## **Financing Policy Brief Series – Recommendations for FfD4**

# **Addressing public debt sustainability concerns**

Prepared by the Economic and Social Commission of Asia and the Pacific (ESCAP)

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## **Key messages (max. 200 words)**

* Public debt distress has three distinct underlying causes. One, economic and fiscal mismanagement; two, temporary liquidity shocks; and three, development deficits and climate financing gaps. These should be evaluated and addressed differently.
* Traditional bilateral, non-traditional bilateral and commercial creditors have shared but differentiated responsibilities regarding sovereign debt restructuring, with the first bearing a responsibility of development aid, the second motivated by the spirit of development cooperation and the third without such commitments.
* Proper resolution of sovereign debt distress should be guided by the above two principles and realities, while taking a pragmatic second-best approach in strengthening existing progress in collective action clauses (CACs) and “anti-vulture” legislation.
* Developing countries, as debtors, should be encouraged to ensure accountable and productive use of borrowed funds and strengthen their effort towards effective public debt management.

## **Problem statement (max. 500 words)**

***General trends and challenges***

Gross public debt levels have followed a U-shaped path in developing Asia and the Pacific since 2000, with average public-debt-to GDP ratios approaching the high levels observed in the immediate aftermath of the Asian Financial Crisis of 1997 (figure 1). Primary fiscal deficits have been the main source of public debt level increase during this period, followed by exchange rate depreciation of local currencies which had much greater impact on small and vulnerable economies. Growing share of commercial and private lending, which on average demand 2.5 times the interest rate compared to official creditors and concessional finance, have further compounded the challenge resulting in growing debt service burdens and steady decrease in maturities of external public debt.

**Figure 1. Median general government gross debt, by subregion, 2000-2027**

*Source*: International Monetary Fund (IMF), World Economic Outlook database.

***Three main sources of public debt distress and their distinct nature***

One, economic and fiscal mismanagement, which represents policy missteps by the government and can theoretically be avoided through greater prudence and accountability of fiscal decision-making.

Two, temporary liquidity shocks, wherein tail risks of economic and financial crises or natural disasters push reasonably managed economies into liquidity and temporary debt distress, but their long-term fiscal solvency remains intact. These risks are beyond the control of debtor countries and are likely to be contained if liquidity support can be provided by the international development community.

Three, significant development deficits and gaps in climate financing, which far exceeds their fiscal capacity. Moreover, much of the basic spending needs, such as social expenses or climate adaptation expenditure, is consumption or insurance in nature, and thus does not generate adequate cash returns for debt servicing and repayment. If financed with debt rather than development transfers, such spendings will almost inevitably result in debt distress.

***Central role of public expenditure efficiency and productive use of public funds***

Efficient public spending and productive use of public funds is arguably the most important principle to ensure public debt sustainability. A relentless emphasis on the productive use of borrowed funds, centralized approval of external borrowing, and close alignment of fund usage with national development priorities has helped several developing Asia-Pacific economies navigate the perils of fast public debt accumulation when they had to leverage debt financing to support their economic take-off.[[1]](#footnote-2)

Yet, ESCAP’s recent research finds weak or generally negative correlation between public debt level and either gross fixed capital formation or social spending on education and health in most developing Asia-Pacific countries.[[2]](#footnote-3) This indicates suboptimal allocation of funds. Even for existing social and infrastructure spending, fiscal savings up to 30 per cent could potentially be achieved when developing Asia-Pacific countries are benchmarked against their best-performing peers.[[3]](#footnote-4)

***Sovereign debt management and monitoring as a fiscal safeguard***

Effective sovereign debt management and monitoring can reduce both debt distress risk and sovereign borrowing costs. Data transparency on outstanding and potential debt claims on the government is particularly important for early detection of debt sustainability challenges and early action to contain the risks and mitigate potential damage. Yet, systematic evaluation of public debt management in many developing Asia-Pacific countries remains sparse. Debt policy rating within World Bank’s Country Policy and Institutional Assessment, as a proxy for debt management quality, underscores a lack of improvements in many developing Asia and the Pacific countries during 2014-2023.

***Challenges of timely debt restructuring and debt relief***

Sovereign debt restructuring is complicated due to two fundamental challenges. First, a sovereign’s ability to honour its debt (that is, its fiscal solvency) is subject to considerable debate. Second, the treatment of public debt distress, emanating from different causes (be it development and climate financing deficits, temporary liquidity bottlenecks, or fiscal mismanagement), should be differentiated. While a systematic solution to sovereign debt restructuring remains elusive, several “patchworks”, such as collective action clauses (CACs) or “anti-vulture” legislation, have been introduced with decent results.

Meanwhile, the *G20 Common Framework for Debt Treatments* continues to face challenges with regards to reaching swift agreements among the main creditors, increase the scale and country coverage of debt reliefs, and compelling private creditors to join the negotiations and provide comparable levels of debt write-downs.

## **Policy solutions (max. 500 words)**

1. **Pursue a differentiated treatment of public debt sustainability concerns according to the underlying causes.** Recognizing the three different underlying sources of public debt distress and the necessity of differentiated treatment for each is the first step towards a systematic and coherent response to the contemporary public debt and development financing challenge. Timely and adequate liquidity support for developing countries affected by unanticipated economic and natural disaster shocks beyond their control is necessary to help them bounce back economically and financially and maintain long-term fiscal solvency. Meanwhile, for public debt distresses caused by sustained economic or fiscal mismanagement, debtor countries rather the creditors should be held primarily accountable for the consequences and needed measures.
2. **Significantly scale up ex ante development transfers as an alternative to ex-post debt relief.** Scaling up ex-ante development transfers voluntarily would be a much more desirable option for the international development community than being forced to provide complicated and painful ex-post debt reliefs. Generous ex-ante development transfers to reduce future necessity for debt relief is not without precedent, as in the example of the NextGenerationEU programme in 2021.
3. **Prioritize productive use of borrowed funds and effective public debt management.** To effectively leverage debt as a tool for expanding development finance without compromising on fiscal sustainability, it is paramount that developing Asia-Pacific countries put the borrowed funds to productive use, rather than wasting them on ill-conceived or poorly-implemented projects or financing wasteful consumption. Effective public debt management through clearly articulated policy objectives and legal frameworks, procedural and institutional transparency and accountability, and strengthened debt statistics can further expand the safety margin for debt financing for development.
4. **Build further on recent progress and take pragmatic approaches regarding sovereign debt restructuring**. Further progress in CACs and “anti-vulture” legislation together with exploring innovative solutions such as state-contingent clauses in sovereign borrowing are arguably better second-best choices compared to introducing ‘hard laws’ and centralized arbitration mechanisms for sovereign debt restructuring. Meanwhile, for the G20 Common Framework for Debt Treatments to fulfil its objective, understanding the necessity of differentiated treatment of debt distress according to its underlying cause and recognizing the shared but differentiated responsibilities of traditional, non-traditional and commercial creditors in sovereign debt restructuring would be helpful steps to move forward.

## **Specific recommendations for FFD4 (max. 300 words)**

* Strongly urge for scaling up ex ante development transfers as an alternative to ex-post debt relief.
* Fully recognize the necessity of differentiated treatment of debt distress according to its underlying cause.
* Fully recognize the shared but differentiated responsibilities of traditional bilateral, non-traditional bilateral and commercial creditors in sovereign debt restructuring for cooperation effort such as the G20 Common Framework to fulfil its purpose.
* Advocate for greater commitments by developing countries to accountable and productive use of borrowed funds and effective public debt management.

**A 75-word summary of the brief for the website.**

Public debt distress has three distinct underlying causes which should be evaluated and addressed differently. Similarly, traditional bilateral, non-traditional bilateral and commercial creditors have shared but differentiated responsibilities in sovereign debt restructuring. Proper resolution of sovereign debt distress should ideally be guided by these two principles/realities, while continuing with pragmatic second-best approaches. Debtor countries should also hold their side of the bargain by ensuring accountable and productive use of borrowed funds and effective public debt management.

1. Such as the Republic of Korea. [↑](#footnote-ref-2)
2. *Economic and Social Survey of Asia and the Pacific 2023: Rethinking Public Debt for the Sustainable Development Goals* (United Nations publication, 2023). [↑](#footnote-ref-3)
3. *Economic and Social Survey of Asia and the Pacific 2019: Ambitions Beyond Growth* (United Nations publication, 2019). [↑](#footnote-ref-4)