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Responding to the Challenges Posed by the Global Economic Crisis to Debt and Development Finance

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Introduction

The financial crisis, which started in 2007 in the United States subprime market, developed into the most severe economic crisis since the Great Depression. Only an unprecedented fiscal and monetary stimulus in the developed world prevented an even more acute global recession, but the price tag for the crisis still remains a record-breaking high.

Even the staggering estimated costs understate the true price of the crisis, as they do not take into account output losses; moreover, they disregard the negative effects of the crisis on human and social development, and it will now take many more years to recover from the setback towards the achievement of the MDGs. While some developed countries and a number of large emerging market countries are now showing some signs of recovery, the effect of the crisis on developing countries has not yet fully unfolded. It is possible that the negative economic and social consequences of the crisis, for example on employment, will be felt for some time to come - especially given that a double-dip recession in the developed economies cannot be ruled out.

The crisis affected developing countries mainly via the trade channel, declines in commodities prices, and financial linkages. Some emerging market economies which entered the crisis with strong fiscal positions or with large war chests of foreign exchange reserves were able to implement counter-cyclical macroeconomic policies. However, most low-income countries were in a much weaker position and were not able to respond to the crisis with adequate policy actions. As a consequence, the severity of the external shocks directly passed through to their economies.

Despite the overwhelming negative impact of the crisis, one positive story to emerge from the economic emergency has been a revival of multilateralism. The UN Conference on the Financial and Economic Crisis in June 2009 called for an increase in the resources that the international community targets at low-income countries. Recent G20 meetings mandated the IMF to create new crisis-response mechanisms and boosted the IMF resource pool. However, most of these resources were directed to middle-income emerging market countries and a much smaller share allocated to low-income countries.

UNCTAD was among the first organizations to identify the channels through which the crisis may affect debt sustainability in developing countries. As the focal point within the United Nations system for dealing with debt issues, UNCTAD has taken a proactive approach in assisting developing countries to cope with the negative impact of the financial crisis on their debt positions through research and analysis, consensus building, and technical assistance. At the request of its Member States, UNCTAD is now tackling several topical issues, such as the promotion of responsible sovereign lending and borrowing as well as risk management.

While much has been achieved on these issues during the past months, more action is needed in order to alleviate the impact of the crisis on the world's poorest countries. This UNCTAD publication, prepared by UNCTAD's Debt and Development Finance Branch, encapsulates UNCTAD's contributions to some of the most pressing areas for action in the fields of sovereign debt, as well as official development assistance. It therefore represents a contribution to the ongoing discussion on the reform of the international financial architecture.

The publication is arranged in two parts: Part 1 (Chapters I to III) consists of three comprehensive analyses of the recent dynamics in debt markets with a detailed discussion of how debt markets and development finance have been affected by the financial crisis. Part 2 (Chapters IV to VIII) aims to provide concrete policy recommendations in specific areas of debt and development finance, which UNCTAD considers vital under the current circumstances.

Chapter I, which draws upon the UN Secretary General's report "Towards a durable solution to the debt problems of developing countries", gives a comprehensive overview of the recent trends in sovereign debt markets. The Chapter provides a detailed discussion of the impact of the economic crisis on developing countries and its potential implications for debt sustainability. It highlights that lower growth prospects, higher financing costs and a decrease in remittances are leading to soaring debt ratios and are a source of concern for the debt sustainability of several low-income countries. In this context, the chapter presents a critical evaluation of the IMF/World Bank debt sustainability framework (DSF) for low-income countries. The chapter also includes a detailed discussion of the dangers of private external debt, which has increased significantly over the past decade, especially in countries with access to international capital markets. The chapter also reviews recent advances in debt relief through the Multilateral Debt Relief Initiative (MDRI) and Highly Indebted Poor Countries (HIPC) initiative and evaluates recent trends in official development assistance (ODA). It shows that donors are still far from meeting their commitments for the 2010 ODA targets.

Chapter II is based on an UNCTAD secretariat note delivered to the President of the 64th session of the UN General Assembly in September 2009. This chapter complements the analysis of Chapter I by discussing the international policy responses to the financial crisis and by providing a detailed analysis of the determinants of debt sustainability in developing countries. The Chapter shows that private financial flows (including investment flows and remittances) to developing countries have fallen since 2008, and argues that a recovery cannot be expected before 2010. Low-income countries are facing higher debt service ratios and this has become an obstacle to their poverty reduction programs, putting at risk their recent advances towards achieving the MDGs. The chapter also includes a conceptual discussion of why developing countries suffer more frequently from debt crises and discusses the relationship between debt sustainability and debt structure.

Chapter III is a paper prepared for the Debt Managers' Seminar organized by the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), in February 2009. The paper was among the first to point out that the global financial crisis would reverse the gains made in the past decade in reducing the debt burdens of developing countries and might also carry the risk of a new debt crisis because of a dangerous combination of external shocks, the higher cost of debt servicing and the pressing need for increasing new external and domestic borrowing.

Chapter IV argues that a temporary debt moratorium, which I first proposed at the High-Level Segment at the United Nations Economic and Social Council (ECOSOC) in April 2009, could be beneficial for both lenders and borrowers. Developing countries have been hit by the worst exogenous financial shock in decades, and low-income countries are ill equipped to fight the economic and social consequences of this shock. Alleviating the liquidity problems of these countries and providing them with the fiscal space needed to combat the economic and financial crisis would also help stabilize global demand and should thus be regarded as an integral component of developed countries' stimulus packages.

Chapter V focuses on the volatility of Official Development Assistance (ODA). It shows that aid flows tend to collapse during periods of global economic crisis, exactly when developing countries need them most. The chapter presents an innovative plan aimed at delinking the budget of aid agencies from the business cycle in donor countries.

Chapter VI introduces the work of the Debt Management and Financial Analysis Software programme (DMFAS), which is part of the Debt and Development Finance Branch of UNCTAD. It is UNCTAD's flagship technical cooperation programme in the area of debt management. This chapter argues that effectively managing a country's public debt is not only the back-bone for sound public financial management, but also a prerequisite for good governance, and the success of poverty reduction programmes in developing countries. DMFAS is contributing to this objective with capacity building activities at the country level, the core of which is the software itself, used for debt management and financial analysis.

Chapter VII discusses how UNCTAD is playing a leading role in the debate on promoting responsible sovereign lending and borrowing. It describes a project aimed at establishing a forum for broader dialogue among stakeholders with the aim of developing a set of guidelines to promote and foster mechanisms for responsible sovereign lending and borrowing.

Chapter VIII describes a project in which UNCTAD will help a selected group of developing countries to develop and adopt innovative risk management techniques. The overall goal of the project is to improve the institutional capacity of developing countries to address the debt servicing implications of external shocks and climate change through risk analysis and the use of innovative instruments.

Supachai Panitchpakdi
Secretary-General of UNCTAD

PART 1

Chapter I

External debt and development: Towards a durable solution to the debt problems of developing countries[1]

A. Introduction

The present report is submitted to the General Assembly in accordance with paragraph 4 of Assembly resolution A/RES/63/206. It includes a comprehensive analysis of the external debt situation and debt-servicing problems of developing countries and transition economies. It aims to describe new developments and key trends in external debt and related areas of development finance and to provide a basis for deliberation of related policy issues.

B. Recent trends

During 2008, the dollar value of total external debt of developing and transition economies (henceforth developing countries) increased by $176 billion, surpassing $3.6 trillion at the end of the year. Developing countries' output grew more rapidly than debt and total external debt decreased from 25 per cent of GNI in 2007 to 21.8 per cent of GNI in 2008. As a group, developing countries continued to accumulate international reserves which, by the end of 2008, surpassed $4.2 trillion.

The data in the Annex are weighted averages and are heavily influenced by the behaviour of some large developing countries which, over the last few years, recorded rapid output growth and reserve accumulation. A simple average, which gives each country the same weight, would yield a debt to GNI ratio which is twice as large as the weighted average reported in the Annex.

High average reserve coverage is also driven by a few large countries. At the end of 2008, four countries (Brazil, Russia, India, and China) held about two thirds of the total reserves of developing countries. As a consequence, there are large differences across regions and countries. While the East Asia and Pacific region and the Middle East and North Africa region hold reserves which are much larger than their external debts, all other developing regions have reserves lower than their external debts, but higher than their short-term external debt. There are, however, several countries in Eastern and Central Europe that have international reserves which are well below their short-term external debt.

Debt composition is also changing rapidly. In the first half of the current decade, about 60 per cent of total long-term external debt of developing countries was owed to private creditors (varying from 21 per cent in sub-Saharan Africa to 78 per cent in Latin America and the Caribbean), by 2008 the share of debt owed to private creditors was 75 per cent (ranging from 33 per cent in sub-Saharan Africa to 93 per cent in the transition economies of East Europe and Central Asia). Over the same period, the share of total long-term external debt issued by private borrowers grew from 30 per cent to 50 per cent. Debt issued by private borrowers is particularly important in the transition economies of East Europe and Central Asia, where it amounts to 72 per cent of total external long-term debt.

C. The current economic crisis and risks to debt sustainability

The trends discussed above are a reflection of the benign conditions that characterized the world's economy over the period 2003-2007. They have not yet factored in the shockwaves of the economic and financial crisis.

The early view that developing countries had managed to decouple their economies from those of the developed world is proving to be incorrect. Economic growth is slowing across all regions and several developing countries are expected to experience negative growth in 2009. Total growth of the developing world will remain positive in 2009, but if China and India are excluded from the group, output of the developing world will contract by approximately 1.5 per cent.

In 2008, GNI growth in Asia was 5.9 per cent (down from 8.1 per cent in 2007) and is expected to be just above 2 per cent in 2009; growth in the Latin American and Caribbean region is expected to decrease from 4.2 per cent in 2008 to negative 2.6 per cent in 2009; growth in Africa will decrease from 5.1 per cent of to 1.2 per cent; and growth in East Europe will swing from 5.4 per cent growth in 2008 to a loss of income of 5 per cent in 2009. About 62 developing countries out of 166 countries for which data are available are expected to record falling output in 2009 and a larger number of countries are expected to record decreasing income in per capita terms.

Developing countries as a group registered a current account surplus of 3.5 per cent of GNI in 2007. This surplus dropped to 2.5 per cent in 2008 and is expected to shrink further to 1.6 per cent in 2009. In 2007, about 40 per cent of all developing countries had a current account deficit greater than 6 per cent of GNI; by 2008 the share of developing countries with large current account deficits had risen to 53 per cent. In 2006-2007, sub-Saharan Africa had a balanced current account and went into a deficit of 2.3 per cent of the region's GNI in 2008, which is expected to reach 5 per cent in 2009. About 84 per cent of countries in the region ran a current account deficit in 2008, and 70 per cent of the countries in the region had a current account deficit greater than 6 per cent of GNI. Latin America and the Caribbean and Eastern Europe and Central Asia registered a current account deficit in 2008, which is likely to persist in 2009. East Asia and the Middle East and North Africa are likely to maintain current account surpluses in 2009, but these surpluses are driven by a collapse of imports, rather than by dynamism in the export sector.

Financing these current account deficits may become problematic for some developing countries. Preliminary data shows a 50 per cent reduction in net private capital flows to developing countries in 2008 and further reduction in 2009. This "reversal of international capital flows" as it is usually called, should not be regarded a priori as a curse for all affected countries. While many low-income countries do need external resources to finance productive imports, in many market-access countries private flows are often driven by speculative behaviour and end up in overvaluation of the currency and consumption booms. There are thus cases in which the reversal in private capital flows may have a minor effect on GDP growth and even help the affected countries to move towards a more sustainable growth model (Trade and Development Report (TDR), 2008, Ch. IV).

The crisis is also taking its toll on the availability and cost of trade finance. Spreads on 90-day letters of credit have increased by a factor of 25, going from 10-20 basis points to 250-500 basis points. As a reaction to this situation, the communiqué of the G20 Summit held in London in April 2009 included a $250 billion package in support of trade finance.

1. Market access countries

Countries that tap the international capital markets are facing higher borrowing costs driven by the global increase in risk aversion. This increase in borrowing cost may endanger the solvency of private borrowers based in emerging markets as a large share of their external debt contracted during the period 2003-2007 is now coming due.[2]

Sovereign spreads measure the difference between the interest rate paid by dollar-denominated sovereign bonds issued by emerging market countries and bonds with similar characteristics issued by the government of the United States. Average sovereign spreads went from approximately 200 basis points in the summer of 2007 to almost 900 basis points in October 2008. When during the first half of 2009 the "flight to quality" faded spreads decreased again, but they remain significantly higher than before the financial crisis. The evolution of sovereign spreads shows that developing countries that borrow from the international capital market pay a price for external shocks that are unrelated to domestic policies.

In most cases, high borrowing costs are not justified by deteriorating fundamentals but are the result of the general "risk aversion" that was triggered by a shock originating elsewhere. The same markets that had shown their "confidence" in the policies of developing and transition economies by appreciating the currencies of these economies suddenly turn around and flee these markets as if economic policy would have changed dramatically.

As most developing countries borrow abroad in foreign currency, the behaviour of the exchange rate plays a key role in determining these countries' borrowing costs. Since mid-2008, the negative effect of higher spreads has been magnified by the fact that the currencies of several emerging markets and low-income countries have depreciated vis-à-vis the US dollar.

Lower economic growth and higher financing costs are likely to cause a deterioration of the external debt situation of developing and transition economies. Thanks to prudent policies implemented during the last 5 years, many middle income countries are endowed with large war chests of reserves. They are thus well equipped to face one or two years of tight capital markets. The situation is different for several low-income countries which are close to running out of reserves. Countries with liquidity problems have been able to access stepped-up IMF resources. However, if the current conditions persist beyond 2009, several countries are likely to start facing serious liquidity and solvency problems.

Until now, the East and Central Europe region has been most severely affected by the crisis. In 2009, it is estimated that the region will experience the deepest output contraction since 1994 and a worsening of debt to GNI ratios in most countries. There are, however, important differences among countries in the region. The most affected countries are those that ran large current account deficits in the period 2003-2007, often in excess of 10 per cent of GNI. These countries also experienced speculation in their currencies and credit booms driven by excessive lending to households with loans that were often denominated in foreign currency. The burst of the property bubble fuelled by the credit boom restricted the lending capacity of the banking sector. The ensuing credit crunch further exacerbated the drop in manufacturing output and exports. Because of the presence of large foreign currency liabilities, several countries refused to accommodate these pressures and devalue their currency. Since mid-2008, seven countries in the region accessed IMF facilities and more countries received support from the European Union. However, the measures taken so far by the international financial community might not be sufficient to restore market confidence, as demonstrated by Latvia's failure to issue around $100 million of treasury bills in June 2009.

2. Low-income countries

Many low-income countries are on the brink of a balance of payment crisis brought about by terms of trade shocks, decline in export demand, and reduction in tourism and remittance flows. According to the World Bank, 18 countries have international reserves which cover less than 4 months of imports and 16 countries have consumed 20 per cent or more of their reserves since September 2008.[3] Several HIPCs are affected by the global economic and financial crisis through a number of channels. Completion-point countries are facing an average current account deficit of 8 per cent of GNI and the average current account deficit of decision point and pre-decision point countries exceeds 10 per cent of GNI. This highlights the need for highly concessional or grant based external financing for all HIPCs, including post-completion point countries.

The traditional channel through which the global economic cycle affects growth in low-income countries is the collapse in demand for commodities, on which low-income countries depend highly. Another channel is through the lending activities of foreign owned banks which controlled nearly 40 per cent of developing countries' domestic banking assets at the end of 2007.[4]

An analysis of the impact of the global economic crisis on debt sustainability in a sample of 49 low-income countries found that the financial leverage of the banking system increased markedly since mid-2008. This increase in leverage makes these countries vulnerable to systemic banking crises which may have negative effects on economic activity and debt sustainability. There is evidence that foreign owned banks have contributed to this overall increase in leverage and thus to the propagation of the crisis.[5]

Given the devastating effects of the financial crisis and the urgent need to prevent the worsening of debt ratios, which may lead to lower social expenditures and increase poverty, the UNCTAD secretariat proposed a temporary debt moratorium or standstill on official debt for low-income countries (see paragraph 15 of A/CONF.214/3). In comparison to the size of the stimulus packages for developed countries, the total amount of such a temporary debt moratorium is miniscule, constituting about $26 billion for 49 low-income countries for 2009 and 2010 combined. However, such a policy could provide recipient countries with breathing space and offset some of the negative effects of contracting export revenue and financial inflows. The moratorium could function as a countercyclical measure and, by contributing to macroeconomic stability in recipient economies, play a role in sustaining global demand.

D. Private external debt and its vulnerabilities

The development and deepening of financial markets and financial reform policies have enhanced access to the international capital markets by private borrowers from developing countries. In the early 1990s, less than 10 per cent of total external long-term debt issued by developing countries was owed by private borrowers and most foreign borrowing was done by the public sector. Over the last 15 years, private firms and banks have been drawing finance from international markets in increasingly larger amounts. As a consequence, the share of total external long-term debt owed by private borrowers increased to 22 per cent in the second half of the

1990s, it surpassed 30 per cent in the first half of the current decade, and reached 50 per cent in 2008.

Data from the Bank for International Settlements on total bank cross border claims by reporting banks and total international securities are less comprehensive than those reported in the Annex, but allow for a finer breakdown of the borrower type for both short-term and long-term external debt. These data indicate that about 80 per cent of total external debt of developing countries was owed by private sector borrowers at the end of 2008.

According to the World Bank, more than 3,000 corporations based in emerging markets tapped the international capital markets during 2002-2007 either by issuing bonds or borrowing through syndicated bank loans. As a result, corporate debt is now responsible for the majority of short-term external debt of developing countries.[6]

There are, however, large regional differences. Debt owed by private borrowers is particularly important in market-access and upper middle-income countries. Thus, the share of this debt to total long-term external debt in 2008 is large, in Latin America and the Caribbean (42 per cent), in East Asia (45 per cent), and in East Europe and Central Asia (72 per cent), whereas it is much smaller in sub-Saharan Africa (12.7 per cent) and South Asia (26 per cent). Surprisingly, the share of debt owed by private borrowers is the lowest in the Middle East and North Africa region (7.5 per cent), which includes several middle- and high-income countries. This may be due to the fact that in some cases it is difficult to distinguish between public and private debt. This is especially the case in the smaller Gulf countries which have undertaken several public-private projects. While official statistics report no private external debt for the United Arab Emirates (UAE), the UAE issued $100 billion of publicly guaranteed corporate debt between 2006 and 2008, making it one of the largest issuers of external corporate debt in the emerging world.

The fact that private sector entities are now able to access the international capital market diminishes the traditional role of the state as an intermediary for such financing. It has been argued that since private agents (both lenders and borrowers) are better equipped at evaluating the risk of their actions, private external borrowing does not lead to vulnerabilities as long as the fiscal accounts are balanced. This view was discredited by several debt crises, which hit countries with high private investment rates and balanced fiscal accounts. Therefore, the fact that a country has large share of its external debt owed by private borrowers should not be interpreted as an indication of lower vulnerabilities. In fact, it is often impossible to separate public from private liabilities and this is especially the case for bank debt, which, due to implicit or explicit deposit insurance, is a contingent liability of the public sector.

There are conditions under which private external debt may lead to over borrowing and generate more vulnerabilities than public sector external debt. Large inflows of private capital can lead to overvaluation, with the concomitant loss of competitiveness and unsustainable current account deficit. Moreover, private external debt often leads to the accumulation of currency mismatches in the balance sheets of firms and households. Over-confidence in the private sector's ability to cope with a general loss of competitiveness has been at the root of many financial crises, including the one in East Asia in 1997/98 and the most recent one in Eastern Europe and Central Asia. At the end, the unavoidable depreciation hurts the banks if their clients have currency mismatches in their balance sheets. This occurs when firms that produce non-tradable goods borrow in a foreign currency or when households hold mortgages denominated in a foreign currency because the interest rate there is lower.

Prudential regulation aimed at avoiding such mismatches is hard to implement because the total external exposure of the private sector is more difficult to measure and quantify than the external exposure of the public sector. Such difficulties are amplified by the fact that private agents often assume currency risk by using sophisticated derivative instruments. Policies aimed at developing domestic bond markets may enable corporations to avoid excessive external exposure, but developing countries need to be careful to avoid policies that could increase the risk of financial instability by facilitating inflows and outflows of hot money.

Private external borrowing also plays a central role in the diverging trends of developing countries' net and gross external liabilities. In 1970, net international liabilities (both debt and equity) of developing countries as a group made up about 18 per cent of the group's total GNI. These net liabilities resulted from the difference between gross international liabilities amounting to 27 per cent of the group's GNI and gross international assets amounting to 9 per cent of the group's GNI. By 2004, net international liabilities had decreased to 2 per cent of GNI, but gross exposure had increased to 80 per cent of the group's GNI. Larger gross assets and liabilities may bring advantages in terms of international diversification and access to technology but they also increase vulnerabilities linked to valuation effects or sudden capital flow reversals.

E. Debt relief and official development assistance

1. Progress under the HIPC Initiative

As of June 2009, 35 of the 40 eligible countries qualified for debt relief under the enhanced HIPC Initiative. In January 2009, Burundi was the 24th country to reach completion point under the Initiative. Since the last report, Togo (November 2008) and Côte d'Ivoire (March 2009) reached decision point, increasing the number of decision point countries to 11. Countries that are making progress toward reaching completion point include Afghanistan, Central African Republic, Guinea, Guinea-Bissau, and Haiti, and Liberia. With the exception of the Kyrgyz Republic, which may decide to officially opt out from the Initiative, the remaining pre-decision point countries are conflict or post-conflict cases in which progress can be expected to be very limited.

Completion-point countries received an estimated debt relief of $38 billion in end-2008 NPV terms. World Bank estimates suggest that the debt stocks of the 35 post-decision point HIPCs have declined by approximately 80 per cent and debt ratios have substantially improved from 1999 to 2008 with respect to NPV of debt to exports (from 457 per cent to 133 per cent), NPV of debt to GNI (from 114 per cent to 38 per cent), debt service to exports (from 18 per cent to 6 per cent), NPV of debt to revenue (from 552 per cent to 153 per cent) and debt service to revenue (from 22 per cent to 6 per cent). These improvements do not automatically imply a more favourable medium-term debt situation for these countries. Out of the 24 HIPC completion point countries only eight are classified as being at low risk of debt distress, while four countries are classified as being at high risk or are already in debt distress.

All completion point HIPCs have benefited from additional debt relief under the Multilateral Debt Relief Initiative (MDRI), but not all HIPCs benefit equally from the MDRI as the Asian Development Bank does not participate in the Initiative.

2. Paris Club activities

Since the last report, six countries rescheduled their debt with Paris Club creditors.[7]

In October 2008, Djibouti concluded an agreement with Paris Club creditors to reschedule its debt under Houston Terms, including a full deferral of moratorium interest during the 36 month consolidation period. The agreement covers principal, interest and arrears at the end of August 2008, as well as a deferral on payments of post-cut-off debt and short term debt during the consolidation period. Creditors have expressed their willingness to consider a debt treatment under the Evian approach at some future date.

The Republic of Congo reached the decision point under the HIPC Initiative in March 2009, and a Paris Club meeting ensued in December 2009. Debt payments falling due over the three year consolidation period were treated under Cologne terms, leading to a cancellation of approximately $805 million and a rescheduling of $155 million.

Togo reached the decision point in November 2008 and had a Paris Club meeting in January 2009. It obtained a rescheduling under Cologne Terms of its debt obligations falling due during the consolidation period. This treatment led to an additional cancellation of $22 million of debt owed to Paris Club creditors. A number of creditors have expressed their willingness to grant additional debt relief beyond the agreed terms.

Burundi reached the completion point in January 2009 and had a Paris Club meeting in March 2009. The treated loans comprised the debt stock as of 1 January 2009 and arrears as of 31 December 2008. Burundi obtained a 100 per cent cancellation of ODA and non-ODA loans as well as a 95 per cent reduction of the previously rescheduled ODA credits, which represents an annulment of $129.5 million of external debt obligations. With further bilateral pledges, the country will no longer have Paris Club debts following this agreement.

The financial crisis contributed to a collapse in tourism revenues on which the country heavily depends. As a consequence, the Seychelles became unable to continue servicing its debts. A Paris Club meeting took place in April 2009. It led to a treatment under the Evian Terms and gave rise to a complex agreement. All arrears as of the end of October 2008 and maturities due between November 2008 and June 2009 were first rescheduled and deferred. Then a net present value reduction of 31.4 per cent was applied on all outstanding principal due as of July 2009 after the rescheduling and deferral have been applied. A further reduction was agreed on the remaining outstanding principal due on 1 July 2010 after the implementation of the first reduction, with the aim of achieving an overall 50 per cent net present value cancellation of the treated debt stock.

Côte d’Ivoire reached decision point under the HIPC Initiative in March 2009 and had a Paris Club creditors meeting in May 2009. Debt obligations falling due during the consolidation period were treated under the Cologne Terms, but as the country’s external viability required further assistance, creditors agreed to go beyond the usual terms and granted a capitalization of moratorium interest with a six year deferral, as well as a deferral of arrears over 7.5 years. Creditors also agreed to a deferral on repayments of arrears on post-cut-off date debts and to a deferral on obligations falling due during the consolidation period on post-cut-off date debts. This treatment is a sign that official bilateral creditors are willing to provide exceptional assistance to countries needing it to regain sustainability.

3. Trends in official development assistance

Official development assistance (ODA) by DAC donors rose to its highest level in 2008 to $119.8 billion, reaching 0.3 per cent DAC donors' total GNI. About 7 per cent of the total consisted of debt relief and ODA net of debt relief increased by 12 per cent with respect to 2007. It is possible that this increase in ODA still reflects decisions taken during the previous period of high and stable economic growth in donor countries and that the ODA may be negatively affected by the current crisis.

OECD estimates suggest that donors will need to increase current ODA expenditures by $10 to 15 billion to meet their aid commitments for 2010; but aid targets may fall short of the additional development resources needed to respond to the challenges posed by the global crisis. Aid will have an important role to play in providing much needed counter-cyclical resources and help governments to support social expenditure and expand infrastructure.

During past banking crises in donor countries, ODA has dropped anywhere from 20 to 40 per cent and then recovered very slowly. Besides budget cuts, economic crises in the donor countries may lead to an automatic reduction in ODA because some donors set their aid targets as a percentage of GNI, and so a drop in GNI may lead to a drop in aid. Moreover, aid budgets are usually fixed in domestic currency, should that currency depreciate against the recipient's currency, the value of the aid budget will decrease as well. There is thus a risk that aid will decrease at a time when it is needed the most. A collapse in aid could eliminate some of the progress towards meeting the Millennium Development Goals.

A positive sign is that several donor countries restated their commitment to foreign aid. By adopting the DAC High-Level Meeting Action Plan on 27-28 May 2009, donors acknowledged the need for meeting the current aid shortfall and signalled their willingness to deploy additional resources to multilateral institutions. However, aid could be made more stable and predictable by developing funding modalities in which the budgets of the various aid agencies no longer depend on the business cycle of donor countries.[8]

F. New trends and modalities in multilateral financing

The period 2003-2007 was characterized by strong global economic growth. A large number of developing countries also registered large current account surpluses and faced low external finance requirements. Moreover, abundant international liquidity and low risk aversion allowed several developing countries to borrow from the international capital market at spreads comparable to the interest rates charged by the international financial institutions, without any burden in terms of conditionality. As a consequence, lending by the largest IFIs decreased dramatically over this period. For instance, the International Bank for Reconstruction and Development (IBRD) – the non-concessional lending arm of the World Bank Group – had consecutive negative net flows throughout the period 2002-2007, meaning that debt repayments were greater than new issuances of loans. In the case of the IMF, outstanding credit went from $96 billion in 2002 to $15 billion in 2007.

Access to multilateral finance is now much more attractive and needed because several developing countries started having current account deficits exactly when international liquidity began drying up and sovereign spreads started soaring. Net lending by the World Bank went from negative $500 million in 2007 to positive $2.8 billion in 2008 and it is expected to increase at a very fast pace over the next three years. For instance, IBRD gross lending which stood at $13 billion in 2008, up from $10 billion in 2007, is expected to reach $35 billion in 2009, with total gross lending exceeding $100 billion over the period 2009-2011. Most of the new loans are expected to take the form of fast disbursing Development Policy Loans. The World Bank is also increasing lending by its concessional arm – the International Development Association

(IDA)– and is making $2 billion available for fast track financial assistance in the form of grants and interest free loans for social safety nets, infrastructure, education, and health. Finally, the private sector arm of the World Bank –the International Finance Corporation (IFC) – is also expected to increase its activities in support of public-private infrastructure projects, bank lending in emerging and low-income countries, microfinance institutions, and trade finance.

The regional development banks are also stepping up lending. In Latin America and the Caribbean, the Inter-American Development Bank aims at providing a credit line of $6 billion to member countries that face liquidity problems. Latin American countries with liquidity problems will also be able to access a $1.5 billion facility created by the Andean Development Corporation and the 7 members of the Latin American Reserve Fund (FLAR) will have access to a $1.8 billion balance of payment support credit line.

In Africa, the African Development Bank created a $1.5 billion facility for countries that have liquidity problems and need rapid access to credit. It also coordinated several agencies towards the creation of the African Financing Partnership with the objective of providing $15 billion worth of loans for infrastructure, agribusiness and SMEs, to promote trade, and to strengthen financial sectors.[9]

In Asia, the Board of the Asian Development Bank (ADB) announced a tripling of the Bank’s capital base from $55 billion to $165 billion. The ADB intends to increase lending by more than $10 billion to $32 billion for 2009-2010. It also created a $3 billion facility for countries that face liquidity problems and need balance of payment support. The ASEAN+3 group agreed on a program labelled Chiang Mai Initiative Multilateralization which establishes a $120 billion regional fund aimed at providing short-term liquidity support to countries that face foreign exchange risk. Japan also announced its intention to supply Asian nations with an additional $60 billion in emergency swap agreements and to provide guarantees on yen-denominated bonds issued in Japan by foreign countries or companies.

A strong indicator of the deepening of the global economic crisis is the sharp increase in the demand for IMF loans and assistance. Over the period from the first quarter of 2002 to the third quarter of 2008, the average number of countries seeking non-PGRF (Poverty Reduction and Growth Facility) loans amounted to 6 annually. Between November 2008 and May 2009, 23 countries began accessing non-PRGF IMF facilities. Out of these 23 facilities, 13 were traditional Stand-by Agreements (SBAs), seven of which have been approved under the IMF fast-track Emergency Financing Mechanism (EFM) procedure.[10] An additional seven loan agreements were extended under the Exogenous Shock Facility (ESF) and three agreements under the newly created Flexible Credit Line (FCL) facility.[11]

The FCL is a facility that aims to provide rapid access to credit to countries that pre-qualify under the terms of the facility. The stated aim of the FCL is to eliminate uncertainties about a country's ability to access IMF resources. Only countries that are deemed to have strong economic fundamentals and policies and are committed to continue such policies in the future are eligible to access the FCL.[12]

Besides introducing ex-ante qualification criteria as in the case of the FCL, the IMF also announced the 'modernization' of conditionality attached to loans, effective 1 May 2009. The intention is to move to a review-based approach to monitoring the implementation of IMF programs instead of using performance criteria. The intention of the new approach is to adapt conditions attached to loans to country specific circumstances and eliminate the need for formal waivers for countries that do not meet targets by a specific date.

While the introduction of some flexibility may be a step in the right direction, there is the risk that these reforms and new facilities will not substantially alter traditional IMF conditionality which has been the subject of many criticisms in the past. A 2007 IMF Independent Evaluation Office report on "Structural Conditionality in IMF Supported Programs" found a number of the IMF conditionalities to reach outside the Fund's core areas of responsibility. It remains to be seen whether the reform will indeed limit IMF conditionality to the

Fund's mandated areas of work or if it will only lead to operational rather than substantive changes to conditionality.

The G20 and International Monetary and Financial Committee (IMFC) communiqués of April 2009 requested a revision of the IMF/World Bank Debt Sustainability Framework (DSF) for low-income countries with the objective of enhancing the flexibility of the Framework. The current version of the DSF uses explicit limits on the net present value of external debt, above which external debt is considered unsustainable. There are serious issues on how these thresholds are calculated and how they relate to the World Bank's Country Policies and Institutional Assessment (CPIA) index (A/63/181).[13] The World Bank and IMF are elaborating a proposal aimed at addressing some of the issue raised by critics of the DSF, but it appears that the CPIA will remain central to calculating debt thresholds.

The DSF does not make any distinction between debt used to finance investment projects and debt used to finance current expenditure (A/63/181). This is problematic because investment projects can increase GNI growth and thus improve a country's ability to service its debt. A more flexible DSF which allows for higher debt thresholds when external borrowing is used to finance high-return investment projects would be desirable as it would recognize that not every increase in debt leads to a reduction in government wealth.[14] Moreover, as current expenditure tends to be the most rigid component of the government budget and investment is the typical adjustment variable when the debt exceeds the threshold fixed by the DSF, adding flexibility to the DSF may contribute to reducing the volatility of public investment in developing countries.

In increasing the flexibility of the DSF, it is necessary to recognize that financing investment projects that generate returns which are higher than the interest rate charged on the loan is a necessary but not sufficient condition for external sustainability. Only projects that have a high return and can, either directly or indirectly, generate the foreign currency necessary to service the debt will not harm external sustainability.[15]

An additional issue relates to debt composition that recent research has shown to be as important as debt levels in determining debt sustainability.[16] The DSF should be revised and expanded to include both domestic and foreign debt and control for debt structure by giving different weights to different types of debt. For instance, all other things being equal, long-term debt denominated in domestic currency generates less vulnerabilities than short-term debt denominated in foreign currency. The recent discussion in the IMF Executive Board on building debt thresholds that consider the currency-denomination of domestic debt is a welcome step in the right direction.[17]

A related issue has to do with the fact that several low-income countries that are eligible to borrow under the IMF Poverty Reduction and Growth Facility (PRGF) or have access to IDA loans face minimum concessionality requirements that prevent them to engage in external borrowing that does not have a concessional component of at least 35 per cent. Current proposals aimed at granting more flexibility to these countries focus on “average” concessionality requirements, under which new external borrowing by these countries need to have an average rate of concessionality of at least 35 per cent but individual loans may have lower levels of concessionality. More should be done in reducing total concessionality requirements, especially because there is some discussion of making concessionality requirements even tighter for countries which, according to the DSF, are deemed to face a high risk of debt distress.

G. Policy conclusions

Developing countries are paying a steep price for an economic crisis caused by policy and regulatory mistakes of some developed countries. Prevention of future crises will require more even handed surveillance of all major financial centers (A/CONF.214/3). Decisive and bold policy action is required to limit the setbacks in terms of increased poverty and progress towards the MDGs resulting from the crisis. It is reassuring that the G20 communiqué of April 2009 acknowledged that the global financial system is ill equipped for responding to the current crisis and agreed to deliver a large policy package. Another positive step is the recognition that developing countries that are hit by external shocks need to be provided with ample liquidity with no strings attached. This is a positive deviation from the old attitude that "if a country is in crisis, it must be its fault."

There are, however, also sources of concern. First and foremost, the G20 communiqué did not recognize that the current crisis stems from excessive speculation made possible by the absence of a coherent global monetary and regulatory system and it did not agree on a coordinated global stimulus package.[18] Second, some of the resources necessary to fund the proposed $1.1 trillion package agreed upon in the G20 communiqué have yet to be identified. Moreover, it is not yet clear what terms and conditions will be attached to the new resources and whether the IMF which will receive more than 70 per cent of the new resources, will truly reform its conditionality policies. Third, the G20 did not allocate enough resources to low-income countries and small and vulnerable states.[19]

Low-income countries have limited ability to respond to external shocks and many of them are facing difficulties in servicing their external debt. It is the duty and obligation of the international community to provide assistance and resources to help mitigate the adverse consequences of the crisis without requiring the accumulation of unsustainable levels of debt.[20]

Low-income countries with high debt levels need to be given alternative financing opportunities for MDG achievement. A debt moratorium or standstill would immediately and unconditionally liberate resources and give countries the fiscal space to respond to the specific circumstances they are facing. Such a moratorium can be viewed as a part of a multifaceted approach to mitigating the impact of the crisis and reduce the build-up of unsustainable debt in vulnerable economies.

Past experience shows that financial crises in donor countries are followed by a collapse in foreign aid. While several donors have committed to increase aid, it is worrisome that the G20 communiqué did not include any clear commitment to increasing aid to low-income countries. Switching to a system in which aid agencies are funded with an endowment would be useful in delinking aid delivery from the business cycle of donor countries and thus reduce aid procyclicality. In fact, it would also be advisable to develop aid delivery mechanisms with a built in insurance component which leads to an automatic increase in aid when recipient countries are hit by a negative external shock. Along similar lines, the international community should help countries with market access to develop new debt instruments and institutions which automatically reduce (or at least avoid amplifying) debt service in the presence of negative external shocks (paragraph 31 of A/CONF.214/3 highlights the need to devise mechanisms aimed at providing more stable sources of development finance).

A continued deterioration of economic conditions may push some market access countries towards sovereign default. It is thus lamentable that the design of a mechanism aimed at facilitating the resolution of sovereign insolvency has been marginalized in the international discussion. The outcome document of the UN conference on the world financial and economic crisis underlines the need of a more structured framework for international cooperation in this area (paragraph 34 of A/CONF.214/3). In this context, it would also be desirable for the international community to discuss and promote responsible lending and borrowing.

External debt of developing countries[a]

(Billions of United States dollars)

	All developing countries and economies in transition						Sub-Saharan Africa					
	1990-94	**1995-99**	**2000-05**	**2006**	**2007**	**2008[e]**	**1990-94**	**1995-99**	**2000-05**	**2006**	**2007**	**2008[e]**
Total debt stocks	1 468.8	2 061.5	2 397.6	2 858.4	3 466.0	3 642.0	191.4	226.2	217.9	172.5	195.1	199.7
Long-term debt	1 192.3	1 660.0	1 931.8	2 195.5	2 602.3	2 785.7	158.2	177.1	180.6	127.1	143.9	146.2
Private (share)	47.6	54.3	60.5	70.8	74.3	75.4	25.2	24.0	21.5	30.0	33.0	33.3
Private PNG (share)	8.4	21.8	29.6	43.8	49.6	49.5	4.1	5.6	5.3	6.8	10.9	12.7
Short-term debt	240.0	336.2	385.6	643.1	848.2	830.5	26.3	41.3	30.5	42.3	47.9	49.5
Arrears	119.8	117.4	94.8	90.9	95.7	97.8	40.1	59.7	39.5	39.6	39.9	39.5
Debt Service	130.5	240.6	347.4	481.3	501.3	512.9	8.6	12.4	12.6	20.6	15.6	15.4
International Reserves	268.7	564.2	1 198.3	2 653.0	3 751.5	4 219.8	16.0	26.7	49.4	114.9	140.4	155.4
Debt Indicators (percentage)												
Debt Service/Exports	18.5	19.3	17.2	12.3	10.2	8.0	12.7	14.7	9.4	7.6	5.0	3.7
Total Debt/Exports	180.8	149.2	107.1	65.6	65.8	57.0	243.2	227.0	150.6	60.3	56.8	48.0
Debt Service/GNP	3.3	4.5	5.0	4.2	3.6	3.1	3.0	3.9	3.1	3.0	2.0	1.7
Total debt / GNP	37.3	38.2	34.8	25.1	25.1	21.8	67.6	70.8	54.9	24.7	24.9	22.2
Reserves/Short-term debt	112.0	167.8	310.7	412.5	442.3	508.1	60.7	64.5	161.9	271.7	293.3	313.9
Reserves/M2	14.3	19.5	23.1	30.1	33.8	31.1	14.9	21.8	27.7	34.0	27.9	32.7

External debt of developing countries[a]

(Billions of United States dollars)

	Middle East and North Africa						Latin America and Caribbean					
	1990-94	**1995-99**	**2000-05**	**2006**	**2007**	**2008e**	**1990-94**	**1995-99**	**2000-05**	**2006**	**2007**	**2008 e**
Total debt stocks	124.7	131.6	129.4	129.3	136.4	133.5	483.9	684.2	772.3	729.0	825.7	865.0
Long-term debt	103.7	114.9	111.3	107.3	113.4	112.7	375.4	541.4	645.6	622.9	684.8	723.9
Private (share)	37.3	26.5	34.1	42.8	41.5	42.0	64.5	74.1	78.2	80.3	82.4	82.3
Private PNG (share)	0.9	2.1	4.1	6.0	5.7	7.5	11.7	30.7	34.8	36.9	41.1	42.4
Short-term debt	19.2	13.9	16.3	21.5	22.7	20.5	93.0	120.5	97.4	105.4	140.1	140.3
Arrears	4.9	2.3	0.8	0.3	0.3	0.3	43.5	12.1	20.1	21.5	25.2	27.5
Debt Service	15.9	17.1	16.6	28.5	18.2	20.3	43.4	107.9	137.4	176.9	147.5	137.7
International Reserves	25.4	43.8	85.3	169.1	216.3	261.8	92.0	160.0	192.9	312.8	450.6	500.5
Debt Indicators (percentage)												
Debt Service/Exports	21.0	18.5	11.5	11.0	5.8	5.1	25.0	33.6	30.6	22.9	16.0	12.3
Total Debt/Exports	147.5	132.9	85.3	48.1	41.3	33.2	235.1	194.4	152.2	85.6	85.4	77.2
Debt Service/GNP	7.7	5.6	4.1	4.8	2.5	2.3	3.4	5.8	7.0	6.0	4.2	3.4
Total debt / GNP	60.5	43.4	32.5	22.0	19.0	15.3	38.8	36.9	39.6	24.5	23.7	21.5
Reserves/Short-term debt	132.6	315.5	524.0	786.0	953.1	1278.1	98.9	132.8	198.0	296.8	321.7	356.8
Reserves/M2	14.1	20.7	25.8	32.4	34.0	35.1	15.4	23.3	21.3	20.7	24.4	23.5

External debt of developing countries[a]

(Billions of United States dollars)

	East Asia and Pacific						South Asia					
	1990-94	**1995-99**	**2000-05**	**2006**	**2007**	**2008 e**	**1990-**	**1995-99**	**2000-05**	**2006**	**2007**	**2008 [e]**
Total debt stocks	300.5	509.7	546.4	666.5	741.5	765.5	138.1	154.2	176.1	249.8	304.7	311.3
Long-term debt	239.7	396.3	398.1	418.5	450.7	475.9	122.0	142.5	165.8	217.7	253.3	264.0
Private (share)	47.5	59.3	56.3	58.6	60.7	62.5	24.7	27.9	35.7	45.5	48.6	48.3
Private PNG (share)	15.6	32.3	33.2	38.4	43.0	44.7	2.7	7.2	15.0	39.7	41.2	26.1
Short-term debt	59.2	105.4	136.1	247.7	290.5	289.4	9.7	8.3	8.0	29.8	49.1	41.9
Arrears	8.4	15.4	19.0	24.7	25.3	25.1	0.1	0.5	0.3	0.2	0.4	0.4
Debt Service	33.9	57.0	75.1	70.9	75.6	69.0	10.2	14.7	20.9	20.5	42.5	45.3
International Reserves	96.9	225.5	571.7	1 315.7	1 856.7	2 292.4	18.2	35.3	103.2	198.5	302.3	274.8
Debt Indicators												
(percentage)												
Debt Service/Exports	15.5	12.9	9.9	5.1	4.0	2.7	25.1	20.6	14.6	7.5	12.9	11.4
Total Debt/Exports	123.9	105.3	64.8	38.5	34.7	29.7	288.3	190.1	122.7	85.3	87.0	78.2
Debt Service/GNP	4.2	3.9	3.5	2.0	1.7	1.2	2.7	2.8	2.7	1.8	2.9	2.8
Total debt / GNP	36.9	35.4	25.2	18.4	17.0	13.8	36.5	29.2	23.7	21.7	21.1	19.4
Reserves/Short-term debt	163.6	213.9	419.9	531.1	639.1	792.1	188.1	423.3	1 293.7	665.1	615.3	656.0
Reserves/M2	14.9	16.2	19.8	28.0	32.4	31.0	10.7	14.1	22.2	24.7	28.8	22.9

External debt of developing countries[a]

(Billions of United States dollars)

	Europe and Central Asia					
	1990-94	1995-99	2000-05	2006	2007	2008[e]
Total debt stocks	230.3	355.6	555.5	911.4	1 262.6	1 367.0
Long-term debt	193.3	287.7	430.4	702.0	956.2	1 062.8
Private (share)	53.1	53.0	70.9	89.1	91.7	92.7
Private PNG (share)	4.3	15.8	41.0	66.8	72.0	71.8
Short-term debt	32.6	46.7	97.3	196.4	297.9	289.0
Arrears	22.8	27.4	15.1	4.5	4.7	5.0
Debt Service	18.4	31.5	84.9	163.9	202.0	225.2
International Reserves	23.1	72.9	195.8	542.1	785.1	728.5
Debt Indicators (percentage)						
Debt Service/Exports		13.4	20.1	19.1	18.7	14.9
Total Debt/Exports		130.1	121.4	96.8	107.9	90.7
Debt Service/GNP		3.4	6.7	6.9	6.6	6.0
Total debt / GNP		38.5	45.7	38.4	41.5	36.3
Reserves/Short-term debt	70.8	155.9	201.3	276.0	263.6	252.1
Reserves/M2	13.6	31.6	46.4	57.3	58.9	44.5

Source: World Bank, Global Development Finance 2009 (online database).

[a] Developing Countries as defined in the Global Development Finance publication.

[e] Estimate.

Chapter II

The impact of the financial and economic crisis on debt sustainability in developing countries[21]

A. Introduction

This paper is prepared in response to a request by the former President of the General Assembly H.E. Miguel d'Escoto dated 6 July 2009 for UNCTAD to prepare a paper on the impact of the crisis on debt sustainability. Furthermore, this paper is a contribution to the follow up of the United Nations Conference on the World Financial and Economic Crisis and its Impact on Development held in June 2009.

The paper is divided into three parts. The first part (Section B) describes the impact of the crisis on developing countries. It shows that this crisis has demonstrated, once again, the vulnerability of developing countries to exogenous shocks and that the global downturn raises concerns with regard to the capacity of developing countries to weather the storm without laying the foundations for a debt crisis in the years to come. In this context, it is essential for policy makers to be aware of key determinants of debt sustainability and how they have evolved over the last two years. However, debt sustainability should not be viewed as simply the capacity to continue servicing debt obligations without taking into account the fact that higher debt serving costs necessarily mean fewer funds available for fighting poverty and meeting MDGs.

The second part of the paper (Sections C) shows that developing countries suffer debt crises with debt levels which, for the standard of the advanced economies, are relatively low (a phenomenon often referred to as debt-intolerance). The paper rejects the conventional wisdom that this phenomenon is due to poor policies or institutions and argues that the key determinants of debt intolerance are the economic and debt structure of developing countries.

The third part of the paper (Section D) discusses international and domestic long-term policies aimed at reducing the probability of debt crises. This section also points out that, even with better policies, debt crises and sovereign defaults are bound to happen and that the cost of such crises could be attenuated by putting in place an international debt resolution mechanism which would allow a speedy, equitable and transparent debt restructuring process.

B. Recent trends

The financial crisis ignited by increased defaults on subprime mortgages in the United States in 2007 has turned into the most severe global economic downturn in the last seventy years. The crisis has spread from the financial sector to the real economy during the course of 2008, and deepened substantially after the bankruptcy of Lehman Brothers in autumn of 2008. During 2008 the debate on the decoupling of developing countries from the evolving economic slump in the developed economies was still inconclusive, but by the end of 2008 the data was clearly signalling that developing countries will face a substantial deterioration in their growth prospects accompanied by the worsening of a number of key economic and social indicators.

Growth in HIPC countries is expected to average 2.7 per cent in 2009 compared to 5.8 and 5.6 per cent in 2007 and 2008 respectively. For non-HIPC developing countries, GDP growth is expected to slow to 0.7 per cent in 2009 compared to 8.1 per cent in 2007 and 5.7 per cent in 2008. These numbers hide large cross-country differences in performance, as the non-HIPC developing countries excluding China are expected to record a decrease of 1.8 per cent of their GDP in 2009 compared to 2008, and about 62 (out of a total of 166 countries for which data are available) developing countries are expected to record negative output growth in 2009, while an even larger number of countries are expected to record negative growth in per capita terms.

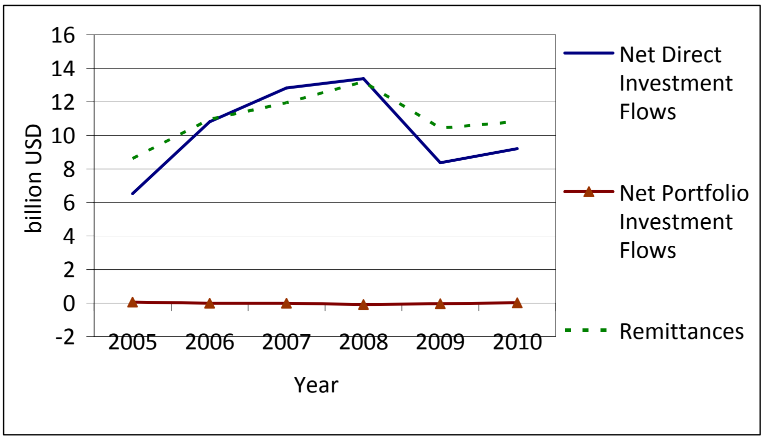
Developing countries as a group registered a current account surplus of 3.5 per cent of their GNI in 2007, but by 2008 the surplus dropped to 2.5 per cent of GNI and it is expected to shrink to 1.6 per cent in 2009. Few countries with large surpluses heavily influence the group average, and excluding China, the figures look even more worrying. Non-HIPC developing countries registered a current account surplus of only 0.8 per cent of GNI in 2007, and already in 2008 moved to a deficit of 0.3 per cent of GNI. Moreover, over half of the developing countries had current account deficits exceeding 6 per cent of GNI in 2008, and HIPCs as a group recorded a current account deficit of 6.8 per cent of their GNI in 2008.

The deterioration in developing country current accounts was largely driven by the collapse in exports and to a lesser degree by a decrease in remittances. The drop in exports due to decreased global demand led to a decline of 30 per cent between September 2008 and March 2009 in the value of globally traded goods. This decrease is explained by a simultaneous slump in export volumes and in export prices, especially in the commodity sector. Although low-income countries dependent on single-commodity exports are likely to suffer most in the course of the crisis due to a sharp contraction in developed countries' industrial activity during late 2008 to mid 2009, middle-income developing countries have also recorded large decreases in exports, reflecting a sharp deterioration of trade in manufactured goods, resulting from a reduction in spending by consumers in the developed and developing countries.

As remittances account for a relatively small fraction of migrants' income, these flows tend to be fairly stable even during economic downturns. This explains why remittances have proven to be more resilient than other financial flows in the recent crisis, though some countries suffered sharp declines. After peaking at record $328 billion in 2008, remittances to developing countries are expected to decrease by 7.3 per cent in 2009, compared to a drop of over 50 per cent in net private financial flows in the same period. The drop in remittances is directly linked to the recession in advanced market economies and the decrease in migrant workers' aggregate earnings who are often employed in the hardest hit sectors, such as construction and auto production. The most affected region by the decline in remittances will be sub-Saharan Africa, registering an 8.3 per cent decrease followed by Latin America with a decline of 6.9 per cent. Workers' remittances are regarded as both an important stabilizing factor in current account dynamics for many developing countries and as a cushion against poverty for receiving households. It is this latter effect that has caused concerns for many developing countries as the weakness of the economy and decreasing government revenues are already jeopardizing a number of social programs.

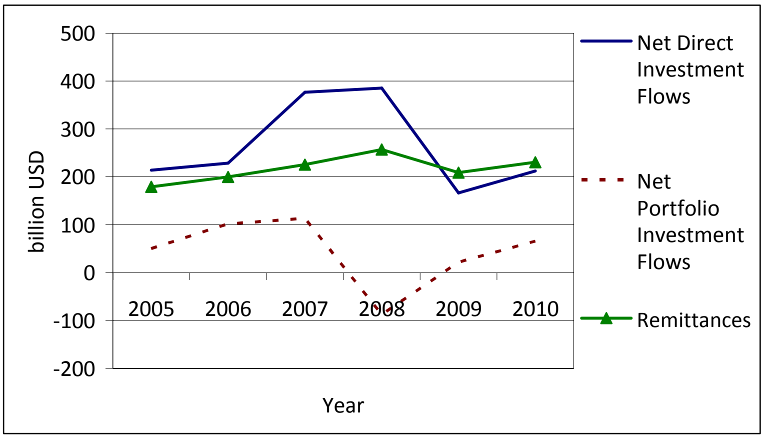
Due to a general decrease in other financial flows, the relative importance of remittances has grown notably for smaller developing countries. In HIPCs, remittances will overtake net direct investment flows in 2009, the latter decreasing as a consequence of the financial crisis by more than 30 per cent in 2008/9 (see figures 1 and 2). It is expected that the most affected countries by the drop in remittances in 2008 and 2009 will be Guyana, Honduras, Haiti, Lesotho, the Republic of Moldova, and Tajikistan.

Figure 1. Financial flows to HIPCs



Source: EIU data and UNCTAD calculations.

Figure 2. Financial flows to non-HIPCs

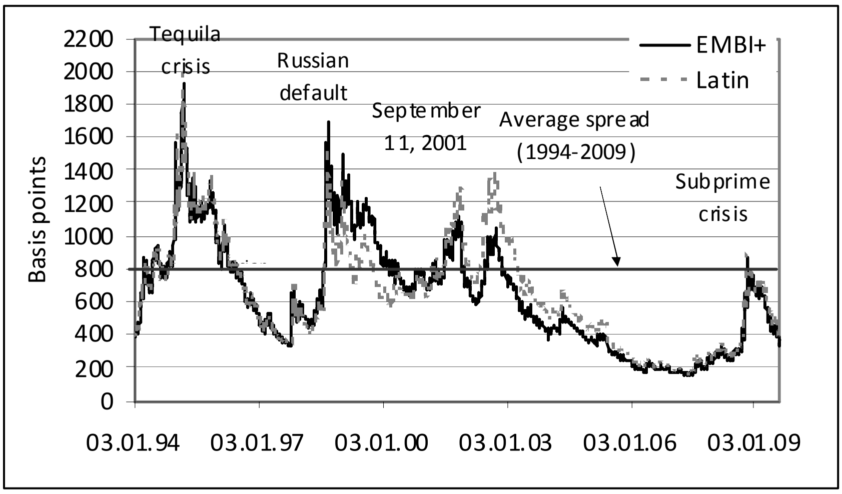


Source: EIU data and UNCTAD calculations.

While it is true that some developing countries may benefit from moving from a current account deficit to a current account surplus position and that developing countries with a current account surplus may receive limited or no benefits from financial globalization and the associated private capital inflows (TDR, 2008), it is also true that adjustments should be gradual. Therefore, a sudden stop of private capital flows may be a source of considerable pain, at least in the short run. Coping with such a reversal of private inflows is one of the main policy challenges for a number of developing countries in 2009. This is especially, but not uniquely, true for those countries that are running a current account deficit. Net private capital flows, which surpassed $900 billion at the peak of the previous cycle in 2007, dropped to $465 billion in 2008, and are expected to be below $200 billion in 2009.

Not only has the availability of external private finance decreased over the last two years, but the cost of accessing international capital has become higher to developing countries as the financial turmoil deepened. The global financial crisis and the accompanying rise in risk aversion, in particular after the collapse of Lehman Brothers in September 2008, led to a drastic increase in sovereign borrowing spreads for emerging markets as a group. The spread over comparable treasuries increased from around 200 basis points in mid 2007 to over 850 basis points at the height of the crisis in late 2008 and early 2009 (see figure 3). Following a series of interventions by monetary and fiscal authorities around the world, and the propagation of the view that the global financial system will not collapse, spreads started decreasing from late February 2009, and have now dropped to levels that prevailed prior to Lehman's bankruptcy. However, current spreads of 350 basis points still imply higher borrowing costs for emerging markets as a group compared to pre-crisis levels, and for countries that rolled over their debt during 2009 a heavier debt service burden on their economies in coming years.

Figure 3. EMBI composite and Latin spreads

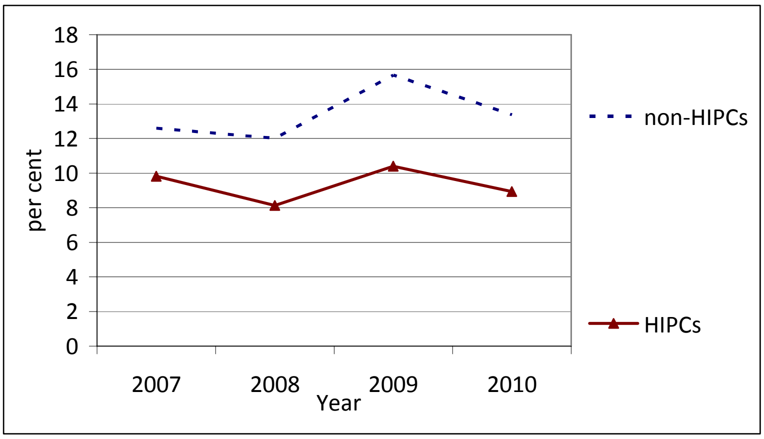


Source: Bloomberg.

With a synchronized global financial crisis and the resultant sudden stop of credit provision, IMF has been functioning as the lender of last resort. Therefore, the severity of balance of payments difficulties encountered by developing countries is exemplified by the fact that the average number of countries seeking non-PRGF[22] IMF loans amounted to 6 per year prior to the crisis, whereas from October 2008 to August 2009 alone the number of countries accessing such facilities increased to 24. Furthermore, whereas the average amount of disbursed IMF funds for all non-PRGF programs averaged SDR 2 billion a year between 2003 and 2007, the support for the 24 countries from the end of last year amounted to over SDR 100 billion.

Debt stock reductions associated with the HIPC and MDRI initiatives coupled with robust international growth of the previous years led to an impressive improvement in debt indicators between 2003 and 2007. While total public debt held by developing countries increased by $176 billion during 2008, basic debt ratios still showed a moderate decline as the full impact of lower export and slower GNI growth did not yet filter through to developing countries. However, the decline in global demand and the resulting drop in developing countries growth and export performance will partially reverse the big gains made on the external debt front up until the end of 2008. For example, the debt service to exports ratios is expected to worsen for both HIPC and non-HIPCs during 2009 (see figure 4).

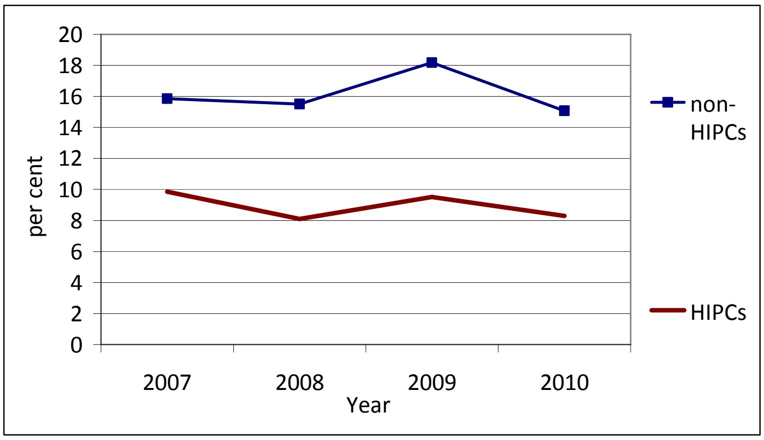
Figure 4. Debt Service to Exports Ratio



Source: EIU data and UNCTAD calculations.

It is likely that debt service burdens, both as a share of exports and as a percentage of government revenues will remain more elevated both during 2009 and well into 2010 than in the pre-crisis years. In 2009, debt service in relation to government revenue will increase by more than 17 per cent for both HIPCs and non-HIPCs (see figure 5). For HIPCs, this increase is due to both an increase in absolute debt service payments as well as a substantive decrease in government revenues. Even prior to the crisis, the capacity of many developing countries to meet MDGs was constrained by a lack of domestic resources, and the increased share of government revenues devoted to debt servicing is worrisome, as more countries are likely to fall behind on planned poverty reducing programs. The Millennium Development Goals Report expects that the number of people living in extreme poverty will be an estimated 55 to 90 million higher compared to the pre-crisis level.[23] In this context, the UNCTAD Secretariat has proposed a temporary debt moratorium on official debt for low-income countries which would amount to approximately $26 billion for 49 low-income countries for 2009 and 2010.

Figure 5. Debt service to revenues ratio



Source: EIU data and UNCTAD calculations.

A recent study commissioned by UNCTAD has found that the global financial crisis has substantially weakened the banking sector in a number of low-income developing countries.[24] Looking at financial leverage, measured as total liabilities divided by total equity from the bank balance sheet information, the study finds an increase in this indicator during the post crisis period. Furthermore, the total bank capital ratios of most countries have shown a decrease in the post-crisis period as compared to the pre-crisis period. Interestingly, the ratios tend to be worse for domestic banks owned by foreign banks, reinforcing the increasingly held view that developing counties have suffered disproportionately for the excesses generated by international centres of private finance. If the global crisis extended beyond 2010, the risk of bank failures would increase in some developing countries adding further pressure on their already strained budgetary positions, as governments would be obliged to rescue some of the big banks whose failure would pose a systemic risk to the economy. Even in the more optimistic scenario under which global growth resumes in early 2010, a weakened domestic banking sector could hamper a rapid resumption of economic activity in developing countries and thus further delay the achievement of MDGs. The weakening of the banking sector in developing countries caused by the financial crisis shows once again how developing countries as innocent bystanders of the crisis, nevertheless, have to cope with the repercussions of crisis which has derailed or slowed down their economic growth. It also demonstrates the different trajectories of the financial crisis across countries. In the developed world, the economic crisis was triggered by the financial sector. While in many developing countries, it was the global economic crisis which brought problems to their financial sector. Though there was a time lag, the negative impact on growth, poverty reduction and debt servicing capacities could nevertheless be significant.

C. Debt sustainability in developing and advanced economies

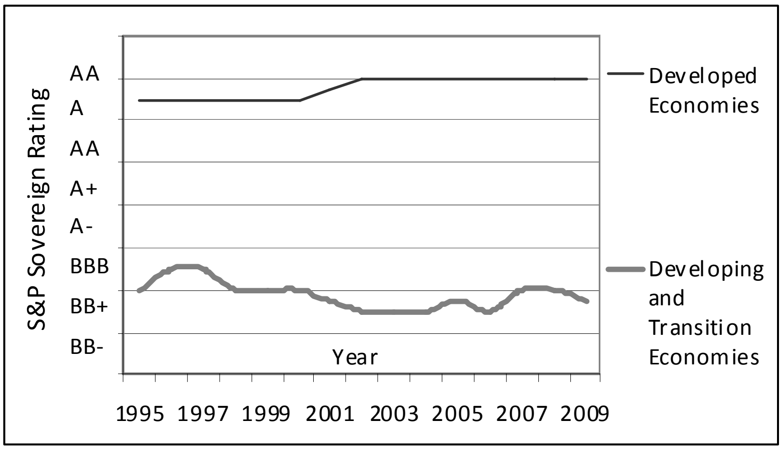
Developing countries and transition economies are subject to frequent debt crises which are characterized by low credit ratings and high sovereign spreads.

Of course different developing countries face different types of problems. Low-income countries are indeed unable to sustain high levels of debt. This is unlikely to be due to poor institutions and policies, as it is often claimed. Low tolerance to debt is driven by the fact these countries have poorly diversified economies and are excessively reliant on the exports of few commodities. This leads to a vicious circle. Low-income countries need credit to develop their productive sector and diversify their economies, but if they borrow they end up suffering the devastating and destabilizing consequences of debt crises. The answer to this dilemma is more concessional finance.

Middle-income countries that can access the international capital market face different types of problems. On average, it is not true that these countries go into crisis because they borrow “too much” (even though this is the case for some of them). Frequent crises are instead driven by a suboptimal debt structure which is partly the consequence of a poorly designed international financial architecture.

This latter point can be illustrated by looking at credit rating, sovereign spreads, and debt levels.[25] Over the period 1995-2009, the median sovereign credit rating of a large sample of developing countries oscillated between BB- and BBB while the median credit rating of the advanced economies remained above AA+ (see figure 6). Low credit ratings lead to high and volatile borrowing costs. During 1994-2009, spreads on dollar denominated sovereign debt averaged 640 basis points and went as high as 1920 basis points (see figure 3). This begs the question: what are the roots of this situation? Why do developing countries have low ratings and high and volatile spreads?

Figure 6. Median S&P credit rating in developed and developing economies

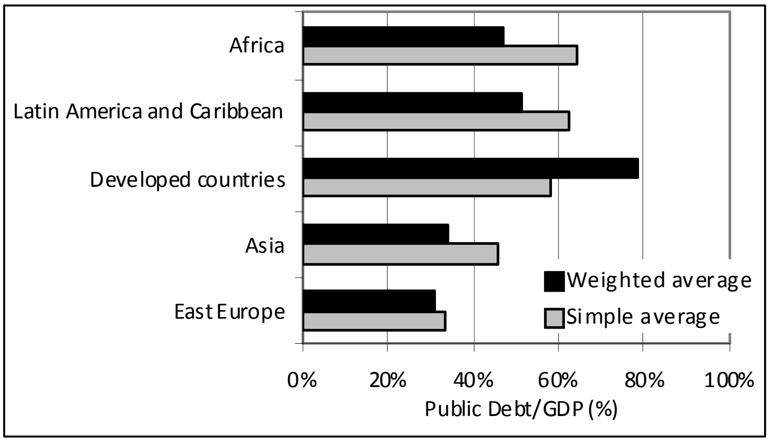


Source: UNCTAD calculations based on Bloomberg data.

An economist's natural answer to the above question is: "bad fundamentals". However, the excessive volatility of emerging market spreads casts doubt on any explanation that is purely based on "fundamentals". Volatility would be justified if it were caused by the choice of domestic policies, with low spreads rewarding good policies and high spreads punishing bad policies. However, there is overwhelming evidence that volatility is often driven by external factors.[26] It is hard to identify changes in fundamentals that would justify the abrupt swings in spreads documented in Figure 3.

The same argument can be made by looking at the level of public debt over GNI, which is one of the most commonly used indicators of a country's ability to face its obligations. Figure 7 shows that, on average, developing countries do not have levels of public debt that are substantially higher than those of the advanced economies. When examining simple averages, only Africa and Latin America have debt levels which are higher than the developed counties, but the difference is fairly small (6 percentage points in the case of Africa and 4 percentage points in the case of Latin America). In contrast, Asia and East Europe have average debt levels which are substantially lower than the average of the developed economies.[27]

Figure 7. Public debt as a percentage of GDP (2004-2008)



Source: "Public Debt around the World: A New Dataset of Central Government Debt," Ugo Panizza and D. Jaimovich, Applied Economics Letters (March 2008).

These relatively low levels of debt do not mean that debt is not a problem for developing countries. On the contrary, they mean that debt is a much bigger problem for developing countries than for the developed countries. Japan has a public debt ratio to GDP that is well above 150 per cent and yet there is little concern about the solvency of Japan. At the same time, developing countries often face debt crises with debt levels which are as low as 30 per cent of GDP. There is something that makes debt riskier in developing countries. What is it? Why is debt a big problem for developing countries and a much smaller problem for the developed countries?

The standard explanation

According to the conventional wisdom this situation is due to the presence of poor polices and institutions. With respect to policy prescriptions, this view maintains that the only way in which developing countries will be able to sustain higher levels of debt is by improving their institutional set up. However, the argument goes, improving institutions will require time and effort, in the meantime developing countries should maintain low levels of debt. This is the approach at the basis of the IMF/World Bank Debt Sustainability Framework (DSF) for low-income countries which relates the level of sustainable debt to the score of the World Bank's Country Policies Institutional Assessment (CPIA) index.

This view, which may be labelled as "institutional fundamentalism", appears to be too strong in its conclusions and is not consistent with the high levels of volatility documented above. Such volatility in borrowing costs is often driven by the fact that foreign investors can change their mind very rapidly. The same policies and institutions that in one moment are deemed to be prudent and are "rewarded" with massive capital inflows and low spreads can suddenly become, in the view of investors, irresponsible and are "punished" with large capital outflows and high spreads (TDR, 2009).

The role of debt structure

An alternative and more promising class of explanations focuses on debt structure. It argues that what matters are the characteristics of the debt contract. For instance, the literature on "original sin" (Eichengreen and Hausmann, 1999; Eichengreen, Hausmann, and Panizza, 2005)[28] has focused on the currency composition of external debt and argued that the presence of foreign currency debt plays a key role in reducing debt sustainability.[29] Debt maturity is also important because short term-debt leads to rollover risk and thus increases vulnerability vis-à-vis long-term debt. The Mexican crisis of 1994/95 and the Russian crisis of 1998 are a clear demonstration of vulnerabilities linked to maturity mismatches (see Appendix).

Focusing on currency composition helps to explain why developing countries face frequent debt crises and a country like the United States faces no problems sustaining its debt. The difference is not due to where they borrow as they both borrow abroad and, on average, developing countries borrow abroad less than the United States. They even borrow abroad in the same currency as the United States (mostly US dollar); the difference being that the United States can print the dollar, whereas developing countries cannot.

D. How to make debt safer

There is a heated debate on why countries have different debt structures and whether it is possible to introduce new instruments that can improve debt sustainability.

In one camp there are those who, while not denying the role of good institutions and policies, argue that the set of debt instruments currently available to developing countries is mainly due to a combination of historical accidents and inertia. As a consequence, it is possible, although not easy, to introduce new and better debt instruments that can improve debt sustainability. In the opposite camp, there are those who argue that the available set of instruments is just a reflection of institutional failures which lead to poor contract enforcement and lack of policy credibility. According to this view, there is no shortcut and nothing can be done without addressing institutional failures.

The latter view appears to be too extreme. While it is unlikely that new financial instruments will, by themselves, allow developing countries to sustain the same debt levels that can be sustained by many developed countries, marginal improvement in debt structure is likely to reduce the probability of a debt crisis, at any given level of debt.[30] Moreover, most developing countries have investment opportunities with a potential return that is higher than the cost of funds. Hence, in theory, borrowing to finance these projects can improve a country's welfare. In some cases, developing countries may be able to finance these investment projects by mobilizing domestic resources. In other cases, external debt is the only alternative.

Avoiding over-borrowing

Innovative debt instruments can limit the risk of a debt crisis at any level of debt. However, for any set of debt instruments, the risk of a debt crisis can be reduced by borrowing less. This suggests that the first step towards achieving debt sustainability is to borrow for the right reason and not borrow too much during "good times". This does not mean that countries should not borrow, but rather that they should not over-borrow. Borrowing for the right reason means that debt should only be used to finance projects that generate returns which are higher than the interest rate charged on the loan. Moreover, foreign currency borrowing should be limited to projects that can either directly or indirectly generate the foreign currency necessary to service the debt (TDR, 2008).[31]

A way to maintain prudent debt levels is to complement macro-level debt sustainability analysis with a careful evaluation of the sustainability of each project. Before borrowing abroad, a country should evaluate a project by asking the following three questions: (i) Will the project have a social return which is higher than the cost of funds? (ii) Will the project generate the amount of foreign currency necessary to service the debt? (iii) Will the resource flows match the payment schedule of the debt contract? Only projects with positive answers to the above three questions should be financed with standard external debt contracts. It is likely that in low-income countries there are several high social return projects that do not satisfy the second and third requirements, in which case such projects should be financed with grants and concessional loans.

Excessive borrowing by the public sector is often driven by political or electoral considerations and by the fact that politicians may decide to maximize their own welfare rather than that of their constituencies. There is, by now, ample empirical evidence that public sector over-borrowing can be limited by increasing the transparency of the budgetary process and the reliability of fiscal and debt statistics (see below) and by having a well working system of automatic fiscal stabilizers. Of course, discretionary fiscal policy remains important, especially at times of crisis, but it should be accompanied by rules that reduce their potential to generate a deficit bias (TDR, 2008, ch. VII provides a detailed discussion of these issues).[32]

This highlights the important role of responsible borrowing and lending. Although there is no agreed set of definitions or principles, shared responsibility by both borrowers and lenders is crucial to avoiding the unsustainable (and sometimes fraudulent) accumulation of debt. UNCTAD has launched a project aiming to address some of these issues, which includes the development of guidelines and criteria for assessing legitimacy of sovereign debt.

Excessive borrowing, especially external borrowing, is also an issue for the private sector.[33] In fact, in many cases it is impossible to separate public from private liabilities. This is especially the case for bank-debt. The presence of implicit or explicit deposit insurance implies that, in the case of a banking crisis, bank liabilities are absorbed by the public sector. Thus, the external debt of private banks is a contingent external liability of the public sector.

Moreover, there are conditions under which private external debt may lead to over-borrowing and end up generating more vulnerabilities than public sector external debt. For instance, in most developing countries, the cost of borrowing is linked to total (public and private) foreign debt and thus external borrowing generates a negative externality, because each borrower increases the cost of funds for all other borrowers. If the government is the only borrower, it will make its borrowing decision by taking into account the effect of this upward sloping supply of funds. However, private agents do not internalize the fact that their borrowing decisions have a negative effect on other agents' borrowing costs and will thus borrow more than what is socially optimal.

Another source of vulnerability is linked to the presence of moral hazard. Private borrowers may decide to minimize borrowing costs and accumulate currency and maturity mismatches if they think that they will be bailed out in the event of a currency or liquidity crisis. In particular, currency mismatches linked to the presence of liabilities in foreign currency and assets in domestic currency have been at the root of many debt crises, including the Asian Crisis of 1997/98 and the current problems facing several countries in Eastern Europe and Central Asia. This problem cannot be solved by simply requiring banks to match their foreign currency liabilities with foreign currency assets. Even if a bank perfectly matches its assets and liabilities, a currency devaluation can hurt the bank's balance sheet if the bank's clients have a currency mismatch (this is the case when firms that produce non-tradable goods borrow in foreign currency or when households hold foreign currency denominated mortgages). In fact, some private agents amplify potential mismatches linked to their normal borrowing needs by engaging in carry trade and speculating with derivative products. These activities may end up causing them enormous losses and the unwinding of these speculative positions contributed to destabilizing several foreign exchange markets.[34]

Prudential regulation should be aimed at avoiding such mismatches, but the implementation of such prudential regulation is made difficult by the fact that external private borrowing is more opaque than external public sector debt and total external exposure by the private sector is more difficult to measure and quantify than the external exposure of the public sector. This opaqueness is complicated by the fact that private sector entities often take currency risk by using sophisticated derivative instruments. Given these problems, there are instances in which controls on capital inflows can play a useful role in limiting over-borrowing and losses in external competitiveness.

Improving debt management

The current crisis has once again highlighted the importance of effective debt management for debt sustainability in developing countries. As with previous crises, effective management of a country's public debt has proved to be a valuable asset in mitigating the effects of external shocks. Effective debt management contributes to the attainment and maintenance of sustainable debt levels through three key dimensions: providing input to the decision-making process, implementing policies, and ensuring adequate coverage of the country's debt.

Debt management's input to the government's decision-making process consists of the provision of debt data and strategy proposals. The availability of reliable and timely debt data is essential for prudent risk analysis and the elaboration of government strategies aimed at ensuring sustainable debt levels. Key factors are the allocation of an adequate number of trained staff, efficient information flows and the implementation of effective management information systems. Additionally, the government must be prepared to make use of the information and recommendations that the debt management function can provide. In countries where these conditions are met, debt sustainability analysis can rely on accurate data and the resulting policies are strengthened; where this is not the case, the analysis and resulting decision-making suffer.

For the implementation of policies, appropriate regulatory frameworks, organizational structures and operational procedures are essential. When the appropriate legal and institutional frameworks are in place, and the organizational structure defines clear responsibilities, the consequential improvements in accountability and transparency levels promote the effective implementation of government policies for achieving debt sustainability. On a macroeconomic level, debt management must be treated as an integral part of the government's overall macroeconomic framework, strengthening the decision-making process and ensuring consistency with other macroeconomic objectives and policies. At the micro-administrative level, debt management functions must be integrated with the broader processes of public finance management and administration, including the integrated financial management systems. Countries that satisfy these conditions have been able to use debt management to mitigate the effects of financial crises. However, where these frameworks, structures and resources are lacking or are weak, there is insufficient capacity to effectively implement government policies related to debt sustainability, resulting in inconsistency between government objectives and the actual results.

Another prerequisite for debt management to support debt sustainability is full coverage of a country's public and publicly guaranteed debt obligations, as well as the monitoring of private non-guaranteed and short term debt. The Asian Crisis underlined the need for governments to maintain comprehensive coverage of such liabilities. However, many countries still have limited coverage of their debt, maintaining debt records for only some categories of central government debt. The consequence of this incomplete information is weaker ability to undertake comprehensive risk and debt sustainability analysis.

Developing new debt instruments

Developing countries can reduce the risks of a debt crisis by consistently running fiscal and current account surpluses. However, even if a country decided to do so (and there are several reasons why this may not be optimal or feasible), it would still be left with an existing stock of debt. As financial crises are often driven by liquidity problems and not by solvency problems (and even solvency problems are sometimes the outcome of a liquidity crisis), having a debt structure that limits the risks of such a crisis is key for guaranteeing sustainability.

Section C above highlighted the risks of foreign currency borrowing. Several developing and emerging market countries have been successful in reducing these risks by switching from the international to the domestic debt market. However, this option is not available to all countries and several developing countries still need to rely on the international capital market, where issuing in domestic currency is extremely difficult. The international financial institutions can help broaden the investor base for long-dated local currency instruments by issuing their own bonds in the currencies of their borrowing countries. In the past, multilateral development banks issued bonds denominated in the currencies of emerging economies with the objective to minimize their own borrowing costs. Recently, they accelerated this process because they recognized that by borrowing in local currencies they could provide support for the creation of markets for such instruments and thus contribute to development using both the asset (their loans) and the liability (their funding) sides of their balance sheets.[35] Of course, these policies would become easier if the international financial architecture would move towards a less dollar centric system (see TDR, 2009 for proposals in this direction).

Debt sustainability could also be improved by issuing contingent debt instruments. For example, GDP indexed bonds are of particular interest because they provide for lower payments when capacity to pay is low.[36] However, creating a market for such securities poses a number of challenges especially because someone needs to pay the fixed cost linked to the design and issuance of the new instrument. Also in this case, the international community could play an important role by providing technical assistance and strengthening the quality and reliability of the statistics necessary for pricing the new instruments. In the extreme, international financial institutions could be the first to issue innovative and contingent debt instruments.

The creation of new instruments may require the intervention at the international level because of the required market size, externalities, and the need for homogenous standards. But the international community could also help address a more fundamental problem. Issuing local currency or contingent debt is analogous to paying an insurance premium. In order to accept debt instruments with a more variable return, international investors are likely to ask for some form of compensation. Paying such a premium might be politically costly and policymakers may object to an insurance policy that may benefit future governments. [37] If the international financial institutions were to create a critical mass of these instruments and demonstrate their benefits, it would be harder for self-interested politicians to reject the use of such instruments.

E. Conclusions

The financial and economic crisis of the last two years has highlighted the need for further policy actions both at the domestic and international levels in order to generate economic growth rates in developing countries capable of preserving debt sustainability as well as meeting the MDGs. In this regard, it is important to distinguish between short-term actions aimed at minimizing the impact of the current crisis, and longer term policies that would need to be implemented to increase the robustness of the global economy and reduce global imbalances.

In times of crisis low-income countries have smaller margins to manoeuvre when it comes to weathering external shocks. Accordingly, an immediate short-term measure to be adopted when a crisis erupts is for lenders to provide low-income countries with greater flexibility to respond to external shocks. Within the context of the current economic crisis, in April 2009, UNCTAD called for a debt moratorium on the sovereign debt of low-income countries to provide them with the breathing space they need to mitigate the negative impact of the global crisis. Encouragingly, in July 2009, the IMF announced the provision of interest payments relief to low-income countries in the form of zero payments for concessional lending facilities until the end of 2011.

At the G8 summit in Gleneagles and at the UN Millennium summit, countries decided to increase ODA flows to $130 billion by 2010. Although there are encouraging signs that a number of countries are on track to meet their national targets, some countries have cut aid budgets at a time when ODA is more important than ever in mitigating the negative impact of the global economic and financial crisis. It is important that all donor countries fulfil the existing pledges, and go beyond them in light of the difficult situation faced by developing countries. Additional aid would be essential for meeting the MDGs as the current targets were agreed before the financial crisis slashed economic growth and government revenues in developing countries, and created a situation where a number of countries have to curtail their social spending to maintain macro-economic stability and ensure debt sustainability.

Some HIPC countries are moving again towards an unsustainable debt position. The number of high-risk post-completion point countries increased from four to five over the last twelve months.[38] This increase is particularly worrisome as there is no scope for further debt relief for this country group. Continued and increased access to highly concessional finance is therefore needed to maintain debt sustainability beyond the completion point.

In terms of longer term actions, policies aimed at improving debt sustainability in low-income countries should start by recognizing that such countries have enormous needs in terms of investment in social and physical infrastructure but a limited ability to sustain the external debt necessary to finance these investments. Therefore, such countries face a dilemma. Either maintain sustainability and forego investment opportunities with high social returns, or try to borrow and invest as much as they can but then face recurrent debt crises. Both options will lead to low growth; the first – which is implicit in the World Bank/IMF debt sustainability framework – because of low investment and the second because of high volatility and stop and go cycles. A way out of this Hobson's choice would be full debt cancellation and a large step up in aid. Such a Big Push would produce a virtuous circle that may put today's low-income country on a path of stable growth and sustainable debt. Even though developed countries made several pledges to scale up aid to low-income countries (especially Africa) there is no evidence of a major rethinking of international policy towards the debt problems of low-income countries.

Several middle-income countries entered the crisis with relatively strong fundamentals (as measured by current account surpluses and large international reserves). This position of relative strength, contributed to averting a more profound economic downturn than the one that some of these counties are going through. As opposed to previous global shocks, several emerging market economies managed to avoid a collapse of their domestic currencies and their banking sectors remained stable. However, as the world emerges the near collapse of the global financial system, it is time to think about medium term policies that would improve the financial prospects of emerging market countries.

It is worth mentioning that this crisis makes countries reconsider some of their policies and becomes an opportunity to introduce changes. It has, once again, shown the dangers of excessive foreign borrowing both on a net and gross basis (i.e. foreign borrowing which is not driven by a current account deficit). Hopefully, more developing countries will learn from this crisis and start to adopt prudent policies, which will isolate them from the vagaries of international finance. This transition, however, needs to be gradual. A sudden swing from a current account deficit to a current account surplus, which originates from a capital flow reversal, may have serious economic costs.

Economists and practitioners are now converging towards the idea that debt crises are related to both debt levels and debt composition and that there are important interactions between domestic public debt and external debt. Improving debt management capacity at the domestic level can lead to a more optimal debt composition and can reduce the risks of over-borrowing. At the same time, international policies can help developing countries to move to a safer debt structure which would make the countries more resilient to external shocks. One of the reasons for developing countries' high cost of borrowing is that lack of accurate and timely information on debt level and debt structure is associated with a perceived increase in the risk of the debt issued by these countries, the international community should devote more funds for technical assistance to reinforce developing countries' ability to effectively manage debt and report accurate statistics.

Even in the presence of a more coherent international financial system sovereign defaults are bound to happen. It is thus necessary to put in place a debt resolution mechanism aimed at guaranteeing a speedy and fair resolution of sovereign debt crises. UNCTAD has proposed the creation of such a mechanism for a number of years, and the current crisis has again demonstrated that the international financial system would greatly benefit from resolving debt problems in a rapid and equitable manner.

Appendix. External versus fiscal sustainability

Debt sustainability exercises for developing countries have traditionally concentrated on external debt. This is due to the paramount importance of the transfer problem and to the fact that, until the early 1990s, most external debt of developing countries was public and most public debt of developing countries was external. However, the crises in the 1990s and 2000s were characterized by either the presence of massive private external debt or a large stock of domestic public debt. In the current environment, about half of the long-term debt of developing countries is issued by private borrowers and more than 50 per cent of public debt is issued domestically.

Therefore, when policymakers talk about debt sustainability they have in mind different definitions of debt. Some think about external debt sustainability and the associated transfer problem, others focus on public debt sustainability and the associated budgetary problem. Some even claim that there is no transfer problem associated with the presence of external private debt and that only external public debt should be of concern.[39]

Those who worry about external sustainability are interested in checking whether the country can generate the foreign currency necessary to service the external debt. However, they do not look at whether the different sectors of the economy are able to generate the resources necessary to pay their own debts. Those who worry about public debt sustainability look at the evolution of total public debt without worrying that servicing the public debt may require scarce foreign currency.

Both concepts are important, but mixing them up adds confusion to the debt sustainability discussion. The objective of this appendix is to clarify the differences between different types of debt in terms of the different types of vulnerabilities that they create.

External sustainability

The observation that in order to repay its external debt a country needs to earn foreign currency on a net basis was at the basis of Keynes' (1929) criticism of those who thought that a large external debt is mainly a budgetary problem.

The key difference between external and domestic debt is that the ability of generating international currency to pay interest and principal is not directly related to a country's ability to grow or to broaden its tax base. Thus, debt-to-GDP or the debt-to-revenues ratios are not adequate measures of a country's ability to repay its external debt. Even the often used debt-to-exports ratio is problematic because a large export sector is not sufficient to generate the needed resources if import growth outpaces export growth. Unless a country's external debt is issued in its own currency, the money necessary to cover international obligations on a net basis (i.e. without creating new debt) can only be generated in presence of a current account surplus. This means that net foreign debt is always a debt that has to be repaid in terms of internationally tradable goods and services.[40]

The accumulation of large net foreign liabilities is always the outcome of a persistent current account deficit. Thus, in order to evaluate whether a given amount of debt is sustainable or not, it is necessary to understand the mechanisms that drive the behaviour of the current account. There is evidence that large swings in the terms of trade like those following oil price hikes have immediate and quantitatively significant consequences for trade and current account balances. In the same vein, the reduction of deficits in countries with a sizable share of tradable industrial goods usually goes hand in hand with a devaluation of the nominal and the real value of the currencies affected. Indeed, empirical evidence has shown that changes in the real effective exchange rate have the potential to reduce deficits or to induce swings in the trade and current account from deficit to surplus.

In light of this evidence, a large current account deficit accompanied by a real appreciation and a loss in overall competitiveness is a stronger indicator of non-sustainability of the resulting debt than a deficit which is not accompanied by a loss of competitiveness. It is sometimes claimed that developing countries need to accept large inflows and the resulting currency appreciation because they do not possess enough own savings and hence they need to import capital in order to invest and grow. However, this line of argument loses persuasive power in a world, where developing countries as a whole are both growing and investing at unprecedented pace and are net exporters of capital.

Moreover, as the 2004 US Economic Report of the President has put it: “The desirability of positive net capital flows and a current account deficit depend on what the capital inflows are used for. Household borrowing – an excess of household spending or investment over saving – provides a useful analogy. Household debt could reflect borrowing to finance an extravagant vacation, a mortgage to buy a home, or a loan to finance education. Without knowing its purpose, the appropriateness of the borrowing cannot be judged. Similarly for countries, borrowing from abroad can be productive or unproductive.” (p. 256). Hence, debt piled up against one or the other activity appears in different light and debt sustainability cannot be evaluated on the basis of macroeconomic ratios only.

Thus, if a country or a region faces a sharp real revaluation, the concomitant net inflow of capital should not be interpreted as a sign of strength or as the result of investors’ decision to “save” in favor of this region. A sign of strength would be an inflow without an overvaluation. Otherwise, devaluing countries are exporting capital as the necessary complement of their success on the goods market and not as autonomous resource transfer. As the movement in relative prices is the cause of capital flows, it is inconsistent to complain about the negative effects of the overvaluation and to praise the net capital inflow at the same time.

These considerations bear some important lesson for the analysis of external sustainability. In particular, the analogy with calculations of sustainable government debt is misleading and we should refrain from following this path of analysis. Any attempt in measuring sustainability needs must include a thorough analysis of the causes of indebtedness.

Fiscal sustainability

The term "fiscal sustainability" is often used without having a clear definition in mind. The International Monetary Fund defines a policy stance as sustainable if: "a borrower is expected to be able to continue servicing its debt without an unrealistically large future correction to the balance of income and expenditure" (IMF, 2002, p. 4).[41]

Formal tests of sustainability tend to be problematic and rather demanding in terms of data requirement. Thus, analysts have developed rule of thumb indicators aimed at checking whether current policies can stabilize or reduce a given debt ratio for a given real interest rate, growth rate of the economy, and initial stock of debt. This indicator is usually used to analyze the primary surplus that is required to stabilize the debt-to-GDP ratio:

PRIMARY SURPLUS = (INTEREST RATE - GDP GROWTH) *PUBLIC DEBT

There are several caveats that apply to this approach. First, it is not solidly based on any well-specified definition of sustainability and it mostly focuses on stabilizing a particular debt-to-GDP ratio but it does not say anything about the optimality of this ratio. Second, the indicator does not establish necessary conditions for long-run sustainability. There are good reasons why a country may want to run a deficit and it may be sub-optimal to prevent a country from conducting counter-cyclical policies because these policies would lead to overshooting a fiscal ratio that corresponds to a long-run equilibrium. Third, evaluating the above equation requires assumptions on GDP growth, interest rate, government expenditures and revenues, and implicitly assumes that these variables are exogenous. However, most of these variables tend to be endogenous and correlated with each other. It is unrealistic to assume that changes in the primary deficit will have no effect on the interest rate and growth, or that changes in growth do not affect the primary surplus. In fact, deficits incurred to finance public investment should be treated differently from deficits incurred to finance current expenditure. According to current practice, public sector adjustment strategies bundle together current expenditure and public investment. The Rio Group (a permanent mechanism of political consultations and interaction between 19 Latin American countries) put forward a proposal aimed at excluding investment expenditure from fiscal deficit targets. The main argument in favour of this proposal is that, as current expenditure tends to be difficult to adjust (because it is mostly composed of wages and entitlement programs), investment is the typical adjustment variable when the deficit exceeds the target. The proposal argues that the inclusion of investment expenditures in the target budget balance considers every increase in debt as a reduction in government wealth, implicitly assigning no value to investment expenditure as an addition to net wealth. The Rio Group, instead, would favour the adoption of sustainability indicators similar to the one proposed by Buiter (1985).[42]

Finally, the indicator does not take into account a host of factors that characterize the situation of most developing countries and greatly increase uncertainty. In particular, developing countries often have limited capacity to raise taxes (because of a large informal sector), have a volatile revenue base, are subject to large external shocks (both real and financial) that increase the volatility of GDP growth and that of debt service, and are characterized by large levels of liability dollarization. All these elements complicate the management of fiscal policy and greatly increase the difficulty of evaluating sustainability.

Interactions between external and fiscal sustainability

There are important linkages between external and fiscal sustainability. The most obvious among these linkages is that about 50 per cent of external debt of developing countries is public debt and about 50 per cent of public debt of developing countries is issued externally. But there are also less obvious linkages. Consider, for instance, a country with no public debt but a large external private debt. The inability of private borrowers to service this debt can lead to a currency and banking crisis which can then have negative implications on fiscal sustainability. However, crisis can also originate in the market for domestic debt. The Mexican crisis of 1994/1995 originated in the market for CETES which are domestic currency domestic bonds and the Russian crisis of 1998 originated in the GKO market which are domestic currency domestic bonds.

The most important interaction between fiscal and external sustainability has to do with the behaviour of the exchange rate and, unfortunately, this interaction introduces an unpleasant trade-off. This can be seen by recalling that a real devaluation is a necessary condition for restoring external sustainability and that a large share of public debt in developing countries is denominated in foreign currency and, as a consequence, a large devaluation can lead to a sudden jump in the debt-to-GDP ratio (for evidence along these lines see Campos, Jaimovich and Panizza (2006) "The unexplained part of public debt", Emerging Markets Review, Vol. 7/3, pp. 228-243).[43]

Hence, a currency appreciation can jointly have a positive effect on fiscal sustainability and a negative effect on external sustainability. However, if this situation is associated with a rapid deterioration of the current account, the improvement in fiscal conditions will only be temporary. This is exactly the problem with the Lawson doctrine, which may lead governments to ignore their external financial fragility, which will eventually lead to a currency crisis and a fiscal crisis. However, this trade-off also implies that allowing currency devaluation in presence of foreign currency debt may lead to a debt crisis and possibly to a costly debt default. This is why some developing countries suffer from "fear of floating".

As a change in the composition of public debt and a switch to domestic borrowing can reduce these asymmetries and improve the trade-off discussed above, several developing countries are now retiring external public debt and substituting with domestically issued debt. According to some commentators and economists, this switch in debt composition will shield developing countries from future debt crises. While it is true that domestic debt tends to be safer (from the issuer's point of view), the recent switch from external to domestic borrowing may lead countries to trade one type of vulnerability for another. For instance, countries that are switching from external to domestic debt could be trading a currency mismatch for a maturity mismatch and excessive domestic borrowing could have a negative effect on monetary credibility and thus lead to high domestic interest rates (see Calvo (1988) "Servicing the Public Debt: The Role of Expectations" American Economic Review, Vol. 78/4, pp. 647-661).

These interactions between external and fiscal sustainability point to the fact that domestic debt should be included into DSA exercises. Currently, this is not common practice for at least two reasons. The first reason has to do with the fact that while domestic debt may have an effect on external sustainability, the vulnerabilities of domestic debt are different from those of external debt. Thus, it would be wrong to simply sum the two types of debt. The second reason is more pragmatic and has to do with the fact that it is hard to find data on the level and composition of domestic debt. Even worse, we do not even have a good definition of domestic and external debt. In fact, while the official definition of external debt focuses on the residence of the creditor (external debt is debt owed to non-residents), most countries classify external and domestic debt based on the place of issuance and the legislation that regulates the debt contract (external debt is debt issued in foreign countries and under the jurisdiction of a foreign court).

Chapter III

Collateral damage from the global financial crisis: Could developing countries land in another round of debt crises?[44]

By Yuefen Li[45]

When the financial system imploded in the United States by the subprime mortgage crisis, some people still hoped that the "decoupling" theory could be vindicated and that developing countries having weak financial linkages with the rest of the world could be insulated. Now with GDP growth estimates of Africa, Asia and Latin America being revised lower and lower and the stimulus packages in the developed world getting bigger and bigger, it is evident that the current financial crisis has some distinctly different features from all other major crises, in particular those that have hit the developing world in recent decades. Not only because the epicenter of the crisis is in the world's largest economy and the complexity and the magnitude of the crisis is unprecedented, but also because its trajectory is from the centre of the international financial system to the periphery.

From the way it evolves now, it seems that no country can escape the impact of the deepening and widening crisis. A U-shaped crisis recovery seems to be one possibility and the bottom of the U is most likely to be deep and protracted. Many people have even speculated that the crisis recovery could be an L-shaped one. The drying up of liquidity and negative impact arising from other transmission channels carry the grave risk of reversing the hard-won economic improvements made in the developing countries during the past decade, including the general improvements of the sovereign external debt situation of the developing countries. A rather worrying trend is that there is great likelihood that the countries at the periphery may suffer disproportionately greater in intensity and duration of time than the countries at the centre. The financial crisis has fundamentally undermined the main underpinning factors leading to the recent improvements of debt situation of the developing countries. Worse still, it has resulted in multiple exogenous shocks such as terms of trade reversal, decline in export demand, reduction in remittances, and a possible cut in ODA or delayed commitments of ODA, to name a few. For many low-income debtor countries, one external shock could leave them in shambles. Mitigating the impact of multiple shocks will be an unprecedented challenge for many of them, thus there is a great possibility that a new wave of debt crises may arise if necessary support from the international community is not forthcoming.

This paper examines the reversal of two important and favorable conditions which had reduced the debt burdens of developing countries before the onset of the financial crisis, i.e. the broad-based fast economic expansion and debt relief. (What about shifts in spreads and exchange rates? Devaluations will raise debt/GDP ratios and higher spreads will raise the cost of short-term debt.) It further examines how external and domestic liquidity have been negatively affected as well as how shifts in spreads and volatility of exchange rates resulted in higher cost of borrowing and rising debt/GDP rations. The final section provides some policy recommendations for moving forward.

A. Introduction

One risk which has not yet attracted sufficient attention in international circles is the looming debt crisis in some low-income countries. The improved external debt situation in the developing world in recent years has led to various degrees of complacency on the sides of the creditor and debtor countries. However, debt sustainability is a dynamic concept rather than a static one. The current financial crisis has already significantly undermined the factors underpinning the improvements in external debt. In addition, there is a tendency to forget that domestic debt and external debt can be fungible and can impact each other. Therefore, domestic public debt should be considered as an important part of the debt sustainability equation. Recent years have witnessed the increasing prominence of domestic debt in many low-income countries. With the unfolding of the financial crisis, its primary and secondary effects are affecting negatively the availability of financial resources to service the public debt. Some governments in low-income countries are facing significant domestic debt arrears and widening financial gaps to service their debt. What the international community does not want to see is a scenario of an economic recovery in the developed world followed by another wave of debt crises in the developing and transition economies, in particular the low-income countries.

The spillover of the global financial and economic crisis to developing countries and its effect on their debt sustainability vary according to the degree of their openness to the international capital markets and their stage of development. Developing countries with large exposure to international banks, bond and equity markets, namely the market access countries, were the first to feel the pain and some are facing acute challenges to roll over their external debt These countries are facing a four-edged sword, i.e. plunging asset prices, higher cost of borrowing, a massive capital flight and a decrease in exports. Some major emerging economies endured losses from their exposure to toxic assets. Some countries have become more resilient with respect to past crises owing to their foreign exchange reserves and stronger fiscal position. However, emerging countries which relied heavily on foreign borrowing in good times are being hit hard and some of them had to resort to IMF crisis loans. Pakistan, Georgia, Ukraine, Latvia, El Salvador and Belarus and Seychelles were among the first to face unsustainable debt situations mainly caused by the volatile and weakening externalities. More Central and Eastern European countries are facing both liquidity and solvency challenges. How to deal with a debt crisis in these countries is now a subject of considerable debate. As the end of the tunnel for the financial crisis is not yet in sight, it seems that the list of countries to suffer from liquidity crisis and sovereign default could continue to grow.[46]

Countries with weak financial linkages with the international capital market are mainly suffering from the secondary effects of the crisis given rise by the global economic contraction, such as decline in word trade, tourism and remittances. Some of them are enduring both the primary and secondary effects of the financial crisis and, therefore, greater challenges to maintain macroeconomic stability and debt sustainability. This is especially true as most low-income countries have little policy space with respect to both fiscal and monetary policies.

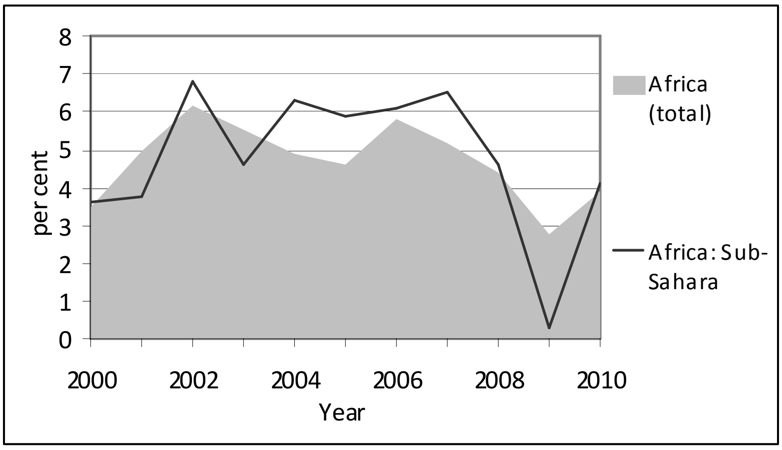
B. From broad-based economic expansion to economic contraction and unprecedented multiple exogenous shocks

Before the financial crisis, the cross country average of the external debt situation of developing and transition economies showed a net improvement, though it was far from a permanent exit from the debt trap. One important underpinning factor that induced the decrease in debt servicing burden was the unprecedented broad-based global economic expansion during the past decade or so.[47] GDP growth was higher and steadier in many countries. In Africa, GDP growth rates ranged from 5.9 per cent to 8.1 per cent for about 65 per cent of Africa's population during 1997-2007.[48]

Solid economic growth around the world, commodity price hikes, low interest rates and better macroeconomic policies spurred faster economic growth in developing countries. Unfortunately, the US subprime mortgage crisis very quickly reversed this positive trend and has spiralled into a global economic crisis. World growth is projected to fall from 5.2 per cent in 2007 to ½ a per cent or even negative growth in 2009, making the lowest rate since World War II. Both the IMF and World Bank have drastically scaled back their forecasts for African economic growth in 2009 – with the IMF estimating growth of 3.25% and the World Bank forecasting growth of 3.5%. These forecasts are half of the rates that were expected six months ago. Both institutions have warned that they could be subject to further downward revisions. In Africa, economic growth will slow to 2.9 per cent in 2009, down from 4.9 per cent in 2008. Growth in sub-Saharan Africa will drop to 1.7 per cent from 5.5 per cent in 2008.[49] The effects of that slide will be far-reaching.

Lower GDP growth means lower government revenues, less fiscal space, less finance for poverty reduction, and less money to service debt (Figure 1).

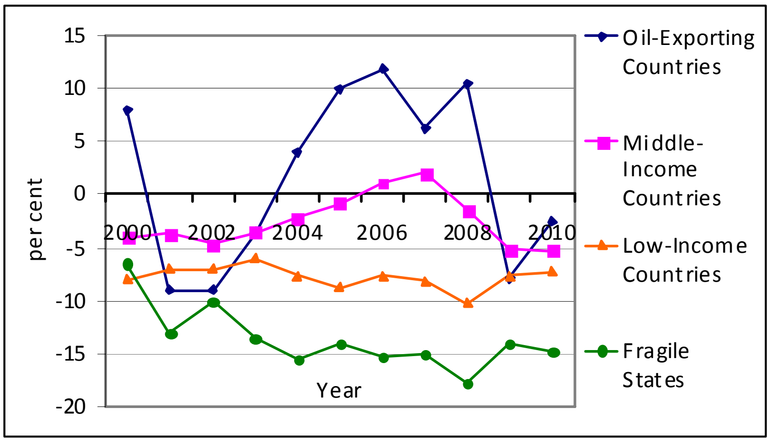
Figure 1. Real GDP growth of Africa and SSA



Source: Economic Intelligence Unit.

One main transmission channel of the global financial and economic crisis affecting developing countries has been a decrease in export earnings and worsening terms of trade owing to reduced global demand for exports. International trade is a main driver of GDP growth and export revenue is an important means for developing countries to earn foreign exchange to pay their external debt. A sharp decline in export revenues will lead to current account difficulties and financing gaps. As a matter of fact, signs of deterioration in the external situation of developing countries began to surface during 2007. Two thirds of developing countries suffered a deterioration of their current account balance, 50 per cent of developing countries closed the year with a current account deficit greater than 5 per cent of GNP, and about a quarter of developing countries ran current account deficits greater than 10 per cent of GNP. The financial crisis will certainly worsen the situation, adding to the difficulty of debt servicing (Figure 2).

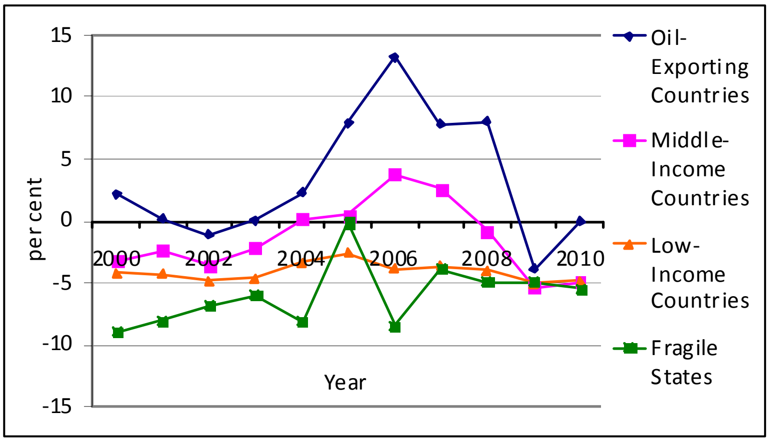
Figure 2. Current account balance of SSA



Source: Economic Intelligence Unit.

According to a recent debt sustainability analysis of post completion-point HIPC countries conducted by the IMF, these countries are most susceptible to shocks affecting their exports. This is mainly due to having a low export base, concentrated in a few commodities and great reliance on export revenue for debt servicing and government expenditure. Exports amount to approximately a third of sub-Saharan GDP. On average, Africa has benefited from improved terms of trade over the past few years. Oil and mineral exporters in particular have benefited greatly from booming prices. The global slowdown is particularly pronounced in countries dependent on commodity exports (Figure 3).

Figure 3. Budget balance (in % of GDP) of SSA



Source: Economic Intelligence Unit.

Oil prices fell from their peak of $147 per barrel in June 2008 to a recent low of $40.50 a barrel. The price of copper fell from about $4.10 per pound to under $1.40 per pound, and cobalt fell from $53 per pound to about $13. For oil and mineral importing countries, this is good news as the import bill will be cut down. However, for oil and mineral exporting counties, the sharp decline of prices has had a ripple effect on external reserves, a depreciating currency, declining capital inflows, shrinking export markets and declining export-import trade financing. Zambia, for example, enjoyed increase of prices of copper for some years. In the third quarter of 2008, total copper export earnings dropped 32.6% to $758 million,[50] compared with $1.2 billion the previous year. Botswana's economy remains over-reliant on minerals – especially diamonds – which account for about half of government revenues, one-third of GDP and more than 70% of export revenues. Diamond revenues are expected to decline by half this year, with prices estimated to slump by 15% and production by 35%. Because of higher commodity prices before the crisis, some of the exporting countries had already initiated major operations to increase supply, with the economic downturn and the resultant contraction in demand, there have been closures of mining operations, the suspension or cancellation of projects in sectors hardest-hit. Both the labour market and the government fiscal position have been negatively affected by such responses. As for countries which do not have a heavy reliance on oil and mineral exports, the terms of trade shock is not as big, but the contraction of exports is also apparent. In all regions exports contracted faster than GDP. The WTO has forecasted that world trade will contract by 9% in 2009. Therefore, they may also face balance of payment problems as the crisis deepens.

Similar to trade in goods and commodities, tourism is a major foreign exchange earner and contributor to economic growth for some countries. However, the knock-on effect of the crisis on tourism has been profound. According to the World Tourism Organization, the second half of 2008 saw growth come to a standstill with the number of international arrivals declining slightly, while in 2009 international vacation travel could drop up to 2 per cent in 2009 as the economic crisis worsen.[51] Some countries have experienced much deeper decline. For instance, at least five Caribbean countries have suffered double-digit drops in tourist so far in 2009.[52]

Not only did the sharp drop in commodity prices worsen the export performance of developing countries, but protectionism has also had a negative impact. The United States was the first to move towards this direction. The US newly passed $787 billion stimulus bill has ‘Buy American’ provisions that was signed into law on 17 Feb 2009 by the US President. The ‘Buy American’ provision requires the purchase of iron, steel and manufactured products from American enterprises. Though this has sparked sharp criticism and threats of legal challenges from US trading partners, some European countries followed, taking the principle “if you can’t beat them, join them”. Many developing countries can neither beat them nor join them, because they lack the large funds needed to play the stimulus game. According to the World Bank, since the beginning of the financial crisis, officials from various governments proposed 66 measures involving trade restrictions, of which 47 eventually took effect.[53]

The credit crunch has not spared trade financing (trade credit and insurance/guarantees) which is the life blood to international trade. Its scarcity and higher cost is bound to intensify the contraction of world trade. The Asian financial crisis in 1997 has shown that low-income countries are prime victims in the general reassessment of risks and liquidity shortages that characterize periods of financial crisis (Auboin and Meier-Ewert 2008).[54] As the financial crisis unfolds, it is increasingly more costly for developing-country exporters to borrow from international financial markets or to apply for export credits and/or export insurance. “Spreads on short-term trade credit facilities soared to 300–600 basis points above LIBOR, compared to 10 to 20 basis points in normal times”, according to Auboin and Meier-Ewert. Spreads on sovereign debt is now around 800.

During times of faster economic growth, governments of many low-income countries stepped in to provide guarantees or resort to domestic borrowing for large projects like infrastructure and capacity expansion of large enterprises. Assumption of contingent liabilities in the form of guarantees by sovereigns helps to leverage private sector participation in areas of national priorities, thus re-invigorating economic development. However, this may also lead to vulnerabilities in times of crisis. Many developing countries do not have good data on their exposure to such vulnerabilities. As the recession worsens and becomes protracted, more firms and banks in the developing countries could encounter difficulties. Low income countries are at a disadvantage because they do not have the same amount of public funds to bail out their troubled companies or financial institutions like what has been done in the developed world. This may make their enterprises less competitive in the global market and increase the likelihood of facing financial difficulties. The build-up of contingency liabilities owing to government guarantees for large projects during the period of easy and abundant liquidity and the “too-important-to-fail” enterprises which are facing problems because of the financial crisis would further erode the fiscal position of the government and increasing the debt burden.

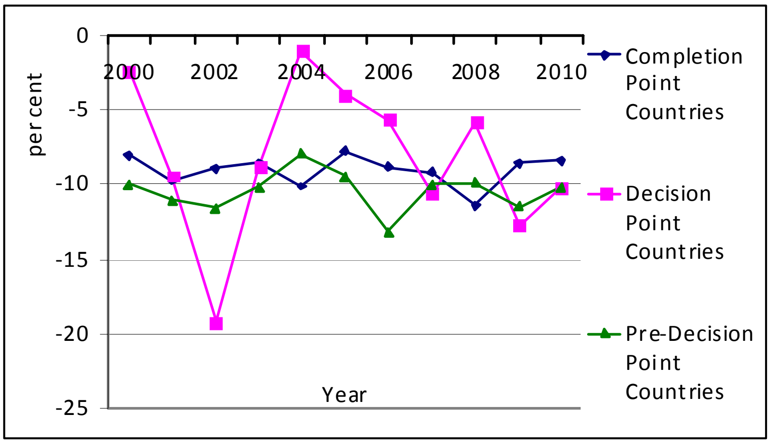
C. International debt relief has peaked but many HIPCs remain under debt distress

The debt relief initiatives, both the HIPC initiative and the Multilateral Debt Relief Initiative (MDRI) have contributed to the improvement of HIPC debt ratios – though an important part of the Initiatives simply wrote off arrears that were subsequently counted as ODA. However, debt relief may have peaked and debt write-offs under the HIPC Initiative are set to decline since 24 out of 34 decision-point HIPCs have reached the completion point.

While debt relief provided under the two initiatives improved the debt ratios of the completion point countries, the 2008 HIPC and MDRI Status of Implementation Report[55] indicates that maintaining debt sustainability beyond the completion point remains a concern.

A significant number of completion point countries will continue to remain in a moderate or high risk of debt distress. Only 9 out of 24 completion point countries have a low risk of debt distress according to the most recent debt sustainability analysis (DSAs). While the number of countries with a high risk rating increased from one to four since 2007. On the whole, post-completion-point countries' debt sustainability remains vulnerable to shocks, particularly those affecting exports, and is highly sensitive to the terms of new financing (Figure 4).

Figure 4. Current account balance (% of GDP) of HIPCs



Source: Economic Intelligence Unit.

Such a discouraging picture of debt sustainability for the post completion point countries highlights the high vulnerability of these countries to external shocks. Unfortunately, the current financial crisis is actually presenting a dangerous cocktail of a mix of multiple external shocks with unprecedented intensity, making the slippage back to unsustainable debt by some countries as a certainty rather than possibility.

D. A severe drought of international financial resources to meet debt servicing needs

Currently, liquidity is flowing in one direction, namely to the most developed countries from emerging markets and low-income countries alike. Therefore, both emerging and frontier markets are providing liquidity to portfolios managed in the major markets to cover their mounting losses and margin calls. However, the accelerating growth of money supply has made little impact on the credit crunch and there is no picking up of bank lending because of the persistent risk aversion and the insistent tendency of flight to quality.

Readily available and low-cost capital played a crucial role in spurring growth around the world. Easy money was also behind the growth in Africa in the past decade. But with this, developing countries have also been increasingly exposed to liquidity shocks. Now the absence of easy liquidity for all but the safest borrowers has been causing pain everywhere.

1. Developing countries are being crowded out from the capital markets

Currently, financial flows that fuelled growth in low-income countries are drying up. This constitutes an extremely serious constraint for these countries as this is the time when external inflows are needed most to stimulate economic growth and to roll over debt. Virtually all major developed economies have initiated large fiscal stimulus packages to counter a recession. The packages have been revised upwards and will be amounting to around $5 trillion by the end of 2010, according the G-20 London Summit of 2 April 2009.

Such kind of interventions in debt markets has been unprecedented. At this year's Global Economic Forum in Davos, many economists and officials asked how the stimulus packages would be paid. The answer could be simple: first crowd out other investors in the market and second print money as if it has the status of one of the international reserve currencies.

The crowding out effect is already apparent. A number of developing and low-income countries which announced their intentions to float bonds, such as Senegal, Tanzania, and Ghana, have already been forced to shelve their plans knowing that the pool of capital in the world is limited and they cannot compete with countries with better ratings. The $2.5 billion hybrid rights issue and public offer by Ecobank Transnational Incorporated (ETI) can also showcase how developing countries have been squeezed out of the international capital market. Ecobank simultaneously launched the issuance in the three West African stock markets, namely the Ghana Stock Exchange, the Nigerian Stock Exchange, and the Bourse des Valeurs

Mobilières Régionales (BVRM) in the West African Economic and Monetary Union (UEMOA) countries in August 2008. It was the biggest cross-border share issuance on the continent. The original expectation was that the offer could be oversubscribed. But the global credit crunch and collapse in stock markets dampened investors' interest. The offer was extended by four weeks to Oct. 31. Even so, the share issue fell far short of the target of $2.5 billion and raised $566 million. One feature worth noting is that the subscribers are largely African instead of international investors.

Crisis of confidence in the international financial system has given way to a withdrawal of funds from almost all corners of the developing world. Ironically, the re-pricing of risks by investors led to a torrential flow of capital back to the epicenter of the crisis from the periphery. A flight to safety and liquidity – which essentially means a flight to US treasuries – has become the dominant strategy of investors all around the world. Foreign banks and enterprises in the developing world are repatriating their capital and profits back to their headquarters making it increasingly difficult for even well managed emerging markets to access external financing. Bearing in mind that many banks in LICs are foreign owned, its impact could be significant. The Bank of International Settlement's data shows that in the space of just three months from October to December banks globally cut their portfolios of foreign loans by $1,800bn or 5.4 per cent after adjusting for exchange rate movements.[56] This means many of the emerging and developing countries are now having very limited if no access to international credit markets if at all, thus creating a greater risk of re-entering into the vicious circle of mounting external debt becoming unsustainable.

"Financial mercantilism" in some countries is further intensifying this trend of a large scale retreat from international business and concentrating on domestic markets in the developed world. Some governments of developed countries have encouraged their banks to invest mostly in domestic assets, and repatriate capital back from abroad to their headquarters to assist troubled parent banks and financial institutions. This is a new form of protectionism which is centred on credit availability rather than trade. It has also sped up the drying up of liquidity in developing markets. At the G20 summit in April 2009, there was the call for “no financial protectionism”.

In addition to a scarcity of funds, the cost of borrowing has increased and could be even higher in the future. If developing countries’ bond issuers insist on raising funds through capital markets, paying higher interest rates is the only way for developing country bond issuers to compete with the most advanced countries. Emerging market spreads increased from less than to 200 at the beginning of 2007 to 653 basis points on 25 February 2009. This is equivalent to sowing the seeds for unsustainable debt servicing down the road. However, for the moment, the general drying up of liquidity itself, rather than the cost, is the most important factor for the reduced access to finance for developing countries, which might induce considerable roll-over risks of short-term and maturing debt.

2. Outflows of foreign capital from domestic capital markets in developing countries

The improved debt ratio of developing countries in the past few years is partly due to the change in the structure and composition of debt. Domestic bond markets have gained importance in many developing and emerging market countries. Recent years have witnessed the increasing prominence of domestic debt in many low-income countries. Non-resident purchases of domestic public and private debt were substantial for some years. This has raised the risk that a sudden shift in investor sentiment could lead to instability in the domestic financial market. Indeed, with the onset of the financial crisis, institutional and other foreign private investors who used to invest in domestic instruments in the developing countries started to convert the public debt instruments from local currencies to dollars in major international financial centres. They have done the same with private debt. For instance, in the London market, foreign investors in Uganda have converted a significant amount of public and private instruments denominated in Uganda shillings.[57]

As the economies of many developing countries are small in size, such kind of capital flight would lead to downward pressure on their currencies. This would put these countries in a tight spot. On the one hand, currency depreciation would increase the burden of debt servicing. On the other hand, with the sharp decline of global demand, depreciation will not lead to an increase of exports earnings. For example, low-income countries do not have the capacity to defend their currencies as they do not have sufficiently high foreign exchange reserves in the first place.

In their effort to protect their investments in times of crisis, it seems the foreign investors who once entered domestic capital markets in developing countries in search of higher yields may contribute to creating sovereign debt crises in these developing countries as they withdraw their capital to seek safety in developed markets. The withdrawal of foreign investors can weaken the confidence in local currencies and prompt an increase of demand for foreign currencies from domestic investors and the general public. These dynamics would lead to downward pressure on the local currencies and intensify capital flight.

Nigeria is an example. Starting with the fall out of Lehman Brothers, foreign investors began to pull out from Nigeria's capital markets in mass. The stampede led to a crash of stock prices. The Nigerian Stock Exchange index fell from a high of more than 66,600 in March 2008 to about 23,000 in February 2009, leaving some Nigerian banks heavily exposed through excessive margin lending and raising uncertainties about their capital adequacy. The decision by Nigeria in February 2009 to re-impose foreign exchange restrictions in an effort to stem the decline of the naira and the outflow of capital shows the significance of the worrying trend of the withdrawal of foreign investors from developing markets.

3. A decline in remittances

Remittances are a mainstay for many developing economies, providing valuable hard currency that is used to finance the current account deficits and debt payments, not to mention meeting consumption demands of the poor households. According to the World Bank estimates, migrants sent some $283 billion back home to developing countries in 2008, a figure much larger than the total ODA flows. A drop in remittances is another main channel of transmission for the financial crisis. Recent data shows that, for the first time in almost a decade, the financial crisis and ensuing economic downturn is significantly slowing down the flow of global remittances to developing countries. The impact on recipient countries will be felt more acutely in 2009. The World Bank projects that the overall remittance flows are to fall by 5 per cent to 8 per cent in 2009.

The importance of remittances varies considerably across the continent. For Africa, though it depends less on remittances than Latin America or South Asia, remittances have increased steadily in past years. African diasporas send back some 15 billion USD per year, amounting to the equivalent amount as FDI. Examples of countries with a high dependency on remittances (measured in per cent of export earnings) are Lesotho (60%), Uganda (40%), Senegal Guinea-Bissau, Togo, Benin, Burkina Faso (15-25%).[58] East Africa as a whole has benefited from significant Diaspora remittances from overseas. As a flow it appears to be less volatile. However it is bound to be seriously affected if there is a drastic worsening in the labour markets of the migrants' recipient countries.

4. A possible reduction in ODA flows

While some developed economies are debating best ways to spend their billion dollar stimulus packages, most low-income countries do not have the financial ammunition to stimulate their economies. For aid dependent countries and countries which suffer from current account and fiscal pressure, ODA can function as an economic stimulus to their economies. Therefore, at times of global economic downturn, ODA is of greater importance to poor countries. The negative impact of a slow down of ODA flows to aid-dependent countries will be severe as an important part of the government expenditures are financed by ODA. Some governments even use ODA to sustain debt service. A decline of ODA would mean that these governments may have to cut certain social expenditures which will further increase the misery of the poor population. To some degree scaled up ODA could serve to somewhat cushion the impact of any reversal in private capital flows, reduction of export revenue and remittances thereby reducing the likelihood of a sharp decline in spending on social sectors that would otherwise have dire consequences for poverty reduction.

As other sources of financing are plummeting, ODA as a source of development finance is more important than ever. Unfortunately, ODA, much like capital flows, tends to be pro-cyclical. When the financial crisis is starting to affect the real economy on the home front, it requires vision and courage for donor governments to send taxpayer's money abroad to assist poor countries. Even though ODA occupies a small percentage of the GDP of donor countries, very few of which have reached the UN target of 0.7% of GNI, budgetary pressures resulting from stimulus packages could also lead to a reduction of the volume of aid.

At the International Review Conference on Financing for Development in Doha in December 2008, donors reaffirmed their aid targets in an 'aid compact' and pledged that the financial crisis would not lead to aid cuts. However, it seems as though some donors are moving in the opposite direction. A number of countries have already indicated their intention to reduce ODA in 2009. The Irish government revised its budget for 2009 and slashed its ODA by 95 million euros, more than 10 per cent of the amount originally budgeted. Italy had a deeper cut amounting to 56 per cent, while Latvia announced that it a cut in aid by 100 per cent.

Some donor countries link their ODA budget to their GDP, consequently a slow down in economic growth in these countries would automatically result in a decline in the quantity of ODA for the developing world. Therefore, a scaling up of ODA would come under pressure as a result of a downturn in economic growth and as well as a result of developed market governments becoming more inwardly focused on domestic budgetary priorities, some donors are taking their time in making firm commitments to recipient countries. For ODA dependent countries, whose government expenditure relies heavily on ODA, they will face the difficulty of formulating budgets without knowing for certain the forthcoming amount of ODA for 2009.

The G20 London summit recognised that the current crisis has a disproportionate impact on the vulnerable in the poorest countries and reaffirmed the commitment to achieving their respective ODA pledges, including commitments on Aid for Trade, debt relief, and the Gleneagles commitments, especially to sub-Saharan Africa.

All these above-mentioned factors combined have led to the most dramatic and sharp decline of capital flows to developing countries. According to International Institute of Finance, net private capital flows to emerging markets are forecast to slow substantially to $165 billion in 2009, after an estimated $466 billion in 2008. The most significant weakness is for net bank lending which had a net outflow from the emerging markets of about $61 billion at the beginning of 2009, after a net inflow last year of $167 billion and a record of $410 billion in 2007. Private flows to Latin American will be halved.

E. Conclusions and recommendations

Even though most low-income countries have undertaken reform and pursued sound macroeconomic policies, the current financial crisis which is not of their making is disproportionately penalizing the developing countries as liquidity is leaving their markets and flowing back to the epicentre of the crisis which has opened a floodgate of bond issuing to finance gigantic stimulus packages. The developing countries are facing a sharp decline in both domestic and international liquidity coupled with other aftershocks of the financial crisis, thus weakening their debt servicing capabilities.

The market access countries are the first to feel the primary effects of the financial crisis. With globalization and the resultant increase in economic integration in the world economy, many developing countries are facing the challenges of both the primary and secondary effects of the crisis – even though it take time for the secondary effects to play out their impact on the real economy. The ensuing global recession has not only dried up liquidity but also reduced financial inflows and export revenue, threatening the fiscal balance and macroeconomic stability of the developing countries. Some of them have been facing a liquidity challenge since the beginning of the financial crisis, which has evolved to solvency problem for a number of them.

For low-income countries with weak financial linkages with the developed market, the multiple external shocks have started to reveal gaps between revenues and spending, outflow of capital has put downward pressure on their currencies and a decline in foreign exchange reserves. Lower export earnings and inability to impose countercyclical taxation measures will widen their gap of foreign exchange needs. All these developments do not augur well for their ability to sustain external debt, even for the post-completion point HIPC and MDRI countries. Though many HIPCs have reached completion points, there is no room for complacency as some of them are still under debt distress.

The complexity and the possible protraction of the financial crisis will add burden to the already existing debt distress. Challenges to rollover either domestic debt or external debt could trigger a debt crisis. After successive rounds of debt relief, domestic debt is paradoxically ballooning for some low-income countries. For some, domestic public debt is like a ticking time bomb as arrears have been accruing and financial resources to service the debt have been sharply declining with the deepening of the financial crisis. The collateral damages of the crisis carries the risk of reversing the hard won achievements made on improving the debt situation of the developing countries and trigger a debt crisis for some vulnerable countries.

In order to brace for the crisis and avoid sinking back into a debt trap, debtor governments should prioritise spending and adopt a more cautious attitude towards non-concessionary borrowing as well as domestic borrowing.

Economic diversification may be difficult to pursue during crisis, but it is nevertheless necessary to keep in mind the need for such a drive to reduce economic vulnerabilities.

Temporary imposition of foreign exchange restrictions might not be the best way to assure investors and may turn out not as effective because of various leakages. Nevertheless, they may still be necessary if the outflow of capital is proved to be sudden and large. Such restrictions could be designed specifically to help stabilise the depreciating currency. Governments which have the capacity to do so should try to stimulate economic growth that is conducive to increases in job opportunities and incomes.

Special balance of payments support to HIPC countries and low-income and other developing countries in debt distress should be provided in a timely manner, bearing in mind some special arrangements and facilities from the IMF and the World Bank (the Exogenous Shocks Facility (ESF) of IMF and financial crisis facilities of the World Bank).

Because of severe external shocks on developing countries caused by the crisis, MDRI and the HIPC initiative might be inadequate for the HIPCs. A more flexible and speedy approach is needed for countries facing debt servicing difficulties. Current global crisis management measures need to take a multi-pronged approach to tackling the challenges of developing countries while taking into consideration the challenges posed toward maintaining debt sustainability of developing countries. In view of the building up of pressure on debt servicing, a temporary debt moratorium for low-income countries should be put in place. One advantage of such a policy response is that it could be implemented expeditiously. Unlike scaling up ODA, creditor governments should not have to go to extra lengths to ward off domestic political pressure. In addition, the burden of locating financial resources and working out implementation measures should not be as onerous as emergency aid packages from the IMF and other multilateral financial institutions. Crisis prevention is a much preferred option than having to resort to crisis management. To work on remedies when the debt crises explode would be too costly and also causing too much human suffering. Right now, according to the World Bank, the interest and principal combined for 49 low-income countries for 2009 and 2010 is amounting to $26 billion, miniscule comparing with the stimulus packages adopted by developed countries. However, this kind of speedy and direct response from creditors could give them a fiscal breathing space and allow those countries to dedicate all their financial resources to address humanitarian and reconstruction needs. This avoided the scenario of countries receiving emergency aid on the one hand and servicing debt out their limited resources on the other.

A further shift of ODA from loans to grants should be encouraged. Bold international measures should be taken to reduce or even break the procyclicality of ODA. At this time of crisis it is crucial for donors to keep their commitments made under the 2002 Monterrey Consensus, the 2005 Gleneagles Communiqué, the importance of which was reaffirmed by 2008 Doha Declaration.

The risk of an increased number of sovereign defaults once again highlights the need of a structured approach to resolving defaults and disputes between sovereigns. An internationally agreed legal framework for the predictable and orderly restructuring of sovereign debt could make the process less costly. Serious consideration should be given to the idea of creating a mechanism aimed at guaranteeing a speedy resolution of debt crises. For example, an independent international body could be mandated by both debtors and creditors – guaranteeing fair burden-sharing – to evaluate the debt situation of all countries faced with external debt problems and to propose the level and form of debt relief that needs to be provided.

Debt management will be more important than ever as the current financial crisis will make debt sustainability a great challenge. It is imperative to promote capacity-building in debt management, including the capability to provide timely and correct debt data is essential for crisis prevention.

PART 2

Chapter IV

Call for a temporary debt moratorium for low-income countries to counter the impact of global economic crisis

When a developing country is hit by a large natural disaster with widespread destruction, the international community quickly mobilizes in support of this country. Within a month of the 2005 tsunami in the Indian Ocean, Paris Club creditors promptly announced their willingness to offer a temporary debt moratorium to devastated countries. Though this was less visible than other emergency aid, the speedy and direct response from creditors, it allowed those countries to dedicate all their financial resources to address humanitarian and reconstruction needs. This avoided the scenario of countries receiving emergency aid on the one hand and servicing debt out their limited resources on the other.

The current global economic crisis has all the characteristics of an economic tsunami. Most developing and low-income countries (LICs) are innocent bystanders and yet have been hit from several directions, including: plummeting commodity prices, lower external demand for exports, reduced remittances, and for countries with access to the international capital market, higher spreads and cost of financing. The collateral damage from the crisis carries the risk of reversing the hard won achievements made on improving the debt situation of the developing countries and could trigger a debt crisis for some vulnerable countries. Debt servicing pressure on low-income countries, including HIPCs having reached the completion point, has been mounting, threatening their debt sustainability. Decisive action must be taken both at the national and international level to avoid entering another round of debt crises.

Repeated warnings given lately point to the risks to debt sustainability of developing countries. UNCTAD sounded the alarm bell that the primary and secondary effects of the crisis could push some developing countries into debt crises.[59] The World Bank estimates that developing countries will encounter a huge financing gap of $270 billion-$700 billion due to the sharp deterioration of financial conditions associated with the global crisis.[60] The IMF also warned that about 28 LICs exceeding 60 per cent debt-to-GDP ratio indicating a higher risk to debt sustainability as the threshold defined under the debt indicator for weak performers is 30 per cent, half of their current level.

Crisis prevention is a much preferred option than having to resort to crisis management. To work on remedies when the debt crises explode would be too costly and also causing too much human suffering. Estimates of the World Bank for 2009 and 2010 indicate that combined interest and principal for the 49 low-income countries amounts to around $26 billion, miniscule comparing with the stimulus packages.

Given the devastating effects of the financial crisis, the urgent need to prevent the worsening of debt ratios and the increase of hunger and social suffering in the low-income countries, a temporary debt moratorium for low-income countries should be offered. Such type of assistance would be similar to the ones provided after the Hurricane Mitch in 1998 and the tsunami in 2005. For these two natural disasters, Paris Club creditors agreed not to expect any debt payments on eligible sovereign claims from the stricken countries ranging from one to three years depending on the loss to economy caused by the disasters. They offered that the deferred amounts be repaid over some years with a period of grace.

The proposed debt moratorium should be automatic and applicable to all LICs in order not to penalize countries that adopted prudent policies. In addition countries should not be subject to adherence of performance criteria.

One advantage of such a policy response is that it could be implemented expeditiously. Unlike scaling up ODA, creditor governments should not have to go to extra lengths to ward off domestic political pressure. In addition, the burden of locating financial resources and working out implementation measures should not be as onerous as emergency aid packages from the IMF and other multilateral financial institutions.

In comparison to the size of the stimulus packages for developed countries, the total amount of such a temporary debt moratorium is miniscule. However, for the LICs, it could provide them with an important fiscal breathing space and to offset to certain degree the loss incurred by contracting export revenue and decline in other financial inflows. It could function as a countercyclical measure which could contribute to the macroeconomic stability in these economies, which will benefit the global economy as a whole.

The international community should work together to avoid the scenario of an economic recovery in the developed world followed by another wave of debt crises in the developing and transition economies, in particular the low-income countries. Current global crisis management measures need to take a multi-pronged approach that incorporates the voice and urgent needs of low-income countries. The solutions proposed to tackle the crisis must also take into consideration the challenges posed to developing countries in maintaining long-term debt sustainability.

Chapter V

Keeping ODA afloat: No stone unturned[61]

If past experience is anything to go by, today's financial crisis will deal a hard blow to official development assistance flows. It could take ODA years to recover, dampening prospects for achieving the MDGs by 2015. Keeping aid afloat – ensuring that aid flows are sustainable and predictable – is critical to helping developing countries cope and also to stabilizing global demand. This is a tall order, given the scale of the crisis. Fresh new thinking is often the only way out of desperate situations such as this. UNCTAD puts one option on the table in this policy brief. The proposal may strike some as ambitious, naïve, or otherwise unviable. But today especially, every possible solution deserves consideration.

The current recession, and some of the stimulus measures being introduced to combat it, is compounding budget deficits and budget reallocations in many donor countries. ODA is a soft target in such situations; during past banking crises, it has dipped anywhere from 20% to 40%. A recent study[62] found that the crises affecting Finland, Japan, Norway and Sweden in the 1980s-1990s were all followed by a substantial decline in foreign aid, ranging from 10% in Norway to 62% in Finland. Furthermore, ODA levels tend to recover very slowly – in Sweden's and Norway's case, six-to-nine years after the trough, according to the same study. Finnish and Japanese aid flows, meanwhile, have yet to return to their pre-crisis peaks.[63] Given the depth of today's crisis, the recovery period is likely to be similarly long.

Recent econometric calculations by UNCTAD of all donor countries that have undergone a banking crisis in the past 30 years confirm the positive correlation between banking crises and shrinking ODA (see figure). In the year of the crisis, average ODA drops by about one percentage point. In the following year, the cumulative drop is about four percentage points, and in the fifth year, 30 percentage points.

While the dip is partially driven by the extraordinary experience of Finland, the dotted line in the figure shows that the slump is significant even when that country is excluded from the analysis.

What will this mean for developing countries, especially those whose development, domestic spending and daily survival depend heavily on foreign aid?

First of all, if ODA recovers from the present crisis as slowly as it did previously – say, three to four years hence, just when world markets are beginning to pick themselves up again – developing countries will be caught short, lacking the productive capacity they need to take advantage of reviving opportunities.

Second, since some donors set their aid targets as a percentage of GDP, a drop in GDP could lead to a drop in aid. Moreover, aid budgets are usually fixed in domestic currency; and if that currency depreciates against the recipient's currency, the value of the aid budget in the recipient currency will decrease as well. The UK's aid budget, for example, is expressed in pounds, whose exchange rate has fallen steeply in recent months. Its recent depreciation will thus translate into a "real" decline of British ODA for most of the countries receiving that aid.

This dire situation cannot be addressed through worn-out remedies. New thinking will be needed – and indeed, several innovative proposals are already on the drawing board or in the trial stages, including a currency transaction tax, global lotteries, vulnerability funds, subsidized investment funds for developing countries, and markets targeting ethical investors. Another solution that merits serious thinking, even if it initially appears utopian, would be to create safe, ODA-specific endowments funded by the interest on the assets. The endowment model has worked repeatedly well for educational institutions, and could similarly fulfil the critical need for predictable ODA flows.

Predictability has generally not been assured thus far, because aid budgets, like other government budget lines, are subject to annual or pluriannual decision-making processes. If aid agencies were instead provided with an endowment, and their activities funded through the interest earned on principal, this would give them a degree of independence and help stabilize the global economy in the process. In order to eliminate debt roll-over problems this endowment could be created by issuing government consols ("consolidated annuities"; i.e., government bonds with no maturity date). The aid agency could then use the interest revenues from the consols to fund its activities – but would be prohibited from using the capital.

Is it feasible?

Several concerns could be raised about this proposal, but all of them can be addressed.

The first concern might emanate from financial markets and voters in reaction to a large and sudden rise in the country's debt-to-GDP ratio. However, the funding mechanism proposed by this policy brief would involve an increase in "gross" but not "net" government debt, since the newly issued government bonds would be held by one of the government's own agencies, with no change to the aggregate balance.[64]

A second concern could be that the government would fail to honour the consols – the reason being that because they represent debt the government owes to itself, defaulting on them would be of little consequence. While this possibility is fairly remote, the concern could be dismissed if the aid agency were allowed to sell some of the consols and use the proceeds to buy other types of long-term government bonds – as long as it were not also allowed to hold risky assets. If there were any defaults on the consols, and the consols were held by any party other than the government, that party would view the default as a sovereign default, with all the damaging impact such an event can engender.[65] The government would thus have a strong incentive to honour its obligations.

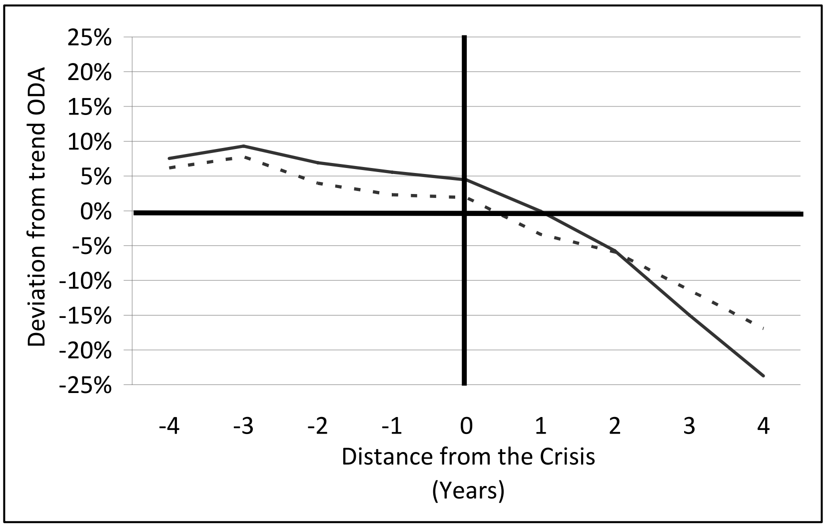
A third possible concern is that the proposed funding mechanism would not protect the quantity of aid from fluctuations in the exchange rate of the donor currency. This could be addressed by endowing the aid agency with government bonds denominated in a mix of currencies – or by having aid agencies from different countries exchange part of their endowment, which would also allay the second concern. In fact, donor governments might even consider endowing the aid agencies with debt instruments issued in emerging market currencies and thus develop a useful new market for debt denominated in such currencies. Clearly, however, the costs and benefits of altering the currency composition of the endowment need to be evaluated carefully, because linking the aid budget to the value of the currency of emerging market countries could lead to procyclical aid flows.[66]

In everyone's interest

As previously mentioned, the endowment proposal may appear ambitious and politically unviable – especially in today's global economic environment, where donor governments are likely to give higher priority to domestic concerns than external obligations. But the magnitude, complexity and global dimensions of the current crisis are such that all possible responses must be considered.

It is now widely accepted that the crisis can be tackled only through coordinated global responses that involve not just developed but also emerging, transition and developing economies. For the latter, foreign aid provides the main, and in some cases the only, source of the financing needed to prevent their sliding into deep recession and losing their hard-earned productive and exporting capacities. For these countries, the kind of stimulus package that more advanced nations are able to offer themselves is simply out of reach. But their economic survival depends on keeping demand healthy. And given the extent of global interdependence today, maintaining aid commitments and stabilizing aid flows will do much more than help recipient countries: it will also help stabilize global demand, which is in everyone's interest.

Figure 1. Banking crises and Official Development Assistance



Source: UNCTAD calculations, based on OECD data.

The solid line includes all DAC donors that underwent a banking crisis in the 1970-2002 period. The dashed line excludes Finland. Both lines measure the percentage deviation of ODA from its long-run trend.

Chapter VI

DMFAS – UNCTAD's response to capacity-building needs in debt management

A. Introduction

The experiences of successive financial and debt crises have clearly demonstrated the need to build the capacity of developing countries to effectively manage their public debt. While good debt management contributes to improved governance, debt sustainability and ultimately poverty reduction, these benefits are possible only when a country has adequate human and institutional debt management capacity. It is an unfortunate fact that many developing countries lack the required capacity and need external assistance to build it. This paper describes how UNCTAD has responded to this important need through its policy of providing technical assistance in debt management by way of its Debt Management and Financial Analysis System (DMFAS) Programme.

The chapter first introduces the DMFAS Programme, which is part of the Debt and Development Finance Branch of UNCTAD, then describes the precise needs the programme addresses. It then provides an overview of the approach the programme takes in assisting developing countries and countries with economies in transition to strengthen their debt management capacity.

B. The focus of the DMFAS Programme

In establishing DMFAS as one of its flagship technical cooperation programmes, UNCTAD has committed to providing the highest quality assistance to developing countries in strengthening their human and institutional capacity to manage public debt. The programme is a good model for how the United Nations builds capacity at the country level, in support of good governance, development and poverty reduction. In partnership with other organizations and the donor community, it provides countries with the means to improve their management of public liabilities, and consequently public resources, through the strengthening of their institutional capacity in this important area.

DMFAS is also a very good example of UNCTAD's commitment to providing sustained support for development. Over a period of 27 years, the programme has supported over 100 institutions in more than 66 countries, responding to the changing and increasingly complex needs of debt management offices. Having originated as a means to help countries build good external debt databases, the programme's scope has gradually widened to encompass all domestic and external public debt, and private external debt. The programme has also expanded in terms of the debt management functions it supports, from the original recording of debt to the inclusion of debt data validation, debt statistics and the provision of the data critical to risk analysis, debt sustainability analysis and strategy formulation. With its focus on sustainable capacity-building, the programme's activities are designed to help governments achieve the benefits of improved governance and poverty reduction that good debt management can provide.

C. The needs DMFAS addresses

Significant progress has been made by many countries in strengthening their debt management capacity. However, many countries still do not have either the required skills and knowledge to effectively manage their debt or access to comprehensive and reliable debt data. Others still have limited coverage of their debt, maintaining debt records for only some categories of central government debt. The consequence of incomplete information is a weaker ability to undertake the comprehensive risk and debt sustainability analysis and strategy formulation needed for good decision-making at the highest levels. There is also much work to be done in integrating debt management functions with the broader processes of public finance management and administration, including integrated financial management systems. Furthermore, the demands on debt management offices evolve and additional and sustained support is necessary to assist them to adequately adjust to the changes in their financial environments.

Among the key challenges faced by developing countries in managing debt are high staff turnover in debt management offices and the dynamic changes in financial practices, demand and technology. High staff turnover creates the need for sustained assistance in training new staff on a periodic basis. The dynamic changes in finance and debt practices result in the need for the debt management offices to regularly adapt the organizational procedures, the skills of debt management staff and the computer systems available to them. In facing these challenges, countries need appropriate capacity-building solutions designed to suit the particular needs of their debt management offices; a "one-size-fits-all" approach would be insufficient.

The DMFAS Programme addresses these needs through a comprehensive approach to capacity-building that focuses on its areas of comparative advantage.

D. DMFAS approach to capacity-building

The DMFAS Programme's approach to addressing the many needs of developing countries to strengthen their capacity in debt management has a number of core elements:

- Systematic needs assessment and consultation;
- Comprehensive, tailored, results-based projects;
- State-of-the-art Web-based software;
- Portfolio of capacity-building modules;
- Support for integration with other functions and systems; and
- Synergy and coordination with other technical assistance providers.

Each element is described in the following paragraphs.

1. Systematic needs assessment and consultation

The first step in UNCTAD's approach to debt management capacity-building is to fully understand the needs of developing countries. This is done at both the international and regional level, and at the level of individual countries.

At the international and regional levels, the approach that has proven to be most effective has been twofold: (a) maximizing the synergies between UNCTAD's research and analytical work in debt management and development finance; and (b) participating in international standard-setting bodies such as the Task Force on Finance Statistics, and monitoring new practices in the area of debt management, including through the multi-stakeholder dialogue at UNCTAD's biennial Debt Management Conference. Consultation with developing countries through the DMFAS Advisory Group also provides valuable insights into evolving requirements.

At the national level, DMFAS systematically conducts comprehensive needs assessments of countries' needs. Assessments are done in close collaboration with national authorities and solutions to identified needs are generally incorporated into a technical assistance project document.

Overall, by working directly with the countries as well as with international and regional organizations involved in debt, the programme identifies best practices in debt management and translates them into specialized products and services.

2. Comprehensive, tailored, results-based projects

Country-specific technical assistance projects serve as the delivery vehicle for DMFAS' technical assistance to individual countries. A comprehensive project is designed to address the identified needs and the activities within are customized to the specific situation of the country. These tailor-made projects are designed to produce clear and measurable outputs and results. Specific elements of the project are selected from the programme's range of products and services.

3. State-of-the-art Web-based software

The core component of the DMFAS services is the Debt Management and Financial Analysis Software (also known as DMFAS) designed to meet the operational, statistical and analytical needs of debt managers and bodies involved in elaborating public debt strategies. The software is a public good that is updated regularly in line with changing needs and is designed to strengthen the institutional capacity of countries to manage their debt.

The latest version of the software, DMFAS 6, was launched in November 2009 and provides comprehensive coverage of all debt instruments and types: public external debt, publicly guaranteed debt, domestic debt (including money market instruments, bonds, and notes), private external debt (detailed or aggregated), and short-term external debt.

DMFAS 6 also provides the essential functionality for all debt management functions: debt data recording and operations, debt securities auctioning, debt reorganization, statistics and analysis (including ratios and sensitivity analysis). It is built on a flexible, modular design that facilitates customization, including availability in five languages. As such, it satisfies a range of different requirements in back, middle and front offices.

As a Web-based system that provides a debt portal, this version can be run over the Intranet or Extranet, or as a stand-alone system. It also contains interfaces to other financial management systems such as Integrated Financial Management Systems (IFMIS), debt strategy tools (such as the Medium-term Debt Strategy System (MTDS)) and the external providers of financial information (Reuters, for example).

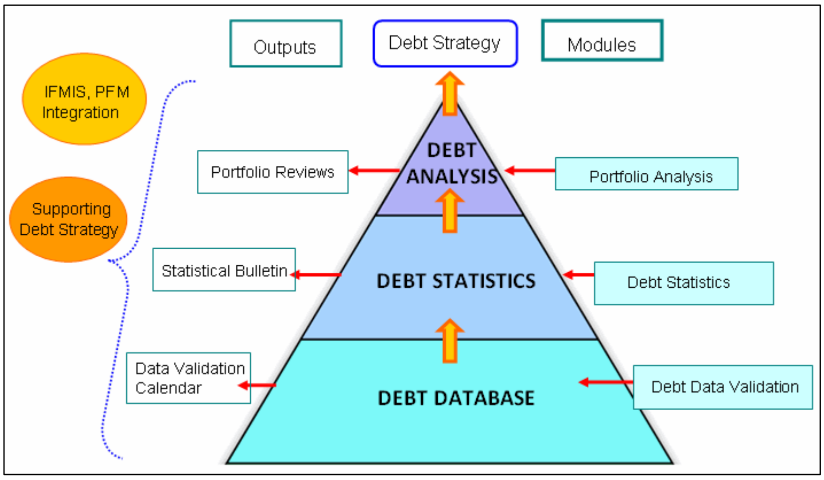
The programme also provides continuous Helpdesk support to the users of the system.

4. Portfolio of capacity-building modules

In addition to the provision of software, DMFAS also offers a portfolio of comprehensive capacity-building services in debt management. The portfolio includes standard, flexible training modules for using the DMFAS system, debt data validation, debt statistics, debt portfolio analysis and integration with other systems. An important element of UNCTAD's approach to capacity-building is the focus on concrete results; most training provided is done through the organization of workshops that produce tangible outputs (a statistical bulletin or validation calendar, for example). This approach helps to ensure the sustainability of local capacity.

The portfolio of capacity-building modules that the programme offers to developing countries is designed to support a bottom-up approach. Figure 1 shows the coverage of these modules for each of the tiers of the DMFAS capacity-building pyramid. This bottom-up approach complements the top-down approach of other providers who concentrate on capacity-building in debt strategy, risk and debt sustainability analysis.

Figure 1. DMFAS capacity-building modules



In the context of capacity-building, one of the key success factors for DMFAS has been its ability to facilitate cooperation between the debt offices of different countries. This has enabled many countries to benefit from the experience and knowledge of countries that are more advanced in certain areas of debt management.

5. Full support for integration with other functions and systems

DMFAS provides training, support and guidance to countries in response to their requests for support in integrating their debt management systems with other systems and functions in the overall public finance management (PFM) framework. The programme provides support in the development and maintenance of interfaces both directly between systems such as budget and accounting, and also with integrated systems such as IFMIS. Support and training is also provided for interfacing the DMFAS system with the tools offered by other providers, such as MTDS and the Debt Sustainability Framework (DSF) of the World Bank and the International Monetary Fund. A more recent development is the need to interface DMFAS with Aid Management Systems.

Standard interfaces to commonly-used software such as MTDS and DSM-Plus are provided as part of the DMFAS software.

6. Synergy and coordination with other technical assistance providers

A key element of UNCTAD's policy for debt management technical assistance is cooperation with other providers of technical assistance in the area of debt management capacity-building. This cooperation has three aspects: (a) liaising with partner debt management technical assistance providers to coordinate activities; (b) focusing on the programme's core competencies – recording to debt portfolio analysis; and (c) joint activities with organizations that specialize in cross-cutting themes such as aid management and statistical harmonization. This three-fold approach enables the programme to avoid duplication and build on comparative advantages. It also enables it to better satisfy the precise needs of developing countries with respect to public governance issues interlinked with debt management. The programme's work is complementary to that of the organizations with which it cooperates, and there are clear interdependencies. For example, to formulate effective debt strategies with the assistance of the World Bank or the IMF, the country must first build a comprehensive debt database to be able to produce reliable reports and statistics with the support of a provider such as DMFAS, after which relevant analysis can be carried out and well-informed decisions can be made.

The programme has built productive working relationships over the years with regional organizations, multilateral organizations, regional development banks and others. The recently finalized partnership agreement between DMFAS and the Debt Management Facility (DMF) led by the World Bank is a good example of effective cooperation between providers. In this initiative, the DMFAS focus on “downstream” activities complements the “upstream” activities of the World Bank and the IMF.

E. Summary

As UNCTAD’s primary policy response to the needs of developing countries to strengthen their capacity to manage debt, the DMFAS programme assists countries in obtaining the benefits of improved governance, debt sustainability and ultimately poverty reduction that good debt management can provide. DMFAS offers countries a comprehensive range of products and services in key areas from debt data recording to debt portfolio analysis. The state-of-the-art debt management software it provides is complemented by a portfolio of results-oriented capacity-building modules. Assistance is tailored to the needs of individual countries through comprehensive projects. A focus on areas of comparative advantage and cooperation with other providers ensures complementarity and synergy. Having successfully provided technical assistance in debt management for over 27 years, the programme has a proven track record for results in assisting countries to build and retain adequate human and institutional capacity for effective debt management.

Chapter VII

Promoting responsible sovereign lending and borrowing, including developing guidelines and criteria for assessing legitimacy of sovereign debt

An increasing interest in engaging in responsible lending and borrowing has been observed in recent years, both from the lender and from the borrower side. Borrowers, especially from developing countries, have brought the issue to the fore by questioning lending motives and the use of borrowed funds by previous governments. There are widely differing views among stakeholders, including civil society, of what constitutes responsible practices. No universally agreed principles for responsible sovereign lending and borrowing currently exist. A unilateral repudiation of debt is not a realistic option for most borrowers, because it would have a negative effect on the country's reputation and may cost the country dearly with respect to new financing and investments. An approach which can be part of an international consensus is hence needed. Therefore, UNCTAD has recently initiated a project under the broad heading of Promoting Responsible Sovereign Lending and Borrowing.

This project involves, inter alia, the development of a set of guidelines to promote and foster mechanisms to enhance responsible sovereign lending and borrowing. The private sector has already established codes of conduct in certain areas, such as the Equator Principles, that may provide inspiration. The project therefore aims to build consensus around a set of guidelines that eventually could lead to the establishment of criteria to assess whether the contracting of sovereign debt has been performed in accordance with internationally accepted principles.

Hence, the resolution of issues arising in the context of sovereign lending and borrowing could be facilitated if lenders and borrowers could refer to an agreed set of standards to observe during the negotiation phase. The parties would then not only have a common reference point in the case of a dispute, but they would also be encouraged to follow generally accepted principles that enhance responsible practices.

The project will also study closely connected topics such as the analysis of new sovereign lenders and their lending practices, including the re-emergence of export credits and impacts on future debt sustainability. The project seeks to establish a forum for broad dialogue among lender and borrower States. Therefore, based on multidisciplinary elements and considerations (e.g. economic, legal, social, development, etc.) the set of guidelines for responsible lending and borrowing will be enhanced.

Project objectives

Create a forum for the study and documentation of the practices and standards on responsible sovereign lending and borrowing and related consensus-building activities. This will include inter alia the analysis of new sovereign lenders, their lending practices and impacts on future debt sustainability.

Develop a set of guidelines to promote responsible sovereign lending and borrowing and invite a discussion on the possible use of such guidelines as criteria for assessing legitimacy of sovereign debt.

Promote the discussion on the different options for a structured approach to resolving defaults and disputes between sovereigns and private creditors.

Create a global debt portal targeted at borrowers, lenders, policy-makers, debt managers and researchers.

UNCTAD has set up two working groups to commence discussions and the drafting of the guidelines. These two groups are the Expert

Working Group (Expert Group) and the Advisory Group. The creation of these groups involved extensive interaction and consultation with key stakeholders. UNCTAD coordinates and is the secretariat to the Expert Group, which comprises distinguished experts who act in their professional capacity, and represent no national or outside interest other than the fostering of responsible sovereign lending and borrowing. Given the need for the Expert Group to conduct extensive consultations with a broad range of very different interest groups, and the considerable interest observed among stakeholders in becoming a member of the Expert Group, it has a diverse composition including academics, lawyers, economists, policymakers, members of civil society, etc. The Expert Group acts as a source of technical and policy analysis that will inform the discussion on factors that could promote responsible sovereign borrowing and lending.

The Advisory Group is composed of government representatives, representing national, regional, as well as other interests. The group will draw from each member’s experience and political interests and will provide input to the Expert Group. As its name indicates, the Advisory Group will advise the Expert Group on the most salient features to be considered for the drafting of the guidelines to promote responsible sovereign lending and borrowing. The Advisory Group is open to any constituent of UNCTAD interested in joining its activities and helping to promote responsible practices in the subject area.

The first Expert and Advisory Group meetings were held in Geneva in November 2009. The response of both groups has been very positive. The Expert Group engaged in discussions on the substance of the project and their duties as well on the more practical aspects of their working process. Members of the Advisory Group expressed great interest in the initiative and voiced their support for the project.

Chapter VIII

Building capacities to address financial implications of external shocks and climate change mitigation through innovative risk-management instruments

The project is financed through the sixth tranche of the United Nations Development Account, and is planned for an execution over a period of 38 months. It will be implemented through a sequence of activities aimed at developing appropriate risk management policies to address climate change and external financial shocks, as well as country experiences in managing these risks. The results of this policy development effort and country experiences will be delivered to end-users through workshops, the provision of policy advice to national policymakers and decision-makers, and the publication of a synthesis paper on the appropriate use of instruments for managing currency, interest and climate change risks.

The project builds upon lessons learned from years of research and interaction between UNCTAD staff, and policymakers and debt managers from developing countries. In addition to its long-standing Debt Management (DMFAS) programme, UNCTAD has assisted a number of developing countries in Latin America and the Asia–Pacific region to re-profile their debt in the wake of natural disasters. Over the past several years, a number of debt managers have raised concerns that they need additional training to address risks to debt servicing arising from an increasingly integrated global financial system through adopting new instruments available to manage such risks. In addition, there is growing interest amongst policymakers in understanding the available options, such as issuing catastrophe bonds for mitigating the financial impact of natural disasters and diminishing the probability of debt default caused by exogenous shocks.

The overall goal of the project is to improve the institutional capacity at the national level in five developing countries from the Asia–

Pacific region to address the debt servicing implications of external shocks and climate change through risk analysis and the use of innovative risk-management instruments. The five countries that will benefit from the project are India, Viet Nam, the Philippines, Thailand and the Maldives.

The countries were selected using multiple criteria. India, the Philippines and Thailand all have successfully developed domestic capital markets, and are increasingly integrating their debt strategy to encompass an interplay between domestic, regional and global marketplaces to tap into the cheapest source of financing for development. Bond debt now accounts for the bulk of their debt stock, and their exposure to global movements in exchange and interest rates has increased substantially over the years. In this context, these countries are reporting an increasing need to adopt sophisticated risk management techniques in order to fully reap the benefits of globalization while using instruments and techniques that will mitigate the adverse impact of global financial volatility.

Viet Nam is a newcomer in the international capital market, with a successful launch of a $750 million global bond in 2005. Its rapid economic growth and the continuation of its integration into the international financial system make it essential for Vietnamese debt management institutions to fully understand the risks associated with external commercial debt. In particular, there is a need for extensive training of staff in the debt management office, as the transition from official debt to commercial borrowing has occurred rapidly, and there is a lack of sufficiently qualified staff to address risk management issues.

The increased integration of the Asia–Pacific region into the global financial system has brought a number of benefits to their economies. However, being part of an integrated world capital market has also increased the exposure of their debt obligations to exogenous financial shocks beyond the control of national governments. The volatility of international interest rates and sudden movements in the cross rates of some of the key world currencies can produce undesired outcomes for countries' external debt obligations as well as create large swings in capital flows affecting local capital markets and domestic borrowing costs. The recent volatility in food prices can place additional strains on government budgets and poses risks for continued debt servicing.

Climate change and the expected increase in extreme weather events increase the risk of disruptive and costly inland flooding and coastal area damage in India, the Philippines, Viet Nam and Thailand. The Maldives represent a special case, as its budgetary position is heavily influenced by tourist revenues, which are dependent on a benign climate in its coastal region. Yet the risk of rising sea levels and more frequent storms raises the likelihood of more weather volatility, which can cause important disruption to its main revenue-generating activity. As the tsunami of 2004 demonstrated, the Maldives can go into an unsustainable debt position in a matter of days as a result of extreme weather. In this context, instruments for managing risks emanating from weather events have become an important element for achieving debt sustainability and avoiding financial crisis.

At present, there is insufficient institutional capacity in developing countries in the region to analyse risk. In these circumstances, a number of countries in the region have indicated that they need to increase their capacity to manage risk associated with the increased integration of their economies into the global financial system, as well as risks associated with climate change and extreme weather events. As a result of the project, all countries will have an improved tool kit for analysing risks to their debt position emanating from climate change risk and risks posed by exogenous shocks. Furthermore, debt managers will acquire the know-how for using innovative risk management instruments to mitigate the effects of these risks and minimize the impact of exogenous shocks on the financial soundness of their economies. It is expected that the improved capacities to deal with exogenous shocks will persist well beyond the termination of the project. Previous experience also indicates that, after the completion of projects, debt managers who met during workshops continue to exchange experiences and best practices amongst themselves.

Endnotes

[1] This chapter is based on official UN document A/64/167 of the United Nations General Assembly (24 July 2009).
[2] The World Bank estimates that developing countries corporate debt falling due in the first six months of 2009 amounted to $100 billion.
[3] World Bank (2009), Global Development Finance, Washington, D.C.
[4] The presence of foreign banks is particularly important in East Europe and Central Asia and in sub-Saharan Africa. Contrary to conventional thought, foreign banks located in low-income countries are often less efficient than domestic banks. See Detragiache, Tressel, and Gupta, 2008, "Foreign Banks in Poor Countries: Theory and Evidence," Journal of Finance, vol. 63.
[5] Gande and Senbet (2009) "The Impact of Global Economic Crisis on Debt Sustainability of Low-Income Countries," unpublished, University of Maryland.
[6] World Bank (2009), Global Development Finance, Washington, D.C.
[7] Countries covered in the previous report that rescheduled their Paris Club debt in 2008 are The Gambia, Guinea, Liberia and Togo.
[8] UNCTAD,2009, "Keeping ODA afloat: no stone unturned", UNCTAD Policy Brief No.7, March, http://www.unctad.org/en/docs/presspb20092_en.pdf.
[9] The partnership includes the Agence Française de Développement, the Development Bank of Southern Africa, the European Investment Bank, the German Federal Ministry for Economic Development and Cooperation, the Islamic Development Bank and the World Bank.
[10] This financing mechanism was established in 1995 to provide rapid financing to member countries. Until September 2008 the mechanism had only been employed five times: four times during the Asian crisis and once for Turkey in 2001.
[11] A precursor of the FCL was the Contingent Credit Line which was created in 1999 but discontinued in 2003 because no country ever applied for the facility.
[12] Qualification criteria include: strength of the current account, strength of public finances, the sustainability of public debt, and level and stability of inflation.
[13] The appropriateness of the CPIA was recently questioned by the IMF Executive Board which agreed on the need for "objective, credible criteria"

for the assessment macroeconomic management capacities (see IMF, Public Information Notice No. 09/39, March 30, 2009).

[14] Governors representing 11 borrowing members of the Inter-American Development Bank discussed this problem in a 2004 open letter known as the "Carta de Lima".

[15] UNCTAD (2008), Trade and Development Report, Chapter 7.

[16] Inter-American Development Bank (2007), Living with Debt.

[17] IMF, Public Information Notice No. 09/39, IMF Executive Board Discusses Reforms of Lending Instruments for Low-Income Countries, March 30, 2009.

[18] UNCTAD (2009), "The global economic crisis: systemic failures and multilateral remedies", Report by the UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation.

[19] Only $50 billion were targeted specifically to low-income countries (A/CONF.214/3). Nearly one quarter of the additional resources committed by the G20 will take the form of the issuance of SDR. Since SDR are allocated according to IMF quotas, only about one half of the increase in SDR will be translated into the Fund's ability to extend loans to developing countries, with a very small share going to low-income countries.

[20] There are some low-income countries that are able to absorb larger amounts of debt which should be granted more flexibility under the DSF.

[21] This paper was prepared for the President of the General Assembly and sent out on 30 September 2009.

[22] PRGF: IMF Poverty Reduction and Growth Facility. We look at non-PRGF programs as they reflect the changes in the economic landscape excluding the ongoing HIPC activities which follow a timetable of their own.

[23] United Nations (2009). "The Millennium Development Goals Report 2009", New York, 2009.

[24] Amar Gande and Lemma W. Senbet (2009): "The Impact of Global Economic Crisis on Debt Sustainability of Low-Income Countries" (mimeo, UNCTAD).

[25] Sovereign spreads measure the difference between the borrowing cost of the US government and that of dollar-denominated debt issued by emerging countries. The difference in borrowing costs derives from the pricing of perceived risks of default and expected losses.

[26] For instance, sovereign spreads in Latin America reached a high of 1700 basis points after the Russian crisis in 1998, and yet Latin America had no economic connections with Russia. This was a case of “financial contagion” driven by the fact that the same Wall Street investors who held Russian bonds also held Latin American bonds. When Russia defaulted in 1998, these investors indiscriminately sold the whole asset class. Even starker examples of the exogenous nature of volatility are the sudden increase in spreads in the aftermath of September 11, 2001 attacks and the current financial crisis. Both of these events concerned the centre of the world financial system but had large negative effect on the borrowing costs of emerging market countries.

[27] In fact, weighted averages – placing greater weight on larger economies – show that developed countries have the highest debt levels. It may be argued that the above discussion, which focuses on total public debt, is misleading because developed countries have much lower levels of external debt with respect to developing countries. There are two possible answers to this criticism. The first is that debt sustainability exercises that only focus on external debt are flawed. There is ample evidence that domestic public debt is a considerable source of vulnerability and that many debt crises originate in the domestic debt market (Reinhart and Rogoff (2008) “The Forgotten History of Domestic Debt” NBER Working Paper 13946). Moreover, in a world in which several emerging market countries have open capital accounts and borrow by issuing bonds, the distinction between external and domestic debt becomes somewhat artificial. Second, a comparison of the external debt situation of the developing world with that of the United States shows that there is no evidence than the United States has lower external debt than the average developing country. While there is some worry about a possible depreciation of the US dollar, there is little concern about a default by the US government, yet US Treasury bonds continue to carry a AAA credit rating and pay very low interest rates.

[28] (Eichengreen and Hausmann (1999) “Exchange Rates and Financial Fragility” NBER Working Paper 7418. Eichengreen, Hausmann, and Panizza (2005) “The Pain of Original Sin”, in: Eichengreen and Hausmann (eds.) “Other People’s Money”, University of Chicago Press.

[29] Consider the case of two countries with similar debt levels but with different debt composition: Country D has all of its debt denominated in domestic currency and country F has all of its debt denominated in foreign currency. Further assume that the two countries enter a recession and decide to adopt expansionary macroeconomic policies, which lead to a depreciation of the exchange rate. In country D, the expansionary policies are likely to stimulate the economy and improve both external and debt sustainability. In country F, the currency depreciation will increase the domestic currency value of the debt (this is often referred to as a negative balance-sheet effect) and may lead to a higher debt ratio and possibly to a debt crisis. As a consequence, countries with a large amount of foreign currency debt may face serious constraints in conducting countercyclical macroeconomic policies.
[30] A standard answer to this claim is that if such new instruments were viable there would be no need for policy interventions because the market would provide them. This line of reasoning does not recognize that the creation of innovative instruments would lead to positive externalities and therefore limit market incentives for the supply of such instruments (Borensztein, Levy Yeyati, and Panizza (2006) “Living with Debt”, Harvard University Press and Inter-American Development Bank).
[31] Since money is fungible, the latter statement does not need to be applied literally. However, whenever a country borrows abroad it needs to make sure that the economy can generate the external resources necessary to service the debt.
[32] The need to increase spending and cut taxes during bad times is often not matched by the desire or ability to cut spending or increase taxes in good times.
[33] According to the Lawson-Robichek doctrine any payment problem linked to private external debt would only affect the parties directly involved in the debt contract and will not have the macroeconomic effects which are typically associated with sovereign debt crises. This view was discredited by the debt crisis of 1982 and the Asian crisis of 1997/98 which hit several countries with large current account deficits but high private investment rates and balanced fiscal accounts.

[34] For a discussion of carry trade, see UNCTAD (2007) Trade and Development Report, Chapter I. For a discussion of derivative-related exposures in the corporate sector, see Alejandro Jara, Ramon Moreno, and Camilo Tovar (2009) "The Global Crisis and Latin America: Financial Impact and Policy Responses" BIS Quarterly Review, June 2009.

[35] Eichengreen and Hausmann (2005) "Original Sin: The Road to Redemption" (in: Eichengreen and Hausmann (eds.) "Other People's Money", University of Chicago Press) proposed that the multilateral development banks should issue bonds denominated in an index that pools currency risk from a diversified group of emerging economies.

[36] For discussions of GDP-Indexed Bonds see Borensztein and Mauro (2004) "The Case for GDP-Indexed Bonds", Economic Policy, Vol. 19, No. 38, pp. 165-216, April 2004, and Griffith-Jones and Sharma (2006) "GDP-Indexed Bonds: Making It Happen" UN DESA Working Paper No.21, ST/ESA/2006/DWP/21.

[37] Recently, the Minister of Finance of Mexico received high praises for having adopted a prudent policy aimed at hedging the volatility of oil prices. This hedging policy was prudent and wise, and it would have been prudent and wise even if the prices of oil had increased instead of decreased (like buying insurance is prudent even if one does not have accidents). However, one could imagine the type of criticism the Mexican government would have been subject to if the price of oil had increased instead of decreased. This type of political risk is one of the main reasons why policymakers have limited incentives to enter into such insurance contracts. In fact, even articles that praised the Mexican Minister Agustin Carstens labelled this policy as a "gamble" rather than as a prudent insurance policy (Javier Blas "Mexico's big gamble on oil pays off," Financial Times, September 8, 2009).

[38] "Heavily Indebted Poor Countries Initiative and Multilateral Debt Relief initiative - Status of Implementation", IDA and IMF, September 2009.

[39] This latter view is often referred to as the Lawson doctrine and takes its name from a 1988 speech of the British Chancellor of the Exchequer Nigel Lawson who, while commenting on the UK current account deficit, stated that: "in the past […] UK current account deficits were almost invariably associated with large budget deficits, poor economic performance, low

reserves and exiguous net overseas assets. The present position could not be more different." Ironically, within one year from this speech the UK entered into a deep recession.

[40] In theory this is also true when external debt is denominated in a country's own currency, but countries that can issue the currency in which their debt is denominated have the options to debase their debt by printing more money.

[41] IMF (2002) "Assessing Sustainability." Policy paper prepared by the Policy Review and Development Department, May 28, 2002. Washington, DC.

[42] Buiter (1985) "Guide to Public Sector Debt and Deficits" Economic Policy: A European Forum 1: 13-79.

[43] This is the reason why the literature on original sin and currency mismatches (Eichengreen, Hausmann and Panizza (2005) " The Pain of Original sin" (in: Eichengreen and Hausmann (eds.) "Other People's Money", University of Chicago Press) argues that external borrowing may be dangerous even in the absence of a transfer problem. As the external debt of developing countries tends to be in foreign currency, a country's ability to repay its debt will depend on the behaviour of the real exchange rate which, in developing countries tends to be very volatile (Hausmann, Panizza, and Rigobon (2006) "The long-run volatility puzzle of the real exchange rate" Journal of International Money and Finance, Vol. 25/1, pp. 93-124). There should be no vulnerabilities for countries, like the United States, that can borrow abroad in their own currency (or better in a currency they can print).

[44] Based on the presentation at the Debt Managers' Seminar organized by MEFMI, 23-26 Feb. 2009.

[45] Mrs. Yuefen Li is Head of Debt and Development Finance Branch of UNCTAD. The views expressed are solely those of the author and do not necessarily reflect the views of UNCTAD or its Member States. The author is grateful to Yilmaz Akyuz, Kristine Forslund, Matthias Rau-Goehring, Makameh Bahrami and Ugo Panizza for very helpful comments and statistical assistance. The paper was updated to include some new data.

[46] Sunil Kewalramani, Will 2009 be the year of sovereign defaults? Business Standard, January 24, 2009, New Delhi.

[47] External debt and development: towards a durable solution to the debt problems of developing countries, United Nations document for the General Assembly, A/63/181, 28 July 2009. website: http://www.un.org/ga/search/view_doc.asp?symbol=A%2F63%2F181&Submit=Search&Lang=E.

[48] World Bank News Release No:2009/219/AFR, Call for Action to Mitigate Effects of the Financial Crisis on Africa., 5 Feb. 2009.

[49] Global Monitoring Report 2009: A Development Emergency. The World Bank and the IMF , April 2009, p.25.

[50] Source of information: Bloomberg.

[51] International Tourism Challenged by Deteriorating World Economy, 27 January 2009, World Tourism Organization, http://www.unwto.org/media/news/en/press_det.php?id=3481&idioma=E.

[52] Griffith, W., Caribbean Tourism Organization, http://www.ilocarib.org.tt/portal/images/stories/contenido/pdf/ILOinCaribbean/Meetings/GFC09/Griffith-GFC.pdf.

[53] Gamberoni, E and Newfarmer, R. Trade protection: Incipient but worrisome trends, 4 March 2009. http://www.voxeu.org/index.php?q=node/3183.

[54] Auboin, Marc and Moritz Meier-Ewert (2008). "Improving the Availability of Trade Finance during Financial Crises," WTO.

[55] Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation, Prepared by the Staffs of IDA and IMF, September 2008, Washington.

[56] Bank of International Settlement, Detailed Tables On Provisional Locational And Consolidated Banking Statistics At End-December 2008, Basel, Switzerland, April, 2009.

[57] Monthly Economic review, Bank of Uganda, Feb. 2009.

[58] Holmqvist , Göran: How is Africa affected by the financial crisis – and by global recession?, 10 October 2008, The Nordic Africa Institute.

[59] Web link: http://www.unctad.org/sections/gds_debt/docs/gds_dmfas_bn02-09_en.pdf, Feb. 2009.

[60] The World Bank, "Swimming against the tide: How developing countries are coping with the global crisis", March 2009.

[61] Published as UNCTAD Policy Brief No. 7, March 2009.
[62] David Roodman, "History says financial crisis will suppress aid", 13 October 2008, http://blogs.cgdev.org/globaldevelopment/2008/10/history_says_financial_crisis.php.
[63] Some of the countries that cut their aid in the 1980s-1990s have recently pledged to increase it, despite mounting domestic difficulties in facing the current crisis.
[64] Holding total aid constant, the proposal only involves a shift in the composition of government budget, with aid moving from non-interest current expenditure to interest expenditure.
[65] Ugo Panizza, Federico Sturzenegger and Jeromin Zettelemeyer, «The Economics and Law of Sovereign Debt and Sovereign Default», Journal of Economic Literature, forthcoming. Mr. Panizza is a senior economist at UNCTAD.
[66] For a discussion of "original sin" in international finance see Eichengreen, Hausmann and Panizza (2007), "Original Sin, Debt Intolerance and Currency Mismatches: Why They Are Not the Same and Why It Matters", in S. Edwards (ed.), Capital Controls and Capital Flows in Emerging Economies: Policies, Practices and Consequences. NBER and University of Chicago Press.