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Poor Debt Management, Low Government Revenues

Why developing countries are facing a renewed debt crisis

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Why developing countries are facing a renewed debt crisis

Bonn, 11 February 2019. The International Monetary Fund (IMF) and the World Bank (WB) have again branded almost half of low-income countries as heavily indebted - despite the extensive debt relief received by most low-income countries between 2000 and 2012 under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). High foreign debt hampers the development of these countries because the money has to be used for interest and principal payments and is not, therefore, available for key investments, such as infrastructure or social spending.

Long-standing internal and external problems are again among the key causes of debt in low-income countries. However, the current situation differs significantly from previous debt crises. In particular, the creditors involved have mainly granted non-concessional loans and not concessional loans.

Poor debt management and low government revenues due to inefficient tax policies and weaknesses in the rule of law are among the internal causes. Furthermore, the loans are often used for the consumption of goods, rather than for productive investments. In addition, there are external shocks, such as falling commodity prices since 2011 or natural disasters like floods or storms. Structural problems, such as a poorly diversified economic and export structure, result in their economies being highly vulnerable to price and demand fluctuations on the world market.

What is new about the current debt situation is that the creditors - and therefore the debt structure - have changed significantly. Developing countries have significantly increased their borrowing at market conditions, especially from new lenders such as China and India, and from private creditors. According to the United Nations Conference on Trade and Development (UNCTAD), public debt at market conditions as a share of total debt doubled between 2007 and 2016 in low-income countries, rising to 46 percent. Compared to the concessional loans from traditional bilateral (notably lenders in the OECD Development Assistance Committee) and multilateral creditors such as the IMF and WB, these loans have higher interest and shorter maturities. This further jeopardises the debt sustainability of developing countries.

Compared to those countries that are not members of the Paris Club, public debt as a share of GDP in low-income countries doubled between 2007 and 2016. One of these lenders stands out in particular: China. In contrast, loans from members of the Paris Club have declined considerably.

In developing countries, the amount of public debt owed to private creditors as a share of total debt rose from around 40 percent in 2000 to 60 percent in 2016, according to UNCTAD. Moreover, not only has foreign debt increased, but domestic debt has also risen sharply in developing countries.

In order to prevent a renewed debt crisis in developing countries, it is of primary importance to establish good debt management practices. The capacity for public debt management needs to be improved and an appropriate debt structure established which takes into account loan maturities and the ratios of domestic and foreign currency. Good debt management also provides greater transparency and more complete data on the debt situation in developing countries. The good debt management measures implemented to date by lenders, such as the Debt Management Facility of the World Bank, the International Monetary Fund and UNCTAD's Debt Management and Financial Analysis System Programme, must be further expanded and improved. Another important element is establishing a set of uniform principles for responsible lending and borrowing. There have been various proposals so far from the United Nations, the G20, the OECD and the Institute of International Finance (a global association of private financial institutions).

In the event of a debt crisis, it will be difficult to coordinate with such a heterogeneous group of creditors. As a result, the use of collective clauses in bond contracts should be extended now to simplify any future restructuring of government bonds.

Given the expected rise in global interest rates and the shorter maturities of non-concessional loans, there will continue to be considerable risks for the debt sustainability of developing countries in the future. It is high time that action is taken and agreements at international level reached in order to stop another debt crisis occurring.