

G20 Study Group on Debt Sustainability
The World Bank Response to Call for Evidence¹
6 June 2008

The current debt sustainability outlook

1. *What is your general assessment of the overall state of debt sustainability in low-income countries, both at present and in terms of future prospects?*

Significant progress has been made over the past decade in helping low income countries (LICs) achieve and maintain debt sustainability. Key factors include debt relief, progress in developing and implementing the low income country debt sustainability framework (DSF), and improvements in public financial management. In addition, favorable international terms of trade, combined with growth-promoting macroeconomic and structural policies, have been key factors in maintaining debt sustainability.

Debt burdens have declined as a result of debt relief. The debt stocks of the 23 post-completion point HIPCs have been reduced by nearly 90 percent, while the average projected debt service obligations of post-decision point HPCs have been reduced substantially and are expected to decline further as more HIPCs qualify for MDRI relief.²

Notwithstanding the decline in debt burdens, long-term debt sustainability remains a challenge. Although HIPC Initiative and MDRI debt relief have contributed to improved debt indicators, approximately only a quarter of the 23 post-completion-point HIPCs are classified as having a low risk of debt distress with the remainder being at either moderate or high risk.³ This suggests that underlying vulnerabilities remain and must be addressed. While policies aimed at diversifying exports, strengthening institutions, and using external resources efficiently are paramount for long-term debt sustainability, prudent borrowing commensurate with a country's repayment capacity and strengthened debt management are also crucial.

2. *How do you go about assessing the debt sustainability of low-income countries?*

Since its endorsement by the Bank and Fund Executive Boards in April 2005, the joint Bank-Fund debt sustainability framework for low income countries has become a key input to country borrowing strategies.⁴ The objective of the DSF is to

¹ This document was prepared jointly by the Economic Policy and Debt Department, the Resource Mobilization Department, and the Banking and Debt Management Department of The World Bank.

² From USD 110 billion in end-2006 NPV terms before traditional debt relief, to USD 12 billion. Source: HIPC documents; and IDA and IMF staff estimates.

³ Debt distress classification for post-completion-point HIPCs refers to the assessment made under the latest available joint IMF-World Bank Debt Sustainability Analyses (DSAs) as of May 2008 and includes the effect of MDRI.

⁴ The Executive Boards of the Bank and the Fund approved the debt sustainability framework (DSF) for low-income countries (LICs) in April 2005 (IDA/R2005-0056 and BUFF/05/69, SM/05/109) and

assist LICs in their efforts to achieve their development goals without creating future debt problems, and to keep countries that have received debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) on a sustainable track. It allows creditors to tailor their financing terms in anticipation of future risks and helps borrowers balance the need for funds with the ability to repay their debts. Since 2005, approximately 150 Debt Sustainability Analyses (DSAs) have been prepared under the framework, roughly three-quarters of which were jointly conducted by the Bank and the Fund.

The framework is built on three pillars: (i) a standardized forward-looking analysis of debt and debt-service dynamics under a baseline scenario, alternative scenarios, and standardized stress test scenarios; (ii) a debt sustainability assessment based on indicative country-specific debt-burden thresholds that depend on the quality of policies and institutions in the country; and (iii) recommendations on a borrowing (and lending) strategy to limit the risk of debt distress, while maximizing the resource envelope to achieve the Millennium Development Goals (MDGs).

Policy-dependent debt-burden indicators are used because the debt levels that LICs can sustain are influenced by the quality of their policies and institutions. These debt-burden thresholds are not seen as rigid ceilings but as guideposts for informing debt sustainability assessments. Policy performance 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. The risk classification depends on the indicative thresholds and therefore on the CPIA score. In this way, LIC DSAs form the basis for determining the grant/loan mix in future IDA allocations (and those of some other multilaterals, including the African Development Fund and the International Fund for Agricultural Development).⁵

In November 2006, the framework was reviewed in light of Bank and Fund Board concern over new policy challenges posed by an emerging, new financial environment for LICs.⁶ Significant debt relief had led to the perception of a large borrowing space in some LICs. Simultaneously, the emergence of new creditors and the rising importance of domestic debt led to an expansion in the volume and sources of funds available to these countries. In view of the risks raised by these developments, the Boards endorsed recommendations to enhance the rigor and quality of DSAs and the effectiveness of the DSF through its more active use by a broader group of debtors and creditors. 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.*

reviewed it in April 2006 (IDA/R2005-0046 and BUFF/06/74, SM/06/123) and November 2006 (IDA/SecM2006-0564 and BUFF/06/174 Rev 1, SM/06/364).

⁵ IDA only countries judged to be at high risk of debt distress risk receive 100 percent grant financing from IDA, while countries at moderate risk receive a 50/50 blend of grants and traditional credits, and countries at low risk continue to receive 100 percent credit financing on standard IDA terms.

⁶ See IDA and IMF, “Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries”, May 2007.

3. *In your view, what are the key factors that impact on a country's debt sustainability outlook?*

Empirical analysis demonstrates that the risk of debt distress for LICs depends significantly on three factors: debt burden, the quality of a country's institutions and policies, and external shocks.⁷ A key finding of the analysis, which underpins the policy-dependent debt thresholds of the DSF, is that relevant thresholds for a country differ according to the quality of a country's policies and institutions. The basic idea is that a country with better institutions and policies can carry a heavier debt burden and thus the risk of debt distress rises sharply at a higher threshold level relative to a country with weaker policies and institutions. Close assessment and monitoring of these determinants of debt distress is essential in the case of LICs because, unlike in middle and high income countries, there are "few market indicators available to signal risks of future sovereign debt default." Borrowers can help achieve and maintain debt sustainability by keeping new borrowing commensurate with the capacity to repay, adopting better policies and institutions that help accelerate growth, managing debt prudently, and increasing resilience to exogenous shocks. As debt sustainability can only be achieved if all creditors take debt sustainability concerns into account in their own lending decisions, creditors can help by enhancing existing mechanisms for information-sharing and coordination among borrowers and creditors.

LICs face significant policy, institutional and operational challenges in prudently managing their debt, not least because of institutional weaknesses and scarcity of skills. In addition, conditions in global markets, and the new borrowing space created by HIPC and MDRI, have attracted new creditors, who increasingly view these countries as attractive borrowers. This adds new urgency to the need to strengthen PDM frameworks, including debt market development, to ensure debt sustainability and has resulted in a renewed emphasis in the Bank on debt management capacity building among borrowers. While poor debt management can add to the debt burden, fiscal policy is the main determinant of the debt level and is therefore the principal tool for achieving and maintaining debt sustainability.

Policies that support private sector-led growth are critical to generating 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".⁸ Furthermore, empirical research has indicated that movements in debt ratios have been dominated by movements in the denominator (exports and GDP),⁹ highlighting the importance of growth-promoting macroeconomic and structural policies for achieving debt sustainability. A weak export base and fragile revenue-to-GDP ratios would,

⁷ See Kraay and Nehru, "When Is External Debt Sustainable?", World Bank Policy Research Working Paper 3200, February 2004.

⁸ World Bank (2001), "The Challenge of Maintaining Long-term External Debt Sustainability"

⁹ World Bank (2004). "Is Sovereign Debt Helping Development?", unpublished manuscript

however, require that these countries depend on concessional borrowing to finance growth-promoting policies, programs and projects.

Opportunities and risks of increased borrowing space

4. *What do you consider to be the key opportunities and risks for borrowers of increased borrowing space following debt relief?*
5. *What do you consider to be the key opportunities and risks for lenders of increased borrowing space following debt relief?*

Looking at debt ratios post-MDRI would give the impression of increased borrowing space following debt relief. A static look at a country's debt ratios post-MDRI shows that many LICs have debt ratios significantly lower than MICs. However, there is a need to look beyond the debt ratios at the underlying fundamentals of the country. Experience has shown that debt relief does not automatically translate into low risk of debt distress, and for several post-MDRI countries, unless improvements in macroeconomic fundamentals are made, debt ratios may again converge to pre-MDRI levels in the long term. 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.

A key opportunity and risk is the increased access to non-concessional financing. This poses an opportunity to finance projects that in credit-constrained countries may be able to generate positive economic rates of return and enhance prospects for growth. Debt distress in most LICs would not increase rapidly with traditional multilateral creditors, especially given their increased harmonization with the IDA14 grant allocation system.¹⁰ However, significant scaling up and a greater share of less concessional or non-concessional borrowing could exacerbate debt distress risks, underscoring the *importance of enhanced creditor coordination and improved debt management*. In many cases, LICs lack a coherent framework to fully assess the related costs and risks of new financing. There is also the risk to borrowers that early moves towards *increased creditworthiness and market access can be quickly reversed* if new borrowing opportunities are not used judiciously. The risks to lenders may be payment default, and possibly a new round of debt relief.

6. *What are the most important factors that you take into account in making a decision to lend to a low-income country? How do you take into account the World Bank/IMF Debt Sustainability Framework? And how do you ensure appropriate levels of concessionality in your lending?*

In terms of the volumes of assistance, IDA's 80 eligible borrowers have very significant needs for concessional funds. But the amount of funds available for lending, which is fixed once contributions are pledged by donor governments, tends to be well

¹⁰ As was pointed out in the November 2006 DSF review, 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. See IDA and IMF, "Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief", November 6, 2006.

below the countries' needs. IDA therefore must allocate scarce resources among eligible borrowing countries. This is done on the basis of borrowers' policy performance and institutional capacity in order to concentrate resources where they are likely to be most helpful in reducing poverty.

For deciding on the terms of assistance, the key element that needs to be taken into account is the Bank/IMF Debt Sustainability Framework. For IDA, the DSF is the key factor in determining the terms of support to a low-income country. 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 the country, even though IDA grants already embed a 60 percent grant element¹¹. The traffic lights, which are assigned annually to each IDA-only country, 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 in debt distress. The configuration of highly-concessional credits and grants by traffic light is then given as follows: a green light results in an allocation of 100 percent IDA credits (with a grant element of 60%); 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.

Policy approaches to support debt sustainability

7. *What is your assessment of the steps borrowers should take to help maintain debt sustainability? Are there any ways in which G20 members could facilitate this?*

The World Bank has taken concrete steps to help countries maintain debt sustainability, including (i) jointly with the IMF developing, implementing and broadening understanding of the low-income country debt sustainability framework (DSF)¹²; (ii) designing and implementing IDA's grant allocation system linked to DSF risk ratings; (iii) developing and implementing IDA's Non-Concessional Borrowing Policy; and (iv) developing tools on a collaborative basis – as global public goods – and providing technical assistance to strengthen debt management capacity and institutions.

The Bank actively encourages LIC borrowers to take advantage of efforts towards capacity building for improving debt sustainability along three dimensions¹³:

¹¹ DSAs have increasingly been used as the basis for traffic light ratings throughout IDA14, from 4 in FY06 to 50 in FY08 and 60 in Y09.

¹² The Executive Boards of the Bank and the Fund approved the debt sustainability framework (DSF) for low-income countries (LICs) in April 2005 (IDA/R2005-0056 and BUFF/05/69, SM/05/109) and reviewed it in April 2006 (IDA/R2005-0046 and BUFF/06/74, SM/06/123) and November 2006 (IDA/SecM2006-0564 and BUFF/06/174 Rev 1, SM/06/364).

¹³ While these efforts are primarily focused on low-income countries (LICs), many of which have received substantial debt relief through the HIPC and MDRI Initiatives, the tools and technical assistance are also applicable and available to middle-income countries facing challenges in maintaining debt sustainability.

- ***Debt sustainability analysis (DSA)*** – The objective of a joint Bank-Fund low-income DSA is to monitor the evolution of a country’s debt burden indicators and to guide future financing decisions. The DSA is a standardized, forward-looking analysis of external and public debt and debt service indicators under a baseline scenario based on realistic assumptions and under standardized shocks. As such, the DSA helps identify vulnerabilities and assess whether a country’s current borrowing strategy may lead to future difficulties servicing its debt.¹⁴ For the borrower, the DSA guides decisions on new borrowing to match financing with ability to pay; for the creditor, it allows financing terms to be tailored in anticipation of future risks.
- ***Debt management performance assessment*** – The Debt Management Performance Assessment (DeMPA) tool, which was launched in 2006, is a methodology for identifying strengths and weaknesses in debt management operations through a comprehensive set of indicators spanning the full range of government debt management functions.

The tool builds on the measurement framework developed for the Public Expenditure and Financial Accountability (PEFA) Program, and covers core central government debt management functions relating to: governance and strategic 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 15 performance indicators allows the identification of areas in need of priority attention. By becoming an internationally recognized standard, DeMPA contributes to harmonization of debt management service delivery. The tool also provides a methodology for monitoring performance over time, and enables the development of detailed and actionable reform programs to strengthen PDM capacity and institutions.

- ***Design of Medium-Term Debt Management Strategies (MTDS)*** – The Bank and the IMF are collaborating on the development of analytical tools and methodological approaches for the design of country-led Medium-Term Debt Management Strategies (MTDS). The toolkit includes a guidance note on the process of designing and implementing a debt management strategy in a low-income country (LIC) context, a template for strategy documentation, and quantitative cost-risk analysis tools.¹⁵

An MTDS helps to “operationalize” country authorities’ debt management objectives – e.g. ensuring the government’s financing needs and payment obligations are met at the lowest possible cost consistent with a prudent degree of risk – expressing the government’s preferences with regard to cost-risk tradeoffs in the form of the desired composition of debt, and by describing the plan that the government intends to implement to achieve this composition. An MTDS will have a strong focus

¹⁴ An important aim of the DSA is to classify countries according to their risk of debt distress. These classifications are used to determine the grant shares in new IDA assistance to the country. To date, training workshops have been staged in Mexico City, Accra, Dakar, Maputo and Windhoek to groups of countries covering most IDA-only borrowers, reaching over 40 LICs.

¹⁵ The Bank and the IMF have undertaken to provide TA to 4-6 LICs before reporting back to their Boards in late 2008.

on managing the risk exposure embedded in the debt portfolio - specifically, potential variation in the cost of debt servicing and its impact on the budget - and in particular identifying how cost and risk vary with the composition of the debt.

Building debt management capacity in LICs 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. In this context, the World Bank is in the process of establishing a multi-donor financing facility to support the scaled up and accelerated implementation of debt management activities in cooperation with other technical assistance providers.¹⁶

B. Are there any ways in which G20 members could facilitate this?

Ways in which G20 members could support these efforts include:

- (i) Contributing to a common understanding of the principles of collectively sustainable lending to LICs through participation in the outreach programs of the Bank, the IMF and other creditors;
- (ii) Encouraging their external financing institutions and the multilateral financial institutions in which they are shareholders to increase their understanding and acceptance of the DSF through the sharing of country-specific information and attendance at DSA training workshops¹⁷;
- (iii) Harmonizing their lending practices broadly along the lines suggested by the risk assessments contained in Debt Sustainability Analyses (DSAs) conducted jointly by the World Bank and the IMF¹⁸;
- (iv) Adopting policies on non-concessional borrowing to be applied in their lending operations with low-income countries;¹⁹ and
- (v) Sharing their experience/expertise on strengthening the relationship between debt management and debt sustainability.

¹⁶ The Debt Management Facility for Low-Income Countries (DeMFLIC) would have the specific objective of: (i) scaling-up the application of the DeMPPA program, (ii) designing debt management reform programs based on DeMPPA results, (iii) enhancing coordination among the international providers of debt management technical assistance, (iv) supporting the development of medium-term debt strategies; and (v) promoting learning via training activities.

¹⁷ The major regional development banks play a more active role today in the DSA process, having made significant progress in harmonizing their lending practices with the DSF.

¹⁸ The 2006 review of the DSF 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. See World Bank and IMF, “Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief”, November 2006.

¹⁹ Similar action was taken by Export Credit Agencies in the OECD context. The *Principles and Guidelines to Promote Sustainable Lending Practices in the Provision of Official Export Credits to Low-Income Countries*, adopted by OECD Export Credit Agencies in January include an agreement to adhere to IDA and IMF concessionality requirements in low-income countries.

8. *What is the role of the commercial sector in supporting debt sustainability?*

The commercial sector is motivated by profit-making opportunities, so they will be present where such opportunities exist. The benefit of the commercial sector – i.e. the market discipline that they impose on governments by penalizing poor policies and governance, and by demanding more information and increased transparency – must be balanced with the moral hazard that they may over-lend and take on excessive risk based on the expectation that sovereign governments will not go bankrupt and/or that they will be bailed out by donors.²⁰ Therefore, it is difficult to expect that market discipline of commercial sector lenders alone could be relied upon in supporting debt sustainability, highlighting the importance of increased collaboration with commercial creditors and the principle of shared creditor responsibility.²¹

From the borrower’s perspective, the commercial sector represents an additional source of funding, which, from a diversification perspective, is also important, given the significant aid volatility that countries experience. In addition, with the expected decline in concessional sources of funding over the medium term, for many high-end LICs the commercial sector has to be part of the overall menu of alternatives. To the extent that funds are channeled to infrastructure projects expected to generate economic returns, and the commercial sector is willing to participate (especially where the official sector is not willing), this funding source is expected to play an increased role. However, it is critical to ensure that the projected economic return exceeds the higher interest cost and exchange rate risk that accompany these loans.

9. *What do you think the role of the IFIs should be in supporting debt sustainability – in particular, through their own lending criteria, policy frameworks and the technical assistance they provide to borrowers and lenders? And are existing policies fulfilling this?*

As a creditor itself, IDA’s grant allocation system, has been a key element of IDA’s role in helping countries maintain debt sustainability.²² According to the grant allocation introduced by IDA, all IDA-only countries receive IDA assistance with a grant element of between 60 percent and 100 percent, depending upon their risk of debt distress.

Steady progress is also being made in creditor coordination, and in disseminating information about debt risks to other creditors, which is important given that IDA is only one creditor among many that finance LICs. The increased availability of information on the DSF has led to the adoption of similar grant allocation systems by other MDBs. OECD Export Credit Agencies also agreed to a set of

²⁰ The existence of moral hazard reduces the likelihood that rigorous credit risk analysis (i.e. the usual self-correcting mechanism) will constrain over-lending by commercial creditors.

²¹ The official sector, for its part, must make it clear that international debt relief initiatives will not bail out imprudent commercial creditors, and focus on providing credible policy advisory services and enable transfers of technical knowledge.

²² See response to question 6 for detailed description.

sustainable lending guidelines linked to the DSF. Increased collaboration is also being seen with emerging market bilateral creditors.

IDA's Non-Concessional Borrowing Policy (NCBP) was designed 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.*

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). Consideration could be given to non-concessional finance—on a case-by-case basis—depending on: (i) the impact on debt sustainability; (ii) the availability of concessional resources; (iii) the impact on poverty reduction; and (iv) the overall strength of a debtor country's policies and institutions, as well as of the quality of the investment to be financed and of the overall public expenditure program.

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 debtors and 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.

10. *How do you think official and commercial lenders, borrowers and the IFIs can best work together to ensure that lending and borrowing decisions support debt sustainability? How do you publicise or report information on lending decisions?*

Coordination among creditors is a significant element in any strategy to achieve and maintain debt sustainability in LICs. Beyond enhancing channels for communication and knowledge exchange, the key resource to creditors of all types in this regard is the joint Bank-Fund DSF. Efforts by the Bank and the Fund to enhance channels for communication and exchange of information about debt risks are ongoing and are centered around the DSF. Some official creditors have adapted their lending

programs to take account of information on debt sustainability made publicly available by the DSF (i.e. DSA risk assessments).

While creditor coordination is essential, there are compelling reasons for borrowers to strengthen debt management capacity in order to exploit the finance opportunities that are available to them in an optimal manner, both in terms of maintaining debt sustainability, but also in terms of prudent portfolio and instrument selection to manage risk within appropriate levels and to minimize cost. To this effect, as already mentioned, the Bank and the Fund are developing a medium-term debt management strategy (MTDS) framework that analyzes the costs and risks of different borrowing strategies, which will feed into the debt sustainability framework (DSF), and will inform fiscal policy-makers of the interaction between revenue and expenditure policies and debt management policies.

The Bank and the Fund have also published the Guidelines for Public Debt Management (2001) and its Amendments (2003), which underline the importance of coordination between the fiscal authorities and debt managers. Also, one of the indicators of the DeMPA tool addresses the DSA and its relationship to debt management. The DSA includes variables such as the level of total debt, GDP, export earnings, and government revenues and expenditures. Both the key fiscal indicators and the debt sustainability analysis determine the environment in which the debt manager(s) will operate, which is essential for the development of an effective debt management strategy.

The Bank has a well-established debt management advisory service that has traditionally worked with the MICs, but as LICs increasingly have access to greater financing choices, the issues that they confront are steadily converging with those faced by MICs. In this regard, the development of the domestic debt market is also an important policy goal that the Bank supports through its technical assistance program, which will in the long run help to reduce both cost and risk, thereby improving debt sustainability.

The Bank and the IMF publicize comprehensive information about their lending/financing modalities and country programs on their respective websites, as well as in various annual reports. Both institutions publish the latest DSAs on their debt-specific sites, while the Bank also discloses the CPIA numerical scores for the IDA eligible countries.