Ensuring Debt Sustainability in Low Income Countries (LICs)

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Expert Meeting on the Contribution and Effective Use of External Resources for Development, in Particular for Productive Capacity-Building

United Nations Conference on Trade and Development (UNCTAD)

Geneva, 22–24 February 2010
Background / Overview

• Long history of debt relief for LICs:
  ➢ Traditional (Paris Club) Debt Relief (1988-1996)
  ➢ HIPC (1996-1999)
  ➢ Enhanced HIPC (since 1999)
  ➢ MDRI and Post HIPC Paris Club (since 2005)

• These initiatives had significantly reduced the public external debts of some eligible HIPC

• Current economic crisis -- once again a debt crisis?
  ➢ Look at the data (projections) for all LICs based on the IMF’s WEO of October 2009
  ➢ Mini-review of the current CPIA-based DSF
  ➢ Comments on some recent suggestions
Who are the LICs?

- Based on the WB’s July 2009 classification, there are currently 43 LICs:
  - 31 HIPCs (20 post CP, 7 interim, and 4 pre-DP)
    - No good data for most interim and pre-DP (esp. Afghanistan and Somalia)
  - 12 non-HIPCs
    - No data for Myanmar, North Korea, and Zimbabwe

- Hence, in the following we compare **20 post-HIPC-CP LICs** with **9 non-HIPC LICs**
WEO’s growth assumption: current economic crisis is ending

a.) Post HIPC Completion Point LICs

<table>
<thead>
<tr>
<th>GDP growth (percent)</th>
<th></th>
<th>XGS growth (percent)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>actual ave growth 2000-07</td>
<td>12.1</td>
<td>actual ave growth 2000-07</td>
<td>15.3</td>
</tr>
<tr>
<td><em>proj. ave growth 2008-14</em></td>
<td>6.9</td>
<td><em>proj. ave growth 2008-14</em></td>
<td>7.4</td>
</tr>
</tbody>
</table>

b.) Non-HIPC LICs

<table>
<thead>
<tr>
<th>GDP growth (percent)</th>
<th></th>
<th>XGS growth (percent)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>actual ave growth 2000-07</td>
<td>9.8</td>
<td>actual ave growth 2000-07</td>
<td>14.9</td>
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Note: All growth rates are based on data expressed in nominal US$; this overstates the growth rates of LICs to some degree.
WEO’s growth assumption: current economic crisis is ending
WEO’s growth assumption: current economic crisis is ending

Fig. 1b: Ext. Debt Service to GDP (percent)

- Average of Post HIPC Completion Point LICs
- Average of Non-HIPC LICs (excl. Myanmar, North Korea, Zimbabwe)
WEO’s growth assumption: seemingly sustainable post-HIPC-CP LICs
WEO’s growth assumption: seemingly sustainable vs seemingly unsustainable post-HIPC-CP LICs

Fig. 2a: Ext. Debt Service to XGS (percent) of selected HIPC LICs

- Tanzania
- Rwanda
- The Gambia
WEO’s growth assumption: selected non-HIPC LICs
Is this the true picture on the debt sustainability of LICs?

• First, these are projections (possibly too optimistic, especially for the non-HIPC LICs).

• Second, these projections exclude public domestic debt, which has implications for fiscal debt sustainability.

• As the example of Bangladesh shows, public domestic debt can be considerable.
Mini-Review of the Current DSF

• Current DSF is based on the highly subjective CPIA rating
  - Despite some cosmetic changes (adopted in August 2009), the current DSF continues to classify LICs into one of three policy performance categories (weak, medium, and strong) which then corresponds to three different indicative thresholds for debt burdens:

<table>
<thead>
<tr>
<th>Debt Burden Thresholds under the BWIs' DSF (Traffic Light System)</th>
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<tr>
<td></td>
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<tr>
<td><strong>Present value (PV) debt in percent of</strong></td>
</tr>
<tr>
<td>Exports</td>
</tr>
<tr>
<td>Weak Policy LICs (CPIA score &lt; 3.25)</td>
</tr>
<tr>
<td>Medium Policy LICs (3.25 &lt; CPIA score &lt; 3.75)</td>
</tr>
<tr>
<td>Strong Policy LICs (CPIA score &gt; 3.75)</td>
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</tbody>
</table>
Mini-Review of the Current DSF

- The cosmetic changes adopted in August 2009 recognized that the current economic crises requires
  - more aid to developing countries
  - more flexibility in the BWIs’ DSF

- Hence, the two main changes adopted were:
  - recognizing the impact of public investment on growth
    - a step in the right direction;
    - likely another subjective assessment by IMF/World Bank economists.
  - the exclusion of some external debt of state-owned enterprises (SOEs)
    - helps to lower the public debt thresholds
    - likely to increase the risk associated with excessive external borrowing by the corporate sector.
What should be done?

- Debt financing does not make sense for LICs
  - By definition, low income countries are only able to repay old debt through the provision of new debt
  - Based on human development approach, poverty reducing expenditures (despite recognizing that they are investments) should be financed via grants

- However, current aid levels are insufficient to allow grant financing; hence, we rely on debt financing as a second best solution.
What should be done?

Debt Moratorium

• Useful for some LICs, but may – based on macroeconomic criteria – not be needed for all LICs

• A debt moratorium for all LICs may exacerbate already existing inequities resulting from current debt relief initiatives, especially:
  ➢ if they do not take public domestic debt into account
  ➢ as debt relief is typically not additional in the long-run

• A too broad debt moratorium may imply “robbing Peter to pay Paul”

• One option could be to provide a debt moratorium on debt service that is beyond a certain level of debt service
  ➢ this is basically the same as adopting a debt service payment cap
What should be done?

Adopting an MDG-consistent Debt Sustainability Framework

• Gunter, Rahman and Shi (2009) have shown that the capacity to carry debt is related to progress made in social development/achieving the MDGs

• Such an MDG-based debt sustainability framework allows to link debt sustainability directly with the financing of the MDGs

• Linking debt sustainability with achieving the MDGs implies a win-win solution for both donors and LICs:
  - for donors: loans are less costly than grants
  - for LICs that make progress: can get more aid in nominal terms
  - for LICs that do not make progress: can get more grants

• Achievements of the MDGs are measurable more objectively than the World Bank’s CPIA
What should be done?
Reducing the risk associated with excessive external borrowing by the corporate sector

• Instead of
  ➢ excluding some external debt of state-owned enterprises (SOEs) in the DSA

• LIC governments should
  ➢ tax any excessive external borrowing by the corporate sector (SOEs and private enterprises)
What should be done? Linking Debt Relief to Special Drawing Rights (SDRs)

- Bird (2010) emphasized that the creation of SDRs would kill two birds with one stone:
  - It is a superior way of meeting the world’s liquidity needs
  - It would provide development assistance to poor countries

- The creation of SDRs for debt relief is even more appealing as it would also guarantee the additionality of debt relief.
What should be done?
Making Better Use of UN Specialized Agencies

• There are various UN agencies that are global repositories of sector-specific knowledge, like for example for agriculture:
  - FAO
  - IFAD
  - IFPRI

• The more capacity building these agencies would provide, the less the LICs would need to borrow to build such sector-specific knowledge

THANK YOU