INTERNATIONAL MONETARY FUND

Poverty Reduction and Growth Trust—Review of Interest Rate Structure

Prepared by the Finance and the Strategy, Policy, and Review Departments

(In consultation with the Legal Department)

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ABBREVIATIONS AND ACRONYMS

ECF	Extended Credit Facility
ENDA	Emergency Natural Disaster Assistance
EPCA	Emergency Post-Conflict Assistance
ESF	Exogenous Shocks Facility
LIC	Low Income Country
PRGT	Poverty Reduction and Growth Trust
RCF	Rapid Credit Facility
SCF	Standby Credit Facility
WEO	World Economic Outlook

EXECUTIVE SUMMARY

This is the first review of the interest rate mechanism approved under the 2009 reforms of the Fund's concessional lending facilities. The mechanism links the Poverty Reduction and Growth Trust (PRGT) interest rate structure to world interest rates and provides a setting to differentiate interest rates across the various PRGT facilities. The framework requires reviews every two years, with the first such review to be completed by December 31, 2011.

In 2009, the Board also endorsed temporary relief of interest payments on all outstanding concessional loans for PRGT-eligible members. All interest payments on PRGT loans were waived through end-December 2011. At the same time, the rate of charge on loans to PRGT-eligible members under Emergency Natural Disaster Assistance (ENDA) and Emergency Post-Conflict Assistance (EPCA) was subsidized to zero through end-January 2012. This two-year waiver, which became effective in January 2010 alongside the broader Low Income Country (LIC) facilities reform, was aimed at providing exceptional relief during the global economic crisis. As of November 11, 2011, the interest waiver had benefited 18 PRGT-eligible members and one member that graduated from PRGT eligibility in 2010. Combining the interest payments waived to November 11, 2011, and the projected payments for the remaining period of the interest waiver, the total cost to the Fund amounts to SDR 5.8 million.

Staff recommends that as a transitional measure the exceptional interest waiver be extended by one year to end-December 2012 in view of the current severe downside risks to the global economic outlook. *It is proposed that the exceptional relief would expire at the end of 2012, and the differentiated PRGT interest rate mechanism thereafter be allowed to operate as envisaged. On this basis, the applicable interest rates in 2013 would be zero on all Extended Credit Facility (ECF) and Rapid Credit Facility (RCF) loans, and 0.25 percent for Standby Credit Facility (SCF) loans. Additionally, outstanding loans under the Exogenous Shocks Facility (ESF) and subsidized ENDA/EPCA credits would carry an interest rate of 0.25 percent after the interest waiver expires.* In accordance with the PRGT Instrument, the next review of PRGT interest rates would take place by December 31, 2013.

I. INTRODUCTION[1]

1. **A new interest rate structure for Poverty Reduction and Growth Trust (PRGT) loans and a mechanism for setting such rates were introduced as part of the 2009 reforms of the Fund's concessional lending facilities for low-income countries (LICs)**.[2] The new framework involves setting interest rates for outstanding balances under each of the PRGT facilities, and explicitly links the PRGT interest rate structure to world interest rates. The framework requires a review every two years to take account of developments in world interest rates (as reflected in the SDR interest rate), with the first such review scheduled to be completed by December 31, 2011.[3]

2. **In 2009 the Board also endorsed temporary relief of interest payments for PRGT-eligible members on all outstanding concessional loans**. All interest payments on PRGT loans were waived through end-December 2011. At the same time, the rate of charge on loans to PRGT-eligible members under Emergency Natural Disaster Assistance (ENDA) and Emergency Post-Conflict Assistance (EPCA) was subsidized to zero through end-January 2012. This two-year waiver, which became effective on January 7, 2010 alongside the broader LIC facilities reform, was aimed at providing exceptional relief during the global economic crisis. At the April 2011 Executive Board discussion of the use of profits from the Fund's limited gold sale, there was some interest in exploring the scope for using part of the resources linked to the gold profits for extending the exceptional interest relief on PRGT loans beyond 2011, and during the September 2011 follow-up discussion, Executive Directors agreed to consider the issue of whether to extend the exceptional interest relief on PRGT loans in the context of the scheduled review of PRGT interest rates.[4]

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[1] This paper was prepared under the overall guidance of David Andrews and Hugh Bredenkamp, by a team led by Patrick Njoroge (FIN) and Bhaswar Mukhopadhyay (SPR), consisting of Maria Mendez and Futoshi Narita (both FIN), and Kerstin Gerling and Joe Thornton (both SPR). Barbara Dabrowska (SPR) provided very able research assistance.

[2] See *IMF Reforms Financial Facilities for Low-Income Countries* (7/29/09) *and IMF Announces Unprecedented Increase in Financial Support to Low-Income Countries* (7/29/09).

[3] See Section I, paragraph 4(b) of the PRGT Instrument as amended by Decision No. 14354-(09-79), adopted July 23, 2009 and effective January 7, 2010.

[4] See *IMF Executive Board Considers Use of Windfall Gold Sale Profits* (09/16/11).

3. **This paper reviews the structure of PRGT lending interest rates consistent with the agreed framework**. Section II indicates the structure of interest rates resulting from applying the approved mechanism, while Section III reviews the impact of implementing the temporary interest waiver in 2010–2011, and assesses the merits of providing additional interest relief beyond 2011. The paper concludes with a proposal for extending the interest rate waiver for a further year, establishing the interest rates for 2012 and 2013, and completing the review of PRGT interest rates.

II. PRGT LENDING INTEREST RATES

4. **The new PRGT interest rate mechanism was designed in 2009 to balance several competing objectives, including**: (i) making the financing term structure more concessional, especially in the near-term context of low global interest rates; (ii) preserving the Fund's scarce concessional resources; (iii) tailoring financing terms to the needs and capacity of LICs; and (iv) limiting fluctuations in concessionality and subsidy costs. A review-based mechanism where the interest rates would normally be adjusted every two years in light of changes in global interest rates was considered to balance these objectives well. Under the framework, the applicable interest rates on outstanding loan balances under the Extended Credit Facility (ECF), Rapid Credit Facility (RCF), and Standby Credit Facility (SCF) would depend on the prevailing SDR interest rates, with a modest differentiation in the interest rate between facilities to account for the expectation that SCF users will on average have somewhat higher capacity to service debt than ECF and RCF users (Table 1).

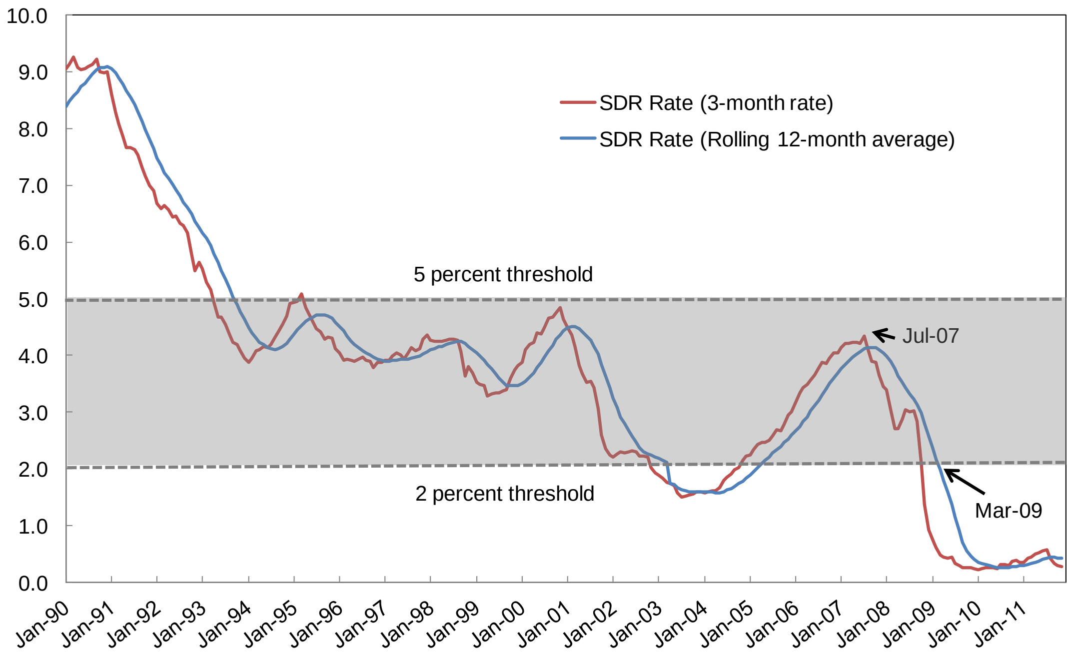
Table 1. Interest Rate Mechanism for the Fund's Concessional Facilities [1/]

	Interest rate for concessional facility (In percent)		
	ECF	RCF	SCF
SDR rate < 2	0.00	0.00	0.25
2 ≤ SDR rate ≤ 5	0.25	0.25	0.50
SDR rate > 5	0.50	0.50	0.75

[1/] The average SDR rate is based on the most recently observed 12-month period.

5. **The SDR interest rate has been at historically low levels in the recent past, and the 12-month average SDR rate is currently below 2 percent (Figure 1)**. As a result of the decline in global interest rates, the SDR rate fell from about 3 percent in August 2008 to below 1 percent in December 2008, and has since then remained below 1 percent. Consequently, the 12-month average SDR rate has been below the 2 percent lower bound in the interest mechanism since March 2009, and was 0.4 percent as at the latest available date (November 18).

Figure 1. SDR Interest Rates, Jan 1990 - Nov 2011
(In percent)



Source: Finance Department.

6. **For 2012 and 2013, the new mechanism for setting PRGT interest rates would indicate a zero rate on all ECF and RCF loans and a rate of 0.25 percent for SCF loans**. This structure of interest rates would be unchanged from the structure that was established with the effectiveness of the LIC facility reforms, inclusive of the modest differentiation in the interest rate between facilities, and would apply for the two-year period from January 1, 2012 to end-December 2013.[5] The PRGT interest rate mechanism does not extend to any outstanding pre-2010 credits under the Exogenous Shocks Facility (ESF) or to the

[5] The very limited experience with SCF arrangements does not suggest any general conclusion about the differentiated interest rate between ECF/RCF loans and SCF loans, as indicated in the interest rate mechanism. Only two SCF arrangements have so far been approved: an 18-month SCF arrangement of SDR 12.48 million, for Solomon Islands on June 2, 2010; and the 18-month blended Stand-By Arrangement/SCF precautionary arrangements, each in the amount of SDR 64.75 million, for Honduras on October 1, 2010.

subsidized emergency assistance provided under the ENDA and EPCA, each of which would carry an interest rate of 0.25 percent when the exceptional interest relief expires.[6] An interest rate equal to the SDR rate would be charged on the amounts of any overdue interest on, or overdue repayments of, PRGT loans.

7. **Applying the PRGT interest rate mechanism would lead to a modest increase in interest rates for some PRGT borrowers were the exceptional interest relief to expire**. Outstanding ECF and RCF loans amount to almost 80 percent of all current PRGT loans, for which an interest rate of zero would apply (Table 2). It is also expected that a large share of PRGT lending would continue to be under the ECF and RCF—since the effectiveness of the LIC facility reforms, commitments have been made totaling SDR 2.0 billion under the ECF and SDR 0.1 billion under the RCF, compared to SDR 0.1 billion under the SCF.[7] However, an interest rate of 0.25 percent would apply on the outstanding loans under the ESF, which amount to SDR 1.1 billion.[8] As noted above, it was envisaged that the interest rate on ESF loans would equal the lowest rate feasible for SCF loans in the interest rate mechanism.

Table 2. PRGT Credit Outstanding 1/
(In millions of SDRs)

Facility	Amount
ECF	3,704
RCF	139
SCF	9
ESF	1,070
Total	4,922

Source: Finance Department.
1/ As of November 11, 2011, excluding arrears.

[6] At the time of the 2009 LIC facility reforms the applicable interest rate on outstanding loans under the ESF was lowered from 0.5 to 0.25 percent. The SCF was conceived as a successor to the ESF (specifically, the High Access Component of the ESF), and with the effectiveness of the LIC facility reforms no new ESF lending was envisaged after the transition period. Consequently, the interest rate on ESF loans was set in line with the lowest interest rate for SCF loans under the PRGT interest rate mechanism (with a modest differentiation with the interest rate on ECF and RCF loans). The ESF was also excluded from the review-based adjustment mechanism so that ESF borrowers would continue to pay at the lower rate even if global interest rates returned to normal levels. See *A New Architecture of Facilities for Low-Income Countries and Reform of the Fund's Concessional Financing Framework—Supplementary Information* (7/20/09), footnote 3.

[7] While SCF credits could increase somewhat over the next two years, they are expected to remain well below those under the ECF and likely also the RCF.

[8] This applies to loans committed either in the period before the LIC facility reforms became effective or the subsequent transition period.

III. TEMPORARY WAIVER OF INTEREST PAYMENTS

8. **The temporary waiver of interest payments that became effective on January 7, 2010 is now coming to an end**. As noted above, the suspension applied to interest payments by PRGT-eligible members on all outstanding PRGT loans through December 2011 and subsidization of the rate of charge to zero percent for subsidized ENDA/EPCA through January 2012. In the absence of the interest waiver, an interest rate of zero percent would still have applied for all ECF and RCF loans, but the interest rate on all SCF and ESF loans, and subsidized ENDA/EPCA credits would have been 0.25 percent. The suspension was envisaged as a one-off measure to help LICs address the impact of the global financial crisis.

9. **The temporary interest waiver provided some additional relief to LICs during the height of the global crisis**. Already suffering from the impact of the food and fuel price hikes in 2008, LICs were hit hard by the global financial and economic crisis in 2009. In 2009, their average GDP growth fell to its lowest level in 15 years, fiscal deficits increased by 2.7 percentage points on average to 4.7 percent of GDP, and average exports fell by 8.6 percent, resulting in a significant deterioration in their external position (Figure 2). Moreover, among the LICs, those with outstanding balances to the PRGT were not only generally poorer to start with, but were also hit especially hard by the crisis.[9] Other measures to cope with the crisis took time to implement and their benefits accrued gradually.

10. **As of November 11, 2011, a total of 18 PRGT-eligible members and one member that graduated from PRGT-eligibility in 2010 had received interest relief**.[10] Combining the interest waived to November 11, 2011, and the projected payments for the remaining period of the interest waiver, the total subsidy resources needed are estimated at SDR 5.8 million (see Table 3). This largely comprised interest payments on ESF loans (SDR 5.1 million) and on ENDA/EPCA credits (SDR 0.7 million).[11]

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[9] For these members, on average, real GDP growth declined to 2 percent, its lowest level in 16 years, fiscal deficits increased by 3.3 percent of GDP and exports declined by 8.2 percent.

[10] Sri Lanka had outstanding purchases under ENDA when the interest waiver became effective. These were fully repurchased before Sri Lanka's graduation from PRGT-eligibility on April 10, 2010.

[11] As a result of the lower interest rates that were introduced at the LIC facility reforms, the overall cost is much lower when compared to all interest payments on PRGT loans in 2009 (a total of SDR 21.8 million).

Table 3. Country Coverage of Temporary Interest Waiver 1/
(In thousands of SDRs)

Countries	Type of Credit			Total
	SCF	ESF	ENDA/ EPCA	
Bangladesh	-	-	647.9	647.9
Cameroon	-	459.8	-	459.8
Congo, Dem. Rep. of	-	566.4	-	566.4
Comoros	-	11.0	-	11.0
Dominica	-	16.2	9.6	25.9
Ethiopia	-	793.4	-	793.4
Guinea-Bissau	-	-	4.7	4.7
Kenya	-	672.0	-	672.0
Kyrgyz Republic	-	164.9	-	164.9
St. Lucia	-	34.1	-	34.1
Sri Lanka	-	-	5.2	5.2
Maldives	-	9.6	0.2	9.8
Mozambique	-	545.9	-	545.9
Malawi	-	171.8	-	171.8
Senegal	-	567.0	-	567.0
Solomon Islands	24.2	-	-	24.2
Tanzania	-	1,062.1	-	1,062.1
St. Vincent and the Grenadines	-	18.5	-	18.5
Samoa	-	28.7	-	28.7
Total	24.2	5,121.5	667.7	5,813.4

Source: Finance Department.

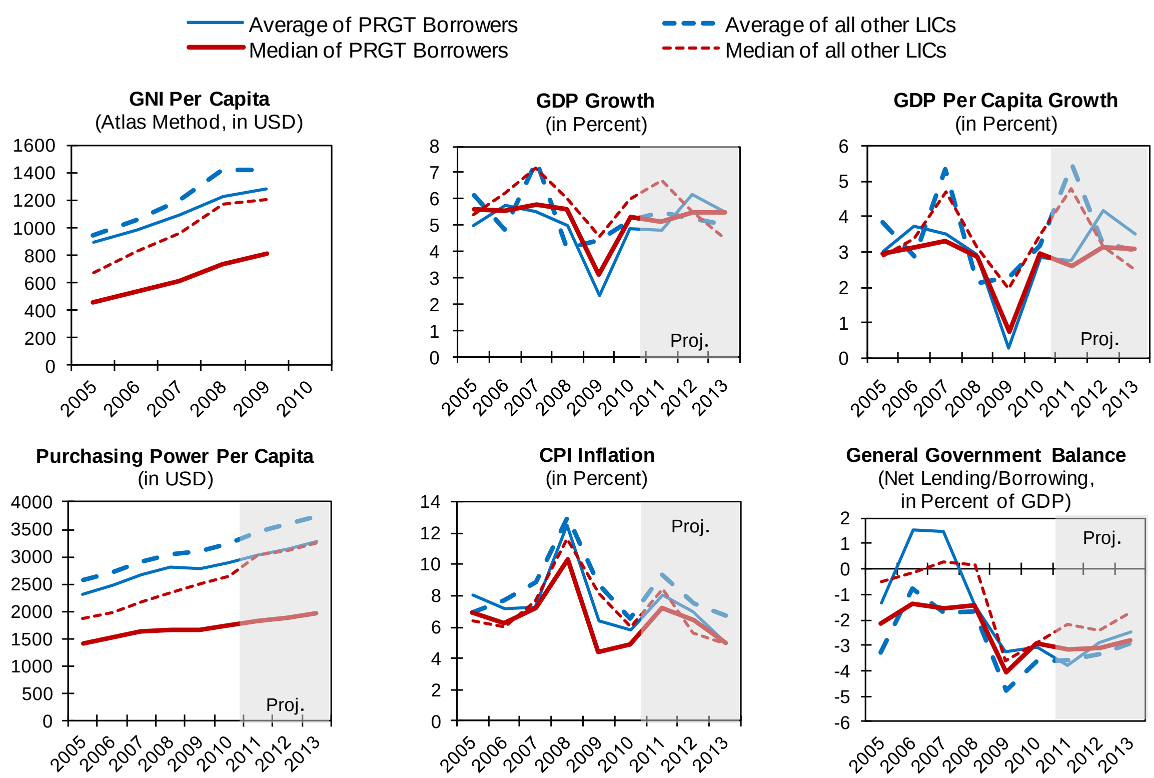
1/ Combines the actual amounts for Jan 8, 2010 to Nov 11, 2011, and the projected estimates for the remaining period of the interest waiver after Nov 11, 2011.

11. **While LICs have recovered reasonably quickly from the global crisis, progress in rebuilding macroeconomic buffers after the crisis has been slow**. Average growth rates, exports, and remittances have returned to pre-crisis levels (Figures 1 and 2). However, fiscal adjustment, which started in 2010 as revenues rebounded along with the economic recovery, has since halted, with the median fiscal deficit of net oil importers remaining at around 3 percent of GDP. Current account deficits (net of foreign direct investment (FDI)) have also widened since the crisis, especially for net oil importers. Reserve coverage, bolstered by the 2009 SDR allocation (which boosted reserve coverage of the median LIC by

about 0.4 months of imports), has declined more recently, in particular in many LICs with pegged exchange rate regimes. Accordingly, the recently conducted Vulnerability Exercise for LICs (VE-LIC) concluded that limited progress had been made in rebuilding macroeconomic policy buffers since the crisis.

12. **Moreover, global downside risks are now severe, and LICs' lower buffers have rendered them more vulnerable than during the previous crisis**. Specifically, the scope for fiscal stimulus is likely to be more limited than in the past, and financing needs could rise sharply in the event of a renewed downturn.[12] Given the dim prospects for a significant expansion of aid budgets, the Fund's support could be particularly important as members seek to mitigate the impact of a downturn, including through concessional borrowing to meet possible needs.

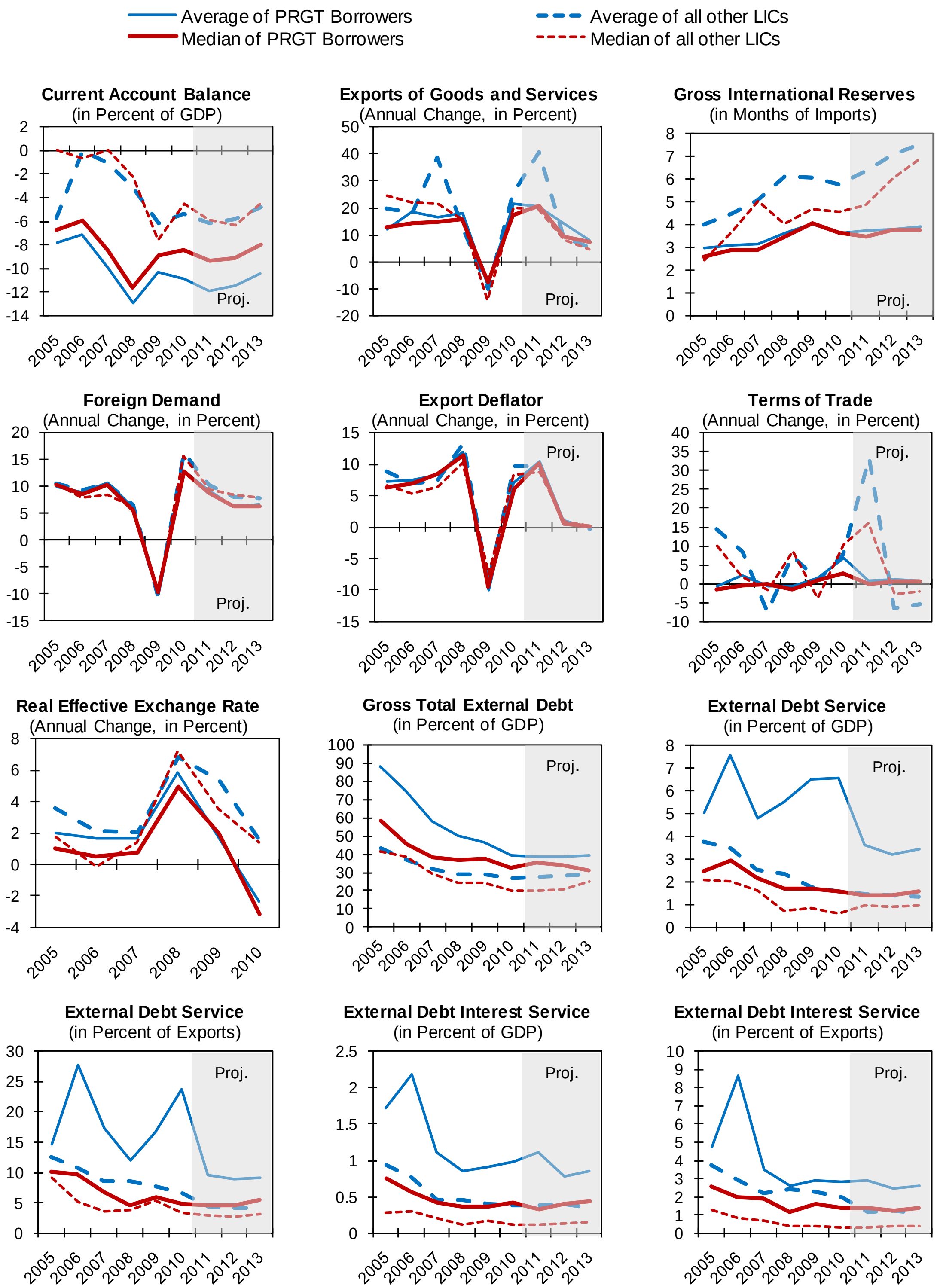
Figure 2. Macroeconomic Performance of LICs (2005–2013)



Source: IMF WEO, WB; and Staff calculations.
Note: All ratios to GDP exclude Timor-Leste.

[12] *Managing Global Growth Risks and Commodity Price Shocks—Vulnerabilities and Policy Challenges for Low-Income Countries* (9/21/11) indicates that a 1½ percentage point decline in global GDP growth could increase LICs' financing needs in 2012 by US$27 billion.

Figure 3. External Position of LICs (2005–2013)



Source: IMF WEO, INS, GEE, and Staff calculations.
Note: All ratios to GDP exclude Timor-Leste.

13. **In view of these downside risks, the staff sees a compelling case for a short-term/temporary extension of the interest waiver through end-2012**. Continued exceptional interest relief would have a modest yet significant impact on payments by LICs with outstanding balances on SCF, ESF, and ENDA/EPCA credits, as well as new SCF disbursements. Based on the total cost for 2010–2011, and given the existing credits and possible new SCF disbursements in the coming year, the cost of extending the temporary interest waiver through 2012 would be modest. While an extension of the temporary relief would further delay the intended differentiation between the instruments—specifically that between the SCF and the other PRGT facilities[13]—on balance, staff favor a limited one-year extension of the interest rate waiver as a transition measure.

14. **Given the modest additional cost, a one-year extension of the exceptional interest rate waiver would be consistent with the financing package approved in July 2009**. Staff's latest projections of subsidy needs—presented in *Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries*—incorporate the operation of the approved PRGT interest rate mechanism, underpinned by a gradual increase in global interest rates in line with World Economic Outlook (WEO) projections. On this basis, the revised interest rates would not require significant additional PRGT subsidy resources and the July 2009 financing package would remain sufficient to meet projected demand over the medium term.

IV. Staff Assessment

15. **Staff recommends that at this juncture the temporary interest waiver for PRGT-eligible members be extended for one further year**. It is proposed that the temporary interest waiver would expire at end-December 2012 and interest rates for the subsequent 12 months would revert to those currently implied by the interest rate mechanism. Specifically, taking into account that the 12-month average SDR rate is currently below 2 percent, the interest rate mechanism would give rise to the following structure of interest rates for 2013: zero percent for all ECF and RCF loans, and 0.25 percent for SCF loans. Outstanding ESF loans and subsidized ENDA/EPCA credits would carry an interest rate of 0.25 percent after the interest waiver expires. Consistent with Section II, Paragraph 4(b) of the PRGT Instrument, the next review of the interest rates on loans under the ECF, RCF, and SCF would be completed by December 31, 2013.

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[13] At the Board discussions of the LIC facility reforms, some Executive Directors emphasized that differentiation was an integral aspect of the new instruments.