The IMF's new Sovereign Risk and Debt Sustainability Framework for Market Access Countries

G-24 Technical Group Session on Addressing the Challenge of Sovereign Debt Distress, Thursday, March 18

Background

- The IMF has two frameworks for assessing debt risks and debt sustainability:
  - Debt Sustainability Framework for Low-Income-Countries (LIC-DSF, joint with the World Bank).
  - Debt Sustainability Framework for Market Access Countries.
- The LIC-DSF was created in its current form in 2017-2018. The MAC-DSF was last reviewed in 2011-2013.
- The ongoing review focuses on the MAC-DSF. In part, it catches up with innovations introduced in the LIC-DSF in 2017-18. In part, it leapfrogs the LIC-DSF.
- Status of the review:
  - new framework approved by Board (with a minor modification) on January 14, 2021.
  - Rollout expected at the end of this year, after guidance note preparation and training.

Aims

To provide a framework that can be used to BOTH assess the risk of sovereign debt distress AND debt sustainability in market-access countries

Sovereign Risk Assessment

Critical for IMF's **surveillance** function: ("Early Warning System" for altering sovereigns to the risk of falling into debt-related **stress**.

Debt Sustainability Assessment

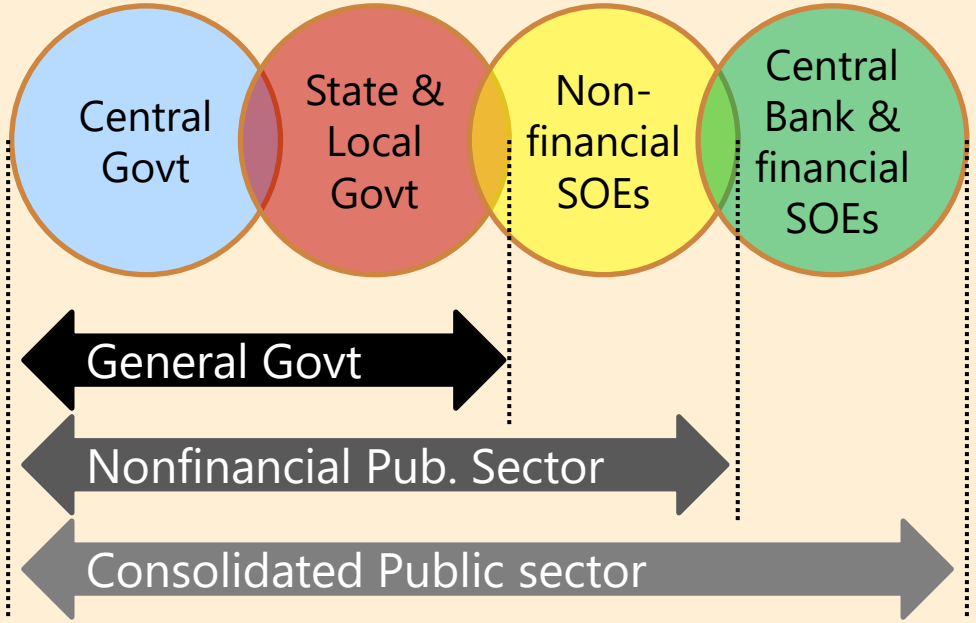
Critical to support IMF **lending** decisions: Underpin the Fund's judgments on whether debt is sustainable (or sustainable with high probability, in exceptional access cases)

Hence, new title: "Sovereign Risk and Debt Sustainability Framework for Market Access Countries (MAC-SRDSF)

Main innovations compared to 2011-13 framework

- Improved predictive capacity
- Provides model-based probabilities of sovereign stress and unsustainable debt (leading to a three-way "bottom-line" mechanical signal)
- Provides information about the *timing* of risks, by associating them with different horizons
- Analysis now includes long-term risks (10-30 years)
- Focus on debt coverage and debt transparency issues
- Much easier to communicate (because of bottom-line, horizon-based signals)

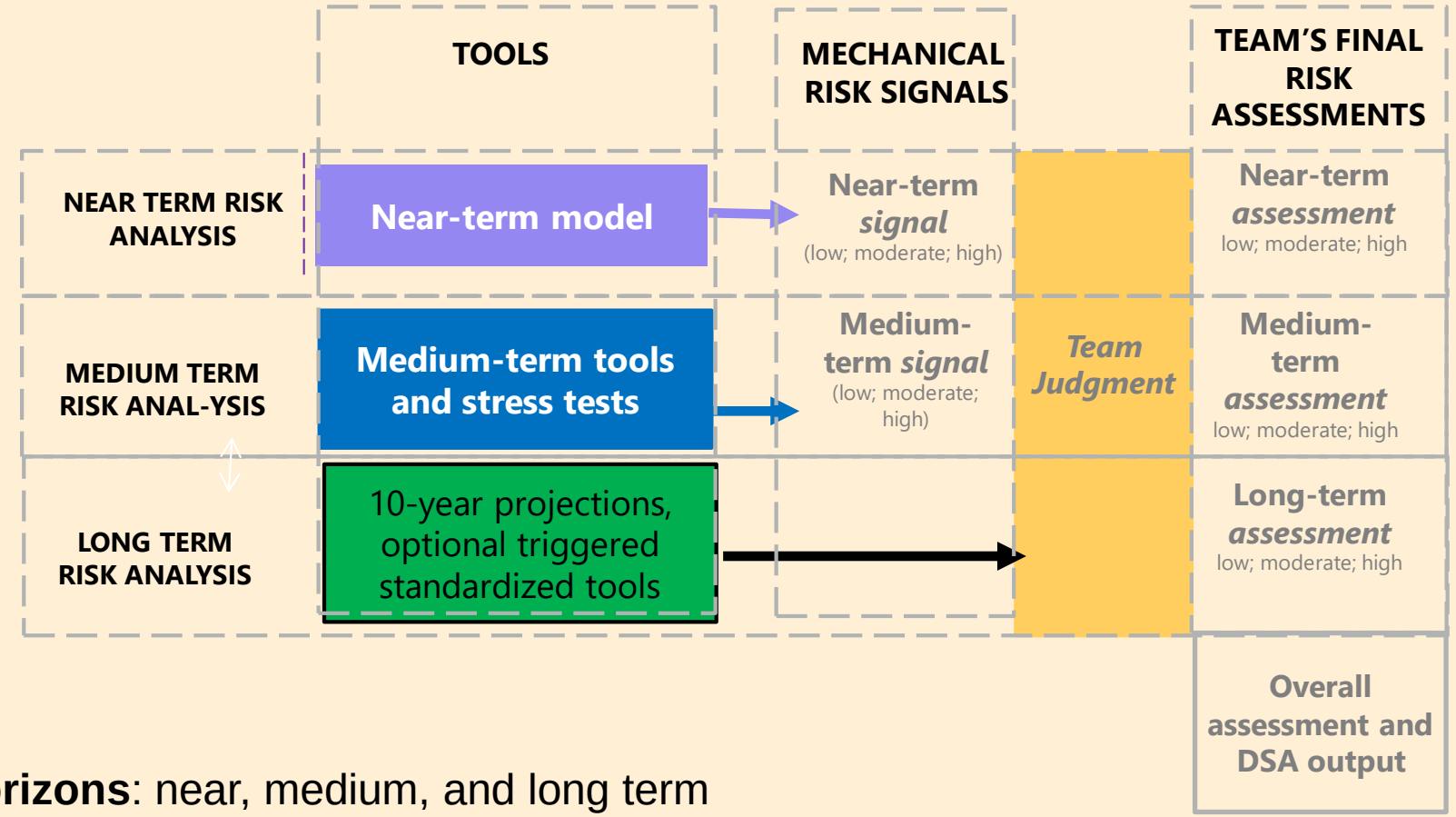
Debt coverage at GG level, with enhanced disclosure



- **General government** (GG) as defined in GFSM 2014 as default minimum institutional coverage
- Broader coverage where economic case exists
- Enhanced disclosure on institutional coverage, instruments, debtholders; essential to support risk analysis and evenhandedness
- Guidelines on how to treat specific central bank liabilities (e.g. liquidity paper, FX swaps)

Closer attention to risks stemming from narrow coverage

Framework for sovereign risk assessment: architecture



- **Three horizons**: near, medium, and long term
- **Three risk ratings** (signals and assessment): low, moderate and high
- **Mechanical signals** generated by new analytical tools for near and medium term
- Optional **standardized tools** for long-term risk analysis
- Use of **judgment** to reach **final risk assessments** at each horizon and overall

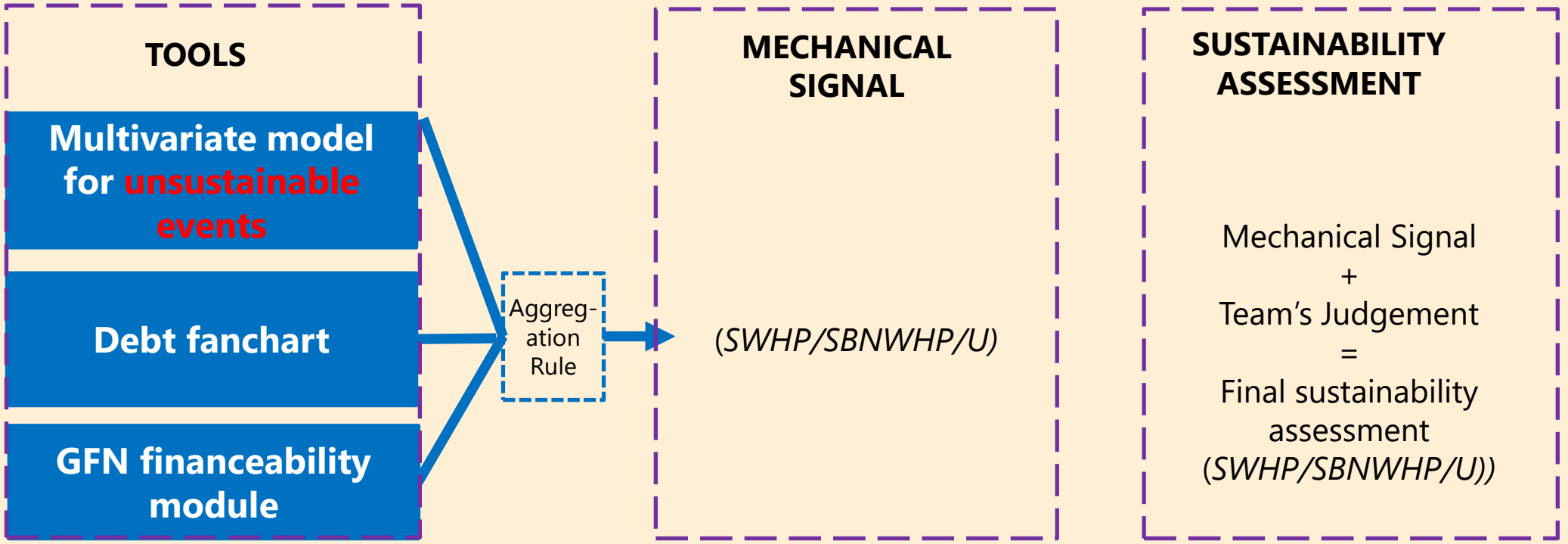
Framework for sovereign risk assessment: analytical tools

- **Near term (1-2 years ahead):** Multivariate logit model to predict stress based on current level of stress drivers (structural, cyclical, debt burden and global) and mitigating factors

- **Medium term (up to 5 years ahead):**
  - **Debt fanchart** tool (Fanchart): accounts for debt levels, likelihood of debt stabilization, and uncertainty around debt projections
  - **Financeability (rollover risk) tool** (GFN): accounts for level of gross financing needs, composition of investor base, and rollover risks
  - Triggered **stress tests** to cover specific vulnerabilities

- **Long term (beyond 5-year horizon):** optional standardized tools to analyze the impact of demographics, scaling up/down of natural resources, large debt amortizations, and climate change

Framework for debt sustainability assessment: architecture



- Focus on **near- and medium-term** tools **calibrated** to predict unsustainable debt events
- Aggregates output from near and medium-term tools into a single **risk index** that is then compared to thresholds
- **Three-way probabilistic assessments** of debt sustainability: sustainable with high probability (SWHP), sustainable but not with high probability (SBNWHP), and unsustainable (U)
- Use of **judgment** in addition to **mechanical signal** to reach **final assessment**

Publication, and implementation timeline

Elements of the analysis to be initially published in staff reports

- *In program cases:*
  - Medium-term sovereign risk signals and medium-term, long-term, and overall assessments
  - Three-way debt sustainability assessment—SWHP, SBNWHP, and U—for exceptional access cases (as is current practice), otherwise two-way sustainability assessments (pooling SWHP and SBNWHP)
- *In surveillance cases:*
  - Medium-term sovereign risk signals and medium-term, long-term, and overall assessments
  - Debt sustainability assessments are optional
- Possibility of publishing near-term signals to be reconsidered after 12 months

Implementation

- The framework is expected to be operationalized in the final quarter of 2021/first quarter of 2022, after the completion of the accompanying Guidance Note and template.
- Extensive engagement with country authorities and other stakeholders prior to implementation.

Backup slides

Realism tools and adjustments

- Realism tools:
  - **Forecast track record** for main drivers of public debt compared to peers
  - **Contribution of debt drivers** to the increase in debt over projection period versus past years
  - 3-year projected **debt reduction** versus past 3-year reductions.
  - 3-year projected **fiscal adjustment** versus past adjustments
  - Expected **REER correction** toward long-term equilibrium
  - **Real activity** : closing the output gap in the medium term and impact of fiscal adjustment on growth
  - **Maturity structure** of new issuances projected and **interest rate spreads**

- **Correction for optimism in the debt fanchart**: when the baseline debt path is assessed to be optimistic relative to a historical trend and more so than in peers, one-sided shocks are applied to skew the debt fanchart to the right.