FINANCING FOR DEVELOPMENT: PROGRESS AND PROSPECTS

Report of the Inter-agency Task Force on Financing for Development 2017

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Chapter III.E
Debt and debt sustainability

1. Key messages and recommendations

Global gross public and private debt of the non-financial sector reached a record high in 2015, showing the continued risks of high leverage, largely due to increases in public debt and continued high levels of private debt. Changes in the composition of debt—including elevated levels of corporate debt in a number of emerging market economies and the rising trend in short-term debt—pose additional risks to an already fragile global economy. In developing countries, although debt ratios remain significantly below their levels in the early 2000s, debt levels have shown a rising trend of late. A much less favourable external environment, the impact of the 2008 world financial and economic crisis, and other risks such as commodity price shocks and an increase in bond issuances in frontier markets—have contributed to renewed increases in aggregate debt ratios and risks to debt sustainability in a number of countries, including some least developed countries (LDCs) and small island developing States (SIDS).

Rising levels of domestic debt also highlight the importance of public debt sustainability assessments. To effectively carry out such assessments, \textit{it is important to improve the comprehensiveness, reliability, and timeliness of domestic and external debt data, as well as data on government assets and contingent liabilities.} Assisting developing countries “through coordinated policies aimed at fostering debt financing, debt relief, debt restructuring and sound debt management, as appropriate”\textsuperscript{1} is thus as urgent as ever. Indeed, the goal of debt sustainability has been one of the salient features of the financing for development process, which recognizes borrowing, both by governments and private entities, as an important tool to finance sustainable development investments.

While there has been notable progress in a number of areas, implementation of this policy agenda remains incomplete. The focus to date has been on sovereign debt management, debt crisis prevention and on market-based solutions for sovereign debt restructuring. International organizations are providing technical assistance for upstream and downstream debt management. Debtor-creditor engagement issues are under discussion, including in the context of the International Monetary Fund (IMF) revisions of its lending-into-arrears (LIA) policy. There is also work in the United Nations toward a platform for debtor-creditor engagement between sovereigns and their private creditors, which should be taken forward. Separately, the IMF is also working on improving information on sovereign debt restructurings. Bilateral official and multilateral creditors have set up new facilities to provide debt relief in the event of natural or public health disasters.

There is also renewed interest among policy makers in state-contingent debt instruments. However, establishing investor confidence in these instruments remains a challenge. \textit{A case can be made for public creditors to increase the use of state-contingent instruments in their lending, building on existing experiences by some donors.} With regard to private creditors, significant progress has been made in incorporating enhanced collective action and \textit{pari passu} clauses in sovereign bond contracts, with the stock of bonds without clauses beginning to decline, albeit slowly. The

importance of providing “breathing space” to a sovereign at the time of debt distress has been highlighted in the policy debate, but remains to be fully addressed. In addition, work on contractual technology for bank loans is lagging behind. While the share of bond debt in total debt has increased over time, for many developing countries commercial bank loans remain the pre-dominant source of external financing. In this context, further work on commercial bank loan contracts is thus warranted. In a new development, a few jurisdictions have passed or debated legislation to discourage hold-out creditors in a bond debt restructuring by limiting creditors’ potential profits from secondary market purchases. Yet, significant concerns surround the operation of creditors buying distressed debt on secondary markets, and whether their activity may go beyond the desirable function of providing market liquidity. Further policy actions to deal with hold-out creditors in a debt restructuring should be considered.

Concerns remain both over the efficiency and equity of these solutions. In the Addis Agenda, countries committed to work toward a global consensus on guidelines for debtor and creditor responsibilities, building on existing initiatives, such as the United Nations Conference on Trade and Development (UNCTAD) principles for responsible borrowing and lending. This work is continuing, including in the United Nations and the Group of Twenty (G20). The ECOSOC Forum on Financing for Development follow-up could be a useful forum to take up these discussions, in continued cooperation with the international financial institutions, in particular the IMF, relevant United Nations entities, including UNCTAD, and other relevant entities.

2. Debt trends

Global gross debt of the non-financial sector reached $152 trillion, or 225 per cent of world gross product, in 2015, two thirds of which are liabilities of the private sector. One of the triggers of the 2008 world financial and economic crisis was the build-up of excessive debt and leverage in the private financial sector in many advanced economies. Following the crisis, their public debt increased significantly, partly due to the realization of contingent liabilities and bank bailouts. Progress on private sector deleveraging has been uneven. If global growth remains subdued, debt servicing and deleveraging will remain challenging for highly indebted countries and could in turn weigh on growth prospects, including in those parts of the euro area characterized by balance-sheet weaknesses.

In developing countries, external-debt-to-GDP ratios declined since the early 2000s and until the 2008 world financial and economic crisis, due to prepayment of debt by some middle-income countries, rapid growth, and debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI). Their overall debt situation remains relatively benign, but debt has recently increased in some cases and the ratio of short-term debt to total external debt is on a rising trend in PRGT-eligible countries, raising additional risks (see online annex).

Declines in export revenue and widening fiscal deficits in the context of slow growth—and, in some cases, commodity price declines—have led to greater demand for external financing and increases in external-debt-to-GDP ratios in low-income countries and LDCs (figure 1). In SIDS, some of which have been caught in debt difficulties for many years, average debt-to-GDP ratios increased from 27 per cent in 2008 to 45 per cent in 2016. Assessing debt sustainability through aggregate indicators can conceal risks in individual countries, however. In five SIDS, external debt-to-GDP ratios rose by 40 percentage points or more over this period. The 20 low- and lower-middle-income countries with the largest increases in debt saw their external debt-to-GDP ratios increase by almost 27 percentage points on average between 2010 and 2015.
In commodity-exporting countries, low commodity prices have led to deteriorating current-account balances and fiscal positions, and to higher debt and falling reserves, particularly in countries dependent on fuel exports. Foreign reserves are set to fall to below three months of prospec-
tive imports in 15 out of 26 commodity-exporting low-income countries, more than double the number in 2014. Overall, external financing requirements as a share of reserves have increased across developing countries since the financial and economic crisis, with increases most pronounced in LDCs (figure 2).

The averages also mask rapid debt build-up in a number of countries. Following a significant net improvement in ratings on risk of debt distress since 2007, the IMF and World Bank's low-income country debt sustainability framework (LIC DSF; box 1) has recently started to show deterioration for some low-income countries. Ratings reached their most favourable point in 2013; only 24 per cent of countries eligible to use the IMF concessional resources under the Poverty Reduction and Growth Trust were rated as facing high risk of debt distress, down from 43 per cent in 2007. Since then, there has been a net deterioration in risk ratings, with relatively more downgrades than upgrades (figure 3). This includes countries that benefited from HIPC and MDRI: as of March 2017, 9 post-completion point HIPC countries are considered at high risk of debt distress by the IMF and the World Bank.

Changes in the composition of debt in developing countries warrant careful attention. Corporate debt has reached elevated levels in a number of emerging market economies. For example, since 2008 the debt of non-financial corporations in 15 emerging and large developing economies more than tripled to about $25 trillion. In some countries, corporate debt is backed by sovereign guarantees, but even if debt is not guaranteed, a socialization of these debts can occur via Governments bailing out banks holding non-performing corporate loans. Possible currency mismatches also present risks. A further appreciation of the United States dollar due to rising interest rate differentials could escalate these risks.

A second major development has been an increase in the number of developing countries, including LDCs, that have been able to borrow on international capital markets over the last five years. As a result, the share of external public and publicly guaranteed debt raised from private creditors has increased significantly in developing countries. Accessing international bond markets allows developing countries to raise untied resources while diversifying their financing options. At the same time, it also increases risks—both currency and roll-over risks—and further exposes borrowing countries to changes in global economic conditions. Indeed, as capital flows to developing countries declined in 2015, bond spreads widened sharply, in particular in commodity-exporting countries.

There is also evidence of rising levels of domestic debt. According to data published by the Bank for International Settlements, the share of domestic debt in total debt securities rose from about 56 per cent in 2000 to 87 per cent in 2015 in 65 developing and emerging countries. Domestic borrowing in developing countries typically carries a higher interest rate than external borrowing, but it can help reduce currency risk and volatility. To effectively carry out debt sustainability assessments, it is important to improve the comprehensiveness, reliability and timeliness of both domestic and external debt data, as well as data on government assets and contingent liabilities.

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6 Defined as current-account balance plus amortization of total short-term external debt at remaining maturity and of long-term debt maturing during the current year.


8 International Monetary Fund, op. cit.


Figure 2.a
External financing requirements of low- and middle-income countries, weighted averages, 2000 – 2016, (Share of international reserves)

Figure 2.b
External financing requirements of least developed countries and small island developing States, weighted averages, 2000 – 2016 (Share of international reserves)

Source: IMF World Economic Outlook database, UN/DESA calculations.
Notes: Low-income, lower-middle-income and upper-middle-income countries’ series: countries classified according to 2016 World Bank income classification; Least developed countries and small island developing States series: classified according to United Nations classifications; PRGT-eligible countries: countries eligible to concessional funding by the IMF, broadly aligned with IDA graduation practices, as of end-September 2016 (for consistency, this series includes 74 countries, including countries that were part of the 2015 PRGT graduation (Bolivia (Plurinational State of), Mongolia, Nigeria, and Viet Nam)). The 2006 spike in low-income countries is due to accounting for MDRI debt relief in a number of low-income countries as serviced debt.
3. Innovative instruments for managing debt burdens

State-contingent debt instruments—which tie a sovereign’s net payment obligations to its payment capacity—have drawn renewed interest from policymakers. Such instruments are designed to provide automatic protection against pre-defined shocks, thus providing both a countercyclical and a risk-sharing function. They can be an important component of efforts to prevent debt crises.

Several types of state-contingent debt instruments have been either discussed or implemented in recent years. GDP-linked bonds, where the coupon and/or the principal of sovereign bonds are indexed to GDP growth, have been discussed since at least the 1980s. Important benefits of GDP-linked bonds include their ability to make balance sheets safer, provide fiscal space during downturns, and decrease the likelihood of debt distress. However, take-up has been limited thus far, and they have primarily been used in debt restructuring contexts or in the form of commodity hedges. Several Governments have issued GDP warrants, which pay out additional interest if GDP growth is higher than pre-defined levels—for example, Argentina (in the context of its debt restructuring in 2005), Greece and Ukraine. However, warrants do not provide symmetric adjustments in cases of lower-than-expected growth.

State-contingent instruments have also been used in official lending. The French Development Agency has issued concessional loans in the past that include a maturity extension if export revenues fall below specified levels, and are thus similar in effect to sovereign contingent convertible bonds. To anticipate shocks from natural disasters, Grenada’s 2015 debt rescheduling agreement with the Paris Club and private creditors included a “hurricane clause”, which seeks to provide debt relief in the aftermath of a natural disaster (box 2). A case can be made for official creditors to increase use of such instruments in their regular lending.

Building on work carried out by the Bank of England, the G20 International Financial Archi-
4. Resolving unsustainable debt situations

Considerable progress has been made since the Monterrey Consensus in reducing the debt overhang in highly indebted poor countries, whose main creditors have been in the public sector. Private creditors also contributed to the debt write-down for some of these countries, although a few holders of private sector claims pursued litigation strategies, which at times negated the efforts of the official sector.

4.1. Actions by official creditors

Beyond the HIPC Initiative and MDRI, which are nearly complete, the IMF has implemented new facilities to help countries cope with natural disasters and other shocks, such as the Catastrophe Containment and Relief Trust (CCR), which provides debt relief in the event of catastrophic natural disasters and public health disasters. Guinea, Liberia and Sierra Leone tapped the CCR in 2015 to cope with the fallout from the Ebola outbreak. Reforms to the IMF Exceptional Access lending framework were enacted in 2016 to eliminate the systemic exemption, introduced in 2010, which has proven ineffective in addressing debt problems and preventing contagion. They instead allow for appropriate flexibility, including the use of a “debt re-profiling” option, in situations when debt is assessed as sustainable but not with high probability.

The IMF also revised its policy on arrears to official bilateral creditors in December 2015. Under the new policy, the IMF can consider lending into arrears owed to official bilateral creditors in carefully circumscribed circumstances. The revision aims to strengthen incentives for collective action among official bilateral creditors and to promote more efficient resolution of sovereign debt crises. The recent IMF programme reviews for Ukraine — completed in a context where there were outstanding arrears to

Box 1
Review of the low-income country debt sustainability framework

The low-income country debt sustainability framework (LIC DSF) is currently being reviewed by staff from the International Monetary Fund (IMF) and the World Bank. The LIC DSF assesses the risk of external debt distress of countries eligible for assistance from the Poverty Reduction Growth Trust (PRGT), taking into account several external public debt burden indicators, as well as the quality of borrower countries’ governance. It plays an important role in the international financing architecture: beyond its main role of giving early warning of potential debt distress, the LIC DSF determines countries’ eligibility for and terms of concessional financing, and provides key input for the application of the IMF debt limit policy, among others.

Preliminary work and external consultations have revealed a number of issues, including forecast errors in medium-term debt projections and inadequate capture of some sources of risks, such as market risk. Additional concerns voiced by stakeholders include the use of the World Bank Country Policy and Institutional Assessment (CPIA) scores as a proxy for the quality of governance. In light of the large investment needs to achieve the SDGs, there have also been calls to better reflect productive investments and their relationship to growth and thus repayment capacity.

A number of reforms to improve the framework are being considered by the IMF. These include (i) developing tools that would help to assess the underlying macro assumptions in baseline projections, enhance stress testing, and reflect market-related risks; (ii) updating the empirical model underpinning the derivation of debt thresholds and the methodology for classifying countries to better reflect country-specific information and to improve the framework’s capacity to predict debt distress; (iii) refining the approach to assigning risk ratings, including streamlining the number of debt indicators; and (iv) strengthening the assessment of total public debt.

an official bilateral creditor, no representative Paris Club agreement, and no creditor consent—was the first (and so far only) case where an assessment of the criteria was provided to the IMF board in order to allow completion of the review.

Lastly, the IMF staff is examining issues related to debtor-creditor engagement in the context of a review of the Fund’s LIA policy. By encouraging dialogue, information sharing, and early input into the debt restructuring strategy, the Fund’s LIA policy aims at promoting efficient resolution of debt crises and a speedy normalization of debtor-creditor relations. In this context, a key issue under consideration is where to draw the perimeter for official claims for purposes of the Fund’s arrears policies.

4.2. Involving private creditors in debt restructurings

As more developing countries tap international financial markets and more countries draw upon alternative sources for sovereign financing, borrowing needs to be managed prudently. Even so, the number of countries that need a more comprehensive approach to debt crisis workouts may grow, especially in a challenging global environment. The Monterrey Consensus welcomed consideration of an international debt workout mechanism. However, proposals for a statutory mechanism did not receive sufficient political support. The focus has instead been on market-based solutions, such as contractual clauses in bond contracts, and “soft-law” approaches.
such as principles and guidelines for debtor and creditor responsibilities.

In 2014, the International Capital Market Association published a new model of enhanced collective action and pari passu clauses for use primarily in international sovereign bond contracts, with a view to reducing issuers’ vulnerability to hold-out creditors in case of a debt restructuring. The enhanced clauses, key features of which have been endorsed by the Executive Board of the IMF, were developed partly in response to New York courts’ interpretation of the pari passu clause in litigation against the Argentina and growing concerns over strategic behaviour by bondholders to build blocking positions in individual bond series. The enhanced clauses allow a supermajority of creditors to approve a debt restructuring proposal in one vote across multiple bond series. The revised pari passu clause specifies that equal ranking of debt securities does not imply a requirement to pay all creditors on a ratable (pro rata) basis. In late 2012, in litigation involving Argentina with its hold-out creditors, the United States District Court for the Southern District of New York had interpreted the pari passu clause as requiring ratable payments, and blocked scheduled payments to exchange bondholders until it paid litigating hold-outs. This caused concern that sovereign debt restructurings would become much more difficult to achieve.

Since that time, progress has been made in incorporating these provisions in international sovereign bonds. Based on information available as of October 2016, the IMF reported that 154 out of a total of 228 international bond issuances since October 2014 have included enhanced collective action clauses, representing 74 per cent of the nominal principal amount. The modified pari passu clause is largely incorporated along with enhanced collective action clauses, with some exceptions. However, the outstanding stock of international sovereign bonds without the enhanced clauses—at about $846 billion as of end-October 2016—remains a challenge. Only about 18 per cent of the total outstanding stock of approximately $1.031 trillion includes such clauses; the share of stock without clauses is declining, but slowly.

In December 2016, five years after the original ruling that assessed Argentina to be in breach of its pari passu clause, the United States District Court for the Southern District of New York found that the same sovereign’s payments to other creditors did not violate rights of non-settling investors and did not breach the pari passu clause. Only actions affecting the ranking of payment obligations would constitute such a breach.

4.3. Legislative efforts to address non-cooperative minority creditors

While the new collective action clauses aim to reduce the ability of non-cooperating bondholders to undermine voluntary restructuring of sovereign debt, the success of ex post litigation has highlighted a gap in the architecture for debt crisis resolution. Largely in response to litigations in their courts, a few jurisdictions have passed or debated legislation to discourage hold-out creditors by limiting creditors’ potential profits from secondary market purchases, including the United Kingdom of Great Britain and Northern Ireland, Belgium, and most recently France. Most of this legislation has focused on limiting claims against countries that benefitted from debt relief under the HIPC Initiative. For example, in the United Kingdom of Great Britain and Northern Ireland, a law was passed in 2010 that prevents creditors from suing in the United Kingdom court to enforce payment on the sovereign debt of HIPC debtors on terms more favourable than agreed under the HIPC Initiative. Similar legislation was also adopted by Jersey and the Isle of Man in 2012 and debated in Australia and the States of Guernsey in 2012 and in the United States of America in 2008.

In contrast, a Belgian law adopted in 2015 is not restricted to heavily indebted poor countries. The law limits creditors’ ability to seek enforcement by Belgian courts of claims that are clearly disproportionate to the purchase price if the debt was purchased in the secondary market (the law applies to the debt of any sovereign). In order for this limit to apply, any one of a number of conditions must be satisfied, such as the creditor’s refusal to participate in a debt restructuring process, the creditor’s sys-

tematic use of legal proceedings to obtain payment on repurchased claims, or the creditor’s abuse of the weakness of the debtor state to negotiate an imbalanced repayment agreement.

4.4. Debt financing principles

In the Addis Agenda, Member States committed to work towards a global consensus on guidelines for debtor and creditor responsibilities, building upon existing initiatives, and in this context took note of the UNCTAD principles on sovereign lending and borrowing and other relevant efforts. This work is continuing, including in the United Nations and the G20.

Most recently, the G20 in collaboration with the Paris Club, has started to work on operational guidelines for the sustainable financing of development. The United Nations General Assembly adopted resolution A/RES/69/319 on basic principles in sovereign debt restructuring processes. The resolution declared that sovereign debt restructuring processes should be guided by basic principles of sovereignty, good faith, transparency, impartiality, sovereign immunity, legitimacy, sustainability and majority restructuring.

The ECOSOC Forum on Financing for Development follow-up could be a useful forum for discussing these issues, in continued cooperation with international financial institutions, in particular the IMF, relevant United Nations entities, including UNCTAD, and other relevant entities.

4.5 Looking ahead

It will be important to continue seeking improvements to existing market-based solutions and consider ways to address outstanding issues. Indeed, as recognized in the Addis Agenda, “there is scope to improve the arrangements for coordination between public and private sectors and between debtors and creditors, to minimize both creditor and debtor moral hazards and to facilitate fair burden sharing and an orderly, timely and efficient restructuring that respects the principles of shared responsibility.”

Among the issues under discussion in the international community are whether commercial bank loan contracts can be improved to facilitate restructuring; how to ensure that during a time of debt distress the borrower has time (breathing space) to identify and implement mutually beneficial policies that promote sustainable adjustment, preserve asset values and support growth; debtor-creditor engagement and creditor coordination as bond finance has become more significant; how to ensure that there are effective mechanisms to restructure every component of debt, given the increasingly important role of new providers of development finance (e.g. non-Paris Club creditors); as well as issues related to regulation in trade and finance and their impact on the debt restructuring process.

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