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Notes

- 1 See *External Debt Statistics: Guide for Compilers and Users*, jointly published by the Bank for International Settlements (BIS), Eurostat, the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), the Paris Club, UNCTAD and the World Bank. However, it should be pointed out that a strict application of this definition is not possible, since most of the external debt due to private creditors is held by investors who are, in principle, anonymous. Consequently, most countries report figures for external and domestic debt by using information on the place of issuance and jurisdiction that regulates the debt contract. This is problematic, because there is anecdotal evidence that more and more international investors are entering the domestic financial markets of developing countries, and that domestic investors often hold bonds issued in international markets. An alternative definition would focus on the currency in which the debt is issued, with external debt defined as foreign currency debt. But this definition does not seem appropriate because several countries issue foreign-currency-denominated debt in their domestic markets and have recently started to issue domestic-currency-denominated debt in international markets. Moreover, there is limited information on the currency composition of debt issued on the domestic market.
- 2 The five largest economies accounted for 50 per cent of the total GNI of the developing world in 2000. China accounted for 60 per cent of the total GNI of the East Asia-Pacific region. Brazil and Mexico for 60 per cent of the total GNI of the Latin America and the Caribbean region, and the Russian Federation for 30 per cent of the total GNI of the Eastern Europe and Central Asia region.
- 3 Foreign investors' holdings of locally issued instruments are supposed to be classified as external debt and not domestic debt, but this is rarely done (see note 1).
- 4 Conventional wisdom suggests that private and public borrowers from emerging market countries can now sell domestic-currency-denominated debt to foreign investors because these investors expect an appreciation of the local currency against the dollar. However, this view is only justified if the lenders expect a larger appreciation than the borrowers, and it is not clear why this should be the case. Caballero and Cowan (2008) suggest that domestic-currency-denominated borrowing is now in vogue because the expected appreciation allows prudent policymakers to hide the implicit insurance premium embedded in this form of borrowing.
- 5 Data on the amount of debt relief also differ depending on whether reference is made to debtor-reported data, such as that of the World Bank's Global Development Finance (GDF) database, or to creditor-reported data in the database of the OECD's Development Assistance Committee (DAC). The main advantage of the GDF database is that it indicates debt relief from all official creditors, including those that are not members of DAC. The main problem with this source is related to the fact that not all developing countries have strong debt recording capacities, and hence GDF data suffer from substantial measurement errors. Creditor-reported data from the DAC database tend to be "cleaner" than GDF data, but the coverage of non-DAC members is limited. As a consequence, the DAC figures tend to be smaller than the GDF figures, and GDF data tend to show greater volatility than DAC data.
- 6 For a discussion of the Paris Club and its procedures, see Rieffel, 2003.
- 7 Data for debt relief are from DAC (OECD-IDS) and for debt-to-GNI ratio from GDF.
- 8 Depetris Chauvin and Kraay (2005) tested the relationship between debt relief, growth and the composition of public expenditure. They found a positive, but not statistically significant, correlation between debt relief and GDP growth, and a positive, statistically significant, but not very robust, correlation between debt relief and government spending on health and education.

- 9 The modalities of eligibility and delivery of debt relief under the MDRI vary among the multilateral institutions. Each institution is separately responsible for deciding the implementation and coverage of the debt relief. While the majority of HIPC are fully covered by the participation of the African Development Bank (AfDB) and IDB, Afghanistan, Kyrgyzstan and Nepal are not, because the Asian Development Bank (ADB) does not participate in the MDRI.
- 10 The frameworks would provide an extremely early warning, as some debt sustainability analyses are based on 20-year projections.
- 11 A minor difference has to do with the stress-testing exercises. Stress-testing is more important in the framework for middle-income countries for at least two reasons. The first relates to data availability, as some low-income countries lack sufficient data. The second has to do with the fact that middle-income countries have a more complex debt structure and are more susceptible to large shocks to their financing costs.
- 12 Countries are classified as low risk if all debt indicators are below the debt burden threshold and will remain below this threshold even if these countries suffer a relatively large negative shock. Countries are classified as moderate risk if their debt indicators are below the debt burden threshold but they risk breaching the threshold in case of a negative shock. Countries are classified as high risk if the baseline projections indicate that the countries will breach the threshold. Countries are classified in debt distress if their debt ratios are in breach of the thresholds (for more details, see World Bank, 2006b).
- 13 While not receiving grants, low-risk countries benefit from the concessional element that is part of all IDA loans.
- 14 It is sometimes argued that there is no transfer problem associated with the presence of external private debt, and that the only problem comes from external public debt. This view is often referred to as the "Lawson doctrine", following a 1988 speech of the then British Chancellor of the Exchequer, Nigel Lawson, who, while commenting on the current-account deficit of the United Kingdom, stated that the position of his country was strong because the current-account deficit was driven by private sector and not public sector borrowing. The Asian crisis, which occurred in a context of low public debt and deficits and was driven by private borrowing, discredited the Lawson doctrine. Indeed, even the United Kingdom entered into a deep recession soon after Mr. Lawson delivered his famous speech.
- 15 In theory, this is also true when external debt is denominated in a country's own currency, but countries that can issue the currency in which their debt is denominated have the option to debase their debt by printing more money.
- 16 As a counterpart to the swing of the debtor country's current-account balance into surplus, creditors need to accept a worsening of their current-account balance, and debt sustainability exercises also need to take into account a potential unwillingness of creditors to accept this.
- 17 In the United States, the 2004 Economic Report of the President emphasized this point by stating: "The desirability of positive net capital flows and a current account deficit depend on what the capital inflows are used for. Household borrowing – an excess of household spending or investment over saving – provides a useful analogy. Household debt could reflect borrowing to finance an extravagant vacation, a mortgage to buy a home, or a loan to finance education. Without knowing its purpose, the appropriateness of the borrowing cannot be judged. Similarly, for countries borrowing from abroad can be productive or unproductive" (United States, 2004: 256).
- 18 Although the value of assets for which there is no secondary market can only be estimated by making several assumptions, in some countries figures for both public debt and public assets are published. One example is New Zealand, where figures for all government-owned financial and physical assets, including roads, bridges and schools, are reported. This approach is likely to be problematic for assessing external sustainability in developing countries, because assets such as public libraries, hospitals and schools have limited liquidity and are unlikely to generate the foreign currency necessary to repay external debt.
- 19 Some tests developed for the United States use more than 100 years of data (Hamilton and Flavin, 1986). See Izquierdo and Panizza (2006) for a recent survey.
- 20 The primary budget balance is the budget balance net of interest payments on the public debt.
- 21 Governors representing 11 borrowing members of the IDB acknowledged this problem, and in 2004 they signed an open letter, which became known as Carta de Lima, asking for the exclusion of investment spending from fiscal targets (see http://www.iadb.org/exr/am/2004/carta_lima.pdf; an English translation of relevant sections of the letter is available at: <http://www.iadb.org/exr/am/2004/index.cfm?op=press&pg=15>).
- 22 Buiter (1985) suggests such an indicator of sustainability, defined as:
- $$SUS = ps - (g - r) \frac{W}{GDP} ,$$
- where W is public sector net worth, ps is the primary surplus, r is the real interest rate, and g is the economy's growth rate.
- 23 Besides local currency bonds, developing countries could issue other types of financial instruments with

- an embedded insurance component. Such instruments include instruments with payments indexed to commodity prices, terms of trade, or the GNI growth rate. Alternatively, countries could obtain contingent coverage through the use of derivative contracts. However, many futures and options markets lack depth and liquidity, and therefore offer only limited scope for insurance (IDB, 2006). Some countries are starting to issue catastrophe (CAT) bonds. For a discussion of the benefits of country catastrophe insurance, see Borensztein, Cavallo and Valenzuela, 2007.
- 24 A sovereign default is usually defined as a situation in which a sovereign debtor fails to fully repay its debt obligations and reschedules those obligations on terms that are less favourable (with respect to the original debt contract) for the creditors (see Panizza, Sturzenegger and Zettlemeyer, 2008, for a survey of the law and economics of sovereign debt and default).
- 25 A memo prepared jointly by the central banks of the United Kingdom and of Canada states that: "The problem historically has not been that countries have been too eager to renege on their financial obligations, but often too reluctant" (Blustein, 2005: 102).
- 26 In some cases the opposite is true, and the decision to default is welcomed by the public. But this usually happens when the decision to default is made by a new government.
- 27 A policy that delays a necessary default might be costly because it may lead to restrictive fiscal and monetary policies and, by prolonging the climate of uncertainty, may have negative effects on investment decisions.
- 28 Similar to *TDR 2001*, Pettifor (2002) and Raffer (1990) have suggested adapting for the international debt market some features of chapter 9 of the United States bankruptcy code, which deals with municipal bankruptcies. According to their proposal, the adapted chapter 9 procedures would be chaired by neutral, ad hoc entities established by creditors and the debtor, as is traditional practice in international law.
- 29 For a more detailed discussion of the SDRM proposal, see Akyüz, 2003: 6–7.
- 30 For SDRM to become operational, the IMF's Articles of Agreement would have had to be amended, which would have required the support of three fifths of the members of the Fund and 85 per cent of the total votes. The amendment of the Articles of Agreement is de facto impossible without the support of
- the United States, which holds 17.1 per cent of the votes.
- 31 A CAC allows a supermajority of bondholders (usually between 75 and 90 per cent) to agree on a debt restructuring that is legally binding for all holders of the bond, including those who vote against the restructuring. CACs are regularly attached to bonds issued under British and Japanese laws. On the other hand, until 2003, bonds issued under New York law did not have CACs attached to them, making the restructuring of such bonds difficult, as it required the acceptance of the restructuring terms by all bondholders.
- 32 Keynote speech by the President of the European Central Bank, J.C. Trichet at the 25th Anniversary IIF Annual Membership Meeting, Washington DC, 20 October 2007, and IMF (2002b).
- 33 Since money is fungible, this does not need to be applied literally. However, whenever a country borrows abroad it needs to ensure that the economy can generate the external resources necessary to service the debt.
- 34 Data problems could be solved if there were political will to do so. In fact, lack of data on domestic debt is a fairly recent phenomenon. Reinhart and Rogoff (2008b) report that the League of Nations used to collect detailed data on the amount and composition of domestic public debt for both developed and developing economies, and that the United Nations continued to collect and publish such data until the early 1980s. It is not clear why it no longer does so.
- 35 Eichengreen and Hausmann (2005) have proposed that the multilateral development banks should issue bonds denominated in an index that pools currency risk from a diversified group of emerging economies.
- 36 For discussions of GNI-Indexed Bonds, see Borensztein and Mauro (2004) and Griffith-Jones and Sharma (2006).
- 37 The international community should also start thinking seriously about odious and illegitimate debt issues. These are controversial concepts on which there is a multiplicity of views. Some argue that odiousness should be defined *ex-post* (EURODAD, 2007), while others argue that declaring odiousness *ex-post* may generate some problems that could be solved by declaring odiousness *ex-ante* (Jayachandran and Kremer, 2006). Still others claim that, given the current state of knowledge, having an explicit odious debt policy, either *ex-post* or *ex-ante*, may do more harm than good (Rajan, 2004).

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