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DEBT SUSTAINABILITY FRAMEWORK

For: **Review**

Note to Executive Board Directors

This document is submitted for review by the Executive Board.

To make the best use of time available at Executive Board sessions, Directors are invited to contact the following focal point with any technical questions about this document before the session.

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DEBT SUSTAINABILITY FRAMEWORK

Background

1. The report of the Consultation on the Seventh Replenishment of IFAD's Resources, as adopted by the Governing Council in February 2006, recommended that:

(a) Commencing in 2007, IFAD should adopt the International Development Association (IDA) model of a debt sustainability framework to govern the allocation of assistance to countries eligible for highly concessional assistance and with high-to-moderate debt-distress risk.

(b) The relevant articles of the Agreement Establishing IFAD should be amended to allow the operation of the debt sustainability framework.

(c) The debt sustainability framework adopted by IFAD should be based on technical economic country analyses (indicative debt-burden thresholds) of debt-distress risk (and, eventually, 20-year forward-looking analyses of debt sustainability) produced by the relevant international institutions competent in that area, i.e. the International Monetary Fund (IMF) and the World Bank, working in collaboration with the countries concerned.

(d) IFAD Member States, and particularly those that are major contributors of official development assistance, should agree to compensate IFAD fully for principal repayments forgone as a result of application of the debt sustainability framework within a pay-as-you-go mechanism, as adopted for the fourteenth replenishment of IDA (IDA 14).

(e) IFAD management should submit to the Executive Board in September 2006 proposals for the operation of the debt sustainability framework, including provisions for: reporting on progress; the share and implications for IFAD's finances; the implications for IFAD's disbursements to developing countries; the implementation of the appropriate modified volume approach for the generation of compensation for service charges forgone; and IFAD's participation in collaboration among multilateral financing institutions to refine and review methodologies used under the debt sustainability framework, as well as calibration of IFAD's approach with the approaches of other international financial institutions.

Developments Since the Adoption of the Consultation Report

2. Subsequent to the adoption of the report, a number of important developments have occurred, including:

- effectiveness of the Multilateral Debt Relief Initiative (MDRI) at the IMF, IDA and African Development Bank following adoption of the debt sustainability framework;

- plans for managing the "free-rider" issue by IDA under the MDRI and the debt sustainability framework; and

- plans for revision of the methodology for assessment of debt sustainability in conjunction with the mid-term review of IDA 14.

3. **The effect of the MDRI on the debt sustainability framework.** The debt sustainability framework (DSF) is an instrument for controlling the sustainability of the external debt of poor developing countries by reducing the risk of future debt distress and debt repayment difficulties through offering development assistance on grant terms at a level discounted from initial allocations under the performance-based allocation system (PBAS). Debt sustainability was initially defined in terms of two sets of country variables: key debt ratios (net present value of debt to exports; net present value of debt to GDP; and debt service to exports); and IDA country policy and institutional assessment (CPIA) scores. Subsequently, forward-looking debt sustainability analyses examined these variables in the context of growth forecasts and financial assumptions and by applying stress tests on various parameters. With the adoption of the MDRI by the IMF in January 2006 and by IDA in fiscal year 2007, the debt sustainability analyses have had to take account of the financial effects of MDRI resources. The MDRI calls for full debt cancellation for countries that reach the completion point under the Debt Initiative for Heavily Indebted Poor Countries (HIPC), hence it will very materially reduce the debt overhang of countries participating in the HIPC Initiative, with significant implications for the number of countries eligible for assistance on grant terms under the DSF, particularly in Africa.

4. **Management of the free-rider issue.** IDA has expressed concern about the "free-rider" issue, namely the risk that fiscal and borrowing space created in recipient countries would facilitate external or domestic non-concessional borrowing.[1] A paper was to be presented to the IDA Board in July 2006 defining forms of borrowing consistent with the DSF and MDRI – as well as the way in which IDA will collaborate with MDRI and DSF recipient countries in ensuring that inappropriate, non-concessional debt is not contracted.

5. **Methodology for the assessment of debt sustainability.** Debt sustainability assessments for DSF purposes were initially implemented by IDA on the basis of current debt ratios and, subsequently, forward-looking debt sustainability analyses of low-income countries. Under the terms of IDA 14, it was agreed that IDA, following a joint study by IDA and the IMF, would produce a review of the DSF for the IDA 14 mid-term review (October 2006). This review is currently under way, with an initial paper prepared in March 2006 and another to be presented to the IDA and IMF executive boards in October. This will include a review of: the need to **increase** the number of debt-distress categories from the current three (red, yellow, green) to five by subdividing the "moderate" category into three; how to deal more systematically with domestic debt; and whether the MDRI methodology needs to be adjusted, including the phasing of debt-reduction measures (HIPC Initiative and MDRI).

Implications for IFAD

6. The operation of a DSF at IFAD is linked to IDA's finalization of the methodology for assessing debt sustainability under its own DSF. Similarly, the estimation of the potential **cost** of operation of a DSF to IFAD (in terms of service charges forgone on the provision of assistance on a grant rather than a highly concessional loan basis) and to its Member States (in terms of their commitment to compensate for principal payments forgone on a pay-as-you-go basis) is heavily dependent upon the methodology for debt sustainability assessment to be confirmed by the IDA 14 mid-term review. Finally, the ability of IFAD to offer a DSF opt-out path to potentially eligible countries so as to underline the voluntary nature of participation will be shaped by IDA's free-rider policy.

7. Considering that all the foregoing issues are dependent upon work in progress at IDA and that these questions are expected to be resolved during the second half of 2006, IFAD management intends to defer presenting proposals for the operation of a DSF at IFAD until the April 2007 session

[1] "The Multilateral Debt Relief Initiative: Implementation Modalities for IDA", IDA paper, 18 November 2005.

of the Executive Board – by which point these matters will have been finalized at IDA – rather than submit a paper in September 2006 that would require revision just a few months later. This is consistent with the position of the Asian Development Bank, which is awaiting final clarification of the IDA methodology to prepare an options paper for the mid-term review of the ninth replenishment of the Asian Development Fund in November, to be followed possibly by a paper to that organization's executive board. The IFAD management position is also consistent with the recommendation adopted by the Governing Council that IFAD should adopt the IDA model of a debt sustainability framework commencing in 2007.