New borrowing post-debt relief: risks and challenges for developing countries

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By implementing the initiative for Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief Initiative (MDRI), the international financial institutions and main bilateral creditors have brought about a major reduction in the debt of developing countries. The issue of their new borrowing is now the subject of intense discussions within international fora.

Indeed, both the borrowing needs of poor countries and the recovery of their financial situation mean that an increase in new debt flows can be expected.

The first part of this article underscores the major improvement in the debt situation of countries post-HIPC and MDRI resulting from the debt cancellation afforded by the international community. Illustrations are given, notably for Franc Area countries.

Against this backdrop, the second part highlights the risks posed to developing economies by some countries' current policy of new borrowing, conducted in particular under the influence of new international lenders. The latter do not necessarily operate within the traditional co-operative framework and employ lending policies that are hardly consistent with the objective of maintaining the long-term debt sustainability of poor countries.

The study concludes that the prevention of the risk of overindebtedness and the financial crises associated with it call more than ever for greater co-ordination between bilateral creditors and international financial institutions. The third part explores ideas for developing co-ordinated strategies. The approaches currently favoured or envisaged include fostering constructive dialogue with emerging lenders, alerting players to the potential risks, defining codes of good conduct, improving monitoring systems, and the introduction of more stringent measures vis-à-vis debtor countries.

Key words: AfDB, Cologne terms, debt relief, DSF, emerging lenders, Franc Area, HIPC initiative, IDA, IMF, MDGs, MDRI, new borrowing, non-concessional borrowing, Paris Club, ratings, sustainability, World Bank

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1| An improved financial situation for developing countries post-debt relief

1|1 Impact of the HIPC initiative[1]

The HIPC initiative, launched in 1996, enabled 21 countries (including 17 in Africa) that had reached the "completion point" to benefit from the almost total cancellation of the stock of their bilateral debt by Paris Club debtors and partial cancellation of their debt by multilateral creditors (IMF, World Bank and regional development banks). Moreover, even before the completion point is reached, the HIPC mechanism provides debt relief measures by Paris Club and multilateral creditors as from the "decision point" that marks the debtor country's entry into the initiative (treatment of flows reducing debt servicing very substantially).[2]

Table 1 shows the estimated impact of the HIPC initiative on all of the countries concerned, setting out the amount of relief already granted to the 21 countries that have reached the completion point and the amount likely to be extended to the 9 countries that have reached the decision point and to the 10 countries that have not attained the decision point but are potentially eligible.

Table 1 Impact of the HIPC initiative on debt reduction (in NPV terms) in the 40 eligible countries

(USD billions)

	Reduction (NPV 2005)
	At 31 December 2006
Post-completion point countries (21)	
Total	30.3
o/w *Sub-Saharan Africa (17 countries)*	*23.2*
o/w *Franc Area (6 countries)*	*4.6*
Post-decision point countries (9)	
Total	11.1
o/w *Sub-Saharan Africa (8 countries)*	*11.0*
o/w *Franc Area (3 countries)*	*2.5*
Potentially eligible countries (10)	
Total	21.8
o/w *Sub-Saharan Africa (8 countries)*	*20.7*
o/w *Franc Area (4 countries)*	*4.6*
Total (40 countries)	**63.2**

NPV: Net present value.
Source: IMF-World Bank data, December 2006.
Banque de France calculations.

1 *For a detailed presentation of the HIPC and MDRI initiatives, see the Franc Area's* Rapport annuel 2005.
2 *During the so-called interim period between the decision point and the expected date of the completion point, countries benefit, from Paris Club creditors under the Cologne terms, from a treatment of flows that consists of a 90% cancellation of commercial debt repayments due as debt servicing during this period, as well as a rescheduling of debts linked to official development assistance.*

At 31 December 2006, the total amount of debt relief granted amounted to USD 30.3 billion (expressed in net present value – NPV – at end-2005)[3] for the 21 countries that had reached the completion point by that date. Sub-Saharan African countries benefited from close to 75% of this amount (USD 23.2 billion). For the six Franc Area countries concerned, this relief stood at USD 4.6 billion, i.e. 15% of total cancellations.

According to IMF and World Bank estimates, the assistance granted by bilateral creditors accounts for close to 49% of the total amount of relief afforded to the 40 eligible countries, with 35% provided by Paris Club creditors (i.e. USD 22 billion). Among the multilateral contributors (46%), the World Bank's share is estimated at 20%, that of the IMF at 9% and that of the African Development Bank (AfDB) at 7%. Lastly, commercial creditors are estimated to have contributed around 5% of the debt cancellation effort.

In total, for the 30 post-decision point countries (which have all benefited, as a minimum, from immediate reductions in their debt servicing with the application of the Paris Club's Cologne terms and the IMF and World Bank's interim measures), implementation of the HIPC initiative should eventually allow them to reduce their stock of external debt by an average of nearly 60%. The ratio of these countries' debt servicing to their export revenues is expected on average to fall from 14% to 6%. By the end of the HIPC process, once the completion point has been reached, multilateral debt should constitute nearly 75% of these countries' stock of external debt.

1|2 The further contribution of multilateral institutions

Announced at the G8 summit in Gleneagles in July 2005, the Multilateral Debt Relief Initiative (MDRI) is a further stage in the recovery of the financial capacity of the world's poorest countries. The MDRI makes countries that have reached the HIPC completion point eligible for cancellation of 100% of their debt with the IMF, the International Development Association (IDA, the World Bank's concessional fund), and the African Development Fund (AfDF, the concessional window of the African Development Bank – AfDB).[4]

Thus, as of 31 December 2006, 23 countries (including 17 Sub-Saharan African countries, with 6 from the Franc Area) have benefited from the MDRI. Two countries, Cambodia and Tajikistan, which are not eligible for the HIPC Initiative, joined the 21 countries that had reached the HIPC completion point; they qualified for the cancellation of their debt with the IMF on account of having a per capita income below USD 380.

3 *Unless otherwise indicated, the data cited in this study are taken from the IMF and World Bank report "Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) – Status of Implementation" (August 2006). The subsequent achievement of the HIPC completion point by Malawi and Sierra Leone, and of the decision point by Haiti has been taken into account in the data given in this section.*

4 *The amounts concerned are as at 31 December 2004 for the IMF and AfDF and 31 December 2003 for the IDA.*

Table 2 Impact of HIPC and MDRI initiatives on debt ratios in post-completion point Franc Area countries

(as a %)

		pre-HIPC ratio (a)	post-HIPC ratio (b)	post-MDRI ratio (c)
Benin	Debt-to-GDP ratio	67.3	51.3	11
	Debt service-to-exports ratio	14.2	8	2.9
Burkina Faso	Debt-to-GDP ratio	57.4	47.7	17
	Debt service-to-exports ratio	21.5	11.5	4.6
Cameroon	Debt-to-GDP ratio	76.6	12.7	3
	Debt service-to-exports ratio	12.5	3.2	1.5
Mali	Debt-to-GDP ratio	111.9	73.6	27
	Debt service-to-exports ratio	14.6	5.8	4.3
Niger	Debt-to-GDP ratio	101.9	69.7	34
	Debt service-to-exports ratio	8.4	4.2	3.6
Senegal	Debt-to-GDP ratio	82.2	49.5	13
	Debt service-to-exports ratio	17.1	7.6	4.7

(a) Data at end-2000.
(b) Data at 31 December of the year in which the completion point was reached.
(c) IMF-World Bank and Agence française de développement estimates for 2006 (2007 for Cameroon).
Sources: IMF, World Bank, 2004 and 2005 Franc Area Annual Reports. Data in nominal terms.

In a second phase, 19 other countries (including 16 Sub-Saharan African countries, with 7 from the Franc Area) are expected to benefit from the MDRI once they reach the HIPC completion point.

The total amount of debt cancellations granted under the MDRI (in nominal terms) is estimated to amount to USD 49 billion (USD 37 billion for the IDA, USD 8 billion for the AfDF and USD 4 billion for the IMF). At 31 December 2006, debt cancellations already approved by the IDA and IMF to the first 23 eligible countries totalled USD 28 billion and USD 3.2 billion respectively. Implemented from 1 September onwards, with retroactive effect to 1 January 2006, debt cancellations by the AfDF are estimated to amount to USD 6.5 billion for 2006.

For the six post-completion point countries in the Franc Area, total debt cancellations stood at around USD 9 billion (of which USD 6.2 billion by the World Bank, USD 2.1 billion by the AfDB and USD 0.7 billion by the IMF).

1|3 A new debt situation for developing countries

The implementation of the HIPC and MDRI initiatives for low-income countries has, therefore, brought about a significant improvement in their financial situation. For the 30 post-decision point countries, these initiatives should result in a sharp reduction of their debt-servicing. As a proportion of their export revenues, this is expected to fall on average from 14% in the year prior to the decision point to 3.9% in 2006 and 3.1% in 2007.

Table 2 shows more specifically the impact of the HIPC and MDRI initiatives[5] on debt ratios in post-completion point Franc Area countries.

The improvement in the risk profile of these countries is, moreover, reflected in changes in their sovereign ratings, with several of them recently raised by the international rating agencies.[6]

2| Assessing the risks associated with some current new borrowing strategies

2|1 Developing countries' borrowing needs remain substantial

By restoring the financial situation of the poorest countries, the multilateral debt relief initiatives have opened up the space for these countries to accumulate new debt, while their borrowing requirements in respect of their development goals remaining large.

By way of illustration, the amount of financing needed for low-income countries to meet their Millennium Development Goals (MDGs) could reach nearly USD 150 billion by 2015.[7] For the majority of Sub-Saharan African countries, the financing costs of the MDGs are estimated at more than 20% of their GDP.

The achievement of these objectives, which were set by the United Nations in September 2000, will require the mobilisation of substantial external resources, notably as a result of:

• the generally inadequate growth rate in low-income countries (between 5% and 6% in the case of African countries)[8] compared with the economic performances originally deemed necessary to reach the MDGs (7%-8% per annum), resulting in lower tax revenues;

• difficulties in gaining access to international capital markets on account of countries' ratings.

5 *Taking account of the anticipated debt cancellations by the AfDF.*
6 *The rating given by Fitch to Cameroon was raised from B- to B in June 2006, and Ghana's rating of B+ is now accompanied by a positive outlook. The Standard & Poor's rating for Cameroon was also raised from B- to B in February 2007.*
7 *UN Millennium Project, Investing in Development, 2005.*
8 *According to the AfDB-OECD report African Economic Outlook 2005/2006.*

2|2 A rapid accumulation of new debt in some countries

Some countries that have benefited from debt relief under the HIPC initiative and/or the MDRI have already posted a rapid increase in their debt ratios. For example:

• Uganda, which was among the first countries to benefit from debt relief under the HIPC initiative in 2000, has high debt ratios. Its external debt-to-exports ratio, which was greatly reduced following implementation of the HIPC initiative in 2000 (standing at 150%), reached 204% in 2004 and 186% in 2005 (the IMF's projections for 2007 are stable). These external debt ratios are just below the indicative sustainability threshold laid down by the Debt Sustainability Framework (DSF) – see box in section 3|1 below – i.e. 200% for countries whose policy performance is deemed "strong" according to the World Bank's Country Policy and Institutional Assessment (CPIA).[9]

• Ethiopia, which reached the HIPC completion point in April 2004, also posts a relatively high debt-to-exports ratio. At end-July 2004, this ratio amounted to 126%. Following implementation of the MDRI by the IMF, at end-July 2005 this ratio stood at 108%. If the maximum debt threshold for countries whose performance is "medium" (150%) is observed, the IMF anticipates a gradual deterioration in the country's debt ratio (132% by 2009) and qualifies the improvements recently observed, which are closely linked to its strong export performance (up by 36% in 2005) and which may be difficult to repeat.[10]

2|3 The role of new international lenders

The renewed increase in the debt of some developing countries is taking place in a context in which new international lenders have appeared (emerging Asian and Latin American countries and the Gulf states), whose financing practices differ in several ways from those of "traditional" creditors.

Indeed, in the attempt to penetrate increasingly attractive markets, notably on account of their commodity needs, emerging lenders are offering very substantial amounts of financing, often much higher than those likely to be extended by the IMF or the IDA, and, moreover, without conditionality with respect to domestic policies, notably regarding governance. This funding is often only slightly concessional or not at all, and may be secured on natural resources or accompanied by commitments by recipient countries (purchases of capital goods, provision of oil at a predetermined price, etc.).

9 IMF, Review of Uganda's performance under past Fund-supported programs, January 2006.
10 IMF, Report on Ethiopia, No. 06/159, May 2006.

For example:

• The Republic of Congo, which reached the HIPC decision point in March 2006, obtained two loans from China in December 2005 and June 2006, of USD 552 million and USD 32 million respectively (the latter being non-concessional). In December 2004, Congo had benefited from debt cancellation by Paris Club creditors and the establishment of an IMF Poverty Reduction and Growth Facility (PRGF) amounting to USD 81.3 million. At end-2005, the country's external debt was still equivalent to nearly 120% of its export revenues, i.e. in excess of the level deemed sustainable under the DSF (100% for countries whose performance is judged "weak").[11]

Moreover, the following examples show that the trend towards new borrowing also includes countries that have not yet benefited from HIPC relief or that are not eligible for this initiative.

• Thus, at end-2005, Sudan's external debt stood at USD 27.7 billion, the bulk of which consisted of arrears, and was equivalent to 690% of its export revenues. The country's arrears vis-à-vis the IMF prevents it from having access to Fund-financed programmes. However, Sudan, which is eligible for the HIPC and MDRI initiatives, has taken out non-concessional loans (USD 800 million in 2005,[12] with USD 700 million scheduled for 2006). In 2005, these new creditors received close to USD 84 million in repayments and interest, whereas the partial payments made by Sudan to the IMF of the interest on its debt amounted to only USD 30 million and no payments were made to bilateral creditors from the Paris Club.[13]

• Angola, whose debt at end-December 2004 stood at USD 10.8 billion, benefited in 2005 from a USD 3 billion loan secured on deliveries of oil.[14] At the end of 2005, this country's external debt represented 38.5% of GDP, i.e. more than the 30% threshold deemed sustainable under the DSF for countries whose policy performance is "weak".[15]

A study conducted by the World Bank on a sample of 39 developing countries benefiting from IDA grants has confirmed the growing share of non-concessional borrowing in their financing methods. It is estimated that, at end-December 2004, close to 27% of the sample's outstanding debts were non-concessional.[16]

11 IMF, Second review under the Republic of Congo's PRGF Arrangement, July 2006.
12 According to information in the press, this loan was extended by China (see The Wall Street Journal, *12 June 2006).*
13 IMF, Report on Sudan No. 06/182, May 2006.
14 According to the above-mentioned article in The Wall Street Journal, *China is thought to be the source of this financing.*
15 IMF, 2006 Article IV Consultation with Angola, November 2006.
16 World Bank, "IDA countries and non-concessional debt: dealing with the 'free rider' problem", 19 June 2006.

2|4 Risks associated with current public borrowing strategies

Compared with grant-based financing, this fresh increase in borrowing to support the financing of development can offer a number of advantages:

• From the borrowers' point of view, it makes possible the use of leverage.

• For international creditors, it gives recipient countries more responsibility and may provide the basis for regular dialogue between governments and lenders.

However, borrowing by developing countries must satisfy the following two requirements:

• The funds obtained via borrowing must contribute above all to financing development within the framework of multi-annual strategies identifying the most vulnerable sectors and the action to be taken. When a country is following a programme, compliance with this criterion is monitored by the multilateral institutions. The latter require, in return for their financial support, that a healthy economic and monetary environment is maintained and that poverty reduction strategies are drawn up. They seek to ascertain that resources are actually allocated to the priority social areas.

• The sustainability of countries' external debt with regard to their repayment capacity and potential output growth must be maintained.

Regarding this latter objective, the lending policies of emerging countries have come under criticism given that they do not belong to the multilateral bodies that manage and monitor debt, such as the Paris Club and the OECD, and are therefore not subject to the common rules that their members have progressively put in place. Indeed, given the large amounts of financing extended outside the multilateral framework (referred to as "free riding"), the lending policies of some emerging countries pose a number of risks.

• **For developing countries,** the main risk is of rapid and unmanaged accumulation of new debt, leading to a situation of overindebtedness identical to that observed prior to the implementation of the debt relief initiatives. Non-concessional funding is highly costly for national budgets. Moreover, when these loans are secured on commodities, they are not always consistent with rational management of these resources aimed at fostering development. Lastly, in the absence, in most cases, of economic policy conditionality regarding the use of the financing provided, these practices do not encourage recipient countries to manage funds in the most effective manner or to improve their systems of governance. They may also be inconsistent with recommendations drawn up by the international community aimed at combating corruption.

• **For international creditors,** new borrowing at non-concessional rates by countries that have benefited from the HIPC and MDRI initiatives undermines the effectiveness of efforts undertaken to restore these countries' solvency, with the cancellation of claims by creditors merely resulting in the accumulation of new debt on terms that compromise their financial situation. Non-concessional new borrowing from unco-operative lenders is all the more questionable in that, with respect to the efforts made by the international community to cancel the debt of the poorest countries, multilateral bodies (IMF, emergency assistance, etc.) could once again be called on to provide financial support in the event of a new rise in overindebtedness.

3| Implementing co-ordinated and prudent borrowing strategies post-MDRI: some key challenges

3|1 Progress towards a common approach

In spite of the preventive measures taken, the risk of financial crises related to countries' overindebtedness cannot be ruled out, particularly given developing economies' vulnerability to external shocks.

Accordingly, the IMF and World Bank have drawn up a joint framework for debt sustainability analyses for low-income countries – the Debt Sustainability Framework (DSF). Endorsed by the Executive Boards of the two institutions in April 2005, the DSF is aimed at helping to identify ex ante situations of fragility, and guiding the lending practices of creditors and the borrowing decisions of low-income countries by providing them with a forward-looking analysis of their financial situation (see box below).

However, the DSF's effectiveness and credibility as a preventive instrument with regard to the risk of overindebtedness depend above all on it being used as widely as possible by international lenders. In this respect, it is encouraging to note that, since it came into force, the DSF has been increasingly used by multilateral institutions, particularly in the definition and monitoring of IMF programmes and the allocation of World Bank assistance. The African Development Bank also follows this approach when allocating funding. Other co-operating creditors (notably the other multilateral development banks and "traditional" bilateral creditors) have shown their support for the DSF's broader use. The spread of this common benchmark beyond multilateral institutions is now one of the major challenges linked to the need for greater co-ordination between creditors.

BOX

The Debt Sustainability Framework (DSF)

The DSF classifies countries into one of three institutional and policy ***performance*** *categories (estimated using the World Bank's Country Policy and Institutional Assessment (CPIA) index): weak, medium or strong. A maximum debt ratio is assigned to each level of performance.*

Debt burden thresholds according to level of performance

	NPV debt stocks as a % of			Debt service as a % of	
	Exports	GDP	Revenue (a)	Exports	Revenue (a)
Weak policy	100	30	200	15	25
Medium policy	150	40	250	20	30
Strong policy	200	50	300	25	35

(a) Revenue excl. grants.
NPV: Net present value.
Source: IMF and World Bank, March 2005.

An analysis of the country's long-term debt sustainability is then conducted under a baseline scenario and in the event of external shocks (variation in export revenues and commodity prices, etc.). The purpose of this stress testing exercise is to ensure that debt burden thresholds are complied with under unfavourable macroeconomic scenarios. The sustainability analysis then enables countries to be divided into three ***risk*** *categories (low risk, moderate risk and high risk), according to how debt ratios react to the different scenarios:*

- *Low-risk countries are those whose current debt ratios are below the thresholds indicated above (depending on the policy performance category) and for which the different scenarios do not predict a significant breaching of them over the next 20 years.*

- *Moderate-risk countries are those whose debt ratios do not exceed thresholds under the baseline scenario but for which debt stock ratios are exceeded and/or a significant increase in debt servicing bringing it close to the threshold is observed under other scenarios (including under the impact of shocks).*

- *High-risk countries exceed thresholds irrespective of the scenario applied.*

The level of default risk determines the distribution of IDA assistance between loans and grants: low-risk countries are only eligible for loans; assistance to moderate-risk countries is half in the form of loans and half in the form of grants; high-risk countries are eligible only for grants.

3|2 The need for additional measures

In addition to promoting use of the DSF, the international community is also seeking to foster dialogue with new creditor countries in order to encourage them to participate in multilateral debt management fora. The action taken in this area has mainly concerned:

• **Alerting players to the potential risks:** in spite of the limitations of warnings with no concrete impact, this is nonetheless useful. Several institutions and leading officials have recently sounded the alarm. Finance ministers and central bank governors of the G8 countries meeting in London in June 2005 underscored their commitment to promoting "grant financing to ensure that countries do not immediately re-accumulate unsustainable external debts". In June 2006, in a document drafted to mark the Paris Club's fiftieth anniversary, the IMF's Deputy Managing Director, Agustin Carstens,[17] also pointed out that emerging creditors "have yet to be included in major international creditor fora", highlighting that these countries "may be tempted to lend significant amounts to low-income countries that have benefited from debt relief initiatives", leading to problems of debt sustainability in these countries. He went on to say that "the international community needs to find ways to engage with emerging donors" and "must convince them that financing to low-income countries should be shaped by co-ordinated international efforts". Similarly, Franc Area ministers of finance meeting in Paris on 12 September 2006 adopted a resolution stressing the need to "preserve the medium-term sustainability of their debt", by paying "special attention to the rate and terms of new borrowing". "The risks associated with the use of non-concessional financing" were highlighted. Lastly, following its meeting on 17 September 2006 in Singapore, the IMF's International Monetary and Financial Committee encouraged all "creditors and borrowers to use the framework in their lending and borrowing decisions". The Committee urged "all creditors to work with the IMF and the World Bank to adhere to responsible lending".

• **Increased responsibility on the part of new international lenders:** the growing participation of these countries in international institutions (as illustrated by the recent review of the IMF quotas allocated to some emerging countries) is likely to lead them to assume greater responsibility in this area.[18]

• **Drawing up, within the OECD, of a code of good conduct** applying to government development agencies and export financing agencies. In the event of non-compliance with the code of good conduct, a mechanism for

17 The Paris Club, the IMF and Debt Sustainability, 15 June 2006.
18 In a similar vein, the United State has, for example, stated that it expects this increasing participation to lead to greater responsibility regarding exchange rates.

unco-operative creditors may be put in place in order to identify countries in breach of common rules aimed at countering risks of overindebtedness ("name and shame"). The OECD is continuing its deliberations on this subject.

With regard to debtor countries, a number of initiatives have been proposed and/or implemented, including some stringent measures:

• **Improvements in systems for monitoring new borrowing:**[19] on 27 November 2006, the IMF decided to make adjustments to the DSF in order to enable better monitoring of countries' post-MDRI debt strategies including when they comply with the sustainability thresholds. The review of the DSF aims in particular to improve the quality and rigour of the sustainability analyses conducted annually by the IMF and World Bank by taking greater account of the weight of domestic debt and debt with private external creditors, especially short-term debt. Moreover, the revised DSF should help to detect situations of fragility at an early stage. The growth rate of debt will thus be more closely monitored, with a danger level (set at an annual increase of external debt between 5% and 7% of GDP) introduced as part of debt sustainability analyses.

• **The introduction of penalties for debtor countries:**[20] although still under discussion among the main creditors, more stringent measures for borrowers were agreed by the IDA on 11 July 2006 with the adoption of a system of penalties for countries that are eligible for grants and/or have benefited from debt cancellation that make use of non-concessional financing. The system of penalties is structured according to the category to which the country belongs as set out in the DSF: low-risk countries (eligible solely for IDA loans) would have less concessional terms for their IDA loans, while moderate to high-risk countries (partly or solely eligible for grants) would receive a smaller volume of IDA assistance. However, such a system could prove to be a weak disincentive in cases where volumes of assistance are low compared with the potential volume of non-concessional lending (this being the case for countries with plentiful natural resources).

19 IMF and World Bank, "Review of low-income country debt sustainability framework and implications of the MDRI" (March 2006) and "Applying the debt sustainability framework for low-income countries post-debt relief (November 2006).
20 World Bank, "IDA countries and non-concessional debt: dealing with the 'free rider' problem", 19 June 2006.

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