

**Follow-up on the High-Level Event on Financing for Development in
the Era of COVID-19 and Beyond
Discussion Group IV: “Debt and COVID-19”
Background Document**

This draft paper presents a basis for discussion for the “fourth discussion group on debt vulnerability” as follow-up on the High-Level Event on Financing for Development in the Era of COVID-19 and Beyond. The discussion group is led by the African Union, the Islamic Republic Pakistan, and the Kingdom of The Netherlands and facilitated by UN-DESA, UNCTAD and the Executive Office of the Secretary General. This draft paper forms the point of departure for co-leads, member states, UN organizations and other expert organizations to provide policy options to find structural solutions for current debt vulnerability challenges.

Background

COVID-19 and its economic fallout are exacerbating already high debt risks. The international community has taken action to provide relief – through the G20 debt service suspension initiative (DSSI), and debt relief by the IMF for 25 countries from the Catastrophe Containment and Relief Trust. But additional debt relief and emergency financing may be needed to avoid widespread defaults and facilitate investments in recovery and the SDGs.

Menu of policy options

The menu of options is organized in two broad categories: first, the immediate crisis response, including standstill on debt service and proposals to expand it; and second, longer-term solutions to achieve debt sustainability while creating fiscal space to invest in the SDGs. This is in line with the approach highlighted by the Secretary-General in his report, “Debt and COVID-19: A Global Response in Solidarity”: (i) a full standstill on all debt service (bilateral, multilateral and commercial) for all developing countries that request it; (ii) debt relief for highly indebted developing countries to avoid defaults and create space for SDG investments; and (iii) progress in the international financial architecture, through fairer and more effective mechanisms for debt crisis resolution, as well as more responsible borrowing and lending.

1. The immediate response - Expanding the debt moratorium (DSSI) and bridging short-term liquidity crises

Estimates suggest that had all eligible countries participated, DSSI would have freed around USD 12 billion (currently about half of all eligible countries have applied for DSSI participation while some countries have indicated that they will not seek relief under the initiative). Proposals to expand the moratorium include:

- ***Extending the date of the existing moratorium beyond end-2020***
- ***Changing eligibility criteria from income level to debt vulnerability.*** The current DSSI relies on income levels to determine eligibility. This has left many highly indebted countries without access (for example, six middle-income SIDS, with average debt service of over 40 per cent of public revenue prior to the crisis, are not eligible). Basing the eligibility criteria on the degree of debt vulnerability rather than income can be a necessary expansion of the DSSI. The Discussion Group could consider specific proposals for such eligibility criteria.

- **Examining impact on credit ratings.** The DSSI should help countries' debt sustainability by providing needed liquidity. Nonetheless, credit rating agencies have put some DSSI eligible countries on negative ratings watch, in part due to the possibility of private creditors joining DSSI and triggering cross defaults. It would be important to clarify the impact on credit ratings to ensure full participation in the initiative. *(See also Discussion Group V on Private Creditors)*
- **Include debt owed to international financial institutions in the standstill.** Between May 1st and end-2020 countries eligible in the DSSI owe around \$5 billion to multilateral development banks. How this impacts MDBs' credit ratings and ability to lend to countries during the crisis needs further analysis, including on whether: a net-present-value-neutral basis standstill, with creditors fully repaid, would indeed significantly impacting their AAA credit ratings, and whether granting debt payment suspensions would impact MDB's implied preferred creditor status (as this is not a legal issue, it would be something to discuss with rating agencies); whether it would reduce resources available to lend, particularly from concessional windows (i.e. how much of these funds would be repaid). Further analysis should show whether or not a suspension of payments to IFI would lead to a further downgrade of the sovereign's credit rating. Alternatively, MDBs could provide new financing at close to zero interest rates (or the same interest rate used in the NPV calculation) to cover upcoming payments, as this should be equivalent to the moratorium on a cash flow basis.
- **Enhance private sector participation** *(See discussion group V)*

2. Longer-term solutions: debt relief, improvements to the international debt and financial architecture

Debt relief: As debt vulnerabilities continue to increase, a more coordinated approach to debt restructuring may be needed. Lessons learnt from previous broad relief initiatives should be taken into account, notably the Highly Indebted Poor Countries (HIPC) and multilateral debt relief initiative (MDRI) provide the historical precedent of writing down debt to sustainable levels to provide space for development investments for low-income countries. Since these initiatives, public debt management capacities have increased, yet this has not prevented the upcoming debt crisis from arising. In finding solutions, the creditor and debtor landscapes should be taken into consideration and closely coupled to initiatives to build back better and bringing countries back on track for achieving the SDGs. As the current crisis evolves, it should be assessed what types of solution are needed. The following approaches could be used:

- **Debt swaps** would channel debt service payments into SDG and climate investments or build-back better programs. As debt swaps require continued payment (albeit into Covid-response measures, the SDGs or climate action rather than debt servicing), they are helpful for countries that are highly indebted, but do not have unsustainable debt burdens. This could include swapping outstanding debt into SDG or climate bonds, for which standards could be developed.
- **Official creditors could exchange debts to apply more concessional terms and reduce debt service in the short run, and better share risks in the medium-term.** For example, official bilateral creditors could apply IDA-terms to their credits to least developed and other vulnerable countries. Debt rescheduling that postpone official bilateral debt service due in 2020-2022 to later years [could free up \\$32.7 billion](#).

- **State-contingent debt instruments** could also be systematically used by official and private creditors and borrowers to include relevant state contingent elements—for terms of trade shocks, disasters (e.g. hurricane clauses), or others—to help countries better manage future shocks.
- **A fund to buy back outstanding stock** of external debt issued on commercial terms could also be considered (see Group V).

Strengthened debt transparency and management: Timely and comprehensive debt data are a prerequisite for effective management of public liabilities, informed borrowing and investment decisions, and for identifying risks of debt crises and limiting their impact. The Addis Ababa Action Agenda already calls for more transparency and better debt sustainability analyses. Solutions include improving debt transparency, better debt sustainability analyses, improving debt management, including of collateralized debt, and more local currency lending.

Sovereign debt restructuring architecture: The Addis Ababa Action Agenda (see Annex) calls for a timely, orderly, effective, and fair sovereign debt restructuring, while restoring public debt sustainability and enhancing the ability of countries to achieve the SDGs. Over the years, several proposals have been developed to this end. These include:

- **Continued improvements to market-based approaches**, such as improved contractual terms and greater use of state-contingent debt instruments (such as linking future payments to GDP growth, or hurricane clauses – see previous points on debt relief), including by official creditors.
- **Further development of soft law principles**, including principles for both fair restructuring and for responsible borrowing and lending to prevent debt crises, and their increasing use by adjudicative bodies—national courts, for example—to guide decision-making.
- **Establishing a sovereign debt forum**, which would provide a platform for discussions between creditors and debtors, in the context of SDG debt relief. It could facilitate further steps such as: agreements on voluntary stays; coordinated rollovers such as in the Vienna Initiative; and other measures.
- **Proposals for statutory approaches**, ranging from arbitration or mediation to a sovereign debt restructuring mechanism (SDRM). As contracts cannot contain all contingencies, sovereign debt restructuring based on “market mechanisms” will likely remain ad hoc and messy. A statutory mechanism would bring together creditors from across creditor classes. However, it faces challenges, including limited political support.

Annex I Financing for Development outcomes on sovereign debt issues

The Financing for Development outcomes (Monterrey Consensus (MC), Doha Declaration (DD), and the Addis Ababa Action Agenda (AAAA)) contain actions and commitments on debt sustainability:

Principles of shared responsibility:

- Debtors and creditors must work together and share the responsibility for preventing and resolving unsustainable debt situations. [MC para 47; AAAA 97]; Maintaining sustainable debt levels is the responsibility of the borrowing countries; however, lenders also have a responsibility to lend in a way that does not undermine a country's debt sustainability. [AAAA 97]
- We will work towards a global consensus on guidelines for debtor and creditor responsibilities (and fair burden sharing) in borrowing by and lending to sovereigns, building on existing initiatives. [MC 51, AAAA 97]

Debt sustainability analysis, transparency, and links to global goals/the SDGs:

- We need to strengthen information-sharing and transparency for debt sustainability assessments [DD 65; AAAA 96]
- Debt sustainability frameworks should give due weight to the development needs of debtor countries, including benefits from expenditures and investment that have long-term social and economic returns. [Doha 66]
- Invite the IMF and World Bank to continue strengthening their analytical tools for sovereign debt management in an open and inclusive process with the UN and other stakeholders. [AAAA 95]
- We welcome the continuing activities in [...] promoting public availability of data on public and publicly guaranteed sovereign debt and on the total external debt obligations of economies, and more comprehensive quarterly publication of debt data. We encourage all Governments to improve transparency in debt management. [AAAA 96]

External shocks

- We encourage consideration of further debt relief steps, where appropriate, and/or other measures for countries affected by external shocks, as feasible. [AAAA 102]
- We stress the need to consider fundamental changes in debt sustainability caused by natural catastrophes, severe terms of trade shocks or conflict, when making recommendations, including for debt relief, as appropriate. [MC 50]

Principles for debt restructuring

- Debt restructurings should be timely, orderly, effective, fair and negotiated in good faith [AAAA 98] with equivalent treatment of all creditors, just treatment of creditors and debtors, fair burden sharing, and legal predictability in debt resolution.[MC 51, DD 58, 60]
- A workout from a sovereign debt crisis should aim to restore public debt sustainability, while preserving access to financing resources under favourable conditions. [AAAA 98]
- We encourage efforts towards a durable solution to the debt problems of developing countries to promote their economic growth and sustainable development. [AAAA 98]
- We further acknowledge that successful debt restructurings enhance the ability of countries to achieve sustainable development and the sustainable development goals [AAAA 98]; Debtors' national policies and strategies linked to attaining the internationally agreed development goals should be taken into account [DD 63]

- We encourage efforts towards a durable solution to the debt problems of developing countries to promote their economic growth and sustainable development. [AAAA 99]

Safeguarding ODA:

- We encourage donor countries to take steps to ensure that resources provided for debt relief do not detract from ODA resources intended to be available for developing countries. [MC 51, DD 57]