

**Collateral Damage from the Global Financial Crisis Could Land
Developing Countries in another round Debt Crises**

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When the financial system imploded in the United States by the subprime mortgage crisis, some people still hoped that the “decoupling” theory could be vindicated and that developing countries having weak financial linkages with the rest of the world could be insulated. Now with GDP growth estimates of Africa, Asia and Latin America being revised lower and lower and the stimulus packages in the developed world getting bigger and bigger, it is evident that the current financial crisis has some distinctly different features from all other major crises, in particular those that have hit the developing world in recent decades. Not only because the epicenter of the crisis is in the world’s largest economy and the complexity and the magnitude of the crisis is unprecedented, but also because its trajectory is from the centre of the international financial system to the periphery.

The manner in which the crisis is unfolding it seems that no country will escape the impact of the deepening and widening crisis. A U-shaped crisis recovery seems to be one possibility, with the bottom of the U likely to be deep and protracted. However, many have speculated that the crisis recovery could be more of an L-shaped one. The drying up of liquidity and the negative impact arising from other transmission channels carry the grave risk of reversing the hard-won economic improvements made in the developing countries during the past decade, including the general improvements of the debt situation of the developing countries. A rather worrying trend is that there is great likelihood that the countries at the periphery may suffer disproportionately greater in intensity and duration of time than the countries at the centre. The financial crisis has fundamentally undermined the main underpinning factors leading to the recent improvements of debt situation of the developing countries. Worse still, it has resulted in multiple exogenous shocks such as terms of trade reversal, decline in export demand, reduction in remittances, and a possible cut in ODA or delayed commitments of ODA, to name a few. For many low-income debtor countries, one external shock could leave them in shambles. Mitigating the impact of multiple shocks will be an unprecedented challenge for many of them, thus there is a great possibility that a new wave of debt crises may arise if necessary support from the international community is not forthcoming.

This paper examines the reversal of two important and favorable conditions which had

¹ The views expressed are solely those of the author and do not necessarily reflect the views of UNCTAD or its Member States. The author is grateful to Kristine Forslund, Matthias Rau, Makameh Bahrami and Ugo Panizza for very helpful comments and statistical assistance.

reduced the debt burdens of developing countries before the onset of the financial crisis, i.e. the broad-based fast economic expansion and debt relief. It further examines how external and domestic liquidity have been negatively affected. The final section provides some policy recommendations for moving forward.

1. Introduction

One risk which has not yet attracted sufficient attention in international circles is the looming debt crisis in some low-income countries. The improved external debt situation in the developing world in recent years has led to various degrees of complacency on the sides of the creditor and debtor countries. However, debt sustainability is a dynamic concept rather than a static one. The current financial crisis has already significantly undermined the factors underpinning the improvements in external debt. In addition, there is a tendency to forget that domestic debt and external debt can be fungible and can impact each other. Therefore, domestic public debt should be considered as an important part of the debt sustainability equation. Recent years have witnessed the increasing prominence of domestic debt in many low-income countries. With the unfolding of the financial crisis, its primary and secondary effects are affecting negatively the availability of financial resources to service the public debt. Some low-income countries are facing significant domestic debt arrears and widening financial gaps to service their debt. What the international community does not want to see is a scenario of an economic recovery in the developed world followed by another wave of debt crises in the developing and transition economies, in particular the low-income countries.

The spillover of the global financial and economic crisis to developing countries and its effect on their debt sustainability vary according to the degree of their openness to the international capital markets and their stage of development. Developing countries with large exposure to international banks, bond and equity markets, namely the market access countries, were the first to feel the pain and some are facing acute challenges to roll over their external debt. These countries are facing a four- edged sword, i.e. plunging asset prices, higher cost of borrowing, a massive capital flight and a decrease in exports. Some major emerging economies endured losses. Some countries have greater absorbing power with respect to past crises owing to their foreign exchange reserves and stronger fiscal position. However, emerging countries with less fire power are being hit hard and some of them had to resort to IMF crisis loans. Pakistan, Georgia, Ukraine, Latvia, El Salvador and Belarus and Seychelles were among the first to face unsustainable debt situations mainly caused by the volatile and weakening externalities. More Central and Eastern European countries are facing both liquidity and solvency challenges. The question as to how to deal with a debt crisis in these countries is now a subject of considerable debate. As the end of the tunnel for the financial crisis is not yet in sight, it seems that the list of countries to suffer from liquidity crisis and

sovereign default could continue to grow².

Countries with weak financial linkages with the international capital market are mainly suffering from the secondary effects of the crisis given rise by the global economic contraction. Some of them are enduring both the primary and secondary effects of the financial crisis and, therefore, greater challenges to maintain macroeconomic stability and debt sustainability. This is especially true as most low-income countries have little policy space with respect to both fiscal and monetary policies.

2. From broad-based economic expansion to economic contraction

Before the financial crisis, the cross country average of the external debt situation of developing and transition economies showed a net improvement, though it was far from a permanent exit from the debt trap. One important underpinning factor that induced the decrease in debt servicing burden was the unprecedented broad-based global economic expansion during the past decade or so³. GDP growth was higher and steadier in many countries. In Africa, GDP growth rates ranged from 5.9 per cent to 8.1 per cent for about 65 per cent of Africa's population during 1997-2007.⁴

Solid economic growth around the world, commodity price hikes, low interest rates and better macroeconomic policies spurred faster economic growth in developing countries. Unfortunately, the US subprime mortgage crisis very quickly reversed this positive trend and has spiraled into a global economic crisis. World growth is projected to fall from 5.2 per cent in 2007 to ½ a per cent or even negative growth in 2009, making the lowest rate since World War II. Both the IMF and World Bank have drastically scaled back their forecasts for African economic growth in 2009 — with the IMF estimating growth of 3.25% and the World Bank forecasting growth of 3.5%. These forecasts are half of the rates that were expected six months ago. Both institutions have warned that growth rates could be subject to further downward revisions. The growth outlook for SSA is estimated to be about 3.5 % for 2009, down from 5.4% in 2008 and 6.9 % in 2007. Lower GDP growth means lower government revenues, less fiscal space, less finance for poverty reduction, and less money to service debt.

One main transmission channel of the global financial and economic crisis affecting developing countries has been a decrease in exports through worsening terms of trade owing to reduced global demand for exports. International trade is a main driver of GDP growth and export revenue is an important means for developing countries to earn foreign exchange to

² Sunil Kewalramani, Will 2009 be the year of sovereign defaults? Business Standard, January 24, 2009, New Delhi.

³ "External debt and development: towards a durable solution to the debt problems of developing countries", United Nations Report of the Secretary General to the General Assembly, A/63/181, 28 July 2009. website:

http://www.un.org/ga/search/view_doc.asp?symbol=A%2F63%2F181&Submit=Search&Lang=E

⁴ World Bank News Release No:2009/219/AFR, Call for Action to Mitigate Effects of the Financial Crisis on Africa., 5 Feb. 2009

pay their external debt. A sharp decline in export revenues will lead to current account difficulties and financing gaps. As a matter of fact, signs of deterioration in the external situation of developing countries began to surface during 2007. Two thirds of developing countries suffered a deterioration of their current account balance, 50 per cent of developing countries closed the year with a current account deficit greater than 5 per cent of GNP, and about a quarter of developing countries ran current account deficits greater than 10 per cent of GNP. The financial crisis will certainly worsen the situation, adding to the difficulty of debt servicing.

According to a recent debt sustainability analysis of post completion-point HIPC countries conducted by the IMF, these countries are most susceptible to shocks affecting their exports. This is mainly due to having a low export base, concentrated in a few commodities and great reliance on export revenue for debt servicing and government expenditure. Exports amount to approximately a third of Sub-Saharan GDP. On average, Africa has benefited from improved terms of trade over the past few years. Oil and mineral exporters in particular have benefited greatly from booming prices. The global slowdown is particularly pronounced in countries dependent on commodity exports. Oil prices fell from their peak of US\$147 per barrel in June 2008 to a recent low of US\$40.50 a barrel. The price of copper fell from about US\$ 4.10 per pound to under US\$1.40 per pound, and cobalt fell from US\$53 per pound to about US\$13. For oil and mineral importing countries, this is good news as the import bill will be cut down. However, for oil and mineral exporting countries, the sharp decline of prices has had a ripple effect on external reserves, a depreciating currency, declining capital inflows, shrinking export markets and declining export-import trade financing. Zambia, for example, enjoyed an increase of prices of copper for some years. In the third quarter of 2008, total copper export earnings dropped 32.6% to US\$758 million,⁵ compared with US\$1.2 billion the previous year. Botswana's economy remains over-reliant on minerals —especially diamonds— which account for about half of government revenues, one-third of GDP and more than 70% of export revenues. Diamond revenues are expected to decline by half this year, with prices estimated to slump by 15% and production to decline by 35%. Because of higher commodity prices before the crisis, some of the exporting countries had already initiated major operations to increase supply, with the economic downturn and the resultant contraction in demand, there have been closures of mining operations, the suspension or cancellation of projects in sectors hardest-hit. Both the labor market and the government fiscal position have been negatively affected by such responses. As for countries which do not have a heavy reliance on oil and mineral exports, the terms of trade shock is not as big, but the contraction of exports is also apparent. Therefore, they may also face balance of payment problems as the crisis deepens.

Similar to trade in goods and commodities, tourism is a major foreign exchange earner and contributor to economic growth for some countries. However, the knock-on effect of the crisis on tourism has been profound. According to the World Tourism Organization, the

⁵ Source of information: Bloomberg

second half of 2008 saw growth come to a standstill with the number of international arrivals declining slightly – a trend which is expected to continue in 2009.⁶

Not only did the sharp drop in commodity prices worsen the export performance of developing countries, but protectionism has also had a negative impact. The US was the first to move towards this direction with its newly passed US\$787 billion stimulus bill. The bill contains ‘Buy American’ provisions that were signed into law on 17 Feb 2009 by the US President. The ‘Buy American’ provision requires the purchase of iron, steel and manufactured products from American enterprises. Though this has sparked sharp criticism and threats of legal challenges from US trading partners, some European countries followed suit, taking the principle “if you can't beat them, join them”. Many developing countries can neither beat them nor join them because they lack the large quantities of funds needed to play the stimulus game.

The credit crunch has not spared trade financing (trade credit and insurance/guarantees) which is the life blood to international trade. Its scarcity and higher cost is bound to intensify the contraction of world trade. The Asian financial crisis in 1997 has shown that low-income countries are prime victims in the general reassessment of risks and liquidity shortages that characterize periods of financial crisis (Auboin and Meier-Ewert 2008)⁷. As the financial crisis unfolds, it is increasingly more costly for developing-country exporters to borrow from international financial markets or to apply for export credits and/or export insurance. “Spreads on short-term trade credit facilities soared to 300 - 600 basis points above LIBOR, compared to 10 to 20 basis points in normal times”, according to Auboin and Meier-Ewert.

During times of faster economic growth, governments of many low-income countries stepped in to provide guarantees or resort to domestic borrowing for large projects like infrastructure and capacity expansion of large enterprises. Assumption of contingent liabilities in the form of guarantees by sovereigns helps to leverage private sector participation in areas of national priorities, thus re-invigorating economic development. However, this may also lead to vulnerabilities in times of crisis. Many developing countries do not have good data on their exposure to such vulnerabilities. As the recession worsens and becomes protracted, more firms and banks in the developing countries could encounter difficulties. Developing countries are at a disadvantage because they do not have the same amount of public funds to bail out their troubled companies or financial institutions like what has been done in the developed world. This may make their enterprises less competitive in the global market and increase the likelihood of facing financial difficulties. The build-up of contingency liabilities owing to government guarantees for large projects during the period of easy and abundant liquidity and the “too-important-to-fail” enterprises which are facing problems because of the

⁶ International Tourism Challenged by Deteriorating World Economy, 27 January 2009, World Tourism Organization, http://www.unwto.org/media/news/en/press_det.php?id=3481&idioma=E

⁷ Auboin, Marc and Moritz Meier-Ewert (2008). “[Improving the Availability of Trade Finance during Financial Crises.](#)” WTO

financial crisis would further erode the fiscal position of the government and increasing the debt burden.

3. International debt relief has peaked but many HIPCs remain under debt distress

The debt relief initiatives, both the HIPC initiative and the Multilateral Debt Relief Initiative (MDRI) have contributed to the improvement of HIPC debt ratios— though an important part of the Initiatives simply wrote off arrears that were subsequently counted as ODA. However, debt relief may have peaked and debt write-offs under the HIPC Initiative are set to decline since 24 out of 34 decision-point HIPCs have reached the completion point.

While debt relief provided under the two initiatives improved the debt ratios of the completion point countries, the 2008 HIPC and MDRI Status of Implementation Report⁸ indicates that maintaining debt sustainability beyond the completion point remains a concern. A significant number of Completion Point countries will continue to remain in a moderate or high risk of debt distress. Only 9 out of 24 completion point countries have a low risk of debt distress according to the most recent debt sustainability analysis (DSAs). While the number of countries with a high risk rating increased from one to four since 2007. On the whole, post-completion-point countries' debt sustainability remains vulnerable to shocks, particularly those affecting exports, and is highly sensitive to the terms of new financing.

Such a discouraging picture of debt sustainability for the post completion point countries highlights the high vulnerability of these countries to external shocks. Unfortunately, the current financial crisis is actually presenting a dangerous cocktail of multiple external shocks with unprecedented intensity, making the slippage back to unsustainable debt by some countries as a certainty rather than possibility.

4. A severe drought of international financial resources to meet debt servicing needs

Currently, liquidity is flowing in one direction, namely to the most developed countries from emerging markets and low-income countries alike. Therefore, both emerging and frontier markets are providing liquidity to portfolios managed in the major markets to cover their mounting losses and margin calls. However, the accelerating growth of money supply has made little impact on the credit crunch and there is no picking up of bank lending because of the persistent risk aversion and the insistent tendency of flight to quality.

Readily available and low-cost capital played a crucial role in spurring growth around the world. Easy money was also behind the growth in Africa in the past decade. But with this, developing countries have also been increasingly exposed to liquidity shocks. Now the

⁸ Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation, Prepared by the Staffs of IDA and IMF, September 2008, Washington.

absence of easy liquidity for all but the safest borrowers has been causing pain everywhere.

a) Developing countries are being crowded out from the capital markets

Currently, financial flows that fueled growth in low-income countries are drying up. This constitutes an extremely serious constraint for these countries as this is the time when external inflows are needed most to stimulate economic growth and to roll over debt. Virtually all major developed economies have initiated large fiscal stimulus packages to counter a recession. The packages have been revised upwards amounting to around US\$ 3 trillion (2 trillion by the US and 1 trillion by other developed countries) by high-rated industrialised countries. Such kinds of interventions in debt markets have been unprecedented. At this year's Global Economic Forum in Davos, many economists and officials asked how the stimulus packages would be paid. The answer to this could be simple: first crowd out other investors in the market and second print money as if it has the status of one of the international reserve currencies.

The crowding out effect is already apparent. A number of developing and low-income countries which announced their intentions to float bonds, such as Senegal, Tanzania, and Ghana, have already been forced to shelve their plans knowing that the pool of capital in the world is limited and they cannot compete with countries with better ratings. The US\$2.5 billion hybrid rights issue and public offer by Ecobank Transnational Incorporated (ETI) can also showcase how developing countries have been squeezed out of the international capital market. Ecobank simultaneously launched the issuance in the three West African stock markets, namely the Ghana Stock Exchange, the Nigerian Stock Exchange, and the Bourse des Valeurs Mobilières Régionales (BVRM) in the West African Economic and Monetary Union (UEMOA) countries in August 2008. It was the biggest cross-border share issuance on the continent. The original expectation was that the offer could be oversubscribed. But the global credit crunch and collapse in stock markets dampened investors' interest. The offer was extended by four weeks to 31 October 2008. Even so, the share issue fell far short of the target of US\$2.5 billion, raising only US\$566 million. One feature worth noting is that the subscribers are largely African rather than international investors.

The crisis of confidence in the international financial system has given way to a withdrawal of funds from almost all corners of the developing world. Ironically, the re-pricing of risks by investors led to a torrential flow of capital back to the epicenter of the crisis from the periphery. A flight to safety and liquidity –which essentially means a flight to US treasuries– has become the dominant strategy of investors all around the world. Foreign banks and enterprises in the developing world are repatriating their capital and profits back to their headquarters making it increasingly difficult for even well managed emerging markets to access external financing. This means many of the emerging and developing countries are now having very limited if no access to international credit markets if at all, thus creating a greater risk of reentering a vicious circle of mounting external debt that becomes unsustainable.

“Financial mercantilism” in some countries is further intensifying this trend of a large scale retreat from international business and concentrating on domestic markets in the developed world. Some governments of developed countries have encouraged their banks to invest mostly in domestic assets, and repatriate capital back from abroad to their headquarters to assist troubled parent banks and financial institutions. This is a new form of protectionism which is centered on credit availability rather than trade. It has also sped up the drying up of liquidity in developing markets.

In addition to a scarcity of funds, the cost of borrowing has increased and could be even higher in the future. If developing countries’ bond issuers insist on raising funds through capital markets, paying higher interest rates is the only way for developing country bond issuers to compete with the most advanced countries. Emerging market spreads increased from less than 200 at the beginning of 2007 to 653 basis points on 25 February 2009. This is equivalent to sowing the seeds for unsustainable debt servicing down the road. However, for the moment, the general drying up of liquidity itself, rather than the cost, is the most important factor for the reduced access to finance for developing countries, which might induce considerable roll-over risks of short-term and maturing debt.

b) Outflows of foreign capital from domestic capital markets in developing countries

The improved debt ratios of developing countries in the past few years are partly due to the change in the structure and composition of their debt. Domestic bond markets have gained importance in many developing and emerging market countries. Recent years have witnessed the increasing prominence of domestic debt in many low-income countries. Non-resident purchases of domestic public and private debt were substantial for some years. This has raised the risk that a sudden shift in investor sentiment could lead to instability in the domestic financial market. Indeed, with the onset of the financial crisis, institutional and other foreign private investors who used to invest in domestic instruments in the developing countries started to convert the public debt instruments from local currencies to dollars in major international financial centers. They have done the same with private debt. For instance, in the London market, foreign investors in Uganda have converted a significant amount of public and private instruments denominated in Uganda shillings.⁹

As the economies of many developing countries are small in size, such kind of capital flight would contribute to depreciationary pressure on their currencies putting these countries in a tight spot. On the one hand, currency depreciation would increase the burden of debt servicing. On the other hand, with the sharp decline of global demand, depreciation will not lead to an increase of export earnings. For example, low-income countries do not have the capacity to defend their currencies as they do not have sufficiently high foreign exchange

⁹ Monthly Economic review, Bank of Uganda, Feb. 2009

reserves in the first place.

In their effort to protect their investments in times of crisis, it seems the foreign investors—who once entered domestic capital markets in developing countries in search of higher yields— may be increasing the risk of triggering sovereign debt crises in the same countries as they withdraw their capital to seek safety in developed markets. The withdrawal of foreign investors can weaken the confidence in local currencies and prompt an increase of demand for foreign currencies from domestic investors and the general public. These dynamics would lead to downward pressure on the local currencies and intensify capital flight.

Consider the experience of Nigeria. Starting with the fall out of Lehman Brothers, foreign investors began to pull out from Nigeria's capital markets in mass. The stampede led to a crash of stock prices. The Nigerian Stock Exchange index fell from a high of more than 66,600 in March 2008 to about 23,000 in February 2009, leaving some Nigerian banks heavily exposed through excessive margin lending and raising uncertainties about their capital adequacy. The decision by Nigeria in February 2009 to re-impose foreign exchange restrictions in an effort to stem the decline of the naira and the outflow of capital shows the significance of the worrying trend of the withdrawal of foreign investors from developing markets.

c) A decline in remittances

Remittances are a mainstay for many developing economies, providing an important source of valuable hard currency that is used to finance current account deficits and debt payments, not to mention meeting consumption demands of poor households. According to the World Bank estimates, migrants sent some US\$283 billion back home to developing countries in 2008, a figure much larger than the total ODA flows for the same year. A drop in remittances is another main channel of transmission for the financial crisis. Recent data shows that, for the first time in almost a decade, the flow of global remittances to developing countries has significantly slowed in the face of the financial crisis and ensuing economic downturn.. The impact on recipient countries will be felt more acutely in 2009.

The importance of remittances varies considerably across the continent. For Africa, though it depends less on remittances than Latin America or Asia, remittances have increased steadily in past years. African Diasporas send back some US\$15 billion per annum, amounting to the equivalent amount as FDI. Examples of countries with a high dependency on remittances (measured in per cent of export earnings) are Lesotho (60%), Uganda (40%),

Senegal Guinea-Bissau, Togo, Benin, Burkina Faso (15-25%).¹⁰ East Africa as a whole has benefited from significant Diaspora remittances from overseas. As a flow it appears to be less volatile. However it is bound to be seriously affected if there is a drastic worsening in the labor markets of the migrants' recipient countries.

d) A possible reduction in ODA flows

While some developed economies are debating best ways to spend their billion dollar stimulus packages, most low-income countries do not have the financial ammunition to stimulate their economies. For aid dependent countries and countries which suffer from current account and fiscal pressure, ODA can function as an economic stimulus to their economies. Therefore, at times of global economic downturn, ODA is of greater importance to poor countries. The negative impact of a slow down of ODA flows to aid-dependent countries will be severe as an important part of the government expenditures are financed by ODA. Some governments even use ODA to sustain debt service. A decline of ODA would mean that these governments may have to cut certain social expenditures which will further increase the misery of the poor population. To some degree scaled up ODA could serve to somewhat cushion the impact of any reversal in private capital flows, reduction of export revenue and remittances thereby reducing the likelihood of a sharp decline in spending on social sectors that would otherwise have dire consequences for poverty reduction.

As other sources of financing are plummeting, ODA as a source of development finance is more important than ever. Unfortunately, ODA, much like capital flows, tends to be pro-cyclical. When the financial crisis is starting to affect the real economy on the home front, it requires vision and courage for donor governments to send taxpayer's money abroad to assist poor countries. Even though ODA occupies a small percentage of the GDP of donor countries, very few of which have reached the UN target of 0.7% of GNI, budgetary pressures resulting from stimulus packages could also lead to a reduction of the volume of aid.

At the International Review Conference on Financing for Development in Doha in December 2008, donors reaffirmed their aid targets in an 'aid compact' and pledged that the financial crisis would not lead to aid cuts. However, it seems as though some donors are moving in the opposite direction. A number of countries have already indicated their intention to reduce ODA in 2009. The Irish government revised its budget for 2009 and slashed its ODA by 95 million euros, more than 10 per cent of the amount originally budgeted. Italy

¹⁰ Holmqvist, Göran., How is Africa affected by the financial crisis –and by global recession?, 10 October 2008, The Nordic Africa Institute.

had a deeper cut amounting to 56 per cent, while Latvia announced that it a cut in aid by 100 per cent.

Some donor countries link their ODA budget to their GDP, consequently a slow down in economic growth in these countries would automatically result in a decline in the quantity of ODA for the developing world. Therefore, a scaling up of ODA would come under pressure as a result of a downturn in economic growth and as well as a result of developed market governments becoming more inwardly focused on domestic budgetary priorities, some donors are taking their time in making firm commitments to recipient countries. For ODA dependent countries, whose government expenditure relies heavily on ODA, they will face the difficulty of formulating budgets without knowing for certain the forthcoming amount of ODA for 2009.

All these above-mentioned factors combined have led to the most dramatic and sharp decline of capital flows to developing countries. According to International Institute of Finance, net private capital flows to emerging markets are forecast to slow substantially to US\$165 billion in 2009, after an estimated US\$466 billion in 2008. The most significant weakness is for net bank lending which had a net outflow from the emerging markets of about US\$61 billion at the beginning of 2009, after a net inflow last year of \$167 billion and a record of US\$410 billion in 2007. Private flows to Latin American in 2009 will be halved.

5. Conclusions and recommendations

Even though most developing countries have undertaken reform and pursued sound macroeconomic policies, the current financial crisis—which is not of their making—is disproportionately penalizing the developing countries. Liquidity is leaving their markets and flowing back to the epicentre of the crisis which has opened a floodgate of bond issuing to finance gigantic stimulus packages. Developing countries are facing a sharp decline in both domestic and international liquidity coupled with other aftershocks of the financial crisis, thus weakening their debt servicing capabilities.

The market access countries are the first to feel the primary effects of the financial crisis. With globalization and the resultant increase in economic integration in the world economy, many developing countries are facing the challenges of both the primary and secondary effects of the crisis—even though it take time for the secondary effects to play out their impact on the real economy. The ensuing crisis of confidence has not only dried up liquidity but also reduced financial inflows and export revenue, threatening the fiscal balance and macroeconomic stability of the developing countries. Some of them have been facing a liquidity challenge since the beginning of the financial crisis, which has evolved to solvency problem for a number of them.

For low-income countries with weak financial linkages with the developed market, the

multiple external shocks have started to reveal gaps between revenues and spending, outflow of capital has put depreciatory pressure on their currencies that has contributed to a decline in foreign exchange reserves. Lower export earnings and inability to impose countercyclical taxation measures will widen their gap of foreign exchange needs. All these developments do not augur well for their ability to sustain external debt, even for the post-completion point HIPC and MDRI countries. Though many HIPCs have reached completion points, there is no room for complacency as some of them are remain under debt distress.

The complexity and the possible protraction of the financial crisis will add burden to the already existing debt distress. Challenges to rollover either domestic debt or external debt could trigger a debt crisis. After successive rounds of debt relief, domestic debt is paradoxically ballooning for some low-income countries. For some countries, domestic public debt is like a ticking time bomb as arrears have been accruing and financial resources to service the debt have been sharply declining with the deepening of the financial crisis. The collateral damage of the crisis carries the risk of reversing the hard won achievements made on improving the debt situation of the developing countries and trigger a debt crisis for some vulnerable countries.

Policy recommendations:

- In order to brace for the crisis and avoid sinking back into a debt trap, debtor governments should prioritise spending and adopt a more cautious attitude towards non-concessionary borrowing as well as domestic borrowing.
- Debt management will be more important than ever as the current financial crisis will make debt sustainability a great challenge. It is imperative to promote capacity-building in debt management, including the capability to provide timely and correct debt data is essential for crisis prevention.
- Economic diversification may be difficult to pursue during crisis, but it is nevertheless necessary to keep in mind the need for such a drive to reduce economic vulnerabilities.
- Temporary imposition of foreign exchange restrictions might not be the best way to assure investors and may turn out not as effective because of various leakages. Nevertheless, they may still be necessary if the outflow of capital is proved to be sudden and large. Such restrictions could be designed specifically to help stabilise the depreciating currency.
- Governments which have the capacity to do so should try to stimulate economic growth that is conducive to increases in job opportunities and incomes.
- Special balance of payments support to HIPC countries and low-income and other developing countries in debt distress should be provided in a timely manner, bearing in mind some special arrangements and facilities from the IMF and the World Bank (The

Exogenous Shocks Facility (ESF) of IMF and financial crisis facility of the World Bank).

- Because of severe external shocks on developing countries caused by the crisis, MDRI and the HIPC initiative might be inadequate for the HIPCs. A more flexible and speedy approach is needed for countries facing debt servicing difficulties. Current global crisis management measures need to take a multi-pronged approach to tackling the challenges of developing countries while taking into consideration the challenges posed toward maintaining debt sustainability of developing countries. Substantial general allocation of Special Drawing Rights (SDRs) could be issued and certain portion should be earmarked for relief to the HIPCs and other low-income countries.
- A further shift of ODA from loans to grants should be encouraged. Bold international measures should be taken to reduce or even break the procyclicality of ODA. At this time of crisis it is crucial for donors to keep their commitments made under the 2002 Monterrey Consensus, the 2005 Gleneagles Communiqué, the importance of which was reaffirmed by 2008 Doha Declaration.
- The risk of an increased number of sovereign defaults once again highlights the need of a structured approach to resolving defaults and disputes between sovereigns. An internationally agreed legal framework for the predictable and orderly restructuring of sovereign debt could make the process less costly. Serious consideration should be given to the idea of creating a mechanism aimed at guaranteeing a speedy resolution of debt crises. For example, an independent international body could be mandated by both debtors and creditors — guaranteeing fair burden-sharing— to evaluate the debt situation of all countries faced with external debt problems and to propose the level and form of debt relief that needs to be provided.