I Overview

Borrowing can help achieve economic and social objectives, and debt is its consequence. Many low-income countries (LICs) require substantial external financing to reach their development objectives, and stepped-up investment in infrastructure is critical to achieve sustained growth and development. External debt financing can help in this regard by channeling resources to projects where the rate of return of the debt-financed investment is at least sufficient to service the debt incurred.

Debt can also expose countries to serious difficulties: If countries borrow too much or suffer shocks to their economies, they may become unable to repay their debts and may have to make disruptive financial and economic policy changes. A large number of LICs accumulated excessive debt starting in the 1970s with a peak in the early 1990s, setting back their efforts to achieve solid growth and alleviate poverty for years.

Debt problems can be particularly difficult for LICs. LICs rely on debt to finance development and are vulnerable to the risks posed by debt. They have macroeconomic and financial features that may undermine their capacity to generate sufficient revenues to repay the debt incurred. These features include narrower production bases and export structures, shallower financial markets, aid volatility, and weaker policy implementation capacity.

In recent years, the debt burden of many LICs has declined, but they are likely to borrow anew to meet their large development needs. The international community has helped lower the debt burden of LICs through debt relief initiatives. The Heavily Indebted Poor Countries (HIPC) Initiative was adopted in the fall of 1996 and enhanced and expanded in 1999. The Multilateral Debt Relief Initiative (MDRI) was adopted in 2005 with a view to ending sizable debt overhangs in the poorest countries and to providing resources to LICs for achieving the Millennium Development Goals (MDGs). Although these initiatives charted a course toward restoring debt sustainability, they did not preclude the rapid buildup of new debt and a new round of debt difficulties.

At the same time, the sources of funds to LICs are expanding, and the increased supply of financing poses risks of future debt difficulties. New or emerging donors, such as Brazil, China, and India, have been increasing their lending activities in LICs. At the same time, global financial markets have sought new opportunities in LICs, especially in Africa, and have purchased LIC sovereign debt, both external and domestic. In addition, many governments have expanded their domestic borrowing. Also, private equity and sovereign wealth funds may in the future become important players in LIC financing. The combination of low debt and new financing sources will allow LICs to make important strides toward achieving their economic goals, but could also pose risks for new debt distress if not managed carefully.

Against this backdrop, the IMF and the World Bank have been intensifying their efforts to help LICs achieve the MDGs and other development objectives while avoiding a new round of debt distress. An analytical framework, the Debt Sustainability Framework (DSF) for LICs, has been developed to help monitor and analyze the sustainability of public and external debt in LICs. The objective of the framework is to help policymakers and other parties, including those in the financial markets, analyze the consequences of incurring debt and conduct regular updates of the analyses.

The IMF and the World Bank promote a broad use of the DSF by governments, donors, and lenders to help prevent the accumulation of unsustainable debts. For borrowers, debt sustainability analyses (DSAs) should be the cornerstone for developing medium-term debt strategies and public expenditure plans that allow sustainable progress toward the country's development goals. The DSF can also help guide creditors' lending decisions. The International Development Association (IDA) uses the DSF to determine the mix of loans and grants that it provides to LICs. Other key multilateral creditors also incorporate elements of the framework in their lending terms and many OECD Development Assistance Committee (DAC) creditors explicitly use the DSF to guide their lending terms.

This paper describes the concept of debt sustainability and why it is important (Section II). Section III presents the DSF and how it helps determine an adequate borrowing and lending strategy that seeks to contain the risk of debt distress, while maximizing the resource envelope to achieve the MDGs. Last, the paper discusses the use of the DSF by governments, donors, and lenders (Section IV). Section V presents some concluding remarks. Appendix I contains answers to frequently asked questions and Appendix II presents a DSA country case study.