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Newsletter by SACE Economic Research

contents:

Over the past decades Low-Income countries (LICs) have strengthened their economic and financial position and their debt indicators have dramatically improved.

However, risks of new unsustainable borrowing policies remain. LICs need to balance development priorities and the desire to save debt sustainability. Furthermore global downturn exacerbates macroeconomic vulnerabilities for poor countries posing additional challenges.

New spending policies could plunge these countries into debt distress once again. Hence the importance of developing sustainable lending practices, that is lending that supports a borrowing country's economic and social progress without endangering its financial future and long-term development prospects.

Debt sustainability framework promoted by the International Financial Institutions, non-concessional borrowing policy and OECD guidelines to promote sustainable lending show a joint commitment to support Low-Income countries on their sustainable borrowing path.

The sustainable practice of lending

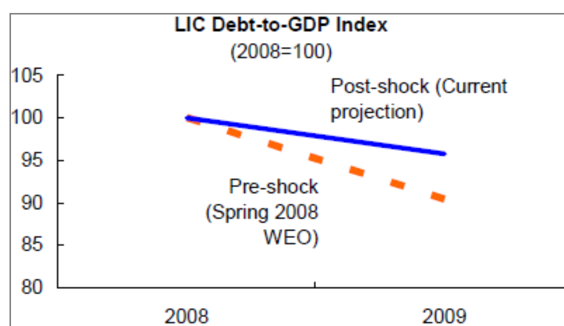
Low-Income countries show signs of improvements in debt burden. Over the past decades Low-Income countries (LICs)[1] have strengthened their economic and financial position and their debt indicators have dramatically improved. The factors that contributed to this phenomenon include not only buoyant international conditions (as for example commercial and financial globalization, high commodity prices) but also these countries' own progress in political stabilisation and budgetary rigour. In this sense, the partial or total cancellation of debt, achieved in the framework of the actions promoted by International Financial Institutions (IFIs), has played a fundamental role as it enabled these countries to earmark resources previously used to service public debt to initiatives for medium and long-term social and economic development.

Risks of new unsustainable borrowing policies still remain. Notwithstanding undoubted improvement achieved by LICs, like Ghana and Mali, these countries still have to tackle mounting difficulties. The main challenge is to maintain a sustainable debt position while pursuing national development objectives. In recent years external financial opportunities has increased but LICs still have large financial requirements in order to meet their own development priorities, as defined in the Millennium De-

[1] According to World Bank classification, economies are divided according to 2007 GNI per capita, calculated using the World Bank Atlas method. Low-income countries group comprise those countries that had a GNI per capita income in 2007 of less than $935.

velopment Goals[2]. Increasing social and infrastructure spending could help those countries to reach these goals but their debt burden would rise again. Some LICs could be tempted to abandon a sustainable track and previous sound borrowing decisions. Particularly post-debt relief initiative could create a misleading perception of a broader possible borrowing space. Therefore long-term debt sustainability involves a joint effort by borrowers, lenders and donors to strengthen borrowing countries capability in implementing a prudent borrowing practice for LICS.

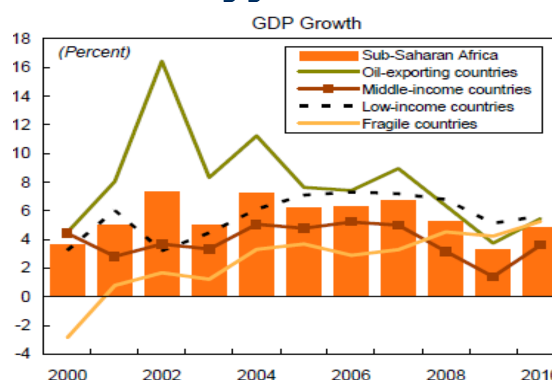
Declining Debt trend



Source: IMF

Despite buoyant debt trend, the outlook is not bright. Debt indicators are projected to continue declining in 2009, but the number of LICs heavily exposed to external financing (debt exceeding 60% of GDP) could rise. The international crisis could furthermore exacerbates LICs' vulnerabilities: the shrink of commercial trade, less favourable commodities prices, the decline in financial flows and the contraction of liquidity impact negatively on LICs macroeconomic performance and the ability to service their obligations. As revenues decline and social spending increases, in conjunction with a reduction in aid flows and tighter financial conditions, fiscal position will come under increasing pressure. Higher public external borrowing to offset the impact of the global crisis and to finance medium-long term development initiatives could consequently increase the risk of debt distress in these countries.

Slowing growth in 2009



Source: IMF

International Financial Institutions play a pivotal role. International Monetary Fund (IMF) and Intentional Development Agency (IDA) of the World Bank provide support to Low-Income countries through policy advice, technical cooperation and financial assistance in order to strengthen macroeconomic fundamentals and support development projects. An analytical framework, the Debt Sustainability Framework for LICs, has been developed to help monitor and analyze the sustainability of public and external debt in LICs. The objective of the framework is to assist policymakers and other parties, including international financial markets, explore the consequences of incurring debt and conduct regular updates of the analyses. In this sense, IMF and World Bank jointly perform a Debt Sustainability Analysis (DSA), providing an assessment of the risk of debt distress gauged on actual debt burden and policy perform-

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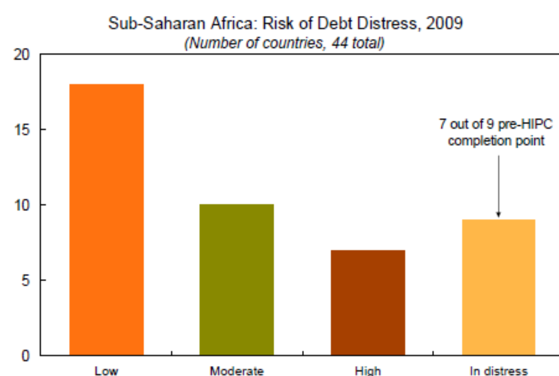
[2] In September 2000, at the United Nations Millennium Summit, world leaders commit their nations to a new global partnership to reduce extreme poverty and set out a series of time-bound targets - with a deadline of 2015 - known as the Millennium Development Goals. These eight goals are: eradicating extreme poverty and hunger; achieving universal primary education; promoting gender equality and empowering women; reducing child mortality; improving maternal health; combating HIV/AIDS, malaria and other diseases; ensuring environmental sustainability; the creation of a global partnership for development, with targets for aid, trade, and debt relief.

ances of the country (the result could underline a low, moderate, high risk or actual debt distress). DSA include debt burden projections and an assessment on country's vulnerabilities to external and policy shocks. Bearing in mind the risk of debt distress, DSA provide also recommendations over a prudent management of the resources necessary to achieve the Millennium Development Goals[3].

Debt sustainability analysis in Sub-Saharan Africa



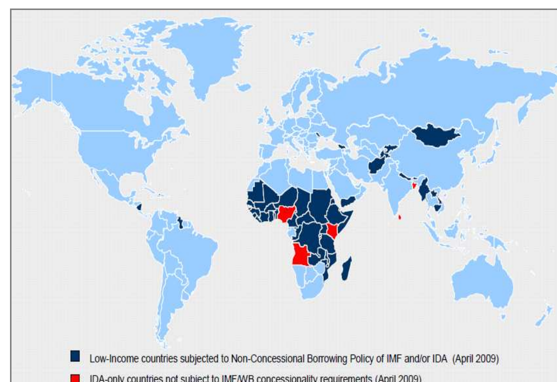
Source: IMF

The non-concessional borrowing policy. Grants and concessional lending remain obviously the most appropriate source of external financing, even after debt relief. IMF and IDA programmes generally lay down specific concessionality requirements to limit external indebtedness. This policy has been applied flexibly and supported by a nonconcessional borrowing policy for LICs, based on the concept of grant element[4]. The grant element measures the concessionality of a loan. It is defined as the difference between its nominal value (face value) and the sum of the discounted future debt-service payments (net present value) to be made by the borrower, expressed as a percentage of the face value of the loan:

$$GE = \frac{(Face - NPV)}{Face} * 100$$

Therefore a financing package must include minimum grant element percentages on non-concessional loans to be in line with World Bank and Fund supported programmes. The minimum grant element required under these programmes is generally 35 percent of the whole investment, or higher in specific cases (50 percent or more for least developed countries)[5]. In this sense, IFIs non-concessional policy aims to ensure that non-concessional credits are utilized for high return development projects and to minimize the risk of debt distress.

Countries subject to non-concessional borrowing policy



Source: SACE

OECD countries are committed to sustain international effort. As seen before, new spending policies could plunge these countries into debt distress once again, hence the importance of the lending countries and their Export Credit Agencies (ECAs) in issuing credit guarantees. OECD Member Countries are deeply involved in sustainable lending issue and recently this commitment became mandatory. In 2008 OECD adopted the "Prin-

[3] Debt Sustainability Analysis are available on: http://www.imf.org/external/pubs/ft/dsa/lic.aspx

[4] For a comprehensive list of countries currently subject to the Non-Concessional Borrowing Policy: http://www.oecd.org/dataoecd/2/57/40817749.pdf

[5] A concessionality calculator is available on IMF and IDA website as a tool to measure the grant element in a financing package. For IMF see: http://www.imf.org/external/np/pdr/conc/calculator/default.aspx

ciples and Guidelines to Promote Sustainable Lending in the Provision of Official Export Credits to Low-Income Countries" to strengthen multilateral debt sustainability efforts through the definition of common sustainable lending practices[6]. Lenders/financiers agree that their commercial operations with sovereign borrowers or counterparts backed by sovereign guarantees will not compromise LICs debt-carrying capacity. Therefore, a financing programme is deemed sustainable if it is able to: (i) generate beneficial economic and social returns; (ii) avoid unproductive spending projects that are not in line with programmes approved under each country's poverty reduction strategy paper, (iii) maintain the sustainability of the debt and (iv) promote good governance and transparency. OECD encourages a strong cooperation between members and a wider participation to this initiative beyond the organization membership.

SACE promotion of sustainable lending practices. SACE has long been applying prudential criteria that comply with the concept of sustainable lending in issuing new credit guarantees to counterparts in LICs. In the evaluation of operations with counterparts in LICs, SACE performs a due diligence based upon the general corporate prudential principles for risk management applied to all its counterparts (creditworthiness, net asset worth, economic and financial quality of the project to be financed, IFIs' valuation) along with specific criteria to applying to operations in these countries. The purpose of this latter analysis is to verify that:
- insured financing complies with concessionality requirements of the IMF/IDA;
- in the absence of minimum concessionality requirements, insured financing complies with the sustainability debt analysis carried out by IMF/IDA;

[6] To consult the text of the agreement, see: http://www.olis.oecd.org/olis/2008doc.nsf/LinkTo/NT000031BE/$FILE/JT03246229.PDF

- there is an assurance by the government authorities of the debtor country attesting to the compliance of the project with existing indebtedness and development plans (e.g. Poverty Reduction Strategy Paper and/or budget);
- all the procedures laid down by national legislation on the subject matter have been complied with (e.g. Parliamentary approval, where required).

SACE shares information with the other ECAs and IFIs on Low-Income country operations. It is also actively involved in defining the operational aspects of sustainable lending practices.

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