



IDA14

**DEBT DYNAMICS AND FINANCING TERMS:
A FORWARD-LOOKING APPROACH TO
IDA GRANT ELIGIBILITY**

**International Development Association
Resource Mobilization (FRM)**

November 2006

ABBREVIATIONS AND ACRONYMS

AfDF	African Development Fund
AsDF	Asian Development Fund
CIRR	Commercial Interest Reference Rate
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
FDI	Foreign Direct Investment
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
PPG	Public and Publicly Guaranteed
PRGF	Poverty Reduction and Growth Facility
PSI	Policy Support Instrument

TABLE OF CONTENTS

Executive Summary.....	i
I. Introduction	1
II. Operationalizing the First Pillar of the Debt Sustainability Framework	3
A. Determining Grant Eligibility through a “Snapshot” Approach.....	3
B. Can the “Snapshot” Approach Accurately Capture Debt-Distress Risk?.....	5
III. Operationalizing the Second Pillar of the Debt Sustainability Framework.....	6
A. Forward-Looking DSAs as the Basis for IDA’s Financing Terms	7
B. Dealing with the Risk of Unsustainable Debt Accumulation.....	10
C. Dealing with Public Domestic Debt	14
IV. Debt Dynamics and the Concessionality of Financing.....	15
A. How Concessionality Affects Debt Dynamics	15
B. IDA Grants and Debt Dynamics	18
C. Non-Concessional Borrowing and Debt Dynamics.....	20
V. Possible Technical Refinements.....	23
A. Dealing with Potential CPIA-Driven Volatility in Performance Categories	23
B. Refining Categories of Debt-Distress Risk and Grant Eligibility.....	25
VI. Conclusions and Issues for Discussion	26

Tables

Table 1: Indicative Policy-Dependent Debt and Debt-Service Thresholds.....	3
Table 2: Performance Categories for Selected Countries, under Current Practice.....	23

Charts

Chart 1: Average Probabilities of Debt Distress and “Traffic Lights”	6
Chart 2: Baseline Projections for Ethiopia: IDA and Other Financing Sources.....	11
Chart 3: Baseline Projections for Mozambique: IDA and Other Financing Sources	12
Chart 4: Ethiopia: Debt Dynamics under Different Scenarios on IDA Grants.....	19
Chart 5: Rwanda: Debt Dynamics under Different Scenarios on IDA Grants	19
Chart 6: Nicaragua: Debt Dynamics under Different Scenarios on IDA Grants.....	20
Chart 7: Angola: Non-Concessional Borrowing and Debt Dynamics	22

TABLE OF CONTENTS (cont'd)

Text Boxes

Box 1: The IDA14 Grants System in a Nutshell	5
Box 2: An Example of DSA-Based Determination of “Traffic Lights”: The Case of Ethiopia in FY07	9
Box 3: The Components of Debt Dynamics	17

Annexes

I. Addressing CPIA-Driven Volatility in “Traffic Lights”	28
II. Policy-Dependent Debt Distress Classifications: FY06	30
III. Policy-Dependent Debt Distress Classifications: FY07	32

Annex Tables

Table A.1: Current Practice versus CPIA Moving Averages	28
Table A.2: Performance Categories for Selected Countries: Current Practice versus Tercile Cutoffs.....	28
Table A.3: Performance Categories for Selected Countries: Quartile and Quintile Cutoffs	29
Table A.4: Traffic Lights, Selected Countries: Current Practice versus Moving Averages	29

Debt Dynamics and Financing Terms: A Forward-Looking Approach to IDA Grant Eligibility

EXECUTIVE SUMMARY

1. **The IDA14 Replenishment introduced a new system for allocating IDA grants base on low-income countries' debt-carrying capacity, underpinned by the joint IMF-World Bank debt sustainability framework (DSF).**¹ The DSF 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” (IMF and World Bank, 2004).²

2. **This paper sets the stage for the operationalization of the forward-looking aspects of the DSF as the central tool for determining IDA's financing terms.** In so doing, the paper discusses a number of key policy and operational issues: (i) joint Bank-Fund debt sustainability analyses (DSAs) as the central tool for determining IDA's financing terms; (ii) the risk of unsustainable debt accumulation; (iii) debt dynamics and the concessionality of financing; and (iv) possible technical refinements to the DSF.

Joint Bank-Fund DSAs as the Central Tool for Determining IDA's Financing Terms

3. **Operationalizing the forward-looking aspects of the DSF, from IDA's standpoint, means relying on DSA-based debt distress risk ratings to determine grant eligibility.** As the forward-looking aspects of the DSF were not fully operational at the time of the IDA14 negotiations, IDA adopted an interim grant eligibility mechanism primarily based on a “snapshot” of countries' external debt situation, grounded on the first pillar of the DSF. As an interim arrangement, the “snapshot” system has provided a reasonable approximation to gauge countries' debt-distress risk. However, its main limitation is that it is largely *reactive*, that is, it does not take into account the impact of future borrowing or vulnerability to shocks. A forward-looking approach would enable IDA to adopt a *proactive* stance regarding countries' debt sustainability prospects. Dynamic analysis would also allow for an *ex ante* tailoring of financing terms that could be implemented *well before* debt ratios come close to the relevant thresholds.

4. **Joint Bank-Fund DSAs follow a regular annual cycle, allowing for course corrections as necessary.** If new information becomes available that leads to changes in countries' debt distress risk ratings, IDA's “traffic light” for the subsequent allocation cycle would be adjusted accordingly. In addition, strengthened precautionary features are being introduced as part of the DSF review, including a more active use of historical scenarios and the consideration of alternative, lower growth, scenarios. DSAs also provide an early-warning

¹ IMF and World Bank (2004a). *Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications*. Washington, D.C., February. See also: IMF and World Bank (2004b). *Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications*. Washington, D.C., September; and IMF and World Bank (2005). *Operational Framework for Debt Sustainability Assessments in Low-Income Countries – Further Considerations*. Washington, D.C., March.

² IMF and World Bank (2005), *op. cit.*

system to detect situations of potentially unsustainable increases in external debt ratios and to inform creditors such as IDA accordingly. Projected IDA allocations are explicitly taken into account in the baseline scenarios in DSAs. Therefore, if concessional borrowing from IDA is a main source of debt re-accumulation risks for any IDA-only country, this would be captured by the DSA, thereby helping IDA to respond preemptively.

Dealing with the Risk of Unsustainable Debt Accumulation

5. **An additional challenge for the creditor and donor community is that the borrowing space freed up by debt relief and the provision of grants by IDA and other multilaterals may have considerably increased the risk of excessive borrowing by low-income countries.** If borrowing and lending take place at a pace that is inconsistent with countries' debt-carrying capacity, it would contribute to the recurrence of unsustainable debt burdens in the beneficiary countries within a few years. All else constant, non-concessional borrowing is associated with higher risk of debt distress than concessional borrowing. However, even concessional borrowing could lead to unsustainable debt accumulation, albeit at a slower pace, if the amounts contracted exceed a country's debt-carrying capacity.

6. **Unilateral action on the part of IDA would not be enough to ensure debt sustainability in low-income countries.** Effective collective action – involving creditors and borrowers alike – would go a long way towards mitigating risks of unsustainable debt accumulation. Some progress in creditor coordination has been made. For example, Multilateral Development Banks have been actively considering similar, DSF-based, mechanisms to establish their financing terms – with the African Development Fund effectively adopting the DSF as the basis for its own grants framework. In addition, the OECD Export Credit Group and the Paris Club have initiated a dialogue with the Fund and the Bank on the role of export credit agencies in supporting debt sustainability. Non-OECD export credit agencies are gradually becoming involved in these coordination efforts as well. However, coordination efforts vis-à-vis commercial creditors are still at a very incipient level.

7. **Ultimately, the responsibility to avoid excessive borrowing rests with low-income countries themselves.** IDA's policy on non-concessional borrowing by grant-eligible and MDRI-recipient countries³ includes mechanisms to discourage excessive non-concessional borrowing, but borrowers themselves need to internalize the importance of long-term debt sustainability. Debt over-accumulation risks need to be dealt with in the context of country-owned, well-designed borrowing strategies consistent with debt distress risk ratings. Such homegrown borrowing strategies will require significant capacity building in debt management in many low-income countries.

Debt Dynamics and the Concessionality of Financing

8. **Different factors – beyond IDA's direct control – affect the impact that IDA grants could have on a country's debt dynamics: i) IDA's share in the country's new borrowing; (ii) growth performance; and (iii) the occurrence of exogenous shocks.** First,

³ IDA (2006). *IDA Countries and Non-Concessional Debt: Dealing with the "Free Rider" Problem in IDA14 Grant-Recipient and Post-MDRI Countries*. IDA/R2006-0137, June.

the impact of IDA grants on debt dynamics tends to be stronger in countries where IDA is a major donor. IDA cannot directly control its share of new borrowing by low-income countries, particularly in light of the increasing importance of emerging creditors. Second, empirical analysis indicates that movements in debt ratios have been dominated by movements in the denominator (exports and GDP), indicating that sound, growth-promoting macroeconomic performance remains the key ingredient in achieving sustainable debt levels. Third, debt dynamics are strongly affected by countries' vulnerability to exogenous shocks. Therefore, besides tailoring financing terms, other aspects of IDA's work – those geared towards strengthening countries' policy performance and preparedness against exogenous shocks – could ultimately help improve debt dynamics.

Possible Technical Refinements

9. **Two remaining technical issues need to be addressed to ensure that the DSF provides an appropriate platform for establishing IDA's financing terms.** These are: (i) the risk that marginal changes in CPIA scores for individual countries may lead them to change performance categories (thereby changing the applicable policy-dependent debt thresholds) without any material change in their economic fundamentals; and (ii) the appropriate interface between debt distress risk ratings and grant eligibility categories. In the first issue, the paper recommends the use of three-year CPIA moving averages instead of year-by-year CPIA scores in order to determine the performance category in which each country belongs. The proposed methodology would reduce the risk that countries shift back and forth from one performance category to another, while generally having only a small impact on the overall grant share. In fact, FY06 and FY07 grant shares would have been practically the same had moving averages of CPIA scores been used in those fiscal years for the purposes of establishing countries' performance categories. In the second issue, the paper concludes that there does not seem to be strong analytical support for revising the current debt distress risk or grant eligibility categories.

DEBT DYNAMICS AND FINANCING TERMS: A FORWARD-LOOKING APPROACH TO IDA GRANT ELIGIBILITY

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),⁴ which rests on three pillars: (i) indicative policy-dependent external debt thresholds; (ii) debt sustainability analyses (DSAs) and associated stress tests (both of which forward-looking aspects); and (iii) “an appropriate borrowing (and lending) strategy that contains the risk of debt distress” (IMF and World Bank, 2004).⁵ As the forward-looking aspects of the DSF were not fully operational, during the IDA14 negotiations it was agreed that the first pillar would be the main basis for grant allocation during early implementation of the system, supplemented by DSAs as these became available.

2. **This paper sets the stage for the operationalization of the forward-looking aspects of the DSF as the central tool for determining IDA's financing terms.** As noted in the IDA14 Deputies' Report:

*"Participants urge that rapid progress be made in the design and implementation of the forward-looking aspects of the DSF, to ensure that grant eligibility can be determined on the basis of a comprehensive assessment of countries' debt sustainability. A proposal will be presented by the Mid-Term Review (i.e., late CY06)."*⁶

3. **The “downstream” work on financing terms will continue to benefit from “upstream” enhancements in the DSF itself.** A critical recent upstream development was the joint IMF-World Bank DSF review exercise. The first and second DSF review papers were discussed by the Bank and Fund Boards, respectively, in April and November 2006.⁷ The DSF review has looked into the experience with the implementation of the framework thus far and paid special attention to the potential implications of the Multilateral Debt Relief Initiative (MDRI) – particularly with respect to the issue of how to deal with the increased post-relief borrowing space in MDRI recipients. While the April DSF review paper concluded that no major changes to the

⁴ IMF and World Bank (2004a). *Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications*. Washington, D.C., February. See also: IMF and World Bank (2004b). *Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications*. Washington, D.C., September; and IMF and World Bank (2005). *Operational Framework for Debt Sustainability Assessments in Low-Income Countries – Further Considerations*. Washington, D.C., March.

⁵ IMF and World Bank (2005), *op. cit.*

⁶ IDA (2005). *Additions to IDA Resources: Fourteenth Replenishment. Working Together to Achieve the Millennium Development Goals*. IDA/R2005-0029, March.

⁷ See IMF and World Bank (2006a). *Review of the Low-Income Country Debt Sustainability Framework and Implications of the MDRI*. March. See also IMF and World Bank (2006b). *Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief*. October.

framework were warranted at the time, the Boards of both institutions requested staffs to do further work, among other issues, on the risks of post-MDRI debt re-accumulation, the role of public domestic debt, and on the scope for refining debt-distress risk categories.

4. **The topics discussed in this paper mirror many of the issues addressed in the DSF review papers, but does so from an IDA perspective.** The key upstream issues in the DSF review papers that have important downstream implications are thus complemented by IDA-specific considerations. In this sense, this paper is to some extent self-contained, as it includes some discussion of the broader policy issues as the backdrop for the IDA-specific ones.

5. **The DSF provides clear guidelines and a transparent methodology to assess the risk of debt distress in low-income countries.** A complete and public discussion of the DSF guidelines and methodology can be found in the World Bank's external website (www.worldbank.org/debt), together with a list of country DSAs conducted during FY06. Guidelines-based debt sustainability assessments are in themselves transparent, insofar as they "must explain all the main assumptions underlying their projections (and hence reasons for optimism where this is the case) and how these drive projected debt ratios and thus risk ratings, giving the opportunity to modulate these assumptions over time as circumstances dictate."⁸ The DSF review exercise has also proposed additional sets of guidelines aimed at strengthening the rigor and quality of DSAs and broadening the scope for an active use of the framework by debtors and creditors.

6. **The remainder of this paper is structured as follows:** Section II briefly describes and assesses the current grant eligibility system based on the first pillar of the DSF. Section III discusses a forward-looking approach to grant eligibility determination based on joint Bank-Fund, DSF-style DSAs and considers ways in which this approach deals with post-debt relief risks of unsustainable debt accumulation. Section IV discusses how increased concessionality can affect low-income countries' debt dynamics. Specific technical issues are discussed in Section V: (i) possible ways of preventing marginal changes in CPIA scores from leading to possibly unwarranted changes in countries' performance categories; and (ii) the interface between debt-distress risk ratings from DSAs and IDA grant eligibility categories. Conclusions and issues for discussion are presented in Section VI. Annex I contains detailed analysis on the issue of preventing CPIA volatility from influencing debt-distress risk ratings, and Annexes II and III display the IDA "traffic lights" for FY06 and FY07, respectively.

⁸ IMF and World Bank (2006b), op. cit., p. 10.

II. OPERATIONALIZING THE FIRST PILLAR OF THE DEBT SUSTAINABILITY FRAMEWORK

A. Determining Grant Eligibility through a “Snapshot” Approach

7. **The IDA14 replenishment introduced a new grant eligibility and allocation framework for IDA** (see Box 1).⁹ In contrast to IDA13, where a target range for the grant percentage was pre-determined and grants were allocated according to multiple criteria for grant eligibility, in IDA14 there is only one, and analytically-based, criterion: countries’ risk of debt distress.¹⁰ Such risk is rated on the basis of two components of the DSF: (i) a “static” component represented by a matrix of policy-dependent external debt thresholds; and (ii) a forward-looking or “dynamic” component represented by debt sustainability analyses (DSAs) and standardized stress tests.

8. **As the “dynamic” aspects of the DSF were not fully operational at the beginning of the IDA14 period, IDA adopted an interim grant eligibility mechanism based on a “snapshot” of countries’ external debt situations.** The key tool in this exercise is the matrix of policy-dependent debt thresholds, reproduced as Table 1 below.

Table 1. Indicative Policy-Dependent Debt and Debt-Service Thresholds¹¹

Performance Category	Debt and Debt-Service Thresholds (%)		
	NPV of debt-to-GDP	NPV of debt-to-exports	Debt service-to-exports
Weak (CPIA≤3.25)	30	100	15
Medium (3.25<CPIA<3.75)	40	150	20
Strong (CPIA≥3.75))	50	200	25

Source: IMF and World Bank (2004).

⁹ A full assessment of the operational and financial implications of the current “snapshot” approach can be found in the companion IDA14 Mid-Term Review paper “Assessing the Implementation of the IDA14 Grants Framework”.

¹⁰ The eligibility system further specifies that IBRD/IDA blend countries and hardened-term (or “gap”) countries are *a priori* excluded from access to grants, irrespective of their external debt situation.

¹¹ Table 1 is a subset of the DSF matrix as presented in IMF and World Bank (2004b). IMF and World Bank (2004b). *Choice of Indicative Debt-Burden Thresholds – Alternative Options*, OM2004-0091, Washington, D.C., November 2004. Compared to the original matrix, Table 1 excludes revenue-based indicators due to data availability/comparability issues, as well as moral hazard concerns. For the purposes of determining grant eligibility under the “snapshot” approach, only the NPV of debt-to-export, NPV of debt-to-GDP, and debt service-to-exports ratios are relevant. For a fuller discussion, refer to IDA (2004a). *Debt Sustainability and Financing Terms in IDA14*. IDA/SecM2004-0457, June.

9. **This mechanism requires that the matrix of thresholds be converted into a country ranking system through a three-step process:**

Step 1: A “snapshot” of countries’ relative positions with respect to the debt-burden thresholds is taken.

- Percentage distances between actual debt-burden indicators and their respective thresholds are calculated.

Step 2: A decision rule for the debt-burden indicators is applied.

- Two variables are computed and compared: (i) the average of the percentage distances of the two stock indicators (NPV of debt-to-GDP and NPV of debt-to-exports ratios) to their respective thresholds¹²; and (ii) the relative distance of the debt service-to-exports ratio to its threshold.
- The indicator that signals the highest debt-distress risk level is chosen.

Step 3: A “traffic light” is assigned to countries according to the risk of debt distress.

- A “green light” indicates a low risk of debt distress; a “yellow light” a medium risk; and a “red light” a high risk.

10. **The “snapshot” mechanism would give way to a grant eligibility system based on a forward-looking determination of countries’ risk of debt distress.** In practice, this means that steps one and two above – involving the calculation of percentage distances to thresholds and the “composite” stock indicator – would no longer be required. Countries’ “traffic lights” would be directly determined by their risk of debt distress as established through forward-looking analysis. However, in those few cases where a recent DSA may not be available, IDA’s “traffic light” would still be determined on the basis of the “snapshot” mechanism.

¹² Together, the two stock indicators form what has been termed a “composite” indicator.

Box 1. The IDA14 Grants System in a Nutshell

The IDA14 replenishment introduced a new grant eligibility and allocation framework for IDA. In contrast to IDA13, where multiple criteria for grant eligibility were adopted, in IDA14 there is only one criterion: countries' risk of debt distress. This risk is assessed on the basis of the methodology proposed in the joint IMF-World Bank debt sustainability framework (DSF) for low-income countries.

The operational arrangements for the implementation of the IDA14 grants framework comprise the following elements:

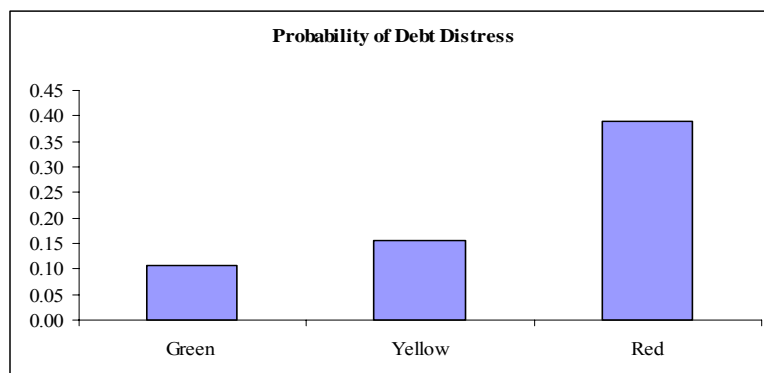
- *A grant eligibility system* based on countries' risk of debt distress, determined in accordance with the DSF methodology. The eligibility system further specifies that IBRD/IDA blend countries and hardened-term (or "gap") countries are *a priori* excluded from access to grants, irrespectively of their external debt situation.
- *A grant allocation system* that accordingly determines countries' terms of assistance but also affects the total amounts they receive through the so-called Modified Volume Approach (MVA). The IDA14 grant allocation system has a direct relationship with the Performance-Based Allocation (PBA) system that was not present in IDA13. This relationship works through the following mechanisms:
 - An upfront volume discount on grants at a 20 percent rate of countries' overall grant allocations, divided into two components: (i) an "incentives-related" discount, which aims to preserve the integrity of the incentive system embedded in the PBA (equivalent to an 11 percent "grants tax"); and (ii) a "charges-related" volume discount, which aims to recoup forgone charge income on grants (equivalent to a 9 percent "grants tax").
 - An incentive to subsets of IDA countries, in two forms: (i) resources generated by the incentives-related discount are allocated to IDA-only countries (excluding post-conflict and "gap" countries) according to performance; and (ii) resources generated by the charges-related discount are earmarked for a "hard-term" window that can be accessed by creditworthy blend countries with income below the IDA operational cutoff.

B. Can the "Snapshot" Approach Accurately Capture Debt-Distress Risk?

11. **Although the "snapshot" approach was never meant to replace forward-looking analysis, as an interim arrangement it has provided a reasonable approximation to gauge countries' debt-distress risk.** Chart 1 below groups countries according to their "traffic lights" (as determined primarily through the "snapshot" system) and displays the 2003 average probabilities of debt distress for each FY06 "traffic light" country grouping. It shows a clear positive association between grant eligibility as determined by the "snapshot" system and the average probability of debt distress for each eligibility category. This should not come as a surprise, since debt burdens – as captured by the "snapshot" system – are among the predictors of debt-distress risk.¹³ In addition, this system explicitly takes into account the impact of policies, another key predictor of debt-distress risk, since it makes full use of policy-dependent external debt thresholds.

¹³ See Kraay, A. and V. Nehru (2004). "When Is External Debt Sustainable?". World Bank Policy Research Working Paper 3200, February.

Chart 1. Average Probabilities of Debt Distress by “Traffic Light”



12. **The main limitation of the “snapshot” system is that it is largely *reactive*. It does not take into account the impact of future borrowing or vulnerability to shocks.** By focusing on historical debt data alone, the “snapshot” system cannot gauge debt ratios’ vulnerability to shocks – it can only provide a lagged, *ex-post* response to shocks when sufficient time has elapsed to allow for their impact to be felt on actual debt ratios. This could potentially lead to wide fluctuations in grant eligibility status once new information is incorporated into actual data.¹⁴ Furthermore, an exclusive focus on historical debt data does not allow for the impact of projected new borrowing – or projected debt relief – to be taken into consideration. Therefore, ratings based on historical data may be overly conservative or optimistic if the projected trajectory of debt ratios is non-stationary – that is, if debt ratios are projected to follow upward or downward trends. To help overcome such limitations during the interim period, Deputies agreed to the use of available DSAs to inform decision-making on grant eligibility before a forward-looking approach is formalized.

III. OPERATIONALIZING THE SECOND PILLAR OF THE DEBT SUSTAINABILITY FRAMEWORK

13. **In contrast with the reactive nature of the “snapshot” approach, a forward-looking approach would enable IDA to adopt a *proactive* stance regarding countries’ debt sustainability prospects.**¹⁵ Dynamic analysis would allow for an *ex ante* tailoring of financing terms that could be implemented *well before* debt trajectories approach the relevant thresholds. This Section discusses how DSAs would form the basis for a forward-looking approach to establishing IDA’s financing terms. It is organized as follows: Subsection A discusses how country-specific assessments of debt sustainability

¹⁴ The introduction of a “yellow light” category helps mitigate the risk of such wide swings in grant eligibility status.

¹⁵ In addition to these broader policy considerations, a critical risk highlighted during the MDRI and DSF review discussions is that post-relief debt re-accumulation may follow an unsustainable path. Therefore, a key task of any forward-looking approach to the determination of IDA financing terms is to help prevent an excessively rapid buildup of new debt, even if the starting point –e.g., following debt relief – is a relatively low debt burden.

translate into a decision on the terms of IDA's financing. Subsection B argues that a DSA-based approach provides an early-warning system to help mitigate the risk of unsustainable accumulation of debt in IDA-only countries. Finally, Subsection C contains a brief discussion on domestic debt issues.

A. Forward-Looking DSAs as the Basis for IDA's Financing Terms

14. **Operationalizing the forward-looking aspects of the DSF, from IDA's standpoint, means relying on DSA-based debt distress risk ratings to determine countries' "traffic lights"**. Joint Bank-Fund low-income country DSAs aim to "monitor the evolution of a country's debt burden indicators and to guide financing strategies."¹⁶ DSAs will typically comprise two blocks: (i) the baseline scenario, which projects debt burden trajectories¹⁷ based on realistic assumptions; and (ii) the sensitivity analysis, which contains alternative scenarios to the baseline (one of them being the historical average scenario, which helps assess the realism of the baseline assumptions) as well as stress tests (discussed in more detail in Box 2 below). DSAs are therefore complex undertakings which provide Bank-Fund country teams with substantial inputs that allow them to make informed judgments about countries' risk of debt distress. In addition, their country-specific nature encourages borrower ownership and facilitates the design of appropriate borrowing strategies.

15. **Joint Bank-Fund DSAs follow a regular annual cycle, allowing for course corrections as new information becomes available.** As noted in the second DSF review paper, "the DSA is updated every year, allowing any incipient problems deriving from the pace of new borrowing or optimistic economic forecasts to be addressed as they arise."¹⁸ If new information becomes available that leads to changes in countries' debt distress risk ratings, IDA's "traffic light" for the subsequent allocation cycle would be adjusted accordingly. In addition, strengthened precautionary features are being introduced as part of the DSF review, including a more active use of historical scenarios and the consideration of alternative, lower growth, scenarios.

16. **The transition to a grant allocation system based on forward-looking analyses has begun.** The determination of "traffic lights" for FY07 has benefited from the substantial increase in the availability of DSAs. In fact, DSAs were used to help establish the FY07 "traffic lights" for 31 countries – about half of all countries that could potentially qualify for grants because of their IDA-only, non-"gap" status. In 14 cases, the debt-distress risk ratings from DSAs differed from those that would be obtained from the "snapshot" approach. In six of these cases the difference stemmed primarily from the impact of the MDRI, which was taken into account in the DSA. As a rule, DSA-based

¹⁶ IMF and World Bank (2006), *op.cit.*, p. 3.

¹⁷ A 20-year projection period is used in all DSAs. See IMF and World Bank (2004a), *op. cit.*, p. 27: "In light of the generally long maturity and grace periods, the projection horizon covers 20 years, which still implies that a sizeable part of the back-loaded debt-service obligations on new loans contracted on IDA, or other highly concessional, terms will not be captured in the debt-service projections – through they are captured in the NPV of debt."

¹⁸ IMF and World Bank (2006b), *op. cit.*, p. 10.

“traffic lights” prevail in case of conflict with those resulting from the “snapshot” approach.

17. **In the context of the DSF, debt relief under the MDRI does not automatically disqualify countries from access to IDA grants.** If MDRI-eligible countries’ risk of debt distress remains moderate or high even after debt relief, they would still be eligible for 50 percent or 100 percent grants. Immediate post-relief data – which would not take into account projected future lending – suggests that almost all MDRI recipients would be “green light” under the “snapshot” approach (except Guyana, which would be “yellow light”).¹⁹ However, these countries are for the most part good (medium or strong) performers, which translate into relatively high IDA allocations per capita and hence comparatively large IDA lending programs. Once IDA resource flows and financing from other sources are taken into account, countries’ debt sustainability prospects may worsen.

18. **In fact, six MDRI-recipient countries are eligible for IDA grants in FY07 once their DSAs are considered.** They are: Ethiopia, Guyana, Malawi, Nicaragua (all “yellow light”), as well as Niger and Rwanda (both “red light”). Debt-distress risk ratings for the first four countries were primarily the result of stress tests – which led to sustained breaches of the relevant debt-burden thresholds. In the case of Niger and Rwanda, the DSAs indicated that their debt sustainability prospects were not substantially improved by the MDRI, particularly in light of their fragile economies as indicated by narrow export bases. Their “red lights” were further motivated by the fact that IDA is a main resource provider for these countries. Therefore, whenever IDA is a potential source of increased debt-distress risk for countries in which it plays a major role, it is all the more necessary to take a prudent stance in establishing financing terms.

19. **In short, differently from the “snapshot” system, debt distress risk ratings emerging from DSAs are forward-looking by definition and as such they more adequately reflect risks of debt over-accumulation.** An important technical consideration is the design of the appropriate “interface” between debt distress risk ratings and “traffic lights”. This issue will be dealt with in Section V.

¹⁹ Indeed this was the assumption used in the projections of post-MDRI IDA assistance flows to beneficiary countries. Refer to IDA (2006). *IDA’s Implementation of the Multilateral Debt Relief Initiative*. IDA/R2006-0042, March.

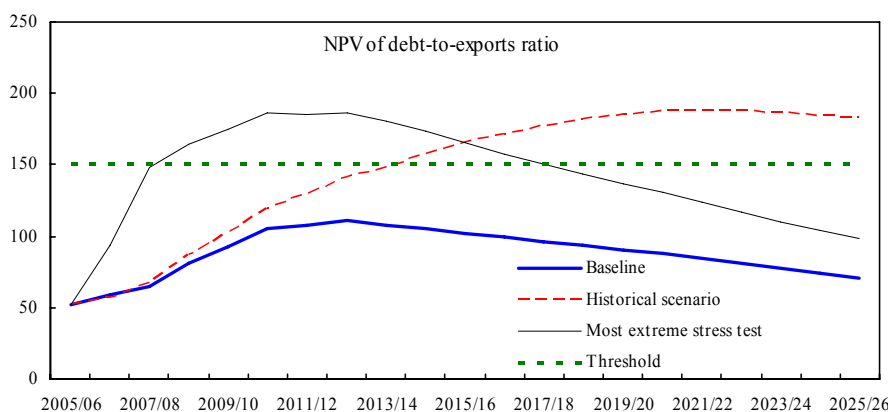
**Box 2. An Example of DSA-Based Determination of “Traffic Lights”:
The Case of Ethiopia in FY07**

Debt-distress risk ratings emerging from DSAs are based on forward-looking analyses of countries’ debt sustainability prospects, taking into account not only baseline debt projections but also standardized stress tests. The DSF methodology employs six standardized stress or “bound” tests to “analyze shocks on the principal macro-economic variable(s)”.^{1/} The first four stress tests involve applying a standardized “shock” to four macroeconomic variables: GDP growth, exports growth, inflation, and net non-debt flows (FDI plus current transfers). This notional shock is applied as follows: the values of the macroeconomic variables under consideration during the first two years of the projection period are calculated as being one standard deviation below their historical average. The fifth stress test combines all four macroeconomic variables together, and the sixth applies a one-time 30 percent nominal exchange rate depreciation in the first year of the projection period.

Stress tests are a critical element in the determination of a country’s debt distress risk rating: even if the baseline projection is “comfortably” below the relevant debt-burden threshold, a breach of such threshold brought about by a stress test may indicate high vulnerability to shocks, warranting a more conservative risk rating.

The determination of Ethiopia’s “traffic light” for FY07 exemplifies this approach. Ethiopia’s DSA^{2/} indicates a moderate risk of debt distress, warranting a “yellow light” (50% grants) classification. As a medium performer, the applicable policy-dependent threshold for Ethiopia’s NPV of debt-to-exports is 150 percent. Although the historical scenario indicates a rising NPV of debt-to-exports ratio, the baseline scenario shows that, after MDRI, Ethiopia’s NPV of debt-to-exports ratio falls well below the threshold throughout the projection period, suggesting a low risk. But Ethiopia’s moderate risk rating is essentially driven by stress testing, which highlights the country’s vulnerability to export shocks. As can be seen from the chart below, the “most extreme” stress test leads to a substantial breach of the threshold. In fact, the NPV of debt-to-exports ratio in this scenario stays above the threshold from 2009 until about 2016, before slowly declining thereafter.

Figure Box.2.1 Ethiopia: NPV of debt-to-exports post MDRI



Source: IMF and World Bank (2006c), p. 11.

1/ World Bank (2005). “How to do a Debt Sustainability Analysis for Low-Income Countries”. Processed. May.

2/ IMF and World Bank (2006c), “The Federal Democratic Republic of Ethiopia – Joint Fund-World Bank Debt Sustainability Analysis.”

B. Dealing with the Risk of Unsustainable Debt Accumulation

20. **The HIPC Initiative and the MDRI substantially improved debt sustainability prospects in eligible low-income countries.** In fact, debt relief under the HIPC Initiative and the MDRI has dramatically reduced debt burdens in many of the poorest countries. The HIPC Initiative has cut debt ratios by two-thirds in 29 countries, providing nearly US\$60 billion in debt service relief over time (based on commitments to date), US\$18 billion of which is from IDA. The MDRI nearly doubles this IDA commitment figure, with the bulk of the new debt relief – currently estimated at US\$36 billion – being provided by IDA.

21. **Debt relief and the provision of grants by IDA and other multilaterals may have considerably increased borrowing space in low-income countries.** If borrowing and lending take place at a pace that is inconsistent with countries' debt-carrying capacity, many of the beneficiaries of debt relief could return to unsustainable debt burdens within six to ten years. All else constant, non-concessional borrowing is associated with higher risk of debt distress than concessional borrowing. However, concessional debt could also lead to unsustainable debt accumulation, albeit at a slower pace.

22. **The second joint Bank-Fund DSF review paper points out that “the main MDB lending allocations would not on their own generate a rapid re-accumulation of debt in most cases” [(p.56)].** If MDB lending does become a source of potential debt-distress, then the DSF-style DSAs would be able to detect it. In fact, DSAs provide an early-warning system to identify situations of potentially unsustainable increases in external debt ratios and to inform creditors such as IDA accordingly. Greater caution in establishing financing terms is needed, in particular, in cases where IDA lending – even at highly concessional terms – might directly contribute to heightened risk of debt distress. The grant element of a concessional credit can be likened to a “price subsidy”. IDA credits are highly concessional, so this price subsidy is rather high at 60 percent.²⁰ However, there could also be a “quantity effect” on countries' projected debt ratios caused by the *sheer volumes* of lending, which could be magnified by low exports-to-GDP ratios (refer to discussion in Section IV). The larger the projected impact of IDA allocations on a country's rate of debt accumulation, the more caution should be exercised in establishing the terms of IDA's assistance.

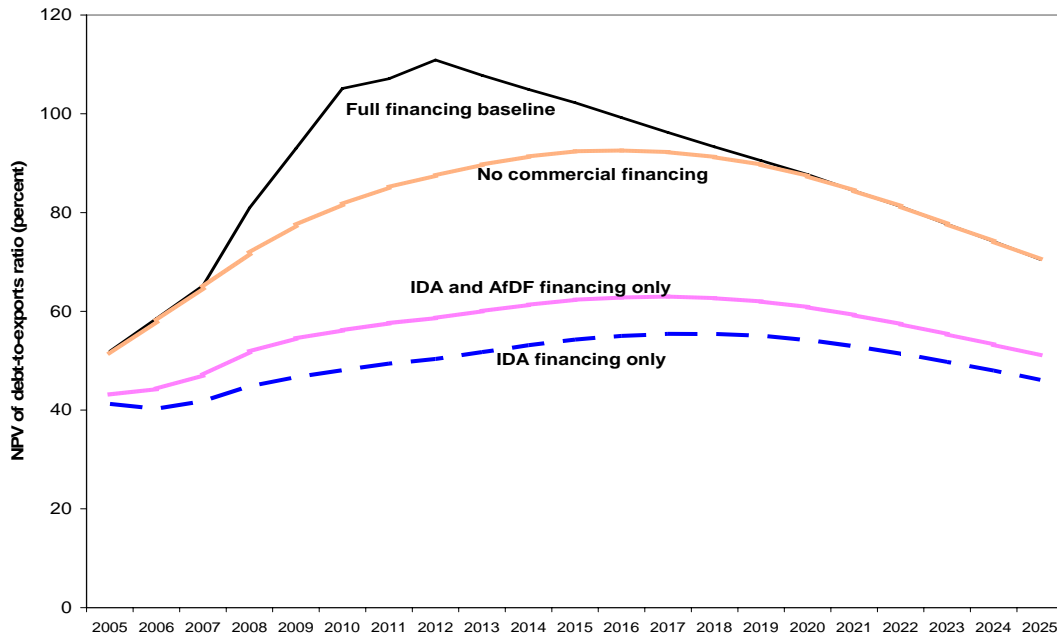
23. **Projected IDA allocations are explicitly taken into account in the baseline scenarios in DSAs. Therefore, if concessional borrowing from IDA is a main source of debt re-accumulation risks for any IDA-only country, this would be captured by the DSA.**²¹ Baseline projections in DSF-style DSAs show the behavior of debt ratios over time taking into account different financing sources, namely: IDA, IMF, other multilateral creditors, official Paris-club creditors, non-Paris-club creditors, and

²⁰ In principle, countries can *always* repay an IDA credit, if they provision appropriately for future repayments by spending only the grant element of the credit.

²¹ In IMF and World Bank [2006b], *op. cit.*, it is noted that “more fundamentally, where potential debt problems could occur, these patterns would immediately be detected by the DSF” (p. 56)”.

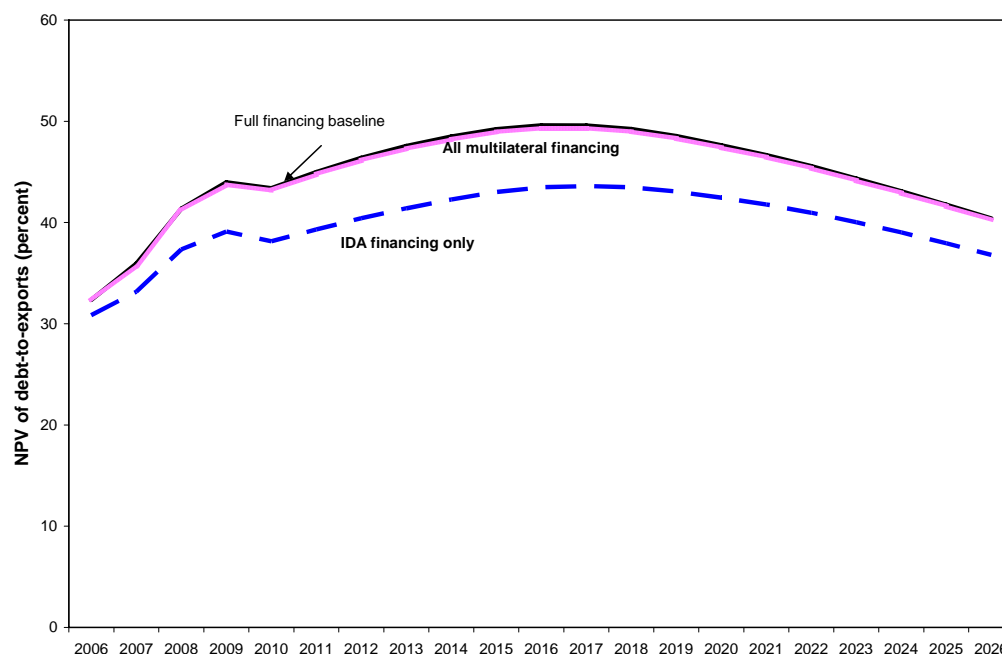
commercial creditors. New borrowing projections of public and publicly guaranteed (PPG) external debt include both the amounts and the terms of the loans by major creditor group.²² However, IDA assistance is usually expressed in regular IDA credit terms – since DSAs are tools on the basis of which the need for IDA grants should be established. Charts 2 and 3 below show how baseline projections in DSAs are decomposed into different sources of financing.

Chart 2. Baseline Projections for Ethiopia: IDA and Other Financing Sources



²² See World Bank (2005), *op. cit.*, p. 20.

Chart 3. Baseline Projections for Mozambique: IDA and Other Financing Sources



24. **The decomposition of the baseline projections in DSAs conveys two key ideas: (i) the source of a potential acceleration in the debt accumulation rate can be detected through the DSA; and (ii) creditor coordination is critical – even if IDA does its part there is no assurance that others would follow suit.** The Ethiopia case (Chart 2) is again illustrative. As discussed in Box 2, Ethiopia received a “yellow light” in FY06 on the basis of its moderate debt distress risk rating, largely due to the sensitivity analysis performed for the DSA. The baseline projections also show a “hump” in the country’s debt trajectory in 2010-12. However, this can be at least partly attributed to borrowing undertaken by Ethiopia’s state-owned flagship air carrier for the purchase of aircrafts.²³ Although IDA lending volumes to Ethiopia are substantial, they explain on average less than half of the rate of change in Ethiopia’s baseline projections for the NPV of debt-to-exports ratio during the initial five years. The Mozambican case, shown in Chart 3, suggests that multilateral lending is the main source of financing and IDA is a major contributor. The Mozambique DSA does not indicate a need for IDA grants since the NPV of debt-to-exports ratio would remain well below the relevant threshold over the projection period.

25. **Therefore, unilateral action on the part of IDA would not be enough. Effective collective action would go a long way towards mitigating risks of unsustainable debt accumulation.** Progress in creditor coordination varies across creditor categories. Progress has been more accelerated with respect to multilateral development banks. In fact, the African Development Fund now provides grants on the basis of countries’ debt sustainability prospects. DSF-based mechanisms are also under

²³ IMF and World Bank (2006c), *op.cit.*

active consideration by other MDBs, including the Asian Development Fund. In addition, the Bank and the Fund have increased outreach to export credit agencies. The OECD Export Credit Group and the Paris Club have initiated a dialogue with the Fund and the Bank on the role of export credit agencies in supporting debt sustainability. Non-OECD export credit agencies have rapidly increased lending, but are only gradually becoming involved in these efforts. However, coordination efforts vis-à-vis commercial creditors are still at a very incipient level.

26. **The DSF is well-placed to provide a possible platform for strengthened creditor cooperation.** As noted in the September 18, 2006 Development Committee Communiqué, “We therefore underscored the importance of the Joint Debt Sustainability Framework of the Fund and the Bank for low-income countries in helping ensure that new borrowing in post-MDRI countries does not undermine their long-term debt sustainability (...). We asked all the multilateral development banks, bilateral donors, export credit agencies and commercial creditors to adhere to this framework.”²⁴ IDA donor governments would play a critical role in enforcing such discipline.

27. **Creditor coordination would help address the “supply side” of unsustainable debt accumulation. The “demand side” – i.e., over-borrowing risks on the part of low-income countries themselves – needs to be dealt with as well.** Supply-side initiatives would not work if incentives for over-borrowing by low-income countries are not attended to. On the demand side, debt relief that is not associated with changes in beneficiary countries’ long-run savings preferences may eventually lead to excessive borrowing or asset decumulation in these countries.²⁵ While IDA’s policy on non-concessional borrowing by grant-eligible and MDRI-recipient countries²⁶ includes mechanisms which discourage excessive non-concessional borrowing, the importance of long-term debt sustainability also needs to be internalized by borrowers themselves. To be successfully contained, debt over-accumulation risks need to be dealt with in the context of country-owned borrowing strategies consistent with maintaining debt sustainability over time. Borrower ownership of such strategies is critical to ensure that debt sustainability concerns are internalized, thereby lessening over-borrowing risks. However, such homegrown borrowing strategies will require significant capacity building in debt management in many low-income countries. There is scope for the IMF and the World Bank to play a significant role in helping build such capacity.

²⁴ Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries. *Development Committee Communiqué*. Singapore, September 18, 2006.

²⁵ See Easterly, W. (1999). “How Did Highly Indebted Poor Countries Become Highly Indebted? Reviewing Two Decades of Debt Relief”. *World Bank Policy Research Working Paper 2225*, November.

²⁶ IDA (2006). *IDA Countries and Non-Concessional Debt: Dealing with the “Free Rider” Problem in IDA14 Grant-Recipient and Post-MDRI Countries*. IDA/R2006-0137, June.

C. Dealing with Public Domestic Debt

28. **Domestic debt has become an increasingly important issue in a number of low-income countries.** For the period between 1995- 2004, average domestic debt has accounted for about 18.7 percent of GDP in 66 low-income countries (LICs). Domestic debt accounts for more than 25 percent of GDP in some countries (e.g. Eritrea, Ethiopia, Guyana, Nicaragua, Solomon Islands and Sierra Leone). As a share of total public debt, domestic debt is on average one fifth of LICs' total public debt, and more than one fourth of total debt in some countries (e.g. Cameroon, Eritrea, and Ethiopia). LICs use on average about 8 percent of public revenues on domestic debt interest payments, representing more than 40 percent of the average total public debt interest bill.²⁷

29. **In the context of the DSF review, progress has been made in mainstreaming domestic debt into debt sustainability analyses.** Difficulties in integrating domestic debt into a threshold-based approach have been acknowledged during the design phase of the DSF.²⁸ Such integration has been marred by a lack of comprehensive historical data on public domestic debt in low-income countries and by difficulties associated with cross-country domestic debt comparability.²⁹ To address these issues, the second DSF review proposes strengthened guidance on how to treat public domestic debt in DSAs.³⁰

30. **Public domestic debt differs from external debt in a number of ways.** Unlike public external debt, domestic debt in LICs is in general of short maturity and high interest rates, resulting in liquidity issues rather than solvency issues. Furthermore, domestic debt serves not only to finance budget outlays, but also to sterilize foreign currency inflows or to develop domestic financial markets. In addition, public domestic debt may be associated with different policy incentives. For example, if domestic debt is held in local currency, it could in principle be "inflated away" through expansionary monetary policy. Repayment incentives may also differ: failure to repay domestic citizens might be politically more costly than failure to repay external creditors.

31. **As a result, changing IDA's financing terms from credits to grants may not be the appropriate policy response to situations where debt-distress risk is primarily driven by domestic debt.** The IDA14 grants framework establishes financing terms on the basis of *external debt*-driven risk of debt distress insofar as domestic debt is not part of the determination of "pillar one" thresholds. This does not make the domestic debt issue any less important; however, it is doubtful whether IDA grants are a suitable policy instrument to deal with fiscal sustainability issues emerging from the build-up of public domestic debt. As noted in the April DSF review paper, "raising concessionality on the

²⁷ The source for the figures in this paragraph is IMF and World Bank (2006b), pp. 40-56.

²⁸ See IMF and World Bank (2004a, 2004b), *op. cit.* As noted in IMF and World Bank (2004b), the empirical thresholds "pertain to public and publicly guaranteed external debt which typically dominates low-income countries' total external and public sector debt, and is the portion most important to the official international community." (p.12, para. 18).

²⁹ See IMF and World Bank (2004b), *op. cit.*, Appendix I, p.39, paras. 4-5.

³⁰ See IMF and World Bank (2006b), *op. cit.*, pp.25-30.

basis of domestic borrowing would entail moral hazard problems.”³¹ Consistently with this, the second DSF review paper points out that, if a difference emerges in the assessment of debt distress risk with or without public domestic debt, such a difference should be explicitly acknowledged in order to enable IDA continue establishing financing terms on the basis of external debt considerations alone.

IV. DEBT DYNAMICS AND THE CONCESSIONALITY OF FINANCING

A. How Concessionality Affects Debt Dynamics

32. **Tailoring financing terms of assistance to countries’ debt sustainability prospects is an important step forward.** The main justification for increasing the concessionality of aid to low-income countries is to enable them to receive resource flows that are consistent with their debt-carrying capacity. By placing debt distress risk at the center of the decision-making on financing terms, the IDA14 grants framework directly addresses the concern that low-income countries’ debt-carrying capacity be duly taken into account when determining the terms of new financing.

33. **However, increased concessionality *per se* should not be seen as a panacea that in and of itself will guarantee sustainable debt trajectories for low-income countries.** Concessionality is just one among many factors that could shape a country’s debt dynamics. As seen in more detail in Box 3, year-to-year changes in the NPV of debt-to-exports ratio – an indication of the pace of debt accumulation – can be decomposed in three components: (i) the *external financing gap*, which – if positive – is the primary source for a rising debt stock, all else constant; (ii) the *endogenous debt dynamics*, which measure the portion of the change in debt ratios which takes place irrespective of new borrowing, and essentially depends on the interplay between the average interest rate on existing debt and the export growth rate; and (iii) the *multiplier*, which measures the impact a given financing gap will have on the change in the debt ratio, and which is determined by two key parameters: the average grant element of new financing and the exports-to-GDP ratio. Strictly speaking, the degree of concessionality of assistance can only directly affect the third component, the multiplier.

34. **It should be noted that, empirically, movements in debt ratios have been dominated by movements in the denominator (exports and GDP),³² and that countries’ policies and exogenous shocks also affect debt dynamics.** Macroeconomic and structural policies could in principle influence all three components of debt dynamics: the financing gap, through fiscal, monetary and exchange rate behavior; the multiplier, through the exports-to-GDP ratio; and the endogenous debt dynamics, mainly through the export growth rate. Exogenous shocks would affect debt dynamics mainly

31 IMF and World Bank (2006a), *op. cit.*, p.10, para. 19. Moral hazard risks are also present in providing grants to countries with high *external* debt burdens. However, such risks are mitigated by the disincentives to non-prudent non-concessional borrowing provided in IDA’s policy on non-concessional borrowing by grant-eligible and MDRI-recipient countries.

32 World Bank (2004). “Is Sovereign Debt Helping Development?”, unpublished manuscript, October.

through the export growth channel, but could also work through the financing gap component. This also shows that, besides tailoring financing terms, other aspects of IDA's work – those geared towards strengthening countries' policy performance and preparedness against exogenous shocks – would also ultimately help improve debt dynamics.

Box 3. The Components of Debt Dynamics^{1/}

In order to fully understand what impact increased concessionality could potentially have on countries' debt trajectories, it is useful to examine which factors govern debt dynamics – that is, the evolution of external debt ratios over time.

Concessionality is just one among many factors that affect a country's debt dynamics. To see this, consider the following equation, describing the dynamics of the NPV of debt-to-exports ratio in a given country:

$$\underbrace{\frac{NPV_t}{X_t} - \frac{NPV_{t-1}}{X_{t-1}}}_{\text{Change in debt ratio}} = \underbrace{\frac{i_t - \varepsilon_t}{1 + \varepsilon_t} \frac{NPV_{t-1}}{X_{t-1}}}_{\text{Endogenous debt dynamics}} + \underbrace{\frac{(1 - GE_t)}{x_t}}_{\text{Multiplier}} \underbrace{(td_t - tr_t - fdi_t + \Delta r_t)}_{\text{Financing gap}}$$

In this equation, NPV stands for the net present value of external debt, X for total exports, and GE for the average grant element of new borrowing (representing the concessionality of assistance). The terms i and ε are, respectively, the average interest rate on existing debt and the growth rate of exports. All other variables are expressed as ratios to the country's GDP: exports (x); trade and services balance (td); current transfers (tr); foreign direct investment (fdi); and changes in foreign assets, including reserves (Δr).

As indicated above, a change in the NPV of debt-to-exports ratio can be decomposed into three components:

- The *endogenous debt dynamics*, which is the component of the change in the debt ratio that takes place independently of new financing. This endogenous component will operate as long as the debt stock at time $t-1$ is non-zero and the interest rate is not equal to the export growth rate. Endogenous dynamics will be stable (unstable) if the export growth rate exceeds (is exceeded by) the interest rate.
- The *financing gap*, which essentially shows the need (or lack thereof) for new financing. A positive financing gap, all else constant, leads to an increase in the debt stock.
- The multiplier, which measures the impact of a given financing gap on the evolution of the debt ratio. The multiplier is governed by two key variables: (i) concessionality of new financing, as measured by the average grant element (GE); and (ii) economic openness, as measured by the exports-to-GDP ratio (x). The larger is the grant element and the higher is the exports-to-GDP ratio, the smaller will be the multiplier and thus the impact of a given financing gap on the country's debt dynamics.

The above decomposition should make it clear that there are several factors affecting a country's debt dynamics: the size of the financing gap; the degree of economic openness; the growth rate of exports; the average interest rate; and the grant element of new financing.

The impact of increased concessionality on a country's debt dynamics works through the multiplier – by reducing the impact of a given financing gap; but it does not affect the endogenous debt dynamics, which are governed by the existing stock of debt, the prevailing interest rate, and the export growth rate. In addition, the effectiveness of increased concessionality as an instrument to slow down debt accumulation depends on the degree of economic openness – if the exports-to-GDP ratio is too small, the multiplier could still be large, even for a large average grant element. Of course, in the limit, if GE equals unity – meaning that all new assistance is in grants terms – the multiplier would be zero, and changes in the debt ratio would be exclusively governed by the endogenous debt dynamics.

^{1/} The analysis in this box draws heavily on Daseking, C. and B. Joshi (2005), "Debt and New Financing in Low-Income Countries: Looking Back, Thinking Ahead", International Monetary Fund, February.

B. IDA Grants and Debt Dynamics

35. **Ultimately, the impact of IDA concessionality depends on IDA's share in a country's new borrowing.** Increased concessionality of IDA assistance also affects debt dynamics through the multiplier channel – but the final outcome clearly depends on how important IDA is in terms of new debt flows to any given country. When IDA shifts its financing terms to a given country from credits to grants, the average overall grant element, all else constant, goes up, lowering the multiplier. As discussed before, the pace of debt accumulation will also depend on the endogenous debt dynamics as well as on the country's degree of economic openness. To specifically gauge the impact of increased concessionality from IDA on a country's debt dynamics, an additional parameter needs to be taken into account: IDA's share in the country's new financing.

36. **The impact of IDA grants on debt dynamics tends to be stronger in countries where IDA is a major donor.** This can be clearly seen in the cases of Ethiopia and Rwanda, shown respectively in Charts 4 and 5 below.³³ Both charts show the behavior of the NPV of debt-to-exports ratio under three scenarios: (i) a baseline in which IDA provides only regular credits; (ii) an alternative scenario in which grants are provided during the IDA14 period and then discontinued; and (iii) a third scenario in which DSF-based grants are provided both in IDA14 and in IDA15, and discontinued thereafter.³⁴ It is clear from both charts that IDA grants do have the power to affect the pace of debt accumulation in countries such as Ethiopia and Rwanda, where IDA is a major donor.³⁵ The greater the concessionality of new IDA commitments over the projection period, the lower the trajectory of the NPV of debt-to-exports ratio for both Ethiopia and Rwanda.

37. **The impact of IDA grants on the debt dynamics of countries in which IDA accounts for a relatively low share of new borrowing will tend to be much more limited.** Nicaragua, where IDA's average exposure is about 2 percent of the country's total NPV of debt, is a clear example of this case. IDA grants alone would have very little impact on Nicaragua's debt trajectories, as shown in Chart 6.

38. **IDA cannot directly control its share of new borrowing by low-income countries, particularly in light of the increasing importance of emerging creditors.** Official bilateral flows from non-Paris Club creditors have steadily increased in recent years. Although the share of these creditors in overall ODA remains relatively small, this

³³ Ethiopia and Rwanda have been selected for because they are clear examples of post-MDRI countries that continue to be eligible for grants (IDA's assistance envelope is comprised of 50% grants for Ethiopia and 100% grants for Rwanda).

³⁴ This exercise is based on available DSAs for Ethiopia, Nicaragua, Niger and Rwanda. It employs the following data for each country: actual IDA commitments for FY06, agreed IDA allocations for FY07, indicative norm allocations for FY08 and FY09. FY09 data are extrapolated for FY10 and FY11 as well. It is assumed any new IDA commitment is disbursed over a 9-year period.

³⁵ IDA's share in Ethiopia's and Rwanda's borrowing has been on average about 40 percent and 75 percent, respectively.

new phenomenon further increases the uncertainty of IDA's ultimate impact on countries' debt sustainability prospects.

Chart 4. Ethiopia: Debt Dynamics Under Different Scenarios on IDA Grants

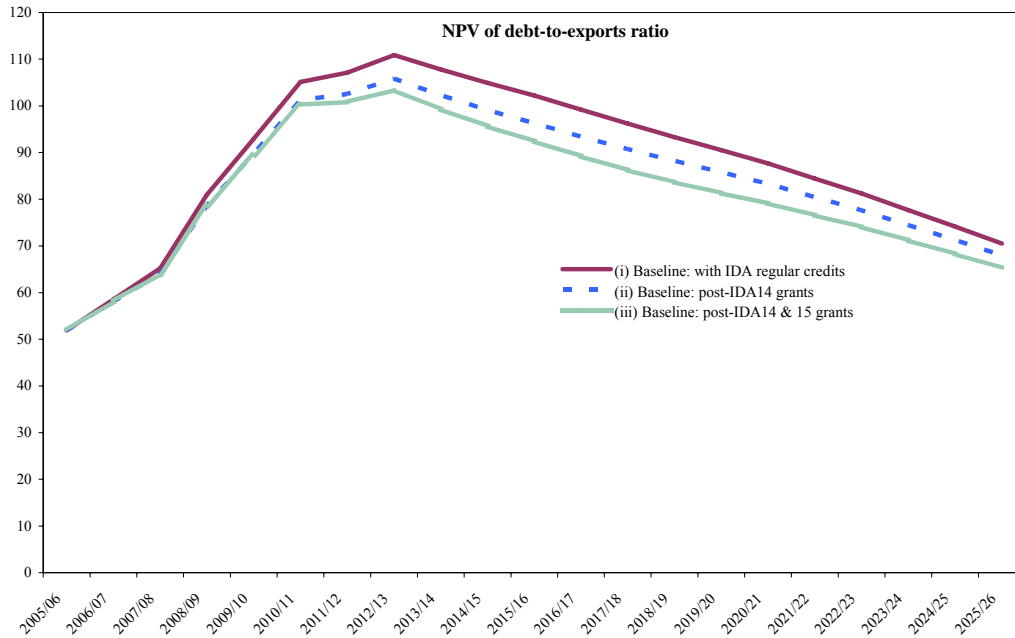


Chart 5. Rwanda: Debt Dynamics Under Different Scenarios on IDA Grants

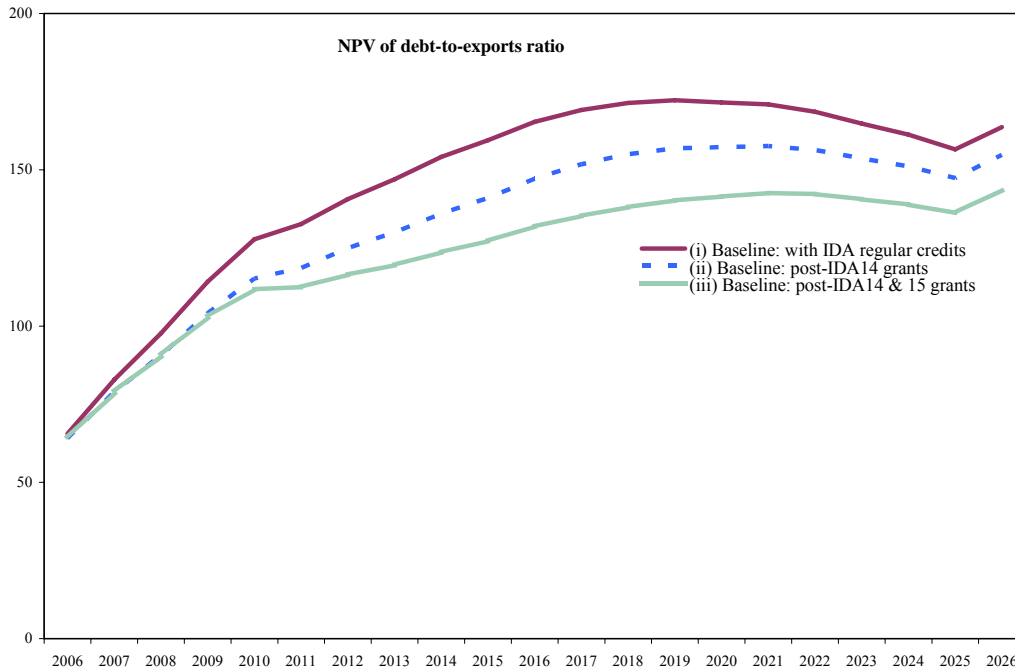
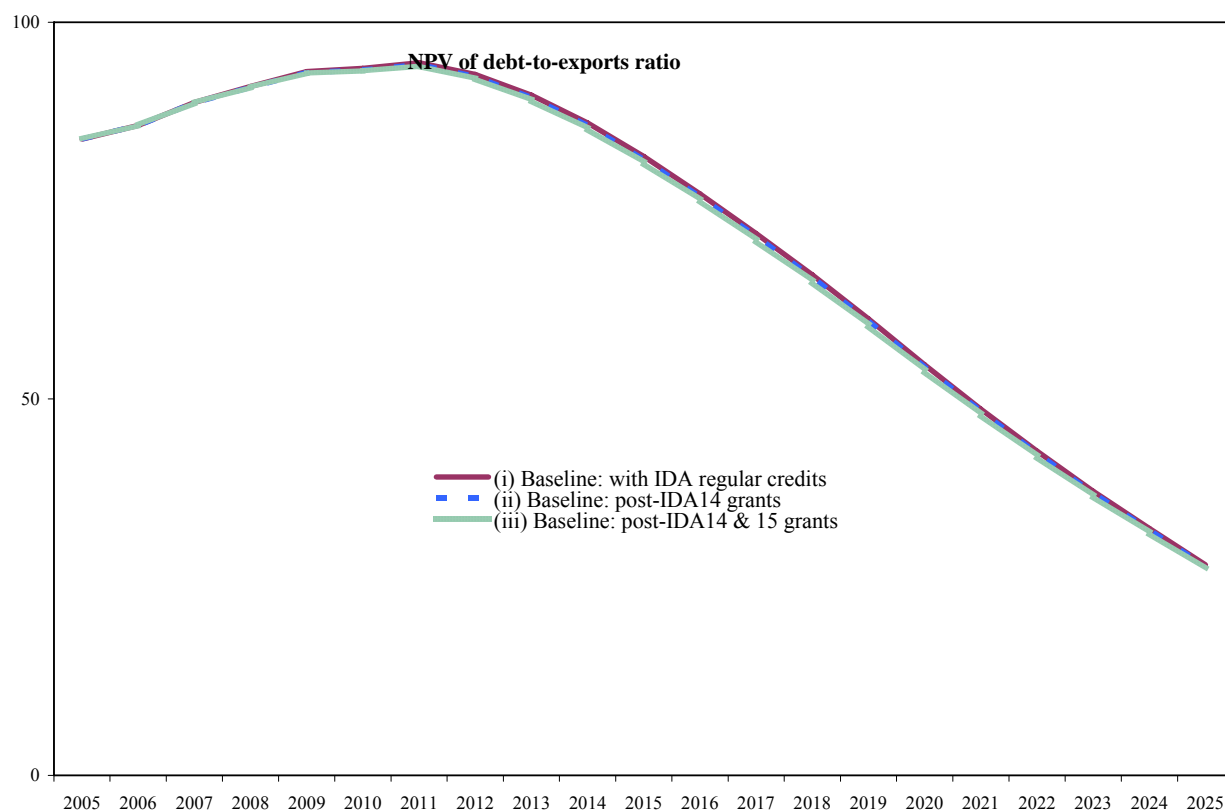


Chart 6. Nicaragua: Debt Dynamics Under Different Scenarios on IDA Grants



39. **Even in countries where IDA would remain a major player, adverse debt dynamics may still result from factors outside IDA’s control, such as exogenous shocks or the unexpected behavior of economic variables.** As discussed above, IDA grants can only affect the average grant element of new financing, but in and of themselves cannot influence the behavior of other key variables such as the average interest rate, export growth, and export-to-GDP ratios. In addition, exogenous shocks – which would mostly affect debt dynamics through the financing gap and the export growth rate – could affect debt trajectories quite independently of the level of concessionality of IDA assistance. Finally, it should be stressed that unwarranted non-concessional borrowing by low-income countries could to some extent undo the benefits from increased concessionality of IDA assistance, as will be seen in greater detail in the next subsection.

C. Non-Concessional Borrowing and Debt Dynamics

40. **As a general rule, low-income countries with fragile and relatively undiversified economies should refrain from non-concessional borrowing.** Looking again at the components of changes in debt ratios analyzed in Box 3, there are two entry points whereby non-concessional borrowing could adversely affect debt dynamics: (i) by increasing the overall cost of borrowing (as measured by the average interest rate), thus

worsening the endogenous debt dynamics (for a given export growth rate); and (ii) by reducing the average grant element of new financing, thereby increasing the multiplier (for a given exports-to-GDP ratio) and magnifying the impact of the financing gap on the pace of debt accumulation. For the most part, low-income countries – particularly those eligible for IDA grants and/or who benefited from MDRI relief – should rely on concessional sources for their financing needs.

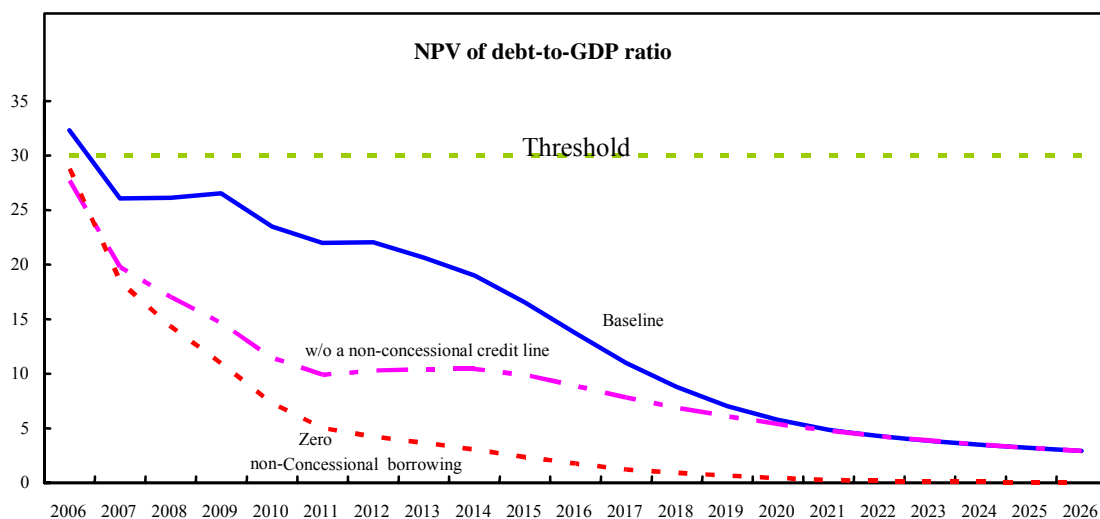
41. **IDA’s policy on non-concessional borrowing by grant-eligible and MDRI-recipient countries³⁶ could be seen as a tool to help protect low-income countries against worsening their debt dynamics through non-prudent borrowing.** IDA’s new policy aims to mitigate the risk that the expanded transfer of concessional resources in the form of grants and debt relief may lead to excessive non-concessional borrowing. It does so by adopting a two-pronged strategy to lending to low-income countries: (i) enhancing creditor coordination around an agreed framework to establish the appropriate concessionalism of assistance; and (ii) discouraging unwarranted non-concessional borrowing through incentives aimed at borrowing countries.

42. **Contracting non-concessional loans may also (at least partly) offset potential improvements in the debt dynamics brought about by stronger export growth.** A higher export growth rate should (all else constant) lead to an improvement in the endogenous debt dynamics component of the changes in debt ratios. However, if stronger export performance is accompanied by increased non-concessional borrowing, then the debt dynamics may not improve at all – particularly if the new non-concessional loans are not guaranteed to sustain high export growth. This can be illustrated by the case of Angola. The alternative baseline scenarios in Chart 7 below indicate a steady decline in the NPV of debt-to-GDP ratio, moving farther away from the applicable threshold of 30 percent.³⁷ This reflects the favorable prospects for Angola’s main export commodity, crude oil. However, each alternative baseline curve is based on different assumptions on non-concessional borrowing. The uppermost curve incorporates disbursements from the known non-concessional loans contracted by Angola. The dashed curve in the middle excludes disbursements from a large non-concessional credit line contracted over the last two years. The lowermost curve excludes disbursements from all non-concessional sources. The main message from Chart 7 is that the NPV of debt-to-GDP ratio would decline much faster as a result of strong export performance in the absence of non-concessional borrowing, providing a greater cushion against exogenous shocks.

³⁶ IDA (2006), *op. cit.*

³⁷ Since Angola is classified as a weak-performing country.

Chart 7: Angola: Non-Concessional Borrowing and Debt Dynamics



43. **However, non-concessional borrowing could be justified under certain circumstances, such as when it is contracted to finance high-return projects with a potentially strong development impact.**³⁸ In principle, non-concessional loans with a high rate of return could generate sufficient cash flow to repay themselves.³⁹ From the point of view of debt dynamics, such borrowing could in itself lead to higher future export growth rates, thus leading to more favorable endogenous debt dynamics. In any case, for that to work, the degree of economic openness has to be sufficiently high (the exports-to-GDP ratio needs to be sufficiently large) in order to compensate for a lower average grant element (and thus a larger multiplier) resulting from the non-concessional borrowing.⁴⁰ Other country-specific considerations in assessing the appropriateness of non-concessional borrowing include debt management capacity, the country’s overall borrowing plans, the impact of the new debt on the country’s macroeconomic framework and debt distress risk, the strength of the borrower’s policies and institutions, and the expected use of the funds thus obtained.⁴¹

³⁸ See IDA (2006), *op. cit.*, for further discussion.

³⁹ The key rule of thumb in this respect is the so-called *golden rule of government finance*: “(...) public investments that attain the market rate of return give rise to no net liability of the government and hence do not lead to present or future taxation. They can be financed by means of debt without any problem.” See Hejdra, B.J. and F. van der Ploeg (2002). *The Foundations of Modern Macroeconomics*. Oxford: Oxford University Press.

⁴⁰ An alternative approach to attempting to estimate return rates would be to assess whether a given non-concessional loan makes sense from the point of view of the borrower’s overall public expenditure framework, particularly its public investment program.

⁴¹ See IDA (2006), *op. cit.*, Box 3, which also discusses a number of loan-specific factors to assess the appropriateness of a given non-concessional loan.

V. POSSIBLE TECHNICAL REFINEMENTS

44. **Two remaining technical issues need to be addressed to ensure that the DSF provides an appropriate platform for establishing IDA’s financing terms.** These are: (i) the risk that marginal changes in CPIA scores for individual countries may lead them to change performance categories (thereby changing the applicable policy-dependent debt thresholds) without any material change in their economic fundamentals; and (ii) the appropriate interface between debt distress risk ratings and grant eligibility categories. On the first issue, the paper recommends the use of three-year CPIA moving averages instead of year-by-year CPIA scores in order to determine the performance category in which each country belongs. On the second issue, the paper concludes that there does not seem to be strong analytical support for revising the current debt distress risk or grant eligibility categories. These issues are addressed in subsections A and B, respectively.

A. Dealing with Potential CPIA-Driven Volatility in Performance Categories⁴²

45. **With absolute CPIA cutoffs, there is a risk that marginal changes in CPIA scores for individual countries lead them to change performance categories without any major change in their economic fundamentals.** This is especially the case for countries of which CPIA scores have fluctuated around the 3.25 and 3.75 CPIA cutoffs. This can subsequently affect the debt thresholds applicable to the country – even if its external debt situation did not materially change. The degree of volatility in terms of performance categories can be gauged by notionally applying the current CPIA cutoffs to countries over a certain period of time. The database used for this analysis covers 63 IDA-only countries between 1998 and 2005. Table 2 summarizes the results of this test for selected countries for the 2001 – 2005 period. The average volatility of year-on-year CPIA scores over the 2001-5 period is 14 percent.⁴³ This volatility could occur in the event of sudden deteriorations in well progressing reforms or well performing institutions or as a result of inevitable “noise” in the CPIA evaluation process.⁴⁴

Table 2. Performance Categories for Selected Countries, under Current Practice

Selected Countries	Performance Categories				
	2001	2002	2003	2004	2005
Burkina Faso	Medium	Medium	Medium	Strong	Strong
Guyana	Medium	Weak	Medium	Medium	Medium
Kyrgyz Republic	Medium	Weak	Medium	Medium	Medium
Moldova	Medium	Medium	Weak	Medium	Medium
Mongolia	Weak	Medium	Medium	Medium	Medium
Nicaragua	Weak	Medium	Medium	Strong	Medium
Senegal	Medium	Medium	Strong	Strong	Strong

⁴² The discussion that follows is relevant both for the “static” and forward-looking approaches.

⁴³ This refers to an average standard deviation of CPIA ratings of 63 IDA-only countries during the five year period.

⁴⁴ See IMF and World Bank (2006b), p. 36, para. 72.

46. **To address this risk, two alternatives are examined: establishing performance categories based on (i) three-year CPIA moving averages instead of year-by-year CPIA scores; and (ii) relative CPIA cutoffs.** The following test scenarios are defined:

- Current practice: absolute cutoffs based on year-on-year CPIA scores.
- Scenario I: absolute cutoffs based on the moving average of CPIA scores.
- Scenario II: relative cutoffs based on terciles of the annual CPIA distribution.
- Scenario III: relative cutoffs based on quartiles of the annual CPIA distribution.
- Scenario IV: relative cutoffs based on quintiles of the annual CPIA distribution.

The results of these scenarios are presented in detail in Annex I, Tables A.1. – A.4.

47. **Absolute cutoffs based on the moving average of CPIA scores (scenario I) seem to better address potential CPIA-driven volatility in performance categories.** The joint Bank-Fund DSF review recommended using this approach⁴⁵, which has a number of advantages over the alternative of adopting relative CPIA cutoffs. First, smoothness is generated without the upward bias noted in the case of relative CPIA cutoffs. Second, absolute CPIA cutoffs – even when used in combination with moving average of CPIA scores – were directly derived from the empirical work behind the policy-dependent thresholds, which is not the case with relative cutoffs. Third, as shown in Annex Table A.4, scenario I generates more prudent “traffic lights” than the scenarios with relative CPIA cutoffs scenarios (Table A.2.-3).

48. **The proposed methodology would reduce the risk that countries shift back and forth from one performance category to another, while generally having a small impact on the overall grant share.** FY06 and FY07 grant shares would have been practically the same had moving averages of CPIA scores been used in those fiscal years for the purposes of establishing countries’ performance categories.⁴⁶ Although so far this risk has materialized in just a few cases, there are a number of countries whose CPIA scores are close to the CPIA cutoff levels (3.25 and 3.75). Therefore, more cases of volatility in performance categories could be potentially seen in the future under current practice. Equity of treatment would require the application of this methodology to all countries undergoing DSF-style DSAs. However, for the vast majority of countries, the

⁴⁵ See IMF and World Bank (2006b), op. cit., p. 37: “(...) CPIA fluctuations – as opposed to secular improvement and deterioration – may translate into undue volatility in the IDA grant share of a given country. (...) To mitigate this problem, a three-year moving average CPIA score to determine the performance category is recommended.”

⁴⁶ The use of moving averages would have increased the total grant envelope by about SDR 1 million in FY06 and by SDR 36 million in FY07, with minimal impact on the overall grant share. In FY06, moving averages would have changed performance categories for four countries: Burkina Faso, Nicaragua, Senegal, and Sri Lanka. Of these four, “traffic lights” would change for Burkina Faso (“green” to “yellow”), Nicaragua (“green” to “yellow”) and Sri Lanka (“yellow” to “green”). The increase in grants for Burkina Faso and Nicaragua would have been largely compensated for by a decrease in grants for Sri Lanka. Despite the change in performance category, Senegal’s “traffic light” would have remained “green”. In FY07, moving averages would have changed performance categories for Burkina Faso, Georgia, Ghana, Mauritania and Tajikistan. However, only Burkina Faso would have seen a change in “traffic light” (from “green” to “yellow”).

use of moving averages would not lead to changes in the performance categories in which they are currently placed.

B. Refining Categories of Debt-Distress Risk and Grant Eligibility

49. **A smooth transition towards a forward-looking grant eligibility system requires an appropriate interface between DSA-based debt-distress risk ratings and the grant/credit mix in IDA.** The current debt-distress risk rating system for DSAs was originally presented in the Bank-Fund "Modalities Paper".⁴⁷ The following debt-distress risk categories are currently in use for DSAs:

- *Low risk:* All debt indicators are well below the relevant policy based thresholds. Alternative scenarios and stress tests do not result in indicators breaching thresholds in any significant way. The country is currently meeting debt service obligations.
- *Moderate risk:* While the baseline scenario does not indicate a breach of thresholds, alternative scenarios and stress tests show a substantial rise in the debt service ratio over the projection period nearing the thresholds and/or a breach of debt stock ratios. The country is currently servicing its debt but has, on occasion, run sporadic arrears to individual creditors.
- *High risk.* The baseline scenario indicates a breach of debt stock and/or service ratios over the projection period. This is exacerbated by the alternative scenarios/stress tests. The country is running sporadic arrears and/or has a history of default.
- *In debt distress:* Current debt stock and service ratios are in significant and/or sustained breach of thresholds. The country is running arrears to multiple creditors and/or poses a significant risk of defaulting on its debt service obligations in the absence of major debt reduction/restructuring.

50. **Under a DSA-based system, the debt-distress risk ratings emerging from DSAs would be converted into “traffic light” assignments for the purposes of determining the credit/grant mix of IDA resources.** However, automatically converting the debt-distress risk definitions currently applied to DSAs into “traffic lights” could give rise to the concern that there could be a tendency to place too many countries in the moderate risk category.

51. **This issue was dealt with in the context of the joint Bank-Fund DSF review, which concluded that there was no pressing need for revising the risk category definitions.** In fact, the incidence of moderate risk cases has been reduced, particularly as a result of the MDRI. On average, only one out of four recent DSAs receives a moderate risk rating. The review also pointed out that subdividing the moderate risk category would “overstate the precision with which the underlying 20-year forecasts can truly be made.”⁴⁸

⁴⁷ IMF and World Bank (2004b), *op. cit.*

⁴⁸ IMF and World Bank (2006b), *op. cit.* p.35, para. 69-71.

52. **Therefore, it is proposed that the interface between grant eligibility and debt distress risk categories continues to be based on three “traffic lights”.** Compared to alternatives – such as implementing a five grant eligibility category model – the “three-light” system combines relative operational simplicity and a nearly one-to-one relationship with the debt distress risk categories in the DSF. Therefore, as with the “snapshot” system, “green light” (100 percent credits) will be assigned to countries with a low risk of debt distress; a “yellow light” (50 percent credits, 50 percent grants) to countries with a medium risk; and a “red light” (100 percent grants) to countries with a high risk or already in debt distress. Grant eligibility will continue to be restricted to IDA-only, non-“gap” countries.

VI. CONCLUSIONS AND ISSUES FOR DISCUSSION

53. **A forward-looking framework for financing terms will allow IDA to play a more proactive role regarding low-income countries’ debt sustainability prospects.** While the current “snapshot” approach to grant eligibility overall produces reasonable approximations to countries’ risk of debt distress, it does not take into account countries’ vulnerability to shocks or the impact of expected changes in their debt burdens (either through new lending or as a result of debt relief). A forward-looking-based system would enable IDA to tailor its financing terms appropriately well before countries’ debt ratios get overly close to the thresholds. However, it is critical that *all* creditors and donors also take into account countries’ debt sustainability prospects in lending and assistance terms.

54. **It is proposed that forward-looking, joint Bank-Fund DSAs be the central tool for determining eligibility for IDA grants.** DSAs are a strong instrument with which to gauge countries’ risk of debt distress, the central variable in the determination of the credit-grant mix in IDA. In addition, DSAs can provide key information and insights for the design of country-owned borrowing strategies consistent with maintaining debt sustainability over time. DSAs also offer an early-warning system to help prevent unsustainable accumulation of external debt in IDA-only countries, and allow IDA to tailor its financing terms accordingly. However, in those cases where a recent DSA is not available, IDA’s “traffic lights” could still be based on the “snapshot” mechanism.

55. **While increased concessionality provides no guarantee that debt dynamics will be favorable for all grant recipients, it is clear that non-prudent non-concessional borrowing worsens these countries’ debt sustainability prospects.** Concessionality of new financing is one among several factors influencing countries’ debt dynamics. Therefore, the impact of IDA grants on countries’ debt sustainability prospects needs to be gauged against the backdrop of countries’ vulnerability to external shocks, degree of economic openness, and macroeconomic as well as structural policies. On the other hand, non-prudent non-concessional borrowing remains the principal source of debt re-accumulation risks. This is clearly recognized in IDA’s new policy on non-concessional lending to post-MDRI and grant-recipient countries.

56. **It is therefore critical that other creditors and donors take borrowing countries' debt sustainability prospects into account when designing their financing programs.** Unilateral action on the part of IDA is not enough; a concerted creditor and donor effort is needed to provide appropriately concessional finance to low-income countries. More progress is needed in terms of creditor and donor coordination, and cooperative mechanisms need to be strengthened to ensure effective collective action. The DSF is well-placed to provide a possible platform for strengthened creditor cooperation.

57. **Additional technical refinements to a DSA-based grants framework have also been considered.** The first enhancement aims to reduce the volatility in performance categories that could result from small, even marginal, movements in CPIA scores. On balance, adopting three-year CPIA moving averages yields superior results to the alternative, namely, shifting to relative rather than absolute CPIA cutoffs. The second enhancement refers to the introduction of additional debt-distress risk categories. Consistent with the recommendation of the joint Bank-Fund DSF review follow-up paper, there does not seem to be a strong analytical support for revising the current debt distress risk or grant eligibility categories.

58. **Deputies may wish to consider the following issues for discussion:**

- Do Deputies agree that DSA-based debt distress risk ratings should determine country eligibility for IDA grants?
- Deputies might want to discuss different ways of accelerating progress in terms of donor and creditor coordination, and of strengthening cooperative mechanisms, in order to ensure effective collective action.
- Do Deputies agree that, from an IDA grant eligibility perspective, three-year CPIA moving averages would help reduce the risk that marginal changes in CPIA scores for individual countries lead them to change performance categories without any major change in their economic fundamentals?
- Do Deputies agree that the current three “traffic lights” combine relative operational simplicity with close adherence to the debt distress risk categories used in the DSF?

Table A.3. Performance Categories for Selected Countries: Quartile and Quintile cutoffs

Selected Countries	Scenario III					Scenario IV				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
Bangladesh	Medium	Medium	Strong	Medium	Medium	Medium	Strong	Strong	Medium	Medium
Benin	Strong	Medium	Strong	Strong	Medium	Strong	Strong	Strong	Strong	Strong
Burkina Faso	Strong	Medium	Strong	Strong	Strong	Strong	Strong	Strong	Strong	Strong
Georgia	Medium	Medium	Medium	Medium	Strong	Medium	<i>Weak</i>	<i>Weak</i>	Strong	Strong
Guyana	Medium	Medium	Medium	Medium	Medium	Medium	<i>Weak</i>	Medium	Medium	Medium
Kyrgyz Republic	Medium	Medium	Medium	Medium	Medium	Medium	Medium	Medium	Medium	Medium
Mali	Medium	Medium	Strong	Strong	Strong	<i>Weak</i>	Strong	Strong	Strong	Strong
Moldova	Medium	Medium	Medium	Medium	Medium	Strong	Strong	<i>Weak</i>	Medium	Medium
Mongolia	Medium	Medium	Medium	Medium	Medium	Medium	Strong	Medium	Medium	Medium
Nicaragua	Medium	Strong	Strong	Strong	Strong	Medium	Strong	Strong	Strong	Strong
Senegal	Strong	Strong	Strong	Strong	Strong	Strong	Strong	Strong	Strong	Strong

As noted in the main text, absolute cutoffs based on the moving average of CPIA scores (scenario I) seem to be a more effective option. First, increased smoothness is generated without the upward bias noted in the case of relative CPIA cutoffs. Second, absolute CPIA cutoffs – even when used in combination with moving average of CPIA scores – were directly derived from the empirical work behind the policy-dependent thresholds, which is not the case with relative cutoffs. Third, Table A.4 indicates that scenario I generates more prudent “traffic lights” than the scenarios with relative CPIA cutoffs scenarios (Table A.2-3).

Table A.4. Traffic Lights, Selected Countries: Current Practice versus Moving Averages

Selected Countries	Current practice					Scenario I				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
Burkina Faso	Yellow	Red	Yellow	Green	Green	Yellow	Red	Yellow	Yellow	Yellow
Guyana	Red	Red	Red	Red	Yellow	Red	Red	Red	Red	Yellow
Kyrgyz Republic	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Moldova	Red	Red	Red	Yellow	Green	Red	Red	Red	Yellow	Green
Mongolia	Red	Yellow	Red	Red	Red	Yellow	Yellow	Red	Red	Red
Nicaragua	Red	Red	Yellow	Green	Yellow	Red	Red	Yellow	Yellow	Yellow
Senegal	Red	Red	Green	Green	Green	Red	Red	Yellow	Green	Green
<i>Number of IDA-only country by light</i>										
Green	11	11	14	20	25	10	11	13	18	24
Yellow	6	5	4	6	5	6	6	5	8	6
Red	45	46	44	36	32	46	45	44	36	32

Note: Traffic lights are all based on historic debt data (“pillar one”) and, for comparison purposes, do not incorporate risk ratings emerging from DSAs (“pillar two”).

ANNEX II. POLICY-DEPENDENT DEBT DISTRESS CLASSIFICATIONS: FY06

Country	NPV of debt-to-GDP 1/	NPV of debt-to-exports 2/	Debt service-to-exports 2/	Debt Distress Classifications (Traffic light)
Strong (CPIA>=3.75)				
	50	200	25	
Armenia	25	101	14	Green
Bhutan	60	241	4	Red
Burkina Faso	16	211	17	Green
Cape Verde	35	139	10	Green
Maldives	27	40	4	Green
Nicaragua	38	157	21	Green
Samoa	33	129	16	Green
Senegal	29	119	15	Green
Tanzania	22	140	6	Green
Uganda	31	262	12	Yellow
Medium (3.75<CPIA<3.25)				
	40	150	20	
Bangladesh	24	166	9	Green
Benin	23	196	15	Yellow
Cameroon	41	177	16	Red
Ethiopia	23	150	9	Yellow 3/
Georgia	37	133	17	Yellow
Ghana	31	88	18	Green
Guyana	77	84	9	Red
Kenya	32	133	17	Green
Kyrgyz Republic	78	216	22	Red
Lesotho	44	114	15	Yellow
Madagascar	27	137	7	Green
Malawi	108	395	8	Red
Mali	32	135	8	Green
Mauritania	70	213	15	Green 3/
Moldova	45	100	18	Yellow
Mongolia	73	119	5	Red
Mozambique	31	123	8	Green
Nepal	35	145	8	Yellow
Niger	21	156	9	Green
Rwanda	59	701	15	Red
Sri Lanka	41	123	10	Yellow
Vietnam	32	62	4	Green
Yemen, Republic of	33	94	5	Green
Zambia	105	391	34	Yellow 3/
Poor (CPIA<=3.25)				
	30	100	15	
Afghanistan	164	300	..	Red
Angola	70	112	16	Red
Burundi	130	1830	61	Red
Cambodia	62	114	1	Red
Central African Republic	137	1080	0	Red
Chad	34	257	13	Red
Comoros	65	481	6	Red
Congo, Democratic Republic of	135	636	12	Red
Congo, Republic of	150	213	2	Red
Cote d'Ivoire	62	155	10	Red
Eritrea	49	318	10	Red
Gambia, The	87	202	12	Red
Guinea	53	239	16	Red
Guinea-Bissau	211	799	24	Red
Haiti	31	186	11	Red
Kiribati	..	..	..	N/A 4/
Kosovo	..	..	..	N/A 5/
Lao People's Democratic Republic	81	308	9	Red
Liberia	614	1919	0	Red
Myanmar	..	146	4	Red
Sao Tome and Principe	273	760	34	Red
Sierra Leone	111	553	16	Red
Solomon Islands	45	145	12	Red
Somalia	..	..	..	N/A 6/
Sudan	91	767	2	Red
Tajikistan	61	101	11	Red
Timor-Leste	..	..	..	N/A 5/
Togo	74	242	3	Red
Tonga	36	174	11	Red
Vanuatu	19	45	2	Green

Notes:

- 1/ In the ratios, both the numerator and the denominator refer to 2003 data.
 - 2/ In the ratios, the numerator refers to 2003 data and the denominator refers to the backward 3-year average of 2001-3.
 - 3/ Classification based on the country's available DSA.
 - 4/ Data are not available. Allocation for FY06 will be on a 100 percent credit basis.
 - 5/ Data are not available. Grant status determined during IDA14 negotiations (IDA14 Report (2005), para 75, p. 27).
 - 6/ Data are not available. Zero allocation for FY06.
- * Grey highlights indicate ratios above the indicative thresholds.

ANNEX III. POLICY-DEPENDENT DEBT DISTRESS CLASSIFICATIONS: FY07^{1/}

IDA-only country	Debt indicator (percent)			Traffic light		Traffic Light for FY07 incorporating DSA-based risk rating 5/
	NPV of debt-to-GDP 2/	NPV of debt-to-exports 3/	Debt-service-to-exports 3/	Debt indicator-based	DSA-based 4/	
Strong performance (CPIA>=3.75) 6/	50	200	25			
Bhutan	88	326	7	Red		Red
Burkina Faso	19	234	15	Green	Green	Green 9/
Cape Verde	33	127	10	Green		Green
Georgia	27	106	15	Green	Green	Green
Ghana	28	78	7	Green		Green
Maldives	31	40	5	Green		Green
Samoa	32	131	7	Green	Yellow	Yellow
Senegal	19	79	17	Green		Green
Tanzania	21	132	6	Green	Green	Green
Uganda	30	250	12	Yellow	Green	Green
Medium performance (3.75<CPIA<3.25)	40	150	20			
Bangladesh	23	167	8	Green		Green
Benin	20	171	13	Green	Green	Green
Cameroon	16	72	17	Green	Green	Green
Ethiopia	26	171	8	Green	Yellow	Yellow
Guyana	65	72	7	Yellow	Yellow	Yellow
Kenya	28	119	9	Green		Green
Kyrgyz Republic	69	200	8	Red		Red
Lesotho	41	106	10	Green	Yellow	Yellow
Madagascar	41	162	7	Yellow	Green	Green
Malawi	60	213	12	Red	Yellow	Yellow
Mali	27	108	8	Green	Green	Green
Moldova	29	69	12	Green	Green	Green
Mongolia	64	118	4	Red	Yellow	Yellow
Mozambique	15	56	4	Green		Green
Nepal	33	159	8	Yellow	Red	Red
Nicaragua	33	148	7	Yellow	Yellow	Yellow
Niger	22	157	10	Green	Red	Red
Rwanda	14	168	16	Green	Red	Red
Tajikistan	29	68	8	Green	Yellow	Yellow
Vietnam	29	56	3	Green	Green	Green
Yemen, Republic of	28	84	5	Green		Green
Zambia	28	110	27	Red	Green	Green
Weak performance (CPIA<=3.25)	30	100	15			
Afghanistan	..	..	..	N/A	Red	Red 8/
Angola	43	81	19	Red	Yellow	Yellow
Burundi	14	184	176	Red	Red	Red
Cambodia	62	106	1	Red		Red
Central African Republic	66	588	12	Red	Red	Red
Chad	18	75	4	Green	Red	Red
Comoros	59	422	6	Red		Red
Congo, Democratic Republic of	31	130	8	Red		Red
Congo, Republic of	205	295	11	Red		Red
Cote d'Ivoire	76	180	6	Red		Red
Djibouti	44	102	6	Red		Red
Eritrea	44	422	20	Red		Red
Gambia, The	94	221	19	Red		Red
Guinea	45	198	21	Red	Red	Red
Guinea-Bissau	269	1001	60	Red		Red
Haiti	27	189	26	Red		Red
Kiribati	..	..	..	Green		Green
Kosovo	..	..	..	N/A		N/A 7/
Lao People's Democratic Republic	64	276	9	Red		Red
Liberia	681	2887	1	Red		Red
Mauritania	60	215	14	Red	Green	Green
Myanmar	..	127	3	Red	Red	Red
Sao Tome and Principe	162	452	43	Red		Red
Sierra Leone	33	182	14	Red		Red
Solomon Islands	51	118	5	Red	Red	Red
Somalia	..	..	..	Red		Red
Sudan	129	899	11	Red		Red
Timor-Leste	..	..	..	N/A		N/A 7/
Togo	69	191	3	Red		Red
Tonga	27	151	8	Red		Red
Vanuatu	18	47	2	Green		Green

Data sources:

- a. NPV of debt (2004) and debt service (2004): Preliminary GDF 2006. The scope of debt and debt service is public and publicly guaranteed external debt and IMF credits. Debt figures do not reflect the effects of MDRI.
- b. GDP (2004): WDI 2005.
- c. Exports (2002-4): WEO 2005.
- d. CPIA (2005), the World Bank (2006).

Notes:

- 1/ As of 06/30/06 for grant-eligible countries only.
- 2/ In ratios, both the numerator and the denominator refer to 2004 data.
- 3/ In ratios, the numerator refers to 2004 data and the denominator refers to the backward 3-year average of 2002-4.
- 4/ Based on available DSF-style DSAs.
- 5/ DSA-based traffic lights (the second pillar) prevail in case of conflict with debt indicator-based traffic lights (the first pillar).
- 6/ Based on 2005 CPIA ratings.
- 7/ Data not available. IDA Deputies determined these countries eligible for grants (IDA14 Report (2005), para 75, p. 27).
- 8/ Rating is based on an estimated debt situation.
- 9/ Rating is based on additional debt sustainability analysis in the context of its DSF-style DSA.
- .. Not available
- * Highlights with italicized figures show indicative policy-dependent thresholds by performance category; other highlights indicate debt indicators above the indicative thresholds.