T7 Task Force Sustainable Economic Recovery

POLICY BRIEF

ADDRESSING THE DEBT CRISIS IN THE GLOBAL SOUTH: DEBT RELIEF FOR SUSTAINABLE RECOVERIES

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Abstract

A debt crisis is looming in the Global South. High levels of public debt service and insufficient fiscal and monetary space are threating recoveries and impeding much-needed investments in climate resilience and the Agenda 2030. This policy brief makes seven recommendations for the G7 to address the debt crisis in the Global South and provide all countries with the opportunity to invest in sustainable recoveries: (1) Reinforce efforts to increase transparency of public and private sovereign debt. (2) Push a reform of the International Monetary Fund (IMF) and World Bank's Debt Sustainability Analysis (DSA) to fully include climate and sustainability risks and investment needs. (3) Encourage the IMF to create an option for all sovereign debtors to request an updated DSA as a basis for negotiations with its public and private creditors. (4) Create legal safeguards for debt restructurings and limiting opportunities for holdouts to derail negotiation processes and outcomes. (5) Increase incentives for private creditor participation in debt reprofiling and restructuring, respecting the principle of comparable treatment of creditors. (6) Initiate a dialogue with sovereign debtor groups representing climate-vulnerable nations. (7) Assure policy coherence by fostering the alignment of new debt issuance with the climate and sustainability targets.

Challenge

A debt crisis is looming in the Global South. According to the International Monetary Fund (IMF), the share of low-income countries that are at high risk or already in debt distress has doubled since 2015, up from 30 percent to 60 percent, with several of these countries facing an immediate need to restructure their debt (IMF 2022, Chabert et al. 2022). But not only low-income countries are feeling the pinch. A growing number of middle-income countries is also suffering from high debt service burdens. Already last year, the United Nations Development Programme estimated that 72 out of 120 low- and middle-income countries faced debt vulnerabilities (Jensen 2021), and the situation has not improved since then. Debt-to-GDP ratios and external debt service as share of government revenue, which had been on the rise already prior to the Covid-19 crisis, have further increased considerably in the two years since the start of the pandemic. The Global Sovereign Debt Monitor 2022 published by MISEREOR and erlassjahr.de (2022) estimates that 135 out of 148 countries surveyed in the Global South are critically indebted. 39 countries are described as particularly critically indebted. This is more than three times as many as before the pandemic.

Meanwhile, almost 50 developing countries experienced a downgrade in their sovereign debt credit rating, shutting several of them out of international capital markets (World Bank 2022a). As highlighted by the IMF, the composition of financing is continuing to evolve toward new, more expensive sources (IMF 2022). Monetary tightening in the US and other advanced economies will further drive up the cost of debt and make international refinancing ever harder for those countries that still maintain access to Eurobond markets. The effects of the war in Ukraine on the world economy, and on food and commodity prices in particular, are likely to significantly worsen the social and economic situation in many developing and emerging market countries, further undermining debt sustainability. Whereas oil, gas, and grain exporters may get temporary relief in the short term, many developing and emerging market countries – including in Sub-Saharan Africa – are net fossil fuel and grain importers. Therefore, those countries get hit by a triple crisis of oil and grain price hikes and by US interest rate hikes.

High levels of public debt service and insufficient fiscal and monetary space have constrained the crisis responses of most low and middle-income economies. While advanced countries were able to implement extremely expansionary fiscal and monetary policies in response to the pandemic crisis, few countries in the Global South had this option. In many low- and middle-income economies, external public debt service has been greater than health care expenditure and education expenditure combined (Munevar 2021). In its October 2021 World Economic Outlook, the IMF warned of a dangerous divergence in economic prospects across countries due to large disparities in vaccine access and in the policy space that governments have to support the economy (IMF 2021). Talk of “building back better” remains hollow if governments are struggling to stay afloat.

The precarious debt situation is not only threating recoveries. It is also impeding much-needed investments in climate resilience and the Agenda 2030. According to the Intergovernmental Panel on Climate Change Sixth Assessment Report (IPCC 2022), these investments are urgent. Governments must climate-proof their economies and public finances or potentially face an ever-worsening spiral of climate vulnerability and unsustainable debt burdens (Volz, Beirne et al. 2020). There is a danger that vulnerable developing countries will enter a vicious circle in which greater climate vulnerability raises the cost of debt and diminishes the fiscal space for investment in climate resilience (Buhr et al. 2018, Beirne et al. 2021). As financial markets increasingly price climate risks, and global warming accelerates, the risk premia of these countries, which are already high, are likely to increase further. The impact of Covid-19 on public finances risks reinforcing this vicious circle. In many countries, including many Small Island Developing States, high public service is crowding out critical investment that is needed for climate-proofing economies and enabling a green, resilient, and equitable recovery.

During the COVID-19 pandemic, the G20 has established new instruments to prevent and manage debt problems in developing countries. To address short-term liquidity problems, the G20 launched the Debt Service Suspension Initiative (DSSI) – a debt moratorium. The DSSI, which ended in December 2021, provided a mere USD 13 billion in temporary relief to 48 low-income countries through a suspension of debt-service payments owed to their official bilateral creditors (G20 2022). Private creditors, who hold the biggest share of developing country debt, did not participate at all. And both interest and amortisation payments have to be made after a repayment period of five years and a one-year grace period in a net present value neutral manner.

To cope with protracted liquidity and insolvency problems, the G20 has put in place the Common Framework for Debt Treatment beyond the DSSI (Common Framework) to restructure and, if necessary, forgive debt in low-income countries (G20 / Paris Club 2020). The Common Framework applies to the same 73 countries eligible for DSSI treatment and thus excludes middle income countries. A major concern is that the Common Framework lacks a mechanism to incentivise private creditor involvement and that, by dealing with countries on a case-by-case basis, it fails to address the first-mover problem for participating nations. As pointed out by the World Bank (2022b, p. 60): "The lack of measures to encourage private sector participation may limit the effectiveness of any negotiated agreement and raises the risk of a migration of private sector debt to official creditors." The Common Framework lacks incentives and mechanisms to bring debtor governments and private creditors together. The uptake to date has been poor for fear that sovereign downgrades would lead to a long-term loss of access to international capital markets. One-and-a-half years after the Common Framework was launched only three countries – Chad, Ethiopia, and Zambia – have applied for debt treatment, and none of them has successfully completed debt restructuring.

One of the policy priorities under the German G7 presidency is to "strengthen the global financial architecture and ensure that the G20 Common Framework for Debt Treatments is implemented effectively" (G7 2022, p. 6). Against this backdrop, this policy brief advances seven concrete proposals for the G7 to make the Common Framework work so that it becomes a tool to effectively address the debt crisis and allow all countries the opportunity to invest in swift recoveries from the pandemic and the chance to achieve the shared goals of the Agenda 2030.

Proposals

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. In the context of the Common Framework and building on commitments to debt transparency already made by the G20, the Institute of International Finance (IIF), the IMF and MDBs, these actors should work with sovereign debtors and bilateral and private creditors to enhance the sharing of detailed sovereign debt information, with provisions for the confidentiality of commercially sensitive information. The G7 already made strong advances under the UK presidency related to disclosing terms of bilateral direct sovereign lending, but more can be done as information remains limited and scattered. The Debt Transparency Initiative (DTI), which was launched by the OECD in 2021 to operationalise the IIF Voluntary Principles for Debt Transparency by collecting, analysing, and reporting on relevant public sector debt data from low-income countries, has not progressed sufficiently. The G7 countries should request private lenders to fully participate in the DTI and disclose their lending to sovereigns. Debtors and creditors should include information about collateralised debt (and other long-term sale or resource-backed arrangements amounting to collateralised debt), and debt to state owned enterprises and sub-national governments backed, de jure or de facto, by the sovereign.

2. Reform the IMF and World Bank's Debt Sustainability Analysis (DSA) to fully include climate and sustainability risks and investment needs. One main weakness of the Common Framework is that debt restructuring and / or relief are not linked to sustainability goals (Volz, Akhtar et al. 2020, Berensmann et al. 2021). Under the Common Framework the assessment of debt sustainability is based on the IMF-World Bank DSA, creditors' assessment, and parameters (G20 2020). However, the IMF-World Bank DSA does not sufficiently consider sustainability criteria and climate risks even though these pose significant threats to the debt sustainability of countries (Beirne et al. 2021; Volz 2021; Volz et al. 2021). Accounting for climate risks and SDG spending needs is fundamental for making sure that DSAs properly capture potential fiscal impacts of climate change and the investment needs of developing and emerging economies to achieve the Agenda 2030. Although the IMF has gradually started to include climate risks in its analysis, the DSAs currently conducted by the IMF and the World Bank fail to sufficiently account for climate and other sustainability risks, while overlooking vital investment needs for climate adaptation and resilience or achieving the SDGs (Volz and Ahmed 2020; Volz, Akhtar et al. 2021, Maldonado and Gallagher 2022). Since 2018, the IMF has started to include a climate stress test in its DSAs for low-income countries, focusing primarily on physical risk, such as climate-induced natural disasters. The Fund is currently working on enhancing its Debt Sustainability Framework for Market Access Countries and plans to include more explicitly the repercussions of climate change on debt sustainability. These are important moves in the right direction, but DSAs also need to systematically account for risks of rising cost of capital, stranded asset risk, as well as investment needs to implement development strategies that will reduce dependency of the economy and of public revenues on fossil fuel-related activities, including fossil exports. Moreover, DSAs should also account for other sustainability risks, such as nature risk (Kraemer and Volz 2022), and investment needs to make progress towards achieving the Agenda 2030. The current five-year horizon for DSAs is too limiting. DSAs should incorporate intermediate and longer-run climate and sustainability risks and spending needs to transform to adaptive, resilient, and zero carbon economies. The G7 should hence promote a revamp of the IMF-World Bank DSAs and make sure that the Common Framework considers climate vulnerability and critical investment needs.

3. The IMF should 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 to support restructuring operations, there is not yet an option for a sovereign debtor to request an updated DSA to support negotiations with its creditors. These updated DSAs should incorporate sustainability risks and investment needs to achieve the Agenda 2030 and extend until 2030. DSA assumptions should be explicit and transparent, and the IMF should be prepared to explain its analysis and conclusions to both sovereign debtors and public and private creditors. The IMF also should expand the use of scenarios in its DSAs, to reflect more clearly how market developments and policy decisions (including decisions that could enhance debtor assets) could affect debt sustainability. For their part, sovereign debtors should cooperate fully and provide as comprehensive an accounting as possible of all forms of debt that create sovereign liabilities.

4. Creating legal safeguards for debt restructurings and limiting opportunities for holdouts to derail negotiation processes and outcomes. Private creditors hold more than 60 percent 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. The G7 play a key role in enforcing comparability of treatment, including through the use of regulatory and legislative options. Many private creditor institutions are based in G7 countries, and a large number of contracts are concluded under London or New York law. Therefore, the G7 could agree on measures and goals that can guarantee the binding inclusion of private creditors and make the Common Framework more effective and attractive. The governments of the G7 recognise that the non-participation of private creditors is one of the main obstacles to solving the debt crisis. However, instead of using their powers to legislate, they are unilaterally relying on moral appeals with little success so far. Instead of waiting to see whether the G20's attempts at regulation in their current form will eventually bear fruit, decisive political action is urgently needed to finally set the course for creating sustainable solutions to the global debt crisis. The German government has created the political basis for this in its coalition agreement. There, the German government committed to the goal of creating a codified sovereign debt workout mechanism and implementing debt relief for particularly vulnerable countries. The German G7 presidency offers an important opportunity to put words into action. The G7 should discuss legal safeguards – 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 by 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, and the UK's Debt Relief Act 2010, which enforced Heavily Indebted Poor Countries' debt relief on private creditors.

5. 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 MDBs 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). All parties participating in good faith restructuring should publicly commit to adhere to the principle of comparable treatment (with the exception of recognised preferred creditors). If some creditors believe that other creditors (whether private or public) are receiving preferential treatment, these may be required to seek the same treatment, as creditor doubt about the fairness of the process will undercut efforts to reach agreement on restructuring terms. Therefore, a shared commitment to comparable treatment, transparency of treatment, and credible mechanisms for ensuring comparable treatment are essential for achieving timely, substantial, and equitable participation by private creditors. IFIs and other public creditors should demonstrate willingness to condition the terms of their ongoing support on comparable treatment for all major creditors. Negotiated restructurings lead to shorter exclusions from markets and lower interest rate premia. To incentivise participation of private creditors in debt restructurings, the G7 should encourage the World Bank to create a guarantee facility that would provide credit enhancement for restructured debt, building on the successful experiences with debt restructurings involving Brady bonds in the late 1980s and the 1990s (Volz et al. 2021). Such a guarantee facility could also facilitate the return to markets of developing countries at relatively low interest rates by providing credit guarantees on new sustainability-linked bonds issued post-default.

6. Initiate a dialogue with sovereign debtor groups representing climate-vulnerable nations. 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. In December 2021, AOSIS announced a *Finance for Acting on Climate in the Eastern Caribbean* (FACE) initiative, proposing a scheme for debt-for-climate swaps. Ahead of the 2021 United Nations Climate Change Conference in Glasgow, the V20 finance ministers – which represent 55 climate-vulnerable nations with a total of 1.4 billion people – issued a statement calling for "a major debt restructuring initiative for countries overburdened by debt – a sort of grand-scale climate-debt swap where the debts and debt servicing of developing countries are reduced on the basis of their own plans to achieve climate resilience and prosperity" (V20 2021, p. 2). Concretely, the V20 (2021, p. 3) called for a "concerted effort by multilateral agencies such as the World Bank Group and regional multilateral development banks to act as guarantors of restructured debt through guarantee facilities for inclusive, sustainable, and resilient recovery efforts." While private creditors have been well represented through their industry associations, the voices and proposals of climate-vulnerable countries have not been sufficiently heard. The German G7 Presidency should invite representatives of climate-vulnerable sovereign debtor groups to the G7 Summit and initiate a dialogue on debt restructuring options for climate-vulnerable nations.

7. Assure policy coherence by fostering the alignment of new debt issuance with the climate and sustainability targets. Building on work initiated by the G20 (IMF 2017), the G7 should encourage the IMF and the major multilateral development banks to make a concerted effort to promote the widespread adoption of sovereign state-contingent instruments to support better public debt management, the climate-proofing of public finances, and the achievement of more ambitious sustainability outcomes. The use of risk-linked sovereign instruments such as cat bonds or resilience bonds and embedding disaster risk clauses in sovereign debt contracts would be an important way for governments, especially in highly climate-vulnerable countries, to mitigate climate risks and scale up investment in resilience (Volz 2022). This should be complemented by introducing climate change considerations in fiscal and financial risk management tools (Monasterolo et al. 2021). Moreover, instruments such as sustainability-linked bonds that incentivise sustainability-oriented policies and investments could help to bring about better sustainability outcomes and contribute to greater debt sustainability. The G7, along with the G20, the IMF, the World Bank and regional development banks should hence promote the issuance of new sustainable sovereign debt instruments to address the COVID-19 recovery crisis, and lay the foundations for sustainable development, following the example of Chile, which in February 2022 was the first country to issue sustainability-linked sovereign bonds. In order to avoid greenwashing and assure transparency on the use of the bonds' proceeds (towards sustainable investments), a process of monitoring and implementation of the green or sustainability-linked sovereign bonds issuance should be put in place.

Implementation

The debt crisis in the Global South is reaching a critical juncture. A worsening global economic outlook, tightening monetary conditions in the US, and rising food and energy prices are likely to significantly worsen the social and economic situation and further undermine debt sustainability in many developing and emerging market countries. Economic history shows that a protracted response to debt crisis leads to worse outcomes and higher costs. Postponing inevitable sovereign debt restructurings and doing 'too little too late' will cause prolonged underinvestment in health, education, and infrastructure, and risk turning what was supposed to be a 'Decade of Action to deliver the Global Goals' into a lost decade for development and climate action. The international community needs to quickly come up with a framework for addressing debt sustainability problems to provide all countries with the fiscal space to respond to the Covid-19 crisis and invest in the SDGs and climate resilience. The role of the G7 will be fundamental in making this happen.

The IMF has called for improvements to the G20 Common Framework and highlighted the urgency of putting in place mechanisms that ensure coordination and confidence among creditors and debtors (Chabert et al. 2022). The G7 now has the opportunity to initiate critical steps to turn the Common Framework into a useful structure for delivering speedy and efficient debt relief for countries that need it. This will not only require the G7 to engage with China, which is now the largest official bilateral creditor in more than half of the DSSI countries (Chabert et al. 2022). Crucially, the G7 need to engage private creditors, which hold more than 60 percent of all debt claims on countries in the Global South. A combination of positive incentives ("carrots") and pressure ("sticks") is needed to bring private creditors to the negotiation table (Volz et al. 2021). Moreover, the G7 need to engage with sovereign debtor groups, several of which have put forward proposals for debt relief that would enable debtor countries to invest in climate resilience and prosperity. As an immediate step, the German G7 Presidency should therefore invite representatives of climate-vulnerable sovereign debtor groups to the G7 Summit and initiate a dialogue on debt restructuring options for climate-vulnerable nations.

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