

General Assembly
Ad Hoc Open-ended Working Group to follow up on the issues contained in the Outcome
of the Conference on the World Financial and Economic Crisis and Its Impact on
Development

Second meeting on
"The impact of the world financial and economic crisis on
debt sustainability of developing countries"
(New York, 12 April 2010)

Informal summary by the Secretariat

Overview. The meeting was co-chaired by H.E. Mr. Morten Wetland (Norway) and H.E. Mr. Lazarous Kapambwe (Zambia), who introduced the topic based on paragraphs 15, 33 and 34 of the outcome document. The presentations by the panelists focused on the joint World Bank/IMF debt sustainability framework (DSF) for low-income countries (LICs), identifying vulnerabilities in LICs and suggesting ways forward including sustainable borrowing and lending. A case study of Poland was presented to illustrate the policies adopted by that country to help keep it on a growth path. The discussion also covered the impact of the crisis on the debt difficulties of some middle-income countries. Some delegates called for a critical analysis of the DSF for both low- and middle-income countries, as well as the international support needed for crisis prevention. Opinions varied between the proposal to establish a new framework and the call to reform the existing debt restructuring mechanisms.

Summary of the presentations by the panelists

Ms. Yuefen Li, Head, Debt and Development Finance Branch, Division on Globalization and Development Strategies, UNCTAD, gave a short assessment of the impact of the crisis on debt sustainability and discussed the need to operationalize the recommendations contained in the Outcome of the Conference on the World Financial and Economic Crisis and Its Impact on Development (A/RES/63/303) related to debt sustainability. The impact of the crisis had been severe. External debt of developing and emerging market countries had increased over 2008 and 2009. Average external debt of developing and transition economies grew by more than 8%, from less than 44% to 52% in the third quarter of 2009. Low-income countries (LICs) entered the crisis in a relatively better position. However, they still faced increasing external debt and there had been a reversal in gains made by those countries. For example, Latin American and CARICOM countries had very high debt to GDP ratios. Those ratios exceeded 100% in several countries in the CARICOM region. There had also been a switch from private to public sector borrowing which was expected to continue and could lead to further challenges.

Ms. Li emphasized that the recovery ahead would likely to be slow as boom periods for commodity or financial markets were usually shorter than bust periods. The global economic crisis had raised the financing gap for developing countries because of the big drop in the world trade, volatility in commodity prices and significant falls in remittances and FDI. With some donor countries having to roll over their public debt, there would be crowding out effects that could further limit resources for developing countries. Overall, more donor support was needed

for developing countries, to enable them to finance countercyclical deficits, boost investment and restore growth without increasing their public debt to unsustainable levels. The donor community should thus honor their ODA commitments despite their reduced growth prospects and increase aid effectiveness through enhanced national ownership. The HIPC initiative was a one-off initiative and it was coming to an end.

The speaker also emphasized the need for the operationalization of proposals contained in the Outcome of the Crisis Conference, such as temporary debt standstills between debtors and creditors, making full use of the existing flexibility within the Debt Sustainability Framework (DSF) and exploring enhanced approaches to the restructuring of sovereign debt. Ms. Li further highlighted the recent UNCTAD project to “Promote responsible sovereign lending and borrowing”, which aimed to draw up a set of universally agreed principles for responsible sovereign lending and borrowing that could promote the adherence to good code of conduct and discourage reckless sovereign lending or borrowing.

Mr. Mirosław Blażej, Counsellor to the Minister of Finance, Poland, presented the Polish experience in terms of debt sustainability and the measures adopted in the country during the world financial and economic crisis in 2008 and 2009. Poland was the only country in the EU with positive economic growth in 2009 (1.7%). Stable access to external flows, a well-functioning banking sector, public investment growth and a prudent monetary policy provided an environment conducive to economic growth. Poland’s reserves were increasing and represented a cushion for over 6 months of imports. On the negative side, there had been a widening of the fiscal deficit and an increase in the general government that was expected to continue. The pension reform in 1999 was a major factor in this connection, since it had increased the fiscal deficit by about 2%.

Poland adopted a series of insurance measures in 2008 and 2009 in case the debt and fiscal situation worsened. The measures included a regulation package to stabilize the financial system, a stability and development plan to increase investment and consumer demand, expenditure cuts in the state budget for 2009 and training and wage subsidies for employees of companies affected by the economic crisis. Additionally, Poland had joined the IMF Flexible Credit Line (FCL) facility. For 2010-2011, Poland had plans to introduce a set of measures to improve its budgetary framework.

Compared to other countries in the region, Poland had the largest GDP growth, lower credit default swap (CDS) spreads, more stable exchange rates and lower credit to GDP ratios. With regard to reform proposals on the international financial architecture, Mr. Blażej favored new measures or initiatives that were based on existing institutions, in light of the cost and time for new measures to become operational.

The use of the IMF Flexible Credit Line (FCL) had been beneficial to Poland as it had reduced the probability of market disturbances in the country and was useful for crisis prevention. It may even have led to drops in CDS spreads, although that effect was difficult to disaggregate. Mr. Blażej stressed new challenges that lay ahead, including funds required for climate change mitigation and adaptation, as well as the challenges posed by the aging of the

population. Overall, the Polish experience was positive and exemplified the need for prudent fiscal and monetary policies.

Mr. Sudarshan Goptu, Acting Director, Economic Policy and Debt Department, World Bank, presented an overview of and the changes made to the debt sustainability framework (DSF) for low-income countries. He stressed that the DSF was just one component of long-term sustainability assessment and represented one of the many tools that were used to make policy decisions. Currently, there were 40 HIPC, 5 of which (Burundi, Central African Republic, Haiti, Republic of Congo and Afghanistan) had recently reached completion point. The debt burdens of the 35 post-decision point countries had been reduced by 80% compared to their decision point levels. The proper institutional framework was necessary to manage public debt prudently and to avoid debt distress episodes.

The DSF had an empirical foundation and the likelihood of debt distress was mainly explained by susceptibility to shocks, the level of debt burdens and the quality of policies and institutions. Debt sustainability analysis (DSA) was carried out annually, and in parallel for external debt and total public debt. Alternative scenarios were worked out based on the predictions of the DSF. The DSF was used to identify countries at high risk and determine the grant-loan mix in International Development Association (IDA) allocations for low-income countries. The framework would also take into account country-specific criteria.

Since the end of last year, changes were introduced to make the DSF more flexible. Minimal or temporary breaches of thresholds, an ability to pay through foreign exchange reserves, remittance inflows that were not captured or a lack of available CPIA scores represented reasons for a less mechanistic use of the framework. Moreover, the DSF would take more accurate account of debts owed by state-owned enterprises (which were excluded if they did not pose a fiscal threat). Finally, the speaker emphasized that, while the DSF addressed the risks that could undermine debt sustainability, it was not a blanket restriction on non-concessionary borrowing.

Mr. Herve Joly, Chief, Development Policy Division, IMF, presented the results of a forthcoming study on LICs' debt vulnerabilities. The study compared pre- and post-crisis debt sustainability assessments (DSAs) to examine the impact of the crisis on debt sustainability in LICs. In the pre-crisis period (the cut off was Spring 2009), there had been a sizeable public debt on average, but the debt ratios were manageable. Debt sustainability varied considerably across countries. One third of the countries were in low risk of debt distress, but about 40% were in the high risk category or in debt distress.

As a result of the crisis, nominal GDP levels would be permanently lower, but real growth should not be affected in the long-run. Higher current account deficits and lower FDI flows were expected, as well as higher primary deficits, partly reflecting countercyclical policies. Debt burden ratios had deteriorated more than expected but were expected to trend downward again in the long term. Because the debt sustainability assessments (DSAs) took a long-term perspective, there had not been many downgrades in risk ratings. (These calculations were based on two important assumptions: that GDP growth was not affected in the long run and that fiscal

space was eventually restored). However the share of LICs that faced higher debt vulnerabilities remained significant, even though no systemic debt difficulties were expected.

The presentation also discussed measures how to address these vulnerabilities. For those HIPC countries that had not reached their completion point, many of their problems could be solved by debt relief. Moreover, the speaker highlighted that high risk did not necessarily mean that debt was unsustainable. Combinations of measures on the lender and borrower side could substantially reduce debt vulnerabilities, but the effects would take time to be seen. He highlighted that more debt relief may be needed in the future in some countries, but traditional debt relief would be effective only if all bilateral creditors participated.

Summary of the discussion

The representative of Yemen (on behalf of the G-77 and China) encouraged the Co-Facilitators to increase the efficacy of the Working Group to help Member States honor their commitments reflected in the Outcome document, in light of its slow implementation. He emphasized that higher debt servicing costs also meant fewer funds towards meeting the MDGs. Measures to mitigate the effect of the crisis on debt sustainability should not be limited to the use of the DSF. At the same time, the DSF should be put under continued review, in an open and transparent matter, involving the views of developing countries.

Temporary moratoriums or standstills on debt servicing for developing countries facing severe difficulties, as called for in paragraph 15 of the Outcome document, were needed to help mitigate the adverse impacts of the crisis and stabilize macroeconomic developments. Such agreements depended on negotiations between debtors and creditors, but could also be established under an independent international sovereign debt workout mechanism.

On the provision of grants and concessionary loans to help ensure debt sustainability, there had been some changes to the IMF lending framework with the purpose of reducing conditionality. However, the IMF FCL facility was only available for “strong-performance actors” and even though there was greater flexibility in some IMF programs, structural reforms would continue to be part of IMF-supported programs. Therefore, there was a need for new and additional resources for developing countries to ensure debt sustainability and resources for social priorities.

Many countries that had not yet completely qualified for the HIPC initiative faced serious development, security and governance challenges, requiring help of the international community. Eligible countries should be able to receive full debt relief from all their creditors, including non-Paris Club members. At the same time, reducing debt service payments was not sufficient to avoid risk of debt distress and a number of completion point HIPCs remained vulnerable to external shocks. Non-HIPC countries also faced debt problems that needed to be addressed.

The speaker reiterated the importance “to explore the need and feasibility of a more structured framework for international cooperation in the area of sovereign debt restructuring”, which was mandated in paragraph 34 of the Outcome document and reaffirmed in General Assembly resolution 64/91. The United Nations, particularly the Working Group, was an

appropriate forum to introduce an internationally agreed legal framework for the orderly restructuring of sovereign debt that could be operationalized through an international body that would guarantee fair burden-sharing, evaluate the debt situation of all countries with external debt problems and propose proper levels and forms of debt relief.

The representative of Chile (on behalf of the Rio Group) highlighted the importance of responsible borrowing and lending in helping prevent unsustainable external indebtedness. All options should be explored in finding a development-oriented solution to the problem of external debt, including debt moratoriums as well as other long-term relief plans that were exempt from conditionalities and freed up the necessary resources to promote development. This should extend to middle-income countries, where 40% of the world's poor lived. The speaker emphasized the need for a mechanism for debt restructuring, particularly for the poorest and highly indebted countries, which would fully take into consideration past experiences and the situation and needs of debtor countries. Some countries in the region continued to have high debt ratios coupled with lack of access to concessionary financing. Therefore, it was important for countries to have access to concessionary loans and financing from the international financial institutions to support sustainability.

The representative of Saint Vincent and the Grenadines (on behalf of CARICOM) stressed the special challenges faced by vulnerable middle-income countries and their particular problems related to access to finance, support for sustainable development and debt sustainability which should be included in the work program of the Working Group. The impact of the crisis had led to increased borrowing which would have problems for countries in the future. Half of the countries in the region had debt ratios higher than 100% of the GDP. For example, Jamaica's ratio was 128 % while St. Kitts and Nevis reached 178%. Debt sustainability was crucial in that region, which included many fragile economies. He noted that small middle-income countries in the CARICOM region were especially vulnerable and should thus receive different treatment compared to larger MICs. There was a need for new measures, such as increases in concessionary financing, to mitigate the impact of the crisis on debt sustainability and to prevent future debt crises. The Working Group should renew the call for flexibility on the lenders side, especially from those countries where the crisis originated. The speaker called for a more structured framework for debt restructuring and suggested that the Working Group recommend modalities for temporary standstills and a debt restructuring facility.

The representative of the European Union noted that the crisis would have lasting and varied impacts on developing countries. Debt vulnerabilities were expected to increase in some countries in the future but was not a systematic problem and should be tackled case-by-case. The IMF had reformed its lending conditions to make them more flexible and introduced relief on interest payments until 2011, which helped mitigate the effects of the crisis. The speaker further welcomed the review of the DSF. He highlighted concessionary financing as the best way to ensure debt sustainability. International assistance for capacity-building was crucial in order to help countries improve their debt management capabilities. An improved framework for debt restructuring can be discussed with the BWIs in the debate.

The representative of Cuba pointed out that the capacity to sustain debt had been severely hurt by the crisis. The level of debt servicing in Latin America had reached \$3.5billion and was

clearly unsustainable. There was also a danger of debt accumulation in the developed world. Reductions in external finance, reduced export revenues and volatile commodity prices posed a risk for new debt crises in developing countries. The speaker underscored that current initiatives for debt relief failed to solve the external debt problems. More debt relief was needed, particularly for the poorest countries. There was also a need to introduce a debt workout mechanism within the UN that allowed for fair burden sharing of debtors and creditors.

The representative of Saint Lucia commended the fact that data presented during the presentations by the panelists was disaggregated by country. The speaker called for more research with disaggregated data, which could help to identify vulnerability and distress and direct resources and assistance to vulnerable low-income countries more effectively.

The representative of Bangladesh stressed that the LDCs bore the brunt of the financial crisis and emphasized the need to establish a sovereign debt workout mechanism. The speaker called for an objective evaluation of the DSF, including its limitations, by a further expert panel. He pointed out that there was very little correlation between the need that arose to borrow to counter the impact of the financial crisis and the assessment of strong, medium and weak polices and the indicative thresholds set out in the framework. In fact, many countries that had been qualified as being at high risk for debt distress as a result of weak institutions and policies did not need to borrow while others that were classified as low risk did call on the IMF for loans.

The representative of Jamaica emphasized that the situation for many middle-income countries (MICs) had worsened and that many of them had to resort to borrowing from the IMF as there was no other option. The speaker emphasized the need for a review of the DSF for MICs.

The representative of the Netherlands noted the very different situations across countries and emphasized how difficult it was to paint a general picture of the debt situation in the developing world. Debt relief seemed to have provided a cushion in the crisis and good debt management was essential. He argued that there was no need for a new large-scale debt relief mechanism, but the needs of specific countries needed to be addressed on a case-by-case basis. Responsible borrowing and lending practices should receive high priority. The speaker welcomed the new initiatives by UNCTAD on this topic and pointed out that the Netherlands was following the OECD guidelines in that regard. The DSF was the most important instrument in preventing a debt crisis. He emphasized that the involvement of non-Paris Club members was important when it came to debt restructuring.

The Co-Chair (Zambia) made a point that “sustainable” borrowing and lending might be a better, more accurate, objective for developing international guidelines to mitigate the impact of the crisis on debt sustainability.

The representative of Russia was in favor of a comprehensive and fair treatment of the external debt problems of developing countries, as part of the international strategy to prevent future debt crises. Russia was ready to discuss relevant measures, including the issues of restructuring sovereign debt on the basis of existing principles. It was important to create transparent and effective mechanisms for providing long-term debt sustainability of LICs.

Responsible borrowing and lending practices were essential. When it came to the determination of debt sustainability, national policy considerations should complement World Bank and IMF analyses.

The representative of France emphasized the need to focus on coordinated measures to avoid new cycles of indebtedness in developing countries. The DSF was the most appropriate tool to calibrate risk and identify responsible policies for financing. She further highlighted that external debt issues in non-HIPC and middle-income countries were dealt with through the Evian approach within the Paris Club, which could be further enhanced and improved. France had considered new loan instruments, including a counter-cyclical concessionary loan set-up by the French Development Agency allowing for additional grace periods in case of exogenous shocks. According to the speaker, sovereign debt restructuring should be based on existing frameworks and the Bretton Woods institutions (BWIs) should play a central role in the discussions.

The representative of Japan stressed the need to remain vigilant and keep guard against possible future debt crises. Sustainable debt management and lending was crucial. Sovereign debt restructuring should be based on existing principles with the involvement of the BWIs. The speaker called for sustainable borrowing and lending.

The representative of Venezuela emphasized the serious impact of the crisis on Venezuela. There was a need to introduce a broader framework for dealing with debt problems. Debt moratoriums were needed for countries that were severely hurt by the crisis. Moreover, the UN system should lead the way in formulating and implementing a sovereign debt workout mechanism to avoid future crises.

Concluding remarks by the panelists

Mr. Joly highlighted that the IMF had reached out extensively to its borrowers. The Fund had conducted training sessions on its DSF as it was critical for borrowers to have an instrument to identify debt sustainability. They were also active in the debt management area and had developed instrument to assess debt management performance and capacity with a view of identifying needs for improved and more effectively targeted future assistance. He further highlighted a joint WB/IMF framework for medium-term management strategies, which was complementary to the DSF.

Mr. Gooptu underscored that the World Bank had regularly conducted side events within their outreach efforts to inform interested parties on changes made to the DSF and collect feedback and input on how the DSF would be applied going forward.

Ms. Li pointed out that the UNCTAD initiative on responsible borrowing and lending was broader than just debt sustainability or economics, since it included issues such as judiciary responsibilities, the impact of climate change and the effect of ageing generations.