Borrowing requirements and external debt sustainability of Sub-Saharan African countries

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The external debt of developing countries has declined significantly in the last decade. Improved macroeconomic performance, coupled with better management of public finances and the positive impact of favourable terms of trade on current account balances have helped these countries to reduce their external debt burden. The Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI) have also played a part in bringing debt down.

Despite these positive developments, which have been partly offset by the recent surge in internal debt, low-income countries (LICs) are still vulnerable to a number of factors that could make their debt less sustainable, such as structural weaknesses in their economies, exposure to shocks, particularly external ones, limited debt management capacity and irregular access to external financing sources. LICs look especially vulnerable because the current financial crisis could increase their borrowing requirements. The crisis has spread chiefly through a sharp shock to the terms of trade, resulting, notably among commodity-exporting LICs, in a pronounced deterioration in public finances (owing to the highly negative impact on fiscal revenue) and external accounts. This has been compounded by a decline in direct investment flows, which are often concentrated in the commodities sector, as well as in remittances. These developments have increased the risk of renewed public and external debt distress. The emergence of new emerging-country lenders, whose lending terms are not always consistent with the framework used by traditional lenders, further aggravates this risk.

The purpose of this paper is to review the issue of debt sustainability among Sub-Saharan African (SSA) LICs. Part One examines the sources of financing for least developed countries and the debt sustainability framework (DSF). Part Two highlights the persistent vulnerability of LICs to the risk of debt distress in an international environment characterised by a financial crisis, soaring internal debt, and the rise of emerging countries in development financing.

Finally, the paper describes the international initiatives taken to more effectively address the increased borrowing requirements of LICs and make the DSF more flexible.

Keywords: IMF, World Bank, debt sustainability framework, HIPC initiative – MDRI, Sub-Saharan Africa.

JEL codes: F33, F34, O55.

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1| Debt sustainability: a decisive issue for LICs as borrowing increases

1|1 Debt situation of LICs in Sub-Saharan Africa

A variety of financing approaches

Low-income countries (LICs) need to borrow substantial amounts to finance their development. Because local savings are generally insufficient (22.7% of GDP on average in Sub-Saharan Africa (SSA) in 2008, compared with 47.7% in developing Asia, cf. Table 1), local financial markets are underdeveloped and access to international financial markets is limited, LICs only have three main sources of financing to cover their borrowing requirements: foreign direct investment (FDI), remittances and public development aid, in the shape of grants or loans.

Obviously, the financing method has an impact on the sustainability of a country's debt. It is generally agreed, for example, that FDI is a preferred kind of financing, insofar as it may be accompanied by technology transfers and could potentially create jobs. Also, FDI flows are less volatile than private capital flows. They may nevertheless result in a long-term transfer of resources that exceeds that of a conventional loan.

Borrowing creates future commitments and necessitates being in a position to generate sufficient income to make regular payments. From an economic and financial perspective, debt financing is however more appropriate than grants when it does not affect the country's solvency and when the interest rate paid is lower than the growth rate of the economy. In the case of LICs

Table 1 Saving rates

(as a % of GDP)

	1990	2000	2005	2008
Sub-Saharan Africa	17.1	17.6	18.9	22.7
North Africa and Middle East	21.8	31.3	41.1	41.6
Developing Asia	29.0	31.1	41.3	47.7
Newly Industrialised Asia	34.4	31.7	31.4	32.1
Latin America	18.6	19.0	22.0	22.1
CIS (excluding Russia)	19.2	17.5	26.3	28.5
India	22.7	23.8	33.4	37.0
China	39.2	36.8	51.2	58.9
OECD	22.2	21.5	20.0	19.3

Source: IMF.

whose public resources, particularly fiscal, are limited, concessional loans[1] can be used to raise larger amounts of financing than grants, especially if they can be combined with funds raised on the markets.

Sharp growth in financing flows to LICs, combined with a change in the structure of these flows

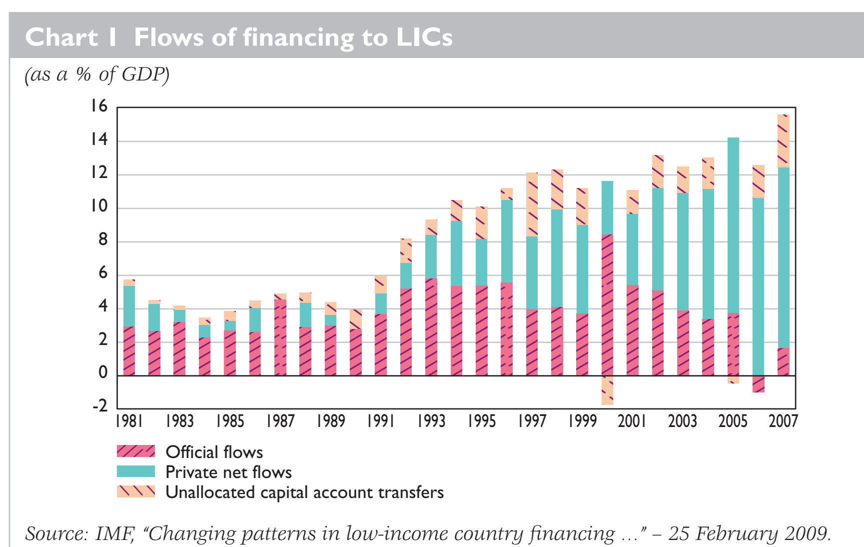
Flows of financing to LICs have risen strongly in the last 20 years (cf. Chart 1), from approximately 5% of LIC GDP in the early 1980s to an average of around 15% in 2007.

Since the beginning of the 1980s, the increase in flows of capital to LICs has been accompanied by a change in the composition of those flows. According to Dorsey et alii (2008), flows of private capital (FDI and remittances) quadrupled from the start of the 1980s to become the main source of financing over the period, averaging 8% of LIC GDP. By contrast, official net inflows changed little over the period, accounting for slightly over 2% of LIC GDP between 1981 and 2005.

The structure of official flows has also changed, with grants and debt cancellations overtaking loans. Grants tripled from 0.5% of LIC GDP in the early 1980s to 1.5% in 2006. This shift also reflects the effects of debt relief measures through the HIPC initiative and the MDRI (Box 1).

Chart 1 Flows of financing to LICs

(as a % of GDP)



Source: IMF, "Changing patterns in low-income country financing ..." – 25 February 2009.

1 *Concessional loans are loans that offer more favourable terms than commercial loans (lower interest rates and longer grace period and maturity). These loans may be considered to comprise a grant element (corresponding to the interest subsidy) and a commercial loan element (particularly the obligation to repay in full).*

Box 1

Debt relief under the HIPC initiative and the MDRI[1]

Introduced by the IMF and the World Bank in 1996 following the G7 summit in Lyons, the Heavily Indebted Poor Countries (HIPC) initiative is designed to reduce the debt burden of HIPCs to sustainable levels (i.e. levels that allow them to service their debt without hindering their development), through external debt relief from the international community. In 1999, the initiative was modified to provide faster, deeper, and broader debt relief and strengthen the links between debt relief, poverty reduction and social policies.

As the table below shows, multilateral creditors make a substantial contribution to the debt relief granted within the framework of the HIPC initiative.

In 2005, to help accelerate progress towards the UN Millennium Development Goals, the HIPC initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI). The MDRI allows for 100% relief on eligible debts by multilateral institutions (chiefly

Cost of the HIPC initiative to the main creditors

(USD billions, net present value at end-2008)

	Post-completion-point countries (26)	Interim countries (9)	Post-decision-point countries (35)	Pre-decision-point countries (5)	Total
	I	II	III = I + II	IV	V = III + IV
Multilateral creditors	**21.4**	**6.7**	**28.1**	**5.3**	**33.4**
International Development Association (IDA)	10.6	2.6	13.2	1.5	14.7
International Monetary Fund (IMF)	3.0	1.5	4.6	1.8	6.4
African Development Bank (AfDB)	2.9	1.9	4.8	0.5	5.3
Inter-American Development Bank (IDB)	1.7	0.0	1.7	0.0	1.7
Other	3.1	0.7	3.8	1.5	5.3
Bilateral and commercial creditors	**17.4**	**11.8**	**29.2**	**11.3**	**40.4**
Paris Club	12.4	8.7	20.9	5.6	26.5
Other official bilateral	4.2	0.7	4.9	4.7	9.6
Commercial	0.9	2.4	3.4	1.0	4.3
Total costs	**38.8**	**18.5**	**57.3**	**16.6**	**73.8**

Source: "HIPC Initiative and MDRI – Status of implementation", IMF, September 2009.

1 Source: IMF.

.../...

the IMF, the IDA of the World Bank and the African Development Fund (AfDF)) for countries that have reached the completion point of the HIPC initiative. [2]

To benefit from the relief, a country must first meet a number of criteria:

• *be an IDA-only country,* [3] *i.e. be eligible only for concessional assistance from the IDA, and be entitled to use the Extended Credit Facility (which replaced the Poverty Reduction and Growth Facility – PRGF);*

• *face an unsustainable debt burden that cannot be addressed through traditional debt relief mechanisms;*

• *have established a track record of reform and sound policies through IMF and World Bank supported programs;*

• *have developed a Poverty Reduction Strategy Paper (PRSP) through a broad-based participatory process.*

Once a country has met or made sufficient progress in meeting the criteria, the Executive Boards of the IMF and World Bank formally decide on its eligibility for debt relief, and the international community commits to reducing debt to a level that is considered sustainable. This is referred to as the decision point. Once a country reaches its decision point, it may immediately begin receiving interim relief on its debt service falling due.

In order to receive full and irrevocable reduction in debt available under the HIPC initiative, a country must:

• *execute satisfactorily IMF and IDA-supported programmes;*

• *implement satisfactorily key reforms agreed at the decision point;*

• *adopt and implement its PRSP for at least one year.*

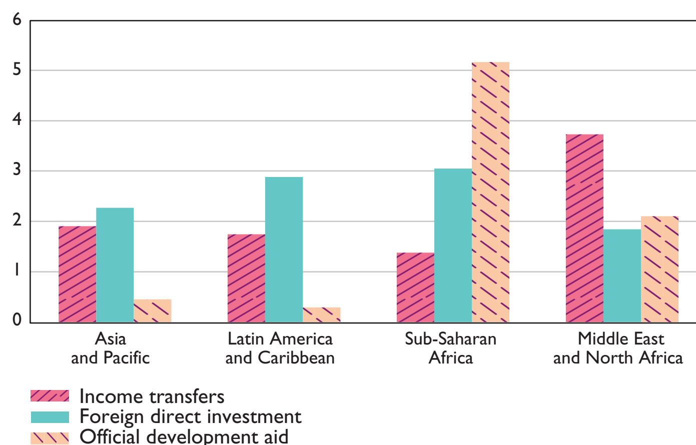
Once a country has met these criteria, it can reach its completion point, which allows it to receive the full debt relief committed at decision point.

2 *In 2007, the IDB joined the three institutions by cancelling all the unpaid debt of HIPCs that had reached the completion point.*

3 *Two criteria are used to determine the eligibility of countries for IDA support: (i) relative poverty defined as GNI per capita below an established threshold (in fiscal year 2010: USD1,135); (ii) insufficient solvency to borrow at market rates, creating a need for concessional financing to pay for development programmes.*

Chart 2 Main sources of external financing, by developing region, 2001-2007

(as a % of GDP)



Source: World Bank.

Compared with LICs overall, however, SSA has a special financing profile and remains the region that is most dependent on official aid (cf. Chart 2). Official aid remained the main source of external financing over the 2001-2007 period. Since 2000, SSA has nonetheless reported a sizeable increase in private capital inflows, particularly remittances and FDI.

The HIPC initiative and MDRI also substantially changed the structure of LIC external debt by creditor type. According to the IMF (2009), countries that had reached the HIPC completion point reported an increase in the share of debt owing to non-Paris Club creditor countries (official and private), whereas debt owing to Paris Club creditors is now virtually zero.

Despite the major debt relief effort by the international community, because LICs are vulnerable to external shocks, they may be suddenly faced with debt crises if their debt is not kept at sustainable levels. The debt sustainability framework was created to prevent new situations of debt distress.

1|2 Debt sustainability framework

In April 2005, the World Bank (WB) and the IMF adopted a methodological framework for monitoring the sustainability of LIC debt. The debt sustainability framework (DSF) is intended to facilitate the introduction of development strategies while avoiding the risks of debt distress.

It is therefore designed to help guide LICs in mobilising the resources needed for their development, while reducing the chances of an excessive build-up of debt in the future.[2] It is used to prepare recommendations on a medium-term debt strategy that is consistent with the country's progress on fiscal policy and structural reforms. The framework thus seeks to incorporate the policies introduced by countries to meet the Millennium Development Goals (MDGs) as well as the rationale behind IMF and WB financial programming.

As Djoufelkit-Cottenet and Raffinot (2008) point out, the DSF is a tool for coordinating donors and borrowers that operates on the principle that donors must stop lending and borrowers borrowing when debt sustainability thresholds are breached.

Under the DSF, the IMF and WB conduct country debt sustainability analyses (DSAs). Two types of analysis are performed, depending on how the framework is being used: LIC-DSAs for low-income countries and HIPC-DSAs, which are used to calculate debt relief for HIPCs (the IMF and the WB are ultimately planning to have just one DSA method based on the LIC-DSA framework). Methodological differences between the two instruments are substantial. Notably, in HIPC-DSAs, indicative thresholds are standardised for all countries, the denominators used for debt indicators (exports and revenues) are three-year backward-looking averages, and the discount rate is determined directly based on the country's currency. DSAs conducted within the HIPC framework are therefore based on backward-looking data and are used to determine the amount of relief at the decision point. LIC-DSAs are based on forward-looking projections and follow a broader analytical framework. Moreover, they use annual denominators that include exchange rate projections and a uniform discount rate of 4%.[3,4]

The debt sustainability of a country is therefore assessed based on the measurement of debt indicators derived from assumptions about the country's current and future macroeconomic situation. These indicators (debt and debt service expressed as a percentage of exports, GDP and fiscal revenue for the current year) are calculated for the following cases:

• a baseline scenario that uses backward-looking data and macroeconomic assumptions to project the long-run trajectory (20 years) of debt to reflect the long maturity of LIC debt (often linked to rescheduling);

2 The IMF (2002) defines sustainable debt as a situation in which a borrower is able to continue honouring its debt service obligations without having to make unrealistic adjustments to the balance of income and expenditures.

3 "Staff guidance note on the application of the joint fund-bank debt sustainability framework for low-income countries (LICs)", IMF, 6 October 2008.

4 The discount rate is used to calculate the net present value of loans. To estimate the NPV of loans to non-HIPC countries, and in order to avoid excessive fluctuations, this rate was set at 5% in 2004. According to the rules, the rate may be adjusted by 100 basis points when it deviates from the commercial interest reference rate (CIRR) on the dollar (six-month average) by more than 100 bps for a period of at least six consecutive months. As a result of interest rate movements in 2009, the discount rate was reduced to 4%.

• alternative scenarios (key variables at historical averages, growth rate permanently lower than that of the baseline, primary balance unchanged in constant terms, interest rates on new loans 200 basis points (bps) higher than baseline);

• stress tests[5] designed to estimate the sensitivity of the baseline to different shocks (including growth, interest rate, exchange rate and balance of payments shocks).

The risk of payment difficulties is assessed by comparing the ratios obtained with indicative thresholds corresponding to external debt that is viewed as sustainable. These thresholds are determined based on the quality of the country's institutions and policies, which in turn is gauged by the country policy and institutional assessment (CPIA) score measured by the World Bank (cf. Table 2).

Since interest rates and maturities on loans to LICs vary considerably, the DSF uses the net present value (NPV) of the debt by applying a uniform discount rate: the commercial interest reference rate (CIRR).[6] The results are thus comparable over time and between countries.

An external debt indicator above the indicative level signals a risk that debt might be unsustainable. There are four risk levels:

• weak, if all the debt indicators are well below the thresholds in the baseline scenario and thresholds are not breached in the alternative scenarios and stress tests;

Table 2 Relationship between CPIA (a) scores and DSF debt indicators (applied to external public debt)

Policy and institutional performance	Net present value (NPV) of debt as a percentage of			Debt service as a percentage of	
	Exports	GDP	Fiscal revenue	Exports	Fiscal revenue
Weak (CPIA ≤ 3.25)	100	30	200	15	25
Medium (3.25 < CPIA ≤ 3.75)	150	40	250	20	30
Strong (CPIA ≥ 3.75)	200	50	300	25	35

(a) Country policy and institutional assessment.
Source: IMF.

5 *The stress tests are calibrated to ensure that the debt ratio that they provide has a 25% likelihood of occurring over ten years.*
6 *Cf. footnote 4. The CIRRs are published by the OECD. These rates are key to calculating the grant element. The IMF uses 10-year average CIRRs for credits whose maturity is 15 years or over, and six-month average CIRRs for shorter-dated loans.*

• moderate, if the debt indicators are below the thresholds in the baseline scenario but exceed thresholds in alternative scenarios or stress tests;

• high, if at least one debt indicator exceeds thresholds in the baseline scenario;

• in distress, if the indicative thresholds are breached; in this case, the country is generally already facing payment difficulties and experiencing debt distress.

As an illustration, Table 3 presents the results of the DSA for the Central African Republic (CAR), prior to the HIPC completion point reached in late June 2009.

Based on this analysis, the CAR is at a high risk of debt distress. One of the main debt indicators, the NPV of external debt-to-exports ratio, is significantly higher than the performance thresholds over the recent period, justifying the CAR's inclusion in the HIPC initiative.

Table 3 External debt sustainability analysis, Central African Republic

Simulated scenarios	Weak performance threshold	NPV of debt as a % of exports	
		2008	Projection 2018
Under baseline	**100**	**287**	**104**
Under alternative scenarios			
including:			
A1. Key variables at their historical averages in 2008-2028	*100*	*287*	*51*
A2. New public sector loans on less favourable terms in 2008-2028	*100*	*287*	*107*
A3. Full delivery of HIPC assistance and MDRI	*100*	*125*	*62*
Under stress tests			
including:			
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	*100*	*287*	*103*
B2. Export value growth at historical average minus one standard deviation in 2009-2010	*100*	*287*	*157*
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-2010	*100*	*287*	*103*
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-2010	*100*	*287*	*132*
B5. Combination of B1-B4 using one-half standard deviation shocks	*100*	*287*	*156*
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009	*100*	*287*	*103*

Source: "Joint IMF/IDA Debt Sustainability Analysis 2008 – CAR", *IDA and IMF, 4 December 2008.*

1|3 Incorporating the DSF within bilateral and multilateral cooperation

The DSF was developed explicitly to provide a framework to deal with the renewed increase in LIC debt following substantial efforts to relieve multilateral and bilateral debt. Thus, whatever their role in macroeconomic monitoring and debt policy guidance, DSAs, which are conducted on a case by case basis using the DSF, are also intended to provide a framework for bilateral and multilateral debt management-related exchanges between LICs and their main donors. The risk analysis provided by the DSA has a significant impact on the amount of funds provided, the way funds are allocated between grants and loans, and the level of loan concessionality.

Within bilateral and multilateral cooperation, the DSF is used in the following mechanisms:

Multilateral cooperation

• The DSAs produced using the DSF are taken into account in IMF and WB financial programming for LICs.[7] In particular, DSAs enable the IMF to determine, within the framework of its programmes, the limits for non-concessional loans to LICs, since access to concessional loans is not restricted (case-by-case flexibility is allowed as regards accessing certain non-concessional loans when circumstances justify this). The concessionality of a loan is measured by its grant element. The grant element is defined as the difference between the loan's nominal value (face value) and the sum of the future debt-service payments in NPV to be made by the borrower, expressed as a percentage of the loan's face value. A loan is considered to be concessional if its grant element is at least equal to 35%.

• The IDA, which distributes concessional loans for the WB, uses DSAs to determine the share of grants and concessional loans that it provides to indebted countries. It is guided by a classification system of "traffic lights" that differs from the approaches used by the IMF and the WB. When allocating financing, the IDA provides countries in the high-risk or "red light" category with all-grant financing, countries in the moderate-risk or "yellow light" category get a mix of 50% loans and 50% grants, while financing to countries in the low-risk or "green light" category is entirely made up of loans.[8]

• The African Development Fund (AfDF), which distributes concessional loans for the African Development Bank Group (AfDBG),[9] also uses IMF/WB

7 Around 80% of IMF loan programmes are concluded with LICs (source: *Finance & Development*, September 2008).
8 See Djoufelkit-Cottenet and Raffinot (2008) for a more detailed description.
9 The AfDBG was set up in 1964. Comprising 53 African member countries, its main task is to promote economic and social development in Africa. In this capacity, it runs the AfDF, which was created in 1972.

DSAs to measure the debt distress risk of African countries and determine financing procedures, especially grant eligibility. The AfDF's classification system, which decides on the distribution of funds based on debt levels, is similar to that of the IDA.

Bilateral cooperation

Under Paris Club agreements, LIC debt is treated on condition that the country is enrolled in an IMF programme, many of which use DSAs. Based on DSA results, the Paris Club may therefore grant debt relief to countries that the IMF and WB declare to be eligible for the HIPC initiative. When the DSA shows an HIPC's NPV of debt-to-exports ratio to be over 150%, the Club can reduce the country's external debt levels by bringing its debt burden down to a manageable level. For commodity-exporting countries, the criterion for granting debt relief is that the NPV of debt-to-fiscal-revenue ratio must exceed 250%.

In October 2003, the Paris Club adopted the "Evian approach",[10] a flexible mechanism for addressing debt sustainability concerns in non-HIPC countries. Under this approach, Club creditors agreed to participate in comprehensive debt treatment for countries whose debt is considered to be unsustainable according to certain criteria, provided the countries have committed to policies that will secure an exit from the Paris Club in the framework of their IMF arrangements. They must also seek comparable treatment from their other external creditors, including the private sector. The Paris Club then determines what relief to provide based on the DSA conducted by the IMF.

Finally, for countries whose debts have been reduced or cancelled (HIPC initiative and MDRI), DSAs are used to guide decisions on new lending, insofar as bilateral and multilateral donors must in principle make sure that the new debt does not create fresh payment difficulties for the country in question.

1|4 Criticism of the DSF

The DSF is a tool used by the international community to analyse and regulate debt flows. However, it has been criticised and challenged on a number of points, including the following:

• **Difficulties in assessing sustainability and using the DSF in economic policymaking:** for Wyplosz (2005), assessing sustainability runs up against the "impossibility principle" because there is no sure way to accurately

10 IMF (2005), Annual Report, *Chapter 3, "Strengthening IMF program support and crisis resolution".*

determine the level beyond which debt would become unsustainable in response to a shock. The forward-looking approach uses a set of assumptions (change in debt, macroeconomic data) for which the DSF can only supply debt-distress probabilities, which are additionally variable over time. The use of medium- and long-term forecasts (20 years) means the results have to be seen in context. Furthermore, from an operational standpoint, it is hard for a country to implement economic policies that might entail major social costs based on mere probabilities. While Wyplosz's analysis does not necessarily cast doubt over the usefulness of the DSF, it is an incentive to take a flexible approach to using the framework.

• **Limitations of stress testing:** stress tests have been criticised notably for not taking account of correlations between shocks, second-round effects,[11] or the impact of government action plans to address shocks. Another complaint is that they do not make it possible to sufficiently differentiate shocks between countries (an event that is considered as highly risky for one country might not necessarily have the same impact in another country).

• **Reliance on CPIA ratings to establish indicative thresholds for sustainable debt:** because of the way it differentiates between countries, an index based on a qualitative assessment of the institutional and policy framework of a country inherently raises questions about its appropriateness and/or objectiveness. Country classification according to the CPIA/Debt ratio matrix creates threshold effects, notably for countries on the border between two categories. Switching from one category to another because of a small change in CPIA rating may have a massive effect on a country because the rating change is accompanied by a change in applicable debt thresholds (cf. Table 2 above) and hence in the assessment of the country's debt risk. When a country is well placed in a group, there is therefore a risk that its capacity to meet debt obligations may be overestimated. By the same token, the ability of poorly placed countries may be underestimated.

• **The ability of DSF debt indicators to measure debt sustainability:** DSF debt indicators are ratios that reflect the capacity of countries to honour their external debt, either through the wealth that they generate (GDP, income), or through the share of that wealth that can be used to generate transferable resources (exports). Comparing the nominal value of a country's debt against the NPV of expected payments to creditors is more akin to assessing the solvency of a borrower country than the sustainability of its debt. Some analysts think that the notion of sustainability should take account of the repayment burden relative to the expenditures needed to achieve MDGs and use other indicators that track, for example, the actual ratio of the debt burden to investment or government spending on

11 Second-round effects are changes in the trajectory of economic and financial variables caused by responses/reactions to shocks by economic agents and authorities.

healthcare and education. Others believe that the DSF should take account of the effects on growth of increased use of new loans (Reisen, 2008) or FDI. Debt sustainability should also be considered in relation to the use made of financing.

• Finally, the financial crisis, which caused a simultaneous deterioration in the prospects for LIC external revenues and an increase in borrowing requirements, highlighted **the need to adjust the DSF more effectively to reflect cyclical movements**.

2| Continued exposure of LICs to debt distress

2|1 Persistent factors of weakness, despite improved debt indicators

Since the beginning of the 2000s, a number of factors have helped to reduce developing countries' debt. Improved macroeconomic performance, coupled with better management of public finances and consolidation of institutional quality, against a recent backdrop of high commodity prices and favourable terms of trade, have aided these countries to reduce their debt burden. Improved external positions (cf. Table 4), particularly among oil-exporting countries, also played a part in reducing external borrowing requirements. The HIPC initiative and MDRI were also key to these changes.

Table 4 Reserves and current account balances

(current account balance, as a % of GDP)

	1997-2002	2003	2004	2005	2006	2007	2008
Reserves (months of imports of goods and services)							
SSA	3.8	3.4	4.3	4.7	5.9	6.0	5.3
Oil-exporting countries	3.9	2.3	4.9	6.7	10.8	9.6	8.4
LICs	3.7	5.4	5.0	4.0	4.0	4.4	3.2
Franc zone	2.4	3.4	3.5	3.5	4.9	5.3	5.1
SADC (a)	3.6	3.2	3.5	3.7	4.2	4.4	4.1
Current account balance (inc. grants)							
SSA	-2.5	-2.8	-1.3	-0.4	4.1	1.1	1.0
Oil-exporting countries	-3.5	-5.9	2.6	7.2	21.2	14.4	14.0
LICs	-6.0	-4.6	-4.2	-6.0	-6.2	-7.5	-9.7
Franc zone	-4.2	-4.9	-4.6	-1.1	-0.6	-2.6	-1.0
SADC	-1.8	-1.4	-2.4	-2.0	-1.3	-3.2	-4.9

(a) SADC: Southern African Development Community.
Source: Regional Economic Outlook, *October 2009, IMF.*

Chart 3 SSA: Domestic and external debt

(as a % of GDP)

Source: Adelegan (O.J.) and Radzewicz-Bak (B.) (2009), IMF, Working Paper *09/213.*

As a result, SSA external debt, which averaged 103% of GDP between 1995-2000, fell to around 34% of GDP between 2001-2008 (Adelegan and Radzewicz-Bak, 2009) (cf. Chart 3).

In 1990, approximately 82% of SSA long-term external debt was held by governments and public entities. By 2008, the share of public and guaranteed private debt was around 64% of SSA total external debt (cf. Table 5). The decline in the portion of public external debt is partly due to the decline in total public debt (which went from 48% of GDP in 2000 to 15% in 2007) and to the increase in private external debt. The proportion of non-guaranteed private external debt in total external debt rose from 3% in 1990 to 10% in 2008.

Table 5 SSA external debt

(debt and use of IMF credit in USD million, share of debt as a %)

	1990	2000	2005	2006	2007	2008
Total external debt (stock)	**176,547.9**	**211,948.2**	**216,250.5**	**173,526.2**	**193,760.7**	**199,677.0**
Long-term debt	**149,372.1**	**173,385.4**	**178,090.8**	**126,940.5**	**146,104.1**	**146,200.0**
o/w: publicly guaranteed debt	*144,096.0*	*162,009.4*	*169,551.8*	*117,682.6*	*126,026.4*	*127,631.0*
non-guaranteed private debt	*5,276.1*	*11,376.0*	*8,539.0*	*9,257.9*	*20,077.7*	*18,569.0*
Use of IMF credit	**6,611.8**	**6,739.3**	**5,947.3**	**3,140.3**	**3,203.3**	**3,986.0**
Outstanding short-term debt	**20,564.0**	**31,823.5**	**32,212.4**	**43,445.4**	**44,453.3**	**49,490.0**
Share of publicly guaranteed debt in total external debt	81.6	76.4	78.4	67.8	65.0	63.9
Share of non-guaranteed private debt in total external debt	3.0	5.4	3.9	5.3	10.4	9.3

Source: Global Development Finance 2009, *World Bank.*

Table 6 Decomposition of long-term external debt by creditor type

(USD millions)

	2000	2005	2006	2007	2008
Publicly guaranteed debt	**162,009.4**	**169,551.8**	**117,682.6**	**126,026.4**	**127,631.0**
owed to official creditors	136,040.6	135,559.1	88,591.5	91,654.8	97,470.0
o/w: multilateral	*54,705.9*	*73,511.8*	*44,260.6*	*48,565.8*	*50,787.0*
bilateral	*81,334.7*	*62,047.3*	*44,330.9*	*43,089.0*	*46,683.0*
owed to private creditors	25,968.8	33,992.7	29,091.1	34,371.6	30,161.0
Non-guaranteed private debt	**11,376.0**	**8,539.0**	**9,257.9**	**20,077.7**	**18,569.0**
o/w: bonds	*1,360.3*	*1,307.0*	*1,484.0*	*4,286.3*	*4,295.0*
banks	*10,015.8*	*7,232.0*	*7,773.9*	*15,791.3*	*14,274.0*

Source: Global Development Finance 2009, *World Bank.*

The structure of external debt by creditor type also changed. The share of publicly guaranteed debt owed to official creditors fell from 84% in 2000 to 76% in 2008, while the share owed to private creditors rose by 8 percentage points to 23% in 2008 (cf. Table 6). The share of publicly guaranteed debt owed to multilateral official creditors, which stood at 34% of total publicly guaranteed debt in 2000, totalled 40% in 2008, while the share of publicly guaranteed debt owed to bilateral official creditors went from 50% to 37% over the same period.

The improved external solvency of SSA countries has nevertheless been accompanied by increased domestic debt.[12] Cabrillac and Rocher (2009) point out that the implementation by African countries of public policies aimed at diversifying their financing approaches has played a part in this trend. Domestic debt in SSA increased from 15% of GDP on average over 1995-2000 to over 22% in the 2001-2008 period. Not all countries have seen the same increase, and cross-country disparities exist, partly reflecting a lack of domestic savings, underdeveloped financial intermediation and overly shallow, illiquid local financial markets. Whereas domestic debt was equal to more than 30% of GDP on average over 2001-2008 in South Africa, Namibia and the Seychelles, it was less than 5% in West African Economic and Monetary Union (WAEMU) countries (Adelegan and Radzewicz-Bak, 2009).

Moreover, LICs remain vulnerable to a number of factors that could affect the sustainability of their external debt. The IMF has assessed the debt prospects for countries that have reached the HIPC completion point. While the MDRI allows countries that have passed the HIPC completion point to benefit from almost total relief on their outstanding bilateral debt towards Paris Club creditors as well as debt relief from multilateral creditors, over 60% of beneficiary countries are still at moderate or high risk of distress.[13]

12 For a detailed analysis of the costs and risks associated with external versus domestic financing, see Beaugrand, Loko and Mlachila (2002).
13 "Heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI) – Status of implementation", IMF, September 2008 and September 2009.

Table 7 HIPC post-completion point SSA countries at a high risk of debt distress

	Last DSA	Results
Burkina Faso	June 2009	The NPV of debt-to-exports ratio exceeds the indicative thresholds, reaching 196.4% in 2024 on long-term decline in cotton exports.
Burundi	March 2009	The NPV of debt-to-exports ratio is expected to reach 169% by the end of 2011. Exports remain weak and depend heavily on a single product, coffee.
Gambia	February 2009	According to 20-year projections, the NPV of debt-to-exports ratio (147% in 2018) is above the reference threshold.
Sao Tomé	February 2009	The baseline points to areas of weakness before planned start-up of oil production in 2014. Some indicators, notably the NPV of debt-to-exports ratio, exceed the indicative thresholds for the 2009-2014 period.

Sources: IMF and World Bank, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation", September 2009 and joint assessments of debt sustainability.

Thus, of the 26 countries that had reached the HIPC completion point by end-July 2009, 12 SSA countries were at moderate risk of debt distress and 4 were at high risk (cf. Table 7).

Similarly, of the 35 SSA countries that are potentially eligible for a PRGF programme (cf. Table 8), 17 are at moderate or high risk of debt distress. These countries share a number of the same vulnerabilities. High risk is generally linked to a narrow export base, concentrated on a few primary products and thus extremely sensitive to shocks (weather and price volatility), and to the quality of generally weak or deteriorating policies and institutions.[14] Oil-exporting countries are not immune to debt distress: Angola and Chad are at moderate risk and Congo is at a high risk, although this country, which reached the HIPC completion point on 28 January 2010, should nevertheless see a sharp reduction in its debt ratios.

Table 8 Risk to debt sustainability of PRGF-eligible African countries

Low risk	Moderate risk	High risk	Debt distress
Cameroon, Cape Verde, Kenya, *Madagascar, Mali, Mozambique,* Nigeria, *Senegal, Tanzania, Uganda, Zambia*	*Angola, Benin, Ethiopia, Ghana,* Lesotho, *Malawi, Niger Central African Republic, Sierra Leone,* Chad, *Rwanda*	*Burkina Faso, Burundi,* Congo, Côte d'Ivoire, *Gambia,* Sao Tomé and Principe	Comoros, DRC, Guinea, Guinea-Bissau, Liberia, Togo, Zimbabwe

Source: IMF website, updated on 4 September 2009. Presentations of debt distress risk to IMF Board cover 2007, 2008 and 2009. Countries that had reached HIPC completion point at 1 July 2009 are in italics.

14 "Heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI) – Status of implementation", IMF, September 2008.

Furthermore, DSAs of countries that reached the HIPC completion point show that the prospects for the future path of debt remain highly sensitive to the terms of new financing (IMF, 2008). In that paper, the assessment of debt sustainability includes a scenario based on less favourable (notably less concessional) new financing. In 60% of DSAs for these countries, the NPV of debt-to-exports ratio goes above the indicative threshold in the alternative scenario, compared with 30% of DSAs of non-HIPC countries.

2|2 The financial crisis has exacerbated the risk of debt distress[15]

The crisis could affect the external financing channels of some SSA LICs

Given how SSA countries specialise in commodities, which make up their main source of income, the crisis has affected them through a sharp shock to their exports and terms of trade, which has impacted current accounts and fiscal revenue.

While SSA countries account for just around 2% of global trade, their openness to international trade[16] is considerable and rising (it rose from 65% in 2000 to 79% in 2008). According to the IMF (2009), a 1% decline in global growth reduces SSA growth by approximately five-tenths of a percentage point. Furthermore, the external accounts of SSA countries are extremely sensitive to changes in the terms of trade.[17] The current account balance of SSA countries went from a USD 1.86 billion surplus in 2008 to a USD 34.27 billion deficit in 2009 (or 0.2% and 3.7% of GDP respectively, cf. Table 9).

Direct investment flows have been supported in recent years by commodity-related projects and held steady in 2008. However, they declined in 2009 as projects in these sectors were postponed or cancelled. Remittances, estimated at USD 20 billion in 2008 in SSA, are also down. According to the World Bank, after growing by 13.4% in 2008, remittance flows to SSA are expected to contract by approximately 3% in 2009. However, the impact of the decline will vary according to how dependent local economies are on remittances.[18]

Overall, these developments will slow the growth in foreign reserves. However, reserves should remain at comfortable levels for oil-exporting SSA countries (7.9 months of imports of goods and services in 2009[19] compared

15 *Chauvin and Lantéri (2009), "How the financial crisis is affecting Sub-Saharan Africa", presentation to Banco de España, Madrid, 21-22 September 2009.*
16 *Measured by ratio of (exports + imports)/GDP.*
17 *According to the WEO of last October, the terms of trade for goods fell by 3.3% in 2009, after increasing by more than 15% in 2008. However, in the oil-producing region of the CAEMC, the BCAS estimates the decline at close to 40%.*
18 *Countries that are heavily dependent, such as Lesotho (24.5% of GDP) and Gambia (12.5%), will be more affected than Kenya (5.3%), Swaziland (3.7%) and Benin (3.6%). World Bank, November 2009, "Migration and Development Brief: Outlook for Remittance Flows 2008-2010".*
19 Regional Economic Outlook Africa, *IMF October 2009.*

Table 9 Main balance of payment items, SSA

(USD billions)

	2006	2007	2008	2009	2010	2011
Current account	**22.63**	**2.05**	**1.86**	**-34.27**	**-27.71**	**-24.90**
o/w: balance of goods and services	*26.41*	*17.70*	*23.05*	*-30.92*	*-12.80*	*-4.55*
net current transfers	*32.72*	*35.94*	*39.59*	*43.52*	*36.89*	*37.97*
net income	*-36.62*	*-51.66*	*-61.04*	*-47.12*	*-51.97*	*-58.46*
Capital account	**39.22**	**15.24**	**6.57**	**9.79**	**11.87**	**6.91**
Financial account	**-46.39**	**1.15**	**6.06**	**45.19**	**41.61**	**44.52**
o/w: net direct investment	*13.26*	*26.42*	*35.87*	*23.54*	*27.93*	*34.25*
net portfolio investment	*19.53*	*11.54*	*-22.62*	*5.92*	*11.97*	*14.65*
other net investment	*-47.47*	*-8.49*	*9.76*	*-0.01*	*12.21*	*12.26*
reserves	*-31.72*	*-28.31*	*-16.94*	*15.74*	*-10.51*	*-16.65*
Pro memoria:						
Official flows, net	8.37	7.39	5.89	15.36	16.06	11.56
Private flows, net	10.90	25.79	21.40	16.79	39.22	47.93

Source: IMF.

with 8.4 months in 2008), while oil-importing countries are likely to see their reserves stabilise, albeit at relatively low levels (4.3 months in 2009, compared with 3.8 in 2008).

Fears have also been voiced concerning the possibility of a reduction in bilateral public development aid if developed countries reassess their commitments because of a shift in fiscal policies. A reduction could have a significant direct impact because most African countries are highly dependent on international aid, which typically accounts for more than 10% of their GDP. However, these fears need to be tempered, since developed countries, including France, confirmed that they would stand by their commitments at the G20[20] meeting in London in April 2009.

Countries with borrowing potential may seek to offset this possible reduction in external financing sources by increasing their non-concessional debt, notably from emerging creditors, which could threaten the sustainability of their debt.

Little room for manœuvre to respond to the crisis

The space that SSA countries have in which to manœuvre to support activity essentially hinges on their fiscal situation and borrowing capacity. Oil-importing countries are subject to especially significant fiscal constraints. In 2009, the deficit (excluding grants) of non-oil-producing LICs was expected at close to 8.1% of GDP (compared with 6.6% in 2008) while the deficit of fragile countries was estimated at 5.7% (compared with 3.9% in 2008). In these countries, however, the downturn is relatively less

20 The G20 comprises members of the G7 (Germany, Canada, USA, France, UK, Italy, Japan) as well as South Africa, Saudi Arabia, Argentina, Australia, Brazil, China, South Korea, India, Indonesia, Mexico, Russia, Turkey and the EU. Basically, the G20 is made up of the major industrialised economies of the G8 plus 11 large emerging economies and the EU.

Table 10 Estimated vulnerability of African countries to the effects of the crisis

Vulnerability	Country
High	Angola, Burundi, Zambia, DRC, CAR, Sudan, Nigeria, Liberia, Côte d'Ivoire, Ghana, Lesotho, Mauritania
Medium	Mozambique, Malawi, Tanzania, Madagascar, Ethiopia, Eritrea, Chad, Niger, Cameroon, Congo, Niger, Burkina, Guinea, Sierra Leone
Low	Kenya, Mali, Senegal

Source: IMF, "The implications of the global financial crisis for low income countries", March 2009.

severe because they already had large deficits. For oil-exporting countries, the relative decline in oil prices has undermined their fiscal positions, with their fiscal balance (excluding grants) moving from a surplus of 6.2% of GDP in 2008 to a deficit of 6.1% of GDP in 2009.

According to an IMF study[21] on the effects of the financial crisis on LICs, 28 LICs already have debt levels in excess of 60% of GDP. Simulations indicate that additional loans to make up for the shortfall in external financing[22] would quickly cause them to breach thresholds indicating high risk of debt distress. Exacerbating this situation is the fact that more than half of LICs' public debt is external and denominated in foreign currencies, which means, for countries with flexible exchange rate regimes, that a depreciation in exchange rates resulting from the deterioration of external balances will likely aggravate debt-to-GDP ratios. The currencies of several countries fell sharply between June 2008 and October 2009: the Ghanaian currency lost 33% against the US dollar, while Nigeria fell 22% and Zambia by 20%.

According to the IMF (2009), around one-third of LICs, of which half in SSA, are highly vulnerable[23] to the negative effects of the crisis on trade, FDI, aid and transfers (cf. Table 10).

2|3 The growing presence of emerging lenders: a source of uncertainty for the debt sustainability of African countries

In recent years, the resumption of borrowing by some countries reflects a changing international environment in which new lenders, particularly among emerging countries, are coming forward. The financing practices of these new lenders differ from the consensual rules applied by traditional donors. For example, emerging lenders offer large amounts of financing, in some cases well above the amounts likely to be provided by the IMF and

21 "The implications of the global financial crisis for LICs", March 2009. This IMF study looks at a sample of 71 LICs, of which half are in SSA.
22 Simulations assume that investment expenditure financing from public development aid and FDI is replaced with public external borrowing.
23 Vulnerability is based on simulations intended to estimate the impact of shocks to trade (decline in commodity prices to 1995-2007 average levels and 10% decline in other exports of goods and services), remittances (36% decline for SSA LICs), aid (20% decline on 2008) and FDI (30% decline relative to 2008 value) in terms of lost GDP and the reserves-to-imports ratio.

the IDA, and without conditionality, particularly on governance. These financing arrangements are often semi- or non-concessional and may be secured by natural resources or associated with commitments by the borrower countries (capital goods purchases, supply of oil at prearranged price, etc.).[24]

The lending strategies of emerging countries are routinely criticised because these countries do not belong to the multilateral bodies that manage and monitor debt and are therefore not bound by the collective rules that members have established over time. China is often cited among the group of new lenders.[25]

At the second forum on China/Africa cooperation in Beijing[26] in November 2006, China announced that it would double its aid to Africa and supply USD 5 billion in additional financing in the shape of loans and credit over a three-year period. In Sharm El-Sheikh in November 2009, at the third China/Africa forum, China said it would grant USD 10 billion in subsidised loans to Africa as part of a three-year programme.

The financial aid provided by China comes in three forms: grants (generally aid in kind); zero-interest loans; and semi-concessional loans (distributed by China Exim Bank and China Development Bank).[27] However, Chinese financing (cf. Table 11) is often criticised for failing to comply with the principles of the Paris declaration, governance rules and international standards.

Table 11 Stock and flows of Chinese FDI in Africa

(% of total FDI in Africa) Stock of Chinese FDI in Africa				*(% of total FDI to Africa)* Flows of Chinese FDI to main African countries			
	2003		2008		2003		2008
Zambia	29.3	South Africa	39.1	Nigeria	32.6	South Africa	87.6
South Africa	9.1	Nigeria	10.2	Mauritius	13.7	Zambia	3.9
Zimbabwe	7.5	Zambia	8.3	South Africa	11.8	Nigeria	3.0
Nigeria	6.5	Sudan	6.8	Zambia	7.4	Madagascar	1.1
Madagascar	5.7	Algeria	6.5	Mali	7.2	Algeria	0.8
Kenya	5.2	Mauritius	2.9	Algeria	3.3	Mauritius	0.6
Gabon	4.9	Tanzania	2.4	Egypt	2.8	Gabon	0.6
Guinea	2.9	Madagascar	1.9	Benin	2.8	DRC	0.4
Egypt	2.9	Niger	1.7	Mauritania	2.3	Kenya	0.4
Mauritius	2.6	DRC	1.7	Uganda	1.3	Tanzania	0.3

Source: 2008 Statistical Bulletin of China's Outward Foreign Direct Investment.

24 Rocher (E.) (2007), "Les risques de ré-endettement des pays en développement après les annulations de dettes", Bulletin de la Banque de France, No. 157, January.
25 "Financing Development in Africa: the growing role of non-DAC development partners", G24 Secretariat, 21 July 2008.
26 The forum on China/Africa cooperation was set up in October 2000 and seeks to strengthen cooperation between China and Africa. The forum meets every three years and gives rise to a three-year action plan.
27 See Reisen (2007).

To limit the potentially negative effects of non-concessional borrowing, the World Bank has introduced a "preventive" framework to gather information about loans taken on by AID clients and their level of concessionality. Reporting obligations are part of the IDA's Non-Concessional Borrowing Policy (NCBP),[28] which was approved by the IDA Board in July 2006,then reviewed in June 2008. It defines the deterrent/disciplinary measures that can be taken against free rider behaviour by certain lenders and non-concessional debt arrangements for MDRI beneficiaries. In fact, the reporting mechanism is not yet fully operational because of the breadth of the procedures and the coordination needed between all the creditors involved. However, the annual DSF[29] exercises should be an opportunity to sound out countries on the prospects for taking on more loans, including, as the case may be, non-concessional loans. If cross-checks show after

Box 2

The DSF and emerging lenders

On 22 April 2008, the DRC signed a cooperation agreement with a group of Chinese firms on investments in the mining sector and public infrastructure. The total loan amount covered by the agreement was USD 9.2 billion, of which USD 3.2 billion for the mining sector and two USD 3 billion loans for public infrastructure projects.

These loans to non-government structures came with non-concessional terms and were covered by an implicit guarantee from the Congolese government or a commitment to service the debt through earmarked government revenues.

According to criteria established by IDA policy, the arrangements did not have a high enough level of concessionality, which could have led to a reduction in the amount of aid granted to the DRC. Also, the terms of the agreement appeared to undermine the preferred creditor status of the international financial institutions (IFIs). The question was then raised as to whether the planned financial arrangements could compromise debt sustainability and threaten the debt relief that the DRC was likely to receive under the HIPC initiative and the MDRI.

In October 2008, after talks with the IMF and the World Bank, the Congolese authorities reaffirmed their interest in the financing, while recognising the potential cost of guarantees provided by the government. The IMF reiterated that the financing was not concessional and might make Congolese debt less sustainable.

.../...

28 Reference document: "IDA countries and non-concessional debt: dealing with the 'free rider' problem in IDA 14 grant-recipient and post MDRI countries", World Bank, 19 June 2006.

29 See IMF report "Staff guidance note on the application of the joint fund-bank debt sustainability framework for LICs", 6 October 2008 for a detailed presentation of the process for carrying out a DSA and its frequency. A DSA is carried out at least once a year for PRGF-eligible IDA countries.

The World Bank acknowledged the country's need for infrastructure investment, but said that the impact of these projects on long-term growth was not clear.

The IMF and the World Bank proposed that certain terms of the agreement be modified to make it more compatible with the terms of a new three-year agreement under the PRGF, paving the way for debt relief under the HIPC initiative and the MDRI and financing insurance from the Paris Club.

At the IMF Board meeting of 11 March 2009 on the application for assistance under the Rapid Access Component of the Exogenous Shocks Facility, it was indicated that if the renegotiation of the Chinese loans was deemed satisfactory, in June 2009 the Board could examine the question of introducing a PRGF programme.

Progress was made in summer 2009. In November 2009, the Congolese authorities approved an amendment to the Chinese agreement including three clauses:

- *withdrawal of the sovereign guarantee for the mining loan;*
- *cancellation of phase two of the infrastructure project;*
- *restriction of the sovereign guarantee to phase one of the infrastructure project.*

Following the signature of the amendment, the IMF and the World Bank carried out a DSA, which found that the loan's concessionality level included an estimated grant element of between 42% and 46%, which was consistent with IMF requirements and did not significantly alter the DRC's debt sustainability in the medium term. On 11 December 2009, the IMF Board approved the conclusion with the DRC of a three-year SDR 346.45 million programme under the PRGF.

the fact that borrowers have not been transparent, they will be liable for disciplinary measures. According to the NCBP, the disciplinary framework should contain, as a minimum:

- provisions for tightening the terms of assistance to borrowers;
- reductions in the amount of aid.

3| On the need for strengthened international cooperation and transparency

Illustrating the impact of the current crisis, the number of applications from LICs to the IMF for financial assistance has significantly increased, climbing from five in 2007 to 23 in 2008. By mid-September 2009, demand for concessional financing from the IMF had reached SDR 2.1 billion,

compared with SDR 0.8 billion for full-year 2008. The increase in borrowing requirements highlights the need to step up cooperation between all donors (new and traditional), and to make donors' methods more transparent, as part of the current reforms to the debt sustainability framework.

3|1 Forging greater international cooperation and transparency within the DSF

Efforts, particularly by G7 and G20 countries, to promote broader use of the DSF have intensified since 2007. At the G7 meeting in Washington in April 2007, finance ministers stressed the importance for debtor and creditor countries of using the DSF as a support for debt and lending policies. They emphasised the need to avoid the emergence of new cycles of debt distress by involving all parties, including lenders.

This idea was again highlighted in the action plan for good financial governance in Africa put together by the G8 in May 2007.[30] The plan emphasised the need for responsible lending practices, based on increased use of the DSF and information-sharing by lenders, to strengthen coordination and promote more effective use of funds.

Meeting in Berlin in October 2007, the G8 finance ministers wanted to further discussions on using the DSF by bringing in commercial creditors to reflect LICs' increased use of private financing sources. Work continued within the G20, which set up a debt sustainability study group in 2008.

This initial round of work has yielded several avenues of discussion, including the following:

• the shared responsibility of lenders and borrowers in minimising the risks of debt distress: borrowers can play their part through efforts to improve transparency, debt management capacity and sound macroeconomic policies; lenders, meanwhile, should use the DSF, which is a key tool in assessing the risks of debt distress and supporting financing decision-making;

• the need to strengthen international cooperation through shared initiatives that make it possible to:
– exchange views in international fora such as the G20;
– support borrowers through technical assistance programmes;
– consider ways to ensure greater coordination in lending decisions;
– improve information-sharing, transparency and available data on lending decisions.

30 "G8 action plan for good financial governance in Africa", 19 May 2007. G8 2007 finance ministers meeting.

3|2 Looking for greater flexibility from the DSF

Following internal reviews of the DSF[31] and recommendations by the G20 London meeting (April 2009), the IMF and the World Bank adopted reforms in January 2010 to enhance the framework's flexibility, without impinging on its main objective, i.e. controlling debt strategies. In particular, the reforms seek to reduce the procyclical nature of the DSF (reduction of threshold effects), notably during crises, take into account all stable external resources (including remittances), and encourage budget spending to be redirected towards economic development (recognise impact of public investment expenditure on growth). Specifically, the reform[32] covers the following aspects:

• **Mitigate threshold effects:** sustainable external debt limits depend heavily on changes in CPIA scores, which are limited in number. Threshold effects have been the subject of concerns in the past, and modifications were made in 2006 with the decision to use a three-year (rather than a one-year) moving average for these indices. In the future, when the CPIA crosses its boundary, a country's performance category will take place only if the CPIA score changes by more than 0.05 from the boundary for two consecutive years.

• **Enhance recognition of remittances:** developing countries that are classified as medium risk or that are likely to change category, and that receive sizable and stable remittances, could have these funds taken into account in the DSA under certain conditions and thus obtain a more favourable risk rating.

• **Integrate the impact of debt-financed investment on growth:** one shortcoming identified with the DSF was that it did not integrate the likely feedback effects from public investment on economic growth and the budget revenues generated. Nevertheless, despite the methodological difficulties involved in identifying and modelling this impact, a two-stage approach was adopted:
– pursue the current approach based on case-by-case analyses;
– extend empirical work by constructing a computable general equilibrium model incorporating the effects of public investment.

• **Define the conditions under which the debt of state-owned enterprises may be excluded.** The new framework considers that debt automatically encompasses all state-owned enterprises. However, in certain cases,

31 IMF and IDA (2008), "Staff guidance note on the application of the joint fund-bank debt sustainability framework for low-income countries", 6 October 2008.
32 IMF (2009), "Debt limits in fund-supported programs – Proposed new guidelines", Strategy, Policy and Review Department, 5 August.

state-owned enterprises that can borrow without a public guarantee and whose operations pose only a limited fiscal risk for the government may be excluded from external public debt. Other specific criteria may also be used to guide decisions, including managerial independence and the existence of subsidies and transfers.

Furthermore, to better take account of changes in the economic environment of LICs, admissible debt ceilings and concessionality terms imposed within the framework of IMF programmes were reviewed in December 2009.

There are several reasons to allow more flexibility on concessionality:[33]

• LICs do not have uniform borrowing requirements, debt levels or aid dependency;

• even if new donors follow less concessional lending practices, their funding may be an additional source of financing for project development, particularly in infrastructure;

• the crisis could cause a reduction in private capital flows to LICs and thus increase their borrowing requirements;

• whereas the concessionality requirement for external debt was, among other things, intended to limit exchange rate risk associated with market financing in foreign currency, the increase in the share of local currency debt held by non-resident agents raises the question of whether it is appropriate to consider only external debt. Until now, external debt was defined based on the criterion of creditor residency (non resident) and was often associated with foreign-currency debt. The IMF recommends the following options: for the most advanced LICs with open capital accounts, if concessionality requirements arise, total public debt should be taken into account, eliminating the distinction between external and domestic debt; for LICs with relatively closed capital accounts or limited integration within international financial markets, the use of the residency criterion is still relevant, with some amendments. For LICs in an intermediate situation with a large amount debt excluded from the application of the residency criterion, a currency denomination criterion might be an option. Concessionality requirements could then be applied to foreign-currency denominated debt, irrespective of the residency of the creditor.

Overall, while concessionality requirements are still based on the vulnerability of member countries, they have become more flexible for countries with higher capacity to manage public resources.

33 IMF (2009), "Changing patterns in low-income country financing and implications for fund policies on external financing and debt", 25 February.

This capacity is based on:

• the budget formulation process, particularly the identification of expenditures needed for development (inclusion of an element covering spending quality and guidance);

• the chain of expenditures, internal and external control mechanisms, the medium-term debt management strategy, including the establishment of a performance track record;

• the quality of institutions and the transparency of policies, assessed by combining the CPIA and Public Expenditure and Financial Accountability (PEFA) indicators.

Given the diversity of available information, to ensure that countries are fairly treated, the IMF has adopted a two-stage approach:

• use of indicators with broad coverage of LICs to enable a preliminary identification of higher-capacity countries: for this, a sub-CPIA (derived from the CPIA and comprising two policy-related components (debt and fiscal) and three components rating the quality of financial management and institutions) and the PEFA are used;

• a more precise classification of countries based on these indicators and additional sources of information, such as the Report on the Observance of Standards and Codes (ROSC), Debt Management Performance Assessment (DeMPA), Project Performance Assessment (PPA) and Worldwide Governance Indicators (WGI), plus the expertise of IMF and WB staff.

To the extent that the DSF has increasingly structured IMF financial programming and monitoring since 2005, the proposals to reform debt ceilings are aimed at ensuring increased flexibility of debt conditions and at customising the debt ceilings of member countries.

Accordingly, the new IMF policy based on the DSF is more flexible, offering several options depending on the economic situation of individual LICs, to guarantee access to concessional financing while leaving open the possibility of taking on non-concessional financing. The options proposed (cf. Table 12) are intended to reflect the diverse situations of LICs in terms of their debt vulnerabilities and debt management capacity.

Thus, as regards ceilings on non-concessional borrowing, four different types of capacity-based concessionality requirements apply.

In the group of low-capacity countries, the concessionality threshold for countries with higher debt vulnerability is at least 35% and applicable to

Table 12 Concessionality requirements: eligibility of African LICs executing an IMF-supported programme at 7 December 2009

Management capacity	Extent of debt vulnerabilities	
	Lower	Higher
Higher	Minimum average concessionality requirement applied to external or total public borrowing; for most advanced LICs, no concessionality requirements and overall nominal debt limit if needed	Overall limit on the PV of external or total public debt; for most advanced LICs, ceilings on nominal external or total public debt
	Cape Verde	
Lower	Minimum concessionality requirement applicable to each debt, but with added flexibility on non-concessional external debt (e.g., higher and untied nonzero limits, if consistent with maintenance of low debt vulnerabilities)	Maintain minimum concessionality requirement applicable to each debt (old system), likely higher than 35 percent, with limited or no room for non-concessional borrowing
	Angola, CAR, Ethiopia, Ghana, Mali, Mauritania, Mozambique, Niger, Senegal, Sierra Leone, Tanzania, Uganda, Zambia	Burkina Faso, Burundi, Comoros, RDC, Congo, Côte d'Ivoire, Djibouti, Gambia, Guinea, Liberia, Sao Tomé and Principe, Togo

Source: IMF.

each loan separately. Non-concessional loans should be the exception. For countries with lower debt vulnerability, the threshold would be 35%, with the option of taking on non-concessional loans up to limits that do not exacerbate vulnerabilities.

In the group of higher-capacity countries, annual debt-accumulation limits are set in PV terms for countries with higher debt vulnerability. In the case of the most advanced LICs, these limits might also be set in nominal terms. A minimum average concessionality requirement for debts contracted or guaranteed over a given period is established for countries with lower debt vulnerability. For the most advanced LICs, consideration might also be given to dropping concessionality requirements.

International cooperation efforts, particularly since 2007, have made the DSF more flexible. These changes, which have taken place while maintaining the DSF's overarching objective, i.e. to preserve the debt sustainability of LICs over the medium term, should make it possible to reflect the new international context in which these countries find themselves, characterised by increased borrowing requirements and a sharp rise in less concessional financing provided by emerging countries.

For this reason, the development of local financial markets operating in local currencies, promoted by a redemption from "original sin", is a key way forward in lessening financing constraints. The development of financial markets in SSA would make it possible to recycle not just local savings, which are insufficient but relatively plentiful when substantial capital flight is factored in, but also migrants' savings and the portion, however tiny, of surplus global

savings drawn by the prospects of diversification. The DSF can play a useful part in building credibility on the way to achieving this desirable shift.

Furthermore, the DSF provides new emerging creditors with a preventive framework to avoid past problems. While their unwillingness to apply rules that they did not help to make is understandable, it is possible to promote awareness about the mutual benefits that the DSF can bring in a multilateral framework. Including the DSF in the G20 development agenda could help in this regard.

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