IDA COUNTRIES AND NON-CONCESSIONAL DEBT: DEALING WITH THE 'FREE RIDER' PROBLEM IN IDA14 GRANT-RECIPIENT AND POST-MDRI COUNTRIES

Resource Mobilization Department (FRM)
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ABBREVIATIONS AND ACRONYMS

AfDF	African Development Fund
AsDF	Asian Development Fund
CFR	Collateralized with Future Receipts
CIRR	Commercial Interest Reference Rate
CAS	Country Assistance Strategy
CP	Completion Point under the HIPC Initiative
DAC	Development Assistance Committee
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
GDF	Global Development Finance
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
LDC	Least Developed Country
MDB	Multilateral Development Bank
MDRI	Multilateral Debt Relief Initiative
MDGs	Millennium Development Goals
MVA	Modified Volume Approach
NPV	Net Present Value
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PPG	Public and Publicly Guaranteed
PRGF	Poverty Reduction and Growth Facility
PSI	Policy Support Instrument

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EXECUTIVE SUMMARY

While the provision of grants and debt relief create significant benefits for recipient countries in the form of strengthened debt sustainability prospects and increased resources for the MDGs, they potentially add to the risk of "free riding". In this paper, the term "free riding" is used as shorthand to refer to situations in which IDA's debt relief or grants could potentially cross-subsidize lenders that offer non-concessional loans to recipient countries. In the context of grant-recipient countries with very limited access to financial markets, free-riding risks would tend to be relatively limited. Such risks would, however, be higher in resource-rich grant-recipient countries that could rely on non-concessional borrowing collateralized with future export receipts. Most importantly, the risks of free riding would be magnified as a result of lower debt ratios resulting from the implementation of the Multilateral Debt Relief Initiative (MDRI). In fact, early evidence indicates that rating agencies may be upgrading commercial risk ratings for post-MDRI countries.

The free rider problem involves both a collective action issue vis-à-vis creditors, and moral hazard risks vis-à-vis borrowers. From a creditor standpoint, the free rider reflects differences between collective and individual interests: IDA and its donors aim to lower the risk of debt distress in low-income countries by providing new financial assistance on appropriately concessional terms; in contrast, other creditors may gain from non-concessional lending following large-scale debt relief or in conjunction with grants provided by IDA. From a borrower standpoint, IDA grants and debt relief may introduce an incentive for countries to over-borrow from other creditors, which would force IDA to continue to increase the grant share of its assistance and/or defeat the original purpose of the MDRI.

IDA's proposed response to free riding in post-MDRI and grant-eligible IDA-only countries is based on a two-pronged approach, contemplating both the collective action and the moral hazard facets of the problem. The first prong, enhancing creditor coordination around an agreed framework, deals with collective action issues. The second prong, discouraging free riding through disincentives aimed at the borrowing countries, deals with moral hazard issues and aims at consistency with IDA's long standing policies.

To implement this proposed course of action, IDA has only two instruments at its disposal – reducing volumes and/or hardening the terms of its assistance. When applying these instruments, trade-offs at the country level emerge: volume cuts reduce resources that could be used to reach the MDGs; hardening of terms may exacerbate debt sustainability problems. Considerable care will therefore be needed when applying these disincentives – individually or in combination.

This paper proposes a framework to use these two instruments in a way that takes into account a country's overall debt sustainability and access to financial markets. Volume cuts would primarily be used in countries in which debt sustainability is a major concern; hardening of terms would be primarily used in countries with stronger debt sustainability prospects and greater degree of market access, consistent with IDA's longstanding policies on blend countries.

Within this general framework, in light of the complexity of the free rider problem, limited data availability, and the wide variety of country cases, a flexible approach to implementing the proposed policies should be followed. Ironclad or "one-size-fits-all" approaches would not work; country-specific circumstances would need to be taken into account when deciding, for example, whether the appropriate response to a free riding case should involve hardening of terms or volume reductions.

Each year, at the time of the IDA allocation exercise, representatives from the Regions, CFP, PREM, DEC and OPCS will meet to review countries' non-concessional borrowing. This group would make recommendations to the Operations Committee on the appropriate IDA response to breaches of the free rider policy. For cases coming up in between the yearly IDA allocation exercise, the same group would convene as needed to discuss the appropriate response. During the initial period of implementation of the free-rider policy, Management will return to the Board when action in an individual country is proposed by the Operations Committee.

In cases where the initial disincentive mechanism did not lead to changes in borrower behavior or where the first breach was extremely large, stronger actions could be considered, requiring Board consideration. This could consist of deepened or extended application of the disincentives for moderate or repeated breaches. However, where breaches are very large or protracted IDA may need to escalate its response further. In this case IDA could seek a strong undertaking from the borrower to abide by an agreed borrowing strategy. If that does not lead to improved borrowing behavior, withdrawal of future financial support or disengaging from the country could be considered.

Given the data reporting issues that hamper the ability to address free riding, the paper describes the ongoing efforts to improve information flows. These include strengthening adherence to the Bank's debtor reporting requirements as well as introducing covenants on reporting requirements in new grant agreements and credit agreements for post-MDRI countries. Clear consequences for misreporting and a strong regular dialogue with countries on their borrowing strategies would help address this weakness. Ongoing efforts to strengthen creditor reporting systems could also provide useful alternative sources of information on new borrowing.

A follow-up paper would be presented to the Board within one year to take stock of ongoing creditor consultations and of accumulated experience with concrete country cases. Management undertakes to report yearly on the implementation of the general guidelines described in this paper.

IDA COUNTRIES AND NON-CONCESSIONAL DEBT: DEALING WITH THE 'FREE RIDER' PROBLEM IN IDA14 GRANT-RECIPIENT AND POST-MDRI COUNTRIES

I. INTRODUCTION

1. **A central element of the IDA14 Replenishment is the new system for allocating IDA grants on the basis of countries' risk of debt distress**. The analytical basis for this system is the joint IMF-World Bank debt sustainability framework (DSF),[1] which rests on three pillars: (i) indicative policy-dependent external debt thresholds; (ii) debt sustainability analyses (DSAs) and associated stress tests; and (iii) "an appropriate borrowing (and lending) strategy that contains the risk of debt distress" (World Bank and IMF, 2005).[2] During the IDA14 negotiations it was agreed that grant eligibility would rest on the first pillar during early implementation of the system, supplemented by DSAs (second pillar) as these become available.

2. **During the negotiations, the IDA Deputies also requested that staff prepare a paper proposing measures designed to discourage "free riding" by non-concessional creditors in the context of IDA14 grants**.[3] The provision of grants by IDA aims to improve the prospects for long term debt sustainability in IDA countries at risk of debt distress.[4] However, free riding, i.e., cross-subsidization through IDA grants of other creditors offering non-concessional terms to grant-eligible countries, could undermine this goal. While it will be important for IDA countries to develop, over time, normal relationships with creditors and a responsible credit culture to facilitate private sector development and public sector accountability, taking on non-concessional lending prematurely or on an unsustainable basis will lead to delays in acquiring good standing in capital markets.

3. **Following the IDA14 negotiations, the potential for free riding in IDA increased significantly as a result of the recently approved Multilateral Debt Relief**

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[1] World Bank and IMF (2004). *Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications*. Washington, D.C., February.

[2] World Bank and IMF (2005). *Operational Framework for Debt Sustainability Assessments in Low-Income Countries – Further Considerations*. Washington, D.C., March.

[3] "Additions to IDA Resources: Fourteenth Replenishment", March 10, 2005. Para 74. Specifically, the IDA Deputies requested a mechanism by which "a country could cease to be eligible for [IDA] grants if its government or other public sector entities contract or guarantee new loans from alternative sources of financing which threaten to defeat the debt sustainability objective that IDA grants are intended to achieve".

[4] Grants are limited to IDA-only, non-"gap" countries rated at medium or high risk of debt distress. IBRD/IDA blend countries and hardened-term countries are not eligible for grants, regardless of their debt sustainability status. Hardened-term countries are IDA-eligible countries whose per capita incomes are above IDA's operational cutoff for more than two consecutive years. Gap countries are those which have been above the IDA operational cutoff for many years, but whose access to IBRD is still very limited.

Initiative (MDRI).[5] Since the debt stocks of most of the recipient countries will be reduced to much lower levels, debt cancellation under the MDRI may magnify the potential free rider issues facing IDA and therefore IDA donors. A key concern is the risk that some non-concessional creditors may be willing to finance even low-return investments, since lowered debt ratios post-MDRI and the prospect of future IDA grants provides reassurance to creditors that post-MDRI borrowers will be able to service their loans. At the same time, to the extent that post-MDRI countries have capacity to manage public expenditures and public debt, this risk may be mitigated. The borrowing space created by MDRI also points to the broader issue of the *pace* of accumulation of new debt - concessional or non-concessional - following debt relief. The review of the DSF jointly being undertaken by the Fund and the Bank dealt with this more wide-ranging concern.[6] The present paper proposes measures to deal with free riding risks – and hence non-concessional borrowing – in the context of IDA grants and MDRI relief, as requested by the IDA Deputies during the negotiations of the IDA14 replenishment and the MDRI. It also updates and expands the earlier Board paper (IDA, March 2006) that dealt exclusively with free-riding in the IDA-grants context.

4. **This paper proposes general guidelines whereby IDA responds to free riding risks by creating disincentives to discourage non-concessional borrowing by grant-eligible countries and post-MDRI countries, while working towards enhancing communication with other creditors about the Bank and Fund's recommendations on the appropriate level of concessionality**. In this process, the DSF would play a key role with respect to both borrowers and creditors: first, as a tool to measure the impact of new, non-concessional debt on a country's debt sustainability, and second, as a basis for communicating concerns about debt sustainability and informing recommendations on the appropriate level of concessionality for IDA grant recipients and post-MDRI borrowers.

5. **The basic approach of this paper can be summarized as follows**. The free riding problem involves a collective action issue vis-à-vis creditors, and moral hazard risks vis-à-vis borrowers. These two aspects of the problem are dealt with through a two-pronged strategy, which involves: (i) enhancing creditor coordination; and (ii) encouraging appropriate borrowing behavior through borrower disincentives. In order to design such disincentives, IDA has only two instruments at its disposal: reducing volumes of IDA assistance and hardening the terms of its assistance. When applying these instruments, trade-offs at the country level emerge: volume cuts reduce resources that could be used to reach the MDGs; hardening of terms may exacerbate debt sustainability problems. Considerable care will therefore be needed when applying these disincentives – individually or in combination. Volume cuts would primarily be used in countries in which debt sustainability is a major concern; hardening of terms would be primarily used in countries with stronger debt sustainability prospects and greater degree of market access, consistent with IDA's longstanding policies on blend countries. But, a

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5 See IDA (2005). *The Multilateral Debt Relief Initiative: Implementation Modalities for IDA.* IDA/SecM2005-0592, November 21.

6 See World Bank and IMF (2006), "Review of Low-Income Country Debt Sustainability Framework and Implications of the Multilateral Debt Relief Initiative (MDRI)," IDA/R2006-0046, March 29.

flexible application of these principles will be needed in order to take into account the complexity of the problem at hand as well as the variety of possible country situations.

6. **The paper is structured as follows**: Section II briefly describes the problem of free riding and the risks of free riding in the context of IDA14 grant-recipients and post-MDRI countries. Section III discusses existing methods to measure concessionality and proposes a concessionality benchmark in order to identify possible instances of free riding. Section IV describes the proposed IDA response to the free-rider problem. Summary conclusions are presented in Section V. Annex I contains a description of different types of non-concessional external lending. The shares of non-concessional loans in total public and publicly-guaranteed external debt stocks as well as debt flows are presented in Annex II through V, while Annex VI and VII provide a breakdown of non-concessional debt by creditor type for different categories of countries.

II. Free Riding Risks associated with IDA14 Grants and MDRI Debt Relief

A. Conceptual Issues

7. **The term "free riding" is commonly used in the context of the sovereign debt restructuring literature**. In that context, it refers to situations in which unanimity among creditors is required, but where "minority holdout creditors may scuttle a restructuring even though it is advantageous to the majority".[7]

8. **In this paper, the term "free rider' is used as shorthand to refer to situations in which IDA's debt relief or grants could potentially cross-subsidize lenders that offer non-concessional loans to recipient countries**. The collective action problem in the grants and post-MDRI context, however, is not as well defined as in the creditor holdout context. In the latter, the collective action problem is clearly expressed in a minority rejection of an approach designed to be unanimous. In the post-MDRI context, there is no such presumption of creditor unanimity when setting the financing terms on new lending. However, free riding as understood here still refers to a potential externality since it reflects differences between collective and individual interests: IDA and its donors aim to lower the risk of debt distress in low-income countries by providing new financial assistance on appropriately concessional terms; per contrast, other creditors and borrowing governments themselves may gain from non-concessional lending following large-scale debt relief or in conjunction with grants provided by IDA.[8] A collective approach is therefore required to broaden creditor acceptance of the goals of debt sustainability.

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[7] Nouriel Roubini (2002), "Do We Need a New Bankruptcy Regime?" Brookings Papers on Economic Activity, No.1, pp. 321-33.

[8] It is possible that high levels of global liquidity may be a factor behind a search for investments with higher yields, even in traditionally risky environments. Thus, new non-concessional lending cannot be solely attributed to the lowered credit risk created by IDA grants or MDRI debt relief, but it nevertheless weakens the intended impact of these IDA flows.

9. **There is also a potential moral hazard problem vis-à-vis borrowers**. IDA grants and debt relief may introduce an incentive for countries to over-borrow from other creditors, which would force IDA to increase the grant share of its assistance. Incentive measures aimed at borrowers could help address this problem.

10. **Appropriate incentive mechanisms for borrowers need to distinguish between two distinct contexts in which free riding may occur: (i) IDA grants; and (ii) debt relief under the MDRI**. In the former context, most grant-eligible countries would be subject to heightened risk of debt distress, limiting their scope for non-concessional borrowing (except, for example, if they could collateralize their future export receipts). In the latter context, most countries would have limited risk of debt distress and improved prospects for non-concessional borrowing. Therefore, incentive mechanisms against free riding will need to cater to these differences.

11. **Trade-offs between the goals of debt sustainability and reaching the MDGs also need to be recognized**. Policies aimed at tackling free riding risks may involve fewer resources available for the MDGs in affected countries. Conversely, if sufficient concessional resources are not forthcoming, free riding through non-concessional lending may provide additional resources towards achievement of the MDGs, even if this undermines debt sustainability in the long run. A pragmatic approach to the problem of free riding needs to consider these potentially conflicting policy goals as well as the financial and policy context of the country and whether sufficient volumes of concessional lending are available.

B. The Risk of Free Riding

12. **It is difficult to anticipate the exact magnitude of the risk of significant accumulation of non-concessional debt.** In the context of grant-recipient countries with very limited access to financial markets, free-riding risks would tend to be relatively limited. Such risks would, however, be higher in resource-rich grant-recipient countries that could rely on non-concessional borrowing collateralized with future export receipts. This is amplified in countries with weak policy environments that do not receive significant flows of concessional resources. In the post-MDRI situation the risk may be greater since large amounts of debt relief and lowered debt ratios increase the borrowing space. This is particularly the case for post-MDRI countries which already have some access to capital markets, (such as Ghana and Bolivia), or will gain access to capital markets post-MDRI. For both groups of countries the risk is higher in those countries without the additional discipline imposed by non-concessional borrowing ceilings under an IMF-supported arrangement.

13. **Under the IDA14 grant allocation framework, the terms of new financial assistance available to individual IDA-only countries are determined annually based on their risk of debt distress, raising a risk of free-riding**. Debt-distress risk classifications, and therefore the credit-grant mix in the allocation norms (prior to any

volume discount),[9] are assigned in accordance with a three-category, "traffic light" system, as follows:

- "Green light": Low risk of debt distress. 100 percent credits.
- "Yellow light": Medium risk of debt distress. 50 percent credits, 50 percent grants.
- "Red light": High risk of debt distress. 100 percent grants.

During FY07, debt-distress risk classifications are determined primarily by means of the forward looking DSF-style DSAs. For countries where those are not available, a comparison between countries' latest available relevant external debt indicators[10] and the applicable external debt thresholds from the DSF.

14. **Notwithstanding the limited borrowing space that they signal, high debt ratios have not always deterred other creditors from providing non-concessional financing, especially in the group of resource-rich countries where loans can be collateralized**. Annexes II and III contain information on non-concessional borrowing for countries which are *currently* classified as high-risk cases in terms of debt distress and which are receiving grants in IDA14. In 2004, about 27 percent of the public and publicly-guaranteed (PPG) external debt stock of 39 IDA-only countries among those classified at high or moderate risk of debt distress in FY07 ("red light" or "yellow-light")[11] was non-concessional.[12] However, only five countries – Angola, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire and Sudan – accounted for 78 percent of the stock of non-concessional PPG external debt in this group of countries. In addition, in 2004, Angola alone accounted for 85 percent of the total non-concessional loan inflows to the 39 countries classified as "red light" and "yellow light" in FY07. Most of these countries are resource-rich, although ongoing conflict in a few inactive IDA countries with little access to concessional resources has also led them to resort to non-concessional borrowing.

15. **Furthermore, free riding risks may be exacerbated by the lower debt ratios brought about by the MDRI**. The debt relief provided by IDA is analogous to some 37

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9 Grant allocations are subject to a 20 percent upfront reduction in volume under the "Modified Volume Approach" (MVA). The 20 percent upfront volume discount facilitates a balance between needs and incentives in IDA's assistance to grant-eligible countries: (i) it helps address moral hazard concerns associated with providing softer terms to such countries, several of which are poor performing; and (ii) it transfers more resources to grant-eligible countries in present value terms than if they were to receive their IDA allocation in standard IDA terms. See IDA (2004). *Debt Sustainability and Financing Terms in IDA14: Further Considerations on Issues and Options*. IDA/SecM2004-0779, December.

10 The debt indicators which are relevant for the purposes of determining grant eligibility are: (i) the ratio of the net present value (NPV) of public and publicly guaranteed (PPG) external debt-to-Gross Domestic Product (GDP); (ii) the ratio of NPV of PPG external debt-to-exports; and (iii) the ratio of the service on PPG external debt to exports.

11 This excludes one "red light" country, Afghanistan, because of data unavailability.

12 It is important to note that the GDF-based data uses DAC's "umbrella" definition of concessionality, as discussed in Section III. If the Fund's definition was adopted for all debt, not just IMF debt, then the share of non-concessional debt for this group of countries would be higher (see also Box 2).

billion[13] of unconditional budget support on grant terms over 40 years for the group of MDRI-eligible countries. In addition, an estimated $5 billion and about $10 billion of debt relief will be provided by the IMF and AfDF respectively.[14] This relief is provided in addition to HIPC debt relief already committed. Post MDRI, debt stock ratios in most recipient countries will be significantly lower than for many middle-income countries (MICs) which primarily borrow on non-concessional terms (see Chart 1). For instance, Ghana, which currently has a B+ foreign currency rating from Standard and Poors, will see its present value of debt as a share of exports fall from 90 percent to 21 percent thanks to the MDRI, placing it well below the ratios for most MICs (see Table 1). It should also be noted that risks facing post-MDRI countries are also related to the assumption of contingent liabilities, in that private external creditors may expand their local private-sector financing given that, with larger fiscal space, these countries are more likely to bail out the private sector if problems arise.

16. **Early evidence shows that rating agencies may be upgrading commercial risk ratings for post-MDRI countries**. As noted in the 2006 *Global Monitoring Report*, "credit ratings have been paying attention to this new reality, and Standard and Poors (S&P) announced its plans to assign sovereign debt ratings for many post-MDRI countries".[15] In addition, Moody's recently upgraded long-term foreign currency credit ratings of Honduras and Nicaragua: from B2 to Ba3 and from Caa1 to B3, respectively. It should be noted, nonetheless, that lower debt ratios alone would not necessarily lead to changes in commercial risk ratings for these countries (these also take into account political risk).[16]

17. **Past non-concessional borrowing patterns cannot be a predictor of risk in the new post-MDRI environment.** Annexes III and IV indicate that the level of borrowing by the post-MDRI countries was on average quite low. But high debt levels in the past may have left many HIPC countries supply-constrained on external borrowing. The likelihood of countries benefiting from HIPC and future debt relief initiatives may have been strong deterrents for commercial creditors to extend non-concessional loans.[17] In addition, the borrowing ceilings under the PRGF arrangements required to develop a track-record to reach completion point under the HIPC initiative, posed additional constraints to non-concessional borrowing that may not continue for all countries post-MDRI.

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[13] See IDA (2005), "The Multilateral Debt Relief Initiative: Implementation Modalities for IDA," IDA/SecM2005-0592, November 21.

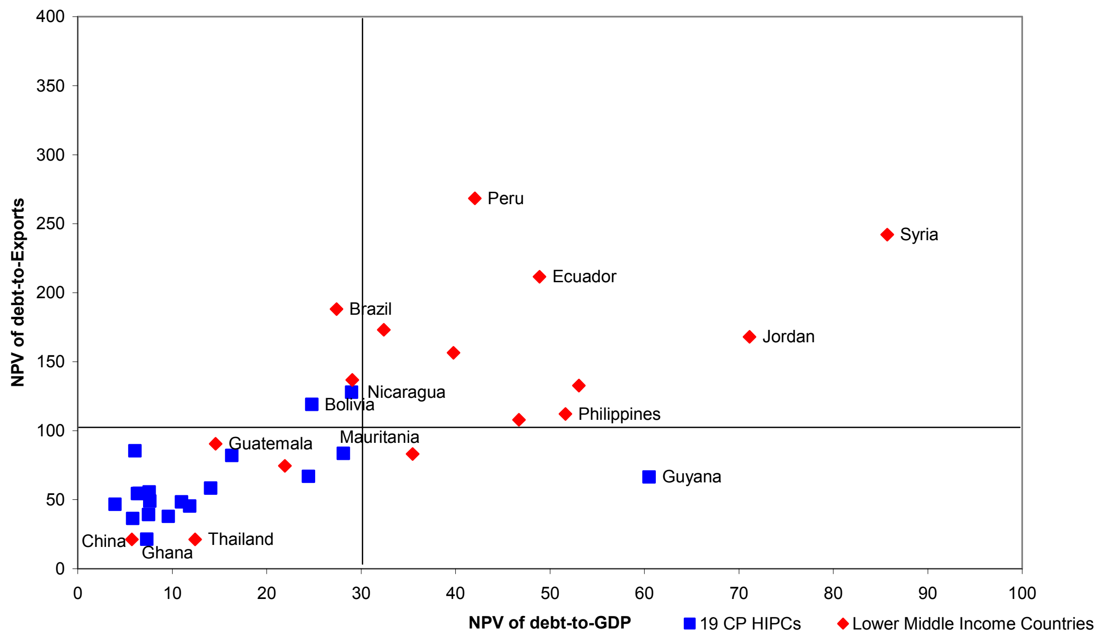
[14] See IDA (2005), "The G8 Debt Relief Proposal: Assessment of Costs, Implementation Issues, and Financing Options," IDA/SecM2005-0466, September 6.

[15] See World Bank (2006), *Global Monitoring Report*, pp. 91-2.

[16] For instance, IBRD considers 8 key factors in its creditworthiness assessments, including political risk, external debt and liquidity, fiscal policy and public debt burden, balance of payment risks, economic structure and growth prospects, monetary and exchange rate policy, financial sector risks, and corporate sector debt and vulnerabilities.

[17] The universal creditor coverage under the HIPC Initiative and the common reduction factor that applied to all creditors meant to address some of the potential free-rider problems. Without such features, there is inherently a higher risk of free-rider problems from the MDRI.

18. **Implementing prudent public borrowing strategies post-MDRI will be key to mitigating the risk of free-riding.** Box 1 points out that much more of grant-eligible and post-MDRI countries' large development needs can be met without jeopardizing debt sustainability if the resources are provided on concessional terms. However, capacity to analyze the impact of new borrowing on long-term debt sustainability and on macroeconomic scenarios remains weak in most HIPC countries.[18]



Source: Debtor Reporting System, WDI 2005, and staff estimates.
1/ Debt ratios based on end-2003 PPG debt and IMF credits, denominator based on 3-year average, 2001-2003.

[18] See World Bank (2006), "Debt Relief for the Poorest: An Evaluation Update of the HIPC Initiative".

Table 1. Debt Burden Indicators: Pre- and Post-MDRI (percent)

Country	Pre-MDRI debt relief		Post-MDRI debt relief		Moody's long-term foreign currency rating 3/	
	PV/GDP 1/	PV/EXP 2/	PV/GDP 1/	PV/EXP 2/		
Benin	23	191	7	55	B+	4/
Bolivia	36	173	25	119	B3	
Burkina Faso	16	223	6	85	B	4/
Cameroon	17	133	11	48	B-	5/
Ethiopia	23	150	8	49		
Ghana	31	90	7	21	B+	4/
Guyana	77	84	61	66		
Honduras	34	92	24	67	Ba3	
Madagascar	27	140	8	39		
Mali	32	132	14	58	B	4/
Mauritania	70	207	28	84		
Mozambique	31	157	16	82	B	5/
Nicaragua	38	167	29	128	B3	
Niger	21	155	8	56		
Rwanda	13	150	4	47		
Senegal	29	116	10	38	B+	4/
Tanzania	23	142	6	36		
Uganda	30	258	6	54	B	5/
Zambia	45	174	12	45		
Average	**33**	**156**	**15**	**63**		
Median	**30**	**153**	**9**	**55**		

Source: Debtor Reporting System, WDI 2005, and staff estimates. Credit ratings from Bloomberg.
Notes:
1/ The numerator is the present value of public and publicly guaranteed debt and IMF credits. Both the numerator and denominator refer to 2003 data.
2/ The numerator is the present value of public and publicly guaranteed debt and IMF credits. The numerator refers to 2003 data. The denominator refers to the backward 3-year average, 2001-3.
3/ As of June 06, 2006.
4/ Standard and Poors long-term foreign currency rating, as of June 6, 2006.
5/ Fitch long-term foreign currency rating, as of June 6, 2006.

Box 1: The Impact of Non-Concessional Borrowing

The results below are based on DSAs for seven MDRI beneficiaries (Nicaragua, Guyana, Tajikistan, Mali, Niger, Uganda, and Zambia). The baseline is represented by the debt ratios after assuming full delivery of MDRI relief from IDA, IMF, and AfDF. We simulated the sensitivity of the debt ratios in these countries to a temporary (10-year) scaling up of concessional and non-concessional borrowing.

Concessional borrowing was modeled as IDA terms — 40 years maturity, 10 years grace period, and an interest rate of 0.75 percent — whereas non-concessional terms was modeled as 20 years maturity, 2 years grace period, and 5 percent interest. The latter corresponds to a grant element of about 10 percent, compared to a grant element of over 70 percent for IDA terms.

Figure 1: NPV of debt-to-exports ratio - Non-concessional borrowing of 1 and 3 percent of GDP 2006-15

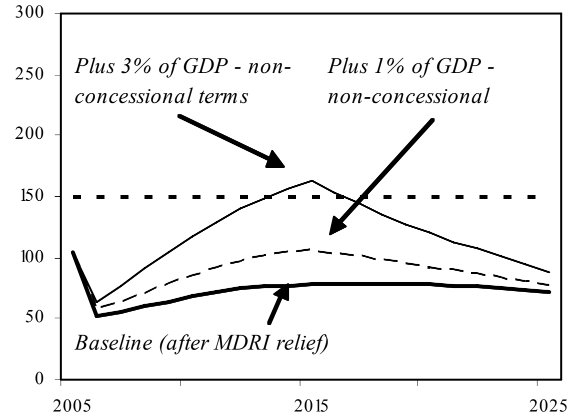


Figure 1 shows that, on average for the countries in the sample, a 1 percent of GDP increase in non-concessional borrowing over 2006-15 does not lead to a breach of the 150 percent thresholds for the NPV of debt-to-exports ratio, whereas an increase of 3 percent of GDP does.

Figure 2 shows the impact of an increase in borrowing of 3 percent of GDP over 2006-15 on concessional and on non-concessional terms. The NPV of debt-to-exports ratio for the non-concessional borrowing scenario increases much more rapidly than the corresponding ratio for concessional terms, peaking at over 150 percent in 2015, about 40 percentage point higher than the peak in the concessional borrowing scenario. Over the remainder of the projection period, the two ratios tend to converge, reflecting the fact that as temporary scaling up of new borrowing ceases, non-concessional debt is more quickly paid off, given its shorter maturity and grace period. The sharper decline in the NPV of debt, though, comes at the cost of much less favorable resource flows (Figure 3). In sum, for a given borrowing path, non-concessional borrowing yields a smaller net resource flow and worse debt dynamics than concessional borrowing.

Figure 2: NPV of debt-to-exports ratio - Non-concessional vs. concessional borrowing 2006-15

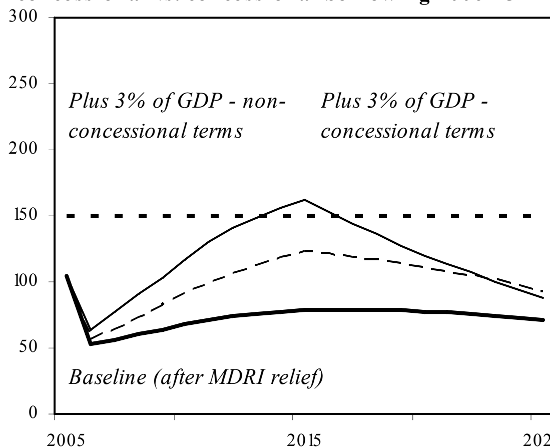
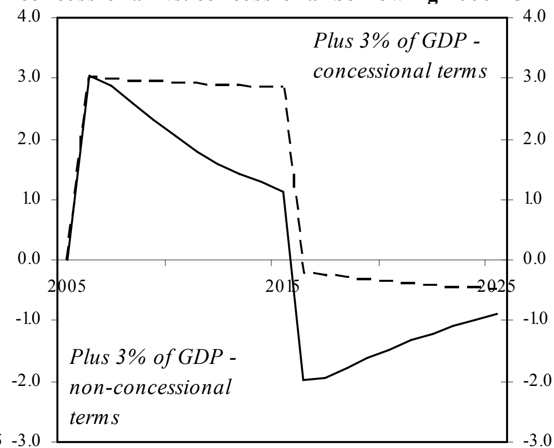


Figure 3: Change in resource flows - Non-concessional vs. concessional borrowing 2006-15



Source: prepared in collaboration with IMF staff

III. Establishing Appropriate Concessionality Benchmarks and Identifying Cases of Free Riding

19. **Before laying out the proposed IDA response to the free-rider problem, it is necessary to select an appropriate concessionality benchmark that would enable the differentiation between concessional and non-concessional lending**. This is a key building block in the identification of actual instances of free riding. Although there is no clear definition of non-concessionality, in general terms concessional debt can be defined as "lending extended by creditors at terms that are below market terms with the aim of achieving a certain goal".[19] In practice, there are different approaches on how to deal with measures of concessionality for the purposes of this paper. As noted in the *External Debt Statistics: A Guide for Compilers and Users*, "[t]here is no unique definition of concessionality, and even the *Guide* does not provide nor recommend one."[20]

20. **There are multiple ways to measure the concessionality of an individual loan**. The OECD's Development Assistance Committee (DAC) definition is commonly used by the OECD and retained for some statistical purposes even in World Bank reports including the Global Development Finance (GDF) publication. Under the DAC definition, "concessional lending (that is, lending extended in terms that are substantially more generous than market terms) includes: (i) official credits with an original grant element of 25 percent or more using a 10 percent rate of discount (that is, where the excess of the face value of a loan from the official sector over the sum of the discounted future debt-service payments to be made by the debtor is 25 percent or more using a 10 percent rate of discount) [and concessional in nature]; and (ii) lending by the major regional development banks ([the] African Development Bank, [the] Asian Development Bank, and the Inter-American Development Bank) and from the IMF and [the] World Bank, with concessionality determined on the basis of each institution's own classification of concessional lending. All external debt not classified as concessional should be classified as non-concessional."[21] The second part of DAC's "umbrella" definition incorporates institution-specific definitions of concessionality by the IMF, the World Bank, and the regional development banks. However, the major drawback of the DAC methodology is that the fixed 10 percent discount rate used implies that even commercial loans could be deemed concessional given today's low interest rate environment (see Box 2).

21. **A practical alternative would be the definition of concessionality used in IMF programs**. Since October 1995, the IMF has adopted for its low-income members a definition of concessionality with a higher grant element test than DAC's. The IMF defines debt as concessional "on the basis of currency-specific discount rates based on OECD commercial interest reference rates, and including a grant element of at least 35

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[19] Dipplelsmann, R. and A. Kitili (2004), "Concessional Debt," IMF Committee on Balance of Payments Statistics, Balance of Payments Technical Expert Group, Issues Paper No.29, p. 3.

[20] IMF (2003a), *External Debt Statistics: Guide for Compilers and Users*, June, p. 45.

[21] *Ibid,* pp. 45-6.

percent, provided that a higher grant element may be required in exceptional cases”. [22] Based on this definition, the ceiling on new non-concessional debt is usually set at zero, although non-zero ceilings can be used for countries close to emerging market status. This definition is the basis for performance criteria[23] in Poverty Reduction and Growth Facility (PRGF)-supported programs on minimum concessionality of newly contracted debt. This definition is also close to that used by the OECD since the mid 1990s to determine the concessionality of lending by export credit agencies.

22. **This paper recommends that the definition of concessionality underpinning such performance criteria in IMF programs be used as an *indicative* baseline on which to identify actual instances of free riding**. There are several advantages to this proposed solution. First, and foremost, it helps minimize the policy uncertainty involved in introducing completely new, and untested, concessionality benchmarks. Second, a breach of the performance criteria has financial implications for countries with a PRGF arrangement, which could in itself help discourage non-concessional borrowing behavior.[24] Third, in line with the DSF, the Fund Board has also endorsed additional flexibility in the minimum concessionality requirement,[25] which would facilitate the judgment-based approach proposed here. It is important to stress that, for IDA’s purposes, such a minimum concessionality measure would not become an automatic performance criteria for IDA assistance but would be used to identify potential cases of free-riding.

23. **It is also proposed that a loan-by-loan approach rather than an aggregate approach be adopted to identify instances of free riding**. This would be consistent with the Fund’s minimum concessionality approach, which applies on a loan-by-loan basis.[26] It could be argued that the DSF methodology would call for a focus on the *average* concessionality of new borrowing rather than on loan-specific information. In fact, DSAs could be used to establish the maximum present value of new borrowing – and thus the overall degree of concessionality – that is consistent with debt sustainability.

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[22] IMF, *Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements – Change in Coverage of Debt Limits.* Executive Board Decision No. 11096-(95/100), adopted October 25, 1995.

[23] See IMF (2002), *Guidelines on Conditionality*, September: “A performance criterion is a variable whose observance or implementation is established as a formal condition for the making of purchases or disbursements under a Fund program” (p. 4).

[24] Depending on the magnitude of the breach and on the nature of the loan, country authorities may request and obtain from the IMF Board a waiver of the performance criteria on minimum concessionality. If given, such waiver could also be accepted by IDA for the purposes of classifying the concerned loan as an acceptable case of non-concessional borrowing. A recent example of such situation was Rwanda’s breaching of the 50 percent minimum concessionality performance criterion under its PRGF arrangement by contracting an energy rehabilitation loan with a grant element of 47 percent. See IMF (2004b), *Rwanda: Second and Third Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility,* IMF Country Report No. 04/270, August.

[25] IMF (2004a). *Op. cit*.

[26] Loan-by-loan accounting of all new loans contracted or guaranteed by the public sector on a quarterly basis is part of the reporting obligations of countries to the IMF under a Fund-supported program.

Box 2. Comparison of Concessionality Benchmarks: DAC vs. IMF

Defining a *concessional* loan involves two steps: the first step is to calculate the grant element (GE) of the loan; and the second step is to determine where this lies relative to an established benchmark of concessionality. Depending on the methodology used to determine the grant element and the concessionality benchmark, a loan is identified as concessional or non-concessional.

The first step in deriving the grant element is sensitive to the choice of the discount rate in computing the present value of expected repayments over the maturity of a loan, as the grant element is the difference between the nominal value of the loan and the discounted present value. This can be measured either as the benefit to the borrower or the opportunity cost to the lender. In OECD DAC statistics the concessionality test is designed to determine whether a donor has incurred an opportunity cost by making funds available for aid, and hence whether the funds can be classified as ODA. The discount rate used to calculate the NPV of a loan in the DAC definition is a flat 10 percent, while that used by the IMF in the context of PRGF performance criterion is the CIRR rate, or currency-specific commercial interest reference rate.

$$GE = \frac{\text{Nominal} - \text{NPV}}{\text{Nominal}} * 100$$

Given that CIRRs are currently at about 5 percent on average, the DAC method would estimate a higher grant element of a loan (i.e., a lower present value) than the IMF method. For instance, Country X contracted an official bilateral loan of US$1 billion with 5 percent interest rate, 16 year maturity and 4 year grace period. The DAC method estimates that a grant element in such a loan is 32 percent (i.e., the discounted present value of expected repayments is $0.68 billion). On the other hand, the IMF methodology estimates concessionality at only 16 percent (i.e., the present value is US$0.84billion).

The second step is to set the level of concessionality:

DAC: Loan is concessional if GE >= 25 percent
IMF: Loan is concessional if GE>= 35 percent (under its PRGF performance criteria).

Using the example above, the DAC method would identify such a loan as ODA, while the IMF would define the loan as a non-concessional one. The table below illustrates how the methodology to define concessionality can result in a significant difference is the estimate of the amount of non-concessional loans in a given country for a given period: the DAC methodology underestimates the total non-concessional loan amount.

Non-concessional loans committed in 2004, selected countries:
DAC methodology vs. IMF methodology (in US$ million)

	Non-concessional loan (face value)	
Country	DAC	IMF
Angola	2350	3387
Cambodia	11	64
Gambia	0	19
Guyana	0	4
Malawi	0	6
Sierra Leone	0	10
Sudan	39	257
Tajikistan	0	23

Source: Staff estimates.

Such an aggregate approach, however, introduces a number of conceptual problems. First, while an aggregate rule based on the NPV of new borrowing would give an indication of the overall degree of concessionality, it could also falsely detect free riding in cases in which the grant element on new borrowing were very high but the lending volumes were large. Second, if a country borrows from different creditors on varying terms, it would be difficult to identify the specific incidence of free riding: Would it be the last loan that lets the country breach the average concessionality benchmark, even it is on the most concessional terms, or would it be the least concessional loan that may have been disbursed well before the concessionality benchmark was reached? In addition to these conceptual issues, at the current stage of implementation of the DSF, focusing on an aggregate NPV ceiling may not yet be feasible for a critical mass of countries. These considerations highlight the difficulties associated with attempting to deter free riding through mechanistic rules based on rigid aggregate NPV ceilings. However, *indicative* aggregate NPV ceilings, when available, could be a complementary, rather than primary, signpost for identifying possible free riding cases.[27] The determination of actual cases of free riding would take into account a number of principles and criteria, as will be discussed further in section IV.

24. **The proposed approach may need to be amended or complemented by alternative sources of information on concessionality for these countries, especially for grant-eligible countries without an IMF PRGF**.[28] To avoid inequity with respect to PRGF countries, the same approach to measuring minimum concessionality should be adopted for non-PRGF countries. Again, the minimum concessionality measure should be taken indicatively rather than strictly, allowing room for judgment in determining when any given loan is an actual instance of free riding. However, if countries have weak data reporting to the Bank, there is an inherent practical difficulty in assessing grant elements of individual loans outside a Fund-supported program. In such cases, indicative aggregate NPV ceilings – focusing on the average concessionality of new borrowing – could play a more prominent role in assessing potential instances of free riding as a complementary concessionality benchmark. This underscores the importance of joint Bank-Fund DSAs for countries without a formal Fund-supported program.

25. **Identifying instances of free riding requires strong and timely access to information on new borrowing**. The General Conditions applicable to IDA credits and grants provide for an ongoing obligation on the part of recipients to furnish to IDA all such information as IDA reasonably requests on the "financial and economic conditions

[27] Some degree of flexibility in applying the proposed concessionality benchmark may be desirable in light of established practice and policies of official creditors, particularly multilaterals. Whenever warranted in terms of a case-by-case analysis, the relevant measure could be the overall concessionality of total new lending by an official creditor to a given borrower or the overall concessionality of a financing package for a particular investment, rather than the grant element of each individual loan provided by that creditor or for that particular investment.

[28] Currently, the following are grant-eligible countries which either never had a Fund-supported program, or for which the last IMF program expired before 2000: Afghanistan, Angola, Bhutan, Eritrea, Liberia, Samoa, Solomon Islands, Sudan, Togo, and Tonga.

in its territory, including its balance of payments and its external debt".[29] The Bank's OP14.10 ("External Debt Reporting and Financial Statements") provides that, in fulfilling this obligation, countries are required to report on their public or publicly-guaranteed, as well as private non-guaranteed, external debt on quarterly basis and to provide an annual summary report.[30] However, compliance with these reporting requirements has been mixed – while most countries do provide at least the annual summaries, the data is often provided with a significant lag, and the quality is uneven.[31] When unavailable within the World Bank's loan-by-loan Debtor Reporting System, some complementary information on new borrowing could be obtained in the context of countries' reporting obligations under IMF programs, through Bank or Fund missions particularly in the context of updates to the DSA, and from OECD's Creditor Reporting System.[32]

26. **The identification of instances of free riding would be limited to external debt**.[33] Domestic debt is usually non-concessional in nature, and all countries need to contract domestic debt and develop their domestic capital markets, hence most countries would have confirmed instances of free-riding if such debt was considered. Where international investors purchase domestic debt instruments, however, these debts become classified as external, and hence would be under the scope of the free-riding policy, especially when these are motivated by the country's lower risk-ratings post-MDRI.[34] In general data on domestic debt is not systematically available, and domestic debt is not part of a country's reporting requirements to the World Bank. The DSF review points to the poor quality and non-comparability of domestic debt data as a continuing problem that will be addressed further in the follow-up to the DSF review. In a number of countries where domestic debt is a significant macroeconomic issue, their IMF programs pursue a strategy aimed at limiting or reducing the volume of net domestic financing and the debt service burden.[35] The September 2004 IDA14 grants paper concludes that "the

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[29] As with other covenants, if this covenant is not complied with, the General Conditions give IDA the right to suspend disbursements under grants and credits and, ultimately, accelerate repayment of credits.

[30] It is pointed out in OP 14.10 (paragraph 4) that "as a condition for Board presentation of loans and credits, each borrowing or guaranteeing country must submit a complete report (or an acceptable plan of action for such reporting) on its foreign debt." Management has updated OP 14.10 to include IDA grants.

[31] The DEC Development Data Group publishes an annual Status Report on country submissions to the Debtor Reporting System. The most recent report (November 2005) shows that 13 countries had not met their reporting requirements under OP14.10, and 19 more were judged to have major problems. Of these 16 were IDA or blend countries and four were low-income countries in non-accrual status.

[32] Another potential source of information on new non-concessional borrowing would be the Berne Union.

[33] This would include public and publicly-guaranteed loans, including loans contracted by public enterprises that entail contingent liabilities for the government.

[34] See IMF (2003a), *op. cit*., pp. 122-125, for a discussion of different approaches to compiling information on nonresident investment in domestically issued securities, which include using data collected from domestic financial intermediaries as well as gathering data on securities from investment dealers "that conduct portfolio investment business on behalf of nonresidents" (p. 123).

[35] See IMF and World Bank (2004b), *Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications*. September. This document

public domestic debt component of the framework should be treated separately from the external debt, and that treatment should be tailored to country circumstances".[36] This paper also recommends that the issue of domestic debt is best dealt with in the context of a country's macroeconomic framework under an IMF-supported program.

27. **There may be cases in which non-concessional borrowing would have stronger economic justification**. One example could be in the financing of large initial investments in projects – including "enclave" projects where appropriate – with potentially high risk-adjusted rates of return. Indeed, PRGF programs may contemplate non-zero limits for non-concessional lending, on a case-by-case basis and for projects for which there is a strong economic case. However, it is difficult to define, *a priori*, the circumstances under which such non-concessional borrowing is economically justified or not justified, and hence such borrowing would need to be considered on a case-by-case basis in the free riding context. At the same time, such investments are often in sectors where the government has long been encouraged by the Bank and the IMF to relinquish its majority share to the private sector. IDA's response will therefore require a case-by-case approach to breaches of concessionality limits given the debt sustainability and policy environment.

28. **It is unlikely, however, that sufficiently strong economic justification could be found for public sector borrowing collateralized with future receipts (CFR), particularly when motivated by the need to finance budget deficits in weak policy environments**. In weak policy environments such borrowing may also be motivated by rent-seeking behavior. In the IBRD context, CFR borrowing would be a violation of the Bank's negative pledge clause.[37] Such borrowing would potentially help perpetuate a country's fiscal and debt unsustainability and as such should be generally viewed as unacceptable in an IDA context as well.

29. **For grant-recipient countries and those that have weak policy environments, avoiding non-concessional borrowing in general would be appropriate**. As pointed out in the review of the low-income country Debt Sustainability Framework, even here "exemptions should continue to be possible where a case can be made to support non-concessional borrowing for a financially viable project that would not otherwise be taken". Given the collective action problem that leads to free-riding, in cases where a lender is willing to share in the risk through the provision of equity finance, an exception could more readily be considered. Box 3 lists a number of criteria that would be taken

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(referred to as the "Modalities Paper") includes a number of case studies of how domestic debt is being treated in IMF programs.

36 IDA (2004), *Debt Sustainability and Financing Terms in IDA14: Technical Analysis of Issues and Options.* September, p. 20.

37 In the Bank it is policy not to take security from a member government. The IBRD, therefore, protects itself by a negative pledge clause which prohibits the government from giving other lenders a position senior to the Bank through the establishment of collateral or otherwise (by similarly securing the IBRD with any collateral given to other creditors and thus preserving IBRD's position). IDA does not have such a clause. This is linked to the fact that IDA does not have a credit rating to preserve. In addition, IDA's financing is closer to a grant than a market loan. To the extent IDA financing is on grant terms, there would be no IDA debt which could be secured under the terms of the IBRD negative pledge.

into consideration when considering whether a given non-concessional loan would be considered an exception for the purposes of the free-rider policy.

30. **For countries with strong governance and public expenditure management records there may be a stronger case for a given project to be financed non-concessionally if there were no other source of financing**. The recent Development Committee paper on fiscal space describes the high marginal productivity of public infrastructure in developing countries, and points to the lower stock of infrastructure as a major constraint to growth.[38] However, it also points out the importance of an efficient, high quality budget system as well as sound public sector management in providing reasonable assurance that expenditures will ultimately be productive. For non-concessional loans, such high quality systems are especially crucial to prevent a build up of debt without the necessary returns to investment to pay for the loan's debt servicing.

31. **It would be prudent to initially apply the same concessionality benchmark to post-MDRI green light countries as is used for grant recipient countries, in order to closely monitor even the countries at low risk of debt distress**. The post-MDRI "green light" countries will have low debt ratios as a result of the debt relief itself, and not as a result of good debt management or strong economic growth. As a result it makes sense to monitor their non-concessional borrowing closely given their fragile financial condition – especially in the early years post-MDRI.

32. **It is proposed to review the need to monitor free-riding in the post-MDRI context in green-light countries periodically, especially where the trajectory of debt indicators continues to be maintained at a sustainable level**. An appropriate vehicle for such a review would be at the time of a new Country Assistance Strategy. Ongoing work on a follow-up to the DSF paper aims to explore whether there is an optimal approach to eventually graduating countries to lower concessionality thresholds. Once countries have demonstrated prudent and sustained fiscal management and strong economic growth, there may be scope for technical assistance to help countries achieve the goal of accessing international financial markets.

IV. PROPOSED IDA RESPONSE

33. **IDA's proposed response to free riding in post-MDRI and grant-eligible IDA-only countries is based on a two-pronged approach, contemplating both the collective action and the moral hazard facets of the problem**. The first prong, enhancing creditor coordination around an agreed framework, deals with collective action issues. The second prong, discouraging free riding through disincentives aimed at the borrowing countries, deals with moral hazard issues and aims at consistency with IDA's long standing policies. Both prongs are presented and discussed in this Section. Subsection A discusses the role of the DSF in this context. Subsection B focuses on the incentive mechanisms applicable both to grant recipients and MDRI recipients. Subsection C deals with the operational implementation of such mechanisms.

[38] See World Bank (2006), "Fiscal Policy for Growth and Development: An Interim Report", DC2006-0003, April 6.

A. Enhancing Creditor Coordination Around the DSF

34. **Part of the complexity of the free rider issue stems from the fact that there is no institutional framework either for a formal creditor coordination process or for the prevention of serious breaches of concessionality benchmarks by opportunistic commercial lenders**. A collective response by creditors around a common approach to concessionality would be the ideal approach to the problem of free riding. However, a formal creditor coordination mechanism to deal with this issue in the context of IDA grants does not exist at present. While there is not a concessionality requirement directly or indirectly related to the DSF, the DSF can provide an analytical basis for recommendations about the desirable concessionality of new borrowing, which is consistent with debt sustainability.

35. **A mechanism to ensure creditor coordination could lead to a superior outcome for all involved creditors**. Free riding may ultimately backfire as the borrowers' risk of default would probably rise and lead to losses to all creditors in proportion to their seniority and exposure.[39] At present, no such formal coordination mechanism exists, though it is possible that the DSF, which aims to inform decisions about prudent lending to low-income countries, could serve as a coordinating tool among creditors. However, the DSF is not an institutional or contractual mechanism to *bind* creditors around a certain course of action. The DSF could therefore only *facilitate, but not ensure*, creditor coordination on the level of concessionality appropriate to individual low-income countries. As such, the DSF could not be expected to solve the free-riding problem associated with the provision of grants by IDA and other official creditors.

36. **The DSF could help the global creditor and donor communities achieve a common understanding of the appropriate level of overall concessionality for low-income borrowers**. The key link with the DSF is the latter's third pillar, or the design of borrowing and lending strategies consistent with the objective of reducing countries' risk of debt distress. The creditor coordination problem may therefore be lessened over time as more creditors rely on the DSF as an analytical basis for a common approach to concessionality. In this context, the Paris Club of bilateral creditors has agreed to use DSAs prepared by IMF staff in the context of Paris Club reschedulings. In addition, some progress has already been made with respect to other multilateral lenders: the African Development Fund (AfDF) adopted the DSF as the foundation for its grant allocation system under AfDF-X; and the Asian Development Fund (AsDF) has adopted a grants framework similar to that of IDA13 – which may be re-assessed during the AsDF-IX Mid-Term Review to further incorporate debt sustainability considerations. Given that most of the concessional assistance reaching IDA countries would likely come from these sources, ongoing progress in strengthening coordination around the DSF among such creditors should help lessen concerns that excessive accumulation of *concessional* debt becomes a major threat to debt sustainability going forward. However,

[39] This does not necessarily hold in case of borrowing collateralized with future receipts, since collateralized debt is senior to non-collateralized debt. Refer to discussion in Annex I.

a number of multilateral creditors have not embraced the DSF to the same extent given limited ability to vary concessionality to take into account debt sustainability concerns.

37. **The immediate next step would be to establish with the IMF a common approach to increase acceptance of the DSF among other multilateral institutions and official bilateral lenders**. To the extent that official creditors are represented by their participation in the IDA Executive Board, improved information flows and creditor coordination is likely to be most effective and may help ensure policy coherence. Coordination around concessionality levels may be more complicated vis-à-vis other official creditors such as export credit agencies, or other multilateral agencies that lend at less concessional terms. These factors would pose less of a problem for borrowing countries that already need to meet performance criteria on minimum concessionality in the context of Fund-supported programs. Ultimately, the DSF can turn into an effective coordination tool only if it can be used to underpin an informal arrangement among official creditors.

38. **The discussion on free riding has brought to the forefront the need to communicate clearly the appropriate level of concessionality as well as any proposed measures in response to the problem**. Such communication is important not only to the recipients of IDA assistance but also to donor and creditor governments which are responsible for ensuring coherence between policies for promotion of exports and those for ensuring debt sustainability in low-income countries. In this context, the donor community has an important role in communicating its policy commitment to grants to its export credit agencies and other affected parties.

39. **Further inputs to the proposed free riding framework may originate from a number of creditor consultation initiatives underway**. First, Staff have consulted with other MDBs regarding the proposed free-rider approach and will encourage them to adopt a similar approach. Second, IDA staff have also attended the spring meeting of the OECD Export Credit Group, where an informal working group was established to explore options to better communicate these aspects of IDA policy at regular meetings of the OECD Export Credit Group. IDA and IMF staff also attended an informal working group meeting in late May that examined ways to maximize the usefulness of data sources beyond debtor-based reporting to also incorporate creditor-based reporting. Maximizing the available data to provide alternative sources would help monitor overall levels of borrowing, including non-concessional borrowing. The participants at the informal meeting also detailed some ways in which the DSF could be made more user-friendly, including through improving availability of the documents to all creditors. They also encouraged more clarity regarding the non-concessional borrowing limits in the IMF-supported arrangement for each country as well as non-concessional borrowing limits linked to IDA's free rider policy. The working group aims to present proposals to the broader OECD Export Credit Group at its fall meeting that would: (i) set out how this group of creditors could better align its policies to the DSF, taking into account the free-riding problem; and (ii) set out potential mechanisms for streamlining creditor reporting and information sharing. Third, contacts with some non-OECD creditors are now being explored, including possible presentations on the DSF and the free riding issue

at the Berne Union in the fall (which includes a number of non-OECD creditors). Finally, in order to increase awareness of the free rider policy and the DSF among commercial creditors, staff will also explore potential contacts with such creditors possibly through the IFC-sponsored "Equator principles" forum or the Global Trade Finance Facility. These consultations should provide IDA with key inputs to further develop the proposed approach to free riding issues.

40. **In response to the input from these creditors, an immediate next step would be to provide all creditors easy access to the DSAs that have been jointly prepared by the Bank and Fund**. Approximately 30 DSAs have been jointly prepared, and while most are currently posted on the IMF's website as attachments to the relevant IMF document, few are available easily on the Bank's website. This is because DSAs are usually appended to Bank CASs and DPLs, which are prepared less frequently than IMF program documents. It is therefore proposed to disclose all joint DSAs already in the public domain in a single location on the Bank's external website.[40] In addition, the DSF template and the relevant guidelines will also be made readily available.

41. **In addition, high-level fora such as the G8 and the G20 could help signal the need for creditors and donors to reflect debt sustainability considerations in their lending**. For example, the recent Pre-Summit statement of G8 Finance Ministers[41] urged all donors "to take account of debt sustainability issues in all their lending practices and share fully information on their lending to low-income countries".

B. Strengthened Debtor Reporting and Public Financial Management Capacity

42. **In the Bank, existing institutional channels such as the Debtor Reporting System (DRS) should be strengthened to obtain better information on new external borrowing, with the Regions playing a major role in ongoing monitoring of non-concessional flows**. As a Bank-wide effort, an informal working group consisting of staff from CFP, SFR, PREM, DEC and LEG has already been established to coordinate this effort and develop a strategy to improve adherence to OP14.10. Such a strategy, now being developed, is likely to require greater involvement of country teams in (a) requesting information from counterparts, and (b) monitoring newspapers and other sources of information on new borrowing by the government. For the reporting requirements to be effective, they must be accompanied by penalties for misreporting. As a result the strategy will also need to set out possible actions that will be taken when countries fail to report or file reports that are seriously flawed or significantly delayed and hence considered inadequate. Criteria are needed to define adequate reporting for this purpose. Actions in response to poor adherence to the reporting requirements under OP14.10 may include a delay in Board presentation of IDA projects for a minimum period of time or until the weaknesses have been addressed.

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[40] Executive Directors highlighted the importance of transparency and disclosure of DSAs to all creditors at the informal Board meeting to discuss the Review of the LIC Debt Sustainability Framework on April 18, 2006.

[41] Pre-Summit held in St. Petersburg. Statement dated June 10, 2006.

43. **In parallel, the Bank is working with the IMF and other donors to establish a global partnership to strengthen debt management capacity in low-income countries**. Significant risks are associated with weak debt management capacity. Debt management offices in many low-income countries lack adequate capacity to monitor and accurately record debt data and new resource flows, let alone effectively manage them. In response, the Bank has initiated a dialogue with other donors on the need to strengthen debt management capacity in low-income countries, in particular with respect to debt recording, reporting and monitoring. One possible proposal is to establish a global debt management partnership and engage with leading international and regional providers of debt management technical assistance. Such a partnership could deliver technical assistance to low-income countries based on a standardized diagnostic tool, and work with a select group of countries that have a demonstrated commitment to sound debt management.

44. **Beyond debt management, capacity building on macroeconomic and fiscal management is also necessary to help reduce the need for non-concessional financing, and Bank and Fund staffs remain engaged in providing such assistance**. Improving the efficiency of a borrower government's public expenditure management would help ensure that the funds released by the debt relief can be better and more transparently used to support growth and poverty reduction. Strengthened public financial management is already a priority in many countries, through public expenditure reviews and expenditure tracking, but it should be emphasized that such improved expenditure management may help to minimize requirements for additional fresh funding and minimize free-riding.

45. **The mere adoption of a common approach to concessionality is unlikely to prevent free riding by opportunistic lenders**. The experience with creditor litigation in the context of the current HIPC Initiative clearly shows that some commercial and official creditors are reluctant to adhere to a majority position and decide to hold out.[42] As with creditor participation in the HIPC Initiative, coordinated use of the DSF by other creditors is voluntary, so that moral suasion is the main means available to the Bank and the Fund.[43] While the Bank and Fund work closely together in broadening acceptance of the DSF also among bilateral and commercial creditors, it is recognized that IDA's main channel to reduce the incidence of free riding by opportunistic lenders is through country disincentives, although this does imply a somewhat asymmetric treatment of lenders and borrowers.

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[42] Litigation proceedings, mostly by commercial creditors, were launched against nine HIPC countries. See World Bank and IMF (2003), *Enhanced HIPC Initiative – Creditor Participation Issues,* April.

[43] One option that comes to mind to strengthen commercial creditors' accountability for the long-term welfare of the poorest countries is to publish incidences of non-concessional borrowing, including naming the creditor involved. However, where large profits are likely to be made, such naming is not likely to be a significant deterrent.

C. Discouraging Free Riding Through Borrower Disincentives

46. **Efforts towards increased creditor coordination around the DSF need to be combined with a focus on borrowers' behavior**. IDA can put disincentives in place that discourage grant-eligible and post-MDRI countries from engaging in non-concessional borrowing. The basis of measurement would be the concessionality benchmark proposed in Section III – namely, the IMF loan-by-loan definition of concessional debt used in PRGF arrangements. Concretely, loans to grant eligible countries and debt relief recipients which have a grant element lower than 35 percent would be identified as potential cases of free riding. In cases where the country has a Fund-supported arrangement and this requires a minimum concessionality benchmark higher than 35 percent, or includes a sub-ceiling for non-concessional borrowing, IDA would harmonize with the IMF approach in identifying cases of free riding. This general basis of measurement would apply equally in countries without an IMF-supported arrangement.

47. **The design of incentive mechanisms needs to reflect the fact that there are only two instruments available to IDA: the terms and the volumes of its assistance**. Therefore**,** disincentives could take the form of reductions to allocated volumes of assistance or hardening of the terms of such assistance – or a combination of both. Two basic mechanisms could be applied – individually or as a combination – to countries in which instances of free riding are detected:

- "Terms-based" mechanism: IDA would harden the terms of its assistance.
- "Volumes-based" mechanism: IDA would reduce its nominal allocation to the affected borrower.

48. **The choice of disincentives should be made on the basis of countries' risk of debt distress and degree of access to financial markets**. On the one hand, the greater is the risk of debt distress, the less appropriate is the use of a "terms-based" mechanism. If a country's debt sustainability prospects are fragile, a volumes-based response would be more suitable, even if it would involve fewer resources to reach the MDGs. On the other hand, if a country's debt distress risk based on a DSA is low, a volumes-based response would reduce resources for the MDGs. Thus hardening of terms would be a more effective response to free riding in this context, in that it reduces the IDA subsidy embedded in the IDA financing and ensures the same flow of resources, while presenting a tradeoff to the country when deciding to take on non-concessional borrowing. This is even more the case if low risk of debt distress facilitates market access and leads to more favorable credit ratings. In such situations, hardening of terms would be consistent with IDA's long standing "notional blend" policy.

49. **A flexible application of the measures available to IDA is required in order to take into account country-specific characteristics and circumstances**. Ironclad rules or "one-size-fits-all" responses are counterproductive to the extent that there are a wide variety of country circumstances requiring appropriately-tailored approaches. In that respect, two broad categories of countries are identified: (i) grant-eligible countries

(regardless of MDRI status); and (ii) "green light" MDRI-recipients. The application of available incentive mechanisms to each category will be discussed in what follows.

a. ***Dealing with Non-Concessional Borrowing in Grant-Eligible Countries***

50. **In the grants context, IDA's response should aim to preserve grant recipients' debt sustainability prospects, while minimizing IDA's potential costs due to free riding**. Grants are allocated to countries whose debt sustainability prospects are fragile. If IDA responds to instances of free riding in such countries by hardening the terms of its assistance, it would conflict with the grants framework's chief goal of containing debt distress risk.

51. **Therefore, a volumes-based mechanism – a reduction in nominal allocations – is recommended as a general rule to ensure consistency with the goal of IDA's grants framework**. Reducing nominal allocations would not lead to further increases in the present value of new IDA borrowing by affected countries, relative to the original allocation, as it would be the case with hardening of terms. Therefore, a volume reduction would better reconcile the objectives of reducing IDA's costs due to possible free riding while preventing countries' risk of debt distress from increasing further.

52. **An important practical consideration would be to determine the magnitude of the volume reduction**. The least distortionary choice for grant recipients with confirmed breaches of the concessionality benchmark would be to reduce nominal IDA grant allocations by the present value of repayments under a regular IDA credit, i.e., to allocate only the grant equivalent of a regular IDA credit. This means that nominal grant allocations to affected grant-eligible countries would be reduced by a further 20 percent to 40 percent, assuming that a regular IDA credit carries a 60 percent grant element. In fact, the 20 percent upfront volume discount adopted in IDA14 under the Modified Volume Approach (MVA) introduces an element of subsidy to grant-recipient countries by transferring to them more IDA resources in present value terms than what would be required to ensure cost equivalence between a grant and a regular IDA credit. This element of subsidy was warranted because the MVA aimed at reconciling the need to address incentive concerns with the goal of helping achieve the MDGs. By lowering the volume of grant allocations to the grant element of an IDA credit in response to free riding behavior, this subsidy would be eliminated. However, it should be stressed that non-concessional borrowing that contributes to debt unsustainability is itself likely to have a deleterious impact on borrowers' prospects for achieving the MDGs.

53. **The proposed measures would apply to grant-eligible "red light" and "yellow light" IDA-only countries alike.**[44] That is, for both country categories their nominal IDA grant allocations would be reduced by a further 20 percent to 40 percent. This reflects the fact that there are no fundamental differences between "red light" and "yellow light" countries: they are mostly a matter of degree of debt-distress risk. However, some differential treatment could be appropriate, in that "yellow light"

[44] This excludes "blend" and "gap" countries which are ineligible for IDA grants.

countries could benefit from a more flexible application of the exceptions to non-concessional borrowing ceilings (see Box 3).

54. **In the same vein, IDA's response to instances of free riding in MDRI recipients that are grant-eligible even after debt relief would also take the form of changes in assistance volumes**. That is, for those countries that are still at a moderate or high risk of debt distress even after MDRI, and hence continue to receive IDA grants, a volumes-based response would still be generally applicable. The fact that these countries still need to receive IDA grants after debt relief stresses their continuing vulnerability from a debt sustainability viewpoint. From this perspective, they are not qualitatively different from MDRI-ineligible grant recipient countries and should therefore be subject to the same set of disincentives.

55. **There are several risks involved with a volumes-based response to free riding**. The key risk is that affected countries may attempt to compensate for their reduced IDA allocations by seeking further non-concessional financing from other creditors. This risk is greater for countries without an IMF program, since they are not subject to the Fund's performance criteria on minimum concessionality. For countries with Fund-supported programs, the risk is lower since the breach of such performance criteria would jeopardize disbursements under the arrangement and support from other donors that is conditional on the Fund program. A related risk with this incentive mechanism is that awareness of the potential IDA response to the non-concessional borrowing may increase the incentive for some countries to not fully disclose borrowing information to multilateral creditors, or develop financing strategies that attempt to mask the extent of a country's obligations.[45]

56. **An important exception refers to cases of grant-eligible countries that have achieved a substantial measure of market access**. There might be instances in which, although a DSA may indicate moderate or high risk of debt distress, countries consistently borrow from financial markets at non-concessional terms, often relying on the country's natural resources as collateral.[46] In such cases, suspension of access to grants and hardening of terms – possibly in combination with volume cuts – could be a more effective response. This is consistent with the long-standing IDA policy that countries that are not yet creditworthy for IBRD but which have some level of market access should get harder terms. One possibility is to *effectively treat these countries as "notional" blends* and apply blend terms or progressively hardened terms to credits they receive from IDA.[47] This hardening of terms is automatic for notional blend countries and those above the IDA per-capita income cutoff.

[45] For instance, countries can establish a special purpose vehicle through which public sector borrowing is collateralized with future receipts (CFR) through an indirect arrangement. These loans are implicitly non-concessional. See Annex 1.

[46] Refer to discussion on CFR borrowing in Section III. Angola, classified as "red light" for FY06 and "yellow light" for FY07, is a clear example.

[47] Notional blends are borrowers that have a capacity or history of market-based borrowing and a per capita income below the IDA eligibility threshold, and which are currently unable to borrow from

Box 3: Principles that would guide exceptions to non-concessional borrowing ceilings.

The concessionality benchmark proposed for the purposes of identifying cases of free riding has been a proven benchmark in PRGF programs, and has served as a useful tool in that context to provide the borrower some "leverage" with the creditor in obtaining the best possible financing for a potential investment. PRGF programs clearly define ceilings on allowable non-concessional borrowing in countries (which are often zero). In the context of the PRGF, these limits can be overridden in one of three ways: (i) agreement ex ante within program criteria by defining a subceiling to accommodate a specific non-concessional loan, (ii) finding alternative financing or co-financing that would make the investment concessional or (iii) making a case that a waiver be granted for the performance criteria.

Similar to considerations that feed into decisions on non-concessional borrowing limits in the PRGF, a number of country-specific and loan-specific factors would be taken into account in the free rider context to assess whether an exception to the zero-ceiling using the proposed benchmark is warranted. Although many proposed loans may have merit on specific economic or financial terms, the country environment in which they occur will strongly influence actual outcomes. There should be a favorable assessment at both the country-specific level and the loan-specific level to warrant an exception.

Country-specific:

- **Overall borrowing plans of the country.** A modest level of overall borrowing by the country on the basis of the DSA to accommodate a particular investment may warrant consideration. For such a consideration, clear reporting of overall borrowing plans is needed, and enhanced creditor coordination through the DSF would facilitate this possibility.
- **Impact of borrowing on the macroeconomic framework.** Whether or not the borrowing would have a deleterious effect on the macroeconomic framework would influence the consideration of an exception.
- **Impact on the risk of debt distress.** The current risk classification, and whether or not the loan is likely to lead to a higher risk of debt distress will be a key consideration. Given their lower-risk of debt distress, and generally better performance, more flexibility is envisaged for "green light" countries. In addition, "yellow light" countries could benefit from somewhat greater flexibility than "red light" ones.
- **Strength of policies and institutions**, especially public expenditure management and debt management. As the fiscal space Board paper makes clear, policies and institutions in particular those governing the efficiency of public investment are critical.[1] Without these, even high return projects may fail to meet objectives.

Loan-specific:

- Development content and potential impact of the loan, i.e., investment will unlock a proven bottleneck to development as determined by analytical work such as a PER.
- Estimated economic, financial and social returns to investment of the project, weighted by the probability that the project will succeed.
- Lender equity stake in the project.
- No additional costs associated with the loan, i.e., collateralization, hidden costs.
- No other sources of more concessional financing are available.
- Concessionality of the overall financing package for a particular investment.

1/ See World Bank (2006). "Fiscal Policy for Growth and Development: An Interim Report", DC2006-0003, April 6.

IBRD due to marginal or deteriorating creditworthiness. Blend terms comprise 35 years maturity, 10 years grace period, 0.75 percent service charge, 0-0.5 percent commitment fee.

b. ***Dealing with Non-Concessional Borrowing in "Green Light" MDRI Recipients***

57. **Volume cuts would be generally inappropriate as an incentive mechanism for "green light" MDRI recipients**. The reason is threefold. First, volume cuts for countries that have already achieved a measure of debt sustainability in the wake of debt relief may undermine the chief MDRI goal of providing additional resources for the MDGs – without significantly affecting their already low debt distress risk. Second, there would be an equity issue vis-à-vis grant recipients: For the latter, the volume cut would bring the allocation down to the grant equivalent of an IDA credit. Since "green light" countries are receiving all of their allocation on credit terms, they are not receiving such a subsidy. Third, and perhaps most important, post-MDRI "green light" status may signal an increased market access capacity. As a result, there is an increased risk that "green light" countries will compensate for reduced IDA allocations with increased non-concessional borrowing. This risk could be increased further by the netting-out mechanism of the MDRI, which requires that debt service forgone be deducted from recipients' allocation norms.

58. **A response to non-concessional borrowing by "green light" MDRI recipients which is more consistent with long-established IDA lending policies would be for IDA to provide hardened but still concessional terms that "follow the market", acknowledging their *de facto* enhanced market access capacity**. Greater market access may indicate that countries could afford less subsidized assistance from IDA. Thus IDA assistance terms could be tailored in a way that is consistent with a country's access to financial markets and IDA's "notional blend" policy.[48] That is, IDA's assistance would still have positive grant elements, but concessionality levels would vary depending on each country's degree of market access. In addition to standard terms (40 years maturity, 10 years grace period, 0.75 percent service charge, 0-0.5 percent commitment fee), the following IDA assistance terms are currently available:

- blend terms (35 years maturity, ten years grace period, same charges), with a grant element of 57 percent.
- hardened terms (20 years maturity, ten years grace period, same charges), with a grant element of 40 percent.
- a less concessional "hard-term" window (blend terms plus interest rate at 200bp below IBRD lending rate in fixed-rate terms) – already available for India, Indonesia, and Pakistan – could be extended to post-MDRI "green light" countries with high levels of market access.

59. **Hardening of terms for "green light" countries that borrow non-concessionally recognizes their heightened ability to access market-based financing**

[48] Presently 13 IDA countries are classified as "blends", but some of these countries – including, Bolivia, Papua New Guinea, Uzbekistan, and Zimbabwe – are "notional blends" in that they are not currently receiving IBRD resources. Until very recently Nigeria was also classified as a "notional blend". Another 4 countries – Albania, Bosnia and Herzegovina, Honduras, and Serbia and Montenegro – have been above the IDA per-capita income cutoff for more than two years and receive "hardened terms" from IDA.

while presenting them with a tradeoff for such actions in terms of the concessionality of IDA's resources. This recognition should be substantiated by IDA's policy dialogue with the country on the implications of such non-concessional borrowing on the country's macroeconomic and debt sustainability. One advantage of this approach is that there would be no volume cuts additional to those required by MDRI's netting-out mechanism. Therefore, the MDRI goal of providing additional resources to these countries to help them meet the MDGs would not be undercut. This approach also acknowledges the goal for these countries to gradually move away from dependence on aid flows towards market based financing. This must be done in a gradual way to reduce the main risk of this approach, i.e., that their debt sustainability prospects worsen. Eventual access to IBRD would be determined by IBRD creditworthiness assessments as per IBRD policies.

60. **Structural economic weaknesses may prevent debt relief from increasing market access capacity in some "green light" MDRI recipients**. Lack of economic diversification, small export bases, and high vulnerability to shocks in fragile "green light" countries suggest that they could easily slip back into "yellow light" or even "red light" status when subject to exogenous shocks. Hence, hardening the terms of IDA assistance could have an adverse impact on these countries' debt sustainability prospects. In such cases, it would seem that volume cuts – as with grant-recipient countries – would on balance be a more appropriate policy response. DSAs and country economic work could help establish whether a given "green light" country is too fragile to be subject to hardening of terms. However, further work will be needed in devising clear criteria to identify "green light" countries for which hardening of terms would not be recommended in case of "free riding".

61. **A pragmatic application of the principles outlined in Box 3 would still be called for**. This includes increased flexibility for better-performing post-MDRI countries at low risk of debt distress. In addition, if flexibility for non-concessional borrowing has already been negotiated in the context of a PRGF arrangement, this new borrowing would not be subject to IDA's incentive mechanisms. The appropriate level of overall borrowing should also be guided by the DSF and the "case-by-case" approach for overall debt accumulation in the country.

D. Operationalizing the Incentive Mechanisms

62. **The operationalization of the incentive mechanisms needs to consider the nature and magnitude of the breach of the concessionality benchmark as well as country-specific circumstances**. There may be instances of relatively small and occasional breaches of the concessionality benchmark by creditors who are otherwise genuinely concerned about the long-term prospects of the countries at hand. However, emphasis should be placed on large breaches of concessionality benchmarks that result from politically-motivated decisions to borrow and/or from the actions of opportunistic commercial lenders, who feel that the space freed up by grants make lending possible to otherwise risky countries. Such borrowing may be motivated by governments who seek the short-term benefits for such non-concessional borrowing without considering the

longer-term costs for the country, which will remain long after that government ceases to be in power.

63. **IDA's response to each breach would be decided pragmatically based on a set of guiding principles.** Regions would play a major role in terms of monitoring the countries' non-concesssional borrowing and carrying out a policy dialogue with the country. Each year, at the time of the IDA allocation exercise, representatives from the Regions, CFP, PREM, DEC and OPCS will meet to review countries' non-concessional borrowing. Based on principles outlined in Box 3, this group would make recommendations on whether a non-concessional loan would be considered a breach of the free rider policy. For cases coming up in between the yearly IDA allocation exercise, the same group would convene as needed to discuss the response.

64. **In addition to determining whether a non-concessional loan is considered an instance of free riding, this group would also need to recommend the appropriate incentive mechanism to apply**. The response would aim to reduce the incidence of free riding through disincentives to prevent serious breaches before they occur, given the potential for free-riding to jeopardize a country's longer term debt sustainability. This could range from a 1-year to a multiple year application of the disincentive mechanism, and at the extreme end of the spectrum there could be a recommendation to withdraw from all future financial assistance in a given country or disengage.[49]

65. The decision made by this group would draw on a number of considerations:

- **Magnitude of the breach**, i.e., to what extent is the loan in question a breach relative to the 35 percent concessionality benchmark outlined in the paper. This depends on the interest rate and amortization schedule of the loan in question.
- **Size of the breach relative to a country's IDA allocation.** If the breach is large in absolute terms or as a share of the country's IDA allocation, the initial disincentive may not be sufficient, pointing to stronger disincentive (i.e. a volume reduction of greater than 20 percent reduction or hardened terms beyond blend terms.
- **Frequency/repeat violation**. For a country with a known record of non-concessional borrowing that has previously taken on a non-concessional loan despite the guidance to the contrary by IDA staff, or where there is an allegation of fraud or corruption, stronger measures may be necessary as discussed in paragraph 63.
- **Notified ex-ante or found out ex-post.** For countries reporting ex-ante that explored alternatives with Bank staff, a shorter application of the disincentive may be warranted.

Based on these factors the group would make a recommendation to the Operations Committee for a decision on the appropriate disincentive measure. For more serious or

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[49] Disengaging here refers to the complete withdrawal of future IDA assistance, including both financial assistance and technical assistance.

prolonged breaches, IDA would retain the option of applying higher volume discounts or progressively harder terms, and/or applying these discounts for a number of years. In instances where the non-concessional borrowing is clearly to the detriment of the country's development and poverty reduction prospects, there are likely to be related governance problems that would simultaneously be captured by IDA's performance-based allocation system, leading to lower overall performance-based allocations. This decision-making process is stylized in Box 4.

66. **In cases where IDA's initial disincentive mechanism did not lead to changes in borrower behavior or where the first breach was extremely large, stronger actions could be considered**. IDA will closely monitor the non-concessional borrowing behavior of countries where free riding has been a problem in the past, especially in cases where the incentive system has led to initial cuts in grant volumes. If the non-concessional borrowing continues despite continued contact between the Bank and the country authorities, and is likely to be detrimental to the long-term sustainability of the country concerned, IDA may have to escalate its response. In this case IDA could seek a strong undertaking from the borrower to abide by an agreed borrowing strategy, consistent with the DSF, in order to continue to provide financing to the borrower.[50] If that does not lead to improved borrowing behavior, disengaging from the country could be considered.

67. **In the early period of implementing the free-rider policy, management will return to the Board when action in an individual country is proposed by the Operations Committee.** In addition, IDA would report regularly on other cases of non-concessional borrowing where the incentive mechanism was not applied, possibly in IDA's annual report of commitments and disbursements.

68. **In cases where non-concessional borrowing has been contracted in FY06 that puts the country at increased risk of debt distress, despite warnings by country teams to the contrary, the country may be asked to cancel that loan agreement**. If the country refuses to cancel the loan, the Bank would consider an immediate application of the relevant disincentive, possibly limiting its assistance to the credit portion of the allocation, or in the cases of a green-light country, an immediate reduction in overall assistance and/or hardening of terms.

69. **It is important to acknowledge that there may be cases where IDA has very little leverage to reduce instances of free riding, even with strong disincentives**. As Table 2 shows, this would be the case especially where the IDA allocation is very small relative to available non-concessional financing sources, such as are available for mineral resource-rich countries. IDA's measures may still help deter free riders if similar measures are also introduced by other official creditors, or if other donors take these IDA measures as a signal for their own grant programs.

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[50] Such an undertaking implies that the contractual terms of any new financing would include a provision addressing non-concessional borrowing so that in the event of a further breach, IDA would be entitled to exercise its legal remedies to suspend (and accelerate if any credits), existing financing agreements.

Table 2. Non-Concessional Debt Flows as a Share of IDA allocations (in percent) 1/

Country	Nonconcessional debt-to-IDA allocations 3/
"Red Light" Countries 2/	
Afghanistan	..
Bhutan	458
Burundi	6
Cambodia	0
Central African Republic	0
Chad	102
Comoros	0
Congo, Dem. Rep.	2
Congo, Rep.	0
Cote d'Ivoire	7
Djibouti	9
Eritrea	0
Gambia, The	0
Guinea	48
Guinea-Bissau	0
Haiti	0
Kyrgyz Republic	0
Lao PDR	0
Liberia	0
Nepal	0
Niger	6
Rwanda	0
Sao Tome and Principe	7
Sierra Leone	3
Solomon Islands	0
Tonga	0
"Yellow Light" Countries	
Angola	2130
Ethiopia	6
Guyana	9
Lesotho	25
Malawi	0
Mongolia	0
Nicaragua	9
Samoa	1
Tajikistan	13

Source: Staff calculations based on *Global Development Finance* (GDF) 2005, preliminary GDF 2006, and FY06 IDA allocations (FRM).

Notes:

1/ Definition of concessionality: "Concessional LDOD (long-term debt outstanding and disbursed) conveys information about the borrower's receipt of aid from official lenders at concessional terms as defined by the DAC, that is, loans with an original grant element of 25 percent or more. Loans from major regional development banks - African Development Bank, Asian Development Bank, and the Inter-American Development Bank, and from the World Bank are classified as concessional according to each institution's classification and not according to the DAC definition as was the practice in earlier reports." (GDF II: Summary and Country Tables, 2005, p. xviii).

2/ Excludes Liberia, Myanmar, Somalia, Sudan and Togo, which were inactive IDA countries in FY06; also excludes Timor-Leste, which receives exceptional grant allocations per the IDA14 agreement.

3/ The numerator refers to the 3-year average, 2002-4, and the denominator to the FY06 allocations.

4/ .. Not available.

70. **Successful implementation of the proposed disincentive mechanisms require strengthened information channels, such as covenants on reporting requirements in new grant and credit agreements**. Additional requirements to notify IDA of any planned non-concessional borrowing, coupled with greater consistency in ensuring that borrowers comply with their debt reporting obligations, would help address the free rider issue. It is proposed that, in addition to the *ex post* reporting currently required of IDA recipients, all new grant agreements, and new credit agreements for post-MDRI countries would include a covenant which would require a country to notify IDA of any planned non-concessional borrowing at least 3 months in advance of contracting such borrowing. Such a covenant would give IDA the chance to intervene and present the country with alternative scenarios and long-term implications of such actions. To date, country teams had to rely on haphazard information on non-concessional borrowing plans in order to have a chance to prevent it. These proposals for strengthening IDA's reporting requirements to include planned non-concessional lending and improve compliance, combined with clear disincentives for non-concessional borrowing could help reduce new cases of free riding. Table 3 sets out the countries to which the IDA free-rider policy would apply.

71. **The various proposals put forward to address the potential free rider risks will involve incremental resources, especially for country teams tasked with the day-to-day country dialogue.** For most grant-eligible and MDRI-eligible countries, the responsibility for DSAs has already been mainstreamed to the country teams. But increased emphasis on improved debt and public financial management, improved debtor reporting, and requirements to be vigilant in detecting new non-concessional borrowing and make recommendations on these will add to the burden on country teams and central units. As a result the above approach will require re-prioritization of work on the Regions' side and strengthening of support from DEC, PRM, CFP, and others.

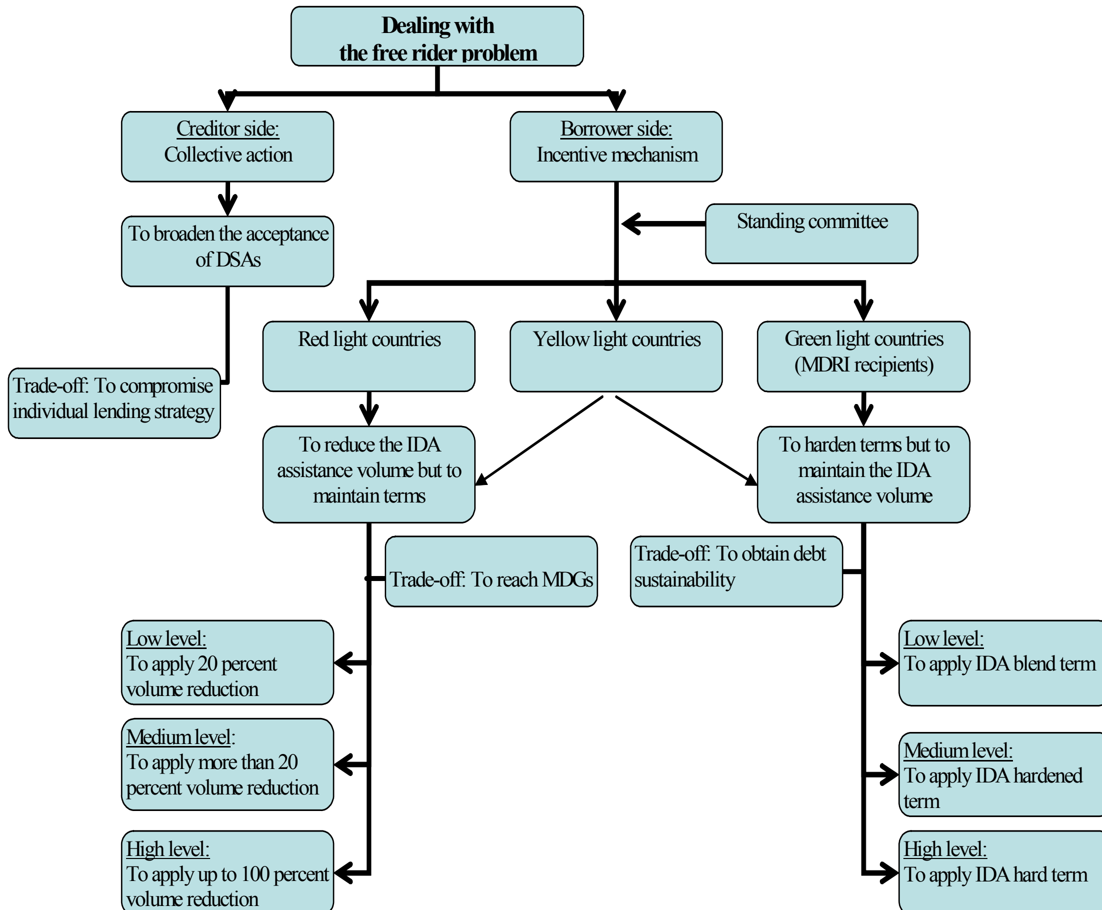
Table 3. Countries Subject to IDA's Free Riding Policy 1/

"Red Light" Countries 2/		"Yellow Light" Countries	Post-MDRI "Green Light" Countries
Afghanistan	Guinea	Angola	Benin
Bhutan	Guinea-Bissau	Ethiopia (MDRI)	Burkina Faso
Burundi	Haiti	Guyana (MDRI)	Cameroon
Cambodia	Kyrgyz Republic	Lesotho	Ghana
Central African Republic	Lao People's Democratic Republic	Malawi	Madagascar
Chad	Liberia	Mongolia	Mali
Comoros	Nepal	Nicaragua (MDRI)	Mauritania
Congo, Democratic Republic of	Niger (MDRI)	Samoa	Mozambique
Congo, Republic of	Rwanda (MDRI)	Tajikistan	Senegal
Cote d'Ivoire	Sao Tome and Principe		Tanzania
Djibouti	Sierra Leone		Uganda
Eritrea	Solomon Islands		Zambia
Gambia, The	Tonga		

1/ This list is subject to change should other countries qualify for IDA grants and/or MDRI. It includes all countries currently elilgible for IDA grants on debt-sustainability grounds, as well as post-MDRI green light countries. It excludes "gap" and "blend" countries which are not eligible for IDA grants, and which receive hardened or blend terms from IDA.

2/ Inactive countries including Myanmar, Somalia, Sudan and Togo are not listed, but would be subject to the free riding policy upon becoming active.

Box 4. Determining the appropriate IDA response



Notes:

1/ The level of free riding is determined by the magnitude of concessionality breach and/ or the size of the breach relative to a country's IDA allocation: i.e., **low** level of free riding refers to a situation where a loan has a concessionality level close to 35 percent and is small relative to the country's IDA allocation; **medium** refers to a concessionality level much less than 35 percent and/or a large size relative to the IDA allocation; and **high** refers to a concessionality level much less than 35 percent and/or a volume which is a multiple of the country's IDA allocation.

2/ In case of repeated free riding instances, volume reductions or hardening of terms can be extended or deepened.

V. CONCLUSION

72. **This paper has outlined a general framework for dealing with the potential free riding problem in grant-recipients as well as in the post-MDRI context as requested by IDA Deputies and Executive Directors**. While the potential for free riding cannot be eradicated by IDA's initiative alone, an appropriate and escalating response by IDA could help keep the problem in check, and help countries maintain the needed long-term flows on reasonable terms with reasonable stability. The proposed framework combines: (i) strengthened adherence to reporting requirements under OP14.10, as well a new clause in all grant agreements, and in credit agreements for post-MDRI countries, requiring advanced reporting on planned new non-concessional borrowing; (ii) incentive mechanisms aimed at restraining instances of non-concessional borrowing by low-income grant recipient and post-MDRI countries; (iii) efforts to broaden acceptance of the DSF as an analytical basis for a common creditor approach to concessionality for low-income borrowers; and (iv) efforts to communicate the debt relief, grant and free riding policies to the creditor community to reduce policy incoherence.

73. **As a result of the increased data needs for identifying cases of free-riding, an informal working group consisting of staff from CFP, SFR, PREM, DEC and LEG has been established to develop a proposal to improve adherence to reporting requirements under OP14.10**. This working group will evaluate the current policy and propose recommendations for strengthening adherence to the policy as well as appropriate responses to breaches of the reporting policy.

74. **It is recommended that the loan-by-loan definition of concessionality underpinning performance criteria in IMF programs be used as an indicative baseline for all grant-eligible and post-MDRI countries in order to identify instances of free riding**. Using this definition, a loan is considered concessional if it has a grant element of at least 35 percent (or more if such higher concessionality is warranted by an IMF-supported arrangement) using CIRR discount rates.

75. **Each year, at the time of the IDA allocation exercise, representatives from the Regions, CFP, PREM, DEC and OPCS will meet to review countries' non-concessional borrowing.** Should they determine that a given loan is in breach of the free rider policy (based on Box 3), they would then also make a recommendation to the Operations Committee regarding the appropriate incentive mechanism, on a case-by-case basis. For cases coming up in between the yearly IDA allocation exercise, the same group would convene as needed to discuss the appropriate response.

76. **The design of incentive mechanisms needs to reflect the fact that there are only two instruments available to IDA: the terms and the volumes of its assistance, or a combination of the two**. The choice of incentive mechanism needs to take into account the countries' risk of debt distress and degree of access to financial markets as well as tradeoffs between the goals of debt sustainability and reaching the MDGs. If a

country's debt sustainability prospects are fragile, a volumes-based response would be more suitable, even if it would involve fewer resources to reach the MDGs. On the other hand, if a country's debt distress risk is low, a hardening of terms would be a more effective response, while maintaining flows to help reach MDGs. A pragmatic approach is needed that considers the individual country situation.

77. **The proposed measure for grant-eligible countries and post-MDRI "red light" and "yellow light" countries would initially be an additional 20 percent reduction to grant-volumes**. This would bring the country's grant volume down by 40 percent after taking into account the 20 percent volume discount applied to all grants in IDA14, bringing the allocation volume down to the grant element of an IDA credit. Deeper and extended reductions to grant volumes would be recommended in response to frequent or relatively large breaches of the free-rider policy. During the early period of implementing the free-rider policy, Management will return to the Board when action in an individual country is proposed.

78. **For post-MDRI "green light" countries, providing hardened but still concessional terms in response to free riding would be most consistent with their greater market access and need for substantial volumes of concessional assistance to make progress towards the MDGs**. In such situations, hardening of terms would be consistent with IDA's long standing "notional blend" policy. Where IDA's initial policy response was not effective at limiting free riding, and hardening of terms beyond "hardened terms" is recommended, Board approval would be sought. Some "green light" MDRI recipients will still have structural weaknesses such as small export bases and high vulnerability to shocks that would preclude hardening of terms. In such cases volume cuts may be more appropriate.

79. **In light of the complexity of the free rider problem and the wide variety of country cases, a flexible approach to implementing these general guidelines should be followed**. By and large, volume cuts would be the default option for grant-eligible countries, and hardening of terms the default option for "green light" MDRI recipients. However, ironclad or "one-size-fits-all" approaches would not work; country-specific circumstances would need to be taken into account when deciding, for example, whether the appropriate response to a free riding case should involve hardening of terms or volume reductions.

80. **It is proposed to continue the dialogue with other creditors to enhance creditor coordination around the DSF**. An ongoing dialog with the OECD Export Credit group has helped to raise awareness of the problem. The group of interested OECD members agreed to present proposals to the broader OECD/ECG community at their semi-annual meeting in November to which a number of non-OECD creditors have also been invited to attend. Their proposals aim to: (i) improve creditor coordination around the DSF principles and ensure high quality lending to LICs; and (ii) streamline reporting requirements for officially supported lending to LICs lending while improving information flows regarding new lending volumes and terms among creditors. Further outreach to other creditors will continue, including to multilateral creditors and non-

OECD creditors. In addition staff will explore potential contacts with commercial creditors in order to increase awareness of the free rider policy and the DSF.

81. **In order to facilitate the use of the low-income countries' debt sustainability framework for all creditors, it is proposed to disclose all joint DSAs on the Bank's external website in a dedicated place**. Upon receiving consent from the relevant country authorities, DSAs would be posted in consultation with the IMF, as quickly as possible after their approval. This would typically be at the time when either the IMF or the Bank is posting the relevant country document on its website.

82. **Management also proposes to present a follow-up paper to the Board within one year to take stock of ongoing creditor consultations as well as to benefit from accumulated experience with concrete country cases**. Management undertakes to report yearly on the implementation of the general guidelines described in this paper**.**

Annex I. Types of Non-Concessional External Lending

The following types of financing flows are commonly treated as non-concessional *external* debt: (i) export credits; (ii) commercial (including syndicated) bank loans; and (iii) bonds.[51]

Officially-supported export credits are those provided by governments through export credit agencies. Officially-supported export credits from OECD countries are regulated under OECD's Export Credit Arrangement.[52] The Arrangement does not have legal force and is in the nature of a "gentlemen's agreement". Its goal is to ensure that export competition among OECD member countries is based on the price and quality of the products being exported rather than on the credit terms offered by export credit agencies (ECAs). Export credits offered at market rates would thus not satisfy the concessionality benchmark discussed in the main text. However, the Arrangement applies concessionality floors to tied aid offered by its participants. According to the Arrangement, its participants "shall not provide tied aid that has a concessionality level of less than 35 percent, or 50 percent if the beneficiary country is a Least Developed country (LDC)." [53] Financial flows that meet such minimum concessionality levels would not be seen as instances of free riding from the point of view of IDA.

Commercial (including syndicated) bank loans are market-based and their terms are negotiated and vary in accordance with the borrower's creditworthiness, usually with a margin above a base rate such as LIBOR. A particular form of commercial borrowing that may lead to very clear instances of free riding is **public sector borrowing collateralized with future receipts (CFR)**. The most common (but by no means the only) CFR arrangements involve collateralization of oil and gas export receivables. Such arrangements are non-concessional, give rise in many cases to governance concerns, may lead to delays in fiscal adjustment when used to finance fiscal deficits, and have seniority over non-collateralized debt.[54] IBRD protects its preferred creditor status against CFR arrangements by including a *negative pledge provision in its loans* (Section 9.03 of the *General Conditions* of IBRD loans), but IDA does not have such a provision.

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[51] See e.g., Johnson and Martin (2004), *Key Analytical Issues for Government External Financing,* Debt Relief International Ltd., Publication No. 8, January.

[52] OECD (2004), *The Arrangement on Guidelines for Officially Supported Export Credits,* OECD Publishing, Updated annually.

[53] OECD(2005), *Arrangement on Officially Supported Export Credits*, OECD, TD/PG(2004)12/REV, January, p. 22. The Arrangement also enumerates some exceptions to this general rule. The United Nations defines the following 49 countries as LDCs: Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina, Burundi, Cambodia, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Samoa, Sao Tome and Principe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sudan, Togo, Tuvalu, Uganda, Tanzania, Vanuatu, Yemen, Zambia (United Nations Conference on Trade and Development, 2004, *The Least Developed Countries Report*).

[54] See IMF (2003b), *Assessing Public Sector Borrowing Collateralized on Future Flow Receivables,* Washington D.C., June.

Bonds are negotiable instruments issued by governments in borrowing countries on international and domestic capital markets. Since commercial interest rates apply to such instruments, they are clearly non-concessional. Given the number and heterogeneity of bondholders, bond debt is subject to even more serious collective action problems than other forms of debt, as witnessed in the ongoing debate on an international bankruptcy regime. While bonds have overtaken commercial bank loans in importance in emerging markets, they are still in very limited use in low-income countries.

Note: Domestic debt (including bonds issued domestically) also usually earns commercial rates and is thus usually non-concessional. Domestic debt has become increasingly important in middle-income countries with market access, but much less so (although there is a great deal of country-by-country variation) in IDA-only countries. In some cases, domestic debt is issued for benchmarking purposes and may represent progress in developing domestic capital markets.

Annex II. Shares of Non-Concessional External Debt Stocks in Total PPG External Debt Stocks for "Red Light" and "Yellow Light" Countries (percent)[1/]

"Red Light" Countries	1970	1980	1990	1995	1998	1999	2000	2001	2002	2003	2004	Average of the latest six years
Afghanistan	..	..	..	..	..	..	..	..	..	..	..	..
Bhutan	..	..	23	6	30	28	34	48	50	56	59	46
Burundi	67	12	8	4	3	3	3	3	3	4	3	3
Cambodia	..	..	0	2	1	1	0	0	0	0	0	0
Central African Republic	38	60	18	10	11	10	10	10	24	9	9	12
Chad	26	34	13	17	13	11	10	9	8	11	10	10
Comoros	0	1	8	4	4	4	4	3	4	4	4	4
Congo, Democratic Republic of	30	79	65	63	62	60	60	60	30	30	30	45
Congo, Republic of	37	68	59	60	56	56	56	55	55	54	64	57
Cote d'Ivoire	53	90	71	62	54	54	54	55	50	49	48	52
Djibouti	0	44	2	1	0	0	0	0	3	4	3	2
Eritrea	..	..	..	0	5	7	6	4	3	3	3	4
Gambia, The	4	30	19	6	4	3	4	3	3	2	2	3
Guinea	23	33	26	18	15	14	14	13	12	12	10	12
Guinea-Bissau	0	35	38	29	20	20	15	9	8	6	4	11
Haiti	27	10	7	0	0	0	0	0	0	3	3	1
Kyrgyz Republic	..	..	..	22	32	29	28	23	17	13	10	20
Lao People's Democratic Republic	10	2	0	0	0	0	0	0	0	0	0	0
Liberia	30	59	47	45	45	45	45	45	45	46	46	45
Myanmar 2/	47	22	8	9	13	12	20	20	18	17	17	17
Nepal	32	1	8	3	1	0	0	0	0	0	0	0
Niger	9	60	32	23	20	17	16	13	10	12	2	12
Rwanda	21	6	1	1	0	0	0	0	0	0	0	0
Sao Tome and Principe	..	16	19	5	3	2	5	6	6	6	6	5
Sierra Leone	67	56	67	34	28	27	19	16	15	16	13	18
Solomon Islands	..	0	25	14	10	8	4	4	4	4	4	4
Somalia 2/	9	8	19	19	19	18	19	19	19	19	19	19
Sudan 2/	53	55	51	51	49	47	52	51	53	54	54	52
Togo 2/	21	67	35	29	21	19	18	18	19	20	24	19
Tonga	..	..	9	14	9	5	3	2	2	2	2	3
Average by period	27	35	25	19	18	17	17	17	16	16	15	

"Yellow Light" Countries	1970	1980	1990	1995	1998	1999	2000	2001	2002	2003	2004	Average of the latest six years
Angola	..	..	84	84	74	77	78	80	79	79	74	78
Ethiopia	45	18	11	11	8	11	10	9	8	9	11	9
Guyana	52	64	37	29	33	13	12	12	11	10	6	11
Lesotho	12	23	23	27	32	31	32	26	22	21	19	25
Malawi	42	59	24	9	5	5	4	3	3	3	4	4
Mongolia	..	..	..	23	3	3	2	2	1	1	1	2
Nicaragua	60	72	60	54	51	49	44	40	37	32	21	37
Samoa	11	37	9	4	3	2	2	1	1	1	1	1
Tajikistan	..	..	..	96	12	11	11	2	13	5	4	8
Average by period	38	41	33	35	24	22	21	19	19	17	15	

Source: Staff calculations based on *Global Development Finance* (GDF) 2005 and preliminary GDF 2006.

1/ Definition of concessionality: "Concessional LDOD (long-term debt outstanding and disbursed) conveys information about the borrower's receipt of aid from official lenders at concessional terms as defined by the DAC, that is, loans with an original grant element of 25 percent or more. Loans from major regional development banks - African Development Bank, Asian Development Bank, and the Inter-American Development Bank - and from the World Bank are classified as concessional according to each institution's classification and not according to the DAC definition as was the practice in earlier reports." (GDF 2005 II: Summary and Country Tables, 2005, p. xviii).

2/ Inactive Country in IDA.

The bolded figures indicate countries in which the respective 6-year average of the non-concessional debt-to-total PPG debt ratio exceeds 40 percent.

Annex III. Shares of Non-Concessional External Debt Flows in Total PPG External Debt Flows for "Red Light" and "Yellow Light" Countries (percent)[1/]

"Red Light" Countries	1970	1980	1990	1995	1998	1999	2000	2001	2002	2003	2004	Average of the latest six years
Afghanistan	..	..	..	..	..	..	..	..	..	..	..	..
Bhutan	..	..	0	0	89	0	64	79	62	73	**76**	59
Burundi	71	3	6	1	2	0	8	13	9	19	0	8
Cambodia	..	..	0	20	0	0	0	0	0	0	0	0
Central African Republic	29	25	3	2	0	0	0	0	0	0	0	0
Chad	64	0	8	0	0	0	0	16	1	31	6	9
Comoros	0	3	-2	0	0	0	0	0	0	0	0	0
Congo, Democratic Republic of	61	72	32	0	0	0	0	0	0	15	0	3
Congo, Republic of	15	91	63	4	0	0	0	0	0	0	0	0
Cote d'Ivoire	58	97	60	18	21	27	12	15	5	4	3	11
Djibouti	0	90	0	0	0	0	0	4	10	0	0	2
Eritrea	..	..	..	0	5	10	2	0	0	0	0	2
Gambia, The	0	46	5	0	-1	4	0	0	0	0	0	1
Guinea	39	54	3	28	20	20	14	5	3	11	0	9
Guinea-Bissau	0	35	0	1	0	0	0	0	0	0	0	0
Haiti	98	40	0	0	0	0	0	0	0	0	0	0
Kyrgyz Republic	..	..	..	9	18	19	9	3	0	0	0	5
Lao People's Democratic Republic	0	0	0	0	0	0	0	0	0	0	0	0
Liberia	51	49	0	0	0	0	0	0	0	0	0	0
Myanmar 2/	89	26	2	81	53	46	19	19	15	6	5	18
Nepal	0	0	1	0	0	0	0	0	0	0	0	0
Niger	3	65	6	0	0	0	6	0	0	0	10	3
Rwanda	0	1	1	0	0	0	0	0	0	0	0	0
Sao Tome and Principe	..	20	8	1	0	24	24	9	4	-2	4	11
Sierra Leone	83	61	17	1	27	11	0	0	0	9	0	3
Solomon Islands	..	0	0	62	0	0	0	-1	0	0	0	0
Somalia 2/	0	35	0	0	0	0	0	0	0	0	0	0
Sudan 2/	68	62	3	47	0	0	66	38	57	50	**41**	42
Togo 2/	4	64	1	0	16	0	0	0	-1	0	**57**	9
Tonga	..	..	0	0	0	40	0	0	0	0	0	7
Average by period	33	39	8	9	9	7	8	7	6	7	7	7

"Yellow Light" Countries	1970	1980	1990	1995	1998	1999	2000	2001	2002	2003	2004	Average of the latest six years
Angola	..	..	93	88	90	93	97	99	97	99	**99**	97
Ethiopia	29	36	32	14	19	11	3	2	4	2	22	7
Guyana	54	57	19	3	0	0	0	3	5	0	0	1
Lesotho	50	44	25	60	57	46	60	20	11	19	4	27
Malawi	46	70	12	2	6	10	2	0	0	0	0	2
Mongolia	..	..	..	9	1	0	0	0	0	0	0	0
Nicaragua	49	35	36	33	6	4	6	13	4	3	0	5
Samoa	0	0	2	0	0	0	0	0	0	2	0	0
Tajikistan	..	..	..	96	0	0	2	22	0	18	1	7
Average by period	38	40	30	34	21	19	21	17	15	17	15	

Source: Staff calculations based on *Global Development Finance* (GDF) 2005 and preliminary GDF 2006. Negative figures reflect approximation errors.

1/ Definition of concessionality: "Concessional LDOD (long-term debt outstanding and disbursed) conveys information about the borrower's receipt of aid from official lenders at concessional terms as defined by the DAC, that is, loans with an original grant element of 25 percent or more. Loans from major regional development banks - African Development Bank, Asian Development Bank, and the Inter-American Development Bank - and from the World Bank are classified as concessional according to each institution's classification and not according to the DAC definition as was the practice in earlier reports." (GDF 2005 II: Summary and Country Tables, 2005, p. xviii).

2/ Inactive country.

The bold figures indicate countries in which the respective ratio of non-concessional external debt flows to total PPG external debt flows exceeds 35 percent in 2004..

Annex IV. Shares of Non-Concessional External Debt Stocks in Total PPG External Debt Stocks for 19 Post-MDRI Countries (percent)[1/]

Country Name	1970	1980	1990	1995	1998	1999	2000	2001	2002	2003	2004	Average of the latest six
Benin	28	50	17	15	9	8	7	6	6	5	5	6
Bolivia 2/	45	70	49	39	25	25	25	28	25	22	20	24
Burkina Faso	16	21	20	12	5	4	5	4	4	3	2	4
Cameroon	21	58	66	48	44	44	43	39	38	35	32	38
Ethiopia 3/	45	18	11	11	8	11	10	9	8	9	11	9
Ghana	52	33	25	17	14	12	10	15	13	11	11	12
Guyana 3/	52	64	37	29	33	13	12	12	11	10	6	11
Honduras 2/	41	67	59	47	37	32	34	27	24	21	19	26
Madagascar	7	50	49	40	29	33	33	26	25	23	5	24
Mali	3	8	4	3	6	6	6	6	1	1	1	4
Mauritania	48	26	29	20	16	17	16	11	8	6	6	11
Mozambique	..	..	51	44	32	24	23	7	6	6	5	12
Nicaragua 3/	60	72	60	54	51	49	44	40	37	32	21	37
Niger 4/	9	60	32	23	20	17	16	13	10	12	2	12
Rwanda 4/	21	6	1	1	0	0	0	0	0	0	0	0
Senegal	24	64	33	30	17	16	15	13	12	12	5	12
Tanzania	6	18	40	28	15	14	13	10	9	6	6	10
Uganda	29	53	33	10	7	5	4	7	5	4	4	5
Zambia	92	62	55	38	32	22	19	26	25	23	22	23
Average by period	33	44	35	27	21	18	18	16	14	13	10	15

Source: Staff calculations based on *Global Development Finance* (GDF) 2005 and preliminary GDF 2006. Negative figures reflect approximation errors.

1/ Definition of concessionality: "Concessional LDOD (long-term debt outstanding and disbursed) conveys information about the borrower's receipt of aid from official lenders at concessional terms as defined by the DAC, that is, loans with an original grant element of 25 percent or more. Loans from major regional development banks - African Development Bank, Asian Development Bank, and the Inter-American Development Bank- and from the World Bank are classified as concessional according to each institution's classification and not according to the DAC definition as was the practice in earlier reports." (GDF 2005 II: Summary and Country Tables, 2005, p. xviii).

2/ Not eligible for IDA grants because of IDA blend or gap status.

3/ Yellow light country.

4/ Red light country (all others not marked 3/ or 4/ are green light countries).

Annex V. Shares of Non-Concessional External Debt Flows in Total PPG External Debt Flows for 19 Post-MDRI Countries (percent)[1/]

Country Name	1970	1980	1990	1995	1998	1999	2000	2001	2002	2003	2004	Average of the latest six years
Benin	46	44	8	5	18	4	1	0	0	0	0	1
Bolivia 2/	35	87	42	49	21	35	37	38	33	27	23	32
Burkina Faso	41	37	14	2	0	0	1	10	2	1	2	3
Cameroon	27	75	84	27	9	9	7	20	1	38	3	13
Ethiopia 3/	29	36	32	14	19	11	3	2	4	2	22	7
Ghana	8	48	30	26	26	12	14	43	23	15	19	21
Guyana 3/	54	57	19	3	0	0	0	3	5	0	0	1
Honduras 2/	41	82	66	38	19	17	67	7	6	3	9	18
Madagascar	3	61	8	2	0	3	7	5	3	1	4	4
Mali	0	21	2	3	0	0	1	0	0	0	1	0
Mauritania	16	24	35	10	5	5	7	4	9	18	13	9
Mozambique	..	..	15	5	2	2	1	9	2	2	2	3
Nicaragua 3/	49	35	36	33	6	4	6	13	4	3	0	5
Niger 4/	3	65	6	0	0	0	6	0	0	0	10	3
Rwanda 4/	0	1	1	0	0	0	0	0	0	0	0	0
Senegal	45	66	5	5	29	2	8	8	4	8	3	6
Tanzania	16	53	20	23	10	3	3	2	0	4	3	3
Uganda	28	85	19	5	2	2	1	2	4	14	4	4
Zambia	96	59	69	12	7	3	2	23	15	18	10	12
Average by period	30	52	27	14	9	6	9	10	6	8	7	8

Source: Staff calculations based on *Global Development Finance* (GDF) 2005 and preliminary GDF 2006. Negative figures reflect approximation errors.

1/ Definition of concessionality: "Concessional LDOD (long-term debt outstanding and disbursed) conveys information about the borrower's receipt of aid from official lenders at concessional terms as defined by the DAC, that is, loans with an original grant element of 25 percent or more. Loans from major regional development banks - African Development Bank, Asian Development Bank, and the Inter-American Development Bank - and from the World Bank are classified as concessional according to each institution's classification and not according to the DAC definition as was the practice in earlier reports." (GDF 2005 II: Summary and Country Tables, 2005, p. xviii).

2/ Not eligible for IDA grants because of IDA blend or gap status.

3/ Yellow light country.

4/ Red light country (all others not marked 3/ or 4/ are green light countries).

Annex VI. Non-concessional Loan Disbursement in 2004 by Type of Creditor

Countries eligible for MDRI as of end-June, 2006

	Bolivia 1/	Ethiopia	Ghana	Mauritania	Niger	Zambia	The remaining 13 countries 2/
Non-concessional							
Bilateral	0%	0%	0%	0%	0%	0%	1%
Multilateral	23%	1%	4%	11%	10%	10%	21%
Bonds	0%	0%	0%	0%	0%	0%	0%
Commercial banks	0%	21%	15%	2%	0%	0%	5%
Other private creditors	0%	0%	0%	0%	0%	0%	4%
Concessional	77%	78%	81%	87%	90%	90%	70%
Total	100%	100%	100%	100%	100%	100%	100%

Source: GDF 2006, early release.
1/ A blend country that has access to the IBRD window, and hence not eligible for IDA grants..
2/ the remaining 13 countries include red or yellow light MDRI-eligible countries, namely Guyana, Nicaragua, and Rwanda.

Countries that are "Red Light" in FY07

	Bhutan	Chad	Sudan	Togo	The remaining 26 countries 1/
Non-concessional					
Bilateral	76%	0%	17%	0%	0%
Multilateral	0%	6%	0%	57%	16%
Bonds	0%	0%	0%	0%	0%
Commercial banks	0%	0%	0%	0%	0%
Other private creditors	0%	0%	24%	0%	5%
Concessional	24%	94%	59%	43%	78%
Total	100%	100%	100%	100%	100%

Source: GDF 2006 early release.
1/ The remaining 26 countries include 2 MDRI-eligible red light countries, namely Niger and Rwanda.

Countries that are "Yellow Light" in FY07

	Angola	Ethiopia	The remaining 7 countries 1/
Non-concessional			
Bilateral	0%	0%	0%
Multilateral	0%	1%	5%
Bonds	0%	0%	0%
Commercial banks	94%	21%	0%
Other private creditors	5%	0%	0%
Concessional	1%	78%	94%
Total	100%	100%	100%

Source: GDF 2006 early release.
1/ The remaining 7 countries include MDRI-eligible yellow light countries, namely Guyana and Nicaragua.

Annex VII. Non-concessional Debt Outstanding in 2004 by Type of Creditor

Countries eligible for MDRI as of end-June, 2006

	Bolivia 1/	Cameroon	Honduras	Nicaragua	Zambia	The remaining 14 countries 2/
Non-concessional						
Bilateral	0%	27%	6%	11%	10%	28%
Multilateral	19%	4%	11%	3%	5%	27%
Bonds	0%	0%	0%	0%	0%	0%
Commercial banks	0%	1%	1%	7%	0%	10%
Other private creditors	1%	1%	1%	1%	7%	5%
Concessional	80%	68%	81%	79%	78%	31%
Total	100%	100%	100%	100%	100%	100%

Source: GDF 2006 early release.
Notes:
1/ A blend country, not eligible for IDA grants.
2/ The remaining 14 countries include MDRI-eligible red or yellow light countries, namely Ethiopia, Guyana, Niger and Rwanda.

Countries that are "Red Light" in FY07

	Bhutan	Chad	Congo, Democratic Republic of	Congo, Republic of	Guinea	Sierra Leone	Cote d'Ivoire
Non-concessional							
Bilateral	59%	3%	21%	42%	6%	10%	12%
Multilateral	0%	5%	6%	5%	4%	2%	12%
Bonds	0%	0%	0%	0%	0%	0%	24%
Commercial banks	0%	0%	0%	15%	0%	0%	0%
Other private creditors	0%	2%	4%	2%	1%	1%	0%
Concessional	41%	90%	70%	36%	90%	87%	52%
Total	100%	100%	100%	100%	100%	100%	100%

	Kyrgyz Republic	Liberia	Somalia	Sudan	Togo	Myanmar	The remaining 17 countries 1/
Non-concessional							
Bilateral	7%	7%	16%	32%	21%	2%	19%
Multilateral	2%	22%	1%	2%	2%	0%	17%
Bonds	0%	0%	0%	0%	0%	0%	0%
Commercial banks	0%	16%	0%	16%	0%	10%	2%
Other private creditors	0%	2%	2%	5%	0%	5%	7%
Concessional	90%	54%	81%	46%	76%	83%	56%
Total	100%	100%	100%	100%	100%	100%	100%

Source: GDF 2006 early release.
Note: 1/ The remaining 17 countries include MDRI-eligible countries, namely Niger and Rwanda.

Countries that are "Yellow Light" in FY07

	Angola	Lesotho	Ethiopia	Nicaragua	The remaining 6 countries 1/
Non-concessional					
Bilateral	14%	2%	3%	11%	7%
Multilateral	0%	7%	3%	3%	10%
Bonds	0%	0%	0%	0%	1%
Commercial banks	39%	9%	3%	7%	4%
Other private creditors	21%	0%	1%	1%	5%
Concessional	26%	81%	89%	79%	74%
Total	100%	100%	100%	100%	100%

Source: GDF 2006 early release.
Note: 1/ The remaining 6 yellow light countries include 2 MDRI-eligible countries, namely Guyana and Nicaragua.