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IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Consultation on the Seventh Replenishment of IFAD's Resources – Third Session

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INFORMATION PAPER

GRANTS AND DEBT SUSTAINABILITY

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ABREVIATIONS AND ACRONYMS

CPIA	country policy and institutional assessment
DSA	debt sustainability analysis
DSF	debt sustainability framework
HIPC	highly indebted poor countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDA 14	Fourteenth Replenishment of IDA Resources
IMF	International Monetary Fund
MFI	multilateral financial institution
MVA	modified volume approach
NPV	net present value
PBAS	performance-based allocation system

I. INTRODUCTION

1. IFAD currently allocates 10% of its annual programme of work to grants made under the grants policy adopted by the Executive Board in December 2003 (document EB 2003/80/R.5/Rev.1). The Board will review implementation of this policy in September 2005. IFAD is also developing a policy on "fragile states" and post-conflict and post-disaster situations, which may involve further proposals on the level and use of grants in its programme of work. Separate from such issues, and external to IFAD, considerable attention has recently been paid to the potentially punitive consequences for development processes that unsustainable debt may imply, and to the use of grants in ensuring that the debt load of poor countries does not rise above sustainable levels.

2. Repayment of debt and interest/service charges has become a major item in public and external finances, and many poor countries have not experienced the dynamism in government revenue and external earnings that would provide a basis for containing the impact of external debt on their pursuit of sustainable development strategies. Proposals for reducing poor countries' burden of external debt have become core elements of the development dialogue about growth and poverty reduction.

3. The first major organized efforts (on a case-by-case basis) in this area were under the auspices of the Paris Club of bilateral donors. The Paris Club has been in existence since 1956, but relief provided to the poorest countries under its so-called Toronto terms and London terms was small, with somewhat greater opportunities emerging under the Naples terms. Significant relief to the poorest countries could only come with the treatment of debt within a framework that includes multilateral agencies – the holders of the larger part of the debt of such countries. The system-wide response coordinating both bilateral and multilateral efforts was the Debt Initiative for Heavily Indebted Poor Countries (HIPC) (launched in 1996 and enhanced in 1999), which provided a common approach to the reduction of the repayment obligations of some of the poorest countries against their existing stock of debt. The HIPC Debt Initiative involves a value transfer to participating countries in the form of reduction of existing debt repayment obligations to achieve sustainable ratios of external indebtedness. Access to debt relief under the Initiative has been conditional upon the development of adequate poverty reduction strategy papers (together with, for example, the adoption of *sound financial management*).

4. Of the 38 countries potentially eligible for debt relief under the HIPC Debt Initiative, 27 have reached completion point (among which 18 have passed the completion point and are receiving irrevocable debt relief). The total cost of the Initiative's relief for those countries is estimated at USD 58 billion (in 2004 net present value (NPV) terms).[1] There are fears that the effort has not been enough. In the bilateral community, strong initiatives have been taken towards *cancellation* of bilateral debt, while members of multilateral financial institutions have promoted a new approach to multilateral development assistance in the Asian Development Fund, the International Development Association (IDA) and the African Development Fund. The approach focuses on delivery of assistance to debt-vulnerable countries on a 100% grant basis, or through a mixture of grants and loans, within a *debt sustainability framework* (DSF).

5. The DSF approach for the allocation of grants in IDA (to IDA-only countries), as developed in the context of the Fourteenth Replenishment of IDA Resources (IDA 14) negotiations, is not intended as a mechanism for increasing the *volume* of assistance to debt-distressed countries above and beyond the general expansion of assistance under IDA 14. Participants in the IDA 14 negotiations stressed that increased grant allocations to debt-distressed countries must not threaten IDA's financial integrity. Nor should increased grant allocations be made at the expense of other IDA countries that are not debt-distressed and not eligible for grants under this heading. Therefore, while IDA 14 includes a significant increase in grants under the DSF, it does so in the context of the organization's performance-based allocation system (PBAS) – as a mechanism for delivering levels of assistance determined *within* the

[1] IMF and IDA, Heavily Indebted Poor Countries (HIPC) Initiative – Statistical Update. Washington, D.C., April 2005.

parameters of that system. It also provides for, or upholds the principle of, *compensation* to IDA for resources or income forgone (and allocable to all IDA countries) as a result of implementation of the DSF, which will be the sole basis for allocation of grants in IDA. Unlike in IDA 13, grants in IDA 14 will no longer be allocated according to multiple, special-purpose eligibility criteria. The objective of the DSF approach is, precisely, *debt sustainability* – by ensuring that the value of assistance determined within a PBAS is delivered in a *form* consistent with debt sustainability concerns, i.e. one that does not add to debt in countries that lack the means of sustaining it.

II. DEBT VULNERABILITY AND IDA ASSISTANCE: IDA 14

6. The general approach to be adopted under IDA 14[2] was approved by the IDA executive directors only in March 2005, and it is evident that a number of key financial and operational issues will be resolved only over time. For example, there is explicit recognition that the basis for assessment of country debt sustainability is provisional, pending finalization of a forward-looking debt sustainability analysis (DSA) by the World Bank and the International Monetary Fund (IMF) (in collaboration), and that work on thresholds for mobilization of a grant-based approach is ongoing.[3] Any discussion of the DSF at this point must reflect more on the principles involved than the provisional operational arrangements. From the perspectives of basic principles, IDA's approach to integrating debt sustainability into its assistance programme involves three elements:

- assessing country debt sustainability and determining the grant component of the assistance programme in the light of that assessment;
- ensuring that grant resource allocations remain within the framework of the PBAS; and
- containing the impact of the provision of grants to debt-vulnerable countries on IDA's resources and its ability to service the requirements of other countries.

7. Taken together, these processes are intended to provide the foundations of an approach that responds to debt vulnerability problems while preserving the integrity of performance-based allocations and the long-term ability of IDA to play its development finance role.

8. **Vulnerability and the level of grants in the IDA country assistance programme.** Determination of whether any particular country will receive its PBAS allocation in the form of loans or grants will be based (until the work on development of the DSA is completed) on assessment of debt sustainability combining two sets of variables: (i) key debt ratios (NPV of debt to GDP; NPV of debt to exports; and debt service to exports); and (ii) country policy and institutional assessment (CPIA) scores. Scores under the key debt ratios being equal, countries with better CPIA scores are considered less debt-vulnerable (within a three-band CPIA rating system – see Table 1).

[2] IDA. *Report from the Executive Directors of the International Development Association to the Board of Governors. Additions to IDA Resources: Fourteenth Replenishment. Working Together to Achieve the Millennium Development Goals*. Washington, D.C., March 2005.

[3] See the options considered in: IMF and IDA. *Operational Framework for Debt Sustainability Assessments in Low-Income Countries – Further Considerations.* Washington, D.C., 28 March 2005.

Table 1: Debt and Debt-Service Thresholds

Country CPIA Score	Ratio		
	NPV/GDP	NPV/EXP	DS/EXP
Strong (CPIA ≥ 3.75)	50	200	25
Medium (3.75 < CPIA < 3.25)	40	150	20
Poor (CPIA ≤ 3.25)	30	100	15

NPV/GDP=Net present value of debt to GDP
NPV/EXP=Net present value of debt to exports
DS/EXP=Debt service to exports

9. On the basis of these calculations of debt sustainability, countries will be assigned a "traffic light" status: a "green light" indicates low risk, a "yellow light" medium risk and a "red light" high risk of debt distress.[4] In the case of "red light" countries, 100% of IDA assistance will be delivered on a grant basis, whereas in the case of "yellow light" countries, that figure will only be 45% (see Table 2). In the case of "green light" countries, no grants will be extended under the debt vulnerability/sustainability heading.

Table 2: Countries with "Red Light" and "Yellow Light" Classification by IDA (November 2004)

"Yellow Light" Countries (45% grants)		
Burkina Faso	Uganda	Kenya
Senegal	Nicaragua	
"Red Light" Countries (100% grants)		
Afghanistan	Guinea	Sao Tome and Principe
Angola	Guinea-Bissau	Sierra Leone
Bhutan	Guyana	Solomon Islands
Burundi	Haiti	Sudan
Cambodia	Kyrgyzstan	Tajikistan
Cameroon	Lao People's Democratic Republic	Timor-Leste
Central African Republic		Togo
Chad	Lesotho	Tonga
Comoros	Liberia	Zambia
Congo	Malawi	
Côte d'Ivoire	Mali	
Democratic Republic of the Congo	Mauritania	
	Mongolia	
Eritrea	Niger	
Ethiopia	Republic of Moldova	
Gambia	Rwanda	
Georgia	Samoa	

4 IMF and IDA, 28 March 2005, also includes a category of "in debt distress", page 17.

10. Naturally, country debt sustainability classifications are not permanent, but will change according to variation in a country's debt ratios, CPIA scores and eventual changes in the threshold ratios for vulnerability. There has been an evolution towards lower thresholds,[5] with the main implications being wider grant coverage and a higher overall grant share. The application of the thresholds published by IDA in November 2004 produced the results presented in Table 3. Within this framework, "the overall grant share is estimated to be around 30%".[6]

Table 3: IDA 14 – Results of "Traffic Light" Allocation

	IDA-Eligible Countries* (Number)
Green (credit only)	19
Yellow (credit/grant blend)	5
Red (grant only)	40
Special transitional cases	2
Number of *grant-eligible* countries	47

*Excludes blend- and hardened-term IDA countries.

11. **Grants and the PBAS framework.** On the basis of the country debt sustainability assessments reported in Table 2, a significant number of countries (47) will receive IDA assistance on a "pure" (100%) or "mixed" (45%) grant basis. The *volume* of assistance will reflect their PBAS allocations, but will not be the same as that allocation. Specifically, IDA will apply what it calls a modified volume approach (MVA) to the performance-based allocations to countries receiving assistance from IDA in the form of grants under this heading. The MVA applies a discount of 20% to the nominal country performance-based allocation, i.e. the country will receive in assistance and in grant form 80% of its nominal performance-based allocation. This discount will be applied to both "red light" and "yellow light" countries. Of this 20%, slightly more than half (11%) will be reallocated to all IDA borrowers according to the performance-based allocation formulas (i.e. it will be added to the initial nominal PBAS allocation) – meaning that grant recipients "get back" part of the resources subtracted in the first step of the MVA. The credit/grant mix applied to these reallocated resources will reflect the country's debt vulnerability status. At the end of the day, grant recipients will receive between 80% and 90% of their nominal performance-based allocation.

12. **Containing the impact of expanded grant volumes on IDA resources.** The need for measures to ensure that the DSF does not negatively affect IDA's overall resource position for future development assistance was explicitly recognized, and IDA 14 explicitly addressed the issue of financing the forgone *charge income* arising from grant financing. Of the 20% volume discount (MVA), 11% would be reallocated to IDA countries, as noted above, and 9% would be retained by IDA to finance forgone charges. These resources (the retained 9%) would generate a compensatory income flow on the basis of being loaned to the International Bank for Reconstruction and Development (IBRD)/IDA countries through a "hard(er) terms" lending window carrying an interest rate calculated on a spread of 200 basis points below the IBRD lending rate in fixed-rate terms. This "internal" compensation mechanism is intended to address only *charge income* forgone, i.e. the income forgone from the IDA service charge. Given the low level of that charge, it represents a modest proportion of loan reflows – of which a significant element is *principal repayment*.

[5] IDA, op. cit., page 26.
[6] Ibid.

13. In the case of the HIPC Debt Initiative, the provisions for compensation for principal repayments forgone[7] are clearly spelled out. In the case of grants under the debt vulnerability heading, IDA 14 recorded that "participants agreed that the forgone principal reflows will be financed through additional donor contributions on a pay-as-you-go basis" (i.e. as payments are actually forgone according to the schedule that would have applied to assistance if provided in the form of an IDA loan).[8]

III. IFAD AND DEBT REDUCTION

14. Notwithstanding IFAD's very small share of the stock of public external debt of poor developing countries, following the adoption of Resolution 101/XX by the Governing Council on 21 February 1997, the Fund has been a full participant in the HIPC Debt Initiative in its various phases. As in the case of other participants, this has taken the form of forgoing income from payments on the interest and principal of eligible existing loans as these payments fall due. The overwhelming majority of relief has been provided to countries in Africa.

15. The original estimate of the value of income forgone by IFAD was about USD 60 million. The expansion of the HIPC Debt Initiative, however, has driven the cost to IFAD to far higher levels: to approximately USD 515 million (nominal value). Unlike other major multilateral debt holders, IFAD was not included in the collective compensation mechanism for loan reflows forgone (the World Bank-administered HIPC Trust Fund). By contrast, the African Development Fund has obtained Trust Fund financing for 84% of its obligations. To date, IFAD has benefited from direct bilateral compensatory support from its Members in the value of approximately USD 67 million,[9] and is seeking entrance into the HIPC Trust Fund mechanism.

16. IFAD's experience with the HIPC Debt Initiative is relevant to a consideration of its relation to the debt sustainability approach. Like the HIPC Debt Initiative, the DSF approach (i) has no explicit caps on the total value of the grant element of assistance; (ii) is likely to have a widening scope of application (and a growing cost); and (iii) requires concrete provisions for compensation equivalent to the provisions made in IDA 14 (paragraph 13, above) if IFAD's long-term ability to respond to the needs of all its developing Member States is not to be compromised.

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[7] In the case of HIPC countries, there is reference to the role of the HIPC Trust Fund "to replace IDA's forgone credit reflows due to debt relief" (IDA, op. cit., page 38). Compare with the 9% set-aside scheme to finance forgone charge income on IDA 14 grants" (Ibid., page 27).

[8] Ibid., page v. The same pay-as-you-go approach to fulfilling commitments to compensation was adopted by the African Development Fund in its Report on the Tenth General Replenishment of the Resources of the African Development Fund, Corrigenda to paragraphs xxii and 7.19 of 1 February 2005. Provisions in the Tenth General Replenishment refer explicitly to compensatory financial provisions being made in future replenishments.

[9] For details, see document EB 2004/83/R.9.

IV. THE IMPLICATIONS OF ADOPTION OF A DEBT DISTRESS METHODOLOGY FOR DETERMINING THE FORM OF ASSISTANCE BY IFAD

17. Participation in systems of debt relief and debt containment can have significant consequences for IFAD, as for any other multilateral financial institution (MFI). It can affect financial sustainability, the distribution of resources among countries, and the balance between pursuit of its specific and specialized responsibilities and its de facto entry into less-targeted development financing arrangements. In effect, there are trade-offs. The nature of these trade-offs varies from institution to institution, as does the form of engagement. While the approaches of IDA and the African Development Fund to debt sustainability are very similar, they are not identical. The approach of the Asian Development Fund in its eighth replenishment (AsDF IX) differs from both. In the context of the sixth replenishment of its resources, IFAD raised the level of grants in its programme of work to 10%. It has also been a full participant in the HIPC Debt Initiative. IFAD is already, therefore, active in using grants and debt forgiveness as development instruments. The issue is how, to what extent, and on the basis of which methodology IFAD should expand its use of grants responsive to debt sustainability as instruments for the promotion of sustainable rural poverty reduction – the purpose for which its resources are constitutionally earmarked. IFAD's value added in the international development effort lies not in innovating development finance mechanisms but in accelerating rural poverty reduction. Consequently, at the Second Session of the Consultation on the Seventh Replenishment of IFAD's Resources (IFAD VII), IFAD was requested to provide an information paper describing the implications of adoption of a debt sustainability approach as piloted by other MFIs. Given the equivalent global scope of IDA and IFAD, this paper provides an estimate of the consequences of the last documented IDA approach.

18. Some of the possible implications of *not* following IDA in adopting a debt sustainability methodology are hinted at in the IDA 14 report, which indicates that IDA will seek to address the "free rider" issue of alternative sources of financing[10] – by which is meant the approach to financiers who continue to lend, or expand lending, in a country where IDA has shifted financing to a grant basis, thereby "taking advantage" of the enhanced space for public borrowing. IDA's intention is clearly *not* to create space for additional lending by other institutions. Indeed, it is probable that the World Bank and the IMF will collaborate to promote *consistency* among financiers in the type of instrument they apply in debt-vulnerable countries – and, in effect, the adoption of a grants-based approach by IDA and other MFIs may make it difficult for IFAD to make a loan, even on highly concessional terms, in what are classified as "red flag" debt-vulnerable poor countries.

19. If the operational implications of IDA's DSF approach cannot be accurately assessed at this point, neither can the financial implications – although they are unlikely to be minor in the medium and long term. Even in institutions that have already adopted the approach, other developments are likely as the issues of relation to the PBAS and financial sustainability are worked on further.

20. It must be stressed, however, that the financial implications of grants under the DSF approach are *intrinsically* different from those arising from the application of IFAD's existing grant policy: there is no cap on the size of the grant component of assistance when the DSF is used. Within the DSF, the individual and total level of the grant component of assistance is determined by factors outside the institution involved: it is driven in part by global economic development and country-level policy and institutional performance. As these change, so will the level of grants – for each country *and for the sum of countries*. In this context, the only practical cap on the volume of grants is the total value of assistance.

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[10] IDA, op. cit., page iv.

21. Not only is there no cap, but it is also unlikely that there will be much stability in the results of the application of the methodology. The importance of primary (mostly tropical) exports for total exports and GDP in many debt-distressed or near debt-distressed countries makes it likely that there will be a rather high level of sensitivity of debt sustainability to fluctuations in the prices of global tropical commodities, suggesting that a significant market downturn would switch many "lights" from green to yellow, and from yellow to red. It is likely therefore that the grant level will demonstrate quite a high level of volatility as the burden of commodity price volatility is shifted, in part, to the finances of MFIs.[11]

22. In addition to the inevitable uncertainties of such a new initiative, the very nature of the debt sustainability methodology prevents calculation of precise financial implications. Nonetheless, *as an illustrative exercise,* it is possible to estimate the implications of the (then) methodology as it produced country "traffic light" classifications for IDA in November 2004 in terms of what would have been the impact on the composition of IFAD's programme of work.

23. The focus of this exercise will be on two dimensions of application of the system: the increased grant level it would introduce in the programme of work; and the implications of this increased grant level for IFAD's financial position.

V. THE INCREASE IN THE GRANT COMPONENT OF IFAD'S PROGRAMME OF WORK ARISING FROM APPLICATION OF THE IDA DEBT DISTRESS METHODOLOGY

24. Estimates of the impact on the current programme of work can be generated by applying the "traffic light" classification to IDA members who are in IFAD's highly concessional borrowing category (see paragraph 9), and applying the relevant grant-to-loan ratios to individual-country PBAS allocations (using the PBAS procedures adopted in September and December 2003, to be reviewed in September 2005) – including the MVA and the 11% reallocation among highly concessional borrowers. This calculation can only *approximate* a real-world effect, since this is the first year that the PBAS has been applied, and analysis can therefore only be based on first-year ex ante allocations. Moreover, there are a number of countries in IFAD's highly concessional borrowing category for which no IDA DSF rating is currently available or for which the IDA classification may not be appropriate for IFAD (e.g. in the case of IDA "blend" countries).

25. In the event, the estimated impact of the application of the DSF to IFAD assistance as ruled by IFAD's PBAS is very similar to the IDA 14 estimate of the impact of the DSF on the composition of IDA's own programme of assistance. The estimated percentage of the total PBAS allocation that would remain in the form of loans would be 75% (see Table 4), with grants taking 22% and 3% being retained.[12] A more relevant comparison with IDA is provided by the impact on commitments of PBAS allocations to countries falling into its highly concessional borrowing category (i.e. IFAD's poorest members). In this category, 68.1% of resources allocated would be delivered in loans and 28.5% in grants (compared to 30% in IDA). About 3.4% would be retained.

[11] The calculation of vulnerability on the basis of contemporaneous values is a deliberate choice to ensure the responsiveness of the DSF to volatility in the debt ratios. See IMF and IDA, 28 March 2005, pages 11-12.

[12] The issue of management of retained values (from the MVA) is a significant operational and financial question for IFAD, which does not have an IBRD-equivalent "partner". While IFAD does lend on non-highly concessional terms (i.e. intermediate and ordinary terms), any placement of retained resources would have to respect constitutional provisions relating to the balance between highly concessional lending and other lending in IFAD's programme of work.

Table 4: Impact of Application of the IDA Methodology to Annual Allocations under IFAD's PBAS (percentage)

	IFAD Programme Divisions					
	Western and Central Africa (PA)	Eastern and Southern Africa (PF)	Asia and the Pacific (PI)	Latin America and the Caribbean (PL)	Near East and North Africa (PN)	Overall
Total PBAS in loans	47.00	47.40	92.46	96.2	85.76	75.44
Total PBAS in grants	47.48	46.88	6.78	3.35	12.85	21.97
Total PBAS retained	5.52	5.72	0.76	0.46	1.40	2.59

26. As could be expected, the continent with the largest shift from loans to grants would be Africa (concentrated in sub-Saharan Africa), reflecting the debt vulnerability that has made the region a focus of global development concern – and the prime beneficiary of the HIPC Debt Initiative. Correspondingly, it is the area where there would be the highest level of retention under the MVA –with Asia and the Pacific and Latin America and the Caribbean being the lowest (the intermediary position of the Near East and North Africa principally reflects inclusion of the Sudan).

VI. IMPACT ON IFAD'S FINANCIAL POSITION

27. For IFAD's highly concessional loans, the application of IDA's DSF would imply an estimated reallocation of 28.5% to grants and 3.4% to a retained portion (see paragraph 25). As shown in Table 5 below, the reallocation of 28.5% from this loan category would result in an additional grant allocation of 20.8%. For purpose of these analyses, and as shown in Table 5, the retained portion of 3.4% is here reallocated to the ordinary loan category, which applies the highest interest rate among IFAD's existing loan categories.

Table 5: Overall Programme of Work Allocation Based on Application of IDA's DSF

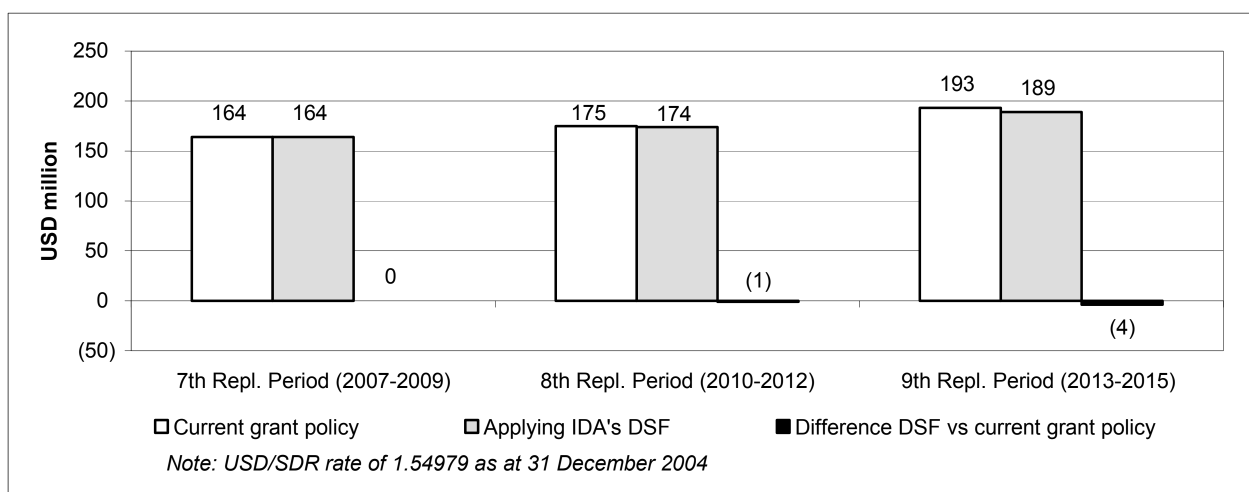
	Current allocation		DSF reallocations		DSF allocation
	Loan/grant category allocations	Overall programme of work allocation	Reallocating 28.5% of highly concessional loans to grants	Reallocating 3.4% of highly concessional loans to retained portion	Overall programme of work allocation
Highly concessional loans	81.0%	72.9%	(20.8%) [a]	(2.5%) [b]	49.6%
Intermediate loans	9.0%	8.1%	-	-	8.1%
Ordinary loans	10.0%	9.0%	-	2.5%	11.5%
Subtotal loans	**100.0%**	**90.0%**	(20.8%)	**0.0%**	**69.2%**
Current grants	100.0%	10.0%	-	-	10.0%
Additional grants	0.0%	0.0%	20.8%	-	20.8%
Subtotal grants	**100.0%**	**10.0%**	**20.8%**	**-**	**30.8%**
Overall programme of work		**100.0%**	**0.0%**	**0.0%**	**100.0%**

[a] The reallocation of 20.8% within the overall programme of work is based on a reallocation of 28.5% (see paragraph 27) from the highly concessional loan allocation of 72.9%.

[b] The reallocation of 2.5% within the overall programme of work is based on a reallocation of 3.4% (see paragraph 27) from the highly concessional loan allocation of 72.9%.

28. As shown in Chart 1, the forgone service charges stemming from the increased grant allocation are projected to be none in the Seventh Replenishment period, USD 1 million in the Eighth Replenishment period and USD 4 million in the Ninth Replenishment period. A reason for the forgone service charges being limited is the allocation of a retained portion to ordinary loans. The chart shows the total projected service charges and interest for the Seventh, Eighth and Ninth Replenishment periods (total period 2007-2015), while forgone principal repayments would have an impact only in later replenishment periods. The forgone principal, unless compensated for in a way similar to IDA 14, would have a substantial, cumulative and growing impact on IFAD's resource position in later replenishment periods.

Chart 1: Service Charges and Interest in the Seventh, Eighth and Ninth Replenishment Periods*
(USD million)



* Based on a programme of work growing 10% annually in the Seventh Replenishment period as per the replenishment scenario presented in documents REPL. VII/2/R.2 and R.3 to the Second Session of the Consultation. The programme of work is here assumed to continue growing 10% annually in the Eighth Replenishment period, and thereafter at the rate of inflation in the Ninth Replenishment period.

VII. CONCLUSION

29. IDA, as the major provider of highly concessional multilateral assistance to poor countries, has responded to growing concerns about debt sustainability by proposing a new global approach to multilateral development financing. Both the African Development Fund and the Asian Development Fund have taken similar steps. The elaboration of a grants-based approach to the delivery of development assistance to debt-vulnerable poor countries represents an important new instrument in the multilateral development toolbox. It represents an opportunity, including the opportunity to support new types of activity. It also represents a challenge. While relevant to all MFIs, it is particularly a challenge for MFIs with a high level of commitment to providing development assistance to Africa.

30. The challenges are of different orders. First, the World Bank and IMF have not finalized the DSA methodology, which should provide a robust basis for country classifications. Therefore, a key element in determining which countries should receive assistance on a grant basis (and at what level) is not yet in place. Second, the absence of any capping device introduces major questions of long-term resource management (compounded by the absence of a complete and automatic compensation mechanism). Third, the role and scope for complementary highly concessional loan-based assistance will remain unclear until policies relating to "free riders" are broadly agreed and applied.

31. In the context of such uncertainties, at present it is impossible to assess with any degree of accuracy the development costs and benefits of the adoption of a DSF approach in IFAD. On the potential benefit side, it would contribute to medium- and long-term containment of the debt service burden of vulnerable poor countries – and to a constructive de-linking of new development investment essential to achieving the Millennium Development Goals (MDGs) from historically accumulated obligations reflected in aggregate country external debt. On the cost side, there are issues pertaining to consistency with the fledgling PBAS and to the possible decline in investment in rural poverty reduction in poor debt-vulnerable countries as a result of application of the MVA.[13] A concern for *all* MFIs, including IFAD, must be the institutional cost of potentially unlimited exposure to a process of forgoing income – at the expense of ability to service the future needs of all developing and poor countries, including those whose stronger CPIA scores make them less eligible for grant-based assistance. The analysis presented above in section VI of the impact of the adoption of a DSF (i.e. for the purpose of illustration, IDA's DSF approach in the November 2004 moment of its evolution) demonstrates a very significant long-term impact on IFAD's liquidity, which would require, in the absence of adequate compensation mechanisms (such as the IDA 14 pay-as-you-go provision for principal repayments forgone), containment of future increases in the IFAD programme of work to maintain financial sustainability.

32. On the one hand, then, IFAD's adoption of a DSF approach would enable it to engage in country activities according to local opportunities and needs identified within the PBAS – without the limitations currently arising from country public external borrowing limits shaped by overall economic management concerns. On the other hand, the construction of the DSF by the "sector leaders" is still a work in progress, and, in the interests of harmonization, the production of any detailed IFAD proposal for the adoption of a DSF or similar should involve close monitoring of finalization of the IDA approach, including its "free-rider" policy as applicable to both "pure" and "mixed" IDA grant scenarios.

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[13] See IMF and IDA, 28 March 2005, pages 2-3: "A lower tolerance for debt distress, reflected in more conservative thresholds, involves costs to donors in the form of additional grant resources required to replace loans. Should grants, however, fall short of what is needed to sustain nominal aid flows, [low-income countries] will bear the cost in the way of forgone development opportunities, including lower financing in pursuit of the MDGs."