INTERNATIONAL MONETARY FUND
AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

Operational Framework for Debt Sustainability Assessments in Low-Income Countries—Further Considerations

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I. Introduction

1. **The Executive Boards of the Bank and the Fund have endorsed the key elements of a proposed debt sustainability framework for low-income countries (LICs).** The objective of the framework is to support low-income countries in their efforts to achieve the Millennium Development Goals (MDGs) without creating future debt problems, and to keep countries that have received debt relief under the HIPC Initiative on a sustainable track. In guiding future financing decisions, the framework rests on three pillars which were broadly supported by both Boards: (i) an assessment of debt sustainability guided by indicative country-specific debt-burden thresholds related to the quality of policies and institutions; (ii) a standardized forward-looking analysis of the debt and debt-service dynamics under a baseline scenario and in the face of plausible shocks; and (iii) an appropriate borrowing (and lending) strategy that contains the risk of debt distress.

2. **Building on initial discussions of the proposed framework in February/March 2004, and further considerations in September 2004, this paper responds to remaining concerns that need to be resolved to make the framework operational**. These concerns relate to the indicative debt-burden thresholds (Section II); the interaction of the framework with the HIPC Initiative (Section III); and the modalities for Bank-Fund collaboration in deriving a common assessment of sustainability (Section IV). This note should be read in conjunction with the original proposal, which presented the wider issues on the use of the indicative thresholds, the evaluation of policies and institutions, and the need for discretion when assessing sustainability on a forward-looking basis.[1] The discussion on these issues in earlier Board papers remains valid. Conclusions and issues for discussion are presented in Sections V and VI, respectively.

II. Choice of Indicative Debt-Burden Thresholds[2]

3. **The choice of the appropriate thresholds under the LIC debt sustainability framework is a policy decision that must balance the risk of debt distress with the costs of applying tighter constraints on new borrowing.** A lower tolerance for debt distress, reflected in more conservative thresholds, involves costs to donors in the form of additional

[1] See "Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications," SM/04/27 and IDA/SecM2004-0035 and "Debt Sustainability in Low-Income Countries—Further Consideration on an Operational Framework and Policy Implications," SM/04/318 and IDA/SecM2004-0629/1.

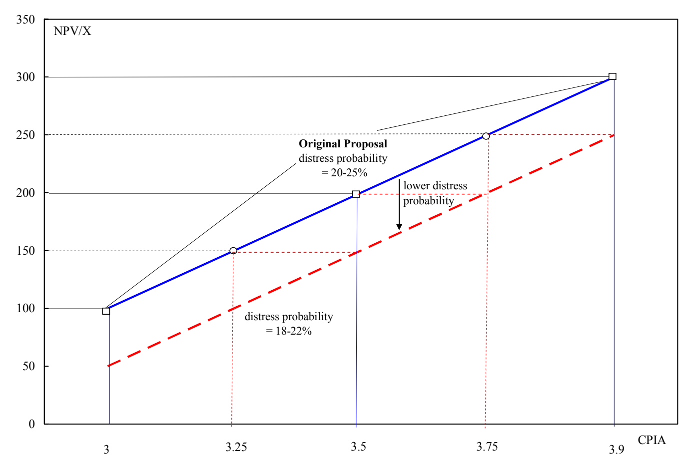
[2] This section builds closely on the information note on "Options for Revising Debt Thresholds in the Joint Bank-Fund Framework for Debt Sustainability in Low-Income Countries," which was discussed in informal Fund and Bank Board seminars on December 6 and December 9, 2004, respectively.

grant resources required to replace loans. Should grants, however, fall short of what is needed to sustain nominal aid flows, LICs will bear the costs in the way of foregone development opportunities, including lower financing in pursuit of the MDGs.

4. **In weighing the trade offs, both Boards have indicated a preference for more conservative thresholds than those originally proposed, particularly at the upper end of the range that is applicable to strong performers.** An adjustment in thresholds to address Directors' concerns can be achieved in two ways: (i) by grouping countries in the "weak," "medium," and "strong" performance categories in a different manner; and (ii) by lowering the probability of debt distress. The first would change the length of the threshold range, and thus, the extent to which country-specific thresholds respond to differences in the quality of policies and institutions. The second would reduce the absolute value of the thresholds. A reconsideration of the indicative debt-burden thresholds that balances debt distress and financing concerns suggests combining the two elements.

5. Setting the upper and lower policy cutoffs in a manner that reduces the threshold range facilitate a more conservative assessment at the upper threshold level—which was perceived as too high. Using the World Bank's Country Policy and Institutional Assessment (CPIA) to gauge the quality of policies,[3] cutoffs of 3.25 (for weak performers) and 3.75 (for strong ones)—compared with original cutoffs of 3 and 3.9—would approximately halve the length of the threshold range (e.g., from 200 to 100 percentage points of exports), while keeping the midpoint broadly unchanged at 3.5 (see text figure). This would yield new NPV of debt-to-exports thresholds of 150-200-250 percent, with some countries shifting from the medium-policy into the strong- and weak-policy categories, respectively (Table 1). While this revision would leave the underlying probability of debt distress, as measured at the three cutoff points, unchanged, it

CPIA and NPV of Debt-to-Exports Thresholds
(In percent)



[3] The Boards have endorsed the use of the World Bank's Country Policy and Institutional Assessment (CPIA) during the discussions of the "Further Considerations" paper, acknowledging that alternative comprehensive indicators would be unlikely to provide more objective or more accurate assessments. They noted that remaining concerns would be alleviated by a prospective move toward more disclosure and a corresponding opening of the CPIA to outside scrutiny, while asking that the use of the CPIA in this process be reviewed periodically.

would affect the thresholds (and distress probabilities) for individual countries, with some facing a higher and others a lower risk of distress.[4]

For a systematic reduction in the risk of debt distress, three options are considered (Table 2).[5] While differing in the underlying distress probabilities and the resulting financing implications, all three options imply a more conservative assessment than the original proposal, with no country being assessed on the basis of a higher threshold.

- **Option 1: Maintaining the lower threshold bound (implying NPV of debt-to-exports thresholds of 100/150/200 percent).** This option would imply a more conservative assessment for "medium" and "strong" performers, while maintaining the original threshold for "weak" performers—which now, however, covers a larger group.[6] Under this proposal, no country would be assessed against a higher threshold than under the original proposal—though for some countries, the threshold would remain the same. The midpoint of the range would be consistent with the uniform HIPC Initiative thresholds of 150 percent of exports and 250 percent of revenue. This has the advantage of presenting an internally consistent approach to the tolerable risk of debt distress between the HIPC Initiative and the forward-looking framework, applied to the "average" country. Compared with the original proposal, Option 1 is more restrictive on new borrowing and would thus require an increase in grant resources to maintain nominal aid flows.

- **Option 2: Setting the upper bound consistent with the HIPC Initiative threshold (implying NPV of debt-to-exports thresholds of 50/100/150 percent)**. This option would apply a more conservative approach to new borrowing of all low-income countries compared with both the original proposal and Option 1.[7] Since the upper bound is consistent with the HIPC Initiative, the latter could not be perceived as "too generous," when compared with the new framework. This also implies, however, that (i) both weak-

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[4] This means, for example, that a country with a CPIA rating of 3 and an NPV of debt-to-exports ratio of 100 percent has the same risk of debt distress as a country with a CPIA rating of 3.25 and a debt ratio of 150 percent. Thus, the distress probabilities measured at the respective cutoff points remain unchanged. However, a country that was already in the poor (strong) policy category under the original CPIA cutoffs, would now be assessed relative to a higher (lower) debt threshold, consistent with a higher (lower) risk of distress.

[5] These options represent a choice among a spectrum of options to reduce the probability of distress, relative to the original proposal.

[6] The corresponding distress probability would be 18-22 percent.

[7] The implied risk of debt distress for Option 2 is 16-19 percent.

Table 1. Low-Income Country Groupings By Quality of Policies and Institutions 1/
(Based on 2003 CPIA)

Original Proposal Using Wider CPIA Range 2/				Modified Proposal Using Narrower CPIA Range 3/			
Strong Policies							
Cape Verde	Sri Lanka	St. Lucia	St. Vincent and Gren.	Cape Verde	Sri Lanka	St. Lucia	St. Vincent and Gren.
Uganda				Uganda			
				Armenia	Bhutan	Grenada	Maldives
				Mauritania	Samoa	Tanzania	
Medium Policies							
Armenia	Bhutan	Grenada	Maldives				
Mauritania	Samoa	Tanzania					
Albania	Azerbaijan	Bangladesh	Benin	Albania	Azerbaijan	Bangladesh	Benin
Bolivia	Burkina Faso	Cameroon	Dominica	Bolivia	Burkina Faso	Cameroon	Dominica
Ethiopia	Ghana	Guyana	Honduras	Ethiopia	Ghana	Guyana	Honduras
India	Kenya	Kyrgyz Republic	Lesotho	India	Kenya	Kyrgyz Republic	Lesotho
Madagascar	Malawi	Mali	Mongolia	Madagascar	Malawi	Mali	Mongolia
Mozambique	Nepal	Nicaragua	Pakistan	Mozambique	Nepal	Nicaragua	Pakistan
Rwanda	Senegal	Vietnam	Yemen, Rep.	Rwanda	Senegal	Vietnam	Yemen, Rep.
Zambia				Zambia			
Chad	Cote d'Ivoire	Djibouti	Eritrea				
Gambia, The	Georgia	Guinea	Kiribati				
Moldova	Niger	Sierra Leone	Tonga				
Vanuatu							
Poor Policies							
				Chad	Cote d'Ivoire	Djibouti	Eritrea
				Gambia, The	Georgia	Guinea	Kiribati
				Moldova	Niger	Sierra Leone	Tonga
				Vanuatu			
Cambodia	Tajikistan	Congo, Dem. Rep.	Congo, Rep.	Cambodia	Tajikistan	Congo, Dem. Rep.	Congo, Rep.
Burundi	Papua New Guinea	Lao PDR	Nigeria	Burundi	Papua New Guinea	Lao PDR	Nigeria
Guinea-Bissau	Comoros	Sao Tome and Princip	Uzbekistan	Guinea-Bissau	Comoros	Sao Tome and Princip	Uzbekistan
Togo	Sudan	Central Afr. Rep.	Haiti	Togo	Sudan	Central Afr. Rep.	Haiti
Angola	Solomon Islands	Liberia	Myanmar	Angola	Solomon Islands	Liberia	Myanmar
Somalia	Timor-Leste			Somalia	Timor-Leste		

Source: World Bank.
1/ Includes all IDA- and PRGF-eligible countries.
2/ Consistent with policy cutoffs of 3, 3.5, and 3.9, for "poor", "medium", and "strong" policies, respectively.
3/ Consistent with policy cutoffs of 3.25, 3.5, and 3.75.

Table 2. Debt-Burden Thresholds Under Alternative Options 1/
(In percent)

Original Proposal

	NPV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue 2/	Exports	Revenue 2/
Weak Policy (CPIA ≤ 3)	**100**	30	200	15	20
Medium Policy (3 < CPIA < 3.9)	**200**	45	275	25	30
Strong Policy (CPIA ≥ 3.9)	**300**	60	350	35	40

Option 1: Narrower Band With Same Lower Bound 3/

	NPV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue 2/	Exports	Revenue 2/
Weak Policy (CPIA ≤ 3.25)	**100**	30	200	15	25
Medium Policy (3.25 < CPIA < 3.75)	**150**	40	250	20	30
Strong Policy (CPIA ≥ 3.75)	**200**	50	300	25	35

Option 2: Narrower Band With Upper Bound Equivalent to HIPC Initiative Threshold 4/

	NPV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue 2/	Exports	Revenue 2/
Weak Policy (CPIA ≤ 3.25)	**50**	20	150	10	20
Medium Policy (3.25 < CPIA < 3.75)	**100**	30	200	15	25
Strong Policy (CPIA ≥ 3.75)	**150**	40	250	20	30

Option 3: Asymmetric Threshold Adjustment

	NPV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue 2/	Exports	Revenue 2/
Weak Policy (CPIA ≤ 3.25)	**100**	30	200	15	25
Medium Policy (3.25 < CPIA < 3.75)	**150**	40	250	20	30
Strong Policy (CPIA ≥ 3.75)	**150**	40	250	20	30

1/ All ratios are rounded, in line with the original presentation.
2/ Revenue defined exclusive of grants.
3/ Implies a probability of distress of about 18-22 percent.
4/ Implies a probability of distress of about 16-19 percent.

and medium-policy countries would graduate from the HIPC Initiative with a debt ratio in excess of their country-specific thresholds; and (ii) some non-HIPC countries would implicitly be judged as having excessive debt. Such an approach would be difficult to justify in the absence of additional debt relief beyond the HIPC Initiative.

- **Option 3: Asymmetric threshold adjustment (implying NPV of debt-to-exports thresholds of 100/150/150 percent).** This option would combine the two defining features of Options 1 and 2, by keeping the lower bound of the original threshold range for weak-policy countries, while applying the HIPC thresholds to all others. Implicitly this approach would build in an additional cushion (i.e., a lower distress probability) for the strong-performing countries—which could be justified on the grounds that these countries are more likely to generate grant resources, in lieu of loans, if their debt ratios approach the thresholds. While this option has some ostensible advantages over the other two alternatives, it is less justifiable on conceptual grounds. It effectively disregards a central element of the framework, which is that countries with strong policies have a larger borrowing capacity than average performers.

6. **The trade-off between alternative thresholds can be evaluated by quantifying the potential impact they would have on new debt flows to low-income countries—and consequently, on the need for additional grants.** Table 3 illustrates this trade-off using, in most cases, actual debt levels as of end-2002.[8] The column "current debt" shows the estimated aggregate level of debt in all low-income countries (post-HIPC assistance, for countries past the decision point), and the split between countries with debt ratios below and above the NPV of debt-to-exports thresholds, respectively.[9] The column "debt at threshold" shows the debt levels consistent with all countries reaching their thresholds under the different options. The difference between the two columns therefore indicates the additional space for borrowing, or the required reduction in debt, that would result if the thresholds

[8] For HIPCs past the decision point, the underlying data refer generally to the (projected) completion point year, and the NPV of debt is measured after estimated HIPC assistance (excluding possible topping up). The country coverage, methodology, and underlying data correspond to Table 1 in SM/04/318 and IDA/SecM2004-0629/1.

[9] Not included are Afghanistan, Kiribati, Liberia, Somalia, and Timor Leste, due to a lack of reliable data. A similar analysis could also be conducted for the NPV of debt-to-GDP and the NPV of debt-to-revenue ratios.

Table 3. Hypothetical Impact of Alternative Thresholds on Total Indebtedness

Options		Current Debt 1/ (1)	Debt at Threshold 2/ (2)	Difference (2) - (1)
		(Total NPV of debt in billions of U.S. dollars, end-2002)		
Original proposal 3/	All countries	286.0	391.7	105.7
(100-200-300) 4/	Initially below threshold	171.3	317.4	146.0
	Initially above threshold	114.7	74.3	-40.4
Option 1 5/	All countries	286.0	300.2	14.2
(100-150-200) 4/	Initially below threshold	132.5	200.8	68.3
	Initially above threshold	153.6	99.5	-54.1
Option 2 5/	All countries	286.0	192.6	-93.4
(50-100-150) 4/	Initially below threshold	35.0	48.8	13.8
	Initially above threshold	251.0	143.8	-107.2
Option 3 5/	All countries	286.0	294.6	8.6
(100-150-150) 4/	Initially below threshold	132.5	195.9	63.4
	Initially above threshold	153.6	98.8	-54.8

Sources: World Bank, Global Development Finance; IMF World Economic Outlook; and HIPC documents.
1/ After HIPC assistance for all countries past the decision point. Data and methodology are consistent with Table 2 of "Debt Sustainability in Low-Income Countries-Further Considerations on an Operational Framework and Policy Implications."
2/ Debt level consistent with respective threshold, aggregated across all countries in that category.
3/ Based on CPIA cutoffs of 3, 3.5, and 3.9, for "weak", "medium", and "strong" policies, respectively.
4/ NPV of debt-to-export thresholds under the respective option.
5/ Based on CPIA cutoffs of 3.25, 3.5, and 3.75.

were assumed to be binding for all countries. Under this assumption, countries currently below their thresholds would have room to borrow up to US$68 billion under Option 1, while countries currently above their thresholds would have to reduce their total indebtedness by $54 billion. This would imply a net increase in overall debt levels of $14 billion.[10] In Option 2, overall debt levels would have to be reduced by about $93 billion, on a net basis, compared with a potential increase of $105 billion under the original proposal. Realistically, it would take a long time for countries to reach the thresholds under Option 2, at least in the absence of further upfront debt reduction. Looking more specifically at the impact on individual countries, Sri Lanka, for example, would not breach the thresholds under

[10] NPV of debt-to-export thresholds of 150-200-250 percent—implying a lower risk of debt distress for some countries but a higher risk for others, compared with the original proposal—would be associated with a net increase of $122 billion in overall debt levels (a $146 billion increase for countries initially below the threshold and a $24 billion decline for those initially above).

Option 1, but would under Options 2 and 3 (Table 4).[11] Honduras, on the other hand, would only breach thresholds under Option 2. In the majority of cases, however, there is overlap in the countries breaching these tightened thresholds—though the debt in excess of the thresholds obviously differs under the different options.

7. **Clearly, the analysis on the implications of alternative threshold options must be interpreted with care.** For one, the thresholds are not intended to be used as rigid ceilings, but rather as indicative benchmarks to inform the overall assessment of sustainability based on a forward-looking analysis of debt and debt-service trends. In a similar vein, it is neither expected nor suggested, that countries with low debt ratios borrow up to their thresholds. Indeed, there must be compelling development reasons underpinning increased borrowing.[12] Finally, it may be more appropriate to focus only on the countries with debt above the thresholds to gauge the need for additional grant resources. For these, however, the required debt reduction may be overstated by roughly US$20 billion to the extent that potential HIPC assistance is not fully accounted for. With these caveats in mind, the analysis, nevertheless, provides some illustration of the potential implications, and the need for additional grants, under the various threshold options.

8. **Based on the pros and cons of the three options, the staffs deem Option 1 as the one that best balances existing constraints.** The criteria on which this recommendation is based are: (i) consistency with the empirical findings; (ii) coherence in the international community's approach to debt sustainability in low-income countries; and (iii) financing implications.

- The central empirical finding underlying the framework is that a country's borrowing capacity depends on the quality of its policies and institutions. While this finding does not imply specific threshold levels (which are a function of the acceptable risk of debt distress), it makes a strong case for thresholds that vary with the quality of policies. An asymmetric threshold adjustment, as in Option 3, is difficult to reconcile with this finding, and is therefore not recommended by the staffs.

[11] Table 4 provides a purely illustrative snapshot and is not intended to prejudge the risk assessment based on a forward-looking analysis and interpretation of the different debt-burden thresholds.

[12] Forward-looking policies would generally be expected to establish a gradual adjustment in debt ratios, based on a country's initial debt level and its risk of debt distress.

Table 4. Comparison of Debt-to-Exports and Debt-to-GDP Ratios With Indicative Thresholds 1/ 2/
IDA/PRGF-Eligible Countries with 2002 NPV of debt exceeding at least one of the two thresholds 3/

Original Proposal	Option 1	Option 2	Option 3
	Countries with "strong" policies 4/		
Bhutan	Bhutan	Bhutan	Bhutan
		Cape Verde	Cape Verde
Grenada	Grenada	Grenada	Grenada
Mauritania	Mauritania	Mauritania	Mauritania
Samoa	Samoa	Samoa	Samoa
		Sri Lanka	Sri Lanka
	St. Lucia	St. Lucia	St. Lucia
		St. Vincent and the Grenadines	St. Vincent and the Grenadines
	Uganda	Uganda	Uganda
	Countries with "medium" policies 4/		
	Bangladesh	Bangladesh	Bangladesh
	Benin	Benin	Benin
	Bolivia	Bolivia	Bolivia
	Burkina Faso	Burkina Faso	Burkina Faso
		Honduras	
		India	
	Madagascar	Madagascar	Madagascar
		Mali	
		Nepal	
Nicaragua	Nicaragua	Nicaragua	Nicaragua
Pakistan	Pakistan	Pakistan	Pakistan
		Senegal	
		Vietnam	
		Yemen, Rep.	
		Cameroon	
Dominica	Dominica	Dominica	Dominica
	Ethiopia	Ethiopia	Ethiopia
Guyana	Guyana	Guyana	Guyana
		Kenya	
Kyrgyz Republic	Kyrgyz Republic	Kyrgyz Republic	Kyrgyz Republic
Lesotho	Lesotho	Lesotho	Lesotho
Malawi	Malawi	Malawi	Malawi
Mongolia	Mongolia	Mongolia	Mongolia
		Mozambique	
Rwanda	Rwanda	Rwanda	Rwanda
Zambia	Zambia	Zambia	Zambia
	Countries with "weak" policies 4/		
Chad	Chad	Chad	Chad
Gambia, The	Gambia, The	Gambia, The	Gambia, The
Georgia	Georgia	Georgia	Georgia
Guinea	Guinea	Guinea	Guinea
Moldova	Moldova	Moldova	Moldova
Niger	Niger	Niger	Niger
Sierra Leone	Sierra Leone	Sierra Leone	Sierra Leone
Angola	Angola	Angola	Angola
Burundi	Burundi	Burundi	Burundi
Cambodia	Cambodia	Cambodia	Cambodia
CAR	CAR	CAR	CAR
Comoros	Comoros	Comoros	Comoros
Congo, Dem. Rep.	Congo, Dem. Rep.	Congo, Dem. Rep.	Congo, Dem. Rep.
Congo, Rep.	Congo, Rep.	Congo, Rep.	Congo, Rep.
Cote d'Ivoire	Cote d'Ivoire	Cote d'Ivoire	Cote d'Ivoire
Djibouti	Djibouti	Djibouti	Djibouti
Eritrea	Eritrea	Eritrea	Eritrea
Guinea-Bissau	Guinea-Bissau	Guinea-Bissau	Guinea-Bissau
Haiti	Haiti	Haiti	Haiti
Lao PDR	Lao PDR	Lao PDR	Lao PDR
Myanmar	Myanmar	Myanmar	Myanmar
Nigeria	Nigeria	Nigeria	Nigeria
Papua New Guinea	Papua New Guinea	Papua New Guinea	Papua New Guinea
Sao Tome and Principe	Sao Tome and Principe	Sao Tome and Principe	Sao Tome and Principe
Solomon Islands	Solomon Islands	Solomon Islands	Solomon Islands
Sudan	Sudan	Sudan	Sudan
Tajikistan	Tajikistan	Tajikistan	Tajikistan
Togo	Togo	Togo	Togo
Tonga	Tonga	Tonga	Tonga
Uzbekistan	Uzbekistan	Uzbekistan	Uzbekistan
		Vanuatu	

Sources: World Bank, Global Development Finance, HIPC Initiative documents; and IMF World Economic Outook.

1/ Based on data reported in Table 2 of "Debt Sustainability in Low-Income Countries-Further Considerations on an Operational Framework and Policy Implications." Excludes Afghanistan, Kiribati, Liberia, Somalia, and Timor Leste for lack of reliable data.
2/ Comparisons of NPV of debt-to-revenue ratios and debt-service ratios with the respective thresholds are not shown, due to gaps in data.
3/ For post-completion HIPCs, data refer to 2003 (2004 for Ethiopia and Ghana). For countries in the interim period, NPVs are estimated after HIPC relief and additional bilateral assistance, but before possible topping up.
4/ Based on the proposed modified policy-cutoffs.

- Coherence in the international community's approach calls for aligning the decision about the appropriate tolerance for debt distress with that implicit in the HIPC Initiative thresholds. In particular, while it may be reasonable to build in a safety margin (i.e., more conservative thresholds) in the provision of debt relief, it is difficult to justify debt relief thresholds that are, in most cases, higher than what is considered appropriate for future borrowing decisions. This is why the staffs do not recommend Option 2 (in the absence of further debt relief) but instead favor Option 1, which centers the debt-burden thresholds around those applied under the HIPC-Initiative.

- In terms of financing implications, all options call for higher grant resources than the original proposal, as more countries would be assessed to be in, or at high risk of, debt distress. However, as discussed above, the implicit restrictions applied to new borrowing are much stricter under Option 2. In the absence of a firm commitment by donors to increase grants by significant amounts, the staffs would deem the financing implications of Option 1 more feasible than those of Option 2.

This said, the proposed thresholds would continue to benefit from ongoing analytical and research work, as well as lessons that emerge in the implementation of the debt sustainability framework.

III. Interaction with the HIPC Initiative

9. **The new framework is distinct from the HIPC Initiative in important ways.** While both are driven by the same objective of preventing excessive indebtedness, the HIPC Initiative requires strict rules to generate the fully-coordinated provision of debt relief by a large group of creditors. The new framework, in contrast, is considerably more flexible and relies on judgment to provide appropriate country-specific guidance of future financing decisions. One of its key elements, that was strongly endorsed by both Boards on the basis of empirical evidence, is that the indicative debt-burden thresholds should depend on the quality of countries' policies and institutions. This feature alone distinguishes the debt sustainability framework from the HIPC approach with its uniform threshold.

10. **Apart from these fundamental conceptual differences, the debt sustainability framework and the HIPC Initiative also have some methodological differences.** These include, in particular, the definition of the debt-burden denominators and the discount and exchange rate rules:

- The **debt-burden denominators** used under the HIPC Initiative (exports and revenues) are derived as backward-looking three-year averages. The use of three-year averages was introduced to obtain a more stable, and representative, measure that evens out any observed volatility in export earnings and revenues. The average was backward-looking, rather than centered around the year for which the debt data are determined, because HIPC assistance was not to be based on projections. For the new framework, which explicitly focuses on the *future* path of the relevant debt-burden indicators, neither consideration is relevant; the assessment relies deliberately on projections that do not build in volatility. For this reason, it is appropriate to use simple contemporaneous values of the relevant denominators, consistent with the approach followed in the underlying empirical analysis.

- The **discount rates** used under the HIPC Initiative are the six-month averages of the currency-specific long-term commercial interest reference rates (CIRRs), which correspond with a maturity of approximately ten-years. These are used to calculate NPVs on a loan-by-loan basis, thereby avoiding the need to convert debt-service payments into a single currency on the basis of exchange rate projections.[13] While the precision of loan-by-loan calculations and the avoidance of projections were considered essential for determining debt relief and burden-sharing among creditors, it is not a practical approach for annual debt sustainability assessments that rely on projections and judgment in the first place. For this reason, the framework relies on aggregate debt-service projections in U.S. dollars, consistent with the approach applied to balance of payments projections in general, and uses the corresponding U.S. dollar discount rate to derive NPVs.[14] In addition, the single discount rate is derived on the basis of a "sticky" rule, that strikes a balance between using the most current information while limiting fluctuations in NPVs in response to temporary interest-rate movements.[15] This approach is, again, governed by pragmatic considerations that would have been contentious in the context of coordinated action on debt relief.[16]

11. **Notwithstanding the justifications for different rules, there is merit in transitional arrangements for HIPCs to avoid sending confusing signals, while the Initiative is still ongoing.** The new framework does not alter any of the HIPC Initiative rules which will continue to govern the Initiative's implementation. However, for HIPCs, presenting debt-burden indicators in annual DSAs on the basis of different rules may create problems for interpreting the outcome with respect to prospective HIPC assistance. For this reason, it is proposed that for HIPCs between the decision and completion points, and for

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[13] The use of currency-specific discount rates under the HIPC Initiative is also justified by burden-sharing considerations.

[14] Future debt-service payments in different currencies would be converted into U.S. dollars using WEO exchange-rate assumptions for the available years, and constant rates thereafter.

[15] More specifically, the discount rate is set initially at 5 percent (close to the current level of the U.S. dollar CIRR) and adjusted by a full percentage point, whenever the U.S. dollar CIRR (six-months average) deviates from the prevailing discount rate by at least this amount for a consecutive period of six months.

[16] This rule will be reviewed periodically to ensure that it is the most appropriate way to calculate the present value of debt stocks. In the meantime, stress tests may be used to determine debt stocks under alternate discount rate scenarios.

those that have just graduated from the Initiative, the LIC DSA will also show the relevant debt-stock indicators under the baseline using the HIPC Initiative rules, including currency-specific discount rates and three-year backward-looking averages of exports (or revenues, for countries qualifying under the fiscal window). In addition, HIPC decision and completion point documents would present, in an annex, a debt sustainability analysis using the LIC debt sustainability framework. This treatment provides the highest degree of transparency in judging a country's debt outlook.

IV. Modalities for Bank-Fund Collaboration on DSAs

13. **Given the desirability of reaching a consistent Bank-Fund assessment of debt sustainability, a high degree of collaboration between the two institutions in preparing DSAs will be essential.** The aim of the collaboration is to prepare a joint DSA for each country and arrive at a common assessment of its debt sustainability outlook for presentation in a common document. To minimize the resource implications, it would be desirable to incorporate DSA preparation into the existing operational practices of both institutions. The modalities for applying the DSA framework should allow the staffs to benefit from each institution's expertise, and be consistent with the uses of DSAs by each institution. Close collaboration would prompt a consistent approach to debt sustainability and provide a coherent view to low-income countries and the donor and creditor community. At the same time, each institution's responsibilities should be taken into account in line with their separate mandates. This section covers issues related to frequency and timing of DSAs, the division of responsibility between the staffs of the two institutions in the preparation of DSAs and preparation procedures, documentation of, and reporting on DSAs, and a mechanism for resolving potential differences of view between the staffs.

Frequency and Timing of DSAs

14. **Ideally, a DSA for each LIC should be prepared on a regular basis, which is relevant to both IDA-only borrowers at the Bank, as well as borrowing and surveillance-only members at the Fund.**

- For each calendar year, Fund (area department) and Bank (regional) staff will agree on a schedule for the preparation of DSAs for individual countries. The general expectation is that only one DSA will be prepared annually for each country.

- For the Fund, preparation of the DSA will normally be required in the context of the Article IV consultation or a PRGF-supported program review. For the Bank, the DSA will be required for Country Assistance Strategies, PRSCs, and for IDA allocation purposes. Country teams are responsible for keeping each other informed of a need for any changes to the proposed preparation schedule.

- Each institution can update the DSA for its own purposes if changes in assumptions are relatively minor, provided the other institution is notified of the changes and given adequate time—normally three business days—to comment. When either institution believes that major changes are warranted, consultation with the other will be required.

15. **In the preparation of DSAs, it will be essential for Bank and Fund staffs to work closely with country authorities.**[17] During missions, the staffs would—as is already the practice—discuss with country authorities key assumptions for the baseline analysis such as the medium-term outlook and new borrowing projections. It would also be helpful to seek the authorities' input on the key risk factors that could inform the choice of alternative scenarios. By increasing familiarity with the DSA framework, this dialogue should also reinforce efforts to develop countries' debt management capacities. Bank-Fund TA operations on debt issues could play a role in disseminating this framework at the country level. These could include Public Expenditure Reviews, Development Policy Reviews, or special-topic reports focusing on debt or fiscal management.

16. **It would also be crucial to collaborate with key creditors when preparing a DSA.** Missions would also provide an opportunity to meet other creditors and reconfirm the details of their prospective lending. To facilitate a broader appreciation of a country's debt sustainability, sharing DSAs with all creditors soon after presentation to the Boards could be helpful inputs into their own thinking and lending policies.

Division of Responsibilities and Procedures for Preparing DSAs

17. **Given the implications of DSAs for aggregate financing and donor coordination in LICs, it is important that they are prepared in a transparent, collaborative manner.**

- In line with existing practice, the two staffs should have a common understanding of the country's expected volumes and terms of borrowing as the basis for debt stock and debt-service projections. In addition to the Bank's medium-term lending scenarios, other key creditors would also be consulted as to their lending plans.

- Fund and Bank staff will cooperate closely to prepare joint DSAs, based on their respective areas of expertise, as described in the Bank-Fund Concordat on collaboration, with the Fund taking the lead on macroeconomic projections and the Bank on long-term growth prospects.[18] Consistent with the Fund's surveillance and

[17] Bank and Fund staff would also follow established guidelines in the sharing of confidential information.

[18] Guidelines for collaboration between the two institutions have been in place since 1966, and were clarified in the 1989 Concordat, *Bank-Fund Collaboration in Assisting Member Countries* (SM/89/54 Revision 1 and R89-45, 3/31/89). According to the Concordat, the Fund has a mandate and primary responsibilities, as well as a record of expertise and experience "with respect to surveillance, exchange rate matters, balance of payments, and their related instruments," and the Bank has a mandate, primary responsibility for, and

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program activities, the Fund's medium-term (three-five year) macroeconomic projection developed cooperatively by Fund staff and the member country authorities will be the starting point for consultation with the Bank on the baseline scenario for the DSA. Fund and Bank staffs will seek to determine a common baseline scenario for the DSA. It is expected that in most cases, country teams will agree on the assumptions underlying the baseline scenario; however, in exceptional cases, this may not be possible (see below).

- Country teams will collaborate on the design of alternative scenarios and stress tests and consider additional country specific factors to be included in the DSA. In that spirit, the design of alternative scenarios and stress tests could also help to test differences of view between the Fund and Bank teams on the assumptions underlying the baseline.

- Simulations for DSAs will be performed using the common agreed template.

- Once simulations have been run and tables and charts prepared, the staffs will review the findings and seek to arrive at a common assessment of the risk classification for the country in question.[19] An assessment of the level of debt risk would be presented in a concluding paragraph.

- If Bank/Fund staff cannot agree on a baseline scenario, and the differences are too large to be handled by alternative scenarios and stress tests, staffs would seek resolution through the dispute resolution mechanism (see below). There will be clear deadlines for review to ensure prompt resolution of differences. In the extremely rare cases where the dispute resolution system is unable to resolve the differences, in the interest of transparency, separate Bank and Fund baseline scenarios will be included in the DSA, with a statement clearly describing the differences between the two.

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expertise and experience in "the composition and appropriateness of development programs and . . . priorities" including sectoral and structural policies, except for the aggregate aspects of macroeconomic policies and their related instruments. In the context of the debt strategy, "the Fund is looked to . . . for an assessment of balance of payments prospects and financing. Bank views are sought with respect to longer-term resource requirements and growth prospects." Subsequently, several papers and guidance notes have been issued to reflect the growing coverage of work and strengthen particular aspects of collaboration; e.g., *Report of the Managing Director and the President on Bank-Fund Collaboration* (SM/98/226 Revision 1, 9/25/98) and *Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality* (SecM2001-0461/1, 8/24/01, and SM/01/219, 8/23/01).

[19] The assessment could be anchored around a risk classification consisting of four categories (low risk, moderate risk, high risk, and in debt distress) as presented in Box 1.

Documentation and Reporting

18. DSAs will be presented in a common standalone document prepared by Fund and Bank teams, and would be subject to the appropriate review procedures of each institution. Each institution will follow review timelines that do not hold up the issuance of DSA documents for the other. Relevant information and databases will be shared to the greatest extent possible to enable the collaboration to proceed expeditiously.[20]

- On the Fund side, the review of DSA documents will follow standard practice. The documents will be reviewed at the time they go to the Board as an appendix to the Article IV staff report and/or program review document. PDR and other functional departments will have three days for review and clearance and management five days for approval. Any substantive changes by Fund management will be communicated to Bank staff at that time.

- On the Bank side, DSA documents will in most cases be reviewed by regional and network management. Only DSA documents going to the Board will be subject to senior management review, like all other Board documents.

- If requested comments are not received from either side within the prescribed deadlines, the other institution can move forward with the internal procedures leading to the issuance of the document.

Dispute Resolution Mechanism

19. **In the exceptional cases when the country teams cannot come to a common understanding on the baseline scenario or the risk classification, they would seek to resolve the disagreements using the following dispute resolution mechanism**:

- At the working level, country economists will discuss the basis for their disagreements. They will determine whether the different viewpoints lead to a material difference, such as a significant difference in debt ratios or a different risk classification. If not, they will seek to accommodate differences using alternative scenarios and stress tests. When material differences arise, the Fund mission chief and the Bank's regional PREM director will attempt to reach an agreement.

- The mission chief and the regional director will, after consultation with their respective review departments (PDR on the Fund side and PRMED on the Bank side), seek a resolution within five working days. If they are unsuccessful, the matter will be elevated to the level of area department director at the Fund and vice president at the

[20] Bank and Fund staff would follow established guidelines in the sharing of confidential information.

Bank to seek a resolution, again within five working days. Failure to resolve the differences at this level will elevate the matter to the attention of the managements of the two institutions.

20. The managements can, within five working days, either resolve the dispute or decide that the DSA document will present the different views of the staffs to the Boards of the two institutions. Each institution will present its views in its own words.

Box 1. Proposed Low-Income Country Debt Distress Classifications

The DSA framework would allow the staffs to classify a country's risk of debt distress. This would facilitate the consistency of treatment among members and cross-country comparability of assessments. A broad classification system could also help enhance the quality and conclusiveness of the analysis, without being unduly precise. The goal is to raise awareness of the need for possible policy response and to provide a framework for such responses.

The staffs propose that the baseline scenario be based empirically on debt indicators. Broader issues related to debt sustainability, namely the quality of policies and vulnerability to exogenous shocks, would be brought to bear in assessing the overall level of risk via stress tests and alternative scenario(s). A strict debt-related assessment would help minimize misinterpretation as a broader policy rating.

For countries that are at moderate risk of debt distress or above, their past record in meeting debt service obligations would also be a factor in determining the classification, given the empirical evidence on this issue. Four suggested categories and related criteria are outlined below:

- **Low risk**: All debt indicators are well below the relevant policy based thresholds. Alternative scenarios and stress tests do not result in indicators breaching thresholds in any significant way.
- **Moderate risk**: While the baseline scenario does not indicate a breach of thresholds, alternative scenarios and stress tests show a substantial rise in the debt-service ratio over the projection period nearing the thresholds and/or a breach of debt-stock ratios.
- **High risk**. The baseline scenario indicates a breach of debt stock and/or service ratios over the projection period. This is exacerbated by the alternative scenarios/stress tests.
- **In debt distress**: Current debt stock and service ratios are in significant and/or sustained breach of thresholds.

Beyond the threshold analysis, the overall risk assessment would also take account of other factors, such as the country's track record in remaining current on its debt-service obligations.

V. Conclusions

21. **The Bank and Fund are in a position to mainstream the low-income country debt sustainability framework in their regular operations**. IDA Deputies at the Bank endorsed the framework as the analytical underpinning for the link between debt sustainability and grant eligibility in IDA-14. Currently, the IDA grant allocation framework uses current debt indicators and the debt burden thresholds to determine debt distress

rankings for IDA-only countries.[21] IDA Deputies have requested staff to present, by the mid-term review for IDA-14, a proposal to transit to a grant allocation system that fully takes into account the key aspects of DSAs. This would require the preparation of DSAs for all IDA only countries by the mid-term review. For the Fund, the framework would form the basis for incorporating debt sustainability considerations more explicitly in its surveillance work and in program design, including conditionality. While preserving debt sustainability has always been a central concern in the design of PRGF-supported programs, current PRGF conditionality addresses this issue chiefly by setting a minimum grant element on new external borrowing, and limits on new nonconcessional external debt and guarantees, without limiting the volume of concessional borrowing. The new framework allows for tailoring the design of conditionality to individual country circumstances, to avoid a significant increase in a country's risk of debt distress.[22] Once the framework is approved by the Boards of the two institutions, staff are ready to begin preparing joint DSAs based on the agreed framework using common templates.

22. **The Framework will be reviewed and evaluated with the view to improve it based on initial experience**. It is proposed that this review will be conducted after 6 months of implementation. Bank and Fund staff will draw lessons from the implementation of the framework by country teams, as well as from ongoing analytical work to further enhance the framework with a view to improving its efficiency and effectiveness.

VI. Issues for Discussion

23. Directors may wish to focus on the following issues:

- Do Directors agree with the staffs' recommendation on the choice of debt burden thresholds?
- Do Directors agree with the transitional arrangements for ensuring consistency between the HIPC Initiative and the new debt sustainability framework?
- Do Directors endorse the modalities for preparing joint DSAs and the roles of the Bank and the Fund in the preparation of DSAs as outlined in this paper?

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[21] For a more detailed description of the current IDA framework see "Debt Sustainability and Financing Terms in IDA-14: Further Considerations on Issues and Options," IDA, November 2004, http://siteresources.worldbank.org/IDA/Resources/DebtSustainabilityNov04.pdf.

[22] Specific suggestions were presented in SM/04/320, the companion paper on the operational framework for debt sustainability analysis in low-income countries—implications for Fund program design.