

Report of the Inter-agency
Task Force on Financing
for Development

FINANCING FOR DEVELOPMENT: PROGRESS AND PROSPECTS 2018



United Nations

This report is a joint product of the members of the Inter-agency Task Force on Financing for Development (members are shown on page xi). The Financing for Development Office of the United Nations Department of Economic and Social Affairs serves as the coordinator and substantive editor of the Task Force report.

The online annex of the Task Force (<http://developmentfinance.un.org>) comprehensively monitors progress in implementation of the Financing for Development outcomes, including the Addis Ababa Action Agenda and relevant means of implementation targets of the SDGs. It provides the complete evidence base for the Task Force's annual report on progress in the seven action areas of the Addis Ababa Agenda (chapters III.A–III.G). The report is by necessity more concise and selective, and should thus be read in conjunction with the online annex.

The online annex of the Task Force also covers several key cross-cutting initiatives that build on the synergies of the Sustainable Development Goals in-depth:

- Delivering social protection and essential public services
- Ending hunger and malnutrition
- Closing the infrastructure gap
- Promoting inclusive and sustainable industrialization
- Generating full and productive employment for all
- Protecting ecosystems
- Promoting peaceful and inclusive societies
- Gender equality
- Investing in children and youth
- Addressing the diverse needs and challenges faced by countries in special situations
- Global partnership

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Chapter III.E

Debt and debt sustainability

1. Key messages and recommendations

At a time when Governments are faced with large financing needs to implement the 2030 Agenda for Sustainable Development, and as global financial conditions are set to tighten, many countries are constrained from raising resources due to their already high debt burdens. Risks for a renewed cycle of debt crises and economic disruption are growing, posing a significant challenge to the achievement of the Sustainable Development Goals (SDGs). Despite a more favorable global economic outlook, emerging debt challenges in developing countries have intensified since the publication of last year's report. Debt-service indicators among developing countries have deteriorated in a widespread manner, and vulnerabilities have increased across developing countries, in particular in several countries that previously benefitted from debt relief under the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief (MDRI) initiatives. Many natural-resource-producing countries have seen rapid debt accumulation as Governments have attempted to cushion the shock from falling commodity prices. Strains are also evident in several countries experiencing conflicts or political unrest, and in some small island developing States (SIDS), which remain vulnerable to disasters.

Recent debt shocks highlight a need for enhanced measures to manage vulnerabilities, including through improving debt management capacities in many developing countries. The international community has long offered technical assistance in public debt management, including at the subnational level and going beyond central government liabilities. It also develops analytical tools to advise Governments of emerging vulnerabilities. The

effectiveness of the tools, however, depends on central authorities having comprehensive information on the financial obligations of all units and levels of government. ***Debtors need to improve their capacity to monitor and analyse debt developments, which will require better and broader data collection. Creditors have a role to play in these efforts by making terms and conditions of lending public, straightforward and easy to track.***

The 2017 Atlantic hurricane season underlined not only the vulnerability of SIDS to natural catastrophes, but also that innovative instruments, such as state-contingent debt instruments that reduce or delay debt-servicing payments in times of crisis, could lessen financial stresses. The International Monetary Fund (IMF) has recently investigated several proposals for such instruments. ***The international community could consider actions to help realize the potential of this market, including through developing model contracts and common standards, providing technical support, and, more ambitiously, by increasing the use of such instruments in official lending.*** An additional proposal from the Economic Commission for Latin America and the Caribbean (ECLAC) is being investigated by a task force of regional institutions that would swap discounted external debt of Caribbean countries for climate adaptation investments. ***Additional detailed analysis of this proposal is warranted with a view to piloting implementation in a limited number of countries on a trial basis. Additional tools could also be explored to ensure that developing countries affected by disasters are not left to deal with growing debt burdens in the longer run.***

Changes in emerging and developing countries' debt compositions may render future insolvencies more complicated to address, with nontraditional development partners gaining increased prominence.

There are also growing obligations to new plurilateral¹ development finance institutions, although there is not yet a global understanding of whether those debts will enjoy the same seniority of payment as debt of traditional multilateral and regional development lenders. The Paris Club provides a forum for official creditor coordination, but does not currently include all countries. ***There is thus a need to re-examine official creditor cooperation mechanisms to address these issues.*** While improved bond contracts—including those that benefit from enhanced collective action clauses—should make borrowers less subject to litigation from distressed debt funds (so-called vulture funds), only 27 per cent of outstanding emerging market bonds have these enhanced clauses. ***The international community should continue to consider ways to strengthen the treatment of the main components of sovereign debt in workouts. In this context, the international community should continue to strengthen the market-based approach through expanded use of enhanced clauses in debt contracts. It should also explore complementarities and incongruities of existing initiatives to specify principles and guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, in line with the commitment in the Addis Ababa Action Agenda (hereafter, Addis Agenda) to work towards a global consensus.***

2. Debt trends

The cyclical upturn of the global economy in 2017–2018, described in chapter I, as well as continued monetary policy support and regulatory enhancements, have led to a decline in global near-term financial stability risks (see also chapter III.F).² However, this generally benign global envi-

ronment masks increased debt risks and vulnerabilities in both developing and developed countries, particularly as monetary policy normalization continues and interest rates rise in global markets.

First, leverage continues to rise in the private nonfinancial sector in both developed and developing countries. Private sector debt—one of the triggers for the 2008 crisis—has continued to increase in the aggregate, with deleveraging uneven across sectors and countries. Second, the search for yield in global markets has allowed several developing countries to return to markets and issue sovereign bonds in 2017, leaving them vulnerable to debt rollover and interest rate risks, especially in the context of rising global interest rates. Third, commodity prices remain low, are only slowly recovering, and thus continue to weigh on balance sheets in commodity-exporting economies.³ A renewed downturn in commodity prices would leave these economies vulnerable to fiscal and corporate debt risks.

Consequently, there is no reason for complacency about the stock of developing-country external debt. Many countries exceed threshold indicators jointly developed by the IMF and the World Bank for analyses of low-income-country debt sustainability (see figures 1 and 2).⁴ Eighteen low-income developing countries were judged by the IMF and the World Bank to have high risk or already be in a state of debt distress (see figure 3), and ratings have been broadly deteriorating. As of end-2017, three countries have seen their rating downgraded relative to 2013, with only three upgrades. Fragile States, African post-HIPC countries, and commodity exporters were most likely to have a weaker debt assessment. Risks in SIDS also remain high, due in large part to their susceptibility to natural disasters.

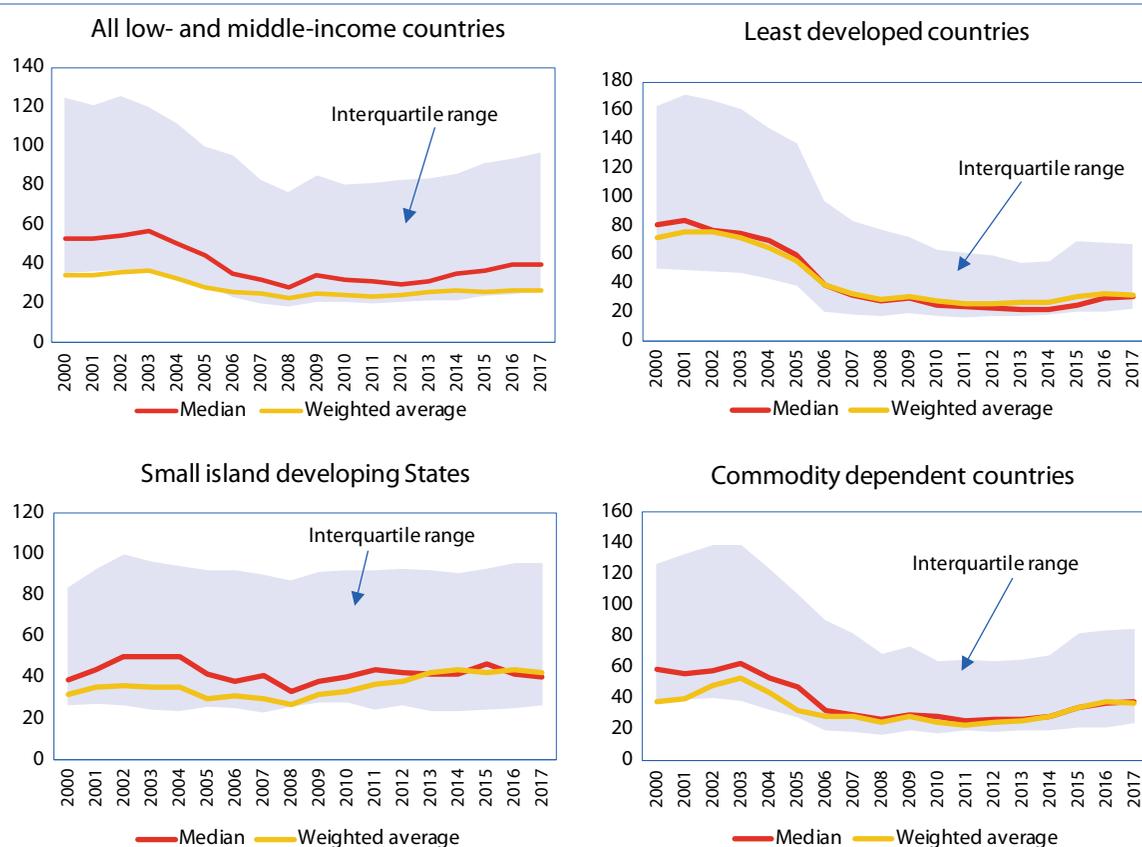
1 The term “plurilateral creditor” refers to official lenders with more than one shareholder that extend non-commercial credit to other sovereigns and that do not have universal/open memberships, unlike established multilaterals such as the African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank and World Bank.

2 International Monetary Fund, *Global Financial Stability Report, October 2017: Is Growth at Risk?* (Washington, D.C., October 2017). Available from <https://www.imf.org/en/Publications/GFSR/Issues/2017/09/27/global-financial-stability-report-october-2017>.

3 United Nations, Report of the Secretary-General on external debt sustainability and development, 31 July 2017, A/72/253. Available from <https://undocs.org/A/72/253>.

4 For countries deemed to have policies and institutions of “medium” quality, the thresholds as revised in 2017 are external debt in excess of 40 per cent of gross domestic product (GDP) and debt servicing above 15 per cent of exports. See International Monetary Fund. *Review of the debt sustainability framework in low-income countries: Proposed reforms* (2017).

Figure 1
External debt of low- and middle-income countries, 2000–2017
 (Percentage of GDP)



Source: IMF World Economic Outlook database, UN/DESA calculations.

Note: Commodity dependent developing countries as defined by UNCTAD, State of Commodity Dependence 2016. Available from <http://unctad.org/en/PublicationsLibrary/suc2017d2.pdf>.

Moreover, the composition of debt is changing. As noted above, many developing countries, including least developed countries (LDCs), have increasingly tapped international financial markets to raise resources. The share of private creditors in public and publicly guaranteed debt has doubled in LDCs, from 8 to 16 per cent of total external public debt, and increased from around 41 to 61 per cent in all developing countries (see figure 4). Increased market-based financing—both domestic and international—can be beneficial, but carries risks. In addition to not embedding concessional interest rates, market-based instruments typically have shorter maturities than official loans. “Bullet repayments”⁵ increase rollover

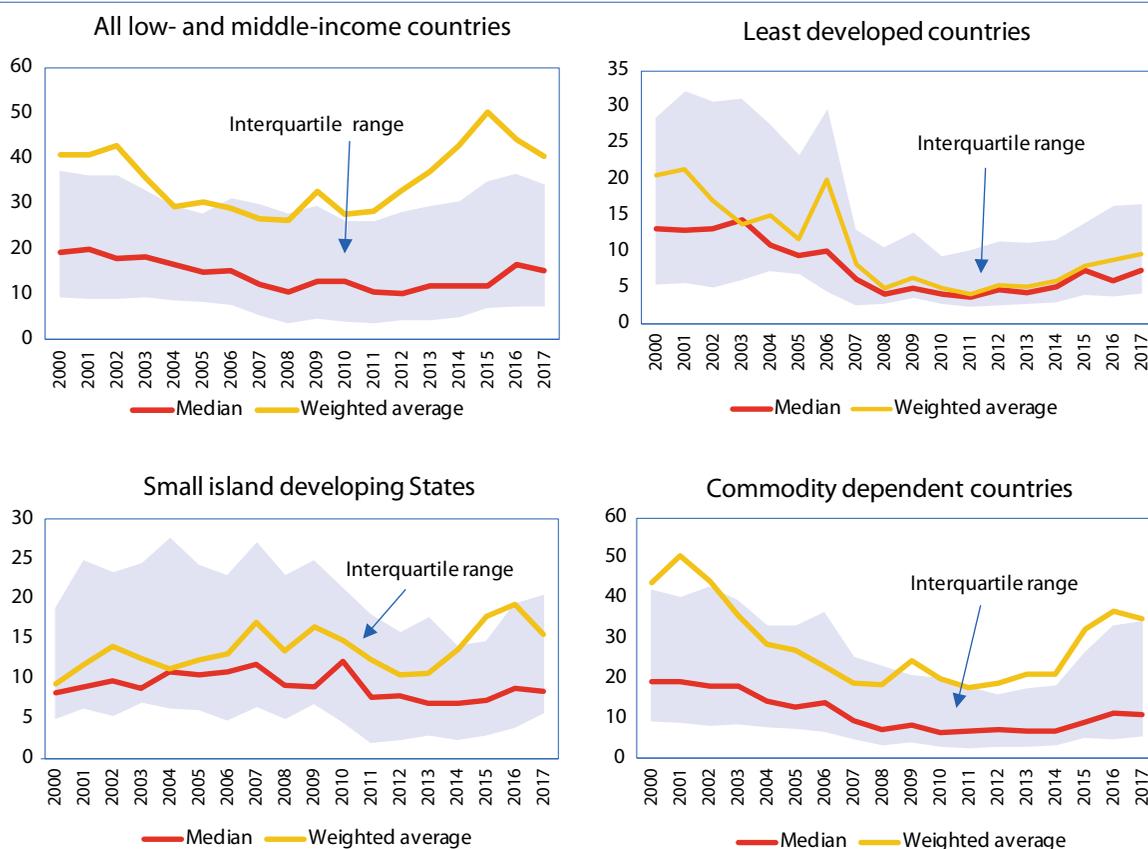
risk, which could be further exacerbated by tightening global financial conditions.

The changing creditor landscape has also resulted in the increasing prominence of non-Paris Club (NPC) bilateral and plurilateral creditors. Between 2015 and 2016, South-South Cooperation drove a more than twofold increase in new bilateral loan commitments to low- and middle-income countries, reaching \$84 billion.⁶ In many cases, lending by NPC bilateral and plurilateral creditors has caused their share in total external debt to exceed the share of traditional Paris Club and multilateral creditors. This has implied a welcome unlocking of new financing, but often on less con-

⁵ A bullet repayment is payment of the face value of a bond on its maturity date, rather than amortized payments.

⁶ World Bank (2017). International Debt Statistics 2018. Available from <https://data.worldbank.org/products/ids>

Figure 2
External debt service of low- and middle-income countries, 2000–2017
 (Percentage of exports)



Source: IMF World Economic Outlook database, UN/DESA calculations.

Note: Commodity dependent developing countries as defined by UNCTAD, State of Commodity Dependence 2016. Available from <http://unctad.org/en/PublicationsLibrary/suc2017d2.pdf>. Debt service includes interest and amortization of short-term debt on an original maturity basis outstanding at the end of the previous year, plus the portion of long-term debt outstanding at the end of the previous year maturing during the current year. Thus, countries whose financial sectors hold substantial gross short-term external obligations will show large debt-servicing ratios, which do not necessarily imply unsustainability.

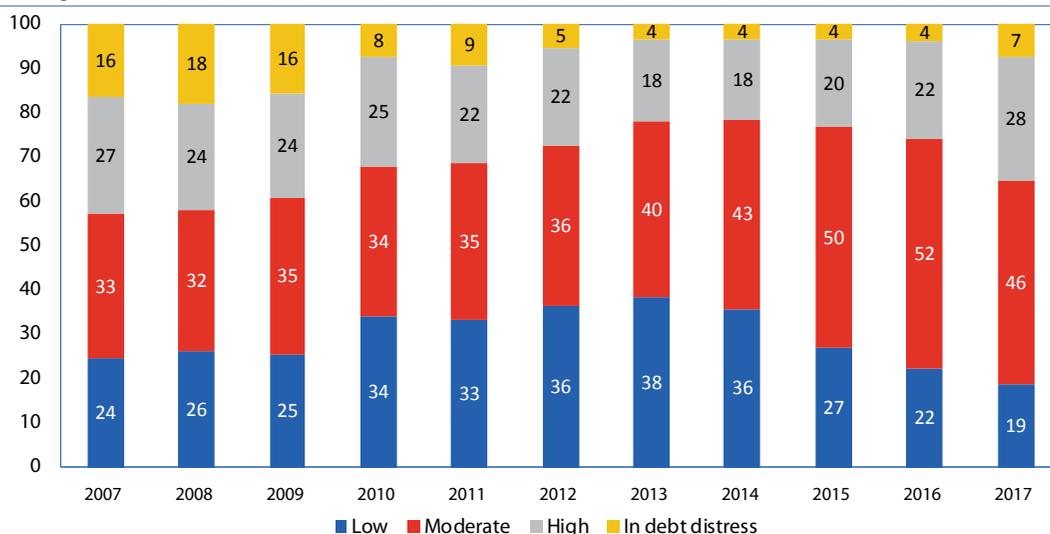
cessional terms. As these creditors are not integrated into existing mechanisms for creditor coordination (e.g., the Paris Club, which has long-standing principles to govern official sector involvement in debt restructurings), any restructuring that may be necessary could be more complicated.

Governments have also increasingly issued domestic debt in recent years, which reduces exchange rate mismatches and is welcome from a financial market development perspective. However, domestic debt often carries higher interest costs and specific risks. Countries where non-resident investors have a significant presence in the domestic debt market can be vulnerable to capital flight and associated exchange-rate pressures if

non-resident investors with short-term investment horizons hold a significant amount of domestic debt and lose confidence in the Government's solvency or economic policies. Moreover, fiscal stress can transmit to domestic financial systems to the degree that banks have invested in local government bonds.

Finally, contracts for non-standard borrowing have been making increasing use of credit enhancements to shift lenders' risks to borrowers. For example, several countries—natural resource producers in particular—have issued debt that includes collateralization provisions. The terms of these provisions are often complex and in many cases non-transparent. They may commit the debtor to

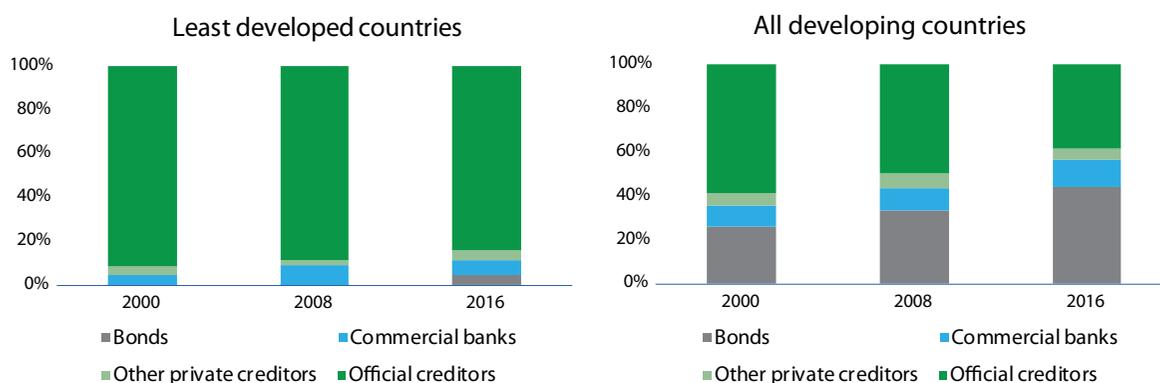
Figure 3
Debt risk classification of low-income countries, 2007–2017
(Percentage of total)



Source: IMF (LIC DSF database).

Note: Published debt sustainability analyses only, latest available per year. Coverage is of low-income developing countries eligible to draw from the Poverty Reduction and Growth Trust at IMF.

Figure 4
Composition of external public and publicly guaranteed debt
(Share of total)



Source: World Bank, International Debt Statistics, UN/DESA staff calculations.

selling commodities to the creditor at below-market prices for some time or to selling specified public assets, although the terms of the loan may appear favourable up front. In cases of insolvency, such collateralization could complicate the restructuring, as these creditors would assert their rights to the assets or exports securing the loan, which could disrupt government operations.

3. Borrowing sustainably to advance sustainable development

Countries face pressing demands for additional public investment in the SDGs. A recent assessment of 26 low-income countries found that existing fiscal

space is likely insufficient to undertake the spending needed to achieve the SDGs.⁷ Investment needs have been estimated to reach up to \$224 billion—about one third of gross domestic product (GDP)—in incremental annual public investment in low-income countries (see also box 1 on SDG expenditures and debt sustainability).⁸

To meet large investment demands in an environment where constraints on further debt financing will likely become more binding, a multipronged approach is needed. It can be helpful to differentiate how borrowed resources are used. Well-designed public sector investments that boost the productive capacity of an economy, including by reducing gender inequalities, can result in higher income for the Government and help offset the associated debt service. Such investments increase fiscal space when the return on public capital exceeds financing costs. Nonetheless, countries that are approaching debt sustainability limits will need to exercise prudence in implementing investment, since the near-term costs can be prohibitive, especially if additional borrowing risks are fuelling a debt crisis. In such cases, debt financing should be confined to projects with clear and large returns that would not tip the country's debt indicators into distressed levels or trajectories.

The recent review of the IMF and World Bank debt sustainability frameworks for low-income countries (LIC DSF) has introduced a “realism tool” for the investment-growth nexus, which would allow users to carefully assess growth assumptions in light of public investment dynamics (see below). Project financing structures can be another option in some countries and sectors if risks can be managed and isolated, possibly through risk sharing structures with development banks and private investors, as appropriate. However, it is critical that any such structure is fully transparent; contingent liabilities can greatly exacerbate debt crises, particularly when their realization occurs as a surprise.

External borrowing is of course not the only source of investable public resources, as indicated in the preceding chapters on mobilization of domestic public resources and international development cooperation. Challenges associated with closing the financing gap underline the continuing need for increased tax revenue as well as access to concessional finance and external grants.

3.1 Public debt management

Effective debt management remains an intrinsic part of sound public financial management and overall good governance. Although considerable progress has been made in recent years in strengthening countries' capacity to manage public debt, debt management remains a challenge for many developing countries—both for central administrations as well as subnational governments—for which continued international technical support is required, and given. As interest grows in the potential of subnational finance to contribute to the SDGs, capacity development support in public debt management will become even more important.

Technical assistance in public debt management can usefully be classified as either “upstream,” which refers to debt analysis or assessment, or “downstream,” which consists of implementation support. Upstream debt management comprises activities related to debt sustainability analysis; debt management performance diagnosis; debt management strategy formulation and the design of reform plans; or local currency government securities market development. Support in these areas is principally provided by the IMF and the World Bank. Downstream debt management technical assistance relates to support in the implementation of policy recommendations, debt data recording and validation, debt operations, and debt reporting and statistics. Organizations involved in providing technical assistance increasingly cooperate to ensure a holistic approach.

7 Anja Baum and others, “Can they do it all? Fiscal space in low-income countries”, IMF WP/17/110 (Washington, D.C., 2017). Available from <https://www.imf.org/en/Publications/WP/Issues/2017/05/05/Can-They-Do-It-All-Fiscal-Space-in-Low-Income-Countries-44889>.

8 Guido Schmidt-Traub, “Investment Needs to Achieve the Sustainable Development Goals”, SDSN Working Paper (2015). Available from <http://unsdsn.org/wp-content/uploads/2015/09/151112-SDG-Financing-Needs.pdf>.

Box 1

SDG expenditures and debt sustainability

The relationship between the Sustainable Development Goals (SDGs) and debt sustainability is explored in ongoing research by the United Nations Conference on Trade and Development (UNCTAD)^a which estimates the cost to government budgets of achieving SDGs 1–4^b by 2030 for a sample of low-income, middle-income and upper-middle-income countries. The UNCTAD SDG model projects the evolution of general government gross public debt if the additional cost is covered by borrowing on commercial terms, on concessional terms or with grant financing covering half the borrowing requirement. These alternative scenarios are compared to a baseline business-as-usual scenario in which government expenditure and public debt follow current trends.^c

The SDG scenario shows that the increase in public debt is likely to be unsustainable in all three cases if additional expenditures are fully funded through debt issuance on commercial terms. If external grants cover 50 per cent of the additional fiscal expenditures, the growth of debt would be more manageable, but still high and likely unsustainable in all three cases.

The resource gap to fully fund the eradication of extreme poverty and hunger and provide quality education and universal health care, while simultaneously stabilizing public debt levels, is significant. Progress in domestic resource mobilization, improved resource allocation in national budgets, and efficient public debt management would help to reduce the gap. The model shows, however, that such improvements would clearly be insufficient on their own, and that the SDGs cannot realistically be financed fully on commercial terms. In the light of large investment needs related to the 2030 Agenda for Sustainable Development, the SDGs will not be achieved without substantial support from the international community for what are essentially high-return investments in international prosperity and development.

- a** A more detailed description of this research can be found on the online annex of the Inter-agency Task Force on Financing for Development, available from <https://developmentfinance.un.org/debt-and-debt-sustainability>.
- b** SDG 1, no poverty; SDG 2, zero hunger; SDG 3, good health and well-being; SDG 4, quality education.
- c** The scenarios exclude the possibility of debt crisis due to a loss of creditor confidence owing to the size of the increase in public debt. They also assume that additional spending has no impact on the baseline rate of economic growth, and no increase in tax revenues. The model does not capture the impact on long-term productivity growth of improvements in human capital associated with the accomplishment of the covered Sustainable Development Goals (SDGs).

Different tools are available to boost debt management capacity. They include the Debt Management and Performance Assessment provided by the World Bank, the Medium-Term Debt Management Strategy tool provided by the IMF and the World Bank, and recording and reporting systems, such as the Commonwealth Secretariat Debt Recording and Management System and the Debt Management and Financial Analysis System of UNCTAD. Institutions, including the IMF, keep these tools under review and adapt them to changing needs.

UNCTAD and the Commonwealth Secretariat continue to be the major providers of downstream technical assistance in public debt management. In 2017, they supported over 100 countries in total. A key objective is to ensure the availability of reliable and timely debt data that is essential for prudent risk analysis and the elaboration of government strategies aimed at ensuring sustainable debt levels. The IMF and the World Bank, with the generous financial support of several bilateral donors, have provided

a range of public debt management technical assistance and training activities to over 25 developing countries during the past fiscal year (July 2016–June 2017). The IMF Statistics Department also provides technical assistance on the compilation of government debt statistics.

The need for Governments to take a comprehensive approach to their nation's debt and asset management has also underlined the importance of improving debt management by subnational units of government, and by other elements of the public sector. Anecdotal evidence suggests that many subnationals are confronted with significant challenges in managing their public debt portfolios, although a number of subnationals have made substantial progress in improving debt management, in some cases with the support of international technical assistance. Coordinated assistance from both central Governments and the international community is needed to build the required level of capacity at the subnational level. The successful cooperation

of UNCTAD and the Government of Argentina in establishing a capacity-building programme for its provinces is an example of such cooperation. In addition, the management of the assets and liabilities of state-owned enterprises, and of the Government's contingent liabilities can be of first-order importance in containing overall costs and risks.

3.2 Reform of the debt sustainability framework for low-income countries

Achieving debt sustainability is a major responsibility of the upstream side of sovereign debt management. The IMF and World Bank developed the LIC DSF to support this aim. Following an extensive review, and responding to changes in the debt landscape noted above, the IMF and the World Bank Executive Boards approved comprehensive reforms to the LIC DSF in September 2017.

Staff analyses and extensive consultations with debtors, creditors and civil society organizations identified several areas for improvement, showing a need to (a) ensure that the LIC DSF incorporates more country-specific information; (b) reflect the evolving financing landscape, including risks emanating from increased market financing and contingent liabilities; and (c) send important early warning signals without unnecessarily constraining countries' borrowing for development.

Against this backdrop, the framework has introduced a series of new features while maintaining its basic architecture including (i) a revised approach to assess country debt carrying capacities using an expanded set of variables in addition to the World Bank's Country Policy and Institutional Assessment indicators; (ii) methodological improvements to the framework's accuracy in predicting debt distress; (iii) tools to help shed light on the plausibility of underlying macroeconomic projections, including public investment dynamics, fiscal adjustments and their impact on growth dynamics; (iv) stress tests tailored to specific country circumstances, including on natural disasters and contingent liabilities; (v) streamlined debt thresholds and standardized stress tests; and (vi) a revised total public debt bench-

mark and tools for assessing risks associated with market-financing conditions.

The new LIC DSF is expected to become effective in the second half of 2018; a guidance note was published in February 2018 to provide operational and technical guidance on its implementation.⁹ The IMF and World Bank will continue to conduct extensive outreach, and provide training opportunities on the new framework, both internally and to country authorities. Priority will be given to countries with weak capacity.

The IMF debt sustainability analysis for market access countries has been developed to monitor risks for countries that typically rely on financial markets for funding. A review of this framework has been initiated.

3.3 Transparency of debt reporting

Effective sovereign debt management requires full information on the terms and conditions of debt, contingent liabilities and domestic arrears, where they are present. These data need to provide broad coverage of the public sector, including subnational governments, social security funds and public corporations. Also, to inform debt projections, data should be available on debt contracts that have been signed but for which funds have not yet been disbursed.

Unfortunately, the full data set is often not available, with key data gaps arising from (i) countries reporting only the direct and guaranteed debt of the central administration; (ii) confidentiality clauses that prevent disclosure of key information; (iii) complex lending terms, particularly on collateralized lending; and (iv) poorly understood contingent liabilities related to potential banking sector stress, loss-making public enterprises or public-private partnerships, among others.

Building a fuller picture of developing countries' indebtedness and potential vulnerabilities will require actions from creditors as well as debtors. Debtor governments should build capacity to collect, analyse and publish debt data for a perimeter that extends beyond the central Government, disclose undisbursed portions of agreed loans, improve

⁹ International Monetary Fund, "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries", 14 February 2018. Available from <http://www.imf.org/en/Publications/PolicyPapers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf>.

accounting of contingent liabilities, keep track of arrears to suppliers, and attempt to limit use of confidentiality agreements in debt contracts they negotiate. They should also better monitor granting of officially guaranteed commercial debt, including those guaranteed by export credit agencies, as default on these loans can give rise to official arrears. Creditors should limit use of confidentiality clauses in debt contracts. Moreover, for collateralized loans tied to natural resource shipments, terms should be kept simple with compliance easy to monitor. A platform to publish comprehensive official and private sector lending is warranted.

4. Natural disasters, shocks and debt sustainability

The devastating impact of the 2017 Atlantic hurricane season put the spotlight on the vulnerability of developing countries to natural disasters and their wide-ranging consequences. Hurricane Irma destroyed infrastructure and homes across Barbuda. Reconstruction costs estimated by the World Bank and Caribbean Development Bank estimated would equal 15 per cent of Antigua and Barbuda's annual GDP. Hurricane Maria swept over Dominica, causing loss of life and unprecedented destruction estimated at 226 per cent of GDP. As climate change is expected to make such events more frequent and more intense, there is need for the international community to address these risks, and for official sector creditors, in collaboration with countries at risk, to work on pre-emptive and reactive policies to provide appropriate support in times of crisis.

In terms of pre-emptive measures, it is important that countries receive sufficient support to finance successful adaptation to climate change. Countries at risk should build sufficient policy buffers in good times to support recovery, including through overall prudent debt management. However, they often face pressures on their fiscal positions from recovery expenditures and already high debt burdens, limiting their ability to invest sufficiently in climate adaptation. Despite existing exceptions for SIDS, many environmentally vulnerable countries have per capita incomes that

make them ineligible to access concessional financing windows. A review of such eligibility and graduation criteria should be considered by the international community, as discussed in chapter III.C.

Most countries also cannot self-insure to the degree necessary. The use of state-contingent debt instruments, which are structured to automatically pay less or postpone payments to creditors during difficult times, could increase the resilience of sovereign balance sheets. There has been increasing international interest in how they might be designed (see box 2). Efforts are warranted to advance such analyses, including encouraging both the private and official sectors to experiment in issuing such instruments.

If a severe natural disaster does hit, provision of timely support is critical. Governments and international institutions have devised a number of quick disbursing loan facilities and insurance programmes to address sudden needs for international funds, as discussed in chapter III.F. There may also be a need to seek debt relief from private and official creditors. Prompt and constructive engagement with creditors can support an orderly and efficient debt restructuring to take place. In this context, steps have been taken and proposals made to address the financial constraints of environmentally vulnerable and highly indebted countries, aiming to ensure debt sustainability while explicitly accounting for climate change adaptation needs and the impact of natural disasters. Grenada's 2015 debt restructuring introduced a "hurricane clause," which allows for a moratorium on debt payments in the event of a natural disaster. ECLAC has proposed a debt-for-climate adaptation swap for the Caribbean, involving discounted purchases from official and private creditors by the Green Climate Fund and channelling them to a Caribbean resilience fund to receive the freed national funds from the participating countries for disbursement to selected climate adaptation investments. A task force comprising several regional institutions was formed in December 2017 to advance work on the proposal.¹⁰ In view of the systemic nature of the challenge that poses risks to the long-term debt sustainability in affected regions and the scale of climate

¹⁰ Economic Commission for Latin America and the Caribbean, "ECLAC establishes task force for Caribbean's Debt Swap Initiative", 27 November 2017. Available from <https://www.cepal.org/en/news/eclac-establishes-task-force-caribbeans-debt-swap-initiative>.

Box 2

State-contingent debt instruments

There has been a renewed interest in the role that state-contingent debt instruments (SCDIs) can play in reducing risks to sovereign balance sheets. Such instruments are designed to link a country's debt obligation to its ability to pay, and can thus provide insurance against risks such as a deep recession, commodity price decline or natural disaster. Instruments include GDP-linked bonds, which would provide stability over the economic cycle; commodity-linked bonds, which could link interest payments to specific commodity prices; and "extendibles," which would provide an automatic maturity extension if a natural disaster occurs.^a In response to growing interest, the IMF developed an associated toolkit to simulate debt and financing need impacts under varying SCDI designs.

Proponents of SCDIs have made a strong case for these instruments over recent decades. Their arguments note that GDP-linked bonds, which link the repayment obligations of a sovereign to economic growth, can stabilize the debt-to-GDP ratio and generate policy space during recessions that can be used to support recovery. Insofar as the debt stabilization benefits of such instruments reduce the probability of sovereign debt crises, the default risk premium on all the sovereign debt should fall. In debt restructurings, SCDIs could provide an important role in facilitating an orderly debt exchange, providing downside insurance to the sovereign while giving upside benefits to the creditors when the recovery is successful.

While the theoretical benefits are clear, critics point out that advocates fail to consider practical complications associated with issuing such instruments in financial markets. The IMF examined these constraints, finding that (i) liquidity and novelty premiums could be high when SCDIs are first issued; (ii) there may also be stigma associated with such "first-movers;" (iii) significant issuance could lead to a reduction in the supply of conventional bonds; (iv) SCDIs could transfer "excessive" risk to the private sector; and (v) issuance could increase the risk of "moral hazard" (meaning the borrower takes excessive risk knowing relief will be provided).

Despite these challenges and constraints, there is scope for greater use of SCDIs, especially by small open economies that are vulnerable to terms-of-trade shocks and natural disasters. Official sector actions could help realize the potential of this market, including through developing model contracts and common standards, providing technical support to debt management and statistic offices, and, more ambitiously, by underwriting or subsidizing their issuance. Public creditors should also consider increasing the use of state-contingent instruments in their own lending, building on existing experience such as countercyclical lending contracts by the Agence Française de Développement.

^a International Monetary Fund, "State-contingent debt instruments for sovereigns", IMF Policy Paper, 22 May 2017. Available from <https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/05/19/pp032317state-contingent-debt-instruments-for-sovereigns>.

change adaptation needs, the international community could also consider a greater use of global risk pooling mechanisms (see also chapter III.F).¹¹

5. Resolving unsustainable debt situations

As the Addis Agenda notes, scope exists to improve the arrangements for resolving sovereign insolvency crises.¹² Recent developments reported above may further challenge these arrangements.

5.1 Official creditor involvement in debt restructurings

A more fragmented official creditor base could pose coordination challenges in future debt restructurings. Effective official creditor coordination will remain essential, given what are referred to as first-mover and free-rider problems.¹³ The Paris Club has extensive experience in negotiating debt relief on behalf of a large group of official creditors in

¹¹ See, for example, United Nations Conference on Trade and Development, "Environmental vulnerability and debt sustainability in the Caribbean: do we have enough tools to address catastrophic risk?", Policy Brief 62. Available from http://unctad.org/en/PublicationsLibrary/presspb2017d11_en.pdf.

¹² *Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda)* (United Nations publication, Sales. E.16.I.7), para. 99. Available from http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf.

¹³ A "first-mover" refers to the first creditor to restructure, who in turn gets the most favourable deal; the "free-rider" is a less cooperative creditor who benefits from concessions given by other creditors.

ways that overcome these problems. Further expansion of the Club would provide one way to address this challenge in the new environment and thereby strengthen the international financial system. Alternatively, official creditors would need to develop other coordination mechanisms.

International practice has been not to restructure debts owed to the multilateral institutions and to the IMF, except in exceptional circumstances, such as those addressed by the Multilateral Debt Relief Initiative of 2005. However, there is thus far no experience in restructuring debts owed to new development finance institutions, and it is unclear whether these creditors will demand senior treatment on par with established multilateral creditors (such as the World Bank) that other official bilateral creditors may not accept. A further complication is the case of public sector entities that have purchased and hold the sovereign bonds of other countries. In these circumstances, there could be a lack of clarity about whether the bondholder is a private or an official creditor. Even where this distinction is clear, the existence of official and private creditors in the same voting pool (e.g., in a bond with collective action clauses) could complicate restructurings.

Against the backdrop of a more challenging official sector landscape, it would be helpful to look back at prior experiences of official sector actions to identify workable approaches for the future. In this context, and as part of its commitment to assemble a comprehensive database on debt restructurings, the IMF is examining ways to present comparable information on both private and official sector involvements (building, for the latter, on the database of Paris Club debt treatments). The effort is expected to be completed by end-2018.

5.2 Private creditor involvement in debt restructurings

Lacking sufficient political support to develop a proposed comprehensive sovereign debt workout mechanism, the international community has focused on encouraging contractual improvements to facilitate restructuring of insolvent obligations to private cred-

itors. In addition, to further encourage cooperative behaviour, a number of “soft-law” approaches have suggested principles and guidelines for debtor and creditor interaction.

In October 2014, the IMF endorsed key features of enhanced collective action and *pari passu* clauses in international sovereign bond contracts. These features are meant to reduce issuers’ vulnerability to holdout creditors in case of a debt restructuring. Between October 2014 and end-September 2017, 245 of the 338 international bond issuances (approximately 87 per cent of the nominal principal value of new internationally issued sovereign debt) included such enhanced collective action and modified *pari passu* clauses. However, with only about 27 per cent (\$294 billion out of \$1.1 trillion) of the outstanding stock of international sovereign bonds having the enhanced clauses, a significant stock without these provisions remains and will decline only gradually.¹⁴ Moreover, the enhanced clauses only apply to bonds; a significant portion of developing countries also have borrowed from banks, to which these clauses do not apply.

While an aim of the contractual reforms was to reduce the ability of non-cooperating bondholders to undermine voluntary restructurings, investors in distressed debt have a role to play in resolving unsustainable borrowing situations. Distressed debt investment funds can provide liquidity in secondary markets for sovereign bonds. However, a subset of these funds that buys the distressed debt at a large discount with the intent to recover the full face value through litigation has made restructurings extremely difficult. Thus, recent legislative efforts have been made to curtail this type of investing, including the Law on Deterring the Activities of Vulture Funds, adopted in Belgium in 2015. A spread of such legislation to other jurisdictions could help to further discourage disruptive behaviour and should aim to strike the right balance between further discouraging disruptive behaviour and preserving secondary-market liquidity.

In the absence of “hard” law oversight of workouts from sovereign insolvency, a number of forums

¹⁴ International Monetary Fund, “Third Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts” (Washington, D.C., 2017). Available from <https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/12/15/pp113017third-progress-report-on-cacs>.

have sought to specify principles and guidelines that, while not mandatory, could, through voluntary adoption, become accepted standards that courts might choose to enforce. Indeed, the Addis Agenda committed Member States to working towards a global consensus on guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, building on existing initiatives.

Such initiatives began with the “Principles for stable capital flows and fair debt restructuring” of the private sector Institute of International Finance (IIF), originally issued in 2004, last updated with an addendum to the principles in 2012;¹⁵ this was followed by the Human Rights Commission’s “Guiding principles on foreign debt and human rights”¹⁶ in 2011, the UNCTAD “Principles on promoting responsible sovereign lending and borrowing”¹⁷ (noted in para. 97 of the Addis Agenda), the General

Assembly resolution on basic principles on sovereign debt restructuring processes¹⁸ that has been adopted into national law by two countries, and the Group of Twenty’s (G20) “Operational guidelines for sustainable financing”.¹⁹

While the IIF initiative focused on recommendations to debtor governments, the other initiatives focused on the responsibility and accountability of borrowers and lenders alike. The UNCTAD Principles also focus on the safeguarding of the public interest in sovereign debt financing and contracting. The G20 guidelines emphasize best practice and are concerned with the sustainability of financing tools and practices. These different foci and emphases provide ample opportunity for the exploration of complementarities as well as incongruities, in line with the commitment in the Addis Agenda to work towards global consensus.

¹⁵ The Principles and the Addendum may be found in Institute of International Finance, “Report on implementation by the Principles Consultative Group” (2017). Available from https://www.iif.com/system/files/32370132_pcg_report_2016-vf.pdf.

¹⁶ A/HRC/20/23.

¹⁷ United Nations Conference on Trade and Development, “Principles on promoting responsible sovereign lending and borrowing”, UNCTAD/GDS/DDF/2012/Misc.1.

¹⁸ A/RES/69/319.

¹⁹ Welcomed by G20 Finance Ministers, Baden Baden, March 2017. Available from http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Schlaglichter/G20-2016/g20-operational-guidelines-for-sustainable-financing.pdf?__blob=publicationFile&v=2.