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The raw reality of the growing (external) debt crisis: A call to action

CDP Working Group on external debt

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The raw reality of the growing (external) debt crisis: A call to action

*CDP Working Group on external debt**

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Abstract: This paper discusses the escalating external debt distress and financial constraints faced by many least developed countries (LDCs) and other developing countries, particularly in the light of the COVID-19 pandemic, rising interest rates, high food and energy prices and currency depreciation. It stresses the importance of a comprehensive financing strategy to address the large scale of investment needs of developing countries. The paper underscores the urgent need for short-term solutions such as multilateral financing and debt renegotiation to tackle the current debt crisis, while simultaneously establishing long-term solutions to prevent future debt crises. It calls for improvements in the contractual approach with private creditors, including enhanced collective-action clauses and a more predictable framework for debt restructuring. To support vulnerable economies, additional SDR allocations contingent on well-defined economic shocks and re-channelled through multilateral development banks, can play an important role. At the same time, there is a need to efficiently allocate concessional finance for climate adaptation and mitigation and for developed countries to transfer additional resources to compensate for historical carbon debt to developing nations. It is also important that developing countries implement preventive measures to strengthen debt management to avoid future debt crises.

JEL Classi ication: F3, F34.

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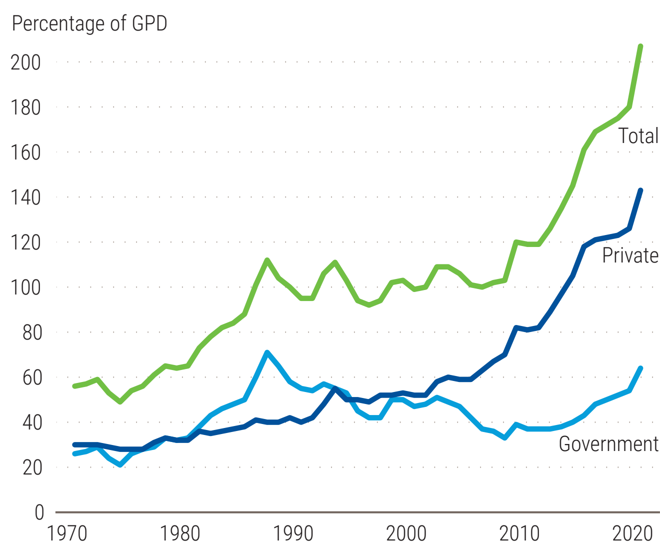
1. Introduction

The Covid-19 pandemic caused greater economic damage in the developing world than the global financial crisis, while with fiscal space squeezed and inadequate multilateral financial support, the slight bounce back in 2021 proved uneven and fragile, dependent in many cases on a further build-up in external debt (UNCTAD, 2023). Various factors have been critical towards further financial distress. First, the United States monetary policy embarking on a decisive tightening cycle. Second, price hikes in some commodity markets adding to inflationary pressures on a global scale. Third, the Covid-19 pandemic lingering on, including high debt burdens that remain unresolved. Fourthly, many developing and emerging economies' currencies have fallen steeply against the US dollar, raising the costs of servicing dollar-denominated debt, and prompting them to draw down their foreign exchange reserves at an alarming rate. This problem is particularly pronounced in Latin America and the Caribbean and in sub-Saharan Africa, where the ratio of external debt to exports is expected to reach in 2022, 169 per cent and 142 per cent, respectively (see figure 1).

Figure 1

Debt, emerging market and developing economies, 1970-2020

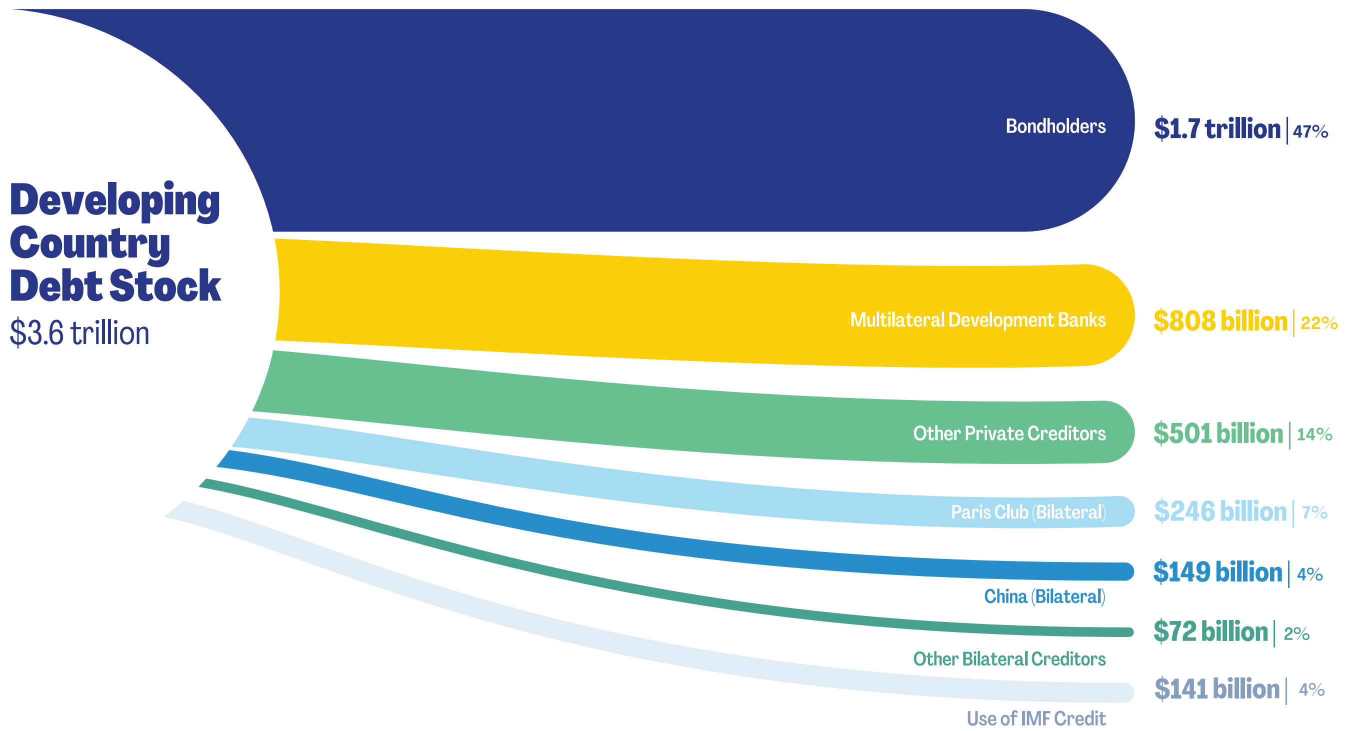


Source: UNCTAD (2023), Trade and Development Report 2022, fig. 1.5, p.7.

Given the large increase in corporate debt, the shift in external sources of finance from cross-border bank lending to issuing bonds in the international capital markets, and the importance of China and other countries as new lenders, the current situation now requires urgently more international institutional cooperation in solving debt distress (Figure 2). The International Monetary Fund (IMF) has warned that around six out of 10 low-income countries (LICs) and three out of 10 emerging market economies are at or near debt distress. Furthermore, if current trends persist, debt vulnerabilities in LICs could reach levels comparable to the pre-HIPC era over the medium to long-term (Chuku and others, 2023). Nearly 60 per cent of all emerging and developing countries have become high-risk debtors (World Bank, 2022).

Figure 2

Emerging market and developing economies' public external debt stock composition in 2021 (billions of US dollars)



Source: Ramos, L., Ray, R., Bhandary, R.R., Gallagher, K.P., and W.N. Kring (2023). *Debt Relief for a Green and Inclusive Recovery: Guaranteeing Sustainable Development*. Boston, London, Berlin: Boston University Global Development Policy Center; Centre for Sustainable Finance, SOAS, University of London; Heinrich-Böll-Stiftung.

2. Mounting challenges

The current debt situation threatens not only a recovery of many affected countries, but also delays necessary investments to attack the growing climate crisis. Economies and public finances must be made climate proof. If not, climate vulnerability and an unsustainable debt burden might reinforce each other, as physical climate vulnerability is driving up the costs of capital of climate vulnerable developing countries. As global warming accelerates, the risk premium of climate vulnerable countries, already being high, might increase further (Cevick and Jalles, 2020). Thus, these vulnerable countries will find themselves in a catch-22 situation where climate vulnerability raises the cost of debt and diminishes the fiscal space for investment in climate resilience (Volz, 2022b).

Particularly, least developed countries (LDCs), many of which are in Africa, have suffered more than most from climate change and development asymmetries. These countries, therefore, **can claim 'carbon credits' as development and growth in other parts of the world have largely excluded Africa and used a disproportionate share of world's natural capital**. As a result, other nations owe a carbon debt to these LDCs, requiring a complete, and costly, overhaul of the international financial system (Lopes, 2023).

Songwe et.al (p.7) argue that: 'The scale of the investments (including those for climate change) needed in emerging market and developing economies over the next five years and beyond will require a debt and financing strategy that tackles festering debt difficulties, especially those of poor and vulnerable countries. Such a strategy should result in a major expansion of both domestic and international finance, from public and private sources, and concessional and non-concessional funding. Emerging markets and developing countries other than China will need to spend around $1 trillion per year by 2025 (4.1per cent of GDP compared with 2.2 per cent in 2019) and around $2.4 trillion per year by 2030 (6.5 per cent of GDP), on the specific investment and spending priorities identified above.'

Piecemeal measures (box 1) **to provide short-term debt relief are inconsistent with the magnitude of the challenges faced by debt countries** in terms of both existing liabilities and future financing needs. Three big issues need to be addressed: a growing risk of a liquidity problem in many countries; a debt-overhang problem in a small set of countries; and a debt-as-insurance problem in climate-vulnerable countries that leads to a vicious cycle of climate and debt vulnerability. Tackling these debt difficulties will require a comprehensive approach with tailored solutions. This entails expanding access to low-cost official liquidity facilities; expanding the envelope of low-cost finance; including systematic debt-suspension clauses in loan contracts in the event of a natural disaster (as pioneered by Barbados); improving the functioning of the G20 Common Framework; modifying criteria for allocating concessional finance to include climate vulnerability; and expanding the use of debt/climate/ nature swaps. These measures are among the five proposals included in the Bridgetown initiative, which are:

BOX 1

Recent external debt relief initiatives

Listed below are some of the recent initiatives introduced in response to external debt distress experienced by many developing counties due the Covid-19.

1. The G20 in May 2020 initiated the Debt Service Suspension Initiative (DSSI) which offered the 73 poorest (International Development Association eligible) countries debt relief by allowing them to postpone debt service payments on official bilateral debt while urging private creditors to join in. **The DSSI did not reach the level of relief expected** – in part due to limited take up – and the initiative ended in December 2021 at a precarious time when many countries faced shrinking foreign reserves and large gross financing needs.
2. The G20 Common Framework for Debt Treatments was adopted in November 2020 with the aim of helping countries not only with protracted liquidity crisis, but also solvency problems. To achieve this effectively, one of the main objectives of the Common Framework has been to bring together the Paris Club and non-Paris Club official creditors. As with the DSSI, this is only open to the 73 poorest countries, thus excluding several middle-income countries (MICs) with debt problems.
3. In August 2021 the IMF issued a historic US$650 billion worth of Special Drawing Rights (SDR) providing a much-needed liquidity injection to many countries. But with more than two-thirds going to wealthy countries, with little or no need for additional reserves, this has been far too little for struggling developing economies. Best estimates suggest that the G20 so far has pledged US$60 billion with a global ambition of reaching US$100 billion, **but not a single recycled SDR has yet reached any low- or middle-income country**.[a] Additionally, the rise in interest rates globally has increased the fiscal cost of SDRs for countries which have used their allocation, becoming a permanent liability.

All in all, **post-pandemic international debt relief initiatives have been woefully insufficient**. The major debt relief initiative remains the Common Framework. However, it has shown little progress to date with only four countries requesting debt treatment, and only one of them, Chad, reaching an agreement more than 18 months after signing on. One major hurdle is how to ensure the participation and comparable treatment of private creditors and coordinate relief between 'traditional' and 'new' major official creditors. This, combined with a general lack of transparency on the total amount of outstanding debt and its contractual terms, greatly complicates restructurings and debt sustainability assessments.

The Global Sovereign Debt Roundtable launched in December 2022 could provide meaningful progress if it leads to the establishment of a set of common rules for sovereign debt restructurings. However, it is unclear at this stage to what extent it will positively impact ongoing cases which need to be dealt with in a timely manner.

a IMF staff and the Rwandan authorities reached in April 2023 staff-level agreement on policies needed to complete the first reviews of Rwanda's Policy Coordination Instrument and program under the Resilience and Sustainability Facility.

1. Drawing in US$5 trillion of private savings for climate mitigation.
2. Widening access to concessional finance for the climate vulnerable.
3. Expanding multilateral development banks lending for climate and SDGs by US$1trillion.
4. Funding Loss and Damage.
5. Making the financial system more shock absorbent.

In the light of the above Ocampo, 2022 (p.1) proposes that: 'Creditors can and must play a critical role in providing debt relief for low-income countries.... Multilateral development banks typically offer long-term loans at concessional interest rates – a competitive advantage in the current environment, particularly for poorer countries. But for the low-income countries, the ratio between multilateral

debt to the total external debt, which depend heavily on costlier private-sector financing has however decreased. Before Covid-19, the main body of official bilateral creditors providing debt relief to low and middle-income countries was the Paris Club, which only covers debts with sovereign creditors. However, in response to the liquidity crisis caused by the pandemic, the G20 and the Paris Club introduced the DSSI. With technical support from the World Bank and the IMF, the DSSI suspended US$12.9 billion in payments owed by 48 low-income countries between May 2020 and December 2021. Yet, this was only a temporary solution: the DSSI did not reduce debt levels and attracted minimal participation by private-sector creditors. Since it expired in December 2021, access to financial markets has tightened, and nearly half of the 73 eligible countries are now at risk of debt distress. At the end of 2020, the G20 and the Paris Club endorsed the Common Framework for Debt Treatments which is meant to coordinate and provide debt relief to DSSI-eligible countries. But only four countries – Chad, Ethiopia, Ghana, and Zambia – have applied to it so far. Earlier this year, the World Bank and the IMF offered a roadmap for improving the program, featuring four recommendations: a clear timeline, suspension of debt payments during negotiations, establishment of clear processes and rules, and expanded eligibility requirements. However, several countries that require immediate debt relief are not among those eligible for the DSSI. Some middle-income countries, such as Lebanon, Sri Lanka, and Surinam, have already defaulted. Others, including Egypt and Tunisia, face severe debt distress. Argentina[1] and Ecuador already restructured their foreign debts in 2020, using traditional mechanisms and with implicit IMF support. Clearly more ambitious reforms are needed. In October 2020, the IMF emphasized the need to improve its existing debt-restructuring mechanism – the so-called “contractual approach” – which was last redesigned in 2014. At the same time, the IMF highlighted the growing problems associated with non-bond and collateralized debts and noted the lack of transparency in this domain. However, these contractual arrangements are also insufficient because half of the sovereign debts of emerging and developing countries lack the enhanced collective-action clauses, which allow several debt contracts to be simultaneously renegotiated. Another possible approach would be to create an *independent panel for sovereign-debt negotiations* that would operate within the United Nations. The IMF already tried to create a similar body at the beginning of this century, but the idea was rejected’.

1 Argentina risks to default again in the first half of 2023.

3. Prospects

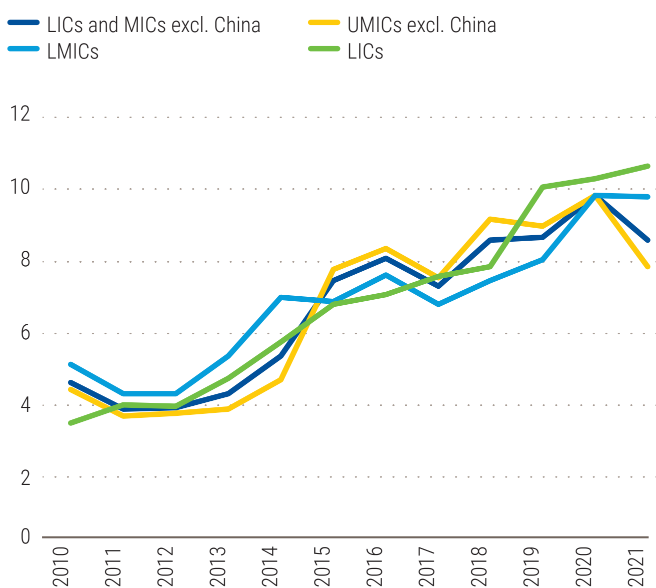
Prospects for affected developing and emerging economies depend largely on the policy responses in advanced economies. Increasing borrowing costs, reversed capital flows, a weakening of China's growth and the economic consequences from the Ukraine war, hamper the recovery in many developing countries, with rising numbers of countries in debt distress and several defaulting. Around 50 developing countries are now exposed to high cost of food, fuel and borrowing, and more than are exposed to at least one of those threats. A widespread developing country debt crisis is looming, severely jeopardising achievement of the 2030 Sustainable Development Goals (UNCTAD, 2023).

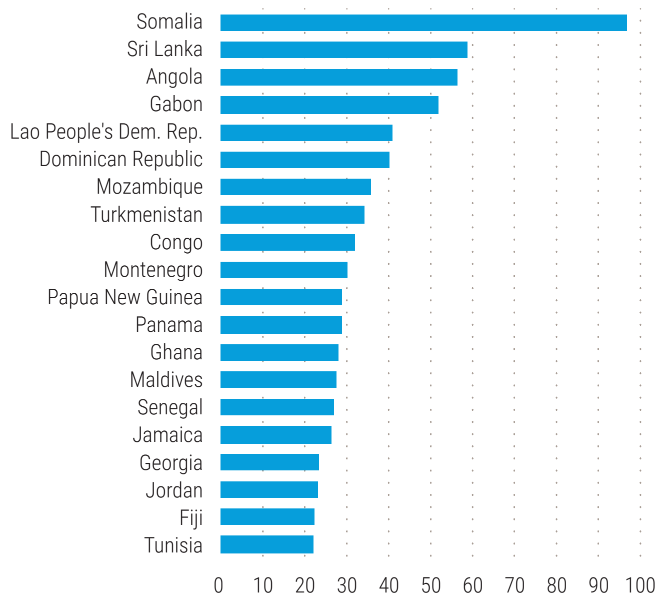
Although debt vulnerabilities are currently lower than pre-HIPC, creditor base is now more fragmented (non-Paris Club creditors, bondholders, etc.) and instruments are more complex to restructure (collateral, etc.). It is important to note that the few countries who have defaulted are just the tip of the iceberg, and an absence of mass debt default could be concealing an underlying development crisis in the making, as countries service their debt at the expense of other expenditures (see figure 3) (Chuku and others, 2023).

To counteract the looming debt overhang in developing countries in an interconnected

Figure 3

Servicing costs on public and publicly guaranteed external debt to government revenues, developing countries and groups, 2010–2021 (percentage)





Source: UNCTAD (2023), Trade and Development Report 2022, fig. 2.5, p. 51.

world global economic governance needs to be rethought with a stronger development perspective. The growing imbalances and inequities of a hyper globalized world order require a reconsideration of the international financial system (Ocampo, 2017) to realise a stable multilateral monetary and financial system with more timely balance of payments support. Scaling up public development finance necessitates an increase in base capital of multilateral financial institutions and stronger incentives that match private finance flows towards productive transformation (UNCTAD, 2023).

4. Policy proposals for international action

Several prerequisites are needed for achieving international action on effective debt restructuring. First, establishment of *a multilateral legal framework for sovereign debt restructuring to facilitate timely and orderly debt crisis resolution* with the involvement of all official (bilateral and multilateral) and private creditors. Such a framework would facilitate the provision of debt relief linked to a debt sustainability assessment that incorporates long-term finance needs, including for the achievement of the 2030 Agenda and the Paris Climate Agreement.

Second, major official creditors must be willing to work together, most notably China and the Paris Club of creditors. The absence of a coordinating multilateral framework manifests itself clearly in the current debt crisis. The different requirements between multilateral organisations, China, other bilateral creditors, and private bondholders are so complicated that it now takes three times as long to resolve a default as it did on average in the two decades before 2020 (Fitch, as quoted in Financial Times 29-03-23). Western creditors and China should concede to each other and create a forward-looking new framework. If there is a malfunctioning of the Paris Club of creditors, then a new framework could be constructed around the G20.

Third, in the new framework haircuts should be spread evenly among creditors not only to limit eventual losses but also to have an accepted standing in developing and emerging countries.

Fourth, debtors and creditors must commit to full transparency on the amount of outstanding loans and terms, and debtors should seek restructuring earlier/pre-emptively. The recently established Global Sovereign Debt Roundtable might be a vehicle to a more ambitious cooperation between all parties concerned, but no decisive steps have been taken yet.

Fifth, if a Debt Sustainability Analysis (DSA) suggests that write-downs are needed to restore sustainability, restructurings should not focus on maturity extensions and interest rate reductions Earlier debt crises were only solved when emphasis was given to debt relief through debt write-downs.

5. Recommendations[2]

5.1. Reinforce efforts to increase transparency of public and private sovereign debt

A strong foundation of shared information is essential for debt sustainability assessments, effective financial management by sovereign debtors, the identification and organisation of creditors, effective risk management by creditors, and equitable debt treatment processes and outcomes. Following the UNCTAD Principles for Responsible Sovereign Borrowing and Lending, this registry would allow the integration of debt data by both lenders and borrowers at the level of specific transactions in a way that ensures interoperability of data across direct and indirect sources of reporting.

5.2. DSAs should be based on realistic expectations about each country's debt dynamics

This includes the use of realistic country specific macroeconomic models, realistic assessment expenditure needs and ability to raise revenues, bearing in mind a country's vulnerability to economic shocks, not in the least to those from climate change. DSA's are to assess correctly whether debt is sustainable. If this is not the case, they should appraise the suitable size and type of debt reducing action to restore sustainability. The IMF should therefore create an option for all sovereign debtors to request an updated DSA as a basis for negotiations with its public and private creditors: While the IMF is committed to producing DSAs for surveillance as well as for supporting restructuring operations, there is not yet an option for a sovereign debtor to request an updated DSA to support its negotiations with its creditors. These actualised DSAs should incorporate sustainability risks and investment requirements to achieve the agenda 2030 and beyond.

5.3. Create legal safeguards for debt restructurings and limiting opportunities for holdouts to derail negotiation processes and outcomes

Private creditors hold more than 60 per cent of all debt claims on countries in the Global South. To reduce debt in critically indebted countries to a sustainable level, the participation of private creditors in debt restructuring and debt relief is crucial. However, ensuring effective comparability of treatment remains a key issue. Legal safeguards need to be introduced – or "legal air cover" (Bolton et al. 2020) – for debt restructurings by initiating the coordinated implementation of national legislation that make it more difficult to undermine multilateral debt restructuring agreements through making multilateral agreements binding ex-post on uncooperative creditors. Historical examples include the 2003 UN Security Council Resolution 1483, which was made into law in the US and the UK, making it illegal to file claims during Iraq's debt restructuring.

2 For elaboration of several of these recommendations see Jensen, 2022.

5.4. Increase incentives for private creditor participation in reprofiling and restructuring, respecting the principle of comparable treatment of creditors

The G7 governments should use their influence in the IMF, G20, Paris Club and multilateral development banks to encourage appropriate organisation and classification of private creditor groups, and constructive consultations between debtors and private creditor groups, when undertaking reprofiling/restructuring operations. In addition, they should provide technical assistance to sovereign debtors to prepare for and undertake negotiations with private creditor groups (and with individual creditors when necessary).

5.5. Initiate a dialogue with sovereign debtor groups representing climate-vulnerable nations

Concessional financing for this group of countries should be increased so that they can invest in climate mitigation efforts without having to increase their level of indebtedness. Several sovereign debtor groupings, including the Vulnerable Twenty (V20), Group of Ministers of Finance of the Climate Vulnerable Forum and the Alliance of Small Island States (AOSIS), have put forward proposals for debt relief. The V20 (Ramos et. al.2022) called for a "concerted effort" by multilateral agencies such as the World Bank Group and regional multilateral development banks to act as guarantors of restructuring. A decrease in debt would allow these countries to allocate resources in climate-related global public goods that also benefit advanced economies.

5.6. Reform and improve the Common Framework and expand eligibility

The Common Framework should be reformed and improved and broaden admission of heavily indebted countries. Debt service payments should be suspended and IMF's 'lending into arrears' policy should be upheld for debtor countries undergoing debt treatment in good faith. This will not only induce continued participation of creditors and observance of a reasonable timeline, but might also remove reluctance in debtor countries being fearful of lower ratings.

5.7 Financial support should strengthen the SDGs

Financial support by the IMF is only provided if a country's debt is considered to be sustainable, or if there is a convincing way restoring a sustaining debt level, in the form of financial assurances in terms of loans and debt write offs, and in commitments by countries to reform as part of an IMF-supported country program. It is primordial that transparency and solidity of financing commitments are increased, including on their specific terms and the lending entities they cover. This would protect vulnerable countries from having their IMF program go off-track, with a significant social and ecological impact, as financing assurances fail to materialize in due time (Ghosh 2023, van der Hoeven and Vos, 2022).

5.8. Pay careful consideration to 'debt for development swaps'

There are a multitude of 'debt for development swap' proposals mostly related to climate, nature, and the environment, based on an understanding that creditors agree to debt write-offs in return for promises that saved debt service payments are to be spent on nature conservation, or investments in climate. However, these debt for development swaps have been mostly small and did not necessarily contribute to debt sustainability. They are therefore unlikely to be an effective alternative to a comprehensive debt restructuring in countries with unsustainable debt.

5.9. Use and support the development of state-contingent debt instruments and expand the use of collective action clauses

While by no means a panacea for avoiding debt distress, one way of helping countries better manage economic volatility - often coming through external or exogenous channels – _and reducing the probability of debt distress is to make use of collective action clauses or state-contingent debt instruments (SCDIs). The current situation characterized by high economic uncertainty and need for debt restructurings has led some proponents to suggest that now is a good time to deploy them (Volz, 2022a). While SCDIs will not be attractive/preferred instruments for all countries and cannot substitute for sound fiscal management and reform, they have the potential to improve public debt management, especially in countries with high exposures to external shocks such as from trade, financial flows or natural disasters and climate change. But despite the many theoretical benefits of SCDIs, they have not yet reached a significant scale, among other reasons due to low liquidity, issues of pricing and measurement of triggers. The current debt restructuring outlook and high level of economic uncertainty, however, offer an opportune moment for the official sector to support their use and act as 'first movers', for instance by including SCDI-clauses in official debt restructurings.

5.10. Prioritise LDCs and other vulnerable countries

Effective international debt restructuring requires additional funding in the form of concessional loans, grants, guarantees and/or specialized funds. Most of the severely debt vulnerable countries today are still relatively small in economic terms. It makes therefore sense to prioritise the most vulnerable countries and expand eligibility criteria depending on further funding.

6. Conclusions

The lack of a consensus on key parameters of the framework for sovereign debt restructurings leads to repeated stalemates. The Global Sovereign Debt Roundtable, launched this year, is a welcome first step towards a more systematic and predictable approach. New statutory bodies such as an independent panel for sovereign debt negotiations and an international bankruptcy court could potentially provide a fair treatment of claims while protecting the sovereignty of debtor countries. Adopting a statutory mechanism for sovereign debt restructurings may not be feasible in the short-term. Thus, it is important to improve the current contractual approach and increase the use of enhanced collective action clauses in sovereign bonds, as well as adopt majority-voting provisions in non-bonded debt instruments. Issues related to collateralized debts and the lack of transparency of some commercial and official claims underpin the need for a reinforcement of ongoing debt transparency initiatives. Multilateral development banks play a vital role in financing countries' development, and it is important to emphasize the need for enhancing their lending capacity. This includes the implementation of the recommendations of the G20-mandated independent review of multilateral development banks' Capital Adequacy Frameworks and general capital increases where necessary. Re-channelling of SDRs and wider use of guarantees as additional tools to fund SDGs or resilience initiatives are encouraged. The international community should urgently improve the method, the process and speed of debt relief to developing countries. The process should begin with establishing a country-owned macro-fiscal framework, including an economic recovery strategy and realistic fiscal inputs. Prolonged debt distress harms both the country and the lenders. The debt relief process should be clear and agreed upon, and inclusive of all relevant stakeholders, including the private sector, to build trust and foster creative solutions. There needs to be an efficient allocation of different financing sources, including compensation for losses and damages and provision of concessional financing for both climate adaptation and mitigation. This should be in addition to a mechanism for developed countries to transfer resources as payment for historical carbon debt owed to developing countries. Stronger preventive actions are called for to avoid future debt crises. Countries should be incentivized to increase their debt management capacity, have full legal and financial details of all their debt, including those of state-owned entities, and regularly interact with their creditors.

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