Managing Debt: Lessons Learnt and Emerging Issues

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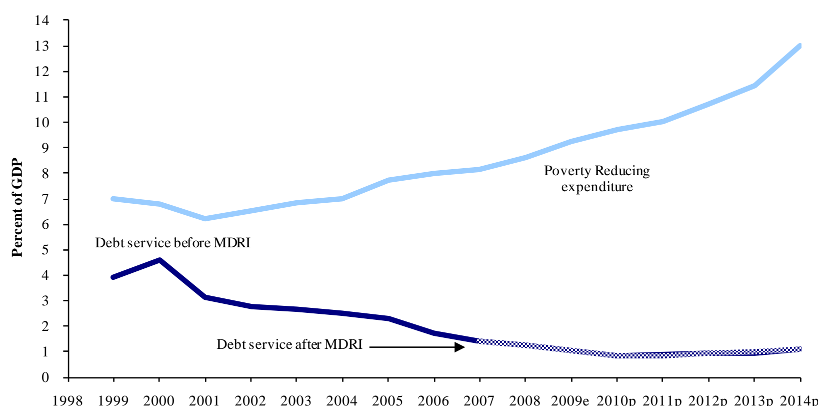
Improved macroeconomic policies and public debt management helped many developing countries avoid sovereign debt distress during the recent global economic crisis. Now that the most acute phase of the crisis has passed, policy-makers are taking stock of the lessons learnt, reevaluating the landscape for debt management in the post-crisis environment, and ensuring that gains made by developing countries are sustained. Against this backdrop, the second Debt Management Facility (DMF) Stakeholoders' Forum took place in Bern, Switzerland on June 8-9, 2011 on the occasion of the 20th anniversary of the Swiss debt relief program. This note summarizes the discussions of the Forum on the lessons of debt relief and emerging challenges faced by low and middle income countries with respect to debt management, going forward.

20 Years of Debt Relief

The build up of foreign debt owed by many developing countries throughout the 1970s and 1980s burdened many nations with unsustainable debts. Subsequent efforts in debt rescheduling and reduction by the Paris Club and other bilateral creditors, and the launch of the HIPC Initiative by the World Bank and the IMF in 1996 that was followed by the MDRI in 2006, have been instrumental in reducing this burden.[1]

These efforts have brought down debt levels significantly in low income countries (LICs), and contributed to the restoration of debt sustainability and creation of fiscal space, allowing countries to direct resources that could otherwise have been used to service debt to increased poverty reducing expenditures (Figure 1).

Figure 1. Average Poverty Reducing Expenditure and Debt Service in HIPCs 1/



Sources: HIPC documents; and IMF staff estimates.
1/Prior to 2009, figures represent debt service paid, and thereafter, projected debt service.

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[1] Switzerland is one of the first bilateral donors that launched an innovative program for providing debt relief to poor, highly indebted developing countries in the early 1990s.

For Ghana, for example, debt relief provided a much needed fresh start. The reduced external debt obligations as a result of the HIPC and MDRI as well as policy reforms that were part of the debt relief programs have reduced pressure on the country's balance of payments position, stimulated economic growth and freed resources to important social sectors. Following the debt relief, the government has consistently spent an average of about 25 percent of its expenditures on poverty reducing activities, compared with 19 percent during the pre-debt relief period. Ghana is adjudged "on track" to achieve the goal of halving poverty by 2015. Similar experience has been reported in Tanzania and Uganda.

Notwithstanding some successful experiences with debt relief, empirical cross-country studies fail to establish, unequivocally, a positive relationship between debt relief and poverty reduction. The causality is even more tenuous between debt reduction and investment, as well as economic growth (Chauvin and Kraay [2005], Arnone and Presbitero [2010]). While data problems (short time series, difficulty in measuring debt relief) are partially to blame, the mixed empirical results are likely to reflect diverse country circumstances, such as the degree of creditor participations in debt relief, and strength of economic reform and institutions, including the debt management capacity (Asiedu [2003], Arslanalp and Henry [2004, 2006]). Others point out that the weak growth response to debt relief is attributed to a reduced new aid disbursement, as creditors substituted costly debt relief with a reduction in new loans and grants. Easterly (2002) argues that the limited impact of debt relief on investment is due to high discount factors in HIPCs.

That said, there is overwhelming evidence that debt relief and LICs' ongoing efforts to strengthen debt management has helped them weather the storm of the late global financial crisis. Recent analysis by PRMED shows that all the 24 post-HIPC completion countries saw their debt distress rating remain unchanged or even improve between the pre- and post-crisis periods (Table 1).

Table 1. Risk of Debt Distress Pre and Post-Crisis: Post-Completion Point HIPCs /1

Country	PRE-CRISIS	POST-CRISIS
Afghanistan	HIGH	HIGH
Benin	MODERATE	MODERATE
Burkina Faso	HIGH	HIGH
Burundi	IN DEBT DISTRESS	HIGH
Central African Republic	IN DEBT DISTRESS	MODERATE
Congo, DR	IN DEBT DISTRESS	HIGH
Ethiopia	MODERATE	LOW
Gambia, The	HIGH	HIGH
Ghana	MODERATE	MODERATE
Guinea-Bissau	IN DEBT DISTRESS	HIGH
Haiti	HIGH	HIGH
Liberia	IN DEBT DISTRESS	LOW
Madagascar	LOW	.
Malawi	MODERATE	MODERATE
Mali	LOW	LOW
Mauritania	MODERATE	MODERATE
Mozambique	LOW	LOW
Niger	MODERATE	LOW
Rwanda	HIGH	MODERATE
Sierra Leone	MODERATE	MODERATE
Tanzania	LOW	LOW
Togo	IN DEBT DISTRESS	MODERATE
Uganda	LOW	LOW
Zambia	LOW	LOW

Source: PRMED.
1/ Pre-crisis refers to debt sustainability analysis (DSA) issued before the collapse of Lehmann-Brothers (before October 2008), while post-crisis refers to the latest DSA available.

What are the lessons from debt relief of the past 20 years? First, experience suggests that debt relief works best when it is comprehensive in terms of creditor participations and fully coordinated with necessary reforms. Second, debt relief restors sustainability, but only for a while unless accompanied by sustained prudence in fiscal policy and debt management. Maintaining sustainability also requirs early detection of vulnerabilities through a thorough debt sustainability analysis (DSA).

Going forward, efforts need to be continued to sustain the gains realized by the 20 years of debt relief. Sustainability of debt, both external and domestic debt, is still a concern for several countries that benefited from debt relief. With an undiversified economic base and slow progress in policy reform, these countries, some of which are fragile states, remain particularly vulnerable to external shocks. There are also countries whose financing needs for development are sizable but remain unmet. Increased partnerships and strategic engagements with non-traditional donors may be one way to ease the financing constraints in these countries. As for the four pre-decision-point HIPCs (Eritrea, Kyrgyz Republic, Somalia and Sudan) and three interim HIPCs (Chad, Comoros, Cote d'Ivoire, Guinea), continued support should be extended in the area of macroeconomic policy framework and debt management in order to prepare them to

reach the completion point. Ensuring full financing of the HIPC/MDRI initiatives as well as improving creditor participation in voluntary debt relief programs also need to be addressed.

Prudent Lending and Borrowing

With the majority of eligible countries having received HIPC/MDRI debt relief, policy debate on debt has shifted to how to avoid the re-accumulation of debt to unsustainable levels. Various analytical tools have been developed to inform borrowing decisions, and policy frameworks introduced to promote fiscal discipline and to prevent a build-up of debt and contingent liabilities. The Bank-Fund debt sustainability framework for LICs and a variety of rules-based fiscal frameworks in both developed and developing countries are some examples. Notwithstanding, the market behavior that was witnessed in the run up to the global crisis led many to believe that creditors also need to exercise more prudent lending practices.[2] How can lenders and borrowers respectively ensure that soverign debt is maintained at sustainable levels?

A few initiatives are currently under way. In April 2011, UNCTAD unveiled a set of Draft Principles with the aim of establishing clear responsibilities for both borrowers and lenders of sovereign debt. The Draft Principles present separately the responsibilities of lenders and borrowers. With respect to the responsiblities of lenders to sovereign entities, the Draft Principles highlight the need for, in particular, ex-ante due diligence standards and responsible credit decisions, as well as ex-post resolution mechanisms. For sovereign borrowers, the Principles call for attention to issues such as fiduciary relationships, transparency, disclosure, management and monitoring of debt, and avoiding incidents of over-borrowing.

Interestingly, one would find that the practices for lenders and borrowers proposed by the Draft Principles are nothing out of the ordinary. Does this mean that creditors and debtors do not exercise ordinary prudent practices? Or does it mean that guidance through general principles is not enough to discourage reckless behaviors?

The European Network on Debt and Development (EURODAD)—a network of 57 NGOs working on issues of debt, development and poverty reduction—asserts that voluntary instruments have been ineffective in preventing irresponsible behaviors in the sovereign debt market thus far, and calls for binding and enforceable rules that define clearly the rights and obligations for both lenders and borrowers.

Guidelines are also developed to promote responsible borrowing. The African Forum and Network on Debt and Development (AFRODAD), a civil society organization based in Zimbabwe, proposes a Borrowing Charter, which suggests principles and guidelines of sovereign borrowing to avoid the return to debt crisis. Amongst the key elements of the Borrowing Charter are the improved disclosure of public debt information to the general public, and greater participation of citizens and parliamentalians in the country's borrowing decisions.

Whilst there is general consensus that these frameworks would be useful, operationalization and actual implementation of the frameworks would face a series of challenges. Besides bringing

[2] Increased prominence of a number of non-traditional lenders is also a source of concern for many stakeholders, due in part to the lack of transparency in their lending terms and conflict with the borrowing country's macroeconomic framework.

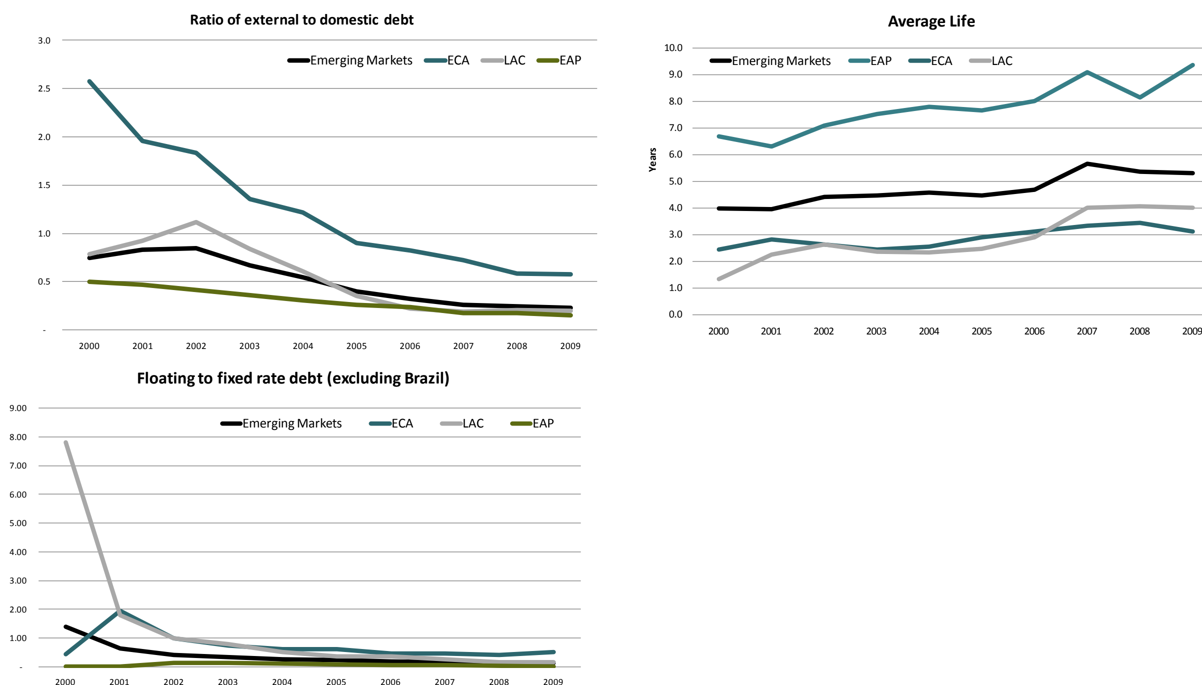
clarity to some definitions (e.g., what exactly is “irresponsible lending”?), creating incentives to both lenders and creditors to abide by the rules will be a challenge, since, like any other rules (e.g., fiscal rules), binding constraints are likely to invite abuse and encourage creative, non-transparent practices that undermine the compliance.

Domestic Debt Market

For much of modern history in developing countries, domestic bond markets had remained underdeveloped owing to a number of policy and structural inpediments: a poor record of macroeconomic management, the absence of a deep and diversified investor base, various regulatory restrictions that hampered the development of primary and secondary market activity, and the lack of adequate infrastructure for the issuance of government and private sector debt securities. The resulting structure of government and private sector debt was heavily biased towards short-term and foreign liabilities, which contributed to the vulnerability to external shocks in the 1990s and early 2000s.

In the past decade, however, domestic bond markets in developing countries have expanded significantly. Increasingly, governments of these countries have become able to issue longer-term local-currency bonds at a reasonable cost domestically, thereby diversifying the sources of funding and risks in their public debt portfolios and reducing vulnerability to external shocks. The average maturity structure of government debt has become longer, while the proportion of floating rate and inflation or dollar-indexed securities has fallen (Figure 2).

Figure 2. Improvements in Debt Portfolio Composition in Developing Countries



Source: JP Morgan EM Debt and Fiscal Indicators (2009) and BIS Financial Stability and local currency bond markets (2008).

The expansion of domestic debt markets reflects conscious efforts by the authorities of most countries to reduce their vulnerability to adverse external shocks, and enhance the degrees of freedom available to them. In this context, a key objective has been the strengthening of demand conditions for domestic debt.[3] This has been accomplished, in particular, through a transition to more stable macroeconomic policies (improved credit worthiness of the government); building of a sound financial system; a move towards privately funded and managed pension systems (e.g., Chile, Mexico); and the removal of restrictions on foreign investment.

Policy initiatives have also been taken on the supply side. Besides a gradual shift of government liabilities to the domestic market, policy makers in developing countries have worked to ensure greater predictability and transparency in the issuance of government securities. These efforts have been supported by a particularly favorable external environment (prior to the crisis), including high commodity prices and their beneficial effects on the external account, and increased interests from foreign investors.

These efforts were rewarded. When the crisis hit, sovereign debt managers faced unprecedented challenges. Financial markets shut down and their opportunities to raise money on international capital markets virtually disappeared during the peak months of the crisis. However, the time and resources invested earlier in designing and implementing debt management strategies provided them with room to manuver. By borrowing domestically, countries that had experienced severe refinancing crises previously were able to avoid external borrowing for almost a year.

This experience has led to a broad consensus that the development of domestic debt markets, together with improved macroeconomic and debt management has indeed helped insulate the sovereign debt portfolio of developing countries during the global crisis.

While much progress has been made, there are challenges ahead. First, still a relatively few developing countries have the ability to issue long-term domestic debt at reasonable cost. The recent switch from external to domestic borrowing may just lead countries to trade one type of vulnerability for another, raising concerns about the trade-off between a currency mismatch (because most governments service debt from their domestic revenue) and a maturity mismatch (Panizza, 2006) and elevated refinancing risks (Jeanneau and Tovar, 2006). Second, with still a narrow investor base and low market liquidity, developing secondary markets and promoting efficiency in trading remain a challenge. In many instances, domestic securities markets are still dominated by government paper in these countries, and non-government bond markets remain relatively under-developed. In this regard, while expanding the market for domestic government bond market has positive externalities for the domestic corporate bond market, there are also risks that the public sector may crowd out private issuers.

Finally, the advancement in domestic debt markets has also brought about a host of new challenges to developing country policy makers: management of volatile capital inflows. Combined with low interest rates in developed economies, the development of domestic capital markets and improved creditworthiness of developing countries have prompted increased capital

[3] Another objective of a domestic debt market is to provide a reference for interest rates, monetary policy transmission and overall financial sector deepening for the private sector.

inflows to these countries. This has put pressure on the price of non-tradables and led to real appreciation of their currency, resulting in a loss of export competitiveness, and posed a threat of a potential destabilizing effect on the financial system. Continued global imbalances and the patchy outlook for global economic recovery add to the uncertainty that lies ahead.

Rising Importance of Sub-national Debt Management

With the increasing scale of fiscal decentralization worldwide, debt owed by sub-national governments and their affiliated agencies have been growing in importance.[4] While the degree of fiscal decentralization varies, globally sub-national governments now account for an increasing role in public service delivery (such as education, health and public utilities) and investments (e.g., to meet infrastructure needs). To pursue these responsibilities, sub-national governments have been granted revenue-raising power and the ability to incur debt.

In many developing countries, sub-national debt markets have been going through a notable transformation. Private capital has emerged to play an important role in sub-national finances, as opposed to borrowing from the national government. As national governments of developing countries access capital markets, sub-national governments are also gaining access to these markets, switching from borrowing from banks and the national government, which has long dominated sub-national financing in many countries, to sub-national bond instruments. Another recent development is the use of public private partnership (PPP) schemes by sub-national governments. PPPs are often used in infrastructure or infrastructure-related services that are strategically important. However, because of the strategic importance of these projects, sub-national governments are unlikely to let the PPP counter-party fail, raising concerns about (implicit) contingent liabilities from PPPs.

Following the 1990s when sub-national fiscal stress and debt crises contributed to macroeconomic deterioration in major countries (e.g., Argentina, Brazil, India, and Russia), sub-national government fiscal framework has been substantially strengtheed across various coutnries. There are diverse approaches to debt management operations and fiscal relationships between national government and sub-national governments (see Box 1).

Adequate implementation of such frameworks requires sound fiscal and debt management capacity at sub-national levels. However, there are concerns that many sub-national entities lack the needed skills, including those for adequate recording and monitoring of data. Greater attention thus needs to be placed in order to build strong debt management capacity at sub-national levels.

[4] The term “sub-national” refers to all tiers of government and public entities below the federal or central government.

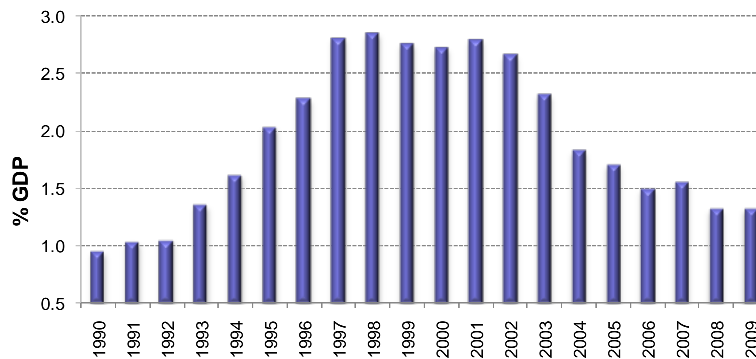
Box 1. Colombian approach to sub-natinal debt management

Colombia is noteworthy for its approach to sub-national debt management. The country has made significant improvements in the regulatory framework to increase fiscal discipline to control debt levels and build capacity at the sub-national level, thereby mitigating the associated risks to the national government.

Over the period 1997-2003, the Colombian national government has responded to a rapidly rising sub-national debt level by imposing a series of regulations to ensure sub-national fiscal sustainability, improve transparency, and restructure existing liabilities. At the same time, measures have been introduced to strengthen sub-national's revenue sources. First, an overall institutional framework was established by Law 358 (1997), which introduced debt limits and imposed a golden rule (borrowing only for investment) for sub-national finances. Subsequent legislations reinforced the framework further by introducing additional requirements: current expenditure limits; elaboration of a medium-term fiscal framework and primary balance targets; valuation of contingent liabilities; obtainment of risk ratings to contract new debt; and rules with respect to obtaining national government guarantees. Moreover, sub-national entities are forbidden to commit future budgets in the last year of government period, and sub-national borrowing activities are closely monitored by the national government. As a result of the reform, Colombia's sub-national debt has fallen sharply since 2001, and the trend has been maintained over the last decade (Figure 3).

The Colombian experience highlights the importance of establihsing a sustainable legal and institutional framework for sub-national fiscal discipline, and debt management adapted to the decentralization process, although the existence of such framework itself is no guarantee for sub-national debt sustainability (Plekhanov and Singh [2007]).

Figure 3. Results of the Reform: Sub-national Debt (in percent of national GDP)



Source: Arbelaez-Martinez (2011).

Institutional Framework

Subnational debt control and fiscal sustainability	
Law 358/1997	• Defines sustainability indicators and limits: Interest payments/ operational savings < 40% Debt/ current revenues < 80% • Debt only for investment expenditure ("golden rule"). • Ministry of Finance must approve indebtness of subnational governments that are above limits. • Subnational governments can use transfers as a guarantee for credits only if these credits finance the same type of spending as transfers.
Law 550/1999	• Defines mechanisms to restructure current liabilities. 13 departments and around 80 municipalities benefited from this law.

Subnational debt control and fiscal sustainability	
Law 617/2000	• Sets limits to current expenditure (as % of non-earmarked current revenues – 50%). • National government can guarantee subnational debt with Colombian financial institutions only to finance fiscal adjustment programs of local governments with no repayment capacity, specifically to pay for the severance payments and compensations required to carry out the adjustment program.
Law 819/2003	• Requires the elaboration of the Medium Term Fiscal Framework and the definition of primary balance targets. • Future budget commitments can be authorized, only in the case of strategic projects (e.g. infrastructure, energy, telecommunications). • Requires the valuation of contingent liabilities. • Subnational governments must obtain risk ratings to contract new debt. • Reinforces indebtness controls set in Law 358.

Conclusion

Improved macroeconomic management and debt management capacity in developing countries have heleped them navigate the financial crisis. However challenges remain in the post-crisis environment.

Debt management has become more complex and cross-cutting in recent years. The rising interest of LICs to issue sovereign bonds on the international capital market, a large build-up of domestic public debt, borrowing by sub-national governments, increased use of PPP schemes, as well as the large private capital inflows—just to name a few—pose significant challenges and risks to developing country policy makers.

Efforts that have resulted in the favorable outcome to date need to be reinvigorated. Debt and debt management matter greatly for development, and these issues cannot be separated from broader macroeconomic and fiscal policies. Past and present experiences from developing and advanced countries provide ample proof that long-term debt sustainability ultimately depends on the health of public finances, the capacity to mobilize domestic resources, the quality of economic governance and sound economic policies that are conducive to sustainable and broad-based economic growth.

Debt management clearly has a role to play in this as well. Prudent debt management can over time lower the costs of borrowing and make countries more resilient against shocks and thus protect their fiscal balances. Prudent debt management also facilitates the development of domestic capital markets, which enhances the ability to implement borrowing strategies with an adequate cost-risk balance. This support includes strengthening of debt management, such as for instance through the DMF, promoting the mobilization of domestic resources and improving the quality of public spending. Prudent debt management and sound fiscal policies put debt relief on a sustainable footing and lay the foundation for avoiding a new debt spiral.

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