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Addressing Debt Vulnerabilities

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We wrote this paper before the current COVID-19 crisis, as background to a shorter article to be published by the Paris Club later in 2020. No doubt the debt landscape will change as the financing to help developing countries confront COVID-19 and its aftermath evolves. However, we believe that the lessons we draw for dealing with low-income country debt will be even more pertinent in the months and years to come.

THE EVOLUTION OF THE PROBLEM

Around the turn of the century, there was a broad recognition that the debt burden of many developing countries was impeding their growth. Much of the debt had accumulated in the context of the Cold War and had not resulted in productive investment. In the face of sluggish economic growth, debt service was eating up an increasing share of budgetary spending, preventing countries from engaging in productive investment in human and physical capital. And even where countries were no longer making service payments, the uncertainty posed by the outstanding debt stock was a disincentive for investors to finance new projects. With considerable outside political pressure, bilateral and multilateral creditors decided that the best course was to forgive existing debt to low-income countries (LICs) in conjunction with a track record of sound economic policies. Thus, the Heavily Indebted Poor Countries Initiative (HIPC) was born in 1996, followed by the Multilateral Debt Relief Initiative (MDRI) in 2005.

But debt relief did not resolve the fundamental saving/investment gaps that LICs were facing. Investment needs were enormous, and productive capacity remained limited, so LICs could not generate enough income and savings to accelerate development on their own steam. In the context of the Millennium Development Goals (MDGs), donors pledged to step up their assistance; at the 2005 Gleneagles Summit many countries pledged to devote 0.7 percent of their gross national income to development assistance. Moreover, having learned the lessons from the previous debt crisis, most of the international financial institutions (IFIs) and traditional donors switched their assistance from loans to grants that would be used for productive investment in infrastructure and the social sectors. LIC governments and their development partners worked to ensure that budgets were recalibrated with the aim of reducing poverty and boosting economic growth.

In the event, the Gleneagles promise of increased donor aid did not materialize and LIC savings/investment gaps remained large. And the world economic situation shifted radically with the great recession of 2007/8. International interest rates in developed markets hit new lows and investors were anxious to find investment opportunities with higher returns. China's booming economy drove up commodity prices, thus increasing the economic attractiveness of commodity-exporting LICs. And the fact that China itself was running substantial balance of payments surpluses and accumulating substantial foreign exchange reserves gave it an added impetus and ability to invest abroad and forge new global alliances, particularly with other developing countries.

These developments all made borrowing an attractive proposition for LIC governments and enterprises. One of the benefits of the so-called structural adjustment programs of the 1980/90s was that the macroeconomic management of many LICs was much improved, with relatively low inflation and stable currencies. While still risky relative to developed markets, with global sluggishness LICs became attractive options in international markets and the most healthy LICs floated euro or dollar bonds to finance government operations. Private companies also saw opportunities to invest in LICs, particularly in the natural resources sector where the loans could be easily collateralized, with the explicit, or sometimes implicit, agreement of governments (but not necessarily ministries of finance). With prevailing high commodity prices, the collateralization appeared to be plausible, although often the exact terms of the loans were not transparent.

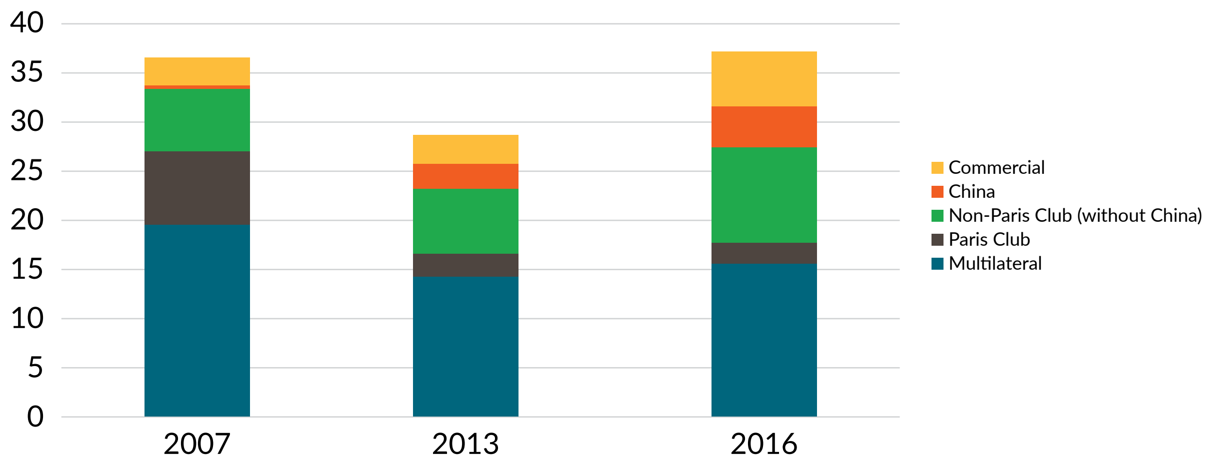
Nontraditional bilateral partners, predominantly China, also ramped up lending to LICs both for commercial projects, particularly in natural resource firms, physical infrastructure, and a variety of government projects from schools to sports stadiums. The terms of the lending were often unclear, even to the borrowing government, but as a partner China appeared to be more responsive to government desires; Chinese projects were quickly executed, with less regard to environmental, social, and governance standards.

The financing landscape shifted again in 2014, as many LICs ran into strong macroeconomics headwinds. With a slowdown of growth in China, commodity demand weakened, lowering prices and quantities of commodities sold and putting in jeopardy the economies of commodity-exporting countries. Collateralized loans quickly became problematic. Fiscal positions did not adjust to the new global economic reality, not only in commodity-exporting countries but in other LICs as well, where sluggish global demand was affecting broader economic activity.

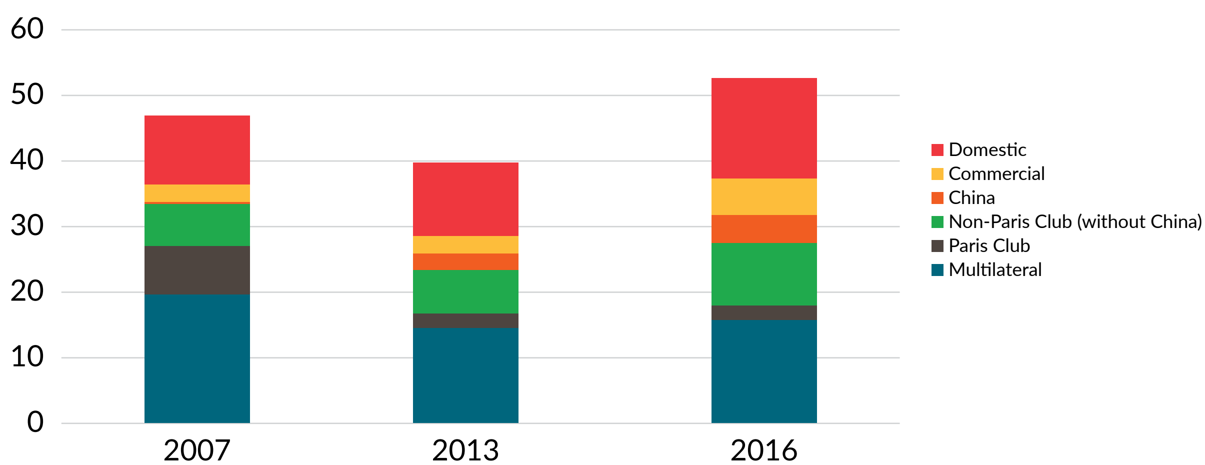
As financing conditions worsened it became clear that economic management tools were not fully up to the task of managing the more complex financing arrangements in which LICs were engaged. In many countries, debt management was weak or decentralized, with state-owned enterprises often taking on loans without central government oversight, even if there was an implicit sovereign guarantee. In some instances, line ministries contracted debt on behalf of the government without the prior knowledge of the central debt office. A combination of poor record keeping, and intentional obfuscation, resulted in uncertainty over the terms of some loans. And in many LICs there was a maturity mismatch on loans: market loans are typically due in five years, yet in developing countries the economic fruits of non-commodity projects, such as infrastructure, schools and hospitals are seen only after 10 to 15 years. The international financial institutions, notably the IMF and World Bank, were also slow to call out the worsening debt situation in many countries, even those where they were providing financing and monitoring economic risks.

Thus, over the last five to seven years, there has been an overaccumulation of debt and countries are running into severe debt management problems. By last count, nearly half the LICs are in debt distress or at high risk of getting there. In these countries, debt service is once again squeezing out room for productive investment and, in some cases, room for spending on ongoing government services. And the problem is more complicated than at the time of the HIPC initiative because the creditors are both more diverse and less organized under existing debt resolution frameworks. As seen in the figures below, since 2013, the debt stock (as percent of GDP) has grown rapidly, with the share of Paris Club debt falling and non-Paris Club creditors, notably China, becoming the lion's share of public debt external debt. Private foreign debt has jumped as well and LIC governments are resorting increasingly to domestic debt markets. There is anecdotal information that these trends have worsened since 2016, the last year for which complete data are available.

External Public and Publicly Available Debt in LIDCs by Creditor (in percent of GDP)



Total Public and Publicly Guaranteed Debt in LIDCs by Creditor (in percent of GDP)



Notes: Figures are in simple averages and may be overly influenced by the experience of countries with very high levels of debt. External debt is defined based on currency demonication.
Source: *Macroeconomic Developments and Prospects in Low-Income Developing Countries*, IMF, 2018.

HOW TO ADDRESS THE PROBLEM

A good general rule of life is that if you are in a hole, the first thing to do is stop digging. Unfortunately, over the past three years while the international community has talked about the growing debt problem, many LICs have dug themselves into a deeper hole, sometimes aided and abetted by their development partners, public and private.

The immediate task is to agree on a near-term plan for arresting the deterioration in the most vulnerable countries. The vulnerable LICs themselves have to be at the center of that process, but IFIs have a **responsibility** for oversight and guidance and **leverage** to spur the appropriate prudence in LICs—they need to exercise both wisely but firmly.

More fundamentally, addressing the burgeoning debt problem requires **mutual accountability**. Creditors and borrowers must recognize that there is a problem and then agree on how to stop it from growing and, in due course, put the vulnerable countries back on a sustainable debt path. Most importantly, all major creditors, traditional and new, need to be part of the process: the rules of the game have to be set taking into account the interests of all creditors and borrowers, which is a much more complex set of actors than in the earlier debt crisis. The old rules of the game are unlikely to work.

Transparency in lending, past, present, and future, will be the first and most important step in dealing with the debt crisis. Without knowing the composition and terms of LICs' debt and the nature of creditors' exposure, there will be little hope of gaining the mutual trust needed to address the current debt problems.

What are the various elements of transparency that are needed?

- For official debt, Paris Club creditors entrust "The Club" to monitor their collective creditor position vis-à-vis LICs. The aggregate claims by Paris Club creditors as a group are available for each borrowing country. But individual creditor country positions are not publicly available, nor are the terms of their loans. Paris Club creditors should hold themselves to the same transparency standards being put forward for private sector financial institutions (see below).

- More complete and consistent data are needed for non-Paris Club official creditors, notably China, which has larger claims on many LICs than all the Paris Club creditors combined. The amounts and terms of their lending are in many cases unknown, although researchers at various universities collect and publish data on Chinese lending. The Paris Club is engaging with China and other official creditors and some data are available to the Club on an ad hoc basis. What is needed is for all creditors to form a common club, but new creditors cannot simply be invited to adhere to an existing set of rules without any say over (at least) the future governance of the club.

- Private creditors do not consistently report the amount and terms of their lending. Under the leadership of the Institute of International Finance (IIF), a set of voluntary standards have been put forward by the international banking community for making loan-by-loan data for financial institutions' lending to LIC sovereigns publicly available. Agreement was slow in the making, as discussions became mired in anti-trust and other more parochial concerns. Although the standards have been adopted by the G20, continued discussions as to where the data will be stored and made available to the public are ongoing. So, no reporting has been done yet and we have yet to see which financial institutions will adhere to the standards. Support from G20 governments will be critical to ensuring that these voluntary standards supply enough private sector loan information to be meaningful in debt analysis. Others have proposed that legislation in the United States and the United Kingdom forcing private-to-sovereign loan disclosure could be another route to better transparency.

- LICs do not report debt on a consistent basis and, given weak financial controls and inter-ministerial reporting systems, often do not have complete and consistent information across governments. LICs need to be held to a higher standard in debt reporting, particularly by the IFIs who provide substantial technical assistance to LIC ministries of finance and debt management units as well as financial assistance when balance of payments situations become untenable. An area of particular concern is erstwhile private sector loans that are either collateralized by sovereign assets or guaranteed by the sovereign, implicitly or explicitly.

- There is no single repository of LIC debt data that is easily accessible by the public. Different cuts of debt data are available in World Bank and IMF reports and databases, as well as in Paris Club reports and through other sources. The World Bank's plans to consolidate debt data by borrowing country should be accelerated.

- There is an important role for civil society and the press to play in analyzing existing debt data, calling attention to questionable loans or lending practices, and flagging untenable overall debt positions. Civil society has a responsibility to push for concerted efforts by creditors and borrowers to confront the impending debt crisis. The responsibility and burden of civil society will only increase as more debt data become public, particularly under the IIF initiative. Creditor and borrower governments should provide civil society organizations with financial support to sustain their vital surveillance activities.

Assessment of debt distress requires continued vigilance by both creditors and borrowers. The World Bank and the IMF have a well-established debt sustainability framework (DSF) to analyze debt dynamics and assess the debt vulnerability of LICs. The framework has been subject to periodic review and revision to make it a better predictor of future debt vulnerabilities. But in the end, the current debt crisis seemed to have emerged as a bit of a surprise to both the creditor and borrower community. While one might posit that it was a unique confluence of events that led to the current situation, it is likely that given chronic savings/investment imbalances in LICs and the tendency of capital to seek return, that the current debt conjuncture was inevitable, whatever the global economic situation.

The slowness of the DSF to sound the alert on the debt crisis was not a technical failure, but at root, a problem of inconsistent policy messages. On policy, the global mandate is to expand LICs budgets to invest to meet the Sustainable Development Goals (SDGs). Yet this is the face of chronic savings/investment imbalances in LICs and stagnant donor financing, so borrowing is the only way to close the gap. To crack down on debt is to crack down on implicitly on development spending. The mixed messages of aggressive investment needs and fiscal prudence result in a policy incoherence that impedes concerted action. For many LICs, this policy conundrum can be at least partially resolved by selling or mortgaging natural resources, which introduces a further set of macroeconomic risks. DSFs may flag potential problems, but they are not an effective policing mechanism, particularly given the debt data gaps outlined above.

Instead, the DSF and other analytic tools should be used to initiate a serious discussion on the financing challenges faced by LICs, on a country-by-country basis and globally. Given current thought on the potential financing needs and uncertainty associated with climate change mitigation and adaptation, these challenges are likely to multiply quickly in the years ahead and so the time for a serious discussion is now. The 2020s version of the Gleneagles Summit is badly needed, but nowhere on the horizon.

Dealing with debt insolvency in LICs is likely to once again become a regular activity if current debt profiles continue to worsen. The bilateral and multilateral institutions that figured large in the HIPC/MDRI era are no longer the principle creditors of LIC. They have been replaced by a multiplicity of new creditors and new types of loans. So, debt rescheduling for LICs this time around will be different and likely more complex than during HIPC/MDRI. Past middle-income debt crises can give some guidance as to how to proceed, but new and more inclusive rules of the game need to be established for treating the LIC debt insolvency. If Paris Club creditors cling to old conventions, the negotiations will move outside the rigor of the Paris Club. Engaging new creditors early on to find rescheduling broadly applicable procedures that recognize their interests will help avoid ad hoc reschedulings, which result in inequitable treatment and introduce uncertainly and gamesmanship.

Provision of effective technical assistance to LICs in debt management and debt workouts can facilitate all the steps outlined above. A great deal of technical assistance (TA) has been given to LICs over the last 30 years, but it is unclear how effective it has been, given the current debt profile of many LICs. The World Bank has found that many LICs continue to have weak debt management capacity. Again, a system of mutual accountability is needed. Debtor countries need to make clear what TA they need and be held accountable for putting that TA to good use. The full span of creditor countries should contribute to the provision of TA, as well as support and monitor its implementation. And, in the end, good technical financial management cannot compensate for political mismanagement. So technical assistance should be complemented by stronger political persuasion, either through tough talk or leveraging of donor resources to encourage sound management and transparency. But for such persuasion to be effective all donors will have to be on board.

CONCLUDING REMARKS

The current debt problem of LICs is symptomatic of a larger problem in the international development finance system. The international community has not figured out how to finance the multitudinous needs of LICs. The structural adjustment programs of the 20th century, along with debt relief in the early 21st century, laid a strong foundation for good macroeconomic management. But in the end, insufficient acceleration in growth, huge development "asks" of the MDGs and SDGs, and turmoil in the global economy left LICs overall in a financing deficit. Hopes for a private sector solution have not materialized, and neither development assistance nor LICs' domestic revenues have grown. So, debt levels increase.

Debt is not inherently bad—in fact, it is fundamental to the kind of social and infrastructure investment that is needed in LICs. But it must be well used. Concerted action by creditors and debtors to hold each other mutually accountable for managing debt accumulation transparently and prudently is the only way to ensure that global lending to LICs contributes to growth and poverty reduction, without destabilizing any country's economy. All creditors need to be included, and trust among creditors and with LICs must be enhanced for any such system to work. And ultimately, the conversation needs to be how creditors and borrowing countries can work together to achieve the SDGs. All parties are going to have to bring to the table new ideas and an openness to change if that goal is to be achieved.

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