STUDY

ECONOMY AND FINANCE

UNDERSTANDING IMF DEBT SUSTAINABILITY ANALYSES

A Toolkit for CSOs to critically engage with the IMF

The IMF is a powerful gatekeeper for financing and debt relief and sets the macroeconomic parameters and incentives for governments on how to deal with a critical external debt situation. At the centre of this are the IMF's debt sustainability analyses. With a de facto monopoly on these analyses comes a huge responsibility that the IMF does not always meet.

Debt sustainability analyses are not just technical documents but deeply political and relevant for CSOs, as the results will have an impact on the government's policies and decisions and the social and economic rights of a country's citizens.

The IMF has a track record of too-little-too-late debt relief and optimistic economic projections. CSOs should therefore have a critical eye on the analyses of the IMF, which are the basis for how a shaky debt situation is being dealt with.

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INTRODUCTION

The economic and fiscal impact of the COVID-19 pandemic led to a drastic deterioration of the debt situation in developing countries: The Global Sovereign Debt Monitor published by erlassjahr.de and MISEREOR[1] shows that 136 out of 152 countries are in a more or less critical debt situation. 40 of them have particularly high debt indicators or are already over-indebted, three times as many as before the pandemic. This group of countries also includes many MENA countries. As early as October 2020, IMF economists and the IMF Managing Director warned of the imminent danger of a lost development decade in developing countries, triggered by the worsening debt situation and resulting sovereign defaults.[2] Now in the third year of the pandemic, the world faces the danger of an ever-growing gap between higher and lower income countries, caused by the uneven economic recovery from the Corona pandemic.[3] In addition, the economic repercussions of the Russian invasion of Ukraine – such as rising food and fuel prices as well as the rise in global interest rates triggered by the turnaround in US monetary policy – fuel the "perfect storm".[4]

High debt can undermine the ability of governments to invest in the recovery and deploy countercyclical measures as needed. The way the debt situation is treated is therefore of utmost importance for the recovery of these countries. Should a crisis arise and a restructuring process become necessary, sovereign debt is the only category of debt for which this process is not regulated by any kind of legal framework. In the Global South, the International Monetary Fund (IMF) instead plays a central role in the recognition and resolution of debt crises.

1.1 THE CENTRAL ROLE OF THE IMF IN THE BUILD-UP AND HANDLING OF SOVEREIGN DEBT CRISES

In general, the IMF de facto sets the macroeconomic parameters and incentive for governments on how to deal with a critical external debt situation. The role of debt sustainability analyses of the IMF are meant to detect and resolve debt crises in a timely manner. In general, the decision of a government to initiate restructuring negotiations depends on a reliable debt sustainability analysis, which identifies risks and unsustainable debt. For the international creditor community, this role should be played by the IMF debt sustainability analysis. It also plays an important role in debt restructuring negotiations. With its debt sustainability analyses, the IMF will determine how much debt relief is needed and will formulate adjustment measures.

The IMF produces such debt sustainability analyses on a regular basis, either as part of its routine monitoring of the economic situation of its member countries through so-called Article IV consultations or as part of its surveillance of financing programs. In the case of Article IV consultations,[5] the analyses are intended to contribute to the early detection of crises and thus to the early initiation of appropriate measures. Given that the document reveals the IMF's concerns about a country's fiscal position and its financing needs, it can be a crucial resource for understanding the advice a country is receiving to fund its development priorities.

In cases of balance of payments problems, many countries turn to the IMF as lender of last resort and ask for a financing program. De facto, the IMF also serves as a gatekeeper towards further multilateral and bilateral financing as well as debt relief by official creditors that coordinate in the so-called Paris Club.[6] Its role is therefore far stronger than would otherwise correspond to the volume of its own lending:

1 Cf. erlassjahr.de and MISEREOR (2023): "Schuldenreport 2023", https://erlassjahr.de/en/news/gsdm-2023/

2 Cf. Georgieva, K.: "The Long Ascent: Overcoming the Crisis and Building a More Resilient Economy", https://tinyurl.com/y5b7u3xx, 06.10.2020

3 https://twitter.com/globalgoalsun/status/1375260211900903424?lang=ca

4 https://www.dw.com/en/debt-crisis-looms-for-developing-countries-amid-perfect-storm/a-62246014

5 As part of the IMF surveillance work, the institution conducts usually annual consultations with its member countries to assess the economic and financial situation of the member and give political recommendations. They are called "Article IV consultations" because these bilateral consultations are required by the Article IV of the IMF's Articles of Agreement.

6 The Paris Club consists of 22 creditor countries, mainly traditional donor countries, that coordinate their interests in debt restructuring negotiations.

- In most debt restructuring negotiations, the IMF will provide the analysis on the debt relief envelope and financing gap, which would form the basis for creditor negotiations. For the Paris Club – the creditor club of 22 mainly Western governments – it is mandatory that a country undergo an IMF program as well as have the IMF debt sustainability analysis as a basis for creditor negotiations. Without an IMF program, the Paris Club would not be willing to start negotiations.

- The IMF oversees the "adequacy" of the measures taken by an indebted country to restore its debt sustainability. To this end, it agrees with the debtor on an economic program, tailored in the context of the financing arrangements referred to above, many of which are often controversial from a social point of view.

In the case of such financing programs between the IMF and member countries, the debt sustainability analyses serve primarily to assess risks to the IMF program: if a country applies for an IMF assistance program, the IMF first analyzes the financing needs of the specific country and whether these can be met without debt relief. This is because, according to its statutes, the IMF must not lend to countries whose debt sustainability is at risk and must tie its disbursements to debt operations if repayment is otherwise not likely with high probabilities for the borrowing country. In debt restructuring cases under an IMF arrangement, the debt sustainability analysis also identifies the amount of debt relief needed.

Central to any debt sustainability analysis are short- and medium-term forecasts of how the debt situation develops in relation to the debtor's ability to generate revenue. This also includes forecasts about whether other donors would make additional funds available in the program period or in relation to the possible extent of fiscal adjustments. This is represented by different indicators, with one central one being the debt-to-GDP ratio. Incorrect, overly optimistic forecasts – especially those of the denominator, such as economic growth (shown in GDP) – can lead to wrong assumptions about the debt risk in the future and thus to misguided political decisions in the here and now. Research shows that deviations between predicted and real growth of as little as one percent can make the difference between a sustainable debt ratio and an exponentially growing one.[7] Thus, the IMF's assumptions and analyses – unlike those of other actors – are central to identifying and overcoming debt crises. As an unresolved debt crisis can hinder development, the IMF's analyses are also central to the question of whether or not critically indebted developing economies will be facing a lost decade of development.

1.2 THE IMF IS REPEATEDLY UNDERESTIMATING DEBT SUSTAINABILITY RISKS

Analyses from the beginning of the pandemic show that debt sustainability analyses of the IMF in 2020 underestimated the Corona-driven recession, with overoptimism on the economic recovery being an intrinsic part of IMF analyses.[8] Various studies show that being overoptimistic on how the future may look is a systemic phenomenon.[9] Not only does the IMF underestimate debt risks, the IMF also regularly proves to be very hesitant in recommending debt restructurings as an option to share burdens and promote growth even in cases where a debt restructuring would be necessary.[10] When the IMF recommends debt restructuring or even makes this a mandatory requirement for their financing programs, countries have usually already had to default to their creditors.

The IMF can execute its approach of avoiding restructuring whenever possible because it one-sidedly relies on adjustment measures in the debtor country, which means that the brunt is borne by the population alone. Especially in countries that have high debt, but which, nonetheless, are still servicing their debt to their creditors, austerity measures are the IMF's standard option, in most cases without any alternative, in order to decrease the debt ratio and restore debt sustainability. In this way, the IMF can provide loans even when debt may be unsustainable, without violating its statutes. In fact, in defining the debt relief envelope and imposing austerity measures, the IMF has a lot to say about who carries which burden when the debt situation becomes a problem: with austerity measures such as tax increases or the elimination of subsidies, the IMF defines the population's share of the burden to resolve the debt crisis. Debt relief relates to the share of the burden that creditors have to take. The IMF's advice will, therefore, determine the distribution of the burden, influencing decisions that affect the life of the people of the debtor state. In the past, the costs of the crisis were often socialized with heavy austerity measures as part of IMF programs, while losses for creditors were avoided as much as possible. This is the problem that the IMF already defined years ago, of "too little too late" debt relief, that "failed to re-establish

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7 Cf. Independent Evaluation Office of the International Monetary Fund (IEO) (2014): "Evaluation Report: IMF Forecasts – Process, Quality, and Country Perspectives", https://tinyurl.com/y3x8mzod

8 Cf. Rehbein, K. (2020): "From growth optimism to a lost development decade – The dangerous role of the IMF in the crisis of the Global South", Focus paper 4, https://erlassjahr.de/wordpress/wp-content/uploads/2020/12/Focus-Paper-4-From-growth-optimism-to-a-lost-development-decade.pdf or Sandefur, J. and Subramanian, A. (2020): "The IMF's Growth Forecasts for Poor Countries Don't Match Its COVID Narrative", https://tinyurl.com/yy59yks

9 Cf. Rehbein, K. (2023): "Dare to take more responsibility – the role of the IMF in delaying debt crisis resolution", in Global Sovereign Debt Monitor 2023 erlassjar.de and MISEREOR and Rehbein, K. (2022): "A decade of rosy forecasts – how the IMF underestimated debt risks in the MENA region", Study Economy and Finance, Friedrich-Ebert-Stiftung.

10 See Rehbein, K. (2023): "Dare to take more responsibility".

debt sustainability".[11] Spending cuts and tax increases in order to reduce the debt as opposed to debt relief by creditors does not only mean hardship for the debtor country's population. It can also be self-defeating, as austerity can lead to lower growth and reduced revenue to pay off the debt. Indeed, it must be assumed that underestimating the contractionary effects of the recommended structural adjustments is one of the main reasons for the optimistic debt forecasts itself. In addition to austerity measures, it is overly optimistic projections of a country's future economic development that have made new loan programs possible which under some circumstances should never have been approved without debt relief. In the case of countries already in default or undergoing debt restructuring negotiations, overoptimistic projections can also lead to a lower possible debt relief envelope. This, in turn, can lead to a lower creditors' share of the burden – but a higher share by the population through fiscal austerity measures.[12]

Although tools in the debt sustainability analyses have become ever more sophisticated (see below), the IMF staff is not independent from political influence such as from its powerful shareholders. Furthermore, the IMF with its lending is a creditor itself and therefore occupies a problematic double role. In Argentina, the political preferences of the US administration then in office led to the biggest IMF program in history – ignoring risks during the program and maintaining the narrative of a liquidity crisis (although it was a solvency crisis) with overoptimistic forecasts.[13] In Egypt, part of the program modalities are motivated by the IMF's own exposure and the risk of not being repaid.[14]

The role of the IMF is central when it comes to the modalities of resolving a fiscal and debt crisis and how the social and economic rights of a country's citizens are affected by adjustments to be made. However, the IMF has a track record of too-little-too-late debt relief for which it bears co-responsibility. Consequently, CSOs should have a critical eye on the analyses of the IMF, which are the basis for how a shaky debt situation is being dealt with, a basis for negotiations with creditors, and a basis for how the burden is shared between the different parties.

1.3 PURPOSE OF THIS GUIDE

This paper is meant to give guidance on how to read a debt sustainability analysis and understand its tools, in order to critically engage with the IMF (such as the mission coming to a country) and government representatives that negotiate with the IMF about a financing program. Terms shall be explained as well as tools used in those analyses. What will not be looked at is the general advocacy towards the IMF, more details on how the IMF functions, as well as terms and tools in relation to fiscal austerity programs. For those aspects, there is already a range of existing toolkits and helpful materials, which include but are not limited to the following:

– Eurodad (2018): "A toolkit for advocacy at the International Monetary Fund" (https://www.eurodad.org/imf-toolkit)

– "On understanding terms and tools of austerity forced on governments and how to understand IMF programs in this regard": Ortiz, I. and Cummings, M. (2022): "End Austerity: A Global Report on Budget Cuts and Harmful Social Reforms in 2022-25", https://www.eurodad.org/end_austerity_a_global_report

– Critical analysis on the international financial institutions, regularly published by the Bretton Woods Project, which are useful in the engagement with the Fund: https://www.brettonwoodsproject.org/

– Materials regularly produced by the Arab Watch Coalition, which critically monitors the IMF's role and programs in the region and also engages with the IMF: https://arabwatchcoalition.org/category/resources/studies/

– Reports and other resources produced by the End Austerity Coalition, a coalition of concerned people, civil society, activists and experts that supports critically assessing and advocating against harmful austerity conditions that are often part of IMF programs: https://endausterity.org/

11 IMF (2013): "SOVEREIGN DEBT RESTRUCTURING – RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE FUND'S LEGAL AND POLICY FRAMEWORK", https://www.imf.org/external/np/pp/eng/2013/042613.pdf

12 See Rehbein, K. (2023): "Dare to take more responsibility" and Doyle, Peter (2022): "On the IMF's Programs – Zambia and Sri Lanka Editions", https://www.niesr.ac.uk/blog/imfs-programs-zambia-and-sri-lanka-editions

13 See https://erlassjahr.de/blog/wer-zahlt-fuer-die-fehler-des-iwf-anmerkungen-zum-evaluierungsbericht-des-juengsten-iwf-programms-mit-argentinien/

14 See http://library.fes.de/pdf-files/bueros/tunesien/20425.pdf

2

UNDERSTANDING IMF DEBT SUSTAINABILITY ANALYSES (DSAS)

2.1 IMF DEBT SUSTAINABILITY FRAMEWORKS – OVERVIEW

There are two debt sustainability frameworks:

– There is one for countries that receive funds under the IMF low-cost financing window, which is the Poverty Reduction and Growth Trust. This mainly includes low-income countries. It is called the Debt Sustainability Framework for Low-Income-Countries (LIC-DSF), which is a joint project with the World Bank.

– There is also a framework for so-called market-access countries, which includes a wide range, from lower middle income to high income countries. This is called the Debt Sustainability Framework for Market Access Countries (MAC-DSF). The framework was recently overhauled and in this process changed its name to "Sovereign Risk and Debt Sustainability Framework for Market Access Countries" (SRDSF). With the frameworks, the IMF assesses to what degree a country can manage its current debt and its capacity to take on more risk (in the IMF's opinion).

In the MENA region, there are only three countries (four, when including Djibouti) that fall into the World Bank defined low-income category, and in only two of these countries are there more or less regular DSAs (Sudan and Djibouti). This means that the debt sustainability of most countries in the region is assessed by the IMF under the SRDSF.[15]

Not many countries have already been assessed under the new framework for market-access countries. The framework has been rolled out as of the end of 2022. That means that analyses before 2022 were still based on the former MAC-DSF.[16] **It is important to look at both previous and newer analyses to identify where the IMF has failed to warn of risks or of a deteriorating debt situation prior to a debt crisis occurring**.[17]

More often than not, DSAs show a deteriorating trend and stronger rhetoric on risks while the overall assessment does not change.[18] This means that it is important to not only look into the most recent DSA when assessing the IMF's assessment of a country's debt situation. However, by understanding the SRDSF, it is also possible to get a hint at what is being said in the MAC-DSF.

The new framework uses potentially more sophisticated tools to assess debt sustainability risks and it combines mechanical risk signals with the judgment of the IMF. Moreover, the presentation of the findings is potentially more reader-friendly, as it works with more colors and standardized pile charts and other visual tools. This can be more useful, however it does so at the expense of reducing the amount of text commentary, which in the past often contained useful details, such as on individual loan conditions, specific contingent liabilities, etc.

Usually, DSAs are part of more comprehensive surveillance and program documents, to which the DSA is annexed. These documents often contain interesting information that is not part of the annexed DSA. It is therefore useful to skim through tables and text in the entire program document and not only rely on the information provided in the DSA.

2.2 WHERE TO FIND A DSA

DSAs are usually part of country documents, either in documents from Article IV consultations or in requests for or reviews of financing programs. DSAs are usually part of the annex of the country document. Sometimes there are a couple of reports per year per country, for example if there are several reviews of a program in a single year. The DSA is not always renewed; often these are done once a year.

Usually you will find a copy of the latest DSA in the country documents until the next DSA is completed, sometimes

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15 The SRDSF is the result of a review of the former MAC-DSF and consists of new features and tools. Thus, DSAs prior to 2023 can be different in appearance compared to DSAs that were conducted in 2023.

16 A comparison between the MAC-DSF and the SRDSF can be found in IMF (2022): "Staff guidance note on the sovereign risk and debt sustainability framework for market access countries", p. 112.

17 See Rehbein, K. (2022): A decade of rosy forecasts.

18 See Rehbein, K. (2022): A decade of rosy forecasts.

with an additional footnote, some newer details in the text passage, etc.

In such cases, where the DSA is just copied in from the last time that a DSA was prepared, it is always interesting to skim through the other sections in the country document in which the IMF explains what risks it sees to the debt situation of the country and compare them with each other, to understand whether the IMF sees the prospect of the baseline scenario likely to materialize or not. This is also explained in more detail below in the section "the baseline scenario".

2.3 WHAT TO FIND IN THE DSA: OVERVIEW[19]

In general, the DSA looks at outstanding debt levels and the financing needs of a country. It sets out different scenarios for debt servicing based on the IMF's own projections for economic growth, public revenues, and other parameters for the country, providing recommendations for a borrowing strategy or giving advice whether a debt restructuring would be necessary.

It does NOT provide a specific figure to determine what absolute level of debt is sustainable for a country, or define when a debt stock will become unsustainable. What it does is to assign either a "risk rating" of external debt distress in low-income countries or a "signal on debt sustainability" in market-access countries.

Box 1
IMF rating and assessment of debt sustainability

For countries assessed under the LIC-DSF:

"Low risk of debt distress"

"Moderate risk of debt distress" (with or without space to absorb shocks)

"High risk of debt distress"

"In debt distress"

The categorization results from mechanical risk signals on public and publicly guaranteed external debt burden indicators. For example: a country's debt will be categorized as having a high risk of distress if any of the debt burden thresholds will breach pre-set thresholds in the scenario that sees the IMF as most likely.

For countries assessed under the SRDSF / MAC-DSF*:*

"sustainable with high probability" (more or less equivalent to a low risk of debt distress)

"sustainable but not with high probability" (could be equivalent to both moderate and higher risk of debt distress)

"unsustainable" (such as in default)

The categorization results from a combination of IMF staff judgment and complex mechanical risk signals on public debt (external and domestic).

The ratings inform the IMF's own lending decisions as well as those of other actors.

Table 1 - What a standard DSA under the SRDSF includes[20]

1. Overview assessment of "Sovereign Risk" and "Debt Sustainability"
2. Debt coverage in the DSA
3. Public Debt Structure indicators
4. Baseline Scenario – the likely future development according to the IMF
5. Realism of Assumptions
6. Risk analysis for the next 5 years (medium-term risk analysis)
7. Public Debt and Debt Service by Creditor / debt restructuring scenario

If you open a DSA (under the SRDSF), you will usually find the following information in this order:

- **Overview assessment of "Sovereign Risk" and "Debt Sustainability" (often titled the "Sovereign Risk and Debt Sustainability Framework Summary")**

Here, the IMF gives an overview on how it sees the debt sustainability risks of the country. It is divided into a "sovereign risk assessment" and a "debt sustainability assessment" (see Box 2).

– Sovereign risk/stress can, for the IMF, relate to loss of market access, huge financing gaps, etc. The assessment is done with a mechanical rating into the categories low sovereign risk (green), moderate sovereign risk (grey) and high sovereign risk (red). The IMF gives an overall assessment, as well as an assessment of the sovereign risk in a five-year horizon. The near-term assessment over the first 1-2 years is not transparent to the public.

19 We will focus in this section on DSA developed under the new SRDSF. A detailed guidance paper by the IMF exists on tools and data used in the SRDSF: IMF (2022): "Staff guidance note on the sovereign risk and debt sustainability framework for market access countries". The methodological descriptions here are based on this guidance paper.

20 A summary table can be found in IMF (2022): Staff guidance note, on page 107.

- The section "debt sustainability assessment" also includes an overall assessment of debt sustainability in the three categories: sustainable with high probability, sustainable but not with high probability, and unsustainable. This is important for lending decisions of the IMF: in the case of unsustainable debt, the IMF is not allowed to lend without any additional measures being implemented, such as a debt restructuring. It is however unclear whether the IMF will truly always use the three-way assessment, or whether the additional option of "unsustainable debt" will only be used in countries with a very high exposure to the IMF (so-called exceptional access cases).[21]

Furthermore, there is a yes-or-no assessment of whether the debt-to-GDP path could be stabilized in the future (up to 10 years) under possible and "realistic" policies that exclude a debt restructuring. And there is a summary assessment at the end that helps in gaining an understanding of underlying IMF assumptions. With "possible and realistic policies", what is often meant is policies the IMF prescribes from fiscal consolidation to market-friendly policies – policies that civil society often criticize.

In countries that will undergo a debt restructuring, there will be a restructuring scenario included, showing how assessments look after an assumed debt restructuring has taken place.

Box 2

Central concepts: Sovereign risk vs. debt sustainability[22] and associated problems

For market-access countries, there is a differentiation between "sovereign risk" and "debt sustainability". Sovereign risk is a new invention of the Fund. "Sovereign risk" is not used by the IMF to guide its own lending decisions, which means that even if the IMF sees sovereign risk to be high, it can still decide to lend. For the IMF, sovereign risk means that a country can have a debt problem that however can be resolved without debt relief, such as through fiscal austerity measures.

When the IMF is asked to lend to a country, it needs to assess whether debt is sustainable or not, i.e. whether a debt problem can be resolved without a debt restructuring. This is to protect its own loans: If debt is assessed as unsustainable, the IMF is not allowed to lend, as it must assume that debt is so high that it may not be repaid. In countries that do not have an IMF program (where the IMF is only supporting surveillance) a debt sustainability assessment is optional.

When debt is assessed as unsustainable, the IMF would have to recommend a debt restructuring. In reality, however, the IMF only rarely and very hesitantly declares a situation to have become unsustainable – which would prohibit it from lending to the member country and could incentivize a debt restructuring. It often only does so when the situation is crystal clear even without IMF assessment – such as when a country has had to default on its payments to creditors (as in the case of Sri Lanka). And the invention of the concept of "sovereign risk" helps in the avoidance strategy, as this is not linked to the IMF lending per se.

Peter Doyle, a former IMF mission chief, strongly criticized "the lengths to which the IMF will go to avoid debt write-offs necessary and sufficient to secure macro sustainability".[23] The 2018 review of IMF conditionality found that among 33 IMF programs in countries with high debt vulnerabilities, in not even half of them was any kind of debt reprofiling or restructuring carried out.[24]

When looking at debt sustainability analyses that have been undertaken since November 2020,[25] in the middle of the pandemic and its resulting global recession, a similar reluctance to discussing debt treatments as a credible option for countries with high debt vulnerabilities can be found.

Out of 86 countries with high debt vulnerabilities, in only ten countries were debt treatments mentioned as a potentially necessary option. Out of those ten countries, there are only four countries which neither defaulted nor entered a debt restructuring already, thus in which the IMF truly recommended debt relief as an option to pursue. In all other cases, scenarios or recommendations in which debt treatments play a role do not exist.

In the past, this approach of avoiding debt restructurings often led to the IMF lending in situations which were unsustainable without a debt restructuring, leading to prolonging debt crises and bailing out other creditors.

Even with more sophisticated tools such as in the new SRDSF, it remains to be seen whether this practice of avoiding debt restructurings as much as possible will fundamentally change.

21 See https://www.g24.org/wp-content/uploads/2021/03/Jeromin-Zettelmeyer_MAC-DSA-Presentation-to-G24.pdf, p. 9.

22 Also see IMF (2022) Staff guidance note, from p. 5.

23 Doyle, P.: "Guest Post: Macroeconomic malpractice in action", Financial Times, 4.1.2019, https://www.ft.com/content/d0e127ed-f65d-3b88-9e26-d95c-c542bb0e

24 See IMF (2019): "2018 REVIEW OF PROGRAM DESIGN AND CONDITIONALITY", https://www.imf.org/~/media/Files/Publications/PP/2019/PPEA2019012.ashx

25 179 IMF country reports in 117 countries that include debt sustainability analyses between November 2020 and September 2022 have been assessed.

Moreover, the IMF has a very narrow understanding of when a debt is (un)sustainable. Public debt is regarded as sustainable as long as the country can still service its debt, no matter what sacrifices this may include in terms of fiscal space for development spending. Public debt would be considered at risk of becoming unsustainable if no realistic adjustment (that is both economically and politically feasible) in the primary balance can reduce debt to a level that allows a country to continue servicing the public debt.

An economically feasible adjustment is one which preserves "potential growth at a satisfactory level". "Politically feasible" means socially acceptable, i.e., to what extent a government is willing and able to sacrifice domestic priorities to meet creditor claims and how much citizens are prepared to accept. This is because the primary balance is the difference between the amount of revenue a government is able to collect and the amount it spends, for instance, on providing public goods and services.

Therefore, stabilizing the primary balance can be achieved by either increasing revenue, such as through higher taxes, or by decreasing spending, such as by cutting expenditures on the provision of public services. A "politically feasible adjustment", therefore, describes the willingness of citizens to live with low-quality health services and poor infrastructure, for example. Frequent social unrest in the MENA region proves that there are limits to what is politically feasible.

- **Debt coverage in the DSA ("Debt coverage and disclosures")**

Next comes an overview of what kind of data on debt owed by which (public) sectors in the country is covered in the DSA. The overview is quite detailed and uses colour codes to show what recommended data is missing or where coverage is good. The section, as all other sections, is completed with a commentary.

- **"Public Debt Structure indicators"**

Next there is different aggregated information on the public debt structure. Each DSA under the SRDSF should have pile charts showing useful information on the public debt structure of the country concerned and the corresponding vulnerabilities that can stem from this. Information is provided, among others, on

a. the currency composition of the debt, and how the IMF expects this to develop in the next 10 years,
b. the legal basis of the debt on a very general basis,
c. those holding the debt (for instance debt held by external private creditors may be more risky than that held by official creditors, etc.),
d. the maturity structure of the debt (the shorter the maturity, the higher the risk), and
e. what the IMF expects to happen in the next 10 years. The charts are followed by a commentary of staff on the expectations of the Fund.

- **The "baseline scenario"**

Next comes the so-called baseline scenario in form of a table with information on how the IMF expects certain developments including the public debt path relative to GDP to develop in the next 10 years. The baseline scenario is the central component in a DSA and will be further discussed in section 2.4 below.

- **"Realism of Baseline Assumptions"**

Here, the IMF includes a "realism check" of its forecasts, which is central for CSO advocacy. More is found in section 2.5 below.

- **Risk analysis for the next 5 years ("Medium-term risk analysis")**

A summary of how the IMF understands debt risks over a period of 5 years. This assessment is an important component of the overall debt sustainability assessment at the beginning. More is found in section 2.6 below.

- **A table on "Public Debt and Debt Service by Creditor" / A debt restructuring scenario**

Sometimes, such as in debt restructuring cases, there may also be a detailed decomposition of public debt and debt service by creditor as well as a debt restructuring scenario that shows assumptions about the debt relief envelope that is needed to bring debt down. More on DSA in debt restructuring cases will be found in section 2.7.

All tools end with a commentary box, where the IMF staff must explain the results and how realism flags or other issues were dealt with in the analysis. This did not exist in the past and is an improvement compared to previous debt sustainability analyses. It helps to get an understanding of the IMF staff thinking and offers greater transparency on how the IMF dealt with issues that came up during the analyses – or if it did not do so.

2.4 THE BASELINE SCENARIO

The baseline scenario is the most important table in the DSA, as it shows what the IMF expects to be most likely over the next ten years in terms of central macroeconomic, debt, and financial parameters.

– The table usually starts with the Debt-to-GDP ratio, which will be an important parameter to critically look at when engaging with the DSA and the IMF.

Often, it is assumed that **the public-debt-to-GDP ratio will fall over the projection horizon, which means that debt sustainability is expected to improve**. This can either be because the numerator – the debt level – is expected to fall, or because the denominator – the GDP growth – is assumed to rise. You may wish to check the latter – the assumption of the IMF about what it thinks most likely in terms of GDP growth in the coming years – in the same table. Does the IMF expect increasing GDP growth over time (for example hypothetically from 1 percent to 2 percent to 3.5 percent, staying that high for the rest of the projection period)? Does the projected debt-to-GDP level fall at the same time? Then the assumption of improving debt sustainability is due to the assumption that the country may be able to grow out of its debt. This may however often not work out that way in reality. One review by IMF itself shows that in the last 20 years, there were only a very few high-debt cases which escaped a debt problem by expected positive economic shocks and without a debt restructuring.[26] Rather, in high debt cases, only 5 percent of IMF programs were successful without a debt restructuring and by just hoping a country would grow out of its debt.[27]

In the past, the IMF often assumed high medium-term economic growth, which had been built on the understandable but nonetheless problematic logic that the IMF must assume meticulous implementation of its economic policy prescriptions (which the country must implement in exchange for IMF financial resources). Most importantly, in order to justify its conditionalities, the IMF must inevitably attribute a growth-promoting effect to them. However, those assumptions often did not come to reality.

This is why, **when looking at the debt-to-GDP development expected by the IMF as most likely, the next step would be to look at what <u>realism checks on such assumptions</u> have to say about the track record of past projection performance of the IMF** and in what ways the result, such as too much optimism in past projections, was taken into account when calculating the baseline scenario (see next section on realism tools).

- Another very important measure to be aware of is the primary balance[28] that the IMF expects the country to achieve over the projection horizon. It is important because all conditionality of the IMF is derived from this number.

It is almost always the case that the IMF expects a quick return to a primary surplus, often a high one, to achieve debt reduction. To achieve the primary surplus, the government needs to increase its revenue or cut expenditures, and thus needs to undertake fiscal consolidation. The higher the expected primary surplus, the deeper the fiscal consolidation measures need to be. However, the theoretical and empirical literature on this question shows that cutting public spending or aiming for a quick primary surplus is by no means effective in reducing government debt ratios under all circumstances. On the contrary, comprehensive austerity measures can backfire, especially in times of crisis, and even lead to an increase in the public debt ratio as a result of austerity measures (e.g. in Greece in the context of the Euro crisis). In fact, empirical evidence shows that especially in crises, a slow adjustment of the budget balance is generally better than a large upfront fiscal consolidation.[29] However, in the absence of sufficient financing options and the willingness of the IMF to push for debt restructurings, the only option that is left for the IMF to recommend is concessions by the country's population through fiscal consolidation.

As is the case with GDP growth, you may wish to check the realism tools on how realistic the fiscal consolidation path the IMF expects from a country really is (see next section). As an example:

The IMF requires currently critically indebted Sri Lanka to run a primary surplus of 2.3 percent of GDP from 2025, from a deficit of -3.8 percent in 2022. Empirical evidence shows that this is a target that is not justified by Sri Lanka's own history, nor by the experience of countries similar to Sri Lanka. Nor does the IMF expect even Sri Lanka's fastest-growing peers in the same post-pandemic environment to achieve such targets. Moreover, the IMF's own analysis (see next section) indicates that the expected fiscal consolidation is unrealistically optimistic. Nevertheless, the targets have not been adjusted.

- In the table on the baseline scenario, there will be several more parameters, such as what the IMF expects to be other drivers of changes in the debt-to-GDP indicator. Besides information on the assumption regarding the debt development, the table also provides assumptions on what funding needs the country may have and what role debt service would play in these funding needs.

2.5 THE CHECK TO REALITY – REALISM TOOLS

The idea behind the realism check is that forecasts in the baseline scenario will be tested against past reality:

- With the realism tools, forecasts of central parameters will be assessed against the historical track record of forecasts, or they will be compared to peer countries or to the historical performance of the country.

26 See IMF (2018): "MACROECONOMIC DEVELOPMENTS AND PROSPECTS IN LOW-INCOME DEVELOPING COUNTRIES – 2018". https://www.imf.org/en/Publications/PolicyPapers/Issues/2018/03/22/pp021518macroeconomic-developments-and-prospects-in-lidcs

27 See IMF (2019): 2018 REVIEW OF PROGRAM DESIGN AND CONDITIONALITY. May 2019. https://www.imf.org/~/media/Files/Publications/PP/2019/PPEA2019012.ashx

28 The primary balance is the difference between the amount of revenue a government collects and the amount it spends (except interest payments).

29 See for example https://ieo.imf.org/en/our-work/Evaluations/Completed/2021-0909-growth-and-adjustment-in-imf-supported-programs

- With the realism tools, the IMF staff examines whether forecasts in the document to assess debt sustainability are too pessimistic or too optimistic.

- There are realism tools for nine different parameters in the current DSA. At the end of the realism table, IMF staff needs to write a summary on the findings and what the results mean for the DSA.

- If the realism check shows a bias with regard to optimism or pessimism, then the baseline numbers should be adjusted, to make sure it is as realistic as possible.

In the past in general, forecasts systematically and systemically have tended to be too optimistic, especially in high-debt cases, rather than too pessimistic. As said above, overly optimistic forecasts can mean dramatically underestimating a debt situation in the future, leading to wrong decisions in the here and now. Optimistic projections justified programs that should never have been agreed to. They cause more hardship for the people of the respective countries and they play a role in underestimating necessary debt relief and therefore the burdens of creditors at the expense of the people of a country.

It is therefore important to have a closer look at forecast optimism and in what ways the IMF will deal with signs of optimism in its analyses.

Realism tools were introduced the first time in 2014, among other reasons due to criticism of systemic overoptimism. In 2021, these tools were refined again, as even with the inclusion of ever more sophisticated tools, forecast optimism still continued.[30]

In the DSA until 2021, even with realism tools introduced and even in cases with a bad forecast track record, deviations were not always explained and there was no transparency as to whether the results of the realism tool led to any changes in the baseline scenario for the country or not.

In the new framework, tools are again more sophisticated, however, unlike in the past, staff now need to explain how they deal with a poor track record in future projections.

We will look at some of the exemplary parameters which, in the critical engagement with the IMF on its debt sustainability analysis, may be most useful.

Box 3

The problematic concept of "public debt" as a central parameter in DSA

In the SRDSF, the central parameter that the IMF sets for debt sustainability is public debt-to-GDP. That means public external and domestic debt. However, according to its statutes, the main role of the IMF is to support countries that are faced by balance-of-payment crises, to which domestic debt is only partially related. When it comes to debt restructurings, the concept of public debt is very problematic: An external debt problem and a domestic debt problem are two fundamentally different issues. As both are included in the "public debt concept", it means that, when it comes to a debt restructuring, there is an incentive to automatically include domestic debt in the picture, even if a country only had an external debt problem. Automatically including domestic claims may mean an unnecessary burden on the country's people who already share the burden through fiscal adjustment measures. Further, civil society organizations face a dilemma when debt sustainability analyses are based solely on public debt: In order to achieve sufficient external debt cancellation and thus reduce public external debt service payments to a sustainable level, the public debt-to-GDP ratio (as the only ratio considered) must be set as low as possible. At the same time, setting the public debt-to-GDP ratio low in the context of an IMF program also narrows the space for deficit spending for social needs without violating program targets. In the past, however, this fixation on reducing the domestic debt-to-GDP ratio as quickly as possible has turned out to be economically inefficient and socially highly problematic. Thus, it would be a good change in policies to analyze public external debt stocks and public external debt service payments separately from public domestic debt.

2.5.1 The "forecast track record" tool

This tool examines the risks to forecasts of 5 indicators that could arise from past forecasting errors. The metrics examined include public-debt-to-GDP and the primary deficit.

The results are compared to a comparison group of countries. The results are shown in a table using colors.

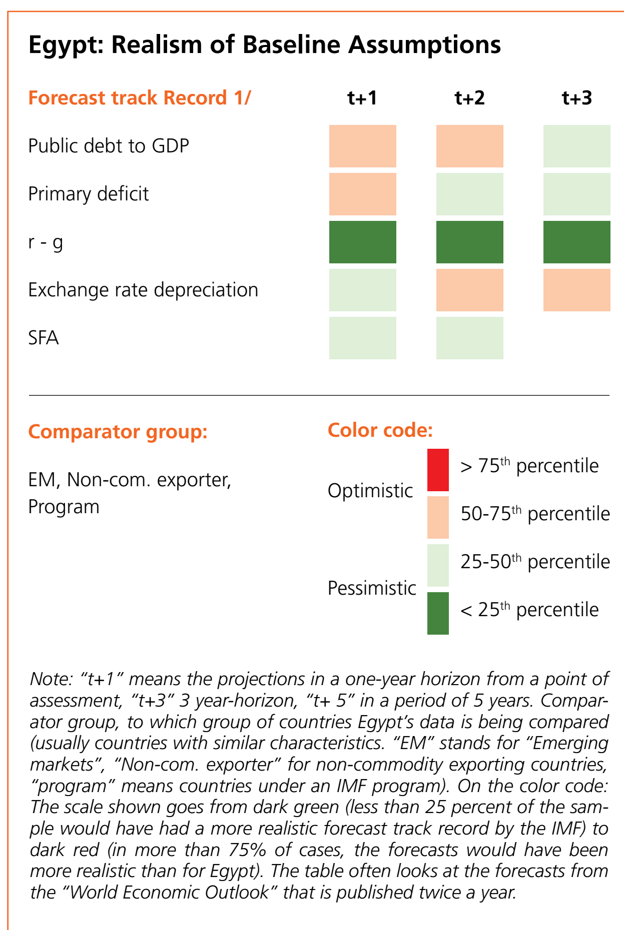
The scale of colors ranges from dark green to dark red.

- Orange and red means optimistic forecasts in the past, green too pessimistic.

30 On reasons for historic overoptimism, see Chapter 3 in Rehbein, K. (2022): "A decade of rosy forecasts".

In general, a table with many red boxes implies that past forecasts were too optimistic and thus also implies a risk for current forecasts.

The example of Egypt:[31] *When the IMF forecasted how public-debt-to-GDP would look one year as well as three years from the time of the analysis in Egypt, obviously, the IMF was more optimistic in Egypt than in other country cases (orange color). This is however different for medium-term growth: here, the IMF was more realistic in Egypt than in the comparative group of countries (light green colour).*

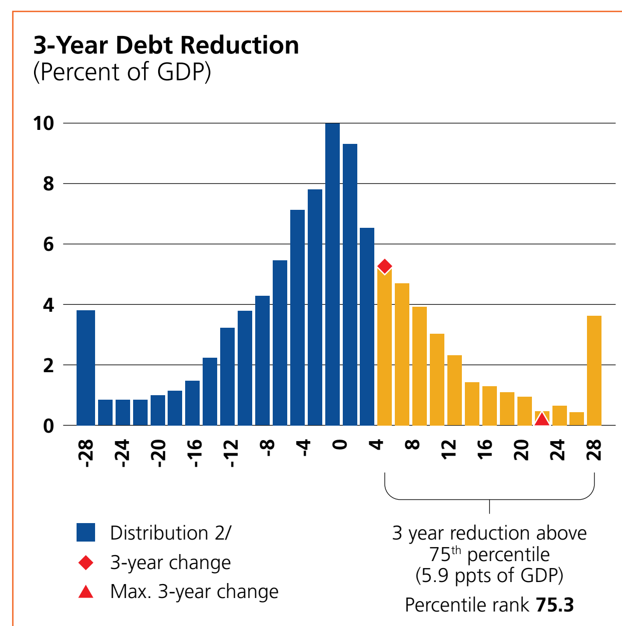


Note: "t+1" means the projections in a one-year horizon from a point of assessment, "t+3" 3 year-horizon, "t+ 5" in a period of 5 years. Comparator group, to which group of countries Egypt's data is being compared (usually countries with similar characteristics. "EM" stands for "Emerging markets", "Non-com. exporter" for non-commodity exporting countries, "program" means countries under an IMF program). On the color code: The scale shown goes from dark green (less than 25 percent of the sample would have had a more realistic forecast track record by the IMF) to dark red (in more than 75% of cases, the forecasts would have been more realistic than for Egypt). The table often looks at the forecasts from the "World Economic Outlook" that is published twice a year.

2.5.2 The tool on "3-year debt reduction":

It compares the projected change in the debt ratio with historical data for all market access countries. The tool displays a distribution of observed changes in the debt ratio over a three-year horizon and maps the country's predicted change in the debt ratio (the red diamond) into this distribution. A large predicted debt reduction (>75th percentile, orange bars) would indicate possible overoptimism in the forecasts.

In the Egypt example below, the graph shows the expectation that in a three-year period during the IMF program, Egypt's expected debt reduction is, in comparison with other countries ("distribution"), slightly ambitious (everything in the area of the orange bars, which is >75th percentile, will be seen as ambitious; if the diamond were in the area of the blue bars, it would not be seen as overly ambitious), but compared to Egypt's own historical track record (the red triangle; the diamond is left of the red triangle), it is seen as modest and therefore wouldn't raise the alarm bells of the IMF. It would potentially raise the alarm bells if the diamond was to the right of the triangle.



2.5.3 The tool "3-Year Adjustment in Cyclically-Adjusted Primary Balance":

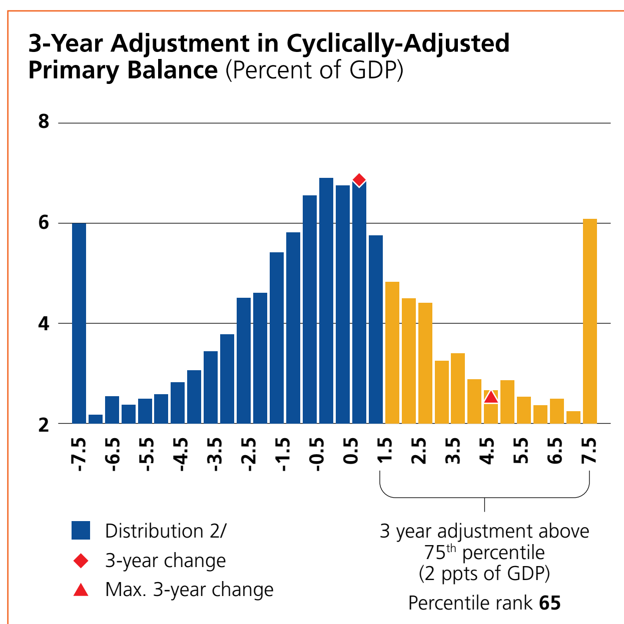
It attempts to identify optimistic assumptions about fiscal adjustments – the standard option that the IMF recommends to countries.

- The IMF looks at how much the country is to be expected to adjust in the next three years – a standard IMF program period and how the country in question compared to other countries that are distributed in the diagram. **The orange bars in the relevant graph begin with a fiscal adjustment of 2 percent of GDP, up to 7.5 percent of GDP.**
- If the country falls into the top quartile of the chart, this means fiscal adjustment is ambitious and potentially expected to be too high to stabilize the debt ratio.

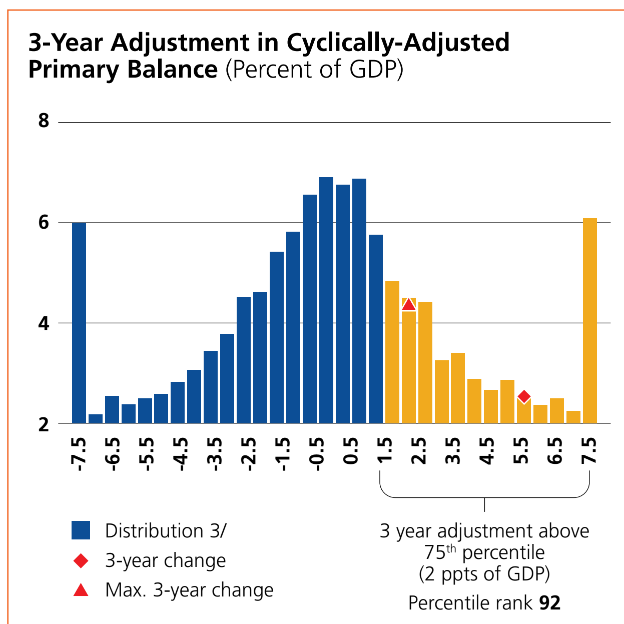
In the case of Egypt, the expected fiscal consolidation is in the range of 1 percent of GDP in three years. Compared to other countries, the expected fiscal adjustment is not seen as ambitious by the IMF. The mentioning of the "percentile rank 65" means that in 65% of the countries the IMF compared Egypt with, the forecasts on fiscal adjustments in % of GDP were less optimistic than for Egypt. This is acceptable for the IMF; if the rank were 75 or higher, this would

31 All the following graphs are recreated from IMF (2023): "Arab Republic of Egypt - Request for Extended Arrangement under the Extended Fund Facility", IMF Country 23/2, unless otherwise indicated. The original graphs can be found on p. 47 of the document. Any omission or errors from the recreation are unintended and to be excused.

raise a "realism flag", thus the alarm bell, that the IMF might demand far too ambitious reforms from the country.



To show a contrary case, here is the realism assessment in the case of Sri Lanka from March 2023,[32] an over-indebted country currently in a debt restructuring:



We see the opposite: the expected fiscal consolidation of Sri Lanka in the next three years (the red diamond) is to the far right of the red triangle (the historic track record of Sri Lanka) and also very ambitious compared to other countries (the red diamond being at the far end of the yellow area). The percentile rank is 92, which means in almost all other countries, the IMF was more realistic than in the case of Sri Lanka.

32 This graph is recreated from IMF (2023): "Sri Lanka - Request for an Extended Arrangement under the Extended Fund Facility", IMF Country Report No. 23/116. The original graph can be found on p. 62. All omissions or errors are unintended and to be excused.

If in a country report, this tool shows that expected fiscal adjustment is ambitious (such as in Sri Lanka), activists can look at tables such as the baseline scenario to assess whether the debt ratio is expected to fall or whether it is actually expected to remain high.

In that case, ambitious fiscal adjustment and potentially consequential hardship to the population will not even lead to an improvement in the debt ratio, and a debt restructuring would be paramount.

The study "Rosy Forecasts"[33] shows cases where the tool showed expected fiscal adjusment to fall into the top quartile of the most ambitious fiscal adjustments historically (such as in the example of Sri Lanka as well). In these countries (Tunisia and Jordan), this is the case despite experience showing that even minor sacrifices on the back of the population had already fueled protests in the past.

There is empirical evidence showing that there is a frequent overoptimistic assumption as to the pace and scope of fiscal consolidation.[34]

2.5.4 The "Fiscal Adjustment and Possible Growth Paths" tool:

This tool tests the consistency between fiscal adjustment and growth assumptions, thus what impact planned fiscal adjustment (spending cuts or revenue increases) will have on economic growth. The impact of fiscal adjustment on growth will be expressed by so-called fiscal multipliers.

- Different fiscal multipliers will be tested with the realism tool and the impact of the planned fiscal adjustment on growth under these fiscal multipliers will be compared with the predicted baseline growth path.
- Large discrepancies between the baseline and the growth implied by the fiscal adjustment paths (e.g., a growth pickup during a consolidation) would be unrealistic: a "realism flag" appears. **The higher the fiscal multiplier, the stronger the reduction in economic growth through the fiscal adjustment**.
- **The IMF often underestimates the impact of its austerity prescriptions on the economy of the country** and in turn on the potential to reduce the debt burden of the country. **If GDP drops, the debt in relation to GDP will rise**. One stark example is Greece from 2010.[35] In the region this is also true for Jordan: the negative impact of fiscal tightening on growth in the different IMF programs had been un-

33 https://erlassjahr.de/wordpress/wp-content/uploads/2022/09/2209-FES-Analysis-Rosy-Forecasts.pdf

34 See Mooney, H., de Soyres, C. (2017): "Debt Sustainability Analyses for Low-Income Countries: An Assessment of Projection Performance", IMF Working Paper WP/17/220, pt. 33.

35 https://www.washingtonpost.com/news/wonk/wp/2013/01/03/an-amazing-mea-culpa-from-the-imfs-chief-economist-on-austerity/

derestimated, i.e. the required fiscal consolidation led to growth shortfalls, instead of promoting growth.[36]

In fact, looking at the assumptions regarding fiscal austerity, whether forecasts are ambitious or realistic and whether debt restructuring plays a role in bringing the debt down to sustainable levels are particularly important for CSO advocacy.

A study published by the IMF in November 2020 shows a correlation between the magnitude of optimism in forecasts of economic growth and expected fiscal consolidation. The authors find that "large planned fiscal adjustments are associated with more optimism bias in growth forecasts than those with smaller planned fiscal adjustments".[37]

This finding is particularly important for high-debt countries that are potentially faced with only a limited amount of fiscal space to support their recovery from the multiple global shocks and a heavy debt burden. **The generation of overoptimistic forecasts will lead to debt sustainability being overestimated,[38] leading to a delay in accepting the inevitable, such as the need for debt relief.** The IMF's own evaluation found that a debt problem in countries with high debt vulnerabilities was downplayed by optimistic forecasts,[39] prolonging the crisis.

2.5.5 The tool on "Real GDP growth":

The realism of real GDP growth forecasts in the DSA is assessed by comparing these forecasts with historical average growth, "potential growth", and the output gap.

– Signs of optimism are present if, for instance, real growth increases significantly over the period compared with the historical average and the "potential growth" path calculated by the IMF. Also, if the orange bars, the "output gap", are positive at the end of the projection period, this is a sign of optimism.

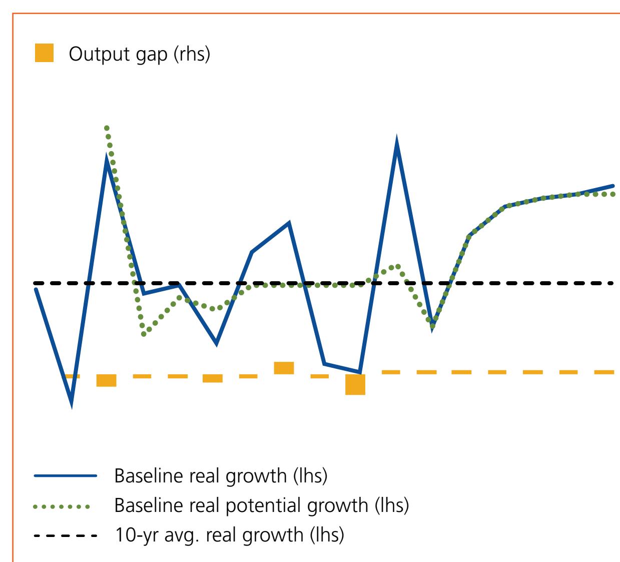
In the example case of Egypt (see graph below), projected growth during the IMF program is close to projected "potential growth" but far above the historical average (black line). The IMF must give an explanation why the baseline growth projection deviates from the past average. In the case of Egypt, the IMF explains that past growth was affected by several major shocks.

36 See IEO (2021): "Growth and Adjustment in IMF-Supported Programs for Middle East and Central Asia", BP/21-01/10.

37 See Ismail, K. et al. (2020): "Optimism Bias in Growth Forecasts – The Role of Policy Adjustments", IMF Working Paper WP/20229.

38 See, inter alia: IMF (2002); Timmermann, A. (2006); IMF (2011); IEO (2014); Mooney, H. and de Soyres, C. (2017).

39 Ibid., as well as IEO (2014). See also IMF (2017): "Review of the Debt Sustainability Framework in Low-Income Countries: Proposed Reforms", page 9, pts. 9 and 10: The IMF's own review revealed that, in 40% of debt sustainability analyses between 2007 and 2010, errors arose in the context of medium-term projections to the extent of 15 percentage points; in 80% of these cases, the state of indebtedness was underestimated, and this particularly related to countries with a high risk of debt distress.



2.6 THE MEDIUM-TERM RISK ANALYSIS

The Medium-Term Risk Assessment (MTRA) looks at the potential solvency ("debt fanchart module") and liquidity ("gross financing needs (GFN) module") risks in the next 5 years, which encompasses most of the IMF program period.

The analysis looks at two parameters that are central for the IMF to assess the debt sustainability:[40]

1. the debt trajectory and stabilization of the debt situation – debt fanchart module; and
2. the look at liquidity risks in the form of financing needs of the country – gross financing needs (GFN) module.

The Debt fanchart module

a) The first indicator is the **"fanchart width"**. This is to look at uncertainty around the development the IMF expects as likely, the "baseline scenario". The higher the value, the more uncertainty around the baseline, so the more uncertainty around what the IMF expects as likely to happen and the higher the possibility of large projection errors. This means that if these uncertainties were to materialize, public debt could turn out to be much higher than envisaged.

b) The next is the **probability** that the debt situation would not stabilize.

   If the probability is high, this means that the policies and measures foreseen would not guarantee fiscal and macroeconomic stability.

40 In addition to these two modules, additional stress tests could be triggered to assess a specific vulnerability, such as a commodity price stress test that provides scrutiny of vulnerabilities arising from large swings in commodity prices or a contingent liability stress test that illustrates potential risks of debt surprises for countries.

c) The third indicator is about the **debt level**. If this remains elevated, then it represents a significant burden and limits options to cushion shocks.

The IMF summarizes the results of these three indicators into an index. This will be the basis for the risk rating. *In the case of Egypt the "Debt Fanchart index" is 2.1. This translates to a "high risk" of debt problems.*[41]

The gross financing module

On gross financing needs, the IMF looks at estimated financing needs seen as likely, bank claims on the government, and how these claims change when there is a stress situation (similarly to the debt module; this will be summarized in an index, which informs the risk rating).

On the basis of thresholds, there will be a rating of low, medium or high risk. If the index is above 17.9, the risk is high. *In the case of Egypt, for example, the index is almost twice as high, with an index of 31.4.*

All six sub-indicators will be compared with other countries that resemble the country in question. *For example, in Egypt's case, the position of Egypt within this comparison group is at the value of around 75. This means that approximately 75% of the countries in the comparison group have a lower value than Egypt for this particular indicator.*

After looking at these indicators, the IMF produces a "Final Fanchart" for both public debt to GDP and GFN.

On the debt trajectory, the Final Fanchart represents the degree of uncertainty regarding the projected public debt.

– The wider the chart, the more uncertain is the situation.

– If the comparison with historical values show a bias toward optimism (or pessimism), the tool automatically adjusts the fanchart.

– IMF staff is asked to use the commentary box to describe assumptions and results, including on judgment, such as excluding an observation in the baseline scenario.

Next to the "final fanchart" is the final result on GFN, which shows the gross financing needs as a percentage of GDP.

– On the one hand the GFN seen as most likely are being forecasted (this is the "baseline"); on the other hand, the potential GFN in the case of an external shock or other adverse event is shown (the "stress scenario").

In the graph a comparison can be made as to how GFN would deviate from the expectation of the most likely outcome if anything unexpected happens, such as a commodity price shock.

2.7 OTHER DATA AND TOOLS IN THE DSA

Besides the tools and concepts mentioned so far, the IMF can also use **tools for long-term debt-related risks**, including climate change, natural resource extraction, and large debt amortizations in the long-term future. While useful, the results of these tools will not be part of the risk assessment. This is criticized by CSOs and there are demands that the implications of climate change (including other issues such as investment needs for sustainable development[42]) should be consistently included in debt sustainability assessments.

If a country needs to undergo a debt restructuring, the IMF will include **a debt restructuring scenario**, calculating what debt relief is necessary to get debt indicators below such a level so that the new risk of debt distress is moderate, while the country has enough space to absorb shocks (this is under the "LIC-DSF" debt sustainability framework for low-income countries). Under the current framework for market-access countries that is the focus of this toolkit (SRDSF), so far there has been only one country case that started a debt restructuring at the time of editorial closing date, which is Sri Lanka (which is in default). One other – Suriname – completed a private sector restructuring before the rollout of the new framework. Under the SRDSF, there is no such overarching rule of debt risk down to "moderate with substantial space to absorb shocks". It is very flexible with regard to what indicators, parameters, and thresholds can be used to define a debt to be sustainable.

In **Suriname,** there is an entire section on "public debt under restructuring scenario",[43] after the display of the DSA tables. It gives information on what the IMF understands as sustainable debt parameters in the country case and it explains how much is expected to be provided in debt relief by creditors. In the end, there is an assessment about whether under the assumed restructuring scenario, public debt is seen as capable to be restored to sustainable. In Suriname, 60 percent debt-to-GDP is seen as sustainable; the IMF explains that this is consistent with other debt restructurings in the region and that at 60 percent, there is some buffer against external shocks.

In **Sri Lanka**,[44] debt is seen as sustainable with a 95 percent debt to GDP ratio. This is very different from Suriname, and there is no clear explanation as to where this very high threshold has come from. If Sri Lanka had been as-

41 Threshold values are <1.13: low risk; 1.13-2.08: moderate risk; >2.08: high risk. See IMF (2022): "Staff guidance note", p. 73.

42 See for example https://unctad.org/system/files/non-official-document/DMC2022_Panel2_Blankenburg.pdf

43 See IMF (2023): "Suriname – Second Review under the Extended Arrangement under the Extended Fund Facility", from p. 54.

44 See IMF (2023): "Sri Lanka – Request for an Extended Arrangement under the Extended Fund Facility", IMF country report No. 23/116.

sessed under the LIC-DSF, the target number would have been substantially lower – which however would have meant a much higher loss for creditors.[45] In the case of Sri Lanka, the commentary boxes in the DSA figures show that the debt restructuring envisaged would still leave the country with high debt vulnerabilities. As said above, according to the framework, IMF staff need to explain any realism flags, deviations, etc. In the case of Sri Lanka, there is no explanation why the debt sustainability parameters have not been adjusted if the DSA tools show that the debt restructuring would not suffice (see below on engaging with the IMF on debt sustainability analyses).

In both cases, there is a detailed decomposition of Public Debt and Debt Service by Creditor included, with useful information on individual creditors as well as items such as collateralized debt, contingent liablities etc.

2.8 INFORMATION NOT PART OF THE DSA – BUT IMPORTANT TO LOOK FOR

What is not part of the direct DSA but is part of tables in the remaining program or surveillance document is a table on "**External Financing Needs and Sources**". This is very useful in understanding how much the IMF expects the country to need in financing over the program period and where the IMF expect this financing to come from. Sometimes it also names concrete lenders that the IMF expected funds to come from. The table is also a standard table and should be part of country documents related to a program with the IMF.

What is very problematic, however, is that the IMF would not assess the availability and necessary funding in relation to the SDGs / national development plans. In stress tests, for example, it solely assesses the necessary capacity to repay creditors, particular the IMF itself.

Program documents often include an "**overall risk assessment to the baseline scenario**", which is often described in the text and shown in the annex "**Risk assessment matrix**". The risk assessment matrix shows events that could substantially alter the expected baseline path. IMF staff judge whether a risk is highly likely to materialize or whether there is a medium or low likelihood. It also explains whether the IMF sees a high, medium or low impact of this risk on the debt/fiscal trajectory of the country.

The risk assessment matrix also gives recommendations, however, which often do not differ from the standard default option of fiscal measures and are sometimes more related to long-term changes that won't affect the immediate situation if the risk were to materialize in the program period.

In the text, the IMF often gives a summarizing assessment, with wording such as "Baseline projections are subject to considerable uncertainty, with risks tilted to the downside."[46] This can provide a hint as to how likely the IMF staff sees the baseline scenario from derailing.

It can be quite revealing to compare these sections of the reports from various years with each other to see whether the language gets more alarming and whether this is shown both in how the baseline scenario is being designed and what recommendations the IMF gives to countries in how to deal with the situation.

Also, not always as part of the DSA annex but somewhere else in the document, are so-called **stress tests**.

- Stress tests simulate different shock scenarios to assess how the debt situation would evolve if, for example, future GDP growth were to be lower than expected. Shocks can stem from a natural disaster, a commodity price shock, a banking crisis, etc. Depending on the economic structure and vulnerability of the country, the IMF has the option to use different scenarios.
- Stress tests have the aim of assessing how the fiscal or debt trajectory would develop if assumptions do not materialize but if some of the risks instead were to materialize.

For example, in the case of Egypt, the IMF experts simulated an "FX availability test", in which they simulated a situation where Egypt would not be able to reaccess capital markets after the program ended and what that would mean in terms of the availability of foreign exchange to repay the IMF, among others. In that case, the IMF tested whether the exposure to external creditors would be high enough to mobilize the needed foreign exchange to repay the Fund through a debt restructuring with these creditors.

What does not exist in DSA is a scenario that would deviate from the standard recommendation of fiscal consolidation as the only appropriate strategy for stabilizing the debt ratio. **Alternative scenarios which incorporate debt restructurings** and partial debt relief and their impact on economic recovery, as well as the improvement of debt indicators, are non-existent. **If such – even if just illustrative, non-binding – scenarios were to exist, it would be possible to identify debt restructuring needs at a significantly earlier stage and support to foster the understanding that debt relief is a growth-promoting option** and not something to avoid at all costs. In addition, this would provide an incentive to draw up more realistic forecasts.

45 See a critique on the chosen parameters: https://www.cfr.org/blog/common-framework-and-its-discontents

46 IMF (2023): "Arab Republic of Egypt – Request for Extended Arrangement under the Extended Fund Facility", IMF Country Report 23/2.

Box 4

Engaging with IMF debt sustainability analyses – example questions to ask when looking at the DSA:

– *Does the IMF see risks to the baseline scenario mainly tilted to the downside? If yes, has the baseline scenario been changed accordingly (to assume those risks to be part of the baseline scenario)? What is said in the text about this?*

– *The baseline table: What is the assumption of the IMF in terms of the medium (5-year) and long-term (10-year) horizon on the debt-to-GDP ratio? Is the assumption that it will decrease? If yes, is this due to the assumption that GDP growth will rise? If yes, on what basis (what does the IMF say in the commentary / text body)? Or is this because the assumption is that debt will decrease? If yes, on what assumption?*

– *IMF programs always have to be fully financed. What does the IMF expect financing needs to be? What is the assumption as to how those financing needs will be met? As an example: Is the assumption that financing needs will be met with new loans from the capital market? If yes, what does the risk assessment matrix say about the risk to access to capital and investor sentiment? Etc. What is the IMF's scenario if expected capital market access (as an example) cannot be realized?*

– *If the table shows the assumption that the debt-to-GDP ratio will remain high over the projection horizon, and debt is expected to be higher than 70 percent of GDP, what is the justification for the IMF to lend anyway and not bind a lending program to a debt restructuring? Is there a commentary on how to deal with that situation?*

– *If the comparison to peer countries will show a substantial deviation, how can that be explained? Is the analysis adjusted to this?*

– *In the medium-term risk analysis, have stress tests been triggered? How have results been reflected in the calculation of, for instance, the debt relief envelope?*

– *If GFN needs are high and driven by debt service, what is the consequence? Are measures recommended that will reduce the debt service by debt treatments?*

– *Is the expected primary balance at a level comparable to peer countries? If not what is the justification of the IMF to expect a target much higher (which is mostly the case) than in peer countries?*

– *If the baseline scenario shows an ever-increasing debt-to-GDP ratio or a debt-to-GDP ratio that remains high, does the IMF recommend a debt restructuring or bring this option as growth-promoting measure into the discussion in the program document?*

– *If the realism tools show a track record of optimistic forecasts, is there an explanation of how the IMF dealt with the results? Is the explanation the IMF gives in its commentary to the realism tools convincing? Is the fiscal multiplier – thus the impact of fiscal consolidation on growth – transparent? Is the past performance of the fiscal multiplier assessed in the DSA and have past assumptions on the multiplier come true? What consequences were drawn from that assessment?*

– *In a debt restructuring scenario, how are the chosen parameters for debt sustainability, such as a certain debt-to-GDP level that the country needs to reach, justified? Look for responses in the text body.*

– *In a debt restructuring scenario, usually, debt sustainability targets will be based on the assumption of a positive future growth and revenue dynamic. What does the DSA say on downside risks? If these are high, has this been incorporated into how debt sustainability targets have been caclulated?*

– *In a debt restructuring scenario, if there is more than one DSA in the period of the restructuring, it makes a lot of sense to look at how the IMF projected revenue and GDP growth are to evolve at the beginning of debt restructuring negotiations and the same numbers after a first agreement has been reached. Are assumptions the same, or are assumptions after the debt restructuring agreement higher? This can indicate a financing gap that results from creditors not having agreed to the full amount of debt relief, a gap, which was then filled with more optimistic assumptions on revenue generation.*

3

RECOMMENDATIONS TO THE IMF TO IMPROVE DEBT SUSTAINABILITY ANALYSES

3.1 BUILDING SAFETY BUFFERS INTO PROJECTIONS

As the information provided by the IMF underpins decision-making by debtors on debt-related economic and policy matters, it is problematic when predictions are systematically overoptimistic. At the same time, no one can see into the future. Hence, it would be plausible to build a safety buffer into every baseline scenario when making forecasts, especially for heavily indebted countries. Often, these countries have little fiscal scope, and small shocks are enough for them to reach the tipping point into a debt crisis. This applies concretely to countries in which the IMF believes "debt is sustainable but not with high probability". The safety buffer could mean that the IMF builds the downside risks that it cites in its analyses as highly likely into the baseline scenario that it sees as probable – and accordingly shapes its projections on economic growth or margins for fiscal adjustment measures. For the decision as to whether an IMF program is to be bound to a restructuring, or whether, in countries without programs, debt relief should be suggested as an option, the probable trajectory of debt in one of the stress scenarios could be used as a basis, rather than the baseline scenario.

3.2 MAKING DEBT SUSTAINABILITY ANALYSES INDEPENDENT AND PUBLIC

So that creditors and debtors potentially agree on realistic forecasts, independent institutions and/or experts – including those independent of the loans and influence of the shareholders – can be consulted in the development of baseline and stress scenarios. After all, the IMF does not hold a legally enshrined monopoly on the development of debt sustainability analyses. It is only when a country applies for a loan program that the IMF's debt sustainability analysis becomes relevant because the IMF's yes or no to the granting of the loan depends on it. Hence, there is no legal reason why the IMF's debt sustainability analysis could not be supplemented or even replaced by one undertaken by other actors or the debtor country's own analysis. But here's the catch: in all debt relief initiatives borne by official creditors, be they the HIPC Initiative in the early 2000s or, currently, the G20 Common Framework, and in the negotiations in the Paris Club, the official creditors make an IMF program the condition for their own debt restructuring. This creates a quasi-legal monopoly of the IMF on which the official creditors, who are at the same time the most important shareholders of the institution, de facto insist.

Apart from the fact that the practice of making access to debt restructuring measures dependent on an IMF loan and adjustment program is fundamentally questionable, the debt sustainability analysis, and the assumptions underlying the calculated need for relief, should be a public good. This means it should be made publicly accessible during negotiations and not only after a program or restructuring was agreed. This is so that independent experts, just like other actors – above all, actors from the country in question – are able to test the assumptions and introduce their own suggestions.

3.3 MAKING DEBT RESTRUCTURING "MORE ACCEPTED"

The fundamental problem is that for countries that have not already defaulted, there are no scenarios in the country documents that differ from the standard recommendation of fiscal consolidation – and with it, internal adjustment at the expense of the country's population – as an appropriate strategy for stabilizing the debt ratio. There are no other scenarios that integrate measures such as partial debt relief and take into account the impact on economic recovery and the improvement of debt indicators. This is tragic, because the IMF does not simply provide loans or make nonbinding suggestions: it sets the parameters for acceptable macroeconomic policies.

If there were such alternative scenarios, the need for debt restructuring could be recognized at a much earlier stage. In the same way, countries could consider debt restructuring as a reasonable option early, or earlier, instead of only when there is no other way out. Moreover, this could well lead to more realistic projections, since the incentive to drive the figures upward in the case of heavy indebtedness (when restructuring is not part of the program) through the demand for more austerity measures would be reduced.

5

ALTERNATIVE DSA DISCUSSIONS

Despite the IMF's own frameworks and regular reviews of those, there are several alternative discussions on DSAs' trying to provide a broader view on issues of debt sustainability including sustainable development. This includes discussions on "growth sustainability analyses"[47] that intend to make sure analyses are not solely oriented to restore payment capacity but instead to sustain growth. Another is the idea of "sustainable development finance assessments"[48] by UNCTAD, with which the development finance needs of countries to achieve significant SDGs will be identified and assessed to determine how these can be made compatible with external financial and debt sustainability. The Friedrich-Ebert-Stiftung together with the civil society network Jubilee USA currently organise a one-year-long expert roundtable on different aspects of DSA practice that will likely bring out more recommendations on how to improve DSA practice.

47 https://www.niesr.ac.uk/blog/imfs-programs-zambia-and-sri-lanka-editions

48 https://mobilizingdevfinance.org/tool/unctad-sustainable-development-finance-assessment-sdfa

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UNDERSTANDING IMF DEBT SUSTAINABILITY ANALYSES

A Toolkit for CSOs to critically engage with the IMF

High debt can undermine the ability of governments to invest in the sustainable development goals and deploy countercyclical measures in crises as needed. The way the debt situation is treated is therefore of utmost importance. Should a crisis arise and a restructuring process become necessary, sovereign debt is the only category of debt for which this process is not regulated by any kind of legal framework. In the Global South, the IMF instead plays a central role in the recognition and resolution of debt crises. Therefore, CSOs should have a critical eye on the IMF's analysis and advice on debt sustainability.

At the centre are the IMF's debt sustainability analyses, including in the determination of how much debt relief is needed. Not only are these documents crucial resources to understand the advice a country is receiving to fund its development priorities. The IMF has a track record of underestimating debt risks, providing overoptimistic assumptions on economic recovery and being hesitant to recommend debt restructurings, with the result that there often is too much of a focus on fiscal austerity, undermining social and economic rights of the population in the country and prolonging debt crises, instead of resolving them.

In CSO advocacy on the IMF, the focus on debt sustainability analyses is so far underrepresented. However, these technical analyses will define the parameters in which a government decides its future policies and they will guide negotiations with creditors. This toolkit aims at increasing the capacity of CSOs to understand the IMF debt sustainability analyses in its framework for market-access countries. The toolkit shall equip CSOs with the knowledge to critically engage with the IMF on its debt-related advice, in order to formulate well-informed demands in their IMF advocacy on social and economic justice.

For further Information on the topic can be found here:
https://mena.fes.de/topics/economic-policies-for-social-justice

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