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Finding solutions to the
debt problems of developing
countries

**Report of the Executive Committee on Economic
and Social Affairs of the United Nations**

(New York, 20 May 1999)



NACIONES UNIDAS



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Explanatory note

The establishment of the Executive Committees to coordinate the work of the United Nations entities working in related areas was an important component of the reform process launched by the Secretary-General in early 1997. The purpose behind this was to secure greater effectiveness and coherence and thereby to enhance the usefulness of the Secretariat for the international community.

This report, “Finding solutions to the debt problems of developing countries”, is the product of a collaborative and coordinated effort of the Executive Committee on Economic and Social Affairs¹ and presents a collective position of the United Nations Secretariat in the economic, social and related fields on one of the most pressing issues of the day. The report was brought to fruition by means of a Task Force created by the Committee and led by the United Nations Conference on Trade and Development (UNCTAD). The report is the second in a series of policy oriented reports the Executive Committee intends to produce over the coming months. The Committee’s first report, “Towards a new international financial architecture”, was issued on 21 January 1999. Future reports will, among others, address such issues as finance for development and social dimensions of macro-economic policy.

¹ The membership of the Committee comprises: Department of Economic and Social Affairs (DESA), Economic Commission for Europe (ECE), Economic and Social Commission for Asia and the Pacific (ESCAP), Economic Commission for Latin America and the Caribbean (ECLAC), Economic Commission for Africa (ECA), Economic and Social Commission for Western Asia (ESCWA), United Nations Conference on Trade and Development (UNCTAD), United Nations Environment Programme (UNEP), United Nations Centre for Human Settlements (HABITAT), United Nations Office for Drug Control and Crime Prevention (ODCCP), United Nations High Commissioner for Human Rights (OHCHR), United Nations Development Programme (UNDP), United Nations University (UNU), International Research and Training Institute for the Advancement of Women (INSTRAW), United Nations Institute for Training and Research (UNITAR), and United Nations Research Institute for Social Development (UNRISD).

I. Introduction

On the eve of the new millennium, a refreshing urgency is inspiring the search for lasting solutions to the debt problems of developing countries, especially the poorest of them. The United Nations, as a universal organization, includes in its membership debtor and creditor countries alike. As stated in Article 1 of the Charter, among the four main purposes of the United Nations is the achievement of international co-operation in solving international problems of an economic, social, cultural, or humanitarian character, and in promoting and encouraging respect for human rights and fundamental freedoms for all. An orderly, dynamic and balanced development of the world economy is therefore a prime concern and responsibility of the United Nations system, including all its component departments, agencies, programmes and funds.

One problem that has been the focus of much attention and contention over the years, with serious implications for the enjoyment of human rights, is that of foreign debt. The debt ‘hangover’ of many developing countries, and particularly of the heavily indebted poor countries (HIPCs), has not been resolved, despite important and significant measures and initiatives adopted by creditors at the national or multilateral levels. ‘Policies of adjustment’ and efforts to integrate HIPCs into the ‘global economy’ should be based on an examination of this phenomenon as it relates to other development priorities. A United Nations system that shares a common understanding on the problem, and agrees on a set of coherent policy responses from a wider development perspective, can complement the key role played by the Bretton Woods institutions on the debt issue. It can thereby be of service to creditor and debtor nations alike.

II. Current debt situation of developing countries and countries in transition

The nature of the debt problems of developing countries may vary from acute balance-of-payments difficulties requiring immediate action to longer-term situations relating to structural, financial and transfer-of-resources problems requiring appropriate longer-term measures. There are also cases where both types of difficulties are present.

The situations described above are also referred to as instances of illiquidity and insolvency. A liquidity problem may arise because of a bunching of debt obligations at a particular time, which cannot be fully serviced as the debtor may experience a shortfall in revenues. The debt can be repaid in full if either recourse to external funding is available on a temporary basis, or if the debt is restructured in terms of the stream of debt obligations so that they better match the debtor's flow of revenues. In the case of insolvency, however, the incapacity of the debtor to pay in full his debt obligations is not due to a temporary shortfall of his revenues, but result from a more structural problem of raising enough revenue in the long term to service his debt. Problems of insolvency cannot be tackled simply by re-scheduling debt, but may require a reduction of debt obligations to match the long-term capacity of the debtor to raise revenue. In practice, the distinction between illiquidity and insolvency problems is not easy to make. This is because it is often difficult to determine whether incapacity to pay is temporary or permanent. The future is difficult to predict, and sometimes problems of illiquidity can turn into insolvency, if they are not tackled in time.

The external debt situation of the developing countries today remains a source of serious concern. The problems of the heavily indebted poor countries (HIPCs),² which are structurally rooted, are far from being resolved, while other poor countries are also facing a mounting debt burden as a result of worsening global economic conditions. The dramatic situations of countries affected by war and natural disasters require urgent assistance that should include significant debt relief. A number of middle-income countries in East Asia have overcome a first phase of an acute balance-of-payments crisis, but still have to resolve their debt problems. Other middle-income countries are encountering serious payments problems, as a result of the contagious spreading of the Asian crisis and of the debt default of Russia.

The situation has dramatically worsened since the beginning of the 1990s. It then looked as if most middle-income countries were well on their way to graduating from the periodic re-scheduling of their debt, while the HIPCs and other low-income countries could reasonably expect to clear their debt overhang problems, with additional relief from both bilateral and multilateral creditors. Not only has the expected debt relief for the HIPCs been slow to come, but the recent decline in commodity prices is now affecting the export growth prospects of many HIPCs and other commodity-dependent countries, both among the low-income and middle-income countries. If commodity prices remain depressed for several years, as predicted by the World Bank, and/or exports fail to grow in volume, the debt servicing capacity of these countries would deteriorate further over the medium term. Already, some countries affected by adverse developments in the external environment have been forced to reschedule their debts, particularly with the Paris Club.

Beyond the immediate task of reducing the excessive debt burden of developing countries, thought should be given to the adoption of preventive measures to avoid unsustainable public and private debt in the future. Those measures should perhaps be aiming at ensuring responsible lending and borrowing behaviour, notably through increasing the accountability and transparency of borrowing and lending activities undertaken by public and private economic agents. The debt management capacity in debtor countries should also be strengthened.

A. Debt of low-income countries

The debt problem of low-income countries has dragged on for more than a decade. This is despite the progressive improvement of debt rescheduling terms. The seriousness of this problem was recognized by the official creditor community in 1987, when the Paris Club decided to apply for the first time more concessional rescheduling terms to the low-income debtor countries in Africa (the so-called Venice terms). The concessionality of rescheduling terms has increased several times in subsequent years. The Toronto terms were introduced in 1989 (33% debt reduction), the London terms in 1991 (50% debt reduction), the Naples terms in 1994 (67% debt reduction) and recently the Lyons terms in 1998 (80% debt reduction) for some of the HIPCs. In 1996, the HIPC Initiative was launched, with a view to providing a framework for multilateral debt relief.

In 1997, when exports of HIPCs were at their highest level over the period 1990-1997, their nominal debt-to-exports remained high at close to 300%, while at the same time their arrears on debt payments totalled \$ 70 billion. Excluding arrears, the nominal debt-to-exports ratio reached 200%, and the ratio of paid debt service-to-exports was equivalent to 13%. The estimated percentage of debt service paid to scheduled debt service (i.e. the sum of paid debt service and arrears) was only 13%. Total debt stocks amounted to \$ 227 billion, of which 26% was multilateral debt.

² The term "heavily indebted countries" is used here in the more generic sense, and does not refer specifically to the group of forty-one countries included in the list defined by the IMF and the World Bank as potential beneficiaries of their debt relief initiative.

The debt overhang of the HIPCs is, thus, far from being lifted. A parallel can be made here with the debt crisis of the 1980s of the middle-income countries: after 7 years (from 1982 to 1989) the Brady plan helped to put an end to the debt problems by providing a significant debt relief. To date, the beneficial impact of the HIPC initiative on the debt overhang of these countries remains limited. Twelve HIPCs had their cases reviewed under the initiative. The debts of two of them had been deemed sustainable and hence not qualifying for further relief after the conclusion of exit agreements on standard Naples terms with the Paris Club. Two other HIPC countries reached the completion point (when multilateral debt relief proper starts to be delivered) in 1998, and three more were scheduled for 1999. So far, reduction in debt stocks and debt service obligations has been relatively small. It should be noted in passing that the debts owed by some HIPCs to the former USSR have been significantly reduced, as the Russian Federation has reduced debts up to 90%.

The servicing of debt absorbs budgetary and foreign exchange resources, and in the absence of any benefits accruing from the investment of the original loan, will have a net negative effect on a government's ability to fund its social expenditure programmes. In this situation, government spending on health, education and social services will be reduced. If these services are efficiently organized, reduced expenditure on them will have an adverse social impact. It may also interfere with the promotion and protection of human rights. According to Article 22 of the Universal Declaration of Human Rights, every one is 'entitled to realization, through national effort and international co-operation, and in accordance with the organization and resources of each state, of the economic, social and cultural rights indispensable for his dignity...'. It is therefore of critical importance that debt servicing requirements not be permitted to detract funds from necessary spending in areas relevant for sustainable human development and for the promotion and protection of human rights, as defined in the principal human rights treaties. In poor indebted countries, this condition is often not fulfilled. Furthermore, for debtor countries which rely on one or a few agricultural or mineral exports, a high level of debt service will tend to accentuate monoculture-based agriculture and increase the rate of depletion of national resources beyond the limits of sustainability.

Debt relief is also needed by poor countries in a post-conflict situation to bring support to their economic recovery after prolonged periods of war or severe civil strife. A group of eleven HIPCs in sub-Saharan Africa³ —all but one Least Developed Countries (LDCs) — has been identified as having exceptional needs for post-conflict economic rehabilitation assistance. For these countries, measures beyond the HIPC framework may be required, including new approaches for providing early assistance and lending into or providing assistance under arrears. The countries struck by natural disasters in Central America in late 1998 also require special "post-catastrophe" relief, in a situation where the necessity of reconstruction must take precedence over external debt-servicing obligations. Moreover, in view of the recent changes in the world economic climate, the cases of the LDCs which carry a relatively heavy debt burden but which have not been included in the HIPC category —about six countries⁴— also deserve consideration for an alleviation of their debt burden.

³ These countries are: Angola, Burundi, Central African Republic, Chad, Democratic Republic of Congo, Republic of Congo, Liberia, Rwanda, Sierra Leone, Somalia and Sudan.

⁴ Afghanistan, Bangladesh, Cambodia, Comoros, Gambia, Haiti and Malawi have been classified as severely or moderately indebted by the World Bank, but were not included in the original list of HIPCs. Malawi has recently been included as HIPC by the Bretton Woods institutions.

B. Debt of middle-income countries

For the middle-income countries that have access to international capital markets, debt problems have also assumed dramatic dimensions. The causes of the debt crises share some similarities, as well as some notable differences. In some countries, like those in East Asia, the debt crisis found its origin in a too rapid external liberalization of the financial sector. In others, such as the Russian Federation and Brazil, the debt problems resulted mainly from the difficulties of raising government revenues sufficiently to reduce the large government budget deficits. One notable feature of the new international financial context is the high speed of contagion of crisis from one country to another. This has further diminished the policy autonomy of debtor countries and required drastic adjustment measures, including sudden large rises in interest rates and overshooting of exchange rate depreciations.

The debt problems of Asian countries affected by the recent crisis share some common characteristics. To a large extent, private sector corporations and banks contracted the new external debt. Rapid financial market and capital account liberalization during the 1990s made possible large-scale private sector external borrowing, and during the year directly preceding the crisis a large exposure to short-term bank borrowing was built up due to lower interest rates on foreign borrowing than on domestic loans. Weakness in the banking system had contributed to a misallocation of credit and to the build up of an asset bubble in the property sector, given the fast rate of credit growth in the financial system. A slowing down of exports and an appreciation of their currencies that were pegged to the US dollar triggered a speculative attack on their currencies. The inability to support the exchange rates led to the floating of their currencies and the withdrawal en masse of external financing, creating liquidity crises which were first addressed by huge bail-out packages mobilized by the IMF and some donor countries to avoid defaults by debtor countries. Debt re-structuring with foreign banks occurred at a later stage, and for some countries this process was much delayed and the problems of shortage of trade finance was not addressed in time to avoid a serious recession.

The social impact of these crises has been huge. In Indonesia, its large population and relatively low per capita income level has led to especially dramatic deterioration in living standards and ignited serious social disorder. In the three most affected countries, Indonesia, Thailand and the Republic of Korea, the rate of unemployment has swelled alarmingly. Clearly, in such circumstances, many human rights are infringed. Rights enshrined in the International Covenant on Economic, Social and Cultural Rights include the right to work, the right to an adequate standard of living and the right to health and education. Other rights are designed to protect children, women and disadvantaged groups. It has become more difficult to ensure that such rights are complied with in countries badly affected by the recent financial crisis.

In the Republic of Korea and Thailand, macroeconomic stability has been largely re-established, with exchange rates and interest rates falling to more sustainable levels. Positive economic growth should resume in 1999. In these countries, debt restructuring at the firm level remains a pressing challenge that must be addressed before sustainable broad-based growth can resume. In the case of Indonesia, macroeconomic stabilization remains incomplete and economic recovery is still out of reach, in addition to which the firm-level debt problem must be resolved. For Indonesia, the debt problem was deeper to begin with and its restructuring was also addressed at a later date than in the former cases. In all three countries, the debt problem is clearly placed in the private sector, distributed between the banking and corporate sectors in varying proportions. The classic transfer of private debt onto the public sector balance sheet has occurred in all three cases, as the government has been forced to issue debt in order to restructure the banking system. The

estimated cost of banking sector restructuring to the governments of these three countries will be substantial, potentially exceeding 10% of GDP.

In the case of the Russian Federation, fiscal management has remained a central problem since the start of the transition to a market economy. The narrow tax base, characterized by a heavy reliance upon commodity exports (especially oil and gas) for tax revenue, has not generated sufficient tax revenue to meet expenditures. This imbalance has led to a large cumulative financing gap, which has been met through the issuance of domestic bonds by the Ministry of Finance (GKOs and OFZs). In the aftermath of the crisis in Asia, lower world prices for oil and other commodities negatively impacted both Russia's export performance and fiscal balance. It became difficult to market rouble-denominated debt, so in 1998 the Government tapped the Eurobond market at increasingly high rates of interest. Higher interest rates due to monetary tightening under an IMF structural adjustment program accentuated the domestic debt burden. By August 1998 the Government could not meet maturing domestic debt payments and announced a 90-day moratorium on payment of various debt obligations. The devaluation and default on domestic debt has devastated the already weak domestic banking sector, which had invested heavily in government debt.

The Russian debt default had a tremendously destabilizing effect upon international capital markets and Brazil and other emerging markets soon came under pressure. Brazil experienced towards the end of August 1998 massive foreign exchange outflows, which were stemmed by sharp increases in interest rates. By September 1998, access by emerging market borrowers to capital markets became even more restricted and costly.

Brazil, like the Russian Federation, suffers from a longstanding fiscal imbalance. The cumulative federal financing gap has been met by domestic debt issuance (much of the debt being short-term and on variable rate). Despite the signing of a three-year stand-by agreement with the IMF in November 1998, the government was forced to float the real in January 1999. Brazil is also reported to have won an informal agreement from a group of foreign bank creditors to roll over their short-term credit to Brazil around the time that the support package was agreed. Unlike the Russian Federation, Brazil has not been cut off from the international capital markets and has successfully launched an international sovereign bond issue. Also, the Brazilian banking system is in a much healthier state than in Russia.

In addition to the debt crises faced by these five countries, the two rounds of crises (East Asian and Russian) have significantly disrupted economic activity in a large number of developing countries. This has occurred mainly through the decline in international commodity prices, along with the reduction in external financial flows and higher cost of external credit since late 1997. This was the case of many countries in Latin America, such as Venezuela, Chile and Ecuador. The latter has been particularly hit, as foreign exchange crisis has been compounded by the emergence of a banking sector crisis.

III. Policy advocacy

When advocating policy changes, it is necessary to be highly selective, if the policy messages are to achieve significant attention. The following issues deserve special attention, although they are not the only important policy issues in connection with debt.

A. HIPC initiative

The HIPC initiative launched in 1996 was a major step towards addressing the debt problems of the poorest countries in a comprehensive way, and towards finding a lasting solution to their debt overhang. The HIPC process was always envisaged to take six years to complete. So it is hardly surprising that as yet only three countries (Uganda, Bolivia, and Guyana) have benefited from the exit debt relief at the completion point.

It is a matter of concern that the implementation process of the HIPC initiative is very slow. The slowness of the process seems to be due to two principal factors:

- The complexity of the process itself, based as it is on the implementation of two ESAF programmes and on eligibility conditions determined by a country-specific debt sustainability analysis;
- The lack of adequate funding for an expeditious resolution of all eligible cases, without damaging the financial standing of the public institutions to whom the debt is owed.

While the review of the HIPC initiative by the Bretton Woods institutions is welcome, the basic issues are the removal of financing constraints on the expeditious delivery of debt relief, and the use of a less stringent definition of debt sustainability. These two requirements are linked, as a shortfall of resources results in stringent criteria, in order to limit the number of beneficiary countries. UNCTAD has already proposed that an independent panel of experts should review the sustainability of low-income country debt.

The prior conditions and safeguards built into the current HIPC initiative must be reduced, to make receipt of debt relief less of an obstacle race. The pre-defined list of HIPCs does not necessarily include all low-income countries that have a problem of servicing their external debt. The specific entry requirements, notably the adoption of IMF or IDA-supported programmes and a previous concessional rescheduling with the Paris Club should be relaxed. Eligibility criteria, based on the threshold and target ranges for debt indicators, should become less stringent, while the analysis of debt sustainability should be made on less arbitrary criteria. At present, eligible countries, in order to receive multilateral debt relief, have to carry through two consecutive three-year ESAF programmes, and make progress on social sector reforms. Going off track with such programmes results in further delay in the HIPC process. This should be reduced to a single ESAF programme, which would be sufficient to ensure that debt relief finally goes to countries with reasonably sound macroeconomic policies.

If the effectiveness of the HIPC initiative has to be enhanced, a first step would be to review the list of countries to be included in the HIPC category. For instance, about half a dozen LDCs are not currently covered,⁵ although on the basis of their debt indicators they would be classified as severely or moderately indebted, thus being vulnerable to adverse external developments. Three quarters of the HIPCs had met the entry requirements at the end of 1998; the remaining nine countries (not including Nigeria) have become potentially eligible as the sunset clause was extended to the end of the year 2000. This clause must perhaps be open for review: although the HIPC initiative should not be considered as a permanent mechanism, it should not be closed before all poor countries having debt servicing difficulties would be given a chance to be included. Other debtor countries, such as low-income countries which have not been granted Paris Club concessional re-schedulings or are assumed to have exited from such re-schedulings, could eventually also need HIPC assistance.

The **debt sustainability criteria** should be relaxed. For the moment, the criteria used to determine which countries would benefit from HIPC assistance (beyond debt relief provided by the Paris Club on Naples terms) are based on the following threshold values:

- the ratio of present value of debt-to-exports should exceed a range of 200-250%;
- the ratio of debt service-to-exports should exceed a range of 20-25%;
- the ratio of present value of debt-to-fiscal revenue should exceed 28%, provided that two other criteria are met, an export-to-GDP ratio of at least 40% and a minimum threshold ratio of fiscal revenue-to-GDP of 20%.

These criteria are too stringent. The debt situation of the HIPCs over the period 1990-97 can be summarised by the following indicators, averaged over the period and over the whole group of HIPCs:

- The nominal debt-to-export ratio⁶ amounted to 405% on average;

⁵ See footnote 2 on page 10.

⁶ Note here that the present value of debt is normally lower than the nominal value of debt. As a rule of thumb, the present value could be equivalent to half the nominal value.

- Total payments arrears represented about 27% of total nominal debt stock; total nominal debt stock without payments arrears was equivalent, on average, to 300% of exports;
- The paid debt service-to-exports ratio reached 18%, while payments arrears far exceeded paid debt service and were equivalent on average to more than 600% of paid debt service.

In the light of these actual indicators which reflect the debt servicing capacity of HIPC's over the period 1990-97, the threshold values of HIPC eligibility criteria look to be too high. Likewise, the fiscal burden of debt servicing can be high and the adequacy of the fiscal window under the HIPC initiative is also being questioned. The foreign exchange constraint as measured by debt-to-exports or debt service-to-exports ratios is not the only constraint on the debt servicing capacity of the HIPC's. The budgetary constraint can be as severe, and in countries belonging to the CFA franc zone, it is even the primary one. HIPC debt relief should seek in the first instance to remove whatever is the binding constraint, be it scarcity of foreign exchange or lack of budgetary resource. The fiscal criterion currently applied should be re-examined in this light. To begin with, the additional two criteria on export-to-GDP and fiscal revenue-to-GDP ratios should be dropped. The export-to-GDP criterion purports to restrict the consideration of the fiscal constraint only to countries with a large export sector. This is highly questionable, as countries with a small export sector could equally face a constraining fiscal shortage. The second criterion, related to fiscal revenue-to-GDP, aims at avoiding problems of moral hazard, whereby debtor governments would not provide necessary efforts to increase fiscal revenue in order to get debt relief. This argument does not apply to countries whose policies, and especially government measures to raise fiscal revenue, are monitored by the IMF in the framework of their ESAF programmes. Furthermore, very few HIPC's can achieve a target of 20% of fiscal revenue-to-GDP.

One option could be to agree on a ceiling for a share of fiscal revenue to be allocated to external debt service, debt relief being provided to meet this benchmark. In general, even **one quarter of fiscal revenue** used for external debt service may be considered as a relatively high ratio in HIPC's, given the competing claims for the financing of infrastructure, social and human development.⁷

In addition to enhancing HIPC's' external viability, reducing fiscal pressure and creating room for transferring resources to social expenditures should also be a key concern under the HIPC initiative. Debt repayment should not take precedence over the fulfilment of human needs and human rights. There is merit in establishing a link between debt relief and poverty reduction, and considerable interest has been expressed recently in channelling resources freed up from debt service to finance social and human development projects. However, any such link should not take the form of additional conditionality imposed on the debtor countries; even "benign conditionalities" in this respect could have the effect of further slowing down the HIPC process. Social policies and expenditures are already being monitored under ESAF programmes, and debtor countries have to show satisfactory progress on social sector reform before decisions on delivery of HIPC assistance are made. Further actions and initiatives linking debt relief and poverty reduction should perhaps be left to the initiative of debtor countries themselves, in order to ensure that such actions are demand-driven and correspond to national priorities, and are well co-ordinated at the recipient level.

⁷ Analysis of available information on the budget revenues and expenditures of twelve HIPC's shows that for those countries which have a high level of fiscal revenue (i.e., ratios of fiscal revenue-to-GDP close to 20%), the ratios of external debt service-to-fiscal revenue are hovering around 25%. For countries whose capacity to raise fiscal revenue is very low, the ratios of external debt service-to-fiscal revenue are very high.

Adoption of new and realistic eligibility criteria would help to ensure the success of the HIPC initiative and provide a real exit to debt re-schedulings. Ideally, the result of debt relief should be to eliminate any external financing gap during the three-year period following the decision point (corresponding to new ESAF programme period).

There seems to be an emerging consensus on the need to lower the threshold and target values for debt indicators. A number of proposals, including proposals from major donor countries (see Box 1), have been made to this effect. Nevertheless, it would be naïve to assume that financing will cease to be an important constraint. Enlargement of the number of beneficiary countries and lowering the debt sustainability targets would bring additional costs. If commodity prices are further depressed in the wake of the global financial crisis, the total cost of accelerated debt relief is likely to rise.

Donor governments should be encouraged to agree on the following package of measures, that would bring debt relief to an adequate level, while committing themselves to ensuring that the initiative is fully financed:

- full cancellation of ODA debts of all HIPCs (which would be in line with UNCTAD Resolution 165 (S-IX));
- debt reduction of at least 80% on their other bilateral official debts, with the possibility of full cancellation for post-conflict countries, countries affected by serious natural disasters and countries with very low social and human development indicators. Paris Club debt eligible for reduction should also include post cut-off date debt.

The funding mechanisms would be:

- partial sales of IMF gold;
- a prompt and substantial general allocation of SDRs, which could be used to further finance debt relief, industrialized countries and other countries in a position to do so being invited to earmark their allocations for this purpose;⁸
- donor countries committing themselves to additional bilateral contributions to the multilateral HIPC trust funds as necessary to ascertain the achievement of debt sustainability targets for individual countries.

Debt relief for the poorest countries should not be provided at the expense of ODA funding for development programmes and projects in these and other countries, which are also dependent on aid for their welfare and development prospects. The financial standing of multilateral development banks and their ability to provide support to all member countries also needs to be safeguarded.

⁸ A general allocation of SDRs would not be objectionable in the present context of global deflation and liquidity crisis in developing countries and countries in transition. Besides HIPCs, middle-income debtor countries also need additional liquidity for economic recovery.

Box 1

RECENT INITIATIVES FOR IMPROVING THE HIPC INITIATIVE

Several G-7 countries have recently announced new proposals for an improvement of the HIPC initiative, with the objectives of speeding up its implementation, easing financing constraints and relaxing some of the criteria.

- The **Cologne Debt Initiative** by the **German** Government announced in January 1999 has the following points:
 - Acceleration of the HIPC process: the interim period leading up to debt relief should be shortened from six to three years. All qualifying countries should be able to obtain the assurance on the extent and timing of their debt relief by the year 2000.
 - The threshold and target figure for debt sustainability criteria should be set at 200% of debt-to-exports, with some flexibility in some cases.
 - Total cancellation of commercial debt by Paris Club in exceptional cases, for some countries qualifying for additional assistance under the HIPC initiative.
 - Total cancellation of official development assistance (ODA) debt in the Paris Club for those HIPCs qualifying for assistance under the HIPC initiative. The debtor country should provide counterpart funds in national currency for projects promoting poverty reduction.
 - Providing resources to the World Bank HIPC Trust Fund to ensure full financing of the HIPC initiative.
 - Safeguarding the IMF contribution to the HIPC initiative, keeping the question of partial sales of IMF golds under review and bilaterally providing the resources required in the short term for the continuation of ESAF.
 - New credit and financing arrangements to improve the debt servicing capability of HIPCs that have been granted an exit rescheduling.
- The **British** Government in September 1997 proposed the Mauritius Mandate aiming at bringing rapidly on board all HIPCs by the year 2000. In March 1999, the British Chancellor announced a new four-point plan for debt relief and assistance for poverty reduction programmes in the poorest countries:
 - Reduction of the debts of the poorest countries by \$50 billion by the end of the year 2000. This could be achieved by bringing changes to the HIPC initiative for a “faster, deeper and wider” debt relief:
 - reassessing current debt sustainability target ratios;
 - halving the six-year time scale;
 - going beyond the 80% debt relief in the Paris Club where necessary.
 - Increasing aid flows to the developing countries to \$60 billion by end of year 2000.
 - A challenge to NGOs to increase their aid donations proportionally.
 - Partial sales of IMF gold (\$1 billion) in order to fund an enhanced HIPC initiative.
- The **President of the United States**, in March 1999, at a Conference on US-Africa Partnership for the 21st Century proposed actions for deeper and faster debt reductions to the level of \$70 billion:

Box 1 (cont.)

- Early relief on multilateral debt under the HIPC initiative, combined with ongoing forgiveness of cash flows by the Paris Club.
 - Complete forgiveness of all bilateral ODA loans to the poorest countries.
 - Deeper and broader reduction of other bilateral debts up to 90%.
 - 90% of new ODA on a grant basis to countries eligible for debt reduction, in order to avoid recurring debt problems.
 - Immediate debt relief and concessional finance to countries emerging from conflicts.
 - Gold sales by the IMF to finance its participation and additional contributions from donor countries to the World Bank Trust Fund to help meet the costs of the initiative.
 - Greater debt relief in exceptional cases.
- **France**, host government of the Paris Club, has made proposals for an enhanced HIPC debt relief:
- Cancelling “for the next generation” debt service payments on ODA debts of all countries eligible for additional assistance under the HIPC initiative as soon as their debts are restructured within the Paris Club. France would in future extend grant aid only to these countries;
 - Going beyond the 80% reduction on non concessional debts treated in the Paris Club (the London terms), if this is necessary to achieve debt sustainability;
 - Accelerating the Paris Club process for eligible debtor countries (extending Lyon terms as soon as decisions on eligibility under the HIPC initiative are taken);
 - For countries not eligible for additional HIPC assistance, extending 67% debt reduction as a general rule under Naples terms and increase the amount of debt eligible for conversion, either by increasing or suppressing the current 20% ceiling.

Apart from more generous debt relief than currently agreed, the French initiative emphasizes equitable burden-sharing among creditors, and more especially among bilateral creditors, and the requirement of “good governance” on the part of the debtor countries concerned. Support is also given to partial sales of IMF gold.

- There are also signs that **Japan**, another major creditor for the HIPCs among the G-7 countries, holding substantial ODA claims on some HIPCs, might be willing to adopt a more flexible position on debt relief for the poorest countries. In October 1998, at the Second Tokyo International Conference on African Development, Japan announced additional debt relief estimated at some \$ 0.5 billion on debts incurred before 1997 (following earlier practice, relief is provided through grants equivalent to debt service payments made by debtors).
- The Government of **Canada** on 25 March 1999 urged the G-7 countries to expand debt forgiveness to the poorest countries and proposed a seven-point strategy to enhance the HIPC initiative:
- Forgiveness of bilateral ODA debt for the HIPCs;
 - Future development assistance to these countries only on a grant basis;

Box 1 (concluded)

- More generous debt relief through HIPC initiative: lowering the debt sustainability target to 150% of exports;
- More timely debt relief: shortening of the track record to three years;
- Expanding the number of countries (adding Haiti, Malawi and Afghanistan to the list and making Honduras eligible for HIPC assistance);
- Full cancellation of Paris Club debt for all LDCs expected to qualify for HIPC debt relief, and also for Honduras;
- Greater transparency in lending and good lending practices.

To provide the international financial institutions with the necessary resources, Canada would support IMF gold sales of up to 10 million ounces and augmenting IMF's ESAF resources.

A first discussion among the G-7 countries of issues relating to the fundamental review of the HIPC initiative was held in Petersberg, Bonn in February 1999. Agreement could be reached by the time of the Cologne Summit in June, and the IMF and the World Bank annual meetings in September will provide the opportunity for finalizing the features of a revised and enhanced HIPC initiative.

Concern has been raised about the ability of multilateral development banks to meet the cost of HIPC debt relief from their own resources. Fear is also voiced with regard to the additional cost that can be charged on lending to middle-income countries, resulting from the need for these institutions to raise income for the financing of the HIPC initiative. Thus, as relief on multilateral debt for the HIPCs is funded by provisions from net income of multilateral institutions, this is likely to have negative consequences for their lending policies: (a) pressure on net income of the multilateral banks has led to some increases on the interest spreads charged on loans to middle-income countries; (b) reduction in resources allocated to other programmes funded by net income, such as technical assistance and grants made to governmental and non-governmental organizations, and a weakened ability of multilateral development banks to grant concessional loans in the future.

Bilateral contributions are needed to allow more multilateral debt relief. It is, thus, essential that debt relief be financed by resources that are **additional** to previously envisaged budgetary ODA allocations. To ensure this additionality it may be helpful to treat the HIPC initiative as an exceptional programme, to be financed by supplementary budgetary resources, as is funding is to countries affected by natural disasters or other emergencies. Additionality may also be obtained by the general allocation of SDRs and the cession by creditor countries of their allocations as grants to those in need of debt relief (thus foregoing the earning of market interest rates on SDRs).

It should indeed be emphasized that a reformed HIPC initiative should be seen as a one-off operation. Once their debt overhang is lifted, HIPCs must be able to make a fresh start, using new aid flows in an efficient way to remove the structural obstacles to their development. These countries will still have to rely for some time on new concessional external sources of finance.

The above analysis leads to set of proposals to make the HIPC initiative more effective. The eight-point proposal advocated by the United Nations is summarized in Box 2.

B. Debt conversion

The debt crisis of the early 1980s gave rise to a number of mechanisms for reducing the debt burden of heavily indebted countries, among which are various types of debt conversions. Chile institutionalized the first debt conversion program in May 1985. The relative success of the program enticed a number of other Latin American countries to follow suit, and debt conversions expanded rapidly in late 1980s.

Originally, only commercial (London Club) debt could be converted. However, since 1991, official bilateral (Paris Club) debt has also become eligible for conversion. Currently, all the Paris Club eligible debt contracted on concessional terms and up to 20 % of debt contracted on commercial terms can be converted.

In the cases of the HIPCs, it is unlikely that debt conversion can play an important role in alleviating their debt burden. Since multilateral debt (which roughly accounts for 25 % of their debt stock) is not eligible for conversion, and there is little commercial debt (which was almost totally bought back under the IDA buy-back facility), the only source for conversion is provided by Paris Club debt. Yet, there are a number of difficulties related to Paris Club debt conversion. First, there is no secondary market for official bilateral debt, making it difficult for investors to obtain information on discount levels, and complicating the tasks of debtors in defining local currency pay out levels. Second, administrative costs tend to be high, as investors need to negotiate debt purchases with each of the Paris Club creditors. Third, Paris Club creditors often disregard prices of secondary commercial debt when setting prices for the bilateral debt, producing cases where some of the official bilateral debt is overpriced from the viewpoint of potential investors. Fourth, in the case of a flow rescheduling, the consolidated amounts tend to be relatively small, as compared with the level of outstanding stock of debt.

Other problems are related to structural deficiencies in debtor countries. For a conversion scheme to be efficient, a set of laws need to be put in place as well as a tight monitoring system to avoid “round tripping”.⁹ In addition, for a conversion program to be successful, it should not have inflationary consequences. This means one of three things:

- either the local currency pay out must not be large (in which case only a small part of the debt is converted);
- or a conversion must be done for assets rather than cash (for example debt for equity swaps);
- or the increase in the domestic money supply needs to be neutralized through various schemes involving the issue of government bonds, requiring, thus, the existence of domestic capital markets.

⁹ Round tripping is an operation whereby an investor purchases the debt at a discount from a creditor, receives the local currency payout from the debtor government, and instead of investing the money in a local project buys foreign currency and transfers it out of the country, reducing, thus, the debtor country's foreign exchange reserves. For example, round tripping took such proportions in Tanzania that the World Bank had to ask the Government to discontinue the debt conversion program.

Box 2

UNITED NATIONS PROPOSALS FOR AN ENHANCED INITIATIVE ON HIPC DEBT RELIEF

- Review the list of HIPCs in order to ensure that all poor countries facing debt servicing difficulties will be considered under the initiative.
- Shorten the time frame for implementation to three years, so that final debt relief can be provided after the first track record of three years of ESAF programmes.
- Apply less restrictive eligibility criteria, notably by reducing the thresholds of debt-to-exports and debt service-to-exports ratios. (Be guided by the fact that over the recent period 1990-97, HIPCs were able to service debt, on average, for up to 18% of their exports and that their nominal debt stock, excluding payments arrears was still equivalent to 300% of exports.) For certain countries facing very severe foreign exchange constraints, the thresholds could be lower than the general eligibility level. The aim should be to provide a real exit from debt re-scheduling.
- Set a ceiling for the share of fiscal revenue allocated to external debt service, and provide additional debt reduction if necessary to meet this benchmark. 25% of fiscal revenue allocated to external debt service is an excessive burden for HIPCs.
- Cancel HIPCs' ODA debts, and extend at least 80% debt reduction on other official bilateral debts to all HIPCs; consider full cancellation of bilateral official debts for post-conflict countries, countries affected by serious natural disasters and countries with very low social and human development indicators. Paris Club debt eligible for reduction should also include post cut-off date debt.
- Full funding of the initiative through partial sales of IMF gold, a new general allocation of SDRs and additional bilateral contributions to multilateral Trust Funds for debt relief.
- Take steps to reverse the current trend of declining ODA and budget new aid funds for social and human development projects and poverty reduction, and adopt procedures to release resources for HIPC relief without impinging on regular ODA budgets: debt relief should not be given at the expense of ODA.
- Linkage between debt relief and poverty reduction, with debtor countries determining their own national priorities. In this respect, increase collaboration with NGOs and the private sector to raise funds for debt relief and development projects in HIPCs.

The HIPCs do not have large privatization programs as did Latin American countries in the 1980s and early 1990s, nor do they possess the necessary resources or adequate capital markets to engage in somewhat complex financial operations to neutralize additional liquidity. Therefore, the inflationary risk of debt conversion in these countries is high.

For these reasons, it has been advocated recently that another mechanism involving pay out in local currency for servicing the external debt might be more appropriate for HIPCs. These proposals are based on the idea that if a country pays debt service in foreign currency to a creditor, it could instead pay the same amount in local currency that would be used within the country for social or developmental projects. Thus, the argument goes, instead of transferring money abroad, it would be used domestically for developmental purposes.

Such arguments are valid if the primary constraint on the debtor country comes from the lack of foreign exchange. However, if the primary reason for the inability to service external debt is a budgetary constraint, debt servicing will run into arrears even if the pay outs are in local currency, unless additional money is printed, resulting, in more inflation. The allocation of local currency as a result of a debt swap would often occur outside adopted budgets, which could have unfortunate

macro-economic consequences (such as printing more money, reducing other budget items, increasing taxes or raising loans in the national private sector).

Local currency pay out would entail other difficulties for the debtor. First, the operations are often demanding in terms of administrative resources, and close co-ordination with creditor countries is needed to manage local currency counterpart funds. Both creditors and debtors might incur substantial costs of planning and monitoring debt swap programmes. The administrative costs will be high if each bilateral creditor will want to implement its own scheme. Secondly, the debtor country would not have any influence on the projects to be financed, as the creditor country would normally look to its own development and/or environmental policies as a basis for identifying projects.

These potential pitfalls do not necessarily imply that mechanisms to allow debt servicing in local currency are not useful. There are examples, such as reforestation programs, and other debt-for-environment swaps where this mechanism has given positive results. If, significant additional debt relief can be obtained through this mechanism, it would be preferable to co-ordinate the operations among creditor countries and to establish a multilaterally coordinated debt swap mechanism, but at the initiative of the debtor country. The debtor country will have to control the macro-economic consequences of such swaps: it should be left to the debtor to decide at what pace it will undertake the swaps and to determine the priority list of projects.

C. Debt of middle-income countries

The issues concerning the prevention and management of financial crises in middle-income countries have been adequately treated in the earlier report of the Executive Committee on Economic and Social Affairs on a New International Financial Architecture. The present report builds on this work and elaborates more on an orderly debt restructuring process, including internationally sanctioned standstills through IMF lending into arrears.

The abrupt cessation of private external lending, especially of trade finance, which accompanied payments difficulties of countries in crisis had brought severe disruptions in their economic activities and in many cases had further weakened their capacity to pay. Furthermore, the recent crises have been addressed either by a declaration of a debt moratorium, as in the case of the Russian Federation, or by the provision of official financial rescue packages under the leadership of the IMF to bail-out private creditors.

Such responses remain unsatisfactory. On the one hand, a unilateral debt moratorium can cut debtors off from sources of external finance for a long time. For emerging market countries that rely on private sources of capital, moratorium can be a powerful source of contagion, transmitting difficulties rapidly to other countries as investors withdraw from other markets for fear of similar losses. This has been observed following the moratorium declared by Russia in August 1998, which has immediately affected Brazil. Furthermore, debtors declaring a moratorium may face legal actions from creditors for seizure of debtors' assets abroad.

On the other hand, the bail-out financial packages mobilized by the IMF and provided under tight conditionality have raised some concerns, besides questions concerning the appropriateness of IMF policy prescriptions. These concerns are related to two particular issues:

- the adequacy of IMF emergency lending: in the light of the recent financial crisis, the sheer size of financial rescue packages and the rapid contagion of liquidity crisis have raise doubts about the capacity of the IMF to mobilize emergency financing of the magnitude required by the countries in distress. In this respect, the G-7 has announced progress made towards agreeing the IMF Quota increase and the New Arrangements to

Borrow, which together would provide additional resources to the IMF of \$90 billion. Despite the increase in IMF resources, is IMF lending sufficient in cases of a global liquidity crisis?

- equitable burden sharing and moral hazard: IMF bail-out packages can create a moral hazard for at least some lenders who have not been forced to bear the full risk of the credits they have extended. Providing official financial assistance might shield creditors and investors from the consequences of bad decisions and sow the seeds of future crisis. It is, thus, necessary to involve private creditors more fully in sharing the burden of emergency financing.

1. IMF lending into arrears

For these reasons, some formal framework is needed to allow payments suspensions that are part of a process of co-operative and non-confrontational debt renegotiations between debtors and creditors. There seems to be some convergence of views that an IMF policy of lending into arrears could provide a solution. The IMF would continue to provide financing to countries even when those countries implement an adjustment and reform plan and seek a negotiated restructuring with creditors in good faith. That arrangement would involve private creditors in negotiating terms of a restructuring. The provision of financial support by the IMF can improve the bargaining position of the debtor, and, combined with the adjustment programme, can signal to the unpaid creditors that their interest is best served by quickly reaching an agreement with the debtor. At the same time, suspension of payments will lower the immediate foreign exchange requirements and reduce considerably the size of a rescue package. A faster disbursing mechanism should also be utilized by IMF to provide trade finance and address the import needs of debtor countries.

Temporary suspension of payments may require the use of exchange controls in order to stem a “rush for exit” by holders of claims, including domestic holders, and some form of protection against legal actions on debtors' assets abroad. It has been suggested that recourse to IMF Article VIII 2 (b) can serve both purposes.

IMF lending into arrears might fail to prevent contagion, because any temporary suspension of payments might trigger fear that other countries might follow suit. But it can provide needed interim finance and can secure a rapid restoration of access to external finance.

2. Contingency clauses

Consideration could also be given to include clauses in debt contracts that would allow for an automatic extension of maturities in times of acute liquidity crisis. The question of moral hazard can be addressed by limiting these cases to liquidity crisis arising from external shocks, beyond the control of debtor countries, such as sharp fall in the terms of trade or sudden withdrawal of foreign capital because of contagion. One caveat to such a proposal is that the inclusion of such clauses could raise the cost of financing, as lenders might ask for compensation for assuming increased risk, and the higher cost would have to be weighed against the perceived usefulness of such clauses in addressing unforeseen events. It should be noted that to avoid any additional source of discrimination in the market such clauses can equally apply to industrialized countries.

3. Debt restructurings

Experiences have shown that an early debt restructuring is often followed by an early recovery. The Republic of Korea negotiated a restructuring of its short-term debt with its creditor banks, soon after signing the IMF agreement, and Thailand obtained an agreement by banks to restructure its short term about six months after the crisis. Indonesia is reported to negotiate debt

restructuring only about a year after the start of the crisis. It is a coincidence that the two first countries have recovered more quickly. An early restructuring helps to provide a breathing space to debtors, while also lifting the uncertainties about payment obligations. In this respect, IMF lending into arrears could also assist debtor countries to reach an early debt restructuring with creditors.

There is an additional problem that eventually might need to be addressed. In the 1980s the practice of syndicated bank lending to sovereign debtors facilitated the debt restructuring process which took place within the informal setting of the London Club. In the 1990s, the size, sophistication and heterogeneity of recent capital flows have reduced the relevance of the procedures used in the past to ensure an appropriate private sector role in resolving severe international financial crisis. In the case of bonds, there exists no framework for an orderly renegotiation of those debt securities. Serious consideration should be given to the G-10 proposal for inclusion of special clauses in debt contracts to allow for collective representation of creditors and qualified majority voting on changing the terms of the contracts, and to force sharing of proceeds of debt repayments. The inclusion of such clauses would need to be consistently applied among developing and developed countries alike.

4. Transparency and accountability

Another lesson drawn from the Asian crisis is the importance of the question of transparency and accountability. A lack of transparency and accountability can exacerbate financial weakness at the firm and national levels and complicate efforts to resolve crisis. Action is needed to improve the transparency and accountability of:

- the private sector (including national firms and banks, but also international investment banks, hedge funds and other institutional investors);
- of national authorities (for dissemination of regular and timely information about foreign exchange liquidity and external debt positions, including short term debt);
- and of international financial institutions.

The international community should intensify efforts to implement these recommendations. It is worth noting in particular the establishment of the Inter-Agency Task Force on Finance Statistics. This includes international institutions such as the IMF, OECD, World Bank, BIS, UN (UNCTAD), the European Central Bank, and Eurostat. Its remit is to examine modalities to improve the compilation and dissemination of data on external debt and reserve assets.

IV. Concerted action by the United Nations

As regards concerted debt-related actions and technical assistance, the need for co-ordination is particularly felt in the areas of debt conversion and debt management. As far as **debt conversion** is concerned, agencies have shown interest in channelling resources freed under debt relief schemes to development programmes, notably in the social and human development sectors. However, as discussed above, a number of considerations have to be assessed before embarking on debt conversions and local currency swaps, in particular the absorption capacity of debtor countries. It is essential that appropriate mechanisms be put in place to ensure effective co-ordination among donor agencies and to secure real benefits to debtor countries, and that debtor countries be fully in charge. In the first instance, agencies should assist debtor countries to develop national strategies and projects for social and human development. Insofar as debt conversion can bring additional relief and resources for development purposes, debt swaps should be co-ordinated among bilateral and multilateral donor agencies and be implemented at the initiative of debtor countries. The costs of such operations should be carefully evaluated, as they can be high in regard of the limited amount of debt reductions that could be obtained through this route. In connection with a multilaterally co-ordinated debt swap mechanism, UNDP has proposed to assist debtor countries to establish the **National Partnership Facility** to channel resources to national programmes for social and human development.

Through this facility, UNDP in co-operation with and at the initiative of the debtor country, can assist the latter to strengthen its capacity to design a human and social development programme which could be financed partly by debt relief and partly by new aid flows.

In order to disseminate and advocate UN position on the debt problems of developing countries, the UN can develop an **advocacy** partnership framework, in co-operation with NGOs and other civil society organization, as well as sympathetic creditor countries.

Debt relief should be a once-and-for-all operation. The best guarantee that debt will remain at sustainable levels after the completion point is an improvement in domestic public financial management, especially debt management. The UN should play its part in strengthening the capacity of debtor countries to implement an **effective debt management** policy. One lesson learned from the 1980s debt crisis and the recent financial crisis is that it is essential to have accurate information on the debts incurred, including short-term private debt. Furthermore, an effective debt management includes such aspects as elaboration of strategies, institutional issues, legal matters, co-ordinating, registering and channelling of information flows for operations and decision making.

In view of the ongoing HIPC process there is also a special need to ensure the concerned debtor countries' ownership of debt sustainability analysis and ability to participate as equal partners in the process. The capacity of HIPCs to apply the methodology of debt sustainability analysis and appraise the implications of debt relief should be strengthened. The quality of governance can also be strengthened by the full exercise of civil and political rights in decision taking procedures concerning debt and other issues.

United Nations technical assistance has already played an important role in developing debt management capacities. In the early 1980s, UNCTAD developed an effective framework analysis for debt management and the computer-based debt management tool, known as the Debt Management and Financial Analysis System (DMFAS). This software, subsequently upgraded, is today installed in 50 user countries, of which 19 are HIPCs. The DMFAS Programme has recently established an interface with the Debt Sustainability Model (DSM+) developed by the World Bank for debt sustainability analysis. UNDP has been the traditional partner and sponsor of the DMFAS Programme; co-operating agreements have also been established with other players in this area, such as the Commonwealth Secretariat.

The DMFAS Programme has built up a unique position as far as capacity building in debt management is concerned, and should be used as a focal point for actions by the United Nations in this area. There is an increased demand for assistance from developing countries as well as countries in transition in the increasingly complex area of debt management.



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