INTERNATIONAL MONETARY FUND

Debt limits in Fund-Supported Programs: Proposed New Guidelines

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ABBREVIATIONS AND ACRONYMS

CIRR	Commercial Interest Reference Rate
CPIA	Country Policy and Institutional Assessment
DeMPA	Debt Management Performance Assessment
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
EPCA	Emergency Post Conflict Assistance
ESF	Exogenous Shocks Facility
HIPC	Heavily Indebted Poor Country
HIPC CBP	Heavily Indebted Poor Country Capacity building Program
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
LIC	Low-Income Country
MIC	Middle-Income Country
MDRI	Multilateral Debt Relief Initiative
MTDS	Medium-Term Debt Management Strategy
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
PEFA	Public Expenditure and Financial Accountability
PPG	Public and Publicly Guaranteed
PFM	Public Financial Management
PPA	Project Performance Assessments
PRGF	Poverty Reduction and Growth Facility
PSI	Policy Support Instrument
PV	Present Value
ROSC	Report on the Observance of Standards and Codes
WGI	Worldwide Governance Indicators

EXECUTIVE SUMMARY

Low-income countries (LICs) face significant challenges in meeting their development objectives, while maintaining a sustainable debt position. To address this dilemma, the international community has largely advocated recourse to concessional external finance. The Fund's existing policy and practice on external debt limits conforms to this preference.

Various factors warranted revisiting the Fund's policy and practice. The situation of LICs has evolved and the patterns of financing of LICs has changed substantially in recent years: many LICs have strengthened their macroeconomic management; debt burdens have been relieved; and official financing is available through a broader group of creditors. In addition, the Bank-Fund Debt Sustainability Framework (DSF) introduced in 2005 is now widely used by countries and integrated with donors' operations.

A review of the Fund's current framework on external debt limits in Fund-supported programs was initiated in March 2009. The Executive Board agreed that the policy had played an important role in preventing the build-up of unsustainable debts, while allowing for adequate external financing. It broadly supported a new framework that moved away from a single design for concessionality requirements towards a more flexible approach. The new framework for concessionality requirements:

- **Includes a menu of options to reflect better the diversity of situations in LICs**, notably on their debt vulnerabilities and macroeconomic and public financial management capacity.

- **Has stronger analytical underpinnings** given its systematic link to debt sustainability analyses (DSAs). It clarifies how and when flexibility should be exercised in a consistent way. It also provides a clear path towards graduation from concessionality requirements.

In support of the new framework, this paper proposes new guidelines on debt limits and provides commentary on key issues. These include:

- **The capacity to manage public resources adequately encompasses a range of dimensions from policy design to implementation.** The budget formulation process should identify which public goods need to be produced and, together with debt policy, how this can be financed in a sustainable way while minimizing risks. Strong public financial management is then critical to ensure effective and efficient implementation of the budget.

- **A two-step process to assess capacity is proposed to ensure uniform treatment of LICs.** First, two quantitative indicators with broad coverage of LICs allow for a preliminary identification of higher-capacity countries, in a way consistent with uniformity of treatment. Second, the preliminary classification is refined using all

other available information. The initial assessment would be done simultaneously for all LICs with a Fund-supported program.

- **The application of more flexible options for concessionality requirements needs to maintain donors' incentives to provide highly concessional financing**. For example, it should avoid leading some donors to reduce the grant element of their new lending, particularly in a period of tight fiscal constraints. It should also address possible concerns that flexibility be used to contract too much (nonconcessional) debt and issues of cross-subsidization.

- **The new framework seeks to mitigate concerns in this area by:** the tight link to DSAs; the incentive to seek concessional terms under all options in the proposed new framework; the emphasis on capacity, which provides confidence that resources are going to be put to good use, and that any nonconcessional borrowing will be contracted to complement scarce concessional resources; and attention paid to the quality and intensity of the dialogue with donors.

- **The new framework includes a presumption that non-LIC debt limits would not include concessionality requirements,** as these members generally have no, or very limited, access to concessional financing. In the exceptional cases where concessionality requirements are relevant for non-LICs, the framework would apply as for LICs.

I. INTRODUCTION[1]

1. **In March 2009, the Executive Board reviewed the policy and practice on external debt limits in Fund-supported programs for low-income countries** (LICs).[2] The Board emphasized the important role of the Fund's framework in preventing the build-up of unsustainable debts in LICs, while allowing for adequate external financing. Directors noted that many LICs continue to be in fragile debt situations, while their development and financing needs remain large. Recourse to external concessional resources, including grants, therefore remains highly desirable for these countries. Nonetheless, the diversity of individual country situations warrants a review of the policy on debt limits to allow for more flexibility in its application.

2. **The Board broadly supported staff's proposal to move away from a single design for concessionality requirements toward a menu of options.** While current policy and practice already entail a significant amount of flexibility, the new approach introduces a formal framework to use this flexibility in a more systematic and consistent fashion. The approach would reflect better the diversity of situations in LICs, in particular with regard to the extent of debt vulnerabilities and macroeconomic and public financial management capacity (henceforth "capacity"). The current policy could continue to be applied to lower-capacity countries, but with more flexibility for those with lower debt vulnerabilities. More flexible options, eschewing the debt-by-debt approach of the current policy, could be considered for higher-capacity countries. For more advanced LICs, consideration could be given to dropping concessionality requirements altogether in setting external debt limits.[3] Unless debt sustainability is a serious concern and capacity is limited, these options, which are summarized in the matrix below (Table 1), offer LICs more flexibility than current practice.[4]

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[1] This paper was prepared by a team led by Hervé Joly consisting of Christian Beddies, Era Dabla-Norris, Julien Hartley, Kenji Hosono, Eteri Kvintradze, Marie-Hélène Le Manchec, Shannon Mockler, and Felipe Zanna. Overall guidance was provided by Dominique Desruelle.

[2] For the purpose of this paper, LICs are defined as members that are eligible for assistance under the Poverty reduction and Growth facility (PRGF), i.e., included in the list of members annexed to decision No. 8240-(85/56), as amended.

[3] As used in this paper, the term "concessionality requirements" refers to both the approach under the current guidelines on external debt of generally distinguishing between concessional and nonconcessional debt for purposes of the external debt limits in Fund-supported programs, and the related practice that has developed in a majority of cases of precluding LICs from borrowing on nonconcessional terms (or limiting such borrowing while not constraining concessional borrowing).

[4] As discussed in IMF (2009) "Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt" (http://www.imf.org/external/np/pp/eng/2009/022509a.pdf), the authorities could choose to opt for tighter debt limits than suggested by this approach, however, if they wish to use these limits as a commitment device.

3. **This paper clarifies a number of issues raised by Directors in March and proposes revised guidelines on debt limits for Board approval; the proposed decision to implement these proposals will be circulated in a supplement to this paper.** While Directors agreed that debt sustainability analyses (DSAs) provided an appropriate basis for assessing debt vulnerabilities, they emphasized the need for objective and credible criteria to assess capacity under the new approach.[5] Section II proposes a simple analytical framework for assessing capacity, which allows a wide range of information to be taken into account while providing uniformity of treatment. Section III specifies how some of the options for concessionality requirements would work in practice and discusses the issue of maintaining donors' incentives to provide highly concessional financing under the more flexible options. Because the policy on debt limits applies to all members seeking a Fund-supported program, Section IV highlights the implications of the proposed amendments to the policy on debt limits for non-LICs. Section V addresses transitional arrangements. Section VI discusses resource implications. Revised guidelines on debt limits are proposed in Supplement 1.

Table 1. Concessionality Options Matrix

		Extent of debt vulnerabilities	
		Lower	**Higher**
Capacity	**Lower**	Minimum concessionality requirement based on the current system, but with added flexibility on nonconcessional external debt (e.g., higher and untied nonzero limits, if consistent with maintenance of low debt vulnerabilities)	Maintain minimum concessionality requirement based on current system, likely higher than 35 percent, with limited or no room for nonconcessional borrowing
	Higher	Minimum average concessionality requirement applied to external or total public borrowing; for most advanced LICs, no concessionality requirements and overall nominal debt limit if needed	Overall limit on the PV of external or total public debt; for most advanced LICs, ceilings on nominal external or total public debt

Source: IMF (2009)[6] .

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[5] The strengthened role of DSAs in the implementation of Fund policies has been further underpinned by the new access policy for LIC facilities and the implementation guidelines.

[6] See IMF (2009) "Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt," http://www.imf.org/external/np/pp/eng/2009/022509a.pdf.

4. **A companion paper prepared jointly with the World Bank reviews some aspects of the debt sustainability framework (DSF) with a view to making it more flexible.**[7] In this review, staffs have been mindful that the DSF is essentially an analytical tool whose integrity should be preserved. A more appropriate vehicle for the Fund to respond flexibly to the needs of its membership is the policy on debt limits, whose increased flexibility is the subject of the present paper.

II. Assessing Capacity

5. **This section specifies the critical functions that need to be covered by an assessment of capacity;** reviews the information available in this area; proposes an analytical framework based on quantitative indicators to initiate identification of higher-capacity countries; and then suggests a process for staff to incorporate other relevant information and reach a more comprehensive assessment of capacity.

A. What are we trying to assess, and what information is available?

6. **The more flexible options for concessionality requirements would be appropriate for countries with higher capacity to manage public resources**. These options—average concessionality requirements or targets on the present value (PV) of new debt—would give more flexibility to the authorities to determine which projects to implement, and how to finance them.[8] Adequate capacity to identify and implement suitable projects, raise the required financing and manage the corresponding debt, and more generally manage public resources well would therefore be critical to ensure that the authorities can handle directly the whole gamut of donors and creditors and their various financing instruments, and more generally make the best possible use of (concessional and) nonconcessional financing. Adequate capacity would also go a long way towards addressing donors' concerns about modifying the Fund's traditional gate-keeper role (see Section III.B). Finally, adequate capacity would be required to ensure that the authorities can meet the more demanding operational requirements of the more flexible options.

7. **The capacity to manage public resources adequately encompasses a range of dimensions, from policy design to implementation.** The budget formulation process should identify which public goods need to be produced and, together with debt policy, how this can be financed in a sustainable way while minimizing risks. Strong public financial management

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[7] This paper includes a number of specific proposals, for instance to address threshold effects and to account better for remittance flows in cases where they are high as a ratio to exports or to GDP.

[8] Under the current approach, a project to be financed on nonconcessional terms requires a nonzero limit for nonconcessional borrowing under the country's program, which is generally granted only after a project assessment (preferably from the World Bank).

(PFM) is then critical to ensure effective and efficient implementation of the budget. Critical elements that should figure prominently in the assessment would include: the overall design of the expenditure program, including budget planning and execution; mechanisms of oversight and internal and external control; design and implementation of a medium-term debt management strategy; and the track record of performance in these areas. For all these elements, the quality of institutions (including legal frameworks and regulations), processes, and staff matter. Efficiency also requires transparency and accountability for these policies and processes to ensure appropriate incentives and reduce the scope for governance problems.

8. **A number of these dimensions are already the subject of formal assessments.** Table 2 provides a summary of the main available indicators. The selection was based on the following principles: (i) relevance; (ii) quantifiable nature, which allows for benchmarking and facilitates cross-country comparisons; (iii) country coverage; and (iv) frequency of update, to allow progress in strengthening capacity to be taken into consideration.

9. **Two indicators stand out in terms of relevance and country coverage**:

- ***Components of the World Bank's Country Policy and Institutional Assessment ("sub-CPIA")***. While the overall CPIA index is very broad in scope—a point made by some Directors during the March 2009 discussion—five of its components appear particularly relevant. They cover fiscal policy, debt policy, the quality of budgetary and financial management, the quality of public administration, and transparency, accountability, and corruption in the public sector. They could be used to derive a new index, a "sub-CPIA" (see below and Annex 1 for more details). An important feature of the sub-CPIA is its availability for 74 PRGF-eligible countries, giving it the broadest coverage of all surveyed indices.

- ***The Public Expenditure and Financial Accountability (PEFA)*** framework measures performance of a country's public financial management (PFM). It offers a comprehensive analysis using 28 indicators grouped in three areas: credibility of the budget, comprehensiveness and transparency, and budget processes, which include elements of both ex-ante and ex-post scrutiny (see Annex 2). PEFA assessments are done every three years and are currently available for 57 countries.

10. **Other sources of information would be mobilized in the assessment of capacity.** They include, inter alia, other formal assessments such as fiscal ROSCs, the World Bank's Debt Management Performance Assessment (DeMPA), Project Performance Assessments (PPA), Worldwide Governance Indicators (WGI), and self-assessments of debt management capacity made in the context of the HIPC Capacity Building Program (CBP) (see Annex 3 for details). Just as importantly, they would include less formal but highly relevant information, such as Fund staff's views on fiscal policy, public financial management, debt management, and any other relevant recent developments or ongoing reforms.

Table 2. List of Available Indicators (as of June 30, 2009)

Indicators	Relevance	Quantifiable nature	Country coverage (PRGF-eligible)	Frequency of update	Availability of the indicator to Fund staff
CPIA	The indicator as a whole is very broad. But five components capture both fiscal and debt policy and the PFM dimensions.	Yes	74 countries, i.e., all the PRGF-eligible countries (excluding Albania, Liberia, Myanmar, and Somalia)	Annually	Yes
PEFA	Relevant, but covers only PFM aspects (more thoroughly than CPIA).	Yes	55 countries	Recommended every three years. It is country demand-driven	Yes
DeMPA	Relevant, but covers only public debt management.	Yes	18 countries	Country demand-driven	No. DeMPA reports are confidential, and access to them has not been granted so far.
HIPC CBP	Relevant, but covers only public debt management	Yes	14 countries	Country's voluntary self-assessment	Summary of reports posted on the web.
ROSCs	Relevant, but covers only fiscal transparency.	Yes	All	Country-demand driven	Yes
WGI	Relevant, but scope is too broad (general governance aspects and the political system)	Yes	All	Annually	Yes
PPA	Relevant, but covers only World Bank's projects in terms of their relevance, efficiency, and sustainability of results.	Yes with limited observations	68 countries	World Bank's agenda-driven	Yes

B. A framework to identify higher-capacity countries

11. **The diversity of available information, while welcome for the assessment of capacity, raises challenges for a uniform treatment of countries.** Many formal assessments are available for only a small set of LICs, and therefore limit cross-country comparisons. Identical issues arise with softer information, which may not fully reflect a broad cross-country perspective.

12. **To address this issue, staff suggests a two-step process**. The first step relies on relevant quantitative indicators with broad coverage of LICs. This would allow for a preliminary identification of higher-capacity countries, in a way consistent with uniformity of treatment. In a second step, this indicative classification would be used as a starting point to determine a more precise classification, using all other available information.

13. **For the first step, staff suggests using the sub-CPIA and PEFA as guideposts.** These two indicators are the most relevant and have the broadest coverage (see Box 1 for the methodology used to construct them and some of their properties). While there is some overlap between the two indicators, they are complementary and using both provides a robustness check on the assessments.

14. **Thresholds need to be defined to identify higher capacity, as neither guidepost provides absolute benchmarks.** Staff suggests defining the threshold for each guidepost as the average score of countries classified as "blend" by IDA, i.e., LICs that are considered creditworthy enough to borrow from IBRD (Table 3).[9, 10]

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[9] This threshold currently happens to correspond to the 75th percentile of each distribution in both cases.

[10] IDA blend countries are countries eligible to borrow from IDA on the basis of per capita income and also eligible to borrow from IBRD on the basis of limited creditworthiness. Given the access to both sources of funds, blend borrowers are expected to limit IDA lending to social sector projects and to use IBRD resources for projects in the "harder" sectors. Country risk ratings are derived on the basis of both quantitative and qualitative analysis. The components considered in the analysis include political risk, external debt and liquidity, fiscal policy and public debt burden, balance of payments risks, economic structure and growth prospects, monetary and exchange rate policy, financial sector risks, and corporate sector debt and vulnerabilities.

Table 3. Average Sub-CPIA and PEFA Scores
(Index)

	Sub-CPIA index	PEFA
Mean of the PRGF-eligible [1/]	3.2	2.2
IDA-only countries	3.1	2.1
Blend countries [2/]	3.7	2.6
75th percentile of the PRGF-eligible countries	3.7	2.6

Sources: CPIA database, World Bank; and PEFA database; and staff estimates.

1/ Simple average.
2/ Excludes Zimbabwe, in view of the large deterioration in its economic situation in past years.

15. **For the 55 LICs for which both the sub-CPIA and PEFA indicators are currently available, a preliminary classification of "higher capacity" would require having a score above the threshold for each indicator.** The sub-CPIA index and the PEFA measure different dimensions of capacity, and there is no reason *a priori* to give a greater weight to one indicator over the other. Countries with both sub-CPIA and PEFA scores below the thresholds would be initially classified in the lower category. Countries with one score above the relevant threshold and the other below the other threshold would be temporarily placed in a "grey area".

16. **The 21 LICs for which only one indicator is available would initially either be placed in the grey area or classified in the lower category on the grounds that information on only one indicator would not be sufficient for a classification in the higher category**.[11] To be placed in the grey area, the available indicator should be above a lower bound that would be defined as the "higher capacity" threshold minus one standard deviation for the score of blend countries. This approach would be consistent with the treatment of countries for which both indicators are available, under which placement in the grey area requires either one of two indicators to be above the relevant threshold.[12]

[11] There are 19 countries that have a sub-CPIA but no PEFA assessment, and two countries that have a PEFA assessment but no sub-CPIA. The countries for which a PEFA assessment is missing include Angola, Bhutan, Cambodia, Chad, Djibouti, Eritrea, The Gambia, India, Kiribati, Maldives, Moldova, Mongolia, Nigeria, Pakistan, Sri Lanka, Sudan, Uzbekistan, Vietnam, and Zimbabwe. Albania and Liberia have a PEFA assessment but no CPIA rating. In addition, there are two other PRGF-eligible countries—Myanmar and Somalia—for which neither PEFA nor sub-CPIA ratings are available.

[12] Annex 4 contains a preliminary and indicative classification of countries that would result from step 1, using the proposed methodology.

Box 1: The Sub-CPIA and PEFA Indices

The sub-CPIA is constructed using two CPIA components that are policy-related (debt and fiscal) and three that rate the quality of public financial management and institutions. Each component is given equal weight, reflecting the assumption that all dimensions are equally important for the assessment of capacity and consistent with CPIA methodology. In the remainder of the paper, the sub-CPIA is based on 2008 CPIA data, reflecting the latest available information. The sub-CPIA is highly correlated with the overall CPIA (see table below). However, Annex 1 shows significant divergences between the two indices in some countries, which justifies the use of the sub-CPIA in the assessment rather than the use of the CPIA itself.

Correlation Coefficients of the Indices of the Various Sub-Components and with the Overall CPIA (in percent)

	Overall CPIA	Proposed sub-CPIA	Component for economic management	Component for public sector management
1. Index				
Overall CPIA	1.00	0.96	0.87	0.91
Proposed sub-CPIA	…	1.00	0.92	0.93
Component for economic management	…	…	1.00	0.71
Component for public sector management	…	…	…	1.00
2. Ranking				
Overall CPIA	1.00	0.95	0.83	0.89
Proposed sub-CPIA	…	1.00	0.89	0.90
Component for economic management	…	…	1.00	0.65
Component for public sector management	…	…	…	1.00

Source: CPIA database, World Bank; and staff's estimates.
1/ The correlation coefficients are significant since their t values are higher than 3.

PEFA ratings for its 28 components are based on an ordinal scale (A to D) and were converted into numerical values and then aggregated using equal weights to construct the PEFA indicator.[1/] This indicator is highly correlated with the sub-CPIA.

Correlation Coefficients of PEFA and Sub-CPIA Index (in percent)

	Overall CPIA	Sub-CPIA	Index for economic management	Index for public sector management
Correlation of indices with PEFA	0.77	0.79	0.70	0.75
Correlation of ranks with PEFA	0.70	0.77	0.65	0.75

Source: CPIA database, PEFA database and staff estimates.
1/ The coefficient are significant ranging from 4.86 to 5.84.

1/ This is consistent with other reports using PEFA aggregation techniques (see Annex 2).

17. **In a second step, all relevant information would be mobilized to arrive at a more precise assessment of capacity**. As indicated above, this would include staff's qualitative assessments on relevant issues as well as the indicators mentioned in paragraph 10. An important consideration would be the country's ability to articulate a sound borrowing strategy in the context of a DSA and a Medium-Term Debt Management Strategy (MTDS).[13] Other relevant considerations include: the country's track record of accessing market financing and managing nonconcessional borrowing; the timely provision of debt data; the country's track record in selecting high-return public investment projects in a transparent and competitive manner; the quality and intensity of the dialogue with donors (to minimize the risk that nonconcessional borrowing leads to reduced donor efforts to provide concessional support);[14] the recent evolution of the sub-CPIA index, particularly if it is close to the threshold; and the country's classification by IDA (e.g., IDA-only or blend).

18. **To further ensure uniformity of treatment, this second step would involve a simultaneous assessment of LICs with a Fund-supported program in the Fall of 2009.** The preliminary classification derived from the use of the sub-CPIA and PEFA indices would be the starting point for an inter-departmental discussion. World Bank staff with relevant expertise would be invited to provide their views. All assessed countries would be reviewed in this second step. For those assessed in the higher or lower category in the first step, clear evidence would need to be presented to justify a change in the preliminary

[13] The Fund and the Bank have provided assistance in this area. The Boards of the two institutions in May 2007 endorsed the development of a methodological framework for the design of MTDS in LICs and subsequently welcomed the progress in developing and implementing the toolkit for strengthening public debt management in March 2009. The MTDS toolkit developed by a joint Bank-Fund team includes a guidance note on the process of designing and implementing a debt management strategy in a LIC context as well as a quantitative cost-risk analysis tool available through the IMF website (http://www.imf.org/external/pp/longres.aspx?id=4326). The objective of the program is to help LICs make well-informed decisions about public debt and its management that is consistent with maintaining debt sustainability and limiting portfolio and default risk over the medium term. The MTDS toolkit has been applied in Bangladesh, Cameroon, Ghana, Kenya, Nicaragua and Moldova and five additional missions are expected this year. The work has been undertaken in close cooperation with various stakeholders, including other technical assistance providers and donors. The important role of an MTDS in the assessment of capacity in the context of debt limits may increase the demand for TA in this area.

[14] This aspect is not captured by any indicators and can only rely on staff's judgment. Arguably, governments' transparent, efficient, and accountable policies and processes are critical for maintaining a close dialogue with donors. However, it could also be the case that weaknesses in the consultation process and coordination with donors are beyond the authorities' control. The PEFA framework was developed partly to enhance coordination among donors. PEFA has three indicators that specifically assess donor practices. However, these do not provide an explicit assessment of the consultation processes that exist between authorities and donors. A starting point would be the existence of donor budget support groups.

assessment. The outcome of this exercise would be to place all LICs with a Fund-supported program in either the lower or the higher category.

19. **An annual stock-taking exercise would be conducted subsequently, to assess the need for changes in the classification based on new information, including evidence provided by the authorities**. This would allow any progress made by a country in the course of a year to be taken into account, possibly leading to a reclassification from the lower to the higher category.[15,16] The possibility of a reclassification from the higher to the lower category could not be ruled out if capacity deteriorates. This could happen, for instance, if a country has proved unable to implement the more flexible options satisfactorily. While reclassifications would be expected to take place at the time of the annual stock-taking exercises, individual changes may need to be considered in between on a case-by-case basis. This would obviously be the case if a member not previously assessed were to request a Fund-supported program. This could also be justified in exceptional circumstances, such as a major development affecting substantially capacity. The classification would be communicated to the Board for information after the annual stock-taking.[17] The authorities' views would be reflected in staff reports, in the event of a disagreement on the assessment.

III. How Would the Various Options for Concessionality Requirements Work in Practice?

A. Operational issues

20. **This section clarifies a number of operational issues regarding some of the options in the matrix.** In particular, it provides guidance on how to (i) determine the size of nonconcessional borrowing limits in countries with lower capacity and lower debt vulnerabilities; and (ii) operationalize the more sophisticated approaches—average concessionality requirement or PV targets—in countries with higher capacity.

[15] This progress may be reflected in the sub-CPIA (which unlike PEFA assessments is revised annually for all LICs) or in the information mobilized in the second step.

[16] The thresholds would be expected to remain unchanged from one year to the next, to avoid raising the bar for higher capacity and to encourage countries to improve absolute performance in this area. While the first annual assessment would likely require significant resources (see Section VI), particularly for AFR, subsequent annual stock-taking exercises would be expected to be much lighter as they would only require assessing whether newly available information warrants a reclassification.

[17] In countries that are subject to a performance criterion on contracting of new external debt under a Fund-supported program and for which the status changes as a result of the annual update any changes to the performance criterion would be reflected at the time of the next review.

Setting nonzero limits on nonconcessional borrowing

21. **As general rule, the size of a nonzero limit on nonconcessional borrowing in countries with lower capacity and lower debt vulnerabilities should not be so large that, if fully used, it would lead to a downgrading of the DSA risk rating.** The DSA should use realistic assumptions for nonconcessional borrowing beyond the period for which a nonzero limit is proposed. For instance, it would not be realistic to assume a large nonzero limit in the near future followed by little or no nonconcessional borrowing in the remainder of the DSA's 20-year forecasting period.

22. **This approach could be complemented by a "speed bump" in some cases.** In countries with large borrowing space—such as post-MDRI countries where debt ratios are far below their DSF thresholds in the baseline and alternative scenarios—the rule proposed in the previous paragraph may leave excessive room for borrowing, including from an absorptive capacity perspective. In such cases it would be appropriate to use a "speed bump", i.e. an indicative limit on the pace at which debt ratios can rise.[18]

23. **Within this group of lower-capacity/lower-debt-vulnerability countries, untied limits—limits not linked to a specific project—would normally be reserved for those with relatively better capacity levels.** Those countries would typically have sub-CPIA and/or PEFA scores close to the above-defined thresholds, or be countries that were initially assessed as being in the grey area.

Setting PV targets or average concessionality requirements.

24. **The solutions proposed to set PV targets or average concessionality requirements were designed to meet two basic criteria:** (relative) simplicity to facilitate implementation and monitorability; and consistency with the DSA. Box 2 explains how these more advanced and flexible options could work. Some issues raised by these options are discussed below. Box 3 clarifies how grants should be treated under the more flexible options.

25. **PV targets (and average concessionality requirements) could be set based either on disbursements or contracting.** The former option would have the advantage of a closer

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[18] For this purpose, one possible rule of thumb is that the PV of debt not increase by more than 5 percent of GDP annually or lower if country circumstances warrant. Empirical work conducted by staffs in the context of the 2006 paper on applying the DSF indeed showed that countries in which debt has grown rapidly (as a share of the previous year's GDP) are significantly more likely to suffer debt distress. "Rapidly" was defined as an annual change in the PV of debt of about 5-7 percent of GDP or more. See IMF and IDA (2006) "Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief," http://www.imf.org/external/np/pp/eng/2006/110606.pdf.

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link to the DSA, which is based on disbursements, while the latter would simplify monitoring, as there are typically more disbursements than debts contracted over any period of time. Staff suggests making both options available.

Box 2: How Would Average Concessionality and PV Targets Work in Practice?

- **Disbursements vs. contracting.** A single loan can generate several disbursements over a period of time. Concessionality calculations in the current debt-by-debt approach are done at the time of contracting, assuming full upfront disbursement. This approach has the advantage of being very simple—a loan is assessed once and for all at contracting—and it does not require a projected schedule of disbursements. By contrast, DSAs are closely linked to balance of payments and fiscal projections and are therefore based on disbursements. To make things tractable, the DSA does not distinguish whether a disbursement corresponds to a new or existing loan, and typically applies standardized terms to all disbursements from a given creditor or donor (e.g., IDA).
- **Setting and monitoring a PV target based on disbursements**. The easiest approach to set the target is to use the projected PV of new disbursements in the DSA. Monitoring of compliance with the target requires getting information on all new disbursements (irrespective of whether they correspond to an existing or new loan) and corresponding schedules of repayment. All new disbursements are converted in U.S. dollars using the same exchange rates as in the DSA, and corresponding PVs are calculated using the DSA discount rate.[19] Individual PVs are then added up and the total is compared to the target for the period.
- **Setting and monitoring an average grant element based on disbursements**. The DSA can provide directly a target, by comparing the projected PV of new disbursements with their nominal values. Monitoring requires the same information and steps as for a PV target.
- **Setting and monitoring a PV target based on contracting**. The DSA cannot be used directly to set such target. However, it is possible to set a target on contracting *consistent with the DSA*. This would require, when the DSA is conducted, information on which future disbursements are linked to debt expected to be contracted in the coming period. The PV of this debt can then be calculated, using DSA parameters, and be used as a target. Monitoring involves the same information (on new debt contracted) and steps as for a disbursement-based approach.
- **Setting and monitoring an average grant element based on contracting**. The PV of new debt contracted in the coming period needs to be calculated first and then compared to the corresponding nominal value. Monitoring requires the same information and steps as for a PV target.

26. **Targets on average grant elements may vary significantly across countries, even among countries with the same degree of debt vulnerabilities**. **For a given country, they may also vary significantly from one year to the next.** Thus, in any given year and country, such a target may exceed or fall short of 35 percent by large margins. These potential variations reflect the diversity of country situations with regard to financing needs and access to concessional resources: for instance, some countries may benefit from very large volumes of highly concessional finance, while others may receive lower volumes of somewhat less concessional finance. It also reflects the timing of delivery of concessional

[19] Currency-specific discount rates are used in concessionality calculations in the debt-by-debt approach.

finance and lumpiness of development projects. These variations are illustrated in Figure 1, which shows the grant element of new financing for a sample of countries with low DSA risk ratings, as assumed in these countries' DSAs.

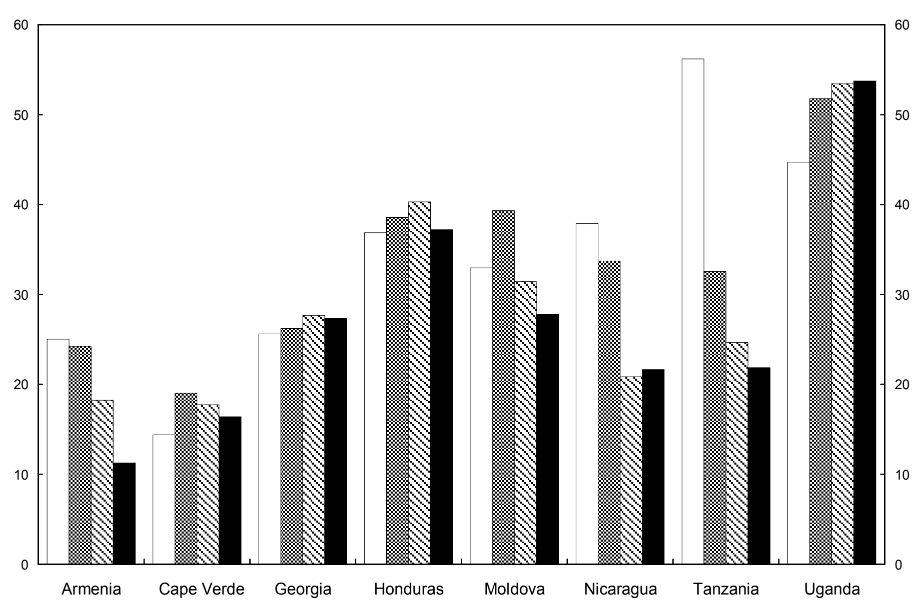
Box 3: The Treatment of Grants

Under the options relying on a debt-by-debt approach to concessionality, grants can play a role in determining the overall concessionality of a financing package. The Fund may indeed assess on a case-specific basis whether an envisaged combination of financing instruments, including grants, can be treated as a package for purposes of meeting concessionality requirements.

However, the essence of the more flexible options, including average concessionality requirements, is to move away from the debt-by-debt approach, which implies a different treatment of grants.

- PV targets or average concessionality targets would be based on PVs of debt calculated in DSAs. These PVs are not affected by grants, since a grant's PV is equal to zero.
- Once a target for average concessionality has been set, countries may have an incentive under this approach to substitute planned grants for highly concessional loans. This would indeed allow them to raise more nonconcessional resources. This seems, however, to be a largely theoretical issue. In practice, countries have limited choice on whether to get a grant or a loan from a donor, as this decision is generally driven by the donor's own policies.
- In some rare cases, grants may need to be taken into account in the monitoring of targets. This would be the case, for instance, if a concessional loan expected from a donor at the time of the DSA ended up being a grant. This grant would need to enter the average concessionality calculations to avoid penalizing the country for getting better-than-expected terms. Conversely, an expected grant eventually materializing as a concessional loan should not be taken into account in average concessionality calculations.

Figure 1. Projected Grant Element of New Financing for Selected Low-Risk Countries (in percent)



27. **Both average concessionality requirements and PV targets need to be consistent with the fiscal framework.** There may be cases where debt limits solely based on sustainability considerations would allow for too much borrowing from a demand management perspective[20]. In such cases, binding limits on the overall fiscal deficit or nominal debt should take precedence.

28. **PV targets or average concessionality requirements would be more appropriate as annual indicative targets than as performance or assessment criteria, at least in an initial phase.** Setting these targets requires many assumptions (e.g., on the expected timing and terms of new disbursements or contracting) and is significantly more complex than setting debt limits tied to specific projects. Moreover, while targets in Fund-supported programs for LICs are typically set semi-annually to coincide with six-monthly program reviews, PV or average concessionality targets should preferably be set on an annual basis, since they are derived from DSAs that use annual data. Compliance with indicative annual targets would be an important element of program reviews.

29. **For the most advanced LICs, concessionality requirements could be dropped.** These countries, in addition to being assessed as higher capacity, would be expected to have higher per capita income, a strong track record of macroeconomic and public resource management, significant market access, and satisfactory experience in dealing with nonconcessional financing. As pointed out in IMF (2009), these countries would likely be classified as gap or blend countries by IDA and therefore not subject to IDA's Nonconcessional Borrowing Policy. Such a treatment would be applied on a case-by-case basis and clearly justified in the relevant program document.

B. Addressing concerns with the flexible approaches

30. **During the March 2009 discussion, Directors stressed the need for adequate safeguards to maintain donors' incentives to provide highly concessional financing in the more flexible options**. As discussed in the previous paper, the issue of donors' incentives is a real one, particularly for those for which concessionality requirements have proved binding. In the absence of a requirement applying to all new debt, some donors may be tempted to reduce the grant element of their new lending, particularly in a period of tight fiscal constraints. Possible additional concerns about the more flexible options include (i) the risk that this flexibility be used unwisely, either to contract too much debt in general or too much nonconcessional debt in particular; and (ii) cross-subsidization issues, i.e., the perception of a donor that its efforts benefit ultimately a less concessional donor or creditor—by creating space for such lending—rather than the country itself.

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[20] IMF (2009) "Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt," http://www.imf.org/external/np/pp/eng/2009/022509a.pdf.

31. **Staff is of the view that these concerns should be mitigated by the following considerations**.

- The ***risk of excessive borrowing*** is addressed through the tight link to DSAs. PV targets set a limit on total new borrowing, while average concessionality requirements would only be considered for lower-vulnerability countries. Should an average concessionality requirement lead to excessive borrowing one year, the problem could be fixed the next year through a more constraining target.

- The ***risk of excessive nonconcessional borrowing*** is also addressed in both options. The scope for nonconcessional borrowing is limited by the need to meet the target for the average grant element or the PV of new borrowing. In both options, the authorities have an incentive to seek concessional terms so as to get a higher nominal amount of resources for a given target.

- ***Making sure the country, not another creditor, benefits from a donor's efforts***. First, it should be stressed that this issue already arises in the current approach to concessionality. Many traditional donors provide grants, and are therefore much more concessional than other donors or creditors providing loans. A significant share of programs also include some space for nonconcessional borrowing. Second, this concern is addressed in the more flexible options by making them available only to higher-capacity countries. This requirement should provide confidence to donors that their resources are going to be put to good use, and that any nonconcessional borrowing will be contracted to complement scarce concessional resources and finance expenditures that will ultimately benefit the country. Third, as mentioned in Section II, the quality and intensity of the dialogue with donors will be taken into account in determining higher capacity. An ongoing and open dialogue on spending plans and financing options should go a long way towards addressing donor concerns.[21]

32. **While the new approach to concessionality may lead donors to reallocate some of their concessional resources across LICs, it should not be perceived as an invitation to reduce their overall efforts.** Concessional resources remain the most appropriate mode of financing for most activities in LICs. More such resources are needed, not less, including to address the implications of the ongoing financial crisis.

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[21] Such a dialogue is taking place in Liberia and helped donors, who are expected to provide only grants under the Fund-supported program, accept the idea that room should be made under the program for new (concessional) loans to repair the free port of Monrovia, a critical infrastructure project.

IV. IMPLICATIONS FOR NON-LICS

33. **The changes to the policy on debt limits have implications for both LICs and non-LICs, as the current guidelines apply to all Fund members**. They were drafted to allow for sufficient flexibility to account for the diversity of individual country circumstances.[22] The same coverage and flexibility are suggested for the proposed new guidelines. Two aspects of the reforms with particular implications for non- LICs are discussed below.

34. **There would be a presumption that debt limits in Fund-supported programs for non-LICs, if any, would not include concessionality requirements.[23]** This would be consistent with the fact that such countries, because of their higher per-capita income, generally have limited or no access to concessional financing. Having concessionality requirements in this context would therefore be largely irrelevant. This presumption would also be consistent with the philosophy behind the concessionality matrix for LICs, which provides a path towards graduation from concessionality requirements. This would also be consistent with recent practice in non-LICs, for which only a few have debt limits and out of those most programs do not include concessionality requirements (Table 4). Where appropriate, debt limits would be established in Fund-supported programs for non-LICs, including possibly nominal debt limits.[24]

35. **The definition of external debt in the context of the guidelines on debt limits should follow the principles discussed in March 2009 on the use of the residency criterion for all members.[25]** In countries with open capital accounts, the distinction between external and domestic debt based on residency is very difficult to make in practice—raising the issue of the monitorability of external debt limits. For members with still relatively closed capital accounts or very limited financial integration with the rest of the world, the use of the

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[22] The current guidelines state 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 relating to official and officially guaranteed foreign debt will be included in upper credit tranche arrangements."

[23] In other words, debt limits, if any, would generally not make the distinction between concessional and nonconcessional external debt.

[24] In principle, there could be situations where a non-LIC receives substantial concessional financing, in which case concessionality requirements might be relevant. In such a case, the considerations used to determine which option in Table 1 is most appropriate for LICs—i.e., the extent of debt vulnerabilities and capacity—would then apply similarly to non-LIC to ensure uniformity of treatment. In practice, such a situation is likely to be exceptional, as per-capita income is a key criterion for donors to determine eligibility for concessional assistance.

[25] Residency would remain the relevant criterion for policies on arrears.

residency criterion would still be relevant with some amendments[26]. Otherwise, where there is a need to mitigate the exchange rate risk associated with foreign currency nonconcessional borrowing, a currency denomination criterion could be used.

Table 4. Minimum Concessionality Requirement and Debt Limits in Selected Non-LIC Program Countries (in millions of USD, unless otherwise specified)

Country	Concessionality Requirement	Non-zero limit on MLT debt	Non-zero limit on ST debt	Fiscal deficit target[1/]
Ukraine	n/a	n/a	n/a	set
El Salvador	n/a	n/a	n/a	set
Belarus	n/a	n/a	n/a	set
Serbia	35	50-550 mil euro (external debt)	10 million euro (external debt)	set
Seychelles	n/a	10-39 (external debt)	0 (external debt)	set
Romania 2/	n/a	n/a	n/a	set
Hungary	n/a	n/a	n/a	set
Costa Rica	n/a	4,356-4,447 billion colones (total debt)	n/a	set
Belarus	n/a	n/a	n/a	set
Guatemala	n/a	n/a	n/a	set
Latvia	n/a	n/a	n/a	set

1/ Includes cases where targets are set on the primary balance.
2/ Romania has a ceiling on the issuance of guarantees.

V. Transitional Arrangements and Review

36. **It is expected that the new debt limits policy will be implemented over time.** If the Executive Board approves the proposed decision, the capacity assessment of each LIC will be finalized through an interdepartmental consultation. Staff expects that this could be completed by end-November and thus, it is proposed that the new Guidelines enter into effect on December 1, 2009. Countries that are subject to a performance criterion on external debt limits under a Fund-supported program and for which the status will change under the matrix approach would continue to be subject to the old policy on external debt limits until the relevant performance criterion is amended following the entry into force of the new Guidelines.

37. **A review of experience with this new approach could be conducted after a fairly short period of time, say two years.** An early review would be justified given the number of conceptual and technical innovations embedded in the new approach. It would allow to take

[26] See IMF (2009) "Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt," http://www.imf.org/external/np/pp/eng/2009/022509a.pdf.

stock of the experience with it, and to address any teething problems with some of the technical aspects (e.g., setting and implementing limits on PVs).

VI. Resource Implications

38. **Staff believes that the additional resource requirements to implement the proposals set forth in this paper are manageable.** As of July 2009, there were 35 programs with concessionality requirements. Staff estimates the gross resource needs to be about 1/3 of a staff-year to conduct the initial capacity assessment. Subsequent updates would be significantly less resource-intensive.[27]

39. **Resource savings from the streamlining of DSA requirements (see companion paper on the DSF) would offset these costs.** In the absence of major changes in the debt sustainability outlook and of program requirements, staff proposes to conduct full DSAs only once every three years with lighter annual updates in between. Once the global economic environment has stabilized, the implied annual resource savings are estimated at slightly less than one staff-year.[28] Some of these savings could be allocated to deeper analysis of the public investment-growth nexus.

VII. Issues for Discussion

- Do Directors agree with the proposed two-step approach to measure capacity?
- Do Directors agree that the first step should rely on the sub-CPIA and PEFA indices?
- Do Directors agree that the assessment of capacity should be conducted annually for program countries and be communicated to the Board for information?
- Do Directors agree that staff's proposals sufficiently address the issue of maintaining donor incentives to provide highly concessional resources?
- Do Directors agree that in certain circumstances the residency criterion could be replaced by a currency of denomination criterion?

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[27] This estimate is based on the following assumptions: (i) Preparing the annual update of quantitative indicators as discussed in Section II: 4 staff days; (ii) Departmental preparation for round table and checking of quantitative indicators and preparing additional "soft" information based on country information: 70 staff days (one desk economist per country for two days); and (iii) Roundtable discussion including two staff members from each area department, FAD, MCM, and 4 staff members from SPR: 18 staff days (18 staff members for one day).

[28] This assumes that 25 staff days are needed per DSA and 25 percent savings for the updates. Assuming that circumstances would allow about half of the 70 annually produced DSAs to be streamlined, the savings would be about 220 staff-days.

ANNEX: TOWARD AN ANALYTICAL FRAMEWORK FOR ASSESSING MACROECONOMIC AND PUBLIC FINANCIAL MANAGEMENT CAPACITY

Annex 1. Rationale, Content and Overview of the sub-CPIA Index

40. **The overall CPIA index provides an assessment of a country's policies and institutions that goes beyond the dimensions most relevant for assessing a country's capacity to manage adequately its public resources.** The assessment is based on 16 equally weighted components grouped in four clusters (Box A1), with the rating scale spanning from 1 (low) to 6 (high). Since the CPIA assigns equal weight to all four clusters, countries that rate higher on one dimension relative to another can end up with very similar overall CPIA scores. Similarly, a country's low rating on the public financial management cluster does not preclude it from having a high overall CPIA rating (Figure A1).

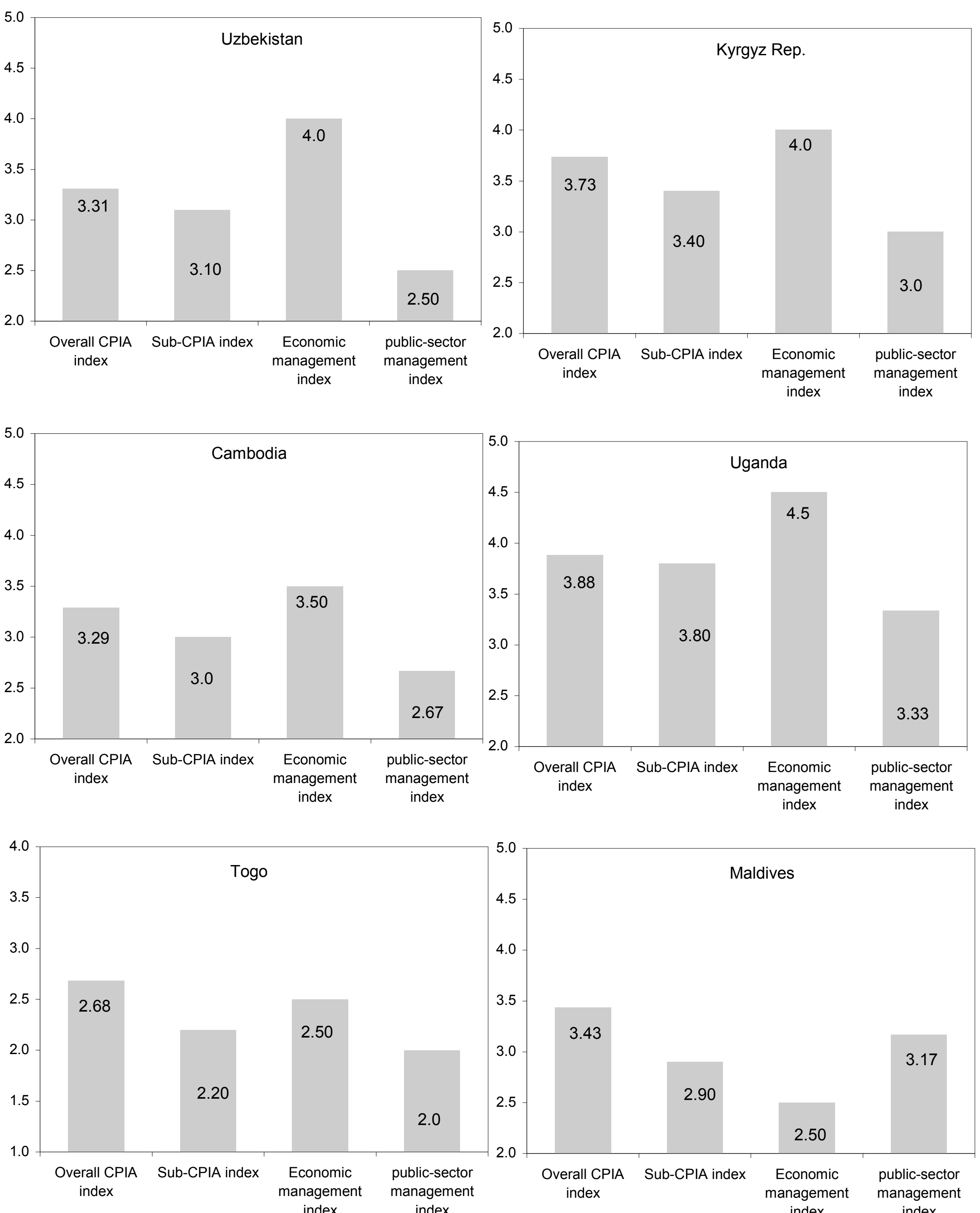
41. **The sub-CPIA index is constructed using five components of the CPIA.** It includes two criteria that are policy-related (debt and fiscal) and three that rate the quality of public financial management and institutions. Below is the World Bank's description of each component.[29]

Box A1. Components of the CPIA

A. Economic management	B. Structural policies
1. Macroeconomic management	4. Trade
2. Fiscal policy	5. Financial sector
3. Debt policy	6. Business regulatory environment
C. Policies for social inclusion/equity	D. Public-sector management and institutions
7. Gender equality	12. Property rights and rule-based governance
8. Equity of public resource use	**13. Quality of budgetary and financial management**
9. Building human resources	14. Efficiency of revenue mobilization
10. Social protection and labor	**15. Quality of public administration**
11. Policies and institutions for environmental sustainability	**16. Transparency, accountability and corruption in the public sector**

[29] Macroeconomic management and revenue mobilization are excluded from the analysis. The former is one of the core areas of expertise in the Fund and would serve as an important element in step 2 of the capacity assessment. The latter is related to repayment capacity and therefore captured in the debt vulnerabilities dimension of the options matrix.

Figure A1. CPIA and its Components for a Sample of Countries (2008)



Sources: World Bank's CPIA database; and staff simulations.

42. **Component A2 assesses the short- and medium-term sustainability of fiscal policy and its impact on growth**. Fiscal policy is not sustainable if it results in a continuous increase in the debt-to-GDP ratio and/or creates financing needs that cannot be adequately met by the supply of funds available to the public sector. This component covers the extent to which: (i) the primary balance is managed to ensure sustainability of the public finances; (ii) public/expenditure/revenue can be adjusted to absorb shocks if necessary; and (iii) the provision of public goods, including infrastructure, is consistent with medium-term growth. Sustainability is defined inclusive of off-budget government spending items and contingent liabilities. The impact of fiscal policy on economic growth depends on the marginal productivity of government spending and on the distortions introduced by taxes collected to finance this spending. *Main sources: World Bank Database (Development Data Platform); and IMF Article IV Consultation and other relevant reports.*

43. **Component A3 assesses whether the debt management strategy is conducive to minimizing budgetary risks and ensuring long-term debt sustainability.** This component evaluates the extent to which external and domestic debts are contracted with a view to achieving/maintaining debt sustainability, and the degree of coordination between debt management and other macroeconomic policies. Adequate and up-to-date information on debt stock and flows is an important component of debt management strategy. Timely, accurate statistics on the level and composition of debt, both domestic and external, is necessary as is capacity to analyze the volatility of debt servicing due to exchange rate and interest rate shocks. A dedicated debt management unit should be able to monitor new borrowing with a view to ensuring debt sustainability, including headroom to leverage additional resources in the event of exogenous shocks. Effective inter-agency coordination on issues related to debt management and debt sustainability is also crucial. This component covers the adequacy of the debt recording systems, the timelines of the public debt data, and the effectiveness of the debt management unit. *Main sources: World Bank Database (Development Data Platform); IMF Article IV Consultation and other relevant reports; and World Bank's Debt Reporting System-reporting status ratings.*

44. **Component D13 (quality of budgetary and financial management)** assesses the extent to which there is: (i) a comprehensive and credible budget, linked to policy priorities; (ii) effective management systems to ensure that the budget is implemented as intended in a controlled and predictable way; and (iii) timely and accurate accounting and fiscal reporting, including timely and audited public accounts and effective arrangements for follow up. Each of these three dimensions should be rated separately. For the overall rating for this component, these three dimensions receive equal weighting. *Main sources: PEFA Performance Measurement Framework; IMF Code of Good Practices on Fiscal Transparency; and World Bank's PRMPS Governance Indicators.*

45. **Component D15 assesses the extent to which civilian central government staffs are structured to design and implement government policy and deliver services effectively**. Civilian central government staffs include the central executive together with all other ministries and administrative departments, including autonomous agencies. It excludes armed forces, state-owned enterprises, and sub-national government. The key dimensions for assessment are: (i) policy coordination and responsiveness; (ii) service delivery and operational efficiency; (iii) merit and ethics; and (iv) pay adequacy and management of the wage bill. For the overall rating for this component, these four dimensions receive equal weighting. *Main sources: Civil service wage and employment database; and World Bank's PRMPS Governance Indicators.*

46. **Component D16 (transparency, accountability, and corruption in the public sector)** assesses the extent to which the executive can be held accountable for its use of funds and the results of its actions by the electorate and by the legislature and judiciary, and the extent to which public employees within the executive are required to account for the use of resources, administrative decisions, and results obtained. Both levels of accountability are enhanced by transparency in decision-making, public audit institutions, access to relevant and timely information, and public and media scrutiny. Each of the three dimensions are rated separately: (i) the accountability of the executive to oversight institutions and of public employees for their performance; (ii) access of civil society to information on public affairs; and (iii) state capture by narrow vested interests. For the overall rating for the components, these three dimensions receive equal weighting. *Main sources: World Bank's PRMPS Governance Indicators*

47. **The analysis of the sub-CPIA index shows the following results**:

- The average rating for PRGF-eligible countries was 3.2 in 2008, with IDA-blend countries performing on average much better than other LICs (Table A1).
- For all clusters examined, the difference between the average for IDA-only countries and that for blend countries is large.
- On average, the index for fiscal and debt policies is higher than that for the PFM across all groups of countries.

Table A1. Average Rating of the Proposed Sub-CPIA Index (2008)

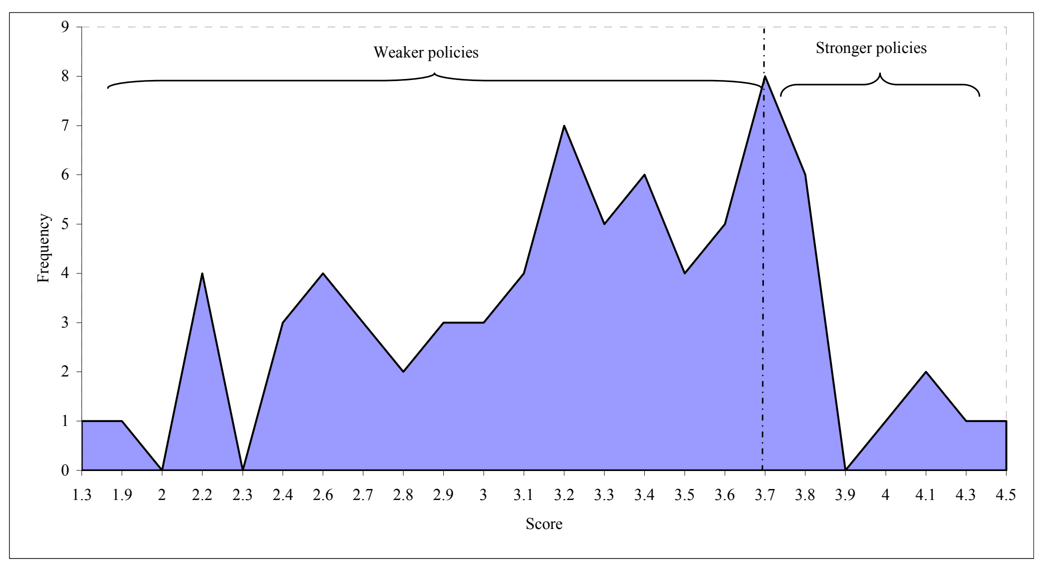
	Overall CPIA index	Sub-CPIA index	Index for fiscal and debt policy			Index for public sector management more relevant for debt and project management			
			Average [1/]	Fiscal policy (A2)	Debt policy (A3)	Average [1/]	Quality of Budget. & Finan. Mgt. (D13)	Quality of Public Admin. (D15)	Transpar., Account. & Corrup.in Pub. Sec. (D16)
Mean	3.32	3.21	3.48	3.45	3.51	3.03	3.24	2.99	2.86
Median	3.34	3.30	3.50	3.50	3.50	3.17	3.50	3.00	3.00
Mean:									
PRGF-eligible	3.32	3.21	3.48	3.45	3.51	3.03	3.24	2.99	2.86
IDA-only countries	3.24	3.12	3.38	3.39	3.37	2.95	3.15	2.92	2.79
Blend countries [2/]	3.77	3.67	4.00	3.79	4.21	3.44	3.71	3.38	3.25

Source: CPIA database, World Bank; and staff estimates.

1/ Simple average.
2/ Excludes Zimbabwe.

- The distribution of the data is left-skewed with most of the ratings concentrated between 3.1-3.8 (Figure A2). There are five countries located in the right tail (with a rating at 4 and above), namely Armenia, Bhutan, Cape Verde, Georgia, and Samoa. Armenia, Georgia, and Cape Verde are blend countries; and Bhutan and Samoa are IDA-only countries.

Figure A2. Distribution of the Sub-CPIA Index, 2008



Annex 2. Content and Overview of PEFA

48. **The PEFA framework was developed between 2003 and 2005 through extensive consultations both with donors and governments**. It is jointly financed by the World Bank's Development Grant Facility (DGF), the European Commission (EC), the UK's Department for International Development (DFID), the Swiss State Secretariat for Economic Affairs (SECO), the Royal Norwegian Ministry of Foreign Affairs, the French Ministry of Foreign Affairs, and the International Monetary Fund (IMF). A Secretariat implements the PEFA work and is located in the World Bank offices in Washington, DC.

49. **The PEFA framework measures performance of a country's PFM**. It offers a comprehensive analysis of PFM, using 28 indicators grouped in three areas: credibility of the budget (4 indicators); comprehensiveness and transparency (6 indicators) and budget cycle (18 indicators), which include elements of both ex-ante and ex-post scrutiny (Table A2). Its comprehensiveness is also evidenced by its wide coverage of PFM areas, which some of them can be the focus of other single indicators (Table A3).

50. **The PEFA framework neither measures the factors affecting performance nor involves fiscal or expenditure policy analysis.** It focuses on the operational performance of the key elements of the PFM system, rather than legal frameworks, the sustainability of fiscal policy, and the returns on public projects. The current PEFA database covers 88 countries of which 57 are PRGF-eligible[30] The database includes a number of reports (33) that are still in the draft stage since the governments have not yet given formal approval to the ratings. Only 55 latest country assessments are final documents.

	PEFA
Total number of countries	88
PRGF	57
Non-PRGF	31
IDA only	48
Blend	9
Final	55
o/w PRGF	38
Draft	33
o/w PRGF	19

Sources: PEFA Secretariat; and IMF staff estimates.

[30] Received from the PEFA Secretariat on April 29, 2009.

Table A2. PEFA Indicator Set

	A. PFM out-turns: credibility of the budget
PI-1	Aggregate expenditure out-turn compared to original approved budget
PI-2	Composition of expenditure out-turn compared to original approved budget
PI-3	Aggregate revenue out-turn compared to original approved budget
PI-4	Stock and monitoring of expenditure payments arrears
	B: Cross-Cutting Issues: comprehensiveness and transparency
PI-5	Classification of the budget
PI-6	Comprehensiveness of information included in budget documentation
PI-7	Extent of unreported government operations
PI-8	Transparency of inter-government fiscal relations
PI-9	Oversight of aggregate fiscal risk from other public sector entities
PI-10	Public access to key fiscal information
	C. Budget Cycle
	C.i. Policy-based budgeting
PI-11	Orderliness and participation in the annual budget process
PI-12	Multi-year perspective in fiscal planning
	C.ii. Predictability and control in budget execution
PI-13	Transparency of taxpayer obligations and liabilities
PI-14	Effectiveness of measures for taxpayer registration and tax assessment
PI-15	Effectiveness in collection of tax payments
PI-16	Predictability and availability of funds for expenditure commitments
PI-17	Recording and management of cash balances, debt and guarantees
PI-18	Effectiveness of payroll controls
PI-19	Competition, value of money, procurement
PI-20	Effectiveness of internal controls for non-salary expenditures
PI-21	Effectiveness of internal audit
	C.iii. Accounting, recording and reporting
PI-22	Timeliness and regularity of accounts reconciliation
PI-23	Availability of information on resources received and service delivery
PI-24	Quality and timeliness of in-year budget reports
PI-25	Quality and timelines of annual financial statements
	C.iv. External scrutiny and audit
PI-26	Scope, nature and follow-up of external audit
PI-27	Legislative scrutiny of the annual budget law
PI-28	Legislative scrutiny of external audit reports
	D. Donor Practices
D-1	Predictability of direct budget support
D-2	Financial information provided by donors for budgeting and reporting of project and program aid
D-3	Proportion of aid that is managed by using national procedures

Source: PEFA report, June 2005

Table A3. A Comparison of PEFA and Other Indicators

Assessment Tools:	Overlaps with PEFA:
The Country Policy and Institutional Assessment (CPIA)	CPIA assessment is carried out by the World Bank, and the ratings are used to guide the Bank in the allocation of IDA resources to recipient countries. In contrast, the PEFA assessment is usually undertaken as a multi donor collaborative effort and any links to fund allocation are more indirect. PEFA assessments inform primary CPIA indicator on quality of budgetary and financial management (No. 13) and to some extent indicator on transparency, accountability and corruption in the public sector (No. 16)
Debt Management Performance Assessment (DeMPA)	DeMPA assesses strength and weaknesses in public debt management operations. DeMPA and PEFA are complementary. DeMPA is a mode detailed and comprehensive assessment of government debt management than currently reflected in PEFA. The DeMPA assessment could be used to undertake a detailed assessment of the underlying factors leading to a poor PEFA ratings in the area of debt management; alternatively, if the DeMPA assessment precedes a PEFA assessment, the later can use the DeMPA results to inform its indicators. DeMPA was modeled after PEFA. It uses 15 indicators that cover 6 core functions of public debt management. Currently regularity and country coverage of DeMPA are limited (only 17 completed country reports, o.w. 3 reports are publicly available) as it is the most recent assessment with the first pilot cases starting in 2007.
Paris Declaration /OECD Aid Effectiveness indicators	The Paris Declaration (endorsed on 2 March 2005) is supported by a set of 12 Indicators of Progress on aid effectiveness which were developed as a way of tracking and encouraging progress against the broader set of partnership commitments, that improves transparency and accountability on the use of development resources. Progress Indicator 2(a), which deals with public financial management system is closely linked to the PEFA framework. Progress Indicator 5 is closely aligned to the PEFA Performance Indicator D-3 whilst the Indicator 7 is closely linked to the PEFA D-1, D-2 and the second (ii) dimension of PI-7.
HIPC-AAP Expenditure Tracking Indicators	The HIPC expenditure tracking indicators are being replaced by the PEFA indicators as the basis for tracking PFM performance in the analytical work undertaken by the World Bank and the IMF. The 16 HIPC Expenditure Tracking Indicators which have been applied primarily in 27 African and Latin American countries between 2000 and 2005 have formed the foundation upon which the 28 performance indicators of the PEFA PFM Performance Framework were elaborated. The evolution to the PEFA Framework made the PFM indicators applicable to a wider range of countries, broadening the scope of PFM subjects covered, and introduced a more rigorous scoring methodology. The HIPC and PEFA indicators are characterized by the same level of aggregation.
DFID's Approach to Managing Fiduciary Risk	DFID has for a number of years used a specific analytical instrument, known as the DFID Fiduciary Risk Assessment, to assess and record fiduciary risk in relation to its budget support operations. This instrument used a set of 15 benchmarks or indicators, covering the fiduciary risks associated with PFM systems, together with a narrative which included the risk of corruption. With the launch of the PEFA Performance Measurement Framework, DFID is replacing its internal guidance on conducting fiduciary risk assessment, so that - where available - PFM assessments based on the PEFA indicator set now constitute the foundation for DFID's fiduciary risk assessment. The additional element of anti-corruption assessment, however, is still maintained by DFID in its guidelines. Also, internal guidelines of several other bilateral donor agencies (e.g. France, the Netherlands, Sweden and Denmark) have been updated to refer to the PEFA indicator set as the preferred basis for assessing performance of PFM systems in client countries.
OECD Procurement indicators	The Baseline indicators have been developed as part of a collaborative effort by the World Bank/OECD-DAC Procurement Round table initiative on strengthening procurement capacities in developing countries. The tool is predominantly based on macro indicators designed to examine key elements of a public procurement system under four pillars. While the PEFA Framework includes one specific procurement indicator with three dimensions (PI-19) as well as reference to procurement issues as part of other indicators, the OECD Procurement indicators cover in much greater depth the procurement aspects in a PFM system.

Source: PEFA Secretariat report August 7, 2007 World Bank report on DeMPA tool February 5, 2008

51. **Cross-country comparisons of PEFA indicators require both conversion of ordinal indicator ratings into numerical values and an allocation of weights to individual indicators.**[31] The reports using PEFA aggregation techniques, so far, have assumed that all PEFA indicators have equal weights and that the numerical interval between the alphabetic scores of the ordinal scale is of equal magnitude. The findings presented below also convert the four ordinal PEFA scores (A,B,C,D) to numerical scores (4,3,2,1) with "+" score given ½ point and assign equal weight to each of 28 government PFM indicators. We use the latest available PEFA scores for each country.[32]

52. **Key findings are very similar to those of the sub-CPIA index. Data show the following results:**

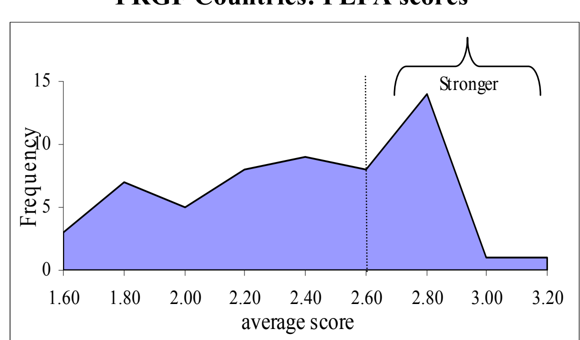
- IDA-blend countries score significantly higher than PRGF-eligible countries on average.
- The distribution of the PEFA average scores is skewed for PRGF eligible countries.

Average PEFA Scores

	Simple average
Mean:	
All countries (88 countries)	2.4
PRGF-eligible (57 countries)	2.2
Non-PRGF-eligible (31 countries)	2.4
IDA-only countries (48 countries)	2.1
Blend countries (9 countries)	2.6

Source: PEFA database and own estimations

PRGF Countries: PEFA scores



[31] See "Issues in Comparison and Aggregation of PEFA Assessment Results Over Time and Across Countries", PEFA Secretariat report, May 13, 2009 for a discussion of issues related to assigning weights and conversion from ordinal to numerical scores.

[32] PEFA indicators are no exception to problematic issues of cross-country comparisons such as the risk of "like" may not be compared with "like" as the scope and year of assessment may not be the same, definitions of PFM terms may differ across countries (arrears, transfers, entities), and the quality of assessments and judgment by the assessors could vary considerably across countries.

Annex 3. Overview of Additional Indicators

World Bank's Debt Management Performance Assessment (DeMPA)

53. **DeMPA assesses strength and weaknesses in public debt management (PDM) operations.** DeMPA assesses effectiveness of the processes involved in sovereign debt management, highlighting the strengths and weaknesses in the institutional arrangements supporting public debt management operations in countries. It covers all six core functions of PDM: (1) governance and strategy development; (2) coordination with macroeconomic policies; (3) borrowing and related financing activities; (4) cash flow forecasting and cash balance management; (5) operational risk management; and (6) debt records and reporting.

54. **DeMPA is a more detailed and comprehensive assessment of government debt management than PEFA.** The latter covers overall PFM aspects including debt management, while DeMPA focuses exclusively on PDM. PDM operations in DeMPA are scored across a number of different dimensions under each indicator, adopting a scoring methodology similar to PEFA. An important difference relative to PEFA is the emphasis placed on meeting a minimum requirement that is considered a necessary condition for effective performance, i.e., achieving a C score for a specific dimension. Failure to meet that minimum requirement signals a serious deficiency in performance.

55. **Regularity and country coverage of DeMPA is currently limited**. DeMPA assessments are country-demand driven and there in no pre-determined list of countries where these assessment are undertaken. Initial assessments covered diverse set of countries including HIPCs, LICs, and MICs. Only three DeMPA reports are publicly available.

HIPC CBP

56. **The main objective of the HIPC Debt Strategy and Capacity Building Program (CBP)[33] is to enable HIPC governments to develop a full independent capacity to design and execute their own national debt strategies.** Another purpose is to help agencies that provide technical assistance to these governments to evaluate how successful they were.

57. **The main principle of the HIPC CBP self-assessment methodology is to allow each country to compare its existing technical and institutional capacity to international best practices, thereby allowing each country to give itself a score in each area.** Countries analyze their performance in four aspects of debt management capacity: debt

[33] The CBP has been implemented by 5 partner institutions: BCEAO/BEAC, CEMLA, DRI, MEFMI and WAIFEM.

strategy and sustainability analysis, high-quality legal and institutional framework for debt management, personnel and capacity building plans. Countries also assess their technical and institutional capacity in external and domestic debt recording, negotiation and servicing, forecasting macroeconomic scenarios and costing national poverty reduction strategies; and quality of capacity building plans. Countries score themselves from 1 (worst) to 5 (best).[34] Self-assessments are mainly done by debt units. Quality control on these self-assessments is done by agencies that provide assistance.

Fiscal ROSCs

58. **Fiscal ROSCs provide an assessment of fiscal transparency practices.** ROSCs do not assess PFM implementation practices and effectiveness as they are largely focused on transparency issues. Qualitative assessments are in relation to the IMF Code of Good Practices on Fiscal Transparency, based on the authorities' response to the IMF fiscal transparency questionnaire and other documents provided by the authorities. Both the undertaking of a fiscal ROSC and its subsequent publication are voluntary. As of March 2009, 88 countries from all regions and levels of economic development had posted their fiscal transparency ROSCs on the IMF's web page. Updates to published ROSCs can be undertaken at any time at the request of the authorities. Countries can also opt for a full ROSC reassessment after 5 years. As of September 2008, more than 25 countries had undertaken updates or complete reassessments.

[34] Summaries of 14 self-assessment reports are posted on the web http://www.hipc-cbp.org/.

Annex 4. Preliminary and Indicative Classification of Countries

59. **Depending on the availability of CPIA and PEFA indicators, figures A3 and A4 highlight how countries would be assessed in step 1:**

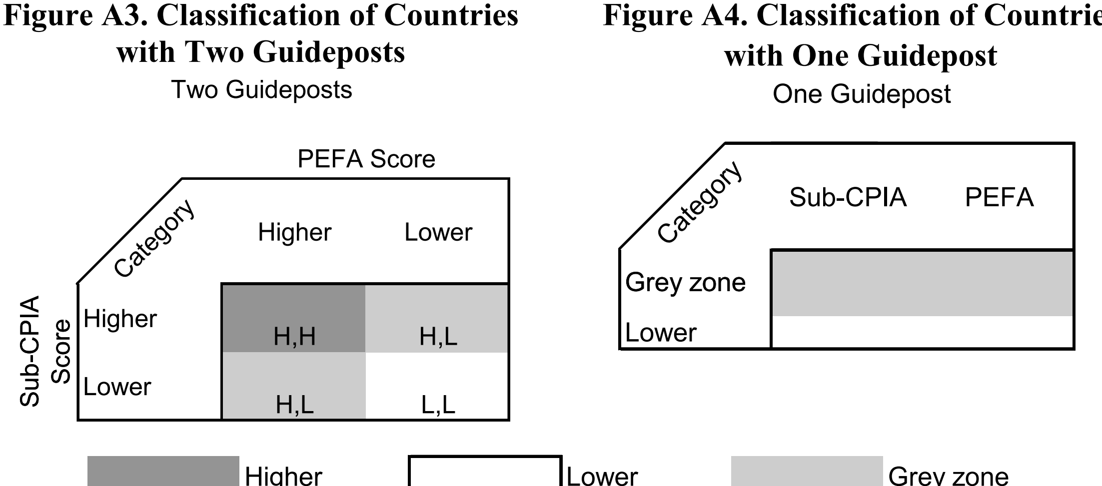


Figure A3. Classification of Countries with Two Guideposts

Figure A4. Classification of Countries with One Guidepost

60. **Based on current data, this framework would lead to the following preliminary assessment of capacity** (detailed in Tables A4 and A5 below):

- Eight countries would be in the higher category.
- Twenty countries would be in the grey zone.
- Forty-eight countries would be in the lower category.

Table A4. Classification of Countries with Two Guideposts

Indicators and quality of policies		PEFA Score	
		Higher	Lower
Sub-CPIA Score	Higher	**8 countries:** Armenia, Azerbaijan, Bolivia, Burkina Faso, Cape Verde, Dominica, Georgia, Tanzania.	**7 countries:** Ghana, Mali, Nicaragua, Rwanda, Samoa, St. Lucia, Uganda.
	Lower	**6 countries:** Ethiopia, Grenada, Honduras, Mozambique, St. Vincent, Zambia	**34 countries:** Cameroon, Guyana, Kenya, Madagascar, Malawi, Nepal, Papua NG, Sierra Leone, Vanuatu, Yemen, Bangladesh, Benin, Kyrgyz Rep., Lesotho, Niger, Senegal, Afghanistan, Timor-Leste, Burundi, C.A.R., Comoros, Congo, Rep., Cote d'Ivoire, DRC, Guinea, Guinea-B., Haiti, Lao PDR, Mauritania, Solomon Is., STP, Tajikistan, Tonga, Togo.

Higher Lower Grey zone

Table A5. Classification of Countries with Only One Guidepost

	Sub-CPIA Score	PEFA Score
Grey zone [1/]	India, Bhutan, Moldova, Vietnam.	
	Nigeria, Pakistan.	Albania
Lower	Angola, Cambodia, Chad, Djibouti, Eritrea, The Gambia, Kiribati, Maldives, Mongolia, Sri Lanka, Sudan, Uzbekistan, Zimbabwe	Liberia

1/ Defined as the average of the blend countries minus one standard deviation applied to the ratings of the blend countries.

Grey Zone Lower