

Financing for Sustainable Development Report 2019

Inter-agency Task Force on Financing for Development



United Nations

This report is a joint product of the members of the Inter-agency Task Force on Financing for Development (a full list of members can be found on page x). The Financing for Sustainable Development Office of the United Nations Department of Economic and Social Affairs serves as the coordinator and substantive editor of the Financing for Sustainable Development 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 Sustainable Development Goals. It provides the complete evidence base for the Task Force's annual report on progress in the seven action areas of the Addis 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 also covers several key cross-cutting initiatives that build on the synergies of the Sustainable Development Goals:

- 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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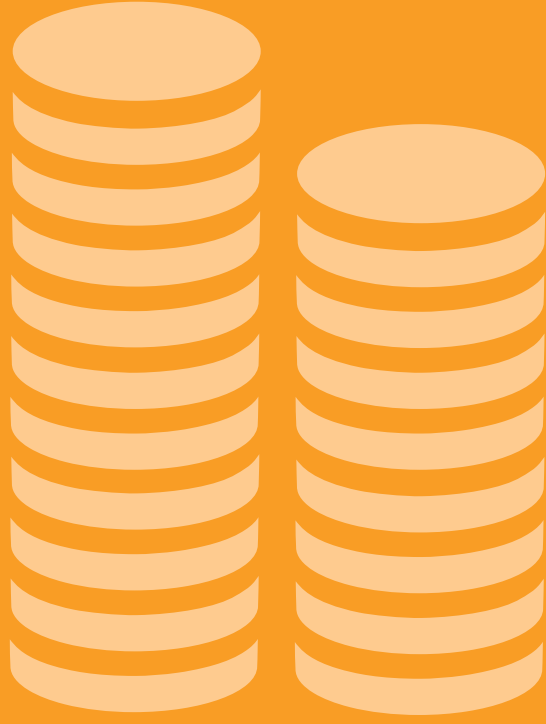
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DEBT AND DEBT SUSTAINABILITY





Chapter III.E



Debt and debt sustainability

1. Key messages and recommendations

Countries face pressing demands for additional public investment in the Sustainable Development Goals (SDGs), but high debt burdens may threaten their ability to raise sufficient financing. Public debt levels have continued to rise since the publication of last year's Task Force report, with some middle-income countries experiencing debt levels last seen during the debt crises of the 1980s. Debt vulnerabilities in developing countries exist due not only to higher levels of debt, but also because of increased risks from a shift in debt composition. A rise in external debt that carries variable interest rates and greater reliance on commercial debt have increased refinancing risks. A more prominent role of non-traditional creditors and market-based financing also presents new challenges for debt crisis resolution.

The rise in public debt has been accompanied by an increase in corporate debt, particularly in middle-income countries, as many large companies took advantage of the long period of unusually low international interest rates. Further increases in global interest rates could create concerns for financial stability, and in many cases, for public debt sustainability as private liabilities often become public during crises. While debt levels in the majority of developing countries remain sustainable, the rise in the number of countries in or at high-risk of debt distress demands the attention of global policy makers.

To retain fiscal space for SDG-related investments in this challenging context, multipronged policy action is needed, at both the national and global levels. This includes measures to improve debt management, debt transparency, and debt sustainability assessments. It can include differentiating how debt financing is used, and prioritizing borrowing for productive investments that can create fiscal space (see chapter II).

The international community is stepping up its work to help countries reduce debt vulnerabilities. Updating analytical tools — such as the Interna-

tional Monetary Fund (IMF) and World Bank's recently revised framework for debt sustainability analysis in low-income countries — can help countries identify risks, make policy corrections, and better understand the relationship between public investment, growth, and debt sustainability. *Debtors and creditors are encouraged to use newly available tools to help inform sustainable borrowing and lending.*

The rise in floating rate debt issued in a low interest rate environment may indicate that some governments have not adopted a sufficiently risk-informed perspective in their debt management. *Governments need to carefully monitor the growth of debt, including contingent liabilities and debt of their private sectors, through a risk-based approach. To address systemic risks posed by private borrowing, governments should aim to adjust regulatory policy frameworks during periods of rising risks. Strengthening debt management through technical assistance and training will help countries deal with existing debt more effectively.* At the same time, there is also a need for complementary actions on the global level in other action areas of the Addis Ababa Action Agenda, including strengthening international tax cooperation, providing reliable sources of concessional development finance, and strengthening macroeconomic policy coordination and the global financial safety net.

The full effectiveness of efforts to improve analytical tools and debt management will require greater debt transparency. *While the primary responsibility for debt transparency lies with debtors, the international community and creditors also have an important role to play. Creditors share the responsibility for making the terms and conditions of lending public, straightforward, and easy to track.* Creditors should also strive for simplified lending terms and avoid onerous conditions on sovereign borrowing. International institutions can update data standards and provide technical

support to improve the capacity to record, monitor, and report debt.

Efforts to provide clear guidance for responsible sovereign lending and borrowing should also be reinforced, building on existing efforts such as UNCTAD's Principles to Promote Responsible Sovereign Lending and Borrowing and the Group of Twenty (G20) Operational Guidelines for Sustainable Financing. *There is merit to exploring how these approaches can complement each other and to work towards global consensus guidelines for debtor and creditor responsibilities, in line with the mandate in the Addis Agenda.*

There continues to be a role for innovative mechanisms to reduce risks to sovereign balance sheets. Although their use so far has been limited, there has been increasing interest over the last year in state-contingent debt instruments (SCDIs), which allow a country's debt service obligations to be linked to its ability to pay. Following the severe hurricane season of 2017, there has been particular interest in developing climate resilient instruments for Caribbean economies susceptible to disasters. The international community can continue to support these efforts, including through technical work to consider appropriate design options for state-contingent debt instruments.

Official creditors should consider increasing the use of state-contingent instruments in their own lending. The Economic Commission for Latin America and the Caribbean (ECLAC) has proposed a swap of some of the region's external debt for debtor country commitments to make annual payments into a new Caribbean Resilience Fund. *Piloting implementation of this or similar proposals in a limited number of countries of the region should be considered.*

While the evolution of private and public cross-border financing modalities and sources of credit have increased the variety and scope of international financing for development, they have also raised concerns that decentralized debt workout processes no longer serve their function well. Changes in the creditor landscape and the increase in collateralized lending have raised new restructuring challenges and brought new salience to the issues of creditor coordination and long-standing challenges in the existing architecture. *It is thus time to revisit existing mechanisms for debt workouts to determine ways to improve their efficiency. Areas ripe for progress may include exploring ways to strengthen creditor coordination, and creditor and debtor dialogue, along with specific elements of debt workouts, such as standstills.*

2. Growing debt, increasing risk

Global debt levels continue to hit new record highs. The Institute of International Finance (IIF) estimates that by the end of March 2018 global debt stocks had reached \$247.2 trillion, having risen by nearly \$25 trillion from a year earlier, and up from \$168 trillion at the onset of the financial crisis.¹

2.1. Public debt

Public sector debt levels in developing countries have risen since 2010, not only in terms of the total value of their obligations but also relative to gross domestic product (GDP) (figure 1). Public debt ratios have largely remained flat in advanced economies in aggregate, albeit at elevated levels compared to before the crisis, and with large increases in some countries (see also chapter III.F.).

Over the past five years, public debt of developing countries rose by 15 percentage points of GDP, from 36 per cent in 2013 to 51 per cent in 2018. While debt levels fell significantly in least developed countries (LDCs) following debt write-offs in the mid-2000s, they have been rising since 2012. Public debt reached 46 per cent of GDP in 2018 on average. This increase reflects adverse shocks and sluggish policy adjustment in some cases, and sustained expenditure increases in others. Data coverage and governance issues also contributed to debt surprises. Debt levels in small island developing States that are vulnerable to natural disasters remain high. Debt increases were also significant among countries in fragile and conflict-affected situations.

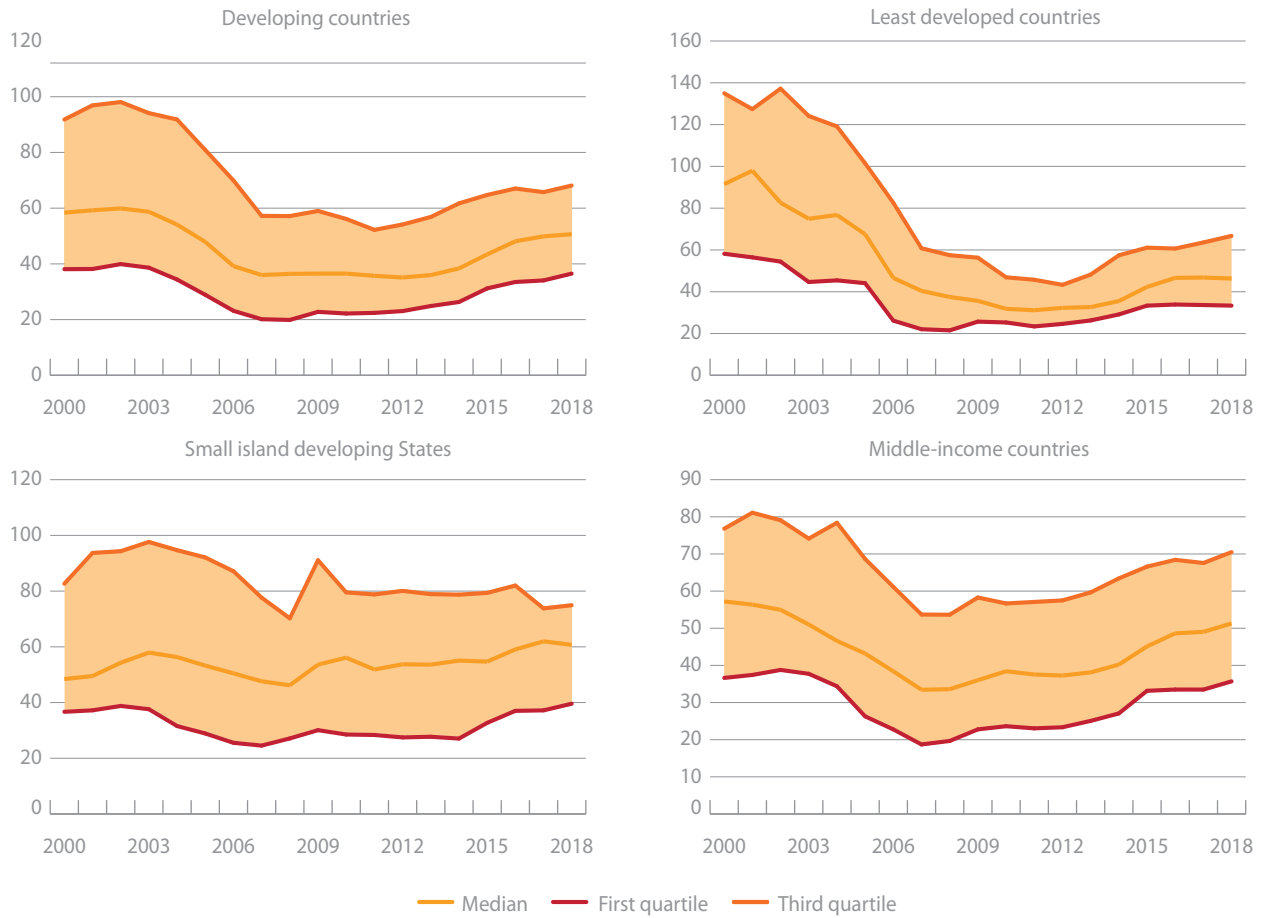
Overall, 40 per cent of LDCs and other low-income countries were assessed as being at a high risk of or in debt distress according to the IMF-World Bank debt sustainability analyses (figure 2). Safety margins for countries at moderate risk of debt distress have also eroded.

The heightened vulnerabilities reflect both higher public debt levels and increased risks from the shift in debt composition toward more financing on commercial terms, leading to higher debt servicing costs as well as increased refinancing, interest rate, and capital flow reversal risks. External debt carrying variable interest rates has increased significantly in recent years. In LDCs, variable interest rate debt now amounts to one third of total external debt, making them much more vulnerable to changes in international interest rates (figure 3). Furthermore, rising exposure to non-traditional creditors has complicated debt resolutions in recent stress events.

The associated rise in debt-servicing costs is an immediate concern, particularly in LDCs, not least because they face serious challenges in implementing the SDGs. Given that these economies are characterized by shallow domestic financial and banking systems, as well as limited access to international financial markets, their options to re-finance maturing debt obligations are limited. Debt service obligations compete directly with other public expenditure for available resources. Indeed, public debt service in LDCs increased from 3.4 per cent of GDP in 2015 to 4.3 per cent in 2017. Over the same period, public expenditure on health care and education, also as a share of GDP, has remained stable, albeit with a slight decline in 2017 (figure 4). Further increases in external debt-servicing costs may induce declines in government expenditure in these areas.

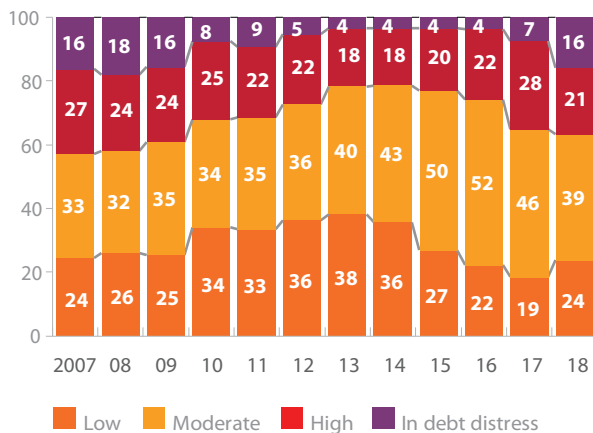
Some of the most pronounced increases in debt were experienced in middle-income countries. Together with changes in the composition of debt, they have resulted

Figure 1
Public debt, 2000-2018
(Percentage of GDP)



Source: IMF World Economic Outlook, DESA calculations.

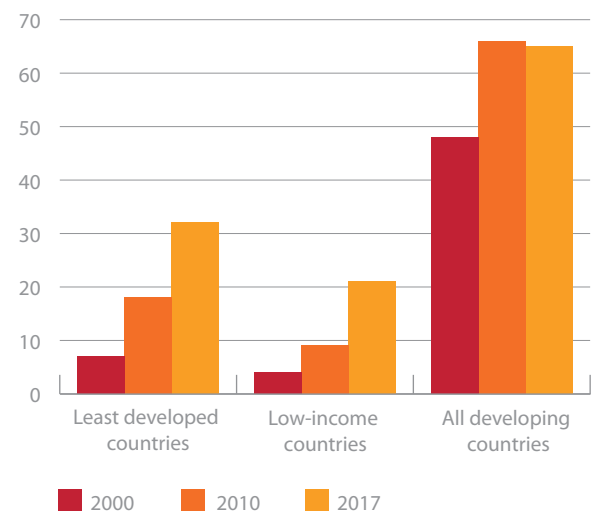
Figure 2
Debt risk classification of low-income countries, 2007-2018
(Percentage of total)



Source: IMF (DSF database).

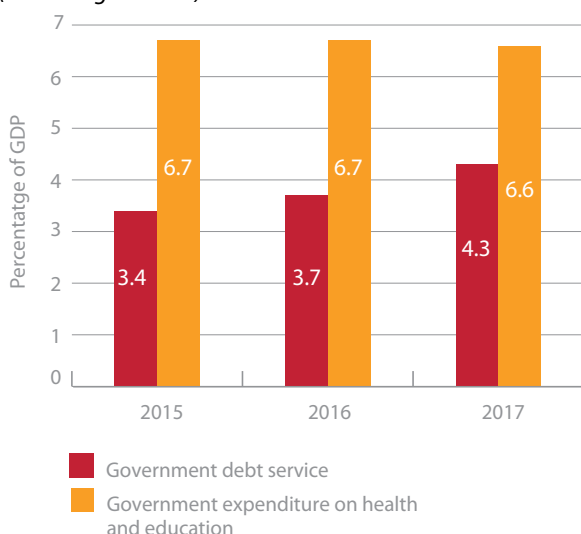
Note: Published debt sustainability analyses, latest available year. Coverage is of low-income developing countries eligible to draw from the Poverty Reduction and Growth Trust at IMF.

Figure 3
External debt with variable interest rates 2000-2017
(Share of total external debt)



Source: World Bank International Debt Statistics, DESA calculations.

Figure 4

Government expenditure on public debt service, education and health care in LDCs*(Percentage of GDP)*

Source: UNCTAD secretariat calculations based on based on World Development Indicators (World Bank) and DSA LIC country reports between 2015 and 2018 (IMF)

Notes:

1. Government debt service is defined as the sum of interest and the amortization of medium- and long-term debt. Figures for LDCs were obtained from the latest IMF DSA country reports. For countries for which official data on debt service was not yet available for the 2015-2017 period, IMF estimates for relevant country reports were used.

2. Estimates for public expenditure in LDCs is constrained by the availability of data. Where official data on government expenditure for education and/or healthcare was not available for the 2015-2017 period, the latest available data were used. The main implication is that the impact of rising external debt service burdens on this expenditure will be underestimated, where increased external debt service costs rose after the allocation of public expenditure to public investment in education and health.

in elevated debt risks. In many cases, the increase in public debt levels reflected understandable policy responses: several countries took advantage of very low interest rates to finance public investment and smooth consumption following the 2014-15 collapse in commodity prices. However, in a number of cases, delayed adjustment to the persisting trend of lower commodity prices, and weaknesses in macro-policy frameworks played a role in driving up debt to potentially unsustainable levels.

In addition, non-resident holdings of domestic currency debt have risen, while external debt that carries variable interest rates rose in line with overall external debt increases. Contingent liabilities have also been on the rise. Public private partnerships (PPPs) — where debt-like obligations can be difficult to disentangle in complex payment contracts — and guarantees are growing in usage. According to the World Bank's Private Participation in Infrastructure (PPI) database, PPI

was up 7 percent over the year in the first half of 2018, totalling \$43 billion. Implicit liabilities within complex structures may continue to grow as blended finance is scaled up. Nonetheless, several countries have strengthened their resilience to debt-related risks through macro-fiscal policies and building external and fiscal buffers, such as increased foreign and fiscal reserve coverage.

2.2. The growing importance of private sector debt

The rise in public debt has been accompanied by a rise in corporate debt. This is the case particularly in middle-income countries, where companies took advantage of the long period of unusually low international interest rates. Corporate debt now significantly exceeds historic levels. Figure 5 illustrates the upward trend in developing country private external debt over the last two decades.

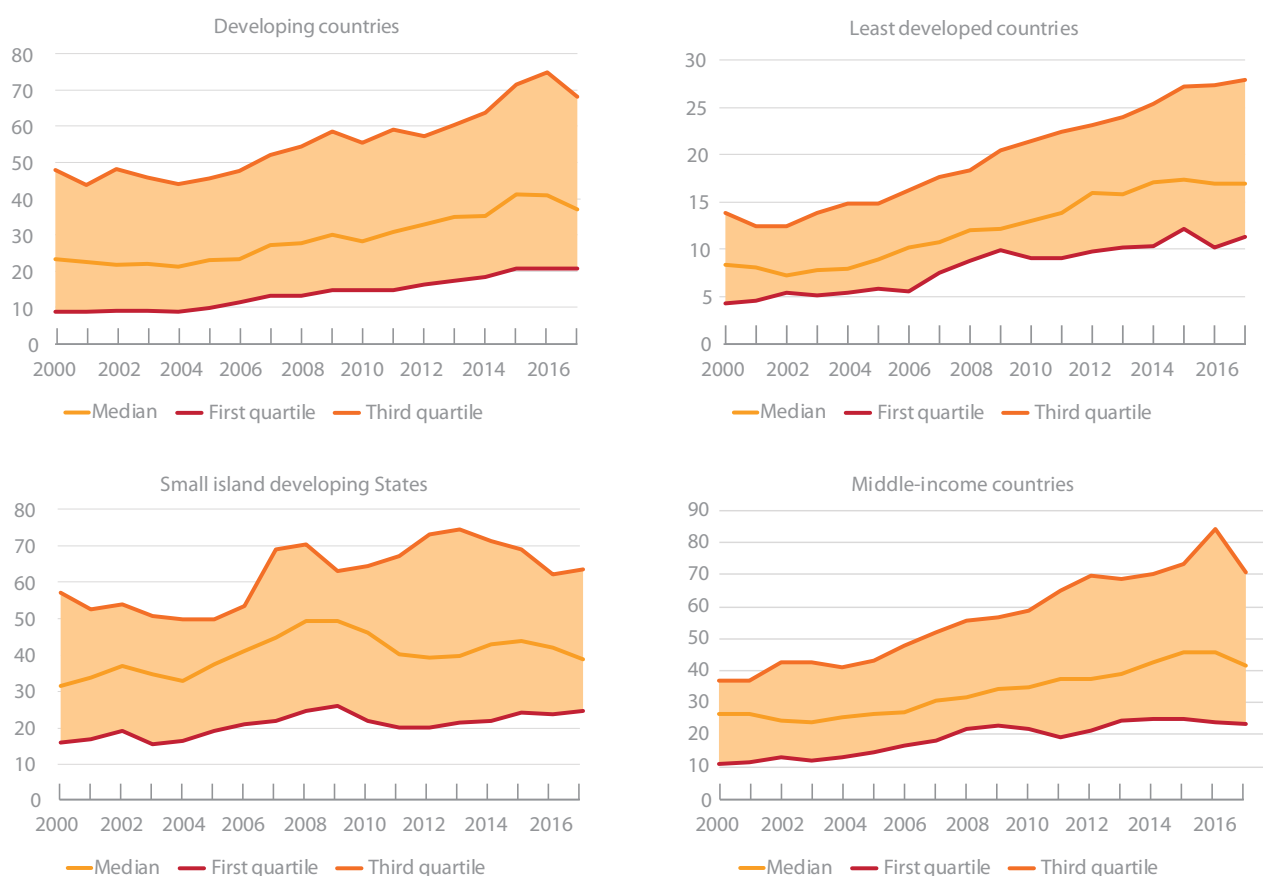
Overall, private external debt of developing countries increased from 23 to 37 per cent of GDP in 2017. This trend is mirrored across developing country groups; in LDCs for example it increased from 8 to 17 per cent. Private debt levels are higher at the upper end of the distribution within each grouping.

The composition of private debt holders has also changed, initially in South and South-East Asian economies, although this is now also evident in other regions. For example, in Latin America and the Caribbean, the share of the private sector borrowing in external bonds and bank loans rose from 29.2 per cent of the total during 2000-2007 to 60.2 per cent in 2017. Non-financial corporate debt shows the most significant increase, from \$41 billion in the pre-crisis period to \$289 billion in 2017.² Financial sector foreign borrowing grew from \$47 billion in the pre-crisis period to \$241 billion in 2017. In Sub-Saharan Africa, the level of private non-guaranteed debt in total long-term external debt stocks increased sevenfold in the first 15 years of the millennium, from \$10 billion to \$70 billion.³

Outside China, where corporate bonds are predominantly domestically owned, large developing country corporates are rife through assets held abroad. Further increases in global interest rates will lead to rising debt-servicing costs, raising concerns for financial stability and ultimately public debt sustainability.

The increase in non-financial corporate debt does not always seem to have translated into productive investments, with growth of non-financial corporate debt outpacing the speed of private capital formation in many emerging economies (figure 6). This could be due in part to growing demand for carry trade operations. Instead of investing in productive capacity, resources raised through issuance of bonds in international markets are used to finance short-term and speculative investment in domestic markets to take advantage of high local interest rates.⁴

Figure 5
Private external debt, 2000-2018
(Percentage of GDP)



Source: UNCTAD secretariat calculations based on IMF Global Debt Database.

3. Sustainable and responsible borrowing and lending for sustainable development

Countries face pressing demands for additional public investment in the SDGs (see chapter II). While public debt can support investment needs when the capacity to mobilize other sources of financing is limited, prudent and efficient use of borrowed resources is essential. To meet large investment demands in an environment where constraints on further debt financing will likely become more binding, a multipronged approach to safeguarding debt sustainability is needed. This approach could include strengthening debt sustainability assessments, strengthening debt management, and improving transparency and data quality (box 1).

To avoid a further deterioration in the debt sustainability of developing countries, such policies directly targeting improved debt sustainability and debt transparency need to be supported and complemented by

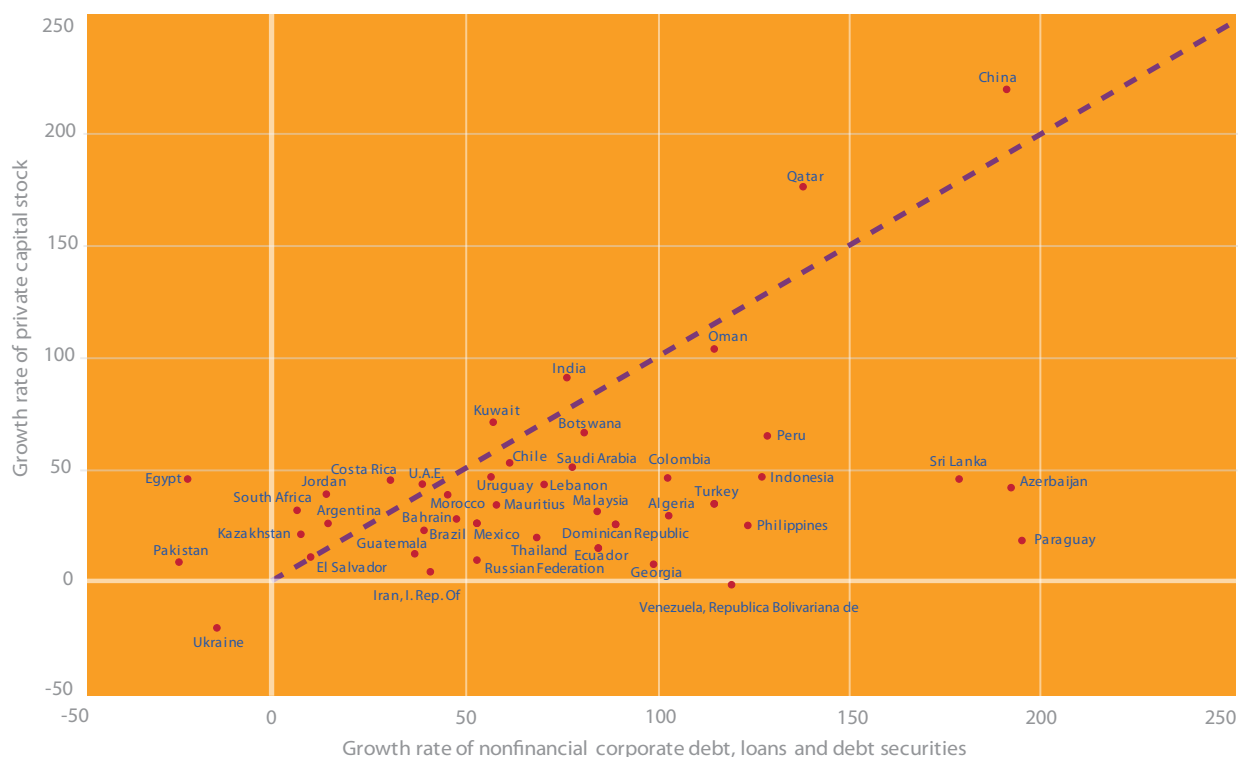
national, international and regional macroeconomic policy coordination designed to facilitate stable international liquidity provision and measures to strengthen developing countries' ability to manage capital flows (see chapter III.F) as well as provision of reliable sources of development finance (see chapter III.C). Rising debt risks also call for renewed attention to commitments made in the Addis Agenda to work towards global consensus on guidelines for debtor and creditor responsibilities, building on existing initiatives.

3.1. Strengthening tools to assess debt sustainability

Debt analysis helps countries assess risks in their fiscal and financing plans, and identify vulnerabilities for policy corrections. In 2017, the IMF and World Bank strengthened their joint framework for assessing the sustainability of public and external debt of low-income countries (LIC-DSF), or debt sustainability assessment. The new framework became operational on 1 July 2018. It was deployed by 17 countries by end-2018 and 17 train-

Figure 6

Growth rates of non-financial corporate debt and private capital stock, selected developing countries, 2008-2015



Source: UNCTAD secretariat calculations, based on IMF Global Debt Database and IMF Investment and Capital Stock Data.

ing sessions have been provided for country officials. The new framework allows for more granular debt analysis, taking better account of country-specific circumstances and the evolving landscape. It also makes stronger requirements on debt data coverage and disclosure, responding to growing concerns on debt transparency among the international financial community.

The new LIC-DSF also introduced a “realism tool” for the investment-growth nexus to allow users to better understand the potential impact of public investment and growth dynamics on debt sustainability. As noted in last year’s report, well-designed public sector investments that boost the productive capacity of an economy can result in higher income for the Government and help offset the associated debt service. In the outcome document of the 2018 ECOSOC Financing for Development Forum, Member States of the United Nations encouraged “further work in this regard, including how this could be incorporated into public debt analysis, notably through the use of tools for quality assessment, while ensuring that risks of debt distress are flagged consistently and in a timely manner”. While a full model of investment, growth and debt dynamics is challenging, the new ‘realism tool’ is a helpful step in better understanding the relationship among public investment, growth, and debt sustainability.

In addition, the IMF has started to review the frame-

work for assessing debt sustainability in countries with significant access to international debt markets (MAC DSA). Based on backtesting analysis and consultations with IMF stakeholders, the review will seek to propose consistent coverage of the main fiscal risks facing countries; incorporate relevant country-specific factors; improve the framework’s capacity to identify stress episodes; better capture uncertainty around baseline assumptions; and provide more structure for determining when to exercise judgment in the assessment. It is expected that a final set of proposals will be considered by the IMF Executive Board during 2019 and introduced in country analyses during 2020.

Undertaking and publishing debt sustainability analyses can help enhance debt transparency. The IMF also uses assessments from the LIC-DSF and MAC-DSA frameworks to help inform whether public debt conditionality may be needed in IMF-supported programs. Under the current Debt Limits Policy, public debt conditionality should normally be included in IMF programmes when a member faces significant debt vulnerabilities, or when there are merits to using debt targets instead of, or as a complement to, “above-the-line” fiscal conditionality.⁵ A periodic review of the Debt Limits Policy is underway, examining whether the policy has been implemented as envisaged, is effective when used, and whether rising debt vulnerabilities and

the changing financing landscape and instruments have revealed weaknesses in the existing policy.

3.2. Improving public debt management

The primary objective of debt management is to raise required funding at the lowest cost over the medium term, consistent with a prudent degree of risk. In an evolving and more complex financing landscape, greater capacity to manage the cost-risk trade-offs in public debt management is essential to enable countries to address rising debt vulnerabilities. The recent rise in debt vulnerabilities due to the shift in debt composition suggests that these trade-offs may not have always been fully considered in borrowing decisions. For example, the increase in floating rate borrowing during the period of extremely low interest rates could have indicated incomplete risk analysis of floating- versus fixed-rate borrowing.

In some cases, borrowing constraints have been relaxed, as even countries with heightened debt vulnerabilities have now been able to access financing. Some of these borrowers have relied on financing that includes greater protection for some creditors in case a debt resolution is needed, such as through collateralized borrowing. The increased prevalence of domestic debt and private debt, extra-budgetary debt and subnational debt,

and the growing importance of PPPs and other contingent liabilities exacerbate the problem.

In this context, the international community is stepping up its capacity building efforts. Through the Debt Management Facility (DMF), a multi-donor trust fund that funds technical assistance to 84 countries, the IMF and the World Bank funded 83 capacity development activities in 2018, with a further 92 planned for 2019. A third phase of the DMF will be launched in 2019 to increase funding. Planned areas of support will include helping countries to develop debt management reform plans, formulate and implement medium-term debt management strategies, and build capacity to develop domestic debt markets. In light of the strong linkages between debt management strategies and other financing policy objectives, such as financial sector development and macrofinancial stability, such efforts can also support strengthening of integrated national financing frameworks (see chapter II). In response to changes in the financing landscape, the focus of technical assistance will be adapted by broadening the institutional coverage, and addressing risks arising from non-traditional financial instruments and non-debt liabilities, including instruments that may not be statistically or legally defined as debt.

The UNCTAD's Debt Management and Financial

Box 1

The multipronged approach to addressing emerging debt vulnerabilities

In response to calls by the international financial community, IMF and World Bank staff developed a multi-pronged work programme to address emerging debt vulnerabilities. The work programme, which was presented to the Executive Boards of the IMF and the World Bank in November 2018, comprises four key work streams:

1. **Improve debt analysis and early warning systems.** The work programme seeks to buttress the existing IMF/World Bank tool set for fiscal and debt risk assessment through: (i) a steadfast implementation of the new LIC DSF with enhanced features to better capture evolving debt vulnerabilities; (ii) a review of the MAC DSA framework to improve its crisis predicting capacity and ensure transparent and robust risk analysis; and (iii) the continued provision of needed training and technical assistance to support the implementation of these initiatives.
2. **Enhance debt transparency.** Debt transparency is critical to ensuring effective risk assessment to support sustainable borrowing and lending. IMF and World Bank staff will build on the existing data dissemination standards and initiatives for improving the availability and timeliness of comprehensive and reliable debt data. Under the work programme, staff will also explore different options for improving access to IMF/World Bank debt data and analysis and for promoting debt transparency through enhanced outreach to both traditional and non-traditional lenders.
3. **Strengthen debt management capacity.** Continued technical assistance is needed to support borrower countries' capacity development against the backdrop of an evolving creditor and instrument landscape. Important weaknesses have been identified in the areas of legal and institutional frameworks, human resources, governance, and audits and internal controls. Against this backdrop, IMF and World Bank staff will scale up support for debt transparency and fiscal risk analysis, including in the context of the Phase III implementation of the Debt Management Facility, and develop better targeted reform plans tailored to country specific needs as identified by enhanced and expanded diagnostic tools.
4. **Review debt policies.** Debt policies need to adapt to current and new debt challenges, set incentives for sustainable borrowing and lending, and support the debt resolution architecture. In this context, IMF and World Bank staff will undertake a review of their respective Debt Limits Policy and Non-Concessional Borrowing Policy in close consultation with all important stakeholders in the coming months. The IMF also plans to resume the Lending into Arrears Policy Review in late 2019.

Analysis System (DMFAS) Programme also reinforced its efforts. DMFAS shapes its assistance around the growing importance of domestic financing, the need to integrate debt management into the larger public finance management (PFM) framework, and to support the international focus on improving debt data transparency. In 2018, the programme supported 84 institutions in 57 countries (mainly low-income and lower-middle income) in strengthening their capacity to record, process, monitor, report and analyze public debt. It paid particular attention to helping countries produce clearly identifiable outputs through tailor-made technical assistance projects for strengthening debt management systems and the quality and reporting of debt data. Assistance provided led to improved debt coverage, enhanced transparency and reporting, improved operational risk management and greater integration with other PFM systems.

There is nonetheless a continuing need for technical assistance, not only because the sources and debt instruments continuously evolve, but also because countries often employ too few staff in relation to the workload; not enough of them are well-prepared, and turnover can be high. In light of the growing number of initiatives to scale up technical assistance in public debt management, continued coordination efforts among providers help reinforce the overall effectiveness and efficiency of the various initiatives, promote synergies and minimize overlap and duplication.

3.3. Enhancing data quality and transparency

One common challenge in public debt management is debt data quality and transparency. Strengthening debt data quality and transparency helps countries have a more complete picture of their debt, guiding borrowers, informing creditors' decisions on the appropriate magnitude and terms of lending, and enabling a broader community of stakeholders to monitor emerging risks. In a number of countries, there are significant gaps both in the data collected on public sector debt and the public availability of that data—gaps which have contributed to unfavourable surprises when unrecorded debt is ultimately exposed.

These gaps can take the form of off-budget activities such as sovereign guarantees of private investments and state-owned enterprise debt. Confidentiality requirements may cloud the terms and conditions of loans, particularly collateralized debt. Moreover, in countries that only record debts when disbursed, contracted but undisbursed government borrowing will be hidden. In addition, the contingent liabilities built into PPP contracts are rarely recorded, despite their potential to generate public debt in the event the projects fail.

Only the borrower can possess all the data and information on its borrowing activities; the borrower thus has responsibility for ensuring debt transparency. The average quality of debt management in institutions in developing countries has been improving only slowly

however, leading to a lack of comprehensive debt data reporting. Results from the World Bank's Debt Management Performance Assessment in 37 countries that have received at least two assessments over 2008-2015 point to uneven improvements in core debt management functions, particularly in areas central to debt transparency. Although there were some improvements in areas such as coordination with monetary policy and managerial structure, progress in, for example, debt evaluation and reporting, debt administration and data security, and operational risk management has been limited. Moreover, performance in the areas of audit and coordination between debt management and fiscal policy declined.

Greater efforts are therefore needed in the area of capacity development in recording, monitoring, assessing, and adequately reporting debt, and the associated vulnerabilities and fiscal risks, supported by targeted training and technical assistance. In this context, the IMF launched the Data for Decisions Fund in June 2018, a trust fund to support capacity development in national statistics, which has identified improving the quality of debt data as an immediate priority. UNCTAD has also launched new initiatives in this area, as described in box 2. These efforts should be complemented by reforms to enhance governance in public financial management, as well as a strengthening of the legal framework for monitoring the borrowing of off-budget entities/funds and state-owned enterprises.

3.4. Creditor responsibilities

Creditors can also improve public debt information, and their data on loans can be complete and be compared with the data on borrowing recorded by debtor Governments. To this end, the IMF, the World Bank, the Bank for International Settlements, the Organization for Economic Cooperation and Development (OECD) and the Paris Club have prepared creditor as well as debtor-generated data sets in the Joint External Debt Hub that they make public and continually seek to upgrade.

The IMF and World Bank also promote debt transparency and sustainable lending through direct outreach to both traditional lenders (through the established OECD/Paris Club frameworks) and non-traditional lenders (through tailored advice and technical support). Outreach to non-traditional creditors will scale up, with a new training course for emerging creditors on debt sustainability analysis to be offered starting in the spring of 2019.

The private sector Institute of International Finance has put forward an initiative for a coordinated information-sharing platform to encourage greater—albeit voluntary—disclosure among private lenders. It will be important to secure disclosure of the right information, and for lenders in all G20 members to participate. All types of creditors should strive for simplified lending terms and avoid onerous conditions on sovereign borrowing. For example, in several recent distress cases, collateralized lending has complicated debt resolution.

Efforts to define and guide responsible sovereign

Box 2

Improving high quality debt recording and reporting

UNCTAD, through the the Debt Management and Financial Analysis System (DMFAS) Programme, has launched initiatives that are specifically designed to support countries in their efforts to improve capacity for high quality debt recording and reporting. The Debt Data Quality Assessment Methodology, developed in a joint initiative by UNCTAD and the Commonwealth Secretariat, is a framework to systematically assess the quality of databases recorded in debt management systems. It complements existing tools by adding granularity to those initiatives as it specifically targets countries' databases.

The development of DMFAS 7, the seventh major version of UNCTAD debt management software, has been launched. The new software will provide comprehensive support for the recording, monitoring and analysis of external and domestic debt and respond to meet major challenges and new practices in debt management. It will expand coverage of external and domestic public debt to include detailed and aggregated debt data for different institutional sectors, and a wider range of debt instruments and other types of liabilities. A redesigned debt securities module will be developed to improve the recording of related transactions and reports.

UNCTAD will also scale up its capacity-development support to countries in debt data recording, monitoring and reporting. In addition to its current focus on debt data validation, debt statistics and the production of statistical bulletins, it will include training on the development of procedures manuals. The traditional classroom and hands-on training will increasingly be complemented by new delivery methods such as e-learning and self-learning.

lending should also be reinforced. Rising debt risks call for renewed attention to commitments, made in the Addis Agenda, to work towards global consensus on guidelines for debtor and creditor responsibilities, building on existing initiatives. They include the UNCTAD Principles to Promote Responsible Sovereign Lending and Borrowing (2012), which provide a comprehensive normative framework to guide best practice in sovereign lending and borrowing. The G20 Operational Guidelines for Sustainable Financing (2017) aim to enhance access to sound financing for development, while ensuring that sovereign debt remains on a sustainable path, by fostering information-sharing and cooperation among borrowers, creditors and international financial institutions, as well as learning through capacity-building. The differences in emphasis between these approaches suggest that there is merit in exploring their complementarities and possible incongruities, in line with the mandate in the Addis Agenda.

4. Innovative and risk-reducing borrowing instruments

There are several types of innovative debt instruments that can help policymakers better manage risks and/or give countries room for SDG-related investments. One category, state contingent debt instruments (SCDIs), aims to reduce debt payments during periods of low fiscal revenue—for example, by tying debt payments to GDP, commodity prices, or catastrophic events—thus creating counter-cyclical liabilities. A second category, which aims to swap debt payments into SDG-related investments, can be particularly useful for countries with limited fiscal space for SDG-related investments.

4.1. State-contingent debt instruments

State-contingent bonds linked to commodities, such as oil, have been on the agenda since the 1970s, with SCDIs discussed more broadly since the emerging market crises of the 1980s and 1990s. More recently SCDIs have received increased attention. SCDIs link debt service to a measure of the sovereign's capacity to repay. They could help preserve fiscal space in bad times and reduce the number and cost of sovereign debt crises. In the context of rising debt risks and increased volatility, interest in an increased role for SCDIs has continued to develop.

The Paris Club launched a “resilience workstream” in 2018, and the finance ministers of the Group of 7 endorsed work towards drafting a term sheet that could be used as a model for “climate resilient instruments” (CRIs) that could be attractive to developing country issuers susceptible to disasters. Such instruments can complement ex-ante financing mechanisms, which enable governments to invest in disaster risk reduction and resilience.

Following the severe hurricane season in 2017, there has been particular interest in developing CRIs for Caribbean governments. The Caribbean is among the most disaster-prone regions in the world, with average annual damage of about 2.4 per cent of GDP from 1990 to 2014, and extremely severe damage of about 200 per cent of GDP in the worst cases. In May 2018 the Governor of the Eastern Caribbean Central Bank (ECCB) requested the collaboration of the World Bank and the IMF in exploring the potential use of state-contingent instruments.

A World Bank/IMF technical working group was set up and has focused on two broad designs for CRIs. The first CRI is a form of insurance, which could be purchased to cover a specified amount of debt service payments following disasters, allowing countries to reallocate budgetary funds towards recovery and re-

silent investments. The second option would build on the “hurricane clauses” introduced in Grenada’s debt restructuring and would embed automatic maturity extensions following disasters directly into debt contracts. In the latter case, the International Capital Markets Association (ICMA) have developed draft “term sheets” and sought feedback in early 2019 from key stakeholders.

SCDIs have also featured in debt restructurings, where the creditors are in any case facing potential losses on their defaulted credits. Thus, two sovereign debt restructurings in 2018 introduced state-contingent features that will provide downside protection to the issuers. In Chad, the restructuring of debts owed to a private oil trader introduced mechanisms that will accelerate or slow principal repayments depending on the availability of oil receipts. Given Chad’s dependence on oil revenues to pay debt service, this should reduce the likelihood of costly repeat restructurings in coming years. Barbados introduced “hurricane clauses” in its comprehensive debt restructuring of both domestic and external claims, with the domestic exchange completed in November 2018.

Nonetheless, despite their potential, complications such as novelty and liquidity premia demanded by investors, adverse selection and moral hazard risks, and adverse political economy incentives have hindered wider market development of SCDIs to date. Efforts by public institutions to underwrite or subsidize SCDI issuance, incorporate SCDIs into their own lending portfolios, or to act as market makers for SCDIs issued by sovereigns could help further realize the potential of this market.

4.2. Debt swaps

Debt conversion or debt swap mechanisms cancel part of a country’s debt in order to release resources that would have been used for debt servicing for investments in sustainable development priorities. Debt swaps have a long history, and have been used both to purchase commercial debt in secondary markets and to swap bilateral debt. Examples include debt-for-nature swaps and debt-to-health swaps. More recently, the Seychelles converted some of its sovereign debt to the Paris Club for marine conservation efforts and climate adaptation programming.

The Economic Commission for Latin America and the Caribbean has proposed debt swaps to reduce the debt burden of participating countries while channelling more funds into green investments in the region (box 3). Debt conversion mechanisms have generated substantial resources for sustainable development investments over their history;⁶ because they tie freed resources to a specific end use, they are not an appropriate instrument to address countries facing debt distress.

Box 3

A Caribbean debt swap for climate adaptation investment

The Caribbean region is heavily indebted and periodically exposed to devastating hurricanes, as in 2017. High debt has brought about a period of fiscal consolidation which continues to restrict the capacity of Governments to sustain social spending and invest in much needed climate-resilient infrastructure, while not relieving the debt burden. In this context, the Economic Commission for Latin America and the Caribbean (ECLAC) has proposed a swap of some of the region’s external debt for debtor-country commitments to make annual payments into a new Caribbean Resilience Fund. The proposal is being developed by a regional task force that is now seeking to engage three countries of the region in a first phase of the project.

ECLAC proposes that the Green Climate Fund (GCF) buy up some of the external private debt of participating countries at a discount reflecting financial market sentiment about the debt, and that it also negotiate a discounted value of the country obligations to certain bilateral and official creditors. GCF would then pay down the discounted country obligations to those creditors over a period of years. For their part, the Caribbean countries would commit to pay into the new Caribbean Resilience Fund the amount that they would have paid as debt servicing to its former creditors.

The participating countries would thus exchange the affected debt obligations for an obligation to pay an amount annually into the new regional fund – an amount that would have otherwise been used to pay the debt servicing on the discounted debt. Annual payments would possibly be bolstered by donor contributions of various donors. The fund would be used to finance green investments in the participating countries.

5. Resolving unsustainable debt situations

The growing complexities of creditor compositions and structure poses formidable challenges to ensuring that resolution of unsustainable debt situations is timely, orderly, effective, fair and negotiated in good faith, as called for in the Addis Agenda. With debt vulnerabilities increasing in many developing countries, upcoming restructurings will have to address new complications, including the increased importance of non-traditional official creditors, uncertainties around the claims covered by restructuring, and the growth of collateralized borrowing (box 4).

There is no one-size-fits-all solution to these issues under the current international architecture for sovereign debt resolution, and in the absence of a more systematic multilateral solution to this question. Borrowers have sought the help of legal and financial advisors to develop appropriate incentives and penalties to encourage creditors to accept a proposed restructuring and to minimize problems with holdouts.

The IMF has been reviewing its policy on lending into arrears to strengthen incentives for debtor-creditor engagement and timely resolution of debt problems. An ongoing review of that policy with respect to private claims is expected to resume. The policy with respect to official arrears was reformed in 2015, and set up to work in tandem with Paris Club processes. However, it does not provide the same incentives towards resolution when the bulk of creditors are not members of the Paris Club. Options to use the Paris Club as an ad hoc coor-

inating mechanism for official creditors, or for a large creditor to take this role, have not gained traction versus the use of advisors to coordinate.

The growing importance of official creditors outside the Paris Club and the proliferation of debt-creating financing instruments and modalities, such as collateralized lending, have raised challenges in debt restructurings. The complexities of resolving unsustainable debt situations have brought new salience to the issue of creditor coordination and long-standing challenges in the existing architecture. It may be timely to review whether a path towards a consensus on these issues might be forged, including on specific elements such as creditor coordination, debtor-creditor dialogue, or temporary standstills, in line with the Addis Agenda, which recognized scope to improve the arrangements for coordination between public and private sectors and between debtors and creditors.

Box 4

Challenges to the resolution of unsustainable debt situations

In the Gambia, public debt was determined to be unsustainable in 2018, following sharp increases in debt resulting from fiscal slippages and governance issues. A large share of the Gambia's external debts are owed to non-traditional official creditors, including a dispersed set of non-Paris Club official bilateral creditors and plurilateral institutions. The restructuring is ongoing, with coordination issues slowing progress.

In the Republic of the Congo, a delayed policy response to sharp falls in oil prices in 2014 prompted a deterioration in the fiscal position, ultimately pushing the country into external default. Resolution of this situation has been complicated by the existence of substantial collateralized debts, the extent of which was not fully revealed until the country had already fallen into debt distress. In essence, this makes the collateralized creditor senior to other creditors, since in the case of default, it is more likely to be repaid. In addition to making it more difficult to restructure the obligations, these collateralization arrangements exacerbated the liquidity pressures that precipitated default.

Venezuela is currently experiencing a severe economic crisis and has defaulted on selected external debts. The restructuring will have to deal with multiple complications. First, the creditor base is extremely heterogeneous, including private creditors, official bilateral lenders (including non-Paris Club members), and multilateral agencies, and will pose major co-ordination challenges. Second, the debt structure is complex, including significant amounts of collateralized debt.

In Mozambique, the authorities have been in ongoing discussions to restructure their debt since 2016 after a combination of delayed fiscal policy responses and large amount of previously unreported debt left the country in debt distress. While discussions are still in progress in November 2018, the Government announced recent agreements with some of its creditors to restructure one its Eurobonds through a combination of reprofiling and sharing future revenues from offshore gas projects.

Endnotes

- 1 Institute of International Finance (IIF). Global Debt Monitor Database, July 2018. IFF estimates of global debt stock are based on household, nonfinancial sector, corporate financial and public sector debt for 72 countries.
- 2 Data of the Economic Commission for Latin America and the Caribbean.
- 3 United Nations, Report of the United Nations Secretary-General on external debt sustainability and development, document A/71/276.
- 4 Bank for International Settlements, *BIS Quarterly Review September 2014: International banking and financial market developments* (Basel, 2014).
- 5 International Monetary Fund, *Staff Guidance Note on the Implementation of Public Debt Limits in Fund Supported Programs* (Washington D.C., 2015).
- 6 See for example: United Nations Department of Economic and Social Affairs, *World Economic and Social Survey 2012: In Search of New Development Finance* (New York, 2012).