INTERNATIONAL MONETARY FUND

Staff Guidance Note on Debt Limits in Fund-Supported Programs

Prepared by the staff of the IMF

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ABBREVIATIONS AND ACRONYMS

CIRR	Commercial Interest Reference Rate
CPIA	Country Policy and Institutional Assessment
DeMPA	Debt Management Performance Assessment
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
EDSS	Economic Data Sharing System
FAD	Fiscal Affairs Department
HIPC CBP	Heavily Indebted Poor Country Capacity Building Program
LIC	Low-Income Country
MDRI	Multilateral Debt Relief Initiative
MTDS	Medium Term Debt Management Strategy
NIR	Net International Reserves
OECD	Organization for Economic Cooperation and Development
PEFA	Public Expenditure and Financial Accountability
PPG	Public and Publicly Guaranteed
PRGT	Poverty Reduction and Growth Trust
PV	Present Value
ROSC	Report on the Observance of Standards and Codes
SOE	State-Owned Enterprise
TMU	Technical Memorandum of Understanding
WEO	World Economic Outlook

I. Introduction and Overview[1]

1. **In August 2009, the Executive Board approved new guidelines on external debt limits in Fund-supported programs.**[2] Debt limits seek to prevent the build-up of unsustainable debts, while allowing for adequate external financing. The new framework moves away from a single design for debt limits (or, to use the usual terminology, concessionality requirements) towards a more flexible approach.[3] Specifically, this framework is based on a menu of options to reflect better the diversity of situations in member countries, particularly PRGT-eligible countries (henceforth low-income countries or LICs). The new framework also has stronger analytical underpinnings given its systematic link to debt sustainability analyses (DSAs). It clarifies how and when flexibility should be exercised in a consistent way in setting debt limits.

2. **The new framework for concessionality requirements is based on a "Concessionality Matrix."** The latter is to be used for determining the type of concessionality requirement available to a member country based on an assessment of two characteristics that are particularly relevant in this context:[4]

- ***The extent of debt vulnerabilities***. A country where debt sustainability concerns are higher should adopt tighter debt limits. Conversely, if debt vulnerabilities are lower, looser limits could be considered, which could allow for some nonconcessional borrowing. DSAs are the instrument to assess the extent of debt vulnerabilities.

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[1] This guidance note was prepared by Christian Beddies, Era Dabla-Norris, Julien Hartley, Kenji Hosono, Kadima Kalonji, Annette Kyobe, Shannon Mockler, and Malaya Zumel. Overall guidance was provided by Dominique Desruelle and Hervé Joly.

[2] See IMF 2009: "Debt Limits in Fund-Supported Programs—Proposed New Guidelines" http://www.imf.org/external/pp/longres.aspx?id=4357, "Debt Limits in Fund-Supported Programs—Proposed New Guidelines—Supplementary Information and Proposed Decision" http://www.imf.org/external/pp/longres.aspx?id=4359, and "Debt Limits in Fund-Supported Programs—Proposed New Guidelines—Revised Proposed Decision, and " IMF Executive Board Reviews the Low-Income Country Debt Sustainability Framework and Adopts a More Flexible Policy on Debt Limits in IMF-Supported Programs," http://www.imf.org/external/np/sec/pn/2009/pn09113.htm.

[3] As used in this guidance note, the term "concessionality requirements" refers to both the approach under the previous guidelines on external debt that generally distinguishes between concessional and nonconcessional debt for purposes of the external debt limits in Fund-supported programs, and the related practice that has developed in a majority of cases of precluding LICs from borrowing on nonconcessional terms (or limiting such borrowing while not constraining concessional borrowing). Unless specified otherwise, debt limits and concessionality requirements refer to external debt throughout the note.

[4] See paragraphs 8(g) and (h), "Debt Limits in Fund-Supported Programs—Proposed New Guidelines—Supplementary Information and Proposed Decision" http://www.imf.org/external/pp/longres.aspx?id=4359.

- ***The country's capacity to manage public resources***. One of the virtues of the previous policy is that it requires limited capacity from country authorities. The methodology and information requirements are relatively simple. It is also easy to know where they stand regarding the attainment of their objectives on a continuous basis. This approach remains broadly appropriate for countries with low or moderate administrative capacity. However, countries with a strong track record of macroeconomic discipline and public financial management (including a strong capacity to identify and implement suitable projects), and where capacity is developed enough to handle directly the whole gamut of donors and creditors and their various financing instruments, can benefit from use of a more sophisticated approach.

Table 1. Concessionality Matrix

		Extent of debt vulnerabilities	
		Lower	**Higher**
Capacity	**Lower**	Minimum concessionality requirement based on the previous debt-by-debt approach, but with added flexibility on nonconcessional external debt (e.g., higher and untied nonzero limits, if consistent with maintenance of low debt vulnerabilities)	Maintain minimum concessionality requirement based on previous debt-by-debt approach, likely higher than 35 percent, with limited or no room for nonconcessional borrowing
	Higher	Minimum average concessionality requirement applied to external or total public borrowing; for most advanced LICs, no concessionality requirements and overall nominal debt limit if needed	Overall limit on the PV of external or total public debt; for most advanced LICs, ceilings on nominal external or total public debt

See IMF 2009: "Debt Limits in Fund-Supported Programs—Proposed New Guidelines" http://www.imf.org/external/pp/longres.aspx?id=4357.

3. **The authorities could choose to opt for tighter debt limits than implied by the concessionality matrix.**[5] Such a situation could arise, for instance, if the authorities felt that tighter debt limits were compatible with their policy objectives, but were easier to implement than more flexible options.

4. **The guidance provided in this note is primarily relevant for members who normally have access to concessional financing (i.e. LICs).** Consistent with the new

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[5] See IMF (2009) : "Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt," http://www.imf.org/external/pp/longres.aspx?id=4320.

policy, which aims at providing a path towards graduation from concessionality requirements, such requirements could be dropped for the most advanced LICs and members to whom concessional financing is normally not available (non-LICs), as discussed in Section V.[6]

5. **The new guidelines on debt limits in Fund-supported programs entered into effect on December 1, 2009**. Changes to performance criteria on external debt limits under existing Fund-supported programs for members whose status will change under the matrix approach would normally be reflected at the time of the first program review initiated after December 1, 2009.

6. **The guidance note is primarily intended for Fund staff and focuses on technical implementation issues pertaining to the new features in the guidelines.** A more concise and less technical description of the new policy on external debt limits in Fund programs is available on the Fund's external webpage on concessionality (http://www.imf.org/concessionality). This note is structured as follows. Section II defines "debt vulnerabilities" and "capacity." Section III covers debt limits in countries with lower capacity, including the size of nonconcessional debt limits. Section IV provides guidance on how to operationalize the new options for concessionality requirements available to countries with higher capacity. Section V deals with debt limits in advanced LICs and non-LICs. Section VI discusses the use of the residency or currency denomination criterion. Section VII provides guidance on setting and monitoring targets on total public debt. Section VIII covers the treatment of the debt of state-owned enterprises (SOEs).

II. Assessing Debt Vulnerabilities and Capacity

7. **The classification of a country as having lower or higher debt vulnerabilities should be based on the most recent DSA**. Countries with a low or moderate DSA risk rating will generally be in the lower vulnerability category, and those with a high risk rating (or in debt distress) in the higher vulnerability category. While this broad mapping of ratings and debt vulnerabilities is expected to be applied, judgment may need to be used in some cases. For instance, ratings are based on ratios for external public and publicly guaranteed (PPG) debt.[7] In cases where domestic public debt is assessed to increase debt vulnerabilities

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[6] See paragraphs 8(g) and (h), "Debt Limits in Fund-Supported Programs—Proposed New Guidelines—Supplementary Information and Proposed Decision" http://www.imf.org/external/pp/longres.aspx?id=4359.

[7] The ratings are determined as follows: **Low risk**. All debt indicators are well below relevant country-specific debt-burden thresholds. Stress testing and country-specific alternative scenarios do not result in indicators significantly breaching thresholds. In cases where only one indicator is above its benchmark, judgment is needed to determine whether there is a debt sustainability problem or some other issue, for example, a data problem. **Moderate risk**. While the baseline scenario does not indicate a breach of thresholds, alternative scenarios or stress tests result in a significant rise in debt-service indicators over the projection period (nearing thresholds) or a breach of debt or debt-service thresholds. **High risk**. The baseline scenario indicates a

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significantly, consideration could be given to shifting a country with a moderate rating to the higher debt vulnerability category.[8] When a country has no debt rating, for instance because its DSA was conducted using the framework for middle-income countries (non-IDA only countries that have significant market access), the assessment of debt vulnerabilities should be based on the main conclusions of the latest DSA.

8. **A first assessment of capacity was conducted in November 2009, in coordination with the World Bank, to place all program or near-program LICs in either the lower or the higher capacity category.** In a first step, a preliminary classification of higher and lower capacity was derived using sub-CPIA and PEFA indices and associated thresholds (see IMF 2009 "Debt Limits in Fund-Supported Programs—Proposed New Guidelines," http://www.imf.org/external/pp/longres.aspx?id=4357). A higher capacity classification required having a score above the threshold for each indicator; countries with both scores below the thresholds were placed in the lower capacity category. Countries that scored above the relevant threshold for one of the indicators, and below for the other, were placed in the "grey zone."[9] The second step involved a simultaneous assessment in a roundtable discussion with departments. Four criteria played a critical role in arriving at a final assessment of capacity: (i) a country's track record of accessing market financing and managing nonconcessional borrowing; (ii) the timely provision of debt data and the ability of the authorities to do their own DSA; (iii) the existence and satisfactory implementation of an articulated medium-term debt management strategy (MTDS); and (iv) the country's track record in selecting high-return public investment projects.[10]

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protracted breach of debt or debt-service thresholds but the country does currently not face any payment difficulties. This is exacerbated by the alternative scenarios or stress tests. **In debt distress**. Current debt and debt-service ratios are in significant or sustained breach of thresholds. The existence of arrears would generally suggest that a country is in debt distress, unless there are other reasons than debt-service burden for not servicing its debt. See "The Joint World Bank–IMF Debt Sustainability Framework for Low-Income Countries", http://www.imf.org/external/np/exr/facts/jdsf.htm.

[8] This may happen if domestic debt is relatively large or has other characteristics that increase risks (e.g., short maturity increasing rollover risks).

[9] As discussed in IMF 2009: "Debt Limits in Fund-Supported Programs—Proposed New Guidelines," http://www.imf.org/external/pp/longres.aspx?id=4357, the threshold for each guidepost is defined as the average score of countries classified as "blend" by IDA, i.e., LICs that are considered sufficiently creditworthy to borrow from IBRD. Currently this happens to correspond to the 75th percentile of each distribution in both cases.

[10] Information used in the assessment was drawn from Reports on the Observance of Standards and Codes (ROSCs), publicly available World Bank Debt Management Performance Assessments (DeMPA), self-assessments of debt management capacity made in the context of the HIPC Capacity Building Program (HIPC CBP), and staff's qualitative assessments on relevant issues.

9. **Annual stock-taking exercises will subsequently be conducted.** The main issue will be to determine whether developments in the course of the preceding year warrant a change in classification. These developments could be reflected in the most recent sub-CPIA or PEFA assessments, or in any other relevant source of information. In this regard, the annual updates will provide an opportunity for the authorities to make the case for a different classification. Individual changes can be considered intra-annually on a case-by-case basis.[11] The two-step process will have to be followed for countries which have not previously been assessed (see Annex 1).[12]

III. Debt Limits in Lower-Capacity Countries

10. **For lower capacity countries, concessionality requirements continue to apply debt by debt, but more flexibly for countries with lower debt vulnerabilities.**[13] This section clarifies how to exercise this flexibility and use DSAs actively in this process.

A. Countries with higher debt vulnerabilities

11. **Debt limits are expected to be tighter in these countries than in countries with lower debt vulnerabilities and higher capacity.** The minimum concessional requirement should be consistent with the results of the DSA, and a grant element higher than 35 percent may be required on a case-specific basis. The minimum concessionality requirement needs to reflect the projected average grant element in the DSA during the program period, which in turn would take account of the need to mitigate debt vulnerabilities.

12. **Nonconcessional borrowing should be exceptional in these countries.** Exceptions include cases where concessional financing is not available for a critical and highly profitable project included in the authorities' development strategy. Projects to be financed by nonconcessional borrowing would generally be expected to have been carefully evaluated by a reputable source (e.g., the World Bank or a Regional Development Bank).[14] There could

[11] The possibility of a reclassification from the higher to the lower category cannot be ruled out if capacity deteriorates. This could happen, for instance, if a country has proved unable to implement the more flexible options satisfactorily.

[12] The latest classification of program LICs can be found at http://www.imf.org/external/np/pdr/conc/.

[13] The methodology used to assess concessionality, including the treatment of integrated financing packages, remains unchanged as outlined in "Debt Limits in Fund-Supported Programs—Proposed New Guidelines—Supplementary Information and Proposed Decision" http://www.imf.org/external/pp/longres.aspx?id=4359. A grant element calculator is available at: http://www.imf.org/external/np/pdr/conc/index.htm.

[14] Such projects would normally be expected to be relatively large, thus justifying the use of independent evaluators. In the case of smaller projects, a full-scale independent evaluation may not be feasible. In these cases, country teams are expected to ascertain that due diligence has been exercised in the selection of the projects (e.g., these projects are listed as priority projects in the country's development strategy; an in-house feasibility study was conducted).

also be exceptional cases where financing with a grant element below the concessionality requirement could be allowed based on the debt structure, borrowing costs, and other debt management considerations. Such exceptions should take into account various market risks (including exchange rate risk) and be based on a comprehensive analysis of the project to be financed. In any event, the DSA should confirm that nonconcessional borrowing will not result in a significantly and persistent increase in debt vulnerabilities.

B. Countries with lower debt vulnerabilities

13. **Space for nonconcessional borrowing can be considered more systematically for countries with lower debt vulnerabilities.**[15] A minimum concessionality requirement of 35 percent will be set, but a certain amount of nonconcessional borrowing could be exempt from this requirement. A general principle for determining the size of this "nonzero limit" on nonconcessional borrowing is that it should not be so large that, if fully used, it would push a country into the higher debt vulnerability category. The impact of such borrowing should be carefully assessed through an interactive process between the DSA and the fiscal framework. Debt management considerations (e.g., substitution of external debt for domestic debt) could also be taken into account. The assessment should be based on realistic assumptions for nonconcessional financing *beyond* the period for which a nonzero limit is proposed. A profile where nonconcessional borrowing is very large upfront and then decreases rapidly would generally not be considered realistic unless nonconcessional resources are used to finance upfront very lumpy and critical infrastructure projects.

14. **This approach should be complemented by a "speed bump" in some cases**. In countries with large borrowing space—such as post-MDRI countries where debt ratios are far below their DSF thresholds in the baseline and alternative scenarios—the rule proposed in the previous paragraph may leave excessive room for borrowing, including from an absorptive capacity perspective. In such cases it is appropriate to use a "speed bump", i.e., an indicative limit on the maximum pace at which debt ratios can rise (in present value terms). The suggested speed bump is 5 percent of beginning-of-period GDP annually but may be lower if country circumstances warrant it.[16] For countries where borrowing above this limit is contemplated, the DSA should include a detailed explanation of the expected growth dividend and include an alternative "high borrowing-low growth dividend" scenario.

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[15] Some of these countries already enjoyed significant space under past policy and practice. For such countries, the new policy may not systematically lead to increased space for nonconcessional borrowing in the near future.

[16] The same speed bump is used in the debt sustainability framework (DSF), IMF 2009: "Debt Limits in Fund-Supported Programs—Proposed New Guidelines" http://www.imf.org/external/pp/longres.aspx?id=4357, and IMF 2006:"Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief" http://www.imf.org/external/np/pp/eng/2006/110606.pdf.

15. **A distinction should be made between countries with low and moderate risk ratings in setting nonzero limits.** The general principle proposed in paragraph 13 rules out a downgrading of the risk rating for moderate-risk countries, but not for low-risk countries. In practice, this implies that countries just above and below the boundary between low risk and moderate risk should be accorded similar flexibility. Rating downgrades for low-risk countries on account of a nonzero limit are, however, expected to be rare. In addition, for moderate-risk countries, nonzero limits should not bring debt ratios in the baseline scenario to a level where it would take only a small shock to lead to a rating downgrade.

16. **Untied nonzero limits may be used for countries with relatively higher capacity levels within this group.** Unlike tied limits, which are associated with specific expenditures or projects which can, and are expected to, be evaluated ex-ante by a reputable source, untied limits allow a country to borrow nonconcessionally for a use which is not fully specified ex ante in program conditionality. From a debt sustainability perspective, this is a more risky form of nonconcessional borrowing which should be considered only for countries where capacity is deemed sufficient.[17] Thus, it would be expected that (i) the sub-CPIA and PEFA scores are close to the thresholds used to distinguish lower and higher capacity, and (ii) other evidence (e.g., the country's experience in choosing projects with high returns) would confirm that the country in question is able to direct such nonconcessional borrowing to projects that are likely to yield a sufficiently high growth dividend. With respect to (i), countries could qualify for untied limits if both their sub-CPIA score and PEFA score are within the average of the blend countries minus one-half standard deviation. Countries whose classification between the lower and higher categories was debated in the second step of the capacity assessment process could also be considered.[18]

17. **Proposed tied or untied nonzero limits should be explicitly discussed in the DSA,** including the terms and purpose of the envisaged nonconcessional borrowing. If terms are unknown, which could potentially be the case for untied limits, staff is strongly encouraged to use conservative assumptions, i.e., either market terms if these are known or a zero grant element.[19]

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[17] Although the use of an untied limit need not be specified ex ante, it does not mean that there should be no discussion between staff and the authorities on this issue. For instance there may be circumstances in which staff is of the view that issuing a sovereign bond is not advisable, and in that case any untied limit would not be expected to be used for that purpose. In some cases, a gradual approach to untied limits may be appropriate, i.e., the overall envelope for nonconcessional financing may be split into a tied and an untied component to allow the authorities to gain experience with untied limits before increasing their size.

[18] The thresholds are 3.67 for the sub-CPIA index, and 2.64 for the PEFA index, corresponding to the average score for countries classified "blend" by IDA.

[19] A zero grant element using the DSA methodology does not necessarily imply a zero grant element using the standard concessionality calculation because of differences in the discount rate. Also, a zero grant element according to the standard concessionality calculation may still imply more favorable terms than under the DSA

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IV. Debt Limits in Higher-Capacity Countries

18. **The more sophisticated options for concessionality requirements in higher-capacity countries do not rely on a debt-by-debt assessment and thereby provide significantly more flexibility**. This section explains how to set and monitor targets on the accumulation of debt in present value terms (PV targets) and on the average concessionality of new debt.[20]

A. Setting and monitoring PV targets for countries with higher debt vulnerabilities

19. PV targets are expected to be used for higher-capacity countries with higher vulnerabilities because they limit overall debt accumulation, while still leaving some margin for maneuver to the authorities regarding the structure of borrowing.[21]

20. **PV targets should be set as annual indicative targets and derived from the DSA.** While targets in LICs with Fund-supported programs are typically set semi-annually to coincide with six-monthly program reviews, PV or average concessionality targets will preferably be set on an annual basis as they derive from DSAs that use annual data. To the extent that sufficiently reliable information is available on the timing of external financing operations, the annual target could be complemented by semi-annual or quarterly "guideposts" to facilitate assessments of whether the authorities are on track to meet the annual targets. To allow time for staff and members to gain more familiarity with the use of these targets, PV and average concessionality targets will generally be established as annual indicative targets (rather than performance criteria) under Fund arrangements for a transitional period of two years from the effective date of the decision (December 1, 2009). Targets should be derived from the path of the PV of debt in the DSA's baseline scenario, which should be consistent with the macroeconomic framework and debt sustainability. Detailed guidance on where to find the relevant information in the DSA template is provided in Annex 2.

21. **Monitoring requires timely and comprehensive information on expected disbursements during the period covered by the target.[22]** Information should cover disbursements out of both existing and new loans. All disbursements should then be

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methodology. More conservative assumptions in the DSA, reflecting market terms, may therefore be appropriate.

[20] As pointed out above, the authorities could choose to opt for tighter debt limits (applicable to lower-capacity countries).

[21] While external debt distress ratings in DSA are based on various debt and debt service ratios, PV targets are to be set in dollar terms.

[22] See Section IV.C. for a discussion of setting targets on the basis of debt *contracted*, rather than disbursed.

aggregated to calculate a PV based on the DSF methodology; a new sheet was added to the DSF template to facilitate this (see Annex 2). Accordingly, TMUs should include reporting requirements on external debt allowing for such calculations. It should be highlighted that, for the authorities to know whether they are on track to meet their PV target in the course of the year, close and regular monitoring of actual and projected disbursements will be required (including both amounts and their terms). Updated projections and calculations should be regularly shared with staff. Country teams should actively monitor the implementation of the annual targets throughout the year and report to the Board in the context of program reviews on whether targets are expected to be met. Adjustments to the targets, for example in cases where donors' actual disbursements deviate significantly from projected disbursements, can be proposed in program reviews, if necessary.

B. Setting and monitoring average concessionality targets for countries with lower debt vulnerabilities

22. **In contrast to PV targets, average concessionality targets do not limit total borrowing.** In principle, a country could borrow unlimited amounts under this approach as long as financing is sufficiently concessional on average. In practice, the limited availability of concessional resources makes such a situation highly hypothetical. However, should an average concessionality requirement lead to excessive borrowing, thereby jeopardizing debt sustainability, a PV target could be used instead.

23. **Setting and monitoring an average concessionality target requires basically the same steps as for a PV target.** The DSA can provide directly a target, by comparing the projected PV of new disbursements with their nominal value (see Annex 2). Monitoring requires the same information and steps as for a PV target, and data requirements are identical.[23] Active monitoring of whether the authorities are on track to meet their target also requires updating regularly their projections of new disbursements and associated terms.

C. Contracting vs. disbursements

24. **PV targets and average concessionality requirements can be based either on disbursements or contracting of debt.** The former option has the advantage of a closer link to the DSA, which is based on disbursements, making the setting of a target relatively easy; the latter option is more complex at the target-setting stage, but simpler at the monitoring stage, as there are typically more disbursements than debts contracted over any period of time. Both options are available for countries with higher capacity.[24]

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[23] A difference in the process of setting and monitoring PV targets or average concessionality targets is the treatment of grants in certain circumstances. See Section IV.D.

[24] The worksheet described in Annex 2 allows for both options.

25. **Targets based on contracting should be set consistent with the DSA.** The principle is to calculate the PV of the new debt expected to be *contracted* (instead of *disbursed*) over the period, assuming full upfront disbursement of debt at the time of contracting. Under the contracting approach, a loan therefore contributes to an annual PV target on debt accumulation only in the year during which it is contracted. Under the disbursement approach, the same loan may contribute to PV targets over several years through staggered disbursements. For a PV target based on contracting, consistency with the DSA means (i) taking into account all debts included in the DSA (and only those debts) and projected to be contracted during the period under consideration; and (ii) using DSA methodology to calculate the aggregate PV (see Annex 2).

D. Treatment of grants

26. **Grants are not explicitly taken into account when setting targets under either option**. PV targets or average concessionality targets are based on PVs calculated in DSAs. By definition, these PVs are not directly affected by grants, whose PV is equal to zero.[25]

27. **Grants may need, however, to be taken into account in the monitoring of average concessionality targets.** If the monitored financing mix focused only on loans, perverse incentives could be created. A country in which a projected grant turns out to be a concessional loan would suddenly have more space to take on nonconcessional debt—worsening its financing profile on both counts. Conversely, a country could be penalized for getting a grant where a concessional loan was initially expected. This seems, however, to be a largely theoretical issue. In practice, countries have limited choice on whether to get a grant or a loan from a donor, as this decision is generally driven by the donor's own policies. Should this issue arise and sufficiently detailed information be available, adjustments could be made at the monitoring stage for such substitutions involving grants. Should the issue of substituting grants with concessional loans be considered significant and insufficient information be available to make adjustments, a shift to a PV target would be desirable.

V. Debt Limits for Advanced LICs and Non-LICs

28. **For the most advanced LICs, concessionality requirements could be dropped in Fund-supported programs.** These countries, in addition to being assessed as higher capacity, would be expected to have per capita income above the IDA operational cutoff, a strong track record of macroeconomic and public resource management, and sustained past and prospective access to nonconcessional financing from capital markets and official lenders.

[25] However, grants do play a role upstream in the macroeconomic framework, by reducing borrowing requirements.

29. **Concessionality requirements are not expected to be included in Fund-supported programs for non-LICs.** This reflects the fact that such countries, because of their higher per-capita income, generally have limited or no access to concessional financing. Having concessionality requirements in this context would therefore be largely irrelevant. This presumption is also consistent with the philosophy behind the concessionality matrix for LICs, which provides a path towards graduation from concessionality requirements.[26]

30. **Even in programs without concessionality requirements, however, debt limits may still be considered**. If debt vulnerabilities remain high, or if the coverage of the public sector in the fiscal accounts is narrow, debt ceilings on nominal external or total public debt, or in some cases sub-ceilings on specific types of debt, could be contemplated, consistent with the fiscal framework.

VI. The Criterion for Defining "External" Debt

31. **In defining "external" debt, the new guidelines move away from the exclusive use of the residency criterion to define debt subject to concessionality requirements**.[27] The increasing role of nonresidents in domestic debt markets in a number of LICs has blurred the traditional distinction between external and domestic debt. In addition, information on transactions involving nonresidents is generally incomplete or unduly delayed, raising the issue of whether a debt limit based on the residency criterion can be monitored. Finally, such transactions are typically not under the control of the authorities, and concessionality requirements should not be designed in such a way that they can be met only through the use of capital controls. In this context, a broader issue is whether it is desirable to curb such transactions, for example from a market development perspective.

32. **For the more advanced LICs and non-LICs with an open capital account, the focus of debt limits, if any, should be on total public debt,** obviating the need to distinguish between external and domestic debt. A distinction of debt based on characteristics (e.g., currency of denomination), may however still be desirable from an external vulnerability standpoint, even if not applied for debt limits purposes.

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[26] In principle, concessionality requirements could be considered in certain non-LICs. There could be (unlikely) situations where a non-LIC receives substantial concessional financing, making concessionality requirements potentially relevant. In such a case, the considerations used to determine which option is most appropriate for LICs—i.e., the extent of debt vulnerabilities and capacity—would apply similarly to ensure uniformity of treatment. The extent of debt vulnerabilities would be assessed based on the main findings of the DSA. Likewise, the assessment of capacity would be based on the sub-CPIA and PEFA to the extent these are available and all other available relevant information.

[27] The approach for debt limits does not modify the approach under other Fund policies involving external debt (e.g., the lending into arrears policy and exchange restrictions under Article VIII). For these policies, the residency criterion remains relevant for these other policies.

33. **For LICs with relatively closed capital accounts or very limited financial integration with the rest of the world, the use of the residency criterion remains appropriate.** Nonresident acquisition of domestically-issued debt in the secondary market is expected to be very limited and could then be systematically excluded from concessionality requirements to address monitoring issues.

34. **In such cases, additional vulnerabilities stemming from transactions with nonresidents need to be addressed in the program**. To that effect, safeguards should be applied on a case-by-case basis taking into account country circumstances. These safeguards should ensure that:

- The program relies on an appropriately broad concept for the fiscal deficit performance criterion, to close any definitional loopholes;
- All new borrowing on the domestic market should normally be in local currency;
- Relevant changes are made in the program's design (e.g., higher NIR targets), if needed to mitigate vulnerabilities associated with significant nonresident holdings of domestic debt;
- Any such transactions are fully reflected, to the extent possible, in the external DSA, including with an explicit assessment of the vulnerabilities potentially associated with them (e.g., higher rollover risk in the case of short-term borrowing, a potential threat to the exchange rate and/or reserves in the event of sudden withdrawals);
- The authorities report to the Fund the terms of new domestic borrowing, including the currency composition, and take steps over time to improve their monitoring of secondary market transactions; and
- The authorities are not signatories in transactions that involve the immediate repackaging of domestic debt instruments for the sole purpose of reselling the repackaged instruments to nonresidents.

35. **For LICs in an intermediate situation, a currency of denomination criterion could be used.** For these countries, a system based on residency with exclusions may lose its internal coherence if the debts excluded from the application of the residency criterion become large. In such cases, concessionality requirements could be applied to foreign-currency denominated debt regardless of the residency of the creditor. Country teams should also be mindful of the possibility that domestic debt could be foreign currency indexed or that the repayment currency may not be the same as the issue currency. The additional measures and safeguards mentioned above to address risk arising from large nonresident inflows into domestic-currency debt may also need to be considered.

VII. Setting and Monitoring Targets on Public Debt

36. This section provides recommendations on how to set and monitor targets on total public debt on a case-by-case basis for countries with higher capacity.

37. **Public debt is a more comprehensive concept, and therefore more relevant from the perspective of debt management and fiscal sustainability, than external debt alone.** Setting limits on public debt also addresses the issue of the increasingly blurred distinction between external and domestic debt in some LICs. However, it raises a number of operational issues, such as the definition of public debt (e.g., treatment of domestic arrears, inclusion of subnational government debt, and central government domestic guarantees), whether the required information is available, comprehensive, and timely, and whether DSAs provide sufficient guidance on how to set limits. At this juncture, the recommendation is that such targets could be tried in specific cases where the potential problems are considered manageable by the country teams and the authorities.

38. **The public DSA can be used to set a PV or a nominal target for total public debt.** The latter is defined in the template as the sum of PPG external debt and domestic debt of the government. The template generates a PV for this aggregate by assuming that the PV of domestic debt is equal to its face value. The process for setting and monitoring a PV target on total public debt is identical to that for PPG external debt. As for PPG external debt, the targets should be derived from a baseline scenario consistent with the macroeconomic framework and where public debt appears sustainable.

39. **This approach has a number of limitations, which should be kept in mind.** First, the coverage of total public debt in fiscal accounts is generally limited. In particular, it does not include all the domestic debt of the public sector. Moving to a broader coverage, however, would raise challenging monitoring issues. Second, in addition to budget financing, domestic debt is often used to conduct monetary policy, manage the exchange rate, or support the development of domestic financial markets. These objectives should be kept in mind when setting the targets. Third, when the coverage of fiscal accounts is actually broad, there may not be significant benefits in having a nominal total debt target compared with having a target on the fiscal deficit.[28] Fourth, targets on total public debt do not address potentially important issues related to the composition of debt. They may need to be complemented by separate targets on external or domestic debt/financing. In practice, this is equivalent to setting targets on external and domestic debt/financing. Lastly, measuring domestic debt on a gross basis may not always be meaningful when governments hold large and variable deposits in the banking system, and the way treasury operations are managed

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[28] However, while deficit targets in countries with broad coverage do work as a proxy for debt vulnerabilities, debt level changes may reflect large valuation changes or proceeds from net asset sales not covered in the fiscal balance.

may lead to fluctuations in gross debt levels. In such cases, net domestic debt may be more relevant (and controllable).

VIII. Treatment of SOEs in Debt Limits

40. **Public enterprises and other official sector entities should be covered by external debt limits established under Fund arrangements, unless an explicit selective exclusion is made in the TMU.**[29] A case for selective exclusion can be made for public enterprises and other official sector entities that are in a position to borrow without a guarantee of the government and whose operations pose limited fiscal risk to the government.[30] The objective is to avoid constraining inappropriately their operations and potentially hampering investment.

41. **Exclusions should be based on the following considerations.** First, as much information as possible should be gathered on the concerned enterprise, regarding its managerial independence; relations with the government; the periodicity of audits; publication of comprehensive annual reports and protection of shareholders' rights; financial indices and sustainability; and other risk factors. A detailed list of indicators is available in Annex 3. Second, acknowledging that comprehensive information on SOEs may not be readily available in LICs, earlier Fund staff work pointed out two criteria that should be binding in the determination of fiscal risks. An enterprise should be judged to have a high risk if it carries out uncompensated quasi-fiscal activities and if it has negative operating balances. By contrast, enterprises could be deemed to have a low fiscal risk even if they do not meet all the criteria listed in Annex 3 or when not all necessary information is available, for example based on their financial strength.

[29] This treatment of SOEs is consistent with the treatment under the DSF.

[30] SOEs that require a sovereign guarantee to borrow externally are automatically covered under the debt-limits policy.

ANNEX 1: THE CAPACITY ASSESSMENT PROCESS

42. **Annual capacity assessment updates are expected to be lighter exercises than the initial assessment conducted in 2009.** In particular, since most program countries will already have been classified the previous year, there will be no need to follow the two-step process described in IMF (2009): "Debt Limits in Fund-Supported Programs—Proposed New Guidelines" http://www.imf.org/external/pp/longres.aspx?id=4357, for these countries. Rather, the main issue will be to determine whether developments in the course of the preceding year warrant a change in classification. These developments could be reflected in the most recent sub-CPIA or PEFA score, or in any other relevant source of information. In this regard, the annual updates will provide an opportunity for the authorities to make the case for a different classification.[31] The annual update could also be an opportunity to discuss any cross-country issues arising from the implementation of the new system, such as the experience with the new options (e.g. PV targets, untied limits, nominal ceilings, average concessionality). The two-step process will only be followed for countries which have not previously been assessed.

43. **The assessment of capacity is coordinated with the World Bank as much as possible.** To facilitate coordination, assessment updates will be synchronized and a reconciliation/dispute resolution process will be available. Annual updates are expected to take place around midyear. Classifications of countries needing to be assessed by both institutions will be shared immediately after the updates. If there are discrepancies, a reconciliation meeting should be held within 5 working days following the exchange of classifications. The meeting will include representatives of central units **and the concerned area departments/regions. The objective would be to reconsider the classification of these countries with** a view to reaching an agreement. If no agreement is reached, the managements will, within five working days, either resolve the dispute or decide that the institutions will have different views. These cases are expected to be rare.

Ad hoc intra-annual assessments

44. **While reclassifications are expected to take place at the time of the annual updates, individual changes can be considered intra-annually on a case-by-case basis.** Ad hoc intra-annual assessments cover two situations: (i) countries not assessed by the Fund originally but which subsequently become program countries in the course of the year; and (ii) countries where a major development warrants a reconsideration of the capacity assessment between annual updates.

[31] The possibility of a reclassification from the higher to the lower category cannot be ruled out if capacity deteriorates.

Annex 2: Setting and Monitoring PV and Average Concessionality Targets on External Debt Using the DSF Template

45. This annex provides a step-by-step description of the setting and monitoring of PV and average concessionality targets on external debt both for the disbursement- and the contracting-based options. A new sheet labeled "PV Targets" has been added to the DSF template to allow for that and which is available at:
http://www.imf.org/external/pubs/ft/dsa/templ/dsatemp.xls
to conduct the DSA and set the PV or average concessionality targets.

A. Disbursement-based targets

Step 1: Setting the PV or average concessionality target

46. Assumptions on disbursement schedules and terms are taken directly from the DSA (sheet 'Inp_Outp_debt' Section 3 NEW MLT DEBT), and are used to calculate the PV and average concessionality targets (see screenshot 1). It is critical to use terms and amounts that reflect staff's best knowledge of the country authorities' borrowing plans, as they will directly impact the PV and grant element targets. To ensure that projected disbursements at the target setting stage are converted at the same exchange rates as actual disbursements at the monitoring stage, country teams need to record DSA exchange rates (see step 2 below).

Screenshot 1:

	A	B	C	D
1		**DISBURSEMENT BASED**		click here to go to th
2				
3		**SETTING THE TARGET**		
4		**Disbursement-based target setting**	**2010**	**2011**
5		**Total PV of new MLT debt (in billions of USD)**	**0.31**	**0.35**
6		**Average Grant element of new disbursements**	**32.52%**	**33.33%**
7				
8		**Multilaterals**	0.233	0.282
9		IMF	0.002	0.002
10		IDA	0.038	0.038
11		...	0.000	0.000
12		...	0.000	0.000
13		Other Multilateral	0.192	0.242
14				
15		**Official Bilaterals**	0.060	0.048
16		PC	0.045	0.030
17		...	0.000	0.000
18		...	0.000	0.000
19		Others Paris Club	0.045	0.030
20		NPC	0.016	0.018
21		...	0.000	0.000
22		...	0.000	0.000
23		Others Non Paris Club	0.016	0.018
24				
25		**Commercial**	0.020	0.020
26		...	0.000	0.000
27		...	0.000	0.000
28		Others Commercial	0.020	0.020
29				
30		PV of new disbursements PPG	0.313	0.351
31		Grant element of new disbursement (percent)	32.52	33.33
32				

Step 2: Monitoring the target

47. The user needs to specify the terms and conditions of each actual disbursement. To be consistent with the DSF methodology, each disbursement is treated as a separate loan to which the terms specified in the original loan document are applied. It is critical that the exchange rates used to convert each disbursement into U.S. dollars are identical to those used at the target setting stage. Thus, exchange rates need to be entered in the exchange rate block of the sheet (click on the “Change Exchange Rates” button). In addition, interest rates, maturity, grace period and number of principal payments per year need to be entered in the yellow shaded areas (see screenshot 2 below). This information will be used to calculate the

PV and average concessionality of the actual disbursements to be compared to the target as set in step 1 above.

Screenshot 2:

	A	B	C	D	E	F	G
35		**MONITORING THE TARGET**					
36		**Disbursement-based monitoring**	**2010**	**2011**	**Click here to enter exchange rate assumptions**		
37		**Total PV (in billions of USD)**	**0.26**				
38		**Average Grant Element**	**32.88%**				
39							
40		**LOAN TERMS**	**Currency (select from list)**	**Interest Rate**			
41							
42		**Multilaterals**					
43		IMF	SDR	0.50%	10	5	2
44		IDA	USD	0.75%	40	10	2
45		(Multilateral1)	USD				
46		(Multilateral2)	USD				
47		(Multilateral3)	USD	1.00%	20	10	2
48							
49		**Official Bilateral**					
50		(PC1)	USD	3.00%	20	7	2
51		(PC2)	USD				
52		(PC3)	USD				
53		(PC4)	USD				
54		(PC5)	USD				
55		(Non-PC1)	USD	2.00%	20	10	2
56		(Non-PC2)	USD				
57		(Non-PC3)	USD				
58		(Non-PC4)	USD				
59		(Non-PC5)	USD				
60							
61		**Commercial**					
62		(Commercial1)	USD	4.00%	6	1	2
63		(Commercial2)	USD				
64		(Commercial3)	USD				
65							

48. The amount of each disbursement in original currency is entered separately (see screenshot 3 below).

Screenshot 3:

	A	B	C	D
68		**Face Value of Disbursements**		
69		**(in billions of loan currency units)**		
70			**2010**	**2011**
71		**Multilaterals**		
72		IMF	0.002	
73		IDA	0.100	
74		(Multilateral1)	0.000	
75		(Multilateral2)	0.000	
76		(Multilateral3)	0.200	
77				
78		**Official Bilateral**		
79		(PC1)	0.050	
80		(PC2)	0.000	
81		(PC3)	0.000	
82		(PC4)	0.000	
83		(PC5)	0.000	
84		(Non-PC1)	0.015	
85		(Non-PC2)	0.000	
86		(Non-PC3)	0.000	
87		(Non-PC4)	0.000	
88		(Non-PC5)	0.000	
89				
90		**Commercial**		
91		(Commercial1)	0.020	
92		(Commercial2)	0.000	
93		(Commercial3)	0.000	
94				

Step 3: Comparing the PV and average concessionality of projected loan disbursements to the targets

49. The terms and amount of each disbursement are used to calculate the PV and average grant element of the disbursement in a given year (screenshot 4). The sum of the PVs of all disbursements and the average grant element appear at the top of the "Monitoring the Target" box (screenshot 2) and are to be compared to the corresponding targets atop the "Setting the Target" box (screenshot 1).

Screenshot 4:

	A	B	C	D
96				
97		**PV of Disbursements (in billions of USD)**		
98				
99			**2010**	**2011**
100		**Multilaterals**		
101		IMF	0.001	0.000
102		IDA	0.050	0.000
103		(Multilateral1)	0.000	0.000
104		(Multilateral2)	0.000	0.000
105		(Multilateral3)	0.132	0.000
106				
107		**Official Bilateral**		
108		(PC1)	0.045	0.000
109		(PC2)	0.000	0.000
110		(PC3)	0.000	0.000
111		(PC4)	0.000	0.000
112		(PC5)	0.000	0.000
113		(Non-PC1)	0.012	0.000
114		(Non-PC2)	0.000	0.000
115		(Non-PC3)	0.000	0.000
116		(Non-PC4)	0.000	0.000
117		(Non-PC5)	0.000	0.000
118				
119		**Commercial**		
120		(Commercial1)	0.020	0.000
121		(Commercial2)	0.000	0.000
122		(Commercial3)	0.000	0.000
123				
124				
125				
126		**Grant Element of Disbursements**		
127				
128			**2010**	**2011**
129		**Multilaterals**		
130		IMF	23.47	0.00
131		IDA	50.31	0.00
132		(Multilateral1)	0.00	0.00
133		(Multilateral2)	0.00	0.00
134		(Multilateral3)	33.90	0.00
135				
136		**Official Bilateral**		
137		(PC1)	10.41	0.00
138		(PC2)	0.00	0.00
139		(PC3)	0.00	0.00
140		(PC4)	0.00	0.00
141		(PC5)	0.00	0.00
142		(Non-PC1)	22.60	0.00
143		(Non-PC2)	0.00	0.00
144		(Non-PC3)	0.00	0.00
145		(Non-PC4)	0.00	0.00
146		(Non-PC5)	0.00	0.00
147				
148		**Commercial**		
149		(Commercial1)	0.00	0.00
150		(Commercial2)	0.00	0.00
151		(Commercial3)	0.00	0.00
152				

B. Contracting-based targets

Step 1: Setting the PV or average concessionality target

50. Information on new borrowing expected to be contracted over the period is to be obtained from the country authorities and entered in the yellow shaded areas (see screenshot 5) for the first year of projection. This includes the face value of the loan, interest rate, maturity, grace period and number of principal payments per year. It is critical to use terms and amounts that reflect staff's best knowledge of the country authorities' borrowing plans, as they will directly impact the PV and grant element targets. In addition, to ensure that projected loans to be contracted at the target setting stage are converted at the same exchange rates as actual disbursements at the monitoring stage, country teams need to enter the DSA exchange rates (see step 2 below).

Screenshot 5:

CONTRACTING BASED

SETTING THE TARGET

Contracting-based target setting	**2010**
Total PV (in billions of USD)	**6.96**
Average Grant Element	**29.33%**

Click here to enter exchange rate assumptions

	Currency (select from list)	Face Value (in billions of loan currency units)	Interest Rate	Maturity	Grace Period	Payments per annum
Multilaterals						
IMF	SDR	0.600	0.50%	10	5	2
IDA	USD	2.250	0.75%	40	10	2
...	USD					
...	USD					
Other Multilateral	USD	4.600	1.00%	20	10	2
Official Bilaterals						
PC						
...	SDR					
...	USD					
Others Paris Club	USD	1.500	3.00%	20	7	2
NPC						
...	USD					
...	USD					
Others Non Paris Club	USD	1.100	4.00%	15	5	2
Commercial						
...	USD					
...	USD					
Others Commercial	USD					

Step 2: Monitoring the target

51. In the course of the year, the user enters the terms and amounts of contracted loans. As under the disbursement approach, it is important that the exchange rates used to convert each disbursement into U.S. dollars are identical to those used at the target setting stage. Thus, exchange rates need to be entered in the exchange rate block of the sheet (click on the "Change Exchange Rates" button). Additional information that needs to be entered includes interest rates, maturity, grace period and number of principal payments per year (see yellow shaded areas in screenshot 6 below). This information is used to calculate the PV and average grant element of the contracted loan. PVs and grant elements are then aggregated for comparison with the targets.

Screenshot 6:

	A	B	C	D	E	F	G	H
191		**MONITORING THE TARGET**						
192		**Contracting-based monitoring**	**2010**	Click here to enter exchange rate assumptions				
193		**Total PV (in billions of USD)**	**6.41**					
194		**Average Grant Element**	**29.49%**					
195								
196		**Creditors**	**Currency (select from list)**	**Face Value (in billions of loan currency units)**	**Interest Rate**	**Maturity**	**Grace Period**	**Payments per annum**
197		**Multilaterals**						
198		IMF	SDR	0.600	0.50%	10	5	2
199		IDA	USD	1.500	0.75%	40	10	2
200		IDA2	USD	0.750	0.75%	40	10	2
201		(Multilateral1)	USD	4.000	1.00%	20	10	2
202		(Multilateral2)	USD					
203								
204		**Official Bilateral**						
205		(PC1)	USD	1.450	3.00%	20	7	2
206		(PC2)	USD					
207		(PC3)	USD					
208		(PC4)	USD					
209		(PC5)	USD					
210		(Non-PC1)	USD	1.000	4.00%	15	5	2
211		(Non-PC2)	USD					
212		(Non-PC3)	USD					
213		(Non-PC4)	USD					
214		(Non-PC5)	USD					
215								
216		**Commercial**						
217		(Commercial1)	USD					
218		(Commercial2)	USD					
219		(Commercial3)	USD					
220								

ANNEX 3: INDICATORS FOR THE EXCLUSION OF SOEs

52. The following indicators are intended to help guide the decision to exclude a particular SOE:

- **Managerial independence, including pricing and employment policies**. Relevant criteria include: i) cost-covering price setting for non-tradables; ii) average prices within 10 percent of the international benchmark for producers of tradables; and iii) a tariff setting regime compatible with the long-term sustainability of the SOE in regulated sectors, which is comparable to private firms in the sector. Employment policies should be independent of civil service laws and should not be subject to intervention by the government in wage setting and hiring, except when clearly justified to address specific risks.

- **Relations with the government,** including i) the existence of direct or indirect subsidies, on-lending by the government and/or explicit or implicit loan guarantees that go beyond those given to private enterprises; ii) quasi-fiscal activities such as uncompensated functions or absorbed costs which are not directly related to the SOE's business objective and/or substituted for government spending (e.g. subsidies to the public given directly by the SOE compensated with government transfers); (iii) the nature of the regulatory and tax regimes, wherein the SOE should be subjected to the same standards as private firms in the industry; and (iv) the frequency of profit transfers from the SOE to the central budget.

- **Periodic audits.** There should be periodic audits carried out and published by a reputable private accounting firm applying international standards. A major international firm should ideally audit large public enterprises.

- **Publication of comprehensive annual reports and protection of shareholders' rights**. Published annual reports should include i) audited balance sheets; ii) profit and loss statements; iii) off-balance sheet liabilities; iv) levels and changes in the enterprise's overall activity; v) employment and investment; and vi) comparisons against other firms in the industry and international benchmarks. Moreover, the governance structure should allow for the appropriate protection of minority shareholder rights.

- **Financial conditions and sustainability.** Relevant indicators include: i) market access, including industry-wide comparable costs of debt and borrowing rates comparable to private firms without a government loan guarantee; ii) less-than-full leveraging entailing a debt-to-asset ratio comparable to the industry average; iii) profitability, defined as operating balance to assets ratio, or defined as a positive ratio and higher than the average cost of debt in cases where there is no relevant comparator; and iv) records and evaluations of past investments, demonstrating an average rate of return at least equivalent to that required by cost-benefit analyses to approve new projects.

- **Other risk factors**, include but are not limited to, vulnerabilities stemming from i) contingent liabilities relative to its operating balance; ii) currency mismatches between the SOE's main sources of revenue and its debt; and iii) the importance of the public enterprise, as defined by size (e.g. debt service, employment, customer base, sales) and/or function (e.g. the provision of essential inputs or services).