Debt Sustainability, Non-Concessional Borrowing and The World Bank's Anti-Free Riding Policy

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Executive Summary

The paper aims at shedding light on the non-concessional borrowing situations in LICs and reviews the recent World Bank policy proposal that has a stated aim of guarding against accumulation of unsustainable debts in LICs. We also offer suggestions for promoting sustainable debt positions in LICs through policy actions by national governments and international development partners, particularly the World Bank.

We first review the profiles and stylized facts on non-concessional borrowing in the countries. Our review shows that natural resource rich countries and countries in conflicts (that are therefore in arrears with BWIs) account for the bulk of non-concessional debt stock and flows, particularly public and publicly guaranteed types. But it would not be illogical to anticipate that post-MDRI countries too could soon start (or might have just started) contracting non-concessional debts in sizeable amounts. We also highlight the geographical concentration of bilateral external credits that characterises many countries, with outstanding credits from emerging creditors like China, Kuwait and Saudi Arabia accounting for high percentage of GDP of the borrowing countries. We point out that this could make the borrowers more vulnerable. In addition, we review the available descriptive and "qualitative" information about the activities of emerging creditors in LICs, with emphasis on the lending activities of China in Africa.

The above is followed by a review of the likely reasons that could have made the countries resort to non-concessional borrowing. There, we identify a number of supply factors at the creditors' end and demand factors in the borrowing LICs. Also, we discuss the likely prospects and benefits to the countries of borrowing as well as the likely dangers and problems with such borrowing.

The latter and larger part of the paper is devoted to a review of the World Bank's recent document on anti-free riding policy proposal. We summarise the main contents of the document, including the peculiar concept of free riding adopted and the concessionality benchmark to be used. We also summarise the proposed responses, including the use of DSF as the coordinating tool for the creditors as well as discouraging of borrowers being complicit in free riding through a combination of cuts in volume of IDA assistance and hardening of terms of IDA credits. Then, we evaluate the proposed policy document by highlighting its possible advantages and disadvantages.

The notable benefits of the proposal are identified to include reduction of the incidence of opportunistic creditors financing low-return projects; guarding against moral hazard problem of reckless borrowing by LICs with a view to becoming (or continuing being) eligible for IDA grants; strengthening through the use of DSF of bargaining position of LICs in contracting foreign loans; and discouragement of LICs from embarking on large borrowing until they have put in place adequate debt management capacity and governance institutions.

The notable disadvantages and problems, on the other hand, include the philosophy or fundamental objective, which seem to have prompted the World Bank proposal, that is

routed in inappropriate perception by the World Bank of its role as a competitor with other creditors in provision of resources to LICs and its similarly inappropriate sentiment that it is evil for it to cross-subsidise private investors, particularly emerging creditors, irrespective of the consequences on the LICs. Also, the discrimination against LICs by IDA in allocating its resources is identified as a part of the problem that drives LICs to contract non-concessional loans and the proposed policy document has nothing to offer in addressing this issue. The policy would also hinder attainment of MDGs (or financing of growth-promoting infrastructural and other large expenditure projects) by the LICs by discouraging them from borrowing, just as the penalty of further reducing IDA grant allocation to them can make them resort further to non-concessional borrowing. The implied increased financial oversight of and intrusion in the affairs of government by the World Bank in implementing the policy would also erode sovereignty of the countries, just as it would run counter to the much acclaimed principles of ownership and alignment that are a part of the Paris Declaration on Aid Effectiveness. The acceptance and legitimacy, in the eyes of LICs and creditor community, of DSF, on which the whole policy rests, are also in doubt. Besides, the proposed policy glosses over all other fundamentals that affect debt sustainability and focuses on only volume of loans. In addition, it is one sided and asymmetrical by penalising only borrowing LICs for breaching the concessionality guidelines while leaving the creditors untouched. Finally, the policy may not be easy to enforce as LICs that breach the guidelines could easily hide this fact from IDA while, for many of them, even the maximum penalty (viz: disengagement from the "offending" country) at the disposal of IDA may be insufficient to deter some LICs, particularly resource rich countries.

Finally, we give a number of recommendations to policy makers in LICs as well as their international development partners, particularly, the World Bank in helping the countries attain or maintain sustainable debt positions. Specifically, we suggest that policy makers should refrain from reckless and injudicious borrowing; strengthen debt management capacity as well as the legal framework for managing of debt and broader government finances; diversify geographical sources of their foreign loans; pay attention to the exchange rate and monetary management challenges posed by inflow of foreign resources; and diversify export base as well as promote economic and export growth policies. To the international development partners, especially the World Bank, we suggest that the Bank should be at the forefront in providing and championing an initiative of a multilateral framework for promoting debt management capacity in LICs, similar to the IF and GCAP networks – that are respectively for promoting micro and small enterprises and technical assistance on trade-related matters. We also suggest that the Bank should do more in promoting exports in LICs; refrain from perceiving itself as a rival to other creditors in the loan market for LICs and from seeing cross-subsidisation of emerging creditors as necessarily a bad thing; liberalise or relax its conditionalities; and desist from the existing discrimination against LICs in allocating IDA resources. We recommend that Bank extend the proposed policy to cover the domestic debt also. Finally, we suggest that the Bank extend sanctions for breaching the concessionality guidelines in its proposal to creditors too, particularly by spearheading an adoption of international agreement whereby lending to LICs that flagrantly breach concessionality norms be treated as odious and illegitimate.

1. Introduction

1. Partly as a result of recent global liquidity and rising economic and international political profiles of what have now been referred to as emerging creditors, supply of credits to low-income countries (LICs) is on the increase. Similarly, debt reliefs from (mainly official) creditors to LICs and increased provision of grants to them by a number of multilateral development banks in their resource allocation policy could have created a borrowing space, just as improved macroeconomic indicators in a number of them have enhanced their debt carrying capacity that has given them an incentive to borrow more.

2. An unwanted effect of the above-noted development is that a sizeable portion of the loans are non-concessional, raising concerns about future debt sustainability in these countries. A response to this concern is a stated objective of the World Bank in its recent policy document for regulating foreign borrowing by those LICs that have either received MDRI benefit from IDA or are grant-eligible recipients of IDA allocations.

3. In this paper, we try to beam a searchlight on non-concessional borrowing by (and, hence, lending to) LICs by reviewing their borrowing profiles and stylised facts; analysing possible reasons for the borrowing; and highlighting the positive effects as well as possible dangers of doing so. Particularly, we review the aforementioned World Bank policy document that aims to prevent what is referred to there as 'free riding', whereby the grants and debt relief provided by IDA provide incentives for more non-concessional borrowing by, and lending to, the affected LICs, resulting into what is described there as cross-subsidization by IDA of these non-concessional creditors. We not only describe the main provisions in the policy document, we also analyse the possible prospects as well as likely challenges of implementing the proposed policy.

4. The rest of the paper is organised into three sections. In Section 2, we discuss non-concessional borrowing by LICs. In Section 3, we review the World Bank's anti-free rider policy while the last Section is on recommendations, summary and conclusion.

2. A Review of Profiles and Stylised Facts on Recent Non-concessional Loans to LICs and an Evaluation of Implications of the Borrowing

2.1 Categories of Non-concessional Lending

5. Following the typology adopted in World Bank (2006, Annex 1, pp. 35 – 36), we classify non-concessional lending into three - viz, officially supported export credits; commercial bank loans; and bonds - as discussed below. To these, we also add domestic credits as the fourth category.

6. ***<u>Officially-supported export credits</u>:*** **These are provided by creditor governments through their respective export credit agencies (ECAs)**. The bulk of DAC or OECD member countries' non-concessional credits to LICs used to be channelled via their ECAs but, recently, the volume of this type of lending by OECD

countries is being regulated and curtailed somehow through the organisation's Export Credit Arrangements, a form of "gentlemen's agreement".

7. ***Commercial (including syndicated) bank loans:*** **The terms of these are market-determined.** As pointed out in World Bank (2006), a particular form of this loan category that is prone to free riding is public sector borrowing collateralised with future receipts (CFR). The most common CFR arrangements entail collateralisation of oil and gas export receivables, which BWIs have often contended to give rise to governance concerns.

8. ***Bonds:*** **These are negotiable instruments issued at commercial interest rates by borrowing governments in the international and domestic capital markets.** But bond issuance is more common with emerging economies than LICs, although a sizeable volume of bonds issued recently by LIC governments in their respective domestic markets have been held by foreign residents. As pointed out in IMF and World Bank (2006, p. 9, Footnote 4):

> *For instance, there has been increased foreign investor interest, including in domestic public debt, in Cameroon, Ghana, Kenya, Malawi, Nigeria, Tanzania, Uganda and Zambia. Investment using other financial instruments, including public-private partnerships, has also become increasingly common. Recent investment has been particularly strong in Zambia, where the shares of government securities held by foreigners increased from a negligible amount in April 2005, the time of HIPC completion point, to over 20 percent of the total stock by April 2006. In addition to financial institutions, bondholders may emerge as a creditor group to LICs.*

9. ***Domestic loans:*** Although this fourth category is excluded from the aforementioned World Bank (2006) source, **it nevertheless constitutes an important category of non-concessional loans to governments in LICs.** Probably in an effort to promote development of domestic capital market or as a conscious attempt to finance the budget, many LIC governments resort to issuance of bonds in the domestic market, the bulk of which ends up being held by residents.

2.2 Some Stylised Facts

(a) Stylised Facts based on DAC Statistics and Concept of Concessionality

10. Tables below present some statistics on the state of non-concessional borrowing by IDA grant-recipient countries that are currently classified as high- and moderate-risk (viz: "red light" and "yellow-light", as explained later in Paragraph 57) cases in terms of debt distress by IDA. Table 2 shows that, in 2004, about 27 percent of public and publicly-guaranteed (PPG) external debt of 39 IDA-only countries among those classified at high or moderate risk of debt distress in 2006/07 (i.e., IDA's June to July fiscal year) was non-concessional. **Out of the 39 countries in this group, only 5 countries – Angola, Democratic Republic of Congo, Republic of Congo, Cote d'Ivoire and Sudan – accounted accounted for 78 percent of the stock of the non-concessional**

PPG debt while, in flow terms (See Table 1), Angola alone accounted for 85 percent of the total non-concessional PPG inflows.

11. **It is noteworthy that most of these countries are resource rich,** a feature that makes them find it easy to access external financial markets by collateralising their future exports receipts. **A good number of others are in conflicts or in arrears** (i.e., inactive with the BWIs), thereby hindering their access to concessional external resources, including eligibility to receive IDA resources – a likely factor that makes them resort to non-concessional PPG external loans.

12. **It should also be noted that not many of such countries are MDRI beneficiaries or even HIPCs.** First, many HIPCs, because of debt burden, had little access to external loan market. Second, most of HIPCs and MDRI beneficiaries had little freedom to borrow externally due to the limits on such loans that often feature as a part of conditionalities under the IMF's PRGF programme that is a precondition for eligibility under the HIPC Initiative. Third, because of the universal coverage of all types of external creditors (whether commercial or official) under the HIPC Initiative, many creditors might be unwilling to lend to HIPCs so as to avoid the possibility of their credits being covered by future debt relief as and when the HIPCs become eligible for it. Thus, it would appear that HIPCs and post-MDRI countries have refrained from non-concessional borrowing. However, as rightly pointed out in World Bank (2006, paragraph 17), "Past non-concessional borrowing patterns cannot be a predictor of risk in the new post-MDRI environment".

13. In Table 3, the trajectory of non-concessional debt profiles of LICs, analysed on the basis of risk of debt distress classification, over 2000 to 2004 period, is shown. The average non-concessional to total PPG debt stock ratio for the "red light" LICs is shown there to be about 16 percent over the period while it is about 7 percent for the ratio of non-concessional PPG debt flows to the total. For the "yellow light" LICs, the corresponding non-concessional to total PPG debt stock and debt flow ratios are higher, being about 18 percent and 17 percent respectively. These higher non-concessional debt ratios are due to the presence of Angola, which has just recently been upgraded from "red light" to "yellow light" status. The corresponding ratios for post-MDRI LICs (some of which simultaneously belong to either "yellow light" or "red light" categories) are broadly the same as for the "red light" category. In each of these categories, however, there are considerable variations in the corresponding ratios for individual members of the category. Thus, the group average masks the divergences.

14. In Table 4, statistics on borrowing (both concessional and non-concessional types) by selected LICs from each of the selected major emerging bilateral creditors are highlighted. **From this Table, it can be seen that outstanding credits from a single emerging creditor constitute sizeable percentages of GDP** (e.g., 48 percent of borrowing by Sao Tome & Principe from China; 13 and 11 percent of Mauritanian credits from Kuwait and Saudi Arabia respectively; etc). **Such credits similarly constitute high percentages of total outstanding official bilateral credits** – ranging between 10 percent and 53 percent in 15 out of 22 cases shown in the Table.

Table 1: Non-concessional Loan Disbursement, as percentage of Total, in 2004 by Type of Creditor

	19 Countries eligible for MDRI as of end-June, 2006							Countries that are "Red Light" in 2005/06					Countries that are "Yellow Light" in 2005/06		
	Bolivia	Ethiopia	Ghana	Mauritania	Niger	Zambia	remaining 13 countries1/	Bhutan	Chad	Sudan	Togo	remaining 26 countries2/	Angola	Ethiopia	The remaining 17 countries3/
Non-Concessional	**23**	**22**	**19**	**13**	**10**	**10**	**30**	**76**	**6**	**41**	**57**	**22**	**99**	**22**	**6**
Bilateral	0	0	0	0	0	0	1	76	0	17	0	0	0	0	0
Multilateral	23	1	4	11	10	10	21	0	6	0	57	16	0	1	5
Bonds	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Commercial Banks	0	21	15	2	0	0	5	0	0	0	0	0	94	21	0
Other Private Creditors	0	0	0	0	0	0	0	0	0	24	0	5	5	0	0
Concessional	**77**	**78**	**81**	**87**	**90**	**90**	**70**	**24**	**94**	**59**	**43**	**78**	**1**	**78**	**94**
TOTAL	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: World Bank, June 2006, Annex VI. (Note that DAC's concessionality definition, and not that of IMF/IDA, as discussed in the text, is the one adopted here).

1/ The remaining 13 countries include 3 red or yellow light MDRI-eligible countries, namely Guyana, Nicaragua and Rwanda.

2/ The remaining 26 countries include 2 MDRI-eligible red light countries, namely Niger and Rwanda.

3/ The remaining 7 countries include 2 MDRI-eligible yellow light countries, namely Guyana and Nicaragua.

Table 2: Non-concessional Debt Outstanding, as percentage of Total, in 2004 by Type of Creditor

	19 Countries eligible for MDRI as of end-June, 2006						Countries that are "Red Light" in July 2005-June 2006														Countries that are "Yellow Light" in July 2005-June 2006				
	Bolivia	Cameroon	Honduras	Nicaragua	Zambia	remaining 14 countries1/	Bhutan	Chad	Demo. Rep. of Congo	Rep. of Congo	Guinea	Sierra Leone	Cote d'Ivoire	Kyrgyz Rep.	Liberia	Somalia	Sudan	Togo	Myanmar	The remaining 17	Angola	Lesotho	Ethiopia	Nicaragua	remaining 6 countries3/
Non-Concessional	**20**	**32**	**19**	**21**	**22**	**69**	**59**	**10**	**30**	**64**	**10**	**13**	**48**	**10**	**46**	**19**	**54**	**24**	**17**	**44**	**99**		**22**		**6**
Bilateral	0	27	6	11	10	28	59	3	21	42	6	10	12	7	7	16	32	21	2	19	0		0		0
Multilateral	19	4	11	3	5	27	0	5	6	5	4	2	12	2	22	1	2	2	0	17	0		1		5
Bonds	0	0	0	0	0	0	0	0	0	0	0	0	24	0	0	0	0	0	0	0	0		0		0
Commercial Banks	0	1	1	7	0	10	0	0	0	15	0	0	0	0	16	0	16	0	10	2	94		21		0
Other Private Creditors	1	1	1	1	7	5	0	2	4	2	1	1	0	0	2	2	5	0	5	7	5		0		0
Concessional	**80**	**68**	**81**	**79**	**78**	**31**	**41**	**90**	**70**	**36**	**90**	**87**	**52**	**90**	**54**	**81**	**46**	**76**	**83**	**56**	**1**		**78**		**94**
TOTAL	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**		**100**		**100**

Source: World Bank, June 2006, Annex VII. (Note that DAC's definition of concessionality (as opposed to IMF/IDA's own), as discussed in the text, is the one adopted here).

1/ The remaining 14 countries include 4 red or yellow light MDRI-eligible countries, namely Ethiopia, Guyana, Niger and Rwanda.

2/ The remaining 17 countries include 2 MDRI-eligible red light countries, namely Niger and Rwanda.

3/ The remaining 6 countries include 2 MDRI-eligible yellow light countries, namely Guyana and Nicaragua.

Table 3: Share of Non-Concessional External Debt Flows and Outstanding Debt Stock in Total Public and Publicly Guaranteed Debt Flows and Stock for "Red Light", "Yellow Light" and First 19 Post-MDRI Countries (percent), 2000 - 2004

	Debt Flows						Debt Stock					
	2000	2001	2002	2003	2004	Average 2000-	2000	2001	2002	2003	2004	Average 2000-
"Red Light" Countries												
Afghanistan												
Bhutan	64	79	62	73	76	71	34	48	50	56	59	49
Burundi	8	13	9	19	0	10	3	3	3	4	3	3
Cambodia	0	0	0	0	0	0	0	0	0	0	0	0
Central African Republic	0	0	0	0	0	0	10	10	24	9	9	12
Chad	0	16	1	31	6	11	10	9	8	11	10	10
Comoros	0	0	0	0	0	0	4	3	4	4	4	4
Congo, Dem. Rep. of	0	0	0	16	0	3	60	60	30	30	30	42
Congo, Rep. of	0	0	0	0	0	0	56	55	55	54	64	57
Cote d'Ivoire	12	15	5	4	3	8	54	55	50	49	48	51
Djibouti	0	4	10	0	0	3	0	0	3	4	3	2
Eritrea	2	0	0	0	0	0	6	4	3	3	3	4
Gambia, The	0	0	0	0	0	0	4	3	3	2	2	3
Guinea	14	5	3	11	0	7	14	13	12	12	10	12
Guinea-Bissau	0	0	0	0	0	0	15	9	8	6	4	8
Haiti	0	0	0	0	0	0	0	0	0	3	3	1
Kyrgyz Rep.	9	3	0	0	0	2	28	23	17	13	10	18
Lao, People's Dem. Rep.	0	0	0	0	0	0	0	0	0	0	0	0
Liberia	0	0	0	0	0	0	45	45	45	46	46	45
Myanmar	19	19	15	6	5	13	20	20	18	17	17	18
Nepal	0	0	0	0	0	0	0	0	0	0	0	0
Niger	6	0	0	0	10	3	16	13	10	12	2	11
Rwanda	0	0	0	0	0	0	0	0	0	0	0	0
Sao Tome & Principe	24	9	4	-2	4	8	5	6	6	6	6	6
Sierra Leone	0	0	0	9	0	2	19	16	15	16	13	16
Solomon Islands	0	-1	0	0	0	0	4	4	4	4	4	4
Somalia	0	0	0	0	0	0	19	19	19	19	19	19
Sudan	66	38	57	50	41	50	52	51	53	54	54	53
Togo	0	0	-1	0	57	11	18	18	19	20	24	20
Tonga	0	0	0	0	0	0	3	2	2	2	2	2
Average, by period	**8**	**7**	**6**	**7**	**7**	7	**17**	**17**	**16**	**16**	**15**	16
"Yellow Light" Countries												
Angola	97	99	97	99	99	98	78	80	79	79	74	78
Ethiopia	3	2	4	2	22	7	10	9	8	9	11	9
Guyana	0	3	5	0	0	2	12	12	11	10	6	10
Lesotho	60	20	11	19	4	23	32	26	22	21	19	24
Malawi	2	0	0	0	0	0	4	3	3	3	4	3
Mongolia	0	0	0	0	0	0	2	2	1	1	1	1
Nicaragua	6	13	4	3	0	5	44	40	37	32	21	35
Samoa	0	0	0	2	0	0	2	1	1	1	1	1
Tajikistan	2	22	0	18	1	9	11	2	13	5	4	7
Average, by period	**21**	**17**	**15**	**17**	**15**	17	**21**	**19**	**19**	**17**	**15**	18
1st 19 Post-MDRI Countries												
Benin	1	0	0	0	0	0	7	6	6	5	5	6
Bolivia	37	38	33	27	23	32	25	28	25	22	20	24
Burkina Faso	1	10	2	1	2	3	5	4	4	3	2	4
Cameroon	7	20	1	38	3	14	43	39	38	35	32	37
Ethiopia	3	2	4	2	22	7	10	9	8	9	11	9
Ghana	14	43	23	15	19	23	10	15	13	11	11	12
Guyana	0	3	5	0	0	2	12	12	11	10	6	10
Honduras	67	7	6	3	9	18	34	27	24	21	19	25
Madagascar	7	5	3	1	4	4	33	26	25	23	5	22
Mali	1	0	0	0	1	0	6	6	1	1	1	3
Mauritania	7	4	9	18	13	10	16	11	8	6	6	9
Mozambique	1	9	2	2	2	3	23	7	6	6	5	9
Nicaragua	6	13	4	3	0	5	44	40	37	32	21	35
Niger	6	0	0	0	10	3	16	13	10	12	2	11
Rwanda	0	0	0	0	0	0	0	0	0	0	0	0
Senegal	8	8	4	8	3	6	15	13	12	12	5	11
Tanzania	3	2	0	4	3	2	13	10	9	6	6	9
Uganda	1	2	4	14	4	5	4	7	5	4	4	5
Zambia	2	23	15	18	10	14	19	26	25	23	22	23
Average, by period	**9**	**10**	**6**	**8**	**7**	8	**18**	**16**	**14**	**13**	**10**	14

Source: World Bank, June 2006, Annex 2 to Annex V. DAC's concessionality definition (and not IMF/IDA's own), as explained in the text, is adopted here.

Table 4: Debt Outstanding and Disbursed from Non-DAC and DAC Creditors in Selected LICs

Selected Low-income Countries	Main Emerging (non-DAC) Creditor	Debt Outstanding and Disbursed (in percent of recipient's GDP)			Share in Total Official Bilateral Debt (in percent)	
		from the main emerging creditor	from all non-DAC creditors	from DAC creditors	of the main emerging creditor	of all non-DAC creditors
Sao Tome & Principe	China	48	160	88	19	65
Mauritania	Kuwait	13	47	19	19	71
Mauritania	Saudi Arabia	11	47	19	16	71
Eritrea	Kuwait	9	20	7	33	73
Belize	China	9	29	21	18	58
Comoros	Kuwait	9	17	1	48	94
Gambia	China	9	22	5	32	81
Angola	Brazil	8	23	38	13	38
Eritrea	Saudi Arabia	8	20	7	29	74
Solomon Islands	Taiwan Province of China	8	11	4	53	76
Sudan	Saudi Arabia	8	30	24	14	56
Comoros	Saudi Arabia	7	17	1	38	94
Lesotho	South Africa	6	8	7	38	53
Guinea Bissau	Kuwait	5	36	69	5	34
Guinea Bissau	Brazil	4	36	69	4	34
Congo, Rep.	Brazil	3	19	72	4	21
Seychelles	South Africa	3	12	19	10	39
Mauritania	Brazil	3	47	19	4	71
Swaziland	South Africa	2	3	8	19	28
Uzebekistan	South Korea	2	4	28	6	12
Mongolia	South Korea	2	6	29	5	17
Ghana	South Korea	1	3	16	6	16

Source: IMF and World Bank (November 2006, Box 1)

(b) "Stylised Facts" and Qualitative Information based on IMF/IDA's Concept of Concessionality

15. The statistics presented in Tables 1 to 3 relate to definition of concessionality by the DAC of OECD, which, as explained later (See paragraph 53), is very different from that being adopted by the IMF in its PRGF programme, which is also the same that is to be adopted by IDA in implementing its anti-free riding policy. As illustrated later in Table 5, **most of loans that meet DAC's concessionality definition would fail to meet IMF/IDA's own concessionality definition.**

16. **For our present purpose, the statistics that would be appropriate are those based on the one being adopted by IMF/IDA. It would be misleading to place much reliance on DAC's concept of concessionality** as, due to the high discount rate of 10 percent being used (as opposed to the CIRR used under IMF/IDA's definition – as explained later in Paragraph 53), even most commercial loans would qualify as being concessional in this era of very low global interest rates at which most external commercial loans are contracted. This is in addition to the adoption by DAC of 25 percent grant element threshold (compared to 35 percent adopted by IMF/IDA). Beside, DAC relies exclusively on each of the major multilateral creditors' own

definition of concessionality, without questioning how appropriate it is, leading to the likelihood of inconsistency in definitions.

17. **However, statistics based on the IMF/IDA's concept of concessionality are not available, at least not to the same extent as those based on DAC's definition.** One reason for this is that DAC's definition has a longer history and has therefore gained greater acceptance in the literature and published statistical sources. Another reason is that the bulk of new concessional lending to LICs is from non-DAC or emerging bilateral creditors, commercial banks that are based in such countries as well as multilateral institutions whose major shareholders are not DAC members. As a result, all these creditors have little working relationships with and volunteer little lending information to DAC and other international bodies (including BWIs) that compile (on the basis of what is called Creditor Reporting System, CRS) and disseminate statistics on international lending and other forms of resource transfer to developing countries. A third reason is that attempts by the BWIs to gather similar information from the borrowing countries (on the basis of what is referred to as Debtor Reporting System, DRS) are still at a formative stage, yet to bear fruits.

18. Following from the above, it has been pointed out in IMF and World Bank (November 2006, Box 1, p. 8) that "The terms of emerging creditors' credits to LICs are not well known. Many have non-traditional financial structures (including implicit and explicit collateralisation, foreign exchange clauses, and variable fees) that hamper the assessment of their impact on debt sustainability". This means that it would be difficult to demarcate between those loans that concessional and those that are not, even if statistics are available on the volume of non-grant resource transfers from these creditors. So, for now, there is no source of systematic data, hard facts or official information on the magnitudes and trends of new loans to LICs.

19. **As a result, our appraisal of the profiles and stylised facts on lending classified on the basis of this strict concept of concessionality would largely be "impressionistic" and would devoid of being based on systematised and reliable statistics and hard facts.** In this context, we have decided to reproduce below what some sources have described the profiles of non-concessional loans to be. **In other words, our remaining discussion of profiles and stylised facts on non-concessional borrowing would, in the absence of statistics on proper concept of concessionality, be carried out in an "impressionistic" and "qualitative" manner,** devoid of reproduction of reliable and generally accepted official statistics on this appropriate concessionality concept in the same manner as we have been able to do for the less relevant (for the present purpose) but more orthodox concept of concessional and non-concessional credits that originate from DAC sources. Four of such "qualitative" or "impressionistic" descriptions of emerging creditors activities in LICs are reproduced below.

20. **First "qualitative" Source:** One source that has provided some impressionistic information about the activities of emerging creditors is that of Leo *et al* (2006, pp. 11 - 12). This source has characterised these activities as follows:

> *Increased lending from non-OECD creditors (so-called "emerging creditors") likely will be the largest free-riding danger. Export promotion activities from these countries are expected to increase dramatically over the next several years. For example, China is*

already very active in sub-Saharan Africa – channelling billions of dollars in non-concessional loans to countries eligible for, or undergoing, debt relief. In 2005, China lent $814 million on non-concessional terms to Sudan – a country with an external debt burden more than four times the sustainable thresholds… China has recently signed memorandum of understanding for several large-scale infrastructure projects, such as $2.6 billion for two dams in Mozambique and $500 million for Ghana's Biu Dam. In addition, China's commitments at the UN Millennium Review Summit include the provision of $10 billion in concessional loans and preferential export buyer's credit to developing countries over the next three years. It is unclear how much of this assistance actually will be concessional. India, meanwhile, has committed $500 million in Export-Import Bank lines of credit to West African countries under its Techno-Economic Approach for Africa-India Movement. With significant oil revenue windfalls, Middle East and OPEC countries also are expected to significantly ramp up their development assistance activities in low-income countries largely in the form of loans. Although increased export-based lending from OECD bilateral creditors is also cause for concern, efforts are currently underway within OECD's Working Party on Export Credits and Credit Guarantees (ECG) to adopt guidance contained in the debt sustainability framework (i.e., DSF of IMF AND World Bank).

21. **Second "qualitative" Source:** Another source of information about the activities and features of emerging creditors is that of IMF and World Bank (2006, p.8, Box 1), describing these in the following manner:

Over recent years, a number of emerging creditors have increased their official bilateral aid flows to LICs. According to debtor data, the share of these creditors in total official assistance to LICs is still small (around 10 percent) but is increasing steadily. In several cases,, official loans from a single emerging creditor represent a large share of the recipient's GDP, but in most cases are still well below the share from traditional creditors. … Emerging creditors are numerous. The six largest non-Paris Club bilateral creditors to LICs are Brazil, China, India, Korea, Kuwait, and Saudi Arabia. … Available data indicate that China has become, by a large margin, the largest creditor in this group, with claims of US$5 billion as of end-2004 (compared with US$2.5 billion in 1994). Kuwait, the second largest creditor in this group, had claims of US$2.5 billion. Although precise data are not yet available, there is evidence that lending by emerging creditors, and particularly China, has increased very sharply in 2005 and 2006.

22. **Third "qualitative" Source:** Some other sources focus on the emerging creditors' (particularly, Chinese) lending to Africa. For example, Swann and McQuillen (Nov. 2006) contend that China has in fact displaced the World Bank in terms of volume of resource transfer to the continent. They claim that:

*China has committed $8.1 billion this year to Nigeria, Angola and Mozambique, according to World Bank figures. That compares with $2.3 billion pledged to Sub-Saharan Africa by the Washington-based World Bank. China may announce more deals (*which it actually did*) at a Sino-African forum starting today in Beijing, cementing its place as the top official source of finance to Africa … China has a more commercial*

agenda than the World Bank, the US and France, the top Western donors, and terms of some of its loans are less favourable. The US provided a net $3.5 billion in loans and grants to sub-Saharan Africa in 2004, according to the Organisation for Economic Cooperation and Development. France extended $3 billion. Eximbank, China's overseas lending arm, has provided about $12.5 billion in infrastructure loans to Africa since 1994, a figure that excludes mining and oil projects, according to the World Bank.

23. **Fourth "qualitative" Source:** Still on Chinese lending and other resource transfers to Africa, another commentator, Nnanna (Dec. 2006), has this to say:

Sinopec, one of China's leading oil companies, signed oil exploration pact with Johnson-Sirleaf (Liberian President) delegation to the Beijing summit. … Earlier this year, the China National Offshore Oil Company (CNOOC) bought a 45 percent in a Nigerian oil and gas field for $2.27 billion. CNOOC currently own oil blocs in Equitorial Guinea, Gabon and Chad and has investments worth several million dollars in some Zambian mines. … China National Petroleum Corporation (CNPC) bought into the Sudan consortium in 1996. … Sonatrach, Algeria's biggest corporation, which over the years has been reluctant to open up to foreign companies, also signed a deal with CNPC during the (November 2006 Sino-African) summit. … Even before the summit, CNPC had started drilling activities at the Tenere bloc in Niger Republic… CNPC today operates in Mauritania, Nigeria, Chad, and Egypt. Reports indicate that the corporation is currently considering the construction of oil pipelines that will link northern and western Africa together. …

According to reports, China at the Beijing summit decided to double its assistance to Africa by 2009, provide $3 billion preferential loans and $2 billion preferential credit to Africa over the next three years. There were also agreements to set up China-Africa Development Fund to the tune of $5 billion to encourage Chinese companies to invest in Africa. China has also promised to open its market to Africa by increasing the number of export items from 190 to 440 and receiving zero tariff treatment from the least developed countries in Africa which have diplomatic ties with it. Over the next three years, China has decided to train 15,000 African professionals, build 30 hospitals and malaria prevention/treatment centres in Africa. In addition, the Asian Tiger has decided to dispatch 300 youth volunteers to Africa, build 100 rural schools and increase the number of Chinese government scholarships to Africa from the current 2,000 to 4,000 a year by 2009. …

2.3. A Review of Possible Supply and Demand Factors Driving Non-concessional Borrowing by Low-income Countries (LICs)

(a) A Review of Possible Supply or "Push" Factors

24. In order to examine supply-related factors that could have been responsible for the awakening interests in lending (whether on concessional or non-concessional basis) to LICs, it may be more informative to disaggregate the loan finance into various categories of suppliers, viz: multilateral, official bilateral and private lenders.

25. **Multilateral lenders that exclude DAC members as major shareholders**: As for multilateral lenders, those involved are outside lenders (like the World Bank, AfDB, AsDB, IADB, etc) that have DAC countries as major shareholders. Instead, the prominent ones would include the ones where major oil-exporting countries are prominent members, e.g. Islamic Development Bank, OPEC Fund, Arab Bank for Economic & Social Development, Arab Bank for Economic Development in Africa, Arab Monetary Fund, etc. **Expectedly, the performance of petroleum energy products in the world market would be a driving force for their increased lending activities.**

26. **Emerging bilateral creditors:** Concerning official bilateral lenders (that are now being referred to as emerging creditor countries), oil exporters still come into the scene (See Table 4). Again, the driving force for the increase in the tempo of lending activities of such countries is simply the oil boom in the world market. These oil exporters include Kuwait, Saudi Arabia, other Gulf Region countries, and Venezuela. But of greater dimension is the arrival of those countries that are truly emerging creditors, mostly regional economic powers, like South Africa, Brazil, South Korea, India, and the most important of them all, China. Good economic growth performance in these countries is a factor that raises the profiles of these countries' governments in the international bilateral resource transfers in general and non-concessional lending in particular. Because of their rising profiles, these governments have also been enamoured to pursue various political and strategic objectives, in addition to commercial ones, through international resource transfers. China, the most publicised source of credits from emerging creditors, provides a good illustration. Because of its rapid industrial expansion, crude petroleum and metallic minerals are needed as raw materials and LICs provide a ready source for these industrial inputs. As a result, the country needs LICs' partnership, which takes the form of joint ventureships in oil and metallic minerals exploration/exploitation, with the attendant need for Chinese credits for such projects and even for unrelated projects that are needed to cement and strengthen the new partnership. This is beside the traditional strategically/politically-motivated resource transfers to get support on the China-Taiwan issue. **In short, like bilateral transfers by DAC countries, commercial/economic and political/strategic considerations - which are, in turn, propelled by good economic performance and the attendant rising profiles of the emerging creditors as regional economic powers - are the driving force behind the increasing resource transfers (including non-concessional credits) from the emerging creditors.**

27. **Commercial creditors:** Finally, in the case of private flows (including, to some extent, export credit agencies' lending), **the global liquidity or plethora of funds prevailing in international financial markets and the attendant low interest rates have propelled international investors to explore LICs as destinations for their otherwise "idle" funds. Also, improved macroeconomic conditions, including better export performance as a result of rising prices of primary commodities, have improved the debt service payment prospects of many LICs, just as the reduced debt levels as a result of debt relief initiatives.** As rightly summarised in IMF and World Bank (2006, Paragraph 7), "Lower debt levels, strengthened macroeconomic fundamentals, and improved prospects in LICs have increased their attractiveness for ECAs (i.e., export credit agencies). In addition to the ECAs of developed countries, emerging economies are stepping up their lending to LICs.With abundant global

liquidity and compressed spreads in emergin markets, private external creditors have also extended their activities in LICs to a number of Sub-Saharan African countries".

(b) A Review of Possible Demand or "Pull" Factors

28. These are the factors that are making LICs embrace external loans, separate from the above-discussed "push" or supply factors. **Expectedly, the borrowing space created by IDA's grant resource transfers and, for post-completion point HIPCs, the MDRI benefits could have been an attraction not only for lenders to increase their credit flows to the LICs as mentioned in the preceding paragraph, but also an incentive for LICs to seek more foreign loans. Another factor that could be responsible is the improving economic performance of these countries, mainly as a result of improving terms of trade** (precisely, prices of commodity exports), which have enhanced their debt re-payment capacity and, therefore, has created borrowing space of some sorts. Whether this improving terms of trade is sustainable is a different issue.

29. Apart from the borrowing space generated by the aforementioned improving terms of trade as well as MDB grants and MDRI benefits, a number of other factors have generated borrowing interest in LICs.

30. **One of these is political, relating to low standard of governance and public sector mismanagement.** The deteriorating or, at least, non-improving standard of governance and public sector management in some LICs has been motivating officials in such countries to repeat similar borrowing binge that was a factor that led to the previous external over-borrowing and consequential debt burden in the past. First, debt management practices, including debt recording, in many LICs still leave much to be desired and these often lead to over-borrowing. More importantly, either because of the desire to mismanage/misappropriate public funds or to show-off by embarking on some white elephant and grandiose projects that may eventually be abandoned half-way, such officials seize every available opportunity they come across to raise external loans, with little regard to the productivity and repayment capacity of the credits. More than in the previous cycle of borrowing binge, the embracement of democratic form of government by a greater number of LICs has created the need to please the electorates, particularly when elections years are approaching, by embarking on high profile, though often needless, programmes that could only be facilitated through reckless foreign loans. It is this type of borrowing that World Bank (2006, p. 26, paragraph 62) refers to by stating that "Such borrowing may be motivated by governments who seek the short-term benefits for such non-concessional borrowing without considering the longer-term costs for the country, which will remain long after that government ceases to be in power". To reduce this kind of borrowing, LICs should improve debt management practices and also have strict fiscal responsibility laws with adequate provision to guard against such reckless and politically motivated and unpatriotic borrowing. This is also an area where collaborative efforts and assistance of development partners, including multilateral ones like the World Bank, IMF and regional development banks, are desirable.

31. But the demand or "pull" factors are not all driven by poor governance, corruption or low standard of debt management practices. **Some are driven by actual and genuine need for**

foreign resources in the face of dwindling sources of other external financial resources, particularly foreign grants and highly concessional loans. The following are notable reasons and instances of decreasing volumes of foreign grants and highly concessional loans:

- **Volumes of conventional aid have fallen.** Actual volumes of foreign aid from bilateral (i.e., DAC countries) and multilateral sources, other than debt relief and special purpose assistance, have been falling despite the pledges to increase them.

- **IDA allocation formula (and allocation formulas of regional development banks, RDBs, too) puts LICs in a disadvantage in several ways.** First, performance-based allocation (PBA) formula used by IDA discriminates against LICs due to the very high positive correlation between per capita income of a country and its score under the Country Policy and Institutional Assessment (CPIA), which is the major driver of PBA. Second, for those that receive IDA allocations in form of grants or a 50-50 mix of grants and credits, they respectively have to suffer 20 percent and 10 percent reduction in the volume of IDA resource transfers to them vis-à-vis if the entire transfers are in the form of credits only. For cash-strapped LICs that therefore have very high rate of time preference or discount rate, the disadvantage of suffering 20 percent volume reduction associated with never having to make a repayment for the grants could conceivably outweigh the disadvantage of receiving an unreduced volume of credits but having to repay (over some decades) the virtually interest-free credit at some very distant future dates. If such countries are confronted with a choice, they would likely choose the latter option with smaller disadvantage. Third, for those LICs that have become eligible under the multilateral debt relief initiative (MDRI), the netting-off mechanism adopted by IDA in allocating what it gets as replenishments from its donors also means the net IDA resource transfers to such countries would have been greatly reduced and might possibly become nil or close to nil. Most of the above also apply to resource transfers by RDBs.

32. **Attainment of post-MDRI status provides a safety valve, a long-awaited opportunity and freedom, for the government to realise its dream of higher economic growth through public expenditure on the hitherto relatively neglected infrastructural and related government expenditure programmes that can only be feasibly financed (particularly since debt relief does not enhance cashflow into the government coffers) through government borrowing domestically and, especially, internationally.** Receipt of debt relief, whether under the HIPC initiative or MDRI, does not only fail to lead to immediate resource transfers to the beneficiary countries, it also limits the scope for their discretionary spending and the period immediately after becoming eligible for the irrevocable MDRI benefits provides the earliest opportunity to attend to such hitherto neglected discretionary spending that have been pent-up over the years. First, debt relief is essentially an accounting or bookkeeping exercise that does not lead to an explicit or actual resource transfers to the recipients. The implicit resource transfer entailed is realised in form of saving of funds that would have otherwise been used in servicing the debts when due and, for long-term debts, the saving is spread thinly over many future years, often up to about 40 years. Second, before receiving debt relief, a HIPC must have been having a PRGF programme with the IMF and a similar programme with the World Bank over a number of years. During such programme years, government spending programme must have, in principle, been driven by civil societies,

grassroot population, etc through the popular participation that is embedded in the required PRSP process. In practice, government spending programme would have been driven, either mainly or equally with the grassroot participation at the domestic level, by the BWIs due to the clout they have in determining the contents of PRSP. Whether the government spending programme has been driven by the BWIs or grassroot participation at the domestic level, the fact still remains that spending programmes that are favoured by the drivers would necessarily be oriented towards poverty reduction, with emphasis on social expenditure items (on health, education, gender issues, micro-enterprises development, provision of clean water, etc) that would hardly lead to an immediate and "big bang" substantial economic growth. These pro-poor government spending programmes, by their nature, are oriented towards small-scale projects and the bulk of whatever positive impacts they have on growth would take a very long term to materialise. Large-scale infrastructural and similar projects for bringing about high growth that would have been on the radar screen of the government would have been relatively neglected in the interim. So, attainment of post-MDRI status provides the earliest opportunity for the government to attend to financing growth-promoting infrastructural projects, often through borrowing. This is why the arrival of emerging creditors like China provides a mutually beneficial and timely coincidence.

33. Many of the ideas in the previous paragraphs have also been echoed in Simpson (Dec. 2006, p. 3), who expresses the following views:

> *The large scale of Chinese investment shows an understanding that debt can provide the necessary funds for growth ... Much of the defence of pro-poor conditionality (in the programmes with the BWIs) rests on the idea that small-scale projects, such as providing local communities with clean water, have immediate benefit for the poorest. But for all the talk of immediate benefits, Western development agencies (i.e., BWIs mainly) are seeking to deny HIPCs access to desperately needed investment capital. The fear that money is the source of evil in Africa leads development agencies to starve developing countries of cash. And HIPC countries more than anyone else desperately need capital. Development funding is at an historical low, ... it is their(i.e., development agencies') fear that large scale development leads to corruption and waste that has led to this situation. Debt relief is no answer to this. Despite the headline figures of $50 billion or more, debt relief is designed to allow small amounts to trickle down to the poor over many years ... not only is development funding at an historic low, debt relief figures have artificially inflated these funds. ... a notional amount that reflects the long-term benefit developing countries receive is recorded as current funding, as if it were cash payments. The poor in developing countries are forced to wait for the benefits over the course of a generation. But the notional amounts credited to debt relief are not merely accounting trickery. Unlike cash, notional debt relief cannot be used to buy things. But developing countries are able to convert the notional figures into cash by taking on new debt. The World Bank calls this 'free-riding'.*

2.4 Benefits and Challenges of Foreign Borrowing by LICs

34. Whether raising new foreign loans, even non-concessional types, by LICs is beneficial or not depends on the context of the borrowing country, the purpose and motive for borrowing and

the extent of concessionality, or lack of it, of such loans. **It is not appropriate to generalise by saying raising of new loans is good or bad.** Having said that, we discuss below some likely benefits of raising new loans, after which we highlight possible dangers that this may pose.

(a) Benefits and Prospects

35. **Borrowing from international financial markets can help LICs to imbibe, over time, responsible borrowing culture and start cultivating proper relationships with creditors.** The World Bank (2006, paragraph 2) too acknowledges that "it will be important for IDA countries to develop, over time, normal relationships with creditors and a responsible credit culture to facilitate private sector development and public sector accountability".

36. **In the face of dwindling concessional resources and given the desirability of meeting the MDGs and also undertake hitherto neglected infrastructural and related high growth-promoting spending (that had suffered relative neglect in favour of anti-poverty social spending prior to graduating from the HIPC Initiative), other external sources, including non-concessional ones, may justifiably need to be resorted to.** As discussed above, IDA resource transfers have fallen short of the desired volumes due to its PBA that discriminates against LICs; 20 percent volume discounts against grant receipts; netting-off of MDRI benefits from IDA transfers; etc. The same broadly applies to transfers from other multilateral sources, particularly regional development banks. Bilateral transfers (other than debt relief and special purpose assistance) too have fallen. But both the freedom and need for much increased government spending on large-scale infrastructural and other related projects have increased upon graduating from the HIPC Initiative.

37. **Countries in conflict may have no option than to resort to borrowing.** Some LICs, particularly countries in conflict, do not have access to multilateral concessional resources of the IMF, World Bank and regional development banks because they are in arrears or inactive, making it almost inevitable to turn to non-concessional external sources.

38. **Improving debt management capacity, macroeconomic indicators and governance-related institutions may justify increased borrowing.** Some LICs have recorded strengthened macroeconomic fundamentals, debt management capacity, and overall economic prospects, including terms of trade improvements that can support higher debt-export ratios. For such countries, there would be an additional justification for new external loans.

39. **Non-concessional borrowing may be a way of avoiding trading-off of a country's sovereignty and freedom, through avoidance of onerous conditionalities associated with concessional sources, and this can have justification in some instances.** The so-called concessional resources from the multilateral institutions and some bilateral sources have their implicit price to pay in form of conditionality, be it economic or political, which can make some sovereign countries that have penchant for freedom to resort to non-concessional sources that do not have such strings attached. There is no such thing as "free lunch" even with grants from IDA and other so-called concessional sources, for the concessionality of the financial terms comes at the expense of trading-off recipient country's sovereignty and some countries, whose governments have sovereignty looming large in their utility functions, can understandably (and,

sometimes, justifiably) forgo the so-called concessional for non-concessional resources. For example, resource transfers from China, even if non-concessional from the perspective of financial terms, may often be more "concessional" in terms of not having many strings attached.

(b) Problems and Challenges

40. As rightly pointed out by IMF and World Bank (2006), expansion in the volume and sources of funds available to LICs carries a number of risks.

41. **Hard loan terms may apply.** The terms of new financing, if non-concessional, could burden poor countries with market interest rates or close to market interest rates and/or short maturities they can ill afford.

42. **Debt sustainability may be endangered.** Even, for the so-called concessional finance other than outright grant, the danger of debt over hang could still be looming. This applies equally to credits from IDA and regional development banks, PRGF purchases, and "soft" bilateral loans.

43. **Contracting substantial loans from a single or undiversified source is risky.** As highlighted earlier, loans from a single bilateral source is large in relation to GDP and/or total external debt portfolios of many LICs (see Table 4). Financing of such loans, by their sheer volume, could overwhelm many LICs and raise sustainability concerns.

44. **Borrowing by LICs with low debt sustainability fundamentals can make them vulnerable.** Some LICs still have very low fundamentals (like low economic growth, exports and other macroeconomic indicators as well as low debt management capacity and institution) to support raising of new loans, particularly non-concessional types. For such countries, it would be inadvisable to start raising new loans until such fundamentals have improved.

45. **Governance-related institutions and appropriate legal framework, including fiscal responsibility law, are also a part of such fundamentals.** The state of governance in some LICs is still less than satisfactory. For instance, many of them are still yet to have satisfactory fiscal responsibility laws that would check excessive borrowing, particularly by politicians when election years are approaching. Raising of new loans by such countries could be politically motivated and the proceeds my be squandered or outrightly misappropriated, with little or no benefits to the generality of those being governed. For such countries, it would be inadvisable to start raising new loans until governance indicators have improved.

46. **In particular, short-term foreign private capitals can make LICs vulnerable.** As rightly pointed out by IMF and World Bank (2006), short-term foreign private debt inflows could expose LIC recipients to abrupt reversal in market sentiment. It can also create balance sheet problems, particularly when foreign private debt inflows crowd out domestic banks, leading the banks to lend to higher risk projects, possibly including unhedged foreign currency loans.

47. **Foreign financial inflows, in general, can create exchange rate and monetary management challenges for LICs.** Grants and new loans, whether concessional or not, on a large scale could also create monetary and exchange rate management challenges, including the so-called Dutch Disease that may arise from almost inevitable over-valuation of domestic currency.

3. IDA'S Recent Anti-Free Rider Policy Document and Its Evaluation

3.1 Background Issues about the World Bank's Recent Policy Document on Dealing with Free Riding

48. In March 2006, the World Bank prepared a paper for its Board on how to deal with the problem that free-riding poses for it in the context of incentive for borrowing by IDA countries from outside the BWIs that IDA's grant allocation could create. After considering the paper, the Board mandated the Bank to extend and update the paper, particularly to also cover how to deal with the associated free riding arising from the borrowing space created by the (about-to-be-implemented) MDRI benefits. This led to an updated version of March 2006 policy document that was dated June 2006, prepared by World Bank (2006). It is this latter policy document whose salient provisions are discussed below.

(a) Concept of Free-riding

49. The document explains its concept of free-riding, which differs somewhat from the conventional meaning of some creditors holding out within the context of collective action designed to be unanimous for dealing with a problem debt. **In this particular case, a free rider is used to refer to situations in which IDA's debt relief or grants could potentially cross-subsidise lenders that offer non-concessional loans to recipient countries.** It justifies the use of free-riding to describe the situation because, like the conventional concept of free riding, there is some potential externality since differences between collective and individual interests are also inherent in this case, viz: "IDA and its donors aim to lower the risk of debt distress in low-income countries by providing new financial assistance on appropriately concessional terms; per contrast, other creditors and borrowing governments themselves may gain from non-concessional lending following large-scale debt relief or in conjunction with grants provided by IDA" (World Bank, 2006, paragraph 8).

50. The free-riding concept also covers the potential moral hazard problem vis-à-vis borrowers whereby, according to the document, IDA grants and debt relief may introduce an incentive for countries to over-borrow from other creditors, which would force IDA to increase the grant share of its assistance under the IDA debt sustainability threshold-based grant-credit mix policy.

51. **The concept of free riding is limited to only external debt, to the exclusion of domestic debt** (unless it is held by non-residents) which, arguably, could also be a subject of free riding.

52. A prototype free riding, depicting Chinese lending to Sudan, as described in an IMF Staff Report, is reproduced in Box 1. The typical sentiments of BWIs to free riding cases, and what appear to be the three actual reasons for the sentiments, are also stated there. It would be noted that **the concern about debt sustainability of the borrowing country is just one of such reasons and it is, in fact, mentioned last. The other reasons - subsidising China and the possible losses to parliamentarians in the BWIs' donor countries – seem to loom larger.**

Box 1: Sudan Case Study – Prototype Free Riding and Resulting Attitude of BWIs

A prototype free riding, depicting Chinese lending to Sudan, as described in an IMF Staff Report is reproduced below (culled from Leo *et al*, p. 12, Box 3, which was, in turn, extracted from IMF Staff Report for Sudan on Article IV Consultation and Staff-Monitored Program, EBS/06/59, April 19, 2006):

Although Sudan is a heavily indebted country on the path to debt reduction through the HIPC Initiative and MDRI, it has been borrowing on non-concessional terms from bilateral and multilateral creditors for several years. The magnitude of new non-concessional borrowing in 2005, however, showed a dramatic increase. From $310 million in 2004, Sudan ratcheted up its non-concessional borrowing to $935 million, nearly $800 million more than permitted under its IMF Staff-Monitored Programme (SMP). In 2005, non-concessional loans from China totalled $814 million, while loan contracts with the Islamic Development Bank and the Arab Monetary Fund amounted to $102 million. Non-concessional loans of similar magnitude from China are planned for 2006.

These loans are problematic for three reasons. First, the promise of forgiveness represents a subsidy to China and other creditors that presumably expect to be repaid in full from donors providing debt relief to Sudan. Second, the increase in Sudan's debt burden as a result of the new lending increases the amount of relief required to meet target HIPC debt thresholds. In essence, parliamentarians from traditional donor countries would be asked to increase debt relief funding to help guarantee repayment of recent non-concessional loans from China, OPEC countries, and others in excess of IMF SMP guidelines. Third, these loans directly threaten the future external sustainability of Sudan, whose current debt burden is more than four times HIPC target thresholds. If new lending continues unabated in advance of HIPC relief – and these debts are not reduced – Sudan's external debt could remain near or in breach of debt distress thresholds even after delivery of HIPC and MDRI.

Source: Leo et al, p. 12, Box 3, which was, in turn, extracted from IMF Staff Report for Sudan on Article IV Consultation and Staff-Monitored Program, EBS/06/59, April 19, 2006.

(b) <u>Concessionality Benchmarks to be used by IDA in Identifying Cases of Free Riding</u>

53. The document establishes a concessionality benchmark for differentiating between concessional and non-concessional lending. For a number of reasons, it deems the generally accepted DAC's definition of concessionality to be inappropriate. **Instead, it opts for the IMF's definition of concessionality that is used in connection with external borrowing limit conditionality in the PRGF programmes with client countries.** First, in line with the IMF's PRGF programme and as opposed to DAC's interest rate that has always been pegged at 10 percent, it adopts the commercial reference interest rate (CIRR) that is currently about 5 percent, in view of global downward movement of interest rates, in computing the net present value (NPV) of future debt service payments. This means that it is the CIRR that is used in deriving the grant element (GE), defined as: (nominal value of debt – NPV of debt) ÷ nominal value of debt. Therefore, the GE would be lower than that of DAC. Second, unlike the DAC's definition

of concessionality as loans with GE of 25 percent or above, the GE threshold is now 35 percent. A consequence of this is that many loans that are regarded as being concessional according to DAC will not meet the concessionality standard under the present situation, meaning that the concept of concessionality is more conservative and stricter than that of DAC. To illustrate this, the document presents the comparison, reproduced here as Table 5, between the present concessionality concept and that of DAC.

Table 5: Non-concessional Loans committed in 2004, selected Countries
(DAC Methodology vs. proposed IDA Methodology (in US$ million)

Country	Non-concessional Loan (face value)	
	DAC Methodology	*Proposed IDA Methodology*
Angola	2,350	3,387
Cambodia	11	64
Gambia	0	19
Guyana	0	4
Malawi	0	6
Sierra Leone	0	10
Sudan	39	257
Tajikistan	0	23

Source: World Bank (June 2006, p. 12, Box 2)

54. This IDA's concept of concessionality is also virtually the same as that used by the OECD since the mid 1990s to determine the concessionality of lending by export credit agencies.

55. As in the case of aforementioned IMF programme, the concessionality is also to be applied here on a loan-by-loan basis, rather than on aggregate loans, in identifying instances of free riding. This means that concessionality of each loan contract is to be determined on a stand alone basis, instead of lumping together two or more loan categories. Among other reasons, this is to guide against false detection of free riding in cases in which the grant elements on new borrowing were very high but the lending volumes were large.

3.2 IDA's proposed Responses to Free Riding

(a) Use of DSF as Its Policy Anchor

56. **The joint IMF-World Bank Debt Sustainability Framework (DSF) would be at the centre of the response of IDA to its idea of free riding.** The DSF, for this purpose, would be used as the "credit rating" document, as a guide on the level of debt distress risk of each LICs.

57. **Earlier, since the onset of the IDA-14 grant allocation framework, DSF had started to be similarly used in determining the terms and volumes of new financial assistance available to individual IDA-only countries.** The credit-grant mix in the allocation norms and the resulting volumes of resource transfers are assigned in accordance with a three-category "traffic light" system as follows:

- “Green light”: Low risk of debt distress. 100 percent credits.
- “Yellow light”: Medium risk of debt distress. 50 percent credits, 50 percent grants (with the grant portion subject to 20 percent volume discount and, hence, 10 percent overall reduction on the combined transfers of credit and grant).
- “Red light”: High risk of debt distress. 100 percent grants, subject to 20 percent reduction because it is in grant form.

58. In the present situation of free riding, as explained later, it is the DSF that is proposed to be the document for determining whether loans are concessional; for rallying creditors into forming a united front in addressing free riding; and as a basis for sanctioning LICs that raise non-concessional loans.

(b) <u>Enhancing Creditor Coordination around the DSF</u>

59. **Creation of an institutional framework for a formal creditor coordination process is proposed, using the DSF as a coordinating tool among creditors.** It is envisaged that the DSF could help the global creditor and donor communities achieve a common understanding of the appropriate level of overall concessionality for LICs. This is based on the assumption that more and more creditors will be using DSF as their standard “credit rating” document by relying on it as their analytical basis for a common approach to concessionality.

60. While noting that some creditors and donors, particularly bilateral ones that are Paris Club members as well as Asian Development Fund and African Development Fund, have started to rely on the DSF in their decisions on resource transfer to LICs, it proposes that IDA establishes “with the IMF a common approach to increase acceptance of the DSF among other multilateral institutions and official bilateral lenders”. There is also the plan to get inputs through a number of creditor consultation initiatives underway and provide all creditors easy access to the debt sustainability analyses (DSAs) that have been jointly prepared by the World Bank and IMF (See Box 2 for the distinction between DSF and DSA). High-level fora such as the G8 and the G20 would also be used to signal the need for creditors and donors to reflect debt sustainability considerations in their lending.

Box 2: Some IDA-specific Terminologies and Concepts

For easy understanding of some terms that are more or less specific to IDA, they are explained below:

DSA and DSF
As explained in Footnote 2 of the IMF and World Bank (November 2006):

"'DSF' (or Debt Sustainability Framework) refers to the new framework for joint debt sustainability analyses in LICs. 'DSA' (or Debt Sustainability Analysis) refers to an analysis of debt sustainability in a particular country. At times, the DSAs performed under the DSF are referred to as 'low-income country DSAs', in order to differentiate them from the debt sustainability analyses conducted prior to the introduction of the framework".

Categories or Status of IDA Resource Recipients
The explanation below is from the IDA free-rider document (IDA, June 2006)

Blend country: A blend country is the one that is eligible to receive both IDA and IBRD resources. Blend terms comprise 35 years maturity, 10 years grace period, 0.75 percent service charge, 0 – 0.5 percent commitment fee, with a grant element of 57 percent.
Notional blend country: This is a borrower that have a capacity or history of market-based borrowing and a per capita income below the IDA eligibility threshold, and which are currently unable to borrow from IBRD due to marginal or deteriorating creditworthiness. The main difference between blend and notional blend status is that the per capita income is below IDA's operational cutoff for the latter. Blend terms equally apply to "notional blends".
Hardened-term country: This is an IDA-eligible country whose per capita incomes are above IDA's operational cutoff for more than 2 consecutive years. Hardened terms comprise 20 years maturity, 10 years grace period, 0.75 percent service charge, 0 – 0.5 percent commitment fee, with a grant element of just 40 percent.
Gap country**:** This is a borrower that has been above the IDA operational cutoff for many years, but whose access to IBRD is still very limited.
IDA-only, non-gap country: This is a country whose per capita income is below IDA's operational (or has not been above it for consecutive years). Cutoff and has no access to international credit markets. It is only such countries that are eligible for IDA grant allocation. Standard IDA credit terms (viz:40 years' maturity, 10 years grace period, 0.75 percent service charge, 0 – 0.5 percent commitment fee, with a grant element of 60 percent) apply to such countries.

Box 3: Countries Currently subject to IDA's Free Riding Policy 1/

"Red Light" Countries		"Yellow Light" Countries	Post-MDRI "Green Light" Countries
Afghanistan	Guinea	Angola	Benin
Bhutan	Guinea-Bissau	Ethiopia (MDRI)	Burkina faso
Burundi	Haiti	Guyana (MDRI)	Cameroon
Cambodia	Kyrgyz Rep.	Lesotho	Ghana
Central African Republic	Lao, PDR	Malawi	Madagascar
Chad	Liberia	Mongolia	Mali
Comoros	Nepal	Nicaragua (MDRI)	Mauritania
Congo, DRC	Niger (MDRI)	Samoa	Mozambique
Congo, Republic of	Rwanda (MDRI)	Tajikistan	Senegal
Cote d'Ivoire	Sao Tome & Principe		Tanzania
Djibouti	Sierra Leone		Uganda
Eritrea	Solomon Islands		Zambia
Gambia. The	Tonga		

Source: World Bank (June, 2006, page 30, Table 3)
1/ The list would have change since June 2006, after when, for instance, Malawi and Sierra Leone reached post-completion point of the HIPC Initiative.

(c) ***<u>Discouraging Free Riding through Borrower Disincentives</u>***

61. The list of LICs to be covered by the policy is as provided in Box 3. This list could change as more countries reach the completion point under the HIPC Initiative.

62. **The stated rationale for resorting to penalising LICs that breach the concessionality guidelines is due to likelihood of not being able to sufficiently rally other creditors through the DSF.** According to the document (p. 20, paragraph 45), "The mere adoption of a common approach to concessionality is unlikely to prevent free riding by opportunistic lenders. … While the Bank and Fund work closely together in broadening acceptance of the DSF also among bilateral and commercial creditors, it is recognised that IDA's main channel to reduce the incidence of free riding by opportunistic lenders is through country (i.e., LIC) disincentives". This is the basis for resorting to disincentives, through sanctions, aimed at the LICs and these take the form of reductions to allocated volumes of assistance or hardening of the terms of such assistance – or a combination of both - which can even escalate to total disengagement of IDA from the sanctioned LICs, if the breach of concessionality is deemed severe enough.

63. **Ordinarily (i.e., in the absence of escalated sanction being applicable), an LIC in breach of the concessionality requirement would be subjected to either a reduction in volume or hardening of terms of the assistance, but not both. Volume reduction would apply to those grant eligible IDA-only LICs (irrespective of whether or not they are MDRI recipients) that are characterised with greater risk of debt distress, viz: those belonging to either the afore-mentioned "red light" or "yellow light" debt distress classifications.** The proposed sanction would initially be a reduction that would bring the affected country's grant volume down by 40 percent after taking into account the afore-mentioned 20 percent volume discount applied to all grants in IDA-14, thereby bringing the allocation volume down to the grant element of an IDA credit. Arithmetically, this means that if a country would have been entitled to $100 credit from IDA so that it would receive only $80 because the country can only receive the resource transfer in grant form due to its being characterised with high debt distress risk, it would now suffer a further reduction for breaching DSA-based concessionality borrowing condition by getting just $60 instead.

64. **For the second group, which are the "green light" MDRI recipients, hardening of terms would apply, instead of volume reduction.** This is claimed to be consistent with long-established IDA lending policies of providing hardened but still concessional terms that "follow the market", acknowledging their de facto enhanced market access capacity. The "hardness" of the terms would be graduated according to the country's access to financial markets, although the hardest terms would still have some positive grant elements. In addition to standard terms (40 years' maturity, 10 years grace period, 0.75 percent service charge, 0 – 0.5 percent commitment fee, with a grant element of 60 percent), any of the following IDA assistance terms that are currently available (See Box 2) can apply to such a country:

- blend terms (35 years maturity, ten years grace period, same charges), with a grant element of 57 percent.
- hardened terms (20 years maturity, ten years grace period, same charges), with a grant element of 40percent.

- ➢ a less concessional “hard-term” window (blend terms plus interest rate at 200 basis points below IBRD lending rate in fixed-rate terms - for MDRI “green light” countries with high levels of market access.

65. **Two exceptions are singled out in the document. The first applies to those “red light” or “yellow light” grant eligible IDA-only countries that, despite their high debt distress risk status, do have access to financial markets,** as in the case of extractive mineral export-based economies that could easily borrow from financial markets by collateralising their future receipts from the exports. For such LICs, suspension of access to grants and hardening of terms – possibly in combination with volume cuts – could be IDA’s response. **The second exception applies to a “green light” MDRI recipient that, despite its belonging to low debt distress risk category, still has structural weaknesses** (like absence of economic diversification, small export base, etc) that make the country vulnerable to slipping easily back to “yellow light” or even “red light” status when subjected to exogenous shocks. IDA would likely apply volume reduction, as opposed to hardening of terms, to such a country.

66. In all the above cases, the sanctions are stated to have the aim of reducing the incidence of free riding to prevent serious breaches before they occur. These could range from a 1-year to a multiple year application of the disincentive mechanism, and at the extreme end of the spectrum there could be withdrawal of IDA from all future financial assistance in a given country or even disengagement from the country (i.e., complete withdrawal that includes both financial and technical assistance).

(d) Operationalising the Borrower Disincentives

67. **Pragmatism and case-by-case treatment are to form the basis of implementing the anti-free riding policy sanctions.** In other words, it would be “discretion-based”, as opposed to “rules-based”. In several parts of the paper, it is acknowledged that one-size-fits-all approach would not be suitable and country-specific circumstances would be considered. As stated in World Bank (2006, Paragraph 49), “A flexible application of the measures available to IDA is required in order to take into account country-specific characteristics and circumstances. Ironclad rules or ‘one-size-fits-all’ responses are counterproductive to the extent that there are a wide variety of country circumstances requiring appropriately-tailored approaches”.

68. **Having stated the above, the same document enunciates those important factors that would guide the pragmatism and use of discretion.** Specifically, factors enunciated in Box 4 below are mentioned, and further elaborated upon by the points below:

- **Magnitude of the breach.** Small breaches of concessionality benchmark (i.e., marginal deviation from the 35 percent concessionality benchmark) would not normally attract sanctions, which would mainly aim at large breaches “that result from politically-motivated decisions to borrow and/or from the actions of opportunistic commercial lenders, who feel that the space freed up by grants make lending possible to otherwise risky countries”.

- **Size of the breach relative to a country's IDA allocation.** If the breach is large in absolute terms or as a share of the country's IDA allocation, the initial disincentive may not be sufficient, pointing to the need for a stronger disincentive.
- **Frequency/repeat violation.** For a country with a known record of non-concessional loan despite the guidance to the contrary by IDA staff, or where there is an allegation of fraud or corruption, stronger measures may be necessary.
- **Notified ex-ante or found out ex-post.** For countries reporting ex-ante that explored alternatives with Bank staff, a shorter application of the disincentive may be warranted.

Box 4: Principles that would guide Exceptions to non-concessional Borrowing Ceilings

Similar to considerations that feed into decisions on non-concessional borrowing limits in the PRGF, a number of country-specific and loan-specific factors would be taken into account in the free rider context to assess whether an exception to the zero-ceiling using the proposed benchmark is warranted. Although many proposed loans may have merit on specific economic or financial terms, the country environment in which they occur will strongly influence actual outcomes. There should be a favourable assessment at both the country-specific level and loan-specific level to warrant an exception.

Country-specific:

- **Overall borrowing plans of the country.** A modest level of overall borrowing by the country on the basis of the DSA to accommodate a particular investment may warrant consideration. For such a consideration, clear reporting of overall borrowing plans is needed, and enhanced creditor coordination through the DSF would facilitate this possibility.
- **Impact of borrowing on the macroeconomic framework.** Whether or not the borrowing would have a deleterious effect on the macroeconomic framework would influence the consideration of an exception.
- **Impact on the risk of debt distress.** The current risk classification, and whether or not the loan is likely to lead to a higher risk of debt distress will be a key consideration. Given their lower risk of debt distress, and general better performance, more flexibility if envisaged for "green light" countries. In addition, "yellow light" countries could benefit from somewhat greater flexibility than "red light" ones.
- **Strength of policies and institutions,** especially public expenditure management and debt management. As the fiscal space Board paper makes clear, policies and institutions in particular those governing the efficiency of public investment are crucial. Without these, even high return projects may fail to meet objectives.

Loan specific:

- Development content and potential impact of the loan, i.e., investment will unlock a proven bottleneck to development as determined by analytical work such as PER.
- Estimated economic, financial and social returns to investment of the project, weighted by the probability that the project will succeed.
- Lender equity stake in the project.
- No additional costs associated with the loan, i.e., collateralisation, hidden costs.
- No other sources of more concessional financing are available.
- Concessionality of the overall financing package for a particular investment.

Source: IMF and IDA. June 2006, p. 24, Box 3.

3.3 Appraisal of the World Bank's Anti-Free Riding Policy Document

69. **The issue of free riding has now been brought into the realm of "diplomatic" controversy between the World Bank and China.** The international press often reports the World Bank President criticising Chinese lending to LICs, particularly in Africa, mainly on the grounds that such lending can affect debt sustainability of the borrowing countries and also that conditionalities are not attached so that corrupt and unworthy LIC governments often receive loans from China. The Chinese authorities too have been similarly reported in the international press to be countering the World Bank. For example, as reported in Financial Express (Nov. 2006), a spokesman for China's Ministry of Foreign Affairs said "The World Bank shouldn't be

the only bank providing loans to Africa. No individual organisation can monopolise relationships with African countries. China needs Africa, and Africa needs China".

70. **Thus, an appraisal of the World Bank policy document must not be one-sided, but evenly balanced.** This is to prevent the evaluation from making a case and being a megaphone for China if the evaluation is too critical of the policy document and from being a megaphone of the World Bank if it mainly praises the document as the best that has ever happened. Accordingly, we will try to be as balanced as feasible below by highlighting both the strengths and weaknesses or challenges of the policy document as we perceive the pros and cons to be.

(a) Prospects and Advantages for LICs of Implementing the Anti-free riding Policy

71. We earlier discussed the problems and dangers of non-concessional foreign borrowing (See Paragraphs 41 – 47). Most of these dangers can be guarded against through implementation of the proposed measures. Thus, some of the benefits of implementing the anti-free rider policy identified below would inevitably overlap with the previously discussed problems of non-concessional borrowing.

72. **Lower-return projects are now being more prone to being financed by lenders.** There might be a tendency for opportunistic creditors to finance low-return projects due to reduced risk of future debt servicing associated with such lending as a result of MDRI relief and prospects of future grants. As pointed out by IMF and World Bank (2006, paragraph 3), "A key concern is the risk that some non-concessional creditors may be willing to finance even low-return investments, since lowered debt ratios and the prospect of future IDA grants provides reassurance to creditors that post-MDRI borrowers will be able to service their loans".

73. **Similarly, the potential moral hazard problem of reckless borrowing, with a view to continuing to maintain, or be re-classified into, grant-receiving status under IDA's and regional development banks' grant-credit mix policy, will also be discouraged.** It is in this vein that the World Bank (2006, paragraph 9) states that "There is also a potential moral hazard problem vis-avis borrowers. IDA grants and debt relief may introduce an incentive for countries to over-borrow from other creditors, which would force IDA to increase the grant share of its assistance. Incentive measures aimed at borrowers could help address this problem".

74. **Potentially, the use of DSF in the context of anti-free riding policy can strengthen the bargaining position of LICs while negotiating loans from non-IDA sources, including bilateral (e.g., Chinese) and commercial ones, as they would now have a basis for negotiating the terms towards the concessionality threshold prescribed by IDA.** This means they will be strengthened in convincing would-be lenders that, while they are willing to contract the loans, they are rather incapacitated in doing so unless the terms would not make them breach IDA's concessionality threshold so as to enable them receive IDA resources under favourable terms. Also, from the creditors' side, a sort of peer pressure against non-concessional lending can develop (e.g., through "naming and shaming" of non-concessional lenders, especially official creditors). Probably this benefit is what IMF and World bank (2006, paragraph 28) envisages by stating that "A minimum concessionality requirement can help borrowers obtain more suitable credit terms by raising awareness among lenders of their financial vulnerabilities".

75. **It is desirable for a number of countries to wait a bit more before starting to borrow from abroad, particularly on a large scale, until after they have put in place adequate debt management and governance institutions.** Implementation of the anti-free riding policy can prevent such countries from rushing into pre-mature foreign borrowing, which was a major cause of unsustainable debts in the past. As the IMF and World Bank (2006 Paragraph 34) rightly points out, "In many LICs, improvements in public debt management are necessary prior to borrowing from private external creditors on a significant scale. In particular, a desirable debt-management framework should assign the legal authority to borrow, and identify permissible instruments and accountability mechanisms…".

76. **There is also the argument in the World Bank's anti-free riding policy document that governments who take on irresponsible non-concessional borrowing are usually not taking into account what is best for their countries' long-term poverty reduction goals.** This is to counter the view (See Paragraph 82 below) that the penalty of grant volume reduction in response to a breach of IDA concessionality guidelines would starve the government of funds needed for implementing policy on poverty reduction and other MDGs, probably forcing the government to resort to further non-concessional borrowing.

77. **Finally, implementation of the proposal can possibly discourage the type of lending that is adjudged by international standard to be unethical.** A case that is often cited in the literature is lending to dictatorial and oppressive regimes, particularly in countries like Sudan, which continues to be strengthened by resource transfers from China in its repeated human rights violations and brutality the Darfur region despite the international outcry and protests against the practice. Another case is commercial bank lending, particularly from Chinese commercial banks, that run foul of what is referred to as the Equator Principles - a voluntary code of conduct, formulated under the auspices of the International Finance Corporation, pledging that projects financed by commercial bank loans would meet prescribed social and environmental standards and which are claimed to be in observance by over 80 percent of bank lending and which Chinese commercial banks have generally not been observing.

(*b*) *<u>Problems and Challenges of the Proposed Anti-free Riding Policy</u>*

78. We earlier discussed the possible benefits of foreign borrowing, even of non-concessional type, by LICs, including post-MDRI ones (See Paragraphs 35 – 39). Most of these benefits can be reduced or prevented as a result of hindrances that can be posed to judicious borrowing through implementation of the proposed anti-free rider measures. Most of these benefits can be lost, as a result. Thus, some of the problems of implementing the anti-free rider policy identified below would inevitably overlap with losing of the previously discussed prospects and benefits of foreign borrowing.

79. **A major problem with the proposed policy is the underlying conceptual framework and perception of IDA regarding what it role should be – as to whether it should be a competitor with other international creditors in the loan markets of LICs or as a promoter that should catalyse credits from other sources into these usually neglected credit outlets.** As can be seen from Box 1 and elsewhere, typical perception in the BWIs (including IDA) on

this free-rider issue seems to be that the emerging creditors are depriving BWIs of business and patronage by LICs. This perception, however, runs counter to the philosophy and fundamental objectives of setting up the BWIs, which includes the use of taxpayers money in the major shareholders or donor country members of these multilateral institutions for facilitating and catalyzing finance from outside sources to (and for the development of) developing countries until such countries are able to wean themselves of dependence on BWIs by being able to adequately access international finance markets on their own. So, their seeming rivalry with these other sources of credits can be regarded as disappointing as they should instead herald it and see it an achievement on their part. This is why Simpson (2006, p. 1) expresses a surprise that "Western development banks, rather than celebrating the large-scale infrastructural development that Chinese funding has allowed, are threatening to cut development funds to Africa's poorest nations that take on Chinese loans". In the same vein, Tan (2006, pp. 21) expresses bewilderment at this apparent inconsistency that:

> *Given this history of Bank and Fund policy and practice, it is difficult to understand why the institutions are so particularly concerned with the issue of 'free riding' in the context of new non-concessional borrowing by its members. While it is acknowledged that imprudent borrowing should be discouraged in the context of future debt sustainability, the rationale that the fiscal and borrowing space of countries freed up by grant allocations and debt relief will give rise to the potential of 'free riding' by non-concessional creditors is at odds with the traditional practice of the Bank and Fund. The conventional view of the Bank and Fund of official development financing – with its element of public subsidy – as the facilitator of private finance contradicts the institutions' current approach to the adoption of non-concessional debt by client countries. It appears as if the Bank and the Fund are now competing with private capital and even with alternative non-concessional official financing, such as export credit agencies, for the business of client countries as they see their own roles diminishing in the wake of recent developments.*

80. **Related to the above point that the anti-free rider policy runs counter with what the role of IDA should be is also the inappropriateness and inconsistency in the perception by the World Bank (or BWIs in general) that for it to subsidize other creditors to LICs amounts to "free riding", which is an evil.** This runs counter to the huge subsidies by the BWIs (using the same public finance from the BWIs' donor countries) in the past to private international lenders' activities in developing countries. First, the activities of MIGA and, to some extent, IFC (both, members of the World Bank Group) are to facilitate private financial flows to developing countries and these activities entail some subsidies to the private sector and investors one way or the other. Second, IMF lending to developing countries is often motivated by the need to bail out private creditors and this too entails subsidizing private investors or lenders. If subsidies to private investors were not evil then (and even up till now, as such subsidies are still ongoing), while should they now be evil in the case of emerging creditors' activities? This would amount to double standard. As rightly pointed out by Tan (2006, p. 23), "Consequently, there is very little difference in the 'free ride' accorded by these bailout operations to private creditors and the 'free ride' that the Bank and Fund are worried will be given to non-concessional lenders to grant and debt relief-eligible countries".

81. **In addition, by discriminating against LICs in its resource allocation, the IDA itself is a part of the problems that drive the LICs to resort to foreign non-concessional borrowing in the first place and, therefore, a part of the solution lies in reforming its allocation policy.** As discussed earlier, IDA allocation policy discriminates against LICs, resulting into reduced volumes of IDA resource transfers to them, in a number of ways. First, the PBA approach is regressive, to the disadvantage of LICs. Second, the 20 percent volume discount against IDA grant recipients reduces what they receive from IDA accordingly. Third, the IDA's implementation of MDRI entails netting off, possibly resulting into little or no new net transfers from IDA to such post-MDRI countries.

82. **Another problem is that it will reduce the likelihood of LICs attaining MDGs, as sources of external debt finance outside IDA would normally be needed for a meaningful progress towards MDGs attainment, particularly in the face of decreasing volumes of other conventional official sources.** This is particularly the case with IDA grant receiving LICs that would suffer volume reduction as a result of breaching the concessionality borrowing guidelines. This problem is recognised but neglected by the World Bank (2006, paragraph 48), stating "If a country's debt sustainability prospects are fragile, a volume-based response would be more suitable, even if it would involve fewer resources to reach the MDGs". In other words, in resolving the tradeoff between debt sustainability and meeting of MDGs, the proposed policy resolves to sacrifice the latter on the platform of the former.

83. **The converse is also applicable in the sense that penalising IDA grant receivers through volume reduction, by reducing the volume of resources available to meet the desperately desired government spending, can force such countries to resort to further non-concessional borrowing.** The World Bank (2006, Paragraph 55) anticipates this problem by stating that "there are several risks involved with a volumes-based response to free riding. The key risk is that affected countries may attampt to compensate for their reduced IDA allocations by seeking further non-concessional financing from other creditors". Despite this realisation, nothing is done to ameliorate it or otherwise reduce the risk.

84. **Also, as an elaboration of what has been pointed out earlier, restrictive conditions on borrowing would tend to deprive the countries of freedom to judiciously raise external loans to promote growth.** This has been recognised by the the World Bank (2006, paragraph 27) in stating that "there may be cases in which non-concessional borrowing would have stronger economic justification. One example could be in the financing of large initial investments in projects – including 'enclave' projects where appropriate – with potential high risk-adjusted rates of return… IDA's response will therefore require a case-by-case approach to breaches of concessionality limits given the debt sustainability and policy environment". **In other words, IDA is being paternalistic in the sense that IDA's judgement will supersede that of an elected government, which has the mandate of the people (governed) to use its discretion to promote their welfare and growth of the economy.** Bona fide exercise of such mandate would now be supplanted by that of IDA in far away Washington concerning how best the welfare and economic growth are to be promoted. It is now IDA that will tell the government how much, if any, foreign borrowing the government can raise. It is this paternalism to the LICs that Tan (2006, pp. 24, 28) has decried in the following words:

These measures imply increased financial oversight of the public finances and debt management policies of client countries by the Bank, Fund and other official creditors and greater control over what is a sovereign right of countries to enter into external financing agreements. …There is a paternalism which underpins the Bank and Fund's approach to debt sustainability, particularly in relation to the accumulation of non-concessional debt by low-income countries, which assumes that only bretton Woods institutions have the capacity to assess a country's debt sustainability and ability to assume further financial obligations instead of the country itself or international capital markets. … Correspondingly, countries are not entrusted with the task of managing their own debt, having to be reigned in by IDA disincentive measures and IMF conditionality in order for them not to fall into future debt distress.

85. **Closely related to the above is the fact that implementation of the anti-free riding proposal will likely contravene the much acclaimed principle of ownership and alignment that is one of the pillars of March 2005 Paris Declaration on Aid Effectiveness.** According to this principle, authorities in the partner countries are to formulate and own their economic programmes and development partners only have to take these as given and align their own programme of assistance to suit the partner countries' programme. But, if it is now left to IDA in Washington to give permission to the projects to be financed by external loans from non-IDA sources, this would contravene the spirit behind the ownership and alignment of the Paris Declaration.

86. **The justification and legitimacy, for the use of DSF as the credit rating document for LICs in prescribing LICs' borrowing limits and in coordinating creditors, can be questioned.** First, DSF is the document of BWIs alone, with virtually no inputs from LICs. This is not to talk of the very contentious and controversial CPIA on which the reliance on policy-dependent debt distress classification by the DSF is based. **The credibility and legitimacy of DSF in the eyes of LICs are therefore in doubt. In addition, its credibility and legitimacy in the eyes of creditors (whether commercial or non-DAC bilateral creditors or even multilateral creditors not under the influence of DAC bilateral ones) would also be in doubt** not only because they did not have inputs into its design but also because it is doubtful if they would regard it as being more reliable than those credit ratings that have been done for a number of LICs by private and more professional international credit rating agencies. At best, these creditors can use it as a supplement and at worst, they would simply ignore it. The IDA is to use the DSF in convincing the creditors that (World Bank, 2006,Paragraph 35) "Free riding may ultimately backfire as the borrowers' risk of default would probably rise and lead to losses to all creditors in proportion to their seniority and exposure". It looks obvious that these creditors are more astute than to wait to be given this information by IDA before making their lending decisions. They should better know than IDA as to which LICs are in their best interest to lend to. This view had earlier been stated in a broadly similar vein by Tan (2006, pp. 25, 26, 28) as follows:

Implicit in the (anti-free rider policy) paper is that financial markets do not make competent assessments of countries' debt sustainability or if they do make rational choices to lend to highly distressed countries, such lending must be premised only on the improved repayment prospects guaranteed by the overall reduction of debt obligations

as a result of IDA grants and debt relief. … the HIPC experience has also demonstrated that a 'common' mechanism that is designed and driven by one set of creditors – the IFIs, led primarily by the Bank and the Fund and their major shareholders – and imposed on another set of creditors (namely non-Paris Club creditors, and commercial lenders), will not be effective in achieving policy consensus and uniformity in delivery of commitments because of the perception of partiality. Similarly, under the IDA proposals, it is not only the Bank and the Fund who are setting the concessionality benchmarks to be adhered to by other creditors but these institutions are also assessing country's compliance with such benchmarks and debt sustainability thresholds under the DSF. It is therefore unlikely, and unsurprisingly so, that these measures would be adopted by other official creditors (and less so by commercial creditors) aside from possibly the Paris Club creditors who also represent the major shareholders of the Bank and the Fund.

87. Thus, as already admitted by the IMF and World Bank (2006, Paragraph 11), "Only a small number of creditors (the Bank, the Fund, and certain multilateral and bilateral creditors) use the DSF actively. Other creditors and most debtors have little familiarity so far with the instrument and little incentive to use it now, limiting its overall effectiveness".

88. **Even, in the unlikely event that DSF is accepted by all creditors as a rallying and coordinating document, many commercial and official creditors would still not abide by its contents if it is not in their commercial, political or strategic interest to do so.** As rightly pointed out by Tan (2006, p. 25), "This is even more acute for commercial creditors who 'free ride' as they are less subject to the peer pressure that sovereign creditors may be subjected to under the auspices of the Bank and Fund or Paris Club coordination mechanisms to assume some responsibility for concessional breaches". As also frankly admitted by the IMF and World Bank (Nov. 2006, paragraph 45), "The mere adoption of a common approach to concessionality is unlikely to prevent free riding by opportunistic lenders. The experience with creditor litigation in the context of the current HIPC Initiative clearly shows that some commercial and official creditors are reluctant to adhere to a majority position and decide to hold out".

89. **The debt coverage of anti-free riding is also too narrow by excluding domestic debts.** First, the distinction between domestic and external loans is blurred at the operational level. This is because, while government bonds held by non-residents are, in principle, classified as foreign debts, the same free riding policy document acknowledges that available statistics for most LICs do not separately identify the residency status of government bond holders, making all bond issuance to be operationally treated as a part of domestic debts. Second, contracting of domestic debts too can affect debt sustainability, just as contracting of foreign debts. Given the degree of substitution that exists between the two types of debt, if implementation of IDA anti-free riding policy is constraining an 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 IDA is trying to prevent. So, if the true aim of IDA is the professed one of using its anti-free rider policy to protect LICs from reverting or getting into an unsustainable debt situation, domestic debts should not have been exempted. While it is true that virtually all domestic debts are non-concessional and their coverage, without some discrimination, by the anti-free rider policy could amount to zero tolerance of domestic

borrowing (which may negate achieving the objective of developing domestic bond markets in many LICs), this can be addressed by simply putting a non-zero limit on (instead of total exclusion of) domestic debt in the government loan portfolio.

90. **By glossing over other important debt sustainability fundamentals (like how to improve debt management capacity and legislative framework as well as the denominators of conventional debt capacity ratio), the anti-free rider policy document wrongly presupposes that contracting of non-concessional loans is the main (and, probably, only) way of reverting to unsustainable debt situation.** The policy document hardly makes any reference to other factors that affect debt sustainability. The only notable reference to these other factors in the document is as contained in Paragraphs 43 and 44, which read "In parallel, the Banks is working with the IMF and other donors to establish a global partnership to strengthen debt management capacity in low-income countries. … Beyond debt management, capacity building on macroeconomic and fiscal management is also necessary to help reduce the need for non-concessional financing, and Bank and Fund staffs remain engaged in providing such assistance". However, such reference is just in passing, without much emphasis that it deserves. In addition, other issues that can affect accumulation of unsustainable debts, particularly governance factors and legal *cum* institutional environment (including design, promulgation and implementation of appropriate fiscal responsibility laws that would guard against politically motivated and injudicious borrowing) are glossed over. More importantly, measures that would enhance the denominators of conventional debt re-payment capacity ratios (viz: promotion of economic growth by raising the GDP or promotion of exports) are totally ignored and these matter as much as reducing debt volumes in attaining sustainable debt positions. This omission is particularly worrisome, in view of the precarious positions of many post-MDRI LICs concerning these debts sustainability fundamentals. As pointed out by Leo *et al* (2006, p. 8), "First, while lower levels of indebtedness inevitably increase a country's debt-bearing capacity, HIPCs and MDRI recipients have not achieved low debt burdens through strong growth or prudent debt management. In many cases, significant structural weaknesses and vulnerable export sectors remain. These weaknesses contribute to a debt intolerance that continues to constrain the debt-bearing capacity of MDRI countries, even after relief". **Arguably, it might be more effective in assisting LICs attain debt sustainability if all the efforts IDA is dissipating in designing its anti-free rider policy, and would continue to dissipate in implementing it, can be diverted to assisting these countries to promote export growth and diversification as well as in promoting the broader economic growth.**

91. **Resort to penalising LICS that breach concessionality guidelines is one-sided and asymmetrical, without any penalty whatsoever against the opportunistic creditors.** It is inappropriate to take undue advantage of financial needs or desperation of IDA recipients by penalising them for the breach and leaving the creditors, which are the other party in the financial transactions resulting in the breach, untouched. As rightly observed by Tan (2006, p. 24), the policy document "also does not provide for creditor accountability for the contraction of non-concessional loans by affected countries". **Thus, the World Bank would do more good than implementation of its present anti-free rider policy to these LICs if it can be at the forefront of spearheading the creation of a sort of international agreement or convention that would regard lending to LICs, that constitutes an extreme breach and disregard by**

creditors of generally accepted concessionality benchmarks and safeguards, as being odious.

92. **Also, the penalties proposed for a concessionality breach, in form of either volume reduction or hardened terms, can induce some of the countries to resort to hiding of facts from the IDA so as not to be seen to have breached the guidelines.** This possibility is also anticipated by the World Bank (2006, Paragraph 55) in stating that "A related risk with this incentive mechanism is that awareness of the potential IDA response to the non-concessional borrowing may increase the incentive for some countries to not fully disclose borrowing information to multilateral creditors, or develop financing strategies that attempt to mask the extent of a country's obligations". The only measure that is proposed in the policy document for dealing with this risk is simply to intensify information gathering by the World Bank on borrowing by its client countries from both the debtor and creditor sides. But the prospect of this being very successful is rather doubtful.

93. **For many LICs, the IDA penalties are not likely to be sufficient to deter them from non-concessional borrowing.** The volume of IDA resources being received by some countries (particularly, resource rich ones) is rather too low, particularly in relation to the volume of external non-concessional borrowing and, in the event of a tradeoff, such countries would rather forgo IDA resources in preference to these other sources of foreign finance. Also, a number of LICs, by being inactive IDA members (i.e., countries in arrears) mainly as a result of being afflicted with conflicts, are not receiving IDA resources, making them to be immune from IDA penalties (This explains their exclusion from the list in Table 5). But, as discussed earlier (See Paragraph 11), it is the resource rich countries and inactive IDA members that have been mostly in breach of the proposed IDA guidelines on concessionality borrowing. While post-MDRI and some other IDA countries, which are the only ones whose behaviour can be affected by the proposed penalties, might also breach such guidelines, this has hardly happened so far and such breaches are only anticipatory. **In effect, the prescribed penalties in the proposed guidelines can only change the behaviour of mainly those LICs that had hardly been in breach of the guidelines while the behaviour of those LICs that had been running foul of the guidelines is not amenable to the guidelines' influence.** The anti-free riding policy document (World Ban, 2006, Paragraph 69) too realises this problem by pointing out that "It is important to acknowledge that there may be cases where IDA has very little leverage to reduce instances of free riding, even with strong disincentives. … this would be the case especially where the IDA allocation is very small relative to available non-concessional financing sources, such as are available for mineral resource-rich countries". Despite recognising this problem, all that is done in the policy document is to hope that other creditors would team up with IDA to make the impact more felt by such LICs.

4. Recommendations, Summary and Conclusion

4.1 Recommendations

94. From the foregoing, a number of recommendations can be deduced and what is done here is to assemble and highlight them. The first set of recommendations constitute action points

for governments in the LICs while the last set comprises action points for the World Bank and, to a limited extent, other international development partners.

(a) Action Points for governments in LICs

95. First, policymakers in LICs should refrain from reckless and injudicious borrowing, whether domestically or abroad. They should raise loans under most favourable terms available and in moderate volumes. For concessional loans, they should be prudent about the volumes, as the loans will still have to be repaid sooner or later. Cost-benefit analysis of loans should be made before contracting such loans, with reliable evidence that the productivity or benefit of the loans exceeds the cost. This leads to the next recommendation concerning debt management capacity, as proper analyses of costs and benefits of loans is a feature of enhanced debt management capacity.

96. Government should strengthen debt management capacity in all its ramifications. How to do this is outside the scope here, as this is a wide terrain by itself. All that is to be mentioned here is that debt recording, analysis (including DSA) and negotiation *cum* re-negotiation or rescheduling (particularly, in connection with foreign loans) should be accorded priority.

97. The legal framework for debt management and broader government finances should similarly be strengthened. First, fiscal responsibility issues should be rules-based, as opposed to discretions-based. This would call for enactment of comprehensive fiscal responsibility legislation, with strict and comprehensive provisions guiding borrowing and preventing politically motivated borrowing, particularly in anticipation of election periods. Public financial management guidelines too should guard against financial mismanagement, including misappropriation of public funds, of which proceeds of loans form a part.

98. Policy makers should also diversify geographical sources of their loans, instead of concentrating on one or very few bilateral sources that would make them more vulnerable.

99. In addition, they should pay attention to the exchange rate and monetary management implications of inflow of large foreign resources, including loans.

100. The aforementioned areas of government attention mainly affect the numerators of the conventional debt sustainability ratios or indicators. There is also the need to pay attention to the denominators of these ratios. Accordingly, policy attention should focus on promotion of economic growth as well as government revenue. More importantly, policies aimed at increasing export earnings and diversification should be accorded priority.

(b) Action Points for the World Bank

101. First, international development partners, particularly the World Bank, should complement efforts of governments in LICs in implementing the aforementioned actions points. In this regard, they should augment national government efforts aimed at strengthening its debt management capacity. As earlier discussed in Paragraph 90, The World Bank policy document already hints that efforts will be made to collaborate with the IMF and other donors to establish

a global partnership to strengthen debt management capacity in LICs as well as macroeconomic and fiscal management capacity .This is welcome as a step in the right direction. But, beyond this, development partners should actually institutionalise a multilateral framework for debt management capacity, the objective of which would include strengthening of debt management capacity in LICs; transferring to them of debt management “know how” or “technology”; and dissemination to them of best practices in debt management. Such an institution, with its own secretariat, should be modeled broadly along those of Consultative Group to Assist the Poor (CGAP) - that is an institutional collaboration among private, bilateral and multilateral agencies (including the World Bank) for assisting microenterprises in developing countries- and the Integrated Framework of Trade-related Technical Assistance (IFTTA, or simply IF) – formed as a network of six multilateral organisations (including the World Bank). While there are some private and quasi-private initiatives or outfits for providing debt management capacity building services to developing countries, this should be more formalised and made more elaborate through an institutionalised multilateral network of development partners with like minds on the subject. Given its expertise and comparative advantage, the World Bank should be at the forefront in providing and championing this multilateral initiative and it should rally bilateral agencies and other multilateral bodies like the IMF, UNCTAD, etc in support of this cause.

102. The World Bank should also catalyse and cajole national governments in LICs to diversify their export base and increase their export earnings in other to attain sustainable debt positions. In this regard, the Bank should be an advocate for the countries in international trade negotiations and policy fora, including at the Doha Development Rounds. It should also provide more aid for trade facility in concessional loans or grants.

103. The World Bank should refrain from perceiving itself as a competitor with other creditors, whether commercial, emerging bilateral or multilateral creditors. Instead, it should see it as an achievement on its own part if grant or debt relief to LICs creates a borrowing space in the finances of LICs, which then results into catalysing funds to LICs. After all, this is a reason for establishing the Bank. Similarly, the Bank should refrain from lamenting and being highly passionate about its grants and debt relief cross-subsidising other lenders. It should realize that this is not the first time its assistance would subsidise private investors in this manner. If it wants to devise a policy aimed at preventing LICs getting or reverting to unsustainable debt situation, this should be done on its merit and not to be mixed with the controversial objective of preventing taxpayers money in donor countries being used to cross-subsidise other creditors. If cross-subsidisation of other creditors is the only viable way of helping LICs develop and attain the MDGS, let the subsidisation be!

104. The World Bank, through IDA, should refrain from discriminating against LICs in its aid allocation, so as not to make them resort to non-concessional loans. First, the PBA formula should be reviewed in order to remove its regressivity. Second, the netting of mechanism in allocating MDRI-induced donors replenishment to IDA should be removed. Third, the 20 percent volume discount on grants should be reduced or even eliminated. Finally, conditionalities attached to IDA resource allocation should be streamlined and liberalized so as not to scare away many LICs from approaching IDA for finance and make them resort to non-concessional credits that have few or no strings attached.

105. To the extent that the World Bank must implement its anti-free rider policy, domestic debt should be covered for effectiveness.

106. Also, the anti-free rider policy should not penalise only the borrowers but the lenders too should be made to bear some responsibility. Specifically, as earlier suggested in the paper, the World Bank should be at the forefront of spearheading the creation of a sort of international agreement, convention or protocol that would treat lending to LICs, which constitutes a flagrant and extreme breach by the creditors of generally accepted concessionality benchmarks or norms, as being odious and illegitimate.

4.2 Summary and Conclusion

107. Low-income countries that presently have sustainable debt positions can ill afford to get into or revert to the vulnerable debt situations that many of them were until recent. Those that are still having unsustainable debt cannot afford to worsen the situation through reckless borrowing. All these underscore the objective of this paper, which aims to shed light on the non-concessional borrowing situations in LICs; and review the recent World Bank policy document that has a stated aim of guarding against accumulation of unsustainable debts in LICs; and suggest national and international policy interventions for sustainable debt positions in the countries.

108. We first review the profiles and stylized facts on non-concessional borrowing in the countries. Our review shows that natural resource rich countries and countries in conflicts (that are therefore in arrears with BWIs) account for the bulk of non-concessional debt stock and flows, particularly public and publicly guaranteed types. But it would not be illogical to anticipate that post-MDRI countries too could soon start (or might have just started) contracting non-concessional debts in sizeable amounts. We also highlight the geographical concentration of bilateral external credits that characterises many countries, with outstanding credits from emerging creditors like China, Kuwait and Saudi Arabia accounting for high percentage of GDP of the borrowing countries. We point out that this could make the borrowers more vulnerable. In addition, we review the available descriptive and "qualitative" information about the activities of emerging creditors in LICs, with emphasis on the lending activities of China in Africa.

109. The above is followed by a review of the likely reasons that could have made the countries resort to non-concessional borrowing. There, we identify a number of supply factors at the creditors' end and demand factors in the borrowing LICs. Also, we discuss the likely prospects and benefits to the countries of borrowing as well as the likely dangers and problems with such borrowing.

110. The latter and larger part of the paper is devoted to a review of the World Bank's recent document on anti-free riding policy proposal. We summarise the main contents of the document, including the peculiar concept of free riding adopted and the concessionality benchmark to be used. We also summarise the proposed responses, including the use of DSF as the coordinating tool for the creditors as well as discouraging of borrowers being complicit in free riding through a combination of cuts in volume of IDA assistance and hardening of terms of IDA credits. Then,

we evaluate the proposed policy document by highlighting its possible advantages and disadvantages.

111. A conclusion that emerges form our review is that whether borrowing would be beneficial or not to a low-income country depends on the circumstances of the country in question. The same consideration applies to whether the proposed World Bank anti-free riding document can have net benefit for each of the targeted LICs. Thus, while we express reservations on many aspect of the policy document, we cannot but agree with the statement in the document that " Ironclad rules or 'one-size-fits-all' responses are counterproductive to the extent that there are a wide variety of country circumstances requiring appropriately-tailored approaches".

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