

SUSTAINABLE FINANCING FOR INVESTMENT IN LOW-INCOME COUNTRIES

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1) STRUCTURE OF PRESENTATION

- Current LIC Debt Sustainability
- Issues:
 - Longstanding Critiques of LIC-DSF
 - Whether Include LIC Financing Needs
 - Impact of Three Types of Finance
- Implications for DSF and Broader Dialogue

2) CURRENT LIC SUSTAINABILITY

- According to IMF analysis 2010:
 - pre-financial crisis 1/3 of LICs each had low risk, moderate, high/in distress (half of latter OK post HIPC)
 - post not much change in ratings
 - likely improvement in country policies, fiscal adjustment plus more concessional finance would solve problems for the 1/3 with high risk
- SO WHAT IS THE PROBLEM ?
 - increase in debt of 5-7% PV/GDP, so crisis closed borrowing space sharply (IMF was using 5-7% PV/GDP increase as "caution flag")
 - fiscal adjustment based on REDUCING spending by 1% GDP in future therefore incompatible with scaling up
 - will concessional finance be available ?

3) CRITIQUES OF LIC-DSF

- Insufficient account of shocks - especially those (climatic/economic) hitting LICs > generic
- Overstresses export and GDP ratios when in context of fully open capital account in most LICs, major issue is PV and esp DS/budget revenue: 13/14 unsustainable countries = export or GDP ratios, only 1 based on revenue ratios
- Threshold effects: averages of original study converted into sharp changes of sustainable levels through small changes in performance
- "Performance" too broad – not focussed on key debt management/expenditure management
- Thresholds adjusted down to HIPC Initiative levels, not based on evidence – too conservative

4) COVERAGE OF LIC FINANCE NEEDS

- Most LICs are not including in DSF scenarios:
 - their full financing needs for reaching the “social sector” MDGs – ie are aiming to fall well short on education and health goals
 - needs for improving social protection to protect against future crises
 - massive infrastructure needs already discussed in this seminar (plus other ideas emerging from recent G20 such as huge investments in vocational/tertiary education, financial inclusion etc)
 - potential financing for climate change adaptation/mitigation – promises of US\$100 billion a year by 2020
- Given current low prospects of sharp increase in grant aid during 2011-15, much if not most of these flows (especially for the last 2) will come via loans
- Need for systematic scenarios in LICs which include these aspects – offer realistic path to sustainable growth, MDGs and confronting climate change without compromising debt sustainability

5) DOMESTIC DEBT

- Pre-crisis ? HIPC CBP: markets much more developed than most analysis describes, domestic debt rising rapidly, domestic debt arrears and even defaults have hit private sector hard
- PV and especially service burdens very high (average interest 6-15%), maturity short so refinancing risk
- In crisis, two-thirds of debt increase (3/4 of service) was domestic debt – because international community delivered external financing very slowly or insufficiently
- Current situation: more than 20 countries with domestic debt >15% of GDP, public debt service (mainly domestic for post-HIPC) >15% of revenue
- Interest rate/refinancing risk > exchange risk of external debt
- Much closer attention needed: cannot assume lower inflation will cut interest rates, good to develop financial markets - markets will “discipline” governments – disastrous results

6) PRIVATE SECTOR DEBT

- Burden considerably underestimated, because many LICs have no adequate system for monitoring, esp. offshore, intra-company, or short-term trade finance
- Scale: across 24 LICs where we have worked in detail to improve monitoring, accounts for average 32% of external debt or 15% of GDP, and growing rapidly
- Also potential high volatility – individual companies overindebtedness, or collapses in trade finance due to commodity price falls, have caused massive problems in foreign exchange markets, eaten up LIC reserves
- Vital to include in analysis with realistic forecasts

7) CONTINGENT LIABILITIES/GUARANTEES

- Many LICs being attracted by PFI/PPP financing for infrastructure – looks like no debt liability therefore sustainable; also benefit of private sector expertise in constructing infrastructure – but:
 - Often massive budget revenue losses (returns of 20-25% pa) therefore much “fiscal growth” effect of infrastructure lost..... Much more expensive than borrowing
 - Assumption that low-risk not borne out: many examples of poor delivery, cost overruns, default by private sector – dumps major actual costs or liabilities on public sector
 - Need to ensure careful project/contract design, high capacity to negotiate with contractors and monitor delivery
- Other key risks of financial sector contingent liabilities and guarantees of parastatal/private sector debt

8) IMPLICATIONS FOR DSF

■ Ambition:

- base forecasts on scenarios which finance the MDGs and key infrastructure/combating climate change, and include likely shocks for individual LICs

■ Coverage:

- Design public debt thresholds to include domestic debt
- Monitor/analyse private sector debt much more closely
- Fully include contingent liabilities/guarantees with scenarios where lose revenue, become explicit debts

■ Flexibility:

- Apply the recently-agreed flexibility actively so that countries with lower vulnerability and higher capacity can be seen to borrow more and show positive impact of well-designed/executed investment to others
- More fundamental: place main emphasis on budget revenue related ratios (would increase sustainability), use evidence-based rather than HIPC-linked ratios, switch from thresholds to probabilities of crisis to avoid threshold effects

9) IMPLICATIONS FOR DIALOGUE

- Current system encourages countries to design huge financing needs but stops them from financing them responsibly – drives them to expensive/risky funds ?
- At global level get clear message across that unless G8/G20 provide massive extra GRANT or highly concessional loan finance (including through innovative financing given poor fiscal prospects for aid increases), LICs cannot invest enough to accelerate development, reach the MDGs and combat climate change without wildly unsustainable debt levels.
- Responsibility of G8/G20 to show greater consistency of objectives, and of BWIs to simulate and present to G20 scenarios which demonstrate this message clearly