DEBT RELIEF FOR A GREEN & INCLUSIVE RECOVERY

Debt Relief for a Green and Inclusive Recovery (DRGR) project

https://drgr.org/

Focal Point: Sarah Ribbert, Project Coordinator, ribbert@boell.de

Chapter I. Sustainable development and financing for development

(Add your organization's concise, concrete, and action-oriented recommendations for Chapter 1)

Debt relief is vital to achieve the Sustainable Development Goals and must be integral to the resource mobilization efforts

Climate-related shocks are becoming more frequent and severe throughout the world, bringing devastating humanitarian, ecological and economic consequences (IPCC 2023, OECD 2015). More than ever, countries must invest in climate resilience and just transitions. According to the Independent High-Level Expert Group on Climate Finance, emerging markets and developing economies (EMDEs) excluding China need $1 trillion in external finance per year by 2025 to accomplish the targets in the Paris Agreement on climate change and achieve the UN 2030 Sustainable Development Goals (SDGs) (Songwe et al. 2022).

However, for many EMDEs, high debt burdens put achieving climate and development goals out of reach. According to the World Bank 2023 International Debt Report (IDR), in 2022 lower-middle income countries paid $443.5 billion in debt service payments (public and publicly guaranteed debt, including International Monetary Fund (IMF) obligations). This is the highest level in history, and it is expected to increase by 10 percent in 2023-24 compared to the 2021-22 period. Moreover, rising interest rates in advanced economies and largely unfavorable exchange rate movements compound these debt service burdens, squeezing fiscal space and further jeopardizing countries' ability to invest in key priorities (IDS 2023).

More than ever, it is urgent to discuss debt relief as a core component of the development finance architecture. Current high interest rates are making it impossible for most developing countries to tap new resources in the market or refinance their current position. One in every four EMDEs countries is shut out from bond markets as their yields are more than 10 percentage points above those of the US (Fleming and McDougall 2023). In 2022, lower middle-income countries saw a retrenchment of long-term finance from the private lenders in the amount of $189 billion. Although lending volumes from multilateral development banks (MDBs) to developing countries increased by 1.5 percent between 2021 and 2022, it is far below the level required to achieve the SDGs (IDS 2023). Considering the current situation and the unlikely improvement in the near future, a joint effort in debt relief could provide developing countries with more financial flexibility. This would aid them in investing in sustainable development and achieving the SDGs.

An ambitious and comprehensive debt relief initiative is needed to enable countries to achieve the SDGs

Based on analyses by the IMF (2023) and the United Nations Development Programme (UNDP) (2023), the Debt Relief for a Green and Inclusive Recovery (DRGR) Project identified 69 countries that are particularly vulnerable to debt distress and would require debt relief, and the researchers calculated that more than $800 billion in debt needs to be restructured across all creditor classes (Ramos et al. 2023).

The shortcomings of the Group of 20 (G20) Common Framework in orchestrating debt relief negotiations have been widely acknowledged (Setser 2023, Ahmed and Brown 2022, Ramos et al. 2023). Key reforms to the Common Framework and the broader international financial architecture are needed to make it more inclusive and effectively expand the fiscal capacity of developing countries. These include broadening the Common Framework to also include middle-income countries, establishing an automatic debt standstill, overhauling the debt sustainability framework, implementing a Brady bond-like arrangement, incorporating multilateral development banks into debt relief initiatives while preserving their AAA ratings and setting a standard for private sector involvement.

An automatic debt standstill should be implemented for any country applying to the Common Framework, granting a pause of 18-24 months in debt service. This mechanism serves a dual purpose. Primarily, it motivates creditors to hasten negotiations, providing borrowing nations with a clearer understanding of the restructuring process. Secondly, it offers critical short-term liquidity to countries amidst debt restructuring. Under the current unpredictable nature of debt relief, accruing arrears often elevate the costs of restructuring beyond the original claims. An automatic standstill would more equitably share the restructuring costs between debtors and creditors.

Reforming the Debt Sustainability Framework (DSF) is imperative. The IMF and the World Bank, in close collaboration with other relevant international organizations, should integrate climate risk assessments, adaptation necessities and sustainable development investments into their debt sustainability analyses (DSAs). Additionally, it is vital to base DSAs on realistic macroeconomic assumptions and scenarios. A revised DSF is essential for accurately gauging the extent of debt relief necessary for countries to achieve sustainable debt levels while retaining the fiscal capacity for critical climate and development investments.

To incentivize participation of commercial creditors, a contemporary adaptation of the Brady-bond arrangement is proposed, linking debt relief with assurances of debt recoverability and economic policy reforms, while ensuring the tradability of new bonds. This modern variant could connect the resources conserved through debt relief to SDG-linked investments. The collectability of new bonds could be guaranteed through a facility, potentially under the aegis of the World Bank. This proposal might be especially appealing to Chinese creditors, who could convert their bank loan-based finance into bonds, subsequently tradable on secondary markets.

The concept of a "Shanghai Model" that incorporates features of the Brady bond is under discussion in China (Ramos et al. 2023, Qian & Wang, 2022).

The inclusion of MDBs in debt restructuring processes is crucial. Although they typically charge lower interest rates, MDBs represent a substantial portion of external sovereign debt service for numerous countries in the coming years. The prevailing understanding is that MDB involvement should be limited to providing additional concessional loans. However, an outright refusal by MDBs to consider debt relief could deter some countries from pursuing beneficial debt relief. Including MDBs in debt relief processes is not only prudent – safeguarding their AAA credit ratings – but could also refine their business model. As the debt crisis intensifies in the Global South, MDBs are increasingly allocating resources to grants rather than concessional credits, thus impacting their future project financing capabilities. Restructuring the debt of International Development Association (IDA) clients and reevaluating IDA's concessional policies to focus more on grants for green and sustainable investments is a pivotal step (Zucker-Marques et. al 2023).

Finally, establishing a benchmark for private sector engagement is essential. Recent debt restructuring scenarios reveal that bondholders frequently incur smaller losses compared to other creditors, despite higher interest rates to offset default risks (Zucker-Marques 2023). A clear benchmark, possibly pegged to the returns on US risk-free investments, should be established. This would ensure that, post-restructuring, bonds from developing countries do not yield returns exceeding those of similar risk-free assets issued in the same period. This benchmark would enhance transparency and ensure fairness across creditor classes. The use of value recovery instruments in debt restructuring should reflect the real payment capacity of countries, ensuring protection against downside risks. An interest collar or band could offer this protection, providing greater predictability in financial outcomes.

References:

Ahmed M. and Brown H. (2022). Fix the Common Framework for Debt Before It Is Too Late. Center for Global Development, January 18. From https://www.cgdev.org/blog/fix-common-framework-debt-it-too-late

Fleming, S. & McDougall M. 2023. US interest rates add to 'silent debt crisis' in developing countries. Financial Times. November 7th.

IPCC. 2023. AR6 Synthesis Report: Climate Change 2023. Available at: https:// www.ipcc.ch/report/ar6/syr/

OECD. 2015. The Economic Consequences of Climate Change. OECD Publishing, Paris. Available at: https://read.oecd-ilibrary.org/environment/the-economic-consequences-of-climate-hange_9789264235410-en#page3

Qian, Y& Wang Y. (2022). Reflections on Sovereign Debt Restructuring in Low-Income Countries and the 'Shanghai Model' 30th January, Boston University Global Development Policy. Available at: https://www.bu.edu/gdp/2022/01/30/reflections-on-sovereign-debt-restructuring-in-low-income-countries-and-the-shanghai-model/

Ramos, L., Ray, R., Bhandary, R.R., Gallagher, K.P., and W.N. Kring (2023). Debt Relief for a Green and Inclusive Recovery: Guaranteeing Sustainable Development. Boston, London, Berlin: Boston University Global Development Policy Center; Centre for Sustainable Finance, SOAS, University of London; Heinrich-Böll-Stiftung. Available at: https://drgr.org/our-proposal/report-guaranteeing-sustainable-development/

Setser, B. W. (2023). The Common Framework and its discontents. Development and Change.

Songwe, V., Stern, N., & Bhattacharya, A. 2022. Finance for climate action: Scaling up investment for climate and development. London: Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science. Available at: https://www.lse.ac.uk/granthaminstitute/publication/finance-for-climate-action-scaling-up-investment-for-climate-and-development

Zucker-Marques M. (2023). Winner Takes All – Twice: How Bondholders Triumph, Before and After Debt Restructuring. 16th November, Debt Relief for a Green and Inclusive Recovery. Available at: https://drgr.org/news/winner-takes-all-twice-how-bondholders-triumph-before-and-after-debt-restructuring/

Zucker-Marques, M., Volz, U. and Gallagher, K.P. (2023). Debt Relief By Multilateral Lenders. Why, How and How much? Boston, London, Berlin: Boston University Global Development Policy Center; Centre for Sustainable Finance, SOAS, University of London; Heinrich-Böll-Stiftung.