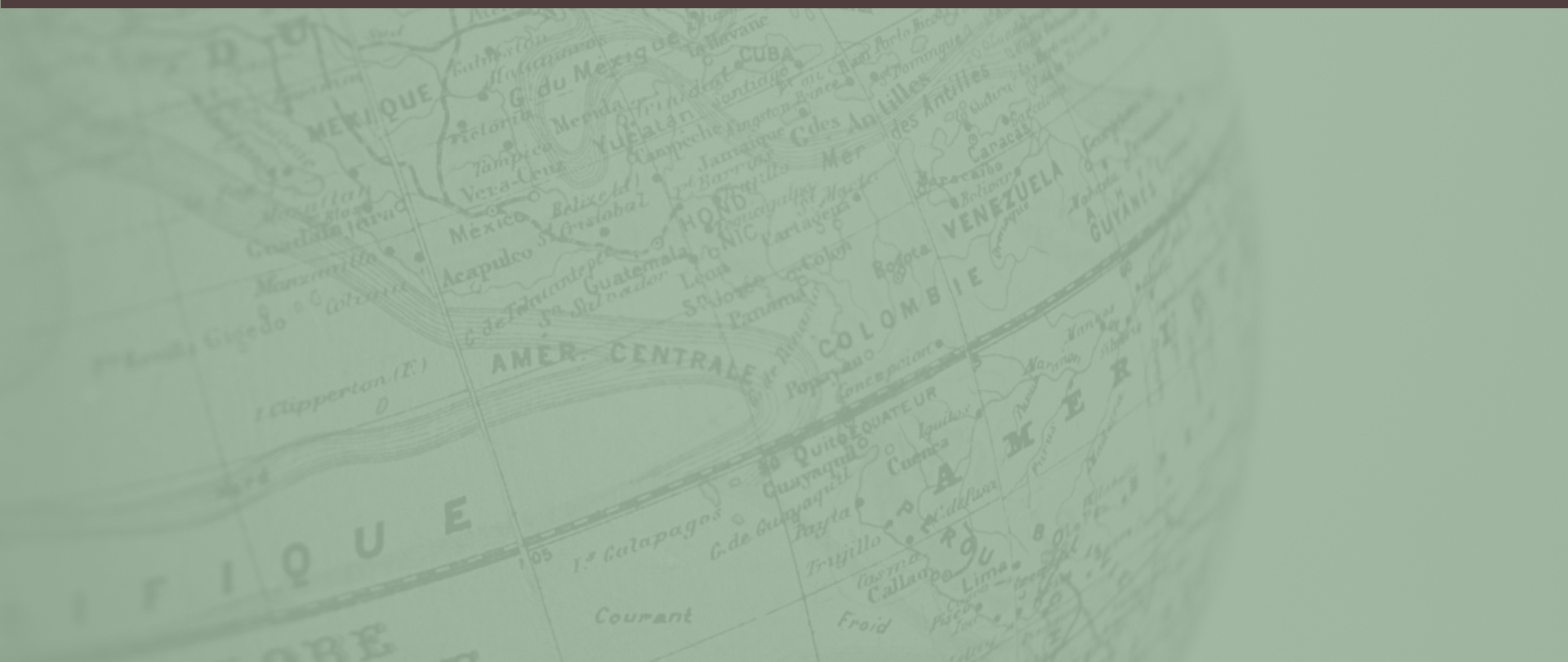


Evolution of Sovereign Debt of Developing Countries: Past and future challenges

UNCTAD short course, Geneva, Switzerland

24 March 2014



Outline

- Background of debt challenges in developing countries over the decades
- UNCTAD's contributions
- Current debt situation of developing countries
- Debt difficulties: mitigating risk and solving problems

Background: evolution of debt in developing countries (in a nutshell)

- **1960s** – Slow growth exports for developing countries, deterioration of terms of trade, hardening of terms of lending, growing indebtedness
- **1970s** – shift to private sources of finance (emerging mkt), acceleration of debt servicing, growing trade deficits, skyrocketing oil prices
- **1980s** – high interest rates and recession in developed countries, debt crisis in Latin America, ad hoc debt restructurings, Brady Plan

- **1990s**

- Increased volatility of capital flows , financial deregulation, increased financial fragility, financial crises,
- Reduction of bilateral debt of poorest countries, move towards more cooperative and comprehensive debt relief to address multilateral debt (HIPC)

- **New Millennium**

- Vast improvements in debt ratios from debt relief initiatives, robust global growth (until 2007),
- Global financial and economic crisis, debt difficulties in developed countries, the Great recession,

Highlights of UNCTAD's initiatives and achievements

- 1960s -
 - UNCTAD advocated for assistance to developing countries to assist them in debt sustainability assessments and debt consolidation.
 - Advanced proposals on debt relief and guidelines for debt rescheduling.
 - Advanced the adoption of early warning system imbedded in an institutional framework to ensure rescheduling didn't disrupt the development process and is tailored to country specific circumstances.

UNCTAD's initiatives and achievements (con't)

- 1970s –
 - UNCTAD IV – developed countries pledged to promptly address the needs of LDCs for debt relief in a multilateral framework.
 - **Resolution 165** of the 9th TDB – 18 developed countries adopted measures that provided debt relief to 45 countries to an estimated \$6 billion.
 - UNCTAD V: Called for the establishment of an international debt commission
 - Debt relief should not be limited to crisis response, should examine problems in overall dev. context

UNCTAD's initiatives and achievements (con't)

- 1980s
 - UNCTAD pointed to the lack of a well articulated, impartial framework for resolving international debt problems
 - proposed creating a chapter 11 process (US Bankruptcy code) at international level.
 - Assisted developing countries in Paris Club negotiations
- 1990s
 - Warned of increasing financial fragilities associated with unfettered capital
 - Pushed for multilateral debt relief for developing countries

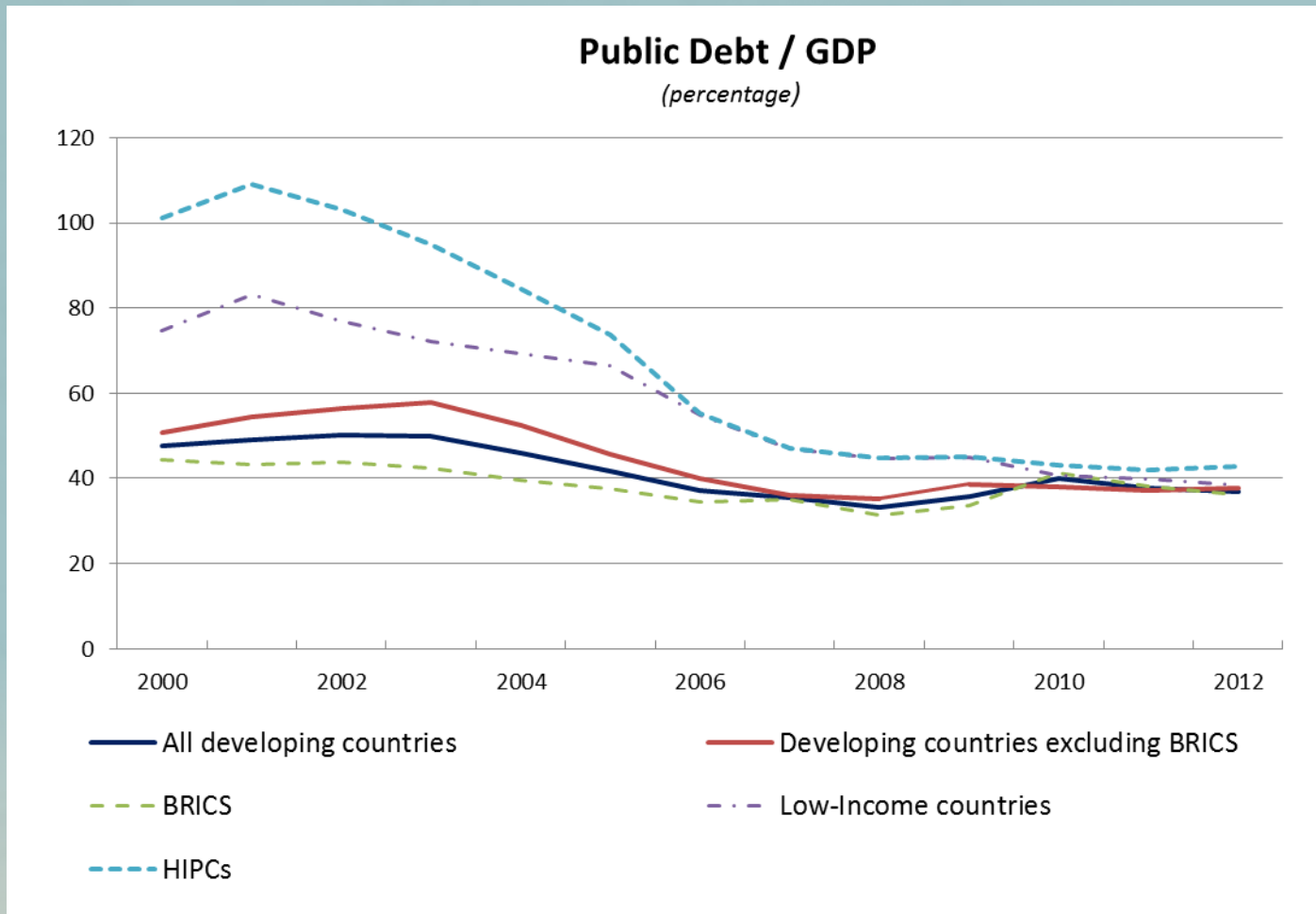
Current areas of work

- UNCTAD's three pillars
 - International consensus building
 - General Assembly negotiations
 - Responsible Sovereign Lending and Borrowing, Debt workouts
 - Technical assistance
 - DMFAS Programme
 - Paris Club advisory service
 - Capacity building projects working with Ministries of Finance and Central Banks (ALM, risk management, debt sustainability)
 - Research and analysis
 - Study and report on emerging issues in the international arena

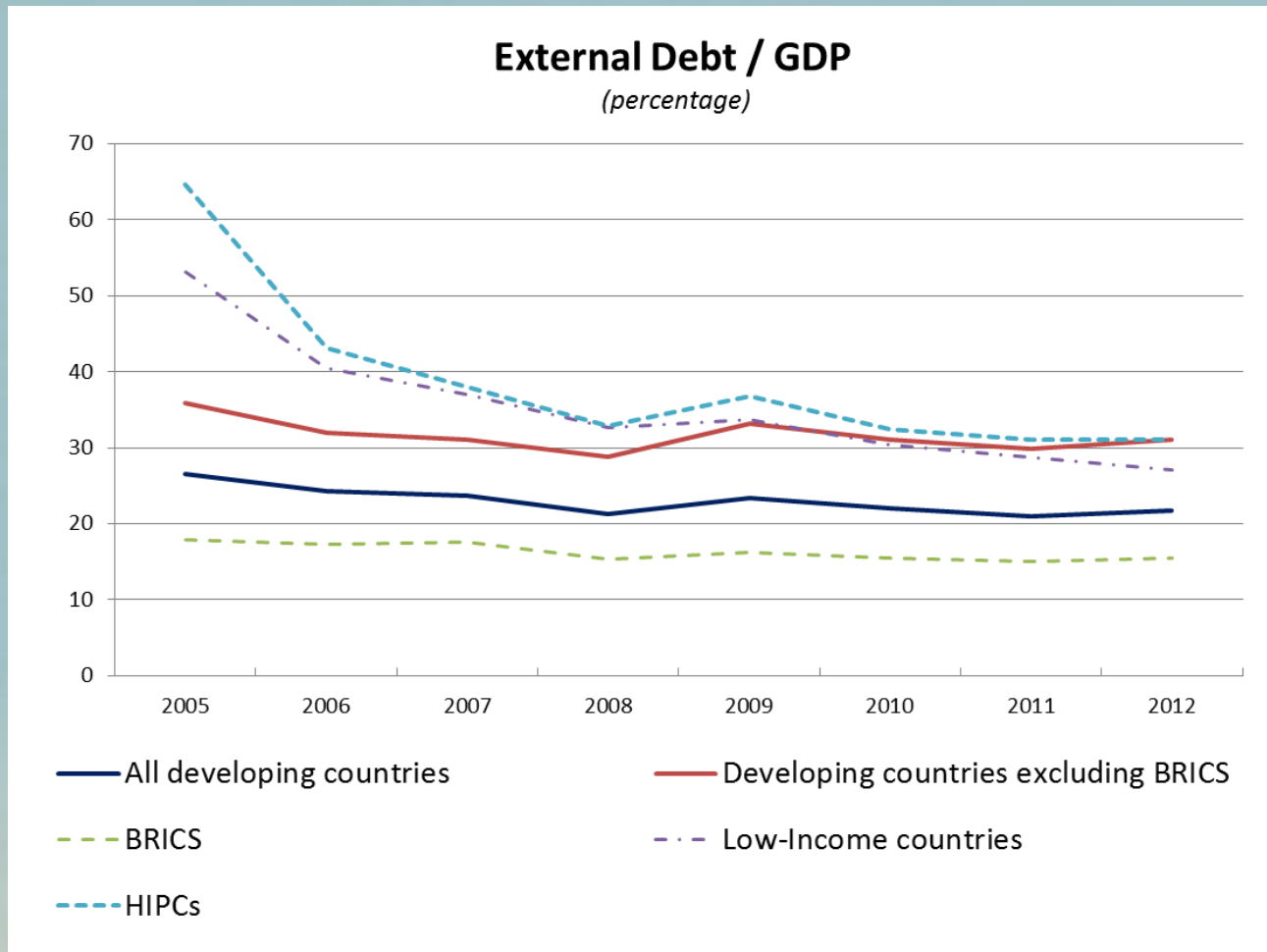
Current Debt Situation: Progress

- Developing countries have been successful on average in reducing their external debt ratios due to:
 - Favorable external conditions and rapid GDP growth from 2003-2007
 - Debt relief delivered under the HIPC Initiative & MDRI
 - MICs external debt reduction came in response to the financial crises that struck in the 2nd half of 1990s.

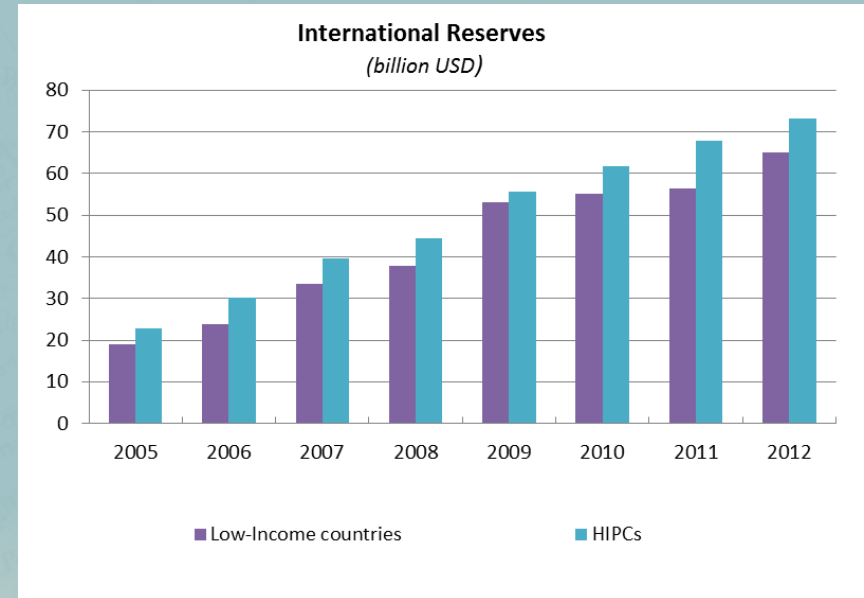
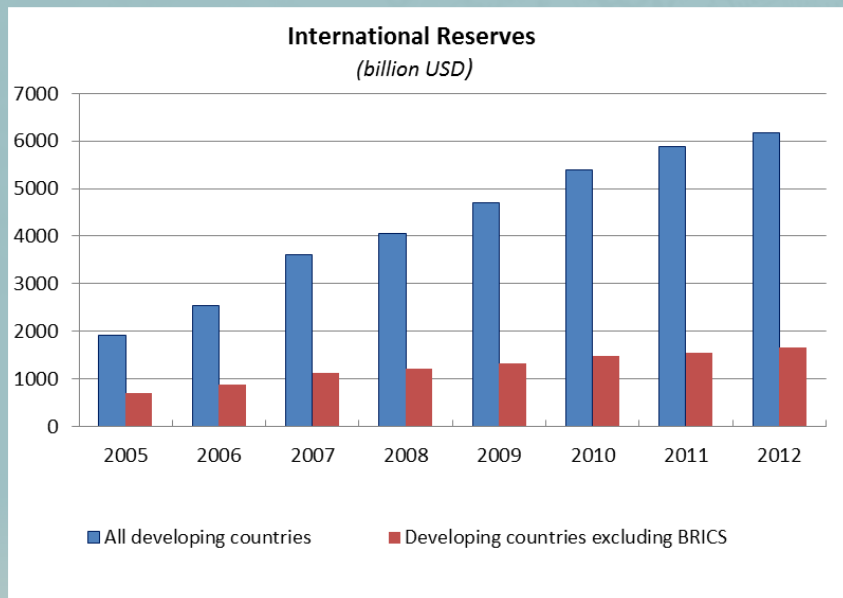
Debt Ratios



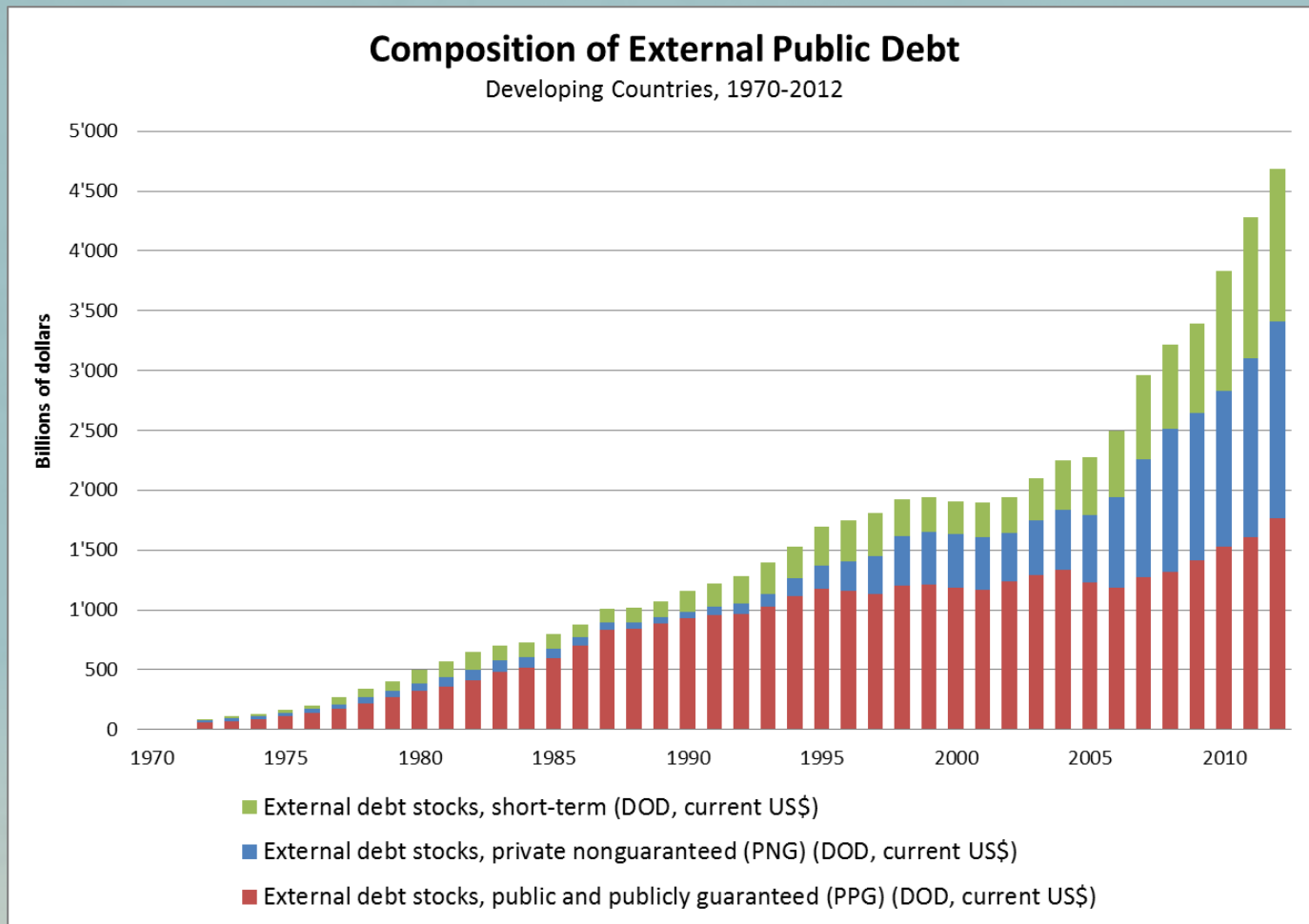
External debt to GDP



Increases in international reserves



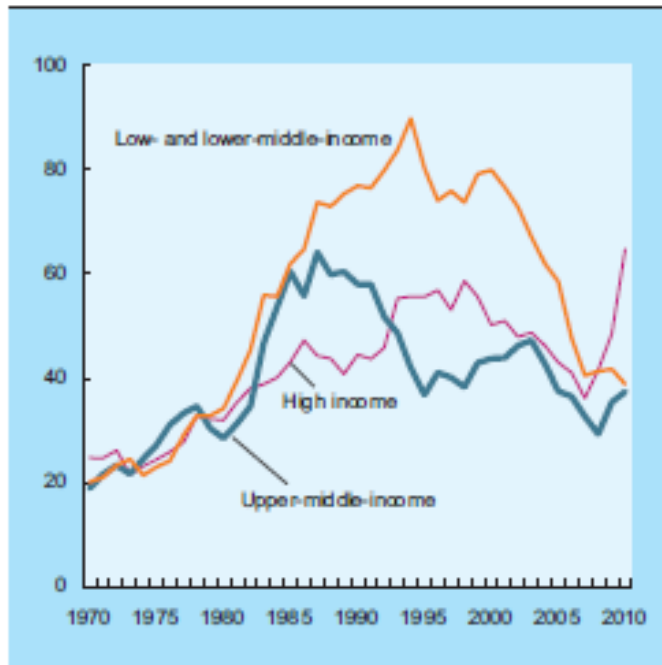
Changing Composition of Debt



Evolution of public debt

**RATIO OF PUBLIC DEBT TO GDP
IN DEVELOPING COUNTRIES, BY
INCOME GROUP, 1970–2010**

(Median, in per cent)

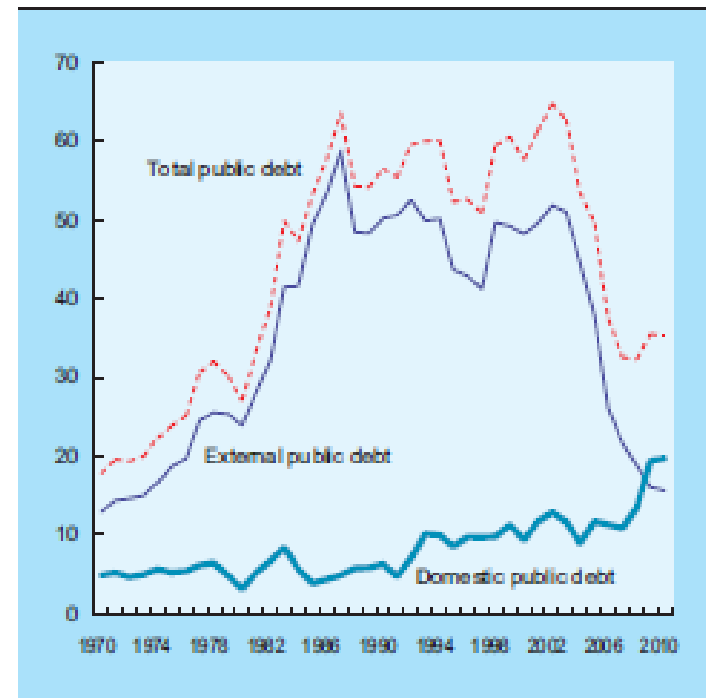


Source: UNCTAD secretariat calculations, based on World Bank, *Global Development Finance*; and national sources.

Note: The classification of income groups follows that of the World Bank.

**RATIO OF TOTAL, DOMESTIC AND
EXTERNAL PUBLIC DEBT TO GDP IN
DEVELOPING COUNTRIES, 1970–2010**

(Median, in per cent)

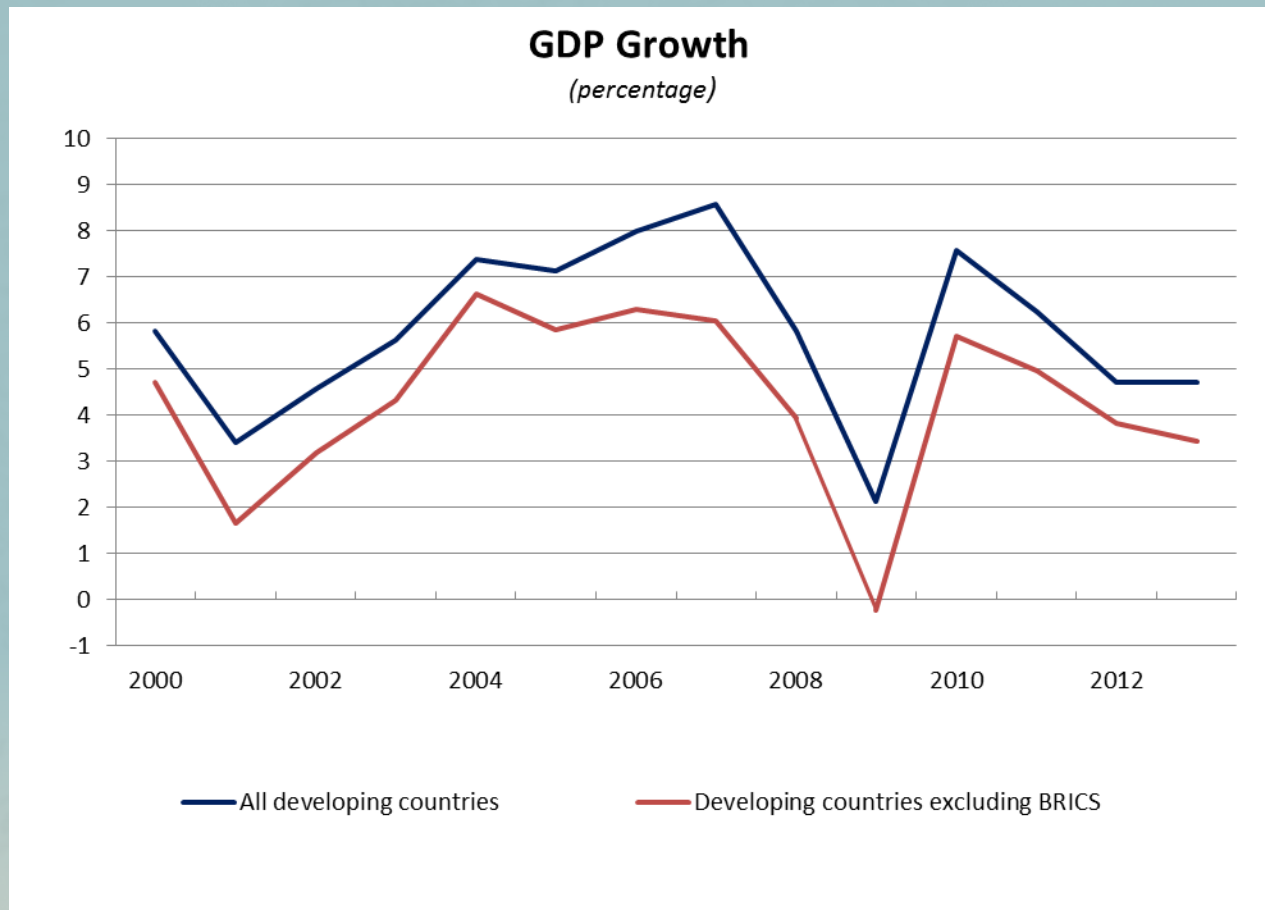


Source: UNCTAD secretariat calculations, based on World Bank, *Global Development Finance*; and national sources.

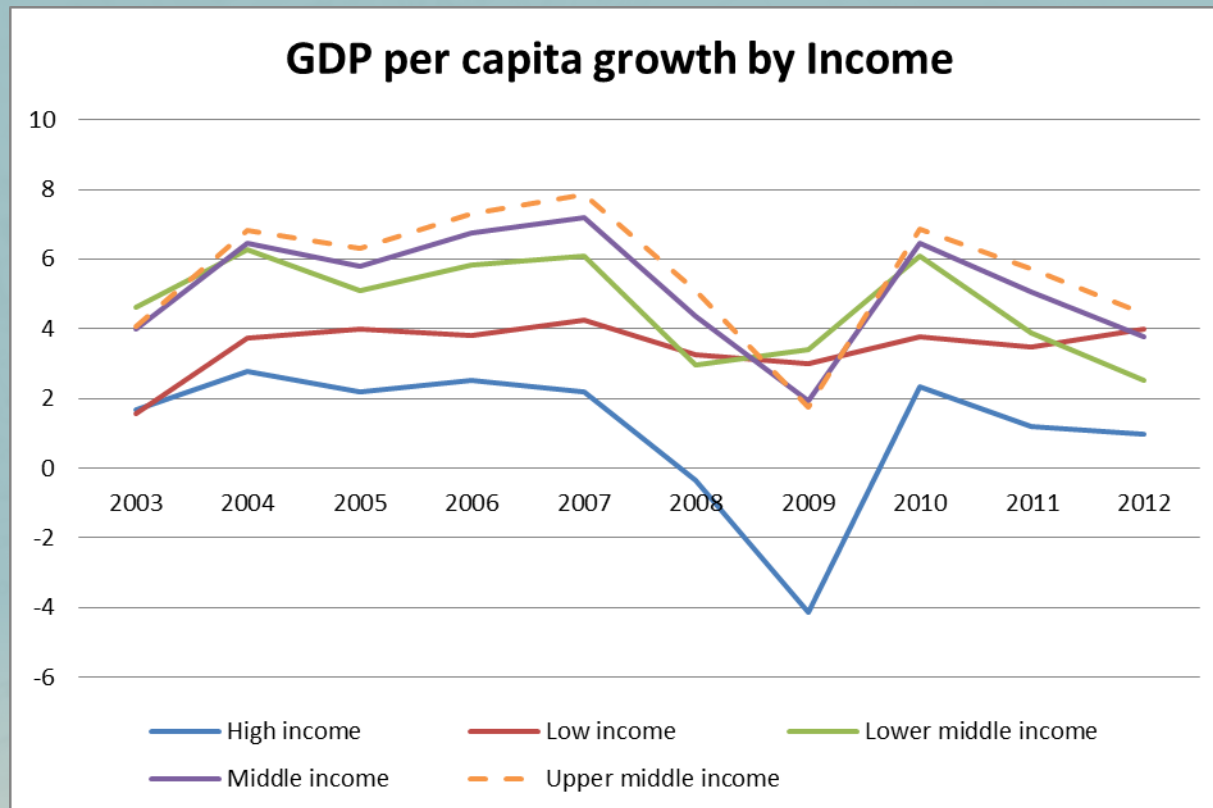
Impact and Implications of the crisis

- The global financial crisis brought significant implications for developing countries vis-à-vis
 - Trade
 - Remittances
 - ODA
 - Investment
- Continued fragile/unsteady global recovery = weakened demand in export markets
- Reduced policy space

GDP Growth in Developing countries



GDP per capita growth by Income





DEBT DIFFICULTIES: MITIGATING RISK AND SOLVING PROBLEMS

Why do countries borrow money?

- Sovereign borrowing is an important vehicle to mobilize resources to finance public and private investment.
- Most developing countries have investment opportunities with a potential return that is higher than the cost of funds.
- Developing countries may be able to finance these investment projects by
 - Mobilizing domestic resources.
 - External debt

International financing solutions

- Countries with undeveloped domestic capital markets must look to international financing for solutions
 - Domestic markets lack both the size and depth to permit governments to raise funds in the local currency.
 - International financing is riskier than borrowing from local markets
 - Exchange rate mismatches and volatility
 - Exogenously set interest rates.

In theory...

- Classic theory asserts that countries will borrow in bad times and repay in good times.
 - Countries, if ever, will only default in good times (strategic defaults)
 - Defaults are bad for the economy and they have long and lasting negative consequences.
 - Sovereign borrowing is procyclical
 - It increases when economic growth is high and contracts when economic growth is low.

See Eaton and Gersovitz, (1981))

In Reality

- Ideally countries can borrow when they need funds
 - BUT international capital markets are not willing to provide credit at a reasonable interest rate during bad times
- Therefore, countries borrow in good times because that is when they have access to credit
- Governments (like private debtors) can find themselves in a situation in which they are unable to service their debts.
 - Sometimes countries borrow too much in good times and this behavior sows the seeds of future crises

Defaults

- Default is the failure to meet debt service payments.
 - More strictly, a default on payment occurs only when a creditor takes legal action over arrears in payment.
 - The conditions that constitute a default are listed in the loan agreement.
- Most of the defaults observed are justified (or unavoidable ex-post) episodes
- Strategic defaults are extremely rare
 - Possibly because strategic defaults policymakers believe that this type of default would indeed be very costly

Debt crisis

- A *public debt crisis* occurs when a government is unable to fully comply with its debt service obligations vis-à-vis either domestic or external creditors.
 - Common assumption: debt crises always originate from excessive budget deficits that have become unsustainable.
- Public debt crises often do not have a fiscal origin, but they can be caused by
 - unsustainable fiscal policies,
 - irresponsible lending for purposes that do not increase the overall productivity but amount to zero sum games over the medium term

Causes of Debt Crises

- Crises may be triggered by a number of exogenous shocks:
 - Currency crisis,
 - Banking crisis
 - Terms-of-trade shocks affecting the debt-to-GDP ratio and/or debt-to-export ratio.
 - Interest rate shocks.
 - Large adverse shocks to economic fundamentals.
 - Excessive borrowing or sub-optimal borrowing inconsistent with economic fundamentals.
 - Sudden capital flows reversals and contagion effects.
 - Natural disasters

Debt restructuring

- When a debt crisis occurs, there is a need for debt restructuring.
 - Debt restructuring is a central component of the discussion on external debt
 - It can only be seen as an exceptional instrument in the debt's general management over the medium term.
- Rescheduling provides countries with debt relief through postponement
 - In the case of concessional rescheduling, a reduction in debt service obligations

Policy responses

- Standard response to a sudden jump in public debt is often fiscal retrenchment.
 - The most appropriate response should address the origin of the crisis

Example: If a crisis originates from the bursting of an asset bubble, the response should be financial reform

- Instead of fiscal retrenchment, counter cyclical policies to absorb the deleveraging might be more effective

Strategies to mitigate and address Debt crises

- Problem solving:
 - Avoid over borrowing
 - Making debt safer and improving debt management
 - Establishing international norms on sovereign lending and borrowing
 - Improving upon existing debt restructuring arrangements

Avoid over-borrowing

- The risk of a debt crisis can be reduced by borrowing less
 - Borrow for the right reason and not borrow too much during "good times."
 - Debt should only be used to finance projects that generate returns which are higher than the interest rate charged on the loan
 - Foreign currency borrowing should be limited to projects that directly/indirectly generate the foreign currency necessary to service the debt

Safer debt instruments

- Improvement in debt structure is likely to reduce the probability of a debt crisis.
 - Switching from the international to the domestic debt market
 - This can prove to be difficult for some countries
 - Issuing contingent debt instruments
- Downside: investors are likely require higher compensation for investments with variable returns.

Improving Debt Management

- Effective debt management contributes to the attainment and maintenance of sustainable debt levels through
 - providing input to the decision-making process, through availability of reliable and timely data
 - implementing policies, and
 - ensuring adequate coverage of the country's debt.

Establishing and adhering to international norms

- UNCTAD's Principles for Responsible Sovereign Lending and Borrowing
 - To establish internationally recognized principles that promote and reinforce responsible sovereign lending and borrowing practices.
 - At present there are no such universally agreed principles that exist.
 - First step in the process of preventing (and if necessary resolving) future problems.
 - Eventually such guidelines could help identify criteria to assess whether the sovereign debt has been contracted in accordance with internationally accepted principles.

Current approach to debt restructuring

- Addressed through various institutions and arrangements:
 - Paris Club (official creditors)
 - London Club (private creditors)
 - Bond exchanges
 - Highly Indebted Poor Country Initiative (HIPC) & Multilateral Debt Relief Initiative (MDRI) (multilateral debt relief)

Problems with the current (non) system

1. Multifaceted (large undertaking involving numerous stakeholders)
2. Lengthy debt renegotiations
 - Costly & time consuming
 - Some cases do not restore debt sustainability
3. Need to coordinate interests of all stakeholders
 - dispersed creditors and hold out bondholders
4. Lack of access to private interim financing during the restructuring process
5. Over-borrowing caused by debt dilution
6. Delayed defaults

Debate surrounding a formal mechanism

- Arguments in favor:
 - The lack of such a structured mechanism is a major failure of the current international financial architecture which leads to long delays in debt restructuring, unfair outcomes, and loss of value for both debtors and creditors.
- Arguments against:
 - The current system has all the necessary contractual instruments for dealing with sovereign defaults and that the creation of a new institution for dealing with sovereign insolvencies would be useless at best and dangerous at worst.

Formal debt work out mechanism

- The global financial system would benefit from:
 - Greater predictability (less uncertainty = less cost)
 - Inclusive process
 - Reduce delayed defaults
- Independent body (not a creditor)
 - Fosters transparency
 - Timely resolution of problems
 - Coordinates interest of all stakeholders



THANK YOU