Policy Brief

RESOLVING DEBT CRISIS IN DEVELOPING COUNTRIES: HOW CAN THE G20 CONTRIBUTE TO OPERATIONALISING THE COMMON FRAMEWORK?

Task Force 7
International Finance and Economic Recovery
RESOLVING DEBT CRISIS IN DEVELOPING COUNTRIES:
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Kathrin Berensmann (German Institute of Development and Sustainability, IDOS)
Mma Amara Ekeruche (Centre for the Study of the Economies of Africa, CSEA)
Christopher Heitzig (Africa Growth Initiative, AGI, Brookings Institution)
Aloysius Ordu (Africa Growth Initiative, AGI, Brookings Institution)
Lemma W Senbet (University of Maryland and Brookings AGI Distinguished Advisory Group)
Abstract

The debt situation in many low-income countries (LICs) following the COVID-19 pandemic has deteriorated considerably. While many LICs had participated in the G20’s Debt Service Suspension Initiative (DSSI) by April 2022, only three countries have taken part in the Common Framework for Debt Treatment beyond DSSI. To better operationalise the Common Framework, the G20 should incentivise private and public creditor participation including those of Non-Paris Club members. In addition, G20 members should encourage the application of the comparability of treatment clause and urge multilateral creditors to participate in the debt restructuring process. The G20 should encourage full disclosure of debt among creditors by promoting the OECD Debt Transparency Initiative and by adopting the G20 Operational Guidelines. Moreover, the G20 should support local capacity building for public financial management in LICs and should promote that debt treatment under the Common Framework is subject to scaling up sustainable investments in debtor countries. Finally, the G20 should use its weight in the managing boards of the international financial institutions to push IMF-WB debt sustainability analyses to better include sustainability criteria.
Challenge

As a result of the COVID-19 pandemic, the debt situation in many countries has deteriorated considerably. The rising interest rate environment is being fueled by the Russia-Ukrainian war, and hence it will further worsen the debt situation in developing countries with the attendant rising debt service costs (Malloch-Brown, 2022). According to the International Monetary Fund and the World Bank, 60 percent of LICs are facing high risk of default or in distress (IMF, 2022a). To make matters worse, many developing countries cannot reduce their debt burden on their own, because they cannot generate sufficient revenue, especially from their tax systems. The Group of 20 addressed this debt problem in 2020 with two initiatives for developing countries. First, the G20 established the Debt Service Suspension Initiative (DSSI) to tackle the liquidity problems, which expired in December 2021, and second, the G20 put in place the Common Framework for Debt Treatment beyond the DSSI (Common Framework) to address debt crises. While many LICs participated in the DSSI, only three countries, Chad, Ethiopia and Zambia, have used the Common Framework, and implementation in these three countries has been a challenge. The IMF managing director, Kristalina Georgieva has said action must be taken quickly to implement the Common Framework (Georgieva and Pazarbasioglu, 2021). Under the Indonesian G20 and the German G7 presidencies promoting the Common Framework represents policy priorities in their Communiqués (G20, 2022; G7, 2022).

The main reasons for the low participation and delayed implementation of the Common Framework have been: (i) non-participation of some bilateral and private creditors and creditor coordination problems and (ii) non-transparency of debt contracts. Further challenges are the missing link of debt restructuring and/or relief with sustainable development. In addition, the Common Framework has limited eligibility to LICs. As many lower- and middle-income countries (LMICs) and middle-income countries (MICs) have also been highly indebted in the course of the COVID-19 crisis and the Russian-Ukrainian war, the Common Framework should also offer these countries debt treatments.
Proposal for the G20 to Operationalise the Common Framework

This policy brief provides proposals on how the G20 can address these problems and better operationalise the Common Framework. Since the G20 is the most important forum gathering the main creditors of developing countries, decisions made by the G20 are crucial to resolving debt problems in these countries. The G20 is particularly important because this forum includes non-Organisation for Economic Co-operation and Development (OECD) countries that have become major lenders to developing countries in the past decade, such as China and India. In cooperation with international financial institutions, particularly the IMF, the G20 has already contributed to the resolution of debt problems in developing countries in the past as it has established a number of initiatives to prevent and manage debt crises in developing countries, including the recent initiatives – the DSSI, the Common Framework and the G20 Operational Guidelines for Sustainable Financing (G20, 2017; G20 and Paris Club, 2020).

HOW CAN THE G20 CONTRIBUTE TO IMPROVE CREDITOR PARTICIPATION?

One main challenge for implementing the Common Framework is creditor coordination and the low participation of private and official creditors in debt restructurings and/or debt relief. While the aim of the G20 Common Framework is to facilitate the debt restructuring of bilateral official debt and private debt, the first country that requested to participate since January 2021, Chad, has been unable to complete the process (IMF, 2021a). Chad’s largest private creditor, Glencore, has been reluctant in offering debt restructuring options. In 2020, Chad paid over 85 percent of its interest payments on external debt to Glencore, amounting to US$45 million (IMF, 2020).

Historically, private creditors have not participated in many debt restructuring initiatives because first, there is little financial incentive among them to pay below-market interest rates, as was seen in the case of the DSSI. A second problem is that there are no unified private creditor committees, making it hard to have a unified perspective, as has been seen in the recent case of Argentina. Recent research suggests that private creditors wield a de facto preferred creditor status among sovereign borrowers (Schlegl, Trebesch and Wright, 2019). Accordingly, it should come as no surprise that private creditors have been reluctant to participate in the Common Framework (IIF, 2020).

In the same vein, sovereign borrowers are concerned that not paying back private creditors...
will change the terms of future borrowing, a fear that they do not share to the same degree for with bilateral lenders. The same incentives that secure this preferential status for private creditors make it difficult to enact policies that encourage participation in the Common Framework. Creditors that are punished by policies for not participating may simply pass on that cost to sovereign borrowers in future lending agreements, making it more expensive for sovereigns to borrow money.

One option for governments is to reward companies for their participation in the Common Framework. In particular, G20 nations could allow companies domiciled in their countries to use part of the net present value of lost revenue as a result of the Common Framework as an income tax deduction in the year of the restructure. For instance, if, say, an Italian bank restructured its lending to Ethiopia in 2023 that resulted in it incurring a $20 million haircut in the net present value of its loan, the bank could then reduce its taxable income by $20 million in 2023, in addition to any lost revenue as a direct result of the restructuring. While G20 countries would lose money from this policy, it ultimately could help spread the cost of the restructuring more equitably across the public and private lenders. This is the bright side of the initiative. However, the dark side is that this may lead to moral hazard, since it could be viewed by the private creditors as government subsidy, and they may engage in excessively high-risk lending in the future. This tradeoff has to be carefully managed and should be offered as a one-time initiative (no precedence). The private sector may be interested in participating in this policy for a number of reasons, including improved liquidity (if the income tax reduction exceeded the short-term return from the loans) and public relations. In addition, countries could enact anti-vulture fund legislation and prevent some of these funds from avoiding a negotiated settlement. Another promising option being used is to have collective action clauses (CACs) that allow private creditors to participate in a negotiated settlement with other creditors, and that would penalise holdouts.

Bilateral creditors, on the other hand, are more likely to incur haircuts on their debt than multilateral and private creditors. However, coordination problems between Paris and non-Paris Club creditors complicate and delay the restructuring of debt. It is questionable whether all bilateral creditors will equally take part in debt restructurings, in particular China as a main bilateral creditor. The three countries that have engaged creditors on debt treatment under the Common Framework – Chad, Ethiopia and Zambia – all owe China a significant share of their debt. China holds about a fifth of Chad’s debt and a third of Ethiopia’s debt, but nearly half of Zambia’s debt (World Bank, 2022a). China has already deferred $5.7 billion in debt as part of the DSSI, more than any other lender (World Bank, 2022a). Yet, it remains to be seen whether Chinese lenders will actually incur losses on their debt.

Multilateral creditors remain as important as bilateral creditors in a developing country context. In Sub-Saharan Africa (SSA), multilateral debt accounted for 32 percent of total debt,
amounting to $144 billion, in 2020 (World Bank, 2021). Despite this fact, the IMF, the World Bank and other multilateral development banks fail to provide debt restructuring options due to their preferred creditor status. Meanwhile, the volume and disaggregation of debt liabilities require the broad participation of all official creditors to bring debt to a sustainable path. Multilateral claims should be restructured under the same terms as bilateral claims as specified under the Common Framework, and should not be given preferential treatment. The G20 countries should encourage the application of the comparability of treatment clause and urge multilateral creditors to participate in the debt restructuring process (Rivetti, 2022).

**HOW CAN THE G20 CONTRIBUTE TO ENHANCE TRANSPARENCY OF DEBT CONTRACTS?**

Another obstacle to the implementation of the Common Framework is the lack of transparency in loan agreements, which is necessary for equal creditor treatment in debt restructuring. Enhanced transparency is interrelated with creditor coordination and would improve the latter.

Almost 40 percent of low-income developing countries have never published debt data on their websites (World Bank, 2021). When debt data is available, it is often limited to the liabilities of the central government, excluding lower levels of government, public companies including the central bank and publicly guaranteed debt taken on by wholly or partially owned state enterprises, as well as privately owned companies. When comparing public debt data across the available sources, one may notice discrepancies of up to 30 percent of GDP (Rivetti, 2021). Debt obfuscation stems in part from incipient or nonexistent public debt management legal frameworks (PDMLFs) (Awadzi, 2015). Nigeria and The Gambia have published good examples of PDMLFs, but many countries of Africa either do not have a PDMLF or have not published on a key public financial institution website.

In addition, there are strong incentives for both borrowers and creditors alike to not publish debt agreements. On the one side, borrowers may benefit (i.e. by borrowing more at a lower interest rate), at least in the short run, from concealing the full degree of indebtedness. Nondisclosure may also be a way for borrowers to circumvent borrowing limits and other financing rules such as IMF the Debt Limits Policy (IMF, 2021b) or the International Development Association’s Sustainable Development Finance Policy (World Bank, 2022b). On the other side, private creditors may wish to appease the borrowers wishes in order to deepen business relations with the sovereign entity. Moreover, private creditors may not see the commercial benefit to publicly revealing the terms of their lending for others – including competing creditors – to see. It is for this reason that, in general, private creditors only report tradeable debt. Africa’s debt market, with only a nascent bond repo market, may not inspire many reasons for private creditors to publicise debt dealings.
In the global debt governance (GDG) system a number of instruments have been established to enhance transparency, including the G20 Operational Guidelines for Sustainable Financing, which encourages the voluntary sharing of loan information among private and official creditors (G20, 2017; Berensmann, 2022 and 2018) and the “OECD sustainable lending principles for official export credits” (OECD, 2018). In addition, the pandemic has renewed efforts to improve debt transparency. DSSI beneficiaries are committed to disclose all public sector debt (World Bank and IMF, 2020). Moreover, the OECD launched a new initiative – the Debt Transparency Initiative - to operationalise the Institute of International Finance (IIF) Voluntary Principles for Debt Transparency (IIF, 2021), with the aim to improve the understanding of the context into which creditors and debtors enter (OECD, 2021).

The Common Framework provides an excellent opportunity for the G20 to enhance public debt transparency. The drafting of the PDMLFs, along with the full public disclosure of public and publicly guaranteed debt, could be a prerequisite for bilateral debt restructuring according to the Common Framework. The G20 should encourage full disclosure of debt among creditors by promoting the OECD Debt Transparency Initiative and by adopting the G20 Operational Guidelines.

HOW CAN THE G20 CONTRIBUTE TO IMPROVE INTERNAL RESOURCE MOBILISATION AND PUBLIC FINANCIAL MANAGEMENT IN LICS?

The operation of the Common Framework should also be forward-looking, not short-sighted, and take the opportunity to foster the necessary reforms to reduce the risk of debt crisis and future restructuring by improving public financial management (PFM) that comprises (i) revenue administration, (ii) public financial management and (iii) public debt management (PDM). Hence, debt treatment under the Common Framework should be tied to reforms in PFM (World Bank, 2021b). We focus here on revenue administration and PDM with respect to local currency bond markets.

Internal resource mobilisation should be considered in operationalising the Common Framework, since borrower countries should also play a role in their part in building capacity for debt servicing and fostering investor confidence. Moreover, the enhanced investor confidence can help incentivise participation of the creditors, particularly private ones, in the Common Framework. Accordingly, the tax system should be reformed including efficient tax collection and improving the tax base in the respective borrower countries. In the course of the COVID-19 crisis, LICs saw general government revenue decrease from 14.8 percent in 2019 to 14.1 percent of GDP in 2020 (IMF, 2022b). SSA faces the lowest tax revenue/GDP ratio (16.5 percent – a 30-country sample), compared with the global average of 34.3 percent and the Latin America and Caribbean average of 23.1 percent (OECD, 2020). G20 members should partner with the LICs in capacity development tax revenue generation through a variety
of investments such as in human resources, digitalisation and the strengthening of institutions.

COVID-19 and the current crisis are also an awakening for LICs to accelerate self-reliance, particularly the urgency for the development of domestic financial markets, including bond markets, both in terms of depth and inclusivity (Allen et al., 2016 and 2021). Thus, domestic resource mobilisation should be looked at more broadly beyond tax collection to include internal market development for longer-term self-reliance and sustainability. In the case of SSA, COVID-19 reinforces the need to accelerate the implementation of a highly promising continental trade agreement (World Bank, 2020) to enhance the integration of disparate financial markets regionally so that we have financial sectors that are fit for purpose. The G20 members should partner to provide technical assistance in the acceleration of implementing the African Continental Free Trade Area (AfCFTA), as well as supporting local capacity building for financial sector development, including generation of talented financial manpower and financial regulatory capacity.

The G20 partnership in technical assistance and capacity development is crucial and can even extend to the efforts of LICs in mitigating illicit flows and leakages which also undermine the debt servicing capacity and help maintain external debt dependency.

**HOW CAN THE G20 CONTRIBUTE TO BETTER LINK THE COMMON FRAMEWORK WITH SUSTAINABLE DEVELOPMENT?**

A further challenge of the Common Framework is that debt restructurings and/or relief are not aligned with sustainability goals. While the COVID-19 pandemic has highlighted the vulnerability of our societies to shocks, it also offers an opportunity to “build back better”. Therefore, we should use the pandemic as an opportunity to put the world on a more inclusive and sustainable path in line with international commitments and link debt restructuring processes to the Sustainable Development Goals (SDGs).

Accordingly, the debt treatment under the Common Framework should require an increase in sustainable investments and should be tied to investments and reforms that promote the Agenda 2030 and the Paris Agreement. Accompanying financial support by multilateral development banks (MDBs) should be linked to sustainable development by better including SDGs into MDBs’ financial instruments.

Since climate change involves risks to the debt sustainability of countries (UNEP, 2020; Volz et al., 2020) debt sustainability analysis (DSA) for debt treatment under the Common Framework should include sustainability criteria. As the DSAs under this framework are based on the IMF-WB DSAs, the DSAs should better take into account climate risks (Maldonado and Gallagher, 2022; V20, 2021; Volz et al., 2021; Volz et al., 2022). Similarly, DSAs should consider
the volume of investments in climate adaptation because these investments reduce climate risks. The IMF is currently working on proposals for economic principles to include climate change adaptation into fiscal policy and suggestions to plan and mainstream climate change into fiscal policy (Massetti and Bellon, 2022a and 2022b). These proposals could also be adopted and integrated in DSAs.

The G20 should promote that debt treatment under the Common Framework is subject to scaling up sustainable investments in debtor countries, and the G20 should use its weight in the managing boards of the IMF and the World Bank that their DSAs better include sustainability criteria. Moreover, the Common Framework should be better linked to health financing, as the latter is one of the key elements of the sustainable development agenda. In particular, in response to the pandemic, it is necessary to encourage more investment in health security in developing countries so that they could have stronger protections against health crises.
To conclude, the G20 plays a crucial role in solving debt problems in LICs. This is because the G20 is composed of the largest creditors of LICs, but the LICs are by themselves unable to mobilise sufficient financial and non-financial resources for dealing with the multitude of crises: debt, health, climate, food insecurity, energy and the Russia-Ukraine war.

- G20 members should promote the application of the comparability of treatment clauses and urge multilateral creditors to participate in the debt restructuring process.
- The G20 should support full disclosure of debt among creditors by promoting the OECD Debt Transparency Initiative and by adopting the G20 Operational Guidelines.
- The G20 should support capacity building in LICs for internal resource mobilisation and public debt management, including investments in digitisation.
- G20 members should partner in providing technical assistance in the acceleration of implementing AfCFTA and financial sector development.
- The G20 should promote that debt treatment under the Common Framework is subject to scaling up sustainable investments in debtor countries, and the G20 should use its weight in the managing boards of the IMF and the World Bank that their DSAs include sustainability criteria.
- The G20 should support the Common Framework to be better linked to health financing.
- The G20 should open the Common Framework for other developing countries beyond LICs.
- The G20 debt treatments should take into account the effects of the Russian-Ukrainian war foremost rising interest rates, tightening financial conditions, food crisis because these new conditions will further worsen debt problems in developing countries.
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