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Foreign debt to the fore again

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Once again the topic of foreign debt is hitting headlines.

This time, it is in Samoa.

Based on Debt Sustainability Framework analysis, International Monetary Fund (IMF) and the World Bank (WB) have recently assessed low income countries. The latter do not include Fiji, as its per capita income of US$4,430 places the country in upper middle income group.

The objective is to minimize risks to low income countries arising from further unsustainable debts. Soon Millennium Development Goals will be replaced by Sustainability Development Goals (SDG). Achieving SDGs require investments in infrastructure for which low income countries have to depend upon external resources: loans and grants.

High debt risk countries

The latest list released by IMF and WB in June, classifies Samoa, Republic of Marshall Islands (RMI) as high risk countries; Papua New Guinea and Vanuatu as low risk countries and Tonga as moderate risk country.

Tonga's budget for 2014-15 is funded by aid to a larger extent than ever before: 59 percent. Weaning away from external debt was the subject of intense discussion last month both in the country's parliament and media.

As RMI is classified as high risk country and from debt sustainability point of view is considered no longer credit worthy, Asian Development Bank announced that the country will be eligible only for grants, not new loans.

Samoa's external debt

The debate on debt sustainability is not new.

In early April, a visiting IMF Mission referred to increase in expenditure for recovery and reconstruction in the face of recent external shocks, including the global financial crisis, the tsunami and cyclone. Based on the high risk classification, the Mission warned against any further rise in Samoa's debt. It advised a process of gradual fiscal consolidation, once the recovery has taken hold.

That drew Samoa’s Prime Minister (PM) to react in his press conference:

"We don't have to just swallow (whatever advice) is given. We have to use our brains and make a decision that best suits our situation".

He was recalling IMF’s advice in 2003 asking Samoa not to proceed with the construction of the SamoaTel headquarters, Virgin Samoa joint venture and the construction of Development Bank Building.

Samoa rejected the advice and went ahead.

Defending the debt

In his latest defence of debt, PM rejected the claims that Samoa’s foreign debt was imposing severe burden on the future generations of the country.

Although the debt (most of which is external, as domestic borrowing is minimal) is 960 million tala (US$ 423 million) or 66 percent of gross national income (GNI), as against RMI’s debt to GNI ratio of 70 percent, Samoa’s PM said that annual debt servicing obligations was only 51million tala or 7 percent of government revenues of 700 million tala. Further, PM stressed the annual flow of benefits from the projects, when completed would more than offset the original cost.

The argument put forward by PM is sound.

Thus, an externally funded project would be justified if the internal rate of return exceeds the market rate of interest.

The conditions for a successful borrowing programme is the choice of projects which are growth enhancing rather than image building, unproductive projects. That underscores the need for careful screening of projects.

Debt service ratio

The true indicator of debt servicing capacity is how much of export earnings generated each year are paid out to foreigners for meeting annual debt obligations, known as total debt service (TDS). Additionally two ratios are used: reserves to external debt; and reserves equivalent to average monthly imports.

In Samoa, TDS is low, hovering around at 5.3 percent during past three years. This is because 60 percent of outstanding debt stock is concessional loans from WB and ADB. However, the ratio of foreign exchange reserves to external debt is declining from 66 percent in 2009 to 40 percent in 2012; and from 6.2 months import equivalent reserves in 2009 declining to 4.4 in 2012.

Fiji belonging to higher middle income group is not eligible for concessional borrowings. However, Fiji's public debt is relatively low at 50 percent; and external debt is only 19.1 percent of GNI. The TDS ratio is well below 2 percent. Ratio of foreign exchange reserves to exports is 126 percent and in terms of months of imports, it is well above 4 months of imports.

The way to avoid debt defaults and crises is increasing foreign exchange reserves through commodity exports and tourism, and by encouraging higher remittance inflows. Above all, projects funded by debt should be capable of earning additional foreign exchange