

VI. EXTERNAL DEBT BURDEN AND SUSTAINABILITY

A. Introduction

113. As transitional economies, the CLV countries¹³ require substantial assistance and support from the international community and MFIs such as ADB to meet their development, social, and policy reform challenges. Achievement of the CLV countries' Millennium Development Goals will certainly require substantial external financing. But in trying to help these countries, it is important to avoid overburdening them with debt, or exceeding their absorptive capacities. Indeed, high debt itself can be an obstacle to growth, as argued in the vast debt overhang literature. The MFIs should carefully assess the issue of debt sustainability in formulating their lending and other programs. Are the current CLV debt levels sustainable, and can the CLVs continue to absorb additional lending?

114. Furthermore, transitional economies such as the CLVs typically rely on foreign capital to finance a chronic shortfall of domestic savings over investment, or the gap in their external current accounts. This itself is not problematic if the foreign funds are channeled, either directly or indirectly, into productive investments that enable the country to grow and generate future export earnings so it can repay its creditors. Thus, apart from the macroeconomic perspective of total debt burden and its sustainability, it is also important to look closely at individual projects in which MFIs invest, to ensure that their marginal contributions are to add to, rather than detract from, economic growth and development.

B. Cambodia

1. Debt Burden

115. Cambodia's estimated external debt is about \$2.2 billion (Table A2.10). About 60% of this debt is owed to Russia and another 15%, to the US. These debts are not being serviced, and are subject to negotiation. Almost all of the remaining debt is on highly concessional terms. Discussions with Russian authorities in June and September 2002 resulted in an understanding on the broad terms for the pre-cutoff date debt, but further negotiations are required for the post-cutoff date debt. Although no agreement has been reached on Cambodia's debt to Russia, the 2000 resolution of this debt for Viet Nam and recent positive developments for Lao PDR suggest the possibility of a favorable and speedy resolution. On the US debt, a number of exchanges have occurred since April 2002 to determine the precise amount of the debt that might be written off, and the amount to be rescheduled. Negotiations are ongoing.

116. Putting aside the nonserviced debts owed to Russia and the US, Cambodia has a low and manageable external debt situation, in both stock and flow terms. The stock of external debt has remained relatively stable since 1999, with a nominal value of about \$0.6 billion. As a share of GDP, the external debt is only about 16%, and the trend has been downward since 1999. In relation to the other 77 PRGF-eligible countries, this ratio would place Cambodia in the most favorable position with the lowest debt-to-GDP ratio. The debt-to-exports ratio has also fallen sharply since 1999, and is now less than 25%. This level is considered comfortable. Similarly, the ratio of debt to government revenue (excluding grants) has also been trending down.

¹³ Although Myanmar is also a transitional economy and GMS member country, we have not included it in our analysis because of data constraints. At the end of 2000, Myanmar was estimated to have a \$5.4 billion outstanding external medium- and long-term public debt.

2. Debt Service

117. While the debt stock has remained relatively unchanged over recent years, debt service has been dropping sharply (Table A2.11). The debt service ratio has fallen from about 18% in 1998 to less than 3.5% in 2002. That level is comfortable, considering that only 3 of the 78 PRGF-eligible countries had lower debt service ratios than Cambodia. The low debt service ratio largely reflects the high share of concessional loans. The average interest on new commitments in 2001, for example, was only 0.9% (Table A2.12). World Bank projections suggest that debt service will fall to about 2% in 2004. The Asian financial crisis highlighted the significance of adequate foreign exchange reserves relative to debt service payments (the reserve coverage ratio). Reserve coverage has also increased over the years, and is currently healthy.

C. Lao PDR

1. Debt Burden

118. Lao PDR's total external debt is now about \$3 billion, or slightly higher than 170% of GDP (Table A2.13). At face value, this appears to be a significant debt burden. But more than half of Lao PDR's total debt is with Russia, and is not being serviced. Lao PDR has long been negotiating with Russia on final disposition of this debt. In June 2003, the two governments agreed in principle to (i) write off 70% of the debt owed to the Russian Federation, and (ii) service the remaining debt of \$380 million over a 33-year period at a preferential interest rate. This is consistent with the terms of Russia's memorandum of understanding as a creditor in the Paris Club. A specific agreement relating to the interest rate, grace period, flow rescheduling, and payment modalities (cash, goods, and/or investment) is still pending.

119. Of the remaining debt in convertible currency, less than 5% is commercial, and the rest is long-term concessionary with bilateral and multilateral donors. Counting only debt in convertible currency, the debt stock is less than the country's GDP, and has remained at or below 70% over the past few years. In nominal terms, this amount to about \$1.2 billion or \$700 million in net present value terms. For a transitional economy seeking rapid economic development, this ratio should appear neither surprising nor unwarranted, as long as borrowed resources are used productively. Compared with the other PRGF-eligible countries, this ratio would place Lao PDR in the bottom half. Before resolution of the Russian debt, Lao PDR ranked 14th highest of the 78 PRGF-eligible countries. Although the debt-to-exports ratio has stabilized in recent years, it remains high. The ratio of debt to government revenue has also declined, but at more than five times revenue it remains disturbingly high. Lao PDR has had long-standing problems with revenue collection. The country has recently instituted measures to address the problem, so hopefully the ratio will decline over time.

2. Debt Service

120. The debt stock may appear somewhat high, but various flow measures relating to debt servicing confirm that it remains manageable. The debt service ratio remains low at about 8% of the country's exports of goods and services (Table A2.14). Lao PDR's debt service ratio is within the 20% of countries with the lowest debt service ratio. The reserve coverage ratio also remains healthy, at about 5. None of the Russian debt was being serviced prior to the agreement reached in June 2003, so Lao PDR's debt servicing burden will probably increase slightly because a small portion of this debt soon must be serviced. The average interest on new commitments remains low, at 1.2% in 2001. An average grace period of almost 9 years will provide breathing space

(Table A2.15). If the Nam Theun 2 hydropower project and the OXIANA mine of the Lane Xang Mineral Co. begin to generate revenue, the debt service burden as a share of exports is likely to diminish considerably. If the project materializes, Nam Theun 2 is expected to generate about \$30 million per year for 10 years, starting in 2009. Afterward, the revenues will increase sharply as the share going to the Government increases.

121. Lao PDR is officially classified as an HIPC (highly indebted poor country) when the Russian debt is included in its debt burden. The Government believes that Lao PDR is able to comfortably service its debt, and the country has not sought debt relief. The recent in-principle agreement reached on the Russian debt further reinforces this position. Even before the agreement, Lao PDR's inclusion in the HIPC list was borderline. Once the agreement is implemented, Lao PDR should no longer be classified an HIPC country.

D. Viet Nam

1. Debt Burden

122. Viet Nam is the only Mekong country that has successfully concluded negotiations with Russia to resolve its outstanding debt. Viet Nam's external debt position has improved since reaching the agreement with Russia in September 2000 in which Viet Nam secured a major write down of its outstanding nonconvertible debt dues. Viet Nam's stock of total external debt is currently about 40% of GDP, and its nominal value has remained less than \$15 billion over the past 3 years (Table A2.16). Viet Nam is in the bottom fourth of PRGF-eligible countries in terms of debt-to-GDP ratio. The Russian government has agreed to discount its claims on Viet Nam by 70%. Of the remaining debt (valued at one transferable ruble per dollar), 50% will be written off, and the balance of \$1.7 billion will be repaid over 23 years—10% in cash and 90% in goods. Ongoing negotiations with Russia could further reduce the debt stock. The profile of future debt servicing obligations shows a declining trend. The debt-to-exports ratio has also declined over recent years.

2. Debt Service

123. Viet Nam's debt service payment has remained stable at about \$1.1 billion over the past 3 years (Table A2.17). With a stable debt service payment and strong growth in exports, it is not surprising that the debt service ratio has been declining since 1998, and is now only about 10% of goods and services exports. As with the debt-to-GDP ratio, Viet Nam's debt service ratio also falls in the bottom four compared with other PRGF-eligible countries. World Bank projections suggest that the debt service ratio will fall to 7.5% in 2003. The average interest on new commitments has declined steadily from 2.4% in 1998 to 1.0% in 2001 (Table A2.18). The reserve coverage ratio has also been increasing over the years, and has now surpassed 3.

124. Viet Nam's debt experience clearly highlights the vast improvement in its overall debt position following resolution of the Russian debt burden. Lessons for Cambodia and Lao PDR are obvious; once the Russian debt is resolved, the situation improves enough that the country no longer looks vulnerable in terms of stock or flow indicators of external debt. The Viet Nam experience suggests that debt vulnerability in much of the Mekong region has historical roots that can be traced back to the command economy that operated during the Soviet era. Resolving this debt overhang transforms the outlook for debt sustainability radically.

125. Another reflection of the Soviet era influence is the fact that Viet Nam had been classified as a HIPC based on historical data. But even before resolution of the Russian debt,

analysis of debt sustainability based on medium- to long-term projections by the World Bank and IMF in 1996 indicated that Viet Nam's debt burden was sustainable. This status has not changed since then. On this basis, Viet Nam has not been eligible for debt relief through the HIPC initiative. Recent trends indicating improvement in Viet Nam's external debt situation, in addition to resolution of the Russian debt, reinforce the position that Viet Nam will not get debt relief under the Initiative. Viet Nam has now graduated from being classified as a severely indebted to a moderately indebted country under the World Bank Debtor Classification System.

E. Looking Forward

126. A question that must be asked is whether current and future borrowings of the CLV countries is likely to result in a repeat of the debt problems associated with the Russian debt? In other words, is history likely to repeat itself in these countries, and are MFIs like ADB playing a role in reinventing these problems? This is unlikely for several reasons. First, the nature and structure of the CLV countries' economies today differ from their economies when the Russian debt was accumulating. The CLV countries have come a long way since in moving toward a market economy, and in adopting and instituting market-based mechanisms and principles. Many current or rapidly emerging checks and balances were absent during the command economy period. Also, legal, bureaucratic, and administrative systems have been evolving to ensure that borrowings and investments are secure and put to productive use. Rather than adding to economic vulnerability, recent and current borrowings are helping reduce it, and contributing to economic growth and development by improving basic infrastructure, enhancing productivity, reforming institutions and policies, and contributing to human development. By promoting private sector development in particular, MFIs such as ADB are actually working toward reducing the governments' reliance on foreign borrowings and thus, curtailing the buildup of future debt.