



IMF POLICY PAPER

2016 POVERTY REDUCTION AND GROWTH TRUST— REVIEW OF INTEREST RATE STRUCTURE

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- The **Staff Report** on Poverty Reduction and Growth Trust—Review of Interest Rate Structure was prepared by IMF staff and completed on August 24, 2016 for the Executive Board’s consideration on October 3, 2016.

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POVERTY REDUCTION AND GROWTH TRUST—REVIEW OF INTEREST RATE STRUCTURE

EXECUTIVE SUMMARY

This paper reviews the interest rate structure that would apply to the PRGT in 2017–18. Based on the interest rate setting mechanism agreed in 2009, the interest rate for the Extended Credit Facility (ECF) would be zero and the rate for the Standby Credit Facility (SCF) would be 0.25 percent. The interest rate for the Rapid Credit Facility (RCF) was set permanently at zero in July 2015.

Since the current mechanism was agreed, the Executive Board has granted successive exceptional interest waivers on all outstanding Fund concessional credit, setting all interest rates charged at zero percent. These waivers have been extended three times, providing interest rate relief to many low-income countries at a time when they faced considerable headwinds from the global economic environment.

A strong case remains for maintaining zero rates on Fund concessional credit at the current global economic juncture. The global outlook for LICs has not significantly improved since the last review and downside risks remain significant. At the same time, many Directors noted at the last review in 2014 that the possibility of a prolonged period of very low interest rates warrants an early re-examination of the mechanism, including an exit strategy from repeated application of the waiver, with the objective of safeguarding the self-sustaining capacity of the PRGT.

The paper seeks to respond to this call. It proposes that the PRGT interest rate mechanism be amended to accommodate anomalies created by a prolonged period of very low interest rates. Specifically, a new threshold is proposed whereby both the ECF and the SCF rate would be set at zero when the 12-month average SDR rate is less than or equal to 0.75 percent. This proposal will likely keep all PRGT interest rates under the mechanism at zero through at least 2020 given current market expectations while incurring only minimal subsidy costs and eliminating the need for continual waivers. In addition, staff proposes to waive interest rate charges on outstanding legacy balances under the Exogenous Shocks Facility (ESF), which are not determined via the interest rate mechanism, until the next review.

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Glossary

ECF	Extended Credit Facility
EFF	Extended Fund Facility
ENDA	Emergency Natural Disaster Assistance
EPCA	Emergency Post-Conflict Assistance
ESF	Exogenous Shocks Facility
ESF-HAC	Exogenous Shocks Facility—High-Access Component
ESF-RAC	Exogenous Shocks Facility—Rapid-Access Component
FCL	Flexible Credit Line
IMF	International Monetary Fund
LICs	Low-Income Countries
PLL	Precautionary and Liquidity Line
PRGT	Poverty Reduction and Growth Trust
RCF	Rapid Credit Facility
SBA	Stand-by Arrangement
SCF	Standby Credit Facility
SDR	Special Drawing Rights
WEO	World Economic Outlook

INTRODUCTION

1. **This paper reviews the interest rate mechanism established in 2009 and proposes rates that would apply to PRGT loans in 2017–18.** The interest rate structure for PRGT loans and the mechanism for setting interest rates on PRGT facilities formed part of the 2009 reforms of the Fund’s concessional lending facilities for LICs.^{1, 2} Following changes introduced in July 2015, the mechanism now differentiates among two PRGT facilities (ECF and SCF) and is subject to periodic review—currently at two-year intervals—to reflect developments in world interest rates.
2. **The paper proposes a modification of the interest rate mechanism to make it better suited to a very low interest rate environment.** The current two-year extension of the interest waiver of PRGT loans is due to expire at the end of this year. Responding to calls made by many Directors at the time of the last review, the paper reviews the interest rate mechanism and proposes a modification that would avoid charging interest rates to some PRGT borrowers that would exceed PRGT funding costs when global interest rates are very low. This would also unify interest rates (at zero) across all PRGT facilities subject to the interest rate mechanism (ECF and SCF) in such an environment. It is also proposed to waive interest rate charges on outstanding legacy ESF credits until the next review of the mechanism. These modifications would maintain the current zero rates on all PRGT obligations for another two years, and possibly until 2020 for the ECF and the SCF, while allowing rates to be set using the agreed mechanism for the first time.
3. **The outline of the paper is as follows.** The next section describes the PRGT interest rate structure and its application to date. The third section discusses the implications of the existing interest rate mechanism in the current environment. The fourth section discusses a possible way forward that would modify the current mechanism in a way that makes it operable when interest rates are very low. The paper also includes proposed decisions to revise the mechanism and establish interest rates using this revised mechanism for the period through end-2018.

BACKGROUND

4. **The PRGT interest rate mechanism was adopted in 2009 as part of a comprehensive reform of the IMF’s concessional facilities.** The objective of the 2009 reforms was to increase the flexibility of IMF support to LICs and better tailor assistance to countries’ diverse needs given their heightened exposure to global volatility. The interest rate structure and adjustment mechanism

¹ See The Chairman’s Summing Up—Financing the Fund’s Concessional Lending to Low-Income Countries—Further Considerations; A New Architecture of Facilities for Low-Income Countries and Reform of the Fund’s Concessional Financing Framework—Supplementary Information and Revised Proposed Decision (2009) and Poverty Reduction and Growth Trust—Review of Interest Rate Structure Decision No. 15035-(11/116), adopted on December 1, 2011.

² For the purpose of this paper, the term “concessional” is used to reflect the subsidized nature of PRGT loans; it does not imply that PRGT loans necessarily have a grant element of 35 percent, as per the usage under the Fund’s debt limits policy.

aimed to balance the following objectives: (i) increase concessionality of PRGT financing, especially in the context of low global interest rates at the time; (ii) preserve the Trust's scarce resources; (iii) avoid permanently zero interest rates; (iv) tailor financial terms to LICs' needs and capacity; and (v) limit fluctuations in concessionality of PRGT instruments and subsidy costs.

5. **The mechanism applies to interest rates on loans under the SCF and ECF.** It does not apply to loans under the ESF, which carry a flat rate of 0.25 percent,³ or to loans under the RCF, which were set to zero permanently in July 2015 in support of countries hit by natural disasters or in fragile situations (see below). Under the mechanism, the interest rates on outstanding loan balances under the SCF and ECF are differentiated and are set for two years, based on the average SDR interest rate in the preceding 12 months (Table 1). In particular, the Board in 2009 decided to set the rate charged on SCF loans at 25 basis points above that for the ECF, as users of the SCF on average are expected to have somewhat higher capacity to service debt than ECF users, and reflecting also differences in the duration of their balance of payments financing and adjustment needs.

6. **Since its introduction in 2009, the application of the PRGT interest rate mechanism has been deferred several times, most recently through end-December 2016** (Box 1). Upon adoption of the PRGT interest rate mechanism in 2009, the Board also endorsed temporary relief, through end-December 2011, of interest payments on all outstanding concessional loans, including the subsidized ENDA/EPCA outstanding loans. Subsequently, the Board decided to extend the waiver on interest payments on two occasions through end-2014.⁴ In the 2014 Review, Directors approved a further extension of the temporary interest rate waiver, this time through end-December 2016. As a result, the PRGT interest rate mechanism has so far not been allowed to function.

7. **At the 2014 Review, many Directors also called for an exit strategy from the waiver.** Directors noted that a further extension of the exceptional interest waiver by another two years would signal the Fund's continued support for LICs at a time when these members continued to face economic headwinds from the global economic environment. However, they also emphasized that it remains important that the PRGT interest rate mechanism be allowed to operate as intended, once the exceptional circumstances subside. Many Directors noted that the possibility of a prolonged period of very low interest rates warrants an early re-examination of the mechanism, with the objective of safeguarding the self-sustaining capacity of the PRGT.⁵

8. **In July 2015, the PRGT interest rate mechanism was modified to further enhance support for PRGT-eligible countries that are in fragile situations or hit by natural disasters.** As

³ Prior to the 2009 reforms, the interest rate on ESF loans was fixed at 0.5 percent. The interest rate mechanism also did not apply to the former ENDA/EPCA, which carried a subsidized interest rate of 0.25 percent for PRGT-eligible users after the 2009 reforms. There is no longer any outstanding subsidized ENDA/EPCA credit.

⁴ See Poverty Reduction and Growth Trust—Review of Interest Rate Structure (2011), Poverty Reduction and Growth Trust—Review of Interest Rate Structure (DEC/15035, December 1, 2011), Poverty Reduction and Growth Trust Interest Rate Mechanism—Extension of Temporary Interest Rate Waiver (2012), and Poverty Reduction and Growth Trust Interest Rate Mechanism—Extension of Temporary Interest Rate Waiver (DEC/15303, December 21, 2012).

⁵ See Poverty Reduction and Growth Trust—Review of Interest Rate Structure (2014) and the Acting Chair's Summing Up, Poverty Reduction and Growth Trust—Review of Interest Rate Structure (2014).

(continued)

part of the Fund's response to the UN-sponsored dialogue on policies to promote financing of the 2030 Development Agenda, the Board approved an increase in concessionality of fast-disbursing support under the RCF by setting the interest rate levied on RCF financing permanently at zero, while preserving the PRGT interest rate mechanism for the SCF and ECF (Table 1).⁶ A number of Directors noted potential risks from setting the RCF interest rate at zero, as it could set a precedent for other PRGT facilities, ultimately straining the self-sustainability of the PRGT. The modest cost involved with this modification left the average annual lending capacity of the self-sustained PRGT intact at about SDR 1¼ billion. However, it was assessed that a proposal to extend interest relief to *all* concessional facilities to 2030 would substantially erode the PRGT's annual lending capacity.

Table 1. Interest Rate Mechanism for the Fund's Concessional Facilities (In percent)			
SDR rate ^{1/}	ECF	RCF ^{2/}	SCF
SDR rate < 2	0.00	0.00	0.25
2 ≤ SDR rate ≤ 5	0.25	0.00	0.50
SDR rate > 5	0.50	0.00	0.75

1/ Average SDR rate for the latest 12 months.
2/ Rate set permanently to zero as of July 2015.

⁶ See Financing for Development—Enhancing Safety Net for Developing Countries (2015) and The Chairman's Summing Up: Financing for Development—Enhancing the Financial Safety Net for Developing Countries (2015). As well as setting the interest rate levied on RCF financing at zero percent, the Board also approved a 50 percent increase in PRGT access norms and limits and a rebalancing of the funding mix of concessional to non-concessional financing under blended arrangements from 1:1 to 1:2 for better-positioned PRGT-eligible countries that receive blended Fund financial support, thereby better targeting scarce concessional resources to the poorest LICs.

Box 1. Impact of the Interest Rate Waivers, 2010–16

The exceptional interest rate waiver in place since January 2010 has provided savings to a total of 20 member countries at relatively low cost, estimated at SDR 19.4 million (Table).^{1/} This consists of SDR 17.3 million in foregone interest payments on ESF loans, SDR 0.8 million on ENDA/EPCA credits, and SDR 1.2 million on SCF loans. Members with outstanding ECF or RCF credit did not accrue any additional gains from the waiver, as the rate on such credits would have been set at zero under the interest rate mechanism (the 12-month average SDR rate ranged from 5 to 44 basis points over that period). Of the total savings, 39 percent were provided to the lowest income quartile of the PRGT-eligible group and 13 percent to fragile states. Low global interest rates contributed to the low cost incurred by the PRGT as a result of the interest rate waiver. The foregone interest rate income due to the waivers has reduced the PRGT's permanent annual lending capacity by SDR 4–5 million or less than ½ percent.

The exceptional interest rate waiver also helped avoid a situation whereby some PRGT interest rates exceeded the cost of funding on such credits. The interest rate on the SCF and ESF would have been set at 0.25 percent in the absence of the waiver, higher than the cost to the Fund of securing PRGT resources during 2012–16. Such a situation would have been at odds with the concessional nature of PRGT financing during a period of very low global interest rates.

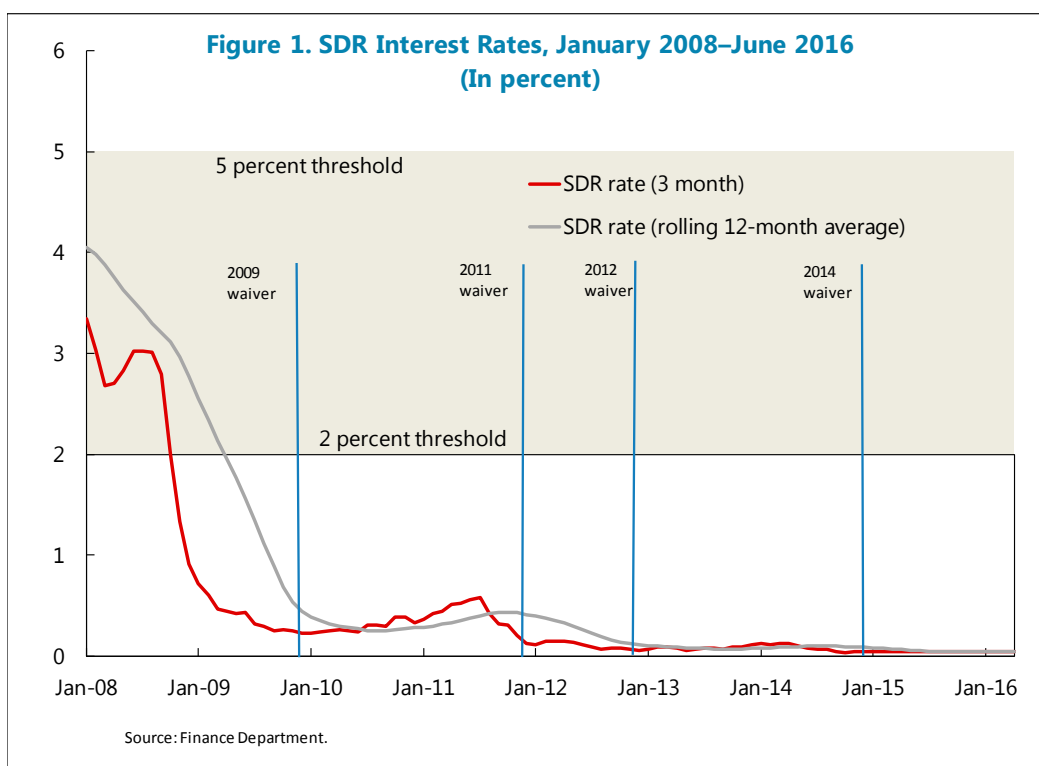
Interest Savings From Temporary Interest Waiver, Jan. 2010–Dec. 2016 ^{1/}				
(In thousands of SDRs)				
Country	Facility			Total
	SCF	ESF	ENDA/EPCA	
(In thousand of SDRs)				
Bangladesh	-	-	806	806
Cameroon	-	1,512.7	-	1,513
Comoros	-	16.5	-	16
Congo, Dem. Rep.	-	1,840.7	-	1,841
Dominica	-	53.4	12	65
Ethiopia	-	2,984.1	-	2,984
Guinea-Bissau	-	-	5	5
Kenya	-	2,198.1	-	2,198
Kyrgyz Republic	-	528.8	-	529
Malawi	-	540.0	-	540
Maldives	-	33.8	0	34
Mozambique	222	1,851.8	-	2,074
Rwanda	98	-	-	98
Samoa	-	96.9	-	97
Senegal	-	1,958.6	-	1,959
Solomon Islands	165	-	-	165
Sri Lanka	-	-	7	7
St. Lucia	-	112.2	-	112
St. Vincent & Grenadines	-	60.1	-	60
Tanzania	723	3,559.3	-	4,282
Total	1,207	17,347	829	19,383

1/ Based on monthly average of credit outstanding until July 2016 and projections of repayments from existing disbursements thereafter.
Source: Finance Department.

1/ All but one of these countries are currently PRGT eligible. In addition, Sri Lanka had outstanding purchases under ENDA when the interest waiver became effective and these were fully repurchased before Sri Lanka's graduation from PRGT-eligibility on April 10, 2010.

CURRENT INTEREST RATE MECHANISM AND OUTLOOK

9. **Reflecting recent trends in global interest rates, SDR interest rates have remained at near zero** (Figure 1). The 3-month SDR rate has declined from 0.23 percent at the time of the first interest rate waiver in January 2010 to 0.05 percent as of end-June 2016. The SDR rate has remained flat at 0.05 percent—the floor for this rate—since the last interest rate review in 2014. As a result, the 12-month average SDR rate, which serves as the reference rate under the interest rate mechanism, has declined slightly to 0.05 percent, from 0.09 percent since the 2014 review.



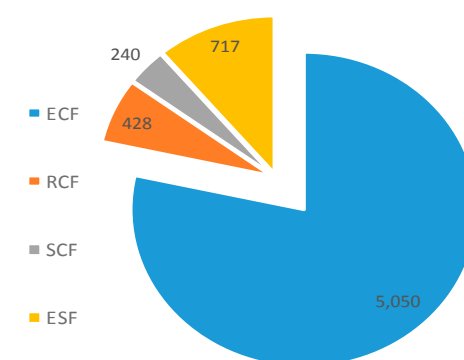
10. **Given low global interest rates, the application of the PRGT interest rate mechanism implies that the ECF would carry a zero interest rate for 2017–18.** Upon expiration of the temporary interest waiver at end-2016, an interest rate of 0.25 percent would apply to outstanding credit under the SCF. Separately, as the interest rate mechanism does not cover the ESF, charges for outstanding ESF balances (SDR 0.7 billion as of end-July 2016) would be 0.25 percent (the standard ESF rate) upon expiration of the waiver.

11. **The bulk of PRGT outstanding debt would not be charged any interest.** For most PRGT borrowers, accounting for some 85 percent of outstanding PRGT loans, an interest rate of zero would apply (Figure 2). This includes outstanding credits under the ECF, which account for the bulk of PRGT lending, as well as credit under the RCF, which now has a permanently zero interest rate.

12. **However, positive interest rates would be charged on some PRGT lending under the current mechanism.** For outstanding credits under the SCF (SDR 240 million as of end-June 2016), an interest rate of 0.25 percent would apply. Some credit made available under the SCF has not been drawn by members that treat the SCF as precautionary, and no interest is charged on such available balances.⁷ Although a significant share of new PRGT lending would continue to be approved under the ECF and RCF, staff expects that demand for the SCF would pick up over the medium term as more countries develop and gradually gain market access, making such members potentially more subject to episodic short-term balance of payments needs. For the period January–June 30, 2016, total new PRGT commitments amounted to SDR 0.6 billion, of which SDR 0.5 billion under the SCF and SDR 0.1 billion under the ECF.

13. **At the same time, the global economic outlook for LICs has not improved since the previous review, while downside risks remain significant.** Global growth is expected to remain modest in 2016 at 3.1 percent, while lower commodity prices, weak external demand, and tighter financial conditions are weighing on LIC near and medium-term prospects. Short-term economic vulnerabilities among LICs have increased steadily due mainly, but not exclusively, to weaker conditions in commodity exporters while delayed policy adjustment has reduced buffers.⁸

Figure 2. PRGT Credit Outstanding, as of end-June 2016 (In millions of SDRs)

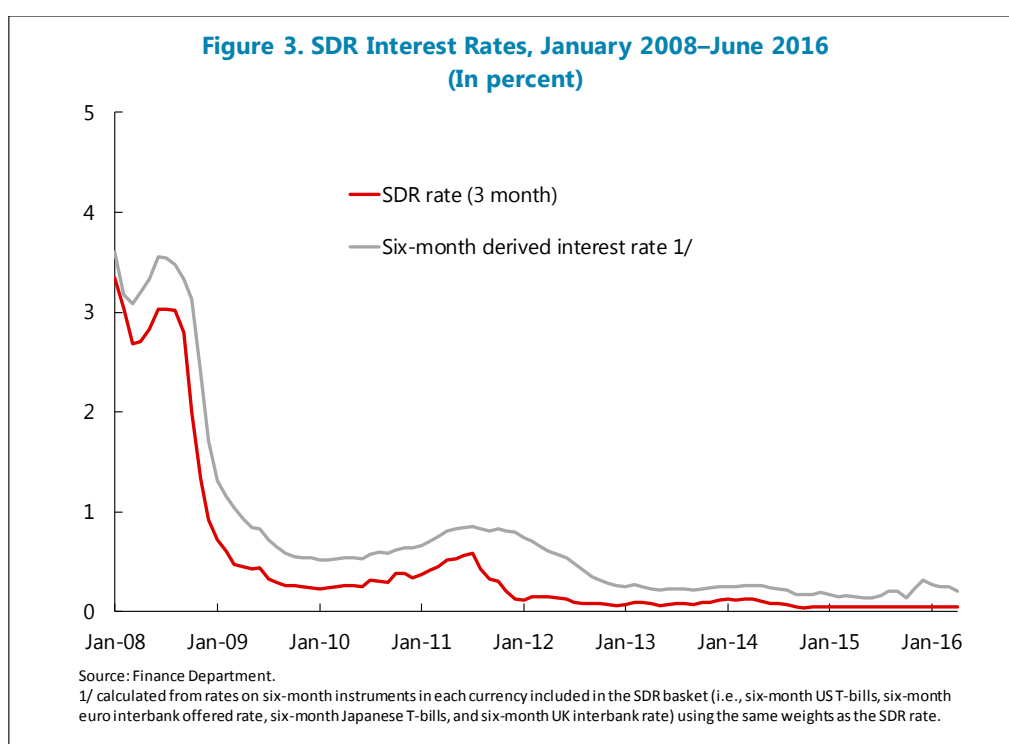


Source: Finance Department.

⁷An availability fee of 0.15 percent is charged on available but undrawn balances. For GRA resources, an up-front commitment fee (15 basis points on committed amounts of up to 115 percent of quota; 30 basis points for amounts in excess of 115 percent and up to 575 percent of quota; and 60 basis points for amounts in excess of 575 percent of quota) applies to the amount that may be drawn during each annual period under an SBA, FCL, PLL, or EFF. This fee is refunded on a proportionate basis as subsequent drawings are made under the arrangement.

⁸ See Macroeconomic Developments and Prospects in Low-Income Developing Countries (IMF, 2015).

14. **Against this background, a strong case remains for maintaining zero rates on all Fund concessional credit at the current global economic juncture.** Global interest rates remain close to zero (Figure 3), and market expectations of the timing and pace of interest rate normalization have been substantially revised down.⁹ As a result, the period of very low global interest rates could continue for some time, though the inclusion of the renminbi in the SDR basket in October 2016 is expected to initially lead to a slight increase in the SDR rate and funding costs.¹⁰ Applying the current interest rate mechanism in these circumstances would mean some PRGT borrowers would face an increase in interest rates and be required to pay a rate on their outstanding concessional credit exceeding the PRGT's cost of funding such credits. The next section discusses a proposed modification of the mechanism that would avoid such an anomaly and accommodate the possibility of a prolonged period of continued very low interest rates.



⁹ See Global Financial Stability Report, April 2016.

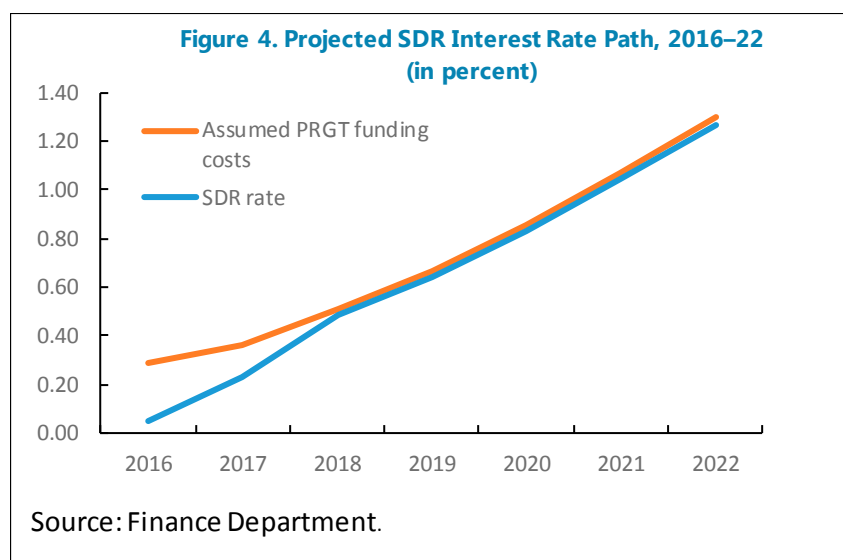
¹⁰ Based on market interest rates from November 2015–May 2016, staff estimates indicate that the inclusion of the renminbi would increase PRGT funding costs and associated SDR rates *ceteris paribus* by about 22 basis points. The estimate of the PRGT self-sustained capacity (SDR 1.24 billion) calculated in the Update paper already incorporated this effect (see Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Countries, April 2016).

PROPOSED WAY FORWARD

15. **The current interest rate mechanism did not anticipate the situation of prolonged very low global interest rates.** The mechanism sets a rate of 0.25 percent on SCF credit whenever the SDR reference rate is below 2 percent (the rate on ECF credit would be zero). It was envisaged that this rate would still be concessional even when global interest rates were relatively low by historical standards. However, when global rates are close to zero, the mechanism can deliver a situation where some PRGT borrowers would face a lending rate above the funding cost for the PRGT, as discussed above.

16. **To address this, staff proposes to modify the PRGT interest rate mechanism to preserve the concessional nature of PRGT financing in periods of very low global interest rates.** Specifically, it is proposed to add an additional threshold for the SDR reference rate below which the SCF interest rate would be set at zero, along with the ECF rate. Combined with the RCF zero rate, this would ensure that all PRGT credit would have a zero interest rate in such circumstances, without the need for the Board to grant successive waivers, except for legacy loans under the ESF (see below). It would also provide a more predictable path for adjusting rates going forward, and better safeguard the self-sustaining capacity of the PRGT.

17. **A judgment is needed on where to set the new threshold.** If it is set too high, the additional subsidy cost could undermine the current self-sustained capacity of the PRGT, particularly if rates were to remain below the threshold for a prolonged period. Staff considered several options based on current market expectations of the path for the SDR interest rate (Figure 4). These numbers are



only indicative, and could change if market expectations for global interest rates are significantly revised. A threshold of 0.5 percent would ensure that rates remain at zero for 2017–18, while a threshold of 1 percent could result in zero interest rates until 2023–24, with a somewhat higher subsidy cost. On balance, staff proposes a threshold of 0.75 percent, which on current market expectations, would likely keep ECF and SCF rates at zero through at least 2020. The proposed new thresholds are set out in Table 2.

Table 2. Proposed Interest Rate Mechanism (In percent)			
SDR rate ^{1/}	ECF	RCF ^{2/}	SCF
SDR rate ≤ 0.75	0.00	0.00	0.00
0.75 < SDR rate < 2	0.00	0.00	0.25
2 ≤ SDR rate ≤ 5	0.25	0.00	0.50
SDR rate > 5	0.50	0.00	0.75

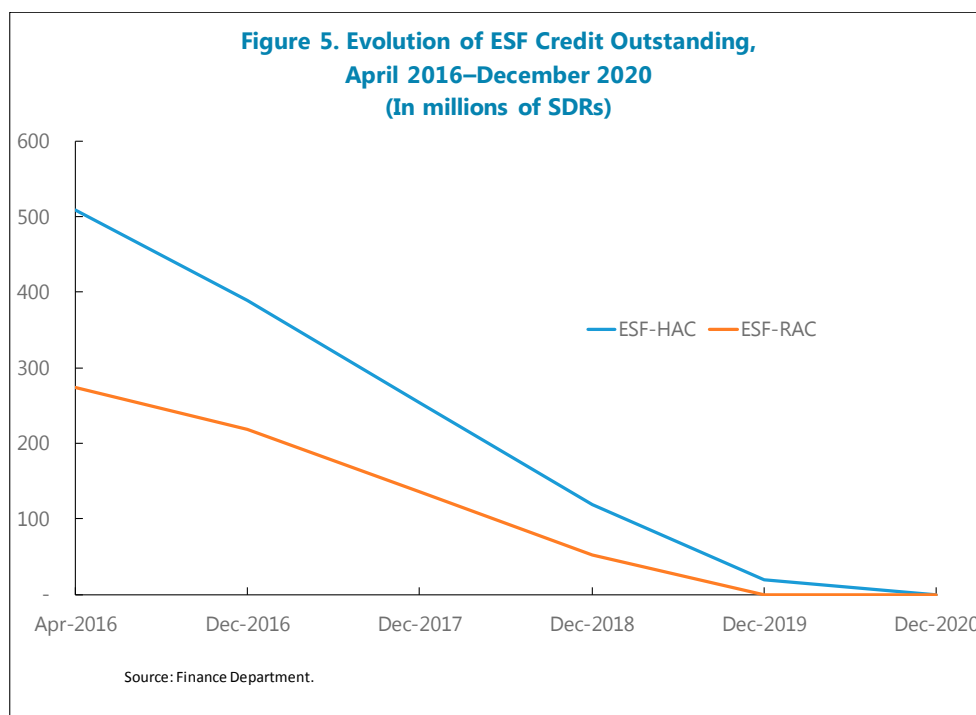
1/ Average SDR rate for the latest 12 months.
2/ Rate set permanently to zero as of July 2015.

18. **The proposed modification would achieve several objectives:**

- **PRGT credit would remain interest-free over 2017–18 and possibly longer.** This seems appropriate given the continuation of the exceptional circumstances in place when the Board approved the last waiver. On current expectations for a gradual normalization of global interest rates, the revised mechanism would yield a zero interest rate through 2020.
- **PRGT financing would remain concessional even in periods of very low global interest rates.** This would avoid the situation whereby the PRGT rate charged on borrowers could potentially exceed the cost of financing of the PRGT, and thus resolve the anomaly which was noted by Directors when they considered the extension of the exceptional temporary waiver the last time around.
- **It would avoid the need for continued waivers.** If such a threshold had been included in the original mechanism, the need for successive waivers would have been avoided. This would provide an exit strategy, as called for by many Directors at the last review, and allow the rules-based mechanism to function as originally intended. It would also provide a more predictable path for future interest rate adjustments, in line with the original intention.
- **It would maintain the original differentiation in rates across PRGT facilities during more normal times, but unify them when interest rates are very low.** The modified mechanism would allow for an equalization of interest rates across PRGT facilities when global interest rates are very low while maintaining the differentiation among rates once global rates normalize, thus preserving scarce concessional resources for those facilities that tend to be used by poorer PRGT-eligible members. This differentiation, which entails a slightly higher charge for the SCF, was agreed in 2009 as part of the facilities reform for LICs.
- **It would preserve the self-sustaining PRGT capacity.** The cost to the PRGT of the proposed modifications (including ESF credit, see Table 3) is expected to be relatively low, based on current market expectations, and staff estimates suggest that the PRGT self-sustained lending capacity would remain close to its target of SDR 1¼ billion.

Table 3. Staff Proposals—Annual Subsidy Cost to PRGT, 2017–24				
(In millions of SDRs)				
Years	Subsidy Cost at Different SDR Rate			
	Thresholds 1/			
	0.5	0.75	1.0	1.5
Interest lost on SCF loans relative to baseline				
2017–18	5.5	5.5	5.5	5.5
2019–20		10.2	10.2	10.2
2021–22			13.5	13.5
2023–24				29.4
2017–24	5.5	15.7	29.1	58.6
Memo item:				
Impact on the self-sustained PRGT capacity relative				
to baseline (million SDRs) 2/	-1	-3	-6	-14
Source: Finance Department.				
1/ Assumes SDR rates rising above 0.5% in 2018, above 1% in 2021 and above 1.5% in 2023.				
2/ PRGT capacity without modification of the interest rate mechanism is estimated as SDR 1.23 billion based on assumptions consistent with the April 2016 Update to the Board on Fund's Concessional Assistance and revised interest rate projections.				

19. **To complement the above change, staff also proposes to waive the interest rate on outstanding balances under the ESF until the next review.** ESF loans are legacy loans, most of which will be repaid in the next few years. As of end-July 2016, loans outstanding under the ESF amounted to SDR 698 million, of which SDR 449 million are under the ESF-HAC and SDR 249 million under the ESF-RAC (Figure 5). Loans under these facilities are not included under the PRGT interest rate mechanism, and the rate on outstanding ESF loans would be set at 0.25 percent upon expiration of the temporary interest rate waiver at end-2016. As these facilities were broadly superseded by the RCF (in the case of the ESF-RAC) and the SCF (in the case of the ESF-HAC), respectively, under the 2009 LIC reforms, the proposal would set the interest rate for outstanding ESF credit to zero, aligning it with PRGT rates until the next review. This proposal would result in interest savings estimated at SDR 2.0 million for 14 PRGT-eligible countries that have outstanding credit under the ESF. All loans under the ESF are expected to be repaid by November 2020.



CONCLUSIONS

20. **This paper proposes a modification of the PRGT interest rate mechanism to preserve the concessional nature of PRGT financing in periods of very low global interest rates.** Under the modified mechanism, the interest rate on the SCF and the ECF would be set at zero for the period 2017–18. Staff also recommends to waive interest rate charges on outstanding balances under the ESF until the next review. This approach would broadly maintain the capacity of the self-sustaining PRGT, allow the rules-based interest rate mechanism to function and provide an exit from the strategy of successive waivers, and provide continued support to LICs amidst the current challenging global environment. Consistent with Section II, Paragraph 4(b) of the PRGT Instrument, the next review of the PRGT interest rate structure would be completed by December 31, 2018.