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Statement by Mr. Bergo and Mr. Bartkus 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 the papers in response to the call by the G-20 and IMFC on options to enhance flexibility in Debt Limits in Fund-supported programs and in the Debt Sustainability Framework (DSF) and the discussion of important issues pertaining to the Debt Sustainability Analysis (DSA). We broadly agree with the suggestions in the papers.

Review of Some Aspects of the Low-Income Country Debt Sustainability Framework

The goal of the IMF/WB Debt Sustainability Framework remains to help LICs meet their development financing needs without re-accumulating unsustainable levels of debt. We consider Debt Sustainability Analyses (DSA) and debt management one of the most important areas of work of the Fund and the World Bank in low-income countries. It is important that creditor countries and organizations adhere to the principles of prudent and responsible lending to LICs. Caution should be exercised in view of the weak financial conditions in many LICs. However, it is also important to underline that the primary responsibility for maintaining debt sustainability rests with the borrowing countries themselves.

We note that continued close cooperation between the Fund and the Bank is important for an effective implementation of the DSF. Further, we urge that co-ordination with official and private creditors that do not apply the DSF in their lending decisions is strengthened in order to avoid that increasing access of LICs to non-concessional sources leads to a re-accumulation of unsustainable debt.

Could staff comment on whether any estimates have been made with respect to the extent the increased flexibility may affect borrowing of LICs (to what extent the proposed changes will really induce a greater space for investments etc)?

<u>Public investment-growth nexus</u>

The impact of public investment on growth tends to be positive on average. However, we underline that policy recommendations based on the DSF must be based on realistic projections of investment returns. In view of this, we endorse a country specific approach and close Fund-Bank cooperation when decisions on lending for large public sector investment projects are taken in LICs.

Efforts to improve the institutional and policy making environment in many LICs are important to provide the desired growth from public investment. We welcome the idea to give priority to cases where augmentation of investment is imminent, or where the investment environment increases the likelihood of such scaling up. A policy for determining such cases could be useful, and *we would like to ask staff to elaborate on this.*

Role of remittances

Applying flexibility in terms of the recognition of remittances in DSAs, and hence also the impact on risk ratings, is a preferable option until a more formal inclusion of remittances into the DSF can be done. We agree with the suggestion that flexibility should be applied in countries where workers' remittances are relatively large in comparison to exports or GDP. However, poor data quality is a serious limitation. *Has staff been reflecting on how to address this issue in the DSAs?*

Threshold effects

The large thresholds effects in the DSF, due to fluctuations of countries' CPIA scores, are problematic since a consequent change in rating not always reflects a change in a country's debt outlook. We therefore welcome staff's proposal, i.e. Option 1, to increase the inertia of changes in applicable debt thresholds following changes in countries' CPIA scores.

The rule of changing the discount rate

We agree to keep the rule of the DSF and adjust the discount rate to 4 percent in new DSAs since the rule strikes an appropriate balance between limiting volatility while being market-based. Moreover, no members appear to be at risk of having their ratings moved from low to moderate due to lowering the discount rate from 5 to 4 percent.

The treatment of state-owned enterprises debt in DSAs

We believe that the current treatment of SOE debt in DSAs has its merits. The proposal to exclude SOEs' external debt in DSA would obviously increase the fiscal space for many LICs, but this would not happen without considerable risks. Past crises have demonstrated that such debt positions can easily become public sector liabilities. Also, the validity of this proposed change in treatment fully depends on the soundness of the staffs judgment on whether the fiscal risks of such debt eventually materialize or not. In this respect, we would at least suggest to produce parallel DSA scenarios with SOE debt excluded and included to ensure transparency in the final assessment. Further, it is important that assessments made on a case-by-case basis, are guided by strict principles as a minimum. We also believe that it would have been interesting if the staff paper had included estimates of the effect such change would have on some of the countries involved.

Streamlining DSAs

We agree that streamlining the DSAs is appropriate in order to free up resources for more urgent and critical work. However, it is important that the quality of the DSAs are not affected negatively by such streamlining.

Debt Limits in Fund-Supported programs

We welcome the proposal to increase flexibility in the Fund's policy on debt limits in Fund-supported programs for LICs. The proposed approach would help to better reflect the diversity of situations in LICs, with regard to the different debt vulnerabilities and macroeconomic and public financial management capacity in these countries. It would also strengthen uniformity of treatment of countries in similar circumstances. We note that a more systematic link to the DSA and DSF plays a critical role to ensure that the proposed more flexible approach is implemented in a consistent way.

We consider the proposed two-step process for identifying higher capacity countries to be broadly appropriate. We agree that using the sub-CPIA component is more relevant when assessing countries' macroeconomic and public financial management capacity for the purpose of identifying what debt limits should be set for a particular low-income country seeking the Fund's support. Taking into account the broad country coverage of the sub-CPIA and PEFA, we agree that these indicators be used as guideposts for the first step of country capacity assessment. We also support staff's proposal that countries for which only one indicator is available should be placed in the gray area or classified in the lower category as information from only one indicator would clearly not be sufficient to classify the country in the higher category. At the same time, we wonder whether it would not be more suitable to use similar or maybe somewhat broader sub-CPIA component in the DSF as well, instead of relying on the broad CPIA indicator? *We would appreciate if staff could comment on this issue.*

We also note that in the previous paper (SM/09/56) staff had indicated that the concessionality requirement for low-income countries with lower capacities and higher debt vulnerability would generally be set at 50 percent or higher, whereas there is no such reference in the current proposal. *Therefore, we would like to ask staff to comment, whether we shall interpret the current proposal as somewhat loosening expectations on the general concessionality requirements for this group of countries?*