International Monetary Fund

Strategy, Policy and Review Department

Improving the Debt Sustainability Framework: A Work Agenda

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Sustainable Investment Scaling up in Low-Income Countries

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Outline of presentation

- Key features of the Debt Sustainability Framework (DSF)

- Challenges for the DSF related to the scaling up of public investment

- Work Agenda

The DSF is built on 3 pillars

1. Forward-looking analysis of debt burden indicators under a **baseline scenario** and **stress tests**
   - Based on macroeconomic forecast, including the investment-growth nexus
   - Standardized stress tests to assess the country's vulnerabilities
   - Checks against historical outcomes

2. Indicative policy-dependant **debt-burden thresholds**
   - Better policies/institutions, higher thresholds for external PPG debt
   - Use of CPIA
   - Mandatory assessment of total public debt vulnerabilities

3. **Recommendations on a borrowing (and lending) strategy** to limit the risk of debt distress while maximizing resources to achieve the development goals

Challenges for the DSF

- Scaling-up makes accounting for the investment-growth nexus even more critical

- Aid is limited and LICs will likely need to rely more on domestic resources and nonconcessional external borrowing

Two key issues to address

- Is the DSF too conservative?
  - Realistic baseline scenarios?
  - Adequate measures of repayment capacity?
  - Thresholds needed and appropriate?
  - Stress tests adequate?
- Is there enough emphasis on total public debt?

Investment-growth nexus

- Not a DSF issue per se, but critical for DSAs
  - Better analysis of the investment-growth nexus will lead to better baseline scenarios and DSAs
- Focus in DSAs has already increased (e.g. DRC and Mozambique)
- Work is underway to improve further the analysis of the investment-growth nexus

Measures of repayment capacity

- In the past, only GDP, exports and government revenue
- More recently, greater recognition of remittances in some DSAs (e.g. Nepal and Tonga)
- Work is ongoing on a more explicit consideration of remittances
  - Preliminary results indicate that remittances do matter

Revisiting thresholds

- Re-estimation of external thresholds suggests that they are still appropriate
- Is the CPIA an adequate measure of the policy performance?
- Are thresholds for debt burden indicators needed?
  - Alternative is to consider thresholds on the probability of debt distress

Total public debt

- Currently, no thresholds on total public debt, only on external PPG debt
  - External borrowing has historically been the main source of financing for LICs
- Practical issues:
  - Different uses (monetary policy)
  - Different risk (seignorage, financial repression)
  - Coverage of domestic debt
  - Quality of data (especially debt service)

Thresholds for public debt?

- Domestic debt matters for the risk of external debt distress (IMF 2006)
- Thresholds?
  - Work is underway, but outcome is uncertain
  - Which measure of indebtedness?
  - How do we define domestic debt events?
- Rating based on public debt?

Public debt: other analyses

- Focus on more traditional analyses:
  - Debt-stabilizing deficits
  - Contingent liabilities
  - Analysis of the share of government revenues used to service domestic debt
  - Greater focus on roll-over risks
  - Cost/benefits of financing options through MTDS

Stress Tests

- Mechanical application of stress tests may not always lead to relevant shocks but they still affect the risk rating
- Alternatives to the current approach:
  - Stochastic simulations (richer interactions across macroeconomic variables)
  - Historical scenarios
  - Analysis of tail risks

Concluding remarks

- DSA is as good as the baseline scenario (investment-growth nexus)
- Work is underway to improve different aspects of the DSF. Comments welcome!
- Tradeoff between sophistication, applicability to all LICs, and ease of use