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# Insurance as a Tool to Reduce Vulnerabilities

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John Williamson's excellent chapter addresses one of the core tasks of the Fund. There are various views on the role of the IMF in lowincome countries, but there should be little doubt that the Fund has an important role to play when it comes to shocks that result in severe balance of payments problems. Taking the Fund's Articles of Agreement, this role is at least two-fold. First of all, it includes monitoring economic developments and providing policy advice on how to better prepare for shocks and how to respond once a shock hits. Second, the Fund is to provide countries with resources to correct balance of payments problems without taking measures destructive of national or international prosperity. This rightly puts a shock for one country in a global perspective.

Unfortunately, many shocks are exogenous, that is, beyond the control of a country's authorities. Although shocks may be exogenous, they are no surprise. We know for a fact that the average low-income country has a major natural disaster every  $2\frac{1}{2}$  years and experiences a commodity price shock every  $3\frac{1}{2}$  years. As such, it is not beyond, but within the control of a country to anticipate to a shock in order to mitigate its impact. I therefore fully agree with Williamson's notion that a country's vulnerability is a function of both the occurrence of shocks *and* the quality of its policy reactions. I also generally agree with what seems to be a core element in his proposals, that is: *matching*, for example matching good times with bad times.

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## Insurance Through the Market?

Let me now comment on a number of Williamson's thoughtprovoking ideas. His first proposal is to have a fresh look at international commodity stabilisation agreements, especially for non-oil commodities.<sup>2</sup> I have three observations.

First, I agree that many stabilisation schemes in the past had too many objectives. This is contrary to the well-known rule of the first Nobel Prize winner for economics, Jan Tinbergen, implying that one instrument should be employed to reach one goal. Arrangements did not only aim at stable prices, but also at reasonable prices, guaranteeing incomes, protecting vested interests, and so on.

Second, stabilisation schemes not only require excellent early detection systems and timely public interventions, but they also presuppose strong political commitment to save the surpluses in good times to use them in bad times. But from the Nobel Prize winners Kydland and Prescott we have learned that this idea of intertemporal matching bumps into time-consistency problems. Are politicians able to withstand popular pressure and to stick to the rules?

Third, the success of stabilisation schemes hinges on the assumption that the price shock is temporary and will revert itself in the short run. In other words, counter-cyclical interventions require the existence of a cycle in order to smooth prices over time. However, (IMF) research indicates that taking a forty-year period (1957-98), shocks took more than 5 years or were even permanent for two-thirds of all major commodities, i.e. 27 out of 44 (Paul Cashin *et al.*, 1999). The actual lack of matching opportunities over time seems to be the main reason why the various international agreements, for example for sugar, tin and coffee, turned out to be financially unsustainable and broke down. Of course, it is hard to predict the duration of an adverse price shock, but wouldn't it be wise to err on the side of caution and to focus on adjustment towards export diversification rather than to set up new large-scale stabilisation schemes?

An alternative strategy would be to focus on the micro-level: governments can promote the development of a financial sector that offers all kinds of insurance or other market-based mechanisms to manage risks (microfinance, catastrophe bonds, forward contracts, etc.). Rather than technical constraints, the thin financial markets constitute the main

<sup>&</sup>lt;sup>2</sup> Indeed, an agreement for oil seems to be most logical at the moment, but I agree that given the strategic importance of oil, this might be a non-starter.

problem in low-income countries in this respect. During 1985-2000, for example, less than 1 percent of low-income countries' total losses from natural disasters were covered by insurance. It is estimated that less than 2 percent of the volume of futures and options instruments can be attributed to developing countries (IMF, 2003).

Therefore, advice from international organisations, especially the Fund and the Bank, bilateral donors, and commercial banks will be crucial. In this respect, it is worth mentioning the recently created the Netherlands Financial Sector Development Cooperation, being a concrete example of a public-private cooperation aimed at promoting financial sector development in emerging market economies, transition countries and low-income countries. It is supported by three ministries (Finance, Development Cooperation, Economic Affairs) and four major commercial banks and the FMO (Finance for Development Organisation).<sup>3</sup>

More specifically, the World Food Programme (WFP) has started an interesting pilot in this area. The objective of the pilot is to contribute to an *ex ante* risk-management system to protect the livelihoods of Ethiopians vulnerable to severe and catastrophic weather risks. The pilot uses a weather derivative to demonstrate the feasibility of establishing contingency funding for an effective response in the event of low precipitation. The WFP will buy an insurance policy that pays out when the rainfall in Ethiopia is below a certain level. In years of good or mediocre rainfall, the WFP will pay interest, out of its income from donors, but when drought comes, bondholders will lose their principals. Should disaster strike, the WFP will have ready cash to support farmers. This scheme should be up and running by 2007. Similar activities are part of the Commodity Risk Management (CRM) initiative of the World Bank with financial support of a number of donors (Panos Varangis *et al.*, 2004).

## Insurance By the IMF?

This brings me to the second of Williamson's proposals, which relates to the Fund's role of providing financial assistance. He proposes to restore the Compensatory Financing Facility (CFF), the Fund's anti-shock facility, in its earlier form in order to facilitate its use. The economic literature seems to make a reasonably strong case for the principle of

<sup>&</sup>lt;sup>3</sup> See www.nfx.nl for an overview of FMO's activities.

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providing external finance to help support domestic absorption of a temporary shock and to support policy reforms to smooth adjustment to more *permanent* shocks. Apart from the technical complication how to distinguish between the temporary and permanent shocks, as noted earlier, practice is understandably more nuanced. Even in the case of a clearly permanent shock, temporary financing may be warranted to smooth the adjustment path to the new equilibrium, as noted in the Fund's Articles. I expect that in most cases addressing the shock requires both financing and adjustment. The obvious route would then be to augment existing PRGF arrangements, preferably with only marginally increasing conditionality. Since the start of the ESAF and PRGF, one out of four arrangements has been augmented, with an average augmentation of nearly 1 percent of GDP. In 2004, the IMF also decided that either a new PRGF or an augmentation of an existing PRGF could be justified when a country is hit by a shock resulting from a multilateral trade agreement. In my view, this move is welcome and consistent with another purpose in the Fund's Articles, namely to facilitate the expansion of international trade - in fact, a third reason why the Fund has an important role to play in relation to shocks. More recently, the Fund introduced a new shock facility for low-income countries that do not yet or no longer have a Fund arrangement. It will be important that the actual use of this facility should meet the same criteria as normal PRGF programmes. This will avoid inefficient facility-shopping by members and promote equal treatment.

The practice of the next years will show whether there is still a rationale for a CFF for low-income countries. Let me nevertheless make three other comments on the CFF. First, it might be worthwhile to consider reintroducing an oil-import element, which was added temporarily from November 1990 to December 1991 when oil prices rose sharply as a result of the first Gulf War. Second, a good thing of the CFF is that its eligibility criteria explicitly include that the shortfall should be temporary by calculating the deviation from the trend over a five-year period. Third, the criteria require that the shortfall should be beyond a country's control. This mitigates what is called the Samaritan's dilemma: governments may have less incentive to undertake structural reforms when they expect the Fund, with the multilateral and bilateral donors in its wake, to come to their rescue. In addition to addressing the humanitarian needs, it is important that these extra funds are effectively put into use to reduce vulnerability for the medium turn. As with all kinds of insurance, moral hazard needs to be minimised.

# **Insurance Through Further Debt Relief?**

Avoiding the Samaritan's dilemma is also an important element in the Birdsall-Williamson proposal to compensate HIPC countries for exogenous shocks that push their debt burden again above the HIPC norm. In my view, the proposal comes close to what is now happening under the name of topping up, the costs of which are part of the overall HIPC Initiative. Moreover, this exercise is largely, if not fully, overtaken by the recent initiative for multilateral debt relief, as discussed by Brilman, Jansen and Van Koesveld in this volume. Additional debt relief will enlarge a country's fiscal space to reach the MDGs and comes down to a form of budget support. Finally, for the post-HIPC situation as well as other low-income countries, we should in principle apply the new and forward-looking debt sustainability framework that is being developed by the Fund and the Bank. This framework is meant to prevent debt crises, notably by providing grants, rather than to solve them *ex post*.

#### **Possibilities for Self-Insurance?**

The Samaritan's dilemma also brings us back to the notion that a country's vulnerability is a function of both the occurrence of shocks and its own policies. These policies should include structural measures, notably export diversification, but also monetary and fiscal policies as a kind of self-insurance. Regarding fiscal policies, Williamson got inspired by the European Stability and Growth Pact, especially by its peer monitoring mechanism. As part of strengthening and clarifying the Pact, it has been decided to pay more attention to the extent to which countries can and should match good and bad times over the economic cycle. Second, the logic of the Golden Rule is intuitively appealing, as it should safeguard investments during economic downturns. This touches on the new discussion in the Fund and the Bank on what is called creating fiscal space for public investment. A focus on the current balance, however, guarantees neither macroeconomic stability nor debt sustainability, not to mention the quality of investment. At least, the Golden Rule should be accompanied by a debt rule, like in the UK. Additional debt may be compensated by an increase in assets, but we should note that debts are certain, while the value of assets will only be known in the future. In this sense, the Golden Rule may in fact run the risk of creating another kind of balance sheet mismatch. I prefer that investment expenditures are an integral part of the budget and overall priority-setting.

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# **Insurance Through Currency Matching?**

The last and potentially most promising idea is Williamson's support of the Eichengreen-Hausmann proposal. It intends to solve the so-called original sin, implying that developing countries are hardly able to borrow in their own currencies, which results in a currency mismatch problem. I have a number of general observations. First, an important issue is the question of whether the new bonds issued by the multilateral banks will gain the interest of private investors. The answer probably depends on the risk and return characteristics of the newly created bond. It seems likely that the required return on new bonds probably has to exceed the return on US dollar bonds in order for investors to buy them. As a consequence, the interest rate that multilateral banks will require for local currency loans to developing countries will also be higher than on dollar loans. This implies a trade-off for governments: either they borrow in their own currency and pay a somewhat higher interest rate or they maintain their exposure to exchange rate depreciations with large potential consequences for financial stability in the long run. The viability of the Eichengreen-Hausmann proposal therefore depends on the question of whether risk-return features can be such that both the lenders and the borrowers of funds will be willing to participate in this new market. Does a basket of developing countries' currencies provide sufficient opportunities for risk sharing? Recent history has shown that in times of financial distress, developing countries' exchange rates not seldomly tend to move in the same direction. The transmission of exchange rate shocks throughout the Asian crisis countries and the devaluation of the Brazilian real following the Russian crisis are merely examples of the many episodes in which exchange rate shocks in one or more countries have jumped over to other countries. This limits the degree to which a basket of currencies provides risk-sharing opportunities.

A second and more practical question is how the multilateral banks will maintain the matching of assets and liabilities. To assure a liquid market, it seems preferable to fix the composition of the basket of currencies. But then the portfolio of outstanding loans to developing countries on the asset side should also have a fixed composition in order to assure the matching of assets and liabilities. This implies strict constraints on the provision of loans by the multilateral banks, which seems very undesirable. Indeed, lending policies should be based on countries' performance and opportunities rather than the banks' portfolio considerations. This argument does not deny the possibility that the multilateral banks start with adopting the proposal for only part of their portfolios. For developing countries themselves, keeping some debt denominated in foreign currency would have the advantage of keeping the discipline not to engage in competitive devaluations. Third, Hausmann and Eichengreen propose to use inflation-indexed loans to remove any perverse incentives for governments for creating excessive inflation. The question is which inflation index should be used. To fully eliminate the moral hazard problem, the inflation index should be composed or at least checked by an institution that is independent of all the stakeholders involved. A good starting point could be to include only those developing countries that comply with the Special Data Dissemination Standard (SDDS), which is part of the Fund's surveillance tool kit.

It seems that this proposal, too, brings us back to the role of the IMF with regard to shocks in developing countries. Through monitoring, policy advice and temporary finance the Fund can assist countries in better anticipating and responding to shocks. John Williamson has put on the table a number of very stimulating proposals to reduce the vulnerability of developing countries. The bottom-line seems to be that when we cannot escape bad luck, we should at least ensure that it is matched by good policies and good instruments! Most of his proposals rightly comprise an element of softening fluctuations over time by a kind of matching or insurance. Since this is the core business of both public and especially private banks and insurance companies, it seems natural that they are closely involved. In my view, this avenue is very much worth exploring further. I am pleased to note that the Fund and especially the Bank have taken up this important challenge as part of their work programmes.

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