Financing for Sustainable Development Report 2022

Inter-agency Task Force on Financing for Development

Bridging the Finance Divide

United Nations

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

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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) provides additional data and analysis on progress in implementation of the Financing for Development outcomes, including the Addis Ababa Action Agenda and relevant means of implementation targets of the Sustainable Development Goals.

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The production of this report and the online annex of the Inter-agency Task Force are generously supported by the Federal Ministry for Economic Cooperation and Development of Germany.

How to cite this report:

United Nations, Inter-agency Task Force on Financing for Development, *Financing for Sustainable Development Report 2022.* (New York: United Nations, 2022), available from: https://developmentfinance.un.org/fsdr2022.

United Nations publication

Sales No. E.22.I.6
ISBN: 978-92-1-101452-5

Debt and debt sustainability

Chapter III.E

Debt and debt sustainability

1. Key messages and recommendations

Global public debt surged further in 2021, from already elevated levels. Global public debt reached around 99 per cent of gross domestic product (GDP) in 2021. The scale and dynamics of the rise in public debt varied across country groups, depending on initial conditions and fiscal space. Developed economies financed massive fiscal interventions at historically low rates, many middle-income countries (MICs) and small island developing States (SIDS) saw a significant increase in debt, while least developed countries (LDCs) and other low-income countries (LICs)[1] were constrained in their fiscal response, including by limited market access. Debt levels are expected to remain elevated in many countries, sustained by high gross and external financing needs and the lingering impact of the pandemic on growth and revenues.

This recent surge in debt compounds debt vulnerabilities that predated the pandemic. Debt vulnerabilities, which had risen over the past decade, driven by widening fiscal deficits and lagging growth, increased sharply under the impact of the pandemic. About 60 per cent of LDCs and other LICs are now assessed to be at high risk of debt distress or in debt distress by the IMF/World Bank Debt Sustainability Framework, a substantial increase from about 30 per cent in 2015. While short-term risks of fiscal crises moderated in most MICs in 2021, around a quarter of MICs remain at high risk. The development of domestic bond markets should contribute to fiscal and financial resilience, but excessive sovereign borrowing from the domestic banking system can also exacerbate vulnerabilities through the sovereign-bank nexus.

Interest costs are rising in the poorest countries and remain elevated in SIDS, as they grapple with higher interest rates, slower recoveries and persistent revenue shortfalls. Gross external financing needs are also rising in many LDCs and other LICs, driven by higher external debt service—including deferred payments from the Debt Service Suspension Initiative (DSSI)—and widening current account deficits, although some oil exporters are benefiting from rising global oil prices. Their greater reliance on debt on commercial terms or near-commercial terms was associated with higher interest costs. As global uncertainty and inflationary pressures increase and financial conditions tighten, including due to the war in Ukraine, the ability of some countries to refinance outstanding debt is being called into question.

A combination of monetary policy support, pre-existing buffers in some countries and concerted support provided a liquidity cushion to combat the pandemic. Monetary policy support in developed economies enhanced global liquidity, which also benefited some MICs, LDCs and other LICs in the form of continued fund flows and bond purchases. Official lending, the G20/Paris Club-led DSSI and the more recent IMF allocation of Special Drawing Rights (SDRs) have helped to provide liquidity support. Some countries were able to tap pre-existing buffers and domestic financing sources, including central bank financing. Nonetheless, most LDCs and LICs were forced to curtail other Sustainable Development Goal (SDG) spending and investment. Domestic buffers and financing options may be running low, while external financing conditions are tightening.

- *Against this backdrop of high debt and debt vulnerabilities, with the expiry of the DSSI and limited availability of affordable financing for most LDCs and other LICs, improvements in debt crisis prevention and resolution have acquired added urgency.*

Supporting the recovery and investing in sustainable development, while managing debt vulnerabilities, will require comprehensive actions. Countries face a compound challenge of maintaining spending to cope with the immediate consequences of the pandemic, sustaining the recovery, restoring buffers and expanding investment in the SDGs. This will require national actions and international support across the action areas of the Addis Ababa Action Agenda, including addressing debt challenges.

With debt challenges likely to increase further with the tightening of global financing conditions, the debt resolution architecture needs to be further improved. Seeking early debt resolution when this is needed can help countries to avoid doing "too little too late". This includes stepped-up implementation of the Common Framework and further progress on contractual approaches.

Stepping up implementation of the Common Framework is essential to allow for fast action when countries are under financial stress.

- *This will require greater clarity on the processes and timelines, early engagement with all stakeholders, more clarity on how comparability of treatment of private sector creditors will be implemented, and expanding the Common Framework to other non-DSSI-eligible heavily indebted vulnerable countries;*
- *A standstill on debt service payments during the negotiation under the Common Framework can help to provide relief to the debtor at a time when it is under stress, as well as incentivize faster procedures to realize actual debt restructuring.*

Private creditor participation in debt restructuring can be further improved:

- *Through continued strengthening of collective action clauses in bond contracts;*
- *Model majority restructuring clauses for payment terms in syndicated loans, which official and private sector creditors are currently developing under facilitation by the G7, could also close an important gap in private sector debt resolution;*
- *In case of a systemic crisis and where the existing contractual resolution toolkit is unable to address such a crisis effectively, legislative solutions may be considered as a last resort.*

Debt swap initiatives are advancing in several regions. Debt swaps can free up resources for investments in key priorities, although they are not a means to restore debt sustainability in countries with solvency challenges.

- *More standardization and country ownership could help to increase the uptake of debt swaps.*

At the domestic level, the following elements are critical:

- *Credible medium-term fiscal frameworks, which balance the needs for short-term support with medium- term fiscal sustainability. Fiscal policies should aim to boost revenues and improve expenditure transparency and efficiency;*
- *Financing should be calibrated to reduce costs and roll-over risks, including through the development of domestic debt markets;*
- *Debt management policies should enhance transparency and proactively address deeper vulnerabilities.*

Debt management and debt transparency must be strengthened to prevent debt crises. Even prior to the pandemic, debt management capacities had not kept up with the increasing complexity of the debt landscape despite progress made by countries. The pandemic, associated revenue losses and greater financing needs have further increased these pressures.

- *Strengthening respective capacities should remain a key focus of the international community.*

Effective debt management depends on comprehensive data on debt.

- *The international community should continue to coordinate data collection processes, while working to close data gaps. The continued implementation of the World Bank Sustainable Financing Policy, the new IMF Debt Limits Policy, the G20 Operational Guidelines for Sustainable Financing and the OECD Debt Transparency Initiative, should enhance debt transparency and encourage improvements in debt management capacity.*

Vulnerability to climate shocks has exacerbated debt challenges, particularly in SIDS. The United Nations is developing a Multidimensional Vulnerability Index (MVI). Vulnerability informs allocation of concessional finance to an extent (for example, through small State exceptions and small economy terms in concessional windows of development banks) and is taken into account in debt sustainability assessments (through reflecting environmental risks).

- *An MVI could contribute to a holistic assessment of vulnerabilities and complement existing tools.*

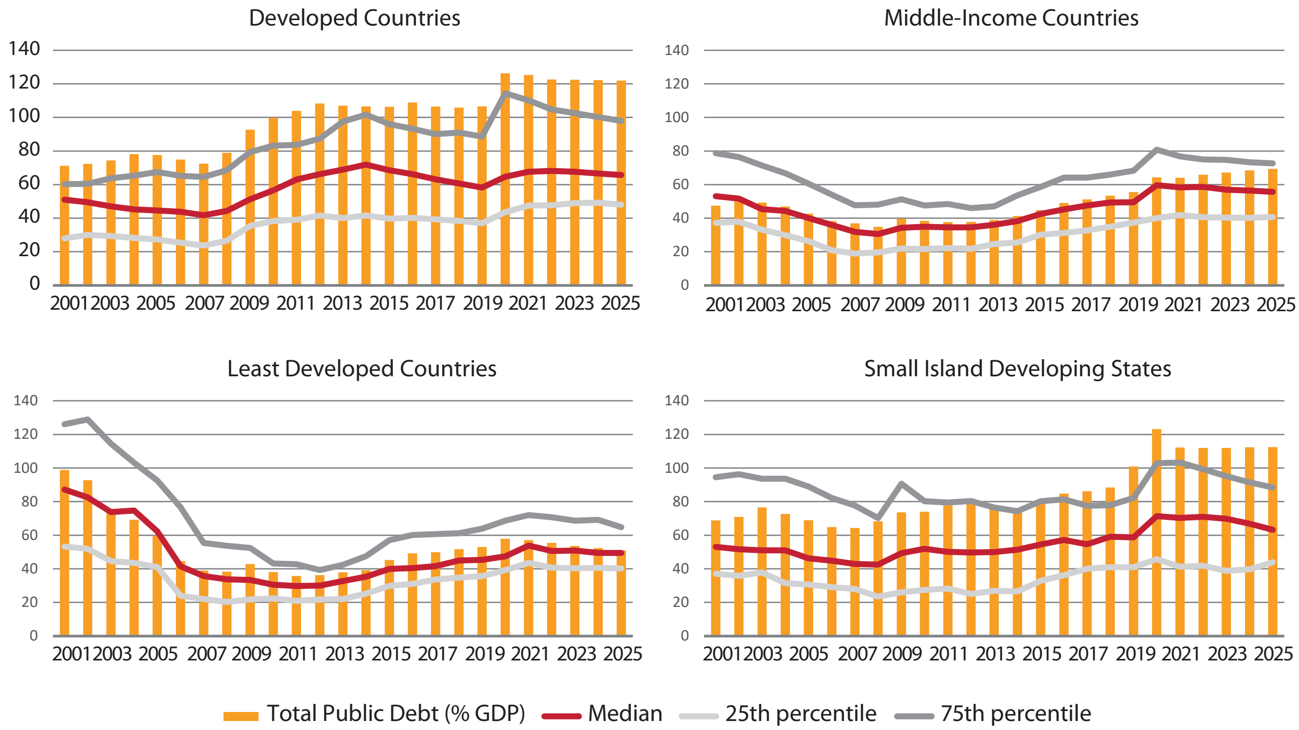
2. Debt trends: the impact of the pandemic

2.1 Public and external debt levels across income groups

Debt levels have increased across the board, but trajectories differ across income groups. Developed countries' gross public debt, which was stable between 2012 and 2019, jumped 18 percentage points during the pandemic, to an estimated weighted average of 122 per cent of GDP by the end of 2021. In many developing countries, the COVID-19 shock and related debt increases have compounded debt vulnerabilities that arose prior to the pandemic, driven by slowing growth, large and sustained primary deficits and rising interest costs. The COVID-19 shock exacerbated all three drivers. SIDS saw an increase in public debt of around 11 percentage points of GDP. MICs, which had seen debt levels rise by around 15 percentage points between 2012 and 2019, added another 9 percentage points. LDCs and other LICs, which experienced a similar increase in debt to MICs between 2012 and 2019, added another 6 percentage points.

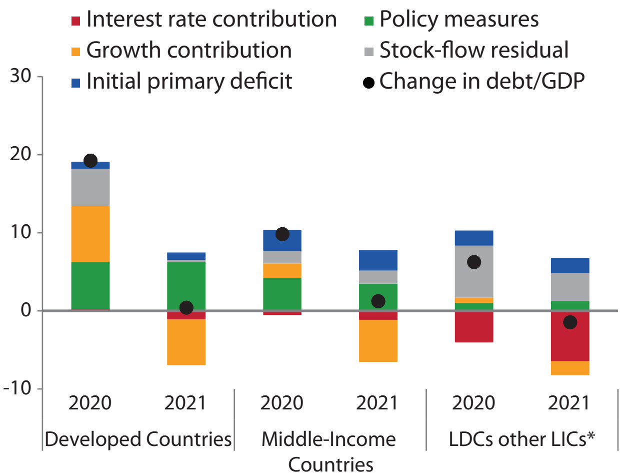
Debt expansion amid the pandemic was driven by the need to finance policy responses to the pandemic against a backdrop of contracting or slowing economic activity. Debt dynamics and scale differ across countries and country groups, reflecting differences in initial conditions, fiscal space and access to affordable finance. Developed countries borrowed at historically low rates to finance massive fiscal interventions, while LDCs and other LICs were constrained in their fiscal response, in part due to limited access to market finance. As a result, financing of policy measures was a significantly smaller driver of public debt in the poorest countries. Pre-pandemic fiscal deficits, exchange rate depreciation and stock-flow adjustments, including from the realization of contingent liabilities and bailouts, were the main debt drivers (figure III.E.2).

Figure III.E.1
Public debt evolution in developed and developing countries, 2001–2025
(Percentage of GDP)



Source: IMF WEO database with UN/DESA staff calculations.

Figure III.E.2
Drivers of change in public debt, 2019–2021
(Percentage of GDP)



Source: IMF Fiscal Monitor, October 2021 with IMF staff calculations.
Note: The stock-flow residual is the change in the debt ratio resulting from factors such as bailouts or changes in exchange rates.
* This group includes Eritrea, Sudan and Zambia.

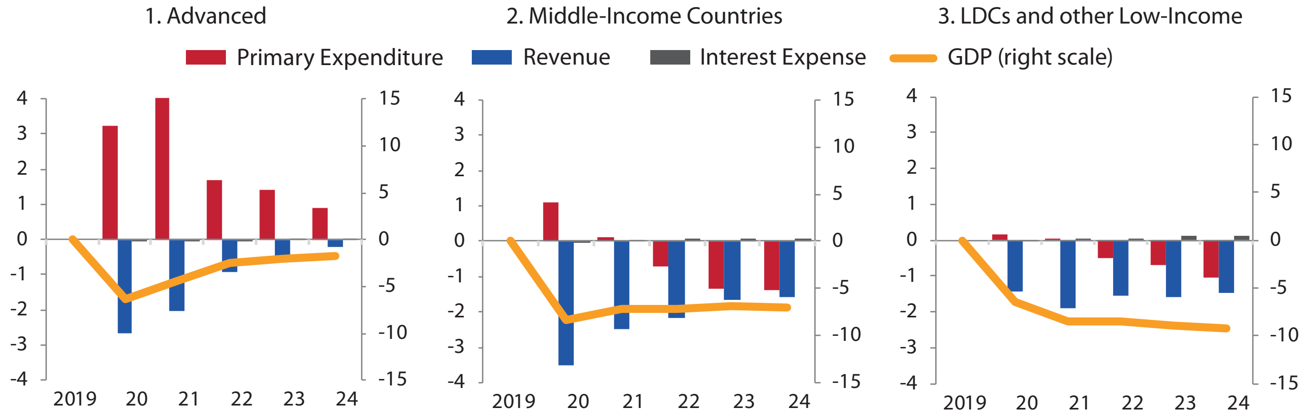
Debt levels are expected to remain elevated in developing countries, sustained by high gross and external financing needs and the lingering impact of the pandemic on growth and revenues. Low vaccination rates and pandemic-related scarring are expected to have a long-lasting negative impact on growth and revenues in LDCs and other LICs. Over the next three years, economic output is expected to remain 8.8 per cent below projections made in 2019 for the median country, while developed countries are projected to mount a full recovery (see chapter I). Revenue shortfalls are expected to be 1.6 percentage points of GDP over this period for the median LDC/LIC (figure III.E.3). The situation is more mixed in MICs, where the rebound in growth improved primary balances in 2021. However, rising borrowing costs, concerns over inflation, depreciations and further deterioration of financing conditions are leading to retrenchment in some countries (see also chapter II).

2.2 Changing composition of debt

Rising debt compounds pre-pandemic challenges related to changes in the creditor base. LDCs and other LICs have increasingly resorted to commercial borrowing to finance development needs, with tradeable debt securities (or bonds) the fastest growing commercial borrowing source. This contributed to the growth in interest costs (figure III.E.4). Non-Paris Club creditors led the increase in bilateral official lending.

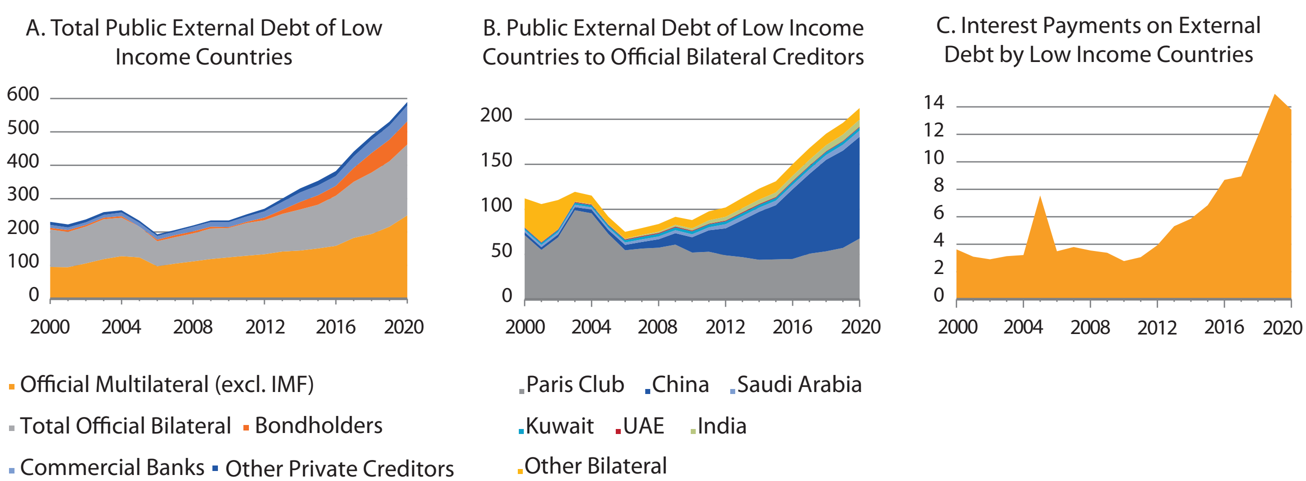
While some LDCs and other LICs are becoming increasingly reliant on commercial borrowing, most still lack access to international

Figure III.E.3
COVID-19 impacts on growth, fiscal and debt prospects, 2019–2024
(Deviation from pre-pandemic projections, percentage of 2019 GDP, median by group of countries)



Source: IMF Fiscal Monitor, October 2019, using WEO database and IMF staff estimates.
Note: All quantities are converted into 2019 prices using the projected evolution of the GDP deflator.
* This group includes Eritrea, Sudan and Zambia.

Figure III.E.4
Evolving external public and publicly guaranteed debt composition in least developed and low-income countries, 2000–2020
(Public and publicly guranteed, billions of United States dollars)

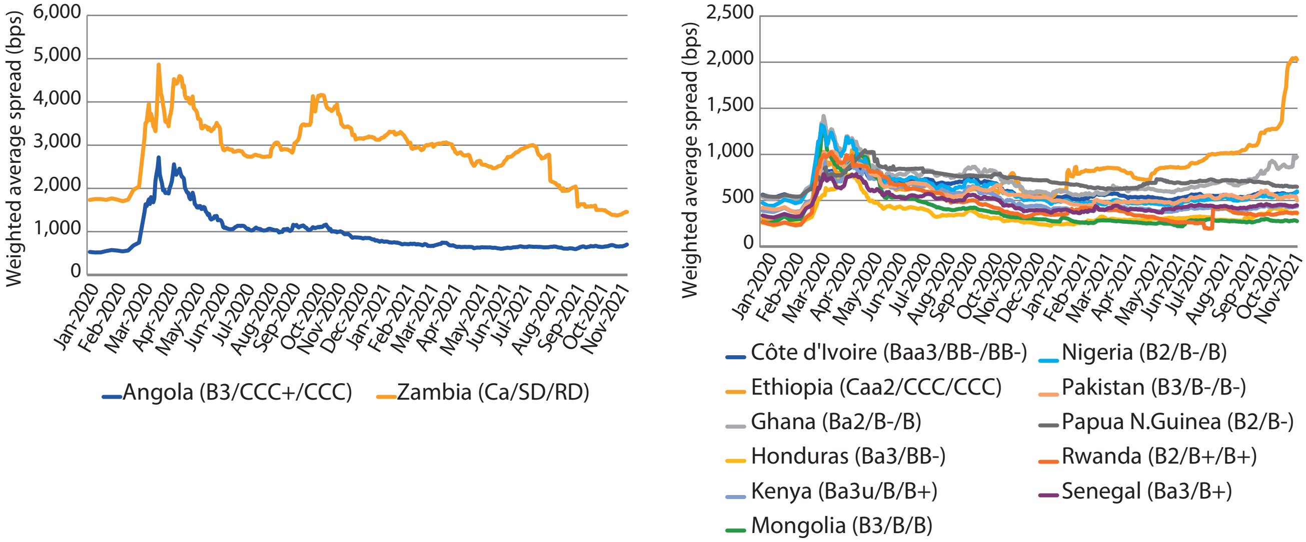


Source: World Bank International Debt Statistics Database.
Note: DSSI-eligible countries plus Eritrea, Sudan, and Zimbabwe. In 2005, Nigeria reported interest payments for USD 4.9 billion.

debt markets. One in three LDCs and other LICs have issued bonds over the past decade, with outstanding Eurobonds totalling $52 billion. For these countries, international bondholders constitute a large share of the creditor base. This stock of Eurobonds is concentrated in a few countries, with Nigeria, Ghana, Angola, Côte d'Ivoire, Kenya and Pakistan accounting for over 70 per cent of the total amount. As a percentage of GDP, borrowing on international bond markets is the highest for Mongolia (27 per cent of 2019 GDP), Senegal (18 per cent of GDP) and Ghana (15 per cent of GDP).[2]

After the initial sharp widening of interest rate spreads at the outset of the pandemic, some LDCs and other LICs returned to the market in late 2020 and 2021. But financing conditions have since started to tighten, particularly for the most vulnerable. Ghana, Pakistan and Côte d'Ivoire were able to issue debt as financial markets recovered from the initial pandemic shock. The recent tightening of market conditions amid uncertainty over the future course of the pandemic and rising inflation has led to renewed widening of interest rate spreads, particularly for countries with fiscal and debt vulnerabilities. Countries with significant fiscal and debt vulnerabilities have been virtually cut off from capital markets. For others, bond spreads remain above pre-crisis levels (see figure III.E.5).

Figure III.E.5
Foreign currency bond spreads, select LDCs and other LICs
(Basis points)



Source: IMF staff calculations using data from Bloomberg LLC.

Developing countries have also increased their domestic borrowing over the last decade. The development of domestic bond markets can increase financial resilience and mitigate exchange rate risks. In the context of the pandemic, the combination of high gross financing needs and widening spreads contributed to a greater reliance on domestic borrowing. However, excessive domestic sovereign borrowing could intensify the sovereign-bank nexus in the event of a crisis.[3]

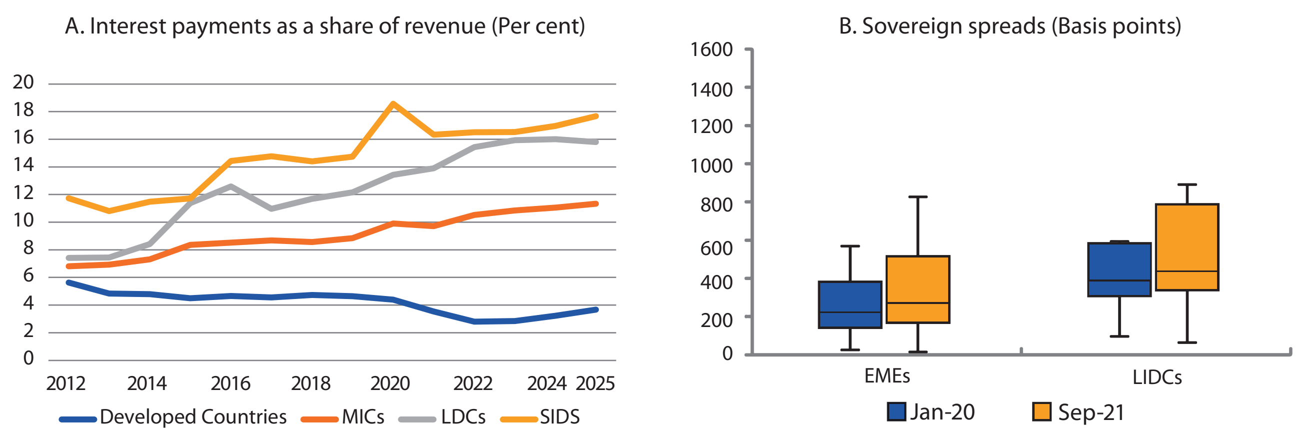
2.3 Indicators of debt vulnerability

A range of debt indicators, such as interest burdens, external financing needs and fiscal adjustment requirements (as described in sections 2.1 and 3), all point to rising debt vulnerabilities.

Interest to revenue ratios and sovereign spreads are rising. The share of revenue dedicated to interest payments has fallen in developed countries in recent years, despite growing debt levels. A growing share of revenue is dedicated to interest payments in MICs, while LDCs and SIDS have witnessed sharp increases, reflecting diverging borrowing costs. Widening credit spreads (the difference between the sovereign's borrowing cost and "risk-free" bonds, e.g., US Treasuries) on bonded debt signal rising re-financing/liquidity risks for those LDCs and LICs with access to debt markets (figure III.E.6).

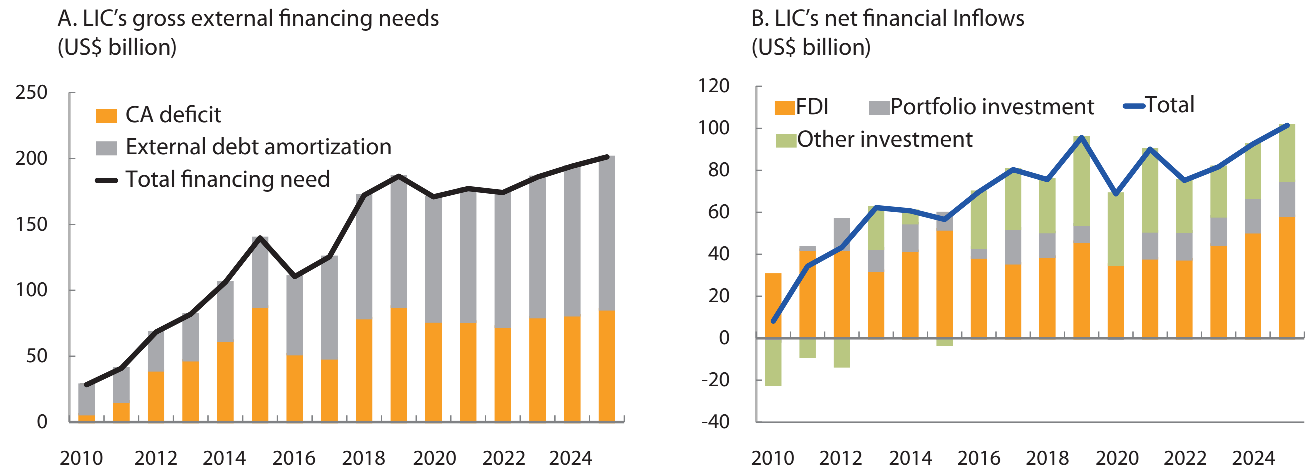
External financing needs (EFNs) in LDCs and other LICs are also projected to increase, driven mainly by higher external debt service and widening current account deficits, with the exception of some oil exporters. The availability of financing to meet those needs is

Figure III.E.6
Interest payments as a share of revenue and sovereign spreads



Source: Panel A: IMF WEO data, DESA Staff calculations; Panel B: JPMorgan Emerging Market Bond Index (EMBI) spreads, collected from Refinitiv Datastream, IMF Staff calculations.

Figure III.E.7
External financing needs and financial flows of LDCs and other LICs



Source: IMF. 2021. World Economic Outlook.
Note: DSSI-eligible countries plus Eritrea, Sudan, and Zimbabwe.

uncertain. External financing needs are expected to increase from $101 billion in 2019 to over $166 billion in 2025 in LDCs and other LICs, on the back of higher current account deficits and higher external debt amortization (see figure III.E.7). The average EFN-to-GDP ratio is expected to narrow in 2022 as economies recover, but to remain above the historical average. The average annual amount of external debt service falling due in 2021-2025 is more than twice as much as the pre-crisis average (2010-2019).[4] With the expiry of the DSSI, deferred debt service will add to debt service needs for the 43 countries that participated in the initiative over this period. At the same time, at the end of 2020, about half of LDCs and other LICs had reserve cover for less than two years of EFNs, up from 30 per cent in 2018. The availability of external financing to meet rising needs may be undermined by the tightening of international financing conditions as monetary policy support measures in some advanced economies are unwound.

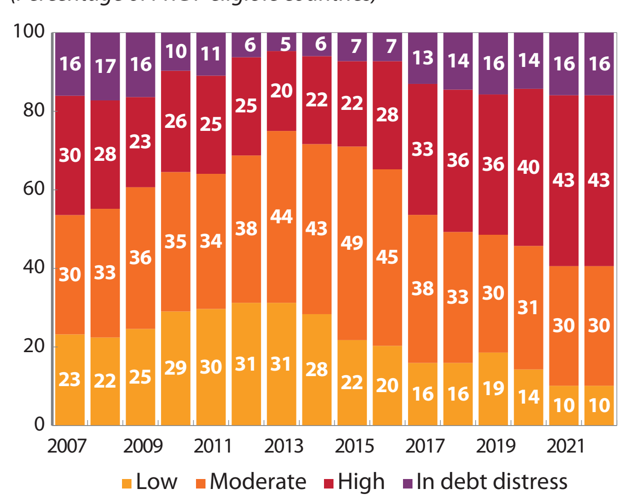
2.4 Debt sustainability risks in developing countries

Debt vulnerability indicators worsened for LDCs and other LICs in 2021 and remained elevated for some MICs. The short-term risk of a fiscal crisis moderated for developed countries and most MICs in 2021, according to an IMF methodology for assessing the risk of a fiscal crisis using machine learning. Nonetheless, around a quarter of MICs remain at high risk.[5] But debt risk ratings for LDCs and other LICs worsened during this period. Around 60 per cent of countries that use the IMF/World Bank Debt Sustainability Framework (LIC DSF) are now assessed at a high risk of debt distress or in debt distress, a large increase from around 30 per cent in 2015 (figure III.E.8). Twelve countries' debt risk ratings have been downgraded since the beginning of the pandemic (figure III.E.9).

3. Response to the pandemic

A combination of monetary policy support, pre-existing buffers in some countries and concerted multilateral and bilateral support provided a liquidity cushion. Monetary policy support in developed countries enhanced global liquidity, which also benefited some MICs and LDCs and other LICs in the form of continued fund flows and bond purchases. Official lending, including IMF Rapid Financing Instrument loans (RFIs) and Rapid Credit Facility loans (RCFs), the DSSI and the more recent IMF allocation of SDRs, have helped to provide liquidity support to many LICs. In addition, some countries were able to tap pre-existing buffers and domestic financing sources, including central bank financing. However, domestic buffers and financing options may be running low, while external financing conditions are tightening. With the expiry of the DSSI at the end of 2021,

Figure III.E.8
External debt distress ratings for LICs using IMF/World Bank LIC DSF, 2007–2022
(Percentage of PRGT-eligible countries)



Source: IMF/World Bank Debt Sustainability Framework. Data as of 15 December 2021 to 22 February 2022.

Figure III.E.9
Upgrades and downgrades in the LIC DSF, 2018–2022

	2018	2019	2020	2021	2022*	Main reasons for a change in risk of debt distress		
Downgrade								
Kenya	M		H			May	2020	A worsening in economic outlook due to the pandemic.
Zambia		H	D			May	2020	Entered into restructuring negotiations.
Rwanda	L	L	M			June	2020	A worsening in economic outlook due to the pandemic and updates on investment program.
Papua New Guinea	M		H			June	2020	A worsening in economic outlook due to the pandemic.
Madagascar	M	L	M			July	2020	A worsening in economic outlook due to the pandemic.
Guinea Bissau	M			H		January	2021	A worsening in economic outlook due to the pandemic and higher fiscal deficits in 2018–19.
Tanzania	L			M		September	2021	Pandemic's adverse effect on the country's exports.
Timor-Leste	L			M		July	2021	Projected increase in debt service payments as existing loan grace periods come to an end.
Uganda	L		L	M		June	2021	Downgrade reflects risks such as delays in oil exports and a shift in financing composition towards non-concessional loans.
Comoros	M	M	M	H		October	2021	Mainly due to higher debt service obligations.
Chad	H	H	H	D		December	2021	Uncertainties around the pandemic and oil price volatility.
Malawo	M	M	M	H		December	2021	Large financing needs in the coming years and low level of international reserves.
Upgrades								
Gambia	D	D	H			March	2020	Reflect debt restructuring agreed before the pandemic.
South Sudan		D	H			November	2020	Reflect debt restructuring agreed in July 2020.

Source: IMF/WB LIC DSAs.
Notes: D: in debt distress (grey), H: high (red), M: moderate (orange), L: low (green). Blank years reflect the rating assigned in the latest DSA available at that time.
* As of 22 February 2022.

participating countries need to resume servicing their official bilateral debts in 2022, raising debt service due to above 2019 levels (figure III.E.11).

International support to ease fiscal pressures from debt burdens during the pandemic focused on providing LDCs and other LICs "breathing space" to respond to the pandemic. Seventy-three least developed, low- and lower-middle-income countries were eligible to participate in the DSSI, which aimed to temporarily ease pandemic-induced financing constraints by suspending debt service payments to bilateral official creditors. The goal was to free up resources to mitigate the human and economic impacts of the pandemic. Adopted in April 2020, the DSSI was extended twice for six-month periods through to end-2021. Preliminary G20 estimates point to $12.9 billion of total debt service deferred under the initiative.

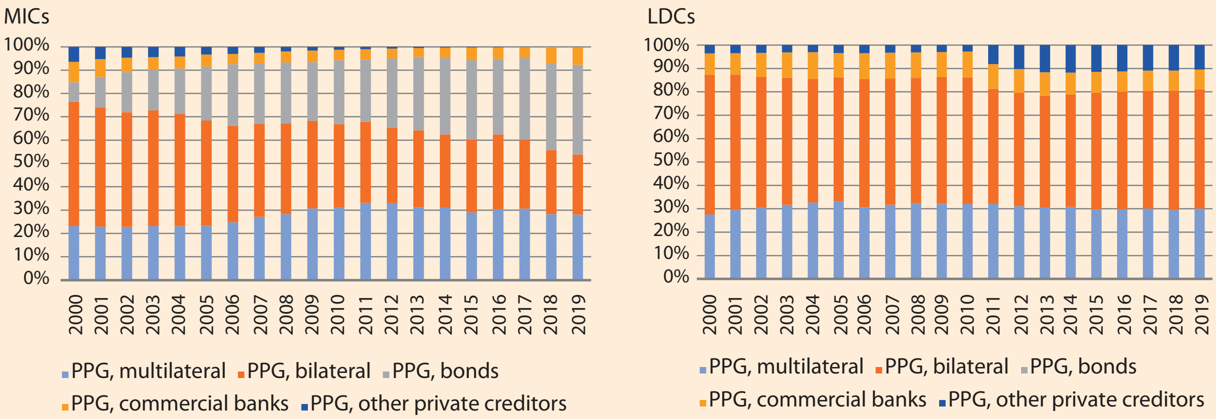
Recognizing that the DSSI provided only a temporary respite, the G20 and Paris Club endorsed the Common Framework for debt treatment in November 2020. Under the Common Framework, G20 and Paris Club creditors agreed to coordinate and cooperate on debt treatments for DSSI eligible countries that need debt relief in the context of and consistent with the parameters of an Upper Credit Tranche (UCT) quality IMF programme. The Common Framework requires that participating debtor countries seek debt treatment on terms at least as favourable from other creditors, including the private sector, thereby enabling comprehensive debt resolutions.

As of December 2021, three countries had requested debt treatments under the Common Framework (Chad, Ethiopia and Zambia). First steps in these cases have been taken, with the formation of creditor committees for two cases, and the provision of official financing assurances, which are needed to access fresh IMF financing, in one case. Chad, whose request for an IMF-supported programme was approved by the IMF's Executive Board in December 2021, has also entered discussions with its main commercial creditor, who holds the majority of its commercial debt. The next step will be for Chad to finalize the debt restructuring agreement with its Common Framework official creditors and to seek comparable efforts from its private and other official creditors. Notwithstanding these important milestones under the Common Framework, implementation has faced challenges and no debt treatment has been completed one year after the initial requests. Progress in these initial cases has been slower than anticipated. Along with the challenges to be expected in the initial phases of a new framework, these delays also reflect coordination issues among official creditors as well as within creditor

Box III.E.1
Pandemic and debt challenges in the Arab region: a regional perspective

The pandemic has exacerbated debt vulnerabilities for LDCs and MICs in the Arab region.[6] Public debt in the region reached 60 per cent of GDP in 2020, with MICs facing the highest debt burden relative to their output level. Several LDCs in the region are at high risk of debt distress (including Djibouti, Comoros and Mauritania) or in debt distress (Somalia), in some cases owing in part to the adverse impacts of the pandemic. Growing reliance on private creditors over the past decade (figure III.E.10) has increased borrowing costs and refinancing and roll-over risks, while the share of concessional borrowing from official creditors (both bilateral and multilateral) has declined.

Figure III.E.10
Composition of external public debt in Arab region MICs and LDCs, 2000–2018



Source: IMF/WB data, ESCWA calculations.

The Arab region has faced rising public and external debt burdens over the last decade due to low growth and persistent fiscal and trade deficits. In MICs in the region, external public debt service consumes nearly 11 per cent of their export earnings, which is much higher than the global average for MICs at 6.4 per cent. LDCs in the region have followed a similar trajectory. This increasing debt service burden poses liquidity challenges and strains fiscal space, which could have otherwise been used for investment in financing the COVID-19 recovery and the SDGs.

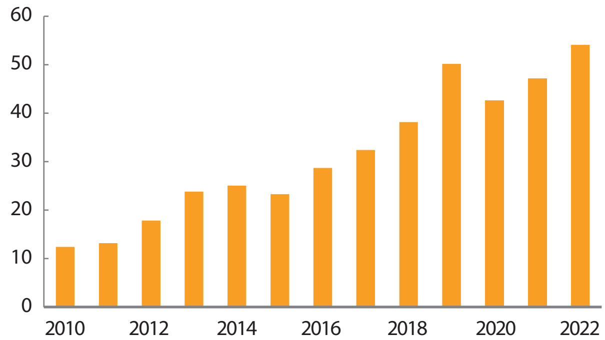
A number of factors have driven debt accumulation in MICs. The economic shock induced by COVID-19 has pressured public finances through reduced revenues, higher spending needs (on health and social safety nets), a reduction in growth and a rise in contingent liabilities. In many countries, these COVID-induced pressures exacerbated pre-existing vulnerabilities, including slow growth, large public sectors and an inability to bring down deficits in the face of adverse regional and security shocks over the last decade (for example, in Jordan, Lebanon, Morocco and Tunisia). Commodity price volatility has also affected debt accumulation for oil exporters during the pandemic.

In some countries in the region, constrained fiscal space and liquidity challenges have led to inadequate fiscal support to mitigate the adverse effects of the pandemic and progress towards a resilient recovery. Of the total global fiscal support of $18.7 trillion, Arab countries allocated $94.8 billion, or around 4 per cent of their GDP in 2020, far below global averages.[7] In some cases, international support (including an SDR allocation of around $37 billion to the region) was not sufficient to mitigate the adverse effects of the pandemic, putting the region at risk of suffering from deep and long-lasting adverse effects.

Countries in the Arab region need both international support and national actions to build back better. An important priority for the region is to strengthen international support to MICS—including eligibility for the Common Framework, the provision of concessional financing and rechannelling of SDRs. National policy measures include development of medium-term debt stabilization scenarios that take into account SDG financing needs, domestic revenue mobilization, prioritization of investments in inclusive growth and productivity, and operationalization of innovative debt instruments such as debt swaps, for example, in the context of the Climate/SDGs Debt Swap and Donor Nexus Initiative, launched by ESCWA (see also below). ESCWA has also proposed the establishment of a debt management support group at the regional level, i.e. an Arab Debt Management Group (ADMG), to promote peer learning and to share lessons on improved debt management practices toward improving macroeconomic stability and fiscal space for financing the SDGs.

Source: ESCWA.

Figure III.E.11
External public and publicly guaranteed debt service for DSSI participating countries
(Billions of United States dollars)



Source: World Bank IDS and creditors' data.
Notes: (i) Debt service for 2020 to 2022 is based on debt contracted through the end of 2020; (ii) debt service in 2020 and 2021 is adjusted down by the DSSI relief reported by G20 and policy bank creditors; and (iii) debt service in 2022 reflects the first DSSI repayment.

countries, where multiple institutions and agencies can be involved, and call for improvements in processes and decision-making (see also below).[8]

New financing from the IMF, the World Bank and other multilateral development banks helped countries to meet increasing needs, complementing the liquidity support provided by the DSSI (see chapter III.C). From the start of the pandemic to end-2021, the IMF approved approximately US$170 billion in new financing, covering 90 countries. IMF assistance to LICs totalled approximately US$23.9 billion, covering 55 countries. The World Bank provided US$33 billion in 2020, including US$5.5 billion in grants. The IMF has also provided debt service relief through grants to the 31 poorest and most vulnerable countries under the Catastrophe Containment and Relief Trust (CCRT), covering debt service to the IMF falling due between April 2020 and April 2022 of about US$1 billion.

In August 2021, the IMF implemented the largest allocation of SDRs in history for a total amount of US$650 billion, $21 billion of which went to LICs (see chapter III.F). To magnify the impact of the SDR allocation, IMF member countries with strong external positions can voluntarily channel their allocations to help vulnerable countries. G20 countries have committed to channel US$100 billion in this context (see chapter III.F).

Concerted international efforts to support developing countries helped to free up resources to counter the pandemic and forestall a widespread debt crisis but could not prevent a reduction in other SDG-relevant expenditures. The 43 countries covered by the IMF and World Bank fiscal monitoring under the DSSI increased COVID-related spending by 1.6 per cent of GDP on average in 2020, despite average revenue losses of 2.4 per cent of GDP. The pandemic response, combined with the decline in revenues, contributed to a widening of the overall fiscal deficit by 1.8 per cent of GDP. Limited access to financing implied a need for spending prioritization, leading to significant reductions in other spending, particularly public investment, which fell by 1.1 per cent of GDP on average[9] (see chapter II). This could have implications for these countries' long-term growth and development.

4. Advancing the debt policy agenda

Supporting the recovery and investing in sustainable development, while managing debt vulnerabilities, will require national actions and international support across the action areas of the Addis Agenda. Debt vulnerabilities need to be addressed in a holistic manner, with actions necessary across the Addis Agenda. A key domestic policy priority in this context is creating fiscal space through revenue mobilization, expenditure efficiency and better debt management. Authorities should build credible medium-term policy frameworks which balance the needs for short-term support and investments in recovery with medium-term fiscal sustainability, for example, through integrated national financing frameworks (INFFs). On the revenue side, there is a need to improve progressivity of income taxes, reduce distortions arising from tax exemptions, broaden VAT bases and use technology to improve tax administration. On the expenditure side, authorities should re-prioritize spending, protecting investments in the SDGs, and improve spending efficiency and the quality of public procurement (see chapter III.A). Transparency and good governance are key to ensure that funds are used where they are most needed (see chapter II). Debt management should carefully calibrate the financing mix, develop domestic debt markets (see also chapters II and III.B) and act early to address deeper vulnerabilities.

Against the backdrop of high debt and debt vulnerabilities and with the expiry of the DSSI, limited availability of affordable financing for most LDCs and other LICs and deteriorating financing conditions, international support and efforts to improve debt crisis prevention and resolution are more urgently required. In the wake of a global shock and in light of large unmet financing needs for global priorities such as climate action and the SDGs, national actions must be complemented by an international response. The international community has taken significant steps to address the socioeconomic fallout from the COVID-19 pandemic, but additional efforts will be needed to close the recovery gap.

4.1 Debt crisis prevention—transparency, debt management and responsible borrowing and lending

Debt transparency by debtors and creditors is a necessary component of debt crisis prevention and a key aspect of responsible borrowing and lending; it has received heightened attention in the context of the current crisis. Transparency enables more effective debt management by debtors and better risk management by creditors—both of which are important tenets of responsible borrowing and lending. Data gaps make it harder for countries to manage debt and for borrowers and creditors to assess debt sustainability. This can increase uncertainty in markets and raise the cost of borrowing not only for individual borrowers but for developing country sovereign borrowers as an asset class (see chapter II). Lack of reliable data also makes it more challenging for over-indebted countries to restructure debt promptly when necessary and generate a durable economic recovery.

Debt transparency and debt management

Enhancing debt transparency has been a key priority for the international community and efforts have accelerated since the onset of the pandemic. Transparency is one of four pillars in the

IMF-World Bank Multipronged Agenda (MPA) (see box III.E.2). The implementation of the World Bank's Sustainable Development Finance Policy (SDFP) in July 2020 was instrumental in increasing the number of countries publishing debt reports (see box III.E.3). The June 2021 IMF Debt Limits Policy (DLP) enhances transparency by requiring a debt holder profile table in all IMF programme reports. The OECD launched the Debt Transparency Initiative in March 2021 to enhance disclosure of private creditor lending to developing countries (see box III.E.4).

Box III.E.2
The IMF-World Bank Multipronged Agenda

The IMF-World Bank MPA is being adapted to address increasing debt risks from the pandemic and to support post-pandemic recovery. The MPA, an ongoing effort by the IMF and World Bank to address debt vulnerabilities in developing countries, has four pillars: (i) strengthening debt transparency; (ii) strengthening countries' capacity to manage debt; (iii) applying accurate debt analysis tools; and (iv) strengthening international financial institution (IFI) policies. Recent modifications have focused on developing customized advice to address pandemic-related debt and fiscal risks and adapting the modalities of capacity development delivery to the pandemic environment; supporting more comprehensive borrower reporting to international statistical databases; strengthening IFI policies on debt reporting and data dissemination; enhancing outreach to creditors, including IMF and World Bank support to Common Framework implementation in the first three cases; and the release of new analytical tools, most notably the IMF's sovereign risk debt sustainability framework for market access countries, which provides a clearer signal on sovereign debt risks.

Box III.E.3
World Bank's Sustainable Development Finance Policy

The SDFP incentivizes countries to move towards transparent and sustainable financing and to further enhance coordination between the International Development Association (IDA) and other creditors. Under the first of its two pillars, the Debt Sustainability Enhancement Program (DSEP), the IDA's annual allocations are tied to performance and policy actions (PPAs) in (i) debt transparency; (ii) fiscal sustainability; and (iii) debt management, informed by World Bank diagnostics and supported by World Bank financing operations and technical assistance. Countries that do not satisfactorily implement their PPAs will have 10 or 20 per cent of their annual Country Allocations set aside depending on their debt risk, and face restrictions in their access to frontloading and reallocations.

Since the SDFP became effective in July 2020, 33 IDA countries that prepared PPAs published annual debt reports or/and quarterly debt bulletins as a result of the SDFP implementation. Similarly, six countries strengthened their Public Investment Management (PIM) regulations and ten countries started conducting annual fiscal risk assessments to inform fiscal policy decisions.

The second pillar, the Program of Creditor Outreach, aims at stronger collective action and closer coordination among borrowers and creditors to mitigate debt-related risks. The Program of Creditor Outreach has focused on SDFP implementation updates, targeted outreach to development partners, expanding collaboration and exchange of information with multilateral development banks and bilateral partners, and supporting IDA countries to sustainably finance their development.

Box III.E.4
The OECD Debt Transparency Initiative

The OECD launched the Debt Transparency Initiative (DTI) in response to widespread calls to improve the consistency, comparability, scope and frequency of debt statistics. The DTI aims to collect, analyse and report on private sector lending to vulnerable LICs.[10] The DTI operationalizes the Voluntary Principles for Debt Transparency developed by the Institute of International Finance, which provide guidelines for the public disclosure of private creditors' lending to sovereigns.

The OECD Secretariat has formed two groups to help support the Initiative: the Debt Data Users Group, and the Advisory Board on Debt Transparency. The former, composed of the Institute of International Finance (IIF) and debt analysts from central banks, finance ministries, IFIs, private lenders and asset managers, provides feedback on debt data collection, refinement of the Reporting Template and support for analytical content. The latter, which also includes civil society organizations and academia, provides a broad range of perspectives on the scope of the initiative and a preliminary assessment of the data collection and gaps.

Following the launch of the test portal, the OECD has begun to receive sample data for in-scope financial transactions from international banks. The OECD Secretariat, with the support of the Advisory Board, will seek to assess the robustness of the data and, with the Committee's approval, will make transaction-specific data available through a progress report. Furthermore, it will begin to make transaction-specific data periodically available on its portal beginning in early 2022. To supplement debt data collection from lenders and other investors, the OECD will also provide aggregated and country-specific trends and descriptive statistics from commercial data providers, as this information is not readily available to the public.

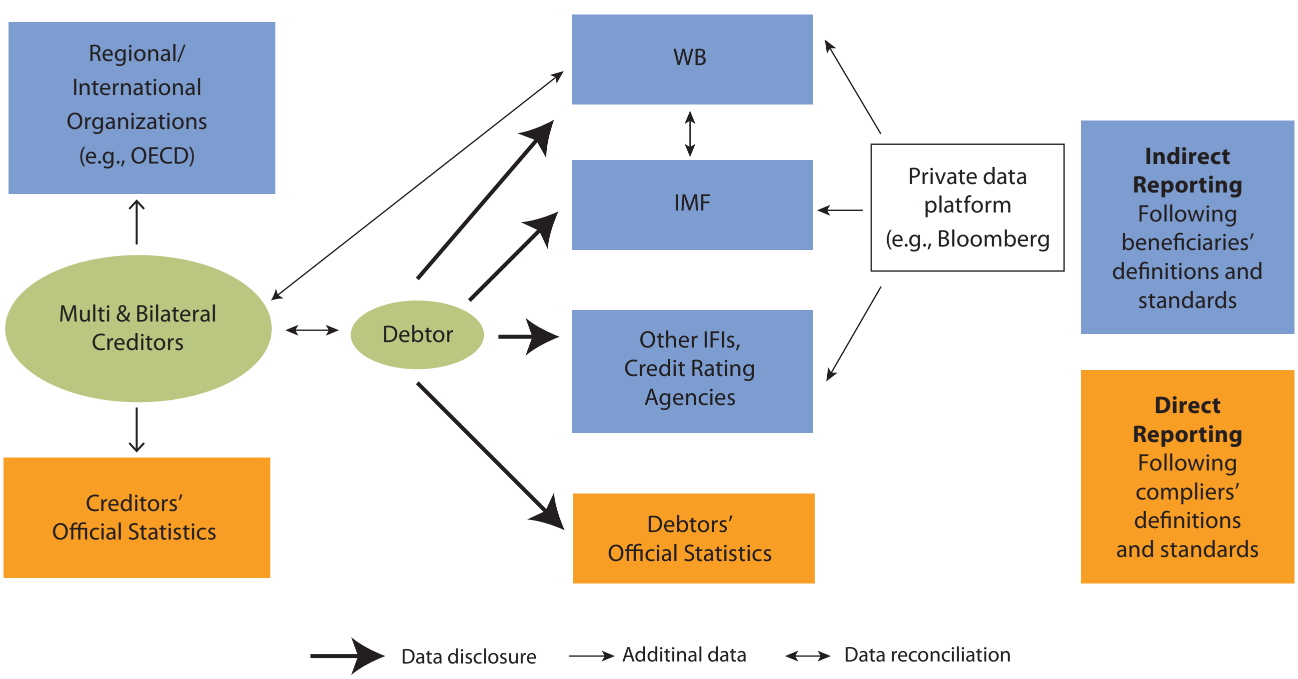
Despite recent improvements, debt data coverage and transparency remain a challenge. Public disclosure of sovereign debt data is still limited for many countries, in particular LDCs and other LICs. 23 per cent of LICs have not published any data about their sovereign debt for more than two years.[11] Instrument and sectoral coverage differ, as debt management offices typically do not have the legal mandate, incentives or capacity to collect data or report them beyond the central government level. Commercial loans contracted with private external creditors are also prone to misreporting or non-disclosure. Statistics on guarantees are not disclosed in 30 per cent of LICs, while estimates of contingent liabilities from public-private partnerships are available in official debt statistics in less than 10 per cent of cases. Expenditure arrears, typically converted to debt through securitization, are also hard to quantify given the absence of well-performing accounting systems. Resource-backed loans, accounting for around 8 per cent of total new borrowing in Sub-Saharan Africa, pose special challenges. There are also considerable data gaps regarding public sector domestic debt.

More coordinated data collection and reporting would contribute to improved debt transparency. Multiple direct and indirect sources of public debt data co-exist. Most efforts to advance debt transparency fall primarily on the shoulders of borrowers through their (indirect) debt data reporting via the World Bank and IMF. Debtor countries also publish official statistics—limited in the case of many LDCs and other LICs—and report to credit rating agencies in addition to the IFIs. Official creditors also publish data in their own official statistics and report to regional and international organizations. Private sector index and data providers collate statistics from different sources, but these are usually not publicly accessible (figure III.E.12). Commercial creditor disclosures, which can be key drivers of transparency, are scarce. This complex ecosystem can create discrepancies and leaves gaps.[12] Differences in debt definitions, some of which may not follow statistical and accounting reporting standards, and errors can lead to discrepancies of up to 30 per cent of GDP across sources with the same expected coverage. Uncoordinated data requests by external actors overburden often short-staffed debt management offices.

Greater efforts are needed to enhance transparency by creditors. As noted, both lenders and borrowers stand to benefit from debt transparency. Data collection from private creditors, for example, in the context of the OECD DTI (see box III.E.4), complements data collection by borrowers and IFIs. However, some reporting is restricted due to confidentiality clauses in loan contracts. The 2019 IMF and World Bank "G20 Operational Guidelines for Sustainable Financing—Diagnostic Tool" highlights that a good practice would suggest use of publicly available templates for financing agreements and refraining from including confidentiality clauses in loan agreements, as well as information-sharing on new and existing lending, including on the volume, terms and other conditions. To enhance transparency, creditors will need to refrain from using these clauses.

On the national level, strengthened legal, institutional and operational frameworks for debt management can help to improve debt transparency statistics, reduce the risk of debt crises and free up resources for investment. International support is needed to help developing countries put in place effective legal frameworks for debt management, including: clarifying the borrowing authority, the delegation of power and the debt authorization cycle; defining public debt according to international standards; and regulating debt data disclosure statistics to ensure comprehensiveness, timeliness and full accessibility.[13] Some countries, such as Barbados, Kosovo, Kyrgyz Republic, Philippines and Sierra Leone, already go beyond publishing debt statistics to require disclosure of external debt contracts as a matter of domestic law.

Figure III.E.12
Direct and indirect data reporting of government debt



Source: Rivetti, D. 2021. *Debt Transparency in Developing Economies*. World Bank.

Capacity development and improved debt management

Improving and expanding the capacities of debt management offices is critical. A more complex and diverse creditor landscape combined with fiscal pressures from the pandemic has increased the burden on debt management offices. But while many such offices are structured according to international sound practices of back, middle, and front office, less than 50 per cent meet the minimum requirements of staff capacity.[14] Enhancing information technology systems and development and implementation of modern and integrated debt recording and management systems, with definitions and calculation methods aligned with international standards, can greatly contribute to increasing transparency and better debt management.

Strengthening debt-management capacity is a key focus of international support. It is one of the four pillars in the IMF-World Bank MPA (see box III.E.2) as well as a focus of the United Nations system's support on debt sustainability. The IMF and World Bank are developing customized advice to address pandemic-related debt and fiscal risks and are adapting the modalities of capacity development delivery to the pandemic environment. Under its Debt Reduction Facility, recently extended, the World Bank is piloting the financing of legal advisory services to central governments in specific areas related to public and publicly guaranteed borrowing from external commercial creditors that are not linked to debt reduction operations. This effort is in line with a key request from Member States during the United Nation's 2020 dialogues on Financing for Development in the era of COVID-19.

The United Nations system is also supporting developing countries in "downstream solutions", including capacity for high-quality debt recording and reporting. Such "downstream" solutions complement the technical assistance in "upstream" areas (including governance, debt sustainability analysis and debt strategy) provided by the IMF, World Bank, other IFIs and regional entities. The relevance of such assistance was highlighted during the pandemic, when increasingly complex debt portfolios and weaknesses in legal and institutional frameworks, staffing, skills and systems undermined countries' capacity to ensure the availability of high-quality debt data. These challenges were compounded by the limited capacity of many debt management offices to work remotely. In this challenging context, UNCTAD's Debt Management & Financial Analysis System (DMFAS) Programme provided support to 60 mainly low-income or lower-middle-income countries, helping them to build and sustain the appropriate capacity for handling public resources and liabilities effectively. Improvements in debt transparency and debt management were achieved through strengthening debt management systems and the quality and reporting of debt data. Capacity-building activities included training on data validation, reporting standards and the production of statistical bulletins. Assistance was also provided for recording and reporting on COVID-related debt reorganization initiatives such as the DSSI. Key indicators of achievement in debt transparency included improved debt coverage, with 91 per cent of supported countries having comprehensive databases on government and government-guaranteed external debt. In addition, the number of countries using the DMFAS to record domestic debt rose to 71 per cent by the end of 2021. In relation to reporting, 85 per cent of supported countries reported effectively to the World Bank Debtor Reporting System in 2021 and 36 countries produced Debt Portfolio Reviews, a 38 per cent increase from 2019.

Additional facets of responsible lending

Debt crisis prevention is a shared responsibility. In the Addis Ababa Action Agenda, Member States reiterated that maintaining sustainable debt levels is the responsibility of borrowing countries, but that lenders also have a responsibility to lend in a way that does not undermine a country's debt sustainability. Principles for responsible borrowing and lending highlight two common areas of creditor responsibility: transparency for both debtors and creditors, as discussed above; and the responsibility of creditors for risk assessment and management. For example, the UNCTAD Principles include creditor responsibility for realistic assessment of a sovereign borrower's capacity to service a loan based on the best available information and due diligence. The G20 Operational Guidelines for Sustainable Financing also emphasize that official lending should be consistent with IMF and World Bank debt limit policies. In 2021, the IMF and World Bank supported G20 creditors to undertake a second round of self-assessment using the IMF-World Bank Operational Guidelines for Sustainable Financing–Diagnostic Tool, which revealed incremental progress and areas for further work (see box III.E.5). The principles of the Institute of International Finance include vigilance and enhanced risk management by private creditors and other market participants, along with an open dialogue between creditors and debtors and sustained surveillance efforts. Enhancing reporting and transparency along with strengthened credit analysis would reduce uncertainty and improve the efficacy of debt markets, ultimately impacting countries' borrowing costs. Credit rating agencies, which provide information and credit analysis to markets, play an important role in this area (see chapter II).

Strengthened loan contracting processes can contribute to responsible borrowing decisions; creditors share related responsibilities. Jurisdictions have, for example, enshrined lending and contracting processes in law and deemed unauthorized loans that did not follow these procedures as void; some have challenged the enforceability of foreign debt issued in violation of domestic legislation in foreign courts.[15] Specific transactions, such as external loans or guarantees, may require enhanced review. But as debt crisis prevention is also a creditor responsibility, creditors are equally obliged to determine, to the best of their ability, whether decisions have been duly authorized, for example.[16]

Box III.E.5
The Operational Guidelines for Sustainable Financing

In 2021, the IMF and World Bank supported G20 creditors to undertake a second round of self-assessment under the Operational Guidelines for Sustainable Financing, which revealed incremental progress and areas for further work. Creditors were invited to use the online diagnostic tool available on the IMF and World Bank websites to assess their lending practices. The assessment evaluates progress by participating lenders in implementing the Guidelines on the basis of standardized implementation practices. The results of the second round of self-assessment implied improvements in the implementation of good practices in some areas and identified information-sharing and transparency as areas in need of further improvement.[17]

In the context of shared global commitments to climate action and the SDGs, responsible lending should also include analysis of social and environmental impacts. This is already happening with regard to risk assessment but can also encompass assessment of the impact of lending on the SDGs (see chapter III.B).

4.2 Creating space for SDG and climate investments

Efforts to address debt challenges and avert protracted debt crises should take into account lessons from past efforts. In recent history there have been several episodes of widespread debt challenges that endangered development prospects. Responses by the international community to these crises included coordinated efforts through the Paris Club, the Brady Plan and the Heavily Indebted Poor Country and Multilateral Debt Relief initiatives. Improvements to the debt resolution architecture over the past years, particularly the widespread use of collective actions clauses and enhanced collective action clauses, have increased the speed of debt treatment, improved creditor participation and reduced holdouts.[18] However, restructuring can still be protracted with the attendant socio-economic consequences.[19] The challenge of improving speed and creditor participation is especially important given the changing creditor landscape and the greater role played by commercial and non-Paris Club creditors in LDCs and other LICs.

Linking efforts to global priorities such as climate action and the SDGs could potentially enhance (public and private) creditor interest. Private investors with sustainability commitments may be willing, in some cases, to pay a premium for sustainability considerations. This could improve the terms of private sector participation in restructurings, as recently seen in the case of Belize's restructuring.[20] Linking efforts to global priorities could also facilitate mobilization of resources from development partners who have existing commitments in these areas; and it could facilitate the use of proceeds as intended, as countries have already formulated SDG and climate investment priorities in their national strategies, nationally determined contributions and INFFs.

Several initiatives are advancing to create additional fiscal space. The *Financing for Sustainable Development Report 2021* laid out a menu of options, along with benefits and challenges, that could provide debt relief and enhance fiscal space for developing countries, ranging from debt swaps and debt buy-backs to debt relief for the most vulnerable countries. Debt treatment is taken forward in the context of the Common Framework (see next section). The IMF has provided debt service relief to 31 of the poorest countries (see above). Debt swaps—more suited to countries that are fiscally constrained but do not have unsustainable debt burdens—have also received further attention. Debt swaps can free up resources for investments in key priorities, although they are not a means to restore debt sustainability in countries with solvency challenges.[21] They have been considered in the climate context in particular (see box III.E.6).

Box III.E.6
A new generation of regional and thematic debt swap initiatives

In the Arab region, ESCWA launched the Climate/SDGs Debt Swap and Donor Nexus Initiative to assist countries in climate finance, while reducing their debt burdens. The initiative aims to create a long-term swap mechanism by considering the scalability of the swap amount, donor support and a key performance indicator (KPI) framework to maximize the impact of the swap. The initiative encourages the participation of MICs in the region that are facing high debt burdens and bilateral creditors who are serious about supplementing their commitments to overseas development assistance and climate finance pledges. Several Member States of ESCWA have shown interest in implementing the initiative. For instance, Jordan has established a national inter-agency taskforce to support implementation of the initiative through concrete proposals with linkages to climate change projects aligned with national priorities. A KPI regional framework has been developed, which will aid both the selection and the monitoring of projects and policy actions in national contexts.[22] Ultimately, the success of the initiative will depend upon the support of donor countries as well as creditor coordination.

In Latin America and the Caribbean, ECLAC is progressing on operationalizing the Debt for Climate Adaptation Swap initiative for the Caribbean. Under this initiative, some of the region's external debt is swapped in exchange for debtor-country commitments to make annual payments into the Caribbean Resilience Fund. The swap initiative is one of the three pillars of this Fund, a segregated Unit Trust mechanism designed to attract long-term, low-cost finance for development to the Caribbean. Three pilot countries, Antigua and Barbuda, Saint Lucia and Saint Vincent and the Grenadines, have initiated discussions on debt reduction. ECLAC is also preparing targeted capacity building among debt managers in the pilot countries, partnering with other United Nations agencies.

The World Food Programme (WFP) is implementing debt-for-food security swaps. WFP has implemented six debt swaps across five African countries (Egypt, Madagascar, Mozambique, Guinea-Bissau and Mauritania) with five bilateral creditors (Germany, Russia, France, Italy and Spain). These debt swaps have so far mobilized over US$87 million for WFP programmes in areas such as school feeding, nutrition, local agricultural development and community resilience to climate change. WFP works with both debtor and creditor countries to identify potential debt swap opportunities, negotiate agreements and implement programmes.

Bilateral partners have also long used debt swaps. For example, France has signed debt-for-development swaps (known as "Contrats de désendettement et de développement") with 18 countries. These debt-for-grants swaps bring progressive debt relief on top of immediate debt cancellation obtained at the time of completion. In practice, the debtor country directs the full servicing of the debt to a special fund that finances jointly selected development projects in the country. Civil society organizations are also regularly consulted to discuss progress. More than €5 billion of debt will be converted to grants at the end of the conversion process, with Côte d'Ivoire, Cameroon, the Republic of Congo and the Democratic Republic of the Congo as the four main beneficiaries. The most frequently targeted sectors were infrastructure, education and health.

These emerging experiences and experiences from an earlier generation of debt-for-development swaps provide a number of lessons for the design and implementation of debt swap programmes. The uptake of debt swaps has been limited due to high transaction costs and complex and time-consuming planning, negotiations and implementation. Additionally, in many cases, the size of the debt swaps was too small to have a real impact in providing debt relief.[23]

More standardization and country ownership could help increase uptake:

- Greater harmonization of processes should be considered, which speaks to the value of regional initiatives. For example, debt swap term-sheets could be designed.[24] This could reduce the complexity for all stakeholders involved, help speed up negotiations and reduce the likelihood of disputes. The term- sheet would also serve as a template and basis for a more detailed, legally binding document and address issues such as currency risks. Similarly, monitoring, reporting and verification requirements across debtors, creditors and implementing partners could also be harmonized to lower transaction costs.
- Building capacities of local officials and ensuring country ownership is a priority. This includes capacities of local officials to identify potential debt swap opportunities. Because debt swaps commit authorities to provide agreed-upon funding to selected projects, these projects must be aligned with local development priorities and programmes—for example, as part of national development plans, INFFs or nationally determined contributions.

4.3 Multidimensional vulnerability and debt

Climate change is exacerbating debt vulnerabilities across LDCs, LICs and particularly SIDS. Due to their structural conditions, such as remoteness, small size or reliance on tourism, SIDS are particularly vulnerable to external shocks. They often carry high debt burdens due to narrow resource and tax bases. Climate change is exacerbating these vulnerabilities and has contributed to further elevating debt burdens. Disasters alone have caused annual average damage of 2 to 3 per cent of GDP in Caribbean and Pacific SIDS, while major events can cause extremely severe damage (for example, in Dominica in 2017, amounting to 226 per cent of GDP).[25] Unsurprisingly, public debt tends to increase significantly in the aftermath of such disasters. Disaster shocks are critical in assessing risks to sovereign debt given the prominent role they have played in some default episodes in SIDS (for example, in Antigua and Barbuda in 2004 and 2009, Dominican Republic in 1998, Grenada in 2004 and Suriname in 1992).

In response, steps have been taken to account for climate-related vulnerabilities. These include adjusting primarily income-based metrics and assessments in the allocation of concessional finance. For example, IFIs and multilateral development banks provide exceptional access for SIDS to concessional windows (see chapter III.C).

Debt sustainability assessments by IFIs have been updated to take disaster impacts into account. For countries highly exposed to disasters, the IMF-World Bank LIC-DSF calls for reflecting the effects of natural disasters in baseline macro-fiscal projections along with additional stress tests. For such stress tests, the calibration of a natural disaster shock (based on past disaster events between 1980 and 2015) calls for a decrease in real GDP growth and nominal export growth of 1.5 per cent and 3.5 per cent respectively in the year of the shock, and a one-off increase in public debt (by 10 percentage points of GDP in the second year of projections). The standard 10-year projection horizon can also be extended, if warranted, to capture long-term vulnerabilities, including from natural disaster events. The IMF's new sovereign risk and debt sustainability framework for market access countries also has a natural disaster module. Assessments of countries at risk of such disasters, such as SIDS, will include specific stress tests that simulate debt paths under major disaster shocks. They will inform the medium-term risk assessment.

To support a more systematic consideration of the vulnerabilities of developing countries, including SIDS, the United Nations has initiated development of an MVI. In recognition of the specific challenges facing SIDS, the General Assembly called for an appropriate measurement of their vulnerabilities and international action to address them. To this end, it set up a high-level panel of experts to finalize an MVI by the end of 2022 (see chapter IV). The 2021 Financing for Development Forum called on the Inter-agency Task Force to explore the "potential use of the MVI for SIDS' debt restructuring with the aim of building credit worthiness and expanding access to financing, including concessional financing"[26] (see box III.E.7).

4.4 Debt crisis resolution

Rising debt vulnerabilities, tightening global financing conditions and ever-increasing climate risks have all added urgency to the quest to improve sovereign debt resolution. Seeking early debt resolutions when needed can help countries to avoid doing "too little too late". The more heterogenous creditor landscape and greater reliance by LDCs and other LICs on commercial finance has added complexity to the task. Additional actions are needed to improve the efficiency of the debt resolution architecture beyond the DSSI and the Common Framework.

Contractual approaches

Private creditor participation in debt restructuring can be further improved by continuing to strengthen the contractual approach to sovereign debt resolution. Compared with earlier periods, sovereign debt restructurings have become more pre-emptive, shorter in duration and with higher creditor participation on average due to the inclusion of collective action clauses and enhanced collective action clauses in bond contracts.[27] However, a significant share of outstanding bonds do not include such clauses. Non-bonded debt also currently requires unanimous creditor consent to change payment terms. This increases the potential for a small number of holdout lenders to hinder a restructuring supported by the majority. This issue is becoming more acute, given the increasing heterogeneity of creditors holding such instruments and the disproportionate impact it has on LDCs and other LICs.

Official and private creditors are cooperating to develop model majority voting provisions for payment terms in syndicated loans and to encourage their widespread adoption. Contractual reforms take effect only on a forward-looking basis, as new lending agreements are signed, and over time, as pre-existing debt matures. For example, despite strong uptake of enhanced collective action clauses in new bond issuances after their endorsement by the international community in 2014,

Box III.E.7
Multidimensional Vulnerability Index and debt carrying capacity

As a transparent and systematic indicator for country vulnerabilities, an MVI could over time help to inform financing needs assessments and allocations. An MVI would present a simple means to communicate countries' complex vulnerabilities through an indicator. Global acceptance of an MVI could lead to its application in donor allocation decisions as a complementary criterion to per capita income (see chapter III.C). For example, it could complement current practice, such as small State exceptions, or the use of vulnerability in formula that determine country allocations, for example, by the Caribbean Development Bank.[28] An MVI could also incentivize a scaling up and better targeting of international support to investments in risk reduction and climate resilience, including targeted instruments such as state-contingent financing by public lenders and quick-disbursing and insurance-like instruments.

High vulnerability could also imply lower capacity to carry debt. Public debt carrying capacity is primarily related to the resources available to a Government to service its debt. Countries at lower levels of GDP have less flexibility to accommodate payments and are thus at higher risk of default (see also chapter II). High vulnerability would be expected to exacerbate these risks—for example, the capacity to service debt may vary, and fall unexpectedly following shocks. In a situation of recurrent shocks, current per capita income may not sufficiently reflect the risks of future shocks and become a poor proxy for future capacity to pay.[29] When vulnerable countries are found to have lower debt tolerance, they could be eligible for a more concessional financing mix, but also be subject to more stringent borrowing limits.

An MVI could complement tools assessing debt carrying or debt absorption capacity, particularly in an age of growing systemic risks and more frequent and severe climate disasters (see the *Financing for Sustainable Development Report 2021*), as it would reflect elevated risks of future shocks and their impacts in one indicator. High vulnerabilities, as reflected in an MVI, could also contribute to the calibration of debt relief needed to restore sustainability in the context of debt restructuring.

Note: This box reflects the views of UN/DESA.

about 50 per cent of all outstanding bonds as of end-June 2020 still did not include them. Therefore, discussions should advance quickly. However, it is recognized that careful consultation in the design of these contractual reforms is needed to ensure that they are legally feasible and effective and sound from a regulatory perspective and that there is market acceptance.

Domestic debt restructurings

Rising debt vulnerabilities and the growing share of domestic debt may lead to more domestic debt restructurings. Prior to the mid-1990s, with limited financial markets and widespread capital controls, debt distress in developing countries was often dealt with via currency devaluation, inflation, financial repression and, when necessary, an external debt restructuring. Since then, the share of domestic debt has been rising. With a high number of countries at risk of debt distress, domestic restructurings may be needed more frequently to restore sustainability.

Domestic restructurings avoid some of the costs of external debt restructuring, but also pose unique challenges. Sovereigns have considerable flexibility in restructuring domestic debt, including through changes in domestic laws. Domestic restructurings can also potentially limit reputational costs, supporting efforts to retain access to external financial markets. At the same time, domestic debt is disproportionally held by banks and pension funds. Thus, sovereign stress can easily spread to other parts of the economy, with potentially serious adverse effects on financial stability and economic activity.

Sound design can help to achieve the required debt reduction while minimizing risks to the domestic financial system and broader economy. Financial stability considerations play an important role in a domestic restructuring—stress tests prior to a restructuring can provide critical information to inform the design of, and need for, policy support. Depending on the severity of spillovers to the financial system, the policy response may need to include liquidity support, regulatory measures, recapitalization and the establishment of a financial sector stability fund. Casting a wide net across claims can support participation by lowering the relief sought from each creditor group. In 2021, the IMF introduced a policy toolkit for analysing and restructuring domestic debt, including a comprehensive dataset of domestic debt restructuring events. The toolkit includes a decision framework that allows authorities to adopt a "net benefits" approach to domestic debt restructuring, whereby the benefits of a reduced sovereign debt burden are weighed against the fiscal or broader economic costs of achieving that debt relief.[30]

The global architecture

The Common Framework aims to overcome collective action challenges and ensure fair burden sharing when addressing debt sustainability and protracted liquidity problems, but uptake has been limited and progress slow. Efforts to ensure that "resolution of unsustainable debt situations is timely, orderly, effective, fair and negotiated in good faith", as called for in the Addis Agenda, have focused on finding contractual solutions to commercial creditor coordination challenges, enhancing debtor-creditor dialogue and improving coordination of official creditors. The Common Framework represents an important step in this effort as it brings together, for the first time, all major bilateral creditors.

Implementation of the Common Framework has faced challenges and several design elements need to be improved.

- **More timely and efficient processes.** Progress in the initial cases has been much slower than anticipated. Along with the challenges to be expected in the initial phases of a new framework, these delays reflect coordination issues among official creditors as well as within creditor countries, where multiple institutions and agencies can be involved.[31] In its October 2021 Declaration, the G20 committed to step up efforts to implement the Common Framework in a timely, orderly and coordinated manner, which is needed to give more certainty to debtor countries and facilitate IMF and multilateral development banks' quick provision of financial support;

- **Provision of standstills.** With expiry of the DSSI, countries are faced with the prospect of resuming debt service even when they approach the Common Framework. The G20 agreed that creditor committees may discuss relevant solutions on a case-by-case basis. A more comprehensive approach providing a standstill for the duration of negotiations should be considered;
- **Comparability of treatment of private creditors.** Further clarification on how comparability of treatment will be effectively enforced is needed, including through implementation of the IMF arrears policies, beyond the parameters already included in the Common Framework;
- **Expanding access.** Eligibility criteria to the Common Framework follow the DSSI, and thus exclude a number of highly vulnerable and indebted MICs. As the Common Framework decides debt treatments on a case-by-case basis and is primarily a platform for creditor coordination, expansion of access should be strongly considered.

The existing architecture and contractual resolution toolkit may not be able to address a systemic crisis effectively. Implementation challenges with the Common Framework suggest that it may be a stepping stone toward but is not a substitute for a more comprehensive solution to sovereign debt resolution challenges in case of widespread debt distress in a systemic crisis. In this case, financial incentives (such as sweeteners) or legislative solutions could be helpful. With respect to the latter, several countries have adopted national legislation to limit the ability of holdout creditors to recover claims in certain circumstances (through so-called vulture fund laws). There have also been proposals to adopt legislation that focuses on the timing of lawsuits (for example, giving courts discretion to impose stays on sovereign litigation) or that immunizes sovereign assets from judicial actions by creditors, either adopted in key jurisdictions or at the international level. However, these instruments raise significant legal and policy issues, would require careful consideration and would be expected to be used only as a last resort and on a time-bound basis to address the unique challenges posed by the crisis.[32]

Endnotes

1 Throughout this chapter Least Developed and other Low-Income Countries (LDCs and other LICs) refers to the 73 countries eligible to the Debt Service Suspension Initiative (DSSI).

2 International Monetary Fund. 2021a. Macroeconomic Developments and Prospects in Low-Income Countries—2021. IMF Policy Paper PR21/92. March.

3 Bouis, Romain. 2019. “Banks’ Holdings of Government Securities and Credit to the Private Sector in Emerging Market and Developing Economies.” IMF Working Paper 19/224. October; IMF. 2021g. “Regional Economic Outlook. Middle East and Central Asia. Arising from the Pandemic: Building Forward Better,” Chapter 2.

4 IMF. 2021a.

5 This exercise is distinct from the debt sustainability assessment for market access countries (MAC DSA) and the IMF-World Bank debt sustainability framework for lower income countries (LIC DSF). For more on the machine learning methodology please see “How to Assess Country Risk: The Vulnerability Exercise Approach Using Machine Learning” IMF (2021).

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