DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

The contents of this document are preliminary and subject to change.

GRAY/09/3334

August 28, 2009

Statement by Mr. Fayolle on Debt Limits in Fund-Supported Programs--Proposed New Guidelines; Review of Some Aspects of the Low-Income Country Debt Sustainability Framework
(Preliminary)
Executive Board Meeting 09/91
August 31, 2009

We welcome this opportunity to discuss possible avenues to enhance flexibility in debt limits in Fund-supported programs and in the DSF, as called by the G20 leaders. We warmly thank staff for an excellent, albeit very technical, set of papers on critical and complex issues.

Debt Limits in Fund-Supported Programs

As stated in March, we recognize that LICs is not anymore a uniform category of countries in terms of income level, debt sustainability and management capacity. In that regard, we agree that a single design for concessionality requirements is not flexible enough and that a menu of options is more appropriate.

We very much welcome the new guidelines orientations on debt limits as well as their analytical underpinnings. We support the essence of the more flexible options, including average concessionality requirement or PV targets, consisting of moving away from the debt-by-debt approach for countries having strong management capacities.

We would like to focus our comments on three points.

We acknowledge that almost all PRGF-eligible countries will benefit from more flexible options for concessionality requirement. **However, countries with lower capacity management and higher debt vulnerabilities will not benefit from the reform** and the minimum concessionality requirement may likely even increase. From our bilateral meeting with staff, we understand that the Fund wants to signal to the international community that these countries have to be financed exclusively through highly concessional resources or grants. Recognizing that the primary objective here is to preserve debt sustainability, we are nevertheless concerned that these countries could become unable to realize much-needed and growth-inductive investments, by lack of available concessional financing. This situation is most likely to occur at a moment where the financing needs are huge, and the donors have to constrain their budget to cope with the crisis. Investment in infrastructure are key for long-run growth, and their need is huge in LICs in general and in post-conflict countries in particular. *Staff's proposals on how to resolve this dilemma would be welcome*.

We very much welcome the refinement that staff provides in the measure of public resources management capacity. That was one of our major concerns in March. We commend staff for the analytical work that has been done in a short period of time. We support the two-steps approach to measure capacity and we agree that the first step should rely on the sub-CPIA, which is a much more accurate measure of public resources management capacity than the overall CPIA indicator, and on the PEFA. Given the lack of availability of PEFA for a significant number of LICs, we strongly encourage staff to work towards expanding its scope as much as possible.

We support the idea of reconsidering the residency criterion to define the external debt. We agree with staff that concessionality requirements could be applied only to foreign-currency denominated debt for LICs with open capital accounts and those in an intermediate situation. We acknowledge that the use of the residency criterion would still be relevant for LICs with still relatively closed capital accounts, that is to say for most of them. For these countries, however, given that the definition of external debt is key for concessionality requirement, we would welcome some clarification on the criteria for exclusion of nonresident debt from concessionality requirements. *Does staff confirm that nonresident acquisition of <u>domestically</u>-issued debt will be systematically excluded? What will be the status of the <u>regionally</u>-issued debt from countries belonging to monetary unions? Finally, could staff indicate what could be the implications of this classification change as for Paris Club debt treatment is concerned?*

<u>Review of some Aspects of the Low-Income Country Debt Sustainability Framework</u>

In order to strengthen the legitimacy of the DSF as a widely recognized instrument and a common tool for multilateral and bilateral creditors, it is necessary to improve it on an ongoing basis and respond to critics when they are relevant. In this context, keeping in mind the necessity not to unduly penalize the most vulnerable countries, we think that the issues identified by staff are relevant and we agree with most of the proposed adjustments.

On the other hand, we think that providing a set of clear rules is the very strength of the DSF. In looking for more flexibility, we should therefore avoid giving too much room for judgmental approaches, relying too much on "case-by-case" analyses, which could be accused (even if wrongly) of undermining consistency and equality of treatment among countries.

This being said, we would like to emphasize the following comments :

While recognizing the methodological challenges, we welcome the work done by staff to improve the understanding of the growth- public investment nexus and better take into account the impact of debt-financed investments in DSAs. We support staff's approach to construct comprehensive models to be used when a significant scaling up of investment is ongoing or imminent, and to focus on an indicator-based approach for the time being. We also agree that the return on debt-financed investment relies on the economic and institutional environment, and in particular, on government's ability to realize the fiscal dividends of growth. **However, we would caution against putting too much emphasis on the quality of policies and institutions, especially in light of the well-known limitations of the available tools and indicators** (CPIA, Doing business surveys…). **We think that the impact on growth primarily depends on the project itself, especially with respect to large investment projects**. To that extent, while we acknowledge that a minimal critical project-size should be defined, we think that developing a project-by-project analysis framework would be a relevant tool to assess the growth-investment nexus and would usefully complement the approach developed by staff. *We would welcome staff's comments on that point.*

Debt sustainability analysis should better take into account all sources of revenues contributing to the financing of the economy, and **especially remittances, when those are a very significant source of income for a country**. Given the data collection challenge, **we support the proposed asymmetric treatment of remittances in DSAs, i.e. serving for a favorable risk rating if needed when remittances are relatively large in comparison to exports or GDP**. *Could staff give an estimate of the percentage rates behind the term "relatively large"?* While we suggest continuing to improve data collection, we think that a further review of the thresholds, given its operational impact, should only be implemented when a comprehensive and robust set of data is available, and supported by strong empirical evidence.

We welcome the proposal to smooth potential "threshold" effects linked to movement in CPIA and we support Option 1, which preserves the clarity of the framework. **However, we are concerned by the relative rigidity of Option 1 in the case of a CPIA improvement** . We agree that a downgrade in the CPIA rating should be sustained over a certain period of time before impacting country's debt thresholds. In light of the G20 recommendation for greater flexibility, we are wondering whether the same lag is necessary in such cases when a CPIA improvement should lead to an upgrade in the risk rating. *We would welcome staff's comments on the opportunity of such an asymmetric approach.* In addition, **we regret that staff stick to the use of the full CPIA and do not even consider using sub-indicators** (as proposed in the IMF companion paper), potentially more closely related to debt management capacity. *Staff's comments on this choice would be welcome*.

We acknowledge the advantage of keeping the present rule for the determination of the discount rate as introducing some more inertia would weaken the link between the discount rate and market interest rates. However, we would recommend being cautious as the mechanical decrease in the discount rate will increase the present value of debt, and is likely to deteriorate debt distress ratios. While we note that staff consider the impact to be limited, we think that this could be a source of concern and that **the decrease in the discount rate could be seen as a tightening of the DSF, opposite to G20 commitments.**

Special attention should be given to the perimeter of the debt. We think that a clear definition, consistent between IMF and World Bank analyses, is of outmost importance. As far as the SOEs are concerned, we welcome staff's orientations with a view to excluding the debt of specific SOEs from the scope of the public debt. However, we believe that more specificity is needed to guide the assessment of the potential fiscal risk for the government (footnote 51). We think that too many criteria would be an impediment to an unambiguous assessment of the "fiscal risk for the government". Therefore, we would recommend prioritizing the criteria used for the exclusion provision and focusing on some of them. In addition, *we would appreciate staff's comments on any provision that could be introduced regarding the potential exclusion of local governments' debt.*

Finally, we welcome the proposal to reflect authorities' views in DSAs, as it can help enhance country ownership of the analysis. We also agree with the proposal for streamlined DSAs, keeping in mind that risk ratings should be updated on an annual basis.