The Changing Landscape of Sovereign Debt
Presentation at UNCTAD, April 11, 2013

Introduction

Thank you for this opportunity to discuss the changing debt landscape, particularly as it affects the developing world. We think this landscape can be characterized as the post-Heavily Indebted Poor Country Initiative (HIPC) world, which presents both opportunities and challenges for the international community. I would especially like to talk about the opportunities for developing countries to access new sources of credit to finance development and the challenges of successfully managing new debt so that it leads to sustainable growth and stability and not default and impoverishment.

Financing for Development

Let me start by observing that, in addition to accessing external sources of financing, developing country governments need to raise increasing amounts of domestic revenue in order to have a strong base for development. The ability to raise significant domestic revenue allows governments to exert much greater control over policy decisions, as well as to calibrate when and where they will go to meet other financing needs. To be in control of policy, you must be in control of your finances and must have a diversity of revenue sources. This is only possible when a country is able to raise domestic revenues through a variety of taxes and from a broadening tax base. Domestic tax revenues need to be sustainable and steadily increasing as a share of GDP.

President Obama highlighted this in March 2011 when he announced a United States initiative called "Domestic Financing for Development," or DF4D. The purpose of the initiative was to draw attention to the need for countries to mobilize domestic resources, improve transparency and fight corruption, so they can have more control over their own development. Former Secretary Clinton launched the initiative in May 2011 to promote sustainable economic prosperity and reduce aid dependency by mobilizing domestic public revenue, improving budget transparency, and fighting corruption as the best means to empower developing countries to take greater ownership of their own development agenda.

We view this Public Financial Management agenda as an opportunity to work with partner countries to strengthen the political will for reform while providing technical assistance, such as taxation expertise, that builds capacity and ownership. We have initially worked with partner countries such as Tunisia, Zambia, El Salvador, Honduras, and Kyrgyzstan but are expanding as others have shown interest and identified their specific capacity needs. In April 2012, we launched a fiscal transparency innovation fund to help countries implement proposals that would help make their governments more accountable for how public resources are utilized. We are now implementing these projects in eleven countries in Africa, the Middle East, Central America and Central Asia.

I do not want to suggest that domestic tax revenue mobilization can meet all development financing needs. Access to other sources, including external and domestic credit, is also vital. That said, it should be noted that domestic revenue mobilization and access to credit are strongly linked. Countries that are successful in mobilizing domestic resources through tax revenues are in a much better position to access external and domestic debt financing. These are both critical elements of development financing. To give a glimpse of the extent of these financing needs, I would note that the World Bank estimates that sub-Saharan Africa alone will need $93 billion a year for investments in roads, power and water.

New Debt Landscape (some observations)

I now would like to offer a few observations about the new debt landscape, including some remarks on new sources of credit for developing countries. As a backdrop, we should first briefly take stock of the Heavily Indebted Poor Countries (or HIPC) Initiative and what it achieved. Most significantly, HIPC helped restore debt sustainability through debt reduction packages for 36 countries, 30 of which were in Africa (although Chad has yet to complete the HIPC process). In total, $76 billion of bilateral debt relief was provided through the HIPC process, in addition to $51 billion associated with the Multilateral Development Relief Initiative (MDRI). These Initiatives, together with associated debt relief efforts, have reduced the debt burden for participating countries by over 90 percent as compared to the debt levels existing prior to entering the HIPC process. As a result, these countries have subsequently been able to increase poverty-reducing expenditures in areas such as education, health, rural development, and other social sectors by an average of more than three percentage points of GDP over the past ten years. But HIPC is winding down, with only three countries -- Eritrea, Somalia and Sudan – remaining, so we are now moving into a post-HIPC environment, where the emphasis is shifting from debt relief to debt sustainability and effective debt management.

The post-HIPC landscape has seen a marked increase in the variety and complexity of debt financing instruments, making debt management an even more critical government task. Three trends are worth noting.

First, sovereign to sovereign lending is still large and significant, but the range of sovereign lenders has expanded as important new creditors have emerged, and changed as several countries, including the United States, have switched primarily to grants instead of loans as official development assistance to developing countries.

Second, private lending (or market/commercial borrowing) has steadily increased in size and importance, especially relative to sovereign lending. It is worth noting here that private sector and public sector creditors are not the same. They have different objectives and incentive structures for providing credit to developing countries. The private sector is primarily focused on profits and market development while the public sector seeks to foster economic development, stability and trade.

Finally, many developing countries are now able to access increasing amounts of debt financing in their domestic debt markets.

To elaborate further on these trends, I would highlight the emergence of non-Paris Club creditors such as China, Brazil, India, Venezuela and others as significant providers of credit to developing countries. Many of these countries were aid recipients not too long ago and some still have active if shrinking assistance partnerships. The important point, however, is they are now increasingly extending assistance and investment loans to developing countries. For example, the Export-Import Bank of China, according to its president, provided $37 billion to all African countries during the last 7-8 years, almost four times the approximate $10 billion that the U.S. Export-Import Bank authorized to African countries during the same period.

We also have seen many developing countries going successfully to the international bond market to raise funds. This is a striking trend driven by global demand from some investors for the higher yields offered by developing countries; yields that they cannot get in other markets at this time. On the flip side, developing countries are attracted to this type of financing because they can get lower rates and longer term financing relative to what they can get in their domestic markets. To take note of a few recent cases, Mongolia raised $1.5 billion in November 2012, Zambia $750 million in September 2012 (which was 15 times oversubscribed even though Zambia had been the beneficiary of a multibillion debt relief package in 2006), and Namibia issued a $500 million bond in 2011. More developing countries are expected to tap this financing resource in the future, a resource that was unavailable to them in the past.

Debt Sustainability

So while developing countries have a wonderful opportunity to access new credit resources, the challenge they face in the post-HIPC world is how to make effective use of the new credit resources to promote growth, which is ultimately the best way to reduce poverty, while still maintaining debt sustainability. In our view, both creditors and borrowers have a shared interest in debt sustainability as the best way to avoid debt distress and minimize the need for debt workouts in the future. Although some feel otherwise, debt workouts are not cost free for either the creditor or the debtor country. Creditor countries must often write-off the debt at a cost to their taxpayers, which can also result in some reluctance or restrictions on providing new loans, while debtor countries can lose access to credit needed to finance development or end up paying a higher borrowing cost until they can reestablish their creditworthiness.

Sound public financial management practices are at the heart of maintaining debt sustainability, but for developing countries, which can be more susceptible to external shocks, the capacity to repay should be enhanced with buffers that can lessen the impact or severity of such shocks. And repayment is important -- a high expectation of repayment will lower the cost of borrowing for developing countries by keeping financing costs low. The key practices in sound public financial management include transparency; anti-corruption efforts; fiscal discipline, which for many can include eliminating inefficient subsidies; and effective borrowing.

And by effective borrowing, I mean loans that produce economic growth and development, which then generate the revenue needed to repay the loan and make new investments. This can include investment in both human and physical capital that builds productive capacity and helps to unlock greater economic activity. Governments that have emerged from a debt overhang need to make the most of their newly available borrowing space by making sure that the money goes toward projects that are prioritized, well thought out, and adequately prepared. It is not possible to make all investments at once without exposing economic vulnerabilities and increasing the risk of renewed debt distress. It is essential to strike the right balance.

This is where the development of increasingly sophisticated debt management capacity is important. Debt management capacity building should be a top priority for countries as their debt levels rise, particularly if they are at moderate to high risk of debt distress. Again, countries vulnerable to debt distress should consider a cushion to withstand external shocks. Debt management is an essential tool to help countries build these cushions and manage risk. Effective debt management is a crucial step in avoiding a need for new debt relief and we applaud the help that UNCTAD's Debt Management and Financial Analysis System provides to more than 60 countries in learning how to better manage their debts.

We also want to highlight the Debt Sustainability Framework (DSF), which was developed by the International Monetary Fund and the World Bank to help guide countries and donors in mobilizing the financing of development needs, while reducing the chances of an excessive build-up of debt in the future. The framework, approved by the IFI boards that encompass all of their membership, can guide the borrowing decisions of developing countries in a way that matches their financing needs with their current and prospective repayment ability, taking into account each country's circumstances. However, the effectiveness of the Debt Sustainability Framework in preventing excessive debt accumulation depends on its widespread use by borrowers and creditors. Developing countries can use it to help develop sustainable medium-term debt strategies. Creditor countries can take into account the results of debt sustainability assessments in their lending decisions. Our review of recent assessments indicate that nine out of 29 post-HIPC countries in Africa are already considered to be at a high or moderate risk of debt distress, suggesting a broad need for more careful debt management.

Debt Workouts

Although the emphasis in the new debt landscape should be on debt sustainability and debt management, there are still going to be some situations where a country cannot avoid seeking debt relief. It is important to remember, though, that debt relief as such does not create growth and development. It must be accompanied by sound economic governance (including transparency and anti-corruption efforts) and fiscal and monetary policy management. Debt relief by itself not a panacea, and as I mentioned earlier, it is not cost free for either the creditor or debtor country.

The Paris Club group of creditors has provided a practical mechanism and built 57 years of experience in working out sovereign debt issues, including by supporting private sector workouts. The Paris Club has successfully concluded debt workout arrangements that are in the interests of both creditor and debtor countries. The HIPC initiative came out of the collaborative efforts of Paris Club members. A more recent example of a successful workout was in January of this year, when Paris Club members agreed to cancel $5.9 billion of their claims on Burma, thereby supporting Burma's democratic transition and economic reform program.

The Club, while flexible and informal, operates on the basis of five key principles, three of which I'll highlight. First amongst these is a case-by-case approach, in which the treatment each debtor receives is customized to its needs and situation. Another is solidarity, under which each member takes into account other members' claims – ensuring that burdens are shared when there are workouts, but also that countries work together – when appropriate – to ensure collection of debts that can be paid. And finally, the Club also works by consensus, so all members feel comfortable that the group is working in their interests.

The Paris Club can and has improved and evolved over time and is currently considering how to adapt to the changing debt landscape. Expanding the Club's membership to encompass a larger sovereign creditor base would lead to better coordination of lending practices, support for debt sustainability, and effective debt workouts as a last resort.

U.S. Objectives as a Creditor

To conclude, the post-HIPC debt landscape offers exciting opportunities and tough challenges for the international community, and especially for developing countries. Debt sustainability has been restored for many low income developing countries and new credit resources are available to help finance development and growth. Countries that borrow effectively, manage their debt wisely, and maintain debt sustainability could benefit from a virtuous cycle of growth and development. Building better debt management and overall public financial management capacity should be a key objective for all.

The United States will continue to play an important role in supporting developing countries. We look to help promote economic growth and development, maintain financial stability and security, and foster trade and investment. We believe it is important to keep credit markets functioning efficiently so that debt financing at the lowest possible cost remains an option for developing countries. We look forward to working with developing countries and emerging creditors to make the most of the opportunities while overcoming any challenges of the new debt landscape.