



Financing for Sustainable Development Report 2021

Inter-agency Task Force on Financing for Development



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The online annex of the Task Force (<http://developmentfinance.un.org>) provides additional data and analysis on progress in implementation of the Financing for Development outcomes, including the Addis Ababa Action Agenda and relevant means of implementation targets of the Sustainable Development Goals.

Inquiries about the Task Force or its report and online annex can be sent to:

Financing for Sustainable Development Office
Department of Economic and Social Affairs
2 United Nations Plaza (DC2-2170)
New York, N.Y. 10017
United States of America
+1-212-963-4598

developmentfinance@un.org

<http://developmentfinance.un.org>



Federal Ministry
for Economic Cooperation
and Development

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Debt and debt sustainability



Chapter III.E



Debt and debt sustainability

1. Key messages and recommendations

Debt levels are rising across developing and developed countries, as economies contract and fiscal deficits widen, under the impact of the COVID-19 pandemic.

Global public debt is projected to approach 100 per cent of gross domestic product (GDP) in 2020, up from 65 per cent in 2008. The increase in public debt is more pronounced for developed countries, as developing and least developed countries were more financially constrained in their response to the pandemic and recession. Nonetheless, debt sustainability indicators worsened across the board. Five sovereigns defaulted in 2020. A third of emerging market economies are assessed to be at high risk of fiscal crisis, and over half of least developed and other low-income countries are assessed to be at high risk of, or already in, debt distress.

International support helped prevent a more wide-spread and systemic crisis in 2020. Actions by central banks across income groups helped ease financing conditions and reduced stress in debt markets for middle-income countries. Least developed and other low-income countries relied on emergency financing from the International Monetary Fund (IMF) and multilateral development banks. The Debt Service Suspension Initiative (DSSI), available to 73 least developed and low-income countries, allowed participating countries to redirect limited resources from debt service to crisis response.

Nonetheless, risks remain elevated. More developing countries may face worsening solvency concerns requiring fiscal adjustments, that would be challenging in the context of COVID-19. Debt sustainability in many cases hinges on fiscal adjustment, that would be hard to achieve in the current crisis context. Some countries' debt may become unsustainable, particularly if the impact of the COVID-19 shock is more protracted. Even where debt remains sustainable, pandemic related scarring effects could be exacerbated without access to fresh finance, if authorities are forced to withdraw fiscal support prematurely and deprioritize investment.

For countries where debt remains sustainable despite rising vulnerabilities, debt crisis prevention is a priority.

This includes enhancing debt transparency by both debtors and creditors, enhancing fiscal sustainability and strengthening debt management capacity. The international community is assisting members in these areas, including through the World Bank and IMF Debt Management Facility, which coordinates closely with many other debt management technical assistance providers, and the Debt Management and Financial Analysis System programme of the United Nations Conference on Trade and Development (UNCTAD) in the area of debt management. The IMF and World Bank's Multipronged Approach addresses debt vulnerability through improved transparency, debt management capacity, analytical tools, and international financial institutions' debt policies.

- Borrowers should regularly disclose comprehensive and timely information of public and publicly guaranteed debt, including borrowing terms and collateral conditions.
- Creditors should also ensure that lending practices are fully in line with sustainable, responsible, and transparent financing practices and disclose the amounts and terms of financing provided.

A range of instruments and tools exists to create fiscal space for investments in pandemic response and recovery, and to reduce the likelihood of future crises.

Greater use of state-contingent debt instruments could provide automatic and fast relief for future shocks, and ensure faster and more durable restructurings (e.g., in case of climate-related disasters or other shocks).

- The international community could further develop standard terms for inclusion in sovereign debt contracts, and official bilateral creditors could systematically include such clauses in their own lending, building on existing experiences.
- In addition, debt swap initiatives have been or are being launched in several regions, and could be further expanded.

The current crisis provides an opportunity to further strengthen the international debt architecture to allow speedy and efficient restructuring. The debt resolution architecture has proven generally effective in addressing most recent restructuring episodes, which primarily involved private sector holdings of sovereign bonds. Yet, the architecture should be strengthened to cope with the potential increase in restructurings in the aftermath of the pandemic, and amid a changing creditor landscape. A range of actions can be considered.

- Collective action clauses and equivalent terms should be included in all bond and nonbond debt contracts to reduce holdout risks. Debt restructuring would also be facilitated by greater transparency of contract terms.
- Credit enhancements and debt buy-backs could be considered in specific circumstances to incentivize creditor participation without reducing relief for the debtor.

Market-based solutions may not be sufficient in case of a systemic crisis. Statutory instruments may be needed.

- As a last resort, in the context of systemic crisis, legal options in major financial jurisdictions should be considered to limit litigative action by hold-out creditors; any such legislation would need to be carefully tailored to limit the impact on creditors' rights and avoid undermining the secondary market in sovereign debt.
- The international community could provide additional financial and technical support for countries with limited legal capacities (e.g., by strengthening support to existing facilities such as the African Legal Support Facility).

The recently adopted G20 Common Framework for debt treatments beyond DSSI is a step on the road to improving the international debt architecture. The Common Framework brings together Paris Club and Group of 20 (G20) non-Paris Club creditors and requires that participating debtor countries seek a treatment at least as favourable as the one agreed under the Framework from other official bilateral and private creditors. It could serve as a first step towards a more universal and possibly permanent framework for efficient sovereign debt resolution.

- The United Nations continues to provide a valuable platform for considering and advancing such proposals, and to bring all relevant stakeholders together to consider debt crisis prevention and fair and effective debt crisis resolution as a necessary condition for achieving the Sustainable Development Goals (SDGs).

2. Debt trends and vulnerabilities

2.1 The COVID-19 shock and trends in global debt

Fiscal support to mitigate the impacts of COVID-19 has pushed public debt levels that were already elevated before the pandemic to record highs. The pandemic unleashed a compound shock of shrinking economies, falling revenues and rising expenditures, pushing debt up across all income groups. Unprecedented fiscal actions, amounting to about \$16 trillion globally, in combination with falling revenues due to the fiscal shock, are expected to push public debt to 98 per cent of global GDP—up 14 percentage points over end-2019.¹ In total, non-financial sector debt (sovereigns, households and non-financial corporates) was expected to reach \$210 trillion, or 274 per cent of GDP, by end-2020—up

\$16 trillion over the last 12 months, with public debt accounting for almost two thirds of the overall increase.²

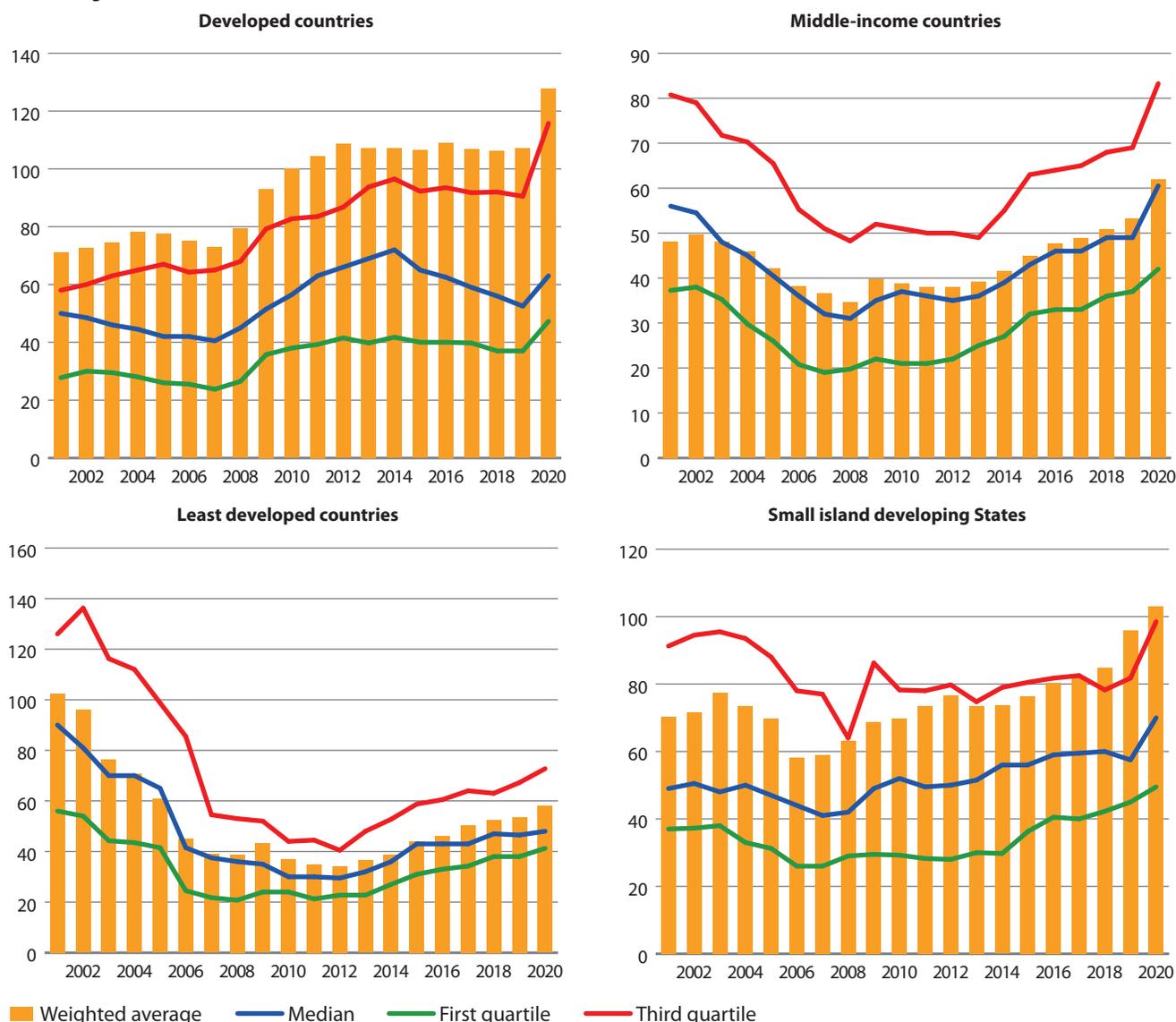
The increase in public debt is more pronounced for developed countries, followed by middle-income and least developed and other low-income countries. Public debt in developed countries is projected to increase by 20 percentage points compared to 2019, reflecting their very strong fiscal response to the crisis. Middle-income countries are also projected to continue expanding their borrowing, pushing public debt up by 9 percentage points to 62 per cent of GDP. For least developed and other low-income countries, the increase is more moderate (figure III.E.1), reflecting limited fiscal space and financing capacity. Despite emergency support, these countries' limited market access has constrained their COVID-19 response: least developed countries (LDCs) have increased their fiscal support by only 2.6 per cent of GDP, compared to significantly larger stimulus in developed countries (see chapter I).

Growing debt service in developing countries is diverting public expenditure and foreign currency from the COVID-19 response and recovery, and from investments in the SDGs. Debt service will exceed 25 per cent of tax revenue in over half of developing countries for which data is available in 2020, and exceed 40 per cent of tax revenue in a quarter of them. In small island developing States (SIDS), median debt service represents 30 per cent of revenue (figure III.E.2). In part, this reflects the changing composition of debt and developing countries' growing reliance on commercial debt. In LDCs, commercial debt accounts for 17 per cent of external debt, up from 12 per cent a decade ago, and for more than one third of debt servicing costs (see previous editions of the Financing for Sustainable Development Report (FSDR) and figure III.E.3). In part, it also reflects the growing divergence of interest rates, and the rising relative cost of borrowing in developing countries. While median effective interest rates fell in developed countries over the last decade, they increased in developing countries.³ This dichotomy has worsened since the start of the crisis.

2.2 Financial vulnerabilities had been rising in developing countries prior to the pandemic

Many developing countries entered 2020 in a vulnerable position, with public and external debt already at elevated levels. Public and external debt levels of developing countries were already elevated on the eve of the COVID-19 outbreak (see previous editions of the FSDR), with developing countries spending 14.6 per cent of their export revenues to meet external debt obligations in 2019, at almost twice the level of a decade earlier. In a post-2008 environment marked by extensive monetary accommodation and near-zero interest rates in developed countries, global financial investors' search for yield led them to increasingly invest in "frontier economy" sovereign bonds issued in international debt markets. Many LDCs and low-income countries who had not been able to access capital markets before were now able to borrow on international financial markets. In sub-Saharan Africa alone, 21 countries had outstanding obligations on sovereign Eurobonds to the equivalent of \$115 billion at the beginning of 2020, following a steep increase in their issuance since 2017. The rise in external indebtedness was not matched by sufficiently strong GDP growth in developing countries, with average external debt-to-GDP ratios rising from 26.5 per cent in 2009 to 33.1 per cent in 2019. Median debt was significantly larger still, at 39 per cent of GDP, owing in part to the modest external debt-to-GDP ratio of China.⁴

Figure III.E.1
Public debt across income groups, 2001–2020
(Percentage of GDP)



Source: UN DESA calculations, based on IMF WEO.

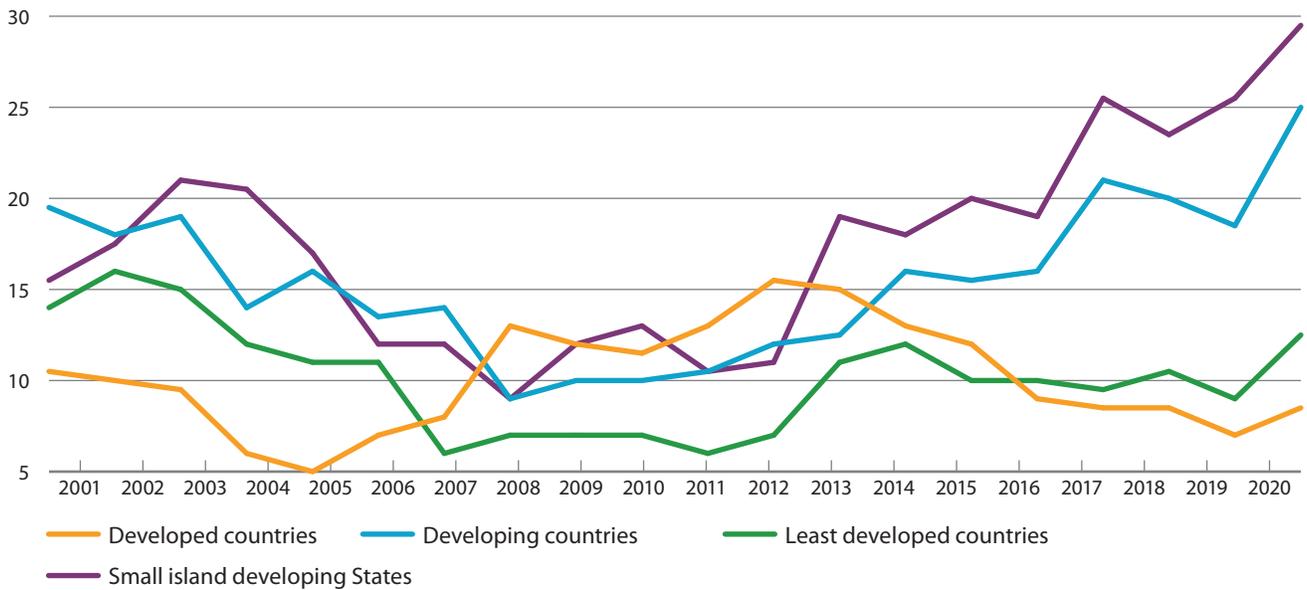
The increased reliance in commercial borrowing, in the context of a relative decline in official development assistance and other forms of official finance, contributed to growing financial vulnerabilities in some countries, including risks of sudden stops. While funding from international and domestic capital markets allowed countries to finance new investments, it also raised refinancing and rollover risks (see FSDR 2020). Volatility of flows was exacerbated by the growth of passively managed, benchmark-driven financial investment strategies, and the inclusion of frontier economies in flagship benchmark indices.⁵ Such investment strategies are highly sensitive to shifts in global financial conditions, with the resulting capital flows amplifying adverse financial conditions. Their influence is not limited to passive fund management, since “active” funds aim to outperform passive investment strategies. By

some estimates, 70 per cent of emerging market country allocations of investment funds are influenced by benchmark indices.⁶

2.3 Responding to the COVID-19 shock

Debt issuance by emerging markets maintained its upward trend despite the pandemic, benefiting from accommodative monetary policies by major central banks; but economies with lower credit ratings or weak fundamentals—many least developed and other low-income countries among them—saw their access curtailed by rising costs (figure III.E.4 and figure III.E.5, panel 1). Five countries that are eligible for the G20 Debt Service Suspension Initiative issued Eurobonds post-COVID-19 (Benin, Côte d’Ivoire, Honduras, Mongolia and

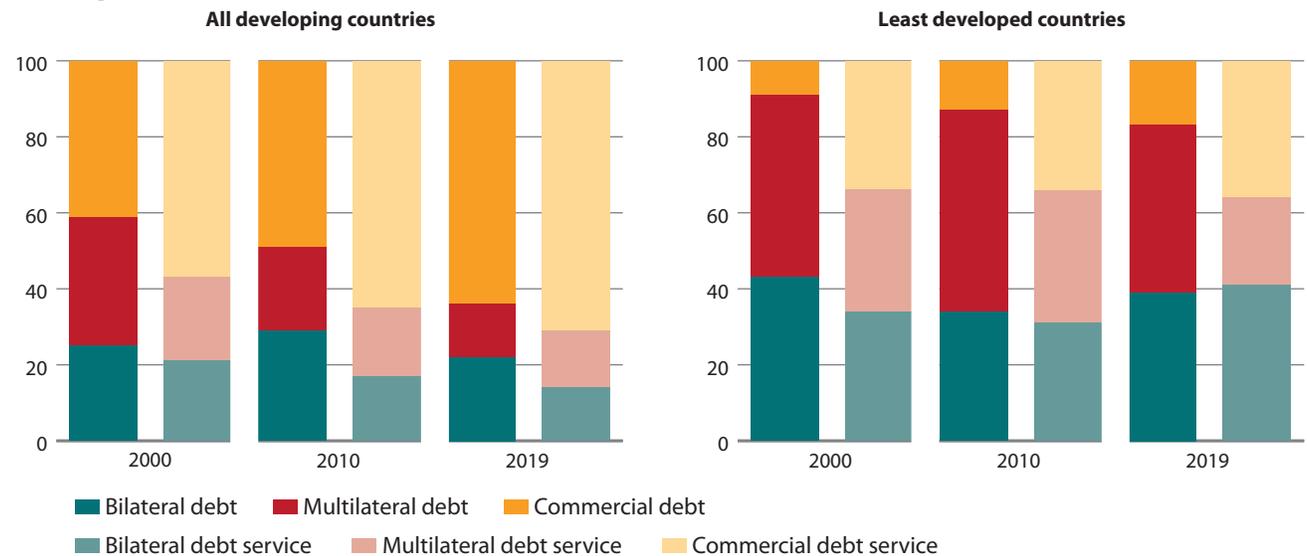
Figure III.E.2
Debt service as a share of revenue, median, selected countries
 (Percentage)



Source: UN DESA, based on IMF data.

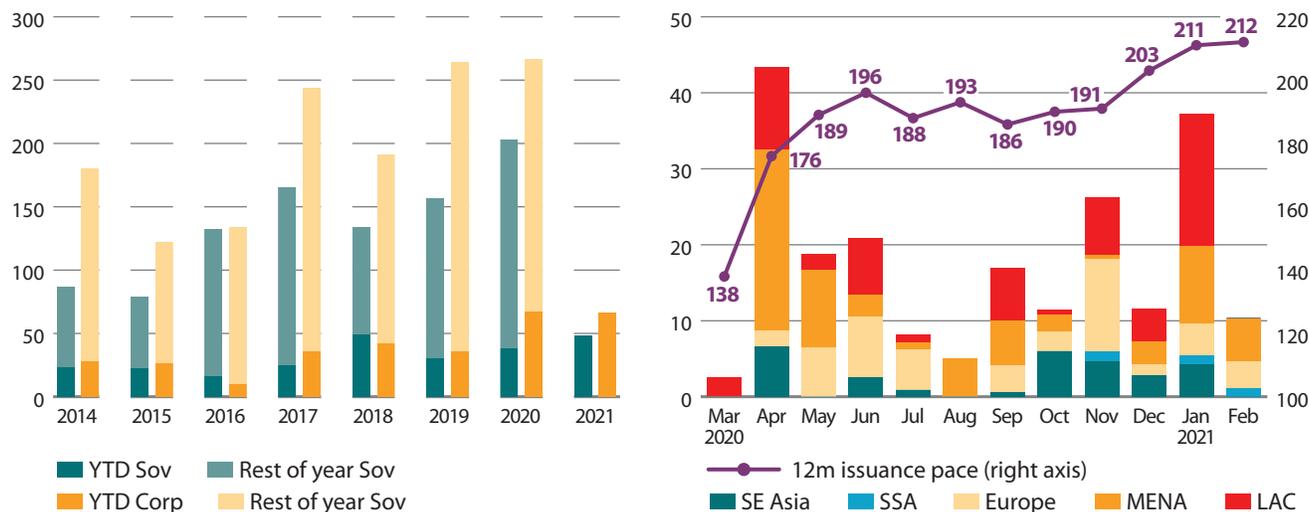
Note: Selected countries for which data was available (including 8 developed countries, 57 developing countries, 20 LDCs, and 18 SIDS; details available upon request).

Figure III.E.3
Composition of external debt stock and debt service
 (Percentage)



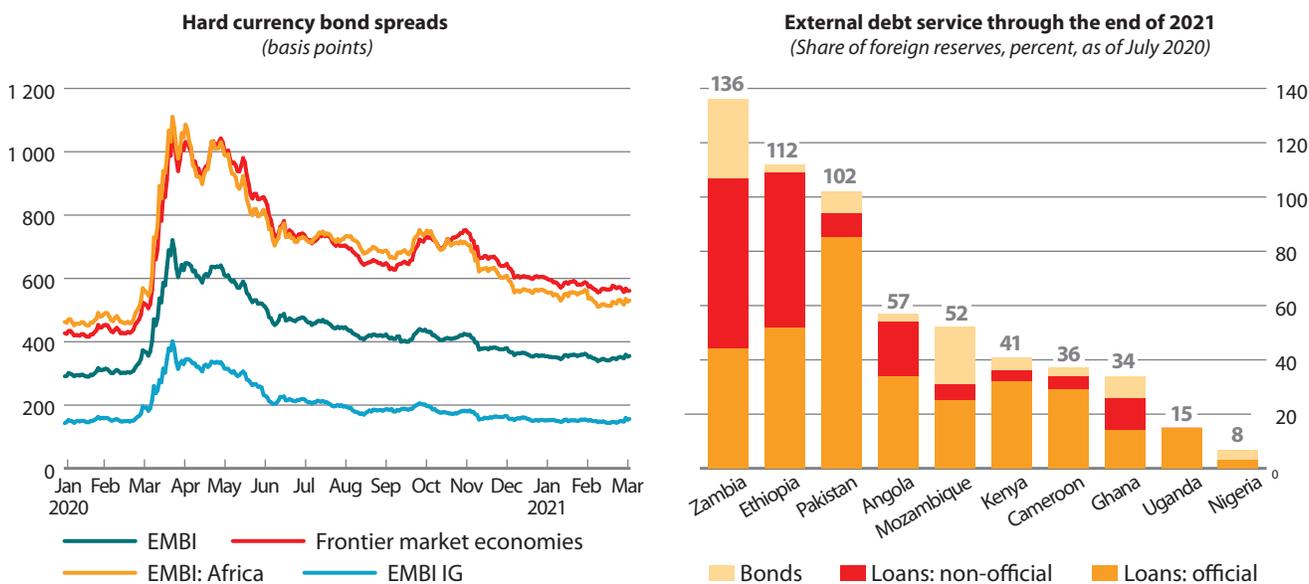
Source: UN DESA, based on World Bank World Development Indicators.

Figure III.E.4
Emerging markets bond issuance continued apace despite the pandemic
 (Percentage)



Source: Bloomberg, Bond Radar.

Figure III.E.5
Emerging market and frontier economy spreads and refinancing needs



Source: Bloomberg, Bond Radar.

Uzbekistan), several were able to borrow in the syndicated loan market, albeit in smaller amounts. Middle-income-country issuers continued to tap the international capital markets in 2020 (Albania (B+), Belarus (B), Jordan (B+), El Salvador (B-), Ukraine (B), etc.).

Least developed and other low-income countries in particular face significant external financing pressures. Developing countries face significant external debt repayments on their public and publicly guaranteed external debt over the coming years. Some of the African countries and LDCs with very high refinancing needs in 2021 (figure III.E.5, panel 2) will not have access to financial markets at affordable rates. At the same time, many of them have seen their access to foreign currency curtailed through multiple channels, including non-resident capital flight, contractions in trade, remittances, and investment volumes. As a result, external financing needs of LDCs and other low-income countries are projected to have more than doubled compared to recent historic averages in 2020. Although the pressure should moderate somewhat in 2021, external financing needs are expected to remain elevated.⁷ LDC and other low-income country foreign exchange reserves are projected to fall by about \$22.5 billion collectively in 2020, leaving half of these countries with less than 2 years of coverage for external financing needs, and some with less than a full year of coverage. After receiving emergency financing in the first half of 2020 from the IMF, and increased lending by multilateral development banks (MDBs), many LDCs and other low-income and countries will continue to rely on international support, or else face liquidity challenges (see chapter III.F.) or unsustainable debt situations.

2.4 Debt sustainability and risk reassessed in the pandemic context

The rapid growth of debt levels and financing needs has exacerbated debt sustainability risks across the globe. Among the 151 economies covered by the three major rating agencies, 42 have experienced downgrades since the pandemic, including 6 developed countries, 27 emerging market economies, and 9 low-income and least developed countries. More than one third of emerging market economies (31 out of 84) are at high risk of fiscal crisis,⁸ according to a new IMF methodology for assessing the risk of a fiscal crisis using machine learning (figure III.E.6).⁹

Least developed and other low-income countries' debt vulnerabilities further worsened during 2020. Just over half (56 per cent) of low-income and least developed countries that use the IMF World Bank Debt Sustainability Framework (LIC-DSF) are now assessed at a high risk of debt distress or in debt distress—a modest increase compared to end-2019 when the share was 51 per cent (figure III.E.7). Since the onset of COVID-19, LIC-DSF debt distress ratings were downgraded for six countries (Guinea-Bissau, Kenya, Madagascar, Papua New Guinea, Rwanda and Zambia), while two were upgraded (Gambia¹⁰ and South Sudan) (table III.E.1). The downgrades largely relate to the worsened macroeconomic outlook amid the pandemic. Zambia recently defaulted on its commercial debt, having been hit hard by the impact of the pandemic, exacerbating an already difficult economic situation.

So far, rising debt levels and downgrades of credit and risk ratings have been associated with a limited number of cases of evident debt distress. Three middle-income countries were in debt restructuring/distress at the outset of the pandemic (Argentina, Lebanon and Venezuela),

and one initiated a restructuring soon after its onset (Ecuador). The number of least developed and other low-income countries in debt distress fell to 9 from 10, with Gambia and South Sudan leaving the list and Zambia joining it. In both Ecuador and Zambia, substantial preexisting vulnerabilities were exacerbated by the COVID-19 shock. Actions by monetary authorities in advanced countries, which supported historically low interest rates, and favourable market financing conditions for middle-income countries, along with international support measures for low-income and least developed countries, helped forestall more widespread defaults.

3. Responding to the crisis

Liquidity support helped countries weather the immediate impact of the crisis, but additional measures may be needed to address rising solvency risks. Initial measures included monetary easing, access to fresh concessional financing, suspended debt payments on bilateral debt service, and targeted but limited relief on some multilateral debt.

3.1 Monetary policy

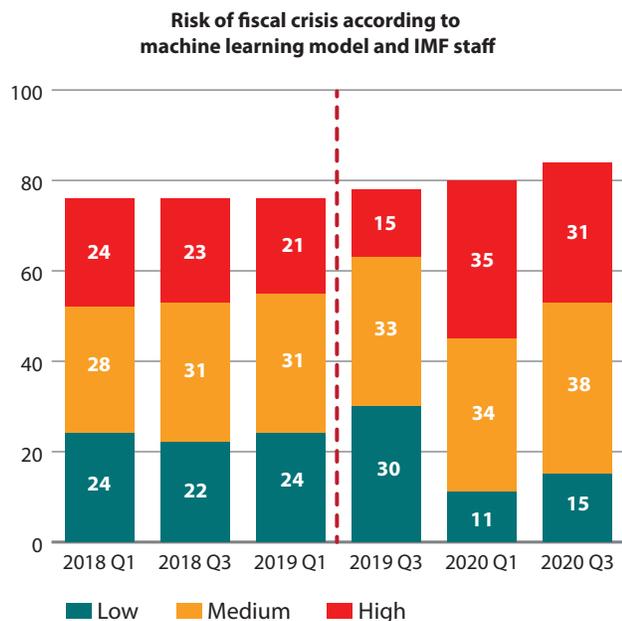
Monetary authorities across the world cut policy rates, undertook asset purchases, macroprudential and other easing measures, bringing borrowing cost to historical lows and increasing liquidity. Ninety per cent of central banks lowered interest rates, some to historic lows.¹¹ The Group of 10 central banks expanded their balance sheets by \$7.5 trillion, easing liquidity and stabilizing debt markets for both developed and some middle-income countries, and about 20 emerging market economy central banks launched asset purchase programmes (APPs) for the first time (see also chapter I).¹² Monetary easing and liquidity support was also beneficial to countries cut-off from bond markets: it prevented disruption to trade credit and syndicated loan markets and helped mitigate the shock on global liquidity and the world economy.

3.2 Support by international financial institutions

In response to the pandemic, the IMF provided over \$100 billion in financing to over 80 member countries. As of end-November 2020, \$11.8 billion went to 50 low-income countries, while \$90.4 billion has been made available for emerging market economies. The countries requesting emergency financing committed to supporting priority and COVID-19-related spending, including for the health response and social and economic support (see chapter III.F).

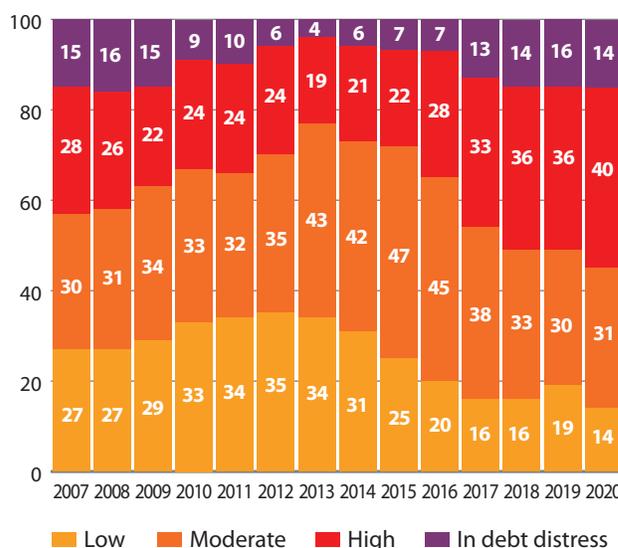
In March 2020, the IMF adapted the Catastrophe Containment and Relief Trust (CCRT) to provide debt service relief for its poorest and most vulnerable members for up to two years. To date, all 29 CCRT-eligible members have received grants covering one full year of debt service payments to the IMF through April 2021, totaling about \$500 million. The second year of debt service relief is estimated at about \$463 million, but further relief will require donors to commit additional resources. CCRT-eligible countries have used the freed-up resources to support priority and COVID-19-related public spending, including on health. IMF staff estimates that average 2020 expenditures on health and social protection in CCRT beneficiary countries will increase by about 0.5 percentage points of GDP compared to the pre-COVID 2020 baseline projections.

Figure III.E.6
Debt vulnerabilities in emerging economies
(Percentage)



Source: IMF.
Note: Red dashed line denotes methodological break (adoption of machine learning model as basis for IMF staff judgment). High/moderate/low risk refer to countries with risks above the 80th percentile, between the 50th and 80th percentile, and below the 50th percentiles of all model-based ratings based on data for the last 15 years.

Figure III.E.7
Evolution of the Risk of Debt Distress of Lower Income Countries covered by the World Bank, IMF DSF
(Percentage)



Source: IMF-World Bank LIC DSF database.
Note: As of November 17, 2020.

Table III.E.1
Upgrades and Downgrades in the IMF World Bank Debt Sustainability Framework since March 2020

	2018	2019	2020	2021*	Main reasons for a change in risk of debt distress
Downgrades					
Kenya	M		H		May 2020 A worsening in economic outlook due to the pandemic.
Zambia		H	D		May 2020 Entered into restructuring negotiations.
Rwanda	L	L	M		June 2020 A worsening in economic outlook due to the pandemic and updates on investment program.
Papua New Guinea	M		H		June 2020 A worsening in economic outlook due to the pandemic.
Madagascar	M	L	M		July 2020 A worsening in economic outlook due to the pandemic.
Guinea-Bissau	M			H	January 2021 A worsening in economic outlook due to the pandemic and better debt coverage, borrowing for infrastructure projects, higher fiscal deficits in 2018–19.
Upgrades					
Gambia	D	D	H		March 2020
South Sudan		D	H		November 2020

Source: Low-income countries debt sustainability assessments.
Note: D: in debt distress (orange), H: high (red), M: moderate (yellow), L: low (green). Blank years reflect the rating assigned in the latest DSA available at that time.
* As of 19 February 2021.

Box III.E.1

A regional perspective: fiscal implications of COVID-19 and rebuilding better in Asia-Pacific

In 2020, Asia-Pacific developing countries announced an estimated \$1.8 trillion, or 7 per cent of their GDP, for COVID-19 health response and relief measures for households and firms. However, countries that entered the crisis with limited fiscal space—including least developed countries (LDCs), small island developing States and countries at high risk of debt distress—relied on smaller fiscal support packages, at the risk of delaying the recovery.

The International Monetary Fund and multilateral development banks committed \$38 billion to assist Asia-Pacific developing countries in combating the pandemic (figure III.E.1.1). Such support was greater than 1 per cent of gross domestic product (GDP) in 22 out of 37 recipient countries and on a par or exceeding the government COVID-19 fiscal package in 8 countries. However, support was predominantly in the form of loans, with grants and debt relief accounting for less than 4 per cent of total support. Moreover, given that many countries need to continue servicing debt to these same multilateral lenders, net inflows are substantially smaller, as shown here for LDCs in the Asia-Pacific region.

Policy options for recovery

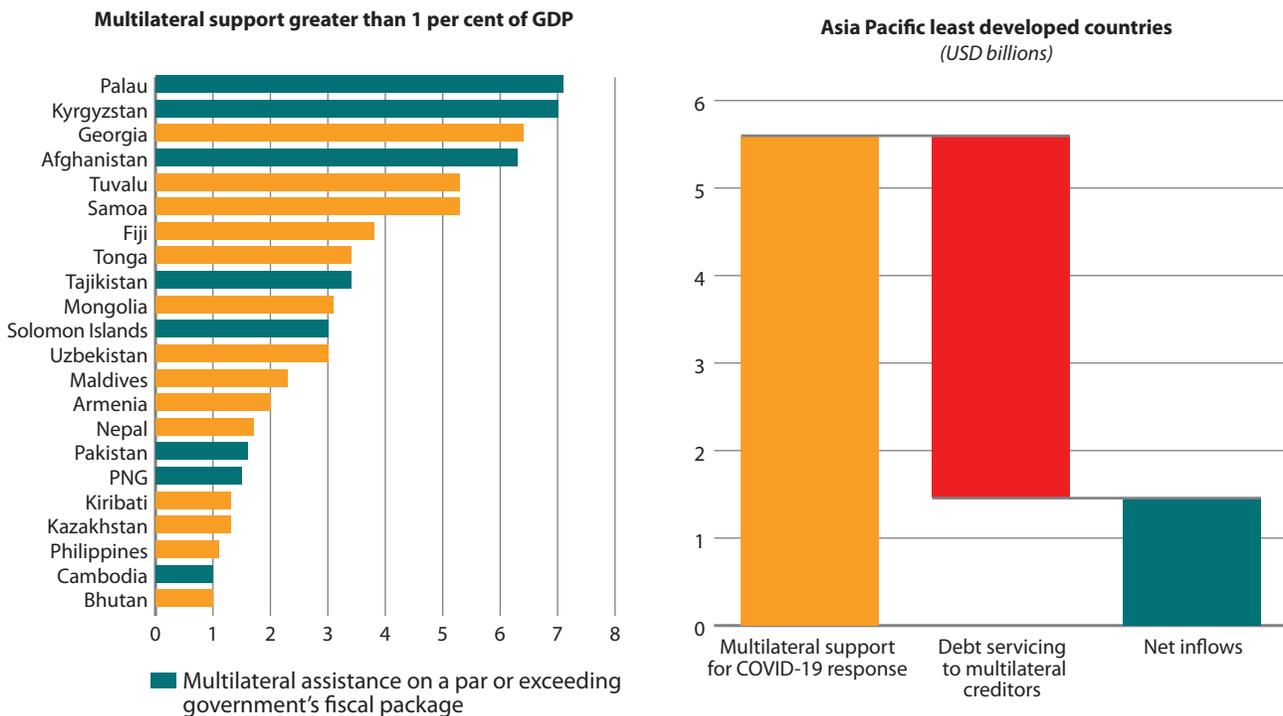
Policymakers will have less room to maneuver going forward. However, abrupt fiscal consolidation in 2021 could be self-defeating, as seen in

the post-2009 European debt crisis as well as the 1997 Asian financial crisis, when fiscal and monetary tightening led to a deeper recession. Instead, investing in Sustainable Development Goal (SDG) priorities could reap a double dividend by enhancing a country’s resilience to future shocks as well as supporting economic recovery. In the Economic and Social Survey of Asia and the Pacific 2021, the Economic and Social Commission for Asia and the Pacific (ESCAP) proposes a “build forward better” recovery package with a focus on social services, digital access, and green development. Model simulations illustrate that such a package would deliver significant positive economic outcomes as well as social and environmental benefits. It would reduce the number of poor people in the Asia-Pacific region by almost 180 million people and cut carbon emissions by about 30 per cent in the long run. The package, which includes the elimination of fuel subsidies and introduction of a carbon tax, would likely push up the government debt-to-GDP ratio by 10 percentage points by 2030.

Nevertheless, the outlook is challenging. Combined with the impacts of COVID-19, the government debt-to-GDP ratio in Asia-Pacific developing countries is projected to rise steeply from 51 per cent in 2019 to about 74 per cent by 2030. The increase is steeper still for the region’s LDCs. The ESCAP Survey therefore recommends a range of policy options that are implementable given countries’ institutional capacity, along with closer engagement with international development partners and the private sector.

Source: UN ESCAP.

Figure III.E.1.1
Multilateral support committed



Source: UN ESCAP

Multilateral development banks have pledged to scale up support to developing countries. MDBs collectively announced a total of over \$200 billion of support to developing countries. The World Bank Group expects to deploy up to \$160 billion between April 2020 and June 2021 and has provided \$4 billion in grant financing to low-income and least developed countries (see chapter III.C.). World Bank financing is usually provided on highly concessional financial terms or grants to low-income countries and loans at below-market pricing to middle-income countries. International development association (IDA) credits, which constitute a large share of IDA resources, are provided at low interest rates and with long grace periods and maturities. More than half of IDA19 active countries already receive all or half of their IDA resources on grant terms, which carry no payments at all. These significant amounts of grants are targeted to low-income countries at higher risk of debt distress. The grant share in IDA has been increasing over time in response to increased debt vulnerabilities in client countries, since the Grant Allocation Framework (based on the joint IMF-World Bank Debt Sustainability Assessment) uses a forward-looking methodology. For countries that borrow on regular IDA terms, the six-year grace period means that debt service on new borrowing to address the COVID-19 crisis will not commence until the country has had a chance to recover.

3.3 Debt Service Suspension Initiative

In April 2020, G20 Finance Ministers endorsed the Debt Service Suspension Initiative to bolster crisis mitigation in low-income and least developed countries. By suspending debt service payments to official bilateral creditors for a limited period (initially from May to December 2020, now extended until end-June 2021, with the possibility of a further six-month extension), the DSSI temporarily frees up resources for eligible countries (all active IDA countries and LDCs). The first phase of DSSI benefited 43 out of 73 eligible countries with debt service suspension to official bilateral creditors of \$4.9 billion (75 per cent of eligible payments).

Participating countries made commitments on monitoring fiscal impacts, transparency of public debt, and compliance with IMF and World Bank policies on debt limits. Fiscal monitoring supported by the IMF and the World Bank suggests that DSSI relief (totaling 0.4 per cent of GDP) has contributed—together with IMF/World Bank lending—to COVID-19-related spending averaging just over 2 per cent of GDP in DSSI participants, notwithstanding major revenue losses. Under the DSSI, debtor countries also commit to disclosing public debt to IMF and World Bank Group staff; the World Bank has published detailed data on external public debt and potential debt service suspension amounts from the DSSI, facilitating data sharing and coordination among creditors. Participants under the DSSI also commit to prudent borrowing: new non-concessional debt is undertaken only if such borrowing is in compliance with limits agreed under the IMF Debt Limit Policy (DLP) or the World Bank Sustainable Development Financing Policy (SDFP) (see also *FSDR 2020*).

The financing impact of the DSSI would have been stronger if not for the lack of private sector participation, and the exclusion of some vulnerable and highly indebted countries. Participating countries were not obligated to seek comparable treatment from their private creditors, even in countries where commercial debt accounts for about one fifth of external debt. This was due to concerns that such an obligation

would deter countries concerned about potential adverse impacts on their creditworthiness from participating. While private sector creditors were encouraged to participate in the DSSI, very few countries elected to make DSSI requests to private creditors; with the exception of a national policy bank participating as a commercial creditor, no private creditors participated on a voluntary basis. DSSI eligibility criteria also exclude a number of developing countries in need—for example, non-IDA-eligible small island developing States that are highly vulnerable and have high debt service burdens. There were calls from the beginning of the DSSI to not only expand the time frame (which has since been done) but also to broaden the scope of beneficiary countries.

4. Additional proposals to address the immediate crisis

Despite international support, solvency concerns are rising in 2021, threatening to deepen development setbacks and undermine recovery from the pandemic. Risks are high for more countries to tip into unsustainable debt, especially if the COVID-19 shock is more protracted and deeper than envisaged in macroeconomic frameworks, underlying the debt sustainability assessments. High debt service repayments already facing many developing-country Governments in 2021 and beyond, and the wider adverse macroeconomic impacts of the COVID-19 crisis, make decisive action to widen the scope of existing initiatives imperative.¹³

A range of proposals have been made, including in discussions at the United Nations, to prevent a spiraling of sovereign debt crises that would undermine not just pandemic response and recovery, but also SDG achievement. Discussions in the follow-up to the High-level Event on Financing for Development in the context of COVID-19 have brought to the fore a wide range of proposals to address both liquidity challenges and the immediate debt crisis, and more medium-term proposals and structural changes, including to advance reform of the sovereign debt architecture (box III.E.2). The remainder of the chapter will look at progress in these areas, with section 4 focusing on proposals to provide immediate relief that do not require changes in the debt architecture, and section 5 focused on forward-looking, medium-term and architectural issues.

4.1 Moving beyond liquidity support: targeted debt relief

A menu of instruments and tools exist to address solvency concerns in highly indebted countries. Debt standstills and new concessional emergency loans can help address liquidity crises arising from temporary balance-of-payment problems in the wake of the COVID-19 crisis. As the impact of COVID-19 becomes clearer, the focus is shifting from providing liquidity support to addressing solvency concerns and debt situations of those countries that face unsustainable debt situations. Adoption of the Common Framework for Debt Treatment Beyond DSSI by the G20 and the Paris Club last November reflects this recognition (see section 5 below). There are several other mechanisms that could be used to give countries relief in the short run. Depending on countries'

specific circumstances and debt profiles, debt swaps, debt exchanges and reprofiling, and debt buybacks can be considered:

- **Debt swap initiatives have been, or are being launched in several regions, and could be further expanded.** Under the Economic Commission for Latin America and the Caribbean's Debt for Climate Adaptation Swap initiative for the Caribbean, three pilot countries—Antigua and Barbuda, Saint Lucia, and Saint Vincent and the Grenadines—are ready to initiate negotiations with creditors for debt swaps under this programme.¹⁴ More recently, the Economic and Social Commission for Western Asia launched a Climate/SDGs Debt Swap Initiative to establish a Debt Swap Mechanism for Member States in the Western Asia region. Such initiatives have the potential to overcome

high transaction and monitoring costs of project-based debt swaps, by standardizing terms and linking to existing cooperation frameworks and their monitoring;¹⁵

- **To address commercial debt, debt buy-backs have been proposed.** Similar to the Debt Reduction Facility (DRF) accompanying the Heavily Indebted Poor Country Initiative (HIPC), commercial debt trading at a discount would be bought at market prices, thus providing relief to the debtor without restructuring. Debt buy-backs are thus similar to the market-based swap discussed above, but have no conditionalities for the use of proceeds. However, such a mechanism would be appropriate only if debt is trading at a steep discount. Because buy-backs increase secondary market prices, strict criteria for eligibility, including price

Box III.E.2

Debt vulnerability discussions at the high-level events on Financing for Development in the Era of COVID-19 and Beyond*

In the follow-up to the High-level Event on Financing for Development in the Era of COVID-19 and Beyond, two discussion groups composed of States Members of the United Nations and various international institutions developed a menu of policy options^a to address financing challenges in the area of sovereign debt: one group on debt vulnerability and one focusing on private sector creditors engagement (see box 1 in the Introduction of *Financing for Sustainable Development Report 2020* for more details on this process). A range of policy options that were not negotiated or endorsed by the international community or members of the Inter-Agency Task Force on Financing for Development were organized into three broad areas:

- Debt standstills and alternatives to provide liquidity**, to extend and expand the Debt Service Suspension Initiative, in terms of eligibility (e.g., on the basis of vulnerability to exogenous shocks rather than standard per capita income criteria), time frame (to at least the end of 2021), and creditor participation (e.g., through a voluntary credit facility, see also below);
- Provision of debt relief in the short term**, to allow countries to immediately address the fallout from the pandemic, consider debt cancellations, exchanges, swaps or buy-backs;
- Improvements in the international sovereign debt architecture**, to prevent future crises (e.g., through improved transparency, greater use of state-contingent debt instruments) and improve crisis resolution (e.g., through improvements to market-based approaches, legislative strategies, or multilateral approaches such as a Sovereign Debt Forum or Sovereign Debt Authority).

Proposals on debt standstills

One proposal to enhance private sector creditor participation in standstills is the establishment of a central credit facility (CCF)^b at financial institutions with preferred creditor status. Countries requesting assistance from private creditors in the form of temporary standstills would pay interest payments coming due during the standstill period into the CCF to fund crisis response and later on to repay creditors. In exchange

for releasing the debtor from its obligations to the private creditor, the relevant amount would be credited to the creditors' account in the CCF. In addition to a guarantee of equal treatment, there would also be an international (seniority) backup to assurances of future full repayment of outstanding debt obligations.

It has also been suggested that debtor States could make use of the International Law Commission's Articles on the Responsibility of States for Internationally Wrongful Acts, and thus of customary international law, through two avenues: invocation of the necessity defence that excuses temporary non-performance on international obligations to address "a grave and imminent peril" (arguably including the servicing of commercial debt during a pandemic);^c or plea of distress with less taxing requirements or burden of proof to meet relevant criteria in a debtor country affected by a global pandemic.^d However, it is important to acknowledge that private sector standstills can trigger debt default, depending on the structure.

Proposals for the debt architecture

Proposals discussed included the establishment of a sovereign debt forum, which could provide a platform for discussions between creditors and debtors—particularly in the context of debt relief and its role in achieving the Sustainable Development Goals—and facilitate agreements on voluntary stays; or an international sovereign debt authority—constituted as an expert-based authority or standing body independent of creditor as well as debtor interests—that could coordinate and further develop many of the proposals discussed here.^e

Source: UN DESA.

^a Available at <https://www.un.org/en/coronavirus/financing-development>.

^b Bolton, P. et al. 2020. "Born out of necessity: A debt standstill for Covid-19." CEPR Policy Insight Nr. 103, April.

^c Weidemaier, Mark, and Mitu Gulati. 2020. "Necessity and the Covid-19 pandemic." *Capital Markets Law Journal*, Volume 15, Issue 3, July 2020.

^d Paddeu, F. and F. Jephcott. 2020. "Covid-19 and Defences in the Law of State Responsibility. Part II." *Blog of the European Journal of International Law*, 17 March.

^e UNCTAD (forthcoming). 2020. A modest proposal for an International Sovereign Debt Authority. *Trade and Development Report 2020*. Update, March.

* This box summarizes discussions at the high-level event on FfD, and presents some elements of the menu of options emerging from these discussions. These options were meant to provide a broad array of ideas, but there is no consensus on them, and they have not been endorsed by members of the Inter-Agency Task Force on Financing for Development or the international community.

caps, would be needed, and may impact scale of operations;

- **To address official debt, official creditors could also reprofile or exchange their debts, granting more concessional terms to vulnerable countries.** For example, official bilateral creditors could apply IDA-terms to their credits to least developed and other vulnerable countries, lengthening average maturities or lowering average interest costs. They could also systematically include relevant state-contingent elements—for terms of trade shocks, disasters (e.g., hurricane clauses), among others—to help countries better manage future shocks. A joint initiative and/or development of common term sheets could set standards and reduce the time for implementation;
- **Outright debt cancellations of official debt could be considered for the most vulnerable countries.** The IMF has provided relief to the 29 poorest developing countries through the donor-funded CCRT, providing grants that effectively cancel debt repayments through April 2021. With sufficient donor funding, these types of trust-funded multilateral initiatives could be expanded. Debt cancellation done bilaterally would partially count as official development assistance (ODA) under updated Development Assistance Committee rules (see chapter III.C). One proposal is to provide comprehensive debt relief on official debt in return for commitments in investments in health and social spending, and climate action, building on experiences of the HIPC Initiative / Multilateral Debt Relief Initiative (MDRI).¹⁶ Another proposal has been for use of ODA to reduce external debt burdens in vulnerable developing countries in exchange for commitments by beneficiary developing countries to use liberated funds for response and recovery investments in local currency, primarily in their health and social sectors.¹⁷ Any debt cancellation efforts of official debt also must address burden sharing across creditors, and inclusion of private creditors in particular. Such inclusion has proven difficult in the current architecture (see below).

5. Rebuilding better: sustainable debt and investing in recovery and the SDGs

The current crisis reflects the materializing of debt risks that have built up over several years. While the dramatic impact of the crisis requires an immediate response, there is also a need to address the underlying challenges, both at national levels and in the global architecture. Such challenges and efforts to address them relate to debt crisis prevention and debt crisis resolution.

5.1 Debt sustainability and the SDGs after COVID-19

The COVID-19 shock has dramatically worsened the baseline for debt sustainability and SDG investments. The fiscal outlook for developing countries is significantly more challenging than it was just 12 months ago. At the same time, the global pandemic and ensuing recession have also caused sustainable development setbacks across many SDG investment areas (see chapter I). Yet, even prior to COVID-19, the borrowing needed to finance the SDGs would have sharply increased interest burdens

and debt vulnerabilities (see FSDR 2020). Creating fiscal space for public investment in the SDGs, particularly in heavily indebted countries, has become an even greater challenge. This requires progress across the action areas of the Addis Ababa Action Agenda.

Taking into account medium- and long-term risks, liabilities and assets can help improve management of public balance sheets and support SDG achievement. As discussed in last year's report, how borrowed resources are used has implications for the ability to repay debt. Productive investments in the SDGs can generate future revenue and growth; while increasing debt ratios in the short run, they can lead to lower debt ratios over time and create a positive feedback loop. Balance sheet analysis (see chapter III.B) has several benefits. It can help Governments (i) link and improve management of public assets and liabilities, including by better matching maturity profiles of assets and liabilities; and (ii) more consistently consider medium- and long-term risks and contingent liabilities, such as pandemic risks and climate-related risks. Efficient long-term investments in the SDGs and in climate resilience may enhance long-term debt sustainability, even when the rise in debt could increase vulnerabilities. Longer-term balance sheet analysis could help countries design instruments that can reduce debt vulnerability risks while facilitating such investments.

Debt sustainability assessments are also increasingly incorporating such elements. For example, the IMF/World Bank low-income countries' debt sustainability framework (LIC-DSF) includes, since 2018, a "realism tool" to assess contributions of public investment on growth. Recent revisions to the debt sustainability assessment for market-access countries have introduced long-term assessment tools.

5.2. Debt crisis prevention

Debt management and debt transparency

Debt crisis prevention requires strengthening debt management and debt transparency. However, there are important gaps in the data on public debt in low-income and least developed countries that the international community is working to address. Few countries achieve the recommended data coverage of (i) the general government; (ii) government-guaranteed debt; and (iii) non-guaranteed debt of non-commercial public corporations.¹⁸ Data on the terms and conditions of loans are also often incomplete. Collateralized debt exposures have also come to light, alongside increased use of escrow accounts to stockpile debt service. These gaps hinder assessment of risks and can lead to debt surprises. Since the fall of 2018, the IMF and the World Bank have been implementing a Multipronged Approach to address debt vulnerabilities and improve debt management and transparency (box III.E.3); UNCTAD also provides support in the area of debt management (box III.E.4).

Responsible borrowing and lending

Multiple initiatives are under way to promote responsible borrowing and lending. Responsible borrowing and lending practices are critical for crisis prevention. Efforts to promote responsible borrowing and lending include dedicated policies by international financial institutions (IFIs), such as the IMF Debt Limits Policy, and the World Bank Sustainable Development Financing Policy. They also include "soft-law" approaches that promote good practices, enhance transparency, and promote cooperation

between debtors and creditors, such as the G20 Operational Guidelines for Sustainable Financing, the Institute of International Finance (IIF) Voluntary Principles for Debt Transparency (which the OECD has proposed that it

Box III.E.3

The International Monetary Fund and World Bank Multipronged Approach

Under the first pillar of the Multipronged Approach (MPA), the International Monetary Fund (IMF) and the World Bank are working to strengthen debt transparency by assisting borrowing countries, and by reaching out to creditors. For instance, the IMF is providing technical assistance to build borrower capacity to record, monitor, and report debt. The IMF and the World Bank provided analytical guidance to borrowers and creditors and are supporting the Group of 20 (G20) in enhancing debt transparency under the Debt Service Suspension Initiative.

The second MPA pillar supports capacity development in public debt management to avert and mitigate debt vulnerabilities, through diagnostic tools, training, and in-depth technical assistance on medium-term debt strategies and annual borrowing plans, risk management and other issues.

The third pillar seeks to provide suitable analytical tools to analyze debt developments and risks. The IMF and the World Bank have operationalized a new low-income-countries debt sustainability framework (LIC DSF) since July 2018, which recommends a broader coverage and reporting of public debt, including of contingent liabilities. It also contains new tools to gauge the realism of the debt baseline and macroeconomic projections, incorporating impacts of public investments. The market access country debt sustainability assessment (MAC DSA) is currently being updated to provide a more comprehensive and consistent coverage of debt-related risks; incorporate relevant country-specific factors; better capture uncertainty around baseline assumptions, including through tools to assess realism of assumed fiscal multipliers and potential growth rates; and provide more structure for the application of judgment in the assessment.^a The IMF applies this framework to 120 countries with significant market access.

Under the fourth pillar, the IMF and the World Bank are adapting their lending policies to better address debt risks and to promote efficient resolution when a debt problem arises. In this context, the review of the Debt Limits Policy aims to provide countries with more flexibility while adequately containing debt vulnerabilities.

Both the IMF and the World Bank have developed various fiscal risk management tools to encourage governments to identify, evaluate, and manage their exposure in view of the significant impact that fiscal risks present to public finances. Finally, the IMF and the World Bank have extensive interactions with creditors, including at the Paris Club and G20, which enable a continuing dialogue on responsible lending and related issues.

Source: IMF.

^a IMF. 2021. Review of The Debt Sustainability Framework For Market Access Countries. Policy Paper No. 2021/003.

host the IIF data repository), and the UNCTAD principles on promoting responsible sovereign lending and borrowing. In the Addis Ababa Action Agenda, Member States had committed to working towards a global consensus on guidelines for debtor and creditor responsibilities, but such global consensus remains elusive (see FSDR 2020).

The IMF modified its Debt Limits Policy to provide countries more flexibility in financing while still containing debt vulnerabilities.¹⁹

A key objective of the review, completed in October 2020, was to strike the right balance between providing space for public investment and maintaining debt sustainability. The review found that debt vulnerabilities have been broadly contained for countries with IMF-supported programmes, notwithstanding remaining challenges in relation to off-balance-sheet debt risks and debt transparency. At the same time, implementation of the policy on non-concessional borrowing appears to have been tighter than anticipated in several countries, thus restricting their ability to borrow for needed investments. To address these challenges, the policy was modified to (i) enhance debt data disclosure; (ii) allow for greater tailoring of debt conditionality for low-income countries with market access; (iii) broaden the deployment of present value limits to more countries that normally rely on concessional financing and are at moderate risk of debt distress; (iv) provide greater clarity on circumstances under which exceptions to non-concessional borrowing limits can be accommodated in countries that normally rely on concessional financing and are at high risk of debt distress; and (v) clarify the definition and measurement of concessional debt. These reforms are currently targeted to take effect in Spring 2021.

The IDA and other MDBs have maintained or even enhanced the concessionality of their support over more than a decade to avoid exacerbating debt risks.

Learning from the past, the IDA developed a grant allocation framework that aimed to help countries maintain the hard-won gains of HIPC and MDRI. Several other MDBs followed suit with similar grant allocation frameworks. These frameworks provided grants to countries based on the risks of future debt distress. However, in the absence of a unified approach by all creditor groups, increasing concessionality of MDBs alone is unable to fully stem the tide of rising debt risks. The newly introduced IDA Sustainable Development Financing Policy takes a broad and more systematic view of drivers of rising debt vulnerabilities with the aim of providing stronger incentives and a more proactive and systematic engagement at the country level.

Financing instruments to share risks

Financial instruments that tie debt service to economic conditions could reduce the likelihood of future crises.

State-contingent debt instruments (SCDIs) link debt service obligations to a predefined state variable (GDP, exports, or commodity prices, for example). They can be designed to provide additional creditor compensation in good times (value recovery instruments) and/or provide additional relief in bad times, such as disasters. In the context of debt restructurings, they may help avoid protracted disputes about the economic outlook by tying debt service to future outcomes. They can thus facilitate quicker agreements and facilitate countries' return to markets. The United Nations has long called for such clauses to be incorporated into official lending. However, to date, such clauses have been used only sparingly, both in official and commercial debt.

The use of state-contingent debt instruments in market debt has been relatively limited so far, although sovereign debt

restructurings have presented opportunities to use them to embed long-term resilience in debt structures. Creditors have historically discounted these instruments severely, given their illiquidity, idiosyncratic risk profiles, and lack of correlation with fixed income investment portfolios. In designing new instruments, it will be important to learn from historical experience and choose appropriate state variables that minimize measurement issues, avoid lagging indicators, and structure payouts properly (including through the use of floors and caps). So far, SCDIs have most commonly been used in debt restructurings, where key challenges—such as first-mover problems on the sovereign side (i.e., stigma of issuing an instrument that provides debt relief in downturns) and on the creditor side (i.e., first buyers of such instruments risk subordination to other fixed income creditors)—do not apply. (Stigma concerns are less relevant, and the entire debt stock can turn over, avoiding subordination.) During recent restructuring in Barbados and Grenada, clauses were introduced to allow for maturity extension and interest forbearance following hurricanes and other disasters. Such clauses provide valuable insurance

Box III.E.4

Technical assistance for debt management and transparency: the UNCTAD Debt Management & Financial Analysis System Programme

Concerns about debt data transparency have deepened as a result of the COVID-19 crisis. It highlighted and, in many instances, aggravated existing weaknesses in countries' capacity to record, monitor and report public debt effectively. Common problems include incomplete coverage of total public debt, increasingly complex debt portfolios, poor information flows, weak information systems, high staff turnover and inadequate capacity-building. These problems have been compounded by the constraints associated with COVID-19-related sanitary measures; in particular, the need for staff to telework has highlighted inadequacies in the management of operational risk by many debt management offices.

The international community can provide valuable support to developing countries' efforts to respond to these challenges. Technical assistance has been proven to be an effective way to strengthen capacity in areas such as debt data recording, monitoring and reporting, and there is significant demand for support. For example, in 2020, over half of the 60 countries supported by the United Nations Conference on Trade and Development (UNCTAD) Debt Management & Financial Analysis System (DMFAS) programme benefited from support in accessing their debt databases remotely as a result of COVID-19-related restrictions, and many countries received technical advice and support for implementing debt restructuring. As part of the international response to the crisis, efforts to enhance and improve capacity for public debt management should be scaled up and adapted to the current challenges. Importantly, providers need to intensify their efforts to adapt their delivery methods, capitalizing on technology to provide more remote support and online capacity-building opportunities while travel restrictions continue to impede traditional face-to-face training.

Source: UNCTAD.

at low cost against exogenous shocks, and are increasingly relevant in the context of climate change. Their use could be expanded to a wider group of countries and broader sets of shock criteria, such as commodity prices or public health crises.

Symmetric instruments could be particularly suited to the post-COVID-19 context, but their effectiveness will depend on market uptake. The post-COVID-19 outlook leaves sovereign debtors exposed to uncertainty on both the upside and downside. In this environment, exchange bonds with symmetric payoffs linked to growth could reduce the chance of repeated defaults in a manner mutually beneficial to both creditors and debtors. Good state variables should be outside the control of debtor governments but still well correlated with debt sustainability. Examples include commodity prices, trading-partner GDP, or merchandise exports as measured by trading partners.

State-contingent debt instruments are not a panacea for the inherent challenges of a debt restructuring, but with official sector leadership, they can play a bigger role going forward. To realize the potential of SCDIs, the official sector can (i) endorse standardized term sheets developed by reputable legal and market professionals (akin to the approach adopted for enhanced collective action clauses (CACs)), such term sheets have been developed for GDP-linked bonds;²⁰ (ii) enhance data provision to facilitate the use of common state variables not subject to manipulation risk; (iii) explicitly recognize the resilience afforded by downside or symmetric SCDIs in assessments of debt sustainability; and (iv) incorporate standardized SCDIs in official debt restructurings and official lending, such as for example France's prêts très concessionnel contracyclique.²¹ This would also signal support for the instrument class (see section 5.3 on standardizing triggers in debt contracts).

5.3. Debt crisis resolution

Reforming the international debt architecture is urgently needed to address a potential increase in sovereign debt restructurings in the aftermath of the pandemic, including the possibility of a systemic crisis. The international architecture for debt resolution includes debt contracts, institutions such as the IMF and the Paris Club, and policy frameworks that support orderly debt restructuring. Reforms should be aimed at providing speedy and sufficiently deep debt relief to countries that need it, benefiting not only these countries but the system as a whole.

Challenges in the current system

The existing market-based system for restructuring sovereign bonds—based on CACs, bond exchange offers and supported by IMF debt sustainability analyses and financing—has improved restructuring processes. The inclusion of CACs—a provision in bond contracts which allow a majority of bond holders to bind the minority of holders to the terms of a restructuring—has reduced minority creditors' ability to delay or derail restructuring while "holding out" for better terms. Relative to previous restructuring episodes, the dozen restructurings of privately held sovereign debt, mostly involving bonds, since 2014 have generally proceeded smoothly. In particular, these restructurings have mostly been pre-emptive and undertaken before default, had a shorter average duration (1–2 years), and had a higher creditor participation on average.

However, challenges remain with a market-based approach. These challenges include the large outstanding stock of international sovereign bonds without enhanced CACs; an increase in subsovereign debt without enhanced CACs; and information asymmetries preventing common understandings on both the perimeter of restructuring operations (i.e., the debts subject to the treatment) and on how each claim is classified (e.g., official versus private claims). In addition, other types of debt have been harder to restructure, because they either lack majority restructuring provisions (syndicated bank loans) or involve collateral. Restructurings in some developing countries involving such loans were protracted, incomplete, and non-transparent. These types of claims, particularly the use of collateral, have become more prevalent and pose a challenge to the system. They exacerbate coordination challenges in a decentralized market-based process, where both individual creditors and debtors may be incentivized to postpone necessary restructurings.

Options for reform

The market-based system can be further strengthened, by promoting the adoption of enhanced CACs, inclusion of majority restructuring provisions for payment terms in loan agreements, and more widespread use of state-contingent clauses. In addition to continued promotion of enhanced CACs, proposals have been made to further strengthen them (e.g., by an increased use of trust structures). The greater use of state-contingent clauses could also promote fast and successful debt restructuring, for example, in case of disasters.

In a systemic crisis, statutory “sticks” and financial “carrots” can be used to discourage holdout creditors. Financial “carrots” include financing by the IFIs of debtor-provided cash or credit enhancements that lower the risk, and hence the value of the assets offered to creditors, without reducing debt relief from the perspective of the debtor. “Sticks” could include both targeted domestic law tools and international law options. The former could include “anti-vulture fund” legislation to limit litigation by uncooperative creditors, which has been used to prevent holdout behaviour in the context of the HIPC and MDRI initiatives. The latter could include a United Nations Security Council resolution, which could be used to immunize specified assets from attachment by holdout creditors or otherwise discourage holdout behaviour. These tools have their drawbacks and limitations. IFI resources used to support debt restructuring could be diverted from other uses and undermine the institutions’ balance sheets and credit ratings, so they need to be used judiciously. Statutory instruments can raise important legal and policy issues, and would be expected to be used only as a last resort and on a time-bound basis to address the unique challenges posed by a systemic crisis.

Developing countries require additional legal support to safeguard their interests in complex restructuring processes. Financial and legal advisors play a key role in restructuring processes, guiding sovereigns through the process and leading their engagement with commercial creditors.²² The international community could provide financial and technical support to strengthen such legal advice for countries with limited legal capacities—for example, by strengthening support to existing facilities such as the World Bank’s Debt Reduction Facility or the African Legal Support Facility.

International coordination needs to be further strengthened to promote comprehensive and orderly debt resolutions.

The G20 and the Paris Club adopted a Common Framework for Debt Treatment Beyond DSSI on November 13, 2020. The Common Framework²³ brings together existing Paris Club creditors and other official creditors in the G20. It establishes principles to guide this group of official creditors to coordinate debt resolution for DSSI-eligible countries that request it, on a case-by-case basis. The framework aims to facilitate comprehensive and timely debt resolution and equitable burden sharing among creditors, including private creditors: countries are expected to seek treatment on comparable or better terms from other creditors, including private sector creditors. A debtor seeking a debt treatment must also have or request an IMF programme. Three countries (Chad, Ethiopia and Zambia) have so far requested debt restructuring through the Common Framework.

The Common Framework is only available to DSSI countries but could serve as a step towards a more universal and permanent framework for sovereign debt resolution. Eligibility for debt treatment under the Common Framework is limited to countries eligible under the DSSI. It thus excludes a number of highly vulnerable middle-income countries, including SIDS. It also requires complex case-by-case negotiations, even if the purpose of the Common Framework is to streamline those. And while countries are expected to seek comparable treatment from private creditors, voluntary participation in debt relief initiatives such as HIPC has historically been challenging²⁴ (box III.E.5). Despite its limitations, the effective operationalization of the Common Framework will help provide relief to low-income and least developed countries with unsustainable debt burdens or liquidity difficulties on a case-by-case basis. It may also serve as a step towards a more universal and possibly permanent framework for efficient sovereign debt resolution. Proposals for such frameworks were discussed during the High-level Event on Financing for Development in the Era of COVID-19 and Beyond (see box III.E.3). The United Nations continues to provide a valuable platform for advancing them, due to its capacity to bring all relevant voices to the table and to link sustainable debt and fair and effective debt crisis resolution to sustainable development progress.

Box III.E.5

International debt relief initiatives: a brief historical perspective

The only modern debt relief programme based on an international treaty is the 1953 London Agreement on Germany's war debt. The treaty brought all West Germany's official and private creditors to the table, excluded all debt incurred by Germany during the occupation of Europe in the Second World War, and forgave over 50 per cent of the remaining war debt incurred prior to 1933 and after 1945. It also limited the amount of export revenues that could be spent on debt servicing to 5 per cent of the total in any one year; allowed low interest rates of between 0 and 3 per cent to be paid in Deutsche Mark; and included a state-contingent clause: all debt service payments could be postponed in the event of an annual trade deficit.

Since the 1980s, with the advent of more frequent developing-country debt crises, two informal negotiation forums—the Paris Club, founded in 1956, for official bilateral debt owed to its creditor member states, and the London Club founded in 1976, to address sovereign debt owed to private creditors—gained greater attention. The Paris Club takes decisions by consensus, with its members agreeing to act as a group to protect their collective interests. Terms to allow debt relief for poor developing countries were first introduced in 1988 under the so-called Toronto terms and subsequently revised until the adoption of the “Naples terms” in 1994 that allow for up to 67 per cent reduction of bilateral debt owed to its member states on a present-value basis. The last debt relief programme agreed under these terms was for \$1.4 billion of Somalia's debt with Paris Club creditors in March 2020.

The London Club originally provided an ad hoc forum for debtor countries to renegotiate their commercial bank debt with members of the Club. Each “London Club” is formed at the request of a debtor country and dissolved on agreement of a restructuring, with negotiations led by an Advisory Committee that more recently has also included non-bank creditors, such as hedge funds holding sovereign bonds. Support to the negotiations—for instance in the form of debt sustainability analyses—is provided by the Institute of International Finance (IIF),

founded in 1983, and an Economic Subcommittee. However, the London Club does not establish binding resolutions and there is currently no comprehensive mechanism for the restructuring of sovereign debt owed to private creditors—a situation that has provided ample opportunities for uncooperative creditors to purchase distressed sovereign debt at a steep discount and aggressively litigate to recoup the debt's full value plus interest.

The 1989 Brady Debt Reduction Plan recognized that London Club sovereign debt restructurings were insufficient to resolve mounting developing-country debt crises. Under the plan, defaulted sovereign bank loans by London Club members were exchanged for cheaper collateralized 30-year bonds. In exchange for some amount of debt relief to participating, mainly middle-income developing countries by London Club members, multilateral and bilateral creditors provided the funds for debtor countries to buy back their remaining commercial debt and swap it for “Brady bonds” guaranteed by zero-coupon US Treasury bonds.

In the meantime, debt by poor developing countries kept rising to increasingly unsustainable levels. This eventually led to the first international debt relief initiative, the Highly Indebted Poor Countries (HIPC) initiative in 1996. This initiative was followed in 2005 by the Multilateral Debt Relief Initiative (MDRI). Overall, both initiatives afforded about \$70 billion of debt relief to just over 30 poor developing countries. Commercial debt reductions were mainly channelled through the Commercial Debt Reduction Facility (DRF) of the International Development Association (IDA) that channelled donor funding to eligible countries to reduce this debt.

While these international debt relief initiatives succeeded in reducing external sovereign debt burdens substantively in beneficiary developing countries, this achievement has largely been reversed following the global financial crisis, with the renewed sharp rise of sovereign and private indebtedness across the developing world.

Source: UNCTAD. 2020. From the Great Lockdown to the Great Meltdown: Developing Country Debt in the Time of Covid-19. Trade and Development Report 2019 Update 2, April, pp 14–15.

Endnotes

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- 2 Institute of International Finance. 2020. Global Debt Monitor – Attack of the Debt Tsunami. November 2020.
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- 5 The main benchmark index that tracks USD-denominated government bonds issued by frontier economies, the J.P. Morgan NEXGEM index, was launched in 2011 with only 17 countries. By April 2020, this had increased to 36 countries (3 HICs, 25 MICs, 2 LICs, 6 transition economies, 4 Least Developed Countries (LDCs) and 2 SIDS).
- 6 Raddatz, Claudio., Schmukler, Sergio L. and Williams, Thomas. 2017. “International Asset Allocations and Capital Flows: The Benchmark Effect.” *Journal of International Economics*, 108 (C): 413–30.
- 7 External financing needs are calculated as current account balance + capital account balance + external debt amortization - net FDI inflows. These are calculated for 53 out of 73 LICs for which data is available from the WEO. The overall EFN estimate is derived by extrapolating to cover the countries for which data is not available.
- 8 The methodology referenced in this paragraph models the probability of a fiscal crisis and is distinct from the low-income country DSF, which assesses the risk of debt distress.
- 9 IMF staff developed a machine learning model to assess the probability of a fiscal crisis on the basis of an extensive range of variables. The methodology allows for interactions between variables and non-linearities. This exercise is distinct from the debts sustainability assessment for market access countries (MAC DSA) and the IMF-World Bank debt sustainability framework for lower income countries (LIC DSF). For more on the machine learning methodology please see “How to Assess Country Risk: The Vulnerability Exercise Approach Using Machine Learning”, IMF Forthcoming (1).
- 10 Gambia’s upgrade from an “in debt distress” rating to a high risk of debt distress is related to the finalization of a restructuring agreement. Also, the downgrade of Senegal’s risk rating preceded the onset of COVID-19.
- 11 For more on Policy Responses to COVID-19 please refer to the IMF Policy Tracker.
- 12 See Chapter II in the IMF Global Financial Stability Report, October 2020: Bridge to Recovery, IMF October 2020 (2).
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