

DEBT SUSTAINABILITY IN LOW INCOME COUNTRIES—RECENT EXPERIENCE AND CHALLENGES AHEAD¹

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¹ This paper has been prepared by Christian Beddies and Marie-Helene Le Manchec (SPR, IMF) and Doerte Doemeland and Henry Mooney (PRMED, World Bank) as background paper for the conference “Debt Relief and Beyond: A World Bank Conference on Debt and Development.” The authors are indebted to Shannon Mockler (SPR, IMF) for excellent research assistance.

EXECUTIVE SUMMARY

Low-income countries (LICs) continue to face significant challenges in meeting their vast development needs while maintaining a sustainable debt position. These challenges, which include limited capacity to generate revenue and foreign exchange, are further exacerbated by changes in the financial landscape, including the emergence of new creditors and more complex financial instruments.

The IMF and the World Bank have intensified their efforts to help LICs avoid a new round of debt distress, while achieving their development agenda. The Debt Sustainability Framework (DSF) for LICs was put in place in 2005 to guide the borrowing decisions of LICs in a way that matches their financing needs with their current and prospective repayment ability, and provide guidance for creditors' lending and grant-allocation decisions to ensure that resources are provided on terms that are consistent with long-term debt sustainability.

The DSF has improved access, timeliness, comparability, and quality of information on the debt situation of LICs and in turn, has increased borrowers' and lenders' capacity to make informed decisions. The IMF and World Bank have been engaged in outreach activities with both borrowers and lenders to disseminate the LIC DSF. But strong collaboration among all stakeholders is required to support LICs in attaining their development objectives while also achieving or maintaining debt sustainability

A review of debt sustainability analyses (DSAs) over the past three years shows that:

- ***Post-completion-point Heavily Indebted Poor Countries (HIPCs) are now in a better debt situation than other LICs.*** This reflects the direct effect of debt relief, but also that post-completion-point countries have on average a stronger quality of policies and institutions than pre-completion point HIPCs and to some extent non-HIPC LICs. Nonetheless, less than half of the post-completion point HIPCs have a low risk of debt distress rating, highlighting that they remain fragile to an array of shocks.
- ***Non-HIPC LICs display somewhat greater vulnerabilities than post-completion-point countries.*** Average debt ratios are significantly higher and the distribution of debt distress ratings is skewed towards the high risk of debt distress category. However, these economies appear, on average, more resilient to shocks—reflecting stronger macroeconomic performance in the past—compared to post-completion HIPCs.

Still, debt sustainability analyses continue to face challenges, and further work may be needed to address them:

- ***The accuracy of underlying assumptions:*** Assumptions are critical as they influence the outcome of the debt ratio trajectories and ultimately the debt distress rating. However, macroeconomic projections are difficult to make, in particular those related to the investment-growth nexus.
- ***The evolving financial landscape:*** Domestic debt accumulation is not currently reflected in the debt distress rating and increasing private capital flows may create new vulnerabilities that are not fully captured in DSAs.

- ***Limited domestic capacity:*** The effectiveness of the DSF hinges on the ability of borrowing countries to use it to guide their borrowing decisions.

I. INTRODUCTION

1. **Low-income countries (LICs) continue to face significant challenges in meeting their vast development needs while maintaining a sustainable debt position.** LICs have a number of macroeconomic and financial features that can complicate their capacity to generate sufficient revenues to repay the debt incurred and expose them to greater solvency and liquidity risks. These features include narrower production bases and export structures, shallower financial markets, less efficient tax systems, higher dependence on aid, and a weaker quality of policies and institutions.

2. **While debt relief through the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI) have charted a course toward restoring debt sustainability, these initiatives cannot preclude the rapid buildup of new debt and a new round of debt difficulties.** The combination of low debt and new financing opportunities will allow LICs to make important strides toward achieving their economic goals, but could also pose risks for new debt distress if not managed carefully. Thus, the implementation of adequate policies and reforms geared toward entrenching macroeconomic stability and strengthening the resilience of the economy are critical in safeguarding debt sustainability.

3. **Against this backdrop, the IMF and the World Bank have been intensifying their efforts to help LICs avoid new rounds of debt distress, while meeting their development agenda.** An analytical framework, the Debt Sustainability Framework (DSF) for LICs, was introduced in 2005 to help monitor and analyze the sustainability of external and public debt in LICs. The objective of the framework is to guide lending for creditors and borrowing decisions for policy makers based on regularly updated debt sustainability analyses (DSAs). Major multilateral institutions, such as IDA and the African Development Bank, use the risk of external debt distress classification of the DSA as the main criteria for deciding on the grant-loan mix LICs receive.

4. **Still, challenges remain.** Long-term debt sustainability requires adequate policies from borrowers and lenders. Sustained efforts from the international community are critical to support LICs in achieving and maintaining debt sustainability. An analysis of DSAs over the past three years shows that achieving and maintaining debt sustainability hinges on export diversification, the provision of new financing primarily on concessional terms and for many LICs a strengthening of the quality of their policies and institutions.

5. **The paper is organized as follows:** Section II summarizes the main features of the DSF. Section III takes stock of the current debt sustainability situation in LICs, draws patterns, and highlights existing vulnerabilities. Section IV discusses the challenges surrounding the conduct of DSAs, highlighting areas where further work may be needed. Section V provides some concluding remarks.

II. THE DEBT SUSTAINABILITY FRAMEWORK²

A. What is the DSF?

6. **While maintaining debt sustainability should be a central objective for all countries, LICs have particular characteristics that make it a challenge.** LICs face large financing needs to meet their development objectives. They depend more on aid flows, which tend to be difficult to predict. Their production and export structures are often concentrated on few raw commodities with prices being determined in world markets. LICs are also more prone to weather vagaries, which often engender large unexpected reconstruction costs. Their policies and institutions are weaker, including in the area of project and debt management, complicating the implementation of sustainable macroeconomic policies, impairing investor confidence, and increasing chances that scarce public resources are diverted toward unproductive uses. These features contribute to their high sensitivity to external and domestic shocks, as well as lower-than-expected returns on public investments.

7. **To assist LICs in maintaining debt sustainability, the Bank and the Fund introduced the LIC DSF in 2005.** The framework is built on the DSA framework for middle-income countries (MICs), introduced by the IMF in 2002, and takes into account the specific characteristics of LICs. It should be seen as a tool to help policymakers strike a balance between achieving development objectives while maintaining macroeconomic stability. It is also a device that can guide lenders in aligning their aid policy and preventing the reemergence of debt distress. The design and objectives of the DSF differ in several important ways from those of the DSAs that are carried out under the HIPC Initiative and the two exercises should not be mistaken.³

8. **The DSF has become a critical instrument to analyze a country's capacity to finance its policy objectives and service the ensuing debt without unduly large adjustments.** The main objectives of the DSF are to:

- Guide the borrowing decisions of LICs in a way that matches their financing needs with their current and prospective repayment ability, taking into account each country's circumstances;
- Provide guidance for creditors' lending and grant-allocation decisions to ensure that resources are provided to LICs on terms that are consistent with both progress towards their development goals and long-term debt sustainability;
- Improve World Bank and IMF assessments and policy advice in these areas; and

² This chapter draws on Barkbu, Beddies, and Le Manchec (2008).

³ DSAs for HIPCs, called debt relief analyses (DRA), were first requested by the Executive Boards of the World Bank and the IMF in spring 1995, in the context of discussions on means to alleviate high debt burdens. When the HIPC Initiative was adopted in 1996, the HIPC DRA became the key tool for determining a country's eligibility for, and the amount of, assistance under the Initiative, based on current levels of debt. LIC DSAs under the DSF are forward-looking with a view to assessing the risks associated with future debt accumulation.

- Help detect potential debt crises early so that preventive action can be taken.

9. **Under the DSF, DSAs consist of:**

- An analysis of a country's projected external and public sector debt burden and its vulnerability to external and policy shocks—baseline and shock scenarios are calculated. DSAs focus on the present value of debt obligations, and trajectories of debt ratios are analyzed over 20 years given that loans to LICs are primarily concessional and therefore carry long maturities;
- An assessment of the risk of debt distress based on indicative external debt burden thresholds that depend on the quality of the country's policies and institutions; and
- Recommendations for a borrowing (and lending) strategy that limits the risk of debt distress.

10. **The external debt distress risk is assessed by comparing external debt burden indicators against policy-dependent debt-burden thresholds (Table 1).** The thresholds reflect the empirical finding that the debt levels that LICs can sustain are influenced by the quality of their policies and institutions. In other words, LICs with weaker policies and institutions tend to face repayment problems at lower levels of debt. However, the indicative thresholds are not to be seen as rigid ceilings. Rather, they constitute guideposts for informing the assessment of debt sustainability and of the risk of debt distress. There may be cases where a mechanistic approach would imply an unreasonable rating. There are four possible ratings of external debt distress:

- **Low risk**, when all the debt burden indicators are well below the thresholds;
- **Moderate risk**, when debt burden indicators are below the thresholds in the baseline scenario, but stress tests indicate that the thresholds are breached if there are external shocks or abrupt changes in macroeconomic policies;
- **High risk**, when one or more debt burden indicators breach the thresholds under the baseline scenario; or
- **In debt distress**, when the country is already having repayment difficulties.

Table 1. Debt Burden Thresholds under the DSF
(Applying to external public debt)

	PV of debt in percent of			Debt service in percent of	
	Exports	GDP	Revenue	Exports	Revenue
Weak Policy	100	30	200	15	25
Medium Policy	150	40	250	20	30
Strong Policy	200	50	300	25	35

11. **The quality of policies and institutions is measured by the Country Policy and Institutional Assessment (CPIA) index, compiled annually by the World Bank.** The DSF divides countries into three performance categories: strong, medium, and poor. To reduce undesirable uncertainty regarding the country's financing terms from IDA (and possibly other donors) from annual fluctuations in the CPIA, the three-year moving average CPIA score is used to determine a country's policy performance under the DSF.

12. **The DSF takes into account the risks posed by the accumulation of domestic debt but acknowledges the different nature of these risks.**⁴ Public DSAs are now a key part of the DSF. However, their interpretation poses challenges because there are no accepted thresholds for the risk of total public debt distress. Moreover, external and domestic debt are qualitatively different concepts, making it difficult to simply add them under the DSF. The risks of default on external and domestic debt are different since governments often resort to seignorage or financial repression, rather than default, in response to pressures from domestic debt. The use of domestic debt is not limited to budget financing, but also serves other policy objectives, such as the conduct of monetary policy. The financial terms of domestic debt, including its maturity profile, are significantly different from those of external debt, leading to a set of risks that are different.

B. How can it be used?

13. **The effectiveness of the DSF depends on its broad use by borrowers, donors, and lenders.** The DSF helps inform borrowers about the amount and terms of financing that are consistent with long-term debt sustainability and progress toward achieving their development objectives. It also provides guidance to donors and lenders on lending and grant-allocation decisions that are consistent with these goals. The DSF can thus help

⁴ See IMF and IDA (2006), Appendix 1, and Kraay and Nehru (2006).

minimize the risk of debt crises and promote the use of scarce concessional resources by the countries that need them most. Its effectiveness in achieving these objectives increases with the number of borrowers, donors, and lenders using it.

14. **The DSF has improved access, timeliness, comparability and quality of information on the debt situation of LICs.** This has improved borrowers', donors', and lenders' capacity to make informed decisions. Country-specific information on debt sustainability is easily accessible. The IMF and the World Bank have established dedicated pages on their external website in order to give the general public easy access to information on their work on debt-related issues in LICs.⁵ Effective information-sharing, nevertheless, hinges on further efforts from borrowers, donors, and lenders. Debtor-reported information, which is the main source of data for DSAs, still suffers from weaknesses in many LICs, such as lack of reliability, comprehensiveness, and timeliness.

Borrowers

15. **The DSF can help borrowers identify debt-related vulnerabilities so that they adequately take these into account when formulating their policies.** It is a tool for assessing the risks associated with a country's current debt situation and evaluating the potential implications for medium- and long-term sustainability of different policy choices, such as front-loading or back-loading some key public investment projects or spending of scaled-up aid.⁶ It can also help identify policies that are consistent with maintaining or achieving debt sustainability, such as determining the appropriate terms for new financing.⁷ In particular, the DSF can help determine an appropriate pace of debt re-accumulation for countries that have received debt relief and are faced with increased borrowing space. Lastly, it can be used as a device by governments in their communication with donors, lenders, and other stakeholders, including when discussing their poverty reduction strategies.

16. **The DSF provides a platform for developing a medium-term debt management strategy (MTDS).** The MTDS should seek to address the vulnerabilities uncovered in the DSA. It should help operationalize a country's debt management objectives by outlining cost-risk trade-offs in meeting the government's financing needs and payment obligations.

Lenders

17. **The lack of comprehensive information from LICs and their pervasive institutional weaknesses require a more proactive approach by lenders.** Unlike MICs,

⁵ See <http://www.imf.org/concessional> and <http://www.worldbank.org/debt>.

⁶ See Barkbu, Beddies, and Le Manchec (2008), for an example of alternative scaling-up scenarios.

⁷ Many outlays related to achieving development objectives do not, by nature, generate sufficient cash flow to the government in the near term to service nonconcessional debt.

the quality of LICs' data is poor, and their overall domestic capacity is limited. Thus, the implementation of sustainable lending practices is critical to safeguard their debt sustainability. In practice, such lending should follow a number of broad principles: it should foster development, preserve debt sustainability, and support good governance and transparency. Although debt relief has significantly reduced debt ratios in many LICs, maintaining debt sustainability may prove challenging in a volatile macroeconomic and weak policy environment.

18. Increased creditor coordination can facilitate sustainable lending practices.

Coordination gives confidence to each creditor that other creditors will not provide financing on terms that jeopardize debt sustainability and hence undercut their own efforts to prevent payment difficulties. Although the DSF can help promote these good practices, donors and lenders face operational difficulties in implementing information sharing and coordination in practice, and must also take into consideration other constraints when making financing decisions.

19. The DSF is used by an increasing number of creditors. Multilateral creditors represent a large share of external financing to LIC governments. IDA started to use DSAs' risk of debt distress rating as a criterion for grant eligibility in mid-2005. Regional development banks, such as the Asian Development Bank, the African Development Bank, the Inter-American Development Bank, and the International Fund for Agricultural Development, have adopted similar systems for grant and lending decisions. Bilateral official creditors also use the DSF as an input for financing decisions, but coordination among these creditors faces challenges. Bilateral official creditors include a diverse group of creditors with respect to traditions for coordination, policy objectives, and investment strategies. Some initiatives for coordination have already succeeded. In January 2008, OECD member countries adopted a set of principles and guidelines that adhere to IDA and IMF concessionality requirements and refer explicitly to the DSF.⁸ These principles have been officially endorsed by European Union countries and are designed to ensure that loans supported by their export credit agencies are in line with sustainable development objectives.⁹

20. To reinforce the effectiveness of the DSF, the Bank and the Fund have increased their outreach efforts on the DSF with nearly all major multilateral and bilateral creditors to LICs. Outreach opportunities to commercial creditors have been pursued as well. In addition, mailboxes to answer specific questions on DSF issues have been created.¹⁰ As pointed out above, an increasing number of creditors are referring to the DSF to make

⁸ See OECD Working Party on Export Credits and Guarantees (2008).

⁹ [http://www.oecd.org/olis/2008doc.nsf/LinkTo/NT00000962/\\$FILE/JT03238627.PDF](http://www.oecd.org/olis/2008doc.nsf/LinkTo/NT00000962/$FILE/JT03238627.PDF)

¹⁰ LendingToLICS@worldbank.org and LendingToLICS@imf.org.

their financing decisions. But broader coordination and information sharing will require additional outreach efforts from interested parties, including the IMF and the World Bank.

III. THE CURRENT DEBT SUSTAINABILITY OUTLOOK IN LICs

21. **DSAs performed under the DSF provide a comprehensive view of the debt outlook of LICs.** Since the implementation of the DSF in 2005, 181 DSAs have been completed covering 70 LICs (90 percent of PRGF-eligible countries).¹¹ Using data from those DSAs, this section looks at how debt relief has affected the prospects in LICs and highlights key debt-related vulnerabilities in both HIPC and non-HIPC LICs.

A. Debt Sustainability in Post-MDRI Countries¹²

22. **DSAs confirm that post-completion-point countries (unsurprisingly) are in a better debt situation than the other HIPCs.** At end-2007, the PV of the debt-to-export ratio for post-completion-point HIPCs averaged 61 percent. This contrasts with an average of 234 percent for pre-completion-point HIPCs.¹³ The average in post-completion-point countries masks, however, large discrepancies, with Zambia's PV of debt-to exports ratio at 14 percent and Mauritania's at 138 percent. The PV of external debt-to-export ratio is below its relevant threshold at end-2007 in all but two countries.

23. **The risks of debt distress are also lower for post-completion-point countries than for the other HIPCs.** Under recent DSAs, most post-completion-point countries have received a low or moderate risk rating (Figure 1). The better rating distribution reflects both lower debt ratios—a direct outcome of debt relief—and the fact that post-completion-point countries tend to have, on average, better policies and institutions than other HIPCs (Figure 2).¹⁴ Export growth was, on average, stronger in pre-completion point countries (12 percent vs. 10 percent), but this reflects the impact of oil-exporting countries (Table 2). Excluding oil exporters, the average export growth rate was stronger in post-completion point countries (by about 2½ percentage points).

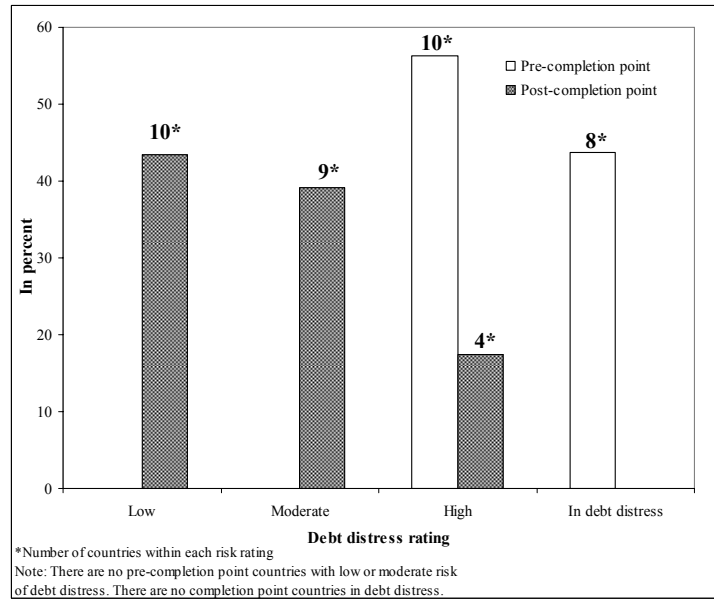
¹¹ For some PRGF-eligible countries with market access, e.g. India and Pakistan, MIC DSAs are conducted.

¹² This section draws on (reference to external version of the latest HIPC progress report)

¹³ For HIPCs in the interim period, debt ratios incorporate only the impact of interim debt relief.

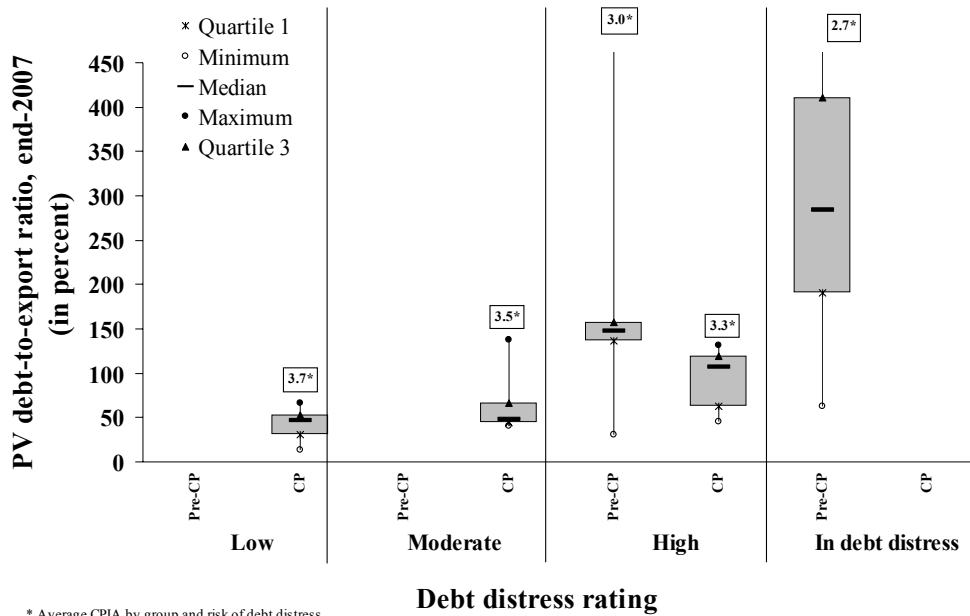
¹⁴ Better policies and institutions lead to a higher capacity to carry debt and translate, under the DSF, into higher indicative thresholds.

Figure 1: Risk of Debt Distress in HIPCs



Sources: Latest joint Bank/Fund DSAs available for LICs.

Figure 2. Distribution of the PV of Debt-to-Exports Ratio in HIPCs 1/



Note: There are no pre-completion point countries with low or moderate risk of debt distress. There are no completion point countries in debt distress.

Sources: Latest joint Bank/Fund DSAs available for LICs.

1/ Based on the 2007 PV of debt-to-exports ratio under the baseline scenario.

Table 2. Macroeconomic Performance in HIPCs
(In percent; 1998-2007)

	Real GDP growth		Export growth		Net FDI (in percent of GDP)	
	average	<i>stdev</i>	average	<i>stdev</i>	average	<i>stdev</i>
Pre-completion Point	3.7	4.1	12.1	24.2	4.2	3.6
Excluding hydrocarbon rich or potentially hydrocarbon-rich 1/	3.0	3.8	7.8	17.7	2.7	2.7
Debt distress rating						
High	4.1	3.8	11.4	25.2	4.1	3.3
In debt distress	3.1	4.5	12.9	23.0	4.3	4.0
Completion Point	5.2	3.6	10.2	16.1	3.9	2.8
Excluding hydrocarbon rich or potentially hydrocarbon-rich 2/	5.2	3.7	10.2	14.5	3.6	2.1
Debt distress rating						
Low and moderate	4.9	3.6	11.0	15.9	3.6	2.1
High	6.4	3.7	6.4	17.1	5.5	6.4

Sources: Latest joint Bank/Fund DSAs available for LICs; and Guide to resource Revenue Transparency.

1/ Excluding Chad, Congo, Rep., and Sudan.

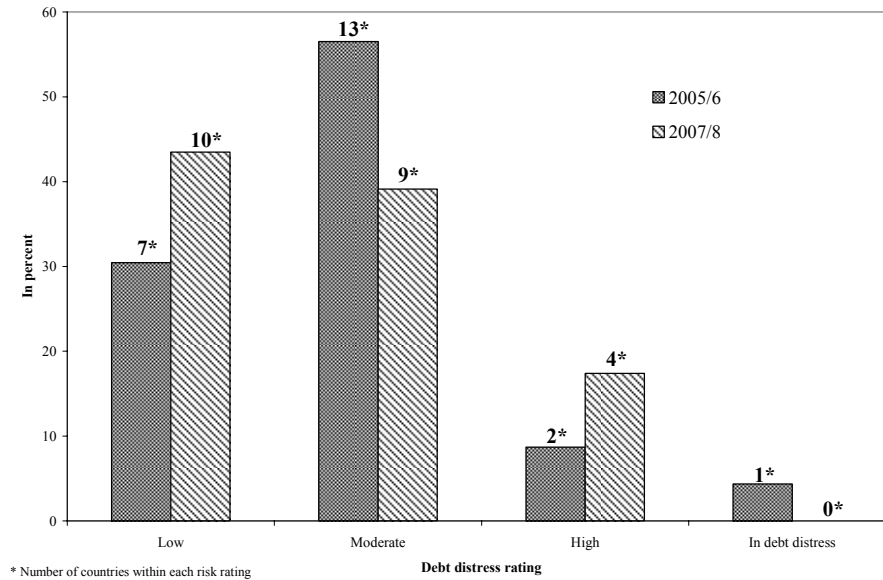
2/ Excluding Bolivia, Cameroon, Mauritania, and São Tomé and Príncipe.

24. **Long-term debt sustainability remains, however, a challenge.** Despite the significant decline of debt burdens thanks to debt relief, less than half of the post-completion-point HIPCs have a low risk of debt distress according to the most recent DSAs. Furthermore, there is evidence of deterioration in the distribution of ratings with the number of countries with a high risk rating increasing from two to four between 2007 and 2008 (Figure 3). In addition to Rwanda, for which the latest DSA confirmed the previously given high risk rating and The Gambia, which was assessed high risk in December 2007 despite its access to full debt relief at the completion point. Burkina Faso and São Tome and Príncipe have recently joined the group of high debt distress countries.

25. **The four countries rated as high risk share a number of vulnerabilities.** A close look at the individual DSAs shows that the high risk ratings are generally associated with a limited capacity to carry debt. This reflects (i) a higher concentration of key raw commodities in total exports compared to other post-completion-point countries and a lower export base for São Tomé and Príncipe and Rwanda, rendering them highly susceptible and sensitive to shocks (e.g., droughts and price volatility); and (ii) a poorer, or deteriorating, quality of policies and institutions as measured by the CPIA index.¹⁵

¹⁵ For more detailed information, see IMF and IDA (2008), Box 4.

Figure 3. Risk of Debt Distress Ratings of Post-Completion-Point Countries (2007-2008)



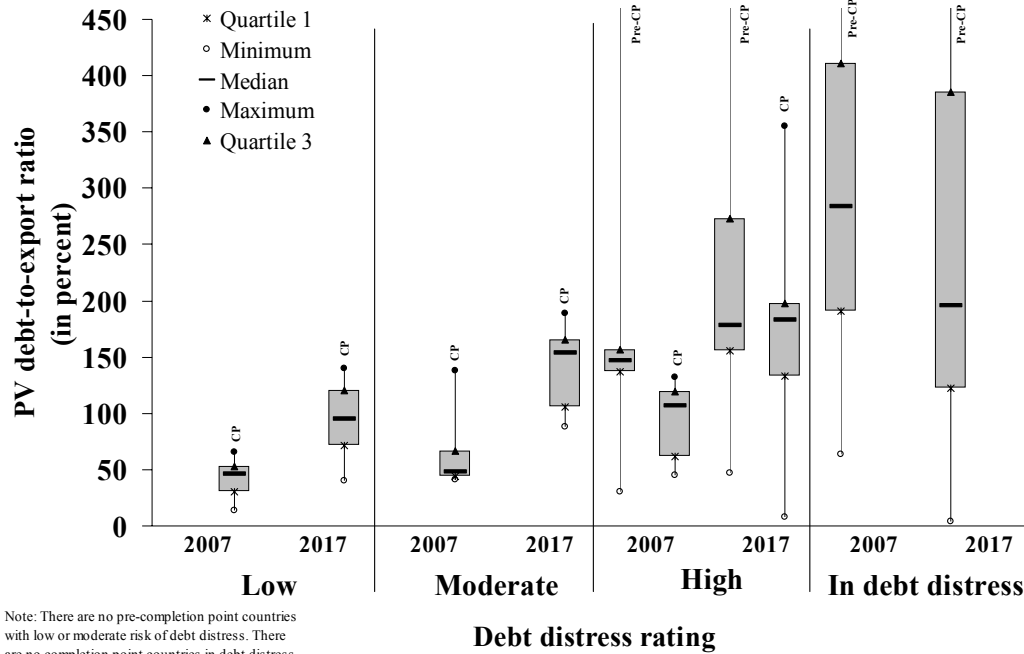
Sources: Latest joint Bank/Fund DSAs available for post-completion-point HIPC

26. **Post-completion-point HIPCs with a low and moderate risk of debt distress exhibit also, to various extents, a vulnerability to export shocks.**¹⁶ The debt ratio trajectories under the most extreme stress test—reflecting often a shock to exports—increase significantly after 10 years in each individual DSA (Figure 4).¹⁷ In low-risk countries, which have, on average, lower initial debt ratios and a higher capacity to carry debt thanks to better policies and institutions, the external debt ratio—albeit much higher after the shock—remains at manageable levels. The increase is, on average, much larger for moderate-risk countries (with an average deviation of 76 percentage points compared to the baseline scenario against 54 percentage points for low-risk countries). The dispersion of outcomes appears also larger than for low-risk countries.

¹⁶ The following analysis focuses on the PV of external debt-to-exports ratio, which was found to be the indicator breaching most often its indicative threshold, and therefore most likely to drive the risk rating.

¹⁷ The DSF includes a standardized shock to exports and a shock to exports combined with a shock to GDP and non-debt creating flows.

Figure 4. Distribution of the PV of Debt-to-Exports Ratio in HIPCs 1/



Sources: Latest joint Bank/Fund DSAs available for post-completion-point HIPCs
 1/ The 2007 figures refer to the baseline scenario and 2017 figures to the most extreme stress test.

27. **DSAs also show that the debt outlook of post-completion-point HIPCs is highly sensitive to the terms of new financing.** The DSF includes a standard alternative scenario that models the impact of a 2 percent increase in the interest rate for new borrowing. This assumption of less favorable terms—despite being mild—leads to a breach of the PV of external debt-to-exports ratio in about 60 percent of cases for post-completion-point HIPCs. This result confirms that these countries should continue to borrow on concessional terms (even when the borrowing space is large) and approach nonconcessional financing with caution.

B. Debt Sustainability in non-HIPC LICs

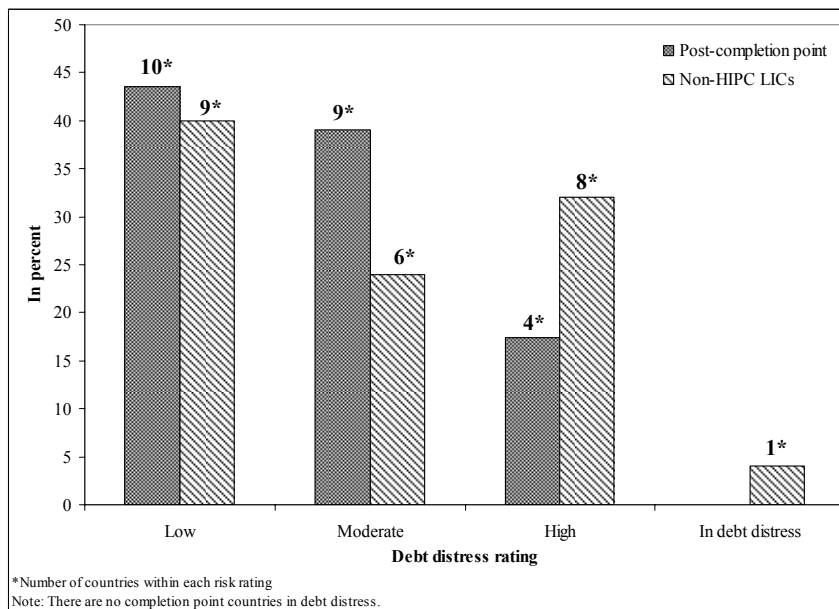
28. **Debt ratios in non-HIPC LICs are higher than those of post-completion-point countries.** At end-2007, the PV of debt-to-exports ratio for those non-HIPC LICs averaged 80 percent compared with 61 percent for post-completion-point HIPCs.¹⁸ Moreover, the range of the ratios across countries is wider, with Nigeria having a low PV of debt-to-exports ratio of 8 percent and Grenada at 231 percent. More generally, dispersion in the distribution of the debt ratios is greater (the standard deviation of the debt ratio is 36 percentage points

¹⁸ Non-HIPC LICs include 24 countries for which data were available.

higher than in post-completion-point HIPCs). At end-2007, the PV of debt-to-export was below its relevant threshold for all but four countries.

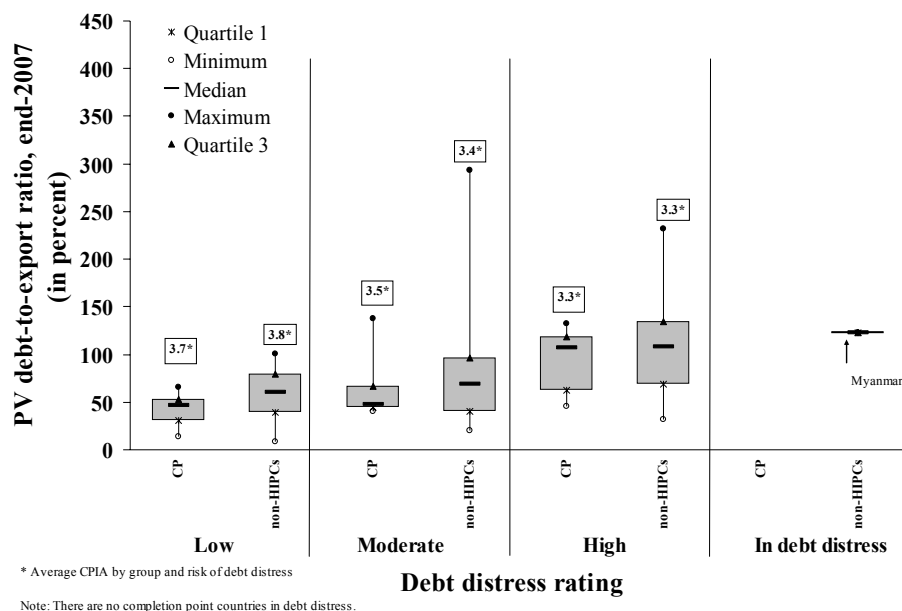
29. **Likewise, the risks of debt distress tend to be higher compared to post-completion-point countries.** Debt sustainability is a concern in over one-third of non-HIPC LICs compared to less than one-fifth of post-completion point HIPCs. Of these countries, one country (Myanmar) is in debt distress and the remainder are rated at a high risk of debt distress (Figures 5 and 6). This weaker performance largely reflects higher initial debt ratios and, to a lesser extent, weaker policies and institutions. Both factors overcome the positive impact of slightly higher export growth rate (a 10-year average of 11 percent in non-HIPC LICs compared to 10 percent in post-completion-point HIPCs) (Table 3).

Figure 5. Risk of Debt Distress in Completion Point HIPCs and Non-HIPC LICs



Sources: Latest joint Bank/Fund DSAs available for LICs.

Figure 6. Distribution of the PV of Debt-to-Exports Ratio in Completion Point HIPC and Non-HIPC LICs 1/



Sources: Latest joint Bank/Fund DSAs available for LICs.
1/ Based on the 2007 PV of debt-to-exports ratio under the baseline scenario.

Table 3. Macroeconomic Performance in Non-HIPC LICs
(In percent; 1998-2007)

	Real GDP growth		Export growth		Net FDI (in percent of GDP)	
	(1998-2007)		(1998-2007)		(1998-2007)	
	average	<i>stdev</i>	average	<i>stdev</i>	average	<i>stdev</i>
Completion Point	5.2	3.6	10.2	16.1	3.9	2.8
Excluding hydrocarbon rich						
or potentially hydrocarbon-rich 1/	5.2	3.7	10.2	14.5	3.6	2.1
Debt distress rating						
Low and moderate	4.9	3.6	11.0	15.9	3.6	2.1
High 1/	6.4	3.7	6.4	17.1	5.5	6.4
Non-HIPC LICs	5.0	3.2	11.3	15.9	4.6	3.6
Excluding hydrocarbon rich						
or potentially hydrocarbon-rich 2/	4.5	3.1	9.8	14.4	4.8	3.4
Debt distress rating						
Low and moderate	5.8	3.4	14.6	16.3	3.7	3.0
High and in debt distress	3.9	3.0	7.2	15.4	5.7	4.5

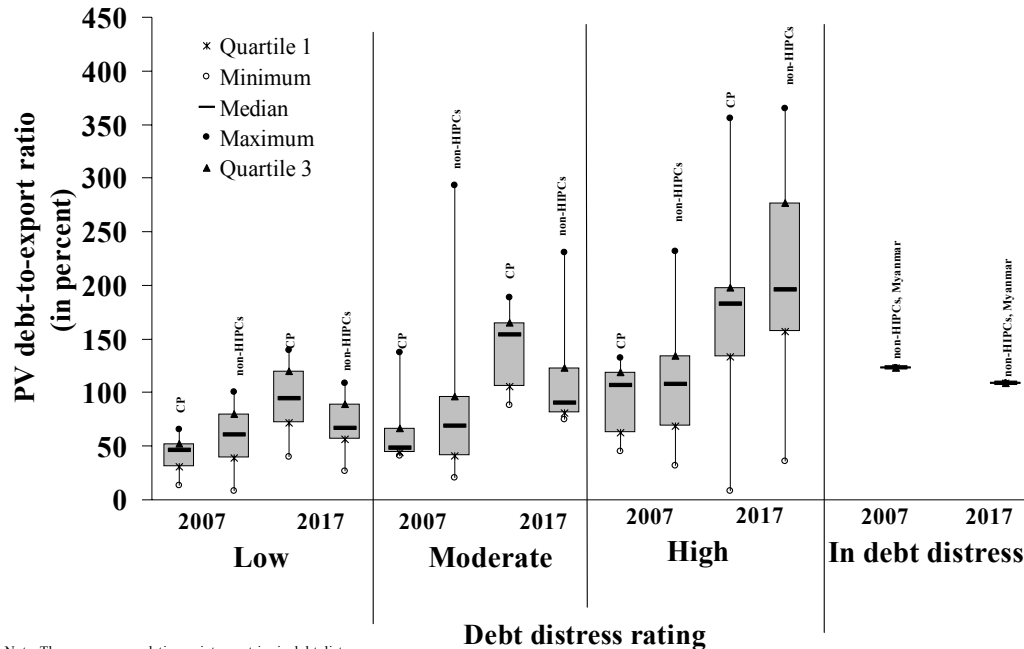
Sources: Latest joint Bank/Fund DSAs available for LICs; and Guide to resource Revenue Transparency.

1/ Excluding Bolivia, Cameroon, Mauritania, and São Tomé and Príncipe.

2/ Excluding Angola, Nigeria, Vietnam, and Yemen.

30. **However, non-HIPC LICs' economies appear to be more resilient to exogenous shocks.** While the average PV of debt-to-export ratio under the most extreme stress test increases significantly by 42 percentage points after 10 years, the increase is still less than in post-completion-point countries (68 percentage points). This outcome partly reflects the higher 10-year historical average export growth. Looking at individual country categories, low and moderate rated non-HIPC LICs exhibit stronger resilience to shocks (Figure 7).

Figure 7. Distribution of the PV of Debt-to-Exports Ratio in HIPCs 1/



Note: There are no completion point countries in debt distress.

Sources: Latest joint Bank/Fund DSAs available for LICs.

1/ The 2007 figures refer to the baseline scenario and 2017 figures to the most extreme stress test.

C. Concluding Remarks

31. **Debt sustainability has improved for most post-completion-point countries, but vulnerabilities persist.** Adequate policies, including prudent borrowing policies and reforms in the area of debt management, are critical to maintain debt sustainability. The advice also applies to the countries at low risk of debt distress as their strengthened macroeconomic fundamentals are attracting a new range of investors and creditors and a larger spectrum of financial instruments, thereby exposing their economies to new vulnerabilities.

32. **Non-HIPC LICs appear to be more indebted than post-completion-point countries, but they are more resilient to shocks.** Although their PV of debt relative to export was on average one-third higher at end-2007 than in post-completion-point countries, they appear to be in a better position to cope with the associated vulnerabilities. Nonetheless,

the distribution of debt distress ratings, skewed towards the high debt distress category, highlights that these countries should continue to implement policies that will minimize the risks posed by debt, including continued efforts to mobilize concessional resources and to ensure the productive use of external financing.

33. **There are some indications that post-completion-point countries are converging towards non-HIPC LICs.** With debt relief, their debt burden has significantly diminished, eliminating the sizable debt overhang and paving the way for better macroeconomic performance. As illustrated in Table 4, their average growth rates of GDP and exports and inflows of FDI are now more similar to those of non-HIPC LICs than to those of pre-completion point LICs. Furthermore, their performance has improved markedly in 2006-07 following the provision of MDRI debt relief. Relatedly, economic volatility tends to be less pronounced in post-completion-point countries and non-HIPC LICs than in pre-completion-point countries.

Table 4. Macroeconomic Performance Across Country Groupings
(In percent; unless otherwise indicated)

	Real GDP growth		Export growth		Net FDI (in percent of GDP)	
	1998-2005	2006-07	1998-2005	2006-07	1998-2005	2006-07
Pre-completion Point	3.5	4.6	13.5	9.0	3.4	6.9
Excluding hydrocarbon rich or potentially hydrocarbon-rich 1/	2.7	4.1	8.3	8.7	1.8	6.2
Debt distress rating						
High	4.2	4.1	11.7	11.7	4.0	4.3
In debt distress	2.5	5.2	15.9	5.6	2.8	10.2
Completion Point	4.9	6.4	8.9	15.3	3.6	5.4
Excluding hydrocarbon rich or potentially hydrocarbon-rich 2/	5.0	6.0	9.2	13.8	3.3	4.9
Debt distress rating						
Low and moderate	4.5	6.5	9.5	17.2	3.6	3.8
High	6.5	5.9	6.5	6.4	3.5	13.2
Non-HIPC LICs	4.6	6.2	10.6	14.3	4.1	6.4
Excluding hydrocarbon rich or potentially hydrocarbon-rich 3/	4.3	5.5	8.7	14.2	4.2	7.1
Debt distress rating						
Low and moderate	5.3	7.8	14.2	16.8	3.4	4.7
High and in debt distress	3.8	4.2	6.2	11.3	4.9	8.6

Sources: Latest joint Bank/Fund DSAs available for LICs; and Guide to resource Revenue Transparency.

1/ Excluding Chad, Congo, Rep., and Sudan.

2/ Excluding Bolivia, Cameroon, Mauritania, and São Tomé and Príncipe.

3/ Excluding Angola, Nigeria, Vietnam, and Yemen.

34. **Overall, LICs remain vulnerable, regardless of the country categories.** Therefore, it is important that borrowers and lenders continue to monitor debt sustainability. Measures geared toward entrenching macroeconomic stability, diversifying their export base and increasing the overall quality of policies and institutions could help them expand their borrowing in a sustainable manner. A strengthening of domestic capacity, for instance with

the implementation of an MTDS or other measures in the area of public financial management, will also be key for informed policy decisions (including the level of sustainable borrowing) and improved communications with creditors.

IV. CHALLENGES GOING FORWARD AND ISSUES FOR DISCUSSION

35. **The financial landscape in LICs has changed markedly in the past few years, creating new challenges.** In some LICs, debt relief, stronger macroeconomic fundamentals, and rising commodity prices have led to increased interest by new creditors, including domestic ones. New types of financing offer the opportunity to step up development, but they also raise significant analytical difficulties and policy questions, as well as risks.

36. **While LICs recognize the importance of mobilizing resources in a sustainable manner, many of them have voiced concerns that the DSF, and relatedly the IMF's and the World Bank's concessionality policies, unduly constrain financing for development,** particularly to develop infrastructure. The following elements have been the sources of particular concern:¹⁹

- **Economic assumptions.** Baseline scenarios are often criticized for being too conservative. The evidence, however, suggests that projections tend to be too optimistic. Optimism was shown in the IEO's 2003 report, which concluded that actual GDP growth outcomes fell short of projected growth in the context of the 159 IMF programs considered by the study, by an average of 1.5 percentage points during the various two year periods that were studied.²⁰ Likewise, a 2006 World Bank IEG report found that the projected average growth of GDP and exports for 2005-2010 were more than twice their 1990-2000 averages, and 2.5 times their 1980-2001 averages.²¹ The report also concluded that this optimism appears to have diminished in recent years.²² This issue will need to be revisited once more vintages of DSAs are available to assess whether new projections are corrected to take into account past forecasting errors.
- **Investment and growth.** Stepped-up investment in infrastructure is critical to supporting long-term growth in many LICs. However, the links between higher

¹⁹ These concerns were recently voiced at the 2008 African Caucus meeting in Nouakchott.

²⁰ See IEO (2003). The report which considered the experiences of countries under various IMF programs, including the Enhanced Structural Adjustment Facility, the Poverty Reduction and Growth Facility, and Stand-By Arrangements.

²¹ See IEG (2006) for a survey of growth projections enclosed in HIPC DSAs.

²² For example, the study found that, on average, GDP growth and projections from completion point HIPC DSAs for the period of 2000-2010 were 0.42 and 0.11 percentage points lower, respectively, than those for the same period included in earlier decision-point DSAs.

investment and growth are difficult to quantify, especially as economic growth and debt sustainability depend on many other factors—such as the strength of macroeconomic and structural policies, the quality of institutions and decision making processes, and the management of exogenous shocks. Thus, further work in this area, which goes well beyond the DSF itself, may be needed.

- **Assumptions on the quality of policies and institutions.** The DSF uses the World Bank's CPIA to measure a country's quality of policies and institutions. The CPIA is a diagnostic tool, providing results that are comparable across countries and since June 2006 its numerical ratings have been disclosed and detailed information about the exercise made publicly available.²³ Some LICs have suggested, however, a switch to a system for evaluating country policies that is more transparent system and country-led.²⁴
- **Domestic debt.** Domestic debt undoubtedly matters for the assessment of overall fiscal sustainability. While thresholds for overall public debt would allow a more systematic integration of domestic debt into the DSF, their design poses conceptual and practical challenges. Moreover, the distinction between domestic and external debt has become increasingly blurred with the participation of foreign entities in secondary market trading. Additional work is needed to more systematically conceptualize the impact of domestic debt on total debt sustainability.
- **Private creditors.** Foreign investors are increasingly entering domestic markets for equities and domestic debt. With these new opportunities, many LICs wish to accelerate borrowing to address their development needs, in particular those that have large fiscal space as a result of the provision of debt relief.²⁵ The menu of financing instruments is also expanding, for example with the possible use of Public Private Partnership (PPP) arrangements. While the DSF was strengthened in 2006 to address these new developments, further work on this issue may be required to provide more specific guidance on how to monitor and contain these new risks.
- **Capacity constraints in LICs.** These constraints hamper the effective use of the DSF by borrowing countries. The World Bank and the IMF have put forward several initiatives to strengthen domestic capacity, including technical assistance in the area of debt management and DSF training workshops. But, these efforts need to be

²³ For detailed information about the CPIA, please visit go.worldbank.org/74EDY81YU0 and <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:21359477~menuPK:2626968~pagePK:51236175~piPK:437394~theSitePK:73154,00.html>

²⁴ See for example the HIPC Finance Minister's Communiqué, October 10, 2008, which is available at http://www.hipc-cbp.org/files/en/open/Advocacy/MM15_Declaration_EN.pdf

²⁵ However, the current financial crisis could reduce investor appetite as many potential lenders are squeezed for liquidity.

intensified. Continued collaboration between donors and creditors and stepped-up and well-targeted technical assistance is critical in building LICs' capacity to monitor debt and ensure debt sustainability.

37. **The DSF is a tool to assess debt sustainability prospects in varying circumstances, and as such it must be flexible enough to adapt to changes in the financial environment as well as advances in our understanding of macroeconomic linkages.** The current version of the DSF crystallizes the current state of our knowledge and thus represents the best instrument now available to analyze debt sustainability in LICs. However, it is not a static tool. Continuous work—hopefully nourished with inputs from a broad range of users—is needed to deepen its analytical foundations and improve its relevance and effectiveness.

V. CONCLUSIONS

38. **LICs have often struggled with large external debts and destabilizing macroeconomic outcomes, ultimately constraining development.** While debt relief has given many LICs a chance for a fresh start, they continue to face an array of challenges. The financial landscape has and will continue to change. Debt relief has created significant borrowing space that will need to be filled very cautiously. Moreover, the menu of financing options is expanding and its composition changing. The increased availability of resources for growth-enhancing investment from nontraditional creditors is a welcome development. However, additional financing needs to be managed carefully to avoid excessive debt accumulation and a return of the debt problems of the past. Finally, domestic market development provides new opportunities for additional financing but also poses risks.

39. **The DSF can help address these challenges by guiding borrowing decisions of LICs in a way that matches their financing needs with their current and prospective repayment ability.** It also provides guidance for creditors' lending and grant-allocation decisions to ensure that resources are provided to LICs on terms that are consistent with both progress toward their development goals and long-term debt sustainability and helps to improve World Bank and IMF assessments and policy advice in these areas, and help detect potential crises early so that preventive action can be taken.

40. **The introduction of the DSF has also improved access to information and emphasis on the debt situation in LICs,** hence increasing borrowers', donors', and lenders' capacity to make informed decisions, ultimately reducing the risk of renewed episodes of debt distress. For most LICs, concessional flows will remain the most appropriate source of external financing for some time to come. But some LICs will develop faster and become more mature market economies. Nonconcessional financing will then play a more prominent role given the scarcity of concessional resources or a country's desire to tap international capital markets. The DSF is well placed to guide such decisions by showing the impact of such borrowing on overall debt sustainability.

41. **Nonetheless, significant challenges remain.** The Fund and the Bank have worked to take into account more fully the growth potential offered by increased infrastructure and other investment in the DSF. However, the links between higher infrastructure investment and growth are difficult to quantify. Moreover, as highlighted above, the integration of domestic debt and private sector flows has proven to be difficult. Further work in these areas, which would go well beyond the DSF itself, may be needed.

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