



Commonwealth Ministerial Debt Sustainability Forum

Grand Resort, Limassol, Cyprus, 30 September 2009

Review of the Debt Sustainability Framework

Ministerial Discussion Note

1. Background

The joint World Bank/ IMF Low Income Countries (LICs) Debt Sustainability Framework (DSF) was launched in 2005 to assess LICs risks of debt distress, and based on this risk assessment, whether its finance should come in the form of grants or loans. The DSF provides the basis of allocation under IDA14 and of other groups of lenders such as the OECD's Export Credit Agency working group, African Development Fund and Asian Development Fund. In order to counter excessive non-concessional borrowing by grant-eligible countries following Multilateral Debt Relief Initiative (MDRI), IDA developed a non-concessional borrowing policy (NCBP) in July 2006.

2. The shortcomings of the framework have been understood for some time especially its rigidity. The financial and economic crisis has accelerated the need for review as countries needs for external finance has grown. Recognising this issue G20 Finance Ministers at their meeting in April 2009 agreed that flexibility of the DSF should be reviewed. As a result, the IMF/WB are currently undertaking this review¹ and will report back to the International Monetary and Financial Committee (IMFC) and Development Committee (DC) at their annual meetings in October 2009.

3. CMDSF Finance Ministers have long held a concern about the need for greater flexibility in the application by the IFIs of the NCBP and the DSF. At their April 2009 meeting Ministers emphasised the importance of ensuring that the views of borrowing members are fully integrated into any revised policy. The Secretariat has started the process of seeking these views². This note builds on this work setting out three key issues and suggesting areas for discussion by Ministers. It is anticipated that positions will be developed and agreed which will be taken forward by the Chair and the Secretariat in attempt to try and influence policy development and application.

¹ There has been no consultation process or outreach.

² A review document was developed by the Commonwealth Secretariat which was sent to CMDSF debt managers. 7 out of 15 countries responded. We would like to thank the following countries for taking the time to provide their valuable feedback upon which has informed this note: Cameroon; Kenya; Lesotho; Tanzania; Tonga; Uganda; and Sierra Leone. The Secretariat would also like to thank MEFMI for also providing their input.

2. Key Issues For Discussion

2.1 Exogenous Shocks - A System Fit for Managing Vulnerability and Crisis?

4. In the past an increase in external financing combined with exogenous shocks and macroeconomic mismanagement, led to a build up unsustainable debt in many LICs. An important determinant of the LIC debt crisis has been their vulnerability to exogenous shocks. Many LICs have a number of structural features (macroeconomic and financial) which impact their debt carrying capacity and expose them to greater solvency and liquidity risks. These features include narrower production bases and export structures³, shallower financial markets, less efficient tax systems and higher dependence on aid.

5. The DSF is based on the view that the quality of a countries policies and institutions are the main determinants of a country's debt carrying capacity and hence risk of debt distress in LICs. It posits that a country with higher quality policies and institutions can sustain a higher level of debt. Policy performance is measured by the Country Policy and Institutional Assessment (CPIA) index⁴, which in itself is subject to a well known set of shortcomings. These shortcomings include concerns about its objectivity and transparency as the assessments are undertaken by World Bank staff with no agreement with country authorities⁵.

6. Whilst the DSF attempts to deal with the quality of policies and institutions as a determinant of debt carrying capacity it completely fails to take into account LIC vulnerability to exogenous shocks, arguably a key determinant of debt distress, in defining debt distress thresholds.

7. Vulnerability is only given significance as crisis predictors in the alternative scenario and stress testing predictions. But even here the approach remains problematic, as the shocks are pre-designed with little flexibility to consider other country specific shocks⁶. In reaching conclusions from these standard stress test the WB/IMF adopt an obscure and highly discretionary approach to determining the risk of debt distress. This is a cause of concern as the conclusion on the risk of debt reached by staff determine the financing options open to LICs.

8. A further problem with the DSF is the risk of pro-cyclicality. The crisis will worsen debt ratios (as tax revenues decline and expenditure increases) which will pose challenges to Government in its ability to pursue appropriate fiscal measures without breaching thresholds.

9. The majority of respondents to our survey agreed that the DSF does not adequately take into account the vulnerability of their country to exogenous shocks. The majority also agreed that the thresholds should take this vulnerability into account.

³ In particular, the concentration of their exports in a limited number of primary commodities whose prices are volatile and in long-run secular decline.

⁴ The CPIA rates countries according to their economic management, structural and social policies as well as public sector management and institutions.

⁵ MEFMI have also raised concern with the policy aspect of the CPIA when linked to long-term borrowing. Short-term Government (5 years) borrow long-term but there is no guarantee that subsequent Government for the remaining loan maturity will have or put in place the same of better policy strength as the Government that borrowed.

⁶ This problem was highlighted by many respondents.

10. In thinking about how the policy framework can be improved to help manage vulnerability and crisis, Ministers may like to consider the following questions:

- **Is there over-reliance on the CPIA as the guiding criterion for debt sustainability? Is the risk to debt sustainability determined mainly by the quality of policies and institutions?**
- **Should thresholds take into account vulnerability? If yes, should this supplement the consideration of a country's quality of a country's policies and institutions?**
- **Should the Secretariat undertake further work in this area and should the CMDSF advocate that vulnerability should be taken into account in the determination of the thresholds?**
- **Is the DSF and NCBP restricting (in terms of potential breach of thresholds) your ability to pursue fiscal expansion to mitigate the impact of the crisis?**

2.2 Greater flexibility – A system which supports financing for growth and development?

11. Priority in reform needs to be on ensuring a system which increases and facilitates financing for growth and development. Currently the NCBP threatens LICs with cuts in highly concessional financing from IDA and other concessional lending windows, if they borrow at non-concessional terms from commercial or new sovereign lenders, which in the view of the WB put debt sustainability at risk⁷.

12. This policy is problematic on a number of fronts:

- In practice in LICs which have a Fund-supported program, the IMF has set zero limits on non-concessional external borrowing, although some flexibility has been applied on a case-by-case basis⁸. This one-size-fits-all is problematic as it does not recognise diversity of situations in LICs. This diversity impacts the ability of a LIC to prudently manage its public debt.
- LIC development and financing needs remain large and the policy fails to recognise that often non-concessional borrowing by LICs is determined by a lack of sufficient concessional finance to fund necessary infrastructure and social spending, including the failure of donors to meet their aid commitments⁹. At the same time there is an emergence of new donors and creditors who are willing to finance infrastructure investment yet their finance may be less concessional than that of traditional donors.

⁷ The DSF is used as the NCBP policy anchor.

⁸ Non-zero limits on non-concessional borrowing have been applied under current fund-supported programmes in Mozambique, Uganda and Zambia. The “standard” practice of zero tolerance with a minimum concessionality requirement ranging from 35% to 100% was applied to 65% of LICs with Fund-supported programs in LICs as of mid-January 2009. This included Tanzania (35% concessionality requirement); Malawi (35%); Sierra Leone (35%); and The Gambia (45%). Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt, IMF 2009.

⁹ All respondents highlighted this problem.

The majority of countries surveyed indicated that lack of concessional finance, aid unpredictability and the NCBP are frustrating their ability to fund growth and development. This issue assumes even more significance with the global crisis which is starting to have a severe impact on LICs. The WB/IMF current policy framework unduly constrains financing for growth and development.

- It focuses exclusively on the quantity of new borrowing taken on by LICs with little qualitative consideration of the borrowing and its impact on growth and development. There may be cases where there is a strong economic justification for non-concessional borrowing and it is widely recognised that there is a need for stepped-up infrastructure investment to support long-term growth. Extreme caution is exercised in incorporating a public investment growth dividend in the current policy framework as it has not always resulted in a growth dividend. The resulting restrictive framework impinges on a country's freedom to prudently raise external loans to promote growth and development.
- Domestic debt is excluded from the NCBP, yet, in many LICs the distinction between external and domestic debt has become increasingly blurred¹⁰. Given the degree of substitution that exists between the two types of debt, if implementation of the NCBP is constraining LIC government in contracting foreign loans to finance a desired programme, all the government needs to do would be to resort to the domestic bond market and raise equivalent amounts in domestic currency – with the same degree of adverse effect on debt sustainability that the NCBP is trying to prevent. However, if domestic debt was included in the NCBP it could amount to zero tolerance of domestic borrowing although this could be addressed by simply putting a non-zero limit on (instead of total exclusion of) domestic debt in the government loan portfolio.
- The NCBP is impacting the freedom of debt managers to pursue their debt management objectives and develop their capacity to reduce dependence on concessional finance, which may result in a sub-optimal portfolio. For example, the majority of respondents indicated that as a result of the NCBP and aid unpredictability they are resorting to the domestic debt market to plug the gap. Domestic debt may not always be preferable to non-concessional external borrowing.

13. In thinking about reform of the NCBP, Ministers may like to consider the following questions:

- **How has the NCBP impacted your choice of finance and ability to fund projects to promote growth and development?**
- **Should there be limits on non-concessional external borrowing? If yes, what factors should be considered in determining the limits? Should these limits only apply when there is adequate concessional finance available to fund borrowing which is economically justified?**

¹⁰ The increasing role of non-resident purchases of domestically-issued bonds has blurred the traditional distinction between external and domestic debt, which is based on a residency criterion.

- **Should LICs be treated uniformly or should there be flexibility according to country circumstance?**
- **Should there be limits on domestic debt given the degree of substitution between external and domestic debt?**

3. DSF Access Criteria

14. To assess debt sustainability, debt burden indicators are compared to indicative thresholds over a 20-year projection period. Indicative policy-dependent external debt-burden thresholds are set in relation to the CPIA. A debt-burden indicator that exceeds its indicative threshold suggests a risk of experiencing some form of debt distress. There are four ratings for the risk of external debt distress:

- **low risk:** when all the debt burden indicators are well below the thresholds;
- **moderate risk:** when debt burden indicators are below the thresholds in the baseline scenario, but stress testing indicate that the thresholds could be breached if there are external shocks or abrupt changes in macroeconomic policies;
- **high risk:** when one or more debt burden indicators breach the thresholds under the baseline scenario; or **in debt distress**, when the country is already having repayment difficulties¹¹.

The indicative thresholds are given below:

Debt Burden Thresholds under the DSF					
	NPV of Debt in % of:			Debt service in % of:	
	Exports	GDP	Revenue	Exports	Revenue
Weak Policy	100	30	200	15	25
Medium Policy	150	40	250	20	30
Strong Policy	200	50	300	25	35

15. The results of the debt sustainability analysis determine the grant/loan mix of IDA allocations and those of some other multilaterals, including the African Development Fund. The results also impact the design of the IMF program. A traffic light system is used as follows:

- “Red Light” IDA-only countries at high risk or in debt distress receive 100% grant financing from IDA. An upfront discount of 20% is then applied to the grant component¹².
- “Yellow Light” IDA-only countries at moderate risk receive 50/50 mix of grants and traditional credits.
- “Green Light” IDA-only countries at low risk receive 100% credit financing on standard IDA terms.

16. In light of the brief overview of the system, Ministers may like to consider the following issues and questions:

¹¹ Source: IMF DSF fact sheet May 2007 available on IMF website.

¹² The upfront discount is applied to address the incentive distortions implicit in this allocation mechanism but this results in an overall reduction in financial flows to high risk countries.

17. **Indicative Thresholds:** The majority of respondents to our survey indicated that the indicative thresholds were set too high thereby under-estimating the need for grant financing. Some countries also raised the concern that following HIPC and MDRI some country debt ratios are very low compared to the indicative thresholds which is sending out wrong signals about the ability to borrow, when in many cases significant structural features remain which impact the country debt carrying capacity. Some countries indicated that in the post-relief environment they have adopted lower country-specific thresholds to guide their debt sustainability analysis.

- **Are these thresholds set too high?**
- **Have you adopted lower country-specific thresholds to guide sustainable borrowing?**

18. **The Loan/Grant Mix:** The majority of respondents to our survey indicated that all IDA-only countries should be eligible for some form of grant finance, especially where there are clear and large poverty reduction spending needs. Some countries who had strong policies and low risk of debt distress due to debt relief felt that this mix discriminates against them. Others also urged caution on the 50/50 mix for countries in moderate risk of distress.

- **Should all IDA- only countries be eligible for some % of grant financing?**
- **Does the current mix penalise against those countries who have strong policies and institutions?**
- **Should all IDA-only countries be treated the same?**