

Civil Society position on the IMF and World Bank Debt Sustainability Framework Review

June 2016

This position has been written and agreed by:

International Networks:

African Forum and Network on Debt and Development (Afrodad)
Red Latinoamericana sobre Deuda, Desarrollo y Derechos (Latindadd)
European Network on Debt and Development (Eurodad)
Society for International Development

National organisations:

11.11.11-Coalition of the Flemish North-South Movement (BELGIUM)
All We Can: Methodist Relief and Development (UK)
Both ENDS (NETHERLANDS)
Bretton Woods Project (UK)
Budget Advocacy Network (SIERRA LEONE)
CAFOD (UK)
Caritas Honduras (HONDURAS)
Centre national de coopération au développement (CNCD-11.11.11) (BELGIUM)
Centre of Concern (USA)
Centro de Iniciativas en Políticas Ambientales (NICARAGUA)
Centro de los Derechos del Campesino (NICARAGUA)
Coordinadora Civil (NICARAGUA)
Corporación de Investigación y Acción Social y Económica CIASE (COLOMBIA)
Debt Justice Norway (NORWAY)
Erlassjahr.de (GERMANY)
Foro Social de Deuda Externa y Desarrollo de Honduras FODSEH (HONDURAS)
Fundación Jubileo (BOLIVIA)
Fundación Red Nicaragüense de Comercio Comunitario (NICARAGUA)
Fundación SES (ARGENTINA)
Instituto Popular de Capacitación IPC (COLOMBIA)
Integrated Social Development Centre (ISODEC) (GHANA)
Jesuit Centre for Theological Reflection (ZAMBIA)
Jubilee Debt Campaign (UK)
Jubileo 2000 Red Ecuador (ECUADOR)
Kenya Debt Relief Network (Kendren) (KENYA)
Malawi Economic Justice Network (MALAWI)
Movimiento Tzuk Kim-Pop (GUATEMALA)
Mozambique Civil Society Budget Forum (FMO) (MOZAMBIQUE)
National Justice and Peace Network (UK)
Red de Organizaciones Sociales de Managua (NICARAGUA)
Tanzania Coalition on Debt and Development (TANZANIA)

For more information contact Tim Jones at Jubilee Debt Campaign, tim@jubileedebt.org.uk

Background

The IMF and World Bank are conducting a review of their Debt Sustainability Framework (DSF) for low income countries. Under the DSF Debt Sustainability Assessments (DSAs) are conducted for all countries which can and are borrowing from either the IMF's concessional lending fund (the PRGT) or the World Bank's concessional fund IDA. This is all low income countries plus some lower middle income countries which have recently graduated (eg, Ghana) and some middle income small states (eg, Grenada).

The DSAs assess whether governments are at low, moderate or high risk of debt distress or in debt distress. Debt distress is defined as not being able to pay external government debts.

The DSAs are supposedly used by lenders to guide their lending:

- The World Bank is meant to give all loans to low risk countries, a mix of half loans and half grants to moderate risk, and all grants to high risk and in debt distress (though it has not always kept to this). The African Development Bank and Asian Development Bank are meant to do the same.
- The IMF uses the DSA to guide its limits on borrowing for countries following IMF economic conditions as part of an IMF adjustment programme
- Other multilateral lenders use it. For example, the Inter-American Development Bank uses DSAs to assess how concessional its lending is to the five countries in the region with DSAs.
- OECD governments are supposed to use it to guide their lending. For instance, they are not meant to give non-concessional loans to moderate and high risk of debt distress countries (though it is not clear that they always keep to this).
- It is unclear how much other government lenders, such as China, use it.
- Private sector lenders have no rules, but the risk rating would be expected to influence how willing they are to lend, and at what interest rate, along with other analysis such as that conducted by private ratings agencies.

Introduction

Both borrowers and lenders are responsible for ensuring loans are sustainable and used well. Borrowers should conduct rolling debt sustainability assessments, linked to transparent and accountable national development plans. All major public borrowings should be consistent with these up-to-date assessments and plans. For lenders to act responsibly, they should be guided by country-owned plans and assessments. If no such plans exist in a particular country, they should question whether it is responsible to lend.

Debt sustainability assessments conducted externally should be done by independent but accountable bodies such as UN agencies. External assessments should not be used as a means to impose economic policy conditions on a country. However, they should ensure that lenders act responsibly, which might mean restricting lending where it would be irresponsible.

Debt sustainability assessments should also be used to guide whether a government is in need of debt cancellation and help in indicating how much. Assessments for these purposes should be conducted by a body independent of lenders and borrowers but accountable, such as a UN agency.

Changes to the Debt Sustainability Framework

Below are the changes we think should be made to the Debt Sustainability Framework (LICs) and so included in the review:

Summary

- 1) Independence of assessments**
- 2) Based on the Sustainable Development Goals**
- 3) Help encourage useful, productive investment**
- 4) Stop including irrelevant criteria**
- 5) Debt service to government revenue is the most important indicator**
- 6) Include currently hidden liabilities**
- 7) Include domestic debt but maintain distinction with external debt**
- 8) Conduct more work on external private debt**
- 9) Review stress tests**
- 10) Include all countries**

1) Independence of assessments

External debt sustainability assessments should be carried out by a body which is democratically accountable, but independent of creditors and debtors. The IMF and World Bank are both significant lenders, and so therefore have a conflict of interest. For instance, they have an incentive to be overly positive about the debt prospects of countries which are large borrowers from them and have closely followed their economic policies. In contrast, the IMF and World Bank also have an incentive to be overly negative about the debt prospects of countries which have ignored their 'advice'. The World Bank and IMF currently hold 30% of external debt of governments covered by the Debt Sustainability Framework, and 40% of external debt of low income country governments.¹

Assessments should therefore be moved to be implemented by an independent but accountable body, such as a UN agency.

2) Based on the Sustainable Development Goals

The history of the last 40 years is that governments tend to continue to pay debts for too long after they have become a large drain on resources, leading to economic stagnation and increasing poverty through cutting social spending rather than debt payments. Rather than judging based on ability to pay, whether debts are sustainable should be based on an assessment of whether the debt is preventing the meeting of basic needs. Basic needs have been defined by the international community in the Sustainable Development Goals for the period from 2015 to 2030.

3) Help encourage useful, productive investment

At present, DSAs are based on overall debt figures. This means no distinction is made between countries where investment through debt can be shown to be productive.

It is important for overall figures to be continue to be used. However, a case can be made that where a particular investment can be shown both before and during that it will improve the debt situation through the government revenue it generates, with positive impacts on reducing poverty and inequality, then for debt linked to that project, it can 'sit outside' the debt sustainability framework.

¹ Calculated from World Bank. World Development Indicators database.

However, a high bar would need to be met for such investment to ensure that it genuinely does improve the debt situation and reduce poverty, including for:

- All documents concerning the project to be publicly released prior to contracts being signed so it can be scrutinised by the media, civil society organisations and other concerned media
- The national parliament in the country concerned to have specifically scrutinised and approved the project
- The project to be independently evaluated before, during and after the project, and for some or all of the debt to be cancelled if there are failures on the part of the lender
- The project is part of a transparent debt strategy plan and national development plan

4) Stop including irrelevant criteria

The one way the current DSF seeks to address the quality of borrowing and lending is through the use of World Bank Country Policy and Institutional Assessment (CPIA) scores. A higher CPIA score increases the threshold levels at which a country moves to a higher risk rating. However, most of the 16 criteria used in the CPIA are irrelevant for how well debt will be used, with some of them pushing particular economic policies including:

- Trade liberalisation
- Deregulation
- VAT as the main source of tax income

At the least, the Public Investment Management Assessment should be used rather than the CPIA.

5) Debt service to government revenue is the most important indicator

At present five different debt statistics are assessed to work out the risk rating. There is concern that this has contributed to DSAs being overly complicated and used less by borrower governments. However, no one indicator can capture all debt risks so a range of indicators do need to be used. Flow indicators which capture actual costs cover more of the risks of both principal, interest and timing of payments, than stock.

The most important statistic within DSAs is how much government revenue is being spent on debt payments, both external and domestic separately, and combined. This actual cost of debt is far more important than the overall stock of debt, even when measured in Net Present Value terms. External debt service compared to exports is also vitally important as this captures the balance of payments income out of which external debt payments must be made.

The importance of these figures mean DSAs continue to need to project several decades into the future to capture the flow over time.

6) Include currently hidden liabilities

DSAs need to include all future obligations on a government as far as possible. One such of these is payments arising from public-private partnerships. Many public-private partnership schemes follow a UK designed model, where private companies are guaranteed payments over a specific proportion of time in return for building infrastructure. This has kept the debt off the books and out of DSAs. In contrast, if the same investment had taken place through government borrowing, it would be fully included.

There is a risk that this incentivises governments to actually undertake investment through public-private partnerships, even if they are ultimately much more expensive, as has been the case in the UK.

Some public-private partnerships create a clear annual liability to the government in terms of the guaranteed payments or lost earnings. These could be easily included in the flow of debt service and revenue figures, which, as argued above, should be the main criteria.

Other forms of public-private partnerships create contingent liabilities; payments which will need to be made under a certain set of circumstances. These payments should also be included in DSAs, for instance through an additional modelled 'shock' of the liability having to be paid, on top of (rather than instead of) the other modelling of shocks.

Other contingent liabilities should also be included, such as the risk of having to bail out domestic banks.

7) Include domestic debt but maintain distinction with external debt

Domestic debt began to be included in DSAs following the last review, with risk ratings changed if it is particularly high. However, Debt Sustainability Assessments still need to do more to take into account the impact of domestic debt, including through specific ratios to analyse domestic debt. Both domestic and external debt need to be assessed as both present risks to the local economy. However, it is right to maintain the distinction between external and domestic debt as:

- External debt leads to flows of resources out of a country, domestic debt is the move of resources within a country, from taxpayers to lenders
- External lending is more likely to be volatile, based on financial changes elsewhere in the world
- It is easier for a government to regulate domestic debt during a financial crisis, but harder to default on it given the domestic financial impact
- External debt is more likely to be owed in foreign currency, and so have exchange rate risk (though this is not its defining feature), but domestic debt can have a more expensive nominal interest rate, depending on the strength of the local market

There are concerns that not all domestic debt is actually domestic debt, but rather local currency debt being bought by external actors. Therefore, more assistance should be given to ensure debt is properly being defined as domestic or external.

8) Conduct more work on external private debt

Another welcome change during the last review of the DSF was the inclusion of external debt owed by the private sector. This is now being reported in more countries, though in others reported levels are suspiciously low. This review should restate the importance of including external debt owed by the private sector in the monitoring, and amending risk ratings where large risky external private debts exist.

9) Review stress tests

Ahead of the last review in 2012, IMF and World Bank research stated that *"in only 7 out of 60 cases did the actual level of debt in 2010 exceed the level projected by the most extreme stress test"*.² The emphasis here seemed far too complacent about 12% of cases being worse than the most extreme stress test. A similar review should be conducted to see whether DSA stress tests continue to fail to deal with negative economic changes, and whether they adequately model when more than one negative change happens at a similar time, such as falls in commodity prices at the same time as an increase in the value of the dollar.

² IMF and World Bank. (2012). Revisiting the Debt Sustainability Framework for Low-Income countries. IMF and World Bank. 12/01/12.

For instance, the June 2013 DSA for Ghana said under the most extreme stress test, the worst external government debt service to revenue would get in 2015 would be 10%.³ The most recent December 2015 DSA says it was actually 38.4%.⁴

Similarly, Zambia's May 2012 DSA said with the most extreme shock, external government debt service in 2016 would be 6% of revenue.⁵ The June 2015 DSA now says it will be over 10%.⁶

10) Include all countries

Debt crises can arise in any country, no matter what their income level. Moreover, the financial crisis of 2007-08 showed that private sector ratings agencies can have severe failures. Furthermore, the DSAs that are conducted for low income countries provide far more transparent data, such as on government debt service compared to revenue, than the less extensive DSAs that are conducted for middle and high income countries.

Whilst the risk ratings may take in different factors, full DSAs should be conducted for all countries, rather than singling out low income countries. Whilst the methodology for risk ratings might differ, all DSAs for all countries should include debt service to government revenue, external debt service to government revenue and external debt service to exports.

³<http://www.imf.org/external/pubs/ft/dsa/pdf/2013/dsacr13187.pdf>

⁴<http://www.imf.org/external/pubs/ft/dsa/pdf/2015/dsacr15245.pdf>

⁵<http://www.imf.org/external/pubs/ft/dsa/pdf/2012/dsacr12200.pdf>

⁶<http://www.imf.org/external/pubs/ft/dsa/pdf/2015/dsacr15152.pdf>