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FACTSHEET

The Joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries

Low-income countries (LICs) have often struggled with large external debts. The IMF and the World Bank have developed a framework to help guide countries and donors in mobilizing the financing of LICs' development needs, while reducing the chances of an excessive build-up of debt in the future. The Debt Sustainability Framework (DSF) was introduced in April 2005 and is periodically reviewed. The current framework was reviewed in 2012 and a new framework was formally discussed in September 2017, which will be implemented during the second half of 2018.

Strategic approach to reach goals

The framework is designed to guide the borrowing decisions of LICs in a way that matches their financing needs with current and prospective repayment ability.

Under the DSF, debt sustainability analyses (DSAs) are conducted regularly. These consist of:

- an analysis of a country's projected debt burden over the next 20 years and its vulnerability to external and policy shocks—baseline and stress tests are calculated;
- an assessment of the risk of external debt distress, based on indicative debt burden thresholds that depend on the quality of the country's policies and institutions; and
- recommendations for a borrowing (and lending) strategy that limits the risk of debt distress.

Assessing debt to avoid risks

The DSF analyzes both external and public sector debt. The framework focuses on the present value of debt obligations for comparability, as terms extended to LICs vary considerably. A 5 percent discount rate is used to calculate the present value of external debt.

To assess debt sustainability, debt burden indicators are compared to indicative thresholds over a projection period. There are four ratings for the risk of external public debt distress:

- low risk, generally when all the debt burden indicators are below the thresholds;
- moderate risk, generally when debt burden indicators are below the thresholds in the baseline scenario, but stress tests indicate that thresholds could be breached if there are external shocks or abrupt changes in macroeconomic policies;
- high risk, generally when one or more thresholds are breached under the baseline scenario, but the country does not currently face any repayment difficulties; or
- in debt distress, when the country is already experiencing difficulties in servicing its debt, as evidenced, for example, by the existence of arrears, or debt and debt service indicators are in significant or sustained breach of thresholds.

Countries with significant public domestic or private external debt vulnerabilities, or both, are assigned an overall risk of debt distress to complement the rating on the risk of external public debt distress.

LICs with weaker policies and institutions tend to face repayment problems at lower levels of debt than countries with stronger policies and institutions. The DSF, therefore, classifies countries into one of three policy performance categories (strong, medium, and poor), using the World Bank's Country Policy and Institutional Assessment (CPIA) index, and uses different indicative thresholds for debt burdens depending on the performance category.

Thresholds corresponding to strong policy performers are highest, indicating that countries with good policies can generally handle greater debt accumulation.

Debt Burden Thresholds Under the DSF

	PV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue	Export	Revenue
Weak policy	100	30	200	15	18
Medium policy	150	40	250	20	20
Strong policy	200	50	300	25	22

Integrating debt issues into policy advice

The DSF has enabled the IMF and the World Bank to integrate debt issues more effectively in their analysis and policy advice. It has also allowed comparability across countries.

The DSF is important for the IMF's assessment of macroeconomic stability, the long-term sustainability of fiscal policy, and overall debt sustainability. Furthermore, debt sustainability assessments are taken into account to determine access to IMF financing, as well as for the design of debt limits in Fund-supported programs, while the World Bank uses it to determine the share of grants and loans in its assistance to each LIC and to design non-concessional borrowing limits.

The effectiveness of the DSF in preventing excessive debt accumulation hinges on its broad use by borrowers and creditors. LICs are encouraged to use the DSF or a similar framework as a first step toward developing medium-term debt strategies. Creditors are encouraged to incorporate debt sustainability assessments into their lending decisions. In this way, the framework should help LICs raise the finance they need to meet the Sustainable Development Goals (SDGs), including through grants when the ability to service debt is limited.

In September 2017, a new framework was formally discussed by the IMF and World Bank Boards. It is expected to come into effect in mid-2018, six months after a new guidance note has been prepared. Key reforms include: (i) moving away from relying exclusively on the CPIA to classify countries, and instead using a composite measure based on a set of economic variables; (ii) introducing tools to scrutinize projections; (iii) recalibrating standardized stress tests while adding tailored scenario stress tests; and (iv) providing a richer characterization of debt vulnerabilities (including vulnerabilities from domestic debt and market financing and better discrimination across countries within the moderate risk category). The framework will also be simplified by reducing the number of debt indicators, thresholds, and standardized stress tests.