

Compensatory Financing for Shocks: What Changes Are Needed?

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I. Introduction

One of the key aims of a development supportive international financial architecture –that is, one supporting growth and poverty reduction— is the provision of adequate countercyclical official liquidity in the face of external shocks.

External shocks tend to have very large negative effects on developing economies' growth, investment and poverty. As such, they can be very harmful for meeting the MDGs. When a developing country suffers an external shock, the trade balance, fiscal accounts and the overall level of economic activity suffers. 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 private investment, lower wages, higher unemployment, and therefore higher poverty (see for example Guillaumont *et al*, 2003; IMF, 2003).

These shocks are very costly both for low- and middle-income countries. Low-income countries have more limited room to build cushions of reserves and fiscal resources as a buffer against shocks. Such "self-insurance" in the form of higher reserves may have a particularly high opportunity cost for low-income countries, but also have high costs for middle-income countries.¹ These costs are both the opportunity costs of not using such reserves for higher investment or consumption as well as direct financial ones. The latter include both the social losses incurred by countries associated to the difference between interest rates earned on reserves and the average cost of external liabilities, as well as, for central banks, the difference between the former and the costs of open market operations (to the extent that the monetary effect of reserve accumulation is sterilized using this policy instrument). The decline of the U.S. dollar, in which these reserves are mainly held, has further added to these financial costs of holding reserves (see Rodrik, 2006 and Cortez, Izurieta and Vos, 2008). As a result, effective official compensatory flows can play a crucial role in avoiding unnecessary costs to developing countries and poor people, both by reducing the need to hold such high levels of reserves and – more importantly – by helping avoid unnecessary adjustment. As regards the former, the existence of adequate and reliable official compensatory facilities would reduce – but clearly not eliminate – the need for a minimum prudent level of countries' foreign exchange reserves.

Thus, 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, whether these relate to terms of trade, volatility of private capital flows or natural disasters. In this paper we focus mainly on shocks arising from trade; we therefore do not examine issues related to volatility of capital flows or natural disasters, even though there are also important. Indeed, external shocks due to natural disasters may increase, given likely trends in climate change, though it seems desirable to separate direct financing for natural disaster alleviation from financing for terms of trade

¹ During 2007-2008, even many low-income countries have accumulated fairly large levels of foreign exchange reserves; this is in part owing to a deliberate policy attempt at greater "self-insurance"; however, it is also due to good luck in the terms of trade trends, which may be temporary.

shocks; it seems appropriate to expand the latter, also to cope with possible indirect effects of natural disasters, e.g. droughts in other countries, on terms of trade.

The current international environment of strong commitment to the MDGs and of increased aid, as well as the potential increases in resources that the innovative sources of finance initiative will hopefully generate, is in many ways very favourable for providing adequate official liquidity and aid for shocks; this requires an appropriate architecture for economic shock financing be put in place, and ensuring sufficient resources are made available for this aim. Such an architecture would build on existing institutional mechanisms and instruments, but would modify them significantly 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. Existing contingency financing mechanisms provide too few resources, do so too slowly and carry excessive and inappropriate conditionality.

There is a great urgency to improve existing compensatory financing mechanisms quickly and/or design new ones where gaps exist. This urgency arises firstly from the fact that the global economic outlook has turned gloomy and that developing countries (especially LDCs) are likely to be highly vulnerable to a slowdown in the developed economies (see again Cortez, Izurieta and Vos, 2008). Secondly, this urgency is greater given major increases in the price of many foodstuffs and of oil, which will affect countries, that are net importers of those products. Thirdly, climate change may increasingly generate new shocks, both via natural disasters, but also via causing large changes in terms of trade. As discussed below, existing mechanisms are clearly inadequate, as reflected in their very limited use. Therefore, they need to be quickly improved.

Appropriate, sufficient and speedy official compensatory financing, where necessary, could help developing countries to sustain growth. This would not only contribute to poverty reduction in those countries, but could also play a fairly important role in helping avoid a large slowdown in the world economy in 2008 and 2009.

II. Broad Principles

1. Compensatory financing and the nature of the shocks

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 (see for example, IMF, 2003).

External shocks can have both short-term and long-term impacts, some of which can in turn be sizable in magnitude. In the first instance, all shocks have important negative short-term effects, if reserves and additional external finance are not available.

There is therefore a clear need for rapidly disbursing, low conditionality official liquidity to compensate for a very large proportion of the shock (see Table 1 in relation to low-

income countries). For low-income countries, these loans should be concessional. It is moreover important that the country's fiscal policy framework be built on mechanisms (and that the IMF and donors accept them, or even better, encourage them) that allow fiscal deficits to expand when a country is hit by a shock, rather than reduce such deficits, as is usually the case. This will help maintain economic activity and allow the structural policies necessary to manage possible long-term effects of the shock to be financed.

If the shock proves to be temporary (e.g. brief deterioration of terms of trade, or one year drought) and were to be financed quickly for a high proportion of the shock through 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, a purpose that was then 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). Indeed, many of the principles and the design of the original IMF Compensatory Financing Facility (CFF, which resulted from a UN initiative, drawing particularly from initiatives taken at UN ECLAC and UNCTAD by Raul Prebisch) were appropriate for dealing with shocks.

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.	When more permanent nature of shock becomes clearer
B. Natural disasters	Speedy, low conditionality. Scale relatively small, if grants quickly available	Large and quick disbursement of grants.

Source: Griffith-Jones and Gottschalk (2005)

If a shock that proves ex-post to be more permanent (e.g., terms of trade deterioration is not reversed, droughts repeat themselves), repayment of compensatory official liquidity should be automatically extended. Such flexible repayments linked to duration of shocks was indeed a feature of the initial CFF. Furthermore, in the case of low-income countries, there is a clear case for the international community to provide grants for a significant proportion of the long-term effects of shocks (see again Table 1). In the case of middle-

income countries, there is in turn a case for the international community to provide parallel long-term financing to face the structural sources of the shock.

There is indeed growing evidence from recent research that the duration and severity of commodity price shocks are hard to predict, and that some of these price shocks may be persistent (see, for example, IMF, 2004a, especially Box 2). If the shock is likely to be more permanent, any conditions or incentives attached to loans should tackle the source of the problem. For example, if it seems likely that the price of the main export will remain low, financial support should be given for measures to encourage export diversification; these could include both more competitive exchange rates, but also key investments to facilitate such diversification. If the problem is continued high oil prices, investment in greater energy efficiency, as well as the search for alternative domestic sources of energy, is to be supported. In turn, if natural disasters recur (e.g., due to climate change phenomena), long-term prevention and adaptation policies are called for.

In all of these cases, structural policies to adapt to the specific source of the shock are called for rather than traditional macroeconomic adjustment policies. Furthermore, by generating adverse effects on domestic economic activities, traditional contractionary macroeconomic adjustment policies may actually block the financing for the structural adjustment policies that are required. Actually, the appropriate response to such shocks would generally be to increase rather than reduce budget or current account deficits, as the counterpart of the financing of investment in structural adjustment. This responds to one of the essential lessons of the 1980s and 1990s: that structural adjustment to major external shocks is extremely costly when undertaken in the context of contractionary macroeconomic policies. It is, of course, essential that such investment take place, to guarantee that the increased short-term deficits are consistent with long-term macroeconomic sustainable growth. It is positive that this analysis is increasingly recognized by senior IMF officials, but unfortunately is not sufficiently reflected in IMF practices.

If the shock is from the very beginning large, like a major natural disaster that destroys a great deal of housing, social infrastructure and/or productive capacity, there is still a potential role for very quick disbursing international official liquidity. This is particularly the case when there is a clear impact on the country's capacity to import. 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. 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.

In this case, it is crucial 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.

2. Detailed principles for compensatory financing

The key features of the official compensatory liquidity that needs to be provided should follow six principles: a) it should be speedy, b) it should be sufficiently large in proportion to different shocks, c) it should have low or no conditionality, d) it should be highly concessional for low-income countries, e) there should be better alignment of allocation with needs, and f) shocks should be 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, it states: "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 IMF lending facilities is to build scenarios into all Fund programmes. Thus, programmes could include provisions that lending would automatically increase, based on previous calculations, should certain levels of deterioration of terms of trade or reversals of capital flows occur, and the programme are otherwise on track. It is positive that such scenario building is introduced into the Fund's new TIM (Trade Integration Mechanism; see below for description). Alternative scenarios are also included in some PRGFs, but no additional resources are predicted for such scenarios, which reduce their relevance and, thus, enhanced PRGF lending linked to shocks.

Unfortunately, the Exogenous Shocks Facility (ESF), also approved by the IMF in 2005, does not guarantee sufficiently speed of disbursement. Nor does it deal adequately with the second criteria, that of scale (see details below).

- b) As regards scale, the more liquidity is provided quickly in proportion to the shock, the smaller the costs of adjustment. 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 negative export price shocks averaging 6.8 per cent of GDP in the year of the shock, the loss of income due to reduced growth over four years is about 14 per cent of initial output, with asymmetric effects, as positive shocks did not increase growth sufficiently to compensate for the negative effects. Furthermore, shocks of these size have proven to have long-term effects on the growth trajectory, indeed explaining the frequency of growth collapses that the developing world experienced since 1980 (Ocampo and Parra, 2007).

Large counter-cyclical compensatory financing for external shocks could be consistent with counter-cyclical issues of SDRs, following the proposals made by the United

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

Nations Executive Committee on Economic and Social Affairs (1999) and Ocampo (2002), among others. The existence of such SDR issues could facilitate the creation and expansion of compensatory financing, especially in face of generalized shocks. SDR issues could also be a way to fund the subsidy element in compensatory financing for low-income countries, following a broader framework suggested by Stiglitz (2006, ch. 9), among others. However, such subsidies could alternatively be funded by increased grants from donors to the IMF for this purpose.

- c) A renewal of SDR issues by the IMF may be particularly appropriate, at a time when the fall of the dollar may re-open the discussion on the reform of the international reserve system and the role which the SDR could play in it.

As pointed out above, in the face of a clearly temporary negative shock, financing equivalent to a large proportion of the shock could avoid unnecessary costs for growth and poverty reduction. This is particularly clear in a context of rising aid flows (where compensatory financing could be understood as frontloading future aid flows) and/or if the temporary negative shock is followed by a positive shock. Furthermore, it can be argued that current trends in overall higher commodity prices linked to the dynamism of China and other Asian economies, together with a clear return of the business cycle especially in developed countries, provide a very good context for compensatory financing, as declines in export prices are far more likely to be temporary and possibly not so linked for a time to the long-term deterioration of terms of trade that Prebisch-Singer predicted and that the IMF (2004a) refers to in its review of its Compensatory Financing Facility (CFF), as a possible reason for the CFF's smaller relevance.

Indeed, this statement on CFF seems based on a clear misunderstanding on the evidence on the long-term deterioration of the terms of trade. Although valid for the twentieth century, such trend was the result of two major downward shocks, in the 1920s and 1980s, not of a secular decline (Ocampo and Parra, 2003). And the circumstances surrounding commodity prices in the early twenty-first century, based on increased demand from China and other Asian economies, may be closer to those of the nineteenth century, where the terms of trade showed a long-term improvement rather than deterioration.

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 1976-1981, on average about 50 per cent of export shortfalls of developing countries were financed (Griffith-Jones, 1987).³ This is in quite a sharp contrast with current practice, where augmentation of PRGF,

³ As discussed below, shortfalls in the CFF were calculated as the difference between the value of exports in the shortfall year with the medium trend value of export earnings in that year. Overall, this seems a good methodology, as it implies that greater compensatory liquidity financing is provided initially when a shock occurs, and less liquidity financing would be given if the shock persists, as the medium trend value (calculated for 5 years) becomes lower.

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 less than 20 per cent of the shortfall! (IMF, 2003.) For recent, even lower, figures for 2005-2008, please see Table 3 below. 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 (or at least a very large proportion) of coverage of shocks that are deemed temporary seems very strong, and even a large proportion of more permanent shocks should be financed if such funds are used as a temporary bridge to introduce the more structural policies required. This would imply either no quota limit or a far higher one.

- d) 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 implies that countries do not have to adjust in the first instance, at least until it is evident that it has a more permanent character. If countries had access to private financial markets, they could borrow, which is what developed countries do. As low-income countries often cannot borrow, it is desirable that the international community provides this financing. Similarly, middle-income countries are often subjected to international credit rationing as their economy deteriorates; indeed, a capital flow reversal may be the main shock facing a middle-income country. 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 high conditionality Fund programme, for countries that have successfully approved annual Art IV consultations, which reflect reasonable macro-economic policies. Furthermore, as discussed below, it is even clearer that low-income countries with a Policy Support Instrument (PSI), which has conditionality but does not provide loans, should not –as they now have to– fulfil additional conditions to get IMF lending if hit by shocks. Indeed, the introduction of a PSI is welcome in that it provides *ex-ante* conditionality to influence policy in good times, e.g. to curb excessive expansion; however, the other side of the coin is that countries performing well under the PSI should get automatic lending if hit by external shocks.

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 (see below). 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 and were also amply used.

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 (for external shocks), but also for the pragmatic reason that it will ensure speed of international response.

- e) Concessional for low income countries: There is broad consensus that resources should be provided in the case of low-income countries, either in the form of grants or very concessional loans. Given that official liquidity has a number of potentially positive features, the case seems very strong to allocate additional grant resources to make such compensatory 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. A main reason for higher concessional 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 Multilateral Debt Relief 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.

For large natural shocks that cause major damage, the case for significant grant resources is equally strong. The Mitch Hurricane shock of 1998, which implied massive infrastructure and property destruction both in Honduras and Nicaragua, 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.

- f) 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 (2001) show, natural disasters, which are more visible appear proportionally to attract more external financing than terms of trade 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.
- g) 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 and food prices, which affect many low-income countries' imports and which is a source of major concern to developing countries – would be to measure export shortfalls in terms of export purchasing power, 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. This is particularly important for the calculation of export shortfalls, for the purpose of provision of grants, for example by the EU's FLEX or bilateral compensatory loans, such as the interesting new French counter-cyclical loan facility (see Cohen, Djoufelkit, Jacquet and Valadier, 2008). An alternative, possibly more politically

attractive option –though somewhat less precise technically– would be to consider the creation of a new low conditional IMF Oil Facility at the IMF, and the broadening of the existing Compensatory Financing Facilities to include all food imports, and not just cereal imports, and including some provision for compensating for higher oil and food prices in existing grant facilities, such as FLEX (see below). Furthermore, new issues, especially in relation to whether fluctuations in workers’ remittances should be included amongst external shocks.

III. Current Facilities

Given the great variety of instruments and shocks, we will focus here mainly on external shocks linked to trade. These include two major compensatory financing mechanisms for terms of trade shocks: a) the Compensatory Financing Facility of the IMF (a loan facility) as well as IMF facilities for low-income countries (PRGF augmentation and its newer External Shock Facility, ESF), and the IMF facility for trade-related balance of payments adjustments, available to all Fund members (TIM) and b) the European Commission's grant programme for ACP countries (previously STABEX and Sysmin, and now FLEX),.

a) IMF mechanisms for export shortfalls

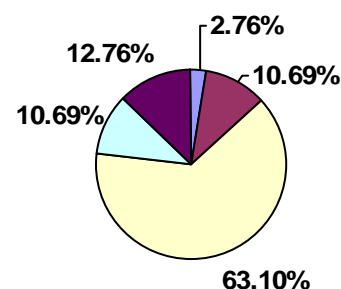
i) *The CFF*

As discussed, the CFF has historically been a very important instrument by which the Fund helped finance exogenous shocks. During certain periods, it has 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, 1980) Even since 1990, it represented a fairly high proportion of IMF lending (see Table 2 and Graph 1).

Table 2: Use of Facilities, 1990 - 2006.

Facility	Percentage Use
SRF	2.76 %
EA	10.69 %
SBA	63.10 %
CFF	10.69 %
EFF	12.76 %

Graph 1: Use of Facilities, 1990 - 2006



Sources: IMF and Banco de España

■ SRF ■ EA ■ SBA ■ CFF ■ EFF

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. This was because, as discussed above, the limits for drawing –as per cent of quota—were fairly high. As a result, a large number of countries received CFF with a high per cent of average access in proportion to shortfall. Furthermore, when major oil price increases occurred in the 1970s, Oil Facilities were introduced, which were also widely used, even in the 1990s (see IMF, 2004a). 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). The shortfall was estimated 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). This seems a more appropriate calculation method, as it takes into account the fact that a deceleration of export growth could lead to a fall of output 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, which made the conditionality attached to the CFF linked to that of upper credit tranche borrowing and therefore very high, the CFF has not been used at all, despite several temporary and exogenous shocks that affected many countries. Indeed, the IMF (2004a) itself recognizes that when shocks happened since 2000, and especially in the face of the shock of September 11, 2001, countries needed the CFF but did not or could not use it. For

example, at least one country, according to the IMF, preferred to tighten fiscal and monetary policy than recur to the CFF. It seems clear that one of 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. Naturally, another reason is that recently –due to high commodity prices– there may have been less need for such lending; however, this second reason is likely to change as the world economy slows down, or as net importers of food and oil face Balance of Payments constraints. 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.

ii) *PRGF augmentation*

Since the creation of the PRGF, augmentation of 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. 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, 2005a), PRGF average augmentation was very small compared to the impact of the shock; furthermore, it was granted to only half the countries with PRGF experiencing shocks. As can be seen in Table 3 below, the total amount of PRGF augmentation provided between early 2005 and early 2008 was extremely low, at below 200 million SDRs, and represented very low proportions of quotas and shocks.

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

iii) *The unused ESF*

In 2005, a second PRGF window was created, for low-income countries that faced a sudden and exogenous shock requiring temporary financing without a PRGF arrangement. It was called the ESF (or External Shocks Facility). It 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 not to increases in the price of imports (e.g. of oil, or most food), currently a very important shock for many low-income countries. It would therefore seem essential to broaden this new facility –as well as the PRGF augmentation mechanism– to include prices of imports, and to estimate all shortfalls in terms of export purchasing power (or, what is equivalent, capacity to import).

The second and main problem with the ESF is linked to conditionality. This can take two different forms: if a country requests first a PSI (a Policy Support Instrument) which has conditionality but no lending, and if it then negotiates adjustments to the PSI to get an ESF loan, there is additional conditionality, which seems particularly problematic. If a country does not have a PSI, it requires typically an IMF verified poverty reduction strategy in place to get the ESF. It would be sad and indeed ironic if poverty increased because of IMF delays in approving lending just because the country did not have a verified poverty reduction strategy! As discussed, this is 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.

A third problem is that to get an ESF, the PSI has to be suspended, which several countries find problematic;⁴ this is an anomaly, which could be easily changed.

A final problem is that the second window (the ESF) places 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" (IMF, 2005b). 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 is the constraint on PRGF Trust resources for the subsidy element. Though this may be factually correct, donors—in the context of increasing aid initiatives— could allocate additional resources to the PRGF Trust, which would be very effective in terms of poverty alleviation. Indeed, the IMF should encourage them to do so.

The fact that no country has used the ESF seems to indicate that the problems in its design outweigh potential benefits.

b) EU grants for export shortfalls

The EU has for a long time, since 1975, had compensatory mechanisms in the form of grants for ACP (African, Caribbean and Pacific) countries hit by terms of trade shocks. Initially, these were instruments like Stabex and Sysmin, which expired with the Lomé Convention, signed between the European Union and the ACP countries. 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—seems to disburse less funds than previous ones (see below) but has the advantage over previous EU instruments that it is more targeted on the shocks, rather than on how the resources should be used (for more details, see Griffith-Jones and Gottschalk, 2005).

⁴ Interview material

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 grants 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. Envelope B can currently be used by 76 ACP countries, implying a fairly small allocation per country, as the total amount is relatively small. It is important to point out that the budget for FLEX has a further 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. This limit can restrict granting of approved resources, as indeed happened for example in the case of 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 European 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. The first one is that export revenues should fall by 10 per cent (2 per cent for least developed, landlocked and island). The second is 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 terms of purchasing power (capacity to import). This is particularly relevant and urgent as currently a number of ACP countries are suffering from a large increase in oil and food prices, but is more broadly applicable.

Though it is welcome that the criteria for public deficit increases has been made less stringent (which 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 activity and imports as discussed

above). Therefore, one of the desirable changes is to eliminate the deficit deterioration criteria as a pre-condition for FLEX disbursements.

The scale of FLEX disbursements was initially very modest, though it has increased somewhat since it was modified, 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. Based 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 quite significantly.

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.

Thus, there is not just a problem of possible adaptation of criteria, but also a limitation of resources, which impedes countries 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 Lomé IV, and 31 per cent in Lomé III. For countries that benefited from the instrument, it reached over 60 per cent during Lomé III and IV.

Once a country meets the criteria, and it has a satisfactory macroeconomic situation (established either because it has an IMF programme or as evaluated by European Commission economists), it can receive FLEX as programme support. In macroeconomic aspects, except for the rather strange fiscal criteria, FLEX conditionality seems relatively flexible. If the macroeconomic 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. Reportedly, negotiations with the European Commission can become protracted. 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 month-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 restrictions 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 issues 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 introduced in 2004 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. It does not, however, deal with more long-term effects of WTO agreements.

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, 2004b).

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 in a 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 or (ii) on a non-discriminatory basis.

The design of TIM seems to have very positive 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).

Table 3 below summarizes total IMF lending for external shocks in the 2005 – early 2008 period, under PRGF augmentation, ESF (zero amount until now) and the new TIM. The total amount, under 200 million SDR, is extremely small and well below that forecast by the IMF itself.

Table 3 - Total IMF compensatory financing for low income countries (2005 - Jan. 2008)⁵

Year	Country	PRGF Type	Amount (in millions of SDRs)	Amount (in % of quota)	Date Approved	Reason
2005	Bangladesh	Augmentation	53.3	10.0	28 July 2004	Associated with approval of new created Trade Integration Mechanism
	Kenya	Augmentation	50.0	18.4	20 Dec 2004	Rising oil prices drought
	Azerbaijan	Reduction	12.9	8.0	22 Dec 2004	Cancellation of review
2006	Niger	Augmentation	19.7	29.9	14 Nov 2005	Severe drought a terms of trade deterioration
2007	Burkina Faso	Augmentation	6.0	10.0	8 Sept 2006	Decline in terms trade
	Moldova	Augmentation	30.8	25.0	15 Dec 2006	Sharp increase in natural gas import prices and disruptions in wheat exports to traditional markets
	Kenya	Reduction	75.0	27.6	11 April 2007	Improved external position
2008	Burkina Faso	Augmentation	9.0	15.0	9 Jan 2008	Expected decline cotton exports and rise in oil imports
Total⁶			80.9			

Source: IMF Annual Reports 2005, 2006, 2007, POD database. We thank Mark Plant, from the IMF, for providing recent data.

⁵ These figures include augmentation of PRGF, due to terms of trade shocks or trade regime changes the new ESF (External Shocks Facility) for non-PRGF countries was not used at all.

⁶ The total reflects net flows, equal to augmentation minus reduction.

IV Policy recommendations on a shock architecture

The world economy –and developing countries—have changed since compensatory financing was first introduced. In particular, as a group, developing countries are now less dependent on commodity exports. However, many low-income countries are still very dependent on a few –or one—commodity exports, and several low, as well as middle-income, countries have high dependence on oil and food imports. The latter is particularly problematic, as their prices have increased sharply and rapidly. As a result, they are still 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 international financial system should aim to address so that long-term growth is not undermined. Therefore, appropriate official compensatory financing mechanisms have a very important role to play. Temporarily, commodity prices are on the whole high; however, it is very probable that there will be declines in these prices, especially as the world economy is quickly slowing down. And, of course, many developing countries are adversely affected by high commodity, particularly, food and energy, prices.

The following broad suggestions are borne from the analysis above and from the relevant literature, and complement the six criteria for compensatory financing developed in the second section of this paper:

1. Scaling up

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

In a context of scaling up of aid and/or innovative sources of finance, higher resources should be allocated for financing shocks. This would need to be linked to fewer restrictions (e.g. higher per cent of IMF quota for access, expansion of limits and availability of resources for FLEX) on the scale of facilities, so that a far larger proportion of shortfalls of exports could be financed.

In spite of the many limitations, FLEX is a useful instrument. Its major problem is limited scale, which should be therefore significantly increased (see above for more specific proposals). Also, some peculiar conditionalities (particularly those associated with budget deficits) should be dropped.

2. Both loans and grants are valuable

In the case of low-income countries, 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. For middle-income countries, loans play a particularly valuable role.

Closer coordination between institutions providing loans and grants seems urgent.

3. IMF lending for trade shocks need far reaching changes

There should be significant simplification of IMF facilities as they are too many (e.g. enhanced PRGF, ESF and TIM) and are too complex. Indeed, low-income countries are not even acquainted with – or fully understand – all the facilities available.

Indeed, though the focus of our proposal is on how to improve existing IMF facilities, an option to consider may be to merge all these IMF trade compensatory financing for low-income countries into one low conditional facility at the IMF.

Lower conditionality is clearly needed. 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 into them automatic augmentations for terms of trade or other external shocks.

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 terms of export purchasing power (or, what is equivalent, import capacity), or – should this not be done – if a new Oil Facility was activated at the IMF, and if all financing shocks facilities included all food imports (and not just cereals). Economic analysis shows clearly that the relevant variable is capacity to import.

Though apparently less urgent, conditionality on the CFF should be lowered, to help middle-income countries deal with possible trade shocks.

4. Grants need a focal point

A potential focal point for all grants for this purpose could be the European Commission. However, the key problem for the Community being a focal point is coverage of countries, as many low-income countries are excluded; also other donors would have to be included.

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. 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; the fact that the World Bank has recently launched a disaster facility may facilitate the World Bank's role in responding to trade shocks. However, countries themselves seem to prefer dealing with bilateral donors, which they consider more agile.

5. Creativity needed in bilateral or multilateral lending

Of particular interest as regards bilateral concessional loans is the new French counter-cyclical lending instrument, which has been used already by Senegal and Burkina-Faso. It allows countries to stop servicing debt (up to a maximum of five years in total) in cases when they have an export shortfall. There seems to be a case for other donors to make similar loans and/or for institutions like the World Bank or regional development banks to consider lending in such a manner, or via other mechanisms (e.g. growth-linked loans) that allow lower payments in bad times, and could require higher payments in good times.

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