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Statement by Mr. Pereira and Mr. De la Barra 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

1. At our March discussion on external debt limits in Fund-supported programs for low-income countries (LICs), we questioned the real objectives of this initiative and the risk of toughening that policy with the key aim of preventing the build-up of debt in light of this global crisis. Admittedly, the recessionary forces and disproportionate impact of this global crisis on LICs could be the main driver of debt explosion. Neither irresponsible spending nor excessive leverage could solely explain the burden of debt for LICs in the future ahead. The global recession is the main problem for LICs, particularly if the recovery in advanced countries proves to be weak and gradual. Thus, in a world of subdued growth and protracted financial deleveraring, we underscored the importance of allowing for ample external financing to help these countries meet their development goals. The case was made when discussing the prospects for advanced countries, who have spent and borrowed as never before to pave the way back to prosperity. For the same purposes and with the key objective of avoiding long-lasting setbacks to poverty reduction efforts, LICs need ample access to concessional external resources—including grants. Unfortunately, the lack of sufficient concessional resources precluded more fundamental changes in our lending facilities for these countries, notably in relation to access levels.

2. For today's discussion, our position and concerns remain unchanged, as we fail to see the flexibility advocated by the staff in revisiting this framework. In a nutshell, we observe that the proposed new framework for concessionality requirements is based on two basic elements: 1) tighter links between debt limits and unreformed debt sustainability analyses (DSAs); 2) stronger emphasis on "capacity" on a still brittle methodological basis as a way to ensure that resources are going to be put to good use (the so-called new guideline on debt limits). In our view, there is a risk that these changes could either serve as a device to reallocate scarce concesssional resources across LICs or reduce their contributions given "downgraded" ratings or "lower" capacity. In the best cases, the idea will be that

nonconcessional borrowing will be contracted to complement limited concessional resources. Thus, once again, the availability of concessional resources is the main problem, as advanced countries face unprecedented fiscal constraints for years to come.

3. Key for today's discussion is to assess the advocated flexibility of the proposal. We very much welcome the staff's recognition that despite the DSAs' potential usefulness, there are still significant shortcomings that need to be addressed. However, we fail to see that the two fundamental problems in the DSA framework had been adequately addressed before tightening its links with debt limits. An in-principle recognition will not suffice in times of crisis.

4. First, on the critical issue of public investment and growth nexus, the staff suggests continuing the current multi-pronged approach and promises more active research with the hope that these efforts could be incorporated in DSAs as much as possible in the future. Our understanding is that the staff will stick to the guidance provided by the Board in 2006, put more emphasis on institutional capacity and the ability to capture returns on public investment adding new indicators and come up with a new methodology to help underpin growth projections used in DSAs in the future ahead. Interestingly, we again acknowledge this deficiency in the DSAs but recognize that little can be done in the short term—at least in a broad basis—adducing dubious nexus in recent empirical literature.

5. We claim that if we understimate the impact of debt-financed investment on growth, the DSA will be too procyclical, artificially constraining the ability of LICs to finance their development goals (the so-called anti-investment bias). More recognition of the inter-temporal impact of productive public investment remains of the essence. While the quality of the investment is important, few could challenge that public investment will not increase long-term growth prospects in LICs, particularly in the case of development and social infrastructure. Methodological weaknesses explain why the literature falls short of providing unambiguous results on the size of the impact of investment on growth. Nevertheless, when we turn to physical indicators, studies show significant positive contributions.

6. Two new realities will also prove that the current framework will unduly constrain the financing needs of LICs. First, the increasing role of non-traditional sources of official financing in LICs. The bulk of financing for non-traditional partners is in support of physical infrastructure development rather than budget support. The prospect of a significant expansion in the engagement of non-traditional development partners is already palpable. Thus, DSAs need to be adapted now to take into account the growth potential offered by stepped-up financing for infrastructure development. It is disappointing that the staff report fails to mention the role and consequences of non-traditional donors.[1] Second, there is insufficient recognition of the complementarities between private and public capital, a key factor in the future in understanding possible virtuous cycles and crowding-in effects.

1 We recommend "Financing Development in Africa: the Growing Role of Non-DAC Development Partners" – G24 Secretariat, July 2008.

7. On balance, we are disappointed to see that the staff puts renewed emphasis on assessing the quality of policies and institutions rather than strengthening the analytical underpinnings of the asset-created nature of public investment.

8. Not considering the role of remittances as a key inflow that ease LICs' capacity to repay is the second big shortcoming in the staff's efforts to revamp the DSAs. Amusingly, the staff report concludes that there is strong case for taking into account remittances, but data availability precludes a more formal consideration of this issue. While concomitant of the associated operational constraints, it seems to us that the case-by-case adjustments could be marginal, as they will be considered only when there is a breach of thresholds under the baseline or stress tests if remittances proved to be large and stable. Given that these flows have become increasingly larger in LICs as a source of non-debt creating external financing in foreign exchange and that they tend to be counter-cyclical and stable, we believe that it will be important to re-estimate the thresholds at this juncture to allow LICs more room for maneuver to pursue more flexible borrowing strategies.

9. We appreciate the staff's proposal to reduce the "threshold effect" problems. Admittedly, the sensitivity of debt distress thresholds to small fluctuations of countries' country policy and institutional assessment (CPIA) scores has been long claimed. The three-years moving average CPIA rating still proves to be insufficient to avoid undue material changes in countries' debt outlook. Two alternative options are put forward. On balance, we favor increasing the granularity as it would imply smaller changes in applicable thresholds following changes in policy performance categories.

10. However, we have fundamental problems with the CPIA methodology, thus we doubt that the proposed approach will provide the needed flexibility for LICs. These "performance criteria" that try to score countries' policies with standards that resemble a one-size-fits-all has received many criticisms. It is rigid, arbitrary and backward looking. Thus, the changes introduced could be useful, but fall short, in our expectations, of a comprehensive revision of the CPIA methodology. On the contrary, in the new proposed framework, the role of sub-CPIA and public expenditure and financial accountability (PEFA) in assessing capacity seems to be strengthened.

11. We also favor the granularity approach because it could mitigate the impact of the proposed change in the discount rate. We are disappointed with the staff's proposal of keeping the rule and consequently reducing the discount rate to 4 percent in future DSAs. This will be to the detriment of LICs, as it will give rise to movements in present value that do not properly reflect LICs' debt burden. This global crisis will push LICs' debt ratios up, closer to their thresholds. By reducing the discount rate, many will unnaturally migrate to higher risks of debt distress at the time when there will be increased social and development demands and less domestic resources. We remain unconvinced that the effects from lowering the discount rate would be small on a case–by-case basis, even though the average may show

slight changes. We also would like the staff to explore an alternative rule for the future, since sudden movements in interest rates cannot be ruled out.

12. All in all, given our deep concerns about the lack of broad reforms in the DSAs, we fully support that the authorities' views be reflected in the analysis. It is critical to allow the opportunity to provide their views on issues of concern, as well as the construction of alternative scenarios based on the assumptions provided by the authorities. Similarly, we agree that state-owned enterprises that pose limited fiscal risk should be excluded from public and publicly guaranteed debt (PPG) external debt. However, the specific considerations stated in footnote 51 seem to be hard to determine. We would favor a more streamlined set of specific considerations to avoid judgments ending in asymmetries.

13. Turning to the proposed new guideline on debt limits in support to the new framework on concessionality requirements, we find no reasons for complacency. It would be difficult to better reflect the diversity of situations in LICs with the new formal framework focused on capacity performance through the same indicators (CPIA-PEFA). In previous discussions, we have claimed that assessing a country's capacity to manage public resources is a multi-dimensional and complex process that cannot easily translate into numeric indicators or thresholds.

14. For today's meeting, the staff proposes that if a country has a higher capacity, more flexible options for concessionality requirements will be provided. However, the contrary will also be true and given the sensitivity of thresholds to small changes in CPIA, we are concerned that this new approach could be used to reallocate scarce concessional resources or reduce then. In a nutshell, countries could be blamed for lower concessionality (not donors[2]) due to limited capacity despite undisputable development and financing needs. To be clear, no one put into question the need to ensure good use of concessional resources and sound accountability mechanisms to tax payers (particularly in times of distress). The key problem is how we assess that capacity (and the degree of accuracy and certainty associated with it) vis-à-vis how it could result in flawed decisions that put at risk the most vulnerable segments of the population. More precisely, we concur that donors' concerns have to be addressed in order to mitigate the risk of reduced donor aid in a period of tight fiscal constraints. Thus, we are not advocating de-linking LICs' borrowing from DSAs, but to reform it to remove rigidities which unduly restrain LICs' borrowing capacity for development. A true rebalancing of global demand to recover the engine of growth must include LICs if it intends to be sustainable and equitable.

15. In general, we remain unconvinced that the new framework to identify higher-capacity countries will benefit LICs in the context of this global crisis or result in a more precise assessment.

2) In paragraph 32 of SM/09/215, the staff asserts that the new approach to concessionality should not be perceived as an invitation (to donors) to reduce their overall efforts.

16. Last but not least, we firmly believe that the Fund needs to develop a comprehensive and uniform DSA framework for advanced countries. This is indeed a key priority, as measures to support the financial system have expanded sovereign balance sheets and risk exposures triggering systemic concerns. In recent Article IV consultations of systemically important advanced countries, the need to better assess the impact of this crisis on potential growth has been clear. It is also critical to give uniform treatment to the extensive use of guarantee facilities and the management of off-balance sheet contingent risks. *We invite the staff to comment on their work in this area.*