TO LEND OR TO GRANT?

A critical view of the IMF and World Bank's proposed approach to debt sustainability analyses for low-income countries

Working paper

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Background

The IMF and World Bank have produced a paper outlining a new approach to donor financing for Low-Income Countries (LICs). The paper proposes a new set of considerations for analysing debt sustainability in LICs and therefore the levels of credit recipient countries can afford to take on. The need for a fundamental rethink of the World Bank and IMF's approach to debt sustainability has emerged for 3 reasons:

- The cases of Niger, Rwanda and Ethiopia have highlighted one of the weaknesses of the *Heavily Indebted Poor Country* (HIPC) Initiative and the inadequacy of its approach to debt sustainability. The three countries require access to additional finance in order to maximise their prospects of achieving the MDGs. But the only sources of finance available to them are further concessional loans that will take their debts over the HIPC Initiative's defined thresholds of sustainability (150% debt-to-exports ratio). So, under existing financing rules, there is an inconsistency between adhering to HIPC's current thresholds of debt sustainability and the financing required to meet the MDGs.
- Some countries' debt ratios have moved into ranges deemed by the HIPC framework to be unsustainable. These newly unsustainable positions have emerged after Completion Point because of declines in commodity prices, a decline in discount rates and some creditors refusal to participate in the HIPC Initiative.
- The HIPC Initiative's approach to debt sustainability has focused narrowly on a so-called "backward-looking" approach to debt write offs. This approach has been set in a standardised, "one-size-fits-all", framework that sets a common threshold of sustainability across a range of eligible countries irrespective of their capacity to service future borrowing. The Bank and Fund argue a new approach is required that will set ranges of sustainable debt levels on the basis of country-specific variables.

The new approach to debt sustainability

The IMF is proposing to introduce a new set of debt sustainability analytical measures to determine the creditworthiness of LICs and their risk of "debt distress". The proposed framework focuses on three measures. These are:

- The robustness of policies and institutions as measured by the World Bank's CPIA (Country Policy and Institutional Assessment) indicators.
- The vulnerability of LICs to exogenous shocks – with vulnerability being defined as the frequency and duration of adverse shocks.
- The level of debts to fiscal revenue.

According to the Fund's analysis, those countries more likely to fall into debt-distress are those with poor CPIA ratings, a higher vulnerability to shock and higher levels of debt-to-fiscal revenue. And conversely, those with good policies and lower levels of vulnerability can have higher debt levels without incurring real risks of debt distress.

The Fund's new approach proposes the official creditor community's lending policies adjust the level of the grant element in new financial flows to LICs according to the capacity of aid recipient countries to maintain their debt-servicing obligations. In other words, a higher level of grant should be made available in new financing for countries that are, according to the new tests, at risk from debt distress and, conversely, higher levels of concessional financing are affordable for countries with good policies and stronger institutions and at lower risk to shocks.

Analysis

On the positive side, there are elements of the new approach to debt sustainability that should be welcomed.

- The HIPC Initiative's one-dimensional approach to debt sustainability, the debt-to-exports criterion, was frequently criticised by NGOs for, amongst other failings, its weakness as an accurate predictor of future debt sustainability. The volatility of export earnings makes the HIPC Initiative's debt sustainability analysis an unreliable guide of future debt sustainability. A country specific approach that includes a broader range of indicators is needed in order to build up a more realistic picture of the constraints facing LICs.

- The Bank and Fund's paper addresses, albeit weakly, the issue of financing the MDGs and throws the onus on the official donor community to come up with requisite finance in a form that will not precipitate a new debt crisis post-2015.

- The paper also reasserts an important recognition that when debt ratios are unstable and rising, debt stocks can constitute an important constraint to development even in circumstances where there is a net inflow of resources.

- The paper sets out some interesting work on the possibility of predicting future debt distress. It acknowledges the need for more thorough stress testing to assess the destabilising effects of potential shocks.

The weaknesses of the IMF's proposed approach stem from the lack of serious treatment it gives to recasting financing instruments and debt sustainability around the achievement of the MDGs.

- The paper makes an artificial distinction between the HIPC Initiative's "backward looking" approach to debt sustainability and debt sustainability in the context of new "forward financing strategies". In other words, the role that debt relief can play in accessing new financial flows, and finance in a form that has significant advantages over and above current aid regimes[*], is completely sidestepped by the paper. It is self-evident that a LIC's current debt stocks have an impact on future external financing requirements. The

[*] Debt relief is more stable and predictable as a form of *de facto* resource transfer to LICs. Unlike aid, it is a counter-cyclical transfer, it has an anti-inflationary and pro-growth dynamic and it can enhance local accountability for the prudent management of public resources. There is no evidence that aid flows exhibit these positive interactions. Tied aid denies recipient countries up to $5 billion per annum (almost 10% of global ODA) whereas debt relief is untied; Source: DRI Strategies for Financing Development Newsletter, Issue 18, 1st Quarter 2004, p. 3. [See CAFOD, Oxfam GB, Christian Aid and Eurodad paper – *A Joint Submission to the Review on Debt Sustainability2002*

financing constraints of LICs will be loosened and their future borrowing needs lightened if they are carrying over reduced levels of debt stocks from HIPC Initiative-type operations. The Fund and Bank need to reconsider the role that debt relief can play in providing additional development resources. And in the context of the urgent need to close the MDG financing gap for all LICs (HIPC and non-HIPC), there is an urgent need to review the case for further debt relief in a new MDG financing framework.

- There is the further benefit of debt stock reductions that is not touched on in this paper. Empirical work by the IMF shows a positive interaction between debt reductions and economic growth in LICs. This dynamic relationship between debt relief and economic growth is worth looking at with renewed urgency both because the MDGs are more likely to be achieved with higher levels of growth and because higher economic growth has a bearing on the levels of new credit LICs can afford to take on. We argue that external debt reduction is more pro-growth than conventional ODA transfers. Particularly in those LICs where domestic debt burdens are significant, channelling additional debt relieved resources to retiring domestic debt can reduce the crowding-out of private sector investment, which would in turn spur economic growth. Recent empirical evidence in two working papers[1] produced by the IMF clearly shows a positive relationship between debt stock reduction and rising economic growth, notably through an increase in the quality and quantity of domestic and foreign investment. This important dynamic and the implications this has for forward financing strategies is missed out in the Fund's paper.

- Of all the variables the IMF and World Bank propose using for assessments of the sustainability of future borrowing, no mention is made of the critical constraint faced by LIC governments – the requirement to finance their poverty reduction programmes (a requirement set out by the PRS framework and by virtue of their commitment to the Millennium Declaration). The paper develops a series of stress tests with a set of variables. But these variables do not include poverty reduction imperatives and the tension faced by recipient governments between meeting the competing priorities of financing Poverty Reduction objectives adequately or financing their debt-servicing obligations.

- The Fund and Bank's proposed approach of using a set of CPIA and vulnerability indicators as measures of debt distress is too narrow to capture the potential stresses and instabilities faced uniquely by all LICs. The CPIA and commodity price vulnerability indicators are in reality proxies for the more pervasive and deeper dynamic of stress faced by all LICs – deep, widespread and persistent levels of poverty and a lack of resources. The levels of poverty in LICs present inherently destabilising challenges. It is self-evident that a country with levels of absolute poverty in excess of 60% of its population is challenged by more unstable social, political and economic dynamics – including internal migration flows, epidemiological crises, famine and high levels of human and political

[1] External Debt, Public Investment, and Growth in Low-Income Countries *Benedict Clements, Rina Bhattacharya, and Toan Quoc Nguyen* © 2003 International Monetary Fund
And External Debt and Growth" IMF working paper April 2002 *Catherine Pattillo, Helene Poirson, and Luca Ricci*

insecurity. The magnitude of the challenges associated with large human development deficits may significantly detract from LICs' debt repayment capacity. But assessments of levels of poverty are not directly captured in the Bank and Fund's CPIA and export vulnerability approach. It is worth bearing in mind an original point made by NGOs in an earlier paper - "lower income countries are likely to be characterised by deeper MDG financing gaps. The donors should aim to give higher volumes of aid in grant form where per capita GDP is lower. In other words, the degree of concessionality in new flows for LICs, running from grant aid to concessional loans, should be adjusted according to the depth of human development needs in LICs."[2]

- While recipient government policies and institutional strengths are clearly important variables to consider in assessing LICs' creditworthiness, using the CPIA as a criterion for assessing the likelihood of debt distress pins a great deal of weight on a weak analytical tool that has been heavily criticised for relying too heavily on the subjective judgement of World Bank staff. Leaving aside concerns about the lack of a sound evidence base for some of the criteria used to assess CPIA rankings, there are serious concerns about the viability of using the CPIA as a central determinant of future creditworthiness. Some commentators have noted degrees of confidence of World Bank staff in their own CPIA assessments varying by as much as 90%[3]. Also, the CPIA works on assessments of the current policy and governance environment. However, the policy environment is subject to both rapid changes and to re-appraisals depending on the changing priorities and preferences of donors.

- The paper does not address the *prima facie* conflict of interests when major creditors such as the IMF and World Bank act as creditors and retain their monopoly of analytical functions in assessments of country-specific debt sustainability thresholds. We would argue that in the interests of equity and transparency, a more independent institutional arrangement is required. Such a structural rearrangement should clearly separate the analytical and creditor functions currently held by the international financial institutions. If such a division of functions is not possible in the short term, there should at least be an institutionally independent auditing or peer review mechanism housed outside the Bank and Fund or other bilateral creditors.

- On debt management, the IMF and World Bank propose a narrow cadre of officials in recipient countries analysing currency denominations, debt stocks and debt servicing flows. This is an insufficient treatment of the political dynamics that surround new borrowing in recipient countries. In order to reduce the risk that future borrowing will lead to sustainability problems, donors should support the building of recipient countries' capacity to manage debt. Civil society, Parliaments and the private sector should be involved in any decisions to contract new debt, and in how those resources are used. This requires greater transparency on the part of official and commercial creditors

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[2] Debt and the MDGs – September 2003 www.cafod.org.uk/policy- *Henry Northover – CAFOD; Paul Ladd - Christian Aid; Francis Lemoine – Eurodad; Romilly Greenhill - Jubilee Research* September 2003

[3] How well do measurements of an enabling domestic environment for development stand up? - *Barry Herman (UN) XVII Technical Group Meeting of the Group of 24* - March 2004

in new lending agreements. Civil society organisations throughout Africa are calling for greater openness, transparency and accountability on new borrowing decisions made by governments. Donors should be assisting these efforts by coordinating their lending decisions and ensuring a broad group of in-country stakeholders are involved in donor policy-making. Irresponsible borrowing also has its corollary in irresponsible lending. Creditors too need to monitor each other's lending decisions.

Finally, the design of a framework that adjusts the terms of new finance consistent with achieving the MDGs and averting future debt crises needs also to include assessments of the reciprocal obligations on the part of donors to provide the necessary levels of development finance now and in the future. The IMF should develop a signalling role for itself, one that will alert the international community to the MDG financing shortfall faced by LICs and to highlight where bilateral donors' provisions of development finance are off-track.

Henry Northover
CAFOD - April 2004

www.cafod.org.uk/policy