8

An Agenda Going Forward

We have shown that there is a wide gap between present actions and the potential of multilateral development banks to support their clients' risk-management policies, although there are some promising recent initiatives. We have also discussed the possible reasons behind the existence of this gap. Going forward, multilateral development banks need to prioritize actions to overcome it.

Domestic currency initiatives

A first priority for multilateral development banks should be to concentrate efforts on helping their clients, especially the low-income countries and the lower tier middle-income countries, to develop long-term domestic currency capital markets. Doing so would require a significant change in multilateral institutions' current risk-management policies, coupled with increased technical assistance in this area. Multilateral development banks' own supply of loans and guarantees in domestic currencies and of currency and domestic interest rate derivatives is still very limited. Most important, these operations are highly concentrated in countries that already have relatively deep domestic currency and swap markets, where multilateral development banks merely intermediate currency risk and retain the credit risk, thereby achieving some cost savings for their clients but little developmental impact (for example, no significant

Center for Global Development | www.cgdev.org

extension of maturities). This is a direct result of their refusal to retain any currency risk on their balance sheets and/or to undertake aggressive issuance of their debt indexed to a wide pool of their clients' domestic currencies. As a consequence, the countries that would have a greater need for the support of multilateral development banks in developing their domestic currency markets are precisely those that have no access to their domestic currency operations or currency swaps.

Fortunately, this is an area in which there are several promising initiatives such as the IFC's MATCH program and The Currency Exchange (TCX), in which several regional development banks will participate. Both of these initiatives are based on the principle that a global fund can retain currency risks and achieve significant overall risk reduction by pooling currency risks across the globe. As the proof of the pudding is in the eating, the eventual success of the IFC's MATCH initiative should be measured by the number and volume of operations in "frontier" markets (those with underdeveloped domestic currency capital markets), and the success of TCX should be measured by its actual capacity to significantly extend maturities in countries that have only short-term domestic currency markets. The World Bank should consider following the example of the IFC in this regard, and regional development banks that are not members of TCX should be encouraged to explore joining this initiative.

A totally different initiative, the World Bank–sponsored GEMLOC, can also have an important effect in helping developing country domestic currency debt become a significant asset class. It is a hedge fund linked to an "investability" index and a technical assistance program. Although it will initially begin operations in countries with already developed domestic currency capital markets, hence having limited developmental impact, there are plans to extend it to a large number of countries. Its eventual success should be measured by the number of currencies in which it invests and, even more so, by how fast it reaches underinvested markets and shows some clear developmental impact.

Indexed debt pilots

A second area of priority should be to develop pilot programs for GDP-indexed or terms of trade–indexed debt or a combination thereof. In particular, GDP-indexed debt instruments could help achieve a high degree of macroeconomic stabilization for issuers, as debt payments would increase in good times and be reduced automatically in bad times. At the same time, a global pool of GDP-indexed bonds would provide the maximum risk-reduction potential for investors through global diversification (the remaining undiversifiable risk would be that associated with global GDP growth).[1] The stabilization and risk-diversification potential of terms of trade–indexed bonds would be lower but still quite substantial. The creation of these macro-markets

1. Shiller 2003 and 2004.

Center for Global Development | www.cgdev.org

requires strong convening power to help overcome coordination problems and first-issuer risks and costs, in addition to other, relatively minor, problems associated with pricing, GDP or terms of trade accounting, and so forth.[2] A global multilateral development bank like the World Bank would be in privileged position to help develop these markets. Regional development banks could also play this role by joining in an effort with global reach, as some of them are doing through TCX with respect to the development of global currency markets.

The first priority could be to develop a pilot program with the simultaneous issuing of GDP-indexed (or terms of trade–indexed) bonds by a group of small countries situated in different regions.[3] If the participating countries are well chosen, the pool would offer significant risk diversification for investors. The overall issue would be small enough to be easily absorbed by the market, but at the same time, being small countries, the issuers may achieve significant stabilization potential. The World Bank could absorb the costs associated with the design of the bonds, their covenants, and issuance.[4]

The lessons of these experiences would permit a proper follow-up, either by proceeding with a second, more ambitious pilot multi-bond issuance or by convincing a selected group of investment-grade or near-investment-grade countries to become individual issuers of GDP-indexed debt (as was done with the introduction of new collective action clauses in sovereign bonds, with the leadership of Mexico). Over time, multilateral development banks themselves should begin to offer regularly GDP-indexed (or terms of trade–indexed) loans as one more option at the moment of deciding on the financial characteristics of each operation.[5] It should be stressed that such loans could help reduce their clients' credit risk, as the probability of default can be significantly reduced when a significant portion of a country's debt is GDP indexed.[6]

Catastrophic insurance initiatives

Similarly, multilateral development banks with global reach are in an especially advantageous position to help achieve significant risk-reduction benefits through global diversification of other developing country risks, such as those associated with natural disasters. The World Bank has a variety of recent initiatives in this regard.

To begin with, the Caribbean Catastrophic Reinsurance Facility covers governments' estimated short-term cash needs in the aftermath of disasters for a group of 16 Caribbean countries. The facility operates on a parametric basis. The World Bank

2. Chamon and Mauro 2005.

3. Williamson 2008.

4. Simultaneously, the multilateral development banks may begin experimenting with GDP-indexed (or terms of trade–indexed) loans for some of their clients.

5. Today, countries may choose currency of denomination among a set of permitted currencies, fixed or floating interest rates.

6. As shown in the simulations included in Chapter 5.

Center for Global Development | www.cgdev.org

contributed to its capital, and several donors finance part of the premiums paid by participating countries. The facility retains some risk, which is significantly reduced by pooling, and diversifies the rest either through reinsurance or the issuance of catastrophe bonds. The World Bank estimates that through a combination of reduced cost of capital, risk pooling, and partial risk retention, premiums were reduced by approximately 68 percent as compared with individual country solutions.[7] In principle, reinsurance and catastrophe bond premiums not only may be lower but also become less volatile thanks to the retention capacity of the facility. This successful example could be replicated in other regions, either through World Bank or regional development bank sponsorship. Moreover, a Global Catastrophic Reinsurance Fund could achieve much higher risk-diversification benefits, but significant coordination problems would have to be overcome in creating it.

Another World Bank initiative in the making is that of issuing a Global Catastrophe Mutual Bond, which would cover short-term cash needs for several governments for a variety of natural disaster risks. The World Bank would pay debt service to investors out of fees paid by countries, corresponding to the amounts and types of events they want to insure against. Donors would be encouraged to pay for specific poor countries' fees. Disbursements to countries would be based on parametric coverage, thus allowing for automatic disbursements that would cover governments' expected short-term cash needs. The World Bank has estimated that savings in expected premiums, as compared with stand-alone country catastrophe bond issuance, would be around 50 percent on average for a group of 10 representative countries[8] covering two types of risks (earthquakes and hurricanes). Adding more countries and disaster risks would achieve even higher diversification gains. It is expected that the Global Catastrophe Mutual Bond would also achieve significant fee stability compared with current high market premium volatility.

There is, however, a potentially more ambitious role for multilateral development banks in helping developing countries to achieve higher catastrophic insurance penetration. The need to do something in this area is highlighted by the fact that the fraction of expected economic loss for natural disasters that is insured in industrial countries rose from around 20 percent in 1980 to about 40 percent in 2006, while the corresponding figure for the average of developing countries has stayed at a very low 3 percent. The diversification benefits that could be achieved through a global pool of both public and private risks could be very substantial. The World Bank has estimated that, on average, premiums can be reduced more than 40 percent in global pools, compared with the average premium for individual countries acting alone. Given these significant savings, the Mexican authorities requested that the World Bank

7. Of which about 35 percentage points were attributable to a lower cost of capital and the rest to risk-diversification benefits (Ghesquiere and Mahul 2007).

8. Six in Latin America (Chile, Colombia, Costa Rica, Dominican Republic, Mexico, and Peru), two in Asia (Indonesia and the Philippines), and two in Europe and Central Asia (Albania and Turkey).

Center for Global Development | www.cgdev.org

study the viability of establishing a Global Catastrophic Reinsurance Facility to which both governments and private insurers could have access. The significant reduction in premiums that could be achieved, plus an expected reduction in volatility of fees, might yield important increases in catastrophic insurance penetration in participating countries. The facility would benefit from seed capital contributions from the World Bank and multilateral institutions, but it has been envisioned that it would eventually be a fully private endeavor. Initial studies suggest the financial viability of the proposal.[9] It should move forward.

Helping to deal with other types of exogenous shocks

Helping developing countries reduce exposures to currency risks (by supporting the development of long-term capital markets in domestic currencies through various means), terms of trade and output risks (through the development of terms of trade–indexed and GDP-indexed debt, while continuing to help diversify their economies and improve their macro-policies), and natural disasters risks (through integrated prevention and insurance programs such as those of the Caribbean Catastrophic Reinsurance Facility and those envisaged for the Global Catastrophe Mutual Bond and Global Catastrophic Reinsurance Facility) would go a long way toward helping them reduce their macroeconomic volatility and proneness to crises. But these are not the only types of risk against which developing countries would benefit from more protection.

As mentioned in the first chapter, exogenous capital flow shocks have been on several occasions a primary source of substantial output and welfare losses, and private capital flow volatility augments the impact of any other shock. Protection against major capital flow shocks is the responsibility of the IMF, which has long been struggling to create an operational automatic facility to help countries protect against these shocks. Multilateral development banks can play only a minor role in this respect, given the limited size of their outflows in comparison with private capital flows. But they could begin to be part of the solution, and not of the problem, if they at least would be true to their stated goal of acting countercyclically with respect to private capital flows. Achieving this goal, however, would require a significant change in internal culture, incentives, and procedures.

Contingent credit loans or lines could help governments cover limited liquidity risks. General-purpose deferred drawdown options offered by the World Bank are a case in point. The initial design of the deferred drawdown options was so poor that they essentially had no takers. An improved recent design might increase their usage. The World Bank and most other multilateral development banks have contingent credit loans or lines that disburse against the occurrence of a natural disaster, a

9. Gurenko and Zelenko 2007.

Center for Global Development | www.cgdev.org

terms of trade shock, or any other calamity. Although helpful, these credit lines are a second-best option to proper insurance facilities, as it is not wise to burden disaster-stricken countries with additional debt.

Recent events have shown how useful it would have been for countries to be partially covered against food and energy price risks. Debt indexed to terms of trade would have helped food and energy importer countries deal with the balance-of-payments aspect of the shock, but it is desirable to develop financial instruments that would give automatic budget finance for, as an example, increased expenditures in conditional cash transfers, which might be the best available program to help the poor affected by the shock. Other examples include the potential impact of epidemics and other health shocks, and climate change effects.

As this partial list suggests, there is a continuous need for multilateral development banks to innovate in new financial instruments that, adequately linked to technical assistance and capacity building, may help developing countries manage a variety of risks. This consideration suggests that, eventually, multilateral institutions should contemplate deeper internal reforms designed to create the right operational incentives to promote and use financial innovations and to remove the present biases in favor of traditional lending. The de-bundling of traditional lending, technical assistance services, and administrative budgets would play a key role in such reforms. As importantly, or perhaps more so, it is necessary to achieve a clearer consensus among stakeholders about the role of multilateral development banks in a world of large and increasing private capital flows. We hope that this study may contribute to this end and help sustain the effort to innovate even in present times of temporarily high demand for traditional loans.