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POOR COUNTRY DEBT: A NEVER-ENDING STORY?

Although the 'debt crisis' no longer threatens the international financial system, many low-income countries are still struggling with large debt overhangs. A combination of strong domestic reform programmes and commercial debt relief and restructuring under the Brady plan has improved the situations of Latin American and other middle-income debtor countries. However, no transformation is in sight for severely indebted low-income countries (SILICs). The purposes of this paper are to describe the progress made with the debt problems of these countries, to analyse the present situation and to survey the options now open to creditors.

Thirty-two countries are currently classified as SILICs,[1] 25 of which are in sub-Saharan Africa. As a proportion of the total for all developing countries, SILIC debt is about a tenth, almost half of which is owed by only four countries (Nigeria, Vietnam, Côte d'Ivoire and Sudan). The group includes some countries with exceptionally high debt ratios, some of which have large political as well as economic problems.

As shown in Figure 1, most SILIC long-term debt is owed to official bilateral and multilateral creditors (mainly the IMF, World Bank and African Development Bank), as distinct from commercial lenders. The main bilateral creditors are Japan (owed 12% of all SILIC bilateral debt), France, Germany and USA (11% each), UK (6%) and Italy (5%). These and other OECD creditor governments negotiate with debtors through the Paris Club – see Box 1. Russia, which has taken over the loan assets of the former Soviet Union, is the most important non-Paris Club creditor.

Evolving creditor responses

The positions taken up by creditor countries since the early 1980s can be interpreted as a gradual coming to terms with the true severity of the SILIC debt problem and the non-recoverability, therefore, of many past loans. Three phases can be distinguished.

The initial response

When the 'debt crisis' broke in the early 1980s, many official creditors took the view that the debtors were facing a temporary liquidity problem. For SILICs, creditors adopted a two-pronged strategy of (1) continuing financial flows to these countries and (2) providing short-term, non-concessional debt relief. Continuing the flow of finance (in conjunction with IMF and World Bank 'adjustment' programmes) was meant to restore growth and debt-servicing capacity. Capital inflows were intended to help fill balance-of-payments and investment gaps, permitting continued servicing of outstanding debt. Eventually, export-led growth and anticipated improvements in SILIC terms of trade would enhance domestic performance and credit worthiness. In the meantime, debtor countries were to be kept on a short leash, rescheduling service payments on small slices of the debt stock falling due over 12–18 month periods, on a case-by-case basis.

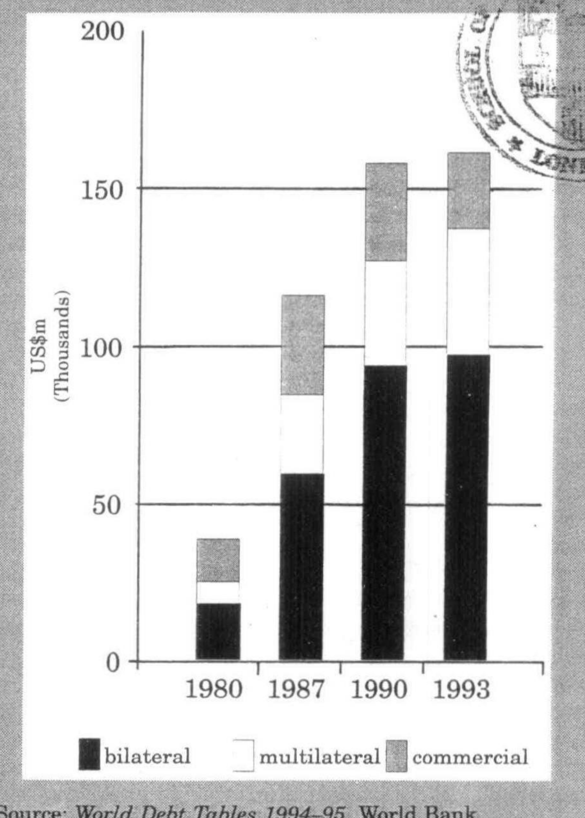
1. Officially defined as countries with debt-to-GNP and debt-to-export ratios larger than 80% and 220% respectively, and GNP per capita less than $675. The present 32 SILICs are: Burundi, Central African Republic, Côte d'Ivoire, Equatorial Guinea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Kenya, Laos PDR, Liberia, Madagascar, Mali, Mauritania, Mozambique, Myanmar, Nicaragua, Niger, Nigeria, Rwanda, Sao Tomé and Principe, Sierra Leone, Somalia, Sudan, Tanzania, Uganda, Vietnam, Yemen, Zaire and Zambia. It should be noted that the SILIC group is not a fixed grouping. Following substantial debt write-offs, Egypt 'graduated' from the SILIC group in 1994, whilst Guinea, Vietnam and Yemen are new entrants.

Box 1: The Paris Club

The Paris Club is a forum bringing together debtors and their official creditors in a unified negotiating framework, with a permanent secretariat supplied by the French Treasury. It is mainly composed of OECD governments (former socialist creditor countries have not taken part) and its traditional function has been to avoid defaults on loans made by members. Traditionally, temporary relief has been provided to countries in imminent danger of defaulting by rescheduling 12–18 month slices of officially guaranteed export credits and intergovernmental loans. Debts acquired after the first time a debtor country visits the Paris Club (known as *post-cut-off date* debt) are not eligible for rescheduling. A *moratorium interest rate* is charged on rescheduled principal and interest payments on the basis that it should cover the cost incurred by each creditor agency in refinancing the rescheduled debt.

Paris Club rescheduling agreements are linked to the adoption of IMF programmes by the debtor government for the period in which the rescheduled debts would have fallen due (the *consolidation period*). A multilateral agreement with the Paris Club is followed by bilateral negotiations with each creditor country to agree the implementation of the terms agreed with the Paris Club, the loans to be covered by the agreement and the moratorium interest rate. In some cases the debtor must even negotiate at the creditor agency level. This process can be lengthy and is very demanding on the limited number of SILIC officials experienced in such negotiations. After the consolidation period, if the debtor is again unable to service debt falling due it must return for a new cycle of negotiations.

Figure 1: SILIC long-term public debt stock



Source: *World Debt Tables 1994–95*, World Bank

Box 2: The Multilateral Debt Problem

So far, almost all negotiations about official debt have concerned bilateral credits. The multilateral creditors or international financial institutions (IFIs) (chiefly the World Bank, the IMF and the African Development Bank) have *preferred creditor* status. This entails, first, that their past loans must be serviced if a borrowing government is to be entitled to further credits and, second, that multilateral debt cannot be rescheduled or forgiven. IFI loans have therefore largely been kept off the debt relief agenda. This situation is changing, however.

For one thing, the share of the IFIs in total debt and (especially) debt-servicing has been rising fast: interest payments on long-term debt to multilateral creditors increased by 30% during 1987–93, whilst combined interest and principal payments increased by 60%. These return flows have reduced the IFIs' contribution to SILICs' financing inflows. There was a long period when the IMF was a net recipient of return flows, and net lending by the World Bank is much less than its gross figure ($0.8bn against $2.3bn in 1993).

The relative growth of IFI credits has also put SILICs under greater pressure. At present, eleven SILICs (Burundi, Ghana, Guinea-Bissau, Guyana, Honduras, Mauritiana, Nicaragua, Sao Tomé and Principe, Somalia, Tanzania and Uganda) have debt-servicing commitments to the IFIs equivalent to more than 15% of export earnings, and the same number of countries are in arrears to the IFIs – an almost unknown situation prior to the mid-1980s.

The IFIs' main strategy for dealing with the growing claims of their past credits has been to refinance them on softer terms. The International Development Association concessional window of the World Bank and a special fund in the African Development Bank have provided highly concessional loans. The World Bank ceased non-concessional lending to nearly all low-income countries in the early 1980s. Additionally, for adjusting countries with non-concessional loans still outstanding the World Bank has introduced a so-called 'Fifth Dimension', whereby IDA reflows are used to pay interest due on past non-concessional loans. The IMF also provides concessional assistance, mainly through its Enhanced Structural Adjustment facility (ESAF), funded by voluntary donor contributions. However, the 'especially vigorous' conditionality incorporated in ESAF has limited use of this.

The dawning awareness

Gradually it became evident that this approach was not working and, indeed, was based on a mis-diagnosis. Far from an export-led growing out of debt, SILIC economies deteriorated further. Exports declined further, aggravated by more terms-of-trade deteriorations. These factors and debt-servicing claims imposed an import shortfall (imports fell by 30% in 1980–87), depressing capacity utilisation and investment. The growing budgetary claims of interest payments (swollen by increased indebtedness and currency devaluations) and the IMF's insistence on reduced budget deficits forced governments to cut back on domestic spending. Public investment bore the brunt of this, in turn depressing the profitability of private investment. Economic and social services were also seriously reduced. Even more striking to creditors was the continued rapid growth of the debt stock and servicing obligations. SILIC debt doubled in 1982–87.

Realising the shortcomings of past approaches, creditors began to soften their stances. Bilateral donors wrote off past aid loans on an increasing scale, and a growing number of them (including the UK) adopted the principle of only providing grant aid to SILICs. In 1987 official creditors began to concede 'Special Terms' to low-income countries. With the adoption of the 'Toronto Terms' in 1988 the Paris Club was offering options which not only enabled rescheduling on a long-term basis for remaining debt but – in a crucial breakthrough – also included the option of forgiving part of the debt being rescheduled and extended concessional terms to non-concessional (export credit) debt. The multilateral creditors also began providing relief, chiefly through increased use of 'concessional windows' for low-income countries (Box 2).

Tackling the debt stock

As a result of these initiatives, the growth of long-term SILIC debt slowed, stabilising at around $165bn from 1990. A further breakthrough occurred in 1991 when, under the so-called 'Enhanced Toronto Terms', the possibility of going beyond the traditional short-leash approach to a reduction of debt stocks was envisaged for countries which faithfully execute their IMF and Paris Club agreements for three years. No debtor country has yet reached this point but the form that debt-stock reduction should take was agreed in December 1994 (see Box 3 on the 'Naples Terms'). Even with these advances, however, there is substantial recognition of the need to go further. Most SILIC economies remain depressed and the gap between debt-servicing obligations and actual payments continues to widen, with only 42% of contractual obligations being met in 1993 and accumulated arrears of $56bn.

Analysis of the present situation

Softening creditor responses have brought important changes to SILIC debt situations. In addition to stabilising total debt, one result has been that the shares of debts to other governments and to multilateral creditors have risen (Figure 1), while the share of commercial debt has fallen, to only 15% of the total in 1993. Partly as a result, and as a consequence of reduced access to commercial markets, the average terms of new loans have improved: in 1993 75% of all long-term loan disbursements were at concessional rates, compared with 40% in 1980.

There have also been important changes in the pattern of SILIC debt-servicing payments. In 1993 almost half of payments were made to multilateral creditors, with bilateral creditors receiving just over a third. The large proportion going to multilateral creditors (against their share in total debt of a quarter) reflects their 'preferred creditor' status and the severe penalties incurred by countries which fall into arrears with these agencies (Box 2).

Just how sustainable is the present situation? Debt ratios are a useful short-cut to assessing a country's debt situation. Evidence on the debt overhang is provided by a country's **debt-to-GNP ratio**. For SILICs this has remained at the high average level of 110–120% in recent years (compared with 'only' 42% in severely indebted middle-income countries). Since external debt has to be serviced in foreign exchange, the **debt-to-exports ratio** is a measure of the feasibility of repayment, and for SILICS this ratio has been around 550% since 1987. However, this measure does not capture the degree of concessionality (in terms of grace periods or sub-market interest charges) in the debt stock. The **net present value of debt-to-exports ratio** takes account of the grant element in the debt. Based on past experience, the World Bank has adopted the rule of thumb that ratios above 200% are unlikely to be sustainable, but in 1994 it calculated that *only one SILIC had a ratio below 200%, with the median value being 438%.*

The cash-flow situation is indicated by the **debt-servicing-to-exports ratio** – probably the most important single indicator. In 1993 SILICs spent 18% of their export earnings on debt-service payments (contractual commitments were, of course, much larger). This was significantly lower than in much of the 1980s, when the ratio regularly stood at 25–30%, due largely to increased exports. Because of the widening gap between due and actual payments, however, principal and interest arrears have risen steadily, almost quadrupling over the last five years.

The debt situations of the SILICs can, of course, only be assessed in the context of overall financial flows in and out of these countries. Table 1 shows that net transfers on long-term debt (new loan disbursements minus principal and interest

Table 1 Net Transfers to SILICs ($bn)

	1980	1987	1988	1989	1990	1991	1992	1993
net transfer on long-term Debt	5.4	3.9	6.0	5.2	1.3	-1.0	-1.0	-0.1
net transfer on FDI	-2.7	-0.4	-0.2	1.8	0.4	0.7	0.7	0.7
grants	3.4	6.0	7.7	7.6	10.5	11.2	10.8	10.6
overall net transfers	6.1	9.5	13.5	14.6	12.2	10.9	10.5	11.2

Source: *World Debt Tables 1994–95*, World Bank

payments) declined steeply – from the late 1980s high of $6bn to *an outflow* of $1bn in the early 1990s, returning to approximately zero in 1993. Unlike many other developing countries, SILICs have not benefited from the recent surge in foreign direct investment; net transfers on FDI have remained below $1bn since 1990. Negative transfers were avoided because of much increased grant flows, rising from $3.4bn in 1980 to $10.6bn in 1993. Overall, net transfers therefore remain large, although well below their late-1980s peak.

Box 3: The Enhanced Toronto and Naples Terms

In December 1991 the Paris Club introduced what have become known as its *Enhanced Toronto Terms* (ETT). These are available to SILICs to whom the World Bank will lend only on its soft-window (IDA) terms – a group of countries defined restrictively to limit possible claims. Under the ETT, arrears and payments on pre-cut-off date debt falling due over a 12–18 month period are eligible for restructuring. Aid (official development assistance) loans not forgiven are rescheduled on a very long-term basis. For non-oda (export credit) debt a 'menu' approach is adopted, in recognition of creditors' differing legislative and budgetary constraints. Creditors can choose from three options:

(A) Half of the debt under consideration to be written off, the remainder rescheduled at market rates (23 years maturity including 6 years grace period).

(B) Rescheduling at concessional interest rates so that repayments (in net present value terms) decline by half (repayments over 23 years with no grace period).

(C) Long-term rescheduling without any concessional element (24 years maturity including a 14-year grace period) – an option inserted at the time principally to accommodate the USA.

During the moratorium, the creditor may choose whether to require that interest be paid on both principal and interest payments rescheduled. Under options A and B the repayment profile is 'graduated' – low initial servicing obligations, rising slowly, designed to relate obligations more closely to (perhaps improving) debt-servicing capacities.

An important addition to the above options was the incorporation of a 'goodwill clause' stating that after a period, during which IMF programmes and previous Paris Club agreements must be complied with, the country's remaining debt stock would be considered for reduction. In December 1994 creditors decided the terms under which this commitment would be implemented, with a 'special initiative' labelled the *Naples Terms*.

Under these, countries with per capita income below $500 or a net present value debt-to-export ratio over 350% (i.e. only a few countries) which have remained in compliance with IMF and Paris Club agreements for three years will be granted a 67% reduction in pre-cut-off date debt or debt service. The remaining most indebted poor countries are eligible for a 50% reduction. The Naples Terms are intended to act as an 'exit mechanism' – the debt-stock reductions will be granted on the understanding that the debtor country does not return to the Paris Club for further reschedulings.

Although the effects naturally vary between countries, the evidence suggests that SILICs generally continue to experience severe foreign-exchange constraints. The state of their international reserves provides one indicator of this: having improved somewhat in the immediately preceding years, these dipped sharply in 1992–93, equivalent to an average of under six weeks of imports (compared with nearly 18 weeks for all developing countries). The figures on import volumes also point to severe difficulties: stagnant in 1991–93 at levels below the 1980 figure and with a sharp fall projected for 1994.

Moreover, welcome as it is, the increased volume of grants is no substitute for action on debt, for two reasons. First, if grants are diverted to debt servicing, imports and growth will be retarded. Inflows are necessary to finance the gap between investment (averaging around 18% of GDP) and savings (12%), not to mention the continuing balance-of-payments needs. Even more pressingly in some cases, they are needed to relieve budgetary pressures. Second, there can be no guarantee that grant flows will be sustained and they therefore cannot be relied upon for debt servicing. With evidence of an 'aid crisis' and donor disillusionment with aid to Africa, reliance on grants looks increasingly risky.[2]

In short, while the creditor-donor initiatives of recent years have succeeded in broadly stabilising the SILIC debt situation, and achieving large and rising net financial inflows, they have not succeeded in reducing debt stocks, nor prevented growing arrears. Nor, in most debtor countries, have they been able to engineer the economic recovery needed for any fundamental improvement in debtor foreign-exchange constraints. Some perspective on what has been achieved by debt concessions is provided by the fact that by March 1994 $14bn of debt had been rescheduled under the Enhanced Toronto Terms, achieving $2bn worth of net present value debt reduction, against a present value of debt of the order of $150bn. A solution is even more distant for those who owe a high proportion of their debt to international institutions.

Inevitably, the Naples Terms (Box 3) were a compromise between those who wanted to do more and those wanting to do the minimum. Some creditors accept that the relief currently on offer is inadequate. Of the small number of countries likely to become eligible for the full Naples Terms, it has been estimated that only one could attain a debt-to-export ratio below the World Bank's target of 200%. In practice, the Naples Terms appear likely to provide few debtors with an exit from the debt renegotiation treadmill. It appears that creditors have still to come fully to terms with the chronically limited debt-servicing capabilities of most SILICs. What, in that case, are the options for further relief?

Options for further debt relief

In considering possible lines of action, official bilateral debt and multilateral debt are best considered separately.

Taking **bilateral debt** first, the possibilities include:

- *Increasing the percentage of debt reduction* available on non-concessional debt from the Naples maximum of 67%.

2. See 'Aid in Transition'. ODI *Briefing Paper*, 1994(4), November.

Some creditors have talked of going to 80% in deserving cases; others have even accepted the principle of debt forgiveness, with the greatest reluctance.

- *Widening the types of debt eligible*, by bringing in post-cut-off date debt (see Box 1).
- *Widening the rules governing the eligibility of countries for the most favourable treatment.* At present a number of poor and seriously indebted countries are excluded.
- *Dealing with the accumulating arrears to non-Paris Club creditors*, through debt buy-backs, following the example of commercial debt deals, or by offering non-Paris Club creditors equivalent relief on their own debts in return for writing off their SILIC loans.
- *Widening the scope of Paris Club negotiations* by finding ways of bringing non-Paris Club creditors within collective negotiations or of securing their agreement to provide debt reductions comparable with those agreed by the Paris Club.
- *Reducing the costliness to debtors of institutional arrangements.* Ideas here include suggestions for simplifying the negotiation of the bilateral agreements which follow a Paris Club agreement; and shifting the forum for debt discussions to donor meetings which can take a comprehensive view of a country's need for financial assistance, including aid and debt relief.
- *Marketising official debt.* Bilateral debt could be auctioned to private investors, who could swap these assets for equity claims in debtor countries, although the process would be limited by the availability of investment opportunities.

The recent 'Naples' decision on debt-stock reduction – an agreement achieved only with great difficulty – reduces the probability of additional concessions in the near term. Things will have to get worse before they can be made better. The suggested institutional reforms appear particularly unlikely for the foreseeable future.

What now of **multilateral debt?** The options can be simplified to three: (a) no change – continuing to refinance past loans on more concessional terms, subsidised from bilateral resources and augmented by special bilateral assistance for difficult cases; (b) as for (a) but with greater use by the principal multilateral creditors (the IMF and World Bank) of their own resources to subsidise refinancing;
(c) abandonment of the 'preferred creditor' status of the multilateral creditors, making their past loans eligible for rescheduling or writing off.

The *no change* option is that preferred by the multilateral creditors (who have tried hard to keep multilateral debt off the agenda) and is the most likely in the near term. However, this position threatens to become unsustainable. Its weakness is that it makes substantial and escalating claims on bilateral resources intended for developmental or humanitarian purposes and which, in several donor countries, are being cut. *Abandonment of preferred creditor status*, although recently proposed in a report by British Parliamentarians[3] and widely urged outside official circles, appears unlikely, since it is fiercely resisted by the institutions themselves, who have the support of major shareholder governments in this.

If change comes, it is most likely to involve *greater use of the institutions' own resources* to subsidise refinancings: some utilisation of the IMF's gold stocks (notionally valued at \$35–40bn) and the World Bank's prudential reserves (around \$20bn). Some slight movement in this direction might be discerned from a recent decision that the Fund should contribute from its own resources to subsidisation of the interest rate on its ESAF credits. Another straw in the wind was a recent proposal by UK Chancellor of the Exchequer Kenneth Clarke that the IMF should sell 10% of its gold stock, invest the proceeds and use the profits generated to subsidise the refinancing of past credits on a longer-term basis. The immediate prospects for this proposal have been prejudiced by the large claims that the recent Mexican rescue package have made on the IMF's liquidity, but more of this type of thinking is likely to surface in future.

3. All Party Parliamentary Group on Overseas Development, *Africa's Multilateral Debt: A Modest Proposal* (London: ODI, 1994).

How much economic benefit from debt relief?

It is important not to exaggerate what further debt relief might do for SILIC economies. To a substantial extent, further concessions would simply be recognising the existing situation, that many bilateral debts are not being serviced, rather than providing new resources. Even now, actual service payments are equivalent to only a little over a third of gross inflows of new capital and under a fifth of export earnings.

That the more binding constraints on SILIC development lie elsewhere is suggested by the fact that they have long been able to borrow on favourable terms and yet have been unable to avoid debt defaults. For example, even in 1980 new loans to SILICs were at an average interest rate of under 6% and with a maturity period of 19 years (the comparable averages for middle-income borrowers were 10½% and 12½ years). Creditors argue, therefore, that the more fundamental tasks are to improve SILICs' investment productivity and export performance. An improved policy environment, they argue, is a necessary condition for better economic performance in many SILICs, hence creditor linkage of relief to adjustment programmes, and on a country-by-country basis. On this view, greater debt relief can provide important backing for governments seeking to tackle their countries' basic economic problems, but on its own is unlikely to achieve much.

However, to the extent that debt relief resulted in reduced actual debt-service payments and represented 'new money', i.e. was not offset by reduced aid flows, there would be some immediate balance-of-payments relief. Debtors' often critical fiscal difficulties would also be reduced. The foreign exchange freed could be used to increase imports, helping to raise production and investment at home. Diminishing the level of debt would help normalise trade relations, with a reduction in the risk premium paid for imports. It would also help build investor confidence because, with more of the benefits of policy reforms accruing at home rather than to creditors, commitment to – and the credibility of – reform programmes might be increased.

If sufficient relief were provided, particularly if the debt stock were adequately addressed, this would provide debtor governments with the prospect of graduation from the onerous Paris Club rescheduling cycle. This is what the Naples Terms are supposed to do, but these terms may prove too restrictive to have much effect. A release of professional manpower, presently locked up in protracted negotiations, should help create a stronger policy-making capability.

Conclusion

Although creditors have provided increasingly concessional terms for the poorest indebted countries, they have not fully come to terms with the limited debt-servicing capabilities of SILICs. The latest Naples Terms have been designed to facilitate final debt-stock reduction but these do not go far enough to provide the desired exits from the rescheduling process. There is still a need for greater debt relief on a case-by-case basis.

However, it is not a panacea for poor indebted countries. Reductions in outstanding claims would release resources and improve the investment climate. But it is domestic policy which in the end holds the key to their future prospects.

For further information please contact Tony Killick at ODI