Debt distress and development distress

Twin crises of 2021

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I. Introduction

Just over a year into the COVID-19 crisis, it is apparent that there is great urgency for governments to address an overlapping set of issues—among them health, climate, nature, resilience, recovery, jobs, and inequality—at a scale far larger than would have been imaginable before the onset of the crisis.

Political leaders have concluded that bold action today on resolving debt and development distress simultaneously is less risky than caution and incremental change, or an effort to sequence debt resolution before development. This recognition draws a parallel between dealing with the pandemic and dealing with broader issues of global equity and fairness. Just as success in the fight against COVID-19 is not achievable until there is almost universal vaccination and the virus dies out, it is equally true that all countries need to shift to a path of sustainable development to build resilience into the global economy. Efforts of all countries are needed to avoid surpassing the tipping point thresholds of greenhouse gas concentration and to conserve the planet's biodiversity, as extinction cannot be reversed.

Government ambition, in turn, must be reflected in the willingness to undertake policy reforms and to put in place new investments that will transform economies in the desired direction. Those new investments must be financed. For most emerging markets and developing countries, a sizable portion of the finance must come from abroad in the form of debt.

Against this background and logic, the international financial system is not performing well in its core function of allocating the world's savings in a fashion that is globally efficient. The business-as-usual scenario presented by the International Monetary Fund (IMF) in its World Economic Outlook predicts that Africa, Latin America, and the Middle East will each have negative net financial flows (excluding grants) in 2021. Debt levels have risen such that governments in half of all low-income countries are either already in debt distress or at high risk. Of the other half, only 11 low-income country governments are classified as having a low risk of debt distress.[1] Most of the low-income countries in debt distress, such as Mozambique, Somalia, Sudan, and Zimbabwe have had long track records of development distress.

Governments need to continue to borrow and invest. The private sector will not be a substitute. Foreign direct investment is falling. United Nations Conference on Trade and

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[1] IMF (2020). "List of LIC DSAs for PRGT eligible countries."

Development (UNCTAD) estimates a global fall of up to $100 million in 2021, coming on top of a 40 percent decrease in 2020.[2] Latin America, Africa and structurally weak and vulnerable economies will be hit especially severely. Greenfield investment announcements, cross-border mergers and acquisitions, and global project finance in infrastructure have tumbled. In the first half of 2020, cross-border private provision of infrastructure in developing countries fell by 56 percent.[3]

The developing world is therefore currently facing twin crises—a balance of payments and debt crisis that may upend development progress, and a development crisis that could erupt into a debt crisis as the state of the economy deteriorates.

Before COVID-19, most debt crises were the result of development crises—governments that had borrowed money that was poorly invested, spent on consumption or on responding to natural disasters, or outright stolen, simply could not repay debt service in full when the bills came due. The international policy response was therefore rooted in fixing development policy before resuming additional financing.

Entering 2021, however, there is a large group of developing countries, including both low-income countries and market-access countries, that faces a different problem.[4] These countries have had long periods of national economic growth and public revenue growth exceeding the interest rate on debt, suggesting that debt dynamics are stable in the long run. However, current liquidity shortages and sharp hikes in risk premia charged in global capital markets are changing debt dynamics in predictable ways, creating risks that development momentum will be lost if priority is given to servicing external debt at current market rates by cutting back on public spending.

Any slowing of sustainable growth in emerging markets and developing economies (EMDEs) beyond that already occasioned by the impact of COVID-19 would be bad for the world economy on three counts. It would slow global growth; EMDEs have accounted for two-thirds of global growth since 2000, and 40 percent excluding China. It would prolong the pandemic by reducing resources for basic public health. It would sharply curtail efforts to mitigate climate change if poor countries are unable to adequately preserve forests, soils, and pasturelands and invest in renewable energy sources. Thus, there is a narrow economic self-interest for coordinated global action to address the twin debt and development crises, in addition to the fundamental moral self-interest of sharing responsibility for promoting human rights across the world, including for those being left behind by the existing economic conjuncture.

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[2] UNCTAD (2020). "World Investment Report 2020."
[3] World Bank (2020). "Private Participation in Infrastructure (PPI) database."
[4] Kharas and Dooley (2020). "COVID-19's legacy of debt and debt service in developing countries." Brookings Institution Working Paper 148.

This paper addresses policy options in three areas to respond to the current context:

- How to improve on the debt resolution mechanism to address the debt overhang issue
- How to maintain development momentum for those countries facing a liquidity shortage
- How to reform the international architecture to reduce the risks of future debt crises

In thinking through policy options in the current context, three lemmas of economic theory should be kept in mind:

(i) COVID-19 represents a temporary shock to each individual country's economy. The appropriate economic response to a temporary shock is to borrow money, either from future generations in the case of domestic debt or from foreigners, in order to smooth consumption over time.

(ii) Most developing countries in recent times have had track records of sustainable debt dynamics. The growth in GDP, or public revenues, has exceeded the rate of interest on external debt over a medium to long term horizon (10 to 20 years). In such cases, it is efficient to borrow for investment and consumption. In a recent paper, we documented that at least three-quarters of developing countries currently facing liquidity issues fall into this category, responsible for two-thirds of debt service due in 2021.[5]

(iii) The critical parameter determining the choice between investment in fossil fuels and renewables is the cost of capital. If developing countries are to be brought into the global effort to address climate change, mechanisms must be put in place to provide them access to capital on reasonable terms. It is in developing countries where urbanization is fastest, and where the growth in demand for energy is highest. Their choices will dictate the carbon footprint lock-in for much of the planet.

[5] Kharas and Dooley (2020), op. cit.

II. One year into the crisis, where are we?

This year should see a rebound in economic growth in EMDEs to 5 percent (3.5 percent excluding China).[6] Almost every economy is expected to return to a positive growth rate. Countries borrowed heavily during 2020, in line with what economic theory suggests is an efficient response. But their differential access to global liquidity is made clear by the following aggregate figures: When the figures for 2020 are tallied, public debt is expected to rise by 17 percentage points of GDP in advanced economies, 12 percentage points in emerging markets, and 8 percentage points in low-income countries.[7] Six developing countries have defaulted since the pandemic began: Argentina, Ecuador, Belize, Lebanon, Suriname, and Zambia.[8] Others have seen their creditworthiness deteriorate: 36 developing countries have had their credit rating downgraded by one of the three major ratings agencies, and an additional 28 have had their outlook downgraded.[9] While some middle-income countries in Latin American and the Middle East, as well as China, Indonesia, and the Philippines, have returned to international bond markets since March 2020, only two countries in sub-Saharan Africa have returned to the market (Côte d'Ivoire, Benin).[10]

The international financial institutions (IFIs) have rallied to provide support. Figure 1 below shows new commitments by major agencies linked to COVID-19 relief or debt relief in some fashion. Approximately $150 billion has been committed, a sizable amount, but a small fraction of the $2.5 trillion in additional financing that the IMF estimates is needed by developing countries.[11] Around 100 countries have benefited from an IFI program. In addition, countries continue to benefit from regular project financing provided by the multilateral development banks (MDBs), adding perhaps another $100 billion to crisis financing.

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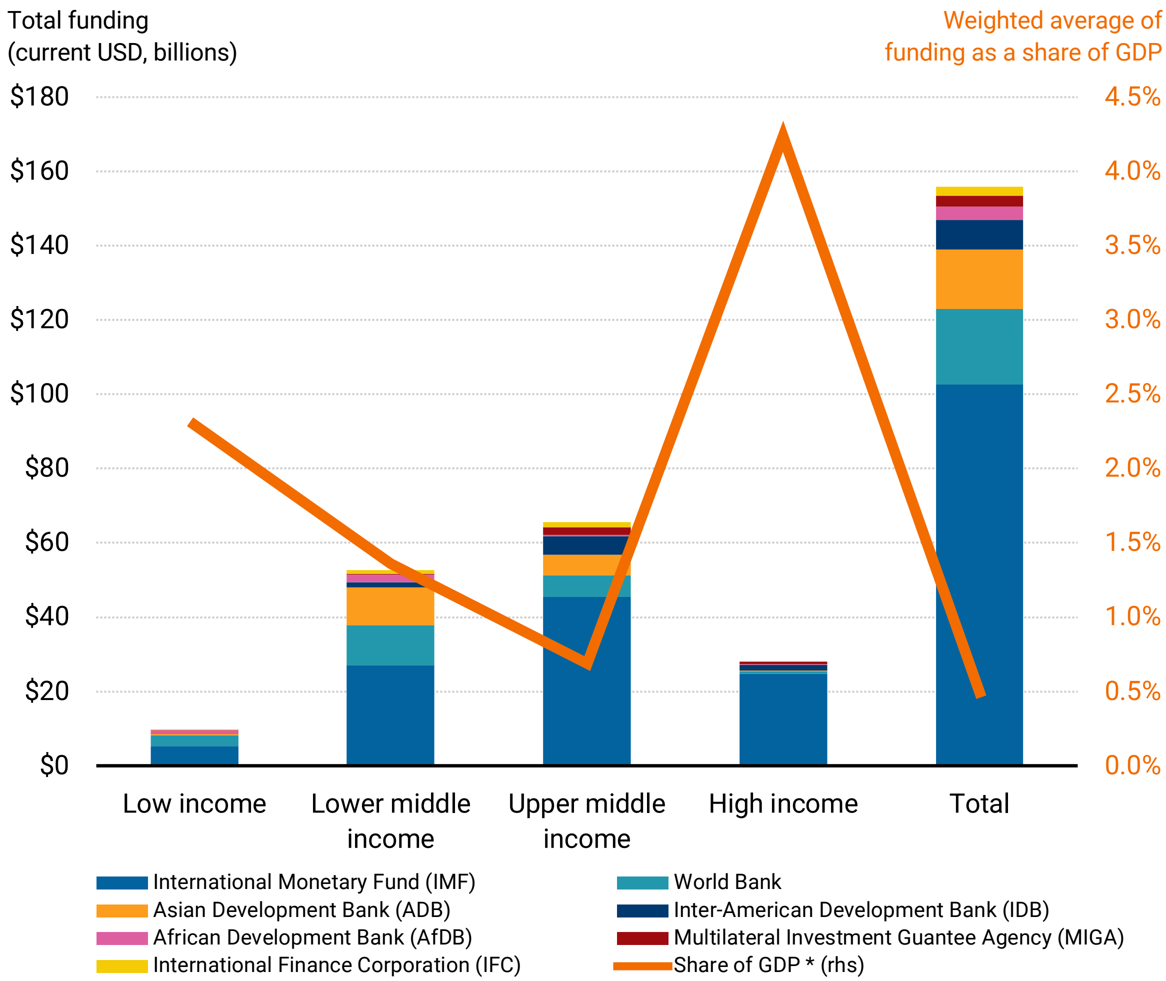
[6] World Bank (2021). "Global Economic Prospects." January.
[7] Breuer and Cohen (2020). "Time is Ripe for Innovation in the World of Sovereign Debt Restructuring." IMF Blog, Nov. 19.
[8] Pham (2021). "EM Sovereigns: Debt sustainability remains a concern but will only become acute for some." ING, Jan. 7.
[9] See Fitch, Moody's, and S&P Press Releases, accessed Jan. 28, 2021.
[10] Fitch (2020). "Debt Markets Re-Open for Sub-Saharan Issuers." Nov. 19.
[11] Mohieldin and Keller (2020). "Financing a comprehensive and equitable COVID 19 response." Brookings Future Development Blog, Sept. 18.

Figure 1. New IFI commitments in response to COVID-19 and debt crises, 2020



Source: World Bank, IMF, IFC, MIGA, AfDB, ADB, and IDB (2021). Weighted average of funding as a share of GDP excludes India for lower-middle-income and China for upper-middle-income. High-income countries include a number of small island states, Chile, Panama, Romania, and Uruguay.

The experience of the past year exposes some weaknesses in the current system. There is a debate as to whether the scale of new financing from the MDBs has been adequate, especially when compared to the financing offered to developing countries at the time of the Great Recession. Financing levels are roughly comparable in real terms across the two crises, but the change in financing is far smaller this time around—a projected increase of just 30 percent for the COVID-19 crisis compared to 70 percent for the Great Recession crisis.[12]

The bulk of the financing response in the short-term has come from the IMF, largely through its rapid credit facility. Countries can quickly receive funds from the IMF up to 100 percent of their quota. Richer countries have larger quotas, and for this reason,

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[12] Humphrey and Prizzon (2020). "Scaling up multilateral bank finance for the Covid-19 recovery." ODI Blog, Nov. 18.

much of the IMF's new financing has gone to upper-middle-income countries. Only two countries, the Ukraine and Jordan, have gained access to finance in amounts above their quota. This disconnect between "need for finance" as determined by the size of the economic and health shock and "access to finance" determined in the first instance by pre-set quotas complicates the international system's ability to ensure an equitable financing outcome.

The experience of the last year reveals considerable heterogeneity among developing countries. On the one hand, developing country governments have benefited from the decline in interest rates (nominal and real) brought about by monetary easing in major economies around the world. On the other hand, they have been made worse off by the flight to safety and rise in risk premia. The net impact varies sharply by country, depending on the initial level of indebtedness, need for macroeconomic stabilization, size of external reserves, and many other factors.

This heterogeneity poses a problem for policy design. A coordinated response is needed to simultaneously address debt and development crises. At the January 2021 World Economic Forum, the U.N. Secretary General echoed calls from others in the political, academic and civil society communities for additional action, including liquidity support for middle-income countries, debt relief for all countries that need it, and the issuance of additional Special Drawing Rights (SDRs) to help developing countries finance recovery and vaccination efforts.[13]

Almost one year into the COVID-19 pandemic, we review global efforts to see what progress has been made to address debt overhangs and debt crises, and medium-term development financing. We identify roadblocks and suggest where to go from here. We conclude with thoughts on the longer-term agenda of reforming the international financial architecture to address structural weaknesses that have contributed to current problems.

[13] Guterres (2020). "Secretary-General's special address at Davos Agenda." Jan. 25.

III. Addressing the debt overhang and debt crises

Developing countries can suffer from a "debt overhang" problem that prevents them from undertaking profitable new investments. Paul Krugman puts it this way: "It is not true, for example, that the existence of a secondary market discount on debt (presumably more or less equal to the subjective probability of nonpayment) means that new money should not be put in. It only means that such new money will not be provided voluntarily."[14] He goes on to elaborate on the reasons why concerted lending in the face of high indebtedness, either coordinated through multilateral institutions or through enforced participation of existing creditors, can lead to an improvement in creditworthiness over time, even as nominal debt increases, as long as growth grows faster than the stock of debt.

Both debt forgiveness and coordinated new lending can help resolve the debt overhang problem. Debt forgiveness can create conditions under which countries can return to voluntary market access. It is the instrument of choice in domestic bankruptcy proceedings such as Chapter 11 negotiations and has the advantage of not requiring a "coordinator" between debtors and creditors except in the short-term. Concerted new lending provides for greater creditor control over how new funds are spent and on the use of the returns, but has the disadvantage of requiring a mutually-agreed-upon coordinator for an extended period of time. For countries, restructuring of existing debt claims and concerted action in providing new financing are mutually complementary, not alternatives. They can result in different distributional effects, but both will solve the economic inefficiencies caused by the debt overhang.

Debt Service Suspension Initiative (DSSI)

In April 2020, the G-20 agreed to a temporary standstill on bilateral debt service for low-income countries. Of the 73 countries eligible (countries eligible to access IDA resources in FY19 and Angola), 46 are currently participating in the DSSI. Since it took effect in May 2020, the scheme has offered countries $5 billion in deferred debt service payments.[15] The standstill initially covered debt service payments due between May and December 2020 and has since been extended to June 2021. In addition, the IMF has provided debt service relief to 29 countries under the Catastrophe Containment and Relief Trust

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[14] Krugman (1988). "Market-Based Debt-Reduction Schemes." NBER Working Paper No. w2587.
[15] World Bank (2021). "COVID 19: Debt Service Suspension Initiative." Brief, Jan. 12.

(CCRT), amounting to $489 million; this provides grant funds that low-income countries can use to offset debt service owed to the IMF.[16]

The DSSI can be conceptualized as follows: it is a program designed to give a financial breathing space to liquidity-constrained low-income countries. Its benefits are tangible; participating countries commit to devote the resources saved to mitigating the health, economic and social impact of the COVID-19 crisis. For example, Ethiopia, with $473 million in potential savings from DSSI from May to December 2020, used saved funds to invest in personal protective equipment (PPE), contact tracing, and hospital equipment.[17] Cote d'Ivoire, with a potential savings of $224 million during the same period, was later able to access international markets in November. Yet the program has Type 1 errors of excluding deserving middle-income countries that are experiencing severe liquidity shortages, alongside Type 2 errors of providing liquidity support to low-income countries when debt forgiveness might be a preferred option.

Reflection

Limited degree of ambition: The DSSI has opened up a limited amount of fiscal space in some countries, but the total amount of deferred payments is still quite small—about $5 billion. Of this, about $3.5 billion is deferred principal repayments. The participating bilateral creditors are merely agreeing to extend the maturity of their loans to a time when the global economy will have hopefully recovered from the COVID-19 induced recession. They are not offering any reduction in the net present value of their claims but countries are now able to request such a reduction (see G-20 framework below).

Perceived adverse cost-benefit of participation: According to a September World Bank report, most countries not yet participating in the DSSI do not intend to join.[18] About half of these cited low amounts of debt service due in the next year, so were not worried about making payments. Ten cited concerns about the potential negative impact on their credit rating, and hence their cost of borrowing on international markets, if they participated. There is merit to this fear—although no credit agency downgraded a country for simply requesting to join the DSSI, Moody's did place some DSSI countries on negative watch, citing the G-20 call for private sector participation in the DSSI. A few countries, including Vanuatu who originally opted into the initiative and has since bowed out, did not participate because they did not want to request IMF financing (per G-20 term sheet, countries opting into DSSI must have a financing arrangement with the IMF).

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[16] IMF (2021). "COVID-19 Finance Assistance and Debt Service Relief." Last updated Jan. 26.
[17] Oqubay (2020). "Ethiopia's Response to COVID-19." OECD Development Matters, May 26.
[18] IMF and World Bank (2020). "Implementation and Extension of the Debt Service Suspension Initiative." Sept. 28.

Box 1. Kenya case study

Kenya is illustrative of a sizeable group of DSSI eligible countries who were initially hesitant to participate in the DSSI. Though they had $630 million in bilateral debt service from May-December 2020, they opted not to participate in the DSSI due to fear of a credit rating downgrade, which would then make future borrowing on international markets more expensive. However, in November 2020 Kenya officially requested debt relief under the DSSI from Paris Club creditors, reportedly after seeing that other countries had not been subject to the credit ratings downgrades many feared.[19] The Paris Club approved Kenya's request in January 2021, and the country is currently in talks with China to negotiate interest deferral with them.[20] China holds 21 percent of Kenya's external debt, behind the World Bank at 25 percent. Kenya has $620 million in bilateral debt service due in the first half of 2021 that is now eligible for suspension under the DSSI. However, the country also has $408 million due to multilateral creditors and $300 million due to bondholders and commercial creditors.

Kenya was able to avoid participating in the DSSI in 2020 thanks to substantial additional financing from the major multilateral institutions. Kenya received a combined $2.1 billion COVID-19 package from the IMF, World Bank, IFC, and the African Development Bank (AfDB).[21] However, this kind of support is not recurrent, so Kenya is facing shortfalls this year.

Limited eligibility: As Figure 2 shows, DSSI countries have $16.6 billion in bilateral debt service due in 2021, $13 billion from countries that have currently opted into the program. The bulk of bilateral debt payments due in 2021, however, amounting to $31 billion, are from middle-income countries not eligible for DSSI. While some of these countries have adequate market access to refinance their debts, most countries do not. For instance, six middle-income countries (Albania, Georgia, Jordan, North Macedonia, Sri Lanka, Zimbabwe) with speculative credit ratings (below investment grade, but above a CCC rating)[22] have high debt-to-GDP ratios but relatively strong economic growth over the past 10 years, with growth outstripping the average interest rate on publicly held debt. These countries have $11.5 billion in debt service payments due in 2021, $4 billion bilateral, but are currently not covered by the DSSI. Without additional assistance, they could be forced to cut back on development spending.

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[19] Reuters (2020). "Kenya makes U-turn on joining G-20 debt relief initiative." Nov. 18.
[20] Herbling (2021). "China in Talks with Kenya for Debt Relief after Paris Club Deal." Bloomberg, Jan. 18.
[21] See COVID-19 financing trackers for the IMF, World Bank, IFC, and AfDB.
[22] We are using the categories formed by Trading Economics, an aggregator of economic and financial market data.

Box 2. Sri Lanka case study

Sri Lanka is a lower-middle-income country, and as such is currently not eligible for the DSSI. Though the country has a high debt-to-GDP ratio at 67 percent, it has had strong growth over the past 10 years (though slowing in the past 5), meaning if growth continues, debt levels will stabilize and then start to decline even without policy adjustments to the primary surplus.

Sri Lanka has been under a $1.1 billion IMF program since 2016 to mobilize government revenue to get their debt on a sustainable trajectory, while still prioritizing social and investment needs.[23] Though the country has made some progress on structural reforms and transparency, the Easter Sunday terrorist attacks in April 2019 severely set back progress on government revenue targets, due to subsequent declines in tourism, which accounts for 5 percent of GDP. The government primary balance fell from a projected 1.5 percent to 0.2 percent in 2019, with the government cutting spending to offset revenue shortfalls. While tourism was expected to rebound in 2020 to help the country get back on track, the global shutdown brought on by COVID-19 halted this recovery. In addition to the current economic setbacks caused by the pandemic and terror attacks, the country is vulnerable to natural disasters, meaning any future economic recovery is tenuous.

Sri Lanka has $4.5 billion in public debt service due in 2021: $1.5 billion to bilateral creditors, $1.9 billion to bondholders, $700 million to multilateral entities, and $400 million to commercial lenders. Though not DSSI eligible, it did receive $820 million in IFI COVID-19 related funding in 2020 from the World Bank, IFC, and ADB.[24] Sri Lanka will likely need much more help to get on a sustainable growth path, given its back-to-back economic hits in 2019 and 2020.

Limited creditor participation: The DSSI is an agreement between G-20 governments to suspend payments due on their official bilateral debt. Yet private creditors make up the fastest growing segment of debt, even in low-income countries. As Figure 2 shows, DSSI eligible countries have $14 billion in debt service due to bondholders and private creditors in 2021. Though private creditors have agreed to work with DSSI countries to restructure debt on a case-by-case basis, there is no coordinated architecture for this process, and ratings agencies have said such efforts would likely result in a credit downgrade.[25] This private debt typically has much higher interest rates and shorter

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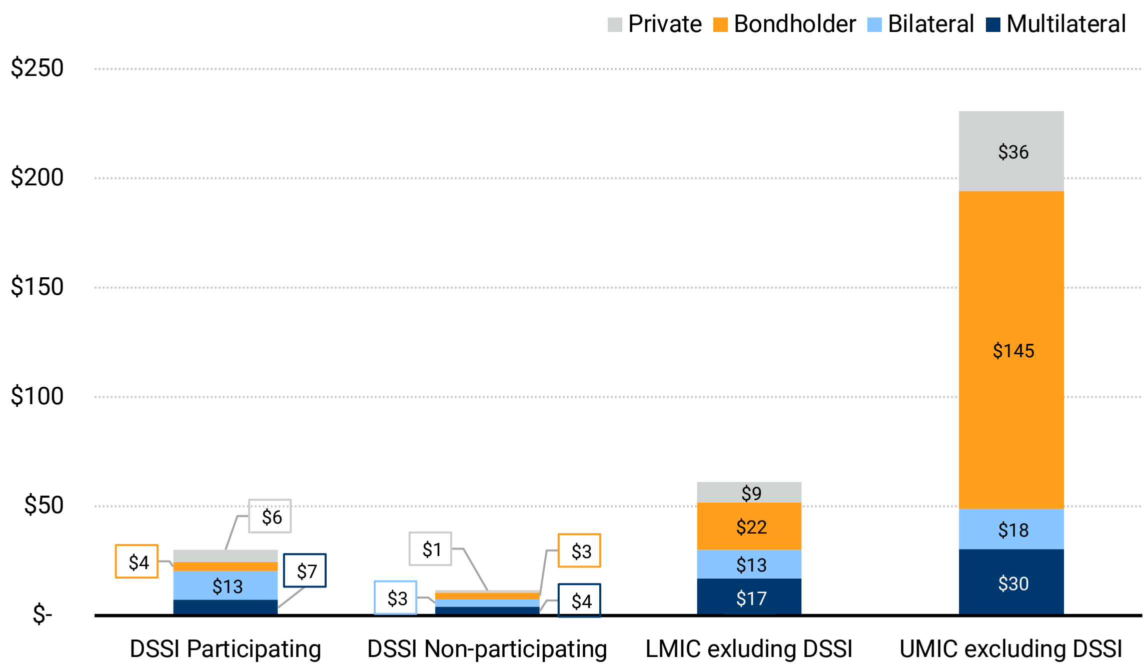
[23] IMF (2019). "Sri Lanka – Sixth review under the Extended Arrangement Under the Extended Fund Facility and request for waiver of nonobservance and modification of performance criterion." IMF Country Report no. 19/335, November.
[24] See COVID-19 financing trackers for the World Bank, IFC, and ADB.
[25] IIF (2020). "IIF Letter to G-20 Regarding the Debt Service Suspension Initiative (DSSI)." Sept. 22.

maturities than official bilateral or multilateral debt. So far, there has been no private creditor participation in the DSSI, and given this, the fiscal breathing room created by official bilateral creditors serves to first pay back private creditors, rather than generating resources for priority social spending.

Figure 2. Total external debt service 2021, public and publicly guaranteed

Billions, current USD



Source: World Bank International Debt Statistics (2021).

G-20 Common Framework for Debt Treatments

In November 2020, the G-20 agreed to a shared framework to help DSSI eligible countries pursue debt restructuring.[26] This process will be pursued on a case-by-case basis at the request of the debtor. Country needs will be determined by IMF and World Bank debt sustainability analysis. Under the framework, bilateral creditors agreed to fair burden sharing—a debtor seeking relief from one creditor must seek similar terms from other creditors, including private creditors. The framework is noteworthy for getting agreement among all G-20 members, including non-Paris Club creditors like China, India, Turkey, and Saudi Arabia.

Chad was the first country to request debt relief under the framework in January 2021.[27] Yet Paris Club creditors account for less than 4 percent of Chad's total debt stock, and

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[26] G-20 (2020). "Statement: Extraordinary G-20 Finance Ministers and Central Bank Governors' Meeting." Nov. 13.
[27] Shalal (2021). "Chad becomes first country to ask for debt overhaul under G-20 common framework." Reuters, Jan. 27.

the country has no outstanding Eurobonds. 40 percent is held by private creditors, the majority by commodity trader Glencore on an oil backed loan to a state mining company, which has already been restructured in 2018. The IMF has proposed a $560 million financing program and World Bank President David Malpass has warned that Chad may need a deep reduction in net present value of debt to address its debt overhang problem.

Ethiopia has also requested debt relief under the G-20 framework.[28] Ethiopia has been participating in the DSSI, benefitting from potentially $700 million in bilateral debt service relief in 2021 if the initiative is extended through the end of the year. However, Ethiopia also has $700 million in debt service due to commercial creditors and private bondholders, and another $300 million to multilaterals. An additional complication is that portions of Ethiopia's debt service due to the China Eximbank has already been restructured. A finance ministry statement highlights the dilemma: "implementation … will address the debt vulnerabilities of the country, while preserving long-term access to international financial markets."[29] Immediately after the announcement of Ethiopia's debt relief request, the price of Ethiopia's 2024 Eurobond fell by 8.4 percent.

Zambia became the third country to request debt relief through the G-20 framework on February 5, 2021.[30] The country has $3 billion in outstanding Eurobonds, in addition to $3.5 billion in bilateral debt, $2.1 billion borrowed from multilateral entities, and $2.9 billion from commercial lenders; $3 billion of this total is held by China or Chinese banks.

Reflection

If more countries seek debt relief, it is useful to learn from past experience with debt reduction programs such as the Heavily Indebted Poor Countries (HIPC) initiative started in 1996. That program successfully transferred resources to countries seeking debt relief, but by redirecting aid towards debt relief countries, it may have inadvertently reduced concessional funds going to other countries. At the same time, HIPC took a long time from inception to the so-called completion point for a country. The intent was to take time to implement structural reforms to mitigate the risk of future debt crises, but in practice, HIPC did little to fundamentally alter debt dynamics and most HIPC countries steadily built up debt again. HIPC countries also showed little systematic tendency to grow faster, either as compared to their prior history or compared to non-HIPC countries, with global trends being far more important for GDP and export growth. HIPC countries showed a mixed impact in terms of acceleration of progress towards the MDGs, although spending on education does appear to have been significantly

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[28] Wheatley and Schipani (2021). "Ethiopia asks for debt relief as Covid takes toll." Financial Times, Feb. 1.
[29] Mohammed and Thomas (2021). "Exclusive: Ethiopia to seek debt relief under G-20 debt framework." Reuters, Jan. 29.
[30] Reuters (2021). "Zambia requests debt restructuring under G-20 common framework." Feb. 5.

increased. Overall, evaluations suggest that paying more attention to public expenditure management would have improved the impact of HIPC.[31]

Private creditor participation: In the G-20 framework, debtor countries are only "required to seek from…private creditors a treatment at least as favorable as the one agreed in the MOU (a legally non-binding memorandum of understanding between debtor and creditors)." There is no binding commitment for private creditor participation. The case of Ethiopia already illustrates different incentives facing bilateral creditors and debtor country governments. The former are eager to ensure equal treatment including private creditors; the latter are eager to preserve their credit rating in private capital markets by minimizing the need for recontracting private debt service. Although there is an argument that any form of recontracting would have a significant impact on future access to capital markets, research suggests the opposite. There is little if any long-term impact on future capital market access of recontracting in the face of clearly unpredictable shocks.[32]

The limited participation of private creditors in voluntary debt reduction initiatives is not surprising. It is one of the lessons from implementation of the Heavily Indebted Poor Countries. Private creditor participation below anticipated levels generated a shortfall in HIPC relief that was substantial for some countries.[33]

China question: It is unclear whether obligations due to China's state-owned development banks should be treated as bilateral official credits or as private credits. Although the framework seeks parity in treatment between these two classes, the difference is that bilateral governments have agreed to fully participate, while private creditor participation remains voluntary and could in theory have different parameters. The experience to date suggests that a case-by-case approach is being applied.

Limited eligibility: The G-20 framework only applies to DSSI eligible countries, that is IDA-eligible countries and Angola. There are at least 34 countries (with $44 billion in debt service in 2021) with substantial risk of default, of which only 25 ($12 billion in debt service) are eligible to participate in the DSSI and G-20 framework.[34]

Accountability: When money moves fast, there is a risk of corruption and favoritism that reduces impact of public spending and, in the worst cases, reduces public trust and confidence in government. The Open Government Partnership champions open decision

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[31] World Bank IEG (2006). "Debt Relief for the Poorest: An Evaluation Update of the HIPC Initiative."
[32] Bolton et al. (2020). "Legal Air Cover." CEPR Discussion Paper No. DP15336.
[33] World Bank IEG (2006), op. cit.
[34] Kharas and Dooley (2020), op. cit.

making, open budgets, open aid, open contracting, and oversight by formal institutions like auditors and informal grass-roots organizations.[35]

Proposals

While the DSSI and the G-20 framework represent important steps in providing a mechanism to coordinate debt relief in the wake of COVID-19, further reform of these two programs would allow for greater coverage and impact.

1. The IMF and the World Bank have supported calls to extend the DSSI period until the end of 2021. The G-20 has agreed to review if this is required at the time of the 2021 Spring Meetings. Oxfam and the Jubilee Debt Campaign have called for extending the DSSI until the end of 2022.[36] UNCTAD suggests annual renewals of the DSSI based on debt sustainability analysis.[37] Other ideas include tying forbearance to COVID-19 deaths or vaccination rates.

2. The G-20 should extend DSSI eligibility, and hence Common Framework eligibility, to all lower-middle-income countries, all small island countries, and all countries deemed to have been seriously affected by the crisis. This would roughly double the size of financial relief provided by bilateral creditors and significantly enlarge the scope for private participation. The U.S. Treasury Department had indicated its willingness to consider this, although the policy position of the Biden administration is not yet clear.[38]

3. The IMF and the World Bank should review their respective debt limits policy and Sustainable Development Finance policy to ensure that new non-concessional borrowing for sustainable development is encouraged rather than discouraged for a transitional period for DSSI countries. Furthermore, the G-20 should ensure that debt relief granted under the DSSI/Common Framework is additional to existing concessional aid, both for the recipient country concerned and in the aggregate aid volumes provided by donors.

4. The IMF programs accompanying the DSSI should transparently link deferred financing to specific projects/spending to advance sustainable development, using metrics/nomenclatures to link new financing with national sustainable

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[35] Pradhan (2020). “Making Trillion Dollar Stimulus and Safety Nets Work for All: The Essential Steps We Can Take Now.” Open Government Partnership Blog, July 24.
[36] Christian Aid, Oxfam, Global Justice Now and Jubilee Debt Campaign (2020). “Passing the Buck on Debt Relief.” July.
[37] UNCTAD (2020). “From the Great Lockdown to the Great Meltdown: Developing Country Debt in the Time of COVID-19.” Trade and Development Report Update, April.
[38] Shalal (2020). “U.S. says it is open to extending G-20 debt framework to other countries.” Reuters, Nov. 13.

development programs and nationally determined contributions under the Paris Agreement as put forward by country authorities.[39]

5. Private sector participation should be encouraged through use of the "necessity defense" to provide legal air cover to countries in the event of a renewed sudden stop this year, or for those countries most severely impacted by the crisis.[40] One option could be the adoption of a new U.N. Security Council Resolution, for a limited time period of the pandemic and perhaps a limited category of countries, protecting developing country assets from seizure by private creditors. This could be based on the precedent of U.N. Security Council resolution 1483 that in 2003 immunized Iraq's sales of petroleum from "any form of attachment, garnishment, or execution." It was binding on all member states and hence prevented private creditors from using the courts in any country to grant them remedies against debt restructuring. With this in place for a limited period of time, Iraq was able to negotiate with private creditors and obtain favorable debt reduction terms. The worst fears expressed at the time, namely that such measures would undermine the entire sovereign debt market, clearly did not come to pass and indeed the markets responded well to the orderly restructuring. A modified version of this approach would be creating a legal shield in countries where most court seizures would likely be brought, namely the U.S. and U.K.[41]

6. Patrick Bolton of Colombia University and others suggest setting up a central credit facility, governed by a multilateral entity like the World Bank, where countries seeking forbearance could redirect their interest and principal payments, and receive them back as low-interest loans for specific pandemic mitigation spending.[42] Such a facility would allow debtor countries to initiate a debt suspension process without waiting for creditor coordination. Creditors whose interest payments were redirected into the facility would get a stake, proportional to their size. Such a mechanism would thus require creditors to opt out, rather than opt in. The group estimates that such a facility could provide up to $800 billion in loans to low-income countries with a 12-month standstill from bilateral and private creditors.[43]

7. Offer partial credit guarantees that can be used to provide rolling collateral for interest and principal repayments. Some private creditors may be willing to

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[39] Cavalli et al. (2022). "The Contribution of the European Cohesion Policy to the 2030 Agenda: An application to the Autonomous Region of Sardinia." FEEM Working Paper.
[40] Bolton et al. (2020). "Legal Air Cover," op. cit.
[41] Bolton et al. (2020). "Legal Air Cover," op. cit.
[42] Bolton et al. (2020). "Born Out of Necessity: A Debt Standstill for COVID-19." CEPR Policy Insight 103, April.
[43] Bolton et al. (2020). "Born Out of Necessity," op. cit.

reduce the net present value of their claims, if their residual claims are enhanced, as done in the Brady bond exchanges. Several MDBs have successfully used these instruments to mobilize private capital for development. The United Nations Economic Commission for Africa (UNECA) has called for the creation of a special purpose vehicle, guaranteed by a multilateral or central bank, for developing countries to exchange commercial debt for new concessional papers with longer maturities and lower coupon rates, similar to the Brady Plan.[44]

8. Use the negative pledge clause more aggressively. The World Bank, the African Development Bank, and other MDBs have negative pledge clauses in their loan contracts that could be used if private creditors attempt to secure their own repayment by using collateral that may be explicitly, or implicitly, included in their loan contracts. Triggering the negative pledge clause would give MDBs leverage to encourage greater private creditor participation. This is an important tool at the MDBs disposal, given the rise of collateralized lending in resource rich developing countries.

9. Use debt swap mechanisms to link debt forgiveness with specific purposes in order to leverage and direct debt relief for maximum impact. The United Nations Economic Commission for Latin America and the Caribbean (ECLAC) has proposed debt swaps for payments into the Caribbean Resilience Fund.[45] Swaps could be linked to pandemic investments, climate change mitigation, ecosystem and biodiversity preservation, or green recovery efforts. However, some developing countries may have limited capacity to handle conventional and new debt swaps, thus such mechanisms would likely need to come with technical support from MDBs, U.N. agencies, or bilateral governments.

10. Ensure transparency, inclusion, and citizen voice in decisions on public spending, contracting and monitoring, with follow-up remedies to redress episodes of capture of funds by politically-connected groups or individuals.

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[44] Soto (2020). "Africa Eyes Own 'Brady Plan' as Debt Relief Proposal Takes Shape." Bloomberg, Apr. 28.
[45] ECLAC (2017). "ECLAC Advocates for Caribbean's Debt Swap Proposal and Establishes Trask Force for its Implementation."

IV. Addressing the financing shortfall

Debt service suspension and debt relief will not provide the additional financing needed to meet the requirements of pandemic funding, economic recovery and transformation to a green economy. The IMF estimate of resources needed by EMDEs just for economic recovery was $2.5 trillion.[46] As argued above, new financing and debt relief are complementary measures as long as the additional resources are properly used for projects with positive net present value in both social and financial terms. Thanks to massive injections of liquidity by major central banks, the discount rate used to evaluate new investments is now very low, opening up opportunities even in the presence of high existing debt levels.

There are three proposals for major additional financing for EMDEs: an SDR allocation, more ambitious lending by MDBs, and a new facility to provide liquidity support for the private sector in developing countries.

New SDR allocation

In August 2009, the IMF issued SDR182.6 billion (about $280 billion equivalent) to support member countries to manage the Great Recession. [47] The 2020 pandemic is larger and more widespread, so deserving of a larger allocation.

There is now a call for another issuance, with amounts ranging from under SDR475 billion (about $680 billion at current exchange rates—the upper bound on an issuance that avoids new legislation in the United States) to anywhere from $1-3 trillion.

A new SDR issuance enjoys widespread, but not unanimous, support. EU leaders, including President Macron and Chancellor Merkel, and African leaders, have called on the IMF to issue additional SDRs to help finance the COVID-19 response.[48] This move is supported by IMF Managing Director Georgieva,[49] Larry Summers and Gordon Brown,[50]

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[46] Georgieva (2020). "Transcript of Press Briefing by Kristalina Georgieva following a Conference Call of the International Monetary and Financial Committee." Mar. 27.
[47] IMF (2017). "Special Drawing Rights (SDR) allocations."
[48] European Council (2020). "Only victory in Africa can end the pandemic everywhere - World leaders call for an urgent debt moratorium and unprecedented health and economic aid packages." Press Release, Apr. 15.
[49] Georgieva (2020). "The Great Lockdown: Worst Economic Downturn Since the Great Depression." Press Release, Mar. 23.
[50] Summers and Brown (2020). "National governments have gone big. The IMF and World Bank should do the same." Washington Post, Apr. 14.

the Financial Times editorial board,[51] academic,[52] and civil society organizations.[53] It has also has supporters in the U.S. Congress, with Sen. Durbin and Sen. Sanders calling on the U.S. Treasury to support an additional SDR allocation.[54] On July 31, 2020, the U.S. House of Representatives passed legislation authorizing the administration to support an allocation of no less than SDR2 trillion, although this was not pursued further.

An SDR issuance requires the approval of 85 percent of the votes in the IMF Board. Because the U.S. voting share is 16.5 percent, it has a veto power over any new issuance, and the past administration opposed it.[55] However, the Biden administration has signaled its support. An allocation of up to SDR475 billion would require a 90-day Congressional notification but not necessarily approval, so in the interests of speed, this could be a preferred tactic, buying time to craft and pass legislation in support of a larger SDR issuance.

A new SDR issuance is not the perfect solution. The original purpose of the SDRs is to provide global liquidity to manage balance of payments disequilibria, not to finance specific expenditure programs of member states. Hence, SDRs are distributed to member countries according to a formula reflecting their systemic importance in the global economy. This formula, known as the country's IMF quota, assigns the majority of any new SDR distribution to advanced economies. EMDEs would get 38.45 percent of a new allocation; DSSI eligible countries would get 4.5 percent, of which low-income countries (World Bank definition) would get only 1.5 percent.[56]

Nevertheless, a new SDR issuance is the most feasible way of expanding global resources to help achieve global priorities, even in developing countries. Following a new issuance, there can be a reallocation under which countries with excess SDRs can lend them to those requiring additional resources at a market determined interest rate, currently equivalent to 0.064 percent. There is a precedent under which countries with surplus SDRs have lent them, on a voluntary basis, through an IMF Poverty Reduction and Growth Trust (PRGT) facility to low-income countries, accompanied by grants to offset cash costs and technical assistance to improve the effectiveness of policies and spending. This same mechanism, or a new facility with a similar structure, could again be used, thereby helping countries respond to the COVID-19 pandemic, re-invigorate

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[51] Financial Times Editorial Board (2020). "New issuance of SDR is vital to help poorer countries." Financial Times, Apr. 12.
[52] Weisbrot and Arauz (2020). "G-20 Should Call for IMF to Issue 3 trillion SDRs, CEPR Economists Say." CEPR Press Release, Mar. 26; Gallagher, Ocampo and Volz (2020). "It's time for a major issuance of the IMF's Special Drawing Rights." Financial Times, Mar. 20.
[53] Oxfam et al. (2021). "Letter to President-Elect Biden on Global Covid Relief." Jan. 14.
[54] Durbin (2021). "Durbin, Sanders, Garcia, Collogues Call on Treasury to Support IMF Assistance for Developing Nations Amid COVID-19 Pandemic." Press Release, Jan. 25.
[55] Politi (2020). "US holds off on IMF plan to boost emerging economies' finances." Financial Times, Apr. 15; Politi (2020). "Mnuchin defends US opposition to emerging markets liquidity plan." Financial Times, Apr. 16.
[56] IMF (2017). "Special Drawing Rights (SDR) allocations."

economic growth to support a strong global recovery, fight inequality, and forcefully address the threat of climate change.

The advantage of using the PRGT is that it is already established and has existing safeguards present in all IMF programs in place, so funds could be rolled out quickly. During the last year, PRGT funds have been unconditional, a policy which could be continued if IMF shareholders approve. However, some creditors may prefer to tie new resources to specific uses for pandemic related investments, Sustainable Development Goal (SDG) outcomes, or climate change initiatives. A further consideration in using the PRGT is that it would exclude most middle-income countries who would then only benefit from their rather modest initial SDR allocation.

Additional MDB lending and granting

The preferred instrument for supporting public sector development spending is MDB finance. The MDBs offer financing on much more reasonable terms than bilateral lenders or private creditors, allowing developing countries to take on debt in a more sustainable way. They have preferred creditor status, making it less risky for them to lend in situations where countries are suffering from debt overhangs. They can offer even better terms to low-income countries by blending funds with grants received from member governments and from profits accruing from their banking operations.

Multilateral development funds, providing concessional flows to low-income countries, have front-loaded their commitments in response to the crisis. These higher lending and granting levels, however, cannot be sustained. Without further action from donors, the funds would have to retrench at a time when client countries still require considerable support. The most feasible solution is to accelerate the timetable for agreeing on a fresh replenishment of the funds. For example, IDA is embarking on its 20th replenishment, currently scheduled to mobilize money to be provided to clients for a three-year period starting on July 1, 2023. If IDA negotiations can be concluded during 2021, then it could start its activities on July 1, 2022 instead, thereby permitting all remaining IDA 19 funds to be allocated one year ahead of schedule.

There is more agreement on helping low-income countries than on expanding market-based lending to middle-income countries. In recent years, MDBs have cut back on market-based lending, relative to the overall size of sovereign debt markets. For a number of reasons, middle-income countries have increasingly turned to private capital markets where they have accessed far larger volumes of financing, albeit on harder terms.

The higher interest rates and shorter maturities of private capital, coupled with procyclical market access, are at the heart of much of the current difficulties faced by developing countries. In an earlier paper, we indicated that developing countries would be saving $140 billion per year in lower debt service if they had borrowed on MDB non-concessional terms.[57] One of the reasons so many countries now face debt service difficulties is that the official development finance system exited too early in favor of private finance. Rather than pulling back, in the current context, the MDB system should dramatically scale up financing.

This is not just a countercyclical measure. Sharply higher public investment in developing countries is needed to upgrade their physical, human, and natural capital in the next two decades, and these investments can best be financed by MDBs.

We suggest that the MDBs target developing countries with a speculative credit rating, below investment grade but above CCC rating.[58] These countries gain the most from multilateral financing and accompanying policy advice and technical assistance. As Table 1 below shows, these are also countries that are largely ineligible for DSSI assistance, yet they have significant debt service obligations. The debt service of speculative grade developing countries is further broken down into debt service owed by countries where debt levels are below thresholds of excessive debt, and debt service owed by countries with track records of growth (g) that is higher than interest rates (i). Both categories are suggestive of liquidity problems, rather than solvency problems, so provision of multilateral finance to these countries would seem appropriate.

Table 1. Total external debt service 2021, public and publicly guaranteed, for countries with speculative credit ratings

	Developing countries, Speculative credit rating		DSSI countries, Speculative credit rating	
	Countries	**Debt service**	**Countries**	**Debt service**
Total	74	$133 billion	43	$29 billion
Debt-to-GDP ratio <55%	47	$79 billion	31	$24 billion
Debt-to-GDP ratio >55%, (i-g) negative	18	$16 billion	12	$5 billion
Other	9	$38 billion	0	$0

Source: World Bank International Debt Statistics (2021). Credit ratings based on Trading Economics classifications (2020). (i-g) refers to the interest rate minus growth differential. Negative (i-g) implies the country is growing faster than interest is accruing, meaning debt ratios will fall over time without adjustment in the primary surplus/deficit.

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[57] Kharas and Dooley (2020), op. cit.
[58] We are using the categories formed by Trading Economics, an aggregator of economic and financial market data.

There is ample scope for MDBs to be more ambitious. According to one calculation, the major MDBs could raise lending by an amount between $750 billion to $1.3 trillion simply by taking more risk onto their balance sheets and using risk-management parameters closer to levels used by market-based commercial bank institutions.[59] Ramping up in this fashion would not involve any additional resources from shareholders.

The MDBs could also expand their use of blended finance to crowd in additional private sector financing through the use of guarantees and expansion of their private sector windows and guarantee facilities like the Multilateral Investment Guarantee Authority (MIGA). The Global Investors for Sustainable Development Alliance (GISD), a group of leaders in the investment and business community, has called for the creation of a blended finance fund for the SDGs, modeled after the International Finance Corporation's (IFC) Managed Co-Lending Portfolio Program (MCPP) to scale investment for projects necessary to achieve the SDGs.[60] Blended finance has been used for sustainable infrastructure investments through initiatives like FAST-Infra[61] and the Climate Finance Leadership Initiative,[62] and similar work could be done to bring in the private sector in pursuit of pandemic recovery, green transition, and SDG achievement in other sectors as well. Expanded use of blended finance and guarantees does come with enhanced risk, thus such moves must come alongside larger conversations amongst the MDBs' shareholders about their risk tolerance.

At a time when bold and ambitious measures are needed, the ability to unleash the firepower of the MDBs is a major asset for the international community. But any technical solutions to enhance MDB resources must also be accompanied by a new political understanding of a more ambitious role for the MDBs that would then have to be reflected in changes to the nature and scale of the conditionalities and approval timeframes associated with new MDB commitments.

A liquidity and support facility

Beyond the MDBs, there are ways to increase EMDE access to markets at more favorable terms, providing additional liquidity in the near term, and more sustainable debt down the line. UNECA has proposed the creation of a special purpose vehicle for Africa, modeled on repurchase "repo" facilities in U.S. and Europe.[63] Such an entity would receive seed funding from a multilateral or central bank, backed by a funded

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[59] Humphrey (2020). "All hands on deck." ODI Briefing Paper.
[60] GISD (2020). "Renewed, Recharges and Reinforced: Urgent Actions to Harmonize and Scale Sustainable Finance."
[61] Buchner et al. (2020). "FAST-Infra." Climate Policy Initiative.
[62] Bloomberg (2021). "The Climate Finance Leadership Initiative."
[63] Songwe (2020). "Africa needs its own 'repo' market." Financial Times, June 25.

commitment or guarantee, allowing it to obtain an A+ credit rating. Governments would be able to borrow from this facility to finance short term liquidity needs, at better terms than international markets. Private lenders, likewise, could get access to financing from this facility to buy EMDE bonds, which they can pledge as collateral against the facility. Such a vehicle would thus incentivize private investment on the continent, while also lowering spreads and increasing market access for governments. The facility could prioritize financing for recovery and green linked investments, ensuring additional financing is used for development goals. This move would require G-20 and central bank support initially, but would be self-sustaining. UNECA has called for an initial $50 billion injection, which could then be leveraged to $250 billion in new lending.[64] Such funding could come from SDRs, on-lent to the facility by developed countries.

Proposals

To summarize the above, we recommend a number of steps to expand developing county access to financing in the near term to address the current liquidity crunch.

1. Approve a new allocation of SDRs at IMF/World Bank Spring meetings of at least $500 billion equivalent, below the threshold for approval by the U.S. Congress. Debate on the merits of a larger allocation could also be initiated, but with full recognition that the legislative process requires far lengthier deliberations and is politically more complex.

   Establish an SDR reallocation mechanism through the PRGT facility or some other facility that could be oriented more specifically toward green finance.

2. Conclude IDA 20 replenishment by December 2021, with agreement on use of funds to support countries' implementation of SDGs, nationally determined contributions under the Paris Agreement, and biodiversity.

3. Target a substantial expansion of multilateral lending at developing countries with a speculative credit rating who are facing liquidity constraints in accessing finance at reasonable terms.

4. Establish mechanisms to improve terms of developing country market access, such as the proposed Liquidity and Support Facility, and build platforms and instruments to mobilize greater private sector investment in EMDEs.

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[64] UNECA (2020). "Building Forward Together: Financing a Sustainable Recovery for the Future of All."

V. Architecture

The COVID-19 crisis has revealed the weaknesses of an international financial architecture that has permitted successive waves of developing country defaults and restructurings, each time with substantial developmental costs. The current architecture reflects the asymmetries of the world: it is procyclical, contractionary, and biased towards creditors. There are numerous gaps in transparency, and lack of clarity in roles and responsibilities in different states of the world. There are no processes that bind all creditors and debtors to a uniform set of standards. The architecture reform will require new tools, instruments, and legislative backing, but also a mindset shift towards responsible borrowing and lending with fair, transparent, and equitable workouts, should those be required.

Any movement towards specific reforms, therefore, must be based on a process with accepted legitimacy by a wide tranche of stakeholders that today include non-Paris Club official creditors, multiple different private creditors, commodity traders, and others; hence the need for a periodic, institutionalized review of debt and debt like financial flows to transparently share information. It is in the interest of all parties for international institutions to create an open dialogue to build trust and transparency in a systematic way.

Below, we outline a number of innovations in the international financial system that have strengthened the architecture in selected instances but have not yet been systematically incorporated everywhere. We also highlight a number of broader concepts that underlie any larger reform effort.

Collective actions clauses (CACs) in debt agreements

After the IMF's endorsement in 2014, CACs have been included in almost all new sovereign bonds to date.[65] CACs allow a majority of bondholders to bind an uncooperative minority in debt restructuring efforts. Some CACs apply series by series, meaning that creditors must reach a consensus threshold (75 percent, determined by holding amount) on each bond during restructuring efforts.[66] A two-limb agreement, recently used in the Argentina and Ecuador restructurings, requires reaching 50 percent creditor consensus per series, and 66.6 percent agreement overall. A single limb

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[65] IMF (2014). "Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring." IMF Policy Paper, October.
[66] IMF (2020). "The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors – Recent Developments, Challenges, And Reform Options." Policy Paper No. 43.

agreement, which has yet to be used, requires 75 percent aggregate consensus threshold, allowing large creditors to bind uncooperative creditors across series. CACs can work in conjunction with anti-vulture fund legislation to limit litigation efforts by uncooperative creditors. Such legislation, currently enacted in the U.K., Belgium, and France, limits the ability of holdout creditors to use the courts to get payment. The EU finance ministers have agreed in principle to incorporate single-limb CACs into all Eurobond agreements starting in 2022. While CACs represent a promising future mechanism for greater debt cooperation, they are not retroactive—many developing countries have outstanding debt stock without CACs.

Box 3. Ecuador case study

Ecuador was hard hit by the COVID-19 pandemic, and the country's outstanding debt levels made it difficult to finance economic recovery efforts. Right at the start of the pandemic in March, Ecuador had $340 million in debt service due.[67] Though it received pressure to default and use these funds for pandemic response, it honored these obligations, and then worked out a deal with bondholders to suspend $810 million in payments due from April to August 2020, as they engaged in a larger restructuring effort.[68] These negotiations were contingent on a new IMF program, which the IMF agreed to in August 2020, giving Ecuador $6.5 billion over 27 months to support the bond restructuring plan and fund the 2020 budget.[69] Ecuador was able to reach an agreement with the majority of its bondholders to restructure $17.4 billion in debt, largely due to the inclusion of collective action clauses (CACs) in the bond agreements. Ecuador's creditors formed three creditor committees, one of which contained the major institutional bondholders, and the government successfully coordinated negotiations between the three groups.[70] After the first round of negotiations, Ecuador reached 60 percent aggregate support, which helped get the rest of the creditors on board after another round of negotiations. With the CACs, Ecuador was able to reach 98.3 percent aggregate approval, and hold off a legal challenge by two creditors (which was rejected by a New York court). Separately, Ecuador negotiated a one-year deferral on interest payments due to the China Development Bank, and renegotiated a loan held by a state-owned oil company.[71] It also received a new $2 billion loan from a Chinese bank to help finance pandemic recovery efforts. In September, Fitch upgraded Ecuador's credit rating from default to B- and their outlook to stable, reflecting the success of the restructuring effort.[72]

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[67] Long (2020). "Ecuador basks in glow of debt-restructuring success." Financial Times, Sept. 6.
[68] Long (2020). "Ecuador reaches deal to postpone debt repayments until August." Financial Times, Apr. 17.
[69] Kueffner, Martin and Bartenstein (2020). "IMF's $6.5 Billion Allows Ecuador To Restructure Bonds." Bloomberg, Aug. 28.
[70] IMF (2020). "The International Architecture," op. cit.
[71] Long (2020). "Ecuador basks in glow of debt-restructuring success," op. cit.
[72] Fitch (2020). "Fitch Upgrades Ecuador to 'B-'; Outlook Stable." Sept. 3.

The architecture could be strengthened over time if all major financial centers made it mandatory to include CACs in all maturities exceeding one year. At present, the EU is the only jurisdiction to do this.

State-contingent mechanisms

State contingent mechanisms like GDP or disaster-linked bonds, especially in small island and climate vulnerable states have also proven useful.[73] Natural disaster clauses have been used by Grenada in 2015 and Barbados in 2018.[74] These automatically extend loan maturities and suspend interest payments immediately following a shock. Similar mechanisms have been built into World Bank instruments, namely the Catastrophe Deferred Drawdown (Cat DDO) and Contingency Emergency Response Component (CERC), which have been used to redirect existing project finance towards COVID-19 relief efforts. A GDP linked instrument, used in Argentina in 2005 and 2010, and Greece in 2012, allows interest rates to grow when a country experiences strong economic growth, and shrink when growth slows. This helps countries share their economic risk with creditors.

State-contingent mechanisms are also helpful for restructuring domestic liabilities. Governments have the right, *de facto,* to alter the terms of domestic debt in responding to a major unforeseen event.

Box 4. Barbados case study

Barbados underwent its first restructuring in 2018-2019, which included a number of novel features.[75] The country experienced a decade long recession after the 2008 financial crisis, with burgeoning debt that became unsustainable. The restructuring covered central government domestic debt, including treasury bills, and government debt to external commercial creditors (bilateral and multilateral debt excluded). Both domestic and external creditors formed committees to carry out the negotiations. The government used a novel approach to resolving domestic debt, passing legislation that retrofitted a collective action mechanism onto existing domestic debt. Under this CAC, 75 percent of aggregate creditors could bind minority holders in a restructuring deal. The government reached a deal with domestic creditors in October 2018, achieving 100 percent participation through the CAC. The country's external private debt consisted of

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[73] UN (2020). "Financing for Sustainable Development Report 2020." Report of the Inter-agency Task Force on Financing for Development.
[74] IMF (2020). "The International Architecture," op. cit.
[75] Anthony, Impavido and van Selm (2020). "Barbados' 2018-2019 Sovereign Debt Restructuring – A Sea Change?" IMF Working Paper No. 20/34, Feb.

a handful of Eurobonds and a loan from Credit Suisse. The Eurobonds all contained CACs with a 75 percent creditor threshold, but the commercial debt did not. However, it did include an exit consent, typically used on bonds, allowing the majority of creditors (50 percent +1) to approve amendments to the loan agreement. After a number of rounds of negotiations, the government reached a deal with the external creditor committee in October 2019, consisting of a 26 percent haircut, issuance of new long-term debt with 10-year maturity and 6.5 percent interest, and a $40 million repayment plan between 2019-2021. Creditor support on the Eurobonds reached an average of 93 percent, well above the CAC threshold, and 100 percent on the Credit Suisse loan.

Barbados used both domestic and external restructuring to build future debt sustainability. As a small island vulnerable to natural disasters, it included a natural disaster clause in its newly restructured debt. This would allow for the deferral of interest and principal payments for two years after a natural disaster. The triggering of this clause was linked to payouts from the Caribbean Catastrophe Risk Insurance Facility (CCRIF).

Creditor committees

Sovereign debt is the only class of debt without built in bankruptcy mechanisms that provide guidance on the formation of creditor committees. Under Chapter 11 of the U.S. corporate bankruptcy law, for instance, the U.S. trustee must appoint a committee of creditors to oversee the corporate reorganization or liquidation measures.[76] These appointed members have a fiduciary duty to other creditors not on the committee, and must ensure that unsecured creditors are represented in the proceedings.

Creditor committees have been used to varying degrees in sovereign debt restructurings over the years. Bank advisory committees were common during the Latin America debt crisis in the 1980s, but did not have a fiduciary duty to represent other creditors, and had to reach unanimity on each item in a restructuring package, leading to their downfall.[77] Creditor committees have since fallen into disuse, partially due to the expanded diversity of the creditor universe. Debtor countries typically meet with all creditors individually, and then try to put forward a proposal that will be amenable to all.

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[76] Buchheit (2009). "Use of Creditor Committees in Sovereign Debt Workouts." Business Law International 10(3): 205-2017; DeSieno (2014). "Credit Committees in Sovereign Debt Restructurings: Understanding the Benefits and Addressing Concerns," in Guzman, Ocampo and Stiglitz (eds), Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises (Columbia University Press 2016).

[77] Buchheit (2009), op. cit; DeSieno (2014), op. cit.

Some have pushed for the resurrection of the creditor committee in the wake of COVID-19 as a means of bringing together official and private creditors.[78] There are many benefits to a committee approach. Committees allow for all creditors to be on the same page in a world of non-transparent debt data; all receive access to the same financial information and can see what others' claims are[79]. They allow the debtor to negotiate with a single body, rather than jumping around from creditor to creditor. Once a consensus is reached, committees, like CACs, can limit holdouts by endorsing the deal, and apply pressure on others to sign. However, there are some risks. Due to the diverse nature of creditors, there are likely to be competing creditor committees made up of groups of like-minded creditors, as was the case in the recent Argentina and Ecuador restructurings. This can prolong the process, and limit some of the collective action that the committees aimed to address. Committees are also difficult to break up—once a debtor begins a negotiation with a committee, it is hard to walk away and try restructuring outside of that body if the process gets slowed down. Committees can also be costly—debtors are usually responsible for the legal fees incurred by the committee.

Some of these concerns could be mitigated with adequate planning. For instance, during Belize's restructuring in 2006, the government put out a memo indicating it was ready to recognize creditor committees if they agreed to a set of terms.[80] First, the committee must represent 51 percent of the outstanding debt stock, to limit competing committees, and agree to operate by 75 percent consensus. They must agree to support the deal reached by the committee, and conduct all negotiations in a timely manner, with two-weeks for background preparation, and two days for the first round of negotiations. The government also committed to put all information related to the restructuring online to ensure transparency.

At issue is who has the responsibility to establish and oversee such committees. An earlier proposal for the IMF to take the lead was floated in discussions over a global Sovereign Debt Restructuring Mechanism (SDRM) of the early 2000s.[81] Under this, the equivalent of an International Debt Court could organize committee formation and determine representation, lay out terms to ensure confidentiality, limit litigation, and cap reimbursable legal expenses.[82] The proposal was not adopted by member states, however. A blend between the voluntary and statutory approaches has been suggested in a manner akin to the World Trade Organization's dispute settlement process; namely a

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[78] Gelpern, Hagan and Mazarei (2020). "Debt standstills can help vulnerable governments manage the COVID-19 crisis." PIEE, Apr. 7.
[79] Buchheit (2009), op. cit; DeSieno (2014), op. cit.
[80] Buchheit (2009), op. cit
[81] IMF (2003). "Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism."
[82] DeSieno (2014), op. cit.

voluntary negotiation that takes place within pre-established timelines, before the judicial arbitration kicks in.[83]

Transparency

The gaps in debt transparency have grown larger over time with more diverse creditors. The World Bank's expanded International Debt Statistics database publishes monthly principal and interest payments by country and creditor, as reported by the debtor, with a process of reconciliation of data with creditors.[84] However, this process is not well developed for creditors in some countries, notably China, nor for non-bonded loans (syndicated loans, domestic debt, arbitration awards, central bank deposits and swaps, and contingent liabilities) and collateralized loans in developing countries, that are increasingly being used, especially in resource rich economies. The nature and value of assets provided as collateral is also unknown: collateralized bonds and syndicated loans accounted for 15 percent of emerging market bonds since 2002.[85] In addition, non-syndicated loans, notably from commodity traders, also fall outside the debtor or creditor reporting systems.

Restructuring efforts are complicated when there is a lack of debt transparency. The IIF has called on commodity traders to adhere to its transparency guidelines.[86] Notably, 40 percent of Chad's debt stock, the first country to seek restructuring under the G-20 framework, is from private lenders, largely the commodity trader Glencore.

Building consensus for new norms and standards for transparency in debt reporting and data reconciliation between creditors and debtors in a timely and comprehensive way is the foundation for a more resilient international financial architecture. The current voluntary process is insufficient. The World Bank reports that half of all IDA countries do not have "adequate" capacity in their debt management policy and institutions, including poor data quality.[87] One solution is to provide additional technical assistance to improve such capacity. Another is to shift incentives for governments to provide more accurate and complete information, in a fashion similar to the IMF's Misreporting Policies.

Aid

Ultimately, the resilience of the international financial system rests on the volume and allocation of aid. Without aid, poor countries would simply be unable to flourish. Yet aid

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[83] Ocampo (2017). "Resetting the International Monetary (Non) System." Oxford University Press.
[84] World Bank (2021). "International Debt Statistics 2021."
[85] IMF and World Bank (2020). "Collateralized Transactions: Key Considerations for Public Lenders and Borrowers."
[86] IIF (2019). "Voluntary Principles for Debt Transparency."
[87] IDA (2019). "Addressing debt vulnerabilities in IDA countries."

is coming under increasing pressure, being tasked with ever more responsibilities: managing the pandemic, funding biodiversity and management of the global commons; conflict resolution and peacekeeping; research and development in food security; debt relief; and humanitarian assistance in the face of ever more destructive natural disasters.

These pressures are not new, but they are increasing. For the past 50 years, since 1972, official development assistance (ODA) provided by members of the Development Assistance Committee (DAC) has oscillated around 0.3 percent of their national income. If DAC member states had achieved their target of 0.7 percent of national income, they would now be disbursing an additional $200 billion per year in grant equivalent funds. This would have been enough to fully cover the debt service of all non-investment grade developing countries. The debt crisis would have disappeared.

Reaffirmation of the need to raise aid to achieve the 0.7 percent target is therefore a central pillar of the debt architecture. Even at the sharply lower current levels, if aid gets diverted to non-country programmable causes, however justifiable, it can undercut the broader parameters of development finance. This is the risk today where large amounts of aid are being sought for priorities that are not programmable by recipient countries for development purposes. The recipient country ownership of aid is falling again. Therefore, obtaining a commitment to maintain the level of country programmable aid as a share of national income should be a minimum ask from DAC countries.

Accountability

International law holds governments accountable for all debts incurred by their predecessors. The concept of odious debt, namely debt that did not benefit the sovereign people of the country, has never been grounds for dismissal of an obligation by an international tribunal. With that as backdrop, it is all the more important to ensure that governments are held accountable by their citizens for any debts they incur and will leave to their successors.

The measurement and tracking of public expenditure are a foundation of the international financial architecture that remains weak. Globally, governments spend $13 trillion on public contracts, but only about 3 percent of these are published openly. 70 governments across the world have joined the Open Government Partnership's call for open contracting, but such transparency should become the norm not the exception for any projects using international finance.[88] State capture by the politically connected is one of the core weaknesses of the architecture, assisted by institutional devices such as

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[88] Open Government Partnership (2021). "Open Contracting and Public Procurement."

the "ignorance" defense for lawyers and accountants helping set up trusts and other means of hiding illicit assets, the hiding of beneficial ownership, and the prosecution of bribery.[89]

One concrete idea for enhancing accountability is to use country platforms as a device for coordinating financial flows in a way that brings consistency to financial and regulatory reporting. The idea of country platforms comes out of the G-20 Eminent Persons Group on Global Financial Governance.[90] Country platforms would provide a forum for developing countries and creditors to coordinate and align financing, specific investment projects, and implementation within an overall national strategy, usually within specific sectors. Country platforms can create pools or portfolios of real assets, with enough transparency and standardization for any bank or financial institution to mitigate individual project risk. This can potentially reduce the very high regulatory hurdles that currently restrict private flows to developing countries. For example, Solvency 2 rules would force a European insurer to charge about 40 percent of a loan for Latin American or African infrastructure against its capital; a pooled approach could reduce this substantially.

Proposals

1. Make the inclusion of CACs mandatory in all new sovereign bond issuances in major financial centers, following the EU example, and encourage other legislative actions such as anti-vulture fund decrees.

2. Encourage use of state-contingent mechanisms in new debt. Disaster-linked mechanisms offer useful practical examples.

3. Establish improved international debt workout processes, with a combination of voluntary negotiation and international arbitration, including authority to establish creditor committees to ensure fair and equitable workouts.

4. Strengthen debt reporting by both debtors and creditors and improve incentives and technical assistance for building capacity in debt institutions.

5. Maintain or increase current levels of country programable aid as a share of GDP, even in the face of additional competing claims on aid.

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[89] OECD (2014). "Illicit Financial Flows from Developing Countries: Measuring OECD Responses."
[90] Global Financial Governance (2018). "Achieving Greater Development Impact: Collaborating across the System." Report of the G-20 Eminent Person Group on Global Financial Government (EPG).

6. Use country platforms and other institutional mechanisms to achieve greater coordination and alignment of financial flows and public investments, in a way that supports transparency and accountable monitoring and reporting.

VI. Conclusion

Three major agendas are shaping the policy responses around the use international finance to mitigate the impact of COVID-19 in 2021. In each area, ambition and urgency are needed.

The first agenda is around debt relief and restructuring. The initial response of the international community in 2020, through implementation of the DSSI and emergency lending by international financial institutions, has bought time. But an increasing number of countries, including many not currently eligible to participate in the DSSI, are likely to seek debt relief this year and could overwhelm the current case-by-case approach. The current system also remains unclear about private creditor participation in debt work outs.

The second agenda is how to restore enough financing to governments in EMDEs to allow them to meet pandemic-related expenses, short-term counter-cyclical fiscal responses to recession, and long-term expansion of public investment to achieve transformational decarbonization. All this in the context of increasing debt levels. There are options for the international community to step up official financing, through SDR allocations, MDB ambition, and new liquidity and blended finance facilities.

The third agenda is to use the crisis to make progress on strengthening the international financial architecture. There has been piecemeal progress over the past ten years or so, including on issues as diverse as collective action clauses and transparency of beneficial ownership, but the system, as a system, remains weak. One of the most important pillars, the provision of grant aid to poor countries, is under pressure to respond to multiple crises, but there is no agreement that the new functions will be incremental to existing levels of support. With very large sums of money flowing through government programs, there is a greater need for transparency and oversight.

This paper provides some suggestions in each of these three areas. Underlying all of them is the belief that multilateral coordination and development of global norms and standards can lead to improved outcomes. We believe that success on this agenda will be measured by the ability of the international financial system to transfer resources from rich countries to poor countries in ways that will permit governments and businesses in these countries to invest efficiently, effectively, and inclusively.

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