

Mr. Paul Ladd, UNDP-New York Headquarters

1. The economic crisis and developing country indebtedness

The first phase of this e-discussion is considering the effectiveness of the international community's response to the economic crisis. In this context I would like to raise the issue of how the crisis – and the response of the international community – may impact on indebtedness in developing countries.

It has become clear that many developing countries are facing severe financing constraints due to reduced foreign investment, remittances, exports and growth (and hence lower domestic taxes and other revenues). Many are now seeking to fill balance of payments and budgetary gaps with concessional finance from the World Bank and IMF. These sources of finance have recently been augmented by the shareholders of those institutions, including at the London G20 Summit.

As the majority of the \$1.1 trillion in new finance pledged at the G20 Summit will be made available to developing countries in the form of loans, it is very likely that developing country debt levels will start to rise again. This is not a problem *per se* – countries have a right to borrow to invest for the future and to smooth out rough times. The question becomes whether debt levels will rise to the extent that some countries find themselves in debt distress, and will therefore require a new round of multilateral debt cancellation.

Beyond the \$1.1 trillion headline figure from the London Summit, there was another less-well-noticed commitment in the communiqué – to review the World Bank and IMF's debt sustainability framework (DSF). The DSF was introduced in 2005 and is used to judge what 'safe' levels of debt might be, especially for countries that have benefited from debt relief under the HIPC (Heavily Indebted Poor Countries) and MDRI (Multilateral Debt Relief Initiative) schemes and have started to borrow again. The DSF is linked to the World Bank's Country Policy and Institutional Assessment (CPIA): countries judged by World Bank staff to have better policies and institutions are more likely to be able to carry higher levels of debt; countries with worse policies and weaker capacity can carry less debt.

Because the economic crisis is causing unprecedented difficulties, some developing countries may start to find themselves in a new kind of debt trap. But the trap this time will be one of not being able to borrow enough. With grant finance from donors under threat, the DSF may serve to restrict the ability of countries to borrow and put in place counter-cyclical fiscal policies and maintain investment that supports long term growth and development.

A recent paper in *Development Policy Review** explores whether the DSF is unduly restricting the ability of some countries to borrow, thereby locking them into a low-debt, low-growth path. It posits that, in addition to policies and institutions, a country's ability to repay debt will improve if it is making more progress on development and the MDGs. This is intuitive – a country that immunizes all of its children and puts them in school is more likely to be in a position to support economic growth and pay back loans in the future. The paper finds that using an MDG-index to assess debt sustainability would allow some countries to take on more borrowing. This is an important finding when one considers the ongoing financial and economic crisis and the additional needs it is creating.

No matter how the DSF is reviewed and refined, debt problems will still occur in the future. This is the same for countries as it is for individuals and private companies. Economic shocks – whether it is losing a job or losing a market – can turn a position of debt sustainability into a position of debt unsustainability. But unlike individuals and companies who can enter bankruptcy procedures to restructure and reduce the burden of unsustainable debt, this is not an option for countries. Recognizing this gap in the international architecture, an attempt was made by the IMF in 2003 to set up a debt restructuring mechanism for sovereign debts. The attempt failed, largely because of insufficient support from the IMF's shareholders, many of whom had an eye on the profitability of their own financial services industries. But the time has come to revisit and improve on this proposal, and to use the opportunity of the crisis to plug a gap in the institutional fabric. An improved sovereign debt restructuring mechanism would need to cover all debts, require all creditors to take a debt haircut, and be transparent in the process of restructuring.