The Fallout from the Financial Crisis (2): External Debt Sustainability
Should More Be Done for the Poor?
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First assessments that the global financial crisis will only have a limited impact on low-income economies are wrong.

International Financial Institutions (IFIs) and donors should not overlook low-income countries in the rush to stabilise the emerging markets.

Commitments need to be maintained on both debt relief and debt management, as many low-income countries will struggle to service debt in the new harsher international environment.

Since the credit crisis first erupted, relatively little attention has been given to the consequences of the financial crisis on low-income countries’ indebtedness. Although in recent years developing countries as a group have benefited from increasing private flows (particularly FDI and remittances), many low-income countries are still heavily dependent on external official aid and debt flows.

It is widely believed that low-income countries are less exposed to financial contagion than emerging markets, principally because local banks are not strongly integrated into the global financial system, and because the complex structured financial instruments at the heart of the crisis are rarely used in poor countries. Moreover, in recent years better macroeconomic policies, debt relief, and favourable external conditions (high commodity prices combined with low interest rates) contributed to lower external debt ratios in many low-income countries.

However, first impressions can be misleading. According to the IMF and World Bank classification, only nine Heavily Indebted Poor Countries (HIPC) are rated as enjoying a low risk of debt distress (IDA and IMF, 2008). The latest data available show that about one third of low and lower-middle countries have a present value of external debt-to-GNP ratio greater than 50 per cent, still within a range in which these countries could be considered vulnerable to external shocks.

The financial crisis will further compromise external debt sustainability for many developing countries, as growth rates and export earnings fall. Moreover, foreign debt is denominated in hard currencies, making repayment ability highly sensitive to shifts in exchange rates. And with the collapse in commodity prices and the recent appreciation of the dollar, exchange rates in many low-income countries have already been falling.

At the same time, fiscal deficits are expected to worsen not only because of the drop in export revenues but also because of the need to increase social spending and safety nets and to provide the fiscal stimulus required to mitigate the worst consequences of the financial crisis. Many low-income countries’ governments are likely to find themselves between a rock and a hard place in this crisis.
Another concern is that the debt relief process – which still involves 18 countries – may slow down because of unforeseen cuts in donors’ pledges and commitments. The other main question is whether HIPC countries will be able to meet existing goals and objectives to be eligible for debt relief in the new harsher international environment.

In addition, new channels of financing for low-income countries, such as sovereign bond issues, will be closed down as the credit market tightens (several countries have recently issued or planned to issue sovereign bonds, among them Ghana, Cameroon, Kenya, Mongolia and Uganda).

To avoid countries tipping over the edge from a situation in which debt is sustainable to one in which suddenly they are unable to meet their payments, now, more than ever, debt renegotiations need to be kept on track and, where possible, the number of eligible countries expanded.

Further reading:
IDA and IMF (2008), Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation.