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From: The Secretary

Subject: **2020 Review of the Policy on Public Debt Limits in Fund Supported Programs—Technical Note on Lessons and Proposed Reforms**

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Conclusions:	Page 21
Questions:	Mr. Flanagan, SPR (ext. 36724) Ms. Gold, SPR (ext. 37934) Mr. Shukurov, SPR (ext. 34458)

April 23, 2020

2020 REVIEW OF THE POLICY ON PUBLIC DEBT LIMITS IN FUND SUPPORTED PROGRAMS—TECHNICAL NOTE ON LESSONS AND PROPOSED REFORMS

Approved By
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BACKGROUND

1. **The IMF's Debt Limits Policy (DLP), dating back to the 1960s, establishes the framework for setting conditionality to address debt vulnerabilities in IMF-supported programs.** Debt conditionality is an important instrument in the Fund's toolkit, intended to complement other program conditions that help achieve macroeconomic sustainability.[1]

2. **The last review of the DLP was completed in 2014.** Reforms introduced at that time were aimed at broadening the focus of the policy and included: (i) changes to let the policy encompass both domestic and external public debt; (ii) establishing closer links between debt conditionality, debt vulnerabilities, and the capacity to adequately record and monitor debt; and (iii) allowing use of quantitative limits on external debt specified in present value terms (PV) terms (when debt reporting and monitoring capacity is adequate). Key elements of the DLP in its current form are described in Box 1.[2]

3. **This review occurs against the backdrop of a marked shift in the borrowing landscape.** Debt levels have been rising across a wide range of member countries, and in addition, there has been a marked shift in sources of external financing for LICs toward new official creditors and private capital markets.[3] As a result of rising debt and debt service, the share of countries assessed at high risk of, or in, external debt distress under the LIC DSF has more than doubled since 2013. The next section considers the context in more detail.

4. **The present review aims to assess the role of the DLP in the context of the evolving credit landscape and examine whether it has provided the right balance between making room for investment and maintaining a sustainable debt position.** The review is taking place within the five-year policy review cycle.[4] It is occurring in parallel with the World Bank's review of its Non-Concessional Borrowing Policy (NCBP). It considers whether the policy has been implemented as envisaged and effective where it has been applied, drawing some lessons to inform the review (Section on lessons from the DLP implementation).

5. **The proposals are informed by the views expressed by Directors in an informal Board session in May 2019.** They cover: (i) strengthening the link between debt conditionality and specific debt vulnerabilities; (ii) enhancing debt data disclosure; (iii) tightening guidance on concessionality; and (iv) strengthening incentives for improvements in debt management to support setting debt conditionality (Section on reform proposals).

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[1]See *Review of the Policy on Debt Limits in Fund-Supported Programs* (SM/13/53).

[2]For detailed discussion, see *Reform of the Policy on Public Debt Limits in Fund-Supported Programs—Proposed Decision and Proposed New Guidelines* (SM/14/304).

[3]See *Evolution of Public Debt Vulnerabilities in Lower Income Economies* (SM/19/292).

[4]See *Selected Streamlining Proposals Under the FY16-FY18 Medium-Term Budget—Implementation Issues* (SM/15/81).

Box 1. Key Elements of the Debt Limit Policy

Public debt conditionality is normally included in Fund arrangements when a member faces significant debt vulnerabilities or when there are merits to using debt targets instead of, or as a complement to, "above-the line" fiscal conditionality. More specifically,

- *For countries that do not normally rely on external financing on concessional terms:* Debt conditionality is implemented if significant vulnerabilities are identified in the MAC-DSA that are not adequately addressed by fiscal conditionality. Debt conditionality either takes the form of limits on total public debt or targeted debt limits, depending on the nature of debt vulnerabilities.
- *For countries that normally rely on external financing on concessional terms*: The assessment of debt vulnerabilities is informed by the LIC-DSF. For countries assessed at:
  - Low risk of external debt distress: limits on public external borrowing are not required;
  - Moderate risk of external debt distress: limits take the form either of i) a PV-limit on external debt if the capacity to record and monitor debt is assessed as adequate or ii) a nominal limit on non-concessional borrowing (NCB) if not;
  - High-risk of external debt distress: a performance criterion (PC) is typically set on the nominal level of NCB, which is set at zero, absent circumstances warranting an exception. A PC or indicative target (IT) on concessional borrowing (CB) is also included.

Two exceptions from the above specifications for high risk and moderate risk cases are provided:

- In countries where use of debt conditionality is warranted but capacity to capture and monitor the contracting of debt is weak, the PC would take the form of a limit on the accumulation of non-concessional external debt; supplemented by a memorandum item on the accumulation of concessional external debt in nominal terms.
- In countries with an open capital account and significant financial integration into international markets, a limit on total public debt accumulation could be more appropriate than a limit on external debt.

The 2014 DLP also provided guidance on debt coverage and program documentation

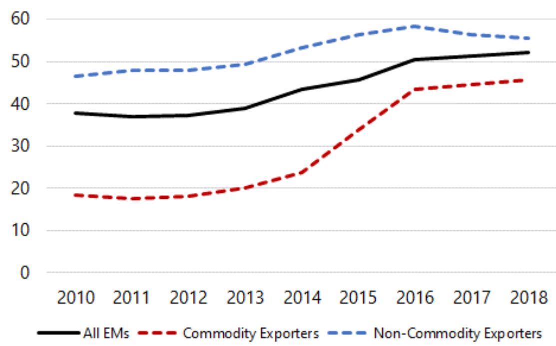
- Debt limits normally cover public and public guaranteed debt or targeted subcomponents of such debt, unless program objectives or institutional circumstances warrant otherwise.
- The policy allows for limits to be set on a contracting or disbursement basis, with a preference for a contracting basis when external financing consists mostly of project loans disbursed over an extended period (given uncertainties over the precise pace of project implementation).
- Program documents are required to include a borrowing plan used as a basis to derive quantitative limits, and to aid in the assessment of causes of any non-observance of debt conditionality and/or the case for modifications to the latter at program reviews.

CONTEXT FOR THE REVIEW

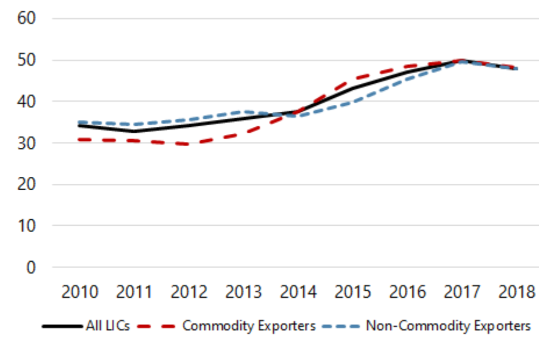
6. **Debt levels have risen markedly across a broad range of LICs and emerging market economies in recent years** (Figure 1). The median public debt-GDP ratio in LICs increased from 36 percent in 2013 to some 50 percent in 2018, with some stabilization recorded in 2017−18. The share of LICs assessed to be at high risk of, or in, external debt distress under the LIC DSF increased from 23 percent (2013) to 51 percent (2018) over this period (Figure 2). The median public debt-GDP ratio among EMs rose to 51 percent in 2018, up from 39 percent in 2013. With domestic capital market deepening in many countries, domestic public debt levels have increased relative to GDP, although the share of domestic debt in total public debt has not changed markedly (Figure 3).

Figure 1. Public Debt Developments in EMs and LICs, 2010–18

Public Debt in EMs
(Median, percent of GDP)

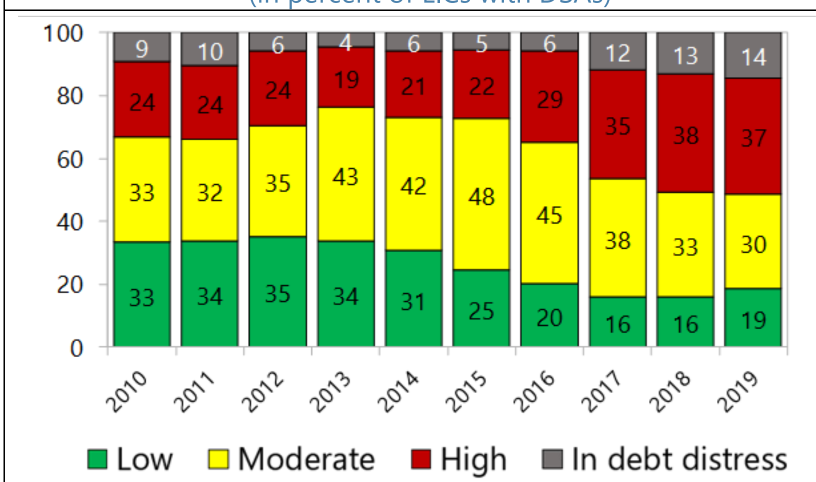


Public Debt in LICs
(Median, percent of GDP)



Sources: WEO and Fund staff calculations.

Figure 2. Evolution of the Risk of External Debt Distress
(in percent of LICs with DSAs)

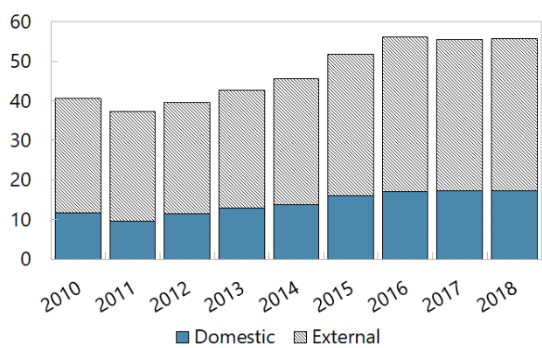


Source: LIC DSA database as of end-July 2019.

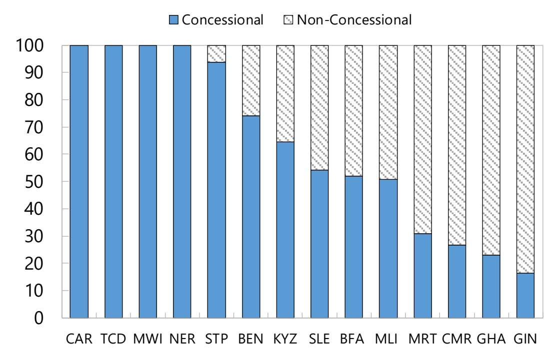
7. LICs have come to rely increasingly on non-concessional borrowing (NCB), including from private capital markets, while borrowing from non-Paris Club (NPC) bilateral creditors has also increased steadily over time.[5] Debt owed to commercial and NPC creditors (as a share of GDP) more than doubled between 2010 and 2018, with each accounting for about one-quarter of total external public debt in 2018 (Figure 3). In several recent Fund-supported programs with LICs, NCB has accounted for at least half of the planned external borrowing (Figure 4). LICs have also become increasingly reliant on domestic debt, which has risen from an average of 12 percent of GDP in 2010 to 17 percent of GDP in 2018.

Figure 3. Structure of Public Debt in LICs

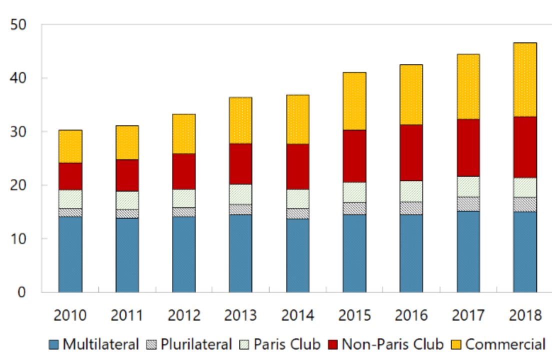
Evolution of Domestic and External Debt
(Simple average, in percent of GDP)



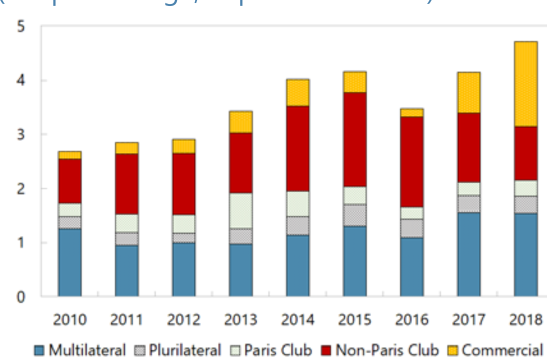
Financing Mix in the External Borrowing Plan at the Time of Program Request in Selected PRGT Programs, 2015–18
(Number of countries)



Creditor Composition: Stock of External Debt
(Simple average, in percent of GDP)



Creditor Composition: Disbursements of External Debt
(Simple average, in percent of GDP)



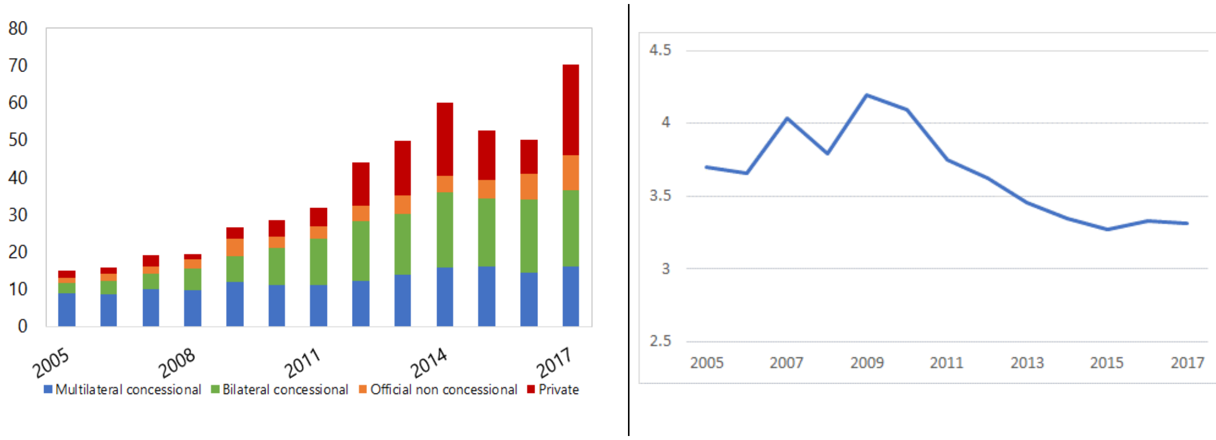
Sources: IMF staff reports, LIC DSA database, World Bank Debtor Reporting System

[5] "Concessional borrowing" refers to loans with a grant-element of at least 35 percent, evaluated at a discount rate of 5 percent; "non-concessional borrowing" refers to loans not assessed to be concessional. The term "semi-concessional" refers to loans with a positive grant element (but less than 35 percent).

Figure 4. Evolution of Financing in LICs, 2005–17

Composition of Gross External Financing (Billions of USD)

Concessional Resources (Percent of LICs GDP)



Source: World Bank.

8. The supply of concessional financing (including grants) to LICs has declined significantly as a share of LIC GDP, a mirror image to the increasing reliance on NCB. Annual official development assistance (ODA) to LICs has shown little change relative to GDP levels in donor countries in recent years but has steadily declined in relation to GDP in recipient countries, given faster trend growth in LICs (Figure 4).[6]

9. The quality and coverage of public debt data in LICs has become an increasing concern:

- Efforts to expand the coverage of public debt data to SOEs have identified sizable levels of public debt not previously captured within existing measures of public debt obligations (e.g., around 10 percent of GDP in Republic of Congo).
- PPPs have become increasingly important in a number of LICs (with one-half of this investment accounted for by three countries). PPP contracts typically involve some form of public guarantee that represents a contingent liability for the state.
- Discussions for several Fund-supported programs have highlighted the role of complex debt instruments, often entailing collateralization.

10. There have been limited improvements in debt management capacity in LICs. Progress in strengthening debt management capacity over the course of Fund-supported programs has been relatively slow (as measured by the CPIA debt policy rating).

- Four countries experienced upgrades (Burkina Faso, Madagascar, Mali, and Niger) during the program period (out of 20 countries supported by PRGT-supported programs with weak

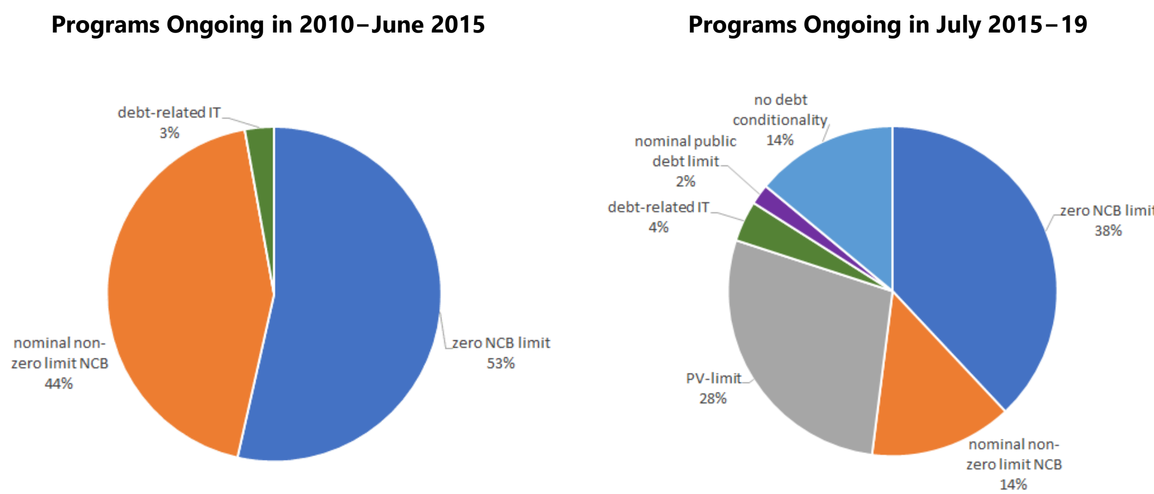
[6]The high ratio of ODA to LIC GDP observed in 2005-06 was due in good part to provision of debt relief.

capacity). Liberia and Mozambique experienced capacity downgrades after their programs concluded. This compares with four upgrades (Benin, Maldives, Myanmar, and Vanuatu) and five downgrades (Cabo Verde, Dominica, Papua New Guinea, Tajikistan, and Zambia) out of 40 PRGT-eligible countries outside of Fund-supported programs.

- The limited progress in debt management challenges may reflect deeper complexity than anticipated, and progress in building capacity could take more time (i.e., more than the typical three-year program), reflecting other more pressing priorities and limited human resources and institutional capacity.[7]

11. There have been substantial changes to debt conditionality in PRGT-supported programs, while GRA-supported programs have seen little change. The introduction of PV-limits and easing of requirements for low-risk countries meant that 28 percent of programs ongoing in July 2015–December 2019 had debt limits in the form of PV limits, and 14 percent had no debt conditionality. In GRA-supported programs, instances of quantitative debt conditionality were broadly similar, with 62 percent of programs having some form of debt conditionality in July 2015–December 2019, compared with 61 percent of programs in 2010-June 2015 (Figures 5 and 6).

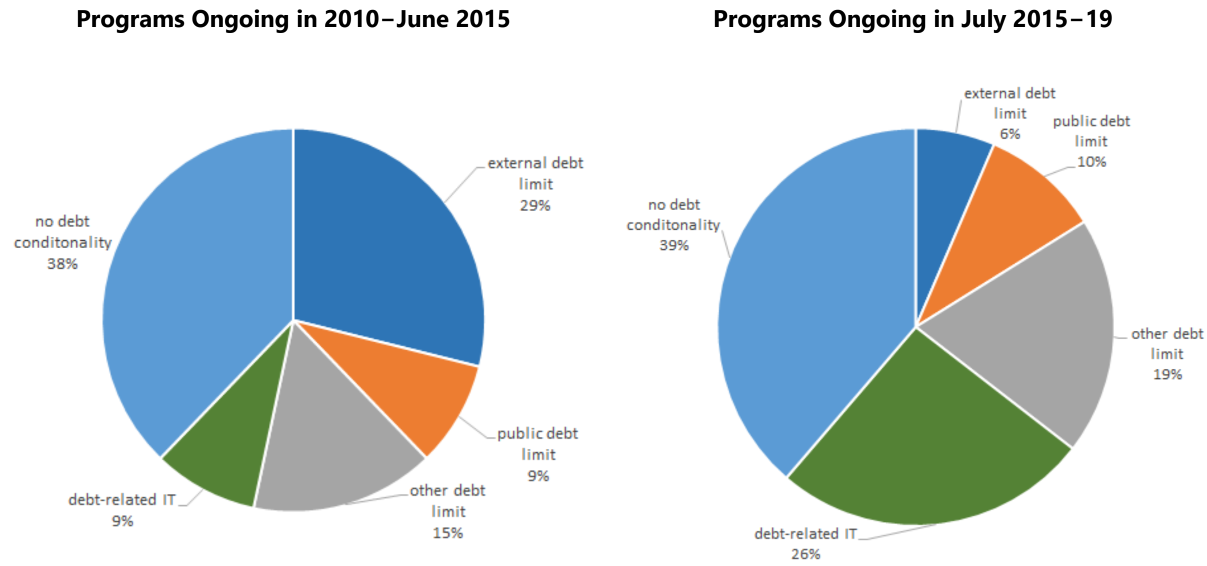
Figure 5. Debt Limits in PRGT-Supported Programs 2010–19[1]



Source: Fund staff reports.
[1]Through end-December 2019. Includes programs for which conditionality data are available, including 71 programs ongoing between 2010–June 2015 and 50 programs ongoing between July 2015–December 2019. Reflects most recent form of conditionality in a given period.

[7]13 of 15 countries supported by PRGT programs that were assessed to have weak debt management capacity are fragile and/or conflict-affected states.

Figure 6. Debt Limits in GRA-Supported Programs 2010–19[1]



Source: Fund staff reports.
[1]Through end-December 2019. Includes programs for which conditionality data are available, including 45 programs ongoing between 2010−June 2015 and 31 programs ongoing between July 2015−December 2019. Reflects most recent form of conditionality in a given period.

12. While overall debt risks have trended up, they appear to have been contained in Fund-supported programs:[8]

- *For PRGT-supported programs, the empirical evidence suggests that public debt vulnerabilities have largely been contained*. The average public debt-to-GDP ratio for countries under PRGT-supported programs has remained broadly unchanged over the course of program periods (versus significant increases for countries contemporaneously outside of PRGT-supported programs, see Figure 7).[9] PRGT-supported programs typically entailed no change in debt risk ratings (Table 1). Risk ratings deteriorated in a handful of cases, reflecting: natural disasters (Haiti); protracted debt restructuring cases (Sao Tome and Principe); fiscal slippages (Kenya, Mozambique, Sierra Leone);[10] and liquidity pressures following commodity price and security shocks (Chad).

[8]The sample considered here includes 81 Fund-supported programs ongoing between July 2015 and December 2019: 50 programs supported by the PRGT ("PRGT-supported programs") and 31 programs supported by the GRA ("GRA-supported programs").

[9]The 2018 Review of Program Design and Conditionality found that actual debt ratios in Fund-supported programs exceeded *program projections* by large margins. In this paper, staff has analyzed actual debt ratios in PRGT and GRA programs versus actual debt ratios in pre-programs and non-programs.

[10]In Mozambique, the fiscal slippage occurred through non-transparent off-budget operations.

- *Debt vulnerabilities appear to have been reduced in most GRA-supported programs*. The average public debt-to-GDP ratio declined in countries under GRA-supported programs, while debt ratios in countries not in GRA-supported programs increased (Figure 8). However, in some countries, public debt-to-GDP increased after program approval due to weaker-than-expected GDP growth, fiscal slippages, as well as currency depreciations (e.g., Angola, Argentina, Georgia, Jordan, and Tunisia).

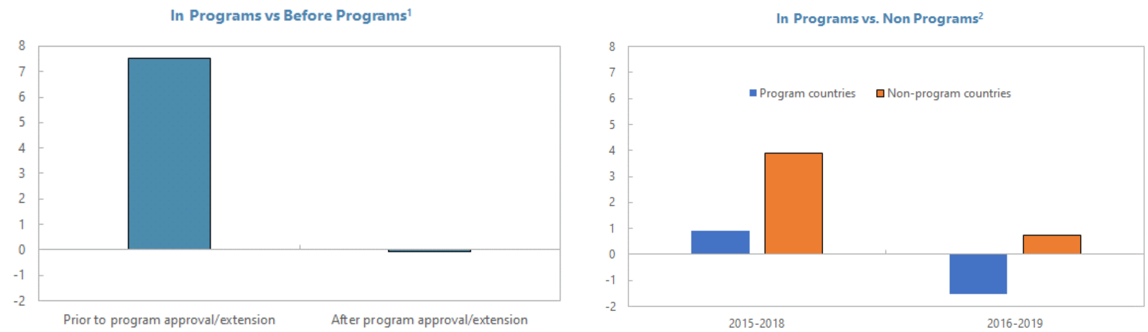
13. Strong adherence to debt and fiscal conditionality contributed to the positive track record of containing debt vulnerabilities.[11] In general, there has been a strong record of adherence to debt conditionality, with relatively tight implementation (reflecting few modifications and exceptions).[12] Between 2015 and December 2019, there were only eight cases of non-observance of debt limit PCs, with about half reflecting weak management or internal reporting issues.[13] Where these non-observance cases were meaningful, the program targets were subsequently revised to address the underlying factors, or to limit space for new borrowing, and none of these PRGT-supported programs saw debt vulnerabilities deteriorate. In the few programs that have gone off track, the primary drivers were related to external or exogenous shocks or fiscal performance.

[11]Given the modest number of cases, it is not possible to provide econometric evidence on the impact of debt conditionality on debt vulnerabilities.

[12]The compliance rate for fiscal QPCs has been over 80 percent over our sample period, while that for debt QPCs stands close to 95 percent.

[13]Reasons for non-observance of debt limits included weak public financial management and debt monitoring (Cameroon, 2017 (two occasions); Iraq, 2016; Malawi, 2018; Mauritania, 2017); and reporting slippages (Guinea, 2017; Liberia, 2015; Mozambique, 2015). Out of four programs that went off-track—Haiti 2015, Mozambique 2015, and Sierra Leone 2017 before the first review, and Kenya 2015 after the second review—one case was because of non-observance of the program debt limit (Mozambique, 2015).

Figure 7. Change in Public Debt Levels in PRGT-eligible Countries Over a Three-year Period
(average percentage points of GDP)

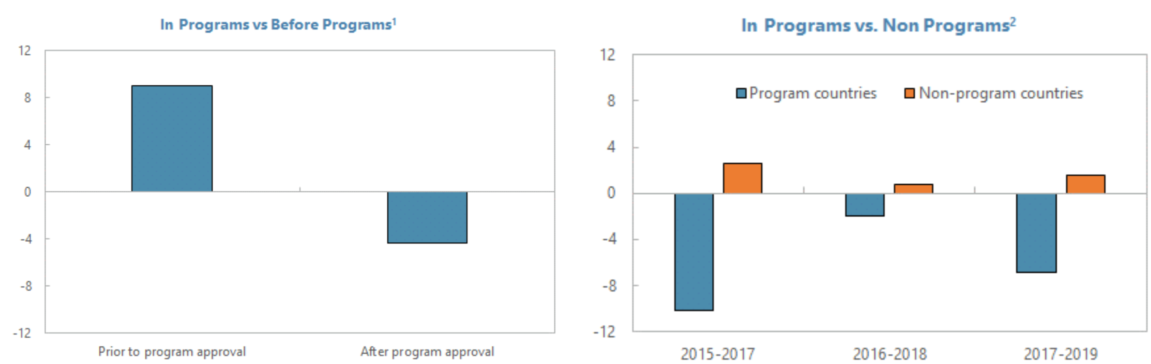


Source: WEO.

[1]Includes PRGT programs for which three years of data are available: Liberia, Mali, Guinea-Bissau, São Tomé and Príncipe, Ghana, Kyrgyz Republic, Afghanistan, Central African Republic, Côte d'Ivoire, Madagascar. Excludes programs that did not complete more than one review and countries at low risk of debt distress. The change is calculated from three years before/after program approval year.

[2]Program country groupings based on approval/extension year and for which three years of data are available: 2015-18 (Liberia, Mali, Guinea-Bissau, São Tomé and Príncipe, Ghana, Kyrgyz Republic); 2016-19 (Afghanistan, Central African Republic, Côte d'Ivoire, Madagascar). The change is calculated (i) from three years after program approval year for program countries (i.e., 2015 and 2016); and (ii) over 2015-2018 and 2016-19 for non-program countries.

Figure 8. Change in Public Debt Levels in MAC DSA Countries Over a Two-year Period
(average percentage points of GDP)



Source: WEO.
[1]Includes GRA programs for which two years of data are available: Egypt, Gabon, Georgia, Iraq, Jamaica, Jordan, Kosovo, Morocco, Seychelles, Serbia, Sri Lanka, Tunisia, Ukraine. Excludes programs that did not complete more than one review. The change is calculated from two years before/after program approval year.
[2]Program country groupings based on approval year for which data are available: 2015–17 (Serbia, Ukraine), 2016–18 (Egypt, Iraq, Jamaica, Jordan, Kosovo, Morocco, Sri Lanka, Tunisia), 2017–19 (Gabon, Georgia, Seychelles). The change is calculated (i) from two years after program approval year for program countries (i.e., 2015, 2016, and 2017); and (ii) over 2015–17, 2016–18, and 2017–19 for non-program countries.

Table 1. Risk of External Debt Distress Ratings during IMF-Supported Programs in LICs

Country	Program Approval Year	T	T+1	T+2	T+3	T+4	T+5
Grenada	2014	D	D	D	D		
Chad	2017	D	H	H			
Republic of Congo	2019	D	D				
Sao Tome & Principe	2015	H	H	H	D		
Afghanistan	2016	H	H	H	H		
Cameroon	2017	H	H				
Central African Republic	2016	H	H	H	H		
Chad	2014	H	H	H			
Ghana	2015	H	H	H	H	H	
Mauritania	2017	H	H	H			
Sierra Leone	2018	H					
Ethiopia	2019	H					
Cabo Verde	2019	H					
Central African Republic	2019	H					
Mozambique	2015	M			D	D	
Haiti	2015	M	H				
Sierra Leone	2017	M	H				
Benin	2017	M	M	M			
Burkina Faso	2018	M					
Cote d'Ivoire	2016	M	M	M	M		
Guinea	2017	M	M	M			
Guinea-Bissau	2015	M	M	M	M		
Kyrgyz Republic	2015	M	M	M	m	M	
Malawi	2018	M	M				
Mali	2013	M	M	M	M	M	M
Mali	2019	M					
Mozambique	2013	M	M				
Niger	2017	M	M	M			
Togo	2017	M	M	M			
Honduras	2014	M	M		M	M	
Madagascar	2016	M	M	M	L	L	
Liberia	2019	M					
Kenya	2016	L		M	M		
Liberia	2012	L	L	L	M	M	M
Kenya	2015	L					
Moldova	2016	L	L		L		
Rwanda	2013	L	L	L			
Rwanda	2016	L	L	L	L		
Senegal	2015	L	L	L	L		
Tanzania	2014	L	L	L	L		L
Uganda	2013	L		L	L		
Honduras	2019	L					

Source: Joint IMF and World Bank LIC DSF Database.

LESSONS FROM IMPLEMENTATION OF THE DLP SINCE JULY 2015

14. Based upon the review of implementation of the 2014 DLP, staff has identified five lessons:

A. One Size Does Not Fit All

15. With the evolving credit landscape, some changes have emerged within the set of countries that normally rely on official external concessional borrowing.

- Most countries continue to rely on a mix of concessional and non-concessional borrowing from official sector lenders. The scale of NCB has increased in many countries over time, underscoring the importance of having a sound mechanism for determining when NCB is warranted in those cases where conditionality continues to take the form of limits on NCB.

- There are some countries that have also begun to access international capital markets on a significant scale for general budget financing purposes, whose borrowing plans envisage continued tapping of capital markets during Fund-supported programs.[14]

16. For this second sub-group of countries, there is an anomaly in the current policy framework: where such countries are at high risk of debt distress, the policy is that NCB can be accommodated only under exceptional circumstances, yet external financing from private capital markets can be embedded in program design (with improved terms for market access typically an important program objective). In principle, this situation can be managed through repeated use of the "debt management operations" exception, but this process has proven to be cumbersome in practice with potentially long lead times (given the timing of reviews) that do not align well with changing market conditions. This has had unintended consequences, including creating a bias towards reliance on more expensive domestic or regional (in currency zones) financing and creating difficulties for debt management operations and issuances. For moderate risk countries in the second sub-group, the current policy has some additional leeway—allowing the use of a limit on total nominal public debt as a standard limit—but this is the right tailoring in only very specific circumstances (i.e., in cases where there is substantial foreign investor participation in the domestic bond market).[15]

[14]Note that this grouping of countries includes, but is not limited to, the "countries with an open capital account and significant financial integration into international markets" under the current policy.

[15]This option has been chosen in only one case (Kenya).

B. There are Debt Data Disclosure Gaps

17. Debt vulnerabilities increasingly stem from public sector activities outside the perimeter of fiscal/debt coverage:

- *PPPs:* While more countries have been using PPPs as a potentially useful tool in meeting infrastructure needs, mission chiefs have noted that the use of PPP arrangements was, in some cases, motivated by a desire to shift debt obligations off the public balance sheet (and possibly circumvent debt limits) rather than by wider efficiency objectives. PPP agreements in countries subject to NCB limits have increased by an average of 0.8 percent of GDP since program inception, compared with 0.4 percent of GDP for periods of similar duration prior to the program.[16] In response to an increased usage of PPPs, some Fund-supported programs introduced additional conditionality to limit PPPs (Burkina Faso 2018), or MEFP commitments to suspend the development of new PPPs (Niger 2016).

- *SOEs and SPVs*: In some Fund-supported programs, SOEs carrying large fiscal risks were not covered by conditionality and borrowing by these entities has increased (Cameroon). Also, special purpose vehicles (SPV) have been structured in such a way that appears to remove the government from legal obligations but may still involve an implicit contingent liability (Ghana).

18. In addition, incomplete disclosure of borrowing terms/conditions to staff can impair a full assessment of vulnerabilities. See the cases of Angola and Ecuador, where collateral(-like) structures complicated the assessment. Obtaining information on these activities is critical, and the Fund's policies allow this. While this was done in Angola and Ecuador, it has not been routine. Tackling vulnerabilities that can become evident through greater data disclosure to staff may not be easily achieved through fiscal conditionality.

C. The Shift to Use of PV Limits in Cases of Countries at Moderate Risk of Debt Distress has been More Modest than Anticipated

19. With hindsight, the requirements for accessing PV-limits have been too demanding. The methodology for assessing debt recording/monitoring capacity introduced in 2014 captures broad debt management competencies, not only the narrow issue of capacity to record/monitor debt (which is the relevant factor for assessing whether quantitative conditionality on aggregate debt levels can be deployed).[17] The CPIA debt policy rating that features in the methodology covers not merely monitoring capacity but also such factors as to whether the debt management strategy is conducive to minimizing budgetary risks and ensuring long-term debt sustainability.

[16] Statistics based upon data from the World Bank's *Private Participation in Infrastructure Database*.

[17] See IMF (2014), Annex III.

20. This helps explain why a shrinking minority of countries at moderate/high risk of debt distress have been deemed to have adequate capacity to record/monitor debt. The decline, from 43 percent in 2016/17) to 33 percent (in 2018/19), is due mainly to reassessments of countries that have been downgraded to high risk. This evolution is consistent with an erosion of the quality of debt management policies (tracked by the CPIA debt policy score), but there is no evidence to suggest that it is grounded in any weakening in pure recording/monitoring capacity.

D. There were Few Cases of NCB in IMF-Supported Programs where NCB was Possible

21. Access to NCB was tightly restricted in both high risk and moderate risk countries. Aside from those countries tapping bond markets, exceptions were granted in only two out of nine (high risk) cases where a zero NCB limit is presumed (Cameroon, Mauritania). In these two cases, exceptions were granted repeatedly. In the five (moderate risk) cases where NCB is not presumed to be zero, NCB was set at zero throughout the IMF-supported program in three cases (Guinea-Bissau, Malawi, Togo), with no exceptions. This very uneven distribution of exceptions suggests that the policy is not being implemented in an even-handed manner.

22. The guidance on when to accommodate NCB exceptions for high risk cases may have been difficult to interpret.[18] Scarcity of cases and experience in the inter-departmental review process indicate this is a problem area. For projects, exceptions can be granted when they are considered integral to the authorities' development program and concessional financing is not available, but the current policy provides little guidance on how to assess this. In addition, there is little guidance on how to assess the debt sustainability implications for projects, and the current policy is silent on how to handle repeated requests for project exceptions. For debt management operations, exceptions can be granted when they improve the overall debt profile—but what constitutes such an improvement is not well-specified. Overall, the lack of clarity on exceptions has made policy implementation difficult for the authorities to understand and for staff to explain.

[18]The existing guidance states that non-zero limits on non-concessional external borrowing may be allowed only under exceptional circumstances where: "a) financing is needed for a project integral to the authorities' development program for which concessional financing is not available or b) non-concessional borrowing is used for debt management operations that improve the overall public debt profile." (see paragraph 35 in Staff Guidance Note on the Implementation of Public Debt Limits in Fund-Supported Programs).

E. Definition of Concessionality

23. Issues arise in both non-standard financing arrangements and in high-vulnerability debt cases:

- There is an issue with non-conventional project financing packages where the grant element is to be provided in kind. While experience with these is limited to date, it has revealed that such packages are difficult to evaluate, since they typically do not follow standard competitive procurement procedures, and the concessional element may be cross-financed by over-invoicing in other dimensions of a broader deal. The use of (unrelated) collateral presents a similar evaluation challenge:[19] the use of collateral can lead to better loan terms and conditions, but the standard method of estimating the PV of debt (using a 5 percent discount rate) takes no account of the value of the collateral given.

- The high concessionality tool, where concessionality for program purposes can be defined to entail a grant element in excess of 35 percent (for use in particularly vulnerable debt situations), has been used very infrequently, with only two cases recorded since July 2015 (Afghanistan, CAR). The tool has not been used in other country cases with similar economic conditions, raising questions about evenhandedness of application. Evidence is scant that it led to a meaningful increase in the concessionality of financing (which for many donors was already pre-determined by the DSA rating).

REFORM PROPOSALS

24. The overall picture suggests that some modifications are needed to ensure that the policy provides the right balance between sustainable development and finance in countries that normally rely on concessional external financing. The lessons discussed in the previous section point to five reform themes: (a) accommodating the special circumstances of countries that continue to rely on concessional external financing but are also tapping international capital markets; (b) enhancing debt data disclosure to staff; (c) embedding a new approach to debt recording/monitoring capacity; (d) clarifying the policy for accommodating NCB; and (e) adjusting the definition of concessionality. The proposed reforms aim to provide flexibility where warranted and to provide safeguards where warranted, without a bias in either direction.

A. Improving the Policy's Fit to Country-Specific Circumstances

25. The discussion above has highlighted a problem of insufficiently tailored conditionality for countries that normally rely on official concessional external financing but also tap international capital markets on a regular basis.

[19]Collateral is "unrelated" when it has no relationship to a project financed by the loan. An example would be borrowing to finance the budget deficit, collateralized by oil revenue receipts.

- It is proposed that for such cases, countries at high and moderate risk of debt distress would be subject to (as a default assumption) a PV limit on public external borrowing (allowing external financing to evolve within an overall debt envelope). Country teams would have the flexibility to use alternative formulations if the case can be made that these are better tailored to address critical vulnerabilities.[20] An example could be a PC limit on the amount of (net) external borrowing for general budgetary purposes envisaged, alongside a non-zero limit on NCB for project finance. As an alternative example, an overall limit on public debt could be a preferred choice in cases where there is substantial foreign investor participation in the domestic bond market (as is currently allowed for under some circumstances).[21]

- To be eligible for such treatment, countries would need to meet the following conditions: i) the country has had significant access to international capital markets in recent years,[22] ii) access to these markets is an inherent element of the member's borrowing plan under the proposed program, and iii) the member has demonstrated the capability to manage market borrowing (as reflected in the existence of a Medium-Term Debt Strategy (MTDS) and an actively updated annual borrowing plan).

26. This reform would be expected to deliver several benefits: better alignment of program conditionality with the country's financing mix; eliminating inconsistency of program design in countries that expect to continue tapping international capital markets; and incentivizing countries seeking such treatment to improve debt management capacity.

B. Enhancing Debt Data Disclosure to Staff

27. In light of disclosure concerns, staff proposes to strengthen guidance on pursuing adequate debt-related information. Thus, the policy would introduce an explicit expectation that critical debt data disclosure gaps would be addressed upfront in Fund-supported programs (e.g., the recent case of Angola). In line with the Guidelines on Conditionality, prior actions could be appropriate for this purpose, which would also bring the Fund's misreporting policy into play. Where capacity limitations impair upfront disclosure to staff, additional debt-related information would be pursued during the IMF-supported program, using structural benchmarks where warranted and operating in close coordination with the World Bank under its Sustainable Development Financing Policy (SDFP)).

28. Teams would be encouraged through guidance to pursue a risk-based approach. Efforts would need to focus on improving disclosure to staff in areas where debt vulnerabilities (e.g.,

[20]Identification of vulnerabilities would be informed by the DSA and staff judgement.

[21]Current staff guidance limits use of this option to situations where the country is at moderate risk of debt distress.

[22]As a working hypothesis, drawing on principles similar for those used for determining market access for PRGT blending and graduation purposes, "significant access to international capital markets" could entail cumulative borrowing of at least 50 percent of quota in at least two of the preceding three years. This access definition could also be met if the program assumes international capital market financing of at least 100 percent of quota over the course of the program period.

collateral) are most likely to occur, and the Guidance Note would define red flags to signal when to pursue this (e.g., the existence of large state-owned enterprises with significant liabilities).

29. This reform would be expected to deliver several benefits. Better information would provide a more comprehensive picture of debt-related risks and reveal debt vulnerabilities that could be targeted with debt conditionality (e.g., collateral exposures that create risks). It would furthermore strengthen program design and improve complementarity with fiscal conditionality, while facilitating the design of appropriate safeguards in Fund-supported programs.

C. New Approach to Debt Recording/Monitoring Capacity

30. There would be a general expectation that the capacity of countries to monitor/record the incurring of debt is adequate for the purposes of setting conditionality on aggregate debt levels (including in present value terms), unless staff assesses that a member's capacity is not adequate. In cases where the capacity is not deemed to be adequate (and staff would need to justify such a determination in the staff report), the current NCB-based policy regime would be retained.[23] The broader use of PV limits that should ensue for this change is consistent with the thrust of the 2014 DLP reforms, and would build on the experience and capacity that countries have had to acquire in in reporting on concessional borrowing (CB) (all PRGT-supported programs with countries with weak debt recording/monitoring capacity have included a memo item on CB since 2015).

31. The expected increase in the number of countries (at moderate risk of debt distress) making use of PV limits would be accompanied by a safeguard to flag cases where there is a significant risk that shocks push moderate risk countries into a high risk or distress situation. Balance is needed here, as insurance against what are possibly low probability events can have a restraining impact on desirable development. Specifically, staff would propose the introduction of stronger guidance on the scrutiny of borrowing plans when: (i) a country is classified at moderate risk with limited space to absorb shocks; and (ii) the country DSA and RAM point to a plausible shock that could have a large impact.[24]

32. These reforms would be expected to deliver several benefits. The proposal would expand the flexibility provided by PV limits to a wider set of countries. It would provide the countries with incentives to optimize the terms of their borrowing (as they can borrow greater volumes if it comes at higher concessionality), while eliminating distortive threshold effects (currently, all financing provided at a rate of concessionality even slightly below 35 percent is considered as non-concessional). At the same time, enhanced monitoring for countries with limited space to absorb shocks would provide a safeguard (see above).

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[23]Guidance on how to assess the adequacy of monitoring/recording capacity would be provided in the new guidance note on the debt limits policy; the assessment would not entail use of the CPIA indicator.

[24]The Guidance Note would elaborate. One type of scrutiny could be the degree of flexibility in the borrowing plan (adequate flexibility in project execution would help countries manage shocks).

D. Clarification of the Policies for Accommodating NCB

33. Subject to the exception discussed in sub-section A above, staff proposes to retain the presumption of a zero limit on NCB in countries assessed to be at high risk of debt distress, while providing greater clarity on the circumstances under which exceptions to this rule would be accommodated. The enhanced guidance would address exceptions for projects and for debt management operations. DSAs would be brought into the assessment and used to: (i) inform a (required) indicative target on the PV of external borrowing (replacing, in the absence of capacity constraints, the existing memo item on CB or PC/IT on CB); and (ii) guide what constitutes an "improvement in the overall public debt profile" in the context of debt management operations. With respect to projects, staff proposes to use existing good practices to clarify when projects are "integral to the authorities' development program for which concessional financing is not available" (see Box 2). In case project exceptions are sought repeatedly, guidance would emphasize the need for a fresh assessment of the criteria (whereby evidence of past misuse of exceptions would be a reason to set a higher bar). In cases where a country repeatedly requests debt management exceptions, teams should assess whether this could be a signal that the country should be recast as a country that accesses international capital markets for general budget financing purposes (for which zero NCB-limits form a poor fit).

Box 2. Clarifying Guidance on NCB Exceptions

Clarifying guidance on what is critical for national development

- Signals to determine what is critical for national development could include at least one of the following:[1]
  - The project is commercial in nature (e.g. a joint venture);
  - The project is part of an existing Public Sector Investment Program (PSIP) or a national development plan (NDP);
  - The project is endorsed/undertaken by an MDB;
  - The country is assessed as an adequate performer under the Public Investment Management Assessment (PIMA) (if available).[2]

Establishing no alternative concessional financing

- Signals that could readily be achieved by country authorities could include any of the following:
  - a recent donor conference;
  - recent policy/program consultations with key development partners that provide concessional funding (such as the World Bank, regional development banks, and bilateral development agencies);
  - the recent transmission of documentation from the country authorities to MDB(s) on development priorities;
  - an explicit indication that MDB(s) cannot provide concessional financing to the country in question.

[1]Where questions arise about one signal—e.g., about the quality of a PSIP or NDP—a second signal would be expected.

[2]The Guidance will specify what an "adequate" performer is under the PIMA.

34. This reform would be expected to have several benefits. It would strengthen the Fund's ability to strike the right balance when considering whether NCB exceptions should be granted (and in what volume). It would furthermore make the process more transparent and consistent across all applicable cases, while making it easier to explain to the authorities, the Executive Board, and staff.

35. The revised policy for countries that normally rely on official concessional external financing would also preserve the possibility to add conditionality to address specific vulnerabilities. This could include, but would not be limited to, problems with domestic debt vulnerabilities, collateral, or specific contingent liabilities (e.g., from SOEs/PPPs).[25]

E. Adjusting the Definition of Concessionality

36. The review would make three proposals:[26]

- **Blended financing arrangements that include the provision of resources in kind, would be treated as non-concessional with zero grant element.**
- **Similarly, financing involving collateral would be treated as non-concessional** (with zero grant element) if the collateral is unrelated to the transaction being assessed (to be defined in guidance).[27]
- **Staff also proposes eliminating the "high concessionality tool".** Under this proposal, the standard concessionality threshold would apply to all cases (35 percent). A higher threshold would be allowed in debt resolution cases, when this is deemed an integral part of restoring sustainability.

37. These reforms would be expected to have several benefits. They would be expected to prevent circumvention of debt limits by properly reflecting the higher costs of the transactions, while simultaneously creating greater clarity for the evaluation of such transactions. Finally, maintaining only one definition of concessionality would simplify the framework (with little, if any, loss in terms of ability to catalyze concessional financing).

DEBT MANAGEMENT CONSIDERATIONS

38. Debt management considerations potentially interact with staff's ability to establish debt conditionality. Countries need adequate capacity to monitor the contracting of debt, which staff assesses to be within the reach of the majority of countries. Where the capacity can be

[25]While staff are not to intervene in debt restructuring negotiations, they can advise both the debtors and creditors as to what is required to restore sustainability, as this is a critical condition for Fund financial support (to ensure that the country would have the capacity to repay the Fund).

[26]The Guidance Note would also consider the guidelines on financing packages, which have proven complex and difficult to administer.

[27]Note that whether a collateralized transaction would be subject to conditionality would be a case-by-case consideration based on the criticality of the vulnerability potentially created.

demonstrated to be lacking, the existing approach to conditionality can be applied. An updated borrowing plan is an important input into the design of an IMF-supported program. An MTDS and a related annual borrowing plan are important steps toward managing market borrowing and, under the proposed policy, would be a requirement for using the approach to conditionality for countries that normally rely on official concessional external financing and have significant access to international capital markets.

39. Where debt management problems are identified: there would be a continued expectation that there will be program measures to address them. However, other priorities could limit progress in this area, since any conditionality must pass standard criticality and parsimony tests (to be assessed case-by-case). Where Fund-supported programs could not accommodate specific debt management reforms due to other priorities, there would be opportunities for the World Bank to consider supporting such reforms under the proposed SDFP.

SUMMARY AND EVALUATION

40. Under the reform possibilities discussed, the architecture of the DLP would evolve, but not radically. Fund policy already encourages a focus on debt data disclosure issues (and this has been happening of late); the current DLP already envisions the use of PV limits in some cases; the current DLP already contemplates non-zero NCB limits (through exceptions); and there is already some (limited) tailoring for countries integrated to international capital markets. In some sense, the proposed direction of reform attempts to make the successful practices in these areas more standard. Table 3 compares the existing and proposed policies.

41. Overall the reforms would provide countries with more flexibility to manage their debt situation where appropriate, whilst installing safeguards to ensure debt sustainability. Table 2 provides a high-level overview of the reform proposal, along these lines.

Table 2. High-Level Summary of Proposals

	Reforms provide more flexibility where appropriate…	… subject to safeguards
Moderate risk countries	PC on PV limits of external borrowing would be used in more countries, providing incentives to maximize concessional financing and eliminating distortive threshold effects	Higher scrutiny would be required when the borrowing plan places the country in a "limited space to absorb shocks" category (to be defined in the Guidance)[1]
High risk countries	Higher demand for NCB exceptions in countries that do not have significant access to international capital markets is likely given the shift in the credit landscape; a clear framework would help ensure that these are made available to finance critical projects or debt management operations that improve debt profile/PV PC on PV limits of external borrowing would be used in countries that have significant access to international capital markets	IT on PV limits of external borrowing in countries that do not have significant access to international capital markets would help prevent the use of exceptions leading to an excessive accumulation of debt Safeguards would be introduced concerning repeated use of NCB exceptions in these countries Conditions for using tailored conditionality in countries that have significant access to international capital markets
All countries		Greater debt data disclosure to staff and tighter concessionality definition

[1]A borrowing plan should not move a country to high risk as at present.

Table 3. Current and Proposed DLP: Countries that Normally Rely on Official Concessional External Financing

DSA Rating	**Current Policy**[1]			**Proposed Policy**[2]	
	Weak capacity to record/monitor debt	**Adequate capacity to record/monitor debt**		**Adequate capacity to record/monitor debt**	
		No significant links to international capital markets	Significant links to international capital markets	No significant access to international capital markets	Significant access to international capital markets
Low	None except targeted if needed			None except targeted if needed	
Moderate	PC on nominal NCB CB memo item	PC on PV of external borrowing	PC on PV of external borrowing Or PC on total public debt accumulation	PC on PV of external borrowing (in most cases)	PC on PV of external borrowing[3] (but alternatives should be utilized if better targeted to vulnerabilities)
High	PC on zero NCB (with exceptions for critical projects/debt management) CB memo item	PC on zero NCB (with exceptions for critical projects/debt management) PC or IT on CB	PC on zero *foreign currency* NCB (with exceptions for critical projects/debt management) PC or IT on *foreign*	PC on zero NCB (with exceptions for critical projects/debt management)[4] IT or PC on PV of external borrowing	PC on PV of external borrowing (but alternatives should be utilized if better targeted to vulnerabilities)[3]

[1]Debt limits targeted to a specific critical source of debt vulnerability may be used regardless of risk category.
[2]Where the country team determines that there is weak capacity to monitor the incurring of all forms of debt, the current "weak capacity" regime would apply, supported by a more focused capacity building effort.
[3]Limits can be set on the currency basis if accurate high-frequency data on external borrowing is not available because of foreign investors moving in and out of domestic instruments, as well as between domestic-currency and foreign-currency bond issues.
[4]The process of granting NCB exceptions would be more transparent and consistent across countries.