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New Challenges on External Debt

With five short paragraphs, "external debt" is the Cinderella of the "leading actions" in the Monterrey Consensus. The Consensus highlighted that the responsibility for debt crises should be fairly shared between creditors and debtors, argued for the creation of a mechanism for the resolution of sovereign debt crises, and requested that debt relief should be delivered expeditiously and should be additional to existing aid flows. It also suggested that the debt sustainability framework adopted by the Bretton Woods Institutions should be kept under constant review.

The presumption was that access to external resources is necessary for igniting growth in poor countries. However, empirical evidence has not been kind to this view. Over the last few years, several developing countries have been growing rapidly while running large current account surpluses. Econometric studies show that reduced reliance on external capital is linked to higher economic growth. As a consequence, the new orthodoxy is that external capital is, at best, not necessary, and, at worst, detrimental to economic growth.

The new evidence suggests that external finance is not necessary for all countries or at all times. After all, econometric estimates only tell us what happens in the *average* country; the finding that foreign capital is bad for growth, on average, does not rule out that some countries actually benefit from external resources. Moreover, it is important to distinguish among different types of inflows where each type has different costs and benefits. There are also different uses for such inflows, and the effects of such inflows on the economy will depend on how these resources are used. Finally, the evidence shows that foreign capital does not contribute to economic growth in the current international set-up.

However, the evidence cannot say anything about what would happen with a revamped international financial and aid architecture. A key challenge for a policy agenda on external debt is to identify which countries can benefit from external resources, and how these resources can be used to maximize growth and social development. However, this is not the only challenge. Even countries with positive net foreign assets may have a gross external debt. In the presence of mismatches in the composition of gross external assets and liabilities, gross external debt could still be a source of vulnerabilities.

The recent evolution of external debt

The recent evolution of the developing countries' debt situations involves several interesting patterns. The data show lower average external deficits, lower external debt ratios (external debt went from 39 percent of GDP in 2000 to 25% of GDP in 2006), and larger international reserves.

In 2000, 50% of public sector long-term external debt was owed to official (multilateral and bilateral) creditors. In 2006, this share had dropped to 42%. In 2000, external debt owed by private creditors amounted to less than 30% of total long-term external debt. By 2006, this share increased to 41%. As a consequence, the share of total long-term external debt owed to private creditors increased from 59% to 71%. In 2006, total international reserves of developing countries were about the same as the total external debt of these countries, and reserves continued to increase at record rates during 2007, reaching $3719 billion at the end of 2007. As most international reserves are held in assets issued by the advanced economies, developing countries as a group no longer have a net external debt.

Thus, the data suggests a net improvement in the external debt situation of developing countries. However, if one moves beyond averages, it becomes clear that this improvement is partly driven by the behavior of a few large countries. There is a wide dispersion in current account trends of developing countries and this dispersion has been increasing over time. Moreover, improvements in debt ratios are partly driven by favorable external conditions.

An economic crisis in the developed world and a sudden jump in the risk aversion of international investors could reverse the current positive trend. In fact, there are already some signs that things could get worse. During 2007, two thirds of developing countries suffered a deterioration of their current account balance and 50% of developing countries closed the year with a current account deficit greater than 5% of GDP.

Debt relief provided under the HIPC and MDRI initiatives helped several low-income countries reduce their debt ratios, but has not been fully successful in achieving long-term debt sustainability. More than half the post-completion point countries are still considered as having either a moderate or high risk of debt distress, and only 10 out of 22 post completion point countries have graduated to the low risk category.

This suggests that, contrary to what is often claimed, it is not true that developing countries no longer have an external debt problem. So, what is to be done?

Towards a new consensus

The policy agenda on the "external" debt of developing countries should focus on the following seven points:

i. Recognize that not all countries need the same amount of external resources or are able to sustain the same amount of debt, and that debt sustainability depends on how debt is used. Emphasize that the ability to repay debt (which is at the core of standard debt sustainability analysis exercises) is different from the need for external resources. There are countries that face an unsustainable debt situation and need more resources. Likewise, there are countries that do not have problems sustaining a higher level of debt, but are in a situation in which a net flow of external resources could be deleterious for economic and social development (which could generate sustainability problems in the long-run). Identifying these different groups of countries should be the objective of a revamped Debt Sustainability Framework (DSF). The low-income country DSF should abandon the practice of defining debt thresholds on the sole basis of poorly measured indicators of policies and institutions, while debt sustainability analysis exercises should focus on both assets and liabilities.

ii. Recognize that debt sustainability is an issue for both low and middle income countries and that debt relief efforts should not, in principle, discriminate between these groups of countries. Debt relief should be truly additional, and could be accompanied by increases in other forms of aid. Evaluation of debt relief initiatives should include an explicit measure of the additionality of debt relief.

iii. Recognize that past debt relief efforts have been unfair to countries with large developmental needs but low debt levels and ensure that these countries are rewarded for conducting prudent macroeconomic policies. A way to accomplish this is to include all low-income countries in the Multilateral Debt Relief Initiative.

iv. Recognize that financial crises in countries with market access are often driven by liquidity problems and not by solvency problems – even solvency problems are sometimes the outcome of a liquidity problem. Help developing countries create new instruments and institutions that can reduce the likelihood of a liquidity crisis. Acknowledge that international coordination is particularly important because some of the shocks that may lead to a liquidity crisis depend on external factors, which often originate from policy decisions of the advanced economies. Given that an increasing share of external borrowing originates in the private sector, it is also necessary to carefully supervise the activities of private agents and ensure that private borrowing does not generate excessive vulnerabilities in the balance sheets of domestic banks and corporations.

v. Recognize that vulnerabilities which may lead to debt crises are related to both debt levels and debt composition, and that there are important interactions between domestic public debt and external debt (excessive accumulation of domestic debt often lead to external debt crises). As vulnerabilities cannot be identified without prompt and reliable data on the composition of both external debt and domestic public debt, encourage international coordination aimed at producing and disseminating such data. Donors should support programs aimed at improving the debt management and data collection capacities of developing countries, and ensure that they report comparable data covering domestic public debt. The international dialogue should move from "External Debt" to "External Debt and Total Public Debt".

vi. Recognize that, even with improved debt management and better and safer debt instruments, debt crises are bound to occur, and that the lack of a mechanism for recognizing a situation of insolvency in the early stages of a debt crisis may lead to costly delays in the restructuring process. It is unfortunate that the discussion on the possibility of creating such a mechanism, which had gained momentum after the Argentinean crisis, is no longer salient in political discussions. The international community should not abandon the idea of creating a debt resolution mechanism aimed at guaranteeing a speedy solution to debt crises and fair burden-sharing between creditors and debtors. In fact, there should be two crisis resolution mechanisms – one for middle income countries with a large share of commercial debt, and one for low income countries which have a large share of their debt with official creditors.

vii. Start thinking seriously about odious and illegitimate debt. These are controversial concepts on which there is a multiplicity of views. Some argue that odiousness should be defined ex-post, while others argue that declaring odiousness ex-post may generate some problems that could be solved by declaring odiousness ex-ante. Still others claim that having an explicit odious debt policy, whether ex-post or ex-ante, will do more harm than good. The lack of a forum for a dialogue on odious and illegitimate debt has led to a situation in which the debate is often dominated by participants with extreme views, and in which there is no way to separate, and give greater legitimacy to, reasonable and feasible approaches to the problem (from more radical views). While the new consensus should not take a position on a definition of odious and illegitimate debt, it should promote the creation of such a forum.

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