

Maintaining Debt Sustainability in Low-income Countries (LICs)

*The Challenges and Safeguards
for Managing Opportunities for
External Private Financing*

Introduction and Presentation Plan

Introduction – Underlying philosophy

- Philosophy of earlier presentations on accessing the capital market presupposes that a right decision, compatible with economic development and debt sustainability of the sovereign borrower, has been made to borrow from abroad.

- Based on this premise, the presentations then addressed how best to borrow from abroad.
- In the present session, however, the underlying philosophy of the presentations would address the issue of whether foreign borrowing would be in the interest of the country, from the developmental and debt sustainability perspectives, as well as whether creditors too should lend to such countries.

- They aim at urging sovereign borrowers to exercise constraints; lenders to exercise more responsibility; and international development partners to also assist in this regard.
- Somehow, the presentations seem to moderate somewhat the implied or apparent encouragement to borrow as contained in the presentations during the preceding session.

Presentation Plan

- Organised into 4 Sections as follows:
 1. History of Borrowing and Lessons to Learn from It
 2. Reasons for Current prevalence of Borrowing – Supply and Demand factors

3. Benefits and Challenges of Foreign Borrowing

4. Policy Recommendations

1. Lessons from Developing Countries' Experience with Borrowing and Lessons to be learnt

- We first provide in the paper a brief historical perspectives, for 4 episodes covering almost two centuries of developing countries' international commercial borrowing, viz:

- Episode of 1820s – 1860s, when the newly established Latin American states borrowed heavily from Europe, mainly for paying for their wars of liberation;

- Episode of 1870s – 1914, when Latin American states (and Canada too) borrowed from Europe mainly for financing infrastructure;

- Episode of 1920s – 1960s, when developing countries outside Latin America (as well as European developed countries) joined the bandwagon of foreign commercial borrowing; and
- Episode of 1970s – 1990s, when euro-/petro-dollar and syndicated loans came to dominate the scene as instruments of lending.

- Each of the above borrowing-lending episodes was followed with debt repayment problems and, hence, unsustainable debts, culminating into series of debt rescheduling, etc.

- Some specific lessons that can be distilled from these borrowing-lending episodes include the following:

(a) In most of the episodes, allurements to borrow or over-borrow were often created by excess global liquidity and the attendant low borrowing costs. But this (particularly, under floating rate terms) can create debt repayment problems.

- (b) Pressure from lenders was also a cause of the past borrowing binges and the resultant debt crises, particularly during the episode of 1970s – 1990s.
- (c) Often, the borrowing binge arose from poor governance, weak public sector institutions, and inadequate debt management capacity that aggressive (often, irresponsible) creditors took undue advantage of.

(d) Unanticipated cessation of new lending can occur, as it did just prior to onset of WWII. To guard against vulnerability to such a situation, sovereign borrowers should refrain from anticipating new foreign lending as a source of finance for serving existing debts.

(e) To guard against the deteriorating terms of trade-induced disappointment of the type that occurred during the episode of 1970s – 1990s, primary commodity exporters should not regard the current high export earning capacity and favourable terms of trade the sole indicators of their debt-carrying and, especially, new borrowing capacities. These have to be adjusted for, using a suitable risk assessment methodology.

2. Possible Demand and Supply Factors Driving Recent Upsurge in Foreign Borrowing

- Supply or “push” factors are identified to include:

- (a) The global liquidity or plethora of funds that have prevailed in international financial markets and the attendant low interest rates; and
- (b) Improved macroeconomic conditions, including better export performance as a result of rising prices of primary commodities – this can be regarded as both supply and demand factors.

- Demand or “pull” factors, on the other hand, include:
 - (a) Borrowing space created by IDA’s grant resource transfers and, for post-completion point HIPCs, the MDRI benefits;
 - (b) Improving economic performance of these countries, mainly as a result of improving terms of trade (precisely, prices of commodity exports);
 - (c) For oil importers, need for foreign exchange to meet rising import bills induced by rising energy costs.

(d) Political factor, relating to low standard of governance and public sector mismanagement. With higher standard of governance (including enhanced debt management capacity, existence of suitable fiscal responsibility laws, etc), borrowing could have been less than what is being observed.

(e) 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:

- volumes of conventional aid have fallen; and
- allocation formula of IDA and regional development banks put LICs at a disadvantage in several ways.

(f) 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 through government borrowing.

3. Benefits and Challenges of Foreign Borrowing by LICs

- Possible benefits to LICs from foreign borrowing are as follows:
 - (a) It can help LICs to imbibe, over time, a responsible borrowing culture and start cultivating relationships with creditors.

(b) 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.

- (c) Improving debt management capacity, macroeconomic indicators and governance-related institutions that are taking place in a number of LICs may justify increased borrowing.
- (d) 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 be justified in some instances.

On the other hand, there are potential challenges and problems with foreign borrowing, including the following:

- (a) Hard loan terms may apply.
- (b) Debt sustainability may be endangered.
- (c) Borrowing by LICs with low debt sustainability fundamentals can make them vulnerable.

- (d) Governance-related institutions and appropriate legal framework, including fiscal responsibility law, are also a part of such fundamentals.
- (e) In particular, short-term foreign private capital can make LICs vulnerable.
- (f) Foreign financial inflows, in general, can create exchange rate and monetary management challenges for LICs.

4. Policy Recommendation

- Action points for LIC governments:
 - (a) They should refrain from reckless and injudicious borrowing, whether domestically or abroad.
 - (b) They should strengthen debt management capacity in all its ramifications.

- (c) Legal framework for debt management and broader government finances should similarly be strengthened.
- (d) Attention should be paid to the exchange rate and monetary management implications of the inflow of large foreign resources, including loans.
- (e) Priority should be attached to promoting exports and diversifying the export base so as to reduce reliance on foreign loans.

- Action points for international creditors:
 - (a) They should be cautious in lending to LICs by taking their future debt-repayment capabilities into consideration.
 - (b) They should consider the borrowing governments' intention, as to whether the loan proceeds are not likely to be judiciously used.
 - (c) They should be good international corporate citizens by adhering as far as possible to the Equator Principles or lending morality.

- Action points for International Development Partners:
 - (a) They should augment national government efforts aimed at strengthening debt management capacity.
 - (b) They should be advocates for LICs in international trade negotiations and policy fora, including at the Doha Development Rounds.

(c) They should also provide more aid for trade in the form of concessional loans or grants.

(d) Multilateral and bilateral aid agencies should boost their financial transfers to LICs so as to reduce their need to resort to non-concessional loans.

Thank You for Listening!