Assessing debt sustainability in LICs

the main issues

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The "impossibility principle"

> *Because debt sustainability is a forward-looking concept, it cannot be assessed with certainty. In that sense, debt sustainability analysis [. . .] is impossible. At best, [. . .] one can make educated guesses but it is important to recognize at the outset that these are just guesses, no matter how sophisticated they may be*
>
> *Charles Wyplosz (2007)*

But – to reach the most educated guesses as possible – something can be (and it has been) done. I propose four main issues for discussion:

1. LICs' vulnerability
2. Domestic debt and crowding out
3. Optimistic projections
4. Threshold approach

Institutions and policies are not the only things that matter

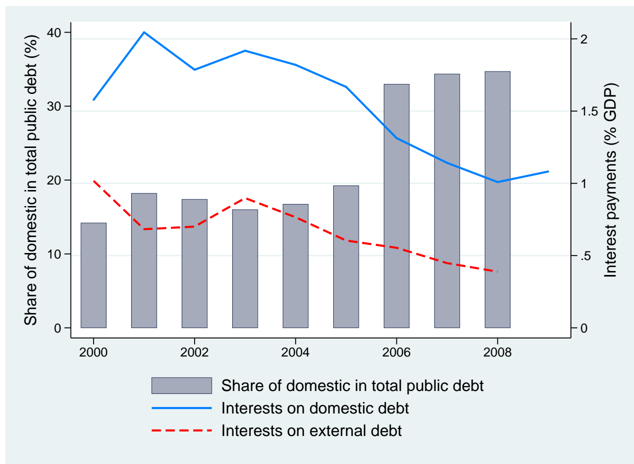
- Structural **vulnerability** (EVI) rather than governance (CPIA) is a suitable predictor of debt distress episodes in LICs (Ferrarini 2009):
  - **contingent DSF**: focus on exogenous BOP shocks and on a *contingent credit line*
- **Domestic debt** is the missing link explaining external default and high inflation (Reinhart & Rogoff 2009).
- It is not only debt overhang, **crowding out** can be a binding investment constraint.
- The DSF should be based on the estimation of the Kraay and Nehru (2006) model on a broader set of determinants of debt distress episodes.

Table: Debt distress, public debt, policies and vulnerability

DSF Risk Rating	Public debt (% GDP)	Interest (% GDP)	CPIA	EVI
low	46.3	0.8	3.5	42.8
moderate	46.4	1.5	3.3	48.6
high	61.7	1.7	3.1	49.3
in debt distress	94.7	1.2	2.6	49.4

Data at 2009 refer to the sample of HIPCs, excluding AFG, KGZ, MRT, SLE and SOM because of missing data.

The “unintended consequence”: rising domestic debt



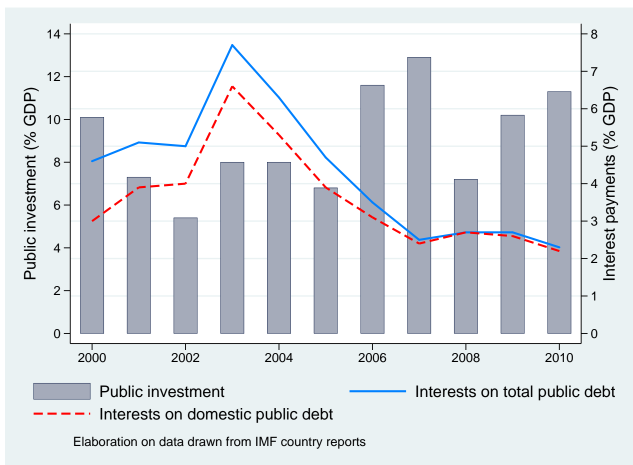
Elaboration on data drawn from IMF country reports. The sample of 24 LICs includes: Bolivia, Burundi, CAF, Ivory Coast, Cameroon, Chad, Ethiopia, The Gambia, Ghana, Honduras, Haiti, Kenya, Madagascar, Mozambique, Mauritania, Malawi, Rwanda, Senegal, Sierra Leone, Tajikistan, Tanzania, Uganda, Zambia and Zimbabwe. Data are unweighted averages.

The crowding out effects of domestic debt

- Costs of domestic debt outweight benefits if some prerequisites (a sound macroeconomic and legal framework and a broad investor participation) are not satisfied, as in several LICs.
- Government borrowing could crowd out lending to the private sector, especially to SMEs and rural borrowers, and debt service could crowd out public investment.
- The DSF and subsequent changes make important step forwards, but ...
- ... inspect the black box of domestic debt (Arnone & Presbitero 2010):
  1. maturities are biased towards short-term instruments;
  2. the banking sector remains the main holder of government securities.
- ... monitor the (productive) destination of public financing.

- A great effort should be done in **collecting and disseminating data** on domestic debt and public investment

Rising interest payments and lower investment: the case of Malawi



- Malawi's domestic debt market is still underdeveloped: it is dominated (94%) by Treasury Bills (91, 182 and 273 days) and the Reserve Bank of Malawi is the main holder.
- Similar pictures emerge in Zambia, Senegal, Ghana and Kenya (Afrodad)

Is the framework overly-optimistic?

- The DSA is based on overly optimistic projections, especially for HIPCs (Leo 2009) and on defensive forecasting (Dreher, Marchesi & Vreeland 2008).
- Downward revisions in exports and GDP growth rates in the wake of the global crisis are associated with severe deterioration of debt dynamics in several LICs (Arnone & Presbitero 2010; IMF 2010):
  - Vietnam PPG external debt in 2012 was projected at 27% in the 2007 DSA, while is now projected at 43% of GDP.
- Proposals:
  - lending conditions based on existing debt sustainability level;
  - extend the sensitivity analysis with multiple shocks and feedback effects.

Table: Accuracy of 1-year WEO GDP growth projections

Category	2001	2002	2003	2004	2005	2006	Average
Low-Income Countries	-0.03	-1.05	0.37	1.58	-0.26	0.39	**0.17**
HIPCs	0.59	1.38	0.92	2.17	0.24	-0.06	**0.87**
Non-HIPCs	-0.91	-3.49	-0.61	0.55	-1.12	1.16	**-0.74**

Source: Leo (2009), calculation based on the IMF WEO Database. Negative figures indicate growth exceeded projections.

Debt sustainability requires limited deficits and strong growth, but . . .

- Poor institutions, weak policies, and economic vulnerabilities still put several LICs at risk of debt distress and impair growth (Depetris Chauvin & Kraay 2005; Presbitero 2009).
- Out of 23 post-CP countries where a comparison over a 5-yrs window around MDRI is possible:
  1. no growth accelerations: only 4 show a statistically significant increase in the average GDP growth, while 5 exhibit lower growth rates
  2. no fiscal consolidation: 7 show significant improvements in government financing, but 3 a significant worsening budget balance
- No downward trend in total financing after MDRI (Leo 2009; Arnone & Presbitero 2010).
- If growth is fragile (Arbache & Page 2009), budget deficits appear sustainable:
  - (non-concessional) loans may be too risky,
  - disentangle between long-term sustainable growth and exogenous shocks.

Critical issues on the DSF threshold approach

- The framework is of little help for countries far away from thresholds:
  - provide a more severe guidance on government spending: (counter-cyclical) budget deficit thresholds;
  - focus on the links between debt, investment, growth and institutions to mitigate debt overhang, crowding out and output and policy volatility (Presbitero 2008; Cordella, Ricci & Ruiz-Arranz 2010; Malone 2010)
- Perverse incentives?
  - Improvements in the DSF increases the size of IDA allocation but also the loan share: weak incentives to improve institutions.
  - Linking thresholds (and the size and term of lending) to economic vulnerability makes the process more exogenous.

Summing-up and issues for discussion

- Shift from a "debt threshold paradigm" – good to deal with the emergency of a debt crisis – to a new one for tranquil times:
  - **flexible and country-tailored** to specific vulnerabilities and constraints to infrastructure investment;
  - based on **simple rules on debt stocks and flows and on budget deficits** to preserve sustainability,
  - **growth-enhancing**, focused on reducing vulnerabilities and improving policies and institutions:
    - *how to insulate good-performers LICs with a nonzero limit to nonconcessional borrowing from external shocks?*
  - considering in an integrated way **all sources of government financing**: grants, (concessional and commercial) external and domestic debt, remittances.