Grant *versus* loans in a world without crystal balls

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Blending Grants and Loans
Marketplace on Innovative Financial Solutions for Development
Paris, March 4, 2010

Outline

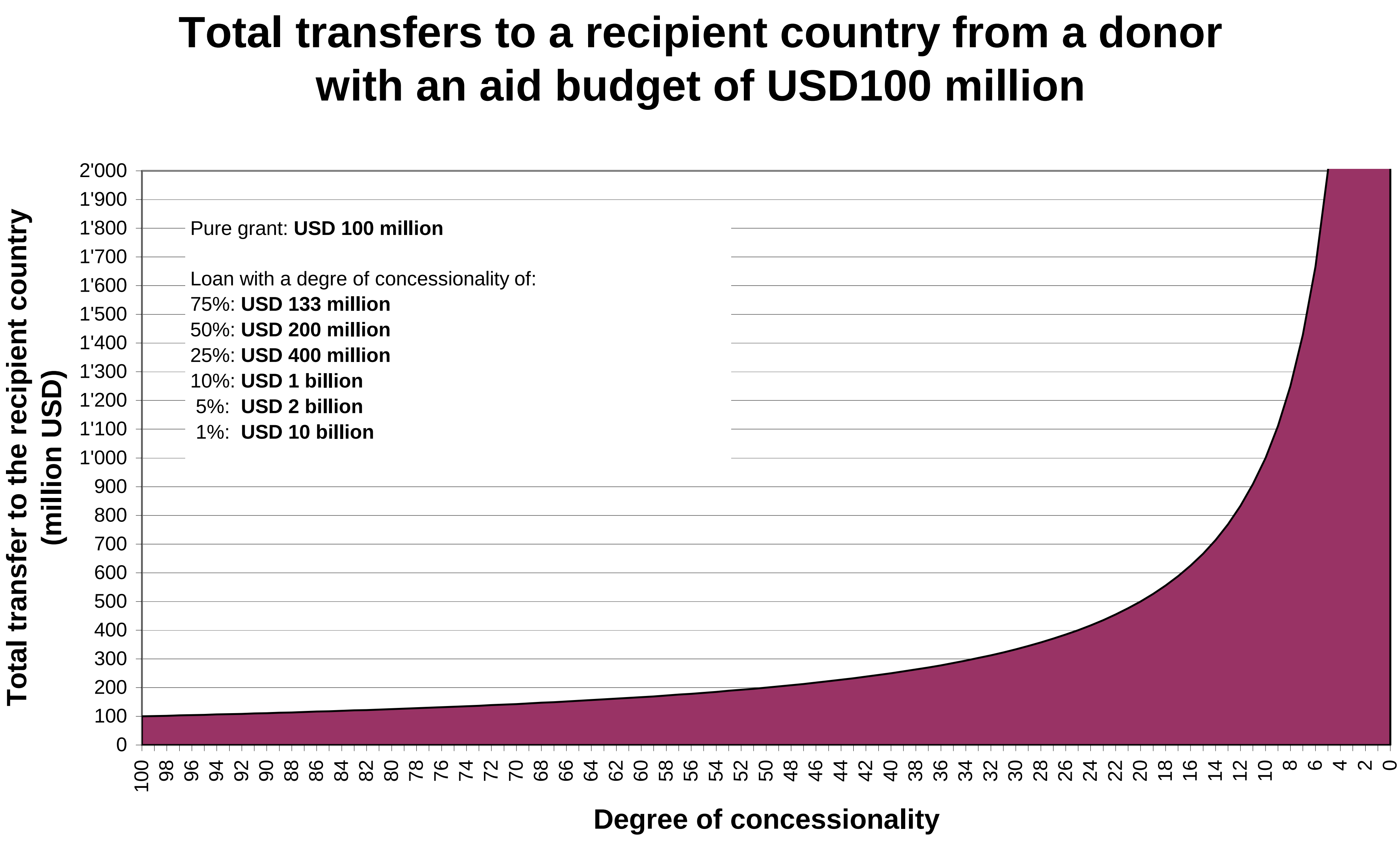
- Wrong arguments in support of grants
- Conventional wisdom and the crystal ball
- Three proposals, one of them in the spirit of Niels Bohr

Are grants better than loans?

- Some say: yes!
  - "The World Bank has driven poor countries into a ditch by lending instead of donating funds to fight poverty"
    - Paul H. O'Neill, US Treasury Secretary (February, 20, 2002)
- Some say: it depends (or YO!)
  - But the things the answer depends on are hard to quantify

Two (wrong) arguments in support of grants

- The silly one:
- "Grants are better because you don't have to repay"
- What about the most basic lesson in economics?
  - TASATAAFL
    - *There ain't such a thing as a free lunch*
- For any given aid budget, the degree of concessionality determines total transfers to recipient countries



Total transfers to a recipient country from a donor
with an aid budget of USD100 million
Total transfer to the recipient country
(million USD)
Degree of concessionality
2'000
1'900
1'800
1'700
1'600
1'500
1'400
1'300
1'200
1'100
1'000
900
800
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Pure grant: USD 100 million
Loan with a degre of concessionality of:
75%: USD 133 million
50%: USD 200 million
25%: USD 400 million
10%: USD 1 billion
5%: USD 2 billion
1%: USD 10 billion

Two (wrong) arguments in support of grants

- The sophisticated one:
- "Given a country's ability to pay, any mix of grants and loans will lead to the same flow of external resources" (Meltzer Commission)
  - “In theory, there is no difference between theory and practice. In practice there is" (Y. Berra)
- Equivalence between grants and loans require perfect capital markets
  - Cohen, Jacquet, and Reisen (2007), Cordella and Ulku (2004)

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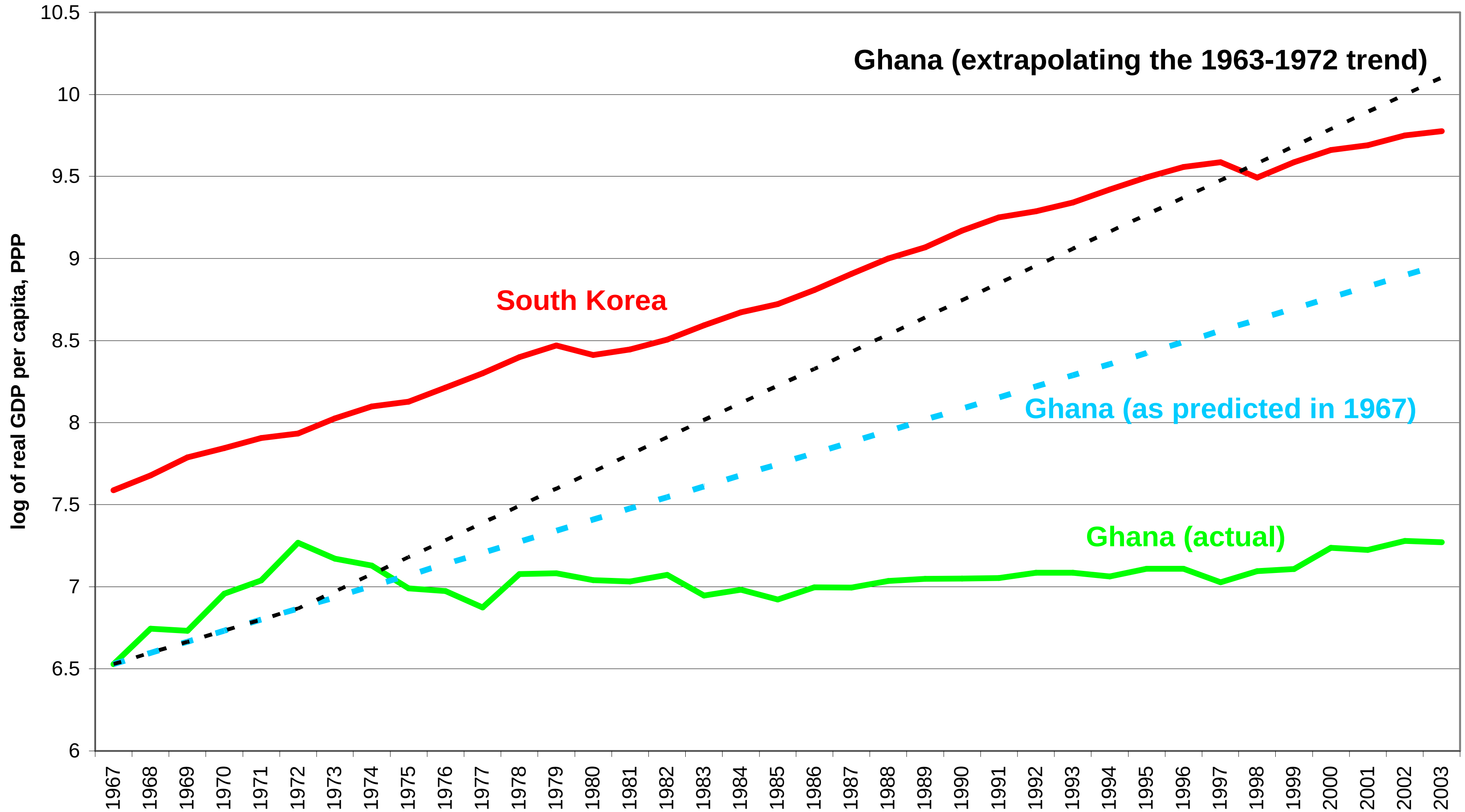
The basic trade-off and the conventional wisdom

- With grants you don't need to pay back (a debt crisis down the road is less likely) but you get less money
- With loans you need to pay back but you get more money
- So, the solution to the grants *versus* loans dilemma is simple
  – Countries that can absorb large inflows and that can sustain higher levels of debt should get loans
  – Countries that have problems absorbing large inflows and that have debt sustainability problems should get more grants
    - This is the basic message of Cordella and Ulku (2004)

The basic trade-off and the conventional wisdom

- There is a problem with the conventional wisdom:
  - Loans will be due in 10, 20 or even 30 years.
  - How do we know whether countries will be able to repay?
- We need a crystal ball:
  - Project evaluation
    - But money is fungible, we need a macro approach
  - The Debt Sustainability Framework (DSF)!
    - ..we forecast growth over the next twenty years
    - ..we look at the quality of policies and institutions
    - ..and we decide whether a country will be able to repay
- The problem is that the noise to signal ratio is huge
  - In the late 1960s many economists thought that Ghana would achieve rapid growth and nobody thought much of South Korea

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so (Mark Twain)



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Navigating the loans *versus* grant debate without a crystal ball

- If we don't know whether countries will be able to repay, why don't we just move from *ex ante* to *ex post* grants?
  - A modest proposal
  - A more ambitious proposal
  - A proposal in the spirit of Niels Bohr
    - *We all agree that your theory is crazy. The question that divides us is whether it is crazy enough to have a chance of being correct.*
      - (Niels Bohr to Wolfgang Pauli after Pauli's presentation of Heisenberg's and Pauli's nonlinear field theory of elementary particles, Columbia University, 1958)

The modest proposal: automatic debt relief in the wake of natural disasters

- Initiatives aimed at responding to unsustainable debt arising from natural disasters rely upon a patchwork of ad hoc measures
  – This tends to be inefficient, and sometimes inequitable
  – Predictability and efficiency could be improved by making greater use of debt contracts with built-in insurance clauses

Automatic debt relief in the wake of natural disasters

- Four problems that limit the use of contingent contracts
  - Adverse Selection:
    - Only countries that face significant risk have incentives to buy insurance
  - Externalities:
    - There are fixed costs involved in creating new debt instruments and individual agents have limited incentives in paying these costs
  - Complexity:
    - Not all debt management offices have the ability to properly evaluate the costs and benefits of contingent debt instruments
  - Political economy:
    - Policymakers have limited incentives to buy insurance contracts with costs that must be paid upfront and benefits that may accrue only years later

Automatic debt relief in the wake of natural disasters

- These problems do not apply to loans extended by the international financial institutions
  - Adverse selection can be addressed by including natural disaster insurance in all loans extended by these institutions.
      - Since IFIs' lending rates are not affected by country-specific credit risk, they should not be affected by country-specific natural disaster risk.
    - This form of risk sharing, which is in line with the cooperative nature of the IFIs, would also bypass political economy obstacles
  - Externalities are less relevant because the IFIs do not operate in a competitive market.
    - Addressing such externalities can be seen as part of the mandate of these institutions.
  - The menu of debt contracts issued by the IFIs tends to be small.
    - Managing such debt contracts should not be a daunting task for debt management offices with limited institutional capacity

Automatic debt relief in the wake of natural disasters

- Possible problems:
  - Moral hazard
    - Not an issue if the trigger is parametric
    - Moreover, I believe in Paul Krugman
      - Meltzer Commission: "the importance of moral hazard cannot be overstated"
      - Paul Krugman: "oh yes it can"
  - Such a policy may lead to an increase in the spreads charged by the IFIs
    - Not necessarily because countries hit by a natural disaster are going to get their debt relief anyway, but in a messier way
      - Maybe there is a free lunch, after all

A more ambitious proposal

- Make debt payments contingent to commodity prices
- Costs and benefits:
  - Similar to the modest proposal but things can be slightly more complicated
    - Guillaumont, Guillaumont Jeanneney, Jacquet, Chauvet, and Savoye (2003)

The Bohr proposal

- Allocate official credit on the basis of need under the assumption that countries will be able to repay (possibly after a grace period)
- Set the repayments of official loans as a fixed percentage (up to a maximum) of the borrower's GDP
- Grants come *ex-post* (like in HIPC) but the rules are decided *ex-ante*

The Bohr proposal: Advantages

- No need for crystal balls
  - Grants will only go to countries that really need them
    - There are many sources of uncertainty besides commodity prices and natural disasters
- It gives the right incentives to lenders
  - No loan pushing
  - Less irresponsible and tied lending

The Bohr proposal: Problems

- Moral hazard
  - 1 Less incentives to grow
    - See Paul Krugman
  - 2 Fake statistics
    - This is a serious issue, we do need better statistics
  - 3 New lenders may jump in after (or before) the country gets debt relief
    - Prohibit (or limit) new borrowing (as it is done now)
    - Allow new borrowing only if it has the same GDP clauses as existing debt
      - Silver lining: this would jump start the market for GDP indexed bonds
- How do you determine needs?
- The actual aid envelope is only known ex-post
  - This is OK, rich countries should be more able to bear risk
  - With temporary shocks, payments could be postponed but not cancelled
    - The maturity of the loan is not fixed in advance
      - Like highway concessions in Chile (Engel, Fischer, and Galetovic, 2001)
      - …but Aguiar and Gopinath (2007)
- Nasty regimes
  - Adopt an odious debt doctrine (nobody will lend to them)

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