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Statement by Mr. Legg and Mr. Duggan 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
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We thank Fund and Bank staff for two comprehensive and high-quality papers on debt-related matters. Our comments address the issues raised in each paper in turn.

Debt Limits in Fund-Supported Programs

We attach great importance to debt sustainability in low-income countries, many of whom have received extensive debt reduction through the Paris Club, HIPC Initiative and MDRI. While an alarming number of low-income countries remain at risk of debt distress, there is a small but growing cadre of low-income countries that are successfully maintaining sustainable debt positions and have demonstrated the institutional capacity to utilize increased debt financing for development, including on non-concessional terms. Appropriately, it is this group of countries that stand to benefit from the additional flexibility in the setting of debt limits proposed by staff.

When the proposed new guidelines were discussed in March, we noted that current policies are not a constraint to setting program conditionality on non-concessional borrowing according to individual country circumstances and that DSAs are already a standard reference point in this process. Nonetheless, we can also see the benefits of introducing a standardized analytical framework to promote rigor, transparency and evenhandedness in the setting of program conditionality in this area. Therefore, we are ready to go along with the proposed framework, but would like to make five specific points on its application.

First, while the proposed framework will assist in making consistent and evenhanded decisions, it should be seen as a complement to – but not a substitute for - the professional judgment of staff. The DSA, CPIA and PEFA are useful indicators; however, we should not lose sight of the fact that other important factors are not adequately measured by these tools, some of which are mentioned in the staff paper. Therefore, we believe that the second stage of the process - where a broader range of qualitative factors will be taken into account - is critical to the overall framework.

Second, we note the statement in the staff report that "As a general rule, the size of a nonzero limit on nonconcessional borrowing in countries with lower capacity and lower debt vulnerabilities should not be so large that, if fully used, it would lead to a downgrading of the DSA risk rating" (para 21). This should be understood as, while there may be exceptional circumstances where it may be justified to set a nonzero limit that would push a country from low to moderate risk of debt distress, under no circumstances should nonzero limits be set that, if fully utilized, would push a country into high risk of debt distress.

Third, given that the CPIA incorporates factors such as the sustainability of fiscal policy and whether the debt management strategy is conducive to minimizing budgetary risks and ensuring long-term debt sustainability, our priors would be that very few countries at higher risk of debt distress would also fall into the higher capacity category. Staff's preliminary assessment supports this judgment, indicating that only two countries are currently located in this quadrant of the matrix. In our view, careful consideration should be given before a determination is made that these countries are well-placed to manage greater flexibility on the contracting of commercial debt. Similarly, we would expect conservative application of staff's proposal that lower-capacity/lower-debt-vulnerability countries - close to the CPIA/PEFA benchmarks - could be deemed eligible for untied debt limits (i.e. limits not linked to a specific project).

Fourth, while the objective is to raise the total volume of financing available to low-income countries capable of managing non-concessional debts, the risk that some creditors could see the untying of debt limits and more liberal concessionality requirements as an opportunity to provide financing on less concessional terms than might otherwise have been the case, is a real one. The only protection is how well-positioned the low-income country is to negotiate financing terms with donors and other potential creditors, where our sense is that this could be difficult to assess. Again, this is an example of a criteria that is not captured in the CPIA or PEFA where judicious judgment will be required.

Fifth, we agree that the increasing role of nonresidents in domestic debt markets in a number of low-income countries has blurred the distinction between external and domestic debt. To address this issue, we support defining debt limits on the basis of the currency of denomination, rather than the residency criterion, where appropriate.

Finally, given the considerable risks and uncertainties, we strongly support staff's proposal that experience under the proposed new approach be reviewed after a relatively short period of time, where two years strikes a reasonable balance.

Review of Aspects of the Debt Sustainability Framework

The DSF's prominence as a tool for assisting low-income countries in the management of their debts and guiding the lending practices of official creditors has increased over time, which is a credit to both the strength of the framework and the objectivity of IMF and World Bank staff in undertaking assessments. We welcome the opportunity to consider proposed refinements to the DSF in response to the request of G20 Leaders. Our reactions to each of the proposed issues for discussion are as follows.

Investment-growth nexus: There is a reasonable conceptual basis for incorporating the growth dividend of public investment in DSAs. As detailed in the staff paper, however, producing robust quantitative assessments of the growth return from public investment is a daunting and resource-intensive challenge. The empirical evidence is mixed and factors such as the quality of institutions and investment choices matter enormously. Therefore, while we can support the proposal in principle, this is on the understanding that staff will take a highly conservative approach, particularly in cases where a detailed country-specific and project-level analysis (of the type being conducted in the DRC) is absent.

Remittances: We support incorporating remittances in final risk assessments for countries where they are a stable and significant source of foreign-source income and on the basis of reliable data. Given data limitations, we agree with staff's judgment not to incorporate remittances in a re-estimation of debt sustainability thresholds at this juncture.

Addressing CPIA fluctuations: We can go along with staff's proposed Option 1, but would caution against its automatic application. Given that CPIA ratings are already subject to smoothing through the use of a 3-year moving average, we need to be careful not to ignore the information content of the most recent CPIA assessments. Therefore, if there is reason to believe that the latest movements in CPIA assessments – regardless of how large or small in numerical terms - are indicative of a material and sustained change in policies, this should be reflected in the thresholds by using the flexibility inherent in the existing DSA process.

Discount rate: To avoid the potential for unhelpful short-term noise in DSAs, we believe that further thought should be given to extending the reference period for setting the discount rate from 6 months to, say, 12 or 24 months. The discount rate should only change in response to developments that are relevant to low-income country debt burdens over the 20-year timeframe of the DSA. It is clear that the change in the long-term U.S dollar CIRR over the last 6 months is related, in part, to historically-low policy rates in the US and the flight to safety associated with a period of unprecedented market disruption. Indeed, with fledgling signs of a recovering global economy, the CIRR has already risen to above 4½ per cent.

Coverage of DSAs: The perimeter should include all debts where there is a material risk that liability will ultimately rest on the public sector balance sheet. It is also important, however, not to restrict the borrowing of financially-viable SOEs necessary to conduct their commercial activities and therefore we can support the approach proposed by staff.

While not raised specifically in this latest staff paper, we also reiterate our call for further work on incorporating domestic debt in DSAs. This work should acknowledge the contribution of prudent management of domestic debt to fiscal and overall debt sustainability objectives (where the staff paper discussed in March noted that domestic debt service payments represent about 40 per cent of low-income country total public debt service obligations), while recognizing the different risk profile and additional policy functions of domestic debt (e.g., liquidity management and developing domestic financial markets).

Finally, we support inclusion of the authorities' views in DSA documents and staff's proposal to conduct streamlined DSAs in the absence of major changes to a country's debt sustainability outlook in-between comprehensive three-yearly updates.