity and predictability, but may not be so well targeted to countries' needs. Indeed, debt service on all concessional debt is reportedly quite low in many LICs, because of HIPIC debt reduction; thus deferral of debt payments would not give so much liquidity relief, as may be required to face large shocks. This point has some validity, especially for those LIC countries that do not have any or much concessional debt. The conclusion is that counter-cyclical lending is a valuable instrument, but –given its limitations of scale, and variability by countries-has to be seen as a complement to other well designed instruments in a shock absorber architecture, such as low conditionality, sufficiently large and speedily disbursed compensatory finance by the IMF, World Bank and the European Commission.

In that sense the CCL, though partial, is a valuable instrument for LIC countries; countries like it, as they are in the driver seat, as they can decide if they have debt holiday or not, it can be speedily used and has no additional conditionality.

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