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DEBT LIMITS IN FUND PROGRAMS WITH LOW-INCOME COUNTRIES

EXECUTIVE SUMMARY

At the conclusion of the Executive Board's discussion of the review of the Fund's Debt Limits Policy (DLP) in March 2013, Directors called on staff to develop the reform proposals outlined in the paper into a more concrete form that could serve as the basis for further discussion at an informal Board meeting.

The reform proposal developed here argues for a new approach to the handling of external borrowing plans in Fund arrangements with low-income countries. It builds on the input received during the March Board discussion and from consultations with stakeholders carried out by staff in the ensuing months. The specification of limits on the accumulation of external debt in countries to whom concessional financing is not normally available is not discussed here, but will be covered in the Board paper that formally proposes the reform of the DLP.

Key features of the proposed approach include:

- It focuses on the aggregate *borrowing plan*, rather than only on nonconcessional borrowing.
- It is *country-driven* and *flexible*, in the sense that the policy dialogue is focused around the countries own investment/borrowing plan.
- As a counterpoint to enhanced flexibility, it places emphasis on the *transparency of financing assumptions*, thereby facilitating both the ex evaluation of plans and the assessment of the implementation record in program reviews.
- Policy dialogue on individual loans occurs only in the case of *macro-significant* loans, where macro-significant is defined in terms of loan size relative to GDP.
- The assessment of performance is broad-based, evaluating the general implementation of the debt/financing plan, rather than focused exclusively on performance in relation to a single measure (such as the level of NCB).

Approved By
Seán Nolan

Prepared by a team from SPR led by Laurence Allain and comprising Karina Garcia, Hajime Takizawa, Geneviève Verdier, Natalia Novikova, Calixte Ahokossi, Yi Xiong, Jay De and Yan Sun-Wang, under the overall guidance of Seán Nolan, Peter Allum, and Reza Baqir (all SPR).

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OVERVIEW

1. **At the conclusion of the Executive Board's discussion of the review of the Fund's Debt Limits Policy (DLP) in March 2013, Directors called on staff to develop the reform proposals outlined in the paper into a more concrete form that could serve as the basis for further discussion at an informal Board meeting.** Directors also called on staff to develop a proposal for reform of the system of discount rates used in the analysis of external debt issues in low-income countries (LICs), to be brought to the Board on a stand-alone basis ahead of the next discussion of the DLP.
2. **A paper on reform of the system of discount rates ([Unification of Discount Rates Used in External Debt Analysis for Low-Income Countries](#)) was brought to the Board in early October and approved on a lapse of time basis on October 11, 2013.** A similar paper was approved by the Executive Board of the World Bank shortly afterwards.¹
3. **Staff has engaged in extensive consultations on the proposed reform of the DLP with stakeholders, including the World Bank, since the March 2013 Board meeting.** The proposal described here seeks to respond to the concerns raised in these consultations and to incorporate the valuable input received.

Current Fund Policy on Debt Limits

4. **The Fund's policy on the use of debt limits in Fund-supported programs, in its current form, came into effect in December 2009 (annex).²** An associated guidance note to staff ([Staff Guidance Note on Debt Limits in Fund-Supported Programs](#)) was issued shortly afterwards. The first paragraph of the policy states that: *"When the size and the rate of growth of external indebtedness is a relevant factor in the design of an adjustment program, a performance criterion establishing a limit on official and officially guaranteed external debt will be included in Fund arrangements in the upper credit tranches or under the PRGF-ESF Trust."*

¹ The Bank and the Fund use a similar discount rate system for the purpose of calculating the grant element of loans.

² This policy refers to the *Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements* (see [Decision No. 6230-\(79/140\)](#), as amended).

5. **Additional guidance is provided in the case of Fund-supported programs with members to whom concessional financing would normally be available.**³ The guidance depends on country circumstances, in particular the quality of public resource management capacity and the extent of external debt vulnerabilities. For countries deemed to have weak capacity, the performance criterion limits or precludes the accumulation of **nonconcessional debt**.⁴ This approach has typically also been taken in the case of countries deemed to have strong capacity.

6. **The experience with this approach to setting performance criteria on external debt in Fund arrangements with LICs has been mixed (see [Review of the Policy on Debt Limits in Fund-Supported Programs](#)):**

- The sharply distinct treatment of concessional borrowing and nonconcessional borrowing (NCB) is difficult to justify when very marginal changes in loan terms or discount rates can move a loan from one category to the other.
- The policy dialogue on external borrowing issues with country authorities is now heavily focused on the issue of specific projects financed by nonconcessional debt—a distortion of what should be a richer dialogue on developing investment assessment capacity and debt management issues, at a time when the range of financing options available to LICs has expanded significantly.
- Operational features of the policy—notably the use of a performance criterion on a variable (NCB) that can shift markedly in response to economically insignificant shifts in loan terms—have created significant difficulties, including a sizeable number of waivers and misreporting cases triggered by events that were not economically significant. Reform of the system of discount rates has addressed some, but not all, of these operational details.

³ Countries for which concessional financing is normally available (in the sense that they obtain the bulk of their financing on concessional terms) are typically characterized by low levels of income. As shorthand, these countries are henceforth referred to as LICs.

⁴ The term “nonconcessional debt” is used to refer to all debt with a grant element that is lower than a specified threshold, typically 35 percent.

Proposed New Approach

7. **The annotated PowerPoint presentation below proposes a new approach to the handling of external borrowing plans in Fund arrangements with LICs.** The specification of limits on the accumulation of external debt in countries to whom concessional financing is not normally available is not discussed here, but will be covered in the Board paper that formally proposes the reform of the DLP. Key features of this approach include:

- It focuses on the aggregate *borrowing plan*, rather than only on nonconcessional borrowing.
- It is *country-driven* and *flexible*, in the sense that the policy dialogue is focused around the countries own investment/borrowing plan.
- As a counterpoint to enhanced flexibility, it places emphasis on the *transparency of financing assumptions*, thereby facilitating both the ex evaluation of plans and the assessment of the implementation record in program reviews.
- Policy dialogue on individual loans occurs only in the case of *macro-significant* loans, where macro-significant is defined in terms of loan size relative to GDP.
- The assessment of performance is broad-based, evaluating the general implementation of the debt/financing plan, rather than focused exclusively on performance in relation to a single measure (such as the level of NCB).

REFORM PROPOSAL

Debt Limits in Fund Programs with Low-Income Countries: Reform Proposal



December 2013

Structure of Presentation

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	Slides
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•Program Design: Assessing the Borrowing Plan	13-14
•Description of Borrowing Plan in Program Documentation	15-19
•Assessing Implementation in Program Reviews	20
•Operational Issues	21-26

Focus: Low-Income Countries

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- Why distinctive treatment (from market-access cases)?
 - LICs typically rely significantly on official sector financing provided on concessional terms
 - Donors' willingness to provide concessional funding is dependent, inter alia, on (a) reassurances regarding sustainability of external debt servicing over time; (b) comfort level with "burden-sharing"
 - Desirability of ensuring that LICs receive funding on generous terms, thereby expanding the impact of external borrowing on income growth and poverty reduction

While the policy on debt limits in Fund-supported programs applies to all Fund members, concessional financing has been excluded from debt limits since the origins of the policy in the 1960's. Historically, this reflected the Fund's desire to protect flows that play an important role in the development process and that were seen as less harmful to debt sustainability.

Post-HIPC, donors' willingness to provide concessional funding—a key resource for the poorest countries—is dependent on (a) confidence that hard-won debt sustainability will remain in place over the medium term and (b) a comfort level with the extent of equitable burden-sharing across official creditors.

Concessional financing continues to play a critical role in the development process of the least well-off countries. We henceforth use the terms "low-income countries" (LICs) and "countries for which concessional finance is generally available" as being equivalent. As a shorthand, these countries are referred to as LICs in the rest of this presentation.

For the purposes of this presentation, the terms "debt", "borrowing," and "loan" are used interchangeably and refer to the concept of debt set out in Executive Board Decision No. 6230-(79/140) point 9, as revised on August 31, 2009 (Decision No. 14416-(09/91).

The Wider Context

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- Differences of views among the membership (borrowers vs. lenders, traditional vs. emerging lenders)
- Desirability of broad alignment between Fund and World Bank on policies regarding external borrowing by LICs
- Concurrent developments
 - Growing menu of borrowing options for LICs
 - “Sustainable lending” initiatives (G-20, UNCTAD)
 - DAC debate over “concessional in character”
 - Some traditional donors considering shifts from grants to loans

The March 2013 Board discussion on the Review of the Policy in Debt Limits in Fund-Supported Programs ([Review of the Policy on Debt Limits in Fund-Supported Programs](#)) provided a wide range of views. Some Directors argued in favor of increased flexibility in the debt limits policy, while others stressed that enhanced flexibility should not come at the price of reentering a lend-and-forgive cycle.

The Board also emphasized the objective of maintaining, to the maximum extent possible, broad consistency between the Fund’s debt limits policy and the Bank’s nonconcessional borrowing policy (NCBP).

The proposed reform takes place in the context of a number of concurrent developments, both in the external financing circumstances facing LICs and in the international dialogue on aid flows. LICs now face a wider range of financing options, including both a larger range of bilateral lenders and access (for some) to international financial markets. Among official lenders, there is ongoing debate regarding “sustainable lending practices” and the appropriate definition of “concessional” and an expanding discussion of financing for the post-2015 development agenda; also, some traditional donors are giving consideration to making more use of loans instead of grants in the provision of development assistance.

Evolution of Policy on External Debt Limits (1)

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- Pre-2009:
 - Principle: tight limits on non-concessional external borrowing (NCB), exemptions from “zero NCB” granted on ad hoc basis
 - No limit on contracting concessional loans, other than implicitly via the debt sustainability assessment (DSA)
- BUT
- Investment financing needs far exceed supply of concessional finance →
 - Accommodation of NCB needed if adequate public financing levels are to be reached

Prior to the 2009 reform, the basic design of debt conditionality in LICs involved (a) a zero limit on nonconcessional borrowing (NCB) and (b) no limits on concessional borrowing, leaving overall borrowing levels uncapped in most programs.

Over time, the scale of LICs’ investment needs, coupled with the limited supply of concessional finance and the increased availability of semi-concessional or commercial loans, led to an increasing number of carve-outs in Fund programs to accommodate some nonconcessional borrowing for specific projects.

As of early 2009, about one-third of PRGT-supported programs had an ex ante positive NCB limit; adding in cases where waivers were granted for exceeding the limit, about 40 percent of programs accommodated some level of NCB.

Evolution of Policy on External Debt Limits (2)

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- 2009 Reform: increased flexibility to tap NCB within well-specified framework
 - Positive NCB limit depending on institutional capacity and debt vulnerability
 - For countries with weak capacity → NCB tied to projects, requirement for independent scrutiny of projects
 - For countries with higher capacity/solid track record → untied limits
- Performance criterion remains on the level of NCB

A key objective of the 2009 reform was to provide a structured framework to evaluate proposed NCB, in a context of significantly improved macroeconomic management and performance in many LICs and increased financing options for these countries.

The 2009 reform involved a shift from a single design for concessionality requirements to a menu of options that took into account the diversity of countries' circumstances. In particular, it laid out specific guidance relating the type of debt limits to be included in LIC programs to a country's debt vulnerabilities, as assessed under the joint IMF-World Bank Debt Sustainability Framework (DSF), and to its macroeconomic and public financial management capacity. The resulting classification of countries based on these two dimensions is summarized in a "concessionality matrix" that is updated annually.

Problems with the Current Framework

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- Exclusive focus on NCB:
 - Unconstrained aggregate borrowing levels
 - Narrow focus of attention: small loans with grant element below 35% receive high scrutiny, large loans with grant element above 35% receive no scrutiny
 - Small changes in grant element shift loans from concessional to NCB, resulting in the non-observance of the PC
- Independent assessments of projects in weaker capacity countries are typically not available

The 2009 reform left one key feature of the established approach unchanged: the debt limits policy focuses exclusively on the level of nonconcessional borrowing.

Viewed from an economic perspective, this sharp distinction between concessional and nonconcessional borrowing is difficult to justify, given that very minor shifts in loan terms (or, in the past, discount rates) could shift loans from one category to the other. The argument that, all other things being equal, obtaining loan A with a grant element of 40 percent is better than obtaining a broadly similar loan B with a grant element of 30 percent is, of course, compelling—but the argument that loans with a grant element of 20–30 percent are inherently problematic when loans for a similar purpose with a grant element of 35 percent or more are **not** available is clearly wrong. Focusing the policy dialogue on external borrowing with country authorities exclusively on the issue of nonconcessional borrowing is an overly narrow approach as borrowing options and associated debt management challenges increase. Focusing staff efforts on establishing the growth impact of a small subset of investment projects (NCB-financed), rather than forming a view on the overall investment-growth nexus, is also problematic.

The current approach to setting conditionality also has significant technical weaknesses: (a) concessional borrowing plans are rarely discussed and not subjected to quantitative limits; (b) loans can easily shift from one category to the other on the basis of economically insignificant shifts in loan terms; (c) loans with a grant element of 30 percent and loans with an interest rate of LIBOR plus 500 bps are arguably viewed as being equally problematic; and (d) reliance on independent assessments of projects financed with nonconcessional loans proved to be very difficult to operationalize, given the absence of parties willing to undertake such assessments.

For further discussion of these technical weaknesses, see [Review of the Policy on debt Limits in Fund-Supported Programs](#).



**Towards a more comprehensive approach
to assessing and monitoring external
borrowing policies in LICs**

Key Objectives of the Reform

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- **Overarching principle:** *ensuring debt sustainability over the medium-term*
 - DSA remains the centerpiece of the policy
 - But this does not anchor debt limits in many LICs
- **Additional principles:**
 - Borrowing policy should be economically sound/justifiable
 - Policy needs to contain solid incentives to promote borrowing on “concessional” terms

An overarching principle of the debt limits policy (DLP) is to ensure that a country’s debt vulnerabilities, as assessed through the DSA, are kept in check. While maintenance of debt sustainability over the medium-term acts as a constraint on the accumulation of external debt, countries need to have access to adequate external financing to support strong growth—implying, typically, a need both for adequate donor support and for judicious use of borrowing opportunities that are not fully concessional.

For many countries at low/moderate risk of encountering debt distress, the debt sustainability assessment does not provide a binding constraint on borrowing levels over the near-to-medium term: i.e., there is sizeable borrowing space, given current low levels of debt. Given absorptive constraints and weaknesses in public resource management capacity, it is important that this valuable “space” be used effectively, in the sense of maximizing the development payoff from expanded borrowing levels.

LICs currently receive a very large share of their external financing on concessional terms, sharply easing the burden of future debt service on budgets and external positions: reform to the Fund’s DLP needs to maintain incentives for both creditors and borrowers to provide/seek financing on terms as favorable as possible to the borrower.

Main elements of the new approach

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Transparent specification of the borrowing program

- Specification (including quantification) of the main elements of the external borrowing plan in program documents
- Macro-significant elements of the program assessed by Fund team

Review-based assessment of implementation

- Team reviews implementation of the borrowing plan; evaluates the significance of any substantive deviations from plan; and seek understanding with authorities on appropriate remedial measures, where needed
- Program documents contain sufficient information to allow the Board form a view on merits of staff assessment

The new approach has several features:

- It focuses on the aggregate *borrowing plan*, rather than only on nonconcessional borrowing.
- It is *country-driven* and *flexible*, in the sense that the policy dialogue is focused around the countries own investment/borrowing plan.
- Alongside enhanced flexibility, the approach places emphasis on the *transparency of financing assumptions*, thereby facilitating both the ex ante evaluation of plans and the assessment of the implementation record in program reviews.
- Policy dialogue on individual loans occurs only for *macro-significant* loans.
- The assessment of performance is broad-based, evaluating the general implementation of the borrowing plan, rather than focused exclusively on performance in relation to a single performance criterion.

These features are discussed in detail in the next slides.

Familiar elements of the new approach

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Role of Debt Sustainability Analysis (DSA)

- Borrowing plan must be consistent with debt sustainability over the medium-term

Definition of Concessional Loans

- 35% grant element (GE) or above
- Recommended norm for minimum level of concessionality on official sector loans

Role of Debt Vulnerability

- Continues to influence staff assessment of borrowing plan

As noted earlier, keeping debt vulnerabilities in check remains an overarching objective for the Fund's debt limits policy: the DSA retains a central role in assessing borrowing plans.

The definition of concessional loans remains unchanged: loans that contain a grant element of at least 35 percent. The Fund continues to urge official lenders to provide concessional credit to LICs.

The extent of debt vulnerabilities continues to play a key role in staff's assessment of a borrowing plan; countries deemed to be at high risk of/already in debt distress are handled with additional safeguards (see slide 25).

A Three-Step Process

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Program Design/Negotiation

Iterative dialogue on the proposed macroeconomic program, including the external borrowing plan



Depiction of Borrowing Plan in Program Documents

Discussion of the Borrowing Plan in the MEFP/Staff Report



Assessment of Implementation: Program Review

Program Design: External Borrowing Plan (1)

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- **Macroeconomic assessment of the proposed plan**
 - Is any proposed scaling up of public investment wise/feasible, given implementation capacity limits?
 - Is any proposed increase in borrowing levels to be accompanied, at a minimum, by an equivalent increase in public investment levels?
- **Consistency with Medium-Term Debt Sustainability?**
 - Does the plan significantly affect the risks to maintaining debt sustainability?

The authorities' external borrowing plan is examined across a number of dimensions:

Macroeconomic assessment of the investment and associated financing plan:

- Is any proposed scaling up of public investment sound, given established implementation capacity? There has been significant staff analytical work undertaken to assess the appropriate pace of scaling up under different circumstances; more work on quantifying appropriate "speed bumps" on scaling up may be warranted (see [Staff Guidance Note on Debt Limits in Fund-Supported Programs](#) for current guidance).
- Are proposed increases in external borrowing accompanied by commensurately higher public investment levels? If not, is there a compelling argument for financing more consumption via external borrowing? What is the country's track record in this context?

Consistency with medium-term debt sustainability:

- The authorities' plans should be consistent with appropriately containing risks to debt sustainability, as assessed using the DSA. Existing guidance on how this principle is to be implemented is contained in the Staff Guidance note on the debt limits policy ([Staff Guidance Note on Debt Limits in Fund-Supported Programs](#): see, for example, paragraphs 14–16). This guidance note will be revised in light of any changes agreed to the debt limits policy itself; it will also look at how to assess whether DSAs for a country have any repeated bias (too optimistic/too pessimistic).

Program Design: External Borrowing Plan (2)

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- Discussion of planned macro-significant loans

Project Loans:

- Discussion of economic rationale and financing arrangements for macro-significant projects

Other Loans:

- What is the economic case for any planned sovereign bond issues, syndicated loans, other non-project loans?
- What risk mitigation measures are being taken (e.g., to contain rollover/ repricing risk, humps in debt service)?

Quality of Projects Financed by External Borrowing:

- At an early stage in the program, staff would assess, with the engagement of Bank-Fund experts, the processes currently adopted by the government in assessing investment projects for inclusion in the public investment program, identifying key areas of weakness. This would provide an inventory of areas where capacity development needs are acute that would help guide the provision of technical assistance.
- Staff would discuss with the authorities the *macro-significant* projects included in the proposed borrowing plan—"macro-significant" projects being those which involve loans in excess of 1–2 percent of GDP, with the exact threshold depending on country circumstances. The discussion would cover the rationale for the project, its role in the national development strategy, and the choice of financing arrangements.
- Staff will need to obtain a realistic sense, from dialogue with country authorities and development partners, of the likely contribution of expanded public investment to growth as an input in conducting the DSA—where the investment-growth nexus plays a key role.

Loans Unlinked to Specific Projects

- For loans not explicitly tied to specific projects (e.g., sovereign bond issues, and syndicated loans), staff would discuss with the authorities the economic case for undertaking such loans and the specific modalities envisaged. Budget support loans negotiated on concessional terms with multilateral financial institutions or bilateral official donors would not warrant such a dialogue.
- For countries considering large loans on commercial terms or at short maturities, staff would discuss planned measures to handle likely humps in debt service and rollover/repricing risk. The development of a medium-term debt management strategy would be a high policy priority.

MEFP: Description of the Borrowing Plan (1)

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- Quantitative description of external borrowing program, including breakdown by loan type:

Fully-concessional loans	• grant element at or above 35%
Semi-concessional loans	• positive grant element, but less than 35%
Commercial loans	• no grant element

- Summary statistics on the concessionality features:
 - Expected level of borrowing that is not fully concessional
 - Average Level of Concessionality

A key feature of the new approach is an emphasis on transparency in the disclosure of the authorities' borrowing plans. The memorandum of economic and financial policies (MEFP) would be expected to include a clear description of their medium-term borrowing plans, including projected levels and anticipated financing terms; for the year ahead, a quantitative specification would be required, with any numbers for ensuing years being indicative in nature. The next slide provides an example of the description that would be called for in program documents (either the MEFP or the staff report).

For the year ahead, the summary data provided would include planned levels of concessional and other loans (semi-concessional and commercial) and weighted average measures of the average level of concessionality, derived from the agreed borrowing plan.

The term "semi-concessional loan" is used to refer to a loan that has a positive grant element but does not meet the 35 percent grant element threshold.

Example: Country's borrowing plan

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Group of instruments	Terms 1/	Volume of new contracts, US million	Grant element 2/
Year 1			
1 Highly concessional multilateral external loans	Regular IDA terms	35	60.6%
2 Bilateral concessional loans		30	35.0%
3 Bilateral semi-concessional loans	Fixed rate at 2%, 20-year maturity, 5-year grace period	20	26.6%
4 Loans on commercial terms		15	0.0%
	Total amount of new debt	100	
	Average grant element of (1)-(4)		37.0%
	Present value of the new debt	63	
Memorandum items			
Year 2 (indicative)	Total amount of new debt	100	35-40%
	Present value	60-65	
Year 3 (indicative)	Total amount of new debt	120	35-40%
	Present value	72-78	

1/ Assumes no fees.

2/ Given a discount rate of 5% per annum.

This table provides an example of the information that would be expected to be provided in the MEFP.

MEFP: Description of the Borrowing Plan (2)

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- Summary description of macro-significant projects, including economic rationale and funding sources
- Explanation of plans for any significant non-project external commercial borrowing
- Additional safeguards, if warranted

The MEFP would include a summary discussion of (a) key macro-significant project loans expected to be contracted in the period ahead, including the project's role in the national development strategy and the planned funding sources and (b) the status of any plans for significant untied external commercial borrowing under consideration by the authorities and the economic case for such borrowing.

For countries facing either a high level of debt vulnerability or burdened by weak domestic resource management capacity, additional safeguards may be warranted (see slides 25–26).

MEFP: Program Conditionality

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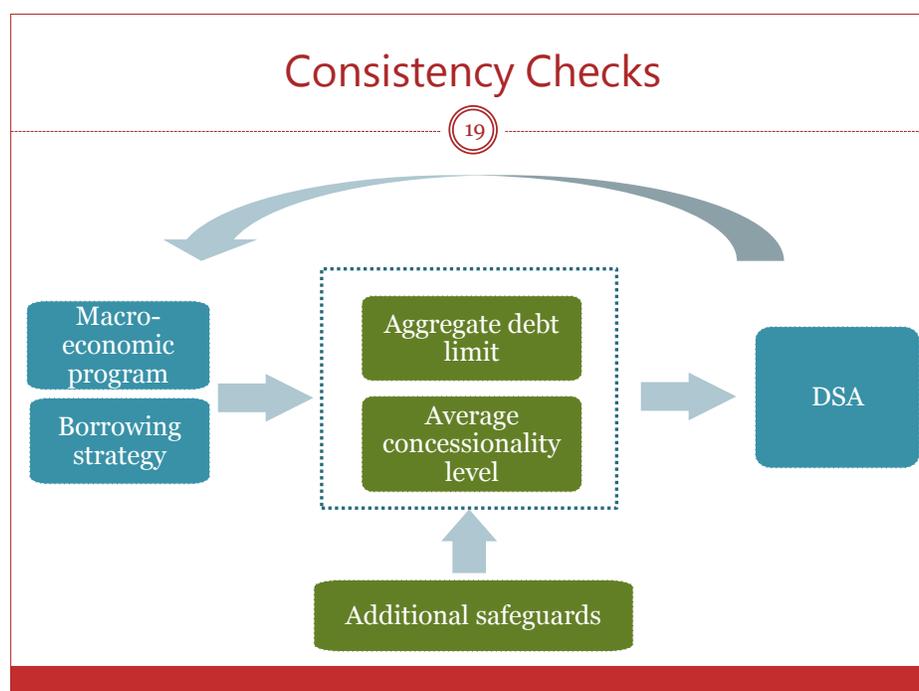
- Quantitative performance criterion on the contracting of new external debt
- Indicative target on some summary measure of the concessionality features of the borrowing plan

The MEFP contains a series of policy commitments, including proposed levels of different types of borrowing and summary statistics: what is now needed is the (parsimonious) specification of quantitative performance criteria (PCs) and/or indicative targets (ITs). The choice of specific variables to set as performance criteria and/or indicative targets should reflect the core objectives of the policy, while paying appropriate attention to issues such as ease of measurement (to limit misreporting risks) and ease of interpretation (to facilitate monitoring by country authorities, using measures aligned with domestic policy debate).

For the DLP, staff are of the view that the appropriate quantitative targets are:

1. *A performance criterion on the contracting of new external debt* (to contain the accumulation of new debts).
2. *An indicative target on some summary measure of the average level of concessionality of the newly contracted debt* (to ensure that the mix of loans contracted (in terms of concessionality of terms) is aligned with the mix of concessional and nonconcessional financing contained in the borrowing plan).

The precise technical specification of these measures has been the subject of active debate with stakeholders, with various suggestions having been made. These are discussed below.



The chart summarized the manner in which the performance criterion and indicative target are set.

The proposed borrowing program would be assessed in accordance with the tests described previously: a key requirement is that the borrowing plan be consistent with containing risks to debt sustainability. Should the plan not meet this test, the macroeconomic program and borrowing plan would need to be revised to fully incorporate this requirement.

The indicative target on the average concessionality would reflect the financing terms that the authorities are likely to obtain. There would be a strong expectation that the resulting grant element would be close to the level the country has obtained in the recent past and similar to the financing terms available to countries with similar characteristics.

Additional safeguards could be injected into the process if warranted, particularly for countries with a high level of debt vulnerability.

Program Review: Assess Performance

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- Review-based assessments of implementation of borrowing plans/commitments
- Addressing deviations from planned policies/targets
 - Deviations assessed on case-by-case basis in program reviews, as is currently the case with non-observance of other PCs
 - Where warranted, corrective actions could include steps to strengthen debt management and/or adjustment of future borrowing plans (less borrowing, more favorable terms)
 - Program suspension in cases of large or systematic deviations

The implementation of the authorities' borrowing plans, including its concessionality level, will be assessed during program reviews.

Deviations from quantitative program targets will be evaluated in light of the specific circumstances of the case, as is done with deviations from other PCs and the case with non-observance of other PCs (e.g., fiscal and monetary targets).

Non-observance of the performance criterion on the accumulation of debt would require corrective actions or remedial measures in order to be waived, allowing the review to be completed by the Board.

Deviations from the indicative target on concessionality would not require a waiver, but would require investigation and assessment by staff and explanation in Board documents. The assessment would examine the factors contributing to the deviation, establishing whether they were benign (e.g., timing delays) or reflective of a borrowing strategy different from that envisaged under the program.

Non-observance of the PC and IT could warrant corrective or remedial actions—which might include capacity strengthening measures or, potentially, modifications to future borrowing plans. Large and/or repeated deviations from targets would raise questions as to the credibility of the authorities' commitment to their stated borrowing strategy, potentially leading to an extended delay in completing a review.

Operational Issues

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- Specifying/setting the performance criterion on aggregate borrowing
- Specifying/setting the indicative target on average concessionality
- Handling countries with high debt vulnerabilities
- Additional safeguards

Performance Criterion on Contracting New Debt

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- Annual limit on the contracting of new external debt, with illustrative mid-year targets if feasible
- Indicative projections for the outer years of the program
- Valuing loans: nominal or present values?
 - Nominal: easy to monitor by staff; easy for the country authorities to track; links, with average concessionality, to a PV level
 - PV: conceptually appealing; enhances incentives for concessional financing, but with operational disadvantages

1. The performance criterion (PC) would cover the contracting of all new debt, regardless of its concessionality features.
2. Typically, the PC would cover only external debt. In situations where the primary concern is the accumulation of public debt in all forms (i.e., domestic and external), the limit could be set on total public debt—an option already allowed for under the current policy. In such cases, concessionality requirements would apply only to external debt.
3. As currently, debt limits would be set on the contracting of new debt rather than on the disbursement of loans.
4. The PC would take the form of an annual limit, with indicative limits for the outer years of the program; where realistic, illustrative mid-year targets could be specified.
5. Debt limits could be set either in nominal or present value terms. Each approach has merits and disadvantages: on balance, staff favors setting debt limits in nominal terms.
 - Nominal limits are easy to track and monitor by country authorities and to explain at the political level: they would not be affected by minor shifts in the concessionality level (relative to expectations) of loans, which would affect PV calculations, potentially producing minor non-observance of the performance criteria, with the associated need for waivers and (given measurement difficulties) potential misreporting problems.
 - PV limits are conceptually appealing—since it is the PV concept that lies at the core of the DSA—and have the merit that highly concessional loans count much less against the limit than do commercial loans. But monitoring of a PV target by country authorities will likely be more difficult, while the target itself may be more difficult to explain at the political level.

Indicative Target on Average Concessionalality

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- Set on the weighted-average level of concessionalality of newly contracted loans
- Commercial loans assigned zero grant element
- Teams can choose instead to set the IT on the contracting of debt measured in present value terms

Staff proposes to set the indicative target on the weighted-average level of concessionalality of the borrowing plan. In staff's view, this is the simplest measure to summarize the concessionalality mix of a multi-loan borrowing plan and it is also a familiar concept to relevant stakeholders.

This said, this measure has some practical shortcomings:

- The weighted-average could move sharply if large loans with concessionalality levels far-removed from the average (e.g., IDA loans and commercial loans) were to either drop out of the borrowing plans or to be significantly delayed. In practice, staff can, during a review, disentangle the impact of such developments on the average level of concessionalality, producing adjusted estimates that can be compared with the program target to assess the evolution of concessionalality levels in other elements of the borrowing program—but the headline number would move around.
- The weighted-average level of concessionalality could be open to misinterpretation by lenders as the "target" level of concessionalality that the Fund is seeking from official creditors. **This is not the case:** the Fund urges official creditors to lend on fully concessional terms to LICs, meaning with a grant element of at least 35 percent. To avoid sending misleading messages in cases where average concessionalality is expected to be significantly less than 35 percent, the indicative target might instead be set on the present value of new debt (which, used alongside the nominal debt limit, can capture average concessionalality trends).

Thus, teams would have the option of setting the IT either on (a) the average level of concessionalality or (b) the present value of external debt contracted. (Note that, used as an indicative target, deviations from the target due to minor shifts in the financial terms of loans (relative to expectations) could be assessed judgmentally, rather than involving the non-observance of a performance criterion).

Average Concessional: Recent Patterns

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Average concessionality of new commitments contracted by PRGT-eligible countries in 2009-11

	Average grant element 1/	Number of observations
Cross-country	39.4%	158
By income group		
Low	43.0%	72
Lower-middle	33.9%	71
Upper-middle	27.4%	15
Memo:		
Standard deviation	12	

Sources: IMF staff estimates; WDI

1/ Weighted by the volumes of new external commitments. Calculation of grant element is based on 5 percent discount rate.

2/ Economies are divided according to 2012 GNI per capita, calculated using the World Bank Atlas method. GNI cut-off thresholds are: low income group below \$1,035; lower-middle income group \$1,036 - \$4,085; upper-middle income group \$4,086 - \$12,615

Staff estimates show that the average grant element of external loans contracted, weighted by loan size, was some 39 percent for PRGT-eligible countries during 2009–11. *On average*, external loans to PRGT eligible countries were fully concessional—but the average levels presented in the table masks significant variation of concessionality levels across countries and, for individual countries, over time.

When the sample is broken down by per-capita income level, it can be seen that the average grant element differs across income groups. Lower income countries generally borrow on more concessional terms; higher income countries in the sample typically receive less generous terms.

Staff also calculated the average grant element broke down by risk of debt distress. Results show that countries with higher risk of debt distress or in debt distress have lower average grant element, because these countries (i) tend to receive grants rather concessional loans, and (ii) in some cases, have very limited access to concessional financing owing to their debt situation (e.g., existence of arrears).

Countries with high debt vulnerabilities

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- Assessment of borrowing space requires careful use of DSA – any deterioration in the debt trajectory would require a strong justification
- Borrowing that is not fully concessional would require a strong justification (as in current guidance)
- Option to define “full-concessional” as requiring a higher grant element than 35% if warranted by gravity of debt situation

For countries with high debt vulnerabilities (i.e., countries rated as being at high risk of debt distress or already in debt distress), the need for the authorities to maintain tight control over debt accumulation is a very high priority. In such situations, the shift towards a more flexible approach to setting debt limits, along the lines envisaged here, could be premature. It is proposed, therefore, that the current policy applied under such circumstances should remain substantially unchanged—specifically:

1. Any borrowing plan that would lead to a deterioration in the debt trajectory from the previous DSA would require a compelling justification (e.g., as in the case of a well-designed project of strategic importance for growth).
2. Borrowing that is not fully concessional would require a strong justification.
3. In difficulty cases, program conditionality could be adjusted to define concessional loans as having a grant element higher than 35 grant element.

Additional safeguards

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- Countries with weak capacity
 - An explicit ex ante consultation clause on **all** commercial loans?
- Enhance LIC negotiation capacity on loan terms
 - Track the recorded concessionality levels for “comparable” countries (e.g., income level) and over time: include information in staff reports?

Countries that have significant capacity constraints and governance weaknesses face a higher risk of entering into commercial agreements that would create risks to debt sustainability or, at a minimum, represent a poor deal for the country. To guard against this, programs could include an explicit ex ante consultation clause for all commercial loans, stipulating that country authorities would have to discuss with Fund staff any planned loans at commercial terms before contracting it.

The enhanced transparency of borrowing plans under the proposal is also expected to raise countries' bargaining power in loan negotiations. This would happen, inter alia, by providing countries with information on borrowing terms obtained by similar countries. Concessionality levels for a set of comparable countries (e.g., countries that have a similar income level and/or have a similar set of creditors) could be systematically tracked and reported on. Such comparison could be included in staff reports and used by country authorities in negotiations.

To Summarize

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- **Main elements of the new approach:**
 - Transparent specification of the borrowing program
 - Review-based assessment of implementation
- **Design of quantitative conditionality**
 - Performance criterion: aggregate nominal limit on new external debt contracted
 - Indicative target: weighted average level of concessionality or present value of external debt contracted
- **Additional safeguards for countries with high debt vulnerabilities**



End

GUIDELINES ON PERFORMANCE CRITERIA WITH RESPECT TO EXTERNAL DEBT IN FUND ARRANGEMENTS

1. When the size and the rate of growth of external indebtedness is a relevant factor in the design of an adjustment program, a performance criterion establishing a limit on official and officially guaranteed external debt will be included in Fund arrangements in the upper credit tranches or under the PRGF-ESF Trust.
2. For purposes of this performance criterion, the concept of “external” debt may be defined on the basis of the residency of the creditor or the currency of denomination of the debt. The residency of the creditor would normally be used as a criterion for defining external debt in the case of members with relatively closed capital accounts or very limited financial integration with the rest of the world. Each external debt performance criterion will specify which of these two criteria is being used for purposes of the definition of debt in the particular performance criterion.
3. As specified in further detail in paragraph 9 of these guidelines, the external debt performance criterion will include all forms of debt, including loans, suppliers’ credits and leases, that constitute current, i.e., not contingent, liabilities, which are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which require the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments discharge the principal and/or interest liabilities incurred under the contract.
4. The external debt performance criterion will include external debts with maturities of over one year, and, in appropriate cases and where specifically provided, other financial instruments that have the potential to create substantial external liabilities for governments.
5. The external debt performance criterion will usually be formulated in terms of debts contracted or authorized. However, in appropriate cases, it may be formulated in terms of net disbursements or net changes in the stock of external official and officially guaranteed external debt.
6. Flexibility will be exercised to ensure that the establishment of an external debt performance criterion will not discourage capital flows of a concessional nature, particularly for members to

whom such concessional flows would normally be available, including members eligible for assistance under the PRGF-ESF Trust.

7. Normally, the external debt performance criterion will include a subceiling on external debt with maturities of over one year and up to five years; additional subceilings may also be included on debt with specified maturities beyond five years.

8. In accordance with these guidelines, the following considerations will apply when establishing an external debt performance criterion in Fund arrangements:

a. These guidelines will be applied with a reasonable degree of flexibility while safeguarding the principle of uniformity of treatment among members. These guidelines should be interpreted in the light of the Guidelines on Conditionality (Decision No. 12864-(02/102), adopted September 25, 2002, as amended.

b. The external debt performance criterion will be established in a manner that is mindful of the need to ensure consistency between external debt management policies and domestic financial policies. Where external debt per se is not a matter for concern, but adjustment programs have as a main objective to reduce excess demand pressures and restore overall balance to the public sector finances, arrangements may include a performance criterion on total debt, i.e., both domestic and foreign financing of the overall public sector deficit.

c. Normally the external debt performance criterion will relate to official and officially guaranteed external debt and will include all public enterprises and other official sector entities unless an explicit exclusion is made, as well as private debt for which official guarantees have been extended and which, therefore, constitute a contingent liability of the government. An explicit exclusion could be made for specific public enterprises or other official sector entities that are assessed to be in a position to borrow without a guarantee of the government and whose operations pose limited fiscal risk to the government.

d. In cases where the member's external debt management policy covers private sector debt without official guarantee and there is an established regulatory mechanism to control such debt, the external debt performance criterion should be adapted accordingly.

e. The external debt performance criterion should include short-term debt of a maturity of less than one year, while allowing some flexibility in light of the different institutional reporting procedures employed by members and the statistical difficulties of recording that category.

f. The appropriate level and composition of external debt for purposes of the external debt performance criterion will be determined based on an assessment of existing and prospective developments in the member's external payments situation, the member's external debt vulnerabilities as assessed in debt sustainability analyses and its macroeconomic and public financial management capacity.

g. For members to whom concessional financing would normally be available, the following specific considerations shall apply in establishing the external debt performance criterion, taking into account the assessment and classification methodologies set forth in SM/09/215 (August 7, 2009):

(i) For members with lower capacity and higher debt vulnerabilities, the performance criterion would generally preclude any accumulation of nonconcessional external debt. Concessional external debt would be excluded from coverage of the performance criterion. For these purposes, concessional debt is defined as debt with a grant element of at least 35 percent, although a higher grant element may be required on a case-specific basis for members in this category. Concessional debt would generally be determined on a debt-by-debt basis, using currency-specific discount rates based on the OECD commercial interest reference rates. Decision No. 11248-(96/38), adopted April 15, 1996, shall apply for purposes of determining the method of calculation of the discount rate.

(ii) For members with lower capacity and lower debt vulnerabilities, the performance criterion would generally set a ceiling on the accumulation of nonconcessional external debt. Concessional external debt would be excluded from coverage of the performance criterion. For these purposes, concessional debt is defined as debt with a grant element of at least 35 percent, and would be determined as specified in subparagraph (g)(i) above.

(iii) For members with higher capacity and higher debt vulnerabilities, the performance criterion would generally be set on the present value (PV) of external debt.

(iv) For members with higher capacity and lower debt vulnerabilities, the performance criterion would generally be set on the average concessionality of new external debt, based on the most recent debt sustainability analysis.

(v) For members covered under subparagraph (g)(iii) or (g)(iv) above that also have a strong track record of macroeconomic and public financial management, significant market access, and experience in dealing with nonconcessional financing, the performance criterion could be set on nominal external debt.

h. The external debt performance criterion in arrangements of members for whom concessional financing would normally not be available will not distinguish between concessional and nonconcessional debt, but rather would be set on nominal external debt.

i. Notwithstanding subparagraphs (g)(iii) and (g)(iv) above, for a transitional period of three years following the effective date of Decision No. 14416-(09/91), targets on the PV of external debt or on the average concessionality of new external debt may be established as annual indicative targets, rather than as performance criteria.

j. In principle, a performance criterion on external debt will incorporate by reference the definition of debt set forth in point No. 9 below. Financial instruments that are not covered under the definition but have the potential to create substantial external liabilities for governments will be included in the performance criterion where appropriate, in which case they would be explicitly specified.

9. (a) For the purpose of this guideline, the term “debt” will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract.

Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lesser retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.

(b) Under the definition of debt set out in this paragraph, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.