PROTECTING GRANTS FROM THE IMPACT OF EXCHANGE RATE FLUCTUATIONS

Outline: This paper presents recommendations for addressing the impact of exchange rate fluctuations on grants. Part 1 outlines the issues and explains the problem faced by some grant recipients. Part 2 describes measures proposed to alleviate or counter this problem.

Decision Points:

The MEFA Committee recommends that the Board decide:

1. That in cases where a funding shortfall caused by an adverse currency fluctuation is jeopardising the viability of the grant-supported program, the CCM may apply for Phase 2 funding on an accelerated basis in order to permit the program to continue uninterrupted without curtailing program activity.

2. To direct the Secretariat to evaluate the implications of the Global Fund offering top-up grants and multi-currency denominated grants as further means of protecting grants from the impact of exchange rate fluctuations and to present its analysis and recommendations to the Board in June 2004.
Part 1: Background to currency-related shortfalls affecting some grants

1. Grant proposals submitted to the Global Fund incorporate 5-year budgets denominated in US dollars. However, the underlying programs frequently include expenditures that will be incurred in local currency or other non-US$ currencies.

2. In preparing proposal budgets, grant applicants must make assumptions about future exchange rates with regard to non-US$ expenditures. Almost inevitably, over the 5-year life of the proposal actual exchange rates will deviate from the rates assumed when preparing the proposal budget.

3. Where the US dollar has appreciated in relation to the local currency (or other expenditure currency), the grant (in US$) would provide a greater amount of local currency than had been foreseen in the budget. In this situation, the PR may end up utilising less of the approved grant amount or, alternatively, may have the capacity to augment the program to utilise the currency “windfall”. The Fund’s performance-based funding principles and periodic reporting act as an effective control to monitor such situations.

4. In contrast, where the US dollar has depreciated in relation to the local currency (or other expenditure currency), the grant (in US$) would provide a lesser amount of local currency than had been foreseen in the budget. This may jeopardise implementation of the program supported by the grant.

5. While over a longer time horizon the US dollar has typically appreciated against currencies of developing countries, this has not been the case in the past two years – the period in to which the Fund’s grants fall – as illustrated in Attachment 1.

6. This recent phenomenon of a depreciating dollar is currently affecting some grants (see illustrative example in Attachment 1) and will leave the PR with a funding shortfall in circumstances where:
   - a substantial element of project expenditure is in currencies against which the US dollar has significantly depreciated, and
   - the program is running on (or close to) schedule, with no compensating budget savings (or other sources of funding) to offset the currency loss.

7. Any strategy adopted by the Fund to protect the viability of a grant-supported project in such circumstances would need to balance this objective with the need to avoid exposing the Fund to undue risk that could restrict its grant-making ability, and be subject to availability of funds.
Part 2: Measures to address the problem

8. Three potential measures have been identified to alleviate or counter the currency-related problem:
   - Acceleration of Phase 2 funding
   - Top-up grants
   - Multi-currency grants

   The first of these, acceleration of Phase 2 funding, could be implemented immediately on Board approval. The others require further analysis.

9. Acceleration of Phase 2 funding
   a) Where it is anticipated that Phase 1 funding (for years 1-2) would be exhausted early due to currency fluctuations, the CCM could be permitted to apply for Phase 2 funding (for years 3-5) on an accelerated basis. For successful applications, Phase 2 funding would be made available before the normal end of Phase 1.

   b) This acceleration of Phase 2 funding would permit the program to continue uninterrupted without curtailing program activity. (Such an approach is reflected in the proposed Policy for Phase 2 Grant Renewals outlined in Annex 4, paragraph 33.)

   c) It is possible that over the 5-year combined duration of Phases 1 and 2, the currency loss may correct itself (if the dollar were to appreciate sufficiently). However, if this did not occur, the PR could again face a funding shortfall during Phase 2; the measures proposed for further analysis below would cater for this.

   d) This is a measure that could be implemented immediately on Board approval, since it would fit within the (proposed) Phase 2 renewal process.

10. Top-up grants
    a) As mentioned in paragraph 9(a), the acceleration of Phase 2 funding would defer the potential shortfall for possible future resolution by dollar appreciation or budgetary savings. In the event of the shortfall recurring in Phase 2, a solution would be to make a “top-up” grant.

    b) A top-up grant would permit the CCM to apply during Phase 2 for additional grant funds, if currency movements have rendered the existing grant insufficient to meet the agreed program objectives.

    c) Since a top-up grant would be additional to the Phase 1 & Phase 2 amounts, a mechanism for Board approval, possibly outside normal round timetables, would need to be established. Rules for
calculation of a currency loss giving cause for a top-up grant would require careful consideration. Furthermore, rules would need to be established for repayment of the top-up in the event of currency losses being subsequently reversed. These aspects require further analysis.

d) Accordingly, if the Board so directs, the Secretariat would further evaluate this option and report back to the Board at its June 2004 meeting.

11. Multi-currency denominated grants

a) While the two mechanisms described above are geared towards alleviating currency-related shortfalls after they have arisen, they do not offer any preventive aspect.

b) A mechanism for limiting the risk of a currency-related shortfall arising would be to denominate grants in currencies other than the US dollar, or a combination of currencies that includes the dollar. Hence the risk for the grant recipient would not be related solely to fortunes of the dollar, but instead to the fate of those other currencies. In an extreme example, where the entire program expenditure was in the same currency as the grant, the PR would carry no currency risk.

c) Some grant/loan making institutions either offer recipients a choice of currencies or denominate their grants/loans in a combination of currencies such as SDR\(^1\) (Special Drawing Rights). As mentioned above, a combination of currencies spreads the risk over a ‘basket’ of currencies.

d) A multi-currency grant policy could be applied to all (future) grants or made available as an option to grant recipients. It could apply to new round grants as well as Phase 2 grants for existing rounds.

e) Unlike the other two mechanisms (described at 9 & 10 above), any strategy for denominating grants in a currency other than the US dollar would create a currency risk for the Fund. (There is no such risk at present, since the Fund’s assets and commitments are all in US dollars.)

f) Mitigating that risk would require a currency management/hedging strategy designed to avoid exposing the Fund to an inappropriate degree of risk. In essence, such a strategy would link the assets of the Fund to the currencies of its grant commitments (through various mechanisms). The Trustee advises that such additional complexity would require modification of the systems it currently employs for the Fund.

\(^1\) The SDR serves as the unit of account of the International Monetary Fund and some other international organizations. Its value is based on a basket of 4 key currencies: the US$, Euro, Sterling and Yen.
g) If the Board so directs, the Secretariat would further evaluate this option in conjunction with the World Bank and report back to the Board at its June 2004 meeting.

**Decision Points:**

The MEFA Committee recommends that the Board decide:

3. **That in cases where a funding shortfall caused by an adverse currency fluctuation is jeopardising the viability of the grant-supported program, the CCM may apply for Phase 2 funding on an accelerated basis in order to permit the program to continue uninterrupted without curtailing program activity.**

4. **To direct the Secretariat to evaluate the implications of the Global Fund offering top-up grants and multi-currency denominated grants as further means of protecting grants from the impact of exchange rate fluctuations and to present its analysis and recommendations to the Board in June 2004.**
Attachment 1

Historical context

Viewed over the longer term, the US$ has appreciated against the currencies of many developing countries. However during the past 2 years – the period in to which Global Funds grants fall – this trend has reversed in many currencies. The following graph shows the performance of the US$ against an illustrative sample of developing country currencies as well as some major currencies.

Historical Change in Exchange Rates: US$ vs Other Currencies

![Graph showing historical change in exchange rates]

*Euro historical data based on a 3yr period

Example

This example, based on an existing grant, illustrates the issue:

<table>
<thead>
<tr>
<th>Example of impact of US$ depreciation against Local Currency (LCY)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase 1 Grant amount</td>
</tr>
<tr>
<td>Proportion of costs in local currency</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Time Frame</th>
<th>Exchange Rate LCY to US$</th>
<th>Local Currency Equivalent</th>
<th>Potential shortfall %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proposal submission</td>
<td>12.0</td>
<td>LCY 300m</td>
<td>-</td>
</tr>
<tr>
<td>Signing grant</td>
<td>7.5</td>
<td>LCY 188m</td>
<td>(38%)</td>
</tr>
<tr>
<td>Current</td>
<td>7.0</td>
<td>LCY 175m</td>
<td>(42%)</td>
</tr>
</tbody>
</table>

Of course if, in the remaining period of the grant, the US$ were to appreciate against the local currency, then some or all of the above shortfall could be recouped.