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Institutional Changes to Prevent the Recurrence of Debt Problems

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1 Introduction

While many initiatives have been adopted and implemented over the past two decades, low-income countries have recurrent debt problems. We argue that this does not just reflect economic causes. Rather, the recurrence reflects the failure to reform the international institutional structure for decisionmaking related to low-income countries' debt, external financing and debt sustainability. Applying the framework of Claessens and Underhill (2005), we develop some options to build sustainable financing structures for the low-income countries that are largely dependent on official development assistance. The options concern institutional changes, policy changes and financial policy changes.

Persistent debt problems of the low-income developing countries have led to repeated debt restructuring and debt relief initiatives since the early 1980s. The list of initiatives is long, with the Highly Indebted Poor Countries (HIPC) being the latest. The large number of initiatives highlights that the underlying causes of the debt problem have often not been addressed. Many other symptoms exist to suggest continued deeper causes behind the low-income countries' debt problems. Although debt has been reduced under HIPC for many low-income countries, some countries still suffer from a debt overhang. Other countries risk a recurrence of debt problems when new external financing is being provided on inappropriate terms. There are furthermore ongoing debates on whether the right approaches for debt relief are being used,

From: Helping the Poor? The IMF and Low-Income Countries
FONDAD, The Hague, June 2005, www.fondad.org

on the modalities of financing for low-income countries, particularly the mix between grants and loans, and on the appropriate analytical and empirical approaches to determine countries' debt sustainability. More generally, there is a strong perception of a poor match between countries' development financing needs and the availability and forms of public capital and much disappointment and scepticism among policy-makers and citizens worldwide on the contribution of the international financial system to global development.

The recurrent nature of the debt problems, the ongoing debates, and the limited and poor resource transfers are but signs of the need for deeper reforms to the institutional framework for dealing with the financing problems of low-income countries. Fundamentally, the design, institutions, and governance of the international system governing low-income countries' debt, financing and debt sustain-ability remain very similar to those of a few decades ago. We argue that the lack of institutional changes greatly contributed to the recurrence of debt problems. Institutional changes to avoid a recurrence will not be easy, though, and will require answering fundamental questions regarding the nature of the governance framework of the international financial system.

Claessens and Underhill (2005)[1] develop an analytical framework that lays out the general elements to be addressed when rethinking the governance mechanisms of the international financial system. They develop a framework for analysing the tensions between the achievement of global and national development objectives in a world of fragmented governance, multiple institutions, accelerated financial integration and increased private sector roles. Many of the issues on the design of the international financial system also arise when it comes to dealing with the external financing of low-income countries. This chapter therefore tries to apply the framework to the current issue of the debt overhang and maintenance of debt sustainability in low-income countries.

Much of the debt of low-income countries originates from official sources and the debt problems can in large part be attributed to uncoordinated lending associated with a poorly functioning interna-tional institutional framework. The focus needs thus be on the rules and institutions governing resource transfers to low-income countries. The HIPC-initiative also involves important institutional design issues.

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[1] See also Claessens (2002), Underhill (2003) and Underhill and Zhang (2003).

Going forward, to assure that debt burdens remain sustainable, there is a need to coordinate on the appropriate amounts and terms of new (debt) financing. Again, it is the institutional design that will importantly affect the outcomes.

This chapter makes a number of suggestions how institutional coordination on resource transfers to low-income countries can best be organised, taking into account the divergent interests of multilateral and bilateral organisations. Different options for more prudent and coordinated lending are explored and analogues to other coordination problems are investigated.

The chapter is organised as follows. Section 2 explores the nature of the debt problem of low-income countries. Section 3 develops options concerning institutional changes. Policy change options are addressed in Section 4 and financial policy changes in Section 5. Section 6 concludes.

2 The Nature of the Debt Problems of Low-Income Countries

The debt problems of low-income countries has backward-looking aspects (what caused the debt build-up), current aspects (how to deal with the current debt problems), and forward-looking aspects (how to assure sustainable debt structures). We analyse these three aspects from the perspective of the design of the international financial system (for analysis of other, economic aspects, we refer to the assessments done by multilaterals, e.g. World Bank/IMF 2004).

The main starting point is that much of origin of the debt problems of the low-income countries (or for that matter more generally, international debt and financing problems) centres on international coordination problems. Put differently, it is hard to explain the debt and financing problems of the low-income countries in the context of a single, (altruistic) lender or donor, without any moral hazard of possibly bailouts. Such a lender would presumably have lent prudently and avoided excessive debt build-ups. Even if a country's external debt had become unsustainable nevertheless, for example, because of adverse shocks, such a lender would presumably have taken the correct actions in terms of restructuring or reducing the debt, such that perverse impact on the country would be avoided.

That single lender model does not describe reality, however. Indeed, Birdsall, Claessens and Diwan (2003), show that much of the debt problems of low-income countries are due to uncoordinated lending, with continuing loans in the face of ever-increasing debt burdens, especially to multilateral lenders. And they show that the debt build-up undermined the willingness and ability of donors to exercise selectively with respect to the quality of policies being pursued by the countries. More generally, it is hard to explain the recurrence of debt problems without reference to the underlying institutional environment for resource transfers to low-income countries. By implication, there are lessons from studying empirically the behaviour of resource transfers in the past as to what aspects of the institutional environment have mattered most.

The current debt problems are being addressed under the HIPC-initiative, already requiring increased coordination and burden sharing among creditors. The current round of official debt reduction, although associated with large transaction costs and introducing much uncertainty, can help clarify the implicit governance of the international financial system. In particular, the process informs us on the implicit objectives and bargaining strengths of the various participants, strengths that will also affect the process going forward. Altruistic objectives of many donors, for example, can weaken their positions in terms of recovery on debts relative to those more commercially oriented creditors. As we observe already, some donors are willing to buy out other creditors, as they are more eager to get on with the "development business" (which can be for good reasons, as when they care more about poverty and development, or because of less good reasons, as when they have mandates to disburse funds (more) easily without regard for policy). More generally, the processes followed and the outcomes are affected by the institutional setup, and as such there are lessons on how to reform the system to improve on outcomes.

Going forward, it is likely that external financing for low-income countries will mostly take the form of grants, and as such need not lead as easily to a renewed official debt crisis (although development and growth are, of course, not assured). However, since there will be some new debt financing from the official sector, mostly concessional loans, new debt problems cannot be excluded. Furthermore, the countries can always try to borrow from the private sector, especially when their headroom is enlarged through official debt reduction. To assure that debt burdens remain sustainable and to avoid new debt problems, one of the key issues has been a country's maximum level of debt that is sustainable.

To determine sustainable debt levels, a framework has been adopted, taking into account among others, the country's economic and institutional characteristics.[2] Within this limit, the issue has been to agree on the appropriate amounts and terms (degree of concessionality and maturity) under which such assistance is to take place, and to achieve some coordination vis-à-vis any private creditors lending to governments (and possibly even for private to private lending). The question is how to organise institutional coordination on resource transfers to low-income countries, taking the divergent interests of multilateral and bilateral organisations into account. Again, many of these are questions of institutional design.

Jointly, the lessons from the build-up of the debt in the past, the current round of debt reduction and the emerging framework for assessing debt sustainability and new development financing can teach us valuable lessons to improve institutional structures. While empirical approaches are still few and complete conceptual frameworks still lacking, different options for more prudent and coordinated lending should nevertheless be explored and analogues to other coordination problems investigated. We classify these options under institutional changes, policy changes and financial policy changes.

3 Institutional Changes

The analytical framework identified in Claessens and Underhill (2005) suggests many institutional changes that can improve the external financing process for low-income countries. One option for institutional change is more transparency in the decisionmaking process among official donors and creditors and more disclosure on actual outcomes.

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[2] The new framework in Claessens and Underhill (2005) is based on current financing structures not to imply a breach of maximum (NPV) debt to GDP ratios that differ by countries' institutional capacity. Within that maximum, donors and creditors have to coordinate on a country basis on a mix of aid grants and debt financing and the terms of the debt financing. There are many questions here. What to do with the international financial institutions such as the IMF that only lend (and on less concessional terms than other creditors do)? Since it is largely an *ex ante* framework, it does not stipulate what to do *ex post*, i.e. if the country gets hit by a shock and debt ceilings are breached. How to balance project and programme support (e.g. a project may have a very high rate of return and be financeable with debt, yet the overall limits may be breached)? What is the desired path of debt burdens towards these maximums, particularly if the country has just received debt relief? Only some of these questions are addressed.

More transparency could highlight to outsiders (including NGOs, researchers, parliaments, taxpayers in donor countries and citizens in low-income countries) and even to insiders any flaws in the processes, false tradeoffs, looming unsustainable financing structures, etc. This transparency could include more and better disclosure of the minutes of IMF and World Bank decisions and of the Paris Club meetings, more disclosure on outcomes in terms of actual debt relief and new financing, and more clarity on debt sustainability outcomes.

This increased transparency will put pressures for change. It is difficult to predict, however, what direction and form these pressures will take and what their outcome might be. Unsound private sector lending can perhaps be discouraged by more clarity on debt burden, but whether there are pressures that restrain official lenders sufficiently is unclear. After all, many of the problems have been known for a long time, yet governments have made few changes. There is equal scope that the increased transparency invites new constituencies to voice their opinion and be heard in ways that may not aid to the quality of the process.

A second option would be changes in the decisionmaking processes. One aspect here is addressing the severe conflicts of interests that exist in the official financing business, in particular the joint roles of the World Bank and the IMF as creditors, development agencies and assessors of the quality of the adjustment programmes. These conflicts of interests seem to have played a role in the debt build-up, as World Bank and IMF were perhaps too eager to approve programmes allowing other donors to disburse. In turn, the international financial institutions were willing to approve weak programmes since they had to defend their own loans against the risk of default by the country, defaults that would have been quite costly as it meant both financial costs and a loss of reputational capital for these institutions. Addressing these conflicts of interests calls for a greater separation of functions, although it is hard to conceive how this may be done. While separation could involve an independent, third party assessment of the country's debt sustainability, how to assure a high quality and credible assessment without a close involvement including a lending role is not obvious. After all, part of the information value these institutions provide is derived from their close lending relationships. Nevertheless, the existence of independent evaluation agencies in other financial markets, such as rating agencies, suggests that it is not impossible.

A second, and related, aspect of the decisionmaking processes is the coordination among the various forums involved in external financing for low-income countries. There are quite a few actors, the Paris Club, the IMF, the World Bank, and others, each of which have different sets of stakeholders, or at least with different influences. More and better coordination could involve changes in procedures. For example, IMF approval of the macroeconomic content of a programme could be provided independently of IMF's own lending. It could even involve IMF approval on a regular basis without any relationship to a programme, as has been contemplated and as will become more routine when IMF lending will become less important. It could also mean changes in formal approval procedures. For example, approvals in the Paris Club, the IMF, the World Bank on programmes, lending and debt relief could be done jointly, to avoid unnecessary coordination issues.

A third aspect of the decisionmaking processes concerns the individual voting processes in each forum. These could be revised, possibly combined with more disclosure. To date unanimity has been the norm, but this might lead to worse outcomes compared to qualified decisionmaking. Many forms of qualified decisionmaking are possible, including majority, double majority, supra-majority, votes in proportion to financial stakes, like in creditor committees for debt restructuring and bankruptcies, or some combination of these voting systems depending on the exact issue at stake. More formal voting and revealing the votes could change incentives, although much of this will be at the margin, as international financial decisionmaking likely will continue to be dictated by implicit contracts. Disclosing the voting records could force more accountability, although again it will be hard to predict what the outcome thereof might be.

4 Policy Changes

As noted, many of the issues on the external financing of low-income countries centre on poor coordination among creditors and donors. Besides institutional changes, changes in policies could perhaps help coordination, provided of course that these changes in policy are credible, which in turn may require institutional changes. One policy that achieves by definition more coordination is reducing discretion among creditors and donors. Linking the debt ceilings to the country's institutional environment, for example, as is proposed under the new debt sustainability framework, helps reduce discretion in lending. That policy change though only covers some part of official development assistance, since the ceilings are only limits on aggregate debt burdens and within this framework the aid allocation across countries is still free. Given the (revealed) sub-optimality of aid allocation decisions, continued aid to bad performing or institutionally weak countries can thus not be excluded. There may be other reforms needed as well for better aid allocation, which, if implemented, would help improve debt sustainability by enhancing countries' growth prospects.

One option along these lines is introducing more formal rules in the aid allocation that reward good policies and penalise bad policies. This is the idea behind the Millennium Challenge Account according to which at least some part of US aid will be allocated based on (independent) assessments of countries' institutional environments. Also, the International Development Association (IDA) and some other donors already use indicators like the World Bank's Country Policy and Institutional Assessment (CPIA), although these are more subjective. An obvious option would be to extend the rules also to other donors for their aid allocation, or at least for part of their aid budgets. By making aid allocation more explicitly a function of countries' institutional environment and capacity to absorb external financing productively, the degrees of freedom of donors would be reduced and thereby aid allocation could improve. Over time, as country's prospects improve, the debt limits could in turn be relaxed.

There are costs to this more formal approach, though. For one, the approach prescribes implicitly a certain development model, as countries will be judged according to some template. It also implies a form of conditionality. On both aspects, there is much evidence accumulating that these are not the best ways to go. As pointed out by many recently (e.g. Rodrik, 2003), the path taken to development has varied greatly among successful countries. And there is much evidence that ownership by the country, rather than conditionality, has been critical to successful reform and growth. Furthermore, there are many questions on the specific measures used. There are many subjective elements in the indexes proposed, for example, introducing not only noise, but also maybe pro-cyclical biases when well-performing countries are rated higher and low-performing lower, even when there are no structural differences. This would mean that those countries most critically in need of assistance and undertaking reform, yet not showing positive outcomes, would be hurt. Approaches could be designed that preserve the reduced discretion among lenders and donors, yet allow for country differentiation and country ownership.

These include peer-based reviews (such as in NEPAD), the country setting its own benchmarks against which it would be assessed, and a process of a country commenting on its own (lack) of achievement of certain benchmarks.

Even with debt limits and better coordination in terms of aid allocation, an external or internal shock may still hit a country and its debt then needs to be reduced. A policy change would be to use in such cases a more formal restructuring or "bankruptcy" regime, which would have effects *ex post*. Here, one can design *ex ante* rules as to how debts will be reduced in specific circumstances. For example, there could be automatic reduction in debt or debt service ("haircuts") for all or a subset of creditors. Seniority rules and other loss-sharing rules could be invoked, granting more value to some creditors. There could be rules set on how the restructuring process needs to be conducted, including on what voting rules to follow for approval of restructuring plans, the deadlines for submission of proposals, the rules, if any, for cram downs on recalcitrant creditors, and what role, if any, of a third-party arbiter. These and other issues are similar to those that present themselves in domestic restructuring and bankruptcy regimes, thus providing experiences from which to draw. Some of these rules already exist in the international financial system, either implicitly or explicitly, but these could be formalised, improved or extended.

One very specific restructuring rule, which would be quite draconian, could be that debt relief is to be granted automatically if debt exceeds the threshold set under the debt sustainability framework. Furthermore, the degree of relief by each creditor could be made inversely related to the commercial degree of its terms (i.e. the lower the degree of concessionality, the more debt reduction would be required). This and other rules could be introduced by simple agreement among donors (in general or on a country-by-country basis, say following a debt relief operation) or be introduced in the form of official IMF, World Bank or Paris Club policy statements.[3] These rules, if made credible, might affect individual creditor behaviour *ex ante* sufficiently to avoid or at

[3] One model to follow is using the so-called London rules that have been used in the UK for dealing with domestic debt restructuring. Note that many of these issues have already been discussed in the Sovereign Debt Restructuring Mechanism (SDRM), a statuary-based approach, necessary because of the multitude of debtors. The difference in the context of official debts would be that changes can be introduced in a contractual way, e.g. all creditors sign on to some rules *ex ante*, rather than a formal, judicial/statuary mechanism.

least reduce the occurrence of crises due to uncoordinated lending, and would surely make the *ex post* resolution simpler.

5 Financial Policy Changes

Besides policy changes, there has been much discussion recently on changes in the modalities of lending and official development assistance to low-income countries. Clearly, increased concessional lending, even moving to grants only, will reduce the likelihood of debt problems. Improved risk management can help mitigate the impact of external shocks of debt burdens. Financial engineering and use of markets can also help deal with debt overhang problems and sustainability issues.

Financial engineering and market-based mechanisms that facilitate greater coordination among creditors with heterogeneous constraints and preferences are not unique in international finance. During the debt crisis of the mid-1980s, one model to achieve quicker coordination was a menu of debt and debt service reduction options. This allowed creditors with different tax, regulation and other constraints, including their own capital adequacy, to choose options that best matched both the creditors' and the debtor's interests. Options were similar, but not identical in terms of debt reduction equivalent. Official creditors today also differ, for example, in terms of the degree of concessionality on new financing, varying from some 34 percent to 63 percent (World Bank, 2004, Table 3). More generally, private and official creditors have heterogeneous preferences for financing firms, projects and countries, leading to complex financial structures that nevertheless can be optimal *ex ante*.

In the context of the debt problems of the low-income countries, a menu of options is already being used, although not to the same degree as commercial banks did for the middle-income countries in the 1980s. One option used is the credit buy-down mechanism (CBM) where, instead of receiving principal and interest payments from a borrower, the creditor receives the present value of these flows from another donor, effectively turning the loan into a grant for the borrowing country. It is used to increase the grant element of already contracted multilateral debt, but essentially plays on differences in creditor preferences and opinions. These and other instruments have already been suggested to be used on wider scale. This expansion could include donors buying debt from other official creditors in a type of secondary market or through an auction type process (e.g. in the context of a debt relief operation donors could be asked to provide bids for the right to buy up official debt). The price determination will also provide for a measure of donor preferences.

In the context of the debt sustainability, that is on a forward-looking basis, financial policy mechanisms could also be found to deal with donors' preferences. One option could be aimed at dealing with those altruistic creditors that cannot bind themselves not to bail out in case the country does misbehave or if shocks happen. Here the analysis by Cordella, Dell'Ariccia, and Kletzer (2002) provides for a useful framework. They present a model of conditional aid as an implicit contract between altruistic donors (concerned about the consumption of the poor), and recipient government representing the interests of the well-offs. It explains why donors who are also debt-holders keep providing aid without granting debt relief. With debt relief the recipient government would regain access to private credit markets, but the possession of the funds would give the government an incentive to meet the needs of its most powerful citizens, which generally are not the poor.

In their model, the private debt market is suboptimal from the country's overall welfare point of view. This is because the government cannot commit not to borrow for socially undesirable purposes – since the borrowing group (the enfranchised) does not represent the whole country welfare – and the donors cannot commit not to bail out the country – since donors have altruistic objectives, for example, they care about the disenfranchised, i.e. the poor.

The model shows that donors can benefit from becoming creditors, not (just) providing grants but also debt financing, as official debt can lock the debtor out of the private credit market. By locking the country out of the private credit market, donors can, by a mixture of *ex ante* debt relief and aid grants, still achieve their desired outcome, i.e. poverty reduction or other objectives aimed at the disenfranchised.

The model is useful and has some similarities to situations with various official lenders lending at different degrees of concessionality. The model can be interpreted, for example, as a situation where one official creditor (the more private type) extends mainly non-concessional debt. Given the pre-commitment problems of donors, it can be efficient to let this lender (the "IMF" or "World Bank") extend more debt, in the extreme until the country's debt limit, which would lock the country out of the other official debt market (as well as the private market), forcing other lenders to provide only grants.

From: Helping the Poor? The IMF and Low-Income Countries
FONDAD, The Hague, June 2005, www.fondad.org

It still leaves some need for coordination among creditors, as the one creditor would face a high risk of default and might need to be compensated for the *ex post* debt relief it has to grant in some circumstances. The current approach is to let other donors "incur the bill" as they care more about the country in terms of final outcomes, but that is *ex post* very costly as it involves complex negotiations. One institutional, *ex ante* based solution could be notional risk provisioning: creditors willing to provide financing need to "deposit" some fraction of resources in a general account as insurance for the main lender against bad risks or policy underperformance. If any official lender worries about risks less than others do, they ought to be willing (or forced) to provide more financing upfront including the deposit or otherwise pay a higher price.

This model of coordination could also involve a menu, even with a market-based auction process. A neutral third party could set lending ceilings, and the right to provide non-grant resources within these limits could be "auctioned off," with the "price" being the degree to which lenders or donors would be willing to contribute to a collective provision fund. Regardless, there would need to be specific rules on how funds are to be made available in cases of default. It also still leaves the issue on how to set the annual lending and aid ceilings in line with absorptive capacity and the final sustainability of debt burdens, but that is necessary to resolve regardless of the approach chosen. And it assumes of course that the supply of concessional resources exceeds the financing ceilings. The key to any of these proposals is that the rules are agreed upon *ex ante*, rather than having slow, extended debt-restructuring negotiations with most of the costs imposed on the debtor country.[4]

6 Conclusion

This chapter has argued that the debt problem of the low-income countries represents the outcome of institutional weaknesses. It has put

[4] *Ex post*, the current HIPC debt reduction also entails burden-sharing, where the costs of debt reduction for the IMF and World Bank, which can be argued to be currently the debt providers limiting the ability of other lenders to provide debt financing, are being paid for by donors. The difference with the proposed approach is twofold: it is aimed at the core of the problem, the uncoordinated lending, rather than the financing of debt relief; and the mechanisms are agreed upon *ex ante*, and thereby more efficient as there is no *ex post* bargaining.

forward some options for reform, involving institutional changes, policy changes and financial policy changes. None of the options proposed deals with all the problems surrounding official development assistance, and some of the options create their own problems. Much more work is needed to analyse these and other options. The point of presenting the reform options here rather is to suggest that changes can be made to the overall institutional environment that over time can address the current debt problems and, most importantly, can help prevent the recurrence of debt problems.

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