THE ROLE OF MULTILATERAL GRANTS IN FINANCING THE MDGs

COMMISSION FOR AFRICA BACKGROUND PAPER

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Development Finance International

September 2004

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CHAPTER 1: INTRODUCTION

Since 2000, the international community has switched large amounts of development financing provided by multilateral lending organisations (IDA, AfDB and AsDB), from highly concessional loans to grants, for low-income countries, notably in Africa. This followed a similar move by most bilateral donors, which in the 1990s shifted to grants for HIPCs and other low income countries (LICs).[1] In the context of a massive global campaign to reduce low-income country external debt, it was also seen as a way to finance the Millennium Development Goals (MDGs) without compromising LIC long-term debt sustainability.

In 2003-04, in the context of the latest replenishments of multilateral organisation funding by bilateral donors, and given continuing concern over LICs' high debt to multilateral institutions, as well as higher prospects of bilateral grant funding for development, there has been pressure to increase multilateral grants further and to extend them to a wider range of countries. The financing pattern over the next 3 years will be especially critical for Africa to meet the MDGs by 2015, as most development projects take six to nine years to implement and become fully productive.

This paper examines the role of switching multilateral funding from loans to grants, in the cost-effective financing of the MDGs for African countries. It aims to do the following:

- Review the recent trends in multilateral institution resources and funding, and consider the proposed resource allocation needs for their forthcoming replenishments;
- Review proposed frameworks for allocating grants in their forthcoming replenishments;
- Consider the advantages and disadvantages of increasing or broadening grant allocations.

Most of the recent discussion has focussed on IDA, the largest multilateral provider of resources, and its 14th replenishment. Given that other major regional providers, such as the African and Asian Development Banks, have followed IDA's lead so far on grant provision, this note focuses on IDA.

CHAPTER 2. IDA GRANTS

2.1 IDA Resources and their Allocation[2]

IDA resources available to the poorest countries rose by only 40% between 1997-99 and 2003-05, but IDA is now requesting a 32% increase to a projected SDR 23.1 billion[3] in 2006-08. This request is based on maintaining its share of overall ODA flows, in the context of enhanced donor commitments since Monterrey of about $18.5 billion per year.[4] It is also based on country-by-country projections of the resources required to implement PRSPs and Country Assistance Strategies (CAS), as well as opportunities to scale up assistance particularly in Africa and South Asia where there is greatest need.

Allocation of IDA resources among countries is determined using a Performance Based Allocation (PBA) system, with actual commitments depending on whether countries meet performance triggers. As shown in Table 2.1, African countries (mostly HIPCs) have been the main beneficiaries of recent increases: their funds have increased by 230%, and to 49% of IDA's total. The main losers have been Europe and Central Asia, and Latin America and the Caribbean. Under IDA 14, Africa and South Asia are projected to receive large increases, with a higher share to African non-HIPCs (mainly Nigeria).

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[1] See Johnson, Martin, Bargawi (2004) for more discussion of these issues.

[2] See IDA14, June 2004 and IDA July 2002 for more details.

[3] All IDA analysis is in SDRs. 1SDR = 1.466 US$ at end-June 2004.

[4] If IDA were to try to keep its share of the funding needed to attain the MDGs, which have been estimated at US$30-50 billion a year, it would need an increase of 52 - 86%.

Table 2.1 IDA Resource Allocation by Region

Region	IDA 11 (FY97-99)[1] actuals		IDA12 (FY 00-02)[2] actuals		IDA 13 (FY 03-05)[2] estimate		IDA 14 (FY 06-08) projections	
	SDR bn	%	SDR bn	%	SDR bn	%	SDR bn	%
Africa	4.9	38.3	7.2	48.0	8.7	49.0	11.3	49.0
HIPCs*	4.4	34.5	6.4	42.7	7.5	42.1	9.6	41.6
non-HIPCs*	0.3	3.8	0.8	5.3	0.8	4.5	1.4	6.1
South Asia	4.2	32.2	3.9	26.0	5.5	30.7	7.3	31.5
East Asia	1.1	8.6	1.8	11.8	1.7	9.7	2.2	9.6
Europe & Central Asia	1.6	12.4	1.2	7.7	1.1	6.3	1.1	4.6
Middle East & North Africa	0.3	2.3	0.3	2.1	0.3	1.7	0.7	3.0
Latin America & Caribbean	0.8	6.1	0.7	4.3	0.5	2.7	0.5	2.3
Total (SDR billions)	12.9	100.0	15.1	100.0	17.8	100.0	23.1	100.0

* excludes regional projects. [1] excludes China and Egypt. [2] Excludes HIPC debt service grants. Actual commitments for FY03 and projections for 04-05.
Source: World Bank

2.2 Financing IDA

IDA is financed on a 3-year basis through a process known as replenishment of resources, comprised of new donor commitments, donor funds carried forward from the previous replenishment[5], IDA internal resources including repayments by IDA borrowers, and transfers from the net income of the World Bank's hard lending window (the IBRD). Table 2.2 summarises the main components of IDA financing for IDA12 and IDA 13. New donor commitments have historically accounted for well above half, and nearly 70% of them are provided by the G7 (United States 20%; Japan 16%; Germany 10%; United Kingdom 10%; France 6%; Canada 4% and Italy 4%), followed by Sweden, the Netherlands and Switzerland. Internal IDA resources now account for around 40%, but have been rising fast recently as IDA principal repayments fall due. Other sources have declined as a share of the total.

Table 2.2: Funding Sources for IDA 12 and IDA 13

	IDA 12 (FY00-02)		IDA 13 (FY 03-05)	
	SDR billion	%	SDR billion	%
Donor contributions*	8.6*	56.6	10.0	54.9
Carryover from previous			0.2	1.1
Internal IDA resources	5.9	38.8	7.3	40.1
IBRD net income	0.7	4.6	0.7	3.8
Total	15.2	100.0	18.2	100.0

*includes small carryover from IDA 11
Source: World Bank

Discussions on how to fund the IDA14 replenishment of SDR 23.1 billion began in early 2004. One option is to maintain IDA13 funding proportions, implying donor commitments of SDR 12.7 billion, internal IDA resources (including carryover) of SDR 9.5 billion, and IBRD income of SDR 880 million.

However, a key issue is financing IDA14 is the proportion of IDA14 to be provided as grants, because grants reduce IDA's income over time due to lower repayments of loan repayments, service charges and commitment fees (known as IDA reflows) by IDA borrowers (see Section 2.3.2. below).

2.3 IDA Grants

2.3.1. Framework for Grants Under IDA 13

At the time of the IDA13 replenishment, it was agreed to increase the concessionality of resources to the poorest and most vulnerable IDA countries by expanding grants to 18-21% of overall IDA resources. The mid-point of this range would imply IDA 13 grants of SDR 3.5 billion.

Countries eligible for receiving IDA grants, rather than loans, are as follows:

- the poorest with a per capita income of not more than $360/year,
- debt vulnerable with expected long-term present value of debt to exports ratio of 150% or above, after all possible debt relief options have been exhausted, and
- post-conflict countries.

[5] This is the difference between sources of IDA funding over a 3-year period and what is committed to countries.

In addition to providing a proportion of overall country programmes as grants, it was also agreed that grant rather than loans would fund emergency programmes to recover from natural disasters (floods, earthquakes or droughts), and anti-HIV/AIDS programmes, in IDA-only countries.

Table 2.3 sets out the grant categories and shares available in principle under IDA13 and what has actually been delivered in FY2003. For example, debt vulnerable countries can in principle receive 40% of IDA13 in grants whereas in FY2003 the actual share was 27%. Grants accounted for 17% of total IDA commitments in FY2003, below the projected 18-21% for IDA 13. To date over 50% of IDA13 grants have been used for social sectors. Grant use has been mainly concentrated in Africa (82%) and South Asia (14%),[6] and the largest recipients are Ethiopia, Afghanistan, Zambia, Mozambique, Uganda and Ghana.

Table 2.3: IDA13 Grants Allocation

Classification	% grants of country IDA13 allocation (principle)	% allocation of grants (FY03 actual)	Grants as % of total IDA 13 financing (FY03 actual)
Post-conflict	Up to 40%	25%	4%
Debt vulnerable (expected long-term PV/XGS > 150% after debt relief) & poorest IDA countries (per capita GNP < $360)	Up to 40%	27%	6%
Poorest IDA countries (per capita GNP < $360)	Up to 23%	19%	3%
Total			17%

2.3.2. Proposed Framework for Grants Under IDA14

The proposed framework for IDA14 grants would use debt sustainability as the key allocation criterion.[7] IDA will establish *a priori* the level of grants each country requires to reduce its risk of debt distress, such that the most debt distressed receive 100% grants, and the least receive 100% loans.

The proposed framework also links grants to a country's policy performance, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA) score, on the basis that better performing countries are able to bear a higher debt burden and therefore have less need for grants. Table 2.4 below sets out the proposed debt sustainability thresholds for strong, medium and poor performing countries.[8] In the proposed IDA14 framework, debt sustainability will be measured using three indicators: PV of debt/GDP, PV of debt/exports and debt service /exports[9].

Table 2.4: Debt Sustainability Thresholds and Policy Performance for IDA14

Debt sustainability indicators	Country Policy and Institutional Assessment score		
	Strong (CPIA ≥ 3.6)	Medium (2.9 ≤ CPIA ≥ 3.6)	Poor (CPIA ≤ 2.9)
PV of debt/GDP	60	45	30
PV of debt/exports	300	200	100
PV of debt/revenue	250	200	150
Debt service/exports	35	25	15
Debt service/revenue	40	30	20

Source: IMF World Bank

[6] See IDA October 2003 for more details.

[7] It is not yet clear whether this will be the only criterion, as some donors indicated in the most recent discussions a wish to retain grants for emergency and anti-HIV/AIDS programmes.

[8] For more details, see IDA June 2004.

[9] The PV/budget revenue and debt service/budget revenue have been dismissed by the BWI on the flimsy grounds that there is a moral hazard of reduced revenue collection by governments and the non-availability of accurate revenue date. There is no evidence to support the former and the IMF publishes comprehensive budget revenue data for all PRGF countries. See Martin, Johnson and Bargawi 2004 for more details.

By assessing each country's debt ratios, in comparison with the thresholds set out above, its eligibility for IDA grants will be determined on the basis of a 'traffic light system for lending' as follows:

- If a country is more than 10% below the threshold (ie debt sustainable), a 'green light' indicates it will receive 100% IDA loans,
- If a country is borderline, defined as being between 10% above and 10% below the threshold, a 'yellow light' indicates it will receive 50% IDA loans and 50% IDA grants,
- If a country is more than 10% above the threshold (ie with unsustainable debt), a 'red light' indicates it will receive 100% IDA grants.

Using this traffic light lending system and 2002 debt data, Table 2.5 below illustrates country eligibility for grants under IDA14. The main points to note are as follows:

- The projected amount of IDA14 grants is SDR 4.9 billion (21% of IDA14), an increase of SDR 1.4 billion on the estimated IDA 13 grants of SDR 3.5 billion (19.5% of IDA 13).
- The number of IDA-only countries eligible for IDA14 grants is projected to fall to 34, compared with 43 under IDA13. Eligible African countries will fall from 30 to 22.
- Thirteen countries which received IDA13 grants will not be eligible for IDA14 grants. These include Djibouti, and 12 African HIPCs (Benin, Burkina Faso, Chad, Ghana, Kenya, Madagascar, Mali, Mauritania, Mozambique, Niger, Tanzania, Uganda). Ten of these are post-HIPC completion point and Madagascar is projected to reach its completion point by end-2004 and therefore their ratios have been reduced by HIPC relief. Of the other two, Kenya had sustainable debt levels without HIPC, and Chad is expected to become sustainable due to large oil revenues.
- Five African countries not eligible for IDA13 grants will receive IDA14 grants. These include four HIPCs (Cameroon, Comoros, Liberia and Sudan) and one non-HIPC (Lesotho).

While the actual volume of IDA resources for each country is set out in a country's CAS, its performance is assessed annually through the CPIA system. Therefore the actual level of grant assistance to be provided each year during IDA14 will be reviewed annually, as is done in IDA13.

Table 2.5 IDA11 - IDA 14 Assistance

	IDA 11 (FY97-99)	IDA 12 (FY00-02)	IDA 13 (FY03-05)		IDA 14 (FY06-08)		
	Total[1] (SDR mn)	Total[1] (SDR mn)	Total[1] (SDR mn)	grant eligibility[2]	Total[1] (SDR mn)	% grants[3]	Projected grants (SDR mn)
AFRICA							
HIPCs							
Benin	62	67	92	debt vulnerable	150	0%	0
Burkina Faso	78	220	272	debt vulnerable	274	0%	0
Burundi	0	101	151	post-conflict	173	100%	173
Cameroon	189	78	118	-	195	50%	98
Central African Republic	0	34	2	income per capita	9	100%	9
Chad	52	163	151	income per capita	70	0%	0
Comoros	21	14	6	-	9	100%	9
Congo, Dem. Rep.	0	400	960	post-conflict	1009	100%	1009
Congo, Rep.	0	72	73	post-conflict	64	100%	64
Cote d'Ivoire	372	190	89	post-conflict	229	100%	229
Ethiopia	565	689	832	debt vulnerable/ natural disaster	1469	50%	735
Gambia, The	39	36	6	debt vulnerable	22	100%	22
Ghana	317	402	506	income per capita	538	0%	0
Guinea	113	129	38	other IDA/HIV AIDs	86	50%	43
Guinea-Bissau	19	39	7	debt vulnerable	11	100%	11
Liberia	0	0	292	-	41	100%	41
Madagascar	302	322	314	income per capita	468	0%	0
Malawi	191	79	193	debt vulnerable/ natural disaster	225	50%	113
Mali	116	249	153	income per capita	236	0%	0
Mauritania	63	174	89	income per capita	99	0%	0
Mozambique	333	346	312	income per capita /HIV AIDs	375	0%	0
Niger	146	167	138	debt vulnerable/ HIV/AIDs	145	0%	0
Rwanda	127	157	159	debt vulnerable/ HIV/AIDs	203	100%	203
Sao Tome and Principe	0	8	5	debt vulnerable	4	100%	4
Senegal	284	351	124	-	220	0%	0
Sierra Leone	0	102	135	post-conflict	91	100%	91
Somalia	0	0	0	-	0	0%	0
Sudan	0	0	227	-	399	100%	399
Tanzania	201	621	738	income per capita	1089	0%	0
Togo	81	-	3	income per capita	18	100%	18
Uganda	402	613	613	debt vulnerable	757	0%	0
Zambia	370	285	190	debt vulnerable/ HIV/AIDs	194	100%	194
Total HIPCS	**4443**	**6108**	**6988**		**8872**		**3464**
(% of total Africa)	90.1%	84.4%	80.1%		78.2%		
Non-HIPCs							
Angola	4	25	126	post-conflict	220	100%	220
Cape Verde	58	25	20	-	19	0%	0
Djibouti	18	39	25	other IDA/HIV AIDS	9	0%	0
Eritrea	79	182	94	post-conflict	43	100%	43
Kenya	203	279	335	income per capita	462	0%	0
Lesotho	20	31	26	-	30	50%	15
Nigeria	0	535	668	-	1029	0%[4]	0
Zimbabwe	107	4	2	-	259	0%[4]	0
Total non-HIPCS	**489**	**1120**	**1296**		**2071**		**278**
Regional projects	0	11	437		401		
Total Africa	**4932**	**7239**	**8721**		**11344**		**3742**
Total South Asia	4169	3946	5454		7292		581
Total East Asia	1112	1770	1718		2227		222
Total ECA	1598	1084	1126		1058		238
Total LAC	793	651	476		542		92
Total MNA	273	279	282		685		0
Total All IDA Countries	**12872**	**14968**	**17783**	**3468**	**23145**		**4874**
Grants as % of total				**19.5%**			**21.1%**

[1] Actuals for IDA 12 and projections for IDA13 and IDA14. [2] Share of commitments. [3] Based on traffic light lending system, using 2002 data. [4] Blend or hardened term country (100% credits).

Source: IDA

2.3.3. Advantages and Disadvantages of IDA14 Framework for Grants

The main advantages of the proposed framework are:

1) it simplifies the system for grant allocation, by eliminating criteria related to income level and post-conflict status.
2) it targets the instrument of grant allocation more clearly on a problem it can help resolve – that of potential renewed unsustainability of debt.
3) it eliminates the tying of grants to particular types of programmes – emergency and anti-HIV/AIDS. Such tying ran a major risk for some countries of skewing country spending and aid mobilisation decisions to grant-funded priorities and therefore its elimination is desirable.
4) It introduces a link between grant allocation and country policy performance, on the basis that sustainable debt levels vary according to performance.

However, African governments also perceive major disadvantages with this framework:

1) The link between grant allocation and country performance is perverse, appearing to imply that countries with less good performance will be "rewarded" with grants. To offset this risk (and to fund its lost loan repayments due to grants), IDA has proposed reducing the overall disbursements to countries by 9% - 20%, cutting their MDG funding (see below).
2) The framework assumes that debt overhang burdens are more important than liquidity by focusing mainly on overhang indicators. It fails to analyse service/revenue, which is the vital indicator for African governments, whose primary concern is to free budget liquidity so as to fund the MDGs immediately. Debt service/revenue should be the primary indicator used.
3) The threshold ranges proposed are far too wide. The top end risks encouraging very rapid borrowing by good performers, and the bottom end risks severely constraining MDG financing for bad performers, as well as distorting the allocation of IDA so that the vast majority of its grants go to the worst performers. For these reasons it would be desirable to narrow the ranges to 50%-40%-30% for PV/GDP, 200%-150%-100% for PV/XGS and 250%-200%-150% for PV/revenue, and 25%-20%-15% for service/exports and service/revenue for strong-medium-poor performers respectively. (See Option 1 below).
4) The basis for the ranges (ie tying to CPIA) has also not been clearly accepted by the Board of the World Bank, other institutions or IDA countries themselves. CPIA is still widely regarded as non-transparent and controversial in its judgements. The assessment of policy performance and grant needs should be led by the country in a public self-assessment which would fit more comfortably with PRSPs.
5) The debt sustainability thresholds do not take into account other factors such as 'shocks' and domestic debt which the BWIs have identified in earlier work.[10] Urgent analytical work is needed to make sure that they do.
6) The ranges of grant allocation are far too wide. No country should get 100% grants as this, if adopted by all multilateral development banks, would end a "loan repayment culture" for these countries and undermine all efforts to restore their ability to borrow in the long-term. Similarly, no recently severely debt-distressed country should have 100% loans, as this would provide incentives to recreate the debt problem rapidly. In addition, the policy-dependent triggers from green to yellow to red lights will mean that countries with very little difference in debt ratios may get widely differing grant levels. A better range of grant levels would be 30%, 50% and 70% (or 20%, 40% and 60%) - which would also be in line with the spread of grant levels for debt-distressed countries under IDA 13 (see Option 2 below)
7) The analysis is done using ex post debt data, which do not necessarily reflect current or projected debt sustainability. For example, the 2002 data for Uganda yields a PV/exports ratio of 136.9% whereas the PV/exports ratio in 2003/04 was 245%. In addition, annual reassessment of country eligibility and failure to take other aspects into account could cause major volatility in country financing patterns. For example, external shocks might make more countries eligible for IDA grants by pushing up their ratios; and receipt of HIPC relief could end grants by reducing ratios sharply for many countries. The framework needs to focus on current and projected rather than historical debt sustainability.

2.3.4. Financing IDA Grants

IDA provision of grants rather than loans means that IDA loses potential future reflows (principal repayments, service charges and commitment fees) over a 40-year period.[11] IDA13's grant

[10] For discussion of shocks, see IMF –IDA 2004 and Martin and Bargawi 2004 b.

framework means that IDA will forego SDR 4.1 billion of reflows in nominal terms, equivalent to about SDR 1.4 billion in present value terms, as set out in Table 2.6.

Table 2.6: Estimated Foregone Reflows of IDA13 Grants

	Nominal terms		Present value terms	
	(SDR million)	(%)	(SDR million)	(%)
Principal repayments*	3413	84%	1064	74%
Service charges (0.75%)	603	15%	324	23%
Commitment fees (0.50%)	50	1%	47	3%
Total	**4065**	**100%**	**1436**	**100%**

* Foregone over the period 2013-2044.
Source: World Bank

It was agreed under IDA13 that the foregone service charge and commitment fee reflows, of SDR 653 million, would be financed through additional donor contributions. If these are paid in equal annual instalments over 3 years, donors will need to commit SDR 410 million in nominal terms, to cover the present value of foregone charges. If donors pay over 6 or 9 years, as often in the past , nominal costs will rise. The final period will be decided in the IDA14 agreement (late 2004/early 2005).

The foregone principal repayments will be financed as they arise over 40 years on a 'pay-as-you-basis' starting in 2013. In 2013-2015, they will total only SDR 137 million. Subsequently the annual principal repayments foregone increase to a maximum of SDR 137 million/year for the years 2025-42.

So the total cost of IDA13 grants in terms of additional donor contributions to finance foregone reflows for the period up to 2015 will be at least SDR 547 million, rising thereafter.

Increasing grant financing under IDA14 will further reduce future reflows and IDA commitments considerably in future years. IDA proposes 3 options (separately or combined) to avoid this decline:

1. Additional donor contributions, as donors already accepted for IDA13. This is the mechanism preferred by the World Bank. However it means donors will finance the foregone service and commitment fees up front and they will not necessarily know the cost of future contributions in advance. The risk here is that actual proportion of grant financing in IDA14 will be determined annually on the basis of country's performance, as assessed by the PBA system. *The cost to donors of upfront additional contributions to cover foregone IDA14 reflows is estimated to be about SDR 580 million in service fees and commitments fees in the period up to 2015.*[12] *Coupled with offsetting losses from IDA13 grants this totals SDR 1.13 billion in years up to 2015.*

2. Changing the level of IDA assistance by reducing the amount of disbursements to countries to offset the lost reflows due to grants. An upfront fee of about 9% would represent the present value to IDA of the foregone service charge and commitment fee income (about ¼ of total reflows foregone), whereas an upfront charge of 20% would cover about 55% of total foregone reflows, including principal repayments.[13]

3. Hardening the lending terms for IDA loans by (1) reducing the 35-year maturity for loans to blend countries by 5 or 10 years or (2) shortening the 40-year maturity by 5 years for 10 richer IDA-only borrowers who are not debt distressed. This could finance around 10% of the amount needed.

Of these options, additional donor contributions are by far the most desirable for sustainable financing of the MDGs. Another feasible option (but with relatively little scope for expansion as IBRD net income is small unless interest charges are increased on middle-income IBRD borrowers) might be a higher transfer from IBRD net income, which would reduce MDG funding only for middle-income countries. Both other options would reduce net financing availability for low-income countries, but the worst by far is option 2, which would cut financing for the most debt-distressed countries. This is definitely the opposite of what the international community would wish in financing the MDGs.

[11] Some have recently attempted to argue that IDA reflows are not significant – but they already amount to 40% of IDA funding (albeit that some of this is paid by HIPC initiative relief) and will rise rapidly over the next ten years as principal payments on earlier loans fall due.
[12] With 10 year grace period, principal repayments are not due to commence until 2016 at the earliest.
[13] On the basis of a 6% discount rate. See IDA June 2004 for more details.

2.4 Alternative Options for IDA Grant Allocation

The following presents the outcomes of alternative options for the allocation of IDA14 grants. [14]

OPTION 1: LOWER RANGE OF DEBT SUSTAINABILITY THRESHOLDS[15]

Lowering the sustainability thresholds to 50%-40%-30% for PV/GDP, 200%-150%-100% for PV/XGS and 25%-20%-15% for service/exports for strong-medium-poor performers, respectively, would result in grant financing rising by 24% from the currently proposed SDR 4.9 billion (21% of total IDA14 resources) to SDR 6.0 billion (26% of IDA14 resources)[16]. Almost all of this increase in grants would benefit Africa countries, as Cameroon, Chad, Malawi and Lesotho become eligible for 100% grants, and Benin, Kenya, Madagascar, Mali and Mauritania are able to access 50% of their IDA14 allocation in grants, instead of all loans. Given the marginal debt sustainability of many of these countries (see Martin, Johnson and Bargawi), it would seem highly desirable to lower the thresholds.

The cost in terms of foregone service charge and commitment fee reflows in the period up to 2015 is estimated to be about SDR 712 million (SDR1.26 billion including IDA13 losses).

OPTION 2: DIFFERING GRANT LEVELS

Under the proposed traffic light system of lending, countries will be able to access current 100%, 50% or 0% grants depending on whether they are classified as red, yellow or green light in terms of debt distress. Narrowing the range of access to grants to 70%, 50% and 30% for countries classified as red, yellow and green light, and using the BWI proposed debt thresholds would result in total grant financing for IDA14 of SDR 6.5 billion, 28% of total IDA14 resources. This would mean an additional 17.5% of grant resources for African countries, as countries previously classified as only eligible for loans would now receive 30% of their IDA allocation in grants[17]. This would be a highly desirable option to smooth changes in external financing terms for African countries.

The cost in terms of foregone service fee and commitment charges reflows in the period up to 2015 is estimated to be about SDR 764 million (SDR 1.31 billion including IDA13)

Narrowing the access range further to 60%, 40% and 20% for red, yellow and green light countries would result in almost the same grants of SDR 5 billion (21.4% of IDA) as the proposed framework.

The cost in terms of foregone service fee and commitment charges reflows in the period up to 2015 is only slightly above that of the currently proposed framework (SDR 600 million for IDA 14 + SDR 547 million for IDA 13).

OPTIONS 3A AND B: LOWER RANGE OF DEBT SUSTAINABILITY AND DIFFERING GRANT LEVELS

Option 3a: combining Options 1 and 2a (70-50-30%) would mean grants of SDR 6.9 billion (30% of IDA14), *with a cost to donors of SDR 828 million (SDR 1.38 billion including IDA 13).*

Option 3b: Option 1 and Option 2b (60-40-20%) together would yield grants of SDR 5.4 billion (23.4% of IDA14), *with a lower cost to donors of only SDR 648 million (SDR 1.2 billion including IDA 13).*

OPTION 4: 100% IDA14 GRANTS FOR ALL HIPCS

This option has recently been proposed by the US Treasury. If all HIPCs receive 100% grants, this implies grants of SDR 10.5 billion (45% of IDA14), of which SDR 8.8 billion would go to African HIPCs.

The cost in terms of foregone service fee and commitment charges reflows in the period up to 2015 is estimated to be about SDR 1.24 billion (SDR 1.8 billion including IDA 13)

OPTION 5: 100% IDA14 GRANTS FOR ALL AFRICAN COUNTRIES OR ALL LOW INCOME COUNTRIES

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[14] Ideally this paper would have conducted the same costing estimates for the other MDBs but this has not been possible given lack of data and the short working time allocated to the paper.

[15] Data for PV/budget and debt service/budget are not available to test the impact of using these indicators.

[16] This analysis is done on the basis of 2002 data, available in IDA June 2004.

[17] These countries are HIPC countries Benin, Burkina Faso, Chad, Ghana, Kenya, Mali, Mauritania, Mozambique, Niger, Senegal, Tanzania and Uganda, and non-HIPCS, Cape Verde and Djibouti.

If all African IDA countries, including Nigeria and Zimbabwe currently classified as blend countries, are eligible for 100%, then grants would account for 52% of all IDA 14 resources (SDR 12.0 billion). Nigeria would be able to receive grants of more than SDR 1.0 billion.

If all low-income countries are given 100% IDA grants, these would total SDR 12 billion (less than expected because there are a large number of middle income countries which receive IDA funds as "blend" countries). The only HIPC to lose will be Guyana, which is middle income, and would no longer be able to access 50% IDA grants because of its borderline debt sustainability.

The cost in terms of foregone service fee and commitment charges reflows in the period up to 2015 of each of these proposals is estimated to be SDR 1.42 billion (SDR 1.96 billion including IDA13).

The analysis of alternatives to the proposed framework for IDA14 grants indicates priorities as:

1. a broader range of countries can be protected against debt distress with the currently proposed level of IDA grants - SDR 4.9 billion (21% of IDA14) - by having grant levels of 60%-40%-20% for countries classified as red-yellow and green light in terms of debt distress (Option 2).
2. more countries could be protected against debt distress, at thresholds which are more realistic, and with less distortion of allocating grants to worse performing countries, if we lower the debt thresholds and the range of grant levels, for an extra cost of only SDR 48m (Option 3b).
3. these countries could receive more secure protection against debt distress with more realistic thresholds and a slightly higher grant allocation, for an extra cost of only SDR180 m (Option 3a)
4. extending IDA grants to all HIPCs, all African IDA-eligible countries or all low-income countries will significantly add to costs, up to SDR 1.4 billion, in the period up to 2015. The question is whether bilateral donors are willing to provide much higher contributions up to 2015, in addition to the additional donor contributions of SDR 2.7 billion a year needed for IDA 14 funding.
5. if this proportion of IDA grants were to be repeated over the next ten years - into IDA15 and IDA16 (2009-14), assuming a 10% nominal increase for each replenishment, it could increase cumulative diversion of resources to subsidising IDA grants to SDR 2.46 billion by 2015 (in addition to the SDR 5.4 billion of new donor contributions for continuing IDA replenishments).
6. beyond 2015, the costs of foregone principal reflows on all options would rise considerably. The current IDA 13 agreement and IDA 14 proposals would cost an average SDR 270 million a year to offset lost principal reflows, and if extended into IDA 15 and IDA 16 would cost SDR 530 million.
7. the more far-reaching proposals would have a very major impact on donor resources if continued until 2015. Option 4 (100% grants for all HIPCs) would divert around SDR4.5 billion by 2015 to offset lost charges, plus SDR38 billion to offset lost principal reflows over the next 50 years (peaking at SDR1.5 billion a year in 2034-2043). Option 5 (199% grants for all African or low income countries) would cost 13% more – SDR 5.1 billion for charges and SDR43 billion principal.
8. Whichever option is chosen, LICs should not pay for it by receiving reduced IDA disbursements, which would severely undermine their ability to attain the MDGs.

CHAPTER 3: GRANT FINANCING FROM OTHER MULTILATERAL INSTITUTIONS

3.1. International Monetary Fund

All current IMF support to Africa is through loans. LICs receive Poverty Reduction and Growth Facility (PRGF) funds which, embarrassingly for the IMF, have a grant element below the 35% concessionality benchmark which the IMF insists on for new borrowings by all HIPCs and most African LICs, forcing African countries to have exemptions from IMF ceilings in order to borrow PRGF, and undermining its credibility as an advocate of long-term debt sustainability. [18]

There has been some recent discussion of increasing the concessionality of Fund lending, with suggestions ranging from 35% (HIPC Ministers, 2002/03) to 50%. Some Board members have suggested in the past that more concessional terms could undermine the "temporary" nature of Fund assistance (even though IMF concessional lending has existed for 20 years and many countries have had Fund programmes for 10 years). Fund staff have recently indicated that raising the level of concessionality for all loans to 50% would require a 29-year maturity period and cut annual lending capacity by around SDR200 million (IMF 2004b), and on this basis recommended against greater

[18] See Martin and Bargawi 2004a for more details.

concessionality. However, they have not tested any more nuanced increase in concessionality, and it would be easy to increase concessionality somewhat without excessive costs to future lending.

Some have suggested that the Fund should provide grants for the poorest and most heavily indebted members. This is not a feasible option, for two reasons:
1. The Fund's resources have historically had a revolving nature, which grants would undermine;
2. The effects on future lending capacity would be huge, with PRGF resources expiring by 2011 even if grants were provided at only SDR 660 million a year, and the new cost to donors of refinancing PRGF for grants being prohibitive.

However, it is vital that:
- concessionality for all loans to IDA-only low-income countries (PRGF, emergency and post-conflict assistance) be raised to match IMF minimum GE recommendations of 35%. This could be done by increasing the maturity period to 15 years.
- for the most debt-vulnerable and poorest (e.g. HIPCs during the interim period), consideration could be given to a grant element of 50%. This would require grace and maturity of only 10 and 25 years respectively.

The estimated reduction in IMF lending capacity from such moves would be minimal – under SDR 100 million. Such additional concessionality could be achieved without drawing on donor resources by, for example, using resources liberated through revaluation of IMF gold reserves. Moreover, regardless of any changes in IMF lending terms, the IMF should aim to phase out its lending to "post-stabilisation" low-income countries as fast as possible, which could reduce IMF lending needs by an average SDR500 million a year during 2006-15 (see Martin, Johnson and Bargawi 2004 for more details).

3.2. African Development Bank and Fund

For African countries, the African Development Fund is a major provider of highly concessional loans and grants to the poorest countries. The ADF's loan terms have a 50-years maturity, compared with IDA's 40-years maturity, and are therefore slightly more concessional.[19] The ADF has in recent years followed IDA's lead and been providing a higher proportion of its resources as grants. Under ADF-IX (2002-04), grants will account for US$620 million, 19.5% of total ADF resources, an increase from 7.5% under ADF-VIII, with the same criteria for allocations as for IDA13. The poorest countries, with per capita income less than or equal to $360, can receive grants of up to 27%, as can Angola and Sudan. All other countries, including blend countries Nigeria and Zimbabwe, can receive up to 7.5% grants. Proposals for financing ADF-IX grants by donor contributions are similar to IDA13, and the foregone reflows are put by ADF at US$ 764 million (of which US$133 million are due before 2015).

The forthcoming replenishment of ADF-X for the period 2005-07 anticipates an increase in resources of 15-20% in real terms, to a level of US$ 4.1 billion. The ADF is considering options for future grant allocations and how to meet the costs of foregone reflows. Assuming that the proposals on the table are similar to those discussed above for IDA, namely 21% of commitments in the form of grants (US$861 million), the estimated costs of the proposals in terms of foregone reflows are US$1.1 billion (US$1.9 billion including the ADF-IX costs), of which US$185 million (US$318 million) fall due before 2015.[20] If this practice were extended to ADF-XI to XIII (ie until 2015), the cumulative costs would be US$5.8 billion. If all ADF resources were to be provided as grants for ADF-X, the costs including ADF-IX would be US$5.9 billion, and cumulative costs for ADF IX-XIII would be US$24.2 billion.

3.3. Other RDBs

It would be preferable to coordinate the shift to grants across regions so as to maintain comparability across regions. Therefore it is vital to examine the policies of other regional development banks:
- the ***Asian Development Bank*** is proposing, as part of the 9th replenishment of Asian Development Fund (ADF IX), to establish a grant programme to reduce the debt burden of its poorest members, assist post-conflict countries, combat HIV/AIDs and provide priority technical assistance. Donors have agreed that up to 21% of ADF IX can be provided as grants. As total resources for ADF IX (2005-08) are US$7 billion, grant funding will be up to US$ 1.5 billion over the 3-year period. These grants are to be financed in the same manner as for IDA14[21], by additional donor contributions to meet foregone interest costs of US$ 163 million and foregone

[19] See Annex 1 of Johnson. Martin and Bargawi 2004, for details of the lending terms of different multilateral institutions.
[20] See African Development Fund April 2004 for more details.
[21] See Asian Development Fund June 2004 for more details.

principal to be financed in future replenishments. However, the ADF eligibility criteria for grants are similar to the ones used for IDA13, that is per capita income less than or equal to $360, debt vulnerability and post-conflict. The poorest debt-distressed or post-conflict countries (Afghanistan, Cambodia, Krygyz Republic, Lao PDR and Nepal) will receive up to 50% grants, other post-conflict countries (Tajikistan and Timor Leste) 40% grants, the Solomon Islands 30% and Sri Lanka 15%. Full 100% grants are also available for HIV/AIDs and infectious diseases programmes. It would be desirable to modify the criteria to match an improved version of the IDA 14 proposals. If this were done, a broad estimate of costs would be around US$1.8 billion and US$7 billion if extended through till 2015.

- The ***Inter-American Development Bank*** has not changed policy in line with other RDBs, because it has relatively few low-income members. It provides grants only for technical cooperation, averaging only 0.4% of disbursements in the last 5 years. However, there is a strong case for it to consider providing grants to its low-income members (Guyana, Haiti, Honduras, Nicaragua – and possibly Bolivia whose GDP has collapsed again to low-income levels) on the same basis as IDA. This would imply grants of around US$550 million a year.

3.4. Other Multilateral Development Institutions

Other multilateral institutions fall into three main groups:

- ***Grant-providing institutions*** – the UN family and the European Union. As these institutions are already providing grants, if bilateral donors are willing to fund higher grant levels for financing the MDGs, they should consider providing more grants through especially the UN institutions, which have suffered a major decline in their share of global development assistance during the last 20 years, rather than expanding grant windows in the multilateral development banks. In terms of the international financial architecture, the MDBs were created as banks, which were expected to lend and be repaid, distinct from the grant-providing institutions, and Africa Commission members need to consider whether they want to change this architecture fundamentally.
- ***Institutions providing highly concessional loans and grants*** – notably the UN International Fund for Agricultural Development (IFAD). If other multilateral organisations are to be provided with money to shift to grants for some countries, so should IFAD. It has the same terms as IDA, and is already providing 7% grants. Given the major contribution to rural development IFAD is making, it would be iniquitous for it to be continuing to lend to countries to which the MDBs are providing grants. Applying 21% grants to its replenishment would imply grants of approximately US$100 million a year (a cumulative US$1.25 billion if extended through to 2015), which would be well worth the funding cost.
- ***Institutions providing marginally concessional or non-concessional loans.*** These include a wide range of multi-regional institutions (eg BADEA, Islamic Development Bank, OPEC Fund) as well as sub-regional institutions (Andean Fund, Caribbean Development Bank, Central American Bank for Economic Integration, East African Development Bank, West African Development Bank). It is vital to remember that these institutions have harder terms on their loans because they require higher reflows to fund future commitments, given that they receive lower levels of donor or member state contributions. However, the provision of only marginally concessional loans by these institutions puts them in the same position as the IMF, undermining the long-term debt sustainability of borrowing countries. As a result, it would be highly desirable for them to ensure a minimum 35% or 50% grant element along the lines described in 3.1 above. It has not been possible to estimate the cost of enhancing their grant elements, but it would be desirable to fund this greater concessionality in the same way as has been applied for HIPC Initiative-related debt cancellation – through the establishment of a trust fund resourced by bilateral contributions.

CHAPTER 4. WIDER ISSUES AND OPTIONS FOR ACTION

4.1. Wider Issues

The analysis above also raises a number of wider issues, namely:

1. *Are grants necessarily the most efficient way of funding the MDGs relative to highly concessional debt ?* From the point of view of African countries, they would obviously prefer grants to loans if the switch to grants had no effect on the overall flows of financing to fund the MDGs. However, if (as proposed by IDA) switching to grants was going to result in an offsetting reduction of net flows, they would prefer to have the higher levels of (concessional) loan finance rather than the grants. This is for two reasons: their top priority is to fund the MDGs up front, and they believe

that receiving more finance now, promoting growth and reducing poverty, will make them much more able to repay (concessional) loans in future.

2. *If we are going to provide higher grants, should they go via bilateral or multilateral sources ?* Opinions on the relative desirability of multilateral and bilateral aid vary widely. While multilateral aid is commonly seen as superior for being more free of political/strategic influences and of tying to donor country exports, the best bilateral aid is often seen as superior for having less conditionality and less cumbersome disbursement procedures. African countries have reached the conclusion that one should not make any a priori judgements about this issue – but that the best bilateral aid is likely to be better than any of the multilateral aid providers. They also strongly favour a diversification of aid sources so that aid is not increasingly channelled via the IFIs or in knee-jerk support of their conditionality.[22]

3. *If some bilateral donors (eg the US) insist on all of their additional bilateral contributions being disbursed through bilateral channels, are other donors prepared to divert large amounts of their funds to support the multilateral system ?* It would seem that some of the highest-quality bilateral donors would be prepared to do so – but, as discussed in 2 above, African governments would not necessarily prefer such like-minded donors to channel higher proportions via multilateral institutions. In addition, it would be vital that such increased contributions by like-minded bilateral donors be reflected in increases in their voting shares in the multilateral institutions, so that they could also influence multilateral institutions to be more like-minded and improve their aid quality.

4. *Is it desirable for some multilateral institutions to switch to more grants while others do not ?* Effectively at the moment IDA and AfDF grants are providing space for countries to pay future debt service to the IMF and other multilateral lenders, who provide less concessional loans. As a result, it would be highly desirable to have a common framework across all major multilateral institutions for deciding on when to vary the concessionality of multilateral funding.

5. *Would changes from loans to grants have any impact on wider policies of the multilateral institutions, such as project appraisal, organisational, management and programming procedures, ESW and due diligence ?* Overall, it is unlikely that a change in the form of financing would have very much effect on any of these areas. This is because multilateral institution policies are not (and should not be) primarily driven by an analysis of the likelihood of repayment of financing, but rather by the likely contribution to poverty reduction of the programme or project funded. Provided a switch to grants is conducted in the context of an analysis of its effect on debt sustainability and continued efforts to enhance the quality of development finance, there should be no major effect.

6. *Is a switch to grants the priority step in ensuring long-term debt sustainability ?* The answer to this is a clear no. Based on past experience, there have been three clear causes of unsustainable debt: a) irresponsible lending by creditors and borrowing by debtors (ie poor "quality" development financing); b) external shocks which have transformed sustainable debt into unsustainable debt; and c) poor economic policies by debtor countries. Far more can be achieved by improving the quality of future development financing,[23] by protecting countries against shocks,[24] and by ensuring maintenance of good economic policies, than by providing grants.

4.2. Priority Options for Action

Finally, the above analysis suggests options for action. Table 4.1 shows the advantages and disadvantages of these options, from the point of view of cost and of the views of low-income African countries, the multilateral institutions themselves and bilateral donors.[25] The resulting priorities are:

OPTION 1) IMPROVED MDB GRANT ALLOCATIONS

Refining the proposed allocation of grants under IDA14 (and therefore also AfDF and AsDF, and especially IADB, in order to provide consistency across all of the MDBs) should be the top priority, to have more realistic levels of debt sustainability thresholds in line with African government views, and

[22] See Johnson, Martin and Bargawi 2004 for details.
[23] See Johnson, Martin and Bargawi 2004 for details.
[24] See Martin and Bargawi 2004b for details.
[25] The annual lost reflow costs quoted in the table are all limited to current replenishments of each institution. Costs for extending similar grant levels through to 2015 are quoted in Chapter 3.

a narrower range for grants to avoid sudden changes to financing patterns. It would improve the allocation and quality of MDB financing and make it more appropriate to the needs of low-income debt-distressed African countries, at minimal cost.

In addition, it should be possible to find sufficient funding to extend these grant proposals through until 2015 in order to guarantee continuing attention to long-term debt sustainability by all the MDBs. The costs of this extension would be very significant but not prohibitive, and are outweighed by the advantages of tailoring MDB financing to the needs of their most debt-distressed members.

Should dramatically more financing be available to subsidise MDB grants for a wider range of countries (and especially to offset the very large long-term reduction in reflows from loans), the priority should be to allocate them to the most debt distressed countries (generally HIPCs) rather than to all African IDA-recipient countries or all IDA-only countries – as neither of the latter groups really need grants to reduce their debt burdens. However, this is less of a priority that steps 2-4 below.

OPTION 2) HIGHER GRANTS FOR IFAD

The second priority should be for IFAD to have its grant levels increased to 21% to match those of the MDBs, for the sake of comparability and because it would have a relatively low cost.

OPTION 3) MORE GRANTS THROUGH GRANT-GIVING INSTITUTIONS

The third priority should be for donors to provide much higher levels of funding through some of the existing grant institutions (notably various high-performing agencies of the UN system) rather than subsidising loans into grants on a higher scale for loan-providing institutions.

OPTION 4) HIGHER IMF GRANT ELEMENT AND LOWER LENDING

The second priority should be further to subsidise IMF lending to ensure that it has a grant element of 35% compatible with its own rules for maintaining debt sustainability. However, this should be combined with enhanced efforts by the Fund to end its lending role for countries which have managed to stabilise their macroeconomies, and the subsidy should be funded by savings from reduced lending, as well as gold revaluations, rather than any new bilateral donor contributions. The IMF should not provide grants, as this would be too expensive in diverting MDG funds for the subsidy.

OPTION 5) HIGHER OTHER MULTILATERAL GRANT ELEMENT

In order to ensure consistency across the multilateral system and avoid the MDB grants encouraging moral hazard by allowing other multilaterals to make (and African countries to borrow) more loans, other multilaterals should increase their grant element to a minimum of 35%, and to 50% for more debt-distressed countries.

TABLE 4.1
ADVANTAGES AND DISADVANTAGES OF MULTILATERAL GRANT PROPOSALS

Proposal	Cost (pa, 2005-15)	LICs	IFIs	Donors
IDA Grants				
IDA 13 framework	SDR 55 m +	Advs: Avoid Future Debt Problem Disadvs: Tying to Sectors		
IDA 14 framework	SDR 58 m	Advs: Closer Link to Debt Sustainability Disadvs: Too Narrow Criteria, too wide ranges of grants		
Revised IDA 14:				
Realistic thresholds	SDR 71 m	More objective thresholds, 9 African countries get more grants	Overall, as costs increase, IFI more dependent on donor contributions due to loss of reflows, and risk of potential fall in disbursements.	Overall, as costs increase, more potential for diversion of nbilateral donor contributions due to loss of reflows, to prevent potential fall in disbursements.
Narrower grant range (30-50-70%)	SDR 76 m	African countries 17.5% more grants		
Narrower grant range (20-40-60%)	SDR 60 m	Less volatility of financing patterns		
Realistic thresholds + 30-50-70	SDR 83 m	Combine advs and disadvs of previous options above		
Realistic thresholds + 20-40-60	SDR 65 m			
All HIPCs	SDR 124 m	Disadv: not all HIPCs need grants	Major risk of over-dependence on donor contributions and fall in disbursements	Massive long-term costs of these bigger steps (SDR43-48 billion if extended into IDA XV/XVI) make them low priority
All Africa IDA	SDR 142 m	Disadv: not all Africa IDA need grants		
All LICs	SDR 142 m	Disadv: not all LICs need grants		
IMF				
1) grants to LICs	SDR 400m	Not necessary – others give grants	Major loss of resources – ends PRGF	Disadv: high bilateral aid diversion
2) higher GE	<SDR 100m	Improves credibility of minimum grant element policies	Affordable though reluctant to make funds more concessional	Adv: fundable by gold revaluation
3) lower lending	-SDR 500m	Savings to lend to others at higher GE	Agreed to taper out lending	Adv: savings on funds
Other MDBs				
AfDF IX/X as IDA	US$ 32 m			
AsDF IX as IDA	US$500mpa of grants*	Important to have grant flows from RDBs to retain their role as important regional institutions with low-cost finance	Comparable treatment with IDA desirable for AfDF and AsDF, not excessive costs IADB middle-income members highly reluctant	In favour of comparable treatment across MDBs.
IADB grants LICs	US$550mpa of grants*			
Other Multilaterals				
IFAD as IDA	US$100mpa of grants*	High-quality IFAD flows need to be as concessional as those of MDBs	IFAD open to comparable treatment with MDBs	
Higher GE for other multilaterals	No data	Need to avoid risk of possible decline in new lending	Possible decline in new lending unless fund through additional donor funds like HIPC	Possible diversion of donor funds into trust fund to refinance grants

Note – * = no annual cost calculations possible due to lack of data

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