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Statement by Mr. von Stenglin and Mr. Dahlhaus 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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I. Debt limits in Fund supported programs

As a consequence of the current global financial crisis, several LICs have significantly higher balance-of-payments financing needs. At the same time, it must be borne in mind that around 70 percent of LICs, many of which have already received HIPC and MDRI debt relief, are at high or moderate risk of reaching unsustainable debt levels. Two conflicting concerns thus have to be balanced. On the one hand, financing needs of LICs have risen and on the other, debt sustainability should be maintained.

We welcome the fact that the reform proposal strengthens the links of the Fund's debt limit policy to the DSF and DSAs. The proposed new approach would increase flexibility for both lender and borrower, although the current debt limit policy already allowed some flexibility to be exerted. Under the new approach, it would be possible to take into account the different situations of LICs more systematically, which seems appropriate as the debt situation in LICs varies considerably.

Furthermore, the success of the DSF depends on the extent to which the framework and the individual DSAs are used as guiding tools by a wide range of creditors as well as debtor countries. By strengthening the systemic links between the DSF and its debt limit policy, the Fund fulfils its key role in promoting the effective application of the framework.

We would like to comment on the following issues:

(i) Two-step approach

We welcome the fact that macroeconomic and public financial management capacity plays a prominent role within the new approach and concur with the proposed two-step approach to measure capacity. Use of components of the CPIA Index for the preliminary assessments seems appropriate. It is consistent with the DSF since the CPIA is already used under the DSF.

In addition, the CPIA has been published and is available for nearly all LICs. The parallel use of the PEFA indices also seems appropriate to allow cross checking and to heighten the robustness of the assessment.

Yet, **the new approach is far more complicated than the approach currently in use.** There is no uniform methodology for the four different country types identified in the concessionality matrix of the new proposal and, while allowing better recognition of country-specific aspects, this works counter to comparability and uniformity of treatment across various country types. This, as well as the current Board Decision to enlarge LICs' access to Fund financing, underscores the **need for careful monitoring and makes an annual assessment of capacity as well as annual DSAs advisable.** Should an assessment suggest a deterioration in terms of vulnerabilities or capacity, staff must not shy away from lowering debt limits and/or reclassifying a country, if needed.

(ii) Question of maintaining donors incentives to provide highly concessional resources

To prevent a (renewed) debt crisis for LICs in the aftermath of the current global financial and economic crisis, reinforced access to highly concessional resources and grants is needed. In this connection, we see not merely a theoretical but a real risk that the proposed flexible options – average minimum concessionality requirements and present value targets for public debt – could negatively influence the donors' incentives to maintain lending on highly concessional terms. We would appreciate further staff suggestions on how to avoid negative incentives on top of the measures already included in the proposal. Meanwhile we suggest to limit the more flexible options, i.e. average concessionality requirement and PV of external or total public debt, to the "top performers" of the "higher capacity countries".

II. Guidelines

We can agree to the proposed reforms of the Guidelines on Performance Criteria. However, we would expect any non-observance of debt-related indicative targets to be taken seriously in the context of program reviews and to be analyzed as to whether the slippage is due to problems in the application of the new methodology or, first and foremost, due to mistakes in the country's debt policies. In addition, **we stress the need for the imbedded transitional arrangements** (Guideline 8 i) for the more complex flexible options, as the latter are still untested and must be reviewed in the light of experiences gained.

In view of the complexity of the new approach and the resulting risk of "unpleasant surprises", we call for great care in its application and support an **early review, i.e. in no less than two years' time.**

III. Review of some aspects of the LIC Debt Sustainability Framework

The DSF is essentially an analytical tool, whose integrity must be preserved in changing political and global economic environments. Therefore, the staff rightly separated the question of the effectiveness of the DSF as an analytical tool in capturing countries´ debt vulnerabilities from the question of how the results of country-specific debt sustainability analyses based on the DSF are used in the context of the lending policies of the Bank and the Fund. We concur with staff that, for the Fund, the policy on debt limits is a more appropriate vehicle for responding to the call for greater flexibility.

(i) The Investment-growth nexus

The issue of the public investment-growth nexus is an important and complex one that extends well beyond the DSF. The size of the impact of investment on growth is hard to predict; more research is in our view needed. We therefore welcome the ongoing research in these areas at the Bank and the Fund. We expect this research to ultimately help underpin growth projections used in DSAs. However, as model based approaches remain highly resource intensive and as no definitive methodology is established at this point in time, one should **refrain from hastening to include ambitious but untested methodologies in the DSAs.** Rather, one should rely on the indicators suggested in 2006 to try to take into account the quality and efficiency of public investment. Generally, the growth dividend of public investment must be judged conservatively to avoid a new lend and forgive circle.

(ii) Remittances

Workers remittances have become an increasingly important and stable source of external financing for many LICs. We agree that they can play a useful role in lessening debt vulnerabilities. However, in view of the existing deficits, further efforts to improve the quality and coverage of data are needed before considering a more formal inclusion of remittances in the DSF. We concur with staff that even without a formal inclusion of remittances flows in all DSAs there should be the flexibility to take the size of remittances into account in assigning the risk ratings in those countries where workers remittances are relatively large and may be seen as significantly supplementing domestic resources available for debt servicing.

(iii) Thresholds

In comparison to Option 2, Option 1 has the key advantage that it keeps the framework as simple / transparent as possible. However, Option 1 leads to greater inertia in a possible recognition of growing risks within the DSAs. The thresholds of the DSA are indicative ratings. Especially in the current situation, a clear and simple analysis is the necessary basis for exerting flexibility within creditors' lending policies in order to find the right balance between growing debt vulnerabilities and enlarged financing needs in many LICs. Therefore, **at this point we do not see any advantage in introducing another element to smooth the threshold effects on top of retaining the three-year moving average CPIA rating.** In this context, we would welcome it if Bank staff invested further work into fostering the quality of the CPIA, as it plays such a prominent role in the DSF.

(iv) Discount rate

As the staff rightly states, changes in the PVs on account of movements in interest rates are hard to interpret from a debt sustainability perspective. Therefore, we see the **need for a more**

general discussion on the rule setting the discount rate. At this juncture, we concur with the staff's recommendation to keep the rule and adjust the discount rate to 4 percent in new DSAs as it strikes an appropriate balance between limiting volatility while being market-based.

(v) External debt of state-owned enterprises

To some degree, this recommendation appears to be at odds with the generally rising awareness of the fiscal risks stemming from government activities not reflected in the fiscal budget. External debts of public enterprises and entities should only be excluded from the calculation of external public debt on a selective basis and in very limited cases where the government's liability is limited to its shares value and where public enterprises conduct "normal private business". All other state-owned enterprises, especially local utilities with a monopoly, should be included in the calculation, as the government has a de facto bailout responsibility.

(vi) Appropriateness of streamlined DSAs

In view of the ongoing crisis and the proposed introduction of more complex, flexible options within the debt limit policy of the IMF, a close monitoring on the basis of annual data/ analyses of LICs' debt sustainability is of great importance.

Nevertheless, in a more stable global economic environment, a streamlining of the DSAs to ease the workload could be appropriate in cases where there are no major changes in the debt sustainability outlook and program requirements.