IDA15

THE ROLE OF IDA IN ENSURING DEBT SUSTAINABILITY: A PROGRESS REPORT

International Development Association
Resource Mobilization Department (FRM)
September 2007

Abbreviations and Acronyms

AfDB	African Development Bank
AfDF	African Development Fund
AsDB	Asian Development Bank
CP	Completion Point
CRS	Creditor Reporting System
DeMPA	Debt Management Performance Assessment Tool
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
DRS	Debtor Reporting System
ECG	OECD Working Group on Export Credits and Guarantees
FRM	Financial Resource Mobilization Department
FY	Fiscal Year
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
ISN	Interim Strategy Note
IMF	International Monetary Fund
LIC	Low Income Country
LICUS	Low Income Country Under Stress
MDB	Multilateral Development Bank
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MVA	Modified Volume Approach
NCBP	Non-Concessional Borrowing Policy
NPV	Net Present Value
OP	Operational Policy
PREM	Poverty Reduction and Economic Management Department

TABLE OF CONTENTS

Executive Summary i

I. Introduction 1

II. Progress in Implementing the Debt Sustainability Framework 3
Features of Recent DSAs 4

III. Incorporating Debt Distress Risk Ratings into IDA's Grant Allocation System 5
An Assessment of the Grant Level 11
The Impact of IDA Grants on the PBA system 13

IV. Implementing the Non-Concessional Borrowing Policy in Grant-Eligible and Post-MDRI Countries. 16
Update on Creditor Outreach and the DSF 18
Update on Borrower Country Cases and Debtor Reporting 21

V. Capacity Building in LICs to Manage New Borrowing 24

VI. Conclusions and Issues for Discussion 26

Tables:
Table 1 Performance category in FY07-8 based on a single-year CPIA vs a three-year CPIA average: selected countries. 11

Figures:
Figure 1a: The number of traffic lights by source 7
Figure 1b: The number of countries by traffic light 7
Figure 2: Burkina Faso: the NPV of debt-to-exports ratio, with and without MDRI 8
Figure 3: Sensitivity of the NPV of debt-to-exports ratio post-MDRI 8
Figure 4: Distribution of grants and credits by period 12
Figure 5: Weighted average CPR by traffic light group in FY08 13
Figure 6: Relationship between IDA CPR and resource transfers 15

Boxes
Box 1: The Impact of IDA Grants on Debt Dynamics 14
Box 2: The Bank's Decision-Making Process in a Case of Non-Concessional Borrowing 17
Box 3: MOU on Cooperation Export-Import Bank of China and IBRD and IDA 20

Annexes:
Annex 1: Traffic lights for FY08 IDA allocation: IDA-only countries 27
Annex 2: Movements in Traffic Lights in IDA14 29
Annex 3: Grant Eligible and Post-MDRI countries to which the Non-Concessional Borrowing Policy applies 32
Annex 4 Principles that would guide exceptions to non-concessional borrowing ceilings. 33

EXECUTIVE SUMMARY

1. Following the implementation of the HIPC Initiative and the MDRI, IDA has taken a number of concrete steps in order to help countries maintain debt sustainability. These steps include progress in developing, implementing, and broadening understanding of the low-income country debt sustainability framework (DSF); designing and implementing IDA's grant allocation system linked to DSF risk ratings; developing and implementing IDA's Non-Concessional Borrowing Policy; and, developing tools and providing technical assistance aimed at strengthening borrowers' debt management capacity.

2. The joint Bank-Fund DSF launched in April 2005 has passed from its initial stage of development to a mature phase of implementation. The analytical rigor and availability of forward looking DSAs, the "dynamic" pillar under the DSF, has steadily improved throughout IDA14. Annual DSAs are now available for the majority of IDA-only countries, and for many countries they have been completed for the second or third time. These DSAs help identify vulnerabilities and highlight the importance of both growth and prudent debt management in maintaining low debt ratios over the long term.

3. The DSF-based IDA grant allocation system is functioning smoothly, with a clear process established to translate DSF risk ratings into IDA "traffic lights". Grant eligibility for 50 out of 59 potentially grant eligible countries is now based on forward-looking DSAs. The assignment of traffic lights is subject to a clear internal clearance process, involving country teams and relevant units in the Bank, which is working well. The relationship between DSF debt distress risk ratings and IDA traffic lights will continue to be guided by clear rules, while some element of judgment can be incorporated for those instances where changed country circumstances are not reflected in available DSAs or in borderline cases.

4. The grant share in the IDA14 envelope may reach 22 percent, or about SDR 4.7 billion out of total financing of SDR 21.8 billion depending on whether reactivation of non-accrual countries is confirmed in FY08. This is lower than the 30 percent expected at the time of the IDA14 negotiations. Two factors explain the lower than expected grant share during IDA14 to date: (i) the impact of HIPC and MDRI which reduced the number of "red light" countries; and (ii) a smaller number of countries reactivating from non-accrual status than expected at the time.

5. The Non-Concessional Borrowing Policy (NCBP) approved by the Board in July 2006 is under implementation, with steady progress being made in creditor coordination. Although this is a challenging area, IDA is well placed to lead creditor coordination and introduce borrower disincentives for unwarranted non-concessional borrowing: the two main prongs of the NCBP. IDA and IMF outreach to other creditors has led to the adoption of similar grant allocation systems by other MDBs. Progress has also been made in initiating a dialogue with OECD Export Credit Agencies and emerging market bilateral creditors, including a signed MOU for cooperation with China Eximbank. Only one case of applying borrower disincentives has been discussed thus far – Angola – whose financing terms have been hardened. Lack of available information and reporting

lags make NCBP implementation particularly challenging, but efforts are being made to address this problem.

6. A renewed emphasis in the Bank on debt management and capacity building among borrowers has become a key element of IDA's role in ensuring debt sustainability. This will help improve information flows, adherence to reporting requirements, and the accuracy of DSAs. The Bank and the IMF have developed and piloted a new diagnostic tool to: (i) measure debt management capacity; and (ii) identify areas in need of technical assistance. The first round of implementation of this tool is expected in early 2008. In addition the Bank and IMF are working to produce a tool to help countries put together medium-term debt strategies.

7. Debt relief and increased concessionality of assistance need to be combined with policies that support private sector-led growth in order to generate sustainable trajectories for debt-burden indicators over time. IDA's policy advice and direct financial assistance in support of structural reforms and infrastructure investments has direct implications for debt sustainability, since strong growth of GDP, revenues and exports helps lower debt ratios. While maintaining debt sustainability is ultimately the responsibility of debtor countries and all creditors collectively, IDA plays a key role in helping ensure debt sustainability through initiatives that help alleviate countries' debt burden as well as through its support to growth-promoting policies.

The Role of IDA in Ensuring Debt Sustainability: A Progress Report

I. Introduction

1. **This paper responds to the request made by IDA Deputies to assess progress in implementing the policies that IDA has put in place specifically to help countries maintain debt sustainability.** It will focus in particular on (i) the progress in developing and implementing the low income country debt sustainability framework, (ii) IDA's grant allocation system which links IDA financing to the risk ratings arising from the DSF, (iii) IDA's Non-Concessional Borrowing Policy and the related creditor outreach on the DSF, and (iv) strengthening borrowers' debt management capacity.

2. **Over the last 10 years, IDA has played an important role in helping countries achieve and maintain debt sustainability.** IDA has provided debt relief and tailors the terms of its assistance to debt sustainability, while providing technical assistance to borrowers and facilitating coordination among creditors. In addition, IDA's direct financial assistance has aimed at economic growth in client countries, a key factor in maintaining debt sustainability.

3. **Debt relief through the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) has helped lower debt and debt service ratios in many countries, allowing them to increase poverty-reducing expenditures.** For example, the average debt-service-to-exports ratio has declined on average by over 18 percent before the decision point to about 8 percent four years after the decision point.[1] Lower debt burdens have translated into an increase in poverty-reducing expenditures. For post-Decision Point HIPC countries, such expenditures increased on average to 9 percent of GDP in 2006, up from 7 percent in 2000.[2]

4. **Debt relief needs to be combined with policies that support private sector-led growth in order to generate sustainable trajectories for debt-burden indicators over time**. In fact, "assuring debt sustainability depends not only upon the absolute level of debt, but also upon the successful implementation of a comprehensive set of policies that are expected to enhance economic growth and poverty reduction, on assuring access to adequate concessional flows from the international community, and on sound debt management".[3] Furthermore, empirical research[4] has indicated that movements in debt ratios have been dominated by movements in the denominator (exports and GDP). This further highlights the importance of growth-promoting macroeconomic and structural policies for achieving debt sustainability.

5. **IDA's platform role in supporting the country-based development model helps low-income countries unleash private sector-led growth and attain debt**

---

[1] IDA and IMF (2007). "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation". IDA/SecM2007-0540, p. 9.

[2] Ibid., p. 7.

[3] World Bank, "The Challenge of Maintaining Long-term External Debt Sustainability", April 20, 2001.

[4] World Bank (2004). "Is Sovereign Debt Helping Development?", unpublished manuscript, October.

sustainability.[5] IDA's policy advice and financial assistance helps countries improve their macroeconomic performance and strengthen the micro-macro linkages in the development process. IDA's support for investment climate reforms, structural reforms, and infrastructure investments all have direct implications for debt sustainability, since strong growth of GDP, revenues and exports help lower debt ratios.

6. **Besides supporting sustainable development in client countries, IDA has taken a number of concrete steps in order to help countries address debt sustainability challenges.** A key step was the development of the joint Bank-Fund Low Income Countries Debt Sustainability Framework (DSF) based on research by the Bank and the IMF into the determinants of debt distress risk. The DSF provides a forward-looking assessment of the risk of debt distress using a baseline scenario, a standard set of stress tests, and where necessary other alternative scenarios that take into account country-specific vulnerabilities. The framework provides insight into the risks involved in new borrowing and lending, guiding both borrowers and creditors.

7. **The IDA14 Replenishment introduced a grant allocation framework for IDA based on the DSF.** The risk rating determined under the DSF is translated into a "traffic light" for each IDA-only country. Low risk ("green light") countries receive regular IDA credits on highly concessional terms. Moderate risk ("yellow light") countries receive a mixture of IDA credits and grants, while countries at high risk or in debt distress ("red light") receive only grants. This grant system provides a comprehensive rationale for grants based on debt distress risk, and moves away from a multi-purpose and exogenously determined level of grants as under IDA13.

8. **For most low-income countries IDA is only one of many financing partners, hence an important focus of IDA has been on enhanced creditor coordination.** Debt sustainability can only be achieved if other creditors take debt sustainability concerns into account in their own lending decisions. As a result a key program of outreach on the DSF is ongoing in collaboration with the IMF.

9. **In addition, IDA has stepped up efforts to increase countries' capacity to manage their debts, and is providing the tools for them to make informed borrowing decisions.** The Bank has developed a Debt Management Performance Assessment Tool, piloted in five low-income countries and is working in collaboration with the IMF to develop debt management capacity in low-income countries, with the first round of implementation planned for early 2008. A practitioners' program is also being considered through which government officials could gain experience working with Bank staff on debt management issues, creating a two-way flow of knowledge and learning on debt management issues in low income countries.

10. **The paper is organized as follows:** Section II will focus on progress in the implementation of the low-income country debt sustainability framework (DSF) as the analytical basis for helping borrowers and creditors assess the appropriateness of their

---

[5] World Bank, "The Role of IDA in the Global Aid Architecture: Supporting the Country-Based Model", June 2007.

borrowing and lending strategies. Section III will review the implementation of the IDA14 grant system which uses the DSF risk ratings as a key input for decisions on financing terms. Section IV assesses implementation of the non-concessional borrowing policy and creditor outreach in the DSF. Section V looks at the role for borrowers, and how IDA assistance with debt management and medium term debt strategies can help inform borrowing decisions. Section VI presents issues for discussion.

II. Progress in Implementing the Debt Sustainability Framework

11. **Since its endorsement by the Executive Boards of the Fund and the Bank in April 2005, the DSF has become a key input to country borrowing strategies and to the lending decisions of many official creditors.** The November 2006 DSF review examined how the framework could help assess the scope for debt accumulation, particularly given the apparent borrowing space created by debt relief under the MDRI. [6] The review responded to Bank and IMF Boards' request to enhance the rigor and quality of DSAs and the effectiveness of the DSF.[7] The review emphasized the potential for the DSF to detect emerging vulnerabilities and help prevent the re-emergence of debt distress, if broadly applied by creditors and borrowers.

12. **As of end-June 2007, the vast majority of IDA-only countries had been assessed under the joint Bank-Fund DSF for low-income countries.** Of 59 potentially grant-eligible IDA-only countries in FY08, 50 had had recent joint Bank-Fund DSAs, of which 42 were conducted in FY07.[8] Of the remaining nine, a further four were pending and the remaining five still had inadequate data to perform DSAs. In FY08, the vast majority of IDA-only borrowers will therefore be assessed for the second, third, or even fourth time under the DSF. Of the 50 DSA-based risk ratings mentioned above, 15 (30 percent) were assessed at moderate risk. The highest frequency (21, or 42 percent) was high risk (or in debt distress); low risk ratings made up the remaining 14 (28 percent).

13. **A guidance note for the staff of the Bank and the IMF has been produced based on the November 2006 review and the quality and rigor of DSAs is gradually improving.** The main improvements entail more systematic analysis of total public debt (including domestic debt and the debts of state-owned enterprises); more stringent checks of the realism of the macroeconomic assumptions underpinning DSAs; explicit guidance on the appropriate pace of new borrowing in countries where debt burden ratios are well below the DSF thresholds (as is the case in MDRI recipients in particular); and

---

[6] World Bank and IMF (2006), "Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief", November.

[7] In particular the Fund and Bank Boards called on staffs to enhance the rigor and quality of DSAs and the effectiveness of the DSF through: (i) strengthening the application of the DSF by using its built-in precautionary aspects; (ii) designing realistic baseline macroeconomic and growth scenarios; (iii) integrating domestic debt more systematically into the assessment of debt sustainability; and (iv) introducing additional vulnerability indicators in cases where debt to private external creditors is significant.

[8] The 59 countries excludes those IDA-only countries ineligible for grants in IDA14 as a result of gap status (Angola, Georgia, Honduras and Sri Lanka), and Nigeria, due to its blend status at the beginning of the IDA14 period. It also excludes Timor Leste which is potentially grant eligible, but its grant eligibility is based on its special status rather than on debt distress risk.

greater use of precautionary features of the DSF, such as retrospective analysis of departures from the assumptions of previous DSAs and special scrutiny of projections of high growth dividends associated with ambitious borrowing plans.

Features of Recent DSAs

14. **Debt sustainability analysis of total public debt, incorporating domestic debt, has been included in all DSAs for which information on domestic debt was available.** In most cases, incorporation of domestic debt did not change the overall message of the external debt sustainability analysis, either because domestic debt levels were low or because fiscal needs were projected to be largely covered by external finance. However, in certain cases (e.g., Bangladesh, Kenya, Moldova, Senegal, and Vietnam), where domestic debt is a large share of GDP, or where domestic contingent liabilities were potentially significant, incorporation of domestic debt gives a clearer picture of the government's overall debt sustainability challenges.[9] This should in turn inform the country's medium-term debt management strategy, guiding the appropriate mix between external and domestic debt.

15. **Recent DSAs have also placed greater scrutiny on the realism of macroeconomic assumptions.** An example is the Mongolia DSA, which details the factors that underpin the real GDP growth assumptions in each year. For instance, changes to the GDP profile in Mongolia were explained by developments in the Oyu Tolgoi Mine, with growth highest when the main mine's production was due to start, and declining to more modest rates thereafter. Other cases where particularly detailed accounts of the assumptions driving growth projections can be found include Ghana, Ethiopia, and Vietnam, with a particular focus on primary resource sectors described in detail in (for example) Angola, the DRC, São Tomé and Príncipe, Sudan, and Yemen.

16. **A number of DSAs have included tailored country-specific scenarios to assess risk, examples include Mauritania, Ghana, Republic of Congo, and Guyana.**

- In the Mauritania DSA (November of 2006), a country-tailored alternative scenario featured lower oil production than in the baseline. This scenario highlighted Mauritania's key vulnerability, and under this scenario Mauritania's debt service to exports ratio would only stay below the relevant 15 percent threshold if Mauritania could finance the substitution of oil revenue with concessional borrowing.[10]

- In Ghana three alternative scenarios were investigated: one looked at lower growth of exports and GDP than expected from structural reforms and infrastructure investment, one assessed the impact of higher non-concessional borrowing than in the baseline framework, and one assessed a combination of these two scenarios. In any of these scenarios the risk of debt distress would

---

[9] DSAs are required to explicitly flag situations where public domestic debt may lead to a different risk classification from consideration of external debt indicators alone. See World Bank and IMF (2006), op.cit., p.23.

[10] See World Bank, "Mauritania: Joint Bank-Fund Debt Sustainability Analysis", February, 2007.

be notably higher than in the baseline. These highlight the main risks for debt sustainability coming from the relatively undiversified exports base, and the need for cautious new borrowing and wise use of borrowed resources.[11]

- In the Republic of Congo, a non-adjustment fiscal scenario, which assumes that the authorities will continue with current fiscal policies, shows a strikingly different debt sustainability outlook than the baseline, primarily due to the high non-oil deficit, which would lead to unsustainable levels of new borrowing.[12]

- In Guyana, three additional stress tests were undertaken. These included only partial realization of the benefits of sugar-sector restructuring, lower future gold prices than projected, and weaker growth as a result of shocks.[13]

17. **Recent DSAs have also provided comparisons with previous DSAs.** In the case of Burkina Faso, the more favorable macroeconomic outlook in the 2007 DSA relative to the previous DSA was justified on the basis of unexpectedly good export performance in the most recent years. The overall moderate risk rating in the DSA was not changed however, as the DSA also highlighted the impacts of scaling up aid on debt distress risks.[14] These scenarios emphasized the need for increased aid to be mostly on grant terms to ensure debt sustainability. Other cases that give more detailed attention to the comparison with previous DSAs are Guyana and Vietnam.

18. **The DSF framework has thus passed from its initial stages of development to a more mature phase of implementation and incremental improvement.** The availability of successive forward-looking DSAs for most LICs now provides an important tool for borrowers in designing not only their debt management strategies but also their broader macroeconomic policies. The annual DSAs also provide useful guidance to other creditors, as these DSAs are now publicly available on the World Bank and IMF websites for countries who have provided consent to the DSA's disclosure. The effectiveness of the DSF is ultimately dependent upon its broad use by both borrowers and creditors.

III. Incorporating Debt Distress Risk Ratings into IDA's Grant Allocation System

19. **The grant allocation system in IDA14 is based on external debt distress risk ratings, and represents the main tool for IDA to help ensure debt sustainability.** Under the grant allocation system in IDA, a country's external debt distress risk rating is translated into a "traffic light" which in turn determines the mix of credits and grants for

---

[11] See IMF, "Ghana: 2007 Article IV Consultation", June 20, 2007.

[12] See IMF, "Republic of Congo: 2007 Article IV Consultation", June, 2007.

[13] Guyana has not yet agreed to publish its 2007 DSA.

[14] The scaling-up scenarios used conservative estimates taken from analytical work of the potential impact of scaled up aid on GDP growth. See Burkina Faso DSA for more on this. The DSA's estimates of the growth impact of the scaled up aid were derived from the specifications in "Counting Chickens When They Hatch: The Short Term Effect of Aid on Growth" by Michael Clemens, Steven Radelet, and Rikhil Bhavani (2004).

the country. The traffic lights comprise three categories: green corresponds to a low risk of debt distress; yellow to a moderate risk of debt distress; and red to a high risk of debt distress or actually being judged to be in debt distress. A traffic light is assigned annually to each IDA-only country. The configuration of credits and grants by traffic light is then given as follows: a green light results in an allocation of 100 percent IDA credits; yellow light results in an allocation of 50 percent IDA credits and 50 percent grants; and red light results in an allocation of 100 percent grants.

20. **The grant allocation system was built on two pillars:** a "static" pillar – based on a one-year "snapshot" of debt indicators relative to the DSF matrix of policy-dependent external debt burden thresholds; and a "dynamic" pillar – an assessment of debt distress risk based on a forward-looking DSA that assesses debt trajectories relative to the matrix of policy-dependent external debt burden thresholds, and the impact of alternative scenarios and stress tests on these debt trajectories. In FY06-7, debt distress risk ratings were primarily based on the 'static' pillar, i.e. a comparison between its latest available relevant external debt indicators[15] and the applicable external debt thresholds.[16] This owed to limited availability of DSAs at an early stage of DSF implementation.

21. **The availability of DSAs has increased significantly over the IDA14 period, consequently the vast majority of traffic lights were determined on the basis of the dynamic pillar in FY08.**[17] DSAs have increasingly been used as the basis for traffic light ratings throughout IDA14, from 4 in FY06 to 50 in FY08 (see Figure 1.a). At the time of determining the FY08 traffic lights, DSAs had yet to be completed for only nine countries (mostly HIPC pre-decision point countries) and hence their traffic lights are based on the 'static' pillar: namely Bhutan, Democratic Republic of Congo, Cote d'Ivoire, Kiribati, Maldives, Myanmar, Somalia, Sudan, and Vanuatu.[18]

22. **The number of grant-eligible countries (red plus yellow lights) has been stable over the three-year period of IDA14.** Annex 2 documents the changes in traffic lights during IDA14. For FY06, 42 countries were eligible for grants: 33 red light countries, nine yellow light countries.[19] For FY07, the number of grant-eligible countries

---

[15] Although there are five debt indicators under the DSF, the indicators which are relevant for the purposes of determining grant eligibility under the static pillar are: (i) the ratio of the net present value (NPV) of public and publicly guaranteed (PPG) external debt-to- Gross Domestic Product (GDP); (ii) the ratio of NPV of PPG external debt-to-exports; and (iii) the ratio of the service on PPG external debt to exports. For more on the underlying matrix of debt indicators see IMF and World Bank (2004a), "Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications", February.

[16] For more on the static pillar see IDA (2004), "Debt Sustainability and Financing Terms in IDA14: Further Considerations on Issues and Options", November.

[17] This was endorsed by IDA Deputies at the IDA14 Mid-Term Review meeting in November 2006. See IDA (2006a), "Debt Dynamics and Financing Terms: A Forward-Looking Approach to IDA Grant Eligibility," presented at the IDA14 Mid-Term Review Meeting, November.

[18] See Annex 1. For FY08, an unpublished DSA for Eritrea confirms the red light rating obtained with the static pillar. For Kiribati, neither a DSA nor debt data was available and its traffic light was assumed to be green.

[19] For Kosovo, eligibility was based on its status as part of Serbia (previously Serbia and Montenegro) under the United Nations Administration and its eligibility will continue during IDA14 until its status

decreased to 39 (30 red light countries, 9 yellow light countries), reflecting the lower incidence of red light countries, from 33 to 30. In FY08, the number of grant-eligible countries was 41: 28 red lights and 13 yellow lights (see Figure 1.b).

Figure 1a: The number of traffic lights by source

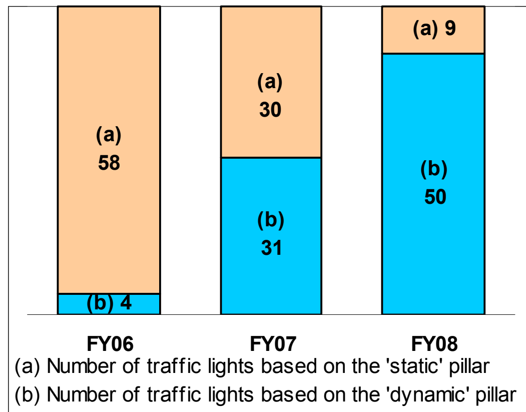
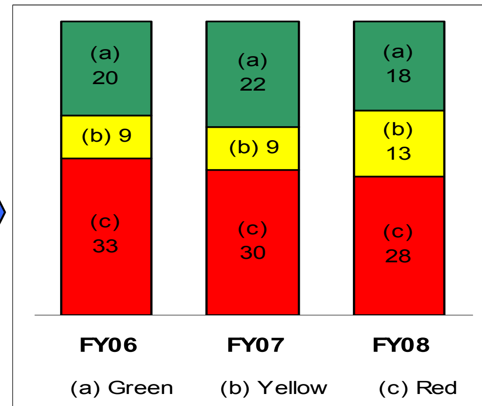


Figure 1b: The number of countries by traffic light



23. **The fact that the number of grant eligible countries has been stable in IDA14 even after debt relief under HIPC and MDRI highlights the importance of increasing economic resilience to help maintain the reduced debt ratios achieved by debt relief.** Debt relief provided under the HIPC Initiative and then MDRI during IDA14 reduced debt ratios for most post-completion point HIPCs, but debt relief "does not automatically translate into credits-only status for its recipients".[20] While the static pillar would indicate many more green light countries, the forward-looking DSAs are better predictors of debt distress. As a result, under the dynamic pillar, of the 20 post-MDRI countries which could qualify for IDA grants, nine are green light countries in FY08. For several post-MDRI countries, unless improvements in macroeconomic fundamentals are made, debt ratios would converge to pre-MDRI levels in the long term (see Figure 2 showing the impact of MDRI on the long run trajectory of the NPV of debt-to-exports ratio of Burkina Faso).[21] For many countries, baseline indicators remain below their policy-dependent debt thresholds. However, stress tests in the DSF highlight sensitivity to non-concessional external borrowing or exogenous shocks, such as a sharp decline in exports (see Figure 3a and b and Annex 2).

24. **In essence, the grant system based on forward-looking DSAs incorporates future prosperity or vulnerabilities into current financing decisions.** For instance, in FY06, while the static pillar suggested a red light for Mauritania and a green light for Ethiopia, Rwanda and Zambia, their forward-looking DSAs indicated a low risk of debt distress for Mauritania given its strong oil prospects, a moderate risk for Ethiopia and

---

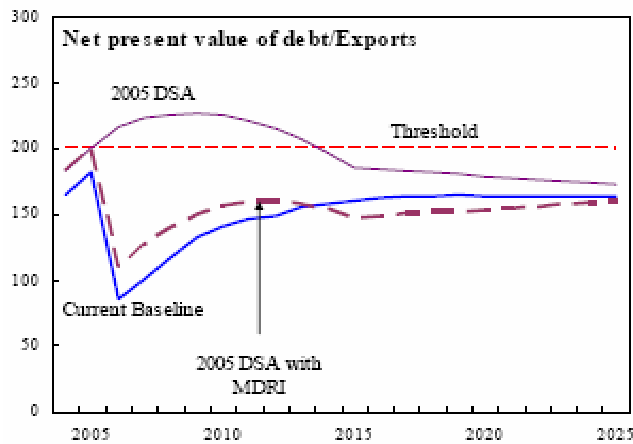
changes and it is able to borrow. Timor-Leste was eligible for grants on the basis of its post-conflict status during the IDA14 period (IDA, 2005a).

[20] IDA (2006a), *Op.cit.*

[21] This also reflects debt mechanics: if new borrowing is kept unchanged then the weight of existing debt in total debt tends to decrease over time.

Zambia, and a high risk for Rwanda given the expected upward trend in the simulated trajectory of their debt ratios, even after reaching the HIPC completion point. The dynamic pillar is able to assess future risks by looking at the likely trajectory of new borrowing and expected movements in the main economic variables. It also assesses the impact of stress tests calibrated to the historical economic performance of GDP growth, exports, and other relevant factors. Switching to the dynamic pillar of the DSA therefore enables financing terms to reflect debt distress risks over the medium term, and via annual updates, enables IDA financing terms to react to changes in underlying economic conditions.

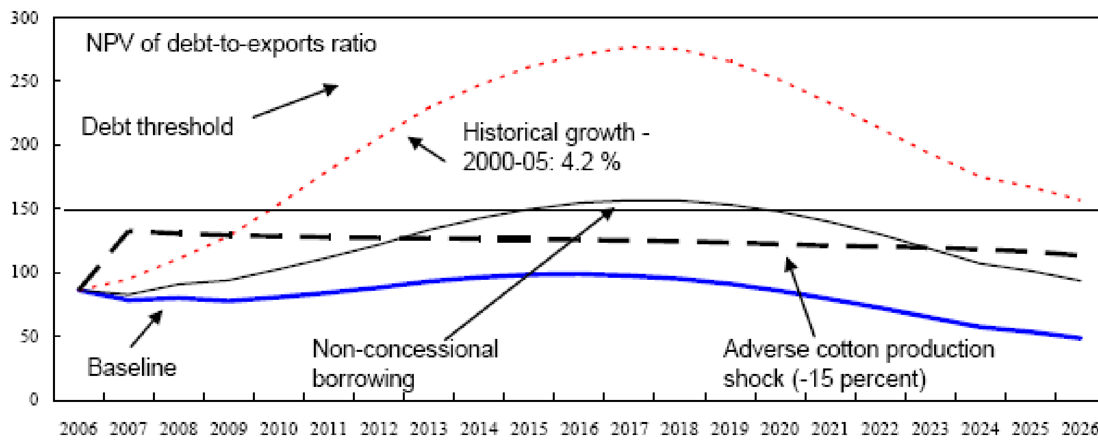
Figure 2. Burkina Faso: NPV of debt-to-exports ratio, with and without MDRI



Source: IMF (2007), "Burkina Faso: Joint World Bank-IMF Debt Sustainability Analysis," in "IMF Staff Report—Request for a Three-Year Arrangement under the Poverty Reduction and Growth Facility," p. 32, April 02.

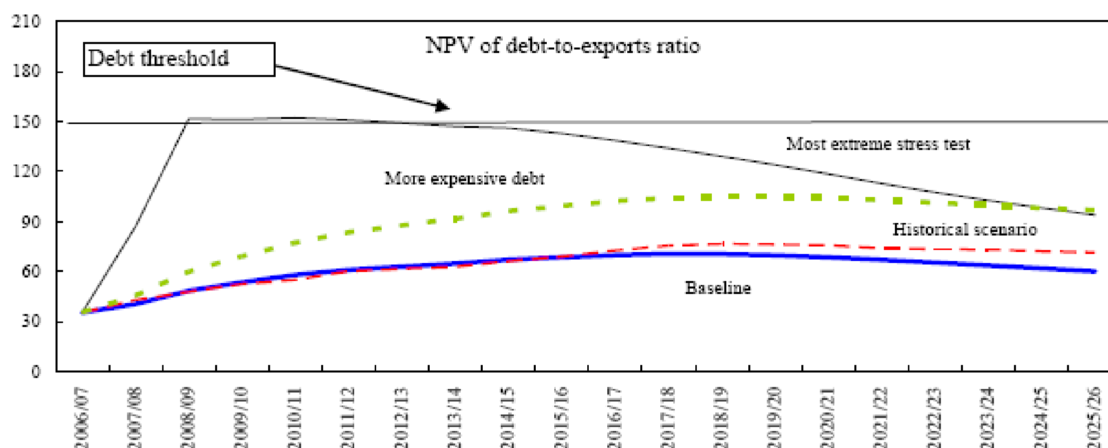
Figure 3. Sensitivity of the NPV of debt-to-exports ratio post-MDRI

(a) Sensitivity to financing terms: Benin



Source: IMF (2006), "Appendix IV: Debt Sustainability Analysis," p. 72, Figure 2. in "Benin: Article IV Consultation, First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waiver of Nonobservance of Performance Criteria," November 10.

(b) Sensitivity to export growth: Ethiopia



Note: Most extreme stress test refers to a shock in export growth.
Source: IMF and IDA (2007), "The Federal Democratic Republic of Ethiopia: The Joint IMF/World Bank Debt Sustainability Analysis 2007," p.5. Figure 1. May 22.

25. **Like the CPIA, the assignment of traffic light ratings is subject to a Bank-wide clearance process, and subsequently traffic lights are published on IDA's website.** Based on the risk ratings from the most recent DSA, regions are sent a list of the proposed traffic lights. There may be exceptional cases where the country team or regional management disagrees with the traffic light. In each case, the determination of the appropriate traffic light is approved by the relevant units in the Bank (country team, PRMED, and FRM). This process is functioning well and has been in place for all traffic light determinations in IDA14. The traffic lights for all IDA-only countries are then published annually in OP 3.10 Annex D in terms of grant percentage, which is available on the Bank website.[22]

26. **There are at least two types of situations that may call for judgment at the time of the grant allocation process and lead to differences between published risk ratings and traffic lights.** The first situation involves cases where there has been a major change in country circumstances since the most recent DSA was prepared, such as eligibility for MDRI, or major revisions in projected oil revenues. The second situation represents borderline cases or situations where the traffic light associated with the risk rating needs to be reassessed. In either of these two circumstances where the country team feels that the risk rating may need to be revisited, this is done according to the process described above.

27. **Actual cases where traffic lights differ from final risk ratings are unusual – only two occurred in FY08 – and will continue to be monitored to see whether each judgment call is borne out by subsequent developments.** In FY07 there were more frequent differences from published DSAs primarily because DSAs for Benin, Mali, Mauritania, Tanzania and Uganda needed to be updated with additional scenarios incorporating the impact of MDRI. Based on these scenarios, risk ratings and their

[22] http://siteresources.worldbank.org/OPSMANUAL/Resources/OP310_AnnexD_RevJul_10_2007.pdf

associated traffic lights were then approved by the relevant units in the Bank. Apart from DSAs not reflecting debt relief from MDRI, the differences between final published risk ratings and traffic lights are:

- In the case of Madagascar, a green light for FY07 was based on preliminary projections as part of an ongoing joint Bank-Fund DSA that was not yet finalized.[23]
- In the borderline case of Burkina Faso in 2006, the relevant units in the Bank collectively agreed that the stress test in the DSA that caused a debt ratio to breach its threshold was extreme, and alternative scenarios led to a low risk and green light rating for the FY07 traffic light exercise.
- The DSA completed in February 2007 for São Tomé and Príncipe showed a moderate risk. Since the conclusion of the DSA, however, the prospects for oil revenues had declined. A revision of the macroeconomic assumptions in the DSA suggested a high risk of debt distress. As a result, relevant units in the Bank concluded that São Tomé and Príncipe should be classified as a red light country for the FY08 allocation exercise.
- Based on the DSA analysis, Ghana's risk of debt distress is between "low" and "moderate." The analysis underlying the DSA for Ghana is based on the assumption of a 100 percent credit allocation from IDA. That assumption does not jeopardize Ghana's debt sustainability prospects going forward, given that the probability of a shock that would produce debt distress is very low. Therefore, the relevant units in the Bank jointly agreed that retaining "green light" status (100 percent of IDA assistance in credit terms) during FY08 would be an appropriate course of action from the point of view of Ghana's debt sustainability prospects.

28. **It is too early to assess whether basing the debt thresholds on performance using the three-year moving average of CPIA has had an impact on the volatility in traffic light ratings.** In the mid-term review paper, simulations indicated that this change, introduced for FY08, would reduce volatility. In the first year of implementation of this new methodology for determining the performance benchmark, country teams were given the flexibility to maintain a 1-year performance rating if the use of the 3-year average rating would increase volatility.[24] Table 1 shows performance rating movements in selected countries and indicates that a three-year average helps maintain the same performance categories in FY08 as in FY07 in some countries. At the same time, it suggests that the three-year average does not completely eliminate volatility in the performance category (see Burkina Faso in Table 1). Annex 1 shows the traffic lights for each country and the basis of the performance rating in each country in FY08.

---

[23] Once completed, the published 2006 DSA indicated moderate risk. A subsequent DSA, published in July 2007, upgraded the debt distress risk rating to low and confirmed the green-light status for FY08.

[24] See World Bank, "Staff Guidance Note on the application of the Bank-Fund Debt Sustainability Framework for Low-Income Countries", May 3, 2007.

Table 1. Performance category in FY07-8 based on a single-year CPIA vs a three-year CPIA average: selected countries.

Country	FY07 based on 2005 CPIA	FY08 based on 2006 CPIA	FY08 Based on 2004-6 average
Burkina Faso	Strong	Medium	Medium
Maldives	Strong	Medium	Strong
Mauritania	Weak	Medium	Weak
Nicaragua	Medium	Strong	Medium
Vietnam	Medium	Strong	Medium
Yemen, Republic of	Medium	Weak	Medium

Source: World Bank staff calculations.

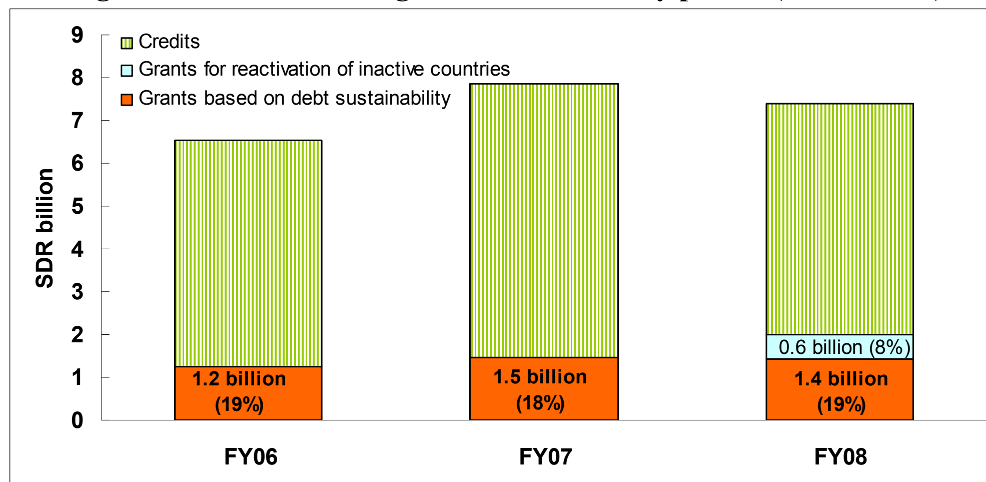
29. **The move towards the dynamic pillar in the IDA14 grant allocation system is thus progressing as expected and no changes are proposed.** This forward-looking traffic light system based on the risk of debt distress is proactive and enables IDA to tailor its financing terms in anticipation of future risks. At the same time regular updates of DSAs enable IDA's financing terms to adjust in response to actual movements in economic variables and the pace of borrowing. Risk ratings are receiving greater scrutiny in cases where DSAs indicate a low-moderate or a high-moderate rating to avoid overly conservative or mechanistic risk ratings. The flexibility employed when translating DSF risk ratings into traffic lights will continue to be based on the due process described above and carefully monitored.

An Assessment of the Grant Level

30. **Grant financing in IDA14 may reach up to SDR 4.7 billion, or about 22 percent of the total SDR 24.8 billion IDA14 envelope (see Figure 4).** The level of grants has been steady throughout IDA14, but is lower than the 30 percent projected at the time of the IDA14 replenishment negotiations.[25] In FY06 commitments in the form of grants amounted to about SDR1.3 billion out of a total volume of credits and grants of SDR 6.5 billion (US$9.5 billion). In FY07 eligible IDA countries committed grants of SDR 1.5 billion out of a total IDA commitment of SDR 7.9 billion (US$ 11.8 billion). Grant usage was slightly lower than projected in FY07, while the total commitment was higher than the total allocation (SDR 7.7 billion). In FY08 grants are expected to be 19 percent of total IDA financing, and 27 percent if reactivation takes place for countries in arrears.

[25] World Bank, "Additions to IDA Resources: Fourteenth Replenishment. Working Together to Achieve the Millennium Development goals", March 10, 2005.

Figure 4. Distribution of grants and credits by period (SDR billion)



31. **Two key factors explain the lower grant share to date than estimated at the time of IDA14.** First, although HIPC and MDRI did not automatically lead to green light status for all countries, there are fewer red light countries (of the 20 post-completion point HIPCs which could qualify for IDA grants, one is still rated as red light and 10 are rated as yellow light).[26] Second, the reactivation of countries in arrears – for which grants amounting to about SDR 1 billion were estimated to be allocated – has not yet materialized, lowering the grant share to date. Irrespective of the grant share, however, additional grant flows have been delivered through HIPC and MDRI – the equivalent of budget support in the form of grants.[27]

32. **As outlined in the IDA14 Deputies report, there are two transitional cases which are exceptions to the debt-distress-based grant eligibility criterion – Kosovo and Timor-Leste.** For IDA14, Kosovo was eligible for grants based on its status as part of Serbia (and previously Serbia and Montenegro) under United Nations Administration. In IDA15, as long as Kosovo's status remains as it was in IDA14, it is proposed that Kosovo's eligibility for grants would continue. Timor-Leste was grant-eligible in IDA14 to avoid a "sudden shift of status vis-à-vis other IDA13 grant-recipient countries under the post- conflict criterion".[28] Management proposes that Timor-Leste continues to have access to the grants equivalent of its PBA allocation (i.e. 60 percent), given its continued post-conflict status and constraints on its ability to contract external debt.

33. **The impact of IDA's grant allocation system on debt sustainability is contingent on a number of factors, including whether borrowers and other creditors will incorporate debt sustainability considerations into their own financing decisions.** The expectation is that where IDA is a key creditor, the debt relief already

---

[26] There are 22 post-completion point HIPCs, but Bolivia and Honduras are not eligible for IDA grants as Bolivia is a blend country and Honduras is a gap country.

[27] See World Bank, "Assessing Implementation of the IDA14 Grant Framework". Once MDRI relief is counted, the grant share in IDA14 is estimated at about 24 percent.

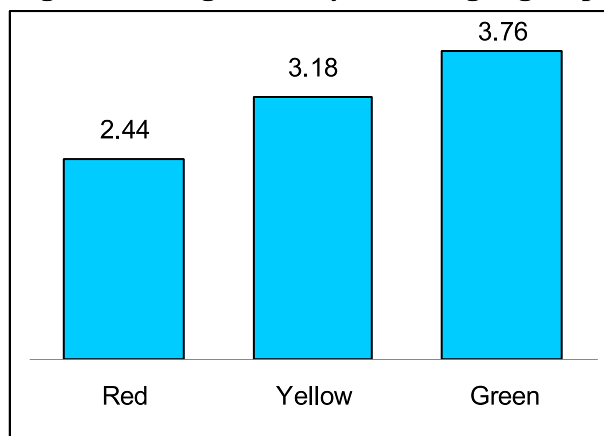
[28] See IDA (2005), "Additions to IDA Resources: Fourteenth Replenishment"., pp.27.

delivered through HIPC and MDRI as well as grants where necessary going forward, will help countries maintain sustainable debt trajectories, and gradually allow a reduction in the need for grants or debt relief in the future. Where IDA is not a key creditor, there will be risks in maintaining debt sustainability unless borrowers and other creditors take debt sustainability considerations into account in their borrowing and lending decisions. The impact of IDA grants on debt dynamics is further elaborated upon in Box 1.

The Impact of IDA Grants on the PBA System

34. **The discount on grant volumes embedded in the grant allocation system (modified volume approach, or MVA) aims to maintain IDA's performance incentive.** Under the PBA system, the main determinant for a country's IDA allocation amount is the country's IDA performance rating (CPR).[29] An improvement in performance, holding all else constant, increases the allocation amount and therefore the resource transfer amount. Any modifications, including the grant allocation system, to the PBA system must ensure that the positive relationship between performance and resource transfer remains intact. Given the negative correlation between risk of debt distress and performance (see Figure 5), grants based on debt sustainability can result in higher resource transfers to low-performing countries, thereby weakening the performance incentive in the PBA. This weakening is moderated by applying the 20 percent discount to grant volumes.

Figure 5. Weighted average CPR by traffic light group in FY08 [1/2/3/]



1/ Weights are group-specific ones that are inversely proportional to the variance of an observation in the traffic light group.
2/ The number of observations: Red=25 (excluding countries with non-accrual status and with CPR unavailable, namely Liberia, Myanmar and Somalia); Yellow=13; Green=18.
3/ See IDA (2006a) "Debt Dynamics and Financing Terms: A Forward-Looking Approach to IDA Grant Eligibility," for further analyses on this.

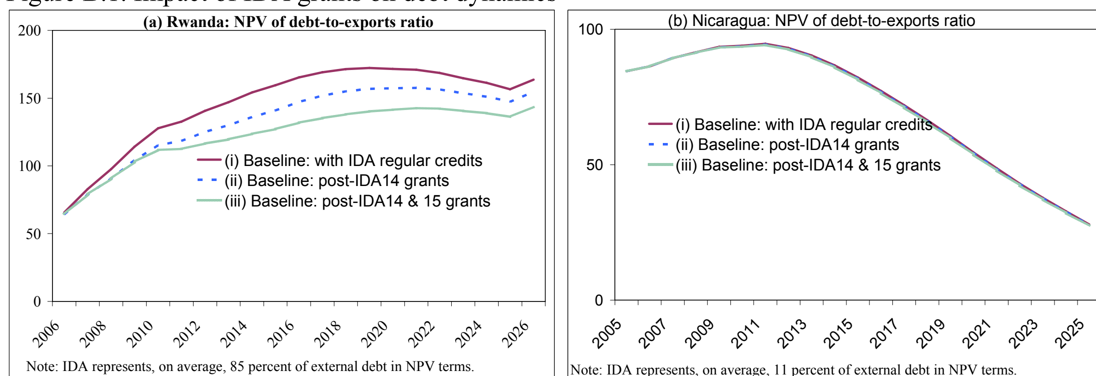
[29] See IDA (2007), "IDA's Performance-Based Allocation System: Simplification of the Formula and Other Outstanding Issues", September. Figure 1, pp. 2-3 for an explanation of the CPR.

Box 1: The Impact of IDA Grants on Debt Dynamics

A country's debt dynamics depend on the existing debt burden, the concessionality of new financing and its growth performance. The impact of the existing debt burden on debt dynamics is through the difference between growth rates (GDP or exports) and interest rates. The debt dynamics, all else constant, are stable when growth rates are the same as interest rates. A positive new financing requirement, holding all else constant, raises debt ratios. The grant element in new financing determines, all else constant, the extent to which the debt dynamics increase as a result of new financing: i.e. new financing with 100 percent concessionality keeps the debt dynamics unchanged, while new financing with zero percent concessionality will fully impact the debt dynamics.

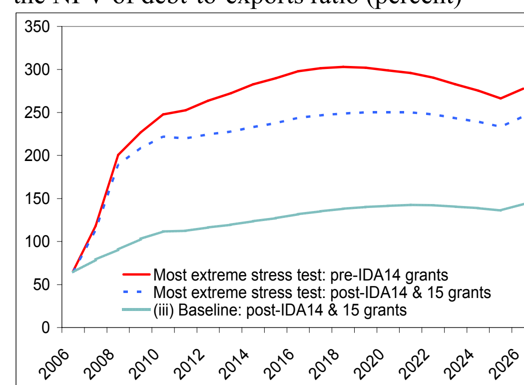
The impact of IDA grants on debt dynamics, in turn, depends on the share of IDA in total new financing. As shown in Figure B.1.a, when IDA accounts for more than 80 percent of total external financing, IDA14 grants clearly reduce the speed of new debt accumulation (the dotted line in the figure). Continued IDA grant financing (IDA14 and 15) results in even further reducing the speed. On the other hand, in an economy with a small IDA exposure in the total external financing, the impact of IDA grants on the debt dynamics is minimal (Figure B.1.b).

Figure B.1. Impact of IDA grants on debt dynamics



Even in an economy with high IDA exposure, an adverse economic shock can erode the positive impact of IDA grants on debt dynamics. As shown in Figure B.2, an extreme negative shock on exports lowers exports earnings and requires more financing needs, and therefore shifts the debt-to-exports ratio upwards, beyond 200 percent, despite IDA14 and 15 grants. Nonetheless, it is notable that the impact of the adverse shock on debt dynamics is smaller in the presence of grants. These suggest that a country's debt sustainability calls not only for grant financing but also for better economic management and improved resilience so as to moderate the impact of a given shock on the economy.

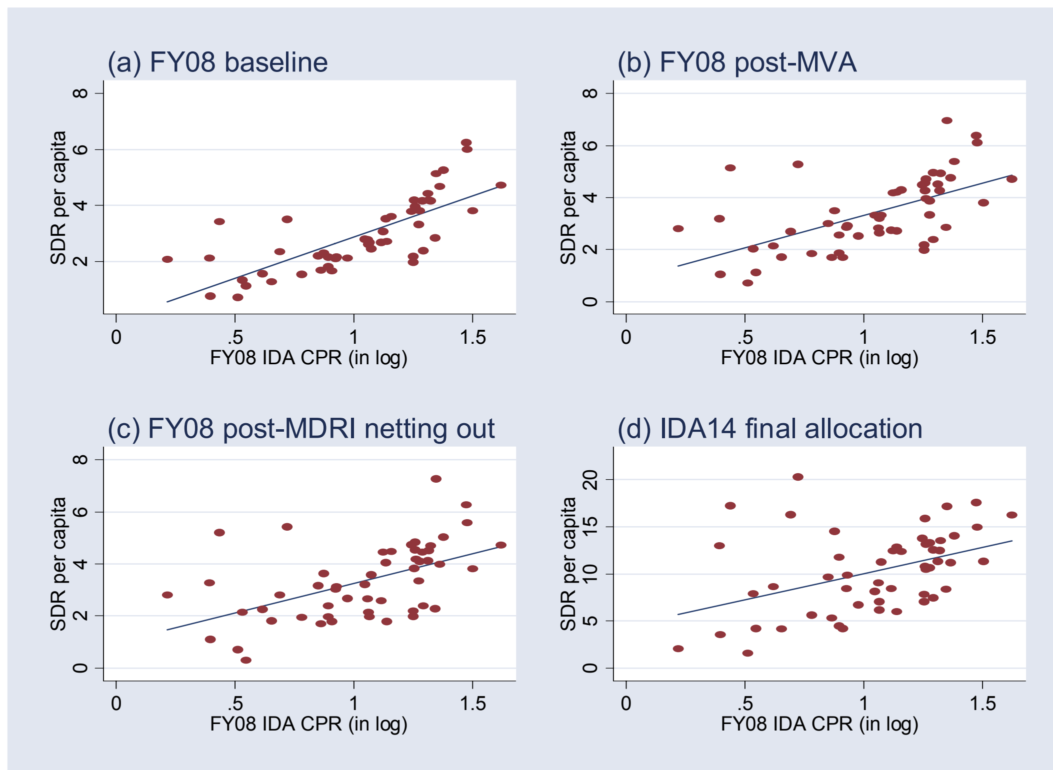
Figure B.2. Impact of an adverse export shock on the NPV of debt-to-exports ratio (percent)



Source: Staff simulation, and IDA (2006a), "Debt Dynamics and Financing Terms: A Forward-Looking Approach to IDA Grant Eligibility," pp. 15-20, prepared for the IDA14 Mid-Term Review Meeting, Nov. 20-21.

35. **Overall for IDA14 (Figure 6.d), the relationship between performance and resource transfers remains strong.** Figure 6 shows the regression results of the real resource transfer with and without grants against IDA's country performance rating. Figure 6.a (baseline) shows that, as expected, without any grant in IDA allocations (i.e. credits only), IDA performance is positively associated with resource transfers (as measured by the grant element of IDA assistance volumes) per capita. Even after the introduction of the IDA14 grant allocation system and the associated discount on such grants in FY08, the relationship still holds (Figure 6. b. post-MVA).[30] The association becomes somewhat weaker when taking into account MDRI netting out and the reallocation of resources netted out under MDRI (another addition to the PBA system, Figure 6.c), but remains strong overall for IDA14 (Figure 6.d).

Figure 6. Relationship between IDA CPR and resource transfers [1/2/3/4/]



1/ IDA CPR coefficient is: (a) 2.94 (b) 2.48 (c) 2.28 (d) 5.56 (all are statistically significant at the 1 percent level).
2/ The number of observations is 53 countries, excluding countries with population less than 1 million, those in non-accrual status and those with capped allocations.
3/ The variable FY08 IDA CPR is expressed in logarithms, taking into account the quadratic function of CPR in the PBA allocation formula.
4/ The following grant element is assumed: 60 percent for IDA credit; 80 percent for the mix of IDA credit and grants; 100 percent for IDA grants.

---

30 See IDA (2006a), "Debt Dynamics and Financing Terms: A Forward-Looking Approach to IDA Grant Eligibility," pp. 15-20, prepared for the IDA14 Mid-Term Review Meeting, Nov. 20-21 for the relationship in FY06 and FY07.

36. **Another link between debt-related issues and IDA's resource allocation system refers to the impact of MDRI's netting out mechanism on new IDA allocations to post-completion point HIPCs.** The netting-out mechanism was put in place to preserve the equity between MDRI beneficiaries and non-MDRI countries. However, given the upward trajectory of debt service relief over the medium-term, many MDRI recipients would be receiving large cuts to their IDA allocations perhaps even to zero as a result of the netting out mechanism. While MDRI netting out may not reduce the overall assistance package which consists of new IDA plus debt service relief, it does reduce new IDA commitments thus limiting IDA's ability to play a platform role in the country. This may create an incentive for affected countries to resort to other forms of less favorable financing if alternative concessional resources are constrained.

IV. Implementing the Non-Concessional Borrowing Policy in Grant-Eligible and Post-MDRI Countries

37. **In July 2006, the Executive Board of IDA approved a framework for IDA's response to non-concessional borrowing risks in grant-eligible and post-MDRI countries.**[31] As was pointed out in that paper, debt stock ratios post-MDRI in most recipient countries will be lower than debt ratios in many middle-income countries. Debt relief and IDA grants increase the apparent borrowing space and financing options available to recipients that can be used to accelerate progress in meeting the MDGs. At the same time, this presents a challenge for borrowers to manage that borrowing space effectively to increase growth and meet poverty reduction targets while maintaining debt sustainability.

38. **The primary objective of IDA's Non-Concessional Borrowing Policy (NCBP) is to address the risk that non-concessional loans to grant-eligible and post-MDRI countries may lead to a rapid re-accumulation of debt and thus undermine borrowers' debt sustainability prospects.** Low-income countries (LICs) continue to require significant investments in order to make progress towards MDGs, and much more can be done without jeopardizing debt sustainability if debt flows are on concessional terms. It is important to note that although debt relief led to low debt ratios post-MDRI, other broad economic circumstances are largely unchanged. In fact simulations outlined in the November 2006 DSF review paper showed that some countries could return to pre-debt relief levels of indebtedness in 6 to 10 years unless lenders respond to higher debt distress risks with higher concessionality.

39. **The focus on non-concessional borrowing stems from the greater risks that such borrowing puts on debt sustainability.** Although large volumes of concessional financing could also increase debt distress risks, for a given borrowing path, non-concessional borrowing yields a smaller net resource flow and worse debt dynamics than concessional borrowing. Non-concessional lending increases debt ratios more rapidly, and in general repayments are required quickly, even though most investments require a long gestation period to yield returns. When the expected growth impact of an

[31] 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.

investment is not realized, non-concessional financing poses a greater risk to debt sustainability. As a result concessional finance remains the most appropriate source of financing for LICs with large financing needs. It should be noted, however, that any borrowing, even on concessional terms, poses risks if the expected growth dividend does not materialize.

40. **The NCBP is not a blanket restriction on non-concessional borrowing, and acknowledges that under certain circumstances non-concessional loans can appropriately be part of a financing mix that helps promote economic growth.** While concessional financing continues to be the most appropriate form of financing for most LICs, there may be cases where non-concessional borrowing may warrant an exception to the policy (i.e. no disincentive mechanisms would apply in such a case). The NCBP paper describes the considerations that feed into decisions on whether a particular instance of non-concessional borrowing could be considered an exception to the policy (See Annex 4). This assessment is on the basis of both country-specific policies and investment plans and loan-specific criteria. The Bank's process for addressing new cases of non-concessional borrowing and determining the appropriate response is summarized in Box 2 (below).

Box 2. The Bank's Decision-Making Process in a Case of Non-Concessional Borrowing

- Data is received by FRM from annual reports to DEC, as well as via alternative sources.
- Follow-ups are undertaken (via the country team, and with other creditors) to verify the accuracy of the data, and obtain as much information as possible on the projects for which non-concessional borrowing was contracted.
- Each year, at the time of the IDA allocation exercise, representatives from the Regions, CFP, PREM, DEC and OPCS meet to review countries' non-concessional borrowing, if anything significant has been raised prior to the allocation exercise.
- For cases coming up in between the yearly IDA allocation exercise, the same group convenes as needed to discuss the response, once sufficient information is received about the nature of the loan.
- Based on principles outlined in Box 3 of the NCBP paper, this group makes recommendations on whether a non-concessional loan would be considered a breach of the NCBP.
- The group also recommends the appropriate disincentive mechanism in response to a breach (either a cut in allocation volumes, or a hardening of the financing terms).
- Based on these factors the group makes a written recommendation to the Bank's Operations Committee for a decision on the appropriate disincentive measure, along with detailed justification for the decision.
- The Board is informed of the decision to apply a disincentive mechanism ahead of the next IDA project in the affected country.

41. **Even in countries where IDA's policies and decisions may have little impact on the decisions by authorities, other facets of IDA's role may nonetheless help shape borrowing decisions.** Capacity building in debt management, providing a tool for developing medium term debt strategies, and providing advice on managing oil revenues are other ways to increase the likelihood that borrowing is responsible. IDA is also well placed to lead, together with the IMF, dialogues with other groups of creditors.

42. **This section will review implementation of the two key pillars of the NCB policy**: (a) increased incorporation of the DSF among creditors and borrowers in their lending and borrowing decisions (including increased creditor collaboration, strengthened information flows, strengthened debt reporting and debt management capacity); and (b) discouraging non-concessional borrowing through borrower disincentives. Given that borrowers ultimately decide on which loans to contract, improved debt management and the development of medium-term debt strategies are critical to the NCBP and are discussed in detail in section V.

Update on Creditor Outreach and the DSF

43. **For most low-income countries, IDA is only one of many financing partners, and hence creditor outreach is vital to maintaining debt sustainability.** Discussions on the LIC DSF have been held with nearly all major multilateral and bilateral creditors to low-income countries. The World Bank and the IMF have undertaken extensive outreach activities involving the Export Credit Group of the OECD, the Berne Union (of export credit insurers), the OPEC Fund, and other Arab multilateral creditors and some emerging market donors. Not only have these exchanges contributed to a common understanding of the principles of collectively sustainable lending to low-income countries, but information flows have also improved.

44. **To increase accessibility of the DSF, a number of steps have been taken by staffs of the Bank and Fund to make it more user-friendly, and make individual DSAs readily available.** Based on feedback received during creditor and borrower consultations, a dedicated webpage on the Bank and on the Fund's website has been established so that DSAs can be easily accessed, where countries agree to their publication. [32] To increase understanding and broaden acceptance of the DSF, this page provides easy links to each new DSA as well as links to the various DSF policy documents and the DSF user's guide. In addition, webpages have been set up to provide guidance to creditors and borrowers on concessionality, including a concessionality calculator and relevant information on the Bank's non-concessional borrowing policy and the Fund's concessionality policy. [33] As the NCBP applies to grant-eligible and IDA-only post-MDRI countries, this list changes slightly from year to year (see Annex 4 for the list in FY08, which is also posted on the external website).

45. **Discussions are underway to agree on a more active role for the major regional banks[34] in the DSA process.** These discussions are in response to the willingness expressed by these institutions to harmonize their lending practices broadly along the lines suggested by the risk assessments contained in DSAs carried out by Bank and IMF staff. This process is close to completion, which will lead to concrete guidelines signed by the leaders of the respective banks describing processes for the staff of these institutions to have input into the DSA process.

---

[32] See http://www.worldbank.org/debt and http://imf.org/dsa

[33] This website can be accessed via the World Bank external website by searching for "non-concessional", and via the IMF external website (http://imf.org/concessionality).

[34] The African Development Bank, Asian Development Bank, Inter-American Development Bank, European Bank for Reconstruction and Development, and European Investment Bank.

46. **As a result of outreach on harmonizing lending policies with the DSF, an increasing number of MDBs are incorporating elements of the DSF into their own financing terms, and some of them are contemplating adoption of their own policies on non-concessional borrowing.** The African Development Fund has a grant allocation system that is almost identical to that of IDA, with a similar traffic light system and a modified volume approach.[35] Another creditor, the International Fund for Agricultural Development has also incorporated the DSF into its decisions on grant eligibility. Similarly, the Asian Development Fund discussed a proposal at its Board in late July for a grant allocation system that mirrors that of IDA14. However, available data suggest that some MDBs may still be lending on non-concessional terms to grant-eligible and post-MDRI countries, and outreach with these creditors in particular is being strengthened.

47. **Progress made in collaboration among multilateral creditors on the DSF could potentially have an important impact on the debt ratios in most LICs, as multilateral creditors are bound to continue to account for the bulk of new borrowing.** Although interest in LIC financing in a post-MDRI context is growing among other creditors, notably bilateral creditors, multilateral creditors will be the key drivers in the debt ratios in most LICs. The November 2006 review pointed out that full disbursement of MDB allocations on concessional credit terms combined with conservative growth assumptions would not lead to a rapid re-accumulation of debt in most cases. In cases where MDB lending would lead to risks of debt distress, the DSF would detect this early on and MDB assistance would be provided on more concessional terms.

48. **Given the new landscape in many LICs post-MDRI, extending creditor collaboration to bilateral creditors, in particular non-traditional creditors, becomes vital to maintaining debt sustainability.** While debt distress in most LICs would not increase rapidly with traditional multilateral creditors, especially given their increased harmonization with the IDA14 grant allocation system, significant scaling up and non-concessional borrowing could exacerbate debt distress risks. The 2006 DSF review pointed out that debt sustainability would be jeopardized "relatively rapidly under scenarios of significant increases in new borrowing by LICs from other creditors in addition to the main MDBs, particularly if borrowing is contracted at or near market interest rates."[36]

49. **A dialogue is ongoing with the OECD Working Group on Export Credits and Guarantees (ECG) on the importance of incorporating debt sustainability considerations into lending decisions.** World Bank and IMF colleagues attended regular ECG meetings and workshops in 2006 and 2007. Information sharing has improved as a result of this dialogue, and at the April 2007 meeting the OECD ECG agreed to reinstate a streamlined version of reporting of commitment data on lending to

---

35 Small differences may arise as a result of different assessments of performance, or as a result of the different timetable – with IDA's grant eligibility determined at the start of the fiscal year (July), while the AfDB's allocations and eligibility start at the beginning of the calendar year.

36 World Bank and IMF, "Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief", November 2006.

IDA-only countries, and to share (on a confidential basis) this information with the Bank and the IMF to help supplement debtor information in the DSAs. As a result of improved outreach on the DSF and debt distress risks, the ECG also agreed to extend the statement of principles on unproductive expenditures from the group of HIPCs to all IDA-only low-income countries. There are also ongoing discussions on how to promote sound and sustainable lending practices, in particular in relation with the DSF.

50. **Particularly important, given the recent increase in the volume of new lending from non-OECD bilateral creditors, have been the discussions held with the major external financing institutions of these countries.** Delegations have held constructive dialogues with China and India in particular: mutual understanding has increased considerably. This dialogue will continue to be an important component of creditor outreach by the Bank and the Fund.[37] Among other areas of cooperation, an MOU was signed in May 2007 between the Chinese Exim Bank and the World Bank to "enhance their ongoing cooperation within their respective authority (including staff secondments, knowledge sharing and exchange on various aspects of development assistance, such as fiduciary and financial management, procurement, and environmental and social impact analyses)". The scope of the MOU is as follows: strengthened communication and knowledge exchange, participation in donor coordination mechanisms and frameworks, co-financing of projects, and staff exchange (see Box 3). A similar MOU is being discussed between the Bank and the China Development Bank.

Box 3: MOU on Cooperation between the Export-Import Bank of China and the World Bank

An MOU with the Export-Import Bank of China was signed with the World Bank on May 21, 2007. The MOU aims to improve the development impacts of the respective operations of both organizations through cooperation. The MOU specifies (i) the principles on which the parties will enhance their ongoing cooperation (including staff secondments, knowledge sharing and exchange on various aspects of development assistance such as fiduciary management, procurement and environmental and social impact analysis) and (ii) certain key terms and conditions to be utilized when co-financing.

Among the principles for financing sustainable development on which the cooperation will be based are:

- Promote sustainable economic and social development;
- Ensure that assistance contributes to measurable development results and impacts;
- Take measures (consistent with each party's respective guidelines, policies and procedures) to identify, minimize and mitigate adverse environmental and social consequences of development initiatives; and
- Collaborate on ensuring sustainable development financing through appropriate levels of concessionality.

The scope of the cooperation:

- Strengthen communication and knowledge exchange, including country analysis, financing plans and specific projects in partner countries.
- Facilitate participation in donor coordination mechanisms and frameworks.
- Identify possible projects suitable for cofinancing, and work together on these.
- Encourage exchange of experience and staff training.

[37] Discussions with non-OECD bilateral creditors on the DSF have also been held within the OECD ECG forum and in the Berne Union.

51. **The Bank will continue to explore increased opportunities for collaboration with creditors, including the OECD, emerging market bilateral creditors and commercial creditors.** The China Exim Bank MOU with the World Bank is a positive step in that direction. Further areas that are being discussed include the possibility of focusing on collaboration with emerging market creditors in individual African country cases. Discussions have also been held with representatives from investment banks to share information on the DSF, to understand how investment banks active in emerging markets assess risks in IDA countries, and to discuss ways to enhance the dialogue. The Bank will continue sharing data and technical workshops to familiarize creditors with the technical details of debt sustainability analyses. This will also afford opportunities to the Bank to learn more about the policies of other creditors, including their risk assessments and other factors that determine their lending decisions. The Bank and IMF will also continue to provide advice to OECD country ECAs in their goal of developing sustainable lending guidelines that could be tabled for approval at their fall ECG meeting.

Update on Borrower Country Cases and Debtor Reporting

52. **Implementation of the second prong of the NCBP has preceded as set out in the July 2006 NCBP paper.** However, it is too early to assess the effectiveness of the policy given the single case to date. While the first prong of the NCBP involved strengthened creditor collaboration, and strengthened debt reporting and debt management capacity, the second prong involves discouraging unwarranted non-concessional borrowing through disincentive mechanisms. After Board approval of the overall NCBP framework, staff circulated an internal guidance note that detailed the various aspects of the policy and the need for country teams to be involved in its implementation. An increased focus on adherence to OP14.10 was also complemented by increased consultations with other creditors, and improving access to creditor-based debt data to complement the DRS.

53. **The first case of non-concessional borrowing to be assessed under the new policy was that of Angola.** Angola contracted substantial amounts of non-concessional borrowing over the last few years. It is estimated that this amounted to $15.5 billion (about 35 percent of its 2006 GDP) since 2004. While most of this borrowing took place before the approval of the non-concessional borrowing policy, several large loans were contracted after the policy was in place, and formed the basis of IDA's assessment.

54. **In the case of Angola the implementation of the policy led to the decision to harden the terms of Angola's borrowing.** This decision was based on the country-specific and the loan specific factors described in the NCBP paper (reproduced in Annex 4). In certain circumstances some non-concessional borrowing may be warranted if the financing were to help build a key piece of infrastructure, particularly in a strong-performing country. The loan-specific assessment took into account the costs of the borrowing and the lack of information on the projects to be financed from the loans and their estimated returns. The country-specific assessment of the policy environment showed that Angola's weak policy and institutional frameworks do not provide a strong platform for such volumes of borrowing on commercial terms.

55. **The decision to switch to hard-term lending in Angola balances the tradeoffs between debt sustainability and progress towards the MDGs.** Providing IDA grants to a country which consistently borrows large volumes on non-concessional terms was felt to be a poor use of IDA concessionality. At the same time, cutting the volumes of IDA financing in this post-conflict country was felt to be counter-productive as this would further reduce IDA's already limited engagement needed for technical assistance and capacity building. In terms of the impact on debt sustainability, IDA lending on any terms only marginally affects the trajectory of the NPV of debt-to-GDP or the NPV of debt-to exports ratio, given the small share of IDA in overall financing flows.

56. **The Angola case illustrates some limitations of the NCBP, in particular when IDA financing is small relative to other sources and when information is inadequate.** Where IDA financing is dwarfed by other sources of financing, the possibility of a disincentive effect is small. The case also points out the difficulties with weak debt reporting. Although there may be informal sources of information or media reports on non-concessional borrowing, a decision by IDA requires additional time to receive confirmation of the size and nature of the borrowing from the borrower.

57. **The Angola case also points out the importance of looking beyond the grant allocation system and the NCBP in helping resource-rich countries achieve debt sustainability.** Here, attention to helping countries with debt management, medium term debt strategies, and resource management policies will be important complements to the policy. The Angola Interim Strategy Note (ISN) outlines the Bank's continued engagement with the government in policy dialogue and nonlending technical assistance in the petroleum sector. For many countries technical assistance from the Bank can help over the long term to build up their institutional and technical capacity to manage oil and mineral resources, and the related social and environmental impacts. Technical assistance can also help improve transparency, promote private sector investment and generally improve the contribution of the mineral sector to the country's economic development and poverty reduction. The multi-donor Extractive Industries Transparency Initiative trust fund administered by the Bank could be an additional source of grant financing to help countries improve the transparency of activities in this sector.

58. **Unless future cases also involve large and clearly disproportionate non-concessional borrowing, application of this prong of the non-concessional borrowing policy may be difficult.** In particular where borrowing is being contracted by low-risk countries with strong policies and institutions, and where a lack of concessional financing is leading to non-concessional borrowing, it will be difficult to determine the appropriate disincentive. In such cases a more in-depth assessment of the potential returns to the investment are needed, requiring more detailed information on the country's investment plans. At the same time, based on existing literature, empirical evidence on the link between debt-financed investments and growth is ambiguous.[38]

[38] See World Bank and IMF, "Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief", November 2006, Appendix 3.

59. **A number of small non-concessional loans have been identified by the DRS thus far for the period July to December 2007 for countries subject to the NCBP**. While a number of cases of non-concessional borrowing also came on the radar screen in FY06, these took place before the approval of the non-concessional borrowing policy. In FY07 non-concessional borrowing by Angola was confirmed from a number of emerging market creditors.[39] A number of commercial loans were also reported by another country, but it was determined that these formed part of an overall package that is concessional. Two other countries reported multilateral loans that did not meet the Bank's definition of concessionality, although the amounts are small.[40] Staff is following up with the authorities and the creditors concerned on the nature of these loans. Staff will also continue to follow-up with the relevant creditors during regular consultations.

60. **As a result of the NCBP and increased efforts to encourage adherence to OP14.10, most countries by the end of July had provided their annual reports to the DRS.** A special Bank working group has been leading the efforts to increase adherence to reporting requirements under OP14.10 and increase the quality of these reports.[41] Only 16 IDA-only countries had not yet provided their annual reports under OP14.10 by the end of July, 2007. This adherence level was about two months ahead of reporting performance from previous years. Countries that were not compliant with the annual reporting requirement were informed that they are required to submit their end-2006 annual report or provide an acceptable action plan for such reporting before any new IDA operation can be presented to the Board. Subsequently five additional countries submitted acceptable reports, including one country which reported for the first time in almost a decade. Reports with significant gaps or quality issues were received from another 3 countries, and staff is following up on these.

61. **However, more progress is needed on quarterly reporting to have timely information.** Very few countries have provided quarterly reporting for the first or second quarter of calendar year 2007, and more work needs to be done to improve adherence to quarterly reporting. Here the increased Bank emphasis on debt management should go a long way to improving capacity to report on a quarterly basis. As discussed earlier in the paper, parallel efforts are also underway for improved information flows from other creditors on the terms and volumes of new lending to low-income countries.

62. **The advanced reporting requirement introduced by the NCBP has led to discussions with some borrowing countries.** This requirement asked that countries report to the Bank their plans for non-concessional borrowing ahead of contracting the loans, giving the Bank a chance to present the country with alternative financing

---

[39] In Angola, debtor reporting was a key focus of the IDA NCBP response. A full debt report was submitted by Angola in August 2007, although a few remaining issues are being followed-up with the authorities.

[40] The definition of concessionality is set out in IDA (2006b), *Op.cit*. and an accompanying template published on the IDA website provides a tool to calculate the concessionality of any given loan.

[41] The first measures included increased scrutiny for countries ahead of Board presentation, and special reminder letters were sent out at the beginning of the year to all IDA-only countries. Where reports are incomplete or are internally inconsistent, a further dialogue with the country authorities takes place to correct the inconsistencies.

scenarios and implications of such borrowing. The supplemental letter on Financial and Economic Data that is included in the signing package for all IDA Credit and Grant Agreements was revised to include this new requirement for grant-eligible and post-MDRI countries. While no specific report was submitted as a result of the advance reporting requirement, several countries discussed their desire to increase access to financing with the Bank country team, and indicated that without additional concessional financing that they would consider commercial financing for important infrastructure investments. A dialogue with these countries has been taking place in the context of their Bank and IMF programs on the best means to finance the investments, including through broader assessments of fiscal space.

63. **In countries that have expressed interest in contracting new loans, the Bank can help by providing advice on debt management, help develop medium term debt strategies, and outline best borrowing practices.** Bank technical assistance can also provide guidance to ensure favorable loan terms and facilitate the best use of such finance in order to reduce the risks of costly financing for non-viable projects. For instance, the Bank can focus on ways to mobilize additional private capital to complement ongoing and planned public investments. It can also outline the menu of financing options from the Bank group, including guarantees from IDA and MIGA, investment financing (debt, equity and quasi-equity) from IFC, and IBRD enclave lending and enclave guarantees to provide additional support to a country's infrastructure development.

64. **In sum, the two main prongs of the NCBP are being implemented, with steady progress being made in creditor coordination around the DSF, and with borrower disincentives applied to one case.** IDA and IMF outreach to other creditors has led to the adoption of similar grant allocation systems by MDBs. An ongoing dialogue on the importance of taking debt sustainability into consideration in lending decisions has taken place with OECD Export Credit Agencies and emerging market bilateral creditors. With 6 months of information since the approval of the NCBP, only one case of borrower disincentives has been discussed by the Board thus far – Angola – whose financing terms have been hardened. Very recently two new cases of non-concessional borrowing have been confirmed and brought to the attention of staff, including a Eurobond issue of US$750 million by Ghana. In addition, media has been reporting on large scale borrowing in another grant-eligible country that has yet to be confirmed. Staff is in the process of verifying information regarding these cases, and as new cases are brought forward, the process outlined in Box 2 will be followed.

V. Capacity Building in LICs to Manage New Borrowing

65. **Despite the efforts of various technical assistance providers on public debt management, much remains to be done.** The recent Bank-Fund paper on strengthening debt management practices points out that in LICs "challenges tend to be more acute –

capacity, institutional arrangements, governance, all need considerable strengthening."[42] That paper points out that a number of international providers of technical assistance provide debt management related capacity building. However, each specializes in a particular area, such as providing debt management software, or improving analytical capability, or training staff in debt management units. There remains a need for a systematic approach to deal with the entire debt management process, including case-by-case assessment of gaps and weaknesses.

66. **Efforts towards capacity building for improving debt sustainability in LICs have been ramped up along three dimensions:**

- **First, debt sustainability analysis training workshops have been delivered** to groups of countries covering most IDA-only borrowers. Recent DSF workshops have been given in Mexico City, Accra, Dakar, Maputo, and Windhoek, reaching about 40 LICs.

- **Second, a Debt Management Performance Assessment Tool (DeMPA) was launched in 2006 and has been piloted in five LICs (Malawi, Gambia, Guyana, Nicaragua, and Albania).** The tool assesses 'sound practice' for effective and efficient debt management based on what has worked well in different country situations. This comprehensive and standardized tool has been developed jointly by PREM and the Bank's Treasury, incorporating broad consultation with the IMF and all existing service providers in this area. The tool builds on PEFA indicators for public financial management, and covers core central government debt management functions relating to: governance and strategy development, coordination with macroeconomic policies, borrowing and related financing activities, cash flow forecasting and cash balance management, operational risk management, and debt records and reporting. The measurement of 14 performance indicators allows the Debt Management Performance Assessment tool to pinpoint areas in need of priority attention. DeMPA will enable a common assessment among donors, and provides a methodology to monitor debt management performance over time.

- **Third, work has begun towards strengthening joint technical assistance by the Bank and the IMF in low-income countries.** In the coming year, medium-term debt management strategies will be developed with Bank-Fund technical assistance in an initial group of LICs, based on analytical tools and methodological approaches currently under development. These strategies should help countries towards better decision making over debt composition, as well as the level of borrowing.

67. **The Bank is working to develop and apply these tools more broadly across LICs.** The Bank plans to apply DeMPA in 60 Low-Income Countries over the next three

---

[42] See World Bank, "Strengthening Debt Management Practices – Lessons from Country Experiences and issues Going Forward", April, 2007.

years. DeMPA will be disseminated externally for further comment and refined to provide web-based materials that will be the basis for staff and client training programs. The debt management toolkit will initially be applied in 4-6 countries in 2008 before rolling out more broadly as part of country assistance strategies.

68. **This joint work of IDA and the IMF will complement ongoing outreach to creditors and help reinforce sustainable lending practices.** Ultimately the most effective means of attaining debt sustainability in LICs is strengthened debt management capacity: the ability to analyze debt strategy, fiscal policy, and broader economic policy in light of their long-term effects on debt sustainability and vulnerability to economic shocks, and to manage the existing and new debt stock to control debt service and reduce fiscal and foreign exchange risks coming from the public debt portfolio. Building this capacity will be a long-run endeavor, one that is part of the core mandate of IDA but that can only be delivered in partnership with other institutions.

VI. Conclusions and Issues for Discussion

69. **Debt relief and increased concessionality of assistance need to be combined with policies that support private sector-led growth in order to generate sustainable trajectories for debt-burden indicators over time.** IDA's policy advice and financial assistance helps countries improve their macroeconomic performance and strengthen the micro-macro linkages in the development process. IDA's support for investment climate reforms and infrastructure investments all have direct implications for debt sustainability, since strong growth of GDP, revenues and exports help lower debt ratios. While maintaining debt sustainability is ultimately the responsibility of debtor countries and all creditors collectively, IDA plays a key role in helping ensure debt sustainability through initiatives that alleviate countries' debt burden as well as through its support to growth-promoting policies.

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

- Do Deputies agree that the DSF risk ratings based on forward-looking DSAs provide an effective basis for the IDA grant allocation system?
- Do Deputies agree that the IDA14 grant allocation system is functioning reasonably well and that this system should continue to be used as the basis for determining the mix of credits and grants in IDA15?
- Do Deputies agree that Timor-Leste should continue to have access to the grant equivalent of its PBA allocation (i.e. 60 percent), given its continued post-conflict status, and constraints on its ability to contract external debt?
- Do Deputies agree that based on its status as part of Serbia under United Nations Administration, Kosovo's eligibility for grants would continue in IDA15 as long as its status remains the same?

Annex 1. Traffic lights for FY08 IDA allocations: IDA-only countries

(based on joint Bank-Fund LIC DSAs available as of end-June, 2007)

Country	FY08 traffic light		Debt stock indicators (2005, percent) 4/		
			NPV of debt-to-GDP	NPV of debt-to-exports	
Strong performance (CPIA>=3.75) 3/			***50***	***200***	
Bhutan	Red	1/	79	357	
Burkina Faso	Yellow				
Cape Verde	Green				
Ghana	Green				
Maldives	Green	1/	33	43	
Nicaragua	Yellow				
Samoa	Green				
Tanzania	Green				
Uganda	Green				
Vietnam	Green				
Medium performance (3.75<CPIA<3.25) 3/			***40***	***150***	
Bangladesh	Green				
Benin	Yellow				
Cameroon	Green				
Ethiopia	Yellow				
Guyana	Yellow				
Kenya	Green				
Kyrgyz Republic	Red				
Lesotho	Yellow				
Madagascar	Green				
Malawi	Yellow				
Mali	Green				
Mongolia	Yellow				
Mozambique	Green				
Nepal	Red				
Niger	Yellow				
Rwanda	Red				
Senegal	Green				
Yemen, Republic of	Yellow				
Zambia	Green				
Weak performance (CPIA<=3.25) 3/			***30***	***100***	
Afghanistan	Red				
Burundi	Red				
Cambodia	Yellow				
Central African Republic	Red				
Chad	Red				
Comoros	Red				
Congo, Democratic Republic of	Red	1/	107	389	
Congo, Republic of	Red				
Cote d'Ivoire	Red	1/	61	137	
Djibouti	Red				
Eritrea	Red	1/ 8/	42	675	
Gambia, The	Red				
Guinea	Red				
Guinea-Bissau	Red				
Haiti	Red				
Kiribati	Green	6/			
Lao People's Democratic Republic	Red				
Liberia	Red				
Mauritania	Yellow				
Moldova	Green				
Myanmar	Red	1/ 2/	N/A	128	
Sao Tome and Principe	Red	7/			
Sierra Leone	Yellow				
Solomon Islands	Red				
Somalia	Red	1/2/	N/A	1091	5/
Sudan	Red	1/	65	473	
Tajikistan	Red				
Togo	Red				
Tonga	Red				
Vanuatu	Green	1/	15	35	

1/ Due to the unavailability of a joint Bank-Fund DSA at the time of the FY08 allocation exercise, the traffic light is based on the historic debt stock indicators (the first pillar of the DSF) and performance category is based on 2004-6 CPIA average.
2/ 2006 CPIA ratings are unavailable and a weak performer is assumed.
3/ Based on performance category used in DSAs, unless otherwise specified.
4/ The debt service-to-exports indicator is not presented as the two debt stock indicators already exhibit a red light for the countries. NPV of debt refers to public and publicly guaranteed external debt plus IMF credits in consistency with the DSF. Exports refer to 2003-5 year average. The source of NPV of debt data is the World Bank Global Development Finance 2007; that of GDP is the World Development Indicators 2007; and exports the World Economic Outlook 2007.
5/ The ratio is as of end July 2006 ("HIPC - issues related to the sunset clause", August 2006).
6/ Neither DSA nor debt data available. "Green" light is assumed.
7/ Based on an expected new DSA rating of high debt distress risk (to be conducted in September).
8/ An unpublished DSA for Eritrea also confirms the red light rating.
N/A not available.

Annex 2: Movements in Traffic Lights in IDA14

Country	Change in Traffic light				Explanatory remark		
	IDA14 negotiations	FY06	FY07	FY08	Change in FY06	Change in FY07	Change in FY08
Angola	Red	Red	Yellow	**Not applicable**		DSA indicates a moderate risk of debt distress on account of its narrow export base and vulnerability to new external financing.	Ineligible for grants in FY08 due to the application of IDA's Non-Concessional Borrowing Policy and as a result of its reclassification as a "gap" country.
Armenia	Green	Green	Not applicable	Not applicable		Classified as a "gap" country in FY07.	
Benin	Green	Yellow	Green	**Yellow**	Higher debt-to-exports indicator	Lower debt stock indicators; available DSA incorporating the impact of MDRI.	Unlike the previous DSA, the latest DSA explicitly assesses the country at a moderate risk of debt distress - the possibility of slower-than-projected growth, volatile export prices and output, and new non-concessional borrowing could lead to a breach of thresholds, placing the country at a moderate risk of debt distress.
Burkina Faso	Yellow	Green	Green	**Yellow**	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from medium to strong).		The latest DSA conducted a country-specific scenario (that retains the fiscal stance of 2006 PRGF) as a robustness check and confirms a moderate risk of debt distress.
Cameroon	Red	Red	Green	Green		Reaching HIPC completion point; an available DSA incorporating the impact of MDRI.	
Djibouti	Not applicable	Not applicable	Red	Red		Revised GNI estimates allowed country to remain "IDA-only".	
Ethiopia	Red	Yellow	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	**Not applicable**	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.	Classified as a "gap" country in FY08.
Guyana	Red	Red	Yellow	Yellow		Decrease of the debt-to-GDP ratio; available DSA incorporating the impact of MDRI.	
Kenya	Yellow	Green	Green	Geen	Lower debt-to-exports ratio.		
Lesotho	Red	Yellow	Yellow	Yellow	Lower debt stock indicators.		
Malawi	Red	Red	Yellow	Yellow		Available DSA suggests a moderate risk after HIPC completion point and MDRI, due to its narrow export base (high concentration on tobacco).	

Annex 2: Movements in Traffic Lights in IDA14

Country	Change in Traffic light				Explanatory remark		
	IDA14 negotiations	FY06	FY07	FY08	Change in FY06	Change in FY07	Change in FY08
Mali	Red	Green	Green	Geen	Lower debt stock indicators.		
Mauritania	Red	Green	Green	**Yellow**	Its available DSA indicates a low risk of debt distress on account of oil production.		The latest DSA updates its debt distress risk to "moderate", owing partly to hold-out problems in the HIPC process.
Moldova	Red	Yellow	Green	Green	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from poor to medium)	Lower debt-to-GDP ratio;	
Mongolia	red	Red	Yellow	Yellow		Available DSA suggests a moderate risk, reflecting higher revenues from mineral resources.	
Myanmar	Not available	Not available	Red	Red		Data approximation indicates a red light.	
Nepal	Green	Yellow	Red	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	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	**Yellow**	Lower debt stock indicators.	Even after MDRI, debt dynamics do not improve significantly in the long run; thresholds are breached under stress tests.	Incorporating the actual MDRI debt relief in the latest DSA contributes to improve Niger's debt outlook over the short term - a moderate risk of debt distress.
Samoa	Red	Green	Yellow	**Green**	Lower debt stock indicators.	DSA indicates the country's vulnerability to shocks.	A new preliminary DSA indicates a "low" risk of debt distress.
Senegal	Yellow	Green	Green	Green	An upward change in debt thresholds, triggered by its 2003 CPIA rating improvement (from medium to strong)		
Sierra Leone	Red	Red	Red	**Yellow**			A "moderate" risk rating in its DSA is attributable to debt relief under both the enhanced HIPC initiative and the MDRI recently obtained by their reaching the HIPC completion point.
Somalia	Not available	Not available	Red	Red		Based on estimated current debt situation in the country.	

Annex 2: Movements in Traffic Lights in IDA14

Country	Change in Traffic light				Explanatory remark		
	IDA14 negotiations	FY06	FY07	FY08	Change in FY06	Change in FY07	Change in FY08
Sri Lanka	Green	Yellow	Not applicable	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	**Red**		DSA indicates lower debt stock because of debt swap and cancellation arrangements. Furthermore IMF debt relief under the MDRI.	Its latest DSA assesses the country at a high risk due to a large-size concessional loan contract for infrastructure and energy sector projects and to an intention to contract an additional loan for building a hydro power station.
Uganda	Yellow	Yellow	Green	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 .	
Yemen	Green	Green	Green	**Yellow**			Its "yellow" light originates in a moderate risk rating in its most recent DSA, owing to lower than anticipated future oil exports.
Zambia	Red	Yellow	Green	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.	

Annex 3: Grant Eligible and Post-MDRI countries to which the Non-Concessional Borrowing Policy applies [1/2/]

MDRI recipient and green light (9)	Yellow light (13)	Red light (28)	
Cameroon	Benin	Afghanistan	Bhutan
Ghana	Burkina Faso	Burundi	Central African Republic
Madagascar	Cambodia	Chad	Comoros
Mali	Ethiopia	Congo, Democratic Republic of	Congo, Republic of
Mozambique	Guyana	Cote d'Ivoire	Djibouti
Senegal	Lesotho	Eritrea	Gambia, The
Tanzania	Malawi	Guinea	Guinea-Bissau
Uganda	Mauritania	Haiti	Kyrgyz Republic
Zambia	Mongolia	Lao People's Democratic Republic	Liberia
	Nicaragua	Myanmar 3/	Nepal
	Niger	Rwanda	Sao Tome and Principe
	Sierra Leone	Solomon Islands	Somalia 3/
	Yemen, Republic of	Sudan 3/	Tajikistan
		Togo 3/	Tonga

1/ This list is updated annually and subject to change should other IDA-only countries qualify for IDA grants and/or MDRI. It includes all IDA-only countries which are currently eligible for IDA grants on debt-sustainability grounds, as well as post-MDRI green light countries. It excludes "gap" or "blend" countries which receive hardened or blend terms from IDA and are not eligible for IDA grants. Should a country's IDA-only status change mid-year, the list would be updated at that time to reflect the change.

2/ In addition to these 50 countries, Timor-Leste is also subject to the policy given its eligibility for exceptional grants.

3/ Inactive countries, which would be subject to the NCBP upon becoming active.

Annex 4

Principles that would guide exceptions to non-concessional borrowing ceilings[43]

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

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

Country-specific:

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

Loan-specific:

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

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

[43] Based on IDA (2006b), O*p. cit*. Box 3.