

## High-Level Political Forum on Sustainable Development Side Event Cluster IV on Liquidity and Debt Vulnerability

### “Financing a sustainable recovery: The role of debt-relief instruments”

Thursday, 15 July 2021

7.30 – 9.00 am (New York time)

#### Event Summary

On 15 July 2021, the United Nations Department of Economic and Social Affairs (UN DESA) and the United Nations Economic and Social Commission for Western Asia (UN ESCWA) co-organized a virtual HLPF side event, as part of Cluster IV (Liquidity and Debt Vulnerability) of the *Financing for Development in the Era of COVID-19 and Beyond Initiative*. The event brought together the United Nations (including the Regional Commissions), International Monetary Fund, World Bank, academics, creditors, and debtors to discuss **efforts to develop instruments that can facilitate debt relief**. It was attended by over 170 participants, comprising Member States (including national policy makers), UN agencies, academics/think tanks, the private sector, and civil society.

In the opening remarks, Ms. Rola Dashti, *Under-Secretary-General of the United Nations and Executive Secretary of UN ESCWA*, and Mr. Navid Hanif, *Director of DESA’s Financing for Sustainable Development Office (FSDO)*, stressed the importance of both addressing immediate debt crises and expanding the fiscal space of countries in need to mitigate the COVID-19 impact, and investing in the SDGs and climate action. The Secretary-General’s statement that solidarity is in everyone’s self-interest was echoed.

During the discussion, moderated by Ms. Sharon Spiegel, *Chief of the Policy Analysis and Development Branch, FSDO/DESA*, speakers agreed on the need to address both **the risk of default for countries with unsustainable debt** and **the need to widen fiscal space for countries with high debt burdens that are unable to invest in the SDGs**. Challenges discussed include involvement of private creditors, a changing public creditor landscape, political willingness, and questions around the conditionality of support.

To overcome these challenges, Ms. Stephany Griffith-Jones, *Financial Markets Program Director, Initiative for Policy Dialogue, Columbia University*, presented a proposal of a **Guarantee Facility for Green and Inclusive Recovery**, which would make a clear link between debt relief and the investment needed to promote an inclusive and green transformation. It would include: i) enhanced Debt Sustainability Analyses (DSAs), which include long-term factors, such as climate; ii) mechanisms to include the private sector, such as debt swaps with guarantees and/or other incentives to bring in the private sector; and iii) linking debt relief to country plans rather than to donor-imposed conditionalities. Based on studies of the Brady Plan, the proposal could entail haircuts on the private debt for countries that are insolvent, as well as debt swaps with a guarantee (e.g., a partial guarantee of the principal and guarantee of 18 months interest payments). Linking the debt relief to country plans would then mean that the government itself

would decide about the allocation of the funds in line with national priorities guided by the Agenda 2030 and the Paris Agreement (which Ms. Griffith-Jones referred to as self-conditionality).

On DSAs, all of the speakers agreed that **debt sustainability analyses should include an assessment of climate risks**. The IMF noted that they would be providing such a framework within a year. Stephany Griffith-Jones argued that DSAs should also include a feedback mechanism to account for the effects of investment in resiliency on long-term debt sustainability.

On the **inclusion of private creditors in debt relief initiatives**, speakers agreed that the private sector would only join an initiative when there was a high risk of default, i.e. when the risk/losses of not participating were greater than those of participating. Mr. Jeromin Zettelmeyer, *Deputy Director, Strategy and Policy Review Department of the IMF*, argued that there was a well-established playbook for addressing private creditor involvement in debt restructurings, e.g., through the use of collective action clauses. He noted that whereas the private sector participates in debt restructurings when it is clear that a country is at high risk of default, they are unlikely to participate in a voluntary debt swap, which would write down the value of their loan to give the debtor country fiscal space for additional investment. Others noted that there were still inefficiencies in private restructurings that collective action clauses hadn't solved and that needed to be addressed. In particular, market-based debt restructurings were often too little too late. Ms. Griffith-Jones suggested that the public sector could use other instruments, such as guarantees, to incentivize private creditors to participate in debt exchanges, even when there was no immediate threat of default. She further argued that there should also be other incentives, such as regulatory or tax incentives, to encourage debt relief by private creditors.

Referring to Ms. Griffith-Jones' call for a **clear link of debt relief to national plans**, Mr. Marcello Estevão, *Global Director, Macroeconomics, Trade and Investment Global Practice of the World Bank*, agreed on the **need for clear country programs that spell out country priorities**, which he proposed to set up similar to the Poverty Reduction Strategy Papers (PRSP) process. UN DESA noted that the concept of Integrated National Financing Frameworks (INFFs), brought forward by the Inter-Agency Task Force, could serve as a basis for such thinking.

Mr. Zettelmeyer also highlighted the need for greater **official sector coordination**. The **official creditor landscape has become more diversified** over the past few years as the Paris Club – historically the main mechanism for official sector creditor coordination – today only represents a part of the official creditor landscape. Other creditors, such as China, now have a larger presence. To illustrate, Mr. Thomas Melonio, *Executive Director for Research and Innovation, French Development Agency*, pointed out that in Africa, 20% of debt was held by China, 20% was held by private creditors and the rest was held by multilateral institutions and bilateral members of the Paris Club.

The G20's **Common Framework** brings together a broad group of public sector creditors, with the goal of helping countries at high risk of debt default, including by bringing in private creditors on comparable terms. To date, three countries (Chad, Ethiopia, and Zambia) have requested debt treatment under the Common Framework, though as of yet, discussions are ongoing.

Mr. Zettelmeyer identified the lack of **political willingness** on the part of creditor countries as an obstacle to debt swaps. This is particularly challenging in the current environment where all countries are concerned over their domestic public finances. Mr. Zettelmeyer mentioned the agreed new allocation of Special Drawing Rights (SDRs) and the idea of relending some of these SDRs to a fund that would lend to eligible countries at a very low interest rate. Acknowledging that this would not equal a full fiscal transfer, he argued that transfers and grants remained possible solutions to support countries in need, though political will was needed in that area as well. Mr. Sheldon McLean, *Coordinator, Economic Development Unit, UN ECLAC subregional headquarters for the Caribbean* agreed with the need to explore possibilities regarding a reallocation of SDRs to finance debt relief mechanisms.

A cross-cutting issue raised by several speakers is the **issue of transparency**. Together with the IMF, the World Bank has implemented the **multipronged approach to address debt vulnerabilities** by enhancing debt transparency, strengthening debt management capacity, and providing countries with suitable tools to analyze debt sustainability.

Speakers also discussed **specific challenges around debt swaps**. Mr. Estevão stated that debt swaps might only be useful under very **specific conditions**. He argued that the link to climate could only be established within a deeper debt restructuring after the risk of debt distress had been moderated through a broader restructuring. He expressed concerns that climate objectives would overlay the purpose of dealing with a debt crisis and warned that debt swaps might end up reducing fiscal space if poorly structured. This is in part because debt swaps usually entail very **high transaction costs** due to a complicated and lengthy preparation, negotiation, and implementation process. In this regard, the question was raised whether there was **any possibility of having standardized term sheets to reduce the transaction costs**.

Mr. Melonio noted that the French Development Agency (AFD) was already using debt swaps. He presented the agreement over Cote d'Ivoire's debt cancellation that was reached with France in 2012 and includes a "contrat de désendettement et de développement" (debt reduction-development contract) – a **debt for grant swap** – on top of the immediate debt cancellation. This implies that Cote d'Ivoire continues to pay its debt, but each time it does, France makes an equivalent grant to a specific joint account. The allocation of the grants is jointly decided on by the debtor and the creditor. From the perspective of the French government, this means smoothing the cost of debt forgiveness over time and increasing visibility as each grant payment is noticed individually over the years. Mr. Melonio noted, however, that the **heterogeneity of the debt of different countries** would **require some level of flexibility** in the design when trying to craft a solution.

Another example of a debt swap is the **debt for grant swap to protect the environment in the Seychelles**, which the government of France agreed on in preparation for COP21. While showcasing this as a successful example of a debt for climate swap in a middle-income country, Mr. Melonio acknowledged that, while relevant to learn from, it might be a very specific case.

Given the changing creditor landscape, Mr. Melonio called for **more coordination** with regards to any kind of debt relief, including debt swap arrangements, going forward. One creditor country moving alone could only provide temporary support to the debtor country and others were needed to fundamentally change the debtor country's situation. Additionally, for bilateral governments, debt cancellation could imply a high cost. To coordinate, **political agreement** was key, but probably also the most difficult to achieve.

Currently, **several regions are exploring different types of debt swaps. These can learn from AFD's experience, including on the need for greater creditor coordination, as well as from each other.** Mr. Saleh Kharabsheh, *former Minister of Energy and Mineral Resources, former Minister of Environment, Jordan; Member, Advisory Board, ESCWA Climate/SDGs Debt Swap Initiative*, talked about the specific needs of the Arab countries, most of whose public debt to GDP ratio remains high, with some allocating about 30% of their annual budget to debt service. He explained **ESCWA's recent proposal** of a **Climate/SDGs Debt Swap Initiative** aimed at supporting Member States that are facing high debt burdens and need additional financing for the SDGs and climate action. In this proposal, debtors are responsible to develop a clear spending plan (as also stressed by other speakers), including a monitoring and evaluation framework. While initial discussions are being held between one debtor and one creditor country, the aim is to involve more debtor and creditor countries and MDBs and private creditors.

In the Asia-Pacific region, vulnerability of highly indebted Pacific small island developing States (SIDS) to climate risks is especially high. To address this, the Pacific Island Forum has proposed to set up a **Pacific Resilience Facility** with the purpose of providing small grants for community level disaster risk reduction projects. Mr. Alberto Isgut, *Officer in Charge, a.i., Financing for Development Section, Macroeconomic Policy and Financing for Development, UN ESCAP*, described how the United Nations Economic and Social Commission for Asia and the Pacific (UN ESCAP) is supporting the Forum's secretariat on a feasibility study on debt swaps as a possible funding mechanism. He also identified **creditors' willingness to forgive debt as a major challenge**. However, for the Pacific SIDS, the process might be slightly simplified as most of their debt is with a relatively smaller group of official creditors.

The United Nations Economic Commission for Latin America and the Caribbean (UN ECLAC) has proposed the creation of a **Caribbean Resilience Fund**, which would include opportunities for financing debt reduction through debt swap initiatives. Mr. McLean explained the idea to set it up as a segregated resilience trust fund with three windows: green growth; liquidity, solvency and debt reduction; and climate resilience building. This could also make the use of the funds more tailored. UN ECLAC has been pursuing a debt for climate adaptation swap, commencing in a few pilot countries: Antigua and Barbuda, St. Lucia and St. Vincent and the Grenadines.

In addition to debt swaps, speakers also touched on **state-contingent debt instruments**. Mr. Melonio discussed **countercyclical loans** offered by AFD. While donors typically grant a grace period of up to 10 years, in this case, the grace period is reduced to 5 years, in return for giving countries the option to retain a grace year in case of macroeconomic difficulties. Country examples where this has been done are Senegal, Tanzania, Congo, and Mozambique. In each case,

ex-ante triggers were defined that would determine the delivery of a grace year. One example for such an ex-ante trigger would be a decline in the international price for cotton for cotton-exporting countries. Mr. McLean also stressed that **hurricane or disaster-linked clauses** in debt restructuring initiatives, as done in Grenada, would be key moving forward. As with the case of debt swaps, Mr. Melonio called for coordination amongst creditors on financial tools that have such a prevention effect, which could be a lesson for regional initiatives to consider.

The event was a further step in strengthening the international and regional discourse on debt relief, especially in relation to climate change and preparedness and the upcoming COP26. Discussions will continue in the context of Cluster IV as well as in other settings in efforts to find and operationalize solutions to the challenges that have been discussed.