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## Debt management solutions for trade and development

Note prepared by the UNCTAD secretariat\*

### I. Introduction

1. Despite existing debt relief initiatives and favourable conditions on world financial markets, debt instruments remain an important source of finance for developing countries. Debt management to ensure debt sustainability also acquires a new urgency, especially in the light of ongoing changes in the debt structure of many developing and emerging market economies. A good public debt management strategy, covering external and domestic debt, can reduce currency and maturity mismatches, and thus can help to mitigate the potential risks associated with external and domestic shocks. Without good debt management, debt crises can undermine achieving national economic objectives with regard to exchange rates, trade finance, investment climate, creditworthiness and external competitiveness.

2. Effective debt management alone, however, cannot lead to a virtuous circle in which external borrowing increases export capacity which, in turn, generates the resources necessary for repaying the debt. So debt sustainability remains a challenge for a number of low-income and middle-income countries. In these countries, borrowing needs to be complemented with grants and other forms of aid. Official development assistance (ODA) can play an important role in supporting debt sustainability in providing grants and concessional loans to countries in the pursuit of their development objectives. This highlights the importance of fostering greater coherence and coordination in the global aid and financial architecture.

### II. Recent trends

#### A. External debt and public sector borrowing

3. In 2006, total external debt of developing countries increased in nominal value (from \$2.742 trillion to \$2.851 trillion) but decreased as a share of their gross national product (GNP) from 29 to 25 per cent. Developing countries as a group reduced their

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sovereign external debt with both official and private creditors. During 2006, sovereign debt buybacks reached \$30 billion<sup>1</sup> and over 2005–2006, repayments of bilateral debt to Paris Club countries and of multilateral debt to the international financial institutions exceeded new lending by approximately \$145 billion.<sup>2</sup>

4. A significant reduction of sovereign external debt was made possible by debt relief and favourable external conditions. High commodity prices, high liquidity, low risk aversion and low spreads allowed several middle-income countries to refinance their external obligations and substitute external debt with domestic debt. This highlights the important interplay between the external and domestic components of viable public debt strategies.

5. Analysis of public debt in developing countries has traditionally focused on external debt owing to three causes: (a) external borrowing can increase a country's access to resources, but domestic borrowing only transfers resources within the country; (b) since central banks in developing countries cannot print the currency necessary to repay external debt, external borrowing is associated with vulnerabilities that may lead to debt crises; and (c) there are no comprehensive, reliable data on domestic public debt.

6. Some of these rationales for focusing exclusively on external debt may no longer be valid in the current environment, in which several developing countries are adopting policies aimed at retiring public external debt and substituting it with domestic debt. Notwithstanding the limitations of available data on the level and composition of public debt, it is estimated that between 1994 and 2004, domestic public debt rose from 16 to 24 per cent of developing countries' GNP and that the share of domestic public debt over total public debt grew from 39 to 57 per cent.<sup>3</sup> There is evidence that this trend has since accelerated. In 2006, more than 70 per cent of the stock of public debt of emerging market countries was issued domestically.<sup>4</sup>

7. Low-income countries (LICs) also have a tradition of domestic borrowing. Accumulation of domestic public debt can be driven by either too little or too much foreign aid. Countries that run a budget deficit not fully matched by donor flows often issue domestic debt because the standard policy advice of the international financial institutions is to limit external borrowing at commercial rates. The build-up of domestic debt driven by foreign aid inflows is often the result of Governments' decisions to sterilize aid inflows to avoid appreciations of the real exchange rate.

8. Until recently, sovereign borrowing was at the centre of financial flows to developing countries, but in the last few years, corporate borrowing has become increasingly important. In 1996, only 20 per cent of long-term external debt was owed by private borrowers. In 2006, that share had doubled to 41 per cent. During 2002–2006, private borrowers contracted 60 per cent of developing countries' external long-term bank loans and issued 75 per cent of developing countries' external bonds.<sup>5</sup> The increase in corporate borrowing has been especially important in Eastern Europe and Central Asia. During 2006, firms from this region contracted new debt for \$135 billion, and they account for 40 per cent of total corporate debt of developing countries, up from a 19 per cent average over 1996–2003.

9. By relying more on the international markets, corporate borrowers may have increased their exposure to interest rate and currency risk, and this exposure raises several policy challenges. The most important among these is to assess the public sector's contingent liabilities arising from private sector borrowing. Governments

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<sup>1</sup> This was done by issuing new external debt with more favourable conditions.

<sup>2</sup> World Bank, 2007, global. Some buybacks were financed by development finance.

<sup>3</sup> Panizza U (2007). Domestic public debt in developing countries. Unpublished, UNCTAD.

<sup>4</sup> JP Morgan (2007). Emerging markets debt and fiscal indicators.

<sup>5</sup> World Bank (2007). Global development finance.

need to pay particular attention to the rapid increase in foreign currency borrowing by domestic banks. Although there are no indications that the banking sector as whole has over-borrowed in recent years, some banks in Eastern European and Central Asian countries have borrowed heavily in international capital markets, and on-lent those funds in the domestic market. This could lead to currency mismatches either in the banks or in the ultimate borrowers' balance sheets and thus increase financial fragility.

## **B. Aid and debt relief**

10. The second half of the 1990s was characterized by declining ODA. But this situation was reversed in 2002 and, by 2005, ODA from donors of the Development Assistance Committee of the Organization for Economic Cooperation and Development rose to \$82 billion (0.33 per cent of gross national income (GNI) of developed countries). Despite this recent trend, which was spurred by debt relief and other exceptional flows, the current and projected levels of ODA still fall short of the Group of Eight (G8) pledge to double aid to Africa by 2010. Donor countries as a group are still committing less than the agreed target of 0.7 per cent of GNI to aid (with notable exceptions). Notwithstanding the inconclusive evidence and arguments presented by aid sceptics as to the necessity and impact of ODA, for many LICs it remains the only source of financing for a range of developmental and poverty-reduction policy programmes.

11. However, aid allocation remains characterized by selectivity and instability. The top 20 aid recipients received more than half of net bilateral ODA and less than 50 per cent of aid recipients received 90 per cent of all aid, with many of the poorest LICs receiving very little assistance. A large part of the recent increase in aid was due to debt relief under the Highly Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). Debt forgiveness represented 5 per cent of overall ODA flows in 1990, whereas in 2006 the share was 30 per cent.

12. A key component of the HIPC Initiative upon its launch in 1996 was the notion of "additionality". However, ODA less debt forgiveness declined from the start of the initiative to its lowest level by 1998. Only since 2003 has nominal ODA less debt forgiveness risen above pre-HIPC values to levels comparable to those prevailing in the early 1990s. While nominal ODA less debt forgiveness remains at levels similar to those prevailing in the early 1990s, real ODA less debt forgiveness is well below its pre-HIPC levels. These findings suggest that debt relief under the HIPC Initiative has not been additional.<sup>6</sup> Ten years after the launch of the initiative, it would be worthwhile to reconsider the modalities and eligibility criteria for debt relief in a manner that ensures additionality and separates future debt relief for LICs from critical ODA requirements.

13. Since the launch of the enhanced HIPC Initiative in 2000, delivery of debt relief has been steady, if slow, with an annual average of three countries completing the programme and two countries starting the programme. In 2007, Afghanistan was added to the list of eligible countries, increasing their number to 41. Of these, 22 have completed the programme, 8 are between decision and completion point, and 11 have yet to reach the decision point. A decade after the process began, it has become increasingly urgent to expedite this process and deliver the needed debt relief.

14. Between 1995 and 2005, total debt stocks for the 28 HIPCs that had reached the decision point declined by approximately 10 per cent in nominal terms (from \$116 billion to \$104 billion) and by 50 per cent as a share of GNP (from 140 to 70 per cent of GNP). Among the objectives of the HIPC Initiative was to free resources for poverty reduction activities. In fact, the decline in the debt service ratio to GNP in

<sup>6</sup> See UNCTAD, *Trade and Development Report 2006*, pp. 89–100. A World Bank evaluation finds that the enhanced initiative has been additional. However, this evaluation uses as the point of reference the year in which ODA reached its lowest level in three decades (when measured as a ratio to donor countries' GNP).

HIPC completion countries was accompanied by an increase in the ratio of poverty reducing expenditures to GNP. However, evidence on decision point HPICs' progress towards achieving the Millennium Development Goals by 2015 indicates that it is unlikely that this increase in poverty reduction expenditures will be sufficient to achieve those targets.<sup>7</sup>

15. Under the MDRI, 22 HIPC countries have benefited from 100 per cent cancellation of their outstanding multilateral debt claims from the International Monetary Fund (IMF), International Development Association (IDA) and the African Development Bank. At the end of 2006, the Inter-American Development Bank (IADB) announced its intention to also cancel the debt of its HIPC members, clearing the way for five Latin American HIPCs to benefit from the MDRI upon completion of the HIPC Initiative.<sup>8</sup> However, the financing modality of the debt cancellation by IADB raises concerns as it reduces the resources of the bank's concessional lending arm and may lead to lower concessional lending to LICs in Latin America and the Caribbean.

### III. Debt sustainability analysis

16. Over the last few years, IMF has developed a debt sustainability framework (DSF) for middle-income countries (MICs) with market access and IMF and World Bank jointly developed a DSF for LIC. The main objective of the DSF for MICs is to examine vulnerabilities and devise policies aimed at reducing the probability of a debt crisis. The DSF for LICs also aims at guiding their borrowing decisions and grant allocation of the multilateral development banks. In particular, the framework uses a set of thresholds to establish a country's eligibility for IDA grants. These thresholds are determined by a combination of the country's debt ratios and the Country Policy and Institutional Assessment (CPIA) ranking.<sup>9</sup>

17. There are several issues with the commonly adopted DSFs. A major problem concerns the definition of debt. Although the increasing importance of domestic borrowing is often recognized, most debt sustainability analyses concentrate on external debt and do not integrate the dynamics between domestic and external debt. The standard justification for this approach is that external and domestic public debt have different default risks and hence cannot be simply added to each other to form a single indicator of total public debt. However, an aggregate debt ratio where "riskier" types of debt have a higher weight than safer types of debt would be superior to the current practice of either assigning the same weight to all types of debt or of assigning a weight of one to all types of external debt and a weight of zero to all other types of debt. Better information on debt structure and more research on vulnerabilities arising from different types of debt are needed to help in designing such an indicator. This would in turn improve the overall coverage of debt management strategies and reduce the probability of debt crises through better tracking of debt risks.

18. The most important issue with the DSF for LICs is its use of debt thresholds aimed at measuring a country's risk of debt distress and determining eligibility for IDA grants. The thresholds are calculated by using an econometric exercise that does not provide results that can always be relied upon to predict the probability of debt distress, and which is combined with blunt DSF classifications that group countries

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<sup>7</sup> See table 3.A2 of UNCTAD, *Trade and Development Report 2006*, pp.124–125.

<sup>8</sup> As the Asian Development Bank did not signal its intention to participate in the MDRI, there are three HIPCs (Afghanistan, Kyrgyzstan and Nepal) that will not benefit from full debt relief under the MDRI.

<sup>9</sup> The CPIA index is a subjective index quantifying country performance across four categories: economic management, structural policies, social inclusion policies, public sector management and institutions. The index is composed of 16 indicators and ranges from 1 to 6 (weak to strong).

into general categories.<sup>10</sup> This may lead to suboptimal outcomes, as the borrowing capacity of those at the top of the group may be underestimated and those at the bottom may be overestimated. The current framework risks replacing the former “one-size fits all” approach to a “four-or-five-sizes-fit-all” approach.

19. Moreover, legitimate concerns remain with respect to the determining influence of the CPIA index in establishing debt thresholds. The concepts of good governance and institutional quality are inherently subjective and, since the World Bank is also making recommendations to countries on issues of governance and best practices, the index may reflect how well countries are implementing the bank’s policy advice. Another concern pertains to the accuracy of the measure and the consistency with which it is measured across countries. Measurement problems need to be taken into serious consideration when deciding how much weight the index has in lending decisions. An additional dilemma is that the CPIA is used to both allocate IDA resources – through the IDA resource allocation index – and to guide IDA grant-allocation decisions through the DSF. Other things being equal, a higher CPIA score is associated with more resource allocation, and a lower CPIA score may lead to more grants. It is puzzling that, on the one hand, better policies are associated with more resources and, on the other hand, countries with higher levels of debt – and presumably poorer policies – may be awarded higher grant elements than countries with stronger policies and moderate levels of debt.

20. Finally, the DSF for LICs is based on the primacy of debt servicing and does not explicitly include an evaluation of the financing needs necessary for reaching the Millennium Development Goals. As stated in the Secretary-General’s follow-up report to the Millennium Summit: “We should redefine debt sustainability as the level of debt that allows a country to achieve the Millennium Development Goals and reach 2015 without an increase in debt ratios”.<sup>11</sup> Other considerations have also been cited in United Nations forums, such as the Commission on Human Rights, which called for the drafting of guidelines for external debt relief programmes to ensure that the need to service foreign debt will not undermine obligations for the realization of fundamental economic, social and cultural rights.<sup>12</sup> Meanwhile, the growing legal and political interest in concepts such as odious debt and responsible lending adds yet another dimension to the concept of debt sustainability and its applicability as currently defined.<sup>13</sup>

21. While a simple rule to define debt sustainability would be welcome, more collaborative research is needed to justify the use of a restricted and uniform set of indicators to define debt sustainability. Until then, it is best to assess debt sustainability for development purposes on a case-by-case basis, with the full engagement of borrower Governments in adapting sustainability criteria to the situation at hand. This also calls for greater public scrutiny and an informed public debate on the methodology and appropriateness of assessing governance in developing countries.

#### **IV. Global rules for international finance and trade**

22. Discussion of global rules in connection with external debt typically focuses mainly on arrangements capable of making debt crisis less likely and of facilitating their management and resolution. Subjects include bankruptcy mechanisms for sovereign – and sometimes also private – cross-border debt, improvements in terms and funding for IMF crisis lending and pre-crisis intervention in the markets for

<sup>10</sup> Wyplosz C (2007). Debt sustainability assessment: the IMF approach and alternatives. HEI Working Paper No. 03/2007, Graduate Institute of International Studies, Geneva.

<sup>11</sup> <http://daccessdds.un.org/doc/UNDOC/GEN/N05/270/78/PDF/N0527078.pdf?OpenElement>. Page 18

<sup>12</sup> Resolution 2004/18 of 16 April 2004 appointed an independent expert to examine and report on such guidelines.

<sup>13</sup> See Howse R (2007). The concept of odious debt in public international law. UNCTAD Discussion Paper No. 185, July.

international debt. But the framework within which countries manage their external debt is also affected by developments elsewhere affecting rules for trade and trade finance, balance-of-payments measures and foreign investment.

23. The importance of the latter set of rules was recognized in the Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policy Making, adopted at the time of the establishment of WTO. This declaration acknowledged the links between economic policies as follows: “Successful cooperation in each area of economic policy contributes to progress in other areas. Greater exchange rate stability... should contribute towards the expansion of trade, sustainable growth and development, and the correction of external imbalances. There is also a need for an adequate and timely flow of concessional and non-concessional financial and real investment resources to developing countries and for further efforts to address debt problems, to help ensure economic growth and development.” Such coherence in global policymaking requires that “the international institutions in each of these areas follow consistent and mutually supportive policies”.

24. As a starting point in analyzing the trade–debt link, it is necessary to note the commitment of United Nations member States in the Millennium Declaration to “an open, equitable, rule-based, predictable and non-discriminatory multilateral trading and financial system”. Whilst acknowledging that the concept of equity in international trade and in financial rules and institutions lacks a generally-accepted definition, it may be recalled that international rules (including those of WTO and the IMF Articles of Agreement) incorporate fairness, a concept closely related to equity. Moreover, one important ingredient of equity in international instruments concerning trade, finance and development is the notion that rules should be adjusted to the development needs of countries’ different situations. Another ingredient is that of people’s right to “voice and participation”, i.e. their right not to have a vision of development forced on them or decided by others. The Millennium Declaration also contains a distributional component, since the concept of global solidarity requires that “global challenges must be managed in a way that distributes the costs and burdens fairly in accordance with basic principles of equity and social justice”.

25. Concerning exchange restrictions, there is a generally accepted view of the intent of General Agreement on Tariffs and Trade (GATT)/WTO provisions for goods trade that, regardless of the effect of the restrictions on trade transactions, they do not impose disciplines going beyond those of IMF. However, such rulings are permissible for exchange restrictions not endorsed by IMF, a scope which has been used by GATT and WTO as the basis for narrow interpretation of countries’ right of recourse to trade measures. More generally, it is valid to question the apparent presumption of GATT/WTO case law that exchange restrictions not endorsed by IMF entail violation of GATT/WTO rules.

26. The GATT/WTO provisions for goods trade leave no scope for rulings on exchange controls applying to capital as opposed to current transactions. However, the corresponding provisions for balance-of-payments restrictions in the case of services trade under the General Agreement on Trade in Service (GATS) could lead to challenges to capital controls on the ground that they are inconsistent with a country’s specific commitments interpreted in combination with general GATS obligations. Hence, guidelines should be drawn up for such cases by institutions with a mandate to take account of equity in the trade and financial systems.

## **V. New instruments for financial crisis prevention**

27. The fact that official and corporate lenders from several developing countries have become active in international capital markets reflects increasing complexities in the current structure of the international financial architecture. Reforming existing institutions in line with new realities and building consensus on crisis prevention and

resolution mechanisms could help in improving the efficiency and universal credibility of the international financial system.

28. There is now a consensus that the composition of debt is as important as its level. Other things being equal, a safer debt structure for borrowers can substantially reduce the probability of a debt crisis. Under the right circumstances, safer debt instruments that may reduce the risks of sovereign borrowing include domestic currency debt, long-term debt and debt contracts which require payments that are linked to the borrower's ability to pay. Of particular interest are GDP-indexed bonds which provide a mechanism for linking a country's debt servicing obligations to the level of economic activity, so that in times of high growth debt servicing would be higher, but lower during recessions.

29. Insuring against negative shocks to the economy has two advantages for borrowing countries. Firstly, it helps to maintain fiscal solvency, since it is usually the arrival of negative shocks that renders unaffordable a level of debt that was up to that point sustainable. Secondly, it can improve fiscal policy because, during bad times, Governments would have less debt servicing costs and more fiscal policy space. A frequently mentioned problem is the complexity of pricing these new instruments. Pricing issues could be alleviated by creating a set of comparable instruments issued by different emerging economies. A coordinated effort of several countries could generate the necessary critical mass. One such example is the Asian Bond Market, a multi-country coordinated bond market created in the late 1990s, grouping countries in South and East Asia within an overarching goal of strengthening financial systems through better utilization of regional savings and minimizing the risk of mismatch of currencies and maturities. International institutions could play a role in supporting the development of a market for safe debt instruments, both through policy advice and by promoting a coordinated issuance of such instruments by a number of countries to provide benchmarking.

30. New forms of lending could also benefit LICs with limited market access. For instance, most lending by the international financial institutions (IFIs) is either in United States dollars, euros, yen, or special drawing right (SDR). The IFIs could consider a system in which they borrow and lend in the currencies of their client countries and hence help the development process with both their assets (through local currency loans) and their liabilities (by helping to develop the international market for bonds in the currencies of developing countries).<sup>14</sup>

31. Financial innovation can reduce vulnerabilities but can also be a source of new risks. One of the latest developments in the derivatives markets has been the introduction of credit default swaps (CDS).<sup>15</sup> While CDS can increase market efficiency and reduce borrowing costs, the risks associated with these instruments must not be ignored. This market requires that all parties involved – the credit originator, the creator of the structured product and the purchaser of the instrument – have risk modelling and management capabilities that parallel their own respective risks, and that they conduct their activities with strong internal controls. This is a challenging task as CDS are customized, often unique, illiquid and difficult to price. The ongoing financial crisis since 2007 highlights how weakly regulated financial innovation may increase the opaqueness of the financial system.<sup>16</sup>

<sup>14</sup> See chapter 10 of Eichengreen B and Hausmann R (2005). *Other people's money*. University of Chicago Press; and Hausmann R and Rigobon R (2004). *IDA in UF: On the benefits of changing the currency denomination of concessional lending to low-income countries*. Unpublished. Harvard University.

<sup>15</sup> In its simplest form, a buyer of a CDS pays a default premium to the seller of the swap. In exchange, if a default occurs, the seller of the swap covers the losses the buyer has incurred as a result of the default. One of the variations of the CDS involves covering the credit spread risk (the loss in the security's value due to the widening of the credit spread over the risk-free United States Government treasury rate), which can be hedged with credit spread options.

<sup>16</sup> Recent developments on global financial markets. Note by the UNCTAD secretariat. TD/B/54/CRP.2, 28 September 2007.

32. Sovereign debt is not the only source of vulnerabilities. Governments also need to assess their contingent liabilities arising from private sector borrowing. The question of contingency risk faced by Governments and their capacity to manage such risks appropriately will need to be given more attention in the future, as it is increasingly unlikely that the benign international financial environment of recent years can continue indefinitely. Monitoring the growth and the stock level of corporate debt alone by the financial authorities is likely to be insufficient, as additional attention should be paid to the maturity structure of the corporate debt and its currency mix.

33. While new debt instruments could play a role in reducing the probability of debt crises if used wisely, it is important to recognize that the likelihood remains low that in the near future sizeable sums can be raised by developing countries through such instruments. Hence, prudence in issuing new debt and policies aimed at avoiding over-borrowing by both the public and the private sectors will remain essential for avoiding debt and financial crises. As for new financial architecture needed at the international level, reform should focus on improved crisis prevention, but should not rule out that even an improved system would not be crisis-free. Hence, mechanisms for crisis resolution are also needed, along the lines of the now-defunct proposal for a sovereign default restructuring mechanism.

## **VI. Debt management capacity-building**

34. Given the critical importance of sound debt management to sustainable development and the marked weaknesses of many developing countries in this area, it is clear that a comprehensive capacity-building approach is required. A bottom-up, holistic approach directed at strengthening the capacity of debtor countries is needed. Such initiatives must be founded upon well-defined requirements of the countries themselves, an excellent knowledge of the range of support available and the challenges inherent in achieving sustainable results. At the same time, there is much room for improvement in the provision of the required support by the international community.

### **A. What countries need**

35. Developing countries need capacity-building support directed at strengthening their capability in all aspects related to debt management. This support must be tailored to the needs and particularities of each country, conducive to the development and implementation of viable medium-term public debt strategies.

36. International support for building the required capacity must form a comprehensive and coordinated framework that enhances the practical and analytical skills of government officials responsible for public (external and domestic) debt management. It should focus on the full range of functions, including (a) establishing effective governance, accountability and transparency frameworks; (b) improving functional organization and structure of debt offices; (c) ensuring coordination among national institutions dealing with debt management; and (d) setting up operation manuals, procedures and description of functions.

37. There are two principal components of this support: tools and training. In order to ensure that the country benefits from best practices and the advantages of the latest technology and tools in the most cost-effective manner, support must also include the provision of the necessary tools to aid in the registration and management of external and domestic debt information (including monitoring of private sector contingent liabilities). Adequate training must be provided in debt data validation, public debt statistics, composition and level of public debt through portfolio analysis, risk analysis and debt sustainability analysis – all of which are necessary to develop debt strategies – and on the effective use of the tools.



38. A critical feature of international support as described here is the sustainability of assistance to the country. Given the common problems of many developing countries such as the lack of qualified personnel, high staff turnover and the infrequency of some debt management functions, training and support must remain available on a permanent basis, whilst at the same time being adapted to changing needs.

## **B. What technical assistance is available**

39. There are many official providers of technical assistance in the area of debt management and debt sustainability analysis. The main international organizations involved in providing technical assistance in debt management are the World Bank, IMF, the Commonwealth Secretariat (Comsec), the UNCTAD's Debt Management and Financial Analysis System (DMFAS) Programme, regional organizations and the HIPC Capacity-Building Programme. These programmes offer a range of products and services. For example, UNCTAD and Comsec are the two main providers of computerized debt management tools for debt management. Nevertheless, in spite of the existence of a large number of technical assistance providers, there are gaps in key areas such as debt portfolio analysis, cost-risk analysis and development of debt strategies. In addition, coherent, systematic cooperation between providers at different levels is still at an early stage.

## **C. Possible improvements**

40. The effective provision of debt management technical assistance presents many challenges for both the recipient countries and the providers. These are principally the insufficiency of available resources to respond to demand and ensure sustainability, inadequate coordination, and the need for greater recognition of the importance of effective debt management by the countries themselves.

41. With respect to the availability of resources, the efforts of international organizations to respond to the demand for assistance from countries are hampered by a shortage and unpredictability of funding. This problem is particularly evident in programmes that are committed to providing long-term support to debt management offices, and which consequently need to maintain the capacity to adapt their products and deliver their services in response to the changing needs of countries.

42. Concerning coordination, it is not always clear which institution is involved in which particular area, with the consequent risk of duplication or overlapping, and of creating confusion among donors and beneficiaries. A clear definition is needed of which organizations are best suited to provide different types of support, and plans should be shared. Moreover, there is a need for regular evaluation of debt management technical assistance on a global level.

43. As for the need for greater recognition of the importance of effective debt management by recipient countries themselves, it is critical that they acknowledge the importance of effective debt management to ensuring debt sustainability. Adherence to best practices in debt management and a strong political will to introduce needed reforms are two key elements to accompany capacity-building efforts from technical assistance providers.

## **VII. Conclusions**

44. The past few years have been characterized by a favourable international environment for reducing the burden of external debt upon developing countries, not witnessed for many years hitherto. Ample global liquidity, together with favourable external conditions and policy improvements, led to low risk aversion and translated into low spreads and large access to resources by middle-income developing countries. There are, however, signs that the situation may yet change. Since the second half of

2007, a deepening and spreading crisis has affected credit and financial markets in the main advanced economies. So far, there has not been any significant contagion to developing countries, but past experiences show that crises can spread rapidly through a variety of linkages and mechanisms. Moreover, a number of developing and transition economies maintain large current account deficits and overvaluation of their exchange rates.

45. If a global downturn in the economic cycle were to occur, as seems increasingly possible in early 2008, the correlation amongst a number of key economic variables could suddenly increase, producing higher risks than each event individually. This is especially an issue in the current environment characterized by an amplified importance of highly leveraged, opaque structured financial products which are difficult to pace and hence to trade.

46. Debt relief has been too slow, has not been additional as planned, and should be expanded to LICs which were not part of the HIPC and MDRI initiatives. It is necessary to speed up the process and scale up ODA flows, with the ultimate objective of reaching the Millennium Development Goals. Meanwhile, the shortcomings of the DSF for LICs as currently designed and operated need to be further examined, discussed and addressed. While a simple rule to define debt sustainability would be welcome, more research is needed to justify the use a narrow set of indicators to define debt sustainability. Until then, it is best to assess debt sustainability for development purposes on a case-by-case basis, incorporating a more flexible range of indicators and parameters.

47. On the positive side, several developing countries used the last few years to improve their debt management strategies. The financial crises that hit emerging market countries in the second half of the 1990s made policymakers well aware of the risks of external borrowing and are at the root of the switch towards more domestic borrowing. Most domestically-issued debt has the advantage of being denominated in the domestic currency, and hence may reduce currency mismatches and may count on a more stable investor base. Governments that are trying to reduce the risk of a debt crisis by limiting excessive foreign borrowing and by developing the required infrastructure and institutional setup for an effective domestic debt market should be encouraged and supported.

48. However, policymakers should not be too complacent, as the new structure of debt could also lead to new vulnerabilities. Debt composition matters, but it is necessary to move beyond the external/domestic debt dichotomy. The switch to domestic borrowing could entail important trade-offs and, in deciding the optimal structure of public debt, debt managers should consider these trade-offs between the cost and risk of alternative forms of financing.

49. As systemic weaknesses are often identified after a financial crisis starts to unravel, policymakers should be aware of possible new vulnerabilities. Crisis prevention requires detailed and prompt information on debt structure. The international community can play a major role in helping developing countries to improve their capacities to record and disseminate information on the structure of total public debt. This would help the research community to identify possible new vulnerabilities and thus help countries to improve their debt management strategies and further reduce the risk of a debt crisis. The creation of the DMFAS Programme of UNCTAD was an important step in this direction, but to ensure sustainability, continuous support and more coordination among the various national debt offices are needed.

50. The importance of UNCTAD's role in the provision of technical assistance in debt management has been recognized by different stakeholders. The 2007 resolution of the General Assembly on external debt and development (A/62/417/Add.3) calls for continued cooperation in respect of capacity-building activities in developing

countries in the area of debt management and debt sustainability. The recent meeting of the DMFAS Advisory Group in November 2007 reiterated the continued importance of debt management and of effective technical assistance in response to the changing needs of developing countries and countries in transition. It stressed the importance of the continued support from the DMFAS Programme to developing countries and countries in transition in building their capacity to improve debt management.

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