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Recent developments in external debt

Report of the Secretary-General

Summary

The present report, submitted in compliance with General Assembly resolution 61/188, reviews recent developments in the external debt of developing countries and the related recent phenomenon of capital flows from developing to developed countries. It analyses the role of new borrowing strategies and new debt instruments and reviews progress in the Highly Indebted Poor Countries Initiative and developments in Paris Club rescheduling. The report points to several issues related to the debt sustainability framework for low- and middle-income countries and discusses potential vulnerabilities arising from the increasingly important role of structured finance.

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I. Introduction

1. The present report is prepared for the consideration of the General Assembly, in compliance with the request made by the Assembly in paragraph 25 of its resolution 61/188. It contains a comprehensive and substantive analysis of the external debt of developing countries. The report aims at elucidating new developments and key trends in external debt and related areas of development financing, and providing reference for deliberation of the policy issues it raises.

II. Recent trends

2. In 2006, total external debt of developing countries increased in nominal value (from $2,742 billion to $2,851 billion) but decreased as a share of their gross national product (GNP) from 29 to 25 per cent (see statistical annex to the present report). Sub-Saharan Africa and the Middle East and North Africa regions experienced the biggest drop in external debt ratios (from 37 to 24 per cent and from 28 to 14 per cent, respectively). South Asia is the only region where the external debt ratio did not change, but, together with East Asia, this is also one of the two regions with the lowest stock of external debt. East Europe and Central Asia witnessed a small reduction of external debt (from 41 to 40 per cent of GNP) but remains the region with the highest external debt ratio. Latin America and the Caribbean is the region with the second highest level of external debt, but external debt in this region is decreasing rapidly.

3. Different factors drive varying regional trends. In sub-Saharan Africa, the decrease in the debt ratio comes from a net decrease in nominal debt (from $215 billion to $173 billion) mostly owing to debt relief. In the Middle East and North Africa, nominal debt remained broadly constant, whereas the decrease in the debt ratio was mostly due to GNP growth. In South Asia both debt and GNP grew by about 10 per cent. In East Europe and Central Asia, external debt grew by 14 per cent and nominal GNP grew by 19 per cent. In Latin America and the Caribbean the drop in external debt was due to both lower nominal debt levels and high GNP growth.

4. Developing countries as a group reduced their sovereign external debt with both official and private creditors. During 2006, sovereign debt buybacks reached $30 billion[1] and over 2005-2006 repayments of bilateral debt to Paris Club countries and of multilateral debt to the international financial institutions exceeded new lending by approximately $145 billion.[2] This translated into an increase in the share of debt owed to private creditors, which went from 66 to 71 per cent of long-term external debt from 2005 to 2006. The reduction in external sovereign debt was partly compensated by an increase in external borrowing by the private sector. As a consequence, the share of developing countries' long-term external debt which is not public or publicly guaranteed doubled since the second half of the 1990s, reaching 41 per cent in 2006.

5. The reduction of sovereign external debt was made possible by debt relief and favourable external conditions. High commodity prices, high liquidity, low risk

[1] Some buybacks were financed by issuing new external debt with more favourable conditions.

[2] World Bank, *Global Development Finance 2007* (Washington, D.C., 2007).

aversion and low spreads allowed several middle-income countries to refinance their external obligations and substitute external debt with domestic debt. This highlights the important interplay between the external and domestic components of viable public debt strategies.

6. Bonded debt, which was negligible before the 1990s, now accounts for over a quarter of developing countries' debt stock. This poses several challenges to debt policy planning as external factors play a role in determining the spreads on emerging markets' external debt and this leads to sources of volatility which are beyond the direct control of domestic financial authorities.

7. Interestingly, 2006 witnessed a reversal in the long-term trend towards more bond financing. A decline in net bond flows was more than compensated by an increase in net bank lending.[3] Thus, it would be misleading to focus on bonded debt without examining the evolution of the stock of bank debt, which remains an important source of financing for several developing countries. In fact, the majority of developing countries (60 per cent of the total) never accessed the international bond market between 1980 and 2006 and only around 20 emerging market countries regularly issue bonds in international capital markets. In this connection, South-South syndicated bank loans have acquired an increasing importance. While this form of finance only accounts for approximately 5 per cent of bank lending to developing countries, it is growing rapidly and it has become an important source of finance in sub-Saharan Africa, where South-South lending represents 20 per cent of total syndicated bank loans.[2]

8. All regions, with the exception of Latin America and the Caribbean, also observed an increase in their share of short-term external debt, which now stands at about 22 per cent of total external debt. This increase in the share of short-term debt is unlikely in itself to generate vulnerabilities because it was more than compensated by a net increase in international reserves, which now amount to more than four times the level of short-term debt. This is well above the Guidotti-Greenspan rule of thumb, which suggests that reserves should be equal to short-term debt.[4] While the majority of developing countries are characterized by high international reserves and current account surpluses, some countries (especially in Eastern Europe and Central Asia) are in a more fragile situation and exhibit large current account deficits and a net appreciation of the real exchange rate.

III. Capital flows from developing to rich countries

9. The last few years witnessed record financial inflows to developing countries but these inflows were more than compensated by large current account surpluses and unprecedented reserve accumulation. By the end of 2006, international reserves of developing countries were above $2.5 trillion. This created a situation in which the developing world is lending to the advanced economies (especially to the United

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[3] Net private debt flows increased by $24 billion. This was driven by a $26 billion increase in long-term bank lending and a $4 billion increase in short-term debt and a $6 billion decrease in bonded debt.

[4] Traditionally, optimal reserve coverage has been measured in terms of months of imports. The focus on imports implicitly assumes that balance of payment crises tend to occur in the trade balance. However, recent balance of payment crises originated in the capital account (hence, the focus on short-term debt and other financial variables).

States of America which, with a current account deficit of approximately $850 billion, is the largest borrowing country). Economic theory suggests that capital should flow from rich to poor countries but capital flows are going in the opposite direction, prompting a vivid policy debate.

10. This accumulation of reserves is seen by some observers as evidence of mercantilist policies that violate International Monetary Fund (IMF) rules against exchange rate manipulation.[5] Countries that are accumulating exchange rate reserves argue that their strategy is driven by the need to self-protect against future currency and financial crises. In this sense, their strategy offers them double protection. First, in keeping exchange rates slightly undervalued and more competitive, these countries are able to avoid sudden jumps of their exchange rate, while overvalued exchange rates are difficult and often impossible to defend. Moreover, a slightly undervalued currency is consistent with lower, pro-growth domestic interest rates. Secondly, by accumulating ample war chests of reserves, they stand ready to deal with possible market turbulence.[6] While it is commonly thought that there is a fiscal cost linked to reserves accumulation, this is only the case for countries characterized by high interest rates. Countries that manage to maintain domestic interest rates which are lower than the interest rate paid by the reserves (such as China) are actually making a net gain from reserve accumulation.

11. Furthermore, countries with a weak banking system may want to accumulate reserves to deal with a possible banking crisis. If this is the case, the relevant prudential ratio is international reserves scaled by bank liquid liabilities (which can be proxied by M2).[7] Although the ratio of reserves to M2 has grown considerably over the last 15 years (going from 11 to 29 per cent), it is only now close to the 30 per cent threshold which some analysts consider as a prudent level of reserves for countries with weak banking systems. Moreover, East Asian countries, which exhibit some of the highest rates of reserve accumulation, have a reserve to M2 ratio which is lower than the developing country average (this is also the case in China and India, with ratios of approximately 25 per cent).

12. Thus, it is not surprising that recent research shows that most countries hold reserves for precautionary and not mercantilist, reasons.[8] The fact that these strategies are favoured over the use of the protection mechanisms provided by international financial institutions points to possible weaknesses in the international financial architecture. The financial crises that hit several emerging markets in the late 1990s were devastating and several developing countries found the post-crisis adjustment "policy packages" proposed by the international financial community to be intrusive in the sphere of governance, encroaching upon their sovereignty and

[5] M. Goldstein, "A (Lack of) Progress Report on China's Exchange Rate Policies", Peterson Institute for International Economics (June 2007). Ironically, most of the concern in this respect is for China (whose currency is slowly appreciating) and not on other countries with large surpluses (such as Japan or Switzerland) which, because of carry trade, are facing real depreciations.

[6] If developing countries did not value the option of being able to rapidly deploy their reserves, it would be hard to explain why most reserves are kept in low-return liquid assets.

[7] A low declining of reserve to M2 ratio is a leading indicator of a currency crisis (G. Kaminsky and C. Reinhart, "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems", in *The American Economic Review*, vol. 89, No. 3 (June 1999), pp. 473-500.

[8] J. Aizenman and J. Lee, "International Reserves: Precautionary versus Mercantilist Views, Theory and Evidence" (2005), *Open Economies Review* (forthcoming).

generally ineffective. Thus, such countries adopted pre-emptive policies aimed at minimizing the need for reliance on international bailout in case of future crisis. Such a trend, which is partly driven by the fact that the major advanced economies are not fully committed to adopting policies aimed at guaranteeing global financial stability, marginalizes useful international financial institutions and leads to the adoption of second-best policies. This highlights the importance of achieving a truly cooperative monetary system and a reform of the international financial institutions that, by giving more voice to developing countries, would increase ownership of the policy prescriptions they advocate.

13. Another reason why developing countries are running current account surpluses and accumulating international reserves is that while economic theory suggests that financial flows should promote growth in the recipient countries, there is empirical evidence that developing countries that rely less on foreign capital are able to raise domestic investment and grow at a faster rate than countries that rely more on foreign capital. There are different explanations which apply to different types of countries for this paradox: (i) traditional models argue for a causal link going from saving to investment to growth; in some cases, however, faster growing countries can save more and hence are able to internally finance their investment needs;[9] (ii) developing countries with underdeveloped financial systems may do a poor job at channelling foreign flows to its most productive use;[10] (iii) capital flows often result in an appreciation of the real exchange rate, which is damaging for the export-oriented manufacturing sector and creates monetary conditions adverse to overall growth. This points to the conclusion that: (a) policies that stimulate growth can also generate the financial resources necessary for sustaining growth with a smaller need for external financial flows; and, (b) countries with less developed financial sectors should be cautious of fully opening their capital account. To do so before the domestic financial intermediation system can ensure productive and efficient allocation of domestic and international resources could lead to the opposite of the expected outcome.

IV. New borrowing strategies of developing countries

14. Analysis of public debt in developing countries has traditionally focused on external debt. However, several countries are now adopting policies aimed at retiring public external debt and substituting it with domestic debt. Although data on the level and composition of public debt are not fully reliable, available estimates indicate that over 1994-2004, domestic public debt rose from 16 to 24 per cent of developing countries' GNP and that the share of domestic public debt over total public debt grew from 39 to 57 per cent.[11] There is evidence that this trend accelerated over the last two years. In 2006 more that 70 per cent of the stock of public debt of emerging market countries had been issued domestically.[12]

15. Low-income countries also have a tradition of domestic borrowing. Accumulation of domestic public debt in low-income countries can be driven by

[9] See UNCTAD, *Trade and Development Report 2006*, chap. I, annex 2.

[10] E. Prasad, R. Rajan, and A. Subramanian, *Foreign Capital and Economic Growth*, International Monetary Fund (2007) (unpublished).

[11] U. Panizza, Domestic Public Debt in Developing Countries, UNCTAD (2007) (unpublished).

[12] JP Morgan Chase, "Emerging Markets Debt and Fiscal Indicators" (2007).

either too little or too much foreign aid. Countries that run a budget deficit which is not fully matched by donor flows often issue domestic debt because the standard policy advice of the international financial institutions is to limit external borrowing at commercial rates. The build-up of domestic debt driven by foreign aid inflows is often the result of Governments' decisions to sterilize aid inflows in order to avoid appreciations of the real exchange rate.[13]

16. Analysis of public debt in developing countries has traditionally focused on external debt owing to three reasons. First, external borrowing can increase a country's access to resources, but domestic borrowing only transfers resources within the country. Secondly, since central banks in developing countries cannot print the currency necessary to repay external debt, external borrowing is associated with vulnerabilities that may lead to debt crises. Thirdly, there are no reliable data on domestic public debt. There are, however, reasons to think that some of these rationales for focusing exclusively on external debt may no longer be valid in the current environment.

17. The access to external resources argument would still be relevant if countries were able to track the residence of the ultimate holders of their bonded debt. According to the official definition, external debt is all debt owed to non-residents. However, this definition is difficult to apply in the current global financial environment where a large share of external debt due to private creditors takes the form of bonds traded in anonymous markets. As a consequence, most countries classify as external all debt issued on the international market and classify as domestic all debt issued in the domestic market. The information is thus misleading because it does not measure what it promises to do and "external" debt data are a poor measure of the actual transfer of resources across countries. A definition which classifies as external all debt issued under foreign law does not lead to misleading conclusions regarding the residency of the holders of a country's debt. This definition is the one which is de facto adopted by most national statistical offices and should also be considered as the de jure definition of external debt. Countries that can provide information on residence of the holders of public debt should be encouraged to do so. However, as these data are difficult to obtain, it is better to start with what is measurable and build on that towards a revamped data reporting system.

18. The second argument for focusing on external debt alone is also weak. In countries with an open capital account, currency and maturity mismatches are the real source of vulnerabilities and policymakers need to explicitly recognize the trade-off involved in switching to more domestic borrowing.[14] Excessive focus on the external/domestic debt dichotomy diverts attention from the fact that vulnerabilities arise from the structure of total public debt. For instance, countries with a large stock of external debt which is long term and denominated in domestic currency are less vulnerable than countries which have a large stock of domestic debt denominated in foreign currency and with a short maturity.

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[13] This suggests that some countries receive more aid than what they can absorb. For more details see the report of the Secretary-General entitled "Follow-up to and implementation of the outcome of the International Conference on Financing for Development" (forthcoming).

[14] These trade-offs include the possibility of trading a currency mismatch for a maturity mismatch and the fact that the switch to domestic borrowing could pressure institutional investors and banks to absorb "too much" public debt and this may have a negative effect on financial stability and crowd out private issuers.

19. The third argument for focusing on external debt remains valid. Researchers at the International Monetary Fund (IMF) and the Inter-American Development Bank attempted to collect data on the composition of total public debt for various subsets of developing countries,[15] but at this stage there is no dataset with a global coverage for all developing countries. The advisable policy response to this problem is to increase the set of available information and to pay greater attention to the important and growing domestic component of public debt.

V. New instruments and players

20. There is now a consensus that the composition of debt is as important as its level. Other things equal, a safer debt structure for borrowers can substantially reduce the probability of a debt crisis. Under the right circumstances, safer debt instruments that may reduce the risks of sovereign borrowing include domestic currency debt, long-term debt and debt contracts which require payments that are linked to the borrower's ability to pay. Of particular interest are GDP-indexed bonds which provide a mechanism for linking a country's debt-servicing obligations to the level of economic activity, such that in times of high growth debt servicing would be higher, whereas the opposite would hold during recessions.

21. Small amounts of GDP-indexed bonds were issued in Brady deals in the 1980s, but failed to attract any trading interest. However, there are now increasing opportunities for developing countries to issue instruments that provide greater insurance against various risks that affect their economies. Insuring against negative shocks to the economy has two advantages for borrowing countries. First, it helps to maintain fiscal solvency (it is usually the arrival of negative shocks that renders unaffordable a level of debt that was up to that point sustainable). Secondly, it can improve fiscal policy because during bad times Governments would have less debt-servicing costs and more "fiscal space".

22. A frequently mentioned problem is the complexities of pricing these new instruments. While contingent instruments like GDP-indexed bonds are more difficult to price than plain vanilla bonds, they should not be more difficult to price than some widely traded emerging market derivatives. Pricing issues could be alleviated by creating a set of comparable instruments issued by different emerging economies. Though small and occasional additions to the pool of GDP-indexed bonds, would not solve the issue of a sizeable amount of comparable instruments, a coordinated effort of several countries could generate the necessary critical mass. International institutions could play a role in supporting the development of a market for GDP-indexed bonds, both through policy advice and by promoting a coordinated issuance of such instruments by a number of countries to provide benchmarking.

23. New forms of lending could also benefit low-income countries with limited market access. For instance, most lending by the international financial institutions is either in United States dollars, euro, yen, or special drawing rights. The

[15] O. Jeanne and A. Guscina, *Government Debt in Emerging Market Countries: A New Data Set,* IMF Working Paper 06/98 (April 2006); and K. Cowan, E. Levy Yeyati, U. Panizza, and F. Sturzenegger, *Sovereign Debt in the Americas: New Data and Stylized Facts*, Inter-American Development Bank Research Department Working Paper 577 (October 2006).

international financial institutions could switch to a system in which they borrow and lend in the currencies of their client countries and hence help the development process with both their assets (through local currency loans) and their liabilities (by helping to develop the international market for bonds in the currencies of developing countries).[16]

24. While new debt instruments could play a role in reducing the probability of debt crises, it is important to recognize that the likelihood remains low that in the near future sizeable sums can be raised by developing countries through such instruments. Hence, prudence in issuing new debt and policies aimed at avoiding overborrowing by both the public and the private sectors will remain essential for avoiding debt and financial crises.

25. Since financial futures started trading in 1972, the worldwide derivatives industry has seen impressive growth rates of around 25 per cent a year. In 2006, the outstanding nominal value of swaps and derivatives stood at $286 trillion (about six times the world's GNP). One of the latest developments in the derivatives markets has been the introduction of credit default swaps. In its simplest form, a buyer of a credit default swap pays a default premium to the seller of the swap and, if a default occurs, the seller of the swap covers the losses the buyer has incurred as a result of the default. Credit default swaps now amount to about 20 per cent of the face value of emerging market sovereign debt and are particularly important in Latin American countries.

26. Credit default swaps can lead to a better distribution of risk, increase the efficiency of financial markets and reduce borrowing costs. Thus, the growth of the credit default swaps market could be a positive factor for developing countries. It could also be a source of risk, however, especially if all parties involved do not have risk modelling and management capabilities that parallel their exposure to the market. Keeping track of these risks is complicated by the fact that financial innovation is often faster than the pace of improvement in market infrastructure. Some investors may have taken large positions without understanding them well and a shock may cause this market to unravel. If conditions turn unexpectedly for the worse in an emerging market country, the sellers of credit default swaps may not be able to absorb their losses and spark a sell-off of risky assets with negative repercussions for emerging market issuers.

27. Collateralized debt obligations have also grown exponentially over the last few years. Collateralized debt obligations represent a group of financial assets which are sliced into different parts (tranches) that carry different risks. Collateralized debt obligations are difficult to value and are rarely traded. Credit rating agencies played an instrumental role in the development of the collateralized debt obligation market, as the ratings assigned to various tranches allow institutional investors to participate in an otherwise sub-investment grade market. However, it is unclear if the ratings assigned to collateralized debt obligation tranches are a good reflection of the risk of these instruments. Recent events related to the crisis of subprime mortgage lending suggest that the market value of some collateralized debt obligations is well below their book value. This is another reason for more scrutiny of the role of credit

[16] See B. Eichengreen and R. Hausmann, editors, *Other People's Money*, University of Chicago Press (2005), chap. 10, and R. Hausmann and R. Rigobon, "IDA in UF: On the benefits of changing the currency denomination of concessional lending to low-income countries" (2003) (unpublished).

rating agencies, an issue already noted by the General Assembly in its resolution 61/188.

28. Until recently, sovereign borrowing was at the centre of financial flows to developing countries, but in the last few years corporate borrowing has become increasingly important. In 1996, only 20 per cent of long-term external debt was owed by private borrowers. In 2006 that share had doubled to 41 per cent. During 2002-2006, private borrowers contracted 60 per cent of developing countries' external long-term bank loans and issued 75 per cent of developing countries' external bonds.[2] The increase in corporate borrowing has been especially important in Eastern Europe and Central Asia. During 2006, firms from this region contracted new debt for $135 billion and they account for 40 per cent of total corporate debt of developing countries, up from a 19 per cent average over 1996-2003.

29. By relying more on the international markets, corporate borrowers may have increased their exposure to interest rate and currency risk and this exposure raises several policy challenges. The most important among these is to assess the public sector's contingent liabilities arising from private sector borrowing. Governments need to pay particular attention to the rapid increase in foreign currency borrowing by domestic banks. Although there are no indications that the banking sector as a whole has overborrowed in recent years, some banks in Eastern European and Central Asian countries have borrowed heavily in international capital markets, and on-lent those funds in the domestic market. This could lead to currency mismatches either in the banks or in the ultimate borrowers' balance sheets and thus increase financial fragility.

VI. Debt sustainability analysis

30. Over the last few years, IMF developed a debt sustainability framework for middle-income, market access countries and the IMF and World Bank jointly developed a DSF for low-income countries. While the main objective of the framework for middle-income, market access countries is to examine vulnerabilities and devise policies aimed at reducing the probability of a debt crisis, the framework for low-income countries is also aimed at guiding International Development Association (IDA) grant-allocation decisions. Although the increasing importance of domestic borrowing is often recognized, most debt sustainability analyses in both middle- and low-income countries concentrate on external debt and do not integrate the dynamics between domestic and external debt. The standard justification for this approach is that external and domestic public debt have different default risk and hence cannot be simply added to each other to form a single indicator of total public debt.

31. An aggregate debt ratio where "riskier" types of debt have a higher weight than safer types of debt would be superior to the current practice of either assigning the same weight to all types of debt or of assigning a weight of one to all types of external debt and a weight of zero to all other types of debt. Better information on debt structure and more research on vulnerabilities arising from different types of debt could help in designing such an indicator. This would in turn improve debt management and reduce the probability of debt crises through better tracking of debt risks. Another problem with the standard debt sustainability framework is that it gives too little weight to the fact that almost all the variables that drive the evolution

of public and external debt depend on each other and are endogenous with respect to debt levels. Finally, the standard approach is unsuitable to support debt restructuring as it does not fully distinguish solvency from liquidity problems. Thus, it is difficult to use this approach to apply the provisions in the Evian approach for debt write-offs for non-heavily indebted poor countries (HIPCs).

32. The most important issue with the debt sustainability framework for low-income countries has to do with its use of debt thresholds aimed at measuring a country's risk of debt distress and determining eligibility for IDA grants. According to the framework, debt sustainability is driven by a combination of the country's debt ratios and the quality of its policies (as measured by the Country Policy and Institutional Assessment index). The thresholds are calculated by using an econometric exercise that does not predict very reliably the probability of debt distress and the debt sustainability framework classifications are blunt, grouping countries into general categories. This may lead to sub-optimal outcomes, as the borrowing capacity of those at the top of the group may be underestimated and those at the bottom may be overestimated. The current framework risks replacing the former "one-size fits all" approach to a "four or five-sizes fits all" approach.

33. Several concerns remain with respect to the use of the Country Policy and Institutional Assessment index. The concept of good governance and institutions is inherently subjective and, since the World Bank is also making recommendations to countries on issues of governance, the index may reflect how well countries are implementing the Bank's policy advice. Another concern pertains to the accuracy of the measure and the consistency with which it is measured across countries. Finally, the index may not offer the proper incentive and rewards for low performers and fragile States.[17]

34. The Country Policy and Institutional Assessment is used to both allocate IDA resources — through the IDA resource allocation index — and to guide IDA grant-allocation decision — through the debt sustainability framework. Other things equal, a higher Country Policy and Institutional Assessment score is associated with more resource allocation and a lower score may lead to more grants. It is puzzling that, on the one hand, better policies are associated with more resources and that, on the other hand, countries with higher levels of debt and poorer policies may be awarded higher grant elements than countries with stronger policies and moderate levels of debt.

35. Finally, the debt sustainability framework is based on the primacy of debt servicing and does not explicitly include an evaluation of the needs that are necessary for reaching the Millennium Development Goals. As stated in the report of the Secretary-General on follow-up to the outcome of the Millennium Summit: "… we should redefine debt sustainability as the level of debt that allows a country to achieve the Millennium Development Goals and reach 2015 without an increase in debt ratios" (see A/59/2005, para. 54). Other considerations have also been cited in United Nations forums, such as the Commission on Human Rights, which called for the drafting of guidelines for external debt relief programmes to ensure that the need to service foreign debt will not undermine obligations for the realization of

[17] See Center for Global Development, *The World Bank's Work in the Poorest Countries: Five Recommendations for a New IDA*, report of the IDA 15 Working Group (2007).

fundamental economic, social and cultural rights.[18] Meanwhile, the growing legal and political interest in concepts such as odious debt and responsible lending, adds yet another dimension to the concept of debt sustainability and its applicability as currently defined.[19]

VII. Debt relief and official development assistance

36. Since the launch of the enhanced HIPC Initiative in 2000, delivery of debt relief has been steady, if slow, with an average of three countries completing the programme and an average of two countries starting the programme per annum. Since 2006, four countries reached the completion point and two countries reached the decision point.[20] In April 2007, Afghanistan was added to the list of eligible countries, increasing the number of eligible countries to 41. Of these, 22 have completed the program, 8 are between decision and completion point, and 11 have yet to reach the decision point. A decade after the process began, it has become increasingly urgent to expedite this process and deliver the needed debt relief.

37. Between 1995 and 2005, total debt stocks for the 28 HIPCs that had reached the decision point declined by approximately 10 per cent in nominal terms (from $116 billion to $104 billion) and by 50 per cent as a share of GNP (from 140 to 70 per cent of GNP). There have been changes in the composition of HIPC debt, which has become increasingly multilateral (and concessional in nature) and long term. Among the objectives of the HIPC Initiative was to free resources for poverty reduction activities. In fact, the decline in the debt service ratio to GNP in HIPC completion countries was accompanied by an increase in the ratio of poverty reducing expenditures to GNP. It is unlikely, however, that this increase in poverty reduction expenditures will be sufficient to achieve the Millennium Development Goals by 2015.[21] This raises the question of additionality of aid which was supposed to be a key component of the HIPC Initiative.

38. Net nominal official development assistance (ODA) disbursement by the 22 member countries of the Development Assistance Committee (DAC), less debt forgiveness, declined from the start of the Initiative to its lowest level in 1999. It is only in the past few years that nominal ODA less debt forgiveness has risen above the 1996 value. But nominal ODA less debt forgiveness remains at levels similar to those prevailing in the early 1990s and real ODA less debt forgiveness is well below its pre-HIPC levels. ODA levels went from 0.33 per cent of donor countries' GNP in 1990 to an estimated 0.25 per cent of donor countries' GNP in 2006. These findings suggest that debt relief under the HIPC Initiative has not been additional.[22] Ten years after the launch of the Initiative, it would be worthwhile to reconsider the

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[18] The Commission on Human Rights, in its resolution 2004/18 of 16 April 2004, appointed an independent expert to examine and report on such guidelines. See *Official Records of the Economic and Social Council, 2004, Supplement No. 3* (E/2004/23), chap. II.

[19] See R. Howse, "The concept of odious debt in public international law", UNCTAD Discussion Papers (forthcoming).

[20] Completion point: Cameroon, Malawi, São Tome and Principe and Sierra Leone. Decision point: the Congo and Haiti.

[21] See table 3.A2 of the UNCTAD *Trade and Development Report 2006*.

[22] A World Bank evaluation finds that the enhanced Initiative has been additional. However, this evaluation uses as the point of reference the year in which aid reached its lowest level in three decades when measured as a ratio to donor countries' GNP.

modalities and eligibility criteria for debt relief in a manner that ensures additionality and separates future debt relief for low-income countries from more critical ODA requirements.

39. Under the Multilateral Debt Relief Initiative (MDRI), 22 HIPC countries have benefited from 100 per cent cancellation of their outstanding multilateral debt claims from IMF, IDA, and the African Development Bank. At the end of 2006, the Inter-American Development Bank announced its intention to also cancel the debt of its HIPC members, clearing the way for five Latin American HIPCs to benefit from MDRI upon completion of the HIPC Initiative.[23] However, the financing modality of the debt cancellation by the Inter-American Development Bank raises concerns as it reduces the resources of the Bank's concessional lending arm and may lead to lower concessional lending to low-income countries in Latin America and the Caribbean.

40. The past 12 months have again shown that the number of Paris Club meetings is on the decline compared to the previous decade. There were six Paris Club meetings, five for HIPCs and one for a non-HIPC. Malawi, São Tome and Principe and Sierra Leone reached the completion point over the last 12 months, and obtained a 100-per cent debt reduction of their Paris Club debt. The case of Haiti was treated under Cologne terms as the country reached the decision point in November 2006, with the special provision that moratorium interest would be postponed until 2010. The Central African Republic reached an accord with IMF on its Poverty Reduction Strategy Paper in December 2006, and in April 2007 obtained a rescheduling of its debt obligations falling due between 2006 and 2009 under Naples terms. It is expected that a Cologne terms rescheduling will take place when the country reaches the decision point.

41. The trend of prepaying Paris Club debt has continued in 2006/2007. The Paris Club accepted Peru's proposal for the prepayment of $2.5 billion and Macedonia's offer to prepay $104 million. Although the size of the deals in 2007 is not comparable to last year's record-breaking Russian Federation prepayment agreement for $22 billion, countries have continued to reduce their external debt burden vis-à-vis official bilateral creditors.

42. Meanwhile, the emergence of new bilateral lenders has prompted concerns that the new entrants are benefiting from the latest round of debt relief without sharing the burden of costs.[24] This argument is based on the claim that official creditors that did not participate in the latest round of debt reduction are endangering the progress made thus far by making non-concessional loans to countries, thus risking unsustainable debt situations in the future. While these concerns might be warranted, they are in one respect at least somewhat dubious. One of the objectives of debt relief was to address debt-overhang and thus encourage new investment and social expenditure. This is exactly what is happening, with several African countries for example benefiting from a net increase in infrastructure investment. By reducing the influence of the traditional donor cartel, the presence of new lenders and donors is also leading to some healthy competition and allowing recipient countries to

[23] As the Asian Development Bank did not signal its intention to participate in MDRI, there are three HIPCs (Afghanistan, Kyrgyzstan and Nepal) that will not benefit from full debt relief under MDRI.

[24] International Development Association, "IDA Countries and Non-Concessional Debt: Dealing with the 'Free Rider' Problem in IDA14 Grant-Recipient and Post-MDRI Countries" (June 2006).

choose among different development paradigms. After all, debt relief did not liberate much resources as most of this debt was not serviced to start with.[25] The best way to address alleged free-riding is to give new lenders and donors more voice in the decision-making process of the international financial institutions. This would also address what is probably the most serious problem brought about by the presence of new lenders, the fact that they are included neither in the current system aimed at dealing with debt rescheduling and debt renegotiation, nor in the relevant aid effectiveness and development cooperation forums.

43. Even including debt relief, current and projected levels of ODA fall short of the G-8 pledge in 2005 to double aid to Africa by 2010, while the most recent reiteration of pledges indicates a downward revision of targets rather than the scaling-up expected and required. Donor countries as a group are still committing less than the agreed target of 0.7 per cent of GNP to aid. The international aid system consists of more than 150 agencies and includes increasing South-South capital and aid flows, with several emerging economies in Asia, Latin America, and the Middle East becoming sources of external finance and aid for low-income countries. This advent of new donors should be used to spur deeper and wider reform of the international aid architecture, which, in the current set-up, gives inadequate voice to recipient countries.

44. The Paris Declaration,[26] endorsed in March 2005 by over 100 countries, is a first step in this direction. However, the emphasis of aid effectiveness is still on the accountability and governance of recipients. The United Nations is the appropriate organization to initiate the establishment of a permanent mechanism that represents the interests of the recipient countries and donors alike. UNCTAD could help setting the scene for such a universal forum through discussing the design of a new set of criteria for debt and aid measurement and evaluation.

VIII. Policy conclusions

45. The past few years have been characterized by a favourable international environment for the external debt of developing countries, not witnessed for many years hitherto. Ample global liquidity, together with favourable external conditions and policy improvements, led to low risk aversion and translated into low spreads and large access to resources by middle income developing countries. There are, however, signs that the situation may yet change. Long-term interest rates in the developed world are rising and the first half of 2007 has seen localized turmoil in some emerging market countries. Moreover, a few developing and transition countries are still characterized by large current account deficits and overvaluation of their exchange rates. Even though there have been no major financial crises in the recent past, a range of issues remain at the top of the international agenda for deeper cooperation in this area.

46. On the positive side, several developing countries used the last few years to improve their debt management strategies. The financial crises that hit emerging

[25] In this sense, debt relief brings new resources only to countries that did not accumulate large arrears.

[26] Paris Declaration on Aid Effectiveness, adopted by the High-Level Forum on Aid Effectiveness, Paris, 28 February-2 March 2005, available from www.oecd.org.

market countries in the second half of the 1990s made policymakers well aware of the risks of external borrowing and are at the root of the switch towards more domestic borrowing.

47. The international capital market can provide large amounts of funds, but the supply of these funds tends to be volatile. Large industrial countries can borrow abroad in their own currency, but most international borrowing by developing countries is in foreign currency. The incidence of foreign currency debt, together with the volatility of the real exchange rate that characterizes some developing countries, increases the instability of GNP growth and capital flows and the risk of sudden debt explosions.

48. Most domestically issued debt has the advantage of being denominated in the domestic currency and hence may reduce currency mismatches and may count on a more stable investor base. As a consequence, Governments which are trying to reduce the risk of a debt crisis by limiting excessive foreign borrowing and by developing the required infrastructure and institutional set-up for a well working domestic debt market should be encouraged and supported.

49. However, policymakers should not be too complacent as the new structure of debt could also lead to new vulnerabilities. Debt composition matters, but it is necessary to move beyond the external/domestic debt dichotomy. The switch to domestic borrowing could entail important trade-offs and, in deciding the optimal structure of public debt, debt managers should consider these trade-offs between the cost and risk of alternative forms of financing. In fact, in the current environment characterized by open capital account and by an increasing entry of international investors in domestic debt market, the traditional dichotomy between external and domestic debt does not make as much sense as it used to make in the past. Excessive focus on external debt may distract policymakers from the fact that the real sources of vulnerabilities are maturity and currency mismatches and lead to a situation in which the maturity and currency composition of domestically issued debt are not included among the vulnerability indicators used to predict financial crises or debt sustainability.

50. As vulnerabilities are often identified after a financial crisis starts to unravel, policymakers should be aware of possible new vulnerabilities. Crisis prevention requires detailed and prompt information on debt structure. The international community can play a major role in helping developing countries to improve their capacity to record and disseminate information on the structure of total public debt. This would help the research community to identify possible new vulnerabilities and thus help countries to improve their debt management strategy and further reduce the risk of a debt crisis. The creation of the Debt Management Financial and Analysis System Programme of UNCTAD was an important step in this direction, but to ensure sustainability more resources, continuous support, and more coordination among the various national debt offices are needed.

51. The presence of global imbalances and the fact that capital is flowing uphill from poor to rich countries is a source of concern as some important emerging market countries may decide that they no longer need the help and support of the international financial institutions. This highlights the need for a reform of the governance and the structure of relevant international institutions and the development of a truly cooperative global monetary system based on the ideas on which the Bretton Woods Institutions were founded more than 60 years ago. As the

current favourable external environment may not last forever, policymakers should use tranquil times to prepare for the next challenges. In this connection, it is regrettable that no progress has been made towards developing a mechanism for the resolution of sovereign default. This should remain a priority for the international community.

52. Debt relief has been too slow and has not been additional as planned and should be expanded to low-income countries which were not part of HIPC and MDRI initiatives. It is necessary to speed up the process and scale up ODA flows with the ultimate objective of reaching the Millennium Development Goals. There are serious issues with the current structure of the debt sustainability framework for low-income countries. While a simple rule to define debt sustainability would be welcome, more research is needed to justify the use of a small set of indicators to define debt sustainability. Until then, it is best to assess debt sustainability for development purposes on a case-by-case basis, with the full engagement of borrower Governments in adapting sustainability criteria to the situation at hand. This also calls for greater public scrutiny and an informed public debate on the methodology and appropriateness of assessing governance in developing countries.

53. The question of contingency risk arising from private sector borrowing and Governments' capacity to manage such risks appropriately will need to be given more attention in the future, as it is unlikely that the recent favourable international financial environment will continue indefinitely. This situation is rendered more precarious by the fact that global liquidity encourages international investors to take risks, leading to a situation in which a decline of credit quality is associated with lower spreads. While this may be explained by an increase in investors' ability to manage risk, statistical analysis suggests that risk spreads are much lower than what empirical models predict.

54. If a global downturn in the economic cycle were to occur, the correlation among a number of key economic variables could suddenly increase, producing higher risks than each event individually. This is especially an issue in the current environment characterized by an increasing importance of highly leveraged, opaque and difficult to price structured financial products. The unravelling of the market for these products could lead to a flight to quality and have serious negative consequences in both developing and advanced economies.

Annex

External debt indicators

(Billions of United States dollars)

	All developing countries						Sub-Saharan Africa					
	1990-94	1995-98	1999-03	2004	2005	2006[a]	1990-94	1995-98	1999-03	2004	2005	2006[a]
Total debt	1 522	2 090	2 367	2 767	2 742	2 851	191	229	214	238	215	173
Long-term debt	1 237	1 667	1 938	2 178	2 147	2 216	158	179	175	198	177	134
Private creditors (percentage)	48	53	59	62	66	71	25	24	22	21	24	36
Private borrowers (percentage)	8	20	28	31	37	41	4	5	7	7	7	14
International reserves	277	565	865	1 655	2 054	2 568	16	26	37	63	84	120
Debt indicators (percentage)												
Short-term debt/total debt	16	17	15	18	20	22	14	18	15	14	15	20
Total debt/exports	180	147	125	91	74	..	245	231	180	125	89	..
Debt service/GNP	4	5	6	5	5	5	4	5	4	3	4	3
Total debt/GNP	38	39	40	34	29	25	68	72	64	48	37	24
Reserves/short-term debt	110	158	246	336	376	418	63	62	117	192	263	343
Reserves/M2	11	19	20	27	28	29	14	21	27	29	32	39

	East Asia and the Pacific						South Asia					
	1990-94	1995-98	1999-03	2004	2005	2006[a]	1990-94	1995-98	1999-03	2004	2005	2006[a]
Total debt	300	502	522	588	621	653	138	152	166	196	191	210
Long-term debt	240	383	409	404	400	408	122	140	157	183	177	193
Private creditors (percentage)	47	59	57	54	57	59	25	28	33	38	38	41
Private borrowers (percentage)	15	31	33	34	36	37	3	7	12	16	20	23
International reserves	97	213	376	803	1 020	1 292	18	33	71	150	157	171
Debt indicators (percentage)												
Short-term debt/total debt	20	23	19	29	34	37	7	6	4	5	6	7
Total debt/exports	124	106	79	52	44	..	289	194	146	109	84	..
Debt service/GNP	5	4	4	3	3	3	3	3	3	3	3	2
Total debt/GNP	37	35	29	22	21	19	37	30	26	22	19	19
Reserves/short-term debt	168	195	382	464	480	529	228	398	1 068	1 469	1 325	1 174
Reserves/M2	14	15	16	23	25	26	10	13	18	27	23	22

	Middle East and North Africa						Latin America and Caribbean					
	1990-94	*1995-98*	*1999-03*	*2004*	*2005*	*2006*[a]	*1990-94*	*1995-98*	*1999-03*	*2004*	*2005*	*2006*[a]
Total debt	147	161	151	169	153	150	487	668	781	816	728	711
Long-term debt	123	138	128	141	124	119	378	522	654	669	622	618
Private creditors (percentage)	35	26	29	33	39	43	64	72	78	78	78	81
Private borrowers (percentage)	1	4	5	5	9	13	11	27	36	31	33	35
International reserves	28	46	66	112	135	164	92	161	169	227	263	304
Debt indicators (percentage)												
Short-term debt/total debt	15	12	14	16	18	20	19	18	13	13	13	13
Total debt/exports	158	149	106	81	62	..	233	192	175	137	102	..
Debt service/GNP	8	6	5	4	4	3	4	6	9	8	7	6
Total debt/GNP	64	50	39	35	28	14	39	37	45	42	31	26
Reserves/short-term debt	125	235	315	417	484	549	98	131	174	219	284	333
Reserves/M2	12	17	17	22	23	24	19	28	26	30	27	27

	Europe and Central Asia					
	1990-94	*1995-98*	*1999-03*	*2004*	*2005*	*2006*[a]
Total debt	257	378	532	760	834	955
Long-term debt	216	305	415	583	647	743
Private creditors (percentage)	57	54	67	76	84	89
Private borrowers (percentage)	4	13	33	47	59	63
International reserves	..	86	145	300	395	522
Debt indicators (percentage)						
Short-term debt/total debt	14	14	17	19	20	21
Total debt/exports	..	118	130	105	94	..
Debt service/GNP	3	4	9	9	10	8
Total debt/GNP	..	38	54	46	41	40
Reserves/short-term debt	116	171	162	206	234	263
Reserves/M2	20	32	41	49	49	53

Source: UNCTAD calculations based on World Bank, Global Development Finance 2007. Developing Countries as defined in the Global Development Finance publication.

[a] Estimated.