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Poverty Reduction and Growth Trust—Review of Interest Rate Structure

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- The **Staff Report** on Poverty Reduction and Growth Trust—Review of Interest Rate Structure, prepared by IMF staff and completed on November 17, 2014 for the Executive Board's Consideration on December 10, 2014.

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POVERTY REDUCTION AND GROWTH TRUST—REVIEW OF INTEREST RATE STRUCTURE

EXECUTIVE SUMMARY

This paper provides the basis for the second review of the interest rate structure approved under the 2009 reforms of the Fund's concessional lending facilities. Based on the application of the Poverty Reduction and Growth Trust (PRGT) interest rate mechanism, PRGT interest rates for 2015–16 would be zero percent for both the Extended Credit Facility (ECF) and Rapid Credit Facility (RCF), and 0.25 percent for the Stand-by Credit Facility (SCF). The interest rate on remaining balances of the Exogenous Shock Facility (ESF) is not set by the PRGT interest mechanism and it would be 0.25 percent. In accordance with the PRGT Instrument, the next review of PRGT interest rates will take place by December 31, 2016.

The IMFC has called on the Fund, as trustee, to consider a further temporary extension of PRGT interest relief, while safeguarding the self-sustaining capacity of the PRGT. The current two-year extension of the interest waiver on PRGT loans is due to expire at the end of 2014, with rates then set under the interest rate mechanism.

This paper explores the case for extending the exceptional interest waiver. Such an extension would signal the Fund's continued support for low-income countries (LICs) at a time when these members continue to face economic headwinds from the global economic environment. While most LICs have been growing relatively strongly, others remain vulnerable to downside risks to the global recovery. It would also avoid an unusual situation where the rate charged on SCF and ESF credits would exceed the PRGT's cost of borrowing for such loans. Continued exceptional interest relief would have a modest impact on payments by PRGT-eligible members with outstanding balances on SCF and ESF loans, and those receiving new SCF disbursements. Absorption of the total cost of a two-year extension of the exceptional interest relief would keep the PRGT's financial position consistent with the self-sustained baseline capacity envisaged under the three-pillar strategy for PRGT financing.

On balance, staff recommends a further extension of the interest waiver through end-2016. At the same time, however, it remains important that the PRGT interest rate mechanism be allowed to function as intended once conditions return to normal, as a permanent waiver on PRGT interest payments would undermine the average annual lending capacity of the self-sustained PRGT of SDR 1.25 billion.

Approved By
Siddharth Tiwari and Andrew Tweedie

Prepared by the Finance and Strategy, Policy, and Review Departments (In consultation with the Legal Department)

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Glossary

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

INTRODUCTION

1. **This paper reviews the interest rate structure of the PRGT to determine the rates that would apply to PRGT loans in 2015–16, using the interest rate mechanism established by the Board in 2009**. The interest rate structure for PRGT loans and a mechanism for setting those rates were adopted as part of the 2009 reforms of the Fund's concessional lending facilities for LICs.[1] The mechanism differentiates interest rates among the PRGT facilities and links them to world interest rates. The PRGT interest rate structure is reviewed every two years, to take account of developments in world interest rates as reflected in the SDR interest rate.[2]

2. **This paper also considers the case for a further temporary extension of interest relief**. The current two-year extension of the interest waiver on PRGT loans is due to expire at the end of this year, with rates then set under the interest rate mechanism as described above. Responding to the call made in the October 2014 IMFC Communiqué, the paper considers the case for a further extension of interest relief and the implications for the self-sustaining capacity of the PRGT.[3] On balance, the staff recommends a further two year extension of the interest waiver.

3. **The outline of the paper is as follows**. Section II of the paper describes the PRGT interest rate structure. Section III reviews the cost of the exceptional interest waiver over 2010–14 and assesses the costs and benefits of extending the waiver beyond 2014. The paper concludes with a proposed decision completing the review of PRGT interest rates by (i) establishing the interest rates for 2015 and 2016 and (ii) extending the exceptional interest waiver for the same period through end-2016.

PRGT LENDING INTEREST RATES

4. **The PRGT interest rate structure and the mechanism for its setting were adopted in 2009 with the following objectives**: (i) making the PRGT financing more concessional, especially in the context of low global interest rates; (ii) preserving the Trust's scarce concessional resources; (iii) tailoring financing terms to the needs and capacity of PRGT-eligible members; and (iv) limiting fluctuations in concessionality of PRGT instruments and subsidy costs. A mechanism where the PRGT interest rates are set in reference to the SDR interest rate, and reviewed every two years in light of changes in global interest rates, was considered by the Board to balance these objectives well. Under the mechanism, the interest rates on outstanding loan balances under the ECF, RCF, and the SCF are differentiated: the rate charged on SCF loans is 0.25 percent higher than that for the other two facilities, as SCF users, on average, are expected to have somewhat higher capacity to service

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[1] See *IMF Reforms Financial Facilities for Low-Income Countries,* Decision No. 14354-(09/79), adopted July 23, 2009, and *Poverty Reduction and Growth Trust—Review of Interest Rate Structure,* Decision No. 15035-(11/116), adopted December 1, 2011.

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

[3] See *Communiqué of the Thirtieth Meeting of the IMFC* (Press Release No. 14/466, 10/11/14).

debt than ECF and RCF users (Table 1). In 2009, it was also decided to exclude the ESF from the review-based PRGT interest rate mechanism and to set the interest rate charged on ESF credit at 0.25 percent.

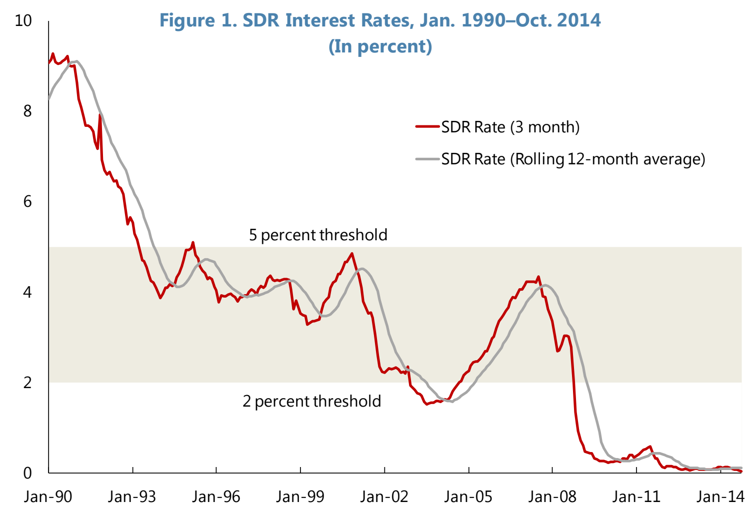
Table 1. Interest Rate Mechanism for the Fund's Concessional Facilities [1/]
(in percent)

	ECF	RCF	SCF
SDR rate < 2	0.00	0.00	0.25
2 ? SDR rate ? 5	0.25	0.25	0.50
SDR rate > 5	0.50	0.50	0.75

1/ Average SDR rate for the latest 12 months.

5. **Under the PRGT interest rate mechanism, the PRGT rates for 2015–16 would be set based on the average SDR rate that prevailed in the prior twelve months**. The SDR interest rate has been at historically low levels since early 2009. In line with the decline in global interest rates, the SDR rate fell sharply during the latter part of 2009 and has been below 1 percent since December 2008, reaching almost zero in October 2014.[4] Thus, the 12-month average SDR rate is currently well below the 2 percent threshold established in the interest rate mechanism (Figure 1).

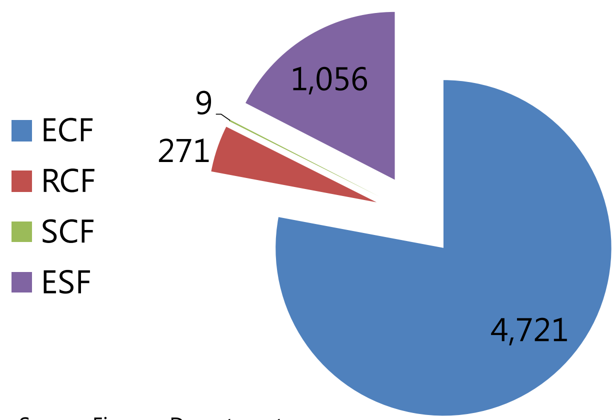
Figure 1. SDR Interest Rates, Jan. 1990–Oct. 2014
(In percent)



Source: Finance Department.

[4] A 5 basis point floor on the SDR rate was introduced on October 24, 2014 together with a change in the rounding rules on the calculation of the SDR interest rate; see *Recent Fall in the SDR Interest Rate—Implications and Proposed Amendments to Rule T-1* (10/16/14).

Figure 2. PRGT Credit Outstanding, as of end–September, 2014 (In millions of SDRs)



Source: Finance Department.

6. **In the context of current low global interest rates, application of the PRGT interest rate mechanism implies that only members with outstanding credit under the SCF and ESF would be charged interest**. With the average SDR rate below 2 percent, the interest rate on ECF and RCF loans would be zero percent, while the rate for the SCF would be 0.25 percent. As noted above, the rate charged on the ESF would also be 0.25 percent.[5] This implies that the bulk of PRGT outstanding debt would not be charged any interest, as outstanding ECF and RCF loans amount to more than four-fifths of all current PRGT loans (Figure 2). It is expected that a large share of new PRGT lending would continue to be under the ECF and RCF—for example, since 2009, and as of end-September 2014, total new commitments amounted to SDR 4.0 billion under the ECF, SDR 0.3 billion under the RCF, and SDR 0.4 billion under the SCF.[6]

[5] At the time of the 2009 LIC facility reforms, the applicable interest rate on outstanding loans under the ESF was lowered from 0.5 percent to 0.25 percent. The SCF was conceived as a successor to the ESF (specifically, the High Access Component of the ESF), and, with the effectiveness of the LIC facility reforms, no new ESF lending was envisaged after the transition period. The ESF was excluded from the review-based adjustment mechanism so that ESF borrowers would continue to pay at the lower rate even if global interest rates returned to normal levels. See Decision No. 14385-(09/79), adopted July 23, 2009.

[6] While SCF credits could increase somewhat over the next two years, they are expected to remain well below those under the ECF and likely also the RCF; see *Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries*, (10/03/2014), pp. 15. Also, some credit made available under the SCF is not drawn, and therefore no interest is charged, as members can treat the SCF as precautionary. In those cases, an availability fee of 0.15 percent is charged on available but undrawn balances.

EXCEPTIONAL WAIVER OF INTEREST PAYMENTS

7. **In 2009, the Board decided to provide temporary interest relief on all outstanding concessional loans to PRGT-eligible members**. This waiver became effective on January 7, 2010 alongside the broader LIC facilities reform and was to last until end-2011. It aimed to provide exceptional relief to PRGT-eligible members during the global economic crisis. At the same time, the rate of charge on loans to PRGT-eligible members under Emergency Natural Disaster Assistance (ENDA) and Emergency Post-Conflict Assistance (EPCA) was subsidized to zero through end-January 2012.

8. **The temporary interest waiver has been extended twice, most recently through end-2014**. At the time of first review of the PRGT interest rate mechanism in December 2011, the Board agreed to extend the exceptional interest waiver for one year, to end-December 2012.[7] This extension was agreed in view of severe downside risks to the global economic outlook. The Board considered this a transitional measure, and it was also agreed that the PRGT interest rate mechanism would be allowed to operate as envisaged thereafter. In December 2012, against the background of the continued global economic crisis, the Board endorsed a further extension of the exceptional interest waiver, to end-2014, to signal the Fund's continued support to PRGT-eligible members. At that time, the Board also decided to postpone the next review of the PRGT interest rate structure to end-2014 and endorsed an extension of the subsidization to zero percent of the rate of charge on outstanding ENDA and EPCA purchases by PRGT-eligible members.[8,9]

9. **The exceptional interest waiver in place since January 2010, and set to expire at end-2014, has provided interest savings to 18 PRGT-eligible members and one member that graduated from PRGT eligibility in 2010**.[10] The total amount of interest payments waived (including projected amounts through end-2014) is estimated to be relatively modest at SDR 14.6 million (see Table 2). This comprises forgone interest payments on ESF loans (SDR 13.3 million), on ENDA/EPCA credits (SDR 0.8 million), and on SCF loans (SDR 0.5 million).

[7] Poverty Reduction and Growth Trust—Review of Interest Rate Structure (11/23/11), and Decision No. 15035-(11/116), adopted December 1, 2011.

[8] The subsidization of the rate of charge on outstanding ENDA/EPCA purchases was extended to April 4, 2013 when the last remaining repurchases on ENDA credits were due; there were no outstanding EPCA credits.

[9] Poverty Reduction and Growth Trust—Extension of Temporary Interest waiver (12/14/12), and Decision No. 15303-(13/1), adopted December 21, 2012.

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

Table 2. Interest Savings From Temporary Interest Waiver, Jan. 2010–Dec. 2014 [1/]

(In thousands of SDRs)

Country	Facility			**Total**
	SCF	ESF	ENDA/EPCA	
	(In thousand of SDRs)			
Bangladesh	-	-	806	**806**
Cameroon	-	1,170.3	-	**1,170**
Comoros	-	16.5	-	**16**
Congo, Dem. Rep.	-	1,397.3	-	**1,397**
Dominica	-	41.3	12	**53**
Ethiopia	-	2,222.1	-	**2,222**
Guinea-Bissau	-	-	5	**5**
Kenya	-	1,709.0	-	**1,709**
Kyrgyz Republic	-	416.9	-	**417**
Malawi	-	431.9	-	**432**
Maldives	-	25.1	0	**25**
Mozambique	-	1,415.6	-	**1,416**
Samoa	-	73.1	-	**73**
Senegal	-	1,488.3	-	**1,488**
Solomon Islands	119	-	-	**119**
Sri Lanka	-	-	7	**7**
St. Lucia	-	86.8	-	**87**
St. Vincent & Grenadines	-	47.0	-	**47**
Tanzania	357	2,733.2	-	**3,091**
Total	**476**	**13,274**	**829**	**14,580**

1/ Based on monthly average of credit outstanding until August 2014, projections thereafter.

Source: Finance Department.

10. **The October 2014 IMFC Communiqué called on the Fund as trustee to consider a further temporary extension of interest relief, while safeguarding the self-sustaining capacity of the PRGT**. Extending the interest waiver would further delay the introduction of the interest rate mechanism agreed in 2009. On the other hand, there would seem to be a number of arguments for a further extension, as discussed below.

11. **While most LICs have been growing relatively strongly, others remain highly vulnerable to downside risks to the global recovery**.[11] Many LICs have shown economic dynamism and resiliency to adverse shocks. However, their still-limited export diversification and weakened policy buffers leave them less well-positioned to handle adverse shocks than prior to the global crisis. Recent Fund staff analysis concluded that a number of LICs—mostly fragile states—are assessed as highly vulnerable to a sharp growth decline. It was also estimated that a protracted

[11] See *Macroeconomic Developments in Low-Income Developing Countries—2014 Report* (09/19/2014).

period of slower growth in advanced and emerging market economies would have a significant adverse impact on the Fund's poorest members. Frontier market economies face new risks stemming from opening up of access to financial markets, and a number of small-economy PRGT-eligible members are in a particularly vulnerable macroeconomic situation.

12. **The global environment of near-zero interest rates has created an unusual situation where some PRGT borrowers would be required to pay a rate exceeding the PRGT's cost of funding on such credits, should the PRGT interest rate mechanism be applied**. As noted above, the PRGT interest mechanism was designed in part to limit fluctuations in concessionality of PRGT instruments and subsidy costs. However, with the SDR rate currently well below 0.25 percent, an unusual situation has arisen in which the PRGT's cost of funding would be less than what PRGT borrowers would be charged on their outstanding SCF credits, which was not intended by the PRGT interest rate mechanism. Borrowers with outstanding credits under the ESF would be similarly affected. It would also imply an increase in interest rates paid by a subset of PRGT borrowers at a time when global interest rates remain near zero.

13. **Reflecting the very low interest rate environment, the total cost of a further extension of the exceptional interest relief would be modest and remain consistent with the self-sustained capacity envisaged under the three-pillar strategy for PRGT financing**. Staff has estimated the cost to the PRGT—in terms of additional subsidy cost and impact on the self-sustained lending capacity of the PRGT—of extending the waiver by another two years. Based on the existing commitments under the ESF and SCF, and projected new commitments under the SCF, staff estimates that the cost of such an extension, measured in terms of additional subsidy resources, would amount to about SDR 3 million annually in 2015–16 (Table 3). Given these modest amounts, staff also estimates that the PRGT's average annual lending capacity would remain consistent with Pillar I of the self-sustained strategy (which envisages an annual concessional lending capacity of SDR 1.25 billion, on average).[12]

Table 3. Interest Waiver—Annual Subsidy Cost to PRGT, 2015–16
(In millions of SDRs)

Years	Subsidy Cost
2015	2.9
2016	3.4
2015–16	**6.3**

Source: Finance Department.

[12] The latest assessment of the self-sustained lending capacity of the PRGT is discussed in *Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries* (10/03/2014).

14. **On balance, staff sees a case for extending the exceptional interest waiver through end-2016**. While an extension of the temporary relief would further delay the intended pricing differentiation between the instruments—specifically that between the SCF and the other PRGT facilities—a continuation of exceptional relief for another two years would signal the Fund's continued support for LICs at a time when these members continue to face economic headwinds from the global economic environment. Such an extension would provide some relief, albeit modest, on payments by LICs with outstanding balances on SCF and ESF loans, and those receiving new SCF disbursements. The extension of the waiver would also acknowledge recent developments in the SDR interest rate, which averaged 9 basis points in the last 12 months, and thus avoid a situation where the rate charged on SCF and ESF credits would exceed the Fund's cost of borrowing for such loans.

15. **It remains, however, important that the PRGT interest rate mechanism be allowed to function as was originally envisaged to assure the integrity of the self-sustained framework for the PRGT**. The current global environment of low interest rates allows the cost of a temporary interest waiver to be absorbed while keeping the self-sustained capacity of the PRGT at an appropriate level. However, prolonged extension of the waiver of interest payments on concessional lending would eventually undermine the self-sustained capacity of the PRGT, especially once global interest rates return to more normal levels. Staff has estimated that a permanent interest waiver on PRGT loans would reduce the PRGT's average annual lending capacity by about SDR 0.12 billion, thereby pushing the PRGT's self-sustained lending capacity well below the SDR 1.25 billion envisaged under Pillar I of the self-sustained strategy for the PRGT. These estimates underscore the need to eventually restore the PRGT interest rate mechanism as intended by the Board, once global conditions normalize.

STAFF ASSESSMENT

16. **Staff recommends the exceptional interest waiver for PRGT-eligible members be extended for a further two years until end-2016**. It is proposed that the exceptional interest waiver would expire at end-December 2016. Consistent with Section II, Paragraph 4(b) of the PRGT Instrument, the next review of the interest rates on loans under the ECF, RCF, and SCF would be completed by December 31, 2016.