# DEBT SUSTAINABILITY FRAMEWORK
# FOR
# LOW INCOME COUNTRIES

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## ABBREVIATIONS

| | |
|---|---|
| AfDF | African Development Fund |
| CIRR | Commercial Interest Reference Rate |
| CPIA | Country Policy and Institutional Assessment |
| CPR | Country Performance Rating |
| DOD | Disbursed Outstanding Debt |
| DRI | Debt Relief International |
| DRS | Debtor Reporting System |
| DSAs | Debt Sustainability Analyses |
| DSF | A Debt Sustainability Framework |
| FSO | Fund for Special Operations |
| GDF | Global Development Finance |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| HIPC | Highly Indebted Poor Countries |
| HIPC-CBP | HIPC Capacity Building Programme |
| IADB | Inter-American Development Bank |
| IDA | International Development Association |
| IFI | International Financial Institution |
| IMF | International Monetary Fund |
| INT | Interest |
| LIC | Low Income Country |
| MDGs | Millennium Development Goals |
| MDRI | Multilateral Debt Relief Initiative |
| MTDS | Medium-Term Public and External Debt Strategy |
| MTTF | Medium-Term Fiscal Framework |
| NPV | Net Present Value |
| OECD | Organisation for Economic Cooperation and Development |
| PDMO | Public Debt Management Office |
| PNG | Private Non-Guaranteed |
| PRGF | Poverty Reduction and Growth Facility |
| PRS | Poverty Reduction Strategy |
| PSI | Policy Support Instrument |
| TDS | Total Debt Service |
| XGS | Exports of Goods and Non-Factor Services |

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## INTRODUCTION

A Debt Sustainability Framework (DSF) for Low Income Countries (LICs)[1] was prepared by the International Monetary Fund (IMF) and World Bank in February 2004 to identify countries in actual or potential debt distress and formulate a basis for assessing grant eligibility of LICs during the Fourteenth Replenishment of the International Development Association (IDA). Follow up documents were prepared later that year after discussion of the proposed framework by the Boards of both institutions. A paper[2] was prepared in September 2004 for the G24 Technical Working Group that summarized the position as it had evolved up to that time. Subsequently, the framework was refined and developed further in the context of the experience gained in its implementation and policy revisions by the staff of the World Bank and IMF. The latest document -Applying the DSF for LICs Post Debt Relief[3]- was prepared by the two agencies in November 2006 and will be reviewed in this paper.

The preparation of the debt sustainability analyses (DSAs) for LICs by the staff of the IMF and World Bank is now a standard operating procedure. The results of these are used by the former for monitoring and surveillance programs and formulating a policy agenda in LICs including ceilings for non-concessional borrowing in program countries. The DSAs are used by the World Bank for assessing debt distress and estimating the eligibility for IDA grants and major lending operations in the context of Country Assistance Strategies.

This paper provides an assessment of the DSF described in the November 2006 paper leading to an update of the September 2004 paper. It reviews the application of the policies and changes that have taken place in the past two years in:

a) the Country Policy and Institutional Assessments (CPIAs) performed by the World Bank[4] and used for determining debt distress;
b) the implementation of the IDA 14 Grant Allocation Framework[5];
c) the implementation of the Multilateral Debt Relief Initiative (MDRI)[6] and the Highly Indebted Poor Countries (HIPC) Initiative[7];
d) the emergence of the free rider problem due to the provision of grants and debt relief to LICs[8];

[1] Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications, IMF and World Bank, February 2004.
[2] Debt Sustainability Framework for Low Income Countries: Policy and Resource Implications, Nihal Kappagoda and Nancy C. Alexander, G 24 Secretariat, September 2004.
[3] Applying the Debt Sustainability Framework for Low Income Countries: Post Debt Relief, IMF and World Bank, November 2006.
[4] CPIA 2005 Assessment Questionnaire, World Bank, December 2005 and IDA Country Performance Ratings 2005
[5] Implementation of the IDA 14 Grant Allocation Framework: Status Report, IDA, October 2005.
[6] Review of Low Income Country DSF and Implications for the MDRI, IMF and World Bank, March 2006.
[7] HIPC Initiative and MDRI – Status of Implementation, IMF and IDA, August 2006.

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

The November 2006 paper attempts to improve the rigour and quality of DSFs undertaken in the LICs. It highlights the three concerns and issues that need to be addressed as work continues on improving the methodology and countries develop public debt management capacity to benefit from debt relief. *First*, the Framework is based on benchmarks for public and publicly guaranteed external debt. Debt relief extended under the HIPC Initiative and the MDRI provides greater opportunities for LICs, in particular their private sectors, to borrow on non-concessional terms. Private non-guaranteed (PNG) debt is becoming an increasing share of the external debt of LICs as a result but it is currently not included in the benchmarks used in the DSAs. In view of this, the vulnerabilities that may be caused by such borrowing need to be monitored. *Second*, the paper examines the issues on which research should continue such as the integration of domestic debt into assessments of external debt sustainability and debt distress. At present, separate analyses on external and domestic public debt sustainability are undertaken with no agreed benchmarks for domestic debt based on inter-country analyses. The macroeconomic linkages between domestic and external debt should also be examined as the methodology is developed. *Third*, there are continuing concerns about the use of CPIAs for assessing debt distress although improvements have been made.

Improvements to the DSF should be placed in the context of the capacity of public debt management offices (PDMOs) to understand and undertake this analysis. The staff of the PDMO should be capable of preparing DSAs and dialoguing effectively with those from international financial institutions (IFIs). The action that needs to be taken to build up this capacity by the LICs, with the assistance of the IFIs, is discussed in the paper. The emphasis should be on the analytical capacity for conducting DSAs and formulating a debt policy and strategy. There should also be a capability to analyze the financial and economic rates of return on projects and programs financed from borrowed funds to ensure that they are on terms that will enable debt sustainability to be maintained.

The LICs and IFIs should promote the wider acceptance and use of the DSFs by other creditors to assess whether their new lending and terms enable debt sustainability to be achieved and maintained by the borrowing countries. At the meeting held in February 2007, the Ministers of Finance of the G7 countries stated that it is imperative for creditors and donors to take account of debt sustainability issues in their lending practices. They further stated that the development of a charter of responsible lending would represent an important step in achieving this objective.

[8] IDA Countries and Non-Concessional Debt – The Free Rider Problem, IDA, June 2006.
[9] Report of the Managing Director to the International Monetary and Financial Committee on the IMF's Policy Agenda, IMF, September 2006.

## BACKGROUND AND DEVELOPMENTS SINCE 2004

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

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

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

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

Action should be taken by the LICs to benefit from the debt relief received and avoid debt distress by building up public debt management capacity with the technical assistance provided by the IFIs and other donors. There are some urgent analytical issues that are engaging the attention of the IFIs at the same time. One is the strategy that should be adopted in countries that have a substantial borrowing space from the benefits of the MDRI. Issues of absorptive capacity of foreign inflows as countries borrow to increase investment, productivity of investments and the impact on growth of higher investment levels need to be addressed. Another issue is the integration of domestic public debt in the DSAs. Countries need to prepare medium to long-term forecasts of their balance of payments and budget deficits making full provision for the investments required to achieve the Millennium Development Goals (MDGs) and the annual maintenance costs of these investments. DSAs should be conducted for the borrowing levels needed to finance these expenditures.

DSAs currently conducted compare thresholds that are based on public and publicly guaranteed external debt. Indicators based on total external debt that includes PNG external debt and on total public debt that includes domestic borrowing of the public sector could deviate significantly from these levels. High levels of domestic public debt that are more prevalent in LICs than high levels of PNG external debt are difficult to handle in DSAs because there are no agreed thresholds based on empirical analyses. Research is continuing on developing the methodology to undertake DSAs on total public debt as the servicing of domestic public debt is an equal drain on public resources similar to servicing external public debt.

## Debt Sustainability

The sustainability of external debt of a country is its ability to service all foreign public and publicly guaranteed and PNG debt (covering all short, medium and long-term debt) without compromising its long–term goals and objectives which in the present context is the achievement of the MDGs. Countries use various debt indicators and benchmarks for these to estimate sustainable levels of borrowing. Sustainability is a dynamic concept that should be judged using numerous indicators.

DSAs were prepared by the IFIs for the countries that benefited when the HIPC Initiative was launched in 1996. Some middle income countries were included by the IMF in 2002. The World Bank requires the DSAs in LICs to assess debt distress and assist in determining grant eligibility under IDA 14. The IMF now requires DSAs on an annual basis for both program and surveillance purposes. In operational terms, joint DSAs are done by the Bank and Fund for IDA only, Poverty Reduction and Growth Facility (PRGF) eligible countries.

The implementation of the HIPC Initiative and the MDRI in 2006 provided an opportunity for the countries that benefited from debt relief to formulate strategies that would avoid severe debt accumulation as they pursue the MDGs. External borrowings that are within ceilings determined using only indicators for public and publicly guaranteed external debt would inevitably require the mobilization of residual amounts in the domestic market or additional revenue generation by the government. The ability of countries to mobilize the required resources in the domestic debt market depends on the state of development of this market and the availability of savings in the country.

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

## Debt Indicators

The external debt problems of a country are typically associated with the accumulation of arrears on external debt service payments exceeding ten percent of the external debt outstanding; an application to the Paris Club for debt restructuring of official debt when a breakdown in the payments system is judged to be imminent; and entering into an agreement with the IMF which is a *sine qua non* for the Paris Club to proceed with discussions on debt restructuring. An IMF agreement could be entered into under the PRGF or Policy Support Instrument (PSI), two facilities that are available to the LICs from the IMF.

While these are the external manifestations of a debt crisis, there are three main causes of debt distress. The *first* is a high level of debt judged by the absolute amount or net present value (NPV) of debt outstanding as a ratio of GNI, exports of goods and non-factor service (XGS) or government revenue. The *second* is a weak institutional and policy environment which makes it likely that these countries will experience debt distress at lower debt ratios than those with a strong environment. This is due to weak debt management capacity and limited capability to use resources in a productive manner. The *third* is external shocks to the economy that affect the country's capacity to service debt without compromising its long-term development goals. The position is exacerbated by the inability to formulate adequate policy responses to these shocks.

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

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

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

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

The GNI or GDP - as stated earlier - are also used to measure the capacity to make debt service payments and estimate debt indicators. They measure the size of the economy though this does not necessarily translate into a capacity to pay. Export earnings, on the other hand, are available to make debt service payments but their accessibility to the government is dependent on the openness of the economy. The usefulness of export earnings as a measure of the capacity to make debt service payments would also depend on the scope of debt included in the stock of debt, i.e., total external debt or public debt.

Government revenue is a third measure for estimating the capacity to repay government and public and publicly guaranteed debt. In the past, the World Bank and IMF argued against the use of government revenue for two reasons. The *first* is the difficulties in estimating it. There is no rationale of this argument when the GDP estimate (which would suffer from some of the same problems of estimation as government revenue) is found acceptable. Further, government revenue is a variable that is often monitored in IMF programs and countries are working towards improvements in estimation. *Second*, a moral hazard argument is advanced against the use of government revenue as lower revenue collections will lead to higher estimates of the debt indicators.

External debt and fiscal indicators provide guidance on the medium and long-term sustainability of public sector borrowings but they are not useful in forecasting debt service difficulties arising from short-term balance of payments problems. Forecasts of liquidity shortages require the use of indicators that are related to the level of foreign exchange reserves. This brings up issues related to the definition of foreign exchange reserves, the indicators of reserve adequacy that are useful in forecasting financial crises and the benchmarks that could be used for the chosen indicators. The foreign exchange reserves coverage and the short-term indebtedness ratios are two indicators that could provide warnings of impending crises to policy makers if statistics are available in a timely manner.

It has been discussed in international forums that a comprehensive definition of public debt should be used when DSAs are conducted. Those done under the HIPC Initiative were confined to public and publicly guaranteed external debt although domestic debt is a serious concern in many of the affected LICs. The domestic debt market may be in the early stages of development but government arrears and Central Bank and commercial bank overdrafts could be significant. Similarly PNG external debt could be considerable in countries that have liberalized their capital accounts and received foreign direct investment as some of the inflows classified as investment are debt rather than equity. Consequently, DSAs of public and publicly guaranteed external debt only provide a partial assessment of a country's debt sustainability.

## Threshold Values of Selected Indicators

Once the indicators are selected, threshold values that enable the state of indebtedness of countries to be determined should be estimated. The use of indicators has gone through several phases since the early eighties as described below. After the debt crisis of 1982 the World Bank began classifying countries as highly indebted, moderately indebted and less indebted using four external debt indicators. These were modified in the early nineties based on experience gained in their use and the introduction of the NPV to measure the debt burden. In the mid- nineties, threshold values were used to assess the eligibility of LICs to receive assistance under the HIPC Initiative. In 2005, the DSF introduced threshold values for the selected indicators to assess debt distress in countries borrowing from the IDA. Their evolution is described below.

*Global Development Finance (GDF)*

The four indicators used by the World Bank in the eighties for assessing the indebtedness of countries were the nominal stock of total external debt to GDP (and later GNI) and XGS, and debt service and interest payments to XGS ratios. In the early nineties 90s, the nominal stock of total external debt was replaced by the NPV of external debt in the two stock indicators as it captured the concessionality of loans better than their nominal values. The threshold values for the classification of indebtedness were based - as stated - on inter-country analyses undertaken by the World Bank using data reported to its Debtor Reporting System by borrowing countries. These values are set out in Table 1

**Table 1: Critical Values of External Debt Indicators**

| **Indicator** | **Highly Indebted** | **Moderately Indebted** | **Less Indebted** |
|---|---|---|---|
| **DOD/GNI** | > 50 % | >30% & < 50% | <30 % |
| **DOD/XGS** | >275% | >165% & < 275 | <165% |
| **TDS/XGS** | >30% | >18% & <30% | <18% |
| **INT/XGS** | >20% | >12% & < 20% | <12 % |
| **NPV/GNI** | >80% | >48% & <80% | <48% |
| **NPV/XGS** | >220% | >132% & < 220 | <132 % |

DOD- Disbursed Outstanding Debt, INT- Interest, TDS- Total Debt Service
Source: Global Development Finance, The World Bank, 2004.

*HIPC Initiative*

The HIPC Initiative launched in 1996 and enhanced in 1999 to address the debt problems of the world's poorest countries was also dependent on debt indicators to determine the extent of debt relief. There are two milestones in the initiative which are the Decision and Completion Points. The *Decision Point* is that at which a country is judged to be eligible to receive assistance following a good track record of reform programs and economic performance. At this Point the amount of debt relief necessary to bring the ratio of the stock of public and publicly guaranteed external debt to XGS down to 150 percent at the *Completion Point* of the program is decided and implemented. The *Completion Point* is the point at which all the remaining debt relief is received. The use of this threshold will result in these countries being in the moderately indebted category at the Completion Point.

At the Completion Point - the final milestone - countries are assessed for additional assistance that may be required due to exogenous shocks or changes in market conditions of interest and exchange rates and become eligible to receive funds from what is called the Topping Up Facility of the HIPC Initiative. An alternative debt sustainability target of 250 percent was set for the ratio of the stock of public and publicly guaranteed external debt to government revenue (introducing a fiscal indicator) in highly open small economies with an exports to GDP ratio of at least 30 percent making a strong fiscal effort with the government revenue to GDP ratio of at least 15 percent.

***Debt Sustainability Framework***

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

The DSF chose three stock and two flow indicators for consideration from among the debt indicators available for judging sustainability. These were the NPV of public and publicly guaranteed external debt to GDP, XGS and government revenue, and debt service on the same debt to exports and government revenue. The ratios based on government revenue were eliminated from consideration for the reasons set out above and thresholds set for the remaining three indicators for public and publicly guaranteed external debt.

The approach adopted in the DSF was to set thresholds for countries classified as strong, medium and weak performers based on an assessment of policies and institutional capacity using the CPIAs prepared by the World Bank. The thresholds finally adopted for the IDA 14 allocations are set out in the Table 2. The ratios that use government revenue[11] are also included in the table although they were not used in the DSF methodology. It is seen that these thresholds bear no relationship to the critical values for total external debt used in the GDF or for public and publicly guaranteed external debt used in the HIPC Initiative. The CPIA introduced an additional variable to assess the capacity of countries to borrow based on its policy environment and institutional development.

[10] Debt Sustainability in Low Income Countries: Proposal for an Operational Framework and Policy Implications by Mark Allen and Gobind Nankani, IMF and IDA, February 3, 2004.

[11] Debt Sustainability in Low Income Countries: Further Considerations on an Operational Framework and Policy Implications by Mark Allen and Gobind Nankani, IMF and IDA, September 10, 2004.

**Table 2**
**Thresholds for Debt Indicators in the DSF**

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

## Country Policy Institutional Assessments

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

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

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

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

used to estimate the degree of debt distress of the LIC enabling the IDA to assess the extent of grant eligibility within the allocation determined by the CPR.

**Debt Distress**

Kray and Nehru[14] identified the level of probability of experiencing debt distress that borrowers seem willing to tolerate as 25 percent based on the experience of countries in their sample. Thereafter debt thresholds dependent on the country's policies and institutions measured by the CPIA[15] were derived. A distress probability of 25 percent[16] indicates that there is a 75 percent chance that none of the chosen indicators of debt distress would exceed the thresholds in the next five years. On the other hand, there is a 25 percent chance that at least one of the indicators of debt distress will exceed the threshold in the next year and will continue to do so for at least three years. Table 2 sets out the debt thresholds for the chosen indicators of countries with poor, medium and strong institutional capabilities and quality of policies with the cut offs at the 25th, 50th and 75th percentiles of the CPIA index ranked in ascending order. The CPIA was estimated to be 2.9 for the 25th percentile and 3.6 for the 75th percentile. Thus poor performers from the point of view of institutional strength and quality of policies are those with a CPIA of less than 2.9, those judged to be medium performers are in the range of 2.9 to 3.6 while those of strong performers exceed 3.6.

A ranking system that could be used for making grant allocations was formulated in the Framework paper[17]. The first step was the selection of debt indicators that can be used to measure debt distress. The elimination of the indicators that are dependent on government revenue left a combination of two stock and one flow indicator to judge debt distress. The analysis in the paper argues that the debt stock to exports ratio which is judged to be "the most suited indicator of repayment capacity and thus of a country's long-term solvency" showed that fewer countries exceeded the policy dependent threshold across the board while the debt stock to GDP ratio included a larger group of countries[18]. A combination of the two stock indicators was considered more suitable rather than the two considered separately. Short-term liquidity considerations are best captured using the debt service ratio. Consequently, the composite stock indicator and the debt service ratio are the two indicators used in the DSF to assess debt distress of the low income countries.

The next step is to assess how the indicators fare in relation to the selected thresholds for the three groups of countries. This is done by determining the percentage above

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[14]. When is External Debt Sustainable? Aart Kray and Vikram Nehru, Policy Research Working Paper 3200, The World Bank, February 2004.

[15] A higher probability permits a higher threshold for debt though at the risk of future debt distress. Thus the probability of debt distress and the debt thresholds for the chosen indicators are policy decisions that need to be made.

[16] Ibid footnote 1 – see footnote 19.

[17] Ibid footnote 1.

[18] Ibid footnote 2, Annex 1.

or below the threshold each country's indicators are, a negative number indicating that it is above the threshold and vice versa. In the third step, the average percentage for the composite stock indicator and that of the debt service ratio are used to measure the level of debt distress. When both are above the threshold, the higher percentage deviation determines the level of debt distress. When both are below, the lower percentage deviation determines the level of debt distress. If one is above and the other below the threshold, the one above determines the level of debt distress. The last step in the process that would assist the IDA in making grant allocations is to classify the countries into three groups. Two bands, 10 percent above and below the thresholds are selected for this classification. If the operational ratio, i.e. the composite stock indicator or the debt service ratio is 10 percent or more below the threshold, IDA provides its assistance as credits. If it is 10 percent or more over the threshold, IDA assistance would only be provided as grants. A mixture of grants and credits is provided when the ratio is between the two. This system has been referred to as the "traffic light system"[19] in the Framework paper. The 20 percent band width was considered adequate to prevent changes in classification brought about by small variations in the countries' debt ratios and consequently of grant requirements. The band width is a judgement between a smaller or larger call on grant funds from the IDA which has resource implications for each replenishment.

The DSF was based initially on current levels of debt indicators rather than on projections for the IDA 14 period which would take account of likely exogenous shocks to the extent that they can be forecast. It was recognised that the DSAs should allow for the dynamic nature of the debt ratios. Exogenous shocks to the economy are largely unanticipated and have a negative impact on several macroeconomic variables. These are natural disasters such floods and droughts, political instability or civil strife, declines in prices of a country's major exports and a sharp reduction in capital flows due to a withdrawal of donor support or outflows of private capital due to a loss of confidence in the economy.

As stated in the Framework paper, LICs are more prone to exogenous shocks than other developing countries and the impact of shocks are more prolonged as judged by the affected macroeconomic variables. These are principally GDP or GNI, exports, real exchange rate, terms of trade and loss of welfare. Further, where the exchange rate has depreciated the burden of servicing foreign currency debt on the budget would have increased accordingly. Such shocks to the economy should require balance of payments support of the type that is provided under the IMF's Exogenous Shocks Facility for LICs and Compensatory Financing Facility. Such facilities, when available should be provided and disbursed promptly to respond to the need if it is essentially a problem of liquidity. Where the impact of the shock is of a longer-term nature and the shock itself is persistent, assistance for export diversification and infrastructure and other long-term development should be provided on terms judged affordable on the basis of the DSF.

[19] Ibid footnote 2.

**IDA Allocation Framework and Grant Eligibility**

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

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

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

The governance factor has a heavy weight and changes in the ratings of the governance criteria can result in significant changes in the allocation of IDA funds. This led to questions being raised during the Review whether the role of governance in the allocation system should be recalibrated while keeping the central policy focus of governance. One proposal was to remove the exponent of 1.5 currently applied and use a linear governance factor. This would reduce the effective weight of governance in the CPR while increasing the average per capita allocation of IDA funds to countries in the bottom quintile. This was not pursued due to the need to maintain the link between performance and allocations and avoid year to year volatility in the country allocations resulting from changes in the governance ratings. A three-year moving average of the portfolio performance rating is now used.

[20] IDA's Performance Based Allocation System: Update on Outstanding Issues, IDA, February 2004.

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

The methodology developed by the DSF has been used to determine IDA allocations and grant eligibility. As stated, the resources made available to each IDA country (IDA only or blend) during the Fourteenth Replenishment are based on performance using the CPR and need that is established by its per capita GNI. Eligibility for grants is restricted to IDA only countries based on assessments of severe or moderate debt distress using the DSF methodology. IDA blend countries are not eligible even if they are judged to be in debt distress. Grant eligibility is based on debt distress only and not on multiple criteria as under IDA 13. Further, the proportion of grant funding was not predetermined as in IDA 13 and instead it is based on need estimated by the DSF developed jointly by the World Bank and IMF.

In the first year of IDA 14, debt distress was assessed by comparing the current public and publicly guaranteed external debt indicators to the thresholds given in Table 2. The DSAs that were to be done by the time of the Mid-Term Review of IDA 14 at the end of 2006 are expected to contain forward looking debt indicators that will enable grant eligibility to be determined annually taking account of changing CPRs and debt indicators.

## Implementation of the HIPC Initiative and MDRI

### *HIPC Initiative*

The HIPC Initiative, (as stated) was launched in 1996 to address the debt problems of the world's poorest countries. It was enhanced in 1999 to provide deeper and more rapid relief to a wider group of countries and consolidate the links of the Initiative with poverty reduction. It called for the voluntary provision of debt relief by multilateral, bilateral, and/or commercial creditors, and aimed to provide a fresh start to countries struggling to cope with foreign debt that places too great a burden on export earnings and fiscal revenues.

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

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

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

Thirty countries are benefiting or have benefited from the HIPC debt relief. Twenty one have reached the Completion Point. Nine are receiving some debt relief and a further ten are potentially eligible for HIPC debt relief pending agreement on macroeconomic reforms, poverty reduction strategies or plans to clear arrears. Many of them have been beset by civil war, cross-border armed conflict and governance challenges (including in some cases the buildup of substantial arrears on external debt). In the thirty countries in which HIPC debt relief packages have already been approved, debt service payments have declined by about 2 percent of GDP on the average between 1999 and 2005. These resources need to be targeted at the poor for debt reduction to have a tangible impact on poverty. Before the HIPC Initiative, eligible countries were spending slightly more on debt service than on health and education combined. Since then their expenditures on health, education and other social services have increased significantly and is now more than five times the amount of debt service payments. A review of the Initiative by the World Bank's Independent Evaluation Group cautioned about the need to manage expectations of what could be achieved by debt relief as long-term sustainability depended on success in institutional development to support sustained economic growth.

### *Multilateral Debt Relief Initiative*

In June 2005, the Group of 8 industrial countries proposed that the IMF, IDA of the World Bank and the African Development Fund (AfDF) of the African Development Bank cancel 100 percent of the debt outstanding due from countries that have reached Completion Point under the enhanced HIPC Initiative. While the HIPC Initiative called for coordinated action by all creditors to reduce the external debt of the qualifying countries to sustainable levels, the MDRI went further and provided full debt relief from the selected institutions to free resources that could be used by these countries to achieve the MDGs. Further, unlike the HIPC Initiative, the MDRI did not call for parallel debt relief from official bilateral or private creditors or multilateral institutions apart from the AfDF, IDA and IMF and the assistance was additional to that received under the HIPC Initiative. The Inter-American Development Bank (IADB) agreed to extend similar assistance in January 2007 from its Fund for Special Operations (FSO). Each institution had separate responsibility for implementing this decision that resulted in different coverage.

In the case of the IMF, MDRI relief is extended to all HIPCs once they reached the Completion Point under the Enhanced Initiative and non-HIPCs with a per capita income of $380 or less. The extent of debt relief covers the full stock of debt owed to the IMF at the end of 2004. There is no provision for relief on disbursements made after January 1, 2005. Beginning in January 2006, 21 HIPCs that had reached Completion Point and two non-HIPCs with a per capita income of less than $380 qualified for debt relief that amounted to $3.5 billion. Following approval by the Board of the World Bank in March 2006, the IDA provided MDRI assistance from July 2006 to HIPCs that reached the Completion Point. The coverage in IDA was different and only included the debt outstanding at the end of 2003. Twenty one countries have qualified to receive MDRI assistance from the IDA to date. Country eligibility and qualification for assistance from the AfDF are the same as that for the IDA. This was provided from July 2006 and backdated to January 2006. Seventeen post-Completion Point HIPCs had qualified to receive MDRI assistance from the AfDF at the end of 2006. IADB assistance will be provided to qualifying countries on the stock of outstanding FSO debt at the end of 2004. There were four eligible countries at the end of 2006.

Only the MDRI debt relief by the IMF provided additional resources to post-HIPC countries. This is not the case with the other three agencies. Annual debt service forgiven each year as a result of the MDRI is deducted from the annual allocations to each qualifying country by the AfDF and IDA. The countries could receive additional allocations dependent on funding provided by the donors to these agencies to compensate for foregone debt service payments. The IADB debt relief is being funded from internal FSO resources.

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

### *Remaining Issues*

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

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

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

## Non-Concessional Borrowing by LICs[21]

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

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

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

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

[21] Ibid footnote 8.

PRGF arrangements and Policy Support Instruments (PSIs) with of the IMF have limits placed on non-concessional debt. These limits have been in existence for upper credit tranche arrangements for non-concessional external debt since 1979 to prevent a build up of external debt. The present limits have been placed to prevent countries building up their external debt burdens by filling the borrowing space that has been created by the LICs that have received HIPC and MDRI assistance. The effectiveness of these limits also depends on whether the ceiling is placed on public and publicly guaranteed debt defined broadly.

The incentive mechanisms that could be offered by the IDA to avoid the moral hazard problem are the volume or terms of assistance or a combination of both. The choice depends on the risk of debt distress in the country and the degree of access to financial markets. There is also the trade off between debt sustainability and the need to have adequate resources to reach the MDGs. If the risk of debt distress is high, a reduction in volume should be preferred even at the risk of having fewer resources while a hardening of terms would be the preferred response to keep the flow of resources needed to reach the MDGs if the risk of debt distress is low. A flexible approach has to be adopted to meet the needs of each country.

## PRESENT STATUS OF THE DSF

The DSF is used by the Bank and Fund to undertake joint DSAs for all IDA only, PRGF eligible countries. Joint DSAs are not required for IDA blend countries that are eligible for the PRGF. The DSAs enable the LICs to formulate a prudent external borrowing strategy that limits the risk of debt distress. It was adopted by the IDA and African Development Bank to make grant allocations under IDA-14 beginning in FY 06 and the Tenth Replenishment of the AfDF respectively. As stated, a high, moderate or low risk of debt distress dictated the volume of grants provided to LICs by the IDA within the allocation for the replenishment determined for the country. The DSF also sets out the modalities for collaboration between the staff of the Bank and Fund in the preparation of the DSA for each LIC.

The joint Bank-Fund DSA for a low income country provides a basis for monitoring the debt burden indicators and guidance in formulating an appropriate borrowing policy and strategy. It is a forward looking analysis of external and public debt and debt service indicators based on realistic financing assumptions and expectations of exogenous shocks. Assessments of debt sustainability are based on a comparison of the country indicators with the debt burden thresholds that are dependent on the quality of the country’s policies and institutions. Country specific factors are also taken into account where possible.

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

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

Another challenge facing the LICs and IFIs is to foster a broader use of DSFs by both debtors and creditors. The borrowing countries should use the DSFs to formulate a borrowing policy and strategy that balances their financing requirements to reach the MDGs with the risk of debt distress. This highlights the need for LICs to improve their public debt management capacity to undertake the analytical work required. Export credit agencies, commercial creditors and non-OECD bilateral creditors should also coordinate their lending activities and engage in responsible lending to the LICs.

## Domestic Debt Sustainability

DSAs use thresholds for judging the sustainability of public and publicly guaranteed external debt. The thresholds for indicators based on total external debt that include PNG debt and on total public debt that include domestic borrowing of the public sector could deviate significantly from these levels. High levels of domestic debt are more prevalent in LICs than high levels of PNG external debt. Domestic debt is difficult to handle in DSAs because there are no agreed thresholds for debt indicators.

It is recognized that public domestic debt is significant in many LICs. This poses a risk for external debt due to competing claims for government resources that are needed to convert to foreign exchange to make debt service payments. Further, domestic debt carries risks brought about by higher interest rates and shorter

[22] Ibid footnote 7.
[23] Ibid footnote 3.

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

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

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

- Debt Service/Government Revenue which measures the ability to make debt service payments on the domestic debt of the government from government revenue;
- NPV of debt service/Government Revenue which measures the present value of debt service payments on the government's domestic debt relative to its capacity to repay;
- Interest Payments/Government Revenue which measures the proportion of government revenue required to make interest payments on the domestic debt of the government;
- DOD/GNI which measures the level of the government's domestic debt stock relative to GNI on the assumption that it is available for repaying it; and
- DOD/Government Revenue which measures the level of the government's domestic debt stock relative to its capacity to repay.

These ratios correspond to those used in the World Bank's Global Development Finance report to assess the external indebtedness of countries with government revenue replacing XGS. As stated, unlike in the case of external debt there are no internationally agreed benchmarks for assessing the sustainability of the domestic debt. The following provisional benchmarks for domestic debt have been suggested based on experience gained by Debt Relief International (DRI) in implementing the HIPC Capacity Building Programme (HIPC-CBP)[24].

[24] Key Issues for Analyzing Domestic Debt Sustainability, Alison Johnson, Debt Relief International, London, 2001.

**Table 3**
**Provisional Thresholds for Domestic Debt Sustainability**

| Domestic Debt Indicator | Range (%) |
|---|---|
| Debt Service/Revenue | 28-63 |
| NPV of Debt/Revenue | 88-127 |
| Interest/Government Revenue | 4.6 – 6.8 |
| Debt/GNI | 20-25 |
| Debt/Revenue | 92-167 |

Source: Debt Relief International, 2001.

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

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

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

GDD- Government Domestic Debt, GR- Government Revenue

Table 4 provides estimates of average domestic debt indicators for selected HIPCs in Africa and Latin America for the period 2002-04.[25] These countries are beneficiaries of the HIPC Initiative that was designed to reduce their public and publicly guaranteed external debt to sustainable levels. One of the nine countries had three indicators, two had two and four had one above the threshold levels. One country had all three indicators in the threshold ranges, four had two and two had one. Only one country had all the indicators below the ranges and thus had sustainable levels of

[25] Compiled by Alison Johnson of Debt Relief International, London from IMF and country sources.

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

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

a. all DSAs should include a domestic public debt DSA done at the same time to enable a comprehensive assessment of the country's debt sustainability;
b. domestic debt issues should receive increasing attention where domestic public debt has been increasing rapidly and is a larger share of public debt or is expected to be in the future;
c. the public debt DSA should examine the vulnerabilities related to domestic debt using indicators such as those suggested above in this section; and
d. the public debt DSA should identify situations where the inclusion of domestic public debt could result in a different classification of indebtedness from that obtained by reviewing external public debt and debt service alone.

The IFIs need to work with the LICs to improve the quality of data on domestic debt and government revenue. The experience of the DRI in implementing the HIPC-CBP indicates that the data is available but requires a greater effort in compilation.

## Fostering Creditor Coordination

The Finance Ministers of the G7 countries have called for greater coordination among lenders and the formulation of a charter that would govern their lending. The availability of DSFs and their usefulness to individual creditors needs to be promoted by the World Bank and IMF. The first step has been taken by posting the list of LICs for which DSAs have been undertaken and the dates on which they were done on the web sites of these agencies. A direct web link to the document is provided where the country has consented to the posting of the DSA on the web sites.

The Bank and Fund have begun outreach programs with creditors by attending meetings of the OECD export credit group, European Export Credit Agencies and Paris Club. More needs to be done by contacting commercial creditors. Considerable attention needs to be paid to the sources of non-OECD official assistance. The overall share of the emerging creditors - as these countries are referred to - in total official assistance remains small. It is of the order of 10 percent though in a handful of LICs the share is significant. Brazil, China, India, Korea, Kuwait and Saudi Arabia are the six largest non-OECD creditors with China being the largest and Kuwait the second. The need to coordinate this lending is important given that LICs in Africa are large recipients and have benefited from HIPC and MDRI assistance. Consulting the DSF and using it is a choice that has to be made by each creditor.

There is no institutional or contractual basis requiring countries do so as the main objective is to enable borrowers and creditors to make informed choices based on the DSAs. The IFIs will continue their outreach programs to contact all creditors to increase awareness of the DSFs and the free rider problem. This is particularly important when emerging creditors provide loans to developing countries without reference to international guidelines. All joint DSAs prepared by the IMF and World Bank are being placed on their web sites after obtaining the approval of the LIC should and this encourage their use by all creditors.

## Reporting External Debt

The paper of November 2006[26] states that the reporting of central government liabilities should be strengthened in the context of a broad definition of public debt. This should include borrowing by the central government and its agencies; states, provinces or similar political subdivisions including their agencies; autonomous public bodies such as state enterprises and subsidiaries in which they have joint ownership with the private sector and a major shareholding; and publicly guaranteed debt. After over two decades of debt management technical assistance by the Commonwealth Secretariat, United Nations Conference on Trade and Development and IFIs including the World Bank, it is surprising that data issues continue to be a problem for external debt. It is reported that about half the LICs that are required to report to the World Bank's Debtor Reporting System (DRS) do not do so or there are moderate to major problems associated with the data submitted. The paper states that the technical assistance provided in the past has focused on the provision of debt management software without emphasis on the quality of data.

Annual data is obtained by the World Bank but it is reported that data submissions are delayed and has uneven coverage. This makes it necessary to complement debtor reporting with data from creditor records. It is understood that the staff of the OECD, Bank for International Settlements and Berne Union are working with the staff of the World Bank and IMF on reporting mechanisms to validate and supplement data collected through the DRS. It is expected that this data will be integrated into the Joint External Debt Hub but it would not cover lending by emerging and private creditors who are not members of the OECD or the Berne Union.

IFIs have taken action is to set a mandatory reporting requirement in all grant and credit agreements for advance reporting of non-concessional loans in post-MDRI borrowing countries. A web page on concessionality including a facility to calculate concessionality has been established to assist LICs in this regard.

[26] Ibid footnote 3.

**Improving the Capacity for Public Debt Management**

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

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

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

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

Governments should establish guidelines that should be in the public domain for managing risk in the loan portfolio that embody the strategy adopted by debt offices for achieving their stated objectives. Appropriate models should be used to quantify the costs and risks of alternative strategies adopted by the debt offices to manage financial risk. It should be recognized that debt management is also a financial business that carries large exposures to market, credit, liquidity, rollover and operational risks in countries that borrow extensively in capital markets. It is important that the staff of PDMOs should have experience in capital market operations and portfolio expertise and understand the risk management culture required of a sovereign borrower. There should be a sound risk monitoring and control environment in the debt offices to reduce operational risk that is important for a sovereign borrower. These skills do not exist in most PDMOs of LICs.

## FUTURE ACTION ON THE DSF

There should be a continuing review of the various aspects of the DSF in the context of its objectives which are to assist the LICs avoid the accumulation of unsustainable public debt levels cause debt distress and provide a mechanism for the IDA to assess grant eligibility for IDA-only countries. Coordinated action by all OECD and non-OECD creditors and LICs is required to mobilize the resources required for these countries to meet the MDGs.

Threshold levels of debt indicators provide the basis on which the DSF is formulated. It is therefore important that a broad definition of public debt be adopted to take account of all the liabilities of the public sector. Research needs to continue to estimate threshold values that will enable countries to determine sustainable levels of total public debt and total public and publicly guaranteed external debt. The present methodology does not assess the sustainability of total public debt and this is needed to assess macroeconomic stability by taking account of both the domestic and external borrowings of the public sector. Until this is done the analysis is incomplete though the sustainability of external and domestic borrowings of the public sector can be assessed separately. Work continues on integrating external and domestic public debt in the DSAs for the LICs.

Many of the LICs have foreign exchange controls and do not enjoy convertibility of their capital accounts. With domestic public debt increasing in many LICs, greater effort in domestic resource mobilization becomes an option that should be pursued.

The issue of convertibility remains whether the domestic resources are raised from revenue mobilization or domestic borrowing. The ability to raise domestic loans would also depend on the state of development of the domestic capital market.

Government revenue should be used in the analysis to estimate sustainable levels of public debt as it is a critical variable affecting payments of public debt service. It is understood that data issues are a concern in using this variable similar to that in the case of domestic debt. There is no theoretical basis for not using government revenue and efforts should be made in programs monitored by the World Bank and IMF in the LICs to achieve the much needed data improvements.

The implementation of the HIPC Initiative and MDRI need to continue for the countries that ended 2006 between the Decision and Completion Points and those that are at the Pre-Decision Point stage. The assistance of the World Bank and IMF will be imperative to prepare the latter group of countries for debt relief under the HIPC Initiative.

Given the tremendous international effort that was made to implement the HIPC Initiative and more recently the MDRI, it is important that the LICs that benefited manage their future public borrowing more efficiently than in the past. Capacity has to be built up for effective public debt management with the assistance of the IFIs and other technical assistance agencies. The various aspects that need to be strengthened have been mentioned in the previous section. Debt relief and restructuring since the early eighties has been very disruptive for developing countries that struggled to cope with the requirements set out by the Paris and London Clubs and more recently the HIPC Initiative and MDRI. This highlights the need to build up the analytical capability of PDMOs to prepare a MTDS for the LIC to benefit from the debt relief received.

In addition to the action that is required by the LICs and IFIs, the creditors also need to operate within the DSF that is formulated for each LIC. The call by the G7 Finance Ministers for a charter for lending needs to be pursued.

## ANNEX 1
## CRITERIA USED FOR CPIAs IN 2005[27]

### Economic Management

- Macroeconomic Management
- Fiscal Policy
- Debt Policy

### Structural Policies

- Trade
- Financial Sector
- Business Regulatory Environment

### Polices for Social Inclusion and Equity

- Gender Equality
- Equity of Public Resource Use
- Building Human Resources
- Social Protection and Labor
- Polices and Institutions for Environment Sustainability

### Public Sector Management and Institutions

- Property Rights and Rule-based Governance
- Quality of Budgetary and Financial Management
- Efficiency of Revenue Mobilization
- Quality of Public Administration
- Transparency, Accountability, and Corruption in the Public Sector

[27] Country Policy and Institutional Assessments, 2005 Assessment Questionnaire, The World Bank, December 2005.