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Original sin, debt relief and domestic bond market development: the potential role of Debt Conversion Development Bonds

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Overview

- Reduce external debt of countries/debt titles *outside* the major debt relief initiatives…
- … and provide additional funding for development (MDGs/NDPs)

  Potential for (new-style) debt-for-development swaps?

- Ability to frontload and scale up…
- … and stimulate domestic capital (bond) market development and reduce (domestic) “original sin”

  Potential of ‘Debt Conversion Development Bonds’?

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Structure

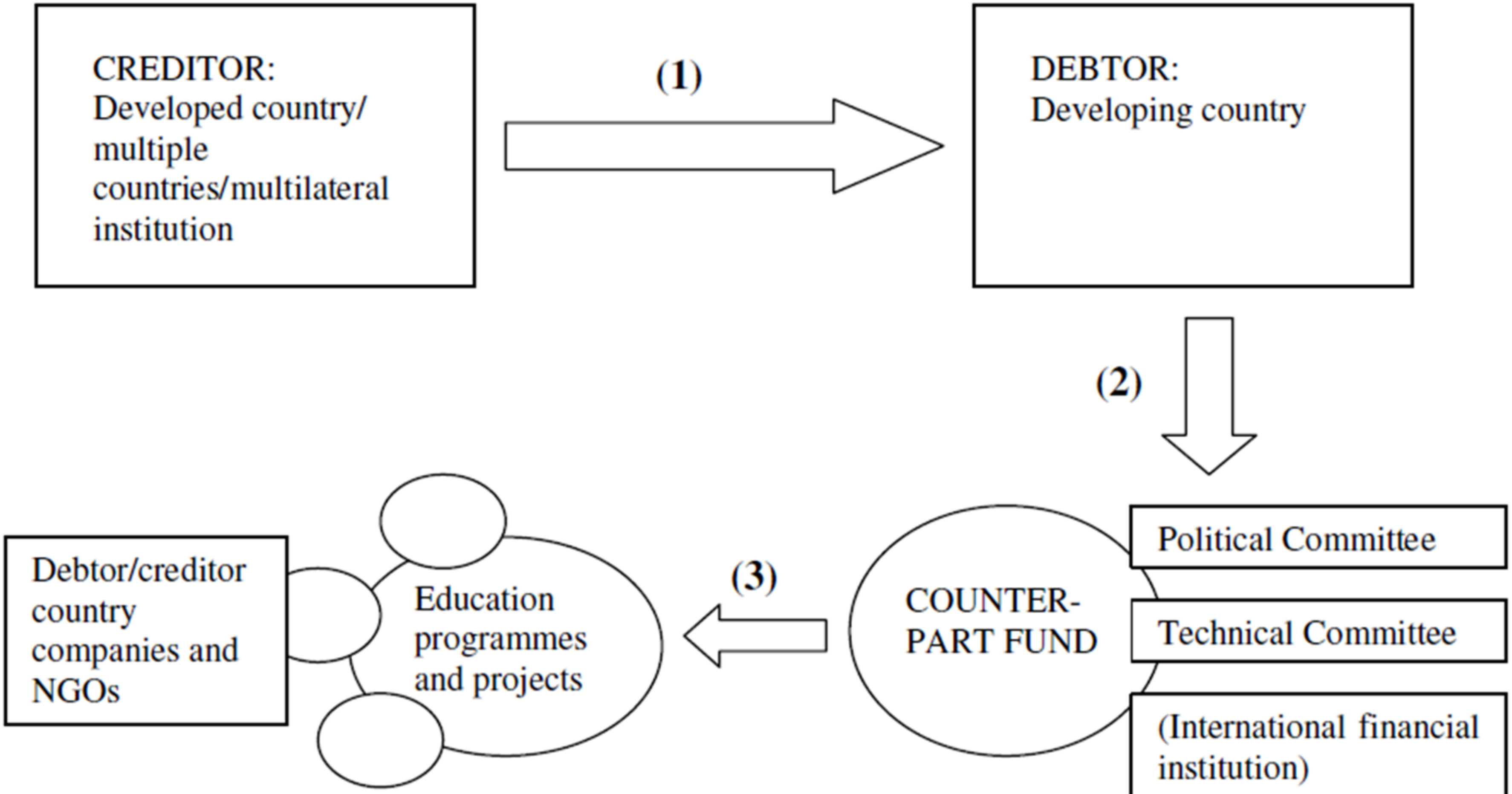
- Situating debt(-for-development) swaps within wider debt relief efforts
- An assessment framework and a (non-exhaustive) checklist for debt swap effectiveness and efficiency
- Remaining problems: scaling up and (sometimes) desirability to frontload
- Potential role of DCDBs

1. Situating debt swaps within wider debt relief efforts

- What are debt-for-development swaps?

  The cancellation of external debt by the creditor in exchange for the debtor goverment's commitment to mobilise domestic resources (in local currency) for specific development goals

  (projects, sectoral, multi-sectoral, National Development Programme)
- Typical schematic presentation: see next slide



CREDITOR:
Developed country/ multiple countries/multilateral institution
(1)
DEBTOR:
Developing country
(2)
Political Committee
Technical Committee
(International financial institution)
COUNTER-PART FUND
(3)
Education programmes and projects
Debtor/creditor country companies and NGOs

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3 ‘generations’ of debt relief

<table>
<tr><th></th><th colspan="2">Bilateral (Paris Club)</th><th colspan="2">Bilateral (non-Paris Club)</th><th colspan="2">Multilateral</th><th colspan="2">Commercial</th></tr>
<tr><td>Before HIPC Initiative (1950s-1996)</td><td colspan="2">- common terms for LICs (Toronto, London, Naples), LMICs (Houston) and other countries (classic)
- debt swaps
- parallel ODA relief</td><td colspan="2">- ad hoc debt relief</td><td colspan="2">- exceptional debt relief</td><td colspan="2">- London Club treatments
- debt swaps
- Brady deals
- IDA-DRF buy-backs</td></tr>
<tr><td></td><td>HIPCs</td><td>non-HIPCs</td><td>HIPCs</td><td>non-HIPCs</td><td>HIPCs</td><td>non-HIPCs</td><td>HIPCs</td><td>non-HIPCs</td></tr>
<tr><td>HIPC Initiative (1996-...)</td><td>- bringing debt down to debt sustainability thresholds through debt relief under Lyon (80%) and later Cologne (90%) terms</td><td rowspan="2">- common terms
- debt swaps
- tailored debt relief through Evian approach</td><td>- participation in bringing debt of HIPCs down to debt sustainability thresholds (varies per creditor)</td><td rowspan="2">- ad hoc debt relief (including debt swaps)</td><td>- bringing debt of HIPCs down to debt sustainability thresholds</td><td rowspan="2">- exceptional debt relief</td><td rowspan="2">- participation in bringing debt of HIPCs down to debt sustainability thresholds through London Club treatment, debt swaps, IDA-DRF buy-backs</td><td rowspan="2">- London Club treatments
- debt swaps
- IDA-DRF buy-backs</td></tr>
<tr><td>Beyond HIPC Initiative (2006-...)</td><td>- providing 100% debt relief to post-completion point HIPCs</td><td>- ad hoc debt relief (including debt swaps)</td><td>- MDRI: providing 100% debt relief to post-completion point HIPCs (IDA/IMF/AfDF/ IADB)</td></tr>
</table>

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2. Building blocks to assess swap practice (I)

- Nominal debt swapped/relieved is not necessarily a good indicator of resources liberated (and fiscal space):
  - Depends on debt service schedule: need to compute in '(Net) Present Value'
  - Depends on whether debt would be serviced ('discount')
  - Depends on whether debt relief is substitute for traditional aid by donor

- 'Earmarking' does not necessarily lead to additional resource availability for education
  - Depends on whether recipient country/donor substitutes ("fungibility")

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Building blocks to assess swap practice (II)

- We should also look at potential indirect effects of debt relief, caused by relieving 'debt overhang' (e.g. positive effects on domestic revenue mobilization)

- To what extent do swap practice fits the 'New Aid Architecture' (NAA)
  - Policy aligned?
  - System aligned?
  - Non-earmarked?

In other words, look like 'General Budget Support' (GBS), or at least like 'Sector Budget Support' (SBS)

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A checklist

Better-engineered debt swaps would...	***Why?***
...target (non-concessional) debt titles that are due in a relatively short period of time, carry (near-)market interest rates and would have been likely to be serviced without the swap intervention.	*to ensure a greater transfer of international purchasing power*
... be negotiated between debtor and creditor countries on the basis of PV rather than nominal figures.	*to increase overall transparency*
...respect original debt service schedules ...entail larger discount rates to account for the possibility of non-repayment of the original debt, if applicable.	*to generate true fiscal space*
...be gauged against previous and predicted trends of donor support for education as well as debtor country budget lines reserved for the sector.	*to ensure additionality in a double sense*
...be policy-aligned with the debtor country's own national and education sector development plans.	*to ensure country ownership*
...be system-aligned, using existing debtor country systems in the education sector to the maximum extent possible	*to reduce transaction costs and build long-term capacity*

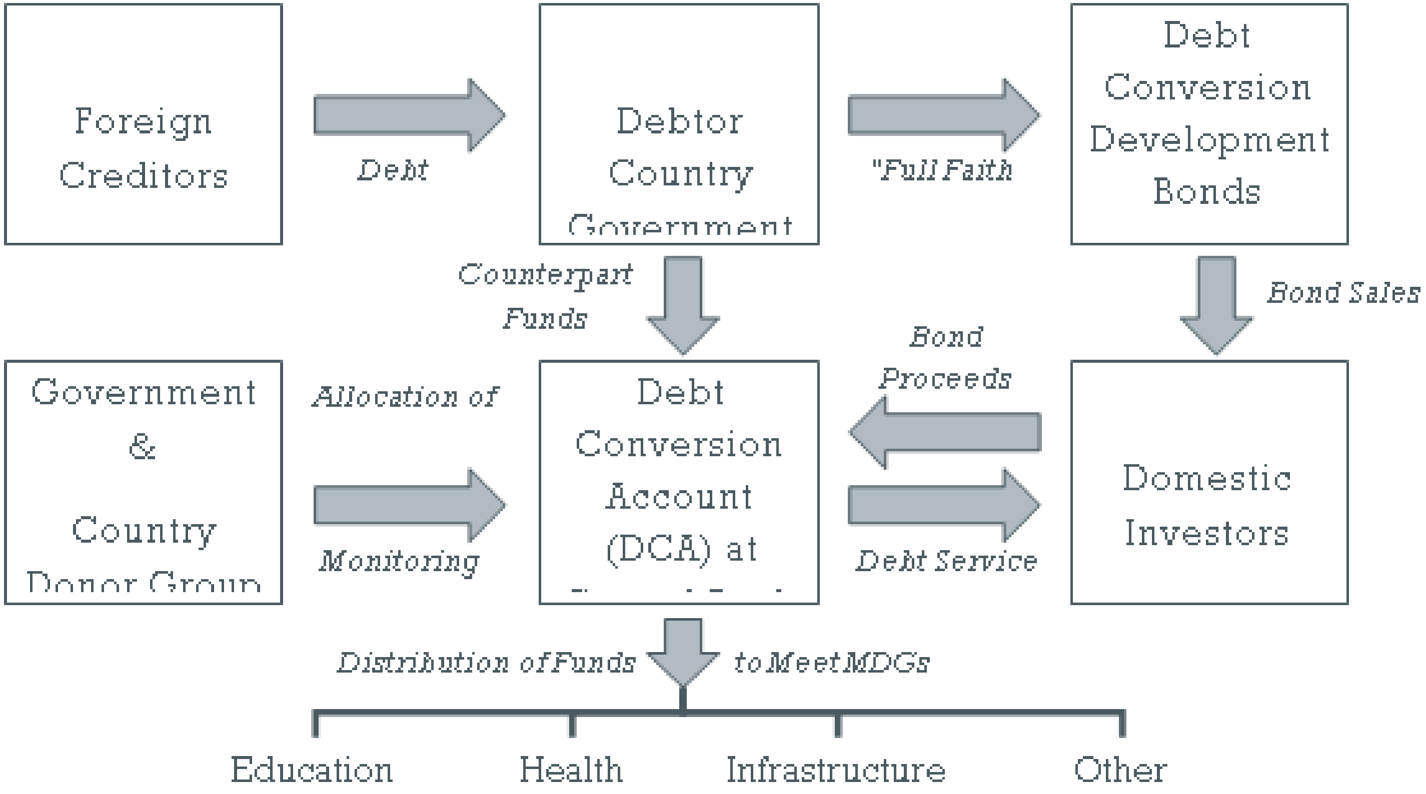
3. Remaining issues

- Debt swaps are very small (‘marginal’) operations: necessity to scale up, through multi-creditor swaps
  - May in practice be quite difficult due to differences in creditor policies
- Funds for development become available at the pace of schedule of debt service cancelled
  - Suppose it is useful to frontload: can we use bond emissions to realize frontloading?

4. The potential case for DCDBs

- How could this work? See next slide
- Issuance of DCDBs does not necessarily require debt swaps: could also be engineered through pre-committed future donor flows (equivalent to the IFF(Im) mechanism)
- Other positive externalities
  - Help develop domestic bond markets: provide longer-term fixed interest rate securities
  - Help overcome domestic ‘original sin’: i.e. the inability of countries to borrow long-term in their own currency

Debt Conversion Development Bonds



Conclusions

- Debt swaps typically look like old-style project aid but should look more like (G)BS: lead to debt relief policy for "excluded" countries?
- To be engineered effectively (checklist)
- To be scaled up, could start by common donor effort in individual countries
- In case frontloading is desirable, this could be done through the issue of long-tenor domestic currency bonds (DCDBs), helping to overcome (domestic) "original sin"

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Thank you for your attention