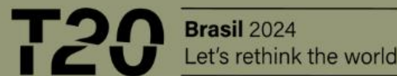
T20 Policy Brief



Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

How Can the G20 Contribute to Debt Sustainability in Low- And Middle-Income Countries?

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Abstract

For the first time, and after many proposals have been mooted, a global debt governance system is emerging. After decades as an informal and ad hoc process under the aegis of the Paris Club, the governance of sovereign debt problems has evolved significantly since November 2020 and the introduction of the G20 Common Framework for Debt Treatments beyond the DSSI (CF). Notably, the CF brings all creditors together; official creditor committees have been chaired jointly by France and China, and a Global Sovereign Debt Roundtable (GSDR) has been formed to develop agreements on methodologies and implementation issues.

Cases treated under the CF have been few and time-consuming. However, important learning and cooperation processes have been initiated, forming a basis for the CF to be further developed and become able to treat multiple and simultaneous cases more quickly. Even with an expansion of MDB lending, the risk of debt distress in many low-income countries (LICs) and lower-middle-income countries (MICs) remains acute. Thus, the international financial architecture needs a debt treatment system that acts swiftly and proactively to ensure that cases of debt distress do not lead to social and economic crises, but rather restore the investment process for sustainable growth.

Associated reforms would include improving coordination mechanisms and transparency in a CF extended to include MICs and better linked to sustainable longer-term development pathways in line with the SDGs and climate transition. The recent reforms of the IMF policies on lending into arrears are helpful in supporting such debt treatment processes.

The G20 provides the space and expertise to build on this progress to establish a new Global Sovereign Debt Treatment System (GSDTS). As part of this system, we also propose a new G20 Universal Code of Conduct under the G20 Financial Stability Board (FSB).

Diagnosis

Sovereign debt problems in the developing world are visible in three closely connected stages: excessive debt accumulation, liquidity problems, and solvency problems. Too much debt build-up arises under favorable international market conditions, especially for MICs, and through access to bilateral official lending, in the case of LICs. Excessive debt is often accumulated in periods of low interest rates, during which sovereigns overborrow and private and public investors take risks to increase yields.

According to the World Bank, about 60 percent of the LICs are either at high risk of debt distress or in debt distress (World Bank 2023). As table 1 shows, the external debt of LICs has grown faster than that of MICs in the last decade. This rapid debt accumulation happened under low global interest rates after the Global Financial Crisis (GFC) of 2008-09 and the following adjustment of monetary policy (Estevão and Essel 2022). Low LICs' debt stocks, after large-scale debt forgiveness for many countries under the Heavily Indebted Poor Countries (HIPC) initiative, also contributed to an overly optimistic view on LICs' ability to borrow sustainably.

TABLE 1. Debt growth across country categories

	Increase in external debt, 2012-2022, in percentage
LICs	109
Lower MICs	89
All MICs	58
Upper MICs (excluding China)	28

Source: World Bank, 2023, p.10-11, 28

In addition to a majority of LICs at risk of, or already in, debt distress, a number of lower MICs are also highly likely to face binding liquidity or solvency problems in 2025-2026, as debt service commitments increase while net financing flows fall (see Albinet et al. 2023). Hence, the need for a global debt governance system that can simultaneously handle multiple cases of debt distress, distinguishing between severe liquidity problems and solvency problems (Berensmann 2017).

Furthermore, creditor composition in developing countries has changed radically over the last two decades, with China becoming the largest bilateral creditor, and private bond markets outstripping official sources as developing countries' financiers. At the end of 2021, 61% of the gross long-term public and publicly guaranteed external debt stock of LICs and MICs was held by private creditors as opposed to official creditors, a significant increase from 46% in 2010. Obligations of IDA-eligible countries to non-Paris Club creditors as a percentage of total bilateral creditors has increased from 42 percent in 2010 to 68 percent in 2021 (World Bank 2023).

When the debt situation deteriorates or discipline fails and crises occur, there is no agreed mechanism for timely, equitable, and minimally disruptive resolution. Hence debt distressed countries are reluctant to proactively seek debt treatment under the current global debt governance system (Berensmann 2017). This stresses the need for a new international architecture to deal with debt issues. We propose (1) to reform the G20 "Common Framework for Debt Treatment beyond DSSI" (CF) and (2) to create a universal, voluntary code of conduct for creditors and debtors.

As a matter of history, the international community has opted not to have a formal legally binding comprehensive mechanism to solve sovereign debt problems. Several initiatives have been tried but never led to significant breakthroughs. The IMF´s (2021) SDRM proposal was deemed "too rigid and inflexible to deal with uncertain and changing

circumstances”. Ten years after its issuance, a United Nations General Assembly resolution (2014) demanding the creation of a “multilateral legal framework for sovereign debt restructuring” remains an empty call. UNCTAD´s (2015) Roadmap and Guide for Sovereign Debt Workouts unsuccessfully advocated for the establishment of a Debt Workout Institution to coordinate negotiations and decide on disputes as a last legal resort.

Instead, a variety of more flexible, decentralized, soft-law, cooperative arrangements emerged over time. They prevailed to provide a remedy because they managed to gain the required international political support. Their common distinctive ingredient is that rules are binding only to actors who voluntarily accept them.

The Common Framework, a creditor initiative agreed upon by the G20 and the Paris Club, is the last one of such Arrangements (Paris Club, 2020). It carries five important features:

- It is a fundamentally sound initiative considering the many political constraints.
- In an increasingly fragmented landscape, it promises the development of a coordinated multilateral debt renegotiation framework and discussion backstop.
- There is no other viable alternative in sight. Yet, the CF does not block other more targeted initiatives that might be needed.
- At a time when multilateralism retrenches and geopolitics face a critical crossroads, it involves, for the first time, all private and official creditors, including non-Paris Club members (now the dominant bilateral creditors).
- The participation of China in the CF is a notable evolution of the international financial architecture.

CF cases are incredibly challenging and complex. Although progress is sluggish in absolute terms, it does take place. Historically, slow progress is the norm, but relative to the debt problems we face, it is insufficient and happens too late. This Policy Brief aims to contribute to an accelerated catch-up process.

Recommendations

We call on the G20, encompassing the largest creditors to LICs and major shareholders in the multilateral institutions and representing the voice of debtor countries, to accelerate the strengthening of sovereign debt management and governance.

Recommendation One: Develop further the Common Framework (CF) and the Global Debt Sovereign Roundtable (GDSR) as the pillars of a Global Sovereign Debt Treatment System (GSDTS)

The GSDTS should be recognized and used as a timely, efficient, fair and inclusive process to resolve debt problems of various types and degrees with access to financial packages that promote sustainable growth and well-being.

The current CF needs to be further developed and reformed, while not precluding other more focused initiatives. The participation and the coordination of creditors should be improved. The GDSR (GSDR 2024) must develop processes and practices to facilitate greater and speedier success in the CF negotiations.

We call for the following measures:

a) **Engage early with lenders, incentivize their involvement, and support regulatory and legal action against creditor holdouts.**

"Collective Action Clauses" (CACs) in sovereign bonds allow a supermajority of creditors to approve restructuring terms and bind the dissenters, speeding up the process.

This is evidenced by the cases of Argentina and Ecuador, which became the first countries to test the latest enhanced CACs in 2020 and whose restructurings closed within months after announcing that they secured respectively 94 and 98 percent creditor participation.

Early engagement with commercial creditors is critically needed to shorten the duration of the restructuring process. This could be done through parallel and coordinated negotiations of official and private sector creditor committees, providing simultaneous full disclosure of the debt sustainability analysis (DSA) by the World Bank and the IMF and the key restructuring targets to all creditors.

Legislation and regulatory changes currently discussed in New York State and the UK might encourage broad private sector participation. In 2020, an estimated 52 percent of the total outstanding stock of international sovereign bonds was governed by New York law and 45 percent by English law. Cooperation and coordination are needed. Influencing private conducts in bond markets requires both legal guarantees for debt restructuring and limiting the possibilities for objectors to disrupt negotiation processes and outcomes (Volz et al. 2022). Legislation must protect LICs facing debt distress from being sued by private creditors for a sum greater than that those creditors would have received, had they participated in the CF.

Furthermore, the G20 could encourage the World Bank and the Multilateral Investment Guarantee Agency (MIGA) to create a facility providing partial guarantees for restructured debt of private creditors, building on the successful experience of debt restructurings with Brady bonds in the late 1980s and 1990s (Volz et al. 2021).

b) Sovereign debtors should be required to commit to not servicing holdouts.

To maintain cooperation, the creditor majority and the IMF should require sovereign debtors to commit, as part of program conditionality, to not service holdouts until they

agree to provide comparable treatment (Henning 2023). This provision follows long-standing norms, regularizes practice in recent cases, and applies as a matter of policy to any official and private sector holdout creditors in future cases. To limit the possibility of holdouts receiving preferential treatment after the completion of the IMF program, it is recommended to mandate transparency legislation, enhance post-program surveillance, and provide alternative long-term sources of finance, such as through the MDBs. Introduction of claw-back clauses, benefiting creditors who have participated in debt restructuring, in case holdout creditors get preferential treatment after negotiations are finalized could also disincentivize debtors to deviate from initial restructuring parameters.

c) Foster transparency on debt, macroeconomic data, and in CF procedures

The CF governance arrangements should be improved and reformed to ensure broad creditor representation and trust. To increase the CF's transparency, clear and early agreements on data-sharing must be struck between the debtor and all creditors (Estevão 2022). The methodology used for the DSA should be transparent to all actors to incentivize prudent debt engagement practices and provide a clear measure of fairness of treatment.

Furthermore, well-defined rules for comparing debt relief across different types of creditors are needed. We recommend a straightforward approach based upon a single factor - debt reduction in Net Present Value (NPV) terms - and a single discount rate, the one used in the IMF and World Bank's DSAs, which is consistent with the contributions by the different group of creditors to restore debt sustainability.

All parties to a fair restructuring should publicly commit to comply with the agreed principle of comparable treatment, except for recognized preferential creditors such as MDBs, which should contribute to debt treatment deals via identified new financing.

Sovereign debtors should cooperate fully and disclose details of all sovereign liabilities and macroeconomic data (Volz et al. 2022). Countries applying for CF treatment need to know the procedural rules to expect. The G20 should encourage private lenders to participate in the OECD Debt Transparency Initiative (Berensmann et al. 2022).

d) Expand the CF to MICs and include the possibility of standstill on debt service for CF applicants.

As many MICs are also highly indebted, the CF should be extended to them. The CF process has already been used as a model for debt rescheduling by countries that are not formally eligible to participate (Suriname and Sri Lanka).

When a debtor country applies for debt rescheduling under the CF, it should benefit from a suspension of debt service with the involvement of private creditors, and the IMF should trigger its reformed "lending into arrears" policy (IMF 2024). A universal Code of Conduct (see below) would contain provisions to set the conditions and prevent abuse of the debt service standstill provision.

e) Better link debt restructuring with sustainability in CF outcome packages.

The IMF and the World Bank should better incorporate climate and other ESG risks in their DSAs. The volume of investments in climate adaptation should be considered in debt treatment, as they are crucial to reduce climate risks (Volz et al. 2021, Volz et al. 2022, Berensmann et al. 2022). The integration of debt treatment packages with development strategies and fiscal management could be advanced by using the Integrated National Financing Frameworks of the SDG financing system. Blended finance instruments should complement efforts by policymakers and international organizations to attract more funding for needed investments and compensate losers from policy

changes and the climate transition, especially for developing countries. MIGA's scope and role should be extended.

Recommendation Two: Develop a complementary Universal Code of Conduct, under the Financial Stability Board, to certify this system and link it to other issues of global financial stability.

The GSDR, in conjunction with the FSB, should prepare a draft of the Code of Conduct for consideration by the G20 Working Group on International Financial Architecture.

A universal code of conduct should be developed to reinforce governance by having common broad principles throughout the whole debt engagement process. Its rules would include inter alia transparency and timely information flows, coherent financial support, including capacity building, and regular dialogue between sovereign debtors and creditors.

A universal code of conduct should combine elements from the different public and private sector proposals (Berensmann 2022), including those of the Institute of International Finance, the United Nations, the G20, the IMF, and the OECD. Because of its voluntary nature, this universal code of conduct would need an incentive structure to encourage adherence. The FSB should develop the code of conduct into a proper regulatory standard with workable supervision.

Scenario of Outcomes

For too long, the world has taken a tragically languorous approach to resolving debt crises in developing economies, delivering relief that is either "too little" or "too late." This stresses the urgent need to focus on pre-empting major crises rather than reacting to them.

The international community does not have a formal, legally binding comprehensive mechanism to fix sovereign debt problems. Therefore, strengthening the CF and the GSDR provides a much-needed operational remedy. At a time when multilateralism retrenches and geopolitics face a critical crossroads, the CF involves, for the first time, all private and official creditors, including non-Paris Club members, notably China, now the dominant official bilateral creditors. In an increasingly fragmented landscape, the CF stands out as the most relevant effort towards the development of a coordinated multilateral debt renegotiation framework and discussion backstop.

By implementing the proposed changes to the procedures for restructuring sovereign debt, we anticipate achieving more timely and significant reductions in debt burdens compared to historical and recent cases. The holdout problem among official creditors would be eliminated or at least significantly alleviated. The debt restructuring process would be more transparent, contributing to better understanding and visibility of equitable treatment among creditors, therefore to confidence and trust. With greater speed and predictability, we expect both debtors and creditors to use these arrangements for restructuring as opposed to relying on opaque, bilateral solutions to extreme debt distress.

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