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Re-examining sovereign debt: Forgiveness and innovation

A sense of complacency about the challenges of managing sovereign debt may have set in

Key points

- While debt trends currently look sustainable, they are vulnerable to downturns in the international economy and increased volatility.
- Relatively little has been done to improve the international architecture of debt and to ensure that all developing countries have adequate and sustainable access to debt financing for development.
- The objective of change and innovation should be to ensure developing countries can utilise debt financing for their development objectives in a sustainable way.

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Debt for many low income countries has been written down, and interest rates for middle income countries are at all time lows. While on a number of metrics developing countries' sovereign debt positions look healthier than any time since the 1970s, current trends are contingent on high global economic growth and liquidity. A sense of complacency about the challenges of managing sovereign debt may have set in. This is risky, and there is much work to be done to improve conditions for all borrowers to ensure sustainable debt financing for development. This Briefing Paper highlights trends in sovereign borrowing and discusses remaining institutional weaknesses of the sovereign debt regime that require attention.

Senegal: the country's debt has been rescheduled 14 times.

Recent trends in sovereign borrowing

On average, metrics such as total debt/exports and average interest rates have improved in both low and middle income counties since the 1990s (see Table 1 and Box 1 for background information). Debt as a percentage of GNI (Gross National Income) in middle income countries has been reduced slightly after a peak during the financial crises of the 1990s, and has decreased substantially in low income countries due in no small part to debt forgiveness initiatives such as Highly Indebted Poor Countries (HIPC). This trend will be reinforced by the Multilateral Debt Relief Initiative (MDRI), which was agreed at the 2005 G8 summit in Gleneagles.

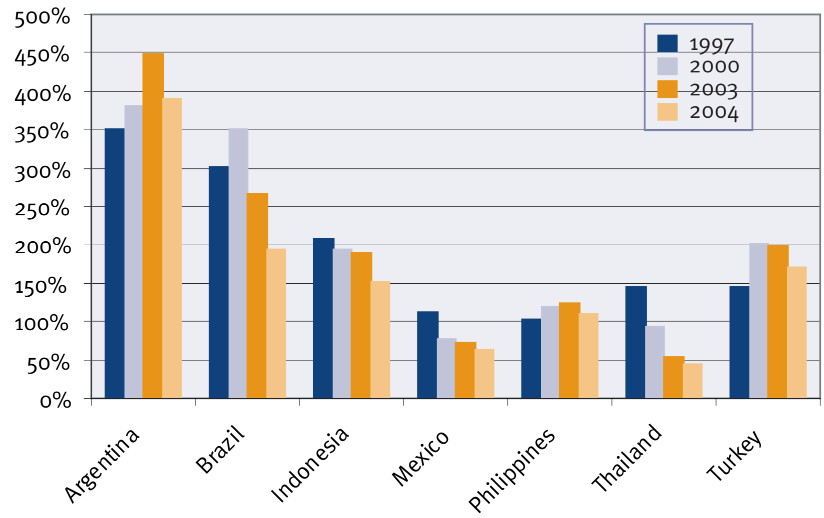
Average data, as the World Bank has argued in its 2005 Global Development Finance report,

Table 1: Evolution of debt profile and sustainability metrics

	1996	1998	2000	2002	2004
Low Income					
Average interest (%)	3.7	3.0	3.5	2.4	1.8
Total debt/Exports (%)	267.8	258.9	188.9	171.5	123.4
Total debt/GNI (%)	53.2	51.1	44.8	41.4	35.6
Middle Income					
Average interest (%)	6.8	7.1	7.5	5.6	4.8
Total debt / Exports (%)	128.5	143.0	113.8	110.0	84.2
Total debt / GNI (%)	35.0	40.6	38.5	38.2	33.6

Source: Global Development Finance, World Bank

Figure 1: Total debt to exports for selected middle income countries



Source: Global Development Finance, World Bank

hide risks especially for some of the largest middle income countries whose performance impacts financial markets globally. Figure 1 shows that while the debt/export ratio for some of the largest issuers has improved, Argentina, the Philippines and Turkey represent major exceptions. Similarly, a trend towards declining debt/GNI ratios is driven by a few countries whereas Argentina, Brazil, the Philippines and Turkey have seen these ratios increase (see Figure 2).

Additionally, ratios involving total debt hide the recent growth in domestic debt, which has been facilitated by the expansion of domestic bond markets. Domestic debt for all developing countries rose from 19% of GDP in 1993 to 34% in 2002, and brought some advantages: risks stemming from currency devaluation are reduced, for example. But domestic bonds present new challenges in terms of regulatory risk and, as many have been purchased by international investors, may be as volatile as international bonds. There is also a risk that the availability of domestic bonds will prevent governments from addressing underlying fiscal problems.

Is institutional change necessary?

The positive trends in sovereign debt metrics are contingent on international conditions such as high commodity prices, strong growth, low international interest rates and sustained commitment to debt reduction as a form of official development assistance. A reversal in any of these trends could quickly change this, as increasing financial market volatility this year has already started to do, and highlight remaining institutional weaknesses in the debt regime.

Multilateral and bilateral debt

While debt forgiveness has become an important source of resource transfer in the past ten years, HIPC has not brought the expected benefits. A 2006 evaluation by the World Bank's Independent Evaluation Group (an update of a similar evaluation undertaken in 2003) found that debt sustainability metrics (net present value of debt/exports, debt/revenue and debt service/exports) for 11 of 13 HIPC countries have deteriorated significantly since their debt was forgiven. In eight countries, these metrics exceed HIPC debt sustainability thresholds again. And, of the eight countries that have reached HIPC completion point more recently, six are at risk of slipping back into unsustainable debt levels.

Part of the reason for this is that metrics for measuring and ensuring debt sustainability are relatively primitive. As noted above, debt is judged to be unsustainable when it rises over a certain debt/revenue and debt/export level. But nothing prevents newly creditworthy HIPC countries from contracting new debt from private sources after completion, frequently at high interest rates given their lack of private borrowing history. In periods of high international liquidity, like the present, accessing this finance is easier. Thus, while the HIPC initiative addresses stocks of existing debt, it is not useful for controlling flows of debt. HIPC also faces challenges in matching goals and outcomes. The link between debt forgiveness and poverty reduction is complex: money previously used for debt service might be used by a government for social programmes, to stimulate growth or for other spending that has the potential to reduce poverty, but poverty reduction is not an 'assured' outcome of debt relief, even when taken in coordination with a poverty reduction strat-

Box 1: Debt concepts and categories

Sovereign borrowing can be divided into credit provided by public and private entities. Each category then has a further set of subdivisions. Within public debt, there is state-to-state lending (bilateral) and credit provided by multilateral institutions such as the IMF, the World Bank and other development finance institutions (multilateral). Within the private debt regime, there are loans offered by large commercial banks, and sovereign bonds, which are underwritten by banks and traded on international capital markets.

Sovereign debt default or 'distress' (difficulty in making payments) in the case of bank loans and bilateral loans is managed by ad hoc organisations (the London Club and Paris Club, respectively) whereas multilateral debt distress is organised exclusively for the poorest countries under the HIPC initiative and, more recently, the MDRI. The least institutionalised setting is that which is in place for sovereign bonds, where distress and default are settled via a market mechanism rather than through an institutionalised process.

Low income countries tend to borrow heavily from public sources, as they are generally not perceived to be creditworthy enough to access private credit and international capital markets. By contrast, middle income countries raise a significant portion of their debt privately – a trend reinforced by their inability to borrow publicly on concessional terms. However, the distribution of borrowing has changed over time. For low income countries the big change has been from bilateral to multilateral borrowing. Bilateral debt has decreased from 50% of all debt in 1990 to 34% today, while multilateral debt has increased from 27% to 42% for the same period. This means that debt managed by the IMF and World Bank has become more important than debt covered by the Paris Club. The middle income countries have also seen a large shift towards sovereign bonds, which grew from 12% of financing in 1990 to 34% today – complicating the organisation of restructurings and defaults.

egy paper (PRSP) or other national development programmes.

MDRI is planned to be granted under the architecture of HIPC, thereby mimicking the problems stated above. MDRI will also create pressure to extend debt forgiveness to new countries, many of whom are poor and heavily indebted but have not yet qualified for HIPC write downs because their governments do not meet governance and economic performance criteria. Either MDRI will be given to these countries despite remaining weaknesses, creating the risk that these countries will reverse the gains from debt forgiveness by borrowing irresponsibly in the future (moral hazard), or it will not be nearly as far reaching as G8 governments have pledged.

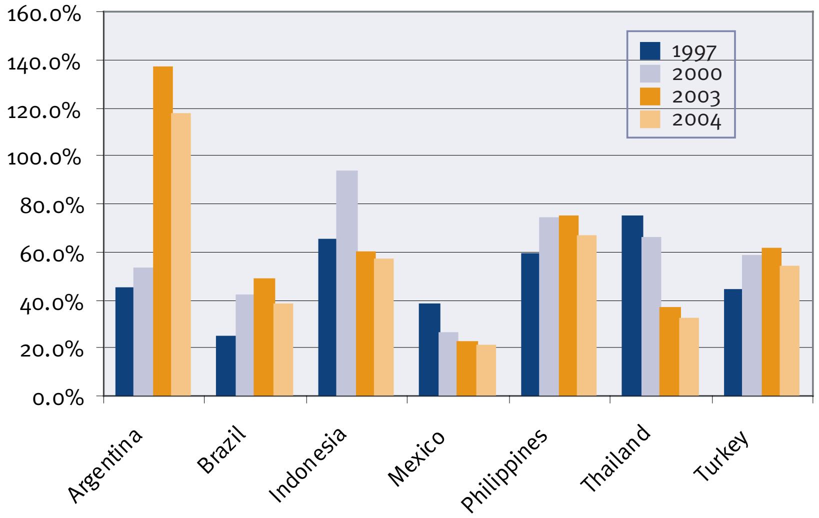
Forgiveness of Paris Club bilateral debts faces challenges. There have been calls for it to be more transparent, less politicised, and to use a different or more sophisticated set of metrics to gauge sustainability. The terms of Paris Club lending and restructuring are strongly influenced by political relations between debtors and creditors – the largest recent write down was for Iraq, for example. Another major problem for the Paris Club is distinguishing between crises of liquidity and those of solvency, resulting in 'serial rescheduling' by some borrowers. Many African as well as Latin American and Asian nations have had their debt burdens treated repeatedly. Senegal's debt has been rescheduled 14 times; Argentina, Bolivia and Ecuador have had Paris Club debt rescheduled eight times. Paris Club write downs in the past have also been a way of motivating more debt service capacity to borrow and meet the expense of servicing multilateral debt.

Private debt

The serious problem of lack of institutionalised mechanisms to organise private debt defaults and restructurings has been set aside since the IMF's proposed sovereign debt restructuring mechanism (SDRM), a proposed legal mechanism for sovereign debt, was rejected by creditors and debtors alike in 2003. Suggestions since that time by large borrowers such as Brazil and Mexico to generate rules of best practice for default and restructuring have not attracted interest.

The increased use of 'collective action clauses' (CACs), which were seen as an alternative to the SDRM, falls short of addressing institutional weaknesses. CACs allow a specified percentage of investors, generally a super-majority (e.g. 75%), to agree to restructuring terms in the event of default or distress. Without such clauses, all bond holders have the right to block agreement, which creates incentives for some investors to 'hold-out' for a better deal. While allowing a super-majority to determine terms for a single bond in distress is an advantage, CACs do not allow for creditors to act collectively if they are holding different or multiple bonds (i.e. CACs do not help achieve sovereign bond 'aggregation').

Figure 2: Total debt to GNI for selected middle income countries



Source: Global Development Finance, World Bank

Innovations in sovereign borrowing

The picture is not entirely bleak, however. Some modest attempts to improve debt architecture have occurred. In October 2003, the Paris Club pledged to undertake 'a more tailored response' to debt restructurings (the 'Evian Approach'). The approach stresses a commitment to assess long term debt sustainability. However, Paris Club debt forgiveness is still highly politicised.

The most substantial innovation is occurring in private debt: and a host of new instruments have arisen to reduce payment risk for borrowers:

- Countries such as Colombia and Brazil have been able to issue international debt in their own currencies, helping to moderate the risks of currency devaluation.
- Argentina linked the value of its restructured bonds in 2005 to GDP growth through a GDP warrant. The idea of indexing sovereign debt repayments to GDP growth has been around since the early 1990s, and could help countries adjust to cyclical downturns. Interest payments are reduced when GDP growth declines beneath an agreed 'trend line'. Investors receive a premium when growth is above this trend, giving them exposure to an 'equity like' instrument. The bonds might also act as a public good by reducing default probability and contagion. Widespread issuance of such bonds, however, is still some way off. Markets are unsure how to price GDP-linked bonds – thus, GDP-linked bonds issued by highly creditworthy countries (e.g. OECD economies) would be useful to help set market prices.
- There has also been a resurgent interest in commodity-linked bonds, and more specifically, bonds linked to global oil prices. Research has demonstrated that structuring bonds which are issued by oil exporters for purchase exclu-

sively by oil importers creates a 'natural hedge'. Interest rates on the bond would increase when oil prices are high and decrease when prices are low. Importers of oil (e.g. India) benefit from an increased revenue stream from their investment at times when they most need it to maintain purchases, and exporters (e.g. Trinidad and Tobago) pay less interest when their key export has less value, reducing the burden of debt servicing. Widespread issuance of these bonds is complicated by a mismatch in supply and demand: exporters flush with cash when prices are high are not looking to issue debt, for example. There are also potential political implications for governments who agree to pay more interest when oil prices are high. Threshold levels have to be set carefully to minimise this problem.

- Argentina and Ecuador, who have faced difficulty issuing debt on the capital markets since their defaults, have issued bonds exclusively for the Venezuelan government. To date, Venezuela has purchased US$3.2 billion worth of Argentine debt, which they have then sold on to Venezuelan banks, and again onwards to international investors, generating profits of some US$200 million.
- In July 2006, Venezuela and Argentina announced that they plan to issue US$2 billion worth of 'joint' sovereign bonds. Argentina would benefit from the lower interest rates Venezuela pays, and Venezuela benefits politically as the bond moves towards regional financial integration. Uniquely, the risk premiums on such bonds would probably be priced based on the difficult to quantify political relationship between the two countries, rather than on individual sovereign risk.

The ideas listed above face challenges in being implemented more widely. Pricing these instruments is a significant challenge for markets, which decreases their desirability. And while new instruments would make it easier for developing country governments to borrow on 'safe' or 'favourable' terms, the architecture to address default and distress is still missing.

Remaining agenda for reform

While debt trends currently look sustainable, they are vulnerable to downturns in the international economy and increased volatility. Improvements in the debt regime have largely come from the efforts of developing country governments to increase the sustainability of their debt profiles and take advantage of market innovations. Relatively little has been done to improve the international architecture of debt and ensure that all developing countries have adequate and sustainable access to debt financing for development.

The remaining agenda is substantial. First, it is worth asking what the MDRI is expected to accomplish so that it is not billed as a panacea for reaching a broad set of development goals. Some agreement on how long term sustainability could be measured is also needed. This accomplishment would also be beneficial for bilateral debt. A related challenge is to ensure that governments benefiting from debt reductions have sufficient debt management capacity to borrow sensibly in the future. There is a risk of becoming over-indebted again quickly – a particular challenge given the rise of 'emerging' lenders (e.g. China, India and Brazil).

Second, there are calls for a renewed dialogue on the organisation of the private debt regime. Given the failure of the SDRM, this discussion is likely to be better achieved if initiated by debtors, with input from creditors, rather than being led by the IMF. An interesting starting point for discussion is whether the current market mechanism is perceived to be sufficient, particularly given the outcomes of the Argentine restructuring, in which creditors took significant losses. Even without a complete change to the sovereign debt architecture, there are ways to improve the market process, for example by making it easier for debtors to share sensitive information about debt repayment capacity during negotiations without suffering losses.

Third, in order to help countries benefit from recent financial market innovations such as GDP-indexed bonds and given their public goods nature, there may be a case for international organisations to promote their development, by underwriting them or helping to price them in the first instance.

The overarching objective of any changes and innovations is to ensure that both low and middle income developing countries can utilise debt financing for their development objectives in a sustainable way. Innovations in extending credit, reducing repayment risk and minimising the costs of restructuring and default are likely to be better if informed by this goal.

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