

How the developing world is striving to free itself of debt [Print](#)

By Joanna Chung in London

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The head of the Nigerian government's Debt Management Office is as mild-mannered as debt management officers come. But even he could not resist what in that profession must be the equivalent of a sportsman's victory dance: a flourish to demonstrate the consummate mastery of his game.

Into his PowerPoint slide presentation detailing Nigeria's clearance of more than \$30bn (£15bn, €23bn) of its external debt, Mansur Muhtar, the official, slipped an unexpected but dazzling image of fireworks.

It signalled that Nigeria, once seen as one of the world's financial basket cases, had entered a promising era: from \$35bn, debt was almost entirely cleared last year, through write-offs and windfall revenues from oil.

Nigeria is just the latest example of a phenomenon taking root in the developing world. After decades under mountains of debt, many countries are digging themselves out. Thanks to high commodity prices and, in some cases, debt forgiveness programmes, many of the seemingly hopeless cases of old are paying off debts and avoiding new ones.

Russia, whose \$40bn domestic debt default and financial collapse in 1998 sent shock waves throughout the world, has used its windfall from high oil and gas prices to pay off a large chunk of its foreign debt. Moreover, debt reduction has not been limited to oil exporters: Argentina, historically a serial defaulter – most recently on \$100bn worth of debt in 2001 – ended its relationship with the International Monetary Fund a year ago and is paying more money back to creditors than it is borrowing in fresh loans or bonds (see below right).

Countries scarred by past crises, including Mexico, Brazil, Indonesia, the Philippines, South Korea and other countries in Latin America and Asia have taken steps over the past five years to insulate themselves from the effects of a future global financial crisis. In stark contrast to past periods of strong global growth and low interest rates, they are husbanding resources rather than spending them – many are paying off public debt, running budget and/or current account surpluses and building foreign exchange reserves. When they do issue bonds, governments are increasingly doing so locally rather than in international capital markets.

One striking measure of this new thriftiness is what has happened to the stock of Brady bonds – the once dominant market instrument in emerging markets, issued in the 1990s in exchange for defaulted bank loans of the 1970s and 1980s. With governments increasingly buying back or exchanging the bonds for new ones at advantageous rates, the supply of such bonds that reached a peak of \$156bn in March 1997, according to IMF data, has virtually disappeared.

“Governments are taking advantage of favourable market conditions to deleverage and pay off external debt,” says Mansoor Dailami, manager of international finance at the World Bank's development prospects group. “The ratio of total external debt to gross domestic product has significantly dropped in many of these countries. Some of these countries are no longer high debtor countries, though obviously there is still high internal debt.”

This is all the more unusual because it has never been more attractive for emerging economies such as these to borrow internationally. A glut of savings worldwide has driven interest rates and risk premiums – the extra interest paid on riskier bonds – to historic lows. Investors' hunger for higher returns has driven a flood of money into emerging markets in the past four years.

Certainly, the ability of many low-income countries to pay down debts would not have been possible without the commodities boom witnessed in recent years. Helped by rising demand from China and India, the price of oil and raw materials has risen sharply. Commodity exporters like Brazil and Nigeria have boosted their export earnings and no longer need to raise much cash from the capital markets. Inflows from other sources – such as the remittances that migrant workers send back home – have also risen usefully in many emerging markets.

As a result, developing countries that spent the 1990s with huge deficits have enjoyed a turnaround. As a group, they ran a current account deficit of \$89bn in 1998. But by 2005 this had moved into a surplus of \$248bn, according to the World Bank's latest Global Development Finance report. In 1992-97, the group ran a cumulative deficit of \$547bn.

"The tide has turned," says Stephany Griffith-Jones, an economist at the Institute of Development Studies at Sussex University who has tracked capital flows for almost 30 years. "It is quite an anomaly but developing countries are now the net exporters of capital."

The reluctance to accumulate foreign debt also appears tied to a change in attitude towards global capital markets, which just a decade ago were seen as the quick route to jump-starting economic growth.

But painful memories of past financial crises have not faded from the minds of government officials and policymakers. The financial turmoil resulting from crisis in Latin America in 1982, the so-called "tequila crisis" in 1994-95, the Asian contagion in 1997-98, the Brazil crisis in 1999 and Argentina upheaval of 2001 have steadily taught developing countries that a reliance on volatile world capital markets has serious consequences. When the world economy is strong and liquidity plentiful, bankers and bond investors alike have been happy to lend money to developing country governments. But when times have turned tough and when governments have really needed the money, the markets have denied them access to finance. As the American author Mark Twain is once said to have remarked: "A banker is a fellow who lends you his umbrella when the sun is shining and wants it back the minute it begins to rain."

Martin Redrado, president of the central bank of Argentina, says: "The financial crises taught [emerging market governments] that they cannot continuously finance the public sector deficit through the international capital markets. Self-insurance is the best way to deal with volatility and shocks in the international capital markets."

This distrust of global capital markets has led some governments to experiment with capital controls, or at the very least, efforts to dissuade foreign investors from flooding their markets with hot money. Facing a rapidly appreciating stock and bond market and a surging local currency, Thailand, for example, imposed capital controls in December, a move that caused the stock market to fall 15 per cent in a day before the military government was forced into partial retreat.

Liqun Jin, vice-president of the Asian Development Bank, says it was a pre-emptive action. "Thailand has experienced excessive capital flows for speculative purposes which has put a lot of pressure on the export sector and is disruptive to the economy."

Underlying the skittishness about foreign capital is the volatility it introduces into a nation's economy: capital inflows can cause currencies to appreciate and domestic inflation to rise, making exports uncompetitive. Worse still, when the tide turns and investors and bankers lose their appetite for riskier assets – money flows out. The results can be catastrophic, as central banks raise interest rates to protect their currency, which can cause waves of

bankruptcies and hurt domestic banks.



Such experiences have encouraged governments to strengthen their finances, helping to drive a four-year boom in emerging markets. Many governments have been consciously increasing their holdings of international reserves. Commodity exporters including Chile, Russia, Kazakhstan and Algeria – unlike during past booms – have used stabilisation funds to save substantial parts of the windfall.

Hung Tran, deputy director of the monetary and capital markets department at the IMF, says: “Many countries have made use of the strength of global growth and buoyant commodity markets to improve their fiscal stances and build up their foreign exchange reserves.

“Many have pursued active debt management operations to reduce foreign currency debt and replace that with local-currency debt, thus making them less vulnerable to external shocks than in the past.”

While shifting borrowing to local currencies is not a panacea, the move helps reduce vulnerabilities to foreign exchange rate risk. At the same time, governments have taken advantage of the appetite of investors for emerging market debt by issuing bonds of longer maturities, thereby reducing the stock of shorter-dated debt.

In addition, a widespread move from fixed to floating exchange rates has made many emerging market economies more resilient. Unlike in the past, an outflow of funds can now be accommodated by falling exchange rates.

Joyce Chang, head of emerging market research at JPMorgan, says these and other policy changes mean that “many emerging market countries find themselves in a much stronger position to weather a downturn in the cycle than at any time in the history of the asset class.”

Nevertheless, some observers say the cycle of boom and bust is inevitable. Boom times for emerging economies in the past have invariably ended in disaster. Moreover, few people expect cyclical factors that have been fuelling the appetite for emerging market assets – such as excess liquidity and strong commodities – to last indefinitely.

Some emerging market economies remain highly vulnerable. Not every government has taken advantage of the benign financial conditions in recent years to protect their economies to the same extent. David Beers, global head of sovereign ratings at Standard & Poor’s says: “The rising tide has not necessarily raised all boats. Some boats are leaking.”

He points out that aside from Russia, much of emerging Europe, including Turkey and Hungary, is suffering from large current account deficits. Latin America’s creditworthiness has generally improved but there are big differences between countries. “Brazil has been running primary budget surpluses and improving its debt structure, Venezuela has raised spending in line with higher oil revenues,” says Mr Beers.

Guillermo Calvo, professor of economics, international and public affairs at Columbia University, thinks there will be another serious slump in the developing world. He says that the risk premiums in Latin America are too low.

“There is no indication in the region that there has been a big push for major structural reform since 1998,” he says. “Everything seems to be going in the right direction for Latin America but much of the growth you see is due in large extent to much better external conditions. If you take away some of those better external conditions, such as favourable terms of trade, the growth rate in the region is actually very poor.”

If there is an abrupt slowdown in the world economy, emerging economies are still likely to be far more vulnerable than developed ones, say most experts. Economic slowdowns in the US and China – important destinations for emerging-market exports – number among the top concerns of emerging-market investors.

New categories of risk exist too. While emerging market governments are borrowing less, borrowing by emerging market companies is on the rise. According to JPMorgan, corporate debt issuance has risen from \$21bn in 2002 to \$111bn in 2006. While this shift to corporate borrowing is generally welcome, Mr Tran of the IMF says it needs to be monitored.

“For this new set of borrowers, it is important to understand the impact of the debt on their balance sheets to ensure that there are no undue stresses,” he says. “A fundamental currency mismatch in the corporate sector was at the root of the Asian financial crisis [that began in 1997].”

Meanwhile, in line with the growth of domestic bond markets, overseas investors have been pouring money into local currency assets in search of higher returns. A change in sentiment

or sharp currency moves could lead them to pull out their capital.

That could trigger a fall in local markets, particularly in the absence of a strong domestic institutional investor base. Some of the worst financial crises in the past followed defaults on domestic debt, such as in Russia.

Alejandro Werner, Mexico's undersecretary of finance and public credit, admits the last few years "have been exceptionally good for emerging markets".

He has no doubt that some emerging economies will suffer if global economic circumstances change. "But you have to separate what is a normal adjustment to a change in the business cycle from a complete disruption to the operations of the capital markets that you have seen in the past," he says. "Emerging economies are on much more solid economic ground now and that means there are no amplification mechanisms that turn a downturn in the business cycle into a full-blown crisis."

Ricardo Hausmann, director of Harvard University's Center for International Development and a former planning minister of Venezuela, says: "A systemic shock to the market looks less likely and the countries that used to be epicentres of crises – the Argentinas, the Brazils, the Mexicos – don't look particularly vulnerable." But he adds: "People are always looking at a repeat of the last crisis, the kind of imbalances that caused it. Maybe the next crisis could come from somewhere completely different and unexpected."

That message is reinforced by the ADB's Mr Jin: "Never rule out another financial disaster ... It is absolutely important for policymakers to keep the spectre of past financial crises in mind."

Argentina marks a self-reliance milestone

It is five years since Argentina devalued its currency and defaulted on its debt, bringing to a shattering end a decade during which the country had often been viewed as a poster child of International Monetary Fund-backed market reform.

By early 2002, with the economy sinking and the country wracked by political crisis, it was widely assumed that it would take many years for an isolated and impoverished Argentina to recover. But already, Argentina is prospering again. Néstor Kirchner, its popular centre-left leader, has presided over four successive years of expansion above 8 per cent and is expected to win a second term at elections due this year.

More remarkably, the president has achieved his objectives by turning his back on international creditors and the multilateral lending agencies that have policed the international financial markets for the past 60 years.

Mr Kirchner abruptly severed Argentina's relationship with the IMF by repaying the almost \$10bn (£5.1bn, €7.7bn) it owed at the beginning of last year. Speaking a few months later, Mr Kirchner raised a cheer as he bid goodbye to the Fund with a derisive "ciao".

Martin Redrado, the president of Argentina's central bank, says the country's relationship with international capital markets has been turned on its head. Once a net borrower, Argentina now pays more money back to creditors than it borrows in fresh loans or bond issues. The government's unswerving pursuit of a fiscal surplus, an improved external situation leading to a current account surplus and a much lower debt burden mean that Argentine paper is more highly valued by investors. "Argentina is well insulated from future shocks," says Mr Redrado, emphasising the protection allowed by the country's sizeable foreign exchange reserves.

All of this is in stark contrast to the free-wheeling 1990s. In the early part of the decade when Argentina stabilised its economy, it controlled the hyperinflation that had dogged development efforts throughout the 1980s by fixing the value of its currency to the dollar through a restrictive convertibility scheme (in which a dollar was held in reserve for every

peso in circulation) and selling state assets to foreign investors.

But the fixed exchange rate made foreign goods so cheap that Argentina's industrial infrastructure suffered and unemployment rose. When the privatisation programme ran out of steam, the government was forced to borrow increasing amounts on capital markets to compensate for lost income – exacerbated by tax evasion and corruption – building up a debt burden that ultimately became unrepayable.

Claudio Loser, the former IMF official who was in charge of the Fund's relationship with Argentina throughout the 1990s, admits mistakes were made. The Fund's initial scepticism of the convertibility regime soon receded, yet it failed to see the importance of developing an institutional framework to support the reforms, doing little to ensure that newly privatised companies were properly regulated. As the government's debt burden accumulated, the Fund failed to persuade the government to cut spending and, when it finally did win agreement for action, spending cuts slowed the economy and made a default more likely. It also withdrew its financial support from Argentina too late, thus aggravating the crisis when it finally came.

By the same token, Mr Loser insists that many policies introduced after the crisis, such as a floating exchange rate and a tighter fiscal policy, were in line with what the Fund would recommend.

Equally, although Mr Kirchner has derived many benefits from fiscal reform, much of his successes are due to a sharp shift in external circumstances. Buoyed by high commodity prices and booming demand from Asia for products such as soya, Argentina's exports have grown rapidly, rising from \$26bn in 2002 to \$47bn in 2006.

But Mr Kirchner's government was entirely responsible for the radical restructuring package of some \$100bn in sovereign debt forced on creditors at the beginning of 2005, dramatically reducing Argentina's spending on debt service payments. True, Argentina can no longer issue debt abroad without risking the seizure of its assets from funds that have launched legal challenges against the deal (owners of some \$20bn of debt have refused to accept the restructuring). But with markets awash with liquidity, international investors' appetite for risk means they are willing to buy debt paper issued locally.

On secondary markets, Argentine debt has been much in demand. The yields offered by Argentine bonds have fallen and spreads over US Treasuries are at all-time lows. Just a week ago Moody's, the rating agency, upgraded the outlook on Argentine sovereign debt from stable to positive.

The GDP warrants issued as a part of the restructuring deal were one of the hottest investments in emerging markets in 2006, almost tripling in value. Additionally, Venezuela's President Hugo Chávez has been more than happy to use part of his enormous oil windfall to buy Argentine debt paper.

"The fact that Argentina cannot access the international markets by issuing debt in a foreign jurisdiction is not crucial," says Nouriel Roubini, an economist at the Stern School of Business at New York University and a former adviser to the US Treasury.

For the moment, nothing is likely to shift this scenario. However if liquidity dries up on the international markets and risk aversion returns, Argentina would certainly become more vulnerable. That could be exacerbated by a fall in commodity prices, causing export revenues to fall and fiscal accounts to weaken.

Few expect another crisis on the scale of the last, but Argentina may yet come round to restoring its relations with the international capital markets – and possibly even with the IMF.

Additional reporting by Dino Mahtani

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