



THESSISMUN 2007

THESSALONIKI INTERNATIONAL STUDENT
MODEL UNITED NATIONS

United Nations General Assembly 2nd Committee Topic Area A

Debt sustainability: proposals of an operational policy mix



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"We will have time to reach the Millennium Development Goals – worldwide and in most, or even all, individual countries – but only if we break with business as usual. [...] So we must start now. And we must more than double global development assistance over the next few years. Nothing less will help to achieve the Goals."

Former United Nations Secretary-General

Kofi A. Annan

Introduction

Debt sustainability which is defined as the ability to manage debts so they do not grow, is an essential condition for economic stability. Alternatively, "sustainability of debts" is considered as the condition under which these debts can be serviced without resort to exceptional financing or a major future correction in the balance of income and expenditure. In economic analysis, debt sustainability is defined on the basis of the behaviours of lenders and borrowers involved in the contractual relationship.

In order to achieve economic growth and development, economic stability is required. Yet, many low-income countries have significant difficulties in achieving and maintaining their development objectives, including the Millennium Development Goals (Goal 8: Develop a Global Partnership for Development). As a result, special action is to be taken, in order to ensure that these countries will reach the goals that the International Community has set by the target date of 2015.

Debt Sustainability is aimed not only at achieving the LICs' goals through the granting of loans, but also at maintaining them. In the past, despite access to low-cost financing, many low-income countries accumulated high levels of debt that imposed a heavy burden on their economies and ultimately required costly debt relief to be resolved. With many "graduated" HIPC countries experiencing rising debt burdens again, and debt ratios in some other low-income countries also reaching elevated levels, there is a clear need for guidance on how much debt these countries can afford to



accumulate. Such guidance is particularly urgent in light of the sizeable spending requirements associated with achieving the MDGs.

Historical Background

Low-income countries are a diverse group—ranging from poor countries with weak policy records and histories of war and civil strife to relatively advanced economies that have some access to private capital inflows and are on the verge of becoming emerging markets (most countries in this group rely predominantly on official financing).

The increase in many low-income countries' debts, beginning in the 1970s and peaking in the early 1990s, was accompanied by disappointing performance in their struggle against poverty. In the case of the Heavily Indebted Poor Countries (HIPC), nominal debt stocks rose from moderate levels in the early 1980s to some 800 percent of exports and 160 percent of gross national income in the mid-1990s, in many cases constituting a debt overhang that may have contributed to these countries' poor growth performance. In a global environment in which many economies prospered from growing trade and financial integration, some of the world's poorest countries were left further behind -seemingly unable to put large amounts of net external financing to good use. Due to payment difficulties, net flows to these countries [(grants and loans) - debt service paid] were positive, averaging 13 percent of GDP per country over 1984–96, but much of the new flows were in the form of new debt, and grants were not used to relieve the overall debt burden.

As of 1996, low-income countries, mostly in Africa, had an extremely difficult external debt situation that influenced their prospects for economic development. For these countries, even full use of traditional mechanisms of rescheduling and debt reduction - together with continued provision of concessional financing and pursuit of sound economic policies – would be insufficient to attain sustainable external debt levels within a reasonable period of time and without additional external support.

The acknowledgement that the debt stocks of these countries were effectively unsustainable, and that indebtedness itself could be among the factors impeding investment and growth, started to take hold only in the early 1990s, when the Paris Club began to consider stock-of-debt operations,



and culminated in 1996 in the HIPC Initiative, with its comprehensive treatment of all outstanding obligations.

The importance of Depts & Dept Sustainability

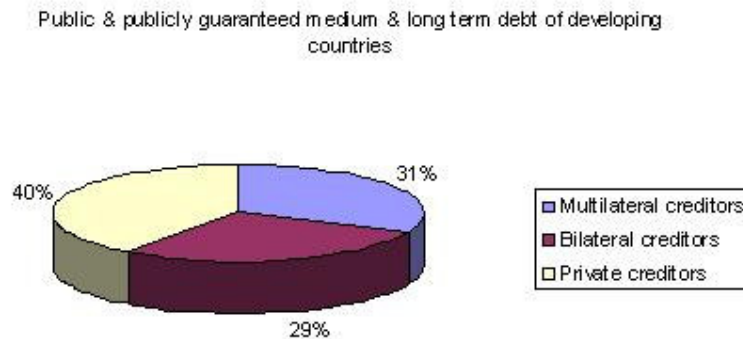
Certain characteristics of many low-income countries adversely affect their ability to cope with high debt:

- a- Risks of misuse and mismanagement of resources, due to weak public institutions, poor governance, and generally low implementation capacity;
- b- Returns on investment that frequently accrue only over the long term, and whose benefits (such as, from improved security and health care) may be diffuse and cannot be easily captured by governments in the form of higher taxes to repay debts; and
- c- Narrow and highly volatile production and export bases that make these countries particularly vulnerable to exogenous shocks that can significantly worsen their debt dynamics.

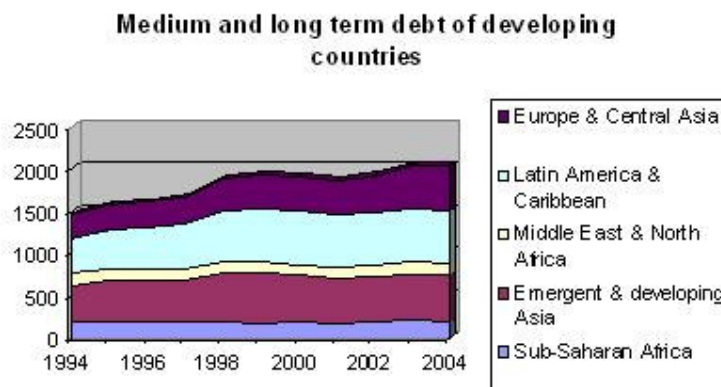
According to the Paris Club, external debt is a vital source of financing for developing and emerging countries. In the case of developing countries, it comprises several types of debts (by debtor, be creditor etc.). The creditworthiness of a country, in other words its capacity to repay its external debt, appears to be the most important issue in the case of a debt: Being creditworthy is a key to success for developing countries, since this makes it possible for them to borrow larger amounts to finance growth development. In addition, a creditworthy debtor is in a position to borrow funds used to refinance its existing debt obligations. It can furthermore be argued that, if a country is expected to service and repay its debt from its own future resources, high debt creates adverse incentives associated with (present and anticipated) distortionary taxes. But if debt service that is considered excessive relative to the available resources is expected to be covered by increased aid flows or debt relief, this may undermine a government's incentives to maintain sound macroeconomic policies and increase its own repayment capacity.



Over the years, the share of private debt (debt owed by private debtors) and the share of private claims (debt owed to private creditors) has increased, as is shown in the following figure, reflecting the increased role of the private sector in both industrialised and developing countries:



According to the IMF, also the medium and long term debt of developing countries (excluding countries in transition) has increased as follows over the past eight years:



Excessive debt in low-income countries is a serious problem. Given low-income countries' reliance on official flows, debt sustainability depends largely on the willingness of official creditors and donors to provide positive net transfers through new financing. Excessive debt levels create adverse incentives for private investors or governments to engage in activities that spur long-term growth. In addition, while market rollover risks are limited in most low-income countries, those that are heavily indebted



are particularly vulnerable to interruptions in aid flows in response to changing priorities of official creditors and donors.

One should not forget the corresponding risk to official creditors, in case they are forced to maintain a positive net transfers to a country or to provide debt relief to ease the constraints that excessive debt service would otherwise impose on the use of countries' scarce resources. Creditors may even be forced into new lending or debt relief for the purpose of maintaining positive net transfers. In this view, the responsibility falls on the low-income countries.

In practice, however, responsibilities should be put on both sides: On one hand, the low-income countries that seek new loans are responsible for maintaining debt sustainability. They must develop and strengthen policies and institutions that enhance their capacity to manage debt and reduce their vulnerability to exogenous shocks ranging from international trading conditions to natural disasters. On the other hand, creditors and donors need to comprehensively review long-term debt projections, which incorporate forward-looking analysis and account for possible shocks. They also need to explore options that can help limit the potential impacts of adverse exogenous shocks or help low-income countries cope with them.

Finally, it is significant to note that a debt can be serviced for long periods, or suddenly become unsustainable, depending on the willingness of official creditors' and donors to provide positive net transfers through concessional loans and grants.

Criteria, according to which a country is (or will be) likely to service its debt

The World Bank suggests that only three facts explain the risk of future debt distress and, as a result, of a country's ability to repay its loans:

1. The public external debt of the country
2. The quality of policy performance of its government
3. The experience of shocks.



However, a country's ability to service its loans depends also on the following:

- Existing debt burden
- Prospective path of its deficits
- The financing mix between loans and grants
- The evolution of its repayment capacity
- The quality of institutions (apart governments)
- Capacity of the country to generate balance-of-payment receipts
- The volatility of these receipts
- Creditors, such as international organizations or governments, and donors do not provide sufficient new financing in terms of loans or grants for financing a country's primary deficit
- Very high costs of servicing domestic debt.

Reasons for which low-income countries result in a debt crisis

The reasons that make a country result in a debt crisis or that may deprive it of the possibility to repay its loans to its borrowers can be described as follows:

- The financing provided to these countries does not generate the economic growth envisaged; in other words, borrowing decisions were predicated on growth projections that never materialized
- Complex and painful regimes of fiscal austerity
- Prescription of unpopular policy reforms in controversial areas
- Complicity of creditors

Further reasons that explain the dissonance between debt and growth, which is often the case in those crisis countries, are:

- The vulnerability of exogenous shocks, e.g. adverse terms of trade or weather



- The waste of resources due to policy deficiencies, poor governance and/or weak institutions (this applies especially to typically public-sector dominated economies)
- Inadequate debt management
- Nonconcessional lending and refinancing policies of creditors (primarily in the early years) that were, in part, motivated by their desire to promote their own exports
- Political factors, e.g. civil war, social strife etc., which often result in devastating economic consequences

The HIPC Initiative

Started in 1996, the Initiative for the "Heavily Indebted Poor Countries" (HIPC Initiative) was designed to provide exceptional assistance to eligible countries following sound economic policies to help them reduce their external debt burden to sustainable levels. That is, to levels that will comfortably enable them to service their debt through export earnings, aid, and capital inflows. This assistance entails a reduction in the net present value (NPV) of the future claims on the indebted country. Such assistance helps to provide the incentive for investment and broaden domestic support for policy reforms.

The HIPC Initiative was enhanced in 1999 as an outcome of a comprehensive review by IDA and the IMF, including public consultations. The Initiative's debt-burden thresholds were adjusted downward, which enabled a broader group of countries to qualify for larger volumes of debt relief. Moreover, a number of creditors, including the main multilaterals, started to provide earlier assistance to qualifying countries in the form of interim relief at decision point. Finally, the "floating completion point" was introduced, providing incentives to speed up reforms and increase country ownership.

In order to be eligible for special assistance by the HIPC, a country must satisfy the following criteria:

- Be eligible only for concessional assistance from the IMF and World Bank ("IDA-only")



- Face an unsustainable debt burden, beyond available debt-relief mechanisms such as Naples terms (where low-income countries can receive a reduction of eligible external debt of 67 percent in NPV terms)
- Establish a track record of reform and sound policies through IMF- and World Bank-supported programs.

The Debt Sustainability Framework

The Debt Sustainability Framework, lately reviewed in 2005 and 2006, is a “forward looking” approach that aims to guide borrowing and lending decisions for low-income countries on terms that allow borrowing countries to devote resources toward achieving the MDGs, while also staying within their means to repay loans. By accounting each country’s specific circumstances, the framework tries to help borrowing countries balance their need for funds with their current and prospective ability to repay their debts. Linking a country’s borrowing potential to its current and prospective ability to service debt should help countries avoid accumulating excessive debts.

The effectiveness of the DSF depends on its broader use by debtors and creditors. The paper considers a number of options in this regard, including strengthening the link between the results of debt sustainability analyses and policy advice, further outreach to official creditors, and the development of medium-term debt strategies that balance development needs with the risk of debt distress. The broader use of the debt sustainability framework, as well as its use as a device for better communication and coordination between creditors and borrowers, and among creditors, would also facilitate communication and coordination on debt-related issues among creditors and between creditors and debtors. While recognizing that the primary responsibility for avoiding debt re-accumulation lies with the borrowers, further exploration of ways to encourage responsible lending by all creditors is desirable. To this end, timely, high-quality data on borrowing and lending operations, as well as improved quality and availability of data on overall financial flows to low-income countries shall be of high importance.



What can be done?

So far, there have been a number of proposals referring to Debt Sustainability. However, there is still a long way to go. The World Bank and the International Monetary Fund are expected to play the most important role in the years to come. Nevertheless, one should not forget that the countries suffering debt crisis cannot fight this without the assistance of the economically stable ones.

Some proposals for action to be taken include:

- Coordination of work programs in advance, upstream engagement and consultation on the substance of the work, allowing time for genuine differences to be resolved, and transparent recording of final outcomes
- New lending should be geared to a country's capacity to carry debt—which in turn, depends on its ability to use these resources effectively for development and growth, and on its vulnerability to shocks.
- In the case that additional resources, beyond a country's capacity to carry debt, may be productively employed to generate growth and achieve the MDGs, these resources should be provided in the form of grants rather than loans.
- The appropriate threshold ranges shall be chosen for debt-burden indicators based on empirical findings and an explicit consideration of country-specific circumstances
- Projection and interpretation of the debt-burden indicators shall take place, and ideally under the policy baseline and under probable "stress scenarios" which incorporate a country's vulnerability to exogenous shocks
- Increased aid allocation and broad participation among donors -as is suggested by the required increase in the availability of resources to low-income countries
- New borrowing even on concessional terms shall be pursued with caution, based on prudent economic projections and recognition of country-specific circumstances and risks
- Broadening of the current debt-relief initiative



- Extension of the debt-cancellation initiative to include debt owed to other multilateral creditors
- Poor countries shall not fall into the constraints of conditionality
- Potential creditors and donors shall also consider giving additional resources in the form of grants and/or highly concessional loans for low-income countries with high levels of debt distress
- Greater emphasis shall be placed on signalling to the member country and donors of a need to shift to grant financing when there is a strong likelihood of debt distress
- Improvements in the policy and institutional environment in the medium term can lower the likelihood of debt distress for any given level of the debt burden
- The severity of the debt problem and creditors' abilities to respond shall determine the appropriate response
- The targeted level of "sustainable" debt of a country shall vary with the quality of its policies and institutions, as well as with the shocks that the country experiences
- Increase in the concessionality of financing to low-income countries

Other key issues & challenges to be further examined:

- The debate on methodological issues, e.g. the appropriate discount rate for calculating the net present value of debt (and perhaps of exports, GDP or revenues), the different roles of debt stock and debt service indicators etc.
- Assessment of debt sustainability in relation to indicative country-specific debt-burden thresholds taking into account the quality of policies and institutions
- Strengthening management of debt and public finances.
- Ensuring full participation by creditors
- Analysing debt sustainability and development



- Alternative approaches to debt sustainability analysis
- The role of institutions
- The link between trade and debt
- The international regulatory environment,

Conclusion

As has been analyzed, Debt Sustainability is an issue that affects many of the countries, let these be the low-income ones (in the role of loan-receiving) or the economically stable ones (in the role of loan-giving). A fundamental premise is that avoiding debt distress in low-income countries is desirable for three main reasons:

- 1- Resolving debt distress is costly;
- 2- Non-repayment of loans to multilateral lenders can have perverse distributional effects among borrowing countries; and
- 3- In order to meet the MDGs endorsed in Monterrey, Doha, and Johannesburg, there should be a significant increase—if not a doubling—in official development assistance to poor countries.

However, the World Bank suggests that non-financial variables are key determinants of debt distress, especially the quality of policies and institutions. More analytically, the Bank's research highlights the importance of countries' history of non-repayment and macroeconomic instability in driving market perceptions of the likelihood of default. As a result, it shows that contemporaneous policies and institutions also matter for the likelihood of debt distress.

To sum up, in order to achieve Debt Sustainability and, as a matter of fact, the Millennium Development Goals, an efficient cooperation between the two parts (low-income ones and economically stable ones) shall take place. Finding an operational policy mix will be the work of the 2nd Committee.



Abbreviations & Acronyms

CPAs: Country Program Assessments

DSA: Debt Sustainability Analysis

DSF: Debt Sustainability Framework

GDP: Gross Domestic Product

HIPC: Heavily Indebted Poor Countries

IDA: International Development Association

IMF: International Monetary Fund

LIC: Low-income Countries

MDGs: Millenium Development Goals

MDRI: Multilateral Debt Relief Initiative

NPV: Net Present Value

Sources

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