Debt Sustainability in Low Income Countries

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Outline

- Debt trends in Low Income Sub-Saharan Africa
- Grants versus loans and what to do about the DSF
- Blending in

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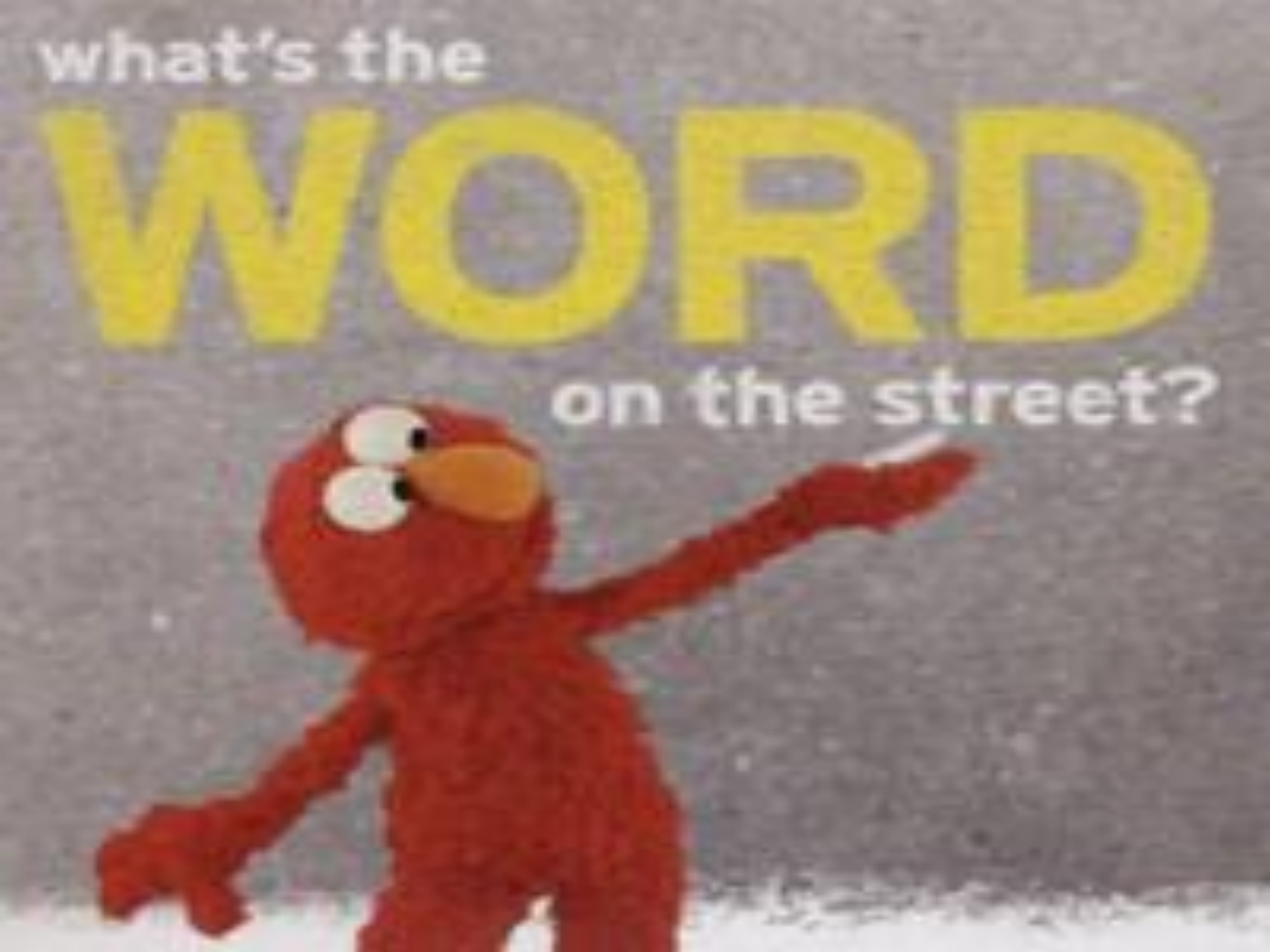

what's the
WORD
on the street?

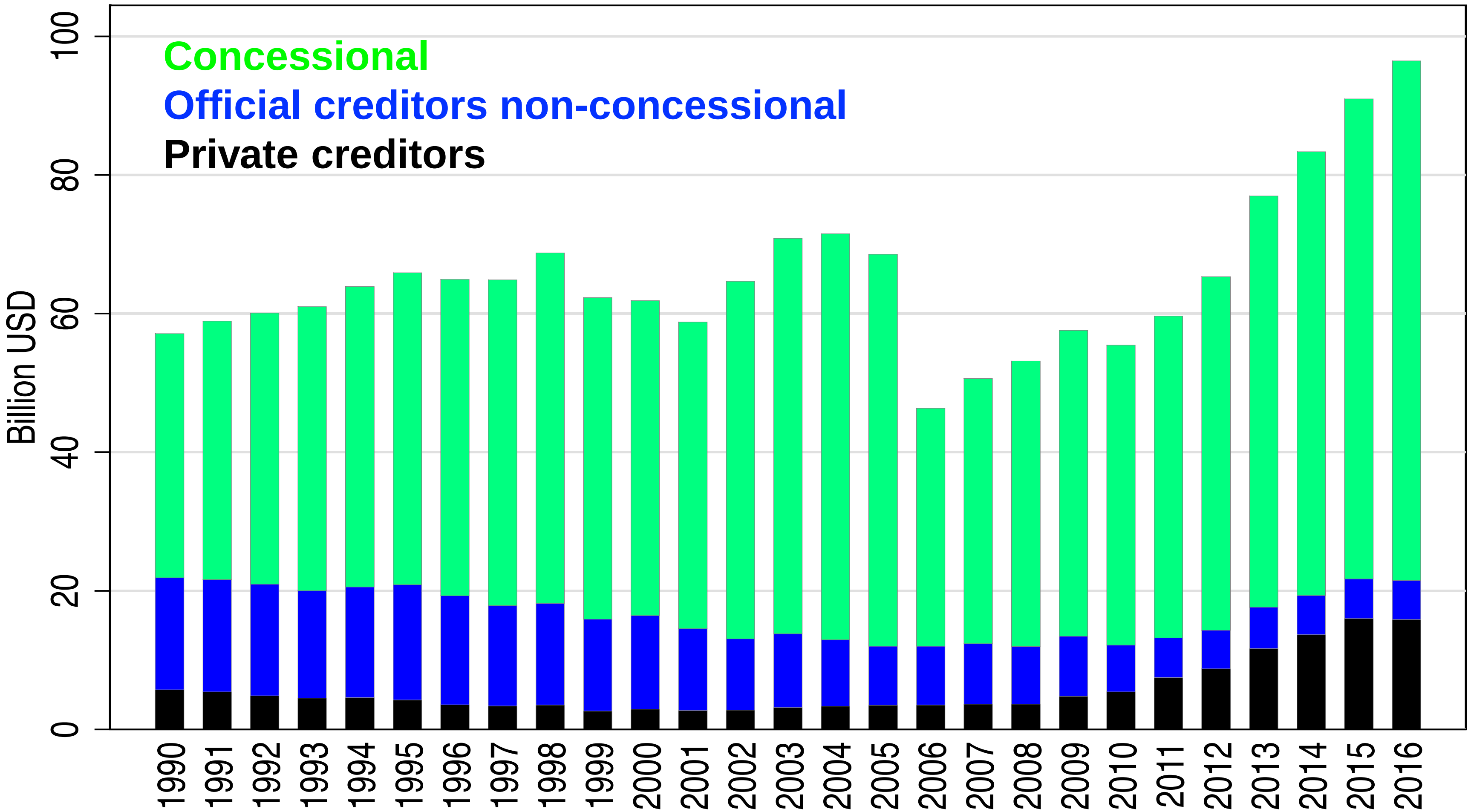
UNSUSTAINABLE

The widening primary deficits in Sub-Saharan Africa in the post-global financial crisis period, weaker currencies, and rising borrowing costs—along with poorer growth prospects—are creating perverse dynamics of debt accumulation that might jeopardize public debt sustainability

Countries shifted away from traditional concessional sources of financing, toward more market-based and domestic debt. The share of multilateral and concessional debt declined and the share of non-Paris Club (**AKA CHINA**) debt increased.

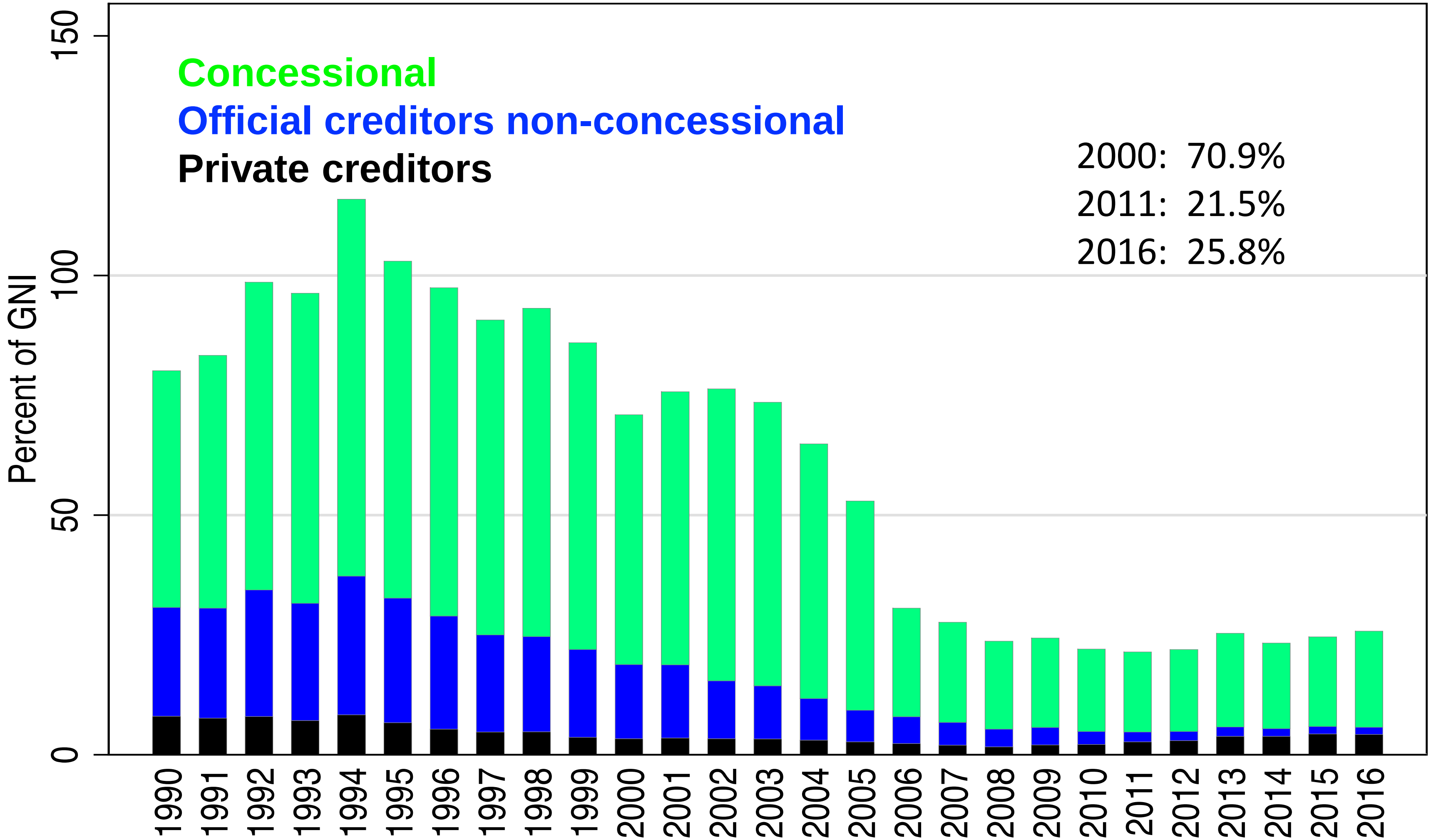
World Bank (2018)

PPG External Debt in Low Income Sub-Saharan Africa



Source: Own calculation based on WB data

PPG External Debt in Low Income Sub-Saharan Africa



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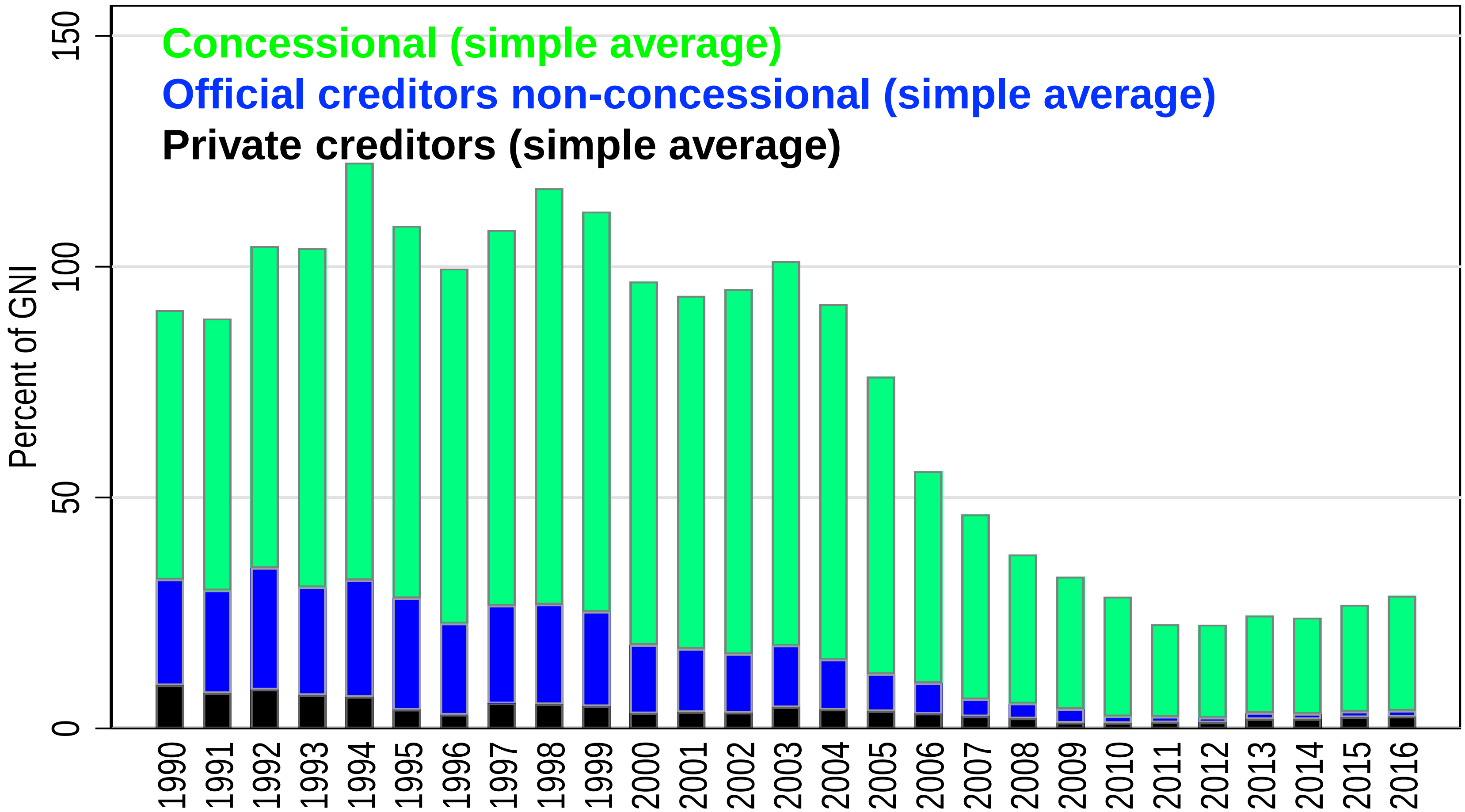
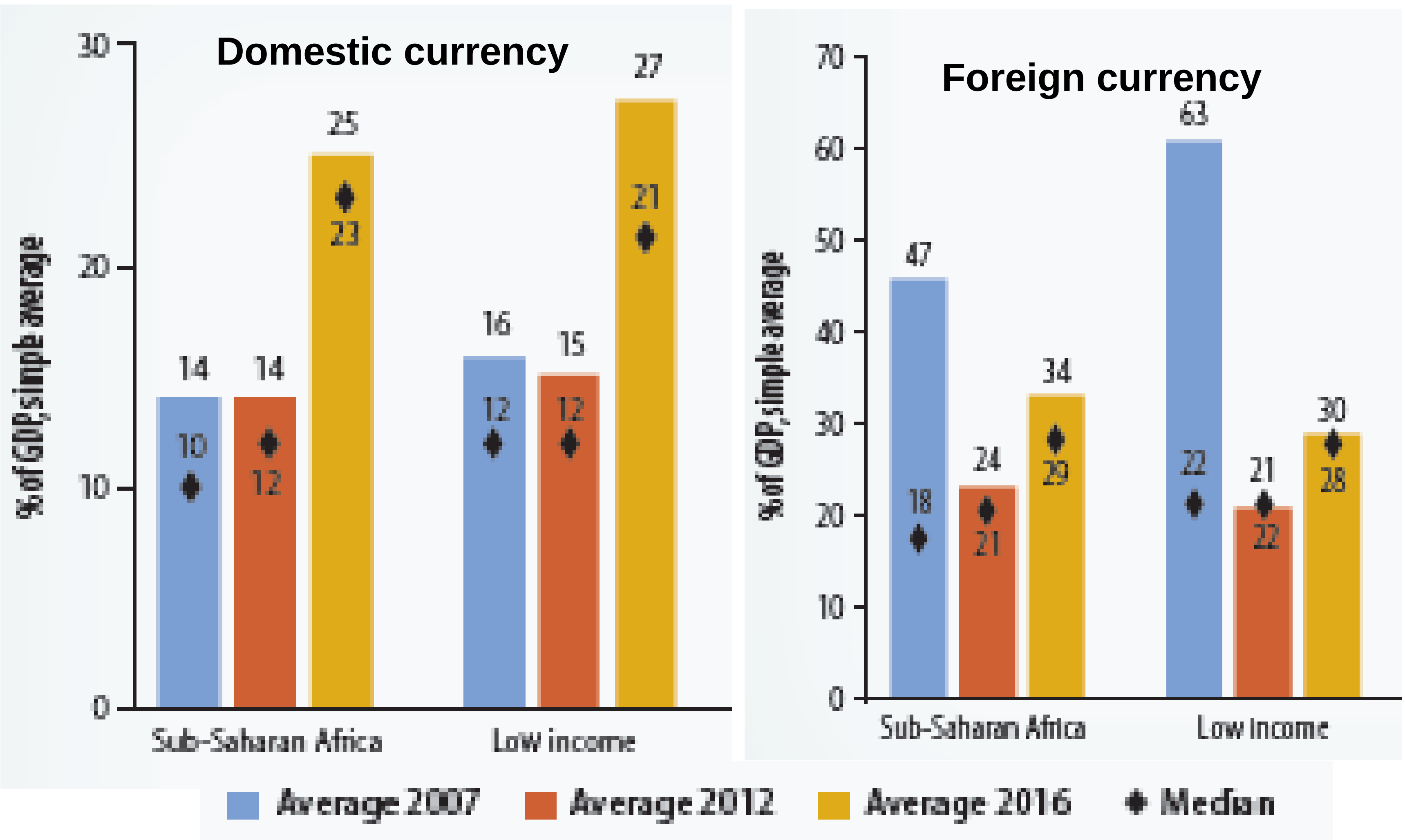
PPG External Debt in Low Income Sub-Saharan Africa



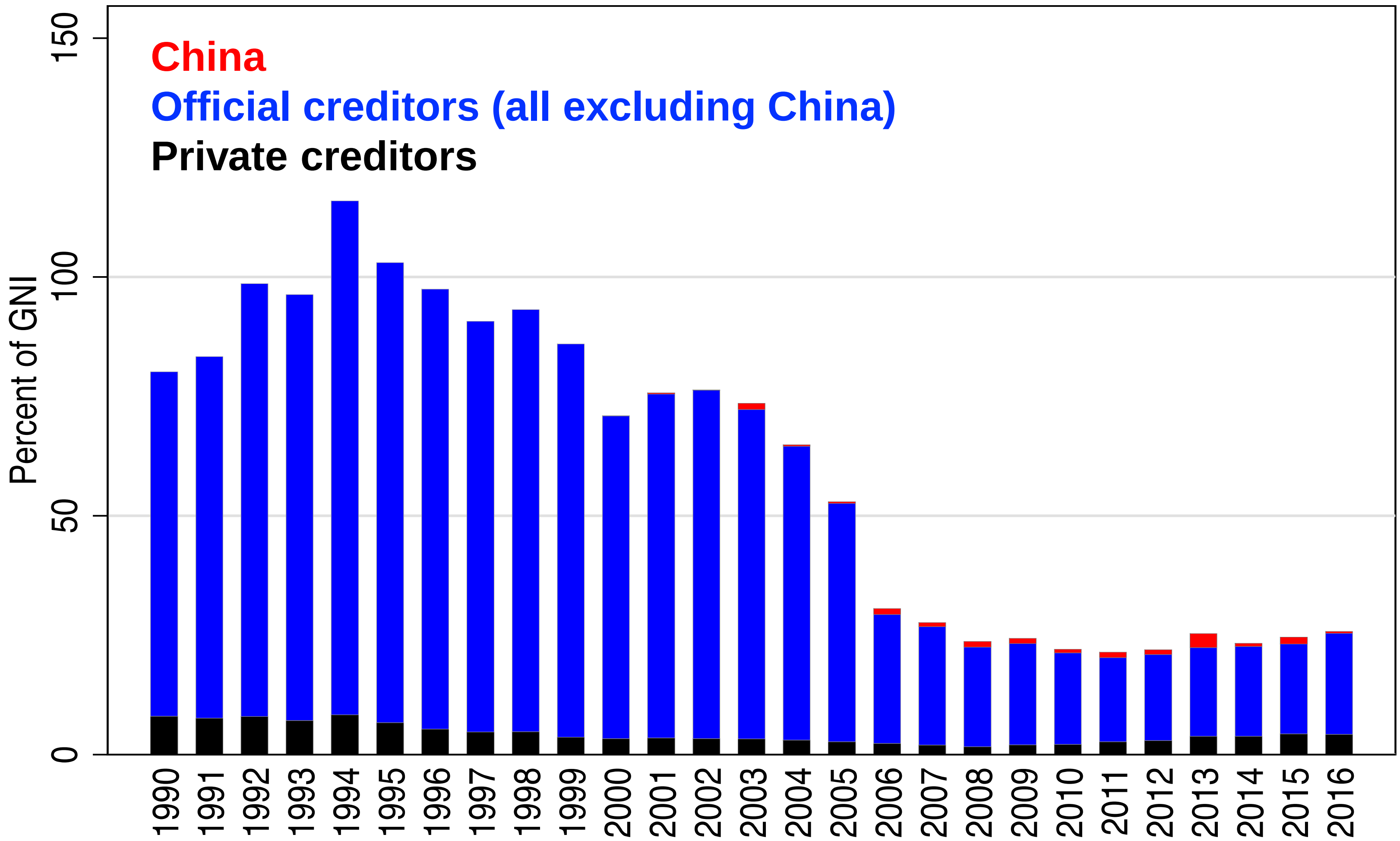
Source: Own calculation based on WB data

Domestic and External Debt in Low Income Sub-Saharan Africa



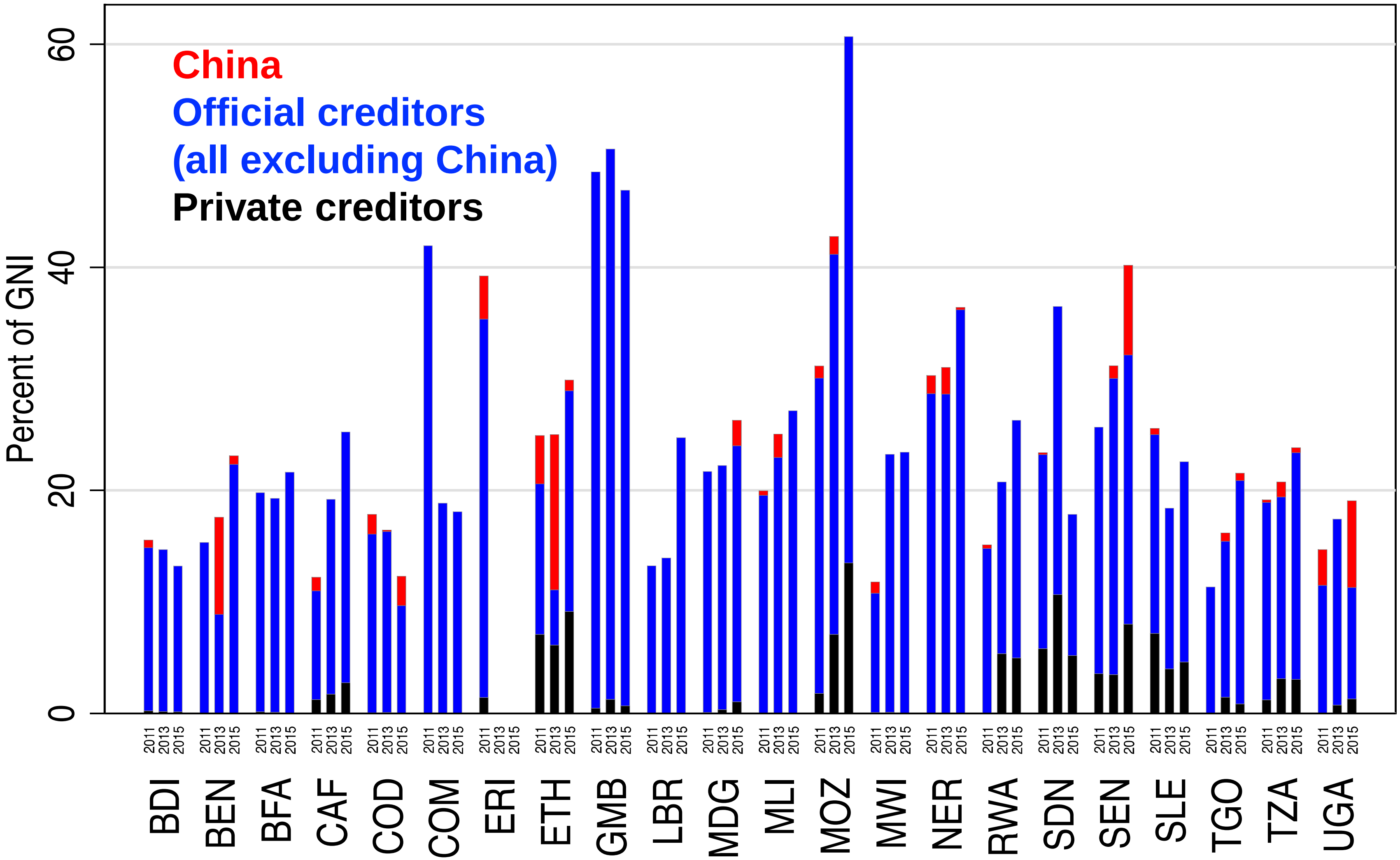
Source: World Bank, 2018

PPG Debt in Low Income Sub-Saharan Africa



Source: Own calculation based on WB & SAIS data

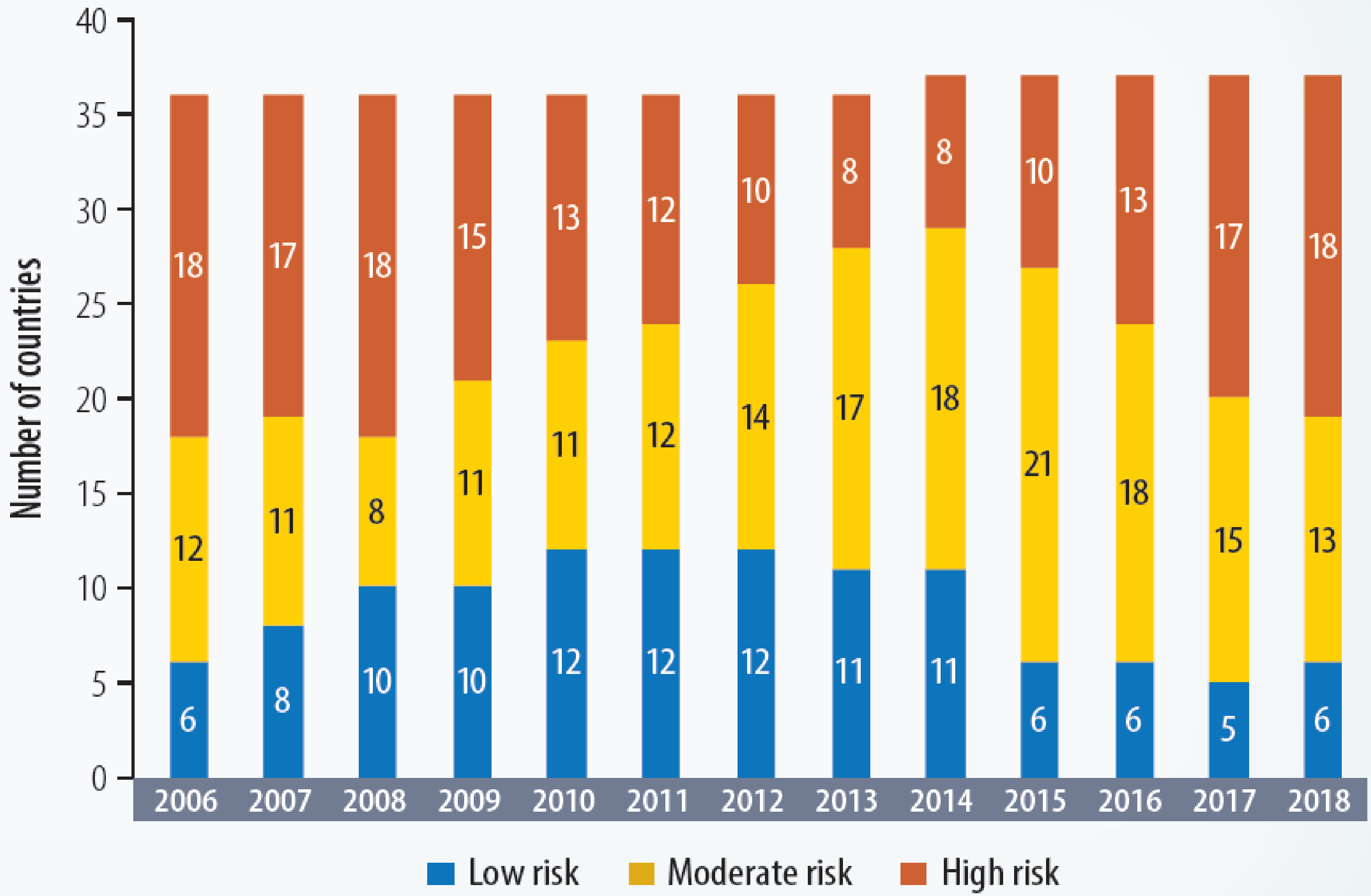
PPG External Debt in Low Income Sub-Saharan Africa



Source: Own calculation based on WB & SAIS data

Still, we are worried

FIGURE 2.15: Evolution of the Risk of Debt Distress: LIC DSF Countries in Sub-Saharan Africa



Source: World Bank/IMF LIC DSA database.

Note: Covers all IDA-eligible countries with LIC DSAs, including inactive countries.

Source: World Bank, 2018

Didn’t we have the DSF?

- The DSF guides concessional lending decisions
  - ..we forecast growth over the next twenty years
  - ..we look at the quality of policies and institutions
  - ..and we decide whether a country will be able to repay
- Green light countries:
  - More money under the form of concessional loans
- Yellow light countries:
  - Less money half concessional loans, half grant
- Red light countries
  - Even less money, but all grant

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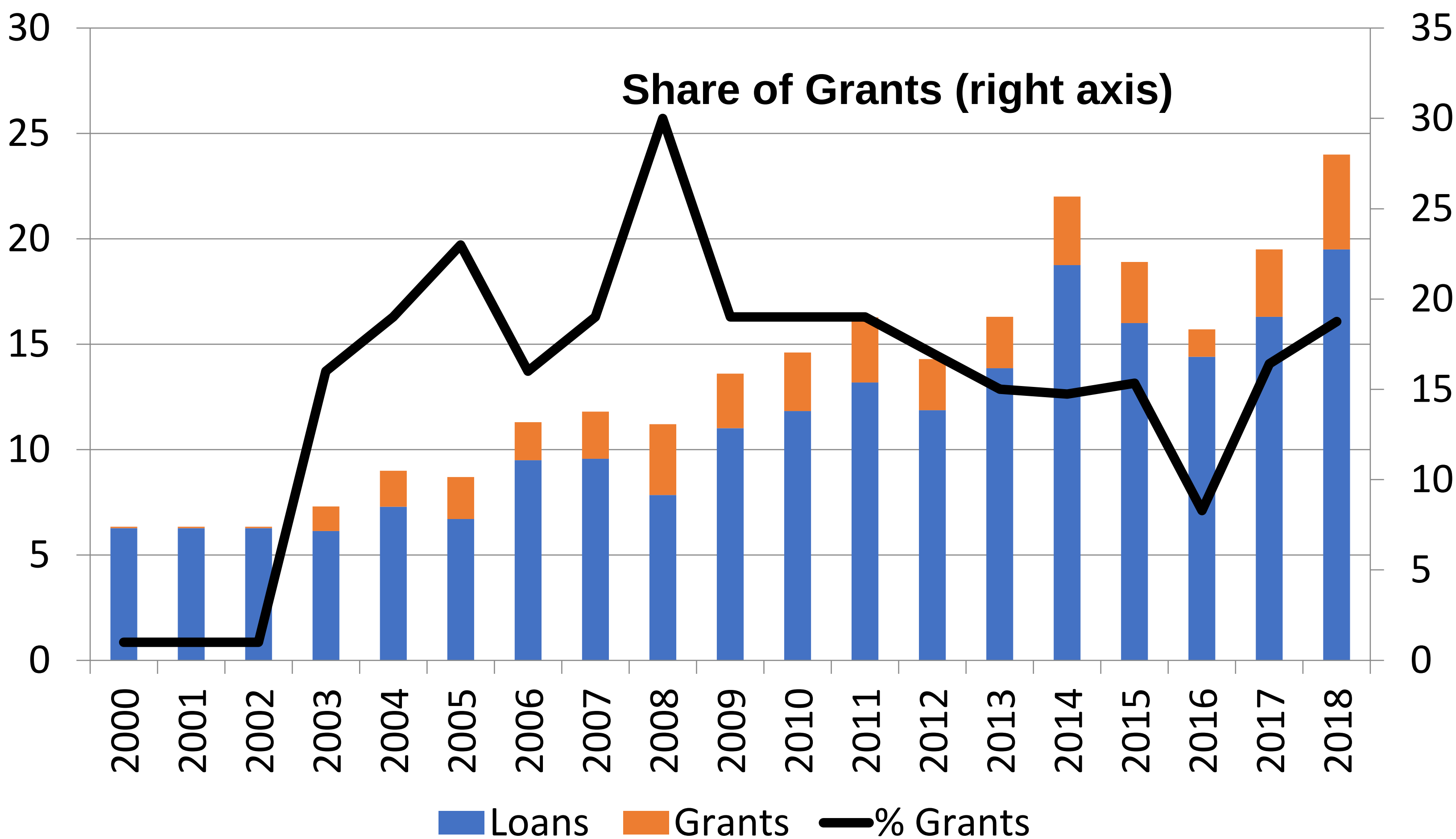
The push for grants

- *The World Bank has driven poor countries into a ditch by lending instead of donating funds to fight poverty*
  - Paul H. O'Neill, US Treasury Secretary (February, 20, 2002)
- *It is critical that the Bank provide more of its funding as grants*
    - *Steve Radelet, CGD, 2005*

IDA commitments: Grants versus loans (billions USD)



Problems with DSF

- Politics
  - Lang and Presbitero (2017) “Room for discretion? Biased decision-making in international financial institutions,” *Journal of Development Economics*
    - Identify cases where the risk rating implied by the application of the DSF's rules was overridden to assign a different rating.
    - They show that political interests influence the rating.
    - Countries that are politically aligned with the institutions' major shareholders are more likely to receive an improved rating; especially in election years.
- Possibly too conservative
  - Berg et al. (2014) “Assessing Bias and Accuracy in the World Bank-IMF's Debt Sustainability Framework for Low-Income Countries” IMF WP
- **Massive measurement error**
  - DSF needs **long-term** growth forecasts and the noise to signal ratio is huge

Panizza (2015) "Debt Sustainability in Low-Income Countries: The Grants versus Loans Debate in a World without Crystal Balls," in P. Guillaumont (ed.) *Financing Sustainable Development by Addressing Vulnerabilities*, FERDI.

(This)… may be the best theoretical indicator of sustainability, <u>it cannot however be constructed … one must make projections of</u> ***<u>g</u>*** *<u>far in the future, far beyond what is known with any accuracy</u>.*

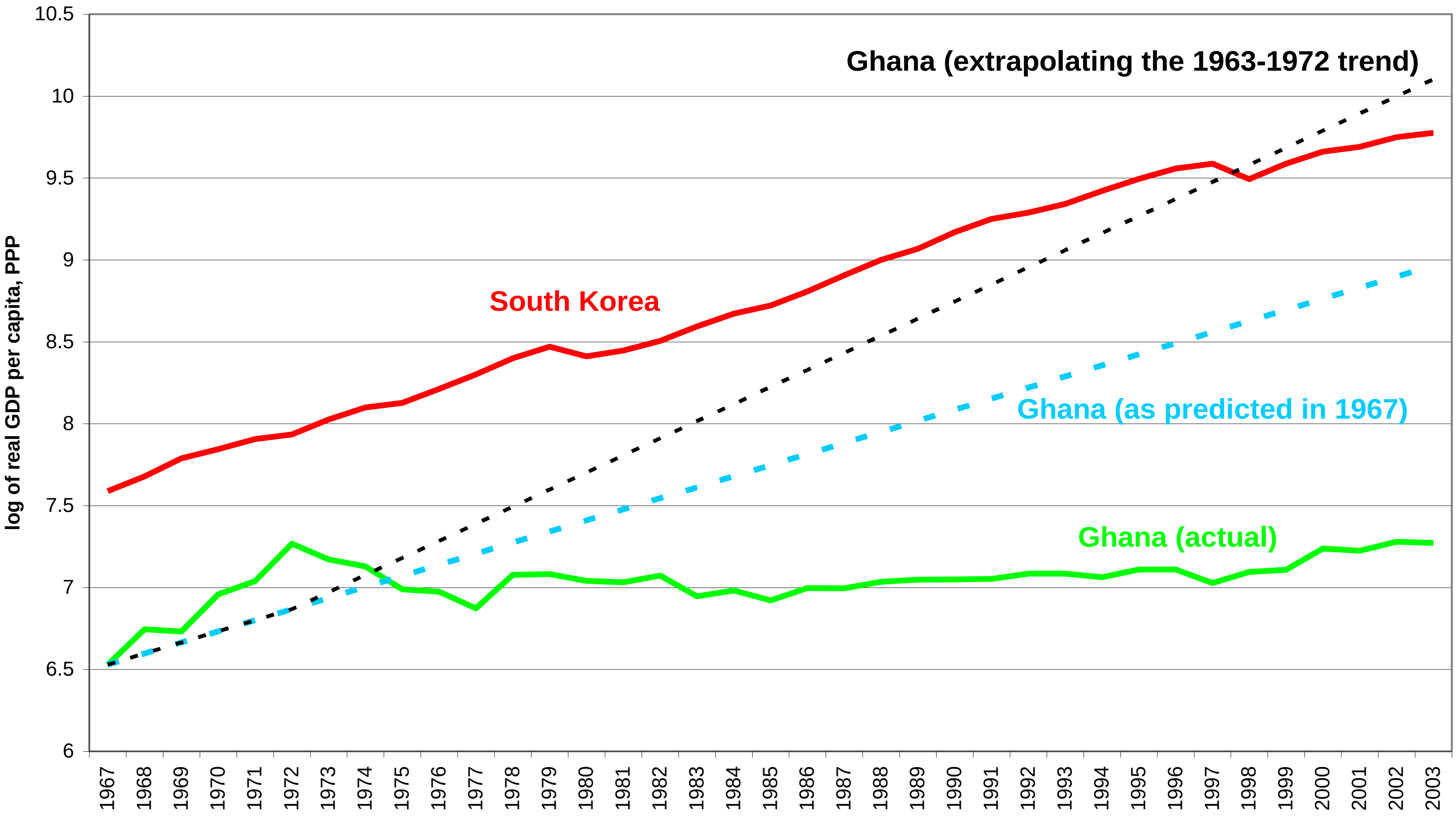
Olivier Blanchard (1990) about developing fiscal sustainability indicators for OECD countries

GDP Growth Forecasts

Forecast Period	Abs. value of forecast error		Forecast Error			Best forecast
	Mean	Median	St. Dev.	Min	Max	
	OECD Countries (22 countries)					
1990-2010	17%	12%	26%	-28%	103%	0.3%
				Ireland	Japan	Australia
1985-2005	16%	14%	21%	-49%	53%	-1%
				Ireland	Japan	Switzerland

In the late 1960s many economists thought that Ghana would achieve rapid growth and nobody thought much of South Korea

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so **(Mark Twain)**



Talking about LIC and EMs, Wyplosz (2005) says:

DSA is <u>*mission impossible*</u>*, …as sustainability is entirely forward looking… any indicator will be both* <u>*arbitrary and too imprecise to serve as tool for policy prescription*</u>.

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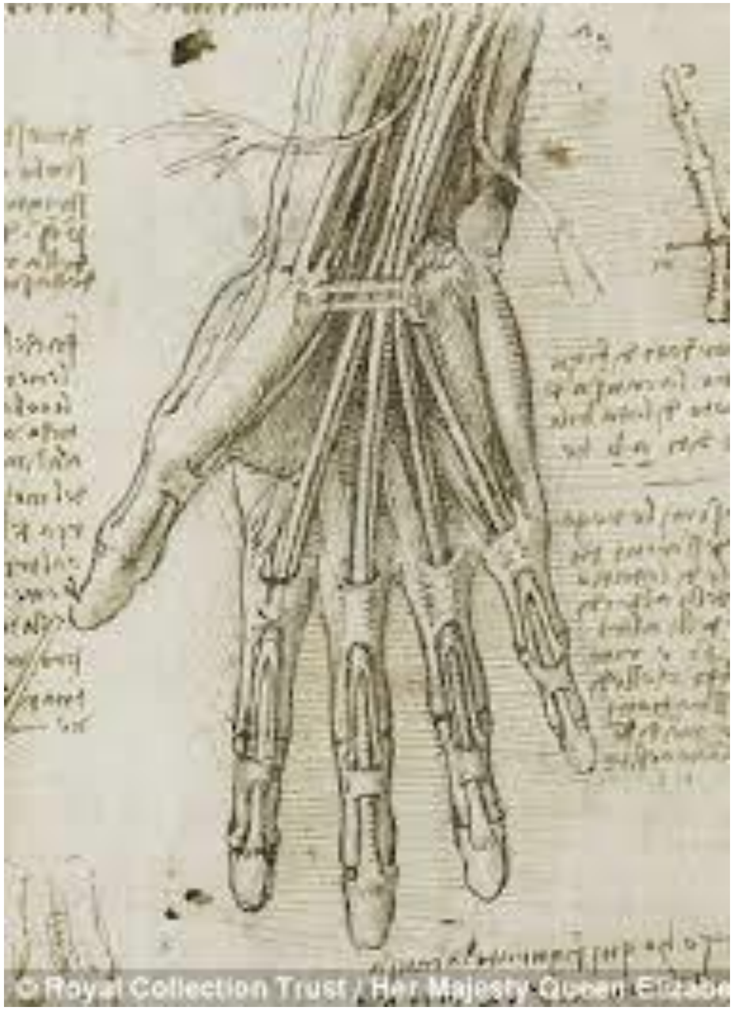
Art & Science



How to decide on grants versus loans without a crystal ball

- You need a tool to beat a tool
- If we don't know whether countries will be able to repay, why don't we just move from ***ex ante*** to ***ex post*** grants?
  - A modest proposal
    - Automatic debt relief in the wake of natural disasters
  - A more ambitious proposal
    - Make debt payments contingent to commodity prices (AFD)
      - Guillaumont, Guillaumont Jeanneney, Jacquet, Chauvet, and Savoye (2003)
  - A proposal in the spirit of Niels Bohr
    - *We all agree that your theory is crazy. The question that divides us is whether it is crazy enough to have a chance of being correct.*
      - (Niels Bohr to Wolfgang Pauli after Pauli's presentation of Heisenberg's and Pauli's nonlinear field theory of elementary particles, Columbia University, 1958)

The Bohr proposal

- Allocate official credit under the assumption that countries will be able to repay (possibly after a grace period)
- Set the repayments of official loans as a fixed percentage (up to a maximum) of the borrower's GDP
- Grants come *ex-post* (like in HIPC) but the rules are decided *ex-ante*
    - Technicalities discussed in Panizza (2015)

The Bohr proposal: Advantages

- No need for crystal balls
  - Grants will only go to countries that really need them
    - There are many sources of uncertainty besides commodity prices and natural disasters
- It gives the right incentives to lenders
  - No loan pushing
  - Less irresponsible and tied lending

The Bohr proposal: Problems

- Moral hazard
  - 1 Less incentives to grow
    - …but…
  - 2 Fake statistics
    - This is a serious issue, we do need better statistics
  - 3 New lenders may jump in after (or before) the country gets debt relief
    - Prohibit (or limit) new borrowing (as it is done now)
    - Allow new borrowing only if it has the same GDP clauses as existing debt
      - Silver lining: this would jump start the market for GDP indexed bonds
- How do you determine needs?
- The actual aid envelope is only known ex-post
  - This is OK, rich countries should be more able to bear risk
  - With temporary shocks, payments could be postponed but not cancelled
- Nasty regimes
  - Adopt an odious debt doctrine (nobody will lend to them)
  - Or, see Hausmann and Panizza (2017) and Gulati and Panizza (2018a, 2018b)

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- Will blended finance and the cascade approach be a sea change or just another wave?
- We'll see

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