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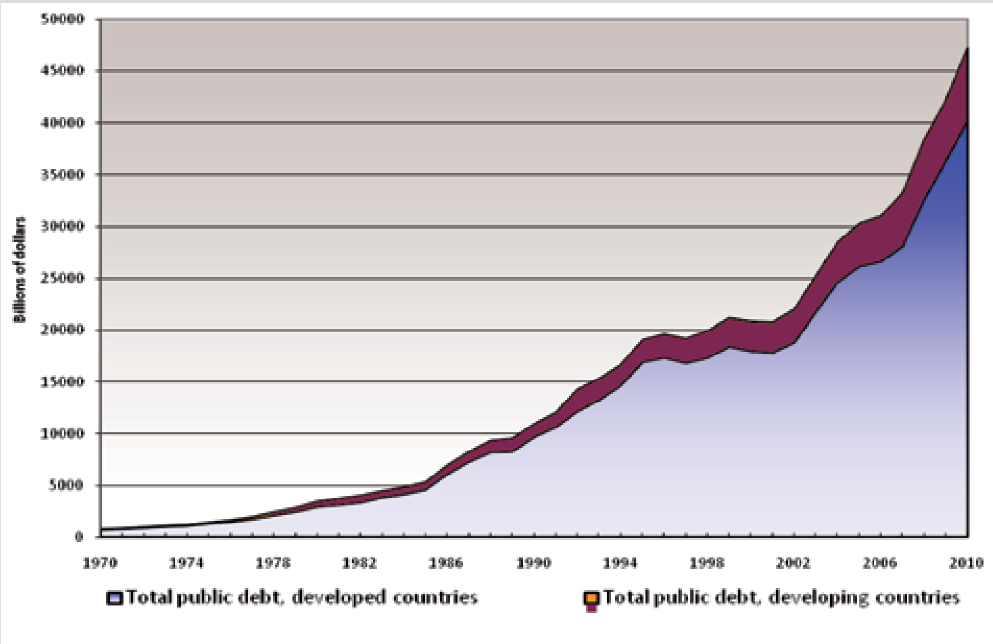
SOVEREIGN DEBT CRISIS: FROM RELIEF TO RESOLUTION

The current discussion on sovereign debt has concentrated on the predicaments of Europe and other developed countries, which have accumulated new debt very rapidly in recent years (graph 1).

Figure 1. Total Public Debt, 1970-2010



The fact that developing countries are not in the spotlight is partly due to the recently improved debt ratios of most developing regions. This largely reflects their stronger growth performance over the past decade, along with the ongoing debt relief for the Heavily Indebted Poor Countries (HIPCs). However, these averages mask substantial heterogeneity among developing countries and do not reveal the vulnerabilities still faced by many of them (table 1).

Table 1: Emerging and Developing Economies: External Debt Service Payments (percentage of exports of goods and services)

	2003	2004	2005	2006	2007	2008	2009	2010	2011 (p)	2012 (p)
Central and Eastern Europe	40	40	46	49	49	55	71	60	57	58
Commonwealth of Independent States (a)	31	32	33	36	39	40	48	36	25	27
Developing Asia	26	19	21	20	19	19	23	18	17	16
Latin America and the Caribbean	57	46	45	40	34	30	39	30	28	29
Middle East and North Africa	21	19	17	16	14	14	20	18	15	16
Sub-Saharan Africa	25	24	26	27	17	16	19	16	10	11
Total	33	28	28	27	25	26	32	26	22	22

(a): including Georgia and Mongolia.
(p): projections
Source: IMF World Economic Outlook, April 2011, statistical appendix.

Key points

- Debt crises can be very costly, especially for the poor.
- UNCTAD's principles of responsible sovereign lending and borrowing specify the key responsibilities of lenders and borrowers.

• Orderly debt workout procedures can prevent financial meltdown and drastic falls in living standards.

At another level, despite the fact that developing countries, as a group, are running large current account surpluses and have thus become net capital exporters, most of these countries are still net importers of capital. In 2011, 94 developing countries (out of 128 for which data were available) were running a current account deficit; alarmingly, 64 of these 94 countries had a deficit greater than 5 per cent of gross domestic product (GDP). Almost all Least Developed Countries (LDCs) (42 out of 47 for which data are available) had a current account deficit both in 2010 and in 2011. About two-thirds of the countries belonging to this group (33 in 2010, and 36 in 2011) had a current account deficit greater than 5 per cent of GDP (for illustrations, see table 2).

Table 2: Current account balance, 2003-2010 (% of GDP), select developing countries

	2003	2004	2005	2006	2007	2008	2009	2010
Argentina	6.3	2.1	2.9	3.6	2.8	2.1	2.7	0.8
Brazil	0.8	1.8	1.6	1.3	0.1	-1.7	-1.5	-2.3
China	2.8	3.6	5.9	8.6	10.1	9.1	5.2	5.2
Colombia	-1.0	-0.8	-1.3	-1.8	-2.9	-2.8	-2.2	-3.1
Ghana	1.3	-6.7	-10.3	-5.1	-8.7	-12.4	-6.1	-8.6
Guinea	-5.4	-4.4	-5.5	-7.8	-10.8	-11.6	-9.7	-7.2
India	1.5	0.1	-1.2	-1.0	-0.6	-2.6	-1.9	-3.0
Mexico	-1.0	-0.7	-0.6	-0.5	-0.9	-1.5	-0.7	-0.5
Morocco	3.2	1.7	1.7	2.2	-0.2	-5.1	-5.4	-4.3
Mozambique	-17.5	-10.7	-11.6	-10.9	-9.8	-11.9	-12.0	-9.5
Nicaragua	-17.2	-15.4	-16.1	-16.0	-21.6	-24.6	-13.3	-14.7
Pakistan	4.3	-0.8	-3.3	-5.3	-5.8	-9.6	-2.5	-0.9
Sierra Leone	-8.4	-9.0	-8.5	-6.7	-9.6	-11.5	-10.4	-16.8
South Africa	-1.0	-3.1	-3.4	-5.3	-7.0	-7.3	-4.0	-2.8
Sri Lanka	-0.4	-3.1	-2.7	-5.3	-4.3	-9.5	-0.5	-2.9
Sudan (the)	-5.3	-3.8	-10.1	-13.2	-7.0	-2.3	-7.7	-1.9
Tajikistan	-0.3	-2.7	-0.8	-0.8	-13.3	0.9	-3.6	-6.8
United Republic of Tanzania	-1.1	-4.1	-7.8	-7.9	-11.0	-12.9	-9.0	-8.6
Turkey	-2.5	-3.7	-4.6	-6.1	-5.9	-5.7	-2.3	-6.5
Uganda	-1.8	-0.9	-0.3	-4.0	-5.9	-9.1	-6.7	-10.2
Viet Nam	-4.9	-2.1	-1.1	-0.3	-9.8	-12.0	-6.8	-4.1

Source: World Bank, World Development Indicators, September 2011.

Although external debt crises do not always have either a fiscal or a financial origin, there are cases in which these crises are triggered by unsustainable fiscal policies or by institutional capital market arrangements that conceal the true risks of lending and borrowing. On some assessments, crossing a threshold public debt to GDP ratio of 60 per cent for emerging economies or 90 per cent for developed economies risks a sharp slowdown in growth and heightens vulnerability to a debt crisis triggered by a flight to safety by nervous bondholders (Reinhart and Rogoff, 2010). However, it has proven to be very difficult to identify a critical level of "sustainable" debt, and the evidence of mechanical links does not appear to survive closer empirical investigation (UNCTAD, *Trade and Development Report,* 2011).

What is not in doubt is that debt crises are both costly and difficult to mitigate, the more so if the onus to adjust is placed on the borrowing country. Such crises can have a severe impact on output through several channels, including higher borrowing costs, exclusion from international capital markets, the reduction of international trade, lower consumption, investment and productivity, and the much greater likelihood of currency and banking crises. Furceri and Zdzienicka (2011) estimate that debt crises reduce output growth by 5-10 percentage points in the short term and that, after eight years, output is lower by about 10 per cent compared to the country's output trend. These estimates of output loss are consistent with others found in the literature. In addition to these costs of debt crises to the economy as a whole, the adjustment strategies implemented under the guidance of the International Financial Institutions have had an especially severe impact upon the poor and other vulnerable social groups, as has been demonstrated by a string of studies of the impact of the 1982 international debt crisis on Latin America and Sub-Saharan Africa, and the social implications of the East Asian crisis of 1996-97.

Putting in place mechanisms aimed at preventing the repetition of such events should be a top priority for the international agenda. In 2009, UNCTAD introduced an initiative to establish a set of principles of responsible sovereign lending and borrowing. This process has been inclusive and transparent with the participation of a range of stakeholders, among them experts in economics and law, senior representatives of the private sector, NGOs, and observers from the multilateral financial institutions. In May 2011, UNCTAD released a set of draft principles specifying the key responsibilities of lenders and borrowers. Such principles offer economic, legal and moral guidelines for lending and borrowing. This initiative has been encouraged by the UN General Assembly Resolutions A/RES/65/144 and A/RES/66/189, and it has won support from many countries and institutions.

Nevertheless, debt crises are bound to happen even with the best policies and institutional arrangements. This is why UNCTAD has been a longstanding advocate of orderly debt workout procedures drawing on national bankruptcy laws. It is lamentable that the international financial architecture still lacks a mechanism aimed at facilitating the resolution of sovereign insolvency and impeding litigation by providing a resolution mechanism to debt distress that is legally binding on all creditors. Procedures should help prevent financial meltdown in countries facing difficulties servicing their external obligations, which often results in a loss of market confidence, currency collapse, drastic interest rate hikes and, consequently, a spike in unemployment and a drastic fall in living standards.

Given these vulnerabilities, and the potentially severe implications of debt crises, governments must be able to deploy countercyclical policies when this becomes necessary. In particular, when the private (financial and non-financial) sector deleverages very rapidly in the wake of a debt crisis, governments must be able to run fiscal deficits for significant periods in order to stabilise the economy. In other words, there is no external or fiscal debt level which is ‘right’ for all countries or at all times. What is important, instead, is to have domestic policy space to address rapidly changing circumstances, as well as a multilateral consensus on dealing with the problem whenever it arises. Policy actions aimed at reducing the prevalence and the costs of sovereign debt crisis should include the following:

1. The universal adoption of a set of principles aimed at promoting responsible lending and borrowing. Such principles should emphasize the co-responsibility between creditors and borrowers and include principles such as due authorization, due diligence, the protection of the public interest, transparency, disclosure, and agreed procedures for debt restructuring if that becomes necessary. In view of the heterogeneity of national conditions, these principles should not include specific thresholds or quantitative targets. As with any set of voluntary standards, free-riding and enforcement will pose significant challenges but, in the absence of effective global action, the burden of coping with international financial instability will continue to fall mainly on developing country governments, economies, societies and political systems.

2. A reform of the international financial architecture aimed at facilitating the resolution of sovereign debt crises. Such a reform would require the adoption of temporary standstills for both public and private debt. In order to avoid conflicts of interest, the standstill should be decided unilaterally by the debtor country and sanctioned by an independent panel. Standstills should be accompanied by debtor-in-possession financing, which would automatically grant seniority status to debt contracted after the imposition of the standstill. The international financial

institutions should lend into arrears for financing imports and other vital current account transactions. Debt restructuring could also be facilitated by rollovers and write-offs based on negotiations between the debtors and creditors, and facilitated by the introduction of automatic rollover and Collective Action Clauses (CACs) in debt contracts.

3. An improved early warning system. The credit rating agencies are supposed to be whistle-blowers, but all of them failed in the run-up to the current crisis. Indeed, as these agencies have no liability in case the market proves them wrong, they have an incentive to bias credit ratings upwards in order to satisfy their customers. This is most clearly seen in the case of private instruments, but a similar effect could, arguably, be observed in the overrating of the sovereign debt instruments issued by financially fragile states before the crisis. UNCTAD has proposed subjecting these agencies to regulatory oversight, and regularly publishing their rating performance. performance.

Reference

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