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How to prevent and resolve debt crises in LICs?

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How to Prevent and Resolve Debt Crises in LICs?

Kathrin Berensmann

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Preface

This paper presents a study written on behalf of the Federal Ministry for Economic Cooperation and Development (BMZ). The author is solely responsible for the content of this paper. The views expressed in this paper are those of the author and do not necessarily reflect the views or official policies of the BMZ. The author would like to thank, in particular, Gundula Weitz as well as Alexander Freese, Paul Garaycochea, Roger Fischer, Mario Sturm and Michael Klingberg for valuable comments. In addition, the author also greatly appreciates the comments of, in particular, Peter Wolff as well as Markus Loewe and Ulrich Volz.

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Abbreviations

ADB	Asian Development Bank
AFD	Agence Française de Développement
AfDB	African Development Bank
BCEAO	Banque Centrale des Etats de l’Afrique de l’Ouest (Central Bank of West African States)
BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (Federal Ministry for Economic Cooperation and Development)
CCL	Counter-Cyclical Loan
CPIA	Country Policy and Institutional Assessment Index
CRW	Crisis Response Window
DAC	Development Assistance Committee
DeMPA	Debt Management Performance Assessment
DLP	Debt Limit Policy
DMF	Debt Management Facility
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
ECF	Extended Credit Facility
ECG	Group on Export Credits and Credit Guarantees
ELF	Emergency Liquidity Facility
ENDA	Emergency Assistance for Natural Disasters
ESF	Exogenous Shocks Facility
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FDI	Foreign Direct Investment
FTAP	Fair and Transparent Arbitration Process
GDP	Gross Domestic Product
Gemloc	Global Emerging Markets Local Currency Bond
GNI	Gross National Income
HAC	High Access Component
HIPC	Heavily Indebted Poor Countries
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDF	International Debt Framework
IFAD	International Fund for Agricultural Development
IFC	International Financial Cooperation
IFI	International Financial Institution
IMF	International Monetary Fund
LIC	Low Income Country
LMIC	Lower Middle Income Country
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
MIC	Middle Income Country
MIGA	Multilateral Investment Guarantee Agency

MTDS	Medium-Term Debt Management Strategy
NCBP	Non-Concessional Borrowing Policy
NPV	Net Present Value
OCED	Organisation for Economic Co-operation and Development
OP	Operational Policy
PBG	Policy-based Guarantee
PCG	Partial Credit Guarantee
PDM	Public Debt Management
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PRG	Partial Risk Guarantee
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction and Strategy Paper
PSI	Policy Support Instrument
RAC	Rapid Access Component
RCF	Rapid Credit Facility
RDB	Regional Development Bank
SBA	Standby Arrangement
SCF	Standby Credit Facility
SDR	Special Drawing Right
SDRM	Sovereign Debt Restructuring Mechanism
SMEs	Small and Medium-sized Enterprises
SOEs	State Owned Enterprises
SSA	Sub-Saharan Africa
TCX	Currency Exchange Fund N.V.
UNCTAD	United Nations Conference on Trade and Development
UNESCO	United Nations Educational, Scientific and Cultural Organization
WAEMU	West African Economic and Monetary Union
WB	World Bank

Summary and policy recommendations

The global financial crisis has had an impact on the debt levels of Low Income Countries (LICs), with higher borrowing needs jeopardising debt sustainability in LICs. According to the IMF, a country's external debt may be seen as sustainable if the country is able to meet all of its current and future debt-service payments without having to restructure its debt or the accumulation of debt, and without impairing its prospects of economic growth. This definition is quite narrow from an overall development perspective because it does not include domestic debt and therefore it does not extend to fiscal debt sustainability. Nevertheless, this definition should mainly contribute to understanding the external dimension of debt sustainability. Debt sustainability represents one important prerequisite for sound growth and development.

However, the magnitude of these effects is still uncertain because data on debt levels for 2009 are not yet available. Latest Debt Sustainability Analyses (DSAs) of the International Monetary Fund (IMF) / World Bank (WB) show that nearly one third of LICs are at high risk of external debt distress or are already in debt distress. If we add countries at moderate risk of debt distress, this share increases to nearly two thirds of LICs. The global financial crisis has contributed in some graduated Heavily Indebted Poor Countries (HIPC), i.e. countries which have received debt relief under the HIPC-Initiative, to a deterioration of the debt situation because exports have declined in these countries and GDP growth has been lower than projected before the crisis. It should be noted, however, that these high debt levels are not due solely to the global financial crisis.

Many LICs have been and will continue to be unable to generate sufficient financial resources to mitigate the effects of the present global financial crisis. Even though the magnitude of the effects of the global financial crisis on the debt situation in LICs also depends on policy responses and domestic factors as well as on the interaction of various shocks, many LICs have been and will continue to be dependent on concessional donor credits and grants. Since the cause of the global financial crisis was economic and financial mismanagement on the side of industrialized countries, they must be seen as responsible for the effects of the crisis in developing countries and should therefore provide additional financial resources to LICs.

New financing options need to be elaborated to augment subsidised lending to LICs because current financial resources of major multilateral lenders to LICs are not sufficient. However, new financing is useful only in the case that LICs have sufficient absorption capacities. Problems in this area are generated by capacity deficiencies, structural economic problems, or unsound macroeconomic policies. The recent global financial crisis has shown that appropriate instruments for absorbing such an exogenous shock need to be flexible and anti-cyclical. Moreover, a large amount of money has to be available in the short-term.

What we find here is a trade-off between two objectives. On the one hand, financing to LICs needs to be increased which generates higher debt levels, but on the other hand, debt sustainability should be maintained. Therefore, financing instruments of donors need to be highly concessional. For achieving these two goals we have to distinguish between measures aimed at preventing and at resolving debt crises even if it is difficult to draw a clear dividing line between these two categories because some measures are geared to both crisis prevention and resolution.

Prevention of new debt crises

Better monitoring and assessment frameworks as well as more concessional funds for LICs are necessary to prevent debt crises in LICs. Viable policy instruments to prevent debt crises in LICs include the general frameworks of the IMF and the World Bank in LICs – the Debt Sustainability Framework (DSF), the Debt Limit Policy (DLP) and the Non-Concessional Borrowing Policy (NCBP) assuming an important role in the global debt governance. Nevertheless, there appear to be uncoordinated parallel structures for the overall debt policy of IMF / World Bank because the DLP and the DSF adopt different analytical frameworks for assessing capacity. These different analytical frameworks could lead to different results concerning LICs' debt sustainability. Therefore, these frameworks have to be streamlined. In addition, the NCBP and the Fund's DLP should be harmonized by using the same concessionality requirements and by using similar rules for providing non-concessional loans. Moreover, it is questionable whether these frameworks have been overly effective because debt sustainability of many LICs has been endangered.

The increase in the amount of concessional facilities of the IMF by up to US\$ 17 billion through 2014 is in general appropriate to help to ensure debt sustainability in LICs. Higher lending volumes of concessional facilities would enable LICs to borrow more on concessional terms rather than having to resort to non-concessional financing, which could generate future debt service problems. However, the IMF has to ensure that borrowings are used for increasing productive capacities. Another important question is whether this new role of the IMF in LICs is appropriate or whether it negatively affects the division of labour of the International Financial Institutions.

The new concessional lending instruments of the IMF include more flexible short-term financing instruments in the event of exogenous shocks. However, the practice will show whether this new lending architecture for LICs works. More flexible rules for blending concessional financing with non-concessional financing is generally useful. However, there should be an increase in non-concessional credits only in exceptional cases when debt sustainability is not endangered.

Similarly, the International Development Association (IDA) has reacted to the crisis and implemented appropriate reforms:

- **IDA Fast Track Facility:** In December 2008, the World Bank Group established this facility amounting to US\$ 2 billion to frontload grants and long-term, interest-free loans designed to support LICs in their efforts to mitigate the effects of the global financial crisis. Since this facility is part of the IDA 15 fund, these are not additional financial resources.
- **IDA guarantees:** This instrument plays an important role to support countries in leveraging IDA resources by mobilising private project financing and should thus be extended. For this reason, it was appropriate to establish IDA guarantees as a standard instrument.
- **IDA Crisis Response Window:** In December 2009, the World Bank established a new pilot Crisis Response Window (CRW) in IDA for the remainder of the IDA 15 period (January 2010 – June 2011); it has a volume of US\$ 1.3 billion and its aim is to protect

LICs from future crises. Since the CRW supports LICs quickly in the event of exogenous shocks, it is in this regard complementary to IDA loans and grants. However, concerning financing conditions which are similar to IDA loans, i.e. long maturity, grace period and service charges, it is to some extent questionable whether the CRW is complementary to existing IDA instruments. A shorter repayment period is in some cases preferable in that long maturities tie up concessional resources for a longer period of time than necessary, because e.g. some countries may need such funds only for a shorter period of time. For this reason there could be a need for a short-term flexible concessional instrument. With regard to the division of labour between International Financial Institutions, it is questionable, however, whether the IMF and the World Bank both need short-term lending instruments.

The financial crisis has led to growing government financing gaps as a consequence of lower tax revenues and higher expenditure needs. One important measure to ensure external debt sustainability is to improve capacity-building in LICs for public debt management (PDM) because a good PDM can help to identify and quantify the most relevant risks associated with different financing options and, in addition, support an effective debt management. The World Bank and the IMF have increased the debt management capacity of borrowers and developed the so-called Medium-Term Debt Management Strategies (MTDS). Thus, IFIs have already started with a large programme to enhance capacity building in the field of debt management. These provisions have to be implemented for a while and could then be evaluated.

The Counter-Cyclical Loan represents an innovative instrument to prevent debt crises which is currently used by the Agence Française de Développement (AFD). This instrument provides the debtor country with the opportunity to suspend payments in the event of exogenous shocks. In addition, this instrument could serve to improve the debt management of partner countries. However, debt crises can only be prevented if donors are coordinated. Inter-donor coordination is important for preventing a debt crisis in one country because, relative to a country's total debt, loans provided by one bilateral donor represent only a small share of the total credit involved.

Another option to reduce external debt vulnerability in LICs is to establish local currency bond markets. However, necessary structural conditions are not given in many LICs. For this reason, local currency bond markets represent a viable instrument to reduce external debt only for a few LICs. In the future, it will be a promising instrument to reduce external debt as many Middle Income Countries (MICs) have proven. For this reason donor support to LICs in developing their domestic debt markets have been stepped up. Donor initiatives such as the World Bank's Gemloc Program and the TCX initiative of bilateral donors are an important step in this direction.

Resolution of debt crises

Viable policy instruments to resolve debt crises include first, an insolvency procedure for sovereign debt because it offers the opportunity to ensure a restructuring process that proceeds in an orderly and predictable manner. In the current international financial architecture there is no comprehensive procedure, or roadmap, available to restructure a country's foreign debt. The lack of a comprehensive approach to restructure debt leads to high costs resulting from delays in initiating restructuring processes. Due to heteroge-

neous creditor groups debtors may have problems in reaching a timely agreement with their creditors. In comparison with a timely restructuring, these delays generate high costs such as losses in currency reserves and a decline in economic output. Moreover, a timely restructuring contributes to preserving the value of claims.

Second, a moratorium on the debt service of LICs could contribute to debt sustainability in the short-term. The main advantage of a moratorium is that it provides the debtor time to improve his liquidity situation. However, a moratorium should only be implemented in the case that it is the only instrument available in the short-term, because moratoriums entail numerous problems. First, a moratorium violates the fundamental principle on which all contracts are based, namely that terms and conditions need to be met in full and on time. Second, a moratorium may encourage moral hazard on the part of debtors. Therefore, a moratorium should be established only in exceptional cases and with creditor consent. If a moratorium is established, it should cover debt service only, in that its main intent should be to provide the debtor short-term liquidity. Eligibility should be determined on the basis of criteria such as debt indicators and / or income level. Moreover, the reason for high debt levels should be considered, i.e. a moratorium should be offered to LICs only in the case of exogenous shocks.

Third, debt swaps, in particular triangular agreements, present a viable instrument to reduce debt, to increase the development leverage of donor countries and to increase development measures in partner countries that would not have been implemented without the debt swaps. Under trilateral debt swaps, the creditor and the debtor country cooperate with a third party and the creditor usually places the funds in a trust account that is administered by an independent body. By using trilateral agreements the problems posed by fiduciary risks and windfall effects could be reduced, because the money for development projects is paid into a fund managed with established evaluation mechanisms.

1 Objectives of the study

The current global financial crisis has jeopardised the external debt positions of various low income countries (LICs) because revenues from exports and growth rates have declined. In addition, remittances as a major source of external financing have decreased and Foreign Direct Investment (FDI) to LICs has also fallen. Many LICs will not be able to close this financial gap with their own resources and have therefore to resort to higher external borrowing (IMF / IDA 2009, 22; IMF 2009d and 2009e, 22; World Bank 2009a). Despite debt relief initiatives over the past decade, such as the Heavily Indebted Poor Countries (HIPC)-Initiative and the Multilateral Debt Relief Initiative (MDRI) and the establishment of the Debt Sustainability Framework (DSF), a new round of debt distress in LICs appears to be likely, in particular in cases of exogenous shocks.

The objective of this paper is to assess various policy instruments used by donors to ensure debt sustainability in LICs. This study focuses mainly on those policy instruments which are currently under discussion, including those which international financial institutions (IFIs) have recently implemented.

Policy measures have to meet two opposing objectives. On the one hand, financial resources to LICs need to be increased on account of the existing financial gap. The World Bank has estimated that the financing gap for core spending on sectors important for poverty reduction – health, education, safety nets, and infrastructure – amounted to about US\$ 11.6 billion in 2009 (World Bank 2009e, 2). On the other hand, debt sustainability should be maintained and future debt crises should be prevented. In this regard, prudent lending and borrowing plays an important role, which means in this context that additional financial resources need to be highly concessional. In addition, instruments for debt monitoring and assessment have an important role to play. This paper presents and assesses various policy instruments that can serve to extend financing for LICs without significantly endangering their debt sustainability.

To attain these two goals we have to differentiate between measures aimed at preventing and at resolving debt crises. This distinction plays an important role for adopting various policy instruments in situations which have not yet escalated into crises. However, it is not always possible to draw a clear dividing line between these two categories because some measures are geared to both prevention and resolution.

In view of the breadth of the topic, this study seeks more to provide an overview of various policy instruments designed to prevent and resolve debt crises than to present these policy instruments in detail. In addition, the paper concentrates on donor policy instruments and does not include policy instruments of recipient countries.

This paper is structured as follows: Chapter 2 presents briefly the current debt situation and debt structure of LICs. Chapter 3 assesses policy instruments to prevent debt crises in LICs and chapter 4 discusses alternative policy instruments to resolve debt crises in LICs. Finally, chapter 5 concludes with a review of policy instruments and provides recommendations.

2 Current debt situation and debt structures of LICs

A country's external debt may be seen as sustainable if the country is able to meet all of its current and future debt-service payments without having to restructure its debt or the accumulation of debt, and without impairing its prospects of economic growth.

This definition is quite narrow from an overall development perspective because it does not include domestic debt and therefore it does not extend to fiscal debt sustainability. However, this definition should mainly contribute to understanding the external dimension of debt sustainability (IMF / IDA 2001, 4).

The global financial crisis has affected debt levels of LICs in 2009. However, the magnitude of these effects is still uncertain because data on debt levels for 2009 are not yet available. Latest Debt Sustainability Analyses (DSAs) of the International Monetary Fund (IMF) / World Bank (WB)¹ show that nearly one third of LICs are at high risk of external debt distress or are already in debt distress. If we add countries at moderate risk of debt distress, this share increases to nearly two thirds of LICs. High risk countries or those that are already in debt distress include eight pre-completion HIPC countries, six non-HIPC countries, seven HIPC post-completion point countries / post-MDRI countries and one non-HIPC / post-MDRI country (Table 1).

The global financial crisis has contributed in some graduated HIPCs to a deterioration of the debt situation because exports have declined in these countries and GDP growth has been lower than projected before the crisis. Seven post-completion point HIPCs which have in addition received debt relief under the MDRI are at high risk of external debt distress: Afghanistan, Burkina Faso, Burundi, Gambia, Haiti, Republic of Congo and Sao Tomé and Príncipe.² It should be noted, however, that these high debt levels are not due solely to the global financial crisis.

The future debt situation could deteriorate even further. This is due to the fact that these risk ratings are based on the most recent DSAs of IMF and World Bank, which have mainly been carried out during 2008, 2009 and at the beginning of 2010. For this reason the macroeconomic framework used in these DSAs may not fully mirror the unfavourable effects of the current global financial crisis. Recent IMF and the World Bank simulations reflecting the effects of the global financial crisis have indicated an increase in debt vulnerabilities for a number of HIPCs.

- **Moderate risk countries:** Five post-completion point HIPC countries could experience aggravated debt vulnerabilities: Ethiopia, Malawi, Mauritania, Nicaragua, and Sierra Leone. However, in three countries, Ethiopia, Mauritania and Nicaragua, violations of DSA limits under the updated scenarios are temporary and / or small.
- **Moderate risk countries:** One country in this category, Mali (post-completion point country), could be faced with increased debt vulnerabilities. However, this vulnerability will probably not be serious (IMF / IDA 2009, 23-24).

1 DSAs available as of February 2010 or earlier, but DSAs are based on data of 2007 and 2008 (IMF 2010a).

2 Some country cases are presented in detail in the appendix of this paper.

Table 1: List of LIC DSAs for PRGF-Eligible Countries			
Country	Risk of debt distress^a	Minimum grant element for external financing (in per cent)	Country Category
Afghanistan	High	60	HIPC post-completion point + MDRI
Burkina Faso	High	35	HIPC post-completion point + MDRI
Burundi	High	50	HIPC post-completion point + MDRI
Comoros	In debt distress	50	HIPC pre-decision point
Democratic Republic of Congo	In debt distress	--	HIPC Interim
Republic of Congo	High	50	HIPC post-completion point + MDRI
Côte d'Ivoire	High	35	HIPC Interim
Djibouti	High	35	Non-HIPC
Gambia	High	45	HIPC post-completion point + MDRI
Grenada^b	High	35	Non-HIPC
Guinea	In debt distress	35	HIPC Interim
Guinea-Bissau	In debt distress	50	HIPC Interim
Haiti	High	35	HIPC post-completion point + MDRI
Lao P.D.R.	High	--	Non-HIPC
Liberia^c	In debt distress	100	HIPC Interim
São Tomé and Príncipe	High	50	HIPC post-completion point + MDRI
Sudan	In debt distress	--	HIPC pre-decision point
Tajikistan	High	35	Non-HIPC MDRI
Togo	In debt distress	35	HIPC Interim
Tonga	High	--	Non-HIPC
Republic of Yemen	High	--	Non-HIPC
Zimbabwe^b	In debt distress	--	Non-HIPC

Source: Modified version of IMF 2010a; IMF 2010b

a "All LIC DSAs are expected to include an explicit rating of the risk of debt distress. However, some DSAs contain a discussion of the risk of debt distress, but no explicit rating. This has been the case for countries for which International Development Association does not require a rating for operational purposes (IDA-blend countries)." (IMF 2010a, 1)

b "PRGF-eligible non-IDA only countries." (IMF 2010a, 1)

c "The program does not envisage any external borrowing." (IMF 2010a, 1)

Even if, according to IMF and IDA, a major debt crisis for HIPC countries is quite unlikely to occur in the aftermath of the global financial crisis, recent DSAs have pointed to higher debt vulnerabilities in several HIPC countries (IMF / IDA 2009, 24). For this reason, prudent lending and borrowing is central to ensuring debt sustainability in these countries. New and existing instruments for preventing and resolving debt crises need to be assessed.

Appropriate instruments have to take into account specific features of LICs with respect to their debt structure. LICs tend to borrow more from official creditors, while more advanced economies tend more to be indebted with private creditors. Official multilateral and bilateral creditors account for a large share of external financing to LICs. In 2008 long-term external outstanding and disbursed debt of official creditors accounted for more than 87 per cent of total long-term external outstanding and disbursed debt, while the figure for private creditors in LICs was less than 13 per cent. Multilateral creditors of LICs accounted in 2008 for 52 per cent of total long-term external debt, and among these IDA accounted for 35 per cent, IBRD 1.6 per cent and the IMF for 4.5 per cent of total long-term external debt (World Bank 2009f). Similarly, the financial terms for credits differ between LICs and MICs. LICs tend to borrow mainly on concessional terms. Governments of LICs borrow chiefly from external sources, and this leads to a closer link between external and public debt sustainability (Barkbu et al. 2008, 3 and 7).

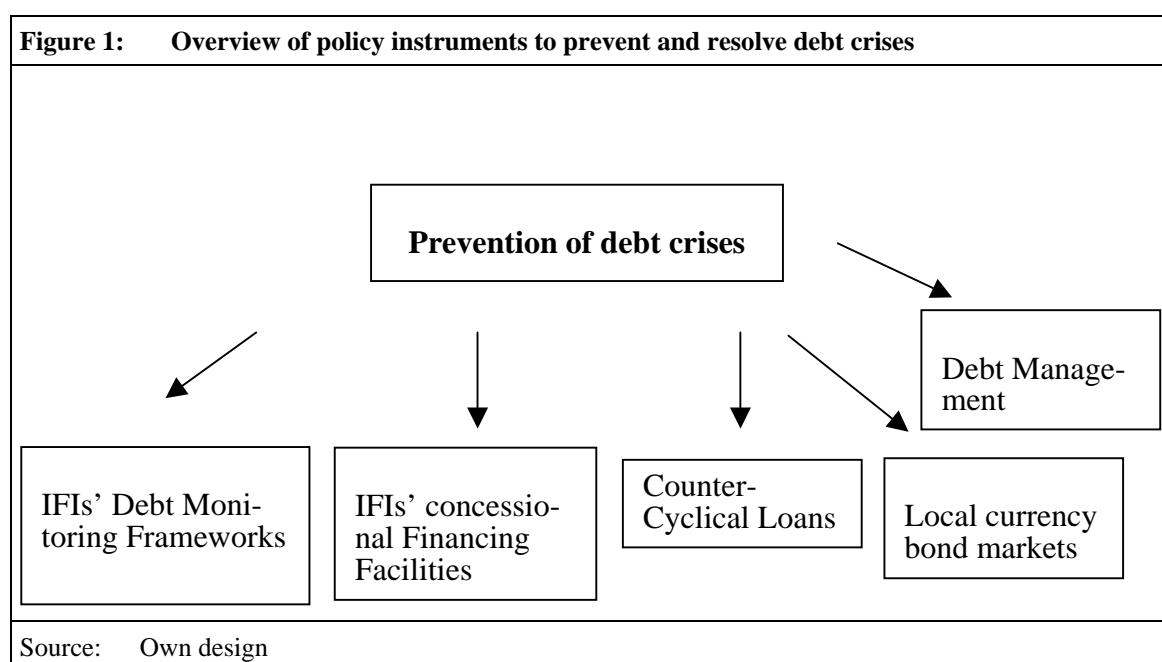
Appropriate policy instruments need to take into account the specific economic features of LICs, because their specific economic structures contribute to their lack of capacity to generate enough revenue to repay their debt and render them vulnerable to greater solvency and liquidity risks. Among the specific economic characteristics of LICs are a narrow production base and export structures that are often focussed on a small number of commodities, and with prices decided in world markets, this leads in LICs to high vulnerability to exogenous shocks. Other such features include shallow financial markets, relatively inefficient tax systems, high dependence on aid flows that tend to be difficult to predict, and policies and institutions of weak quality, in particular when it comes to project and debt management (Beddies et al. 2009).

Moreover, different financing instruments are not appropriate for all LICs because countries belonging to this country category are at different stages of development. LICs include countries with Gross National Income (GNI) per capita in 2008 of US\$ 975 or less, as defined by the World Bank. Currently 43 countries belong to this group. However, this per capita income limit is not identical with the per capita income limit for countries qualifying for IDA credits and grants, because IDA countries are countries that had, in 2008, a GNI per capita income of US\$ 1,135 or less. This group is further divided into two subgroups:

- **IDA-only countries:** The first group is called IDA-only countries; these receive only IDA credits and grants. Currently 49 countries belong to this sub-group. These countries are only eligible for IBRD loans within the IBRD Enclave Framework.
- **Blend countries:** The second group is called blend countries; these are eligible for IDA loans because of their low per capita incomes. However, blend countries are also eligible for IBRD loans because they are creditworthy enough to borrow from the IBRD. Currently there are 15 blend countries (World Bank 2009c).

3 Policy instruments to prevent debt crises in LICs

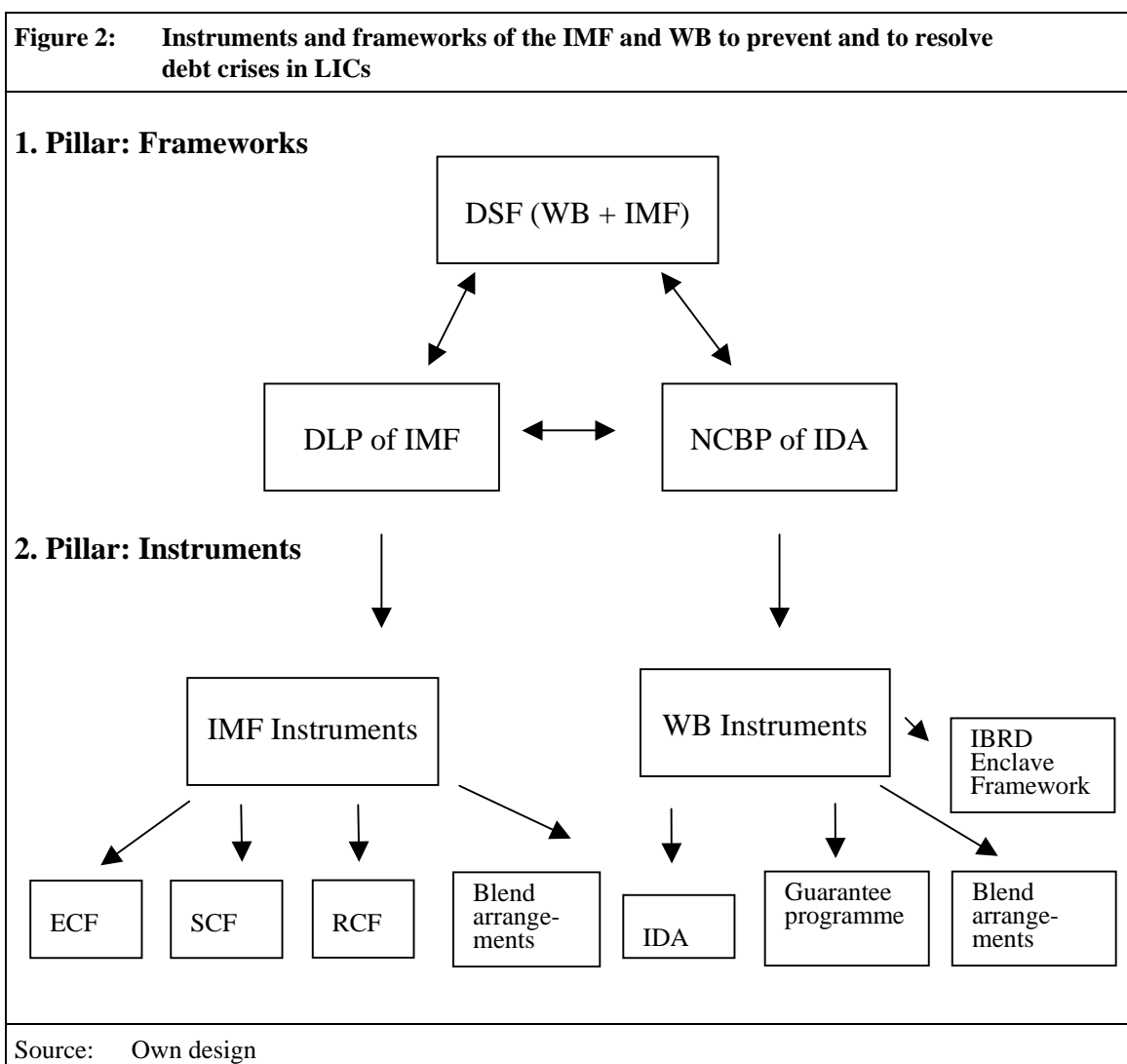
Policy instruments used for crisis prevention include in particular instruments that accord consideration to prudent lending and borrowing. What this means in this context is that the debt situation in LICs should be monitored and assessed and that donors mainly provide concessional loans or grants to LICs. Debt monitoring and assessment frameworks, such as the Debt Sustainability Framework (DSF), the Non-Concessional Borrowing Policy (NCBP) of IDA, and the Debt Limit Policy (DLP) of the IMF, assume important roles here. Similarly, donor concessional financing facilities are necessary to prevent debt crises in LICs. In addition, counter-cyclical loans for the event of exogenous shocks, development of local currency bond markets and adequate debt management represent important policy instruments to prevent debt crises (Figure 1).



3.1 IFIs' frameworks on the macro level to ensure debt sustainability

The lending framework of the Fund and the World Bank consists of two pillars. The first pillar comprises three instruments at the macro level to monitor and assess the debt situation in LICs and to implement appropriate measures, which could be referred to as global debt governance.³ The second pillar includes financing and guarantee instruments of IFIs for LICs. The IMF has recently established three new concessional financing facilities: The Emergency Credit Facility (ECF), the Standard Credit Facility (SCF), and the Rapid Credit Facility (RCF), and the World Bank provides concessional loans and grants through IDA (Figure 2).

³ Other institutions of global debt governance include the Paris Club and the London Club.



The first pillar comprises three instruments: The DSF of World Bank and IMF, the DLP of the IMF and the NCBP of IDA – while the DSF represents a common framework of IMF and World Bank for debt monitoring and assessment. The second and the third instrument are frameworks of the IMF – the DLP – and of IDA – the NCBP, both take the DSF into account. These three frameworks function as guidelines for the adoption of lending instruments and set limits and guidelines to further lending of official multilateral and bilateral donors.

The DLP and the NCBP in particular have been established in response to donor concerns about the generation of free rider problems.⁴ There is a risk that debt relief or grants could potentially cross-subsidise lenders that provide non-concessional loans to debtor countries, i.e. non-concessional lending in grant-eligible and post-MDRI countries, because debt relief and IDA grants have opened up room to accumulate new debt.

⁴ These risks tend to be high in resource-rich grant-recipient countries which have the opportunity to borrow on non-concessional terms due to potential future export receipts.

These free rider problems include, on the one hand, collective action problems on the creditor side, because there are differences between collective and individual interests. A creditor has an incentive to provide non-concessional loans to recipient countries which have substantially improved their debt levels by means of debt relief initiatives. On the other hand, moral hazard arises on the debtor side because IDA grants and debt relief have also opened up room for borrowers to accept non-concessional loans from other creditors.

One main problem is that IMF and World Bank have established parallel structures for global debt monitoring; these frameworks have on the one hand the same functions, but on the other hand they use different instruments to assess debt sustainability. Adoption of these different instruments could lead to different results concerning debt sustainability. For this reason these three frameworks need to be aligned.

3.1.1 Reform of the Debt Sustainability Framework

The DSF presents a common tool of World Bank and IMF to monitor and assess debt levels in LICs. The current reform of the DSF includes various instruments to enhance the flexibility of the DSF, but it does not address problems related to the comprehensiveness of the three instruments of IMF and World Bank – the DSF, the DLP and the NCBP.

One option for accelerating financing to LICs is to increase the flexibility of the DSF, because concerns have been raised that the DSF improperly limits LICs in financing their development goals in light of the current crisis. It was with a view to improving the analysis of the debt policies of LICs and to averting new rounds of debt distress in the future that the IMF and the World Bank established the DSF, an analytical framework (see Appendix Box 7). It was put in place in 2005 to supervise and examine the sustainability of external and public debt in LICs. In this regard, the DSF offers guidelines for prudent borrowing on the debtor side and prudent lending on the creditor side. In addition, it is based on the DSA framework for MICs, which was established by the IMF in 2002 and takes into account the specific features of LICs.

One point of concern in view of the current global financial crisis is that the DSF could prove to be pro-cyclical, because a deterioration of the macroeconomic situation generates higher debt ratios followed by a mechanical downgrading of risk rating, and therefore also by tighter borrowing thresholds, even though more financing may be needed in times of temporary shocks (World Bank / IMF 2009b, 1). Two safeguards against the DSF's pro-cyclical effect exist:

- **Inter-temporal approach:** The DSF is an inter-temporal framework which guarantees that short-term macroeconomic fluctuations do not significantly affect risk ratings, in this way addressing concerns about pro-cyclical effects. The DSF represents a dynamic approach to DSAs, one in which risk ratings are based on 20-year projections and not only on current debt ratios. For this reason temporary changes in the macroeconomic environment probably have only a limited effect on DSAs.
- **Requirement to carry out judgmental in assigning risk ratings:** The evaluation of risk ratings is based not only on a mechanistic use of thresholds but on a judgemental approach which is adopted, for example, in cases that involve a marginal and temporary breach of thresholds or in which it is difficult to compile a Country Policy and In-

stitutional Assessment Index (CPIA) rating. In several cases the World Bank and the IMF have not adopted thresholds mechanically, e.g. in the cases of Mongolia (2009), Madagascar (2008), Mali (2008) and Bhutan (2007) (World Bank / IMF 2009b, 3-5).

Another point of concern has been overly optimistic growth and export growth projections compared to actual and historical levels justifying relatively high levels of new loans to LICs. For this reason IFIs should use more conservative GDP and export growth projections (Leo 2009). To increase the flexibility of the DSF the following reforms have been implemented:

Investment-growth linkage: One weakness of the DSF is that the effect of investment on growth financed by credits has not been given due consideration, a circumstance that has led to conservative borrowing policies. On the one hand, fiscal deficits rise to finance public investment in the short-term, but on the other hand, productive public investment generates positive returns in the long run. This policy could have a negative bias on projects with high returns (World Bank / IMF 2009b 8-10; IMF 2009c). However, quantitative *ex-ante* measurement of returns on public investment poses difficulties, because it is difficult to trace and evaluate *ex-ante* a large number of benefits and costs. In addition, estimates conducted *ex-post* are often neither available nor robust. Moreover, *ex-post* assessments are done within a specific context, and this prejudices their adoption for new projects (Misch / Wolff 2008).⁵ To address this problem the World Bank and the IMF will operationalise the current research of the Fund and the World Bank on the investment-growth linkage and including the results in DSAs, wherever possible.

Formal consideration of remittances: Another reform measure addresses remittances. Since remittances represent an important source of foreign income, they will in the future be considered with more flexibility when risk ratings are set. However, since data are often not available and reliable on account of substantial measurement changes, DSF thresholds will not be re-estimated for all LICs (World Bank / IMF 2009b, 17-21; IMF 2009c).

State owned enterprises (SOEs): Another reform is to exclude debt from public and publicly guaranteed external debt in case the SOE can lend without a public guarantee and its operation poses constrained fiscal risks for the government because this would not lead to situations in which such debt could overly affect a country's risk rating. In the former framework inclusion of external debt of SOEs is considered to be too rigid (World Bank / IMF 2009b, 32-33; IMF 2009c). However, it might be difficult to evaluate *ex-ante* whether this type of debt poses a risk for the government or not. In addition, the amount of this type of debt could vary substantially from country to country. For this reason it is necessary to carefully assess on a case-by-case basis whether this type of debt would pose a risk to a country's budget or not. Uniform treatment of all LICs should be guaranteed.

Addressing "threshold effects": One point of criticism of the DSF has been that small changes in CPIA scores have a large impact on thresholds and thus a significant effect on risk ratings and recommendations on borrowing. For this reason more flexible thresholds should be used. The World Bank and the IMF have made one reform to mitigate these threshold effects. This reform includes an increase in the inertia of changes in applicable

5 For a further analysis of the link between debt-financed investment and growth, see IMF 2006a, 56-60.

debt thresholds due to changes in country CPIA ratings.⁶ The main advantage of this reform is that all countries with CPIA ratings near the performance category boundaries would benefit from the inertia. One disadvantage of this reform is that maintained improvements in CPIA ratings may be translated into higher applicable debt categories only with a time lag (World Bank / IMF 2009b, 21-26).

In sum, these reforms of the DSF improve the application of this framework, but most of them will probably only have incremental effects on single countries and will not substantially increase flexibility of the DSF for both donors and partner countries.

3.1.2 Reform of the Fund's current Debt Limit Policy

The Fund's Debt Limit Policy (DLP) functions as a mechanism to maintain debt sustainability and debt limit setting framework of the IMF. It is designed to contribute to prevent an accumulation of external debt in LICs. It was introduced thirty years ago and it applies for all members with a Fund-supported programme. On the one hand, LICs have to meet development objectives requiring higher external resources. On the other hand, sustainable debt positions have to be ensured. The response of the international community to this dilemma has been to provide mainly concessional external financing. In Fund supported programs for LICs the current DLP means that, in general, no limitations are set for concessional financing,⁷ zero ceilings are set for non-concessional borrowing.⁸

However, there has been some flexibility: Non-concessional lending has been adopted on a case-by-case basis. In nearly 40 per cent of IMF programs in LICs in place as of mid-January 2009 non-concessional loans have been allowed. Non-concessional loans have been allowed first, to finance specific projects for which concessional loans were not available, e.g. infrastructure projects and second, to promote a gradual move from concessional to market based finance (IMF 2009a, 9-10). In addition, it could prove difficult for the IMF to keep track of all non-concessional loans to LICs, in particular those credits provided by non-Development Assistance Committee (DAC) creditors or private creditors.

The IMF has established a new approach for the DLP, one that, moving away from a single design for concessionality requirements, is geared more to a menu of options (Box 1). The aim of the new approach is to accord more consideration to DSF and DSA as well as to the diversity of situations in LICs with respect to the extent of debt vulnerability and macroeconomic and public financial management capacities. Concessionality require-

6 This reform is based on the following rules: First, a three-year moving average CPIA rating (not a single-year rating) to assess performance is applied. Second, in case a country's three-year moving average CPIA rating breaches the applicable CPIA threshold, there are two cases: In the event that the amount of the breach is above 0.05, the country's performance would change immediately. Should the magnitude of a breach be at or below 0.05, the country's performance category would change only if the breach were continued for two consecutive years.

7 This means that the general practice has been not to limit concessional financing and to prevent non-concessional financing. In addition, fiscal programs include targets that are in line with the design of these external debt limits.

8 The following types of debt are covered by the external debt limits: Official and officially guaranteed foreign debt. The definition of external debt is based on the creditor's place of domicile (IMF 2009a).

ments should no longer be adopted for most advanced LICs, i.e. countries with higher per capita income, a strong track record in macroeconomic and public financial management, significant market access, and experience in dealing with non-concessional financing (IMF 2009a, 16-20).

There are several advantages of the new approach. It increases flexibility for both lender and borrower. It is possible to take into account different situations of LICs, in particular the extent of their debt vulnerability and macroeconomic and public financial management capacity. LICs with higher capacities benefit from more financing options. LICs with lower capacities benefit from a more flexible use of the current approach in that they would have more financing choices. The debt situation in LICs varies considerably: About 30 per cent of LICs are assessed as being at low risk of debt distress. These countries could also borrow in part on a non-concessional basis without jeopardising their debt situation (IMF 2009a, 21).

One matter open to question is, however, whether the above mentioned parallel structures will be dissolved with the reform of the DLP. Compared to the former DLP, the Fund has taken one important preliminary step in the right direction by reforming its DLP. The new approach links together various methodological instruments of IMF / World Bank. The new proposal links the DLP more closely to the DSAs in that in the new approach one of the two decisive criteria – the extent of debt vulnerabilities – is based on the DSAs (Box 1).

In spite of this useful reform, the link to other important frameworks of global economic debt governance, in particular to the DSF, is not complete. For the DLP and the DSF different analytical frameworks for assessing capacity are used. While for the DSF the CPIA Index is applied for which scores are set by the World Bank without the support of the IMF, for the DLP a sub-CPIA Index, the PEFA and other sources of information to assess a country's capacity are used. Due to these different analytical frameworks adopted for the DSF and the DLP, countries could be classified differently. Moreover, the new DLP has some additional shortcomings. The new approach is far more complicated than the old. In addition, there is no uniform methodology for different country types in the new proposal, and this works counter to comparability and uniformity of treatment across various country types.

There is some question first, as to which donors and creditors are committed to making their lending consistent with Fund (and Bank) concessionality requirements, e.g. OECD export credit agencies, other multilaterals, etc., and second, which donors have actually applied these concessionality requirements. A survey of the IMF asking bilateral creditors and Multilateral Development Banks about their lending practices came to the conclusion that about one third of respondents use IMF/IDA minimum concessionality requirements in deciding on the level of concessionality of their loans (IMF 2009a, 27).⁹

9 In assessing these results, it important to note that the response rate was low (about 35 per cent).

Box 1: New Debt Limit Policy of the IMF

In the new approach for the DLP two criteria are decisive:

- **The extent of debt vulnerabilities:** If a country is in a situation of high debt distress, there will be general limits not only on non-concessional debt but as well on total debt and / or higher minimum concessionality requirements. Two categories are established. In the lower vulnerability category there are countries with a low or moderate DSA risk rating, and the higher vulnerability category contains countries with a high risk rating or in debt distress.
- **A country's macroeconomic and public financial management capacity:** The former approach did not require strong public financial management capacities and methodology and information requirements were low. The former approach should be adopted for countries with lower capacities, but with more flexibility and a more systematic link to DSAs. By contrast, a more sophisticated approach would be appropriate for countries with strong capacities and a good track record in macroeconomic discipline.

For assessing this capacity the Fund has established a two-step process. In the first step two quantitative indicators are adopted to ensure uniform treatment of all LICs. One indicator is the so called sub-CPIA Index including those five elements of the CPIA Index which are relevant for a country's macroeconomic and public financial management capacity: Fiscal policy, debt policy, the quality of budgetary and financial management, the quality of public administration, and transparency, accountability, and corruption in the public sector. The second indicator is the Public Expenditure and Financial Accountability (PEFA) framework measuring the performance of a country's public financial management. In the second step all other information of the country related to a country's capacity are taken into account such as the Fund Staff's opinions on relevant recent economic developments or reforms as well as formal assessments such as fiscal reports on the Observance of Standards and Codes or the Debt Management Performance Assessments etc.

To define thresholds for higher capacity countries the Fund uses the average score of countries classified as "blend" countries by IDA because these countries are regarded as being adequately creditworthy to lend from International Bank for Reconstruction and Development (IBRD). All countries having scores of the sub-CPIA Index and PEFA above these thresholds are classified as high capacity countries. Countries with both scores below threshold are classified as low capacity countries and those countries with one score above and below threshold would be temporarily in the grey area leading to a more detailed assessment in the second step.

The new DLP is based on a menu of options relying on DSAs. Decisions taken under the new approach for any option concerning concessionality requirements are based on the two criteria named above. Consequently, there are four different cases:

- **Lower capacities / higher vulnerability:** For countries of this type the concessionality level is 35 per cent or more. Non-concessional debt is generally precluded from the performance criterion on external debt.^a
- **Lower capacities / lower vulnerability:** The concessionality level for countries of this type is at least 35 per cent. The performance criterion generally adopts a limit on the volume of non-concessional external debt.
- **Higher capacities / higher vulnerability:** For countries of this type there is a debt limit in present value terms on external debt.
- **Higher capacities / lower vulnerability:** For countries of this type the performance criterion is generally based on the average concessionality of new external debt. For this purpose the most recent DSA is used (IMF 2009a, 18-19; IMF 2009h; IMF 2009g, 8-9).

a Performance criterion on external debt includes debt which is a current and not contingent liability under a "contractual arrangement through the provision of value in the form of assets (including currency) of services". (IMF 2009g, 9)

3.1.3 Reform of IDA's Non-Concessional Borrowing Policy

IDA's Non-Concessional Borrowing Policy (NCBP) represents a specific mechanism of IDA at the macro level to ensure debt sustainability and which is the equivalent to the IMF's DLP. It outlines IDA's proposed response to the free rider risks stemming from non-concessional borrowing after grants and debt relief have been provided.

To address these free rider problems, the Bank has established a strategy consisting of two pillars. The first pillar of the NCBP is concerned with outreach to other creditors. The aim of the NCBP is to increase awareness and to encourage other creditors to include debt sustainability and the DSF in their lending decisions. Having in mind these difficulties and the complex process to coordinate various multilateral and bilateral donors the World Bank has been successful in outreaching other creditors because many multilateral and bilateral donors have used grant allocation systems similar to that of the IDA (Box 2).

Box 2:	Non-Concessional Borrowing Policy (NCBP) and its outreach to other creditors
<p>Many multilateral creditors have used grant allocation systems similar to that of the IDA, including e.g. the AfDB, the ADB, and the International Fund for Agricultural Development (IFAD). By contrast, the IADB accepts the risk of debt distress in coming to decisions on the level of concessionality proposed to borrower countries (ADB 2009b; AfDB 2009c; IDA 2008a, 1-2).</p> <p>Similarly, many bilateral creditors have made efforts to incorporate debt sustainability and the DSF into their lending decisions. OECD member countries have agreed to establish a set of principles and guidelines on sustainable lending within the Working Group on Export Credits and Credit Guarantees (ECG) (Box 8 in the Appendix).</p> <p>Some progress has also been made on dialogues with bilateral emerging market creditors, e.g. a Memory of Understanding for cooperation with the China Eximbank was signed in 2007. Despite some success in creditor outreach, further discussion with a small number of multilateral creditors, private creditors and non-OECD bilateral creditors is necessary (Azizali 2008, 10; IDA 2008a, 1-2; 2008b; 2007, 16-21 and 2006, 2).</p>	

The second pillar incorporates measures aimed at helping borrowers to reduce the risk of debt distress. These measures include improved capacity-building support for debt management in LICs and reporting requirements for borrowers concerning their plans for non-concessional borrowing. NCBP concessionality requirements are an incentive for governments to negotiate better financing terms. The NCBP adopted a rule requiring all IDA Credit and Grant Agreements to include, in a supplemental letter on financial and economic data, an advanced reporting requirement for the borrower. This includes a rule obliging countries to report to the Bank about their plans for non-concessional borrowing before contracting a loan. Consequently, Bank staff and authorities of grant-eligible and post-MDRI countries need to discuss alternative financing scenarios and the implications of such borrowing. This pillar also includes possible IDA responses to non-concessional borrowing, such as reduction of the volumes of IDA assistance and adjustment of IDA lending terms (IDA 2008a, 1-2 and 2006, 2).

In exceptional cases and under specific criteria the NCBP allows non-concessional loans that serve to promote economic growth. These specific criteria include, first, country-specific criteria, such as e.g. a country's overall borrowing plans, the impact of borrowing on the macroeconomic framework, the impact on the risk of debt distress, and the strength of policies and institutions. Second, loan-specific criteria are included, such as the development content and potential impact of a loan, the estimated economic, financial,

and social returns on investment of a project, the lender equity stake in a project, a requirement that no additional costs should be associated with the loan and that no other sources of additional concessional financing are available. In addition, concessionality is required for the overall financing package for a particular investment (IDA 2008a, 20).

The NCBP represents a case-by-case approach which allows for flexibility in specific circumstances. The Bank has established a process to analyse non-concessional borrowing in countries subject to the NCBP: The first step involves an assessment of whether public or publicly guaranteed non-concessional borrowing has been contracted. In the next step country teams discuss the new non-concessional loan with the authorities. The NCBP committee drafts and discusses an internal Bank note and writes a recommendation for the management, which then discusses and decides on the appropriate IDA measures. Before the next project is shown to the Executive Board, the NCBP committee informs the Board of any disincentive measures. By September 2009 there had been two cases of hardening of terms (Angola and Ghana) to mirror the countries' improved market access. In addition, in six cases exceptions with regard to the NCBP have been made: Cameroon, Democratic Republic of Congo, Mali, Republic of Congo, Rwanda and Senegal (IDA 2008a, 8-13 and 2009c, 13).

The NCBP is well integrated into the lending architecture of the World Bank in that it represents a policy complementary to other policies and tools the World Bank has established to ensure debt sustainability in LICs, including e.g. the DSF and additional capacity building in debt management and the development of medium-term debt management strategies provided in connection with the new Debt Management Performance Assessment (DeMPA).

However, sometimes the NCBP's options to influence policy decisions are limited. This is in particular the case when IDA financing is low relative to other external financing sources and when information is inadequate. For example, IDA financing for Angola has been low relative to the country's total external financing (IDA 2008a, 13-14). There is a good basis for close coordination in that IMF and IDA's concessionality policies adopt the same definitions of grant element and have a harmonised approach for non-concessional borrowing.¹⁰

The NCBP has some shortcomings. One main problem involved in the use of the above mentioned sanctions is that these measures entail trade-offs at the country level in that a cut in the volume of IDA reduces resources available to reach Millennium Development Goals (MDGs) and harder lending terms endanger debt sustainability. Countries may resort to further non-concessional borrowing from other creditors. This kind of risk is lower for countries with an IMF programme because a breach of the Fund's performance criteria on minimum concessionality would endanger disbursements under the Fund programme as well as from those donors that adhere to the Fund's performance criteria (IDA 2008a, 1-2 and 2006, 23). Problems in implementing the NCBP include a lack of available information and reporting lags. The awareness of countries that IDA may reduce volumes in response to a breach of the NCBP may be an incentive for countries not to inform IDA on their borrow-

10 One key element of the NCBP is minimum concessionality requirements for grant-eligible or post-MDRI IDA-only countries. This is complementary to the concessionality requirements of the IMF. Under the NCBP the minimum grant element required is 35 per cent or higher if a higher minimum level is required under an existing IMF arrangement.

ing on non-concessional terms (IDA 2006, 23; IMF 2007). Another main disadvantage of the NCBP is that it restricts debtor countries' freedom to borrow (Azizali 2008, 9).

To ensure close coordination, a reform of the NCBP should be in line with a reform of the Fund's Debt Limit Policy. The IMF and IDA concessionality policies have already adopted the same definitions of grant element. However, the Fund's new approach and a reform of the NCBP should be consistent.

3.2 IFIs' financing facilities for LICs

The second pillar includes IFI concessional and non-concessional financial instruments for LICs. The design of these instruments contributes to crisis prevention because inadequate terms for IFI financing facilities for LICs could endanger debt sustainability in LICs. For this reason prudent lending is important. Translated into IFI instruments, prudent lending means that terms for credits to LICs need to secure debt sustainability, i.e. they need to be highly concessional. IMF concessional financing facilities include the Emergency Credit Facility (ECF), the Standard Credit Facility (SCF) and the Rapid Credit Facility (RCF). Accordingly, this study proposes policy instruments for these two pillars. In addition, an appropriate amount of such concessional loans is needed for LICs to prevent them from falling back on non-concessional loans.

One option for extending financing to LICs is to increase the flexibility of IFI lending frameworks to LICs. In this section the focus is on policy instruments for Bretton Woods institutions – the World Bank and the IMF – because other multilateral donors such as the Regional Development Banks (RDBs) – The African Development Bank (AfDB), the Asian Development Bank (ADB) and the Inter-American Development Bank (IADB) – have only adopted a few reform proposals for LICs in the aftermath of the current global financial crisis – with the exception of the European Union (EU), which has temporarily (2009/10) established a so-called “EU Vulnerability Flex,” with a volume of €500 million, to provide short-term support to the African, Caribbean and Pacific Group of States (IDA 2009b). However, some RDBs have increased their financial support to LICs (Box 3).

Box 3: Instruments of the Regional Development Banks in the aftermath of the global financial crisis

The **ADB** has approved payment of an additional US\$ 400 million to the Asian Development Fund, and borrowers of this fund are allowed to front-load their complete 2009-2010 biennial allocation. In addition to that, the ADB has increased its crisis related lending by more than US\$ 10 billion for 2009-2010, leading to total ADB assistance for this period of about US\$ 32 billion (ADB 2009a; 2009b; 2009c). However, thus far there is no official information available on the exact amount of additional resources specifically directed to LICs in this region. In addition, the ADB has established a Counter-Cyclical Support Facility with a volume of US\$ 3 billion. However, this facility is offered on non-concessional financial terms and therefore keyed to MICs (ADB 2009d).

The **AfDB** has contributed US\$ 500 million to the Global Trade Liquidity Program, a temporary donor crisis-response initiative (AfDF 2009d). In addition, the AfDB has set up a US\$ 1.5 billion Emergency Liquidity Facility that provides non-concessional loans to MICs (AfDB 2009a).

The **IADB** intends to provide additional resources to all countries in the region (IADB 2009), but at present there is no official information available on the exact amount of additional resources directed specifically to LICs in this region. Furthermore the IADB established a “Liquidity Program for Growth Sustainability” for regulated financial institutions faced with reduced access to foreign and inter-bank credit lines; it amounts to US\$ 2 billion. Additional resources for IADB's concessional window have been mobilised internally.

3.2.1 Reform of IMF financing conditions for LICs

a) Increase of concessional financial resources to LICs and of general concessionality

To meet higher financing needs of LICs and to ensure debt sustainability, the IMF has increased the amount of concessional financing it makes available: The Fund's concessional lending capacity has been raised to US\$ 17 billion through 2014, including up to US\$ 8 billion in the first two years. This amount is higher than what was called for by the Group of Twenty in the spring of 2009, namely to increase new lending over two to three years by US\$ 6 billion. In the previous 3 years the average concessional lending was about US\$ 1 billion per year (IMF 2009j, 1). This higher amount of concessional lending will be channelled through new access policies for LICs for the Fund's concessional lending facilities. Moreover, the Fund has offered interest relief to LICs, which are not required to pay interest on outstanding IMF concessional loans through the end of 2011, and interest rates for all concessional facilities have been reduced by 0.25 per cent (IMF 2009i).

b) Reasons for a reform of the Fund's lending framework

In view of the global financial crisis, the Fund's financial support to LICs needs to be more flexible. In July 2009 the IMF has simplified and strengthened the lending facility architecture and financing framework for LICs (IMF 2009f). Reform of the current architecture of the Fund's financing facilities for LICs has been implemented because the two existing financing instruments on a concessional basis – Poverty Reduction and Growth Facility (PRGF) and the Exogenous Shocks Facility (ESF) – have not proven flexible enough to cope with the current global financial crisis.

Box 4: The former concessional lending facilities of the IMF: PRGF and ESF

The **PRGF** was a concessional medium-term financing instrument designed to address protracted balance-of-payments problems, and it included a three-year programme. The following problems were associated with the PRGF. First, concessional resources were in this way tied up for a longer period of time than necessary, because e.g. some countries may have needed such funds only for a shorter period of time. Second, PRGF-programmes were subject to intense structural conditionality and provided only modest flexibility in the timing of the adjustment process. Third, countries may have had the perception that Poverty Reduction Strategy Paper requirements were too rigid. Another problem was that some countries used PSI or surveillance-only engagement instead of the PRGF. These members may not be willing to return to an instrument related to poverty reduction and HIPC debt relief (IMF 2009b, 24; IMF 2009f, 15).

The **ESF** offered short-term concessional credits to address exogenous shocks. The ESF had two components: The ESF Rapid Access Component (RAC), which was used for rapid assistance for exogenous shocks on the basis of a commitment to adequate policies, and the ESF High Access Component (HAC), a 1-2 year programme that was adopted for exogenous shocks. However, this instrument could not be used in the case of domestic problems such as banking troubles or a decline in confidence. In addition, it was difficult to distinguish between exogenous and endogenous contributions to balance-of-payments problems (IMF 2009b, 23; 2009f, 20). In view of the deeper integration into global markets and their developing financial sectors precautionary facilities would be important for LICs. But none of the concessional financial facilities address potential balance of payments problems (IMF 2009f, 20).

Consequently, in a context characterised by increasing global volatility and diverse needs of LICs, the Fund's instruments for LICs were not sufficient. The following gaps had emerged in the Fund's concessional facility architecture:

- A flexible short-term financing instrument,
- a precautionary instrument, and
- a flexible emergency financing instrument, also for LICs in fragile situations (IMF 2009b, 23).

c) Reform of the Fund's lending framework for LICs

The IMF's concessional lending facilities have been modified to strengthen the Fund's lending tools in the following way. The new architecture offers a unified facilities framework under the new Poverty Reduction and Growth Trust, including three new concessional lending facilities and one non-financial instrument:

- **The Extended Credit Facility (ECF):** The PRGF is replaced by the ECF, which offers medium-term support to LICs with protracted balance-of-payments problems. The repayment period is 5.5 – 10 years. The ECF maintains the basic structures and most important requirements of the former PRGF. However, some weaknesses of the PRGF have been addressed by allowing more flexibility concerning the timing of Poverty Reduction Strategy documents. Besides, the length of the arrangement is more flexible. In addition, more flexibility in the country's choice of its adjustment path is recognised.
- **The Standby Credit Facility (SCF):** The SCF has been established to address short-term balance-of-payments needs, including those generated by exogenous shocks. As this facility also addresses exogenous shocks, it supersedes the High Access component of the ESF. Maturity would be between 12 – 18 months and use limited to two and a half of a five-year period. A country could obtain financial resources even in the event of a balance-of-payments need that is seen as potential but not immediate. The repayment period is 4 – 8 years.
- **The Rapid Credit Facility (RCF):** This facility takes on the role of addressing urgent balance-of-payments needs. It provides an outright disbursement and is therefore subject to only limited conditionality, i.e. it is founded on *ex-ante* policy undertakings and under it there is no need for a review-based programme or *ex-post* conditionality. This facility can be provided in the event of natural disasters or other exogenous shocks, and it thus substitutes for the Emergency Natural Disaster Assistance and the Rapid Access Component of the ESF. In addition, the RCF can be adopted repeatedly, based on a performance track record, and it also substitutes for the subsidised Emergency Post Conflict Assistance.
- **The Policy Support Instrument (PSI):** This instrument has not changed significantly in that it still represents the Fund's non-financial policy support tool. It can be used to ease access to the SCF and the RCF (IMF 2009f).

The adoption of these new financing facilities will show whether they can address the three gaps of the former instruments mentioned above, i.e. a more flexible short-term financing instrument, a precautionary instrument, and more a flexible emergency financing instrument.

d) Increased flexibility of rules for blending concessional financing with General Resource Arrangement funds

In light of the evolving financing needs of LICs, another possibility available to increase the flexibility of the IMF's lending policy would be to revisit the application of rules for blending concessional financing with General Resource Arrangement resources which are non-concessional resources. In addition to the higher access to financing, blending arrangements have another advantage for recipient countries – positive signalling. By making use of blending arrangements a country shows that it is able to repay credits with non-concessional term. For the IMF, blending arrangements offer the opportunity to provide scarce resources for those LICs not having access to non-concessional resources (IMF 2009f, 39).

Eligible countries for blend arrangements have often chosen to use either General Resource Arrangement financing only or PRGF financing only. One explanation for this is the rigid concessional component of blended arrangements which can be very small for countries having used PRGF in the past. In addition, blending has not been used with the former Exogenous Shock Facility (IMF 2009f, 39). For a PRGF credit countries would have required a PRSP which would have taken time. Since 2004 some countries that have met the criteria for blend arrangements have chosen General Resource Arrangement financing only (Pakistan, Georgia, and Honduras) (IMF 2009b, 24; 2009f, 39).

In the course of the last ten years, blend arrangements have played a minor role. The IMF Board has only approved four blend arrangements (Albania, Liberia, FYR Macedonia and Sri Lanka) (IMF 2009f, 39). In Albania, for example, a three year PRGF-arrangement (SDR 8.5 million or 17.5 per cent of quota) had been blended with a three year Extended Fund Facility in the same amount because of a rapid income growth in the past 10 years (IMF 2006b).

For these reasons the Fund has reformed the current guidelines on blend arrangements, including the following preconditions for a blended arrangement:

- A member's per capita income limit for blending is increased to the current IDA operational cut-off (US\$ 1.095), or
- a member needs to have received significant recent or prospective non-concessional borrowing from private capital markets or the hard windows of official bilateral and multilateral lenders.
- To limit recourse to General Resource Arrangement financing, access to concessional financing in a blended arrangement is limited normally to half of total access.
- Blended arrangements are only for those countries that meet minimum standards of debt sustainability within the DSA.
- The blending mechanism applies consistently for all facilities.
- Blending is allowed in exceptional cases, e.g. for arrears clearance operations.
- Access limits under the concessional facilities and the General Resource Arrangement-based facility will be decided on a case-by-case basis, for which criteria such as balance of payments, strength of the programme and debt sustainability are important (IMF 2009f, 39-40).

In the case that none of these preconditions is met, the respective country is eligible only for concessional financing.

In sum, an increase of blend arrangements is one viable policy option to expand financial resources to LICs. However, blend arrangements should not endanger debt sustainability of LICs because loans are provided on non-concessional terms.

3.2.2 Reform of IDA financing conditions for LICs

In the aftermath of the global financial crisis and the global food crisis, two main reforms have been carried out in IDA to absorb these exogenous shocks in LICs in the short-term: The establishment of the Fast Track Facility and the Crisis Response Window.¹¹

IDA: Fast Track Facility

In December 2008, the World Bank Group established a Fast Track Facility amounting to US\$ 2 billion to frontload grants and long-term, interest-free loans designed to support LICs in their efforts to mitigate the effects of the global financial crisis. Since this facility is part of the IDA 15 fund these are not additional financial resources and the question of compensation is not addressed. The standard frontloading rule allowing countries to frontload up to 30 per cent of their annual allocation has been extended to 50 per cent of their annual allocation. This facility offers rapid financial resources to LICs for programmes or projects intended to mitigate the effects of the global financial crisis in the following sectors: Social safety nets, infrastructure, education, and health. Rapid disbursement has been made possible by shortening the review period (World Bank 2008; World Bank 2009d).

Crisis Response Window

In December 2009, the World Bank established a new pilot Crisis Response Window (CRW) in IDA for the remainder of the IDA 15 period (January 2010 – June 2011); it has a volume of US\$ 1.3 billion and its aim is to protect LICs from future crises (World Bank 2009g; IDA 2009b). With the implementation of the pilot CRW, IDA has responded to requests by the G20 and the Bank's Development Committee to assess the advantages of a new crisis response mechanism (G20 2009; World Bank 2009g). This facility should become one part of the world financial architecture (Zoellick 2009; World Bank 2009e, 23).

To implement the CRW, the World Bank has suggested an approach with two phases. In the first phase a pilot CRW will be established in the second half of IDA 15 (Janu-

11 In addition, the World Bank Group has launched a bundle of initiatives to mitigate the effects of these crises on poor countries, including e.g. the Vulnerability Finance Facility, comprising the Global Food Crisis Response Program, and the Rapid Social Response, as well as the Infrastructure Recovery and Assets Platform, a multi-donor programme designed to support spending on infrastructure during the recent global financial crisis. Moreover, the International Finance Cooperation has established several crisis response initiatives, including the Global Trade Finance Program and a new Global Trade Liquidity Program, a new Infrastructure Crisis Facility and the Microfinance Enhancement Facility (IDA 2009c). However, it is not yet clear what share of the financial resources from these initiatives is provided to LICs and what share is provided additionally to the resources already committed for LICs.

ary 2010 – June 2011) and in the second phase the World Bank will present a more general CRW in the course of the IDA 16 replenishment process (IDA 2009b, 14).

Non-oil exporting IDA-only countries (56) only are eligible for this facility. The following types of IDA countries are excluded from the CRW. IDA blend countries do not have access to this facility because these countries have some access to IBRD and market based finance. Moreover, net oil exporters – Angola, Chad, Republic of Congo, and Nigeria – are excluded from the CRW because they have recently made high wind-fall gains from rapidly increasing oil prices, which will probably stay above pre-crisis levels in the medium-term. In addition, four countries with IDA and IBRD loans and credits in protracted arrears, Myanmar, Somalia, Sudan, and Zimbabwe, do not have access to the CRW (IDA 2009b, 14).

The allocation process for this facility includes two steps: In the first stage, 85 per cent of resources will be allocated by means of a rules-based approach, i.e. resources are provided in accordance with the growth impact of the crisis and per capita income levels. In the second stage, 15 per cent of resources would be allocated to regions to address country specific needs which are not appropriately mirrored in the rules-based allocations (IDA 2009b, 14). The terms of assistance under the CRW are identical to those under which IDA resources are offered (IDA 2009b, 22).

The aim of the CRW is to support LICs quickly in the event of exogenous shocks. For this reason resources are to be utilised rapidly, including fast processing and approval of funds, i.e. shortened management review periods and application of crisis response provisions in line with the World Bank's existing operational policies.¹² Resources that have not been committed six months after the initial allocation will be reallocated to the region for other countries there which need funds in the aftermath of the crisis and which are able to use these resources effectively for a crisis related purpose. This facility is designed to provide resources quickly to safeguard core spending on health, education, social safety nets, infrastructure and agriculture (Zoellick 2009; World Bank 2009e, 23; IDA 2009b, 20-21).

This facility will be financed through a redeployment of internal IDA resources and through voluntary donor contributions. Internal resources include donor reimbursement of arrears clearance costs funded from the IDA 14 commitment authority and resources set aside for arrears clearance during IDA 15, as well as extraordinary investment income from IDA resources during the 2009 fiscal year (July 2008 – June 2009) (World Bank 2009g, 22-23).

In general, implementation of a CRW is useful because it rapidly provides financial resources to LICs in the event of exogenous shocks. Speedy processing and approval of funds could ensure fast disbursement and utilisation of funds. Another advantage of the CRW is that it is closely linked to IDA instruments and operational policies because of the application of IDA's lending instruments for delivery of CRW resources, including e.g. Operational Manual (OP) 8.60: Development Policy Lending, OP 8.00: Rapid Response to Crises and Emergencies and OP 10.0: Investment Lending (World Bank 1994; 2004; 2005 and 2007).

However, it is to some extent questionable whether the CRW is complementary to existing IDA instruments, because the financing conditions are similar, i.e. long maturity,

12 For a detailed description of implementation and accountability mechanisms, see IDA 2009b, 20-22.

grace period and service charges. A shorter repayment period is in some cases preferable in that long maturities tie up concessional resources for a longer period of time than necessary, because e.g. some countries may need such funds only for a shorter period of time. For this reason there could be a need for a short-term flexible concessional instrument, i.e. because IDA credits have long maturities: 20, 35 or 40 years with a 10-year grace period before the start of repayment of principal.

The new CRW should be integrated into the international aid architecture. Compatibility with the international aid architecture means that this is an instrument complementary to other instruments of other multilateral lenders and that it does not undermine the effects of other instruments. On the one hand, the CRW is complementary to the recently introduced instruments of the IMF, including short-term concessional facilities for LICs such as the Rapid Credit Facility and the Standby Facility, because these latter instruments address stabilisation of the macro economic situation. In contrast, the CRW should support key public spending on health, education, social safety nets, infrastructure and agriculture. On the other hand, it is questionable whether this instrument is compatible with instruments of other multilateral and bilateral donors. Another problem associated with the new CRW could be difficulty in differentiating between countries that have exogenous shocks-related needs and those that have general needs. Nevertheless, the CRW, with an appropriate design, should become a standard instrument of IDA in the future because it represents one important concessional financing window for LICs in the event of shocks.

World Bank guarantee programme: IDA guarantees

Another option to increase lending to LICs is to extend IDA guarantees. The global financial crisis has led to a decline in FDI in IDA countries. Private investors have become more risk-averse and are calling for more risk mitigation instruments such as IDA guarantees which are one part of the World Bank Guarantee Programme (Box 5) (IDA 2009a, 4).

Box 5: World Bank Guarantee Programme

The World Bank established the guarantee programme in 1994 to mobilise private sector financing. The guarantee programme could prove to be a catalyst for new sources of finance. Private sector involvement in developing countries should be encouraged by facilitating the mitigation of risks that lenders are unable to assume. The Bank can provide guarantees for private loans with or without an associated Bank loan (World Bank 2005, 1 and 2009b).

The World Bank guarantee programme provides for two basic kinds of guarantees:

- **Partial credit guarantee (PCG):** The aim of the PCG is to buttress government commercial borrowing by means of enhancing credit terms. This type of guarantee includes debt service defaults on a specified portion of credit, usually for a public sector project.
- **Partial risk guarantee (PRG):** The aim of the PRG is to support private sector investment in developing countries by reducing political risk. This type of guarantee includes debt service defaults on a loan, usually for a private sector project in the event that such defaults are generated by a government's failure to fulfil its commitments under project contracts.

The World Bank guarantee programme includes four types of guarantees:

- IBRD project-based guarantees that cover both partial risk and partial credit structures,
- IBRD policy-based guarantees that cover the partial credit structure,
- IBRD enclave guarantees in IDA-only countries that cover the partial risk structure, and
- IDA guarantees that apply to the partial risk structure only.

Under the IDA guarantee programme established in 1997, IDA can provide, in IDA-eligible countries, partial risk guarantees to private lenders for private sector investment projects. The aim is to support countries in leveraging their IDA resources by mobilising project financing. Until the summer of 2009 this leverage was ten times higher than the IDA commitment. In the summer of 2009 the total amount was increased to US\$ 1.5 billion from initially US\$ 500 million. In addition, the pilot status of this programme ended in the summer of 2009 (IDA 2009a, 5). For this reason, the structure of this type of lending has been maintained. The following preconditions for receiving these guarantees have to be met:

- This type of guarantee can be applied to projects which are not sufficiently supported by IFC or MIGA and are not eligible for an IBRD enclave guarantee.
- IDA guarantee operations are possible only for projects in sectors for which the partner country puts in place a policy framework accepted by IDA (World Bank 2005, 2).

The IDA guarantee programme has the following advantages:

- **Integration within the World Bank financial architecture for LICs:** This instrument is well integrated within country assistance strategies and the World Bank's policies and procedures (IDA 2009a).
- **Reaching development objectives:** This programme has contributed to attaining development objectives, because IDA guarantees have enabled IDA countries to attract private capital for complex infrastructure projects in difficult economic and political circumstances (IDA 2009a, 12).
- **Increasing project efficiency:** This instrument has contributed to increasing development efficiency in IDA countries by increasing private sector participation in projects (IDA 2009a, 13-14).
- **Improvement of financial terms for IDA countries:** IDA guarantees have led to an improvement of borrowing costs and an extension of maturity beyond maturity under the Bank guarantee (IDA 2009a, 14-15).

By providing IDA country governments access to lower-cost and longer-maturity debt financing than would otherwise be accessible to them in national or international markets, IDA contributes to closing the financial gap caused by the global financial crisis (IDA 2009a, 27).

Another option to support an increase in financing for LICs would be to extend the spectrum of IDA guarantee instruments: While current IDA guarantees include only PRGs, the IBRD also provides PCGs that consist of two different instruments. The first instrument consists of PCGs which are normally adopted to support loans of sovereign governments (or state-owned public entities) from the international financial markets in combination with Bank-supported investment operations. The second instrument consists of policy-based guarantees (PBGs) for fiscal support in combination with development policy lending. The main difference between these instruments is that PCGs support investment lending and PBGs support development policy lending (IDA 2009a, 26). This option is currently under discussion at the World Bank.

IBRD Enclave Framework

Another option to increase financing for LICs is to provide additional IBRD resources to IDA-only countries within the IBRD Enclave Framework including guarantees and loans.¹³ IDA-only countries, which are by definition not creditworthy for IBRD lending, are only permitted to receive financial support for projects from IBRD within this framework. IBRD enclave loans and guarantees present important parts of IBRD financial instruments. However, the utilization requires very specific circumstances and conditions, i.e. each potential enclave project must fulfil Board authorized credit enhancement criteria. In addition, such a project needs to support a strong development.¹⁴

IBRD enclave guarantees in IDA-only countries is therefore one of four parts of the World Bank guarantee programme (World Bank 2005, 1). The guarantee amount is limited to 25 per cent of the financing needed for one enclave project and an aggregate guaranteed amount of US\$ 300 billion annually. Generally, enclave guarantees cannot be accelerated, i.e. under such guarantees the IBRD's payment obligations to the lender cannot exceed the annual principal and interest obligations originally agreed under the guaranteed loan (World Bank 2005, 2).

The preconditions for an IBRD enclave guarantee in IDA-only countries are:

- The guarantee is used for commercial private projects in IDA-only countries which are expected to generate foreign exchange outside the country.
- The country should have enough foreign reserves to be able to meet payments subject to the IBRD guarantee if the guarantee is called.
- The country uses revenues generated by any projects with such a guarantee for productive development purposes (World Bank 2005, 2).

IBRD enclave PRGs are used for private sector projects with strong credit-enhancing features that alleviate risks to the IBRD. When providing PRGs, the World Bank works together with IFC/MIGA where appropriate. For example, enclave PRG support for the South Africa Regional Gas Project (2003) was provided within a cooperation framework with IFC and MIGA. The IBRD enclave guarantee programme has the following main advantages. First, guarantees can lead to an improvement of borrowing costs and an extension of maturity beyond the maturity under the Bank guarantee. Second, guarantees can increase the flexibility of financing terms.

IDA-only countries are also eligible for IBRD loans within the IBRD Enclave Framework. One important eligibility criteria for IBRD enclave loans is that loans have to be used for critical investments with high return rates in the following sectors: Infrastructure and natural resource projects.

13 There are only a few information available about the working IBRD Enclave Framework. In addition, no empirical data about the amount of IBRD enclave loans and guarantees etc. have been published. However, for this study the staff of the World Bank has provided some information on the IBRD Enclave Framework.

14 This information has been provided by the staff of the World Bank.

IBRD enclave loans represent an important opportunity for IDA-only countries to obtain non-concessional loans for certain economically and financially viable projects. One main benefit is that the commercial discipline required for loans and guarantees within the Enclave Framework generates high efficiency in development terms. In addition, requirement of a government counter-guarantee makes certain that the project is among the top development priorities of the government, taking into account the higher costs compared to IDA terms.

However, the volume of IBRD loans and guarantees has been small. Since 1968 the World Bank has provided US\$ 787.7 million within the Enclave Framework, including 14 IBRD loan operations with 2 IBRD Partial Risk Guarantees (for 1 project). In 2000 the Board of the World Bank authorised the last enclave loan and in 2003 the Board approved the most recent enclave project (Southern Africa Regional Gas Project Guarantee). However, within the World Bank Guarantee Programme IDA has offered PRGs and both IFC and MIGA have been actively providing their own guarantee instruments. One reason for the low interest on enclave loans and guarantees has been that there had been mixed performance for past projects, with six of the 14 projects rated unsatisfactory.¹⁵

Another problem could be that debt sustainability might be undermined because loans are offered on non-concessional terms. However, according to World Bank staff, loans provided within this framework have been designed with the aim of not endangering debt sustainability by choosing export oriented projects which have the capacity to generate foreign exchange and good rates of return. Since IBRD enclave loans could have implications for the NCBP, it would be necessary to test them, on a case by case basis, for consistency with the current NCBP policy. However, enclave loans will probably fulfil criteria for an exception to the policy because these loans usually have been high-return investment projects that meet priority development needs and generate their own export receipts. Other points of concern are that IBRD enclave loans could use up scarce IBRD resources in LICs, which may have more difficulties in repaying them than IBRD countries. Moreover, it is usually more time-consuming to assess IBRD enclave loans than IBRD loans because it is more difficult to identify and assess critical investments with high return rates in LICs.

In sum, the IBRD Enclave Framework represents an important opportunity for IDA-only countries to obtain additional financial resources and it is an important step towards more market orientation. However, it is important to ensure that debt sustainability is not jeopardised by providing loans for projects with high return rates.

3.3 Capacity-building in LICs to manage debt

The financial crisis has led to growing government financing gaps as a consequence of lower tax revenues and higher expenditure needs. One important measure to ensure external debt sustainability is to improve capacity-building in LICs for public debt management, because better debt management contributes to improving the quality and comprehensiveness of debt data and information systems. In addition, better debt management

¹⁵ These data have been provided by the staff of the World Bank.

facilitates the development of sound and efficient domestic debt markets, which could be an alternative source of financing for governments of LICs (Dömeland / Braga 2009, 7).

The Bank and the IMF have increased the debt management capacity of borrowers and developed so-called Medium-Term Debt Management Strategies (MTDS). Thus, IFIs have already started with a large programme to enhance capacity building in the field of debt management. These provisions have to be implemented for a while and could then be evaluated.

In November 2008 the Bank set up a multi-donor trust fund, the Debt Management Facility (DMF), for LICs, a grant facility financed by a multi-donor trust fund with commitments of US\$ 12 million over 4 years. The aim of the facility is to strengthen debt management capacity and institutions in developing countries, using the following instruments:

- **Medium-Term Debt Management Strategy (MTDS):** This is a toolkit used to formulate and implement a debt management strategy for the medium-term for each country; in particular this instrument is used to determine the right composition of debt portfolios based on macroeconomic indicators and the market environment.
- **Debt Management Performance Assessment (DeMPA):** This is a methodology for analysing public debt management performance on the basis of a set of indicators that include all government debt management functions. The Bank / IMF support the systematic adoption of the DeMPA tool in LICs.
- **Targeted capacity-building and technical assistance:** This includes, for example, a debt management practitioner's programme, including training and outreach to promote learning and knowledge generation (World Bank / IMF 2009a).

Since internal and external debts are closely related and the DeMPA, MTDS, and DSF address debt issues, these frameworks should closely be linked. DeMPA and MTDS represent targeted debt management frameworks that focus on how the composition of debt is managed. By contrast, the DSF concentrates on how long-term debt sustainability is affected by the level and composition of debt. The linkages between these three frameworks become obvious when sovereign debt management has the task to set up and execute a strategy for managing the government's debt (World Bank / IMF 2009a, 9). The aim of this process is to reach government sovereign debt management goals, for example by increasing the required amount of funding or building and maintaining an efficient market for government securities.

The MTDS represents a framework for formulating and establishing a debt management strategy that leads to the required amount of funding. Here a government's risk and cost objectives need to be attained and they need to be in line with debt sustainability. The main task of MTDS is to decide on the adequate composition of debt portfolios in the light of macroeconomic and market environment and related vulnerabilities. The MTDS is used to decide on a government's plan to attain the desired portfolio composition in the medium-term.

The DeMPA has the task of assessing the effectiveness of the processes involved in sovereign debt management and highlighting their strengths and weaknesses. This

framework analyses all functions of debt management that affect a government's ability to effectively formulate and put into practice a credible MTDS. In this context the DeMPA analysis can contribute to debt sustainability in the long-term by pointing to areas that need to be improved to achieve sound debt management practices.

The main role of the DSF is to determine a level and terms of borrowing that can be maintained. This framework assesses whether the level and terms of current and expected future borrowing, combined with a medium-term macroeconomic framework, will lead to debt sustainability (World Bank / IMF 2009a, 9). The DSF can support developing countries in working out their own MTDS. It offers a platform for developing an MTDS and is designed to support countries in operationalising their debt management objectives on the basis of an analysis of the cost-risk trade-offs involved in matching a government's financing needs with its payment obligations (Barkbu et al. 2008, 17; Beddies et al. 2009). Good debt management practices are also important for developing markets for domestic government debt.

On the whole, improvement of public debt management and an effective use of these frameworks is important. Capacity-building in LICs to manage debt represents an important measure to ensure external debt sustainability. The main tasks of the IFIs will be to successfully implement these frameworks and to monitor and evaluate them continuously. While these frameworks present valuable provisions, they are not discussed controversially because there is an agreement among experts that these measures are needed and should be used in practice for a while and then to be evaluated.

3.4 Flexible Counter-Cyclical Loan in the event of exogenous shocks

Lending instruments with flexible repayment conditions could contribute to prevent *ex-ante* debt crises in LICs. To mitigate the effects of exogenous shocks, such as export shocks, and to ensure that countries will be able to repay debt in times in which shocks occur, lending instruments of bilateral donors need to have flexible repayment conditions.

One option open to bilateral donors to increase the flexibility of their repayment structure in times when shocks are anticipated is to link their debt instruments to exogenous shocks. In the event of an exogenous shock, terms of payment could be changed automatically, i.e. loans could be converted into grants, interest rates lowered, or repayment periods extended. To ensure debt sustainability, a country's debt principal repayment could be linked to its export revenues. The effect of this instrument is, however, constrained because the volume of this instrument is likely to account for only a small share of a country's total debt. In addition, some donors provide to LICs only grants and not loans.

A new instrument, called the Counter-cyclical Loan (CCL), has been proposed by Cohen et al. (2008). The aim of this instrument would be to prevent debt crises *ex-ante* and to avoid costly debt restructuring processes (Valadier 2008, 6). In the event of changes in export earnings, public debt service would be automatically adjusted, leading to a reduction of debt service during crises. Faster repayment would be required during boom periods.

There are other proposals than export data on linking debt repayments to exogenous shocks and reflect a country's capacity to repay debt, such as terms of trade, GDP, fiscal revenues, commodity prices or the exchange rate. Criteria for appropriate variables are:

- **Good indicator for repayment capacity:** Variables should represent a good proxy to reflect a country's repayment capacity, i.e. changes of these variables should directly affect repayment capacities and could represent one cause of debt crises (Gilbert / Tabova 2004, 9).
- **Timeliness of data:** Variables need to be accessible rapidly, because, first, the counter-cyclical effect of the instrument needs to be guaranteed. Second, rapid access to data is necessary for operational reasons. The former EU Stabex regime, for example, was based on export revenues for which data were available only with a significant time lag, and this led to a pro-cyclical instead of a counter-cyclical effect (Gilbert / Tabova 2004, 9).
- **Constancy of data:** As the repayment schedule for this instrument is based on data for exports, the data need to be constant. This rules out the use of data corrected over time. For example, GDP data are often corrected over time because complete data are often available only with a time lag.
- **Reliability of data:** In the case that data are reported by debtor countries, the data could be misreported or manipulated.
- **Avoidance of distortionary effects:** Substitution effects should be avoided.

Exports may be viewed as an appropriate trigger in that, first, export shocks affect repayment capacity and represent one of the main causes of debt crises (Gilbert / Tabova 2004, 9). Empirical evidence for the relation between export shocks and debt crises in LICs can be found in an analysis by Cohen et al. (2008, 5). These authors have looked at 90 debt distress episodes between 1970 and 2004 and found that the probability of a debt crisis is substantially higher if a country has had an export shock in three preceding years. LICs' vulnerability to export shocks results from their dependence on a small number of commodities. Second, data on merchandise exports are available rapidly, guaranteeing counter-cyclicalities. Third, compared to commodity prices and terms of trade, exports include both price and quantity effects, avoiding substitution effects (Cohen et al. 2008, 20).¹⁶ According to an empirical analysis by Gilbert / Tabova (2004, 35-36), export changes usually reflect the same magnitude of quantity and price changes, while quantity effects tend to exceed price effects.¹⁷

There are some operational challenges associated with exports. LICs may have an incentive to misreport their trade statistics. Mirror trade statistics, i.e. other countries' imports from the borrowing country, are used for this reason. In addition, there is a problem with time lags, as in the case of the former EU's Stabex scheme, the reason being that publication of export data involves time lags that affect the counter-cyclicalities of credits.

¹⁶ If the trigger was a qualitative shock such as a natural disaster or political shock, these events would be mirrored in export statistics, which represent an appropriate indicator for this type of shock.

¹⁷ However, this analysis is based only on ten countries (Gilbert / Tabova 2004, 35).

One possibility to reduce time lags is to use data on merchandise exports, which are available earlier than those for total export earnings. Nevertheless, the possibilities available to misuse the scheme in such a manner is limited because suspensions are restricted to five years at most (Cohen et al. 2008, 21).

Commodity prices also represent a good indicator because they have an influence on a country's repayment capacity. A major part of Least Developed Countries' exports (70 per cent of total exports) are unprocessed primary commodities (Valadier 2008, 5). In the event of volatile commodity prices, export revenues will necessarily also be volatile. In addition, commodity prices are available rapidly, and the data are reliable because they cannot be manipulated by debtor countries.¹⁸ There are three main disadvantages: First, quantity effects are not represented and second, manufactured goods are not captured. These two disadvantages would also apply for terms of trade. Moreover, the exporting countries have no incentive to shift their export structures away from commodities (Cohen et al. 2008, 21; Djoufelkit-Cottenet / Valadier 2008, 20-21).¹⁹ The other variables mentioned above are not appropriate for the following reasons. Data on GDP and fiscal revenues are not available rapidly. In addition, exchange rates only reflect price effects and not quantity effects.

Another question is the term of payment to which the instrument should be linked, i.e. interest rates, maturity, or grace period. Usually concessional loans offered to LICs by multilateral and bilateral donors have the following payment structure: Long maturities, long grace periods and low interest rates. For example, an IDA loan has a maturity of over 40 years, a grace period of 10 years and an interest rate of 0.75 per cent. Low interest rates are granted because these countries' repayment capacity is low. Long maturities are used to stretch repayment (Djoufelkit-Cottenet / Valadier 2008, 19-20).

The Counter-Cyclical Loan of the AFD

Agence Française de Développement (AFD) has been using such an instrument – Counter-Cyclical Loan – with innovative financing terms. The aim is to find instruments that preserve debt sustainability without initiating a new round of debt relief. For this reason instruments should be designed in such a manner that they address the causes of debt crises, such as exogenous shocks to export revenues. AFD's new lending instrument is built on the assumption that export shocks are one of the most important causes of debt crises in LICs.

AFD has proposed flexible loans based on the following principle: In the event of a shock, the debtor country has the opportunity to suspend its capital repayments up to a defined number of suspensions. The grace period of a loan is divided into a fixed initial grace period and a moving grace period, which can be used in the event of a shock.

In the event of an export shock a country can make use of its floating grace period, i.e. postpone its capital repayments that year. A country's permission to suspend expands as time passes, i.e. repayments made between year 6 to year 10 could be placed in a

18 Gilbert / Tabova (2004) analyse the possibility of indexing loans to commodity prices.

19 The AFD has adopted a credit scheme whose maturity changes with changes in cotton prices (Djoufelkit-Cottenet / Valadier 2008, 19 FN 6)

fund whose return can be redeemed to the country in the form of additional suspensions. Should no shock occur in a country, loan maturity would be reduced, and the country's rights to suspension would also be redeemed, net of the grace period (Box 6) (Cohen et al. 2008, 18-20).

Box 6: AFD-Instrument: Debt scenarios

The debt instrument has the following features: A 30-year loan with a fixed initial 5-year grace period and a minimum floating grace period of 5 years instead of the fixed ten-year grace period typically granted for a concessional loan. The grace periods of up to 5 years can be used by a country in the event an export shock occurs. An export shock is defined as a downward deviation of 5 per cent of export earnings from a 5-year moving average of their past values (Cohen et al. 2008, 5). The interest rate is 1 per cent (1.5 per cent). Two cases are modelled:

- **No export shock:** A country starts to repay the loan in the sixth year. The debtor country can invest repayments from year 6 to 10 at a 6-month EURIBOR rate – 1 per cent (1.5 per cent). Interest on these capital repayments can be redeemed to the country in terms of additional suspensions of capital repayments. In the event the country never uses its right to suspend the payment of the principal, the repayment period would be reduced by 5 to 7 (6 to 9) years. Due to the investment, the reduction of the repayment period could be more than 5 years.
- **Worst case scenario:** An export shock directly after the initial grace period lasts for 5 years. The debtor country can draw on its five floating grace periods directly after the initial five grace years.

Source: Cohen et al. 2008, 10; Djoufelkit-Cottenet / Valadier 2008, 19-20

Countries eligible for access to the AFD instrument need to meet two criteria. First, these countries have to have completed the HIPC-Initiative and taken part in the MDRI. Second, these countries need to be so-called green light countries as per the DSF.²⁰ The AFD has established this instrument in autumn 2007. Until July 2009 three countries have adopted this instrument. Until now no experience of rescheduling in case of exogenous shocks exists because the fixed grace period is still in use.

The instrument offers several advantages for both of the parties involved, development agencies and debtor countries:

- **Prevention of debt crises:** This instrument contributes to preventing debt crises because it ensures that money is available in times of exogenous shocks resulting from reduced debt service. In relation to a country's total debt, however, credits provided by AFD are likely to account for only a small share. What would be needed to prevent a debt crisis in one country is inter-donor coordination. First, other donors would need to have used a similar instrument. Second, to ensure that an effect on debt service materialises at the same time, the definition of shock would need to be identical.
- **Ex-ante disciplining effect:** Debt service from year six to ten has been invested in a conservative way (6-month EURIBOR), and not been put in a risky investment.

²⁰ Currently, AFD analyses opportunities to apply this instrument to LMICs. Financing terms of loans to LMICs differ from those to LICs; in particular, loans to LMICs usually have shorter grace periods or none at all and shorter repayment periods.

- **Farsighted instrument:** This instrument facilitates debt management for partner countries and would therefore enable partner countries to use credits instead of grants only.

Development agencies have the following specific advantages:

- **Lower risk:** In case the debtor does not need flexible grace periods, compared to a loan without flexible grace periods the debt is repaid earlier leading to a shorter repayment period.
- **Lower degree of concessionality:** The shorter repayment period generates a lower grant element.

Development agencies are faced with the following specific disadvantages:

- **Increase in administrative costs:** Introducing such a new instrument would increase specific administrative costs for development agencies, including e.g. monitoring costs for trigger conditions. In addition, development agencies could encounter accounting difficulties. For the financial departments of development agencies, use of this new instrument is more complicated than standard instruments of financial cooperation, because rescheduling of loans needs to be considered in accounting. Moreover, technical problems could occur. Usually the IT systems of development agencies are designed for particular types of loans. For this reason IT systems have to be adjusted for new instruments. Due to these implementation problems, initial fixed costs (that is, technical costs) are quite high for development agencies. However, if the number of countries using this innovative instrument could be extended, for example to cover LMICs,²¹ and if this instrument became a standard financing instrument, these fixed costs could be reduced thanks to economies of scale.
- **Loss of competitiveness vis-à-vis other donors:** If other donors offer better financing conditions, debtor countries would opt for other donors' financial instruments. Although, there is already such competition among donors, because various donors currently provide loans with different financing conditions. However, many bilateral donors offer LICs credits for IDA conditions.
- **Moral hazard problems:** In addition, moral hazard problems on the debtor side could occur. The debtor could e.g. have an incentive to opt for overindebtedness because his debt service is in the future. Again, the opportunity to incentives of this type is limited because suspensions are limited to five years at most.
- **Limited applicability:** This instrument can only be applied to loans with long maturities.

21 One disadvantage involved in the use of LMICs is that it might make donor coordination more difficult because LMICs are not indebted mainly to official creditors such as LICs but also to private creditors. In addition, the maturity structure of credits to LMICs differs because this type of country also borrows for short time periods.

The debtor countries are faced with the following specific disadvantages:

- **Lower grant element:** If the debtor does not need the additional five flexible grace periods, the repayment period would be shortened leading to a lower subsidy despite the shorter repayment period.
- **Opportunity costs for the debtor:** On the one hand, debtors have the opportunity to invest their repayments from year 6 to 10 at a 6-month EURIBOR rate, i.e. on market terms. On the other hand, debtor countries have opportunity costs because these countries have to invest in a quite conservative way (at a 6-month EURIBOR rate) and cannot invest this money in other projects that might provide higher rates of return. In this way money could be diverted away from alternative investment opportunities.
- **Lower volume of investments in development programmes:** In case of flexible grace periods it is questionable whether repayments from year 6 to 10 are used for development purposes.
- **Disincentive for politicians:** Since politicians are elected for a short time period, they have a shorter time horizon and thus a higher discount rate. Politicians who have the choice between an immediate grace period of five years and a grace period provided only in times of shocks would probably choose the first alternative. In the case of the AFD-instrument, politicians of debtor countries have no alternative within the French Financial Cooperation because countries eligible for this instrument have no alternative to this kind of financial support. However, as mentioned above, debtor countries could choose to use loans offered by other donors.

On the one hand, this is an interesting innovative instrument. The instrument could represent an appropriate instrument to prevent debt crises in that the debtor country would have the opportunity to suspend payments in the event of exogenous shocks. In addition, this instrument could serve to improve the debt management of partner countries. However, debt crises cannot be prevented unless donors are coordinated. Inter-donor coordination is important for preventing a debt crisis in one country because, relative to a country's total debt, loans provided by one bilateral donor represent only a small share of the total credit involved. If donors were to implement the instrument in a coordinated way, it would have the potential to mitigate the adverse effects of exogenous shocks on LICs by means of automatic stabilisation.

On the other hand, it would be difficult to implement this instrument. It can only be applied for a small group of countries because, first, only LICs are eligible to receive highly concessional credits with long maturities. A flexible grace period can be included only in the case of long maturities. Second, only those LICs with a green light in the IDA traffic light system would have the opportunity to use this instrument. In addition, timely availability of export data is questionable, and this might lead to pro-cyclical instead of counter-cyclical effects. Moreover, there are several disadvantages for debtor countries: Lower grant element, high opportunity costs for the debtor, lower volume of investments in development programmes and disincentives for politicians. The low volume of the AFD might also reflect these practical difficulties. Nevertheless, it is open to question whether bilateral donors need a shock facility for LICs which some multilateral institutions already have or are about to establish: The IMF has recently established the Stand-by Credit Facility and the Rapid Credit Facility to address exogenous shocks as well as urgent balance-

of-payments needs. In addition, IDA has recently established a Crisis Response Window for LICs for the remainder of the IDA 15 period.

3.5 Development of the local currency bond markets

For reducing external debt local currency bond markets for LICs could take on an important role, in particular local government bond markets. However, in many LICs necessary structural conditions are not met. Consequently, this presents an instrument which is currently not important in many LICs, but will be a promising instrument to reduce external debt in the future.

The development of domestic government debt markets plays an important role, first, in reducing the dependence of LICs on external finance such as in Sub-Saharan Africa (SSA). As the external debt of LICs consists mainly of government debt, the local currency government bond market is more important for ensuring external debt sustainability than the local currency bond market for enterprises. In addition, a developed public bond market is a prerequisite for private debt markets, because government securities function as a benchmark to establish a risk-free yield curve that provides the opportunity to price corporate risks appropriately. Moreover, public debt markets support the establishment of good legal and technical infrastructures for debt instruments. Relatively low-risk government securities serve to familiarise new investors with debt instruments (IMF 2007, 67).

Second, compared to direct borrowing from the central bank or commercial banks, issuing bonds in domestic financial markets is a market-based approach that contributes to debt sustainability. Compared to government borrowing from central banks, which is often associated with higher inflation rates and interest rate distortions, market-based borrowing is a cost efficient means of financing government debt. Moreover, a domestic debt market can serve to promote fiscal discipline and public financial management (PFM), leading to lower borrowing costs. In addition, smoothly functioning government debt markets facilitate the development of financial markets. Government debt often takes on the role of a benchmark return for the issuance of other securitised debt, e.g. corporate bonds, because government debt is usually the least risky asset in an economy. In this regard government debt is a precondition for the emergence of private debt markets. By allowing government debt to serve as collateral, and by reducing transaction costs, government debt markets promote interbank money markets. Another advantage is that government debt markets could contribute to diversifying the make-up of market participants in domestic financial markets, because government securities are long-term investment vehicles for non-bank institutions like insurance companies or pension funds.

Third, introduction of local currency bond markets reduces the exchange rate risk associated with financing in foreign currency. A depreciation of the domestic exchange rate could significantly increase debt in foreign currency, endangering debt sustainability in the respective country (Burger et al. 2009, 1; IMF 2007, 55).

However, there are many structural weaknesses in many LICs domestic debt markets which are underdeveloped, for example in SSA, with the exceptions of South Africa

and Mauritius. Financial markets are often narrow and concentrated, and LICs in SSA face many structural challenges in domestic debt markets.

- **Narrow investor base:** There are only a limited number of investors in domestic debt, most of them commercial banks, although auctions of government debt have been oversubscribed in many countries. In SSA, the West African Economic and Monetary Union (WAEMU) area is a good example for this phenomenon.
- **Short maturity of government securities:** Banks are for asset management reasons mainly interested in short-term papers leading to lower macroeconomic (rollover) risks for issues of government papers.
- **Impediments to secondary market development:** Since auctions of government debt are often oversubscribed, many investors hold their papers to maturity, a circumstance that obstructs secondary market development. In addition, in SSA there is enough liquidity in the banking system implying that banks do not need to sell securities in the secondary market. Moreover, short-term papers hamper secondary market development.

In addition to these structural problems, there are **difficulties involved in issuing debt:**

- **Lack of market information:** In LICs information on the debt market is often not available. Missing information leads to inefficient markets and increases the risks involved in participating in the market. One exception to this is, for example, the WAEMU region in SSA. The respective central bank (Central Bank of West African States, BCEAO) manages treasury bill issuance for member countries and makes public comprehensive data on outstanding amounts. However, regular information on country funding plans is not readily obtainable, even for BCEAO countries. It is therefore important to improve the transparency and predictability of debt issuance.
- **Lack of trained personnel:** Personnel training in debt management is important for the issuance of domestic securities.
- **Lack of a solid legal framework:** An efficient institutional structure and a good legal framework are important when it comes to issuing and monitoring domestic debt (IMF 2007, 64-65).

Necessary conditions for introducing domestic government debt markets

There are a number of important preconditions for the sustainable development of domestic debt markets:

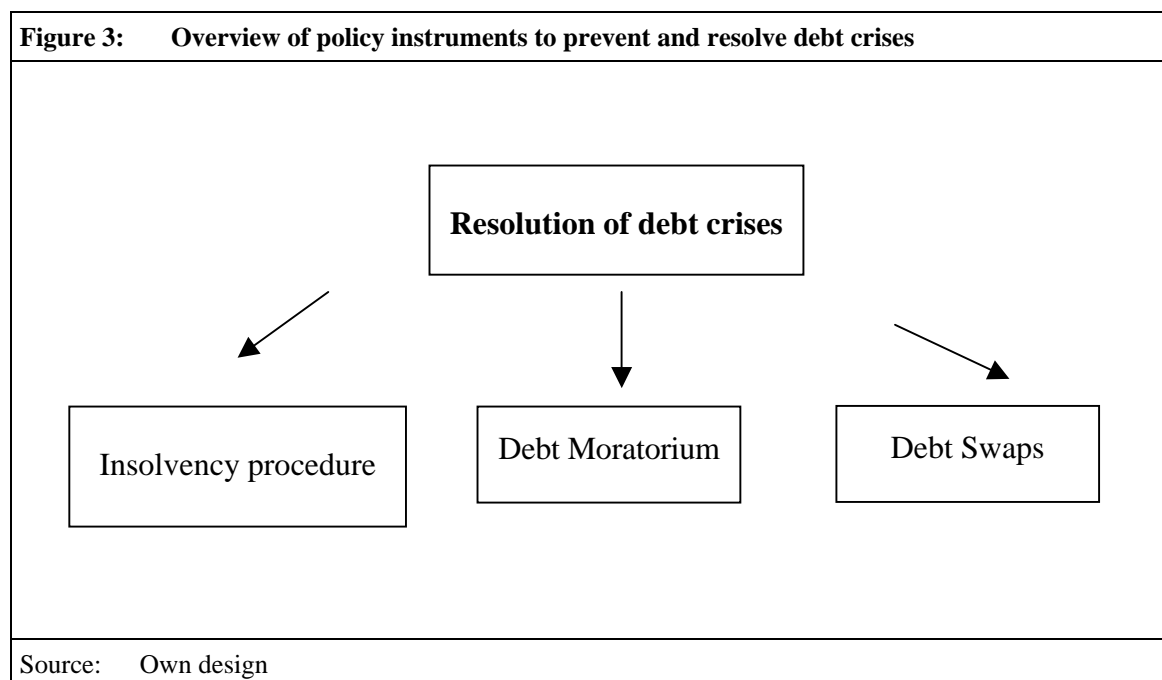
- **Macroeconomic framework:** A sound and predictable macroeconomic framework is important for government debt markets. This includes in particular the elimination of interest rate controls, because interest rate limits on alternative investments to government securities would affect the latter's auction outcomes and possibly distort investor calculations.

- **Institutional framework:** Good debt management should be based on a sound legal and regulatory system.
- **Structural reforms:** Market-based instruments call for smoothly functioning infrastructure, including e.g. trading, settlement, and depository systems. Moreover, debt should be issued in keeping with a pre-announced schedule. In addition, auction results should be published promptly.

Donors are already supporting LICs in developing their domestic debt markets. The World Bank's Gemloc Program (Global Emerging Markets Local Currency Bond program) supports the development of local currency bond markets. One important initiative of donors in support of the development of private bond markets in developing countries is the Currency Exchange Fund N.V. TCX (Norfund 2009). Another important initiative to develop local currency debt markets in Africa is the African Financial Markets Initiative established by the AfDB (AfDB 2009b).

4 Policy instruments to resolve debt crises in LICs

Policy instruments for crisis resolution include in particular instruments which are applied in the case a country has already accumulated high external debt. Although it is difficult to draw a clear dividing line between those instruments geared to crisis prevention and those geared to crisis resolution, there are some instruments which are mainly used if countries are already heavily indebted, such as an insolvency procedure for sovereign states, a debt moratorium, and debt swaps.



4.1 Insolvency procedure for sovereign states

An insolvency procedure for sovereign states presents one viable instrument to resolve debt crises in LICs. A sovereign insolvency procedure is a framework for dealing with over indebted countries. The main characteristic of an insolvency procedure is that the countries would have to restructure their foreign debt in accordance with given rules and on the basis of a majority creditor decision that is binding for minorities. Several proposals for an insolvency procedure for sovereign states have been made:²²

- **Chapter 9 / Raffer proposal:** In this proposal an insolvency procedure for states would apply the most important principles of Chapter 9 Title 11 of the United States Code (Adjustment of Debts for a Municipality) (Raffer 1990; 2001; 2005a; 2005b).
- **Fair and Transparent Arbitration Process (FTAP):** A similar proposal, the so-called the FTAP for indebted countries of the South, has been put forward by international non-governmental organisations; it builds on various elements of Chapter 9. For this reason many of its elements are similar to Raffer's proposal (Kaiser / Schroeder 2002; Raffer 2005b, 362).
- **Chapter 11 / Schwarcz proposal:** A further proposal advanced by Schwarcz is mainly based on Chapter 11 Title 11 U.S.C. (Reorganization); it develops a normative framework for an international sovereign insolvency procedure (Schwarcz 2000).
- **Sovereign Debt Restructuring Mechanism (SDRM):** The IMF suggested a legal framework for dealing with overindebted countries: The SDRM. The objective is to generate incentives for a timely and efficient restructuring process (IMF 2003).
- **International Debt Framework (IDF):** Another proposal which was mainly developed for MIC but could also be applied to LIC is the IDF. It presents a non-statutory approach which is linked to the G20 and comprises, first, an IDF Secretariat to improve the transparency of and the ways in which information is made available on debtor countries by instituting a regular debtor-creditor dialogue. Second, the IDF includes an IDF Commission to support an orderly debt-restructuring mechanism (Berensmann / Schroeder 2006).

There are many advantages of an insolvency procedure in LICs. An insolvency procedure can significantly contribute to an orderly and predictable restructuring process. Currently, there is no satisfactory alternative procedure, or roadmap to restructure a country's foreign debt in an orderly and timely manner. An insolvency procedure could substantially enhance the speed of agreement among creditors and thereby reducing economic costs of an *ad hoc* restructuring process. For this reason an orderly mechanism could add to shortening the restructuring period, raising confidence and reducing the cost of capital (IMF 2002, 33). There are high costs that result from delays in initiating restructuring processes

22 For an overview of the main proposals for international insolvency procedures, see Berensmann / Herzberg (2009). A history of ideas regarding international insolvency procedures can be found in Rogoff / Zettelmeyer (2002).

because highly indebted countries tend to draw out a restructuring process fearing the high costs concerned with restructuring. Another reason for delays in initiating a restructuring process is mainly uncertainties about the process itself.

Moreover, collective action problems constitute one main obstacle to orderly and timely restructuring. Debtors faced with heterogeneous creditor groups may have problems in reaching a timely agreement with their creditors. Three main collective action problems exist. First, the holdout problem: A creditor minority could obstruct a restructuring process favourable to a majority of creditors (holdouts). Second, the rush to the exit problem might occur. If creditors fear that their debtor may have significant problems in servicing his debt, creditors may try to sell their claims as soon as they possibly can. Since the first creditors who sell their bonds are likely to achieve a better price for their claims than the following creditors, it is rational for the individual creditor to seek to be the first to sell his claims. Third, the rush to the courthouse problem might be an obstacle to restructuring because creditors may take legal action to secure their claims (Berensmann 2003 18; IMF 2002, 4-6).

However, there are several problems involved when LICs initiate insolvency procedures. First, countries initiating an insolvency procedure could lose access to international capital markets. However, many LICs have no access to international capital markets. In addition, access mainly depends on a country's overall economic development.

Second, the procedure might serve to reinforce debtor moral hazard. Making it easier to adopt the mechanism would be an incentive for debtors to open an insolvency procedure. Moreover, there is a signal problem if the international community is prepared to restructure and forgive debt within a permanent procedure.

Third, it could take a long time to establish an insolvency procedure for sovereign states because some of the proposals for an international insolvency procedure, such as Schwarcz (2000), include a legally binding framework to ensure long-term predictability. Here an insolvency procedure would be established under international law and then – if necessary – transposed into national law, which would be very time-consuming.

Despite these difficulties, an insolvency procedure represents an appropriate instrument to attain debt sustainability in LICs in that such a procedure offers the opportunity to guarantee that a restructuring process proceeds in an orderly and predictable manner. The current international financial architecture contains no comprehensive procedure, or roadmap, to restructure a country's foreign debt. The lack of a comprehensive approach to restructuring debt leads to high costs resulting from delays in initiating restructuring processes.

4.2 Moratorium

Another option available to cushion negative effects of the financial crisis and to ensure debt sustainability is to offer a moratorium on the debt service of LICs. The Secretary-General of United Nations Conference on Trade and Development (UNCTAD), Supachai Panitchpakdi, has recently (April 30 2009) proposed to establish, temporarily, a moratorium on the official debt service for all developing countries without any condition-

ality or performance criteria and ending as soon as the world economy recovers (Kaiser et al. 2009, 15; Panitchpakdi 2009; UNCTAD 2009 and 2009b, 37). In 2005 the Paris Club offered a moratorium for debt repayments of tsunami-hit countries (Berensmann 2005).

A debt moratorium could present both a measure to prevent and to resolve a crisis.

In 1998 the unilaterally announced debt moratorium of Russia was applied as an instrument to resolve the Russian financial and debt crises. By contrast, the proposal of UNCTAD aimed at preventing debt crises in developing countries (UNCTAD 2009b, 37).

Under a moratorium the debtor suspends his payments for a given period of time.

The main aim is to temporarily reduce net debt payments. There could be a differentiation between a standstill and a moratorium. While under a standstill the debtor suspends his payments, with creditor consent, for a given period of time, under a moratorium the debtor decides unilaterally to suspend payment. However, the boundary between these two types of suspension of payment is not clearly defined, because a moratorium may gain the tacit agreement of creditors once it has been implemented. The more relevant criterion is whether payment suspensions have been agreed on a voluntary basis and in a cooperative process (Berensmann 2003 31; G10 1996, 21).

In general, a moratorium could cover various types of debt, e.g. with a view to treating all debtors of one particular debt class equally, a suspension of payment should be adopted uniformly to all claims in a particular class. There could be differences between different classes based, for example, on the following criteria: The severity of the liquidity problem, the composition of a country's debt, the role played by specific creditor classes in restoring balance-of-payments equilibria (G10 1996, 10).

The main advantage of a moratorium is that it provides the debtor time to improve his liquidity situation and to offer them some breathing space. Scarce foreign exchange earnings in debtor countries could be used for imports instead of debt servicing (UNCTAD 2009a). Moreover, it is an instrument which could easily be adopted in the short-term. In addition, a moratorium agreed upon between creditors and debtor can serve to prevent a creditor minority from disrupting a cooperative negotiation.

However, there are some drawbacks associated with a moratorium. First, a moratorium violates the fundamental principle subject to all kind of contracts that the terms and conditions need to be fulfilled in full and on time (G10 1996, 21). Second, a moratorium could endanger debtor's access to international financial markets. Even though it appears to have been a good offer, only a few countries made use of it in 2005. While Sri Lanka and Indonesia accepted the offer, Thailand and Malaysia did not, because they were afraid of losing their good reputation and jeopardising their credit standing. Their creditors could have asked for higher interest, and a crisis country would have been faced with the risk of losing access to the international financial markets (Berensmann 2005). This danger would not be given in LICs because their access to international financial markets is limited in any case. Another main drawback of a moratorium is that it may encourage moral hazard on the part of debtors.

The following operational difficulties are associated with an adoption in Germany.

First, Germany as a member of the Paris Club could only offer a moratorium to a country if the Paris Club has agreed upon such as in the case of the tsunami-hit countries in 2005. Second, a suspension of payments would generate administrative costs in terms of new redemption schedules.

For LICs a temporarily installed moratorium can contribute to resolving a debt crisis. However, this instrument should be adopted only when it is the only one available, because it is associated with many problems. A moratorium should be established only in exceptional cases and with creditor consent. For this reason the proposal of UNCTAD to offer a moratorium for all LICs irrespective of their debt levels is not advisable.

Criteria for eligibility should be determined to guarantee that a moratorium is put in place only in exceptional cases. The following criteria could be adopted:

- **Debt indicators:** The criteria for these indicators should be in line with the DSF, i.e. a country's debt indicators should exceed the debt limit thresholds of the DSF.
- **Income level:** Only LICs should be eligible.
- **Causes for high debt levels:** A debt moratorium should only be implemented in case exogenous shocks present the main cause for unsustainable debt.

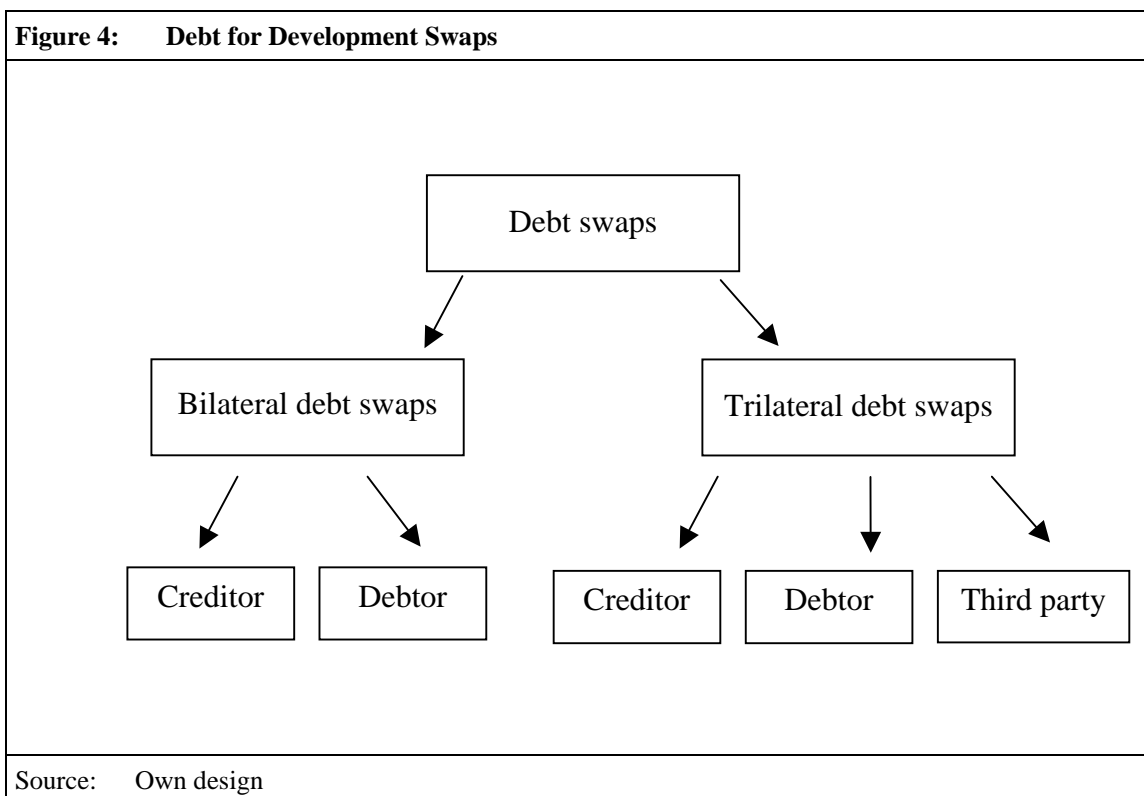
A moratorium should apply for debt service only because the main intention should be to provide the debtor short-term liquidity.

4.3 Debt for Development Swaps

Another instrument under discussion in the international community as a means of assuring debt sustainability in LICs is debt for development swaps.²³ Under a debt swap relief is provided for external debt and in exchange the debtor government commits to use additional domestic resources for an agreed development purpose (UNESCO 2007, 4).²⁴ Since the late 1980s many countries have adopted this instrument, including, for example, Belgium, Canada, Finland, France, Germany, Italy, the Netherlands, Norway, Russia, Spain, Sweden, Switzerland, the United Kingdom, and the US (Moye 2001, 23-25). The German Government, for example, provided to 19 countries debt swaps amounting to €1.36 billion between 1993 and 2008 (BMZ 2009). Various types of debt for development swaps are presented in Figure 4.

23 Debt swaps other than debt for development swaps would, for example, include debt-equity swaps, debt-for-export swaps, debt-for-offsets swaps, or debt buy-back swaps. For an overview of various swaps, see Moye 2001.

24 For this purpose various terms are adopted, including e.g. debt conversion, debt exchange or debt swap, which refer to the same procedure (UNESCO 2007, 4).



Under bilateral debt swaps the creditor country provides debt relief and the debtor government invests in development projects. These investments may account to 100 per cent of the debt relief provided. Under trilateral debt swaps the creditor and the debtor country cooperate with a third party and the creditor usually places the funds in a trust account that is administered by an independent body (BMZ 2009).

Debt swaps in the form of debt for development swaps are usually carried out in the area of poverty reduction in various sectors, including e.g. the health or environmental sector and they are conducted in the form of projects, programmes, basket-financing, or budget-financing.

Debt swaps have various advantages for the debtor country. First, they reduce debt, although the amount provided by debt swaps is quite small compared to total debt. Second, they provide debtor countries with the opportunity to engage in additional development measures that they may otherwise not have implemented without the additional funds made available by a debt swap.

Debt swaps have the following advantages for donors. First, debt relief is conditioned and debt swaps therefore increase the development leverage of donor countries in their policy dialogue with recipient governments. Donors have the opportunity to direct money from the budget of the partner for specific purposes. Second, debt swaps serve as a signal to partner countries that their structures are recognised, because projects are proposed by partner countries, and this serves to increase ownership of recipient countries (Berensmann 2007; Moye 2001, 7).

There are, however, some problems involved with debt swaps. They may strain partner budgets because partner countries are required to invest in development projects and thus

need to make advance outlays in national currency. In addition, there may be fiduciary risks if partner countries implement projects autonomously without disposing of appropriate administrative structures. Moreover, windfall effects are possible because it is generally difficult to estimate whether the recipient country would have implemented these development projects without the additional funds provided through debt swaps; this is referred to as the additionality problem.

The problems posed by fiduciary risks and windfall effects could be reduced by adopting trilateral agreements. Under trilateral swaps the creditor country provides debt relief and the debtor country conducts the development projects in cooperation with a third party. These third parties generally have established and approved administration and evaluation mechanisms.

The German participation in the Global Fund to Fight AIDS, Tuberculosis and Malaria is one good example for a trilateral agreement. The German government has provided debt relief to the Indonesian (€50 million) and Pakistan government (€40 million), which have paid a part of this debt relief (Indonesia: €25 million and Pakistan: €20 million) into the Global Fund (BMZ 2009). In addition, these trilateral funds represent an innovative approach to debt swaps, and their adoption should be extended.

5 Policy recommendations

The global financial crisis has had an impact on the debt levels of LICs, with higher borrowing needs jeopardising debt sustainability in LICs. Even though the magnitude of these effects is still uncertain due to a lack of data, the debt situation of LICs is likely to further deteriorate in the future. Debt sustainability represents one important prerequisite for sound growth and development.

What we find here is a trade-off between two objectives. On the one hand, financing to LICs needs to be increased, but on the other hand, debt sustainability should be maintained. Therefore, financing instruments of donors need to be highly concessional. In addition, the recent global financial crisis has shown that appropriate instruments for absorbing such an exogenous shock need to be flexible and anti-cyclical. Moreover, a large amount of money has to be available in the short-term.

For achieving these two goals we have to distinguish between measures aimed at preventing and at resolving debt crises even if it is difficult to draw a clear dividing line between these two categories because some measures are geared to both prevention and resolution.

Prevention of new debt crises

Policy instruments used for crisis prevention include, in particular, instruments that accord consideration to prudent lending and borrowing. What this means in this context is first, that the debt situation in LICs should be monitored and assessed and that donors mainly provide concessional loans or grants to LICs. Debt monitoring and assessment frameworks, such as the Debt Sustainability Framework (DSF), the Non-Concessional Borrowing Policy (NCBP) of IDA, and the Debt Limit Policy (DLP) of the IMF, assume

important roles in the global debt governance. Nevertheless, there appear to be uncoordinated parallel structures for the overall debt policy of IMF / World Bank because the DLP and the DSF adopt different analytical frameworks for assessing capacity. These different analytical frameworks could lead to different results concerning LICs' debt sustainability. Therefore these frameworks have to be streamlined. In addition, the NCBP and the Fund's Debt Limit Policy should be harmonized by using the same concessionality requirements and by using similar rules for providing non-concessional loans. Moreover, it is questionable whether these frameworks have been effective because debt sustainability of many LICs has been endangered.

Second, donor concessional financing facilities are necessary to prevent debt crises in LICs. The increase in the amount of concessional facilities of the IMF by up to US\$ 17 billion through 2014 is in general appropriate to help to ensure debt sustainability in LICs. This higher volumes of concessional financing would enable LICs to borrow more on concessional terms rather than having to resort to non-concessional financing, which could generate future debt service problems. However, the Fund has to ensure that borrowings are used for increasing productive capacities. Another important question is whether this new role of the IMF in LICs is appropriate or whether it negatively affects the division of labour of the International Financial Institutions.

Similarly, IDA has reacted to the crisis and implemented appropriate reforms:

- **IDA Fast Track Facility:** The temporary establishment of this facility was also useful in extending concessional financial resources to LICs. However, these are not additional financial resources because this facility is part of the IDA 15 fund.
- **IDA guarantees:** This instrument plays an important role to support countries in leveraging their IDA resources by mobilising project financing and should be extended. For this reason, it was appropriate to establish IDA guarantees as a standard instrument.
- **IDA Crisis Response Window (CRW):** Since the CRW supports LICs quickly in the event of exogenous shocks, it is in this regard complementary to IDA loans and grants. However, concerning financing conditions which are similar to IDA loans, i.e. long maturity, grace period and service charges, it is to some extent questionable whether the CRW is complementary to existing IDA instruments. A shorter repayment period is in some cases preferable in that long maturities tie up concessional resources for a longer period of time than necessary, because e.g. some countries may need such funds only for a shorter period of time. For this reason there could be a need for a short-term flexible concessional instrument. With regard to the division of labour between International Financial Institutions, it is questionable, however, whether the IMF and the World Bank both need short-term lending instruments.

Third, adequate debt management represent important policy instruments to prevent debt crises. The financial crisis has led to growing government financing gaps as a consequence of lower tax revenues and higher expenditure needs. One important measure to ensure external debt sustainability is to improve capacity-building in LICs for public debt management (PDM) because a good PDM can help to identify and quantify the most relevant risks associated with different financing options and, in addition, support an effective debt management.

Fourth, local currency bond markets are another option to reduce external debt vulnerability in LICs. However, necessary structural conditions are not given in many LICs. For this reason, local currency bond markets represent a viable instrument to reduce external debt only for a few LICs. In the future, it will be a promising instrument to reduce external debt as many Middle Income Countries (MICs) have proven. For this reason donor support to LICs in developing their domestic debt markets have been stepped up. Donor initiatives such as the World Bank's Gemloc Program and the TCX initiative of bilateral donors are an important step in this direction.

Resolution of debt crises

Viable policy instruments to resolve debt crises include first, an insolvency procedure for sovereign debt because it offers the opportunity to ensure a restructuring process that proceeds in an orderly and predictable manner. In the current international financial architecture there is no comprehensive procedure, or roadmap, available to restructure a country's foreign debt. The lack of a comprehensive approach to restructure debt leads to high costs resulting from delays in initiating restructuring processes. Due to heterogeneous creditor groups debtors may have problems in reaching a timely agreement with their creditors. In comparison with a timely restructuring, these delays generate high costs such as losses in currency reserves and a decline in economic output. Moreover, a timely restructuring contributes to preserving the value of claims.

Second, a moratorium on the debt service of LICs could contribute to debt sustainability in the short-term. The main advantage of a moratorium is that it provides the debtor time to improve his liquidity situation. However, a moratorium should only be implemented in exceptional cases and with creditor consent, because moratoriums entail numerous problems. First, a moratorium violates the fundamental principle on which all contracts are based, namely that terms and conditions need to be met in full and on time. Second, a moratorium may encourage moral hazard on the part of debtors. If a moratorium is established, it should cover debt service only, in that its main intent should be to provide the debtor short-term liquidity.

Third, debt swaps, in particular triangular agreements, present a viable instrument to reduce debt, to increase the development leverage of donor countries and to increase development measures in partner countries that would not have been implemented without the debt swaps. By using trilateral agreements the problems posed by fiduciary risks and windfall effects could be reduced, because the money for development projects is paid into a fund managed with established evaluation mechanisms.

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Appendix

Box 7: Debt Sustainability Framework

Unlike the Enhanced HIPC-Initiative, the framework involves a country-specific approach for assessing debt sustainability based on threshold values for debt indicators, including e.g. debt or debt-service payments in relation to exports, GDP, or government revenues. Instead of automatically applying the same values for all countries concerned – as was done under the HIPC-Initiative – the new framework will take into account the quality of national institutions and economic policies, which will be measured with the aid of the internal rating procedure (CPIA) used by the IDA for granting credit. If countries do well on the CPIA index, higher debt is seen as sustainable because better institutions and economic policies are regarded as a positive measure of a country's repayment capacity. Three country types are distinguished in this connection: Countries with poor, moderate, and good performance on the CPIA Index. The main **elements** of the DSF are:

- An assessment of a country's projected external and public sector debt burden and its vulnerability to exogenous shocks, including a calculation of baseline and shock scenarios.
- An analysis of the risk of debt distress based on indicative external debt burden thresholds that hinges on the quality of a country's policies and institutions.
- Recommendations for a borrowing (and lending) strategy that limits the risk of debt distress.

The DSF is a standardised analytical framework which on the one hand takes into account country-specific circumstances and other hand makes cross-country comparison possible. The **central objectives** of the DSF are to:

- **Guide borrowing decisions of LICs:** This framework is conceived to guide borrowing decisions of LICs in ways that bring their financing needs into line with their current and future repayment ability, in particular as regards decisions on adequate terms for new financing or a suitable pace of debt re-accumulation for countries that have obtained debt relief. In addition, governments can apply the DSF in their dealings with donors, lenders, and other stakeholders.
- **Direct creditor lending and grant-allocation decisions:** The DSF is designed to provide guidance for creditors' lending and grant-allocation decisions that allow creditors to ensure that financial resources are offered on terms that do not endanger debt sustainability in LICs. Major multilateral institutions, including the IDA and the African Development Bank, have adopted the DSF for coming to decisions on the right grant-loan mix for LICs.
- **Contribute to crisis prevention:** The DSF is designed to contribute to identifying crises at an early point in order to be able to take preventive measures.

The DSF has the following **strong points**:

- **Improved information:** The DSF has significantly improved access to information and the timeliness, comparability, and quality of information on the debt situation of LICs. This better information base has improved the decision capacities of borrowers and lenders.
- **Improved creditor coordination:** Improved creditor coordination can facilitate sustainable lending practices. Each creditor is informed about the lending conditions of other creditors, and may be confident that other creditors will not offer financial resources on terms that endanger debt sustainability.
- **Coverage of nearly all creditors to LICs:** The DSF has been adopted by nearly all major multilateral and traditional bilateral creditors.

Nevertheless, the framework does have several **weaknesses**:

- **Exactness of the assumptions made:** Since assumptions affect the outcome of debt ratio trajectories and debt distress ratings, they play an important role in the DSA. The problem is, however, that it is difficult to make macroeconomic projections, in particular to project the investment-growth nexus.
- **Domestic debt:** The build-up of domestic debt is currently not mirrored in the debt distress rating.
- **Private creditors:** Private capital flows pose new risks that are not included in DSAs.
- **Little adoption of DSF by non-traditional creditors:** These creditors often do not adopt the DSF.
- **Restricted domestic capacity:** The effectiveness of the DSF is dependent on the ability of borrowing countries to adopt the framework as a means of guiding their borrowing decisions (Beddies et al. 2009; IMF 2006a; Rocher 2007, 43-44).

Box 8: OECD Export Credit Group: Principles and guidelines on sustainable lending

OECD member countries have agreed to establish a set of principles and guidelines on sustainable lending within the Working Group on Export Credits and Credit Guarantees (ECG). Compared to their total portfolio, their current exposure is small, partly due to the recent debt relief initiatives. However, these creditors are interested in new lending to LICs.

Members of this working group have agreed that for most LICs lending on a concessional basis is the most suitable source of external financing. In addition, they acknowledge that official export credits to public entities should be in line with sustainable lending practices, i.e. lending should not jeopardise the future and long-term development outlook. This group has agreed on the following set of principles and guidelines which follow IDA and IMF concessionality requirements and take the DSF into account:

- ECG members will monitor concessionality requirements and report to the IMF and the IDA. Consequently, export credit agencies will make available non-concessional credits only if these credits enable LICs to continue to match the relevant concessionality requirements.
- In providing official export credits to IDA-only countries without concessionality requirements, ECG members will consult the most recent DSA analysis of IMF and World Bank.
- For larger credits with a repayment term of two years or more, ECG members will ask government authorities to assure that this credit is compatible with a country's agreed borrowing and development plans.

The European Union member states have officially approved these principles. The aim is to guarantee that loans supported by their export credit agencies are consistent with sustainable development objectives (Beddies et al. 2009; OECD 2008).

Nevertheless, in practice there are operational problems in establishing information sharing and coordination, thus protracting credit guarantee procedures. Bilateral official creditors outside the OECD constitute a group of creditors quite diverse in terms e.g. of their investment strategies and policy objectives. Similarly, with respect to the concessionality requirements, it might be difficult to include private creditors.

Examples of graduated HIPC and MDRI countries in high debt distress

In **Burkina Faso** the global financial crisis has had an impact on real GDP growth, exports and external debt. Due to lower global demand in the aftermath of the financial crisis, projections for real GDP growth have been reduced by 1.4 percentage points for 2009 and 1.9 percentage points for 2010 (Table 2). Similarly, projections for exports have been decreased substantially for 2008 and 2009. However, projections for 2010 have been increased by 34 per cent, and this significant increase is partly due the low levels noted between 2007 and 2009. On the one hand, reduction in GDP growth and exports have been due in part to lower external demand and a decline in the prices for cotton, Burkina Faso's main export commodity. On the other hand, lower international oil prices and higher gold prices will have mitigated these negative effects.

Burkina Faso remains at high risk of debt distress. The IMF projects that external debt levels in terms of exports will increase substantially from nearly 123 per cent in 2008 to nearly 145 per cent in 2009. However, this indicator for external debt levels is projected to decrease, as early as in 2010, to 121 per cent (IMF 2009l, 19). Although projections for debt in terms of revenues have not been corrected by the IMF in the aftermath of the global financial crisis, this indicator is likely to increase from about 85.1 per cent in 2008 to 114.5 per cent in 2011 (Table 2).

	2007	2008		2009		2010		2011
	Est.	Prog.	Proj.	Prog.	Proj.	Prog.	Proj.	Proj.
GDP at constant prices	3.6	4.5	5.0	4.9	3.5	6.0	4.1	5.3
Exports	-2.9	6.6	-2.8	21.0	13.1	10.1	44.4	6.3
NPV of external debt (per cent of exports)	110	123.2	122.6	131.3	144.7	138.6	121.0	130.0
NPV of external debt (per cent of revenues)	85.5	93.2	85.1	108.5	106.9	114.4	112.3	114.5

Source: IMF 2009l, Table 1, 19

The global financial crisis has had a substantial impact on macroeconomic indicators in **Gambia**, leading to a likely decline in GDP from 6.1 per cent in 2008 to 3.6 per cent in 2009 and a decrease in exports from 8.8 per cent in 2007 to -5.4 per cent in 2008 and -1.0 per cent in 2009 (Table 3). Two main reasons for this development are lower tourism figures and a decline in remittances by 20-30 per cent in the first quarter of 2009 (IMF 2009k, 6).

The country remains at high risk of debt distress even after HIPC and MDRI debt relief. According to the DSF, Gambia is considered a weak performer: The indicative threshold for the net present value of external debt in per cent of GDP is 30 per cent; the NPV of external debt in per cent of exports is as high as 100 per cent. In 2008 Gambia exceeded one of these thresholds: Debt in terms of exports was 135 per cent and debt in terms of GDP amounted to 26.25 per cent. One reason why debt in terms of exports is high is that projected exports have declined and the currency has substantially depreciated against the US-Dollar. In addition, Gambia has taken out new loans (IMF 2009k, 13).

	2007	2008		2009		2010
	Act.	4 th Rev.	Act.	4 th Rev.	Act.	Proj.
GDP at constant prices	6.3	5.9	6.1	4.6	3.6	4.3
Exports	8.8	-6.9	-5.4	0.9	-1.0	2.2

Source: IMF 2009k, 13

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