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Debt Sustainability in Low-Income Countries - Recent Experience and Challenges Ahead

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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.

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