In Pursuit of Best Practice in Debt Management

Presentation on Debt, External Shocks and Financial Stability; Assessing the Correlation

Jason Kamweru
Debt Management Consultant

Why Countries Borrow

- Low levels of domestic savings and investment
- Not enough to finance government projects and programmes.
- Developing countries anxious to spur long-term growth and development in their economies seek to supplement their resources by borrowing externally.

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- This borrowing supplements the country's domestic resources and allows it to invest and consume beyond its domestic constraints
- External borrowing can spur economic activity and can lead to faster economic growth but only if these resources are judiciously used.
- Inappropriate or excessive borrowing can over time lead to significant payment difficulties causing a drag rather than a catalyst to economic growth.

- Integral to borrowing externally is ensuring that the investments the debt finances generate sufficient income to be able to repay debt service obligations without compromising other policy objectives.
- Where countries are unable to generate income to pay the debt, a debt crisis can arise through-

- Resources that could have been used to further productive activity are diverted to debt service payments thus compromising economic growth.
- At the same time, the country’s payments difficulties erode its creditworthiness prompting a loss of creditor confidence, making them reluctant to lend further.
- The combined loss of income and fall in financing often escalate to a major debt crisis in the country.

- The past few decades have been replete with external debt crises.
- Some of the debt problems were as a result of poor use of borrowed funds.
- In other cases, rapid debt accumulation occurred in the absence of prudent external debt management by borrowing countries and an inadequate policy framework to determine what level of debt the country could sustain.

- For some developing countries, external shocks in the form of rapidly rising interest rates, rising oil prices, declines in commodity prices, or natural disasters led to the growth in debt service payments far exceeding the growth in export earnings.
- Failures to take action in the face of these worsening terms of trade caused countries to face serious difficulties.

- The frequency and severity of external debt crisis has highlighted the need for countries to manage their external debt prudently.
- Debt managers must therefore have comprehensive, accurate and timely information to effectively manage their external debt portfolio. They must be able to know how much external debt they owe and to whom, and they must also be able to project their future debt service payments and evaluate the consequences of future borrowing..

- They must also be able to determine what type of debts they must contract and how to determine the structure of that debt to minimise costs and limit risks associated with external borrowing.

- Debt managers must be aware of the risks associated with borrowing in different currencies, different repayment periods (maturities) and in instruments with rates that can vary over time. They must also be aware of the government’s debt servicing capacity so they can ensure that they can withstand external shocks without plunging the country into a crisis

External Shocks

- Globalisation and economic integration of countries has brought paradigm shift in international relations, including economic relations.
- Countries making substantial gains from international trade and financial capital flows.
- On the one hand, countries have through international trade been able to benefit from specialization, enhanced productivity due to economies of scale in production of commodities, transfer of knowledge and new technology as well as a wide range of imported goods for local consumers.

External Shocks

official and private financial flows from industrialized countries have boosted developing countries' pace of economic development

On the flipside however, globalization has its demerits; countries, whether developed or developing have had to endure external economic shocks that are transmitted via international trade and capital flows.

An external shock can be defined as an unexpected, unpredictable event which results in drastic economic change. Changes can be either positive or negative.

External Shocks

To the economic policy maker an external shock can be regarded as exogenous.

Commodity price changes that have occurred from time to time, large capital inflows, large interest rate and exchange rate fluctuations as well as most natural disasters and wars can be classified as shocks.

Kenya, being a small open economy has had to endure debilitating external economic shocks.

External Shocks

In 1970s the country endured two types of severe external economic shocks; the sharp increases in global oil prices in 1973 and 1979/80 and the coffee boom of 1977.

Recent studies on Kenya such as World Bank (2011) have shown that in the last few years the country has had to endure external shocks, whose cause can largely be traced to escalating global food and oil prices and the economic upheavals brought about by the global financial crisis that originated from the western world in the middle of 2007

External Shocks

•Because of these shocks, Kenya has thus suffered macroeconomic instability, manifested by higher inflation, increase in the current account deficit, a weaker currency and a weakening of the stock market.

•The two oil shocks in 1973 and 1979 led to Kenya and other oil importing countries to accumulate large deficits. In response, the countries went ahead and borrowed heavily on commercial terms.

•Some economists argue that Kenya was on the verge of economic take-off but the oil crisis cost the country the opportunity

External Shocks

•For oil producing countries, Nigeria represents a good example of negative effects of economic shocks.

•Nigeria was not prepared for the boom that came with rising international oil prices. The country allowed its currency to appreciate, making imports cheaper and discouraging local production in industrial and agricultural sectors.

•Prior to the oil boom, Nigeria was a leading producer of palm oil and was self sufficient in rice production; a main staple in Nigeria

External Shocks

•With huge inflows into the current as a result of oil prices, it became cheaper to import goods than produce locally. Palm oil and rice production were abandoned.

•Local industries were unable to compete with imported products and many of them folded. The country also went on a spending spree.

•When the oil prices started cooling off, Nigeria was faced with huge deficits, leading to the country contracting expensive commercial debt. The seeds of Nigeria's debt crisis were planted during this period.

External Shocks

- In 1977, the prices of coffee in the international market rose as a result of frost in Brazil. Kenya, being a producer of coffee benefitted from the high prices.

- Ugandan coffee was also smuggled into Kenya.

- With the unexpected inflow of foreign exchange, the country went on a spending spree. The country's import bill rose.

- When the coffee prices cooled off, the country was faced with huge deficits which were plugged through external borrowing

Financial Stability

•Financial Stability is a state in which the financial system i.e the key financial markets and institutional financial system is resistant to economic shocks and is fit to smoothly fulfill its basic functions; the intermediation of financial funds, management of risk and the arrangement of payments.

•Need to understand and analyse financial stability first recognised during the international financial crises at the end of 90's.

Financial Stability

•Strengthened by the economic and financial crisis of 2007.

•Causes of financial instability range from; rapid liberalisation of the financial sector, inadequate economic policy, non-credible exchange rate mechanism, inefficient resource allocation, weal supervision, insufficient accounting and audit regulation to poor market discipline.

Financial Stability

•In the financial crises of the end of 90’s and in 2007, it was recognised that there was lack of enough financial data by countries.

•The IMF took a lead in encouraging countries to start reporting their financial data on a more regular basis

•The General Data Dissemination Standards (GDDS) and Special Data Dissemination Standards (SDDS) were improved.

•Currently, 97% of the countries report their financial data to IMF.

Financial Stability

•The two recent financial crises have demonstrated the need to have financial stability.

•The Asian Financial crisis led to an accumulation of debt by Asian countries. The countries had to implement painful economic reforms.

•The 2007 financial crises disrupted the global financial system. Interest rates rose making it more expensive for countries to access international capital

Capital Flows

•capital flows defined as the cross-border financial transactions recorded in economies' external financial accounts

•Inflows arise when external liabilities are incurred by the recipient economy (inflows with a positive sign) and external liabilities are reduced (inflows with a negative sign).

•Outflows are purchases of external assets from the viewpoint of the purchasing economy (outflows with a negative sign)

Capital Flows

- Net flows are the sum of gross inflows and outflows, where outflows are recorded with a negative sign.

Financial Flows and Development

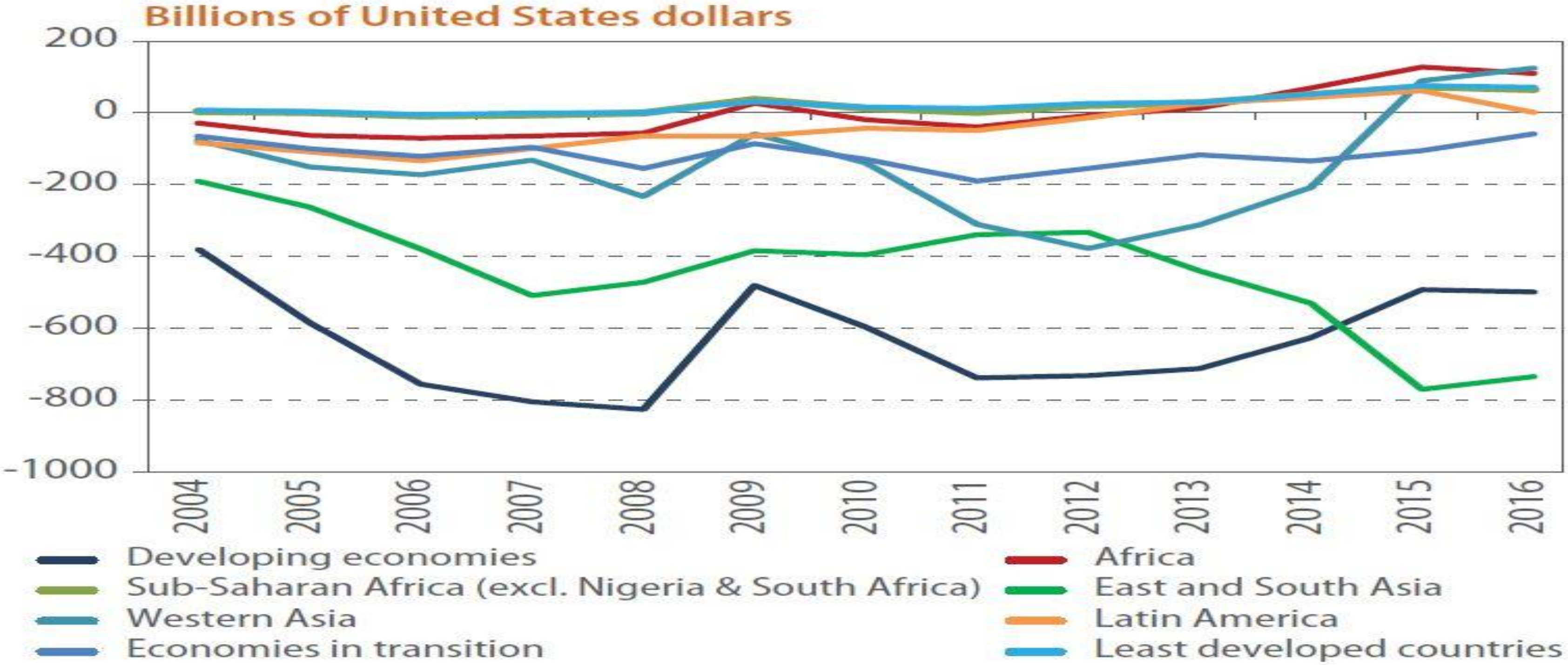
•Long term cross border financial flows can support investment that are a critical engine for productive employment and growth for sustainable development. (SDG8).

•There are three main types of financial flows that can support long term investments, namely; Foreign Direct Investments, Official Development Assistance (ODA) and remittances.

•Net transfer of resources from developing countries continues to be negative. In 2016, net transfers from developing countries were estimated to have reached about USD 500 Billion.

Financial Flows and Development

Figure 1
Net transfer of financial resources to developing countries and economies in transition, 2004-2016



Source: UN/DESA, based on International Monetary Fund (2016d) and World Bank (2016c).
Note: Data for 2016 are partially estimated.

- Negative transfers of financial flows impacted heavily on developing countries.

- To cope, developing countries resorted to using their reserves to support their currencies; a reversal of the pre 2015/16 where countries had built reserves on the back of huge financial flows.

- In many African countries, there was depreciation of local currencies.

- The first Eurobond in Kenya was issued during this period.

Foreign Direct Investment

•FDI is an important source of financial flows especially for developing countries.

•FDI flows into developing countries has been on the decline. In 2016, FDI fell to 209 Billion USD from USD 431 Billion in 2015.

•This decline was a reflection of the fragility of the world economy, persistent weal aggregate demand, sluggish growth in some commodity exporting countries and a slump in profits earned by multilateral enterprises

Foreign Direct Investment

•There are wide regional differences in distribution of FDI inflows

•East and South East Asia attracted more than 70% of global FDI flows in 2015.

•Nigeria and South Africa have dominated in terms of attracting FDI in sub-saharan Africa. For Nigeria, most of the FDI has gone into supporting oil infrastructure.

•There is concern that FDI flows to are on the decline especially to Least Developed Countries (LDC’s), Small Island Developing States (SIDs) and Land Locked Developing Countries (LLDC)

Foreign Direct Investment

- These accounted for a mere 8.4% of FDI's in 2015

•To encourage inflows of FDI into these countries, the following should be done;

-International community to provide insurance

-Investment guarantees or other kind of instruments to support and encourage greater productive investments in LDC's, SID's and LLDC's

-Kenya's share of FDI has historically been low due to restrictive investment climate. For many years it averaged less than 1% of GDP

Official Development Assistance (ODA)

- Public sources of external financing can contribute to finance sustainable development through provision of public goods, which are seldom met by profit motivated private investment.

- Public funds are used to finance investment in health, education and fund infrastructure investment.

- Many developing nations rely on ODA, other external public and private sources to compliment their efforts to provide these services.

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Official Development Assistance (ODA)

• LDC's are heavily dependent on ODA financing which represents 68% of external financing to LDC's in 2014.

•In line with international commitments, donor countries are expected to double or triple their efforts to promote a larger, stable and more effective allocation of ODA.

•To achieve these goals, there is need to;

-Improve aid flows by providing recipients with regular and timely information on planned support in the medium term (predictability)

Official Development Assistance (ODA)

-align aid supported activities with national priorities.

-Provide the most concessional resources to those with greatest needs and the least capacity to mobilise domestic and external resources.

ODA assistance continues to be an important source of financial flows for a number of LDC's

In the case of Kenya, ODA assistance has been historically low, contributing less than 5% of GDP. In the 90's the share of ODA assistance went to an all time low of 2.4% as a result of donor aid freeze.

Remittances Flows

In 2014, developing countries received USD 432 Billion in remittances flows. The actual figure could be significantly higher if transfers through informal and other channels are considered.

Remittances represent a growing and stable source of financial flows for developing countries, outstripping by almost a factor of 3 the ODA flows.

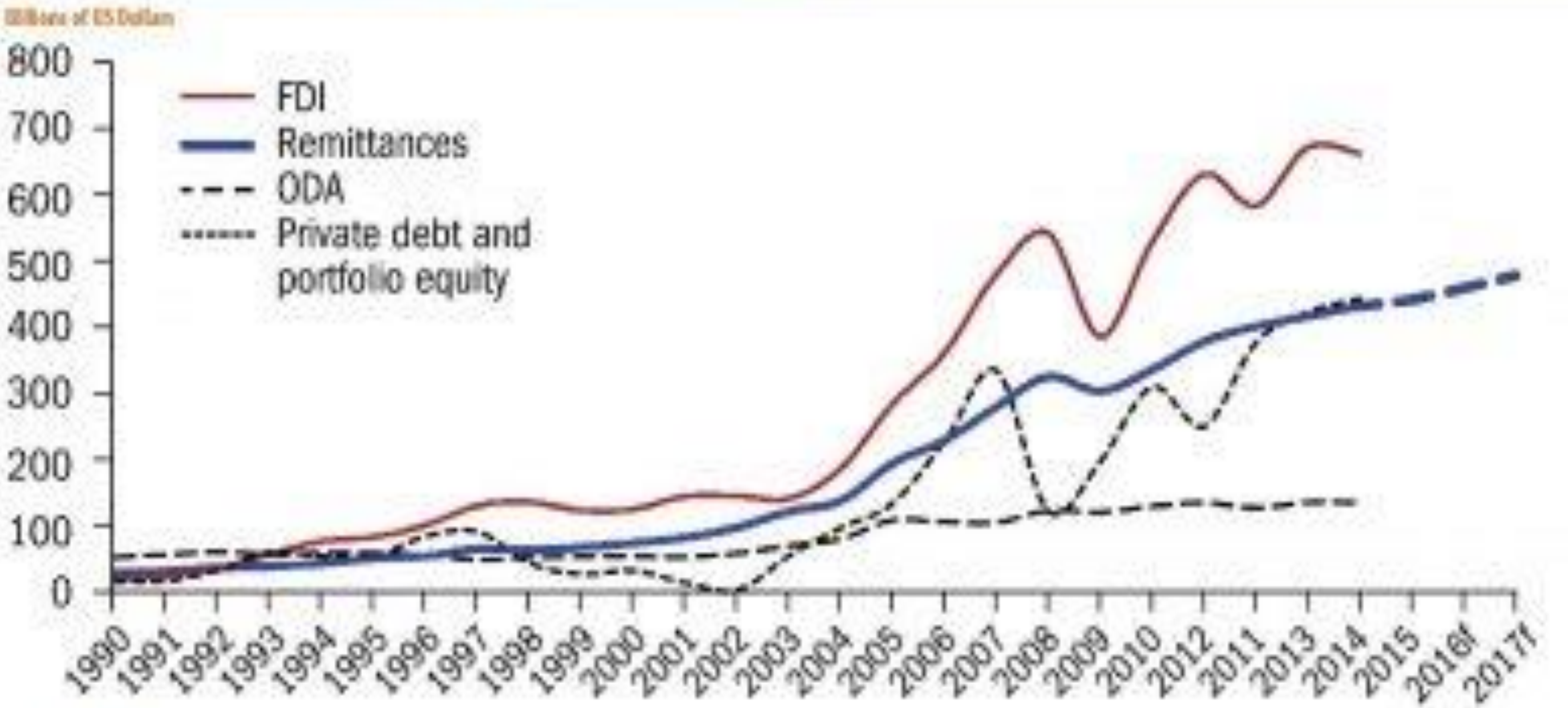
Remittances provide increased liquidity and foreign exchange to recipient countries, facilitating imports of goods and services.

These flows constitute more than 10% of national income in many countries.

Remittances Flows

Figure 2

Remittances to developing countries and other external financing flows



Source: World Bank (Migration and Remittances Factbook 2016, third edition).

Note: Data for 2015 are partly estimated. Data for 2016 and 2017 are forecasts.

•Remittances to developing countries have grown steadily and have proved to be more stable than other external flows.

•They have helped to counterbalance the volatility of other capital flows to developing countries.

•Policy measures needed to enhance the flow of remittances could include;

-providing wider access to credit

-reducing transaction costs.

- Improving formal status of migrant workers

Remittances are susceptible to global economic shocks.

In Africa, the economic crisis of 2007/09 affected the economic growth of a number of countries. Morocco lost nearly 2% GDP growth rate due to decline in remittances.

Compared to other African countries, remittances in Kenya were low, averaging less than 1%. However from 2000 the country has witnessed a rise in remittances to average about 3.4% share of GDP

Trend in Capital Inflows as a share of GDP, 1970-2013

Year	Net ODA	Remittances	Net FDI	Year	Net ODA	Remittances	Net FDI
1970	3.6	0.5	0.9	1994	9.5	1.9	0.1
1971	3.8	0.4	0.4	1995	8.1	3.3	0.5
1972	3.4	0.7	0.3	1996	4.9	2.4	0.9
1973	3.8	0.5	0.7	1997	3.4	2.7	0.5
1974	3.9	0.6	0.8	1998	2.9	2.5	0.2
1975	3.8	0.4	0.5	1999	2.4	3.3	0.4
1976	4.4	0.3	1.3	2000	4.0	4.2	0.9
1977	3.6	0.4	1.3	2001	3.6	4.2	0.0
1978	4.6	0.5	0.6	2002	3.0	3.3	0.2
1979	5.6	0.3	1.3	2003	3.5	3.6	0.5
1980	5.4	0.4	1.1	2004	4.1	3.9	0.3
1981	6.5	1.1	0.2	2005	4.1	2.3	0.1
1982	7.5	1.1	0.2	2006	3.7	2.2	0.2
1983	6.6	1.0	0.4	2007	4.2	2.0	2.3
1984	6.6	0.9	0.2	2008	3.8	1.9	0.3
1985	7.0	1.1	0.5	2009	4.8	1.7	0.3
1986	6.1	0.7	0.5	2010	4.1	1.7	0.4
1987	7.0	0.8	0.5	2011	5.9	2.2	0.8
1988	10.0	0.9	0.0	2012	5.3	2.4	0.5
1989	12.8	1.1	0.8	2013	5.9	2.3	0.9
1990	13.8	1.6	0.7	2014			
1991	11.2	1.5	0.2				
1992	10.8	1.4	0.1				
1993	15.9	2.1	2.5				

Debt is sensitive to shocks and an unstable financial system.

Economic shocks disrupt the stability of the financial system

On one hand, interest rates may rise, making it expensive for countries to borrow.

On the other hand, a dip in interest rates encourages countries to borrow heavily, mostly on variable terms. In most cases, the dip in interest rates is short lived and compensated by a subsequent spike in the rates.

A number of African countries have borrowed from the bond market, attracted by low interest rates. The rates are on an upward swing which will be expensive for the borrowing countries.

Many countries result to borrowing when faced with economic shocks. This leads to rise in stock of debt which can result in unsustainable debt.