Financing for Sustainable Development Report 2020

Inter-agency Task Force on Financing for Development

This report is a joint product of the members of the Inter-agency Task Force on Financing for Development. 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.

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DEBT AND DEBT SUSTAINABILITY



Chapter III.E

Debt and debt sustainability

1. Key messages and recommendations

The debt of developing countries continued to rise in 2019—albeit at a slower pace—and, with it, the risks to debt sustainability. Forty-four per cent of low-income and least developed countries (LDCs) are currently assessed as being at high risk of external debt distress or already in debt distress. COVID-19 and related global economic and commodity price shocks could significantly increase this number. For example, several African countries reliant on oil exports could find themselves in debt distress.

As noted in chapter I, the long period of unusually low international interest rates and unprecedented levels of global liquidity associated with quantitative easing facilitated the growth in borrowing. Developing countries, including LDCs, increased access to commercial financing. Lending by non-Paris Club official creditors has increased, opening new opportunities for borrowers to finance development. However, the shifting creditor landscape has also changed the structure of the debt of borrowing countries, increasing their exposure to interest rate, exchange rate and rollover risks. With commercial debt accounting for a growing share of sovereign borrowing, debt-service burdens are increasing. Steep increases in private sector debt, particularly non-financial corporate debt in emerging markets, have further increased countries' vulnerabilities to external shocks and capital flow reversals.

Rising debt-service costs diminish fiscal space for countercyclical measures and for investments in long-term structural transformation and the Sustainable Development Goals (SDGs). This is a major concern in light of large, unmet SDG investment needs. This calls for a range of national and global actions in three areas: (i) creating additional fiscal space; (ii) preventing debt crises; and (iii) advancing the policy agenda on debt restructuring.

Increased domestic revenue mobilization and more effective spending, along with official development assistance (ODA), can help countries scale up public investment to meet the SDGs while containing debt vulnerabilities. But the fundamental tension will likely remain in many, if not most, developing economies, especially those with high debt burdens. Debt swaps—such as the Economic Commission for Latin American and the Caribbean (ECLAC) proposal to swap some of the Caribbean's external debt for annual payments into a resilience fund—can be a source of funding for additional SDG investments. ***Piloting of the ECLAC and similar initiatives should be considered.***

Debt sustainability also depends on the effective use of borrowed resources. There is merit to exploring options that better identify fiscal space for productive SDG investments. ***A balance sheet approach that clarifies how borrowed resources are used, taking into account public assets created, can lead to better understanding of the impact of investment on fiscal revenue and gross domestic product (GDP).*** SDG investments that boost productive capacity in countries can help generate revenue to meet debt service requirements when investment projects are carefully selected, sustainably financed and effectively executed. ***The Financing for Sustainable Development Report 2019 also looked at the role that well-managed, fiscally sustainable and transparent national and regional development banks can play, building on the call for strengthening them in the Addis Ababa Action Agenda.***

Effective debt management is essential to mitigating risks. ***Strengthening debt management through technical assistance and capacity-building will help countries manage debt more effectively.*** Despite some progress, debt management capacity and transparency need to be continually enhanced in light of the growing complexity of the creditor landscape and debt instruments. While the primary responsibility for debt transparency lies with debtors, creditors share the responsibility for making the terms and conditions of lending public, straightforward, and easy to track. ***To help borrowers avoid debt traps, official creditors should pay appropriate attention*** *to not adversely affect debt sustainability in borrower countries, including by providing financing on more concessional terms and ensuring that lending practices are fully in line with sustainable, responsible financing practices.*

Debt vulnerabilities have increased in many cases due to climate and environmental shocks. Innovative mechanisms, such as state-contingent debt instruments, would allow debtor countries to postpone payments in the event of specified shocks. *Despite a measure of analytical work on such state-contingent loans, there has been limited uptake on the part of private or official creditors. Official creditors can take the lead in using such instruments and promoting their uptake, which is essentially a contractual approach to creating "breathing space" for a borrowing country in periods of stress.*

Experience in recent years indicates that the new landscape has complicated and lengthened the process of debt restructuring. This raises the social cost of debt crises, including on the poorest citizens. *Further work in the international community is thus warranted in order to revisit existing mechanisms and arrive at a fair, effective and timely international process for debt resolution.* Progress in all these areas is needed if countries are to achieve the SDGs by 2030. *The United Nations can provide a forum for informal and inclusive dialogue among all stakeholders that considers policy options for financing SDG investments while maintaining sustainable debt.*

This chapter first examines debt trends at the global level and in developing countries, exploring developments of debt risk assessments, and the underlying changes to public and private debt levels and the composition of debt. The remainder of the chapter explores policy options to mobilize finance for SDG investment while maintaining sustainable debt, through responsible borrowing and lending (debt sustainability assessments, debt management, transparency, and sustainable finance principles), innovative financing instruments, and debt crisis resolution.

2. Recent trends in debt burdens

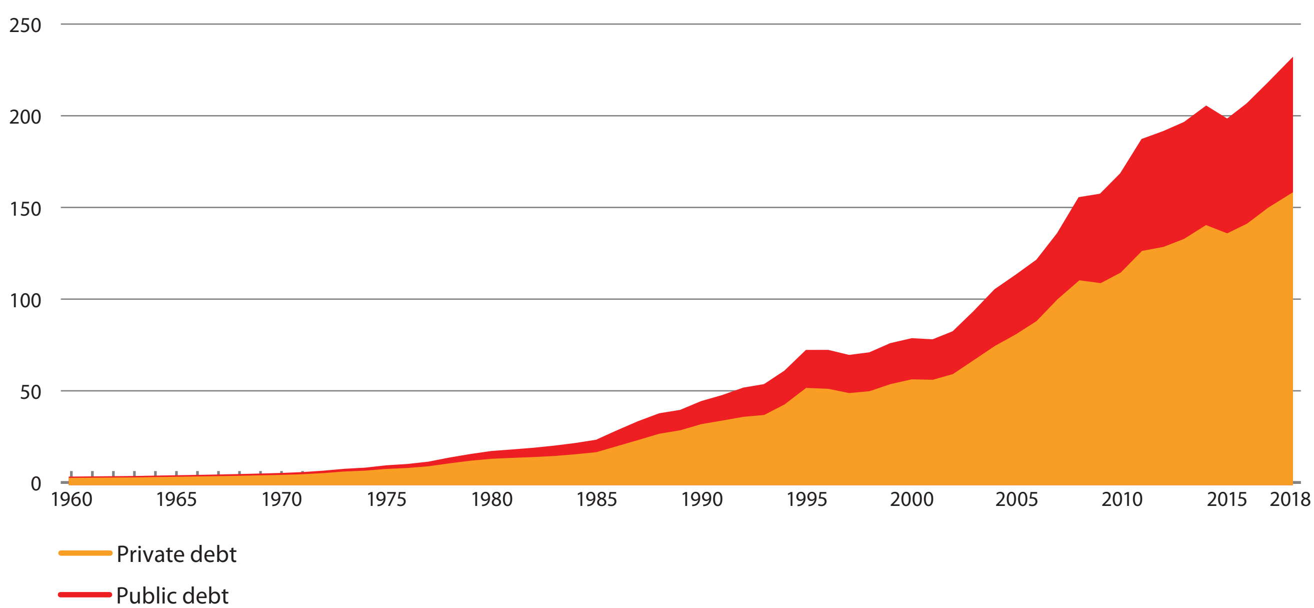
2.1 Global debt trends

Global debt continues to rise. Total global debt stocks grew over 5 per cent in 2018 to reach $228 trillion (or 267 per cent of global GDP), compared to $152 trillion (239 per cent of global GDP) at the onset of the global financial crisis in 2008 (figure III.E.1A). The growth in global indebtedness has been driven by an explosion of private sector debt since the 1980s. In developed countries, the growth rate for debt decelerated after the initial increase in public debt in the wake of the global financial crisis. In developing countries, however, both public and private debt increased, with private debt accelerating particularly sharply following the crisis (figure III.E.1B).

Global factors have been a significant driver of debt flows to developing countries. As noted in chapter 1, quantitative easing in developed economies in the aftermath of the 2008 crisis (with interest rates close to zero or negative) fuelled investors' search for yield, which allowed a growing number of developing countries to borrow from commercial sources. Quantitative easing also reached corporate balance sheets in middle-income countries, as emerging market corporate bonds provided high-yielding investment opportunities.

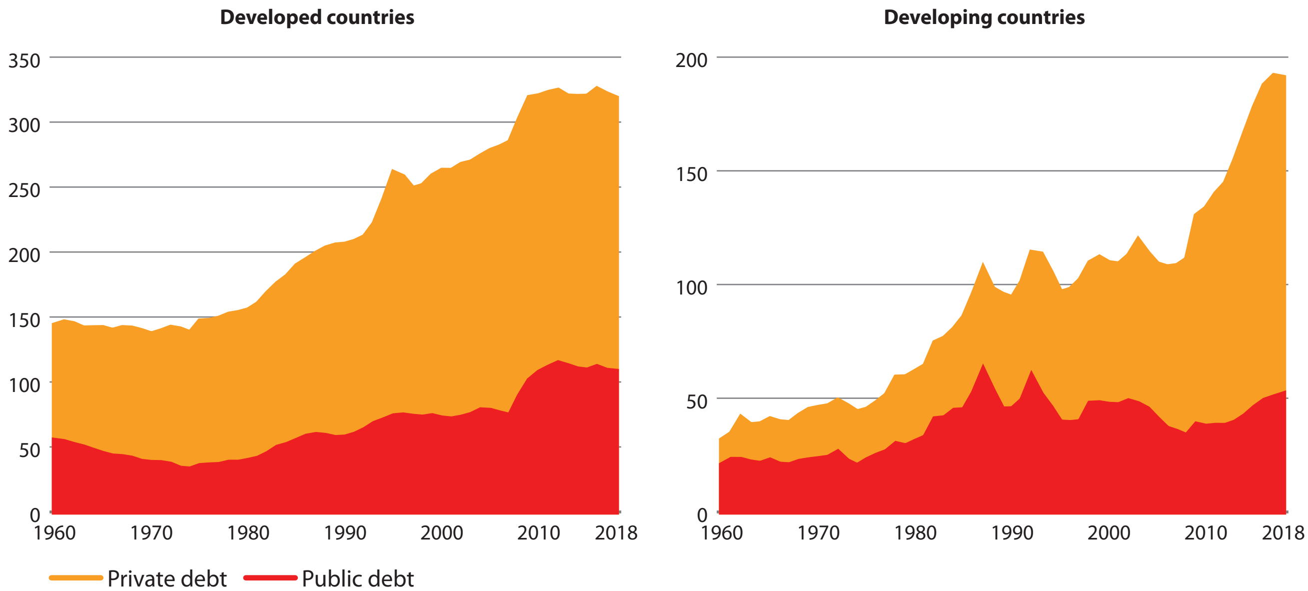
At the same time, global economic growth remains sluggish. Softer growth rates in low-income and least developed countries have coincided with rising interest costs associated with the growing share of commercial debt over the last decade. This has contributed to worsening underlying debt dynamics in these countries.

Figure III.E.1
A. Total debt, global, 1960–2018
(Trillions of United States dollars)



Source: UNCTAD Secretariat calculations, based on the IMF Global Debt Database.

B. Total debt, developed and developing countries, 1960–2018
(Percentage of GDP)



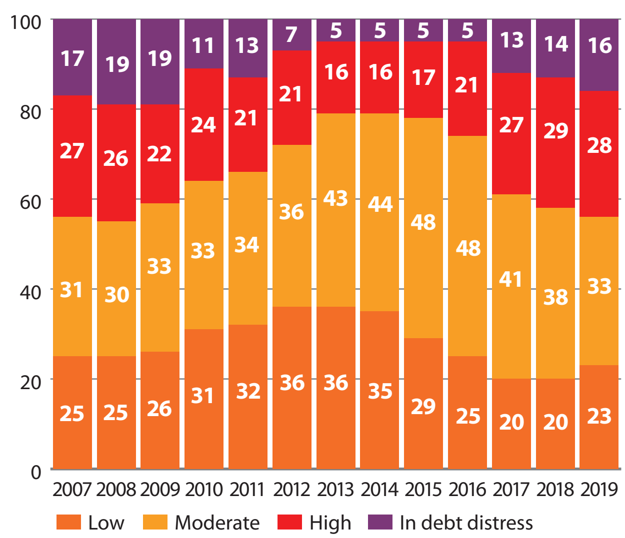
Source: UNCTAD Secretariat calculations. based on the IMF Global Debt Database.

2.2 Development of debt risk assessments

Overall, and prior to the COVID-19 outbreak, International Monetary Fund (IMF) projections pointed to stabilizing debt-to-GDP ratios for low-income developing countries going forward, after several years of upward revisions. Nonetheless, debt sustainability assessment stress tests suggested that many countries remain exposed to a downgrade in the event of global shocks.

COVID-19, along with the sudden and dramatic drop in oil prices, has significantly increased the likelihood that such shocks—particularly weaker-than-expected global growth and a decline in commodity prices—materialize. About 44 per cent of low-income developing countries eligible for the IMF Poverty Reduction and Growth Trust (PRGT) were assessed at high risk of external debt distress or already in debt distress before COVID-19 (figure III.E.2); Nineteen of them are LDCs. Ten countries, including six LDCs, were assessed to be in debt distress as of end-2019 (Eritrea, the Gambia, Grenada, Mozambique, the Republic of the Congo, Sao Tome and Principe, Somalia, South Sudan, Sudan and Zimbabwe).

Figure III.E.2
IMF-World Bank ratings resulting from low-income-country debt sustainability assessments
(Percentage of PRGT-eligible low-income developing countries)



Source: IMF-World Bank LIC DSF database.

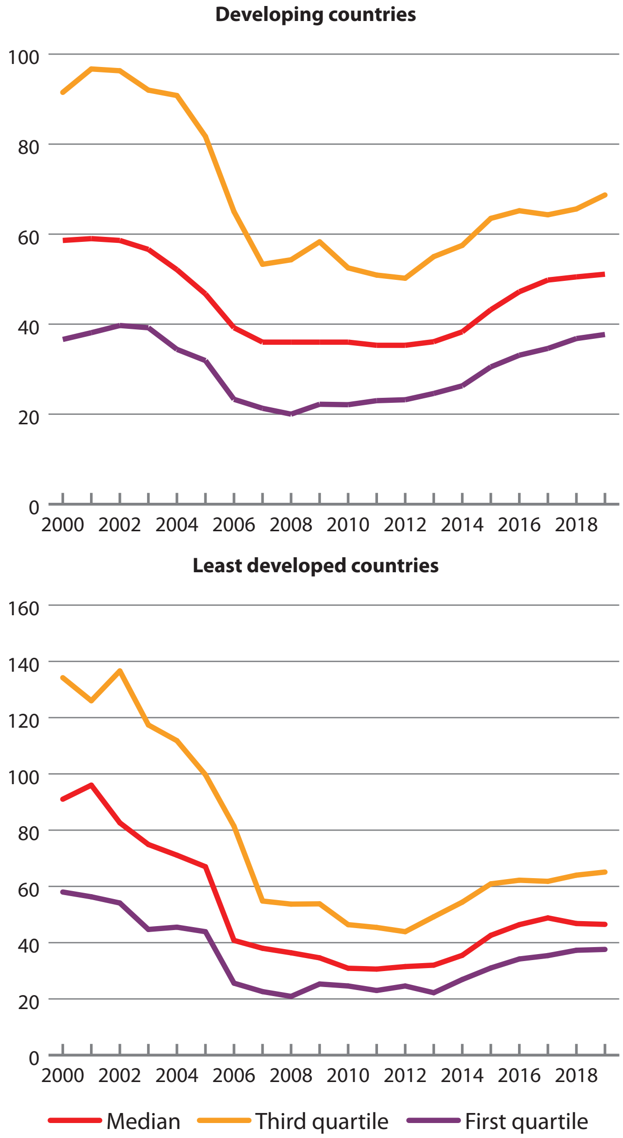
2.3 Public debt in developing countries

Median public debt in developing countries continued to grow in 2019, albeit at a slower pace. After growing as a share of GDP for most of the past decade (from 35 per cent in 2012 to 49 per cent in 2019) the ratio of public debt to GDP is estimated to have stabilized across country groups (figure III.E.3). In LDCs and small island developing States, median public debt was 47 and 58 per cent of GDP, respectively. Nonetheless, the debt-service burden (debt service relative to government revenue) continued to rise, primarily due to changes in the composition of developing-country debt.

2.4 Changes in the composition of debt

Despite declining slightly in 2018, borrowing on commercial terms outpaced other sources of external credit in the last two years in developing countries. Multilateral debt grew by one percentage point of GDP between 2016 and 2018, arresting the decline observed between 2010-2016. Official

Figure III.E.3
Public debt, 2000–2019
(Share of GDP)



Source: UN DESA calculations, based on IMF WEO.

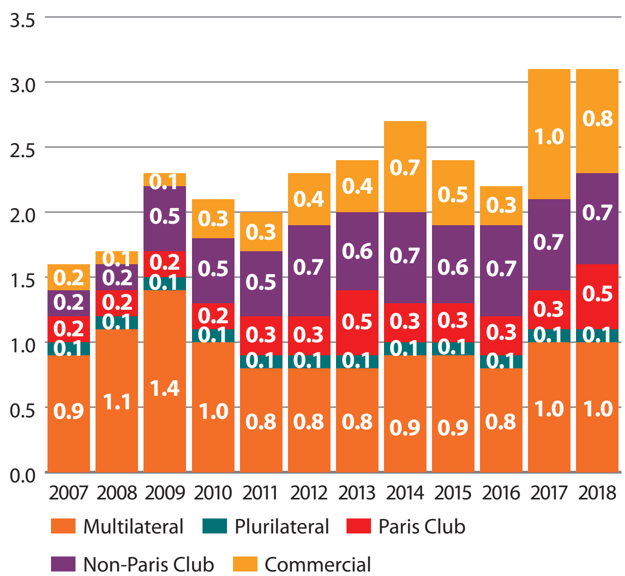
bilateral creditors' lending has been broadly flat in recent years, with China accounting for a larger share versus a decade ago (figure III.E.4).

Among commercial sources of credit, bond borrowing on international capital markets continued to grow over the past two years. Foreign-currency denominated bonds have been the fastest growing source of financing for frontier economies (low-income and least developed countries with international bond issuance as well as other non-investment-grade, infrequent sovereign bond issuers[1]), mainly in sub-Saharan Africa. Local currency debt has also surged, with non-resident holdings continuing to grow in a handful of countries. In Ghana and Senegal, for example, foreign holdings have reached one third of domestic debt at times, while in other countries, their share has been increasing, albeit from a lower base.

Funding from international and domestic capital markets allowed countries to finance new investments, but not without consequence. Such funding embodies higher cost and greater risk than traditional official financing, and the relative decline in ODA has raised the average interest rates on external debt. Total public debt servicing is expected to amount to 13 per cent of fiscal revenues in low-income developing countries in 2019, up from about 12 per cent in 2013. Before the crisis, the debt-servicing burden of the frontier economies was particularly high, absorbing over 25 per cent of their public revenues in 2019, compared to under 15 per cent before 2015. In addition, foreign investment in local capital markets, while bringing additional sources of capital to domestic firms, can also create vulnerabilities in the form of volatile capital flows when investors have short-term horizons and when global risk perceptions change (see chapter III.F for policy options to address capital flow volatility).

At the same time, average maturities on new external commitments continued to fall, further increasing rollover risk. Between 2017 and 2018, the average maturity on external debt decreased from 21.6 to 20.6 years, extending a declining trend that began in 2010. The increased rollover risk particularly affects frontier economies with access to international debt markets. These countries' Eurobond refinancing needs will rise over the next 5 years to an annual average of almost $5 billion, up from less than $2 billion in 2017-2018. Of particular concern are countries where debt redemptions represent a high proportion of foreign exchange reserves (figure III.E.5).

Figure III.E.4
Disbursed debt by creditor type, 2007–2018
(Percentage of GDP)



Source: IMF and World Bank (2020). The Evolution of Public Debt Vulnerabilities in Lower-Income Economies.

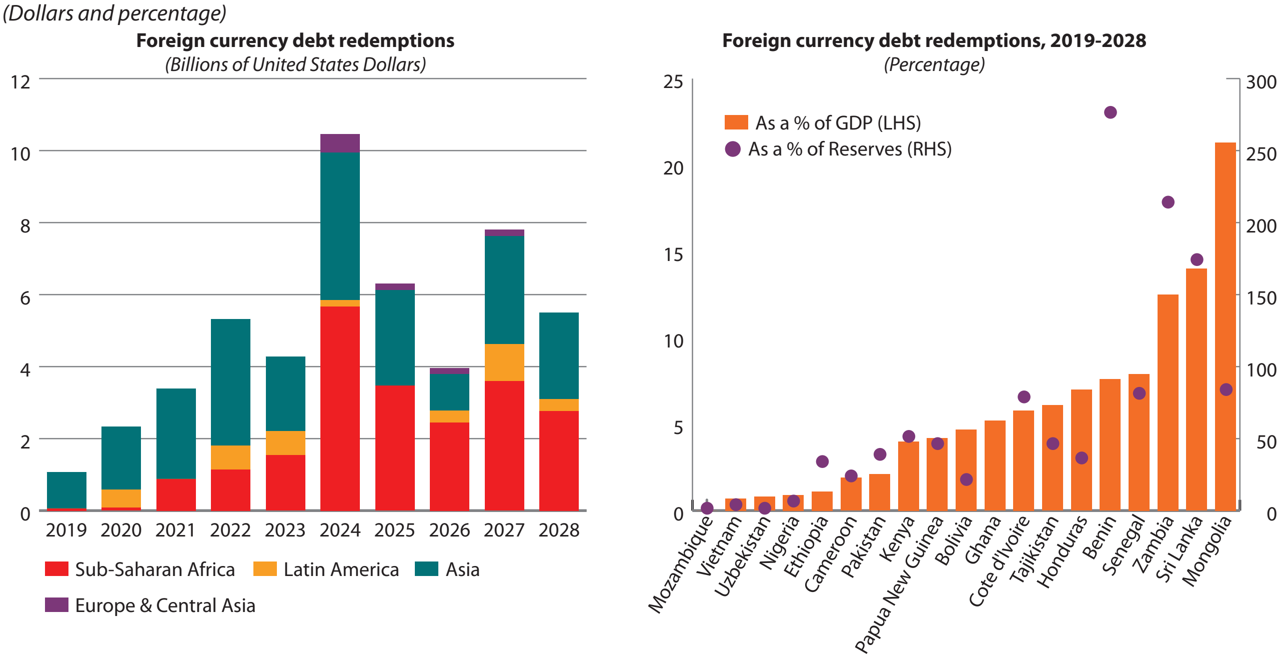
2.5 Private debt trends in developing countries

The growth of private sector debt remains a major driver of total debt growth in developing countries. At the end of 2018, it accounted for 139 per cent of their GDP (see figure III.E.1B above). Lending to non-financial corporations in emerging markets[2] and China in particular accounts for the bulk of this increase (figure III.E.6). But even in low-income countries with shallow financial systems, private sector debt now stands at around 18 per cent of GDP, up from about 12 per cent just before the start of the global financial crisis.

Growing private sector debt raises debt sustainability concerns. As noted above, low global interest rates and a search for yield by international investors facilitated the growth in private credit. Outside of China, where corporate bonds are primarily domestically owned, external creditors hold a significant share of large developing countries' corporate debt (about one third of non-financial sector corporate debt, or about $1.8 trillion, in 26 emerging-market countries excluding China).[3] The build-up in external foreign currency borrowing makes countries vulnerable to capital flow reversals and currency crises, and endangers financial stability and ultimately public debt sustainability (see chapter III.F.)

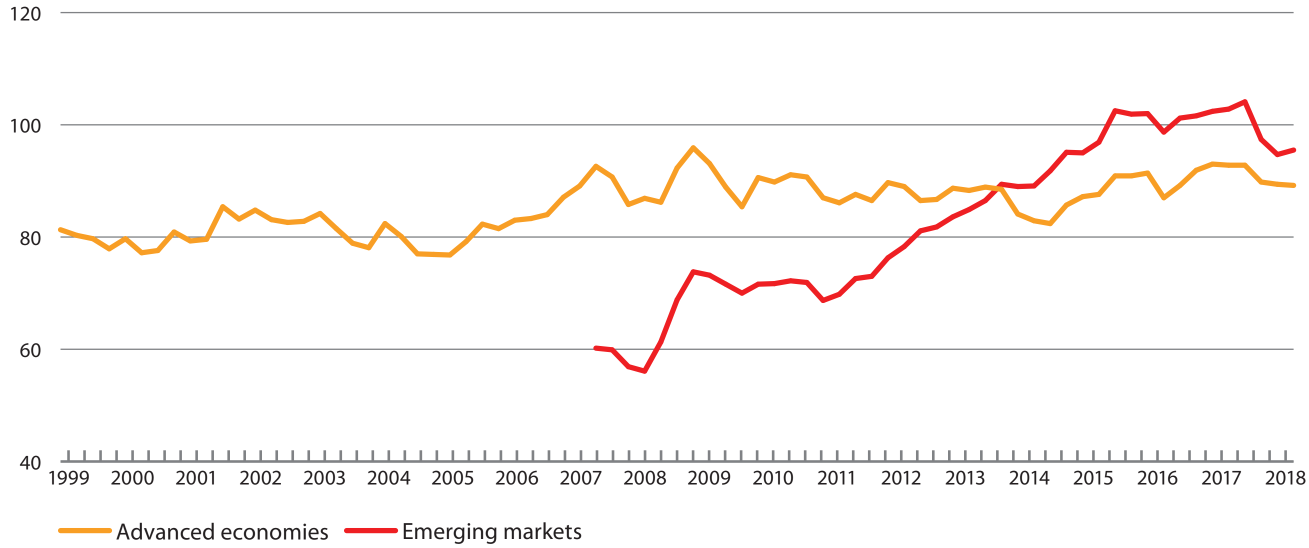
Of particular concern is that this proliferation of private debt does not appear to have boosted productive investment: the growth of corporate debt has outpaced the speed of capital formation in many developing

Figure III.E.5
Foreign currency debt redemptions of frontier economies
(Dollars and percentage)



Source: IMF and World Bank (2020) "The Evolution of Public Debt Vulnerabilities in Lower-Income Economies" based on Bloomberg, IMF WEO, and IMF staff estimates.

Figure III.E.6
Total credit to non-financial corporations, advanced and emerging economies, 2000–2018
(Percentage of GDP)

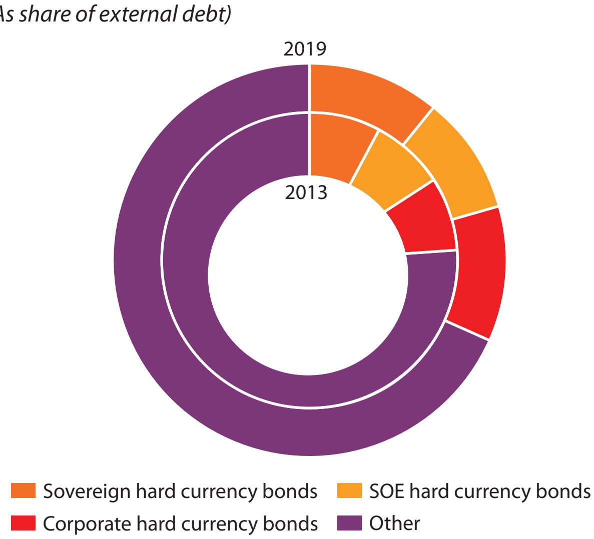


Source: UNCTAD secretariat calculations, based on BIS Credit Statistics. Credit to non-financial corporations is from all sectors at market value.

countries (see Financing for Sustainable Development Report 2019). The creditworthiness of non-financial corporates has been deteriorating.[4]

In some countries, public debt sustainability could also be at risk from rising debt of state-owned enterprises (SOEs). Their debt accounts for a significant portion of total emerging-market debt (figure III.E.7). Similar to private companies, many SOEs have taken advantage of the easy global financial conditions over the past decade to significantly increase their hard currency debt. Rising SOE debt could impact on the Government's fiscal position, particularly in countries with high debt.

Figure III.E.7
Debt outstanding in emerging markets: hard currency bonds by type, 2013 and 2019
(As share of external debt)



Source: IMF (October 2019), Global Financial Stability Report.

3. Sustainable and responsible borrowing and lending for the SDGs

3.1 Debt sustainability and SDG investments

Debt is a key source of financing for sustainable development and the SDGs. Indeed, many SDG investments can generate the resources to repay debt. Yet, the size of SDG financing gaps puts into question developing countries' ability to mobilize sufficient public debt financing to achieve the SDGs while maintaining sustainable debt levels—particularly since debt levels are already elevated in many low-income and least developed countries.

For example, the IMF estimates that investments in SDGs in five areas that typically require public spending (education, health, roads, electricity, water and sanitation) would require additional annual spending of about 15 percentage points of GDP in the poorest countries.[5] Under realistic assumptions about revenue mobilization, ODA, and FDI, the additional spending needed could only be achieved by borrowing on a large-scale on commercial terms that would lead to a sharp increase in interest burdens and debt vulnerabilities.[6] The United Nations Conference on Trade and Development (UNCTAD) estimates that, if financed from additional borrowing, meeting SDGs 1-4 by 2030 would lead to dramatic increases in developing countries' public debt (see box III.E.1), increasing vulnerabilities.

The challenge for countries is how to create fiscal space for additional public investment in the SDGs, particularly for heavily indebted countries. The solution goes beyond this chapter to include policies across the Addis Agenda, including strengthened fiscal management (increased domestic public resource mobilization and efficient spending) (chapter III.A); access to concessional financing (chapter III.C); domestic and international macroeconomic and capital account management (chapter III.F); and other measures discussed throughout this report. There is also a need for efforts, discussed

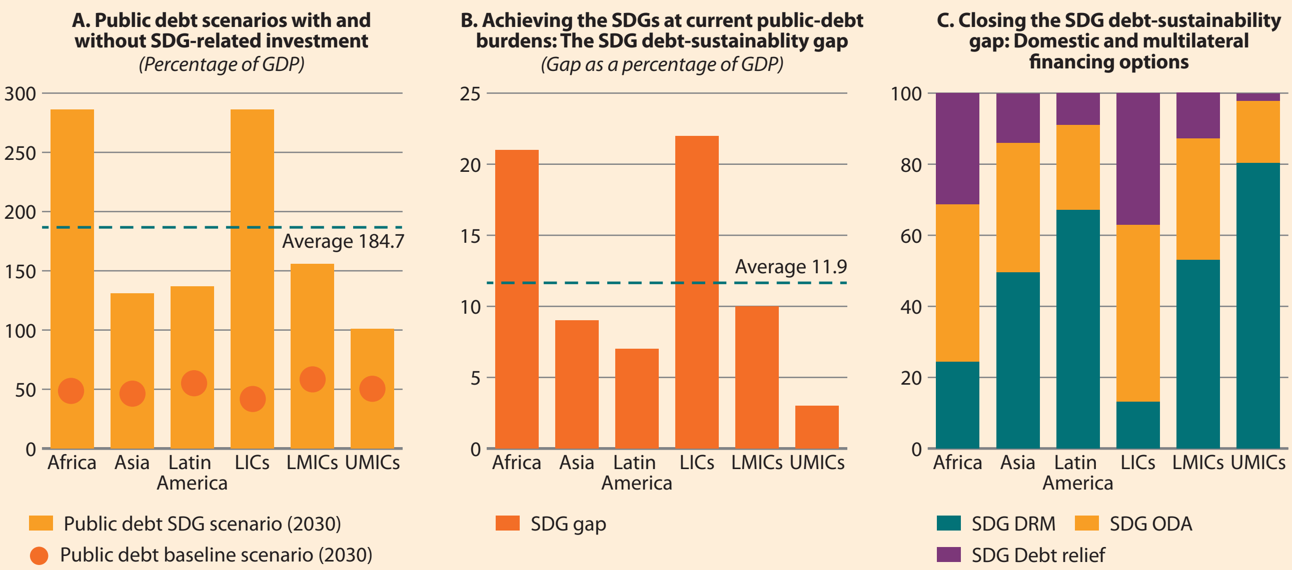
Box III.E.1
Developing-country debt sustainability and the Sustainable Development Goals

The debt sustainability analysis presented here operationalizes the debt sustainability definition proposed by former Secretary-General Kofi Annan in 2005. Updating this definition to meet the 2030 Agenda for Sustainable Development, debt sustainability is defined as the set of policies that allow a country to achieve the Sustainable Development Goals (SDGs) and to reach 2030 without an increase in debt ratios. The analysis focuses on the impact that meeting only the first 4 of the 17 SDGs (poverty elimination, nutrition, good health and quality education) would have on developing-country debt sustainability. Most investments in these SDGs do not offer competitive financial returns and are expected to be met by the public sector. The analysis is based on a sample of 30 developing countries across developing regions and consists of three components.

The first component (figure III.E.1.1A) projects the impact of the investment required to meet SDGs 1-4 on the evolution of developing-country public (gross central government) debt until 2030. It compares a business-as-usual or baseline scenario, which assumes that countries maintain current expenditure patterns and that short-term debt sustainability requirements remain in place, with an "SDG public debt scenario". In the baseline scenario, average public debt is expected to increase from 47 per cent of gross domestic product (GDP) in 2018 to 51 per cent by 2030. The second scenario assumes that Governments depart from business-as-usual practices to meet SDGs 1-4 on time and without external assistance other than current official development assistance grants. Meeting the investment requirements of these SDGs would have a major impact on public debt, with the ratio of public debt to GDP increasing to 184.7 per cent of GDP by 2030, on average. The sharpest increase would, unsurprisingly, be experienced in low-income countries. Unless alternative sources of funding become available, the most vulnerable countries and those in most need of urgent investments to meet the SDGs would thus be least likely to afford SDG investments without triggering a debt crisis.

The second component (figure III.E.1.1B) estimates the SDG debt sustainability gap—that is, the difference between the primary fiscal balance consistent with achieving SDGs 1-4 by 2030 and the balance required to maintain stable public debt ratios. Developing countries would, on average, require 11.9 per cent of their GDP in additional annual resources. The third component (figure III.E.1.1C) considers domestic and external financing options. Even under potentially optimistic assumptions about fast improvements to domestic resource mobilization, meeting investment requirements for the first four SDGs would require significant external assistance, in particular for least developed countries and other low-income countries.

Figure III.E.1.1
Developing-country debt sustainability and the Sustainable Development Goals
(Percentage)



Source: UNCTAD secretariat calculations, based on IMF WEO, WDI, QEDS, FAO (2015), Stenberg and others (2017), UNESCO (2016) and national sources.
Note: LICs= low-income countries; LMICs= lower-middle-income countries; UMICs= upper-middle-income countries. Classifications are World Bank classifications that, for the included countries, are identical with UNCTAD classifications but provide the additional breakdown into LMICs and UMICs. Figures represent unweighted averages per country group. The sample is composed by region and income category: Africa: Benin (LIC), Ethiopia (LIC), Malawi (LIC), Mali (LIC), Mozambique (LIC), Uganda (LIC), United Republic of Tanzania (LIC); Algeria (LMIC), Cameroon (LMIC) and Kenya (LMIC). Asia: Afghanistan (LIC), Nepal (LIC); Bangladesh (LMIC), Cambodia (LMIC), India (LMIC), Indonesia (LMIC), Myanmar (LMIC), Pakistan (LMIC), Viet Nam (LMIC); Thailand (UMIC). Latin America and the Caribbean: Haiti (LIC); Plurinational State of Bolivia (LMIC) and Nicaragua (LMIC); Brazil (UMIC), Colombia (UMIC), Dominican Republic (UMIC), Ecuador (UMIC), Jamaica (UMIC), Mexico (UMIC) and Peru (UMIC).
Source: UNCTAD.

in the remainder of this chapter, to create space for productive investments in the SDGs, including through the use of innovative debt instruments; better identify fiscal space and debt vulnerabilities through strengthened analytical tools; and promote sustainable lending and borrowing practices through strengthened debt management and transparency, and by further advancing the policy agenda on responsible borrowing and lending.

3.2 Identifying opportunities: a balance sheet approach

Productive investments, while increasing debt ratios in the short run, can generate future revenue and higher growth, leading to lower debt ratios over time and creating a positive feedback loop. It is important for heavily indebted countries to analyse the impact of investment and overall risks presented by assets and liabilities in order to better understand where they could have fiscal space. A balance sheet analysis can help in this regard.

For instance, El Rayess and others demonstrate that better managed infrastructure investment could improve the long-term balance sheet impact by almost half in some countries.[7] Another example is the Gambia, where balance sheet analysis brought out the interlinkages of fiscal risks in the public sector, allowing the authorities and donors to assess where to best intervene to reduce these risks.[8] And managing public assets better opens up the potential to raise considerable additional revenue, which in turn can be invested in achieving the SDGs.

At the same time, predicting the impact of borrowing for investment on growth rates (e.g., in the context of debt sustainability assessments (DSAs)) is extremely challenging, due to uncertainties around investment efficiencies and growth feedback. To address the potential feedback, the IMF and World Bank included a "realism tool" in their July 2018 update to the low-income countries' debt sustainability framework (LIC-DSF). The realism tool uses a simple growth accounting framework and decomposes projected growth rates into contributions from changes in the government capital stock (due to public investment) and all other sources. It shows projections for public and private investment, and historical and projected contributions of public investment to growth.

3.3 Debt sustainability assessments: improving analytical tools

Correctly picking up investment growth linkages—as encouraged by the realism tool in the new LIC-DSF) – is one element of a robust debt sustainability analysis. The LIC DSF also newly incorporates other key elements, including additional stress tests tailored to country-specific economic vulnerabilities, increased requirements for debt transparency, and broader debt coverage. To date, eleven countries have expanded the coverage of public debt beyond the standard general government to include key SOEs. Consistent with the message from balance sheet analysis, it is important to correctly capture SOE debt repayment capacity when adding them to a DSF analysis.

The IMF is also currently reviewing the framework for assessing debt sustainability in countries with significant access to international debt markets (market-access country debt sustainability analysis, or MAC DSA). Based on back-testing analysis and consultations with IMF stakeholders, the review seeks to propose more comprehensive and consistent coverage of debt-related risks facing countries; incorporate relevant country-specific factors in the analytical tools to improve the framework's discriminatory capacity; better capture uncertainty around baseline assumptions; and provide more structure for the application of judgment in the assessment.

It is expected that a final set of proposals will be considered by the IMF Executive Board during 2020 and introduced in country analyses during 2021.

3.4 Public debt management

Strengthened debt management is important because it can both free up resources for investment and reduce the risk of debt crises. Developing countries have, in most cases, been making progress with strengthening debt management. The results from 39 countries that have more than one debt management performance assessment (DeMPA)[9] evaluation over the period 2008-2018 reveal improvements for 11 out of 14 dimensions (figure III.E.8). However, gaps in debt management remain. For example, frontier economies failed to make progress in debt reporting and auditing and in the formulation of debt management strategies. Of particular concern is the fact that debt management capacity may not be keeping up with the increasing complexity of debt instruments where it is most needed (i.e., frontier markets). A related concern is that debt management might not always be sufficiently long-term focused. For example, during the period of extremely low interest rate levels, many countries have been taking on loans using floating rate debt instruments, which tend to benefit lenders, even when longer-term debt may be available at a reasonable cost.

Other areas of concern include suboptimal borrowing frameworks; insufficient audits; lack of operational risk management; poor cash flow forecasting and management; insufficient staff capacity in debt management offices; partial debt coverage; and limited reports. Indeed, developments in 2019 underlined the continued need to enhance downstream debt management capacity (debt data recording and validation, debt operations, and debt reporting and statistics) as part of international efforts to address ongoing problems with debt data transparency.

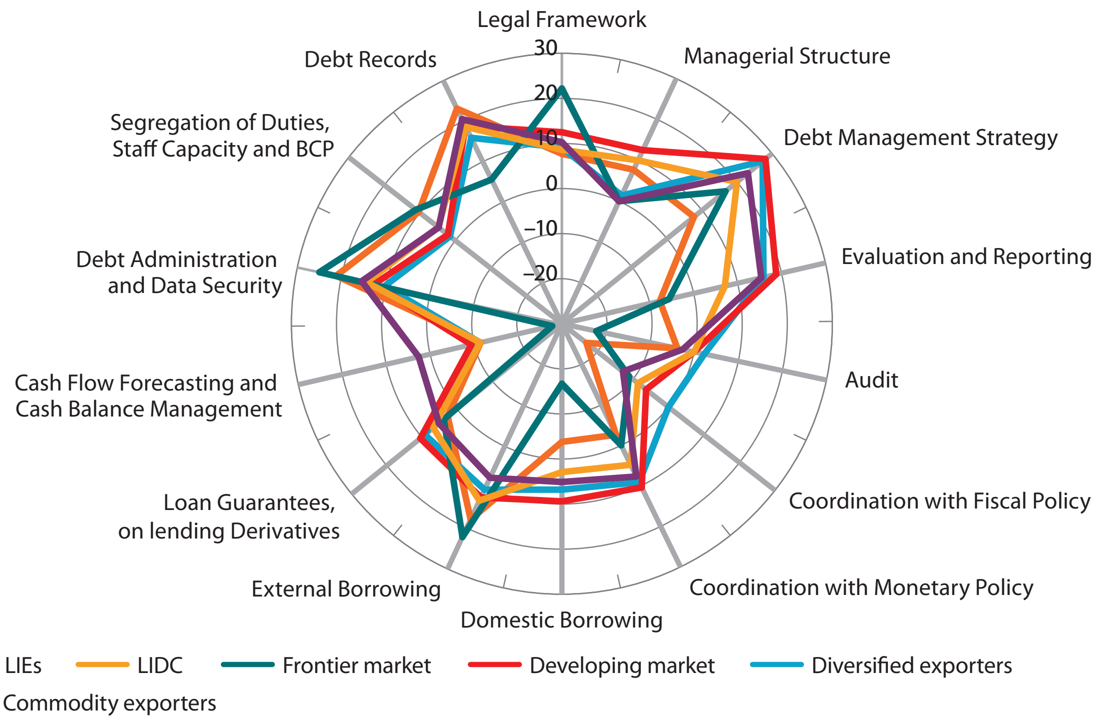
3.5 Debt data, reporting and transparency

Timely and comprehensive data on the level and composition of debt are a prerequisite not only for the effective management of public liabilities, but also for identifying risks of debt crises and limiting their impact. Indicators of debt transparency have improved over time. For the 39 countries with more than one DeMPA during 2008-2018, all but one data transparency indicator improved between the last two DeMPAs. One third of low-income developing countries also regularly publish statistical debt bulletins, including two thirds of frontier markets.

Nonetheless, significant problems remain in many countries with both the quality of public debt data and the level of reporting. Faced with increasingly complex portfolios and the growing importance of domestic financing, many countries have yet to reach the minimum standards in some key areas. High staff turnover continues to be a common and recurrent problem. Limited coverage of total public debt is another common problem, with specific difficulties relating to subnational debt and contingent liabilities. For example, three quarters of countries that have used the new LIC DSF have debt coverage of, at most, public and publicly guaranteed central government debt (including central bank debt) only.

In response, international organizations have continued to step up their capacity development efforts. The Multi-Pronged Approach (MPA) of the IMF and the World Bank provides a framework to help address debt vulnerabilities and close debt management gaps where they exist. UNCTAD, through its Debt Management and Financial Analysis System (DMFAS) Programme,

Figure III.E.8
Change in DeMPA results
(Percentage of the number of countries meeting minimum requirement)



Source: World Bank's DeMPA results as of end-December 2018. The sample includes 39 DMF-eligible countries.

launched the debt data quality assessment (Debt-DQA) framework to assess and monitor the quality of the data recorded in countries' debt databases in November 2019, jointly with the Commonwealth Secretariat. In response to increasing demand, DMFAS expanded its support in 2019, supporting 85 institutions in 58 countries, and organizing 79 capacity-building events. DMFAS also launched a new strategy to respond to a more complex debt landscape (box III.E.2).

Box III.E.2
Debt Management and Financial Analysis System: a new four-year strategy

To address the increasing complexity of the debt landscape, the United Nations Conference on Trade and Development (UNCTAD) Debt Management and Financial Analysis System (DMFAS) Programme has launched a new four-year strategy. Focusing on the delivery of technical assistance in the programme's areas of comparative advantage (i.e., the "downstream" areas of debt management), this strategy complements the work of the World Bank and the International Monetary Fund (IMF), whose focus is primarily on data sustainability analysis and medium-term debt strategies ("upstream" debt management).

Additional challenges and risks for transparency arise from new creditors working outside current structures (the Paris Club, for instance); new and more complex debt instruments and practices; the increased prevalence of domestic debt and private non-guaranteed external debt; and the increasing importance of monitoring contingent liabilities, public private partnerships (PPPs), extrabudgetary debt and subnational debt.

To ensure debt data transparency in this new context, coverage will be expanded to include all central, state and local government debt, contingent liabilities, extrabudgetary debt, state-owned-enterprise debt and private non-guaranteed external debt. As a growing number of governments are moving from pure cash accounting towards accrual accounting, the strategy will support the application of accrual-based international standards for government fiscal and financial reporting, including the Government Finance Statistics Manual (GFSM) and the International Public Sector Accounting Standards (IPSAS). Extensive capacity-development will be provided through a framework of traditional training and online courses. A new version of the software, DMFAS 7, will respond directly to the requirement to improve debt data transparency by expanding debt data coverage, enhancing reporting functions and implementing necessary major technical updates. Effectiveness of delivery will improve through establishing regional offices and cooperation with other providers of technical assistance in debt management, including the World Bank, the IMF and regional organizations.

Source: UNCTAD.

3.6 Responsible borrowing and lending

As rising debt risks threaten achievement of the SDGs in the context of a more complex debt landscape, renewed attention is warranted to the commitment, made in the Addis Agenda, to work towards a global consensus on guidelines for debtor and creditor responsibilities, building on existing initiatives. Multiple complementary sustainable financing initiatives are currently underway to promote responsible borrowing and lending.

The IMF's revised Debt Limits Policy, and the World Bank's new Sustainable Development Financing Policy are both expected to take effect during the second half of 2020. Both policies aim for sharper alignment with the new borrowing landscape, including allowing opportunities to borrow (subject to safeguards); creating better targeting conditions at vulnerabilities; and supporting strengthened debt transparency and debt management. The International Institute of Finance has articulated Voluntary Principles covering debt data disclosures by private creditors. Given the potential for agency problems in borrowers—where borrowing may not always be duly authorized—disclosure by lenders is an important avenue to achieving accountability. The initiative is expected to come to fruition during 2020, upon identification of a host for the data, which would need to be accessible by the public.

The Group of Twenty (G20) articulated their Operational Guidelines for Sustainable Financing in 2017. Their aim is 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".[10] The G20 has made use of a diagnostic tool developed with the assistance of IMF and World Bank staff in 2019 to help creditors diagnose their level of compliance with the 17 practices underlying the G20 operational guidelines.[11] To date, 15 G20 members and 5 non-members have completed the self-diagnostic, with 12 following up on their results with IMF and World Bank staff.

The G20 approach is operationally oriented, given the close links to the operations of IMF and World Bank and the supporting self-diagnostic tool. The UNCTAD principles on promoting responsible sovereign lending and borrowing provide a conceptual framework to guide best practices in sovereign lending and borrowing. They aim to establish a balance between responsibilities of lenders and borrowers; focus on safeguarding the public interest in sovereign debt financing and contracting; and call for a holistic approach to the evaluation of public investment projects and adequate management and monitoring to minimize incidences of over-borrowing and avoid restructuring.

While these quasi-legal ("soft-law") initiatives are voluntary and non-binding, they nonetheless can make an important contribution to promoting responsible borrowing and lending. By enhancing transparency and promoting cooperation between debtors and creditors, they can help address (albeit not remove) collective action problems and mitigate information asymmetries that arise in the area of sovereign debt. Soft-law initiatives will be most effective if information provided is comprehensive (covering all types of debt and debt instruments) and accessible, and if compliance is further incentivized through mechanisms to promote accountability or other complementary measures.

Adjudicative bodies—national courts, for example—could use such principles to guide their actions and decision-making. Jurisdictions could also legislate that sovereign debt transactions are not collectible if certain transparency conditions have not been met. Soft-law mechanisms could thus form a foundation for eventual legal initiatives.

4. Innovative debt instruments

Different types of innovative debt instruments have been proposed, and some implemented on a small-scale or pilot basis. Their main aim is to either (i) create room for additional investments in the SDGs or (ii) better manage shocks and risks. For example, debt swaps and related mechanisms generally do not reduce a country's debt burden; rather they swap a country's debt-servicing payments for investments in sustainable development. State-contingent debt instruments can also create additional fiscal space, but their primary objective is to help countries better respond to shocks by preserving fiscal space in times of crises.

4.1 Debt swaps and related innovative mechanisms to create fiscal space for SDG investments

Debt swaps allow countries to use funds otherwise tied up in debt servicing for a social or environmental initiative. There are several examples of debt swaps that sprang up during the 1980s debt crisis.[12] In debt-for-nature swaps, an international non-governmental organization (NGO) would purchase external debt and offer the debt for cancellation in exchange for a conservation commitment. Alternatively, debt would be exchanged for local currency that local conservation groups or government agencies would use to fund projects in the debtor country. In the Seychelles, a $15 million loan from the Nature Conservancy and $5 million worth of grants from various foundations was used to purchase $20 million worth of Seychelles debt held by European nations, which freed up $6 million for the Seychelles to use on marine conservation. The debt was also restructured to extend average maturity on the notes from 8 to 13 years, with about a quarter of the debt to be paid in local currency. This spread the debt burden over a longer time and lowered the cost of repayment for the Nature Conservancy.

Debt swaps have also been used for social objectives, such as the Debt-2Health initiative, facilitated by the Global Fund to Fight AIDS, Tuberculosis and Malaria, where creditors waive repayment of a portion of their loan to a country that, in return, invests an agreed amount in health. In the latest swap under this initiative, in 2017, Spain cancelled €36 million in outstanding debts owed by Cameroon, the Democratic Republic of the Congo and Ethiopia, in exchange for €15.5 million in investments in domestic health programmes supported by the Global Fund. Debts swapped under this initiative amounted to €200 million until 2017.[13] More recently, ECLAC proposed a debt for climate swap where the Green Climate Fund would buy some of the external debt of participating countries and, instead of making debt-service payments, countries would make payments into a resilience fund, which would finance green investments (see box III.E.3).

Similar to the ECLAC initiative, an SDG debt swap programme could support SDG-related investments in developing countries. The international community and/or NGOs could make an initial contribution to the programme that would be used to purchase external public debt (from either private or public creditors). The beneficiary countries would commit to pay into an SDG investment fund, or invest directly in projects of programmes, in the amount that they would have paid to their former creditors as debt service.[14] A global SDG-related concessional lending programme would be another option. Such a lending facility could include a refinancing facility to allow participating countries to borrow on concessional terms in order to progressively repurchase the outstanding stock of public external debt issued on commercial terms. The principal benefit would be a reduced interest rate and an extension on the maturities of the debt swapped. While not a debt workout mechanism per se, it could help countries avoid a debt crisis.[15] One risk with debt buy-backs of market debt is that bond prices will rise once the programme is public. A strict maximum buy-back price formula in the programme terms of reference can help overcome this issue.

Box III.E.3
The Debt for Climate Adaptation Swap initiative

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 the new Caribbean Resilience Fund. In the proposal, the Green Climate Fund would buy up some of the external private debt of participating countries at a discount. 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 (see Financing for Sustainable Development 2019).

Three "Phase One" countries (Antigua and Barbuda, Saint Lucia, and Saint Vincent and the Grenadines) are moving ahead. Antigua and Barbuda has proposed the use of its Paris Club debt to pilot the scheme, which collectively totals of over $130 million in debt. At the same time, ECLAC is in discussions with the Caribbean Development Bank and the Caribbean Development Fund about housing and management of the Caribbean Resilience Fund.

Source: ECLAC.

4.2 State-contingent debt instruments

State-contingent debt instruments contain a trigger mechanism that automatically defers debt-servicing payments that fall due during a crisis of specified type. A number of bonds with state-contingent clauses in their contracts have been issued, notably for countries in the Caribbean where the trigger is the advent of a hurricane of specified severity. To date, these bonds have not been introduced except by Governments restructuring their debt (Barbados being the most recent example).

At the request of the Eastern Caribbean Central Bank, the IMF and World Bank jointly examined possible structures for such instruments, which were translated into draft "term sheets" by the International Capital Markets Association, in collaboration with the law firm Clifford Chance. A variant of these term sheets has also been endorsed for use on a voluntary basis by Paris Club creditors. So far, the only significant lending with state-contingent clauses by an official creditor was by Agence Française de Dèveloppement, which provided countercyclical loans for project financing to Mali, Mozambique, Senegal and the United Republic of Tanzania between 2008 and 2016 for a total amount of €299 million, of which €215 million were disbursed by end-2018. The French loan allows the borrower to postpone the last five years of an otherwise ten-year grace period and use it at any time during the remaining maturity of the loan to meet a payment exigency. This flexibility, however, comes at a cost and may explain why the model has not been emulated by others.

Other types of state-contingent bonds have been conceived—in particular, bonds with a link to the borrowing country's GDP (i.e. GDP-linked bonds), including the drafting of a term sheet.[16] In such bonds, interest obligations grow larger when countries experience strong growth and shrink when economic conditions deteriorate. While bonds have been issued that pay additional interest if an economy's growth is greater than expected, no bonds have yet been issued when the bondholder risks receiving less than baseline interest in the event of a negative turn of economic events. Official creditors could consider using such instruments, which essentially create "breathing space" for a borrowing country in economic downturns as part of the debt contract, and can thus help prevent debt distress.

Islamic sukuk instruments also share risk between borrower and lender. In the sukuk bond issued by the British Government in 2014, for example, income payments to the investors are paid from profits based on the rental payments from government-owned properties. Other Governments that have issued sukuk bonds structured in different ways include Indonesia, Luxembourg, Malaysia, South Africa, Turkey, and Hong Kong SAR. Sukuk have been backed by revenues from infrastructure projects or exports.[17] There are additional potential sukuk and other Islamic financial instruments that could inspire the development of financial instruments with risk-sharing aspects attractive to lenders and borrowers.

5. When sovereign debt relief is warranted

The international community has struggled to devise better processes and standards for resolving sovereign insolvencies. In the absence of a more systemic and multilateral solution, the current focus of policymaking to resolve sovereign insolvencies has been on contractual solutions, such as the inclusion of enhanced collective action clauses (CACs) in bond contracts.

The new standard is a "single-limb" aggregated voting mechanism, which allows a qualified majority of bondholders across all bond series to bind an uncooperative minority in any of the bond series to the terms of a proposed restructuring. According to the most recent IMF progress report on sovereign debt, published in March 2019, almost 90 per cent of all bonds issued under New York and English law since these clauses were first introduced now include them. While the clauses will restrict the ability of disgruntled bondholders to seek redress in courts, research has demonstrated that there is no observable impact of including the new voting mechanism on the prices of the bonds at the time of issuance. Inclusion of these clauses may even lower borrowing costs, as they reduce the ability of a minority of bondholders to disrupt a restructuring agreement. Euro area finance ministers also recently announced broad support for requiring single-limb CACs in all bonds issued by euro area sovereigns as of 1 January 2022.

Despite this progress, the current framework has some limitations. While uptake of enhanced CACs is high in bonds governed by New York and

English laws (which represent 97 per cent of all international sovereign bonds), bonds issued in other jurisdictions, such as Asia, do not include enhanced CACs. Moreover, given that there is no retrospective application, the outstanding stock of bonds without enhanced CACs remains large, at over 60 per cent. The single-limb voting procedure has also not yet been tested in a sovereign debt restructuring. The debt of SOEs in some countries could represent a growing complication, as most foreign-law bonds issued by SOEs do not have enhanced CACs, and indeed may not include CACs at all (the same applies to subnational government bonds). Also, borrowing from individual financial institutions has increased, which may prove problematic, as a collection of individual loans from different banks would not have collective voting procedures (unlike syndications). They may also raise transparency concerns, as their terms are often not disclosed publicly.

The increased use of loans collateralized with a country's assets (such as oil-related payment streams or stock in a state enterprise) or future tax revenue streams may also pose challenges. This may trigger negative pledge clauses in other creditors loan contracts, requiring provision of equivalent collateral to them. Creditors holding access to collateral can also use their bargaining position to extract more favourable terms, complicating the restructuring process. Excluding project finance, collateralized borrowing represented, on average, 20 per cent of commercial borrowing undertaken over the last five years (down from an average of 32 per cent in the previous five years). But the averages conceal some large differences across countries, with commodity producers in low-income developing countries often heavily relying on this type of financing.

With regard to public creditors, the established mechanism for resolving defaults, the Paris Club, represents a diminishing share of the stock of lending. Notwithstanding its efficient processes, the Club has been involved in few restructuring since 2015 (Grenada, and the pending treatment of Somalia, at the HIPC decision point). Recent non-Paris Club restructurings—which have been protracted and incomplete—appear to bear out growing concerns about reaching timely and effective debt crisis workouts without an agreed international debt-restructuring process. In the case of Chad, an inadequate first restructuring agreement raised the net present value of the loan through the imposition of fees (i.e., no effective debt reduction). It required the country to restructure twice—in 2015 and 2017—in circumstances involving a commercial collateralized lender. For the Republic of the Congo, a restructuring that began in early 2018 remains incomplete (a year-long negotiation with a non-Paris Club creditor recently reached conclusion, but the authorities continue to be in discussions with external commercial commodity traders to restructure collateralized debt). The Gambia's restructuring took two years to reach agreement in principle, complicated by the large role of non-Paris Club creditors and plurilateral institution lenders (and notwithstanding the helpful efforts of the largest creditor to move the process forward). Finally, Mozambique only recently reached an agreement with its bondholders, three years after first announcing the proposal, but other loans remain under negotiation/litigation. For comparison, the average duration of restructuring with commercial creditors (banks and bondholders) over 1998-2015 was about a year and half.[18]

With the efficacy of existing processes to resolve debt crises in question, urgent attention by the international community is warranted. Improvements to market-based approaches can be considered, including greater use of innovations introduced by practitioners (e.g., trust structures), and potential extension of CACs to subnational debt. At the same time, proposals have been made to introduce basic practical steps for sovereign debt restructurings. They include enforcement of a temporary standstill on creditor litigation while debt-servicing payments are suspended by the debtor government on its own initiative, requiring approval by an independent panel; and creditors providing "debtor-in-possession" financing, granting seniority status to debt after the imposition of the standstill, which would give the debtor additional resources for financing imports and other vital current-account transactions.[19]

Endnotes

1 They are Nigeria, Bolivia, Cote d'Ivoire, Papua New Guinea, Tajikistan, Uzbekistan, Zambia, Cameroon, Ethiopia, Ghana, Honduras, Kenya, Mongolia, Mozambique, Pakistan, Senegal, Sri Lanka, Tanzania, Vietnam

2 See Note at figure III.E.6 for countries included.

3 Institute of International Finance Global Debt Monitor Database. Based on 26 selected EMs.

4 *Global Financial Stability Report, October 2019: Lower for Longer* (Washington, D.C., IMF, 2019).

5 Vitor Gaspar and others (eds.), *Fiscal policy and development: human, social, and physical investments for the SDGs* (Washington, D.C., IMF, 2019).

6 Assuming flat official development assistance and foreign direct investment as a share of donor countries GDP per WEO forecast and tax revenues as a share of GDP at 3 percentage points higher than WEO forecast following IMF (2018b).

7 Majdeline El Rayess and others (eds.), *Indonesia's Public Wealth* (Washington, D.C., IMF, 2019).

8 International Monetary Fund, African Department, "The Gambia: Selected Issues Paper", The Gambia: Selected Issues, IMF country report 18/100 (Washington, D.C., IMF, 2018).

9 The debt management performance assessment (DeMPA) is a methodology for assessing performance covering the full range of government debt management operations. It is focused on central government debt and loan guarantees. See http://www.worldbank.org/debt for a description of the DeMPA.

10 IMF and World Bank, "G20 Operational Guidelines for Sustainable Financing—Diagnostic Tool," Staff Note for the G20 IFAWG (Washington, D.C., IMF and World Bank, 2019). Available at https://www.imf.org/external/np/g20/pdf/2019/111519.pdf.

11 Ibid.

12 *World Economic and Social Survey 2012: In Search of New Development Finance* (United Nations publication, Sales No. E.12.II.C.1).

13 The Global Fund, "Spain, Three African Countries and the Global Fund Launch New Debt2Health Initiative". Available at https://www.theglobalfund.org/en/news/2017-11-29-spain-three-african-countries-and-the-global-fund-launch-new-debt2health-initiative/.

14 *Trade and Development Report, September 2019: Financing a Global Green New Deal* (United Nations publication, Sales No. E.19.II.D.15); and Munevar Daniel, "The sustainable development goals and developing-country debt sustainability: An alternative approach", UNCTAD draft research paper. Available at https://unctad.org/en/programmes/debt-and-finance/pages/research.aspx.

15 Ibid.

16 UN DESA, Financing for Development Office, Technical Study Group Report, "Sovereign debt restructuring: further improvements in the market-based approach" (New York: Financing for Sustainable Development Office, 30 August 2017), pp. 18-21. Available at (http://www.un.org/esa/ffd/wp-content/uploads/2017/09/EGM_sovereign-debt_Technical-study-group-report-30Aug2017.pdf).

17 A classic exposition on Islamic financial instruments for governments is: Ul Haque, Nadeem and Abbas Mirakhor, "The design of instruments for government finance in an Islamic economy", IMF Working Paper No. WP/98/54 (Washington, D.C., IMF, 1998). Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=882316.

18 Cruces Juan and Christoph Trebesch, "Sovereign Defaults: The Price of Haircuts", *American Economic Journal: Macroeconomics*, vol. 5 Issue 3 (July 2013), pp.85-117.

19 Trade and Development Report, September 2019: Financing a Global Green New Deal (United Nations publication, Sales No. E.19.II.D.15).