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External Debt

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External Debt

A bird's eye-view at the recent evolution of the developing countries' debt situation reveals several interesting patterns.¹ When we compare the data for the year 2000 (the data available at the time of the formulation of the Monterrey Consensus) with those for 2006, we find lower average external deficits, lower external debt ratios, and larger international reserves. There has been a dramatic change in the composition of borrowers and lenders. In 2000, 50 per cent of public sector long-term external debt was owed to official (multilateral and bilateral) creditors. In 2006, this share had dropped to 42 per cent. In 2000, external debt owed by private creditors amounted to less than 30 per cent of total long-term external debt. By 2006, this share increased to 41 per cent. As a consequence, the share of total long-term external debt owed to private creditors increased from 59 to 71 per cent.

In 2006, total international reserves of developing countries were about the same as the total external debt of developing countries and reserves continued to increase at record rate during 2007. Hence, as most international reserves are held in assets issued by the advanced economies, developing countries, as a group, no longer have a net external debt. However, several surplus countries are large economies, most of the deficit countries are small economies and there are still several small developing countries with a large net external debt. There are also large regional differences. Countries in Asia are characterized by low external debt ratios and some countries in East Europe and Central Asia are characterized by large, and in some cases, increasing external debt ratios.

Over the last six years, the developing countries' total (domestic and external) public debt-to-GDP ratio decreased by approximately 5 percentage points. There was also a decrease in the share of public debt which is owed to external creditors. Again, this decrease was more marked in the larger economies and there are large regional differences. In East Europe, more than 55 per cent of total public debt is owed to external creditors. In East and South Asia, external public debt is less than 30 per cent of total public debt.

Thus, while a quick look at the data shows a net improvement in the external debt situation of developing countries, if one moves beyond averages, it becomes clear that this improvement is driven by the behavior of a few large countries. It would be wrong to claim that developing countries no longer have an external debt problem. Moreover, data on the face value of debt can give a misleading impression on the actual change in the value of external debt of developing countries. Part of the reduction in external debt was due to debt relief under the HIPC initiative and some of the cancelled debt had a present value which was well below its face value. Thus, the net present value of public external debt decreased less than the face value of public external debt.

Until recently, the standard view in most development and academic circles was that access to external resources was a necessary condition for igniting growth in poor

¹ The term "developing countries" is used to identify both developing countries and transition economies.

countries. This view was the main intellectual foundation of the Monterrey Consensus. However, empirical evidence has not been kind to this view. Over the last few years, several developing countries have been growing rapidly while running large current account surpluses. Econometric studies show that a reduced reliance on external capital (including both equity and debt flows) is linked to higher economic growth.

This does not necessarily mean that we need to abandon everything we learned about the potential positive effects of external resources. A fairer view of the new evidence is that external finance is not necessary for all countries or at all times. The finding that, on average, foreign capital is bad for growth does not rule out that some countries are actually benefiting from external resources. Moreover, there are different types of inflows and each type has its costs and benefits. There are also different uses for such inflows and the effects of such inflows on the economy will depend on how these resources are used. Furthermore, the evidence shows that foreign capital does not contribute to economic growth under the current international set-up, but cannot say anything about what would happen under a revamped international financial architecture.

With respect to their external financing needs, developing countries can be divided into two groups: low income countries with limited or no market access and middle income countries with market access (often referred to as emerging market countries). These two groups of countries face different problems and any consensus on what needs to be done on external debt should recognize these differences.

A new policy Agenda on external debt should focus on the following seven points:

- i. *Recognize* that not all countries can benefit in the same way from external resources flows and that debt sustainability depends on how debt is used. Sustainability analysis should focus on both assets and liabilities: Debt incurred to build financial or physical assets is likely to be more sustainable than debt used to finance current expenditure. *Emphasize* that the ability to repay debt (which is at the core of debt sustainability analysis) is different from the need for external resources. There are countries that face an unsustainable debt situation and need more resources. Likewise, there are countries that do not have any problem sustaining a higher level of debt, but are in a situation in which a net flow of external resources could be deleterious for economic and social development (which could generate sustainability problems in the long-run). Identifying these different groups of countries should be the objective of a revamped Debt Sustainability Framework.
- ii. *Recognize* that debt sustainability is an issue for both low income and middle income countries and that debt relief efforts should not, in principle, discriminate among these different groups of countries. As countries that need debt relief are also likely to need more external resources, the official sector should make sure that debt relief is truly additional and could possibly be accompanied by an increase in other forms of aid. Evaluation of debt relief initiatives should include an explicit measure of the additionality of debt relief.

- iii. *Recognize* that past debt relief efforts have been somewhat unfair to countries with large developmental needs but low debt levels. Ensure that these countries are appropriately rewarded for conducting prudent macroeconomic policies.
- iv. *Recognize* that financial crises in countries with market access are often driven by liquidity problems and not by solvency problems - even solvency problems are sometimes the outcome of a liquidity problem. *Help* developing countries create new instruments and institutions that can reduce the likelihood of a liquidity crisis. *Acknowledge* that international coordination is particularly important because some of the shocks that may lead to a liquidity crisis depend on external factors and that these shocks often originate from policy decisions of the advanced economies.
- v. *Recognize* that vulnerabilities which may lead to debt crises are related to both debt levels and debt composition, and that there are important interactions between domestic public debt and external debt. As vulnerabilities cannot be identified without prompt and reliable data on the composition of both external debt and domestic public debt, *encourage* international coordination aimed at producing and disseminating such data. Donors should support programs aimed at improving the debt management and data collection capacities of developing countries and ensure that the various competing systems report comparable data and cover domestic public debt. *Refocus the international dialogue from "External Debt" to "Public Debt."*
- vi. *Recognize* that, even with improved debt management and better and safer debt instruments, debt crises are bound to occur. Thus, the international community should not abandon the idea of creating a debt resolution mechanism aimed at guaranteeing a speedy solution to debt crises and a fair burden-sharing among creditors and debtors. In fact, there should be two crisis resolution mechanisms: one for middle income countries with a large share of commercial debt and one for low income countries which have a large share of their debt with official creditors. The second mechanism should build on the experience of the Paris Club and seek to include all creditors which are not currently participating in Paris Club negotiations. In this context consideration may be given to the creation of an independent body, who is mandated by both debtors and creditors to evaluate the debt situation of all countries faced with external debt problem and to decide on the level and form of debt relief that needs to be provided.
- vii. *Start* thinking seriously about the odious debt issue. This is a controversial concept on which there is a multiplicity of views. Some argue that odiousness should be defined ex-post, while others argue that declaring odiousness ex-post may generate some problems that would be solved by declaring odiousness ex-ante. Still others claim that, given the current state of knowledge, having an explicit odious debt policy either ex-post or ex-ante may do more harm than good. More clarity on this issue is necessary.