International Monetary Fund

IMF Executive Board Discusses the Application of the Debt Sustainability Framework for Low-Income Countries Post Debt Relief

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On November, 27, 2006, the Executive Board of the International Monetary Fund (IMF) discussed the application of the debt sustainability framework (DSF) for low-income countries after debt relief in the context of the Heavily Indebted Poor Countries Initiative (HIPC) and the Multilateral Debt Relief Initiative (MDRI). The discussion was based on a report prepared jointly by the staffs of the World Bank and the IMF.

Background

The Executive Boards of the IMF and the World Bank endorsed the DSF for low-income countries in April 2005, and in April 2006 reviewed its use as well as the implications of the MDRI. The Boards considered the framework broadly appropriate but thought that additional guidance was needed on the application of the framework to address the new policy challenges created by debt relief.

The joint paper proposes to strengthen the application of the DSF itself, reinforce its built-in safeguards, and provide clearer guidance on the design of underlying growth and macroeconomic scenarios. This should enhance further the rigor and quality of debt sustainability analyses, while still allowing for a consistent and flexible treatment of debt accumulation across member countries. The paper also examines the role of nonconcessional debt in countries that have benefited from debt relief, the rising importance of private external creditors, and ways to integrate better domestic debt in the DSF.

The effectiveness of the DSF depends on its broader use by debtors and creditors. The joint paper considers a number of options in this regard, including strengthening the link between the results of debt sustainability analyses and policy advice, further outreach to official creditors, and the development of medium-term debt strategies that balance development needs with the risk of debt distress. The broader use of the debt sustainability framework would also facilitate communication and coordination on debt-related issues among creditors and between creditors and debtors.

Executive Board Assessment

Executive Directors welcomed the opportunity to discuss the application of the debt sustainability framework for low-income countries (LICs) post-HIPC Initiative and -MDRI debt relief, following up on their consideration of this topic in April 2006. Today's discussion focused on how best to integrate into the DSF the policy challenges arising from the perceived increase in borrowing space created by debt relief in some LICs, from the emergence of new creditors, and from the rising weight of domestic debt. While welcome, these developments also raise new risks that need to be addressed as countries continue to make progress towards implementing prudent debt management policies. In light of this, Directors called for improvements to the rigor and quality of debt sustainability analyses (DSAs) and for increased effectiveness of DSAs by fostering their use by borrowers and creditors.

Improving the Quality and Rigor of DSAs

Directors recalled that, at their April discussion, they had supported the development of specific recommendations and guidelines on the implementation of a case-by-case approach, which takes due account of country-specific circumstances for assessing the appropriate pace of debt accumulation in countries with debt below the DSF thresholds. They had emphasized that guidance is needed to ensure that such an approach provides a rigorous, consistent, and evenhanded treatment of debt accumulation across countries. Most Directors viewed staff proposals as striking an appropriate balance between rules and discretion. They welcomed the proposed guidelines for the design of more realistic baseline macroeconomic and growth scenarios that reflect the country's policy and institutional setting, the external environment, and the likelihood of external shocks.

Directors generally supported a strengthening of the precautionary features already built into the DSF, including a more active use of historical scenarios to detect undue growth optimism. Cases in which the baseline scenario includes very large upfront borrowing or in which growth accelerations are critical to the avoidance of debt distress would call for a detailed review of macroeconomic assumptions and policies. In this respect, most Directors felt that an annual increase in the net present value of public external debt or total public debt above the range of 5-7 percent of GDP would be an appropriate "caution flag", based on empirical evidence. A few Directors saw scope for greater use of explicit guidelines on debt accumulation that would provide incentives for improved debt management; in this context, it was suggested that Fund-supported programs could use indicative targets on debt accumulation. Some other Directors cautioned against too exclusive reliance on historical scenarios, arguing that this could fail to capture the higher growth rates that can be expected from good quality investment.

Directors reiterated that concessional flows remain the most appropriate source of external finance for LICs and, in this context, called for continued efforts by the international community to improve the availability and predictability of concessional financing. However, they recognized that consideration should continue to be given—on a case-by-case basis—to nonconcessional finance depending on the impact on debt sustainability and the overall strength of a debtor country's policies and institutions, as well as of the quality of the investment to be financed and of the overall public expenditure program. While the availability of concessional financing will clearly be a consideration in this assessment, many Directors emphasized the need for prudence, implying that the lack of such financing should not be the only justification for supporting recourse to nonconcessional resources.

Directors noted that private external creditors' interest in LICs' sovereign debt instruments, including domestic debt instruments, has increased. While welcome, these new investments may give rise to new vulnerabilities, which need to be monitored carefully. Directors agreed that in such cases additional analysis, focusing on short-term debt-related vulnerabilities, should be used more systematically in conjunction with the DSF.

Directors discussed how to integrate domestic debt better in the DSF, given that domestic debt is substantial in many LICs and is relevant for the risk of external debt distress. In view of the conceptual challenges involved, they felt that it is not feasible to incorporate domestic debt into the existing thresholds. However, Directors considered that scope exists for integrating domestic debt more systematically into the assessment of debt sustainability and the risk of external debt distress. In particular, they stressed the need to ensure that all LIC DSAs include a public debt DSA, which should assess more thoroughly the vulnerabilities related to domestic debt. DSAs should also explicitly flag situations where the inclusion of domestic debt in overall debt and debt-service prospects would lead to a different classification from consideration of external debt and debt service alone. A few Directors cautioned against discriminating domestic debt accumulation in favor of external debt.

Towards More Effective DSAs: Fostering Use by Borrowers and Creditors

Directors underscored that the effectiveness of the DSF in avoiding excessive debt buildup ultimately depends on its broader use by debtors and creditors, including as a device for better communication and coordination between creditors and borrowers, and among creditors. Although the use of the DSF is expanding, it is still limited, and Directors stressed the need for further outreach to official creditors, including towards emerging creditors. While recognizing that the primary responsibility for avoiding debt re-accumulation lies with the borrowers, a number of Directors called for further exploration of ways to encourage responsible lending by all creditors.

Directors stressed the crucial importance of timely, high-quality data on borrowing and lending operations, and saw an important role for the Fund and the Bank in supporting sustained further efforts aimed at improving the quality and availability of data on overall financial flows to low-income countries. In this regard, a number of Directors called on borrowers and creditors to disclose data on these operations on a timely and accurate basis. To promote data transparency and dissemination, Directors encouraged Fund staff, working with Bank staff, to disseminate more broadly and effectively the results of DSAs. Directors welcomed the creation of a dedicated webpage on the Fund's website where DSAs can be easily located, and supported the establishment of a similar webpage on concessionality, including a concessionality calculator and relevant information on the Fund's concessionality policy. They saw merit in allowing public access to the illustrative DSA templates in order to increase transparency and broaden the framework's acceptance among creditors. They also suggested that staff post on the website a summary table listing the countries for which an LIC DSA has been undertaken, their dates, and whether they have been published.

Directors underscored the critical importance of ensuring that debt-related vulnerabilities identified by the DSF are adequately taken into account in the formulation of a country's policies. They urged staff to strengthen further the link between DSA results and Fund policy advice in both surveillance and program contexts. This could include the use of indicative targets on the overall fiscal deficit or debt ceilings, where appropriate. More generally, Directors stressed the importance of using the DSF as an upstream device to inform staff's broader dialogue with the authorities. Directors noted that regular DSAs should become part of sound policy design, and supported using DSAs as a cornerstone for the elaboration of country-owned, medium-term public and external debt strategies (MTDS) that would be closely linked to countries' fiscal frameworks. A well-designed and operational MTDS would thus become an important tool in supporting a country's development objectives, including its progress towards reaching the Millennium Development Goals, while containing risks of debt distress and macroeconomic vulnerability. It could also help guide creditors' decisions.

Directors noted that the design and implementation of an MTDS raises significant operational challenges, and will require substantial capacity building in public debt management given that the ownership and responsibility for the MTDS should rest firmly with the borrowing country. Directors stressed the importance of coordination with the Bank and other technical assistance-providing institutions and agencies, especially in light of resource constraints and the potentially significant costs involved. They looked forward to further clarification—including in the context of forthcoming discussions based on the work of the External Review Committee on IMF-World Bank Collaboration—of the role that the Fund will have to play in this capacity-building effort. It was also suggested that countries should rely as much as possible on existing financial and policy frameworks as a basis for developing and strengthening their debt management policies.

Directors considered that there is no need for revising the existing debt distress categories at this time. Most Directors broadly supported the use of a three-year moving average Country Policy and Institutional Assessment score to determine the appropriate indicative threshold for debt distress.

Going forward, Directors stressed that consistent and effective implementation, on the part of LICs and their creditors, of the debt sustainability framework will be crucial. They encouraged the Fund staff to continue to work in close coordination with Bank staff, as they further develop and refine this important tool in light of experience.

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