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**Research Report**

## The indebtedness of the developing countries. Breaking the spiral of crises with realistic ceilings to ensure a sustainable debt service burden

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## The Indebtedness of the Developing Countries

### Breaking the spiral of crises with realistic ceilings to ensure a sustainable debt service burden

- *At the world economic summit of the G7 countries to be held in Cologne in June 1999 Germany should make its mark as the driving force behind the HIPC Initiative. The overall concept of this initiative, a mix of bi- and multilateral approaches, related conditionality on a case by case basis and transparent rules for reviewing progress towards consolidation, is generally headed in the right direction.*
- *If this initiative is to break the disastrous debt circle, however, it is essential to redefine the term "sustainable debt burden" and to set its threshold values more comprehensively and, in general terms, more conservatively; "sustainable indebtedness" must no longer describe the extreme limit of economic capacity up to which developing countries can be burdened by debt service payments. If it is to be set at an appropriate level, the following four criteria should be applied: sufficient export earnings and foreign exchange reserves to ensure transferability and sufficient domestic savings and government revenues to guarantee the ability to generate debt service funds internally.*
- *Only if all creditors and debtors commit themselves to lower debt ceilings will debt relief operations lead to a sustained breaking of the debt circle. This also means that above these ceilings only grants should be allocated in the future and that donors should forgo the allocation of loans on market terms. What is needed here is nothing less than a new culture of lending discipline.*
- *With its development oriented conditions, the HIPC Initiative is rightly based on the assumption that debt relief is appropriate only if it is ensured that the resulting gain in financial room for manoeuvre is used properly to implement economic and social reform and adjustment policies and does not serve to enrich the elites or to finance civil wars.*

#### Breakthrough on the debt front?

The developing countries' debt problems have been on the international agenda since Mexico's standstill agreement in August 1982. Liabilities grew by 260% from 1980 to 1997 and will have quadrupled by the end of 1999. Debt service arrears have continued to rise sharply. The hopeless situation of many of the poorest countries is a particular challenge to the donor community. And the more advanced economies of Asia, Latin America and Eastern Europe too have confronted the world with repeated setbacks after a period of stabilization in the late 1980s and early 1990s. Now, however, this scenario of an obstinate continuity of crises seems to be changing. Under the heading "new global financial architecture" a broad package of measures for preventing the newly industrializing countries from being afflicted by further payment crises is under discussion. With the moral backing of the Churches and NGO networks, the global "Debt Relief 2000" campaign is exerting growing pressure for the burden on the poorest developing countries to be comprehensively eased. The German Government is preparing a far-reaching debt relief initiative for the G7 meeting in Cologne. Is there a chance that with these new approaches the foundations can be laid for the global consolidation of debt problems that has hitherto failed despite highly creative crisis management and isolated successes?

#### Progress in the search for problem-solving approaches

What has been achieved so far, should not be underestimated. Since the outbreak of the debt crisis in the 1980s the policies, procedures and instruments adopted to overcome payment problems have developed continuously and been tailored to the special requirements of groups of countries and individual cases. Under the 1985 Baker Plan countries in crisis were to have "fresh money" to

enable them to grow out of their debts. The initiative failed, mainly because the liquidity crisis had turned almost everywhere into an insolvency crisis. The Brady Plan in 1989 saw the first application of a concept that made it possible for the overindebtedness of newly industrializing and middle-income countries to be alleviated with voluntary market-related debt and debt service reduction measures in conjunction with credible adjustment programmes. At the same time, attempts were made to develop specific forms of debt relief for the severely indebted low-income countries (SILICs). In the Paris Club a process of continuously softening the debt re-scheduling conditions to the benefit of this group of countries began with the establishment of the Toronto Terms in 1988; they were followed by the Houston Terms in 1990, the Trinidad Terms in 1991, the Naples Terms in 1994 and the Lyon Terms in 1996. The Cologne Terms might be added in 1999.

The commercial and bilateral aid and trade debt relief operations drew increasing attention to the fact that the SILICs had a specific problem, the growing relative weight of multilateral debts, which were not deemed eligible for relief because of the preferred creditor status of the international financial institutions. As the special multilateral debt relief instruments created by the World Bank also failed to lead to a breakthrough, the Bretton Woods institutions and bilateral donors jointly launched the HIPC Initiative, which seeks to reduce the debts of a group of 40 highly indebted poor countries to a sustainable level and for the first time also provides a mechanism for reducing multilateral claims.

In the mid-1990s the newly industrializing countries reported back to the debt front, in changed circumstances and again with alarming systemic risks. The Mexico crisis of 1995 was the harbinger of the turbulence in Asia that

began to shake the world's financial markets in mid-1997. In 1998 Russia found itself compelled to cease payments, and in early 1999 Brazil stood at the edge of the abyss. The leading industrialized countries and the international financial institutions reacted by increasing their crisis intervention funds and aid packages by a total of some US\$ 230bn, an unprecedented amount.

Developing countries' debt, 1980-1997 (US\$bn)				
	1980	1990	1996	1997 <sup>a</sup>
Total debt	603	1444	2095	2171
Long-term	445	1168	1650	1728
Public	377	1108	1397	1429
Private	68	60	253	300
Short-term <sup>b</sup>	145	189	345	357
Arrears	3	113	145	99
HIPC countries	55	189	214	n.a.
Arrears	2	44	66	n.a.

<sup>a</sup> provisional  
<sup>b</sup> excluding outstanding interest on long-term debt  
Source: World Bank, Global Development Finance, 1998

#### The core problem of the current management concept: the definition of sustainable debt

One of the main causes of the generally meagre successes of this impressive array of attempts to solve the problem is that the risks of external indebtedness always end in payment crises, because sustainable debt is interpreted by the donor community as meaning maximum debt service capacity. Even minor changes of economic parameters may lead to insolvency. This explains why errors in debt maturities management, external shocks, the misallocation of borrowed funds and natural disasters are almost inevitably followed by a situation in which a level of debt considered to be sustainable in principle becomes a case of overindebtedness. As external shocks and errors on both the debtor and creditor side are likely to occur at any time, sustainable debt in the real world should no longer be defined as if all concerned were operating under economic laboratory conditions. The ceilings on sustainable debt must therefore no longer reflect the extreme limit of economic capacity up to which developing countries can be burdened with debt service payments; when this limit is set, adequately proportioned risk cushions must be incorporated to avoid payments problems caused by unpredictable disturbances.

Since the 1950s lenders have, to the contrary, increasingly distanced themselves from the principles of cautious credit policy and responsible evaluation of the borrower's creditworthiness. In the 1953 London Debt Agreement the two sides agreed that the cover for Germany's transfer obligations could come only from a current trade surplus. In the mid-1960s the World Bank set the limit on the burden of debt service payments on export earnings at 6 to 7%, a level that is well below the current threshold of 20 to 25%. In the mid-1980s it saw maximum sustainability as being a debt-to-GDP ratio of 40%; today a developing country is not considered heavily indebted until the present value of its debts exceeds 80% of GDP.

#### Operational thresholds for sustainable indebtedness

Realistic thresholds for sustainable indebtedness are crucial for the debt management because they define the scope available to developing countries for borrowing without their taking any appreciable risk of encountering debt service problems. They also indicate the guidelines for debt relief, if the requirements for this are satisfied.

The setting of realistic ceilings related to the individual case presupposes that account is taken of all essential dimensions of the transfer risk and the risk to generate debt service funds internally. In the future all essential factors must therefore be covered by relevant indicators and corresponding thresholds, which are needed for the assessment of the sustainability of debt burdens. The World Bank does not do this with its differentiation between highly, moderately and less indebted countries, which relates solely to export earnings and GDP. With this concept such problem cases as Russia are able to continue as if they were "less indebted" countries.

At least the following four conditions should be taken into account in such threshold values: sufficient export earnings and foreign exchange reserves to ensure transferability and sufficient domestic savings and government revenues to guarantee the ability to generate debt service funds internally. The export earnings available after the deduction of payments for necessary imports must be high enough to ensure the transfer of debt service payments. Foreign exchange reserves must take account of debt service maturities and so be large enough at any time for transfer problems due to an overhang of short-term debts to be avoided. Domestic savings can be used to meet debt service requirements only if they are not needed to cover the essential minimum of investment. Government revenues may be used to service external public debt only to the extent that the performance of core government tasks is not restricted.

All four conditions must always be satisfied at the same time if debt service problems are to be avoided. Dynamically growing export earnings, high government revenues and a savings ratio well above the average were unable to save a country like South Korea from transfer problems in 1997, because its short-term debts had risen to more than three times its foreign exchange reserves.

The following four threshold values for sustainable indebtedness might be regarded as rules of thumb for an initial approach to a comprehensive set of operational ceilings, which naturally need to be tailored to specific groups of countries and possibly extended to take account of private capital inflows in the case of newly industrializing countries, for example; the yardsticks offered here take particular account of the situation of the HIPCs:

- Debt service should not exceed 10 to 20% of export earnings, depending on the degree of foreign trade linkages; this would mean a sufficient additional safety margin compared to the present ceilings.
- Foreign exchange reserves should at no time fall below the total volume of short-term debt service liabilities; cover for all payments obligations due in the next 12 months, for example, might be considered.
- Domestic savings available for investment should not fall below 15 to 20% of GDP (depending on ability to absorb capital) after deduction of the proportion needed for debt service, in order to ensure at least positive growth of per capita income.
- Debt service should not result in the reduction of current public expenditures financed from a country's own revenue to less than 12 to 15% of GDP or of

public investment to less than 3 to 8%. The definition of an operational sustainability ceiling on the servicing of public external debt is crucial because the connection between debt service and poverty-related core tasks of the state is particularly close here.

To break the spiral of ever new debt crises, threshold values that include an appropriate risk cushion should be established in the future as binding ceilings on the incurring of external debt of developing countries and the allocation of credits by private and public lenders. It is not enough to calculate the resulting maximum debt volumes only when crises come to a head. They should be constantly updated and adjusted on the basis of a set of generally accepted, binding rules. They should also be official and published regularly. The scope for incurring debt and debt relief requirements revealed by the specific ceilings in individual cases depend not only on the current levels of the four key ratios but equally on their likely future trend. Given the possibility of widely divergent assessments owing to differing interests, the analysis and evaluation of previous macro data and forecasts of future orders of magnitude should be based on a joint process of deliberation and agreement between debtors' and creditors' representatives, as is already the case with the debt sustainability assessments for the HIPC's.

Only if all creditors and debtors commit themselves to lower debt ceilings of this kind will debt relief operations lead to a sustained breaking of the debt circle. This also means that above these ceilings only grants should be allocated and that donors should forgo the allocation of loans on market terms. What is needed here is a new culture of lending discipline. If, however, the commitment is not sufficiently binding because of the large volumes of funds involved, the associated prospects of gains for many of the actors concerned, the enormous risks and the dangers of moral hazard, effective sanctions should be considered to ensure that less responsible creditors and debtors respect the thresholds.

#### Implications for the HIPC Initiative

The concept of the HIPC Initiative, a mix of bi- and multilateral approaches, related conditionality and transparent rules for reviewing progress towards consolidation, is generally headed in the right direction. Another positive feature is that, unlike the standard classification of debtor countries, it includes, in the shape of the "fiscal criterion", a ceiling on the proportion of government revenues devoted to the servicing of external debt. A problem in several respects, however, is posed by the setting of targets for sustainable indebtedness that are to be achieved by means of the relief measures considered. Except in countries where the fiscal criterion is taking effect (Guyana, Côte d'Ivoire), these targets are only very slightly below and, at 225% in Bolivia's case, even still above the 220% threshold (debt as a percentage of export earnings), the level at which a country is considered to be heavily indebted according to the World Bank's own categorization. Such targets are neither plausible, nor do they further the credibility of the HIPC Initiative in the eyes of an increasingly critical public. They also bear the seeds of failure in themselves.

Similarly questionable are the assumptions on which the "debt sustainability assessment" is based in the various country documents. Almost all proceed from such optimistic scenarios for the development of GDP, exports, investment, savings, etc. that anyone who has observed this group of countries over the last few decades will realize that the extreme limit of possible growth margins achievable under ideal conditions is being interpreted as macro levels that are realistically to be expected. It is

legitimate, of course, to aim at such projections as target scenarios. But it is unhelpful to base specific policy, debt relief and aid scenarios on them.

In line with the vote for debt relief operations to be aligned with sustainability ceilings which include an adequate safety margin, the debt service burden on the HIPC's should be reduced to a level that permits them to finance moderate growth through their own efforts after interest and amortization payments. The possible refinancing of debt service with new resource flows must be disregarded in this context, since, on the one hand, they should be available for additional imports and investment needed for development and, on the other hand, neither the creditors nor the countries concerned can rely on these resource flows being sustained in the future.

#### HIPC Initiative

The initiative for the highly indebted poor countries was launched at the annual meeting of the IMF and World Bank in 1996.

1. Of the group of the 40 poorest developing countries, about 20 are being examined to see if they can expect more help from the international donor community in solving their debt problems than they have received in the past. It is assumed that, without such help, these countries will not achieve a sustainable level of indebtedness in the next five to ten years if no more than the present set of instruments continues to be applied.

2. Timeframe: In a procedure of sequent steps extending over a period of, in principle, two times three years the level up to which the country concerned can sustain debt and its reform and adjustment efforts are comprehensively reviewed. This includes the observation of the effects of the conventional debt relief instruments used. If the results remain unsatisfactory, the additional measures decided in Washington, which are supposed to lead to a breakthrough, are applied after three or six years respectively. They are:

- cancellation of multilateral debts (IMF, World Bank, regional development banks) from a trust fund created specifically for the purpose and administered by the IDA;
- rescheduling of bilateral debts in the Paris Club, with up to 80% being cancelled in certain cases;
- comparable rescheduling measures taken by the public creditors that do not belong to the Paris Club and by private creditors.

3. Financing: According to World Bank and IMF estimates the cost of the HIPC Initiative will amount to US\$ 12,5bn. This is to be provided by the members of the Paris Club, bilateral and commercial creditors and the international financial institutions.

4. The first HIPC countries to benefit from debt relief operations are Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, Mali, Mozambique and Uganda.

As an example of all four of the thresholds proposed above, the application of the criterion of the guaranteed availability of at least 15% domestic savings will be taken to show how the debt relief arising from this approach should be calculated: in the sub-Saharan African HIPC's domestic savings have settled at an average of about 8% of GDP. The deduction of the proportion that should be spent on debt service (currently about 7% of GDP) leaves domestic savings of only 1% of GDP to finance investment needed for development, an amount that everyone's experience has shown to be completely inadequate. Only

if the debtor country in this fictional, but realistic, example is able to achieve a domestic savings ratio of 22% will the necessary minimum of 15% be left for the financing of investment after the deduction of debt service payments. In all cases where an adequate level of savings as defined here is not reached, debts must be completely or partly cancelled.

The argument, which seems irrefutable at first sight, that this approach rewards countries which make little effort to increase their savings ratios overlooks one essential point: the reform and adjustment policies that are called for will satisfy the debt relief conditions only if they ensure, among other things, that the countries concerned largely exhaust their savings potential.

#### Recommendations for the G7 summit in Cologne

The German Government should make its mark as the driving force behind the HIPC Initiative, in accordance with the proposals it has already considered. In doing so it might also become the advocate of additional measures that would make a major contribution to safeguarding the long-term sustainability of debt relief operations.

It should urge the reviewing and supplementing of threshold values for sustainable indebtedness on which the relief operations are based. It should be ensured in this context that the donors are not guided in a first phase by the criterion of ability to finance the resulting debt cancellations, so that undistorted target scenarios may at least reach the negotiating table. Only as a second step should it then be decided what relief should and could be granted to which countries in the context of the current HIPC Initiative and which should follow as part of a second HIPC phase.

Besides realistic sustainability ceilings, the form to be taken by the related conditionality to promote development is the second vital requirement for the success of the HIPC Initiative. As the debate on this is generally proceeding in the right direction, it will not be discussed further at this juncture. In principle, the envisaged debt relief operations with adequate individual conditions attached are likely to have a greater impact on development if the individual sustainability ceilings yet to be defined are applied. However, they should benefit only countries which guarantee that the additional financial room for manoeuvre is used efficiently for investment needed for development and does not serve to enrich the elites, to finance civil wars or to implement prestige projects or simply bad projects. In ensuring that this requirement is satisfied, the creditors are accountable not only to the taxpayer in the donor countries, who is entitled to see the funds being used responsibly, but even more so to the people of the debtor country concerned.

It is also important for the timeframe of the HIPC Initiative to be made generally more flexible. Where domestic acceptance is concerned, it is inappropriate to make HIPCs wait six years for their eventual debt relief. This greatly reduces the incentive effect of the initiative. Countries that show themselves very willing to engage in policy dialogue and demonstrate recognizable ownership

of comprehensive adjustment policies should also have their debts reduced in instalments at an earlier stage of the reform process within their respective sustainability limits as a function of accurately defined policy steps.

The German Government's payment of a substantial contribution into the HIPC trust fund might act as a signal to other bilateral donors still hesitating. The use of this contribution should be made conditional on realistic debt sustainability analyses. This would give a signal how the current close and problematical link between the main creditors' financial margins and the setting of sustainability limits might be effectively dissolved.

Finally, it should be made clear why, if future development processes are to succeed, the goal must be to ensure that the debt relief operations envisaged are not used as a pretext for reducing traditional development cooperation.

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#### Additional readings

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**Eberlei, W. (1999):** Deutsche Gläubigerpolitik gegenüber ärmsten Ländern, Hamburg

**Tietmeyer, H. (1999):** Ein genereller Schuldenerlaß für die ärmsten Entwicklungsländer? Deutsche Bundesbank, Frankfurt

**van Trotsenburg, A. / A. MacArthur (1999):** The HIPC Initiative: Delivering Debt Relief to Poor Countries. World Bank and International Monetary Fund, Washington

**WEED (1999):** Schuldenreport 1999, Bonn