



## REVIEW OF THE POLICY ON DEBT LIMITS IN FUND-SUPPORTED PROGRAMS

March 1, 2013

### **EXECUTIVE SUMMARY**

This review examines the experience with the policy on debt limits in Fund-supported programs across the membership and proposes possible reforms to strengthen the policy. The policy was last reformed in 2009 with a view to adapting it to the changing circumstances in low-income countries (LICs). Given its primary focus on LICs, the reform left the policy applying to the rest of the membership broadly unchanged. This paper represents the first stage of the review and, if Directors agree with the proposed approach, will be followed by a second paper with specific proposals.

The Fund's debt limits policy has been in place since the 1960s. From the policy's inception, concessional flows have been excluded from debt limits under the presumption that such financing was critical for LICs and posed only limited risks to debt sustainability. Over time, the exclusion of concessional flows has led to a bifurcation in the policy, with one branch focusing on members to whom concessional financing is normally available, and the other on those to whom it is not—a distinction which in practical terms has involved differentiating between LICs and non-LICs.

Reflecting this bifurcation, debt limits have played a very different role in GRA and PRGT-supported programs. In GRA programs, debt accumulation is typically controlled through a performance criterion on the fiscal balance, with debt limits (if any) used to broaden the coverage of the fiscal target. Despite the policy's provision that capacity should play a role in the design of debt limits, there is only a weak relationship between capacity and the existence of a debt limit in GRA programs. By contrast, debt limits are quasi-universal in PGRT-supported programs and systematically take capacity into consideration. They mainly aim to control the composition (i.e. the concessional/non-concessional breakdown) of external public debt, with overall debt generally left unconstrained.

While the 2009 reform has broadly met its goals of providing LICs with enhanced flexibility to tap non-concessional resources within a well-specified framework, it has proven complex to implement and in some cases distorted investment and financing decisions. Moreover, available evidence does not provide strong support for excluding concessional borrowing from debt limits—a key aspect of the policy that was left

untouched by the 2009 reform. Indeed, debt accumulation in LICs in the run-up to the Heavily Indebted Poor Countries (HIPC) Initiative was largely driven by an accumulation of concessional debt. In countries that reached the completion point under the HIPC Initiative several years ago, concessional borrowing has been the main driver of recent debt accumulation.

Based on these findings, staff proposes abolishing the binary distinction between concessional and non-concessional borrowing and establishing a unified debt limits framework for all countries. Under the reforms outlined in this paper, debt limits, when needed, would be set in nominal terms based on the volume of contracted or guaranteed debt, rather than on the terms of financing. Where appropriate, the nominal debt limit would be complimented by an indicative target on the average concessionality of new financing to preserve incentives for borrowers and lenders to transact on concessional terms—a key benefit of the current framework. Finally, the capacity dimension would be delinked from the debt limits policy and addressed directly in the structural component of the country’s program.

In addition, staff proposes establishing a single discount rate across all Fund tools and policies in order to ensure, inter alia, closer integration of the DSF and the debt limits policy, a key objective of the proposed reform. To address unwarranted fluctuations of the discount rate, staff would favor resetting the rate to a long-run average, which would bring it back to a level close to its value when the LIC DSF was originally designed, and fix it there until the next review of the LIC DSF.

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## INTRODUCTION

**1. This review examines the experience with the policy on debt limits in Fund-supported programs and proposes possible reforms to strengthen the policy.** The debt limits policy was last reformed in 2009. The primary focus of the reform was to adapt the policy to the changing circumstances of members, particularly in low-income countries (LICs).<sup>1</sup> At the time of the reform, it was expected that the experience with the new policy would be reviewed after a period of two years. As the debt limits policy applies to all Fund members, this review takes a comprehensive look at the way debt limits have been implemented in Fund-supported programs across the membership. This paper represents the first stage of the review and puts forward possible reforms for the consideration of Executive Directors. If Directors agree with the proposed approach, this paper will be followed by a second paper with specific proposals based on Directors' feedback and the outcome of consultations with relevant stakeholders.

**2. The Fund's debt limits policy has been in place since the late 1960s.** The original rationale for the inclusion of performance criteria on external borrowing was to ensure that adjustment objectives, particularly the restraint of domestic demand, were not threatened by unforeseen foreign borrowing.<sup>2</sup> In this context, ceilings on external borrowing were viewed as a logical supplement to ceilings on domestic credit. In addition, in situations where the size of external debt was a cause for concern, adherence to borrowing limits was deemed vital to avoid a further intensification of debt-servicing difficulties and to restore creditor confidence. Over time, the inclusion of debt limits in Fund-supported programs has sought to achieve four main objectives: i) to support adjustment goals; ii) to ensure fiscal and external sustainability; iii) to mitigate (domestic or external) liquidity risks; and iv) to facilitate the resolution of debt problems after they arise.

**3. Because the original rationale for debt limits reflected mostly short-term adjustment concerns, concessional flows—originally identified by their longer maturities—have been excluded from debt limits since the inception of the policy.** Given the limited financing options available to LICs at the time, concessional financing was seen as a critical means of transferring resources and of easing financing constraints.<sup>3</sup> Further, concessional borrowing was seen as posing only limited risks to debt sustainability, particularly given its favorable terms and long maturities. Over time, this exclusion has led to a bifurcation in the policy, with one branch focusing on members to whom concessional financing is normally available, and the other on those to whom it is not—a distinction which in practical terms has involved differentiating between LICs and non-LICs.

<sup>1</sup> For the purposes of this paper, the debt limits policy is used as a shorthand for the policy on debt limits in Fund-supported program.

<sup>2</sup> For the purposes of this paper, the terms "debt," "borrowing," and "loan" are used interchangeably and refer to the concept of debt set out in Executive Board Decision No. [6230-\(79/140\)](#), Point 9, as revised on August 31, 2009 (Decision No. [14416-\(09/91\)](#)). This review does not propose changing the definition of debt.

<sup>3</sup> For the purposes of this paper, low-income countries are those members that are eligible for assistance under the Fund's Poverty Reduction and Growth Trust (PRGT).

**4. The most recent reform of the policy, entered into effect in December 2009, was driven by an acknowledgement of LICs' changing circumstances.** In a context of significantly improved macroeconomic management and performance in many LICs, and a widening array of financing options for these countries, the reform sought to ensure that Fund-supported programs continued to help countries strike the appropriate balance between debt sustainability and borrowing space for productive investments that will support growth. The reform thus moved away from a single design for concessionality requirements toward a menu of options that took into account the diversity of members' circumstances. The new framework sought to provide enhanced flexibility in a systematic and consistent way. In particular, it laid out specific guidance relating the type of debt limits to be included in LIC programs to a country's debt vulnerabilities, as assessed under the joint IMF-World Bank Debt Sustainability Framework (DSF), and to its macroeconomic and public financial management capacity. The resulting classification of countries based on these two dimensions is summarized in a "concessionality matrix" which is updated yearly (Table 1).

**5. Given its primary focus on LICs, the reform left the policy applying to the rest of the membership broadly unchanged.** A notable exception was the expectation that an assessment of macroeconomic and public financial management capacity ("capacity") should be taken into account when designing the performance criterion on external debt for *all* countries (emphasis added). However, the current policy provides only limited guidance on how capacity should be taken into account for non-LICs.

**6. The paper is organized as follows:** it first provides a brief overview of recent debt trends, before reviewing the experience in the implementation of the policy. The paper then puts forward suggested reforms that could address the issues identified during the review. Conclusions, issues for discussion, and next steps are set out in the last sections.

**Table 1. Concessional Requirements: Eligibility of Program LICs for the Various Options (as of December 31, 2012) 1/**

		Extent of debt vulnerabilities	
		Lower	Higher
Capacity	Higher	<p>Minimum average concessional requirement applied to external or total public borrowing; for most advanced LICs, no concessional requirements and overall nominal debt limit if needed</p> <p>Armenia                      Mozambique Georgia                      Rwanda Kenya Moldova</p>	<p>Overall limit on the PV of external or total public debt; for most advanced LICs, ceilings on nominal external or total public debt</p>
	Lower	<p>Minimum concessional requirement applying debt by debt, with flexibility on nonconcessional external debt (e.g., untied nonzero limits, if consistent with maintenance of low debt vulnerabilities)</p> <p>Bangladesh                      Malawi Benin                                      Mali Burkina Faso                      Mauritania Central African Rep.                      Niger Cote d'Ivoire                      Senegal Guinea                                      Sierra Leone Guinea-Bissau                      Solomon Islands Kyrgyz Rep.                      Tanzania Lesotho                                      Uganda Liberia</p>	<p>Minimum concessional requirement applying debt by debt, likely higher than 35 percent, with limited or no room for nonconcessional borrowing</p> <p>Afghanistan Burundi Comoros Gambia, The Grenada Haiti São Tomé &amp; Príncipe</p>

1/ While capacity is assessed once a year, the distribution of countries may change depending on the latest DSA results. The authorities could choose to opt for tighter debt limits than implied by the concessional matrix.

## OVERVIEW OF RECENT DEBT TRENDS

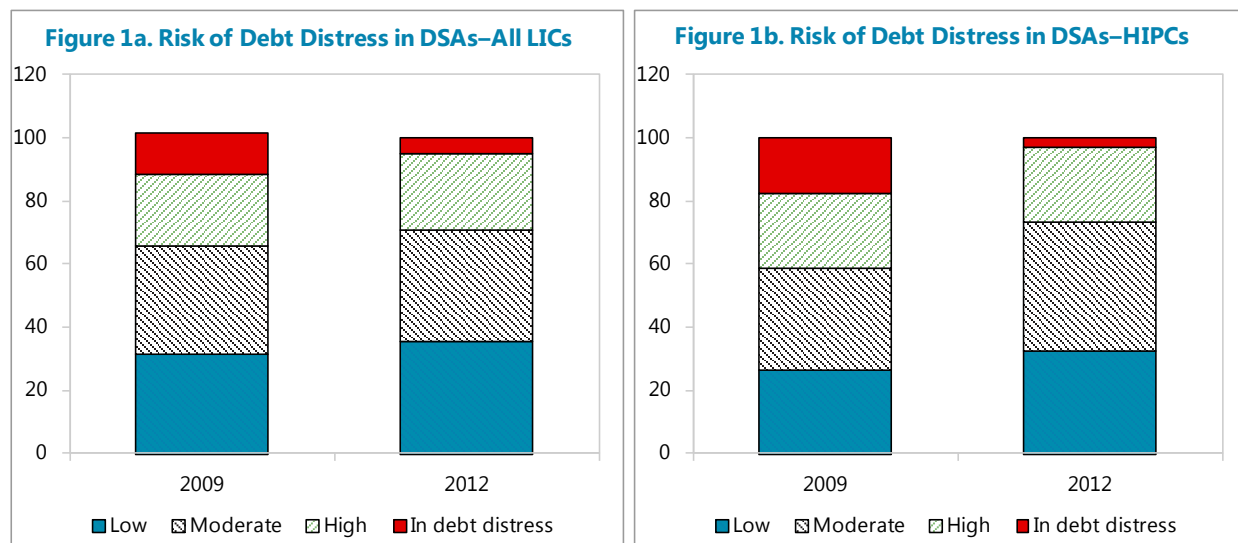
### *Evolution of external debt in LICs*

#### **7. The external debt outlook in LICs has remained broadly stable since the 2009 reform.**

The evolution of the external risk of debt distress in LICs, as assessed in individual countries' debt sustainability analysis (DSAs), indicates that this risk has improved or remained stable in 90 percent of LICs since 2009.<sup>4</sup> Developments were more favorable in Heavily Indebted Poor Countries (HIPCs), with about 30 percent experiencing an improvement in their risk rating, mostly driven by debt relief, while the rating remained unchanged in another 65 percent of HIPCs (Figures 1a and 1b). Among the five LICs whose ratings have worsened during the period, three countries' ratings deteriorated from "moderate" to "high" (Chad, Maldives, and St. Lucia), and two from "low" to "moderate" (Mali and Samoa). Large concessional borrowing was the key driver of the downgrade in one case (Chad);

<sup>4</sup> Throughout this section, "external debt" is used as a shorthand to refer to public and publicly guaranteed (PPG) external debt.

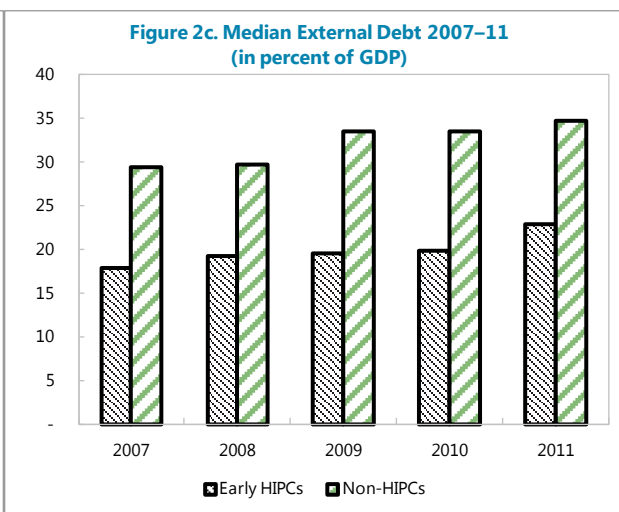
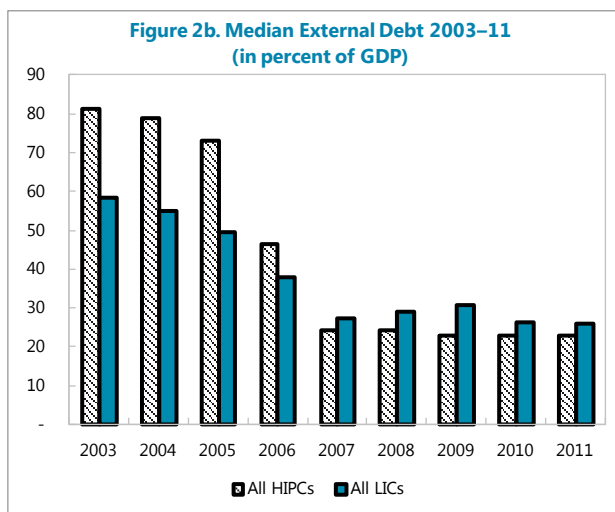
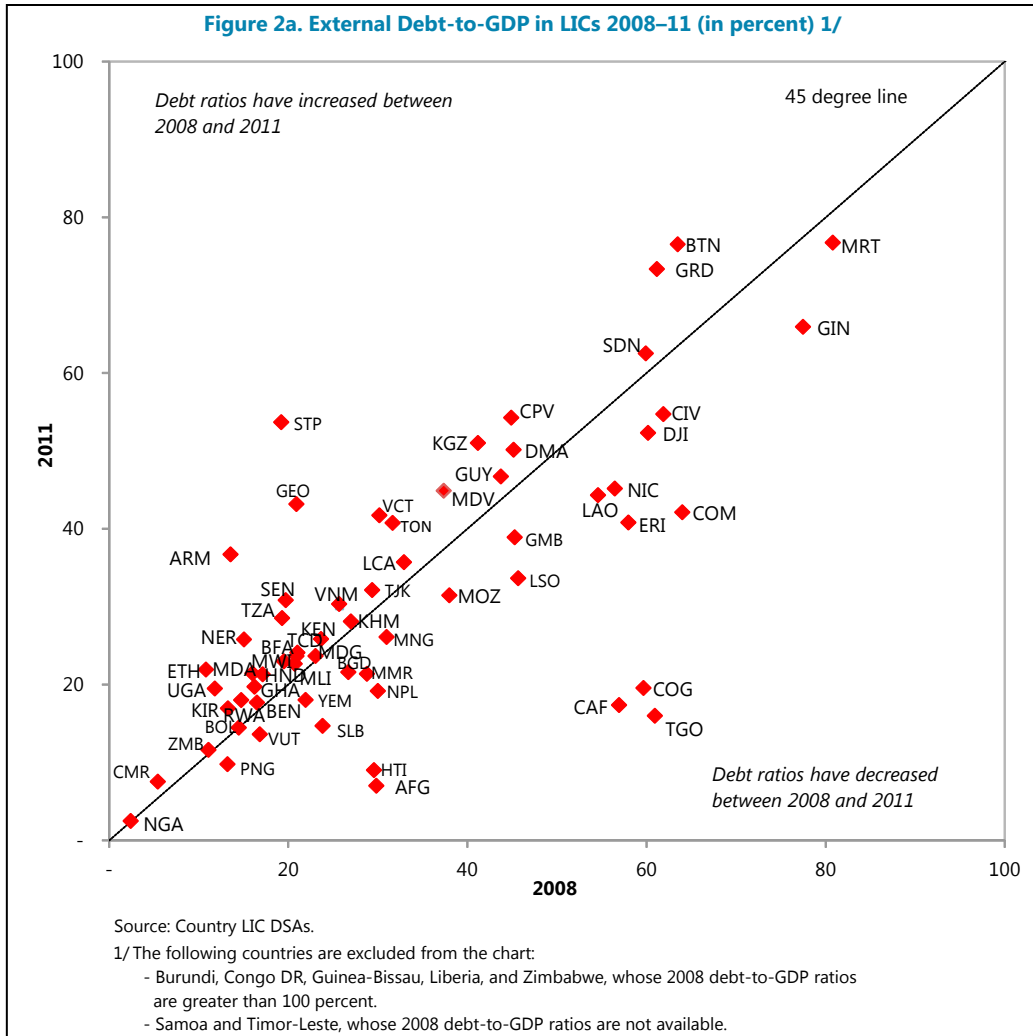
in the four others, the downgrade was caused by either a downward revision to export and growth assumptions (Samoa and Mali) or weaker macroeconomic policies (Maldives and St. Lucia).



Source: Country LIC DSAs.

**8. External debt-to-GDP ratios have remained broadly stable since 2008, but have picked up in some countries (Figure 2a).** Debt ratios remain much lower today than they were a decade ago, thanks mainly to debt relief from the HIPC and Multilateral Debt Relief initiatives (Figure 2b). However, external debt ratios have been climbing in some LICs in recent years. This phenomenon is more pronounced in non-HIPCs and HIPCs which reached the completion point before 2007 (“early HIPCs”), with the median debt-to-GDP ratio having risen by about 5 percentage points in both groups (Figure 2c).





Source: Country LIC DSAs.

**9. Countries with a Fund-supported program (excluding recent HIPCs) have generally tended to accumulate debt faster than their non-program counterparts (Text Table 1).** The average external debt-to-GDP ratio across all program LICs has fallen by 23 percentage points since 2007, dominated by countries that recently reached the HIPC completion point and have benefited from large debt write-offs. Excluding these countries, the average external debt ratio has increased by 2.3 percentage points in program LICs, while decreasing by 1 percentage point in non-program countries. Given broadly comparable growth performance, the increase in debt ratios in program LICs has mainly reflected higher debt accumulation in the wake of debt relief. This increase has generally been accommodated in Fund-supported programs, given the ample borrowing space in recent HIPCs and the objective to help countries address critical infrastructure needs.

Text Table 1. Change in External Debt (2007–11; in percent of GDP)

	# of countries	Average nominal PPG external debt-to-GDP			Average annual nominal GDP growth 2007-11
		2007	2011	Change	
Program LICs	46	53.7	30.9	-22.7	12.1
Program LICs excluding HIPCs reaching CP after 2007	34	30.3	32.6	2.3	12.1
Of which: program HIPCs	19	25.8	29.5	3.7	11.7
program non-HIPCs	15	36.1	36.6	0.6	12.6
Non-program LICs	23	35.2	34.2	-1.0	12.6

Source: Country LIC DSAs.

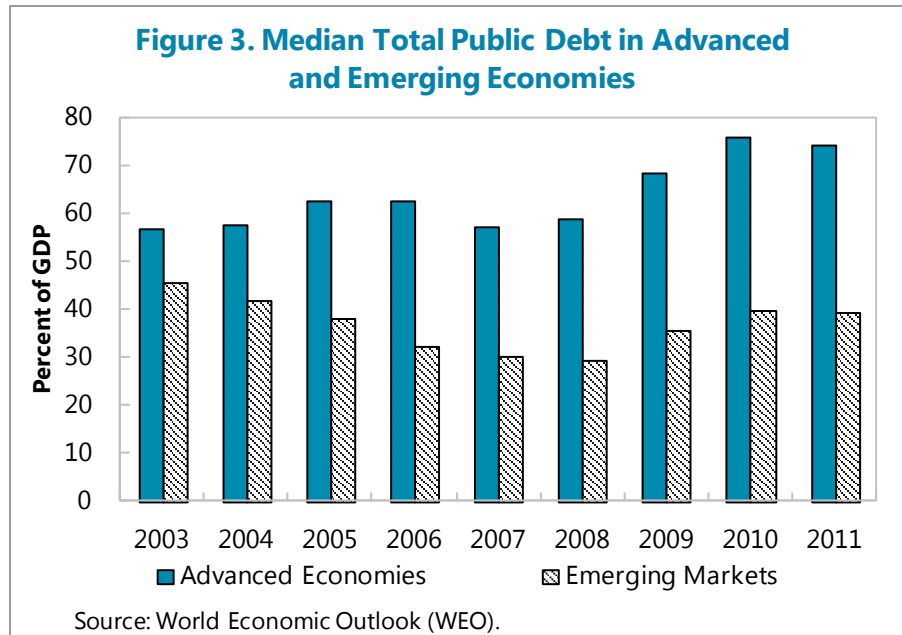
**10. A closer analysis of the five early HIPCs where debt accumulation has been the fastest shows that concessional debt was the main driver of the recent increase in debt ratios (Annex II).** This is perhaps an unsurprising result, given existing limits on access to non-concessional borrowing. The latter has been increasing in all five countries as well, although the pace of disbursements of non-concessional loans has been slow. Taken together, these trends do not support the hypothesis of a substitution of non-concessional borrowing for concessional borrowing in these countries, and suggest that debt ratios are likely to increase further in the coming years as the pace of disbursements picks up.

### ***Evolution of public debt in emerging and advanced economies***

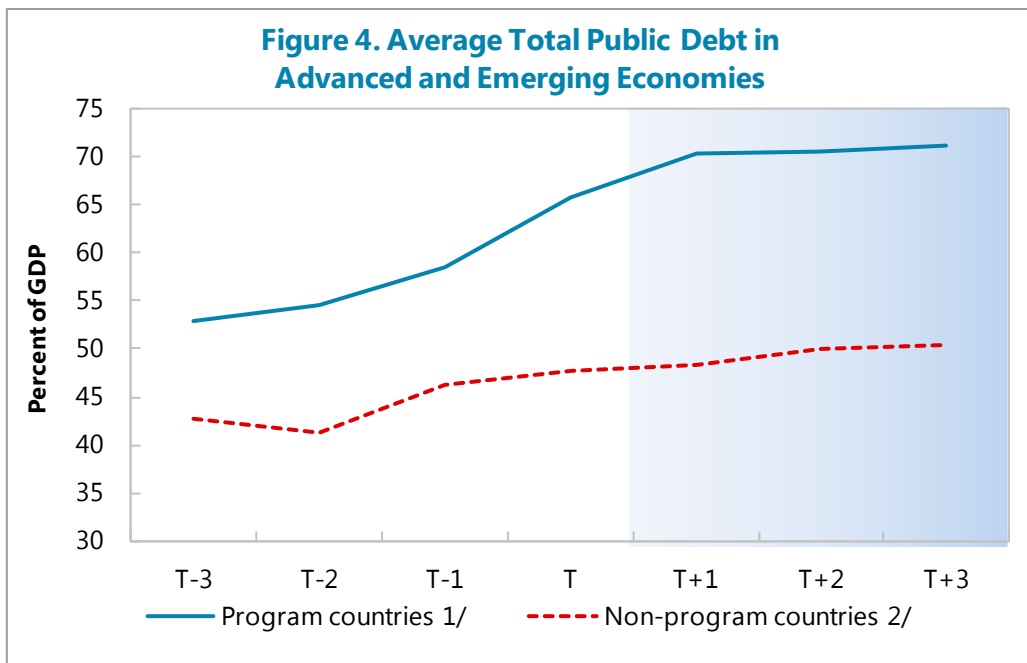
**11. Public debt ratios in emerging and advanced economies have been rising in the wake of the global financial crisis (Figure 3).**<sup>5</sup> This pattern has been much more pronounced in advanced economies, where the median debt ratio (scaled by nominal GDP) reached close to 75 percent in 2011. Lower growth, more persistent budget deficits, and fiscal pressure stemming from population aging and weak financial sectors were the main drivers of the sharp rise of public

<sup>5</sup> Due to the lack of readily available data on public external debt in advanced economies, this discussion focuses on total public debt.

debt in advanced economies. In emerging markets, the median debt ratio has increased by 7 percentage points from its trough in the middle of the last decade.



**12. Fiscal and debt limits in programs with emerging and advanced economies have helped keep debt accumulation in check.** Program countries often had a higher initial debt level than their non-program counterparts: for example, the average public debt ratio at program approval was 66 percent of GDP, 18 percentage points higher than in non-program countries at end-2010. In the three years prior to program approval, the debt-to-GDP ratios in program countries increased twice as fast as in non-program countries, averaging 4.5 percentage points per annum. Following the start of the program, however, the speed of debt build-up decreased to around 1 percentage point per year, in line with developments in non-program countries in 2010–12 (Figure 4).



Source: WEO.

1/ Program non-LICs include countries with an IMF program existing or approved since 2009.

For program countries, T is the year of program approval.

2/ Non-program countries include all other non-LICs, except for six countries that were PRGT-eligible until April 2010 (Albania, Angola, Azerbaijan, India, Pakistan, and Sri-Lanka). For non-program countries, T refers to 2010.

## REVIEW OF IMPLEMENTATION OF THE POLICY

### A. Implementation with respect to LICs

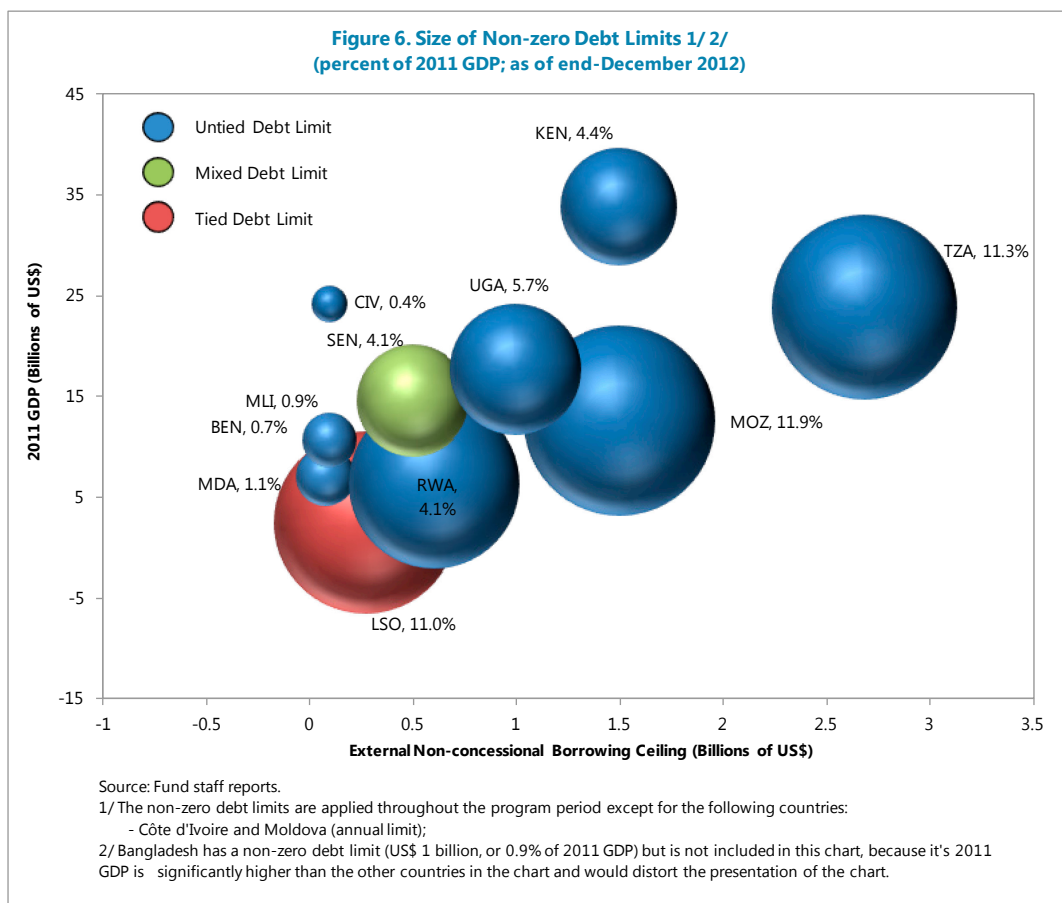
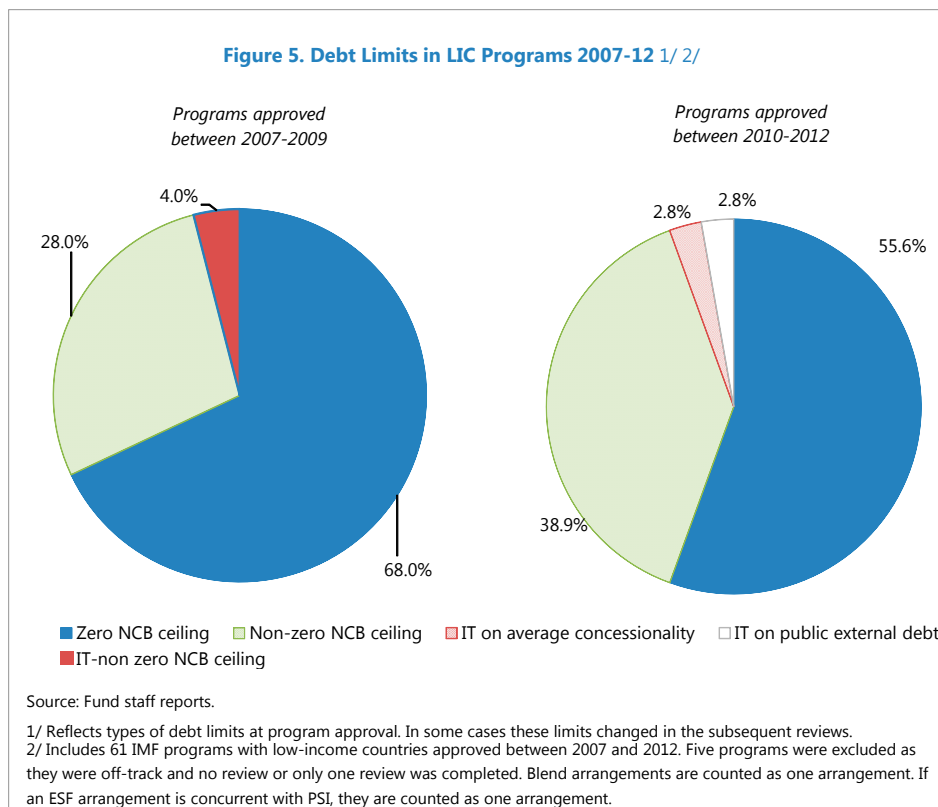
#### *Debt limits in PRGT-supported programs*

**13. While debt limits—in the form of restrictions on non-concessional borrowing—are quasi-universal, concessional borrowing is unconstrained in 80 percent of LIC programs.** All Fund-supported programs in LICs approved during 2007–12 included a limit on external public debt; in all but one case, the limit included a concessionality requirement.<sup>6</sup> No program included a limit on total public debt. Concessionality requirements typically consist of setting a floor on the grant element of a loan, defined as the difference between its face and present values expressed in percent of its face value, with the floor usually set at 35 percent. Given that concessional borrowing was systematically excluded from debt limits, the constraint on concessional borrowing, where present, was imposed via a fiscal performance criterion (PC).<sup>7</sup> These core features of the design of debt limits in Fund-supported programs were not affected by the 2009 reform. An analysis of the interaction between the debt and the fiscal PCs shows that concessional borrowing was capped in only 20 percent of LIC programs, implying that there was effectively no upper bound on the fiscal deficit (and hence external public debt) in about 80 percent of programs. By contrast, domestic borrowing was constrained in almost all programs. In about half of the programs, debt limits had broader coverage than fiscal performance criteria (Annex III).

**14. The policy has broadly met its goal of providing countries with enhanced flexibility to tap non-concessional resources within a well-specified framework.** As envisaged under the policy, both debt vulnerabilities and assessed macroeconomic and public financial capacity have played a key role in the design of the external debt limit. During 2007–09, about 30 percent of programs provided pre-defined room for non-concessional borrowing. Since the 2009 reform, this share has risen by 11 percentage points (Figure 5). As of end-December 2012, 13 out of the 32 program countries were allowed some room for non-concessional borrowing; another 12 countries were eligible for non-concessional borrowing under the new framework but nevertheless faced a zero ceiling in the program. In the majority of cases, these limits were not tied to specific projects (Figure 6).

<sup>6</sup> In four cases—Armenia (2009 and 2010) and Georgia (2008 and 2012)—the debt limit took the form of an indicative target. In the case of Georgia (2012), the indicative target is on public external debt and does not include a concessionality requirement.

<sup>7</sup> The term “fiscal performance criterion (PC)” refers to the PCs that aim to cap all or part of the financing of government other than through a central bank.



**15. While compliance with debt-related conditionality has generally been good, there has been a relatively high and increasing incidence of requests to modify external debt PCs.** (Text Table 2). Out of the 31 modifications of the debt limits requested since 2008, about 90 percent took place between 2010 and 2012. Five programs (Ghana, Kyrgyz Republic, Mozambique, Tanzania, and Uganda) account for three quarters of the requests. The vast majority of requests aimed to increase the non-concessional debt limit to allow additional borrowing. All requests for higher debt limits were granted either in recognition of available borrowing space or to accommodate critical investment.

Text Table 2. Compliance with Debt Limits Performance Criteria in LIC Programs, 2008–12

Year	Met	Waived	Modifications	Total
2008	28	2	1	31
2009	44	4	3	51
2010	59	4	9	72
2011	47	3	7	57
2012	15	4	11	30
<b>Total</b>	<b>193</b>	<b>17</b>	<b>31</b>	<b>241</b>

Sources: Monitoring of Fund Arrangements (MONA) database; and Fund staff calculations.

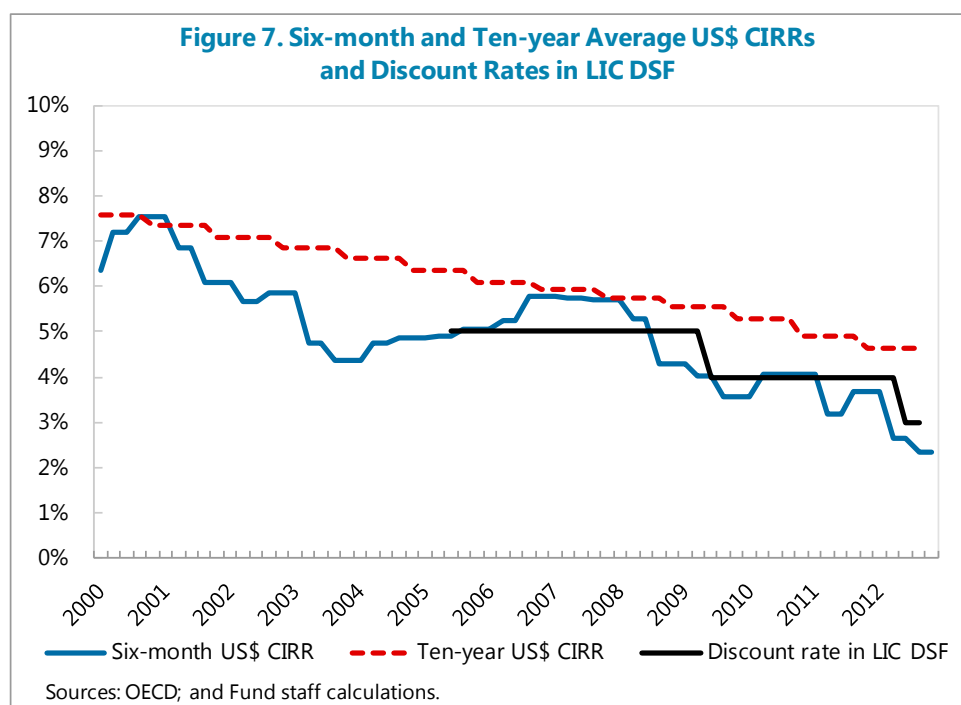
### ***Issues raised in the implementation of the debt limits policy***

**16. Experience with the debt limits policy in LICs has brought significant design and implementation issues to the fore, tempering the advantages of the policy's increased flexibility.** Some of these issues stem from the 2009 reform, while others pre-date it:

- The steady decline in the discount rate used to assess concessionality has progressively reduced the assessed concessionality of any given loan (Figure 7). This trend has taken place against the backdrop of the broadly stable financing terms available to LICs. According to the World Bank's Global Development Finance database, since 1999, the average loan extended by official creditors has had a maturity of 26 years, with a 7-year grace period and an interest rate of 1.4 percent, with little variance.<sup>8</sup> Nevertheless, as a result of the decline in the discount rate, the grant element of the average loan offered by official creditors, as assessed using the Fund's current methodology, has decreased by roughly 20 percentage points since 1999. By contrast, using a fixed discount rate of 10 percent would lead to a decline in the grant element of only 6 percentage points.<sup>9</sup>

<sup>8</sup> Standard deviations were 2.8, 0.8, and 0.1, respectively.

<sup>9</sup> The OECD-DAC methodology uses a flat 10 percent discount rate.



- The current discount rate methodology has also created a discontinuity in the assessed concessionality of shorter and longer term loans (Box 1). The concessionality of shorter-term loans (less than 15 years) is assessed using six-month average Commercial Interest Reference Rates (CIRRs), whereas the concessionality of longer-term loans is assessed using ten-year average CIRRs that are currently much higher.<sup>10</sup> For example, a 15-year maturity loan, with a 5-year grace period, carrying an interest rate of 1.5 percent, has a 28.4 percent grant element according to the grant element calculator. Reducing its maturity by one year (to 14 years) would result, ceteris paribus, in a 15-percentage point drop in the grant element to 12.7 percent.
- Shifts in the discount rate, combined with the longstanding dichotomy established in the debt limits policy between concessional and non-concessional loans, has led to arbitrary outcomes and to numerous requests for modifications and waivers of non-observance of debt limit PCs, as discussed above. These typically arose in cases where loans which were originally assessed to be concessional under the policy turned out to be non-concessional, often by a very small margin, by the end of the negotiating process because of an intervening decline in the discount rate. As a result, these loans, which would have been automatically accommodated in the program had they been assessed as concessional, became subject to additional scrutiny, in spite of the fact that their economic characteristics (financing terms, expected return on the debt-financed

<sup>10</sup> CIRRs are the minimum interest rates imposed on export financing by official bilateral lenders compliant with the OECD's Arrangement for Officially Supported Export Credits. CIRRs have been established for 13 currencies, the majority of which are based on either five-year government bond yields or on three-, five-, and seven-year bond yields, according to the length of the repayment period. CIRRs are adjusted monthly and are intended to reflect risk-free rates prevailing in creditors' markets.



investment) had not changed. Text Table 3 presents examples of recent cases where a change in the discount rate affected project implementation.

Text Table 3. Recent Cases Where Change in the Discount Rate affected project implementation

	<b>Projects affected by change in discount rate</b>	<b>Outcome</b>
Guinea	Islamic Development Bank loan (2012)	Guinean authorities failed to avail themselves of the loan because discount rate changed before signature. The project was ultimately abandoned
Mozambique	Two loans to build a road to the capital city (2012) and improve electricity supply to the capital city (2012)	The authorities used the space under the program's non-concessional borrowing (NCB) ceiling and requested a modification of the ceiling in the following review of the program to accommodate other projects
Senegal	Islamic Development Bank loan for a floating power station (2011)	Grant element was just below the threshold and the authorities held off on project in the hope that the discount rate would go up. In the end, the discount rate went down instead and the authorities had to abandon the project
Sierra Leone	Loan to finance a street lighting project (2011); another to finance e-government security project (2012)	NCB ceiling was breached and the authorities requested and obtained waivers in consecutive reviews
Tanzania	Loan from China Exim-Bank to build a gas pipeline (2012), as well as other loans	NCB ceiling was breached and the authorities requested and obtained waivers in two consecutive reviews
Togo	Loan for a road project (2012)	Loan turned nonconcessional after discount rate went down during negotiations. The project was abandoned

Source: Fund staff reports.

### Box 1. Discount Rates Used for Fund Purposes

Discount rates are used by the Fund for two main purposes: (i) to assess the concessionality of a loan for purposes of the debt limits policy (the “grant element” calculator); and (ii) to calculate the present value of debt in the context of the LIC DSF.<sup>11</sup> Although all discount rates used for these purposes are based on the CIRRs, different methodologies are used to derive them (see table below):

- Discount rates for the grant element calculator use currency-specific CIRRs and are updated regularly (semi-annually or annually), while the LIC DSF uses a single rate based on the U.S. dollar CIRR, which is adjusted only when the six-month average of the U.S. dollar CIRR deviates from the prevailing discount rate by at least 100 basis points for six consecutive months.
- The discount rate for the LIC DSF is calculated based on the six-month average of the long-term CIRRs, while the grant element calculator employs different period averages according to the maturity of the loan. For loans with a maturity of less than 15 years, the six-month average of long-term CIRRs is used. For loans with a maturity of 15 years or more, the ten-year average of long-term CIRRs is used.
- The discount rate for the LIC DSF is derived directly from the long-term CIRRs, with no margin added, while the grant element calculator uses the same base but adds margins to the discount rates to reflect the maturity of the loan. This results in higher discount rates in the grant element calculator.

Further, these methodological differences have resulted in the build-up over time of substantial differences in the various discount rates used for Fund purposes. As a result, the assessment of concessionality can differ significantly across Fund policies and tools (Table 1).

**Table 1. Discount Rates used in Different NPV Calculations**

Purpose	Discount rate	Period for average rates 1/	Margin (%)	Update frequency	Discount rate as of December 2012 (%)	
					US\$	SDR
IMF grant element calculator	Currency specific long-term CIRR from OECD web site plus a margin 2/					
	Loans < 15 year	6-month average CIRR Avg. of 2/15-8/14; update on 8/15 Avg. of 8/15-2/14; update on 2/15	0.75	Update twice on Feb. 15 and Aug. 15	3.09	3.22
	Loans ≥ 15 year for maturity = 15 < 20 years for maturity = 20 < 30 years for maturity ≥ 30 years	10-year average CIRR	1.00 1.15 1.25	Update every Dec. 15	5.32 5.47 5.57	5.09 5.24 5.34
IMF LIC DSA	A fixed discount rate corresponding to the US\$ CIRR, currently 3% (effective as of September 2012)	The discount rate was set initially at 5 percent (close to the U.S. dollar CIRR around March/April 2005, when the LIC DSF was first introduced) and adjusted by a full percentage point, whenever the U.S. dollar CIRR (six-month average) deviates from the prevailing discount rate by at least this amount (100 bp) for a consecutive period of six months.			3.0	

Sources: OECD; and Fund staff calculations.

1/ All the average rates refer to the average of the longest maturity CIRR. For example, the 6-month average US\$ CIRR is the average of CIRR > 8.5 years. See link below for the CIRR data from the OECD.

<http://www.oecd.org/trade/exportcredits/minimuminterestrates.htm>

2/ A margin reflecting the maturity of the loan is added to the average CIRR to derive the discount rate.

<sup>11</sup> The use of discount rates to access LICs' eligibility for the HIPC Initiative in the context of the HIPC debt relief analysis (DRA) is outside of the scope of this paper, and is not discussed here.

- The binary assessment of concessionality can also have a distorting effect on financing decisions. Concessionality requirements have created an incentive for countries to turn to alternative, more costly sources of financing. For example, in countries belonging to the West African Monetary Union (WAEMU), concessionality requirements have created a bias toward domestic and regional financing.<sup>12</sup> In particular, there is evidence that the requirements have increased recourse to CFA-denominated financing from regional development institutions, even though the financing terms they offer tend to be less favorable than those typically extended by external creditors.
- There is some anecdotal evidence that the focus on financing terms can bias the project selection process. When bids for potential projects combine the cost of the project itself with the terms of the linked financing, contractors have scope to cross-subsidize, offering concessional financing terms offset by a higher price on the project itself. To meet concessionality requirements, countries may be constrained to select the bid with the lowest financing costs, even where another option has lower overall costs.
- Tied limits have often been seen as overly restrictive by both authorities and Fund teams and have led in some cases to lengthy delays in investment decisions. Because individual project assessment lies outside the Fund's expertise, the policy requires that projects be assessed by a reputable third party. Meeting this requirement in a timely manner has proven challenging if not infeasible, and has at times been complicated by the confidentiality clauses included in some project agreements.
- The scrutiny given to investment financed by non-concessional resources may have unduly focused policy discussions and authorities' attention on a small part of the investment budget to the detriment of a broader discussion of the authorities' investment strategy.
- Only one of the six countries currently eligible to assess concessionality on an average rather than loan-by-loan basis made use of this option. This low take-up rate reflected implementation difficulties related to the insufficient provision of specific operational guidance, which were compounded by the complexity of the discount rate methodology.
- The debt limits policy's capacity assessment process, which relies on multiple indicators and an element of staff judgment, has proven complex to explain, especially to country authorities. And while the policy foresaw that the results of the capacity assessment process would inform the design of specific measures to enhance debt management capacity, this has not been the typical practice. Further, it has been argued that having two "layers" of capacity assessment—one for the debt limits policy and one for the DSF (where it determines the level of the debt-burden thresholds used to assess the risk of debt distress)—amounts to double-counting.

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<sup>12</sup> In the WAEMU region, external debt is based on a currency, rather than a residency, criterion.

**17. Many of these implementation issues were cited by country authorities in response to a survey carried out by staff in March 2012 (Box 2).** While a majority of countries surveyed felt that the policy helped preserve debt sustainability and was useful in securing better financing terms, many also pointed to lengthy delays related to the need to consult Fund staff on individual projects as well as to difficulties in assessing the concessionality of complex financing packages. About a quarter of respondents reported that the current policy had caused critical and highly profitable projects to be dropped. To overcome identified implementation issues, more than 90 percent of respondents favored moving away from the current loan-by-loan approach to concessionality requirements.

### Box 2. The Debt Limits Policy: Views from Country Authorities

Fund staff surveyed LIC authorities in March 2012 to gather views on their experience with the debt limits policy and seek their input on issues to be covered in the review. The survey was addressed to PRGT-eligible countries that requested a program with the Fund between December 2009 and end-2011. The response rate for the 34 countries surveyed was close to 80 percent. The results of the survey were discussed with the authorities in a Ministerial seminar during the 2012 Spring Meetings.

A majority of countries surveyed (over 80 percent of respondents) felt that the policy helped preserve debt sustainability and was useful in securing better financing terms (about 70 percent of respondents). Country authorities mentioned that the policy provided them with a simple and coherent framework for contracting external debt, helped them adhere to a disciplined borrowing strategy, and motivated their efforts to raise as much concessional funding as possible.

Respondents also raised several implementation issues, including:

- Lengthy delays related to the need to consult Fund staff or request Board approval for individual projects to be financed with non-concessional resources and for augmenting the non-concessional borrowing limit;
- Difficulties in meeting the project assessment requirement;
- Difficulties in assessing the concessionality of Islamic loans and financing packages;
- Difficulty in controlling the borrowing of state-owned enterprises and local governments.

Some of these implementation issues could help explain why about one fourth of the countries surveyed reported that the current policy had caused critical and highly profitable projects to be dropped. They may also explain why two thirds of the countries with access to non-concessional borrowing had not fully utilized the available space at the time of the survey. In addressing this point, authorities also pointed to delays in finalizing borrowing contracts. For some respondents, the incomplete use of the non-concessional borrowing space reflected a deliberate strategy of exploring all possible sources of concessional financing before turning to more expensive resources.

To address the implementation issues, a majority of countries (more than 90 percent) favored an assessment of the concessionality of overall public external debt instead of a loan-by-loan assessment. About 80 percent of respondents also considered that relaxing the 35 percent grant-element threshold for concessional borrowing would help secure additional external financing. By contrast, most of the countries surveyed saw only limited scope for tapping domestic financing sources to finance investment.

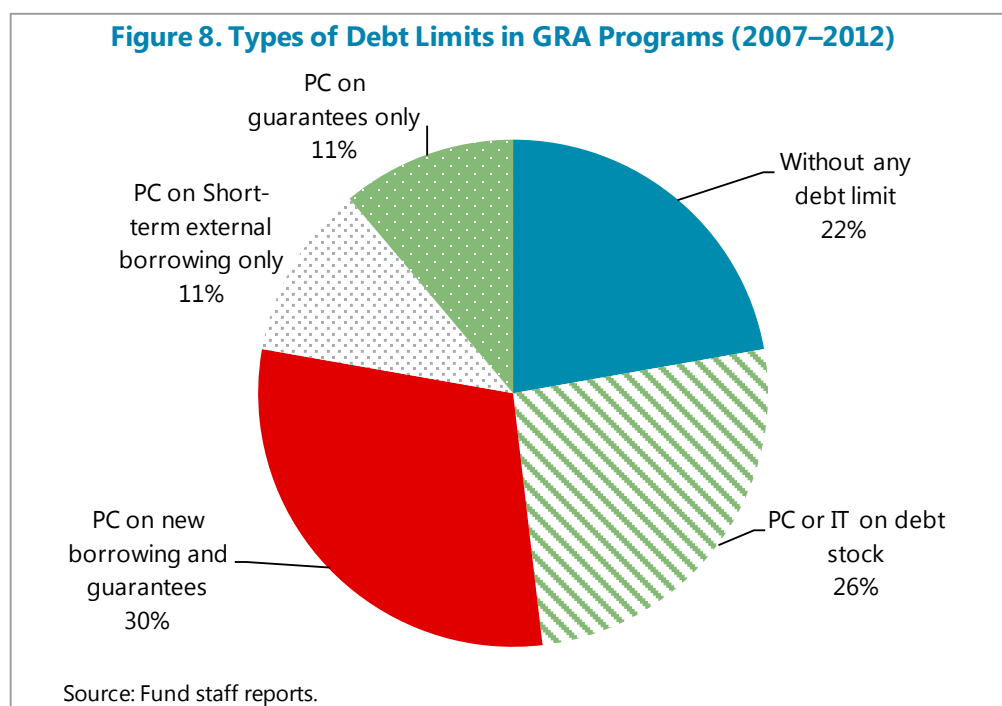
A majority of respondents agreed that debt vulnerabilities and macroeconomic and financial management capacities were relevant factors to take into account in designing debt limits. Almost half the respondents felt the need to further tailor the policy to country situations, including by further differentiating concessionality thresholds according to country characteristics and the profitability of projects.

Respondents also urged the Fund to strengthen its outreach to other international financial institutions and other creditors to promote a broader understanding of the policy, and to step up its capacity building efforts in the area of debt management.

## B. Implementation with respect to emerging and advanced economies

### *Debt limits in GRA programs*

**18. Debt limits are less ubiquitous in Fund-supported programs in the GRA (“GRA programs”) and, through their different scope and coverage, generally complement fiscal targets.** Almost all programs with emerging and advanced economies included a performance criterion on the fiscal balance, effectively capping both the fiscal deficit and government-contracted debt. When imposed simultaneously, debt limits and fiscal targets tended to complement each other due to their different coverage. While fiscal performance criteria typically focused on debt contracted by the central or general government, the coverage of debt limits was often broadened to include public enterprises or debt guaranteed by the government. In a majority of cases, the limit applied to total public debt rather than public external debt only. This is in line with the policy’s provision that the limit can be set on total public debt, in cases where total public debt, rather than total public external debt, is of concern (Figure 8, Annex IV).



**19. Inclusion of debt limits appears to be related to debt vulnerabilities, while capacity plays no discernable role.** In all programs where debt levels were high (roughly defined as 60 percent of GDP or higher) a debt limit was included, in a majority of cases directly on the stock of total public debt. Debt limits were also included in roughly two thirds of programs where debt levels were below 60 percent. Debt levels were well below 60 percent in the six programs where debt limits were not included, and below 30 percent in four of these cases. In five of the six cases where no debt limits were applied, the fiscal target applied to general government balances. In spite of the policy’s provision that the design of debt limits should reflect, inter alia, the country’s macroeconomic and public financial management capacity, the inclusion of debt limits in emerging

and advanced economies did not appear to be systematically correlated with available measures of the country's capacity. An attempt at an ex post mapping of capacity to the inclusion of debt limits in programs with non-LICs did not reveal a discernable pattern (Annex IV, Table 1). This result may partly reflect the fact that the policy only provides limited operational guidance on how capacity should be taken into account when designing debt limits for non-LICs.

**20. Compliance with debt-related conditionality in GRA programs has been good.** Debt-related conditionality was met in more than 95 percent of cases, and modifications rarely sought (Text Table 4).

Text Table 4. Compliance with Debt Limits Performance Criteria in GRA Programs, 2008–12

Year	Met	Not met	Waived	Modifications	Total
2008	8	0	1	0	9
2009	23	1	0	3	27
2010	37	0	0	0	37
2011	28	0	1	1	30
2012	11	0	0	0	11
<b>Total</b>	<b>107</b>	<b>1</b>	<b>2</b>	<b>4</b>	<b>114</b>

Sources: MONA database; and Fund staff calculations.

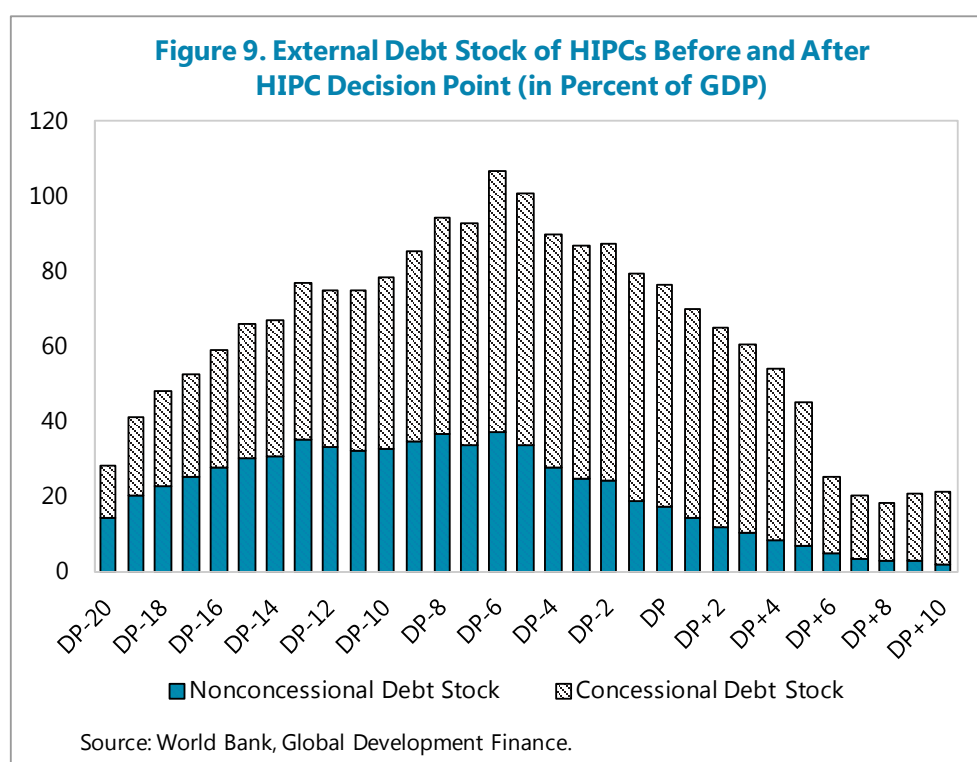
### C. Overall assessment of implementation

**21. Debt limits have played a very different role in PRGT-supported and GRA programs.** In PRGT-supported programs, their main objective has been to control the composition (i.e. the concessional/non-concessional breakdown) of external public debt, with overall public debt generally left unconstrained. By contrast, public debt accumulation in GRA programs is typically controlled through a performance criterion on the fiscal balance, with the inclusion of a debt limit serving to broaden the coverage of the fiscal target.

**22. A key consideration in assessing the overall implementation of the debt limits policy is whether it has helped keep debt vulnerabilities in check, a key objective of the policy.**

- In GRA programs, the role of debt limits is difficult to disentangle from the one played by fiscal performance criteria, given their complementary nature. In spite of the policy's provision that a country's capacity should be taken into account when deciding whether to include a debt limit, there is a weak relationship between available measures of capacity and the imposition of a debt limit. This may be partly due to insufficient guidance, which suggests that developing further guidance on the circumstances under which programs should include a debt limit would help strengthen the implementation of the policy.
- While the debt outlook in LICs has remained broadly stable, the recent pick-up in the pace of debt accumulation, particularly in the earliest HIPC, underscores the need to ensure that Fund-supported programs keep the overall level of debt in check. However, the exclusion of concessional borrowing from debt limits has left overall borrowing unconstrained in the majority

of LIC programs. Available evidence does not provide strong support for excluding concessional borrowing from debt limits. First, as discussed at the time of the 2009 reform, LICs now have a broader range of financing options, reducing the role of concessional resources as a critical means of transferring resources to them.<sup>13</sup> Further, debt developments in the run-up to the HIPC Initiative have highlighted the potential risks to debt sustainability posed by excessive concessional borrowing. Indeed, in the run-up to the Initiative, the accumulation of debt in LICs was largely driven by an accumulation of concessional debt (Figure 9).<sup>14</sup> Debt sustainability in HIPCs was only restored after a significant share of their debt stock (including concessional debt) was written off at completion point, consistent with the idea that the build-up of debt beyond a certain level, regardless of how much of it is concessional, can undermine sustainability. As discussed above, the more recent debt build-up in early HIPCs has again been mainly driven by an accumulation of concessional borrowing. While it is important to maintain incentives that shift financing for LICs toward concessional terms, it is less clear that the take-up of such financing should be completely unrestricted in Fund-supported programs.



<sup>13</sup> See [“Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt,”](#) February 26, 2009, for a discussion of the changing patterns of financing available to LICs.

<sup>14</sup> The accumulation of unsustainable debt burdens in LICs in the 1990s had several different causes, including disappointing growth performance, continued vulnerability to shocks, and weak institutional and macroeconomic frameworks.



**23. The debt limits policy has proven complex to implement in LICs and in some cases distorted investment and financing decisions.** As discussed above, the binary definition of concessionality under the current framework, combined with the continued decline in the discount rate, has reduced the assessed concessionality of loans, led to arbitrary outcomes, and distorted investment decisions. The project-level scrutiny associated with a loan-by-loan assessment of concessionality requirements, which typically lies outside of the Fund's expertise, has proven difficult to implement. Because of its complexity, the capacity assessment process has been difficult to explain to authorities, and was not systematically reflected in the structural component of the program.

**24. Based on the findings of this review, staff sees merit in reforming the debt limits policy.** The main objective of the reform would be to establish a unified debt limits framework that would make overall debt the primary focus in all countries, consistent with a key objective of the policy. Abolishing the binary distinction between concessional and non-concessional financing would also help limit investment distortions and reduce uneven outcomes.

**25. At the same time, the reform should seek to preserve incentives that shift financing for LICs toward concessional terms, a key benefit of the current framework.** As highlighted in the survey of LIC country authorities, concessionality requirements can help countries secure better financing terms (Box 2). While most of the large multilateral lenders have fixed lending terms, several smaller ones explicitly adjust their terms to ensure that they meet concessionality requirements, for example by blending commercially-priced loans with grants. In some cases, countries have also leaned on concessionality requirements in Fund programs to renegotiate the terms of loans. In light of the above, it would be important that any reform of the debt limits policy continue to send clear signals regarding the need for LICs to seek resources on concessional terms and for lenders to make funding available on that basis.

**26. Finally, the modified framework should incorporate a simpler and more stable discount rate structure.** Section IV puts forward a reform proposal designed to achieve these objectives.

## PROPOSED REFORM

### A. Design of debt limits

**27. The proposed reform is predicated on abolishing the binary distinction between concessional and non-concessional borrowing and establishing a unified debt limits framework for all countries. Such a framework could have the following key features:**

- When needed, debt limits would be set on the *volume* of contracted or guaranteed debt, rather than on the terms of financing. The specific coverage would be dependent on debt vulnerabilities identified in the DSA.<sup>15</sup>
- To facilitate monitoring, debt limits would be set in nominal terms for all countries;
- To preserve incentives for borrowers and lenders to transact on concessional terms, the nominal debt limit for countries using the LIC DSF could be complemented by an indicative target on the average concessionality of new financing.<sup>16</sup> This indicative target would serve as a signaling device to indicate what the Fund believes the appropriate financing mix should be and would figure prominently in the policy dialogue on countries' investment financing strategies. Breaching of the indicative concessionality target would lead (via the DSA) to a reassessment of the nominal debt target at the time of the program review, ensuring that the debt trajectory remains compatible with the debt path laid out in the DSA.

Individual projects would no longer be subject to scrutiny by Fund staff, providing country authorities with increased flexibility to manage their borrowing policy within the limits of a borrowing envelope consistent with debt sustainability. It would be more appropriate (and feasible) for Fund teams to focus on the broad institutional framework for public expenditure management and the macroeconomic impact of investment rather than attempting to evaluate individual projects. The new tool developed by Fund staff to assess the fiscal, growth, and debt sustainability implications of alternative investment scenarios can be helpful in that regard (Box 3).

<sup>15</sup> For example, the debt limits could be set on public external or total public debt (i.e., external and domestic), depending on country-specific debt vulnerabilities. In all cases, debt limits are expected to be set on a contracting, rather than a disbursement, basis.

<sup>16</sup> New financing would be measured on a contracting basis. Incentives to transact on concessional terms are needed as concessional and non-concessional loans are imperfect substitutes. This is because of the perception by country authorities of the significant administrative burden often attached to concessional loans.

### Box 3. Understanding the Fiscal, Growth, and Debt Sustainability Implications of Alternative Investment Scenarios

The latest review of the LIC DSF stressed the importance of ensuring that debt sustainability analyses adequately capture the benefits of debt-financed public investment ([“Revisiting the Debt Sustainability Framework for Low-Income Countries,”](#) January 12, 2012). To address these issues, Buffie et al. ([“Public Investment, Growth, and Debt Sustainability: Putting Together the Pieces,”](#) June 1, 2012) have developed a dynamic LIC-specific open-economy multi-sectoral model. This tool models productive sectors that use public capital as an input, different financing strategies (external concessional, external commercial, and domestic) and various fiscal rules that react to debt paths. It complements the debt limits policy by helping country teams and the authorities construct macroeconomic frameworks that incorporate public investment/growth linkages, and can help assess fiscal implications of different investment scenarios, while taking account of public investment management capacity, the rate of return to public investment, absorptive capacity, and other important features.

Simulations carried out with this model suggest that an increase in infrastructure investment can produce large benefits for the real economy in the long run, but that these positive results are contingent upon the country's structural conditions, such as the return to public capital and the capacity to collect revenue. Public investment inefficiencies and absorptive capacity constraints, for example, can imply that the increases in private capital and GDP that result from increased public investment may be disappointing. Furthermore, the increase in fiscal revenue needed to maintain sustainability during the investment period can be large, especially when concessional borrowing does not fully cover the cost of the ambitious public investment plans. Non-concessional borrowing can help ease this transition, but raises the stakes: it allows more ambitious programs of scaling up that can yield impressive long-term gains, but taken together with large front-loaded investment programs and weak structural conditions, can make fiscal policy more challenging.

This model has already enabled country authorities and Fund country teams to build a wide variety of scenarios for public investment surges and other shocks. So far, it has been successfully applied to three countries—Togo ([“Togo—Staff Report for the 2011 Article IV Consultation and Sixth Review under the Extended Credit Facility Arrangement,”](#) August 2, 2011), Burkina Faso ([“Burkina Faso: Staff Report for the 2011 Article IV Consultation and the Third Review Under the Extended Credit Facility,”](#) July 2, 2012) and Côte d’Ivoire ([“Cote d’Ivoire Enhanced Initiative for the Heavily Indebted Poor Countries—Completion Point Document and Multilateral Debt Relief Initiative,”](#) July 13, 2012),—with work underway for seven more countries (Afghanistan, Cape Verde, Ethiopia, Ghana, Liberia, Rwanda, and Senegal). In Côte d’Ivoire, for example, simulation results advise against a massive and sustained surge in public investment due to the likelihood that debt sustainability problems will arise even with fairly optimistic assumptions. The results suggest instead a more gradual investment path alongside structural reforms to increase public investment efficiency, economic productivity, and the ability to collect more revenue.

- The capacity dimension would be delinked from the debt limits policy for all countries and addressed directly in the structural component of the country's program.<sup>17</sup> In the absence of a robust indicator available for both LICs and emerging and advanced economies, designing a common framework for assessing capacity would prove very challenging.<sup>18</sup>
- To strengthen the overall implementation of the policy, clearer criteria defining the circumstances under which debt limits should be included in GRA and PRGT-supported programs would be provided.

**28. The proposed reform would have limited implications for GRA programs.** In particular, no changes to the design of debt limits in GRA programs are proposed. The main modifications would be the formal delinking of the capacity dimension from the debt limits policy, and the provision of guidance on the circumstances under which GRA programs would be expected to include a debt limit.

**29. For LICs, the proposed reform would differ from the current policy in the following ways:**

- The minimum concessionality requirement would no longer be applied to each individual loan. Rather, concessionality would be assessed on an average basis.
- Countries would no longer be subject to a fixed nominal ceiling on non-concessional borrowing. Consistent with the average concessionality target, countries would have the flexibility to contract smaller amounts of "less concessional" debt, or larger amounts of "more concessional" debt. The concessionality target would be expected to vary over time, depending on the profile of expected financing (e.g. it could be lower the year a country decides to issue a sovereign bond, before increasing as the country turns back to traditional sources of development financing).
- Public financial and debt management capacity would no longer be used as an input for the design of debt limits. Given its well-established role in LICs' ability to safely carry debt, the capacity dimension would however remain an important element in assessing debt sustainability and in overall program design.<sup>19</sup> In particular, it will continue to play a key role in the DSF, where it determines the thresholds against which a country's risk of debt distress is assessed. Capacity building needs would be addressed directly in the structural component of the country's program.

<sup>17</sup> As noted above, it could be argued that, for LICs, capacity is already built into the framework, via its role in determining the policy-dependent debt thresholds in the DSF, and hence the country's risk of debt distress.

<sup>18</sup> The CPIA index, which is used to assess capacity in LICs, is also compiled for middle-income countries, but is not publicly available for these countries. The index is not compiled for advanced economies.

<sup>19</sup> For a detailed discussion of the role of capacity in countries' ability to carry debt, see for example "[Revisiting the Debt Sustainability Framework for Low-Income Countries](#)," January 12, 2012.

**30. To complement the expanded coverage of debt limits, fiscal targets would be expected to be set on the broadest available concept of fiscal balance.** As is the case in GRA programs, such a broad definition of the fiscal performance criterion may obviate the need for a debt limit. However, even in cases where the coverage of the fiscal and debt PCs are the same, a separate debt limit may be warranted to capture obligations that are contracted in a given year, but may be disbursed over several years. In some LICs, because of the institutional set-up, it may not be feasible to extend the coverage of the fiscal target, e.g. because financing of foreign-financed investment projects can only be monitored with considerable delay. In these cases, debt limits would continue to play an important role in controlling the overall pace and level of external (or total) borrowing.

**31. Abolishing the concessional/non-concessional dichotomy could raise broader concerns over possible “free-rider” effects.** A policy that eliminated explicit limits on non-concessional borrowing could have the unintended consequence of discouraging concessional financing (including contributions to the PRGT) from creditors concerned about subsidizing creditors that lend on market terms. In practice, these unintended effects are likely to be mitigated by the fact that many lenders’ financing terms are determined by their own lending policies and policy objectives, rather than in reference to the Fund’s policy. Indeed, increased recourse to non-concessional borrowing by LICs in recent years does not appear to have deterred key lenders from continuing to provide highly concessional financing, including grants.

**32. To provide additional safeguards for LICs, financing assumptions should be explicitly discussed in program documents.** Combined with the average concessionality target, this discussion will anchor expectations for the financing mix under the program and ensure that programs continue to provide country authorities some leverage in their discussions with potential lenders. In cases where individual high-cost loans were considered to pose a significant risk to the program, authorities could commit in the letter of intent and the memorandum of economic and financial policies not to contract loans below a given concessionality level. Such a commitment would rule out loans with the most unfavorable terms, thereby mitigating possible free-rider concerns and facilitating the attainment of the average concessionality target.

**33. Setting a limit on the volume of debt contracted or guaranteed could also raise the concern that some concessional loans could be blocked once the debt limit is reached.** Such an outcome is unlikely, however, since available concessional financing is usually known well in advance and is generally desirable, meaning such loans would be systematically integrated in programs’ financing projections. In cases where debt levels are already high, restricting concessional borrowing may be warranted to maintain debt sustainability.

## **B. Reforming the discount rate**

**34. To enhance its effectiveness, the reform proposal outlined above should be combined with a reform of the discount rate methodology.** In order to address the issues raised by the use of multiple discount rates, staff proposes to establish a single discount rate across all Fund tools and policies. Unifying the discount rate is needed to ensure closer integration of the DSF and the debt limits policy, a key objective of the proposed reform. From an operational standpoint, unifying the

various discount rates would eliminate the distortions inherent in the current system, as discussed above.

**35. There is also a need to address the unwarranted fluctuations in the discount rate that have occurred since the DSF was originally designed.** The value of the discount rate in the DSF was originally set at 5 percent, which was the (rounded) level of the US\$ CIRR prevailing at the time.<sup>20</sup> As noted above, the calculated discount rate has since declined markedly as world interest rates have fallen, increasing the computed present value of debt in LICs despite the fact that the fundamental characteristics of their borrowing (including the expected return on debt-financed investment) have not changed. To remedy this, staff would favor using a longer-term average of the benchmark to set the discount rate, and keeping the new rate unchanged until the next review of the DSF. A fixed discount rate would allow for greater stability and predictability in concessionality calculations and avoid the automatic fall in assessed concessionality when world interest rates decline, a key criticism of the current framework. Since modifications to the DSF discount rate require the approval of both Fund and World Bank Boards, the intention would be to put forward a specific proposal in a joint paper by the two staffs.

## CONCLUSION AND NEXT STEPS

**36. Staff is of the view that the proposed reform of the debt limits policy and of the discount rate would have several important benefits:**

- Establishing a unified debt limits framework would make *volume* of contracted or guaranteed debt the primary focus in all countries and do away with the most problematic aspects of the current policy. While the 2009 reform was a useful first step to further adjust the debt limits policy to the changing circumstances of members, particularly LICs, and to strengthen the link between the debt limits policy on the one hand and debt vulnerabilities and public financial management on the other, the review of its implementation suggests that the reform led to uneven outcomes and left some of the deeper issues raised by the policy unaddressed.
- The proposed reform would mitigate the distortions to investment and financing decisions that are inherent in the current framework and provide LICs with increased flexibility to manage their borrowing policy within the limits of an envelope consistent with debt sustainability. Reducing the perceived intrusiveness of the policy on investment financing decisions would also address a key criticism of country authorities.
- While giving countries greater flexibility with regard to the mix of financing terms, the proposed reform would strengthen the links to debt sustainability, thereby mitigating risks over the medium term, relative to the current policy. The effectiveness of the new debt limits in safeguarding debt sustainability would depend, of course—as under the current policy—on the

<sup>20</sup> See “[Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications](#),” February 3, 2004, for a discussion of the methodology used to derive the discount rate in the DSF.

soundness of the underlying DSA and on establishing clear guidance for deriving country-specific limits from the DSA.

- The suggested reform of the discount rate would also significantly streamline the implementation of the policy in LICs and allow for greater stability and predictability in concessionality calculations, addressing another key criticism of the current framework.
- At the same time, the indicative floor on average concessionality and the direct feedback between debt limits and the DSA would ensure that LIC programs retain a strong focus on appropriate financing terms.
- Finally, ensuring that debt management issues are addressed in the structural component of the program, rather than in the debt limits policy, should increase incentives to build up capacity in this area. This reform would also address the evenhandedness issue raised by the current framework.

**37. Given the scope of the current reform, staff proposes to conduct outreach with key constituencies**, including country authorities, lenders, and other development stakeholders to ensure appropriate buy-in before coming back to the Board with a final reform proposal. Staff intend to continue to collaborate closely with the World Bank in the coming weeks to reach an agreement on the reform of the discount rate in the DSF—a joint Bank-Fund tool—and to ensure continued broad alignment of the Fund’s debt limits policies with the Bank’s non-concessional borrowing policy, which is also being reviewed.

**38. As part of a two-stage process for the debt limits review, this paper will be followed by a second paper based on the feedback of Executive Directors and the outcome of consultations with relevant stakeholders.** The follow-up paper will put forward specific policy proposals and be followed by a guidance note to guide and facilitate the implementation of the new policy. As part of the guidance, staff plans to develop tools to calculate and monitor average concessionality.

## ISSUES FOR DISCUSSION

- Do Directors agree that the Fund’s policy on external debt limits should be reformed to establish a unified debt limits framework, which would make the volume of contracted or guaranteed debt the primary focus in all countries, consistent with a key objective of the policy?
- Do Directors agree that the reform proposal put forward in this paper, as presented in paragraphs 27-35, would tighten the link between debt vulnerabilities and debt limits, while limiting investment distortions and reducing uneven outcomes?
- Do Directors agree that the reform proposal contains sufficient incentives to ensure that LICs receive favorable terms on their official financing?
- Do Directors agree that, to ensure its full effectiveness, the reform should be coupled with a reform of the discount rate, which would put in place a single discount rate for Fund purposes?

## ANNEX I. The Concessional Matrix in LICs

The current debt limits policy as it applies to LICs provides a framework based on a “concessional matrix.” This matrix (Table 1) guides the design of debt limits in Fund programs, based on an assessment of two factors that are particularly relevant in this context: i) the extent of debt vulnerabilities and ii) the country’s capacity to manage public resources. The former is based on the debt distress rating assigned to the country in the Debt Sustainability Framework; the latter is assessed jointly by Bank and Fund staff once a year, based primarily on standard indicators according to an established methodology.

**Table 1. The Concessional Matrix for Debt Limits in LICs<sup>1</sup>**

		Extent of debt vulnerabilities	
		Lower	Higher
Capacity	Higher	Minimum average concessional requirement applied to external or total public borrowing; for the most advanced LICs, overall nominal debt limit if needed	Overall limit on the PV of external or total public debt; for the most advanced LICs, ceilings on nominal external or total public debt
	Lower	Minimum concessional requirement based on debt-by-debt approach, but with added flexibility on nonconcessional borrowing	Maintain minimum concessional requirement based on debt-by-debt approach, with limited or no room for nonconcessional borrowing

<sup>1</sup> The policy stipulates that the criteria set out in this matrix apply to members to whom concessional financing would normally be available.



## ANNEX II. Recent Evolution of External Debt in Some Early HIPCs<sup>1 2</sup>

This note discusses the recent evolution of external debt in the 5 HIPCs that reached the completion point before 2007 (“early HIPCs”) and in which debt has been accumulating the fastest in recent years. Specifically, it focuses on the 5 out of 21 early HIPCs where the external debt ratio (expressed in percent of GDP) has increased by more than 2 percent of GDP per year on average: Ethiopia, Niger, Senegal, Tanzania, and Uganda.

In most of these cases, accumulation of concessional external debt is the main driver of the recent increase in debt-to-GDP ratios. At the same time, recourse to non-concessional borrowing has been increasing in all countries. These trends do not support the premise that countries substitute non-concessional for concessional borrowing.<sup>3</sup> The pace of disbursements (as opposed to contracting) of non-concessional loans has been slow, however, suggesting that debt ratios will increase further in the coming years. In three of the five cases, the increase in debt-to-GDP ratios is projected to lead to a permanent upward shift in the debt trajectory, compared to earlier projections.

### ***Ethiopia***

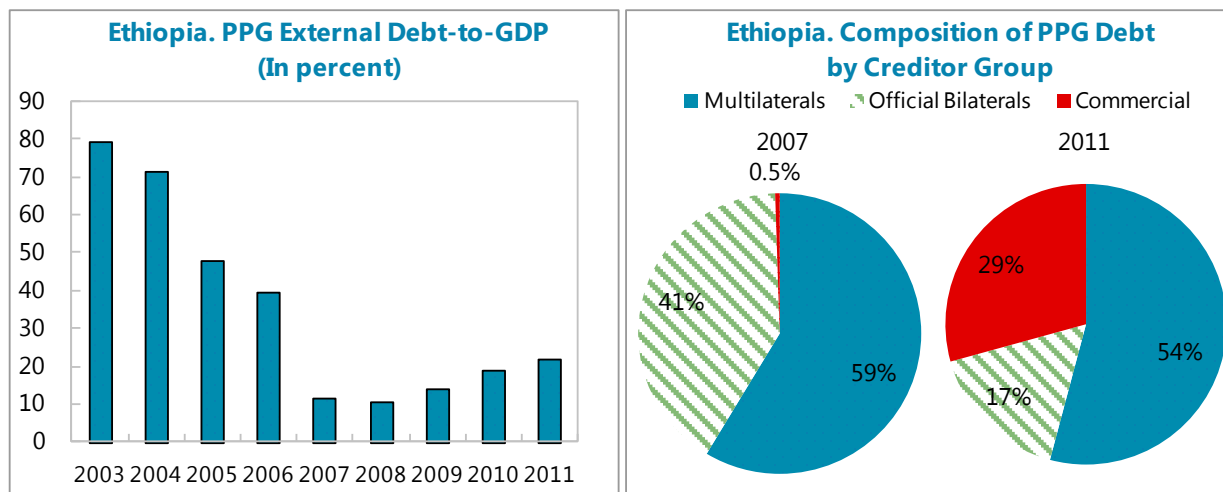
Debt relief provided under HIPC and MDRI lowered Ethiopia’s public external debt stock by about US\$6 billion (about 40 percent of GDP) to 11 percent of GDP in 2007. Since then, the PPG external debt-to-GDP ratio has almost doubled to reach 21.9 percent of GDP in 2011, reflecting inter alia a public-sector-led development strategy that focuses on promoting growth through high public investment. A large part of the investment under the GTP is carried out by public enterprises.

Concessional debt accounted for about 70 percent of Ethiopia’s PPG debt in 2011. The share of non-concessional debt in total PPG debt has increased sharply over the last few years, from 10 percent in 2008 to almost 30 percent in 2011. Nevertheless, a separate analysis conducted by World Bank staff using data from the Medium-Term Debt Strategy (MTDS) database concludes that concessional borrowing accounts for the majority of the recent build-up in external PPG debt in Ethiopia, albeit to a lesser extent than in other countries. A large part of the external borrowing has been used for infrastructure (mainly road and electricity) and industrial investment.

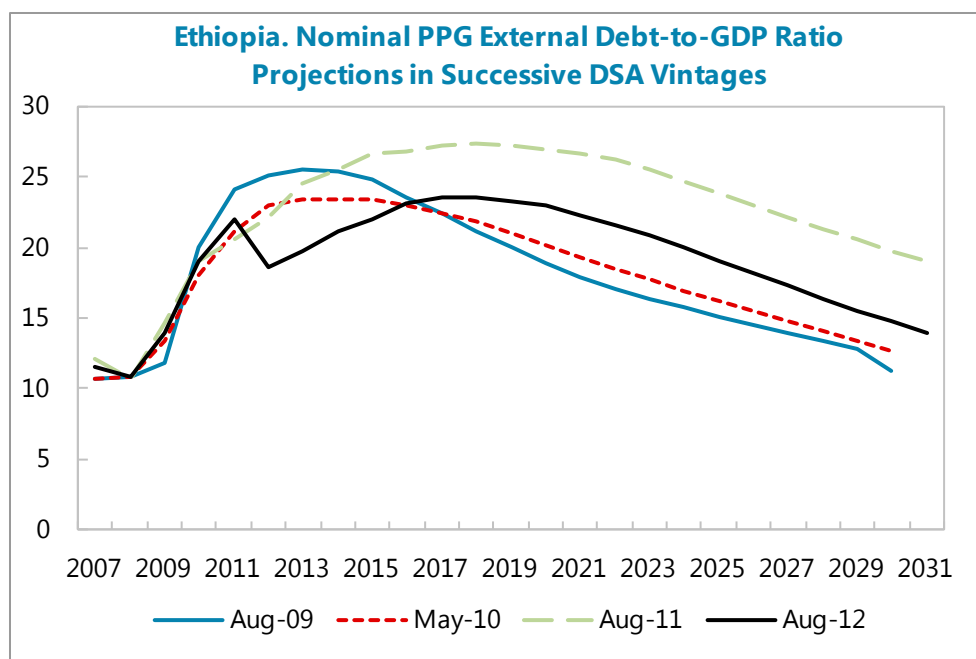
<sup>1</sup> This annex draws in part on an analysis carried out by World Bank staff on the evolution of African public debt since debt relief (“How clean is the slate? African public debt since debt relief”, Merotto D., Thomas M. and, Stucka T., World Bank Working Paper Series, forthcoming).

<sup>2</sup> Data source for the figures in the annex is from country desks and LIC DSAs.

<sup>3</sup> In four of the five countries, IDA commitments over the last three years exceeded initial allocations. The only exception is Uganda, where the volume of unused IDA resources is negligible.



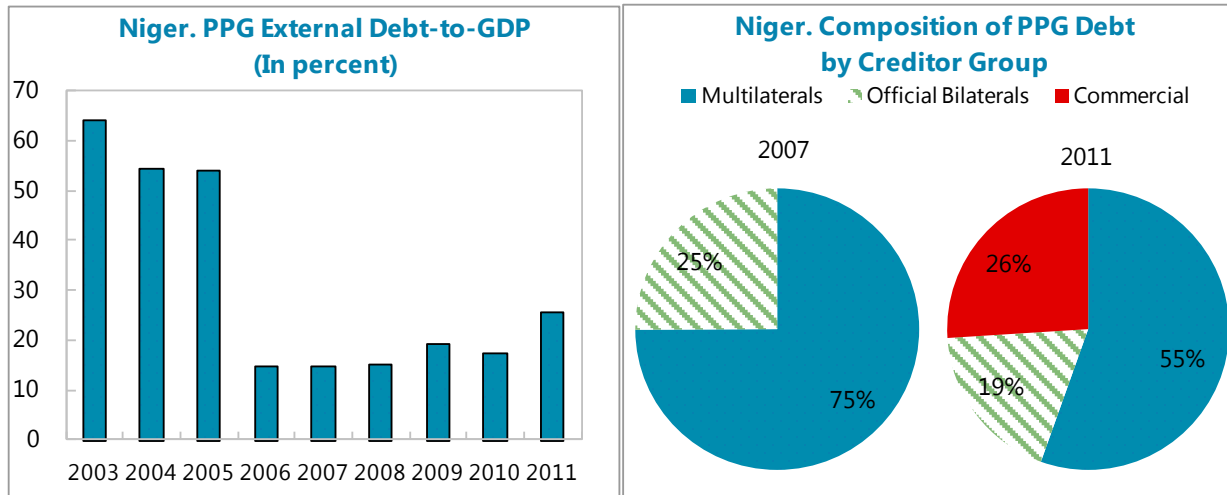
The increase in debt-to-GDP ratios has resulted in permanent upward shifts of the projected medium-term paths in successive DSA vintages. However, following lower-than- envisaged debt accumulation in 2011, the upward shift is currently smaller than had been anticipated at the time of the 2011 DSA.



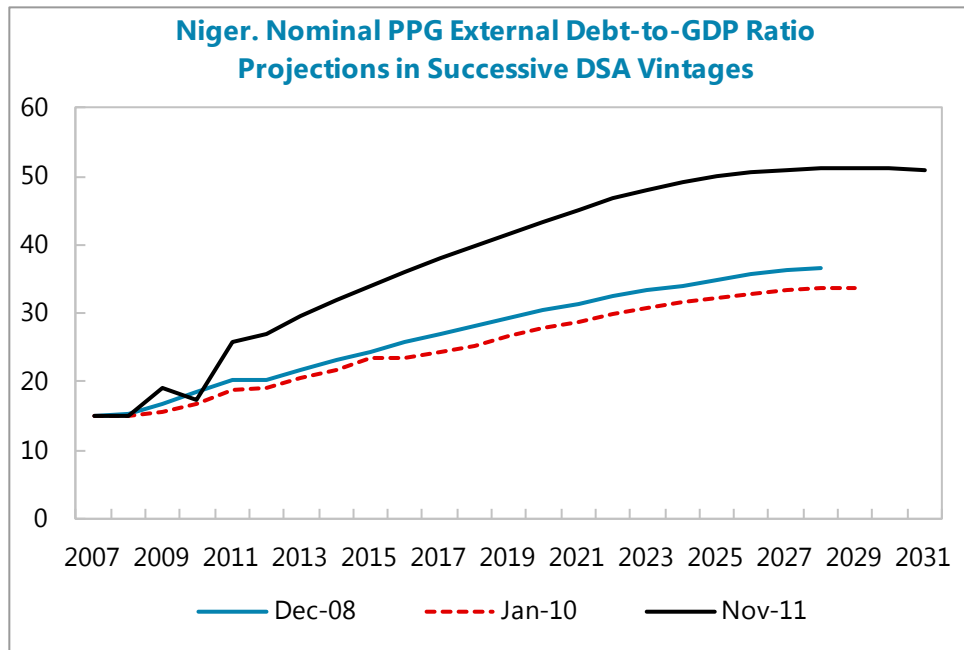
**Niger**

Niger reached the HIPC completion point in 2004 and benefited from MDRI relief in 2006. Consequently, PPG external debt fell from over 90 percent of GDP at end-2000 to about 15 percent of GDP at end-2007. The PPG external debt-to-GDP ratio has since increased sharply to reach 26 percent of GDP in 2011. This increase is mostly attributable to new non-concessional financing

arrangements for large oil and uranium projects in 2010 and 2011, including the contracting of a public guarantee on a large loan to finance the state’s share in an oil refinery.<sup>4</sup> No other non-concessional borrowing was contracted.



The large non-concessional borrowing has resulted in a large one-time upward shift of the projected medium-term path of the nominal debt-to-GDP ratio in the 2011 DSA.

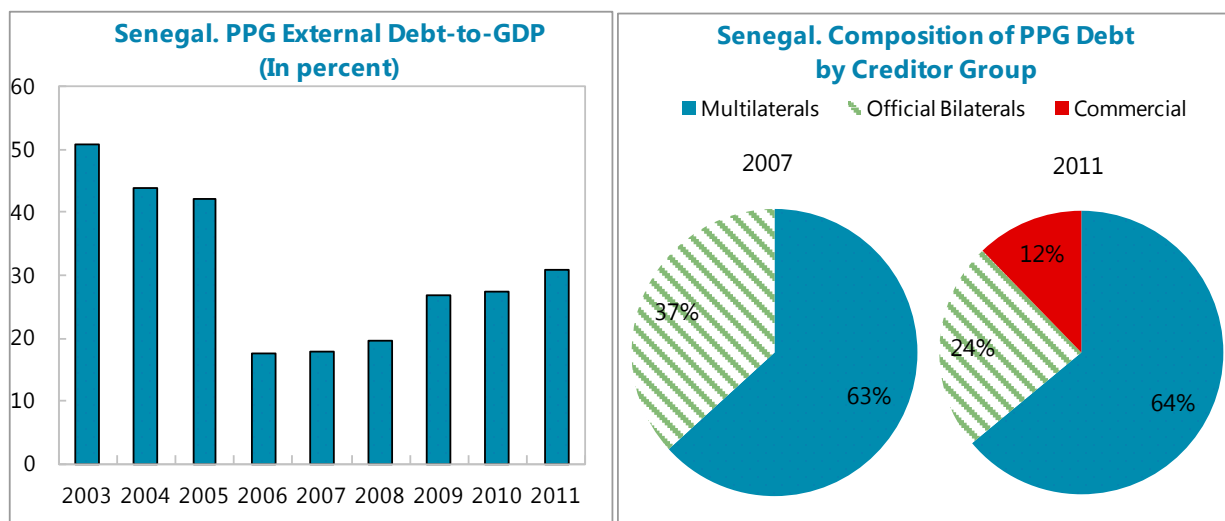


<sup>4</sup> Niger did not have an IMF-supported program at the time when the loan was contracted. Under the current ECF-supported program, the non-concessional borrowing ceiling is set to zero.

## Senegal

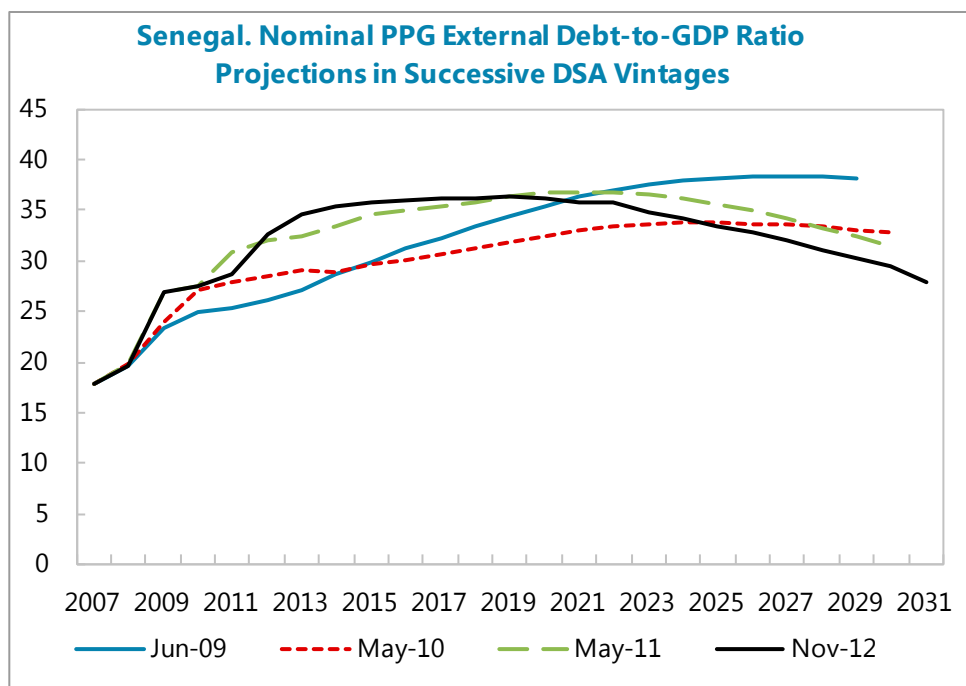
Senegal reached the HIPC completion point in April 2004 and received MDRI relief in 2006. As a result, its PPG external debt declined from 51 percent of GDP in 2003 to 18 percent of GDP at end-2007. However, since then, Senegal's PPG external debt has grown steadily, increasing by about US\$2.3 billion (equivalent to 16 percent of 2011 GDP) between end-2007 and end-2011. About 65 percent of this increase comes from multilateral creditors, 9 percent from official bilateral creditors, and the remaining 26 percent from commercial creditors. As of end-2011, the share of PPG external debt to multilateral and official bilateral creditors accounted for about 90 percent of external PPG debt. MTDS data confirms that concessional debt accounts for the majority of the recent build-up in external PPG debt.

Senegal's PSI (December 2010–13) with the Fund includes a US\$500 million NCB ceiling (equivalent to 4.1 percent of GDP) over the period 2011–13. The limit was originally intended to be used exclusively for a specific road infrastructure project, but was later extended to include other road infrastructure projects, as well as investment in the energy sector, and urban water and sanitation. So far US\$300 million has been contracted under the ceiling by issuing a Eurobond.<sup>5</sup> A separate ceiling equivalent to CFAF 44 billion (increased in the 2nd review from the original ceiling of CFAF 30 billion) in 2011–13 applies for untied non-concessional external debt financing with a grant element of at least 15 percent. No loan has been contracted under the envelope for semi-concessional borrowing yet, but the authorities intend to do so in 2013. The rapid increase in Senegal's public external debt in recent years has mainly been used to finance an ambitious investment program. Since 2000, public investment as a share of GDP has doubled, rising from 5½ percent to nearly 11 percent in 2011.



<sup>5</sup> Following the issuance of a US\$500 million Eurobond in May 2011, with an exchange offer for the outstanding 2009 Eurobond, the remaining ceiling for non-concessional borrowing for 2011–13 is US\$200 million.

The recent increase in the debt-to-GDP ratio along with a projected increase in borrowing in the coming years have resulted in an upward shift in the projected path of debt-to-GDP in the next decade in successive DSAs. However, this upward shift is expected to be temporary, with long-term debt-to-GDP projections now lower than they were in earlier DSA vintages.

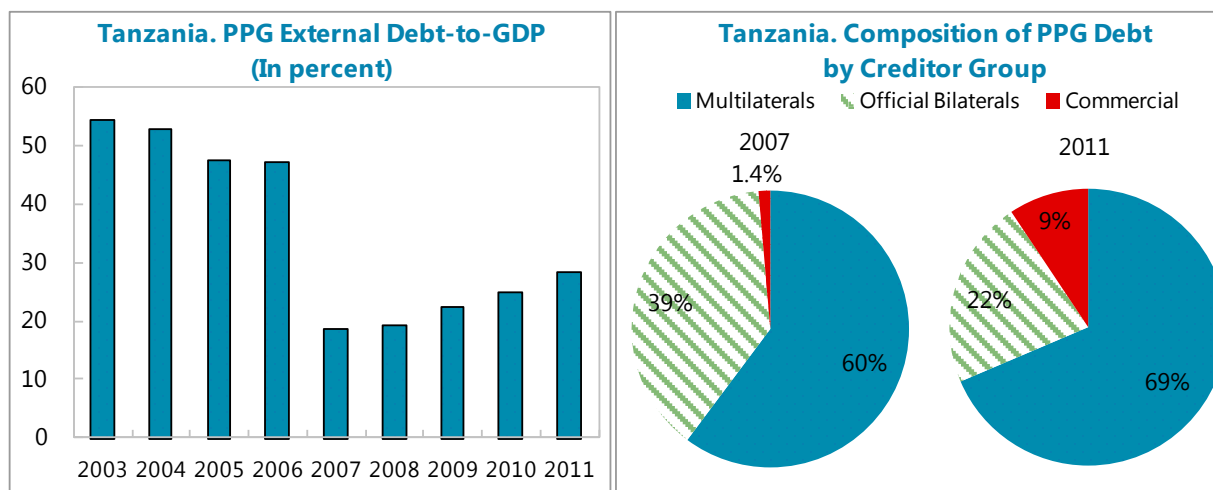


### **Tanzania**

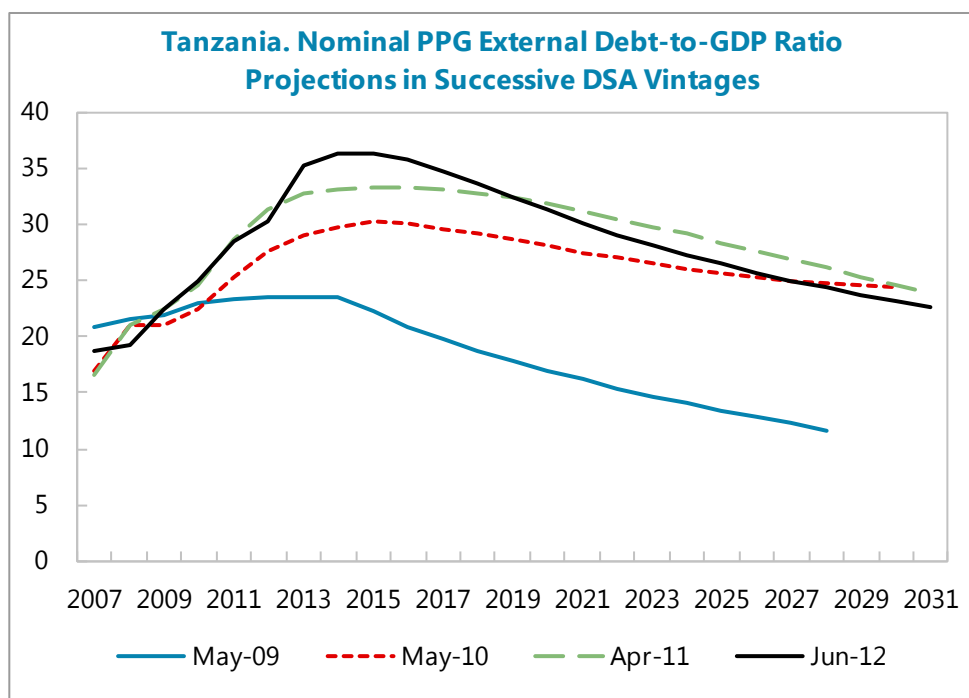
Tanzania reached the HIPC completion point in November 2001 and received MDRI assistance in January 2006. HIPC and MDRI debt relief sharply reduced Tanzania's PPG external debt ratio, from 54 percent of GDP at end-2003 to 19 percent of GDP at end-2007. External PPG debt has steadily crept upwards since then, increasing by about US\$4 billion, equivalent to 12 percent of 2011 GDP, over the past four years. New borrowing from multilateral creditors accounted for about 77 percent of the increase in the stock of debt during that period, with borrowing from official bilateral and commercial creditors accounting for the remaining 5 percent and 17 percent, respectively. As of end-2011, debt to multilateral and official bilateral—the bulk of which is on concessional terms—accounted for more than 90 percent of external PPG debt.

Borrowing on non-concessional terms is expected to pick up as Tanzania uses its cumulative non-concessional borrowing ceiling of \$2.7 billion (equivalent to 11 percent of GDP) under the PSI (June 2010–13) to finance infrastructure spending. This ceiling, set at \$525 million annually at the time of the PSI request in June 2010, was revised three consecutive times, in the context of the 3rd, 4th, and 5th reviews, to accommodate additional borrowing for infrastructure and to add a \$920 million loan

to finance a gas pipeline, which was originally intended to be concessional. So far, about \$2.1 billion has been contracted under the ceiling, and \$505 million disbursed as of end-June 2012.



The increase in the debt-to-GDP ratio has resulted in a permanent upward shift of the projected medium- and long-term path of the nominal debt-to-GDP ratio compared to earlier DSA vintages.<sup>6</sup>

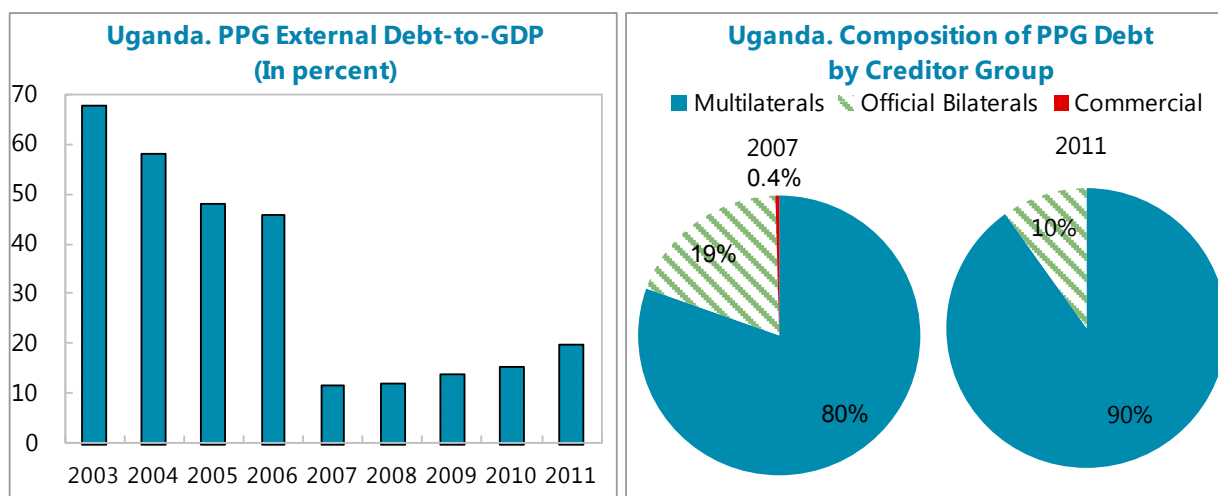


<sup>6</sup> To ensure comparability across DSA vintages, the debt-to-GDP ratios are expressed in nominal terms, and therefore cannot be directly compared to the DSF thresholds, which are expressed in present value terms.

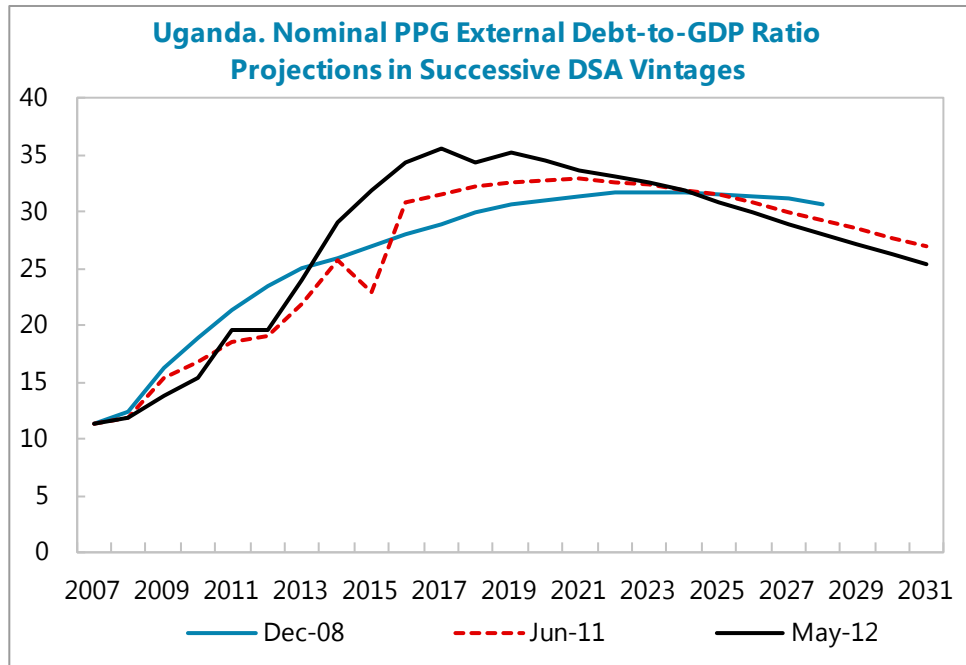
## Uganda

Uganda reached the HIPC completion point in 2000 and received MDRI assistance in January 2006, resulting in a decline in PPG external debt from 70 percent of GDP in 2003 to 10 percent of GDP at end-2007. However, since then, Uganda's PPG external debt has edged up steadily, by about US\$2 billion (about 11 percent of 2011 GDP) as of end-2011. Almost all of this increase comes from multilateral creditors. As of end-2011, debt to multilateral creditors accounted for 90 percent of total PPG external debt, and debt to official bilateral creditors accounted for the remaining 10 percent. MTDS data confirms that concessional debt accounts for the majority of the recent build-up in external PPG debt.

While the authorities have relied primarily on highly concessional financing to fund their infrastructure investment needs, they are planning to increase their recourse to non-concessional sources to fund infrastructure projects. Under its current PSI (May 2010–13) with the Fund, Uganda has a cumulative non-concessional borrowing ceiling of US\$1 billion (equivalent to 5.7 percent of GDP). This ceiling, set at US\$500 million at the start of the program, was revised twice, in the context of the 2nd and the 4th reviews. So far, about US\$455 million in non-concessional debt has been contracted.



The recent increase in debt-to-GDP ratios and projected increase in borrowing in the medium term have shifted the projected path of debt-to-GDP in the next decade upward in successive DSAs. As in the case of Senegal, this impact is expected to be temporary, and long-term debt-to-GDP projections are now slightly lower than they were in earlier DSA vintages.





### ANNEX III. An Analysis of Interactions between Debt Limits and Fiscal Performance Criteria in PRGT-Supported Programs<sup>1</sup>

*This Annex summarizes findings on the relationship between debt and fiscal performance criteria under LIC programs. Key findings are as follows: (i) all but two countries had restrictions on non-concessional borrowing; (ii) only half of LIC programs had a performance criterion (PC) on the overall or primary fiscal balance, and in about half of these programs, foreign-financed capital expenditures were excluded from the PC; (iii) fiscal balance targets were more prevalent in countries where debt levels are already high; and (iv) concessional borrowing was unconstrained in about 80 percent of LIC programs. Overall, the analysis suggests that in many cases debt limits are included in LICs programs, along with fiscal PCs, to control the way the deficit is financed (external vs. domestic, concessional vs. non-concessional), as well as to maintain debt sustainability.*

- **58 out of the 61 LIC programs existing or approved after the new debt limits policy was introduced in December 2009 had some widely-used fiscal PCs along with non-concessional debt limits.**<sup>2 3</sup> A fiscal PC was established normally on a measure of the fiscal balance and/or on net domestic financing of the government. Almost all countries included limits on non-concessional external debt except two countries for relatively advanced LICs (Armenia and Georgia). No program had a debt ceiling on total public debt (external plus domestic public debt),<sup>4</sup> which is a prominent feature of debt-related PCs in GRA programs.
- **Unlike programs for market access countries (MACs), only about half of LIC programs (32 programs) had a fiscal PC on the overall or primary balance (22 and 10 programs, respectively); in about half of these programs, foreign-financed capital expenditures were explicitly excluded (15 programs) from the balance, creating a loophole for concessional loans.** A fiscal PC was often set from the financing side (i.e., net domestic and external financing), most likely to facilitate measurement. Around two thirds of the programs had a PC on

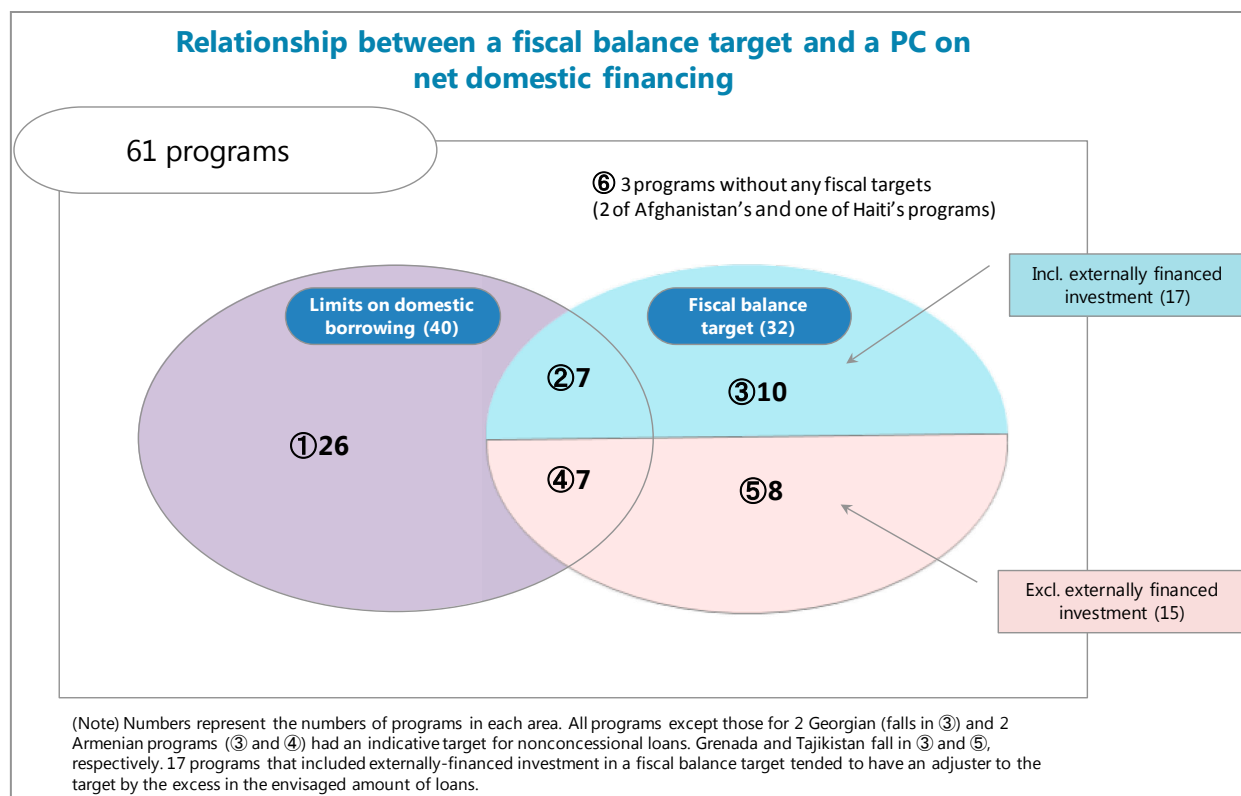
<sup>1</sup> Prepared by Keiichi Nakatani. The analysis was based on staff reports for programs approved after December 2009 or approved earlier but existing as of December 2009. For existing programs, an earliest review completed after December 2009 was used.

<sup>2</sup> Remaining three programs are two Afghanistan ECFs and one Haiti ECF. They had a PC such as a floor on revenues of the central government and the central bank financing of the government.

<sup>3</sup> The term “fiscal performance criterion (PC)” is used throughout this note to refer to the PCs that aim to cap all or part of the financing of government other than through a central bank.

<sup>4</sup> Georgia had an indicative target on total external debt. Unusually, Grenada and Tajikistan had a ceiling on concessional external debt in addition to a non-concessional debt limits.

net domestic credit to the government (40 programs), sometimes in addition to a fiscal balance target (14 programs).



- **Overall, external concessional borrowing was unconstrained in about 80 percent of LIC programs (49 programs).** In addition to programs where foreign-financed investment was explicitly excluded from their fiscal balance target (15 programs), even those covering foreign-financed investment (17 programs) in the target often times carry an adjuster to the target by the excess in the envisaged loan provision, allowing for unlimited concessional borrowing (6 programs). Only some programs covering externally-financed investment (11 programs) without an adjuster implicitly set limits on total external borrowing, and thus, given non-concessional borrowing limits, controlled concessional external borrowing as well.<sup>5</sup>
- **Fiscal balance targets were more prevalent in LICs with high public (external) debt.** The average public (external) debt-to-GDP ratio of programs with the target is 48 percent (37 percent) whereas that without it is 36 percent (23 percent). The relationship between a debt level and a loophole for concessional loans is not as strong, and no clear relation can be established between the inclusion of a PC on domestic financing of the government and the domestic debt level.

<sup>5</sup> In the same vein, a fiscal balance target, along with non-concessional borrowing limits, sets implicit limits on net domestic financing even without an explicit PC on domestic financing.

- **In around half of programs (31 programs), the debt limits PC had broader coverage than the fiscal PC.** But a relatively large number of the programs used the same coverage (usually a central government) for both fiscal PCs and debt limits, probably because data quality on local governments or state-owned enterprises was poor or local governments / state-owned enterprises were not allowed to borrow externally without explicit guarantees from the central government.
- **Fiscal PCs may have been used to achieve different objectives than those that external debt limits tried to address.** For example, in some cases limits on domestic financing of the government may have been included to address crowding out of private investment, combat inflation and consequent exchange depreciation, or achieve the targets established by the monetary union (e.g. in WAEMU).

## ANNEX IV. Debt and Fiscal Limits in Fund-Supported Programs of Emerging Market Countries

*This note summarizes findings on the stylized facts of debt and fiscal performance criteria and their interactions in Fund-supported programs of advanced and emerging market countries.<sup>1</sup> Key findings are as follows: (i) all but one of the 27 programs had a performance criterion (PC) on the overall or primary fiscal balance; (ii) debt limits were less ubiquitous than fiscal PCs and, through their different scope and coverage, generally complemented fiscal targets; and (iii) while debt vulnerability was taken into account systematically in the decision to include a debt PC, the role of capacity is more ambiguous in designing debt PCs in MACs.*

**Fiscal limits, mainly on the overall or primary balance, were widely adopted in the 27 Fund-supported programs of market access countries (MACs) existing or approved since 2009.** To ensure adjustment and sustainability, 26 of the 27 programs had an explicit fiscal PC with the only exception being Bosnia and Herzegovina. The majority (19 out of 26) of fiscal limits were imposed on the general government or the consolidated public sector. The coverage varied in some cases because of the need to better gauge underlying fiscal efforts: in Gabon, for example, fiscal limits were applied to non-oil sectors and in El Salvador 2009 and 2010 to the non-financial public sector. Fiscal limits were applied to the central government for the remaining 7 cases.

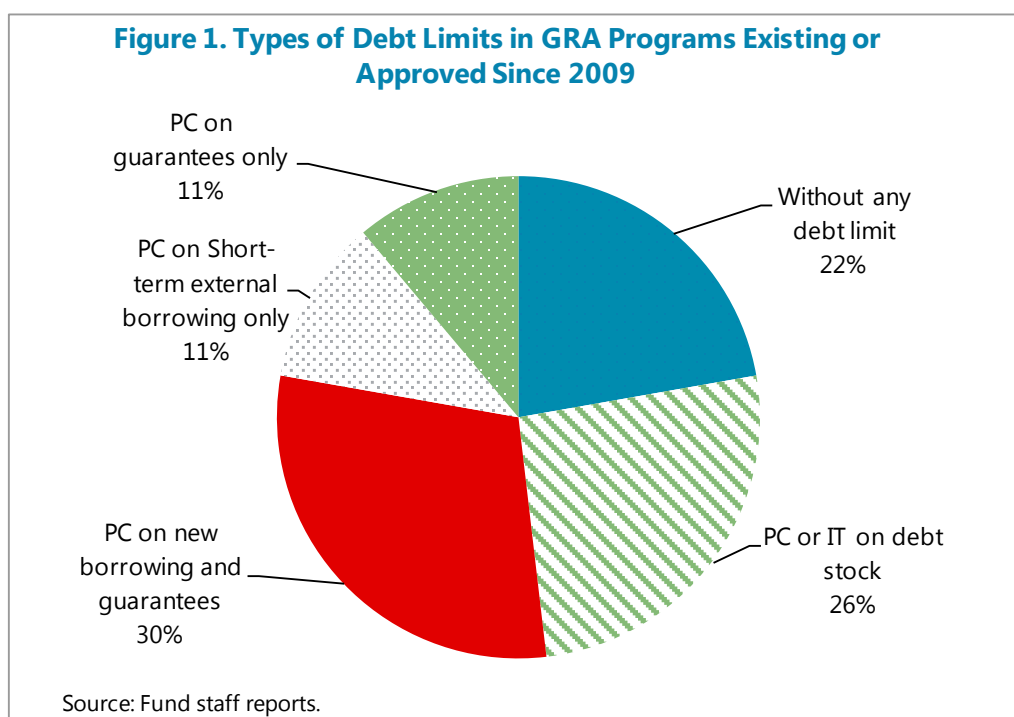
**The application of debt limits in Fund-supported programs was less universal than that of fiscal limits, but was wide-ranging in terms of coverage (central/general government) and scope (flow, stock, or guarantee).** Twenty one of the 27 programs included a form of debt limit. In the six cases where debt levels were low and debt sustainability was not a primary concern, no conditionality on debt was included at all: Belarus, Dominican Republic, El Salvador 2009, Guatemala, Latvia, and Ukraine 2008.<sup>2</sup> In another three cases (Antigua and Barbuda, St. Kitts and Nevis, and Bosnia and Herzegovina) limits were only included for short-term external borrowing (Figure 1). Fifteen of the 27 cases had a form of debt limit applied to either total debt stock or new borrowing. In 8 of these 15 cases, the limit was set on flows, with six of them applying ceilings to new external public debt and the other two to new public debt. Seven cases have limits on total public debt stock: Costa Rica, Greece 2010 and 2012, Hungary, Ireland, Jamaica, and Portugal. Except in the case of Portugal, where it covered the general government, the stock limit was usually applied to the central government. In the remaining three cases (Ukraine 2010 and Romania 2009 and 2011),

<sup>1</sup> Prepared by Yanliang Miao. Kosovo and Iraq are excluded from the sample because of the lack of market access on a durable and substantial basis.

<sup>2</sup> For El Salvador 2009 and Ukraine 2010, the initial programs were cancelled and successor arrangements approved in 2010. In the former case a limit on "gross debt of the public sector (flows)" was added and in Ukraine a "ceiling on publicly guaranteed debt" was included.

standalone limits were applied to public guarantees as the existence of fiscal limits already restrained the rise in debt level.

**Non-concessional borrowing was restricted in four programs with non-LICs (Bosnia and Herzegovina, Peru, and Serbia 2009 and 2011) that had access to concessional financing.** In Bosnia the limit was on short-term external non-concessional debt, while in Serbia (2009 and 2011) and Peru it was explicitly applied to non-concessional borrowing with maturities over one year. Except for Serbia 2011, however, the other three programs were approved before the reform of the Fund's debt limits policy went into effect in December 2009.



**Inclusion of debt limits appears to be closely related to debt sustainability concerns; by contrast, the role of capacity in the decision to include debt limits is less clear-cut (Table 1).**

All 11 cases with debt of 60 percent of GDP or higher had a form of debt limit, with six of them applying limits directly on the stock of public debt. For the six cases without any form of debt limits, debt levels were without exception well below 60 percent. Despite relative high capacity<sup>3</sup> and low debt levels, the four programs with Costa Rica, Serbia 2009 and 2011, and El Salvador 2010 included debt limits. In fact, debt limits were more prevalent among higher capacity MACs (15 out of 17) than

<sup>3</sup> A country's capacity to manage public resources is measured here by the Government Effectiveness Indicator of the World Bank's Worldwide Governance Indicators (WGI) for the year of program request. The indicator is publicly available and "reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation and the credibility of government's commitment to such policies." Countries ranked above the 50<sup>th</sup> percentile are classified as having higher debt management capacities.

in the lower capacity group (6 out of 10). The pattern still held even if the sample was restricted to the 16 MACs with lower vulnerabilities.

**Debt limits and fiscal limits mostly complemented each other.** In the only case (Bosnia and Herzegovina) where there was no explicit fiscal limit, a below-the-line limit on net domestic financing was adopted. Likewise, in the six cases where there were no debt limits at all, all programs had an overall fiscal limit with five of them applied to the general government. The two types of limits, when imposed simultaneously, also complemented and strengthened each other because of their different scope and coverage. While fiscal limits tended to focus on the central or general government, the coverage of debt limits was often broadened to include public enterprises (Seychelles 2008 and 2009 and Serbia 2009 and 2011) or guarantees by the government (Greece 2010 and 2012 and Iceland). In addition, limits on total or new public guarantees helped cover contingent liability risk which explicit fiscal limit could not capture: 11 programs had ceilings on the guarantees granted by the central or general government. Except the aforementioned three stand-alone cases, most (8 out of 11) guarantee ceilings were implemented together with limits on contracting new debt.

**Fiscal and debt limits used in combination, however, could create redundancy, especially when they have the same coverage.** Seventeen of the 27 programs simultaneously imposed fiscal limits and a form of debt limit on the stock or flow of public debt. Though the coverage (central government, general government, or the whole public sector) and scope (flow, stock, or guarantee) of fiscal and debt limits differed in most cases, they did overlap in a few cases. For example, the Costa Rica program included a ceiling on “the debt stock of the central government” in addition to a fiscal PC on “cash balance of the central government.” In Iceland, both debt and fiscal PCs were applied to the central government but the debt limit covered only the contracting or guaranteeing of “medium- and long-term external debt.” Thus, the coverage of the two limits was not identical in this case, as short-term external borrowing was left to be captured by the fiscal PC.

<b>Table 1. Debt Limits, Capacity and Vulnerabilities in MAC programs (existing or approved since 2009)</b>			
	<b>Debt Limit</b>	<b>Lower vulnerabilities</b>	<b>Higher vulnerabilities 1/</b>
<b>Higher Capacity</b>	Yes	Costa Rica (27.2; 64) 2009 Serbia (38.1; 52) 2011 Serbia (50.1; 50) 2010 El Salvador (50.1; 56)	<u>Antigua Barbuda (90.6; 67)</u> Iceland (70.3; 97) Hungary (72.9; 77) 2/ Ireland (92.2; 88) 2/ Portugal (107.8; 79) <u>2009 Seychelles (124.4; 58)</u> <u>2008 Seychelles (130.7; 58)</u> <u>Greece 2010 (144.5; 68)</u> <u>Jamaica (145.3; 63)</u> <u>St. Kitts and Nevis (154.3; 75)</u> <u>Greece 2012, (170.7; 67)</u>
	No	Latvia (17.2; 71) 2009 El Salvador (48.2; 55)	
<b>Lower Capacity</b>	Yes	Bosnia and Herzegovina (36.0; 29) 2010 Ukraine (40.5; 25) Gabon (43.2; 22) Peru (30.4; 36) 2009 Romania (23.8; 47) 2011 Romania (33.0; 47)	
	No	Belarus (34.9; 11) 2008 Ukraine (20.5; 27 ) Guatemala (22.9; 30) Dominican Republic (28.4; 35)	
<p>1/ Defined as countries with a public debt-to-GDP ratio of 60 percent or more. 2/ Indicative target only.</p> <p><b>Reading Note:</b> The first set of numbers in brackets are the year-end public debt-to-GDP ratios for the year of program request from the October 2012 <i>World Economic Outlook</i>; the second set of numbers in brackets are the percentile ranks of the country's Government Effectiveness indicator from the World Bank's Worldwide Governance Indicators (WGI) for the year of program request. Countries ranked above the 50th percentile are classified as having higher debt management capacities. <u>Underlined programs</u> are those eventually went through debt restructurings.</p>			