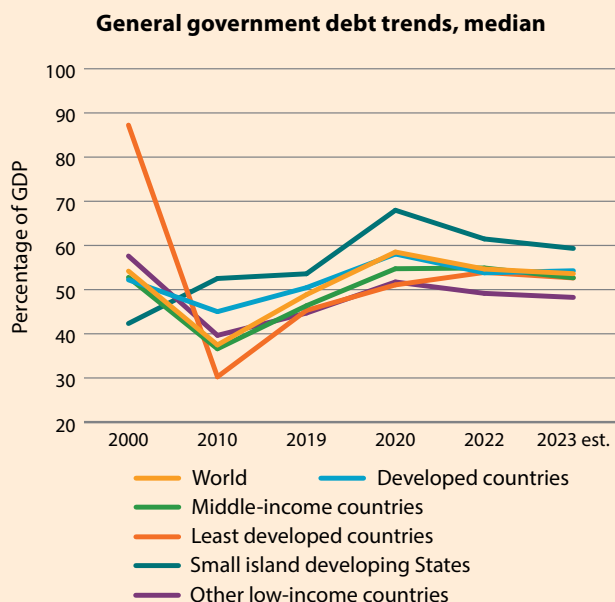


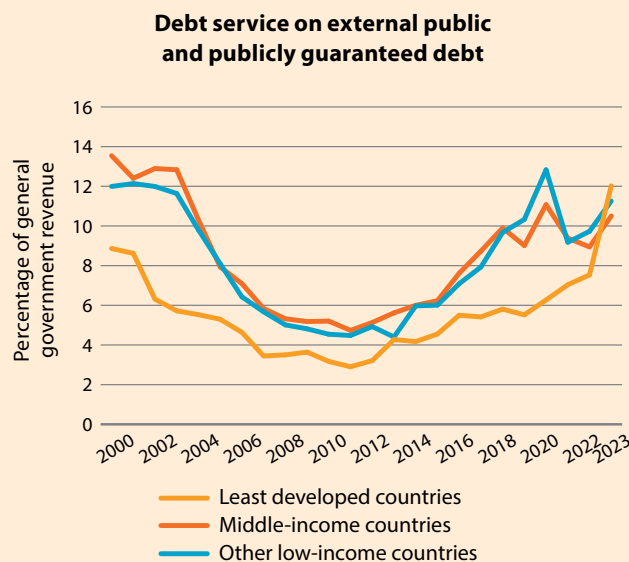


Debt and debt sustainability *in numbers*

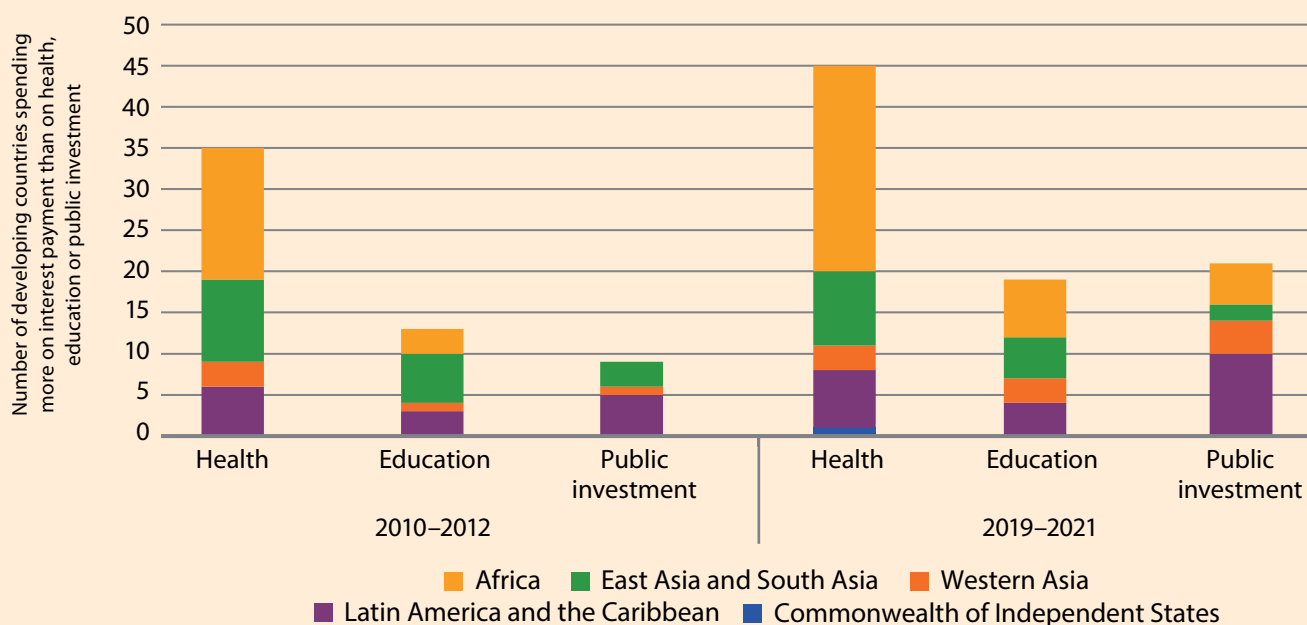
After a sharp rise in public debt during the pandemic and a steady increase in the preceding decade, public debt levels have stabilized.



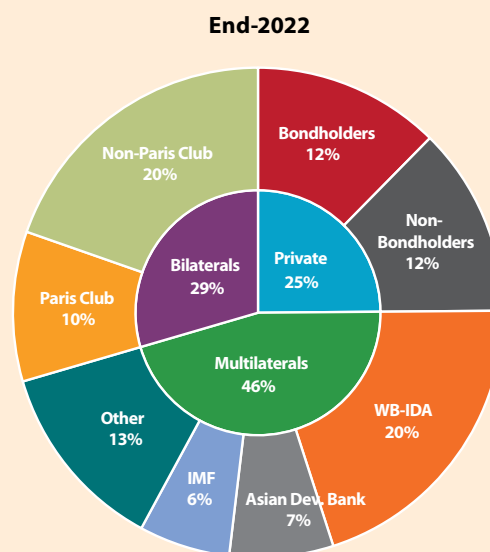
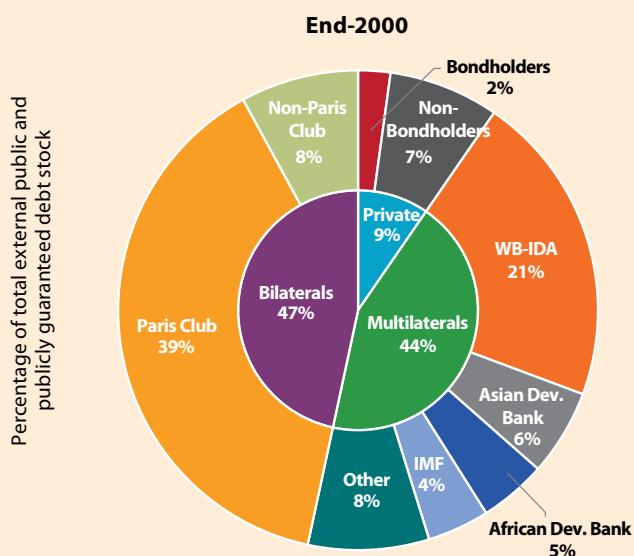
High levels of debt have translated into high debt service burdens, now reaching levels last seen in the early 2000s.



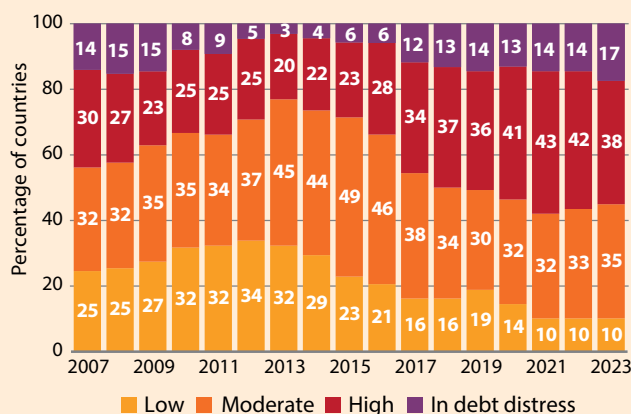
Over the last decade, an increasing number of developing countries spend more on servicing public debt than on health, education and public investment.



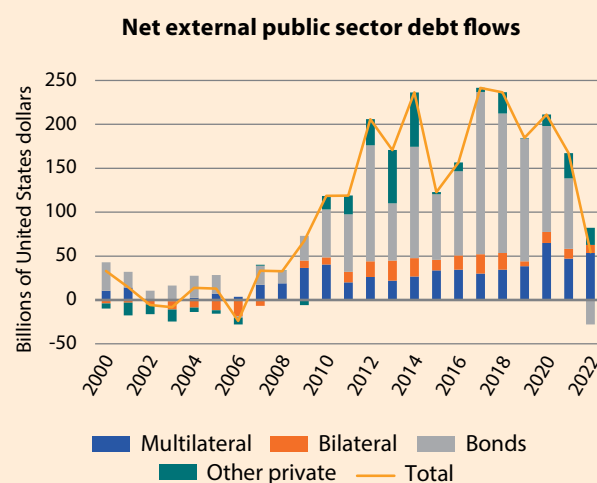
Rising debt service burdens are in part due to changing debt composition: for LDCs and LICs, the shares in external public debt held by commercial creditors and non-Paris Club official creditors more than doubled between 2000 and 2022.



Fifty-five per cent of LDCs and other LICs are at high risk of or in external debt distress, higher than the levels in any year from 2007 to 2019.



Amid tight global financing conditions since 2022, only debt financing from multilateral institutions prevented a drying up of net debt inflows to developing countries.





Chapter III.E



Debt and debt sustainability

1. Key messages and recommendations

Developing countries, especially the poorest and most vulnerable, face continued elevated debt challenges. More than half the countries that use the joint International Monetary Fund (IMF)-World Bank Debt Sustainability Framework for Low-Income Countries are at high risk of or in debt distress. Debt service burdens could crowd out vital investments and constrain progress towards the Sustainable Development Goals (SDGs) in many developing countries. While debt levels have broadly stabilized after spiking in the first year of the pandemic, the high costs of servicing and refinancing debt amid tight global financial conditions add to the debt vulnerabilities of many developing countries. Supporting these countries in navigating their debt challenges is essential given the significant financing needs associated with reaching the SDGs, achieving structural transformation, adapting to climate change and increasing resilience in the face of future shocks.

While median debt levels generally fell across the globe in the first decade of the new millennium, this trend reversed in the second decade. Debt levels around the world have now broadly stabilized near their 2000 levels. Nevertheless, significant variations across countries and country groupings remain. Debt in least developed countries (LDCs), most of whom participated in the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), has increased since the mid-2010s as access to debt markets was restored. The debt increase reversed some, though not all, of the gains from the relief initiatives.

There has been a significant shift in the debt composition of developing countries since 2000, with access to new financing translating into rapidly growing debt service burdens. For LDCs and other low-income countries (LICs), commercial debt now represents a quarter of external debt, up from just 10 per cent in 2010, driven mostly by countries accessing international

bond markets for the first time and the rise of syndicated bank and commodity-backed loans. The share of non-Paris Club creditors in the total external debt stock of LDCs and other LICs now exceeds that of Paris Club creditors. While the broader shift of the financing mix towards private creditors and non-Paris Club creditors has led to greater access to finance, it has also resulted in greater debt servicing burdens—with external debt service alone consuming more than a fifth of tax revenue in 25 developing countries. The greater diversity of creditors also exacerbates creditor coordination challenges in the event of debt restructurings.

High debt service burdens can hamper the implementation of the SDGs. Around 3.3 billion people live in countries where governments spend more on interest payments than on health or education. In a growing number of developing countries, public debt interest service surpasses public spending in crucial sectors. Challenges are particularly pronounced for countries that are most vulnerable to climate shocks. They face high borrowing costs and—when hit by extreme weather events—high recovery costs, which increase debt vulnerability. At the same time, it is essential that countries do more to optimize spending, increase revenues and target growth-enhancing reforms.

With debt service burdens projected to remain elevated for several years amid dwindling new financing options, more needs to be done to reduce the risks of liquidity crises. Global financing conditions remain tight; since 2022, net debt inflows to developing countries as a whole would have turned negative if not for the sustained debt financing by multilateral institutions. High refinancing costs and limited access to international financial markets combined with continuously high external debt repayments in 2024 and 2025 will put significant liquidity pressures on countries. Today, 55 per cent of LDCs and other LICs are assessed as having a high risk of or in debt distress.

Against this backdrop, it is critical to urgently address the debt challenges of developing countries. Intensified action is needed across three priorities: (i) strengthening debt crisis prevention, including through sound debt management and transparency; (ii) finding solutions for countries that face severe fiscal constraints, debt overhangs and insufficient reforms to address underlying problems, to invest in the SDGs; and (iii) a more effective debt crisis resolution mechanism.

In today's more complex environment, debt management is more essential than ever. Technical assistance by various institutions and the sharing of good practices are supporting progress in public debt management. Nevertheless, progress remains gradual and uneven across countries. Fragile and conflict-affected States as well as small developing countries face particularly large resource and capacity constraints.

Debt transparency can play an important role in supporting continued financing flows to developing countries and is the shared responsibility of both borrowers and creditors. While progress has been made in recent years, gaps remain. Borrowers should continue to strengthen their institutional and operational frameworks to enable timely and comprehensive debt reporting. Creditors should follow through on initiatives to support more transparency.

Countries that are solvent but face very high debt service burdens over the next several years will need more systematic support.

With fiscal space already eroded and very high debt service payments coming up amid tight financing conditions, LICs and lower-middle-income countries under tight liquidity pressures face the prospect of further reduced SDG investments or even solvency challenges unless they receive additional support and implement important reforms to address fiscal constraints and weak growth. This will require additional concessional financing, including the sustaining of large volume of highly concessional financing from multilateral lenders, and could include the use of financial instruments such as debt swaps or credit enhancements to enable the rollover of commercial debt, as well as measures to prevent leakage of fresh concessional financing to service non-concessional debt.

The international community needs to continue advancing progress on the resolution of debt distress situations, monitor developments closely, and enhance the toolkit to ensure it has the appropriate tools to support countries when risks materialize. In that context and despite recent important progress, including resolution of debt distress in a few countries, continued efforts to enhance the efficiency of the Group of Twenty (G20) Common Framework are needed, together with exploring other options to mitigate the risks that a financing squeeze might trigger a debt crisis in additional countries.

The Fourth International Conference on Financing for Development provides an opportunity to tackle the challenges of high borrowing costs and debt service burdens and address gaps in the debt restructuring architecture. There is broad recognition of the need to address the fiscal and external constraints of many developing countries that are unable to invest in the SDGs due to high debt service burdens; and of the need to further improve debt resolution processes. Many proposals have been put forward to address these challenges, including financial instruments and contractual innovations that could deliver fiscal space for the SDGs (such as debt swaps, credit enhancements or state-contingent clauses), enhanced analytical tools, stepped up capacity support, domestic

law reforms and enhancements to the Common Framework and other institutional innovations at the international level. However, there still remains no political agreement on a package of reforms that would align the debt architecture with the SDGs. Preparations for the Fourth International Conference on Financing for Development will provide an opportunity to identify relevant elements of such a package and deliver it in 2025.

The rest of this chapter first provides an overview of global debt trends in the past two decades, followed by a section on the interaction between sustainable debt financing and the SDGs. The chapter will conclude by discussing progress made in debt crisis prevention and resolution, while highlighting key challenges that have to be addressed.

2. Overview of global debt trends

2.1 Debt and debt vulnerabilities: Trends and drivers

After declining in the first decade of the new millennium, public debt ratios increased steadily up to 2020, before tapering off more recently. Public debt-to-GDP ratios in developed countries rose sharply starting from 2007 and, after stabilizing in the 2010s, reached a new high during the COVID-19 pandemic when countries financed large-scale fiscal response packages. After decreasing for much of the 2000s in a favourable global economic environment, public debt in middle-income countries (MICs) levelled off after the 2008 world financial and economic crisis, before resuming an upward trend in 2014, which gathered pace during the pandemic. LICs experienced a similar, if more pronounced, trajectory. Debt levels in all country groups have broadly stabilized since 2020 (figure III.E.1).

The decline and subsequent rebound of public debt was most pronounced in vulnerable countries, particularly LDCs and other LICs.¹ In the late 1990s and early 2000s, many LDCs and other LICs benefited from strong economic growth along with debt relief under the HIPC Initiative and MDRI, which significantly lowered external debt-to-GDP ratios across the two country groups (figure III.E.2).² Over the past 10 to 15 years, many of these countries embarked on ambitious, externally financed infrastructure drives, which contributed to a doubling of the stock of external public debt in nominal United States dollar terms since 2010 (figure III.E.3). Debt in small island developing States (SIDS) rose from 42.3 per cent of GDP in 2000 to around 60 per cent of GDP in 2022, after peaking around 2020, as these countries—many of which rely on tourism—were severely impacted by the pandemic (figure III.E.1). SIDS also saw liquidity buffers erode, making them even more vulnerable to external shocks.

The decline and subsequent rebound of public debt was most pronounced in vulnerable countries, particularly LDCs and other LICs.¹ In the late 1990s and early 2000s, many LDCs and other LICs benefited from strong economic growth along with debt relief under the HIPC Initiative and MDRI, which significantly lowered external debt-to-GDP ratios across the two country groups (figure III.E.2).² Over the past 10 to 15 years, many of these countries embarked on ambitious, externally financed infrastructure drives, which contributed to a doubling of the stock of external public debt in nominal United States dollar terms since 2010 (figure III.E.3). Debt in small island developing States (SIDS) rose from 42.3 per cent of GDP in 2000 to around 60 per cent of GDP in 2022, after peaking around 2020, as these countries—many of which rely on tourism—were severely impacted by the pandemic (figure III.E.1). SIDS also saw liquidity buffers erode, making them even more vulnerable to external shocks.

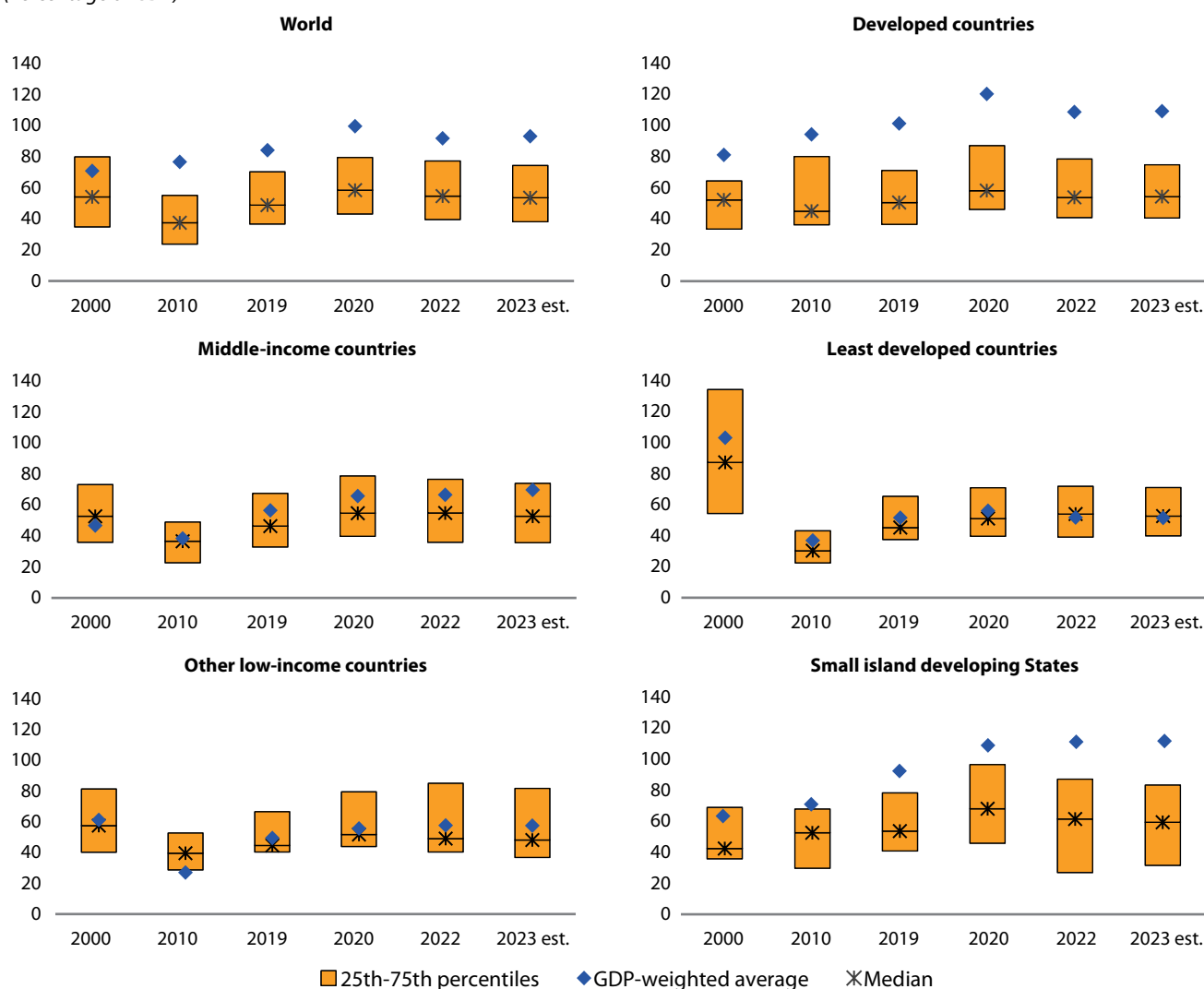
Over the last 20 years, the creditor landscape has become more diverse for many developing countries. For LDCs and other LICs, the shares of external public debt held by commercial creditors—including bondholders and other private creditors—and non-Paris Club official creditors more than doubled, from 17 per cent at end-2000 to 45 per cent at end-2022, with the shares of Paris Club and multilateral creditors declining from 83 per cent to 56 per cent, respectively (figure III.E.4). Similar trends were observed among MICs and SIDS.³

The complexity and riskiness of debt instruments has also increased. Across developing countries, debt with more complex lending terms (e.g. collateralization⁴), more frequent repricing (due to

Figure III.E.1

Overall general government debt evolution in developed and developing countries, 2000–2023

(Percentage of GDP)

**Source:** IMF staff calculations based on IMF WEO database (October 2023).**Note:** Overall general government debt includes both domestic and external debt.

shorter maturities and greater prevalence of variable interest rates) and/or indirect forms of financing, such as state-owned enterprise-related or public-private partnership-related transactions, proliferated.⁵ With access to international bond markets drying up in recent years, many developing countries shifted to syndicated loans, resulting in a significant increase in such loans in this grouping. The increased prevalence of syndicated loans poses challenges as they are typically less transparent, have shorter maturities and include fewer safeguards against holdouts in debt resolution (although efforts have been made to introduce majority voting provisions to such loans; and there are typically far fewer creditors in the case of syndicated loans when compared to bonds, which may facilitate debt resolution). In parallel, domestic debt has become an increasingly important financing source across developing countries, including LDCs and other LICs (figure III.E.2). Development of domestic debt markets can

help to diversify the investor base and support the mitigation of exchange rate risk. However, an increase in domestic sovereign borrowing can also lead to a reduction in available credit for the private sector and enlarge the sovereign-bank nexus, potentially exacerbating the risk of negative feedback loops.

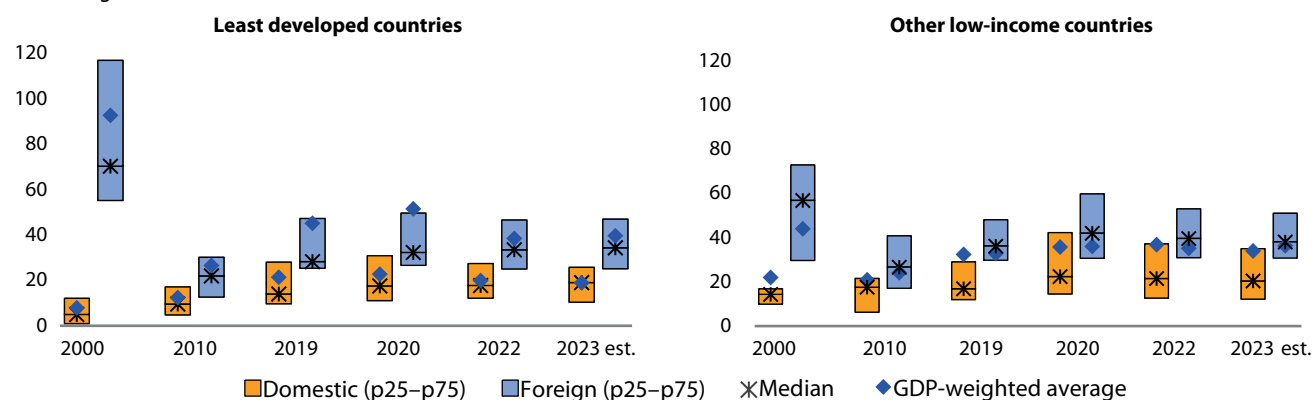
In the most recent post-pandemic period, many developing countries have faced external liquidity pressures, with only scaled-up multilateral financing preventing a collapse in external financing.

LICs and especially LDCs started to see a decline in external financing inflows in 2019, driven by the drop in private inflows and net financing from non-Paris Club official creditors. This downward trend was exacerbated by the pandemic. By the second half of 2022, developing countries with the weakest credit ratings effectively lost access to international bond markets.⁶ Debt financing provided by multilateral institutions prevented

Figure III.E.2

Currency composition of general government debt of LDCs and other LICs, 2000–2023

(Percentage of GDP)

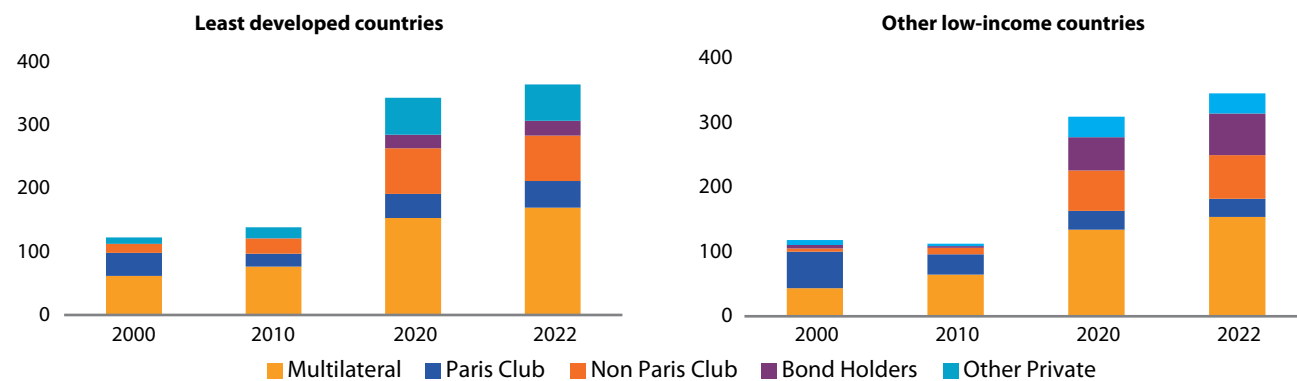


Source: IMF staff calculations based on IMF WEO database (October 2023).

Figure III.E.3

External public and publicly guaranteed debt stock in LDCs and other LICs, by creditor type, 2000–2022

(Billions of United States dollars)

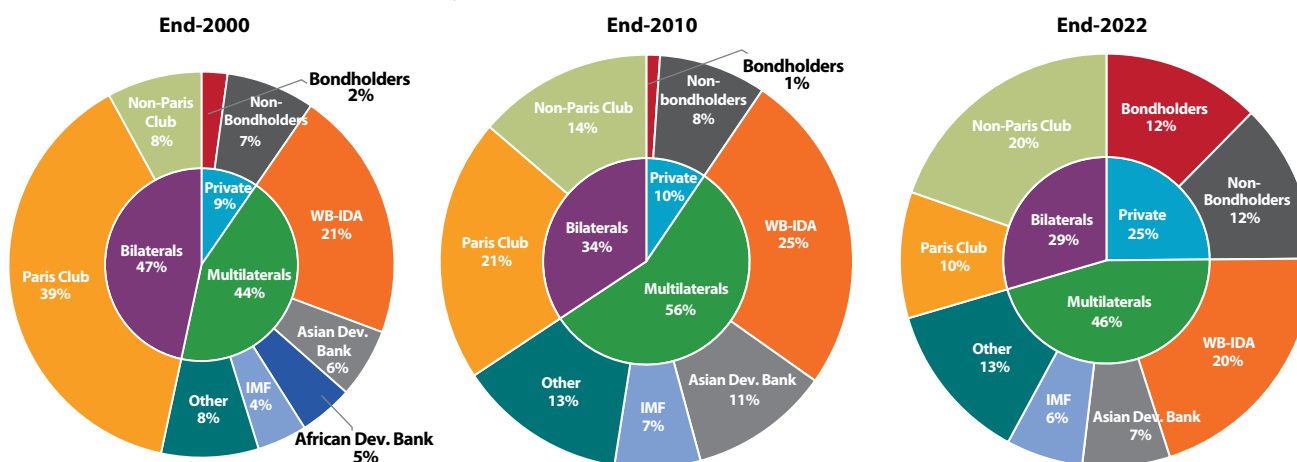


Source: IMF staff calculations based on World Bank International Debt Statistics database.

Figure III.E.4

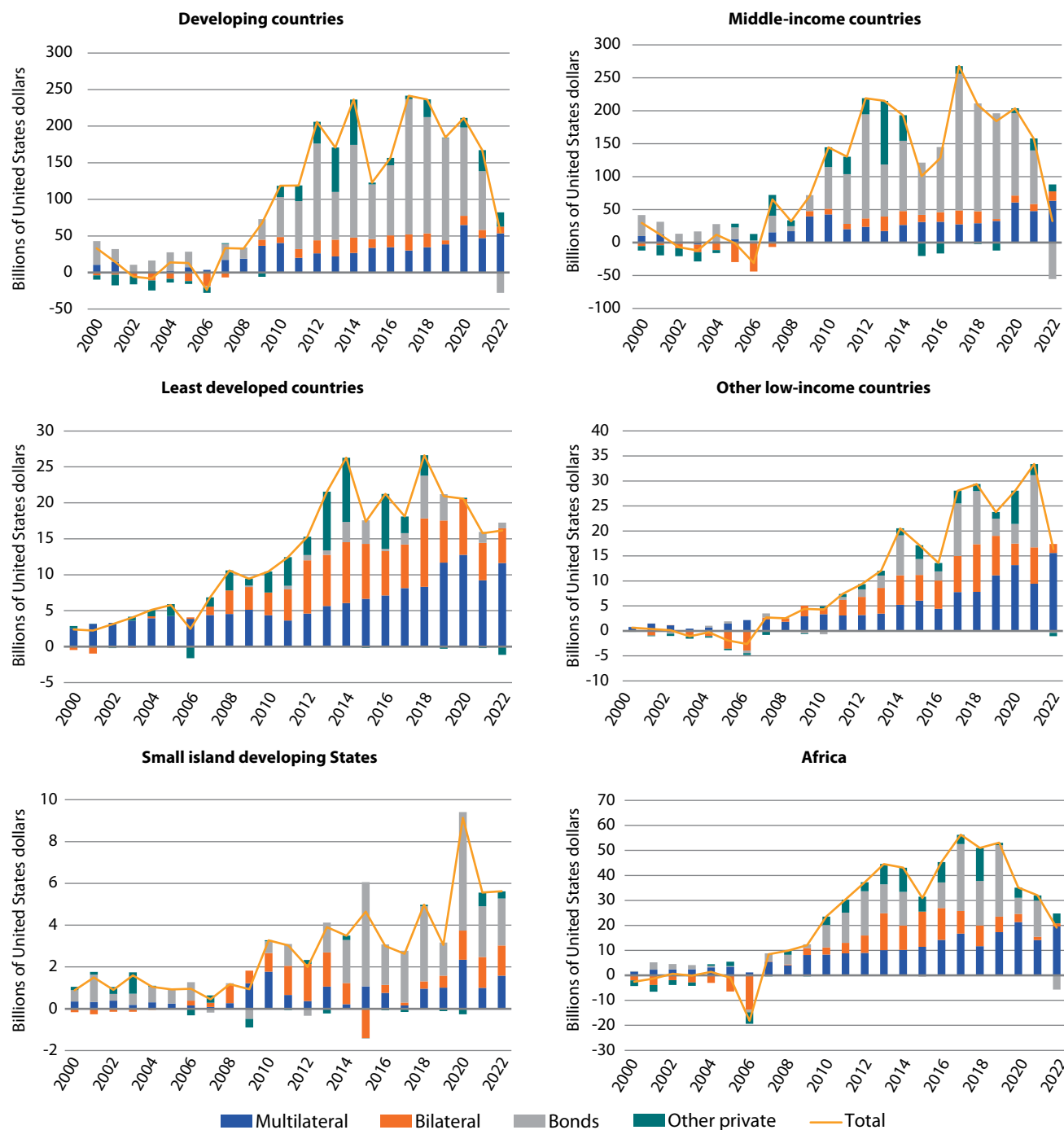
External creditor landscape in LDCs and other LICs

(Percentage of total external public and publicly guaranteed debt stock)



Source: IMF staff calculations based on World Bank International Debt Statistics database.

Figure III.E.5

Net external public sector debt flows, by country group, 2000–2022*(Billions of United States dollars)***Source:** UN DESA calculations based on World Bank International Debt Statistics database.**Note:** Data shows net flows on external public sector debt, measured as new disbursements minus principal repayments.

an overall net debt outflow for MICs in 2022, counteracting the net outflows to bondholders. Multilateral institutions also played a key role in sustaining net debt inflows to LDCs and Africa—where over 70 per cent of all LDCs are located—in the post-pandemic period, as net financing from private creditors was negative (figure III.E.5). In the case of SIDS, net bond inflows were positive in 2022, reflecting an improvement in the external sector as the tourism industry rebounded.

Drivers of debt and debt vulnerabilities

Primary deficits related to large spending needs and external shocks have been one of the key drivers of debt dynamics.⁷ While debt dynamics vary across countries, most LDCs and other LICs have experienced consistent primary deficits (figure III.E.6). Significant spending needs, including for investment in infrastructure, climate actions and other SDGs, were further accentuated in the context of rising international food and energy prices and a weakening of domestic currencies vis-à-vis the United States dollar. Many countries introduced fiscal support measures to mitigate the effects of the crises, putting additional pressure on their fiscal balances and debt. Tax revenue has not kept pace with expenditure (see chapter III.A); neither has concessional financing, with some developing countries experiencing a decline in the amount of concessional finance received.⁸ Other developing countries saw a loss of access to concessional financing altogether as their income level increased, while remaining highly vulnerable to climate and other shocks. Most recently, tightening global financial conditions have increased borrowing costs. At the same time, the differential between the real interest rate and real GDP growth ($r-g$) has remained favourable for debt dynamics in LDCs and other LICs, despite pressures from increasing country risk premia and global interest rates, acting as a countervailing force to persistent primary deficits. Overall, rising debt levels have translated into fast-rising debt service burdens, potentially diverting resources from SDG investment (section 2.2) and increasing liquidity and solvency risks (section 2.3).

2.2 Debt service burdens

Rising debt levels, changing creditor composition and tighter financing conditions have translated into greater debt service

burdens. From 2022 to 2023, the issuance of hard currency bonds by LDCs and other LICs almost dried up and those that were issued carried very high coupon rates; MICs experienced a similar, if less pronounced, deterioration of financing conditions (figure III.E.7). This increase in borrowing costs adds to already rising debt service burdens attributed to growing debt stocks and the associated amortizations as the accumulated debt starts falling due. As a result, debt service payments—including both interest and principal repayments—relative to government revenues have increased dramatically across LDCs and other LICs (figure III.E.8). The median debt service burden for LDCs rose from 3.1 per cent of government revenues in 2010 to 12 per cent in 2023—the highest level since 2000; for other LICs, it rose from 4.5 per cent to 11.3 per cent during the same period. MICs and SIDS also dedicate a growing share of revenue to debt service, although the increases are less pronounced. As reported in the *Financing for Sustainable Development Report 2023*, 25 developing countries (this number remained unchanged in 2023) dedicate more than a fifth of their total revenues to servicing public external debt, the highest number since 2000, which also marked the beginning of the HIPC Initiative, the last large-scale debt relief initiative for developing countries.

Higher debt service costs reduce available fiscal space for development financing. Around 3.3 billion people live in countries where governments spend more on interest payments than on education or health.⁹ Forty-five developing countries, including 29 LDCs and other LICs, spend more on debt servicing than on health; 19, including 8 LDCs and other LICs, spend more on debt service than on education; and in 21, including 4 LDCs and other LICs, public investment is falling behind interest payments on public debt (figure III.E.9).¹⁰ Across regions, this crowding out of development spending is strongest in Africa and Western Asia.

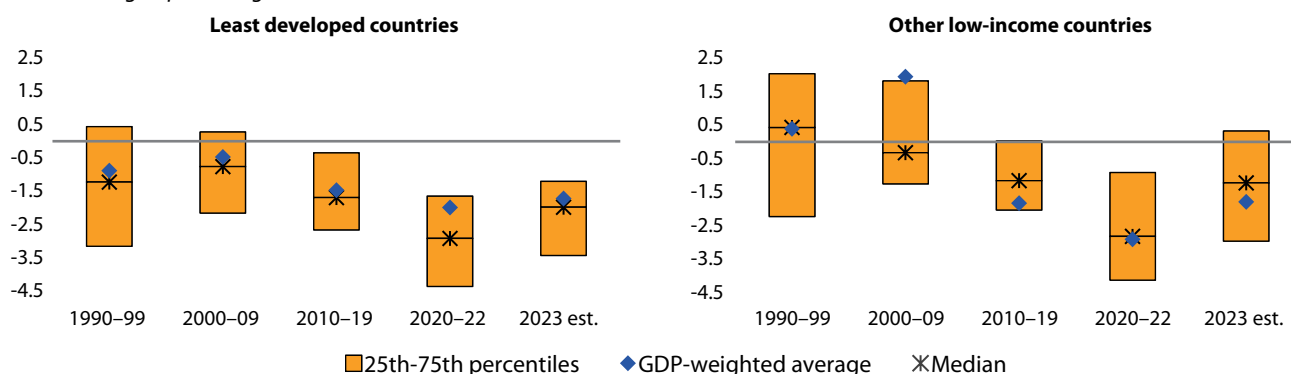
2.3. Elevated debt sustainability risks

High debt levels and tight financing conditions have translated into growing liquidity and solvency risks. Debt service burdens on external debt will remain elevated for LDCs and other LICs as well as many lower-middle-income countries through 2024 and 2025, and ease only gradually after that (figure III.E.10). In LDCs, for example, external debt service will hover around \$40 billion annually between 2023 and 2025, up

Figure III.E.6

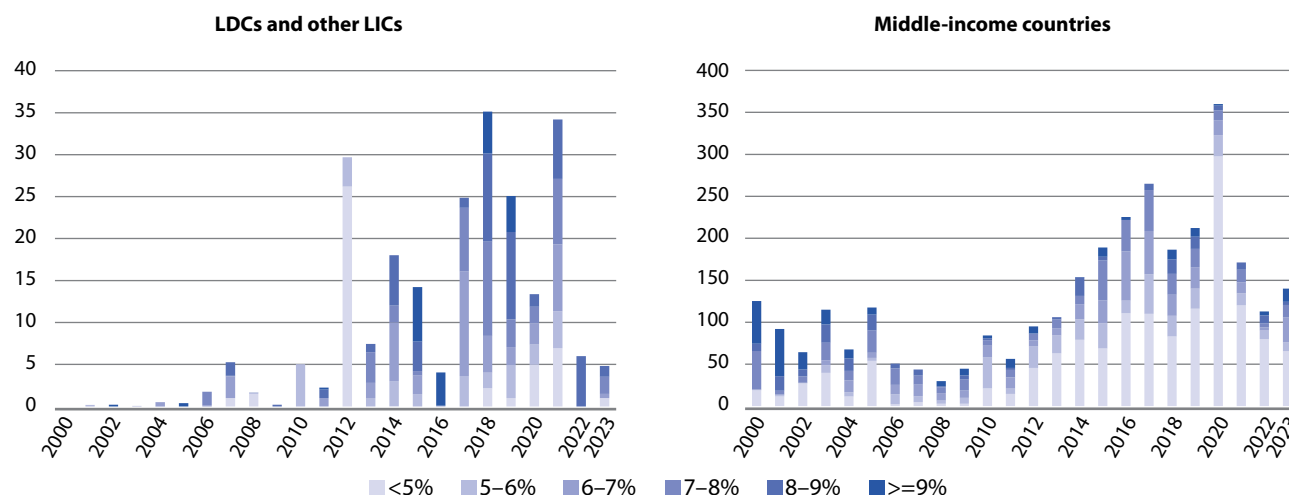
LDCs and other LICs: General government primary balance, 1990–2023

(Period averages, percentage of GDP)



Source: IMF staff calculations based on IMF WEO database (October 2023).

Figure III.E.7

Sovereign bond issuance in hard currencies, by coupon rate, 2000–2023*(Billions of United States dollars)***Source:** UN DESA calculations based on LSEG data.**Note:** Data includes sovereign bond issuance in pounds sterling, euros, Japanese yen and United States dollars.

from \$26 billion in 2021. In a context of very high refinancing costs and limited access to international financial markets, these soaring external debt repayments will put significant liquidity pressures on countries; without a mix of adjustment, reforms to accelerate growth and robust access to concessional financing, there is a risk that they may turn into solvency crises.

The risks of fiscal crises and debt distress in developing countries remain high, particularly in LDCs and other LICs. More than half of all LDCs and other LICs are assessed as having a high risk of or in debt distress, twice the level in 2013, according to the IMF-World Bank Debt Sustainability Framework for Low-Income Countries (figure III.E.11). The debt risk ratings of 15 countries have been downgraded since the beginning of the COVID-19 pandemic; however, in most cases, the vulnerabilities manifested well before the pandemic. Since 2020, five countries have had debt risk rating upgrades, mostly reflecting positive results from debt restructuring. Among the countries assessed as having a high risk of debt distress or in debt distress, four have requested a Common Framework debt restructuring: Chad (completed, with a Memorandum of Understanding signed in December 2022), Ethiopia, Zambia and Ghana. Somalia has completed and Sudan is undertaking a debt restructuring under the HIPC Initiative. Several other countries are engaged (Malawi) or have announced their intention or interest to restructure their debt through bilateral negotiations (Djibouti and Lao PDR).

investments enhance an economy's resilience in the long run, including through reducing debt-related vulnerabilities. The terms on which countries can access debt and other sources of financing, along with how effectively these resources are utilized, will determine whether countries can achieve a virtuous cycle of investment-driven recoveries and resilient development pathways, which will also create the resource base to service debts in the long run. Conversely, countries faced with rising debt burdens and without additional support by the international community may need to forego investments in resilience and long-term development, which will only further undermine their prospects. This challenge is particularly pronounced for climate-vulnerable countries (see section 3.1 below). Better understanding, managing and addressing this interplay between long-term investments in the SDGs and climate action, the closing of financing gaps for SDG investments, the efficient use of debt financing while safeguarding long-term debt sustainability, and implementation of key growth-enhancing reforms will be critical to achieving the SDGs and climate action. Section 3.2 lays out a range of proposals that have been made to this end.

3.1 The debt and climate vicious cycle

The vicious cycle of rising debt and constrained productive investment is especially pronounced in climate-vulnerable countries.

Rising climate vulnerabilities, as reflected by more frequent and severe natural disasters, exert significant pressure on countries' national budgets. The financing needs to address damages, recover from disasters and adapt to climate change are very large—the annual cost of adapting public assets alone has been estimated to exceed 1 per cent of GDP annually for the next 10 years in 50 LICs, while for some small countries it runs to more than 2.5 per cent of GDP.¹¹ Disasters also significantly disrupt economic activities and diminish countries' ability to mobilize domestic and external resources for climate adaptation. To meet urgent needs,

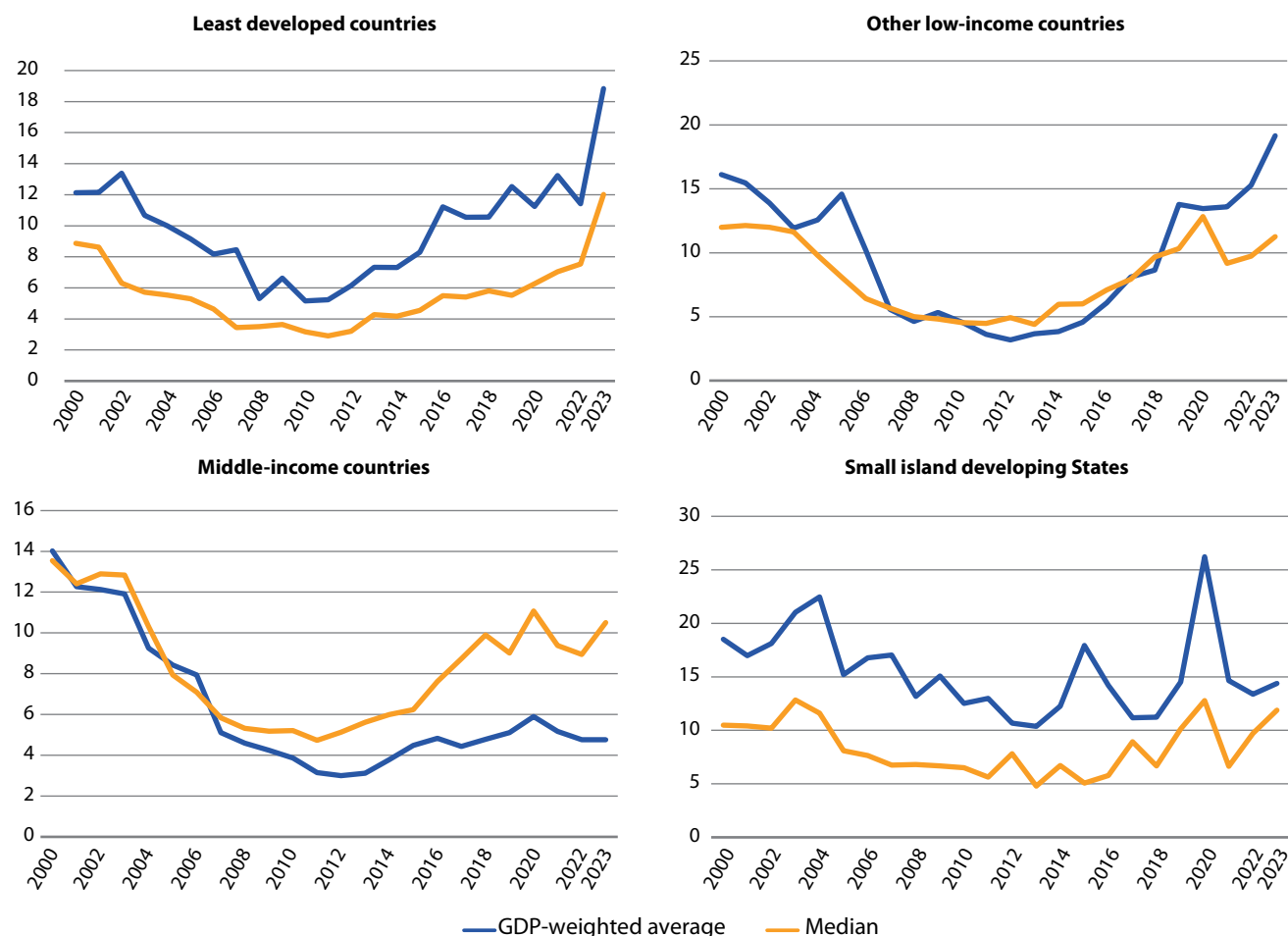
3. Sustainable debt financing and the SDGs

In the wake of multiple global shocks, many countries face difficult trade-offs between maintaining fiscal sustainability and investing in structural transformation, including productive investment, climate action and other SDGs. Effective SDG

Figure III.E.8

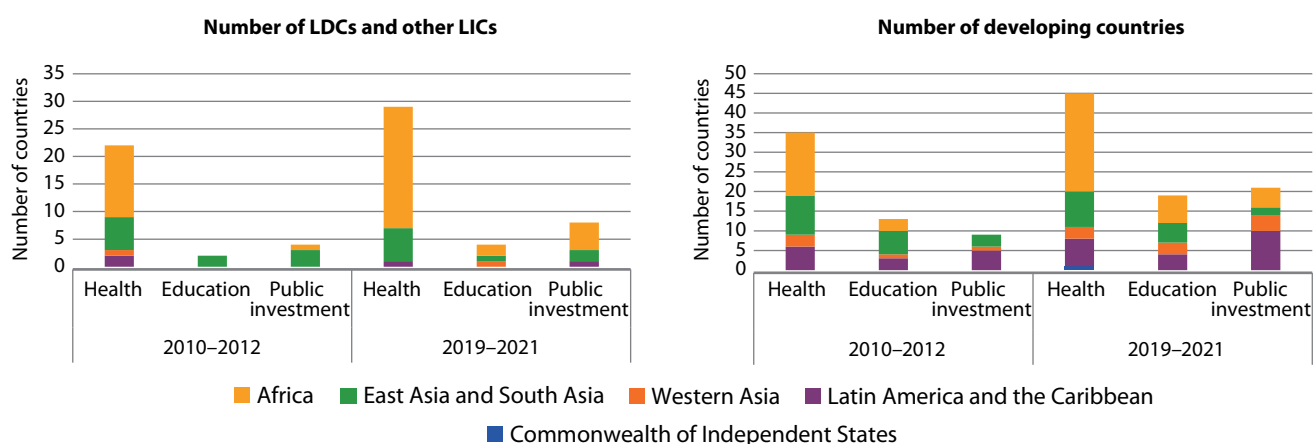
Debt service on external public and publicly guaranteed debt, 2000–2023

(Percentage of general government revenue)



Source: UN DESA calculations based on World Bank International Debt Statistics database and IMF WEO database (October 2023).

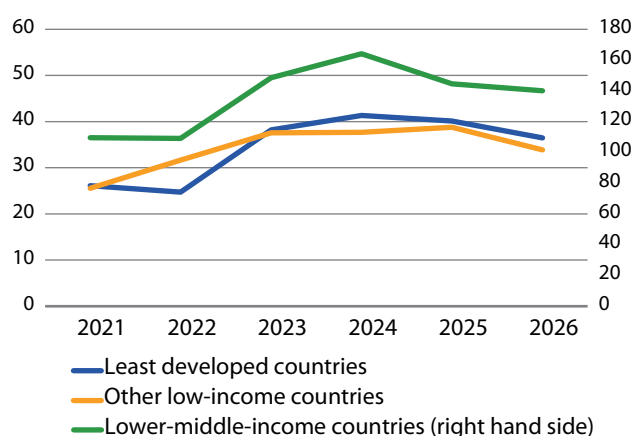
Figure III.E.9

Developing countries that spend more on servicing public debt than on health, education, and public investment, 2010–2012 versus 2019–2021

Source: UN DESA, adapted from United Nations Global Crisis Response Group (2023).

Figure III.E.10

Debt service on external public and publicly guaranteed debt
(Billions of United States dollars)



Source: UN DESA calculations based on World Bank International Debt Statistics database and IMF WEO database (October 2023).

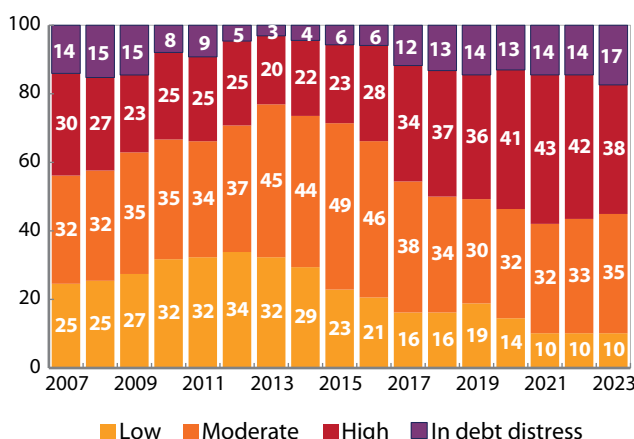
vulnerable countries often have to resort to increased borrowing, leading to a build-up of debt and an increasing share of national budgets allocated to debt servicing. This, in turn, limits their ability to invest in long-term resilience and the SDGs, making them even more vulnerable to future shocks. Consequently, the cycle of borrowing and debt accumulation not only constrains future investment opportunities but also exacerbates vulnerabilities to climate change, creating a self-perpetuating loop of debt and climate challenges.

Climate and debt vulnerabilities increasingly overlap. Some assessments suggest that over half of the debt upsurge in vulnerable countries stems from funding disaster recoveries.¹² As figure III.E.12 shows, 30 out of 68 countries eligible to access concessional finance under the IMF's Poverty Reduction and Growth Trust (PRGT) (44 per cent of the total) are at the intersection of high debt and climate vulnerabilities. This intersection of climate and debt vulnerability is not limited to PRGT-eligible countries. Several lower- and upper-middle-income countries have high climate vulnerability according to the Notre Dame-GAIN Climate Vulnerability Index, and are encountering either serious challenges to their external debt sustainability or are already in debt distress.¹³ Vulnerability to climate shocks is also associated with higher borrowing costs, as creditor perceptions of greater country risk drives risk premia.¹⁴

On the climate mitigation side, developing countries also face greater financing needs associated with the transition to a low-carbon economy, which could further increase debt levels and exacerbate fragile external positions in the short run. Many developing countries are more reliant on brown activities, with less diversified economies.¹⁵ Consequently, the needs for investment in climate mitigation and other green activities as well as in economic diversification are much higher. Closing the investment gap will require increases in external finance, including debt, which will exacerbate their fragile external positions. At the same time, a global green transition could mean that demand for and the product prices of emission-intensive sectors

Figure III.E.11

LDCs and other LICs: External debt distress ratings, 2007–2023
(Percentage of countries)



Source: IMF staff calculations based on IMF/World Bank Debt Sustainability Framework.

Note: Data as of 30 November 2023.

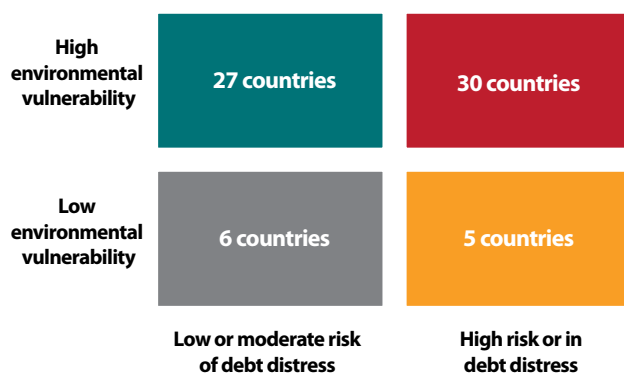
will fall, with adverse implications for the foreign currency revenues of countries that rely on these sectors and their capacity to service external debt burdens.

To break this debt-climate vicious cycle, an ambitious policy agenda at national and international levels is imperative. This agenda should encompass policy recommendations that are discussed throughout this report and noted below—across the action areas of the Addis Agenda. The policy agenda must include the scaling up of affordable international climate finance alongside increases in domestic public and private capital. Smart ways of leveraging domestic and international capital will be needed to help countries achieve the SDGs and climate goals. The size of the financing requirements implies that vulnerable developing countries will need external financing, and on concessional terms, to adapt and build resilience to climate change and avoid further debt build-up (see chapter III.C).

3.2 Scaling up SDG investments while maintaining sustainable debt

High debt service burdens and large unmet financing needs for the SDGs underline the need for progress across the action areas of the Addis Agenda. Creating fiscal space for investment in the SDGs in this very challenging macro-context will require policy action in many areas beyond debt: strengthened fiscal management (increased domestic public resource mobilization and efficient spending) (chapter III.A); development of domestic debt markets that can contribute to financial resilience and help to mitigate exchange rate risks at a time of tightening external conditions (chapter III.B); scaled-up concessional financing, which is particularly important for the poorest and most vulnerable countries (chapter III.C); but also domestic and international macroeconomic and capital account management to address external pressures (chapter III.F). Section 4 discusses the role of debt management and debt transparency

Figure III.E.12

Overlap of debt and climate vulnerabilities in LDCs and other LICs, 2023

Source: UNCTAD Secretariat calculations based on IMF LIC DSA country list (November 2023) and Notre Dame Gain Climate Vulnerability Index (ND-GAIN).

Note: Among the 70 countries currently PRGT-eligible, data is not available for two countries (Eritrea and Kiribati).

in preventing debt crises and efforts to close gaps in the debt resolution architecture so that crises can be addressed more speedily and effectively when they do occur. At the same time, there have been more targeted efforts and proposals to provide affordable debt financing for SDG and climate investments, both through specific instruments and more programmatic approaches.

SDG-linked debt instruments

Large financing needs for climate action and the SDGs have increased interest in financial instruments that more closely link debt financing to sustainability considerations. Such instruments aim to exploit (public and private) creditors' interest in supporting global priorities such as climate action and the SDGs.

For countries that remain solvent but struggle with limited fiscal space for investment in sustainable development, a range of debt instruments could help to mobilize resources for SDG and climate investments. Debt-for-climate and debt-for-SDG swaps allow countries to redirect debt service payments toward investments in sustainable development and climate action. They are useful for countries that have limited fiscal space for SDG investments, but are not a means to restore debt sustainability in countries with solvency challenges. There have been many debt-for-health and debt-for-nature swaps since the late 1980s; after a hiatus, they have regained popularity since 2015. Included in this are bilateral official debt swaps and more complex instruments that involve third parties providing funds with credit enhancements in order to buy back commercial debt at a discount.

Despite some successful examples, the uptake of debt swaps has remained limited, partly due to high transaction costs. Countries have to overcome a number of challenges, including capacity gaps, reporting and monitoring requirements, and the difficulty in identifying potential transactions alongside finding creditors willing to engage in such swaps. Additionally, limited market size can constrain the feasibility of issuing thematic bonds as part of large debt swap operations. Their design

must also assure sovereignty and country ownership over the investments undertaken. Several regional and thematic debt swap initiatives are advancing on these issues, including, for example, the United Nations Economic and Social Commission for West Africa's Climate/SDGs Debt Swap—Donor Nexus Initiative.

The past two decades have seen increasing interest in thematic bonds such as sustainability bonds (e.g. green, blue, social) and sustainability-linked bonds (SLBs). Sustainability bonds are “use-of-proceeds” bonds that aim to finance earmarked green or sustainable activities. SLBs tie the cost of borrowing to improvements from issuers on predefined sustainability indicators within a specific time frame. Since Poland's first issue of sovereign green bonds in 2016, sovereign issuance of bonds to fund decarbonization goals has expanded significantly, reaching \$80.8 billion in 2022.¹⁶ To date, European sovereigns account for most issuances, with developing countries accounting for \$4.1 billion of the 2022 total.¹⁷ The sovereign SLB market is still at a nascent stage, with Chile issuing the first SLB in March 2022.

The purpose of the issuance of sustainability and SLBs should be well defined and integrated into a sovereign's debt management strategy and issuance plans. Commonly cited objectives for sustainable debt issuance include: (i) raising the issuer's profile in the global arena; (ii) building markets for sustainable debt instruments inside a country; and (iii) accessing cost-effective funding and diversifying the investor base. The cost-effectiveness of thematic bonds depends on the size of the so-called greenium, that is, the difference in yields between thematic bonds and conventional sovereign bonds. Despite the growth of the market, the greenium has remained small—from 2.74 basis points for developed countries' bonds to 11.55 basis points for developing countries' dollar- and euro-denominated bonds.¹⁸ The cost savings are thus not on a scale that would make such bonds a suitable instrument for countries that already have high debt levels and that face high spreads in global markets. Countries must also take pre- and post-issuance costs associated with sustainable bonds into account, as well as the costs (and potential benefits) associated with changes to government operations that are needed to issue such bonds.¹⁹ In countries that continue to have borrowing space, donors could consider supporting the issuance of SLBs, for example, by providing support to the development of localized standards and guidelines, or providing a grant element or a guarantee, essentially allowing them to furnish a form of budget support for SDG-linked investments.²⁰

Programmatic approaches

There have also been calls for more systematic support for countries that are not insolvent, but face liquidity pressures over the next several years that are obstacles to investing in recovery, the SDGs and climate action. As noted earlier in this chapter, external debt service burdens are elevated for many developing countries, particularly LDCs, LICs and lower-middle-income countries. While many of them may not need or wish to restructure because they remain solvent, liquidity constraints inhibit their ability to invest in the SDGs, climate action and recovery. Several proposals have been made to provide stepped-up and systematic support to such countries. For example, there have been proposals for a new generation of adjustment programmes that would combine additional new financing from international financial institutions and suspension of principal repayments—a “debt pause”—to avoid leakage of

funds (essentially, the use of highly concessional donor resources to service less-concessional debt) in exchange for a commitment by debtor countries to engage in investment-focused structural reforms that put them on a new and sustainable growth path²¹ (see box III.E.1 for the historic example of the Republic of Korea and an investment-focused debt strategy). Such an approach also falls within the spirit of proposals put forward by the United Nations Secretary-General in the SDG Stimulus and his policy brief on international financial architecture reform, to scale up long-term, affordable financing for SDG and climate investments, while addressing high sovereign borrowing costs and rising risks of debt distress (box III.E.2).

4. Debt crisis prevention and resolution: Progress made and challenges ahead

Amid rising debt vulnerabilities, improvements are needed in both debt crisis prevention and resolution. Both domestic efforts and international actions are needed to create fiscal space for sustainable development investments, address liquidity challenges, mitigate systemic risks and support quick and fair debt restructurings when necessary. In addition to improved debt management and transparency, continued progress towards an architecture that allows for more effective and fair restructurings remains critical, particularly in view of a more heterogeneous creditor landscape, greater reliance on commercial finance, especially by LDCs and other LICs, and geopolitical uncertainty.²² The current architecture needs continued improvement to deliver on all of these objectives.

4.1 Debt crisis prevention

Further strengthening public debt management and advancing public debt transparency are key to mitigating the risk of debt crises.

Debt management and capacity support

Rising debt coupled with a more complex debt landscape have underscored the importance of sound public debt management. The increased heterogeneity of the creditor base and complexity of debt instruments (see section 2 above) have posed significant challenges for public debt management. While fiscal policy is the primary determinant of public debt levels, effective public debt management is a critical component of sound macroeconomic policies. Effective debt management helps to minimize debt vulnerabilities, promote stable access to financing and support the development of a more resilient domestic financial sector, while ineffective management can generate significant fiscal costs and propagate crises. To be effective, public debt management requires a clear mandate built on a sound legal and institutional framework, appropriate human resources and information technology, good governance, political support and effective coordination with other (particularly fiscal and monetary) policies. Another key priority for domestic debt has been the development and deepening of domestic markets, including increased liquidity and more predictable and transparent debt issuances.²³

Steady progress has been made in public debt management practices. Debt Management Performance Assessments have been carried out in 69 developing countries over the past decade. These countries, which

have developed and are pursuing debt management strategies, document improvements in areas such as the legal framework, managerial structure, quality of the debt strategy, publication of statistical bulletins, coordination with the central bank, documented procedures for domestic market borrowing, and staff capacity. Improvements to information technology (IT) systems for debt recording and management are under way across a growing number of countries. However, accomplishments have been slow in other areas and have occasionally faced setbacks, such as during the pandemic. Fragile and conflict-affected States and small developing countries face particularly strong resource constraints, both in terms of staffing and physical/IT equipment. Capacity development in public debt management will remain gradual and—in many contexts—rely heavily on external support.

The IMF and the World Bank provide technical assistance to LICs and MICs through various means, including through the jointly administered Debt Management Facility. The Debt Management Facility programme, which was launched in 2008 by the World Bank, offers advisory services, technical assistance, training and peer-to-peer learning to 86 developing countries. This assistance covers Debt Management Performance Assessments, reform plans and support for strengthening debt management institutions and functions as well as the design of debt management strategies and the development of domestic markets. Additionally, the Government Debt and Risk Management programme provides customized advisory services to enhance public debt and risk management capacity in select MICs. In recent years, delivery of debt management capacity development to LICs has been further enhanced by a growing network of regional advisors located in Regional Technical Assistance Centres, which help the IMF to be responsive to emerging authority needs, including tailoring capacity development to regional challenges and providing sustained on-the-ground support.

The United Nations Conference on Trade and Development (UNCTAD) supports 60 developing countries in building effective debt management capacity, focusing on downstream aspects of debt recording, monitoring and reporting. These efforts complement the technical assistance provided in upstream areas. The UNCTAD Debt Management and Financial Analysis System Programme assists in ensuring the availability of high-quality debt data for reporting and decision-making, enhancing the accuracy and completeness of public debt records and facilitating comprehensive and timely reporting. It also assists in the implementation of debt reorganization initiatives.²⁴ In addition to the UNCTAD programme, there have been other downstream initiatives, including one from the Commonwealth Secretariat that supports developing countries through Meridian, its Debt Recording and Management System.

Debt transparency

In light of increasing public debt vulnerabilities, ensuring debt transparency remains a priority. Transparency is crucial to ensure that governments make informed borrowing decisions based on a comprehensive view of the entire public sector's debt burden and debt-related fiscal risks. Transparency fosters investor confidence and better cooperation with lenders, ultimately increasing the availability of resources and lowering the cost of funding. It also enhances accountability by allowing the public to monitor how public debt is managed. Despite its importance, debt is sometimes incompletely reported in official statistics or hidden through

Box III.E.1**Republic of Korea's strategy to avoid debt distress during economic take-off**

During its economic take-off from the 1960s to the 1980s, the Republic of Korea encountered development financing challenges that are common to developing countries, including persistently high current account deficits, fast-accumulating external debt and low tax revenue. As was the case with many of its peers at that time, development assistance and concessional loans during the cold war era partially mitigated development financing gaps in the country. However, what distinguished the experience of the Republic of Korea was its ability to leverage financing for rapid and sustained development while effectively managing its debt sustainability risks.

A key factor behind the country's success was its emphasis on the productive investment and efficiency criterion for debt-financed development—that is, the marginal economic productivity of its investment had to be higher than the real interest rate payable on the borrowing. The Government of the Republic of Korea played a central role in enforcing this principle through both its own spending decisions and its oversight of the economy. It helped to ensure that development assistance and external debt did not fund short-term consumption, wasteful investment or private capital flight, but instead primarily financed productive investment and increased foreign exchange reserves.

The country's investment ratio more than tripled, from 9.6 per cent of GDP in the late 1950s to 32.2 per cent in the 1970s, while the marginal productivity of capital was maintained at levels that were well above real interest rates paid on foreign debt. Sustained high real economic growth, averaging 8.3 per cent between 1961 and 1980, contributed to keeping the country's debt burdens manageable. For example, if the Republic of Korea had achieved only a 5 per cent growth rate, its foreign debt-to-GDP ratio would have approached 90 per cent of GDP at the beginning of the 1980s, compared to less than the 50 per cent of GDP that was reported. The country's strong economic performance supported growing public revenues and domestic savings, reducing the need for excessive public or external borrowing.

To enforce this successful debt strategy, the Government strengthened institutions and employed a host of policies: a credible, consistent and coherent economic development blueprint as the cornerstone of its national investment and associated debt strategy; productive investment as the top priority throughout its economic take-off; and centralized appraisal of investment and borrowing to ensure the productive and efficient use of funds in both the public and private sectors. The Government also maintained excellent debt statistics throughout the period, which played an important role in supporting informed decision-making.

Source: UN ESCAP.

the use of overly broad confidentiality clauses.²⁵ Since 2018, the Joint IMF-World Bank Multipronged Approach to Address Debt Vulnerabilities has emphasized the importance of public debt transparency, while tracking progress and supporting a broad set of initiatives that are ongoing.

Transparency in debt is also indispensable for facilitating efficient debt restructuring. Accurate and comprehensive debt data is essential for estimating the level of debt relief required to restore a borrower's debt sustainability. Moreover, only maximum disclosure can foster the trust necessary for creditors to achieve equitable burden-sharing. Where accurate information is not readily available, debt reconciliation may lengthen the restructuring process with detrimental costs on the borrower's economy.

Enhancing transparency is the shared responsibility of both borrowers and creditors. Borrowers should strengthen their legal frameworks and improve their debt recording and reporting systems as well as capacity and information-sharing procedures to enable timely and comprehensive reporting. Creditors should encourage transparent financing practices and provide detailed information about their lending portfolios, which can fill in gaps in borrowers' statistics. They should also refrain from including confidentiality clauses in their loan contracts. As the *Financing for Sustainable Development Report 2022* noted, improved reporting and transparency, along with more robust credit analysis, could decrease uncertainty and enhance the effectiveness of debt markets, potentially leading to lower borrowing costs for countries. In this context, the role of credit rating agencies, which supply markets with information and credit assessments and can incentivize disclosure through their rating methodologies, is also important.

Borrowers have made progress in debt reporting, although numerous challenges persist. A review of 60 developing countries found

that less than half require the preparation of key debt-related publications in their domestic legal framework.²⁶ In practice, across the countries eligible to borrow from the World Bank's International Development Association (IDA), 23 per cent do not disclose any debt data, a significant improvement from 40 per cent three years ago. The World Bank debt reporting heatmap has shown the impressive progress some countries have made on debt disclosure.²⁷ Such efforts by borrowers were supported by the IDA's Sustainable Development Finance Policy introduced in 2020, which led to the implementation of over 400 performance and policy actions across more than 60 countries in areas related to debt transparency, debt management and fiscal sustainability. However, progress has been uneven, with some countries regressing in their debt reporting standards due to inadequate debt recording and reporting systems, weak legal and institutional frameworks, or insufficient capacity.

Reporting by creditors on their lending has been mixed. Key bilateral creditors articulated the importance of lender reporting in the Principles and Operational Guidelines for Sustainable Financing adopted by the G20 in 2017. Since then, the Group of Seven (G7) countries have started publishing details of every official sector loan to sovereigns on government websites, although the level of detail varies considerably. The Institute of International Finance published Voluntary Principles designed to enhance transparency in private sector lending in 2019. Subsequently, the OECD's Debt Transparency Initiative built a repository for Institute of International Finance members to disclose their loans to developing countries. However, to date, very few private banks have disclosed any loans.

International organizations can also help to strengthen the coordination of and simplify reporting processes. There is a range of global databases on debt with varying degrees of coverage and data

disaggregation. The World Bank's International Debt Statistics, which is the most comprehensive database for external debt, has significantly increased the comprehensiveness of its coverage, in part due to a new lending policy that promotes the disclosure of public debt data and the reconciliation undertaken with several key creditors.²⁸ Exploring innovative IT solutions which automate data exchange and validation between creditors and borrowers could potentially improve the quality and scope of existing data and greatly simplify reporting efforts.²⁹ Capacity-building support will remain critical. The IMF and the World Bank have stepped up efforts to provide capacity development support with activities, including training courses, that aim to: (i) enhance reporting of public debt data in official publications and investor relations functions; (ii) produce and publish medium-term public debt management strategies and annual borrowing plans; (iii) strengthen legal frameworks and institutional capacity in creditor and debtor countries to support public debt transparency; (iv) improve coverage of contingent liabilities and systematically track lending commitments as well as disbursements; (v) strengthen cash management; and (vi) improve management of fiscal risks.³⁰

Linking debt service to countries' capacity to pay in the face of exogenous shocks

State-contingent debt instruments can serve as a countercyclical and risk-sharing tool to help countries deal with shocks.

State-contingent debt instruments have payouts that are higher in good states than in bad states. They aim to reduce debt payments during periods of low fiscal revenue—for example, by tying debt payments to GDP, commodity prices or catastrophic events—thus creating countercyclical liabilities linked to the sovereign's debt-service capacity. These clauses provide insurance against exogenous risks and may become increasingly important given growing climate risks and other environmental concerns. The G20 Debt Service Suspension Initiative aimed to provide such breathing space to LICs to tackle the pandemic-related economic fallout. But the suspension initiative required each borrower and creditor to agree on debt contract modifications in lengthy processes that proved burdensome for both creditors and borrowers. State-contingent clauses provide an ex ante solution.

Public creditors are pioneering climate-resilient debt clauses in their lending. Climate-resilient debt clauses automatically defer debt payments following the occurrence of certain climate events and natural disasters (such as droughts, earthquakes, flooding and extreme weather). The Inter-agency Task Force has long called on official creditors to take the lead in adopting such clauses in their lending; now several official creditors (the African Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the World Bank, Canada, the United Kingdom and France) have committed to do so. Before that, similar clauses had only been introduced in the context of restructurings, for example, in bond contracts by Barbados and Grenada, deferring repayment obligations in case of natural disasters.

4.2 Debt crisis resolution

Amid rising debt vulnerabilities, the international debt architecture needs to be strengthened so that it can efficiently and effectively help countries to restructure unsustainable debt in a timely manner. This improvement would help to prevent delays in debt

restructurings that can lead to significant development setbacks. When restructuring episodes following a default last longer than the median duration, the average cumulative loss in GDP is estimated to be around 26 per cent relative to the GDP of the year before the restructuring, over the first five years after a country defaults.³¹ In contrast, when restructuring episodes are expected to be shorter than the median duration, they are associated with an average cumulative GDP increase of 2.8 per cent compared to the pre-restructuring year's GDP, over the same time frame. There are also significant social costs associated with delayed debt restructuring, such as prolonged, reduced social spending and its consequences for human development that result from reduced economic output and government revenue.

Strengthening debt analytics

Timely recognition of debt sustainability problems is critical to support debt restructurings when they are needed. As part of its mandate to foster economic and financial stability, the IMF plays a central role in the prevention and resolution of sovereign debt crises. The core functions of the IMF are to: (i) conduct surveillance of its members' policies for systemic stability, including through debt sustainability analyses prepared jointly with the World Bank for those countries using the IMF-World Bank Debt Sustainability Framework for Low-Income Countries; (ii) assist members in solving their balance-of-payments problems through IMF-supported programmes to restore the member's medium-term external viability, and (iii) in particular, in cases of unsustainable debt and a request for an IMF-supported programme, assist the member in designing a macroeconomic adjustment framework and establishing the debt restructuring envelope that is necessary to put debt on a sustainable path while being consistent with the IMF-supported programme's parameters.³² The World Bank offers low-interest loans and grants to developing countries, customizing financing terms according to their debt vulnerabilities. It extends substantial positive net flows to countries facing debt distress, including during debt restructuring, and provides grants to the poorest among them.

The IMF and the World Bank continue to strengthen the analytical tools to assess debt sustainability. In most LICs, debt sustainability assessments are carried out using the joint IMF-World Bank Debt Sustainability Framework for Low-Income Countries. For all other countries the IMF uses the Sovereign Risk and Debt Sustainability Framework for Market Access Countries (MAC SRDSF).³³ The assessment framework for market access countries was revamped in 2021 and has since been rolled out. The new SRDSF signals sovereign stress more accurately and better assesses debt sustainability in market access countries than the previous version, which is a prerequisite for lending by most international financial institutions. In October 2023, the IMF published the SRDSF template for public use. In late 2023, a review of the IMF-World Bank Debt Sustainability Framework for Low-Income Countries was launched to formally assess the effectiveness of the existing framework and re-examine its fundamental features. The review is expected to be a multi-year process. In the interim, a supplementary guidance will be prepared in 2024 to address some of the most pressing issues within the existing framework. There have also been efforts by other stakeholders to develop complementary tools and frameworks, each emphasizing different facets of debt sustainability.

More efficient information-sharing can help to support effective sovereign debt restructurings. Difficulties such as asymmetric

Box III.E.2**The SDG Stimulus and reform of the international financial architecture**

In his proposals for an SDG Stimulus and reform of the international financial architecture, the United Nations Secretary-General put forward proposals for both immediate actions to address the debt challenges of developing countries and for longer-term reforms of the sovereign debt architecture that the Fourth International Conference on Financing for Development could address. These proposals aim to strengthen debt crisis prevention, alleviate fiscal constraints for countries that face extremely high debt service burdens and elevated borrowing costs, and address continued challenges in effectively and fairly resolving sovereign debt crises when they occur.

Recommendations to prevent debt crises from occurring include the following: fulfilling the long-standing commitment of the international community to work towards a global consensus on guidelines for sovereign debtor and creditor responsibilities; improving debt management

and debt transparency, such as by developing a publicly accessible registry of debt data for developing countries; enhancing the information environment and understanding of long-term debt sustainability and SDG financing needs, which can build on ongoing work in the United Nations and beyond; and improving debt contracts and increasing the use of state-contingent debt instruments.

In regard to debt crisis resolution, the Secretary-General proposed strengthening the Common Framework by complementing it with a mechanism that could help to overcome creditor coordination challenges with both sticks and carrots to enforce and incentivize private creditor participation in restructurings for comparable treatment with official creditors. Such a mechanism could also be open to countries with liquidity challenges, helping them to refinance existing high-cost market debt without excessive compensation to private creditors.

Source: UN DESA based on: “United Nations Secretary-General’s SDG Stimulus to Deliver Agenda 2030” and United Nations, “Our Common Agenda Policy Brief 6—Reforms to the International Financial Architecture”.

information and a lack of common understanding and coordination amid creditor fragmentation can impede timely resolution of debt restructurings. Such delays further discourage countries that could benefit from debt restructuring from resorting to it in a timely manner. As part of efforts to support an effective process, including reducing information asymmetries, the IMF and the World Bank have published guidance to staff on information-sharing in the context of sovereign debt restructurings.

Evolution of contractual approaches

In the late 1990s and early 2000s, the international community confronted the difficult prospect of sovereign defaults on bonds held by the private sector. Unlike debt defaults and restructurings during the 1980s debt crisis, which primarily involved the restructuring of syndicated loans held by foreign banks, sovereign bonds were widely held by hundreds, and sometimes thousands, of bondholders, making the “collective action problem” inherent in all restructurings decidedly more difficult.

Although a supranational sovereign bankruptcy mechanism (i.e. the Sovereign Debt Restructuring Mechanism) was proposed in 2001 as a statutory means through which sovereign debt crises could be resolved,³⁴ this proposal did not garner sufficient political support. Instead, a contractual—or “market-based”—approach to sovereign debt restructuring was relied on.³⁵ The market-based approach included incorporating contractual provisions in sovereign bond contracts to help facilitate negotiations between the debtor and its creditors in restructuring agreements. A notable example are collective action clauses (CACs) that facilitate orderly debt restructuring by relying on qualified majority voting by creditors. The uptake of enhanced CACs continues to be high, with 92 per cent of new issuances of international sovereign bonds between June 2020 and December 2022 including such clauses. As of December 2022, 70 per cent of the outstanding stock of bonds included enhanced CACs.

Over a dozen sovereign debt restructurings of private claims were completed between 2014 and 2020 relying on the contractual

approach, but a number of issues remain and threaten to complicate future restructurings. Compared with previous periods, restructurings between 2014 and 2020 generally proceeded more smoothly, were largely pre-emptive and had a shorter average duration and higher average creditor participation, mainly due to the use of CACs. However, sovereign debt restructurings in a few LICs were protracted, incomplete and non-transparent. There have also been more serial restructurings as a result of shallow haircuts.³⁶

New coordination challenges have arisen as the creditor base has become more varied and fragmented. The use of collateral and collateral-like instruments has increased and complicated the reaching of agreement in recent restructurings. Secured creditors may have the ability to seize collateral, attach dedicated revenue streams (for example, relating to oil or natural gas) or draw on amounts deposited in escrow accounts. This leverage puts a ceiling on the amount of debt relief that can realistically be negotiated and leads to particularly acute inter-creditor equity concerns. In addition, informational asymmetries may complicate reaching a restructuring deal given the lack of a clear understanding as to the restructuring perimeter and classification of claims. Creditors may be unwilling to agree to a deal without clarity on those issues given inter-creditor equity concerns.

Domestic law approaches

Several jurisdictions have discussed or advanced efforts in domestic law to help resolve debt crises more effectively. There are several examples of initiatives introduced in the past decade that aim to restrict creditor actions in specific circumstances. In 2010, the United Kingdom passed the *Debt Relief (Developing Countries) Act* (“2010 Act”),³⁷ which limited the recoverable amounts for creditors of countries participating in the HIPC Initiative. At the time, it prevented an estimated loss of £145 million for these countries,³⁸ which otherwise might have accrued due to holdout litigation. In 2015, Belgium implemented legislation that restricts the rights of creditors in relation to debtor countries by limiting their claim to the amount they initially paid to

acquire the debt.³⁹ This law specifically targets situations where creditors seek unjust benefits after purchasing claims on the debtor country at a discounted price on the secondary market. In 2016, France enacted a law that protects certain developing countries from having their assets seized by creditors who bought debt when the debtor countries were in, or near, default.⁴⁰ The law offers protection for the first four years following a default, or if two thirds of the holders of the debt have accepted a restructuring.

More recently, there have been efforts to introduce relevant legislation in the United Kingdom and the United States of America, where most sovereign debt contracts are governed. In the United Kingdom, the International Development Committee of the Parliament issued a recommendation to introduce legislation compelling private creditor participation in international debt relief initiatives, although the bill was rejected.⁴¹ Three legislative bills were previously considered in the New York State Assembly, which envisage establishing a sovereign bankruptcy procedure in New York,⁴² limiting the recoverable amount for creditors in New York courts⁴³ and voiding debt transfers acquired for the purpose of filing lawsuits.⁴⁴ In early 2024, new draft legislation that combines two of the three aforementioned proposed bills was submitted to the New York State Assembly. This new proposed bill would limit the recoverable amount for creditors to what the United States Government would receive if it were a creditor holding an eligible claim, or allow debtor countries to submit their own restructuring plans through the New York courts.⁴⁵

Domestic debt restructurings

Rising debt vulnerabilities and the growing share of domestic debt have increased the risk of more domestic debt restructurings. Domestic currency public debt increased from 8 per cent of GDP in 2000 to 20 per cent of GDP in 2022 for LDCs and from 22 per cent of GDP to 37 per cent of GDP for other LICs, on a GDP-weighted averaging basis (see figure III.E.2 above). From 1990 to 2020, there were roughly 30 stand-alone domestic debt restructurings, compared to 27 external debt restructurings.⁴⁶ With more than half of all LDCs and other LICs at high risk of debt distress, domestic restructurings may be needed more frequently to restore debt sustainability.

While domestic debt restructurings avoid certain costs involved in external debt restructurings, they also pose unique challenges.⁴⁷ Sovereigns have considerable flexibility in restructuring domestic debt, including through changes in domestic laws, as a result of which domestic restructurings typically take less time to conclude. Domestic debt restructurings can also potentially limit the external reputational costs and help to retain external market access. At the same time, because domestic debt is disproportionately held by domestic banks and pension funds, sovereign stress can easily spread to other parts of the economy, with potentially serious adverse effects on the economy. A restructuring of central bank holdings of public debt can adversely affect the central bank's position to conduct monetary operations and regulatory functions. Thus, domestic debt restructuring should be designed to achieve the necessary debt relief while minimizing risks to the domestic financial system and broader economy; a decision framework to identify options that minimize potential economic costs, including financial system disruptions, was presented by the IMF to this end in 2021.⁴⁸

The global architecture

Recent actions taken by the creditor community in regard to the debt challenges faced by developing countries bear some similarities to the responses of the late 1980s and 1990s, but differ in important respects, reflecting the difference in circumstances.⁴⁹

While debt distress indicators in LICs have steadily risen over the last decade, they remain substantially below their levels in the mid-1990s and do not yet indicate a systemic crisis of the type that would require a wholesale, coordinated HIPC-style initiative. As a result, the post-2019 efforts of the creditor community have first focused on rolling out the G20 Debt Service Suspension Initiative to provide immediate cash-flow relief to eligible countries through extended rescheduling and reprofiling of debt. In a second stage, the G20 Common Framework was put in place to provide deeper relief for qualifying countries that request treatment on a case-by-case basis. While creditors have moved faster this time to consider deeper debt treatment, many challenges remain.⁵⁰

Several areas of improvement have been highlighted to strengthen the Common Framework to deliver more quickly.⁵¹ The IMF and the World Bank have highlighted the need for: (i) greater clarity on the steps and timelines of the Common Framework process, enabling the early resumption of essential financing and support for the implementation of a reform programme; (ii) introduction of a debt service suspension for the duration of the negotiation to alleviate liquidity constraints, avoid the accumulation of arrears and incentivize quicker resolutions; (iii) clarity on the parameters and processes to assess and enforce comparability of treatment; and (iv) expanding coordinated debt treatments to highly indebted non-Common Framework-eligible countries that would benefit from such coordination, as they are recipients of large financing from both official and private sector creditors. These calls have been echoed by the Inter-agency Task Force and complemented by additional recommendations. These include recommendations by the Secretary-General in his policy brief on reform of the international financial architecture, which proposed the development of a mechanism that could help to overcome creditor coordination challenges with both credit enhancements (or other carrots) and sticks to ensure comparable treatment of private creditors (see box III.E.2 above).

The Global Sovereign Debt Roundtable (GSDR) is aimed at promoting common understanding among key stakeholders. The GSDR was set up in February 2023 and is co-chaired by the IMF, the World Bank and the G20 Presidency. The GSDR focuses on processes and practices to foster common understanding of key bottlenecks and ways to address them. Participation in the GSDR is broad-based and includes official bilateral creditors, private creditors and borrowing countries. Both traditional creditors such as the Paris Club and new official bilateral creditors have attended its policy meetings and workshops. In October 2023, the GSDR issued a progress report, welcoming the positive momentum in resolving individual debt restructuring cases and reaching common understanding on ways to address key impediments to debt restructuring.

Enhanced international collaboration and further improvement in the global debt restructuring architecture remain important, and bolder reforms can be contemplated should the current liquidity squeeze morph into a more systemic crisis. A strengthened Common Framework can provide an efficient, rules-based framework for

sovereign debt resolution that ensures timely, orderly, effective and fair debt restructurings. However, in its current format, it may not be well equipped to tackle widespread debt distress in a systemic crisis. The current architecture also has gaps in addressing the “development dimension”

of the current debt crisis, with no systematic support available to countries whose high debt service burdens hamper SDG expenditure. To close these gaps, UNCTAD has put forward proposals towards a development-centred sovereign debt workout framework (box III.E.3).

Box III.E.3

UNCTAD proposal for a global debt authority

A sovereign debt workout framework that is development-centred would combine contractual and statutory approaches. This would include: provisions noted above, such as automatic standstills for countries declaring distress to prevent holdouts and encourage debtor countries to not delay initiating the restructuring process; enhanced debt sustainability analyses to reflect the need to achieve the SDGs and climate transition, as well as empower country negotiators with improved data on the potential for growth and fiscal consolidation, including models from developing countries themselves; improving innovative financial instruments such as debt-for-climate swaps or debt-for-nature swaps that can enhance the fiscal space of countries with sustainable debts; and the building of a broader institutional framework that fosters sovereign debt resilience in the face of pressing ecological, social and geopolitical challenges, for example, through mechanisms such as the Loss and Damage Fund.

Additional institutional changes include mechanisms to: determine the perimeter of legitimate debt (relating to rules regarding unconstitutional debt resulting from corruption, opacity, secrecy and flawed authorization or reckless creditor practices); make capital controls and other regulations that affect capital flows key elements of the ordinary financial regulatory toolkit of developing countries; and establish a borrower’s club. Since 1956, official creditors have coordinated their efforts through institutions such as the Paris Club, while various private creditor groups also exist. A borrower’s club would enable debtor countries to discuss technical issues and the use of novel debt instruments (such as green bonds). It would also facilitate mutual learning and allow

countries with recent debt workout experience to advise those in distress. Such a club could lead to a more stable and resilient global debt architecture, benefiting both borrowers and creditors.

The most ambitious institutional initiative proposed by UNCTAD is the creation of a global debt authority to oversee sovereign debt workouts and implement the substantive changes listed above. While this endeavour seems largely aspirational in the current geopolitical space, progress could occur in at least two phases: In the first phase, the global debt authority would function as a coordinating and advisory institution operating under a non-binding charter adopted by a smaller group of interested countries. It would consist of a limited team of staff affiliated with an existing international organization and rely on ad hoc committees of experts who would identify existing sovereign debt-related issues and make recommendations for the global debt authority to provide guidance on soft law, domestic legislation and contractual approaches. Through the work of these ad hoc committees, the global debt authority would establish its network with experts, international institutions, domestic lawmakers and civil society groups, among others. Regarding sovereign debt workout data, global debt authority staff and ad hoc committees would develop and maintain databases of previous agreements, debt sustainability analyses and effective communication strategies. By undertaking these actions, the global debt authority would initiate its operations, build its network for further expansion and develop the resources to play a pivotal role in sovereign debt workouts. In a second phase, the legal basis for the global debt authority as an autonomous entity, neither borrower nor creditor, would be established.

Source: UNCTAD, *Trade and Development Report 2023*, chapter V.

Endnotes

- 1 LDCs and other LICs include 73 CF-eligible countries plus Eritrea, Sudan, and Zimbabwe.
- 2 The IMF and World Bank launched the HIPC Initiative in 1996, expanded it in 1999, and supplemented in 2005 by the MDRI to provide comprehensive debt relief to the poorest heavily indebted countries. By 2007, the average debt-to-GDP ratio of the 36 countries recipients of the full amount of debt relief under HIPC and MDRI fell by around 70 per cent, relative to the early 2000s.
- 3 UN DESA calculations, based on World Bank International Debt Statistics database.
- 4 The presence of collateral can raise the risk of debt distress by reducing budget flexibility (through the earmarking resources) and impairing access to non-secured financing, particularly after adverse shocks.
- 5 IMF (2020). “Reform of the Policy on Public Debt Limits in IMF-Supported Programs,” IMF Policy Paper 2020/061.
- 6 World Bank (2024). Global Economic Prospects January 2024.
- 7 The public debt dynamics equation can be expressed as:

$$\Delta d_t = d_t - d_{t-1} = \frac{r-g}{1+g} d_{t-1} + \varepsilon(1+r^f) d_{t-1}^f - pb_t$$
 where d is public debt in percentage of GDP; r is the real interest rate on overall public debt; r^f is the real interest rate on FX-denominated external debt (deflated by US inflation); g is the real GDP growth; ε is the change in the real exchange rate, expressed in local currency per U.S. dollar unit (with $\varepsilon > 0$ indicating depreciation of the domestic currency), pb is the primary balance in percentage of GDP.
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