OECD DEVELOPMENT CENTRE

POLICY BRIEF No. 31

AFTER GLENEAGLES: WHAT ROLE FOR LOANS IN ODA?

by

Daniel Cohen, Pierre Jacquet and Helmut Reisen

- Cancelling of poor-country debt does not mean that the best way to give aid is through grants only.
- A switch from concessionary loans to grants may limit resources to the poorest countries, worsen their incentives for fiscal discipline and efficiency, and raise the burden of adjustment from exogenous shocks.
- Aid through loans may often prove superior, provided that it maintains debt sustainability.
- A scheme for soft loans, with higher interest rates and cancellation provisions if bad shocks occur, would minimise moral hazard and strengthen debt sustainability.

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A Tale of Two Aid Instruments

Suppose a DAC donor earmarks $1 billion of taxpayers' money for official development assistance (ODA). The donor may use two instruments as an outright grant or in combination with a market loan to produce a concessional loan of $2 billion with a percentage grant element of 50 per cent. Many nowadays think the choice should be clear: provide grants only, leave loans to the market. The purpose of this *Policy Brief* is to qualify and inform this choice.

A crusade of good intentions has militated for total cancellation of poor-country debt since the 1980s. An unlikely alliance emerged between some academics (Lerrick and Meltzer, 2002; Bulow and Rogoff, 2005) and anti-debt lobby groups to recommend a switch from ODA loans to outright grants as a natural lesson to learn from the debt excesses of previous decades. This alliance has argued that loans carry perverse incentives for the recipient countries with low governance scores and contribute to a debt overhang (which grants by definition cannot); they also note a tendency for "defensive lending" (lending that keeps up appearances by rolling over debt) by development banks whom they perceive as natural *loan pushers*.

Since 2000, a major *grants-versus-loans* controversy developed when an influential US Congress Report of the International Financial Institution Advisory Commission (better known as the "Meltzer Commission"; see IFIAC, 2000) concluded that total cancellation of poor-country debt was essential. One of the conclusions of the Meltzer Commission on reforming the World Bank and the International Monetary Fund was that development assistance should be administered through performance-based *grants* rather than (concessionary, or soft) *loans*. Under this system, grants would be disbursed not directly to the government, but to a non-governmental organisation (NGO), charity, or private-sector business that would offer the cheapest bid for a project.

The heavily indebted poor country (HIPC) debt reduction initiative has been seen as proof of failure of the soft loan strategy. The fact that the debt had to be cancelled shows, according to one line of argument, that the poorest countries can simply not repay their debt after all (Bulow and Rogoff, 2005). The argument goes as follows: the poorest countries have no access to financial markets for the simple reason that they are unable to repay their debt. It is then hard to see on what premises foreign governments could expect to be better treated than private bankers, all the more so that they have to count with a public opinion increasingly

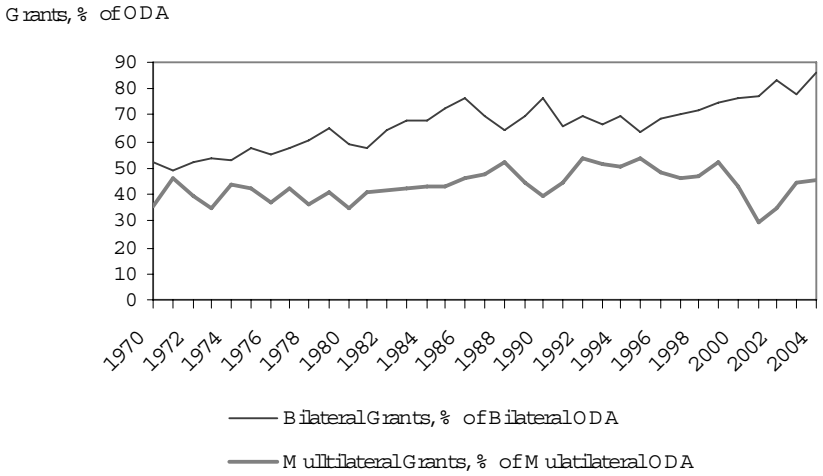
hostile to debt. If anything the HIPC initiative makes that point forcefully. Bulow and Rogoff cite a study conducted by the American Congressional Budget Office (Bulow and Rogoff, 2005) according to which the market value of debt for the multilateral banks is markedly lower than par. In other words, according to this line of argument, the reason why the poor countries haven't got access to international financial markets is the same one as that explaining why the loans of multilateral banks are non recoverable.

Contrary to the institutional argument developed by Bulow and Rogoff, low capital productivity is not necessarily a reason against a policy of subsidised loans. In order to finance an initial accumulation of capital, despite its low return, for example to fund infrastructure, a loan will be better than a grant. The supported country can, if the critical mass of capital is achieved, become perfectly profitable. This may justify subsidising loans with lower interests and longer maturities. The fact that profitability rises over time justifies greater patience on behalf of creditors. Here, the role of public development banks is crucial, as they can pool risk better and can sustain a longer time horizon than private actors.

Figure 1 shows that bilateral donors have increasingly favoured grants over loans during the past three decades; in recent years, this preference has been emulated by the multilateral aid agencies as well; even the regional development banks (except for the Asian Development Bank) have started to provide more grants. The share of loans has substantially declined since the 1980s following the first wave of the developing-country debt crisis initiated by Mexico's default in August, 1982. Bilateral ODA is mostly channeled through grants, with the exception of Japan where loans still account for more than half of gross ODA. To a lesser extent Spain, Italy, Germany, France, and emerging non-DAC donors such as China, also tend to provide some aid through project and contract loans.

The international agreement on debt relief (Multilateral Debt Relief Initiative, or MDRI) reached by the G-8 Finance Ministers in mid-2005 cancelled $56.5 billion in loans owed to the World Bank, African Development Bank and International Monetary Fund. At Gleneagles[1] the Heads of State formally endorsed the agreement made by their Finance Ministers. Fourteen countries in Africa and four in Latin America became eligible for immediate debt forgiveness under the plan, and a further nine should benefit over the next few years. The nations are part of the World Bank's HIPC initiative, in which countries commit to good governance, meet an IMF-endorsed financial plan and root out corruption.

Figure 1. **Grants and Loans as Per Cent of ODA, 1970-2004**



Source: Creditor Reporting System (OECD).

Table 1. **Grants in Relation to ODA and Poverty Incidence**

		1990	2004
East Asia	- Grants, per cent of ODA[a)]	45.4	61.5
	- Poverty incidence[b)]	30.0	12.0
Sub-Saharan Africa	- Grants, per cent of ODA[a)]	80.8	81.7
	- Poverty incidence[b)]	45.0	44.0
Latin America	- Grants, per cent of ODA[a)])	75.7	102.0
	-Poverty incidence[b)]	48.3	44.0

a. ODA disbursements. Net loan reflows explain a share of grants/ODA higher than 100 per cent.
b. Headcount Index (percentage living in households that consume beneath the poverty line, $1.08 per day at 1993 PPP).

Sources: Creditor reporting System (OECD), Millennium Development Goals database and ECLAC.

Whatever can be said about the relative merits of grants versus soft loans, the rising share of grants in ODA has not reduced poverty incidence in the developing world. In fact, where poverty has been reduced – namely in East Asia and the Pacific – the share of grants in ODA has been lower than elsewhere. By contrast, in Africa both grants as a percentage of ODA disbursements and poverty incidence have been on the rise simultaneously. Table 1 reveals some interesting comparisons for East Asia/Pacific and Sub-Saharan Africa, obviously without any causal implications. But the table may provide a first warning before the international community does away with loans entirely: not all debt is bad.

To inform donors' choice whether and when to spend aid through grants or soft loans, this *Policy Brief* will proceed in five steps. First, it will discuss the basic assumption behind the pro-grant argument – that soft loans are equivalent to a mix of market loans and grants when capital markets are perfect and open to all. The *Policy Brief* will secondly explore the impact on net transfers to poor countries that the choice is likely to entail, which allows poor countries to raise investment and smooth consumption (Reisen and Soto, 2001). Third, it will analyse incentives as "little can sensibly be said about grants and loans without considering incentive effects" (Hartford and Klein, 2005). Fourth, the need to extend ODA to help smooth consumption by the poorest in face of adverse shocks is explained and discussed. Finally, it presents a new scheme for soft loans that aims at minimising moral hazard and strengthening debt sustainability even under negative shocks.

The Grant/Loan Equivalence

To follow the grant-versus-loan debate, a capsule summary of basic ODA analysis is required. Concessional loans, as opposed to commercial loans, carry a *grant element* which reflects the financial terms of a loan: interest rate, maturity (interval to repayment) and grace period (interval to the first repayment of capital). The grant element is a measure of the concessionality, or softness, of an ODA loan[2].

In principle, a soft loan can be bought up by a private investor and then sliced into a market loan and a grant; hence the *term grant/loan equivalence*. Basically, the difference between the cash transfer and the price the investor is prepared to pay (as a first approximation), the annuity divided by the market interest rate) is the grant element. For better understanding, Table 2 provides a numerical example.

Table 2. **Grant/Loan Equivalence**

Soft ODA Loan 1 per cent interest rate, no grace period, 30 year duration, annual payments	**Market Loan** 19.5 per cent interest rate (= 4 per cent financing cost for AAA investor +0.5 per cent management fee +15 per cent default risk spread)
• Cash inflow at start = 1 000 • Constant annuities = 38.75 • Investor buys soft loan at 198.72 (38.75: 0.195) • ⇒ Grant element = 80.128 per cent	• Grant = 801.28 • Market loan = 198.72 at 19.5 per cent • ⇒ Cash inflow = 1 000 • ⇒ Annuities = 38.75 for 30 years

Note: Assuming an infinite horizon to facilitate calculation, the annuity (38.75) can be divided by the market interest rate (0.195) to establish the net present value of the underlying income to the investor (198.72). The grant element of the soft loan is 80.13 per cent.

There is a difference between the grant cost to the donor and the grant benefit to the recipient; different levels of capital cost and returns determine the extent of concessionality (Leipziger, 1983):

- In a *benefit* calculation, concessionality would be calculated as the difference between the interest charged and the market rate of interest that the borrower would otherwise have to pay. A borrower with high capital returns will tend to favour loans over grants because he will receive more capital under a loan scheme.
- In an *opportunity cost* calculation, the concessionality would be calculated as the difference between the interest charged and the opportunity cost of investing the ODA loan. A donor with high domestic capital returns will tend to provide aid through grants instead of a higher aid transfer through loans because he has to forgo more capital under a loan scheme.
- Thus, a higher return on capital and higher interest rate spreads in the borrowing country both shift the optimal composition of aid towards loans. Donors will prefer grants to loans when their capital return and borrowing costs are high.

The heart of the Lerrick-Meltzer (2002) argument is that all concessional loans should be thought of as an arithmetic combination between a grant and a market loan[3]; ODA should rather be made of outright grants, and markets or financial intermediaries would provide loans. This would occur at no extra cost either for the donor or for the beneficiary. They build their case on questionable arithmetic (see Box 1).

Box 1. **Tortured Arithmetic of "Development Equivalency"**

Lerrick and Meltzer (2002) maintain that "grants will not cost more than loans", provided the level of aid is the same. They provide the following example: A $100 million 25-year project, financed through a 40-year amortising IDA soft loan, requires $100 million of aid resources under the traditional loan system. If the recipient qualifies for 70 per cent grant aid, the same project would be provisioned through 25 annual payments of $11.2 million, with IDA paying the service provider $7.8 million p.a. and the recipient $3.4 million p.a. In the capital markets, the financeable value of the direct World Bank revenue stream is, according to Lerrick and Meltzer, $81.5 million at an 8.25 per cent yield; the financeable value of the recipient country obligation is $18.5 million, assuming an 18 per cent yield. Thus, a $7.8 million p.a. commitment by the World Bank would be leveraged by private lenders to supply the requisite $100 million in funding.

The calibration applied by Lerrick and Meltzer is clearly ad hoc and questionable.

- *First,* the assimilation of a $100 million investment to a flow of 25 annuities of $11.2 million supposes a discount rate of 10.2 per cent. Assuming that the market rate is 8.25 per cent (which corresponds to the Lerrick-Meltzer view of the AAA World Bank bond), this assumes a risk premium of less than 2 per cent on the considered developing country project. Where this comes from is left unspecified, and may indeed look extremely optimistic. It will also widely differ from a developing country to another.
- *Second,* for calculating the financeable value of the recipient country obligation, an 18 per cent yield is assumed. Obviously, such a rate implies a high default premium, although one might think that it is not even high enough for countries with poor governance. But such high-risk premiums create doubts about whether the poor-country obligation could be banked, and leveraged, by private sector lenders at all. Moreover, Lerrick and Meltzer provide no explanation of the choice of this rate, notably in relation to the discussion in the previous paragraph.
- *Third,* the Lerrick-Meltzer proposal provides no discussion of risk premiums. The exposure to natural and political shocks can be pooled, hence reduced, more efficiently by development banks than by private lenders, who would have to ask high-risk premiums. On the other hand, without matching paid in capital and additional cash reserves, the multilateral banks' rising borrowing suggested by Lerrick and Meltzer could lead to cuts in their AAA ratings, hence higher spreads.

It is precisely because financial markets are imperfect – in that they do not continuously provide finance to poor countries – that development banks and concessionary loans have a *raison d'être*.

Lerrick and Meltzer's argument, therefore, calls for qualification. It is based on the assumption that developing countries have perfect access to international capital markets. Their spending capacity is then determined by their wealth and international interest rates. Grants and concessional loans are in that case fully equivalent. A grants-versus-loans controversy makes sense only when developing countries do not have full access to international capital markets. Under liquidity constraints and for any given willingness on the donor's side to commit taxpayers' resources, many developing country governments will lose in terms of overall resource availability if ODA is available through grants only.

Resource Transfer

What matters to the recipient is the resource transfer – the trade deficit – that aid helps finance. Whether a shift from grants to loans will increase the *transfers* depends on the scale and terms of the loans relative to the scale of the grants. A shift from concessional loans to grants could *reduce* the present value of the resource transfer if the face value of the grants were small relative to that of the loans. Simply put, the value today of total financial resources that would be channelled to developing counries could shrink. This is quite possible since repayments by successful developing countries would cease to refinance soft-loan schemes. A big advantage of loans over grants, at least in theory, is that a given amount of ODA can be leveraged in time as the first borrower partially finances the second and so on.

Many developing country governments will lose in terms of overall resource availability if ODA is available through grants only, as they do not have full access to private capital markets. If a liquidity-constrained country lacks access to capital markets, then lending by a development agency relaxes the constraint. The argument thus comes down to whether or not developing countries suffer liquidity constraints and why, and also whether development institutions are legitimate in moving in. There is substantial evidence that poor countries do suffer pervasive liquidity constraints, for essentially four reasons:

- A lack of credible institutions that would back their commitments to repay the debt limits countries' access to private financial markets for good reasons (Bulow and Rogoff, 2005). Alfaro *et al.* (2005) also conclude from their 1970-2000 empirical investigation that low institutional quality has been the leading explanation for limited market access. Concessional loans in that case make sense only if development institutions are in a better position than private markets to get repaid despite local institutional weaknesses, e.g. due to preferred creditor status or information advantages.

- Another explanation relates to the so-called "Lucas paradox" (Lucas, 1990) – the presence of externalities to physical and human capital – which prevent capital from flowing from (capital-) rich to poor countries. To the extent this means that the profitability of a (private or public) capital investment depends on the presence of complementary (notably public) capital assets – roads, ports, airports, telecommunications, high degree of education – such market failure provides a powerful justification for ODA as a way of supporting primitive capital accumulation leading to a critical level of the capital stock beyond which further investment will be profitable. Loans provide here a superior instrument to grants precisely because there is an eventual return to investment. The characteristics of concessional loans (grace period, long maturities, and low interest rates) allow them to be adapted to those of the considered investment.

- Cohen and Soto (2004) call attention to another explanation, based on an insufficient integration of poor countries into international trade. With a high share of the economy not traded internationally and at current exchange rates, investments in developing countries might be socially profitable, but the local relative price of capital is too high. This discussion relates to the grants-versus-loans debate to the extent that a lack of integration in world markets widens the afore-mentioned difference and means that a developing country might not have the desired access to outside private market finance. In addition, international loans need to be repaid in foreign currency, which affects the country's repayment capacity.

- A fourth explanation for the insufficient access of developing countries to international capital markets relates to volatility in their resources. High volatility translates into higher spreads as the perceived risk on investment increases. In turn, high spreads limit borrowing capacity. Kharroubi (2005) shows how volatility tends to exclude poor countries from international financial markets.

That the leverage effect through development banks can also work well in the African context is well exemplified by Development Bank of Southern Africa (Box 2).

A big advantage of loans over grants, at least in theory, is that a given amount of ODA can be leveraged in time as the first borrower partially finances the second and so on. Formerly poor Asian countries contribute to replenishing IDA resources. What makes the case in favour of this argument weaker is the fact of "*defensive lending*", namely the tendency of the multilateral banks to lend to the same indebted countries the resources, which are supposedly to be repaid.

Box 2. **The Development Bank of Southern Africa (DBSA)**

The Development Bank of Southern Africa (DBSA) provides finance to over 500 municipalities and to a wide range of public utilities and private firms in the fourteen countries of the Southern African Development Community (SADC). It is the leading provider of advice and finance for public private partnerships in the region, as well as a leading partner with international donors and institutions. The Bank lends around $1 billion per year with an average maturity of around 20 years, on terms which reflect the costs of its capital plus a small premium to generate around $100 million surplus, which is recycled into technical assistance and capacity building grants, and a 2 per cent return on assets which builds reserves. With the Bank now reaching maturity, and defaults at well under 1 per cent, repayments now account for almost half of its income, with the balance coming from the markets and global development finance institutions. With investment grade status, the Bank regularly issues bonds on domestic and international markets, but it also acts as a wholesaler for agencies like *Agence française de développement* (AfD) of France and the European Investment and Nordic Investment Banks. The Bank each year funds infrastructure, which benefits an estimated 2 million poor households and creates around 40 000 jobs per year. This state-owned bank provides a model for a new generation of development banks, which although owned by the state are financially and operationally independent, existing without systematic subsidies or guarantees provided by the state. The DBSA has a major development impact at no cost to local taxpayers (but it occasionally benefits through ODA from an indirect contribution from donor countries' taxpayers). Through diligent financial and risk management, which maintains its credit rating, it is able to make loans available to many who otherwise could not access finance, and to extend the reach of those that have limited access. The combination of advisory services, finance and partnerships means that its service extends beyond finance to technical assistance and capacity building, creating a virtuous circle where the discipline of the financial markets is introduced through developmental lending.

The authors gratefully acknowledge the information provided by Dr. Ian Goldin, Vice President at the World Bank and previously chief executive of DBSA.

Table 3. **Evidence on "Defensive Lending"**
Independent Impact of Debt Service (t-1)on New Loans (t), per cent

	Bilateral Lenders	Multilaterals
1980s	17	40
1990s	14	78

Source: Cohen and Reisen (2006).

In a report for the French *Conseil d'analyse économique*, we have produced econometric evidence to show that defensive lending to many African countries was indeed prominent in the 1990s, but not in the 1980s. One interpretation is clearly that debt was too high in the 1990s to be repaid. But, as the 80s demonstrate in particular for the bilateral development banks, this is not an intrinsic feature of soft loans.

Incentive Effects

Donors can rely on little evidence so far on whether the social returns of aid are to a degree *endogenous* to grants and soft loans or not. Those in favour of soft loans argue that pure grants would be used, at least by "donor darlings", to the point where their marginal utility is zero (equalising their zero cost to the recipient). Moreover, as grants do not imply a burden of repayment, they would undermine efforts to mobilise public revenues and thus lead to greater aid dependency.

However, frequent debt forgiveness and serial 'defensive lending' may have undermined any discipline effect inherent in concessionary loans as borrower governments may have come to perceive them as equivalent to grants. Furthermore, those in favour of grants militate for performance-based grants, with close monitoring and targeted accountability.

In a dynamic framework in which recipient countries rely on the continuation of grants and in which development institutions are keen on producing a given level of ODA, the incentive structure is more complex. For example, if it is possible to credibly tie the renewal of a grant to a given level of financial discipline in the recipient country, then the aforementioned disincentive is compensated by the positive incentive of having the flow of grants renewed. However, a possible behavior of "grant pushing" from development institutions might again weaken that incentive.

Consequently, the debate needs to be informed empirically. Clearly, the evidence available so far favours soft loans over grants: they have been utilised more efficiently than grants during the past three decades, despite repeated debt crises. Recent work on aid effectiveness (Sawada, Kohama, and Kono, 2004; Djankow, Montalvo, and Reynal-Querol, 2004) finds that loans do promote growth when governance meets certain standards, while grants do not. Why this is so has been revealed by two in-depth studies produced at UN Wider and the IMF.

The UN Wider study has performed an empirical test based on annual panel data from 1970 to 1999 for 72 aid recipient countries. It shows significantly that concessionary loans are connected with higher tax revenues, less government consumption, higher investment rates and less local public deficit finance (Odedokun, 2003). The same study also finds that aid recipients have a time preference, as shown by the high response of concessional borrowing to the level of the grant element. The study concludes that grants stimulate, in particular in least developed countries, the financing and implementation of projects that fail to meet usual efficiency criteria.

The IMF study (Gupta *et al.*, 2004) examines the experience of 107 countries that received foreign aid during 1970 – 2000 to trace the relative effect of grants and loans on the domestic revenue effort. The results of that study suggest that an increase in overall aid (net loans plus grants) cause a country's domestic public revenues to decline, although the separate effects of its two components are different. An increase in grants is found to cause revenues to decline; for each additional dollar in the form of grants, 28 per cent is offset by lower revenues. By contrast, loans are found to be associated with a higher tax effort. The IMF study also finds that in countries where institutions are weakest (as measured by the average corruption index in the *International Country Risk Guide*), any increase in grant aid would be canceled out by a reduction in public revenues. The IMF authors suggest that the provision of grants should be accompanied by monitored efforts to curb tax exemptions and strengthen tax compliance.

The IMF concern about the budgetary implication of grants gains weight if these imply the need for recipients to co-finance projects, as suggested by the Meltzer Commission. Odedokun (2003) cites a specific example used in the Meltzer report whereby the recipient co-finances 30 per cent of the cost of vaccination of the country's children against measles; he points to the fact that this is equivalent to financing the entire project with a concessional loan of which 70 per cent is the grant element, with no grace period, so that the 30 per cent effective loan is to be paid upfront. Clearly, it is a cause for concern from both the recipient and donor perspective that the grant disappears as tax gifts to influential groups in the most corrupt countries, stimulates consumption and fails to stimulate growth.

Shock Absorption

The benefits of capital flows are not only derived from directing world savings to the most productive investment opportunities, but also from allowing individuals to smooth consumption over different states of nature by borrowing or diversifying portfolios abroad. Developing countries are likely to benefit greatly from inter-temporal smoothing of consumption levels. First, poor countries tend to be more shock-prone than richer ones; this provides another critical explanation concerning the reasons why poor countries haven't access to the international financial markets, namely the volatility of their resources. Second, since per capita income is low, any downside adjustment will hurt more than in countries with higher consumption levels.

Macroeconomic instability, driven by commodity shocks or natural disasters, is a recurrent feature of a poor country's macro economy. For the poorest countries, the annual number of natural disasters between 1997 and 2001 has been one every 2.5 years. Commodity price shocks are also more severe for poor countries. Low-income countries experienced this type of shocks on average every 3.3 years. About 26 heavily indebted countries have an export concentration of more than 50 per cent in three or fewer commodities, while 62 per cent of the total exports of the least developed countries are unprocessed primary commodities (see Guillaumont *et al.*, 2003).

Econometric analysis demonstrates that the volatility of poor countries is a key factor of their exclusion from international financial markets (see Kharroubi, 2006). This exclusion is not necessarily the consequence of a bad governance of the country, nor of a low average return on capital, but actually results from shortcomings in the organisation of the financial markets: the lack of efficient procedure for settling debts in case of negative shocks may become responsible for high spreads and for the exclusion of poor countries from financial markets.

Should these risks dissuade multilateral lenders from conceding loans? In a somewhat paradoxical way, the answer is negative: it should encourage them. For example let us suppose that a country has only one chance out of two of repaying its loans. The expected spread would be double that in rich countries: in many instances this is enough to explain why poor countries have little access to the financial markets.

Now consider a donor hesitating between grants and loans. Assume a loan has even only half a chance to be repaid. Then, for any given amount of taxpayers' money, the use of loans as opposed to outright grants allows to double the contemporary aid volume. This is the essence of the short-term leverage effect that lending allows.

Debt cancellation for the poorest countries in fact should not be interpreted as a negative sign for the future borrowing capacity of poorer countries. It instead invites deeper thinking on a carefully targeted debt cancellation policy as a companion to lending. From this perspective, the comparative advantage of multilateral banks and public creditors depends not on their debt collection procedures, as Bulow and Rogoff (2005) rightfully point out, but on their capacity of cancelling the debt without imposing harm to the country.

Private financial markets, in contrast, suffer from not having clean procedures for debt cancellation. Debtors in distress suffer "bad and ugly" crises, in the words of Stanley Fischer. This is why, far from reducing a country's volatility, private loans actually increase it.

Private lending has also been shown to add to rather than to reduce consumption variability, whether as commercial bank lending or as bond portfolio flows (Reisen and Soto, 2001). Global capital markets suffer from major distortions: the problem of *asymmetric information* causes herd behaviour among investors and, in good times, congestion problems; the fact that some market participants are too big to fail causes excessive risk taking; on the other hand, the liquidity needs of global investors, reinforced by prudential regulation, often prevent them to put small poor countries on their radar screen. Figure 2 shows that emerging market bond spreads (over US treasury bonds) tend to fall when raw material prices rise and *vice versa*. Debt flows to developing countries have been shown to be negatively associated to growth in the OECD area as low OECD asset returns push capital towards emerging-market debt. *US Federal Reserve interest cycles* and spreads on emerging-market bonds (EMBI+), debt-related flows, variations in investor risk appetite and emerging-market crises seem to be closely linked (Kumar and Persaud, 2001).

Figure 2. **Commodity Prices and Emerging Market Spreads**



Source: Own calculations based on market data.

Low OECD-area interest rates rates push hard currency debt flows towards emerging markets; high rates suck them back towards safe havens. As liabilities grow in dollar, yen and euros, mismatches in the balance sheets of emerging-market private and public sector have often developed, in particular when the Fed has kept interest rates lower and longer than in a typical cycle. Slok and Kennedy (2004) provide significant evidence that the G3 monetary impulse (M2) is an important explanatory variable for the EMBI+ spread (the yield difference of emerging-market bonds over US treasury bonds). This finding has again been confirmed mid 2006 when rising interest rates caused jitters in emerging bond and currency markets.

This background militates quite strongly for a public solution, a *lender of first resort* with a shock-absorbing loan portfolio. Both multilateral and bilateral development banks can – and should – fulfil that function (see Box 3).

Box 3. **Findings of the Gurría/Volcker Commission on the Role of the MDBs in Emerging Markets**

- Given the immaturity of their economic and financial institutions, the small size and vulnerability of their markets, and the volatility of global financial markets, access of these countries to private capital can be unreliable, limited and costly for them, exposing them to great insecurity even when their long-run growth prospects are strong.
- Lending is a vehicle for policy change and for promoting international goals.
- Services that are bundled with lending also help to support objectives of the global community: poverty reduction, human development, protection of the environment, financial accountability, and standards of public procurement that curtail corruption and promote competition.
- For the non-borrowing member countries of the MDBs, the benefits of MDB lending to EMEs are substantial and they are not costly to taxpayers.
- Lending to emerging markets does not crowd out, but rather indirectly supports, lending to poorer countries.

Source: Gurría and Volcker (2001).

Development-friendly Loan Design

Following this reasoning, we propose a new scheme of subsidised development loans that changes the way in which the grant element is provided. Our proposal builds on and advances the idea developed by Guillaumont *et al.* (2003), who recommend using the subsidy element embedded in concessional loans to finance cushioning rather than subsidising interest rates. The long decline in world interest rates has partially eroded the usefulness of interest subsidies to developing-country borrowers. By contrast, the provision of state-contingent loans – with an explicit relief clause in case of predefined exogenous shocks – is more useful to recipient countries.

The scheme that we propose is simply the following. Soft loans would carry higher interest rates than they do now, but would contain a provision that the service of the debt would be cancelled should the country experience a negative shock. These provisions will have to be calibrated in order to face raw material shocks and natural disasters by which customers are bound. Furthermore, should a country enter a zone where defensive lending becomes the rule rather than the exception; an external audit procedure will lead the development bank to cancel part of the stock of unsustainable debts of the concerned countries.

To give a practical example (Table 4), developing countries could be classified in four risk groups respectively calling for a 25, 50, 75 or 100 per cent of provisions. In the first group, considered as exceptional, ODA worth 100 units would allow a loan of 400 units. In the second group, the same provision would allow for a loan of 200 units; in the third group, 133; the fourth and last group would call for outright grants.

Table 4. **ODA Loan Scheme (Example)**

ODA	Provisions (per cent)	Loans
100	25	400
100	50	200
100	75	133
100	100	0

The key problem entailed by a debt cancellation policy is linked to the risk of moral hazard it threatens to introduce. The risk is that of transferring resources from properly managed countries that honour their debt commitments toward those who failed to do so. The suggested procedure puts limits to this risk, insofar as the amount of provisions depends on the analysis of the country creditworthiness, that takes into account institutional risks and *a priori* external and internal causes which prevent a country from repaying its debts. Moreover a country which shifts from one risk category to a lower one is rewarded by the fact that the grant component of the loan that it receives becomes a lower part of the conceded credit: it can thus rely on a higher leverage effect as a lower volume of ODA is sterilized as a provision against risk. The more solvent a country (i.e. able to build its institutions to honour its debts), the higher the possible leverage. Instead of a fixed discount (as in the 14th replenishment of the International development Association, IDA 14), our proposed solution resorts to a progressive scale which is a function of the country's good governance.

A country, without any adequate institutional basis (Bulow and Rogoff's argument) would be rejected from the debt system, insofar as it would represent a too high risk. Only the countries whose governance makes the risk acceptable would have thus access to this system which would take in charge (by the public subsidy) the intrinsic risk linked to the volatility of the country.

With regard to that, it is useful to compare our proposal with the way by which the new IDA 14 campaign was designed for the period 2005-2008. The IDA plans to devote around a third of its resources to grants rather than loans. On the basis of criteria of debt sustainability established by the Bank and the IMF, a country can benefit from IDA loans providing its debt remains below the expected criteria. The thresholds account for 100, 200 or 300 per cent of exports according to the institutional risk, as measured by its CPIA (Country Policy and Institutional Assessment, established by the World Bank). If the country does not qualify for new debt because of its already accumulated debt, it can obtain IDA grants.

Box 4. **Reducing Currency Mismatches through Local Currency Lending**

A review of the financial crises that plagued many developing middle-income countries during the 1990s found that currency mismatches in the balance-sheets of public and private borrowers not only increased the likelihood of getting into a financial crisis, but also raised the affected countries' output cost of escaping the crisis (Goldstein and Turner, 2004). Over the last few years, multilateral and bilateral development banks have introduced local currency financing as an additional lending option to their clients, driven by the heightened awareness of the risks entailed in foreign currency lending and the desire to respond better to the financing needs of subnational public and small- and mid-scale private borrowers.From the perspective of developing countries, local currency loans carry considerable benefits (ADB, 2005):· While borrowers from OECD countries can either borrow internationally in their domestic currency or enter a fully hedged transaction if borrowing in a foreign currency, developing-country borrowers usually do not have this option. Development bank lending can *reduce currency mismatches* by extending local currency loans, preferably in co-operation with the local financial sector to complement and catalyse local financial resources. *Local financial markets can be developed* by setting new benchmarks, by spreading best practice standards in documentation, execution, and innovation, by stretching the yield curve and lengthening maturities, and by providing significant diversification opportunities for institutional investors.· *Catalysing local finance* by facilitating the access (e.g. through partial credit guarantees) of non-government borrowers to local currency bond markets and by providing instruments that help lengthen maturities.Care must be taken by development banks that offer local currency lending to avoid crowding out private local actors, either as an issuer of bonds or as a lender.

In order not to penalise a creditworthy country in comparison with another country which is no longer creditworthy, IDA 14 allows for a one-off 20 per cent cut in grant (and sometimes only 9 per cent when the country is coming out from a major conflict). This is meant to reduce the risk of moral hazard through penalising purposeful irresponsible debt policies.

The mechanism proposed here stems from the same idea but applies it more systematically. The leverage effect that debt offers depends indeed on building up provisions, which directly represents the part of the grants coming from the donors. The more creditworthy the country is, the higher is the leverage effect from which it will benefit. Instead of only considering a lump sum deduction, the solution proposed here consists in applying a progressive scale.

Conclusion

It is one thing to welcome debt cancellation and another to consider that lending is a bad thing in general. Far from being contradictory, we think that a debt cancellation policy is a necessary component to sound debt policies. This paradox is quickly settled. Poor countries suffer from high volatility and thus from some dissuasive risk premiums in international financial markets. Subsidising the provisions that the development banks should build up gives the rich countries leverage on aid, which represents a considerable advantage for donors.

Moreover, provisioning corresponds to an explicit and transparent assessment of the country risk and thus calls attention to country specifics and policies. Such provisions should be counted as ODA as their cost is not born by debtor countries. By putting aside a proportion of the volume of ODA available to any debtor country, the scheme actually encourages virtue since required provisions would be lower in less risky countries. Overall, it would provide a powerful incentive for sound fiscal management and a springboard toward full access to international capital markets.

Notes

1. The G8 Summit was held in Scotland in July 2005.

2. The OECD Development Assistance Committee (DAC) calculates the grant element as the difference between the face value of the loan and the discounted present value of the service payments the borrower will make over the lifetime of the loan, expressed as a percentage of the face value. To qualify as ODA, a loan must include a 25 per cent "grant element", in comparison with a loan of similar nominal amount and duration carrying a 10 per cent interest rate. The rate of 10 per cent has no relation to the current market interest rate, but was chosen as an estimate of the opportunity cost of public investment for donors, which in turn can be approximated by the donors' social opportunity cost to public spending on ODA (see, e.g. Young, 2002).

3. This is a worthwhile discussion. Its merit notably hinges on the unbundling of a concessional loan into its basic components: not only does it contribute to greater transparency, but it also highlights the use of taxpayers' money (less visible in a concessional loan) and invites greater focus on the rationale for using subsidies in the first place. One of the crucial questions about ODA is why, when and how to use subsidies. With concessional loans, there is a risk that the subsidy is simply justified by the quest for market share under competition with other donors and with financial institutions. Unbundling thus contributes to greater efficiency.

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