7

Reducing External Debt Burdens to Revive Growth and Development

An as yet unresolved issue that obfuscates determination of additional ODA requirements is the hardy perennial of external debt. In discussing this question it is instructive to recall that, in the 1980s, the Latin American (or middle-income country) debt crisis was serially mishandled for eight years with one misguided plan following another.[50] That happened because the nature of the crisis was only partially diagnosed. The fault was seen to lie in irresponsible borrowing, rather than with equally irresponsible lending by creditors. The main emphasis, therefore, was on protecting the interests of commercial creditors (ostensibly to avoid destabilising the international financial system), regardless of the enormous economic cost and social and political damage inflicted on debtor countries. As a result, by 1989 the debt problem of Latin America, as well as of a few other middle-income countries, ballooned out of all proportion to the initial problem. Effectively Latin America lost two decades of development. Its standard of living in 1990 regressed to that of 1970. A solution to the crisis came belatedly in 1989 (under the Brady Initiative) with the reduction of a significant part – approximately 40 per cent – of the outstanding commercial bank debt of that region through exchanges of syndicated loan balances for marketable bonds of different types.

However, as Table 8 shows, the region's residual debt overhang (along with that of other countries like Turkey, Russia and Indonesia) remains excessive, with disproportionately larger debt service obligations. These resulted in a gross resource outflow on the debt account equivalent to 6 per cent of Latin America's GDP in 1999 and 8 per cent in 2000. It would be inconceivable for such a large debt-service burden not to act as a brake in preventing the region's accelerated development. A debt service burden of that size makes the region excessively vulnerable to financial crises as the experiences of Mexico (1995), Brazil (1998) and now the even more serious debt problems of Argentina and Ecuador (2000–1) suggest. Although Latin America turned a corner with the Brady Initiative, the debt problem of Africa remains largely unresolved 12 years later.[51]

The overall external debt and debt service situation of the developing world, and how it has evolved since 1970, is summarised in Table 14. It highlights the following features:

- In 30 years (1970–2000) the external debt of developing countries increased by nearly 40 times. It increased 9 times between 1970–80

50 These plans, of which there were too many to mention, included the notorious Baker Plan of 1985 which relied on using massive multilateral lending to pay back commercial banks, thus replacing non-preferred creditors with preferred creditors and making the second generation debt problem of these countries even more intractable in terms of debt restructuring. See Rowan, H. *Self-Inflicted Wounds: From LBJ's Guns and Butter to Reagan's Voodoo Economics*. New York: Times Books Random House, 1994, pp. 279–306.

51 This is so despite a series of initiatives to reduce Africa's debt burden since 1985. These include successively more generous rescheduling actions by the London Club (for private debt) and Paris Club (for official bilateral debt). That the debt burden remains suggests that, although progressively more generous, rescheduling terms have still been insufficient; suggesting also that what is needed is outright cancellation of outstanding debt on a much larger scale than the 40 per cent reduction brought about in Latin America. In Africa such reduction may need to range between 75–100 per cent. The most recent efforts to resolve the problem were the highly indebted poor countries' (HIPC) Initiatives of 1996 (HIPC-1) and 1999 (HIPC-2). Notwithstanding the hyperbole surrounding them, these initiatives have yielded little except to divert attention from higher priority development concerns.

Table 14. External Debt and Debt Service Burdens of Developing Countries 1970–2000
(Amounts in US$ billion)

	1970	1980	1991	1995	1996	1997	1998	1999	2000*
Total External Debt	**68.3**	**609.5**	**1,561.3**	**2,162.6**	**2,238.4**	**2,316.6**	**2,536.0**	**2,554.0**	**2,640.0**
of which									
Long-term	61.2	451.6	1,243.3	1,674.0	1,726.2	1,782.8	2,030.3	2,070.7	2,110.0
Short-term	6.3	145.7	279.9	427.4	452.1	463.0	411.9	402.3	420.0
IMF Credit	0.8	12.2	38.1	61.1	60.1	70.8	93.8	81.0	110.0
Official Debt	**33.1**	**190.4**	**691.6**	**927.9**	**894.4**	**865.2**	**946.7**	**956.5**	**1,087.0**
o/w Multilateral/IMF	8.1	61.1	263.0	351.3	346.6	360.5	420.1	426.7	500.0
Bilateral Debt	25.0	129.3	428.6	576.6	547.8	504.7	526.6	529.8	587.0
Private Debt	**35.2**	**419.1**	**869.7**	**1,234.7**	**1,344.0**	**1,451.4**	**1,589.3**	**1,597.5**	**1,553.0**
o/w Guaranteed	13.5	202.9	510.2	587.4	609.4	625.7	676.3	704.6	695.0
Unguaranteed	15.4	70.5	79.6	219.9	282.5	362.7	501.1	490.6	438.0
Short-term	6.3	145.7	279.9	427.4	452.1	463.0	411.9	402.3	420.0
Memo: External Debt									
Low-income Countries	18.5	102.0	360.4	411.4	402.5	387.3	721.6†	730.2	755.0
Middle-income Countries	49.8	507.5	1,200.9	1,751.2	1,835.9	1,929.3	1,814.4†	1,823.8	1,885.0
Total External Debt Service	**6.0**	**93.3**	**162.4**	**241.9**	**279.4**	**305.2**	**316.1**	**349.4**	**398.0**
of which									
Interest Payments	4.1	48.9	72.3	98.6	104.5	109.1	122.6	135.3	153.1
Principal Repayment	1.9	44.4	90.1	143.3	174.9	196.1	193.5	214.1	244.9
Debt Service									
Low-income Countries	2.2	9.3	21.5	30.0	28.4	26.8	65.7†	70.6	78.0
Middle-income Countries	3.8	84.0	140.9	211.9	251.0	278.4	250.4†	278.8	320.0
Net Transfers on Debt	**2.5**	**26.3**	**50.0**	**150.6**	**196.0**	**221.9**	**–43.8**	**–114.6**	**–120.0**
Official	4.7	28.8	41.1	22.8	1.2	10.3	19.2	10.2	24.0
Private	–2.2	–2.6	8.9	127.8	194.8	211.6	–60.0	–124.8	–144.0
Low-income Countries	1.3	12.7	–0.3	–3.1	–3.7	–0.3	–28.6	–26.3	–29.0
Middle-income Countries	1.2	13.6	50.3	153.7	199.7	222.2	–15.2	–88.3	–91.0

Source: GDF-1999 (for annual figures up to 1997) GDF-2001 op. cit. (for 1998–99 figures)
*Figures for 2000 are preliminary estimates subject to revision.
†The sharp discontinuity between the 1997 figures (in GDF-1999) and 1998–99 figures (GDF-2000) for the debt burdens of low- and middle-income countries remains unexplained. It probably involves a different classification resulting in countries that were formerly middle-income moving to the low-income bracket.

from $68 billion to $610 billion. Between 1980–90 it increased by 2.5 times to $1.5 trillion. In the last decade it has nearly doubled yet again to stand at an estimated $2.64 trillion in 2000;

- Debt service burdens have risen even faster – from $6 billion in 1970 to over over $93 billion in 1980, $155 billion in 1990 and nearly $400 billion in 2000. Debt service has thus increased nearly 70 times in the same 30 years; it now accounts for 2.5 per cent of

the annual GDP of the developing world compared to less than 0.5 per cent in 1970;

- Between 1998–2000 developing countries have, in net terms, transferred a total of nearly $280 billion in real resources to industrial countries on the debt account.

Continually growing burdens of external debt and debt service impose a pre-emptive charge on the domestically generated resources and trade earnings of developing countries. Two decades of debt crises since 1982 have made clear the inability of all too many countries to manage such burdens. Although several debt relief initiatives have tried to address the problem, the approach has invariably been piecemeal and on a too-little-too-late basis. In each case the approach taken by creditors to solving the problem has been reluctant, grudging and painfully slow. A plethora of unnecessary, onerous and often counter-productive conditionalities have been applied with each rescheduling to the countries that have sought debt relief. The terms for rescheduling have invariably been unrealistic at the outset. The protracted process has compromised outcomes and delayed the recovery of many indebted countries. In some instances, it may have permanently crippled them.

7.1. Issues Raised by ZPR on External Debt

In the light of this history, ZPR is lamentably weak in its treatment of the unresolved debt issue. Acknowledging that HIPC-1 was a failure and discussing the need for further progress on debt relief, especially in the context of inadequate ODA, the ZPR expects that:

- Under HIPC-2 the debt service of HIPCs will decline by $1.1 billion annually from what would otherwise have been paid and $2.4 billion annually from what would have been due. (If the past record of their over-optimistic projections is taken as a guide, these reductions are probably overestimated by the World Bank and IMF by about 100 per cent, i.e. only half these reductions are likely to materialise as time unfolds.)
- Donors will finance additional debt relief under HIPC-2 with additional ODA.
- If HIPC-2 were further enhanced by HIPC-3, as many debt campaigners are already calling for, it might result in a redistribution of aid among developing countries with the moderately indebted low-income countries effectively paying for the severely indebted ones. That would undermine the fight against poverty.

With no serious recommendations to make on this issue, ZPR acknowledges that the Panel was split in its views. Some of its members believed that further enhancement of debt relief through HIPC-3 would be desirable. Others felt it was worth serious consideration but were concerned that, without assurance of additional ODA by donors, it would have effects on other developing countries that were best avoided and that it would create a borrowers' moral hazard.

7.2. Issues for Consideration at UNCFD on Resolving External Debt Problems

ZPR's concerns about not moving ahead with HIPC-3 in the absence of increased ODA to finance it, and about the possibility of creating moral hazard on the part of borrowers by providing further debt relief are misplaced. It should have been more concerned about creating moral hazard on the part of *preferred creditors* when it accepted, without scrutiny, the arguments put forward by the IFIs. Ever since 1994, when the issue was first brought up,[52] these institutions have resisted writing-down their own claims on HIPCs in the same way that commercial creditors are required to by their respective regulatory authorities, i.e. by

52 Mistry, P. S. *Multilateral Debt: An Emerging Crisis?* Forum on Debt and Development (Fondad), The Hague, 1994.

(a) reducing the provisions that they have made on loans to these over-indebted countries, making a charge against reserves if necessary and then writing down equity capital as a third step; and (b) cancelling outstanding balances of concessional multilateral credits that have been funded by donors in the first place. The IFIs have raised a number of arguments against such action (repeated in ZPR) and suggested a spectre of substantial collateral damage if such action were to be contemplated or mandated by their shareholders to accelerate debt relief.

These arguments have been examined by independent financial experts on a number of occasions and dismissed as invalid. Yet the intransigence of the IFIs has been permitted to undermine the effectiveness of HIPC-1 and HIPC-2, and now to block HIPC-3. If the IFIs were required to write-down their own claims on HIPCs, with official bilateral and private creditors doing the same, the amount of ODA required to fund HIPC-3 would not be an obstacle to further debt relief. It is only an impediment because the IFIs (with donor complicity) choose to make it one. The cost of IFI recalcitrance is being borne by HIPCs in foregone development and deferral of urgent expenditures on health and education.

In influencing SGR and ZPR on this issue, the IFIs have gone a step further in introducing another argument against HIPC-3. In the absence of incremental ODA to finance all the enhanced debt relief likely to be provided under HIPC-3, they suggest that any attempt to enhance debt rescheduling or debt reduction terms would adversely affect the interests of other developing countries and especially the other low-income countries (because of the playback impact of writing down concessional credits). This line of reasoning is both false and unfortunate. It should be repudiated by the international community as a regrettable attempt on the part of the IFIs to resort to divide-and-rule tactics. It should be condemned by the Commonwealth and collectively by all developing countries.

The reality is that all IFIs are effectively global or regional financial co-operatives. It is in the nature of such co-operatives that the more financially capable members should bear the cost of relieving other members from distress when their long-run viability and solvency have been compromised. When write-downs occur, provisions are written down first, then reserves and then capital. The provisions made by all the MDBs against doubtful loans now exceed $8 billion. Their combined reserves exceed $30 billion.

Except in the case of the African Development Bank, writing down the outstanding balances of the non-concessional (or hard window) multilateral debt of HIPCs is unlikely to absorb a significant proportion of the provisions made. It would certainly not eat into their reserves, nor threaten their capital structure, nor increase the borrowing cost of any MDB. The IMF would be unaffected since it does not raise resources through market borrowings. It could engage in whatever write-offs it chose to without any significant consequence for its financial standing.

The group likely to be most affected in the future by cancellation of the outstanding balances of concessional credits to HIPCs (through reduced new commitments that would have been financed by reflows of funds from concessional sources) are the HIPCs themselves. Moreover, the net present value of cancelling their debt now is far greater than the net present value of future disbursements from credit commitments that may or may not be made. The interests of other low-income countries could be protected through appropriate eligibility and allocation criteria applicable to new concessional credits.

If donors are required to increase ODA, they do

not need to do so now in order to provide more concessional resources to the MDBs to finance debt relief. They could just as easily increase ODA gradually later, and allocate the increment to other low-income countries that have not received any benefit from debt relief. There are a myriad ways in which a conflict of interest between severely indebted and less indebted low-income countries could be avoided and could be easily managed if it did arise. Finally, when financial co-operatives take write-downs on their balance sheets, the 'cost' of such write-downs is distributed in direct proportion to the shareholding of individual members. In the case of the Bretton Woods Institutions, the bulk of the cost would be borne by the industrial countries – the same group that is being asked to provide more ODA for the same purpose. Thus the arguments put forward by the IFIs and accepted without challenge by ZPR are misleading.

At UNCFD, this issue should be resolved once and for all. A genuinely independent panel of financial experts needs to consider the issues and implications of IFI write-downs for funding HIPC-3 and to make a final recommendation for all shareholders of these institutions to consider. Such a step is necessary for another reason. What the arguments put forward by the IFIs amount to is implicit, permanent enshrinement of the principle of insulation from any penalties (applied to these institutions or their managers and staff) for the damage they cause through default. That is a dangerous principle to accept in theory or apply in practice. At UNCFD the international community needs to reconsider the type of regulatory oversight needed over the IFIs. Current mechanisms for governance (through Boards of Directors and Governors) are too easily subject to regulatory capture and do not work effectively enough. UNCFD should also consider how financial and other penalties and sanctions can be applied to these institutions when they are in default and when their actions harm the interests of their borrowers. The complete insulation of IFIs from any sanctions creates a more dangerous moral hazard than any incurred by HIPC borrowers.

Contrary to the rhetoric, and the expectations created when it was announced, the first HIPC Initiative (HIPC-1) did not result in reducing swiftly the burden of external debt for the poorest countries. Indeed, as some critics noted at the time, HIPC-1 seemed to have been designed in an overcomplicated fashion so as *not* to work. Elephantine in terms of the staff resources, time and financial resources that went into developing and implementing it, HIPC-1 produced an ant-sized result. At the same time it resulted in the injection of additional conditionalities (unrelated to the specific purpose at hand) that were complex, onerous, intrusive and counter-productive. What HIPC-1 delivered was smoke and mirrors. The debt relief process was made extraordinarily complex and drawn out over too long a period. After three years of HIPC-1 being in place, only a handful of HIPCs had qualified for debt relief and none had actually received it.

It was only when considerable public pressure – organised by the Jubilee 2000 coalition for debt relief – was put on donor governments, that the terms of the first HIPC initiative were revised and relaxed in 1999 to permit meaningful debt relief. HIPC-2 appears to be faring marginally better than HIPC-1 but it does not go far enough. Though relief has been accelerated, the actual relief granted is in most instances insufficient to reduce cash outflows from the exchequers of the poorest HIPCs. What have been reduced, in the main, are contractual obligations that were accumulating arrears and that could not (and would not) have been paid in any event, i.e. creditors writing down debt that was not being serviced but was accumulating arrears. Such debt would not have been repaid in any conceivable circumstance.

After five desultory years, it is evident that the

HIPC initiatives need to be redesigned to reduce the period for pulling the qualifying, decision-point and actual relief triggers. Experience suggests that future versions of these initiatives should not be administered by the IFIs because they have a vested interest in slowing the process down. *Debt reduction for developing countries should, instead, be the responsibility of an Independent Commission on Debt Rescheduling and Reduction that is not controlled by any creditor group with a vested interest in the outcome*. Relief to HIPCs needs to be front-loaded rather than back-loaded if it is to have the desired developmental effect. Concern that the financial resources released by debt relief should not be misappropriated or misused by beneficiary governments is legitimate. But it is doubtful that the procedures aimed at preventing that eventuality under HIPC-1 and 2 will yield the desired outcomes. Instead, with relief being front-loaded, the disincentive for *mala fide* behaviour on the part of the debtor government should be the risk of losing all future ODA flows, bilateral or multilateral, if the resources released by debt-relief, or any other public resources in the country's fiscal system, continue to be misused.

Because the HIPC initiatives have not resulted in a significant, real alleviation of debt burdens, debt crisis management continues to absorb too much of the time and resources of the treasuries and central banks of developing countries. It drains them of scarce resources, financial and human, to address development challenges of a more pressing nature. Debt rescheduling has become an industry whose growth is being fuelled by the IFIs, replete with the panoply of a typical aid industry, including specialist consultants who perhaps benefit more from these initiatives than the HIPCs themselves.

The poorest, least developed countries remain the worst affected by debt. But external debt burdens continue to impede development progress in other developing countries as well. HIPCs account for less than one-tenth of total developing country debt ($225 billion out of $2.6 trillion). As observed above, Latin America's debt overhang remains large enough to be a threat to continued development progress if external shocks were to occur simultaneously on a number of fronts. Apart from these two major groups of severely indebted debtor countries, there are a number of countries with debt overhangs that fall between the cracks of the various formal relief initiatives that have been launched. These countries have external debt levels that are above the safety level of 35 per cent of GDP (often with internal and external debt levels that are together between 70–100 per cent of GDP) and debt service levels that are well above the safety level of 10–15 per cent of sustainable export earnings. Many such countries are small micro-states (often remote islands) with undiversified economies and few prospects for enhancing competitiveness in a globalising world. Regrettably, no action is being contemplated or taken regarding the debt burdens of these countries, many of which are members of the Commonwealth.

External debt therefore continues to be a key financial constraint on development. It has attendant domestic social and political consequences that are difficult to cope with. Therefore it would be appropriate for developing countries as a collective to pursue the idea of a decisive resolution of the external debt issue at UNCFD. New ideas should be considered and studied. These might include notions such as:

- Reviving debt-equity swaps aimed at accelerating privatisation and increasing the equity financing available for privately funded infrastructure projects on a major scale in countries where debt and debt service levels are above prudential limits (35 per cent of GDP for debt and 15 per cent of exports for debt service);
- Applying 'extendable mortgage' principles

to *automatic* sovereign debt rescheduling by keeping debt service payments at a constant dollar level, or at a level not exceeding 15 per cent of export earnings, while automatically extending or shortening the maturity of the adjusted outstanding debt obligation depending on global interest rate movements and the impact of financial crises;

- Activating automatic debt-service reductions or stand-stills in the event of financial crises with automatic debt service rescheduling through maturity extensions;
- Eligible countries with a debt-overhang earning 'debt-write-down credits' for sustained development performance (for example with official creditors agreeing to write down 10 per cent of their outstanding debt obligation for each year if countries sustain a growth rate of at least 6 per cent annually for five years).

Most of all, the unsatisfactory situation whereby creditors, especially the IFIs, continue to monopolise debt alleviation, as well as being the final arbiters and judges of the 'affordability' of debt service and the allowable extent of a debt overhang, needs to be changed. As suggested by SGR, developing countries should collectively press the case for an independent international debt arbitration mechanism, involving creditor and debtor, as well as impartial expert interlocutors, in assessing, adjudicating and passing judgement on debt reduction options. In that connection, an International Convention on Sovereign Debt Restructuring in Financial Emergencies may need to be considered to incorporate the lessons that have been learnt over the last 20 years to remove the inconsistencies and avoid the 'make-it-up-as-you-go-along' approach that has been the hallmark of IFI interventions in restructuring debt burdens.

In the absence of a sea-change in approach to the process of sovereign debt reduction and relief – of a kind that applies the concepts of Chapters 9, 10 and 11 in the US Bankruptcy Code approaches to debt reorganisation to avoid bankruptcy – the experience of 1982–99 casts doubt on the wisdom of continued resort to non-concessional debt-creating flows for financing soft investments in poverty reduction. It is particularly disconcerting that the two main IFIs are now attempting to persuade developing countries to assume further non-concessional debt obligations to finance social investment, international public goods and poverty-reduction programmes (for example in education and health). Necessary though such social investments are, the medium-term financial returns from them will not support the debt-service obligations being created. The notion that the broader economic gains accruing from such investments will result in a sufficiently large increase in growth to accommodate increased debt-service obligations needs to be treated with caution (if not suspicion) by developing country borrowers.