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Maintaining Debt Sustainability in Low-income Countries: The Challenges and Safeguards for Managing Opportunities for External Private Financing

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EXECUTIVE SUMMARY

The recent access of many LICs to the international capital markets constitutes both an opportunity for, and a challenge to, these countries. The LICs interest would best be served, and their development promoted maximally, if they make best use of the opportunities and also rise to the challenges at the same time.

2. This paper is an attempt to inform LIC's decisions aimed at accomplishing this, particularly to safeguard themselves against what had hitherto been recurring cycles of borrowing and subsequent debt crises. The paper aims at shedding light on the prospects and challenges of international commercial fund raising by developing countries, in general, and LICs, in particular. We also offer suggestions for promoting sustainable debt positions in LICs through policy actions by national governments, foreign commercial lenders and international development partners.

3. We first provide a brief historical perspective, covering almost two centuries, of developing countries' international commercial borrowing and how they often resulted in debt crisis situations. This historical perspective is provided with a view to distilling a few lessons.

4. The above is followed by a review of the likely reasons that could have made the countries resort to non-concessional borrowing. We identify a number of supply factors at the creditors' end and demand factors in the borrowing LICs. Also, we discuss the likely prospects and benefits to the countries of borrowing as well as the likely dangers and problems in doing so.

5. Finally, we provide a number of recommendations to policymakers in LICs as well as their foreign creditors and international development partners to assist LICs attain or maintain sustainable debt positions. Specifically, we suggest that policy makers should refrain from reckless and injudicious borrowing; strengthen debt management capacity as well as the legal framework for managing of debt and broader government finances; pay attention to the exchange rate and monetary management challenges posed by inflow of foreign resources; and diversify export base and promote export growth policies. To the international creditor community, we recommend that they refrain from reckless lending; giving loans to likely corrupt regimes and financing of activities that do not meet social and environmental standards. To the international development partners, we suggest that they should assist in promoting debt management capacity in LICs. We also suggest that they should do more in promoting exports in LICs (including through supporting of LICs in the ongoing and protracted Doha round as well as ACP/EU Economic Partnership Agreement (EPA) trade negotiations).

1. INTRODUCTION

Mainly as a result of ample global liquidity in recent years and rising economic and international political profiles of what have now been referred to as emerging creditors, supply of credits to low-income countries (LICs) has been on the increase. Similarly, debt relief from (mainly official) creditors to LICs and increased provision of grants to them by a number of multilateral development banks could have created a borrowing space, just as improved macroeconomic indicators in a number of them have enhanced their debt carrying capacity. The combined effect has been to borrow more. As discussed further in this paper, this has served to enhance access of many low-income countries to international capital markets. Some have already accessed these markets while some are planning to do so in the near future.

2. An unwanted effect of the above-noted development is that a sizeable portion of new loans are non-concessional, raising concerns about future debt sustainability in these countries.

3. Access to international credits is potentially a double-edged sword, depending on how and when the sovereign borrower makes use of this opportunity. The objectives in this paper are to briefly review how the potential benefits of this opportunity to borrow can be harnessed while safeguarding against its possible dangers.

4. The rest of the paper is organised into three sections. In Section 2, we review the origin of major sovereign debt crises in the past with a view to highlighting lessons to be learnt from how irresponsible lending and borrowing contributed to such crises. In Section 3, we discuss reasons for the current external borrowing and review the potential benefits and challenges of such borrowing in Section 4. The last Section is on recommendations, summary and conclusion.

2. LESSONS FROM DEVELOPING COUNTRIES' EXPERIENCE WITH BORROWING FROM INTERNATIONAL CAPITAL MARKETS

2.1 History and Experiences of Past Commercial Borrowing

5. Aggarwal (2002) has provided a comprehensive account of developing countries' experiences in international credit markets, dividing the period since 1820s into 4 epochs, viz: 1820s-1860s; 1870s-1914; 1920s-1960s; and 1970s-1990s. For our present purpose, we too adopt this 4-epoch classification and use the information contained in Aggarwal's piece as the main basis of our discussion.

6. **1820s-1860s Epoch of International Borrowing:** During this cycle of lending, Britain and France were the major players in the international economy and so, lending occurred through bond flotations carried on mainly by merchant banking houses in London and Paris financial markets. **The borrowers, on the other hand, were mainly the newly established Latin American states who needed the funds to meet the two objectives of paying for their wars of liberation and covering current government costs.** As none of these two objectives did little to enhance debt-servicing capacities, debt repayment proved difficult, resulting later in a debt crisis. It was not until the Mexican agreement of 1888 that a final resolution of the continent's several defaults came to a close during this epoch.

7. **1870s-1914 Epoch of International Borrowing:** During this time, lenders were able to organise bondholders' associations in Britain, France and Belgium to strengthen their negotiating ability, **Concerning borrowers' motives, they mainly raised funds for infrastructural development** (with railway expenditures constituting over 40 per cent of the uses of the loans), although many still sought to finance current government spending.

8. **1920s-1960s Epoch of International Borrowing:** After the First World War and prior to 1930s, many other countries outside Latin America also joined the sovereign-borrowing bandwagon, with most capital flowing from the United States, which was becoming the new centre of international finance, to Europe (especially, Germany) and Canada, in addition to the Latin America. Concerning the utilisation of funds by the sovereign borrowers, **instead of financing development projects (such as railways) as under the previous epoch, the funds were used to strengthen foreign holding of reserves; to balance government budgets; and to finance current expenditures.**

9. However, with the severe drop in foreign lending from the United States (particularly around 1928, owing to the diversion of funds to the US stock market and also the ensuing Depression), these foreign borrowers became incapacitated to service their debts. By 1933, most Latin American and European sovereign borrowers suspended at least part of their debt servicing and efforts to reschedule defaulted debts, which began in 1940s, continued until 1960s. **The sudden cessation of new lending from the United States is a pointer to how unpredictable and unreliable foreign credit sources can be. (A similar trend can materialise as a result of the current credit crunch).**

10. **1970s-1990s Epoch of International Borrowing:** During the 1960s, official loans – both bilateral and multilateral – dominated international lending to governments in developing countries. However, there later emerged certain peculiar features of this borrowing epoch that made private credit flows dwarf official lending. **One of these was the emergence of euro-currency credit market (that more or less coincided with the 1973 oil crisis) while another was the practice of loans syndication. Both contributed to increased sovereign borrowing from international capital markets and the resulting debt crises.**

11. **Concerning the simultaneous emergence of euro-currency credit market and the 1973 oil crisis, on the supply side, the latter resulted in plethora of petro-dollar funds in the international financial markets and (together with the low-interest rate regime adopted by the Nixon/Ford administration in the US) depressed international lending rates, including rates on euro-currency bonds/credits. With regard to emergence of loan syndication, it created a negative incentive system to lend with inadequate prudence.** Lead banks, while also lending on their own accounts, relied on large fees (with less risk) obtained from rallying a large number of other (often, smaller) banks into loan syndications for the sovereign borrowers. In effect, the lead banks used to search for (and persuade) sovereign borrowers without adequate attention to the creditworthiness of such borrowers, leaving other banks that were rallied into the syndication arrangement to share the risks without partaking in the fees for arranging the syndication. These other banks relied on the lead banks to do the investigations about creditworthiness of the sovereign borrowers whereas the latter had little incentive to do so, given the allurements of huge syndication fees accruing to them. Invariably, the bulk of lending financed grandiose and unproductive projects, fuelled by embezzlement by corrupt political leaders (including through transfer to foreign bank accounts), was used to support dictatorial regimes, etc. **On the demand side,**

many developing country governments wanted to borrow from international credit markets in order to pay for the rising oil import bills and also the oil price-induced rising import bills of manufactured goods from the developed countries. Also, corruption and other forms of poor governance, pursuit of white elephants projects, debt management institutional challenges, etc weaken many sovereign borrowers in withstanding pressures from international private lenders. Most of the credits were contracted under floating interest rate (linked to euro-dollar rate) terms.

12. The increased borrowing was not sustainable and debt crises inevitably ensued. First, as countries faced pending loan re-payments, they increasingly resorted to short-term borrowing, with its inherent rollover risks. This aggravated the overall debt burden. Second, faced with domestic inflation, the Carter administration in the US resorted to tight monetary (and, hence, high-interest rate) policy, thereby increasing the debt service burden, since the rates were generally linked to euro-dollar rates. The tight monetary policy in the US also transmitted recession to many other developed countries, thereby weakening their demand for exports of developing countries as well as a fall in the prices of their exports and consequential deterioration in their terms of trade. This further weakened their abilities to service their debts and also necessitated raising further loans despite their ever-decreasing creditworthiness. For oil exporters, the collapse of oil markets from 1981 onwards also further worsened their terms of trade. **A lesson to be drawn is that, for primary commodity exporting countries (often with an undiversified export base), the current high export earning capacity and/or very favourable terms of trade should tread cautiously in entering into long-term loan commitments, as such favourable external trade conditions can be ephemeral and transient for primary commodity exports.**

13. Many of these countries still had official multilateral external debts to service, thereby curtailing their capacity to service commercial debts, as the former are traditionally accorded a preferred status. All these factors reinforced each other to lead to the commercial debt crises of the 1980s that first started with Poland and Argentina seeking bank rescheduling in 1981 before many others followed suit. To complete the debt crises review, the Mexican peso crisis of 1994 and the Asian crises of 1997 should also be mentioned, as they too seriously affected debt repayment capacities of the countries involved.

2.1 Some Lessons that can be derived from the past Experiences

14. The following are some of the salient observations and lessons that can be learnt from past experience.

15. **Each of the sovereign borrowing epochs or episodes resulted in debt crises.** Extra safeguards would be needed to ensure that the recent international lending boom too does not end the same way as previous ones.

16. **Also, in most of the epochs, allurements to borrow or over-borrow were often created by excess global liquidity and the attendant low borrowing costs.** In the last epoch of 1970s-1990s, however, the situation was more deceptive due to the floating rate mechanism that was part of most loan contracts. As soon as the low interest regime was over, the interest cost rose astronomically and this exacerbated the debt crises. **A lesson to be learnt from this is that borrowing at either a high interest rate or at a low but floating interest rate can create debt repayment problems and should therefore be guarded against as much as possible.**

17. **Pressure from lenders was also a cause of the past borrowing binges and the resultant debt crises, particularly during the epoch of 1970s- 1990s.** When there is global liquidity, these lenders put pressure on and made overtures to potential sovereign borrowers, with little or no regard to their repayment capacities or the use to which the funds would be put. But as soon as there were signals of repayment difficulties, they would stop new lending and also go through multilateral institutions (especially, the Bretton Woods institutions) to either facilitate repayment by providing official loans to be used in servicing the commercial debts or even outrightly enforce for them the debt repayment by acting as their debt collectors through imposition of severe austerity package as part of “stabilisation programmes”.

18. **It should also be noted that, often, the borrowing binge arose from poor governance (corruption, embezzlement, etc on the part of the political leadership); weak public sector institutions; and inadequate debt management capacity on the part of the sovereign borrowers.** These have been some of the weaknesses that unscrupulous lenders capitalised upon in their reckless quest to over-lend to unworthy sovereign borrowers.

19. As pointed out above in connection with the onset of Latin American and European debt crisis just prior to the First World War (when new sources from the United States dried up), unanticipated cessation of new lending, can occur. This is an event that is outside the control of the sovereign borrowers and which would render it difficult to service the existing debts with new loan proceeds. **To guard against vulnerability to such a situation, sovereign borrowers should refrain from anticipating new foreign lending as a source of finance for servicing existing debts.** Commercial borrowing should be used for purposes that clearly generate sufficient returns to service the debts comfortably.

20. Also, as pointed out above while reviewing the borrowing episode of 1970s-1990s, **primary commodity exporters should not regard the current high export earning capacity and favourable terms of trade, without making suitable assessments based on reliable indicators of their debt-carrying and, especially, new borrowing capacities.** The experience of the borrowing episode of 1970s-1990s shows that even the usual indicators can be misleading, particularly as favourable external trade conditions can be ephemeral and transient. This places a high premium on robust debt management techniques based on sophisticated risk management.

21. The above causes of past commercial debt crises should be guarded against by the sovereign borrowers, international lenders and international development partners. Recommendations on these would be discussed toward the end of the paper.

3. A REVIEW OF POSSIBLE SUPPLY AND DEMAND FACTORS DRIVING NON-CONCESSIONAL BORROWING BY LOW-INCOME COUNTRIES (LICS)

3.1 A Review of Possible Supply or “Push” Factors

22. **The global liquidity or plethora of funds that have prevailed in international financial markets and the attendant low interest rates have propelled international investors to explore LICs as destinations for their otherwise “idle” funds. Also, improved macroeconomic conditions, including better export performance as a result of rising prices of primary commodities, have improved the debt servicing prospects of many LICs, as have the reduced debt levels as a result of debt relief initiatives. As**

rightly summarised in IMF and World Bank (2006, Paragraph 7), “Lower debt levels, strengthened macroeconomic fundamentals, and improved prospects in LICs have increased their attractiveness for ECAs (i.e. export credit agencies). In addition to the ECAs of developed countries, emerging economies are stepping up their lending to LICs. With abundant global liquidity and compressed spreads in emerging markets, private external creditors have also extended their activities in LICs to a number of Sub-Saharan African countries”. The current credit crunch is likely to bring about a qualitative change in the supply side or “push” factors.

3.2 A Review of Possible Demand or “Pull” Factors

23. These are the factors that are making LICs embrace external loans, separate from the above-discussed “push” or supply factors. **Expectedly, the borrowing space created by IDA’s grant resource transfers and, for post-completion point HIPC, the MDRI benefits could have been an attraction not only for lenders to increase their credit flows to the LICs as mentioned in the preceding paragraph, but also an incentive for LICs to seek more foreign loans. Another factor that could be responsible is the improving economic performance of these countries, mainly as a result of improving terms of trade** (precisely, prices of commodity exports), which have enhanced their debt re-payment capacity and, therefore, their borrowing space. Whether this improving terms of trade is sustainable is open to debate.

24. Apart from the borrowing space generated by the aforementioned improving terms of trade as well as MDB grants and MDRI benefits, a number of other factors have generated borrowing interest in LICs.

25. **One of these is political, relating to low standard of governance and public sector mismanagement.** The deteriorating or, at least, non-improving standard of governance and public sector management in some LICs has been motivating officials in such countries to repeat similar borrowing binges that were a factor that led to the previous external over-borrowing and consequential debt burden in the past. First, debt management practices, including debt recording, in many LICs still leave much to be desired and these often lead to over-borrowing. More importantly, either because of the desire to mismanage/misappropriate public funds or to embark on some white elephant and grandiose projects that may eventually be abandoned half-way, such officials seize every available opportunity they come across to raise external loans, with little regard to the productivity and repayment capacity of the credits. More than in the previous cycles of unsustainable borrowing, the embracement of democratic form of government by a greater number of LICs has created the need to please the electorates, particularly when elections years are approaching, by embarking on high profile, though often unproductive, programmes that could only be facilitated through unsustainable foreign loans. It is this type of borrowing that the World Bank (2006, p. 26, paragraph 62) refers to by stating that “Such borrowing may be motivated by governments who seek the short-term benefits for such non-concessional borrowing without considering the longer-term costs for the country, which will remain long after that government ceases to be in power”. To reduce this kind of borrowing, LICs should improve debt management practices and also have strict fiscal responsibility laws with adequate provision to guard against such politically motivated borrowing. Development partners, including multilateral ones like the World Bank, IMF and regional development banks, can play a useful role in assisting governments to assess the quality of expenditure supported by the new borrowing.

26. But the demand or “pull” factors are not all driven by poor governance, corruption or low standard of debt management practices. **Some are driven by actual and genuine need for foreign resources in the face of dwindling sources of other external financial resources, particularly foreign grants and highly concessional loans.** The following are notable reasons and instances of decreasing volumes of foreign grants and highly concessional loans:

- **Volumes of conventional aid have fallen.** Actual volumes of foreign aid from bilateral (i.e. DAC countries) and multilateral sources, other than debt relief and special purpose assistance, have been falling despite the pledges to increase them.
- **IDA allocation formula (and allocation formulas of regional development banks, RDBs, too) puts LICs at a disadvantage in several ways.**
- First, performance-based allocation (PBA) formula used by IDA discriminates against LICs due to the very high positive correlation between per capita income of a country and its score under the Country Policy and Institutional Assessment (CPIA), which is the major driver of PBA.
- Second, for those that receive IDA allocations in the form of grants or a 50-50 mix of grants and credits, they respectively have to suffer 20 per cent and 10 per cent reduction in the volume of IDA resource transfers to them vis-à-vis if the entire transfers are in the form of credits only. For cash-strapped LICs that therefore have very high rate of time preference or discount rate, the disadvantage of suffering 20 per cent volume reduction associated with receiving grants could conceivably outweigh the disadvantage of receiving an unreduced volume of credits but having to repay (over some decades) the virtually interest-free credit. If such countries are confronted with a choice, they would likely choose the latter option.
- Third, for those LICs that have become eligible under the multilateral debt relief initiative (MDRI), the netting-off mechanism adopted by IDA in allocating what it gets as replenishments from its donors also means the net IDA resource transfers to such countries would have been greatly reduced and might possibly become nil or close to nil. Most of the above also apply to resource transfers by RDBs.

27. **Attainment of post-MDRI status provides a safety valve, a long-awaited opportunity and freedom, for the government to realise the dream of higher economic growth through public expenditure on the hitherto relatively neglected infrastructural and related government expenditure programmes that can only be feasibly financed (particularly since debt relief does not enhance cash flow into the government coffers) through government borrowing domestically and, especially, internationally.** Receipt of debt relief, whether under the HIPC initiative or MDRI, therefore, fails to lead to immediate resource transfers to the beneficiary countries. At the same time, the period immediately after becoming eligible for the irrevocable MDRI benefits provides the earliest opportunity to attend to such hitherto neglected discretionary spending that has been pent-up over the years. First, debt relief is essentially an accounting or bookkeeping exercise that does not lead to explicit or actual resource transfers to the recipients. The implicit resource transfer entailed is realised in the form of saving of funds that would have otherwise been used in servicing the debts when due and, for long-term debts, the saving is spread thinly over many future years,

often up to about 40 years. The cash flow effects are further limited by the fact that many HIPC were not servicing much of their debts.

28. Second, before receiving debt relief, a HIPC would have been having a PRGF programme with the IMF and a similar programme with the World Bank over a number of years. During such programme years, government spending programme must have been driven by grass root participation that is embedded in the required PRSP process as well as by the BWIs, due to the clout they have in determining the contents of PRSP. Whether the government spending programme has been driven by the BWIs or grass root participation at the domestic level, the fact still remains that spending programmes that are favoured by these drivers would necessarily have been oriented towards poverty reduction, with emphasis on social expenditure items (on health, education, gender issues, micro-enterprises development, provision of clean water, etc) that would hardly lead to an immediate and “big bang” substantial economic growth. These pro-poor government spending programmes, by their nature, are oriented towards small-scale projects and the bulk of whatever positive impacts they have on growth would take a very long time to materialise. Large-scale infrastructural and similar projects for bringing about high growth that would have been on the radar screen of the government would have been relatively neglected. So, attainment of post-MDRI status provides the earliest opportunity for the government to attend to financing growth-promoting infrastructural projects, often through borrowing. This is why the access to international credit markets provides a beneficial and timely opportunity for such countries.

4. BENEFITS AND CHALLENGES OF FOREIGN BORROWING BY LICs

29. Whether raising new foreign loans, even non-concessional ones, by LICs is beneficial or not depends on the context of the borrowing country, as well as the purpose and motive for borrowing. **It is not appropriate to generalise by saying raising of new loans is good or bad.** Having said that, we discuss below some likely benefits of raising new loans, after which we highlight possible dangers that this may pose.

4.1 Benefits and Prospects

30. **Borrowing from international financial markets can help LICs to imbibe, over time, a responsible borrowing culture and start cultivating relationships with creditors.** The World Bank (2006, paragraph 2) too acknowledges that “it will be important for IDA countries to develop, over time, normal relationships with creditors and a responsible credit culture to facilitate private sector development and public sector accountability”.

31. **In the face of dwindling concessional resources and given the desirability of meeting the MDGs and undertaking hitherto neglected infrastructural and related high growth-promoting spending, other external sources, including non-concessional ones, may justifiably need to be resorted to.** As discussed above, IDA and regional development bank resource transfers have fallen short of the desired volumes. Bilateral transfers (other than debt relief and special purpose assistance) too have fallen. But both the freedom and need for much increased government spending on large-scale infrastructural and other related projects have increased upon graduating from the HIPC Initiative. Pluralistic political parties have also exerted additional pressure for public expenditure.

32. **Improving debt management capacity, macroeconomic indicators and governance-related institutions may justify increased borrowing.** Some LICs have

recorded strengthened macroeconomic fundamentals, debt management capacity, and overall economic prospects, including terms of trade improvements that can support higher debt-export ratios. For such countries, there would be justification for new external loans.

33. **Non-concessional borrowing may be a way of avoiding trading-off of a country's sovereignty and freedom, through avoidance of onerous conditionalities associated with concessional sources, and this can have justification in some instances.** The so-called concessional resources from the multilateral institutions and some bilateral sources have their implicit price to pay in the form of conditionality, be it economic or political, which can make some sovereign countries that have penchant for policy space to resort to non-concessional sources that do not have such strings attached. There is no such thing as a “free lunch” even with grants from IDA and other so-called concessional sources, for the concessionality of the financial terms comes at the expense of trading-off recipient country's sovereignty and some countries, whose governments have sovereignty looming large in their utility functions, can understandably (and, sometimes, justifiably) forgo the so-called concessional for non-concessional resources.

4.2 Problems and Challenges

34. As rightly pointed out by IMF and World Bank (2006), expansion in the volume and sources of funds available to LICs carries a number of risks.

35. **Hard loan terms may apply.** The terms of new financing, if non-concessional, could burden poor countries with market interest rates or close to market interest rates and/or short maturities they can ill afford.

36. **Debt sustainability may be endangered.** Even, for the so-called concessional finance other than outright grants, the danger of unsustainable debt overhang could still be looming. This applies equally to credits from IDA and regional development banks, PRGF purchases, and “soft” bilateral loans. Commercial loans could only aggravate such unsustainable debt levels.

37. **Borrowing by LICs with low debt sustainability fundamentals can make them vulnerable.** Some LICs still have very low fundamentals (like low economic growth, exports and other macroeconomic indicators as well as low debt management capacity and institutions) to support raising of new loans, particularly non-concessional types. For such countries, it would be inadvisable to start raising new loans until such fundamentals have improved.

38. **Governance-related institutions and appropriate legal framework, including fiscal responsibility law, are also a part of such fundamentals.** The state of governance in some LICs is still less than satisfactory. For instance, many of them are still yet to have satisfactory fiscal responsibility laws that would check excessive borrowing, particularly by governments when election years are approaching. Raising of new loans by such countries could be politically motivated and the proceeds may be squandered or outrightly misappropriated, with little or no benefits to the generality of those being governed. For such countries, it would be inadvisable to start raising new loans until governance indicators have improved.

39. **In particular, short-term foreign private capital can make LICs vulnerable.** As rightly pointed out by IMF and World Bank (2006), short-term foreign private debt inflows could expose LIC recipients to abrupt reversal in market sentiment. It can also create balance sheet problems, particularly when foreign private debt inflows crowd out domestic banks, leading the banks to lend to higher risk projects, possibly including unhedged foreign currency loans.

40. **Foreign financial inflows, in general, can create exchange rate and monetary management challenges for LICs.** Grants and new loans, whether concessional or not, on a large scale could also create monetary and exchange rate management challenges, including the so-called Dutch Disease that may arise from over-valuation of domestic currency.

5. POLICY RECOMMENDATIONS, SUMMARY AND CONCLUSIONS

5.1 Policy Recommendations

41. From the foregoing, a number of recommendations can be deduced which are highlighted below. The first set of recommendations constitute action points for governments in the LICs, followed by a set of action points for international lenders, while the last set addresses the international development partners.

(a) Action Points for governments in LICs

42. **First, policymakers in LICs should refrain from reckless and injudicious borrowing, whether domestically or abroad.** They should raise loans under most favourable terms available and in sustainable volumes. Cost-benefit analysis should be undertaken before contracting loans, with reliable evidence that the productivity or benefit of the loans exceeds the cost. This leads to the next recommendation concerning debt management capacity, as proper analyses of costs and benefits of loans is a feature of enhanced debt management capacity.

43. **Government should strengthen debt management capacity in all its ramifications.** How to do this is outside the scope of this paper, as this is a wide terrain by itself. All that needs to be mentioned here is that debt recording, analysis (including DSA) and negotiation *cum* re-negotiation or rescheduling (particularly, in connection with foreign loans) should be accorded priority.

44. **The legal framework for debt management and broader government finances should similarly be strengthened.** First, fiscal responsibility issues should be rules-based, as opposed to discretion-based. This would call for enactment of comprehensive fiscal responsibility legislation, with strict and comprehensive provisions guiding borrowing. This would assist in containing politically motivated borrowing, particularly in anticipation of election periods. Public financial management guidelines too should guard against financial mismanagement, including misappropriation of public funds, of which proceeds of loans form a part.

45. In addition, **attention should be paid to the exchange rate and monetary management implications of the inflow of large foreign resources, including loans.**

46. Priority should be attached to promoting exports and diversifying the export base so as to reduce dependence on foreign loans and other non-current account receipts from abroad.

(b) Action Points for International Creditors

47. International creditors should:

- **be cautious in lending to LICs by taking their future debt-repayment capabilities into consideration;**
- **consider the borrowing governments' intention, as to whether the loan proceeds are likely to be misappropriated,** so as to be good corporate citizens and avoid risking being treated as odious lenders after the corrupt borrowing governments have been replaced;
- be good international corporate citizens by **adhering as far as possible to the Equator Principles or lending morality** (even where the creditors have not formally signed up to this principle), by refraining from lending to finance activities that do not meet social and environmental standards.

(c) Action Points for the International Development Partners

48. First, international development partners should complement efforts of governments in LIC in implementing the aforementioned actions points. **In this regard, they should augment national government efforts aimed at strengthening debt management capacity.**

49. Bilateral and multilateral development partners should also catalyse and encourage national governments in LICs to diversify their export base and increase their export earnings in order to reduce dependence on loans from abroad. In this regard, **international development partners should be an advocate for LICs in international trade negotiations and policy fora, including at the Doha Development Rounds. They should also provide more aid for trade in the form of concessional loans or grants.**

50. **Multilateral and bilateral aid agencies should boost their financial transfers to LICs so as not to make them resort to non-concessional loans. For instance, the World Bank, through IDA, should refrain from discriminating against LICs in its aid allocation.** First, the performance-based allocation (PBA) formula should be reviewed in order to remove its regressivity. Second, the netting of mechanism in allocating MDRI-induced donors replenishments to IDA should be removed. Third, the 20 per cent volume discount on grants should be reduced or even eliminated. Finally, conditionalities attached to IDA resource allocation should be streamlined and liberalized so as not to scare away many LICs from approaching IDA for finance and make them resort to non-concessional credits that have few or no strings attached. Greater priority should also be given to lending for growth-inducing infrastructural development. The same also broadly applies to regional development banks.

5.2 Summary and Conclusions

51. The recent access of many LICs to the international capital markets constitutes both an opportunity for, and a challenge to, these countries. The LICs interest would best be served, and their development promoted maximally, if they make best use of the opportunities and also rise to the challenges.

52. This paper is an attempt to inform LIC's decision-making aimed at accomplishing this, particularly to safeguard themselves against what had hitherto been recurring cycles characterized with the phases of borrowing followed by debt crises. The paper aims at shedding light on the prospects for and challenges of international commercial fund raising by developing countries, in general, and LICs, in particular. We also offer suggestions for promoting sustainable debt positions in LICs through policy actions by national governments, foreign commercial lenders and international development partners.

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55. Finally, we provide a number of recommendations to policy-makers in LICs as well as their foreign creditors and international development partners in helping the countries attain or maintain sustainable debt positions. Specifically, we suggest that policy-makers should refrain from reckless and injudicious borrowing; strengthen debt management capacity as well as the legal framework for managing of debt and broader government finances; pay attention to the exchange rate and monetary management challenges posed by the inflow of foreign resources; and diversify the export base and promote export growth policies. To the international creditor community, we recommend that they refrain from reckless lending; giving loans to likely corrupt regimes and financing of activities that do not meet social and environmental standards. To the international development partners, we suggest that they should assist in promoting debt management capacity in LICs. We also suggest that they should do more in promoting exports in LICs (including through supporting LICs in the ongoing and protracted Doha Round trade negotiations).

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