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**HOW PREDICTABLE IS SWEDISH AID?
A STUDY OF EXCHANGE RATE VOLATILITY**

Númi Östlund

How predictable is Swedish aid? A study of exchange rate volatility

Númi Östlund

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till

Expertgruppen för biståndsanalys (EBA)

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Foreword by the EBA

The financing of aid must be predictable. Development cooperation often takes place in high-risk and volatile environments. Ensuring predictable financing is crucial for managing part of that complexity. Partners should be confident about the amounts and timing of aid disbursements. The centrality of predictability to the overall effectiveness of aid is also recognised in key international documents and texts – for instance, in the *Paris Declaration on Aid Effectiveness*, *Accra Agenda for Action*, *Busan Partnership for Effective Development Cooperation*, and in the work of organisations such as OECD/DAC.

Predictable financing is challenged by the fact that aid is often implemented using a currency other than the donor's. A pledged amount can lose or gain considerably in value depending on whether the recipient side's currency depreciates or appreciates against the donor currency. Regardless the direction of change, predictability is affected and aid becomes less manageable.

In this EBA report, Númi Östlund presents new data on how exchange rate volatility affects the predictability of Swedish aid. The report draws on the analysis of more than 30 000 bilateral activities funded by Swedish aid from 2006-2016, together with case studies of Rwanda and Zambia. This is the first in-depth study of its kind on Swedish aid predictability, and in an international perspective there are only a handful of initiatives and studies looking at exchange rate volatility and aid. The main question in the study is how the predictability of Swedish aid differs between the amount of Swedish krona disbursed and partner budgets (whether in local currencies or in international currencies). Númi concludes that exchange rate fluctuations have a “substantial impact on the predictability of Swedish aid” – for example, the average uncertainty faced by a partner organisation is about (+/-) 9 percent of the yearly amounts budgeted to be received. For a three-year project the uncertainty reaches a staggering (+/-) 27 per cent.

It is not just the confidence about the amounts and timing of aid disbursements that is affected. The report also observes how practices have evolved among partner organisations to handle

uncertainties. Over-contracting and low implementation rates are strategies employed to mitigate risks from currency fluctuations, which means that low predictability carry with it implications at many different stages of development cooperation – from pledges to implementation.

But volatility due to exchange rate fluctuations can be managed better, and this report shows how. The author concludes with a set of balanced recommendations to make Swedish aid more predictable: to provide funding in major currencies and working together with the Swedish National Debt Office using forward contracts; to employ Sida's guarantee instrument to enable innovative financial solutions for smaller currencies; and to work with transparent and efficient contracting rates.

The EBA hopes that this report will motivate a review of current practices on how Swedish aid is disbursed, and to stimulate a more in-depth discussion on how to strengthen the predictability of aid, Swedish and international.

The report was produced in dialogue with a reference group under the leadership of Professor Arne Bigsten, member of the EBA. The analysis, conclusions and recommendations expressed are those of the author.

Gothenburg, March 2018

A handwritten signature in blue ink, appearing to read 'Helena Lindholm', with a stylized flourish at the end.

Helena Lindholm

Sammanfattning

I den här rapporten beskrivs hur förutsägbarheten i svenskt bistånd påverkas av det faktum att större delen av biståndet genomförs i andra valutor än svenska kronor (SEK). Den övergripande frågan som har väglett studien är: *hur förutsägbart är värdet på medel utbetalade i SEK i relation till en partnerorganisations budget som är formulerad i en genomförandevaluta?* Rapporten innehåller också praktiska policyrekommendationer för ökad finansiell förutsägbarhet i svenskt bistånd.

Vikten av ett förutsägbart bistånd, det vill säga att partnerorganisationer kan vara säkra på tid och belopp för biståndsutbetalningar, har länge understrukits av både partnerländer och givare. Studier har visat att kostnader associerade med låg förutsägbarhet är betydande, eftersom de undergräver både givare och partners i deras strävan efter resultat. Förutsägbar finansiering är också ett centralt koncept i de internationella åtaganden för bistånd som slutits i Paris, Accra och Busan.

Valutakurser kan påverka värdet av mottagna medel när givare gör finansiella åtaganden i en annan valuta än den som används av partnerorganisationer eller mottagare. Hur valutakurser påverkar förutsägbarheten inom internationellt biståndet är dock en fråga som hittills inte har studerats i någon större grad. I den här studien utforskas frågan utifrån ett perspektiv: effekten på förutsägbarhet i svenskt bistånd, där åtaganden görs i SEK.

Studiens resultat är framförallt baserat på analyser av över 30 000 bilaterala aktiviteter som finansierats av svenskt bistånd under perioden 2006—2016, utifrån rapportering till the International Aid Transparency Initiative (IATI). Två närmare studier har också genomförts, med besök i Rwanda och Zambia, i syfte att fördjupa kunskapen i hur finansierade aktiviteter kan påverkas.

Resultat

Den övergripande slutsatsen är att växelkursfluktuationer har en väsentlig inverkan på förutsägbarheten i svenska biståndsåtaganden.

Största delen av det bistånd som finansieras av Sverige genomförs i andra valutor än SEK. När det går tid mellan det svenska åtagandet i SEK och utbetalning av medel uppstår en finansiell osäkerhet. Den negativa effekten på förutsägbarheten beror på de berörda valutorna och tiden mellan löftet och utbetalningen. Ju längre tid och ju mer volatila valutorna är, desto större är effekten på förutsägbarheten.

Valutakurser minskar förutsägbarhet i biståndet

Eftersom viktiga finansiella data har visat sig saknas i svensk biståndsrapportering är det inte möjligt att exakt beräkna den finansiella osäkerhet som uppstår. Utifrån antaganden och uppskattningar visar resultaten dock tydligt att det skapas en betydande finansiell osäkerhet på grund av volatila växelkurser. En partnerorganisation eller mottagare kommer i genomsnitt att ha en osäkerhet om värdet av svensk finansiering på cirka (+/-) 9 procent, redan det år åtagandet görs. För ett treårigt projekt växer osäkerheten till i genomsnitt på (+/-) 27 procent.

Hur finansiell osäkerhet sedan påverkar verklig effektivitet beror i stor utsträckning på hur partnerorganisationerna hanterar osäkerheten och på genomförandet av verksamheten.

Det finns goda möjligheter för att minska osäkerheten

Valutakursförändringar är bara en av många risker och osäkerheter som kan påverka förutsägbarheten för biståndsfinansiering eller det faktiska genomförandet av finansierade aktiviteter. Det torde inte vara det största hindret för partnerorganisationer i deras ansträngningar att uppnå avsedda resultat, men effekten på förutsägbarhet och effektivitet är fortfarande signifikant. I rapporten konstateras också att det finns tillgängliga handlingsalternativ för Sida och Utrikesdepartementet (UD), vilka väsentligt skulle kunna minska osäkerheten till följd av valutakursförändringar.

Förutsägbarhet handlar inte om utbetalade medel, utan mottagna belopp

I rapporten understryks vikten av att inte uteslutande analysera finansiell förutsägbarhet i biståndet från ett givarperspektiv. I genomförda intervjuer lyfts ett svenskt perspektiv på risk och finansiering fram, som fokuserar på utbetalningar och budgetar i SEK. Valutakursförändringar ingår inte i den svenska riskanalysen och betraktas ofta som en rent finansiell fråga för partnerorganisationer. Detta perspektiv misslyckas med att tydliggöra riskexponeringen för Sverige – att kursfluktuationerna har en negativ inverkan på de avsedda resultaten.

Överkontraktering och låg implementeringsgrad minskar riskerna

Analysen av enskilda biståndsaktiviteter, i de två fallstudierna, illustrerar hur en del av osäkerheten till följd av växelkursfluktuationer kompenseras av en överkontraktering eller ett underutnyttjande av medel, eller en kombination av båda.

Värdet av svenska åtaganden, i SEK, ökas i många fall genom en låg värdering av den svenska kronan vid en beräkning av det slutliga kontraktsvärdet. Detta medför en överkontraktering, ofta med cirka 10 procent av kontraktsvärdet, vilket ger partnerorganisationer en viss riskhantering. Men överkontraktering är samtidigt ett ineffektivt verktyg för att öka förutsägbarhet, eftersom betydande mängder svenskt bistånd blir uppbundet.

Många organisationer minskar sin finansiella risk genom en begränsad genomförandegrad, när i genomsnitt cirka 80 procent av budgeterade medel spenderas per år. Med resterande 20 procent skapas en finansiell buffert som sänker den finansiella risken över tid. Men det betyder också att organisationer som strävar efter ett effektivt genomförande, som håller sig nära överenskomna planer och budgetar, utsätts för väsentligt större finansiell risk.

Det finns praktiska alternativ för ökad förutsägbarhet

Studien har funnit få exempel på metoder för att mildra valutarisker bland andra givare. Denna finansiella risk är emellertid inte på något

sätt unik för biståndssektorn - tvärtom. Det finns många exempel från andra sektorer av hur förutsägbarheten i finansiella transaktioner kan ökas. Flera av dessa metoder skulle kunna användas för att öka förutsägbarheten i det svenska biståndet. Den övergripande slutsatsen är att flera sådana lösningar inte bara är möjliga utan också enkla, effektiva och kostnadseffektiva.

Rekommendationer

- *Ge förutsägbar finansiering i stora valutor.* En väsentlig del av svenskt bistånd utförs i USD eller andra större valutor. Sida och UD kan erbjuda partnerorganisationer fasta valutakurser för åtaganden i de fall användarna arbetar i större valutor (som USD, EUR, GBP och CHF). Ett sådant erbjudande skulle utgå från samlade valutaterminer, med hjälp av Riksgälden. Det är en tjänst tillgänglig för alla myndigheter. Med hjälp av en sådan tjänst kan en mer förutsägbar finansiering säkerställas för en majoritet av Sveriges partnerorganisationer. Det skulle dessutom, som en extra fördel, sannolikt leda till ett större bistånd, eftersom Riksgälden då skulle köpa valuta för partners till mycket konkurrenskraftiga villkor.

Lösningen kan sannolikt kunna genomföras inom ramen för befintliga administrativa resurser hos Sida/UD och Riksgälden. Det finns inga direkta kostnader för de berörda finansiella instrumenten.

- *Utforska innovativa finansiella lösningar för mindre valutor.* Sida kan eventuellt använda sitt garantiinstrument för att möjliggöra innovativa finansiella lösningar för riskreduktion, för biståndsaktiviteter som genomförs i mindre mer valutor i utvecklingsländer. En svensk finansiell garanti till en eller flera finansiella partners skulle kunna möjliggöra valutasäkrings-tjänster för biståndsorganisationer, där marknaden idag inte kan tillhandahålla sådana. På så sätt kan Sida stödja biståndseffektivitet och möjligen också bidra till ytterligare likviditet i de lokala marknaderna.

Denna lösning kan sannolikt genomföras med hjälp av tillgänglig finansiering och befintliga finansiella instrument.

- *Arbeta med transparenta och effektiva kontraktskurser.* Genom att tillhandahålla ett effektivt sätt att hantera risker (ovan) kan stora resurser frigöras för att möjliggöra mer svenskt bistånd. Genom att komma till rätta med nuvarande kontraktskurser, utan nedvärdering av SEK, skulle mer finansiering vara tillgänglig för ytterligare bistånd. Att använda transparenta och gemensamma valutakurser skulle också säkerställa en rättvis behandling av samtliga partnerorganisationer.
- *Säkerställ att partnerorganisationerna har positiva incitament för att säkerställa en hög implementeringsnivå, i linje med plan och budget.* Sida bör se till att organisationer som strävar efter att följa planer och budgetar inte utsätts för ekonomisk nackdel genom onödig riskexponering.
- *Öka insynen i finansiella transaktioner i rapporteringen till LATI.* Större kvalitet i öppna data ger inte bara möjlighet för ansvarsutkrävande inom det internationella biståndet utan också möjligheter för tjänsteleverantörer att presentera nya lösningar för ett effektivare svenskt bistånd.

Summary

This report examines how Swedish aid predictability is affected by the fact that most of Swedish aid is implemented in currencies other than the Swedish krona (SEK). The main question posed in the study is: *how predictable is the value of the amounts disbursed by Sweden in Swedish krona (SEK) in relation to the partner budget of the working currencies involved?* The report also presents practical policy recommendations for increased predictability of Swedish aid.

The importance of predictable aid, i.e. that *partners can be confident about the amounts and timing of aid disbursements*, has long been recognised by partner countries and donors alike. Studies have shown that the costs associated with unpredictable aid are both diverse and substantial, as they undermine partner countries and donors in their efforts to achieve development results. Predictability is also a central concept in the international agreements on aid in Paris, Accra and Busan.

Exchange rates can have an impact on the value of funds received when the donor has pledged funds in a currency other than that used by partners or recipients. How this affects predictability of aid funding is, however, a question that has received little attention in previous studies. In this report, this question is explored from a single perspective: the effect on the predictability of Swedish funding pledged in SEK.

The study is mainly based on the analysis of over 30 000 bilateral activities funded by Swedish aid from 2006–2016, as reported to the International Aid Transparency Initiative (IATI). Two case studies have also been conducted with visits to Rwanda and Zambia for a more in-depth analysis of how funded activities can be affected.

Findings

The overall conclusion of the study is that exchange rate fluctuations have a substantial impact on the predictability of Swedish aid. The majority of aid funded by Sweden is implemented in currencies other than SEK. As soon as time elapses between a Swedish funding

pledge in SEK and the disbursement of funds, uncertainty arises. This negative effect on predictability depends on the currencies involved and the time between pledge and disbursement. The longer the time and the more volatile the currencies are, the more substantial the effect on predictability.

Exchange rates decrease predictability

As key financial data has been found to be lacking in Swedish aid reporting, calculations of exact financial uncertainty are not possible. Going by assumptions and estimates, the results clearly show that there is considerable financial uncertainty due to exchange rate fluctuations. A partner organisation or recipient will, on average, face uncertainty regarding the value of Swedish funding of about (+/-) 9 per cent in the year funds are committed. For a three-year project, uncertainty thus grows to an average of (+/-) 27 per cent.

How financial uncertainty affects actual effectiveness depends to a large extent on how the partner organisations or recipients involved manage uncertainty, and on the implementation of the activity.

Options to reduce uncertainty are readily available

Exchange rate fluctuation is just one of many risks and uncertainties that can impact the predictability of aid funding or the actual implementation of funded activities. It might not be the biggest obstacle for partner organisations in their efforts to achieve the intended results, but the effect on predictability and effectiveness is still significant. The report also concludes that there are options readily available that could be implemented by the Swedish International Development Cooperation Agency (Sida) and the Swedish Ministry for Foreign Affairs (MFA) that would substantially reduce uncertainty resulting from exchange rate fluctuations.

Predictability is not about amounts paid, but amounts received

The report also underlines the importance of not only understanding aid predictability solely from a donor perspective. Interviews highlight a Swedish perspective on risk and funding that is focused on disbursements and budgets denominated in SEK. Exchange rate fluctuations are not a part of the Swedish risk analysis and are often regarded as a purely financial issue for partner organisations. This perspective fails to address the risk exposure for Sida and the MFA – that the rate fluctuations have a negative impact on the intended development results.

Over-contracting and low implementation rates lower risk

The more in-depth analysis of actual activities included in the two case studies illustrates how part of the uncertainty due to exchange rate fluctuations was offset by either over-contracting or under-performance, or a combination of both.

The value of Swedish commitments in SEK is regularly increased through a low valuation of the Swedish krona when calculating the contract value. This over-contracting, often around 10 per cent of the contracting value, provides partner organisations or recipients with some measure of risk management. But over-contracting is inefficient as a tool to increase predictability, as it means that substantial amounts of Swedish aid are tied up.

Many organisations manage to mitigate some of the risk by keeping their implementation rate in check, with an average of around 80 per cent of budgets being spent per year. With 20 per cent remaining, a financial buffer is created that lowers the financial risk over time. But this also means that organisations that strive for effective implementation, sticking closely to agreed plans and budgets, are exposed to a substantially higher amount of financial risk.

Several practical options are available based on best practices

The study has found almost no examples of best practices for currency risk mitigation among other donors. Exchange rate risks are, however, by no means exclusively found in the aid sector – on the contrary. There are a lot of examples from other sectors of how predictability in financial transactions can be increased. These could in several cases be implemented in the context of Swedish aid to improve predictability. The overall conclusion is that several such solutions are not only feasible but also simple, effective and cost-efficient.

Recommendations

- *Provide predictable funding in major currencies.* A substantial portion of Swedish aid is implemented in USD or other major currencies. Sida and the MFA could offer partner organisations fixed rates for commitments in cases where users work in these larger currencies (such as USD, EUR, GBP and CHF). Such offers would be backed by forward contracts managed by the Swedish National Debt Office (SNDO), a service provided to all government agencies. By means of such a service, improved predictability could be ensured for the majority of partner organisations. It would, as an additional benefit, also likely result in further aid funds, as the SNDO would be purchasing currency for partners at competitive government rates. The solution could likely be implemented through existing administrative resources at Sida/MFA and the SNDO. There are no direct costs for the financial instruments involved.
- *Explore innovative financial solutions for smaller currencies.* Sida could possibly use its guarantee instrument to enable innovative financial solutions for risk reduction in smaller currencies in developing countries. By extending a guarantee to a partner organisation that would provide hedging services for aid organisations, Sida could support aid effectiveness while possibly providing additional liquidity in developing markets. This solution could likely be implemented using available funding and existing financial instruments.

- *Work with transparent and efficient contracting rates.* By providing an efficient means of risk management (above), substantial resources could be freed up to enable more Swedish aid to be provided. By contracting at current market rates, without depreciation of the Swedish krona, more funding would be available for other aid activities. Using a set and transparent rate would also ensure fairer treatment of partner organisations.
- *Ensure that partner organisations have positive incentives to ensure a high implementation rate in line with plans and budgets.* Sida should ensure that organisations that strive to follow plans and budgets are not placed at a financial disadvantage by unnecessary risk exposure.
- *Increase transparency about financial transactions in the reporting to the LATI.* Open data may not only increase accountability but also provide opportunities for solution providers to present new solutions for more effective and efficient Swedish aid.

1 Swedish aid from a currency perspective

In 2014, the Swedish krona (SEK) lost almost 20 per cent of its value compared to the US dollar (USD). This fact was discussed in the financial papers, but it also had an important impact on several hundred aid activities funded by Swedish aid. Partner organisations working in USD lost 20 per cent of the value of Swedish aid funding. As funds lost value, planned activities and budgets were affected. Some organisations had to request additional funding from Sida, while others managed to handle the situation by planning, budgeting or implementing things differently.

The above is not a unique example of how fluctuations in exchange rates can affect aid funding. Most Swedish aid is implemented outside Sweden in currencies other than SEK. The use of more than one currency exposes aid funding to the highly volatile currency market. The result is that aid organisations must take currency fluctuations into account when they estimate the value of their funding over time.

This report maps and analyses Swedish aid flows over a ten-year period, with the specific goal of analysing exchange rate effects on the value and predictability of Swedish aid. It also discusses, in a broader sense, questions of transparency and aid efficiency. The main question posed in the study is: *how predictable is the value of the amounts disbursed by Sweden in Swedish krona (SEK) in relation to the partner budget of the working currencies involved?*

1.1 The importance of predictable aid

The OECD DAC has defined aid predictability as “*when partner countries can be confident about the amounts and the timing of aid disbursements.*”¹ The importance of predictable aid has long been recognised by partner countries and donors alike and is a central

¹ DAC Working Party on Aid Effectiveness, 2011, p. 18.

concept in the international agreements on aid in Paris, Accra and Busan.² Studies have shown that the costs associated with unpredictable aid are both diverse and substantial, as they undermine partner countries and donors in their efforts to achieve development results.³ There are several factors that can affect predictability, from donor and partner characteristics to the aid modalities.⁴

Effects range from undermined economic management of public and project finances to the abandonment of funding for advanced projects that require continuous funding, as well as magnification of economic difficulties in the procyclical world of aid funding. Additional effects are aid fragmentation, increased corruption, rent-seeking and general issues regarding the misuse of aid funds.⁵ Some studies put the cost at 20 per cent of total aid, which would mean annual losses of tens of billions of USD.⁶

Both the Riksdag (Swedish Parliament) and the Swedish Government have declared that predictable funding is one of the preconditions for effective Swedish aid. The importance of recipients and implementing partners, as well as other donors, being able to count on predictable aid is an aspect that Sweden has also recognised through participation in international agreements.⁷ Sweden is often considered as one of the more predictable partners, working with long-term commitments and clear disbursement schedules. Sida normally disburses about 99.9 per cent of its annual

² The Paris Declaration on Aid Effectiveness, 2005, The Accra Agenda for Action, 2008, Busan Partnership for effective development co-operation, 2011.

³ For a review of literature on the subject, see for example DAC Working Party on Aid Effectiveness, 2011.

⁴ Pycroft & Martins, 2009.

⁵ For an overview of the costs of unpredictability and volatility in aid funding, as well as calculations of those costs, see Bigsten et al., 2011.

⁶ Kharas, H., 2008.

⁷ In the Paris Declaration on Aid Effectiveness, 2005, donors pledged to increase predictability in aid disbursements. The Accra Agenda for Action, 2008, sets out requirements for continuous financial information needed for planning. In the Busan Partnership for effective development co-operation, 2011, Sweden committed to regularly providing updated information about planned financial aid flows. See also the Government budget for 2007 (Regeringen, 2006), MFA & Sida, 2009, and the Swedish National Audit Office, 2016.

funds.⁸ Funds allocated to Sida will be disbursed in accordance with the overall budget. This means that once funds are budgeted, the OECD DAC criteria for predictable aid are virtually fulfilled – *at least from a Swedish perspective*.

Although interventions are mainly contracted and funded in SEK, most recipients work with other currencies. How the value of the Swedish krona has changed since the funds were committed becomes an important question for the recipients (see Box 1 below). Exchange rates are often volatile and commitments long, which means fluctuations can have substantial effects. The same is true for many other donors or aid organisations, with more than one currency being involved in the flow from donor to recipient.

Box 1. Exchange rates and predictable aid

Exchange rates are measures of the relative value of two currencies. i.e. the current market price to buy (or sell) one currency in exchange for another currency. Values of different currencies depend on a wide range of underlying economic and political determinants, and as these change, the relative value of currencies will fluctuate. Exchange rates are highly volatile, with developing countries having higher average volatility.⁹

A large portion of aid funding involves one or more currency exchanges. It may, for example, be the case that a donor commits funds in their own currency, not the currency used by a implementing organisation or recipients, or that an aid activity is carried out in several different countries, using different currencies.

As soon as time elapses between funds being committed (or budgeted) in one currency and received (or spent) in another, the aid activity is exposed to a currency risk. The value of incoming funds may, for example, change in the time between commitment and disbursement. The result is uncertainty, or risk. There is a financial risk that funding or costs will diverge from what was budgeted. However, there is also an operational risk that the intended results cannot be achieved because of changes in funding. The link between aid funds and exchange rates can therefore directly impact the predictability of aid.

⁸ Sida 2015b. The Swedish International Development Cooperation Agency, Sida, is a government agency working to reduce poverty in the world. The agency manages Swedish bilateral aid.

⁹ Cevik et al., 2015.

Example: A donor commits to funding a project implemented by an NGO in Kenya. The project will run for three years, and the donor has committed to provide the project with USD 1 million per year. The donor will disburse funds twice yearly. The NGO works in Kenyan Shilling (KES), and therefore the exchange rate between USD and KES will affect the funding available for the project. A strong USD results in a higher amount in KES, while a weak USD leads to a lower amount in KES than budgeted.

How exchange rate volatility affects the predictability of aid is a question that has not received a great deal of attention in previous aid studies.¹⁰ This does not mean, however, that the subject is unknown in the aid world. On the contrary, interviews in the present study and other studies show that a lot of effort is being put into handling fluctuations in funding that arise due to changes in exchange rates.¹¹ How aid recipients and partner organisations are affected and how they cope, however, has not been studied sufficiently, nor has the overall effect on the predictability of aid.

1.2 About the study and this report

This report is a first attempt to describe how Swedish aid predictability is affected by the fact that most of Swedish aid is implemented in currencies other than Swedish krona (SEK). How confident can our partners be that the amounts disbursed by Sweden in SEK will match the expected value in the working currencies involved?

The study is largely based on an analysis of historical data on Swedish aid from the International Aid Transparency Initiative (IATI) database.¹² All Swedish aid activities funded from 2006 to

¹⁰ DAC Working Party on Aid Effectiveness, 2011.

¹¹ Swedish National Audit Office, 2014b.

¹² IATI is a multi-stakeholder initiative that seeks to improve the transparency of aid, development and humanitarian resources. A cornerstone of IATI is the IATI Standard, a format and framework for publishing data on aid funding and activities, intended to be used by all organisations in development. Sweden,

2016 have been included in the analysis. Unfortunately, the IATI data does not include information on the currencies used when funded activities are implemented (see chapter 2.2 for more information on this).

An important part of this study has been to establish well-grounded assumptions regarding currency exposure in the implementation of Swedish aid. Aid has been categorised into three main types in order to map currency exposure. Information about the countries and types of organisations involved has provided key input in terms of coming to an initial understanding of currency use in the implementation of Swedish aid (see chapter 2.2).

Based on these assumptions about currency use and the categorisation of aid, the impact on the value of Swedish aid has then been analysed from the perspective of recipients and partner organisations. Each portfolio of annual commitments has been analysed from the date when Sweden pledged funds until the date when those funds had been fully disbursed. The result, presented in Chapter 2, shows how the value of Swedish aid fluctuates over time in relation to exchange rates. The analysis shows that a few currencies mainly impact the value of Swedish aid, and that some countries and implementing partners are more affected than others by unpredictability due to currency fluctuations.

In Chapter 3, the report changes perspective and looks ahead to describe how exchange rate volatility affects the future predictability of Swedish aid. When Sweden has committed to funding in SEK, what does that mean for the average partner?

While the report describes how exchange rate volatility contributes to the difficulty of predicting Swedish aid, it should already from this point be made clear that the study has not covered the resulting effects on the implementation of aid. Although some examples are given, how predictability affects aid is a larger question that lies outside the scope of this report. It should also be noted that the main focus of the study has been bilateral aid (some comments

through Sida, publishes data about all its aid funding through IATI. For more information, see <http://iatistandard.org/>.

on multilateral aid and exchange rate volatility can, however, be found in chapter 2.2).

During this study, two trips to countries receiving Swedish aid have been conducted to analyse in more detail how bilateral portfolios and individual activities can be affected by exchange rate volatility. The findings from these two visits, to Rwanda and Zambia, are presented in Chapter 4. The study trips provided data about the different types of currency risk that funded activities can be exposed to, and how exchange rate fluctuations are managed by both partners and Sida.

This paper focuses on Swedish aid, but a brief overview of other donors and sectors is provided in Chapter 5. Currency management at a selection of other donors is examined, as well as the best practices of some partner organisations. While the map of currency management in the aid sector is by no means complete (see Box 2 below), the chapter aims to provide a better understanding of options for effective currency management.

Box 2. Exchange rates and transaction costs

The study presented in this report focuses, as described above, on the effect of exchange rate volatility on Swedish aid. It is, however, important to note that currency transactions can also have other effects on aid activities.

One major issue is the fact that each currency exchange carries a transaction cost. How currency transactions are managed can therefore have a direct impact on the amount of aid available to implementing partners or recipients. There are large amounts involved in aid and countless transactions between different currencies. The total costs of currency transactions can thus be substantial for foreign aid. The question has, unfortunately, not received enough attention, so there is almost no data on this apart from a few reports.¹³

¹³ Swedish National Audit Office, 2014b; Backlund and Sörensson, 2015; Boakye-Adjei, 2009; and Boakye-Adjei, 2011.

2 The aid budget from a currency perspective

This section examines the background to how exchange rate volatility can affect Swedish aid. It is divided into two parts, each section mapping exchange exposure in distinct parts of the aid implementation funded by Sweden. Both will explore how different types of organisations are exposed, the importance of how funds are committed, as well as mapping the currencies involved. All this will contribute to an understanding of how exchange rates affect predictability and what uncertain funding means for partners and recipients of Swedish aid.

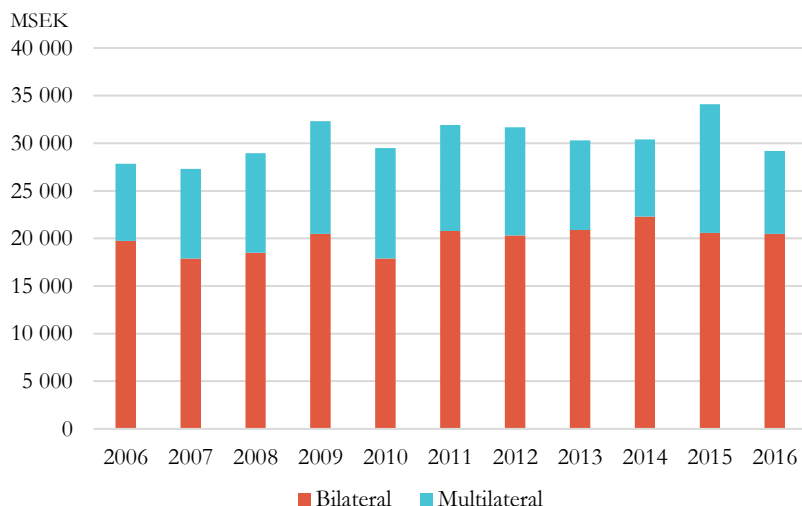
About 80 per cent of Swedish aid funds are used to fund aid activities implemented outside of Sweden.¹⁴ This means that, in most cases, one or more currencies other than SEK will be used in the activities funded. The value of these currencies over time compared to SEK, and the cost of exchange, can thus affect the predictability and efficiency of Swedish aid.

Section 2.1 below presents an analysis of Swedish bilateral aid, describing how that part of the aid portfolio is exposed to foreign currencies. Secondly, section 2.2 describes the multilateral part of the Swedish aid budget, also with a focus on its exposure to foreign currencies.

Bilateral and multilateral aid are dealt with separately from each other in the analysis, since commitment and disbursement patterns are to a large extent governed by different logics in the different aid sectors, with different outcomes from exchange rate volatility regarding the value and predictability of aid.

¹⁴ EBA, 2014.

Figure 1. Swedish aid per collaboration type, 2006–2016



Notes: Figures in SEK million. Figures do not include costs for refugees in Sweden. Source: IATI

In bilateral aid, Swedish commitments are denominated in SEK, and therefore all potential financial currency risk is borne by the partner or recipient. In multilateral aid, commitments are most often denominated in the working currency of the multilateral organisation. As such, the Swedish Government will be exposed to the financial currency risk. The difference thus results in a situation where Sweden covers the risk in its multilateral collaborations, which represent about a third of the aid budget (see Figure 1).

Box 3. Currency transactions in Swedish aid

Swedish aid is managed by Sida (bilateral aid) and the Ministry for Foreign Affairs (MFA – multilateral aid). Since 2011 all financial disbursements have been managed by Sida for both bilateral and multilateral commitments. Sida has an objective to ensure effective currency management, as stated in the ordinance containing the agency's instructions.¹⁵

Transactions are effectuated by Sida, and funds are disbursed to recipient and partner accounts in the agreed currencies. If partners have accounts denominated in currencies other than SEK, Sida uses a commercial bank to effectuate the exchange of funds.¹⁶ For additional information on Swedish aid disbursements, see chapter 2.2.¹⁷

2.1 Currency and Swedish bilateral aid

Bilateral aid comprises funds that go directly from the official source (Sida) to implementing partner organisations in Sweden or other countries. How such activities are affected by exchange rate volatility depends of the kinds of organisations implementing a project, the value and length of the Swedish commitment and the currencies involved. Taken together, these three components (commitment, partner organisation and currency) make up the sections of a “portfolio” that can be analysed from a currency perspective.

¹⁵ MFA, 2010. A minor exception is that, since 2017, the Legal, Financial and Administrative Services Agency manages disbursements of aid funding to Swedfund AB.

¹⁶ For a detailed description of how Sida manages currency purchases, see Swedish National Audit Office, 2014b.

¹⁷ The Swedish National Debt Office (SNDO) is the central government body responsible for financial management and handling tasks including the Government's internal banking and cash management provisions. In 2017 the SNDO procured a new framework agreement for payments that includes currency banking, with the objective of making currency payments more efficient. Government agencies will make currency payments through the centralised service, enabling netting and joint liquidity management. It is estimated that this will substantially decrease the transaction costs involved in currency payments. See <https://www.riksgalden.se/>.

2.1.1 Commitments and disbursements

A typical bilateral activity in Swedish aid runs for three years. Sida commits a fixed amount in SEK that is to be disbursed during the activity period. If the recipient or partner organisation uses one or more non-SEK currencies, uncertainty develops: what will the value of the Swedish krona be at the time funds are disbursed? To understand how Swedish aid can be affected by exchange rate volatility, we thus need to look at the commitments made: their number, their values and their disbursement times.

The bilateral portion of the Swedish aid portfolio encompasses thousands of activities per year. Over the period studied, Sida has on average committed to fund around 2 000 new activities per year. The total number of funded activities per year has declined. In 2006 Sida funded a total of about 7 500 activities. Eleven years later the active portfolio consisted of about 3 000 funded activities. The change towards fewer funded activities is reflected in the average value of commitments, which increased from around SEK 6 million in 2006 to just over SEK 14 million per funded commitment in 2016.¹⁸

The move towards fewer and larger commitments could be connected to a shift in implementation channels. During the period studied, an increasing proportion of Swedish funding has been channelled through multilaterals or international NGOs (INGOs). Both types of organisation have the capacity to manage larger activities as compared to smaller, local organisations.

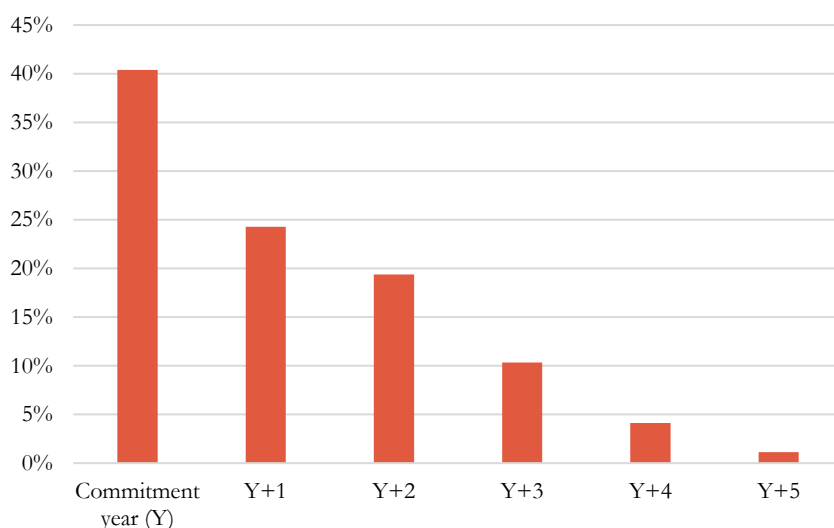
While funded activities have grown in value during the period studied, the average commitment lengths were stable, with the average funded activity running for around three years. There is quite a lot of variation, with both longer and shorter activities. The length of commitments is often connected to the type of aid, with development cooperation often having longer, multi-year contracts

¹⁸ The figures are based on IATI data on Swedish aid. As not all IATI activities have commitments, the yearly totals are based on the number of separate activities with payment data during a specific year.

and humanitarian funds being more flexible in nature, with shorter contract periods.

Sida normally disburses funds throughout the implementation of a funded activity, in relation to how funds are used by recipient or partner organisations. One or more disbursements per year over the contract period is the standard. As mentioned above, the time from commitment to disbursement creates a currency risk. The disbursement schedule thus becomes important in terms of the predictability of Swedish funding.

Figure 2. Average disbursement rate, Swedish bilateral aid, 2006–2016, in per cent

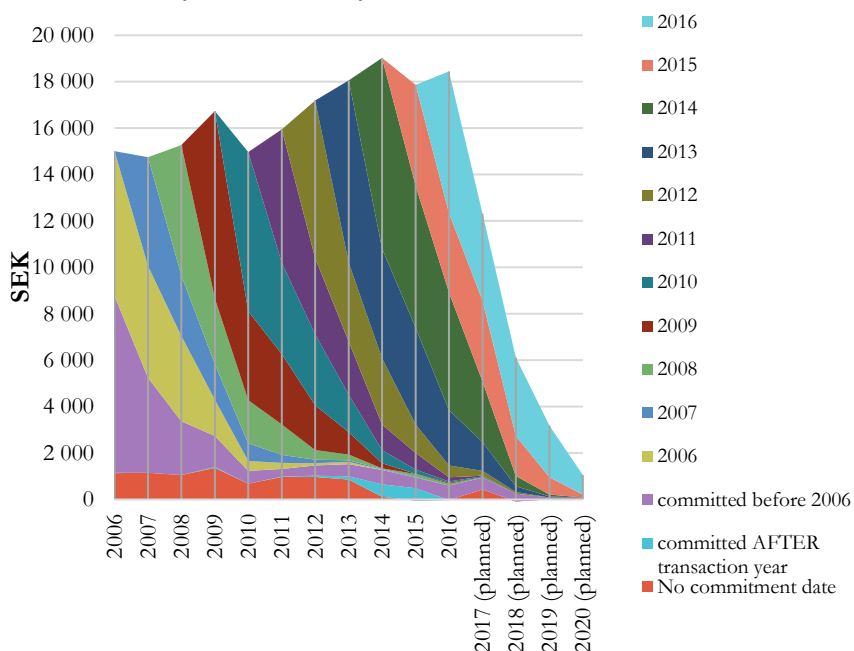


Source: IATI

The average disbursement rate is presented in Figure 2 above. About 40 per cent of funds are on average disbursed within a year of Sida making a commitment. In the following two years, another 45 per cent are disbursed. The higher average figures for the first year can be partly explained by shorter humanitarian commitments, where funds are normally committed and disbursed in rapid succession.

On average, the time from commitment to disbursement is a year or more for about two-thirds of the total funding committed. The delay in funds disbursed during the first year is also significant, however. On average, the commitment date was in March, while the average first disbursement date was in August the same year.

Figure 3. Disbursement of aid per commitment year, Swedish bilateral aid, 2006 – 2016, SEK million



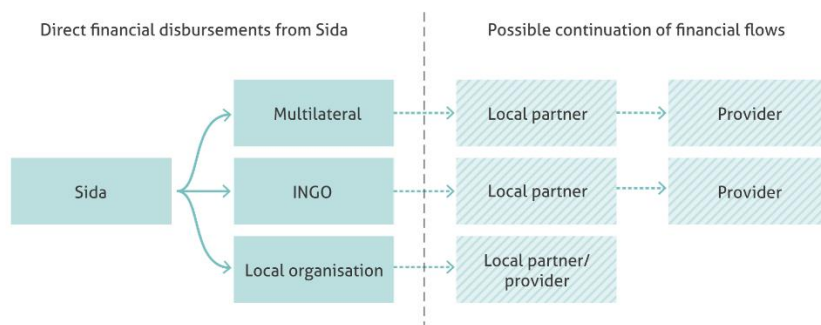
Source: IATI

With an average disbursement schedule in which about 90 per cent of funds are disbursed over three years, Sida's annual payments are linked to commitments made over a series of years. Figure 3 above shows the disbursements made from 2006 to 2016. The diagram shows the length of commitments and therefore how each year's SEK disbursements are linked to recipient and partner budgets going back through the years.

2.1.2 Implementation channels in Swedish bilateral aid

There is a wide array of different kinds of partner organisations implementing Swedish aid, from national governments and local NGOs to large international and multilateral organisations (bilateral activities implemented by multilateral organisations are referred to as “multi-bi”). The types of organisations involved will impact the currencies used and thereby the currency exposure of Swedish aid. Sida funds activities in many countries, channelled through organisations of different kinds.

Figure 4. Funding flows in Swedish bilateral aid



The left-hand side of Figure 4 above illustrates direct disbursements from Sida. On the right-hand side of the figure is a possible continuation. This is to illustrate that funding from Sida is often transferred onwards from the first partner organisation. The figure presents a simplified picture of the number and types of implementation channels; there is a wider range of organisational types. See Box 4 on the next page.

In this paper, organisations will be clustered together in three broad groups to simplify analysis: multilaterals (Multi-bi), INGOs and local organisations (Local); see Box 4 below. The use of groups is an analytical tool to estimate the currencies used in Swedish aid, built on the assumption that local organisations use local currency to a higher extent than international and multilateral organisations.

Box 4. Grouping implementation channels

The IATI has defined eight different implementation channels in aid.¹⁹ These have been used in this study to estimate the currency exposure in Swedish aid. Based on interviews, *very rough estimates* of currency use have been made for each group.

Multilaterals (100% USD)

Bilateral activities are often implemented by multilateral organisations. Such multi-bi activities represented nearly 40 per cent of all bilateral aid in 2016. In this report, it is assumed that all such activities are implemented in USD. This is the normal operating currency in the multilateral domain.

International NGOs (50% USD and 50% local currency)

A substantial and growing portion of Swedish bilateral aid is channelled through INGOs. These are roughly defined as non-governmental organisations that have operations in more than one country. INGOs can have different roles in activities, sometimes implementing the activities directly but often using local partner organisations in the recipient countries. It is assumed here that average currency use is equally divided between USD and local currencies. This will vary widely between individual activities, from zero to 100 per cent USD.

Local organisations (100% local currency)

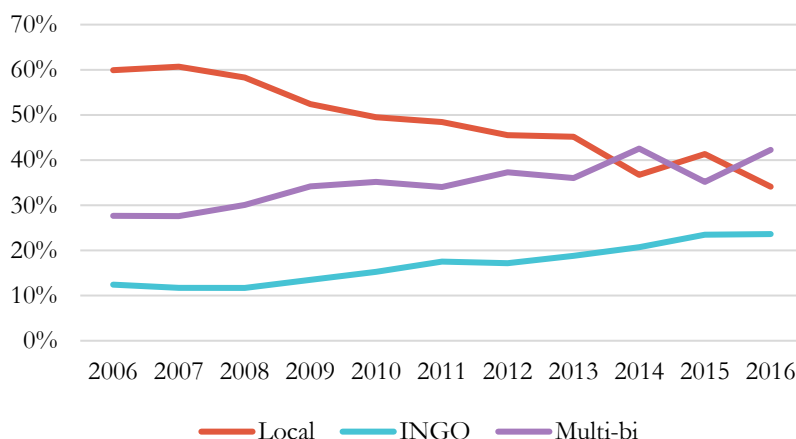
The remaining six IATI implementing channels have been grouped together as one, under the assumption that they mostly use local currency. The group consists of governments, national and regional NGOs, Public Private Partnerships (PPP), private sector partners and academic organisations.

Not all Swedish aid is implemented outside Sweden or in foreign currencies. Part of the funds is used in Sweden or by Swedish organisations working abroad. As such, a certain amount of the funds is not exchanged from SEK. A portion of the funds destined for Swedish organisations has been excluded from the calculations to take this fact into account.

During the period analysed in this paper, the use of multilateral organisations and INGOs has increased from 40 per cent in 2006 to 65 per cent in 2016. Both implementation channels have approximately doubled their respective values over the period, and multi-bi is now the largest implementation channel for Swedish bilateral aid (see Figure 5 below).

¹⁹ The IATI standard can be found at <http://iatistandard.org/>.

Figure 5. Implementation channels, Swedish bilateral aid, 2006 – 2016, proportion of total Swedish aid, in per cent



Source: IATI

The move from a focus on implementation by local partners to a higher use of INGOs and multilaterals has affected the currency exposure of Swedish bilateral aid. With these implementation channels, USD will become a more important currency, and direct exposure to other currencies will decrease.²⁰

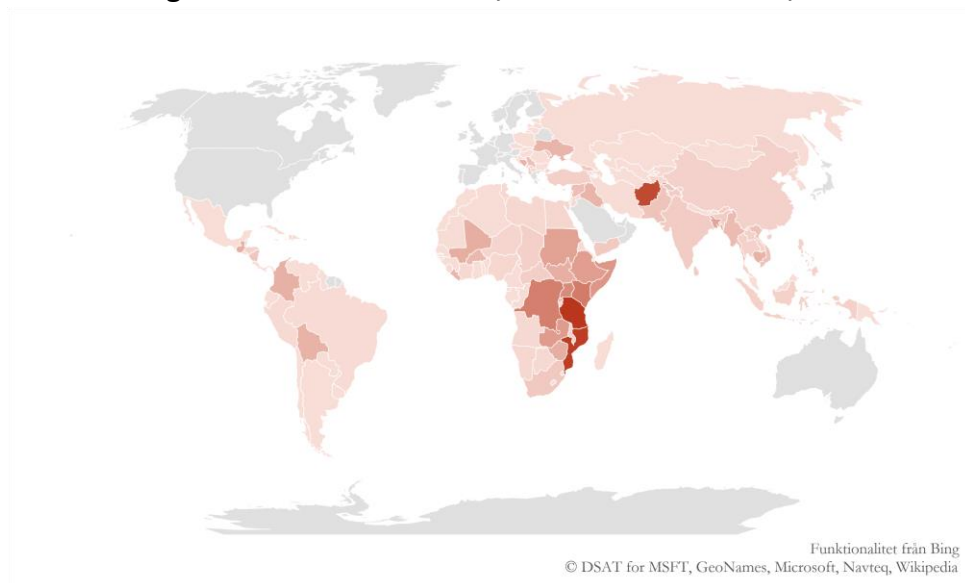
2.1.3 Geographical distribution of Swedish bilateral aid

During the period studied, Sweden funded bilateral aid activities in about 100 countries per year. The distribution of funds does, however, vary widely among the countries, and about a third of funds go to activities that cover more than one country, being thematic, regional or global. The two-thirds that are directly linked to a partner country focus heavily on a few selected partner

²⁰ It should be noted that the analysis in this paper focuses on the first layer of implementing organisations. A large amount of funds moves from larger organisations to either local aid organisations or local service providers. This is, however, seldom reflected in the IATI data.

countries. About ten countries receive about half of all direct bilateral aid on average, or about a third of all bilateral funding.²¹

Figure 6. Partner countries, Swedish bilateral aid, 2006–2016



Note: The shading corresponds to the total average aid received over the period studied. Darker shading corresponds to higher amounts of funding. Source: IATI.

As can be seen in Figure 6 above, Swedish aid has been put to work in large parts of Africa, Asia and South America from 2006 to 2016. Preferred partner countries have primarily been found in eastern Africa, plus Afghanistan. The ten largest recipient countries are presented in Table 1 below.

²¹ For more on this topic, see Hagen 2015.

Table 1. The ten countries receiving the most bilateral aid from Sweden, 2006–2016, yearly average

Country	Bilateral aid, average, MSEK
Tanzania	742
Mozambique	708
Afghanistan	658
Kenya	437
Congo, (Kinshasa)	418
Palestinian Territory	413
Uganda	364
Somalia	314
Zambia	290
Ethiopia	282

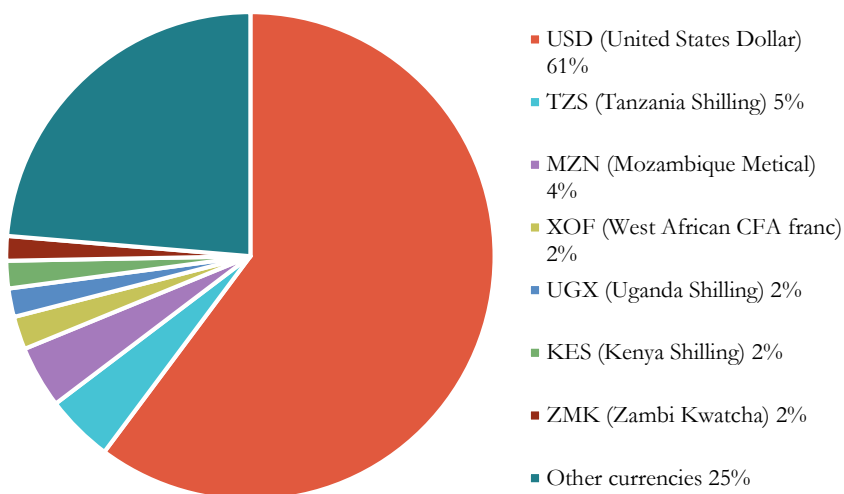
Source: IATI

Geographical distribution by country is part of the way to understand the currencies involved in the implementation of Swedish aid. When combining geographical distribution with the implementation channels described in the section above (2.1.2), a full picture of the currency exposure can be deduced. Let us, for example, look at the assumptions made for the top three countries: Tanzania, Mozambique and Afghanistan.

In both Tanzania and Mozambique, the national governments have been the main partner and implementation channel for Swedish aid. As such, the currencies assumed to have been used are local currencies in those countries. In Afghanistan, Swedish aid has primarily been implemented through multilateral organisations or INGOs. As a result, USD has been the primary currency for Swedish aid in Afghanistan.

Carrying out this analysis for all the partner countries from 2006 to 2016 gives us an estimate of the aggregated currency exposure for Swedish bilateral aid, presented in Figure 7 below.

Figure 7. Average currency distribution in Swedish bilateral aid, 2006–2016



Source: IATI

The dependence on multilaterals and INGOs is clear, contributing to a about 60-per cent stake for USD in the totals. The remaining portion is divided among a wide range of other currencies. As with the totals, a limited number of preferred partner countries represent the largest portion. The top five countries represent about a third of the non-USD currencies. Adding another ten covers another third of the non-USD portion of the portfolio.²²

²² Please note: the above bilateral currency portfolio is based on several assumptions about the final currencies used in the implementation of Swedish aid. The currency transactions made differ from this data, as the direct transactions made mainly involve exchanges from SEK to USD. Funds will then in part be exchanged again in order for partners to receive the implementation currency.

2.2 Currency exposure in Swedish multilateral aid

About one-third of Swedish aid directly funds multilateral organisations (not counting bilateral activities implemented by bilateral organisations; see above). There are a few things that set multilateral funding apart from the bilateral part of the Swedish aid portfolio, and this affects the question of predictability and exchange rate fluctuation.

An important difference is that the commitment types differ from those for many bilateral activities. Direct funding to the multilateral system most often takes the form of core or budget support, committed after negotiations with other national donors. Commitment lengths, disbursement schedules and even commitment currency can be coordinated. This can have a direct impact on the predictability of organisational funding. Several organisations, mostly in the UN system, are funded through one-year core funding. This funding is negotiated and committed to on a yearly basis. A second commitment type is overlapping multi-year core funding, most often provided to multilateral financial institutions such as the development banks.²³

Commitments denominated in other currencies

Several multilateral organisations receive commitments denominated in the working currency of the individual multilateral organisation. When commitments are denominated in currencies other than SEK, the risk exposure is reversed and the Swedish government stands the risk should the value of the Swedish krona decrease. The result is that exchange rate fluctuations do not affect the amount received by the organisation but rather the costs for the Swedish Government.

The multilateral organisation can be confident about the amounts and the timing of aid disbursements without having to take exchange rate fluctuations into account. When funding is

²³ For a more detailed description of Swedish multilateral aid and different types of funding partnerships, see e.g. the Swedish National Audit Office, 2014a.

committed in the working currency, the OECD criteria for predictable funding are to a large extent fulfilled.

This type of commitment can, however, affect the Swedish aid budget and therefore the funding planned for other aid activities. The Swedish National Audit Office (SNAO) audited currency management in Swedish aid in 2014. The SNAO described how volatility in the multilateral commitments due to currency fluctuation was managed by using the rest of the aid budget as a buffer.²⁴ If the value of the Swedish krona increased, new activities could be funded, and if it depreciated, other activities had to be limited. The SNAO audit focused on aid transactions in 2013, when the Swedish krona fell about 10 per cent compared to the currencies used in multilateral commitments. The result was that other parts of the aid budget had to be reduced by SEK 134 million. As payments were mainly made at the end of the year, the unpledged funds available were limited. This meant that changes had a larger relative effect on the remaining budget.

At the end of 2016, Sweden had remaining commitments to multilateral organisations valued at an equivalent of SEK 10 billion. These long-term commitments were almost exclusively made in EUR.²⁵

Since 2011, Sida has managed multilateral financial transactions and is responsible for any financial risk during the budget year. As there is exposure to risk stemming from some of the long-term multilateral commitments, in 2015 Sida started to hedge these to decrease the risk exposure during the current budget year.²⁶ IN this way, risk exposure in relation to the remaining aid budget has decreased.

²⁴ The Swedish National Audit Office, 2014b. After the audit, Sida was tasked with ensuring effective currency management in its government instructions; see MFA, 2010.

²⁵ Sida, 2016a, p. 150.

²⁶ Sida, 2015a, p. 57.

Commitments denominated in SEK

Sweden also makes substantial funding commitments to multilateral organisations in SEK, both multi-year pledges and single-year commitments. These often differ from bilateral commitments in several ways.

Longer-term commitments primarily involve multilateral financial institutions, i.e. the development banks. These are organisations with sufficient capacity to manage the risk exposure. They are also often organised in a way that provides them with a substantial level of “natural hedging”, as they will be funded in a large number of different currencies. Depreciation in one currency is thus matched by appreciation in other currencies, evening out incoming funding.

Those multilateral organisations that receive funding through annual commitments differ from the often long-term bilateral projects in that the time from commitment to disbursement is often much shorter. Uncertainty in the value of a Swedish commitment does not have time to grow when commitment and disbursements take place in rapid succession.

The currencies used are to a large extent major currencies: USD for the most part, but also Swiss Francs (CHF), as many multilateral organisations are based in Switzerland. The use of larger currencies means relatively lower volatility.

That said, there are still multilateral organisations that face uncertainty in their funding due to exposure to exchange rate fluctuations. This is partly due to the fact that multilaterals differ in their organisational capacity to manage financial risk. Multilaterals also differ in how their funding is distributed between donors and between currencies. While the larger ones often have substantial funding in several currencies, smaller organisations might rely on fewer donors. This means that their funding becomes more exposed

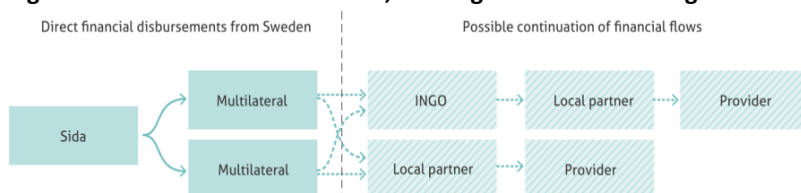
to fluctuations in exchange rates between the donor currency and the working currency.²⁷

A deeper understanding of how different multilaterals are exposed to, and manage, currency risk in their funding would clearly be valuable. Some of the larger, or more advanced, organisations must have working practices that could serve as best practices (see e.g. chapter 5 about IFFIm). Such lessons could likely benefit not only other multilaterals but also other international aid organisations. Such a review is, alas, outside the scope of this study.

Box 5. How do the multilaterals manage to ensure predictable funding in their own commitments?

To a substantial extent, Swedish funding provided in the multilateral system takes the form of core or budget support. How funds are used is then up to the organisations themselves. While many multilaterals have their own operations and implement many activities, a substantial portion of funds is channelled through to different types of implementing partners. As such, the manner in which the multilaterals handle the issue of exchange rates can impact those partners.

Figure 8. Swedish financial aid, through multilateral organisations



Note: Sida only effectuates the financial transactions. The MFA manages the multilateral portfolio.

Just as the value of commitments in SEK can impact predictability of financial aid, so can commitments in other currencies. The multilateral organisations are, in turn, some of the largest donors. An important question is thus also how to manage currency risk when funding other organisations. The multilateral system is made up of a multitude of organisations, and the various currency management practices are unfortunately outside the scope of this report.

²⁷ One such case was recently highlighted in the MFA organisation strategy for UNFPA 2017–2021, where unfavourable dollar rates had significant effects on the total funding. MFA, 2017.

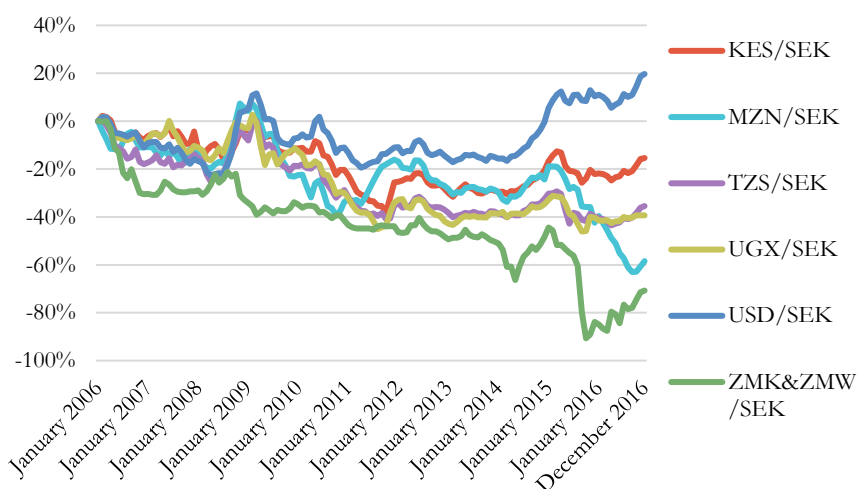
3 The value of Swedish aid

In this chapter, the historical effects of exchange rate volatility on existing bilateral commitments will be described. The historical outcomes illustrate that the value of Swedish bilateral aid has fluctuated due to its connection to exchange rates. In chapter 4, the focus will be on the predictability of Swedish aid commitments going forward.

3.1 The value of Swedish commitments

As described above, Swedish bilateral aid is primarily exposed to the US dollar, and the USD/SEK rate can therefore have a substantial impact on the overall value of Swedish aid. About 40 per cent of funds are implemented in other currencies; however, none of these are large enough to have a substantial impact on the overall portfolio value on their own. The exposure for individual activities can still be substantial, however.

Figure 9. Exchange rates, USD and the five biggest non-USD currencies, change in per cent from 2006, priced in SEK



Note: KES: Kenyan Shilling, MZN: Mozambique Metical, TZS: Tanzania Shilling, UGX: Uganda Shilling, ZMK&ZMW: Zambian Kwacha. Note that a new redenominated Zambian Kwacha (ZMW) was introduced in January 2013, replacing the previous Kwacha (ZMK). In the diagram above, rebased value has been used for calculations of the rate changes. Source: apilayer

Figure 9 above shows exchange rates for USD and the five biggest non-USD currencies. The diagram illustrates the volatility in the currency market. In the total portfolio, the average annual volatility (measured as the standard deviation) was around 15 per cent. The US dollar averaged about 9 per cent annual volatility.

The value of each year's aid commitments fluctuates with the exchange rates until the end of the commitments, when the total contracted amount has been paid out and the activity has been finalised.

Table 2. Change in total value of committed funds disbursed in currencies other than SEK million, per commitment year, 2006–2016

Commitment year	Committed (MSEK)	Total change (MSEK)	Total change (%)
2006	15 991	1 322	9%
2007	9 905	189	2%
2008	12 048	-1 273	-11%
2009	17 319	2 934	18%
2010	16 263	894	6%
2011	12 555	-489	-4%
2012	13 553	-113	-1%
2013	18 199	-1 060	-7%
2014	20 790	-1 765	-11%
2015	12 072	313	4%
2016	15 447	-204	-3%

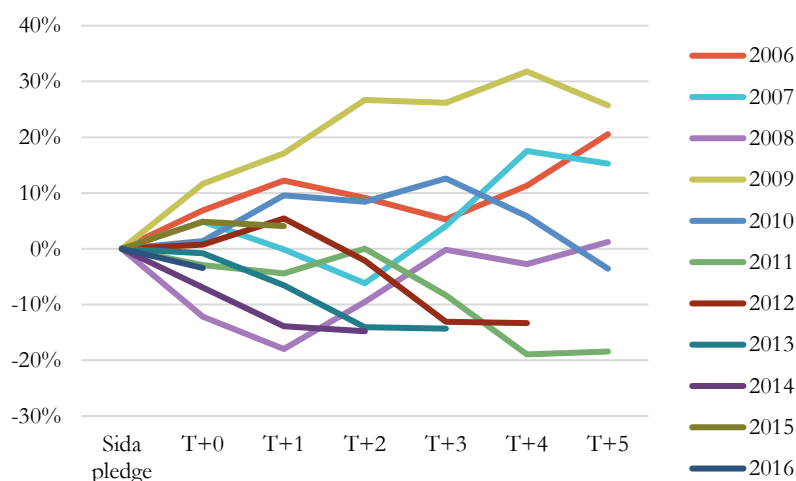
Note: Change in total value of committed funds is calculated as the net value change of all SEK commitments for each commitment year, from a partner perspective. The change is the value of the Swedish krona in relation to the currencies used in the bilateral portfolio. The change in per cent has then been used to calculate a corresponding value change in SEK for illustrative purposes. Note that funds committed in 2012 and later have not been fully disbursed yet, as these activities are still ongoing.

Table 2 above illustrates how much the commitment in SEK changed in value in the period from commitment to disbursement, over a six-year disbursement period. As described above (section 2.1.1), funds are mostly disbursed during the first three years, so this period has the most impact on the aggregated results. While rates may continue to change over time, the last three years only represent about 15 per cent of total disbursements. From 2006–2016, the average change in value was 7 per cent over the disbursement period. There is substantial variation both in how the value of a commitment develops and between different years.

The above table shows the aggregate volatility at the end of an entire disbursement cycle. The value of funding does, however, fluctuate throughout the entire commitment period. The diagram below (Figure 10) shows how the value of an average SEK develops over a six-year period from the time of commitment. It illustrates that the total changes to the value of funds as measured at the end

of a commitment period do not clearly reflect the predictability of aid funding. While the average total deviation from budget was about 7 per cent, the annual deviation from the committed value grew from 6 per cent in the first year to 15 per cent by the end of the commitments. There is ongoing uncertainty in funding due to exchange rate volatility. Rates fluctuate and the value with them. Gains, as well as losses, might be influenced by subsequent rate changes. But overall uncertainty continues throughout the commitment period.

Figure 10. Value of one committed SEK over time per commitment year, 2006–2016, in per cent



Note: The figure shows how value fluctuates from the time Sida pledges funds over time. The first measurement (T+0) is the change in value in the disbursement of funds during the pledge year. The progression of years is represented as T+number of years. Source: IATI, apilayer, author's calculations.

Take for example the Swedish commitments made in 2008 and 2009 respectively. The commitments made in 2008 declined substantially in value during the commitment year and the subsequent two years, when most funds are disbursed. The total loss in value during those years was equivalent to about SEK 1.2 billion or 11 per cent. The main reason was a strong depreciation of the Swedish krona compared to the US dollar. The average commitment rate in 2008 was 6.0667 SEK per USD, and already by the autumn of the same year when most disbursements were made, the rate had increased to

6.9432. This increase, about 14 per cent, naturally had an impact on the USD value of Swedish SEK commitments.

In 2009, the SEK continued to lose value, and the average USD commitment rate that year was 8.5815, around 40 per cent higher than the year before. This strong appreciation of the US dollar continued to decrease the value of commitments made in 2008. When the value of the US dollar decreased over the next few years, the value of commitments made in 2009 increased. Five years later, when most of the funds had been disbursed, the increase in the value of commitments made in 2009 totalled almost SEK 3 billion.

For individual activities, uncertainty is highly dependent on the length of the commitment and the currencies involved in the implementation. The longer the commitments are, the higher the risk. The more volatile the currency is, the higher the risk. On average, funds implemented by local partners in recipient countries are likely to be more affected than funds channelled through multilaterals and INGOs. This is due to the assumption that those organisations are more dependent on USD in their activities. The US dollar is the world's largest currency, and the USD/SEK rate is volatile. But currencies from smaller developing countries are a lot more volatile on average.

Historical analysis shows that exchange rates impact financial predictability and the need to not only analyse predictability from a donor perspective. Sida disburses its entire budget every year, and partners can be confident about the amounts and the timing of aid disbursements. However, their confidence can only cover the amounts in SEK. The predictability of Swedish aid, defined by the amounts of funding received by partners and recipients, has had a strong connection to the involved exchange rates. Overall, fluctuations in USD have had the largest overall impact on the value throughout the studied period, due to the high extent to which this currency was used throughout the implementation of funded activities.

While this analysis shows how the value of disbursed funds has fluctuated, it in no way covers the effects on partner organisations. Some organisations will have managed funding volatility by applying currency risk measures such as hedging. Others mitigate the

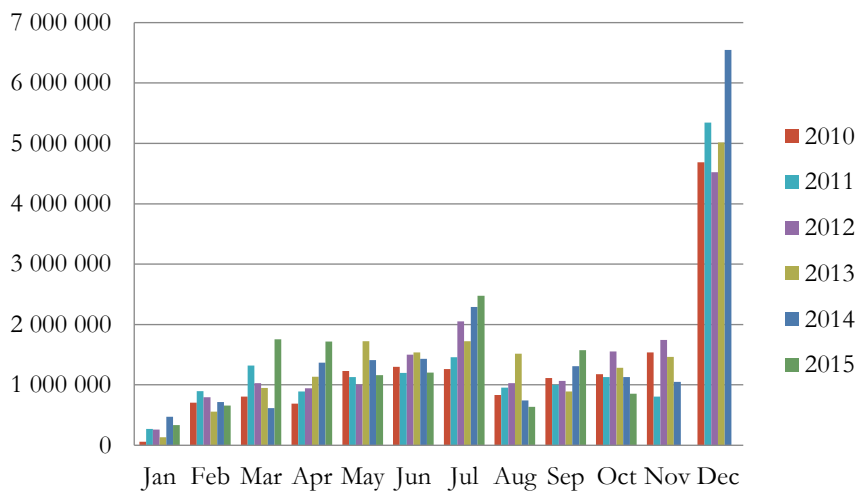
unpredictable funding through planning. In some cases, flows are evened out due to funding fluctuating over the course of lengthy activities, or by the fact that organisations receive funding from different donors in different currencies. See chapters 4 and 5 for an in-depth discussion of these issues.

3.2 The reported value of Swedish aid

Sweden reports its aid to the OECD and IATI. The OECD statistics provide annual ODA (official development assistance) data for international comparisons. The IATI, the International Aid Transparency Initiative, aims at providing transparent and up-to-date information about aid flows. Swedish aid is reported both in SEK and USD, using an OECD annual exchange rate to calculate the USD amounts.

While the rate used might be a good representation of the average annual USD/SEK rate, it does not take into account the fact that Swedish aid is not disbursed evenly throughout the year. Instead, a majority of funds are disbursed in the second half of the year, with December being the major disbursement month (see Figure 11 below).

Figure 11. Sida's bilateral disbursements per month, 2010–2015 (November), in SEK thousands



Source: Sida

If a weighted average USD rate is instead calculated using rates weighted in relation to the amounts disbursed per month, accuracy in reporting Swedish aid in USD could be improved.

Table 3. Comparison between USD/SEK exchange rates used in reporting to the OECD and IATI, and an actual weighted rate, 2006–2016

Year	OECD rate	Avg. rate	Rate difference	Actual budget (MSEK)	Reported OECD USD amount (MUSD)	Actual USD amount (MUSD)	Diff. (MUSD)	Diff. (MSEK)
2006	7.37	7.21	2.2%	27 860	3 778	3 865	87	625
2007	6.76	6.66	1.4%	27 291	4 039	4 096	57	382
2008	6.68	6.94	-3.9%	28 941	4 333	4 168	-164	-1 142
2009	7.63	7.47	2.1%	32 325	4 235	4 328	92	689
2010	7.20	7.14	0.9%	29 503	4 096	4 135	38	272
2011	6.49	6.57	-1.2%	31 911	4 918	4 860	-58	-378
2012	6.77	6.74	0.4%	31 685	4 681	4 699	18	123
2013	6.51	6.53	-0.3%	30 289	4 650	4 637	-13	-85
2014	6.86	7.09	-3.3%	30 406	4 432	4 290	-142	-1 009
2015	8.43	8.47	-0.4%	34 112	4 047	4 030	-17	-146
2016	8.56	8.72	-2.0%	29 182	3 410	3 345	-65	-571

Note: The difference in SEK has been calculated using the rate difference in per cent and the actual budget in SEK. (Avg. = average and Diff. = difference).
Source: IATI, Sida

The average difference between the OECD average rate and the weighted annual average is about 2 per cent. Table 3 illustrates that, from 2006–2016, the differences have varied between +2 per cent and -3.9 per cent. While the difference might appear small, with the size of the Swedish aid budget, the differences in the reported values can still be substantial. Reported aid has twice differed from the actual value by more than USD 100 million, or over SEK 1 billion.

The IATI strives to provide up-to-date information about aid flows to ensure that both developing countries and donors can plan and manage these resources. The use of USD instead of the actual currencies has a substantial effect on the financial transparency of Swedish aid. Even more influential is the fact that the actual disbursements are not clearly reflected in the reporting. There is no data about the number or dates of disbursements in Swedish reporting to the IATI, but rather an aggregated annual sum per

activity. This aggregated reporting is always scheduled on the last banking day in December.

The fact that the actual disbursement dates and data about the actual number of transactions are not reported entails major limitations in financial transparency. Most significantly, it limits the possibility to understand the value of funds received by partner organisations or recipients. As discussed previously in this report, exchange rates fluctuate substantially throughout a year. Not reporting when funds are disbursed thus creates significant uncertainty of the amounts received.

For example, take an activity funded by Sweden, in SEK, where the working currency is USD (which is the most common). As we have seen above, the USD/SEK rate fluctuates constantly throughout the year. The date and the number of disbursements will therefore most likely have a significant impact on the amount in USD received. In terms of data transparency, reporting in which it is uncertain when funds have been disbursed and how much has been received is not optimal.²⁸

According to Sida, the use of aggregated annual data in the IATI is due to the limitations of an ageing financial system used at the agency. This system is now being replaced, and more accurate data is available in other systems. There are plans to update the Swedish reporting process, which will provide more accurate financial data about Swedish aid.²⁹

²⁸ This report is largely based on data from the IATI and can be taken as an example of the effects of current reporting. The lack of data about actual disbursements meant that Sida data about payments had to be added to the analysis to ensure that the number of disbursement distributions was analysed properly. The lack of currency data had to be mitigated by assumptions based on implementation country and organisational type.

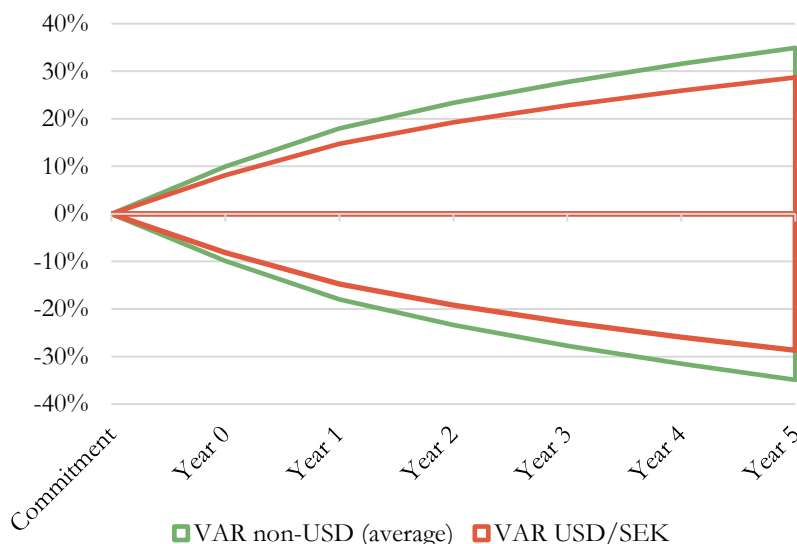
²⁹ Telephone interview with Sida, 10 November 2017.

4 Predictable aid: exchange rate volatility and risk

As the value of the bilateral portfolio fluctuates with the exchange rates involved in the implementation of the funded activities, the predictability of the funding can be questioned. To what degree can partner organisations trust the value of future aid disbursements from Sweden?

The uncertainty of exchange rates, or currency risk, grows over time and is highly dependent on the volatility of the currencies involved. Large currencies such as USD and EUR are more stable, and small and “exotic” currencies are subject to much greater variability. In the section below, the average risk is calculated, followed by a discussion of how uncertainty varies between different currencies and implementation channels.

Figure 12. Value-At-Risk (VAR) calculated for commitments in USD and on average for non-USD currencies used in the implementation of Swedish bilateral aid



Note: The risk for commitments is calculated in SEK. The diagram shows the calculated maximum risk interval during the commitment. For example, the risk for USD-dependent commitments is presented in red. The risk is both positive and negative, as the value of the USD can increase or decrease in relation to SEK over time. See Box 6 below for a further description of the VAR method.

In figure 12 above, the risk, or financial uncertainty, for commitments implemented in USD and other currencies is presented, calculated using the Value-at-Risk (VAR) method. The VAR method provides a risk measurement tool that is used to estimate the maximum possible volatility likely in an asset (for more details on VAR, see Box 6 below). Here, the method is used to provide a rough estimate of the predictability of Swedish funding. The calculations are based on the disbursement rates for the entire bilateral portfolio, showing the level of uncertainty on each average disbursement date.

Box 6. About Value-at-Risk (VAR)

The VAR method is used to measure risk in a certain position over a specific time period, the holding time. The result is a statistical measure of possible losses for the holding time, as a result of normal market conditions. The resulting risk, the possible loss, is given at a certain level of probability.³⁰ The use of the method thus provides us with a way to assess uncertainty in funding, from the exposure to exchange rates.

For example, a VAR for a one-day position can be stated as USD 100 at 90 per cent probability. This means there is a 90 per cent certainty that losses will not exceed 100 USD. Another way to word it is that in ten market days, the expected loss per day is not expected to exceed USD 100 more than once.

VAR is thus a measurement of the certainty that a loss will not exceed a specific level due to exchange rate fluctuations during the holding time. The probability, or confidence level, is chosen when calculating the VAR. The time period comes from the holding time of the position, for example the time between a pledge for funds and the actual disbursement.

In this study, the VAR calculations have been used to assess how predictable aid funding is at the average times of disbursement, calculated from the time Sida commits funding. Since *volatility* in aid flows is not only about loss, calculations in this study have also been made to provide an estimate of how much rates could move in the other direction. The result shows the risk of volatility, positive and negative, or the amount of uncertainty in aid funding.

For a practical example of VAR applied to a single aid activity, see chapter 5.2.

Uncertainty starts to develop from the time of the average commitment (March), and by the time of the first disbursement (August), the average risk or uncertainty has reached (+/-) 9 per cent. This means that there is an uncertainty interval of 18 per cent for the first disbursement. The uncertainty is the value of the SEK at the time of disbursement, as denominated in the implementing currency. This uncertainty then grows over time as seen in figure 12 above. By the second disbursement, the risk will have reached (+/-)

³⁰ For an introduction to VAR, see Linsmeier and Pearson, 2000. Please note that the VAR calculations in this study only consider the exchange rate risk as such. There are, of course, a number of other financial risks that could affect funded activities. Some might also affect the amount of currency risk, both to increase or decrease the risks (for example, inflation and interest rates). For some discussion of this, see chapter 5.1 and 6.1.2.

16 per cent. By the final disbursement of funds, after five years, the uncertainty interval will have reached (+/-) 31 per cent. On average, there is only about one per cent of funds left to disburse by that time, as most commitments are shorter and most of the funds have been paid out before the end of an activity, so the total exposure is small at that time. However, for an individual commitment, the risk can still be substantial.

The USD is the world's largest currency, and its liquidity makes it more stable than most other currencies. Smaller developing economies will have more volatile exchange rates and as such lower predictability. A VAR analysis made for the five largest non-USD currencies shows how the risk develops when more volatile currencies are involved in funded activities (Table 4).

Table 4. Risk (VAR) over time for USD and the five largest non-USD currencies used in Swedish aid

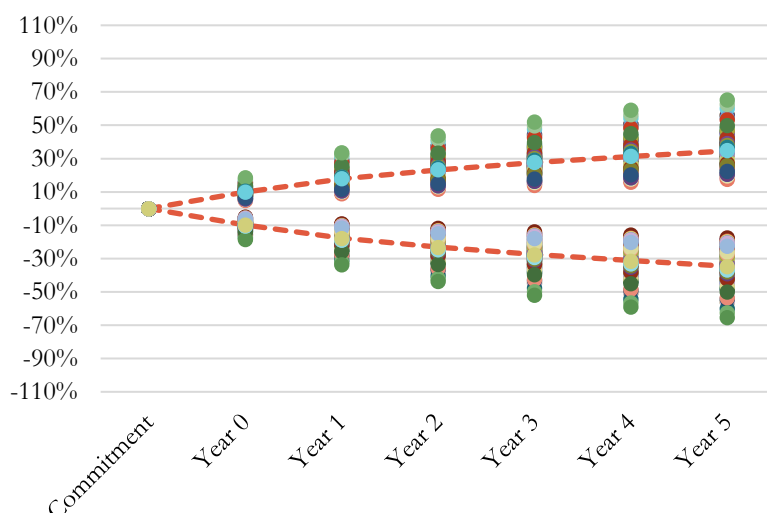
Currencies	Risk year 0	Risk year 1	Risk year 2	Risk year 3	Risk year 4	Risk year 5
USD	(+/-) 8%	(+/-) 15%	(+/-) 19%	(+/-) 23%	(+/-) 26%	(+/-) 29%
TZN	(+/-) 11%	(+/-) 20%	(+/-) 26%	(+/-) 31%	(+/-) 35%	(+/-) 38%
MZN	(+/-) 16%	(+/-) 29%	(+/-) 38%	(+/-) 45%	(+/-) 51%	(+/-) 56%
UGX	(+/-) 10%	(+/-) 18%	(+/-) 23%	(+/-) 28%	(+/-) 31%	(+/-) 35%
KES	(+/-) 9%	(+/-) 16%	(+/-) 21%	(+/-) 25%	(+/-) 29%	(+/-) 32%
ZMW	(+/-) 11%	(+/-) 20%	(+/-) 27%	(+/-) 32%	(+/-) 36%	(+/-) 40%

Note: Risk related to commitments in SEK. Currencies ordered with the most important in terms of Swedish aid at the top.

The five non-USD currencies that each represent more than 2 per cent of the funds used in the implementation of Swedish aid are all African currencies. All show a higher level of risk compared to the USD. While volatility in one currency might not particularly affect the overall aid portfolio, financial uncertainty for activities using these currencies will be substantial. Also, the currencies, while comparatively small, still jointly represented annual aid equal to SEK 2 billion on average from 2006–2016.

For the entire portfolio, with well over 100 currencies, the risk per currency varies widely. The risk spread per currency is represented in figure 13 below.

Figure 13. VAR calculations for all currencies used in Swedish aid from 2006–2016.



Note: The risks are calculated against commitments in SEK. The dotted line represents the average risk. The groups of coloured dots on each year represent the VAR for all the currencies in the overall portfolio and their development per year. As can be seen in the figure, the overall VAR increased over time. The spread also increases, with some currencies having a higher risk.

The currencies used in the implementation of funded aid activities become vital for the predictability of future disbursements. While the average risk grows from (+/-) 9 to 31 per cent over a five-year average disbursement period, the variation is significant. While some currencies have a rather low risk, some provide risk well over (+/-) 50 per cent at the end of commitments. One notable case is the Mozambique Shilling (MZN), which is one of the larger implementation currencies.

It should also be noted that the VAR calculations provide risk guidance at a certain level of confidence. While this is a strong indicator of the maximum risk, it does not mean that there cannot be larger exchange rate fluctuations. An example is the Zambian

Kwatcha (ZMW), which lost about 60 per cent of its value against the Swedish krona in 2015 (see chapter 5.1). This dramatic drop is well beyond the risk estimate for a single year, as well as the estimate for an entire commitment period.

The risk calculations presented in this chapter, as well as historical fluctuations described in chapter 3 above, clearly show how exchange rate fluctuations can affect the predictability of aid for Swedish aid partners. The actual impact on effectiveness in aid delivery will largely depend on the capacity of the recipients and partner organisations involved.

5 Managing volatility in practice

Exposure to exchange rates creates uncertainty in aid funding. How activities are affected differs widely, however, and does not only depend on commitment lengths and involved currencies. In this chapter, we will look more closely at how predictability is affected and how organisations cope with uncertainty. The chapter begins with an analysis of the Swedish aid portfolios in Rwanda and Zambia from a currency perspective. This is followed by an examination of the different types of currency exposure found among the activities studied. Finally, the chapter concludes with findings concerning how Sida and partner organisations work with currency management.

5.1 Sida projects in Rwanda and Zambia

As a part of this study, visits were conducted to Sida units in Rwanda and Zambia. The ambition was to understand in more detail how exchange rates affect Swedish aid. Sida has bilateral teams in both countries and a team working on regional health issues located in Zambia. During both visits, which took place in early 2017, interviews were conducted with Sida staff, representatives of different kinds of partner organisations and other donors. Project budgets were analysed in detail and discussed both with Sida and the implementing partner in order to understand different kinds of currency exposure.

Zambia and Rwanda are both key partner countries in Swedish bilateral aid. In 2016 the combined annual value of their portfolios was about SEK 600 million. The team working with regional health currently manages a portfolio of about the same size as the Zambian one, around SEK 400 million annually.³¹ Together, the three portfolios thus make up a substantial part of Swedish bilateral aid, with a total annual budget of about SEK 1 billion.

³¹ MFA, 2015a.

The bilateral cooperation in Zambia is governed by a results strategy for 2013–2017, with a total budget of about SEK 1.75 billion. Funded activities can be found mainly in the health sector, comprising about 40 per cent of the portfolio in 2016. Other large sectors are social infrastructure and services, governance, democracy, human rights and gender equality, and agriculture, forestry and fishing.³²

Swedish bilateral cooperation in Rwanda is governed by a SEK 900 million results strategy for 2015–2019. This cooperation focuses on Research cooperation and Governance, democracy, human rights and gender equality. Social infrastructure and services and Conflict prevention and resolution, peace and security are two other important sectors.³³

The regional health results strategy is focused on sexual and reproductive health and rights, with a budget of about SEK 1.75 billion for 2015–2019. Through the strategy, Sida is funding regional health activities in countries in sub-Saharan Africa.³⁴

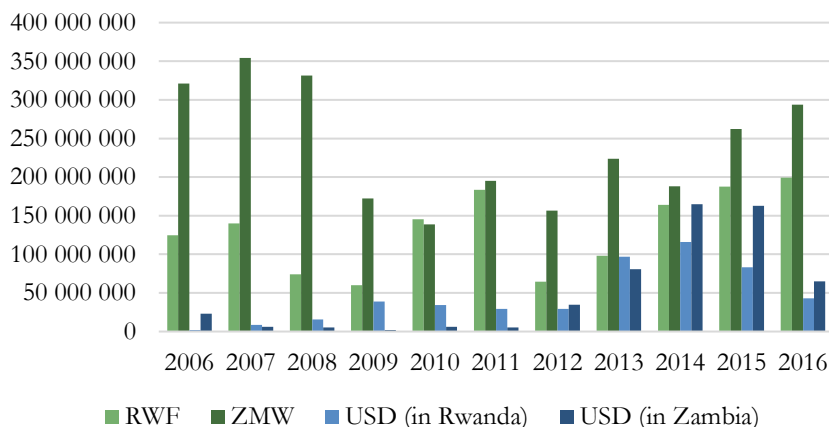
The two bilateral portfolios for Rwanda and Zambia show a similar distribution in their use of implementation channels. Both rely heavily on direct funding through local partners, both working with the government and local NGOs. Rwanda has about three times the size of their commitments to INGOs.

³² MFA, 2013 and Openaid.se, electronic source:
<https://openaid.se/aid/sweden/zambia/2016/>.

³³ MFA, 2015b and Openaid, electronic source:
<https://openaid.se/sv/aid/sweden/rwanda/2016/>.

³⁴ MFA, 2015a. There is unfortunately no way to identify specific Swedish aid strategies in the IATI data, so it has not been possible to isolate and analyse all the disbursements connected to the strategy.

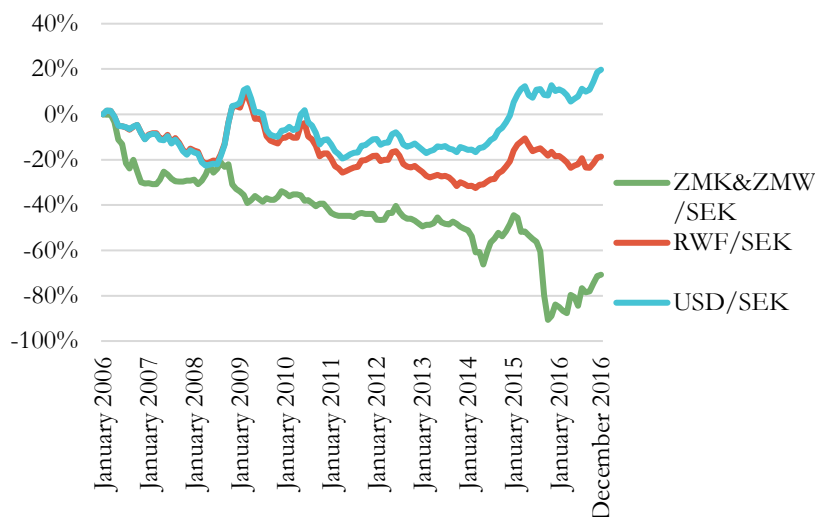
Figure 14. Currencies in the implementation of Swedish funded aid in Rwanda and Zambia, 2006–2016, SEK



The use of local partner organisations results in a relatively high use of local currencies in the implementation of aid funded by Sweden. The use of the USD has increased over time as more and more aid is channelled through international partners. The Rwandan Franc (RWF) and the Zambian Kwacha (ZMW) are however still the dominant implementation currencies, as illustrated in Figure 14 above.

In the regional activities studied, the use of local currencies was much lower. Projects studied had budgets as well as substantial costs in USD and then smaller portions of costs in various local currencies. Between projects, the difference in the use of local currencies was substantial.

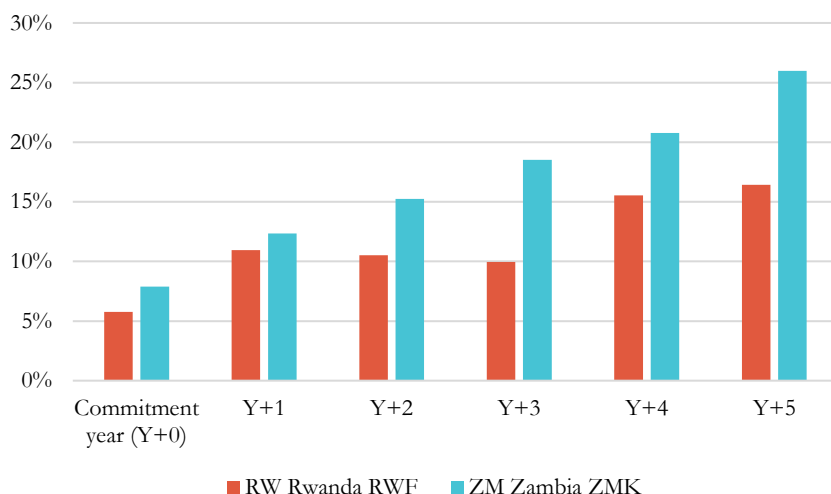
Figure 15. Exchange rates 2006–2016, currencies used in aid activities funded by Sweden in Rwanda and Zambia, changes from January 2006 in per cent



Note: A new redenominated Zambian Kwacha (ZMW) was introduced in January 2013, replacing the previous Kwacha (ZMK). In the diagram above, rebased value has been used for calculations of the rate changes.

During the period studied, there has been substantial exchange rate volatility in all the currencies involved. As illustrated in the figure above, RWF and USD have been quite closely linked in their fluctuations relative to SEK, especially from 2006–2008. Since then RWF has, however, lost value against the Swedish krona, while the USD rate has increased. ZMW lost about 70 per cent of its value against the Swedish krona from 2006–2016 and experienced especially great volatility from 2014–2015.

Figure 16. Average absolute divergence from budget per year in relation to the committed value, in per cent



Source: author's calculations based on data from the IATI.

Figure 16 above illustrates that the average divergence from the value of the budgeted amount grows over time in both countries. The higher overall volatility in ZMW, especially the extreme volatility in 2014–2015, impacts the averages for Zambia.

Both RWF and ZMW, over the entire period of 2006–2016, have depreciated in value against the Swedish krona and the US dollar. This has meant that organisations have received on average more local currency than budgeted, following exchange from SEK. Organisations working primarily in USD have, however, seen a negative trend, especially in the last few years. In the case of the Sida portfolios in Rwanda, Zambia and for regional health, this has especially affected the regional portfolio. The regional implementing partners most often work in USD and have therefore seen the value of Swedish commitments decrease.

Interviews in Zambia illustrated the how different economic factors together creates a complexity that is important to consider when analysing effects. ZMW declined substantially in value against SEK, resulting in more local currency for each Swedish krona over the period. However, over the same period, Zambia experienced

average inflation of about 10 per cent per year (see Figure 17). In Rwanda, the average annual inflation during the period studied was slightly lower but still close to 7 per cent. So while local partners received more local currency for the pledged SEK over time in both countries, the value of those funds steadily decreased.³⁵

Figure 17. Annual inflation in Rwanda and Zambia, inflation as GDP deflator (annual %)



Source: World Development Indicators Data Bank, the World Bank.

A recent study of the effect of currency fluctuations on aid effectiveness in the health sector in Zambia also illustrates the possible complexity of currency exposure in aid funding.³⁶ The study, covering the period 1997–2008, identified a total of 26 international donors providing funding to the Zambian Ministry of Health (MoH). The total funding, about USD 500 million, was pledged in a number of different currencies and then exchanged into a USD-denominated account when received by the MoH. The result was that the value of donor disbursement fluctuated with the exchange rates, negatively affecting the predictability of funding. The fluctuations in funding had immediate negative effects, as

³⁵ Interviews in Zambia, 2017 and the World Bank, 2017.

³⁶ Chansa et al., 2017.

“losses in funding due to exchange rate losses contribute to suboptimal resource allocation and planning, and erratic supplies of inputs and poor service delivery.” The study also notes that exchange rate gains made it difficult for the MoH to predict, plan and utilise resources. The uncertainty in funding did not only affect the MoH, however. Funding to health districts was provided from the USD-denominated funds, exchanged monthly into ZMW when funds were transferred. This resulted in a situation where the lack of financial predictability was extended to the districts, with an exchange rate volatility effect on disbursements from the Ministry of Health to districts ranging from -8 to +19 per cent.

Another recent study describes the relationship between exchange rates and the funding of HIV/AIDS treatment in countries in southern Africa.³⁷ The study highlights the fact that exposures to exchange rate volatility has to be properly analysed for a real understanding of the risk. At a first glance, a depreciation of the local currency against US dollar might seem like a good thing, as it would result in more local funds over time. But the study of exchange rates and funding of HIV/AIDS treatment concludes that a strong USD can result in less treatment. This because a large portion of costs in this sector is denominated in USD, with treatments having to be purchased on the international market. The study shows that a depreciation of the South African rand against the US dollar could result in a decrease in the number of people in treatment of a staggering 50 per cent in just three years, unless more money was made available from local sources.

5.2 The complexity of currency exposure: examples

During the visits to Rwanda and Zambia, a number of Sida-funded activities were studied in more detail. Bilateral activities through local and international organisations were included, as well as regional aid activities in the health sector. The results show a wide variety of different currency exposure models. Some activities

³⁷ Whiteside and Zebryk, 2017.

illustrate quite complex currency exposures, with a large number of institutions, currencies and transactions involved.

The simplest activities in terms of currency exposures are bilateral projects implemented by a local partner, working only in the local currency. In this case there are only two currencies involved: the donor and implementation currencies. The predictability of funding is only affected by the exchange rates of these two currencies.

5.2.1 Project example: risk in Rwandan aid project

Sweden, through Sida, supports a programme entitled the Societal Healing and Participatory Governance for Sustainable Peace in Rwanda.³⁸ The programme aims to contribute to the consolidation of a peaceful and inclusive Rwandan society. It is implemented by the INGO Interpeace together with a local partner in Rwanda, Never War Again.

Sida has committed about SEK 50 million for implementing the programme from 2014–2019. So far during this period, about SEK 40 million has been disbursed in total. During the 2014 agreement year, a total of SEK 5 million was disbursed. In 2015 the disbursement was SEK 8.6 million and in 2016 SEK 13.5 million, followed by SEK 13 million in 2017.

For this example, we are assuming that the budget is in USD, and that costs are split 50/50 between USD and the Rwandan Franc (RWF). Incoming funds and project costs are both exposed to exchange rate volatility. From 2014–2016 a total of SEK 27.2 million was disbursed from Sida. For the sake of this calculation, we are assuming that the remaining SEK 22.8 million will be disbursed

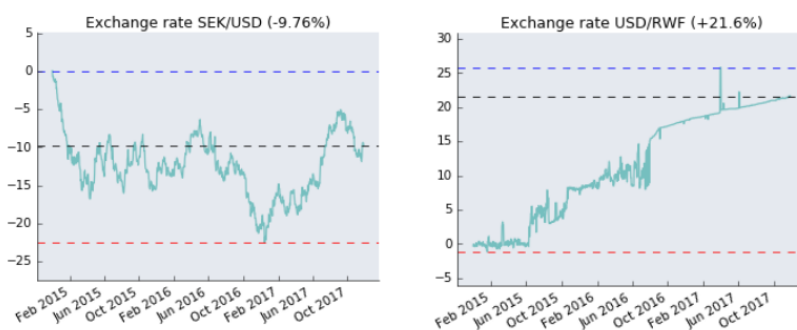
³⁸ IATI data, activity ID: SE-0-SE-6-5116009101-RWA-15220. Information about the activity can be found at <https://openaid.se/sv/activity/SE-0-SE-6-5116009101-RWA-15220/and> <http://www.interpeace.org/programme/rwanda/>. Note that the following analysis has been made solely from the IATI data, without further analysis of the actual budget or interviews with the involved organisations.

evenly from 2017–2019. We are also assuming that costs in RWF will be evenly distributed throughout the project.

Volatility 2014 – 2017

During the first three years of the project, the currency pairs involved have seen substantial fluctuations. The pledged Swedish kronor have lost value against the US dollar to a total of about 10 per cent, with a low at the end of 2016, when the Swedish krona had lost about 22 per cent against the US dollar compared to the rate when funds were committed (see Figure 18). The result is that the value of incoming funds from Sida has decreased by about 12 per cent. At the same time, however, USD has seen strong appreciation against RWF, currently with a gain of about 20 per cent.

Figure 18. Exchange rates, SEK/USD and USD/RWF, December 2014 – November 2017



Source: AidHedge

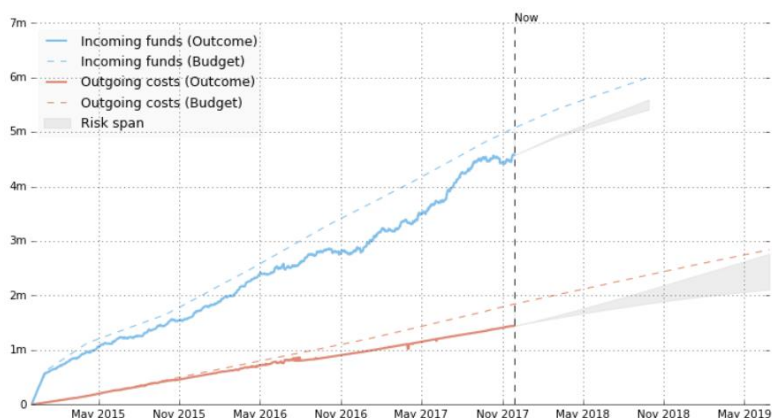
As half the costs are in RWF, the increased value of the US dollar has lowered project costs by about 11 per cent. The project has seen significant fluctuations in funding and costs, but fluctuations have so far had a positive relationship in that decreased funding has been somewhat mitigated by lower costs in local currency.

Predictability, remaining Swedish funding and local costs

Calculating the exchange rate risk for the remaining project period, 2018–2019, using VAR provides an estimate of the financial

predictability of the project. The result illustrated in Figure 19 shows growing uncertainty in both funding from Sida and local costs in RWF.

Figure 19. Exchange risk development in Rwandan aid project, December 2014–June 2019



The dotted blue and red lines represent the budgeted funds and costs respectively. The gap between the lines illustrates the difference in value that will be affected by exchange rates, as all incoming funds will be exchanged into USD but only about half will then be exchanged into RWF. The thick blue and red lines represent how the value of funds and costs has changed due to exchange rate fluctuations. The dotted vertical line represents the project timeline progression. To the right of the line, the uncertainty of the value of funds and costs is represented by a growing grey area. Source: AidHedge.

The analysis shows how predictability decreases over time. As the Swedish krona has decreased by about 11 per cent against the budget currency, USD, the uncertainty span is entirely below budget. There is no chance to recoup losses. Only about 20 per cent of committed funds are yet to be disbursed, and with a limited time until disbursement in 2018, the risk is relatively manageable compared to the overall budget.

The costs in RWF only make up 50 per cent of the budget, but uncertainty is bigger than that of the incoming SEK. Uncertainty grows to a maximum of about (+/-) 23 per cent of the final costs in the budget in 2019. Gains already realised will ensure that costs never exceed budget.

5.2.2 Other exposure types

Many times, activities are supported by several international donors, creating more complex currency exposure with a larger number of incoming funding currencies. In addition, it is common for donors to commit funds with commitment lengths and disbursement schedules that differ from one another. The result is that the implementing organisation must manage rather complex risk exposure from incoming funds.

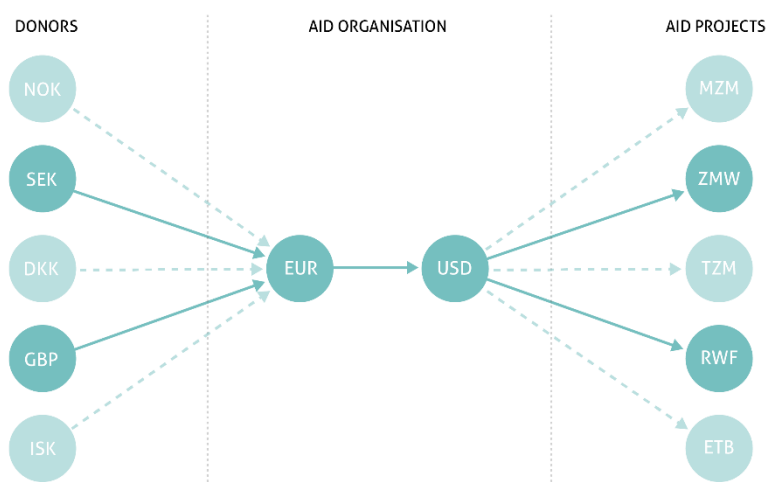
INGOs are an implementation channel growing in importance in Sida's bilateral portfolio. All INGOs interviewed during this study budgeted for all their activities in one common currency, normally USD. The result is an increase in the complexity of currency exposure. First there is uncertainty in the value of the donor disbursement over time, when exchanged for the organisation's budget currency. This is the same risk as that to which local organisations are exposed. However, INGOs will then normally have to exchange part of the funds into the local currency, thus giving a second dimension of uncertainty.

As with local organisations, INGOs often have more than one donor for a single activity. The result is more complex risk exposure, with more currencies involved. Several organisations additionally had more than one working currency internally. For example, an organisation may have EUR as the common budget currency at its international headquarters. Funds from the donor are exchanged into EUR on disbursement. The local office budgets and works in USD, however, and funds are thus exchanged from EUR to USD when transferred from the international headquarters to the local office. In a final step, funds are exchanged into the local currency to cover local costs.

The addition of currency exchanges on the costs side of the budget results in a situation where exchange rate gains or losses can occur without affecting the overall budget. In interviews with Sida staff, it was noted that this led to an additional problem in the financial reporting. If an organisation exchanges funds from the budget currency into another currency and makes a gain, this will only be picked up on if it somehow affects the budget or is observed

in an audit. Sida does not request any specific reporting in this regard but looks at the cash balance in the overall budget. In recent years, many projects have lost funds due to the weak SEK. However, they have benefited from depreciation in other local currencies. One example is ZMW, which has seen noticeable depreciation. An organisation could, for example, report costs in USD that are according to budget but have made substantial gains in local currency.

Figure 20. Example of funding of regional activities, with several sources of funding and implementation currencies



The activities in the regional portfolio illustrated the most complex risk exposures. The implementing organisations normally budget in USD and by definition have costs in several different countries. Just like with the other activities, having more than one donor currency is not uncommon. The result is complex risk exposure with many different currencies, many having a high risk. Also, as commitments from donors and to local partners are of different lengths, there are many overlapping uncertainties.

5.3 Lessons learned: currency management

The study visits included a number of interviews with Sida staff, different types of partner organisations and other donors. At Sida, programme officers, heads of units and controllers were interviewed. At partners, interviewees were a mix of managers, financial staff and programme staff.

Interviews focused on how exchange rate risk was perceived and handled in operations. What effects had the interviewees experienced and how had they been managed? What precautionary measures are in place and to what extent are they working?

5.3.1 Post-fact management is the number one coping mechanism

Overall, the conclusion from almost all interviews was that while exchange rate fluctuations continuously affect funding, their effects are managed on a case-by-case basis. Any fluctuations that have sufficient impact on the budget are normally discussed with the donors and are then managed through changes in the implementation of the funded activity. If the funding exceeds the budgeted funding, this normally results in the activities being extended free of charge. Should funds be lacking, this is likewise managed by reorganising funded activities.

One immediate result of fluctuations in funding is therefore an increase in administrative costs for partner organisations and donors alike, as activities have to be reprogrammed and changes agreed upon. Interviews and budget analyses carried out during the study showed how even small fluctuations can have a substantial impact. For example, in one Sida-funded activity, 60 per cent of the budget was allocated to organisational running costs and the remaining 40 per cent to planned activities. The organisation concluded that a 10 per cent decrease in funding would result in a 25 per cent decrease in funded activities, as funding for activities was cut before organisational funding.

While several partner organisations consciously analysed rates, only one actually had some kind of risk management in place. One of the INGOs working in Rwanda had drawn up a separate annual planning budget, which was set at 80 per cent of the actual budget. The smaller budget covered all the highest prioritised budget items to ensure that these would be implemented according to plan. The two budgets were compared to exchange rates again towards the end of the third quarter, and a final budget for the year was decided upon.

One interviewee in Rwanda with extensive experience from other countries noted that risk awareness locally in Rwanda was low. He argued that this in part could be explained by the decade-long depreciation of RWF in relation to the largest donor currency, the US dollar. Aid organisation staff, both at donors and partners, working in Rwanda had in many cases never experienced substantial appreciation of RWF.

The lack of preparedness for funding fluctuations was thus not only an issue at smaller local organisations. Several large INGOs were interviewed, as well as governmental representatives. Interviewees did, however, highlight that aid organisations have substantial experience of working with unpredictable funding and other forms of uncertainty. A study of donor funding to the MoH in Zambia concluded that while exchange rate fluctuations had resulted in substantial variation in available funding, the overall funding volatility was even higher.³⁹

5.3.2 Low burn rates as a coping mechanism

The most prominently used currency in the aid sector, like elsewhere, is USD. Sida controllers in the case study countries estimated that about half of the SEK funds in bilateral activities were exchanged into USD as the final currency. About 80 per cent of the regional funds were implemented in USD. In recent years the

³⁹ Chansa et al., 2017.

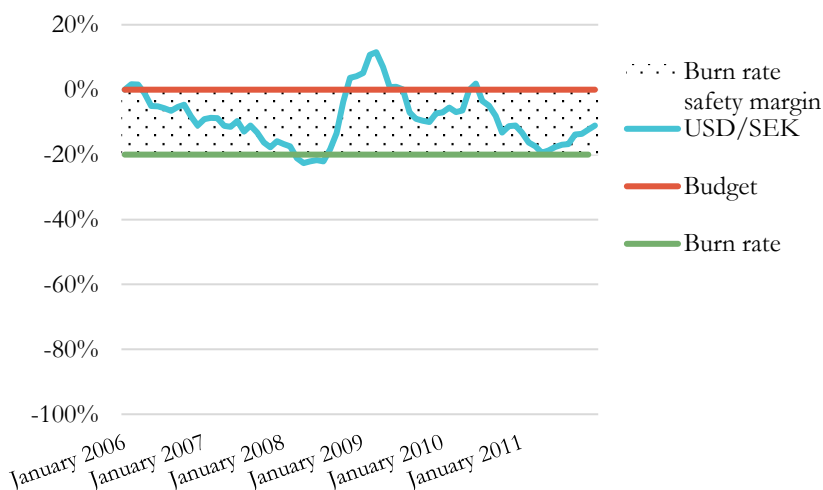
Swedish krona has fallen significantly against the US dollar, about 30 per cent since 2014.

Despite great exposure to the US dollar and the substantial depreciation of the Swedish krona, interviewees could only name one example of a partner organisation requesting and receiving additional funds due to changes in exchange rates during the last few years.

When asked how all other activities had been able to cope with a decrease in funding of almost 30 per cent, interviewees pointed out that almost all partner organisations engage in substantial over-budgeting. The average implementation rate of funded activities, as expressed in funds used (often called the “burn rate”) has seldom exceeded 80 per cent per budget year. From this it follows that funded partner organisations have an annual buffer against exchange rate fluctuations of about 20 per cent of the budget (for an illustrative example, see figure 21).

As long as SEK depreciation is below 20 per cent, the funded activities are therefore not affected. Instead, the funds that roll over to the next budget period soften the blow of decreased funding. With a 20 per cent annual buffer and contracts often spanning three or four years, organisations have a crucial coping mechanism that can be used to manage both currency fluctuations and project activities.

Figure 21. Safety margins in activities from low burn rates. A hypothetical example with USD/SEK rates over a six-year period



Note: The diagram shows a budget line (red), along with spending (green) and exchange rates (blue). If the rates fall below budgeted spending, this would normally result in an underfunded activity. But as the actual spending (green) is substantially lower than budgeted, a much higher rate of depreciation is needed before activities are impacted.

A few interviewees noted that partner organisations that have good planning and budgeting routines and that follow these closely in their implementation are at a major disadvantage. With a high burn rate, their currency risk exposure increases as they diminish their coping capability. Interviewees also pointed out that this increased risk is seldom matched by any formal incentive models from Sida. Keeping a moderate pace in activities, implementing enough to receive the next disbursement, but not a lot more, thus makes financial sense for partner organisations.

5.3.3 Inflated contracts lower currency risk

The first time the issue of different currencies can impact a funded activity is when the budget is converted into SEK. The budget is denominated in the working currency of the partner organisations and is converted into the commitment amount in SEK. Sida often works for an extended period with partner organisations on

preparing commitments, so the time from budgeting to contracting can be long, often months.

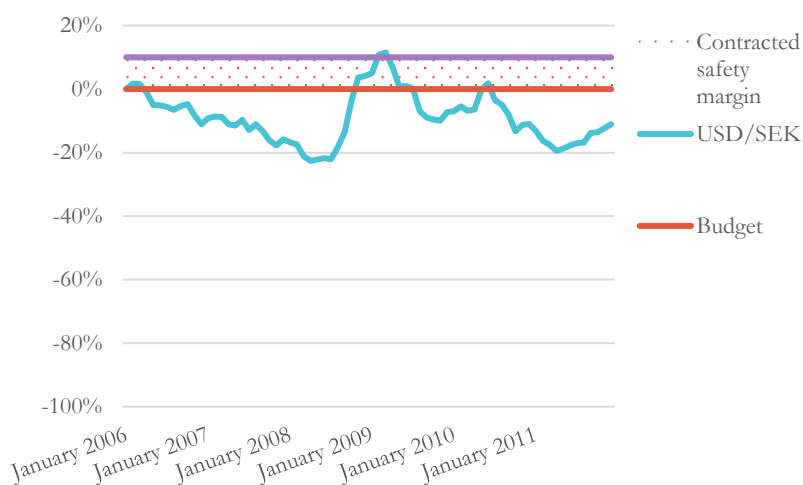
How, and when, the budget conversion rate is decided upon will have a direct impact on the commitment value and thus on available funds in SEK. Sida has no rules or guidelines on how to determine the rate.

In interviews with programme officers, controllers and heads of unit at the agency, it has become clear that an informal procedure has developed, common across units and countries.⁴⁰ The budget conversion rate is set in a negotiation between Sida and the partner organisations at the time of contracting. Exactly how these negotiations are carried out, however, varies widely, being heavily dependent on the experience of both the Sida staff involved and the representatives of the partner organisations.

The results of the negotiations, the final budget conversion rate, often see a use of a lower SEK contracting rate as compared to the spot rate on the contracting day (see figure 22). The actual amount can vary, depending on which Sida staff were involved and the extent to which partner organisations pushed the issue of rates in negotiations. Interviewees estimate that this risk premium varies between 5 and 15 per cent, with an average of about 10 per cent. This estimate is confirmed by the analysis of detailed budgets carried out as a part of the case study.

⁴⁰ This entire sub-chapter is based on interviews with Sida staff in Ethiopia, Rwanda, Ukraine and Zambia, as well as with partner organisations.

Figure 22. Illustration of how lower SEK rates in commitments create a safety margin in funded activities



Note: The hypothetical project has a budget (red) in the partner organisation currency. The purple line is the contract value in the same currency, after an (artificially) lowered value in SEK.

In interviews with Sida staff, the reasoning behind this varies. Some have a clear understanding of how a small decrease in the SEK value affects the entire contracting value. Increasing the contract value is done to provide the partner with an exchange rate margin that can be used in the event that the SEK value decreases during the project. In some cases, the Sida programme officers are not aware of the difference in rates; rather, this is something proposed by the partners. It then only becomes an issue if controllers perceive the proposed difference in the SEK value as “too large”. Some interviewees noted that larger organisations normally have more resources to push for better rates. In bilateral projects implemented by UN agencies, the level of SEK depreciation is often high, as these organisations “basically decide on the rates” by using exchange rates set internally.

The lower SEK value, when converting the partner budget to the contract value, leads to an inflation of contracted amounts in SEK. The contracted value does not represent the underlying value of services on the contracting date. This does not, however, automatically mean that Sida always pays more than necessary for

contracted services. The value of the partner budgets is not inflated. The partners' budget currency is used in implementation and reporting. If rates are unchanged, the additional SEK funds in the contract should thus be paid back to Sida (or allocated to an extension that is thus free of charge). A depreciation in SEK of about 10 per cent means that Sida provides its partners with rudimentary risk management up to that amount while accepting a potential efficiency loss in aid of the same order of magnitude.

At the same time, it means that a portion of Swedish aid funding is tied up in contracting. This affects available funds over the entire lifespan of the activity, with commitments often 3–4 years long. The result is thus that substantial amounts of aid funds are not used effectively. The contracting volumes in the countries in the case study amount to about SEK 1 billion per year. Hence, in these portfolios alone, Sida's contracting practices are tying up about SEK 100 million per year in rolling buffers not actively used in aid activities.

5.3.4 Few relate currency risks to results

In interviews with Sida representatives, currency risk was mostly seen as either a non-issue (due to lack of knowledge of the risks) or as a purely financial risk. Most of those who saw it as a financial risk concluded that as Sida contracts in SEK, this was an issue for the partner organisations, as they alone were exposed to currency risk.

The perception that Sida bears no risk was also strongly evident at Sida headquarters when the NAO audited currency management at the agency in 2014. In its report, the NAO concluded that the agency lacked staff with an understanding of currency issues and that it provided no internal guidance on how to ensure good currency management.⁴¹ This lack of guidance from Sida headquarters is also a recurring theme in interviews with Sida staff in this study. The question of how exchange rates could impact Swedish aid is not part of Sida's operations.

⁴¹ Swedish National Audit Office, 2014b.

Sida's budget and all its contracts are in SEK. So it is true that there is no currency risk in relation to agency finances. Important to note, however, is that while the partner organisations are exposed to all the purely financial risk, Sida must be said to share the operational risk. *That is, the risk that the intended results might not be achieved due to exchange rate fluctuations.*

Sida funds activities with the expectation of results. If, for example, the value of the Swedish krona decreases against the US dollar, there is a risk that funded activities cannot be completed. The alternative is that Sida will have to provide additional funds to ensure the intended results, paying more for activities and results that it has already paid for in full. Interviewees at partner organisations emphasised that the major concern is the lack of predictability. Uncertainty about funding hampers planning and budgeting. Also, all outcomes that diverge from budget, both gains and losses, result in more administration, as the change in budgets must be managed by partners and Sida alike.

The finding that Sida lacks understanding of currency risk is perhaps linked to how it works with risks as such. In a recently published evaluation of Sida's contribution management system, one of the key observations was that the internal processes supporting Sida staff in decision making were especially lacking in terms of risk assessments. Almost 30 per cent of staff identified the agency's current risk assessment as being too complicated. One respondent commented that the risk part of Sida's process is "grossly overworked". A typical critique was that risk assessments were mostly "guesswork". The evaluators concluded that the results of their interviews could be summarised as a "unified, resigned sigh".⁴²

⁴² Danielsson et al., 2016.

6 Perspectives on currency management practices

Swedish aid is by no means unique in that the predictability of funding can be decreased by exchange rate volatility. As soon as there is more than one currency involved in either a funding relationship or in the cost structure of an aid activity, exchange rates can affect the predictability of these transactions. This dynamic is not something limited to the aid sector but a general question for all financial flows involving currency transactions over time.

6.1 Currency management at other donors

A desk review has been conducted as a part of the study. The objective was to find examples of how other aid donors work to decrease the possible negative impact of exchange rate volatility on the predictability of aid. The results are quite disheartening, as not one donor working actively with these questions was found.⁴³ What was found were examples of different donor requirements or practices that can affect the amount of financial uncertainty partners are exposed to. In addition, there are also a few instances of other initiatives aimed at improving financial predictability in the aid sector.

There is a sizeable number of organisations making aid commitments, from large government agencies and multilateral organisations to international and national NGOs. It should be clear that the review by no means covers even close to all possible organisations. *There are likely to be a wide number of interesting practices and solutions in existence ready to be shared in the aid community.*

⁴³ These results were also confirmed by a study of how exchange rates affect HIV/AIDS funding, conducted in 2017. See Whiteside and Zebryk, 2017.

6.1.1 Different donor requirements that can affect currency risk

What emerged from the desk review were mainly examples of how different donors have different requirements or working practices when it comes to how to deal with exchange rates in contracting, and possible gains or losses in funded activities. Sida requires its partners to have a dialogue with the agency about how fluctuations from budget should be handled. This differs from several other donors.

As an example, the Norwegian governmental aid agency, Norad, requires partners or recipients to repay exchange rate gains. The gains are then reallocated to fund other aid activities. An increase in the value of the Norwegian krona (NOK) will thus result in more aid funds to be distributed within a budget year, as partners receive more local currency and repay gains. For organisations working with this type of requirement, there is only negative uncertainty to consider when analysing how exchange rates could affect future funding. It could perhaps be argued that this halves uncertainty compared to Swedish aid, as it restricts the possible fluctuations in one direction. The Norwegian agreements do not, however, include any provisions for currency losses. Negative results due to exchange rate fluctuations must be handled by renegotiating activities or by applying for additional funding from Norad or other donors.⁴⁴

The European Commission (EC) also has requirements that differ from Sida's. Generally, the partner organisations encounter all the exposure to currency risk, just like in Swedish bilateral aid. The EC provides funds in EUR and differs from Sida in that it requires all budgeting and reporting to be in EUR. If an organisation has costs in another currency, they have to cover the currency risk. Unused funds due to exchange rate gains have to be returned to the EC.

In addition, EC requirements dictate that any exchange rate losses incurred by the organisation due to exchanges made that are

⁴⁴ Interviews with partner organisations working with Norwegian aid and the Swedish National Audit Office, 2014b, p 29.

not directly linked to costs are considered non-eligible costs. As such, these would have to be repaid to the EC. If an organisation loses funds on exchanges, they may therefore be required to repay the same amount, effectively doubling the loss. This is most relevant for those organisations whose budget is in a currency other than EUR and subsequently has local costs in one or more currencies. If they change their EC funding into the budget currency (for example USD) and this currency then depreciates in value, the losses will not only result in a direct loss. The loss would be counted as a non-eligible cost when the organisations make exchanges from USD into the working currency. If the depreciation is 10 per cent, the same amount must be paid back to the EC. If the organisation keeps the funds in a EUR-denominated account and only makes exchanges for actual expenditure, there is no such risk.

The above are just two examples of differing requirements with regards to currency management and exchange rates. Many aid organisations work with several different donors. The complexity of often being pledged funding in different currencies, with differing commitment periods, is thus further exacerbated by different financial requirements on how currencies and exchange gains or losses should be managed. This contributes to the administrative burden of the organisations and also makes an analysis of currency risks much more complex.

6.1.2 Other initiatives to manage financial risk in foreign aid

While no donor initiatives to mitigate financial uncertainty for recipients of grants due to exchange rates were identified, there are other relevant initiatives. One is the TCX Fund, a fund started by a number of international development finance institutions (DFIs), following an initiative by FMO N.V., the Dutch development bank.⁴⁵ The fund currently has 22 shareholders, all being either DFIs, multilateral institutions or microfinance organisations.

⁴⁵ See <https://www.tcxfund.com/about-tcx/>

Through the fund, its shareholders can access options for managing currency risks in developing markets. The result is that the shareholders are able to provide the necessary capital in developing countries where there are no commercially available options for currency risk management. The funds' main areas of operation are the microfinance industry and funding of small and medium-sized enterprises.

The International Finance Facility for Immunisation (IFFIm) is an initiative launched in 2004 that aims to provide additional and more predictable funding for the international vaccine alliance, Gavi. IFFIm uses long-term commitments from nine donors as collateral to issue bonds in the financial markets. The bonds allow IFFIm to provide efficient funds to Gavi directly, using the liquidity in the financial markets. It essentially turns donor pledges running for as long as 25 years into available funds to be used by Gavi. In practice, IFFIm uses the World Bank as its treasury. Sweden is one of the nine donors funding Gavi through IFFIm, having pledged SEK 276 million over 15 years.

Gavi's operating currency is mainly USD, and so this is the currency IFFIm provides. The funding pledges from the nine donors are, however, all in other currencies, mostly GBP and EUR. In addition, IFFIm issues bonds in several different markets in a number of different currencies that are mostly non-USD. As a result, Gavi's funds are exposed to currency risks in both incoming and outgoing financial transactions (funds going to and from bond holders, to Gavi and from donors). As IFFIm works in different currencies in different markets, there is additionally an interest rate risk, with differences and changes in rates able to affect the value of funding.

To ensure that funds provided through IFFIm can be made available in USD predictably and efficiently, IFFIm uses hedging to eliminate both currency exchange rate and interest rate risks. Through swap agreements set up with the World Bank, IFFIm is able to ensure that both donor pledges and its bonds are protected

from fluctuations in exchange rates or interest rates. All these measures aim to ensure predictable funding to Gavi.⁴⁶

In the UK, two organisations, Stamp out Poverty and the Charity Finance Directors' Group (CFDG) have been working to improve currency management among British charities. Two reports have been published, focusing on inefficiencies and how best practices could improve currency management in the sector. *Mission Millions*, from 2009, identifies a culture in which aid organisations passively transfer funds abroad without regard to price or currency risks. The report identifies a number of possible improvements that would enable organisations to purchase local currency at more competitive rates. In *Better FX: a guide to improved foreign exchange practice in the UK charity sector* from 2011, the perspective is broadened to include guidance on currency risk management.⁴⁷

6.2 Best practices and available options

Exchange risk exposure is something not at all uncommon in other sectors and industries. As such, there are plenty of resources and lessons learned that could benefit the aid sector. A wide selection of risk-mitigating practices have been developed to increase predictability and lower the costs associated with currency risks.

An initial step in any endeavour to manage unpredictable funding is to analyse and understand the risk and what different outcomes could mean. From such an understanding, different options can then be developed. As discussed above (chapter 4.3), this first step is often not taken by Sida or funded partner organisations. If such an analysis was made, it could provide Sida and the partner with an understanding of how exchange rates might affect funding and, linked to that, the implementation of the funded activity as well.

Just like in other sectors and industries, the first question would concern what different outcomes would mean for the activity. Can

⁴⁶ IFFIm, 2017. See also <http://www.iffim.org/>. The IFFIm set-up is in itself a very interesting means of providing predictable long-term aid funding. In this report, we limit ourselves to the question of how they manage financial risks.

⁴⁷ Boakye-Adjei, 2009 and Boakye-Adjei, 2011.

they be managed by planning and preparing for different scenarios? Perhaps the risk is offset by incoming funds from other donors, denominated in other currencies? As we discussed in chapter 5.3, an inflated contracting amount and/or a low burn rate might mitigate a large part of the risk, or even all of it. For those organisations sticking to their budget, however, how can fluctuations be managed? Some organisations include priorities in their planning so they can cut out or include more activities, depending on the exchange rate outcomes. Such measures will entail administrative measures, often at both the implementing organisation and at Sida. However, planning ahead will at least ensure that activities are not re-planned ad-hoc.

Having gone over the administrative options, there is also a selection of financial options available in the market to mitigate, or hedge, risk. The most common such tool is a forward contract (see Box 7), which allows for a fixed exchange rate for a currency purchase at a future date. Using a forward contract would allow an aid organisation improved predictability in their funding, as the exchange rates are fixed.

Box 7. Hedging exchange rate risk with a currency forward contract

A forward contract is a binding contract between two parties on the right and obligation to buy and sell an item, in this case currency, at a pre-determined price at a given time in the future. The pricing of currency forwards is based on the difference between the domestic interest rate and the interest rate in the country whose currency the forward contract refers to.

For example, if a bank is to supply USD 1 million in a year's time, in order to be able to provide the funds at that time at the contracted price, the bank needs to borrow SEK today that is converted (at the spot price) and invested in USD. When the year has passed, the bank supplies the currency as agreed and pays back the SEK loan with interest. This simplified example gives the following formula for calculating the forward contract price:

$$T = \frac{1 + r_s}{(1 + r_x)} * S$$

Where: T = implicit forward contract price

r_s = interest rate, Sweden

r_x = interest rate, USA

S = Spot rate USD/SEK

If the interest rate in Sweden is higher than in the US, the forward contract price will be higher than the spot rate. If instead the interest rate is lower than in the US, the forward contract price will be lower than the spot rate.⁴⁸

An example: An aid organisation has received a pledge from Sida for a disbursement of SEK 10 million in a year's time. As the organisation budgets and operates in USD, they would like to hedge the disbursement using a forward contract. The current USD/SEK rate, used in the budget, is 8.1463. The total budget is therefore USD 1 227 550. Uncertainty due to exchange rates is (+-) 15 per cent, calculated as a VAR from USD/SEK over the commitment period.

If the US interest rate is 1.25 per cent and the Swedish is 0.5 per cent, the resulting forward price is 8.0859. The result is thus that the organisation would ensure a future payment of USD 1 236 710. If the interest rates had been reversed, the sum would have been USD 1 218 450. The result would have been 100% predictable funding one year from the Swedish pledge being made.

Interviews conducted in the present study and other studies have highlighted that capacity for currency risk management is low in the average aid organisation.⁴⁹ It is also natural that such capacity would be relative to the size and resources available to an organisation. The result, however, is that exposure to currency risk is transferred from the strongest organisations (governmental donors and multilaterals) down through the aid system to those actors with the least capacity for risk management.

⁴⁸ Swedish National Audit Office, 2014b.

⁴⁹ There are few studies on the subject but see Swedish National Audit Office, 2014b, Backlund and Sörensson, 2015, Boakye-Adjei, 2009 and Boakye-Adjei, 2011.

6.2.1 Predictable disbursements in major currencies

In its study of currency management in Swedish aid, SNAO provided case studies from other public sectors subject to currency exposure.⁵⁰ What these studies showed was that the Swedish Government has both the expertise and the capacity to manage currency risk, and that this capacity is readily available to Sida and the MFA. What this means is that there are options available that could be used to increase the predictability of funding.

The largest implementing currency in aid funded by Sweden is the US dollar. Other major currencies, such as EUR, GBP and CHF, are also likely to be in high demand from partners, especially when the multilateral organisations are included in the currency review. For these major currencies, the financial market provides a wide array of options for hedging, such as forward contracts. These options are readily available to all Swedish government agencies through the SNDO, which provides the Swedish Government with banking services and expertise.

Sida and the Swedish MFA could, with the help of the SNDO, explore the possibility of providing their partner organisations with predictable disbursements in major currencies. For those organisations lacking their own financial hedging, this would ensure a substantial increase in funding predictability. The possibility of offering partners an option for predictable funding has also been requested in several interviews with Sida staff and partner representatives.

In practical terms, this could involve including a contractual option to receive specified currency equivalents to the contract amount in SEK. From these contracts, Sida and the MFA would be able to aggregate a schedule for currency disbursements, which could then be used when organising forward contracts through the SNDO. Such a schedule would need to be adjusted somewhat to take into account the fact that a small percentage of disbursements would differ compared to the contract and budget. The SNDO has noted that Sida would need to establish a cash management

⁵⁰ Swedish National Audit Office, 2014b.

projection and a financial plan as a foundation for a forward service. This is, however, something that the SNDO has already recommended to Sida.⁵¹

The result would be a few large forwards contracts synced with planned disbursements, providing Sida with the requested funds in a currency account at the time of disbursement. The disbursement as such should not involve any additional administration compared to a disbursement made in SEK. In addition, the limited administration required to manage such a scheme would most likely cost less than the current administration needed to manage fluctuations at Sida, partner organisations and recipients.

The use of forward contracts would not entail costs that do not fall under the ODA definition. This is because the contract is priced as a change in rate and not as a direct cost (see Box 7 above). With current Swedish negative interest rates, most forwards would additionally experience positive rate movements in forward contracts.

Using the governmental infrastructure to manage currency risk in this manner would provide a lot of partner organisations and recipients with greater predictability. As the Swedish Government obtains rates not available to most partner organisations or recipients, this would also likely result in more funds. Buying currency in an organised fashion through the SNDO would therefore result in more aid for each SEK committed.

In conclusion, exploring forward contracts through the SNDO would enable Sida to offer predictable funding to a large portion of their partners at a limited cost.

6.2.2 Increasing predictability when working with smaller currencies

About 40 per cent of implementation takes place in smaller currencies, mostly the currencies of those developing countries in

⁵¹ Interview with the SNDO, 9 November 2017.

which Sweden funds aid activities. For these currencies, there are far fewer readily available financial options for risk mitigation. The market does not offer financial instruments that would enable hedging in smaller and more volatile currencies. There is simply not enough liquidity in these currencies, and the risk, and therefore the costs, is too high for commercial actors.

As there is no market option available, other measures would have to be sought if the intention was to attempt to decrease the exchange rate risk in Swedish aid. Sida has, in addition to its grants funds, a financial guarantee instrument. The instrument is used to decrease risk in order to increase available capital in developing countries, with the aim of promoting development. It is a flexible instrument designed to address “constraints related to access to capital”.⁵² The guarantee is mainly used to increase available capital in developing countries in which the market is not able to provide risk management services.

A possible way to mitigate some of the currency risk exposure for Swedish-funded aid activities could be to use the guarantee instrument. Through the instrument, Sida could provide sufficient backing needed for an institution which could, in turn, provide risk management to Swedish-funded partner organisations and recipients.

If based on an analysis of currency risk exposure in Sida-funded activities, such a set-up could provide increased predictability in Sida-funded activities. The scheme would be similar to the one used by the shareholders in the TCX Fund but would differ in that the underlying contract would be a funding pledge rather than a loan instrument.

As Sida already has the institutional capacity in terms of the guarantee instrument, the additional administrative costs related to such a solution should be small. The current guarantee portfolio totals about SEK 3.3 billion.⁵³ As the Riksdag (Swedish Parliament)

⁵² Sida, 2016b.

⁵³ Sida, 2016b.

recently decided to extend the funds available for the instrument to SEK 12 billion, there is also ample room for new commitments.⁵⁴

Using the guarantee instrument could provide partner organisations and recipients with much-needed financial predictability. The innovative use of the financial instruments available to Sida would not only decrease the financial risk for partners but would naturally at the same time decrease Sida's risk exposure – the risk that intended results could not be met. This aid funding safeguard would be complemented by the fact that the guarantees provide additional market liquidity in developing countries.

⁵⁴ Regeringen, 2017.

7 Conclusions and recommendations

The objective of this study was to understand how confident Sweden's partners can be that the amounts disbursed by Sweden in SEK will match the expected value in the actual working currencies involved. The conclusion is that exchange rate fluctuations have a substantial impact on the predictability of Swedish aid. The report underlines the importance of not only understanding aid predictability from a donor perspective. *It is not enough to analyse predictability in terms of amounts disbursed; rather, it should be analysed in terms of amounts received.*

A majority of aid funded by Sweden is implemented in currencies other than SEK. As soon as time elapses from a Swedish funding pledge in SEK to the disbursement of funds, uncertainty arises. This negative effect on predictability depends on the currencies involved and the time between pledge and disbursement. The longer the time and the more volatile the currencies are, the more significant the effect on predictability.

As important financial data is lacking in Swedish aid reporting, calculations of exact financial uncertainty are not possible. Going by assumptions and estimates, the results still clearly show that there is substantial financial uncertainty due to exchange rate fluctuations. A partner organisation will, on average, face uncertainty regarding the value of Swedish funding of around (+/-) 9 per cent in the year funds are committed. For a three-year project, the uncertainty then grows to an average of (+/-) 27 per cent.

During the period studied, 2006–2016, the study also shows how the final value of disbursed aid funds, in partner currency, has fluctuated significantly. On average, the value has diverged by about 7 per cent in the period from a Swedish commitment being made until funds have been disbursed.

How this financial uncertainty affects actual effectiveness depends to a large extent on how the partner organisations involved manage uncertainty and on the implementation of the activity. It should also be emphasised that exchange rate fluctuation is just one of many risks and uncertainties that can impact predictability of aid

funding or the actual implementation of funded activities. It may not be the biggest obstacle for partner organisations in their efforts to achieve their intended results, but the effect on predictability and effectiveness is still significant.

The report concludes that there are options readily available that could be implemented by Sida and the MFA and could substantially reduce uncertainty due to exchange rate fluctuations. A number of findings are presented below, together with matching recommendations.

Financial uncertainty is transferred from donor to partners and recipients, resulting in decreased predictability in Swedish aid.

When funding is denominated in SEK, the currency risk exposure falls upon partner organisations and ultimately upon the intended recipients. A financial risk that is manageable for the Swedish Government is transferred to parties that often have substantially lower coping capacity than the Swedish Government. This places an unnecessary strain on implementing organisations.

The fact that financial uncertainty is not considered when funds are committed in SEK highlights a lack of a results perspective in the commitment. The fact seems to be overlooked that while the Swedish Government is not exposed to any financial risk, there is still a risk that rate fluctuations will have a negative impact on the intended results.

Recommendations

- *Provide predictable funding in major currencies.* A substantial part of Swedish aid is implemented in USD or other major currencies. Sida and the MFA could offer partner organisations fixed rates for commitments in which users work in these larger currencies (such as USD, EUR, GBP and CHF). Such offers would be backed by forward contracts, managed by the SNDO, a service provided to all government agencies. Through such a service, up to 100% predictability could be ensured for most partner organisations. An additional benefit is that this likely to result in more aid funds, as the SNDO would be purchasing currency for

partners at competitive government rates that are not available to most aid organisations.

The solution could likely be implemented through existing administrative resources at Sida/MFA and SNDO. There are no direct costs for the financial instruments involved.

- *Explore innovative financial solutions for smaller currencies.* Sida could consider the possibility of leveraging its guarantee instrument to enable financial solutions for risk reduction in smaller currencies. By extending a guarantee, a financial partner could in turn provide financial hedging to Sida partners working in smaller currencies. Sida could thereby support aid effectiveness, ensuring risk mitigation for funded activities. Such a solution could at the same time possibly provide much-needed additional liquidity in developing markets.

This solution could likely be implemented using available funding and existing financial instruments.

Contracting fails to promote aid effectiveness

While this study focuses on exchange rate fluctuations and predictability, findings on this theme also highlight questions relating to how aid effectiveness could be better promoted.

When contracting, the value of Swedish commitments in SEK is regularly increased at Sida through a lower valuation of the Swedish krona. This takes place when calculating the rate between the budget and the contract value. The resulting over-valuation, often around 10 per cent higher than budget, provides partner organisations or recipients with some measure of risk management. However, over-contracting is inefficient as a tool to increase predictability, as it results in substantial amounts of Swedish aid being tied up.

The report also illustrates how partner organisations are provided with some risk mitigation by keeping their implementation rate in check, with an average of around 80 per cent of budgets being spent per year. With 20 per cent remaining, a financial buffer is created that lowers the financial risk over time. However, this means

that organisations that strive for effective implementation, closely corresponding to agreed plans and budgets, are exposed to a substantially higher amount of financial risk.

Recommendations

- *Ensure that partner organisations are given positive incentives to ensure a high implementation rate, in line with plans and budgets.* Sida should ensure that organisations that strive to follow plans and budgets are not placed at a financial disadvantage by unnecessary risk exposure. There are several options to contractually incentivise effective implementation that could promote effectiveness if coupled with risk mitigation options.
- *Work with transparent and efficient contracting rates.* By providing efficient means of risk management (above), substantial resources could be freed up to enable more Swedish aid. By contracting at market rates, without depreciation of the Swedish krona, more funding would be available for other aid activities. Using a set standard rate would also ensure more equal and transparent treatment of partner organisations.

Reporting to the OECD and IATI is not sufficiently transparent.

Currently, financial aid data reported by Sweden lacks the detail needed for it to fulfil some of its purpose. It is not possible to understand when funds have been disbursed or how much has been received. This significantly lowers transparency and has a negative impact on the possibility of promoting effectiveness and accountability.

Recommendation

- *Increase transparency regarding financial transactions in reporting to the IATI.* Increased transparency in Swedish reporting to the IATI could facilitate for solution providers. Open data can not only enable increased accountability but also provide opportunities for solution providers to present new solutions for more effective and efficient Swedish aid.

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