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WORLD CRISIS AND PROTECTING LOW-INCOME COUNTRIES AGAINST EXOGENOUS SHOCKS

By

Patrick Guillaumont

Professor Emeritus, University of Auvergne and President, Fondation pour les Études et Recherches sur le Développement International (FERDI)

Commonwealth Secretariat
Marlborough House
London SW1Y 5HX

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Table of Contents

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Introduction

1. Developing countries, specifically low-income countries, and above all least developed countries, are facing recurrent shocks. While the resources available to the international community to help them cope with such shocks have long been debated, the world economic crisis sheds new light on the problem. There is a risk that the shocks may take on unprecedented proportions, which will bring to light the gaps in the international protection system. This situation gives us an opportunity to consider reforms to this system.

Crisis and instability: obstacles to development

2. Exogenous shocks—whether from external origins (affecting the terms of trade or transaction volume) or natural ones (droughts, typhoons, earthquakes, etc.)—have substantial, adverse effects on many developing countries, as amply illustrated in the literature.[1] We observe these effects not only in the short term when a negative shock occurs, but also in the long term when they impede development. Sustained repercussions from such shocks are attributable to two factors: first, the uncertainty they generate and the increased risks in productive activities; and second, the irreversibility of some of the effects. Accordingly, when a negative shock leads to a loss of physical and human capital, this may generate "poverty traps": diminished income in already low-income countries, resulting in increased mortality in young children, increased schooling drop-out among older children, loss of qualifications among the newly unemployed, etc. These are in fact the results that can be expected when the crisis spreads to these countries.

3. For these two reasons—risk and irreversibility—the positive shocks that typically follow negative ones in the case of external shocks do not cancel out the effects of the latter: instability (terms of trade, exports, etc.) generates risk and asymmetry effects that impede growth, accentuate poverty, and increase political insecurity and the risk of conflict[2]. Moreover, it is important to consider in the design of international protective measures that a series of positive and negative shocks is a factor undermining economic policies, in particular, inducing budget deficits and even poor governance.

4. The analyses and forecasts now produced by the international institutions, economic research institutes, major banks, etc. can only address the immediate consequences of the crisis on developing countries—and this is not an easy matter. They should not overlook the long-term consequences—at once economic, social, and political—that are undoubtedly the most unpleasant.

International aid, a potential shock absorber

5. International aid has an important role in mitigating the consequences of shocks. One of the lessons learned from the great debate during the past few years on the macroeconomic

[1] We have presented an overview of these effects in a number of publications, and particularly Guillaumont (2006a, 2006b, 2009a, and 2009b), and Guillaumont et al. 1999.
[2] See references above and, for an analysis of the effects on poverty and infant-juvenile mortality, see Guillaumont and Korachais (2008) and Guillaumont, Korachais, and Subervie (2008).

effectiveness of aid is that its marginal effectiveness increases in the presence of shocks and instability[3]. In other words, aid reduces the negative effects on growth of vulnerability to exogenous shocks. This is attributable to the stabilizing impact of aid, as we can measure, for example, with respect to export instability. And by stabilising growth, aid becomes more beneficial to the poor, avoiding the multiplication of individual poverty trap cases.

6. The international community does not seem to have a high capacity to avoid the occurrence of external shocks, as indicated by the failure of the ill-conceived attempts to stabilise international commodities prices during the 1960s and 1970s, while it has even less capacity to avoid natural shocks. However, through aid and its various instruments, the international community can help soften the blow of shocks in low-income countries. Ideally, it can provide them with partial insurance against shocks. The international community should therefore focus on the measures best suited to enable the countries to cope with shocks. These measures have been researched according to three approaches, needing to be re-examined and considered below.

Three types of international protection against shocks

7. First, new compensatory financing facilities to address shocks were established a few years ago to replace the older mechanisms whose limits had become evident. These new facilities do not seem sufficient to meet the needs deriving from the crisis. The international institutions must therefore provide exceptional resources for low-income countries. What channels should be used to distribute such resources? How can timely disbursements, proper uses, and ownership by the receiving countries be ensured? To what extent should conditionality be reduced or reformed when the funds are intended to compensate for exogenous and transitory shocks?

8. In addition to the immediate mobilisation of new resources, the international community must help countries manage instability, i.e., series of positive and negative shocks. How can we ensure that financing mobilised to address negative shocks helps promote the adoption of contra-cyclical policies and encourages the authorities to establish mechanisms within the countries in support of the poor? Is it advisable to establish linkages between external debt service and shocks? Should recourse be extended to loans whose service is linked to the external economic situation? Is this a conceivable practice for contributions from multilateral institutions, and specifically the International Monetary Fund? Can debt restructuring itself have a contra-cyclical dimension?

9. Emergency mobilization of additional resources to address shocks and flexible debt service management are not sufficient factors in effective shock protection. We must also explore the third factor—more sustainable and more preventive protection. This approach involves allocating development aid with a certain preference for structurally vulnerable countries. In other words, a country’s structural vulnerability would become a regular criterion in aid allocation. How can this be achieved?

These three approaches will now be examined.

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[3] The concepts and arguments underlying this paragraph have been discussed in several articles (Guillaumont and Chauvet 2001, Chauvet and Guillaumont, 2004, and 2009; and Guillaumont 2006a, 2006b).

Mobilising additional resources to address the crisis: limits and conditions

10. The first approach to anti-crisis protection is, of course, to mobilise additional resources to benefit the countries affected, to compensate at least partially for the forgone foreign exchange revenue resulting from balance of payments deterioration attributable to multiple causes (diminished exports of goods and services, migrant transfers, and net capital inflows) and the loss of the corresponding tax revenue for the state.

Brief survey of existing facilities

11. Instruments have been created to mitigate exogenous shocks, foremost among which is the Exogenous Shocks Facility (ESF) offered by the International Monetary Fund (IMF). The ESF was established in 2005 and recently reformed (in September 2008) and is examined in another report. The ESF was created as concessional financing, under the same conditions as the Poverty Reduction and Growth Facility (PRGF), which distinguishes it from both older compensatory financing mechanisms and other emergency aid policy instruments offered by the Fund (post-conflict assistance or natural disaster assistance for affected countries). Drawings initially could not exceed 25 percent of the quota for the first year, but thereafter could be as much as 75 percent subject to a programme focusing on adjustment to the shock and the existence of a poverty reduction strategy. The reform consisted in increasing the maximum drawings with the establishment of two components: a rapid-access component (25 percent of the quota), and a high-access component (75 percent of the quota). In addition, conditionalities were eased: the only requirement for the rapid access component is a letter of intent to implement a policy to address the shock; while the high-access component requires definition of a programme equivalent to the PRGF; the poverty reduction strategy requirement was eliminated, although the objective is still to reduce the impact of shocks on the poor.[4]

12. Another mechanism that, while relevant, is smaller in scope and is undergoing reform, is the European Commission's facility established in connection with the Cotonou Convention to address export revenue fluctuations, known as "FLEX" and which, due to the crisis, the Commission plans to endow with further resources while supplementing it with a more flexible facility known as the "*ad hoc* vulnerability FLEX" (European Commission, Communication of 8 April 2009) (cf. infra).

13. To the extent that the resources that can be mobilised through these dedicated instruments may be insufficient, further resources are sought through a more intensive use of development finance instruments, with the concern of accelerating disbursements[5].This is what the multilateral development banks aim to do. Accordingly, the World Bank is establishing the "Vulnerability Finance Facility", which is "dedicated to streamline crisis support to the poor and vulnerable". This facility entails three coordinated programmes: the Global Food Crisis Response Program (GFRP), the IDA Fast Track Facility, and the Rapid Social Response Program, designed to provide technical and financial aid to support governments in their immediate responses to crises, through the design of operations that can be implemented more rapidly than standard World Bank operations. In addition, through the Infrastructure Recovery and Assets Platform, the Bank has announced its intention to avoid

[4] Resources are obtained through IMF borrowings in connection with the PRGF-ESF trust account, while interest subsidies are financed by contributions from bilateral donors and creditors and from IMF own resources.
[5] Accelerated disbursements was precisely the topic of a conference organised by the Senegalese authorities in October 2008 in Dakar in collaboration with FERDI.

declines in activity and job losses in the infrastructure sector and to permit rapid recovery. In both cases, the Bank hopes to be able to mobilise additional resources through trust funds (World Bank, 2009). Last, special aid is provided for the private sector, essentially through strengthening of the financial system (the IFC Private Sector Platform). We should expect to see similar initiatives from other multilateral development banks.

14. Similarly, the European Commission, in its recent communication on the support of developing countries in crisis (8 April 2009), emphasised its intention to develop activities in sectors where the crisis has brought to light priority requirements, to accelerate disbursements using more flexible procedures in emergency cases, to accelerate budget support, and to seek co-financing arrangements, as other institutions are doing.

15. It is also common that the existence of external reserves be emphasised among available resources to address the crisis. Clearly, this approach gave China substantial headroom in its recovery plan. However, while many different countries have had relatively substantial levels of reserves during pre-crisis periods, these reserves can quickly be depleted and prove insufficient to finance budget deficits. There is another form of spontaneous shock protection provided by "operations accounts" opened with the French treasury to benefit three African central banks: in the event of transient shocks, the convertibility guarantee associated with these accounts avoids the risk of reserve depletion that would otherwise be present.

Some lessons from the past

16. Nearly half a century of history in compensatory financing instruments sheds some light on the present situation.

17. The IMF Compensatory Financing Facility was established in 1963. This non-concessional facility was replaced by the Exogenous Shocks Facility (ESF). Compensatory financing, which was put to substantial use after its creation, became less popular as the Fund implemented concessional financing, despite the improvements that had been made (extension of coverage to some unexpected shocks other than declining exports). In its initial form, the ESF, established in 2005, remained unused, clearly as a result of the favourable world economic situation, but also owing to the conditionality associated with it. While the September 2008 reform aimed to make way for its use, only three arrangements were executed (in December 2008, with the Kyrgyz Republic, Malawi, and Senegal). Although streamlined, the conditionality in fact remained substantial for the high-access component (PRGF or equivalent). There is also the issue as to whether the IMF will have sufficient resources to meet demand, particularly if the conditionalities are eased.

18. The export revenue stabilisation mechanism, or STABEX, was established by the European Commission in connection with the first Lomé Convention between Europe (then of Nine) and the African, Caribbean, and Pacific Group of States. The STABEX, designed to provide compensation for declines in revenue from the export of specific agricultural products, as a result of prices or quantities, was established according to two principles that would prove contradictory: it was to be automatic (it was hailed at the time as particularly innovative as a result of this feature); and it was to benefit the sectors and people affected by the decline (accordingly exports of each covered product were considered independently of the others). During the period 1975-2000, along with successive Lomé Conventions and under the pressure from European countries the Commission's control over the use of funds gradually increased, at the expense of ever-increasing delays and a *de facto* abandonment of

the principle of automatic action, without providing the affected rural populations with true compensation. The loss of automatic action was reinforced by the fact that the resources dedicated to the facility frequently proved insufficient to meet demand, largely because an incorrect formula was used to calculate the declines (CERDI, 1998; Collier et al. 1999a and 1999b; Guillaumont 2006a and 2006b). The replacement of STABEX with FLEX in 2000 did not truly solve the problems observed from experience with the former facility. With FLEX, compensation became budget aid, which could make it rapid; while its conditionalities slowed it down. It was no longer targeted at groups affected by the decline, although the possibility existed. Last, the calculation formula was such that its triggering proved to be quite limited during the initial years of operation so that it had to be changed, although eligibility did not substantially increase as a result of the crisis, since only officially recorded past exports could be taken into account. The delays in statistical recording and conditionality took away the facility's contra-cyclical potential. Payments under the 2008 and 2009 fiscal years can be expected to remain limited. For this reason, the Commission has recently supplemented the traditional FLEX, which is based only on past export losses, with an *ad hoc* vulnerability FLEX based on parameters such as projected export losses and reduced migrant transfers and financial flows. Both FLEX facilities will receive an endowment of a further €500 million.

Questions of yesterday and today: scale, speed, conditionality, and ownership

19. Today, it is impressive to watch institutions responsible for financing poor countries make every effort to make better, faster use of the instruments available to them—by renaming them (preferably with the vulnerability label) and possibly by supplementing them with other parallel facilities, although rarely by undertaking reforms, owing to insufficient time. Therefore the question arises as to whether the current situation merely calls for additional resources, on an exceptional compensatory basis, or whether the available facilities should undergo permanent revision. In any case, there is the question of how the resources should be channelled. How can we ensure adequate levels, timeliness, proper use, and ownership by the receiving countries of the policies to be implemented?

20. The first problem is the extent of the exogenous shock in question—in other words, the extent of the deficit to be filled. This assessment will be used to determine the extent of each individual country's needs, as well as overall requirements. While each institution may have its own calculation methods adapted to the purpose or configuration of its facility, overall requirements are unique. Of course, the authorities should agree on the nature of the flows expected to change under the exogenous shocks to be compensated. While fluctuations in exports of goods or services or migrant transfers might be largely considered exogenous, it is a more difficult matter to characterise changes in capital flows as such. In addition to the nature of the flows considered, the method for calculating the benchmark value used to compare the observed or projected value for the present period have been subject to discussion.[6] While calculation based exclusively on past data (such as in the case of STABEX and FLEX) seemed suitable for a mechanism designed to be automatic, if it was based on an arithmetic average (as in the previous cases) it was unsuitable for a series registering an upward or downward trend. The solution in this case is either to follow the IMF's example and use an average centred on the year of the decline (which involves a debatable projection for future years), or an extrapolated value based on the trend from a dozen prior years.

[6] These issues were addressed long ago (cf. Guillaumont 1987 and CERDI 1998).

21. A major problem is conditionality, which is at the heart of the discussion on the mobilisation of exceptional resources. In light of the extent of the current shock and the exceptional financing requirements it will generate, donors and lenders may instinctively consider that the allocation of funds should be subject to reinforced conditionality. And perhaps in a highly deteriorated situation, the receiving countries might not be in a position to refuse. However there are a number of criticisms against conditionality for compensatory financing in connection with exogenous shocks, particularly in the context of the current crisis. First, in this situation, the countries are not responsible for the additional deficit to be financed, and if the shocks, however deep, are transitory, they do not require specific corrective measures[7]. Next, the greater the conditionality implemented, the longer the payment delay may be and the greater the risk the financing will lose its stabilising features. Last, there is the danger of going against the principles of the Paris (and Accra) Declarations on alignment and ownership.

22. This problem is not identical in all countries. Its solution depends largely on the country's relationship with the IMF. This is true for the IMF as well as for other donors and lenders, to the extent that the latter normally subject their own assistance to an arrangement with the Fund. When the Fund review has been favourable in connection with the PRGF or Policy Support Instrument (PSI), the IMF may rapidly increase its financing, in connection with the PRGF, or through the ESF without further conditionality (such as Senegal). And the other donors and creditors may supplement this financing. By contrast, the situation is more difficult if the countries have no current arrangement with the IMF, either because they have had no balance of payment problems in recent years, or because the situation and policies have deteriorated too much to meet the requirements of a Fund programme. For all donors and lenders, the solution would seem in this case to be not to use instruments associated with conditionality, which would take too long to define, but to use simple outcome-based conditionality, for example, by asking the country to monitor child mortality and to achieve a certain target in this connection. Attainment of this objective would be a condition for subsequent support. The essential advantage of results-based conditionality is to promote ownership among the receiving country governments and administrations. This should therefore be envisaged in more general terms extending beyond the cases discussed above.

23. The possibility of tension between the objective of speed and ownership is also a factor in the donors' and lenders' concern that the additional resources mobilised in connection with the crisis and in the name of vulnerability are used to protect poor and vulnerable groups through a precise targetting of resources. Verifying these uses takes time, and donors and lenders do not necessarily agree with the receiving countries on how the resources should be used for that purpose.

24. Where project aid is concerned, accelerated disbursements entail the risk of minimal ownership. If all donors and lenders have the capacity to combine speed and ownership with the flexibility that is so sought after today, we should wonder why this capacity has not been put to better use in the past. Revealing this capability and flexibility would be a favourable effect of the crisis.

[7] Different voices are beginning to call for the elimination of conditionalities for compensatory financing of shocks for which the countries are not responsible (cf. Griffith-Jones and Ocampo, 2008; and United Nations, 2009). A fear expressed from time to time is that public expenditure limits ordered will be inconsistent with the contra-cyclical policy that the external aid should, on the contrary, permit.

Promoting contra-cyclical management of instability

25. Beyond the immediate mobilisation of new resources, the international community must help countries manage instability, i.e., the succession of positive and negative shocks. How can we ensure that financing that can be mobilised quickly to address shocks promotes the adoption of contra-cyclical policies and provides incentives for the establishment of coverage mechanisms within the countries to benefit the poor? A partial answer to this question can be considered in this Forum, which consists in establishing a linkage between external debt service and shocks. This solution has not been subject to far-reaching initiatives, as major initiatives such as the Heavily Indebted Poor Countries (HIPC) initiative and the Miltilateral Debt Relief Initiative (MDRI) have not truly incorporated the implications of exogenous shocks.

Addressing both positive and negative shocks

26. As discussed in the previous section, most recent initiatives to address the crisis refer to the need to take "contra-cyclical" measures. This approach requires additional resources at this sharply declining stage of the cycle, which is clearly the most urgent, although it does not truly constitute a "contra-cyclical" policy, which involves addressing both positive and negative shocks. Why is this advisable? The reason is made clear in abundant literature on management of booms: the less effectively boom periods are managed, the more difficult the declines will be. In other words, the problem derives from the fact that the ascending phase of the cycle is managed as if it were permanent, even though it is only temporary. Accordingly, as increased public expenditure during periods of expansion is not downwardly flexible, instability generates public deficits. Or further, as the investments undertaken during periods of prosperity are generally less marginally productive than investments that must be abandoned during periods of rapid decline, instability leads to lower average productivity.

27. The objective is not only to regularise macroeconomic trends; it is also to ensure that households have some degree of income stability, avoiding them to fall into poverty traps, as well as to enhance growth in productivity among risk-adverse ones: in particular, mechanisms that can smooth revenue trends for small farmers destabilised by international price fluctuations or the whims of nature are likely to promote growth in production.

28. The international community can help to smooth economic trends by providing countries some kind of insurance against negative shocks that, to avoid any moral hazard, should be counterbalanced by prudent management of positive shocks. It could at the same time guarantee the functioning of insurance mechanisms for poor players who lack the resources to buy insurance at market conditions. Such mechanisms can themselves be the contractual counterpart of macroeconomic insurance (cf. Collier et al. 1998 and 1999; and CERDI 1998). Debt service management can make it possible to promote this contra-cyclical management with some degree of automatic action, which is tantamount to an insurance system.

Contra-cyclical debt service management

29. While the concept of establishing linkages between external debt service and shocks is a longstanding one,[8] it has only been recently applied, and still remains quite limited. Linkages can be established in two ways—in connection with new loans or in the treatment of existing debt.

30. The first solution consists in granting a loan to a state or enterprise, and adjusting the debt service to reflect an index provided in the contract, according to the evolution of an exogenous factor for the country or enterprise. The Agence Française de Développement used this approach on a limited basis with its contra-cyclical loans. Accordingly, it offers highly concessional sovereign loans with "floating" amortisation, i.e., that can be temporarily suspended. For example, Senegal was granted a loan to clean up the pollution in Hann Bay with an interest rate of 1 percent, a term of 25-30 years, and a five-year floating grace period that can be used in case export revenue should decline substantially[9]. The practice, however, remains limited to AFD, which itself has only used it in a few cases. Different debt service rescheduling modalities reflecting different exogenous factors (export prices or values, assessed from different statistical sources, other balance of payments components, etc.) are still conceivable (Cohen et al. 2007). The same is true for the method for calculating shocks, which can use different approaches, as we have observed for compensatory financing: in this case again it might seem advantageous to refer to trend values.

31. The extended practice of "contra-cyclical" loans might help rehabilitate loans for productive purposes in low-income countries by mobilising new resources for that purpose in times of crisis. Such resources would not necessarily be highly concessional and might even be subject to market rates when countries present low risks of debt crisis and substantial macroeconomic management capacities, which the IMF deems to be two criteria to be used to adjust indebtedness conditions. It does not seem, however, that the IMF would be any more inclined than the World Bank to adopt flexible debt service rules depending on exogenous factors. IMF loans are in fact allocated in connection with balance of payments difficulties deriving from multiple causes and do not lend themselves to a simple definition of a shock.

32. The second way to establish linkages between shocks and debt service pertains to heavily indebted countries that are facing a debt crisis as a result of the international economic situation. An innovation might entail, when debt is being rescheduled, adding a contra-cyclical factor to rescheduled debt service. Contra-cyclical loan mechanisms could be extremely varied and the trigger factor for debt service modulation would be specific to each country.

Limits for today and tomorrow

33. In addition to the mechanisms for implementing contra-cyclical debt service management, the real issue is to give countries incentives to manage booms or positive shocks. During favourable periods, countries should be encouraged to reduce their debt or accumulate reserves for the future. Such incentives would not exist if the practice of contra-cyclical lending remained an isolated case.

34. Another limit is to set aside the poorest countries that are not necessarily the least vulnerable to external shocks. Such countries, which are often no longer heavily indebted, are

[8] Among the relatively recent analyses, see Cohen et al (2007), Gilbert and Tabova (2005), Guillaumont et al. (2007), and Guillaumont (2006a and b).
[9] The borrower was offered the option of a higher interest rate (1.5 percent) and a 6-year floating grace period.

often given grants to reach millennium goals, and external debt instruments in this case can no longer contribute to contra-cyclical management or growth stabilisation. In such cases, some aid should be earmarked to establish guarantee funds against price fluctuations in the commodities most affecting the country concerned. In particular, just as anywhere else, and often even more so in such countries, there is a need for external support for insurance mechanisms to protect the rural poor against fluctuations in prices or in the volume of their crops. The technical problems involved in implementing such mechanisms now do not seem insurmountable (Collier et al. 1998, 1999, Guillaumont and Guillaumont Jeanneney, 2003)[10].

Reflecting structural vulnerability in aid allocation

35. An effective shock protection cannot be expected only from emergency mobilisation of additional resources when a shock occurs and flexible debt service management. We must explore a third approach, which involves taking account of the structural vulnerability of the receiving countries in development aid allocation. In other words, structural vulnerability must be made into a regular criterion for aid allocation. This reform would be part of a general and welcome reform of the allocation criteria (see Guillaumont 2008 for details). This approach would enable a preventive—and thus more sustainable—response to shocks rather than an *ex-post* solution. The international crisis should make this approach easier to implement, and necessary, as the steps taken to address the crisis as examined above will naturally lead to a change in initially planned allocations.

Back to basics in aid allocation

36. Of course, aid allocation criteria vary depending on the source. However, multilateral development banks use a relatively similar performance-based allocation (PBA) formula, which has the feature of giving dominant weight to a subjective "performance" indicator, which in fact is a policy and institutional quality indicator, as the CPIA[11], and less weight to per-capita income. As certain countries in particularly difficult situations and classified as fragile states (or by an other name)[12] by definition have poor performance indicators and still require international support, they are often assigned a specific allocation.

37. This allocation approach is not fully consistent with the principles that we believe should be followed in this connection: equity, effectiveness, and transparency.

38. The first principle is equity. It is poorly represented in the PBA by the per-capita income criterion, due to its assigned little weight, and the underlying concept of equity. If equity corresponds to equal opportunities (the Rawls concept), the criteria should reflect the factors constituting structural growth handicaps for the country, in other words what factors beyond their control do not give them identical chances to grow (or to reach the Millennium Development Goals). Per-capita income is not a good indicator in this case as, according to the theory of convergence, low income should instead be a factor in more rapid growth. To satisfy the principle of equity, aid should be allocated to compensate for structural handicaps.

[10] The trend should also be considered in determining benchmarks to measure losses.

[11] Country Policy and Institutional Assessment (set up and used by the World Bank, then by other institutions)

[12] For instance post-conflict

39. Where development aid is concerned, equity cannot be considered independently of effectiveness. To truly offset the handicaps involved, the aid must be effective. Accordingly, the allocation criteria must reflect the factors that in the receiving countries influence the effectiveness of the aid they receive. The CPIA was initially incorporated into the PBA—as a presumed factor in performance—for that purpose. In fact, according to the theory developed by the World Bank (Burnside and Dollar) aid can only be effective (in terms of growth) if the policies are ”good”. This analysis has been subject to much criticism, specifically on the validity of the econometric results underlying it. The CPIA itself has been criticised as subjective and relatively unstable. Its maintenance in the PBA, with substantial weight, is probably explained by the prevalence of a moral sentiment according to which countries that conduct effective policies should be duly rewarded and encouraged.

40. The third principle is transparency. Aid allocation among countries is a policy choice that should be easily understood by the authorities and public opinion in both North and South. While the PBA is based on a relatively simple formula, its application is subject to a number of changes that ultimately make its interpretation a confusing matter. The main change consists in giving specific treatment to states considered fragile, as defined by a very low CPIA. As a result, allocated aid diminishes with the CPIA level and rises when the latter drops below a certain limit. The existence of different floors and ceilings according to the size of the country, which is a factor in their higher or lower vulnerability levels, leads to other discontinuities that make allocation less transparent.

Structural vulnerability: a criterion according to the principles

41. Reducing the weight of governance (or the CPIA) for the benefit of structural vulnerability would lead to a particular improvement in the aid allocation formula while helping preventively and sustainably protect developing countries against exogenous shocks. Structural vulnerability of countries results of the size of the exogenous shocks to which they are subject and their exposure to such shocks. Structural vulnerability represents this component of general vulnerability that is beyond the country’s control and is not dependent on its policy, and accordingly it is distinguished from the country’s resilience or capacity to cope with shocks, which, on the contrary, is heavily dependent on policy. Structural vulnerability seems to reflect the three principles discussed above and can facilitate their implementation.

42. First of all, structural vulnerability is a handicap that the international community can equitably attempt to compensate. Its impact on growth and development has been broadly demonstrated (see above). Selecting structural vulnerability *ex ante* as an aid allocation criterion makes it possible to treat vulnerability preventively and regularly, without the hazards or delays normally associated with compensatory financing. Of course, it is not the only structural handicap. Low human capital levels should also be considered.

43. Second, as we also recalled in the introduction, structural vulnerability gives aid a stabilising function reflected by a higher marginal effectiveness. Econometric calculations indicate structural vulnerability, especially export revenue instability, as a more robust factor that affects the aid effectiveness in terms of growth than policy or governance: structural vulnerability increases the marginal effectiveness of aid, which corresponds to the fact that aid reduces the effects of vulnerability. In particular, aid has a stabilising impact with regard to exports, which largely explains the contribution of aid to growth. In other words, the more aid allocated to vulnerable countries, the better it protects growth (or avoids negative

growth). In the longer term, aid helps make countries less economically vulnerable by promoting growth and the economic diversification that accompanies it.

44. Last, making vulnerability an aid allocation criterion may help enhance coherence and transparency in allocation. In fact, fragile states are also generally structurally vulnerable. Using the criterion of vulnerability can help treat cases of fragile states without specifically having recourse to this category or asimilar one, as an exception to the principle of performance-based allocation (PBA). This approach would avoid the discontinuity highlighted above. And policy or governance would influence allocation, only as far as it would not result from structural vulnerability. At the same time, fragility in states would be addressed through the allocation of aid not only on a curative basis but also preventively.

45. For these three reasons, in seeking ways to protect developing countries against shocks, it would seem that we can justify making structural vulnerability one of the main criteria for development aid allocation.

Feasibility: structural vulnerability measured through the EVI

46. Of course, we should wonder whether structural vulnerability can be measured with sufficient reliability to be used as an allocation criterion. The United Nations has developed the Economic Vulnerability Index (EVI)—a synthetic index that is officially used to identify least developed countries (LDCs), which seems to correspond fairly precisely to the factors we need to assess. This gradually developed index is a composite that includes seven indicators of exposure to shocks and recurrent shock size (equal weight given to exposure and shocks).[13]

47. Of course, any measurement of a complex phenomenon using a synthetic index is subject to discussion, as shown by the example of governance and the CPIA. The EVI index, however, presents the advantage to be based on objective rather than subjective assessments.

48. The EVI index also offers the feature of having been officially accepted by the United Nations Economic and Social Council (ECOSOC) as a criterion for identifying LDCs, combined with per-capita income and the Human Assets Index (HAI)—a composite index reflecting the state of health and education, where low levels also reflect a structural handicap. Selecting an index such as the EVI (and HAI) as an aid allocation criterion should therefore lead us to give a certain preference to LDCs, which is consistent with the priority they have been given by a number of international conferences. This approach, however, would also give preference to other countries that, without being LDCs, are structurally quite vulnerable, and specifically small island developing states (SIDS)[14]. In application of graduation criteria, several of these countries have in fact leaving the LDC category owing to their high per-capita income and human capital levels (Cape Verde, already graduated

[13] The components of the EVI are as follows (weightings are listed in parentheses):
- Exposure to shocks: population size (in log) (0.25), distance from world markets (0.125); concentration of goods exports (0.0625); and relative share of value added in agriculture, forestry, and fishing activities;
- Size of shocks: instability of goods and services exports (0.125); agricultural production instability (0.0625); and percent of population displaced by natural disasters (0.0626).

A detailed analysis of the EVI is presented in Guillaumont (2008b, 2009a, and 2009b).

[14] Vulnerability of LDCs and SIDS is compared in Guillaumont 2007.

Maldives, and Samoa), although they require a relatively high level of aid owing to their vulnerability.

Conclusion

49. The world crisis represents an exceptional shock for developing countries, especially for low-income countries, and more specifically for LDCs. It has brought to light the gaps in the current system designed to protect countries against exogenous shocks. It seems at the same time, however, to provide an opportunity to correct these problems and to establish reforms hardly conceivable only a short time ago. This is apparent from three standpoints.

50. The system's capacity to provide timely, sufficient compensatory financing has proved limited by the current practice of conditionality, which would seem to provide an opportunity for reform, to move towards results-based conditionality.

51. In addition to the mobilisation of resources to address the crisis, the system should be able to manage instability, i.e., alternating positive and negative shocks, which requires that we focus now on policies to be implemented during recovery. Loans and debt rescheduling with contra-cyclical service capabilities will only be a sufficient incentive or response if the practice is sufficiently widespread.

52. As effective shock protection cannot only derive from the mobilisation of compensatory financing and flexible debt service management, we need now more than ever to take into account structural vulnerability in the allocation of aid among countries, which requires a deep reform of the allocation criteria.

53. While they help support growth in poor countries, the three types of approach examined should also be useful in the long term to reduce their vulnerability.

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