

# The Demand for Loans

## Governments Restructure Their Debt

**More than ever, governments in developing countries have access to capital markets, but most are not using it. Instead, they have restructured their debt portfolios, cutting the share of private sector debt and increasing the share of longer-term multilateral debt. While some argue that this increase in official debt is alarming, the evidence suggests that most governments are sensibly taking advantage of their menu of financing options—extending maturities to lessen their vulnerability to the “rollover risk” posed by shorter-term debt and reducing their overall debt ratios.**

The number of emerging markets rated by Moody's grew tenfold between 1986 and 1999, and the quality of ratings has also risen (figure 1). In broadening the countries rated, the rating agencies were both responding to the demand for ratings of emerging market sovereign bonds and fueling that demand: in the 1970s bank lending was nearly 20 times the bond issues for emerging markets, but by the 1990s bond issues had surpassed bank lending (Setty and Dodd 2003).

This increase in credit quality has been accompanied by extremely small spreads on private debt relative to debt from the aid industry or other official sources (see figure 1 and box 1). The improvement in average credit quality is simple enough to explain: developing countries reduced their debt burdens and adopted better policies. Median inflation rates, for exam-

ple, after ranging above 10 percent for nearly a quarter of a century, fell below 5 percent in 1999 and so far have stayed there.

Yet the availability of cheap money has provoked no surge in indebtedness to private markets like those in the 1980s in many places, especially upper-middle-income countries. Since the late 1990s a much more modest boom has occurred in upper-middle-income countries, while borrowing from private sources by low-income countries has collapsed (see figure 1).

### Away from private, toward multilateral debt

Middle-income countries have greatly reduced their debt burden relative to gross national income (GNI) since 1990, in part by paying off substantial official debt (figure 2). By contrast, low-income countries have preferred to borrow from official sources. In these countries private

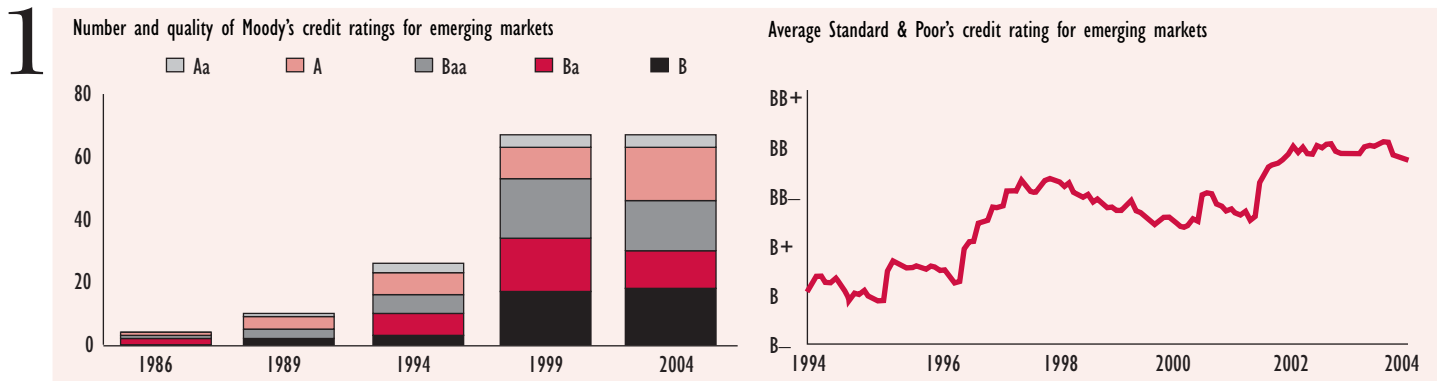
*Facundo Martin,  
Tim Harford, and  
Michael Klein*

*Facundo Martin (fmartin1@ifc.org) is a private sector development analyst, and Tim Harford (tharford@ifc.org) an economist, at the World Bank and International Finance Corporation (IFC). Michael Klein (mklein@worldbank.org) is chief economist at IFC and joint IFC–World Bank vice president for private sector development.*

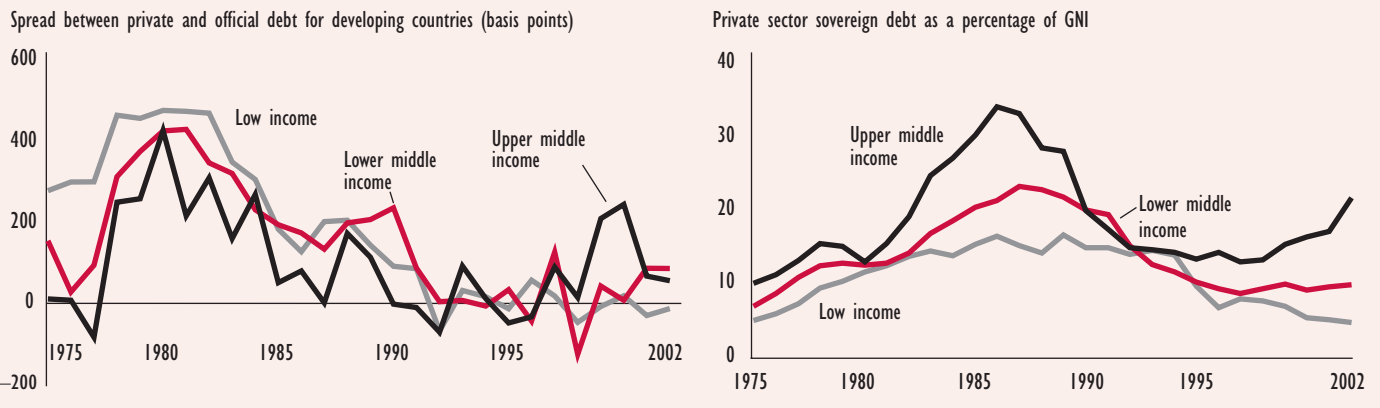
*This Note is part of a series exploring trends in the aid industry, including patterns of aid flows, competition, and the effectiveness of different types of aid.*



**Figure** Emerging markets have seen their credit ratings rise in number and quality . . .



. . . but despite the availability of cheap money have shown no recent surge in private market borrowing



Note: Rating agencies use different scales. The Standard & Poor's BB+, BB, and BB- are comparable to the Moody's Ba. The Standard & Poor's B+, B, and B- are comparable to the Moody's B. Source: for Moody's ratings, IMF 1999 and Moody's; for average credit ratings, IMF 2004; for all other data, World Bank, Global Development Finance database.

sector debt has been falling since the mid-1990s, from about 14 percent of GNI in 1994 to about 5 percent in 2002. Official finance continues to go to low-income borrowers, with the balance of

official debt shifting away from bilateral lenders and toward multilaterals over the past 15 years. (Part of the explanation lies on the supply side: some bilateral lending operations have been wound up.)

Middle-income countries have also clearly shifted away from bilateral debt. For these countries around 60 percent of official debt is now from multilaterals, compared with around 35 percent in 1975. In lower-middle-income countries bilateral debt fell from about 45 percent of GNI in the early 1990s to about 18 percent in 2002. Multilateral debt fell much more modestly, from 25 percent of GNI to 19 percent.

Upper-middle-income countries have borrowed far less heavily, with a larger share of their debt (55 percent) from private sources. They too have restructured their official debt, borrowing less from bilaterals and more from multilaterals.

**Box** About the data

This Note discusses three types of sovereign debt. *Bilateral debt* describes loans to governments from other governments or government agencies, including central banks and official export credit agencies. *Multilateral debt* is debt from the multilateral agencies, such as the World Bank or the regional development banks. Official debt is the sum of bilateral and multilateral debt. *Private sector sovereign debt* is credit extended by commercial banks, exporters, or suppliers of goods or raised from the bond market. All graphs except the top two in figure 1 are based on data from the World Bank's Global Development Finance database. These graphs are limited to countries for which data are available back to 1975—typically 39 low-income countries, 26 lower-middle-income countries, and 14 upper-middle-income countries. These 79 countries produced 59 percent of developing country gross national income (GNI) in 2002. Key omissions include China, the Russian Federation, and the countries of Eastern Europe. Nevertheless, when graphs are redrawn as data become available for additional countries, most patterns are very similar.

Thus bilateral debt has become less important relative to multilateral debt in all country income groups. As a share of total official debt, it fell from 71 percent in 1975 to 40 percent in 2002 in low-income countries, and from 70 percent to 45 percent in lower-middle-income countries. In upper-middle-income countries it fell from 63 percent to about 33 percent.

### Who is lending?

Grouping countries by their recent level of indebtedness gives a similar picture of the composition of official debt: while bilateral debt added up to 65–70 percent of total official debt in 1975, it fell to about 47 percent in 2002 in severely indebted countries, 38 percent in moderately indebted countries, and 32 percent in less indebted ones.<sup>1</sup>

Multilateral debt rose from less than 5 percent of GNI in 1975 in severely and moderately indebted countries to about 44 percent in 2002 in severely indebted countries and 40 percent in moderately indebted ones. From a similar initial level, multilateral debt increased to about 18 percent of GNI in less indebted countries.

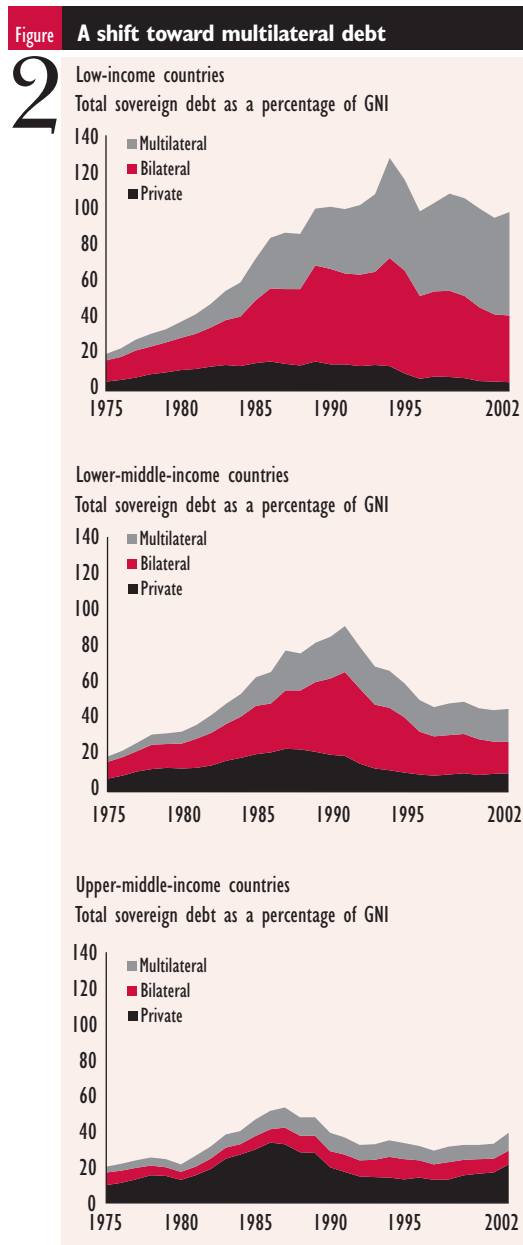
Official debt increased as a share of the total from the mid-1980s to the mid-1990s in all countries, regardless of indebtedness. It rose from 65 percent in 1983–84 to about 78 percent in 2002 in both severely and less indebted countries, following a similar trajectory in moderately indebted countries.

### Multilaterals as lender of first resort?

The picture emerging is that despite declining spreads—and improving credit ratings for many countries—the typical developing country is shying away from borrowing on capital markets and shifting its debt portfolio toward official, especially multilateral, debt.

The chief attraction of official debt appears to be not its cost but its long maturities (figure 3). Official debt has an average maturity of more than 20 years, while private debt has one of around 10 years. For low-income countries, the most avid consumers of official debt, the maturity of official debt is around four times that of private debt.

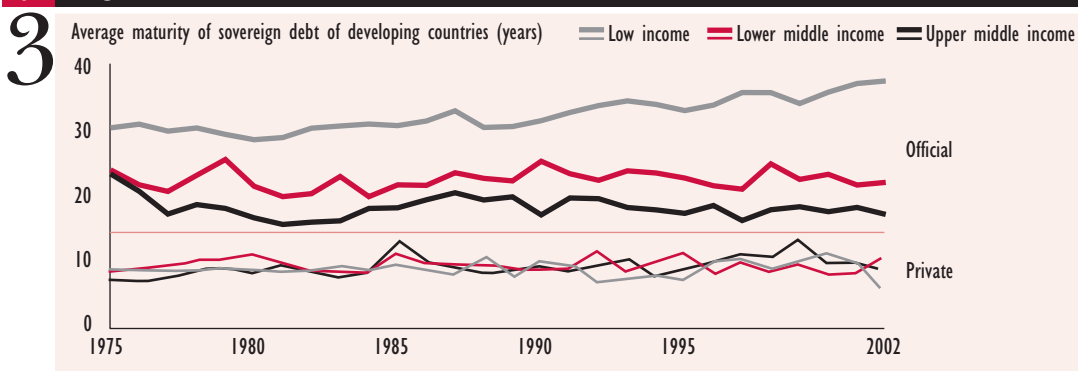
The question is whether this is a positive trend or a worrying one. The pessimistic view is



Source: World Bank, Global Development Finance database.

that countries are using overly generous loans from multilaterals to extend themselves too far, postponing (but increasing) the pain of re-adjustment and leaving the bill for future generations. The optimistic view is that countries are sensibly taking advantage of the financing menu offered them—extending maturities to lessen their vulnerability to the “rollover risk” posed by short-term debt and reducing their overall debt levels.

The evidence here supports cautious optimism. Upper-middle-income countries have

**Figure 3** Long maturities are the chief attraction of official debt

Source: World Bank, Global Development Finance database.

modest debt, while lower-middle-income countries have reduced their debt consistently and substantially since the early 1990s. Low-income countries clearly remain vulnerable, but they have checked their accumulation of debt after two decades and even made modest steps toward reducing it. A possibility remains that indebtedness will move in the wrong direction, but the evidence suggests that developing countries are taking a rational approach in their demand for sovereign debt, with considerable help from the multilateral development banks. There have been frequent suggestions in recent years from nongovernmental organizations and some politicians that there should be no role for official loans in future; the evidence suggests that many countries are learning to use official loans and that the long maturities provided by these loans are a valuable option for the governments of developing countries.

Having said that, most finance for developing countries is no longer sovereign debt but nonsovereign debt or equity. A forthcoming Note in this series will analyze trends in private flows.

## Note

1. Countries are considered severely indebted if the present value of their debt service exceeds 80 percent of gross national income or 220 percent of exports, moderately indebted if one of these ratios is 60 percent or more of the level for severely indebted countries, and less

indebted if these ratios are less than 60 percent of that level.

## References

IMF (International Monetary Fund). 1999. *International Capital Markets: Developments, Prospects, and Key Policy Issues*. World Economic and Financial Surveys. Washington, D.C. <http://www.imf.org/external/pubs/ft/icm/1999/index.htm>.

———. 2004. *Global Financial Stability Report*. Washington, D.C. <http://www.imf.org/External/Pubs/FT/GFSR/2004/02/index.htm>.

Setty, Gautam, and Randall Dodd. 2003. "Credit Rating Agencies: Their Impact on Capital Flows to Developing Countries." Special Policy Report 6. Financial Policy Forum, Washington, D.C.



## viewpoint

is an open forum to encourage dissemination of public policy innovations for private sector-led and market-based solutions for development. The views published are those of the authors and should not be attributed to the World Bank or any other affiliated organizations. Nor do any of the conclusions represent official policy of the World Bank or of its Executive Directors or the countries they represent.

To order additional copies contact Suzanne Smith, managing editor, Room F 4K-206, The World Bank, 1818 H Street, NW, Washington, DC 20433.

Telephone:

001 202 458 7281

Fax:

001 202 522 3480

Email:

[ssmith7@worldbank.org](mailto:ssmith7@worldbank.org)

Produced by Grammarians, Inc.

Printed on recycled paper