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RESEARCH ARTICLE

Transforming 3rd World Debt into Microfinance Liabilities: The Odious Debt Becoming an Opportunity

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Abstract

The international debt relief programs did not encounter decisive solution to the 3rd world indebtedness. The major concerted relief schemes, organized by World Bank and IMF, are ignored by number of creditors. The present forgiving paradigm does not incite creation of sustainable infrastructures nor helps to consolidate the indebted economies on grass root level, assuring halt to debt renewals. Despite the traditional view of the debt as a burden, the situation can be considered an opportunity for erection of sustainable structures in 3rd world countries. This paper proposes a new complementing concept to the old forgiving paradigm, under which the debt is converted into microfinance portfolio liabilities possessed by creditors. The Debt repayment is ensured through stream of revenues generated by a single national microfinance funding source, nursed by diverted debt service payment, eliminating foreign financing and converting creditors into shareholders.

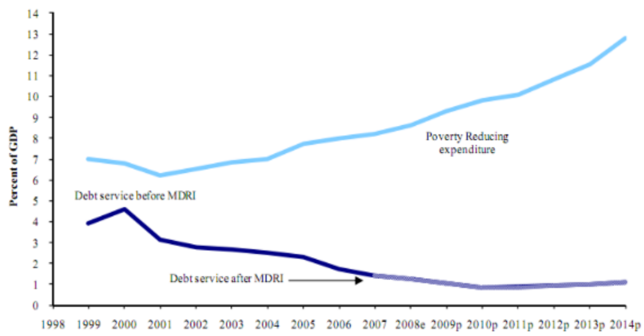
Keywords: *Debt, HIPC, Development, Funding, Microfinance, Public private partnership, Swap.*

Introduction

As the international debt became one of the most complex problems of the world economy, debt relief turned into the dominant development topic of our era. The international indebtedness complicates both the global balance of payments and the financial system stability, with negative impacts on currency stabilization and economic co-operation [1]. The low level of human development of a large number of countries is tied to the lack of investment in the social sector and is directly attributable to the debt burden. Excessive debt impedes growth, creates inflation or tax increases, raised in order to meet debt-service obligations, while deterring private investment and discouraging governments to carry out structural reforms[1].

The relict cost of cold war, during which geopolitical concerns were with "benign neglect" prioritized over financial prudence of the newly independent borrowers, is still being paid by the poorest populations in form of debt service of debt stocks standing at estimated US$3.360 trillion [2].

In the 90s the OECD creditors had realised that debt service diverts funds from poverty reduction expenditures and introduced cancellation mechanisms, such the debt swaps [3]. The debt



Sources: HIPC documents; and IMF staff estimates.
1/ Prior to 2009, figures represent debt service paid, and thereafter, projected debt service.
For detailed country data, refer to Appendix Table 2.

Fig.1: Average poverty reducing expenditures and debt services in HIPCs1[7]

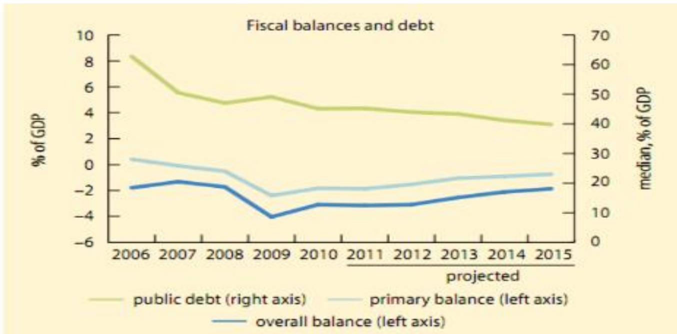


Fig. 2: The debts in low-income countries in 2015 will represent 40% of the GDP of LICs [8]

[1] Debt overhang theory

swap mechanism involves the exchange of debt for another asset with different repayment terms.In a debt-equity swap, debt owed by a debtor government is purchased by an investor in the secondary debt market and converted into an investment in the debtor country. The Brady Plan in 1989 stimulated further growth when debts were exchanged for marketable securities in over-the-counter market composed of brokers, dealers and investors located worldwide. From 1985 to 1996 a total of about US$130 bn was swapped by fifty countries [4]. Brady style initiatives have however not managed to stop new debts from being contracted, enabled by austerity policies at the expense of the populations [5].

The HIPC Initiative[2], launched in 1996 and broadened a decade after through MDRI to provide full relief on eligible debts by the IMF, the World Bank and the AFDF[3], strengthened the links between debt relief and poverty reduction[4] through earmarked debt relief [6]. The earmarked relief linked relief to poverty reduction as a condition for debt waiver, enabling increase of public sector investments with savings generated by reduced debt payments. For the 36 countries receiving HIPC relief, declining debt service has helped to formulate that savings of 1.9% on GDP released, imply up to 90 % annual increase on public education and healthcare spending [7].The excessively selective earmarked relief however did not provide structural solution to the poverty problem. Therefore, it is time to reconsider it.

Inadequacy and Uncertain Future of Major Debt Relief Initiatives

Important questionmarks are related to the future and impact of the Initiatives. Firstly, the HIPC-MDRI do not alter the legal terms between debtors and creditors, until the debt is repaid. High-debt countries tend to have obligations to large numbers of creditors in many currencies, making the long term impact of partial debt relief questionable and raise significant legal challenges related to burden sharing among creditors [8-9]. Secondly, while the major creditors[5] provided debt relief under the Initiatives committments, others keep lagging behind in their contributions or ignoring them. Smaller multilateral institutions, non-Paris Club bilateral and commercial creditors, accounting for about 25 percent of total HIPC Initiative debts, have delivered only up to 39 % of their expected share of HIPC, whilst half of the creditors have not delivered any relief at all [10] .

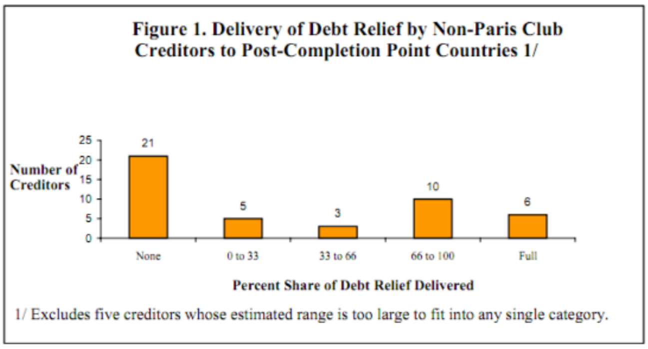


Fig. 3. Only few Non-Paris Club creditors complied with HIPC initiative (IMF)

Thirdly, it is unclear who will finance the Initiatives in the future. Up to present, the total cost of assistance to the 40 countries eligible for the enhanced HIPC-MDRI relief is estimated to have reached $127 billions[6] [11]. Available resources in the PRGT-HIPC trust[7] are insufficient to finance the cost of debt relief to all countries that meet the initial conditions today.

Fourthly, there is a very weak empirical link between HIPC/MDRI debt relief and poverty reduction.The findings indicate that debt relief does not lead to growth in general. Even if the Initiatives represent an important leap forward, government programmes might be more effective in reducing poverty, albeit the increased spending requires substantial increases in levels of public expenditures, which cannot be achieved unless the revenue base rises through higher per-capita income [12]. MDGs require more than debt payment reduction and cannot be achieved without sustained per-capita economic growth [12].

Fifthly, the majority of the world's poor live in countries not eligible for debt relief, indicating inappropriateness of the HIPC eligibility kriteria. Most of the poorest countries do have an unsustainable debt [13]. More countries need debt cancellation than those currently eligible for HIPC-MDRI.At last, systematic blank cheque given to governments in form debt relief, triggers moral hazard potential that may induce recurrence of debts, overspent in order to receive relief in the future.

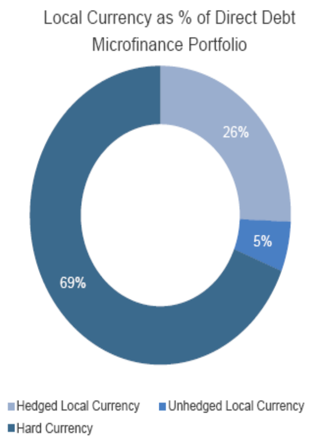
[2] The IMF-World Bank's approach to debt reduction designed to ensure that no poor country faces a debt burden it cannot manage.
[3] African Development Fund
[4] Multilateral Debt Relief Initiative (MDRI)
[5] The World Bank, the African Development Bank, the IMF, the Inter-American Development Bank, and all Paris Club creditors.

[6]Estimate towards end of 2010
[7]The PRG-HIPC Trust was established to provide debt relief under the HIPC Initiative. The resources available to the Trust consist of grants and deposits pledged from 93 member countries and contributions from the IMF.

Inspired by the mentioned shortcomings, this paper proposes re-formulation of a new strategy, transforming the debt into tradable microfinance portfolios, rather then condonation without acquisition of sustainable mechanisms, since their absence in many cases leads to further impoverishment of the debtors nor has such policy earned respect by all creditors due to frail results achieved long term.

Linkage of the Debt and Microfinance

Although debt relief and microfinance development appear today as separate themes in the development architecture framework, microfinance and its attendant services, such astraining and social capital-building, offer contribution to the achievement of all MDGs through its direct impact on poverty reduction. People with access to financial services are able to improve their standard of living in a broad variety of aspects, such as schooling, gender equity, health and resource conservation.[14-15] By empowering the poor, particularly women, microfinance fosters financially self-sufficient domestic private sectors. [16]



Microfinance Debt Characteristics

	2009
Microfinance Debt Growth	15%
Average Debt Investment Size	USD 1.7 mil
Maturity	31 months
Share of Local Currency	31%
Local Currency Invest. Growth	56%
Share of Fixed Interest Coupon	76%
Net Portfolio Yield	7.9%
Loan Loss Provisions 2009	2.0%
Write-off in 2009	0.1%

Fig. The current structure of international microfinance funding

The proposal of this paper is to link the underdeveloped microfinance markets with the creditors unwilling to condone their outstanding debts, in exchange of the claim to microfinance portfolios formed with diverted debt service payments. Under this scenario, debt swapped funding liabilities, established under international supervision in public-private-partnership, belong to the creditors as long as their debts are not repaid or their shares resold to investors in international secondary markets. The swap of the outstanding debt with an asset, valorizing in the long term with beneficial effects on the indebted society and in parallel repaying the debt, might appeal to more creditors than debt relief without any palpable asset in exchange.Furthermore, the proposed swap reduces microfinance capital drain by international sources leaving developing countries in form of interests and dividends paid to microfinance investment vehicles (MIVs). Almost a third, 29% of the total of microfinance funding is today channeled through international financing, draining capital from developing countries [17].

The international microfinance funding gender is also tied to severe problems, such as foreign exchange risk, transforming unhedged loans into a threat for the MFI or heavy investment concentration.The proposed debt-to-microfinance swap substitutes foreign source with a single capital repository in local currency, while dividends paid by the MFIs decrement the indebtedness level of the Debtor. The general idea, harbouring a complex technical solution is structured in several phases below.

Description of the Phases of the Debt-to-Microfinance Swap Mechanism

Preparatory Phase 0

Debtor country participating in debt-to-microfinance swap, submits a binding contract with international umbrella organization Microfinance-to-Debt Committee (MDC) formed by a spectrum of representatives of multilateral institutions, creditors, NGOs and state representatives, coordinating on international level and dealing with creditorship. The contract entails inconditional exigencies:

- Acceptance of standartized accounting as well as methodological taxonomy by both Debtors and Creditors.
- Regulation of the local microfinance sector according to agreed benchmarks.
- Creditors agreement on the debt repayment from DRF profits / sale of bonds and halt to the accrual of new interests on the current Debt amount.

The local MFIs are provided a time period for adherence to the MDC standards, after which Debtor signs a contract with each Creditor under auspices of MDC. Debtor opens Debt Reduction Fund (DRF). The task of DRF is to gradually transform the Debt value into liabilities of MFIs through financing of MFIs with diverted governmental debt service capital and to convert the Debt in tradable shares, stepwise distributed to participating Creditors according to the level of the Debt diverted to DRF.

Initital Phase 1

Debtor government establishes monopoly on microfinance funding, starting on D. Since D, all newly contracted MFI financing is provided through DRF, in the level of expected demand. The value of the shares of DRF is derived from the sum of governmental debt service payments diverted to DRF, converting the value of the unpaid Debt to value of DRF equity. The MFIs are denied to form new external financing obligations from any other sources than DRF. Foreign sources are denied to finance local MFIs. The new regulation forces MFIs with statal participation to channel dividend payments to DRF. DRF capital, collected mainly from the debt service payments, is used exclusively to fund local MFIs. The Debtor government guarantees DRF losses.

Executive Phase 2

All external financing needs of MFIs in Debtors microfinance market, ranging from short term loan to equity are satisfied with DRF capital. Once the DRF fund supplies 100% of the local microfinance funding need, the government stops the debt service payments to DRF, reaching the limits of the mechanism. The growing demand of expanding and deepening microfinance market, leads to gradual enlargement of the funding and thus reduction of the Debt outstanding, not yet converted to DRF shares.

Debt Cession Phase 3

Certified DRF bonds guaranteed by local Central Bank, tradeable in the international debt markets, are held by Creditors, in the volume corresponding to their unpaid liabilities towards the Debtor, and are entitled to receive the dividends generated by DRF or to sell the discounted bonds to to international public, thus settling their debts. The operation is structured in several phases as follows:

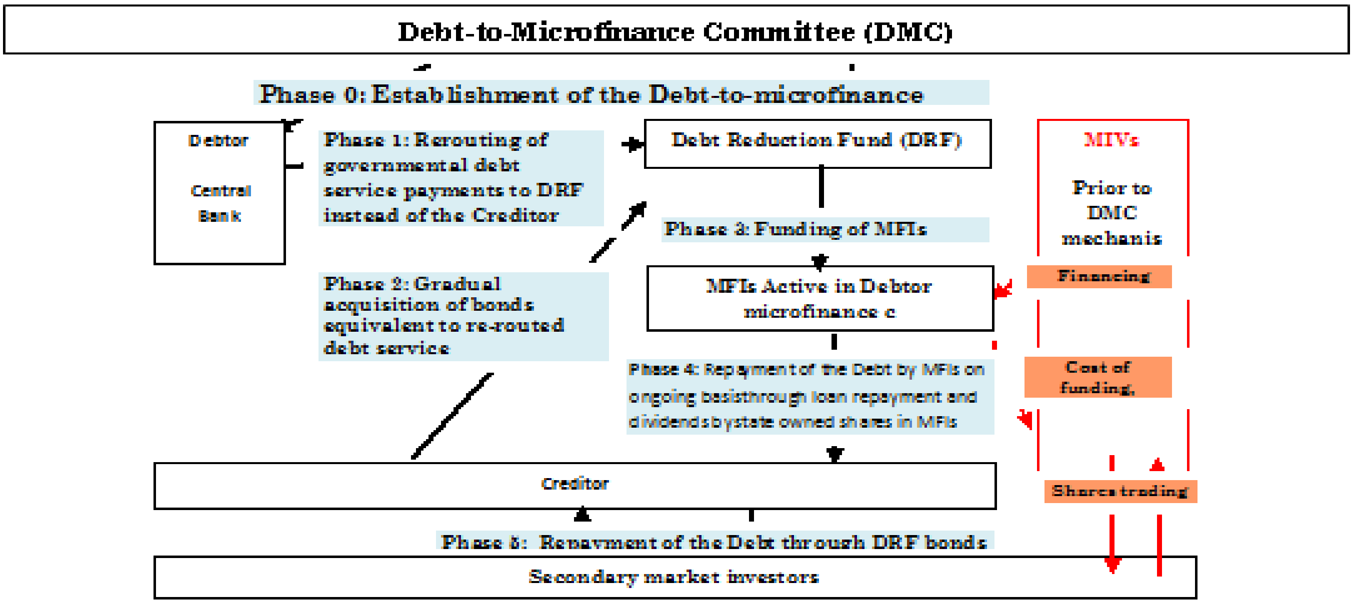


Fig.5: Debt to microfinance DMC mechanism

The DMC structure provides the Creditorship with a robust mechanism of Debt repayment, provided that MFIs are funded with short term loans given the nature of microcredit, usually ranging from 4 to 6 months time. The diverted capital can thus generate high compound interests due to higher capital turnover[8] than other industries. Debt-to-microfinance swap assures lower cost and abundance of working capital for the microfinance clientele, with its multiplex impact on Debtor's society and assures that the profits prior to introduction of debt-to-microfinance paid to international MIVs, will not leave the country, unless reducing the debt burden.

Debt Repayment through DTM on Case of Tanzania

General Description

The exemplification of the need for the sustainable debt relief is particularly relevant for sub-Saharan Africa as out of the 42 HIPCs, 34 are African, while Africa's debt burden is twice that of any other region in the world, with a relatively smaller income fraction. Before extensive debt relief was implemented (1995), sub-Saharan Africa's debt stock was estimated at $340 billion, with annual debt service peaking at $26 billion, GNP at $308 per capita and external debt at $365 per capita [18]. Out of this group of

[8] This ratio represents the number of times the working capital is turned over in the course of year. Working Capital Turnover Ratio = Cost of Sales / Net Working Capital

countries, Tanzania, one of the ten poorest countries in the world, with one of the lowest GNP per head in the world and the percentage of government budget allocations ranging to tens or percent destinated to debt service, is an evident representative [19].

At present about 38 per cent of people living in Tanzanian rural areas are classified as poor. Tanzania has benefited from extensive HIPC-MDRI debt relief, which reduced Tanzania's debt burden sharply by US$3.4 billion in 2007. Total PV PPG external public debt amounted to US$6.5 bn of GDP by 6/ 2010, standing at 24.6 percent of GDP. 64 percent of PPG external debt was owed to multilateral and 15 percent to bilateral creditors.

Despite the Initiatives and sustained GDP growth in the past decade, the country has not achieved significant reduction in poverty and the economy remains donor-dependent as 30% of the budget is dependent upon assistance. Tanzania is on track to achieving the MDGs related to primary education, child mortality, gender equality, and access to improved sanitation, but is lagging behind in other MDGs and will unlikely manage to reduce extreme poverty by 2015[20].

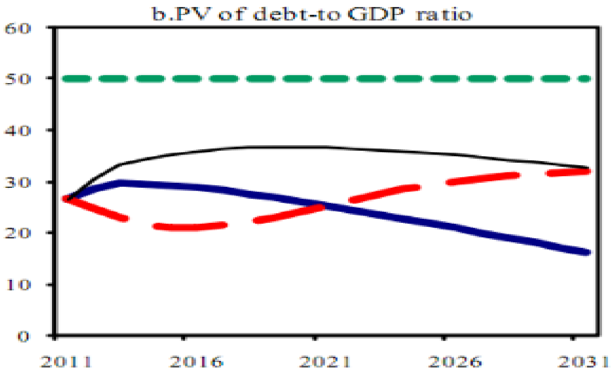


Fig. 6: Tanzania: indicators of public and publicly guaranteed external debt in % of GDP under alternative scenarios 2011-2031 [21]

Microfinance Market in Tanzania

Tanzania, a highly indebted country with low penetration of microfinance, yet politically stable system enjoying continued economic growth, is a suited country for modelation of the debt-to-microfinance swap.

Tanzania's finance industry, has over the past two decades undergone major changes from the originally state-owned system to a liberalized financial sector. In 2000, the government approved the National Microfinance Policy and in 2003 a new revision gave the Central Bank of Tanzania (BoT) responsibility for regulating all financial cooperatives. The World Bank estimated this access rate to financial services at an even lower level of 5% in 2007.

While, it is estimated that there are 8 million of SME's in need of financial services, with the majority ling in the rural areas, all the MFIs in Tanzania serve a combined client population of about 0,4 million of SME's, around 5% of the total demand. According to Mixmarket, the loan portfolio of Tanzanian microloans was 591.3 million USD in 2009, with 233,341 active borrowers and average loan of 2,534

USD.**Debt-to-Microfinance Example on the Case of Tanzania**

The following model serves for raw illustration and was calculated using IMF future Tanzania's debt projections versus coarse assumptions by the authors for period of 2010-2041, supporting the thesis that debt-to-microfinance scheme can repay entirely the debt burden. The financial model was created according to these assumptions:

- α) The total microfinance portfolio in Tanzania as of today reaches 1,013 bn USD, with the potential of 29,862 bn USD microfinance distributed to 8 million borrowers, when the demand is fully met, with average loan balance of 3732 USD / person (at present 2,500 USD / person), with average annual growth of portfolio will be 9.65% between 2010-2041.[9]
- β) The non-deposit liabilities (NDLs) and equity represents in Tanzania 40% of microfinance funding. Out of this sum, 69% is furnished through international funding.[10]
- χ) International funding cost corresponds to average ROE of MIVs, assumed to be 5.9%.[11]
- δ) Local funding cost will correspond to 5.7%. [12]
- ε) Government annual lending will stay at Tsh. 21 Billion (11 millions of USD.)[13], lent at rate of 15% p.a.[14] with average annual growth of 6%
- ϕ) State through equity investments will be receiving dividends from the State owned MFI shares in 30% of the local MFIs[15]

When modeling financial flows, assuming that diverted Debt payments can substitute the funding to microfinance sector and convert the Tanzania's debt to MFI financing liabilities, we

9Based on extrapolation of Mixmarket Tanzania report as of 7/2011

10Assumption based on MIX Microfinance World: SSA Microfinance Analysis and Benchmarking Report 2010, p. 9

112008 average ROE of MIVs, Thesis, Practical Challenges of Microfinance Institutions Dilin Lim, 2009, p. 25

12Assumption based on MIX Microfinance World: Sub-Saharan Africa Microfinance Analysis and Benchmarking 2010, p. 2

13Country Scan, Hivos/MicroNed, p.6, estimating total volume of three main programs, The Rural Financial Services Programme, Small Entrepreneurs Loan Facility Project, Tanzania Second Social Action Fund.

14http://www.indexmundi.com/tanzania/commercial_bank_prime_lending_rate.html

15Based on extrapolation of Mixmarket Tanzania report (7/2011), with average 3.0% ROE of MFIs in Western Africa come to the conclusion that under geometrically extrapolated conditions, the totality of the 2010

Table 1: Microfinance growth in Tanzania and debt-to-microfinance

Projected years	2010	2015	2021	2031	2036	2041
Debt 2010	6500	6 511,95	6 331,41	5 854,56	2 347,65	-249,47
Debt service to 2010 debt (mlllions USD)	46,63	46,72	45,42	42,00	16,84	-1,79
GDP (bn of USD)	22,70	33,30	57,30	141,80	212,70	223,34
Total international funding (bn USD)	0,28	0,58	1,73	6,21	9,32	10,25
Cost of international funding (millions USD)	16,50	34,22	102,07	366,39	824,38	906,82
Accumulated cost of international funding (millions USD)	16,50	122,94	408,19	2 684,53	4 026,80	4 429,47
Total local funding (bn of USD)	0,13	0,27	0,80	2,88	4,32	4,75
Total cost of local funding (millions USD)	7,41	15,36	45,89	164,16	246,24	270,86
Accumulated cost of local funding (millions USD)	7,41	55,14	183,09	1 203,59	1 805,39	1 985,92
Government acummulated funding cost (millions USD)	1,65	9,30	15,40	39,60	59,40	65,34
Total funding need (millions USD)	405,20	850,00	2 530,00	9 090,00	17 725,50	16 498,35
State MFIs earnings (millions USD)	9,12	18,81	56,25	182,45	608,10	668,91
Accum. State MFIs earning (millions USD)	9,12	27,93	84,18	266,63	874,73	1 543,64
Total accumulated supply through debt-to-microfinance (millions USD)	34,68	215,31	690,86	4 194,35	6 766,31	8 024,38
Total supply through debt-to-microfinance (millions USD)	34,67	70,47	207,11	717,44	1 685,38	1 853,92
% of 2010 debt service covered by microfinance program	53	108	327	1 225	7 179	-74 315
Total microfinance portfolio (mm USD)	1 013	2 090	6 250	13 272	19 908	29 862

debt present value could be theoretically repaid within 30 years, in the year 2040. Expressed in other words, the transformation of the debt service capital into funding capital can generate means sufficient to repay the external Debt of Tanzania, relieved of the present and future interests, while boosting local economies.

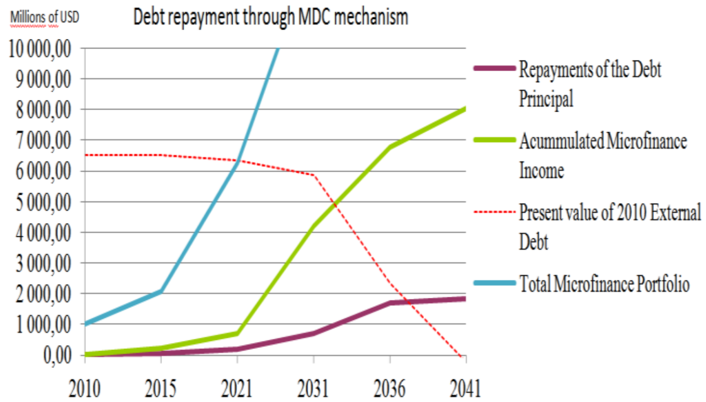


Fig.7: Graph . Tanzania Debt-to-Microfinance model for period 2010-2036

Conclusion

The World Bank estimates that the additional foreign aid required to reach the Millennium Development Goals by 2015, and partial debt relief is among them, is between $40-$60 billion a year [22]. Evidence in countries where MDG costing exercises have been done showed that the requirements for countries to meet the MDGs significantly surpass the volumes of resources made available by debt relief [23]. More so, if the savings are chanelled through poor institutions, they are likely to be wasted. Without functioning markets and social stability functioning at grass root level, economic policies are likely to be badly administered and investments to become distorted. [12][24] Therefore, it is crucial to apply mechanisms that alleviate the debt burden intelligently so that these create infrastructures that permit grass root consolidation of the indebted societies, not only providing temporary solution.

3rd world debt thus becomes a unique oportunity for the international community to form multisectorial infrastructure that enables transformation of developing countries debt into sustainable, productive asset in form of microfinance portfolios. These will be nursed from the diverted debt service savings, and gradually transferred to proprietorship of the creditors, along with the debt repayment, who can resell them on secondary markets.

It is estimated that there is currently a demand for a capital of $250 billion but only an estimated $44 billion has been deployed in microfinancing [25], while the poorest countries pay the rich world almost US$100 million in debt repayments every day [26]. If these installments are diverted into microfinance liabilities, the capital can be provided in abundance to productive populations as well as gradually serve for the Debt repayment, establishing healthy and transparent microfinance sector with multiplex social impact benefits.

Acknowledgement

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List of Abbreviations

AFDF	African Development Fund
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Countries Initiative
IMF	International Monetary Fund
INITIATIVES	HIPC + MDRI
MDGs	Millennium Development Goals
LICs	Low Income Countries
MDRI	Multilateral Debt Relief Initiative
MIV	Microfinance Investment Vehicle
NPV	Net Present Value
ODA	Overseas Development Aid
OECD	Organisation for Economic Cooperation and Development
PPG	Public and publicly guaranteed
PRSPs	Poverty Reduction and Strategy Papers
PV	Present Value
SSA	Sub Saharan Africa
UNDP	United Nations Development Programme