# Policy Brief

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Task Force 1: Development and Economic Prosperity

# Policy Actions for Alleviating Debt Distress and Debt Sustainability Risks in the Global South

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## Abstract

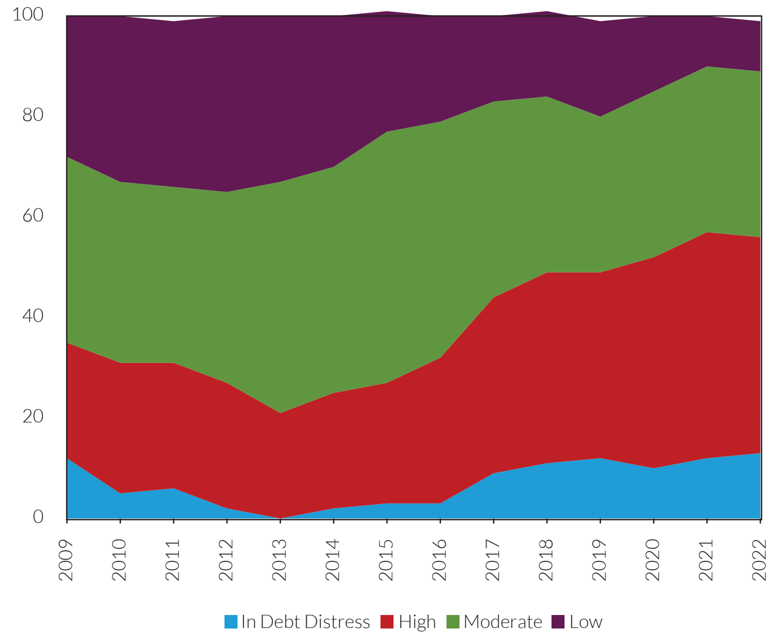
A higher debt burden combined with a fragile growth outlook has amplified debt sustainability risks in low- and middle-income developing economies. These risks are exacerbated by the effect of climate risk vulnerability on the cost of sovereign borrowing. Set against the context of global debt crisis concerns, driven by debt distress exposures and default risks in the Global South, this policy brief proposes actions for the Group of Seven (G7) to address these challenges. This includes proposals on: (i) special drawing right (SDR) allocations and enhancing the operational efficiency of SDR disbursements, (ii) reform of the Group of Twenty (G20) Common Framework; (iii) a new Comprehensive Debt Relief Initiative; (iv) progress on incorporating climate risk exposures in debt sustainability assessments by the International Monetary Fund and the World Bank; (v) mechanisms to bolster resilience to external debt vulnerabilities; and (vi) enhancing the Sustainable Development Finance Policy in multilateral development banks.

## Challenge

Around 60% of the world's low-income countries are either in debt distress or at high risk of it (Figure 1), while around 25% of middle-income countries are also facing debt distress risks (International Monetary Fund 2023). This increases the urgency for debt restructuring. Weakening global economic growth and higher global interest rates due to persistent inflationary pressure around the globe have pushed many low-income economies into fiscal, currency, and debt sustainability risks and to the brink of debt distress (World Bank 2023). In the period following the global financial crisis of 2007–2008, global monetary policy accommodation and lower sovereign borrowing costs led to rising levels of debt accumulation in the face of economic development challenges, as well as financing for the coronavirus disease (COVID-19) policy response more recently. As shown in Figure 2, debt in low-income countries (and in emerging market and middle-income economies (EMEs)) rose sharply during 2013-2020. For low-income countries, debt is projected to stabilize up to 2027, albeit at elevated levels, while for EMEs, further debt rises are projected over this period.

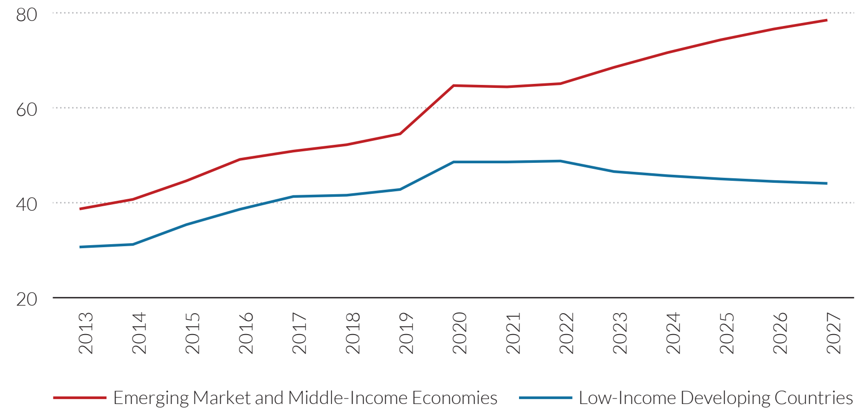
Combined with a positive growth outlook, debt sustainability concerns were less elevated in the years prior to the COVID-19 pandemic. Interest rate growth differentials, a broad indicator of fiscal sustainability, have gradually switched from negative to positive since the pandemic (i.e., the prevailing cost of borrowing is higher than the rate of growth in the economy). Higher interest rates and lower economic growth, along with widening current account deficits and debt service

**Figure 1:** Debt Vulnerabilities of Low-Income Countries (% of all)




Source: IMF Low-Income Country Debt Sustainability Analysis (LIC DSA) Database, 2022 (accessed 23 February 2023).

**Figure 2:** General Government Gross Debt
(% of gross domestic product)




Note: Projections are shown for 2023–2027.
Source: International Monetary Fund (2023).

costs, imply that many economies may face debt sustainability challenges (World Bank 2023). These fiscal risks were compounded by constrained fiscal space due to the pandemic and support for economies owing to amplified inflationary pressures in food and commodities and the cost-of-living crisis in 2022.

On external debt, economies with high levels of external debt denominated in US dollars are particularly exposed, with debt sustainability threatened by surges in the local currency value of the debt and rising debt servicing costs. For EMEs globally, with the exception of emerging European economies, over 80% of external debt is denominated in US dollars, implying significant vulnerability to shifts in exchange rates relative to the US dollar. The recent tightening in global financial conditions and elevated inflationary expectations have made it difficult for the heavily indebted and poor economies to garner external finance, prompting a stronger role for international financial institutions to not only act as lenders of last resort but also incentivize countries to implement policies that strengthen debt management and provide tools to encourage private investment and the mobilization of capital. Policy action is needed at this crucial juncture to alleviate strains on global debt dynamics and minimize the risks of debt distress becoming more pronounced and default materializing.

## Proposals

The Group of Seven (G7) can have a key role to play in alleviating debt distress and debt sustainability risks in developing countries through both championing a more effective implementation of existing multilateral mechanisms and initiatives on debt relief and debt restructuring and proposing new, more targeted measures. In this way, the G7 can be instrumental in averting a wider global debt crisis, while this can also help to mobilize finance in developing economies towards the achievement of global goals on sustainable development.

## Special Drawing Right (SDR) Allocation and Transfer to Heavily-Indebted Poor Countries

In 2021, following an SDR allocation of $650 billion to all International Monetary Fund (IMF) members due to the pandemic, Group of Twenty (G20) countries pledged to channel $100 billion of this amount to the poorest and most vulnerable countries. An SDR allocation provides immediate relief for eligible countries (Kharas and Dooley 2021), and the 2021 SDR allocation boosted liquidity and reserves around the world. About $275 billion of the $650 billion was attributed to emerging market and developing economies, while around $21 billion was disbursed to low-income countries (Pazarbasioglu and Ramakrishnan 2021). While some developing countries kept the allocated SDRs as part of gross international reserves, others used them for relieving constrained fiscal capacity (e.g., Senegal).[1] The $100 billion pledge to reallocate SDRs from G20 countries currently amounts to around $60 billion and is expected to be allocated mainly via the IMF Poverty Reduction and Growth Trust and Resilience and Sustainability Trust.[2] In addition, in order to further support vulnerable countries, operational solutions need to be finalized to support the implementation of SDR transmission through key stakeholders, such as the multilateral development banks (MDBs) while still preserving the SDR reserve asset status, as MDBs can leverage the allocated resources.[3] Given the insufficient progress, G7 leaders should renew further support for the $100 billion pledge in 2023 and also for the actual transfer of the SDRs to those economies most in need, particularly in Africa. G7 economies should also consider transferring the unused share of their own allocations to heavily indebted poor countries. Together with the G20, the G7 should set up a working group to accelerate the removal of operational barriers to SDR transfers, including reforms on prevailing regulatory and legal obstacles to SDR reallocations. In addition, G7 leaders should call for a regular SDR allocation and a renewed IMF quota method that would allow higher SDR shares to be allocated to the poorest and most vulnerable countries (Truman 2022).

## Reform of the G20 Common Framework for Debt Treatment

The Common Framework was adopted by the G20 in November 2020 to address insolvency and protracted liquidity problems for low-income countries eligible for support under the Debt Service Suspension Initiative (DSSI).[4] It provides a mechanism for debt relief on a case-by-case basis. There

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[1] Information on IMF members' use or plan to use SDRs is drawn from staff reports on fund arrangements or Article IV consultations published after the implementation of the general allocation of SDRs on 23 August 2021 (https://www.imf.org/en/Topics/special-drawing-right/SDR-Tracker).

[2] An amount of $21 billion from the United States failed to attain congressional approval but is under review (https://www.cgdev.org/blog/quick-rundown-where-we-stand-sdrs).

[3] Operational solutions include: (i) channeling SDRs through SDR-denominated debt issuance to MDBs and (ii) channeling SDRs as hybrid capital for MDBs. Under the second option, SDR holders would invest in an SDR-denominated hybrid debt instrument issued by an MDB and would receive the SDR interest rate that has to be paid to the IMF and a spread. The instrument would be treated as quasi-equity by the MDB according to the accounting rules (International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP) and rating agency criteria. Simultaneously, SDR holders would commit to provide liquidity support where an investor faces balance of payment needs. This would be underpinned by a liquidity support agreement. Donors who cannot participate in the hybrid capital option could contribute to the liquidity support agreement. MDBs would be able to use this increased lending capacity with a threefold or fourfold leveraging effect.

[4] The G20's DSSI was introduced during the pandemic to provide fiscal space to 48 participating low-income countries, whereby almost $13 billion in debt service payments was postponed. The initiative expired in 2021.

are significant operational challenges with implementing the framework, however, with requests for assistance by only 4 countries (Chad, Ethiopia, Zambia, and Ghana) out of the 36 in high debt distress or at risk.[5] While in principle, it can be an effective tool, in practice there are a number of shortcomings. The length of the restructuring process and uncertainty regarding timelines, combined with the lack of debt relief in the interim period, are key factors discouraging participation in the framework (Ahmed and Brown 2022). Moreover, there is a stigma for countries facing debt distress that engaging in the framework could have negative repercussions for sovereign credit ratings (Coulibaly and Abedin 2023). Fragmentation in the creditor base is a further contributory complicating factor (Eichengreen and Gupta 2023). The G7 can push forward on calls for reforms in four main ways: (i) regulation to encourage private sector participation in negotiations; (ii) for countries engaged in debt restructuring negotiations, debt service obligations should be halted to incentivize creditors to speed up the process; (iii) clarity is needed on the comparability of debt treatment across countries; (iv) enhance mechanisms for coordination between creditors and debtors. In order to further encourage private sector participation in debt resolution negotiations, their involvement could be made conditional on IMF sovereign debt restructuring arrangements (Hagan 2020). The G7 should also spearhead renewed efforts on debt transparency, particularly by private creditors. Regulation on disclosures of their sovereign debt lending can help to better operationalize the Organisation for Economic Co-operation and Development's Debt Transparency Initiative (DTI), which was launched in 2021. This can in turn help to enhance the landscape for debt restructuring under the Common Framework. The voluntary nature of the DTI to date has inhibited its effectiveness.

## New Comprehensive Debt Relief Initiative (CDRI)

Debt relief includes actions to reduce, refinance, restructure, or cancel debt. In order to complement the Common Framework, a CDRI is proposed, in which all three main stakeholders, namely (i) bilateral creditors, (ii) foreign commercial banks, and (iii) private creditors (bond holders), share the debt burden and would suspend their debt repayment for a 5–10-year period, depending on the stakeholders. Incentivization mechanisms to engage bilateral creditors to offer debt relief or debt forgiveness and for private creditor participation are key. As regards CDRI implementation, it should be borne in mind that blanket debt relief may not work because the low-income countries must themselves take corrective policy measures, such as on the sustainability of fiscal and current account balances; a case-by-case approach will be needed to address the problems of the poorest and lowest-income countries. Supported by the G7, the IMF, World Bank, and Institute for International Finance (for bonds) would have key roles to play in implementation, along with the country experts nominated by the individual countries. Table 1 provides details on how this can be achieved, including the specific roles to be played by each type of creditor (i.e., bilateral, foreign commercial banks, and private creditors) in contributing to the CDRI.

[5] https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf

**Table 1:** CDRI Stakeholders and Actions

| Type of Creditor | Actions |
|---|---|
| Bilateral creditors | Bilateral creditors may suspend their debt repayment for 10 years. |
| | Bilateral creditors may also consider debt swap arrangements as part of the CDRI. Such debt swap arrangements may take the following shape:<br>• Debt-for-education and health swap<br>• Debt-for-Sustainable Development Goals spending swap<br>• Debt-for-environment/climate change swap<br>• Debt-for-poverty swap<br>• Debt-for-green swap |
| | Bilateral creditors can enter into swap arrangements with debt-ridden nations, selecting one/two or all of the swap arrangements, ensuring that the amounts are sufficient or meaningful for each swap arrangement. |
| Foreign commercial bank creditors | Proposal to suspend the debt repayment of foreign commercial banks for 8–10 years, i.e., a typical business cycle duration. This period of time would help economies in debt distress and facing default risks to alter the trajectory of their economic output and, thereby, improve debt sustainability dynamics. |
| Private creditors | The most difficult and challenging part of the CDRI would be to convince private creditors to extend the debt repayment period. A solution is proposed as follows: Private creditors may extend the maturity of the bond repayment. For example, if the eligible country has floated a sovereign bond in the international debt market for a 5-year tenure amounting to $1 billion and the payment schedule is prepared such that the principal amount and the interest are to be paid back to the bondholders in 5 years, it is proposed that this payment schedule be extended to 10 years instead of 5 years. This would reduce the annual debt repayment burden by 50%. In other words, the bondholders would continue to receive their payments according to the schedule, but the payments would be 50% lower given that the maturity of the bond has been extended to 10 years. |

Source: Authors.

## Incorporating Climate Vulnerability Exposures into Debt Restructuring Schemes and Debt Sustainability Assessments (DSAs)

Economies that face the highest climate risk exposures also incur the highest premia on sovereign bond yields (Beirne et al. 2021). While some progress has been made to include climate risks in the IMF-World Bank's DSAs, such as climate stress tests for low-income countries, greater efforts are needed to incorporate the assessment of climate change vulnerability in a systematic manner for DSAs across all countries (Volz et al. 2022; Maldonado and Gallagher 2022). Given the significant implications of climate risk for the cost of sovereign borrowing, G7 leaders should call for climate risk exposure to be systematically taken into account by the IMF and World Bank in their assessment of debt sustainability and all creditors involved in debt restructuring negotiations.

## Mechanisms to Enhance Resilience to External Debt Vulnerabilities

While borrowing in US dollar-denominated debt will continue to be necessary for many EMEs, policies should aim to reduce exposure to abrupt US dollar fluctuations. These can include debt restructuring and debt servicing schemes that feature currency hedging components, as well as further progress on local currency bond market development (Beirne and Panthi 2023). In addition, capital flow volatility may call for an assessment of the macroprudential policy toolkit, which could help to smoothen exposure to foreign currency debt and maturity mismatches. In addition, structural policies should be aimed at further enhancing the diversification of EMEs in global trade and finance, boosting productivity and long-run growth potential, and insulating economies from terms of trade shocks and spillovers from abroad. In this regard, improving efficiency in the management of public finances, as well as fostering more effective regulation and supervision in the financial sector, will help to bolster EME resilience during episodes of financial distress, including those driven by tightening global financial conditions. As well as measures to support local currency sovereign bond markets in developing economies, and financial market development that can accommodate appropriate hedging of foreign exchange risks, the G7 should call for a more systematic approach to the surveillance of external debt vulnerability at the global level.

## Enhance the Sustainable Development Finance Policy (SDFP) in Multilateral Institutions to Strengthen Public Debt Management

To help low-income and middle-income countries adopt an appropriate toolbox to strengthen debt management and mitigate debt exposure risks, incentives-based approaches are critical, complementing regulation. The allocation of concessional resources from multilateral development actors is an important area where an incentives-based approach can be applied, given that these resources represent an important source of development finance for low- and middle-income countries. These resources are predictable and provided at low or even zero cost. The allocation of concessional resources appears to be a relevant channel to set up appropriate incentives for strengthening public debt management. This approach was recently adopted by the International Development Association (IDA) and the Asian Development Bank (ADB), who have been jointly implementing the Sustainable Development Finance Policy (SDFP) since 2020 in respect of their common beneficiary countries (IDA 2022; ADB 2020). The African Development Bank Group started to implement a sustainable borrowing policy in 2022 (African Development Bank 2022). The SDFP complements other instruments used by international financial institutions to strengthen debt management and mitigate debt sustainability risks. It is an incentive-based system, whereby countries that previously agreed to strengthen debt management, increase debt transparency, or support fiscal sustainability, can receive a higher volume of concessional resources according to their development needs and implement new policy actions. Examples of policy actions include the design of new taxes, the development and publication of a Debt Management Strategy, or measures to promote local currency bond market development. The start of the SDFP was not smooth, given that it coincided with the COVID-19 crisis, where fiscal rules and frameworks needed to be made more flexible. However, the SDFP has proven to be effective, with more than 50 countries implementing new policy actions to make debt practices more transparent, enhance medium-term fiscal frameworks, strengthen domestic revenue mobilization, and reinforce debt management capacity. In addition, the SDFP facilitates synergies with policy-based lending and has helped to add impetus to policy dialogue among national authorities on fiscal and debt-related issues. The implementation of the SDFP was highly supported by the G7 countries when the most recent replenishments of the IDA and Asian Development Fund took place in 2020 and in 2022. G7 countries continue to be key contributors to these concessional windows as they account for more than 50% of contributions. The G7 should ramp up efforts to advocate initiatives whereby more countries are incentivized to opt for policy options aimed at mitigating risk debt distress risks through better and more transparent planning, sustainable diversification of finance sources, and less dependency on external actors. G7 countries should also call for enhanced coordination between development partners when policy actions are discussed with countries' authorities. In addition, G7 countries should encourage multilateral creditors to (i) focus their discussions with countries on more policy actions addressing structural debt vulnerabilities, setting preventive systems to mitigate the risk of indebtedness, and (ii) provide additional technical assistance to strengthen countries' debt management capacities.

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Think7 (T7) is the official think tank engagement group of the Group of 7 (G7). It provides research-based policy recommendations for G7 countries and partners. The Asian Development Bank Institute (ADBI) is the lead chair of T7 under Japan's 2023 G7 presidency.