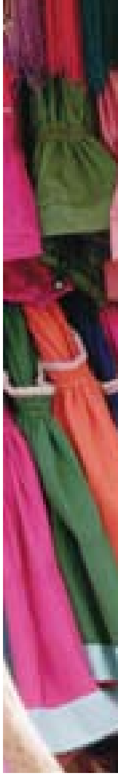

Avoiding Another Debt Trap

Low-income countries need a sustainable borrowing strategy if they are to achieve development goals

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LOW-INCOME countries face serious challenges in meeting their development objectives, embodied in the Millennium Development Goals (MDGs) adopted by world leaders in 2000. Unless they can accelerate economic growth, many of these countries will fall short of achieving the targets, which center on halving by 2015 the proportion of people living in absolute poverty in 1990. While the key to higher sustainable growth lies in the countries' own efforts to strengthen institutions and pursue sound policies, these efforts need to be complemented by financial and other support from the international community. How can the international community help developing countries boost growth enough to meet the globally adopted goals without creating new debt problems that could derail them on the way? The obvious answer is a sizable increase in grants to these countries, combined with a removal of trade barriers and agricultural subsidies in the industrialized world. In the absence of significant progress on both of these fronts, however, maintaining debt sustainability becomes a crucial challenge in achieving the MDGs.

The good news is that the risk of future debt crises is lower now because both debtors and creditors have learned from past mistakes. Many low-income countries have strengthened macroeconomic policies and debt management and have embraced ambitious structural and institutional reform agendas to bolster their long-term growth potential. These policy reforms should, over time, widen production and export bases and reduce vulnerability to shocks, such as adverse terms of trade or destructive weather patterns. Awareness of past mistakes has, in many cases, caused lenders and donors to improve their lending policies and replace nonconcessional financing with concessional loans and grants. Moreover, the Heavily Indebted Poor Countries (HIPC) Initiative is contributing to a significant reduction in the debt burden of qualifying countries, which are also benefiting from more favorable debt-service profiles as a result of the long grace periods and low interest rates on restructured debt and new financing.

Nevertheless, the many weaknesses that remain warrant a cautious approach to new borrowing. Overly optimistic growth projections risk being repeated unless there is a deeper understanding of what drives growth in a particular country. Many structural reforms will take time to bear fruit while most low-income countries will continue for some time to suffer from weak institutions, volatile export and production bases, and limited administrative and debt-management capacity. In addition, the risks of political crisis and war remain significant in many states, while the HIV/AIDS epidemic has posed a new—and, in a number of countries, catastrophic—threat to long-term economic prospects. For these reasons, the most general lesson from the low-income country debt crisis that began in the 1980s and continued into the 1990s—that new borrowing even on concessional terms should be pursued with caution and be based on prudent economic projections and recognition of country-specific circumstances—remains valid today.

Lessons from the past

The experience of the past 25 years—a period when a large number of countries incurred excessive debt, setting back their efforts to achieve sustainable growth and alleviate poverty—serves as a sobering reminder of what can go wrong. What prompted the unsustainable rise in low-income countries' debt ratios? While the specifics differ from country to country, a common theme is that the financing provided to these countries did not generate the economic growth envisaged and that borrowing decisions were predicated on growth projections that never materialized. Some of the specific factors explaining the dissonance between debt and growth were at play simultaneously in most of the crisis countries, including: a vulnerability to exogenous shocks; a waste of resources because of policy deficiencies, poor governance, and weak institutions in economies typically dominated by the public sector; inadequate debt management, reflected in unrestrained borrowing on unfavorable terms; creditors' nonconcessional lending and refinancing policies, primarily in the

Selling cloth at a La Paz market in Bolivia

many low-income countries actually work in their favor, but others limit these countries' capacity to borrow on a sustainable basis.

First, many low-income countries receive hardly any private capital and very little foreign direct investment (FDI) but, instead, depend on official grants and concessional loans to finance investment. As a result, these countries are largely insulated from the volatility of private capital flows that have triggered debt-rollover problems in emerging markets. In addition, the concessionality of financing makes it more likely that the returns on new investments exceed their (subsidized) costs and, hence, that the debt dynamics will be sustainable. On the other hand, aid dependence complicates debt management because aid flows are not under a government's control and are intrinsically uncertain.

Second, investment and debt dynamics in low-income countries—more so than in other countries—are subject to a number of pitfalls. Investment returns depend on how funds are used. With weak public institutions, poor governance, and generally low implementation capacity, many low-income countries are prone to misuse or mismanage resources. Also, payoffs frequently accrue only over the long term, and the benefits of some (such as improved security and health care) may be diffuse and difficult for governments to capture in the form of higher taxes to repay debts. In contrast, debt service (interest, at least) generally starts falling due immediately, potentially crowding out other spending.

Finally, with narrow and highly volatile production and export bases, low-income countries are particularly vulnerable to exogenous shocks that may significantly alter their debt dynamics (see article on page 24).

In a world of limited development aid, countries need to strike a careful balance between the financing they require to meet their development objectives and the debt service they are able to afford. Since low-income countries' economic and social needs are generally high, governments may be tempted to borrow large sums up front to generate the benefits as quickly as possible. This may be appropriate if the efficiency of investment is high—for instance, in situations in which it removes bottlenecks to growth. A cautious borrowing policy, in these circumstances, could prove suboptimal, because countries would forgo opportunities to move onto a higher growth path. The counterargument is that, because of the pitfalls and risks outlined above, low-income countries need to be particularly wary of building up excessive debt. This argues for the pace of new borrowing to grow in step with countries' administrative and absorptive capacity to avoid debt traps and ensure that progress in development is durable. It is, perversely, those countries with the largest needs that typically face the toughest constraints on their ability to take on debt.

A durable borrowing strategy must incorporate these considerations, which generally pose themselves in the form of

early years, motivated, in part, by political considerations and the desire to promote their own exports; and political factors, such as civil war and social strife, that often have devastating economic consequences.

The crisis in low-income countries, in contrast to recent debt crises in emerging market economies, developed in slow motion. Payment difficulties—the first manifestation of problems—were initially addressed through new net lending and repeated debt-service reschedulings, first on commercial and, subsequently, on increasingly concessional terms. In fact, net flows to low-income countries (that is, grants and loans minus debt service paid) remained positive, averaging 13 percent of GDP a country over 1984–96, but much of the new capital was in the form of new debt, which added to the countries' solvency problems. It was not until the early 1990s that the international community began to acknowledge that the debt *stocks* of these countries were effectively unsustainable and that indebtedness itself could be one of the factors impeding investment and growth. Initial debt-reduction operations by the Paris Club were later expanded into the HIPC Initiative, with its comprehensive treatment of all outstanding obligations. The Initiative, launched in 1996 and enhanced three years later, charted a course toward restoring debt sustainability by providing resources for substantial debt relief. However, the HIPC Initiative, which is targeted at the poorest countries with large external debts, is neither designed nor intended to be a permanent mechanism. It will not benefit all low-income countries and, more fundamentally, can only clear up the legacy of the past, not guarantee sustainability going forward.

Roadblocks to recovery

How can low-income countries draw the right lessons from the past and get onto a track of sustainable borrowing going forward? How can they keep their future debt-service obligations in line with their capacity to pay without major economic and social sacrifices in the future? Some features that characterize

How to develop a sustainable borrowing strategy

To design appropriate borrowing policies, countries need to assess the sustainability of their debts on a forward-looking basis. The main considerations for assessing sustainability include what key indicators should be used, whether to focus on public or external debt (or a combination of both), constraints on repayment capacity, and the country's vulnerability to external shocks.

In most low-income countries with large concessional debt, the key indicators will include the net present value (NPV) of debt (public and external) and debt service relative to revenues and exports. Combined with a debt sustainability analysis based on realistic macroeconomic assumptions, a country can determine limits on new borrowing that would keep both the NPV of debt and debt-service payments on a sustainable path. Focusing on the NPV of debt—which is the discounted stream of debt-service payments, as opposed to its nominal face value—means that the more generous the terms of a country's new loans, the more room it has to borrow. Setting appropriate borrowing limits is obviously a decision that must be made in light of an economy's vulnerability to shocks and other country-specific factors. Thus, a meaningful debt-sustainability analysis should always incorporate stress tests of the key variables that allow an assessment of the main risks.

What debt should be included? Because governments cannot control private sector borrowing, public sector debt is, in practice, the operational target for borrowing policies. But the appropriate coverage of the public sector is a difficult issue and varies by country. Some countries, for example, have profitable public enterprises that borrow on commercial terms from private foreign sources (albeit usually with a government guarantee). Deciding whether or not borrowing by such firms should be part of the coverage of public sector debt depends on a variety of considerations. These include the profitability of the public enterprises, their pricing and employment policies, their existing debt and ability to service it, and the risk that any associated contingent liabilities would become realized budgetary liabilities of the government. In general, if loans of public entities are excluded from borrowing ceilings, it is important to monitor the debt of such entities as well as other liabilities associated with weak private enterprise or financial sector balance sheets.

When linking borrowing policies to debt indicators, arguably the most difficult and controversial decision relates to the threshold that defines the "danger zone" at which borrowing should be curtailed. One difficulty in formulating such a threshold, for either an individual country or a group of countries, is that market signals are scarce in low-income countries that borrow almost exclusively from official sources, making it particularly difficult to detect growing solvency concerns.

Using Bolivia as an example

How this approach could work in practice can be illustrated by Bolivia's situation at the end of 2002.

Debt stock indicator. Bolivia benefited from debt relief under the original and enhanced HIPC Initiatives, reaching the completion point in June 2001. Although Bolivia has some access to nonconcessional financing (primarily from the Andean Development Corporation), most of its outstanding debt and new financing is on concessional terms. This would argue for focusing on the NPV of debt as the relevant stock indicator.

Coverage of debt. Bolivia's government has significant domestic debt, totaling 19 percent of GDP at the end of 2002, and its private sector has sizable external liabilities. Given this, the concept of public and publicly guaranteed external debt is not comprehensive enough. Hence, Bolivia's external and public debt should be analyzed separately, and any contingent liabilities of the government should be monitored.

External sector constraints. The ratio of Bolivia's exports to its GDP was about 20 percent in 2002—well below the average of 28 percent for all developing countries—meaning that Bolivia may face foreign exchange constraints. Exports rather than GDP could therefore be selected as the main denominator for assessing the country's debt burden. Similarly, in cases of market stress (Bolivia had problems selling government paper in times of political turmoil), the difficulties in generating foreign exchange may be a key constraint to debt servicing, particularly since most of Bolivia's domestic debt is in foreign currency. Therefore, the debt service-to-exports ratio should also be examined. The ratio of Bolivia's NPV of external debt to exports stood at a comparatively moderate rate of 114 percent at the end of 2002. However, the country's external debt service is projected to be relatively high in 2003, at 18 percent of exports, reflecting a comparatively front-loaded debt-service profile.

Public sector constraints. Bolivia's combined public sector revenue-to-GDP ratio was 22 percent in 2002. This ratio is comparable to those in emerging markets, particularly in Latin America and Asia, suggesting that Bolivia may suffer less from administrative constraints than some other low-income countries—though this conclusion must be qualified, to the extent that revenues are generated by hydrocarbon taxes. Similarly, not much of Bolivia's public sector financing is based on tied aid, allowing for fungibility of resources. However, its public sector debt service absorbed nearly 40 percent of revenues and was equivalent to almost 70 percent of social expenditure in 2002.

Preliminary conclusions. Even though Bolivia's debt ratios did not seem alarming at the end of 2002, its comparatively high external and public sector debt service relative to exports and revenues indicates a risk of encountering debt-servicing difficulties. A forward-looking borrowing strategy for Bolivia should therefore focus on the evolution of its debt-service ratios, in addition to its NPV of debt-to-exports ratio, under realistic baseline projections and alternative scenarios and shocks. Given the significance of debt-service concerns, Bolivia should design its borrowing policies with particular attention to the terms of new loans, including by seeking financing with reasonably long grace and maturity periods.

six (often overlapping) types of constraints on low-income countries' ability to generate the resources necessary to service their debts:

• *Total resource constraints*, given that debt service must be met out of a country's gross domestic product. These constraints may be particularly binding for the poorest countries, where additional claims on resources may push per capita income below the subsistence level.

• *Foreign exchange constraints,* reflecting the limited degree to which domestic factors of production can be transformed into the foreign exchange required for debt service and financing of imports.

• *Fiscal constraints,* reflecting governments' limited ability and capacity to levy taxes to meet debt service on top of other expenditure priorities.

• *Limited fungibility* of resources, resulting, for example, from the earmarking of revenues for subnational governments and agencies or from restrictions on the use of foreign aid for debt service.

• *Rollover constraints,* reflecting reliance on primarily official creditors and donors to refinance lumpy debt-service payments.

• *Political and moral considerations,* such as those associated with the resources allocated to debt service in relation to social or poverty-related expenditure.

Low-income countries differ in the extent to which they are—or are at risk of becoming—subject to these constraints. Some low-income countries are more advanced than others in terms of access to private capital, institutional and administrative capacity, and resilience to economic shocks. As a result, the above constraints may rarely become binding in these countries, which instead face risks similar to those faced by emerging market economies. But even the less advanced low-income countries differ in the specific constraints and the type and magnitude of the typical shocks they face and, thus, in the debt levels they can sustain, as well as in the indicators that are most useful in signaling potential problems.

Forming a judgment on the relative importance of the various constraints and risks in individual countries, though necessarily subjective, is key for assessing their debt-servicing capacity. Debt sustainability assessments always involve a fair degree of judgment, not least because countries' ability to service their debts ultimately depends on their future growth prospects, which are inherently uncertain. Nevertheless, the best countries can do is to make their potential constraints and risk factors explicit elements of their borrowing strategies. How this could work in practice is sketched out in the box on the adjacent page.

Taking the right path

Irrespective of the importance of designing an appropriate borrowing strategy, low-income countries can greatly reduce the tension between large financing needs and debt sustainability through sound economic policies and support from abroad. Financing alone is by no means sufficient to generate the growth needed to meet the MDGs; it must go hand in hand with supportive macroeconomic policies and structural and institutional reforms that improve economic flexibility, governance, and administrative capacity. In addition, there is often room to bolster domestic savings through more efficient revenue mobilization, better expenditure prioritization, and improved incentives for private saving. Such efforts—directly and through a track record of meeting debt-service obligations—would also help attract FDI, thereby reducing the need for debt-creating inflows while providing additional benefits in terms of expertise and technology transfer. In short, it is the combination of financing and policies that is crucial to set off the intended virtuous circle in which productive investment and growth generate, in turn, the capacity to service debt.

While appropriate economic policies and reforms maximize the net benefits of new financing, the international community plays an important role in supporting low-income countries. It does this through responsible lending, provision of grants, and close donor coordination to maximize aid effectiveness and establish an allocation mechanism that encourages strong policies while providing effective risk sharing against exogenous shocks. Arguably, the most effective and lasting support the international community can provide, however, is a reduction in existing trade barriers and an increase in market access for low-income countries' products. In sum, the challenge for low-income countries—to meet ambitious development objectives without compromising debt sustainability—calls for strong domestic policies, a prudent borrowing strategy, and support from abroad. ■

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