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Working Group 2

From Debt To Development

POLICY PAPER

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Policy Paper

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Executive Summary

The COVID-19 pandemic increased sovereign debt levels across the world, particularly in developing countries where debt has reached 55 percent of GDP. However, this trend began way before the pandemic such that between 2010 and 2019, the debt-to-GDP ratio of developing countries increased by 13 percentage points. Consequently, there has been a significant rise in the debt servicing burden which has diverted resources from critical public investments, with many developing countries now spending more on interest payments than on health, education, and climate action combined. The shift in debt composition towards non-Paris Club official creditors and non-concessional private creditors has contributed to this rise in debt servicing costs.

The debt vulnerabilities faced by developing countries are rooted in both structural and systemic factors. Weak domestic economies and exposure to external factors increase the risk of debt crises, while the lack of deep domestic capital markets forces them to borrow overseas, thus exposing them to exchange rate risks. Systemic issues include higher risk premiums due to poor credit ratings and the absence of a dedicated agency for addressing sovereign debt matters. These challenges highlight the need for a comprehensive debt relief and prevention framework that adequately considers these issues.

In this policy brief, four areas of reform are identified, for which policy actions are recommended. These areas (outlined in section 3) include short-term debt relief, prevention of debt accumulation, responsible lending and domestic fiscal consolidation. For each of these areas, actions are proposed that need to be undertaken by the international community to fix them.

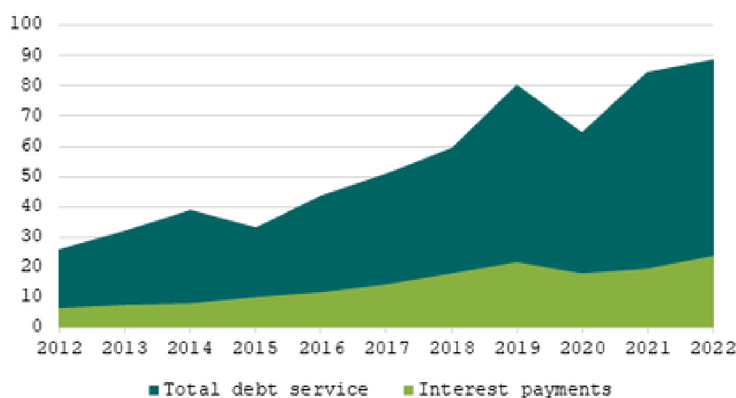
The proposals (presented in section 4) include recommendation for a debt servicing holiday, debt cancellation, debt swaps for development and climate, anti-hold out laws for private creditors, and an independent sovereign debt authority. For debt prevention, the brief proposes reforming the global credit ratings system, promoting the use of state-contingent debt instruments, and increasing availability of concessional financing by MDBs. The brief also promotes the use of guidelines and principles of responsible lending and the adoption of creditor transparency and accountability mechanisms as the means for advancing responsible lending practices. Lastly, capacity building in tax administration is proposed as an area of focus for fiscal consolidation during debt relief initiatives.

1. Debt Vulnerabilities and the Development Agenda

The COVID-19 pandemic has led to a substantial increase in public debt levels in developing countries, now estimated at 55 percent of GDP (1). However, although the pandemic left a big mark, the rising trends in debt accumulation have been there for some time. Looking at the 10 years before the pandemic, the debt-to-GDP ratio of developing countries rose by 13 percentage points, from 35% in 2010 to 48% in 2019. Many developing countries that received significant debt relief under the Highly Indebted Poor Countries (HIPC) initiative have seen their debt levels rise quickly in the years following.

This rise in debt and the associated increase in debt servicing costs have put more than half of all developing economies in or at high risk of debt distress (2). In 2022, debt servicing payments by developing countries reached US$89 billion (Figure 1). One major reason for this is the change in the composition of external public debt which has shifted towards non-Paris Club official creditors such as China and non- concessional private creditors.

Figure 1: Total Debt Service and Interest Payments on External Debt for IDA-Eligible Countries, 2012-22 (US$ billion)



Source: World Bank International Debt Statistics Database

This new sovereign debt landscape presents both short-term and long-term challenges. In the short-term there has been a notable change in the flow of debt funds into developing countries thus posing liquidity challenges for them. In 2022, developing countries experienced net debt outflows of US$185 billion driven by claims by private creditors who took out US$189.4 billion of these transfers as claims on long-term loans (Table 1). Low-income and lower-middle-income countries (LLMICs) have been particularly affected having seen net transfers plummet from $105 billion in 2019 to a mere $20 billion in 2022 (3).

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1. Debt in developing economies | Data Futures Exchange (undp.org)
2. Debt in developing economies | Data Futures Exchange (undp.org)
3. Ishac Diwan and Brendan Harnoys-Vannier, "The collapse of external finance to developing countries", (Finance for Development Lab, 2024)

More importantly, the impact of these outflows goes beyond the short-term liquidity challenges as they also affect the development goals of these countries. The rising burden of debt has diverted essential resources away from critical public investments to the extent that a third of all developing countries spend more on interest payments than on the combined expenditure on health, education, and climate action (4). The UNDP estimates that the average amount of funds that low-income countries spend on servicing interest payments was about 2.3 times more than the spending on social assistance, 1.4 times more than domestic health expenditures and up to 60% of spending on education (5)

Table 1: Net Debt Inflows to Low- and Middle-income Countries, 2012-22 (US$ billion)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				-							-
Net Debt Inflows	612.5	825.9	541.8	323.1	230.9	771.4	569.4	369.0	380.4	555.7	185.0
Long-term	488.6	465.6	406.0	177.3	279.3	438.1	356.6	334.9	373.3	264.3	-94.5
Official creditors	35.6	33.0	51.9	55.9	58.4	59.2	83.7	64.7	123.7	62.7	95.0
Bilateral creditors	16.4	23.8	24.5	14.3	17.3	23.1	20.0	6.1	12.2	11.3	13.6
Multilateral creditors	19.2	9.2	27.4	41.6	41.2	36.1	63.7	58.6	111.5	51.4	81.4
World Bank (IBRD and IDA)	12.0	13.3	14.7	17.9	15.3	12.5	14.8	19.3	26.5	20.5	27.8
IMF (use of credit & SDR allocations)	-6.4	-11.7	-2.1	7.2	6.4	4.4	30.7	20.9	44.8	1.1	14.0
Private creditors	453.0	432.6	354.0	121.5	220.9	378.9	272.9	270.2	249.6	201.6	189.4
Bonds	220.4	166.3	165.8	73.2	121.1	291.2	199.1	235.5	229.1	140.6	127.1
Banks and other private	232.6	266.2	188.3	48.3	99.8	87.7	73.8	34.7	20.6	61.0	-62.4
Short-term	123.9	360.3	135.9	500.4	-48.4	333.4	212.8	34.1	7.1	291.4	-90.6
Memorandum item											
Long-term public and publicly guaranteed	219.5	211.3	201.5	116.6	139.8	279.7	246.3	213.9	257.0	179.5	50.6
Long-term private nonguaranteed	269.1	254.2	204.5	60.7	139.5	158.3	110.3	121.0	116.3	84.8	145.1

Source: World Bank International Debt Statistics database

2. The Structural and Systemic Challenges for Developing Countries

The debt challenges faced by developing countries are deeply rooted in structural and systemic factors that exacerbate their fiscal vulnerabilities. Having structurally weak domestic economies that are highly exposed to external factors put developing countries at high risk of debt crises. The lack of deep domestic capital markets which forces these countries to borrow overseas can create further problems by exposing them to exchange rate risks emanating from the volatility of global commodity markets.

The macroeconomic policies of developed countries, particularly the United States, also significantly impact the debt dynamics of these countries by affecting exchange rates and bond yields globally. The tightening of monetary policy in the US in 2022 is one example of such an impact where the debt sustainability risks in developing countries were exacerbated due to the rise in the cost of borrowing.

Systemic issues include the tendency of credit rating agencies to assign higher risk premiums to developing country debt, further increasing their borrowing costs. The absence of an international agency dedicated to matters of sovereign debt and the lack of an international bankruptcy mechanism for sovereign states is another problem as it leaves indebted nations without a structured process to debt resolution, often resulting in protracted negotiations and suboptimal outcomes.

These and many other challenges collectively contribute to the perpetuation of debt vulnerabilities in developing countries and highlight the need for comprehensive reforms in the global financial system to create a more equitable environment for all nations. Therefore, any proposed debt relief and prevention framework needs to take these challenges into account.

4. 2024 Financing for Sustainable Development Report: Debt and debt sustainability in numbers.

3. The Need for a Coordinated Effort in Debt Relief and Prevention

The challenges posed by the high debt burden on the achievement of the SDGs and on climate action underscore the urgent need for comprehensive solutions to address the current debt situation in developing countries. Therefore, there is a need to ramp up the debt treatment and prevention efforts in a coordinated manner that involves all parties (official and private creditors and the debtor countries). These efforts should focus on four areas namely: reforming the current debt relief framework, preventing future debt accumulation, addressing creditor behavior, and enhancing domestic resources.

3.1 Need for a Reformed Debt Relief Framework

The new debt crisis is the most severe that developing countries have ever faced considering the scale of the debt servicing burden and how widespread the problem is (6). Unfortunately, the main initiative set up to address the crisis – the G20 Common Framework for Debt Treatments beyond the DSSI– has fallen way short on this task. A more comprehensive debt relief framework is necessary, one that is similar to the HIPC Initiative in terms of ambition (including debt cancellation), but also improves upon it in terms of country coverage. Such an initiative should also address the shortcomings of the common framework such as the time delays in providing relief as was the case with Zambia and the lack of appeal to target countries many of which shunned it. Additionally, it should include mechanisms to ensure private sector participation, which has been a challenge with the Common Framework.

Furthermore, the extent to which the current debt crisis is hindering development efforts and climate action calls for a framework that incorporates innovative features such as debt-for-climate/development swaps and state-contingent debt instruments (SCDIs) (7) in order to link debt relief with sustainable development goals and climate resilience. By combining substantial debt cancellation with provisions for countries to invest in poverty reduction, climate action, and sustainable development, an improved debt relief initiative could help countries break free from the debt cycle while advancing critical global objectives.

3.2 Need for a More Effective Debt Prevention Framework

History has shown that debt relief efforts alone are not enough to put countries on a sustainable development path. While the HIPC initiative was largely successful in providing relief to highly indebted poor countries, many of these countries were on their way back to having unsustainable debt within a decade of benefitting from the initiative. This underscores the need for a proactive approach to preventing the recurrence of rapid debt accumulation by pairing debt relief efforts with strategies for debt control.

An effective debt prevention framework should focus on several key areas including expanding access to cheaper financing on the international markets, improving the fiscal situations of developing countries, and promoting responsible borrowing and lending practices. It should also consider structural economic vulnerabilities of countries and provide for ways of countering them such as through the increased use of state-contingent debt instruments to hedge against these structural risks. By implementing such a comprehensive approach, countries can work towards maintaining manageable debt levels and avoiding the need for repeated debt relief interventions in the future.

6. Matthew Martin with David Waddock, “Resolving the worst ever global debt crisis: time for a Nordic initiative ?”, (Norwegian Church Aid, 2024)

7. With SCDIs, debt repayments are linked to the debtor’s ability to pay by considering real world variables or events such as a country’s GDP, commodity prices, or occurrence of climatic shocks.

3.3 The Need to Address Creditor Behavior

The prevailing narrative surrounding debt often unfairly places the blame solely on indebted countries, accusing them of poor governance, corruption, and irresponsible borrowing practices. This perspective absolves creditors of their ethical responsibilities and ignores the complex factors contributing to debt crises. It also fails to acknowledge the role of predatory lending practices, unfair global economic structures, and external shocks that can push countries into debt, regardless of their governance quality.

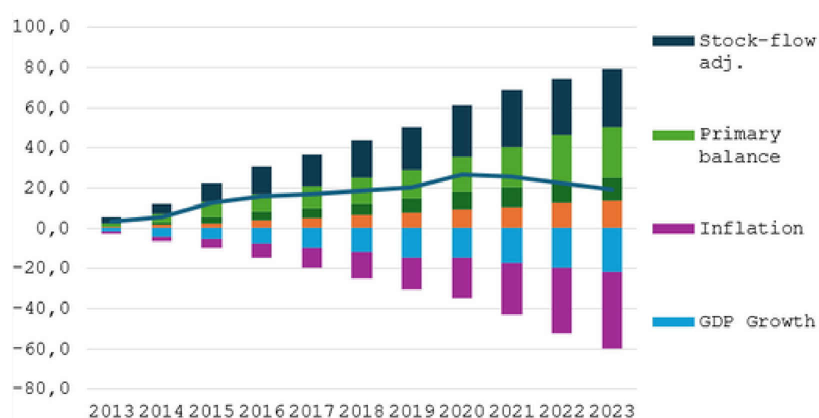
In view of this the United Nations Conference on Trade and Development (UNCTAD) in 2012 proposed a set of Principles on the Promotion of Sovereign Lending and Borrowing, one of which states that "a lender is responsible to make a realistic assessment of the sovereign borrower's capacity to service a loan based on the best available information and following objective and agreed technical rules on due diligence and national accounts". In 2015 the UN General Assembly (UNGA), adopted nine principles on sovereign debt restructuring which promote good faith and constructive debt restructurings. Therefore, having a balanced approach that recognizes the shared responsibility of both debtors and creditors in creating and resolving debt crises by abiding to these principles is essential.

3.4 The Need for Domestic Solutions for Fiscal Consolidation

Country-led solutions to debt prevention that complement international efforts are key to addressing current and future debt crises. For instance, efforts to improve domestic resource mobilization have an important role in maintaining a good primary balance (8) which if consistently negative (i.e. in deficit) is an important driver of debt accumulation, even more than debt service (Figure 2). As such, while the internationally coordinated debt relief initiatives discussed above can help with managing debt levels by keeping debt service in check, maintaining a healthy fiscal balance domestically is equally important for developing countries.

The UN Financing for Development (FfD) has highlighted domestic revenue mobilisation as one solution for closing the development financing gap. Given that the amount of tax revenue determines the primary balance of a country, increasing domestic revenues would help countries control their debt. Therefore, developing countries need to commit to reforms that achieve economic growth and revenue mobilization while the international community (through forums like the FfD and the G20) provides its support to these reforms.

Figure 2: Cumulative debt decomposition for LICs



Source: Source: Author using FDL debt decomposition tool

8. Primary balance is the fiscal balance excluding net interest payments on public debt. That is, the difference between the revenue a government collects and what it spends on providing public goods and services.

4. Making Debt Work for the Sustainable Development Agenda

With a coordinated effort through forums such as the G20 and the UN FfD, the four areas of needs listed above can be addressed, starting with the more urgent need for debt relief, to the longer-run issues of debt prevention, responsible lending and country fiscal reforms. To achieve this, specific and bold action is needed, with ambitious initiatives that will be adequate to transform countries from debt vulnerability to sustainable development. The initiatives/priorities that should be adopted under each of the four needs discussed above include the following.

Establishing a More Comprehensive Debt Relief Initiative

Given the scale of the debt servicing burden currently faced by developing countries and the shortcomings of the common framework on debt treatments in addressing it, the G20 should engage in efforts to establish a new broader debt relief framework targeting substantial levels of debt relief including write-offs. This framework should have the following elements.

1) A Debt Servicing Holiday for Vulnerable Countries

Under this new framework, debt relief must be broad and substantial including a debt servicing holiday of at least 10 years for low-income countries with crippling debt servicing costs. This would free up significant financial resources that are currently being used for debt servicing, allowing countries to redirect funds towards economic recovery initiatives and investments in critical areas such as healthcare, education, and climate mitigation and adaptation. Additionally, a debt servicing holiday helps to prevent countries from falling into deeper financial distress or defaulting on their loans, which could have severe long-term consequences for their economies and citizens.

2) Debt Cancellation

Debt cancellation should be a component of any new international debt relief framework. Debt service suspension and restructuring alone is not enough to resolve the debt vulnerabilities from the current crisis.

3) Debt Swaps for Development and Climate Action

The new debt relief framework should also place high importance on debt for development and debt for climate swaps. These swaps can provide much-needed fiscal space for heavily indebted countries to invest in climate adaptation, mitigation, and sustainable development projects without sacrificing other essential spending.

4) Laws Mandating Private Creditor Participation

Given the challenges that the Common Framework has faced with bringing private creditors to the table, the new debt relief framework must have "anti-holdout" laws to encourage private creditor participation in the debt relief negotiations. This is particularly important given that private creditors now hold most claims on countries in the Global South, making their participation essential for effective debt relief.

5) An Independent Sovereign Debt Authority

Given the increasingly diverse composition of creditors that has shifted dominance away from the Paris Club, a new independent body mandated to coordinate and guide sovereign debt restructurings should be established. This body can be a completely new entity or be embedded within the existing structures of multilateral organisations. The debt authority should be tasked with providing technical and logistical support in the negotiations, including the commissioning of debt sustainability analyses that inform the negotiations (9).

9. https://repositorio.cepal.org/server/api/core/bitstreams/d84a5041-0a2c-4b8e-9b01-d91b187477ce/content

This would improve the current sovereign debt restructuring framework by bringing fairness to debt negotiation processes while fast-tracking and therefore improving the outcomes of negotiations.

Implementing Global Financial Reforms for Debt Prevention

Beyond the short-term debt relief initiatives proposed above, international efforts must also be taken to address the causes of debt accumulation by developing countries. This is because the current global financial architecture is set up in a way that makes it difficult for developing countries to access cheap financing outside of the concessional loans from institutions such as the World Bank and the IMF. This leads to rapid debt accumulation with adverse resultant fiscal effects on economic growth. To address this, the following actions must be taken.

1) Reforming the Credit Ratings System

The cost of credit is determined by a country's credit rating and most developing countries are rated low, arguably unfairly so. The current credit rating system which is dominated by agencies based in the global north fails to adequately account for the unique challenges and contexts of developing economies, often overstating risks and applying standards more suited to advanced economies. A 2023 study by the UNDP found that African countries could save up to US$ 74.5 billion if credit ratings were based on less subjective assessments (10). A more objective credit rating methodology would help reduce the interest costs for developing countries and increase their access to affordable financing to invest in development. As such, initiatives such as the Africa Credit Rating Agency are a welcome development that should be supported to complement the traditional rating agencies.

2) Promoting the Use of State-Contingent Debt Instruments

State-contingent debt instruments (SCDIs) offer significant potential to enhance debt sustainability for developing countries that need sovereign debt restructurings. By linking debt service payments to a countries' ability to pay, SCDIs can provide valuable downside protection and help prevent temporary liquidity problems from escalating into solvency crises (11). For example, instruments with natural disaster clauses, allow for temporary debt service relief when countries are hit by climatic shocks. This provides crucial fiscal space when it is most needed, without requiring a full debt restructuring. As developing countries face growing climate risks and other shocks, promoting greater use of well-designed SCDIs as part of debt restructurings could significantly enhance long-term debt sustainability. The potential benefits in terms of reduced default risk and increased fiscal resilience make this an important area for further development by the international community.

3) Increasing Availability of Concessional Financing by IFIs

One important way of preventing future debt crises is to redirect countries towards more concessional financing by scaling up MDB lending. As suggested by Gallagher et al (2024) (12), the recommendations of the G20 Independent Panel for Review of MDBs' Capital Adequacy Frameworks (CAF) can help to achieve this by optimizing the balance sheets of the MDBs (including through better valuation of callable capital, adjusting equity-to-loans ratios and providing hybrid capital including the use of Special Drawing Rights). Therefore, implementing these recommendations and other actions aimed at increasing MDBs' lending to developing countries should continue to be high on the agenda of the G20 and the shareholders of the Bretton Woods institutions.

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10. https://www.undp.org/press-releases/more-objective-credit-ratings-could-save-billions-african- countries-development
11. 2024 Financing for Sustainable Development Report: Debt and Debt Sustainability in Numbers
12. Kevin P. Gallagher, "Scaling Up Funding and the Role of MDBs", (Club de Madrid Policy Brief, 2024)

Promoting Responsible Lending by Creditors

To address the ethical responsibilities of creditors, a more balanced approach is needed that recognizes the shared accountability of both lenders and borrowers. This can be achieved by incorporating responsible lending practices within the debt relief and prevention framework.

1) Promoting Guidelines and Principles of Responsible Lending

Strong guidelines for ethical lending, including thorough assessments of a country's ability to repay and the potential impact of loans on development goals should be emphasized. To this effect the 2012 guidelines proposed by UNCTAD and the UN principles adopted in 2015 must be promoted in prevention initiatives.

2) Mechanisms for Creditor Transparency and Accountability

Effective mechanisms that promote transparency and accountability of creditors must be put in place and adhered to. These include the requirement of some level of disclosure of loan terms and conditions that would allow scrutiny by all stakeholders, especially the ordinary citizens who will pay for the debt.

Strengthening Domestic Fiscal Efforts to Minimize Debt Accumulation

IMF conditionalities have been a major part of debt relief programs, with the primary objective of ensuring that countries implement necessary reforms and use resources effectively. However, the general effectiveness and impact of these conditions have been subject to debate. Specifically, emphasis on fiscal tightening has been criticized as potentially damaging to the already vulnerable economies by further constraining growth and depriving citizens of the public goods and services that they need. Nonetheless, fiscal consolidation is still key to resolving sovereign debt crises and some emphasis on it is warranted.

1) Capacity Enhancement in Tax Administration

To enhance domestic revenue mobilization, boosting tax administration capacity in developing countries is necessary given the gaps that currently exist. Of particular importance is the ability to leverage digital technologies to enhance tax collection. Greater digital adoption in revenue administrations is associated with higher domestic tax revenue collection and increased tax compliance (13) which would contribute to lower fiscal deficits and stabilize debt. Therefore, enhancement of tax collection capacities should be among the priorities in any initiatives dealing with debt.

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13. ¡Inter-agency Task Force on Financing for Development, "Financing for Sustainable Development Report 2024: Financing for Development at a Crossroads", (New York: United Nations, 2024)

Contributors

This policy paper was commissioned by Club de Madrid and prepared by Joseph Upile Matola, Economist, South African Institute of International Affairs, as part of the work undertaken by the Working Group of Club de Madrid on "From Debt to Development". While the paper reflects the discussions and insights shared within the Working Group, it does not necessarily represent the views or official positions of all members or their respective institutions.

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