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**Exogenous Shocks – Dealing with the Only Certainty:  
Uncertainty**

Paper prepared for the Commonwealth Secretariat<sup>1</sup>

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## **EXECUTIVE SUMMARY**

Uncertainty, risk and attendant constraints on the ability of Commonwealth members including the poorest, smallest and most vulnerable Commonwealth members, to address their macroeconomic, developmental and other challenges in recovering growth and sustainable development, have escalated significantly in recent years and evidence shows that external shocks matter disproportionately for the smallest and poorest members of the Commonwealth.

A key contribution in addressing external shocks comprises adequate and readily accessible shock facilities. Important improvements were made by International Financial Institutions (IFIs) to these facilities in the aftermath of the 2008 and subsequent global financial crisis. There were significant changes to the shock facilities inter alia of the IMF, World Bank, regional development banks and European Union: and resources were augmented significantly.

As uncertainty has deepened and risks have grown, it is opportune for Commonwealth Finance Ministers to assess how best the existing international framework for shock facilities can be improved, in practical ways, to provide the liquidity needed by Commonwealth and other developing countries, as a counter-cyclical instrument to smooth the effects of internal shocks, to sustain growth and to protect social systems through crisis.

The paper assesses progress in the design and use of shock facilities since the crisis. The IMF is reviewing its current shock facilities, presenting a unique opportunity for Commonwealth members to provide practical inputs to the review process. The paper suggests a number of possible contributions.

Commonwealth developing countries have benefitted from the range of shock facilities provided by IFIs since the crisis erupted in 2008. The paper briefly assesses Commonwealth experience, in the context of a sample of Commonwealth developing countries. Lessons learned and ensuring recommendations for improvement in international shock facilities are set out.

A new medium-term challenge is also emerging, which could truncate developing country access to IMF concessional resources. There is a strong risk that in the absence of early action, the subsidy element of the Poverty Reduction and Growth Trust (PRGT) may not be adequately funded, resulting inter alia in a significant reduction in IMF concessional financing for external shocks. The Commonwealth is well placed to mobilise support for replenishment of this element of the PRGT. Key approaches and proposals are proposed and Ministers are asked their views on them.

Text boxes summarising key issues and posing key questions and issues for Ministerial discussions are set out throughout this paper. Ministers are asked to consider what specific steps can be taken by the Commonwealth as a whole to contribute to improvement in shock facilities; and to indicate what role the Secretariat can play in promoting members efforts.

# **Exogenous Shocks – Dealing with the Only Certainty: Uncertainty**

## **Introduction**

In recent years and particularly since the 2008 global financial crisis Ministers have used the opportunity of their annual Commonwealth Finance Ministers Meeting (CFMM) to discuss a series of issues spurred by the sudden emergence of the global crisis. These have included discussion on how best to meet the challenge of higher food and energy prices (CFMM 2008); a wide-ranging policy dialogue focusing on how Commonwealth members can best address unexpectedly large deteriorations in levels of investment, remittances, access to finance for development, reserves, employment, as well as weaker social protection systems (CFMM 2009); the rapid emergence of debt challenges of small and vulnerable Commonwealth members (CFMM 2010); and options both to deliver and utilise aid more effectively as well as to mobilise innovative finance for development (CFMM 2011).

2. A common and inter-twined thread running through these recent Commonwealth Ministerial discussions has been both an on-going sense of uncertainty and a lack of resilience capacity to external shocks. Ministers have grappled with the challenge of uncertainty about the future trajectory of the global economy and the international policy responses required to enable countries, particularly the poorest, smallest and most vulnerable Commonwealth members to respond to external shocks; uncertainty regarding the financial and institutional capacity of these countries to address their vulnerabilities, rebuild their pre-crisis buffers and build new capacities for resilience in the face of persistent crisis; and uncertainty about how resources for development will be secured, on the scale and with the degree of reliability needed to absorb new external shocks as they come, so enabling these countries to eradicate poverty and to achieve higher levels of growth and sustainable development. For all Commonwealth members, experience in the past five years has clearly shown that external shocks matter. They can disrupt both short term growth and long term development; they have become more frequent and more damaging, increasingly transcending economic, geographic and political boundaries; and in an increasingly interdependent world these shocks and the uncertainties that underlie them are becoming more quickly transmitted and amplified.

3. At CFMM 2012, Commonwealth Finance Ministers will again meet at a time of profound uncertainty, on this occasion brought about by the Eurozone crisis, unclear prospects for sustained recovery in the US and Japan and the slowing pace of growth in many dynamic emerging markets. At the same time, additional challenges and risks require urgent global attention and resolution, including increased price volatility; growing demand for and an escalating scarcity of resources; and addressing climate change adaptation and mitigation. In recent years many poor and climate-vulnerable Commonwealth countries have also experienced more frequent, deeper and more costly natural disasters. Determining how best to achieve the Millennium Development Goals (MDGs) and to address successor goals after 2015, when the MDG framework comes to an end, is also emerging as a major long-term challenge and a source of escalating uncertainty, as many developing countries grapple with this challenge in the face of substantially reduced fiscal space, reserves and social safety nets. More immediately, agriculture price shocks are again becoming serious in the face of drought in the US and are of key concern to many Commonwealth developing countries.

4. Finding ways to address these uncertainties and accentuated risks is crucial for all Commonwealth members and points to the need to ensure that sufficient resources and appropriate mechanisms are available both in the short and medium term, to stabilise growth, protect social systems and provide policy space for economies to absorb and respond to shocks and uncertainty. Indeed, the Eurozone debt crisis has shown that a global safety net and shock facilities are needed for all countries; while the Commonwealth's poorest, smallest and most vulnerable developing countries have consistently emphasized their inherent structural vulnerability to exogenous shocks and have highlighted the need to review, systematize and expand shock facilities.

5. Addressing shocks is important for other reasons too. Evidence shows the problem in poor countries is not just a failure to record periods of positive economic growth but also the frequency of downturns (Winters et al., 2010). Low Income Countries (LICs) increased their per capita GDP by only 11 per cent between 1960 and 2007. Either halving negative growth rates, i.e. halving the severity of downturns, or halving the percentage of years of negative growth over the forty seven year period would have increased GDP by about 70 per cent. But if negative growth rates could have been eliminated altogether, GDP per capita for this group of countries would have more than doubled and average annual growth would have increased to over 2 per cent rather than the 0.23 per cent achieved over this period. Poor countries seem to remain poor because they have periods of deeply negative growth that more than cancel out prior periods of positive growth. Such periods of negative or low growth are often caused by external shocks. LICs are often poorly equipped to deal with, and recover from, adverse shocks (Aiello, 2009). Growth in small vulnerable economies, many of whom are commonwealth members, is particularly strongly hit by external shocks (Griffith-Jones and Tyson, 2010). Consequently shocks financing is particularly significant for low income and small vulnerable economies, though important for all developing economies.

6. **At the peak of the global financial crisis, international financial institutions significantly augmented their shock facilities.** These facilities proved crucial to many Commonwealth developing countries as they sought to maintain macroeconomic stability and protect social systems through the crisis. But as uncertainty has continued and additional new challenges have emerged it has become clearer that new, better calibrated and more effective shock facilities are required to help these countries. For these reasons, Ministers have often noted the need to review the external shocks architecture of the IFIs in light of many Commonwealth members structural vulnerability to exogenous shocks. It is timely for Commonwealth Ministers to consider this issue given the broader concern that new shocks are likely to arise from the on-going Eurozone crisis, the general slowdown of the world economy and from a possibly longer period of slow growth internationally. The IMF is also currently reviewing its lending facilities offering an important opportunity for Commonwealth views and perspectives to be highlighted and constituted to the review process. Given the acute severity of shocks the international community needs to stand ready to continue sheltering its poorest and most vulnerable countries from such shocks and it is increasingly important that existing shock facilities are reviewed, in order to establish a more permanent, well-coordinated and financially sustainable shocks architecture.

7. Consequently this paper considers a specific issue, of particular concern to Commonwealth members and particularly to the associations' poorest, smallest and most vulnerable members as these members seek to respond to external shocks and to perennial uncertainty – **the availability and character of multilateral financing to address external shocks.**

8. **Section 1 considers a range of shock facilities provided by international financial institutions in response to the financial crisis.** IMF shock facilities both strengthened and increased considerably through the crisis. But as Commonwealth developing countries seek to cope with external shocks and respond to on-going global uncertainties, the paper finds that **important issues remain regarding the sufficiency and composition of such support.** With the IMF's review of its shock facilities underway, Ministers are asked to discuss their recent experience in accessing shock financing and to consider a number of design issues to strengthen IMF shock financing. The shock facilities provided by the World Bank and by the European Union are also briefly considered and Ministers are asked their views on how these facilities can also be further strengthened.

9. Closely associated with the challenge of strengthening shock facilities is a further issue. There is growing consensus that official liquidity and development finance (both concessional and non-concessional), as well as grants, need to play an important role in mitigating the impact of shocks. This seems to imply the desirability of **allocating a higher proportion of official resources to shock financing in order to** help developing countries including the many Commonwealth countries which lack resilience address shocks. An important policy question is therefore whether more emphasis should be placed on dealing with shocks, to help avoid growth declining in the short term, thus preventing a serious disruption in efforts to pursue development and poverty alleviation, and in such a case how can the potential trade off in allocating less funds to other development activities be addressed. Ministers are asked whether a greater proportion of IFI resources, including resources provided by the IMF, should be allocated to shock financing.

10. **Section 2** briefly examines the experience of a small selected group of Commonwealth small and vulnerable developing countries from the Caribbean, Pacific, Indian Ocean, Sub-Saharan Africa and South Asia, which have benefitted from a variety of shocks facilities since the global crisis emerged in 2008; and from this brief analysis considers lessons for further improvement in the existing range of shock facilities.

11. Beyond strengthening the design of existing facilities and developing new shock instruments, a new challenge is also emerging, which if not addressed will result in a significant reduction in aggregate concessional financing available to Commonwealth and other developing countries. **Section 3** examines this challenge, which pertains to the need to replenish the subsidy element of the Poverty Reduction and Growth Trust (PRGT) – the fund which underpins IMF concessional support to its eligible developing countries. In the absence of substantial replenishment, this is set to fall away significantly from 2014, in turn potentially significantly reducing concessional funding including crucially-needed access to IMF shock financing. The paper considers how Commonwealth members supported by the Secretariat can build consensus and potential Commonwealth advocacy, on reforms which strengthen the exogenous shocks architecture. **Section 4** concludes. Key issues and questions are raised for Ministers' consideration throughout the paper.

## **1. IFI Shock Facilities – Overall Responses to the Financial Crisis**

12. International Financial Institutions (IFIs - including the IMF, World Bank and the Regional development Banks) increased their lending to developing countries very significantly as a response to the major crisis that started in 2007 (Figure 3). Total lending commitments to developing countries jumped dramatically from around \$50 billion in 2007

to around \$175 billion in 2009 and thereafter to an average of just over \$200 billion annually in 2010-2011, resulting in a quadrupling of total lending commitments between 2007 and 2010-2011. Particularly large was the increase in IMF lending during those years.

13. **The IFIs response was very large and positive, especially for MICs and for commitments.** It covered for example quite a large proportion of ACP countries' export shortfalls, especially in 2007 and 2008 (see Table 6 below). Though counterfactuals are always difficult, the large compensatory and generally counter-cyclical IFI lending, combined with the existence of valuable buffers in developing countries including high fiscal space, in many cases high levels of reserves, and lower levels of external debt helped limit growth declines in developing countries in the face of major external shocks. Indeed growth in LICs, which had averaged 6.5 per cent annually in 2005-2007, fell to 5.7 per cent in 2008 and to 4.7 per cent in 2009, according to World Bank data; though undesirable, such a decline could have been worse given the magnitude of the shocks, and was followed by recovery to an average of 6.0 per cent growth in 2010-2011. There were important exceptions to this evolution, discussed further below, especially in countries particularly badly hit by external shocks or especially vulnerable to them. MICs growth was, however, more seriously hit by the international crisis, perhaps because MICs are more closely integrated with the international economy, especially via private capital flows; MIC growth, which reached 8.0 per cent annually in 2005-2007, fell to 5.7 per cent in 2008, and quite significantly to only 2.6 per cent in 2009, though recovering to 7.0 per cent annually in 2010-2011.

14. There are two important caveats to this overall fairly impressive response to the crisis by IFIs. Perhaps most importantly, **total lending commitments to LICs went up by far less than the total for all developing countries**, from \$17.5 billion annually in 2007-2008 to over \$23 billion annually in 2009-2011, that is by around 33 per cent, which is a lot less than the increase in commitments for MICs (see Figures 3 and 4, and Table 4). One could perhaps argue that in some ways, LICs were the Cinderella amongst developing countries in terms of their access to IFI financing though their access did increase, and they had benefited from a previous increase from \$14.5 billion in 2006 to \$17.5 billion in 2007, more linked to food and fuel prices hikes. It is a source of great concern that beyond 2014, funding for subsidies for all IMF lending are currently projected to be very low, which could restrict significantly the Fund's capacity to lend to LICs, to well below pre-crisis levels. Cinderella would become even more abandoned, unless funding is urgently found!

15. Secondly, **the response was also somewhat slow** as the most important increases only happened in 2009-2010, well after the crisis started. This picture is even clearer if we look at actual disbursements, which often lagged commitments quite significantly. Tables 2 and 3 and Figure 1 and 2 below, illustrate these trends. Table 2 shows for example that, though IDA commitments increased quickly in 2007 and 2009, disbursements hardly grew in those years, and only increased modestly in 2008 and especially in 2010, that is well after the shocks had hit LICs. Figure 2a shows the cumulative commitments and disbursements from 2006 to 2011. As can be seen, disbursements are continually less than commitments from 2008 onwards with the cumulative "disbursements gap" increasing to \$286 billion by 2011. The majority (93 per cent of \$265 billion) of this gap relates to MICs where disbursements were slow. **A key policy lesson here is to ensure that both appropriate lending facilities and sufficient resources are in place before crisis and other major shocks hit, and that shocks facilities can be disbursed quickly, implying low conditionality and forward looking triggers.** Furthermore, it may be more appropriate to use special shocks facilities to provide

most of the financing due to shocks, rather than rely also a great deal on broad lending or grant mechanisms, as occurred in 2006-2011.

**Table 2 IDA Commitments and Disbursements**

	\$ millions					
	2006	2007	2008	2009	2010	2011
<b>Commitments</b>	9,506	11,867	11,235	14,041	14,550	16,269
<b>Disbursements</b>	8,910	8,579	9,160	9,219	11,460	10,282

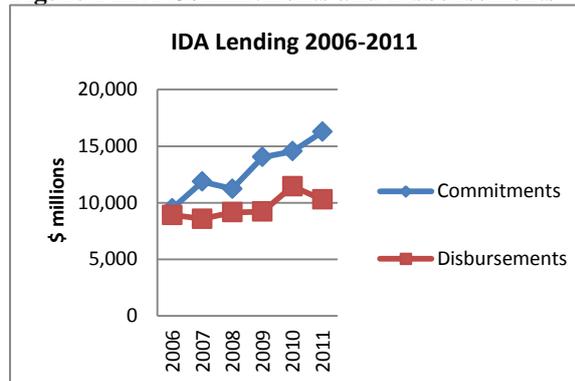
Source: World Bank Annual Reports

**Table 3 IBRD Commitments and Disbursements**

	\$ millions					
	2006	2007	2008	2009	2010	2011
<b>Commitments</b>	14,135	12,829	13,468	32,911	44,197	26,737
<b>Disbursements</b>	11,833	11,055	10,490	18,565	28,855	21,879

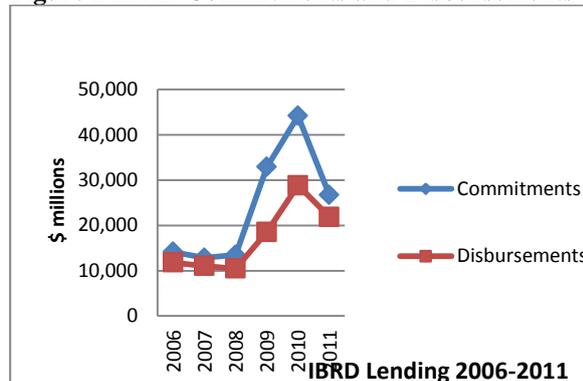
Source: World Bank Annual Reports

**Figure 1 IDA Commitments and Disbursements**



Source: World Bank Annual Reports

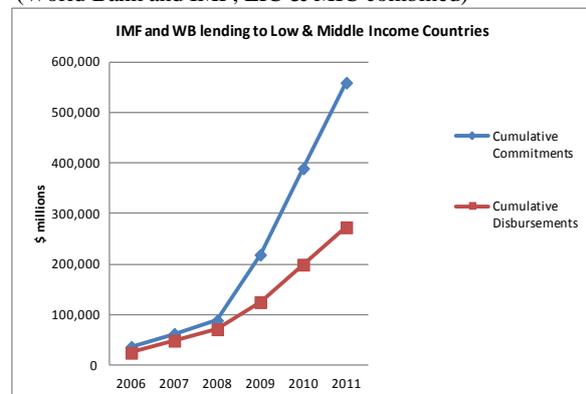
**Figure 2 IBRD Commitments and Disbursements**



Source: World Bank Annual Reports

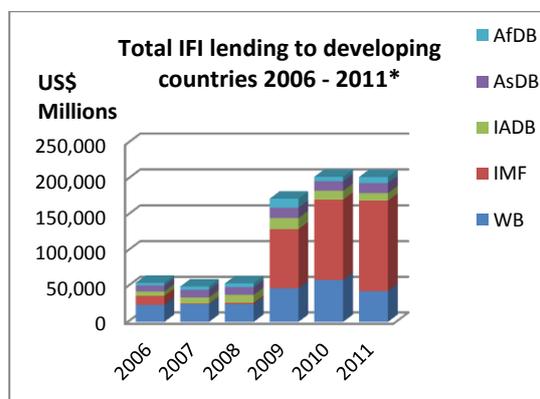
**Figure 2a: Cumulative Commitments and Disbursements 2006-2011**

(World Bank and IMF, LIC & MIC combined)



Source: World Bank Annual Reports

**Figure 3: Total IFI lending to all developing countries by lender (2006-2011)**

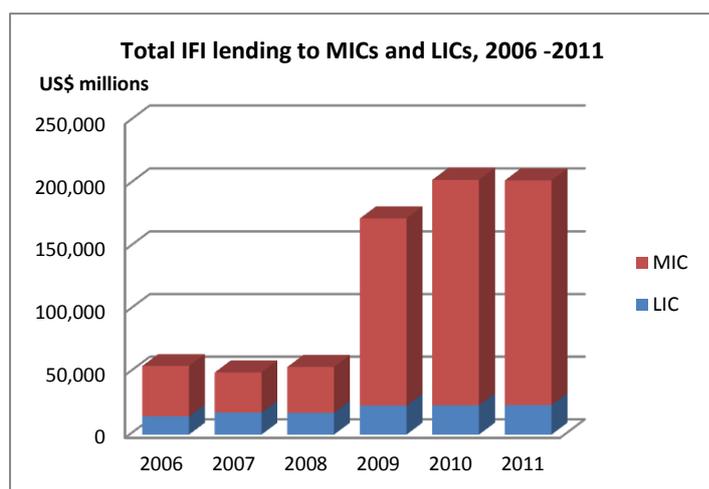


Source: Annual Reports

\* Commitments approved in financial year for low- and middle-income countries, as classified by the World Bank. As referred to lending, excludes EU facilities, which are grants.

16. The IFIs broad response to the crisis was driven by a significant increase in overall lending and it is instructive that much of the response was channelled through regular, rather than crisis facilities. Notwithstanding this, shock financing through special facilities by IFIs also increased significantly for LICs, increasing from very low levels in 2006-2008, to just over \$2.5 billion in 2010, the peak year. Figure 6 illustrates the range and dispersion of these facilities between 2006-2011.

**Figure 4: Total IFI lending to all developing countries by income level (2006-2011)**



Source: Annual Reports

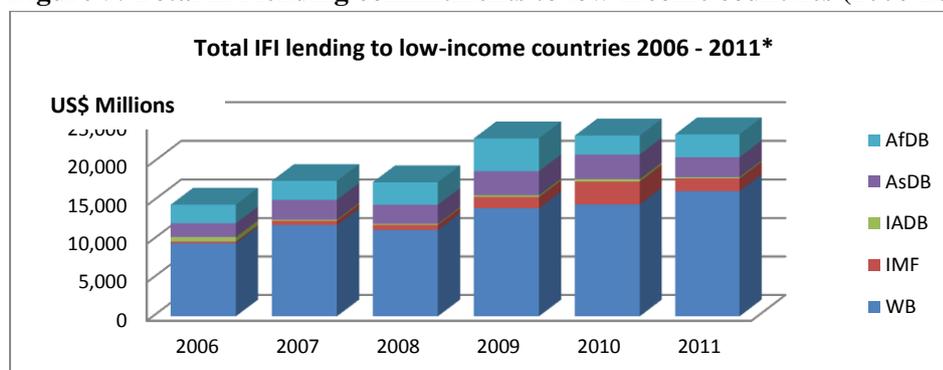
\* Commitments approved by IFIs in financial year for low- and middle-income countries, as classified by the World Bank; excludes EU grants.

**Table 4: LIC and MIC lending commitments for all IFIs (US\$ Millions)**

	2006	2007	2008	2009	2010	2011
LIC	14,516	17,582	17,416	23,092	23,456	23,630
MIC	40,234	32,092	36,584	149,266	179,594	178,937
<b>Total</b>	<b>54,750</b>	<b>49,674</b>	<b>54,000</b>	<b>172,358</b>	<b>203,050</b>	<b>202,568</b>

Source: Annual reports

**Figure 5: Total IFI lending commitments to low-income countries (2006-2011)**



Source: Annual Reports

\*Commitments approved in financial year for low-income countries, as classified by the World Bank. Excludes EU grants

**Table 5 Low income country total IFI lending commitments (US\$ Millions)**

	2006	2007	2008	2009	2010	2011
IDA/WB	9,506	11,867	11,235	14,041	14,550	16,269
IMF	195	550	657	1,452	2,969	1,626
IADB	605	152	138	228	297	181
AsDB	1,802	2,566	2,471	3,134	3,195	2,569
AfDB	2,408	2,447	2,915	4,237	2,445	2,986
Total	14,516	17,582	17,416	23,092	23,456	23,630

Source: World Bank Annual Reports

**Table 6 Financing committed as a percentage of shortfall in export earnings 2006-2009**

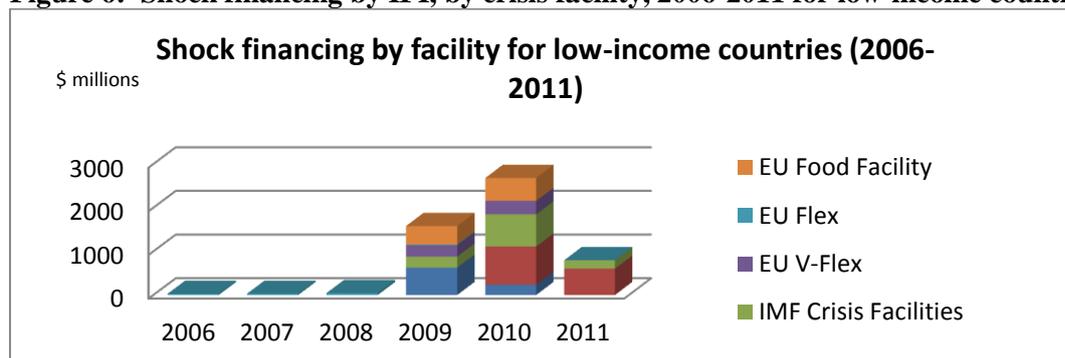
(Note low net export shortfalls in 2007 affected 2007 figures).

IFI	2006	2007	2008	2009	Facilities
EU	4%	18%	22%	7%	FLEX, V-FLEX
IMF	5%	67%	15%	22%	Emergency assistance, SCF/ESF, ESF
IDA	0%	0%	19%	4%	CRW, Food & Social Response Programs
IDA: CRW only	0%	0%	0%	0%	CRW only
<b>All IFIs</b>	<b>9%</b>	<b>84%</b>	<b>56%</b>	<b>34%</b>	

Note: CRW only started to be disbursed in 2010; includes EU grants, as well as IFI loans; refers to ACP countries.

Source: TeVelde, Griffith-Jones, et al, op cit

**Figure 6: Shock financing by IFI, by crisis facility, 2006-2011 for low-income countries**



Source: Annual Reports \* Commitments approved under facility in financial year for low-income countries, as classified by the World Bank. IMF Crisis Facilities consists of the SCF and RCF post 2010, and the ESF in 2010 and prior, which these facilities replaced. EU financing is in the form of grants, whereas IMF, WB and RDB are concessional loans.

### IMF Shock Facilities

17. In recent years, the IMF has made important changes to its lending facilities, especially as a response to the global crisis. Above all the IMF responded rapidly to the crisis with commitments to developing countries increasing very sharply from \$2 billion in 2008 to \$83 billion in 2009 and \$127 billion in 2011. This included, for PRGF-eligible countries, increases in commitments from \$657 million in 2008 to \$1.5 billion in 2009 and \$3 billion in 2010. Commitments subsequently declined to a lower, but still much greater than pre-crisis level, of \$1.6 billion in 2011, as the crisis abated. The fairly strong increase of IMF lending to low income countries was facilitated by a doubling of access as a percentage of quotas for all facilities in 2009.

18. Although these were large and welcome increases in IMF lending for LICs, three particular features of the IMF's response both during the immediate crisis and more recently

have proved challenging, particularly for the poorest, smallest and most vulnerable countries. Firstly, **the increases were far smaller than for MICs**, and more importantly these facilities did not sufficiently compensate for the large scale of the external shocks. Secondly, some aspects of the more recent changes in IMF compensatory financing facilities have proved disappointing, and seem, in several aspects, even to imply steps backwards. Thirdly, beyond 2014, there are insufficient resources for financing the subsidies to sustain desirable levels of IMF lending. Therefore several improvements are needed to the facilities, which we discuss below.

19. **Since 2005, reforms to IMF concessional financing facilities have put increased emphasis on shocks support.** Such a change of emphasis, which has resulted in a greater proportion of IMF lending to LICs going to shocks support in 2008-2012, is to be welcomed, though it is still insufficient in proportion to magnitude of shocks during the period. This followed two decades in which the Fund's financial support to LICs was channelled mainly through three-year financial arrangements, and shocks were addressed by augmenting financing only under these arrangements. This greater emphasis for LICs is in contrast to the trend for MICs, which, especially for trade shocks –as we discuss below - has broadly been going in the opposite direction, reducing for these countries, the importance of IMF compensatory financing for shocks.

20. The shift signals a recognition by the IMF that the size, frequency, and economic cost of external shocks tends to be higher in LICs than in other economies, increasing risk and uncertainty for private agents and governments, and that shocks can set back gains in increasing growth and reducing poverty. Given their heavy reliance on commodity exports, LICs, particularly in Sub-Saharan Africa (SSA), experience median terms of trade volatility nearly twice as high as in the rest of the world. (IMF, 2011). The new approach also recognises that with improved macroeconomic policies and institutions and growing global integration, the importance of external shocks in driving output volatility has increased, compared to that of idiosyncratic domestic shocks (Raddatz, 2008). As we discuss below, the implication of this has hitherto not been fully reflected in IMF shock facilities. **The IMF will shortly put forward a review of its lending facilities. This presents an important opportunity for the Commonwealth to offer proposals which can address these challenges leading to significant improvements in these facilities.**

21. Recognising improved macroeconomic management in many countries and the growing importance of short term shock-related financing needs, reforms were undertaken that created two short-term financing instruments in January 2010 - the **Rapid Credit Facility (RCF)** for emergency support, and the **Standby Credit Facility (SCF)** for short-term support. These complement medium-term support available under the new **Extended Credit Facility (ECF)** and the non-financial **Policy Support Instrument (PSI)**, created in 2005 for LICs with broadly sustainable macroeconomic positions and no financing need. The SCF provides short-term financial arrangements and is applicable to shocks as well as many other circumstances. These new facilities have replaced the previously existing PRGF (“Poverty Reduction and Growth Facility”), the ESF (“Exogenous Shock Facility”) and the Post Conflict and Natural Disaster Facilities. The aim of these recent changes was to streamline and simplify existing facilities and adjust them better to LIC needs. The intention was also to follow a similar structure to that of the MICs, with a strong distinction between long term and short term balance of payments needs.

22. Before analysing these facilities, a broad question to ask is how much is gained by fairly small frequent changes in facilities that require a lot of effort in design by the IMF and understanding of changes by busy policy-makers in countries. This was for example true for facilities like the previous ESF (External Shocks facility), changed when it was widely seen as working rather well. It would seem that far more worthwhile would have been a significant change in terms of scale (so the lending would cover a bigger and more significant proportion of shocks), and a reduction in conditionality, not appropriate for external shocks; the latter, as we point out below would also increase speed of disbursement of IMF loans.

23. **There have been a range of positive features in the past reform of the LIC IMF facilities.** Firstly, the consolidation of facilities simplified some of them. Secondly, the increase of concessionality across all facilities increased from 0.5 per cent to 0.25 per cent and some lending such as to Haiti and Nepal incurred zero per cent interest for a long period, though reportedly the interest saved has to be paid in later years. Thirdly, the RCF is more concessional as regards maturity (up to 10 years). Fourthly, IMF lending to small SVEs, with: a) a population of less than 1 million, and b) level of per capita income no more than twice the level of IDA countries, continues to have more positive treatment, as regards concessionality. **This has been welcome for the many Commonwealth countries that fall in the SVE category.** However, this favourable treatment may reportedly finish once the global crisis is overcome. Fifthly, IMF emergency facilities have been consolidated, for post conflict and natural disasters, as well as external economic shocks in the RCF, though the scale of lending, at only 25 per cent of quota is very small. Finally, the IMF has streamlined conditionality for the SCF to focus on policy actions that are “critical for achieving the program’s objectives”.

24. However despite these several positive features, **the new facilities have several shortfalls from the perspective of compensatory financing especially for countries with difficult access to international private capital markets.** Firstly, the current evolution of IMF facilities means that the original concept of IMF compensatory financing, as providing countries facing purely external shocks with almost automatic, very rapid liquidity constituting a significant proportion of the shock continues to be very sharply diluted, in this instance for LICs. The only low conditionality IMF compensatory financing facility for LICs which remains at present is the very small RCF, which only reaches 25 per cent of a country’s quota per annum. Furthermore, the Compensatory Financing Facility for terms of trade shocks, for MICs that had been so widely and successfully used in previous decades (see for example Griffith-Jones and Ocampo, op cit) had previously also been abolished.

25. In 2009 the IMF created a preventive facility, the Flexible Credit Line (FCL) for MICs, designed for countries that it perceives as having very strong fundamentals, but that risk facing problems with the capital account, shocks that have become more important in recent years. This facility has been used. In 2010, the IMF created another preventive facility for capital account shocks, the Precautionary Credit Facility (PCL) for countries with good policies, but which do not fulfil the same requisites as those with access to the FCL.

26. However, as regards shocks on the trade account for MICs we can see in fact a step backward from the purpose with which the IMF Compensatory Financing Facility was created explicitly recognized in a Fund study (Goreux, 1980); “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*”. This was clearly based on the approach that IMF official liquidity should allow

levels to be maintained in face of temporary external shocks to avoid unnecessary negative effects on growth and poverty reduction. The Compensatory Financing Facility (CFF) was created in 1963, as a low conditionality facility to deal with external shocks relating to trade; a clear trend through the years was a gradual increase in conditionality, even though developing countries pleaded for its' decline. Since 2000, when CFF conditionality was raised to upper-credit tranche level, MICs stopped using it. This fact was utilized incorrectly as an argument for abolishing CFF for MICs.

27. With a small scale exception, the very small RCF - all compensatory financing for LICs became upper-credit tranche conditionality. Indeed the larger Stand By Credit Facility (SCF) is applicable both to countries facing external shocks as well as other Balance of Payments problems, including those caused by policy mistakes which seems conceptually incorrect; it also implies that significant shock financing requires upper credit tranche conditionality, which is both inappropriate and delays lending, making it thus less effective for its counter-cyclical role. As is discussed below in examining the experience of a number of our Commonwealth countries in accessing shock facilities, - and as can be seen in Figure 5 - LIC countries have not used these IMF shocks facilities very much, and they have preferred instead to use the 3 year IMF programmes that have more resources. However, it should be said that the new facilities have been in existence for a short period and so a full assessment is not yet possible.

28. Limiting, or practically eliminating low conditionality compensatory financing at the IMF both for LICs and MICs, seems particularly undesirable in a world where external shocks are far more common due to frequent and increasingly global financial crises. Such an evolution of the world economy would seem to require more and especially tailored compensatory financing, rather than far less and more diluted resources, as seems to emerge from the evolution of IMF facilities, especially for terms of trade shocks. In this regard, it is therefore very positive that the IMF is currently reviewing its low income facilities with a view to making them more responsive to LICs' needs, especially in the context of the continuing Eurozone crisis and slowdown of the world economy.

29. Furthermore, IMF reforms of compensatory financing are in contrast with overall positive trends, of lightening of structural conditionality at the IMF, reflected in the fact that in March 2009, the link between disbursements of IMF loans and performance on structural conditions was eliminated; and the somewhat greater emphasis on more counter-cyclical macroeconomic policies in the light of the crisis, within IMF country programmes. Greater commitments of IMF lending in general during periods of shocks is also very useful, even if it is not channelled through shocks facilities, though it would be more appropriate if it were channelled through them. The latter is an issue that would be worth studying in the on-going reform of IMF facilities.

30. The use of the LICs IMF shock facilities, RCF and SCF, since their launch in 2010 until end-2011 has been fairly limited (see Figure 7 below). Only \$88 million has been committed under the RCF to four countries (St. Lucia, St. Vincent and the Grenadines, Kyrgyz Republic and Nepal), and \$117 million under the SCF to two countries (Solomon Islands and Honduras).

31. The IMF is currently engaged in a review of **IMF facilities for LICs**. An initial paper is expected shortly before the 2012 Bank/Fund Annual Meetings. After consulting with member countries, the IMF is planning to finalize this review by March 2013. It would seem desirable to include the following issues in this review:

- **Enhancing the predictability of shock financing**, for instance by broadening options for contingent support, including making access to Fund resources automatic under certain circumstances. For example ECF three years programmes could have an option for the country to request an automatic increase of the loan if certain external shocks took place, e.g. a reduction of their terms of trade by over 5 per cent. Even the scale of additional resources could be broadly stipulated ex-ante, linked to potential magnitude to shocks. The Fund has in the past used such contingent clauses in very specific programmes, e.g. the TIM; such a practice could be very beneficially expanded to, for example, all ECFs. Ideally the additional access would be less constrained by access limits linked to quotas, and more closely linked to country needs. Flexibility for using IMF resources could be further enhanced by, for example, eliminating existing restrictions, on repeated usage of facilities within certain periods, especially if major and repeated external shocks are happening.
- **Significantly increasing access to low conditionality shocks IMF facilities**. This could most easily be done by significantly expanding the low conditionality RCF for LICs. This would imply that there would be a far better fit between the nature of the shock (external) and the lending instrument the Fund would use a low conditionality facility. A second advantage would be greater speed in commitment of resources, which would increase the counter-cyclical nature of the lending instrument and avoid unnecessary costs to growth and poverty reduction.
- **Tailoring financing terms more closely to debt service capacity**, for instance by providing higher levels of concessionality to the poorest LICs, especially those with higher debt overhang, and providing temporary interest relief during periods of systemic shock, as the Fund has done during this phase of the global crisis.
- Because PRGT subsidy resources are scarce and financing needs large, especially in times of major external shocks, **there may be a case for giving some LICs –that are not seriously indebted– the option of higher access to Fund borrowing, at a somewhat higher cost**. This would imply a blending of concessional loans, based on PRGT resources and GRA loans. It is important that this is seen as a mechanism to increase total levels of access for some LICs in periods of large shocks, and not as a justification to lower their normal access limits, based on PRGT funded concessional loans.
- **Indeed, it seems highly desirable to attempt to keep current levels of access, as proportion of quotas, for the different IMF LIC facilities, once IMF quotas are doubled, and not to reduce them as has been proposed**. This important measure requires an increase of PRGT resources to fund such lending beyond 2014, as we discuss later in this paper.

### **Key Issues and Questions for Ministers**

Ministers' views are sought on several issues raised above, in order to contribute Commonwealth perspectives and approaches to the IMF review process:

- Ministers are asked to comment on whether it is desirable to **allocate a higher proportion of official resources to shock facilities?**
- Do Ministers concur with the view that **the favourable treatment of small states should continue?**
- **How can the predictability of IMF shock financing be improved?**  
Ministers are asked to comment specifically on the suggestion to include options for contingent support; and eliminating existing restrictions on repeated usage within certain periods.
- Should **access to the Rapid Credit Facility** be significantly increased?
- Should **current access limits** be maintained?
- Ministers are asked to comment on the **suggested blending mechanism to increase access levels for LICs that are not seriously indebted.**

### **Shock Facilities: The World Bank and the Regional Development Banks**

32. In addition to the IMF's response, Multilateral Development Banks (MDBs) rapidly increased lending commitments in response to the financial crisis. The World Bank responded strongly to the crisis by almost doubling lending commitments, from \$25 billion in fiscal year 2008 to \$47 billion in 2009 and to \$59 billion in 2010. Some Regional Development Banks responses were also strong, with the AfDB increasing loan commitments by 137 per cent between 2008 and 2009 (see Figure 1).

33. The World Bank delivered its response through four key mechanisms. Firstly, in 2009, a pilot **IDA Crisis Response Window (CRW)** was created for the remainder of the IDA 15 period. As of June 2011, \$1.5 billion was committed under the pilot window; for IDA 16 a permanent CRW was established with resources capped at 5 per cent of the total IDA 16 replenishment resources. This new permanent facility represents a more systematic approach for IDA in dealing with economic shocks and natural disasters and aims to focus only on large scale natural disasters and exogenous economic shocks. Specific triggers are not used for automatic availability of the facility, but to activate consideration on a country case basis. Triggers for consideration are as follows:

- A year-on-year projected decline of GDP growth of at least 3 percentage points in a significant number of IDA countries. The 3 percentage point decline would identify countries eligible for CRW support. This is a very stringent requirement as few country projections of GDP growth reach a fall of 3 per cent or more; the probability of several LICs having such a sharp fall is even smaller. There may be a case for revisiting this criteria and making it less stringent.
- This preliminary ring-fencing would be vetted by an analysis of available fiscal and other relevant data in line with the CRW objective to protect core spending in the short-term and avoid derailing long-term development objectives.

- If a severe shock did not result in a GDP growth decline, CRW support could be considered exceptionally if: (i) the shock is deemed severe in terms of fiscal impact (i.e., additional spending to protect vulnerable groups); (ii) there is consensus a concerted international response is needed; and (iii) existing IDA allocations of affected countries are deemed insufficient.
- Strengthening the trigger mechanisms for the Commonwealth would greatly assist the Commonwealth developing countries. Do Ministers have any specific views or preferences as to how best this mechanism can be strengthened?

34. Secondly, in December 2011, the World Bank approved a new mechanism, the **Immediate Response Mechanism (IRM)**, enabling LICs quick, but limited access to funding during a crisis, providing emergency finance to countries within weeks of a crisis. This would complement longer term emergency financing measures such as the CRW, that typically take around seven months for approval and a further four months to be effective. Funding is not additional to the agreed IDA country allocation, but is drawn from funds committed, but not yet disbursed, under existing investment projects. The IRM will allow IDA countries to rapidly access up to 5 per cent of their undisbursed IDA investment project balances following natural disasters and severe economic shocks. Small states and countries with small undisbursed balances will be able to access up to \$ 5 million. For Borrowers must include contingency emergency response components and agree on implementation arrangements in order to access IRM funds. By late July 2012 IRM had not yet been used by any country. Whilst potentially useful in terms of flexibility, the scale of resources that can be reallocated seem somewhat limited.

35. Thirdly, the World Bank Group set up the **Global Food Crisis Response Programme (GFRP)** in May 2008 to provide immediate relief to countries hard hit by food high prices. Between 2008 and 2010, \$2.0 billion of World Bank funds, was made available. The food programme consisted of a number of components but is centred on support to agriculture and food-related social programs. The latter included school meals, cash and food for work programs and nutritional supplements. Only IDA countries are eligible. And fourthly, the World Bank created a specific new programme – the **Rapid Social Response Programme** - to support LICs in promoting social protection measures and maintaining access to basic social services. The programme aims to coordinate, monitor and report on the Bank's response in thematic areas of safety nets, labour, and access to basic social services and to channel additional donor grant contributions to leverage IDA resources. Priority is given to lower income countries, especially fragile states, states with inadequate social policy responses and states with limited fiscal resources. Total funding for this facility has reached \$260 million.

36. **Overall, the MDBs responded substantially to the crisis.** The crisis demonstrated the **crucial countercyclical role** that they can play when shocks occur. Furthermore, for the first time this valuable role was given open recognition. Whilst the international community had emphasized the role that MDBs play in poverty reduction and the provision of global public goods, this counter-cyclical role was not clearly recognised. This missed many **lessons from past experience, which indicated that, aside from provision of liquidity during crises, it is equally important to provide official long-term finance when private finance dries up during and after crises, not least to maintain the dynamics of investment projects.** In addition a very positive feature of the MDB response was that a number of targeted large regional initiatives were launched, mainly working jointly with other institutions, notably the

World Bank working together with regional development banks (RDBs). Examples are the Joint Plans in Africa, Latin America and the Caribbean, and for Central and Eastern Europe (Te Velde and Massa, I. et al., op cit, for more details). The massive needs caused by the crisis pushed these institutions to collaborate rather than compete.

37. At the same time however, three issues were important in constraining both the response and the timeliness of the MDBs' response. **Firstly, the response was partly constrained by the limitation of their capital** (Te Velde and Massa, I. et al., 2009). In April 2009, the G-20 agreed to support, if necessary, the recapitalization of MDBs to enable increased lending. The Asian Development Bank agreed, in April 2009, to a capital stock increase of 200 per cent, from \$55 billion to \$165 billion; and the capital of the AfDB was increased by 200 per cent at the 2009 Spring Meetings. Similarly, the World Bank and the IADB had their capital increased.

38. **Secondly, there was an insufficient response to the needs of LICs.** At the World Bank, we can contrast IBRD lending commitments to middle-income countries which substantially increased from 2008 to 2009, by \$19.4 billion or 144 per cent, versus IDA lending commitments to low-income countries which were only increased by \$2.8 billion or 25 per cent. The proposal, presented at the end of 2009, to create an \$ 1.3 billion IDA Crisis Response Window, to disburse IDA funds for protecting core spending on health, education, safety nets, infrastructure was thus widely welcomed by developing countries, including several Commonwealth member countries.

39. **Thirdly, the dynamics of rapidly expanding commitments were not reflected in disbursements,** which for the World Bank, both IBRD (77 per cent) and IDA (1 per cent) grew far slower in 2008 to 2009 than the level of commitments. Though the increase in IBRD disbursements was impressive, that of IDA was totally insignificant (see also analysis above, as well as Tables 2 and 3, as well as Figures 1 and 2). This means in practice that the contribution to the recovery was more limited than it could have been, especially for LICs. This needs urgent review and change both for future crises, so as to fully mainstream the counter-cyclical function in general and to external shocks in particular.

40. **In considering the role of MDBs in responding to future crises, there are several opportunities to strengthen responsiveness, some building on pilot and other limited initiatives trialled to date.** For example there is strong scope for MDBs to introduce lending instruments that make developing countries less vulnerable during crises, either because they reduce currency mismatches by lending in local currency or because they adjust maturity of repayments of loans in a counter-cyclical manner, so that net lending can increase more in bad times. Examples include local currency lending by MDBs and new instruments which could include GDP-linked or commodity price linked loans for developing countries. An interesting idea being discussed in the World Bank is to vary loan repayment in relation to the price of oil, for both oil importers and oil exporters, but obviously in inverse ways; countries would benefit while the World Bank would be hedged in its risk of variable repayments, as effects would broadly cancel out. Another interesting mechanism would build on the successful example of Counter Cyclical Loans used by the Agence Francaise de Development which provides debt holidays on their concessional loans to LICs which experience shocks that affect their exports. Such a mechanism could be adopted by the World Bank/IDA, as well as by regional development Banks (see again Griffith-Jones, 2011, op cit).

## Shock Facilities of the European Commission

41. The European Commission (EC) put in place various shock absorbing schemes in response to the crisis that started in 2007; they included V-FLEX and Food facility initiatives. These were added to the existing FLEX facility. In particular V-FLEX was created, as a temporary facility, to allow a larger and more flexible approach to the crisis. Both FLEX and V-FLEX were established only for ACP countries, but the Commission is discussing the possibility of widening the coverage to all developing countries. It should be stressed that all EC facilities are at present in form of grants.

42. Vulnerability to changes in earning from export earnings is affected by natural disasters, weather conditions or export price volatility. This is particularly true for those countries whose exports are heavily concentrated, and where price volatility in these exports can and has been high. As a response to this the **FLEX facility** was set up in 2000 by the EU as its main crisis response facility. The facility aimed to be both more comprehensive and simpler than its predecessors. An interesting feature of the FLEX is that it closely links these issues with the facility trigger, **which is objectively defined through export driven measures**. The trigger was a percentage drop in export earnings below a reference level and that this caused a worsening of the public deficit. For a subset of countries where the agriculture or mineral sector were key sectors, defined as 40 per cent of more of export earnings, these could also act as an alternative trigger. The FLEX was available for a maximum of four successive years. Since 2004, the trigger level for export earning reduction was 2 per cent.

43. The main lesson learned from the initial working of FLEX was that it failed significantly to achieve its objective mainly because of lack of finance to be allocated to ACP countries and delays in providing the financing. An increase of financial resources in the annual FLEX allocation for all ACP countries appeared to be enough to cover the financial requirements of ACPs coping with exogenous shocks in the mid-2000s. However given the seriousness of the global crisis this changed. With regards to the second lesson from FLEX it is unquestionable that the time delay in providing financial support was linked to the fact that the facility operates on the basis of an ex-post rather than a real time mechanism, as triggers were not based on projections.

44. While on balance the FLEX facility operated fairly well since 2000, and especially since 2004, the global financial crisis created huge challenges including in assisting the most vulnerable countries. In late 2007 the temporary **Vulnerability FLEX** or “V-Flex facility was created which sought to offer greater speed and flexibility. V-FLEX eligibility is defined as countries with “**high social, economic and political vulnerability to the crisis**”. In objective criteria this is measured in V-FLEX by a selection of key measures including crisis-driven deterioration in government revenues, foreign reserves and fiscal deficit. Fiscal financing gaps were also moved away from historic measure to forecast measures and on planned cuts in expenditures, especially social expenditures, which can be compensated by the facility. Eligibility was also revised to allow subjective case-by-case eligibility for fragile states. V-FLEX like the original FLEX used as the main delivery mechanism general budget support. Social mitigation through existing programmes and in coordination with other donors is also allowed. By 2010 V-FLEX had committed €524 million in funds.

45. Similar to IFIs, the EC also raised concerns about the impact of food price inflation in late 2007 and 2008. In December 2008 as part of the response to this concern, the European Parliament created the “**Food Facility**”, initially allocating €1 billion for this purpose. The

goal was to bridge the gap between long term, more structural development financing and emergency responses. The Food Facility was designed to support a number of areas relating to improvement in the agricultural sector and to improve food security. The food facility was also directed towards specific countries with 50 being selected for priority, based upon poverty levels and need, vulnerability and high level policy and political environment .The food facility's operation was limited to a three year period, and came to end in 2011.

**Key Issues and Questions for Ministers:**

- **Do Ministers concur with the view that there is a need to revisit the trigger criteria for accessing the World Bank's CRW? Do Ministers have any suggestions on how the triggers could be improved?**
- **What has been the experience of countries in accessing MD8 facilities?**
- **Do Ministers have views on how these facilities could be improved?**

## **2. A Review of Commonwealth Experience and Policy Lessons**

46. In recent years Commonwealth developing countries have been subjected to a very broad range of economic, financial, environmental and other shocks. With membership including 32 small states, 15 small island developing states in the Pacific, Caribbean and Indian Ocean, as well as a large number of poor developing countries in Sub-Saharan Africa and South Asia, the increasing prevalence and deepening magnitude of external shocks has eroded resilience and deepened vulnerability. In turn this has profoundly affected these members' ability to achieve steady growth, strengthen fragile social safety nets and progress with their poverty alleviation and development objectives. To illustrate these challenges we have briefly considered the experience of five Commonwealth countries: **Malawi; Dominica; Guyana; Mauritius; and Samoa in managing exogenous shocks since 2006.** The analysis provides some preliminary country-based evidence as to whether the recent reforms in lending facilities have helped countries better manage their vulnerability to exogenous shocks.

47. Most Commonwealth countries were hit hard by the food and oil price shocks in 2007-08 and the global economic crisis that started in 2007 and deepened in 2009. This clearly is evidenced by the above five Commonwealth countries since all these countries were hit by both types of shocks. In addition, Dominica was simultaneously hit by hurricanes, and later in 2011, by heavy rains, landslides and a tropical storm; and Samoa was hit by a number of natural disasters, including an earthquake and a tsunami in 2009, as well as by higher food and fuel prices again.

48. At the time the five countries were hit by the 2007-2009 external shocks, they had just experienced moderate to strong growth in the preceding period except Dominica, where average growth had been at 1.9 per cent over 2005-2007. Their responses to the shocks had varying degrees of success. Some countries had benefited from debt relief initiatives for example Guyana and an export boom earlier in the decade; moreover, in a context of faster growth, government revenues were on the up. Growing fiscal and external sector space

helped these countries have greater resilience to these shocks; this allowed several countries, and particularly Mauritius, fight the storm with the result that growth deceleration was just moderate; but both Dominica and Samoa saw growth turn negative and remain very low since then. Though there may be other reasons, it is noteworthy that the two smaller economies - both hit by natural disasters, as well as economic shocks - were the ones that suffered the sharpest declines in growth.

49. All five countries had access to some shock facilities – the IMF Exogenous Shock Facility (ESF) until the end of 2009; the new IMF Rapid Credit Facility (RCF) from 2010; the EU FLEX and V-FLEX during 2008-2010; and the World Bank’s Pilot Crisis Response Window in 2010-11. Samoa also benefited from the Asian Development Bank Economic Recovery Support Programme. The amounts received were not, on their own, very large in proportion to the scale of the shocks, albeit significantly higher than in previous shocks’ episodes, altogether amounting to between 24-48 per cent of the increase in these countries’ current account deficits, excluding transfers. In all cases international reserves in 2008 were at 3.1 months of imports or lower, and thus already bordering or under a threshold level understood as critical. Moreover where reserves recovered following the access to the shocks’ facilities, this had more to do with the slowdown in growth in which import values contracted, rather than with the facilities themselves. For example in Malawi, where growth slowdown started only in 2010, reserves hit the low of 0.9 months of imports in 2009.

50. **A factor that greatly helped these countries address external shocks has been a significant increase in broader counter-cyclical official loans at critical periods** – 2009 in Dominica, Guyana and Mauritius, 2010 in Malawi, and 2009 and 2010 in Samoa. A good deal of increased official flows was from general lending from Multilateral development banks, as well as from the IMF, disbursed through projects and programmes not directly related to the shocks. Therefore, the financing of shocks was supported by both specific shocks facilities, as well as increased counter-cyclical official lending through normal mechanisms, as was the case for all developing countries.

51. Reflecting a broader pattern across Commonwealth developing countries as a whole, workers’ remittances saw a variable behaviour across countries. These went up in Guyana in 2010 and Samoa in 2009-10, but remained flat in Dominica and Malawi. For Bangladesh, a Commonwealth country not analysed here, workers’ remittances played a vital role in helping it sustain high growth throughout the crisis period, and after it. So the role of remittances has been mixed, an outcome possibly explained by their countries of origin – pro-cyclical when coming from the US, but counter-cyclical when coming from the Middle-East.

52. The Commonwealth countries analysed share, as common features, large trade deficits in goods and services, and therefore very large current account deficits. The latter, excluding net transfers, is projected for the year 2012 to be at 30 per cent of GDP in Dominica, nearly 34 per cent in Guyana, 12 per cent in Mauritius (despite its success exports story), and 33 per cent in Samoa; and most of them have high level of dependence on specific types of external resource flows. As a proportion of the current account deficit (excluding transfers), in 2010 workers’ remittances were at 50 per cent in Guyana, and official development assistance was at 94 per cent in Malawi and 74 per cent in Samoa. Their international reserves are at uncomfortably low levels, although higher compared to their lowest point during the 2007-2009 crises.

53. All these countries are making great efforts to achieve higher growth and reduce poverty after the 2008-2010 slow down, but government and private sector efforts are undermined by new shocks, which deviate them from long-term strategic planning due to their need to invest time and technical resources to obtain external financing in the short term.

54. **These -and other-developing countries' large current account deficits, high dependence on specific flows and low levels of international reserves make them all very vulnerable to new external shocks,** such as new natural disasters and economic shocks such as a possible deep recession in Europe and a broader slowdown of the international economy. As regards a major slowdown in Europe, including the likely prospect of negative growth, these countries could be hit hard due to lower export opportunities to European markets, lower workers' remittances, and also due to possible lower aid flows from the region. **In this case, it seems especially important for other sources of concessional finance – from the IMF, the World Bank/IDA and the regional development banks- to play an even greater role than in the past phase of the global crisis.** This is particularly because the buffers which many developing countries had in 2007 have been quite severely eroded. Moreover, if the European crisis becomes global, then other export markets will lose dynamism, and aid flows and workers' remittances from various parts of the world may be affected as well. The case for a greater response from the official international community becomes even stronger in such a case.

55. **All these factors point to the compelling need, going forward, for a greater proportion of financing linked to shocks, financed by well-designed and resourced shocks facilities that would be of sufficient scale, fast-disbursing and low conditionality.**

### **3. Funding for the PRGT: An Urgent Challenge After 2014**

56. Beyond the challenge of increasing the scale and quality of current shock facilities and establishing new facilities which can address the escalating range of external shocks confronting developing countries, a new challenge is emerging which if not urgently addressed will significantly curtail the availability of IMF concessional resources as a whole, thereby inter alia limiting urgently needed shock financing. IMF concessional funding is sourced through the Poverty Reduction and Growth Trust (PRGT).

57. In the absence of a major crisis, **PRGT funding seems adequate until 2014.** The IMF Executive Board has approved the partial distribution of the Fund's general reserve to the membership of SDR 700 million attributed to part of the windfall profits from recent gold sales to raise SDR 0.6 billion in subsidy resources. The distribution will be effected once satisfactory assurances have been received from the membership that new PRGT subsidy contributions equivalent to at least 90 per cent of the amount distributed. Commitments under new PRGT-supported programs are expected to increase in 2012 reflecting the weaker global economic outlook, as well as a very big programme for Bangladesh. IMF staff projections suggest demand could rise to about SDR 2.2 billion in 2012 in a high demand scenario linked to a slowdown in the world economy and significant downside risks; with a low demand scenario demand for 2012-2015 would be estimated to reach only 1.6 billion (IMF 2012). If all elements of the 2009 financing package are secured, which seems fairly likely, the PRGT will have an annual average lending capacity of SDR 2.2 billion over 2012–14, or SDR 1.6 billion through 2015.

58. Progress has also been made in securing limited new pledges of bilateral subsidy resources for 2009-2014 period. **Several Commonwealth developed country members have made significant contributions to the PRGT, including inter alia the UK, Australia and Canada and other Commonwealth members. As a consequence, the PRGT has sufficient capacity to accommodate a higher level of demand during this period.**

59. **However the funding capacity of PRGT is woefully inadequate post-2014.** This could threaten to reduce seriously the level of IMF lending to LICs, including shocks financing, unless action taken. The PRGT is projected by the IMF to have a self-sustained lending capacity of only about SDR 0.7 billion annually after 2014, given the existing level of round SDR 4 billion in the PRGT account. This would be approximately 50-70 per cent lower than 2009-2014 estimated average lending, and well below pre-crisis lending, which would be clearly insufficient to address needs. Furthermore, these projections are subject to uncertainties, including: the rate of return on investment of the Reserve Account balance, which is assumed to return to pre-crisis levels; should this be lower, that is if interest rates in major countries did not return to pre-crisis levels, available resources would be lower still.

60. **Clearly, based also on the IMF staff's longer-term projections, additional subsidy resources will be required to support expected demand for concessional financing.** Indeed IMF staff projections indicate longer term demand for the Fund's concessional lending could be SDR 1.1–1.9 billion annually up to 2034, (IMF, 2012, op cit), with SDR 1.1 billion roughly comparable to pre-crisis levels of lending. Naturally if there were to be a new crisis or the world economy were to enter a period of far slower growth, as many observers-including the IMF- fear possible, then annual demand for IMF loans to LICs could increase to levels of at least SDR 1.9 billion and possibly more. Furthermore, there is growing empirical evidence and agreement that greater liquidity funding by the IMF to compensate for external shocks can meaningfully contribute to higher LIC growth. (Te Velde, Griffith-Jones et al, 2011). There is an important case that, if external shocks happen, LICs need both sufficient liquidity and development finance, with speedy provision of sufficient liquidity particularly essential for safeguarding growth.

61. **Based on these projections and analysis, additional subsidy resources would urgently need to be mobilised to ensure that the PRGT has sufficient capacity to meet the expected demand.** It is therefore crucial that the framework for concessional lending on a self-sustained basis should therefore be revisited to ensure that the lending capacity remains in line with projected potential demand.

62. An important issue at present is if the approximately SDR 1.8 billion of remaining windfall profits realised during the gold sales could be used for financing the PRGT to achieve these desirable levels of self-sustained concessional lending to LICs. This would formally require approval by 70 per cent of the votes of the IMF Executive Board of the IMF, which is not easy to achieve; furthermore, IMF staff point out that a 90 per cent of approval by the Board is desirable, to ensure that once the windfall profits are given to member countries they commit to transferring them to the PRGT for lending subsidies to LICs. Here there can be a typical collective action problem, in that countries become more willing to transfer such a contribution, once they know all other countries are committing to do the same. Furthermore, an additional complication is that some member countries may have possible preferences for other uses, such as strengthening the Fund's precautionary balances, (currently below their targeted level) or for funding endowment resources, to finance IMF activities.

63. Based on these considerations, there are powerful arguments to forge a Commonwealth consensus which promotes **the use of the remaining windfall of gold sales to fund the IMF PRGT subsidy account**, given the great significance it has for LIC countries in general, but especially for their ability to have sufficient shock finance. Once recently-approved quota increases become effective, this approach will also enable the IMF to maintain current access limits for LICs – including access to Fund shock facilities - as a proportion of members quotas.

#### Key Issues and Questions for Ministers

- **Ministers are asked to comment on the use of remaining gold sale profits to fund the IMF PRGT subsidy account?**
- **If this is deemed desirable, what role can member countries play in building momentum to achieve this; and what role can the Commonwealth Secretariat play?**

## 4. Policy Recommendations and Conclusions

64. The 2007-2009 years were seen as an exceptional period. In response, the international community made significant efforts to help developing countries, by providing them with increased official finance, especially through the IMF and the Multilateral and Regional development banks, as well as through enlarged EU grant support to ACP countries. The new financing was partly channelled through new shocks facilities, designed to make their disbursements faster and less onerous, and in some cases by embedding higher concessionality.

65. **However, the frequency and depth of shocks experienced in 2007-2009 – seen as exceptional then – has continued, so becoming the new normal. For the poorest and most vulnerable Commonwealth members, it seems clear that the only certainty is uncertainty.** Food and oil price shocks keep returning, and the prospect of a major global slowdown and possibly recession, prompted by financial instability and the on-going crisis in Europe is real. Furthermore, it is possible that the world economy may have a protracted period of slow growth, as many informed observers fear. In this framework, it is not clear whether the new shocks' facilities which have emerged in recent years have been sufficiently effective to help countries meet their urgent external financing needs arising from external shocks. An important shortcoming of some of the new shocks facilities, such as the low conditional IMF RCF has been that the financing provided has been small. It seems desirable both to strengthen the importance and improve shocks financing facilities, and to make them far more permanent, including in their funding.

66. The policy recommendations that emerge from the analysis of Commonwealth countries experiences and from the broader analysis within this paper are that, in a global context in which both economic and natural shocks are becoming more frequent, **it seems appropriate that the shocks' facilities become larger**, so that countries do not need to

regularly seek new financing; and have larger breathing space to rebuild their buffers in order to become more resilient to shocks and therefore better able to focus on long-term inclusive and sustainable growth. And consequently it is important that in its forthcoming Review of IMF low income countries facilities, **a greater proportion of IMF resources be channelled to shocks facilities**. It is also encouraging that the World Bank has made permanent its pilot CRW loan facility for LICs (though the case for liberalizing its rather stringent triggers seems strong); it is also encouraging that the European Commission is currently studying a new shocks facility that would replace in 2014 the broadly successful (fairly large and rapidly disbursing) temporary V-Flex facility, which has now expired. Sufficient scale is a key criterion for making these facilities successful.

67. It is also a major source of concern that just as the international community is beginning to recognize again the great value of sufficiently large scale shocks compensation official finance the resources to make it happen may become more constrained. This is particularly clear for the IMF, where there is a threat that limitations of resources for financing the subsidy element in their loans to LICs, could severely constrain the Fund's ability to lend to LICs after 2014. A substantial number of Commonwealth members will be adversely affected if concessional financing is constrained after 2014. **Consequently it is important that the Commonwealth utilises the remaining part of 2012 and 2013, to seek ways to build international consensus on the need to replenish the PRGT beyond 2014, through concerted action founded on Commonwealth consensus.**

68. If the Eurozone crisis continues to be very serious, European resources for continued shocks financing and official counter-cyclical financing in general are likely to be constrained, as could European bilateral aid, with the exception of the UK. In this context it is essential that developed countries at least maintain – and optimally increase - their commitments to supporting developing countries, especially the poorest and most vulnerable countries, including to shelter them from shocks which developed countries themselves may have caused. Similarly there is a strengthening case for dynamic emerging markets to channel greater resources - including for shocks facilities and more generally counter-cyclical support-to poorer and more vulnerable countries.

69. In conclusion, the poorest, smallest and most vulnerable developing countries, including many Commonwealth members, are increasingly vulnerable to external shocks. Allaying their vulnerability to these is crucial if they are to sustain growth and address their development objectives. Central to this effort is the availability of shocks financing, both for liquidity needs and for long term development finance, the latter to maintain developmentally critical investment expenditure. An urgent objective for the international community is to ensure that these facilities become both sufficiently large in proportion to the scale of the shocks, and are also disbursed in a speedy, low conditional manner, to enable these facilities to fully play their key counter-cyclical role. While expanding general official lending in the face of major shocks is also very valuable as a complement to shocks facilities (as was done in the 2007-2010 period), it is slower, especially as regards disbursements; and there is now a much stronger case to shift a greater proportion of official resources towards shocks facilities. A review of existing facilities, with the view to establish a more permanent, coordinated, and financially sustainable, shocks architecture has also become particularly urgent. Doing this, and providing the resources to fund it, is urgent as the world economic environment could deteriorate significantly soon and undermine development achievements and poverty reduction in developing countries.

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