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Compensatory Financing for Shocks: What Changes Needed?

A Study for DFID

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I Introduction

Economic shocks tend to have very large negative effects on low-income countries and on poor people. As such, they can be very harmful for meeting the MDGs.

When a low-income country suffers an economic shock, the trade balance, fiscal accounts and the overall level of economic activities suffer. The initial effects on these key macroeconomic variables feed through the entire economy, with very negative social and economic effects taking place through reduced government spending, lower wages, higher unemployment, and lower incomes.

Provision of appropriate official liquidity and aid can potentially be very effective for protecting economic growth (and the income of poor people) from the negative impact of economic shocks. African governments have placed very high priority on such measures, as have low-income Western Hemisphere ones (Martin and Bargawi, 2004; interview material). The current international environment of strong commitment to the MDGs and of increased aid is in many ways very favourable for providing adequate official liquidity and aid for shocks, if an appropriate architecture for economic shock financing is put in place, and sufficient resources are made available for this aim. Such an architecture would build on existing institutional mechanisms and instruments, but would modify them so the system would be effective in providing appropriate support (in terms of amounts, speed modality, conditions) to minimise negative unnecessary impacts of shocks on growth. This paper aims to make a contribution to this discussion.

We will first discuss the principles of an effective system, both for liquidity and grant provision (section II). We then examine (in section III) the different parts of the existing system and how it operates, and make specific proposals for modification. For this purpose, we will draw on our Latin American country case studies – Nicaragua, Honduras and Guyana (section IV), and on the process of consultation with different institutions and actors, especially from the developing world. The three countries covered in this study have suffered a great deal from various types of shocks. Their GDP growth was sharply reduced and in some years even turned negative as a result of shocks, and their poverty headcounts increased. Their adjustment reflected lack of access to external financial resources to deal with these shocks, especially economic shocks which are far less visible than natural disasters' type of shocks. These countries' adjustments are thus discussed in great detail, to illustrate their need for compensatory mechanisms. Then, we finish with more general proposals for change of the international architecture for compensating for shocks (section V).

II Broad Principles

In terms of diagnosis of impact of shocks, there is much consensus on many central points, both in the academic literature and in official documents (for an excellent diagnosis, see for example, IMF, 2003).

Exogenous shocks, such as terms of trade shocks, natural disasters or conflicts and crises in neighbouring countries, can have a significant negative impact on developing countries' growth, balance of payments, government revenues and expenditure, debt sustainability and poverty. Low-income countries have a higher incidence of shocks compared to other developing countries and tend to suffer larger damages when these occur. Particularly relevant is that low-income countries have limited room to build cushions of reserves and fiscal resources as a buffer against shocks; such "self-insurance" has a particularly high opportunity cost for low-income countries. As a result, official compensatory flows can play a crucial role in avoiding unnecessary costs to poor countries and poor people.

The large negative impact of external shocks can be both short-term and long-term. In the first instance, all shocks have important negative short-term effects, if reserves and additional external finance are not available. Exports will tend to fall, as will government revenues; as a result if no external finance is provided, imports would fall, as would government spending, including on health and education. Both as a result of this, and as a direct impact of the shock, jobs would be lost and income fall in the private and public sector.

There is therefore in the first instance a clear need for rapidly disbursing highly concessional, low conditionality official liquidity to compensate for a very large proportion of the shock. It is moreover important that the country's fiscal policy framework has in-built mechanisms (and that the IMF accepts them, or even better, encourages them) that allow its fiscal deficit to expand when a country is hit by a shock, rather than reduce it as is usually the case, so that the overall level of activity is maintained. If sufficient assistance were to come in, the after-grant deficit starts to return back to the pre-shock level. It is furthermore important that additional assistance is provided in the form of budget support. This latter point has been strongly emphasised by policy makers of our country studies.

If the shock proves to be temporary (e.g. terms of trade, one year drought) and were to be financed quickly for a high proportion of the shock through concessional official liquidity, any negative impact on growth and poverty could be avoided. Official liquidity would allow levels of imports to be maintained, as well as levels of government spending. This was indeed the purpose for which the Compensatory Financing Facility was created in 1963, purpose that was recognised by the IMF itself in a special Fund pamphlet on the subject "Ideally, the facility would enable a member to borrow when its export earnings and financial reserves are low and to repay when they are high, so its import capacity is unaffected by fluctuations in export earnings caused by external events" (Goreux, 1980).

Table 1

Shock	**Desirable international response for low-income countries**	
	Official liquidity	Grants
A. Terms of trade		
1. Temporary	Speedy, low conditionality. Large scale in proportion to shock.	Not necessary
2. Permanent	Speedy, low conditionality. Large scale in proportion to shock.	Later grants, when more permanent nature becomes clearer
B. Natural disasters	Speedy, low conditionality. Scale relatively small, if grants quickly available	Large and quick disbursal of grants.

Source: authors' analysis

If a shock that seems temporary becomes ex-post more permanent (e.g. terms of trade deterioration remains, droughts repeat themselves), there is a clear case for the international community to: a) provide grants, for a significant proportion of the shock, for countries with reasonable macro-economic and poverty reduction policies; Latin American low-income countries (e.g., Nicaragua) emphasised the need for grants in those circumstances, b) support restructuring of the economy to deal with the shock (e.g. diversification of exports if prices of main exports are low, search for and investment in domestic energy sources and energy conservation if price of oil imports remain high, development of other activities to replace jobs and income of people affected by recurrent droughts, etc.). To a certain extent, as the period becomes longer, dealing with shocks increasingly seems to overlap (though not totally) with broader efforts at a country's development and c) repayment of official liquidity lent because of initial shock could be extended, so that gross disbursements of aid due to shock are not reduced by premature repayment of official liquidity.

If the shock is from the very beginning permanent - and large - like a major natural disaster, that destroys for example a great deal of housing and/or productive capacity, there is still a potential role for very quick disbursing official liquidity. However, for low-income countries, the key role clearly needs to be played by significant grants, which hopefully will also begin to be disbursed quite speedily. Productive capacity, housing, schools and hospitals need to be replaced/rebuilt. Should grants for some reason not be disbursed quickly, there would be a case for fairly large highly concessional official liquidity, though this would seem to be a second best.

A natural disaster type of shock is in some ways easier for the purpose of establishing additional needs, than an economic shock. This is because it is easier to identify the shock and to quantify the needs required, which are often associated with losses of infrastructure, property and earning capacity of people directly hit by the shock.

However, even if the shock is geographically localised or initially affecting just one economic sector, knock on effects may ensue thereby being spread throughout the economy.

It is thus important that assistance is provided in the form of budget support also for dealing with natural disasters, so that the government can contain the knock on effects through increased social expenditure to assist the poor and most vulnerable. For that purpose, in-built mechanisms should be in place to allow the government to run temporarily larger deficits, as well as safety nets that can be activated quickly. Additional assistance may lose effectiveness if the country takes time to build safety nets to reach those affected by the shock, or fails to do so due to insufficient institutional capacity.

The key features of the official liquidity (several of which are also relevant to grants) that needs to be provided should be that: a) it is very speedy, b) it is sufficiently large in proportion to the shocks, particularly for terms of trade shocks, c) it has low or no conditionality, d) it is highly concessional, and e) shocks are precisely measured.

a) As regards the first aspect - speed - the IMF itself clearly recognises its value. In IMF (2005a) a document sent to the Board says "Immediate external financing can have a strong impact in mitigating both the direct and long-lasting secondary effects of shocks in low-income countries. Catalysis (of aid) can be relatively slow, because bilateral donors typically cannot reorient flows quickly. Together, these features suggest that frontloading external financing from the Fund can be an efficient intertemporal reallocation of resources.."[2].

   One operational way of enabling speed of response to shocks into existing lending facilities is to build scenarios into all such programmes, for example for certain levels of deterioration of terms of trade; should these occur, and the programme otherwise be on track, lending could almost automatically increase based on previous calculations. Though this may require greater effort ex-ante, it may save valuable time and effort ex-post. It is positive that such scenario building is introduced into the Fund's TIM (Trade Integration Mechanism); alternative scenarios are also included in some PRGFs, but no additional resources are predicted for such scenarios.

   Unfortunately, the facility proposed in IMF (2005a) op. cit. does not, as we will discuss below, guarantee sufficiently speed of disbursement. Not does it deal adequately with the second criteria, that of scale.

b) As regards scale, the more liquidity - and later aid - is provided quickly in proportion to the shock, the smaller the adjustment required. The evidence that negative terms of trade shocks have large adverse effects on growth is very strong. For example, Collier and Dehn (2001) showed that for export price negative shocks averaging 6.8 per cent of G.D.P. in the year of the shock, the loss of income due to reduced growth reached - over four years - about 14 per cent of initial output, with asymmetric effects, as positive shocks did not increase growth sufficiently to compensate for the negative effects.

Our country case studies reported below clearly show how growth is reduced, and in some instances even turns negative, following a terms of trade or other type of external shock. For example, Nicaragua's growth was reduced from 7% in 2000 to only 0.8% in 2002, following a 14% decline in the country's terms of trade between these two years. If official liquidity had been provided at a sufficient scale and speedily, unnecessary reduction of

[2] Indeed, currently donors have very small or zero contingency resources (interview material). The EU FLEX is slow disbursing and quite small (see below).

growth, as well as the related increased incidence on poverty, could be avoided. World Bank (2000) and other research shows that fluctuation in income growth can have an asymmetric impact on poverty; 1 per cent contraction in per capita income increases poverty more than the equivalent increase in income reduces poverty. For these reasons, the IMF (2003) recognises that even in the case of a permanent shock, "financing to smooth adjustment may be warranted".

As pointed out above, in the face of a temporary negative shock, full financing could avoid any cost for growth and poverty reduction. This is particularly clear in a context of rising aid flows like the present one, and/or if the temporary negative shock is followed by a positive shock, as is often the case. It would also be very easy to implement in the context of the IFF, which would facilitate front-loading of aid. Indeed, it can be argued that current trends in overall higher commodity prices linked to the dynamism of China and other Asian economies provide a very good context for compensatory financing; declines in export prices are for an important period far more likely to be temporary and not so linked to the secular deterioration of terms of trade that Prebisch-Singer detected and that the IMF (2004a) refers to in its review or its Compensatory Financing Facility (CFF), as a possible reason for the CFF's smaller relevance.

It should be pointed out that the scale of the official liquidity for shocks is far more limited than in the past, when the CFF access limits reached 100 per cent of IMF quota, separately for export shortfalls or cereal imports, and 125 per cent of quota, for their joint use, at a time when IMF quotas as a proportion of trade were far higher than at present. It was estimated that for example for 1976-81, on average about 50 per cent of export shortfalls of developing countries were financed (Griffith-Jones, 1987). This is quite a sharp contrast with current practice, where augmentation of PRGF, granted in only about half the cases of terms of trade shocks, has reached only 12 per cent of quota, which the Fund estimates covers only less than 20 per cent of the shortfall! (IMF, 2005.) If there is a balance of payments need, and the country is following reasonable macro-economic and poverty reduction policies, the case for 100 per cent of coverage of shocks seems very strong. This would imply either no quota limit or a far higher one.

c) Low or no conditionality for official liquidity in response to exogenous shocks is essential for two important reasons. Firstly, the fact that a shock is totally exogenous, and initially temporary, implies that countries do not have to adjust in the first instance; if they had financial market access they could borrow, which is what developed countries do. As low-income countries cannot, it is desirable that the international community provides this financing. The rationale for such counter-cyclical official flows seems evident in economic terms; because of the inevitability of international business cycles, official counter-cyclical liquidity is desirable to counteract for their effects. It seems unnecessary to require a Fund programme, for countries that have successfully approved annual Art IV consultations, which reflect reasonable macro-economic policies. Indeed, during the initial decades of the operation of the Compensatory Financing Facility, this principle of low conditionality in response to external shocks was fully recognised, and countries made extensive and successful use of this facility. Similarly, when the first large increase in the price of oil occurred in the mid-1970s, two low-conditional Oil Facilities were created, which worked very effectively. The second reason for low or no conditionality is that it clearly facilitates and ensures speed of disbursement, which is precisely a key advantage of using official liquidity to avoid unnecessary costs on growth and poverty reduction.

Therefore, no or low conditionality is justified not just in terms of good economic analysis, but also for the pragmatic reason that it will ensure speed of international response.

d) Concessionality. There is broad consensus that resources should be provided to low-income countries, either in the form of grants or very concessional loans, a point strongly emphasised in our country case studies. Given that official liquidity has a number of potentially positive features, for a response to shocks the case seems very strong to allocate additional grant resources to make such IMF facilities highly concessional (possibly even more concessional than the current PRGF), and above all not to allow restrictions on the levels of lending to be determined by lack of resources for financing the subsidy. Our country case studies show that for countries like Nicaragua the PRGF concessionality is between 30 and 35 percent today, but the country's policy makers argue the rate should be higher, at about 60% at least. A main reason given for higher concessionality is that it would otherwise be difficult to bring the country's external debt to sustainability levels in the foreseeable future, even after taking into account the debt relief granted under the enhanced HIPC initiative. Such a use of aid seems far more cost effective than giving (far larger) grants, and may also provide better incentives for countries to restructure their economies in the medium-term to reduce vulnerability by greater diversification, so they can pay back concessional loans. However, as pointed out above, for large natural shocks that cause major damage and/or for permanent terms of trade shocks, the case for significant grant resources is very strong. The Mitch Hurricane shock of 1998, which implied massive infrastructure and property destruction both in Honduras and Nicaragua (see below), had a very generous response through both the provision of grants and loans by the international donor community. But as these countries' policy makers have pointed out, assistance in the form of loans resulted in an increase in these countries' debt, which were already extremely high.

e) Shocks need to be precisely measured. Clearly this is a complex area, but valuable progress has been made in the area of appraisal of impact of natural disasters. At the same time, progress on measuring impact of terms of trade shocks seems less evident in existing facilities. A simple improvement - particularly relevant in the context of recent sharply rising oil prices, which affect many low-income countries' imports and which is a source of major concern to developing countries, including our three case studies - would be to measure export shortfalls in real terms (that is in terms of the imports they can buy), thus taking account of both changes in export prices and import prices. This would simply apply economists' well established general preference for real rather than nominal values. A similar argument can be applied for the calculation of export shortfalls, for the purpose of provision of grants, for example by the EU's FLEX or bilaterals.

An alternative, possibly more politically attractive option - though somewhat less precise technically - would be to consider the creation of a new low conditional Oil Facility in the IMF, and include some provision for compensating for higher oil prices in existing grant facilities, such as FLEX.

An additional criterion - applicable also to official liquidity - but particularly relevant for grants is that there is a better alignment of allocation with needs. Indeed, as IMF (2003) and Collier and Dehn op. cit (2001) show, natural disasters, which are more visible appear proportionally to attract more external financing than terms of trade and drought shocks, which are mainly "silent crises". For these silent and slower developing crises, more attention is necessary for providing both liquidity and grants. Indeed, ideally the provision

of concessional liquidity and grants should be in some way proportional to the magnitude of the shock, and resulting impact on the poor and their needs, independently of the nature of the shock.

III The current system for compensating for shocks: evaluation of problems and proposals on how to overcome them

In what follows, we will describe first the existing system, and do a preliminary evaluation, drawing on the principles outlined above. These relate to the effectiveness of the compensatory mechanisms in helping minimise negative unnecessary impacts on growth and poverty reduction. Where relevant, we will add a historical dimension, to see whether the evolution of these facilities implies steps forward or backwards in achieving their aims. We will then make proposals for improving the different existing facilities. The next section assesses to what extent the existing facilities meet low-income country needs through discussing the cases of Nicaragua, Honduras and Guyana. The final section - V - will examine the overall architecture of compensatory financing.

Given the great variety of instruments and shocks, we will focus here mainly on terms of trade shocks, though also mentioning natural disasters.

a) IMF mechanisms for export shortfalls

There have been two major compensatory financing mechanisms for terms of trade shocks, the Compensatory Financing Facility of the IMF (a loan facility) and the European Commission's grant programme for ACP countries (previously STABEX and Sysmin, and now FLEX). The CFF has historically been a very important instrument by which the Fund helped finance exogenous shocks. During certain periods, it played a major role in total IMF financing; for example, between 1976 and 1980, it represented 45 per cent of total credit extended by the Fund to developing countries! (Goreux, op. cit 1981.)

Furthermore, since its creation in 1963 till 2000, a total of SDR 25 billion was disbursed in response to 344 requests for assistance. As regards the share of the shortfall covered by IMF lending, these reached a fairly large proportion at times, of around 50 per cent of the shortfall (Griffith-Jones, 1987); this was because, as discussed above, the limits for drawing - as per cent of quota - were high. As a result, a large number of countries received CFF with a high per cent of average access in proportion to shortfall (see Figure 1). Furthermore, when major oil prices occurred in the 1970s and later, Oil Facilities were introduced, which were also widely used, even in the 1990s (see IMF, 2004). The high number of countries using the CFF was linked not just to generous access, as proportion to quota, but also to very low conditionality, as appropriate due to the fact that shocks were exogenous.

The form in which shortfalls were calculated was interesting, in that it did not require a fall in export earnings (as FLEX does), but the shortfall was calculated as the difference between the value of exports in the shortfall year, with the medium-trend value of export earnings in that year (calculated as a five year average centred on that year). Indeed, this seems a more appropriate calculation method; after all if export growth decelerates, it follows that output falls below its long-term growth trend, and a below-trend output is precisely what one should try to avoid, when an economy is hit by a shock. So, a fall in

export growth rates, and not just a fall in export earnings, should be the criteria for financial assistance for a country facing an external shock.

Finally, another positive feature of the traditional CFF - from a development perspective - was that financing under the CFF augmented total resources available to countries, beyond access limits for the Extended Fund Facility (EFF) or stand-by.

However, since the 2000 review and amendment, the CFF has not been used at all, despite several temporary and exogenous shocks that affected many countries. It seems that the main reasons why the CFF has not been used since it was modified is because of its very high conditionality - requests for CFF can be met only in conjunction with an upper credit tranche arrangement, if the balance of payments is deemed not to be satisfactory; furthermore, for low-income countries, especially highly indebted ones, the fact that the CFF is non-concessional is an additional reason for making it unattractive.

Since the creation of the ESAF, augmentation of ESAF or PRGF arrangements has been the main vehicle the Fund has used to provide financing for low-income countries hit by shocks. This mechanism has the main advantage that financing is concessional (though some heavily indebted low-income countries, e.g. Nicaragua, feel that concessionality is insufficient and could be higher, as mentioned earlier). But this mechanism has a number of problems. Firstly, it is restricted to only some low-income countries - those with PRGF programmes. Consequently, it is linked to a high conditionality Fund arrangement, which as discussed above is inappropriate as terms of trade shocks are caused by external circumstances. Secondly, as the Fund itself recognised (IMF, 2005, op. cit), PRGF average augmentation was very small compared to the impact of the shock - less than 20 per cent; furthermore, it was granted to only half the countries with PRGF experiencing shocks (Martin and Bargawi, op. cit.).

Conscious that PRGF augmentation is limited only to countries with PRGF programmes, and that exogenous shocks affect all low-income countries, the IMF has for a couple of years been exploring alternative options.

At the time of writing, a proposal (IMF 2005, op. cit) was sent to the Executive Board for a PRGF second window for low-income countries without a PRGF arrangement that faced a sudden and exogenous shock requiring temporary financing. The proposal has several positive features, such as that it is concessional and that it could apply to different shocks, including natural disasters as well as commodity price changes - though it does not refer to increases in the price of imports, e.g. of oil, currently a very important shock for many low-income countries. It would seem essential to broaden this second window of PRGF - as well as the PRGF augmentation mechanism - to include prices of imports, so that shortfalls of exports are measured in real terms.

The second - and main problem - with the proposed second window of the PRGF is that it would be linked to a high conditionality Stand-By Arrangement, which is - as discussed - inappropriate given that the shock was exogenous. It would also delay disbursements whilst the programme was negotiated; as discussed above, such delays can be very costly in terms of growth and poverty reduction foregone. The interviews conducted as part of the country case studies show that speed of delivery is a main concern for country policy makers.

The IMF does suggest a potentially interesting modality, a Policy Support Instrument, (PSI), which would have upper credit tranche conditionality, but imply no lending. Should a country then be hit by an exogenous shock, "members with a PSI on track would be presumed to have easier access to the second window". Though it is positive to have a programme in place ex-ante, it is absurd that even countries with a highly conditional PSI would not then have automatic access if faced with a shock, but would have to go back to the Executive Board of the IMF. There is a good case for some frontloading of conditionality (making it ex-ante rather than ex-post), as this can help ensure better policies in normal or good times - when they are easier to implement; however, a case could be made that full high upper credit tranche conditionality is excessive ex-ante, and that an enhanced Article IV consultation could be sufficient. In particular, it seems evident that if a full conditionality PSI is on track, and a country is hit by an exogenous shock which generates an additional balance of payments need, it should have immediate and automatic access to the PRGF second window. For countries without a PRGF or a PSI, it also seems inappropriate that - for financing an exogenous shock - "the program discussions would need to cover the full range of issues associated with upper credit conditionality" (IMF, 2005).

A final problem is that the second window would place an annual limit of 25 per cent of quota, and a total limit of 50 per cent quota for the facility. The Fund document accepts that "this is less than the estimated impact of various shocks". It gives two justifications, the first one is that it is similar to PRGF augmentation (but as discussed above these are clearly insufficient as they meet only a small proportion of the size of the shock); the second justification is the constraint on PRGF Trust resources for the subsidy element. Though this may be factually correct, donors - in the context of increasing aid - could allocate additional resources to the PRGF Trust, which would be very effective in terms of poverty alleviation. Indeed, the IMF could attempt to encourage them more to do this.

Furthermore, it is interesting that the Emerging Natural Disaster Assistance (ENDA) IMF Facility has no formal limits, though in practice amounts have been limited to 50 per cent of quota. This as well as the lack of requirement for a high conditionality programme to disburse ENDA, may indicate the somewhat more favourable treatment for natural disasters than terms of trade shocks suggested above. It would seem appropriate to extend the greater flexibility on conditionality applied for natural disasters in ENDA also to terms of trade related shocks, as they can be equally disruptive of growth, and as neither are the fault of the country.

b) EU mechanisms for export shortfalls

The EU has for a long time, since 1975, had compensatory mechanisms in the form of grants for countries hit by terms of trade shocks. Initially, these were instruments like Stabex and Sysmin, which expired with the Lome Convention. A new mechanism was created under Cotonou, FLEX, which according to the European Commission (2005), resulted from the negotiation between the Community that wanted to put an end to Stabex and Sysmin, and ACP countries, which wanted to maintain these instruments, with some adaptations. The resulting mechanism - FLEX - does seem to disburse less funds than previous ones (see below). In any case, FLEX has the advantage over previous EU instruments that it is more targeted on the shocks, rather than on how the resources should be used.

FLEX has as purpose to support "in cases of short-term fluctuations in export earnings safeguard macro-economic and sectoral reforms that are at risk as a result of a drop in revenue…". It is curious that it does not explicitly mention support of imports, or growth, or poverty reduction, as an aim.

FLEX was set up within the broad financial envelope that supports long-term development of ACP countries. It is part of the national allocations within the so-called Envelope B, to meet unforeseen needs (which include also humanitarian/emergency assistance and debt relief). Envelope A defines programmable aid for 5 years; for this current 5 year period, resources within the B envelope initially included 2.5 billion euros, but after the mid-term review were reduced to 1.75 billion euros, as 750 million euros were transferred to envelope A. Of these resources, 500 million euros remain currently available. Envelope B can currently be used by 76 ACP countries, implying a fairly small allocation per country. It is important to point out that the budget for FLEX has an upper limit, determined for every ACP country. This limit is calculated on the basis of historic vulnerability, which may not always be a good forecaster of current vulnerability. As we see below, this limit can restrict granting of approval resources, e.g. for Guyana. Greater flexibility of allocation between countries of FLEX resources may be desirable, but has reportedly been resisted by ACP countries. However, if in future negotiations FLEX is modified by the Community in ways that ACP countries would consider desirable (e.g. higher levels of resources, and/or more flexible criteria, as well as greater speed of disbursement), perhaps ACP countries could in their turn accept greater flexibility in intra-country allocation within Envelope B.

There are two criteria for ACP countries to be able to access FLEX a) the first one is that export revenues should fall by 10 per cent (2 per cent for least developed, landlocked and island) b) the second was that there should be a 10 per cent increase in the public deficit (criteria which after the recent June 2004 modification was reduced to 2 per cent deterioration).

As regards the criteria of export revenues, the question could be asked whether a fall of 10 per cent in export values is not too stringent, and whether a level of exports below trend of growth would not be more appropriate, as argued above. Furthermore, it would seem essential to measure export shortfalls in real terms (as regards capacity to import). This is particularly relevant as currently a number of ACP countries are suffering from a large increase in oil prices, but is more broadly applicable.

Though it is welcome that the criteria for public deficit increases has been made less stringent (which as we will see below has facilitated larger FLEX drawings), it seems conceptually unclear why any criteria for worsening of fiscal deficits needs to be included, given that the main concern should be safeguarding countries' import and growth capacity. This was also the position of the ACP countries during FLEX negotiations. There is also a contradiction between FLEX requiring countries to increase fiscal deficits as a pre-condition for grants, and IMF PRGFs, which typically do not allow countries to increase fiscal deficits (even though in the face of shocks, such deficits should be allowed to increase to sustain the level of economic activities and imports). Therefore, one of the desirable changes is to eliminate the deficit deterioration criteria as a pre-condition for FLEX disbursements.

The initial scale of FLEX disbursements was very modest (see Table 2), though it has increased since the recent modification, both in terms of number of countries and amounts eligible for grants which reached 13 countries and 77 million euros for 2003, with a similar amount estimated for 2004.

Table 2
FLEX grants made

	Number of Countries	Amounts
2000-2002	6	Euro 36 million
2003	13	Euro 77 million

Source: European Commission (2005)

Furthermore, between 2000 and 2002, only 20 percent of the requests by countries with export losses, fulfilled this criteria for FLEX, whereas with the modified less restrictive criteria, 68 per cent of the requests by countries with export losses fulfilled the criteria for FLEX. Drawing on EC information, it can be calculated that if there had been no public deficit criteria in 2003, the number of countries that could have received grants would have increased from 17 to 24!

There is also a more immediate problem of availability of resources. Even though 17 countries were eligible for FLEX resources in 2003, only 13 got the grants, because in four cases country-specific resources were already exhausted when the country became eligible for FLEX. Guyana figured as one of the 4 eligible countries that did not receive the grant in 2003, because its own budget had already been exhausted due to previous withdrawals in 2000 - 2002 (see below).

Thus, there is not just a problem of possible adaptation of criteria, but also a limitation of resources, which impedes country meeting criteria receiving the grants. This seems to need urgent attention.

In this context, it is important to stress that FLEX seems a far smaller facility than Stabex in terms of aid disbursements (even though its design may be better). Indeed, Stabex represented about 18 per cent of total aid during Lome IV, and 31 per cent in Lome III. For countries that benefited from the instrument, it reached over 60 per cent during Lome III and IV.

Returning to the issue of the criteria, as the Commission, op. cit. points out, the countries which fulfil the first but not the second criteria and therefore are not eligible for FLEX are those with export values much lower than programmed public deficits (this has often been the case for Ethiopia, Eritrea, Niger, Rwanda, Uganda or Madagascar), or low government revenues as proportion of GDP. Whilst it is clear that ACP countries should improve such ratios, it seems very strange to exclude them from aid, as a result of shocks, because these ratios are low, especially as they clearly have a need for such aid. More broadly, these and other countries should have the room to pursue counter-cyclical fiscal policy to help sustain growth; therefore, they may need FLEX - or other aid - the most, for example to help fund safety nets, to avoid negative impact on poverty.

Once a country meets the criteria, and it has a satisfactory macro-economic situation, (established either because it has an IMF programme or as evaluated by European Commission economists) it can receive FLEX as programme support. In macro-economic aspects, except for the rather strange fiscal criteria, FLEX conditionality seems relatively flexible. If the macro-economic situation is not satisfactory, the country can receive funding via new projects. This will add further time that the country needs to wait, in what is already a rather lengthy process. As time is of the essence, to avoid unnecessary import compression, ways could be found to accelerate disbursements. For example, in the original IMF's CFF, shortfalls could be calculated not just for the calendar year, but for any 12 months period (thus not waiting necessarily for December).

Whilst it is true that FLEX has a number of limitations (problems in its criteria, slowness of disbursements, apparent restriction on resources, and somewhat small scale) it does have several advantages, of which perhaps the main one from the ACP countries' perspective is that it gives grants. However, if FLEX were to be improved, and its limitations modified, one major problem would remain. FLEX only is available for ACP countries, which excludes a large number of low-income countries, especially in Asia, though some also in Latin America. Indeed, countries like Nicaragua – which has been hit by recurrent shocks – cannot apply for FLEX, though it would greatly benefit from it. The EU does have programmes in those two regions, but not of the kind that FLEX belongs to. This poses a dilemma for how a programme like FLEX could be generalised to include other low-income countries, besides the ACP ones, and possibly also how other (non-European) donors could be integrated. We will return to these broader architecture in Section V below.

c) IMF support for trade-related balance of payments adjustments

Whatever the limitations of financing terms of trade shocks, it is very positive that the IMF has proposed a new mechanism (the Trade Integration Mechanism - or TIM) to mitigate negative effects of WTO agreements that might give rise to temporary balance of payment shortfalls.

A balance of payments need might result from the erosion of tariff preferences in important export markets, adverse changes in food terms of trade, or the expiration (in 2005) of quotas under the WTO's textiles agreement. According to the IMF, ‘shortfalls are unlikely to be large for most countries, and would eventually be dominated by the positive impact of more open trade. Nevertheless, they could be significant in the short run for some countries’ (IMF, 2005).

TIM details how the Fund would provide access to its resources to meet a balance of payments need associated with trade-related adjustments. In particular, the IMF would:

- discuss with countries facing such balance of payments shortfalls, new arrangements within its existing lending facilities (i.e. the Poverty Reduction and Growth Facility (PRGF));
- take into account the anticipated impact of the trade adjustment on the member's balance of payments in determining size of access under both new and existing arrangements (the "baseline feature"); and

- be prepared to augment arrangements under simplified procedures if the actual balance of payments effect turns out to be larger than anticipated (the "deviation feature").

The TIM is not a special facility. Rather, it is a policy designed to increase the predictability of resource availability under existing facilities.

The TIM is expected to create an increase in IMF financing, for two reasons. First, the explicit emphasis on trade adjustments will ensure that they are carefully estimated and incorporated into the Fund-supported programme. Second, the deviation feature provides countries with a greater degree of certainty that larger-than-anticipated adjustments can be accommodated.

A member country could request consideration under the TIM if it expects a net balance of payment shortfall as a result of measures implemented by other countries that result in more open and non-discriminatory market access. Such measures would normally be introduced either (i) under a WTO agreement of (ii) on a non-discriminatory basis.

A Fund policy aimed at addressing financing needs arising from multilateral trade liberalisation is justified on several grounds. First, the TIM would help ensure that a common framework of analysis and financial support is applied across the membership. Second, the events that are the subject of the policy are predictable and largely exogenous from the perspective of individual members. Third, and most importantly, the TIM would represent a concrete expression of policy coherence.

Quota expiration, preference erosion and other WTO related initiatives are developments affecting Nicaragua, Honduras and Guyana directly. These countries would therefore clearly benefit from TIM. Guyana, for example, faces a major trade shock and thus sustainability issues over the medium term, due to a fall in sugar prices associated with WTO-linked changes in the European sugar market. Obviously, Nicaragua and Honduras are also facing the eminent prospect of CAFTA, considered by their policy makers and politicians as a major trade shock. But, since it is a regional initiative, it might be more appropriate that its short-run social and economic impacts are dealt with through US funding, in the same way the EU has done through its structural funds, rather than through extending TIM to include trade shocks related to regional agreements.

It seems premature to judge TIM since it has so recently been launched. Its design seems to have interesting features, which could very usefully be applied to facilities dealing with terms of trade shocks. This relates to having both an ex-ante baseline scenario, and a deviation augmentation feature; furthermore, augmentation lending due to deviations from baseline "would not normally involve any additional conditionality" (IMF 2004b). This seems a very positive feature which as argued in Section IIa above would be very valuable if extended to terms of trade shocks, which affect some of the poorest countries.

Secondly, recent Fund projections (IMF 2005b) seem to forecast a relatively fairly high level of TIM use, projected over SDR 100 million in 2005 and 2006, linked to the elimination of quotas on textiles and clothing, whose impact should be concentrated in those years. For later years, it projects around half of that amount, that is over 50 million SDRs. It is unclear to what extent this will allow meaningful support, but it is encouraging that the mechanism is in place.

For purposes of comparison, the same Fund document uses history to provide guidance for potential needs linked to PRGF augmentations for terms of trade. Since 1988, ESAF/PRGF augmentations reached only SDR 40 million per annum. During the same period, use of the CFF by PRGF eligible countries also reached about SDR 40 million per year; since 2000 there has been no use of CFF, whilst PRGF augmentation reached SDR 54 million per year. The IMF document assumes that the second window of PRGF will generate little additional demand.

These latter figures, together with the amounts granted through FLEX (discussed above) shows that the scale of loans and grants for terms of trade shocks since 2000 has been really very modest.

In the next section (and in Appendix 1), we will discuss in greater detail the countries' views on shocks financing, and analyse some country statistics focusing on the magnitude of adjustment the countries have undergone in response to shocks. It will show that these countries have suffered a great deal in terms of foregone output and poverty increase, as a result of shocks, and due to the fact their access to external assistance to deal with economic shocks was extremely limited. Section V then will turn back to more general conclusions.

IV Nicaragua, Honduras and Guyana: Further Views and Statistical Analysis

The discussion thus far on the existing and proposed mechanisms for dealing with economic shocks reflects very much the broad views of the governments of the countries covered by this study, as well as our own detailed analysis. The countries' policy makers also called attention to the potential role of regional agreements to deal with shocks. Box 1 briefly describes an existing regional initiative – the San Jose agreement – and makes reference to a proposal for a regional fund to deal with shocks.

Box 1. Central American Regional Initiatives

An example of a regional initiative to deal specifically with shocks is the San Jose agreement. It involves the Central American countries plus Mexico and Venezuela, and concerns oil exported from Mexico and Venezuela to Central America. Beyond a certain price, Central American country governments can apply for loans from Mexico's and Venezuela's government equivalent to up to 20% of the oil revenues to strengthen their reserves. They moreover can borrow to fund development projects on a concessional basis. Although they see this initiative as conceptually interesting, they remark that it lacks flexibility. Borrowing can only be made by governments, while in some cases (e.g. Nicaragua) oil is imported by the private companies, thus being an impediment for the government to benefit from the agreement. Moreover, loans to strengthen reserves are based on market rates, but the countries under the PRGF are not permitted to borrow on non-concessional terms. A further important aspect is that oil prices are not subsidised when oil prices rise, despite demands from the Central American countries.

A further regional initiative was proposed, but not implemented in 2001 to create a Central American Fund to deal with shocks. It would be similar to FLAR, the Andean Community Fund to support countries facing balance of payments problems. The main problem facing this proposal was the lack of resources to take it forward.

Although these initiatives are seen as welcome, and should be fostered, the countries' policy makers themselves recognise that they face the serious problem that there is not sufficient money available in the countries from the region to support them. In addition, in the specific case of the San Jose agreement, help from Mexico and Venezuela – two larger Latin

American countries that are part of the agreement – is expected to be provided mainly in the form of non-concessional loans. However, this is not consistent with the HIPC and PRGF terms, which require a high degree of concessionality for any new loan contracts.

Thus, whilst regional agreements have clear financing limitations, mechanisms at the international level that can provide the resources these countries need to deal with shocks appropriately are also very limited.

Funds for dealing with shocks, regional or otherwise, are seen as crucial by Nicaragua, Honduras and Guyana, as they are faced by a variety of shocks. As one policy maker put it, 'it is important to address them, because shocks feed inflation and affect the most vulnerable groups more strongly'. But the funds to deal with economic shocks internationally are not available in sufficient amounts to meet their needs, take too long to be disbursed, and experience shows they are not easy to access. Despite having suffered various shocks in the recent past, none of these countries had access to the CFF or to an augmented PRGF, and only Guyana had access to FLEX, as both Nicaragua and Honduras are not ACP countries.

Nicaragua applied for a HIPC topping up, which is an instrument under HIPC to bring countries back to debt sustainability levels when hit by a shock. But the response was negative. According to Nicaragua's government authorities, in the Fund's assessment the shock was not deep or long enough for providing a relief. Nicaragua's authorities did not insist, as they feared it could delay the enhanced HIPC completion point, eventually reached in early 2004.

All three countries are at present suffering from the oil shock. But none of them has had access to additional assistance to deal with the shock and their effects. The social and economic effects are very strong and widespread. The shock has put pressure on inflation and fiscal spending, with wages, transport subsidies and electric tariffs going up. Their view is that the Fund has not been flexible in this context. It requires an overall programme thus making the whole process very complex to negotiate.

Looking forward and as pointed out in the previous sections, assistance to deal with shocks should be made available quickly, with low conditionality and high concessionality, the latter especially in light of their still high debt levels, despite the enhanced HIPC initiative. Nicaragua, for example, which reached its completion point in 2004, has nowadays its NPV to exports ratio at 176%, and is expected to reach the sustainability level of 150% only in the year 2014, assuming new debt to be incurred will have a concessionality rate of 60% (BCN, 2005).[3]

These countries' strong preference for grants rather than loans to deal with shocks is also based on the understanding that shocks have major social repercussions, which require grants financing to avoid repayment problems in the future. Loans are more appropriate for productive projects.

Also, these countries' views are that there have been too many actors involved, each undertaking their own agendas. So, there is a need for higher co-ordination among the donor

[3] These calculations also include debt relief by countries outside the Paris Club. For Nicaragua, these countries are numerous, and unwilling to accept the terms of the HIPC initiative. At the same time, if the G-8 proposal for debt cancellation is implemented, and if the year to be considered is 2004, then the NPV to exports ratio decreases to 136% (interview material).

community, with an integrated vision. These problems relate to aid in general, but are reflected in financing for dealing with shocks (see below).

A suggested option would be to have a permanent mechanism available for shocks with the bilaterals, rather than with the multilateral institutions. The bilaterals are seen as more flexible and quicker. Moreover, the countries' negotiating capacity with them is bigger. Their relationship is seen as horizontal and more agile. However, the problem with the bilateral route is that at present donor countries do not have resources to put aside, or in some cases see the opportunity costs of doing so as too high. In face of that, it might be preferable that donor countries put resources in a multilateral pot, though this would of course imply a trade-off, as some of the agility in bilateral relations would be lost.

The countries acknowledge the importance of preventive actions. There have been initiatives to diversify production away from coffee following the collapse in coffee prices. As regards natural shocks, Central American countries have created a Co-ordination Centre for the Prevention of Natural Disasters in Central America – CEDEPRENAC.[4] Its aim is to have preventive plans, financed by various external sources. It also works as a forum for the exchange of information and experiences derived from existing systems and actions at the national level.

In Honduras, a number of actions have been taken to: 1) protect zones vulnerable to flooding, so that losses of production, jobs and income can be avoided; and 2) reduce losses in the agricultural sector caused by drought. In the first case, actions have taken the form of flood control works, and these have been financed with resources from the national budget; in the second case, a Multi-Sector Committee on Drought (COMUS) has been created. It comprises both preventive and mitigating actions, and integrates actions by all sectors (the central and local governments, international donors, NGOs and civil society). It integrates different actions, including the built up of institutional capacities, the strengthening of early warning systems, rescue actions, more sustainable agricultural and livestock production, credit for reducing risk and crop diversification (PRSP PR, 2004).

Nicaragua has in place the National System for the Prevention and Mitigation of Disasters (SINAPRED).[5]Created in April 2000, it is aimed at co-ordinating all aspects of disasters, from prevention to monitoring and mitigation. It integrates various government institutions. Linked to this national system, Nicaragua has the long-established Institute for Territorial Studies (INETER), which generates information, undertake studies and maintain a large information and monitoring networks in various areas including meteorology, geophysics, cartography, and hydric resources – see Box 2 for more details.

[4] CEDEPRENAC is the Spanish acronym for *Centro de Coordinación para la Prevención de los Desastres Naturales en América Central*.
[5] SINAPRED is the Spanish acronym for *Sistema Nacional para la Prevención, Mitigación y Atención de Desastres*.

Box 2. Nicaragua's Institute for Territorial Studies – INETER

Ineter is funded with resources from the national budget to cover all recurrent expenditures. For investment projects, it has both national and external funding (from the World Bank, IADB, DFID, and multilaterals such as Norway, the Czech Republic and others). Among their various activities, they have a project with the World Bank in which they monitor the pluviometric index for areas that produce maize. In case the index falls below a minimum level, an insurance mechanism by the World Bank is activated. The Institute points out that, private insurance mechanisms more broadly, have a very limited impact, as they benefit only a limited number of producers.

The institute suffers from severe budget constraints to undertake their work. Financing from the international organisations are targeted at specific projects, and to support experts (foreign, national) to conduct studies. Although such financing is welcome, it is limited in their view, in face of their needs for research and technical development. There is some support from bilaterals for technical assistance and capacity, but not for systematic technical capacity building. More importantly, there is a lack of support to maintain their information and monitoring networks. Progress has been made since the Mitch disaster, but, in their view, the international organisations lack co-ordination and an integrated approach, that could address their needs.

Thus, progress can be noticed in the area of preventive and mitigation actions for natural disasters, and the establishment and/or strengthening of institutions to reduce the countries' vulnerabilities to disasters.

Although more needs to be done, natural disaster related assistance has been far bigger than that to deal with economic shocks, which are less visible. As noted above, Nicaragua and Honduras have not received any international assistance directly targeted at economic shocks, despite having suffered many of these in the recent past. Guyana was eligible for FLEX funds in 2000 and 2001, but when it applied for the fund again in 2003, although it met the eligibility criteria once again, it did not receive the resources as these had already been exhausted.

In what follows, country external sector statistics are provided for Nicaragua to show that the responses to a fall in export earnings due to shocks have been to adjust to lower import capacity. The same statistics are provided for Honduras and Guyana in Appendix 1. The latter show that Guyana went through a similar adjustment, but not so much Honduras, which benefited from rapid increase in family remittances, thus allowing for a milder adjustment.

Nicaragua

Nicaragua experienced moderate to strong growth in the second half of the 1990s – an average of 5.4% a year during the 1995-1999 period, with a maximum rate of 7% in 1999 – in part as a reflection of the Mitch recovery efforts. Early this century, growth declined sharply, reaching a minimum of 1% in 2002. In per capita terms, it turned negative in 2002 (see Table 3). This deceleration was due to a terms of trade shock and slow down in the world economy, but also to domestic factors, such as a banking crisis, which contributed to growing fiscal imbalance and overall uncertainty.

The banking crisis was rooted in poor financial regulation and frauds. In addition, it was to some extent related to the terms of trade shock. This is because the fall in coffee prices (Nicaragua's principal export) affected the profitability of coffee producers and thereby their ability to honour their loan contracts with the banking sector. So, the terms of trade shock also affected the economy indirectly through contributing to the banking crisis. More

seriously, the banking crisis has long-term effects on growth and social spending and credit provision, as it led to a sharp increase in domestic debt, higher interest rates and decline in credit. Today, banks' portfolios are biased away from credit and towards government bonds.

Table 3: GDP Growth – Nicaragua 1995-2004

%

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*[1]
Total	5.9	6.3	4.0	3.7	7.0	4.1	3.0	0.8	2.3	5.1
Per capita	2.9	3.4	1.1	0.9	4.2	1.4	0.3	-1.6	-0.3	5.1

Sources: ECLAC and BCN. [1] Preliminary.

The terms of trade shock was felt through a steep fall in export earnings of Nicaragua's main export products, such as coffee, though it was compensated by the increase in non-traditional exports and exports from the free-trade zones. Overall, export growth decelerated sharply at the turn of the century. Reflecting the downturn of economic activity, import growth decelerated in tandem. If only merchandise trade is considered, both exports and imports fell in 2001 and 2002 (see Table 4).

Table 4: Exports, Imports and Trade Balance – Nicaragua 1995-2004

US$ million

	Exports					***Imports***				***Trade deficit***
	Merchandise	Free Zone	Other	Total	Annual Growth%	Merchandise	Free Zone	Total	Annual Growth%	
1995	466.0	75.2	3.8	545.0	45.0	881.4	48.1	929.5	15.6	384.5
1996	466.4	124.3	4.5	595.2	9.2	1043.4	78.3	1121.7	20.7	526.5
1997	576.7	163.1	5.0	744.8	25.1	1370.6	102.5	1473.1	31.3	728.3
1998	573.2	181.6	6.2	761.0	2.2	1397.0	112.6	1509.6	2.5	748.6
1999	546.1	196.3	6.2	748.6	-1.6	1698.1	121.7	1819.8	20.5	1071.2
2000	642.8	230.7	7.1	880.6	17.6	1653.2	148.3	1801.5	-1.0	920.9
2001	589.4	296.3	9.6	895.3	1.7	1617.3	187.8	1805.1	0.2	909.8
2002	561.0	347.0	8.7	916.7	2.4	1598.8	235.5	1834.3	1.6	917.6
2003	604.5	433.7	11.4	1049.6	14.5	1720.2	300.9	2021.1	10.2	971.5
2004	755.6	490.7	10.6	1256.9	19.8	2022.0	346.8	2368.8	17.2	1111.9

Source: Banco Central de Nicaragua (BCN).

Table 5 shows the trend in Nicaragua's terms of trade during the 1990s and early this century. It also shows the value of exports of the main export products. Taking 1995 as a base year, it shows that by 2002 and 2004, the terms of trade had declined by over 32% and 35%, respectively. The fall in coffee prices was a major determinant of the terms of trade decline, and was reflected in the country's export values of coffee, which fell by 60% between 2000 and 2002. Coffee prices have recovered in the past couple of years, yet the terms of trade continued to decline further due to the rise in oil prices, on whose imports Nicaragua is heavily dependent, with 80% of the country's energy sources coming from oil. In 2004, crude oil and fuel and lubricants accounted for 21% of Nicaragua's total merchandise imports (BCN, 2005). Nicaragua's dependence on oil is larger than in neighbouring countries. The latter countries succeeded in different degrees in diversifying their energy sources. Unlike their neighbours, Nicaragua has failed to make any meaningful progress in this area due to a lack of an appropriate legal framework for investment in alternative energy sources, such as hydroelectric power.

Table 5: Terms of Trade and Main Exports - Nicaragua

Selected years

Terms of trade base year 1995 = 100							
	1990	**1995**	**2000**	**2001**	**2002**	**2003**	**2004**
Terms of Trade for goods	119.1	100.0	77.3	68.4	67.3	65.0	64.6
Export values US$ million							
	1990	**1995**	**2000**	**2001**	**2002**	**2003**	**2004**
Coffee	76.2	119.7	170.5	98.4	69.2	85.9	126.8
Bovine meet	67.3	55.0	52.2	65.4	81.3	84.1	
Crustacea and molluces	8.8	69.8	118.3	33.0	35.6	73.2	
Gold	14.3	Nd	22.7	29.8	31.7	35.1	45.2

Authors' elaboration. Sources: ECLAC and Banco Central de Nicaragua (BCN).

Deceleration of export growth was a key factor in explaining the slow down of Nicaragua's economy in early this century, reflecting terms of trade decline, and the slow down in the world economy, as pointed out earlier. But through what other channels have the latter factor – the world economy slowdown – also affected Nicaragua?

Official and Private Flows

Net transfers to Nicaragua went up sharply in 1999 following the Mitch Hurricane, falling back in 2002-2002 to levels slightly above those observed in the 1996-1998 period. At first view, it does not seem that world recession affected the country through reduced provision of financial flows. Net transfers were stable and even slightly increased during the world downturn.

Table 6: Net Resource Transfers to Nicaragua – 1996-2004

US$ million

1996	**1997**	**1998**	**1996-1998 Average**	**1999**	**2000**	**2001**	**2002**	**2000-2002 Average**	**2003**	**2004**
554	749	471	**591**	888	573	577	741	**630**	706	866

Source: ECLAC.

Table 7: Selected Flows to and from Nicaragua – 1995 and 1998-2004

US$ million

	1995	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
FDI	89	218	337	267	150	204	201	261
Profit remittances	-29			-70	-77	-71	-77	
Interest paid						-38	-34	-27
Interest rescheduled and forgiven						92	85	94
Family remittances	75			320	336	377	439	519
Transfer to the public sector (grants)		194	307	309	295	248	286	284

Sources: ECLAC, BCN and IMF.

Table 7 displays different types of financial flows, into and out of Nicaragua. There is no particular type of flow that has oscillated sharply over the 2000-2002 period, except perhaps

for the significant drop in FDI in relation to 1998-1999. Official flows did not exhibit a major decline, apart from official grants, which declined if 1999 is taken as a benchmark year. The only flow that exhibits an upward trend has been family remittances, thus emerging as an increasingly important external financing source.[6]

The Central Bank of Nicaragua provides information on grants and loans by categories of donors and lenders for the 2002-2004 period. These are displayed below (see Table 8).

Table 8: Grants and Loans, by Donors

US$ million

Total Grants			
	2002	**2003**	**2004[1]**
Bilaterals	201.1	217.7	172.0
Germany	25.7	28.1	14.0
US	26.7	45.7	28.2
Canada	2.0	2.2	4.3
Denmark	13.9	27.0	31.1
Spain	7.4	2.9	1.7
Finland	3.7	7.9	6.4
Sweden	33.6	33.2	26.0
Switzerland	3.4	7.8	10.0
Holland	9.8	19.6	14.8
Norway	4.2	5.0	4.1
Japan	53.7	22.3	17.1
Multilaterals	47.1	68.3	111.5
EU	25.4	36.4	69.0
Official Loans			
Bilaterals	12.1	29.4	7.9
Spain	6.1	13.6	7.6
Multilaterals	190.6	257.8	326.6
IADB	103.9	98.6	139.8
IDA	71.1	112.2	126.1
IMF	9.2	29.6	41.2

Source: BCN. [1] Preliminar.

In the years 2002-2004, the major donor countries have been Germany, the US, Denmark, Sweden and Japan. Among the Multilaterals, the EU has been a major donor. In terms of official loans, the largest country provider has been Spain. Among the multilaterals, the largest providers have been the IADB, IDA and the IMF. Nicaragua benefited in the period from debt forgiveness in a major way, which was granted under the enhanced HIPC, especially in 2004 when the country reached the completion point. Debt relief was granted mainly by the Paris Club, country governments outside the Paris Club and, among the Multilaterals, the BCIE.

Notwithstanding debt relief granted by the international community, the country has not reached debt sustainability, when the NPV of debt-to-exports ratio is used. As mentioned above, it is nowadays at 176%, and is predicted to reach 150% only in 2014. Moreover, these numbers do not take account of the fact that a significant number of bilateral donors outside the Paris Club do not feel committed to the HIPC initiative.

[6] Net current transfers, of which family remittances is the main component, do not enter in the calculations of net resource transfers, which are taken from ECLAC and defined as the difference between net capital inflows and net income.

Nicaragua is at present experiencing an oil shock, just when it was recovering from the terms of trade shock and world recession occurred in the 2000-2002 period. Nicaragua has been vulnerable to these shocks, given its narrow economic structure and export base, the latter concentrated in a few primary commodities. Export diversification is slowly taking place, mainly through the expansion of free trade zones, but this phenomenon is still incipient. Moreover, the export zones concentrate on the production of textiles, which are vulnerable to China's competition in the US markets. On the positive side, CAFTA potentially opens new opportunities for Nicaragua's exports, though CAFTA itself is seen by Nicaragua's senior policy makers as another shock facing the economy.

Nicaragua's resilience to these shocks has been lowered by the recurrence of not only economic shocks but natural disasters of various sorts. These include hurricanes, droughts, floods, earthquakes and volcanic eruptions. The hurricane Mitch in 1998 alone caused flooding and landslide, with dire economic effects. The agricultural and export sectors faced major losses. The social effects were daunting, with whole communities - amounting to 20% of the country's population - displaced, and some buried. The social and economic infrastructures were badly affected, with 500 schools being disrupted, 300 health centres damaged, and 25% of transport lost (PRSP, 2001).

The recurrent natural disasters have caused increased environmental deterioration. Efforts to diversify the economy through agricultural expansion eastwards have aggravated environmental damages thereby increasing people's vulnerability to shocks.

How has the international community responded to the Mitch and subsequent shocks?

The Hurricane Mitch of 1998 prompted the international donor community to get together at an emergency Consultative Group (CG) meeting in Washington DC in December 1998, and again in Stockholm in May 1999, when a financial package in support of a comprehensive reconstruction programme was elaborated. The response to the emergency situation and reconstruction needs following the Hurricane Mitch were later followed by a series of financing support comprising both shocks related and long-term development finance over a period marked by new shocks (economic and otherwise) and MDG-based development efforts centred around the PRSP process. Table 7 summarises the main financing support Nicaragua has received from 1998 onwards from the Bretton Woods institutions, in chronological order.

Table 9: Types of Donor Support – Nicaragua

End-1998 Onwards

Date	***Type of Assistance***	***Value pledged/disbursed***
December 1998	World Bank Hurricane Emergency Project	US$ 50 million
January 2000	World Bank Economic Management	US$ 21 million
December 2000	Enhanced HIPC Decision Point	
April 2001	Natural Disaster Vulnerability Reduction	US$ 14 million
June 2002	Cooperation Forum among Donors	
December 2002	IMF PRGF (through Dec 2005)	SDR 98 million approved; 56 million disbursed
March 2003	World Bank Programatic Structural Adjustment Credit	US$ 15 million
January 2004	Enhanced HIPC Completion Point	US$ 3,308 million
January 2004	World Bank PRCS	US$ 70 million
March 2004	World Bank Sector TA Project	US$ 24 million

Sources: IMF and World Bank, various documents.

Given Nicaragua's efforts to reduce its foreign debt, its position today in regards to shocks financing is that such financing should be highly concessional or in the form of grants. Government authorities say that the level of concessionality should be 60% or above, otherwise the country will have its debt profile aggravated rather than improved. The PRGF resources have a concessionality of about 35%, which is considered low. So any resources for dealing with shocks under the PRGF (augmented or otherwise) should have a higher concessionality rate.

The PRGF framework emphasizes the need to be cautious towards new debt contracts. It forbids the country to raise new loans that are non-concessional, and requires that new loans have a concessional rate of at least 35%, which is the rate the PRGF programme provides.

V Concluding remarks on a shocks architecture

The world economy - and developing countries - have changed since compensatory financing was first introduced; for example, many developing countries are now less dependent on commodity exports. However, many of the low-income countries are still very dependent on a few - or one - commodity exports. As a result they are very vulnerable to terms of trade shocks, and in practice have few options to moderate their impact. The consequence has been a high degree of macroeconomic volatility, which is precisely what the BW institutions aim to address with their policies, so that long-term growth is not undermined. Therefore, appropriate official compensatory financing mechanisms have a very important role to play. Whilst it is very welcome that new trade shocks (e.g. end of textiles and clothing quotas) are addressed with new facilities, it seems equally important to improve significantly compensatory financing for terms of trade shocks.

The following broad suggestions, are borne from the analysis above, and from the relevant literature:

1. Scaling up

   The scale of existing facilities, and of resources - including for grants and for subsidies to allow concessionality of loans - are too small, in proportion to the shocks. This seems perhaps the most important conclusion.

   In a context of scaling up of aid, or of the implementation of the IFF which would frontload aid fairly significantly, higher resources should be allocated for shocks. This would need to be linked to less restrictions (e.g. higher per cent of IMF quota for access; more flexible FLEX criteria) on the scale of facilities, so a far larger proportion of shortfalls of exports (measured in real terms) could be financed.

2. Both loans and grants are valuable

   Grants are more useful for more permanent shocks, or shocks (e.g. natural disasters) with more permanent effects. However, official lending has an important role to play as potentially speedy, and may provide incentives for changes in economy, to reduce its vulnerability.

3. IMF lending for terms of trade shocks need far reaching changes

   There should be some simplification, as facilities are too many (e.g. within PRGF). Indeed, low-income countries are not even acquainted with – or fully understand – all the facilities available (interview material). Lower conditionality is clearly needed, and this should be made explicit in Board discussions and documents. There is no justification for upper credit conditionality for external shocks, for countries with reasonable policies. A possible way forward to avoid excessive conditionality in times of shock, that could be more acceptable to the IMF, would be - for countries with PRGFs, PSIs or other shadow programmes - to have a baseline scenario for their programme, but embedded in these programmes automatic augmentations for terms of trade shocks, just as these are included for other trade shocks in TIMs.

   Concessionality of lending (possibly even higher than now) is highly desirable, especially for heavily indebted low-income countries.

   It would be very important if export shortfalls were measured in real terms, or a new Oil Facility was activated. Economic analysis shows clearly that the relevant variable is capacity to import, in real terms.

   Finally, very modest limits need to be expanded, so shortfalls are more fully met.

4. Grants need a focal point

   A potential focal point for all grants for this purpose could be the European Commission, in spite of the many limitations of FLEX, which could however be overcome especially if its scale was increased (see IIb for more specific proposals).

However, the key problem for the Community being a focal point is coverage of countries, as many low-income countries are excluded.

An alternative is for the World Bank to play a coordinating role, in assessing (with possible help from the IMF) country needs, and linking up with donors to provide necessary resources for trade or other shocks. The conditions under which such aid would be given should be particularly linked to diversification of the economy, and other measures to decrease countries' vulnerability to shocks - areas in which the World Bank has expertise. Though well qualified for this latter role, a problem may be that the World Bank has limited experience in systematically dealing with providing finance for trade shocks. Though its programmes sometimes are expanded as a result of such shocks the World Bank does not have specific facilities to deal with them. Furthermore, countries themselves seem to prefer dealing with bilaterals, which they consider more agile.

5. <u>There may be a case for one grant facility to deal with trade shocks</u>

Drawing on the experience of the £1 billion U.K. Emergency Facility, a special grant facility could be created by donors to deal with trade shocks. The desirable scale and other characteristics e.g. how run, what type of conditions for disbursement, of such a facility would require further more detailed study, and - naturally - discussions amongst donors. Ideally, such a Trade Facility could replace (by including) existing grant mechanisms.

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Appendix 1: Statistical Analysis for Honduras and Guyana

Honduras

Honduras's GDP growth started to pick up in the second half of the 1990s, after years of poor growth performance. But this new trend was interrupted by the Mitch shock, with growth decelerating sharply in 1998 and turning negative in 1999 (-4.5% in per capita terms; see Table 1.1). The social costs were huge, with deterioration of headcount poverty and non-income indicators (IMF, 2003). The economy rebounded in 2000, but decelerated again in 2001 and 2002 due to the terms of trade shock, drought due to 'El Nino' and 'La Nina', and world recession. Recovery started in 2003, with growth reaching 4.6 in 2004. It is projected to be at 3.5-4.0% in 2005.[7]

Table 1.1: GDP Growth – Honduras 1995-2004

%

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*[1]
Total	4.1	3.6	5.0	2.9	-1.9	5.7	2.6	2.7	3.5	4.6
Per capita	1.1	0.7	2.1	0.1	-4.5	3.0	0.0	0.1	1.0	2.1

Sources: IMF and ECLAC. [1] Preliminary.

There is a close relationship between GDP and export growth patterns in Honduras. Exports witnessed strong growth in the second half of the 1990s until 1998, but turned negative at 15% in 1999, as a reflection of Mitch effects on Honduras' primary export sector. Exports recovered sharply in 2000, but once again growth turned negative in 2001. The trend in imports' followed closely that of exports, but not so much on the downside. In 1999, imports' growth was smaller than in previous years, but was maintained positive, at over 6%. This was made possible by the large external financing made available by the international community in that year. In 2001, when exports turned negative again due to the terms of trade shock (it fell by nearly 4%), imports increased by 3.7% (see Table 1.2). The result was a widening of the trade gap in that year, which partly reflected the fact that growth decelerated less than exports, as it was maintained positive while exports values fell in absolute terms.

Two differences can be noticed between Nicaragua and Honduras regarding their trade performance during the 2000-2002 period. While growth of Nicaragua's exports decelerated but was maintained positive, Honduras' exports had negative growth in 2001, even after including maquillas' exports. However, Honduras' adjustment was relatively less strong than in Nicaragua, which was reflected in the widening in the country's trade deficit. The counterpart of the external adjustment was that GDP growth dipped much deeper in Nicaragua than in Honduras, despite the fact that total exports in the former deteriorated less dramatically.

[7] Interview information.

Table 1.2: Exports, Imports and Trade Balance – Honduras 1995-2004

US$ million

	Exports				***Imports***		***Trade deficit***
	Merchandise	Maquilla	Total	Annual Growth %	Total	Annual Growth %	
1995	1297.7	162.7	1460.4	27.9	1571.1	12.3	110.7
1996	1417.6	203.7	1621.3	11.0	1758.9	12.0	137.6
1997	1534.3	312.7	1847.0	13.9	2038.7	15.9	191.7
1998	1611.9	454.9	2066.8	11.9	2370.5	16.3	303.7
1999	1217.8	538.5	1756.3	-15.0	2509.6	5.9	753.3
2000	1436.2	575.4	2011.6	14.5	2669.6	6.4	658.0
2001	1374.7	560.8	1935.5	-3.8	2769.4	3.7	833.9
2002	1364.3	612.8	1977.1	2.1	2806.1	1.3	829.0
2003	1384.3	710.0	2094.3	5.9	3059.0	9.0	964.7
2004	1580.5	830.7	2411.2	15.1	3678.5	20.3	1267.3

Source: Banco Central de Honduras (BCH).

Why was adjustment in Honduras less pronounced?

As in Nicaragua, the deceleration in exports' growth reflected a decline in the terms of trade, with a fall in the value of exports of the country's main exports, i.e., banana and coffee (Table 1.3).

Table 1.3: Terms of Trade and Main Exports - Honduras

Selected years

Terms of trade base year1995 = 100							
	1990	1995	2000	2001	2002	2003	2004
Terms of Trade for goods	80.9	100.0	103.8	98.4	95.5	91.3	Nd
Export values US$ million							
	1990	1995	2000	2001	2002	2003	2004
Banana	357.9	214.4	124.3	204.2	172.3	132.7	208.3
Coffee	180.9	349.3	339.4	160.7	182.5	183.3	251.8

Authors' elaboration. Sources: ECLAC and Banco Central de Honduras (BCH).

Looking at the financial flows, net resource transfers did increase in the period 2000-20002 in relation to the 1996-1998 period, but not markedly (Table 1.4). What really explains how Honduras managed to sustain and even widen its trade deficit was external financing in the form of family remittances, which is a main component of net current transfers, an item of the balance of payments that has been on the rise in the past several years and that moreover had a significant step change in the year 2001 (Table 1.5). Nowadays it corresponds to 15% of the country's GDP, and is predicted to reach US$ 1.8 billion in 2005.[8]

[8] Interview material.

Table 1.4: Net Resource Transfers to Honduras – 1996-2004

US$ million

1996	1997	1998	1996-1998 Average	1999	2000	2001	2002	2000-2002 Average	2003	2004
92	368	173	**211**	528	161	272	243	**225**	-20	411

Source: ECLAC.

Table 1.5: FDI and Net Current Transfers - Honduras 1995 and 1998-2004

US$ million

	1995	1998	1999	2000	2001	2002	2003	2004
FDI	50	99	237	282	193	175	198	195
Net current transfer of which family remittances is a main component	243	449	696	648	929	969	1092	nd

Sources: ECLAC, BCH and IMF.

Thus, a significant increase in external finance in the form of family remittances played a crucial role in permitting Honduras to maintain and even increase import capacity in 2001, a year in which exports declined.

Of course, that is not to say that, more broadly, external official financing did not help Honduras meet the financing challenges linked to external shocks. The Mitch Hurricane of 1998 was followed by a strong response from the international community in the form of additional external financing. The response was strong in face of the scale of the hurricane's effects. Most of Honduras' population - 80% - was affected, with losses of inventories and fixed assets being of 40% of the country's GDP (PRSP PR, 2005).

The international support to deal with the Mitch effects came mainly from the World Bank, the IADB and other regional banks, and also the IMF, the latter playing an important co-ordinating role as well as providing balance of payments support, which exceptionally did not involve conditionality.[9]

Table 1.6 summarises the main external financing support Honduras received from the BW institutions since the end of 1998, to deal with the Mitch effects, subsequent shocks, and to support implementation of preventive measures to protect against natural disaster shocks, and long-term development.

[9] At the time, the country did not have a PRGF in place - interview information.

Table 1.6: Types of Donor Support - Honduras

End-1998 Onwards

Date	***Type of Assistance***	***Value pledged/disbursed***
December 1998	World Bank Hurricane Emergency Project	US$ 200 million
December 1998	IMF emergency credit; acceleration of new PRGF discussions	US$ 66 million
January 1999	World Bank Supplemental Credit for Transport Sector Rehabilitation	US$ 20 million
March 1999	IMF PRGF (through December 2002)	SDR 157 million approved; 108 million drawn
December 1999	World Bank Supplemental Credit for Social Investment Fund Project	US$ 23 million
May 2000	World Bank Natural Disaster Mitigation	US$ 11 million
June 2000	Enhanced HIPC decision point	
September 2000	World Bank Economic and Financial Management Project	US$ 19 million
November 2000	World Bank Road Reconstruction and Improvement Project	US$ 67 million
December 2000	World Bank Social Investment Fund Project	US$ 60 million
June 2003	World Bank Financial Sector TA Credit	US$ 10 million
October 2003	World Bank Trade Facilitation and Productivity Improvement Project	US$ 28 million
February 2004	IMF PRGF (through February 2007)	SDR 71 million approved; 31 million drawn.
June 2004	World Bank PRSC	US$ 59 million
June 2004	World Bank PRS TA	US$ 8 million
February 2005	World Bank First Programmatic Financial Sector Development Policy Credit	US$ 25 million
April 2005	Enhanced HIPC Completion Point	US$ 556 million

Sources: IMF and World Bank, various documents.

As can be seen, a number of financial packages have been provided to support preventive action, though, as discussed above, these countries feel a more integrated approach is needed.

1) Guyana

Guyana has exhibited low GDP growth for several years, with annual average growth of 0.6 percent between 1998 and 2003 (Table 1.7), after high growth in 1995-1997.

Table 1.7: GDP Growth – Guyana 1995-2004

%

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*[1]
Total	5.1	7.1	7.1	-1.7	3.0	-1.4	2.3	1.1	-0.6	1.6
Per capita	4.6	6.5	6.5	-2.1	2.4	-1.8	1.9	0.9	-0.8	1.4

Sources: ECLAC and IMF. [1] Preliminary.

This performance reflected closely that of exports, which declined by over 17% between 1998 and 2001. Exports have recovered since 2002, but by 2004 had not reached the 1997 levels yet. The dismal export performance reflected successive external shocks, including drought caused by El Nino, lower prices of its main export products, the phasing out of preferential access to the EU sugar markets, and lower demand for timber following the Asian crisis. On the supply side, the country exports have suffered from a progressive depletion of gold reserves, though this has been compensated by prices, which have been on the increase. The decline in the country's total exports would have been even steeper were not for the emergence of the non-traditional shrimps' exports. Imports followed a similarly unstable path during the 1998-2004 period (see Tables 1.8 and 1.9).

Table 1.8: Exports, Imports and Trade Balance – Guyana 1995-2004

US$ million

	Exports		***Imports***		***Trade deficit***
	Total	Annual Growth %	Total	Annual Growth %	
1995	496	7.1	537	6.5	41
1996	575	15.9	595	10.8	20
1997	593	3,1	642	7.9	49
1998	547	-7.8	601	-6.4	54
1999	525	-4.0	550	-8.5	25
2000	505	-3.8	585	6.4	80
2001	490	-3.0	584	-0.2	94
2002	495	1.0	563	-3.6	68
2003	513	3.6	572	1.6	59
2004	589	14.8	647	13.1	58

Source: Eclac, IMF and Bank of Guyana.

Table 1.9: Main Exports - Guyana

Selected years US$ million

	1995	***1996***	***2000***	***2001***	***2002***	***2003***
Sugar	125.5	150.7	118.8	109.2	119.6	129.2
Rice	76.5	93.8	51.8	50.2	45.4	53.9
Gold	94.7	103.5	123.3	127.0	136.3	130.9
Bauxite	82.9	89.8	76.3	61.0	35.3	40.4
Shrimp	3.1	12.6	47.1	49.3	52.6	53.9
Timber	8.3	8.9	35.2	33.0	35.7	30.7

Source: Bank of Guyana.

The external shocks that hit Guyana thus left export levels stagnated between 1997 and 2004. This picture contrasts with Nicaragua and Honduras, where export growth was maintained, though at a lower level.

Table 1.10: Selected Flows to and from Guyana – 1995 and 1998-2004

US$ million

	1995	1998	1999	2000	2001	2002	2003	2004
FDI	74	44	46	67	56	44	26	30
Net current transfers	62	44	39	47	44	40	43	46
Medium and long term capital to the public sector	-27.2	23.9	32.5	52.4	39.4	19.7	16.0	14.1

Sources: ECLAC, Bank of Guyana and IMF.

Unlike Nicaragua and Honduras, Guyana did not benefit from increasing FDI or net current transfers in the form of family remittances. These two types of financial flows actually decreased sharply during the period, and were not compensated by increased aid flows (see Table 1.10).

Table 1.11 displays information on the types of support the country had from BW between 1997 and early 2005. None of these was aimed at helping the country deal with external shocks, with the exception of a US$ 9 million World Bank package to assist the country in coping with El Nino effects in 1998. Most of the external assistance was provided in the form of debt relief. In spite of this, the country's external debt level remains high (IMF, 2005). The country may get relief from the G-8 initiative, but part of the debt is with the IADB, and it is not included in the deal. Nicaragua is experiencing the same sort of problem.

Table 1.11: Types of Donor Support – Guyana

End-1998 Onwards

Date	***Type of Assistance***	***Value pledged/disbursed***
December 1997	HIPC Decision Point	
July 1998	IMF PRGF (through December 2001)	SDR 54 million approved, of which 25 million drawn.
October 1998	World Bank El Nino Emergency Assistance Project	US$ 9 million
October 1998	World Bank Debt Reduction Operation Project	US$ 6 million
May 1999	HIPC Completion Point	US$ 256 million
November 1999	World Bank Financial and private Sector Institutional Development Project	US$ US$ 4.8 million
November 2000	Enhanced HIPC Decision Point	
September 2002	IMF PRGF (through September 2006)	SDR 55 million approved, of which 27 million drawn.
December 2002	World Bank Poverty Reduction Support Credit (PRSC) Project	US$ 12 million
December 2002	World Bank Public Sector Technical Assistance Credit (PSTAC)	US$ 4.76 million
2003	World Bank Country Assistance Strategy (CAS) through 2006	
December 2003	Enhanced HIPC Completion Point	US$ 329 million
March 2004	World Bank HIV/AIDS Prevention & Control Project	US$ 10 million
January 2005	IMF request for waivers on 6 performance criteria	

Sources: IMF and World Bank, various documents.

As mentioned earlier, Guyana had access to FLEX funds, for which it applied in 2000 and 2001 successfully, and again in 2003 when it failed to receive the resources. The figures provided by the EC show that it received in total 8 million euros, which account for a small fraction of their export shortage.

Like Nicaragua and Honduras, Guyana has suffered from the rise in oil prices. In addition, it suffered a major flooding in January 2005. It clearly needs a compensatory facility, but resources from FLEX are closed due to country budget exhaustion. It received some limited external assistance to deal with the floods this year, but not from the WB institutions. The IMF has given a waiver for some PRGF performance criteria, but has not provided additional assistance to help the country deal with the floods.[10]

[10] Interview material.