

February 16, 1996

Statement by Mr. Evans on Debt Sustainability Analysis
for the Heavily Indebted Poor Countries, and
Analytical Aspects of the Debt Problems of Heavily
Indebted Poor Countries
(Preliminary)
Executive Board Meeting 96/13
February 20, 1996

I. I am grateful to the staff for their helpful papers on this important issue. I will comment on the analysis, which (when considering individual countries) tends to minimise the scale of the problems: and I will suggest how we take this forward so as to give our Ministers viable policy options at the Spring Meetings.

Analysis

II. I believe that a debt overhang damages economic performance in the following ways:

- it deters investment in physical and human capital, because of the implicit tax imposed by heavy debt burdens;
- it is liable to lead to bad policy decisions in countries which have already suffered from gross economic mismanagement in the past;
- it creates large elements of uncertainty in an economy: nobody knows how much debt will be serviced in the future and who will pay;
- it absorbs a disproportionate amount of the very limited administrative resources of government in the lengthy business of debt rescheduling and negotiations of new loans to cover old ones.

III. These propositions reflect, I believe, sound economic theory. There is also, as the paper brings out, empirical support for these propositions, particularly from middle-income countries. The evidence for the poorest countries is not overwhelming. But we should recall that in the 1980s we--the international community, including the World Bank and the IMF--committed ourselves to substantial debt and debt service reduction, both in the Paris Club for the poorest countries and via the Brady deals for middle-income countries. We made these commitments because we accepted the argument that debt overhang damages economic performance. Rather than wait for conclusive evidence at the 95 per cent probability level, we accepted the case for new mechanisms to relieve debt; and the evidence of this decade strongly suggests we were right to do so. The very same arguments that we used in the 1980s for commercial debt owed by middle-income

countries and by official debt owed by the poorest countries must also apply to the debts owed by the poorest countries to the multilateral institutions.

Sustainability

IV. The methodology in the staff papers is to look ahead up to 10 years, on the basis of strong economic reform programs being successfully implemented, and judge the sustainability of the debt ratios after five and ten years. I want to suggest that there are several sources of bias in this approach:

- Sustainability is an essentially forward-looking concept; yet the future is increasingly difficult to foresee even in the broadest terms. The moral is that we cannot put all our weight on extremely uncertain projections over ten years: a compromise is to focus on no more than five years ahead.
- No allowance has been made in these projections--e.g. of investment, exports, and output--for any damaging effects of debt over-hang. If, as I believe, these effects can be substantial, there is a bias towards minimising problems.
- The projections assume substantially better economic performance policy than in the past decade. While it is absolutely right to insist on strong policy commitments by countries which seek exceptional treatment of their debts, better economic policies may well only be attainable in the context of more debt relief than is assumed in the projections.
- The vulnerability of these economies to, for example, commodity price shocks, is covered in the analysis, but not incorporated into the findings. I believe the record shows that shocks are more likely to be adverse than beneficial.

V. These four sources of bias reinforce my argument that many of these countries will not be able to sustain their debt burdens without additional forms of debt relief. In my view--and this is a view shared by the IMF and the World Bank representatives at the Paris Club--we need to use cautious, rather than optimistic, assumptions about the future, in order to provide a cushion against possible shocks.

VI. In their second paper, staff come up with 8 countries in the "unsustainable" category. I believe we need to add to that group the 12 "possibly stressed" countries.

VII. We need to respond, in our search for practical new options, to the clearly difficult position of all those 20 countries which cannot currently--or even looking five years into the future--be classified as "sustainable". Some of these countries already have a good track record of economic reform and should benefit straight away from new options to deal with their multilateral debt. For others, we will need to assess debt

sustainability again if and when a track record has been established. In the next stage of our work on developing options, I believe that we may also need to reconsider some of the countries which are currently classified as "sustainable", e.g. as their prospects alter, and less rosy scenarios emerge. And we may need to consider the three countries presently unclassified because of lack of data (Liberia, Somalia, Nigeria). But I would certainly want to focus on the group of 20 countries who are most in need of relief, as assessed in the current analysis, in the first instance.

Eligibility

VIII. The papers point out, rightly, that debt relief in the absence of sound economic policies does not work. So a country should qualify for additional debt relief by the multilaterals only if it meets two conditions:

- (i) a heavy overall debt burden;
- (ii) a track record of sound policies: sometimes this has already been earned; in other cases it will need to be earned in the future.

IX. Putting these two conditions into practice on a case-by-case basis will mean that the number of countries that can and should be helped by additional measures by the IFIs in any one year is likely to be very limited. Thus the costs of additional measures will be moderate.

Policy

X. In the next stage of this exercise staff will identify and evaluate policy options for removing unsustainable debt burdens. I want to suggest some principles on which this should be based:

- (i) A country's total debt problems must be dealt with.
- (ii) At least 20 countries would need to be considered on a case-by-case basis.
- (iii) The creditors must act in a coordinated way: this does not imply a global facility (which is likely to be impractical) but action in parallel.
- (iv) Further action on debt must be linked explicitly to good economic management, including a track record, and must lead to a sustainable outcome.
- (v) Action by the IMF and the World Bank must preserve their financial integrity, above all the continuing ability of the World Bank to borrow on the finest terms.
- (vi) Action by the IMF and the World Bank must rely on the Bretton Woods' own resources.

19-10-19