

Commentary on IMF / World Bank: Revisiting the Debt Sustainability Framework for Low Income Countries.²

On Jan 12th the staffs of the World Bank and the IMF have submitted a paper for their respective board's consideration, entitled "Revisiting the Debt Sustainability Framework for Low-Income Countries."

The document gives a good overview of the present handling of debt sustainability issues in low-income countries. Particularly with eight out of thirty post-completion point HIPC's considered to be at high risk of debt distress by the organisations themselves, the preservation of debt sustainability is a highly relevant issue.

Section (2) of this paper will describe and evaluate the most relevant issues considered for eventual reform or re-design by the staffs. Before coming to that, however, we shall briefly mention two major assumptions in section (1), which are and have always been at the heart of the institutions' handling of debt sustainability issues, and which put the value of the whole framework, including present reform efforts into question. In the final paragraph (3) we shall answer from a civil society point of view those questions, which staffs have posed for decision to their boards, and raise an additional one, which in our view should not be avoided, either.

1. Questionable assumptions

a. "Debt problems start, when governments stop paying their creditors"

All thresholds, which in the DSF have ever been defined in order to separate sustainable from unsustainable debt, have been identified by a kind of regression analysis: This means that analysts have asked from which level of debt countries have started to either run into arrears to all or some of their creditors, have outrightly defaulted, or have started negotiations in any of the creditor-defined negotiation fora, particularly the Paris Club. This is certainly one way to define a critical debt level absent any across-the board logical threshold. However, both, the debt crisis of the nineteen eighties as well as the European state insolvency crisis of today, have demonstrated that countries can continue to pay far too long and be forced to stay away from Paris and other negotiation fora, while their debt – as later negotiations will reveal – has long since become unsustainable. For some time this can be made possible through over-exploitation of a country's natural and social resources – often under repressive regimes and with devastating consequences for an economy's long-term sustainability. As a result of such behaviour, the level of debt at the moment when payments actually gets suspended may already be way beyond of what should be considered a sustainability threshold. This in turn then leads to ultimate haircuts which could be far smaller, had alarm bells rung (and an appropriate mechanism for negotiation be offered) earlier.

Through a more timely restructuring, debt relief would also have been less costly for the creditors. Moreover, in most cases, a shift from private investors to public creditors through bail-out operations of one kind or another, could have been avoided³ and, most importantly

¹ Thanks to Tim Jones of Jubilee Debt Campaign for additional issues raised beyond the first version of this paper.

² all references which do not explicitly state otherwise refer to this document: either pages (p.) or points (pt.)

³ With the corresponding implications for an appropriate incentive structure and the avoidance of creditor moral hazard

from a development and human rights perspective: unnecessary suffering, including the loss of lives due to the breakdown of public services, rural credit and other essential elements of a local economy in the debtor country might have been avoided, too.

While attempts to define debt sustainability with a view to priority MDG financing have failed in the past, this dimension of a debt problem, glooming for long under the cover of a seemingly sustainable debt, which in reality masks an unsustainable resource drain, must not be overlooked.

- b. "The World Bank and the IMF are appropriate institutions for defining debt sustainability and applying thresholds to individual countries."

For practitioners who work on sovereign debt issues it looks like the most natural thing in the world, that those institutions, which handle the greatest wealth of data and have nearly universal access to almost all indebted governments then write the DSAs. However, these same institutions also happen to be the single most important creditors - in quantitative or qualitative terms or both - to most of those debtor countries. Consequently, the recovery value of these institutions' claims depends directly or indirectly on their own assessment. This does not necessarily rule out an accurate assessment of a debtor countries situation. What it does rule out, is that you can trust in the unbiased character of DSA's conducted under those circumstances. Historically, Bank and Fund look back on a long and tragic history of putting their seals of approval on series' of Paris Club agreements, where they attested that whatever the Club was prepared to deliver in terms of debt relief at a given moment, would be sufficient to restore debt sustainability. In reality it hardly ever was, until full cancellation was agreed for the poorest countries under Cologne terms.

This problem is further aggravated by the fact that the denominators in the debt indicators depend completely on the IFIs' projections of overall growth, export earning and fiscal income. These projections, in turn, come out of the IFIs' black box; i.e. they are made according to a methodology which is not revealed, and possibly even can not coherently be revealed, because they depend on a complex set of factors interplaying with each other. As a result, a bias due to the institutions' creditor position – or any political preference – can not reliably be identified. The only way out of this dilemma would be a completely independent assessment done by one or various institutions that have no interests of their own as either debtor or creditor.

Interestingly the present document encourages governments to conduct their own debt sustainability analysis - although "based on the existing template".⁴ In fact, debtor governments should feel encouraged to undertake their own assessments and – even better – to ask independent institutions for an explicitly neutral view.⁵

2. Need for reform and suggestions by staffs

The document gives the DSF in general a good mark by stating that deviations from predictions of future debt levels have been largely accurate between 2006/7 and 2010⁶ – which is not bad given that these are years of major disruptions in the global economy. Moreover, no sovereign default has taken place, which the authors implicitly count as merit of the framework.⁷ An eventual need for reform is being discussed with regard to the following issues:

⁴ pt. 11

⁵ Contrary to the endless list of futile debt restructurings on the basis of WB/IMF assessments in the Paris Club, the few examples, where independent assessments have been used is more encouraging. For a prominent one see: Kaiser, J.: Resolving sovereign debt crisis; FES Dialogue on Globalization, Sept. 2010, p. 24/25.

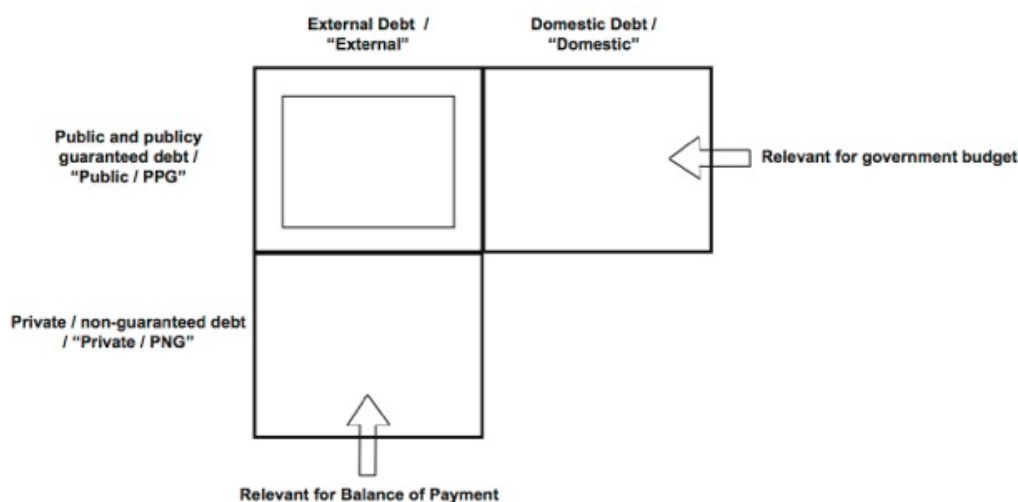
⁶ pt.6; This does not imply, that forecasts were largely accurate, but only that errors were evenly divided among under-estimations and over-estimations.

⁷ pt.7; regarding the eventual existence of a human development crisis in the face of a "sustainable" debt see para 1 of this paper.

- Which debts need to be taken into consideration? DSA's define debt unsustainability largely with regard to public external debt only. Domestic public debt and private external debt have not always been thoroughly analyzed, not least because of a lack of coherent data.

The thresholds that are at the heart of the DSF refer officially to total external debt. However, due to data limitations they include de facto mostly public external debt only. Public domestic debt is left out completely. For a few years public domestic debt has since been considered through separate public DSAs. These, however, have not been equipped with policy guiding thresholds.

Fig.1 Types of debt to be considered in Debt Sustainability Analyses



Domestic public debt has grown to more than a quarter of total public debt until end-2010. In extreme cases it can be as high as 35% or even more than 45% of GDP.⁸ Generally domestic debt conditions are far more adverse than average external debt conditions⁹ – obviously thanks to the fact that external debt in part comes as ODA, while no LIC has any provider of internal ODA.

Given data limitations and other problems, staffs are reluctant to provide policy-relevant thresholds for total public debt. However, by the same methodology as described above, they identify thresholds, which would eventually trigger "deeper discussion of public debt". As there is not much to argue against "deeper discussions" in critical situations, that seems to make sense – given the limited influence the IFIs would have on domestic debt at all, simply because it is regularly issued under domestic law.

Surprisingly, the authors seem to downplay the potential harm that may result from public private external debt,¹⁰ while at the same time revealing that LICs have on average private external debt level to the tune of 17% of GDP. This alone is nearly half of the debt threshold for a medium performer and more than half for a weak performer. However the staff paper treats those debts as a kind of exceptional problem, which should be addressed through (informal and non-standardized) policy dialogue, where necessary.¹¹ Given the experiences of MICs and HICs like Indonesia in 1998 or Ireland in 2009, where private external debt (mostly non-publicly guaranteed) brought the state to the brink of insolvency, a more formal

⁸ Figure 5 on p.15

⁹ Box 3 on p.14

¹⁰ pts. 41-43

¹¹ like possibly in those five LICs, which have ratios beyond 40%.

approach aiming at a stronger regulatory regime towards private inflows on the part of the sovereign would seem appropriate.

- Reconsidering the thresholds. Particularly, should a threshold (with policy implications) be defined for total public debt, too? And should remittances be considered on the income side (which is not the case now)?

The indicative thresholds of the DSF are derived through regressions analyses as described in part (1) of this paper. Authors then undertake efforts to be more precise with their analyses and suggest a revised set of thresholds for the five indicators¹². Only with regard to one indicator – debt service to revenue – does the revision lead to different, i.e. lowered thresholds.

So the staffs suggest to revise debt service thresholds from 35% /30% / 25% of revenue for strong / medium / weak performers respectively to 22/20/18. Obviously much less of a differentiation and generally lower thresholds. However, staffs' test run of the revised thresholds reveals that "only 2 out of 66 LICs would receive a higher risk rating (moving from "medium" to high" risk of debt distress), if the proposed debt service to revenue thresholds were applied. In our view, extending this warning signal is worth the effort.

A high potential for altering risk assessments rests with the question whether or not to include income through remittances. Remittances are a substantial and growing part of hard currency inflows in a few LICs, but irrelevant for others. Moreover, data availability is differing widely between countries. Staffs suggest to take remittances into account where they are relevant, but at the same time to lower export-based thresholds by 20% for these same countries (because the denominator – the income – is higher). This seems to be a valid proposal given the average dimensions of inflows, and the need to capture changes. If remittances fall again, the lowered thresholds would send an earlier warning signal, while in the contrary case of rising remittances, "false alarms" indicating debt-servicing problems, while the central bank is floated with hard currency (thanks to remittances) could be avoided.

- Is the growth potential of new borrowing adequately reflected during the design of debt thresholds?

Here staffs refer to ongoing work with dynamic models on the link between public investment and economic growth. Not much of a tendency as far as higher lower or more flexible debt thresholds are concerned has been revealed so far.

- Are the stress tests, which are at the heart of the switch from a "low" to a "moderate" debt level, adequate?

The stress tests that the DSF applies are essential for moving a country from a "low" to a "moderate" level of debt distress under the DSA¹³. In the past it has already been considered whether shocks by one standard deviation¹⁴ and excluding effects of mutual re-enforcement can be sufficient. In the present document complacency seems to prevail at this point. So, the fact that "only" in 7 out of 60 cases debt levels in 2010 exceeded the levels projected through the most extreme stress tests in 2006/7 is hailed as a proof for the DSAs accuracy. In reality, 12% beyond the most extreme stress tests, where the serious forecast has been the baseline scenario, does not exactly sound like the proof for a "satisfactory track record".

3. If we were the directors...

¹² NPV of debt in percent GNI / NPV of debt in percent of export earnings / annual debt service in percent of export earnings / NPV of debt in percent of revenue / debt service in percent of revenue; see the overview in Box 1 on p.6

¹³ "Low risk countries" do not breach thresholds under the baseline scenario. The risk of debt distress is considered "moderate" if one or several thresholds are breached under a shock scenario. "High" risk countries breach thresholds even under the baseline scenario. For definitions see Box 1 on p.6

¹⁴ respectively one half standard deviation under a combined shock scenario

As usual staffs provide a series of issues for decision-making by their boards at the end of the paper. Let us occupy the directors' seats for a moment and give the requested answers from a civil society perspective:

- Do Directors agree to maintain the indicative policy-dependent thresholds defined in terms of the various debt burden indicators and to introduce revisions to the thresholds for debt service to revenue and for the PV of debt to the sum of exports and remittances?

That seems to make sense.

- Do Directors agree with the need for strengthening the analysis of total public debt and fiscal vulnerabilities in DSAs? Do they agree to introduce an additional risk rating, which would complement the assessment of external public debt, in cases where there are significant vulnerabilities related to domestic public debt or private external debt?

The proposal seems to be too weak. Except for problems with data availability we can not see any reason, why a thorough consideration of domestic debt dynamics and particularly private external liabilities, including the definition of indicators should not be routinely included into public, respectively external DSAs.

- Do Directors agree that country-specific information should be more systematically taken into account when assessing the risk of debt distress?

In principle, who could argue against taking any existing intelligence into account when assessing possible debt problems? However, given the bias through the notorious double role of the IFIs as creditors and experts, it is preferable to make judgements as standardized as possible. Otherwise there would be a growing potential for arbitrary treatment of countries by the IFIs. In absence of a farther-reaching decision to generally commission debt sustainability analyses from a non-creditor institution, we suggest that as a rule a second opinion should be requested.

- Do Directors support ongoing efforts by IMF and World Bank staffs to develop models and tools that will strengthen the treatment of investment-growth linkages in DSAs?

Sure. There is an urgent need to better understand repercussions of investment opportunities either seized or foregone. This is most obvious regarding the practices of granting waivers. As the recent case of an 80m US-\$ loan from India to high-risk Burundi for a hydro dam has demonstrated, the IFIs do not seem to have any coherent policy of deviating from their own DSF-based guidelines, but do this obviously according to political opportunism.¹⁵

At this point we would therefore add an additional question:

- Do Directors agree with the present practice of granting waivers from DSF regulations on an ad-hoc basis, and do directors feel sufficiently informed about individual waivers and the policy underlying them?

No, we are not sufficiently informed and herewith request the staffs to provide a list of all waiver requests, decisions taken in each individual case, and outlining the reasons for granting or rejection of each request.

- Do Directors support the inclusion, on an optional basis, of a new stress test reflecting dynamic linkages between macroeconomic variables?

¹⁵ A recent example is the waiver granted to Burundi for an 80m US-\$ loan under insufficiently concessional terms from India for the construction of the Kabu16 dam. No other explanation for the waiver in the extreme high-risk case of Burundi has been given than the fact that the World Bank likes the project. For a more detailed analysis see: "Der IWF nimmt den Fuss von der Schuldenbremse"; http://www.erlassjahr.de/news_2/burundi-der-iwf-nimmt-den-fuss-von-der-schuldenbremse-neu.html

Yes.

- Do Directors see merit in developing a simplified DSA template, built around a baseline scenario and simple stress tests, to facilitate its use by country authorities?

We certainly do. Moreover, we suggest that staffs actively encourage member governments to do analyses on their own, using the template, but also including additional aspects, which they consider as relevant.

Now, you can have your seats back, gentlemen!¹⁶

Jürgen Kaiser, erlassjahr.de, Feb. 9th, 2012

Contact:

Jürgen Kaiser
erlassjahr.de - Politische Koordination
Carl-Mosterts-Platz 1
40477 Düsseldorf
Tel.: +49 211 4693 217
Fax: +49 211 4693 197
mobil: +49 173 2919374
j.kaiser@erlassjahr.de

¹⁶ Or wait, just one more thing for your exhilaration: Have you been aware that not less than four times does the text tell us that " countries with higher debt burdens are more likely to experience debt distress, and countries with strong policies can sustain a higher debt burden than those with weak policies." Who would have guessed? Thanks for these insights, IFI-economists!