DEBT SUSTAINABILITY FRAMEWORK FOR LOW INCOME COUNTRIES

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INTRODUCTION

A Debt Sustainability Framework (DSF) for Low Income Countries (LICs)[1] was prepared by the International Monetary Fund (IMF) and World Bank in February 2004 to identify countries in actual or potential debt distress and formulate a basis for assessing grant eligibility of LICs during the Fourteenth Replenishment of the International Development Association (IDA). Follow up documents were prepared later that year after

e) the implications of the DSF on the IMF's policy agenda in the LICs[9]; and
f) the need for capacity building in public debt management in the post-debt relief period.

The November 2006 paper attempts to improve the rigour and quality of DSFs undertaken in the LICs. It highlights the three concerns and issues that need to be addressed as work continues on improving the methodology and countries develop public debt management capacity to benefit from debt relief. *First*, the Framework is based on benchmarks for public and publicly guaranteed external debt. Debt relief extended under the HIPC Initiative and the MDRI provides greater opportunities for LICs, in particular their private sectors, to borrow on non-concessional terms. Private non-guaranteed (PNG) debt is becoming an increasing share of the external debt of LICs as a result but it is currently not included in the benchmarks used in the DSAs. In view of this, the vulnerabilities that may be caused by such borrowing need to be monitored. *Second,* the paper examines the issues on which research should continue such as the integration of domestD -0.01.2108 Tw013 Tc

BACKGROUND AND DEVELOPMENTS SINCE 2004

Unlike the HIPC Initiative which assisted LICs to deal with the debt overhang brought about by past borrowing, the DSF is intended to assist these countries reduce the accumulation of future debts to unsustainable levels. While the HIPC Initiative used a single indicator to judge sustainability – the ratio of debt to exports - the DSF uses three debt ratios to judge debt sustainability. These are the ratio of present value of public and publicly guaranteed external debt to the gross domestic product (GDP) and exports, and debt service on the same debt to exports. Further, country policies and institutional capacity and vulnerability to shocks are other factors identified as being important for assessing a country's debt sustainability.

The DSF uses the CPIA for each LIC to classify countries as strong, medium and poor performers and determine different debt thresholds for the selected indicators. The level of debt distress is measured in relation to the debt thresholds for the relevant country grouping leading to an assessment of grant eligibility. The World Bank allocates funds for LICs taking into account both 'need' and 'performance'. While need is based on per capita Gross National Income (GNI), performance is assessed using the CPIA comprised of four clusters which account for 80 percent of the country rating. The Bank rates each government's portfolio performance on outstanding credits extended by it and this accounts for 20 percent of the rating. The level of grants and credits from the IDA to which a LIC has access increases or decreases due to the application of a governance factor to its CPIA and portfolio performance ratings. Consequently, the governance factor is given a high weight relative to other criteria.

Future levels of the selected debt indicators will take account of the impact of exogenous shocks to the extent that these can be forecast in the DSAs. Countries that are judged to be at high risk based on the DSAs will receive the entire IDA allocation as grant funds. Those that are judged to be at medium and low risk will receive 50 and 100 percent respectively of the IDA allocation as credits.

The DSF enables the IDA to assess grant eligibility and assist countries move towards debt sustainability. It provides a framework for bilateral, other multilateral and private creditors to assess the debt sustainability of the borrower though there is no mechanism to make them use it. The need for it is important when IDA lending to a LIC is a small share of total borrowing. It does not deal with the existing stock of debt as this has been dealt with separately under the HIPC Initiative and MDRI. Accordingly there is a need for a 'buy in' to the DSF by all creditors to guide them in lending to the country. For this reason, CPIAs that are central to the DSF have to be more transparent and discussed with the staff in Ministries of Finance and the donor community extensively at the country level as a component of the process of making these assessments. It is important that there is a full understanding of the process at the country level.

Action should be taken by the LICs to benefit from the debt relief received and avoid debt distress by building up public debt management capacity with the technical

that would avoid severe debt accumulation as they pursue the MDGs. External borrowings that are within ceilings determined using only indicators for public and publicly guaranteed external debt would inevitably require the mobilization of residual amounts in the domestic market or additional revenue generation by the government. The ability of countries to mobilize the required resources in the domestic debt market depends on the state of development of this market and the availability of savings in the country.

The revenue generation efforts of the government should be studied in the context of historical trends in domestic revenue growth and government revenue to GNI ratio. Countries should review the possibility of increasing domestic revenues by studying the impact of trade liberalization on revenue generation and through tax and institutional reforms and improved tax administration. The extent to which the domestic resources mobilized can be converted into foreign exchange to make payments overseas for goods and services will depend on the convertibility of the local currency. LICs are moving towards achieving convertibility with encouragement and assistance from the IMF. These issues need to be explored in determining sustainable levels of total public debt. The current approach is to estimate sustainable levels of domestic and external debt separately.

The ability of a country to service debt depends on the existing debt burden and the projected deficits of the balance of payments and budget, the mix of loans and grants in future financing arrangements, the build-up of its repayment capacity measured by the GNI or GDP, XGS and government revenues. The quality of the country's policies and institutions and exogenous shocks to the economy also influence the ability to service debt. The debt management capacity and the ability to formulate adequate policy responses to exogenous shocks are critical issues.

Judging debt sustainability using debt indicators raises a number of conceptual issues. These relate to the types of debt that should be included in the stock of debt and debt service payments (the numerator in the debt ratios); the method used to measure the debt burden; the repayment capacity (the denominator in the debt ratios); and the choice of thresholds for the selected ratios.

Three measures of debt burden are normally considered when debt sustainability is assessed. They are the nominal stock of debt expressed in a single currency, typically the US dollar; the stock of debt measured in NPV terms by discounting the future stream of debt service payments with discount rates relevant to the principal currencies in which the country borrows; and the annual or multi-year payments due on debt service. The nominal stock of debt and debt service payments were the preferred measures of the debt burden until the early nineties 1990s after which the World Bank, IMF and the Paris Club began to use the NPV of debt.

Current debt service ratios are indicators of the present debt service position. Low current ratios may however mask future problems of high debt stock due to grace periods and long repayment periods. The NPV of debt captures the concessionality of outstanding debt obligations but does not take account of the growth in repayment capacity that would be captured by projections of debt service ratios. Therefore

improvements in estimation. *Second*, a moral hazard argument is advanced against the use of government revenue as lower revenue collections will lead to higher estimates of the debt indicators.

External debt and fiscal indicators provide guidance on the medium and long-term sustainability of public sector borrowings but they are not useful in foreca 0 not

Global Development Finance (GDF)

The four indicators used by the World Bank in the eighties for assessing the W

conditions of interest and exchange rates and become eligible to receive funds from what is called the Topping Up Facility of the HIPC Initiative. An alternative debt sustainability target of 250 percent was set for the ratio of the stock of public and publicly guaranteed external debt to government revenue (introducing a fiscal indicator) in highly open small economies with an exports to GDP ratio of at least 30 percent making a strong fiscal effort with the government revenue to GDP ratio of at least 15 percent.

Debt Sustainability Framework

The DSF[10], as stated, enabled the World Bank to make assessments of debt distress in countries borrowing from the IDA and provided a basis for determining grant eligibility during IDA 14. The framework proposed that the denominators used for measuring debt ratios should be relevant for each country with overall resource constraints being captured by GDP, foreign exchange availability by XGS and the government's ability to raise fiscal revenues by government revenue.

Table 2
Thresholds for Debt Indicators in the DSF

Debt Indicator	Strong	Medium	Weak
NPV of debt/GDP	50	40	30
NPV of debt/Exports	200	150	100
Debt service/Exports	25	20	15
NPV of debt/Revenue	300	250	200
Debt service/Revenue	35	30	25

Country Policy Institutional Assessments

The CPIA, as stated earlier is based on a set of criteria covering different aspects of policy and institutional development needed for an effective poverty reduction and growth strategy and the effective use of development assistance. The World Bank began these country assessments in the 1970s to provide a basis for making country allocations for lending by the IDA during each replenishment. The process and criteria evolved over time until the last revision in 2004. Prior to this revision, 20 criteria were in use on a rating scale of 1 (weak performance) to 6 (very strong performance). The criteria focus on policies and institutional arrangements that are within a country's control rather than on actual outcomes such as economic growth rates that are influenced by external factors over which the country has no control.

A panel of experts reviewed the methodology and ratings in 2004[12]. This led to a reduction in the number of criteria from 20 to 16 which continued to be grouped under Economic Management, Structural Policies, Policies for Social Inclusion and Equity, and Public Sector Management and Institutions[13]. It also led to an explicit definition of the rating scale and strong recommendation that these be disclosed to all IDA-eligible countries. The panel endorsed the practice of rating policy and institutional developments based on actual policies and institutional changes that are implemented rather than on intended changes. It is thus seen that IDA country allocations based on CPIAs are dependent on performance rather than intentions.

The four clusters in the CPIA have equal weightage although some have more criteria than others and the criteria within each cluster also receive equal weight. Thus the CPIA is determined by a simple average within each cluster and then an average score for the four clusters. No attempt is made to weight the clusters. The CPIA scores are then used by the World Bank for two purposes. *First,* it enables the IDA Country Performance Ratings (CPR) to be estimated which along with per capita income determine the country allocations for the IDA replenishment. *Second,* it is

[12] Country Policy Institutional Assessments: An External Panel Review – Panel Recommendations and Management Follow-up, World Bank, June 2004.
[13] Please see Annex 1 for a listing of the criteria.

or below the threshold each country's indicators are, a negative number indicating that it is above the threshold and vice versa. In the third step, the average percentage for the

IDA Allocation Framework and Grant Eligibility

The World Bank allocates IDA funds to LICs taking account of both performance and need. The CPIA (or IDA Resource Allocation Index) is a major input in calculating a country's performance. In making this assessment, the Bank aims to ensure that the scores are consistent within and across all regions to which it lends. The IDA's CPR is based on the following:

- The CPIA consisting of the four clusters listed in Annex 1 which has a weight of 80 percent in the CPR;
- The Bank's assessment of country performance on its portfolio of outstanding loans which accounts for the balance 20 percent of the CPR. This is an assessment of the government's ability to manage loan funds including timely disbursement through efficient procurement practices; and
- A governance factor that is applied to the two ratings above to determine the CPR. It also increases or decreases the access the country has to grant funds within its IDA allocation.

It was recognized during the Mid-Term Review of IDA 13 that governance had become the most important factor in the allocation of IDA funds.[20] With the revision of the CPIA clusters, the governance factor is based on six criteria. Five of them are the criteria in the CPIA cluster Public Sector Institutions and Management and the sixth is portfolio performance. The governance factor is estimated by dividing the average rating of the six criteria on a scale of 1 to 6 by 3.5 which is the average of this range and applying an exponent of 1.5 to this ratio. The basis of this exponent is not known and appears to be intended merely to increase the importance of the governance factor. This methodology results in a larger weight being given to governance in the CPR than warranted by its share in the CPIA and by governance and portfolio performance comkTc 0 diTj 2.712 Tca0c3; 2.7ed1.44 Tw (nd) Tj 20.4 0 TD 0 Tc 0 -20

Per capita GNI is used as measure of poverty for the allocation of IDA funds. It is a measure that is available in most countries annually and less subject to serious errors. At present, the IDA focuses on the poorest countries with a per capita income of $1025 at July 2006 that have better governance. During the Review, the management of the Bank took the view that increasing the weight of poverty in the formula for allocating IDA funds would reduce the effectiveness of the use of scarce IDA resources.

The methodology developed by the DSF has been used to determine IDA allocations and grant eligibility. As stated, the resources made available to each IDA country (IDA only or blend) during the Fourteenth Replenishment are based on performance

threshold for eligibility of concessional borrowing from both the World Bank and the IMF and the stock of external public debt should have exceeded 150 percent of its exports (or in certain cases 250 percent of fiscal revenues). There were 40 such potentially eligible HIPCs and each country should have had a program with the IMF at some point since the start of the Initiative in 1996. The provision of debt relief depended on policies being in place to ensure that they contributed effectively to poverty reduction. The fraction of debt that creditors' were asked to forgive (the common reduction factor) was then calculated to bring the country's debt ratio back to a sustainable level (150 percent of exports or in certain cases 250 percent of fiscal revenues).

At the Decision Point, the first milestone, a country is judged eligible to receive assistance following a good track record of satisfactory performance under an IMF program, a Poverty Reduction Strategy (PRS) or an interim PRS in place, and an agreed plan to clear any arrears to foreign creditors. At this point, many creditors such as the World Bank, IMF, multilateral development banks and Paris Club bilateral creditors began to provide debt relief, although many of these institutions maintained the right to revoke relief if policy performance faltered. The amount of debt relief necessary to bring the stock of debt to exports ratio down to 150 percent at the Completion Point, was decided by the participating creditors and implemented.

At the Decision Point, the country agreed on a short list of completion point triggers upon which it will "graduate" from the HIPC Initiative. These included a continued track record of satisfactory performance on an IMF program and the implementation of the PRS for at least one year. Some triggers related to progress in social areas such as health and education, while others related to improving governance or fighting corruption to give donors sufficient confidence that debt relief assistance will be used well. Debt relief from participating creditors became irrevocable at the Completion Point.

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Thirty countries are benefiting or have benefited from the HIPC debt relief. Twenty one have reached the Completion Point. N9scNbeeg.Th1 TDH-0.0172 ( ) Tj -25.8 T020.01(as health an

what could be achieved by debt relief as long-term sustainability depended on success in institutional development to support sustained economic growth.

The MDRI assistance for new countries reaching the Completion Point is automatic. Assessments were made of countries that had reached this point prior to the respective Board decisions to ensure that there has been no policy slippage in regard to the issues that were of concern during the interim period. In particular, countries needed to show satisfactory performance in macroeconomic policies, public expenditure management, implementing the PRS and avoiding debt service arrears.

Remaining Issues

Ten of the countries that were potentially eligible to receive assistance under the HIPC Initiative remained without agreement on macroeconomic reforms, poverty reduction strategies or plans to clear arrears at the end of 2006. Many of them have been beset by civil war, cross-border armed conflict and governance challenges and in some the buildup of substantial arrears on external debt. It would have required a special effort on the part of the IFIs to assist these countries to begin pre-Decision Point programs. The boards of the IMF and World Bank decided to apply the sunset clause for the HIPC Initiative at the end of 2006 and grandfather the countries that met the income and indebtedness criteria based on data for the end of 2004. They are permitted to qualify at their own pace and receive the full assistance under the two Initiatives on reaching the Completion Point.

Most multilateral creditors participated in the HIPC Initiative while the AfDF, IADB (FSO), IDA and IMF provided or are providing assistance under the MDRI. Paris Club creditors provided debt relief on a voluntary basis beyond the HIPC Initiative. Unfortunately, official bilateral creditors outside the Paris Club and commercial creditors have not provided their share of debt relief to the HIPCs. In addition, litigation by commercial creditors against HIPC countries has been rising. A greater international effort will be required to reverse these trends.

Challenges remain for the LICs that have benefited from grant funding by the IDA and debt relief under the MDRI and HIPC Initiatives to ensure that unsustainable debt levels are not accumulated again. They need to strengthen their institutional and policy development capacity for public debt and public expenditure management to formulate effective borrowing strategies that would assist countries to cope with exogenous shocks. Creditors should also look at their lending to the LICs in the context of total borrowings to determine whether the lending volumes and terms are sustainable in the long-term.

Non-Concessional Borrowing by LICs[21]

Debt relief (described in the preceding section) and grant funding by the IDA and the DSF have provided an opportunity for LICs to obtain resources required to achieve the MDGs while keeping their debt burdens within sustainable levels. At the same time, borrowing space has been achieved with the reduction in the levels of debt indicators that could be filled by non-concessional borrowing leading to a moral hazard problem. This could result in unsustainable levels of indicators leading to a return to the need for debt relief. While the OECD donors and IFIs have coordinated their approach in assisting LICs achieve reduced debt levels, other bilateral donors and commercial creditors have not done so. The latter groups have identified opportunities to increase lending to LICs without any restraints imposed on them by being guided by the DSF. This is referred to as 'free riding' and reflects differences between IDA and its donors - who are attempting to lower the risks of debt distress in LICs by extending new assistance on concessional terms - and other creditors who are extending non-concessional assistance and taking advantage of these opportunities.

Credit rating agencies are recognizing the opportunities arising from the borrowing space resulting from debt relief and are providing market signals to commercial creditors. Weak policy environments in LICs will exacerbate this problem. Countries with limited access to financial markets will not face the free rider problem to any significant extent. Resource rich countries that have received debt relief provide opportunities for free riding when future export receipts can be collaterized to non-concessional borrowing. This once again identifies the need for an effective public debt management capacity which will signal the dangers of non-concessional borrowing to the government based on its borrowing policy and strategy.

The IFIs have begun taking other actions in addition to those at the country level. There should be a continuing dialogue with all creditors around the DSF and an exchange of information on debt relief, grants and free riding policies. There appears to be an effective dialogue with the OECD Export Credit Group. One of the actions taken is to set a mandatory reporting requirement in all grant and credit agreements of non-concessional loans in advance of the commitment in post-MDRI borrowing countries. A loan is judged to be non-concessional if it has a grant element of less than 35 percent using Commercial Interest Reference Rates (CIRRs) as discount rates.

Free riding reflects differences between collective and individual interests. IDA and its donors wish to reduce the risk of debt distress in LICs by providing new assistance on concessional terms that are appropriate to the country. In contrast, other creditors and borrowing LICs may gain from non-concessional loans after the large scale debt relief and grant funding by the IDA.

[21] Ibid footnote 8.

of the CPIA unlike the present practice of using the latest annual index. Debt indicator thresholds have been estimated for strong, medium and weak policy performers separately. Accordingly a country is judged to be of low risk if all its debt burden indicators are below the thresholds for the relevant policy performance category. Debt service indicators are expected to rise over the projection period with a breach of some of the thresholds in a medium risk country. Countries that are subject to high risk are expected to breach debt and debt service thresholds during the period of the DSA.

The Boards of the World Bank and IMF endorsed the DSF and its use for IDA grant allocations for FY06 in April 2005. The implementation of the DSF and the implications of the MDRI on the DSAs were reviewed in April 2006[22]. The paper[23] of November 2006 describes the work that has been undertaken to improve the rigor and quality of the DSA for LICs. Discussions of this paper by the Board of the IMF focused on these improvements and the policy challenges of the borrowing space created by HIPC and MDRI debt relief in some LICs that is being filled by commercial external and non-OECD official creditors. Vulnerabilities from these new sources of funds increase when high levels of domestic public debt arise in these countries.

Another challenge facing the LICs and IFIs is to foster a broader use of DSFs by both debtors and creditors. The borrowing countries should use the DSFs to formulate a borrowing policy and strategy that balances their financing requirements to reach the MDGs with the risk of debt distress. This highlights the need for LICs to improve

maturities than concessional external debt. Raising domestic resources for the government could assist in the development of the domestic capital market leading to the setting of more competitive interest rates. This is a benefit that could be realized in the medium to long-term.

It is not possible to incorporate public domestic debt into the existing thresholds adopted for public and publicly guaranteed external debt at the present stage of development of methodology. Until that is done, LIC DSAs should include one on domestic public debt to draw the attention of policy makers in the country to situations where the inclusion of domestic debt in the analysis of overall debt and debt service could lead to a different classification of debt distress.

Among the indicators that are available for undertaking DSAs for domestic public debt

Table 3
Provisional Thresholds for Domestic Debt Sustainability

Source: Debt Relief International, 2001.

Based on these thresholds, governments with ratios above the top of the ranges face an unsustainable domestic debt burden and may have accumulated domestic payment arrears. Those with ratios below the bottom of the ranges can be assessed to have sustainable domestic debt burdens. Countries that fall within the ranges need to monitor their debt situation closely as they face the prospect of unsustainable levels of domestic debt developing.

Table 4
Domestic Debt Indicators for Some Selected HIPC Countries (2002-2004) (%)

	GDD/GDP	GDD/GR	INT/GR	GR/GDP
Benchmarks	20-25	92-167	4.6-6.8	
Ghana	20	94	23.7	20.8
Kenya	25	121	13.1	20.7
Tanzania	15	120	5.3	12.9
Uganda	9	70	11.2	12.6
Malawi	26	110	40.4	23.5
Zambia	21	115	15.3	18.1
Bolivia	20	90	6.1	21.7
Guyana	32	98	9.6	32.4
Honduras	7	41	3.2	18.4
Nicaragua	44	202	17.6	16.3

GDD- Government Domestic Debt, GR- Government Revenue

Table 4 provides estimates of average domestic debt indicators for selected HIPCs in Africa and Latin America for the period 2002-04.[25] These countries are beneficiaries of the HIPC Initiative that was designed to reduce their public and publicly

domestic debt. This illustrates the importance of including domestic public debt in DSAs.

The inclusion of domestic public debt in DSAs will continue to present methodological and data problems. There is however agreement that:

a.

There is no institutional or contractual basis requiring countries do so as the main objective is to enable borrowers and creditors to make informed choices based on the DSAs. The IFIs will continue their outreach programs to contact all creditors to increase awareness of the DSFs and the free rider problem. This is particularly important when emerging creditors

Improving the Capacity for Public Debt Management

It is important for countries in debt distress or those that are likely to be as a result of borrowing necessary to achieve the MDGs to improve their capacity for public debt management. Many developing countries have taken steps to enhance this capacity with the assistance of the IFIs and other donors. There are many issues that countries need to address to achieve the necessary improvements and the more important ones are discussed below.

The preparation of the DSF enables debt vulnerabilities to be identified and taken account of in policy formulation leading to a Medium-Term Public and External Debt Strategy (MTDS). This should lead to a borrowing program that takes account of the resources needed to meet the MDGs, achieves macroeconomic balance, is sustainable and minimizes costs within an acceptable level of risk. These indicate a link between the MTDS and Medium-Term Fiscal Framework (MTTF) and the need for strengthening public debt management capacity. Once a sustainable MTTF has been formulated, the MTDS should address the various components of a borrowing program such as the terms of new borrowing including the mix between fixed and variable rates and between domestic and external public debt and an appropriate currency mix for external borrowing. These clearly indicate the need for the staff in PDMOs to be more than trained debt recorders and be able to undertake comprehensive debt management functions.

The capacity for public debt management of LICs should be improved with the assistance of the IFIs and other technical assistance agencies. This encompasses strengthening the legal and regulatory framework for public debt management; institutional strengthening including the establishment of an appropriate institutional framework for public debt management and staff training; establishing a debt information system for recording, retrieving and analyzing data on public debt; formulating a policy and strategy for public sector borrowing; and preparing a risk management framework for the loan portfolio of the public sector.

There should be effective coordination of policy formulation among the agencies and staff responsible for debt management, and fiscal, monetary and exchange rate policies of the government while maintaining separate responsibility for each of these activities. It will be difficult to implement the macroeconomic policies of the government effectively without this separation and coordination. Borrowing policies should ensure the long-term sustainability of the fiscal deficit. At the same time, debt management policy should not become subordinate to monetary policy. A government's exchange rate policy can have an impact on the strategic benchmarks chosen for debt management that specify the desired currency composition of the foreign currency debt. In view of these considerations, the institutional arrangements

should clarify the objectives of the government in these policy areas and separate accountability for each.

The issue of convertibility remains whether the domestic resources are raised from

ANNEX 1
CRITERIA USED FOR CPIAs IN 2005[27]

Economic Management

- Macroeconomic Management
-