STRATEGIC ISSUES IN MANAGING SOVEREIGN DEBT FOR SUSTAINED DEVELOPMENT: AN ISSUES PAPER FOR THE MULTI-STAKEHOLDER DIALOGUE ON DEBT[1]

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1. The present paper was prepared to support the multi-stakeholder dialogues on "sovereign debt for sustained development" to take place in 2005 as part of the follow-up to the International Conference on Financing for Development, which the United Nations held in Monterrey, Mexico in March 2002. The consultations on debt are aimed to take stock, at both the policy and operational level, of ways in which the challenges to developing and transition economies in the use of sovereign external debt can be mitigated and the opportunities captured.

2. The expectation is that stakeholders will want to focus their discussions on practical and realizable policies and processes for managing external sovereign debt. The emphasis in this issues paper is on sovereign-debt related aspects of crisis prevention, both in terms of taking recent thinking about "debt sustainability" into the operational stage of national policy making and implementation, and in terms of organizational and political mechanisms by which countries may engage relevant stakeholders in appropriate policy discussion. In addition, part and parcel of effective debt management is bolstering creditor confidence that financial instruments and processes will help mitigate the risk of debt crises and resolve those that do occur in a cooperative, speedy and fair manner; indeed, uncertainty-reducing dialogue may itself prevent crises.

3. The paper thus sets out a range of issues that could serve as a baseline for the consultations. The paper is offered as background material, with the expectation that the multi-stakeholder discussants may wish to draw on this paper in choosing a more limited set of issues or questions on which to focus during their consultations.

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I. OPERATIONALIZING "DEBT SUSTAINABILITY"

4. **This section explores the issue of how a government is to know if it has borrowed too much abroad.** The central concept here is that of "debt sustainability": can the government be confident of making the full set of debt repayments as specified in all outstanding loan contracts? The first set of concerns is about on which measure of debt to focus attention; the second is on the concept of sustainability; and the third is on how best to translate recent policy initiatives on assessing "debt sustainability" into operational policy practices.

5. **The official creditor community has recently focused considerable international attention on the question of debt sustainability.** While it is the responsibility of governments to manage their own debt, the major multilateral and bilateral creditors have recently strived to make the concept of debt sustainability operational from their own perspectives. In this regard, two debt sustainability frameworks are being developed, one for low-income countries that are mainly indebted to official creditors, and the other for countries with significant access to international financial markets. Meanwhile, private creditors — and bond-rating agencies on their behalf — continue to apply their methodologies for evaluating borrowing country "credit worthiness", which is their judgement as to the capacity of the borrower to make timely payment of its debt obligations. Thus, while the concept of "debt sustainability" can be given a rather precise meaning, different stakeholders use the term differently.

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6. **A country's external debt sustainability is not the same as that of the government, although it is often the biggest foreign borrower.** The government needs to monitor the country's total foreign debt, not only because of its potential impact on the exchange rate, but also because an external financial crisis of the banking system — the economic sector with most likely access to foreign credit — may perforce lead the government to take over responsibility for the external obligations of the banks. This said, however, the discussions herein will focus on the narrower matter of the sovereign's own external obligations, which is that part of total external debt most directly under the control of national policy makers.

7. **What to include in the government's total external debt is not always straightforward.** In principle, the relevant government debt includes all the obligations of the sovereign (national) government. This usually (but does not necessarily) includes the debt of the monetary authority. As a general rule, it should take account of the contingent foreign liabilities of the government, for example, when the sovereign guarantees the foreign debt of local authorities or parastatals or non-state institutions, although how to value them is not always transparent, especially when the contingent liability is implicit or informal. Also, the government may domestically issue foreign-currency denominated debt or link payments on domestic debt to the exchange rate, in which cases the debt carries a similar set of financial risks to external debt.

8. **Domestic sovereign debt is an important part of the debt burden in many developing countries, but has not yet been the focus of international policy initiatives.** Locally held government debt has traditionally received less attention in debt-management analyses.

However, domestic debt — as it is typically at market rates and short-term — has become an increasingly large part of the debt burden in many countries, with substantial fiscal consequences. That is, in some low-income countries, and also in many middle-income countries, domestic debt service is now higher than external debt service. Commitment to macroeconomic stability may rule out the inflation option and commitment to develop domestic financial markets, which requires "risk-free" government obligations to provide crucial benchmarks, also raises the priority for maintaining investor confidence in domestic government debt. How to deal with excessive domestic debt has not yet been addressed by international policy reform initiatives in the same way as foreign-held sovereign debt, which is understandably seen as a greater priority for global finance. It can safely be said, however, that it is highly complex and requires a case-by-case approach.

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9. **There are some situations in which a government's external debt load can be clearly defined as unsustainable.** Such a situation would be where debt is accumulated at a faster rate than the capacity to repay, implying that at some future point the country will be unable to keep making debt-service payments. Excessively rapid debt accumulation could arise from large government budget deficits or from high interest rates, while the capacity to service debt could be weakened by protracted distress in the economy for any number of reasons.[2]

10. **In most cases, on the other hand, assessing whether a given level of debt is "sustainable" is more complicated.** Debt sustainability is usually conceived as the obverse of an unsustainable situation; i.e., it is defined by what it is not. For example, the Initiative for the Heavily Indebted Poor Countries (HIPCs) defined debt sustainability as a situation where countries that had graduated from the scheme would make a "permanent exit" from the rescheduling process, assuming that they followed strong macroeconomic policies in their post-HIPC years.

11. **Sustainability of sovereign external debt has been defined both in macroeconomic and social terms.** One general approach defines a sustainable foreign debt situation as one in which the government could continue to service its obligations without an "unrealistically large" future correction to the balance of income and expenditure. The International Monetary Fund (IMF) has adopted this approach (IMF 2002). A complementary approach looks at the social and development imperatives of a government's expenditure and its revenue-raising capacity, calculates the funds that could be made available for debt servicing, and compares that to actual obligations. The general thrust of this approach was endorsed by the Member States of the United Nations in the Monterrey Consensus,[3] and in a like spirit the United States Government adopted legislation calling on the Bretton Woods institutions to limit external debt servicing by HIPCs to 10% of revenues, except in the case of countries with public health crises, where the prescribed limit was set at 5% of revenues (Herman 2004, p. 20). Such an approach could be applied equally to monitoring debt levels for sustainability — to flag when difficulties appear on the horizon — as well as to calculating how much debt relief a crisis country needs.

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[2] This is not to say that investors will see the situation as unsustainable until after a buoyancy bubble bursts and a crisis ensues. The question addressed here is the reality, not the perception.

[3] "Future reviews of debt sustainability should also bear in mind the impact of debt relief on progress towards the achievement of the development goals contained in the Millennium Declaration…Continued efforts are needed to reduce the debt burden of heavily indebted poor countries to sustainable levels" (UN 2002, paragraph 49).

12. **Clear-cut assessments are hard to make in practice.** While some factors that determine a country's repayment capacity are within the control of the government, such as fiscal effort in setting the annual budget envelope, other factors can in practice be very unpredictable. Unplanned developments can change a sustainable debt situation into an unsustainable level, even if the country was pursuing prudent economic policies. These developments could include a sharp deterioration in global demand, which would cut back export volumes or collapse commodity export prices. Other potential "shocks" are a spike in international interest rates to which short-term and bank debt servicing are tied, natural calamities such as earthquakes or hurricanes, or an "aid shock" in which anticipated donor support is reduced or delayed. Such shocks diminish economic activity, disrupt economic plans and policies, and make the debt burden harder to carry. The government may also find it politically and socially necessary to raise borrowing in response to the emergency, which even over a limited period, could push the debt level into an unsustainable range. Thus, in practice, debt sustainability assessments entail (a) judgements about the risk of situations arising that would make the stock of debt unsustainable, and (b) decisions about levels of this risk that the nation should bear. Taken together, these judgements help the government to make its overall borrowing and budgeting decisions. These are also the factors that potential creditors should investigate. Indeed, a liquidity crisis (denial of new loans) can arise for a country with a sustainable debt situation if its lenders come to have sufficient doubt that the situation actually is sustainable. This could provoke a default, even if the country's situation was in fact sustainable.

13. **Definitional and measurement difficulties of debt sustainability do not absolve governments of responsibility for deciding whether to take on additional debt or creditors of responsibility in extending additional loans.** It is thus essential to work toward clarifying the issues in managing debt for sustainability.

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14. **The IMF strengthened its approach for assessing public and external debt sustainability in 2002 by adopting a new framework, which was further enhanced in 2003.** This framework was developed as part of the IMF's strengthened focus on crisis prevention and was designed for countries with significant financial market access. IMF now performs debt-sustainability analysis under its framework for most countries in the context of Article IV consultations, and in many cases more frequently, depending on country circumstances.

15. **The IMF approach highlights potential vulnerabilities early on through the use of standardized templates, although country-specific knowledge and judgement remain an indispensable part of the analysis.** The standard templates improve the consistency and discipline of debt sustainability analyses by laying bare the underlying assumptions and subjecting the debt dynamics to rigorous stress testing. An important element that is included in the template is the analysis of gross financing needs to indicate a country's vulnerability to liquidity pressures that typically precede and precipitate debt crises in these countries. The country-specific analysis is essential, however, in deciding at which point the debt dynamics are likely to become unsustainable. Financial crises have occurred at varying levels of debt, making it important to complement the analysis of the debt dynamics with other elements that may be key in gauging vulnerability to crises, including the structure and composition of debt and the country's debt management capacity.

16. **In the special context of low-income countries, IMF and the World Bank have jointly developed an approach to debt sustainability that seeks to identify indicative thresholds that can help both borrowers and lenders design appropriate financing strategies.** A first step in designing these strategies is to analyze the long-term dynamics of different debt-burden indicators under the debtor country's existing policy scenario. Such projections should also assess the sensitivity of the debt-burden indicators to possible shocks. The indicators take the form of ratios of measures of the debt or debt servicing to proxy measures of the capacity to repay. Gross domestic product (GDP), exports and fiscal revenue are the three main variables used. The first assesses the debt burden in terms of the overall economy; the second in terms of the foreign exchange needed to make foreign-currency denominated debt payments; the third in terms of the constraints that governments face in generating their own resources with which to make the payments.

17. **An important area of debate in the IMF-World Bank approach is on the best indicators for assessing debt sustainability.** There are two main numerators for the ratios: the net present value (NPV) of debt[4] and debt servicing over a specified period. NPV is used rather than face value for low-income countries, because it allows for comparability between debt burdens that may have very different levels of concessionality. However, while NPV seeks to capture the overall burden in a single figure, it does not give attention to the profile of debt service obligations over time and thus would not capture any significant bunching of debt service due several years in the future. Thus, NPV should be complemented by long-term debt-service projections, including payments on future loans, to provide a fuller picture of the prospective risk of distress.

18. **A further area of debate is in selection of the threshold values to signal whether the projected paths of the debt indicators continue to be sustainable.** For this, the Bank-Fund analysis draws on empirical estimates of the thresholds to derive indicative benchmarks. However, the recent cross-country econometric studies that have sought to identify the factors that determine a country's ability to sustain external debt and avoid "debt distress"[5] have found substantial ranges of values for these factors (IMF and IDA, 2004 and Kraay and Nehru, 2004). Thus, the indicative thresholds that have been jointly derived from these studies by the staffs of IMF and the World Bank would serve as guideposts rather than rigid ceilings in informing government financing decisions.[6]

19. **Debt ratios that were projected to approach or exceed a country's indicative thresholds would signal to both the borrowing country and its creditors that additional grant resources instead of new loans or domestic policy adjustments were required to maintain debt at prudent levels.** Moreover, as official creditors, in contrast to private markets, do not

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[4] The NPV of a debt is the value that a market-based financial asset would take that yielded a flow of payments over time equivalent to the flow of future debt servicing over the life of the debt. When debt is concessional, NPV is less than face value.

[5] Debt distress refers to actual default events (e.g. incurring arrears) or a country resorting to exceptional financial arrangements to stave off default.

6 The actual threshold levels, when chosen, will reflect an international policy choice on the tolerable risk of debt distress and the financing implications. As these levels are still under consideration by the respective institutions, the framework is not yet operational.

have to demand compensation for higher risk, the setting of indicative thresholds in low-income countries would not in itself create the danger of precipitating a crisis.

20. **Equally, this approach underlines reasons for concern that previously agreed international debt relief for low-income countries was inadequate.** For example, a country that has exited the HIPC Initiative and in a few years approaches its debt indicator thresholds despite sound economic management is put in a parlous position by the assessment that it henceforth requires mainly grant financing or fiscal contraction if the grant financing is not forthcoming. Given the likely coincidence with negative economic conditions, the pro-cyclical aspects of such policies would punish the people of the country. Precisely this concern seems to underline the recent calls by the Governments of the United Kingdom and the United States to deepen the relief from multilateral repayment obligations accorded under the HIPC Initiative.

21. **This notwithstanding, debt sustainability assessments of individual countries are more "art" than "science" and always require a fair degree of judgment.** One of the areas where judgment is indispensable is in interpreting the relative importance of the individual indicators. A high NPV of debt-to-revenue ratio, for example, combined with moderate debt ratios based on exports and GDP, may not necessarily indicate a debt problem but rather a particular weakness in revenue mobilization. Similarly, high debt-service ratios combined with a moderate debt stock suggest that a country may have room to borrow to overcome temporary liquidity pressures. This suggests the threshold analysis should be seen within a medium-term fiscal framework that allows for temporarily higher deficits and public debt indicators, as needed. Another area of judgement is related to the treatment of domestic obligations, as noted earlier, for which thresholds are not available.

22. **In fact, the empirical research underpinning debt sustainability thresholds is at an early stage, as underscored by the finding that the "quality" of policies and institutions is a significant determinant.** Policy quality in the studies has been measured by a confidential World Bank staff assessment that collapses indicators of everything from macroeconomic policy to property rights and corporate corruption, to gender and environmental policy, to trade policy and public debt management and so on into a single index number. It is thus not clear what policy "quality" covers in reality or if the complex indicator is simply capturing a relationship it and its main (and highly correlated) components have with one aspect of policy, such as inflation control (a reasonable proxy for "sound macroeconomic policies"). World Bank experts, moreover, have themselves warned against the inability of the index, the Country Policy and Institutional Assessment (CPIA), or others in its class to confidently discriminate among different countries (Kaufmann, Kray and Mastruzzi, 2003). Thus, while institutional and other broad factors in development are undoubtedly relevant to determining individual country capacity to sustain debt over time, there are reasons to doubt that the CPIA is a sufficient guide.

23. **Thus, while work on the Bank-Fund debt sustainability framework is considerably advanced, the two institutions are undertaking additional work on some issues, with a view to making the framework fully operational across a wide range of low-income countries.** These issues generally fall within three main areas: the modalities for implementing debt sustainability analyses, the specification of indicative thresholds, and the operational implications for the Fund and for other international financial institutions and donors.

II. PROCESS ISSUES IN MANAGING SOVEREIGN DEBT

24. **The main message of this section is that policy coherence on debt is not a natural state and needs to be nurtured.** This section looks at organizational and political aspects of how governments manage their debt and at strengthening the relationships with and among official and private creditors to enhance coherence and confidence. It emphasizes the positive role of information sharing and dialogue among stakeholders whose fundamental interests lie in stronger coherence in policy making.

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25. **Government debt management begins in the debt management office, but is part and parcel of overall economic policy making.** At its most basic level, governments need to know what debt-servicing payments have to be made in what currencies at what times. Not only is this an essential aspect of short-term treasury operations, but also decisions on adding to total debt require full information on the obligations already incurred far into the future and likely to be incurred. Mobilizing and monitoring this information is usually the function of the debt management office. It typically interfaces with debt policy officials, who recommend borrowing policies for adoption by the head of government and legislature. It also interfaces with foreign official and private creditors and the public at large, who also have legitimate and essential needs for debt-related information.

26. **It is important that governments appreciate the linkage between the expected debt-servicing burden of additions to external debt, the heightened risk of default from higher debt levels, and the budgetary opportunities opened by the borrowing for development and poverty reduction.** This implies that the relationships among the overall fiscal budget, the development and poverty reduction expenditures today and projected into the future, the programmed additions to external (and domestic) public debt and the risks thereby incurred need to be appreciated by the relevant decision makers. While it is relatively easy to speak of the need for greater policy coherence from government offices separately focused on debt management, development and poverty reduction, actually forging that coherence may be a challenging task. Nevertheless, it can be done and it may be worth looking at the experience of countries that have addressed these challenges and assess what lessons might be derived.

27. **Better policy coherence at the country level calls for effective intra-government and public communication and dialogue.** To illustrate the problem, consider the ministries responsible for conception and design of individual large infrastructure projects. Their staffs will seek to build coalitions inside and outside the government to promote their projects. It is for the central authority, the budget office and the finance ministry to make the individual initiatives coherent with overall policy needs and an internally consistent macroeconomic framework, which takes into account debt sustainability concerns. In fact, legislators and non-official stakeholders outside the permanent government bureaucracy in debtor countries might play a stronger role in the policy dialogue and thereby serve as a force for greater coherence of policy with national goals as well as improve its internal consistency. However, often they require better communication channels so as to have access to more complete and timely information, as

well as open avenues for their views to be heard by government. In short, greater transparency can help the political process better do its proper job.

28. **Strengthened international cooperation to boost debt-management capacity is also required.** In order to improve external debt management, debt managers in many developing and transition economies need to master various evolving techniques (stress-testing, sensitivity analysis, etc), as well as enjoy access to all relevant information on the portfolios they are managing. Yet, most debt management offices in these countries are overstretched and under funded. Additional resources for capacity building are required so that countries can have greater ownership of their debt sustainability analysis, rather than largely leaving the task to their international partners. Technical assistance can play a large role in overcoming existing constraints. It is thus important to identify the particular areas in which additional assistance is needed.

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29. **Taking on new sovereign debt is not only a borrower's decision. Creditors too must decide whether to extend a loan.** "Due diligence" on the part of the creditors entails assessing the sustainability of the borrower's debt.[7] While international commercial bank lenders have traditionally assessed the creditworthiness of borrowing governments, based on their ongoing relationships with the country concerned, bond buyers rely to a greater extent on independent assessments, as by the bond rating agencies. Nevertheless, large institutional investors typically supplement those with their own assessments, based on varying amounts and reliability of information.

30. **Clear communication channels between a government and its creditors are important, particularly when bonds play a large role in a country's external financing.** Bondholders who operate in a fog of uncertainty are more prone to panic and herd selling than bondholders who develop a measure of confidence based on an ongoing relationship with the borrowing authorities. Simple mechanisms to facilitate such communications have included scheduled conference calls between a debtor government and its major private sector lenders and investment banks. By the same token, and for the benefit of the emerging market sovereign asset class as a whole, it is incumbent on private international financial intermediaries to protect the interest of retail clients through full disclosure of information to them on the risks as well as prospective returns from emerging economy sovereign bond purchases.

31. **Official creditors have increasingly realized that they also need to appreciate better the debt sustainability of their low-income government clients.** While official creditors usually lend with a policy purpose, they are increasingly concerned with the repayment capacity of their clients. Indeed, the heightened international interest in debt sustainability analysis for poor countries is informed by a growing acknowledgement that official creditors have in the past lent to poor country governments well past the point of sustainability and should in the future instead offer more grant financing.

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[7] There is (or some would say, ought to be) a political dimension to due diligence; e.g., some authorities have recently sought to apply the concept of "odious debt" to relieve the successor Government of Iraq from responsibility for servicing loans that had been extended to the earlier regime.

32. **Increased coherence is also needed within and among official creditors.** Sometimes a creditor government's efforts to promote specific exports to aid-receiving countries conflict with the same government's commitment to promote attainment of development goals like those contained in the Millennium Declaration. Similarly, official creditors and donors sometimes provide tied-aid, raising the cost of finance and lowering aid effectiveness. Also, programmes supported by different donors and official creditors in an aid-receiving country can sometimes work at cross-purposes. This has prompted pledges by the international community "to harmonize and align their support behind country-owned development strategies, streamline the use of conditionality, increase the focus on results, and use country systems where appropriate."[8] Indeed, ministers in the International Monetary and Financial Committee, in support of implementation of the Monterrey Consensus, have recently called for international assistance to the Poverty Reduction Strategy process, including from IMF, to be more fully coordinated with domestic economic priorities.[9]

33. **Specific proposals have been made to create more formal international mechanisms, including a multilateral "debt surveillance mechanism" (DSM) and a private (non-profit) "information clearing house"** (Cohen et al., 2004; Samuels, 2002). Each would serve as a central point for the collection and dissemination of "real-time" debt information. The proposals would aim to mobilize timely and credible information on private and official debts and disseminate it in user-friendly ways, and in the process open up better channels of communication between all types of external creditors and borrowing governments. This could also work toward evolving standards of information presentation that more directly meet the needs of potential investors and creditors.

34. **Information systems, however, do not exist in a vacuum.** In the case of the DSM suggested for monitoring low-income countries' debt, its proponents stress the need for the system to be closely related to the policy dialogue that official creditors maintain with borrowers, so that the system's potential role in crisis prevention is enhanced.

35. **Despite potential benefit, the implementation of such proposals is not free of difficulties.** It is still to be assessed whether the costs of establishing and maintaining such data bases would outweigh the public good benefits they could provide for creditors and debtors in helping to prevent a crisis restructuring. Moreover, given the difficulties in creating a mandatory system, it is not clear whether a voluntary arrangement could avoid problems of coverage and still be useful. While part of the challenge could be addressed by clearly defining the goals of such information systems, it is not obvious what level of disaggregation they should make publicly available and to what extent creditors would be willing to disclose loan-related information.

36. **It follows from the above that besides debtor governments and their domestic stakeholders, foreign creditors, public and private, have a shared interest in strong developing country debt management that maintains coherence with major policy goals and that effectively communicates with all the relevant stakeholders.** It is important that

[8] Development Committee (Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries), "Communiqué", Washington, D.C., 2 October 2004, para.6.
[9] International Monetary and Financial Committee of the Board of Governors of the IMF, "Communiqué", Washington, D.C., 2 October 2004, para. 18.

debtors and creditors work together on these issues, not least to ensure that domestic stakeholders — governments above all — take effective ownership of their debt sustainability policies.

III. PRACTICAL WAYS TO CONTAIN RISK AND REDUCE UNCERTAINTY

37. **Aside from monitoring the growth of debt and ensuring an appropriate institutional and political process for its management, practical ways have been proposed to make a given level of debt less risky and to reduce creditor uncertainty.** Risk in this context arises from possible events occurring that would raise the probability of sovereign default, such as those mentioned in paragraph 12. Uncertainty pertains to how governments and their foreign creditors would respond should high-risk situations or outright default occur. A proper approach to debt management requires being prepared to handle the difficult situations so as to contain risk and reduce uncertainty. This section considers responses to both concerns.

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38. **New international financial instruments and better use of existing instruments may give a government greater ability to avoid debt crises from economic shocks.** Some analysts argue that it is no accident that sovereign default on external debt is a relatively frequent occurrence. Given that developing and transition economy governments primarily borrow on fixed terms and given the actual volatility in the world economy, defaults and subsequent debt restructuring are practically the only way for a debtor to reset its system. However, analysts have increasingly asked if it has to be this way. Might greater use of different types of borrowing instruments make the system work more smoothly?

39. **The international community has long offered special financial facilities to mitigate the impact of external economic shocks, and it responds to natural disasters in developing countries through established international facilities and ad hoc support.** These methods for countering the negative effects of external and domestic shocks were created in recognition that the developing economies would be hard placed to respond to such shocks on their own. The instruments developed for such circumstances have employed ex-post financing to help cushion the shock. They include the "B-envelope" grants — also known as FLEX — of the European Union's Cotonou Agreement,[10] and the IMF's Compensatory Financing Facility. Recently, the World Bank has also developed ex-ante market-oriented schemes, such as offering to include hedging products as add-ons to the Bank's non-concessional loans. However, debtor country governments have shown little interest in using these instruments, raising questions of the appropriateness of their design or conditions of use.

40. **Other financial instruments could also be explored, which can help mitigate the effects of shocks on policies.** For instance, while markets exist to provide insurance against natural disasters, which would protect debt repayments in the occurrence of an event, very few countries

[10] The "B" envelope replaces the "Stabex" and "Sysmin" compensation schemes for price volatility of the earlier agreements between the European Union and the associated African, Caribbean and Pacific countries.

currently use them. An alternative option is the issuance of sovereign catastrophe bonds, wherein some or all of the principal and interest repayments are waived in the event of a pre-specified catastrophe.

41. **Sovereign borrowing in local currency is a promising avenue for side-stepping currency risk arising from the natural mismatch between local currency tax revenues and foreign currency debt obligations.** The chief challenge is to make it attractive for foreign lenders to absorb the exchange rate risk themselves. More likely, in fact, foreign investors would swap out of the local currency instrument through a local currency derivatives market, although, as was learned in the 1998 crisis of the Russian Federation, this is too not without risk. Using financial derivatives to manage external liabilities and foreign payment flows has benefits, but it can also be expensive, especially for small countries, which is a reason it is not often done.

42. **There may be scope to expand official and private lending in local currencies.** The multilateral development banks have sought to help reduce the currency mismatch problem by developing facilities to lend in local currency based on local-currency resources they have raised by issuing bonds in the domestic financial market, and some attempts have been made to hedge exchange rate risk. Recently, it has also been suggested that the International Development Association (IDA), the concessional facility of the World Bank, should make its resources available to low-income countries through inflation-indexed, local currency denominated loans. As IDA resources are provided by donor governments and not through the international capital markets, there is flexibility in how the Bank may wish to extend IDA loans (Hausmann and Rigobon, 2003).

43. **Alternative means of reducing the risk of debt distress include loan instruments that tie debt repayments to important economic indicators.** Such instruments provide for lower payments in the event of weak economic performance or economic shocks. In addition, unlike compensatory financing or other forms of liquidity, these coping mechanisms do not add to the debt level during the periods of stress. Instruments linking debt repayments to commodity prices have a long history, albeit with limited “buy-side” interest in them in international financial markets. However, borrowing country interest has revived in promoting such instruments, as well as ones in which payment is contingent on weather patterns and even on the performance of trading partners. This notwithstanding, additional research is necessary to ascertain how best to design them.

44. **Some debtor countries have expressed interest in new instruments, such as GDP-linked bonds, where the repayment schedule is determined by the overall performance of the economy**. Unlike conventional debt instruments, these bonds act as counter-cyclical automatic stabilizers: when economic performance weakens and fiscal revenues accordingly decline, debt repayments are reduced, putting less pressure on the government to reduce other expenditures. Conversely, when economic performance picks up, payments increase when they are easier to afford.

45. **There are also drawbacks to the new instruments.** Firstly, given the variability in the yield on such instruments, financial market purchasers would demand an equity-like premium for holding them. Secondly, while widespread use of such instruments would reduce the riskiness of a given amount of debt and thus raise the level of debt at which a debt-sustainability

indicator should flag concern, it would become even harder than it is today to derive the appropriate new benchmark. Thirdly, some of these new instruments may strengthen incentives to distort national statistical data in order to reduce or change the time path of payments (on the other hand, countries issuing GDP-linked bonds would find it necessary to have trusted and independent statistical offices in order for their debt to be attractive to international investors). Finally, a general phenomenon, shared when any new financial instrument is introduced is that there is an "adoption hurdle" to overcome, as potential buyers of the instrument would be concerned about limited liquidity of the instrument and demand a pricing premium.

46. **Introducing a seniority structure to sovereign debt could address a major source of instability in sovereign debt markets.** Sovereign debt tends to be homogenous: unlike in corporate credit markets, sovereign debt lacks an explicit "seniority" structure that determines the hierarchy of creditors' claims in event of default (except that multilateral creditors are acknowledged to be preferred creditors). As a result, sovereign creditors are more exposed to "debt dilution" than their corporate counterparts: without a seniority structure, any new debt reduces the claims that existing creditors might hope to recover when a default occurs. This gives a strong incentive to existing creditors to sell their holdings when conditions deteriorate, possibly dropping bond prices sharply in secondary markets and raising yields at the same time that the government seeks to expand its borrowing. Heightened prospects of debt dilution will also encourage investors in sovereign debt to hold shorter-term instruments. Higher amounts of short-term debt, in turn, raise the risk of a debt crisis for a debtor who must more frequently roll over the maturing debt by selling new issues.

47. **Explicit seniority in sovereign debt comes with specific risks.** Seniority in sovereign debt could be introduced in a number of ways, but a pragmatic option would be via provisions in bond contracts that protect bondholders from dilution by any future issues.[11] However, reducing the seniority of the latest debt issue sold by the government would raise the risk premium on that issue and thus its interest cost. Also, as a country sought to issue more debt as its economic situation deteriorated, having an explicit seniority structure on its debt might cut off its access to new international borrowing at an earlier stage, increasing the risk of liquidity crises (but also preventing the out-of-hand run up in debt that often precedes a crisis outbreak). Also, and more generally, by complicating pricing, differentiated seniority might serve to make debt more expensive.

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48. **External sovereign debt crises are typically wrapped in uncertainty, as there are no uniform rules, only differentiated informal practices, for righting the situation when a country descends into crisis.** If the major financial protagonists in a debt crisis could step back and view the situation as a whole and from a long-run perspective, they would find it in their interest to reach an orderly and early agreement that provided the debtor country an exit from the crisis into a sustainable debt configuration. However, individual creditors see their main interest in maximizing the value of their claims after restructuring in the debt workout. In addition, private creditors generally seek post-crisis claims with high liquidity, so they may sell them into the market, which is not a consideration for official creditors. Meanwhile, the main interest of the

[11] The contractual approach would broadly mirror the seniority structure used in corporate debt.

debtor government is to minimize its post-crisis debt servicing and return as soon as possible to normal international relationships with the financial markets and official creditors. There has been much concern of late to strengthen the processes by which these different interests are brought together to forge a lasting restructuring of a crisis country's external obligations, let alone an "optimal" one, although it is at best a work in progress.

49. **A particular problem that was feared in the 1990s was that a relatively small number of "hold-out" bondholders could undermine a sovereign debt restructuring, but that fear has ebbed.** The concern was that "vulture" investors would buy distressed bonds at deep discount, not agree to a debt restructuring with a partial write down of the debt, and seek instead to collect full face value in creditor country courts, which if successful would reduce recovery values for the other creditors. This problem did not arise in the 1980s era, which was dominated by commercial bank lending, because the loan agreements required that any bank that captured a higher percentage recovery from a defaulting borrower than other banks had to share it. The fear of holdouts among bondholders, whose bond documents did not contain sharing clauses, was probably exaggerated. In part, this is because a legal device called "exit consents" seemed to be a satisfactory way to contain the threat. However, the recent introduction of "collective action clauses" (CACs) into bonds that were not already subject to them has further reduced the potential for disruption. Although most of the outstanding sovereign bonds of emerging economies do not currently have such clauses, over time they will be rolled over into bonds having them.[12]

50. **A greater source of creditor uncertainty is whether different creditors will receive comparable treatment in debt restructuring.** The government in crisis, in particular of a middle-income country, is likely to have defaulted on several different bond issues with different terms and in different currencies, as well as on syndicated bank loans and on foreign export credits, which would have been taken over by the exporting country's official export credit agency. Very few bond contracts contain "aggregation" clauses that would describe how the claims of holders of different bond issues should be brought together in negotiations with the debtor.[13] Even if they did, there is no mechanism to ensure comparability of treatment with defaulted bank debt, which is handled through a separate negotiation process, called London clubs, or either of these with the debt owed to government creditors through yet another separate process, the Paris Club. Formally, it lies on the shoulders of the debtor government in crisis to bring about comparability, albeit assisted by IMF with which it will have an ongoing macroeconomic adjustment programme. In reality, it is a contest, with the government and the different creditors and their negotiating committees each seeking the best deal they can get. However, unlike a corporate bankruptcy case, there is no judge overseeing the process and ensuring it follows bankruptcy law. There is no such law and no judge, as the debtor is a sovereign government.

51. **A different source of uncertainty is whether the debtor receives sufficient relief to have a reasonable chance to maintain a sustainable debt configuration.** Although some of the creditors will sell their claims on the defaulted government after the crisis is resolved,

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[12] In 2003, Uruguay swapped essentially all its external bonds without CACs into bonds having them, reducing the threat of this problem immediately.

[13] One exception is Uruguay, whose new bonds contain a limited aggregation clause.

government creditors do not have that option and others may not choose to sell. Their concern should be that the restructured debt obligations now be honoured in full and not again become distressed. The record in this regard is decidedly mixed, as many countries have indeed required follow-up debt restructuring. While in a number of cases, the return to debt crisis reflected a new distress event; in other cases, it reflected a continuing of a crisis that was not adequately resolved in the first attempt. Certainly, there is cause for concern over the need for repeated attempts to address the excessive debt burdens of the poorest developing countries through cycles over decades of acknowledgement that the previous treatments did not provide sufficient relief and that more was needed. The current call by two major industrialized countries for additional relief for the HIPCs, as noted earlier, is a striking case in point.

52. **There are different ideas on how to reduce the uncertainty, but no emerging consensus around any of them.** Many difficulties were seen in the IMF initiative to create a Sovereign Debt Restructuring Mechanism, which was called a "statutory" approach to driving creditors and the debtor to more effective negotiations. There has been a marked preference for a "voluntary" and market-oriented approach, although the content of such an approach is not usually spelled out beyond how it would address bond issues per se. If a "code of conduct" for how to approach debt restructuring in a cooperative and effective manner is drafted that wins acceptance by debt-issuing governments and groups of creditors (in particular, bond buyers), then the voluntary approach will be better defined. If not, additional ideas may warrant a review, such as the proposal to create an independent, non-profit "sovereign debt forum," perhaps containing a mediation service and private dispute resolution facilities (Gitlin 2002).

53. **It remains at this moment for individual governments of debtor countries to seek to reduce uncertainty on their own through ongoing open relations with creditors and other stakeholders in the country's external debt situation.** Most important in this regard, on the one hand, are the process issues discussed in section II above, on building transparency and dialogue among the relevant stakeholders, and on the other hand, effective debt management at the operational level and in terms of following coherent policy directions for true debt sustainability, as discussed in section I.

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