TERMS OF REFERENCE
Examining the Feasibility of a Countercyclical Lending Mechanism for the Management of Exogenous Shocks

1. Background

The Countercyclical Loan Instrument

The Agence Française de Développement (AFD) has developed a unique countercyclical loan mechanism to assist low income countries (LICs) with the management of large and unexpected events, by allowing them the possibility of suspending their debt repayments during times of distress.

AFD offers LICs a number of grace periods - both fixed and variable - upon agreement of a loan contract, which is designed ex-ante to match as closely as possible the frequency of their export shocks. These grace periods can be activated through the materialisation of pre-established triggers (for example, an export to GDP ratio falling below 5%). AFD does not, however, compensate LICs for losses due to export declines (such as in an insurance scheme). Instead, they simply aim to support the prevention of future debt crises.

The Economic Basis for Countercyclical Loans

Research by AFD revealed that 70 percent of total LIC exports were unprocessed primary commodities and for a sample of 24 HIPCs, export revenues had fluctuated from 42 percent to 205 percent of their average level from 1970 to 2005. On average, a deviation of 5 percent of current exports compared to LICs past 5-year average represented 1.5 percent of LICs' GDP. AFD research also showed that LIC export price volatility and commodity export dependence made their export revenues especially vulnerable to export shocks. Additionally, over the past 30 years, 59% of the debt crises in HIPCs appeared to be preceded by export shocks. AFD concluded that further negative shocks on LICs' exports earnings are likely to threaten these countries ability to service their debt obligations.

As of the end of 2013, AFD had granted fourteen countercyclical loan contracts to five countries in Sub-Saharan Africa, at a total cost of approximately EURO 295, 500, 000. The first of these contracts was issued in 2007 to assist Burkina Faso with cotton price stabilisation and since then four other countries: Senegal, Mali, Tanzania and Mozambique, have been granted similar financial arrangements to pursue different projects.

AFD primarily targets LICs. In particular, those LICs that have received debt relief through the IMF/World Bank Highly Indebted Poor Countries Initiative (HIPCs). The

main goal of AFD is to ensure that LICs preserve their restored debt sustainability positions in the face of future exogenous shocks.[1]

At the end of 2015 the Government of Grenada secured the first-ever "hurricane clause" as part of its debt restructuring agreement with Paris Club Creditors. This suggests there is growing interest in introducing new forms of countercyclical mechanisms[2].

Furthermore, the German Federal Ministry of Economic Cooperation and Development (BMZ) has also shown considerable interest in countercyclical loans.

Commonwealth Workshops on Countercyclical loans

A priority area for the Commonwealth Secretariat in its strategic planning cycle (2014/16) is to support the debt and financial sustainability of developing countries, specifically the smallest and most vulnerable.

The Commonwealth Secretariat has been promoting the roll-out of countercyclical loans. Since they are one solution to help developing countries deal with the impact of exogenous shocks and avoid the unnecessary build-up of public debt. So far, with support from AFD, the Commonwealth Secretariat has held three workshops on this topic with its member states in the Caribbean, Pacific and Africa. Using the information collected in this study, a workshop will be held in Paris with creditors and international financial institutions to discuss supply side issues, as well as the feasibility of applying the countercyclical loan mechanism more broadly; that is, across several loan portfolios and countries.

AFD discussions with international organisations on this issue, as well as feedback from the Commonwealth's workshops, has brought to the Secretariat's attention possible supply side issues that would need to be addressed if this type of mechanism is to be adopted by other institutions. The IMF has done some work on these precautionary type mechanisms and concluded that while useful, they can present a number of challenges. Similar comments have been uttered by World Bank colleagues who have a preference for crisis loans and disaster risk management insurance, which the World Bank currently offers. Other skeptics warn of possible liquidity management issues, especially where countercyclical loans are applied on a broad scale across countries and portfolios.

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[1] A number of authors are proponents of such state contingent loan mechanisms. For example see:

- Cohen et al 2008. "Lending to the Poorest Countries: A New Counter-Cyclical Debt Instrument", OECD Development Centre Working Paper 269, OECD: Paris.

[2] http://www.clubdeparis.org/en/communications/press-release/rescheduling-of-grenada-s-debt-and-introduction-of-hurricane-clause-19

The most commonly cited advantages and disadvantages of this type of instrument are[3]:

Advantages

Debtor Countries

- Prevention of debt crises
- Ex-ante disciplining effects

Creditors (Mainly Development Agencies)

- Lower risk
- Lower degree of concessionality

Disadvantages

Debtor Countries

- Lower grant element[4]
- Opportunity costs for the debtor
- Lower volume of investments in development programmes
- Disincentive for politicians

Creditors (Mainly Development Agencies)

- Increase in administrative costs
- Liquidity management challenges and negative spillover effects for other lending
- Lower competitiveness vis-à-vis other donors
- Moral hazard problems
- Limited applicability

2. Objectives and Purpose

The objective of this project is to produce a technical paper that outlines the supply side challenges of implementing a countercyclical loan mechanism and to offer recommendations for their mitigation. The project will also seek to highlight the advantages for creditor institutions in offering a countercyclical loan contract.
The findings will inform discussions, planned for later in the year, between the Commonwealth Secretariat, AFD, the Paris Club Creditors and other International Financial Institutions.

[3] Berensmann, K. (2010). "How to Prevent and Resolve Debt Crises in LICs?" German Development Institute, Discussion Paper, 1/2010, ISSN 1860-0441.
[4] In particular, are there additional financial costs to a borrower for taking out a CCL compared to a non-countercyclical loan?

3. Required Outputs

A report and presentation is required and should include the following analysis:

- A detailed review of AFD's countercyclical loan portfolio. This should include i) the rationale for implementing countercyclical loans; ii) a summary of AFD's countercyclical loan portfolio and utilisation of this instrument; and iii) associated costs and benefits of implementing this instrument for both debtors and creditors (based on those outlined in the background section of this terms of reference). This should be supported by financial analysis and modeling where necessary.
- A summary of the supply side challenges that restrict the roll-out of individual and broad-based application of countercyclical loan contracts. This should draw from analysis outlined in the previous section, as well as other literature on this subject and discussions with other international organisations. Use of financial scenario analysis may be required to illustrate the financial and economic trade-offs.
- A review of existing instruments with similar objectives and characteristics[5]. An assessment of the merits of different approaches is required, as is a summary of reasons why institutions have preferred other instruments.
- Recommendations on mitigating measures or arrangements to overcome highlighted supply side challenges.

4. Location and Duration

The project will be completed mainly through desk work. However, some travel may be required for discussions with AFD, BMZ, the Paris Club creditors and other International Financial Institutions (to be agreed with the Commonwealth Secretariat).

5. Reporting

A proposed report structure will be agreed with the Economic Affairs Division within the first 20 days of the contract. The following 12 days will be spent completing a draft version of the report and presentation. This will then be submitted to the Economic Affairs Division for review. 3 working days have been allocated for final revisions to the report and presentation. The overall input for the assignment is estimated to be 35 working days. The specific terms of reference will be agreed when finalising the contract.

The activity schedule for the assignment is foreseen as follows:

[5] This could include other shock facilities and GDP-linked bonds.

Indicative time schedule (working days)	Simultaneous Activity Description
Day 1-20	Desk research, data collection, interviews and submission of draft structure
Day 21-32	Write-up and submission of draft report and presentation
Day 33-35	Completion and submission of final report and presentation

6. Estimated Budget

The budget for this project is £17,500 + travel and daily subsistence allowances.

7. Expert Profile

Senior Consultant(s) – 35 working days

I. The consultant(s) must possess degrees in finance, economics, mathematics, or any other related discipline at Masters and/or Phd level.
II. The consultant(s) should be a financial, micro or macro economist with at least ten (10) years international experience and preferably with at least five (5) years of experience researching issues related to loan/debt instruments or the economics of financial markets;
III. The consultant(s) should ideally possess extensive experience working on policy in developing countries.
IV. The consultant(s) should be fluent in French.
V. Experience of working on issues related to countercyclical loans is desirable.

Please apply for this position by submitting a CV and a short cover letter (2-3 pages) explaining your relevant experience and your approach for completing this work. Applications to be received by Friday 18th of March.

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