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Comment on "*Beyond "Grants versus Loans": How to use ODA and debt for development"*" by
Daniel Cohen, Pierre Jacquet and Helmut Reisen

Paul Reding,
University of Namur, Belgium

The paper provides a thorough and very convincing analysis of the ongoing debate about the comparative advantages of "grants versus loans" as efficient instruments of ODA. Its main thesis can be summarized by the following lines of argument:

- pervasive market failures limit access to international capital markets for ODA recipient countries ;
- in many cases, concessional loans are therefore superior to outright grants in mobilizing resources for development, provided they effectively address the crucial question of maintaining the sustainability of the borrowing country's debt ;
- development agencies have a comparative advantage over the market in making these loans and in designing the appropriate and most efficient "bundle" of "a regular loan" on the one hand (the financial intermediation element) and of "subsidies" (i.e. the grant element) on the other hand;
- in order to design such efficient bundles of "loans +ODA subsidies", new approaches in delivering ODA need to be explored.

I would like to elaborate on four selected themes which bear on the paper's key issues: debt sustainability; the design of new ODA lending instruments; donor coordination; the accounting framework for ODA;

1. Debt sustainability

It clearly is this question which has, in the current debate of "loans versus grants", led to favouring outright grants for poor countries for which, given past experience, prospects of being

able to carry additional new debt are weak. New loans, even on appropriate concessional terms, should therefore only be envisaged for countries whose stock of debt is below a "sustainable debt threshold" and expected to remain so, under normal circumstances. Loans are in this case desirable for the recipient country because they imply a commitment on behalf of the donor which is a priori much stronger than a promised flow of outright grants with an equivalent net present value in terms of ODA. The donor can however only justify such a stronger commitment before his own constituency or before other potential beneficiaries of the allocated ODA resources, if the non-ODA part of the concessional loan can be expected to be fully reimbursed in all states of nature. This raises the following two closely linked issues:

- First, the general issue of the design of the "conditionality framework" under which a given loan would be initially committed and within which the scheduled disbursements would be later made. On this issue, I would just like to stress that effective conditionality requires credibility of conditionality. For credibility of conditionality to exist, i) full "country ownership" surely is a necessary prerequisite, as only in this case will the government be able to be fully committed to it ; and ii) donors should make clear that the conditionality under which the loan is made will indeed , ex post, be effectively applied as announced.
- Second, the proper definition of the debt sustainability threshold: in the new framework for concessional ODA loans proposed by the authors, the importance of this debt sustainability threshold is twofold. First, it determines whether at any moment in time a country may qualify for a loan; second, it is a crucial parameter for the trigger mechanism which allows the borrower to benefit from the "insurance against adverse shocks" component embedded in the loan-ODA bundle, helping him to adjust debt service to current servicing capacity and thereby to escape the debt trap. How then should this debt sustainability threshold be defined, be it as a debt stock or a debt service ratio? The authors indicate that this should give rise to a "careful debate". Indeed, and a complex one! The threshold used for eligibility to HIPC debt reduction has principally be the debt-to-export ratio, modulated by the so-called fiscal window which relates debt to government revenue. The parameter value, initially set to 250% has progressively been lowered to 150%. The authors suggest that this should be a maximum. A new framework for debt sustainability analysis is now being considered by the IMF. In an effort to

provide stronger incentives for institutional reform, it modulates the "indicative threshold" of sustainable debt according to the country's quality of policies and strength of institutions, the threshold being lowest for countries with the weakest institutions and policy quality. Forward looking and "country tailored" thresholds are indeed clearly advisable, as opposed to the fixed and "one-size fits all" threshold of the HIPIC Initiative. What needs however to be more carefully debated is whether it would not be desirable to also modulate this debt sustainability threshold according to the country's performance with respect to selected human development indicators? Given the donors' strong commitment to the MDG, would it not be appropriate, for example, that a country facing unexpected difficulties in fulfilling its human development programme, as embodied in its PRSP, be entitled, under the ODA financed insurance scheme imbedded in the loan commitment, to quicker and larger debt service relief?

2. The design of new ODA lending instruments

A key point rightfully stressed by the authors is that ODA lending needs to be combined with a mechanism which contributes to insure the borrower against adverse shocks to his revenues. Hence their proposal to develop new instruments which embed this insurance mechanism as an ODA financed subsidy. They suggest different ways to do this, proposing a comprehensive scheme which also endeavours to minimize moral hazard.

Obviously, the kind of mechanisms which insure the borrower against adverse shocks which weaken his debt service capacity are today in scarce supply in the private market. Commodity indexed bonds have been issued as part of debt restructuring agreements (so-called recapture clauses in the Mexican and Venezuelan Brady bond deals). Quite recently, Argentina has issued for every restructured bond a GDP-indexed warrant, promising to pay more if actual GDP growth exceeds base line projections. But these are exceptions and they only concern middle-income countries. Given this observed state of market failure there is clearly a role for public intervention, especially for low income countries which happen to be the most vulnerable to exogenous shocks. The case for public intervention is moreover strengthened once it is taken into account that insuring development countries against specific risks has system wide benefits and therefore generates a positive externality.

What are, in this respect, the comparative advantages of development agencies in providing this type of concessional loans with specific insurance clauses? First, they are surely less exposed to informational asymmetry, given their long term involvement with the borrower. Second, and probably more importantly, they can muster the necessary capacity to achieve effective risk pooling across countries. If they offered, for example, GDP indexed loans, they would have the capacity to diversify away the individual GDP risks, given that, as shown by recent research, GDP growth rates are weakly correlated across countries. The same would be true for "inflation indexed local currency" loans, aimed at protecting the country from the negative effect of real exchange rate depreciations. This type of loans would also be a useful addition to the menu of development agencies' ODA loans.

Note however that a strong coordination between donors is a prerequisite in order to successfully implement this new and highly desirable insurance oriented ODA lending framework: to reach optimal risk diversification, the new scheme has to be launched on a sufficiently large enough scale from the start; pooling across countries needs to be extensive enough (with the additional option of mutual reinsurance contracts between donors). Also, debt or debt service reduction provided under this insurance scheme can be poisoned by free-rider problems and therefore call for maximum cooperation between creditors. A key issue is therefore whether donors are indeed ready to engage in close enough multilateral collaboration to launch this new type of ODA loans. The stakes are huge, and not only for poor countries. Indeed, steps taken by donors to provide subsidized GDP-indexed loans or inflation indexed local currency loans might be a powerful signal and strong incentive for private markets and actors to provide for similar bonds to be issued by emerging market sovereigns, or even by developed countries.

3. Donor coordination

While donor coordination is obviously crucial in setting up an ODA "loan cum insurance" framework, as stressed by the authors, there are other arguments that plead for reinforcing the present level of coordination amongst donors.

Coordination presently occurs mainly within OECD's DAC, but needs to be extended beyond, as the DAC does not include potentially important players, like Russia or China. Broad coordination is crucial for establishing a harmonized framework for designing conditionality, a conditionality which promotes aid effectiveness, is tailored to the borrowing country's needs so as to make a full

commitment by its government possible, but is nevertheless still sufficiently streamlined so as to avoid the huge costs different layers of "cross-conditionality" are known to entail. Coordination is also crucial to avoid that donor competition and "loan pushing" result in the weakest conditionality ultimately being applied or, equally as undesirable, that aid is allocated without due regard to the development needs or the absorption capacity of the recipient country.

Given the obvious advantages of stronger coordination among donors and the repeated insistence with which it is called for, particularly from the side of recipient countries, how does one go about in order to foster it and to reign in observable trends towards bilateralism, trends no doubt mainly inspired by geopolitical reasons? Shouldn't one expect from the European Union, which after all provides a large chunk of total ODA, to take on a leading role in this respect?

4. The accounting framework for ODA

The authors stress the problems raised by the current way ODA is measured as an opaque combination of outright grants and of net disbursements of loans, which include, depending on their degree of concessionality, a variable but unreported component of grant element (of at least 25%). Efficient and equitable use of public funds allocated to ODA cannot be monitored – and therefore not be guaranteed - if the accounting framework does not provide for transparent identification of two different categories of flows : on the one hand, aid flows, which indeed represent budgetary outlays, and, on the other hand, loan disbursements or reimbursements which represent balance-sheet operations. Only the first category of flows should be counted as ODA. In measuring the grant element in loans, care should be taken to properly account for the ODA content in loan guarantees or other contingent, off balance-sheet, liabilities which are an important building block of the new approach of delivering ODA in the author's proposal but for which pricing is not necessarily an easy matter. Development of pricing models for instruments such as GDP-linked bonds would for example become necessary.

A related point concerning proper ODA accounting is the treatment of debt-relief which is assimilated as ODA even if just represents long overdue balance-sheet cleaning-up of past losses on unrecoverable debt and does not in any way transfer real resources to the beneficiary country (for Belgium and France, this indeed represented about 50% of ODA in 2003 – an atypically and exceptionally high amount) . Budgetary rules need to invite proper loan-loss provisioning and amortization. This would, as a result, spread the cost of debt relief over time, instead of having to

budget it fully as ODA during the year it is finally granted. Having to count as budgetary outlay the amount of debt cancelled at face value may indeed have made several European governments somewhat reticent to agree to needed debt reduction operations. Given the EU's Pact for Stability and Growth budgetary norm, some governments could indeed have been worried about the effect of comprehensive debt reductions on budgetary deficits. Proper budgetary accounting of debt amortization and relief could therefore also contribute to facilitate in the future timely and orderly debt reduction for debt-distressed countries.

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