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Statement by Mr. Talbot and Mr. Ward 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 thank the Bank and Fund Staff for their papers on the Proposed New Guidelines for Debt Limits in Fund-Supported Programs and the Review of Some Aspects of the Low-Income Countries Debt Sustainability Framework.

Debt sustainability is a crucial and long-term issue, and is central to the development of low-income countries. However, it is a particularly pertinent time to review the frameworks and approaches, given the current economic crisis and the recent significant efforts to provide debt relief under the HIPC and MDRI initiatives. It is vital that LICs do not re-accumulate unsustainable levels of debt as we have seen in the past. Equally, it is essential that we do not unduly constrain countries from accessing the necessary financing to support investment and growth in their economies, which also risks alienating member countries. The challenge in striking a balance between these priorities is incredibly difficult and yet highly important. A failure to get this right – by erring too much on either side – could adversely affect the ability of countries to grow and make progress in reducing poverty and improving the quality of life for all their citizens.

We strongly welcome the acknowledgement by Staff on the tensions involved in taking, on the one hand, a rules-based approach and, on the other, a more judgmental approach. It is important that the overarching framework is neither too mechanistic and inflexible, or too subjective and lacking in transparency and accountability. We welcome the increased flexibility that has been proposed by the Staff, and *we would welcome views from the Staff on their estimates of the impact of the proposed changes and additional flexibility on countries in terms of increased borrowing and investment.*

The effectiveness of the overall approach to debt sustainability by the IFIs relies, to a large extent, on the clarity and simplicity of the framework. We have concerns that the current approach is not understood as widely or deeply as desired, and that a number of the proposed changes will increase, rather than reduce, the complexity of the approach. We therefore encourage Staff to make every effort to provide clarity and transparency for the processes and any decisions taken by the Fund or Bank. We strongly support making widely available the guidelines to the framework and also the sub-guidelines or criteria that inform the judgments of the Staff, for instance, the second stage of determining a country's capacity for debt limits and the criteria regarding state-owned enterprises. Due consideration should also be given to the impact of each proposal on others, including the implications for IDA and the Paris Club.

Debt limits

We broadly welcome the options matrix approach and consider that it supports the overarching aims of growth and debt sustainability. However, we have the following concerns and questions:

- In our statement at the March meeting, we set out our concern that average concessionality could lead to perverse incentives. We note that Staff have now confined the use of this indicator to countries considered to have high capacity and low debt vulnerabilities. However, we continue to believe that it would be more suitable to use the PV indicator throughout the options matrix. For example, under the average concessionality indicator, if a LIC received a highly concessional loan, it could then take on a subsequent large amount of non-concessional lending (potentially at an unsustainable level) without breaching the limits. In comparison, if the same LIC received a grant rather than the initial highly concessional loan, it could be in the situation whereby it would not be able to take on the same subsequent amount of non-concessional lending without breaching the limits even though the overall amount of lending was actually less. These perverse incentives and undesirable outcomes would not arise using a PV indicator. In light of this, and for the sake of simplicity in having one methodology for assessing levels of debt, we maintain the view that the PV indicator should be used for all LICs. *We invite Staff to comment on how they intend to prevent situations occurring as in the above example under their proposed framework.*

- With regard to assessing capacity, we feel that the benchmark for the first test using the CPIA and PEFA scores is too restrictive. If these are the best objective criteria to use – we note here Mr Rutayisire's concerns – the staff proposal seems to limit the number of countries too quickly. Why not consider a less restrictive threshold? *We would welcome Staff views.*

- We welcome the inclusion of a second stage in determining a country's capacity, based around the judgments of the Staff, in order to prevent an overly-mechanistic approach. However, it is very important that the Staff are entirely clear and transparent about the factors informing their judgments, and are able to adequately explain and justify their decisions. On a similar note, it is not clear to us that the PEFA data is as freely accessible as is the case with CPIA data. If PEFA is to play such a central role in determining debt limits, it will be important that these indicators and scores are widely available.

- With regard to assessing capacity, we question whether it is appropriate to set the benchmark for the first test against the CPIA and PEFA to include just the top quarter countries (and which meet the average "blend" score) rather than setting this at a lower level to include a few more countries, for instance, the top third. As just a first sift, the proposal could be considered too onerous and limiting the number of countries too quickly.

- On the sub-CPIA assessment, it seems anomalous that the efficiency of revenue mobilisation is not included as a relevant element for considering whether a country has the capacity to manage and service its debt. On the other hand, the quality of public administration is a broad indicator that goes beyond relevancy for debt management capacity. Therefore, we believe there would be merit in replacing the public administration indicator with the efficiency of revenue mobilisation indicator.

Debt Sustainability Framework

We consider that the DSF has been a useful and largely effective instrument to help guide decisions on debt by countries, creditors and international institutions. Nevertheless, we believe that it is appropriate to take stock of the framework now. In general, we welcome the proposed changes to the DSF, mainly as clarifications and modifications to improve the use of the framework, and we can agree with the majority of the recommendations. However, we have the following concerns and questions:

* On the threshold effect, we agree with Staff that increasing inertia would be preferable to introducing a new band. While a new band would reduce the size of the change in debt limits, it would only apply to countries around the middle of the distribution and by virtue of introducing an extra step could lead to an increase in the number of changes LICs would see in their debt limits over even a short period of time, which would seem to work against the original aim. However, while we agree with the inertia proposal, we share Mr Fayolle's concerns that in its current form it does not support the call for greater flexibility and instead introduces greater hurdles for countries to graduate to better performance categories. We consider this undesirable as it works against one of the key issues that we are seeking to resolve, namely ensuring debt ceilings are not overly restrictive. Therefore, we believe strong consideration should be given to the inertia only functioning when a country's CPIA score deteriorates and to leave, as at present, the treatment of LICs that would move up categories due to an improvement in their CPIA scores. *We would welcome Staff comments on this and how they propose to prevent penalizing better performing countries.*

* With regard to the frequency of updates for DSAs, we appreciate that these can be time-consuming. However in the current volatile environment and given the increasing centrality of DSAs in assessing the debt situation of countries, we believe it is important that DSAs are fully updated on a annual basis. In this regard, we would welcome clarification from the Staff that the proposal is to phase in less frequent DSAs once the global crisis is over and not before, and that less detailed updates will continue to be conducted on an annual basis, which – among other things – will help to determine whether a more detailed analysis should be conducted at that time. We also fully welcome and encourage the inclusion of countries' views either in the DSA or an accompanying document.

* We consider the public investment-growth nexus issue to be a challenging but crucial element of the DSF. We welcome the proposal from Staff to focus further on this in the future and, in particular, support the use of growth-diagnostic studies. It is, of course, essential that such studies are conducted on a case-by-case basis, taking full account of country-specific circumstances. Given the challenges in this area, we urge the Bank and the Fund to work together closely and ensure there is full sharing of analysis between the institutions, as well as drawing on the expertise of any other relevant sources.

* We agree with the proposal that there should be flexibility in considering the level of remittances to inform decisions regarding the ability of LICs to service their debt. However, we would have two main concerns in going any further: first, the current crisis has shown that remittances may be less of a shock absorber than at first glance, since they can be reduced by a common global shock. Second, as noted by Staff the data is scarce, and so we would strongly urge Staff to work with countries to identify ways to improve data.

* We agree with the proposal for some flexibility in determining whether borrowing from state-owned enterprises should be considered part of public external debt. These issues are not always straightforward. However, we would welcome the Staff's clarification that the default will be for SOEs to be included as part of the DSA and that only in clear and exceptional situations will consideration be given to taking them out of calculations. We would also support formalizing the criteria along the lines of footnote 51.

* Finally, while we can agree with the proposal to maintain the discount rate rule and reduce the current rate from 5% to 4%, we have some concerns that a reduction at this stage would run counter to efforts to ensure the DSF is not procyclical. *We would welcome Staff's views on this.*