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Debt sustainability: The right type of borrowing for the right purpose

The Monterrey Consensus recognized that foreign borrowing can be a useful tool for promoting economic development but that "unsustainable" debt can lead to crises and harm economic growth. "Excessive" foreign borrowing also reduces a country's monetary or fiscal policy space and can discourage private investment.

But when is borrowing excessive? On the one hand, large capital inflows are often seen as a sign of the strength of the receiving economy and as evidence of good institutions and investment opportunities. On the other hand, developing countries worry about the accumulation of external debt although, given the limited importance of equity flows, debt accumulation is often the natural consequence of large capital inflows. This is because the perception of capital flows and external debt varies over time.

It is usually during periods of economic boom, when external capital is plentiful, that developing countries sow the seeds of future crisis: booms in capital flows are almost always followed by default waves (Reinhart and Rogoff, 2008a). This suggests that the first step towards achieving debt sustainability is to avoid borrowing too much during "good times" and to use debt financing only for projects that generate returns higher than the interest to be paid on related debt. Moreover, foreign currency borrowing should be limited to projects that can, either directly or indirectly, generate the foreign exchange needed to service the debt.

Recent trends: Good luck, good policies, and the importance of looking beyond averages

Over recent years, developing countries as a group have been reducing their external debt ratios and accumulating foreign reserves, which now exceed their total external debt. However, looking beyond averages, it is clear that this improvement is mainly due to a few large countries and a few countries that had extremely high debt ratios in the mid-1990s.

Moreover, these broad trends have been accompanied by considerable changes in the composition of external debt. In 1990, about 95% of the long-term external debt of developing countries was owed by governments or public sector entities, or guaranteed by such entities. By 2006, this share had fallen to approximately 55%, partly due to an explicit strategy to substitute external public debt with domestically issued debt. In 1994, about 30% of developing countries' total public debt was issued domestically; by 2005, this share had increased to 40% (Panizza, 2008).

While lower debt ratios are partly due to better macroeconomic policies and debt management, factors beyond the influence of national policy makers have also played a role, especially high commodity prices and low international interest rates. However, periods of relative tranquility tend to lead to complacency. Policymakers may start thinking that "this time is different" and substitute caution with optimism. This attitude paves the way for the next debt crisis. Indeed, at the present juncture, the recession in developed economies and spillovers from the ongoing financial crisis could lead to an abrupt deterioration of the debt situation of developing countries. Some countries are, in fact, already suffering from massive capital outflows.

What should countries do to consolidate the advances of recent years? Middle-income countries can reduce the probability of a debt crisis by improving fiscal policy and strengthening the domestic financial system. The first set of policies can help reduce the need to accumulate debt, while the second set of policies can mobilize domestic sources of finance.

Implementing such policies is more difficult for low-income countries which have very little scope to improve their trade balances through active exchange-rate management. These countries face foreign exchange and fiscal gaps which need to be filled by external capital. Governments need external resources to finance projects in the social sector, health and education to meet the MDGs, and in infrastructure. Such projects may have high social rates of return in the long-run, but do not generate the cash flows necessary to service the debt in the short and medium-term.

Since low income countries cannot sustain high levels of debt, they should receive more grants and concessional loans with long grace periods. Where debt relief is necessary due to unsustainable debt burdens, it needs to be additional to other forms of aid. Indeed, in most cases, debt relief should be accompanied by an increase in grant aid to avoid the future recurrence of debt problems.

What type of sustainability?

In discussions of debt sustainability, the focus is sometimes on public debt (or fiscal) sustainability, and sometimes on external debt sustainability. These are related, but different concepts. In a country with 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 a negative impact on fiscal sustainability, as demonstrated during the Asian financial crisis in the late 1990s.

The opposite can also happen. A large domestic public debt has often been at the root of external debt crises (Reinhart and Rogoff, 2008b): for example, the Mexican crisis of 1994–1995 and the Russian crisis of 1998 both originated in the market for short-term domestic currency instruments.

The most important interaction between fiscal and external sustainability has to do with the behavior of the exchange rate. A real devaluation is often necessary for restoring external sustainability, but in the presence of foreign currency-denominated debt, a large devaluation can lead to a sudden jump in the public debt-to-GDP ratio; the opposite can result from a currency appreciation.

However, as a real appreciation tends to lead to a deterioration of the current account, any improvement in fiscal conditions will only be temporary. This trade-off also implies that allowing real exchange rate depreciation in the presence of foreign currency-denominated debt may lead to a debt crisis. Such a trade-off does not arise for countries that can borrow abroad in their own currency. In this case, a depreciation of the real exchange rate will have an immediate positive effect on both fiscal and external sustainability. Thus, developing countries are switching from external to domestic debt, even if the latter implies a higher *ex-ante* interest rate. But this may lead to a new vulnerability as a result of maturity mismatch. One difficult challenge in debt management is having to choose the optimal debt structure by carefully evaluating these trade-offs.

The interactions between external and fiscal sustainability point to the need to include domestic public debt in debt sustainability analyses. However, this would require more information than is currently available with regard to the level and composition of domestic debt. Clearly, different types of debt involve different vulnerabilities, and simply adding them up to calculate a single debt ratio obscures such vulnerabilities. These can be reflected by giving different weights to different types of debt according to the specific risks incurred.

Debt composition matters!

Debt sustainability is determined not only by the level of debt, but also by its composition: Countries with a "safer" debt structure can, other things being equal, sustain higher levels of debt. And for any given level of debt, proper debt management can improve debt sustainability. A major constraint on countries with access to international financial markets is their exposure to these highly volatile markets. Liquidity problems in emerging markets are often triggered by external factors that emerge from policy decisions in developed countries. A fact confirmed by the current crisis, whch originated in the United States but is sending large shockwaves to emerging market countries.

The use of innovative debt instruments that reduce the vulnerability of developing countries to unfavourable international developments could help maintain debt sustainability. Such instruments could include issuance of external debt in domestic currency, which would reduce foreign exchange risk, and of GDP-indexed bonds that allow lower debt service payments when capacity to pay is reduced. Since there are important externalities involved in the creation of safer debt instruments, the creation and utilization of these instruments could be facilitated by support from the international community for developing uniform standards and achieving the required market size. But even with improved debt management as well as better and safer debt instruments, disasters are bound to occur. Thus, the international community should not abandon the idea of creating a mechanism aimed at speedy resolution of debt crises and fair burden-sharing between creditors and debtors.

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