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Working Paper

The role of international financial institutions in macroeconomic crises: improving the architecture of the World Bank and the IMF for managing shocks in developing countries

Discussion Paper, No. 33/2014

Provided in Cooperation with:

German Institute of Development and Sustainability (IDOS), Bonn

Suggested Citation: Berensmann, Kathrin; Wolff, Peter (2014) : The role of international financial institutions in macroeconomic crises: improving the architecture of the World Bank and the IMF for managing shocks in developing countries, Discussion Paper, No. 33/2014, ISBN 978-3-88985-659-3, Deutsches Institut für Entwicklungspolitik (DIE), Bonn

This Version is available at:

<https://hdl.handle.net/10419/199446>

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The Role of International Financial Institutions in Macroeconomic Crises

Improving the Architecture of the World Bank and the IMF for Managing Shocks in Developing Countries

Kathrin Berensmann
Peter Wolff

The role of international financial institutions in macroeconomic crises

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Bonn 2014

Discussion Paper / Deutsches Institut für Entwicklungspolitik
ISSN 1860-0441

Die deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über <http://dnb.d-nb.de> abrufbar.

The Deutsche Nationalbibliothek lists this publication in the Deutsche Nationalbibliografie; detailed bibliographic data is available at <http://dnb.d-nb.de>.



ISBN 978-3-88985-659-3

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Abstract

In their response to the global financial crisis, the international financial institutions (IFIs) have not only increased funds for shock financing, but have also significantly reformed their instruments. Nevertheless, some gaps remain. IFIs should consider the fact that most advanced low-income countries (LICs), which tend to have sound records of macro-economic performance and are to some degree integrated into international financial markets, will graduate in the foreseeable future. For this group of countries, an International Development Assistance (IDA) blended financing facility with a lower degree of concessionality would be appropriate and would also help IDA to sustain its funding. Similarly, the question arises about whether the lending policy of the International Monetary Fund (IMF) is sufficiently differentiated among LICs. The lending framework appears to not fully meet LICs' needs for contingent financing, especially the most advanced of them. To be prepared for future crises, IDA should investigate other funding models to reduce its dependence on annual donor budget processes and increase the volume of its shock windows. With regard to middle-income countries (MICs), the paper confirms that the IFIs' quick response helped to contain a larger systemic crisis. However, for various reasons, the IMF's facilities were not used much, while the International Bank for Reconstruction and Development (IBRD) greatly expanded its policy lending, thus using up a large part of its lending headroom. This calls for a revision of the IBRD's crisis instruments for MICs.

Preface

This study was jointly commissioned by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH as part of the sector project, “International positioning of German development cooperation in development economics”, and the German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE) on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ). The authors would particularly like to thank Felix Schmieding (GIZ), Reinhard Palm (BMZ), Katja Röckel (GIZ) and Johanna Wohlmeyer (GIZ) for their technical support and valuable comments. The authors also greatly appreciated the comments of Margret Thalwitz, Dr. Nannette Lindenberg, Prof. Dr. Stephany Griffith-Jones, Dominique Bruhn, Florence Dafe, Prof. Dr. Ulrich Volz and Dr. Thomas Fues.

The authors thank all their interview partners for our invaluable discussions – including staff of the World Bank, the IMF, the BMZ, the German Federal Ministry of Finance and the German Bundesbank. The authors are particularly grateful for the valuable comments of Dr. Sudarshan Gooptu (World Bank), as well as Dr. Christian Mumssen (IMF) and Dr. Chris Lane (IMF).

The views expressed in this paper are those of the authors and do not necessarily reflect the views or official policies of the BMZ or GIZ. Dr. Kathrin Berensmann is responsible for all issues related to concessional lending by the International Financial Institutions (IFIs). Dr. Peter Wolff is responsible for all sections relating to the IFIs’ non-concessional lending.

Bonn, October 2014

Dr. Kathrin Berensmann, Dr. Peter Wolff

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Abbreviations

ACP	African, Caribbean and Pacific Group of States
ADB	Asian Development Bank
AfDF	African Development Fund
AfDB	African Development Bank
ADB	Asian Development Bank
AsDF	Asian Development Fund
BoP	balance of payments
bps	basis points
BRICS	Brazil, Russia, India, China, South Africa
CADB	Caribbean Development Bank
CMIM	Chiang Mai Initiative Multilateralization
CRW	Crisis Response Window
DAC	Development Assistance Committee
DDO	Deferred Drawdown Option
DPL	Development Policy Lending (Loan)
DPO	Development Policy Operations
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECF	Extended Credit Facility
EIB	European Investment Bank
EM	emerging markets
ERL	Emergency Recovery Loan
ESAL	Emergency Structural Adjustment Loan
ESF	Exogenous Shocks Facility
EU	European Union
FCL	Flexible Credit Line
FTF	Fast-Track Facility
FSAP	Financial Sector Assessment Program
FY	financial year
GDP	gross domestic product
GFSN	global financial safety net
GNI	gross national income
GRA	General Resources Account
G-20	Group of Twenty
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IFI	international financial institution
IL	investment lending
IMF	International Monetary Fund
IRM	Immediate Response Mechanism

LIC	low-income country
LMIC	lower middle-income countries
MDB	multilateral development bank
MIC	middle-income country
MIGA	Multilateral Investment Guarantee Agency
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OP	Operational Manual
p.a.	per annum
PBA	performance-based allocation
PCL	Precautionary Credit Line
PLL	Precautionary and Liquidity Line
PRGF	Poverty Reduction and Growth Facility
PRGT	Poverty Reduction and Growth Trust
RCF	Rapid Credit Facility
RDB	regional development bank
RFA	Regional Financing Arrangement
RFI	Rapid Financing Instrument
SCF	Standby Credit Facility
SDPL	Special Development Policy Lending (Loan)
SDR	Special Drawing Rights
SIL	Specific Investment Loan
UCT	Upper Credit Tranche
UK	United Kingdom
UN	United Nations
USD	United States dollar
WB	World Bank

Summary

Why developing countries need the IFIs' shock architecture

The global financial crisis has again demonstrated the need for a shock architecture to alleviate the effects of exogenous shocks in developing countries. These countries particularly need countercyclical support from international financial institutions (IFIs) because the welfare costs of such shocks are higher there than in advanced countries. In developing countries it is harder to alleviate exogenous shocks because domestic resources, as well as fiscal and monetary policy instruments, often are either unavailable or difficult to implement. The response of the International Monetary Fund (IMF) and the World Bank (WB) to the global financial crisis has been not only to make more funds available for countercyclical financing, but also to adjust their instruments to be able to provide developing countries with extra funding more quickly and more flexibly.

The IFIs are not the only providers of finance in times of crisis. A variety of crisis response instruments are creating the framework of the emerging global financial safety net (GFSN). Besides the shock facilities and countercyclical lending from the IMF and the World Bank, central bank swap lines are also playing an increasing role, either based on bilateral agreements between central banks or plurilateral agreements, as in the new Contingent Reserve Arrangement of the BRICS countries. Other elements of the GFSN are regional financial arrangements, such as the Chiang Mai Initiative Multilateralization (CMIM), countercyclical lending of regional and national development banks and shock-absorbing schemes of the European Union (EU). Yet, it is obvious that in an unstable world economy in which volatile capital flows create severe risks, crisis lending may not suffice. Therefore, crisis prevention (global and regional surveillance with a supervisory framework and debt monitoring) and national efforts to boost resilience against external financial shocks are of utmost importance to reduce the need for external financial support.

This study looks at the use and appropriateness of the IFIs' shock facilities for low-income countries (LIC) as well as for middle-income countries (MIC). Distinguishing between country groups is important because of the higher degree of concessionality that is required for lending to LICs. Funding for LICs must be based on concessionary facilities which have very limited availability, and which are often the countries' only source of external funding. In contrast, MICs are often able to choose between various sources of capital-market-based funding so they are more flexible regarding the type of funding they seek in times of crisis. Differentiated sets of instruments are needed for the diverse needs.

The division of labour among the IFIs

There is generally a clear division of labour among IFIs, and among IFIs and other elements of the GFSN, including central bank swap lines or the reserve pooling of regional financial arrangements. While multilateral development banks (MDBs) are mandated to supply long-term development finance to developing countries and promote sectoral and institutional reforms, the IMF's traditional mandate is to provide short- to medium-term support for countries with macroeconomic and balance-of-payments problems. The IMF's financial support is usually triggered by crises and oriented towards temporary support, whereas the MDBs provide continuous lending.

However, in the specific context of the financial crisis it was necessary to mobilize the lending capacities of all the IFIs in order to prevent severe recessions in developing countries. Reviewing the use and effectiveness of the instruments of the World Bank and the IMF has led to reforming their instruments.

Besides reviewing and adjusting individual instruments on a continuous basis, a holistic view of the GFSN – preferably at the G-20 level – is warranted, so as to permit coordination between actors and instruments and ensure the efficient use of scarce resources in a crisis. To avoid competition over terms with other IFIs, the interest and maturity of crisis response loans should be adjusted in view of market conditions, risk assessments and other actors' policies.

The IFIs' concessional lending architecture for managing shocks

As regards concessional funding, the IMF is mandated to have a toolkit for reacting quickly to macroeconomic exogenous shocks. Since the global financial crisis began the IMF has not only augmented its concessional financing for developing countries – partly financed by gold sales – but it also has fundamentally reformed its concessional funding framework, the Poverty Reduction and Growth Trust (PRGT), and its lending facilities for LICs. IMF reforms in 2009 (introducing new instruments) and 2013 (undertaking further incremental reforms) have clearly helped to increase the flexibility of short-term financing for LICs (and LMICs) in the event of exogenous shocks.

These changes notwithstanding, the question arises as to whether the IMF lending policy is sufficiently differentiated among LICs, particularly in the medium term when more countries graduate from LIC status. One proposal that the IMF discussed in 2012 is a precautionary credit line with ex-ante qualification criteria for LICs (IMF 2012a) – similar to those of the Flexible Credit Line (FCL) or the Precautionary and Liquidity Line (PLL) for MICs. This could be particularly useful if demand remains low for the IMF's shock windows, the Rapid Credit Facility (RCF) and the Standby Credit Facility (SCF). Since providing contingent financing is one of the IMF's most important tasks, it might be appropriate to introduce another contingent financing instrument for LICs, particularly when in the medium term, more LICs are integrated into global financial markets. In 2012, the IMF also floated the idea of having different interest rates for different types of LICs so that scarce concessional resources could be allocated to the neediest countries (IMF 2012a). Since country differentiation will increase, it may be necessary to tailor lending to the different needs. However, interest rate differentiation should not undermine the principle of uniformity of treatment.

In addition to better differentiating the IMF lending policy among LICs, the IMF should increase LICs' annual access to the low conditional shock window – the RCF – despite a limited concessional envelope. The IMF has already approved an increase in cumulative access to the RCF from 75 to 100 per cent, and to the shocks window from 100 to 125 per cent, but this is not likely to suffice.

In contrast to the IMF, IDA has been less flexible in responding to shocks because its institutional set-up, based on three-year replenishment cycles, and its allocation mechanism, based on the Performance Based Allocation (PBA)-system, makes it difficult for IDA to provide funding in the short term. However, in spite of its relatively inflexible institutional set-up, IDA's role in mitigating short-term crises has grown significantly since the global financial crisis began. To complement its primary objective of supporting long-term development in LICs, IDA significantly scaled up crisis support, acknowledging that it is a prerequisite for achieving long-term development goals.

One option for increasing IDA's flexibility might be to reform its funding framework. IDA has made crucial reforms since the start of the global financial crisis. But it should also investigate ways to reduce its dependence on the annual donor budget processes in order to be able to increase its funding for shocks. One innovative approach that Leo (2010) proposed for emerging markets, and that IDA has mentioned but not yet adopted (IDA 2010c, 10), is setting up an IDA blended financing facility.

Another option would be to reform its allocation mechanism. Since it was too complicated to modify the PBA system, IDA permitted exceptions to the PBA formula during IDA15, 16 and 17 to alleviate exogenous shocks. By installing two systematic crisis instruments – the Crisis Response Window (CRW) and the Immediate Response Mechanism (IRM) in IDA15 and IDA16 – IDA shifted the paradigm from ad-hoc financing to systematic crisis response. However, the financial volume of IDA's shock window (the CRW) has been quite small (2 per cent of its envelope under IDA17), although IDA is authorized to expand the CRW volume in exceptional circumstances. Even though the funds allotted to these shock windows absorb scarce IDA resources provided for financing long-term development, their volume should be increased in preparation for any future crises.

However, in view of the limits to IDA resources and their fungibility, one must question if it is enough to increase exceptions to the PBA formula by installing new instruments. The recent reforms should be reviewed to assess whether they serve as a good guide to IDA's development, and to what extent faster response mechanisms should be considered under the current rules for allocation.

The IFIs' non-concessional lending architecture for managing shocks

In times of crisis, the IFIs must have sufficient capital reserves and lending headroom for systemically relevant MICs. The IMF's financial firepower, which at present is mainly being used for mitigating crises in European countries, seems to be adequate for the time being. The WB's lending capacity has been decreasing since the strong upturn of crisis lending by the International Bank for Reconstruction and Development (IBRD) from 2009 to 2012 – partly due to the relatively long maturities and low interest rates of DPLs, which have been the WB's prime instrument for crisis response.

With its April 2014 strategic decision to adopt a new framework for financial sustainability, the WB increased its lending capacity to augment its headroom by about USD 100 billion for the next 10 years. This increased lending capacity boosts the WB's capacity for countercyclical lending; about a third of its lending to MICs will continue to be DPLs which can be used in a countercyclical fashion.

However, the IBRD's roadmap for future crisis lending needs more work. The crisis demonstrated that Development Policy Lending (DPL) can be used in a countercyclical fashion in MICs. But it is not clear if the WB needs a short-term instrument like the Special Development Policy Lending (SDPL) and how it should be accessed without an IMF disbursing programme. A review of the WB crisis lending instruments should make the IMF's shock facilities the prime means for lending in crises and providing sources of liquidity, and restrict the WB to providing countercyclical lending instruments.

The SDPL was introduced in 2004 as a dedicated instrument for crisis lending. However, probably because of its link to an IMF disbursing programme, only Latvia used it. In a crisis, the tightening of financial markets and losses in fiscal revenue typically create the need for countercyclical short- to medium-term loans. Therefore, a WB short- to medium-term countercyclical instrument – as opposed to short-term liquidity for balance-of-payments purposes from the IMF – is a suitable instrument in the IFIs’ crisis response toolkit. In the previous crisis, when most MICs had no balance-of-payments problems, DPLs with long-term maturity were used to this end. It could be argued that waiving the ‘IMF-link’ would create more space to use SDPL. However, current terms give the WB no scope to refinance short- to medium-term loans with the same maturity and risk inappropriately using up the WB’s lending headroom – as has happened in the past with crisis lending. Therefore, refinancing options should be explored for SDPLs, as well as for the Deferred Drawdown Option (DDO), that would not use up WB long-term lending headroom. Perhaps this could be based on contingent refinancing arrangements with selected member countries.

The IMF should maintain the FCL and PLL in light of possible future shocks. Making the IMF’s shock facilities more “attractive” for MICs through clearer access and exit criteria is one way to proceed. The discussion about “stigma” relates to the general debate about IMF governance, which will culminate in the next quota review. In general, shock instruments will have to be maintained because new shocks could more deeply affect MICs than those in the past.

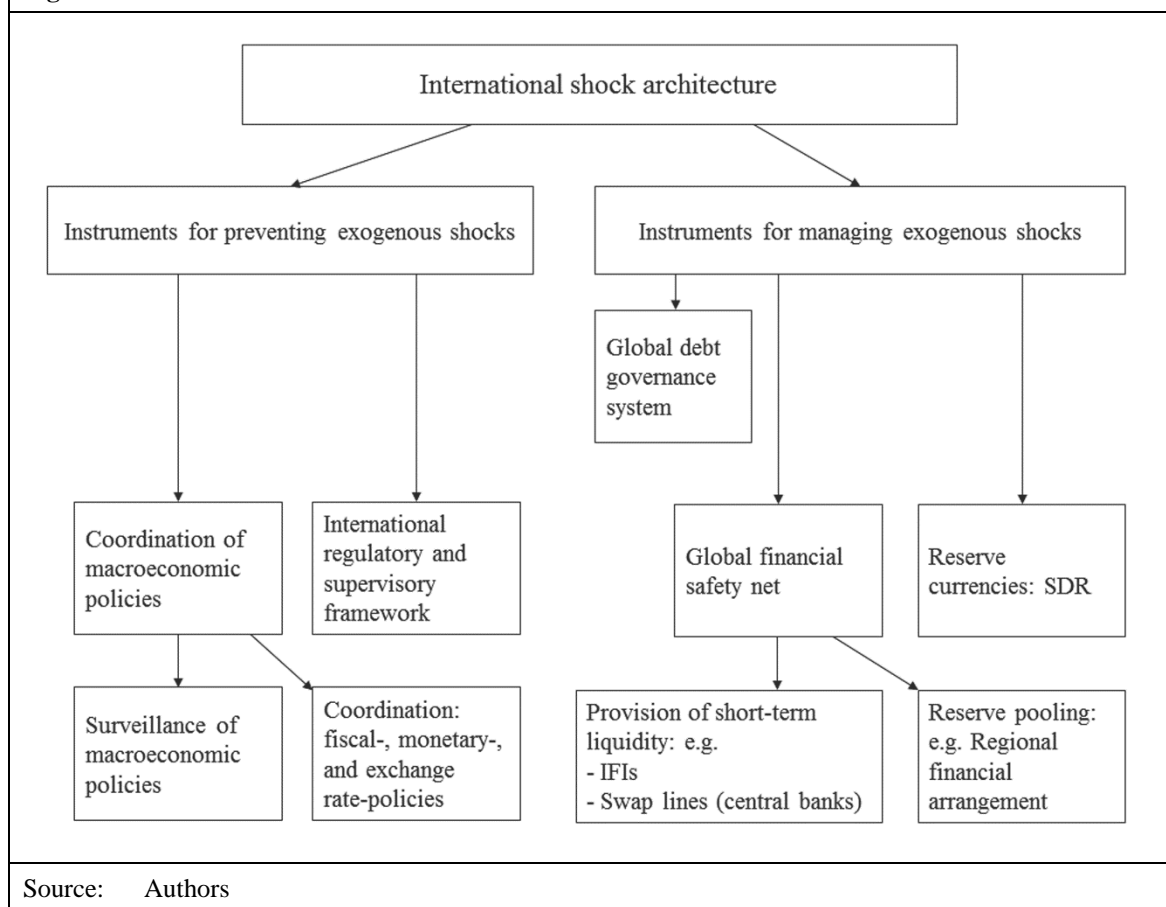
1 Why developing countries need the IFIs' shock architecture

The global financial crisis has once again demonstrated the need for shock architecture that can alleviate the negative effects of exogenous shocks in developing countries. The IFIs' shock architecture constitutes an important pillar of this global scheme. Countercyclical support is particularly needed from the IFIs in developing countries because the welfare costs of such shocks are higher there than in advanced countries. Declining growth rates can have lasting negative effects for poor households because declining income forces households to sell family assets, eat less nutritional food or take children out of school. Macroeconomic shocks can similarly affect developing countries because declining growth rates and deteriorating fiscal and balance-of-payments positions endanger public social expenditures and infrastructure spending. Furthermore, it can be more difficult to alleviate exogenous shocks in developing countries where domestic resources and fiscal and monetary instruments often are unavailable and difficult to implement. In addition, the need for significant public investment and development generates high opportunity costs for keeping substantial reserves at the national level – in order to mitigate the negative consequences of shocks. This scenario implies an important role for IFIs (Griffith-Jones / Gottschalk 2012; IDA 2010a; IMF / World Bank 2011, 5; Lee / Perry / Birdsall 2008).

Given that macroeconomic and financial stability in international financial markets represent a global public good, the IFIs' toolkit for preventing and managing financial shocks represents one element of the shock architecture that consists of several 'lines of defense'. The first are national public instruments, such as currency reserves, fiscal buffers or the development of local currency bond markets, to boost resilience against external financial shocks. The second group includes mechanisms to prevent crises (e.g. coordination of macroeconomic policies,¹ the international regulatory and supervisory framework including the Financial Stability Board, or international debt monitoring and assessment tools) and manage shocks (e.g. the GFSN, including the IFIs' instruments, reserve pooling or central bank swap lines, countercyclical lending by regional and national development banks, and EU shock absorbing schemes). The international shock architecture is summarized in Figure 1 below.

Especially during the global financial crisis, the IFIs have reassumed a crucial countercyclical role by providing financial resources to developing countries. The IFIs have alleviated the effects of this exogenous shock by closing (part of) the financial gap that resulted from the drop in export revenues, remittances, foreign direct investment and taxes, and the drying up of private lending to developing countries. External financing reduces developing countries' need for restrictive fiscal policies and can help to alleviate development setbacks.

1 One example of the coordination of macroeconomic policies is the IMF-led Mutual Assessment Process of the G-20.

Figure 1: International shock architecture

In light of this situation, this paper assesses the IFIs' current shock architecture and analyses how IFIs have responded to the global financial crisis. Our main objective is to develop policy recommendations for improving the IFIs' architecture for managing exogenous financial shocks in developing countries. The paper focuses on the policies and instruments of the World Bank and the IMF. Regional development banks (the Asian Development Bank, ADB; African Development Bank, AfDB; and Inter-American Development Bank, IADB) are also occasionally considered.

The study is structured as follows: Chapter 2 provides an overview of the IFIs' current shock architecture including the IFIs' mandates. Chapter 3 assesses the IFIs' response to the global financial crisis, with a particular focus on the volume and structure of the financial response. Chapter 4 and 5 analyse in detail the instruments of the International Development Association (IDA) and the International Bank for Reconstruction and Development (IBRD) as well as of the IMF, for managing shocks in low-income countries (LICs), lower middle-income countries (LMICs) and middle-income countries (MICs). Chapter 6 summarizes and presents our recommendations for designing shock architecture, mainly for IDA, the IBRD and IMF facilities for LICs, LMICs and MICs.

2 An overview of the IFIs' shock architecture: mandates and instruments

This chapter provides an overview of the IFIs' current shock architecture and mandates. It presents a map of the policies and instruments of the WB and the IMF and, to some extent, those of the regional development banks (RDBs), the ADB, AfDB, IDB and EBRD. This overview covers instruments for preventing and managing exogenous shocks (ex-ante and ex-post instruments).

2.1 The IFIs' mandates

There is generally a clear division of labour among IFIs, and among IFIs and other elements of the GFSN, including central bank swap lines or reserve pooling of Regional Financial Arrangements. While multilateral development banks (MDBs) are mandated to supply long-term development assistance to developing countries and promote sectoral and institutional reforms, the IMF's traditional mandate is to provide short-to-medium-term support for countries with macroeconomic and balance-of-payments problems. The IMF's financial support is usually triggered by crises and oriented towards temporary support, whereas the MDBs provide continuous lending. These tasks of the IMF and the MDBs are complementary. In comparison, loans from the WB and other MDBs tend to have longer maturities, and their concessional financing has a higher degree of concessionality. However, during the global financial crisis, the IMF undertook some extraordinary measures such as relieving the interest on outstanding concessional loans to LICs until the end of 2014 and reducing interest rates on all concessional facilities.

Other examples of the complementary roles of the WB and IMF are their various advisory and surveillance functions, such as the IMF–World Bank Financial Sector Assessment Program (FSAP) and the Joint Staff Assessments of developing country strategy papers (World Bank 2010b, 7–8). The IMF concentrates on macroeconomic issues and the WB focuses on structural policies.

In practice, however, it is difficult to differentiate these tasks. Specific types of loans may meet more than one objective. For example, a long-term development loan may be geared to a strategic long-term vision and also have a countercyclical function. Furthermore, in the face of external financial shocks, the WB is mandated to act countercyclically. There is no clear-cut distinction between the IFIs' tasks, particularly in times of crisis.

Since the outbreak of the global financial crisis, IDA's role in mitigating short-term crises has grown significantly. To complement its primary objective of supporting long-term development in LICs, IDA significantly scaled up its crisis support. The long-term development goal is connected with its short-term objective because short-term resilience is a prerequisite for long-term development. By installing two systematic crisis instruments – the Crisis Response Window (CRW) and the Immediate Response Mechanism (IRM) within the IDA15 and IDA16 periods – IDA shifted the paradigm from ad-hoc financing to systematic crisis response (IDA 2012a, 15).

2.2 The IFIs' instruments for preventing and managing exogenous shocks

This section provides a brief overview of the IFIs' instruments for preventing and managing exogenous shocks – ex-ante and ex-post instruments (Box 1 and Box 2). While these two types of instruments are complementary, it is not always possible to distinguish between the two categories because some instruments, such as guarantee instruments, are geared to both prevent and manage shocks. We focus on instruments for managing exogenous shocks, but also give a brief overview of instruments for preventing them.

The main instruments for preventing exogenous shocks are IMF's bilateral and multilateral surveillance and policy analysis (risk assessments, vulnerability exercises, early warning exercises, FSAPs), as well as IFIs' debt monitoring and assessment frameworks (IMF 2013b) and capacity development. The global financial crisis that broke out in 2008 led to a review and extension of the relevant instruments. Specific financial instruments to prevent exogenous shocks include market hedging, contingent credit lines, guarantee and debt instruments, and insurance (IMF / World Bank 2011).²

The IFIs have several tools for managing exogenous shocks. Ex-post financing from IFIs is often associated with macroeconomic and structural policy reforms. Box 1 and Box 2 depict instruments of the IMF, the MDBs and the European Commission (EC) for LICs and MICs. Later we analyse IDA, IBRD and IMF instruments. Both groups of instruments include tools for LMICs, which are often called 'blend countries', because they are eligible for the IFIs' instruments for both LICs and MICs. For example, at the WB, blend countries can access the financial resources of IDA as well as the IBRD.

2 IFIs assess risk exposures and design instruments, and can support developing countries in designing and establishing such instruments as risk-management strategies or risk-pooling arrangements (IMF / World Bank 2011, 9–11). IFIs can also serve as intermediaries for market-hedging transactions and support the coordinated issuance of contingent debt instruments.

Box 1: IFIs' shock instruments for LICs (and LMICs)			
Agency	Programme	Amount	Key features
IMF	a) Extended Credit Facility b) Standby Credit Facility c) Rapid Credit Facility	Norm: 120% of quota Norm: 120% of quota No norm; annual / cumulative limit: 25/100% of quota or 50/125% if shock is exogenous	Medium-term financing for protracted BoP problems Flexible short-term financing Responds to urgent BoP needs Outright disbursement No programme-based conditionality
IDA	a) Crisis Response Window b) Immediate Response Mechanism c) Fast-Track Facility d) Frontloading of new IDA credits / grants e) New IDA credits / grants f) Additional financing g) Supplemental financing h) Re-programming disbursements for existing IDA operations	USD 1.383 million (FY 2010/11) USD 2 billion (IDA16) Up to 5 % of undisbursed IDA investment project balances (indicative volume: USD 2.2 billion in IDA16) USD 2 billion (2008) USD 1.8 billion (FY 2009/10) USD 2 billion Nepal's Social Safety Nets Project (USD 48 million) Nicaragua's Agricultural Technology Projects (USD 10 million)	Additional allocations: major natural disaster + severe economic crises caused by exogenous shocks Rapid access to undisbursed IDA investment project balances Acceleration of funds to IDA countries Support critical public spending: Front-loading of IDA15 Significant increase in commitments and disbursement in FY 2009/10 compared with FY2007/08 Additional financing to well-performing projects to allow more rapid response to exogenous shocks Provision for IDA development policy operations To restructure operations in a country's current lending portfolio to support recovery from crisis + emergencies
IDA / IBRD^a	Global Food Crisis Response Program	USD 2 billion	
EC	Vulnerability FLEX	EUR 500 million	Temporary financing to ACP countries (2009–2010)
AfDB	a) AfDF Fast Track Programme b) African SME Guarantee Fund	Frontloaded up to 100% of resources for all AfDF countries in 2009 USD 300 million	More flexible fund operations
ADB	Additional funds	USD 400 million	
EIB	EU–Africa Infrastructure Trust Fund		
IDB / ADB / AfDB^a	Trade Finance Initiative	USD 1 billion for each	Lines of credit to financial institutions
Notes: (a) The Trade Finance Initiatives and the Global Food Crisis Response Program are geared to LICs and MICs.			
Sources: IFI websites			

Box 2: IFIs' shock instruments for MICs (and LMICs)			
Agency	Programme	Amount	Key features
IMF	a) Flexible Credit Line b) Stand-by Arrangements c) Precautionary and Liquidity Line d) Rapid Financing Instrument	No formal access limits	Eligibility is based on strong macroeconomic fundamentals.
IBRD	a) Development Policy Loans (DPLs) for MICs b) Deferred Drawdown Option (DDO)	USD 100 billion (two thirds for 'crisis lending')	Soft policy conditionality in DPLs DDO as standby operation
IFC	a) Crisis facilities for trade b) Financial sector c) Infrastructure	 USD 3 billion USD 3 billion	Guarantees for payment risk in trade transactions with local banks in emerging markets Provision of Tiers I + II capital for EM banks
EBRD	Lending increase Financial-sector support Vienna Initiative	+ 55%	
IADB	Liquidity Program for Growth Sustainability	EUR 7.0 billion	To address sudden reversals in capital flows
AfDB	Emergency Liquidity Facility	USD 1.5 billion	Short-term emergency finance support
ADB	Countercyclical Support Facility (CSF)	USD 3.0 billion	Emergency finance support
EIB	Co-financing with IFC's Infrastructure Crisis Facility		
Source: IFI websites			

3 Assessing the IFIs' response to the global financial crisis

This chapter briefly assesses the IFIs' response to the global financial crisis in developing countries. Section 3.1 considers the scale of the IFIs' financial response to this crisis, and section 3.2 discusses peculiarities, including those related to the IFIs' division of labour, and the structure and distribution of financial flows. Since the Bretton Woods institutions – the IMF and the World Bank – have provided the most funding for developing countries, we focus on them.

3.1 The volume of the IFIs' response to the global financial crisis

In response to the global financial crisis, the IFIs significantly scaled up their financial flows to developing countries (Table 1), thereby complying with the G-20 recommendation to provide substantial countercyclical support (G-20 2009).³ Average net commitments from 2009 to 2010 greatly exceeded those from 2005 to 2007: IMF commitments increased by 2,066 per cent, those of the African Development Bank (AfDB) by 116 per cent and the WB's by 121 per cent. In many cases, IFIs have responded as international consortia. One prominent example is the Global Trade Initiative, which involved several MDBs and the IMF.⁴

Table 1: IFI and RDB support to client countries^a – pre-crisis and crisis, 2005–2010 (USD billion)					
	2005– 2007^b	2008	2009	2010	Increase in total lending in 2009– 2010 versus 2005–2007 (per cent)
WB	22.7	34.8	53.9	46.3	121
IFC	5.2	10.0	8.1	9.4	69
EIB	11.6	18.0	23.1	-	99
EBRD	6.3	7.4	10.8	11.8	81
ADB	7.8	10.6	14.1	12.4	69
IDB	7.4	11.0	15.4	13.2	94
AfDB ^d	1.4	1.8	4.3	1.6	116
MIGA	1.3	2.1	1.2	1.5	4
EU	9.9	23.3	22.5	-	127
IMF	5.1	47.2	123.3	96.0	2,066
Total^c	78.6	166.3	276.8	215.5	213
Notes: (a) Data include 147 countries that are eligible WB clients in FY 2009–10. (b) Annual average for FY 2005–07. (c) Totals for the 147 countries listed (not institutional totals). Total for 2010 excludes the EU but assumes EIB=23.1 as in previous year, for comparison purposes. (d) AfDB numbers for 2010 are based on project summary documents available on the AfDB website. All other numbers for 2005–2009 are from AfDB Annual Reports.					
Source: World Bank (2011a, 146–147 Table B.1)					

3 In this section we concentrate on the policy instruments of the IMF and the WB and take into account other multilateral donors such as the regional development banks – the AfDB, ADB and IADB.

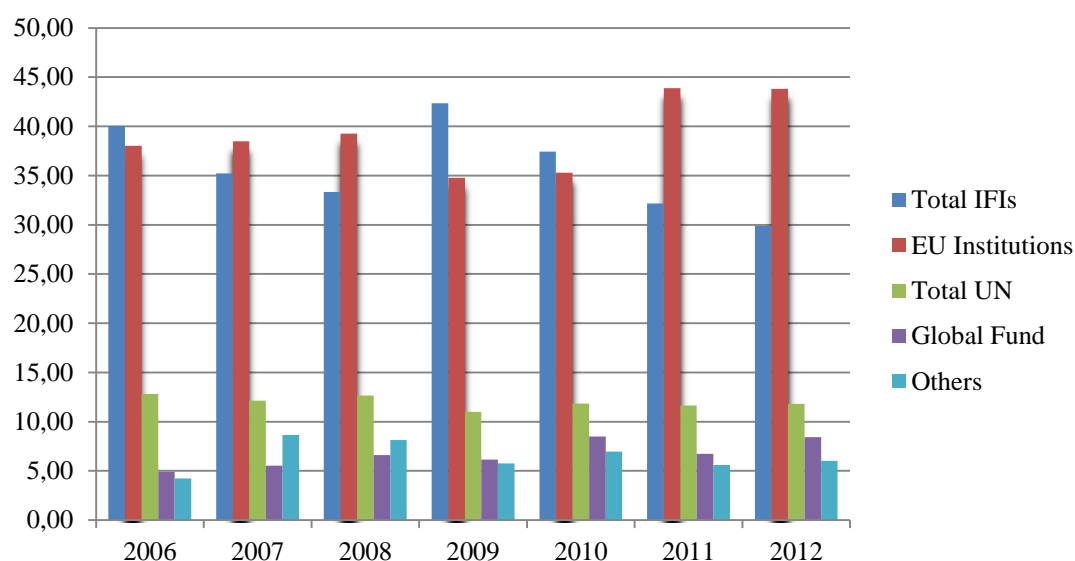
4 The IFIs were not the only providers of financial resources. Central banks began to provide currency swaps: The American Federal Reserve Bank, the European Central Bank, and the Japanese and Chinese Central Banks supplied currency swaps to major emerging market (EM) economies.

3.1.1 Concessional flows

Total concessional flows by multilateral institutions

The IFIs' ability to manage macroeconomic shocks in developing countries depends on the financial resources available to them in the event of shocks. The most important sources of concessional financing for developing countries from 2007 to 2012 were the IFIs and the EU. The IFIs' share of concessional flows ranged between about 30 and 40 per cent in that period, compared to the EU share of 34 to 44 per cent. Figure 2 shows that the EU share exceeded the IFIs' in a number of years (2007, 2008, 2011 and 2012).

Figure 2: IFIs' shares of concessional flows in total concessional flows to developing countries by multilateral organisations*, net disbursements, 2007–2012 (per cent)



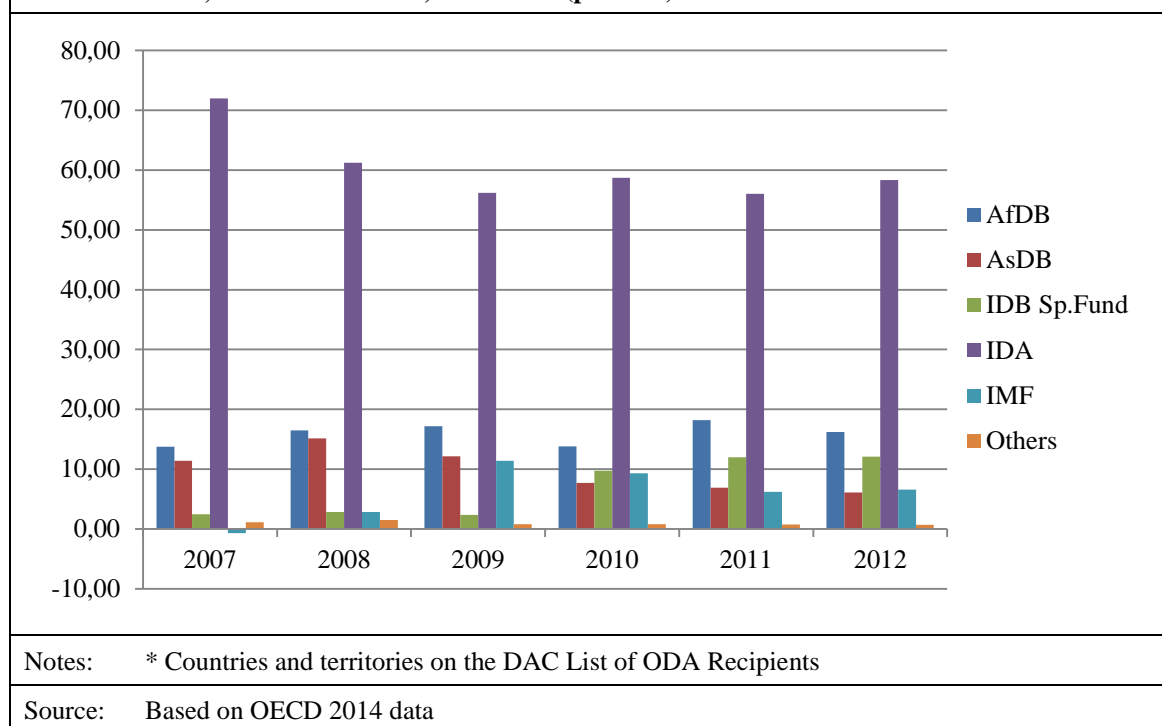
Notes: * Countries and territories on the DAC List of ODA Recipients.

Source: Based OECD 2014 data

Total concessional flows by IFIs

IDA accounted for the far greatest proportion of concessional flows by IFIs in terms of net disbursements to developing countries from 2007 to 2012, as Figure 3 shows. IDA's share of IFI total net disbursements ranged between 56 and 72 per cent between 2007 and 2012. In contrast, the IMF's share of IFIs' total net disbursements varied between 1 and 11 per cent during the same period.

Unfortunately, it is not possible to accurately determine the volume of the IFIs' shock financing because of the aggregate nature of the data, which cover both shock and non-shock financing. Nonetheless, these figures provide helpful information about the relative financial weight of the institutions.

Figure 3: IFIs' shares of concessional flows to developing countries in their total concessional flows, net disbursements, 2007–2012 (per cent)

Comparing the volumes of IDA's and IMF's shock instruments

The lack of disaggregated data makes it impossible to say exactly how IDA and the IMF reacted to the global financial crisis in terms of their shock windows. However, data on potential and committed/disbursed volumes that is available for selected IDA and IMF instruments can be used to make a comparison.

To complement its primary objective of supporting long-term development in LICs – which is related to the short-term goal of building resilience – IDA significantly scaled up the volume of its shock instruments during the global financial crisis and continues to do so. IDA introduced three new instruments to manage the crisis (IDA 2010a, 2010b, 2012a, 2012b, 2013a and 2014)⁵:

- **Fast-Track Facility (FTF):** In late 2008, during IDA15 (FY 2009–11), IDA established an FTF with a potential volume of USD 2 billion to frontload grants and long-term, interest-free loans aimed at alleviating the effects of the global financial crisis in LICs. By late October 2009, a large proportion of this facility – USD 1.5 billion – had been committed for operations in 11 member countries.
- **Crisis Response Window (CRW):** During IDA15 in December 2009, IDA created a pilot CRW to provide rapid support for LICs in the event of severe economic crises and natural disasters. This facility committed USD 1.384 billion. During IDA16 (FY 2012–14) a dedicated CRW amounting to USD 1.335 billion (4.1 per cent of IDA's

5 In addition to these shock instruments, in response to the global financial crisis IDA has also provided funds within its regular allocation process – the performance-based allocation (PBA) mechanism – in a countercyclical fashion.

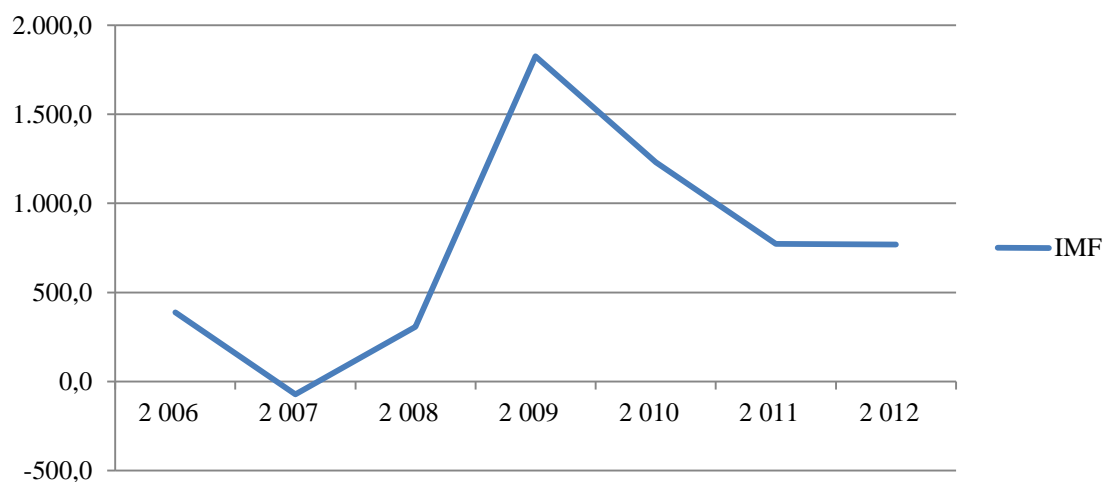
entire envelope) was installed. By late 2012, USD 500 million had been made available to Haiti and USD 250 million to countries in the drought-stricken Horn of Africa. During IDA17 the CRW will be capped at 2 per cent of its envelope.

- **Immediate Response Mechanism (IRM):** IDA established the IRM in December 2011 with a view to better coping with immediate financing needs in the wake of an exogenous shock. This facility had as much as 5 per cent of the aggregate undisbursed IDA investment balances, which would be an indicative estimate of total undisbursed balances of USD 2.2 billion during IDA16. WB staff reported that as of May 2014 no country had accessed IRM resources. However, projects include IRM contingent components.

By establishing two systematic instruments for crises – the CRW and the IRM – during IDA16, IDA shifted its response to exogenous shocks from ad-hoc financing to a systematic approach (IDA 2012a, 15).

In response to the global financial crisis, the IMF has substantially increased its concessional financing to developing countries, partly financing the increase through gold sales. Its concessional lending capacity expanded to USD 17 billion from 2009 to 2014 (IMF 2012a, 7), and its concessional flows (net disbursements) increased from USD -72 million in 2007 to USD 1.825 billion in 2009 (Figure 4). In these aggregate statistics no distinction is made between concessional flows from non-shock and shock windows. However, the IMF's financing instruments all primarily address short- to medium-term macroeconomic problems and therefore, macroeconomic shocks to some extent. From the IMF's shock windows, including the former exogenous shock facilities and the current Standby Credit and Rapid Credit Facilities, a total volume of about USD 1.4 billion was disbursed between 2008 and 2013.

Figure 4: IMF concessional flows shown by 2006–2012 net disbursements (USD million, at current prices and exchange rates)



Source: Based on OECD 2014 data

The IMF has also increased the general concessionality of its loans by offering LICs interest relief on outstanding concessional loans until the end of 2014 and reducing interest rates on all concessional facilities by 0.25 per cent. Moreover, some USD 18 billion of the increased Special Drawing Rights (SDR) allocation (USD 250 billion) has been earmarked for LICs (IMF 2014g).

The IMF is mandated to have financial resources available to ensure macroeconomic stabilization. Since IDA significantly increased the volume of its shock instruments during the recent global financial crisis and continues to do so, it is able to provide multi-sectoral support for developing countries.

3.1.2 Non-concessional flows

Based on a decision at the G-20 Summit in November 2008 in Washington, the IMF tripled its borrowing capacity, based largely on the General Agreements to Borrow, thereby avoiding a cumbersome quota increase. The IMF's main innovative crisis response for MICs was the temporary introduction of the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL) and the Rapid Financing Instrument (RFI) as additions to the traditional standby facilities. These innovations are supposed to increase currency reserves in times of increased risks of spillover or contagion during global crises. They are largely precautionary, providing time for borrowing countries to increase their economic resilience through macroeconomic and structural adjustment measures (IMF 2014b; IMF 2014c, IMF 2014d).

Developing countries' demand for those contingent credit lines was relatively modest. Mexico and Colombia used the FCL but did not draw on it, and Morocco and Macedonia used the PLL, with only Macedonia drawing part of its loan. However, the amounts were unprecedented: Mexico's FCL amounted to 31.528 billion Special Drawing Rights (SDR) and Colombia's to 6.966 billion SDR, far more than the outstanding amount of Standby Arrangements for developing countries, which in 2010 averaged about 7 billion SDR. Morocco's PLL arrangements in 2011 and 2012 amounted to 4.05 billion SDR, and Macedonia's to 413 million SDR (IMF 2014e).

The RFI was not used at all. Demand for the new facilities was below expectations for two main reasons:

- MICs needed less additional finance than anticipated. Many MICs had accumulated considerable currency reserves and didn't need IMF crisis facilities to cushion severe balance-of-payments effects.
- A number of countries were drawing on alternative resources, particularly bilateral swap lines from central banks and loans from MDBs, especially the IBRD, thus avoiding the stigma associated with IMF funding and conditionality.

Nevertheless, as Box 2 shows, introduction of the contingent credit lines led to an unprecedented increase in IMF lending. However, because the FCL was not drawn by Mexico and Colombia, and the PLL was not drawn by Morocco, the IMF's actual disbursements to MICs were basically limited to the traditional standby facilities at pre-crisis levels.

While the IMF's increased lending capacity was met with rather small demand, the WB tripled the IBRD's lending capacity from 2009 to 2011 and committed a record USD 45.4 billion (IBRD and IFC) to MICs in fiscal year 2009/10, largely based on policy lending instruments with sectoral conditionality (fiscal, financial and social sectors) relying on pre-crisis policy analysis. A new instrument, the Deferred Drawdown Option (DDO) served as a standby credit facility, basically to support politically and systemically relevant countries, such as Indonesia, that wanted to avoid the IMF stigma (World Bank 2011a).

Regional development banks complemented the WB by setting up crisis facilities, albeit with limited volumes. The IADB extended USD 3 billion on special crisis lending terms; the ADB extended loans to six countries in the framework of its pre-existing Countercyclical Support Facility; and the AfDB introduced an Emergency Liquidity Facility (see Box 2).

3.2 Peculiarities of the IFIs' response to the global financial crisis

Two peculiarities of the IFIs' response to the crisis are discussed here: relating to the IFIs' division of labour, and to the structure and distribution of the ensuing financial flows.

While MDBs are mandated to supply long-term development assistance, the IMF is mandated to provide short-term support for countries with macroeconomic and balance-of-payments problems during crises. However, during and since the recent global financial crisis, the traditional separation of mandates was partly suspended with MDBs playing a crucial countercyclical role by providing crisis support and expanding their fast-disbursing lending for balance-of-payments and fiscal support – primarily for MICs.

In 2007, the WB overhauled its policy framework for crises and emergencies. The Operational Manual 8.00 "Rapid Response to Crises and Emergencies" was revised to simplify and accelerate the procedures to amplify emergency arrangements (World Bank 2007 and 2011b, 2).

Since the outbreak of the global financial crisis, IDA's role in short-term crisis mitigation has grown significantly. Since resilience is a prerequisite for reaching long-term development goals, IDA significantly scaled up its crisis support to complement its primary objective of supporting long-term development in LICs. By installing two dedicated crisis instruments, the Crisis Response Window (CRW) and the Immediate Response Mechanism (IRM) within IDA15 and IDA16, IDA shifted the paradigm from ad-hoc financing to systematic crisis response.

The dividing lines between investment and development policy operations have similarly blurred since the global financial crisis began. On the one hand, the MDBs have complemented the IMF's traditional role of providing fast-disbursed countercyclical financial resources, such as two crisis-related social programmes of the IADB and the WB in Colombia and Mexico. In FY 2009, the WB loaned Mexico USD 1.01 billion to finance housing and provided Colombia with a USD 0.6 billion credit for a Social Safety Net Project (World Bank 2011a, 13).

On the other hand, the IMF has complemented the MDBs' traditional role of policy-based lending by increasing direct fiscal support to developing countries during and in the aftermath of the recent global financial crisis. When the IMF uses resources to address a country's balance-of-payments problems, it is respecting its mandate and legal framework to provide budget support. In previous IMF lending activities, direct budget support (channeling funds from IMF purchases to the recipient country through the treasury) as well as indirect budget support (channelling funds from IMF purchases to the recipient country through the central bank in order to finance its budget) were broadly applied. They were not new instruments for the recent crisis (IMF 2010, 2).⁶ There is a close connection between balance-of-payments and budget support. External budget support and support for balance-of-payments overlap because external budget support for a government represents *de facto* support for balance-of-payments: It permits the country to hold a larger amount of international reserves and/or make greater external payments. On the other hand, an external loan to a central bank is implicit budget support because it helps the bank to expand credits to the domestic economy for specific international reserve purposes. For instance, a decrease in capital inflows can limit a government's access to budget financing, while an expansionary fiscal policy can generate a widening current-account deficit (ibid., 5).

The concessional funds provided to developing countries were substantially lower than the non-concessional funds mainly (Table 2)⁷ for two reasons: the crisis differently impacted countries and MDBs' institutional inflexibilities have left them little room to provide short-term financial resources to crisis-affected LICs. First, MDBs' PBA guidelines have mainly been geared to supplying long-term concessional financial resources (World Bank 2011a, 18 and 25). Second, the MDB's funding mechanisms for concessional windows, largely based on regular replenishment cycles, have been quite inflexible in the short term. For example, IDA funds are distributed according to the PBA system, taking into consideration country needs and performance. While the PBA system was used for allocating 84 per cent of the total funds under IDA15 (IDA 2012b, 18) and 72 per cent under IDA16 (the IDA Mid-Term Review in late 2012) (IDA 2012c, 4), only a little (16 per cent under IDA15) was made available through exceptional allocations, such as the CRW or post-conflict allocations.

However, in response to macroeconomic crises, the Crisis Response Window (CRW) being used for countries facing natural disasters and economic crises has shown some flexibility of its concessional window in response to macroeconomic crisis. IDA set up the CRW relatively quickly in the aftermath of the global financial crisis because (i) the Pilot CRW was discussed by IDA Deputies at the IDA15 Mid-Term Review in November 2009 (and approved by the Executive Directors in December 2009), (ii) the IDA16 CRW was agreed as part of the IDA16 discussions in December 2010 (and approved by the Executive Directors on February 2011) and (iii) proposals on how to utilize the unused remaining IDA16 CRW funding were discussed at the IDA16 Mid-Term Review (November 2012)

6 Nonetheless, in recent years direct budget support has been applied more often – because since the outbreak of the crisis, a more flexible fiscal response has been necessary and the recipient countries' central banks have become more independent. This means that funds should be channelled through the treasuries rather than the central banks (IMF 2010, 2).

7 The difference between non-concessional and concessional flows would be even larger if the OECD statistics presented in Table 2 for non-concessional flows to developing countries included IMF flows.

and were agreed in the first IDA17 replenishment meeting.⁸ Moreover, IDA set up the Fast Track Facility (FTF) right after the crisis began in late 2008.

Table 2: IFIs' concessional and non-concessional flows to developing countries^a net disbursements, 2006–2012 (USD million)							
	2006	2007	2008	2009	2010	2011	2012
CONCESSIONAL FLOWS							
AfDB	2,180.0	1,424.4	1,802.2	2,749.5	1,829.8	2,271.9	1,902.4
ADB	1,019.9	1,182.0	1,653.6	1,943.1	1,023.1	862.8	716.2
IADB Sp. Fund	216.1	256.7	309.8	379.8	1,286.8	1,497.2	1,414.1
IDA	6,292.0	7,463.1	6,689.2	9,006.0	7,778.7	6,995.3	6,840.2
IMF ^b	387.5	-71.7	307.1	1,825.1	1,229.9	772.4	769.3
Others ^c	110.9	116.5	161.9	131.6	104.9	90.6	79.8
Total	10,206.2	10,370.9	10,923.7	16,035.0	13,253.3	12,490.3	11,722.0
NON-CONCESSIONAL FLOWS							
AfDB	-420.4	109.3	404.9	2,475.2	1,151.7	2,049.7	2,660.5
ADB	2,684.6	3,798.2	4,573.8	6,035.3	3,230.5	3,155.2	3,982.1
IDB	-2,529.2	1,455.1	2,411.2	6,851.6	4,518.2	2,655.0	1,964.3
EBRD	463.1	1,407.8	1,987.6	2,299.9	2,033.0	2,357.0	1,813.2
IBRD	-4,853.1	85.7	3,786.1	11,519.5	18,214.9	1,810.5	7,724.7
IFC	1,544.0	1,990.0	3,210.0	2,245.0	1,692.7	1,425.5	2,181.1
CarDB	35.3	45.9	28.9	53.7	132.2	36.2	-10.3
Total	-3,075.7	8,891.8	16,402.4	31,480.1	30,973.2	13,489.1	20,315.5
Notes: (a) Countries and territories on the DAC List of ODA Recipients. (b) IMF Concessional Trust Funds. (c) Others include the Nordic Development Fund, the EBRD and the CarDB.							
Source: Based on OECD 2014 data							

On the whole, the significant increase of financial funds provided by the MDBs shows that MDBs assume an important countercyclical role. While providing liquidity is crucial during crises, it is also very important to offer long-term finance publicly (Griffith-Jones / Gottschalk 2012, 13).

4 Assessing the IFIs' concessional lending architecture for managing shocks

To respond to the global financial crisis, the IFIs have not only increased funds for shock financing, but also reformed their instruments. This chapter provides a detailed analysis of current IDA and IMF instruments for managing shocks in LICs (and in some LMICs), focusing in particular on the instruments' design and appropriateness. Reforming the IFIs' instruments in response to the global financial crisis has made it possible to more quickly and flexibly provide developing countries with increased funding.

⁸ The WB provided information on the CRW implementation process.

4.1 The design and appropriateness of IDA's shock architecture

IDA's role in economic crises is to alleviate the effects on vulnerable groups and on crucial development spending – for health, education and infrastructure. IDA's emergency financing framework allows it to match short-term crisis support/alleviation with long-term development objectives. The WB regards this linkage of short- and long-term support as one of IDA's advantages (World Bank 2011b, 2).⁹ IDA also plays an important role in short-term crisis mitigation, which is part of the IMF's traditional mandate.

In spring 2007, the WB overhauled its policy framework for crises and emergencies, the Operational Manual (OP) 8.00 "Rapid Response to Crises and Emergencies", accelerating and simplifying the procedures for amplifying emergency arrangements (World Bank 2007 and 2011b, 2). The WB provides three main types of crisis or emergency support: (i) quick (analytical) support to help understand the effects of a crisis and formulate a recovery strategy, (ii) the restructuring of investment projects¹⁰, and (iii) new projects or supplemental financing for existing projects¹¹ (World Bank 2011b, 3).

At first sight, IDA's institutional setting – with its three-year replenishment cycle and PBA mechanism – makes it appear inflexible and unable to provide funds quickly.¹² Appropriate reforms would address either its funding mechanism, by reforming its funding framework, or its allocation mechanism, by reforming its PBA allocation guidelines or authorizing specific departures from the PBA formula.

4.1.1 Reforms of IDA's funding framework

If IDA is to play a role in alleviating exogenous shocks, its institutional set-up, particularly its funding mechanism, must be flexible enough to react to such events. IDA relies on three funding sources: (i) grant contributions from partners, including core funding and potential debt funding; (ii) internal resources, mainly from borrowers' repayment of principal and interest paid on credits awarded to blend countries¹³; and (iii) income earned on investments, including IDA's liquid assets and core liquid balances. A number of good reforms were launched in IDA16 (Box 3), and to ensure IDA's long-term financial sustainability, further reforms were undertaken during IDA17 negotiations.

9 "IDA has had a long-standing involvement in various aspects of crisis response, including the provision of financial support. IDA's key comparative advantages in crisis response are its ability to link short-term crisis mitigation and long-term development objectives, its capacity to work closely and collaboratively with other organizations (notably the UN and IMF), and to build on previous analytical work and the portfolio of projects under implementation." (World Bank 2011b, 2)

10 Under the IRM, for example, IDA countries are allowed to quickly access up to 5 per cent of their aggregate undisbursed IDA investment balances.

11 Moreover, the WB supports emergency prevention and preparation such as arrangements for disaster risk insurance or other risk transfer measures (World Bank 2011b, 3).

12 The current PBA is highly constraining and rewards the past, making it difficult to adequately respond to changing parameters.

13 This had been a slow-growing source of funding since the Gleneagles G8 Summit in 2005 and the share of grants in total IDA disbursements, but IDA17 Deputies partially corrected this (Box 3).

Box 3: Reforms of the IDA's funding mechanism during IDA16 and IDA17

During IDA16 (July 2011), three crucial measures were taken to mobilize additional resources for IDA, increase its long-term financial sustainability and take greater account of IDA countries' economic potential:

- Stricter terms: The terms for loans to blend and gap countries were made stricter: the grace period was reduced from 10 to five years and the maturity shortened from 35 to 25 years. IDA also introduced a 1.25 per cent interest charge and expanded eligibility to try to include all blend countries.
- Acceleration of repayments: IDA invoked the contractual accelerated repayment clause, thus generating credit reflows from previous loans to these countries.
- Prepayment incentives: IDA established a new policy framework, which offers incentives to graduates for early repayment of outstanding credit.

For IDA17, additional reforms were undertaken to improve IDA's resources and long-term financial sustainability in 2013 (IDA 2013b and 2014):

- Revision of the terms for future loans to IDA-only countries: As the grant element (62 per cent) of IDA credits is among the highest of concessional forms of donor financing, it was right to reduce it by shortening the grace period from 10 to six years and the maturity to 38 years. This measure has speeded up reflows during the replenishment disbursement period.¹⁴
- Debt funding: Another reform provides for the inclusion of a limited amount of debt funding (concessional partner loans) within the IDA17 financing framework so as to leverage grant funding. On one hand, with interest rates historically low, a reduced volume of debt funding could be used during IDA17, a substantial amount of IDA funding could be distributed to blend or gap countries, and transitional funds with stricter terms granted to graduating countries. On the other hand, during IDA17, world interest rates could rise or the amount of IDA funding for countries on blend terms could fall.
- Partner participation in financing existing IDA projects: Another reform is the introduction of IDA participation on a trial basis, allowing partners to contribute funding to existing IDA projects that conform to their specific sectoral, thematic and/or region/country focus. If the funds are additional, this is a viable option for increasing partner funding.

Sources: IDA (2012c, 27; 2013b, 14, and 2014)

The appropriateness of IDA's funding mechanisms

Although these reforms have been useful, in order to reduce dependence on annual donor budget processes, IDA should investigate other funding models. The three-year replenishment model makes it difficult to address shocks appropriately. The reforms could also be complemented by a number of other proposals for increasing IDA funding in the event of shocks that IDA had already discussed.

Regarding the first source of funding, partner contributions, other options for IDA include:

- Additional donor contributions: IDA could request additional donor contributions when macroeconomic shocks occur. However, IDA donor countries must obtain payment approval from their parliaments, which can impede a timely response.
- Advancement of flows from future replenishment periods: In exceptional cases, repayments of up to 5 per cent could be brought forward from a future replenishment period. However, this measure would also require parliamentary approval in the countries that finance IDA.

14 Lending terms for small island countries will not change during IDA17 (IDA 2014).

- Increase in bridge financing by the IBRD and the IFC: These organizations could provide IDA with additional funding.
- Debt funding by private donors: Private donor debt funding could also increase IDA's financial resources by leveraging grant funding. However, donor funds can be uncertain since donors are not committed to providing funds and may provide funds irregularly (IDA 2010c, 2010d and 2013b).

A number of options for increasing the second source of funding – internal resources – have been discussed. One innovative approach, with a view to ensuring IDA's financial sustainability and making its funding mechanism more flexible, is to establish an IDA blended financing facility like that proposed by Leo (2010) with three main principles: It should preserve IDA's current allocation system, maintain WB assistance volumes and concessionality degrees for IDA's blend and hardened-term countries, and significantly scale up assistance volumes for IDA-only countries. IDA would decide on the replenishment envelopes for all IDA countries as well as for blend and hardened-term countries, and the IBRD would provide projected loans with non-concessional terms to the blend and hardened-term countries. These countries would repay the IBRD loan principal, while IDA would supply an upfront grant for loan charges and interest payments. The main advantage of this approach is that it transfers loan capital requirements from IDA to the IBRD, releasing scarce IDA funds to IDA-only countries (Leo 2010 and IDA 2010c, 13). With many LICs expected to graduate within about a decade, this facility could assume a crucial role.¹⁵

On the whole, the reforms undertaken during IDA16 and IDA17 have greatly enhanced IDA's long-term financial sustainability. Not only have the reforms increased the volume of internal resources from borrowers, they also have accelerated repayments. Another important step was categorizing LICs according to their financial capabilities. These reforms have shown that IDA's funding mechanisms are not as inflexible in emergencies as they might first appear since IDA can raise additional resources by resorting to one or more of the aforementioned funding sources. A number of measures have already increased IDA's financial flexibility in times of exogenous shocks: lending terms for blend and gap countries that are stricter than regular IDA-only terms, the contractual accelerated repayment clause, and the new policy framework to encourage IDA graduates to repay their outstanding credits earlier than contractually required.

4.1.2 Reforms of IDA's financial instruments for dealing with exogenous shocks

In order to adequately respond to macroeconomic shocks, the IDA's allocation system must be flexible. IDA funds are mostly distributed using the PBA system, which considers country needs and performance: Under IDA15, 84 per cent of the total funds (IDA 2012b, 18) and under IDA16 (IDA mid-term review at the end of 2012), 72 per cent were allocated (IDA 2012c, 4). The remaining IDA funds were provided through exceptional allocations such as the Crisis Response Window (CRW).

15 According to estimates by Morris (2014, 1), within the next 12 years, 45 per cent of all current IDA-eligible countries (82) – or 37 will graduate.

IDA has four financial instruments to respond to emergencies: Emergency Response Operations, Portfolio Restructuring, the CRW and the Immediate Response Mechanism (IRM). The Emergency Response Operations (governed by Operational Manual 8.00 “Rapid Response to Crises and Emergencies”) and Portfolio Restructuring were installed before the global financial crisis; the CRW and IRM were established during and after the crisis to absorb short-term exogenous shocks in LICs.¹⁶ Prior to introducing the CRW, IDA had no systematic crisis response: Ad-hoc funding had to be mobilized for countries that requested support. Resources were frontloaded from IDA country allocations and/or resources were restructured within the countries’ portfolios and projects. In response to the global financial crisis, IDA also set up a Fast Track Facility.

The time needed to respond to an emergency or crisis is an important measure of the speed and effectiveness of financial support. The period from the conception to the implementation of emergency response operations (11.5 months), the duration of the CRW (10.8 months), and the period of portfolio restructuring (11.1 months) have been much shorter than regular IDA Investment Lending (IL) operations (20.3 months) and DPLs (9.6 months), as depicted in Table 3. With a two-week response time, the IRM disburses even faster. However, instruments like the emergency response operations were introduced to ensure the provision of financial resources for medium- to longer-term recovery – and not to disburse funds rapidly (World Bank 2011b, 4).

Table 3: Comparison of response times to prepare IDA operations			
	Eligibility	Instrument	Time
IDA lending operations	IDA and IBRD	Investment lending Development Policy Lending	<ul style="list-style-type: none"> – Average time from concept to approval: ILs 14.3 months; DPLs 6.9 months – Average time from approval to effectiveness: ILs 6.0 months; DPLs 2.7 months
CRW (IDA 15 Pilot)	IDA-only	Investment lending Development Policy Lending	<ul style="list-style-type: none"> – Average time from concept to approval: 6.8 months – Average time from approval to effectiveness: 4.0 months
Emergency Response	IDA and IBRD	Investment lending	<ul style="list-style-type: none"> – Average time from concept to approval: 7.4 months – Average time from approval to effectiveness: 4.1 months
Portfolio Restructuring	IDA-only	Investment lending	<ul style="list-style-type: none"> – Average time from concept to approval: 8.4 months – Average time from approval to effectiveness: 2.1 months
Immediate Response Mechanism	All current IDA beneficiaries	Investment lending	<ul style="list-style-type: none"> – Pre-crisis preparation work – Borrower request approved in 1 week – First disbursement possible within 1 week of approval
Sources: Figure 4 in IDA (2012a, 9) and Figure 1 in World Bank (2011b, 4)			

16 The World Bank also set up a range of initiatives to alleviate the effects of these crises on LICs: the Global Food Crisis Response Program; the Rapid Social Response; and the Infrastructure Recovery and Assets Platform. In addition, the IFC has launched several crisis response initiatives such as the Global Trade Finance Program, the Global Trade Liquidity Program, an Infrastructure Crisis Facility and the Microfinance Enhancement Facility (World Bank 2010a).

The Fast-Track Facility

In late 2008, IDA launched a Fast-Track Facility (FTF), with a volume of USD 2 billion for frontloading grants and making long-term, interest-free loans, that was designed to alleviate the effects of the global financial crisis in LICs. This facility was set up within the IDA15 framework as part of the Vulnerability Financing Facility. Financing came from IDA15 – 0.84 per cent (USD 2 billion) of total IDA resources (USD 42 billion). The FTF led to the adoption of two instruments: Development Policy Operations (DPOs) and investment operations. Reducing the review period made rapid disbursements possible, with the standard frontloading rule extended from 30 to 50 per cent of the annual allocation (World Bank 2008, 2009a and IDA 2012b, 71).

According to the evaluation undertaken by the Independent Evaluation Group (IEG), the FTF effectively achieved its aims, despite the relatively small volume compared with the IDA total (World Bank 2010a, 45). By autumn 2009, much of the FTF – USD 1.5 billion – had been committed for operations in 11 member countries. Nevertheless, some countries were reluctant to frontload their IDA allocations because they wanted to maintain reserves in case the global financial crisis worsened (IDA 2012b, 71).

The Crisis Response Window

In late 2009, IDA set up a pilot Crisis Response Window (CRW) to provide rapid support for LICs in the event of severe economic crises¹⁷ and natural disasters. This facility rapidly provides financial resources to safeguard core spending on health, education, social safety nets, infrastructure and agriculture. It includes fast processing and approval of funds, that is, shorter management review periods and the application of crisis response provisions in line with WB policy. It is funded with IDA internal resources and by the UK. A total of USD 1.3835 billion has been committed to 75 operations in 46 countries. Speedy processing and approval of funds ensures their rapid disbursement and use (IDA 2012a, 7; 2012b, 71–72).

Box 4: The Crisis Response Window: eligibility criteria and allocation modes

All IDA countries experiencing a decrease in projected GDP growth of 3 percentage points or more within one year can make use of the CRW. Their fiscal situation and other relevant data must be assessed with the aim of safeguarding or alleviating the impact on short-term core spending, such as for education, health and operations, maintaining infrastructure and preventing the disruption of long-term development objectives. Countries that have experienced only a moderate fiscal impact from a drop in GDP are ineligible for CRW funds.

The CRW funds are distributed in two stages: 75 per cent are allocated through a rules-based approach, then the remaining 25 per cent are distributed to countries with specific needs, including highest crisis impact, largest pre-existing needs, resources needs and the capability to use the funds effectively. Allocations are estimated per capita.

Source: IDA (2011, 74)

IDA had various instruments to react to countries' specific crisis needs and circumstances that were not earmarked thematically under the pilot CRW. These instruments mainly

17 The CRW should be used when there is extensive or regional drop of at least 3 percentage points in GDP in a considerable number of IDA countries (IDA 2012a, 17).

comprised Specific Investment Loans (SILs) (SDR 480 million or 47 per cent of total SIL), DPOs (SDR 187 million or 28 per cent of total DPOs) and Emergency Recovery Loans (ERLs) (SDR 188 million or 18 per cent of total ERL). Since these funds were not earmarked for specific themes or sectors, they were used for a wide range of purposes, including the maintenance or development of safety nets, health, education, social protection, infrastructure, agriculture and rural development (IDA 2012a, 7–8).

Since the pilot CRW proved successful in rapidly providing additional support for IDA-only countries during IDA16, a dedicated CRW was established. Despite the need for a systematic approach to enable rapid responses to crises, the CRW's volume has been quite small – USD 1.335 billion, or 4.1 per cent of IDA's envelope – during the current IDA16 period, and will be reduced to 2 per cent of the IDA17 envelope (Berensmann 2010; IDA 2012a, 2013a and 2014). The main reason for this small volume is that contingent facilities like the CRW bind scarce concessional resources that could be used for other purposes. For this reason, Management will explain how CRW funds are being used at the IDA17 Mid-Term Review and provide proposals for reallocating unused CRW funds, taking into account IDA core performance-based financing and regional projects as set out in the report of IDA Executive Directors on its seventeenth replenishment (IDA 2014, 44).

The Immediate Response Mechanism

To accelerate access to its resources in the event of exogenous shocks, IDA set up the IRM. IDA had already added instruments to its emergency response framework to support countries in their medium- to longer-term recovery after an emergency or crisis, but none for responding immediately within a few weeks. Therefore, in December 2011, it introduced the IRM to enable rapid responses in crises. It offers IDA countries immediate access to part of their undisbursed project portfolios. All IDA recipients, including IDA-only, IDA-blend and IDA-gap countries, are eligible to use the IRM in case of natural disasters, severe economic shocks or other crises and emergencies.¹⁸

A secondary aim of the IRM is to improve emergency preparedness and response in IDA countries. IDA works with countries on implementation arrangements for the IRM ahead of crises and emergencies as well as on processes for emergency procurement, financial management and crisis response.

The IRM reduces the time between an emergency and access to IDA resources to an average of two weeks, as Table 3 shows. For the response to be rapid, the IRM's operational policies must be flexible, allowing project portfolios to be quickly restructured to cope with emergency needs. In this regard, two preliminary measures are crucial: countries must incorporate contingent emergency response components in existing IDA investment projects, and the borrower and the WB must agree on appropriate implementation arrangements. The WB and the countries have to identify appropriate projects with developmental effects and arrange to permit a rapid drawdown of financial resources from them.

18 The definition of a crisis or emergency is identical to the definition in (OP) 8.00 – “Rapid Response to Crises and Emergencies”: “...[A]n event that has caused, or is likely to imminently cause, a major adverse economic and / or social impact associated with natural or man-made crises or disasters...” (World Bank 2007, 1).

The IRM gives IDA countries rapid access to as much as 5 per cent of their aggregate undisbursed IDA investment balances during the IDA16 period. To guarantee small countries adequate access, they are permitted to draw up to USD 5 million of their undisbursed balances. The IRM funds may not be used to finance DPLs (World Bank 2011b, 5–7).

Within IDA's emergency financing framework, the IRM complements IDA's longer-term emergency response instruments, including the CRW, by providing financial support within weeks rather than months. However, the IRM's financial volume is limited. When it was installed in 2011, undisbursed IDA balances in investment projects for IDA countries amounted to USD 42.8 billion. As access to the IRM is limited to 5 per cent of IDA countries' undisbursed investment balances (USD 5 million for smaller states), during IDA16 the IRM would have an upper limit of USD 2.2 billion – an indicative estimate of the total undisbursed balances under IDA16. However, it is most unlikely that all countries will use this mechanism simultaneously (ibid., 13). As of May 2014, no country has yet accessed IRM resources according to World Bank staff information. Since its establishment a rising amount of projects has incorporated IRM contingent components.

The appropriateness of IDA's instruments

IDA has strengthened its role in alleviating shocks. Compared with the IMF, IDA's relative weight in volume has increased since the global financial crisis started because it has substantially increased the volume of its shock instruments. IDA is also mandated to play a countercyclical role, and has made a major contribution to quickly approving funds.

This assessment reveals that establishing two systematic crisis instruments within IDA – the CRW and the IRM – represents a paradigm shift from ad-hoc financing to a systematic response to crises. These two crisis instruments have several advantages. First, a systematic approach increases the transparency and predictability of IDA's response to exogenous shocks. Second, IDA can now react to crises in a timely manner by rapidly providing financial resources. However, at 2 to 5 per cent of IDA's envelope, the financial volume of IDA shock windows has been quite small and under the IRM, there are high transaction costs for short-term funding at project level. In addition, these new instruments with higher ceilings risk further constraining the flexible allocation of resources.

In light of the Fast Track Facility (FTF)'s importance as a source of contingent financing during and after the global financial crisis, it proved to be an appropriate instrument for alleviating the effects of macroeconomic shocks. It was also institutionally appropriate: in view of IDA's PBA mechanism and its three-year replenishment cycle, the FTF was able to immediately respond to the crisis. While USD 2 billion was less than 1 per cent of IDA15 total funding, IDA's inflexible institutional set-up prevented the rapid disbursement of significant amounts of concessional resources. Yet compared with the volume of concessional funds provided by other IFIs like the IMF, the USD 2 billion available from the FTF was relatively large. It is important to note that these were not additional financial resources, since the FTF was part of the IDA15 fund and included IDA15 resources from existing country allocations.

The CRW has proved to be an important concessional financing window for LICs in the event of shocks, having quickly provided the affected IDA countries with additional funds during the global financial crisis. The CRW is a significant departure from the PBA

formula and enables IDA to react flexibly in times of exogenous shocks. However, requiring that countries experience a projected decrease in GDP growth of 3 percentage points or more within one year is a very strict criterion for access because countries rarely experience such significant declines in their GDP (Griffith-Jones / Gottschalk 2012, 12).

However, the CRW's volume is quite small during the current IDA16 and is to be reduced to 2 per cent of total replenishment resources available during IDA17. Although the CRW volume can be increased in exceptional circumstances – approved by IDA's Executive Directors (IDA 2014, 44) – it remains small. IDA thereby acknowledges the difficulties in predicting exogenous shocks and their impacts. One reason for the small volume is that contingent facilities like the CRW bind scarce concessional resources that could be used for other purposes. The fungibility of resources is limited under IDA. Another reason for the small volume under IDA17 is that the CRW was not fully used under IDA16, where it was used to alleviate the effects of natural disasters and not to respond to macroeconomic crisis. The very nature of a contingent facility means that in periods of resilience it might not be fully used – but such a facility should be available in times of crisis. One way to minimize binding scarce resources is for Management to state which CRW resources were used before the IDA17 Mid-Term Review and provide suggestions for reallocating remaining funds as set out in the IDA Executive Directors' report on its seventeenth replenishment (IDA 2014, 44).

A further problem of the CRW has been that transaction costs have been quite high, since countries received relatively small sums in a relatively large number of small interventions. On the positive side, during the pilot CRW average disbursement rates exceeded those of normal IDA operations.

The IRM complements the IMF's function of responding immediately to macroeconomic shocks. IDA's short-term provision of financial support for specific IDA-financed projects could effectively close short-term financing gaps. In addition, IDA financing differs from that of the IMF. While IDA financing within the IRM is provided at project level, IMF funding takes the form of short-term balance-of-payments support. In this respect, the IRM complements IMF short-term financing.

On the whole, an important strategic question is if it makes sense to subdivide the limited pool of IDA resources with more and more new instruments in exception to the PBA formula. Compared with the IBRD and the IMF, IDA resources have quite limited fungibility. The system has produced externalities that must be more fully assessed to know if recent reforms help to indicate how IDA should further develop.

4.2 The design and appropriateness of IMF's shock architecture

Like IDA, since the global financial crisis, the IMF has not only augmented its concessional financing for developing countries but also fundamentally reformed its concessional funding framework, the Poverty Reduction and Growth Trust (PRGT), and its lending facilities for LICs. Moreover, in response to the crisis it has introduced extraordinary measures such as interest relief to LICs for IMF concessional loans that are outstanding at the end of 2014 and a 0.25 per cent reduction of interest rates on all concessional facilities. However, because of the larger amounts provided in the aftermath

of the global financial crisis, the IMF's concessional lending capacity will significantly decrease after 2014.

This section assesses the design and appropriateness of IMF shock architecture, first by discussing its funding framework and then its instruments.

4.2.1 Reforms of the IMF's funding framework

Since demand projections exceeded the IMF's financing capacity, in 2009 a three-pillar strategy was introduced to preserve the PRGT's financial viability:

- (i) Base envelope: The annual lending capacity includes a base envelope of about SDR 1.25 billion to meet concessional lending needs in normal times. Given that lending can fluctuate significantly from year to year, the self-sustaining PRGT can accumulate funds in years with low lending commitments and reduce capacity in years when lending commitments are high. The IMF has used windfall profits from the sale of gold for this envelope.
- (ii) Contingency measures: If average financing needs significantly exceed the base envelope over a long time, the IMF can reduce funds by taking such contingency measures as postponing reimbursement or temporarily suspending the General Resources Account (GRA) for PRGT administrative expenses, raising additional bilateral funds, changing access to facilities, and modifying blending, interest rate and eligibility policies.
- (iii) Principle of self-sustainability: This principle requires future revisions of LIC facilities to guarantee that in a plausible range of scenarios, the demand for IMF concessional resources will be met with the resources available under the first and second pillars (IMF 2012a, 2013a and 2014a).

The IMF has further decided that doubling quotas under the Fourteenth General Review of Quotas will be offset by lowering access limits and norms of the Extended Credit Facility (ECF), Rapid Credit Facility (RCF) and the Standby Credit Facility (SCF) by 50 per cent to keep the nominal amount of lending constant and avoid threatening the PRGT's financial sustainability (IMF 2012a and 2012d).

As the base envelope is self-sustaining in normal times and contingent measures can be taken when average financing needs exceed the base envelope, the new strategy has proved to be an appropriate means for ensuring the PRGT's longer-term financial viability. Consequently, no further major reforms of the IMF framework for concessional financing are necessary at this point. Before further reforms are undertaken, the experience with the new framework must be evaluated to see whether in the long run it, too, is capable of withstanding major exogenous macroeconomic shocks.

4.2.2 Reforms of IMF's financial instruments for dealing with exogenous shocks

In the aftermath of the global financial crisis not only did the IMF increase funding for LICs but, through reforms undertaken mainly in 2009 and 2013, it also simplified and strengthened the lending architecture for LICs (IMF 2009a and 2013a). Given the growing global volatility and LICs' differing needs, reforms were needed because the IMF's concessional facility architecture lacked three instruments: (i) a flexible short-term financing instrument, (ii) a good precautionary instrument, and (iii) a flexible emergency financing instrument for LICs in fragile situations (IMF 2009b, 23). The two existing concessionality-based financing instruments – the Poverty Reduction and Growth Facility (PRGF) and the Exogenous Shocks Facility (ESF) – were too inflexible to cope with macroeconomic shocks. Accordingly, in 2009 the IMF fundamentally reformed its lending architecture for LICs, and established a unified facilities framework under the new PRGT. In 2013, the IMF introduced incremental supplementary reforms to improve the new lending framework for LICs.

The IMF's instruments of 2009 and 2013

The reform in 2009 mainly introduced a non-financial instrument and three new concessional lending facilities: the ECF, the SCF and the RCF (Box 5). The ECF (formerly the PRGF) has continued to be the most important facility for LICs. With about 30 arrangements per year, its use remained stable from 2008 to 2012. Often it was requested to provide precautionary support rather than mitigate exogenous shocks. In contrast to the ECF, the SCF was used only five times between 2010 and 2013, with USD 87 million going to only two countries. Similarly, nine countries applied to the RCF on 12 occasions for around USD 230 million during the same period (IMF 2012a, 9, and data on the IMF website). That is, from 2010 to 2013, the financial resources allocated to LICs by these facilities were rather modest.

Box 5: Reforms of the IMF's LIC lending framework in 2009

In 2009 the IMF significantly overhauled its lending architecture for LICs and established the following three instruments:

- **The Extended Credit Facility (ECF):** Replacing the PRGF, the ECF represents the main tool for LICs – providing medium-term financing with repayment periods of 5.5 to 10 years for LICs with protracted balance-of-payments problems. The ECF retains the key structures and most important requirements of the PRGF and addresses the latter's weak points, particularly with regard to increased flexibility: the length of the arrangement is more flexible (e.g. programme extension), and so is a country's choice of its adjustment path, including the timing of structural reforms and the timing and other requirements of Poverty Reduction Strategy Papers.
- **The Standby Credit Facility (SCF):** The SCF is comparable to the IMF Stand-by Arrangement for MICs. Its main objective is to make flexible short-term financing available to LICs that have short-term balance-of-payments needs from domestic or exogenous shocks, and policy problems. For this reason, eligible countries have short-term ad-hoc problems, not protracted balance-of-payments problems. This facility can also be used as a precautionary instrument.
- **The Rapid Credit Facility (RCF):** The IMF provides rapid financing as outright disbursements to pay urgent balances. This financing, which can be used repeatedly, is supplied without programme-based conditionality and represents a shock facility if the country is not already using the other two facilities.

Sources: Berensmann (2010); IMF (2009a; 2012b)

The low demand for the new facilities was because they had several shortcomings. The 2009 reforms erected a new streamlined lending architecture for LICs that is better tailored to their needs, but a number of incremental reforms had to be made in 2013. The two main objectives of the 2013 reforms were to: (i) make more efficient use of PRGT resources by tailoring access and financing needs more closely to country-specific circumstances, (ii) augment precautionary financial support for LICs, and (iii) enhance the operational flexibility of the facilities (IMF 2013a).

One problem relates to the volume of the RCF. Much of the IMF's shock financing is subject to Upper Credit Tranche (UCT) conditionality, and the only facility with low conditionality – the RCF – provides only a limited amount of funding (Griffith-Jones / Gottschalk 2012, 11) (Figure 5).

Figure 5: IMF architecture of lending facilities for LICs		
Standby Credit Facility (SCF)	Extended Credit Facility (ECF)	Upper Credit Tranche (UCT) review-based programme
Rapid Credit Facility (RCF) (Shock window)(Transition to ECF)		No UCT programme – outright disbursements
Short-term financing needs	Medium-/longer-term financing needs	
Source: IMF (2009a, 7)		

Despite the increase in cumulative access from 75 to 100 per cent and from 100 to 125 per cent for the shock window that was agreed in 2013, the annual volume of funding is quite small because it allows only 25 or 50 per cent of a country's quota per annum. The IMF has imposed limits on using the RCF to prevent this shock instrument being misused where the ECF would be more appropriate. But recent experience has shown that small islands at risk of frequent natural disasters and countries in fragile situations need time to establish the required capacities for using the ECF. In these cases, the IMF may not have provided sufficient support under the RCF with its sub-limits on annual and cumulative access (IMF 2012a, 23). In addition, low conditionality facilities have the advantage of being committed to quickly enabling the IMF to react rapidly to exogenous shocks (Griffith-Jones / Gottschalk 2012, 11).

A further problem is that UCT conditionality led to the SCF having difficulties providing the appropriate financial resources to address exogenous shocks in the short term. Any additional financing increase and disbursement by the ECF and SCF depended on the outcome of the next scheduled review. To better cope with this problem and the LICs' unexpected financial needs, the IMF eased access to the ECF and SCF – to 25 per cent of quota – so that countries experiencing urgent, unforeseen balance-of-payments requirements can more easily access on-track ECF/SCF arrangements between scheduled reviews (IMF 2013a, 20–22). As these measures can be taken in the short term without review, this reform helps to make the response to exogenous shocks quicker and more flexible – and is therefore a crucial modification of the IMF's LIC lending architecture. However, only time will tell if it leads to increased use of the SCF.

Another important proposal for reform was to relax the rules for SCF arrangements that are treated as precautionary. A member country's access to the SCF can be treated as precautionary if it has a potential, but not immediate, balance-of-payments problem. In such cases, time limits for re-applying for precautionary SCF arrangements are eased: earlier

precautionary SCF arrangements are not counted in the two-and-a-half years of the five-year ceiling. This measure leads to the enhanced application of precautionary SCF arrangements within a five year period (ibid., 23).¹⁹

The IMF's blending policy

With a view to making lending to LICs more flexible, in 2009 the IMF reformed its blending policy and agreed to undertake more reforms in 2013 (Box 6). Blending concessional financing with GRA funds, which are non-concessional resources, has several advantages. Blending entails the use of fewer concessional resources and helps to ensure that the PRGT uses its scarce resources for the poorest members. It also makes the IMF lending policy more flexible, since blending entails greater differentiation of financing terms. For recipient countries, blending has the advantage of increasing their access to funds, and sends positive signals to markets by indicating that countries are able to service non-concessional loans.

Box 6: The IMF's blending policy and its reforms

Prior to the 2013 reform, the blending policy had the following key features:

- The members' per capita income limit on blending had to exceed the current IDA operational cut-off, or their per capita gross national income (GNI) had to exceed 80 per cent of IDA's operational cut-off and they had to have market access. Their debt position also had to be sustainable, that is they could not be experiencing, or be at serious risk of experiencing, debt distress.
- Members had to have sustained market access and be recent or prospective recipients of considerable non-concessional funds from private capital markets or the hard windows of official bilateral and multilateral lenders. Although there was no specific ceiling on sustained past market access, a country was supposed to have had access to international financial markets in at least three of the previous five years, and total access had to have been at least 100 per cent of quota.
- To constrain the use of GRA financing, access to concessional financing was normally restricted to half of the totals. Access was also limited to a ceiling of 25 per cent of quota, with the average annual concessional access limited to 50 per cent of quota. In addition, any concessional access for unblended arrangements above the norm had to be met from GRA resources.
- Blending was permitted in exceptional cases, where financing needs exceeded the applicable access limits.

Access ceilings under the concessional and GRA-based facilities were set on a case-by-case basis, with criteria such as balance-of-payments, programme strength and debt sustainability being decisive.

In 2013, to expand the use of blending, the IMF proposed two strategies. The first procedure provides for progressively increasing blending, while generally retaining the key criteria for deciding on country eligibility. The IMF proposed relaxing the criteria for classifying past market access, which required a member country to have had access to international financial markets in at least two of the previous five years, with its access in the previous five years to not have exceeded 50 per cent of quota. Second, the IMF proposed abolishing both the ceiling of 25 per cent of quota and the limit of 50 per cent of quota on average annual concessional access. The IMF proposed introducing a 50:50 mix of PRGT and GRA financing, which in most cases would reduce PRGT resources. The second proposal was more ambitious, including new modalities of the first approach and lowering income and market-access ceilings in order to enlarge the group of presumed blenders. This approach includes lowering income ceilings for blending from 80 to 60 per cent of IDA's operational cut-off for countries with market access and from 100 to 80 per cent of that cut-off for all other LICs. The main advantages of the first approach were that LICs would graduate incrementally from IMF concessional financing and that increased blending would preserve scarce concessional resources for the poorest countries. The second approach would increase the number of countries eligible for blending – but the new blenders might not be creditworthy. Therefore, the first approach was adopted in 2013.

Sources: Berensmann (2010, 21–22); IMF (2012b; 2013a, 8–9)

19 In 2013, the PRGT facilities were scheduled to be reviewed in five years, or earlier if needed.

The appropriateness of the IMF's concessional lending instruments

On the whole, the 2009 reform greatly improved the IMF's LIC lending architecture by creating a new unified facilities framework under the new PRGT. The new financing facilities – a more flexible short-term financing instrument, a precautionary instrument and a more flexible emergency financing instrument – have filled the gaps in older instruments. In addition, a clearer distinction is now made between short- and long-term financing, and the scale of potential funding available in the event of shocks has grown. Furthermore, conditionality has been reduced to enable more rapid disbursement through the RCF when exogenous shocks occur. However, the RCF and the SCF were not used much between 2010 and 2013.

In 2013, only incremental reforms, such as an increase in cumulative access to the RCF, easier access (25 per cent of quota) to the ECF and SCF, and the relaxation of the rules on SCF precautionary arrangements, were needed. The precautionary SCF is also not subject to any time limits. The reforms aimed to: (i) enhance the efficiency of PRGT resources by tailoring access and financing needs more closely to country-specific circumstances, (ii) increase precautionary financial support for LICs, and (iii) improve the operational flexibility of the various facilities. By and large, these objectives have been achieved. However, it will take time to know if the 2013 reforms lead to increased use of the RCF and the SCF. Was the cumulative increase in access to the RCF established in 2013 sufficient? If not, annual access limits on using the RCF should also be relaxed – although the concessional envelope is not boundless.

The recent IMF reforms that aimed to increase the use of blending have been useful, since the greater number of blending arrangements has helped to diversify the financial options open to LICs (and LMICs) and to preserve scarce concessional funds for the poorest countries. However, blending arrangements should not expose LICs' (and LMICs') debt sustainability to risks.

In spite of these numerous reforms the question arises as to whether the IMF's lending policy is sufficiently differentiated among LICs, particularly in the medium term. In 2012, the IMF had put forward, but not established, the notion of better differentiating financing terms, including interest rates, with regard to LIC capacities and needs. In the current lending framework, financing terms differ among the instruments – the SCF, ECF and RCF – and blend countries also have different financing terms. But it would be helpful to better differentiate financing terms with regard to the different capacities and needs of LICs, ranging from the poorest to the most advanced (those with some capital market access) (IMF 2012a, 24–26). Differences among LICs will become larger as many of them graduate, so it is important to better differentiate between LICs, tailor lending to their needs and allocate scarce concessional resources where they are most needed. However, interest-rate differentiation should not undermine the principle of uniformity of treatment for LIC groups.

A new contingent financing facility for LICs

Another question that arises is whether this lending framework fully meets LICs' need for contingent financing, especially the most advanced LICs, which largely have sound macroeconomic performance records and to some extent are integrated into international financial markets. The PRGT toolkit does not include a specific contingent financing instrument similar to the Flexible Credit Line (FCL) and Precautionary and Liquidity Line (PLL) in the GRA, as discussed by the IMF (IMF 2012a, 30–31).²⁰

A specific contingent instrument should be established in the medium term. Contingent (ex- ante) financing has a number of advantages over ex-post financing. First, it would enable the IMF to provide a more diversified toolkit for LIC contingent financing when major or multiple shocks occur. Second, contingent financing would be more predictable and third, it could be provided more promptly. The main disadvantage of a specific contingent instrument is that it would use up scarce concessional funds and thereby crowd out the financing of other instruments. For these reasons the incremental measures introduced by the IMF may suffice to meet the demand for contingent LIC financing in the short and medium terms. However, in the medium term, when more LICs are better integrated into global financial markets and become LMICs, a specific contingent facility will be required to meet member countries' needs for contingent financing. Moreover, such a facility will be required if demand for the IMF's shock windows – the RCF and the SCF – remains low. Table 4 gives a detailed overview of the IMF and IDA shock windows, as discussed in this chapter.

20 The need for a precautionary facility for LICs was also mentioned in the IMF appendix (2009a, 42) and in IMF (2009b, 18).

Table 4: IMF and IDA shock facilities for LICs				
Facility^a	Eligibility and terms	Function^b	Access	Other aspects
Standby Credit Facility	PRGT-eligible countries 1–2 years SCF-arrangements Charges: 0 % through 2014	“To resolve short-term BoP and precautionary needs”	“Norm is 120% of quota (75% if outstanding PRGT credit > =100% of quota) for 18-month arrangement. Annual/cumulative limit: 100/300% of quota”	“Episodic use is the norm; i.e., no more than 2.5 out of every 5 years.” Precautionary SCF is not subject to any timing restrictions
Rapid Credit Facility	PRGT-eligible countries Outright disbursement Charges: same as above	“Urgent (present) BoP need must exist. Prospective or potential needs may also exist.”	“No norm. Annual/cumulative limit: 25/100% of quota, or 50/125% in case of sudden exogenous shocks” ^c	“One-off disbursements. Repeated use possible based on sudden exogenous shocks or 6-monthly track records”
Fast-Track Facility	Eligibility: IDA + blend countries IDA conditions	Provision of financial resources in the short term	Access limited to IDA allocation: frontloading of up to 50 % of IDA resources Overall limit: USD 2 billion of IDA15	Different lending instruments: Development Policy Operations + Investment operations
Crisis Response Window	Eligibility: IDA-only, IDA-blend and IDA-gap countries IDA conditions	Provision of support in the case of severe economic crisis and natural disasters	Overall limit: 3% of IDA16 2% of IDA17	Different lending instruments: Development Policy Operations + Investment operations
Immediate Response Mechanism	Eligibility: IDA-only, IDA-blend and IDA-gap countries IDA conditions	Provision of support in the short term after an emergency or a crisis for investment projects	Access up to 5 % of their aggregate undisbursed IDA investment balances	Only investment policy lending
<p>Notes: “(a) For PRGT-eligible countries meeting the blending criteria, any concessional financial support should be blended with GRA financing, normally resulting in ECF–EFF, SCF–SBA, and RCF–RFI blends. (b) Balance-of-payments (financing) needs can be present, prospective (i.e., a need that is expected/projected to arise in the future, including during the implementation of Fund [IMF] program), or potential (i.e., a need that may arise under an alternative, typically downside, macroeconomic scenario, but is not expected to arise based on baseline/program projections). (c) An exogenous shock is defined in the same manner as under the ESF: an event beyond the control of the authorities of the member, with a significant negative impact on the economy. In view of these considerations, qualifying exogenous events could include inter alia terms-of-trade shocks, natural disasters, shocks to demand for exports, or conflict or crisis in neighboring countries that has adverse balance-of-payments effects.”</p>				
<p>Sources: IMF facilities based on IMF (2012b, 10 Table 1 and 2013d, 38–39); IDA facilities based on IDA (2012a; 2012b)</p>				

5 Assessing the IFIs' non-concessional lending architecture for managing shocks

5.1 The design and appropriateness of the IBRD's shock architecture

Against the background of its experience in lending to countries struck by financial crises, in the late 1990s the WB redesigned its instrument to be better able to respond. Prior to that, given its mandate to provide long-term development loans, the WB had no specific instruments for responding to external shocks. However, in 1998 the WB added a special loan instrument to its adjustment-lending scheme, the Emergency Structural Adjustment Loan (ESAL), which was only available on an exceptional basis in the framework of international support packages. This instrument was applied in several international support operations for Argentina (1998), Brazil (1999 and 2000), Turkey (2001) and Uruguay (2002), and formed the basis for Special Development Policy Lending (SDPL), which was introduced in 2004, when the WB switched from adjustment lending to development policy lending (World Bank 2009b).

Since then, the WB's OP for Development Policy Lending (DPL), its fast-disbursing lending instrument, reads: "...[C]ountries affected by crisis or conflict may require an unusually quick response from the Bank." (OP 8.60 – Development Policy Lending, August 2004). This sets the stage for generally using DPL as a crisis response instrument – instead of SDPL. Since using SDPL was restricted to exceptional situations and rescue packages coordinated with the IMF and other actors, it gave the WB two new options for crisis lending: the regular DPL as a quick disbursing instrument and the Deferred Drawdown Option (DDO), a special DPL option that allows IBRD-eligible countries to defer disbursements for up to three years, with a possible three-year extension.

The rationale for using the DPL in general for crisis lending, and the DDO in particular, was that the WB wanted to increase lending to countries that were affected by crises or shocks but were not in a severe crisis situation, that is, where an IMF-led rescue package was warranted. Increased policy lending would help the WB to compensate for tightening financial markets or temporary losses in fiscal revenue (ibid., 7).

Special Development Policy Lending

Beyond restrictions on eligibility in severe crisis situations, SDPL features: a link to an IMF-supported disbursing programme, a relatively short three-year grace period with a five-year maturity, and higher pricing (originally LIBOR+400 basis points, bps), that reflects the risks of crisis lending.

In 2009, in the aftermath of the global financial crisis, the WB reviewed the use of SDPL and increased the flexibility of repayment terms by enlarging the original three-year grace period to up to five years and the five-year maturity from five- to 10-year final maturity. To preserve broad comparability with the financial terms of IMF emergency support, the minimum fixed spread (over LIBOR) was lowered from 400 bps to 200 bps, which was comparable to terms of IMF facilities, but maintained the front-end fee of 100 bps (World Bank 2012c). Because of the link to an IMF programme, only Latvia made use of SDPL in 2010–2011.

Regular Development Policy Lending

DPL refers to funds that are rapidly disbursed without being earmarked in the budgets of borrowing countries; SDPLs are supposed to increase expenditures for specific sectors. According to the OP on Development Policy Lending, policy lending

“aims to help a borrower achieve sustainable reductions in poverty through a program of policy and institutional actions that promote growth and enhance the well-being and increase the incomes of poor people. Development policy operations are supportive of, and consistent with, the country’s economic and sectoral policies and institutions aimed at accelerated sustainable growth and efficient resource allocation. They typically support a program of policy and institutional actions, for example, to improve the investment climate, diversify the economy, create employment, and meet applicable international commitments” (OP 8.60 – Development Policy Lending, August 2004).

DPL requires an appropriate macroeconomic framework and can be geared towards achieving general development objectives or sectoral goals; conditionality is geared towards agreed policies and institutional actions. Lending is at the usual IBRD terms, with interest below 100 basis points above LIBOR and 12- to 18-year maturities.

Although not originally intended for crisis lending, due to its quick disbursing nature the regular DPL was the WB’s prime instrument for responding to the global financial crisis. IBRD lending was tripled between 2009 and 2012, with the DPL share at 35 to 40 per cent of annual lending, and commitments for DPL amounting to USD 37 million.

Deferred Drawdown Option

According to the DPL OP, with the DDO it is possible to

“defer disbursement of a single- or multiple-tranche development policy loan for up to three years, provided that (a) overall program implementation is consistent with the Letter of Development Policy, and (b) the macroeconomic policy framework remains adequate” (OP 8.60 – Development Policy Lending, August 2004).

As with regular DPL, there is no link to any IMF programme. However, the pricing is higher than for regular DPL, with a front-end and renewal fees.

Until 2008, use of the DDO was quite limited, with only two Development Policy Options (DPOs) approved. Borrowers hesitated to use the DDO because its financing terms were harder. Another obstacle to using the option was the fact that when funds were actually to be drawn, the WB had to reconfirm the adequacy of the macroeconomic policy framework and the programme’s overall implementation. This created a degree of uncertainty about whether or not the funds would be available when needed (World Bank 2012c, 45).

Against this backdrop, and in consideration of how large demands for funds from crisis countries would affect the WB’s capital base, DDO pricing was raised in 2009 and 2012. The new pricing schedule included a higher front-end fee on undrawn DPOs with a DDO and a renewal fee. In 2012, the pricing structure for the DDO was changed again: the front-end fee was reduced and the renewal fee eliminated and replaced by a new ‘standby’ fee to better align the charges to that period for undrawn balances (World Bank 2012c, 45–46).

The 2008 revisions led to a sharp rise in demand for this lending instrument: 15 DPOs with DDOs were approved for 11 countries, with commitments of USD 9.2 billion. In times of uncertainty and decreasing access to finance in a number of countries, DPOs with DDOs can be interpreted as signalling that the WB is ready to support countries with contingent financing. However, only 10 DDOs have been fully or partially disbursed, with USD 2.5 billion – less than a third of the funds committed – drawn down (ibid., 51).

Indonesia has been the biggest borrower, using the DDO with two operations of USD 2.0 billion each in 2009 and 2012, although neither has been drawn yet. Other countries, such as Colombia, Mexico and Costa Rica, have fully drawn down their DPOs with DDOs.

The appropriateness of WB non-concessional instruments

The WB's Independent Evaluation Group (IEG) has assessed its response to the financial crisis twice (World Bank 2010a and 2011a). In the second, more comprehensive assessment (Phase II analysis), the following conclusions were made with regard to WB lending instruments (World Bank 2011a, 3–12):

- The WB had affected a large countercyclical response, particularly through the increase of quick-disbursing IBRD lending.
- There was a low correlation between lending and the severity of the crisis in borrowing countries. This is related to the fact that the WB built on pre-crisis lending patterns and analysis.
- The second conclusion does not mean that the lending was unjustified. Most probably it helped to calm capital markets in response to increased demand.
- IBRD crisis lending was made at relatively low interest rates, lower than the lending rates of other IFIs. This was a result of low market rates as well as the drop in IBRD pricing shortly before the crisis.
- The relatively attractive interest rates and maturities of IBRD lending – in comparison with other IFIs – reduced the WB's headroom for further lending and responding to future crises.
- As a consequence, it is recommended that a 'roadmap for crisis engagement' be developed, including replenishment of the IBRD's lending headroom as well as partnerships with other IFIs in order to be able to effectively use available funds in a crisis. This could include a short-term countercyclical instrument, such as the SDPL, that is not tied to an IMF programme.

The availability of fast-disbursing instruments – and lending headroom to effectively use them – was key to the WB's crisis response. Extensive use of regular DPLs and DPLs with DDOs has been crucial for supporting countries that were not in crises requiring IMF programmes. This has helped to calm the markets – and had been effective for most MICs in 2009 and 2010, although without a counterfactual, it is difficult to assess the actual effectiveness of lending for mitigating crises in countries that were not severely affected in the first phase of the global financial crisis. As the WB's dedicated crisis response instrument, the SDPL was not used because there were no IMF-led crisis packages in MICs during the crisis (except for Mexico, Colombia, Macedonia and Morocco, where IMF contingent credit facilities were preventively used; see below). Whether or not the

availability of IBRD lending has crowded out IMF crisis lending cannot be determined against this background.

One major issue is the question of lending terms. The favourable DPL lending terms compared with those of other IFIs have clearly encouraged their use but have also helped to erode the WB's lending headroom. The DDO pricing was revised upward after demand for this instrument rose. DDOs provide little revenue for the WB as long as they are not drawn,²¹ but require a charge against its capital. Thus, there is a case for a flexible approach to lending terms in times of crises, with interest and maturity adjusted in view of market conditions and other actors' policies.

5.2 The design and appropriateness of the IMF's shock architecture

In response to the financial crisis, in 2009 the IMF introduced the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL), and the Rapid Financing Instrument (RFI). The FCL and the PLL, including its predecessor, the Precautionary Credit Line (PCL), are intended to strengthen IMF crisis prevention and resolution with limited or no conditionality (or no ex-ante conditionality) – based on a qualification framework.

The FCL is shaped for members with very strong institutional settings, economic fundamentals and records of policy implementation. Countries can request assistance from the FCL when facing potential or real balance-of-payments pressure. It has the following features (IMF 2014c and 2014e):

- Countries can draw on the credit line or use it as a precautionary instrument.
- There is no conditionality.
- It can be used as a renewable credit line.
- There is no cap on the use of IMF resources.
- The commitment fee increases with the degree of access, while the lending rate is the same as for Stand-by Arrangements.

The PLL is tailored for members with sound economic policies and fundamentals but vulnerabilities that preclude them from using the FCL. Like the FCL, the PLL merges a qualification process – but with a lower bar to eligibility – with ex-post conditionality (IMF 2014b and 2014e).

- Like the FCL, it can be used as a precautionary instrument.
- It runs from six months to two years.
- A six-month programme has an access limit of 250 per cent of a country's quota and in case of an exogenous shock, access could be as much as 1,000 per cent of quota.
- The commitment fee and lending rates are similar to the FCL.

21 From date of effectiveness: standby fee of 0.50% p.a. on undisbursed balances and a one-time front-end fee of 0.25%.

The RFI was established to extend the IMF's emergency assistance with a streamlined and more flexible instrument within the credit tranches that replaces earlier policies for post-conflict situations and natural disasters. It is designed for situations where a full-fledged programme is unnecessary, but where commodity price shocks or other sudden shocks create the need for short-term balance-of-payments support (IMF 2014d and 2014e).

- It is similar to the Rapid Credit Facility (RCF) for LICs.
- Access is restricted to 50 per cent of quota annually and 100 per cent on a cumulative basis.
- Lending terms are similar to the FCL and PLL.

Use of the FCL and the PLL has been rather limited, with the former used by Mexico, Colombia and Poland and the latter by Morocco and Macedonia. The RFI has not been used. However, in 2009, Mexico's FCL of USD 46.55 billion (1,000 per cent of quota) was an unprecedented amount and marked a new chapter in IMF crisis prevention and mitigation. Mexico has not drawn down the loan but it has clearly contributed to Mexico's reserve position and creditworthiness, and therefore can be regarded as highly successful (Marino / Volz 2012).

The appropriateness of IMF's non-concessional instruments

Whether the low use of IMF precautionary instruments is a sign of success or of failure is up for debate. The IMF regards the signalling effect of the FCL/PLL as a sign of success. It is not clear, however, whether the reduction of sovereign spreads in the respective countries (Mexico, Colombia and Morocco) was due to IMF precautionary arrangements and how much other factors contributed to the decline of sovereign spreads. Furthermore, not all countries were able to implement strong economic policies through their lending arrangements, reduce their vulnerabilities and strengthen the resilience of their economies. The precautionary facilities can boast only one or two success cases – particularly Mexico.

A major factor in the low use of precautionary facilities is the stigma of using IMF resources and adhering to IMF conditionality. Although there might still be some demand for insurance against the negative effects of external shocks, countries continue to be reluctant to approach the IMF unless they are having acute financing difficulties. The IMF has made several proposals in its "Review of the Flexible Credit Line, the Precautionary and Liquidity Line, and the Rapid Financing Instrument" of January 2014 (IMF 2014e):

- (1) Synchronized arrangements. The 'first-mover' problem could be resolved by coordinating members requesting IMF financial assistance as a group instead of individually.
- (2) Cooperation with Regional Financing Arrangements (RFAs). This proposal could include coordination in co-financing and in consultation among members of RFAs regarding synchronized demands for IMF assistance.
- (3) Support for central bank swap lines. To support a network of bilateral swap arrangements amongst countries, the IMF could cooperate with central banks.
- (4) Pre-qualification for the PLL or the FCL. This measure would allow the IMF to address the first-mover problem because countries would not have to approach the IMF ahead of a formal demand.

Another important issue is the question of access criteria. Since only a few countries have been drawing from the FCL and the PLL the qualification assessments have been rather ad hoc and the predictability of access criteria is unclear. The criteria for the two instruments differ, with the FCL requiring nine and the PLL only five. Clarification and incremental improvements in the assessment criteria are needed. However, there seems to be consensus that the instruments should remain distinct and thus accessible for countries in different circumstances and with different features. This is also an argument for keeping the PLL's ex-post conditionality requirement.

The few countries that used the FCL/PLL tended to use them successively, making the question of exit criteria relevant. This question hinges on the issue of how to measure the external risks that require extended use of the facility, and the idea of introducing commitment fees that could incentivize an earlier exit.

The IMF board has discussed the IMF staff proposals. However, only incremental changes have been made to the 2009 toolkit that had already been slightly changed. Central banks have no appetite to coordinate their bilateral swap policies with the IMF; they insist on their independent role as monetary authorities. There seem to be no concrete options for coordinating with RFAs, which are still in development. Most IMF board members believe that softening access criteria and conditionality could bring about unintended adverse effects.

The IMF toolkit for precautionary lending to MICs, which has not been used much, probably will remain in place until 2017: For the time being, members seem to be unwilling to reserve a larger volume of GRA resources for precautionary purposes. Against the background of the issues discussed above, the IMF Executive Board has adopted only incremental changes to make criteria for accessing and exiting the precautionary facilities more objective. They advise all parties about their eligibility for precautionary funding, using indicators for external stress and institutional strength as objective access criteria (IMF 2014f).

It is difficult to judge the IMF shock facilities for MICs because they have been used so little. Obviously, most MICs did not need the facilities; they had alternative sources of liquidity and were also able to access budget funding. This can be regarded as a positive feature of the emerging GFSN since IMF resources should be accessed only when other sources of finance have been exhausted.

Table 5 gives a detailed overview of the IMF and IBRD shock windows, as discussed in this chapter.

Table 5: IMF and IBRD shock facilities for MICs				
Facility	Eligibility and terms	Purpose	Access limits and conditions	Other aspects
Flexible Credit Line (FCL)	Schedule: 3.5–5 years Instalment: quarterly charges: “Rate of charge plus surcharge (200 basis points on amounts above 300% of quota; additional 100 basis points when outstanding credit remains above 300% of quota for more than three years)”	“Flexible instrument in the credit tranches to address all balance-of-payments needs, potential or actual”	“No preset limit” “Very strong ex ante macroeconomic fundamentals, economic policy framework, and policy track record”	“Approved access available up front throughout the arrangement period, subject to a midterm review after 1 year”
Precautionary and Liquidity Line (PLL) (2011)	Schedule: 3.5 –5 years Instalment: quarterly charges: same as above	“Instrument for countries with sound economic fundamentals and policies”	“250% of quota for 6 months; 500% of quota available upon approval of 1- to 2-year arrangements; total of 1,000% of quota after 12 months of satisfactory progress” “Strong policy frameworks, external position, and market access, including financial sector soundness”	“Large front-loaded access, subject to semiannual reviews (for 1- to 2-year PLL)”
Rapid Financing Instrument (RFI) (2011)	Schedule: 3.5–5 years Instalment: quarterly charges: same as above	“Rapid financial assistance to all member countries facing an urgent balance-of-payments need”	“Annual: 50% of quota; cumulative: 100% of quota” “Efforts to solve balance-of-payments difficulties (may include prior actions)”	“Outright purchases without the need for full-fledged program or reviews”
Development Policy Loan Deferred Drawdown Option (DPL DDO)	All IBRD-eligible borrowers Disbursement: < 3 years, renewable for another 3 years Charges: IBRD loans From date of effectiveness: standby fee of 0.50% p.a. on undisbursed balances One-time front-end fee of 0.25%	Contingent credit line: immediate financing	“Adequate macroeconomic framework and satisfactory implementation”	Can be drawn at any time
Special Development Policy Lending (SDPL)	All IBRD-eligible borrowers Charges: minimum fixed spread (over LIBOR) 200 bps Front-end fee: 100 bps Maturity: 5–10 years Grace period: 3–5 years	“Lending option on exceptional basis for countries approaching or are in a crisis”	“To be eligible for SDPL, a country must have a disbursing IMF-supported program in place, and the SDPL must be part of an international support package.”	
Sources: IMF facilities based on IMF (2013d, 38–39); DPL and DDO based on World Bank (2013, 1–2); SDPL based on World Bank (2012c, 51–52)				

6 Summarizing the assessment and proposals to reform current WB and IMF shock architecture

This chapter summarizes the findings of the assessment and presents recommendations for designing coherent shock architecture. The focus is on recommendations for IDA, IBRD and IMF facilities for LICs, LMICs and MICs. Policy recommendations for the division of labour among IFIs are also outlined.

6.1 Reform proposals for the IFIs' division of labour

While the IFIs' mandates suggest a clear division of labour, their instruments have overlapped during the global financial crisis because the lending capacities of all the IFIs had to be mobilized to prevent severe recessions in developing countries. After reviewing the use and effectiveness of current instruments, it is clear that not all of them have been used as intended and there was less-than-optimal allocation of scarce resources. In anticipation of future needs for shock financing, a holistic perspective of the elements of the GFSN should include not just the IFIs' instruments but also central bank swap lines and the reserve pooling of the Regional Financial Arrangements.

Policy recommendation 1: Review the crisis lending instruments of the WB and other MDBs in the context of the emerging GFSN.

A thorough review of recent IMF instruments resulted in major changes to the concessional facilities and incremental changes to the non-concessional facilities. IDA's instruments have also been reviewed and improved. However, how the IBRD will lend in future crises is still unclear. As was demonstrated during the crisis, in MICs development policy lending can be used in a countercyclical fashion. But it is not clear if the WB needs a short-term instrument such as SDPL and to what extent this instrument should be accessed without an IMF disbursing programme. WB long-term refinancing is not suitable for contingent financing. With great need for infrastructure lending – the G-20 has identified the scarcity of long-term lending as one of the major constraints to global growth – the WB's role in long-term lending should not be compromised in favour of crisis lending. A review of WB crisis lending instruments should consider IMF shock facilities as the prime means to provide loans during crises (and also review other sources of liquidity), and limit the WB to countercyclical lending instruments that would be distinct from the IMF's liquidity provision.

6.2 Proposals to reform the concessional facilities

Proposals to reform the IDA's lending framework

Since IDA's relative weight in terms of volume compared with other IFIs has increased since the outbreak of the global financial crisis, it can be said to have strengthened its role in alleviating shocks. Mandated to play a countercyclical role, IDA has made a major contribution to the increase in short-term funds, despite overlapping tasks among IFIs. However, one problem of the IDA's institutional setting has been institutional

inflexibilities due to three-year replenishment cycles, which make it more difficult to increase concessional funds in the short term. Generally speaking, IDA's institutional set-up could be reformed in two ways: on the funding side, by changing the IDA's funding framework, and on the allocation side, by changing the IDA's allocation mechanism (guidelines) or specific departures from the PBA formula, including instruments for mitigating exogenous macroeconomic shocks in IDA countries, such as the CRW and the IRM.

Policy recommendation 2: IDA should investigate other funding models so as to reduce its dependence on annual donor budget processes.

A number of measures have already improved IDA's financial viability and flexibility in times of exogenous shocks. To reduce its dependence on annual donor budget processes, IDA should study other ways to increase IDA funding in the event of shocks that IDA has already discussed. As regards partner contributions, IDA should further investigate: (i) ways to receive additional donor contributions during macroeconomic shocks, (ii) options to advance flows from future replenishment periods, (iii) options to expand bridge financing by the IBRD and the IFC, and (iv) private-donor debt funding. One innovative approach for emerging markets that was proposed by Leo (2010) and mentioned by IDA (2010c, 10) but has not yet been adopted, is the installation of an IDA blended financing facility.

Policy recommendation 3: IDA should increase the loan volume in its shock windows.

The introduction of two crisis instruments – the CRW and the IRM – signals a paradigm shift from ad-hoc financing to a systematic approach to crises. Although in exceptional circumstances the IDA Executive Directors can approve an increase of the CRW volume, it continues to make up only about 2 to 4 per cent of its envelope. Under IDA17 this is to be reduced to 2 per cent of the total replenishment resources available. Funds used for these shock windows absorb IDA resources needed to finance long-term development. But the volume of these two shock windows should be increased, not decreased, because IDA can help to mitigate future shocks in LICs. There were two other reasons for the small volume under IDA17: the facility was not fully used under IDA16, and in May 2014 (under IDA16) the CRW was being used to alleviate the effects of natural disasters, not to respond to macroeconomic crisis. Nevertheless, by its very nature a contingent facility is not used in times of resilience, and should be available in times of crisis. One measure to minimize binding scarce resources is for Management to inform about the CRW resources that have been used at the IDA17 Mid-Term Review and provide suggestions for reallocating these funds as set out in the report of the IDA Executive Directors on its seventeenth replenishment.

Policy recommendation 4: IDA should review how well the current PBA system and exceptions to it can manage exogenous shocks.

Given the limited pool and fungibility of IDA resources, it is strategic to question whether or not new instruments must be installed to increase exceptions to the PBA formula. Recent reforms should be reviewed to see if they indicate how IDA should further develop. Faster response mechanisms under current rules for allocation should also be considered for development policy lending.

Proposals to reform the IMF's concessional lending framework

The IMF reforms of the lending frameworks for LICs in 2009 and 2013 have significantly contributed to more flexible short-term financing for LICs (and LMICs) in the event of exogenous shocks, and allowed the IMF to better tailor its lending to LICs' needs. In spite of these numerous reforms, it is not clear if the IMF's lending policy is sufficiently differentiated among LICs, particularly in the medium term.

Policy recommendation 5: *In the medium term the IMF should set up an additional contingent financing facility for LMICs.*

One proposal discussed by the IMF (IMF 2009a and 2009b, 2012a) is a precautionary credit line with ex-ante qualification criteria for LICs. If demand for the IMF's shock windows – the RCF and the SCF – remains low in the future, the IMF might design a precautionary credit line for LICs that is similar to the FCL or the PLL in order to provide financial resources with low conditionality in the short term. These innovations would give the IMF a more diversified range of tools for LIC/LMIC contingent financing. Since providing contingent financing is one of the IMF's most important tasks, the introduction of an additional contingent financing instrument for LICs would be appropriate in the medium term, especially because more LICs are better integrated into global financial markets.

Policy recommendation 6: *The IMF should strive to better differentiate the interest rates for LICs and LMICs.*

In 2012, the IMF floated the idea of different interest rates for different types of LICs so that scarce concessional resources could be allocated to those who most need them (IMF 2012a). Since LIC differentiation will increase as many of them graduate, it may be necessary to more clearly differentiate LICs and tailor lending more closely to their needs. However, interest rate differentiation should not undermine the principle of uniformity of treatment.

Policy recommendation 7: *The IMF should increase the RCF annual access limits.*

While the IMF has already approved an increase in cumulative access to the low-conditionality shock facility – the RCF – from 75 to 100 per cent, and to the shock window from 100 to 125 per cent, this is unlikely to suffice. The annual access limits to using the RCF, which amounts to 25 or 50 per cent (exogenous shocks window) of a country's quota per annum, should also be increased – although the concessional envelope is limited.

6.3 Proposals for reforming the non-concessional facilities

Funding for MICs and the related funding framework for IFIs differ fundamentally from LIC funding for two reasons. First, MICs generally have access to a variety of funding sources so IFI funding is viewed as one option among others. Access to IFI funding and the funding terms also play a role; the pricing of funds and the access criteria are decisive. Second, IFIs don't need donor resources for non-concessional funding because they can use capital market funding instead, which makes them able to respond more flexibly to

crises in MICs. However, capital increases for increased lending headroom require one-off donor contributions.

This means that IFIs must have sufficient capital reserves and lending headroom in times of crisis. For now, the IMF's financial firepower, which is mainly being used to mitigate crises in European countries, seems to suffice. It cannot assess future needs for crisis finance in developing countries, where resilience has been strengthened in recent years and macroeconomic management has been rather cautious. Since the strong uptake of IBRD crisis lending from 2009 to 2012, the WB's lending capacity has been decreasing due to the WB's prevailing long-term refinancing, as well as the DPL's relatively long maturities and low interest rates.

With the April 2014 strategic decision to adopt a new financial sustainability framework, the WB increased its lending capacity in order to be able to increase its headroom by about USD 100 billion for the next 10 years. This increased lending capacity strengthens the WB's capacity for countercyclical lending since it is expected that about a third of its lending to MICs will continue to be DPL, which can be used in a countercyclical fashion.

In terms of the non-concessional instruments, our analysis shows that extensive use of the IBRD's regular DPL, and the DPL with DDO, has helped to support countries that were not in full-blown crisis situations that required IMF programmes. This has helped to calm the markets, and was effective for most MICs in 2009 and 2010. In comparison with the crisis response instruments of other IFIs, the IBRD's favourable lending terms for DPLs have clearly encouraged their use, although they have also helped to erode the WB's lending headroom.

Policy recommendation 8: The WB should revive SPDL as a short-term crisis response instrument.

Special Policy Development Policy Lending (SDPL), introduced in 2004 as a dedicated instrument for crisis lending, was only used by Latvia – probably because of its link to an IMF disbursing programme. Since in a crisis situation, tightening financial markets and losses in fiscal revenue typically create the need for countercyclical short- to medium-term lending, a WB short- to medium-term countercyclical instrument – as opposed to short-term liquidity for balance-of-payments purposes through the IMF – is a suitable instrument for the IFIs' crisis response. In the previous crisis, in the absence of balance-of-payments problems in most MICs, DPL was used with long-term maturities. It could therefore be argued that a waiver of the "IMF link" would create more space to use SDPL. However, current conditions give the WB no scope to refinance short- to medium-term loans with the same maturity. The WB's lending headroom would be used up – as it was used up in the past by crisis lending – in an inappropriate manner. Therefore, refinancing options should be explored for SDPL, and for the DDO, that would not use up WB headroom for long-term lending. Such options could perhaps be based on contingent refinancing arrangements with selected member countries.

In the interest of avoiding competition over terms with other IFIs, the interest and maturity of crisis response loans should be adjusted in view of market conditions, risk assessments, and other actors' policies.

Policy recommendation 9: *In light of possible future shocks, the IMF should maintain the FCL and the PLL.*

Making the IMF shock facilities more “attractive” for MICs through clearer access and exit criteria is one way to proceed. The stigma discussion hinges on the general debate on IMF governance, which will culminate in the next quota review and the choice of the next Managing Director. In general, given the likelihood of future shocks that could even more severely impact the MICs, the IMF shock instruments will have to be maintained.

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