

DEBT SUSTAINABILITY FRAMEWORK FOR LOW
INCOME COUNTRIES:
POLICY AND RESOURCE IMPLICATIONS

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ABBREVIATIONS

CPIA	Country Policy and Institutional Assessment
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Highly Indebted Poor Countries
IDA	International Development Association
ICP	IDA Country Performance
IMF	International Monetary Fund
IFI	International Financial Institution
MDG	Millennium Development Goal
PBA	Performance Based Allocation
PNG	Private Non Guaranteed
PV	Present Value

EXECUTIVE SUMMARY

The Debt Sustainability Framework sets out a proposal by the World Bank for identifying countries in actual or potential debt distress situations leading to a formula for determining grant eligibility within the amounts to be allocated during the Fourteenth Replenishment of IDA. It attempts to classify countries based on the performance of their institutions and policies and determine thresholds for selected debt indicators for each country grouping and then estimate the level of debt distress as measured by the forecast levels of the selected indicators from the country DSAs. This leads to a formula for determining grant eligibility within the IDA allocation made on the basis of the Performance Based Allocation System that uses the Country Policy and Institutional Assessment and governance rating of the country concerned. The increase in grants has implications for the future of IDA funding which also needs consideration.

Although called the Debt Sustainability Framework it does not provide a mechanism to ensure that bilateral and other multilateral donors will act in accord with IDA in their lending so that low income countries could reduce their debt vulnerability. This is particularly important when IDA accounts for only a small share of a country's external borrowing. It also begs the question about action that should be taken about current high levels of debt stock. Effective donor coordination will be necessary to achieve debt sustainability which is the objective of the new allocation system. The international community needs to address this issue at the time the DSF is approved in the same way that it was done when the HIPC Initiative was launched.

There are differences between the HIPC Initiative and the DSF. The former was intended to deal with the debt overhang brought about by past borrowing, while the Framework is intended to reduce the accumulation of future debts of low income countries to unsustainable levels. While the HIPC Initiative used a single indicator, that is the ratio of debt to exports to judge sustainability the DSF selects three debt ratios which are the present value of public and publicly guaranteed external debt to gross domestic product and to exports, and debt service on the same debt to exports to judge debt sustainability. Country policies and institutional capability and vulnerability to shocks are other factors identified as being important for assessing a country's debt sustainability.

The DSF uses the Country Policy and Institutional Assessments done for each borrowing country to classify countries by performance and determine different debt ratio thresholds for the selected indicators. The allocations under IDA 14 will be based on the Performance Based Allocation System which is based on the level of poverty measured by per capita income and performance assessed by the CPIA and governance. The level of debt distress of a country is measured in relation to the debt ratio thresholds for the relevant country grouping leading to an assessment of grant eligibility.

The World Bank will allocate funds for low-income countries taking into account both “need” and “performance.” Country performance is to be assessed using the CPIA comprised of four clusters accounting for 80 percent of a country’s rating. Further it will rate each government’s performance on the portfolio of outstanding loans. This accounts for 20 percent of the rating. The level of grants and credits (loans on soft IDA terms) to which a low income country has access will increase or decrease as a result of the Bank’s application of a “governance factor” to its CPIA and portfolio performance ratings. The governance factor is given a high weight relative to other criteria.

The proposed grant allocation system in IDA 14 will be based on the thresholds of the selected debt indicators for the groups of countries that are classified as strong, medium and poor performers based on the CPIAs. Forecast levels of the selected debt indicators will take account of the impact of exogenous shocks to the extent these can be forecast in the country debt sustainability analyses (DSAs). Countries that are judged to be high risk based on the debt sustainability analyses DSAs will receive the entire IDA allocation as grant funds. Countries that are judged to be of medium debt risk will receive 50 percent of the IDA allocation as grants and the balance as credits, while countries that are judged to be low risk will receive the entire IDA allocation as credits.

The World Bank has proposed a combination of mechanisms for financing the grant allocations - replacing foregone credit reflows through additional donor financing, reducing the concessionality of IDA credits, and levying upfront charges on grant recipients. Additional financing by donors could be made up of upfront payments of the foregone service and commitment charges that reflect the cost of doing business to IDA and donors undertaking to finance foregone principal reflows as they come due over the credit repayment period of up to 40 years.

DSAs that are currently conducted compare the indicators to thresholds that are based on public and publicly guaranteed external debt. Indicators based on total external debt that includes private non-guaranteed (PNG) external debt and those on total public debt that includes domestic borrowing of the public sector could deviate significantly from these levels. High levels of domestic debt that are more prevalent than high levels of PNG external debt in low income countries are difficult to handle in DSAs because there are no agreed thresholds based on empirical analysis. Nevertheless, the DSAs should include total public debt as servicing domestic public debt is a drain on resources that is similar to external public debt. Research should be conducted on use of total public debt for DSAs and consequently of government revenue in determining debt indicators and their threshold values. Similarly, studies should also be conducted on determining indicators and threshold values that use total external debt in the estimates of total debt stock.

Given the importance of DSAs for each low income country in the application of the DSF and borrowing from the IMF, it is necessary that these be conducted in a collaborative and transparent manner by the two institutions working closely with the country authorities and major creditors. While the DSAs and risk assessments are to be done in a collaborative manner, it is understood that each institution will make its own assessment and report separately to its respective board. It is recognized that there may be differences between the Bank and Fund in these assessments and possible scenarios and it is not known how these will be played out in the countries where they occur.

Since CPIAs are central to the allocation system of IDA funds there is a need to discuss the process by which these assessments are made. There does not appear to be a full awareness of the CPIA process at the country level which suggests that the process is not uniformly transparent across member countries. The Bank should set out the basis on which these assessments are to be conducted, in particular the ratings and the inputs expected from and the involvement of national staff in the process. There should be opportunities for the Bank to present their findings both to the country concerned and donor community. This would enable the entire donor community to be involved in the discussions as it should because the allocation of grant funds based on debt distress is a concern to all donors particularly if IDA is not the major donor.

There are 13 HIPCs that have reached the Completion Point for the Initiative. Another 14 countries have reached the Decision Point and are at various stages of the cycle while 11 countries from the list of 38 countries that were judged to be potentially qualified under the Enhanced HIPC Initiative have not been able to reach the Decision Point. The calculations for HIPCs at the Completion Point would have to be made using the HIPC methodology. Since this is essentially backward looking, it may give different results from the forward looking methodology proposed in the DSF. It is therefore recognized that transition arrangements are necessary for HIPCs during the interim period

No mention is made in the DSF of IMF lending to low income countries which correspond to the IDA eligible countries. These countries can access the Poverty Reduction and Growth Facility up to 140 percent of their quotas under three year agreements. The loans carry an interest rate of 0.5 percent and are repayable in 10 years after disbursement. This includes a grace period of 5½ years. There is no facility in the IMF that corresponds to the proposed grant facility under IDA 14. The role of IMF lending and the terms on which these will be provided are important for an initiative intended to assist low income countries achieve debt sustainability.

It is estimated that a greater donor effort of the order of \$50 billion annually or a doubling of current official development assistance levels is needed to meet the Millennium Development Goals (MDGs). It is not clear how such assistance will be coordinated to achieve the objectives of the DSF. Other multilateral and

bilateral agencies that have not converted their assistance to grants need to ensure that their assistance programs dovetail into those of the IDA so that the objectives of debt sustainability are not compromised while trying to reach the MDGs.

Introduction¹

1. The Thirteenth Replenishment Agreement of the World Bank's International Development Association (IDA), covering the period 2003-5 inclusive, introduced grant financing for the first time in IDA's 40-year history. The Agreement recognized that unsustainable levels of debt should be a criterion for eligibility of grants for low-income borrowers, along with criteria such as the exigencies of natural disasters, conflict and the HIV/AIDS pandemic. In IDA 13, each borrower was subject to a cap of grant funding equivalent to 40 percent of its total IDA allocation. The exact percentage depended on the criteria used to determine grant eligibility such as unsustainable debt, natural disasters, etc. There was no distinction drawn among borrowers facing different degrees of debt-servicing problems. During IDA 13, officials at the World Bank and International Monetary Fund (IMF) worked on developing a more systematic basis for differentiating among borrowers with actual or potential debt servicing problems with a view to providing higher grant levels to those requiring grants for debt sustainability.
2. These efforts led to the preparation of a paper entitled "Debt Sustainability in Low Income Countries: Proposal for an Operational Framework and Policy Implications"² (referred to hereafter as the DSF) which sets out a proposal for identifying countries in actual or potential debt distress situations, leading to a formula for determining grant eligibility within the amounts of resources to be allocated during the Fourteenth Replenishment of IDA. This paper was discussed by the Boards of the World Bank and IMF in February and March 2004 and by the Development Committee in April.
3. Following these discussions and endorsement of the general principles of the framework, a further paper was prepared by IDA³ to operationalize the framework that was proposed in the earlier paper. The approach adopted in this paper is to determine the level of grants in the IDA allocation based on the level of debt distress assessed in relation to the thresholds applicable to the country. These thresholds are determined by the Country Policy and Institutional Assessments (CPIAs) done by the World Bank for each borrowing country to judge its policies and institutional capability, and by the actual or projected level of the debt indicators that take account of the country's vulnerability to exogenous shocks. Consequently the level of grants in IDA 14 will be an outcome of the framework and not predetermined as in IDA 13 when a cap of 40 percent was placed for each country.

¹ The authors wish to thank Dr Roy Culpeper, President, The North-South Institute, Ottawa for his assistance.

² Debt Sustainability in Low Income Countries: Proposal for an Operational Framework and Policy Implications by Mark Allen and Gobind Nankani, IMF and IDA, February 3, 2004.

³ Debt Sustainability and Financing Terms in IDA 14, IDA, June 2004.

4. The allocation of IDA funds (grant and or credit) is tied to the Performance Based Allocation (PBA) system used by IDA which in turn is dependent among other things on the CPIA done for each borrowing country. The proposed increase in the allocation of grant funds during IDA 14 has implications for the future funding of IDA, as future replenishments are dependent on reflows of principal repayments on credits, unless forgone repayments are offset by a corresponding increase in the level of replenishment by the donors.
5. The key principle in the framework is to reduce the risk of debt service problems through grant funding while facilitating access to financing required by these countries to achieve the objectives of the Millennium Development Goals (MDGs). Unlike the Highly Indebted Poor Countries (HIPC) Initiative that was intended to deal with the debt overhang brought about by past borrowing, the DSF is intended to reduce the accumulation of future debts to unsustainable levels. This overarching objective is welcome and would have significant implications for the volume and type of financial flows to many developing countries. This paper is intended to assist the countries of the G24 to better understand the proposed DSF and assess its implications for the resource requirements of IDA-eligible countries.
6. The next section will discuss the various debt indicators that could be used to assess debt sustainability. It should be noted that debt sustainability as a concept began to be used extensively with the HIPC Initiative of 1996. It is an imprecise concept as evidenced by the need to use numerous indicators to assess sustainability and monitor them frequently. The HIPC Initiative itself had to be enhanced three years after the launch for this reason.
7. This will be followed by a description of the DSF, the PBA system for IDA allocations (including the CPIA on which it is based) and the grant component, and the implications for the future financing of IDA. The concluding section will highlight weaknesses in the proposed framework, recommend alternative approaches and make suggestions for further research work by the World Bank and IMF during IDA 14 and after to strengthen its application to individual countries.

Debt Sustainability and Debt Indicators

8. “Debt sustainability” refers to a country’s ability to service its borrowing, foreign and domestic, public and publicly guaranteed, private non-guaranteed, including both short- and long-term debt, without compromising its long-term development goals and objectives. Countries use various debt indicators and levels to estimate sustainable levels of borrowing. Sustainability is a dynamic concept that should be judged using numerous indicators.

9. It is also useful when judging debt service problems to distinguish those of liquidity from insolvency. This is easy in the case of corporate entities though difficult in the case of sovereign borrowers. Firms that have a negative net worth, when liabilities exceed assets, are insolvent. Those that have a positive net worth may face difficulty in meeting their financial obligations due to liquidity problems. It is difficult to extend the concepts of solvency and liquidity to a sovereign borrower as net worth is difficult to measure in a country. Some countries that have attempted balance sheet budgeting could apply these concepts but they are not many. In view of this, creditors and investors judge liquidity and solvency problems of a country using its debt indicators. There are other non-debt indicators that along with debt indicators enable a comprehensive assessment to be made of a country's solvency and liquidity.
10. As stated in the paper that sets out the DSF⁴, the ability of a country or its government to service debt depends on the existing debt burden and the projected deficits both of its balance and payments and budgets, the mix of loans and grants in its future financing arrangements, and the build-up of its repayment capacity relative to Gross Domestic Product (GDP) and export and government revenues. In addition, the quality of the country's policies and institutions and exogenous shocks to the economy also influence its ability to service its debts.
11. Commonly used external debt indicators fall into five groups. They are classified as liquidity monitoring, debt burden in nominal and present value (PV) terms, debt structure and dynamic indicators. There are corresponding fiscal indicators as well. These are listed and described in Annex 1.
12. Judging debt sustainability using debt indicators raises a number of conceptual and definitional issues. These relate to the types of debt to include in debt stock and debt service payments i.e. the numerator in the debt ratios; the way to measure debt burden; judgment of payment capacity, i.e. the denominator in the debt ratios; and the choice of thresholds for the selected ratios.
13. Matthew Martin⁵ argues that a comprehensive definition of debt should have been used when conducting debt sustainability analyses (DSAs) under the Highly Indebted Poor Countries (HIPC) Initiative, which instead was confined to public and publicly guaranteed external debt. Domestic debt, for example, is a serious concern in many low income countries. Even though the domestic debt market may be in early stages of development, government arrears and Central Bank and commercial bank overdrafts are often significant. Similarly private sector external debt could be significant in countries that have

⁴ Ibid footnote 2.

⁵ "Assessing the HIPC Initiative: The Key Policy Debates", Matthew Martin, in HIPC Debt Relief: Myths and Reality, FONDAD, The Hague, 2004.

liberalized their capital accounts and receive foreign direct investment as much of it is financed by debt rather than equity. Thus DSAs of public and publicly guaranteed debt may only provide a partial assessment of a country's debt sustainability.

14. When assessing debt sustainability, three measures of debt burden are normally considered. The first is the nominal stock of debt expressed in a single currency, typically the US dollar. The second is the stock of debt measured in PV terms by discounting the future stream of debt service payments by a series of discount rates relevant to the principal currencies in which the country has borrowed. The third is the annual or multi-year payments due on debt service. The nominal stock of debt and debt service payments were the preferred measures of debt burden until the early 1990s after which the World Bank, IMF and the Paris Club began to use the PV of debt. However, Martin argues that market perceptions of indebtedness are still based on the nominal stock of debt.
15. Debt service payments crowd out other high priority claims on resources, both external and domestic. Consequently, current debt service ratios are an indication of present payment difficulties. However, low current ratios may mask future problems of high debt stocks due to grace periods and long repayment periods. Therefore projections of debt service ratios also need to be reviewed. At the same time the PV of debt is able to capture the concessionality of outstanding debt obligations but it takes no account of the growth in repayment capacity that would be captured by projections of debt service ratios. It should be noted that projections are subject to errors in forecasting due to uncertainty in growth of the repayment capacity and unpredictable exogenous shocks.
16. Another issue that has come up in the use of the PV of debt in estimating debt indicators has been the fluctuations in the discount rates used for estimating the PVs. Evidence of this has been the adverse implications for HIPC's of the fall in interest rates in creditor countries which reduced the levels of debt relief that HIPC's were eligible. Consequently the DSF proposes the use of a uniform five percent discount rate for all loan currencies that would be changed by a full 100 basis points whenever the market rate (measured by the six month Consensus Interest Reference Rate of the US dollar) deviates from it by at least this amount for a consecutive period of six months.
17. As stated, GDP or Gross National Income (GNI) is used to measure capacity to make debt service payments and estimate debt indicators. Although it measures the size of the economy, it does not translate into a capacity to pay through exports of goods and services. Export earnings on the other hand are available to make debt service but their availability to the government is dependent on the openness of the economy and arrangements made for attracting foreign direct investment. The usefulness of export earnings as a

measure of capacity to make debt service payments would also depend on scope of debts included in the stock, i.e., total external debt or public and publicly guaranteed debt.

18. Government revenue is a third measure that should be considered for measuring capacity to repay public and publicly guaranteed debt. The World Bank and IMF have argued against the use of this measure for two reasons. The first is that there are difficulties of estimation. It is difficult to understand the rationale of this argument when the GDP or GNI estimate is found acceptable and would suffer from the same problems of estimation as government revenue in any country. Further, government revenue is a variable that is monitored in IMF programs and countries will be working towards improvements in estimation. A moral hazard argument is advanced against the use of government revenue in that lower revenue collections will lead to higher estimates of the debt indicators. A similar argument was made in the HIPC Initiative.
19. This issue needs to be revisited for a number of reasons. Government revenue more than any other macro variable captures the opportunity cost of debt servicing. It is appropriate when considering public and publicly guaranteed debt. Further, the IFIs and donors should be keen on building up revenue capacity as a way out of excessive indebtedness, domestic or external.
20. Once the indicators are selected it is necessary to determine threshold values that would enable countries to be classified by their state of indebtedness. After the debt crisis of 1982 the World Bank began classifying countries as highly indebted, moderately indebted and less indebted using four external debt indicators. These were the nominal stock of external debt to GDP and exports, the debt service and the interest payments to exports of goods and services ratios. Thereafter, the nominal stock of external debt was replaced by the PV of external debt in the two stock indicators in the early 1990s. The threshold values for the classification of indebtedness were based on inter-country debt analyses conducted by the World Bank. However, as stated earlier, threshold levels of debt indicators used for assessing debt sustainability are imprecise and based on subjective judgements.
21. The HIPC Initiative launched in 1996 and enhanced in 1999 to address the debt problems of the world's poorest countries was also dependent on debt indicators to determine the extent of debt relief. There are two milestones in the initiative. The first is the Decision Point at which a country is judged eligible to receive assistance following a good track record of reform programs and economic performance. At the Decision Point, the amount of debt relief necessary to bring the debt to exports ratio down to 150 percent at the Completion Point is decided and implemented. At the Completion Point, which is the second and final milestone, countries are assessed for additional assistance that may be required due to exogenous shocks or changes in market

conditions of interest and exchange rates and become eligible to receive funds from the Topping Up Facility. In the case of small economies that are highly open (with an exports to GDP ratio of at least 30 percent) and are making a strong fiscal effort (with a government revenue to GDP ratio of 15 percent), an alternative debt sustainability target of 250 percent was set for the ratio of the debt to government revenue, thereby opening up a fiscal window.

22. The DSF paper argues that the denominators used for measuring debt ratios should be those that are relevant for each country with GDP capturing overall resource constraints, exports capturing foreign exchange availability and government revenue the government's ability to raise fiscal revenues. The paper further states that external debt should be compared to GDP and exports while public debt should be compared to GDP and government revenues. Similarly, external debt service should be compared to exports and public debt service to government revenues.
23. The proposed DSF chose five - three stock and two flow - indicators for consideration from among the debt indicators that were discussed above and in Annex 1. These were the PV of public and publicly guaranteed external debt to GDP, exports, and government revenue, and debt service on the same debt to exports, and government revenue. The ratios based on government revenue were eliminated for the reasons set out in paragraph 18 and thresholds were set for the remaining three.

Debt Sustainability Framework

24. Unlike in the HIPC Initiative where a single indicator – debt to exports - was used the DSF paper selects three debt ratios to judge debt sustainability. Further, country policies and institutional capability and vulnerability to shocks are other factors identified as being important for assessing a country's debt sustainability. In particular, country policies and institutional capability are used to grade countries and determine different debt ratio thresholds for them.⁶
25. As stated, under the proposal, debt sustainability will become a key factor for allocating grants under IDA 14. The international community has also made it a central concern in other multilateral development banks where replenishment negotiations are under way. Following Board approval of the broad principles of the framework paper, the IDA paper⁷ developed the framework into a practical system for allocating grants under IDA 14 based on those aspects of the framework on which there has been international agreement and on which adequate research work has been done. It is

⁶ These multiple factors were identified in the paper "When is External Debt Sustainable?" by Aart Kray and Vikram Nehru, Policy Research Working Paper 3200, The World Bank, February 2004.

⁷ Ibid footnote 3.

necessary to reiterate that the principal objective of the framework is to assist low-income countries maintain sustainable debt levels and reduce the risk to IDA of debt problems in the countries in which IDA will provide a significant share of financing under IDA 14 and later.

26. The proposed grant allocation system in IDA 14 will be based on two pillars. The first is the debt distress thresholds of the selected indicators for the groups of countries that are classified as strong, medium and poor performers based on the CPIAs⁸. The second is projected levels of the selected debt indicators that take account of the impact of exogenous shocks to the extent these can be forecast in the country DSAs. The results of these will then be used to allocate a share which is 0, 50 or 100 percent of the allocation that will be made under IDA 14 as grants. It should be noted that the CPIA has an influence in determining the overall level of IDA funds to a country as well as the debt thresholds that will be applicable to it.

Debt Distress

27. Debt distress is typically associated with (a) the accumulation of arrears on external debt service payments exceeding five percent of the external debt outstanding; (b) an application to the Paris Club for debt restructuring of official debt when a breakdown in the payments system is judged to be imminent; and (c) the country concerned has entered into a Standby or Extended Fund Facility Agreement with the IMF which is *sine qua non* for the Paris Club to proceed with discussions on debt restructuring.
28. While these are the external manifestations of a debt crisis, as stated earlier, there are three main causes of debt distress. The first is a high level of debt judged by the absolute amount or PV of debt outstanding as a ratio with GDP, exports or government revenue. The second is a weak institutional and policy environment in the country which makes it probable for such countries to experience debt distress at lower debt ratios than those with a strong environment. This is because of the greater probability of “misuse and mismanagement of funds” and the limited capability to use resources in a productive manner. The third is external shocks to the economic system that affect the country’s capacity to service its debt without compromising its long-term development goals.
29. In the paper written by Kray and Nehru⁹ the level of probability of experiencing debt distress that borrowers seem willing to tolerate was identified as 25 percent based on the experience of countries in their sample. Thereafter debt thresholds dependent on the country’s policies and institutions

⁸ CPIAs are discussed in greater detail later in the paper.

⁹ Ibid footnote 6.

measured by the CPIA¹⁰ were derived. A distress probability of 25 percent¹¹ means that there is a 75 percent chance that none of the chosen indicators of debt distress would exceed the thresholds in the next five years. On the other hand, there is a 25 percent chance that at least one of the indicators of debt distress will exceed the threshold in the next year and will continue to do so for at least three years. The table below sets out the debt thresholds for the chosen indicators of countries with poor, medium and strong institutional capabilities and quality of policies with the cut offs at the 25th, 50th and 75th percentiles of the CPIA index ranked in ascending order. The CPIA for each country as described below will be the average ranking of all the indicators in the index marked from a low of 1 to a high of 6. Accordingly, the CPIA for the 25th percentile was estimated to be 2.9 and 3.6 for the 75th percentile. Thus poor performers from the point of view of institutional strength and quality of policies are those with a CPIA of less than 2.9, those judged to be medium performers have their CPIAs in the range of 2.9 to 3.6 percent while those of strong performers exceed 3.6.

Table 1
Thresholds for Debt Indicators based on Institutional Strength and Quality of Policies¹²

Debt Indicator	Strong	Medium	Poor
NPV of debt/GDP	60	45	30
NPV of debt/Exports	300	200	100
NPV of debt/Government Revenue	250	200	150
Debt service/Exports	35	25	15
Debt Service/Government Revenue	40	30	20

30. It is shown in the framework paper that the policy based ranking of countries does not translate into a ranking of countries based on debt distress as the correlation is not one to one. Consequently the following actions are taken to generate a ranking system that can be used for grant allocations. The **first** step is the selection of debt indicators that can be used to measure debt distress. The elimination of the indicators dependent on government revenue by the managements of the World Bank and IMF for reasons mentioned above leaves a combination of two stock and one flow indicator to judge debt distress. Unfortunately the decision to exclude revenue based indicators does not capture the acute debt distress of governments that are dependent on the

¹⁰ A higher probability permits a higher threshold for debt though at the risk of future debt distress. Thus the probability of debt distress and the debt thresholds for the chosen indicators are policy decisions that need to be made.

¹¹ Footnote 19 in “Debt Sustainability in Low Income Countries” by Mark Allen and Gobind Nankani, World Bank and IMF, February 2004.

¹² Ibid footnote 2.

domestic market for a significant component of their financing needs which is a major shortcoming in the DSF. We return to this issue in the concluding section.

31. The analysis in the framework paper argues that the debt stock to exports ratio which is judged to be “the most suited indicator of repayment capacity and thus of a country’s long-term solvency” shows that a fewer countries exceeded the policy dependent threshold across the board while the stock to GDP ratio included a larger group of countries¹³. Accordingly, the average of the two stock indicators is considered more suitable rather than the two taken separately. Further, short-term liquidity considerations are best captured using the debt service ratio. Consequently, the composite debt stock indicator and the debt service ratio are the two indicators used in the DSF to assess debt distress of the low income countries.

32. The **second** step is to assess how the indicators fare in relation to the selected thresholds for the three groups of countries. This is done by determining the percentage above or below the threshold each country’s indicators are, a negative number indicating that it is above the threshold and vice versa. **Third**, the average percentage for the composite stock indicator and that of the debt service ratio is used to measure the level of debt distress. When both are above the threshold, the higher percentage deviation determines the level of debt distress while when both are below the lower percentage deviation determines the level of debt distress. On the other hand, if one is above and the other below the threshold, the one above determines the level of debt distress. The **final** step in the process that would assist IDA in making grant allocations is to classify the countries into three groups. Two bands, 10 percent above and below the thresholds, are selected for this classification. If the operational ratio, i.e. the composite stock indicator or the debt service ratio, is 10 percent or more below the threshold, then it is proposed that IDA provides its assistance as credits. If it is 10 percent or more above the threshold, it is proposed that IDA assistance should only be provided as grants. In cases where the ratio is between the two bands, caution should be exercised in new borrowing. This system has been referred to as the “traffic light system”¹⁴ in the Framework paper. The 20 percent band width is considered adequate to prevent changes in classification brought about by small changes in the countries’ debt ratios and consequently of grant requirements. The band width is a judgement between a smaller or larger call on grant funds from IDA.

33. The proposal described above does not fully address the second pillar of the Framework in that it is based on debt ratios estimated on actual data rather projections for the IDA 14 period which would also take account of likely exogenous shocks to the extent they can be forecast. In other words the DSAs

¹³ Ibid footnote 3, Annex 1.

¹⁴ Ibid footnote 3.

that generate debt ratios should provide for its dynamic nature. Exogenous shocks to the economic system are largely unanticipated and have a negative impact on several macroeconomic variables. These are natural disasters such floods and droughts, political instability or civil strife, declines in prices of a country's major exports and a sharp reduction in capital flows due to a withdrawal of donor support or private flows due to a loss of confidence in the economy.

34. As stated in the Framework paper, low income countries are more prone to exogenous shocks than other developing countries, and the impact of shocks more prolonged as judged by the affected macroeconomic variables. These are principally GDP, exports, the real exchange rate, terms of trade and a loss of welfare. Further, where the exchange rate has depreciated the burden on the budget of servicing foreign currency debt would be correspondingly increased. Such shocks to the economic system require balance of payments support of the type that could be provided under the IMF's Compensatory Financing Facility (CFF) and the European Union's Stabex Facility for ACP countries intended to cope with instability of export earnings principally in the agricultural and mining sectors. These need to be provided promptly and disbursed quickly to respond to a liquidity problem. Where the impact of the shock is of a longer-term nature and the shock itself is persistent, assistance for export diversification, infrastructure and other long-term development activities should be provided on terms judged affordable on the basis of the DSF. Further, they should not be based on policy conditionality and provided at low cost which is probably why the CFF has not been accessed since 2000.

Performance Based Allocation System¹⁵

35. Every year, the World Bank rates the economic, social and political performance of each borrowing government by the extent of its compliance with its own definition of "good" policies and institutions. For this purpose, it uses the CPIA. It rates the policy and institutional performance of each government relative to 20 criteria (grouped in four clusters). The World Bank uses this rating of individual governments as a diagnostic tool to a) allocate loan and grant resources among borrowers, b) determine the policy direction of new operations, and c) influence debt threshold targets.
36. World Bank staff uses a formula to divide up the funds available for low-income countries that includes "need" (income per capita) and "performance." For the fiscal years 2003 to 2005, the Bank made resource allocations that were nearly five times higher for the governments in the top-performing quintile than for those in the poorest-performing quintile.

¹⁵ This section draws on the article by Nancy Alexander of the Citizen's Network on Essential Services entitled "Judge and Jury: The World Bank's Scorecard for Borrowing Governments".

37. The CPIA rates countries primarily on the basis of current performance in relation to twenty, equally-weighted criteria^{16,17} that are grouped into four clusters, namely:
- *Economic management*, including management of inflation and the current account; fiscal policy; management of external debt; and management and sustainability of the development program;
 - *Structural policies*, including trade policy and foreign exchange regime; financial stability and depth; banking sector efficiency and resource mobilization; competitive environment for the private sector; factor and product markets; and policies and institutions for environmental sustainability;
 - *Policies for social inclusion*, including gender equity and equality of economic opportunity, equity of public resource use, building human resources, safety nets; and poverty monitoring and analysis; and
 - *Public sector management and institutions*, including property rights and rule-based governance; quality of budgetary and financial management; efficiency of revenue mobilization; efficiency of public expenditures; and transparency, accountability, and corruption in the public sector.
38. Country performance is judged on the rating assigned to the criteria in the policy clusters, governance and portfolio performance. According to the Bank, the purpose of the CPIA is to measure a country's policy and institutional development framework for poverty reduction, sustainable growth and effective use of development assistance. The CPIA rates the extent to which a government has adopted market friendly economic policies such as liberalization and privatization in the context of strict budget discipline and developed institutions, particularly those that protect property rights and promote a business-friendly environment.
39. What constitutes good policies and institutions is subjective and their impact on growth not clear cut. Consequently, the use of CPIAs for allocating aid resources and favouring better performers is contentious. For example, a recent article by Easterly et al¹⁸ casts doubt on the proposition that aid promotes growth in countries with sound policies. It further suggests that research is required to determine whether aid can promote policy change and institutional reform and whether these in fact can promote economic growth.
40. As stated, the World Bank allocates funds for low-income countries taking into account both "need" and "performance." The CPIA is an important input in calculating a country's performance rating. In order to establish a

¹⁶ Please see Annex 2 for a full description of the criteria used and the CPIA for 2003.

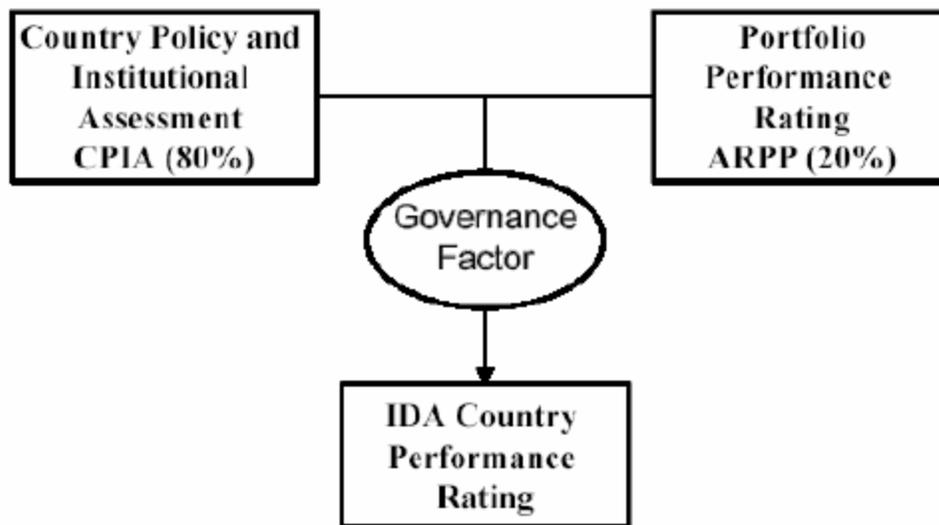
¹⁷ Based on the recommendations of the External Review Panel for the CPIA the World Bank is designing a new format that groups 15 criteria into four clusters. The revised format will be reviewed by the Board of the World Bank in September 2004.

¹⁸ "Aid, Policies and Growth: Comment" by William Easterly, Ross Levine and David Roodman, *American Economic Review* 94:3, June 2004.

government's overall performance ratings (i.e. the IDA Country Performance (ICP) Rating), the Bank aims to ensure that scores are consistent within each, and across all, regions in performing the following calculations:

- a. The CPIA (comprised of the four clusters listed in paragraph 37) accounts for 80 percent of a country's rating;
- b. The Bank rates each government's performance on the portfolio of outstanding loans. This rating accounts for 20 percent of a country's overall rating. It measures how well a government manages its loan funds, including how well it achieves timely disbursement through efficient procurement practices; and
- c. The level of grants and loans to which a borrowing government has access will increase or decrease as a result of the Bank's application of a "governance factor" to the government's CPIA and portfolio performance ratings.¹⁹ Each country's "governance factor" is derived from selected ratings, including the quality of its overall development program and public sector management and institutions.

Chart



41. During the Mid-Term Review of IDA 13, it was recognized that the governance factor had become the most important factor in the allocation of

¹⁹ The methodology involves finding a weighted average of the CPIA score (which counts for 80 percent of the rating) and the portfolio performance score (which counts for 20 percent) and multiplying the result by the "governance factor" to produce the country's IDA Performance Rating.

IDA funds.²⁰ The governance factor is based on seven criteria. Six of them are criteria in the CPIA, i.e. management and sustainability of the development program in the economic management cluster and the five criteria in the public sector management and institutions cluster. Portfolio performance is the seventh criterion. The governance factor is estimated by dividing the average rating of the seven criteria on a scale of 1 to 6 by 3.5 which is the average of this range and applying an exponent of 1.5 to this ratio. The basis of this exponent is not known and appears to be intended merely to increase the importance of the governance factor. This methodology results in a weight of 67 percent for governance in the ICP rating compared to 33 percent for the economic management, structural policy, social policy and portfolio performance combined. The corresponding governance weight in the CPIA is 24 percent.

42. Consequently the governance factor has a heavy weight and changes in the ratings of the governance criteria result in significant changes in the allocation of IDA funds. This led to questions being raised during the Review whether there should be a recalibration of the role of governance in the PBA System while keeping the central policy focus of governance. One proposal made was to remove the exponent of 1.5 currently applied to the governance factor. The application of a linear governance factor reduces the effective weight of governance in the ICP rating from 67 to 60 percent while increasing the average per capita allocation of IDA funds to countries in the bottom quintile by about one-third. When examining the possibility of changing the weight of governance in the ICP rating, it is necessary to balance the need to maintain the link between performance and allocation, avoid year to year volatility in the country allocations resulting from changes in the governance ratings and increasing the transparency of the role of governance in the PBA system.
43. Per capita income is used as measure of poverty for the allocation of IDA funds. It is a measure that is available in most countries annually, less subject to serious errors and simple and transparent. At present, IDA is focused on the poorest countries and among them, those that are better governed. The management of the Bank took the view that increasing the weight of poverty in the formula for allocating IDA funds would reduce the effectiveness of the use of scarce IDA resources.

Allocation of Grants

44. The starting point for the allocation of grants is the system in place for allocating IDA funds based on the PBA system that was described in the previous section. This ensures the link with policy performance that has increasingly been the basis on which IDA funds have been allocated in

²⁰ IDA's Performance Based Allocation System: Update on Outstanding Issues, IDA, February 2004.

successive replenishments. Thereafter, the country groupings based on debt distress are used to allocate grant funds within the IDA country allocations that have been determined.

45. Countries that are judged to be high risk, based on the DSAs using current and projected debt levels that take account of exogenous shocks to the extent possible, will receive the entire IDA allocation as grant funds. The use of current indicators if only these are available assumes that the debt indicators remain static during the replenishment period. In the event that the country concerned is already a blend country, maintaining the principle that prevailed during IDA 13 that grant funds will be available for IDA only countries, a grant allocation will not be possible. Instead, the combination of IBRD loan and IDA credit terms offered to the country will be converted entirely to IDA credit terms²¹. Countries that are judged to be of medium debt risk will receive 50 percent of the IDA allocation as grants and the balance as credits. As in the case of high risk countries, if the country concerned is a blend country, the loan component will be offered on credit terms. Countries that are judged to be low risk will receive the entire IDA allocation as credits.
46. This allocation system is simple to operate but has some shortcomings. Equity considerations raise questions of why countries with similar institutional and policy performance as judged by the CPIA and similar per capita income levels receive IDA allocations on different terms based on the debt indicators. A moral hazard argument could also be advanced that those who mismanaged past borrowings are being rewarded by better terms without even a reduction in the volume of IDA allocations thereby weakening the desired relationship between institutional capability and policy performance and the allocation of funds. In view of this, IDA management has proposed an upfront charge of 20 percent of the value of each grant, presumably to address these concerns. This partly meets some of the financing issues for grants that is yet under discussion and will be described in the next section. No reason is provided for fixing the upfront charge at 20 percent. Fixing the charge at the same percentage irrespective of performance again raises equity concerns that it is intended to address.

Financing of Grants

47. Grant financing during IDA 14 will compromise the future viability of IDA as credit reflows are financing an increasing share of the total commitment authority of IDA. A measure of the problem is illustrated²² by the fact that if 20 percent of the allocations from IDA 14 onwards are in the form of grants, without additional grant financing by donors it will reduce the commitment

²¹ Ibid footnote 3, page 10.

²² Ibid footnote 3, page 12.

authority by about 7 percent in 20 years and nearly 20 percent in 40 years²³. It is not clear why this should be a concern as a 7 percent reduction appears marginal in a time period that is beyond that set for the achievement of the MDGs. It is more important to increase grant funding as quickly as possible to countries, particularly those in sub-Saharan Africa, to achieve the MDGs by 2015. If these funds are provided on credit terms instead of grants there is the prospect of an excessive build up of debt.

48. The World Bank proposes a combination of mechanisms such as replacing foregone reflows of credit principal through additional donor financing, reducing the concessionality of IDA credits, and imposing upfront charges on grant recipients. Additional grant financing by donors is made up of two parts. The first is the upfront payment by donors of the foregone service and commitment charges that reflect the cost of doing business to IDA. The second is the undertaking by donors to replace foregone principal reflows over the repayment period of up to 40 years. IDA and its borrowers may face resource availability problems in the future due to a system of multiple additions by donors over a long time period, which may not be forthcoming.
49. The levying of upfront charges on grants at an adequate level is a more certain way of partly meeting the financing needs brought about by reduced reflows. Levying no charge is contrary to the IDA practice of recovering administrative expenses from beneficiaries. It is estimated that an upfront charge of 20 percent could finance around half the foregone reflows due to grants.
50. Apart from the upfront charges the World Bank argues that it should be possible to harden the lending terms to credit recipients. The terms of IDA lending, which had a maturity of 50 years including a grace period of 10 years, changed in 1987. Since then, the repayment period for IDA only countries has been shortened to 40 years and 35 years for blend countries. In each case there was a grace period of 10 years. During IDA 13, the terms were hardened to a maturity of 20 years for the blend countries when the per capita income had exceeded the cut off for more than two consecutive years. The World Bank maintains it should also be possible to further reduce the maturity period of IDA credits to 30 or 25 years for blend countries without a significant decline in the grant element. This would not be possible for IDA only countries that have been judged to be in medium-level or high-level debt distress. The Bank also concludes that there may be a small group of 10 better off countries, mostly in Asia, for whom a reduction of the maturity period by 5 years could be considered. This approach of hardening IDA terms in order to enable countries in debt distress to receive grants is questionable for reasons both of equity and creating excessive debt build up in the countries whose terms are hardened.

²³ If grants are 50 percent of the IDA allocations, it is estimated that the commitment authority would decline by 17 percent after 20 years and 47 percent after 40 years.

51. Given the uncertainty of the financing arrangements for the allocation of grants that is proposed for IDA 14, the best that can be hoped for if upfront donor contributions (for foregone service charges and commitment fees) materialize and upfront charges for grants are levied (to replace foregone principal reflows) it would reduce the need to harden the credit terms for both IDA only and blend countries. The management of IDA financing arrangements will undoubtedly become more difficult with each succeeding replenishment if the share of grants increases.

Concerns and Issues

Debt Sustainability Framework

52. There are several concerns relating to the DSFs that need to be kept in mind and taken account of in determining a country's strategy for mobilizing external resources. Many of them are recognized and described in the Framework Paper and mentioned again in this paper to complete the description of the DSF.
53. There could be situations when the selected debt indicators are above the threshold values. It is likely that in such situations there would be World Bank and/or IMF supported stabilization programs. They would normally call for reduced levels of borrowing on unaffordable terms, and for more concessional borrowing and grant financing. The reduction of the debt ratios to threshold levels is likely to be gradual as new borrowing on non-concessional terms may have to be made if concessional funds including grants are not available in the required amounts.
54. A different set of considerations may prevail if only a single debt indicator is above the threshold value in which case it is necessary to examine whether this is due to a debt or other problem. A debt service problem identified by comparing with GDP, exports or government revenue may all be affected by statistical issues. Repayment capacity judged by exports may need to take account of high or fluctuating levels of workers' remittances. Similarly government revenue may be affected by poor tax administration requiring action on widening the tax base and more effective revenue collection. Thus borrowing decisions based on a single indicator should take account of the non-debt factors that could affect the level of the indicator before action is taken on new borrowings.
55. It is also necessary to identify stock and flow problems in formulating an appropriate borrowing strategy. A high current debt service ratio combined with a low level of debt stock needs to be handled as a liquidity problem and corrective action taken in the short-term. On the other hand, a low current level of debt service combined with a high level of debt stock could lead to

debt service problems in the future providing an opportunity for corrective action to be taken in a timely manner. If a country has both a stock and flow problem a combination of measures to ease the liquidity constraints and alleviate the longer-term debt stock problem need to be implemented calling for higher volumes of concessional lending and grants.

56. Given the importance of DSAs for each low income country in the application of the DSF and borrowing from the IMF, it is necessary that these be conducted in a collaborative and transparent manner by the two institutions. They should work closely with the country authorities and major creditors to ensure that prospective lending levels and their terms are taken account of in the DSAs. While the DSAs and risk assessments are to be done in a collaborative manner, it is understood that each institution will make its own assessment and report separately to its respective board.²⁴ It is recognized that there may be differences between the Bank and Fund in these assessments and possible scenarios. It is not known how these will be played out in the countries where they occur.
57. Vulnerability should also be assessed by estimating non-debt indicators. Countries that have not liberalized their capital accounts - which is probably the case for most low income countries - should estimate the ratios of their international reserves to imports of goods and services and monitor the reserve level when this ratio declines below the recommended minimum of 3-4 months. Low income countries that have liberalized their capital accounts should monitor the level of short-term debt to international reserves. Indicators of fiscal vulnerability should also be estimated for all low income countries.

*The PBA System*²⁵

58. There are many concerns expressed about the Bank's allocation system for IDA resources. A summary of the issues in the ongoing debate are the following:
- Many are critical of a system, such as the CPIA, that approximates a "one-size-fits-all" set of "good" policies and "good" institutions. For instance, there is little agreement about what constitutes "good" trade policy. Even where there is agreement on general policy principles, there are still disagreements about the pace, sequence and implementation of these policies and their impact such as short-term distributional effects;
 - The Bank's methodology for evaluating a country's governance - e.g., its accountability to its citizens - is unreliable. Yet, the CPIA assigns a greater weight to the governance factor than to any other set of indicators. Those

²⁴ Debt Sustainability in Low Income Countries: Further Consideration on an Operational Framework and Policy Implications, IDA/SecM 2004-0629, IDA, September 10 2004.

²⁵ Ibid footnote 16.

responsible for formulating the governance indicator concede that it has a high margin of error;

- When scores relating to certain criteria (e.g., governance, gender, government accountability) constrain or shape fundamental decisions relating to resource allocation and the role of the government, the process may be in conflict with the Articles of Agreement of the World Bank Group that prohibit interference in a country's domestic political affairs;
- The rating system may further exacerbate unequal treatment of countries by inducing governments with less power and resources to comply with CPIA-derived policies while the more developed and more powerful countries are treated differently;
- The Bank is not the best institution to rate performance in areas where it has less experience and little applied knowledge (e.g., institutional development, gender equality, and labor-intensive growth). The United Nations has a stronger mandate to work in the political arena and assess governance than does the World Bank;
- In today's world, many domestic policy decisions are strongly influenced by external factors (e.g., exogenous shocks, such as drops in commodity prices; natural disasters; changing donor and other financial flows; and the CPIA process itself). Hence, the CPIA rating can affect governments for factors that are beyond their control; and
- There is little debate about the effectiveness of a rating system that encompasses such a broad range of political, social and economic performance criteria. Nor is there much debate about the implications of the system for the policy autonomy of borrowers - particularly low-income borrowers. Instead of addressing such fundamental issues, donors and creditors are competing over who has the best rating system.

Other Issues

59. Other issues also need discussion and clarification. There are 13 HIPC countries that have reached the Completion Point, Ethiopia, Niger and Senegal being the latest to achieve this. It is not clear whether these countries will receive IDA 14 funds based on the DSF or whether there will be a transition period during which they will be treated differently. Another 14 countries that have reached the Decision Point and are at various stages of the cycle should receive debt relief under the Initiative since it has been extended to the end of 2006. Those that reach the Completion Point before the end of 2006 should be treated in the same way as other countries that have already reached the Completion Point. Different arrangements are necessary for the countries that will not reach the Completion Point by the end of 2006. Another 11 countries in the list of 38 countries that were judged to be potentially qualified under the Enhanced HIPC Initiative have not been able to reach the Decision Point. Some have uneven policy records and debts too large to write off given current funding available for the Initiative such as Liberia and Sudan that are both affected by civil strife. The calculations for HIPCs at the Completion

Point have to be made using the HIPC methodology. Since this is essentially backward looking, it may give different results from the forward looking methodology proposed in the DSF. It is therefore recognized that transition arrangements will be necessary for HIPCs during the interim period²⁶.

60. There needs to be effective donor coordination in the implementation of the DSF. It is estimated that a greater donor effort of the order of \$50 billion annually²⁷ or a doubling of current official development assistance levels is needed to meet the Millennium Development Goals (MDGs). It is not clear how such assistance will be coordinated to achieve the objectives of the DSF. Other multilateral and bilateral agencies that have not converted their assistance to grants need to ensure that their assistance programs dovetail into those of the IDA so that the objectives of debt sustainability are not compromised while trying to reach the MDGs. This should be pursued both at the international level and or each Consultative Group.
61. No mention is made in the DSF of IMF lending to low income countries which correspond to the IDA eligible countries. These countries can access the Poverty Reduction and Growth Facility up to 140 percent of their quotas under three year agreements. The loans carry an interest rate of 0.5 percent and are repayable in 10 years after disbursement including a grace period of 5½ years. The funds required for lending under this Facility are borrowed by the IMF from central banks, governments and financial institutions at market rates of interest. The interest subsidy is financed by donor contributions and the IMF's own resources. There is no facility in the IMF that corresponds to the proposed grant facility under IDA 14 and would have to be made up of donor contributions as in the case of the HIPC Trust Fund.

Conclusions and Recommendations

62. The framework summarized in the paper²⁸ starts with a grouping of all low income countries in accordance with the performance of institutions and effectiveness of policies followed by choices of the most appropriate thresholds for the selected debt burden indicators. It is understood that DSAs will become dynamic in nature capturing information as they become available during each replenishment period rather than holding them static for each period. The preparation of forward-looking DSAs will be a development that will take place during IDA 14. The next step is to use this classification system as a basis for decisions on grant allocations within the IDA entitlements based on the PBA system. In the interests of equity and

²⁶ Ibid footnote 25.

²⁷ Global Development Finance 2004, Analysis and Summary Tables, Volume 1, World Bank, 2004.

²⁸ Ibid footnote 3.

financing the grant allocations, management has proposed levying an upfront charge of 20 percent for each grant allocated.

63. The significant change during IDA 14 under the proposal will be that the grant allocation is determined from the debt distress classification and country performance, unlike in IDA 13 when the maximum grant percentage was set ex ante. This increases the operational difficulties for IDA financing due to foregone credit reflows assuming higher levels of grants. The projected requirements for IDA 14 during FY 06-08 are estimated to be \$23.1 billion, compared to \$17.8 billion and \$15.0 billion during IDA 13 and IDA 12 respectively.²⁹ The additional funding needed for IDA 14 is as important as the proposal for grant funding based on the DSF.
64. The following conclusions and recommendations seek to enhance the prospects that, if approved, the DSF would provide a solid basis for the international community, in general, and IDA, in particular, to allocate credits and grants to low-income countries in ways that foster debt sustainability and achievement of the MDGs. Recommendations also seek to address the need for borrowers to claim sufficient “policy space” and flexibility to foster country ownership of development strategies, including the achievement of the MDGs.

CPIA

65. The DSF Proposal is a welcome innovation to the extent that it attempts to tailor assistance to country-specific circumstances, though the CPIA is a limiting factor in this effort. It is essential that the international community gives developing countries adequate space to formulate homegrown policies in a participatory way. In the absence of such moves, the lack of ownership will plague and undercut country performance. No matter what a country's own development strategy (or Poverty Reduction Strategy Paper) says a country will likely feel greater pressure to adhere to CPIA-derived policy prescriptions if it expects to retain external support. Governments are in a double bind if citizens and elected officials choose a path other than that specified by CPIA-derived priorities. Because of instruments like the CPIA, country “ownership” of the development process is compromised.³⁰
66. The CPIA mechanism is one indicator of the increasingly ideological approach to policy-making. Rodrik concludes that, “The broader the sway of market discipline, the narrower will be the space for democratic governance... International economic rules must incorporate “opt-out” or exit clauses [that] allow democracies to reassert their priorities when these priorities clash with

²⁹ Financing Requirements from IDA for Poor Countries during IDA 14, IDA, June 2004.

³⁰ The exceptions would be countries that are large or do not depend heavily on external financing, and can take an independent stand. Such countries, like China, often borrow significant sums from the IFIs but lack crippling debt burdens.

obligations to international economic institutions. These must be viewed not as 'derogations' or violations of the rules, but as a generic part of sustainable international economic arrangements."³¹ Occasionally, such exits from obligations are possible for large borrowers from the IMF and World Bank, but the same is not possible for the smaller low-income countries.

67. Since CPIAs are central to the PBA system there is a need to discuss the process by which these assessments are made. There does not appear to be a full awareness of the CPIA process at the country level which suggests that the process is not uniformly transparent across member countries. It is also not clear whether CPIAs are to be made once for every IDA Replenishment or whether it is a continuous process with an annual update. Whatever the periodicity, the Bank should set out the basis on which these assessments are to be conducted, in particular the ratings and the inputs expected from and the involvement of national staff in the process. There should be opportunities for the Bank to present their findings both to the country concerned and donor community. One could be at meetings of Consultative Groups when these are held either in the country's capital or elsewhere. This would enable the entire donor community to be involved in the discussions as it should because the allocation of grant funds based on debt distress is a concern to all donors particularly if IDA is not the major donor.

Debt Thresholds and Indicators

68. Low income countries that exceed the debt thresholds will find that their capacity to borrow will decline. There are 34 countries that will be grant-dependent during IDA 14. Since more countries will find themselves increasingly reliant on external grant financing, the international financial institutions (IFIs) project that the demand for grants could outstrip the supply. This shortfall could cripple efforts to meet the MDGs in many countries.
69. The DSF enables low income countries to determine their grant eligibility within the allocations made under IDA 14 and beyond. What it does not do is to provide a mechanism to ensure that other donors, both bilateral and multilateral, will do likewise in their lending so that low income countries could achieve debt sustainability. This is particularly important when IDA accounts for a small share of a country's external borrowing. It also begs the question about action that should be taken if current levels of debt stock exceed the thresholds established in the DSF by significant amounts. Effective donor coordination will be necessary to achieve debt sustainability over any time horizon and the international community needs to address this issue at the time the DSF is approved.

³¹ Rodrik, Dani, "Four Simple Principles for Democratic Governance of Globalization". Harvard University, May 2001.

70. The DSAs that are currently conducted compare the indicators to thresholds that are based on public and publicly guaranteed external debt. It is necessary to recognize that indicators based on total external debt that includes private non-guaranteed (PNG) external debt and those on total public debt that includes domestic borrowing of the public sector could deviate significantly from these levels. In situations where PNG external debt is significant – these are not many for low income countries - there could be issues of implicit contingent liabilities arising for the public sector requiring policy action that has an impact on the debt service capacity of the public sector. High levels of domestic debt that are more prevalent than high levels of PNG external debt are more difficult to handle in DSAs because there are no agreed thresholds based on empirical analysis. Nevertheless, the DSAs should include total public debt as servicing domestic public debt is a drain on resources that is similar to external public debt. Some countries have accumulated domestic debt to sterilize large external aid inflows. Whatever the reason, the impact on the budget needs to be assessed as the debt service cost of domestic borrowing is currently higher than that of external borrowing even after providing for exchange rate risks. There are countries that are judged to have a low debt risk when only public and publicly guaranteed external debt is included in DSAs while the consideration of total public debt show a serious state of indebtedness.
71. It is recommended that research be conducted on use of total public debt for DSAs and consequently of government revenue in determining debt indicators and their threshold values. Similarly, it is also recommended that studies be conducted on determining indicators and threshold values that use total external debt in the estimates of total debt stock.

Annex 1

Debt Indicators

Liquidity Monitoring Ratios

- a) The Debt Service Ratio is the proportion of exports of goods and non factor services that is absorbed for debt service payments, i.e., interest, principal and other payments. The basic ratio refers only to long and medium-term debt which covers all loans with an original maturity of one year and above.
- b) The Interest Service Ratio is the ratio of interest payments to exports of goods and non-factor services.
- c) The Short-Term Debt ratio measures the proportion of exports of goods and non factor services that will be absorbed if all debt outstanding with an original maturity of one year at the end of the preceding year is paid without roll over.
- d) Total Debt Service Ratio is the proportion of exports of goods and non-factor services that are absorbed for debt service payments on both long and short-term debt.

Debt Burden Ratios

- a) The total debt outstanding to GDP or GNI ratio compares the amount of disbursed debt outstanding to the size of the economy.
- b) The total debt outstanding to exports of goods and non-factor services ratio measures the ability of the country to repay its debt in a single year from its earnings from goods and non-factor services.
- c) Public debt outstanding to GDP or GNI ratio compares the total of domestic and external outstanding to the size of the economy.

Present Value Indicators

- a) The Present Value of Debt Service to GDP or GNI ratio compares the current cost of future debt service obligations to the overall level of economic activity in the country. Only the current year's PV is compared to the average GDP/GNI of the current and two preceding years.
- b) The Present Value of Debt Service to exports of goods and services compares the current cost of future debt service obligations to the capacity of the country to generate foreign exchange receipts. Only the current year's PV is compared to the average exports of goods and services of the current and

two preceding years. Only the current year's PV is used in both present value indicators to take account of the latest debt situation in the country.

Debt Structure Indicators

- a) The Roll Over Ratio compares principal repayments to disbursements. It could be estimated separately for short-term and long-term debt.
- b) The ratio of short-term debt to total debt outstanding measures the vulnerability of a country's debt situation brought about by its debt structure.

Dynamic Indicators

- a) The ratio of the average rate of interest of the loan portfolio to the growth rate of exports determines whether debt service is growing faster than exports.
- b) The ratio of the average rate of interest of the loan portfolio to the growth rate of GDP determines whether debt service is growing faster than the economy.

Fiscal Indicators

- a) The ratio of government debt (domestic and foreign) service payments to government revenue.
- b) The ratio of government debt (domestic and foreign) outstanding to government revenue.
- c) The ratio of the present value of government debt service to government revenue.
- d) The ratio of the average rate of interest on government loans to the rate of growth in government revenue.

Annex 2 Country Performance Ratings for 2003³²

For each policy cluster in the CPIA, the Bank applies numerical performance ratings from 1 (low) to 6 (high) and these are converted to five “letter” grades. The reason for presenting the data this way is that the Bank places each government in one of five quintiles, based upon the quality of its performance in each area. Quintiles display the performance of governments relative to one another, whereas the real, undisclosed data present nominal scores. The following tables present the World Bank’s aggregated performance ratings of low-income borrowing governments relative to one another. While the letter grades and the quintiles from which they are derived are not exact representations of the numeric scores, they are still highly indicative. The following tables present the World Bank’s aggregated performance ratings of low-income borrowing countries relative to one another.

As stated, to produce each country’s overall performance rating, the Bank applies a heavily-weighted “governance factor” to the weighted average of the CPIA score (which counts for 80 percent of the overall rating) plus the government’s portfolio performance score (which counts for 20 percent). In other words, in order to obtain the IDA country rating, the Bank applies the (absolute) rating of the “governance factor” in column “A” to the averaged (absolute) ratings in columns “B” and “C.”³³

Rating criteria³⁴

The Bank rates each low-income country government on twenty criteria using a numerical scale (from 1 to 6). The 2002 version of these criteria is summarized as follows. Few changes have been made in the 2003 version.

Economic management

- **Management of inflation and current account.** Countries with the highest rating (6) have not needed a stabilization program for 3 years or more. Countries with the lowest rating (1) have needed, but have not had, an acceptable program for 3 years or more.

³² Ibid footnote 16.

³³ Some countries have not been rated and do not appear in any of the tables below, e.g., Afghanistan, Liberia, Myanmar, Somalia, Timor-Leste. An entry of “N/R” indicates that the country was not rated in that category.

³⁴ Recent changes in the allocation system can be reviewed at: www.worldbank.org/ida

- **Fiscal Policy.** Countries with high ratings have fiscal policies consistent with overall macroeconomic conditions and generate a fiscal balance that can be financed sustainably for the foreseeable future, including by aid flows where applicable.
- **Management of external debt.** Ratings take into account the existence and amount of any arrears; whether and how long the country has been current on debt service; the maturity structure of the debt; likelihood of rescheduling, and future debt service obligations in relation to export prospects and reserves.
- **Management and sustainability of the development program.** Degree to which the management of the economy and the development program reflect: technical competence; sustained political commitment and public support and participatory processes through which the public can influence decisions.

Structural policies

- **Trade policy and foreign exchange regime.** How well the policy framework fosters trade and capital movements. Countries with a high grade have low (10% or less) average tariffs (weighted by global trade flows) with low dispersion and insignificant or no quantitative restrictions or export taxes. There are no trading monopolies. Indirect taxes (e.g. sales, excise or surcharges) do not discriminate against imports. The customs administration is efficient and rule-bound. There are few, if any, foreign exchange restrictions on long-term investment capital inflows.
- **Financial stability and depth.** This item assesses whether the structure of the financial sector, and the policies and regulations that affect it, support diversified financial services and present a minimal risk of systemic failure. Countries with a low rating have high barriers to entry and banks' total capital to assets ratio less than 8%. Countries with high scores have diversified and competitive financial sectors that include insurance, equity and debt finance and non-bank savings institutions. An independent agency or agencies effectively regulate banks and non-banks on the basis of prudential norms. Corporate governance laws ensure the protection of minority shareholders.
- **Banking sector efficiency and resource mobilization.** This item assesses the extent to which the policies and regulations affecting financial institutions help to mobilize savings and provide for efficient financial intermediation. Countries with high scores have real, market-determined interest rates on loans. Real interest rates on deposits are significantly positive. The spread between deposit and lending rates is reasonable. There is an insignificant share of directed credit in relation to total credit. Credit flows to the private sector exceed credit flows to the government.
- **Competitive environment for the private sector.** This item assesses whether the state inhibits a competitive private sector, either through

direct regulation or by reserving significant economic activities for state-controlled entities. It does not assess the degree of state ownership per se, but rather the degree to which it may restrict market competition. Ideally, firms have equal access to entry and exit in all products and sectors.

- **Factor and product markets.** This item addresses the policies that affect the efficiency of markets for land, labor and goods. Countries with high scores limit any controls or subsidies on prices, wages, land or labor. Remaining controls are consistently applied and explicitly justified on welfare or efficiency grounds.
- **Policies and institutions for environmental sustainability.** This item assesses the extent to which economic and environmental policies foster the protection and sustainable use of natural resources (soil, water, forests, etc.), the control of pollution, and the capture and investment of resource rents.

Policies for social inclusion and equity

- **Gender.** This item assesses the extent to which the country has created laws, policies, practices, and institutions that promote the equal access of males and females to social, economic, and political resources and opportunities.
- **Equity of public resource use.** This item assesses the extent to which the overall development strategy and the pattern of public expenditures and revenues favor the poor.
- **Building human resources.** This item assesses the policies and institutions that affect access to and quality of education, training, literacy, health, AIDS prevention, nutrition and related aspects of a country's human resource development.
- **Social protection and labor.** Government policies reduce the risk of becoming poor and support the coping strategies of poor people. Safety nets are needed to protect the chronically poor and the vulnerable. The needs of both groups are important, but in countries where the chronically poor remain inadequately protected, an unsatisfactory score (2 or 3) is warranted.
- **Poverty monitoring and analysis.** This item assesses both the quality of poverty data and its use in formulating policies.

Public sector management and institutions

- **Property rights and rule-based governance.** Countries with high scores have a rule-based governance structure. Contracts are enforced. Laws and regulations affecting businesses and individuals are consistently applied and not subject to negotiation.
- **Quality of budgetary and financial management.** This item assesses the quality of processes used to shape the budget and account for public expenditures. It also addresses the extent to which the public, through the

legislature, participates in the budget and audit processes. Ratings should cover both national and sub national governments, appropriately weighted.

- **Efficiency of revenue mobilization.** This item evaluates the overall pattern of revenue mobilization, not only the tax structure as it exists on paper, but revenues from all sources, as they are actually collected. Countries with high scores generate the bulk of revenues from low-distortion taxes such as sales/VAT, property, etc. Top corporate and personal tax rates are in line with international levels. The base for major taxes is broad and free of arbitrary exemptions. Tax administration is effective, cost efficient and entirely rule based.
- **Efficiency of public expenditures.** This item assesses the extent to which the desired results of public programs are clearly defined and the available resources are used efficiently to achieve them. National and sub-national governments should be appropriately weighted. Countries with high scores specify the expected results of public programs. Performance is reported and influences budget allocations. Public servants' compensation is adequate (e.g. at least 75% of comparable private sector compensation) and their hiring and promotion are competence-based. Line agencies have flexibility to make operational decisions and are accountable for results and adhering to budget.
- **Transparency. Accountability and corruption in the public sector.** In countries with high scores, the reasons for decisions, and their results and costs, are clear and communicated to the general public. Accountability for decisions is ensured through audits, inspections, etc. Conflict of interest regulations for public servants are enforced. Authorities monitor the prevalence of corruption and implement sanctions in a transparent manner.

Europe/Central Asia	IDA Country Rating	A Governance	B Overall CPIA Rating	1 Economic Management	2 Structural Policies	3 Social Inclusion	4 Public Sector	C Portfolio Performance
Albania	C	C	C	C	B	C	D	B
Armenia	A	B	A	A	A	B	B	A
Azerbaijan	B	B	B	A	C	D	C	A
Bosnia & Herzegovina	B	B	B	B	B	C	C	B
Georgia	D	D	C	D	D	B	F	C
Kyrgyzstan	C	C	C	C	D	B	D	C
Moldova	C	C	C	D	C	C	D	C
Serbia & Montenegro	B	B	C	C	C	A	C	D
Tajikistan	D	D	D	D	F	D	F	B
Uzbekistan	F	F	F	F	F	C	F	C

Latin America and the Caribbean	IDA Country Rating	A Governance	B Overall CPIA Rating	1 Economic Management	2 Structural Policies	3 Social Inclusion	4 Public Sector	C Portfolio Performance
Bolivia	C	D	B	C	B	B	B	D
Dominica	B	B	C	F	A	B	B	C
Grenada	A	A	A	B	A	A	A	C
Guyana	B	C	C	C	C	D	C	A
Haiti	F	F	F	F	F	F	F	N/R
Honduras	B	B	A	C	A	A	B	D
Nicaragua	B	B	A	C	A	A	A	F
St. Lucia	A	A	A	A	A	A	A	B
St. Vincent & the Grenadines	A	A	A	A	A	A	A	F

South Asia/East Asia/the Pacific	IDA Country Rating	A Governance	B Overall CPIA Rating	1 Economic Management	2 Structural Policies	3 Social Inclusion	4 Public Sector	C Portfolio Performance
Bangladesh	C	D	B	A	B	B	D	F
Bhutan	A	A	A	A	C	A	A	A
Cambodia	F	F	D	C	F	D	F	F
India	A	A	A	A	B	B	A	C
Indonesia	C	D	B	B	B	B	C	D
Kiribati	D	C	D	B	F	F	C	N/R
Lao PDR	D	F	F	D	F	D	F	A
Maldives	C	C	A	B	A	B	A	F
Mongolia	C	C	C	C	C	C	C	C
Nepal	B	B	B	A	B	D	B	D
Pakistan	B	C	B	B	A	C	A	C
Papua New Guinea	F	F	F	F	D	F	F	N/R
Samoa	A	B	A	A	A	C	A	B
Sri Lanka	A	A	A	A	A	A	A	F
Solomon Islands	F	F	F	F	F	F	F	F
Tonga	F	F	D	D	F	C	D	C
Vanuatu	F	F	D	D	F	F	C	N/R
Vietnam	C	D	A	A	D	A	C	C

Middle East/North Africa	IDA Country Rating	A Governance	B Overall CPIA Rating	1 Economic Management	2 Structural Policies	3 Social Inclusion	4 Public Sector	C Portfolio Performance
Yemen	B	C	B	A	D	C	C	C

Africa	IDA Country Rating	A Governance	B Overall CPIA Rating	1 Economic Management	2 Structural Policies	3 Social Inclusion	4 Public Sector	C Portfolio Performance
Angola	F	F	F	F	F	F	F	C
Benin	A	A	B	B	A	F	B	A
Burkina Faso	B	B	B	A	C	B	A	D
Burundi	D	D	F	D	F	F	F	A
Cameroon	C	D	C	B	B	D	D	D
Cape Verde	A	A	A	B	A	A	A	A
Central African Republic	F	F	F	F	D	F	F	F
Chad	D	D	D	C	D	D	D	F
Comoros	F	F	F	F	F	F	F	D
Congo, Dem. Rep.	D	D	D	D	F	F	F	C
Congo, Rep.	D	D	D	D	D	F	D	C
Côte d'Ivoire	D	D	D	F	C	F	C	F
Djibouti	D	D	D	D	C	D	D	D
Eritrea	D	D	D	F	F	B	C	C
Ethiopia	C	B	C	C	F	C	B	C
Gambia	C	C	D	D	C	D	D	D
Ghana	A	A	B	C	B	B	A	D
Guinea	D	D	D	F	D	D	D	D
Guinea-Bissau	F	D	F	F	F	F	F	F
Kenya	C	C	C	C	C	C	B	F
Lesotho	C	C	C	B	C	D	B	F
Madagascar	A	A	B	B	B	B	B	A
Malawi	B	B	C	D	C	B	B	C
Mali	B	C	B	A	C	C	B	C
Mauritania	A	A	A	A	B	B	A	A
Mozambique	B	B	C	C	D	C	C	C
Niger	D	D	D	C	D	D	D	D
Nigeria	F	F	F	F	F	F	F	F
Rwanda	B	A	B	C	B	C	B	C
Sao Tome & Principe	D	C	F	F	F	F	D	B
Senegal	B	B	A	A	A	C	B	C
Sierra Leone	D	C	D	D	D	D	D	D
Sudan	F	F	F	F	F	F	F	N/R
Tanzania	A	A	A	A	B	A	A	C
Togo	F	F	F	F	D	F	F	F
Uganda	A	A	A	A	A	A	B	B
Zambia	C	C	C	D	B	C	B	C
Zimbabwe	F	F	F	F	F	F	F	F

Annex 3

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