A Stability and Social Investment Facility for High-Debt Countries
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Abstract

A number of high-debt emerging-market economies face structural, long-term debt problems that tend to keep their growth rates low, that impart an unequalizing bias to the growth process, that severely constrain social spending and human development, and that make them vulnerable to capital flow reversals. Unless the nature and pace of growth can be improved in these lower-middle income countries, the Millennium Development Goals (MDGs) are unlikely to be met either in many of these countries, or globally. These high-debt emerging-market economies face an impossible choice between draconian and never-ending fiscal austerity, or crisis and a "debt event." Both "bitter pills" impose high social and economic costs.

This paper proposes the creation of a "Stability and Social Investment Facility" (SSF) to be housed either at the IMF or the World Bank. It would be a long-term facility to help high-debt emerging market countries cope with and ultimately overcome what will otherwise remain a chronic structural weakness. The SSF would be an instrument providing a steady and predictable source of long-term funds as well as a strong policy signal to help high-debt emerging-market economies reduce their debt burden without having to forgo vital pro-poor social expenditures and growth programs. For the facility to have a significant impact on debt and income dynamics in the eligible countries, we estimate it would need to lend $10-20 billion a year. The financial cost to the donor community would be the interest subsidy built into the SSF; were the subsidy 200 basis points, the cost in the first year would be $20 million for every $1 billion of lending.

The rationale for the subsidy element is its catalytic role in facilitating a strong commitment to both prudent macroeconomic policies and pro-poor growth policies. The lower interest cost of the SSF, even if modest, would make it financially and politically easier for governments in eligible countries to address their long-term social (MDG) objectives, while maintaining a sound fiscal stance.

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A Stability and Social Investment Facility for High-Debt Countries

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Debt Burden in a Group of Emerging-Market Economies

In its September 2003 issue of the *World Economic Outlook,* the IMF presented a comprehensive analysis of public debt in emerging economies. Total public debt in a group of emerging-market economies rose from approximately 30 percent of GDP at the end of the 1960s, to approximately 60 percent at the end of the 1980s, and to approximately 70 percent at the end of the 1990s.[1]

Defining a benchmark sustainable level of public debt as a level that would equate the stock of debt with the present discounted value of future expected primary surpluses in the budget, the study arrived at the tough conclusion that the median of such "warranted" public debt-to-GDP ratios would be only 25 percent for a sample of 21 emerging-market countries studied, compared with the 70 percent actual ratio for these countries! In addition, the 25 percent compares with a benchmark ratio of 75 percent for a sample of 14 fully industrialized countries in the same study (IMF, 2003, p. 130).

Why is there such a huge difference between these two benchmark ratios? Why should the advanced economies be able to carry so much more debt as a ratio of their GDP than the emerging-market countries? As explained by the IMF (2003), the difference is due to the combination of shorter maturities, much lower fiscal revenue-to-GDP ratios, higher variability of that revenue, higher real interest rates, greater exchange rate risk, and a track record of lower primary surpluses in emerging-market economies.[2] Because of all of these factors, many emerging-market economies ended up in what must be called a "debt trap." Many have debt-to-GDP ratios that are not really sustainable, making them vulnerable to repeated crises of confidence. There are, of course, important differences among emerging-market economies, with many Asian countries in much better shape than some countries in Latin America, the Middle East, and North Africa.

The debt burden of some of the countries described by the IMF (2003) has likely declined somewhat during the past few years, in part because of record low international interest rates, rapid world growth boosting domestic growth rates, a commodity price boom benefiting many of the countries in the group, and, on the whole, strong domestic fiscal efforts (Gill and Pinto, 2005; World Bank, 2004c). Despite these exceptionally favorable circumstances, the overall situation remains difficult and is unlikely to have changed significantly since 2002, a year for which broadly consistent data are available. Table 1 summarizes the evolution of debt from 1992 to 2002 (with 2003 data provided where available in a consistent format) for a group of 29 emerging-market economies.

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[1] In the analysis of this trend, the IMF study (IMF, 2003) defined emerging-market countries as the 27 countries in the Emerging Market Bond Index (EMBI) at the beginning of 2002, plus Costa Rica, India, Indonesia, Israel, and Jordan.

[2] Developing-country financial markets are also shallower, with the ratio of private-sector credit to GDP of only about 25 percent compared with 60 percent and more in advanced economies. Among high-debt emerging-market economies, of course, shallow financial markets reflect as well as reinforce their vulnerability to higher interest rates and other factors noted above.

On the whole, debt burdens have increased significantly in most of these countries. In the sample, 18 countries—among them large ones such as Argentina, Brazil, Egypt, India, the Philippines, and Turkey—had debt ratios in excess of 50 percent at the end of 2002. The median debt burden for the emerging-market group listed in table 1 was approximately 60 percent of GDP in 2002. On average in that year, the emerging-market countries in the sample devoted approximately 5.4 percent of GDP to interest payments for public debt, with a median value of approximately 4.3 percent (table 2). If we consider the 18 countries[3] with debt burdens above 50 percent as a separate target group,[4] the mean and median values for their 2002 interest payments as a percentage of GDP are approximately 7.1 and 5.9 percent, respectively. Consistent data for 2003 are less complete, but the situation did not improve compared with what it was in 2002.

The interest burdens summarized in table 2 reflect the chronic underlying fiscal pressures caused by high debt burdens. Total debt service, including principal rollover, reaches much higher percentages of GDP for a selected group of countries (Goldstein and Wong, 2005). Total debt service is probably a better indicator of vulnerability at times of high stress.

For most of the countries with debt ratios above 50 percent of GDP and high interest payments, maturities are short, leading to the need for substantial rollover of principal every month, which adds to the problem. Regarding these countries, there is a constant underlying fear in financial markets that a combination of unfavorable developments could lead to what is called a debt event—a sudden inability to service debt on time, with ensuing market panic, a surge in interest rates, and pressure on the exchange rate. This kind of event could be triggered by a terms-of-trade shock, sudden political turmoil, or a serious problem in the banking sector. A crisis of confidence could also be caused by contagion from a debt event in a different country.[5] To protect against such an event, the typical high-debt emerging-market economy has to run substantial primary budget surpluses and continuously pay a high risk premium on outstanding and new debt. Table 3 shows that many high-debt emerging-market economies have run large primary surpluses in recent years.

Countries with high public debt-to-GDP ratios, paying high real interest rates on their domestic currency–denominated debt and high sovereign risk premiums on their foreign currency–denominated debt, are likely to need surpluses that are large and thus politically difficult to

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[3] The 18 countries are Argentina, Brazil, Bulgaria, Costa Rica, Ecuador, Egypt, India, Indonesia, Jordan, Lebanon, Malaysia, Morocco, Nigeria, Pakistan, Panama, the Philippines, Turkey, and Uruguay.
[4] The IMF reports that the median public debt-to-GDP ratio in the year before a default was about 50 percent (IMF, 2003, p. 119). Econometric analysis in that study also suggests that "emerging market countries as a group have failed in the past to respond in a manner consistent with ensuring debt sustainability once public debt exceeds 50 percent of GDP" (IMF, 2003, p. 142). However, using this 50 percent figure to identify the target group of countries is not meant to suggest a strict definition of eligibility. Rather, the purpose is to highlight a possible group of countries likely to be in some form of debt trap from which escape through unilateral country effort alone is very difficult.
[5] For a discussion of the possible sources of financial crises and the vulnerability of different emerging-market countries to contagion and external shocks, see, for example, Goldstein and Wong (2005) and Kaminsky, Reinhart, and Végh (2003).

sustain. The recent experience of Brazil illustrates the point. In the six months before its 2002 presidential election, foreign creditors feared that a victory of the leftist (Workers Party) candidate would lead to default on Brazil's foreign debt. Spreads on Brazil's debt rose to above 2000 basis points in March 2002. A crisis was averted, in part owing to an extraordinary arrangement under which all the candidates pledged to adhere to an IMF program were they elected (Williamson, 2002). However, as the cost of borrowing rose throughout 2002, the size of Brazil's already large debt multiplied. The government that was elected has since been obliged to run primary surpluses greater than 3 percent.

Among other problems, the high real interest rates that prevail in high-debt countries exert downward pressure on the growth of GDP, which in turn makes it more difficult to reduce the debt-to-GDP ratio. Figure 1 shows how large and persistent the difference in interest rates on foreign debt has been between developed and emerging-market economies. Data on domestic real interest rates are more difficult to assemble in a consistent fashion, but the difference in such rates between emerging and advanced economies is even larger, reflecting the greater exchange rate risk in the former.

In the group of high-debt emerging-market economies, fiscal policy tends to be procyclical rather than anticyclical as it is in the mature industrial countries. When a recession occurs in an economy that does not have to worry about a debt event, fiscal policy can be expansionary and attempt to stimulate domestic demand. In industrial countries, government expenditures increase by more than national income during a downturn—as should be the case to counteract cyclical recession—and they increase by less than national income during an upturn. The same does not take place in a typical emerging-market economy because the income decline during a downturn tends to worsen the debt-to-GDP ratio, creating debt-event fears that tend to lead to a need to tighten rather than temporarily relax fiscal policy. On the contrary, during an upturn, debt-event fears diminish and governments tend to want to catch up in their expenditures! This makes fiscal policy procyclical instead of anticyclical, a point often emphasized by critics of IMF-backed stabilization programs (Sachs and Radelet, 1998; Stiglitz, 2002). Although this situation is unfortunate, it is really not possible to avoid it in countries where public debt-to-GDP ratios are high because relaxing fiscal policy at a time of crisis is likely to lead to fear of default and deepen the crisis. When a crisis strikes, involuntary debt restructuring accompanied by capital controls seems to be the only other option for such high-debt countries, with disruption and costs that are likely in most cases to outweigh the costs of procyclical fiscal policies, at least in the short term.

The combination of volatile capital markets and economies that are on a tightrope because of high debt-to-GDP ratios has created an important systemic problem for many emerging-market economies and the world economy as a whole. The high interest rates prevalent in these economies create an attractive short-term investment opportunity for mobile and liquid international capital. It is hard for short-term investors to resist opportunities that offer very high real returns in the bond market. The returns can of course be even higher during upturns in

equity markets. When things seem relatively stable politically and the debt-to-GDP ratio has gone down a little—thanks to good growth, or strong fiscal policy performance, or both—short-term capital flows into the typical emerging-market economy, often take place in the form of surges that can exceed 5 percent of GDP. For a while this sets off a virtuous cycle. The exchange rate appreciates, leading to a decline in debt-to-GDP ratios, as a significant part of total debt is denominated in foreign currency. Real interest rates decline in domestic-currency terms as the demand for bonds goes up. Real returns to foreign investors remain very high, however, because of the exchange rate appreciation. This leads to further capital inflows, leading to a further appreciation of the exchange rate, and so on.

At some point the cycle reverses itself, however. The real exchange rate appreciation hurts exports and tends to lower real growth.[6] The current account deficit is likely to deteriorate and the external debt will grow owing to the capital inflows. During the capital surge episodes, interest rates decline, but not to a degree that would really remove the underlying debt worries. As soon as the exchange rate starts to depreciate instead of appreciate, domestic interest rates rise again and so does the debt-to-GDP ratio. If, in addition, the capital surge episode has led to a decline in fiscal austerity—as governments take advantage of the good times to fulfill some electoral promises or prepare for the next election—the rise in the debt-to-GDP ratio might be quite sharp, leading to an acceleration of exchange rate depreciation and a sharper rise in the debt burden indicators. If that is the case, a precrisis or crisis situation develops, bringing with it calls for an even larger primary surplus to restore market confidence. During the crisis management phase, IMF money will tend to replace private capital, in a sense bailing out both the country and private creditors and lengthening the maturity of the debt without reducing it. If the stabilization effort is relatively successful, the exchange rate depreciation will stop, the country will again appear as a good short-term investment opportunity to foreign investors, and the whole cycle is likely to start all over again.

Another important dimension of the problem relates to the fight against poverty and the problem of income inequality in many high-debt emerging-market countries. Although they have higher per capita incomes than the poorest countries that are subject to the Heavily Indebted Poor Countries (HIPC) initiative and that benefit from debt reduction and cancellation,[7] as a group they are host to more than 500 million of the extremely poor, half of the estimated total of approximately 1 billion people living on less than $1 a day. They are home to more than 1 billion poor people if measured by the number of people living on less than $2 a day (tables 4a and 4b). Although in most of the identified 18 high-debt countries the first MDG of halving the proportion of the poor by 2015 will be met, that is unlikely to be the case in others, including India, the Philippines, and Ecuador, on the basis of a linear extrapolation of their rate of progress

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[6] Indeed, there is no evidence that open markets in developing countries have increased growth rates. The potential benefits have apparently been eclipsed by the effects of volatility in inflows and outflows (IMF, 2003).
[7] For analysis of the HIPC program, see Birdsall and Williamson (2002). For further information on the Enhanced HIPC Initiative, including updates on the present status of HIPC countries, see www.worldbank.org/hipc.

since 1990.[8] In rural India, the number of poor appears to have increased since 1990 despite that country's healthy rates of growth;[9] the increase in rural India contributes substantially to the projected estimate in table 4b of an absolute increase in the number of poor in this group of countries between now and 2015. In addition, social indicators today remain surprisingly low in this group of countries: In many of them, infant mortality rates are still above 25 per thousand live births, and, in some, barely half of secondary school age students are in school (table 5).

The rapid overall declines in poverty in China and in urban India reflect their growth success; there is no question that growth is a necessary if not a sufficient condition for poverty reduction. The unfortunate counterpoint to the importance of rapid growth in China and India for poverty reduction is the experience of Latin America since 1990. In that region, growth has been too low to reduce poverty—with the exception of Chile where the debt-to-GDP ratio is much lower. A key source of low growth has been the volatility of economic variables, the repeated financial shocks of the past 25 years, and the resulting high interest rates and high public debt. The region's current high debt levels reflect that past while they also constitute an ongoing risk of continued vulnerability to shocks and another round of low growth.

Among the MDGs, the goal for education is to ensure all children complete primary school by 2015. That is a formidable challenge not only for many of the world's poorest countries but also for some of the high-debt emerging-market countries in our target group. In Latin America in particular, high primary school enrollment rates are misleading because they hide high dropout rates, very low quality of education, and resulting low rates of completion of primary school. In Brazil the primary school completion rate was still below 20 percent in the 1990s for children from the poorest 40 percent of households (Filmer and Pritchett 1998).[10] That many children never complete primary school contributes to the still low secondary enrollment rates in our high-debt group (see table 5) and puts them at serious risk of future low growth given global competitive pressures.

It is also the case that income inequality is relatively high in many countries of the high-debt group (table 6). One among many reasons[11] is that, in the vicious cycle described above, high debt burdens impart an unequalizing bias to the growth process caused by capital market pressures combined with periodic crises. Structurally high real interest rates caused by sovereign default and currency risk act as a mechanism constantly redistributing income to the rich, to both

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[8] On this point, see also the latest human development indicators and related analysis available in the latest *Human Development Report* (UNDP, 2005).

[9] This estimate is based on the number of people in rural areas living on less than $1 a day. There is controversy about changes in poverty in India during the past 15 years. Estimates by Deaton and Dreze (2002) using the national poverty line imply a reduction in both the proportion and absolute number of the rural poor.

[10] Primary completion rates for children from the poorest 40 percent of households were 52 percent in Peru and 67 percent in Colombia during the same period (Filmer and Pritchett, 1998).

[11] The causes of high income inequality include the unequal distribution of assets including land, education, and financial wealth, which is in turn usually rooted in long-standing historical factors (World Bank, 2005c; Engerman and Sokoloff, 2002).

foreign fund owners across borders and domestic owners of liquid wealth.[12] To the extent that high debt reduces public spending, the poor again lose because in general the distribution of public expenditures is itself more progressive than the distribution of income. High interest rates also reduce investment and job creation, tending to reduce the return to labor, the key asset of the nonrich.

Finally, when an actual crisis necessitates further fiscal tightening measures, the burden inevitably falls on the poor and middle-income groups. Deposit insurance is necessary to avoid total economic and social breakdown, but it is also important to remember that deposit protection benefits primarily the better off to the extent that they have on average more deposits than the average citizen. Overcoming a crisis necessitates reestablishing confidence in financial markets. Financial capital is highly mobile and the capital account liberalizations that were implemented throughout emerging-market economies in the 1980s and 1990s mean that capital can flee very quickly if it wants to. Table 7, adapted from Fallon and Lucas (2002) and quoted in *Global Monitoring Report 2004* (World Bank, 2004b), shows the impact of a financial crisis on the number of people living in poverty in four East Asian countries during the 1997–98 crisis.

In addition, the capital market shocks of the past 25 years in high-debt countries have undermined the capacity of their governments to develop and sustain the institutions and programs they need to protect their own poor. With global market players doubting debt sustainability in many of the emerging-market economies at the time of any shock, countries are forced, as noted above, to resort to procyclical fiscal policy to reestablish market confidence. The procyclical austerity policies that the global capital market demands are the opposite of what industrial economies implement when there is lack of growth—including not only reduced interest rates and increased public spending in general but also unemployment insurance, increased availability of food stamps, emergency public works employment, and other ingredients of a sound and permanent social safety net.[13] We know that for the poor the effects of unemployment and bankruptcy can be permanent. In Mexico, for example, increases in child labor that reduced school enrollment during the 1995 "tequila crisis" were not subsequently reversed, implying some children did not return to school when growth resumed (Székely, 1999).

It is true that reducing fiscal pressures on these economies would not automatically guarantee development and maintenance of the programs that constitute a reasonable social safety net. For example, there is no automatic association across countries between public spending on education and health and higher indicators of school achievement or lower mortality and morbidity. Nevertheless, the required budget resources are a necessary condition for success in meeting the MDGs even if they are not a sufficient condition. Moreover, the fiscal pressure that high debt feeds, if prolonged (as it was in the 1980s in Latin America), tends to undermine the institutional capacity of public service delivery systems—for example, drug procurement

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[12] Tax systems that rely on indirect trade taxes and value-added tax do little to create a better distribution of income.
[13] In industrial countries, there is not of course 100 percent replacement of income for the poor during recessions.

systems continually short of funds collapse as do public programs that are key to protecting the poor and vulnerable in bad times.

Countervailing forces, such as good education policies, a progressive tax system, the nature of internal and international migration, and the particular effects of foreign trade, could in theory lead to faster poverty reduction and an improvement in income distribution despite high debt levels. However, evidence in practical terms suggests that a high debt burden makes it difficult technically (requiring unusually disciplined and targeted public spending) and virtually impossible politically to fully compensate the unequalizing nature of the primary income distribution process described above with equalizing and strongly pro-poor fiscal policies.[14] Structurally high real interest rates owing to sovereign default risk and currency risk, combined with fiscal difficulties during a crisis, fundamentally undermine growth that is equitable and pro-poor.

A Bretton Woods Stability and Social Investment Facility for Highly Indebted Emerging-Market Economies

The debate and discussions on reforming IMF lending policies and improving crisis prevention have so far focused in large measure on avoiding contagion and providing protection against external shocks in otherwise healthy economies (Borensztein et al., 2004; Cordella and Levy Yeyati, 2005; Williamson 2005).[15] In this paper the emphasis instead is on addressing the chronic vulnerability of a number of heavily indebted emerging-market countries, such as the target group of 18 countries noted earlier. These countries are particularly vulnerable to contagion and external shocks, as the IMF itself eloquently explained in the September 2003 edition of *World Economic Outlook.* But their problem exists even in the absence of external events. They have accumulated a debt burden that significantly constrains their medium-term growth performance, and when they grow it is very difficult to make that growth pro-poor. And yet the contribution by the IMF itself, and by others, to the debate on the role of the IMF ignores this problem.

The countries concerned currently have only two ways out of this debt trap. The first is to persist with strong fiscal policy for a long time, attract as much foreign investment as possible to boost growth, and accept serious constraints on pro-poor spending programs—all the while avoiding a crisis that would constitute a major setback on the path to debt sustainability. The other way out

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[14] Even Chile's successful targeting of social spending to the poor in the 1980s did not compensate for the overall reductions in public spending on social programs associated with the fiscal pressures following the 1982 banking crisis.

[15] There has been discussion on how to improve upon the contingent credit line (CCL), the now expired crisis contagion facility of the IMF (IMF, 2004). One approach, suggested in a study by Cordella and Yeyati (2005), suggests creating a country insurance facility that could provide a form of interest rate insurance by guaranteeing automatic access to a line of credit at a rate fixed earlier.

is having the ability to negotiate an across-the-board reduction in the debt burden with a whole class of creditors, something that has so far been possible only at times of extreme crisis.

The past three decades do not offer many examples of countries that have reached very high debt burdens and then successfully grown out of the debt trap.[16] For most of the high-debt emerging-market economies it has been more touch and go: periods of improvement alternating with periods of deterioration, including years of crisis during which progress made over a number of years can be lost in a few months. Income distribution has generally worsened significantly.

The financial facilities and program support offered by the Bretton Woods institutions to emerging-market economies should reflect the need to overcome the chronic high-debt problem as well as help countries address specific acute crisis situations. It would therefore make sense to offer two types of facilities to emerging markets: the usual type of facility dealing with an immediate crisis or near-crisis situation as is the case for current standby programs,[17] and a new type of facility that is designed to help overcome the chronic and systemic debt problem highlighted in the IMF (2003) study as well as in later studies, for example by Goldstein and Wong (2005).

The new facility could be called a stability and social investment facility (SSF). It would be a lending instrument that explicitly recognizes the existence of a group of emerging-market economies that has structural, long-term debt problems that keep their growth rates low, that impart an unequalizing bias to the growth process, that severely constrain social spending and human development, and that make them vulnerable to capital flow reversals. Unless the nature and pace of growth can be improved in these emerging-market economies, the MDGs cannot be met globally, even if large increases in aid resources and better performance in the poorer economies allowed them to progress much more rapidly toward the MDGs. It is true that not all emerging-market economies are burdened by excessive debt. The lower-debt economies do not have to struggle with very high real interest rates, they can conduct anticyclical fiscal policies, and they are less constrained in their social and human development spending. Growth in these economies can be pro-poor although it not always is. However, in the high-debt emerging economies—many of them in Latin America as well as in parts of the southern Mediterranean and Southeast Asia—long-term performance is severely constrained by the vicious cycles and vulnerabilities described above.

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[16] One important exception is Chile. When the debt crisis erupted in 1982, the total debt-to-GDP ratio was almost 72 percent. Through the aggressive use of a variety of debt conversion plans between 1985 and 1991, Chile retired an estimated $10.5 billion of debt, most of which was converted into equity in Chilean companies. Chile rescheduled the principal of its debt, but otherwise met its obligations. Chile did not enter into interest arrears, nor did it seek debt reduction under the Brady Plan. It is today one of the few Latin American countries that seems to have escaped the recurrent debt-related crisis syndrome.

[17] For details on various IMF lending facilities, including its standby arrangements, see IMF (2005).

This group of countries could greatly benefit from a long-term relationship with the Bretton Woods institutions that would provide a steady and predictable source of long-term funds at a cost low enough to help them reduce their debt burden without having to forgo vital pro-poor expenditure programs. Such a SSF would be in many ways similar to the long-term budget support provided to International Development Association (IDA) countries by the IMF's Poverty Reduction and Growth Facility (PRGF) and the World Bank's (that is, IDA's) adjustment and program lending, but on terms that would be less concessional. The SSF would not be a short-term instrument designed for acute crisis situations but a long-term facility addressing a chronic structural weakness.

An approach addressing this long-term debt problem could be developed along the following lines. A participating emerging-market country would agree with the Bretton Woods institutions on a medium-term growth and debt reduction program, the centerpiece of which would be a time path for the growth of real income and the reduction of a set of indicators of indebtedness, combined with pro-poor public-sector expenditure policies. The typical qualifying country would be one in which there is no current crisis but where there is a high debt burden and therefore chronic vulnerability. Countries belonging to the target group that was noted earlier—including Brazil, Ecuador, Indonesia, the Philippines, Turkey, and Uruguay—would be among possible candidates. To qualify and to remain qualified, the participating country would have to be certified as having acceptable policies in place, as was the case for the contingent credit line (CCL) proposed in the past. The country should also have a medium-term growth program with a path for the primary surplus and structural policies in support of growth that would lead to a substantial reduction in the debt indicators. This approach would have three elements.

First, conditionality (that is, the conditions attached to lending from the Bretton Woods institutions) would be phased in in such a way that, given the initial conditions, the likelihood of up-front disqualification would be low. The conditionality would be linked to a set of mutually agreed-on and measurable results and could be described in two categories: macroeconomic and social. In both categories, the starting point would be the existing situation, so that implicitly the expectation would be one of staying the course or of gradually modifying and improving policies to attain agreed-on results. With respect to macroeconomics, the conditionality could be framed in terms of expected progress toward lower debt indicators via adequate primary surpluses. Fiscal policy would then need to become more growth oriented, with a gradual change in the structure of revenues and expenditures. The critical, needed primary surplus could be agreed annually as part of the program, as a function of progress toward the debt indicators, and after taking into account external factors over which country policymakers have little control.

With respect to the social issues, conditionality could be framed in terms of expected progress toward reductions in the numbers of people living in poverty, taking into account their total real income, including benefits of social programs and such other more easily measured indicators such as primary and secondary school completion rates and infant mortality rates. Assessment of progress on alleviating poverty and on the social metrics would require establishing the kind of

credible data collection and analysis systems that are critical to the long-run sustainability and evaluation of social, education, health, and other programs that already exist in some form in most of the target countries.

Second, after a robust program has been agreed on, the amount of available SSF financing would be phased in during the program period. A large, up-front disbursement would not be necessary, and moral hazard would thus be limited. Instead, a participating country could count on a stable source of medium-term financing that would not be affected by the ebb and flow of private finance to emerging markets.

Third—and this too is important for the scheme to work—SSF resources would have to be extended at a price low enough and in amounts sufficient for the debt reduction dynamic to work, such that the pursuit of social policies aimed at poverty reduction and broad-based growth would not be stalled by lack of fiscal resources. This could be achieved in various ways; however, they all would require some resources to allow the Bretton Woods institution to extend the loans at relatively low cost. The cost to the borrower should be close to the London Interbank Offered Rate (LIBOR) or slightly below, as opposed to including a 150 to 500 basis-point spread that had been suggested in the various versions of the proposed CCL or that are available in other IMF facilities. Furthermore, maturities should be long, at least in the 8- to 10-year range. The time path for the total global volume of lending would depend on participation rates and could be structured to first increase and then decrease.

What would the size of such a facility have to be for it to make a significant contribution to the debt and income dynamics in the target countries? A comprehensive answer to this question would necessitate careful quantitative work with macroeconomic models for each country, something that is beyond the scope of this paper. The financial cost to the donor community would be the interest subsidy built into the facility, which should be funded along lines similar to what happens for the PRGF. If that subsidy were to be 200 basis points, the cost in the first year would be $20 million for every $1 billion of lending. If Brazil were to borrow $2 billion annually for 10 years from the SSF, the cost of the subsidy to the donor community would grow over time with the increasing size of the stock of SSF debt, with its cumulative size depending on the grace period and repayment schedule.

The benefit to Brazil of using the SSF should be significantly greater, however, than just the cumulative subsidy element in the interest cost. First, the availability of the SSF would allow Brazil to reduce more quickly than otherwise some of its much more expensive borrowing, leading to additional savings on its existing debt stock. Second, both the predictable availability of medium-term finance from the SSF as well as the signaling effect owing to the long-term growth policies agreed on should lower the premium on new borrowings as well as on the existing stock of debt. As the SSF and associated policies take hold, these multiplier effects would be substantial and could amount to, say, another 150 or 200 basis points on all debt rather than on just SSF debt. This would make a huge difference to debt dynamics and create valuable

fiscal space. Lower costs of debt combined with more investment in social infrastructure would over time have mutually reinforcing effects of higher growth, improved social outcomes, and diminishing costs of capital—thereby helping to ensure more of the same. With scaling up and keeping in mind that Brazil's public debt stock amounts to approximately 15 percent of the total debt stock of the 18 high-debt emerging-market target countries shown in table 1, an annual amount of global SSF lending in the range of $10 to $20 billion would be consistent with $2 billion per year to Brazil. This would appear to be a substantial but by no means outlandish amount of lending.

One might question the need for the proposed modest subsidy element, given that it is the signaling and precommitment effects that will necessarily constitute the bulk of the financial benefits to the borrowing countries. The case for the subsidy is based on its catalytic role in facilitating a strong commitment not only to prudent macroeconomic policies but also to pro-poor growth policies that aim at overall social and political stability, enhanced by a message of international solidarity and commitment by the richer countries to the MDGs in both low-income and middle-income countries. The lower interest cost of the SSF, even if the difference is modest, would make it politically easier for many of the target countries to embark on a long-term program with the Bretton Woods institutions. For the scheme to work, the subsidy must be significant enough to have this catalytic effect—but it is not the subsidy alone that can make the difference.

Note that our proposal argues for such a long-term and low-cost facility without specifying whether it should be an IMF or World Bank (or World Bank and regional development banks; to simplify we refer subsequently to only the World Bank) lending instrument. Obviously both institutions would need to be engaged technically; the question is which would house the SSF itself. If the PRGF were shifted to the World Bank and if the owners of the IMF were to narrow the scope of the Fund's activities (that is, focus it on surveillance and short-term crisis management only), the SSF could be a World Bank adjustment lending instrument, substantially scaling up the existing adjustment lending with more results-oriented conditionality and with greater emphasis on steady and predictable (given results) long-term involvement. What would be required in that case would be an increase in World Bank resources allowing a sufficient volume for the SSF to be able to make a difference. If, on the contrary, the PRGF remains an IMF facility and the IMF remains engaged with the poorest countries as a long-term lender, it would be natural to make the SSF an emerging-market companion to the PRGF and allow the IMF to play the required long-term financing role in close cooperation with other development agencies. In that case, despite the large headroom it currently enjoys, it would be the IMF that would need an increase in its resources. In either case, the World Bank, working closely with the United Nations Development Group, would support pro-poor country growth strategies, including establishing the MDG-focused monitoring mechanisms; and the IMF would manage the dialogue on overall macroeconomic strategy and associated conditionality. Very close coordination among all the key institutions would be crucial.

No doubt some will object to any facility involving a concessional element, however mild, for emerging-market countries. However it is not politically realistic to expect our target countries to manage over long periods the truly enormous effort on the fiscal front and on pro-poor policies that their debt history currently demands, when even the most advanced economies, despite their greater ability to implement countercyclical policies, are struggling with popular resistance to the fiscal and structural reforms that equitable and sustainable growth demands. This seems all the more the case for the emerging-market democracies, in the light of the increasing recognition of the fundamental challenge of building and maintaining sound political as well as economic institutions in developing countries. If we are to be politically realistic about the challenge of achieving the MDGs, and if we recognize that the MDGs are a moral and ethical objective of the international community as well as a joint investment in peace and security, the problem of the poor in the highly indebted emerging-market countries must also be addressed. Moreover, is it not the IMF itself that determined in the September 2003 *World Economic Outlook* that the debt burden of a large number of emerging-market countries had reached unsustainable levels? If this is so, is it not necessary for the international financial institutions to actively seek a solution to this problem?

Signs that this need is beginning to be recognized can be seen in some, so far only timid, references in documents and statements prepared by the Bretton Woods institutions as to the desirability of blending in lending instruments for lower middle-income countries. Blending here refers to a mix of concessional and nonconcessional resources. The bulk of the MDG-related resource need must of course be mobilized by these countries themselves. They do have more means than the less developed countries. But when debt burdens inherited from the past are very high, domestic and global capital markets work in a way that puts extreme pressure on the fiscal systems of these countries and makes the achievement of sustained, rapid, and pro-poor growth close to impossible. This destabilizes these countries politically and economically and poses a threat not only to their own people but also to the world as a whole. The problem should be recognized and an element of international solidarity should be offered to these countries, provided they stand ready to use this support to grow out of their debt problem and put in place the policies, tax systems, and institutions that will allow pro-poor growth and achievement of the MDGs.

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Table 1. Public-sector total debt for selected emerging-market economies,
1992–2003
(percent of GDP)

Country	1992	1997	2002	2003
Argentina	30.3	38.1	164.5	146.1
Brazil	37.2	35.4	55.9	58.7
Bulgaria	143.9	99.9	58.7	n.a.
Chile	30.6	13.2	15.9	15.6
Colombia	23.5	27.2	46.8	n.a.
Costa Rica	49.3	52.6	51.0	n.a.
Ecuador	78.5	63.9	60.4	n.a.
Egypt	n.a.	35.6	73.5	n.a.
Indonesia	36.6	23.7	80.7	72.2
Jordan	139.9	84.4	76.3	n.a.
Lebanon	51.0	104.8	177.6	177.9
Malaysia	73.2	56.1	69.9	67.0
Mexico	29.6	51.3	50.2	51.0
Morocco	105.3	99.4	89.6	n.a.
Nigeria	124.7	94.1	87.9	75.7
Pakistan	88.0	93.9	104.2	95.2
Panama	n.a.	65.7	63.5	n.a.
Peru	44.6	34.3	46.7	n.a.
Philippines	81.5	68.2	89.1	n.a.
Poland	86.7	46.9	46.7	51.6
South Africa	n.a.	54.0	40.0	n.a.
South Korea	15.3	18.8	39.6	39.2
Thailand	n.a.	43.5	48.6	n.a.
Turkey[a]	35.7	42.9	78.7	70.5
Ukraine	n.a.	29.7	34.2	n.a.
Uruguay	33.4	39.6	110.5	n.a.
China	16.6	20.0	28.9	n.a.
India[b]	74.5	65.1	81.3	87.0
Russia	116.0	54.7	36.0	33.4
Mean	64.4	53.7	69.2	74.4
Median	50.2	51.3	60.4	68.8

n.a. = not available

a. For Turkey, the figure is expressed in percent of GNP.

b. For India, 1992 data refer to 1991–92, 1997 data to 1996–97 and so on.

Notes: Data refer to consolidated public-sector debt when available. Total public debt is constructed on a gross basis (external plus domestic public debt) except for Brazil and Turkey, which are reported on a net basis. China, India, and Russia are shown separately because of their economic size.

Sources: Gill and Pinto (2005); World Bank (2005a).

Table 2. Interest payments for selected emerging-market economies, 1992–2003

(percent of GDP)

Country	1992	1997	2002	2003
Argentina	1.7	2.3	12.8	4.3
Brazil	4.5	5.2	8.5	9.5
Bulgaria	6.5	7.8	2.2	n.a.
Chile	1.4	0.4	0.3	0.5
Colombia	4.5	2.7	4.6	n.a.
Costa Rica	1.7	5.4	4.7	n.a.
Ecuador	4.8	5.3	3.5	n.a.
Egypt	n.a.	n.a.	10	n.a.
Indonesia	2.2	1.6	5.6	4
Jordan	n.a.	5.1	3.3	n.a.
Lebanon	5.5	15.2	18.1	11
Malaysia	5.5	4	4	3.3
Mexico	3.6	10.7	3.1	3.5
Morocco	5.6	5	4.3	n.a.
Nigeria	10	2.5	6.4	5
Pakistan	5	6.5	6.8	5.3
Panama	5.6	4.5	3.9	n.a.
Peru	5	2.8	1.9	n.a.
Philippines	5.6	6.5	6.1	n.a.
Poland	3.1	3.2	3.1	3
South Africa	4.5	5.5	4.2	n.a.
South Korea	0.6	0.5	2.3	1.6
Thailand	n.a.	2.4	n.a.	n.a.
Turkey[a]	5.4	11.1	16.2	16.2
Ukraine	n.a.	1.8	1.3	n.a.
Uruguay	2.6	2	4.6	n.a.
China	0.5	0.7	0.7	n.a.
India[b]	4.8	5.2	6.2	6.6
Russia	0.8	5	2.3	1.7
Mean	4	4.7	5.4	5.4
Median	4.5	4.8	4.3	4.2

n.a. = not available

a. For Turkey, the figure is expressed in percent of GNP.

b. For India, 1992 data refer to 1991–92, 1997 data to 1996–97 and so on.

Notes: Interest payments computed as the difference between the overall and the primary balance.
China, India, and the Russia are shown separately because of their economic size.

Sources: Gill and Pinto (2005); World Bank (2005a).

Table 3. Primary surpluses in selected high-debt, emerging-market countries, 1990–2003

(percent of GDP)

Country	Largest primary surplus since 1990		Primary surplus		
	Amount of surplus	Year of surplus	1998	2002	2003
Argentina	3.0	2003	0.5	0.9	3.0
Brazil	4.3	2003	0.0	3.9	4.3
Bulgaria	9.2	1996	5.2	1.5	n.a.
Costa Rica	2.9	1993	1.5	−0.3	n.a.
Ecuador	7.7	2000	−1.2	4.5	n.a.
Egypt[a]	n.c.	n.c.	3.8	2.6	n.a.
India	−1.2	1997	−1.5	−3.7	−3.5
Indonesia	3.8	1990, 2002	0.4	3.8	1.7
Jordan	n.c.	n.c.	−1.4	−1.2	n.a.
Lebanon	3.6	2003	−2.2	3.0	3.6
Malaysia	10.2	1997	2.7	3.1	1.7
Morocco	3.4	1992	2.7	−0.2	n.a.
Nigeria	12.9	1992	−4.8	2.5	3.8
Pakistan	3.6	2003	−0.3	2.4	3.6
Panama	7.2	1992	0.5	2.0	n.a.
Philippines	5.9	1994, 1996	4.5	−0.6	n.a.
Turkey	6.2	2003	0.8	4.1	6.2
Uruguay	2.9	1992	0.9	0.3	n.a.

n.a. = not available

n.c. = data not complete for the period since 1990

a. Data are from 1999.

Notes: High debt is defined as a public debt-to-GDP ratio above 50 percent. A minus sign indicates a primary deficit.

Source: World Bank (2005a).

Table 4a. Share of population living on less than $1 per day in selected emerging-market countries, 1990–2015

(percent)

Emerging-market country	Share of population living below $1 per day		Share of population that will remain poor if poverty is halved
	1990[b]	2001[c]	2015
High-debt[a]			
Argentina	7.7	3.3	4.0
Brazil	14.0	8.2	7.0
Bulgaria	**2.0**	**4.7**	**1.0**
Costa Rica	5.0	2.0	2.5
Ecuador	**2.0**	**17.7**	**1.0**
Egypt	4.0	3.1	2.0
India	**42.3**	**35.3**	**21.2**
Urban	24.3	19.3	12.2
Rural	48.1	41.8	24.1
Indonesia	17.0	7.2	8.5
Jordan	**2.0**	**2.0**	**1.0**
Lebanon	n.a.	n.a.	n.a.
Malaysia	**2.0**	**2.0**	**1.0**
Morocco	**2.0**	**2.0**	**1.0**
Nigeria	**59.0**	**70.2**	**29.5**
Pakistan	48.0	13.4	24.0
Panama	12.0	7.2	6.0
Philippines	**20.0**	**15.5**	**10.0**
Turkey	**2.0**	**2.0**	**1.0**
Uruguay	**2.0**	**2.0**	**1.0**
Other			
Chile	6.0	2.0	3.0
China	33.0	16.6	16.5
Urban	1.3	0.3	0.6
Rural	44.4	26.5	22.2
Colombia	**3.0**	**8.2**	**1.5**
Mexico	16.0	9.9	8.0
Peru	**2.0**	**18.1**	**1.0**
Poland	**2.0**	**2.0**	**1.0**
Russia	**6.0**	**6.1**	**3.0**
South Africa	**10.0**	**10.7**	**5.0**
South Korea	**2.0**	**2.0**	**1.0**
Thailand	6.0	2.0	3.0
Ukraine	**2.1**	**2.9**	**1.0**

n.a. = not available

PPP = purchasing power parity

a. High debt defined as a public debt-to-GDP ratio above 50 percent.

b. 1990 data or closest year available.

c. 2001 data or closest year available.

Notes: Percentages are based on 1993 PPP. Data for 2015 are estimates. Countries that are not likely to meet the poverty goal of the Millennium Development Goals are shown in bold.

Sources: World Bank PovCal (http://iresearch.worldbank.org/PovcalNet/jsp/index.jsp); UN Millennium Development Goal Indicators database (http://millenniumindicators.un.org/unsd/mi/mi_goals.asp); authors' calculations.

Table 4b. Number of people living on less than $1 per day and $2 per day in selected emerging-market economies, 1990–2015

(millions)

Emerging-market country	Number of people living on less than $1 per day				Number of people living on less than $2 per day[e]
	Actual		Target, if poverty is halved	Current trend[b, c]	
	1990[d]	2001[e]	2015	2015	2001[e]
High-debt[a]					
Argentina	2.3	1.1	1.7	0.5	n.a.
Brazil	20.7	13.8	14.7	8.2	38.5
Bulgaria	**0.2**	**0.4**	**0.1**	**0.4**	**1.3**
Costa Rica	0.2	0.1	0.1	0	0.4
Ecuador	**0.2**	**2.2**	**0.2**	**2.7**	**4.9**
Egypt	2.3	1.9	1.8	1.4	27.3
India	**359.6**	**364.3**	**264.7**	**370.4**	**809.2**
Urban	52	48.3	n.a.	n.a.	153.3
Rural	303.8	312.1	n.a.	n.a.	655.9
Indonesia	31.9	14.4	22.2	5.3	113.5
Jordan	**0.1**	**0.1**	**0.1**	**0.1**	**0.3**
Lebanon	n.a.	n.a.	n.a.	n.a.	n.a.
Malaysia	**0.4**	**0.4**	**0.3**	**0.6**	**2**
Morocco	**0.5**	**0.6**	**0.4**	**0.7**	**3.9**
Nigeria	**60.1**	**80.2**	**48.3**	**112.7**	**103.9**
Pakistan	51.8	17.1	46.4	4.2	85.8
Panama	0.3	0.2	0.2	0.1	0.5
Philippines	**12.5**	**11.5**	**9.7**	**10.3**	**36.2**
Turkey	**1.2**	**1.3**	**0.8**	**1.7**	**6.7**
Uruguay	**0.1**	**0.1**	**0**	**0.1**	**0.1**
Total[f, g]	**544.4**	**509.7**	**411.7**	**519.4**	**1,234.50**
Other					
Chile	0.8	0.3	0.5	0.1	1.4
China	374.6	211.2	229.8	101.8	591
Urban	3.2	1.4	n.a.	0.5	30.5
Rural	367.6	206.2	n.a.	98.8	560.5
Colombia	**1.1**	**3.3**	**0.8**	**4.2**	**9.3**
Mexico	13.8	9.8	9.5	6.3	25.6
Peru	**0.4**	**4.7**	**0.3**	**5.8**	**9.7**
Poland	**0.8**	**0.8**	**0.4**	**0.8**	**n.a.**
Russia	**8.9**	**8.7**	**4.1**	**8.2**	**34.3**
South Africa	**3.7**	**4.7**	**2.4**	**5.3**	**14.5**
South Korea	**0.9**	**0.9**	**0.5**	**1**	**n.a.**
Thailand	3.4	1.2	2.1	0.3	19.6
Ukraine	**1.1**	**1.4**	**0.4**	**1.3**	**15.5**
Total[h, i]	**407.8**	**245.3**	**249.9**	**133.3**	**720.9**

n.a. = not available

a. High debt defined as a public debt-to-GDP ratio above 50 percent.

b. Countries that have regressed, rather than progressed, toward the Millennium Development Goals are assumed to reach 2015 with the same share of the population living on less than $1 per day as in 2001.

c. For 2015 population projections, the UN medium variant is used.

d. 1990 data or closest year available.

e. 2001 data or closest year available.

f. India, rural and India, urban excluded from all totals.

g. Total excludes Argentina.

h. China, urban and China, rural excluded from all totals.

i. Total excludes Korea and Poland.

Note: Data for 2015 are estimates. Countries that are not likely to meet the poverty goal of the Millennium Development Goals are shown in bold.

Sources: World Bank PovCal (http://iresearch.worldbank.org/PovcalNet/jsp/index.jsp); UN Millennium Development Goal Indicators database (http://millenniumindicators.un.org/unsd/mi/mi_goals.asp); United Nations World Population Prospects: The 2004 Revision (http://esa.un.org/unpp/); authors' calculations.

Table 5. Secondary school enrollment ratios and infant mortality rates in selected countries, 2002 and 2003

Country	Net secondary school enrollment ratio 2002 (percent)	Gross secondary school enrollment ratio 2002 (percent)	Infant mortality rate 2003 (per 1,000 live births)
High-debt emerging-market			
Argentina	81	n.a.	17
Brazil	75	n.a.	33
Bulgaria	87	n.a.	12
Costa Rica	53	n.a.	8
Ecuador	50	n.a.	43
Egypt	81	n.a.	33
India	n.a.	53	63
Indonesia	54	n.a.	31
Jordan	80	n.a.	23
Lebanon	n.a.	79	27
Malaysia	70	n.a.	7
Morocco	36	n.a.	36
Nigeria	29	n.a.	98
Pakistan	n.a.	23	74
Panama	63	n.a.	18
Philippines	59	n.a.	27
Turkey	n.a.	81	33
Uruguay	73	n.a.	12
Group average	64	59	33
Other emerging-market			
Chile	79	n.a.	8
China	n.a.	70	30
Colombia	55	n.a.	18
Mexico	63	n.a.	5
Peru	69	n.a.	26
Poland	92	n.a.	6
Russia	n.a.	95	16
South Africa	66	n.a.	53
South Korea	87	n.a.	42
Thailand	n.a.	76	23
Ukraine	85	n.a.	15
Group average	74	80	22
High-income			
United States	88	94	7
Germany	88	100	4
Japan	100	102	3
Sweden	100	139	3
Group average	94	109	4

n.a. = not available

Sources: UIS (2005); World Bank (2005b).

Table 6. Income inequality in selected countries, 1997–2002

Country	Gini index 1997–2002[a, c]	Income share of poorest 20 percent of population (percent) 1997–2002[c]	Income share of richest 20 percent of population (percent) 1997–2002[c]
High-debt emerging-market[b]			
Argentina	52	3.1	56.4
Brazil	61	2.4	65.6
Bulgaria	49	4.2	54.8
Costa Rica	50	3.7	54.7
Ecuador	56	3	60.4
Egypt	54	3.6	59.4
India	n.a.	n.a.	n.a.
Indonesia	n.a.	n.a.	n.a.
Jordan	38	n.a.	n.a.
Lebanon	n.a.	n.a.	n.a.
Malaysia	44	n.a.	n.a.
Morocco	n.a.	n.a.	n.a.
Nigeria	50	4.4	55.7
Pakistan	n.a.	n.a.	n.a.
Panama	58	2.3	61.5
Philippines	50	4.4	54.8
Turkey	n.a.	n.a.	n.a.
Uruguay	45	4.8	50.1
Group average	51	3.6	57.4
Other emerging-market			
China	45	n.a.	n.a.
Chile	57	3.4	62.2
Colombia	57	2.4	61.5
Korea	37	4.8	41.7
Mexico	51	3.9	56.3
Peru	49	n.a.	n.a.
Poland	32	7.8	40
Russia	43	4.8	48
South Africa	60	3.6	66.1
Thailand	43	5.7	48.9
Ukraine	45	n.a.	n.a.
Group average	47	4.6	53.1
High-income			
United States	39	5.3	45.1
Germany	29	8.5	37.8
Japan	32	n.a.	n.a.
Sweden	26	10	35.8
Group average	31	7.9	39.6

n.a. = not available

a. All Ginis are income based.

b. High-debt countries are defined as countries with public debt-to-GDP ratios above 50 percent.

c. Data are for the latest year available for the 1997–2002 period.

Sources: WIDER World Income Inequality database, version 2.0a, www.wider.unu.edu/wiid/wiid.htm; authors' calculations.
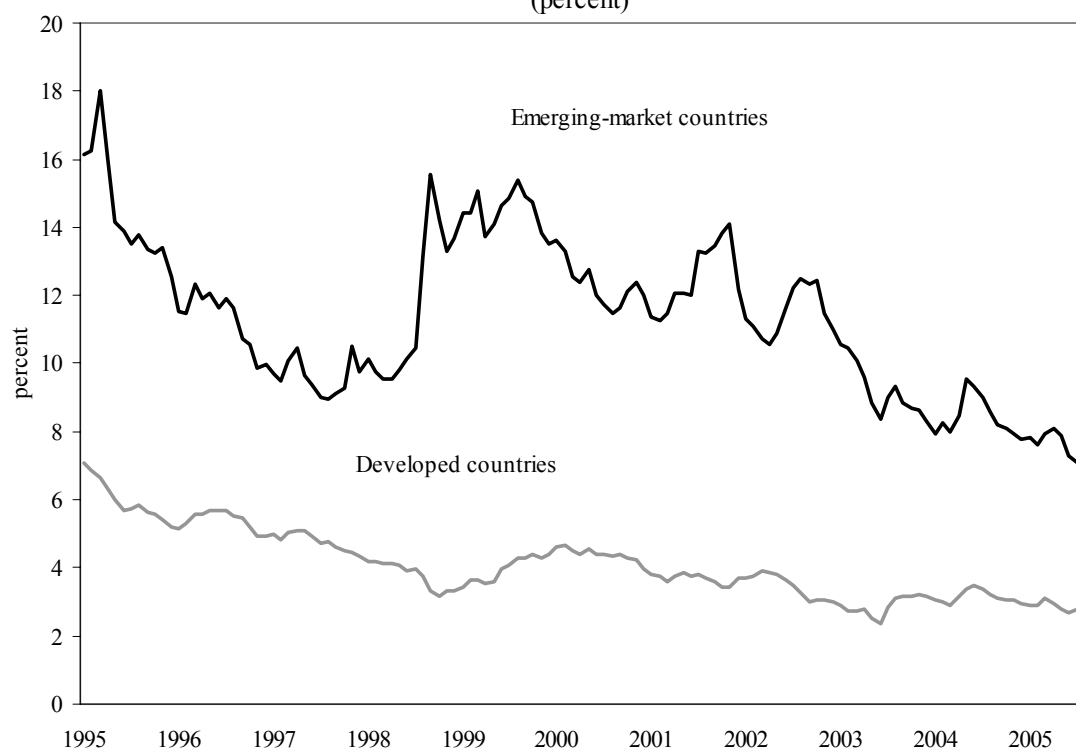
**Table 7. Impact of financial crisis on poverty in East Asia,
1997–998**

(poverty headcount index in percent)

Country	Year of crisis	Overall	Urban	Rural
Indonesia	1997	11	9.2	12.4
	1998	19.9	15.8	23
Malaysia	1997	8.2	n.a.	n.a.
	1998	10.4	n.a.	n.a.
South Korea	1997	2.6	7.5	n.a.
	1998	7.3	10	n.a.
Thailand	1997	9.8	1.2	11.8
	1998	12.9	1.5	17.2

n.a. = not available
Source: World Bank (2004b, 62 [table 4.4]).

**Figure 1. Yields on debt to emerging-market and developed countries,
1995–2005**

(percent)

Notes: Emerging-market yields refer to yields on benchmark emerging-market bond indexes; developed country yields refer to average of long-term (10-year) benchmark government yields for the United States, Europe, and Japan. The end date for the figure is August 2005.
Source: JPMorgan Chase.