Domestic Debt & Achieving MDGs in Low Income Countries

Contents

Executive Summary

1. Introduction

2. Domestic Debt in LICs: Some Stylised Facts
Non-CFA African HIPCs
CFA HIPCs
Non-CFA non-HIPC African LICs
Latin American HIPCs
Asian LICs
Possible Underestimation of Domestic Debt

3. Fiscal/Budgetary Impact of Domestic Debt Burden
High Interest Service Payments
Short Maturity of Domestic Debt
Structural Weaknesses

4. Debt Sustainability and Domestic Debt in LICs
HIPC Initiative and Domestic Debt
Debt Sustainability Framework and Domestic Debt
MDRI, Debt Sustainability and Domestic Debt

5. Rationale for Debt Relief, MDGs and Domestic Debt
HIPC Initiative, MDRI and MDGs
Debt Relief by domestic debt holders!
Donor support for domestic debt reduction!

6. Dealing with Domestic Debt Burden: What can LIC Governments Do?
Improve Debt Recording and Verification
Conduct Total Public Debt Sustainability Analysis with an MDG Scenario
Improve Macroeconomic Performance that promotes MDGs with Debt Sustainability
Institute Structural Policies that reduce quasi-fiscal costs
Domestic Debt Restructuring
General Considerations
Securitisation of Arrears
Debt Restructuring with Debt Reduction

7. Domestic Debt Reduction and Donors
Assist countries to pay off domestic arrears
Assist countries to reduce domestic debt
Assist countries to extend maturities of their domestic debt
Assist countries in the development of long term investors, institutional and retail
Assist countries in debt management

Despite a sharp decline in the share of domestic debt in the total debt of non-CFA African HIPCs during 1980-2000, domestic interest service payments remained high (over 40 per cent of total interest payments). Average implicit domestic interest rate in the late 1990s was 21 per cent compared to only 1 per cent for foreign borrowing. Many governments resorted to domestic borrowing where at least in the short term they could rollover domestic debt to reduce external vulnerability and because of a cap on non-concessional external borrowing in IMF programmes. The recent IMF/IDA analysis for 66 LICs over 1995-2004 also suggests domestic interest payments at over 40 per cent of total interest payments, with real interest rates at an average of 3 per cent. More recent data indicates that in many cases real domestic interest rates have fallen significantly from the peaks and in a number of cases turned negative. However, in countries such as Ethiopia, Zambia and Tanzania which have benefited from full HIPC debt relief, domestic interest payments have been similar or larger in size than external payments and are projected to remain higher. Among other LICs, domestic interest payments dominate in Sri Lanka (6 per cent of GDP throughout 2001-2005, compared to only 0.7 per cent of GDP for external payments).

The high interest service burden of domestic debt is compounded by its maturity structure, which in the case of LICs is dominated by short maturity paper, especially three-month treasury bills. The scope for expanding domestic debt in LICs is complicated by the shallowness of their financial sectors. Another weakness is the concentration of the investor base of domestic debt by commercial banks in majority of African countries: which are therefore able to enjoy relatively high returns from this debt.

Debt Sustainability and Domestic Debt in LICs

The HIPC Initiative established certain thresholds for external debt and those HIPCs with ratios above these thresholds were given relief to bring these ratios down to these thresholds, provided they demonstrated a track record of economic and social reform. The HIPC Initiative however did not preclude the IMF from considering the problem of domestic debt burden, when this became a serious macroeconomic concern. 2003 programmes of Bolivia, Ghana and Nicaragua specifically sought to either limit the growth of domestic debt or target a reduction in debt stock tailored to the development of capital markets and the governments' financing needs, using external concessional resources to substitute high cost domestic debt.

Beyond the HIPC Initiative, IMF/World Bank established the Debt Sustainability Framework (DSF) in LICs with indicative country specific debt burden thresholds taking into account quality of policies and institutions. For each LIC standardised forward looking analysis of debt and debt service dynamics is carried out under a baseline scenario and under plausible shocks, with debt sustainability assessed in relation to the thresholds to establish risks of debt distress, which in turn could advise the strategies of lending institutions, especially IDA in determining grant/credit mix. IMF/World Bank have argued have against including domestic debt in the DSF on the grounds of difficulties of determining empirical thresholds because of lack of comprehensive historical data series for LICs, different characteristics of domestic and external debt and

the specific purpose of the DSF to guide official lending decisions. The Commonwealth HIPC Ministerial Forum (Maputo, March 2005) noted the setting up fiscal responsibility thresholds for total public debt in a number of advanced and emerging economies and the need for working out prudential ratios for domestic debt through more research and analysis. Domestic debt to GDP ratio of around 10 per cent has been suggested in a typical African HIPC, with the situation varying according financial depth, with total public debt to GDP ratio ranging from 40 to 60 per cent of GDP depending on policies and institutions.

The Multilateral Debt Relief Initiative (MDRI) involving 100 per cent debt write off by the IMF, IDA and the AFDF to all Completion Point HIPCs, did not establish any debt thresholds, but has had the effect of bringing down NPV external debt ratios well below not only the HIPC thresholds, but also the indicative thresholds under the DSF. The decline could have the perverse effect of giving non-participating HIPC creditors even less of an incentive to provide debt relief as well as of increasing the complacency of governments regarding the need to tackle the shortcomings of domestic debt. LICs might also over-borrow, underlining the critical importance of the adoption of prudent borrowing policies and debt management strategies by LICs that cover all debt.

Rationale for Debt Relief, MDGs and Domestic Debt

The HIPC Initiative predated the establishment of the MDGs in 2000 and was therefore never guided by it, although it had strong underpinnings with poverty alleviation. MDRI made a much more explicit link with the achievement of the MDGs.

A question arises as to why domestic debt holders should be exempt from providing debt relief that could free up resources for MDGs. A distinction between internal and external borrowing is that the former does not increase a country's real resources but is instead a transfer of purchasing power within the country. Thus any debt cancellation by domestic debt holders would represent a tax on them. It would be a positive for the achievement of MDGs if the resources released through domestic debt relief are used by the government for that objective, but if the resources thus transferred were to affect private sector activity and growth, this may have a negative impact for long term growth and y have ctivi12 T- ( )
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rebalancing of public expenditure, which ensures that resources released from domestic debt servicing are clearly earmarked, just like HIPC or MDRI resources, for poverty alleviation and MDG objectives. On the other hand, it could also be argued that donor support for reducing the domestic debt stock would aid growth in private sector credit and investment, vital for long term growth, poverty alleviation and achievement of MDGs. Government's credit standing would also have improved resulting in lower inflation premiums and therefore lower debt servicing cost for future debt, releasing resources for MDGs. The constraint on reducing domestic debt could be eased if additional external resources were utilised for this purpose, although in a world of finite donor resources, any additionality of resources could be at the expense of other countries.

Dealing with Domestic Debt Burden: What can LIC Governments Do?

Domestic debt database needs to be improved in many LICs with assistance from Commonwealth and other capacity building programmes. With respect to arrears to contractors and other suppliers, which are widely dispersed among different departments, steps need to be taken, though the setting up of appropriate machinery, to verify all such claims, including agreement on disputed claims, with all verified claims recorded on a central register. Governments also need to promote centralised data on contingent liabilities that allows budgetary coordination, transparency and discipline.

Carrying out of total public debt sustainability analysis should become a norm in all LICs. So far, DSAs focus on the outlook for debt indicators over time based on macroeconomic assumptions especially regarding growth, interest rates and fiscal balance, under a baseline scenario as well as under alternative scenarios and shocks. An MDG scenario should also become a norm which starts from the proposition of what is required in terms of financial resources to achieve the MDGs and to what extent debt sustainability becomes a binding constraint. This kind of approach allows a focus on how debt sustainability if seen as a constraint can be eased.

Debt sustainability ratios are highly dependent on macroeconomic variables, especially growth, interest rates and fiscal balances, which also have a bearing on achievement of MDGs. All LICs need to focus on how they can enhance growth, through for example, investment in human and physical capital, structural measures that reduce rigidities in the economy and promote private sector investment and development. All LICs also need to maintain strong anti-inflationary policies through prudent monetary management and government borrowing policies to ensure that interest rates remain low, both in nominal and real terms. Low-inflationary environment is in the interest of the poor, who have limited/static incomes and resources and are extremely vulnerable to steep increases in prices. Finally governments also need to maintain fiscal discipline, enhance poverty reducing and MDG related expenditures through Medium Term Expenditure Frameworks and strengthen revenue enhancement through tax reform and improved tax collection.

For many LICs quasi-fiscal costs associated with state-owned enterprises are a major reason for large financing needs. Reforms are clearly necessary where below-market prices provide indiscriminate subsidies to the entire population resulting in large fiscal

burdens. Automatic price adjustment formulas along with targeted subsidies for the poor not only help to contain the fiscal cost, but assist, by aiding the poor, in the achievement of the MDGs.

Domestic Debt Restructuring

Debt managers in LICs have a key role in debt restructuring, using the opportunity of lower inflationary and interest rate environment to refinance expensive debt instruments dating from higher interest rates to lower rates. They also need to explore prospects for lengthening the maturity structure of domestic debt instruments by gradually reducing issues of short term debt and increasing test issues of longer term debt, but not at the expense of significant increases in yields. Policies are also needed to broaden the investor base, especially promoting investment by retail and institutional investors that are willing to hold longer term government paper.

One of the ways of relieving the immediate burden of the repayment of arrears would be their securitisation. This would ensure their settlement takes place in an orderly fashion over a reasonable period of time. In order to provide some incentive to settle or unduly not penalise small creditors, depending on each country situation, the governments could offer to settle upfront a certain proportion of arrears or all credits up to a certain limit7bould be
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circumstances, but this depends on IMF diagnosis and willingness of donors to provide additional resources. An in-between approach would be insert a degree of automaticity in domestic debt reduction, but based on individual country circumstances. Donors could provide debt relief to countries of up to a maximum of 10 per cent of GDP, with eligibility restricted to all HIPCs with domestic debt ratios above 20 per cent of GDP or total public sector debt ratio exceeding 40-60 per cent depending on the quality of their policies and institutions.

Donors could assist LICs to extend the maturities of their domestic debt by guaranteeing interest payments on the later portions of their maturity, giving confidence to the holders of the debt to hold longer dated instruments. This process could be continued over a number of years until these countries achieve 10 year maturity bonds. Donor technical and financial assistance can be helpful in the development of insurance and pensions industry that are typically geared towards investing long term, with a significant part of the portfolio invested in government bonds offering secure returns.

Debt management is an area where donors can provide immediate technical assistance. The World Bank has proposed the establishment of a global debt management partnership which provides technical assistance based on a standardised diagnostic tool and work with select group of LICs that have demonstrated commitment to sound debt management. A related idea could be a donor funded partnership or possibly even a separate multilateral institution for capacity building, dissemination of international best practices and knowledge transfer on domestic debt management, including management of securitised debts, verification and dealing with non-securitised debts, contingent liabilities and other related areas.

1. Introduction

Achievement of the Millennium Development Goals (MDGs) is a major challenge for
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One key requirement for the achievement of MDGs is to ensure that government and donor resources are increasingly targeted towards these goals. In this respect, debt servicing represents a claim on government resources, which could otherwise be utilised towards the achievement of these goals. International community through the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) has provided substantial external debt reduction and relief to HIPCs, with an explicit aim of assisting these countries on their path towards achieving MDGs.

Governments have to service not only external debt, but also domestic debt, which is also a claim on government resources, which could be utilised for achievement of MDGs. The purpose of this paper is to analyse domestic debt in LICs as permitted by data availability, highlighting particularly the fiscal/budgetary impacts of the domestic debt burden. It then appraises domestic debt in the context of overall public debt sustainability

- During the first half of the 1990s this ratio fell to 6 per cent, as these countries accumulated massive amounts of external debt, with the total public debt ratio at around 138 per cent of GDP.
- In the late 1990s, the accumulation of external debt continued, but domestic debt also rose to 8 per cent of GDP
- The result was a sharp decline in the share of domestic debt in total debt from 22 per cent in the 1980s to 6 per cent in the second half of 1990s.
- There were however sharp variations between HIPCs: some such as Ethiopia, Tanzania and Zambia which relied extensively on domestic debt in the 1990s saw significant falls in domestic debt to GDP ratios to under 10 per cent. Others, such as the Gambia and Ghana, saw their reliance on domestic debt increase sharply to 25 per cent of GDP in the second half of the 1990s. Some counties Malawi, Mozambique, Uganda) continued to have insignificant reliance on domestic debt

Data from aforementioned IMF/IDA paper suggests high domestic debt levels during 1995-2004 in Eritrea, Sierra Leone and Ethiopia of over 30 per cent. More recent domestic debt data, available in some cases through IMF Article IV reports (see Table),

There are five other LICs in Africa which are not HIPCs: Angola, Djibouti, Kenya, Lesotho and Nigeria. Both Kenya and Nigeria had significant reliance on domestic debt in the 1980s (over 20 per cent of GDP). In the case of Kenya this continued; however with donor curbs on lending, there was a significant increase of share of domestic debt in total debt close to 30 per cent. Nigeria saw a decline in reliance on domestic debt in the late 1990s and with a major increase in external debt in the 1990s, saw the share of domestic debt in total debt fall from 37 to 17 per cent. With the recent sharp rise in oil prices and revenues, Nigeria has been accumulating large deposits at the central bank and has been using the concept of net debt. At end 2005 net total public debt amounted to 22 per cent of GDP, with net domestic debt at 2 per cent of GDP, but 2006 figures show negative net public debt, with domestic debt at -1.4 per cent of GDP, a situation which is likely to continue to improve over the next five years. Lesotho and Angola have small to insignificant amounts of domestic debt.

Latin American HIPCs

With regard to Latin American HIPCs, data shows significant reliance on domestic debt. Large fiscal deficits in Bolivia in 2000-03 resulted in a sharp increase in domestic debt from just over 10 per cent to about 23 per cent of GDP, although by 2005 this was brought down below 10 per cent. In the case of Nicaragua at end-2003 the combined public sector domestic debt amounted to 46 per cent of GDP, reflecting mainly liabilities stemming from the property indemnisation bonds issued by the government to resolve the land disputes arising from expropriation of property under the Sandanista regime of the 1980s as well as the restructuring costs of the banking system. By end 2004 this has been brought down to about 30 per cent of GDP. In 2000 Guyana also had significant domestic debt amounting to 37 per cent of GDP. Honduras appears to be the only Latin American HIPC with a steady domestic debt ratio of about 10 per cent.

Asian LICs

Available data point to sizeable domestic debt in Sri Lanka, amounting to about 47 percent of GDP in 2005, with the total public debt to GDP ratio standing at over 100 per

debt stocks fell, while the Ghana, Sierra Leone, the Gambia and Malawi witnessing a significant rise, in the case of the former three exceeding 4 per cent of GDP, and in the case of first two 25 per cent of government revenue.

- Among other African LICs, domestic interest payments as a share of GDP, government revenue and total interest payments rose sharply in Kenya, but fell in Nigeria and Lesotho. In all cases there was a significant increase in implicit domestic interest rates.

There are two main reasons why governments have borrowed domestically despite high interest rates.

- Rising external indebtedness, which requires foreign exchange to service its amortisation, greatly increased the vulnerability of these countries. Many governments resorted to domestic borrowing where at least in the short term they could rollover domestic debt without major macroeconomic implications
- In order to limit external vulnerability many Fund-supported programmes put a cap on non-concessional borrowing. Thus where governments were unable to obtain sufficient concessional assistance to meet their financing requirements, they resorted to relatively expensive domestic borrowing.

The aforementioned IMF/IDA analysis over 1995-2004 points out that on average a typical LIC paid out 8 per cent of public revenues to cover the domestic interest bill. This represented more than 40 per cent of total interest bill, or more than twice its relative share of the public debt stock. The ex-post real interest rate on domestic debt was about 3 per cent in a typical LIC.

More recent data, where available indicates that in many cases real domestic interest rates have fallen significantly from the peaks and in a number of cases turned negative. For example, in the cases of countries which have already [illegible]

The high interest service burden of domestic debt is compounded by its maturity structure, which in the case of LICs is dominated by short maturity paper, especially

Although the HIPC Initiative was not concerned about reduction in domestic debt, this did not preclude the IMF from considering the problem of domestic debt burden, when this became a serious macroeconomic concern (when domestic debt servicing claimed a substantial and rising proportion of government revenue, leading to arrears to domestic debt holders, and, when rising claims on resources by domestic debt, crowded out the private sector, affecting investment and growth). In such cases, IMF programmes have been responsive in their analysis and design, not limiting itself to assessing external debt sustainability, but also focussing on domestic debt. For example, in 2003 programmes of Bolivia, Ghana and Nicaragua specifically sought to either limit the growth of domestic debt or target a reduction in debt stock tailored to the development of capital markets and the governments' financing needs. In all programmes, one of the key instruments in reducing domestic debt burden was the use of external concessional resources, in effect substituting high cost domestic debt with low cost external debt.

Debt Sustainability Framework and Domestic Debt

While the HIPC Initiative was designed to address the existing debt overhang, it was not concerned to maintain long term debt sustainability. For the later purpose a Debt Sustainability Framework (DSF) in LICs was approved by the IMF and the World Bank in March 2005. It established indicative country specific debt burden thresholds taking into account quality of policies and institutions (ranging from NPV of external debt at 30 to 50 per cent of GDP and at 100 to 200 per cent of exports) For each LIC standardised forward looking analysis of debt and debt service dynamics is carried out under a baseline scenario and under plausible shocks, with debt sustainability assessed in relation to the thresholds to establish risks of debt distress, which in turn could advise the strategies of lending institutions. For many LICs, such forward looking Debt Sustainability Analysis (DSA) is already been carried out, usually as an appendix to the IMF Article IV and other reports. IDA has already used the framework as a basis for determining grant/credit mix under IDA-14.

IMF and World Bank have argued against including domestic debt with external debt in the DSF on the grounds of difficulties of determining empirical thresholds because of lack of comprehensive historical data series for LICs, different characteristics of domestic and external debt and difficulties in making inter-country comparisons (e.g. calculating NPV of domestic debt, lack of conditionality in domestic debt, etc.), and finally the specific purpose of the DSF to guide official lending decisions (especially the inappropriateness of using total debt thresholds in all combinations of external and domestic debt). It has thus argued for the treatment of domestic debt on the case by case basis in the context of IMF programmes as above.

However, historical data on domestic debt has begun to emerge and for an increasing number of LICs (e.g. Bangladesh, Bolivia, Burundi, Cambodia, Ethiopia, Guinea, Guinea-Bissau, Honduras, Nicaragua, Nigeria, Sierra Leone, Sri Lanka, Zambia,) the IMF is also beginning to undertake total public debt sustainability analysis[4], in addition to

[4] Between the inception of the DSF in April 2005 to early June 2006, 33 DSAs were published, of which 24 had public debt DSA.

the external debt assessment. Although with low or moderate risk of external debt distress, some countries such as Sierra Leone, Ethiopia, Papua New Guinea, Cameroon. Guyana and Nicaragua had high domestic debt ratios. In some cases, the total public debt

Both IDA and AFDF are funded by bilateral donors through regular replenishments. Donors have agreed that lending capacities of these institutions should not to be significantly impaired and therefore have decided to provide additional resources to these institutions to compensate for MDRI relief provided by them. It should however be noted that, as currently conceived, before additional contributions are taken into account, MDRI relief from IDA does not affect the net resource transfers to all beneficiary countries,

The constraint on reducing domestic debt could be eased if additional external resources were utilised for such domestic debt reduction. At the individual country level, any additionality of resources to reduce domestic debt, would imply that the resources previously used for domestic debt servicing are released providing additional support for the achievement of MDGs. But in a world of finite donor resources, any additionality of resources could be at the expense of other countries.

6. Dealing with Domestic Debt Burden: What can LIC Governments Do?

Improve Debt Recording and Verification

One of the principal problems in a number of LICs is weak domestic debt data base. There is a need therefore to improve such data base, with assistance from say Commonwealth Secretariat CS-DRMS and other capacity building programmes. Such improvements can help countries determine the true size and profile of their domestic debt burden. With respect to improving the quality of data, Commonwealth Secretariat Debt Management Programme has identified a number of practical problems, especially the institutional and manpower deficiencies in the debt offices The CHMF (Livingstone, Zambia, April 2006), noted that the solutions to these were largely country-specific and have expressed their commitment to address them at the level of their individual countries with the help of the capacity building programmes.

While data on securitised debt may be easily gathered, a particular problem arises with respect to arrears especially to contractors and other suppliers of goods and services to governments, which are widely dispersed among different departments often without proper recording by them, making the task of central recording that much more difficult. Steps therefore need to be taken, though the setting up of appropriate machinery, to verify all claims of arrears with the respective parties, including agreement on disputed claims. All verified claims need to be recorded on a central register.

An important area that requires attention in most developing countries is contingent liabilities (CLs). These are created when governments extend financial support to other agents in the economy contingent upon certain events taking place, such as debt default, insolvency or a fall in revenues below a certain level. Explicit CLs include guarantees to promote activities considered to be public goods, such as incentives by government to the market to finance these sectors and projects, that allows increased funding and or better financial terms for the project/activity than on a stand alone basis. Implicit or non-contractual CLs can be as expensive for the government when for example it provides financial support especially to the banking sector to avert systemic risks. CLs are same as debt, but hidden off balance sheet, lacking provision. Governments need to promote centralised data on CLs that in turn allows coordination with the budgetary unit so as to promote budgetary transparency and discipline.

Conduct Total Public Debt Sustainability Analysis with an MDG Scenario

As noted above, while IMF external debt sustainability analysis is gradually beginning to take hold in many LICs as part of Article IV reports, total public debt sustainability analysis has been carried out in limited cases. This latter should become a norm in all LICs.

So far the DSAs have a focus on the outlook for debt indicators over time based on certain macroeconomic assumptions especially regarding growth, interest rates and fiscal balance, under a baseline scenario as well as under some alternative scenarios and under shocks (see Box 1 which describes the analytical underpinnings of growth in public debt) However except in very few cases, there has not been an MDG Scenario, which starts from the proposition of what is required in terms of financial resources to achieve the MDGs and to what extent debt sustainability becomes a binding constraint towards these achieving these objectives. This kind of approach allows a focus on how debt sustainability if seen as a constraint can be eased.

Thus the new equation

$$pdt+1 - pdt = [(r-g-p-gp + ae(1+r))/(1+g+p+gp)]pdt - fbt+1$$

Here if a country's currency depreciates (i.e. ε is positive), it has a debt increasing effect in domestic currency and vice versa.

To this one needs to add a residual R, to take account of changes in cross exchange rates numerical approximations and calculation errors that may explain the discrepancies between the observed change in the stock of debt and the change given by debt creating flows as by the formula above.

Improve Macroeconomic Performance that promotes MDGs with Debt Sustainability

As noted above, debt sustainability ratios are highly dependent on macroeconomic variables, especially growth, interest rates and fiscal balances. These also have a bearing on achievement of MDGs. High growth rates have the effect of reducing the debt ratios; i.e. they can allow countries to have higher debt levels without increasing the debt ratios. Evidence points to high growth rates contributing directly to poverty reduction, although pro-poor government policies and interventions can accelerate this process. All LICs therefore need to focus on how they can enhance growth, through for example, investment in human and physical capital, structural measures that reduce rigidities in the economy and promote private sector investment and development

It has also been noted that the principal problem facing many LIC governments is the high interest servicing burden of domestic debt, arising out of high real interest rates. But reduction of high real interest rates can only come about in a low inflationary environment, which leads the private sector to demand a low inflation premium on domestic debt. All LICs will therefore need to maintain strong anti-inflationary policies through prudent monetary management and government borrowing policies to ensure that interest rates remain low, both in nominal and real terms. It should also be noted that a low-

For many LICs quasi-fiscal costs arising out of contingent liabilities associated with state-owned enterprises are a major reason for large financing needs. Some governments (e.g. Ghana) with the support of the IMF, have addressed these problems through structural reforms, including introduction of automatic price adjustment formula of SOEs in the petroleum, electricity and water sectors. Reforms are clearly necessary where below-market prices provide indiscriminate subsidies to the entire population resulting in

Achievement of MDGs would invariably require higher public expenditures from governments (in addition to the rebalancing of expenditures mentioned above). With limits on raising government revenues, the international community can assist LICs achieve MDGs through substantially increasing their grant levels, so that rises in expenditure do not translate into significant deterioration in fiscal balances. Alternatively or in addition they could substantially increase concessional credits, which would have the effect of substituting costly non-concessional finance that would have been borrowed externally or domestically, thereby curtailing a significant rise in interest payments and future debt ratios. Finally they could provide further exceptional finance to reduce the debt levels of HIPCs. With almost 100 per cent debt relief provided by DAC donors and the major international financial institutions, the candidate most suitable for providing relief from donors' perspective is domestic debt.

There are a number of ways in which donors could assist HIPCs/LICs in domestic debt reduction.

(a) Assist countries to pay off domestic arrears

Donor grant resources could be used to clear verified arrears, especially to suppliers and contractors. This could be done either fully or partially with the remainder securitised (see above). As in the case of Ghana, governments should also be able to partly use resources released from HIPC or MDRI relief to pay off these arrears.

(b) Assist countries to reduce domestic debt

Those HIPCs which have had the benefit of HIPC and MDRI relief, but with high domestic debt ratios, can be assisted directly to reduce their domestic debt levels. There are a number of options:

- Donors could provide resources to reduce domestic debt ratios below a certain uniform threshold, say 10 per cent of GDP, the rationale for which was suggested above. It is also close enough to the ratio used by the IMF in the programme of Ghana. This threshold approach is similar in methodology employed in reducing external debt under the HIPC Initiative and would ensure that domestic debt levels are also brought down significantly, so that overall debt ratios remain well below thresholds and sustainable over the medium term. Another positive for this approach is that a significant amount of short term debt could be retired, with the government having a much better maturity profile of domestic debt. The downside of this approach is that it does not distinguish between different circumstances of countries, including their level of financial depth and development.

- The alternative is to reduce domestic debt according to individual country circumstances, including their macroeconomic circumstances and the level of financial depth and development. This was indeed the approach adopted by the

IMF in its programmes for Bolivia, Ghana and Nicaragua. The pitfall of this approach is that a lot depends on IMF diagnosis and willingness of donors to provide additional resources, so that countries substitute expensive domestic debt for concessional external debt.

- An in-between approach would be insert a degree of automaticity in domestic debt reduction, but based on individual country circumstances, particularly their financial sector development. For example, some countries, especially in Latin America, because of the level of their financial development have been able to sustain high levels of domestic debt. Donors could provide debt relief to countries of up to a maximum of 10 per cent of GDP, with eligibility restricted to all HIPCs with domestic debt ratios above 20 per cent of GDP or total public sector debt ratio exceeding 40-60 per cent depending on the quality of their policies and institutions.

For LICs which are not HIPCs, direct domestic debt reduction may not be appropriate as these countries, with external debt levels below HIPC thresholds, have not benefited from HIPC and MDRI debt reduction or have been reluctant to accept debt reduction in case this affects their credit standing and future borrowing prospects. For these countries, the approach that could be adopted is similar to that adopted under IMF programmes, with gradual reduction in domestic debt accompanied grants and highly concessional borrowing, resulting over time in the substitution of more expensive external debt with low cost concessional finance.

(c) Assist countries to extend maturities of their domestic debt

Donors could assist LICs to extend the maturities of their domestic debt by guaranteeing interest payments on the later portions of their maturity. For example if the maximum maturity a country could borrow is 4 years, donors could support the extension of the maturity of this debt for say a further two years by guaranteeing interest payments for the 5th and the 6th years. This would give confidence to the holders of the debt to hold longer dated instruments. As this debt would be contracted at fixed interest rate, the contingent liability facing the donors would be certain at the outset. There could be a separate guarantee fund set up by donors to take care of such contingent liability. It would be in the interest of LICs not to default on the interest payments, as this could affect their future standing in the markets and development of domestic debt markets. Once 6 year debt becomes widely accepted, donors could offer interest guarantees for the 7th and 8th years, towards making 8 year bond the norm. This process could continue up to the development of 10 year maturity bonds.

(d) Assist countries in the development of long term investors, institutional and retail

Donor technical and financial assistance can be helpful in the development of insurance and pensions industry that are typically geared towards investing long term, with a significant part of the portfolio invested in government bonds offering secure returns.

(e) Assist countries in debt management

Recognising that debt management offices in many LICs lack adequate capacity to monitor and adequately record debt data (let alone effectively manage them), the World Bank has initiated a dialogue with other donors on the need to strengthen debt management capacity in LICs. In particular one proposal is for the establishment of a global debt management partnership that engages leading international and regional providers of debt management technical assistance and which provides technical assistance based on a standardised diagnostic tool and work with select group of LICs that have demonstrated commitment to sound debt management. A related idea could be a donor funded partnership or possibly even a separate multilateral institution for capacity building, dissemination of international best practices and knowledge transfer on domestic debt management, including management of securitised debts, verification and dealing with non-securitised debts, contingent liabilities and other related areas.

Table 1: Non-CFA African HIPCs and other LICs: Domestic and External Debt 1980-2005

(in per cent of GDP, unless otherwise indicated)

	Type of Domestic Debt	Domestic Debt				External Debt				Total Debt				Domestic/Total Debt %			
		1980-89	1990-94	1995-2000	end-2005	1980-89	1990-94	1995-2000	end-2005	1980-89	1990-94	1995-2000	end-2005	1980-89	1990-94	1995-2000	end-2005
HIPCs		**9**	**6**	**8**		**56**	**124**	**156**		**69**	**138**	**169**		**22**	**6**	**6**	11
Burundi	t)c)	3	2	6	20	40	96	138	166	44	98	144	186	8	2	4	
Congo Dem. Rep.		0	0	0		50	126	254		50	126	254		0	0	0	
Ethiopia	t)b)	16	19	10	35	31	115	109	54	47	134	120	89	34	14	9	39
Gambia	t)d)s)	3	13	23		80	84	104		83	96	127		3	13	18	
Ghana	t)	12	8	24	11	19	55	83		32	64	106		38	13	22	
Guinea		..	..	..	16	0	0	91	118	..	..	..	134	..	.. 122	..	12
Guinea-Bissau					48				332				380				13
Madagascar	t)	3	3	3		71	120	110		74	123	113		4	2	2	
Malawi	t)s)	13	8	9		65	100	126		78	109	135		16	7	7	
Mozambique		0	130	80	9	75	207	121 9		75	207	122 7 5		0	0	0	
Rwanda	t)b)	207															

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