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The G-8 Debt Cancellation Proposal and Its Implications for the Fund - Further Considerations

INTERNATIONAL MONETARY FUND

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The G-8 Debt Cancellation Proposal and Its Implications for the Fund—Further Considerations

Prepared by the Policy Development and Review, Legal and Finance Departments

(In consultation with other Departments)

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I. Introduction

1. **The G-8 has proposed that the Fund, the International Development Association (IDA), and the African Development Fund (AfDF) cancel 100 percent of their claims on countries having reached, or upon reaching, the completion point under the enhanced Heavily Indebted Poor Country (HIPC) Initiative.** The proposal was initially presented in the G-8 Finance Ministers' *Conclusions on Development*, issued on June 11, 2005, and reaffirmed in the statement on Africa signed by G-8 Heads of State and Government at the Gleneagles Summit on July 8, 2005. A more detailed technical note from the G-8 was circulated to the Executive Board on July 15, 2005. The stated objective of the proposal is to complete the process of debt relief for HIPCs[1] by providing additional resources to help these countries, most of which are in Africa, reach the Millennium Development Goals (MDGs). At the same time, G-8 countries have committed to ensure that the financial capacity of the international financial institutions (IFIs) is not reduced as the result of debt forgiveness. The cost of debt relief to IDA and the AfDF is to be met by bilateral contributions based on agreed burden sharing; the cost to the Fund is to be covered through the institution's own resources, with a call for bilateral contributions to cover additional needs. The utilization of appropriate grant financing is expected to ensure that countries do not immediately re-accumulate unsustainable external debts and are eased into new borrowing.[2]

2. **In their initial discussions of the G-8 proposal on June 22, 2005, Executive Directors stressed that the Fund will continue to operate under existing policies and procedures until decisions to change these policies are taken by the required majorities.** Directors pointed out that the G-8 proposal raises issues regarding the uniformity of treatment of members, burden sharing, conditionality, and the Fund's financial role in low-income countries. Directors asked staff to prepare an assessment of the proposal, and its financial, legal, and policy implications for the Fund, for Board discussion prior to the

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[1] In this paper, the term HIPCs is generally used to refer to the 35 countries mentioned in the G-8 communique and earlier identified by the staff as being potentially eligible for HIPC assistance. However, no definite list of HIPC-eligible members exists. Under the ring-fencing provision approved by the Fund and Bank Boards in September 2004. HIPC eligibility for pre-decision point countries has to be reassessed on the basis of end-2004 debt stock data, and some countries may be identified as potentially eligible (and some previously identified countries removed) once the relevant data are finalized. Moreover, additional HIPC eligibility criteria apply, including a requirement to adopt a qualifying economic program between October 1, 1996 and the December 31, 2006 expiration of the extended sunset clause.

[2] For a full description of the G-8 proposal, see *The G-8 Debt Cancellation Proposal and Its Implications for the Fund* (7/20/05).

Annual Meetings.[3] Directors emphasized that the Fund's financing capacity should not be undermined, in particular, its capacity to help other low-income countries within the framework of its established policies.

3. **Executive Directors had a follow up discussion on the G-8 proposal and its implications for the Fund on August 3, 2005.** Most Directors expressed support for further debt relief by the IMF as part of the international support for low-income countries.[4] Many Directors viewed the G-8 proposal as going a long way toward completing the process of debt relief for HIPCs, strengthening their capacity to respond to external shocks and freeing resources to help them reach the MDGs. Directors agreed that the Fund must remain fully equipped to advise and assist members in the design of macroeconomic stabilization and structural reforms, in capacity building, and in the provision of financing, whether in response to shocks or to address remaining or emergent protracted balance of payments problems. In addition, Directors had a wide-ranging discussion of how the G-8 proposal should be assessed in relation to the principle of uniformity of treatment of members. All Directors emphasized that their deliberations remained at a preliminary stage and that further clarification and discussion of several key aspects of the proposal and its implications will be needed before the required broader consensus can be reached. Directors reiterated that the Fund will continue to operate under existing policies and procedures until decisions to change or modify these policies are taken by the required majorities.

4. **The Executive Board of the International Development Association (IDA) had an informal meeting to consider the G-8 debt relief proposal on August 4, 2005.** Executive Directors were supportive of the G-8 debt relief proposal but stressed that the financial capacity and viability of IDA should be preserved in order not to undermine its future role in assisting developing countries. In this context, Directors highlighted the importance of an adequate financing arrangement to fund the debt relief to be provided by IDA. Most Directors underscored the importance of additional resources to exploit fully the benefits of the G-8 proposal. While the issue of evenhandedness was raised, many Directors believed that the distribution of additional resources through IDA performance-based allocation system would help ensure uniformity of treatment, on a net basis, across regions and countries. A number of Directors were of the view that recipient countries should be subject to some conditionality to ensure that the resources freed through debt relief are used efficiently toward the Millennium Development Goals (MDGs). Directors asked IDA staff to

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[3] *IMF Executive Board Discusses G-8 Finance Ministers'Proposal for Further Debt Relief for HIPCs* (PIN 05/80, 6/27/05).

[4] The discussion on further debt relief is complemented by the continuing discussion in the Executive Board on ways to enhance the role of the Fund in low-income countries, including through: (i) the establishment of a nonfinancial mechanism to support policies in low-income countries; (ii) financing the continuation of the Poverty Reduction and Growth Facility; and (iii) the establishment of a facility to help countries facing exogenous shocks.

prepare a follow-up paper that would assess in greater detail the financial and operational issues involved in the implementation of the proposal.

5. **This paper responds to the Fund Board's request for additional analysis of the G-8 proposal.** Section II discusses issues related to eligibility and uniformity of treatment. Section III considers conditionality. Section IV raises issues related to countries that are now in protracted arrears to the Fund. Section V discusses its financial implications.

II. Eligibility and Uniformity of Treatment

6. **During the August 3 Board meeting, Directors had a wide-ranging discussion of how the G-8 proposal should be assessed in relation to the principle of uniformity of treatment of members, given that it calls for use of the Fund's resources to grant full debt relief to only a limited set of low-income countries.** Underscoring the importance of sound eligibility criteria for the provision of debt relief, consistent with the uniformity of treatment principle, many Directors requested the staff to examine this issue further, including the implications of broadening the target group and/or the financial envelope. This section considers these issues.

A. Summary of Relevant Legal Considerations

7. **The staff has presented the key legal considerations regarding eligibility for debt relief and uniformity of treatment among low-income members in its first Board paper on the G-8 proposal and its implications for the Fund.**[5] As noted in that paper, the principle of uniformity of treatment applies to the use of both the Fund's General Resources and resources of the Special Disbursement Account (SDA). This principle does not require that members be treated identically. It requires, however, that Fund decisions involving the above resources that differentiate among members be based on the application of criteria that are relevant to the power being exercised.

8. **By design, Article V, Section 12(f)(ii) sets forth an important but limited exception to the overall requirement for uniformity of treatment**, in that it authorizes the Fund to use SDA resources to provide balance of payments assistance to developing countries only, and specifically provides that for this purpose, the Fund shall take into account the level of per capita income. However, while developed countries may be excluded from eligibility under this subclause, the principle of uniformity of treatment still applies among the developing countries to whom SDA assistance may be provided.

9. **Reflecting both the text and objectives of Article V, Section 12(f)(ii), two "entry" criteria have been used to limit developing countries' eligibility or qualification to receive balance of payments assistance from SDA resources on concessional terms**

[5] See *The G-8 Debt Cancellation Proposal and Its Implications for the Fund* (7/20/05).

pursuant to that provision: (i) per capita income, and (ii) nature and extent of the balance of payments problem.

10. **Regarding per capita income, the Fund has generally relied on the IDA-eligibility per capita income threshold as a basis for limiting eligibility for all of its concessional assistance**, including under the Structural Adjustment Facility, Enhanced Structural Adjustment Facility (which became the Poverty Reduction and Growth Facility in 1999) and HIPC Initiative. Importantly, however, a per capita income level that is lower than the IDA threshold could also be used as a basis for providing SDA resources, including as debt relief, to only a subset of PRGF-eligible members. In establishing this lower threshold, the Fund could take into account the finite nature of SDA resources.[6] Moreover, so as to mitigate the "all-or-nothing" consequences of a single threshold, the Fund could—but is not required to—provide for some degree of gradated assistance based on income levels.

11. **Regarding the nature and extent of a member's balance of payments difficulties, this criterion was relied upon as the basis for limiting the availability of the HIPC Initiative to only a subset of PRGF-eligible countries.**[7] Where eligibility or qualification is limited on the basis of this criterion, however, the amount of assistance provided cannot exceed the size of the special balance of payments problem.

12. **Even if a member has met the entry criteria (based on per capita income and the nature and extent of the balance of payments problems), the Fund may apply additional conditions to further limit the availability of financing to otherwise eligible or qualified members if these criteria are relevant.** For example, the Fund has made policy performance a further condition for concessional assistance to members.[8] Moreover, because the Fund's resources are finite, access limits can be imposed to address the very common

[6] Indeed, regarding IDA eligibility, the IDA income threshold was lowered in the 1980s because of the shortage of IDA resources; see *"IDA Eligibility, Terms and Graduation Policies"*, IDA Report No. 26498, 01/01/2001.

[7] With respect to the PRGF, assistance is conditioned upon a finding that the member has a "protracted balance of payments problem." For low income members, however, this condition does not create a significant constraint on qualification, as low-income countries are deemed "a priori" to have a protracted balance of payments problem.

[8] Policy performance could be used to effectively limit eligibility among low-income countries that have protracted balance of payments problems, but this would likely produce a different list than the G-8 proposal. In particular, it is unlikely that all pre-decision point HIPCs would be eligible while non–HIPCs that have successfully performed under recent PRGF arrangements would be eligible, if policy performance were relied upon as the primary means of limiting eligibility.

situation where the needs of eligible members—if fully financed—would outstrip the financing capacity of the Fund.[9]

13. **As a general principle, the requirement of uniformity of treatment does not apply to resources contributed by third parties that are administered by the Fund pursuant to Article V, Section 2(b).** More specifically, upon request by a contributor, the Fund is authorized to establish an account to administer such resources only for the benefit of specified members. Indeed, the Fund has established such accounts on a number of occasions.[10]

B. Uniformity of Treatment and the G-8 Proposal

14. **On the basis of this analysis, the staff has given further consideration as to how the G-8 proposal can be implemented in a manner that is consistent with the requirement of uniformity of treatment.** With respect to per capita income, HIPCs are generally, but not always, the poorest of low-income countries; indeed, a few are among the wealthier PRGF-eligible countries (Table 1).

[9] Where the financing has been provided as loans, access limits may be used to mitigate the issues that may arise regarding the member' capacity to repay the Fund. With respect to grant financing, the Fund may decide that, in addition to the balance of payments problem requirement, it will only provide such financing to members to assist them in servicing their obligations to the Fund. Such a possibility is specifically referred to in the Commentary on the Second Amendment (See *The G-8 Debt Cancellation Proposal and Its Implications for the Fund (7/20/05)*, footnote 31). In the context of the HIPC Initiative, debt relief from the Fund is only made available to members with unsustainable debt (as defined) to the extent that it is needed to eliminate unsustainable debt owed to the Fund. As noted in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund (7/20/05)*, such assistance has also generally been limited to those countries that satisfied the relevant criteria within a specific time period.

[10] Such accounts have been established for different purposes. For example, the Fund has established accounts to administer resources provided to assist specific members in resolving their external debt problems (including in some cases the administration of resources to be used in the discharge of overdue financial obligations to the Fund). Accounts have also been established to administer resources provided to assist specific members in the implementation of their Fund-supported programs.

Table 1. Per Capita Income Levels and Fund Exposure of PRGF-eligible Countries 1/

		Per capita income (2004) (In U.S. dollars)	Projected Fund credit outstanding at end-2005 2/ (In SDRs millions)
1	**Burundi**	90	26
2	**Ethiopia**	110	112
3	Liberia 3/	110	509
4	**Congo, Dem. Rep. of**	120	527
5	**Guinea-Bissau**	160	8
6	**Malawi**	170	47
7	Eritrea	180	-
8	**Sierra Leone**	200	120
9	**Rwanda**	220	53
10	**Niger**	230	78
11	**Mozambique**	250	107
12	**Chad**	260	51
13	**Myanmar**	260	-
14	Nepal	260	14
15	**Uganda**	270	88
16	Tajikistan, Rep. of	280	69
17	**Gambia, The**	290	15
18	**Madagascar**	300	137
19	**Central African Republic**	310	25
20	Cambodia	320	57
21	**Tanzania**	330	234
22	**Burkina Faso**	360	62
24	**Mali**	370	75
23	**Sao Tome & Principe**	370	2
25	**Ghana**	380	265
26	**Togo**	380	10
27	Haiti	390	3
28	**Lao PDR**	390	20
29	Nigeria	390	-
30	Kyrgyz Republic	400	112
31	**Mauritania**	420	49
32	Bangladesh	440	149
33	**Zambia**	450	403
34	**Guinea**	460	64
35	Kenya	460	61
36	Uzbekistan, Rep. of*	460	-
37	**Benin**	530	36
38	**Comoros**	530	-
39	Sudan 3/	530	1,062
40	Solomon Islands*	550	-
42	Timor Leste	550	-
41	Vietnam	550	142
43	Yemen, Rep. of	570	205
44	Papua New Guinea*	580	17
46	Mongolia	590	24
45	Pakistan*	590	1,136
47	India	620	-
48	**Senegal**	670	100
49	Moldova, Rep. of	710	67
50	Bhutan	720	-
51	Lesotho	740	25
52	**Cote d'Ivoire**	770	139
53	**Republic of Congo**	770	11
54	**Nicaragua**	790	140
55	**Cameroon**	800	188
56	Azerbaijan	950	102
57	**Bolivia**	960	173
58	Kiribati	970	-
59	**Guyana**	990	45
61	Angola	1,030	-
62	Djibouti	1,030	13
60	Georgia	1,030	135
63	**Honduras**	1,030	107
64	Sri Lanka	1,040	163
65	Armenia, Rep. of	1,070	117
66	*Vanuatu*	1,340	-
67	*Cape Verde*	1,770	6
68	*Tonga*	1,830	-
69	*Samoa*	1,860	-
70	*Albania*	2,050	56
71	*Maldives*	2,510	-
72	*Dominica**	3,650	6
73	*St. Vincent and Grenadines**	3,650	-
74	*Grenada**	3,760	6
75	*St. Lucia**	4,300	-
76	Afghanistan	...	-
77	Somalia 3/	...	222
78	Zimbabwe 3/ 4/	...	119
	Total	...	**8,114**

Sources: World Bank Operational Manual and IMF Finance Department.

* Not IDA-only
1/ Countries in bold are HIPCs, excluding possible sunset-clause countries. Italics denote small-state eligibility.
2/ Based on Fund credit outstanding at end-2004 and excluding disbursements made thereafter (see Table 6).
3/ Credit outstanding includes interest arrears.
4/ Zimbabwe is currently not PRGF-eligible due to its arrears to the PRGF Trust. These arrears include charges and overdue interest.

15. **However, a per capita income eligibility criterion could achieve an outcome that is very close to the G-8 proposal, both in terms of the target group of members to receive full debt relief and the overall financing envelope.** This approach is possible because the G-8 proposal contemplates, in addition to SDA resources, the use of third party resources that can be distributed among members in a non-uniform manner. More specifically, SDA resources, which are subject to uniformity of treatment requirements, could be distributed uniformly to give 100 percent debt relief to all PRGF-eligible members (HIPCs and non–HIPCs) with incomes below a specified income threshold that have Fund credit outstanding. Resources not subject to the requirement of uniformity of treatment (e.g., the portion of resources in the PRGF Subsidy Account that is attributable to third party contributors) could be used, at the request of contributors and subject to the consent of all contributors, to provide up to 100 percent debt relief for those HIPCs above the designated income threshold. Relative to the G-8 proposal, the extra cost of this approach would be equivalent to the amount of relief that is given to non–HIPCs that fall below the given income threshold.

16. **The provision of debt relief by the Fund to members with the lowest per capita incomes is consistent with the uniformity of treatment requirement.** By giving debt relief to its poorest members, the Fund would strengthen their external positions, thereby helping to address their *a priori* protracted balance of payments problems[11] and freeing scarce resources that these countries could now mobilize in their efforts to reach the MDGs. It would be also consistent with the Articles' specific identification of income as a criterion that must be taken into account in distinguishing among developing members in the use of SDA resources.

17. **An application of this approach would be to use SDA resources to give debt relief to all members with a per capita income below US$380 that have Fund credit outstanding.** This group includes 21 of the 35 HIPCs identified by the G-8, and five additional low–income members that are not on that list.[12] The G-8 proposal already contemplates G-8 and donor financing in connection with three of these members, as one is a protracted arrears case (Liberia), and two are expected to become HIPC-eligible under the extended sunset clause (Eritrea and Nepal) Thus, the list of countries contemplated under the G-8 proposal would be expanded only by two countries: Cambodia and Tajikistan.[13] As

[11] See footnote 9.

[12] On the basis of the 2004 per capita gross national income (Atlas method) from the World Bank's Operational Manual.

[13] Although no data are available at this time on per capita income for Afghanistan, it is likely to be below US$380. However, Afghanistan has no outstanding debt to the Fund. Data are also not available on per capita income for Somalia and Zimbabwe.

noted above, debt relief to the 14 HIPCs that are above the $380 per capita income threshold could, subject to the consent of all contributors, be financed with third-party contributor resources currently held in the PRGF Trust Subsidy Account. These resources could be transferred to—and eventually disbursed from—an account administered by the Fund. This approach implies only a moderate increase in cost relative to providing debt relief only to HIPCs; this increase is equivalent to the cost of relief to the two non–HIPCs that are below the US$380 threshold. The costs and financial implications of implementing the proposal under this form are discussed in detail in section V of this paper.

18. **The US$380 cutoff is the one that allows the closest fit to the financial arrangements contemplated under the G-8 proposal.** A higher cutoff would increase the number of beneficiaries, and thus the overall cost as well as the need for additional bilateral contributions. This approach has advantages and at the same time causes some problems of its own. Its key advantage is that it would satisfy uniformity of treatment requirements by providing a relatively large amount of SDA resources to the Fund's poorest members while, at the same time, keeping down the additional costs of the overall operation, thereby ensuring that the Fund's ability to provide future financing under the PRGF is not impaired. However, from a policy perspective, the absence of any gradation in the availability of debt relief raises fairness issues: members below the US$380 threshold would receive full debt relief, while those non–HIPCs above the threshold would receive nothing. This problem could be in principle mitigated by providing more limited relief to some low-income members above the threshold. For example, gradated debt relief (i.e., progressively declining from 100 percent to zero) could be provided to members with incomes above US$380 up to a second threshold level. Alternatively, different levels of debt relief could be given to countries in successive income brackets. However, any proposal that broadens the country coverage would have a higher overall cost than the approach described above and would require higher additional financing, without which the Fund's future concessional lending capacity would be reduced.

III. CONDITIONALITY

19. **Implementation of the G-8 debt cancellation proposal requires clarification of some of the conditions that should be attached to further debt relief from the Fund.** The G-8 proposal is clear on the conditions for further debt relief for HIPCs that have not yet attained the completion point; attainment of the completion point would qualify them for irrevocable 100 percent cancellation of the stock of debt owed to the Fund as of end-2004. For HIPCs that have already reached the completion point, the G-8 propose that to qualify for debt cancellation, these countries must be current with their payment obligations to the IFIs and not have experienced serious lapses, including in governance, such that their Fund-supported programs would be at risk. The G-8 recognize that implementation of this proposal would require that the eligibility criteria be clarified precisely, particularly for countries that do not currently have a Fund-supported program or whose program is currently off-track, and they have asked staff to suggest modalities to this end. While the G-8 do not see a case for conditionality beyond that of the HIPC Initiative, good governance, accountability and transparency are seen as crucial to releasing the benefits of debt cancellation. For this reason,

the G-8 have asked the Fund and the World Bank to report on improvements in transparency and the fight against corruption so as to ensure that resources freed by debt relief are used for poverty reduction.

20. **Directors have expressed a range of views on the possible conditions that could be attached to the provision of further debt relief from the Fund**. During the August 3, 2005 Board discussion, many Directors agreed with the G-8 proposal that debt relief be provided on conditions already in existence. Many Directors also agreed that debt relief be irrevocable and delivered up front to provide a predictable stream of resources. A number of Directors thought that a phased approach to the delivery of debt relief would be more appropriate. Some Directors also suggested the use of ongoing conditionality, linked to the successful implementation of a Fund-supported program, to help ensure that the freed resources are spent in support of the MDGs. Some Directors believed that linking debt relief to conditionality related to transparency and governance would be difficult to operationalize and may be difficult to implement consistently, as some HIPCs have already reached the completion point.

21. **Against this background, this section seeks to clarify outstanding issues regarding conditionality for additional debt relief.** First, it proposes modalities for defining entry conditionality under the G-8 proposal so as to make it operational. Second, it reviews the advantages and disadvantages of ongoing conditionality. Third, it discusses the conditionality implications of extending debt relief to non–HIPCs. Finally, it examines potential coordination with the World Bank in this area.

A. Making Entry Conditionality under the G-8 Proposal Operational

22. **Against what standard should existing post-completion-point HIPCs be assessed in determining their qualification for additional debt relief under the G-8 proposal?** To ensure that the same conditionality applies to pre- and post-completion-point countries, the standard should be as close as possible to that required to attain the completion point under the HIPC Initiative. In broad terms, experience shows that countries reaching the completion point have satisfied three criteria: satisfactory macroeconomic performance under PRGF arrangements; satisfactory progress in implementing a poverty reduction strategy (PRS); and improvements in public expenditure management (PEM) systems with a view to enhance governance and transparency in the use of resources. Thus, staff could assess whether post-completion-point HIPCs continue to meet these three criteria.[14] These assessments would be presented to the Board, and if approved by the Board, the countries would qualify for

[14] A similar approach was used for the enhancement of the HIPC initiative. Countries that had already qualified for HIPC assistance at the time of the enhancement did not get additional relief automatically, but only after assessments by the Fund that their adjustment and reform efforts and overall progress in poverty reduction was acceptable.

cancellation of their debt to the Fund outstanding as of end-2004 (less amounts repaid prior to the point at which the additional debt relief is delivered).

23. **In operational terms, the three qualification criteria could be further clarified as follows:**

- *The assessment of satisfactory macroeconomic performance* would be relatively straightforward in cases where a Fund-supported program is in place. A country would be found to meet this requirement if a program review has been completed within four months of the implementation date. If more than four months have elapsed since the review has been completed, staff would have to assess whether the macroeconomic conditions required for the completion of the review remain valid. For countries that do not have a Fund arrangement at the time of implementation, staff would have to assess (and the Board confirm) whether macroeconomic policies are compatible with the maintenance of low inflation and fiscal sustainability.[15]

- *The assessment of satisfactory implementation of the PRS* would require an assessment by staff that the country has satisfactorily followed the strategy described in the PRSP for at least one year prior to the date of the assessment. For countries with a PRGF, a recently completed PRGF review could be evidence of satisfactory implementation of the PRS. This would not necessarily be the case for a review under a stand-by or extended arrangement.[16] For these countries, as well as countries without a Fund arrangement, an evaluation of the implementation of any existing PRSP will be needed. If the PRSP is outdated, then the country would have to resume the PRSP process.[17]

- *An assessment that public expenditure management systems are being enhanced to increase governance and transparency* would also be required; this assessment could be informed in part by indicators and analysis prepared by the World Bank. It could compare the situation of one or more relevant indicators (such as progress in strengthening PEM systems, as reported in the joint Bank-Fund reviews of such systems, or the Bank's CPIA) and compare them to the levels reached at completion

[15] For post-completion-point HIPCs that otherwise meet the three criteria, there seems to be no reason to require that the country obtain an arrangement from the Fund in order to qualify for additional debt relief. Currently, three post-completion-point HIPCs (Ethiopia, Madagascar and Mauritania) do not have an arrangement with the Fund, while two (Nicaragua and Uganda) have arrangements that expire before January 1, 2006.

[16] Conversely, delay in, or non completion of, a PRGF review may be due to factors beyond the PRS and may not necessarily indicate that the implementation of the PRS has been unsatisfactory.

[17] This would entail significant resource costs for staff and the authorities, and would also have timing implications for the provision of additional debt relief to the member.

point: unchanged or improved levels would be required to qualify for additional debt relief. Here again, a recently completed PRGF review could also provide evidence of ongoing improvements in the areas of governance and transparency standards are being met, given that public expenditure management assessment and action plans (AAP) have been prepared by the Fund and World Bank staffs for all post-completion-point countries. In addition, an assessment by staff that the country collaborates with the Fund and provides appropriate information in the context of surveillance or use of Fund resources would be needed.

24. **For countries whose performance has lapsed in any of the three criteria, or whose Fund-supported program is otherwise off-track, clear evidence should be required that they meet the criteria before the delivery of additional debt relief.**

- As regards the macroeconomic performance criterion, the requirement could be of a minimum period (six months, for example) of satisfactory performance under a Fund arrangement (or another instrument, such as the PSI). This is the same requirement that pre-completion-point countries have to meet to reach completion point.

- For the PRS criterion, production of a PRSP or progress report and satisfactory implementation of the related strategy for a minimum of one year, possibly in the context of a Fund-supported program. Again, this condition is similar to that required to reach completion point.

- When the lapse is of a structural nature or gives rise to a concern about governance, it would seem appropriate to require commensurate corrective action before the country would qualify for additional debt relief.

B. Ongoing Conditionality

25. **Ongoing conditionality (i.e., conditionality over a substantial period of the time during which relief is to be delivered) can influence the policies and behavior of the beneficiaries of debt relief and help ensure that resources freed by the additional debt relief are not misused.** Its objective would be to encourage countries to continue to adhere to sound policies, including the broad principles of good governance, accountability and transparency that are seen as essential for making progress toward the MDGs, while providing safeguards against any lasting lapse in these areas: if a country's performance were to deteriorate, the provision of debt relief would be suspended until appropriate conditions are restored. In particular, ongoing conditionality could help protect against risks of cross-subsidization of other creditors, by suspending debt relief in cases where recipient countries would contract new, unproductive debt, particularly from nonconcessional sources. If ongoing conditionality were to be applied for additional debt relief, it would have to apply to both pre-and post-completion-point HIPCs.

26. **However, ongoing conditionality has some disadvantages as well**. Ongoing conditionality would make the amount and timing of debt relief less predictable for recipient

countries. It could reduce the degree of country ownership in, and thus the effectiveness of, the PRS. Moreover, implementation of ongoing conditionality could add to the administrative costs of debt relief for both recipients and donors, in circumstances when both groups already find current procedures under the PRS approach excessively cumbersome. To qualify for additional debt relief, they must demonstrate sustained macroeconomic and governance capacities. Beneficiary countries will likely be subject to extensive conditionality, including in the areas of public expenditure management and governance more broadly, in their programs with multilateral and bilateral donors, including in many cases the Fund, for the foreseeable future. Also, conditionality that would continue until the maturity of the debt being cancelled would represent a far more stringent requirement for debt relief than the Fund has applied in the context of the HIPC Initiative, with no clear justification.

27. **Phased or tranched delivery of the additional debt relief over a more limited period of time could be a less onerous form of ongoing conditionality**. Such debt relief could be based on the attainment of conditions on additional test dates (one or more) beyond the completion point.[18] This would be akin to the delivery of debt relief under the enhanced HIPC Initiative.[19] Tranched delivery under the enhanced HIPC Initiative may have supported the observed increase in poverty-reduction expenditures in beneficiary countries.

28. **Overall, staff consider that through the criteria associated with entry conditionality—essentially those required to get to the HIPC completion point—countries will have demonstrated improved performance in key areas for a sustained period of time.** In that context, the cost of adding ongoing conditionality for the debt relief to be provided under the G-8 proposal could well outweigh its potential benefits.

C. Entry Conditionality for Non–HIPCs

29. **If the Board were to expand the G-8 proposal to include non–HIPCs, what sort of conditionality should apply?** To ensure a consistent treatment of beneficiaries, it should be broadly similar to that applied to HIPCs. This does not imply, however, that non–HIPCs should face the same entry conditionality as pre-completion-point HIPCs. The path to completion point has been tailored to the specific context of the HIPC Initiative, that aims at enrolling the participation of a broad range of creditors and targets countries whose performance has tended to be below average, as reflected by their unsustainable debt burdens. Replicating this path for non–HIPCs could unnecessarily delay the date at which they would qualify for debt cancellation, thus reducing the amount of relief that they would

[18] These conditions could coincide with those of a Fund arrangement or they could go beyond it.

[19] Under the HIPC Initiative, the Fund provides interim assistance in the period between the decision point and the completion point, and the remaining relief is provided irrevocably at the completion point.

receive because of the repayments undertaken during that period. It seems more fitting to assess non–HIPCs against the same criteria applied to post-completion-point HIPCs: their performance in regard to macroeconomic stability should be satisfactory, they should be making adequate progress under their PRSs (or be progressing towards one), and they should meet minimum standards regarding governance and transparency. Similarly, in case of performance problems, the establishment of a track record should be required for qualification for debt relief. Ongoing conditionality, if any were to be applied, should also be the same for HIPCs and non HIPCs.

D. Coordination with the World Bank

30. **The G-8 debt cancellation proposal differs from the HIPC Initiative in regards to the degree of cooperation and coordination expected between the Fund and the World Bank as well as other creditors**. The HIPC Initiative is a joint initiative of the Fund and the Bank under which both institutions move in lockstep in the application of conditionality[20] and the delivery of debt relief. The G-8 proposal calls for both institutions to forgive the debt of 35 HIPCs with the same cutoff date, though the precise implementation dates could be different.[21] In addition, the G-8 proposal calls on the Fund and the Bank to monitor and report on the use of resources freed up by debt cancellation. This approach is consistent with the logic of the G-8 proposal in that it does not assume any conditionality beyond the completion point.

31. **There would be sizeable benefits for the institutions involved in cooperating, particularly in the area of conditionality.** For example, assessments of the qualification of post-completion-point HIPCs for additional debt relief could take advantage of the specialized knowledge of the staffs of the Fund and the World Bank, with each institution providing input to the other in its respective area of expertise. The same degree of coordination would also be justified should ongoing conditionality be applied.

32. **The Fund and the World Bank could explore ways to collaborate on a framework for monitoring and reporting on MDG-related spending after debt relief**, as well as on progress in strengthening transparency and accountability and in the battle against corruption.[22] Here again, the reporting framework should take advantage of the respective expertise of each institution and, to the extent possible, rely on existing mechanisms and

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[20] The Boards of both institutions need to agree on the specific completion point triggers in each case and both Boards need to be satisfied (in the case of the Fund, the nonobservance of any trigger conditions needs to be waived) before assistance can be delivered at the completion point.

[21] Another important difference between the G-8 proposal and the HIPC Initiative is that all creditors participate in the HIPC Initiative.

[22] Given the fungibility of resources, it would not be possible to establish a direct link between the resources made available through debt relief and government spending.

processes. On the Fund side, the monitoring and reporting could follow a format broadly similar to that used for post-program monitoring. When relevant, it would be included into Article IV policy discussions, and in a synthesized form into the joint HIPC Initiative progress report.

IV. Issues Related to the Protracted Arrears Cases

33. **The modalities now envisaged by the G-8 proposal would not allow the three protracted arrears cases (Liberia, Somalia and Sudan) to receive debt relief beyond the HIPC thresholds.** In the Executive Board discussion on August 3, 2005, the G-8 said that donors would commit to provide the extra resources necessary for debt cancellation at completion point for three protracted arrears cases. However, normalizing these countries' financial relations with the Fund will require the clearance of all their arrears to the Fund. This would extinguish the debt stock that they owed to the Fund as of end-2004, thereby making them ineligible for debt cancellation under the G-8 proposal, since this proposal targets debt existing as of end-2004, excluding new lending. Under the modalities that have been used in the past, the clearance of arrears would be likely to be followed by large disbursements under a PRGF arrangement, possibly topped up with EFF assistance. Once these countries reach the completion point, they would be eligible for the irrevocable delivery of HIPC debt relief (and additional bilateral debt relief from Paris Club creditors), but this would still leave them with a sizable debt to the Fund.[23] [24]

34. **Special provisions could be established to ensure that the three protracted arrears cases receive the additional debt relief contemplated under the G-8 proposal.** This could be achieved through different modalities (e.g., through the full or partial grandfathering of their existing debt to the Fund as of end-2004, or through a change in the cutoff date to the decision point). Each of these options has benefits and drawbacks, and each imply a different cost to the Fund. These options could be considered by the Board at a time when domestic and international conditions appear to allow for a comprehensive solution of the issue.

V. Financial Implications

35. **At their August 3 meeting, Directors had an initial discussion of the implications of the G-8 proposal for the Fund's finances**. The discussion covered a number of inter-related issues, including the cost of the proposal and its financing, its impact on the Fund's

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[23] Arrears clearance is likely to be facilitated by a rights accumulation program, which allows members to establish a solid track record on policies and payments to the Fund and, on this basis, accumulate "rights" to use Fund resources that are encashed under a successor arrangement following the settlement of arrears.

[24] Depending on the circumstances and amounts involved, similar issues could also arise in connection with other members with protracted arrears to the Fund.

income position and balance sheet, and the size and modalities of the Fund's future concessional lending. Directors called for additional staff analysis of these issues, including with respect to the implications of the G-8 proposal for the likely remaining resources for the interim PRGF, the options for increasing the commitment capacity of the self-sustained PRGF, and additional resource needs. This section responds to these requests and provides further analysis of the impact on the Fund's finances.

A. Cost of the G-8 Proposal

36. **Staff has updated its estimates of the cost of the G-8 proposal for the Fund.** The main change from the estimates presented in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund (7/20/05)* is the use of differentiated country-by-country completion point dates as effective debt relief dates for pre-completion-point countries, with a fixed cutoff date of end-December 2004 on eligible debt. Staff has also considered the costs associated with extending debt relief to two additional countries (Cambodia and Tajikistan), as discussed above.

Revised Cost Estimates

37. **The use of country-specific completion points as effective dates for debt relief for pre-completion-point countries lowers the cost of the proposal to the Fund somewhat**. Previous staff estimates used a simplifying assumption under which debt relief would apply to the pre-cutoff debt stocks outstanding at end-2005 (Table 2). This assumption is maintained for the 18 countries that have already reached completion point, but for the 17 remaining HIPCs, the debt relief date is assumed to coincide with the projected completion point date. This reduces the cost of providing debt relief to these countries by about SDR 125 million (Table 3).[25] This reduction reflects three partially-offsetting factors:

- For the 17 pre-completion point countries, pre-cutoff date Fund credit outstanding at completion point is projected to be lower than that outstanding at end-2005, reflecting forthcoming principal repayments. This reduction is estimated at about

[25] To be comparable with the earlier estimates, these data are presented in NPV terms at end-2005.

Table 2. Fund Credit Outstanding to PRGF-Eligible Countries, 2004—2005
(In millions of SDRs; as of end-2004)

	GRA	PRGF/SAF	Total 1/ (A)	Projected principal repayments during 2005 (B)	Projected credit outstanding at end-2005 resulting from disbursements made prior to January 1, 2005 (A-B)
Completion point countries (18)	**102**	**2,644**	**2,746**	**482**	**2,264**
1 Benin	-	42	42	6	36
2 Bolivia	102	96	198	25	173
3 Burkina Faso	-	74	74	12	62
4 Ethiopia	-	118	118	6	112
5 Ghana	-	302	302	36	265
6 Guyana	-	57	57	12	45
7 Honduras	-	126	126	18	107
8 Madagascar	-	145	145	8	137
9 Mali	-	93	93	18	75
10 Mauritania	-	58	58	10	49
11 Mozambique	-	127	127	20	107
12 Nicaragua	-	160	160	19	140
13 Niger	-	87	87	10	78
14 Rwanda	-	59	59	7	53
15 Senegal	-	131	131	31	100
16 Tanzania	-	272	272	38	234
17 Uganda	-	123	123	36	88
18 Zambia	-	573	573	171	403
Decision point countries (10)	**18**	**1,104**	**1,122**	**73**	**1,048**
19 Burundi	-	26	26	-	26
20 Cameroon	-	215	215	27	188
21 Chad	-	62	62	10	51
22 Congo, Dem. Rep. of	-	527	527	-	527
23 Gambia, The	-	16	16	1	15
24 Guinea	-	79	79	14	64
25 Guinea-Bissau	0	10	10	2	8
26 Malawi	17	42	60	12	47
27 Sao Tome & Principe	-	2	2	0	2
28 Sierra Leone	-	126	126	6	120
Pre-decision point countries (7)	**11**	**279**	**290**	**85**	**205**
29 Central African Republic	6	23	28	3	25
30 Comoros	-	-	-	-	-
31 Republic of Congo	5	13	19	8	11
32 Cote d'Ivoire	-	201	201	62	139
33 Lao P.D.R.	-	25	25	4	20
34 Myanmar	-	-	-	-	-
35 Togo	-	17	17	8	10
Subtotal of 35 HIPCs	**130**	**4,027**	**4,157**	**640**	**3,517**
Protracted arrears HIPCs (3)	**1,666**	**127**	**1,793**	**…**	**1,793**
36 Liberia 2/	479	30	509	…	509
37 Somalia 2/	205	18	222	…	222
38 Sudan 2/	983	79	1,062	…	1,062

Table 2. Fund Credit Outstanding to PRGF-Eligible Countries, 2004—2005 (continued)
(In millions of SDRs; as of end-2004)

	GRA	PRGF/SAF	Total 1/ (A)	Projected principal repayments during 2005 (B)	Projected credit outstanding at end-2005 resulting from disbursements made prior to January 1, 2005 (A-B)
Non-HIPC countries (40)	**633**	**2,629**	**3,262**	**371**	**2,803**
39 Afghanistan	-	-	-	-	-
40 Albania	-	62	62	6	56
41 Angola	-	-	-	-	-
42 Armenia, Rep. of	1	139	140	23	117
43 Azerbaijan	38	96	134	33	102
44 Bangladesh	-	149	149	-	149
45 Bhutan	-	-	-	-	-
46 Cambodia	-	63	63	6	57
47 Cape Verde	-	6	6	-	6
48 Djibouti	-	14	14	1	13
49 Dominica	3	3	6	0	6
50 Eritrea	-	-	-	-	-
51 Georgia	2	169	171	37	135
52 Grenada	6	-	6	-	6
53 Haiti	-	6	6	3	3
54 India	-	-	-	-	-
55 Kenya	-	66	66	5	61
56 Kiribati	-	-	-	-	-
57 Kyrgyz Republic	-	133	133	21	112
58 Lesotho	-	25	25	-	25
59 Maldives	-	-	-	-	-
60 Moldova, Rep. of	54	28	81	15	67
61 Mongolia	-	28	28	4	24
62 Nepal	-	14	14	-	14
63 Nigeria	-	-	-	-	-
64 Pakistan	165	1,043	1,208	72	1,136
65 Papua New Guinea	41	-	41	25	17
66 Samoa	-	-	-	-	-
67 Solomon Islands	-	-	-	-	-
68 Sri Lanka	151	38	189	26	163
69 St. Lucia	-	-	-	-	-
70 St. Vincent and Grenadines	-	-	-	-	-
71 Tajikistan, Rep. of	-	79	79	9	69
72 Timor Leste	-	-	-	-	-
73 Tonga	-	-	-	-	-
74 Uzbekistan, Rep. of	12	-	12	12	-
75 Vanuatu	-	-	-	-	-
76 Vietnam	-	179	179	36	142
77 Yemen, Rep. of	33	209	242	37	205
78 Zimbabwe 2/ 3/	126	81	207	…	119 4/
Total	**2,430**	**6,783**	**9,213**	**1,011**	**8,114**

1/ Excludes HIPC assistance disbursed to Umbrella Accounts and not yet used.
2/ Credit outstanding includes interest arrears.
3/ Zimbabwe is not PRGF eligible due to its arrears to the PRGF Trust.
4/ Stock of arrears outstanding as of end-August 2005.

Table 3. Fund Credit Outstanding to 35 HIPCs 1/
(In millions of SDRs)

	Completion point countries (18)	Decision point countries (10) 2/	Pre-decision point countries (7) 2/	Total of 35 HIPCs
A. Credit outstanding at end-2004	2,746	1,122	290	4,157
B. Projected repayments in 2005	482	73	85	640
Of which: covered by HIPC assistance	295	21	-	317
C. Projected credit outstanding at end-2005 (A-B)	2,264	1,048	205	3,517
D. Projected repayments (end-2005 through completion point)	-	63	154	218
Of which: covered by HIPC assistance	-	15	86	101
(In end-2005 NPV terms)	-	15	80	95
E. Projected credit outstanding at completion point (C-D) 3/	2,264	985	50	3,300
F. Projected credit outstanding at completion point (in end-2005 NPV terms)	**2,264**	**956**	**44**	**3,264**
Memorandum items:				
G. Reduction in credit outstanding from the previous estimates (SM/05/284) (C-F)	**-**	**92**	**161**	**253**
H. Additional costs (in end-2005 NPV terms)	-	37	92	129
Uses of interim HIPC assistance	-	15	80	95
Additional subsidy needs	-	23	12	35
I. Revised cost estimates (F+H)	2,264	993	136	3,394
J. Net reduction in debt relief cost from SM/05/284 (G-H)	**-**	**55**	**69**	**124**

1/ Stock of credit outstanding is related to disbursements made prior to end-2004.
2/ Since the issuance of SM/05/284, one country–Burundi–has reached the decision point.
3/ For the 18 completion point countries, the stock of Fund credit outstanding is as of end-2005.

SDR 255 million (in end-2005 NPV terms), based on the assumptions (made jointly with World Bank staff) regarding the possible timeframe for these 17 countries to reach completion point.

- This reduction would be partially offset by the cost of providing interim HIPC assistance to these countries between decision and completion point. The provision of such assistance is contemplated under the HIPC Initiative.[26] Although the amounts involved are difficult to estimate in advance, current staff estimates suggest that the cost to the Fund of providing interim assistance for the 17 pre-completion point countries could be about SDR 95 million.

- There would be a further partial offset (estimated at about SDR 35 million) associated with the additional subsidy resources needed on PRGF lending to these countries prior to completion point.

38. **With different completion point dates, the cost of the G-8 proposal for the 35 HIPCs is estimated at about SDR 3.4 billion in end-2005 NPV terms**. As discussed in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund (7/20/05)*, part of this cost is already being financed through the enhanced HIPC Initiative, so that the incremental cost is somewhat lower. Table 4 updates the earlier calculations of the incremental cost (see Table 5 of *The G-8 Debt Cancellation Proposal and Its Implications for the Fund (7/20/05)*) under the assumptions described above. The main changes from the earlier estimates are: (i) a lower overall stock of credit eligible for cancellation of SDR 3.3 billion, reflecting the later effective debt relief date for pre-completion point countries (Line A); (ii) a lower HIPC Umbrella Account balance at debt relief date reflecting the amount of HIPC assistance that would now be disbursed as interim relief prior to completion point (Line B); and (iii) lower subsidy savings (Line C). As a result, the incremental cost of the proposal would be about SDR 2.1 billion, compared with SDR 2.2 billion estimated previously.

Additional Costs

39. **As noted in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund (7/20/05)*, the G-8 proposal acknowledged, but did not quantify, two additional costs associated with debt relief.** These are the costs related to debt relief for the three protracted arrears cases (Liberia, Somalia, and Sudan) and the costs of debt relief for other countries that become eligible for HIPC assistance under the extended sunset clause. In both cases, however, the G-8 proposal noted that donors would commit to provide the needed resources

[26] Under the terms of the PRGF-HIPC Trust, the Fund may provide interim HIPC assistance between decision and completion points up to a normal maximum of 20 percent of the total assistance committed at decision point per year, and 60 percent in total.

for these costs. Staff estimates of the cost of providing debt relief to the three protracted arrears cases remain unchanged at SDR 1.8 billion. As for other potential

Table 4. Incremental Cost of Proposed Debt Relief to 35 HIPCs 1/
(In millions of SDRs; in end-2005 NPV terms)

	Completion point countries (18)	Decision point countries (10)	Pre-decision point countries (7)	Total
A. Projected credit outstanding subject to debt relief 2/	2,264	956	44	3,264
B. Projected HIPC Umbrella Account balance at debt relief date	311	400	133	845
Subtotal (A-B)	**1,953**	**556**	**(89)**	**2,420**
C. Potential subsidy savings as result of proposed debt relief	220	96	3	319
Incremental cost of proposed debt relief (A-B-C)	**1,732**	**460**	**(92)**	**2,101**

1/ Assuming that debt relief to the 18 completion point countries takes place at end-2005; for the remaining 17 HIPCs, debt relief would be provided at completion point dates.
2/ Projected credit outstanding is related to disbursements made prior to end-2004.

new HIPCs, the results of preliminary analysis by World Bank and Fund staffs of the HIPC eligibility list under the ring-fencing exercise are reported in the HIPC Status of Implementation.[27] As noted therein, final results will not be available until early 2006, but based on the available analysis so far, four additional countries—Eritrea, Haiti, Kyrgyz Republic, and Nepal—have estimated debt burden indicators above the HIPC threshold using end-2004 data. At end-2004, Fund credit outstanding to these four countries amounted to SDR 154 million. This total is projected to decline to SDR 129 million at end-2005 (Table 2). Five other countries (Bangladesh, Bhutan, Myanmar, Sri Lanka and Tonga) presented incomplete data that precluded a conclusion at this time. Fund credit outstanding to these five countries totaled SDR 338 million at end-2004. It is projected to decline to SDR 312 million at end-2005 (Table 2). Debt relief to new HIPCs would be an additional cost for the Fund.

40. **As discussed above, modifying the G-8 proposal to address uniformity of treatment issues regarding the use of SDA resources would imply adding two countries to the list eligible for debt cancellation.** These two countries (Cambodia and Tajikistan) had Fund credit outstanding of SDR 141 million at end-2004. Further consideration would need to be given to the steps required for these countries to qualify for debt relief, but for preliminary costing purposes, it is assumed here that they could qualify by end-2006. On this basis, the additional cost for the Fund of debt relief for these two members could be about SDR 110 million. This would add to the financing needs associated with the G-8 proposal.[28]

[27] *Heavily Indebted Poor Countries Initiative—Status of Implementation* (8/22/05).

[28] Extending debt relief to a larger group of member countries would be more costly to the Fund.

B. Financing Sources

41. **Under the G-8 proposal as modified to address uniformity of treatment issues as discussed above, financing sources would be the same as envisaged previously, but the mix would be different.** The original proposal envisaged three financing sources: SDR 2.5 billion of resources held in the SDA;[29] the balance of SDR 0.3 billion in the HIPC Umbrella Account; and SDR 0.7 billion from the PRGF Subsidy Account. Under the revised modalities, the main financing sources would be as follows (see Table 5; all figures are in end-2005 NPV terms):

- Pursuant to a decision adopted by an 85 percent majority of the total voting power, SDA resources would be used to meet the cost of providing full debt relief at completion point to members with per capita incomes below US$380. The estimated cost of providing such debt relief to 21 HIPCs below this income cutoff is about SDR 1.4 billion. In addition, two non–HIPC countries (Cambodia and Tajikistan) would be eligible for debt relief using SDA resources based on this criterion, with an estimated cost of about SDR 110 million. Since this would be an added cost with respect to the original G-8 proposal, new bilateral contributions could be sought to compensate this cost. The G-8 proposal includes a commitment to provide the Fund up to US$350-500 million in additional resources to meet difficult-to-foresee costs, and the need for new bilateral grant contributions to compensate for this cost could be considered in that context.[30]

- SDA resources would also be used to provide HIPC assistance (SDR 0.4 billion) at completion point for the 17 countries that have not yet reached that stage and interim HIPC assistance (SDR 0.1 billion) to these countries between decision and completion points. These amounts would be additional to the SDR 0.3 billion held in the HIPC Umbrella Account.

[29] This balance comprises two elements: the corpus of SDR 2.2 billion and investment income of SDR 0.3 billion.

[30] SDA resources that are committed for debt relief under the proposal would in principle be available to all members with incomes below the per capita income threshold that reach the completion point under the HIPC Initiative or otherwise have Fund credit outstanding, including protracted arrears and other HIPC sunset clause cases. The cost of debt relief for these cases would be offset, however, by the additional resources that the G-8 proposal contemplates is to be made available for the protracted arrears and other sunset clause cases.

Table 5. Sources and Uses of Financing
(In billions of SDRs; in end-2005 NPV terms)

A.	**Sources of financing at end-2005**	**4.7**
	SDA	2.5
	Umbrella Account	0.3
	PRGF Subsidy Account	1.7
	PRGF-HIPC Trust	0.1
	Projected additional inflows 1/	0.1
B.	**Uses of financing for debt relief** 2/	**3.4**
	SDA resources for:	
	21 HIPCs with per capita income below US$380	1.4
	Debt relief to Cambodia and Tajikistan	0.1
	HIPC assistance at completion point for the 17 decision and pre-decision point countries	0.4
	Umbrella Account	0.3
	Bilateral contributions from the PRGF Subsidy Account for 14 HIPCs with per capita income above US$380	1.1
C.	**Remaining resources after debt relief**	**1.3**
	Minus: Projected uses of HIPC interim assistance	0.1
D.	**Available resources for subsidizing existing and future interim PRGF** 3/	**1.2**

1/ Mainly reflects projected interest income on bilateral deposit agreements with the PRGF-HIPC Trust.

2/ Excludes HIPC assistance and debt relief to potential sunset clause countries and protracted arrears cases, as discussed in the text.

3/ Includes resources needed for repaying the PRGF Reserve Account associated with early transfers of SDR 43.5 million for HIPC disbursements.

- Resources in the PRGF Subsidy Account provided by bilateral contributors could be used with contributor consent to meet the remaining cost of providing full debt relief for the eligible list of HIPCs with a per capita income above US$380. Preliminary staff estimates suggest that the amount required would be about SDR 1.1 billion.

42. **Relative to the G-8 proposal, this implies more use of resources from the PRGF Trust Subsidy Account for debt relief and less use of SDA resources.** This approach would leave a balance of resources in the SDA of about SDR 0.5 billion,[31] which would be used to replenish the Subsidy Account in order to sustain the Fund's existing and future interim PRGF lending.[32]

43. **Of the resources currently held in the PRGF Trust Subsidy Account, only the resources attributable to bilateral contributors are potentially available for financing debt relief on a non-uniform basis**. These resources could be reallocated to financing debt relief with the consent of the contributors. The Subsidy Account also holds a contribution from the Fund, which was made in 1994 through a one-time transfer from the resources in the SDA and is governed by the same uniformity of treatment requirements as other SDA resources. Thus, in order to determine the amount of Subsidy Account resources potentially available for debt relief, it is necessary to know the share of bilateral contributors in the Subsidy Account.

44. **The estimated breakdown of resources in the Subsidy Account is discussed in Box 1**. As of end-April 2005, 43 member countries have made contributions to the Subsidy Account. Most involved explicit cash contributions, either directly in the form of grants or indirectly through the interest income earned on deposits placed with the Subsidy Account. The sum of these contributions has amounted to SDR 2.1 billion, while the Fund's contribution was SDR 0.4 billion. Interest income earned on the balance in the Subsidy Account has amounted to SDR 0.9 billion. Total disbursements from the Subsidy Account so far have amounted to SDR 1.7 billion. In addition, four members have provided implicit contributions in the form of loan agreements with the PRGF Trust at below-market interest

[31] This would consist of the SDA corpus only, as all investment income would be used, in line with the current decisions, for HIPC operations.

[32] SDA resources may be used for three purposes: (i) to make transfers to the GRA; (ii) for operations and transactions consistent with the purposes of the Fund, including the provision of balance of payments assistance on special terms to developing countries; and (iii) for distribution to developing countries.

Box 1. Subsidy Account of the PRGF Trust

The purpose of the Subsidy Account of the PRGF Trust is to subsidize the rate of interest on PRGF loans to low-income countries to ½ of 1 percent a year. As of end-June 2005, 43 member countries had made contributions to the Subsidy Account.

The table below presents the shares of bilateral contributors and the Fund in total contributions to the Subsidy Account. These contributions comprise two forms: (i) cash contributions in the form of grants or interest income on deposits with the Subsidy Account; and (ii) implicit contributions in the form of loan agreements with the Trust at below-market interest rates, calculated as the difference between the interest that outstanding drawings would have earned at the six-month SDR interest rate and the actual concessional rate paid to loan providers. The allocation of the balance of the Account (SDR 1.7 billion as of end-June 2005) is based on the accumulated balance for each contributor, taking into account the following considerations:

- The calculations are based on monthly data;
- Monthly average balances consist of principal cash contributions plus accumulated monthly allocated income;
- Net investment income is allocated only to cash contributors (based on the accumulated monthly average balance for each contributor); and
- No income is allocated to implicit contributions, as no direct investment income is derived from these contributions.

These calculations do not take into account contributions that are yet to be received. Any such remaining disbursements are, however, included in staff's forward-looking calculation of subsidy contributions on an "as needed" basis (see, for example, Appendix Table 3, *Review of PRGF-HIPC Financing, the Adequacy of the Reserve Account of the PRGF Trust, and Subsidization of Emergency Assistance (3/23/05).*

PRGF Trust Subsidy Account— Shares of Members' Contributions
(In percent of total; end-June 2005)

	Contributor	Share of Total		Contributor	Share of Total
1	Argentina	0.8	25	Luxembourg	0.3
2	Australia	0.3	26	Malaysia	0.8
3	Austria	1.5	27	Malta	-- 1/
4	Bangladesh	-- 1/	28	Morocco	0.2
5	Belgium	2.8	29	Netherlands	3.4
6	Botswana	-- 1/	30	Norway	1.1
7	Canada	6.0	31	Pakistan	-- 1/
8	Chile	0.1	32	Portugal	0.1
9	China	0.3	33	Saudi Arabia	0.4
10	Czech Republic	0.3	34	Singapore	0.5
11	Denmark	1.7	35	Spain	0.2
12	Egypt	0.3	36	Sweden	4.6
13	Finland	1.1	37	Switzerland	2.8
14	France	8.3	38	Thailand	0.3
15	Germany	4.7	39	Tunisia	-- 1/
16	Greece	1.0	40	Turkey	0.2
17	Iceland	0.1	41	United Kingdom	11.1
18	India	0.2	42	United States	4.2
19	Indonesia	0.2	43	Uruguay	-- 1/
20	Iran	-- 1/			
21	Ireland	0.2		**Share of bilateral contributors**	**85.6**
22	Italy	5.9		IMF contribution (transfer from SDA)	14.4
23	Japan	18.1			
24	Korea	1.5		**Total contributions**	**100.0**

Memorandum item:
Total resources in PRGF Subsidy Account (in millions of SDRs) **1,717**

1/ Share is less than half of a significant digit.

rates (this reduces the need for subsidy resources to support the Fund's concessional lending).[33]

45. **The balance in the PRGF Subsidy Account at end-June 2005 amounted to SDR 1.7 billion**. Based on the above, the share of bilateral contributors would be about SDR 1.4 billion, or 85½ percent of the total, while the share of SDA resources would be SDR 0.2 billion.[34] The former would thus be sufficient in principle to meet the estimated needs to provide debt relief under the proposal as discussed above, though it would leave a relatively small margin.

46. **Use of Subsidy Account resources from bilateral contributors for debt relief would require an amendment of the PRGF Trust Instrument.** Since no SDA resources in the Subsidy Account would be used for debt relief, the relevant decision can be adopted by a majority of the votes cast. However, as indicated in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund* (7/20/05), such an amendment would require the consent of all 43 bilateral contributors to the Subsidy Account.[35] If a bilateral contributor decides not to consent, a veto could be avoided by returning in full to the contributor the current resources attributable to that contributor. As a further alternative, the amendment could provide that a contributor could consent to the amendment, but on the condition that the portion of Subsidy Account resources attributed to it be kept in the Subsidy Account for the continued purpose of subsidizing PRGF lending.

C. Impact on the Interim PRGF

47. **The overall impact on interim PRGF lending of these modalities of implementing the G-8 proposal is broadly similar to that presented in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund* (7/20/05) but the composition of**

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[33] Two contributors provided both cash and implicit contributions.

[34] Under the provisions of the PRGF Trust Instrument, any resources remaining in the Subsidy Account at the end of the life of the Trust will be distributed to the Fund, donors, and lenders that have contributed to the subsidy operation, in proportion to their contributions. This principle is applied here. See Decision No. 8759-(87/176) ESAF, December 18, 1987, as amended, *Annex—Instrument to Establish the Poverty Reduction and Growth Facility Trust,* Section IV, Paragraph 6.

[35] The Fund has previously amended "protected" provisions of the PRGF (ESAF) Trust Instrument subject to the consent of contributors. See, e.g., *Decision No. 10530-(93/170), 12/15/93, and Decision No. 10532-(93/170), 12/15/1993* (Reserve Account protected provision amended to allow for a transfer of SDR 400 million from the Reserve Account to the Subsidy Account); *Decision No. 11434-(97/10), 02/04/97, and Decision No. 11610-(97/113), 11/24/97* (Reserve Account protected provision amended to allow for the transfer of up to SDR 250 million from the Reserve Account to the PRGF-HIPC Trust); and *Decision No. 12087-999/118), 10/21/99* (purposes of the PRGF Trust amended in the context of the transformation of the ESAF into the PRGF).

financing would be different. About SDR 1.1 billion of Subsidy Account resources would need to be allocated to debt relief to 14 HIPCs with per capita income above US$380. At the end of the debt relief operation, this would leave an estimated balance of SDR 0.5 billion in the Subsidy Account and SDR 0.5 billion in the SDA (all in end-2005 NPV terms). If the latter amount was transferred to the Subsidy Account to support the Fund's continued concessional lending operations, this would exhaust the SDA and leave a balance of SDR 1 billion in the Subsidy Account. Taking account of a small balance (less than SDR 0.1 billion) in the PRGF-HIPC Trust and the expected future inflows of about SDR 0.1 billion to the PRGF and PRGF-HIPC Trusts, this would leave total resources of about SDR 1.2 billion available for subsidizing existing and future interim PRGF loans.

48. **On current projections, the available subsidy resources could allow new loan commitments under the interim PRGF of about SDR 1.9 billion**. This is less than the remaining PRGF loan resources (SDR 2.7 billion), suggesting that interim PRGF operations would be curtailed as a result of the proposal (in addition to the broader impact of exhausting the SDA). To allow the full use of the available PRGF loan resources, compensation for debt relief to Cambodia and Tajikistan of SDR 110 million and additional subsidy resources of about SDR 100 million would be needed. These projections are highly sensitive to assumptions made regarding the future level of interest rates. Unusually low global interest rates in the past several years have reduced the subsidies needed to support PRGF lending (effectively also reducing the concessionality of that lending), and thus increased the projected volume of PRGF lending that could be supported with existing subsidy resources. Current projections are based on a gradual increase in interest rates towards more normal historical levels, as assumed in the WEO. A more rapid increase would reduce the amount of interim PRGF lending that could be supported with existing subsidy resources. Another area of uncertainty is the potential impact on demand for PRGF lending of introducing a new shocks facility, and of the G-8 debt relief proposal itself (see Annex I on demand for PRGF and shock financing). These caveats notwithstanding, new PRGF loan commitments have recently been running well below historical averages (see forthcoming review of PRGF-HIPC financing), suggesting that existing resources may be sufficient to allow the interim PRGF to continue well into 2007.

49. **The G-8 commits to ensure that the proposed debt relief would not undermine the Fund's financing capacity.** Specifically, the proposal includes commitments to provide additional resources to meet several potential needs. First, the proposal states that in situations where other existing and projected debt relief obligations cannot be met from the use of existing Fund resources (e.g., Liberia, Somalia, and Sudan), donors commit to provide the extra resources necessary. Second, the G-8 is committed, on a fair burden share basis, to cover the costs of countries that may enter the HIPC process based on their end-2004 debt burdens under the extended sunset clause. Third, the G-8 will provide, on a fair burden share basis, up to US$350-500 million to cover difficult-to-forecast costs in excess of existing resources, over the next three years. As regards the last item, staff's updated assessment confirms that a resource envelope of US$350-500 million would be sufficient to cover two specific needs identified above—the cost for the Fund of adding two countries to the list

eligible for debt relief (about SDR 110 million on current estimates) and the additional subsidy resources needed to fully utilize available loan resources under the interim PRGF (about SDR 100 million). It would also include some allowance for the possible need for new donor contributions if any existing bilateral contributor to the PRGF Subsidy Account chose not to reallocate their contributions to debt relief. If these additional resources were not to be forthcoming, subsidy resources required to fully utilize existing loan resources would need to come from the PRGF Reserve Account, which would reduce the self-sustained lending capacity. Finally, the Board has agreed to establish a new shocks facility within the PRGF Trust and the G-8 proposal invites voluntary contributions, including from the oil-producing states, to a new trust fund to support poor countries facing commodity price and other exogenous shocks. [36]

D. Options for Self-Sustained PRGF Lending

50. **It has long been envisaged that, beyond the interim PRGF, the Fund's concessional lending could be financed from the resources accumulated in the PRGF Reserve Account on a self-sustained or revolving basis**. Staff's previous estimates suggested that the resources in the Reserve Account could maintain an annual self-financed lending capacity of SDR 0.6 billion in perpetuity. This projected lending capacity took into account the current balance in the Reserve Account (SDR 3.2 billion), and assumptions regarding the investment return on this balance and the initiation date of the self-sustained operation. It also took account of the need to continue providing adequate reserve coverage to existing PRGF Trust lenders. The projection was based on the assumption that the reimbursement of the GRA for PRGF administrative expenses would be financed from the SDA. Box 2 describes the relationship between the Reserve Account and the size of a self-sustained PRGF.

51. **Taking into account the impact of the G-8 debt cancellation proposal, staff projections indicate that demand for concessional financing could average about SDR 1 billion per year during 2007-11**. The approaches and assumptions used in arriving at this projection are described in Annex I. Demand for standard PRGF financing is projected to average about SDR 0.6 billion a year, while demand for loans under the shocks window could amount to SDR 0.4 billion. These projections are, of course, fraught with uncertainty and highly sensitive to specific assumptions. Staff is of the view, however, that it would be prudent for the Fund to be prepared to provide concessional financing at this level over the period 2007-11, and at similar levels for some time thereafter, given the likely balance of payments needs of low-income countries in their pursuit of the MDGs.

52. **During earlier discussions, most Executive Directors agreed that the estimated demand for future concessional financing on the order of SDR 1 billion per year over**

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[36] Staff estimates of potential demand for the shocks facility are discussed in Annex I.

the medium term would provide a reasonable frame of reference. On this basis, they expressed concern that the envisaged self-sustained PRGF, by relying solely on the resources

Box 2. Reserve Account and Self-Sustained PRGF Commitment Capacity

The terms of PRGF loans determine a law of motion over time for PRGF lending operations. As PRGF loans carry a grace period of 5½ years, there are only disbursements and no repayments during the early years, implying an increasing stock of credit outstanding during this period. When PRGF repayments eventually catch up with disbursements in the steady state, PRGF operations would become self-sustaining in the sense that the Reserve Account resources could be used on a revolving basis to provide PRGF loans with a 0.5 percent interest rate in perpetuity. The maturity profile of PRGF loans implies that an annual self-sustained lending capacity of, say, SDR 0.6 billion would require an underlying Reserve Account that is 7¾ times larger (i.e., SDR 4.7 billion).

The projected lending capacity of the self-sustained PRGF is, therefore, closely linked to the balance of the Reserve Account. At a given initial balance in the Account, the annual lending capacity would need to be calibrated just right in order to produce the self-sustained steady state. Too much or too little lending could lead to waves in future lending. In addition, factors that affect the accumulation of the balance in the Reserve Account will, of course, have an impact on the self-sustained capacity. These factors include the rate of investment return, transfers to the GRA to meet PRGF administrative expenses, expected repayments from the remaining outstanding credit under the Trust Fund and the SAF (mostly associated with the protracted arrears cases), and temporary use of Reserve Account resources by the PRGF-HIPC Trust.

Staff's estimate of an annual self-sustained PRGF lending capacity of about SDR 0.6 billion is based on the assumptions that the self-sustained operation would be launched in 2007 and that the rate of investment return would increase gradually from the current less than 3 percent to 5 percent per annum by 2010 and remain at that level thereafter. These projections have also taken into account the experience with the interim PRGF that disbursements are made typically over 3 to 4 years under PRGF arrangement. The underlying resource base for this lending capacity consists of: (i) a projected Reserve Account balance of SDR 3.4 billion at end-2006, which will grow further during the early years; and (ii) projected interest earnings on self-sustained PRGF loans during the same period.

Since the Reserve Account has historically provided reserve coverage to PRGF lenders at a ratio of 40 percent, the self-sustained commitment capacity is also affected by the profile of projected PRGF credit outstanding financed with bilateral loans. This factor has little to do with the Reserve Account balance; instead, it is sensitive to the assumed profile of interim PRGF commitments and disbursements.

The underlying framework for a self-sustained PRGF operation as described above suggests the need for greater flexibility in addressing uneven demand for PRGF financing. This would be possible by extending the current modalities of interim PRGF lending through continued use of bilateral loan resources for the funding of future PRGF operations, with subsidy resources being provided from the Reserve Account. This approach could allow for a higher lending capacity than SDR 0.6 billion a year through 2011, followed by the continuation of the subsidization at still a significant lending capacity thereafter. The approach would also preserve the option for the Executive Board to waive the reimbursement of PRGF administrative expenses if deemed necessary.

in the Reserve Account, would be insufficient to meet the projected financing needs, and considered that additional resources would be needed to raise this lending capacity.[37] Directors discussed the possibility of allowing a self-sustained PRGF to begin once interim PRGF resources are exhausted, and of augmenting its lending capacity with new bilateral loans. As discussed in previous papers, this approach could meet the projected financing needs in 2007–11, but it would significantly reduce the resources available in the Reserve Account for the continuation of self-sustained PRGF operations thereafter.

53. **An alternative approach would be to maintain the current framework beyond the interim period**. Under this approach, Reserve Account resources would be used to subsidize PRGF lending, with loan resources being provided by bilateral contributors. This approach would have several advantages: it would maintain the current interim PRGF lending framework, which is familiar and tested; it would be more flexible in addressing uneven demand for PRGF financing; and it would preserve the option for the Executive Board to waive the reimbursement of PRGF administrative expenses should it be deemed necessary (see below). Staff estimates suggest that the current Reserve Account balance could subsidize annual PRGF lending of SDR 0.6 billion in perpetuity under this approach.[38] Alternatively, a bigger lending capacity of SDR 1 billion a year could be subsidized through 2011; beyond 2011, the remaining resources in the Reserve Account would continue to generate investment income sufficient to finance the subsidization of an annual lending capacity at SDR 0.5 billion per year. This approach would require additional loan resources of SDR 1 billion per year in 2007–11.[39]

54. **A further alternative approach would be to separate regular PRGF operations from those related to shock financing in future lending modalities.** For PRGF operations, loan resources would be provided by bilateral lending as under the interim PRGF and secured and subsidized by the resources in the Reserve Account. As regards financing for exogenous shocks, loans would also be sought from bilateral creditors and secured by the Reserve Account, but subsidy resources would be met through new contributions, including

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[37] See, for instance, *The Fund's Support of Low-Income Member Countries: Considerations on Instruments and Financing* (PIN 04/40, 4/15/04).

[38] This is contingent, however, on not having used resources from the Reserve Account to substitute for the reduction in the resources of the Subsidy Account and subsidize interim PRGF lending. As mentioned in paragraph 49, using Reserve Account resources to fully utilize existing interim PRGF loans without being offset by additional bilateral contributions would reduce the lending capacity of the self-sustained PRGF.

[39] A variant to this approach (as noted in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund* (7/20/05)) would be to use Reserve Account resources to subsidize PRGF loans at an annual level of SDR 1 billion in 2007–11, followed by a self-sustained PRGF at SDR 0.6 billion per year on a revolving basis as envisaged previously. This would, however, be possible only if new bilateral subsidy resources of SDR 1.1 billion were provided.

the establishment of a separate trust fund, as envisaged under the G-8 proposal. This approach would maintain clarity in funding and lending arrangements and facilitate the mobilization of new subsidy resources for the shocks window, while also permitting the continuation of the subsidization of PRGF lending at SDR 0.6 billion per year in perpetuity. Based on the projected demand for shock financing, the implementation of this approach would require the mobilization of new subsidy resources of SDR 0.5 billion (in end-2005 NPV terms) for 2007–11. However, this structure could introduce undue rigidities in concessional lending operations (particularly given the overlap, mentioned above, between the demand for standard PRGF loans and the demand for shocks financing). It could, for instance, lead to a situation where access to one facility is preferred because of the availability of funds, rather than the specific balance of payments problem. Directors will have the opportunity to consider these issues in more detail in their discussion of implementation modalities for shocks financing.

E. Mitigating the Impact on the GRA

55. **At the August 3 Board meeting, Directors emphasized the importance of assessing the longer-term implications of using the Fund's own resources to ensure its overall financial integrity**. In particular, Directors asked staff to explore available options for (i) addressing the permanent impact of the 1999-2000 off-market gold transactions on GRA income, without increasing the burden shouldered by users of GRA resources, and (ii) reimbursing the GRA for SDA-related administrative expenses of the PRGF.

The Cost of the 1999-2000 Off-Market Gold Transactions

56. **The off-market gold transactions conducted in 1999-2000 generated the resources for the SDA but also led to an increase in the Fund's operating costs**. The transactions generated net proceeds (gold profits) of SDR 2.2 billion which were placed in the SDA to help finance the HIPC Initiative and the continuation of PRGF operations. The transactions were conducted "off-market" and, therefore, did not generate any new cash resources for the Fund. Since the generation of the net proceeds for the benefit of the SDA was accompanied by an enlargement of reserve tranche positions in the GRA, remuneration costs for the GRA increased. The cost increase for the GRA was about SDR 94 million on an annual basis at the time of the off-market transactions.[40]

57. **The impact on the Fund's income position of the off-market transactions has been mitigated through burden-sharing by adjusting the rates of charge and remuneration**. Since April 2000, the Board has annually reduced the net income target by SDR 94 million, and has placed the equivalent amount, raised through burden sharing, to the Fund's Special Contingent Account (SCA-1). This mechanism was designed to shield the

[40] The actual cost to the Fund of the increased remunerated positions varies with the SDR interest rate. At current interest rate levels, the cost is around SDR 60 million per annum.

rate of charge from the on-going effect of the off-market transactions, while maintaining the pace of accumulation of precautionary balances.

58. **Although it was recognized at the time of the off-market transactions that the impact on the GRA would persist for the longer term, the Board adopted a mitigation mechanism of a more temporary nature.** While burden-sharing could be continued for the long term, the placement of the burden-shared proceeds to the SCA-1 constitutes an interim solution. The SCA-1 was established in 1987 to protect the Fund against the impact of arrears, and the account was funded through burden-sharing adjustments.[41] Under the decisions governing the SCA-1, it must be refunded once there are no overdue obligations, or at such earlier time as the Fund may decide.[42] This refundability implies that the current mechanism for mitigating the negative income effect is temporary. The mitigation mechanism is also subject to annual renewal by a Board decision—with seventy percent majority of the total voting power—and complicates the Fund's finances and financial structure.

59. **The use of the SDA corpus as envisaged under the G8 proposal would not have an immediate effect on the GRA balance sheet or the GRA income position**. Nor would it have immediate implications for the current burden-sharing adjustments. It would, however, remove an option that was potentially available for permanently mitigating the impact of the off-market transactions. This option could have entailed a transfer of the SDA corpus to the GRA, or a transfer to the GRA of investment income of the SDA. It should be recognized, however, that this option was not expected to be available under current Board decisions governing the use of SDA resources until well into the next decade.[43]

60. **The Board has yet to consider whether to address the impact of the off-market transactions from a longer-term perspective**. The impact will persist until an equivalent amount of resources is generated for the benefit of the GRA. The current mechanism mitigates the ongoing impact and could, in principle, be continued for the foreseeable future, as was envisaged under the current decision. Under the G-8 proposal, the future, albeit distant, use of SDA resources would no longer be possible and the Board could decide to make provisions for the eventual termination of the current mitigation mechanism. The

[41] In April 2000 the Board considered suspending further accumulations because the SCA-1 balance was deemed adequate for its purpose. However, it was decided to use the SCA-1 as the vehicle for placing the burden-sharing adjustments that arose from the negative income effect of the off-market transactions.

[42] Of the SCA-1 balance at end-FY 2005 of SDR 1.6 billion, around SDR 0.5 billion is attributable to the gold mitigation mechanism.

[43] Use of the SDA for the benefit of the GRA would have to await the generation of sufficient income to meet HIPC assistance needs. At current interest rates, the SDR 1.76 billion earmarked for HIPC assistance from the investment earnings in the SDA would only be achieved by the year 2020.

options that would be available would, in effect, require either an increase in the Fund's income and a reduction in its expenditures or a combination, as is the case through the current burden sharing arrangement.[44] One possibility that would reconstitute the GRA permanently would be to accumulate a balance equivalent to the initial increase in the remunerated positions, i.e., SDR 2.2 billion, in an special account, or an earmarked portion of the Special Reserve. For example, a new account could be established to hold, in place of the SCA-1, the future burden sharing adjustments under the off-market gold transactions mitigation mechanism.[45]

61. **Some Directors asked for an assessment of the option of an outright sale of gold to offset the impact of the off-market transactions.** Issues arising from the mobilization of gold were discussed during the March 2005 Board Seminar on financing possible further debt relief. Many of the issues arising in that discussion would remain relevant for any consideration of outright gold sales to offset the impact of the off-market transactions.[46] If such a sale were agreed by the membership, the net proceeds of such a sale could be invested either in the SDA or the Investment Account (IA), if established.[47] Investment income earned in the SDA would increase the level of the SDA's assets which, under the Articles, can be transferred to the GRA for immediate use in operations and transactions. As such, a transfer from the SDA to the GRA could be used to offset the increased remuneration cost arising from the off-market transactions. Investment income earned in the IA can be used for meeting the expenses of conducting the business of the Fund; all things equal, a transfer to the GRA for this purpose would also mitigate the cost of the off-market transactions. Another possibility would be to sell part of the gold acquired by the Fund after the Second Amendment (i.e., after April 1, 1978), such as the gold which the Fund accepted in payment from Mexico and Brazil in connection with the 1999-2000 "off-market" gold transactions. The full amount of the sales price of such gold would be realized by the GRA and, thus, all

[44] The burden-sharing yields equal amounts from debtors and creditors as a group. With a fixed nominal amount collected, as is currently the case, the cost (in terms of basis points) varies inversely with the level of credit, and thus also the level of remunerated positions. The cost also varies with the level of concentration of debt among debtor countries.

[45] A mechanism similar to that adopted at the termination of the SCA-2 could be adopted for that portion of SCA-1 that has been accumulated so far from the off-market transactions mitigation. The disposition of SCA-1 resources into a new account would require the consent of contributing members to the SCA-1.

[46] Outright gold sales would need to generate total proceeds of SDR 2.2 billion to offset the impact of the off-market transactions. Cash proceeds equivalent to the book value of the gold sold would be retained in the GRA and result in a corresponding decrease in the amount of remunerated reserve tranche positions.

[47] The Executive Board discussion on the Investment Account was held on September 2, 2005.

of the currencies received in payment would have the effect of the reducing members' reserve tranche position *pro tanto*.

The Reimbursement of PRGF Administrative Expenses to the GRA

62. **The GRA was reimbursed for the administrative expenses associated with the Fund's concessional lending operations from their inception in 1976 until 1998**. In that year, the Executive Board decided to forgo the reimbursement as part of the Fund's contribution to the HIPC Initiative. The reimbursement previously paid to the GRA from the PRGF Reserve Account, was instead transferred to the PRGF-HIPC Trust. The decision was extended in 1999 until FY 2004 when the target amount for transfers to the PRGF-HIPC Trust was reached. For FY 2005 and 2006, the Board decided to continue to forgo the reimbursement to the GRA to help support the resources available for concessional lending.[48]

63. **As a general principle, the GRA is authorized to absorb the administrative cost of financial and technical services provided by the Fund pursuant to Article V, Section 2(b), including the administrative expenses of the PRGF Trust.** This principle, derived from Article V, Section 2 (b), was set out in detail by the General Counsel at the discussion of the Fund's income position in April 2004. A decision to this effect can be taken by a majority of the votes cast. However, Article V, Section 12 (i) requires that the GRA be reimbursed in respect of the expenses of administration of the SDA. The resources in the PRGF Reserve Account were transferred from the SDA and are thus subject to this requirement. However, since these resources are presently not used for PRGF lending operations (which are financed from bilateral loan resources), the Board can decide that the GRA will absorb the PRGF administrative expenses.

64. **Reimbursement of expenses associated with concessional lending would be legally required once Reserve Account resources are used to finance PRGF loans.** If PRGF loans start to be funded from the corpus of the Reserve Account (or other resources transferred from the SDA), then the GRA would need to be reimbursed for expenses at least in proportion to the use of Reserve Account resources relative to other funding sources. Such reimbursements would need to be made from the SDA or the Reserve Account. If SDA resources are no longer available to pay for the reimbursement, as would be the case under the G-8 proposal, the cost of PRGF lending would fall on the Reserve Account. The consequent strain on Reserve Account resources would, in turn, lower the self-sustained lending capacity by a potentially significant amount.

[48] The non-reimbursement does not directly affect the rate of charge in the GRA because PRGF expenses are charged to surcharge income rather than regular net income. This has the effect of slowing down the accumulation of precautionary balances.

65. **A continuation of current PRGF financing modalities under a self-sustained PRGF would allow for continued flexibility by the Executive Board regarding reimbursement.** As discussed above, the continuation of modalities would entail the continued use of bilateral loan resources for the funding of PRGF principal, as is the case under the current interim PRGF structure, with subsidy resources provided from the Reserve Account. The possibility of preserving options regarding the reimbursement issue is another factor that could argue in favor of a more flexible financing structure than initially envisaged for self-sustained PRGF lending.

Estimates of the Potential Demand for PRGF Loans 2007-2011

66. **The Executive Board has requested a further analysis of estimates of potential demand for PRGF loans in light of the G-8 debt cancellation proposal**. This appendix reviews staff projections of potential demand for PRGF loans during 2007-11.[49] The first part discusses demand for standard PRGF loans, and the second part discusses potential demand under a shocks window.

67. **The staff's conclusion is that it would be prudent for the Fund to maintain an annual PRGF lending capacity during 2007-11 of SDR 0.6 billion for standard PRGF loans and of around SDR 0.4 billion for shocks financing**. In view of the greater-than-usual degree of uncertainty surrounding the demand for Fund financing from low-income members, arising from the G-8 debt cancellation proposal and the establishment of new Fund instruments (the PSI and the shocks window), different methodologies were used to better gauge potential demand. The demand estimates for standard PRGF loans may, nevertheless, still include some shocks financing as it is difficult to assess the share of past PRGF augmentations that may have occurred in response to exogenous shocks.[50]

Demand for Standard PRGF Loans

68. **Staff project an annual demand for standard PRGF loans with a lower bound of SDR 0.5 billion and an upper bound of, perhaps, SDR 0.7 billion during 2007-11**.[51] This range takes into account current Fund practices under access policies, including the tapered access norms, staff macroeconomic projections, and a country-by-country assessment of the likely future form of Fund engagement, in light of new instruments and the implementation of the G-8 proposal. These estimates thus rely on judgment calls to a somewhat greater extent than previous estimates.

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[49] See in *The G-8 Debt Cancellation Proposal and Its Implications for the Fund* (7/20/05). The modification of the G-8 proposal discussed in this paper does not materially alter the staff's demand projections.

[50] Conversely, the demand may be underestimated as it assumes that the two PRGF-eligible members with the largest quotas (Nigeria and Pakistan) would not request Fund financial assistance under the PRGF or the shocks window during the period 2007-2011.

[51] These estimates do not include any allowance for the use of PRGF resources to help in the clearance of the protracted arrears of Liberia, Somalia, or Sudan. Previously, it was assumed that loan resources from the interim PRGF would be used for this purpose.

69. **Staff estimated the potential future demand for standard PRGF loans from two different angles**. Both are based on the aggregation of individual country estimates but differ in the way these individual country estimates are derived.

- The **first approach** relies on assumptions regarding expected requests for PRGF loans (taking into account the policies governing access to the PRGF, including the tapered access norms) and the timing of new arrangements. Roughly two-thirds of the 54 countries that have accessed PRGF resources in the past, plus a small number of new borrowers, are expected to request a PRGF, usually with a one-year break between successive arrangements.

- The **second approach** projects, on a country-by-country basis, the gross official financing requirements of PRGF-eligible countries during 2007-11 and assumes that the Fund's share in meeting those requirements would be the same as observed during 2000-04. The resulting estimates are then adjusted through country-by-country assessments of the likely nature of future engagement with the Fund, including the choice between a low-access PRGF arrangement and a PSI.

70. **Under the first approach, average annual demand for PRGF loans is estimated to reach SDR 0.8 billion during 2007-11, before taking into account the potential impact of debt cancellation** (Table A1).

Table A1. Projected PRGF Demand 2007-11
(Average annual disbursements in millions of SDRs)

	Before debt cancellation	After debt cancellation
Post-CP HIPCs	138	5
HIPCs between DP and CP	156	74
Pre-DP HIPCs	115	87
Other PRGF eligible countries 1/	353	353
Total	762	519

1/ Includes Zimbabwe, although Zimbabwe is currently not PRGF-eligible due to its arrears to the PRGF Trust.

The potential impact of the G-8 debt cancellation proposal on these estimates depends in part on future policies regarding Fund lending to post-completion point HIPCs. If there would be no further PRGF lending to these countries after they reach the completion point, overall demand would be reduced by more than SDR 0.2 billion per year on average, to SDR 0.5

billion per year.[52] However, this figure should be seen only as a lower bound for the estimate of average annual PRGF demand, as there is no presumption that HIPCs will not have access to the PRGF after debt cancellation.

71. **The second approach includes two scenarios:** a baseline scenario, which only considers debt relief under the HIPC Initiative; and an alternative scenario, which assumes implementation of the G-8 proposal, with the proviso that the additional resources freed up by debt cancellation would be used in the pursuit of the MDGs.[53] Under the baseline scenario, the unconstrained annual average demand for PRGF loans during 2007-11 reaches SDR 1.4 billion (Table A2). Under the alternative scenario, this unconstrained demand is only marginally lower, as resources freed up by the G-8 debt cancellation are assumed to be spent in pursuit of the MDGs.

Table A2. Projected PRGF Demand 2007-11
(Average annual disbursements in millions of SDRs)

	Unconstrained demand		Adjusted demand	
	Before debt cancellation	After debt cancellation	Variant 1	Variant 2
Post-CP HIPCs	558	556	109	135
HIPCs between DP and CP	192	179	130	162
Pre-DP HIPCs	47	45	96	117
Other PRGF eligible countries 1/	614	608	383	515
Total	1411	1388	718	929

1/ Includes Zimbabwe, although Zimbabwe is currently not PRGF-eligible due to its arrears to the PRGF Trust.

72. **There are a number of reasons for the differences in results between the first and second approach.** The second set of results do not take fully into account the rationing effect of PRGF access policies, including the tapered access norms. They also include an element of shocks financing, to the extent that a part of PRGF lending during 2000-04 was undertaken in response to shocks.

[52] This approach also assumes a realistic, yet ambitious, schedule for HIPCs that have not reached the completion point.

[53] The impact of the G-8 debt cancellation proposal was modeled by assuming that Fund, IDA and AfDF debt as of end-2004 would be written off as of end-2005 for countries that have already reached the completion point. For HIPCs that have not reached the completion point a realistic, yet ambitious, schedule for doing so was again assumed. Tentative assumptions were also made regarding additional allocations from IDA and the AfDF in line with the G-8 proposal.

73. **The unconstrained estimates derived under the second approach were adjusted on the basis of a country-by-country assessment of the likely nature of engagement with the Fund for post-completion-point countries.**[54] Two variants of this scenario were considered, the first assuming a one-year lag between successive PRGF arrangements, consistent with the assumption used in the first approach; and the second assuming no lag between arrangements. The first variant gives an average annual PRGF loan demand of about SDR 0.7 billion per year, the second of about SDR 0.9 billion, with a central estimate of about SDR 0.8 billion. Although this adjustment addresses to some extent the first discrepancy (related to access norms), it does not eliminate the potential overlap with shocks financing, which could be of the order of SDR 0.1-0.2 billion.

Demand Under the Shocks Window

74. **On July 25, 2005, the Executive Board of the Fund approved the establishment of a new window within the PRGF Trust** to allow the Fund to provide financing on more concessional terms to low-income countries confronting exogenous shocks.

75. **Staff analysis suggests a demand of SDR 400 million per year over 2007-11 for the shocks window, but there is considerable uncertainty surrounding this estimate.** Alternative calculations support a range of estimates from SDR 240 million to SDR 570 million per year.

76. **The staff's central estimate of an average annual demand of up to SDR 400 million is based on a staff survey of likely demand for shocks financing**.[55] The exercise was carried out as follows:

- Staff projections were guided by historical data on frequency of two types of shocks: terms-of-trade shocks and natural disasters.

- Total demand was estimated without differentiating the demand for PRGF-augmentations from that for financing under the shocks window. Staff assumed roughly similar access levels under the shocks window and PRGF augmentations.[56] Staff also assumed that low-income members would rely mainly on the shocks window in view of its concessionality, except for those countries for which upper

[54] For example, 13 of the 18 countries that have already reached the completion point are assumed to have either a low access PRGF arrangement or a PSI with the Fund in this period.

[55] See *The G-8 Debt Cancellation Proposal and Its Implications for the Fund* (7/20/05).

[56] This contrasts with the historical record, whereby average access in the context of PRGF augmentation has been lower than average access under Emergency Assistance for Natural Disasters (ENDA) or the Compensatory Financing Facility (CFF).

credit tranche conditionality might not be necessary, in which case financing would be provided under ENDA.

- It was assumed that the guidelines on blending PRGF/GRA resources would be applied in determining access under the new window, and that, as noted above, the two low-income members with the largest quotas (Nigeria and Pakistan) would not request financing under the shocks window.

77. **The results are very sensitive to the precise assumptions used.** For example, potential demand would be considerably higher (SDR 570 million per annum) if the blending guidelines were not applied and countries with the largest quotas each requested normal access (25 percent) once under the new window during 2007-2011. Alternatively, if the demand estimate is based on historical use of Fund financing for shocks under various policies and facilities (i.e., PRGF augmentation, CFF and ENDA), the estimate of potential demand for shock financing would decline to about SDR 240 million per year.[57] This is below the staff's central estimate mainly because the size of PRGF augmentations has historically been about half that of the access norms proposed for the new shocks window. The historical frequency of using Fund financing following a shock has also been lower than the staff projection for the new window.[58] However, it seems reasonable to expect that the future demand for shocks-related financing will be higher than historical use because recent guidelines on PRGF augmentation are likely to encourage countries to request more financing following a shock and help staff assess needs (and appropriate access levels) on a more systematic basis. Moreover, the existence of the shocks window may in itself generate additional demand.

[57] In some cases, a new Stand-By arrangement or PRGF arrangement has been motivated at least partly by an exogenous shock, and including such programs would raise the historical average. However, it is difficult to determine what portion of the access from these arrangements was directly related to shocks.

[58] The average frequency of augmentations under PRGF arrangements as been 0.65 per five-year period per program country (36 augmentations approved since 1991 for 283 on-track annual programs). For the CFF and ENDA, the average frequency of use per five-year period by low-income countries was about 0.17 and 0.05, respectively, over the past two decades. Thus, on average, a low-income country requested shock-related financing about 0.9 times per five-year period. The past demand for Fund financing can also be calculated by adding the average use of resources under the three shocks related facilities. The average use of PRGF augmentations was SDR 55 million per annum; the average use of the CFF by low-income countries, SDR 108 million per annum; and that of the ENDA, about SDR 29 million. Adding the forecasted use of the Trade Integration Mechanism (TIM) window (SDR 50-60 million per year) would bring total use to about SDR 245 million per year.