Risks and Opportunities for lending to LICs, and IDA's role.

International Development Association
Resource Mobilization (FRM)

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Roadmap

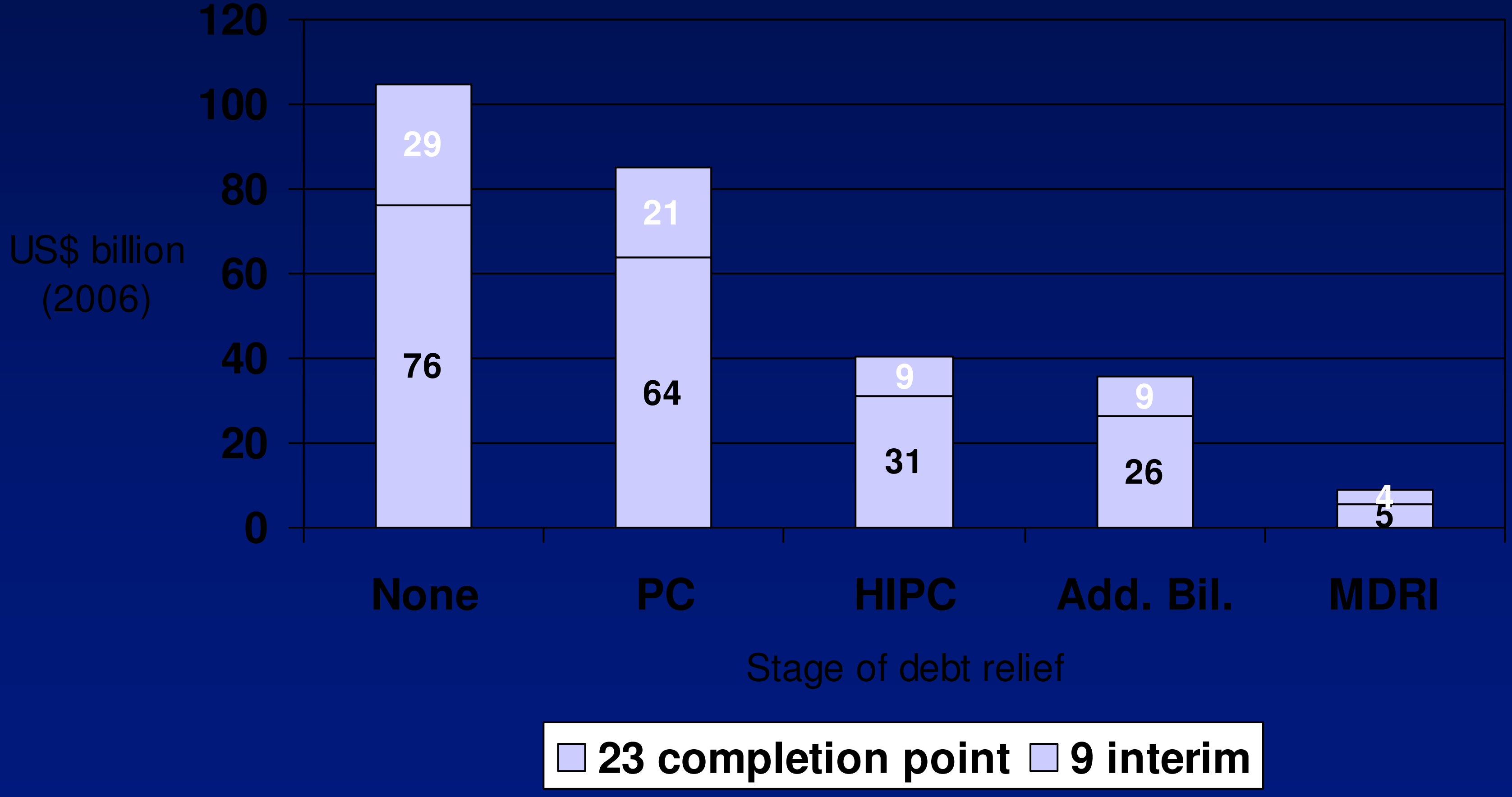
I. Risks and Opportunities

II. IDA’s Grant Allocation System

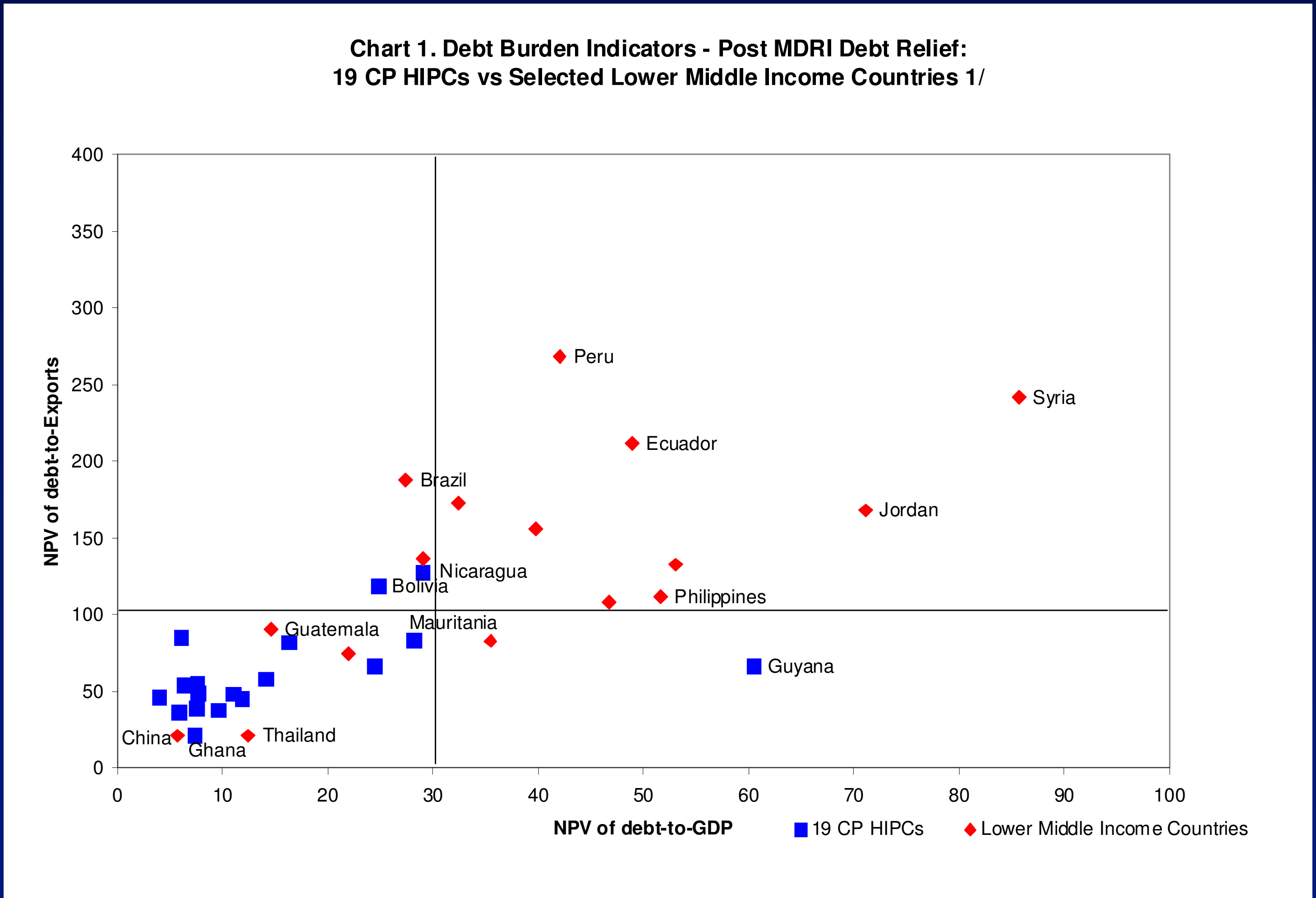
III. Implementing IDA’s Non-Concessional Borrowing Policy

IV. Capacity Building to Manage New Borrowing

Debt stocks after successive debt-relief stages



Debt-to-GDP ratios substantially lower…

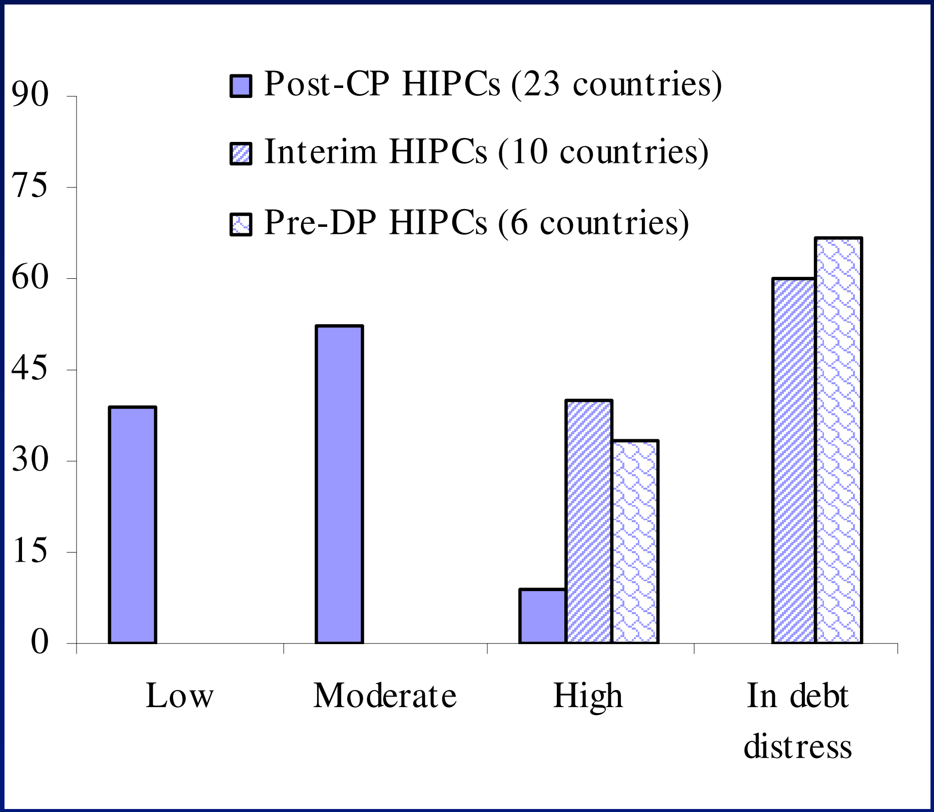


But significant challenges remain…

- LICs have large investment needs…
- LICs have better prospects…
  - better macroeconomic outlook, lower debt ratios thanks to debt relief
  - higher investment and higher growth as a result
- … but significant vulnerabilities remain
  - Export concentration
  - Narrow revenue base
  - Highly dependent on official financing and affected by large and frequent shocks.

Continued vulnerability

- These vulnerabilities are highlighted by the debt distress risk ratings.
- While HIPC and MDRI have reduced current debt ratios for many post-completion point HIPCs, Stress tests in the DSF highlight the continued sensitivity of many countries to non-concessional borrowing and exogenous shocks.
  - Of the 23 post-MDRI countries, 12 are still at moderate or high risk of debt distress.



Increased availability of financing carries risks and opportunities

- Universe of creditors has widened, and financing instruments have become more diverse.
- But, lack of coordination mechanisms and information sharing increases risk of over-borrowing.
- New loans may be large relative to GDP.
- The terms may not match country capacity to repay.
- New risks from reversals in market sentiment.

Lenders and Borrowers have co-responsibility for maintaining debt sustainability

- Borrowers have the first responsibility for outcomes
- But their actual capacity is limited
  - Limited public financial management, public debt management
  - Highly uncertain economic prospects and limited risk management options
- ⇨ Also important roles for creditors –
  - ⇨ Developing mechanisms for information sharing and coordination to help address these risks.
  - ⇨ providing results-oriented financing on appropriately concessional terms

Roadmap

I. Why should we be concerned?

II. IDA's Grant Allocation System

III. Implementing IDA's Non-Concessional Borrowing Policy

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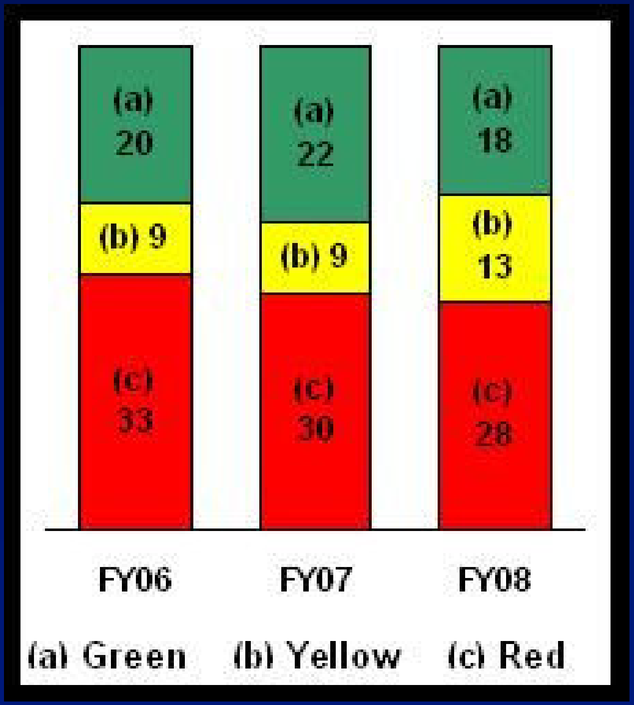
IDA’s Grant allocation system

- All of IDA’s assistance to IDA-only LICs is on highly concessional terms
- The dynamic Low-Income Country Debt Sustainability Framework (DSF) can highlight prospects for future prosperity or vulnerability into current financing decisions, that static debt ratios cannot.
- For instance where a country has strong oil prospects, its forward-looking DSA may indicate a low risk, although current debt ratios are high.
- On the other hand, in countries historically very vulnerable to shocks, the DSF can serve as an “early warning system”, pinpointing higher risks that cannot be captured with current debt ratios.

Evolution of IDA's traffic light system

- IDA's Grant Allocation System **further increases** concessionality for countries if DSF debt distress risks are moderate or high:
- A country's risk of debt distress is translated into a "traffic light" which determines mix of highly concessional credits and grants.

IDA traffic lights FY06-FY08



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IDA's Non-Concessional Borrowing Policy (NCBP)

- Framework for IDA's response to non-concessional borrowing risks in grant-eligible and post-MDRI countries approved by IDA's Board in July 2006.
- Primary objective to address risk that non-concessional lending can lead to a rapid re-accumulation of debt and undermine debt sustainability (and undermine efforts of IDA and other creditors).
- Not a blanket restriction on borrowing, anticipating cases where non-concessional borrowing may be part of a financing mix that helps promote economic growth, particularly where concessional financing is limited.
- Two key pillars to the policy:
  - First: Broadening the use of the DSF among creditors and borrowers.
  - Second: Discouraging non-concessional borrowing through borrower disincentives, and tools to manage their debt.

Creditor Outreach and the DSF

- Increased accessibility of the DSF:
  - DSAs regularly published on IDA and IMF websites, along with explicit guidance on concessionality policies, concessionality calculators, mailboxes for Q&As: (lendingToLICs@worldbank.org/lendingToLICS@IMF.org)
- Ongoing consultations around the DSF:
  - Discussions on the LIC DSF framework have taken place with nearly all major multilateral and bilateral creditors to LICs.

Increased use of the DSF:

- Other multilateral creditors have incorporated DSF risk ratings in their financing decisions: AfDB, AsDB, EBRD, EIB, IADB, IFAD
- OECD ECA members agreed in January to a set of Sustainable Lending Guidelines, linked to the DSF and Bank and IMF concessionality levels

Borrower-level disincentive measures

- Clear definitions of concessionality (Grant element of 35% based on CIRR rates, IMF/WB definition).
- Applies only to IDA only grant-eligible countries or IDA-only post-MDRI countries (list updated annually).
- Case-by-case approach, and set of criteria on which borrowing is assessed to determine whether to grant an exception.
- IDA response to borrowing on case-by-case:
  - Volume response is most likely response in cases where IDA is providing grants.
  - IDA would usually follow the market with a terms response in cases where the country has access to market financing (IDA terms would still have concessional elements).

Update on Implementation

- Implementation of the second prong of the policy has proceeded as set out in the NCBP policy, but acutal cases have been few.
- AfDB recently also announced approval of a similar policy.
- Cases illustrate limitations, in particular where IDA financing is small relative to other sources of financing.
- Points to importance of other creditors taking DSF into account.
- Cases also point out need to look beyond the grant allocation system and the NCBP: Development partners can also help build up institutional and technical capacity to manage oil and mineral resources, improve transparency, help make informed borrowing decisions, etc.

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Capacity Building in LICs to Manage New Borrowing

- Also an integral part of the NCBP.
- Capacity building for improving debt management and medium term debt management strategies is a key factor in improving debt sustainability prospects in LICS.
- Bank's efforts being ramped up in three dimensions:
  - First, debt sustainability analysis training workshops have reached about 40 LICs.
  - Second, a Debt Management Performance Assessment Tool (DeMPA) has been piloted and will be applied in 60 LICs over the next 3 years.
  - Third, medium term debt management strategies will be developed with Bank-Fund technical assistance in an initial group of LICS.
- Joint work of IDA and the IMF in this area will complement ongoing outreach to creditors and help reinforce sustainable lending practices.

End of Presentation

Nuts and Bolts of of the DSF

- The DSF rests on three pillars:
  - Indicative policy-dependent external debt thresholds (based on empirical evidence)
  - Debt Sustainability Analysis and standardized stress tests
  - Formulation of prudent borrowing and lending strategies
- DSF will help improve IMF/WB assessments and policy advice in these areas and guide provision of needed technical assistance

DSF Matrix of Thresholds

Table 1. Low-Income Country Debt Sustainability Framework
Indicative Policy-Dependent Debt and Debt-Service Thresholds (in percent)1/

	Assessment of Institutional Strength and Quality of Policies		
	Weak (CPIA<=3.25)2/	Medium (3.25<CPIA<3.75)	Strong (CPIA>=3.75)
NPV of debt-to-GDP	30	40	50
NPV of debt-to-exports	100	150	200
NPV of debt-to-revenue, excl. grants	200	250	300
Debt service-to-exports	15	20	25
Debt service-to-revenue, excl. grants	20	25	30

1/ Implies a probability of debt distress of about 18-22 percent
2/ CPIA =Country Policy and Institutional Assessment