Unclassified **DCD/DAC(2014)29**

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development **27-May-2014**

English - Or. English

DEVELOPMENT CO-OPERATION DIRECTORATE
DEVELOPMENT ASSISTANCE COMMITTEE

DCD/DAC(2014)29
Unclassified

OPTIONS ON CONCESSIONALITY

DAC Meeting, 10 June 2014

This document is submitted for DISCUSSION under Item 4 of the Draft DAC Annotated Agenda [DCD/DAC/A(2014)7].

This paper invites members to consider the options for reforming the assessment of concessionality of loans for ODA reporting purposes and seeks to launch the process of building political consensus on the reform. Setting aside the technical issues inherent in the various concessionality options, it recalls the objectives of the reform, presents a brief narrative of the options, and requests members' views on which option would best address the objectives of the reform. While at present all options are still under consideration, it invites members to rank them in their order of preference with a view to narrowing down the list and enabling the preparation of a concrete proposal for consideration by the SLM in October.

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A. Introduction

1. This paper invites members to consider the options for reforming the assessment of concessionality of loans for ODA reporting purposes. The options presented are based on previous discussions in the DAC, the March 2014 Senior Level Meeting (SLM), the Expert Reference Group, and the April 2014 Informal meeting of the Working Party on Development Finance Statistics (WP-STAT), where the feasibility of risk-adjusted grant equivalents was discussed.[1]

2. The WP-STAT concluded that the grant equivalent approach was technically feasible, but that a number of implementation issues needed to be further examined. These include the treatment of negative grant equivalents, treatment of existing stock of ODA loans and treatment of debt relief. All three issues are critical for the political credibility of the new measure. They also have implications on the ODA levels of individual loan-extending members, who may therefore need a "phase-in period". The length of this period is essentially a political decision, to be taken by the DAC.

3. Moreover, the WP-STAT noted that further work is required to arrive at an acceptable source of risk premia and that the Export Credit Group (ECG) should be consulted about possible second-order implications of the risk-adjusted grant equivalent option. The Secretariat is developing a proposal on the risk premia[2] for discussion at the next informal meeting of the WP-STAT, scheduled on 24 June 2014. The consultations with the ECG will take place in the week commencing 16 June 2014.

4. Pending clarification on the implementation issues related to risk-adjusted grant equivalents, this paper seeks to launch the process of building political consensus on the reform. Setting aside the technical issues inherent in the various concessionality options, it recalls the objectives of the reform, presents a brief narrative of the options (explaining their underlying rationale), and requests members' views on which option would best address the objectives of the reform. While at present all options are still under consideration, it is time to narrow them down. For this reason, and with a view to preparing a concrete proposal for consideration by the SLM in October, members are invited to rank the options in their order of preference. The DAC agreement on concessionality is applicable to loans extended in 2011-14, so there is a compelling reason to reach consensus on the issue by the end of the year.

B. Objectives of the reform

5. The necessity to reform the concessionality assessment in ODA reporting is well explained in discussion papers presented to the DAC and the WP-STAT over the past two years.[3] If summarised in one sentence, it could be stated that differences in members' practices with respect to the concessionality of ODA loans have cast doubt on the ODA measure as a reliable and consistent indicator of donor effort and, consequently, **the main objective of the reform is to restore the credibility of ODA as an indicator of donor effort**.

6. The current inconsistencies in members' reporting on ODA loans are due to the fact that "concessionality in character" is not precisely defined in the Reporting Directives. Under the DAC

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1 . Cf. DCD/DAC/STAT(2014)1.

2 . This will include risk premia differentiated by country risk category and long-term average risk premia.

3 . See for example DCD/DAC(2013)2.

agreement on concessionality, members have recognised that there are different interpretations regarding the meaning of this term, and have committed to updating and refining the Directives by 2015 to ensure consistency in the application of the definition among DAC members. A key question in this regard is **to clarify whether the grant element calculation, and the discount rate used in that calculation, assesses concessionality from the lender's or borrower's perspective.**

7. Any proposal on concessionality to be presented at the High Level Meeting (HLM) at the end of the year will need to explain how it fulfils the December 2012 HLM mandate to *"establish a clear quantitative definition of concessional in character, in line with prevailing market conditions"*. The other HLM decisions – *"equal treatment of all members"*, *"transparency regarding the terms of individual loans"*, and *"recognising development loans extended at preferential rates, whether concessional in character under a future post-2015 definition or not, as making an important contribution to development"* – will also need to be addressed.

8. The HLM mandate on concessionality also specified five principles on ODA measurement. Three of these relate to the credibility of the ODA measure: ODA reporting should *"withstand a critical assessment from the public", "avoid creating major fluctuations in overall ODA levels"* and *"prevent notions that ODA loan schemes follow a commercial logic"*. The other two –*"maintain the definition of ODA, and only attempt to clarify the interpretation of loans that qualify as ODA"* and "*be generally consistent with the way concessionality is defined in multilateral development finance"* – touch upon the ODA definition. **The reform should aim to comply with HLM decisions and principles to the furthest possible extent.**

9. Finally, the concessionality options cannot be considered in isolation from the general reform of the system for measuring development finance, which sets two additional objectives for the reform. First, the HLM mandate on development finance explicitly mentions that the system should "*represent both donor effort and recipient benefit perspectives of development finance"*. Secondly, the work is generally carried out *"with a view to ensuring that ODA is directed to where it is most needed and where it can catalyse other flows and promote accountability"*. **These resource allocation, mobilisation and accountability objectives, not mentioned in the HLM mandate on concessionality, should also be taken into account.**

C. List of options

10. A general explanation of the dimensions of choice in the reform on concessionality and loans reporting was given in Annex 3 of the SLM paper DCD/DAC(2014)9, reproduced for ease of reference in the Appendix. In brief, **there are three basic options for revising the discount rate of the grant element calculation** [alignment with the IMF/WB discount rate (currently fixed at 5%), applying the currency-specific OECD differentiated discount rates (DDR), or introducing risk-adjusted discount rates] **and two options for the measurement method** [introducing a grant equivalent method (only accounting as ODA the grant equivalent of loans) or maintaining cash flow basis].

11. The current system assesses the concessionality of a loan from the donor perspective, the discount rate of 10% representing the opportunity costs incurred at diverting resources from domestic investment to aid. **The adoption of the IMF/WB discount rate or DDR would maintain the donor perspective of the assessment but change its basis to lenders' funding costs.**

- The IMF/WB rate is set by reference to a 10-year average of the monthly US dollar commercial interest reference rate (CIRR) and includes a term premium, reflecting the generally long tenors of developmental loans to low-income countries (LICs). It is important to note however that this discount rate retains a link to the market conditions. While it is fixed at 5% (and while the aim is to avoid the fluctuations observed in the past that created operational difficulties for the implementation of the IMF's Debt Limits Policy and the World Bank's Non-Concessional Borrowing Policy), it will be reviewed as part of the next review of the Debt Sustainability Framework (DSF) for LICs in 2015 and revised again if market conditions deviate.

– The DDRs also represent lenders' funding costs, but more accurately as they are differentiated by currency and tenor, and updated annually.

12. Both the IMF/WB rate and the DDR are "risk-free discount rates". A risk-adjusted discount rate takes into account both the lender's cost of funds (IMF/WB rate or DDR) and the risk incurred in lending to a particular country (risk premium), and therefore better captures the true costs associated with individual loans. **The adoption of this approach changes the logic of the concessionality assessment from a donor cost to a recipient benefit calculation**.[4]

13. **The rationale for adopting a grant equivalent as opposed to cash flow method in ODA reporting is that it measures concessionality as a continuum and therefore represents a more accurate measure of donor effort**: the concessional element of any developmental loan could be included in ODA and the more concessional a loan is, the more ODA credit it gives. This would imply that the current distinction between ODA and OOF loans would disappear. The distinction between concessional and non-concessional loans would still be relevant at the country level, but could in any case be based on the IMF/WB definition and discount rate.[5] Figure 1 illustrates the way in which the grant equivalent method is articulated with cash flows (recipient receipts' perspective) and highlights the need for data on both concessional and non-concessional debt for debt sustainability analyses.

14. **Recent discussions with the IMF and the World Bank have strengthened the case for adopting the grant equivalent method.** Both organisations support the concept of sliding scale of concessionality as it would be more in line with their debt sustainability assessments, which cover both concessional and non-concessional loans, and which are not limited to LICs.[6] Also note that recent documents of the IMF identify a category of *"semi-concessional loans"*, defined as those with a positive, but below 35%, grant element, while loans with no grant element are referred to as *"commercial loans"*. This terminology reflects the attention paid to the concessionality of loans whatever the level (the more concessional the better). Lending to LICs on "concessional terms" (meaning extending loans with a grant element of at least 35 percent) is promoted, even if indicative targets foreseen under the new debt limits policy would be set at the weighted-average level of concessionality.[7]

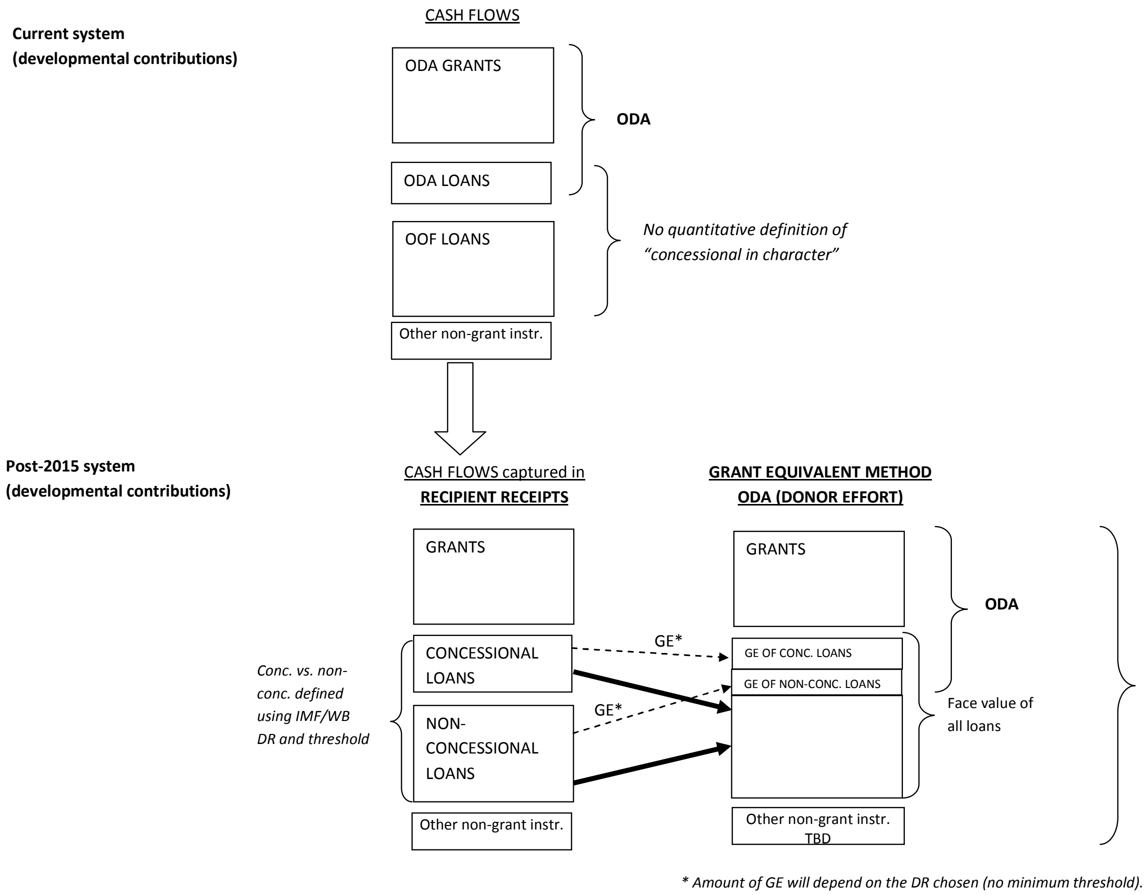
4 . The risk-adjusted discount rate is an estimate of the natural rate of interest that would have been charged in a market transaction.

5. According to the IMF there is no theoretical obstacle to use the 5% discount rate to assess concessionality of lending to non-LIC countries. Indeed, recent documentation on the reform of the discount rate and the debt limits policy present the definition of concessional loans, *i.e.* loans with grant element above 35% calculated using (currently) 5% discount rate, as being valid for all lending. See http://www.imf.org/external/np/pp/eng/2013/122313.pdf, paragraph 5.

6. While the DSF was developed to *"help guide the borrowing decisions of LICs, provide guidance for creditors' lending and grant allocation decisions, and inform IMF and World Bank analysis and policy advice"*, the instrument is applied more broadly. The framework used to assess debt sustainability in market access countries (MACs) is available at https://www.imf.org/external/pubs/ft/dsa/mac.htm.

7. See http://www.imf.org/external/np/pp/eng/2013/122313.pdf, page 28.

Figure 1. From cash flows to grant equivalents



15. **The request by a number of members to explore all options implies, however, that both grant equivalent and cash flow methods should be considered.** Within the cash flow based approach, aligning with the IMF/WB system would mean adopting the 35% threshold and the discount rate of 5%, with the understanding that if these were to change, the DAC definition on ODA would also change.

16. Table 1 below lists the options under consideration. The risk-adjusted grant equivalent options also cover the possible use of proxies for risk premia (e.g. differentiated by country risk category, sovereign vs. non-sovereign borrower) that will be further discussed at the WP-STAT in June. Maintaining the existing system (concessionality assessment based on lenders' opportunity costs) and discount rate is also included to recall the status quo and the fact that, as a minimum, an agreement on a quantitative definition of "concessional in character" is required. It is recalled that grant equivalent options are technically more complex to implement than the cash flow options. As regards grant equivalents, options B, C and D would involve frequent (annual) changes to discount rates while option A would provide for a more stable solution.

Table 1. Concessionality options under consideration

<table>
<tr><th>Measurement</th><th>Basis for assessing concessionality</th><th>Discount rate</th><th>Option</th></tr>
<tr><td rowspan="4">Grant equivalent method</td><td rowspan="2">Lenders' funding costs</td><td>IMF/WB rate</td><td>A</td></tr>
<tr><td>DDR</td><td>B</td></tr>
<tr><td rowspan="2">Lenders' funding costs and risk</td><td>IMF/WB rate + risk premium</td><td>C</td></tr>
<tr><td>DDR + risk premium</td><td>D</td></tr>
<tr><td rowspan="2">Cash flow method</td><td>Lenders' funding costs</td><td>IMF/WB rate (35% threshold)</td><td>E</td></tr>
<tr><td>Lenders' opportunity costs</td><td>10% (25% threshold), need a numerical test for concessional in character</td><td>F</td></tr>
</table>

D. Ranking the options

17. As noted in paragraph 4, **members are requested to express their views on which option would best address the objectives of the reform and, with a view to narrowing down the options, rank the others in their order of preference.** To facilitate the ranking, Table 2 presents the options side by side, with commentary on how they respond to the objectives of 1) clarifying the concept of concessionality, 2) compliance with the HLM decisions on concessionality, 3) compliance with the HLM principles on ODA reporting, and 4) HLM mandate on modernising the measurement and monitoring of development finance post 2015. The table demonstrates that no option would achieve all objectives.

18. The table further identifies **a number of critical questions (see text *in italics*) which may jeopardise the credibility of the reform unless resolved in a manner that satisfies not only DAC members but also the broader group of stakeholders.** These include the treatment in the revised ODA measure of repayments of ODA loans committed and disbursed prior to the reform (whether and for how long these should count as negative ODA) and treatment of debt relief (under options C through F). An agreement on such issues will inevitably involve political negotiations and compromises. **Members' views are invited on the process for addressing them.**

19. **The most important question is probably the most difficult to respond to: What incentives would a reform of the concessionality assessment and loans reporting provide for lending to developing countries?** The current system inherently disincentivises development finance in any other form than grants, thus limiting the scope for lending and more generally the mobilisation of resources from the private sector (e.g. through guarantees). The grant equivalent method would generally incentivise lending, the potential impact of risk-free discount rate options being easier to analyse than those of risk-adjusted discount rates. This raises the question of debt sustainability and the need for safeguards. **One option to consider here might be to formally link development lending to LICs with the IMF/WB recommendation on minimum level of concessionality to these countries.**

20. While recognising that the DAC is the authoritative body for deciding on how to best measure ODA, one needs to pay attention that the reform does not result in unintended consequences. The Export Credit Group (ECG) Secretariat has expressed its concern over the proposed risk-adjusted grant equivalents: allowing the recording as ODA of grant equivalents of loans extended at terms similar to those for export credits would contribute to the blurring of the line between developmental loans and export credits and provide incentives to circumvent the rules set in the Arrangement. **In reviewing the various options against the objectives of the reform, members are therefore invited to also consider what impact the reform could have on the Arrangement.** The paper is also circulated to the ECG members for comments.

21. A questionnaire requesting members to rank the options will be sent to members electronically, with responses requested by 6 June.

Table 2. Concessionality of loans – options and objectives of the reform

OPTIONS / **OBJECTIVES OF THE REFORM**	**Grant equivalent method**				**Cashflow method**	
	Risk-free discount rate		Risk-adjusted discount rate		Discount rate reflecting donors' funding costs	Discount rate reflecting donors' opportunity costs
	IMF/WB rate	OECD DDR	IMF/WB rate plus risk	OECD DDR plus risk	IMF/WB rate	10%
	A	**B**	**C**	**D**	**E**	**F**
1. Clarify the concept of concessionality						
Specify whether grant element measures donor effort or recipient benefit	donor effort	donor effort	recipient benefit	recipient benefit	donor effort	donor effort
2. Comply with HLM decisions						
Establish a clear quantitative definition of concessional in character, in line with prevailing market conditions	Sliding scale of concessionality, counted in ODA if GE>0 Classification of loans as concessional vs. non-concessional could be based on IMF/WB benchmark				35% benchmark	Would require another numerical test
Ensure equal treatment of all DAC members	DDR a better proxy for funding costs as differentiated by currency ***treatment of existing stock of ODA debt?*				35% benchmark	A numerical test would remove ambiguity about official sector subsidy
Transparency regarding the terms of individual ODA loans	Condition for ODA reporting				Condition for ODA reporting	
Recognise development loans extended at preferential rates – whether concess. in character under a future post-2015 definition or not – as making an important contribution to development	In TOSD, with concessional element counted in ODA				In TOSD	

<table>
<tr><th rowspan="4">OPTIONS

OBJECTIVES OF THE REFORM</th><th colspan="4">Grant equivalent method</th><th colspan="2">Cashflow method</th></tr>
<tr><td colspan="2">Risk-free discount rate</td><td colspan="2">Risk-adjusted discount rate</td><td>Discount rate reflecting donors’ funding costs</td><td>Discount rate reflecting donors’ opportunity costs</td></tr>
<tr><td>IMF/WB rate</td><td>OECD DDR</td><td>IMF/WB rate plus risk</td><td>OECD DDR plus risk</td><td>IMF/WB rate</td><td>10%</td></tr>
<tr><td>A</td><td>B</td><td>C</td><td>D</td><td>E</td><td>F</td></tr>
<tr><td colspan="7">3. Comply with HLM principles – ODA reporting should:</td></tr>
<tr><td>Maintain the definition of ODA and only attempt to clarify the interpretation of loans that qualify as ODA</td><td colspan="4">Major change and would require revising ODA definition (focus on grant equivalent) with implications on DAC Terms Rec. Could be considered exceeding HLM mandate on conc., although in line with general mandate on development finance</td><td>Would require revising ODA definition (threshold and discount rate)</td><td>Would require adding to ODA definition a clarification of “concessional in character”</td></tr>
<tr><td>Be generally consistent with the way concessionality is defined in multilateral development finance</td><td colspan="2">Generally consistent; full compliance would require maintaining distinction between conc. and non-conc. loans based on IMF/WB benchmark (relevant for data on recipient receipts)</td><td colspan="2">Inconsistent as IMF/WB definition based on lenders’ funding costs (without country-specific risk)</td><td>Fully consistent</td><td>Inconsistent as IMF/WB definition based on lenders’ funding costs</td></tr>
<tr><td>Withstand a critical assessment from the public</td><td colspan="2">Major change so needs good narrative (e.g. the more conc., the more ODA credit)
**treatment of existing stock of ODA debt?</td><td colspan="2">As for A and B
**treatment of negative GE, debt relief, description of loans at apparently high interest rates as aid?</td><td colspan="2">Cash flow method criticised for counting full face value of loans as ODA
**deduction of “interest received” from ODA, amendment of rules on debt relief?</td></tr>
<tr><td>Avoid creating major fluctuations in overall ODA levels</td><td colspan="4">See scenarios [DCD/DAC/STAT(2014)1]
Minor impact on total ODA, but significant for individual members
**incentives for future allocations?</td><td>See scenarios
Minor impact on total ODA, but significant for individual members</td><td>OK</td></tr>
<tr><td>Prevent notions that ODA loan schemes follow a commercial logic: this includes the principle that financial reflows should be reinvested as development resources</td><td colspan="2">Counts as ODA the GE of both concessional and non-concessional loans
**need for safeguards on concessionality?</td><td colspan="2">Questionable but in line with banking regulations
Counts as ODA the GE of loans extended at terms similar to those of export credits</td><td>Yes (concessionality assessment based on lenders’ funding costs)</td><td>Depends on the threshold for assessing “concessional in character”</td></tr>
</table>

OPTIONS / OBJECTIVES OF THE REFORM	**Grant equivalent method**				**Cashflow method**	
	Risk-free discount rate		Risk-adjusted discount rate		Discount rate reflecting donors' funding costs	Discount rate reflecting donors' opportunity costs
	IMF/WB rate	OECD DDR	IMF/WB rate plus risk	OECD DDR plus risk	IMF/WB rate	10%
	A	**B**	**C**	**D**	**E**	**F**
4. Modernise the DAC development finance framework to better reflect the new global development landscape						
Restore the credibility of the ODA measurement	Major change in methodology, need to explain how in line with existing international commitments on ODA e.g. UN ODA target					Measurement methodology consistent with UN ODA target but does not address previous criticism on ODA loans reporting
Represent both donor effort and recipient benefit perspectives of development finance	Allows for a clear distinction between donor effort (grant equivalent) and recipient receipts (cash flow)				Mixes donor effort and recipient benefit as both called ODA	
Mobilise more resources for the post-2015 sustainable development agenda and increase their effectiveness	Helps mobilise more resources Incentivises lending on highly concessional terms ***Does LIC DSF provide sufficient safeguards against over-indebtedness?*		Helps mobilise more resources to riskier countries but could provide incentives to low-concessionality loans to countries that can least afford them		Does not help mobilise more resources	
Remain straightforward, politically palatable and easily understandable by policy makers and the public	Change in logic but straightforward (assessment based on donor funding costs) *Option B could blur public as two loans with same terms and conditions would result in different levels of concessionality in two different years*		Technically more complex *Could blur public as two loans with same terms and conditions would result in different levels of concessionality when extended to two different countries*			Difficult to explain two different grant element calculations with different discount rates and threshold from donor perspective

APPENDIX: ESTABLISHING A CLEAR, QUANTITATIVE DEFINITION OF "CONCESSIONAL IN CHARACTER" – ANNEX 3 OF DOCUMENT DCD/DAC(2014)9

Introduction

1. A transaction is reportable as ODA only if it is "concessional in character and conveys a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent)". The 2012 DAC High Level Meeting noted "multiple views on the interpretation of 'concessional in character'" in relation to ODA loans. It therefore agreed to "establish, as soon as possible, and at the latest by 2015, a clear, quantitative definition of 'concessional in character', in line with prevailing financial market conditions."

2. Loan concessionality can be expressed in three main ways: long repayment periods, delaying the first repayment, or offering a low interest rate. The first two give the borrower more time; the third reduces the amount he has to pay. The combined effect of all three can be measured in a grant element calculation. To make such a calculation, a neutral or reference rate must be selected as a benchmark. The choice of this rate determines whether, and to what extent, the loan is concessional.

3. It will be noted that the ODA definition already contains a quantitative test – 25% grant element, using a 10% discount rate. However, the HLM decision implies that it did not consider this test was an adequate "quantitative definition of concessional in character", at least given "prevailing financial market conditions". There has, in fact, been much criticism that the 10% discount rate is too high given the current global interest rate environment. The HLM recognised this by stipulating that the new definition should "withstand a critical assessment from the public".

Dimensions of choice

4. One simple test of "concessional in character" could be to stipulate a maximum interest rate. However, this would fail to integrate any concessionality expressed through giving borrowers more time to repay. Discussions in the DAC Working Party on Development Finance Statistics (WP-STAT) and the Expert Reference Group (ERG) have therefore focused on a possible new grant element test.

5. Three main choices need to be made for a new grant element test to serve as a "clear quantitative definition of concessional in character":

- Should the discount rate be fixed, or differentiated by lender, borrower, year, term etc.?
- If differentiated rates are preferred, should these rates be risk-free, or risk-adjusted?
- Should the resulting "grant element" be used as at present to determine which loan flows are recorded as ODA, or converted to a "grant equivalent" amount upfront?

6. A fixed discount rate has the advantage that two loans at the same terms always bear the same grant element, regardless of donor, recipient, currency, year or other factors. The current grant element test uses a fixed rate of 10%, and the IMF recently introduced a fixed rate of 5% for use in debt sustainability calculations for low income countries[8]. But differentiated rates can reflect the costs of borrowing and/or the risk of lending. They are used in the OECD's assessments of the concessionality of tied aid and export credits.

7. Discussions in the WP-STAT and Expert Reference Group have tended to favour differentiated rates. In that case, the next question is whether the rates should be "risk-free", or adjusted to reflect the risk that the borrower may default. "Risk-free" rates, as paid on AAA-rated government bonds, avoid possible arguments about borrower creditworthiness, and whether this is being improved by guarantees, insurance, or the repayment priority ("seniority") of the loan. But risk-adjusted rates better reflect the lender's likely final costs in making the loan. By valuing upfront the risk of default on official loans, they remove the need to report eventual forgiveness of these loans as new aid effort. This would deal with a frequent criticism that DAC debt forgiveness reporting is too generous.

8. Discussants have so far favoured "risk-adjusted" rates. The next question is whether the resulting grant elements should determine whether to record the flows on a loan as ODA – as at present – or whether the "grant equivalent" of the loan should itself be recorded. Recording actual loan flows reflects what the recipient actually receives and repays, while the recording of grant equivalents better reflects the donor effort. Discussants have tended to favour the latter option, which avoids the "sudden death" exclusion of loans that just fail to meet the grant element threshold and the present artificial incentive to bring grant elements up to 25%.

Conclusion

9. The trend in discussions has been towards risk-adjusted, differentiated rates, and counting grant equivalents, rather than actual flows on loans that meet a threshold. This is considered to provide the most accurate assessment of risk and effort. It also appears practicable, as a draft system for establishing the necessary rates was already proposed by four members in 2012.

10. However, it must be acknowledged that this would break with the present flow-based measurements[9], and would imply a major review of debt relief reporting. Less radical proposals are also possible. For example, using risk-free differentiated rates (such as the Differentiated Discount Rates used for assessing tied aid and export credits) would enable retention of debt relief reporting, on a somewhat more defensible basis. Using a fixed rate, but one lower than 10%, would disturb the existing system to an even smaller extent, while still responding to the need for greater realism in the concessionality assessment.

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[8] The IMF rate was roughly the average USD CIRR for the last ten years, with some allowance for long loan maturities in LICs. It is fixed until completion of the review of the LIC debt sustainability framework in 2015.

[9] Flow data would still be collected so as to present accurate data on developing countries' resource receipts.