

Chapter V

External debt

External finance is meant to supplement and support developing countries' domestic resource mobilization. However, since the nineteenth century, developing countries have experienced repeated episodes of rapidly increasing external indebtedness and debt-service burdens that have brought slower growth or recession and eventually produced renegotiation and restructuring. For this reason, the Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002b, annex) emphasized the importance of sustainable debt levels in mobilizing resources for development.

The present chapter analyses the current debate on debt and development in historical perspective. It starts with a brief review of the evolution of developing-country debt and rescheduling in the post-war period. The second section surveys measures to deal with the problem of excessive indebtedness, such as the Heavily Indebted Poor Countries (HIPC) Initiative, as well as more recent proposals for additional relief for low-income countries and new Paris Club arrangements for middle-income countries. Efficient use of external resources requires an adequate understanding, and an operative specification, of debt sustainability. The third section presents and critically assesses recent proposals for sustainability to be applied to low-income countries under the fourteenth replenishment of the International Development Association (IDA-14). In the last analysis, when failure to attain sustainability produces default, renegotiation is necessary. The final section reviews recent experience in this area that suggests the need for urgent action for new approaches to the problem, and provides an assessment of various proposals on the table for discussion by the international community.

Debt and development

The post-war approach to lending to developing countries

In the early post-war period, it had been assumed that development finance would take place in the form of grants or concessional borrowing from multilateral development banks. The potential for private flows was considered limited, given the volatility of such flows in the interwar period and their virtual disappearance (except for trade credits) following the Great Depression. Official flows were to be multilateral, administered by institutions such as the United Nations Capital Development Fund or through the International Bank for Reconstruction and Development (IBRD). In the event, private and bilateral official flows dominated international finance for development. Multilateral lending tended to be restricted to large project financing of infrastructure, evaluated according to efficient use of capital resources, and based on a notional social rate of return. As a consequence, it did not take into account the ability of the country to generate the foreign-exchange resources required to service the debt. Bilateral lending was carried out on an ad hoc, country-by-country basis with little coordination within different agencies in donor countries and with even less cooperation among lenders, with outcomes dominated

From grants and concessional loans to private lending and official bilateral aid

by political or domestic concerns through tied aid, and also with little concern for the impact on the country's ability to service the loans.

Capacity to service debt was not a major consideration in lending for development

Similar problems arose—and, if anything, became more acute—when private markets became the dominant source of financial inflows to developing countries in the 1970s. Foreign currency loans with adjustable interest rates were extended to private sector borrowers or public sector enterprises on the basis of domestic performance and creditworthiness, or were driven by competitive pressures on lending banks to retain market shares, without reference to the borrowing country's ability to service the debt. There had been little coordination among private lenders concerning overall foreign currency exposure at the country level or with respect to assessing the implications of possible changes in dollar exchange rates and interest rates before they sharply increased at the end of the decade. Thus, even when external finance had a positive impact on development, it could be frustrated by the lack of capacity to service the loans, irrespective of whether it was official aid or private market financing. Financing for development could be counterproductive if debt service diverted resources from development purposes.

Rapid external borrowing and debt rescheduling in the 1960s and 1970s

Debt-servicing difficulties were already visible in the 1960s...

Evidence of rapidly increasing indebtedness producing a negative impact on development had already been present during the First United Nations Development Decade. Although developing countries easily achieved the minimum target of an annual rate of growth of gross domestic product (GDP) of 5 per cent by 1970 about half of official foreign-exchange receipts were committed to repayment of debt to official lenders.¹ The decline in official flows during this period, noted in chapter IV, made debt servicing even more difficult and required debt rescheduling. The first Paris Club rescheduling was conducted in 1956 and during the 1960s and early 1970s countries accounting for more than half of outstanding developing-country debt were involved in official refunding or rescheduling negotiations.

...leading to frequent debt rescheduling and calls for debt forgiveness

The continuing decline in official assistance and increasing concentration of multilateral assistance in the poorer developing countries, particularly in sub-Saharan Africa, along with a rapid increase in private sector liquidity due to the expansion of the Eurodollar market in the early 1970s, brought an increase in private market borrowing by a number of fast growing developing countries. Borrowing by non-oil-exporting developing countries in Eurocurrency from private banks jumped from \$300 million in 1970 to \$4.5 billion in 1973, bringing their share of Eurobanks' loans to over 20 per cent. However, the collapse of the commodity price boom that had preceded the 1973 oil crisis quickly created servicing difficulties and by 1974 the Group of 77 were calling for debt cancellation in addition to rescheduling.²

In the 1970s, private lending becomes the principal source of external resources for development

The period after the oil crisis and the breakdown of the Bretton Woods system of fixed exchange rates had brought an increase in outstanding non-oil-exporting developing-country debt from \$78.5 billion at the end of 1973 to \$180 billion in 1976 with about 60 per cent borrowed from private banks through syndicated loans. The result was another round of debt renegotiations (Wellons, 1977) before a final surge of lending at the end of the decade brought the outstanding international indebtedness of developing countries to over \$600 billion at the end of 1981. There were to be 50 official or private negotiations leading to restructuring agreements between 1978 and 1982, the year of the Mexican default.

The International Monetary Fund (IMF) became increasingly involved in official debt negotiations by providing both estimates of the debtor's ability to pay and a standby programme to countries in debt renegotiation.³ This usually entailed an estimate of the debtor's external financing gap and the provision of short-term standby credit to finance it, subject to the introduction of an external adjustment programme to ensure that the gap would be eliminated and to permit the country to return to debt servicing.⁴

As a result of the increase in debt problems in the 1970s, both private creditors and IMF formulated statistical techniques to identify factors that would signal an imminent need for debt restructuring. Among the best indicators of rescheduling identified in a survey of 13 of the studies published between 1971 and 1987 were: the ratio of debt service or debt service due to exports, to GDP, and to reserves; the ratio of amortization to debt; and the ratio of debt to exports, and to GDP (Lee, 1993).

Private and official lenders sought indicators of borrowers' impending debt difficulties

Debt resolution in the 1980s

The numerous defaults by Latin American countries in the 1980s changed the nature of the response to debt renegotiations. Initially, debtors had been encouraged to introduce external adjustment policies in the belief that a return to high growth with external surpluses would provide the resources to repay arrears. These policies produced substantial current-account surpluses but only at the cost of prolonged domestic stagnation and import compression in what came to be called the "lost decade".

Major defaults in the 1980s changed the approach to resolution of debt servicing difficulties

The Brady Plan, introduced at the end of the decade, recognized that the debt could not be repaid through current-account surpluses at acceptable levels of growth and sought to induce creditors to accept write-downs, by offering new credit-enhanced assets in exchange for old debts, and to induce debtors to create domestic conditions that would restore their access to international debt markets, by offering structural adjustment lending. Creditors accepted write-offs, while the issue of Brady bonds allowed Latin American debtors to return to international capital markets, and effectively created a secondary market for debt issued by emerging economies which facilitated this process. The search for yield generated by low interest rates in the United States of America also contributed on the supply side, while decisions to liberalize financial markets and privatize State-owned enterprises contributed on the demand side. As a result, debt reduction was followed by a new phase of international indebtedness.

Brady Plan combined forgiveness and new lending supported by credit enhancement

While private flows were increasing to middle-income countries, there was an increase in the share of official assistance going to the poorest developing countries, in particular in sub-Saharan Africa. The major proportion was in the form of loans that produced an increase in debt stocks from about \$6 billion in 1980 to about \$11 billion in the late 1990s. Debt-service growth was less pronounced owing to repeated debt restructuring, increasing debt-service relief and an increasing use of grants. Because multilateral financial institutions did not in general provide debt relief, or provide aid in the form of grants, while bilateral official aid increasingly took this form, the relative share of multilateral institutions in debt service and debt stocks continued to rise from about one seventh to almost one third, while the share of debt service increased from about one tenth to one third.

The poorest developing countries remained dependent on official assistance

In addition, as a result of the increasing amounts of official aid, net transfers to these recipients—the poorest developing countries—were positive throughout the 1980s and 1990s, and in most countries constituted as much as ten per cent of national income. Since net official aid flows exceeded debt service, the rise in debt stocks did not cause the difficulties that the rise in private debt stocks caused in middle-income Latin American

Both official and private flows can create excessive debt service

countries, although it did create problems for bilateral donors. Since an increasing share of bilateral aid was being used to meet the rising share of debt service due to multilateral institutions, increasing amounts of bilateral aid or relief was required to prevent the debt overhang from having a negative impact on economic performance. Thus, while middle-income countries faced negative net resources transfers in the 1980s, low-income borrowers were faced with an increase in the share of aid used to pay debt service and thus with a decline in real resources for domestic development.⁵ Since solutions similar to the Brady initiative were not possible for these borrowers, a more direct approach was required to reduce debt stocks, which eventually took the form of the HIPC Initiative (see below).

Despite substantial differences in their conditions, both low- and medium-income countries reached the 1990s with expanding levels of official and private debt. Figure V.1 shows the sharp increase in the ratio of total debt to gross national income (GNI) that occurred in the last half of the 1970s and its continuation through the mid-1990s when the ratio stabilized, largely owing to the impact of the Brady and HIPC initiatives.

Another measure of the impact of debt is the use of export revenues to meet debt service, since this precludes their use to finance the imports needed for development purposes and implies either increasing indebtedness or slowing of the development process. The severe pressure placed on developing countries by the debt crisis of the 1980s can be seen in figure V.2, with the substantial improvements in the 1990s largely due to the decline in global interest rates during the decade.

The Monterrey Consensus, noting the negative impact of debt service on development expenditures, recognized that the elimination of excessive debt burdens would make available a major source of additional finance for development and therefore called on debtors and creditors to share responsibility for preventing and resolving unsustainable debt situations.

Debt burdens continued to increase through the 1990s

Figure V.1.

Ratio of total debt to gross national income, 1970-2003

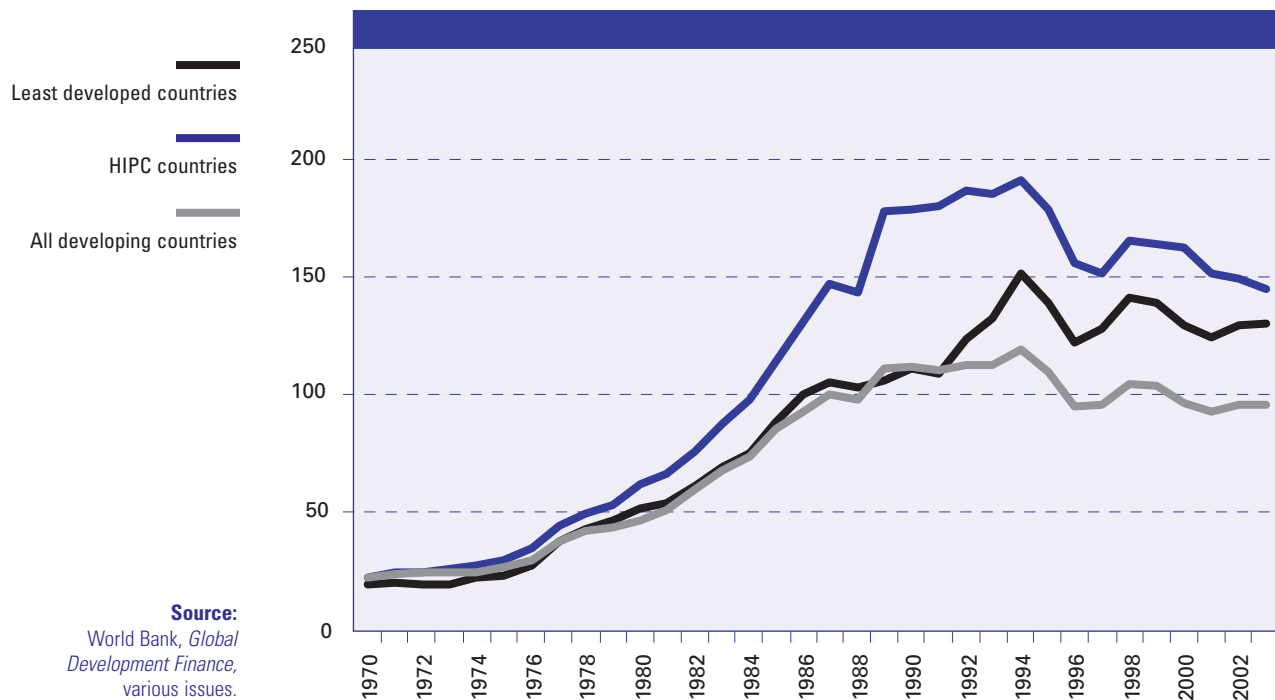
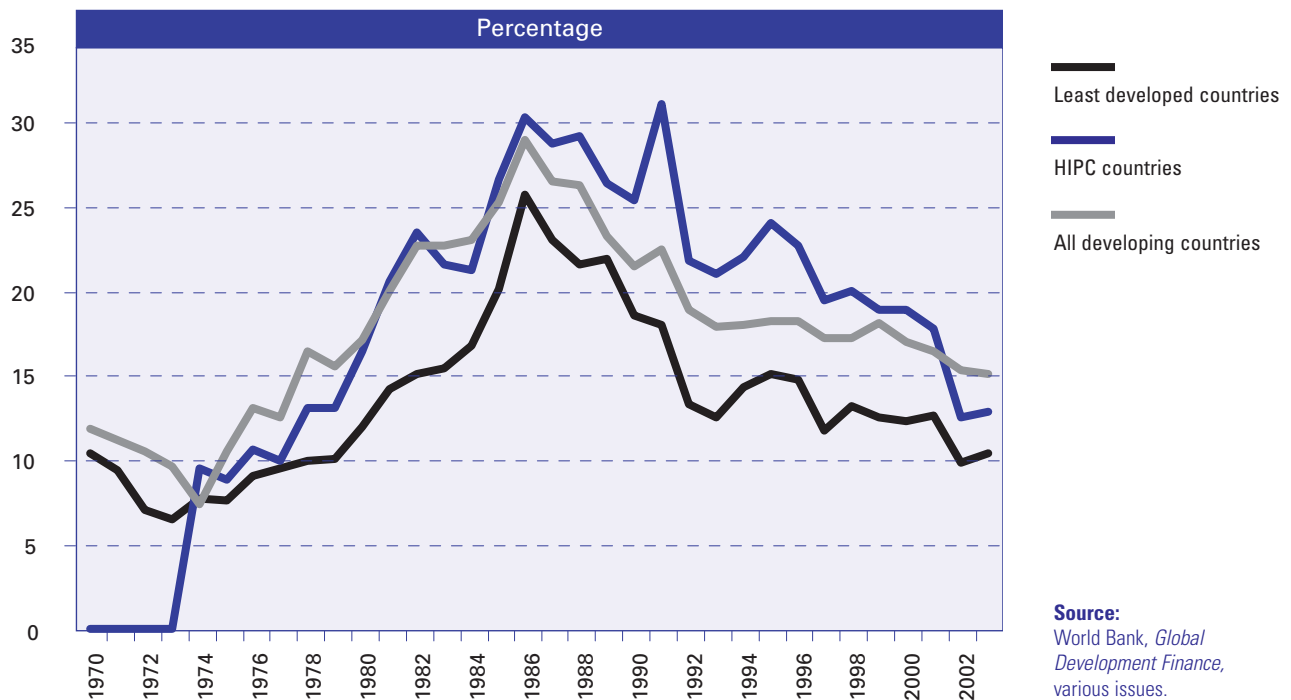


Figure V.2.
Ratio of total debt service to exports, 1970-2003



Debt relief

The Heavily Indebted Poor Countries (HIPC) Initiative

In contrast to the debt burdens of developing countries in general, those of the poorest developing countries continued to increase through the first half of the 1990s (see figure V.1). Recognition of the negative impact of this debt overhang on investment, growth and development in the poorest, heavily indebted countries led to the creation of the Heavily Indebted Poor Countries (HIPC) Initiative in 1996 to reduce the debt of the poorest countries to a level that would make it sustainable and provide an exit from serial rescheduling at the Paris Club. It was intended that any resources freed from debt service should be additional to existing support and available to support growth and poverty reduction.

As the original framework was considered to be insufficient for the attainment of debt sustainability by many poor countries, an “enhanced” HIPC initiative was introduced in 1999 to provide deeper, broader and quicker debt relief. According to the criterion for eligibility in the enhanced HIPC Initiative, a country should face unsustainable debt even after the full use of traditional relief mechanisms.⁶ In an extension of the work noted above that had been undertaken in the 1970s by private banks and IMF on predicting the need for debt renegotiation, the HIPC Initiative used similar variables to determine debt sustainability.⁷

By mid-April 2005, 27 countries had received debt relief, with 18 countries having reached completion point and 9 countries at decision point.⁸ Together with other debt-relief initiatives, HIPC has provided a reduction in debt stocks of the 27 countries of about two thirds. As a proportion of exports, debt service declined from 17 per cent in 1998 to 10

The HIPC Initiative sought to alleviate debt burden for poorest developing countries

Original approach enhanced in 1999 to provide more rapid relief

Twenty-seven countries currently receiving relief under the Initiative

per cent in 2003. Savings from lower debt-service payments provide the potential to increase expenditures targeted to poverty reduction. Among complementary measures of particular importance are those of the Paris Club whose members have granted debt relief beyond HIPC terms. Overall, for these 27 countries, reductions have been funded in roughly equal parts by Paris Club and other bilateral and commercial creditors, on the one hand, and multilateral creditors, on the other. The former group contains three HIPC countries which are themselves creditors: the United Republic of Tanzania and Cameroon, which have agreed to provide HIPC relief on all their claims, and Rwanda, which has provided relief to Uganda. Although the Initiative had been scheduled to expire at the end of 2004, it was extended for a further two years to allow those countries that were eligible to benefit from debt relief.

An additional nine countries could qualify ...

The total cost of providing debt relief to all of the 38 countries potentially eligible for assistance under the HIPC Initiative has been estimated at \$58 billion in 2004 net present value (NPV) terms. A little more than 50 per cent will come from debt forgiveness by bilateral creditors, while the rest will be provided by multilateral lenders, such as IMF, World Bank and the regional development banks. The share of debt relieved by IMF will be financed from income from the investment of the net proceeds from off-market gold sales in 1999 deposited in the Poverty Reduction and Growth Facility (PRGF)-HIPC Trust Fund, plus contributions from member countries. The World Bank has created the IDA HIPC Trust Fund, financed by contribution, to provide funds to reimburse IDA for HIPC debt relief, and to support debt relief provided by eligible regional and subregional creditors. In addition, Paris Club creditors have provided relief to qualifying countries and most have pledged to provide assistance over that required under the HIPC Initiative.

... but the Initiative is still lacking its full funding

However, the Initiative is still not fully funded. IDA has a financing gap of about \$12.3 billion of which about \$1.7 billion will materialize during the IDA-14 period. Ensuring participation from non-Paris Club bilateral and private creditors has been particularly difficult. Of the 51 non-Paris Club countries participating in the HIPC programme, 28 have committed to deliver some or all of their pledged amounts. Securing the participation of non-Paris Club official bilateral (and private) creditors has been a challenge since the creation of the Initiative and recently there have been setbacks. The Libyan Arab Jamahiriya, has withdrawn its commitment to participate, citing its failure to obtain ratification of the commitment from appropriate authorities. Other creditors complained about obstacles complicating delivery of debt relief, including Algeria, where the majority of debt is in kind, thereby making the valuation of repayment obligations problematic. The costs associated with the Sudan, Somalia and Liberia will need to be met by the IMF HIPC Trust Fund when these countries are ready to benefit from HIPC relief, at a total increased cost of \$2.1 billion. Within IMF, low interest rates over the period from 2000 have opened a potential gap in the resources available from the Special Disbursement Account (SDA) to meet IMF costs for HIPC relief.

Paris Club plays a crucial role in the success of HIPC

Paris Club negotiations require a country to seek comparability of treatment from other creditors. However, most commercial creditors have not provided their share of traditional and HIPC debt relief. In the case of at least nine HIPCs, commercial creditors and other bilateral creditors have refused to match Paris Club decisions and have instead pursued full recovery via litigation. In a survey of HIPC countries conducted by IMF in August 2003, nine countries responded that they were facing litigation initiated by commercial creditors and two non-Paris club creditors. Non-delivery of debt relief and resources lost in litigation can substantially affect the debt outlook of HIPCs. Moreover, pending and ongoing litigation can seriously jeopardize the relationship of HIPCs with the international financial community and their access to finance in the future.

It is now generally recognized that most of the debt reduction that was achieved in the HIPC countries took the form of writing off bilateral debts already in arrears, thus freeing up a smaller amount of real resources for poverty reduction spending than had been originally foreseen. Table V.1 shows the nominal debt-service relief for countries that have reached completion point and the arrears at decision point. Nearly 22 per cent of the debt relief classified as aid flows took the form of a write-off of arrears.

Although there are many countries where debt-service ratios and debt management practices have improved, there are others where these debt ratios have deteriorated. Figure V.3 traces debt service before countries had achieved decision point and debt service in 2004 for those of them that had reached completion point. Countries located above the 45-degree line had an increase in debt service and those below had a decrease. Countries located below the -25 per cent and -50 per cent trajectories experienced reduction in debt service of more than 25 and 50 per cent, respectively. Debt service for three of the completion point countries, Mali, Mozambique and Bolivia, was higher than it had been before decision point. If the interest burden of the domestic treasury bills issued to sterilize the impact of aid flows on domestic liquidity had been taken into account, Uganda would have

Reducing debt-service burdens does not necessarily free resources for poverty reduction programmes

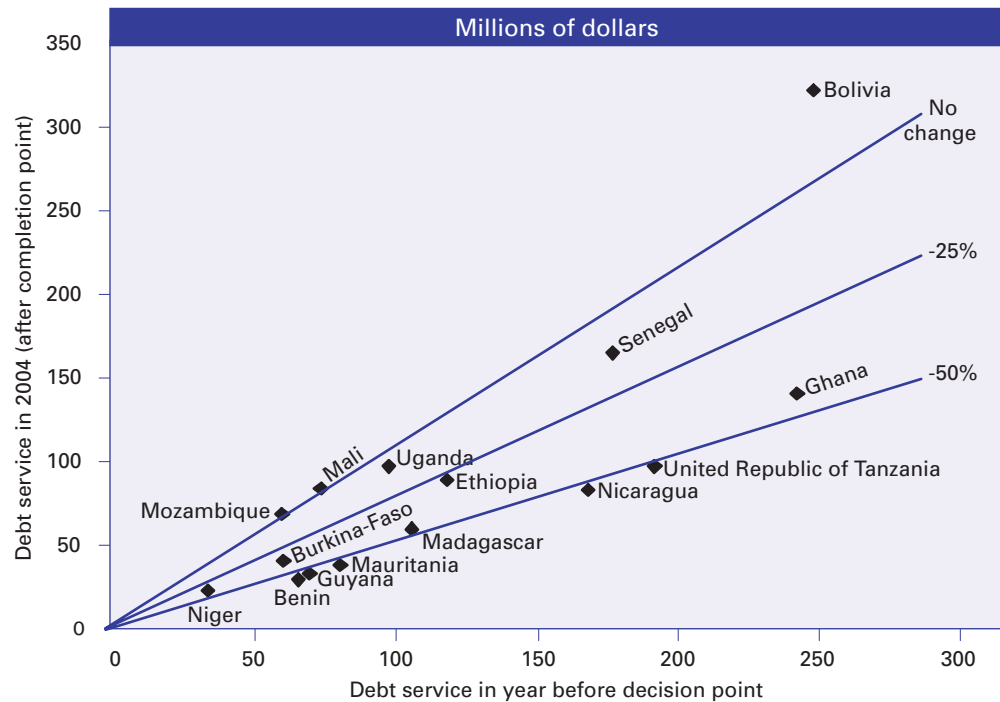
Table V.1.
Debt relief and reduction in arrears for selected HIPC completion point countries

	Enhanced HIPC debt relief		Arrears (principal and interests on long-term debt to official creditors)			
	Completion point	Nominal debt service relief ^a	Year before decision point ^a	Year before completion point or last available (2003) ^a	Year after completion point or last available (2003) ^a	Change since decision point (percentage)
Benin	Mar-03	460	77	20	0	-100
Bolivia	Jun-01	2 060	21	21	0	-100
Burkina Faso	Apr-02	930	39	42	41	4
Ethiopia	Apr-04	3 275	668	593	b	b
Ghana	Jul-04	3 500	13	33	b	b
Guyana	Dec-03	1 353	129	147	122	-6
Madagascar	Oct-04	1 900	725	699	b	b
Mali	Mar-03	895	589	34	115	-80
Mauritania	Jun-02	1 100	535	349	333	-38
Mozambique	Sep-01	4 300	375	898	431	15
Nicaragua	Jan-04	4 500	1 759	1 014	b	b
Niger	Apr-04	1 190	104	60	b	b
Senegal	Apr-04	850	5	17	b	b
Uganda	May-00	1 950	147	147	241	64
United Republic of Tanzania	Nov-01	3 000	1 748	888	1 050	-40
Total		31 263	6 934	4 961		
			22%	16%		

Source: International Monetary Fund and International Development Association (2005b).

- ^a In millions of dollars.
^b Completion point after 2003.

Figure V.3.
Evolution of debt service for countries that had reached completion point



Sources:
DESA, based on data in World Bank, *Global Development Finance 2005* (Washington, D.C., 2005); and IMF, HIPC Initiative—Statistical Update, 11 April 2005.

also been located above the 45-degree line. In Senegal, the reduction in debt service was less than 25 per cent, while a third of the countries had reductions in the ranging from 25 to 50 per cent and a third had reductions of just above 50 per cent.

In some cases, debt reduction was insufficient because forecasts of future conditions were over-optimistic

The success of the Initiative in providing sustainable debt relief has been hampered by the overly optimistic growth and debt-service projections made in assessing country performance. External shocks (commodity price shocks in particular) have not only led to the inability of some countries to meet those projections but also added additional difficulties. In the case of Uganda, the debt-to-exports ratio was 50 per cent higher in June 2003 than before relief had been obtained under the HIPC Initiative. Furthermore, although the Poverty Reduction Strategy Papers (PRSPs) that accompany the HIPC Initiative have been successful in increasing social spending, for some countries the commitments on social spending have exceeded the savings on debt service, leading to accumulation of additional indebtedness. On the other hand, since such programmes are not currently embedded in the country's overall development strategy, the higher priority given to their application has led to neglect of other national priorities. In addition, in many cases, the relief provided has been too slow, especially in the interim period between decision and completion points. As a result of all of these factors, there is an emerging consensus that, despite the Initiative, many poor developing countries may continue to suffer from a debt overhang.

Further, since the introduction of the original HIPC scheme in 1996, there has been a sharp decline in total net official development assistance (ODA) compared with previous trends, and levels have not recovered despite a rise in bilateral aid flows after 2001. Indeed, bilateral ODA flows to HIPCs, after deduction of debt forgiveness, have been stagnant since 1997, and food aid and emergency aid have increased at the expense of project-related grants, which have the largest potential impact for stimulating long-term growth (see chap. IV).

Additional HIPC debt-relief proposals

The deficiencies identified in the HIPC Initiative have spawned a wide range of proposals for augmented debt relief. In line with its objective to front-load the aid resources needed to finance the Millennium Development Goals (see chap. IV), the United Kingdom of Great Britain and Northern Ireland has proposed 100 per cent reduction of debt service for loans from international financial institutions contracted before 2004; such debt-service reductions would apply for the period 2005-2015 in post-completion point HIPC countries and non-HIPC IDA-only countries with transparent and solid public expenditure management as supported by a Poverty Reduction Support Credit with the World Bank. According to this proposal, donors would contribute in line with their global share of IDA. The cost for IMF would be covered by use of IMF gold reserves. Canada has made a similar proposal, but with bilateral donors financing the debt relief. The United States of America has made an alternative proposal for full relief for HIPC countries' outstanding debt to IMF, IDA and the African Development Bank African Development Fund with funding for IMF debt forgiveness coming from the reserve account of the PRGF-HIPC Trust Fund and the Special Disbursement Account. IDA and African Development Fund debt would be cancelled without replenishment and funded by reducing the IDA and African Development Fund allocations for each beneficiary country.

Other proposals would enhance existing relief mechanisms. France would reinforce the HIPC approach by providing liquidity grants, funded by additional bilateral IDA and African Development Fund contributions, for countries facing debt-service problems owing to external factors. Japan has proposed lowering the debt-to-export threshold from 150 to 120 per cent (including private and bilateral debt) for pre-completion point HIPC countries, while post-completion point countries would be granted additional relief if they had a high debt overhang after HIPC debt cancellation.

Recently, Norway has proposed a Millennium Development Goal debt sustainability mechanism⁹ based on principles drawn from the existing proposals. The approach stresses that any new initiatives must confirm and fully finance earlier commitments and cover all present and future HIPC costs to IDA and regional and subregional creditors as well as preserve the ability of international financial institutions to provide high levels of concessional loans in future. Such initiatives should ensure equitable treatment and base multilateral debt relief beyond HIPC on debt sustainability analyses as proposed in IDA-14. It also notes that multilateral debt-service reduction seems preferable to debt stock reduction.

In early June 2005, G-8 Finance Ministers agreed on a proposal for additional debt reduction under HIPC to be submitted for approval by Heads of State and Government at the G-8 Summit in July and by the shareholders of the participating lending institutions at their respective annual meetings in September. Donors agreed to provide additional development resources to provide full debt relief on outstanding obligations to IMF, the World Bank and the African Development Bank, and to IDA and the African Development Fund for HIPC countries that have reached the completion point and to extend similar relief to qualifying countries when they reach the completion point. Donors also agreed to a formula to ensure meeting the full costs of the measures so that they would not reduce the resources available to the lending institutions for support of other developing countries and to ensure the long-term financial viability of international financial institutions. The agreement did not make proposals for dealing with low and middle-income countries that face similar debt burdens but are not eligible for the HIPC process.

Proposals are under consideration for further debt relief for the poorest countries

Concerns have been expressed about full cancellation of multilateral claims

Norway has proposed a compromise approach

G-8 Finance Ministers adopt a compromise proposal on full debt relief for some HIPC countries in June 2005

New measures for official debt relief for middle-income countries (Evian approach)

Middle-income countries also face debt-servicing difficulties

In October 2003, the G-7 finance ministers agreed to adopt a new initiative, termed the “Evian approach”, providing more flexible debt restructuring through the Paris Club for non-HIPC and middle-income countries. The novelty of the approach was the introduction of a debt sustainability framework to provide an orderly, timely and predictable debt workout so as to reduce the occurrence and severity of financial crises. The negotiations are thus carried out on the basis of long-term debt sustainability analysis provided by IMF with specific attention being paid to evolution of debt ratios over time and the debtor’s economic potential. The decision on sustainability rests ultimately with the creditors.

Paris Club is offering a new approach...

It is expected that the analysis will distinguish between liquidity problems and medium- and long-term debt problems. The former will be dealt with under existing arrangements with reductions in debt payments tailored to the debtors’ financing requirements. When debtors have medium- and long-term problems that create questions of debt sustainability, a more comprehensive, country-specific treatment that encompasses coordination with private creditors and puts particular emphasis on comparability of treatment with private creditors will be applied. The treatment thus combines flow treatment and debt stock re-profiling or debt stock reduction. It is expected that the treatment will allow exit from the Paris Club and that comparability will be applied by private creditors. Where necessary, the cut-off date, which for many countries may be traced back to the early 1980s, will be moved forward to determine the debts eligible for restructuring. The approach retains the traditional links to IMF conditionality.

...involving a comprehensive three-stage process

The comprehensive treatment of debt will consist of a three-stage negotiation procedure. In the first stage, a flow rescheduling will be provided under a Fund arrangement that could range from one to three years determined by the past performance of the debtor. The second stage will provide exit treatment, with exact terms and approach dependent upon the results of the debt sustainability analysis of the Fund. In the final stage, exit treatment could be provided in a phased manner over the span of a second Fund programme. The debtors progress and record of payment to the Paris Club would determine the final outcomes of these negotiations.

There are still some technical challenges that need to be worked out so as to make the approach fully operational, such as that posed by the definition of sustainability, in regard to which a transparent framework is required to allow applicant countries to make their own assessments of sustainable debt levels as a basis for negotiation (see the discussion on debt sustainability below). As the Paris Club emphasizes a case-by-case approach to debt restructuring, lack of sufficient transparency in this process could lead to debt-relief outcomes being guided by political considerations. A framework is also needed to enable creditors to distinguish liquidity problems from insolvency. A clear criterion is also needed to determine the new cut-off dates. Finally, clear, transparent principles by which to determine comparability of treatment with private creditors need to be agreed.

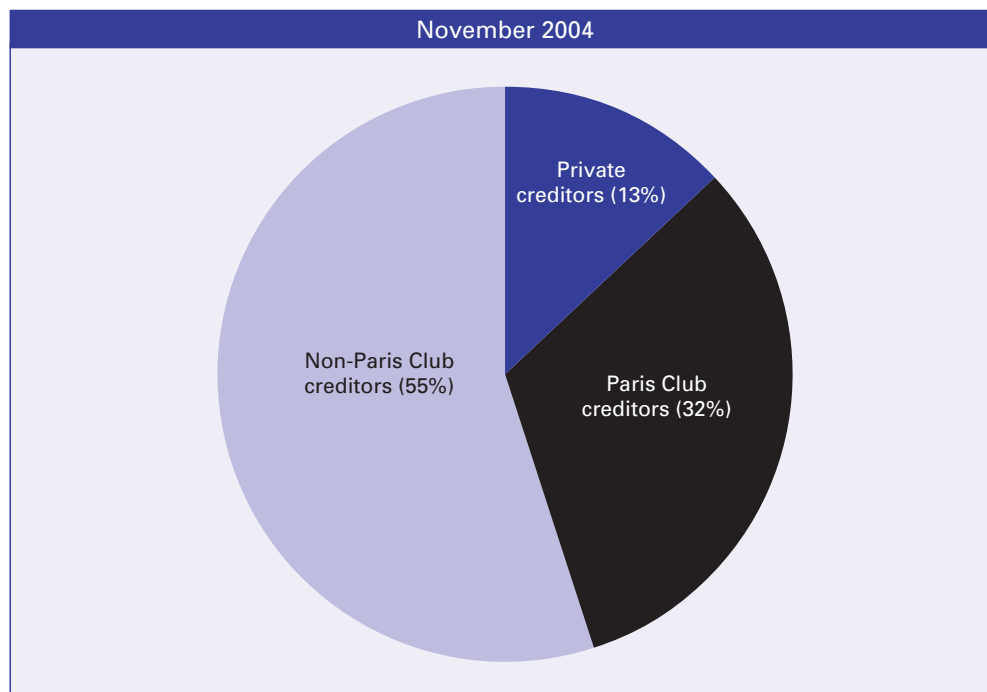
Experience with the new Evian approach is limited...

The experience with the Evian approach is still limited. Kenya, which applied to the Paris Club for financing for a PRGF programme with IMF, was the first country treated. Assessed as experiencing a liquidity problem, Kenya was therefore granted flow rescheduling under Houston terms.

...but Iraq has received relief under its terms

Iraq was the first country to receive comprehensive treatment under the Evian approach. Iraq’s emergence from the conflict that had followed an economic blockade resulted in high demand for investment in critical social areas and an unsustainable debt

Figure V.4.
Composition of Iraq's debt^a



Source:
 Paris Club presentation at the
 UN Multi-stakeholder Meeting.

a Excluding reparations but
 not including late interest.

burden. This produced an agreement with IMF for Emergency Post-Conflict Assistance to Iraq in September 2004 and Paris Club relief in November 2004 on an estimated indebtedness of \$120.2 billion, conditional on a promise by Iraq's then interim Government to seek comparable treatment from other creditors, who accounted for more than two thirds of the outstanding debt (see figure V.4).

The negotiations were based on a debt sustainability analysis that had considered Iraq's particular situation regarding reconstruction needs and combined short-term and medium-term needs. Based on assumptions about oil production and exports associated with discounted oil prices, the debt sustainability analysis concluded that an 80 per cent debt stock reduction would be required to produce sustainability. This implied that Iraq would have, in 2015, debt ratios in line with commonly accepted international standards: external debt at 86 per cent of GDP; external debt at 162 per cent of exports; and debt service at 36 per cent of exports.

This would reduce the total debt stock due to the Paris Club from US\$ 38.9 billion to US\$ 7.8 billion. If there is comparable treatment by non-Paris Club creditors, the ratio of total debt to GDP would fall from 500 per cent in 2004 to 80 per cent in 2008 and the ratio of total debt to exports would fall from 700 per cent in 2004 to 150 per cent in 2008. The treatment is tied to the conditionality and performance criteria included in the Fund's programme.

Debt sustainability

Debt sustainability analysis for low-income countries

Measuring debt sustainability is a crucial component of decisions on debt relief

Identifying sustainable levels of debt and debt service is crucial in determining when external finance supports or hinders domestic resource mobilization. During the 1980s and 1990s, despite access to low-cost financing, many low-income countries accumulated high levels of debt that imposed a heavy burden on their economies, a problem whose resolution ultimately required costly debt relief. The fact that many “graduated” HIPC countries are experiencing rising debt burdens, and that debt ratios in some other low-income countries are at elevated levels, suggests a need for better understanding of sustainable debt levels. A new approach is particularly important in assessing the appropriate financing of the sizeable social expenditures that will be required to achieve the Millennium Development Goals. Further, as noted in chapter IV, one of the major changes introduced in IDA-14 is the use of debt sustainability analysis to determine eligibility for access to grants.¹⁰ The Evian approach, discussed in the previous section, is also centred on debt sustainability analysis.

Debt sustainability in the HIPC Initiative was based on historical experience

As noted above, debt sustainability under the HIPC programme had been based on threshold values of standard debt indicators calculated on historical experience, with an ad hoc adjustment in the enhanced Initiative designed to provide a cushion for external shocks. The new approach¹¹ evolved an analytical country-specific framework grounded in indicative policy-dependent thresholds and a forward-looking analysis of debt dynamics. The basic novelty was to quantify debt sustainability thresholds on the basis of the quality of policies and institutions, reflecting the idea that countries with stronger policies and institutions could support a higher level of debt on a sustainable basis. In contrast with the HIPC approach, which deals with existing debt overhang, the new approach is intended to provide guidance on new borrowing.

A new, forward-looking approach is currently being studied ...

The approach proposed threshold values for traditional debt ratios based on the World Bank Country Policy and Institutional Assessments (CPIAs) that could be used to classify countries in “poor”, “medium” and “strong” policy performance categories. In assessing policy, governance was given a higher relative weight. As an example, a country classified as a strong policy performer, with a value of the CPIA index above 3.9, would be regarded as having a sustainable debt burden if its ratio of NPV of debt to GDP was below 60, its ratio of NPV of debt to exports below 300, its ratio of NPV of debt to revenue (excluding grants) below 350, its ratio of debt service to exports below 35, and its ratio of debt service to revenue (excluding grants) below 40 (see table V.2, entries for sub-item entitled “Strong policy” under first subheading entitled “Original proposal”).

... based on a number of different measures of debt sustainability

In response to a request for lower threshold ratios, particularly for strong performers, in March 2005, IMF and IDA set out revisions based on a series of options (see also table V.2). Option 1 maintains the original threshold for NPV of debt to exports at 100 per cent for a weak policy performer, but lowers the ratio to 150 per cent for medium performers and to 200 per cent for strong performers. This option would reduce the new lending permitted to strong and medium performers and require an increase in grant resources for the latter to substitute for their lower share of loans in normal assistance flows. Option 2 is even more conservative, setting the thresholds for the ratio of NPV of debt to exports at 50/100/150 per cent, respectively, for weak/medium/strong. This option would need additional debt relief beyond the HIPC Initiative, as both weak and medium-risk countries would be graduated from the HIPC Initiative with higher debt ratios than these country-specific

Table V.2.
Debt-burden thresholds under alternative options^a

	Percentage				
	NPV of debt as share of			Debt service as share of	
	Exports	GDP	Revenue ^b	Exports	Revenue ^b
Original proposal					
Weak policy (CPIA \leq 3)	100	30	200	15	20
Medium policy (3 < CPIA < 3.9)	200	45	275	25	30
Strong policy (CPIA \geq 3.9)	300	60	350	35	40
Option 1: Narrower band with same lower bound^c					
Weak policy (CPIA \leq 3.25)	100	30	200	15	25
Medium policy (3.25 < CPIA < 3.75)	150	40	250	20	30
Strong policy (CPIA \geq 3.75)	200	50	300	25	35
Option 2: Narrower band with upper bound equivalent to HIPC Initiative threshold^d					
Weak policy (CPIA \leq 3.25)	50	20	150	10	20
Medium policy (3.25 < CPIA < 3.75)	100	30	200	15	25
Strong policy (CPIA \geq 3.75)	150	40	250	20	30
Option 3: Asymmetric threshold adjustment					
Weak policy (CPIA \leq 3.25)	100	30	200	15	25
Medium policy (3.25 < CPIA < 3.75)	150	40	250	20	30
Strong policy (CPIA \geq 3.75)	150	40	250	20	30

Source: International Monetary Fund and International Development Association (2005).

- a** All ratios are rounded, in line with the original presentation.
b Defined exclusive of grants.
c Implying a probability of distress of about 18-22 per cent.
d Implying a probability of distress of about 16-19 per cent.

thresholds. Option 3 proposes a combination of options 1 and 2 by keeping the lower bound of the original threshold range for weak performing countries, while applying the enhanced HIPC threshold to others. The Fund staff has expressed a preference for option 1.

The new approach also proposes the use of contemporaneous values for debt burden denominators to avoid the criticism directed at the backward-looking three-year averages used under the original HIPC framework. Another departure is the choice of discount rates for calculation of NPVs in the African Development Fund. Instead of six-month averages of the currency-specific reference long-term commercial interest rates, the new framework relies on aggregate debt-service projections in United States dollars using the corresponding United States dollar discount rate to derive NPVs.

Since the new approach is based on the view that good policy environments enhance the ability to sustain debt and inasmuch as these policy assessments are based on the summary CPIA indicator that includes subjective evaluations of the policy and institutional environment, the approach is not wholly transparent. The World Bank has indicated that it will publish the CPIA indicators. A further improvement would be greater transparency in particular with respect to the information that enters as inputs into the calculation of these indicators. It might be more appropriate if the Bank had discussions on the appropriate inputs and findings with the country concerned.

The new approach is based on the idea that domestic policies influence sustainability

As noted above, the new approach is designed to serve as a guide to lending and policy advice within IDA and for other donors. This creates the possibility that both multilateral and bilateral creditors will base their lending decisions on the same CPIA-based indicator and thus reinforce the already existing tendency to herding.

An assessment of debt sustainability analyses

All debt sustainability analyses rely on identifying critical threshold values of debt ratios ...

As we have seen, the key determinants of this and similar debt sustainability analyses are the existing stock of debt, the development of fiscal and external repayment capacity that is closely linked to economic growth, and the availability of new external financing, both concessional and non-concessional. The accepted methodology is to identify “critical” threshold levels for the ratio indicators, most of which were already identified in the earlier studies mentioned above. In the HIPC process, these threshold levels had been arrived at using historical averages of debt indicators prevailing when the countries experienced debt crises. Later analysis established critical values for debt indicators that caused sharp increases in the incidence of default or market-based indicators of risk (such as the premium over benchmark interest rates on debt securities traded in the secondary market). In recent years, the World Bank and IMF have moved away from the latter approach owing to the wide dispersion of the levels of these indicators in countries experiencing debt crises. While IMF continues to monitor these traditional debt sustainability indicators, the multilateral institutions have recognized the limitations of the indicator approach and the necessity of formulating an alternative approach (IMF, 2003f).

... and define sustainability as the ability to continue to service debt without large changes in income and expenditure ...

However, in line with the approach to the work in the 1970s taken by private sector lenders and the Fund in their attempt to forecast the probability of rescheduling,¹² debt *sustainability* is still defined “as a situation in which a borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditure”.¹³ This calculation of *debt dynamics* concentrates on the evolution of the values of the various indicators under alternative assumptions about the behaviour of key internal and external variables and the probabilities of their occurrence.¹⁴ These calculations have been improved by a focus on the components of both historical and projected debt dynamics that attempt to identify whether the stability of debt ratios arises from the behaviour of interest rates, growth rates, inflation or real exchange-rate changes.

... despite elaboration and refinement in their calculation

The Fund has also made efforts to further elaborate the variables affecting solvency in both the external and public sectors by “unpacking” the endogenous debt dynamics. Much of this research, spurred by emerging market currency crises in the 1990s, attempted to identify significant variables that predict debt crises, such as shares of short-term debt, reserve levels, public sector contingent liabilities, appropriate exchange-rate regimes, market responses such as credit ratings and spreads, and the degree of serial and cross-correlation of major variables during crises. It has also led to increasing scrutiny of existing practice. For example, the use of NPV as the measure of outstanding debt has been questioned owing to lack of a clear criterion for the choice of discount rates that are based on fluctuating interest rates of Organization for Economic Cooperation and Development (OECD) countries. This has led to suggestions that a fixed discount rate would be more appropriate.

Further, recent IMF debt sustainability analyses have included “stress testing” where debt dynamics are evaluated under an increasingly wide variety of conditions. These tests include: (a) *baseline projections* of external debt/exports and public debt/revenue with

macro assumptions at central forecasts; (b) *sensitivity tests* using both two-standard-deviation shocks and historical averages; and (c) an *assessment of the external risks* surrounding the scenario and the particular vulnerability of the country in question.

Given the difficulties in forecasting both the movements of macroeconomic variables and the vulnerability of a given country to cross-correlations between variables in the case of an external shock, the major challenge has been to establish, given simple probabilities, what shocks and scenarios can be considered “reasonable”. This has been made more arduous by the fact that recent capital-account crises produced values of debt indicators that exceeded the upper bounds of the stress-test ranges (IMF, 2003f).

An associated difficulty in this respect is how to distinguish a *liquidity* crisis from *insolvency* or, in terms of the objectives of the 1970s forecasting models, how to determine when a restructuring is appropriate, since only insolvency would require debt relief.¹⁵ Based on these earlier models, the evolving approach still regards the inability of a debtor to access finance as the cause of the inability to service debt, without determining whether this is due to a shortage of liquidity or insolvency.¹⁶ However, such a distinction has serious implications for debt restructuring. The debt sustainability analysis results are based on probabilities of certain outcomes, one of them being that of the country’s access to finance in the future which is in itself volatile and subject to error components in predictions. Thus, given the difficulties of forecasting the time-path of crucial variables, there are obstacles in making a country-by-country distinction between chronic and transitory resource gaps, and determining the appropriate perspective (short-, medium- or long-term) to apply in a situation of imminent default.¹⁷ As a result, IMF debt sustainability analyses cannot determine the level of debt that may be considered sustainable for individual countries, and thus the point at which a liquidity problem becomes a solvency problem. A liquidity crisis could turn into insolvency if it is not rapidly contained, through decisive action either by domestic authorities or by multilateral lenders.¹⁸

This lacuna has increased significance, since the proposed Evian approach explicitly relies on debt sustainability analysis to assess the amount of debt relief. The negotiations to return countries to sustainable debt paths will be complicated by the fact that the value of an indicative ratio that is good for one country may be a signal of distress for another, or the same value of a ratio may have a different significance at different points of the economic cycle. The solvency-liquidity distinction forms an important basis for considering debt stock treatments rather than debt flow treatments (for example, a deferral or rescheduling of payments). The lack of a strong and consistent analytical tool to separate liquidity from solvency crises remains a fundamental gap in the evaluation of debt sustainability. In addition, an analysis of the link between debt restructuring and debt sustainability based on past debt negotiations is required. Since the interest rates charged on non-ODA debt in the bilateral agreements after a Paris Club negotiation are often higher and at times vary from those stipulated in the original contract, developing countries frequently complain that they more than repay their obligations in terms of the original contract.

Furthermore, the distinction between liquidity and solvency has other policy implications. The policy advice for an insolvent debtor should generally be for it to pursue a debt-reducing strategy, but advice to an illiquid debtor should be for it to borrow so as to make timely interest payments and prevent the loss of creditworthiness that would lead to insolvency. While the new approach has succeeded in giving a broader range to debt dynamics by taking into account variables that have emerged from a study of recent crises, the analysis still falls short of providing an analytical base for defining threshold levels at which debt is to be considered sustainable.

Forward-looking measures depend on the reliability of forecasting critical variables ...

... and have difficulty distinguishing between liquidity and insolvency crises

The new approach still has difficulty determining a general approach to sustainability

Distinguishing between illiquidity and insolvency is important in framing debt-relief policy

The recent advent of financial crises driven by the build-up of debt underscores the need for analysis and the development of debt sustainability frameworks that are flexible enough to take into account differences across regions and countries. IMF generally regards stable debt ratios as sustainable and rising debt ratios as problematic. Goldstein (2003) points to the difficulties of associating stable debt ratios with debt sustainability. For a middle-income country, the ability to pay depends on the degree of trade openness. Threshold levels for debt-to-export ratios cannot be uniformly applied to all countries. In all of the recent work on debt sustainability, GDP is used as a denominator for threshold levels to reflect the size of the economy. However, the relation between national output and debt sustainability will depend on the ability of the country to divert resources from the non-tradable sector to the tradable sector so as to generate foreign exchange.

A precise measure of public debt is also important in measuring sustainability

Especially since the Asian financial crisis, an additional problem has been the definition of “public debt”.¹⁹ Earlier, this was seen as debt contracted by the sovereign, but it now includes implicit liabilities of the public sector as well. This inclusion was largely driven by the lessons learned from the Asian crisis where large contingent liabilities due to exorbitant bank recapitalization costs in many cases dwarfed the contractual obligations of the sovereign to its external debtors.²⁰ Recent research on the strong links between debt and banking crises and the lack of a comprehensive bankruptcy framework in many emerging markets has led to a recognition of the need to consider contingent sovereign obligations under the umbrella of public debt.

In recent years, developing countries have been advised to develop domestic markets for bonds denominated in local currency. This measure is seen as a means not only to deepen domestic financial markets but also to shield debtors from external exchange-rate and interest rate shocks (see chap. I). As a result, domestic debt levels have risen dramatically since the Asian crisis, especially in East Asia. The emergence of liquid domestic debt markets and the increasing domestic debt burdens of sovereign borrowers have added a new dimension to debt sustainability, reflected in the explicit consideration of domestic debt in recent debt sustainability analyses conducted by IMF. There is concern that the rise of domestic indebtedness may lead to a new emerging market debt crisis in the medium term.²¹

Emphasis on access to external finance in measuring sustainability may have unintended consequences

Paradoxically, since access to finance appears as an important element of the Fund’s approach, the concentration on *debt dynamics* may unintentionally lead to more borrowing. It inadvertently encourages the practice of engaging in new borrowing to meet claims of existing creditors and thus creates the risk of a country’s being caught in an endless spiral of increased borrowing to service rising debt levels. Moreover, capital flows are volatile and thus making judgements on a sustainable level of debt based on the access to external financial flows is bound to produce errors.

A better approach to sustainability would place development objectives at the centre of the analysis

As noted, both the approach to prediction of rescheduling in the 1970s and the recent efforts at redefining debt sustainability deal with the ability to meet debt service, with an increasing focus on the currency and term structure of the debt. However, this does not in effect deal with the sustainability of debt in terms of the ability of the country to generate the resources necessary to meet debt service without sacrificing its domestic development. A truly viable alternative approach to the problem would place development objectives at the centre of sustainability.²² The essence of such an approach was reflected in the call by the Secretary-General (document A/59/2005) for debt sustainability to be defined as the level of debt that allowed a country to achieve the Millennium Development Goals and still service its obligations. In addition to debt dynamics, this would mean that work on debt sustainability should take into account the sources of the capacity to service debt. Thus, more work is needed on defining debt sustainability in terms of:

- The ability to pay.
- The capacity to repay debt taking domestic priorities of human development and poverty reduction into account.
- A level of debt that is growth enhancing, not one that hinders growth.
- Criteria that take the cyclical of capital flows into account.

Debt resolution and debt relief involving private creditors

New approaches and initiatives

The 1990s saw a series of increasingly large financial crises that required access by members to balance-of-payments support well beyond their normal quota drawings on Fund resources. On the one hand, this raised questions concerning the adequacy of existing credit lines to manage crises that had their origin in the capital account rather than the current account, and the level of Fund resources necessary to preserve global financial stability (see chap. VI). On the other hand, it gave credence to arguments that Fund support of capital-account crises had created a risk of moral hazard among private creditors who had come to depend on large Fund support programmes to protect them from loss.

For this reason, critics as diverse as the International Financial Institutions Advisory Commission (2000) and the United Nations Conference on Trade and Development (2001a) argued in favour of strict limits on access to IMF resources. In order to counter the belief that IMF crisis support was simply being used to “bail out” private creditors, leaving the costs of adjustment to domestic residents, many argued in favour of measures to “bail in” the private sector through a new approach to debt crisis and restructuring. This approach reversed normal practice, in which an IMF agreement was considered a precondition for opening negotiations for restructuring in the case of default by requiring the involvement of the private sector in sharing the burden of restructuring in order for it to receive IMF support. However, the experience of debt restructuring following financial crises also led to a number of proposals to provide a more orderly resolution of financial crises caused by excessive external indebtedness.

In 2001, IMF reformulated proposals made since the 1970s²³ for a debt workout mechanism based on private sector bankruptcy legislation and introduced its own proposal for a sovereign debt restructuring mechanism (SDRM).²⁴ The proposal sought to provide a legal framework within which to deal with restructuring of debt in an orderly manner. It met with opposition from private and Paris Club creditors, as well as from some developing countries that preferred voluntary arrangements. The private sector was concerned about the problem of moral hazard and the Paris Club creditors resisted the proposal to place the ad hoc arrangements of the Paris Club within a new legal structure. IMF was also not regarded by some as a neutral arbitrator because of the presence of a conflict of interest arising from the role of IMF as arbitrator and its preferred creditor status.²⁵ Some emerging market economies feared that the initiation of the procedure would result in an increase in their borrowing costs or even in a loss of access to international capital markets. In addition, the proposed new insolvency procedure required an amendment to the IMF Articles of Agreement which would then have to feed into national legislations. In the absence of strong support for the measure, attention shifted to the broader use of col-

Frequent debt crises in the 1990s led to a search for a new approach to debt relief ...

... and brought the appropriate role of IMF in debt crises under discussion

In 2001, IMF formally proposed a statutory debt workout mechanism

lective action clauses (CACs) in bond issues, as well as to the drafting of a voluntary framework in the form of a code of conduct for debt resolution that could be agreed on by debtors and creditors.

Collective action clauses in bonded debt indentures have also been introduced

The increasing use of bonded debt to finance developing countries has been accompanied by an increase in the number of individual creditors, increasing the difficulty in reaching an agreement on resolution in the case of default. CACs provide a solution to this dilemma of collective action and representation by enabling a qualified majority of bondholders to make decisions that become binding on all bondholders and specify voting rules.²⁶ This allows Governments facing difficulty in servicing their bonded debt to declare a standstill without exposing themselves to disruptive legal actions. While a CAC, in principle, does not preclude legal action taken against the debtor by the courts, the inclusion of this provision generally prevents a small group of investors or individual investors from taking disruptive legal action, as has been seen in the recent debt workouts for Ecuador and Argentina.

During the latter part of 2003 and early 2004, some emerging market borrowers, representing more than 75 per cent of the total value of bonds issued in that period, have taken steps to include such clauses in their international sovereign bonds issued under New York law. While Italy had adopted CACs in 2003, as of 2004, German and Swiss legislation still did not include CACs.

It is difficult to introduce these clauses into existing bonds ...

Inclusion of a CAC does not necessarily imply that it will be invoked at the time of a debt restructuring. For example, Pakistan in 1999 restructured its international bonds without invoking the CACs included in these bonds, preferring an offer for a voluntary bond exchange. By contrast, Ukraine made use of the CACs included in four of its outstanding international bonds in April 2000, thereby obtaining the agreement of 95 per cent of its bondholders even though the holders of bonds were widely spread out. Debt restructuring can also take place using mechanisms different from CACs. In mid-1999, Ecuador carried out a restructuring of its bond debt by inviting eight of the larger institutional holders of its bonds to join a consultative group, with the aim of providing a formal communications mechanism.

Concerns that the inclusion of CACs in bond issues might lead to an increase in the cost of borrowing for the issuer do not appear to be warranted in light of the experiences of Mexico, Brazil, South Africa, Venezuela and Belize. Moreover, a recent study comparing the yield on bonds issued in the Euromarket with CACs, and bonds issued in the United States market and Euromarket without CACs, shows that the inclusion of CACs in bond issues in the Euromarket did not impact secondary market yields as of early 2003 (Gugiatti and Richards, 2003).²⁷

... so the proposal will be fully effective only when all outstanding bonds are retired

One difficulty with CACs as a substitute for a more formal mechanism is that only newly issued bonds would contain CACs, so that the collective action problems could be resolved only once all outstanding bonds were retired. Conversion plans to effect the retroactive coverage by CACs of bonds issued without CACs are considered problematic (Krueger, 2003). In addition, there are perceived risks in the use of the clause, inasmuch as debtors, in alliance with a majority of the creditors, may be able to discriminate against a minority. Another difficulty is that a debtor may be in a position to manipulate the voting process by putting real or fictitious claims in the hands of the creditors that are under the influence of the sovereign. Experience with aggregation thus far has been limited to countries that have issued bonded debt on a relatively small scale, such as Ecuador, Pakistan, the Republic of Moldova, Ukraine and Uruguay, and it remains to be seen if the problems of aggregation can be resolved for larger sovereign debtors.

The SDRM proposal aimed at a comprehensive framework within which to deal with sovereign debt problems and relied on various statutory instruments to achieve this objective, such as aggregation of claims, targeted stay on litigation, and a dispute resolution forum; and CACs constitute an instrument that is targeted at facilitating the restructuring of bonds. In conclusion, the objective of codes of conduct for private creditors and sovereign debtors is to develop a comprehensive voluntary framework within which to address potential debt-servicing problems while preserving to the maximum extent possible contractual arrangements. In its communiqué of 24 April 2004 issued on the occasion of its spring 2004 meeting, the International Monetary and Financial Committee of the Board of Governors of IMF encouraged sovereign debtors and private creditors to continue their work on a voluntary code of conduct, and looked forward to reviewing further work on issues of general relevance to the orderly resolution of financial crises. The finance ministers of the Group of Seven (G-7) have also welcomed efforts at the Group of Twenty (G-20) to develop a code of conduct. The idea is to initiate a voluntary dialogue between debtors and creditors so as to promote corrective policy action to reduce the frequency and severity of a crisis and codes that would lead to an orderly debt workout.

The voluntary code of conduct is perceived by debtors as a framework within which they can formally engage creditors and provide information to them. Creditors, on the other hand, see the code as a framework within which debtors would make stronger commitments to engagement and the provision of information. It is expected that a code of conduct will clarify the roles of the sovereign debtor and creditor, help to avoid disruption in the process of crisis resolution and effect a more balanced distribution of the financial burden.

The Institute of International Finance has drafted four key pillars: information sharing and transparency; close debtor-creditor dialogue and cooperation; good faith during a restructuring process; and fair treatment. It is expected that an early dialogue between issuers and investors will lead to a quick rehabilitation of debtors and restore market access. A technical group consisting of Brazil, the Republic of Korea and Mexico has been established to work closely with the private sector representatives and work out a draft code for discussions at the G-20. Creditors do not consider the code as more robust than current market practices. The increased emphasis on sharing information between investors and debtors and investor-creditor relations, which is being given support under the code of conduct is asymmetric, with debtors providing more information but creditors doing nothing about improving the flow of information from their side.

Whether voluntary efforts, such as those reflected in these principles, can provide a sufficiently strong basis for an effective crisis resolution mechanism has yet to be tested. In the long run, it may have to be combined with internationally sanctioned standstills to be used when needed. It is thus essential that the explorations of debt workout mechanisms, including voluntary codes and international mediation or arbitration mechanisms, continue with full support of all stakeholders. Since it will take time for this to be implemented, a transitional framework may also be needed. Overall, there has been less progress in providing institutional mechanisms for the debt problems facing middle-income countries. The experiences of some of these countries are analysed in the next section.

Recently, a voluntary code of conduct has been proposed ...

... and a draft issued for discussion by the G-20

None of the current proposals have yet been made fully effective

Experiences of alternative debt restructuring mechanisms²⁸

Debt restructuring has thus proceeded on an ad hoc basis

In the absence of the implementation of a multilateral framework for debt restructuring like those outlined above, debt crises in the 1990s relied increasingly on voluntary country-by-country negotiations between debtors and creditors. At the same time, resolution moved farther away from the pattern of the Brady Plan. As noted above, the initial response to the Mexican default of 1982 had been voluntary rescheduling and domestic adjustment policies, complemented in the Baker plan by additional IMF and private financing. It was only when the Brady Plan added substantial debt write-downs backed by credit enhancements in the form of collateral for the new Brady bonds that debtors managed to meet their debt service through a return to international credit markets. During the 1990s, the fear that large IMF lending, such as that provided to Mexico in 1994, would create moral hazard led to the view that the market mechanism should be allowed to determine restructuring, as IMF assistance was cut back. This was evident first in the withdrawal of the debt enhancements as part of IMF support in the Russian default.

The Russian Federation provides an example of a restructuring that allowed a rapid return to international markets

Under an IMF facility arrangement, the Russian Federation had implemented a domestic stabilization through control of the money supply that required its fiscal deficit to be financed through market sales of treasury securities (known by the acronyms GKO and OFZ) at interest rates substantially above international levels. This led to a rapid increase in debt service that reached about one third of federal spending in the first quarter of 1998. The major buyers were Russian banks which borrowed dollars through repurchase agreements using the bonds as collateral, earning substantial profits from the large interest rate differential. Given IMF support for a stable exchange rate, the risk of devaluation was considered to be low. Non-residents accounted for about a quarter of the subsequently defaulted debt, financing their purchases with rubles received from repurchase agreements with Russian banks. These investors hedged their currency risks with forward contracts from Russian as well as from Western banks. Falling export revenues due to the collapse of commodity prices after the Asian crisis reduced government revenues and external earnings. Attempts to offset the decline with higher interest rates failed to attract sufficient external inflows to finance government deficits and caused rising debt service that the Government could no longer meet. In August 1998, the Russian Federation suspended payment of debt service and payments on forward contracts. This meant that the collateral behind the repurchase agreements was worthless and banks and foreign investors faced losses of 100 per cent of their investments. The situation was aggravated by the suspension of payment on forwards by Western banks. Russian banks' attempts to repay borrowed dollars increased downward pressure on the exchange rate and international reserves, led to the collapse of the currency and brought technical insolvency for the banks.

In March 1999, a novation scheme accepted by over 99 per cent of creditors (by value) offered 10 per cent of par value in cash, 20 per cent in 3- and 6-month debt securities and 70 per cent in 4-to-5-year securities. The proceeds received by non-residents were deposited into special ruble-denominated accounts that were not freely convertible into foreign exchange or cash rubles. Owing to the complexity of the scheme, there is no reliable estimate of the loss incurred by investors. In a strategy that would later be followed by Ecuador, the Russian Federation suspended service on former Soviet Union foreign debt and began accumulating arrears, but stayed current on all its Eurobond issues and other external debt denominated in foreign currencies contracted by the Russian Federation.

A new agreement with IMF in 1999 contained even more stringent conditionality, but it seems that the major purpose of the new loan was to allow the Russian Federation to stay current on its payments to IMF and to reach agreements with other creditors. In August 1999, a rescheduling was agreed with the Paris Club and in August 2000 with the London Club, exchanging obligations of the Bank for Foreign Economic Affairs for Eurobonds issued by the Russian Federation.

This multistage process of write-offs and renegotiation, accompanied by a recovery in commodity prices, in particular petroleum, rising fiscal receipts, and external budget surpluses along with growth rates in excess of 5 per cent, led international credit rating agencies to classify Russian sovereign debt as investment grade by the end of 2004.

In Ecuador, debt enhancement was not offered and the support of IMF remained questionable in the early stages of its debt renegotiation process. Following a series of climatic, external earnings and political shocks that had led to a banking crisis in August of 1999, Ecuador missed payment of interest on the Brady bond portion of its \$13.6 billion external debt. A month later it announced that it would default only on the Discount Brady bonds, since these bonds had credit-enhanced interest collateral that could be invoked on a 25 per cent vote by holders. When this decision was taken, it activated cross-default clauses in other bonds and made automatic default on the principal of the \$6 billion in Brady bonds, as well as the \$500 million in Eurobonds.

Unable to agree a support programme with IMF, Ecuador initially attempted a domestic stabilization programme based on dollarization. By April 2000, the Government had been granted a one-year IMF standby loan for about \$306 million accompanied by nearly \$2 billion in additional multilateral support. In July, about 97 per cent of Brady investors accepted an offer to exchange the defaulted bonds for about \$4 billion in new 30-year bonds and about \$1 billion in cash to cover accrued interest and amortization. Since the Brady bonds did not contain CACs, any change in terms required the unanimous decision of all the creditors. In order to induce creditors to participate in the restructuring, Ecuador used carefully crafted exit consents that required only a supermajority, plus upfront cash disbursements and principal reinstatement clauses to encourage participation. The haircut of approximately 40 cents on the dollar was marginally worse than the 36 per cent estimated for the Russian default. The restructuring resulted in a reduction of Ecuador's Brady bond and Eurobond stock by 40 per cent and a reduction in service of \$1.5 million over the first five years of the exchange. It also opened the way for a Paris Club agreement restructuring 100 per cent of its \$887 million official debt.²⁹

Ecuador's restructuring provides an example of a successful voluntary restructuring of securities held by a heterogeneous group of bondholders with competing interests in the absence of CACs. However, it is not clear that this market-based approach dependent on the relative bargaining strengths of debtors and creditors has provided long-term debt sustainability, given that Ecuador's current ratios of debt to exports of above 25 per cent and debt to GDP of over 50 per cent place it in the high-risk category according to the new approach to debt sustainability.

In contrast to both the Russian Federation and Ecuador, Argentina was not even provided with additional multilateral financial support after its default in 2001. Argentina had already received exceptional access to IMF resources of 800 percent of quota when IMF suspended a review of an existing arrangement, halting disbursement and effectively declaring to financial markets that it no longer considered Argentina's external debt sustainable. The government default declaration less than a month later made rollover of maturing Fund borrowing the equivalent of "lending into arrears",³⁰ and thus subject to

A new IMF agreement was part of the restructuring

Restructuring in Ecuador progressed only after an IMF agreement

Ecuador is an example of a successful voluntary restructuring without a return to sustainability

Argentina provides an example of an alternative voluntary approach in the absence of an institutional workout mechanism

“good faith” negotiations with creditors. This meant that Argentina was subject to IMF conditionality on its recovery programme and debt renegotiations without receiving any additional resources to support them. This was a clear application of the new approach of refusing to use Fund resources to bail out external creditors,³¹ and to leave restructuring to voluntary market processes.

Without additional IMF support, Argentina faced novel conditions compared with previous debt restructuring experience

The decision to suspend current programmes, along with the Fund’s position as a preferred creditor, meant that Argentina faced its creditors in very different conditions from those of previous debt renegotiations and thus that debt sustainability required a substantially larger debt reduction. Further, Argentina was denied new support to avoid moral hazard problems but at the same time, under lending-into-arrears principles, was required to provide a settlement with creditors to avoid having to repay maturing programmes. Under these conditions, it was difficult or outright impossible to follow a market solution.

What constitutes fair burden-sharing between debtors and creditors?

On the grounds that about 50 per cent of the population was below the poverty line as the result of the crisis that it had been undergoing, Argentina argued that it had made sufficient contribution and that the only equitable debt renegotiation was one that allowed a rate of growth that provided for a recovery of the living conditions of the population and offered the assurance that the solution was sustainable on a long-term basis. Rather than view the negotiation as providing the means by which it could borrow what was required to meet post-restructuring debt service, Argentina argued that the solution would have to make it possible to meet debt service without additional borrowing. Thus, the break with the Brady solution of providing additional funding, write-offs and debt enhancement to ensure a return to capital markets was met in Argentina with a refusal to consider the return to international borrowing as a solution to its debt sustainability. After a series of adjustments to unilateral proposals to creditors, Argentina made an exchange offer at the end of 2004 that implied about a 75 per cent haircut which was accepted by over 75 per cent of creditors.

Argentina highlights and reinforces the need for a new multilateral approach to default resolution

Although it is still unclear if major creditor countries consider this result to have met the good-faith conditions that would allow rollover of existing credits, and although some outstanding creditors have attempted to achieve full consideration through challenges in the courts, the Argentine experience may herald a new post-Brady era in debt renegotiations that highlights the difficulties of the market-based approach and reinforces the need for a new multilateral approach to default resolution.

Notes

- 1 Concessional bilateral credits accounted for about 60 per cent of funds loaned to developing countries, with 6 per cent multilateral credits and a third in direct investment and trade credits in the period. See D'Arista (1979, pp. 57-58).
- 2 An assessment of the pre- and post-debt rescheduling experience of seven developing countries notes that a majority experienced slower growth, investment and net resources transfers after rescheduling, suggesting the need for more substantial relief measures. See United Nations Conference on Trade and Development (1974).
- 3 See United Nations Conference on Trade and Development (1975), where the tendency for creditors to require an IMF standby arrangement as a prior condition for renegotiation is noted.
- 4 United Nations Conference on Trade and Development (1975) notes that the main focus of IMF assessments was on short-run economic problems.
- 5 See Birdsall, Claessens and Diwan (2004, pp. 59-62). These authors show that the result has been for countries with higher debt stocks to receive higher aid flows, irrespective of the policies they follow, thus limiting the policy selectivity that is supported by official donors.
- 6 Regarding the eligibility criteria, it has been argued by some authors that eligibility ratios are not based on a comprehensive measure of either poverty or indebtedness, and that as a result some poor and some heavily indebted countries are not HIPC-eligible. The scope of country selection is also regarded by some analysts as too narrow, as the "IDA-only" criterion disqualifies some otherwise debt-strapped non-IDA countries. It has also been asserted that political and cost factors excluded countries that met eligibility criteria (see Gunter, 2001; G-24 Secretariat, 2003; United Nations Conference on Trade and Development, 2004e).
- 7 These threshold levels were largely based on empirical work undertaken by Underwood (1990) and Cohen (1996). A critique of HIPC using market-based indicators can be found in Cohen (2001).
- 8 In April 2005, Honduras, Zambia and Rwanda reached completion point.
- 9 See Ministry of Foreign Affairs, Kingdom of Norway (2005).
- 10 This reassessment process was initiated in the International Monetary Fund (2002b).
- 11 In a series of papers by IMF and International Development Association (2004 and 2005).
- 12 The Fund's analysis of how outstanding stocks of liabilities evolve over time includes projections of the flows of revenue, expenditure and debt servicing, current account and exchange-rate changes. Assessments of fiscal sustainability are an important element of the debt sustainability exercise and include indicators of public debt and deficits and medium-term fiscal projections. The projected debt *dynamics* in turn depends upon macroeconomic and financial market developments. A key variable is the availability of financing.
- 13 IMF (May 2002b), p. 4.
- 14 The distinction between an analysis of debt dynamics and a broader view of debt sustainability is elaborated in Schneider (2005b).
- 15 Debt relief here refers to a write-off of debt leading to a reduction in the stock of debt. Much confusion arises from the fact that the term is commonly used for both debt write-off and debt rescheduling which allows the debtor grace periods before repaying the amount treated in the rescheduling.
- 16 "Sustainability thus incorporates the concepts of solvency and liquidity, without making a sharp demarcation between them" (International Monetary Fund, 2002b, p. 4).
- 17 This distinction is examined in detail in Roubini (2001).
- 18 As has been stressed by Kenen (2001), and explored further using a more theoretical formulation by Haldane and Kruger (2004).
- 19 See Goldstein (2003) for a discussion within the Brazilian context.
- 20 See figure 3.1 on "Public debt in emerging market economies" in International Monetary Fund (2003a).
- 21 See International Monetary Fund (2003a).
- 22 See Schneider (2005). This issue was consistently addressed in the Multi-stakeholder consultations on sovereign debt for sustained development, held in New York in March 2005 and in Maputo, Mozambique, also in March 2005, and undertaken by the Department of Economic and Social Affairs of the United Nations Secretariat as part of the financing for development process.

- 23** In 1978, the United Nations Conference on Trade and Development raised the question of debt relief, proposing a mechanism of debt reorganization that would be “carried out within an institutional framework that would ensure the application of the principles of international financial cooperation and protect the interests of debtors and creditors equitably” (see UNCTAD, 1978, annex II, p. 2). A more detailed proposal was made in 1980 to create “a multinational forum agreed upon by the debtor and the creditors” see the annex to section B of Trade and Development Board resolution 222 (XXI) of 27 September 1980 which endorsed a set of features to guide members in future operations relating to the debt problems of interested developing countries. The United Nations Conference on Trade and Development subsequently proposed a mechanism based on the 1978 reform of United States bankruptcy law; see annex to chapter VI of *Trade and Development Report, 1986* (United Nations Conference on Trade and Development, 1986) which contains a proposal based on the analysis provided by a New York law firm. Similar proposals have also been made in the 1998 and 2001 editions of the *Trade and Development Report* (United Nations Conference on Trade and Development, 1998 and 2001a).
- 24** For a survey of the various prior proposals in this area, see Rogoff and Zettelmeyer (2002) who curiously do not refer to the prior proposals by UNCTAD.
- 25** A recent proposal seeks to remedy this by using the G-20 to create an independent entity to oversee the mechanism. See Berensmann and Schroeder (2005).
- 26** The use of CACs in bond issues governed by English, Japanese and Luxembourg law has been an established practice. Historically, such bonds issued under United States, German, Italian or Swiss law did not include such clauses. The largest market for sovereign bonds is in New York; however, bonds issued under New York law have traditionally included only majority enforcement provisions, not majority restructuring provisions.
- 27** There is as yet no evidence how CACs may perform if a major sovereign defaults on its bonds that include CACs. The Emerging Market Credits Association has largely remained silent on the type of CAC that should be included.
- 28** For a more complete discussion, see United Nations (2001a), sect. 3.
- 29** Ecuador’s default was not well received by private creditors who objected that Ecuador’s Brady Plan had already involved a 45 per cent write-down and was supposed to have provided permanent resolution. In addition, some accused IMF of having precipitated the default in order to test its new approach to “bailing in” private sector creditors. See BradyNet Forum (<http://www.brady.net/bbs/bradybonds/100090-0.html>).
- 30** Conceived in the late 1980s as a means of resolving the debt crisis, the scope of the Fund’s policy concerning lending into sovereign external payments arrears to private creditors required the debtor to pursue appropriate policies and make a good faith effort to reach a collaborative agreement with its creditors. See IMF (2002c).
- 31** Although some suggested that the exceptional access granted in 2001 allowed foreign creditors to bail out before the crisis (see Cafiero and Llorens, 2002). This is confirmed by the large increase in capital outflows reported in November of 2001 (see Comisión Especial de la Cámara de Diputados, República Argentina, 2005).