Domestic Debt & Achieving MDGs in Low Income Countries

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Introduction

Achievement of Millennium Development Goals (MDGs) is a major challenge for Low Income Countries (LICs). Assessments by international agencies suggest that most LICs, especially in Sub-Saharan Africa, are far from achieving these objectives by 2015. A key requirement is to ensure that government and donor resources are increasingly targeted towards the achievement of MDGs. In this respect, debt servicing represents a claim on government resources. International community has provided substantial external debt reduction and relief to Heavily Indebted Poor Countries (HIPCs), with an aim of assisting these countries on their path towards achieving MDGs. Governments also have to service domestic debt, which if freed, could also be utilised for achievement of MDGs.

Domestic Debt in LICs: Some Stylised Facts

A recent IMF/IDA analysis for 66 LICS over 1995-2004 suggests an average domestic to GDP ratio of about 19 per cent, with domestic debt constituting on average about one-fifth of total public debt. Domestic debt in non-CFA African HIPCs averaged 6-9 per cent of GDP in 1980s/90s but the share of domestic debt in total debt fell sharply from 22 per cent in the 1980s to 6 per cent in the second half of 1990s. More recent domestic debt data for end-2005, available through IMF Article IV reports, shows significant domestic debt/GDP ratios in Guinea-Bissau, Ethiopia, Sierra Leone, Burundi, Zambia and Guinea. With restrictions on convertibility of bank notes since 1993 and development of domestic debt markets, domestic debt has taken hold in a number of CFA HIPCs. Latin American HIPCs such as Bolivia and Nicaragua, showed sharp increases in domestic debt over 2000-03, but these have since been reduced.

As for other LICs, in Africa, both Kenya and Nigeria have had significant reliance n domestic debt, and whereas in Kenya the share of domestic debt in total debt has increased significantly, in Nigeria, with sharp increases in oil revenues, it has fallen, with net domestic debt (after taking account of deposits at the central bank) turning negative in 2006. In the Asian LICs, Sri Lanka has sizeable domestic debt (47 percent of GDP in 2005), in the context of total public debt/GDP ratio of over 100 per cent, while domestic debt in Bangladesh has been around 18 per cent of GDP in recent years.

Overall size of domestic debt may be underestimated as in most cases debt contracted by local government or public enterprises as well as data on domestic arrears and other un-securitised debt is often excluded. In addition, contingent liabilities can also be very large. With external debt being reduced substantially through the HIPC Initiative and the MDRI, the share of domestic debt in total debt is expected to increase significantly.

Fiscal/Budgetary Impact of Domestic Debt Burden

Despite a sharp decline in the share of domestic debt in the total debt of non-CFA African HIPCs during 1980-2000, domestic interest service payments remained high (over 40 per cent of total interest payments). Average implicit domestic interest rate in the late 1990s was 21 per cent compared to only 1 per cent for foreign borrowing. Many governments resorted to domestic borrowing where at least in the short term they could rollover domestic debt to reduce external vulnerability and because of a cap on non-concessional external borrowing in IMF programmes. The recent IMF/IDA analysis for 66 LICs over 1995-2004 also suggests domestic interest payments at over 40 per cent of total interest payments, with real interest rates at an average of 3 per cent. More recent data indicates that in many cases real domestic interest rates have fallen significantly from the peaks and in a number of cases turned negative. However, in countries such as Ethiopia, Zambia and Tanzania which have benefited from full HIPC debt relief, domestic interest payments have been similar or larger in size than external payments and are projected to remain higher. Among other LICs, domestic interest payments dominate in Sri Lanka (6 per cent of GDP throughout 2001-2005, compared to only 0.7 per cent of GDP for external payments).

The high interest service burden of domestic debt is compounded by its maturity structure, which in the case of LICs is dominated by short maturity paper, especially three-month treasury bills. The scope for expanding domestic debt in LICs is complicated by the shallowness of their financial sectors. Another weakness is the concentration of the investor base of domestic debt by commercial banks in majority of African countries: which are therefore able to enjoy relatively high returns from this debt.

Debt Sustainability and Domestic Debt in LICs

The HIPC Initiative established certain thresholds for external debt and those HIPCs with ratios above these thresholds were given relief to bring these ratios down to these thresholds, provided they demonstrated a track record of economic and social reform. The HIPC Initiative however did not preclude the IMF from considering the problem of domestic debt burden, when this became a serious macroeconomic concern. 2003 programmes of Bolivia, Ghana and Nicaragua specifically sought to either limit the growth of domestic debt or target a reduction in debt stock tailored to the development of capital markets and the governments' financing needs, using external concessional resources to substitute high cost domestic debt.

Beyond the HIPC Initiative, IMF/World Bank established the Debt Sustainability Framework (DSF) in LICs with indicative country specific debt burden thresholds taking into account quality of policies and institutions. For each LIC standardised forward looking analysis of debt and debt service dynamics is carried out under a baseline scenario and under plausible shocks, with debt sustainability assessed in relation to the thresholds to establish risks of debt distress, which in turn could advise the strategies of lending institutions, especially IDA in determining grant/credit mix. IMF/World Bank have argued have against including domestic debt in the DSF on the grounds of difficulties of determining empirical thresholds because of lack of comprehensive historical data series for LICs, different characteristics of domestic and external debt and

the specific purpose of the DSF to guide official lending decisions. The Commonwealth HIPC Ministerial Forum (Maputo, March 2005) noted the setting up fiscal responsibility thresholds for total public debt in a number of advanced and emerging economies and the need for working out prudential ratios for domestic debt through more research and analysis. Domestic debt to GDP ratio of around 10 per cent has been suggested in a typical African HIPC, with the situation varying according financial depth, with total public debt to GDP ratio ranging from 40 to 60 per cent of GDP depending on policies and institutions.

The Multilateral Debt Relief Initiative (MDRI) involving 100 per cent debt write off by the IMF, IDA and the AFDF to all Completion Point HIPCs, did not establish any debt thresholds, but has had the effect of bringing down NPV external debt ratios well below not only the HIPC thresholds, but also the indicative thresholds under the DSF. The decline could have the perverse effect of giving non-participating HIPC creditors even less of an incentive to provide debt relief as well as of increasing the complacency of governments regarding the need to tackle the shortcomings of domestic debt. LICs might also over-borrow, underlining the critical importance of the adoption of prudent borrowing policies and debt management strategies by LICs that cover all debt.

Rationale for Debt Relief, MDGs and Domestic Debt

The HIPC Initiative predated the establishment of the MDGs in 2000 and was therefore never guided by it, although it had strong underpinnings with poverty alleviation. MDRI made a much more explicit link with the achievement of the MDGs.

A question arises as to why domestic debt holders should be exempt from providing debt relief that could free up resources for MDGs. A distinction between internal and external borrowing is that the former does not increase a country's real resources but is instead a transfer of purchasing power within the country. Thus any debt cancellation by domestic debt holders would represent a tax on them. It would be a positive for the achievement of MDGs if the resources released through domestic debt relief are used by the government for that objective, but if the resources thus transferred were to affect private sector activity and growth, this may have a negative impact for long term growth and poverty reduction. Also, any reneging of trade contractual payments could seriously affect the willingness of the private sector to provide future credit to governments, while securitised debt holders, if required to provide debt relief, could be deterred from holding future government debt, adversely impacting on development of local government securities and financial markets. On the other hand, any action that serves to reduce the high debt servicing burden, through debt restructuring (reduction in high real interest rates and lengthening of the maturity structure of debt) would be of benefit to the government and country at large and could release significant resources for achievement of MDGs.

A question also arises whether external donors should provide additional resources to reduce the domestic debt stock. If some of the existing resources were diverted to reduce domestic debt, it could be argued that these resources were being taken away from the achievement of MDGs. The only way to ensure that this does not happen is through

rebalancing of public expenditure, which ensures that resources released from domestic debt servicing are clearly earmarked, just like HIPC or MDRI resources, for poverty alleviation and MDG objectives. On the other hand, it could also be argued that donor support for reducing the domestic debt stock would aid growth in private sector credit and investment, vital for long term growth, poverty alleviation and achievement of MDGs. Government's credit standing would also have improved resulting in lower inflation premiums and therefore lower debt servicing cost for future debt, releasing resources for MDGs. The constraint on reducing domestic debt could be eased if additional external resources were utilised for this purpose, although in a world of finite donor resources, any additionality of resources could be at the expense of other countries.

Dealing with Domestic Debt Burden: What can LIC Governments Do?

Domestic debt database needs to be improved in many LICs with assistance from Commonwealth and other capacity building programmes. With respect to arrears to contractors and other suppliers, which are widely dispersed among different departments, steps need to be taken, though the setting up of appropriate machinery, to verify all such claims, including agreement on disputed claims, with all verified claims recorded on a central register. Governments also need to promote centralised data on contingent liabilities that allows budgetary coordination, transparency and discipline.

Carrying out of total public debt sustainability analysis should become a norm in all LICs. So far, DSAs focus on the outlook for debt indicators over time based on macroeconomic assumptions especially regarding growth, interest rates and fiscal balance, under a baseline scenario as well as under alternative scenarios and shocks. An MDG scenario should also become a norm which starts from the proposition of what is required in terms of financial resources to achieve the MDGs and to what extent debt sustainability becomes a binding constraint. This kind of approach allows a focus on how debt sustainability if seen as a constraint can be eased.

Debt sustainability ratios are highly dependent on macroeconomic variables, especially growth, interest rates and fiscal balances, which also have a bearing on achievement of MDGs. All LICs need to focus on how they can enhance growth, through for example, investment in human and physical capital, structural measures that reduce rigidities in the economy and promote private sector investment and development. All LICs also need to maintain strong anti-inflationary policies through prudent monetary management and government borrowing policies to ensure that interest rates remain low, both in nominal and real terms. Low-inflationary environment is in the interest of the poor, who have limited/static incomes and resources and are extremely vulnerable to steep increases in prices. Finally governments also need to maintain fiscal discipline, enhance poverty reducing and MDG related expenditures through Medium Term Expenditure Frameworks and strengthen revenue enhancement through tax reform and improved tax collection.

For many LICs quasi-fiscal costs associated with state-owned enterprises are a major reason for large financing needs. Reforms are clearly necessary where below-market prices provide indiscriminate subsidies to the entire population resulting in large fiscal

burdens. Automatic price adjustment formulas along with targeted subsidies for the poor not only help to contain the fiscal cost, but assist, by aiding the poor, in the achievement of the MDGs.

Domestic Debt Restructuring

Debt managers in LICs have a key role in debt restructuring, using the opportunity of lower inflationary and interest rate environment to refinance expensive debt instruments dating from higher interest rates to lower rates. They also need to explore prospects for lengthening the maturity structure of domestic debt instruments by gradually reducing issues of short term debt and increasing test issues of longer term debt, but not at the expense of significant increases in yields. Policies are also needed to broaden the investor base, especially promoting investment by retail and institutional investors that are willing to hold longer term government paper.

One of the ways of relieving the immediate burden of the repayment of arrears would be their securitisation. This would ensure their settlement takes place in an orderly fashion over a reasonable period of time. In order to provide some incentive to settle or unduly not penalise small creditors, depending on each country situation, the governments could offer to settle upfront a certain proportion of arrears or all credits up to a certain limit, with the remaining amount securitised into bonds.

Where debt levels are such as to affect debt sustainability and there are mounting arrears, governments could seek some debt reduction along with debt restructuring. LICs could use, like some small states, the model of the Brady bonds, offering par value bonds at lower than market interest rates, discounted bonds at market interest rates or very long maturity bonds at market interest rates.

Domestic Debt Reduction and Donors

Donors play an important role in providing grant and other concessional aid as well as exceptional financing through debt relief and all three need strengthening. With almost 100 per cent debt relief provided by DAC donors and the major international financial institutions, the candidate most suitable for providing relief from donors' perspective is domestic debt. There are a number of ways in which donors could assist HIPCs/LICs in domestic debt reduction. Donors could assist LICs to clear verified arrears, either fully or partially with the remainder securitised.

Those HIPCs which have had the benefit of HIPC and MDRI relief, but with high domestic debt ratios, can be assisted directly to reduce their domestic debt levels. There are a number of options. Donors could provide resources to reduce domestic debt ratios, just like the HIPC Initiative, below a certain uniform threshold, say 10 per cent of GDP, which would have the added benefit of retiring short term debt and improving the maturity profile of domestic debt. However this approach does not distinguish between different circumstances of countries, including their level of financial depth and development. The alternative is to reduce domestic debt according to individual country

circumstances, but this depends on IMF diagnosis and willingness of donors to provide additional resources. An in-between approach would be insert a degree of automaticity in domestic debt reduction, but based on individual country circumstances. Donors could provide debt relief to countries of up to a maximum of 10 per cent of GDP, with eligibility restricted to all HIPCs with domestic debt ratios above 20 per cent of GDP or total public sector debt ratio exceeding 40-60 per cent depending on the quality of their policies and institutions.

Donors could assist LICs to extend the maturities of their domestic debt by guaranteeing interest payments on the later portions of their maturity, giving confidence to the holders of the debt to hold longer dated instruments. This process could be continued over a number of years until these countries achieve 10 year maturity bonds. Donor technical and financial assistance can be helpful in the development of insurance and pensions industry that are typically geared towards investing long term, with a significant part of the portfolio invested in government bonds offering secure returns.

Debt management is an area where donors can provide immediate technical assistance. The World Bank has proposed the establishment of a global debt management partnership which provides technical assistance based on a standardised diagnostic tool and work with select group of LICs that have demonstrated commitment to sound debt management. A related idea could be a donor funded partnership or possibly even a separate multilateral institution for capacity building, dissemination of international best practices and knowledge transfer on domestic debt management, including management of securitised debts, verification and dealing with non-securitised debts, contingent liabilities and other related areas.

1. Introduction

Achievement of the Millennium Development Goals (MDGs) is a major challenge for Low Income Countries (LICs)[1]. The targets set under the MDGs require by 2015 halving poverty (i.e. proportion of people whose income is less than a dollar a day) and hunger (from 1990 base); ensuring universal primary education; eliminating gender disparity at all levels of education; reducing by two-thirds the under five mortality rate and three quarters maternal mortality rates (from 1990 base); and halting and reversing the spread of HIV/AIDS, malaria and other major diseases. Assessments by international agencies suggest that most LICs, especially in Sub-Saharan Africa, are far from achieving these objectives by 2015.

[1] Low Income Countries in this paper are defined as IDA-only countries, i.e. those countries eligible to receive funding solely from IDA, the concessional window of the World Bank. The definition thus excludes countries which are eligible to receive funding from the World Bank's normal non-concessional window, including blend countries which receive funding from both concessional and non-concessional windows. All Heavily Indebted Poor Countries (HIPCs) are treated as LICs, although some of them have recently acquired blend status. Some small economies, despite their relatively high income, continue to receive IDA-only funding on the basis of small economy exception, but these are mostly excluded from consideration.

One key requirement for the achievement of MDGs is to ensure that government and donor resources are increasingly targeted towards these goals. In this respect, debt servicing represents a claim on government resources, which could otherwise be utilised towards the achievement of these goals. International community through the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) has provided substantial external debt reduction and relief to HIPCs, with an explicit aim of assisting these countries on their path towards achieving MDGs.

Governments have to service not only external debt, but also domestic debt, which is also a claim on government resources, which could be utilised for achievement of MDGs. The purpose of this paper is to analyse domestic debt in LICs as permitted by data availability, highlighting particularly the fiscal/budgetary impacts of the domestic debt burden. It then appraises domestic debt in the context of overall public debt sustainability and the applicability of the rationale of the extension of the debt relief to the domestic component of the total debt burden. It ends by suggesting ways in which LICs themselves and the international community can relieve the domestic debt burden (within the context of overall debt burden) towards the attainment of MDGs.

2. Domestic Debt in LICs: Some Stylised Facts

General Considerations

Data on domestic debt in LICs remains weak. A recent analysis by the IMF/IDA staff[2] for 66 LICs with 627 observations over 1995-2004 suggests that the distribution of average domestic debt is positively skewed with the mean and the median of about 19 and 15 percentage point of GDP. A number of countries such as Eritrea, the Gambia and Malawi, however had significantly larger domestic debts, contributing to a relatively large (16.5 per cent) standard deviation. One third of the countries analysed had average domestic debt above 21 per cent.

Domestic debt represented about one-fifth of LICs total public debt, with the median at 17.2 per cent and a number of outliers at the high end (e.g. Eritrea). In one-third of countries domestic debt was a quarter or above of total public debt.

Non-CFA African HIPCs

An assessment by another IMF staff working paper[3] on non-CFA Sub- Saharan African countries over the period 1980-2000 also provides some useful insights:

- Domestic debt is not a recent phenomenon in African countries, including HIPCs. The average ratio of domestic debt to GDP for non-CFA HIPCs was 9 per cent in the 1980s, with the total public debt ratio at 69 per cent of GDP

[2] IMF/IDA, Applying the Debt sustainability Framework for Low-Income Countries Post Debt Relief, Appendix 1, Domestic Debt in LICs and Links to External Debt, November 2006

[3] Christensen, Jacob (2004), Domestic Debt Markets in Sub-Saharan Africa, IMF Working Paper 04/46, Washington, IMF.

- During the first half of the 1990s this ratio fell to 6 per cent, as these countries accumulated massive amounts of external debt, with the total public debt ratio at around 138 per cent of GDP.
- In the late 1990s, the accumulation of external debt continued, but domestic debt also rose to 8 per cent of GDP
- The result was a sharp decline in the share of domestic debt in total debt from 22 per cent in the 1980s to 6 per cent in the second half of 1990s.
- There were however sharp variations between HIPCs: some such as Ethiopia, Tanzania and Zambia which relied extensively on domestic debt in the 1990s saw significant falls in domestic debt to GDP ratios to under 10 per cent. Others, such as the Gambia and Ghana, saw their reliance on domestic debt increase sharply to 25 per cent of GDP in the second half of the 1990s. Some counties Malawi, Mozambique, Uganda) continued to have insignificant reliance on domestic debt

Data from aforementioned IMF/IDA paper suggests high domestic debt levels during 1995-2004 in Eritrea, Sierra Leone and Ethiopia of over 30 per cent. More recent domestic debt data, available in some cases through IMF Article IV reports (see Table), shows:

- Significant amounts of domestic debt as a percentage of GDP in a number of cases at end-2005 ranging from 48 to 16 per cent of GDP: Guinea-Bissau, Ethiopia, Sierra Leone, Burundi, Zambia and Guinea. High levels of total public debt in majority of these cases (except Ethiopia and Zambia) reflect the fact that they had not reached the completion point under the HIPC Initiative by end-2005 and had therefore not received full HIPC relief. Thus, in these cases domestic debt accounted for only about 11-14 per cent of total public debt. By contrast with HIPC debt relief, domestic debt was around 30-40 per cent of total public debt in Ethiopia and Zambia.
- In some cases such as Ghana and Tanzania domestic debt stocks have fallen further though concrete measures to reduce domestic debt. For example, by end-2005, Ghana's domestic debt was reduced to 11 per cent of GDP from the peak of 25 per cent.
- A number of countries such as Mozambique and Rwanda continue to have relatively small amounts of domestic debt of less than 5 per cent of GDP. Although Uganda's domestic debt at end -2005 is recorded at 13 per cent of GDP, by end-2006 it was brought down below 6 per cent.

CFA HIPCs

As for CFA-HIPCs, these countries enjoyed full convertibility with the French Franc and until recently did not have any significant domestic debt markets, so that historic data is largely absent. However with restrictions on convertibility of bank notes since 1993 and development of domestic debt markets, domestic debt has taken hold. Data from 2000 indicate sizeable domestic debt to GDP ratios in a number of countries, including Burkina Faso, Cameroon, Cote d'Ivoire, Niger and Togo, exceeding 18 per cent of GDP.

Non-CFA non-HIPC African LICs

There are five other LICs in Africa which are not HIPCs: Angola, Djibouti, Kenya, Lesotho and Nigeria. Both Kenya and Nigeria had significant reliance on domestic debt in the 1980s (over 20 per cent of GDP). In the case of Kenya this continued; however with donor curbs on lending, there was a significant increase of share of domestic debt in total debt close to 30 per cent. Nigeria saw a decline in reliance on domestic debt in the late 1990s and with a major increase in external debt in the 1990s, saw the share of domestic debt in total debt fall from 37 to 17 per cent. With the recent sharp rise in oil prices and revenues, Nigeria has been accumulating large deposits at the central bank and has been using the concept of net debt. At end 2005 net total public debt amounted to 22 per cent of GDP, with net domestic debt at 2 per cent of GDP, but 2006 figures show negative net public debt, with domestic debt at -1.4 per cent of GDP, a situation which is likely to continue to improve over the next five years. Lesotho and Angola have small to insignificant amounts of domestic debt.

Latin American HIPCs

With regard to Latin American HIPCs, data shows significant reliance on domestic debt. Large fiscal deficits in Bolivia in 2000-03 resulted in a sharp increase in domestic debt from just over 10 per cent to about 23 per cent of GDP, although by 2005 this was brought down below 10 per cent. In the case of Nicaragua at end-2003 the combined public sector domestic debt amounted to 46 per cent of GDP, reflecting mainly liabilities stemming from the property indemnisation bonds issued by the government to resolve the land disputes arising from expropriation of property under the Sandanista regime of the 1980s as well as the restructuring costs of the banking system. By end 2004 this has been brought down to about 30 per cent of GDP. In 2000 Guyana also had significant domestic debt amounting to 37 per cent of GDP. Honduras appears to be the only Latin American HIPC with a steady domestic debt ratio of about 10 per cent.

Asian LICs

Available data point to sizeable domestic debt in Sri Lanka, amounting to about 47 percent of GDP in 2005, with the total public debt to GDP ratio standing at over 100 per cent, making Sri Lanka a very highly indebted country. Domestic debt in Bangladesh has been around 18 per cent of GDP in recent years with the total public debt to GDP ratio around 47 per cent. By contrast Cambodia's domestic debt is relatively small, under 4 per cent of GDP, with the overall public debt to GDP ratio at around 54 per cent in 2005.

Possible Underestimation of Domestic Debt

Overall size of domestic debt may be underestimated for a number of reasons:

- In many cases most recent data is not available
- In most cases available data relates to central government only and in many cases includes securitised debt only. Thus debt contracted by local government or public enterprises as well as data on domestic arrears, especially to suppliers and contractors, and other un-securitised debt is often excluded.

- In many instances, contingent liabilities, government guarantees of future payment obligations of public enterprises can be very large. Apart from these explicit contingent liabilities there could be implicit contingent liabilities, which could arise for example from bank restructurings, etc.
- With external debt being reduced substantially through the HIPC Initiative and the MDRI, external debt and total public debt ratios are expected to fall, with the share of domestic debt in total debt increasing significantly.

3. Fiscal/Budgetary Impact of Domestic Debt Burden

Despite a sharp decline in the share of domestic debt in the total debt of non-CFA African LICs during 1980-2000, the servicing of this debt remained high largely because of high interest service payments and the short maturity structure of domestic debt.

High Interest Service Payments

In the 1970s and early 1980s financial systems in practically all African LICs were highly controlled, where the government often forced the state controlled financial system to hold government debt at minimum, mostly negative interest rates. Financial sector reforms, including move towards more liberal debt markets based on flexible and market interest rates led to a sharp rise in nominal and real interest rates:

- For non-CFA HIPCs, nominal Treasury bill (TB) rates increased from 12 per cent in the 1980s to 28 per cent in the early 1990s, before falling back to 20 per cent in the late 1990s.
- Real TB rates, after accounting for inflation, rose from a negative of -32 per cent in the 1980s to a positive 4 per cent by the end of 1990s, with significant rises in most of them.
- Among other African LICs, both Kenya and Nigeria saw a sharp increase in nominal TB rates, with Kenya's real interest rate climbing to 15 per cent by the late 1990s, although Nigerian real interest rate remained a negative 10 per cent.

The impact of these changes on non-CFA African HIPCs was a continuation of sizeable interest payments on domestic debt, despite a fall in the domestic debt to GDP ratio and in the sharp decline from 22 per cent to 6 per cent in the share of domestic debt in total debt:

- While domestic interest payments remained fairly stable at around 1.5 per cent, as a percentage of government revenue they increased from 9.4 per cent in the 1980s to 10.6 per cent in the late 1990s.
- Domestic interest payments as a share of total interest payments, though lower, remained sizeable at around 42 per cent. Average implicit interest rates (derived by dividing interest payments in the budget with the actual debt stock indicate that for the HIPCs at the end of the 1990s, the average implicit domestic interest rate was 21 per cent (having risen from 16 per cent in the 1980s) compared to only 1 per cent for foreign borrowing (down from 2 per cent in the 1980s).
- There were however wide variations across countries, with Ethiopia, Madagascar and Rwanda having cut their interest payments significantly as their domestic

debt stocks fell, while the Ghana, Sierra Leone, the Gambia and Malawi witnessing a significant rise, in the case of the former three exceeding 4 per cent of GDP, and in the case of first two 25 per cent of government revenue.

- Among other African LICs, domestic interest payments as a share of GDP, government revenue and total interest payments rose sharply in Kenya, but fell in Nigeria and Lesotho. In all cases there was a significant increase in implicit domestic interest rates.

There are two main reasons why governments have borrowed domestically despite high interest rates.

- Rising external indebtedness, which requires foreign exchange to service its amortisation, greatly increased the vulnerability of these countries. Many governments resorted to domestic borrowing where at least in the short term they could rollover domestic debt without major macroeconomic implications
- In order to limit external vulnerability many Fund-supported programmes put a cap on non-concessional borrowing. Thus where governments were unable to obtain sufficient concessional assistance to meet their financing requirements, they resorted to relatively expensive domestic borrowing.

The aforementioned IMF/IDA analysis over 1995-2004 points out that on average a typical LIC paid out 8 per cent of public revenues to cover the domestic interest bill. This represented more than 40 per cent of total interest bill, or more than twice its relative share of the public debt stock. The ex-post real interest rate on domestic debt was about 3 per cent in a typical LIC.

More recent data, where available indicates that in many cases real domestic interest rates have fallen significantly from the peaks and in a number of cases turned negative. For example, in the cases of countries which have already benefited from the HIPC debt relief, namely Ethiopia, Uganda and Zambia, real interest rates in the recent past have ranged from minus 1 to minus 3 per cent, although there is an expectation that with inflation being brought under control, real interest rates would turn slightly positive again. At the same time, for Ethiopia, Zambia as well as Tanzania, actual domestic interest payments have been similar or larger in size than external payments and are projected to remain higher. In particular, Zambian domestic interest payments accounted for around 2.8 per cent of GDP through 2002-2005, compared to external interest payments of only 0.6 per cent of GDP. As for countries which had not yet reached the HIPC Completion point by end-2005, external interest payments naturally dominate, although domestic interest payments remain sizeable.

Among other LICs, domestic interest payments dominate in the case of Sri Lanka, with domestic interest payments averaging over 6 per cent of GDP throughout 2001-2005, compared to only 0.7 per cent of GDP for external payments. In Nigeria also domestic interest payments in 2005 were just over one half of total interest payments.

Short Maturity of Domestic Debt

The high interest service burden of domestic debt is compounded by its maturity structure, which in the case of LICs is dominated by short maturity paper, especially three-month treasury bills. The aforementioned IMF/IDA analysis suggests that for an average LIC in the sample, about 67 per cent of domestic debt (with the median at 85 per cent) had a maturity of one year or less. The above mentioned IMF working paper point to average maturity structure of debt for non-CFA African HIPCS for which data is available is less than 180 days, compared with about 1750 days for South Africa and over 3000 days for India. Such debt carries significant rollover risks and therefore a significant debt service burden.

Structural Weaknesses

The scope for expanding domestic debt in LICs, in particular HIPCs, is complicated by the shallowness of their financial sectors. For example, the ratio of broad money to GDP averaged only 20 per cent in African HIPCs in the late 1990s (compared with 57 per cent in South Africa), while the ratio of domestic debt to broad money was 37 per cent in African HIPCs (compared to 81 per cent in South Africa), showing the limitations of domestic debt expansion in HIPCs. Expanding domestic debt in relation to broad money can have a negative impact on private sector lending: The aforementioned IMF paper estimates that an expansion of domestic debt by 1 per cent relative to broad money causes the ratio of lending to the private sector to broad money decline by 0.15 per cent.

Another weakness is the concentration of the investor base of domestic debt in majority of African countries: HIPCs and non-HIPCs. Presence of foreign investors in all African securities markets is generally limited, and the domestic non-banking sector accounts for about 30 per cent of outstanding domestic debt stock. This has left the banking sector, especially the commercial banks as the main holders of government debt. Commercial banks in effect hold monopoly power and are therefore able to enjoy relatively high returns from this debt. Their large holdings reflect fundamental shortcomings of commercial bank operations, in particular institutional weaknesses that undermine lending to the private sector.

4. Debt Sustainability and Domestic Debt in LICs

HIPC Initiative and Domestic Debt

High levels of external indebtedness in HIPCs led the international community to provide debt relief in the 1980s and 1990s, resulting in the establishment of the HIPC Initiative in 1996 (which created a framework for all creditors to provide debt relief to HIPCs) and its enhancement in 1999 (which provided deeper, broader and faster relief). External debt sustainability was defined as the ratio of Net Present Value (NPV) of external debt to exports at 150 per cent or to government revenues at 250 per cent. Those HIPCs with ratios above these levels were given relief to bring these ratios down to these levels, provided they demonstrated a track record of economic and social reform. Thus far 30 HIPCs have reached the Decision Point, with 21 passing the completion point.

Although the HIPC Initiative was not concerned about reduction in domestic debt, this did not preclude the IMF from considering the problem of domestic debt burden, when this became a serious macroeconomic concern (when domestic debt servicing claimed a substantial and rising proportion of government revenue, leading to arrears to domestic debt holders, and, when rising claims on resources by domestic debt, crowded out the private sector, affecting investment and growth). In such cases, IMF programmes have been responsive in their analysis and design, not limiting itself to assessing external debt sustainability, but also focussing on domestic debt. For example, in 2003 programmes of Bolivia, Ghana and Nicaragua specifically sought to either limit the growth of domestic debt or target a reduction in debt stock tailored to the development of capital markets and the governments' financing needs. In all programmes, one of the key instruments in reducing domestic debt burden was the use of external concessional resources, in effect substituting high cost domestic debt with low cost external debt.

Debt Sustainability Framework and Domestic Debt

While the HIPC Initiative was designed to address the existing debt overhang, it was not concerned to maintain long term debt sustainability. For the later purpose a Debt Sustainability Framework (DSF) in LICs was approved by the IMF and the World Bank in March 2005. It established indicative country specific debt burden thresholds taking into account quality of policies and institutions (ranging from NPV of external debt at 30 to 50 per cent of GDP and at 100 to 200 per cent of exports) For each LIC standardised forward looking analysis of debt and debt service dynamics is carried out under a baseline scenario and under plausible shocks, with debt sustainability assessed in relation to the thresholds to establish risks of debt distress, which in turn could advise the strategies of lending institutions. For many LICs, such forward looking Debt Sustainability Analysis (DSA) is already been carried out, usually as an appendix to the IMF Article IV and other reports. IDA has already used the framework as a basis for determining grant/credit mix under IDA-14.

IMF and World Bank have argued against including domestic debt with external debt in the DSF on the grounds of difficulties of determining empirical thresholds because of lack of comprehensive historical data series for LICs, different characteristics of domestic and external debt and difficulties in making inter-country comparisons (e.g. calculating NPV of domestic debt, lack of conditionality in domestic debt, etc.), and finally the specific purpose of the DSF to guide official lending decisions (especially the inappropriateness of using total debt thresholds in all combinations of external and domestic debt). It has thus argued for the treatment of domestic debt on the case by case basis in the context of IMF programmes as above.

However, historical data on domestic debt has begun to emerge and for an increasing number of LICs (e.g. Bangladesh, Bolivia, Burundi, Cambodia, Ethiopia, Guinea, Guinea-Bissau, Honduras, Nicaragua, Nigeria, Sierra Leone, Sri Lanka, Zambia,) the IMF is also beginning to undertake total public debt sustainability analysis[4], in addition to

[4] Between the inception of the DSF in April 2005 to early June 2006, 33 DSAs were published, of which 24 had public debt DSA.

the external debt assessment. Although with low or moderate risk of external debt distress, some countries such as Sierra Leone, Ethiopia, Papua New Guinea, Cameroon. Guyana and Nicaragua had high domestic debt ratios. In some cases, the total public debt outcomes have been compared with the DFS thresholds (especially in relation to GDP and government revenues), which are strictly appropriate for external indebtedness. The paper presented at the Commonwealth HIPC Ministerial Forum in Maputo in March 2005[5] and Ministerial Statement of that Meeting point out that (a) a number of advanced and emerging economies have set fiscal responsibility thresholds for total public debt and fiscal deficits, (b) although in LICs bulk of borrowing comes from external sources on highly concessional terms, this should not preclude working out prudential ratios for domestic debt, especially based on their financial depth and financial sector development, and (c) there is need for more research and analysis in this area.

The aforementioned paper had suggested that if the norm for domestic debt to broad money is taken as 50 per cent (which is slightly higher than the ratio for non-HIPC African countries during the 1990s), then on the basis of the average financial depth in HIPCs of about 20 per cent of GDP, domestic debt to GDP ratio should be around 10 per cent of GDP in a typical African HIPC. The situation would of course vary from country to country depending on financial depth and development.

Given that the thresholds for NPV of external debt under the DSF are 30 to 50 per cent of GDP, depending on the quality of country policies and institutions, the addition of domestic debt of about 10 percent of GDP would yield total NPV public debt to GDP ratio of 40 to 60 per cent of GDP. Debt ratios of 60 per cent of GDP constitute fiscal responsibility thresholds in the European Union and similar ratio is used by the East Caribbean Currency Union. Thus, 60 per cent of GDP for total NPV public debt would seem appropriate for LICs with good policies and institutions, but for majority of LICs it would be much lower. Within this overall limit countries may choose to have various combinations of external and domestic debt depending on their individual circumstances, including cost and risks involved.

MDRI, Debt Sustainability and Domestic Debt

The MDRI was established following the G8 proposal in June 2005 and has resulted in 100 per cent debt write off by the IMF, IDA and the AFDF to all Completion Point HIPCs in 2006. It did not establish any debt thresholds, but has had the effect of bringing down NPV debt ratios well below not only the HIPC thresholds, but also the indicative thresholds under the DSF (the size of the decline varying from country to country depending on the level of debt owed to the three institutions).

The decline in NPV external debt ratios of HIPCs has in fact greatly eased servicing by them of the debt they owe to non-Paris Club and commercial creditors, which were required under the HIPC Initiative to provide comparable relief, but largely failed to do so. In fact it may have had the perverse effect of giving them even less of an incentive to

[5] Dodhia, Dinesh , HIPCs: Debt Relief, Sustainability and the Issue of Domestic Debt, paper presented at Commonwealth HIPC Ministerial Forum, Maputo, Mozambique, 15-16 March 2005.

provide debt relief. In a similar fashion, with the fall in the total public debt ratios, the constraint on servicing domestic debt has also been greatly eased, which may have the effect of increasing the complacency of governments regarding the need to tackle the shortcomings of domestic debt.

More significantly, sharply lower debt burdens with upgraded sovereign risk, has created a potential for new borrowing from market and non-concessional sources (external and domestic), and possibility of a so called free rider problem. It is true that non-concessional borrowing has the potential to allow projects with high rates of return to be financed that would otherwise not be possible. But there could be an incentive to over-borrow. On the one hand, under the DSF, IDA is willing to give increasing quantities of grants to countries with more debt and on the other hand non-concessional lenders may be willing to finance even more unproductive investments, secure in the knowledge that, with MDRI relief and prospect of future IDA grants, the country could cover the debt service. Countries may even have greater incentive to over-borrow domestically, leading eventually to severe debt servicing problems. The above underline the critical importance of the adoption of prudent borrowing policies and debt management strategies by LICs that cover not only external debt but also domestic debt.

5. Rationale for Debt Relief, MDGs and Domestic Debt

HIPC Initiative, MDRI and MDGs

The HIPC Initiative predated the establishment of the MDGs in 2000 and was therefore never guided by it. It nonetheless had strong underpinnings with poverty alleviation. For example the 1996 Initiative had the aim of reducing the constraint on economic growth and poverty reduction imposed by the debt build up in these countries. The1999 enhancement provided an explicit link between debt relief and poverty reduction. Freed resources were to be used to support poverty reduction strategies through Poverty Reduction Strategy Papers (PRSPs), which are developed by national governments in consultation with the civil society. Thus, while since 1999 debt service payments have been declining (from about 4 per cent of GDP for the 29 post-decision point countries to about 2 per cent in 2005), poverty reducing expenditures have increased (from around 7 percent to 9 per cent of GDP over the same period).

In contrast to the HIPC Initiative, the MDRI made a much more explicit link with the achievement of the MDGs. In their statement the G8 said that ‘donors agree to complete the process of debt relief to HIPCs by providing additional development resources which will provide significant support for countries to reach the MDGs’. The MDRI was therefore clearly intended to free up additional resources beyond the Enhanced HIPC Initiative to help countries reach MDGs.

Debt Relief by domestic debt holders!

Given the underlying rationale for both the HIPC Initiative and the MDRI, namely to remove the constraint on growth and poverty reduction and free up resources for poverty

reduction and achievement of MDGs, the question arises whether similar rationale cannot be used with respect to domestic debt. As noted above domestic debt service burden has been significant, claiming resources which governments could otherwise have used for achievement of MDGs. It may thus be argued that if all external debt holders are required to provide debt relief, why then should domestic debt holders be exempt from providing such relief that could free up resources that could be used by the government to achieve MDGs.

However, there are a number of questions whether such an action would be appropriate. First of all, a distinction between internal borrowing by state authorities and external borrowing is that the former does not increase a country's real resources but is instead a transfer of purchasing power within the country over the same stock of resources. Thus any debt cancellation by domestic debt holders would represent a transfer of resources from the domestic debt holders to the government (in effect a tax on domestic debt holders). It would be a positive for the achievement of MDGs if the resources released through domestic debt relief/cancellation are then used by the government for that objective. On the other hand, if the resources thus transferred from domestic debt holders were to affect private sector activity and growth, this may have a negative impact for long term growth and poverty reduction.

There is also a particular question whether all domestic debt holders should be penalised by the government in this way. Significant amount of domestic debt is not securitised but is in the form of arrears to suppliers and other contractors for the goods and services supplied and there is an issue whether governments should be allowed to renege on such trade contractual payments. This could seriously affect the willingness of the private sector to provide future credit to governments. A further question is whether securitised debt holders, if required to provide debt relief, would be willing to hold future government debt. This could particularly have an adverse impact on development of local government securities and financial markets.

On the other hand, it has been noted that one of the key problems of domestic debt is its high servicing burden arising out of high real interest rates, its short maturity structure and heavy concentration of the holding of such debt by commercial banks and their monopoly power, demanding a relatively high inflation premium from the government. Any action that serves to reduce the high debt servicing burden, through debt restructuring (reduction in high real interest rates and lengthening of the maturity structure of debt) would be of benefit to the government and country at large and could release significant resources for achievement of MDGs.

Donor support for domestic debt reduction!

A question also arises whether external donors should provide additional resources, especially in grant form, to reduce the domestic debt stock. Multilateral debt relief in the final analysis has been largely funded by bilateral donors and it could be argued that similar provision of donor aid for domestic debt relief would free up resources that could be used for MDG related activities.

Both IDA and AFDF are funded by bilateral donors through regular replenishments. Donors have agreed that lending capacities of these institutions should not to be significantly impaired and therefore have decided to provide additional resources to these institutions to compensate for MDRI relief provided by them. It should however be noted that, as currently conceived, before additional contributions are taken into account, MDRI relief from IDA does not affect the net resource transfers to all beneficiary countries, HIPCs and non-HIPCs, due to the netting off mechanism. Additional contributions will be allocated to all IDA-eligible countries on the normal Performance Based Allocation (PBA) formula so that all IDA-eligible countries are treated equitably. The result of this approach would be that in a number of cases additional resources received may be less than the MDRI relief. Clearly this approach does not take into account the underlying rationale for MDRI, namely the achievement of MDGs. The CHMF (Livingstone, Zambia, April 2006) therefore strongly recommended that this objective be weighted equally with country performance ratings in the formula for allocating additional contributions.

The above analysis point to two distinct scenarios as far as domestic debt relief is concerned: one in the context of existing external grant/concessional resources, and the second in the context of additional such resources. If some of the existing grant/concessional resources were diverted to reduce domestic debt or debt servicing cost, it could be argued that these resources were being taken away from the achievement of MDGs. The only way to ensure that this does not happen is through rebalancing of public expenditure, which ensures that resources released from domestic debt servicing are clearly earmarked, just like HIPC or MDRI resources, for poverty alleviation and MDG objectives. With public expenditures significantly rebalanced by most HIPCs through the HIPC Initiative debt relief process, there is naturally a question whether further rebalancing is feasible, which is dependent on individual country circumstances.

On the other hand, it could be argued that by clearing arrears and reducing the domestic debt stock, the government is aiding growth in private sector credit which could be vital for investment and long term growth and poverty alleviation and indirectly achievement of MDGs. By lowering government debt stock and improving the macroeconomic environment, government's credit standing would also have improved resulting in lower inflation premiums and therefore lower debt servicing cost for future debt, releasing resources for MDGs.

It would therefore seem appropriate, as the IMF has felt justified in the past doing, to use existing aid resources to reduce domestic debt stock where this has become a serious macroeconomic concern, taking a rising proportion of government resources for such debt servicing and hindering private sector investment and growth. At the same time it is important to ensure that resources released through domestic debt relief are earmarked for achievement of MDGs through further rebalancing of public expenditure, as far as this is possible.

The constraint on reducing domestic debt could be eased if additional external resources were utilised for such domestic debt reduction. At the individual country level, any additionality of resources to reduce domestic debt, would imply that the resources previously used for domestic debt servicing are released providing additional support for the achievement of MDGs. But in a world of finite donor resources, any additionality of resources could be at the expense of other countries.

6. Dealing with Domestic Debt Burden: What can LIC Governments Do?

Improve Debt Recording and Verification

One of the principal problems in a number of LICs is weak domestic debt data base. There is a need therefore to improve such data base, with assistance from say Commonwealth Secretariat CS-DRMS and other capacity building programmes. Such improvements can help countries determine the true size and profile of their domestic debt burden. With respect to improving the quality of data, Commonwealth Secretariat Debt Management Programme has identified a number of practical problems, especially the institutional and manpower deficiencies in the debt offices The CHMF (Livingstone, Zambia, April 2006), noted that the solutions to these were largely country-specific and have expressed their commitment to address them at the level of their individual countries with the help of the capacity building programmes.

While data on securitised debt may be easily gathered, a particular problem arises with respect to arrears especially to contractors and other suppliers of goods and services to governments, which are widely dispersed among different departments often without proper recording by them, making the task of central recording that much more difficult. Steps therefore need to be taken, though the setting up of appropriate machinery, to verify all claims of arrears with the respective parties, including agreement on disputed claims. All verified claims need to be recorded on a central register.

An important area that requires attention in most developing countries is contingent liabilities (CLs). These are created when governments extend financial support to other agents in the economy contingent upon certain events taking place, such as debt default, insolvency or a fall in revenues below a certain level. Explicit CLs include guarantees to promote activities considered to be public goods, such as incentives by government to the market to finance these sectors and projects, that allows increased funding and or better financial terms for the project/activity than on a stand alone basis. Implicit or non-contractual CLs can be as expensive for the government when for example it provides financial support especially to the banking sector to avert systemic risks. CLs are same as debt, but hidden off balance sheet, lacking provision. Governments need to promote centralised data on CLs that in turn allows coordination with the budgetary unit so as to promote budgetary transparency and discipline.

Conduct Total Public Debt Sustainability Analysis with an MDG Scenario

As noted above, while IMF external debt sustainability analysis is gradually beginning to take hold in many LICs as part of Article IV reports, total public debt sustainability analysis has been carried out in limited cases. This latter should become a norm in all LICs.

So far the DSAs have a focus on the outlook for debt indicators over time based on certain macroeconomic assumptions especially regarding growth, interest rates and fiscal balance, under a baseline scenario as well as under some alternative scenarios and under shocks (see Box 1 which describes the analytical underpinnings of growth in public debt) However except in very few cases, there has not been an MDG Scenario, which starts from the proposition of what is required in terms of financial resources to achieve the MDGs and to what extent debt sustainability becomes a binding constraint towards these achieving these objectives. This kind of approach allows a focus on how debt sustainability if seen as a constraint can be eased.

Analytical Underpinnings of Growth in Public Debt

The equation explaining absolute growth in public debt in period t+1 is given by:

PDt+1**= (1+r)PD**t **–FB**t+1

Where PD is the end period public debt in local currency, r is the nominal interest rate, and FB is the primary fiscal balance (balance on government revenues and expenditures plus also on other non debt creating (e.g. unrequited transfers, privatisation receipts) and debt creating flows (contingent liabilities etc.)

In terms of public debt to GDP indicators, if pd is public debt to GDP ratio, g is GDP growth rate, π is growth of GDP deflator, and fb as primary fiscal balance as a proportion of GDP, then

pdt+1= [(1+r)/(1+g)(1+p**)]pdt - fbt+1**

Therefore

pdt+1 - pdt = [(1+r)/(1+g)(1+p**)]pdt - pdt - fbt+1**

Rearranging, change in the net debt ratio given by

pdt+1 - pdt = [(r-g-p**-g**p**)/(1+g+**p**+g**p**)]pdt -fbt+1**

Change in public debt ratio is explained by endogenous (automatic) debt dynamics with a debt increasing contribution of real interest rate ($r-\pi-g\pi$) and debt reducing contribution of real growth rate (g) **MINUS** the primary fiscal balance(fbt+1), including other identified non-debt creating and debt creating flows. If the primary fiscal balance is in surplus (i.e. positive) then it is debt reducing, but if it is in deficit (i.e. negative) then it is debt increasing.

This relationship is fine if the country's entire borrowing is in domestic currency. However, when a country borrows significantly in external currency and is prone to significant changes (depreciation) of its exchange rate and consequently the value of its external debt in local currency, one has to add an additional term to take care of the exchange rate effects on public debt. This is given by $\alpha\varepsilon(1+r)$, where α is the share of foreign currency denominated debt, ε is nominal exchange rate depreciation measured by the increase in the local currency value of the US dollar

Thus the new equation

pdt+1 - pdt = [(r-g-p-**g**p + ae(1+**r))/(1+g+**p+**g**p**)]pdt -fbt+1**

Here if a country's currency depreciates (i.e. ε is positive), it has a debt increasing effect in domestic currency and vice versa.

To this one needs to add a residual R, to take account of changes in cross exchange rates numerical approximations and calculation errors that may explain the discrepancies between the observed change in the stock of debt and the change given by debt creating flows as by the formula above.

Improve Macroeconomic Performance that promotes MDGs with Debt Sustainability

As noted above, debt sustainability ratios are highly dependent on macroeconomic variables, especially growth, interest rates and fiscal balances. These also have a bearing on achievement of MDGs. High growth rates have the effect of reducing the debt ratios; i.e. they can allow countries to have higher debt levels without increasing the debt ratios. Evidence points to high growth rates contributing directly to poverty reduction, although pro-poor government policies and interventions can accelerate this process. All LICs therefore need to focus on how they can enhance growth, through for example, investment in human and physical capital, structural measures that reduce rigidities in the economy and promote private sector investment and development

It has also been noted that the principal problem facing many LIC governments is the high interest servicing burden of domestic debt, arising out of high real interest rates. But reduction of high real interest rates can only come about in a low inflationary environment, which leads the private sector to demand a low inflation premium on domestic debt. All LICs will therefore need to maintain strong anti-inflationary policies through prudent monetary management and government borrowing policies to ensure that interest rates remain low, both in nominal and real terms. It should also be noted that a low-inflationary environment is in the interest of the poor, who have limited/static incomes and resources and are extremely vulnerable to steep increases in prices.

Finally governments also need to maintain fiscal discipline and not allow unsustainable fiscal deficits and debt levels to build up. Fiscal space created by external debt reduction needs to be used wisely, with non-concessional borrowing, both external and domestic, used only for projects that have high rates of return. Many LIC governments as part of the HIPC process or as a consequence of the development of the PRSP have sought to enhance poverty reducing expenditures through Medium Term Expenditure Frameworks and strengthen their Public Expenditure Management Systems for this purpose. This effort needs to be further enhanced with a much clearer focus on the achievement of MDGs. Efforts also need to be directed at revenue enhancement through tax reform and improved tax collection, particularly as government revenue to GDP ratios in many LICs are low.

Institute Structural Policies that reduce quasi-fiscal costs

For many LICs quasi-fiscal costs arising out of contingent liabilities associated with state-owned enterprises are a major reason for large financing needs. Some governments (e.g. Ghana) with the support of the IMF, have addressed these problems through structural reforms, including introduction of automatic price adjustment formula of SOEs in the petroleum, electricity and water sectors. Reforms are clearly necessary where below-market prices provide indiscriminate subsidies to the entire population resulting in large fiscal burdens. Targeted subsidies for the poor not only help to contain the fiscal cost, but assist, by aiding the poor, in the achievement of the MDGs.

LICs could also strengthen their privatisation efforts, particularly where SOEs are a huge fiscal burden and are not of any strategic importance. Privatisation, by forcing market discipline, can also result in efficiency gains. Privatisation proceeds can also be used to reduce domestic debt directly as was the case in Nicaragua. In order to ensure that privatisation does not transform a public monopoly into a private monopoly, a good transparent regulatory regime is essential. Also, in order to ensure that vulnerable groups are protected from steep price increases, targeted subsidies that assist the poor and which are transparent in the budget are also necessary.

Domestic Debt Restructuring

It has been noted above that the current high domestic debt service burden stems from high interest service payments, short maturity structure of domestic debt and the resultant rollover risks and heavy concentration of debt holding by commercial banks which exercise a dominant power in extracting high inflation premiums. Debt managers have a key role in debt restructuring that overcomes these difficulties.

In particular, they should use the opportunity of lower inflationary and interest rate environment to refinance expensive debt instruments dating from higher interest rates to lower rates. Since most of the debt in LICs is short dated, this would effectively imply refinancing such short dated bills at lower interest rates, but the strategy is equally applicable to medium to long term bonds, with governments issuing new bonds at lower interest rates and using the proceeds to buy back more expensive debt, provided this results in a cost saving. Bond contracts could also allow governments to buyback these instruments prior to maturity.

LICs will need to further explore prospects for lengthening the maturity structure of domestic debt instruments by gradually reducing issues of short term debt and increasing the issues of longer term debt. However this should not be done at the expense of significant increases in yields. Slow expansion of test issues will need to take advantage of falling risk premiums on longer term issues as inflation comes down.

Policies are also needed to broaden the investor base, as a diverse base reduces the monopoly power of commercial banks, bringing down not only costs, but also rollover risks through lengthening of maturities. This can be done by a combination of efforts, including promoting investment by retail investors and development and reform of

pension funds to encourage their investment in government bonds. One of the key benefits of the development of institutional investors would be their willingness to hold longer term government paper.

Governments which have been successful in raising debt at different maturities also need to re-arrange their debt profile such that bonds that redeem in years of heavy cash outflow could be converted or refinanced such that their maturities fall in years of low cash outflows.

Securitisation of Arrears

One of the ways of relieving the immediate burden of the repayment of arrears would be their securitisation. This would ensure their settlement takes place in an orderly fashion over a reasonable period of time. The government could also use the opportunity to set a reasonable market rate of interest, with a reasonable maturity of say 5 to 10 years, thereby aiding the development of longer term government securities market.

However from the perspective of the creditors, such tying in of resources would amount to a further delay in receiving their due payments. On the other hand, without arrears restructuring, these creditors may remain unpaid over long period of time and it could be in their interest to agree to such securitisation. However, to provide some incentive to settle or unduly not penalise small creditors, depending on each country situation, the governments could offer to settle upfront a certain proportion of arrears or all credits up to a certain limit, with the remaining amount securitised into bonds.

Debt Restructuring with Debt Reduction

Where debt levels are such as to affect debt sustainability and there are mounting arrears, governments could seek some debt reduction along with debt restructuring. Some small states such as Dominica have used the model of the Brady bonds for both external and domestic creditors. These include offering par value bonds at lower than market interest rates, discounted bonds at market interest rates or very long maturity bonds at market interest rates. Similar approaches could be used by LICs to secure some debt reduction through debt restructuring.

7. Domestic Debt Reduction and Donors

Donor role is critical with respect to both achieving debt sustainability and MDGs. Donors play an important role in providing grant and other concessional aid as well as exceptional financing through debt relief. For many HIPCs/LICs grants play a critical role in enhancing government revenues and therefore improving the fiscal balance. Without such grants fiscal deficits and debt indicators would be significantly higher. At the same time, concessional borrowing by keeping interest rates low (usually under 1 per cent for majority of LICs) also has the effect of curtailing interest payments and growth in debt. Finally by providing exceptional financing through debt relief, donors have directly sought to reduce HIPCs' debt burdens.

Achievement of MDGs would invariably require higher public expenditures from governments (in addition to the rebalancing of expenditures mentioned above). With limits on raising government revenues, the international community can assist LICs achieve MDGs through substantially increasing their grant levels, so that rises in expenditure do not translate into significant deterioration in fiscal balances. Alternatively or in addition they could substantially increase concessional credits, which would have the effect of substituting costly non-concessional finance that would have been borrowed externally or domestically, thereby curtailing a significant rise in interest payments and future debt ratios. Finally they could provide further exceptional finance to reduce the debt levels of HIPCs. With almost 100 per cent debt relief provided by DAC donors and the major international financial institutions, the candidate most suitable for providing relief from donors' perspective is domestic debt.

There are a number of ways in which donors could assist HIPCs/LICs in domestic debt reduction.

(a) Assist countries to pay off domestic arrears

Donor grant resources could be used to clear verified arrears, especially to suppliers and contractors. This could be done either fully or partially with the remainder securitised (see above). As in the case of Ghana, governments should also be able to partly use resources released from HIPC or MDRI relief to pay off these arrears.

(b) Assist countries to reduce domestic debt

Those HIPCs which have had the benefit of HIPC and MDRI relief, but with high domestic debt ratios, can be assisted directly to reduce their domestic debt levels. There are a number of options:

- Donors could provide resources to reduce domestic debt ratios below a certain uniform threshold, say 10 per cent of GDP, the rationale for which was suggested above. It is also close enough to the ratio used by the IMF in the programme of Ghana. This threshold approach is similar in methodology employed in reducing external debt under the HIPC Initiative and would ensure that domestic debt levels are also brought down significantly, so that overall debt ratios remain well below thresholds and sustainable over the medium term. Another positive for this approach is that a significant amount of short term debt could be retired, with the government having a much better maturity profile of domestic debt. The downside of this approach is that it does not distinguish between different circumstances of countries, including their level of financial depth and development.

- The alternative is to reduce domestic debt according to individual country circumstances, including their macroeconomic circumstances and the level of financial depth and development. This was indeed the approach adopted by the

IMF in its programmes for Bolivia, Ghana and Nicaragua. The pitfall of this approach is that a lot depends on IMF diagnosis and willingness of donors to provide additional resources, so that countries substitute expensive domestic debt for concessional external debt.

- An in-between approach would be insert a degree of automaticity in domestic debt reduction, but based on individual country circumstances, particularly their financial sector development. For example, some countries, especially in Latin America, because of the level of their financial development have been able to sustain high levels of domestic debt. Donors could provide debt relief to countries of up to a maximum of 10 per cent of GDP, with eligibility restricted to all HIPCs with domestic debt ratios above 20 per cent of GDP or total public sector debt ratio exceeding 40-60 per cent depending on the quality of their policies and institutions.

For LICs which are not HIPCs, direct domestic debt reduction may not be appropriate as these countries, with external debt levels below HIPC thresholds, have not benefited from HIPC and MDRI debt reduction or have been reluctant to accept debt reduction in case this affects their credit standing and future borrowing prospects. For these countries, the approach that could be adopted is similar to that adopted under IMF programmes, with gradual reduction in domestic debt accompanied grants and highly concessional borrowing, resulting over time in the substitution of more expensive external debt with low cost concessional finance.

(c) Assist countries to extend maturities of their domestic debt

Donors could assist LICs to extend the maturities of their domestic debt by guaranteeing interest payments on the later portions of their maturity. For example if the maximum maturity a country could borrow is 4 years, donors could support the extension of the maturity of this debt for say a further two years by guaranteeing interest payments for the 5^{th} and the 6^{th} years. This would give confidence to the holders of the debt to hold longer dated instruments. As this debt would be contracted at fixed interest rate, the contingent liability facing the donors would be certain at the outset. There could be a separate guarantee fund set up by donors to take care of such contingent liability. It would be in the interest of LICs not to default on the interest payments, as this could affect their future standing in the markets and development of domestic debt markets. Once 6 year debt becomes widely accepted, donors could offer interest guarantees for the 7^{th} and 8^{th} years, towards making 8 year bond the norm. This process could continue up to the development of 10 year maturity bonds.

(d) Assist countries in the development of long term investors, institutional and retail

Donor technical and financial assistance can be helpful in the development of insurance and pensions industry that are typically geared towards investing long term, with a significant part of the portfolio invested in government bonds offering secure returns.

(e) Assist countries in debt management

Recognising that debt management offices in many LICs lack adequate capacity to monitor and adequately record debt data (let alone effectively manage them), the World Bank has initiated a dialogue with other donors on the need to strengthen debt management capacity in LICs. In particular one proposal is for the establishment of a global debt management partnership that engages leading international and regional providers of debt management technical assistance and which provides technical assistance based on a standardised diagnostic tool and work with select group of LICs that have demonstrated commitment to sound debt management. A related idea could be a donor funded partnership or possibly even a separate multilateral institution for capacity building, dissemination of international best practices and knowledge transfer on domestic debt management, including management of securitised debts, verification and dealing with non-securitised debts, contingent liabilities and other related areas.

Table 1: Non-CFA African HIPCs and other LICs: Domestic and External Debt 1980-2005

(in per cent of GDP, unless otherwise indicated)

		Domestic Debt				External Debt				Total Debt				Domestic/Total Debt %			
	Type of Domestic Debt	1980-89	1990-94	1995-2000	end-2005	1980-89	1990-94	1995-2000	end-2005	1980-89	1990-94	1995-2000	end-2005	1980-89	1990-94	1995-2000	end-2005
HIPCs		**9**	**6**	**8**		**56**	**124**	**156**		**69**	**138**	**169**		**22**	**6**	**6**	11
Burundi	t)c)	3	2	6	20	40	96	138	166	44	98	144	186	8	2	4	
Congo Dem. Rep.		0	0	0		50	126	254		50	126	254		0	0	0	
Ethiopia	t)b)	16	19	10	35	31	115	109	54	47	134	120	89	34	14	9	39
Gambia	t)d)s)	3	13	23		80	84	104		83	96	127		3	13	18	
Ghana	t)	12	8	24	11	19	55	83		32	64	106		38	13	22	
Guinea		..	..	..	16	0	0	91	118	..	..	..	134	..	..	..	12
Guinea-Bissau					48				332				380				13
Madagascar	t)	3	3	3		71	120	110		74	123	113		4	2	2	
Malawi	t)s)	13	8	9		65	100	126		78	109	135		16	7	7	
Mozambique		0	0	0		75	207	121		75	207	122		0	0	0	
Rwanda	t)b)	8	9	5		17	55	70		25	65	75		31	14	7	
Sao Tome & Principe		0	0	0		155	422	643		155	422	643		0	0	0	
Sierra Leone	t)b)s)	13	5	7	28	34	94	143	225	47	99	150	203	28	5	5	14
Tanzania	t)s)	26	6	12		71	131	100		96	137	112		27	5	11	
Uganda	t)s)	2	1	2	13	0	73	57	51	2	74	59	64	100	1	4	20
Zambia	t)b)	25	9	6	19	134	178	196	50	159	186	202	69	16	5	3	30
Other LICs																	
Angola		0	0	0		158	113	81		158	113	81		0	0	0	
Kenya	t)b)s)	21	23	22		61	77	52		81	100	74		25	23	29	
Lesotho	t)b)	8	8	5		40	49	58		48	58	62		17	15	8	
Nigeria	t)b)c)s)	28	29	16		49	93	80		77	122	97		37	24	17	

Sources: (1) Christensen,Jakob (2004) Domestic Debt Markets in Sub-Saharan Africa, IMF Working Paper 04/46, Washington, IMF

(2) IMF Article 4 reports for end-2005 data

Notes: t=treasury bills, c=treasury certificates, b=bonds, s=government stock, d=discount note series