



IDA14

**ASSESSING IMPLEMENTATION OF THE IDA14
GRANTS FRAMEWORK**

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

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Selected Abbreviations and Acronyms

AfDF	African Development Fund
AsDF	Asian Development Fund
CAS	Country Assistance Strategy
CPIA	Country Policy and Institutional Assessment
DEC	Development Economics Vice Presidency
DSA	Debt Sustainability Assessment
DSF	Debt Sustainability Framework
FRM	Resource Mobilization Department
FY	Fiscal year
GDF	Global Development Finance
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
MDB	Multilateral Development Bank
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MTR	Mid-Term Review
MVA	Modified Volume Approach
NPV	Net Present Value
PAYG	Pay-as-you-go
PBA	Performance-Based Allocation
PRMED	Economic Policy and Debt Department

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EXECUTIVE SUMMARY

1. This paper responds to a request by IDA Deputies to conduct an assessment of the new framework for IDA grants introduced as part of the IDA14 Replenishment agreement.

In this new framework, there is only one grant eligibility criterion, based on economic analysis: 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.¹ The risk ratings ("traffic lights") are then translated into grant allocations: high risk ("red") is associated with 100 percent grants, medium ("yellow") with 50 percent grants, and low ("green") with zero grants. This is unlike IDA13, where grants were allocated according to multiple criteria for grant eligibility.

2. In this new framework, the aggregate amount of IDA grants and the overall share of grants in total IDA allocations are endogenous variables.

This is also in contrast with the IDA13 grants system, where a target grant percentage range (18 to 21 percent) was determined upfront. The total amount of grants to be provided in IDA14 will depend not only on the number of grant-eligible countries (of 63 IDA-only countries, 44 countries were eligible for grants in FY06 and 41 in FY07), but on the total amount of IDA resources committed to each one of them over the same period. The actual grant share in FY06 was 19.2 percent. For the first two years of IDA14 (FY06-07), the average annual grant share is estimated at about 22 percent of the total IDA envelope. This share rises to about 31 percent of the total IDA envelope *excluding* blend and "gap" (hardened-term) countries.

3. Most recipients of IDA grants are among the poorest countries in the world and are located in Sub-Saharan Africa.

Poorest countries as per the IDA13 definition – those with per capita income less than US\$ 360 – continue to be among the major beneficiaries of IDA14 grants. In fact, in FY06, poorest countries accounted for 73 percent of all grant-financed operations approved during the period. Furthermore, more than 70 percent of total IDA grant commitments in FY06-07 are expected to directly benefit the Africa Region.

4. The IDA14 grant allocation system has a direct relationship with the Performance-Based Allocation (PBA) system, termed "modified volume approach" (MVA).

It involves a 20 percent volume discount on grant allocations, and a reallocation of the resources from such volume discount. The volume discount is 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 volume discount); and (ii) a "charges-related" volume discount, which represents the present value of forgone charge income on grants (equivalent to a 9 percent volume discount). The reallocation process has two tracks: (i) resources generated by the incentives-related discount are allocated to IDA-only countries (excluding post-conflict and "gap" countries) according to the PBA; and (ii) resources generated by the charges-

¹ IMF and IDA (2004). "Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications." February.

related discount are earmarked for a “hard-term” credit window for creditworthy blend countries with per-capita income below the IDA operational cutoff (\$1,025 in fiscal year 2007). These elements interact with the PBA by ultimately affecting allocation volumes as well.

5. **The IDA14 grants system was complemented by IDA’s policy on non-concessional borrowing by grant-recipient and MDRI-eligible countries, adopted by the Board on July 6, 2006.**² A key motivation for this new policy is the risk that IDA grants (and debt relief, in the case of MDRI) cross-subsidize non-concessional loans by other creditors. Indeed, the introduction of this new system increased the need for coordination with other creditors around financing terms. Some progress has been made in increasing such coordination, and the adoption of the DSF as the basis for the African Development Fund’s grants framework is an important milestone.

6. **The new grants framework has also increased the need for accelerated learning on the part of all those affected by the change.** New training needs – on the part of Bank staff, client countries, and other MDBs implementing a similar, DSF-based framework – brought about by the new grants system are being addressed through the provision of regular training carried out by PRMED, with assistance from FRM and DEC.

7. **In order to be sustainable, the new IDA grants framework needs to be appropriately financed.** The financing arrangements for IDA14 grants agreed comprise two elements: (i) forgone principal reflows due to IDA14 grants will be financed through additional donor contributions in future replenishments, on a pay-as-you-go (PAYG) basis; and (ii) forgone charge income on IDA14 grants will be financed through part of the 20 percent “tax” on grants – more specifically, by a charges-related volume discount on grants equivalent to 9 percent of individual country grant allocations, representing the present value of forgone charges. The resources from the 9 percent discount have been made available to creditworthy IBRD/IDA blend countries with income below the IDA operational cutoff under a new hard-term credit window in IDA. In FY06, Azerbaijan, India, and Pakistan benefited from resources from the newly-created hard-term window. In FY07, only India and Pakistan are eligible for hard-term credits.

8. **The primary financial risk from IDA14 grant financing relates to future donor compensation of forgone principal reflows.** A particularly important concern is to ensure additionality of such financing over regular donor contributions in future IDA replenishments. This is a risk that needs to be collectively addressed by the donor community. One option would be for donors to commit to using the “baseline” for compensation under the MDRI also for purposes of IDA grant financing. That baseline has been set at the level of regular IDA14 donor contributions, in real SDR terms.

² See IDA (2006b). *IDA Countries and Non-Concessional Debt: Dealing with the ‘Free-Rider’ Problem in IDA14 Grant-Recipient and Post-MDRI Countries*. IDA/R2006-0137, July.

ASSESSING IMPLEMENTATION OF THE IDA14 GRANTS FRAMEWORK

I. INTRODUCTION

1. **The IDA14 Replenishment introduced a new grant eligibility and allocation framework for IDA.** In terms of grant eligibility, unlike IDA13, where the overall grant percentage was negotiated and then allocated according to multiple criteria for grant eligibility, IDA14 has only one criterion, based on economic analysis: 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.³ The risk ratings ("traffic lights") are then translated into grant allocations: high risk ("red") is associated with 100 percent grants, medium ("yellow") with 50 percent grants, and low ("green") with zero grants.
2. **This paper aims to carry out a key mandate for the Mid-Term Review (MTR) of IDA14:** to "assess implementation of the grant framework, closely monitor the grant level and devise action plan accordingly".⁴ This paper concentrates on issues related to the actual "roll out" of the new system.
3. **The paper assesses two dimensions of the new grant framework: operational and financial.** For each dimension, the paper provides data describing the key operational and financial outcomes, and points to the main operational and financial policy issues involved in the implementation of the new framework. As such, this paper deals mostly with issues related to the grant allocation process as well as to the compensation of IDA for grant-related forgone credit reflows. The discussion of financing issues is limited to credit repayments forgone due to the making of IDA grants in lieu of providing IDA credits. Thus it does not address the more immediate issue of IDA providing debt relief (under the HIPC Initiative and the Multilateral Debt Relief Initiative) and the forgone credit repayments associated with the debt relief. In turn, grant eligibility issues are addressed in depth in the companion paper for the IDA14 Mid-Term Review on the operationalization of the forward-looking aspects of the DSF.⁵
4. **The paper is organized as follows.** Section II provides a brief description of the IDA14 grant eligibility and allocation framework and compares with the grants system under IDA13. Section III discusses the operational outcomes and operational policy issues associated with the new grants framework. Section IV focuses on the grants framework's financial outcomes and financial policy issues. Concluding remarks are presented in Section V. Annexes I and II show country-by-country debt-distress risk

³ IMF and IDA (2004). "Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications. February.

⁴ IDA (2005a). *Additions to IDA Resources: Fourteenth Replenishment. Working Together to Achieve the Millennium Development Goals*. March.

⁵ IDA (2006a). "Debt Dynamics and Financing Terms: A Forward-Looking Approach to Determining Grant Eligibility in IDA". October.

ratings and grant eligibility categories for FY06 and FY07, respectively. Annex III summarizes changes over time in “traffic light” assignments.

II. THE IDA14 GRANT ELIGIBILITY AND ALLOCATION FRAMEWORK

A. An Overview of the IDA14 Grants System

5. **The operational arrangements for implementing the IDA14 grants framework comprise the following elements:** (i) a grant eligibility system based on countries’ risk of debt distress; and (ii) a grant allocation system that determines countries’ terms of assistance but that also affects the total amounts they receive.

Grant Eligibility

6. **The new grant eligibility system is based on countries’ risk of debt distress, determined in accordance with the DSF methodology.** The eligibility system *a priori* excludes IBRD/IDA blend countries and hardened-term (or “gap”) countries from the scope of grant eligibility, irrespectively of their external debt situation.

7. **Until the IDA14 MTR, determination of debt distress risk and, consequently, grant eligibility has rested on the “first pillar” of the DSF.** More specifically, countries current external debt ratios are compared with the DSF’s indicative policy-dependent external debt thresholds (Table 1). As noted, a separate paper⁶ will discuss ways to operationalize the “second pillar” of the DSF- namely, forecasts about future behavior of external debt ratios- into an operational system to determine grant eligibility.

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

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.

8. **Debt-distress risk classifications, and therefore the credit-grant mix in the allocation norms (prior to any volume discount), are assigned in accordance with a three-category, “traffic light” system, as follows:**⁷⁸

⁶ IDA (2006a). *Op. cit.*

⁷ Countries eligible for 100 percent grants will receive funds from the regional envelope for eligible regional projects on grant terms as well. Other countries, including those that receive 50 percent grants, will only have access to resources from the regional envelope on credit terms for eligible projects.

- Green light (low risk of debt distress): 100 percent credits
- Yellow light (Medium risk of debt distress): 50 percent grants; 50 percent credits
- Red light (High risk of debt distress or “in distress”): 100 percent grants.

Grant Allocations

9. **Two key principles underpinned the design of the IDA14 grant allocation system: (i) the strength of the PBA as an incentive system should be safeguarded; and (ii) equity in resource transfers should be preserved across IDA countries.** 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 two channels, one involving a volume discount on grant allocations, and the other involving a reallocation of the resources from the volume discount. During the IDA14 discussions, this approach was termed the “modified volume approach” (MVA). These elements interact with the PBA by ultimately affecting allocation volumes as well.

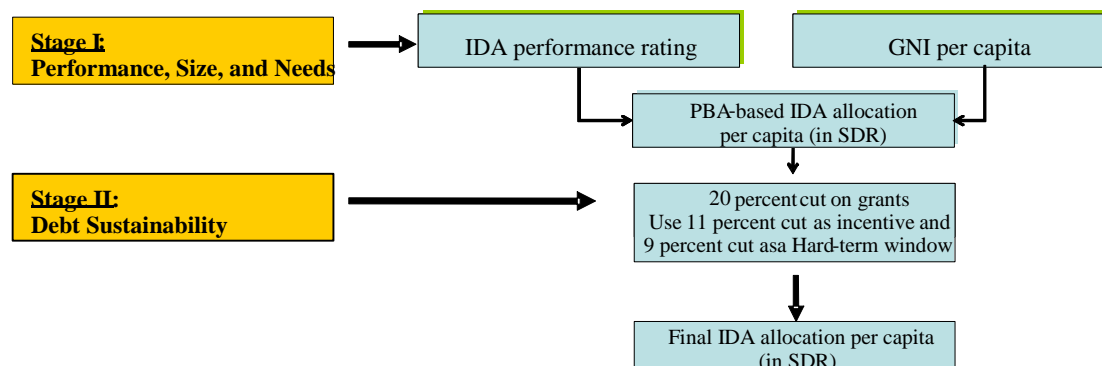
10. **The volume discount works as follows:** a 20 percent upfront volume discount is applied to countries’ overall grant allocations. The volume discount is divided into two components: (i) an “incentives-related” discount, which aims to preserve the integrity of the incentive system embedded in the PBA (equivalent to an 11 percent volume discount); and (ii) a “charges-related” volume discount, which represents the present value of forgone charge income on grants (equivalent to a 9 percent volume discount).

11. **The reallocation process works as follows:** (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” credit window that is available to poor, but creditworthy blend countries with per-capita income below the IDA operational cutoff (\$1,025 in fiscal year 2007).

12. **Therefore, the new IDA grants framework can only be fully understood together with the PBA system.** The latter allocates resources to client countries on the basis of performance (as measured by their Country Performance Rating) and need (as measured by their per capita GNI). With the new grants framework, IDA allocations are now affected not only by needs and performance, but by debt sustainability considerations as well. These interactions are summarized in Chart 1 below.

⁸ Regular IDA credits offer a grant element of about 60 percent, given their long maturity and low charges. As a result, the grant element provided by IDA to ‘green light’ countries is about 60 percent; it is 80 percent for ‘yellow light’ countries; and 100 percent for ‘red light’ countries.

Chart 1. IDA Allocations: Performance, Needs and Debt Sustainability



13. **The main novelty of the IDA14 grants system is to clearly establish grant eligibility on the basis of country characteristics that may change with time and/or policy stance.** As a result, it implies that the aggregate amount of IDA grants and the overall share of grants in total IDA commitments become *endogenous* variables. This is in contrast with the IDA13 grants system, where a target grant percentage range was determined upfront. It should also be stressed that the total amount of grants to be provided in IDA14 depends not only on the number of grant-eligible countries, but also on the total amount of IDA resources committed for such countries over the FY06-08 period. Therefore, even when grant eligibility is clearly established, there remains uncertainty as to the use of available grant resources. The upshot of this discussion is that the meaning of the overall grant share changed considerably between IDA13 and IDA14: while in IDA13 the grant share was a *target*, in IDA14 it is an *endogenous outcome* of the system.

B. Implementing the IDA14 Grants System: How Does It Compare with IDA13?

14. **IDA13 was characterized by a multifaceted view on the appropriate use of increased concessionality.** The broad policy stance of the IDA13 grants system viewed greater concessionality as “particularly relevant for resource-poor countries requiring large expenditures and investments to achieve their poverty-reduction goals and to reduce the incidence of diseases that erodes their prospects for growth. At the same time, many of these countries remain vulnerable to external shocks, including natural disasters, conflicts, and fluctuating commodity prices.”⁹ The IDA13 discussions also focused on the “functionality” of IDA grants, or the notion that grants can be more effective in certain contexts than others: “The functional areas where grants could increase IDA’s effectiveness as a development institution should underpin the use of grants in IDA’s operations.”¹⁰

⁹ IDA (2001a). *Grants in IDA13*. September. Paper for the IDA13 Replenishment discussions.

¹⁰ IDA (2001b). *Grants and Concessionality in IDA13*. November. Paper for the IDA13 Replenishment discussions.

15. **IDA13 therefore introduced a multi-dimensional approach to grant eligibility.** This included several country and thematic eligibility categories: (i) post-conflict countries; (ii) poorest countries with per capita income up to US\$ 360; (iii) debt-vulnerable poorest countries; (iv) natural disaster projects; and (v) HIV/AIDS projects. The IDA13 grants system also envisaged a negotiated target range (18 to 21 percent) for the overall grant share, and recommended ceilings on individual countries' grant shares, varying in accordance with each individual country's applicable eligibility categories. As noted in the *IDA13 Replenishment Retrospective Review*, "though the grant resources provided a useful window to enhance IDA's support for the poorest countries, the multiple and special purpose criteria for allocating grants across IDA countries were overly complex and primarily the result of the diverging views among the IDA Deputies at the time of the negotiations. As a package, they lacked a comprehensive supporting analytical framework."¹¹

16. **The policy stance with respect to grants evolved during the IDA14 replenishment discussions.** This mostly reflected: (i) new empirical work on causes of external debt defaults in low-income countries; and (ii) the design of the DSF. These new developments culminated, as discussed, in the adoption of countries' risk of debt distress as the single grant eligibility criterion in IDA14. From an operational standpoint, there are several advantages associated with the new system:

- It provides a clear and analytically-based criterion for allocating grants, eliminating any ambiguity with respect to the determinants of IDA financing terms.
- It facilitates a more transparent decision-making process on countries' financing terms, which would broadly involve the following stages: (i) annual DSAs are jointly prepared by Bank and Fund country teams, often with assistance from the Bank's Economic Policy and Debt Department (PRMED); (ii) in the Bank, DSAs are cleared by the PREM Sector Director in the applicable Regional Vice-Presidency and by the PRMED Director; (iii) PRMED advises IDA's Resource Mobilization Department (FRM) on countries' debt-distress risk ratings; (iv) FRM generates the proposed "traffic lights" and conducts consultations with the Regions; and (v) once inputs from the Regions are taken into account, "traffic lights" are finalized – prior to the annual IDA resource allocation process.
- It allows for greater ownership of countries' credit-grant mix on the part of the Regional Vice-Presidencies, to the extent that DSAs – jointly carried out by Bank and IMF country teams – are the source of debt-distress risk ratings and thus ultimately of countries' "traffic lights".

17. **The implementation of the new grants system has required a learning process on the part of Bank country teams, country authorities, and staff from**

¹¹ IDA (2006b). *IDA's Thirteenth Replenishment: A Retrospective Review*. IDA/SecM2006-0308/1, August.

other multilateral institutions adopting a similar system – particularly with respect to the workings and applications of the DSF. This has been addressed through numerous DSF training sessions held by PRMED, in cooperation with FRM, Development Economics Vice Presidency (DEC), and the IMF, which have become part of the regular PREM Network training offers.

III. OPERATIONAL OUTCOMES AND OPERATIONAL POLICY ISSUES

18. This Section discusses the results of the first year and a half of the implementation of the IDA14 grants framework. Subsection A focuses on operational outcomes – actuals for FY06 and estimates for FY07 – while subsection B discusses policy issues associated with the implementation of the new framework. Subsection C compares IDA13 outcomes with the emerging IDA14 results.

A. Operational Outcomes

19. **Of 63 IDA-only countries, 44 countries were eligible for grants in FY06:** 33 “red light” countries, nine “yellow light” countries, and the two special cases of Kosovo and Timor-Leste.¹² For FY07, the number of grant-eligible countries decreased to 41, reflecting the lower incidence of “red light” countries, from 33 to 30.

20. **Insights from available DSAs were used in the process of making decision on traffic lights, as stated in paragraph 73 of the IDA14 Deputies’ Report.**¹³ For FY06, traffic lights for Ethiopia, Mauritania, Rwanda and Zambia were based on the latest available DSAs in FY06.¹⁴ While the “first pillar” method suggested a “red light” for Mauritania and a “green light” for Ethiopia, Rwanda and Zambia, their forward-looking DSAs (the second pillar) indicated a low risk of debt distress for Mauritania, a medium risk for Ethiopia and Zambia, and a high risk for Rwanda, even after reaching the HIPC Completion Point. Thanks to their increased availability, in FY07, forward-looking DSAs became the main drivers for determining traffic lights for 31 IDA-only countries (see Table 2).

21. **Actual FY06 commitments in the form of grants amounted to about SDR 1.3 billion (US\$ 1.8 billion), out of a total volume of credits and grants of SDR 6.5 billion (US\$ 9.5 billion).** Therefore, the actual grant share in FY06 is about 19.2 percent¹⁵, as opposed to an initial estimate of about 30 percent for FY06-08. Two

¹² For Kosovo, eligibility is based on its status as part of Serbia and Montenegro under United Nations Administration and will continue during IDA14 until its status changes and it is able to borrow. Timor-Leste, eligible for grants on the basis of its post-conflict status, will be phased out of grant eligibility during the IDA14 period (IDA, 2005a).

¹³ “During the transition to a system that fully takes into account the key aspects of the second [forward looking] pillar [of the DSF], insights from available DSAs will be used to inform the decision on how to classify countries.” (Ibid, p. 26).

¹⁴ Available DSAs were also consulted for a number of other countries. However, such DSAs did not indicate debt distress risk ratings different from those obtained by focusing on countries’ current debt ratios.

¹⁵ The overall grant share for the IDA-only group of countries was 27.9 percent in FY06.

factors explain the lower-than-projected overall grant share. First and foremost, the reactivation of countries in non-accrual countries – for which grants amounting to about SDR 1 billion were estimated to be allocated – did not materialize in FY06. The second explanation lies in the lower-than-expected usage of available grant allocations by some grant-eligible countries, particularly Angola, Burundi, Cameroon, Democratic Republic of Congo and Nepal.

22. **In FY07, eligible IDA countries are expected to receive SDR 1.8 billion as grants,¹⁶ out of projected total IDA commitments of SDR 7.6 billion (US\$ 11.1 billion).**¹⁷ The share of grants, therefore, in total IDA financing is estimated to be around 24 percent.^{18/19} These figures include a notional provision for the reactivation of countries in non-accrual status. If this provision is excluded, then the projected overall grant share in FY07 is about 20 percent.

23. **African countries continues to be the main recipients of IDA grants.** Looking into both actual FY06 grant usage as well as estimated FY07 grant allocations, some general observations can be made: First, Africa has received the largest share of grants: 67 percent of the FY06 actual total grants usage; and 73 percent of the FY07 estimated total grant envelope. South Asia is the second largest grant recipient region – about 17 percent for both periods. Other regions share the remainder (as indicated in Tables 3 and 4). Second, HIPC countries as a group accounted for a large share of the total grant for both periods: 70 percent in FY06 and about 81 percent in FY07. Pre-decision point HIPC countries as a group will account for 39 percent of the FY07 overall grant envelope, up from 7 percent in FY06. The reverse occurred for HIPC completion point countries, which also became eligible for MDRI.

¹⁶ Excludes grants for regional projects.

¹⁷ Figure for the total IDA envelope does include funds for regional projects and for hard-term lending.

¹⁸ Excludes possible grants for regional projects, as noted in footnote 7.

¹⁹ The overall grant share for the IDA-only group of countries is projected at 34.6 percent for FY07.

Table 2. FY06 Outcomes

Category	Number of grant countries	Allocation (SDR million) ^{1/}	Actual Commitment	
			Amount (SDR million)	Share in total grants (percent)
FY06 Total envelope		7277	6538	
<i>of which Grants</i>	43	1598	1252	
(grant share in percent)		22.0		19.2
GRANTS by Group				
By Region ^{2/}				
AFR	25	1113	835	66.7
EAP	7	63	59	4.7
ECA	5	63	88	7.0
LCR	2	48	52	4.2
MNA	0	0	0	0.0
SAR	4	311	218	17.4
By Traffic Light				
Red Light	32	1145	889	71.0
Yellow Light	9	438	354	28.3
Special case (Kosovo and Timor-Leste)	2	15	9	0.7
By HIPC Status				
HIPCs ^{3/}	27	1059	914	72.9
<i>of which</i>				
<i>Completion Point HIPCs</i>	7	342	410	32.7
<i>Decision Point HIPCs</i>	10	541	418	33.4
<i>Pre-Decision Point HIPCs</i>	10	176	85	6.8
Non-HIPCs ^{2/}	16	539	339	27.1

Source: Staff estimates, June 30, 2006.

Notes:

1/ Amounts allocated to active countries. Excludes notional provision for reactivation of non-accrual countries.

2/ Includes Timor-Leste in the East Asia Pacific region, Kosovo in the Europe and Central Asia region, and five inactive countries, namely Central Africa Republic, Myanmar, Togo, Somalia, and Sudan. Of these five, traffic light for Somalia was not assigned for FY06 due to data unavailability.

3/ The number of HIPCs is as of June 2005 for allocation figures and of June 2006 for actual commitment figures.

Table 3. FY07 Grant Allocations

Category	Number of grant countries	Amount in SDR million ^{1/}	Share in total grants (percent)
FY07 Total envelope		7614	
<i>of which Grants</i>	41	1832	
(grant share in percent)			24.1
GRANTIS by Group			
By Region ^{2/}			
AFR	23	1383	75.5
EAP	8	66	3.6
ECA	3	41	2.3
LCR	3	52	2.8
MNA	1	3	0.2
SAR	3	286	15.6
By Traffic Light			
Red Light	30	1568	85.6
Yellow Light	9	251	13.7
Special case (Kosovo and Timor-Leste)	2	14	0.7
By HIPC Status			
HIPCs	26	1513	82.6
<i>of which</i>			
<i>Completion Point HIPCs (or MDRI recipients)</i>	<i>5</i>	<i>266</i>	<i>14.5</i>
<i>Decision Point HIPCs</i>	<i>10</i>	<i>430</i>	<i>23.5</i>
<i>Pre-Decision Point HIPCs</i>	<i>11</i>	<i>817</i>	<i>44.6</i>
Non-HIPCs	15	319	17.4

Source: Staff estimates based on IDA allocations for FY07, July 2006.

Notes:

1/ Includes a notional, unallocated provision for reactivation of non-accrual countries. Excluding such a provision, the size of the FY07 total envelope is SDR 7,226 million and the total grant size is estimated to be about SDR 1,444 million (about 20 percent).

2/ Includes Timor-Leste in the East Asia Pacific region, Kosovo in the Europe and Central Asia region, and four inactive countries, namely Myanmar, Togo, Somalia, and Sudan. Of these four, traffic light for Myanmar was not assigned for FY07 due to data unavailability.

B. Operational Policy Issues²⁰

24. This subsection deals with the following operational policy issues: (i) the impact of the new grants system on the incentive mechanisms under IDA's PBA; (ii) the impact of MDRI on grant allocations; and (iii) the need for enhanced coordination on resource allocation issues with other Multilateral creditors.

Impact on the PBA's Incentive System

25. **A main tenet of IDA's new grant system is to preserve the strength of the incentive system embedded in IDA's performance-based allocation (PBA) system.** A key precept of the PBA is that, all else constant, resource transfers to IDA countries in

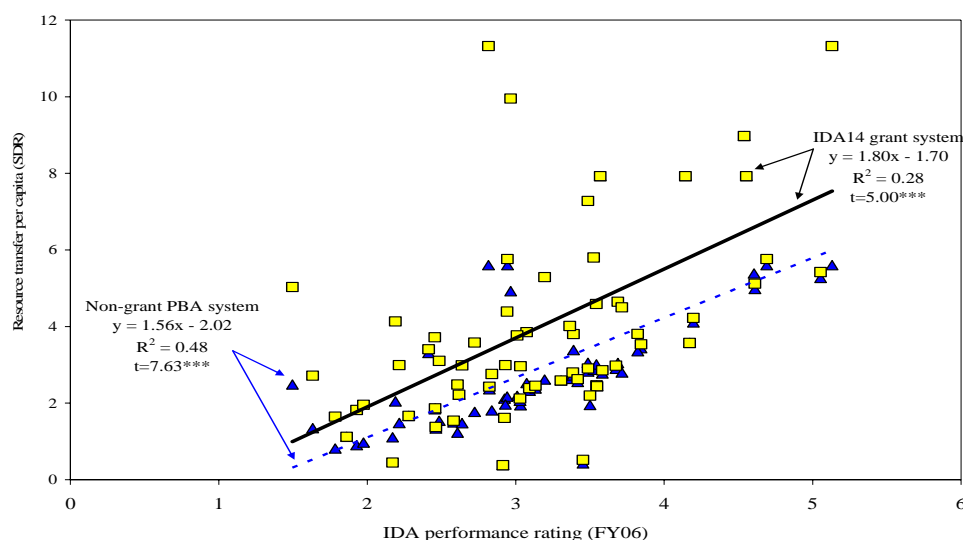
²⁰ Broader policy issues related to the eligibility for IDA grants are taken up in the companion paper on the forward-looking aspects of the DSF, see IDA (2006a), *op. cit.*

per capita terms should be positively correlated with these countries' performance, as measured, for example, by IDA's country performance rating. If this relationship does not hold, or holds only weakly, then incentives for countries to improve performance would be weakened.

26. **A grant eligibility criterion based on countries' risk of debt distress needs to be complemented by adjustments to the resource allocation process in order to prevent a dilution of IDA's incentive system.** This is because the use of policy-dependent external debt thresholds – thresholds that vary in accordance with performance categories – increases the likelihood that countries with the strongest need for increased concessionality are among the weakest performers. The modified volume approach to grant allocations – discussed in Section II – aims to reconcile the goal to provide increased concessionality to countries at moderate and high risk of debt distress with the need to preserve the integrity of the PBA.

27. **A simple method was developed to gauge whether the introduction of grants based on debt distress risk weakens the PBA:** the grant element of IDA assistance – a measure of “real” resource transfers – with and without grants is regressed against IDA's country performance rating. A zero-grants situation (i.e., credits-only) is taken as the baseline. Then grants under the new system are introduced. The test consists of examining the impact of grants on the slope of the regression line (as well as on the relevant diagnostic tests). Charts 2 and 3 illustrate this method, showing the relationship between “real” resource transfers (i.e., the grant element of IDA assistance) and the IDA performance rating for the FY06 and FY07 allocation exercises, respectively.

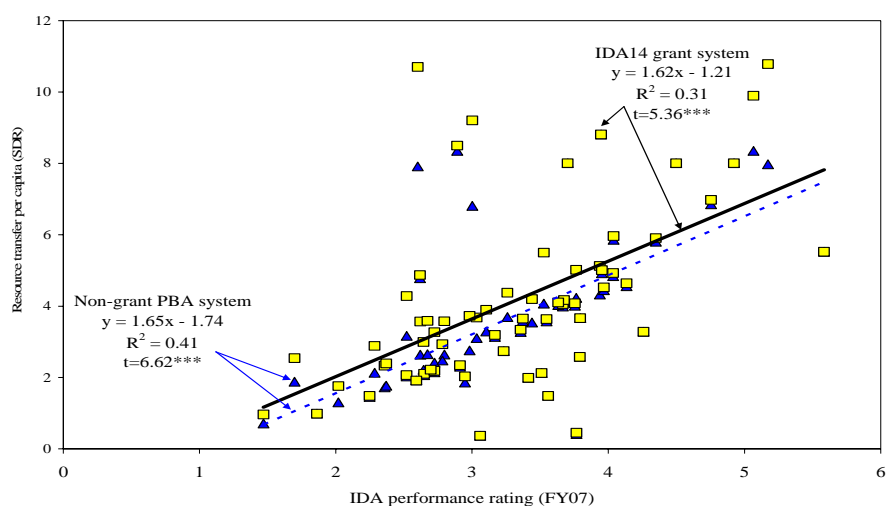
Chart 2. Resource Transfers and Performance: FY06



Notes:

- 1/ A t value measures the statistical significance of the IDA performance rating variable in explaining the resource transfer variable.
- 2/ *** significance at the one percent level.

Chart 3. Resource Transfers and Performance: FY07



Notes:

1/ A t value measures the statistical significance of the IDA performance rating variable in explaining the resource transfer variable.

2/ *** significance at the one percent level.

28. **The modified volume approach seems to have succeeded in preserving the strength of the PBA as an incentive system, while avoiding excessive volume cuts that could hurt countries' chances to meet the MDGs.** In fact, both charts 2 and 3 indicate that approximately the same degree of performance-elasticity of resource transfers post-grants was maintained vis-à-vis the counterfactual, “no-grants” version of the PBA system. In fact, the FY06 allocations show a slight increase in such elasticity (as measured by the regression coefficient), compared to the no-grants case. *Therefore, it seems appropriate to continue applying the MVA even as IDA moves towards a forward-looking system for determining grant eligibility.*

Impact of MDRI on Grant Allocations

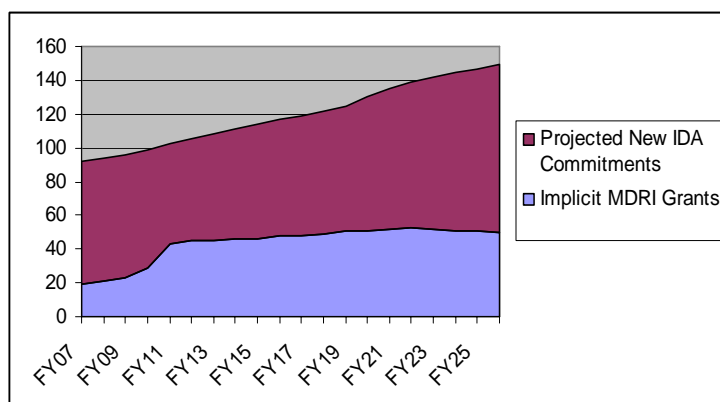
29. **From FY07 onwards, an additional stage to the resource allocation process has been in effect, as a result of the Multilateral Debt Relief Initiative (MDRI).** MDRI would affect the overall concessionality of IDA assistance through three avenues. First, it would affect allocations through the “netting out” mechanism: For MDRI recipient countries, starting in FY07, forgone credit reflows to IDA are deducted from the allocation amounts they would otherwise receive. Donor resources provided to IDA to compensate for reflows forgone as a result of the MDRI are then reallocated to all IDA-only, non-gap, countries, on a performance basis. Second, MDRI would also have an impact on grant eligibility, to the extent that debt relief would significantly lower external debt indicators of eligible countries and reduce their risk of debt distress. Third, forgone debt service under the MDRI can also be interpreted as a way of providing “implicit” grants to beneficiary countries even if they are “green light” under the debt distress risk criterion (see Box 1).

Box 1. Delivering Concessional Flows in the Form of Debt Relief

Grants are not the only instrument with which IDA provides fully concessional resources; the latter have also been provided through debt relief. Under the HIPC Initiative, nominal debt service relief of more than US\$59 billion – of which about US\$ 18 billion from IDA alone – has been approved for 30 countries. Estimated total debt relief under MDRI for all potentially eligible countries is about US\$ 50 billion, of which US\$ 37 billion committed by IDA alone. In fact, full, upfront debt stock cancellation under the MDRI would lead to fiscal effects similar to the provision of 40 years of budget support in the form of (implicit) grants to recipient countries. Under the “netting out” mechanism of the MDRI, forgone debt service is deducted from MDRI-recipients “gross” PBA-based allocations. Given donors’ commitment to provide dollar-for-dollar compensation, the magnitude of total IDA assistance flows to individual MDRI recipients – comprising both new IDA commitments and forgone debt service – would not be affected by the netting out per se. However, the concessionality of total IDA assistance flows would be higher than in the absence of MDRI, once forgone debt service is treated as implicit grants.

This can be seen more clearly in individual country examples, as in the case of Senegal. With a low risk of debt distress even before debt relief, Senegal is a “green light” country both pre- and post-MDRI. However, since Senegal is a recipient of MDRI relief, it will benefit from implicit grants in the form of forgone debt service. The chart below illustrates the projected behavior of the total IDA assistance flows to Senegal over the FY07-FY26 period, under the baseline assumptions used for the MDRI projections on resource transfers,^{1/} decomposing such flows into projected new IDA commitments and implicit MDRI grants.

Senegal: Total IDA Assistance Package Post-MDRI



1/ Refer to IDA (2006c). *IDA’s Implementation of the Multilateral Debt Relief Initiative*, March. The key baseline assumptions are: (i) countries’ relative performance remains the same over the projection period; (ii) IDA allocations are fully committed in any given year; (iii) “gross” PBA-based allocations reflect the assumption that the overall nominal IDA envelope increases by 2 percent per year, and that this increment is uniformly distributed across countries; and (iv) there are no graduations out of IDA, nor reverse graduations back into IDA.

30. **However, available DSAs indicate that debt relief under HIPC and the MDRI does not automatically translate into credits-only status for its recipients.** Indeed, the full implementation of the MDRI contributed to a low risk of debt distress in

Benin, Uganda, and Zambia.²¹ On the other hand, despite debt relief under the Initiative, five MDRI recipients were found to be at medium or high risk of debt distress: Ethiopia, Guyana, Nicaragua (all at medium risk); and Niger and Rwanda (both at high risk). In the cases of Ethiopia, Guyana, and Rwanda, their DSAs suggest that the reductions in debt burdens brought about by the MDRI would be partially reversed over the medium-to-long term. In fact, their long-term debt trajectories are projected to move towards pre-MDRI levels henceforth, even in baseline scenarios. Their FY07 “traffic lights” were determined based on their DSAs so as to reflect the underlying debt dynamics, i.e. they receive grants in FY07.

31. **A downgrade of its 2005 CPIA accounts for Nicaragua’s medium risk rating, compared to its low risk rating (and thus “green light” status) in FY06.** The lower CPIA rating led the country to move from the strong-performing to the medium-performing group. As a result, Nicaragua’s debt ratios were compared against lower policy-dependent debt thresholds. Under these circumstances, its debt-distress risk rating was revised to moderate even after taking the MDRI into account. Accordingly, Nicaragua was assigned a “yellow light” for the FY07 exercise.

32. **Niger’s high post-MDRI debt distress risk rating is explained by its very high vulnerability to shocks, which was captured by its recent joint Bank-Fund DSA.** The DSA indicates the absence of any significant improvement of its debt dynamics even after the full delivery of MDRI debt relief, owing to the country’s large financing requirements and narrow export base.²² Stress tests reinforce this conclusion, since they indicate the risk of significant breaches of the thresholds applicable to Niger. The country’s “green light” status in FY06 was determined on the basis of the “snapshot” methodology, taking into account only historical debt data. If the same method were used in FY07 to determine Niger’s grant eligibility, it would have again indicated “green light” status. Niger’s recent DSA therefore played the central role in establishing the country’s FY07 “red light”.

Coordination with Other Multilateral Creditors

33. **The adoption of a grant eligibility system that responds to countries’ debt-carrying capacity substantially increases the need for coordination with other creditors.** This includes, but is not limited to, multilaterals providing a large share of ODA flows reaching low-income countries. In fact, if other creditors adopt much less concessional terms than those IDA offers to grant-eligible countries, the success of the DSF as a tool for *ex ante* debt distress risk reduction is jeopardized and debt re-accumulation risks are exacerbated.²³

34. **Coordination mechanisms with other multilateral development banks (MDBs) have already been in place for some time.** A key forum is the annual meeting

²¹ A low risk rating of these countries owes in part to improvement of their own macroeconomic performance, i.e. a lower debt-to-GDP or debt-to-exports ratio.

²² IMF and World Bank (2006), “External Debt Sustainability Analysis: Niger”.

²³ Refer to IDA (2006b). *IDA Countries and Non-Concessional Debt: Dealing with the ‘Free-Rider’ Problem in IDA14 Grant-Recipient and Post-MDRI Countries*. IDA/R2006-0137, July.

of multilateral development banks on debt issues. The latest such meeting took place on June 21 and 22, 2006, in Washington, D.C., and was hosted by the World Bank. It focused mostly on debt relief and debt sustainability in low-income countries in the context of the HIPC Initiative and the MDRI. Another key MDB coordination forum is the annual MDBs Technical Meeting on Performance-Based Allocation (PBA) Methods, which started in 2005. The latest such meeting took place in Tunis, Tunisia, on March 8 and 9, 2006 and focused on a number of technical issues related to the MDBs' resource allocation processes. Both fora discussed policy and operational issues involved in establishing financial terms of assistance to low-income countries based on debt sustainability considerations.

35. **Some progress has already been made in broadening creditor acceptance of the DSF as the basis for establishing financing terms of assistance.** The African Development Fund (AfDF) adopted the DSF as the foundation for its grant allocation system under AfDF-X. The Asian Development Fund (AsDF) has adopted a grants framework similar to that of IDA13 – which may be re-assessed during the AsDF-IX Mid-Term Review to further incorporate debt sustainability considerations. Additional efforts to enhance creditor coordination around the DSF are required, and are discussed more extensively in IDA's "free-rider" paper.²⁴

C. Comparison with IDA13 Outcomes

36. **While many of the grant recipients in IDA14 differ from those in IDA13, aggregate grant outcomes do not show a marked difference between the two replenishment periods.** This is illustrated in Table 4 below.

Table 4. Grants for Selected Categories as a Percentage of Total Grants: IDA13 vs. IDA14

Category	IDA14 ^{1/}	IDA13 ^{2/}
Poorest countries	55%	55%
Post-conflict countries	57%	27%
Africa region	77%	75%

Source: Staff estimates.

1/ Figures are based on allocations and include set-aside provisions.

2/ Figures are based on actual commitments and exclude IDA13 natural disaster grants.

37. **Poorest countries as per the IDA13 definition – those with per capita income less than US\$ 360 – continue to be among the major beneficiaries of IDA14 grants.** This is clearly shown in Table 4. In FY06, the first year of implementation of IDA14, in particular, poorest countries received 73 percent of all grant-financed operations approved during the period. This outcome emerges despite the fact that the IDA14 grants system did not target per capita income levels directly, as IDA13 did. In fact, the grant share for poorest countries (excluding natural disaster grants) in total grants provided during IDA13 was 55 percent – 18 percentage points lower than the FY06 figure. In addition, Table 4 shows that sub-Saharan African countries continue to be the

²⁴ IDA (2006b), *op. cit.*

main recipients of grants in IDA14, irrespective of the fact that there is no geographical targeting in IDA's grants system.²⁵

38. **These results should come as no surprise. Different measures of external indebtedness – which directly impact on countries' risk of debt distress – are negatively correlated to per capita GNI.** Since debt distress risk is the basis for financing terms in IDA14, concessionality levels in IDA14 are also negatively correlated with per capita GNI. As a result, most grant allocations benefit the world's poorest countries.²⁶ Since most of the countries with moderate and high risk of debt distress – as well as low income levels – are found in sub-Saharan Africa, it is to be expected that most grant allocations benefit the Africa Region.

39. **The IDA14 grants system also does not earmark grants to any specific sector or type of operation.** The IDA14 replenishment discussions opted for a system where grant eligibility is tailored to individual country characteristics (in this case, countries' debt-carrying capacity), rather than a sector- or project-based approach.²⁷ Therefore, every IDA operation in “red light” countries is grant-financed, irrespective of the sector. By the same token, all IDA operations for all sectors in “green light” countries are credit-financed. In “yellow light” countries, where the overall IDA allocation is divided between credits and grants, there remains some room for country teams and

²⁵ Neither the IDA13 nor the IDA14 grants systems target geographical regions directly in terms of grant eligibility.

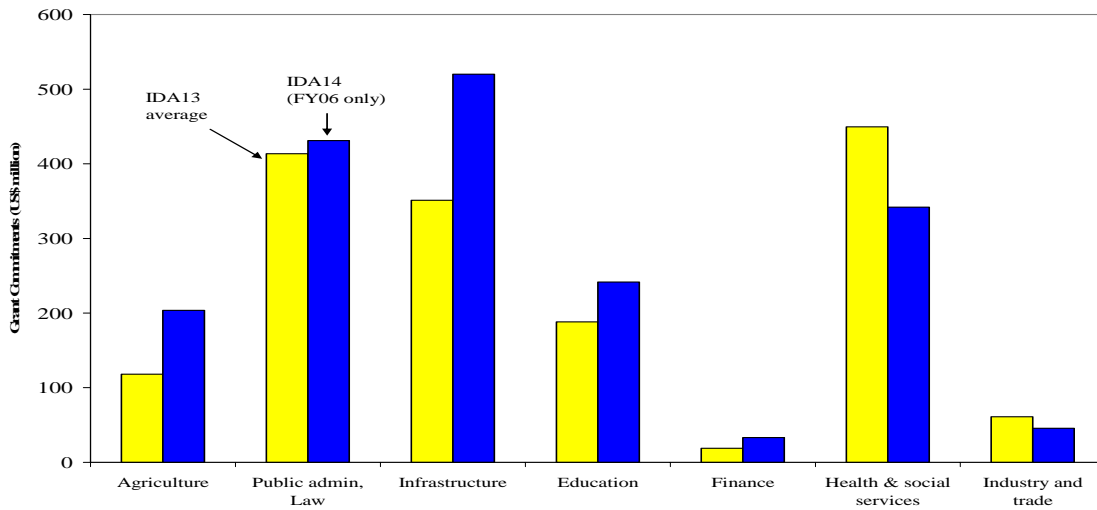
²⁶ See J. Araujo, and S. Yi (2006), “Should Per Capita Income Determine the Concessionality of IDA Assistance?”, World Bank, January, processed, for a detailed discussion of these issues. It might be argued that, in light of these results, the World Bank should use per capita income directly rather than have it proxied by countries' risk of debt distress – see e.g., Radelet, S. (2005), “Grants for the World's Poorest: How the World Bank Should Distribute Its Funds”, *CGD Notes*, Center for Global Development, June. However, from a policy viewpoint, the right question to ask is whether per capita GNI provides a good proxy for countries' risk of debt distress, and not the other way round. In fact, when Radelet (2005, *op. cit.*) argues for an income-based grant eligibility system, he does so mostly on the basis of a *debt servicing capacity* argument. However, per capita income is at best an *indirect and blunt* measure of countries' debt servicing capacity, while debt distress risk is a much more direct one (see Araujo and Yi, *op. cit.*, pp. 4-5). Besides the difficulties involved in choosing an appropriate per capita income cutoff, the chief problem with such an indirect measure is the large scope for “errors of exclusion” (treating a country with per capita income above the chosen cutoff as able to service its debt when it actually is not) and “errors of inclusion” (treating a country with per capita income below the chosen cutoff as unable to service its debt when it actually is). By focusing directly on countries' risk of debt distress as an indicator of debt servicing capacity, the scope for such errors under the IDA14 system is reduced.

²⁷ There is some theoretical appeal to the notion of linking concessionality of financing directly to the characteristics of individual projects (e.g., grants could be provided to projects with a high social rate of return but with an uncertain economic or financial rate of return). Nonetheless, the fact that aid resources are fungible would substantially reduce the efficacy of a project-based approach. See Daseking, C. and B. Joshi (2005), “Debt and New Financing in Low-Income Countries: Looking Back, Thinking Ahead”, International Monetary Fund, February: “Unless there is perfect alignment between the preferences of donors and recipients, some projects that would have been undertaken in any event, financed by government funds, would be put forth for grant financing. The remaining savings could then be used for something less productive (or desirable from the donors' point of view), such as the purchase of another plane for the unprofitable national flag carrier.” (pp. 11-12).

county authorities to decide which terms – credits or grants – to apply to any individual operation or sector.

40. **Nonetheless, there have been some changes in the sectoral composition of IDA grant commitments over the past couple of years.** This is shown in Chart 4 below, which looks into annual average grant commitments for the IDA13 period and compare them with those for FY06, the first year of implementation of IDA14. Most noticeably, grant commitments in the areas of agriculture, infrastructure, education, and public administration and law have increased, and grant commitments for health and social sectors have decreased, in the period under consideration.

Chart 4. Sectoral Composition of IDA Grant Commitments, IDA13-14^{1/2/}



Notes:

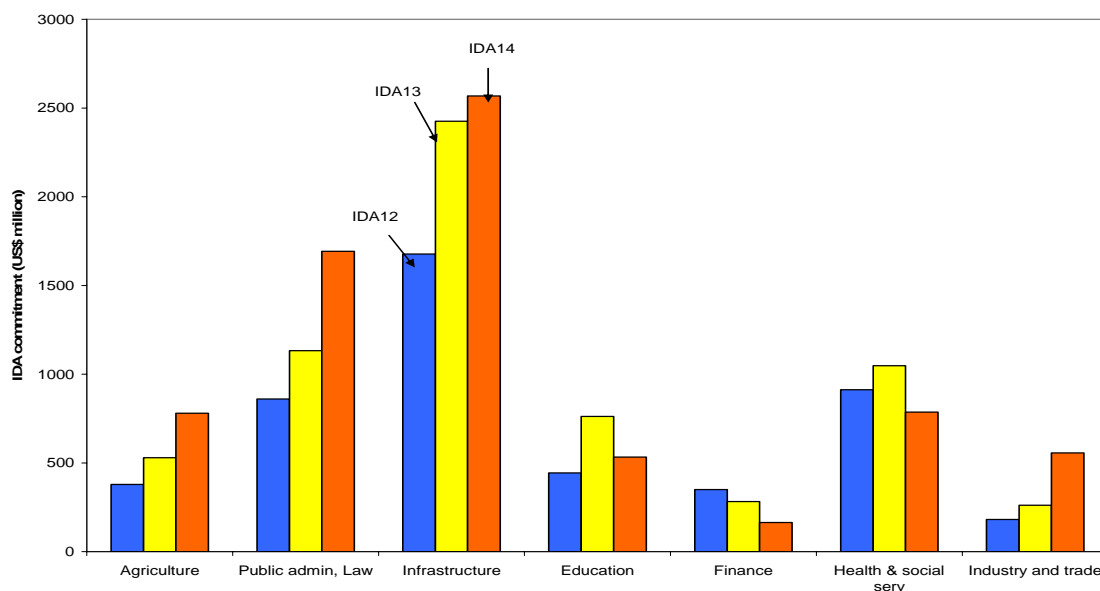
1/ Figures for IDA13 refer to annual average for the period; those for IDA14 refer to FY06 actual grant commitments.

2/ “Infrastructure” encompasses four sectors: information and communication; energy and mining; transportation; and water, sanitation and flood protection.

41. **With just one year of implementation, it is too early to assess whether the DSF-based grants system would have any relevant impact on the sectoral composition of IDA commitments.** Indeed, such sectoral shifts may reflect some broader underlying trend, rather than the mere introduction of IDA14 grants. Chart 5 below, which looks into annual average commitments for the IDA12-14 periods, suggests rising trends in aggregate commitments – grants *and* credits – in the areas of agriculture, infrastructure, and public administration and law. These possible trends are broadly consistent with the observations on grant commitments shown in Chart 4. It should be noted that such sectoral shifts were already underway before IDA14, and they seem to have continued in FY06. On the other hand, aggregate credit and grant commitments in the areas of education and health and social services declined in FY06 compared to the annual averages for IDA13 which was relatively high. Within the health sector, IDA commitments for new HIV-AIDS operations also decreased from SDR 56 million in FY05 to SDR 47 million in FY06. This does not necessarily reflect a

trend, and the picture on commitments for education and health should be clearer when FY07 commitment numbers become available. Many exogenous factors may have come into play, including changes in sectoral priorities in both donor and recipient countries, which are reflected in CAS design, as well as the increasing importance of so-called “vertical” funds.²⁸

**Chart 5. Sectoral Composition of IDA Commitments, Credits and Grants
IDA12-14^{1/2/}**



Notes:

1/ Figures for IDA12 and 13 refer to annual average for each replenishment period; those for IDA14 refers to FY06 actual commitments.

2/ “Infrastructure” encompasses four sectors: information and communication; energy and mining; transportation; and water, sanitation and flood protection.

IV. FINANCIAL OUTCOMES AND FINANCIAL POLICY ISSUES

42. The financing arrangements for IDA14 grants agreed during the IDA14 Replenishment negotiations comprise two elements:

- *Forgone principal reflows* due to IDA14 grants will be financed through additional donor contributions in future replenishments, on a pay-as-you-go (PAYG) basis; and
- *Forgone charge income* on IDA14 grants is being financed through the charges-related volume discount on grants of 9 percent, representing the present value of forgone charges. The resources generated by this discount are made available under a new hard-term credit window in IDA,²⁹ and resources not used under that

²⁸ For example, part of the demand for HIV/AIDS financing may have been met through other available mechanisms such as the Global Fund to Fight AIDS, Tuberculosis, and Malaria (GFATM).

²⁹ The lending terms under the hard-term credit window are those of a standard 35-year IDA credit plus an interest rate in addition to standard IDA charges. The interest rate is more concessional than the

window will be invested as part of IDA’s liquid assets. This would ensure an equitable treatment of grant and credit recipients by charging both recipients for the cost of providing IDA’s assistance.

43. **Forgone credit reflows of IDA associated with the making of grants will be recovered through a combination of donor resources and resources generated by the volume discount on grants.** Table 5 summarizes the grant compensation mechanism for IDA14. The remainder of this Section discusses the financial outcomes (subsection A) and the policy issues (subsection B) associated with the IDA14 financing arrangements for grants.

Table 5. Compensation Mechanisms for IDA14 Grants

	Principal Reflows	Charge Income
Paid by donors	Pay-as-you-go basis	
Paid by grant recipients		Up-front volume discount on grants, set at 9% for IDA14

A. Financial Outcomes

44. **Grants lower IDA’s future credit reflows and, without appropriate compensation, they may reduce IDA’s future financing capacity.** The volume of forgone reflows associated with grant-financed operations approved during FY06-08 is estimated at about SDR 6.4 billion. When adding forgone reflows due to grants approved during IDA13, IDA’s total reflow losses at the end of IDA14 are estimated at about SDR 10.6 billion. Table 6 summarizes these results.

**Table 6. Forgone Credit Reflows due to IDA13 & IDA14 Grants
SDR billion (nominal terms)**

	IDA13	IDA14	Total
Principal Reflows	3.5	5.4	8.9
Charge Income	0.7	1.0	1.7
Total	4.2	6.4	10.6

prevailing IBRD lending rate. IDA donors endorsed a spread of 200 basis points below the IBRD lending rate in fixed-rate terms during the IDA14 period. The actual interest rate is determined on an annual basis, prior to the start of each fiscal year. The rate for FY06 was set at 3.0 percent and for FY07 at 4.0 percent. Eligibility for hard-term credits is determined annually and limited to poor, but creditworthy blend countries. Azerbaijan, India and Pakistan were eligible for hard-term IDA credits in FY06. In FY07, only India and Pakistan are eligible because per-capita income for Azerbaijan exceeded IDA’s operational cutoff (\$1,025 in FY07). For details, refer to IDA (2005b).

Implementation Note: Lending at “Hard Terms” in IDA14. April.

B. Financial Policy Issues

45. As discussed, the grant financing arrangements agreed for IDA14 comprise two dimensions: additional donor contributions on a pay-as-you-go basis for forgone principal reflows and a volume discount on grant allocations for forgone charge income. Each of these dimensions involves different risks and policy issues, which are analyzed in the following section.

Compensation mechanism for forgone principal reflows

46. **Forgone principal reflows due to IDA14 grants require additional donor financing, over and above “regular” donor contributions in future replenishments, and over the 40-year time horizon of the amortization schedule for regular IDA credits.** IDA’s long-term financial projections assume that there will be full compensation for this principal component in future replenishments, starting from IDA16. A shortage in compensatory donor resources would lead to a decrease in future financing assistance from IDA to poor countries. Table 7 summarizes the expected profile of forgone principal reflows, under the assumption of a 25 percent overall grant share in IDA14 and an actual 19.5 percent grant share in IDA13.³⁰ The exact modalities for converting forgone principal reflows into additional donor contributions would be addressed by Deputies in future IDA replenishments.

Table 7. IDA13 and IDA14 Grants: Forgone Principal Reflows (SDR million)

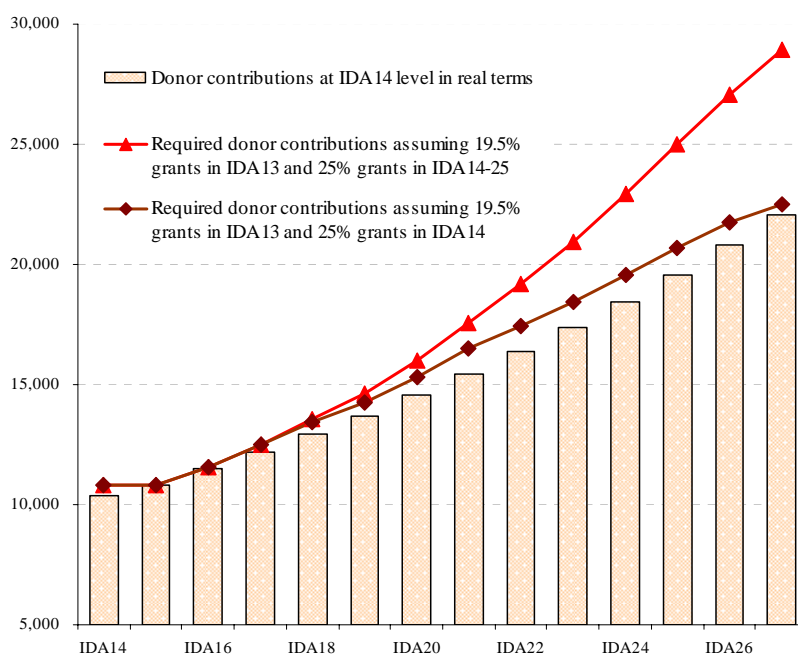
Period	IDA16	IDA17	IDA18	IDA19	IDA20	IDA21	IDA22	IDA23	IDA24	IDA25	IDA26	IDA27	Total
IDA13	71	212	212	235	400	424	424	424	424	424	282	-	3,530
IDA14	-	108	323	323	358	609	645	645	645	645	645	430	5,376
Total	71	319	534	558	758	1,033	1,069	1,069	1,069	1,069	928	430	8,906

47. **The financing modality for forgone principal reflows due to IDA13 and IDA14 grants leads to uncertainty as to the level of future donor contributions, or *funding risk*.** IDA’s long-term financial planning is based on a number of assumptions with regard to the level of donor contributions going forward. Regular donor contributions are assumed to be constant in real SDR terms, hence increasing by 2 percent per year (or 6.1 percent per replenishment) from the level of the last agreed IDA replenishment (currently IDA14). For donors to provide additional resources to compensate IDA for forgone principal reflows due to IDA13 and IDA14 grants, regular donor contributions will need to increase by about 2.2 percent per year (or 6.6 percent per replenishment) on average, starting from IDA16. Furthermore, assuming a level of IDA grants of 25 percent in future replenishments, donor contributions would need to increase by about 3.0 percent per year (or 8.9 percent per replenishment) on average, starting from IDA16 (see Chart 6).

³⁰ Forgone credit reflows are based on the assumption that IDA13 and IDA14 grants are provided in equal annual volumes during fiscal years 2003-2005 (IDA13) and fiscal years 2006-2008 (IDA14). Credit reflows assume regular IDA terms (40 years maturity, including 10 years of grace).

48. **A main risk deriving from the proposed modality for donor compensation of forgone principal reflows is to achieve actual additionality of such financing over regular donor contributions in future IDA replenishments.** This is a risk that needs to be collectively addressed by the donor community. One option would be for donors to commit to using the “baseline” for compensation under the MDRI also for purposes of IDA grant financing. That baseline has been set at the level of regular IDA14 donor contributions, in real SDR terms.

Chart 6. IDA Donor Contributions per Replenishment and Impact from Grant Compensation (SDR million)



Compensation mechanism for forgone charge income

49. **The creation of a hard-term window as the compensation mechanism for forgone charges on IDA14 grants represents another major innovation with respect to IDA13.** To assess its effectiveness, the following financial outcomes are of particular interest: (i) the amount of resources generated by the 9 percent, charges-related volume discount on grants, representing the supply of funds under the hard-term credit window; (ii) the actual usage of available resources under the hard-term window by eligible countries, representing the demand for funds under that window; (iii) the estimated rate of return from hard-term credits and investments in IDA’s liquidity, with a view to generate a rate of return that mirrors the discount rate used to establish 9 percent upfront volume discount on IDA14 grants; and (iv) the impact of grants on IDA’s future cash flows and liquidity.

50. **With an estimated overall grant volume of SDR 5.4 billion during the IDA14 period, the supply of funds under the hard-term credit window would be in the**

order of SDR 403 million. Changes to the overall grant envelope will lead to changes in the availability of resources for hard-term credits. This highlights another element of “endogeneity” in the new grants framework, as the size of the hard-term credit window is not pre-set but determined endogenously.

51. **Resources from the hard-term credit window in FY06 were allocated to Azerbaijan, India, and Pakistan, totaling SDR 165 million.** These allocations are in addition to their regular IDA country allocations. Azerbaijan received SDR 6 million in hard-term resources, representing 12.5 percent of its overall IDA envelope in FY06, and used all of these resources. Hard-term resources allocated to India totaled SDR 97 million, or 11.3 percent of its IDA allocation in FY06, all of which was used. Pakistan carried over its allocation of SDR 62 million, or 12.4 percent of its IDA envelope in FY06, into the remainder of IDA14 (as shown in Table 8). In sum, 62 percent of the hard-term envelope was utilized during the period. This outcome for FY06 suggests that the demand for hard-term credits was rather strong, and that the interest rate set for hard-term credits is sufficiently concessional to make these funds attractive for eligible countries.

Table 8. FY06 Usage of Hard-Term Envelope

Country	Allocation (SDR million)	Share in its respective allocation for FY07 (percent)	Actual commitment (SDR million)
Azerbaijan	6	12.5	6
India	97	11.3	97
Pakistan	62	12.4	0
Total	165		103

52. **For FY07, only India and Pakistan are eligible for hard-term IDA credits.** An amount of SDR 72 million was allocated to India in the form of IDA hard-term credit and SDR 46 million to Pakistan. As agreed with the donors, IDA will invest any surplus funds that were not used for hard-term credits as part of its liquid assets.³¹

53. **However, the hard-term window would still leave a small financing shortfall.** During the IDA14 discussions, it was acknowledged that the expected “investment return” on hard-term credits would be somewhat lower than the 6 percent discount rate used to establish the present value of forgone charges due to grants. This was the basis for the 9 percent volume discount on IDA14 grants to recover forgone charge income.³²

³¹ Unlike for funds invested in hard-term credits which carry a fixed interest rate, funds invested in IDA’s liquidity will not earn a fixed investment return over four decades, creating interest rate risk. However, only a small fraction of resources for hard-term lending is expected to be invested in IDA’s liquidity, given the strong demand for hard-term credits to date. Moreover, the expected long-term rate of return on IDA’s liquid assets (see following footnote) is expected to equal at least the average interest rate on hard-term credits extended during the IDA14 period.

³² The 6 percent discount rate used to determine the charge-related upfront volume discount was established based on IDA’s opportunity cost of lending, set at IDA’s long-term rate of return on its liquid assets which is between 5 and 6 percent per annum. One option would have been to lower the 6 percent discount rate to the expected rate of return on hard-term credits, thus eliminating the expected

Over 40 years, a cumulative financing shortfall of about 11 percent of total forgone charges was projected.³³ This was deemed acceptable since funds from the volume discount would be made available for economic development purposes in blend countries, through the hard-term credit window, rather than being invested as part of IDA's liquid assets.

54. Under the assumption of full demand for available hard-term credits, the cumulative shortfall would be about SDR 17 million over 4 decades, equivalent to only 2 percent of total forgone charges. This improved outcome partly owes to the increased hard-term credit interest rate of 4.0 percent in FY07, which is prompted by higher market interest rates.³⁴ Unless market rates fall substantially until the beginning of FY08, IDA's hard-term interest rate for FY08 will be similar to that in FY07, locking in the return on hard-term credits extended during IDA14 over the 40-year compensation period and eliminating any further interest rate risk. The revised expected cumulative shortfall over 4 decades represents less than 0.5 percent of forgone credit reflows (principal and charges) due to IDA14 grants. This reinforces the conclusion that the primary financial risk from IDA14 grant financing relates to future donor compensation of forgone principal reflows, not the mechanism to recover forgone charges.

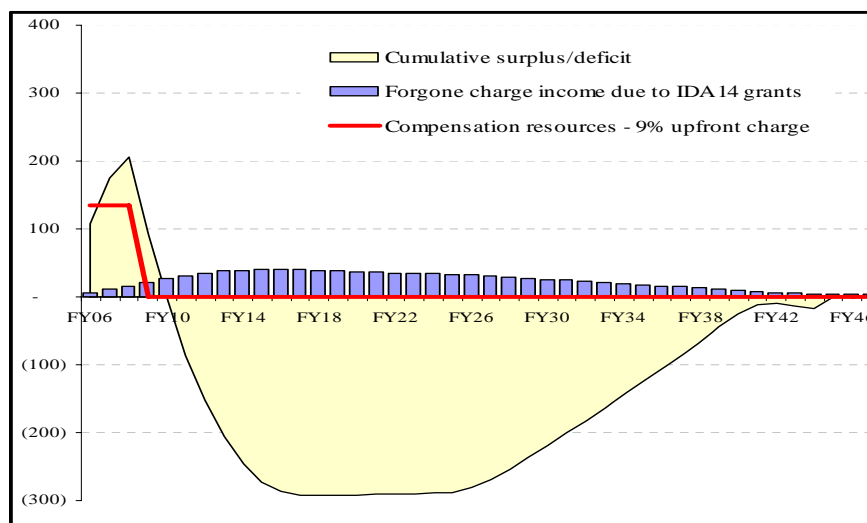
55. Grants committed during the IDA14 period will also have an impact on IDA's future cash flows and liquidity position. This is due to the timing mismatch under the hard-term credit window between cash inflows - represented by compensatory resources retained upfront from the volume discount on grants and subsequent cash inflows (credit reflows on hard-term credits and investment income on funds invested in liquidity); and cash outflows - represented by upfront disbursements on hard-term credits and subsequent annual payments of IDA's allocated Bank administrative expenses, which the charge income is designed to cover. Chart 7 illustrates the impact of IDA14 grants on IDA's future cash flows and liquidity. A liquidity surplus over the first decade is followed by a liquidity deficit over the following three decades. These developments are taken into account for purposes of the future liquidity planning of IDA.

financing shortfall. However, this would have increased the present value of forgone charges, and hence the charge-related upfront discount on IDA14 grants, to more than 10 percent. The charge-related upfront volume discount for grant financing will be reassessed in the context of IDA15.

³³ IDA (2004), "Debt Sustainability and Financing Terms in IDA14: Further Considerations on Issues and Options," IDA14 replenishment meeting, Athens, Greece, December 13-14, 2004.

³⁴ A remaining, albeit small financial shortfall on forgone charges would lower IDA's future liquidity to cover the gap, slightly reducing future commitment levels of IDA. As a result, future credit and grant recipients would cover a share of the forgone charges that were meant to be covered by current grant recipients. To reduce or eliminate the shortfall, the IDA hard-term interest rate could be increased by lowering the discount vs. the IBRD lending rate, from the current discount of 200 basis points to a discount of, for example, 150 basis points, provided that this would not lower borrower demand for hard-term credits. This could be considered within the context of IDA15.

**Chart 7. Compensating Forgone Charge Income Due to IDA14 Grants:
Annual Cash Flows (SDR million)**



V. CONCLUSIONS AND ISSUES FOR DISCUSSION

56. **The IDA14 grants system represents a marked innovation in the way IDA allocates concessionality to its client countries.** It comprises (i) a grant eligibility system that directly addresses countries' debt-carrying capacity, based on their risk of debt distress; and (ii) a grant allocation system that determines countries' terms of assistance but also affects the total amounts they receive, with a clear and direct link to IDA's performance-based allocation system.

57. **Part of the novelty of the system stems from the fact that the aggregate amount of IDA grants and the overall share of grants in total IDA commitments became *endogenous* variables.** This is in contrast with the IDA13 grants system, where a target grant percentage range was determined upfront.

58. **The IDA14 grants system has a number of advantages over the IDA13 approach:** (i) it provides a clear and analytically-based criterion for allocating grants, reducing countries' uncertainty with respect to the IDA financing terms they are eligible for; (ii) it facilitates a more transparent decision-making process on countries' financing terms; and (iii) it allows for greater ownership of countries' credit-grant mix on the part of the Regions.

59. **The new system has increased the need for close coordination with other sources of financing to low-income countries.** Although IDA is a major ODA provider, it is not the only one: financing by other creditors to low-income countries needs to be provided in terms and volumes compatible with the goal of achieving debt sustainability – otherwise, the primary goal of the new grants framework would be defeated. Some progress has been made in increasing coordination around financing terms, and the adoption of the DSF as the basis for the African Development Fund's

grants framework is an important milestone. More needs to be done, however, particularly in light of the recently-approved IDA policy on free riding.

60. **In addition, implementation of the new grants system has required an accelerated learning process on the part of its users and beneficiaries.** This includes Bank staff, client countries, and other MDBs implementing a similar, DSF-based framework. Such new training needs have been addressed through the provision of regular training carried out by PRMED, with assistance from FRM and DEC.

61. **Grants have a significant impact on IDA's future financial capacity and appropriate compensation mechanisms are thus required.** A two-pronged approach for IDA compensation was adopted in IDA14: (i) forgone principal reflows due to IDA14 grants - representing about 85 percent of total costs - will be compensated through additional donor financing, on a pay-as-you-go basis, over and above "regular" contributions in future replenishments; and (ii) forgone charge income - representing about 15 percent of total costs - is being compensated through the charges-related volume discount on grants of 9 percent, representing the present value of forgone charges, and the resources generated by this discount are made available under the new hard-term credit window in IDA.

62. **Both compensation mechanisms involve risks.** First, pay-as-you go compensation for forgone principal reflows is subject to substantial donor funding risk, that is, the risk that future donor contributions fall short of what is needed to compensate IDA for the forgone principal amounts. Second, the hard-term credit window is subject to risk of lack of demand for hard-term resources and a shortfall of lending income vis-à-vis forgone charges needed to cover IDA's administrative expenses. The risks associated with the "compensation from within" mechanism adopted for forgone charge income are modest, however, with an expected shortfall of less than 0.5 percent of total forgone reflows due to IDA14 grants.

63. **The primary financial risk from IDA14 grant financing relates to future donor compensation of forgone principal reflows, especially to ensure additionality of such financing over regular donor contributions in future IDA replenishments.** This is a risk that needs to be collectively addressed by the donor community. In this context, a key option, to ensure resources to countries are not reduced over the long term, is for donors to commit to using the "baseline" for compensation under the Multilateral Debt Relief Initiative also for purposes of IDA grant financing. That baseline has been set at the level of regular IDA14 donor contributions, in real SDR terms.

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

- Do Deputies agree that the DSF-based grant allocation system adequately addresses the concerns related to countries' risk of debt distress as agreed during the IDA14 Replenishment discussions?
- Do Deputies agree that the modified volume approach (MVA) continues to be applied under a forward-looking system for determining grant eligibility?
- Deputies may want to express their views regarding the effectiveness of the financing mechanism of forgone credit reflows due to grants adopted in IDA14.

ANNEX I. 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 ranking ("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 3/
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 7/
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 7/
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 7/
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 (IDA, 2005a, para 75, p. 27).

6/ Data are not available. Zero allocation for FY06.

7/ Zero allocation for FY06.

* Grey highlights indicate ratios above the indicative thresholds.

ANNEX II. 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 source:

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 (IDA, 2005a, 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.

ANNEX III. CHANGES IN “TRAFFIC LIGHT” ASSIGNMENTS OVER TIME

Country	Traffic light			Explanatory remark	
	IDA14 negotiations	FY06	FY07	Change in FY06	Change in FY07
Angola	Red	Red	Yellow		DSA indicates a moderate risk of debt distress on account of its narrow export base and vulnerability to new external financing.
Armenia	Green	Green	Not applicable		Classified as a "gap" country in FY07.
Burkina Faso	Yellow	Green	Green	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from medium to strong).	
Benin	Green	Yellow	Green	Higher debt-to-exports indicator	Lower debt stock indicators; available DSA incorporating the impact of MDRI.
Cameroon	Red	Red	Green		Reaching HIPC completion point; an available DSA incorporating the impact of MDRI.
Djibouti	Not applicable	Not applicable	Red		Revised GNI estimates recast country as "IDA-only".
Ethiopia	Red	Yellow	Yellow	Debt indicators suggested a green light but its available DSA suggested a yellow light due to vulnerability to shocks.	
Georgia	Red	Yellow	Green	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from poor to medium); and lower debt stock indicators.	An upward change in debt thresholds, triggered by its 2004 CPIA rating improvement (from medium to strong); further lower debt stock indicators.
Guyana	Red	Red	Yellow		Decrease of the debt-to-GDP ratio; available DSA incorporating the impact of MDRI.
Kenya	Yellow	Green	Green	Lower debt-to-exports ratio.	
Lesotho	Red	Yellow	Yellow	Lower debt stock indicators.	
Malawi	Red	Red	Yellow		Available DSA suggests a moderate risk after HIPC completion point and MDRI, due to its narrow export base (high concentration on tobacco).
Mali	Red	Green	Green	Lower debt stock indicators.	
Mauritania	Red	Green	Green	Its available DSA indicates a low risk of debt distress on account of oil production.	
Moldova	Red	Yellow	Green	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from poor to medium)	Lower debt-to-GDP ratio; A preliminary DSA.
Mongolia	red	Red	Yellow		Available DSA suggests a moderate risk, benefiting from rich mineral resources.
Myanmar	Not available	Not available	Red		Data approximation indicates a red light.
Nepal	Green	Yellow	Red	Worsening of debt stock indicators.	Available DSA indicates a high risk of debt distress (the debt-to-exports ratio under both baseline and stress test scenarios breach the threshold).
Nicaragua	Yellow	Green	Yellow	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from medium to strong)	A downward change in debt thresholds, triggered by its 2004 CPIA rating deterioration (from strong to medium); available DSA incorporating the impact of MDRI confirms a moderate risk.
Niger	Red	Green	Red	Lower debt stock indicators.	Even after MDRI, debt dynamics do not improve significantly in the long run; thresholds are breached under stress tests.
Samoa	Red	Green	Yellow	Lower debt stock indicators.	DSA indicates the country's vulnerability to shocks.
Senegal	Yellow	Green	Green	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from medium to strong)	
Somalia	Not available	Not available	Red		Based on estimated current debt situation in the country.
Sri Lanka	Green	Yellow	Not applicable	A downward change in debt thresholds, triggered by its 2003 CPIA rating deterioration (from strong to medium)	Status change from IDA-only to "gap".
Tajikistan	Red	Red	Yellow		DSA indicates lower debt stock because of debt swap and cancellation arrangements. Furthermore IMF debt relief under the MDRI.
Uganda	Yellow	Yellow	Green		Its available DSA indicates a low risk of debt distress after the full delivery of MDRI: all debt ratios under both baseline and stress test scenarios remain under the thresholds .
Zambia	Red	Yellow	Green	Reaching HIPC completion point improved the country's debt projections.	DSA suggests a low risk of debt distress after full implementation of completion point HIPC and MDRI.