KFW ECONOMIC RESEARCH

Focus on Economics

No. 31, 19th September 2013

Debt in Low Income Countries: crisis eases, risks remain

Author: Dr Martin Raschen, phone +49 69 7431-2434, research@KfW.de

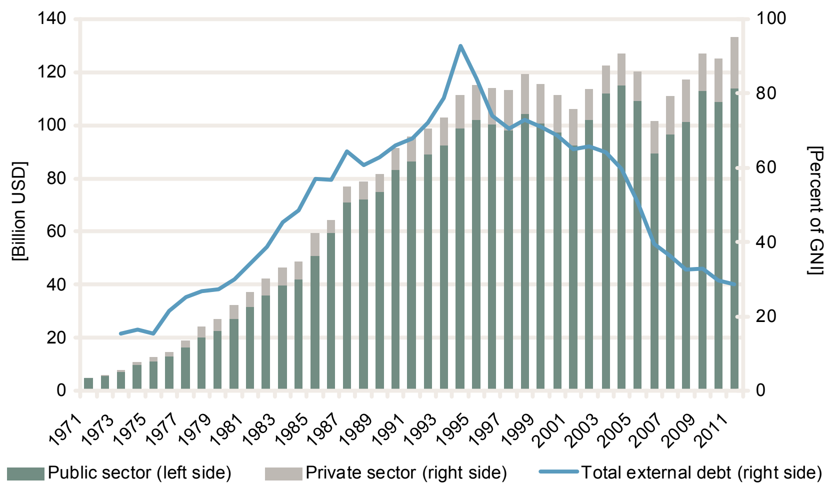
Developing countries' foreign debt is not a feature of the current discussions on the state of the global economy. This is in stark contrast to the situation from the 1970s to 1990s, when these countries' debt rose sharply, many were barely able to service their debts, and development-related investment suffered, cementing poverty. Two factors have contributed to the change for the better since then: debt relief initiatives by creditors and a marked economic upturn in the countries concerned. The subject of foreign debt is by no means completely off the table, and Low Income Countries still need to weigh up the opportunities and risks of external financing.

Development paradigm and rising debt

After the Second World War, industrialised nations experienced an economic boom and the economies of many third world countries also performed well. However, a number of other developing countries were less successful. The global wealth gap widened. In the poorest countries (*low-income countries* – LICs)[1], extreme poverty was widespread. There was no shortage of advice on how to accelerate development. Until the mid-1980s, the dominant development policy paradigm was: LICs should invest heavily in their economic infrastructure and industrialisation, both of which were the responsibility of the government. To achieve this *big push* amid the low savings ratio and limited public budgets, the path of high budget and balance of current account deficits was chosen. Warnings that would be given from a current perspective, namely that given the institutional weakness, it could be risky to base a debt strategy on future growth, were few and far between.

Against this backdrop, the LICs took on more and more foreign debt. Total debt rose from USD 5 billion in 1971 to USD 115 billion in 1995 (see chart 1). This was mainly attributable to public-sector borrowers (government, state-owned enterprises). Private-sector debt (companies, banks) only accounted for around 10 % of the total, which also reflects the low credit rating of the private sector as a whole throughout the period. This could have been a warning sign.

Figure 1: Foreign debt of LICs (public and private borrowers), in absolute terms and in relation to economic output



Source: World Bank, own calculations

Many indicators pointed to the massive debt crisis[2]

The absolute increase in foreign debt already paints a clear picture. The crisis-plagued nature of the development up to the mid-1990s is particularly clear if the weak economic growth at the time is also taken into account. On average, growth in the LICs was only half that of *middle-income countries*. LICs even saw their average GDP decline in some years. As a result, the ratio of foreign debt to gross domestic product in the LICs surged from under 20 to more than 90 % (see figure 1).

A comparison between economic growth and the average interest rate for new loans in the relevant years is also telling. When financing an investment, individual investors should ensure that their income will cover the interest of the loan. The same applies at the level of the economy. The weak economic growth in the LICs meant that GDP growth was higher than the average interest rate for new loans in just six of the 25 years we are looking at. This is already very problematic on its own, but was further exacerbated by the fact that foreign loans were taken out in foreign currencies, mainly the US dollar. Without exception, the currencies of the LICs depreciated against the US dollar during the period, in many cases sharply. This made it much more expensive to service the debt in local currency and was too much for many borrowers.

Lastly, the foreign trade situation also indicated a mounting problem. The LICs' exports generally rose only moderately during the period, even declining in the early 1980s. As a result, the LICs fell further and further behind the international competition. The debt to export ratio climbed from less than 200 % to more than 600 % in the period from 1971 to 1995, and the debt service ratio (interest and principal repayments in relation to exports) rose from around 10 initially to 30 % by the end of the 1980s. Although the subsequent decline in the LIC debt service ratio to 17 % in 1995 at first glance seems to indicate an improvement, quite the opposite is true: the debt service payments declined because the outstanding arrears climbed steeply to USD 26 billion.

Varied causes of the debt crisis

The crisis was triggered by controllable internal factors and uncontrollable external factors. Among the internal factors, the dubious nature of development paradigm from a regulatory perspective has already been discussed. However, this was also encouraged from outside, as donors were prepared to mobilise large amounts to finance these projects. Added to the flawed basic concept were weak project management, a misguided sector policy and generally *bad governance*, including corruption. As a result, many such projects failed to generate the income needed to service the debt. The internal causes of the crisis also included the underdeveloped local capital markets, which left the potential for mobilising internal funding largely untapped. Without this development deficit, demand for foreign financing would likely have been reduced.

The line between internal and external factors is blurred. In any case, wars/civil wars, droughts, floods and similar events also led to a lack of investment.

In the category of uncontrollable external causes of the crisis, the two oil crises and the recession in industrialised nations, protectionism in these countries and unfavourable price trends on the international commodities markets hit the LICs hard.

Various initiatives eased the LICs' debt situation

Initially, many considered the problem to be a temporary one, which the LICs would be able to solve themselves. But it gradually became clear that a large number of LICs had fallen into a debt trap that they would be unable to escape without their creditors' help. In the 1980s, bilateral donors first granted debt relief in the form of debt rescheduling. Since 1988, they have cancelled up to 90 % of the debt through the Paris Club.

The World Bank, IMF and other multilateral institutions did not become involved in this type of initiative until 1996, although their loans accounted for a large proportion of the LICs' foreign debt. Under pressure from both bilateral donors and non-governmental organisations (NGOs), the World Bank and IMF launched the *Heavily Indebted Poor Countries* Initiative (HIPC)[3] to help poor developing countries[4] unable to service their foreign debt[5]. To date, bilateral and multilateral creditors have waived an average of two-thirds of the debt of 32 HIPCs under this initiative. The HIPC debt relief granted amounts to USD 76 billion (present value), which is split between bilateral and multilateral donors at a ratio of 55:45. In addition to the HIPC Initiative, the *Multilateral Debt Relief Initiative* (MDRI) was created in 2005. The World Bank, IMF, African Development Fund and the Inter-American Development Bank have waived USD 37 billion (present value) of the debt of HIPCs under the MDRI. Bilateral creditors have also granted debt relief of USD 11.9 billion (present value) through the Paris Club.[6]

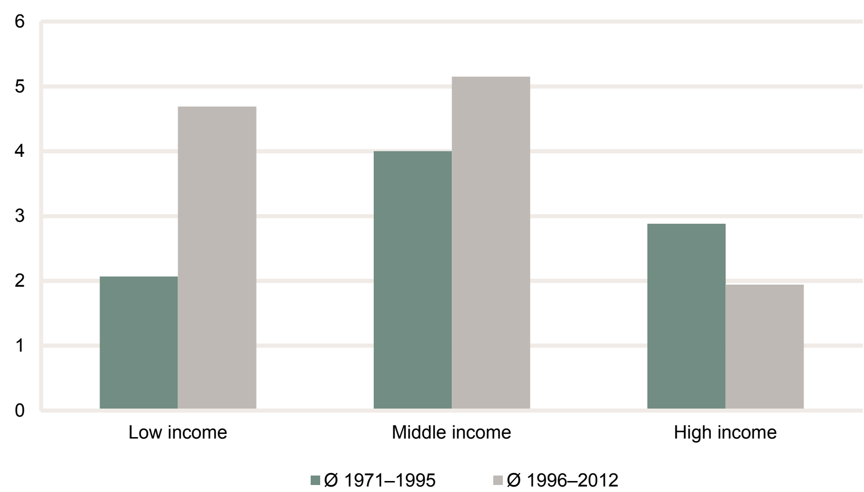
As a prerequisite for all of this support, the developing country must define and implement a programme to improve general economic conditions and fight poverty, as well as to achieve the *Millennium Development Goals* (MDGs). The World Bank and IMF monitor and assess external debt continuously through a systematic *Debt Sustainability Analysis* and provide considerable debt management support to the countries, which has had a very positive effect.

Impressive economic upturn since the mid-1990s

As already mentioned, the weak economic growth up to the mid-1990s was a major contributing factor to the debt crisis. Encouragingly, this has since improved considerably. The LICs have corrected economic policy errors, such as manipulated exchange rates, inflationary monetary policy and excessive budget deficits. They have also significantly improved the regulatory environment for sustainable growth.[7] In a number of cases, this has been achieved through donor-backed Structural Adjustment Programmes. However, good governance is still a long way off and central macroeconomic indicators show that the brightness is marred by shadows. Nevertheless, numerous problematic trends have reversed. A comparison between the periods before and after 1995 reveals the following.[8]

- The growth trend is very positive. Economic growth has more than doubled (from an average of 2.1 % p. a. up to

Figure 2: Economic growth in country groups (actual, in percent)



Source: World Bank, own calculations

1995 to 4.7 % since). In fact, the growth rate in LICs has been faster than that of industrialised nations since 1996, although still slower than in middle-income countries (see figure 2).

- Exports of goods and services have more than tripled.

- LICs have moved considerably closer to achieving monetary stability. Whereas inflation before 1995 averaged more than 10 % p. a. almost across the board (with peak rates of more than 20 %), it has since fallen back to 5–10 %. This is still too high, though, and further efforts to reduce inflation are needed.

- Saving ratios have risen, but are still very low in LICs at an average of 10 %. In industrialised nations, savings ratios have doubled and are around three times higher in emerging countries.

- The inflow of foreign direct investment into LICs has risen sharply. Up to the mid-1990s, these capital flows were close to zero. They have since reached an average of USD 4 billion p. a. (peak of USD 19 billion in 2011). However, this also needs to be viewed in context: China alone receives foreign direct investments of more than USD 200 billion per year.

- Foreign exchange reserves, which barely covered more than 2.5 months' imports on average up to 1995, have subsequently risen to 3.5–4 months' imports. This is still low, however, given that the LICs are highly vulnerable due to their heavy reliance on volatile commodities prices.

- The LICs external imbalance has eased for the time being, but is still a serious issue. The rising current account deficit trend seen until 1995 had turned around by 2002 (-1.5 % in relation to GDP). However, deficits have since climbed back to 2–5 % p. a. A current account deficit does not necessarily have to be a problem if the import surplus contributes to growth and is solidly financed. However, deficits of this scale need to be closely monitored, particularly in LICs.

All in all, the recent trends are commendable. However, it would be disingenuous to pretend that all-round satisfactory economic development is not still some way off for LICs.

HIPCs made good progress towards poverty reduction and MDGs

The picture is equally mixed from a development policy perspective. As already mentioned, debt relief under the HIPC Initiative requires the country concerned to step up its efforts to reduce poverty and generally achieve the MDGs. Relief from debt service requirements provides the financial leeway to achieve this. In their latest HIPC Initiative progress report for the years since 2001[9], the World Bank and IMF reveal positive trends: while the debt service ratio has declined from 14.5 to 3.1 %, public spending to reduce poverty[10] has risen consistently from around 6.3 % of GDP to roughly 9 % (see figure 3). At the same time, however, just seven HIPCs are *on track* to achieve the key MDG of halving poverty, and things do not look at all good for the other MDGs.

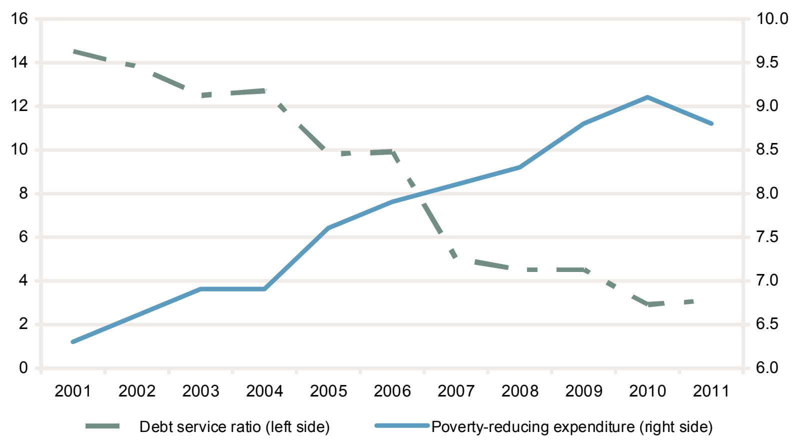
Debt situation improved significantly, but a number of countries are still in "debt distress"

Thanks to the debt relief granted and good economic growth, the LIC debt indicators have improved significantly since the mid-1990s. The ratio of total debt to gross domestic product has declined from its peak of 93 % in 1994 to less than 30 % today (see figure 1). The debt service ratio has also declined from its highest level of more than 30 % at the end of the 1980s to less than 5 %. As already mentioned, the debt service ratio for HIPCs has even fallen to 3 %. This level is sustainable. By way of comparison: the London Agreement on German External Debts between Germany and its opponents in the Second World War provided for a debt service ratio of 5 % for Germany.

However, future developments will need to be carefully monitored so that LICs do not again fall into debt crisis. Sensitivity to external shocks and the quality of the economic and development policy of the country in question need to be analysed. The World Bank and IMF differentiate between four risk categories in their debt sustainability analysis. Currently, 23 LICs are classified in the two highest categories *High Risk of Debt Distress* and *In Debt Distress*. These countries are characterised by their high concentration on a few export commodities and/or weak economic policy institutions, as well as a sometimes problematic debt trend. Although the World Bank and IMF do not consider new debt-relief initiatives in the style of the HIPC Initiative to be necessary, close monitoring of the situation, an improvement in general economic policy conditions (including through donor support) and careful review of the new borrowing conditions a country is able to sustain (keyword: concessionality) are the order of the day.

Two other factors come into play. Firstly, the need for public spending (on infrastructure development, for example) is rising due to the rapid economic growth in the LICs mentioned earlier. The LICs still have access to development aid. However, since this source of financing

Figure 3: Debt service ratio (as a percentage of exports) and poverty-reducing public spending (as a percentage of GDP) in HIPCs



Source: World Bank, IMF

is limited and, at the same time, these countries are finding it difficult to generate higher tax revenue, there could be a strong temptation to fund increased public spending through debt. Secondly, the current economic problems in industrialised nations have led to poorer developing countries becoming attractive targets for financial investors. The HIPCs Senegal, Ghana and Zambia have recently placed bonds on the international capital market (see the following section). These countries have barely any experience with non-concessionary financial products traded on the market.

Development vs. ability to access the capital market

Without doubt, the debt relief granted has eased the situation considerably, but it has not been without side effects. For one thing, it has affected the *sovereign rating* of the countries concerned. Of the 32 HIPCs, which have to date received extensive debt relief, 20 are not even rated by the ratings agencies Standard & Poors, Moodys and Fitch. The ratings of the remaining 12 HIPCs are all *speculative grade*. Five of these 12 HIPCs have not placed any US dollar government bonds on the international capital markets.[11] The other seven are interesting in that they were able to place bonds despite their poor *speculative grade* ratings. It is notable that although six of these seven countries have received HIPC debt relief, they no longer rank among the poorest developing countries thanks to their strong economic growth; they have since been upgraded to the group of *middle-income countries* (Bolivia, Ghana, Honduras, Nicaragua, Zambia and Senegal). Only Rwanda is still an LIC. It is therefore reasonable to assume that debt relief coupled with continued classification as an LIC made a significant contribution to the countries' poor (or total lack of) rating and severely hampered or completely blocked the relevant countries' access to the international capital markets.

The history outlined above should by no means lead to advocating unbridled foreign debt. However, carefully considered borrowing to invest in development fundamentally remains a sensible option from a macroeconomic perspective. This is particularly true at the moment, given the extremely favourable interest rates on the international capital markets. Being largely unable to take advantage of this is the price the HIPCs have to pay for the debt relief received.

There is general awareness of this fact. As a result, four countries that were qualified to receive HIPC debt relief ultimately decided to pull out of the initiative due to concerns regarding their credit rating (The Kyrgyz Republic, Nepal, Laos and Bhutan).

Conclusion

The debt crisis in LICs has been eased significantly through the extensive debt relief granted by creditors and strong economic growth in the debtor nations. This issue is by no means off the table, however, and the development of risk factors still needs to be continuously monitored. The LICs must further improve their macroeconomic and development policy conditions, which includes developing local capital markets. Despite all of the progress made, the LICs still have considerable scope to accelerate their development. This could help them improve their access to the international capital markets and use the funds raised there – responsibly – to make the most of future opportunities. ■

---

[1] In this analysis, *low-income countries* (LICs) are the 36 developing countries with per capita income of no more than USD 1,035, in line with the World Bank classification. 27 of these countries are in Sub-Saharan Africa, eight are in Asia and one is in Latin America. It should be noted that the World Bank adjusts the income threshold each year, which means that the group of LICs changes over time. For example, China, India and Indonesia were still LICs in the 1980s, but are now medium-income countries. This poses a particular problem for the empirical analysis in this paper, as the data used comes from the World Bank, which only provides information on the current country groupings on its website. However, this should not undermine the basic line of reasoning presented in this paper.

[2] The empirical statements in this section are based on the extensive data gathered by the World Bank (*World Development Indicators* and *International Debt Statistics*).

[3] Among the multilateral institutions, the World Bank and IMF are the main players in the HIPC Initiative. However, regional development banks (the African Development Bank, Inter-American Development Bank and Asian Development Bank) also participate, as do bilateral donors.

[4] The LIC and HIPC country groupings are not identical. For example, Bolivia, Zambia and Senegal received HIPC debt relief, but are no longer LICs and are now classified as *lower middle income countries*. See also footnote 1.

[5] The establishment of limits, which if exceeded indicate that a country is unable to service its foreign debt, is carried out on a country-by-country basis in the World Bank and IMF *Debt Sustainability Analysis*. The findings of the *Country Policy and Institutional Assessment* are the decisive factor in the setting of these limits. If a country is classified as "poor quality" (the worst classification), a debt service ratio of 15 % and a debt (present value) that represents 100 % or more of exports and 200 % or more of public revenue is deemed unsustainable.

[6] In addition, bilateral donors have waived debt through *Debt for Development Swaps*. In contrast to (foreign currency) debt relief, the developing country provides additional funding to the national budget in the local currency for development purposes. The commercial banks in the London Club also promised debt relief of USD 4.6 billion (present value) to LICs as part of the HIPC Initiative, but have only partly implemented this so far. The World Bank has made funding to buy back commercial debt available to HIPCs through a *Debt Reduction Facility*. In some cases, financial investors take advantage of the low market value of commercial receivables to buy them up at a low price and then bring legal action for the nominal value, which is not in line with the HIPC Initiative objectives.

[7] See the detailed special chapter in the IMF's *World Economic Outlook*, April 2013. http://www.imf.org/external/pubs/ft/weo/2013/01/pdf/text.pdf

[8] Data source: World Bank

[9] Heavily Indebted Poor countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Statistical update 25th March 2013, http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1256580106544/HIPCStatisticalUpdate2013.pdf

[10] Poverty-reducing public spending includes spending on education, health care, water supply, rural infrastructure, etc. There is no universally applicable definition for this type of spending; it is established on a country-by-country basis.

[11] Source: Bloomberg.