RESPONDING TO RISKS OF COVID DEBT DISTRESS

July 2021

Roundtable Report

This series of roundtable discussions was jointly convened by the Friedrich-Ebert-Stiftung (FES) in New York and the Consensus Building Institute (CBI)

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Conveners

The **Friedrich-Ebert-Stiftung** (FES) is a non-profit German foundation funded by the Government of the Federal Republic of Germany and headquartered in Bonn and Berlin. It was founded in 1925 and is named after Germany's first democratically elected President, Friedrich Ebert. FES is committed to the advancement of both socio-political and economic development in the spirit of social democracy, through civic education, research, and international cooperation. Friedrich-Ebert-Stiftung is the oldest political foundation in Germany.

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The Consensus Building Institute (CBI) is a U.S.-based nonprofit organization that helps leaders, organizations, and stakeholder groups work together to achieve sustainable development goals. CBI facilitates multi-stakeholder negotiations and dialogues; builds individual and organizational collaboration capacity; and produces research and evaluation to strengthen the practice of public collaboration. CBI works with a wide range of multilateral, governmental, NGO and business organizations to build consensus on global development policy issues.

Facilitator

David Fairman is Managing Director at the Consensus Building Institute and Associate Director of the MIT-Harvard Public Disputes Program. For 31 years, he has built consensus and enhanced collaboration capacity on complex public and organizational issues internationally and in the U.S. His primary focus is building effective multi-stakeholder partnerships, organizational strategies, and dispute resolution systems to meet challenges of sustainable development.

Roundtable Participants

Charles Boamah currently provides independent strategic advisory services and serves on the Board of Directors of Africa50, a continental infrastructure development finance entity; on the International Governing Board of the African Institute for Mathematical Sciences (AIMS); and is also a member of the Transformation Leadership Panel (TLP), a continental policy and advocacy body. He retired in March 2020 from the African Development Bank (the AfDB), after 23 years of service in support of social and economic development across Africa. Before assuming his final role at the AfDB as Senior Vice President, Charles served in various capacities, including as acting First Vice President and Chief Operating Officer, as Vice President and Chief Financial Officer and as Controller.

Patrick Bolton is the Barbara and David Zalaznick Professor of Business at Columbia University and visiting Professor at Imperial College London. He is a past President of the American Finance Association, a Fellow of the Econometric Society, the American Academy of Arts and Sciences, and a Corresponding Fellow of the British Academy. He has co-authored Contract Theory (2005) with Mathias Dewatripont and The Green Swan: Central Banking and Financial Stability in the Age of Climate Change (2020) with Morgan Despres, Luiz Pereira Da Silva, Frederic Samama, and Romain Svartzman.

Lee C. Buchheit retired in 2019 after a 43-year legal career in which he advised more than two dozen sovereign borrowers on debt management issues. Mr. Buchheit led the legal teams advising the Republic of Iraq (2005-08) and the Hellenic Republic (2001-12) in their external debt restructurings -- the two largest sovereign debt workouts in history. Mr. Buchheit currently holds several academic and advisory positions.

Homi Kharas is a senior fellow in the Center for Sustainable Development at the Brookings Institution in Washington D.C.. In that capacity, he studies policies and trends influencing developing countries, including aid and development finance, the emergence of the middle class and poverty trends, and global governance and the G-20. He was at the World Bank for almost three decades in various positions, including Chief Economist of the East Asia and Pacific Region. He served as the lead author of the High-Level Panel report on the post-2015 development agenda, presented to the UN Secretary General on May 30, 2013. He has authored multiple books, most recently “Leave No One Behind" (Brookings Press, 2019). He holds a Ph.D. in economics from Harvard University

Nancy Lee is a senior policy fellow at the Center for Global Development and a senior advisor at the Center for Strategic and International Studies. Her work focuses on mobilizing private finance for development, reform of multilateral development banks, gender lens investing, and sovereign debt restructuring. Previously, she was the Deputy CEO of the Millennium Challenge Corporation, an independent US aid agency that fights poverty through country-led compacts. She was also the General Manager of the IDB Lab (formerly the Multilateral Investment Fund) at the Inter-American Development Bank. At the U.S. Treasury Department, Dr. Lee was deputy assistant secretary for the Western Hemisphere and for Europe and Eurasia. She led Treasury’s work to put financial inclusion, SME finance, and women’s access to finance on the G20 agenda.

Yannis Manuelides is a London-based partner with Allen & Overy LLP. A graduate of Princeton University (AB Philosophy, 1980), University of Chicago (MA Philosophy, 1983) and Cambridge University (BA Law 1985), he is an English law qualified lawyer and former member of the Paris Bar. Having practiced for over 30 years in many areas of debt finance (of which six in France) he currently heads his firm’s sovereign debt practice.

José Antonio Ocampo is Professor at the School of International and Public Affairs (SIPA) at Columbia University, Chair of the United Nations ECOSOC Committee for Development Policy, and Chair of the Independent Commission for the Reform of International Corporate Taxation (ICRICT). He has occupied numerous positions at the United Nations and his native Colombia, including UN Under-Secretary-General for Economic and Social Affairs, Executive Secretary of the UN Economic Commission for Latin America and the Caribbean (ECLAC), and Minister of Finance, Minister of Agriculture, Director of the National Planning Office, and Member of the Board of Directors of Banco de la República (Colombia’s central bank).

Yide Qiao is Vice Chairman & Secretary General of the Shanghai Development Research Foundation (SDRF). Mr.Qiao was enrolled into Kennedy School of Government at Harvard in 1985. After graduation, he entered Harvard Institute for International Development and did research work. Since 2005, he has held the position, responsible for the daily work so far. Prior to study in the States, he conducted research at Institute of World Economy, Shanghai Academy of Social Sciences as its Assistant Director. He is a main author of the following books and research reports: “Chinese Economy: The Next 30 Years” (2011), “Rethinking the International Monetary System — 70 Years after the Bretton Woods Conference” (2014), “Global Financial Governance: Challenges, Goals and Reforms” (2016), “Global Financial Imbalance: Implications, Impacts and Countermeasures ” (2017), “Great Changes in Global Finance” (2021)

The Roundtable: Goals and Participants

Friedrich-Ebert-Stiftung and Consensus Building Institute convened the Roundtable on Responding to the Risks of COVID Debt Distress in response to the risk that the COVID economic shock could lead to widespread sovereign debt distress in lower- and middle-income countries. As the multilateral economic response to COVID has unfolded, particularly through the G20 Debt Service Suspension Initiative and the G20-Paris Club Common Framework, the role of private creditors and the mechanisms for engaging with them have been less fully developed than those of bilateral and multilateral creditors. Moreover, there has been limited attention to the risks to middle income countries (MICs), or to the need to support longer-term investments for sustainable development that may be constrained by restructuring programs.

The Roundtable convened experts with direct experience in dealing with debt distress at the policy and operational levels, including former senior government officials and private attorneys who have represented sovereign debtors, bilateral and multilateral creditors, and academic experts who have closely studied the recent history of sovereign debt restructuring.[1] This Report represents the consensus of the group on a set of recommendations that could make private creditor participation in managing the risks of debt distress more complete, more equitable and more effective. The group has also developed recommendations for integrating new and additional multilateral finance into restructuring, to ensure that governments emerging from debt distress are able to continue making investments for sustainable development.

Context for the Roundtable

COVID has produced a global economic shock, including significant contractions in economies around the world; unprecedented fiscal stimulus in many G20 countries; and ongoing risks to economic growth and sustainable development in many middle- and low-income countries. For developing countries seeking to finance sovereign debt in a context where many are experiencing credit rating downgrades, there is a significant risk of repeating the pattern of “sudden stops” in capital market access as developed countries exit the crisis, reduce fiscal stimulus, and raise interest rates.

[1] Participants engaged in the roundtable and endorse the report in their personal capacities, not on behalf of their institutions. While endorsing the report as a whole, participants have a range of views on the relative importance and priority of individual recommendations.

Some middle-income countries (MICs) and low-income countries (LICs) will be able to manage these impacts and risks through domestic adjustment, particularly in countries with adequate fiscal space to provide cash transfers and other forms of consumption support to offset COVID-driven unemployment, while maintaining investments for development. In a significant number of MICs and LICs, however, foreign debt service is becoming a significant constraint on fiscal space, even when economic fundamentals appear sound.[2]

The current G20 Debt Service Suspension Initiative (DSSI) has helped 46 of 73 eligible countries (predominantly LICs along with some small island state MICs) maintain liquidity by deferring bilateral debt service, though the total amount deferred to date is less than $6 billion. There has been no formal private creditor participation in DSSI, though the Institute of International Finance did prepare a toolkit to guide private creditors if a government did ask them to suspend debt service. Though debtor governments have the option to request private creditor participation in DSSI, it appears that concerns about credit risk downgrades and potential loss of private investor confidence have deterred DSSI-eligible governments from making such requests.

The DSSI and the associated G20-Paris Club Common Framework for Debt Treatments Beyond the DSSI (Common Framework) may not be sufficient to meet the challenge should global economic conditions become less favorable to sovereign debtors. Moreover, as noted, the current scope of both DSSI and Common Framework is limited to countries eligible for the World Bank's IDA window (predominantly LICs), and does not extend to most MICs.

As fiscal stimulus in the leading economies tapers, some MICs and LICs may be able to continue rolling over debt to maintain liquidity without facing solvency issues. Others may not: those who were already in debt distress before COVID, those that the COVID shock tipped into distress, and those whose stock of debt and cost of debt service put them at high risk if interest rates, currently at historic lows, rise. The following table (from Kharas and Dooley 2020) shows the scale of the challenge.

Table 1. External public debt stock and debt service due by credit score, billions (current USD)

	Credit score	Substantial risk	Speculative	Investment grade	Total
All developing countries	Number of countries	34	74	12	120
	Debt stock (2019)	$409	$1,239	$1,453	$3,102
	Total debt service (2021-2022)	$92	$265	$318	$676
DSSI eligible countries	Number of countries	25	43	0	68
	Debt stock (2019)	$127	$364	$0	$492
	Total debt service (2021-2022)	$32	$74	$0	$106

[2] See for example the recent statement of African Finance, Planning and Economic Development Ministers, noting the significant and growing gap between the international finance needed to maintain liquidity and the availability of concessional and commercial investment: "Communique of African Ministers of Finance, Planning and Economic Development on Covid-19 and the Economic Situation in Africa," UN Economic Commission for Africa, March 29, 2021.

This table indicates that in the next two years, MICs and LICs with credit ratings below investment grade will need to pay debt service amounting to $357 billion (of which $251 billion is owed by MICs, and $106 billion by LICs). Kharas and Dooley note that in 2021 alone, countries rated "substantial risk" owe $48 billion of this amount; countries with debt/GDP ratios over 55% owe another $54 billion.[3] Managing this risk effectively is in the joint interest of sovereign debtors and of sovereign, multilateral and private creditors. Failure to manage the risk effectively could trigger a global debt crisis with negative impacts not only in MIC and LIC debtor nations, but also in the financial systems and economies of creditors.

Focus of the Roundtable: Private creditor participation and additional financial support

The Roundtable has focused its assessment and recommendations on two major approaches to risk management: promoting full, equitable and transparent private creditor participation in debt reprofiling and restructuring where needed; and providing additional financial support to MICs and LICs where necessary to maintain investments for sustainable development. These approaches are linked and should be understood as complementary and mutually reinforcing.

I. Private Creditors and Debt Restructuring

Over the past decade, private creditors have funded an increasing proportion of sovereign debt in many MICs and in some LICs. To some extent, this trend represents successful maturation of public finance in MICs and LICs. However, it also reflects an era of low interest rates in most of the leading economies, which has spurred global investors to pursue the generally higher yields offered by MIC and LIC bonds and loans. In most cases, private debt service is more costly for most LIC and many MIC sovereigns than servicing their debt to bilateral and multilateral creditors. Where private debt is either a significant share of the total debt stock or where its refinancing is likely to cause or aggravate debt distress, it ought to be included in reprofiling and restructuring in order to avoid or resolve debt distress.

Current institutions and mechanisms for including private creditors in sovereign debt restructuring began to evolve in the 1980s, during the Latin American debt crisis. On the official side, the Paris Club has well-established norms and procedures for bilateral official creditors and debtors to work out restructuring terms (usually linked directly to IMF programs), though not all bilateral creditors are Paris Club members. While negotiations to restructure privately held sovereign debt do not have a comparable institutional structure, a set of commonly accepted processes and steps has developed to guide private creditor negotiations.

Historically, renegotiation of privately held sovereign debt has been heavily influenced by IMF program negotiations and Paris Club negotiations with sovereign creditors. These public creditor negotiations

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[3] While the debt/GDPs ratio is a commonly used metric for assessing the risk of debt distress, there are other metrics that provide complementary information and may be important to use in particular cases. These metrics include debt service/government revenue, debt service/export revenue, and others. When a debt stock/national income ratio is used, in some cases GNI may be a more useful denominator than GDP.

usually establish the debt sustainability envelope and, through it, the net present value (NPV) reduction of both official bilateral and private debt necessary to stay within the envelope.

Three other factors have also been very important in making debt renegotiation more or less predictable and orderly: (a) the capacity of the sovereign debtor to negotiate effectively with its public and private creditors; (b) the predominance of private creditors with a direct and long-term interest in the country's economic performance, as opposed to certain short-term speculators seeking to free-ride at the expense of the debtor and the remaining creditors during restructuring negotiations; and (c) the degree to which private creditors are able to organize themselves collectively to pursue an equitable resolution.

With regard to the last factor, private creditors' ability to organize, the different forms that private lending takes raise challenges for creditor coordination and collective action. Among bondholders, collective action challenges are being alleviated by the increased use of collective action clauses (CACs) and trust structures for sovereign bonds. These provisions drag along would-be holdouts into a restructuring deal that is acceptable to a supermajority of bondholders. Still, their presence in bond documents is not yet universal and their expected operation is not yet fully tested. In particular, enhanced CACs, which expand the menu of options available to aggregate bondholders across bond series, have only been issued for the past several years, while trust structures have limited take-up because of the additional up-front and maintenance costs of having a trustee, however modest these costs may be. A further challenge to collective action is that other forms of collective lending, such as syndicated loans, do not have, and possibly cannot ever have, collective action provisions in the way that bond issues with enhanced CACs do.

In many cases, simply establishing the identities and holdings of private creditors can be a challenge to collective action. Private loans, credits to projects, credits to state owned enterprises and/or sub-nationals supported by the sovereign *de jure* or *de facto*, resource-backed loans or long-term offtake arrangements amounting to secured debt, joint private and officially-backed export credit financing, all add to debt opacity, make the assessment of debt sustainability more difficult, and do not have obvious solutions for creditor coordination and collective action. These will continue to make it difficult to ensure full, equitable, and effective private creditor participation, especially in LICs where sovereign debt management capacities are more limited.

A final aspect of the collective action challenge is the expansion of bilateral public creditors beyond the Paris Club. In many ways the participation of major emerging economies (e.g. China, India, Turkey, Brazil, Gulf states) in development finance is a very welcome development. At the same time, it has complicated the resolution of debt distress. Non-Paris Club creditors do not necessarily follow the Paris Club approach to collective renegotiation of bilateral debt. There are also differences in where non-Paris Club creditors draw boundaries between public development finance institutions (DFIs) and private commercial financial institutions, in the nature of credits for large and long-maturity infrastructure projects in LICs and MICs, the level of transparency of key terms in credits, and the availability of information about previous relief granted by some of these creditors. As a result of these differences, it can be harder to establish the identities and status (public or private) of the creditors, to determine whether they will participate on comparable terms in sovereign debt workouts with other creditors, and to align the interests of different creditor groups in complex debt restructurings.

Going forward, debt treatment processes will need to address these challenges to creditor collective action with legitimacy and integrity so as to minimize and fairly allocate deadweight economic losses, and ensure a quick return of the sovereign debtor to sustainable development. Both Paris Club and private creditor norms and practices will need to adapt to the enlargement of the official bilateral creditor group through the Common Framework.

Recommendations to promote transparent, full, fair, and effective private creditor participation in responding to debt distress

The Roundtable participants recognize that in the next 18-24 months, major institutional reforms are unlikely to replace the current, mostly ad hoc reprofiling and restructuring sovereign debt regime. Therefore we are offering recommendations for the short-term and for the longer term. Timeframes notwithstanding, all of the following recommendations aim to (a) increase transparency and fairness in the negotiation process and its outcomes, (b) improve predictability within a rules-based context, (c) incentivize broad-based and well-organized private creditor participation, and (d) limit opportunities for holdouts to derail negotiation processes and outcomes.

1. Increase the transparency of public and private sovereign debt to both creditors and debtors.

A strong foundation of shared information is essential for debt sustainability assessments, effective financial management by sovereign debtors, the identification and organization of creditors, effective risk management by creditors, and equitable debt treatment processes and outcomes. Serious and ongoing problems of undisclosed, nontransparent sovereign debt undermine prudent fiscal and debt management, prevent other creditors from accurately assessing creditworthiness, weaken the IMF/World Bank debt sustainability analyses, and risk saddling debtor country taxpayers with excessive, ill-advised, and/or unauthorized debt obligations. While acknowledging some technical complexity in categorizing the forms and terms of different kinds of debt, and some political and commercial sensitivities regarding increased transparency, the benefits of creating an accurate, comprehensive and shared information base far outweigh the costs to all parties with an interest in efficient and equitable debt management.

Short term:

- In the context of Common Framework debt treatments and IMF programs, and building on commitments to debt transparency already made by the G20, the Institute of International Finance, the IMF and multilateral development banks (MDBs), these actors should work with sovereign debtors and bilateral and private creditors to **enhance the sharing of detailed sovereign debt information, with provisions for the confidentiality of commercially sensitive information**. Debtors and creditors should include information about collateralized debt (and other long-term sale or resource-backed arrangements amounting to collateralized debt), and debt to state owned enterprises and sub-national governments backed, *de jure* or *de facto*, by the sovereign.

- **The IMF should create an option for any sovereign debtor to request an updated debt sustainability analysis (DSA) as a basis for negotiations with its public and private creditors**. While the IMF is committed to producing DSAs for surveillance as well as to support restructuring operations, there is not yet an option for a sovereign debtor to request an updated DSA to support negotiations with its creditors. DSA assumptions should be explicit, and the IMF should be prepared to explain its analysis and conclusions to both sovereign debtors and public and private creditors. The IMF also should expand the use of scenarios in its DSAs, to reflect more clearly how market developments and policy decisions (including decisions that could enhance debtor assets) could affect debt sustainability. For their part, sovereign debtors should cooperate fully and provide as comprehensive an accounting as possible of all forms of debt that create sovereign liabilities.

Longer term:

- Building on existing IMF and World Bank mechanisms for debt registration and information sharing, and on the IIF Principles for Debt Transparency, **the IMF and the World Bank, in collaboration with the Bank for International Settlements, the Long-Term Investors Club and regional development banks, should establish a cyber-secure sovereign debt registry or repository, where detailed information can be shared between sovereign debtors and their creditors,** and aggregated information can be publicly available to all. This system should include protocols for verifying and updating the information provided by both sovereign and private creditors**.** The OECD's ongoing Creditor Reporting System, and its work on a repository for debt information provided under the Voluntary Principles for Debt Transparency could be a starting point for this registry.
- **The G20 should lead in the publication of their own sovereign debt contracts.** Some countries, like the Philippines, already publish their sovereign debt contracts. All countries should aim to publish their debt contracts as a matter of policy recognizing that public debt should be public. Clearly and narrowly defined exceptions justified on legitimate confidentiality grounds should be allowed, as suggested in the IIF Principles for Debt Transparency.[4]
- **The IMF, World Bank, and other official providers of technical assistance on debt management should promote inclusion of debt transparency standards and requirements as part of domestic law** governing sovereign debt authorization.

[4] See IIF 2019, "Voluntary Principles for Debt Transparency," Sec. 6, accessed at https://www.iif.com/Publications/ID/3387/Voluntary-Principles-For-Debt-Transparency.

- **The World Bank's Debt Management Performance Assessments for member countries, which include debt transparency criteria, should be published** to help potential creditors determine whether a country provides sufficient information to judge creditworthiness.
- **Creditor countries and adjudicating jurisdictions should undertake a coordinated approach to limiting enforceability only to debt that has met a shared standard of transparency.**

2. **Increase incentives for private creditor participation in reprofiling and restructuring, respecting the principle of comparable treatment of creditors**.

Short term:

- **The IMF, G20, Paris Club and MDBs should encourage appropriate organization and classification of private creditor groups, and constructive consultations between debtors and private creditor groups,** when undertaking reprofiling/restructuring operations. In addition, they should provide technical assistance to sovereign debtors to prepare for and undertake negotiations with private creditor groups (and with individual creditors when necessary).
- **All parties participating in good faith restructuring should publicly commit to adhere to the principle of comparable treatment (with the exception of recognized preferred creditors).** If some creditors believe that other creditors (whether private or public) are receiving preferential treatment, they may be required to seek the same treatment, and in any case creditor doubt about the fairness of the process will undercut efforts to reach agreement on restructuring terms. Therefore, shared commitment to comparable treatment, transparency of treatment, and credible mechanisms for ensuring comparable treatment are essential for achieving timely, substantial and equitable participation by private creditors.
- **IFIs and all public and private creditors participating in good faith restructuring should use the means available to them to ensure that the sovereign debtor and all of its major creditors abide by the principle of comparable treatment.** Building on the Common Framework agreed among the G20, Paris Club and IMF, public creditors should act jointly to promote comparable treatment and limit preferential treatment (whether on the basis of prior contractual agreements or ad hoc use of their commercial or strategic influence).
- IFIs and other public creditors should **require full disclosure by the sovereign debtor of any and all ongoing debt service payments,** building on the Paris Club's option to request a full accounting of the terms of restructuring agreements achieved with creditors, and the IMF's ongoing surveillance of adherence to the conditions of its programs**.**
- In addition, IFIs and other public creditors should demonstrate willingness to **condition the terms of their ongoing support on comparable treatment for all major creditors**. Such conditions should leave ample room for **discretionary use of all available tools** (e.g. ongoing surveillance and reporting, scheduling and disbursement of additional tranches of funding, technical and legal support to the sovereign debtor, public statements regarding the status of

restructuring, engagement with individual creditors to address issues of comparability, etc.) to promote the outcome of comparable treatment for all creditors.

Longer term:

- **Financial regulators with jurisdiction over significant financial sectors should offer domestic regulatory incentives for their financial institutions to participate in reprofiling/restructuring,** e.g. allowing the same balance sheet treatment of deferred payments as allowed for deferral of payments from domestic clients.

- **MDBs and official agencies should consider providing credit enhancements and other sweeteners to private creditors in the context of restructuring,** when the public interest is served by incentivizing private creditor participation in debt swaps and other forms of refinancing with public benefits (e.g. social and green bonds)**.**

- **Where private and public creditors and sovereign debtors agree on debt reprofiling/restructuring, the sovereign debtor should consider establishing a central credit facility (CCF) administered by an MDB.** By redirecting some portion of freed up funds through a CCF, the administering MDB and other creditors could monitor how these funds are applied, reducing moral hazard.

- **Credit rating agencies should consider ways to reflect accurately the post-restructuring outlook for sovereign debtors**. While the credit rating agencies provide a legitimate market service, there is a public interest in ensuring that successful efforts to reprofile and/or restructure sovereign debt do not result in unwarranted ratings downgrades. In most cases of reprofiling and restructuring, rating downgrades are inevitable once the transaction is implemented. Nonetheless, rating agencies should be asked to consider

  (a) the period during which these most adverse ratings will last;

  (b) how quickly the benefits of reprofiling/restructuring can be reflected in new ratings;

  (c) whether and how new rating criteria could be introduced alongside the established ones in order to give a fair and accurate picture of the restructured sovereign's new potential; and

  (d) in broader terms, how to minimize the procyclical impact of ratings changes on boom/bust cycles in sovereign debt.

- **Jurisdictions whose law is frequently chosen to govern sovereign debt contracts should consider measures to avoid abuse of their legal system by creditors seeking preferential recovery against sovereigns instead of participating in an agreed, good faith restructuring based on comparable treatment.** These could draw from lessons learned in (a) recent sovereign litigation (most notably the Argentina litigation in New York, London and Brussels), (b) the debates on statutory mechanisms to facilitate debt restructuring (most notably the Sovereign Debt Restructuring Mechanism promoted by the IMF in 2002/03), (c) more targeted measures in relevant jurisdictions designed to limit preferential recoveries through a judicial process in sovereign debt restructurings supported by official sector financial resources and/or debt relief (such as the UK Debt Relief (Developing Countries) Act of 2010).

- **Launch a multilateral process to explore the potential to establish a stable sovereign debt restructuring mechanism (SDRM) under multilateral auspices.**
- **The G20 Finance Ministers should establish a commission of senior public and private leaders (with good representation from creditor and debtor countries) to examine these and other options and make recommendations.**

II. Additional financial support to maintain investments for development

The recommendations above address the role of private sector creditors in responses to debt distress. It is critically important to link the treatment of current private debt to a forward looking approach, in order to sustain appropriately targeted sovereign debtor investments to meet development goals. Many debt restructuring processes have not succeeded in this regard. They have unfolded in a way that produced "too little, too late" from the perspective of both sovereign debtors and creditors. Debt restructuring has often not occurred until sovereigns faced both illiquidity and insolvency; restructuring has generally not aimed to enable new investment beyond the scale necessary to resolve existing debt; and the sovereign debtors have often needed to impose longer-term austerity beyond the immediate period of adjustment in order to service the restructured debt while maintaining debt sustainability. The overall costs of such delays, which extend well into all aspects of the domestic economy and undermine all key long-term stakeholders, cannot be overstated.

While some countries forced into debt restructuring have certainly needed to rein in spending and increase domestic resource mobilization, many have been subject to changes in external economic conditions (e.g. unfavorable changes in commodity prices and interest rates in leading economies) that were beyond their control and difficult to insure against through economic policy. In the context of COVID, MICs and LICs have been exposed to a major and unforeseeable economic shock. The impact of COVID threatens to undermine the capacity of governments to make progress toward the globally agreed Sustainable Development Goals, and risks reversing progress already made in reducing poverty, making societies more equitable, and making them more environmentally sustainable.

It is possible that gradual tapering of fiscal stimulus in the leading economies, along with an effective global public health response to COVID, will provide a "soft landing" for some MICs and LICs that are currently at risk of debt distress. However, if interest rates rise, private capital flows may turn negative in many MICs and LICs, and the drag on growth from continuing COVID challenges will undercut their growth prospects for at least the next 2-3 years. The IMF currently projects that 47 countries will not return to their 2019 GDP/capital levels before 2025.

Some countries managing the risk of debt distress in the next 2-3 years will not lose access to private capital markets; others will be able to regain access to private capital markets quickly as part of their reprofiling and/or restructuring. However, even those countries that do maintain or quickly regain access to private capital may find that the terms for new lending are expensive. Too heavy a reliance on private creditors in the aftermath of restructuring can create a new cycle of debt overhang, high debt service burdens and risk of another round of distress. Moreover, developing countries were already in need of substantially expanded multilateral finance for SDG-focused investment before the COVID crisis. The need for additional multilateral finance is clear and urgent.

Roundtable participants believe that it is possible and desirable to undertake restructuring in ways that enable countries emerging from debt distress to continue making investments that advance sustainable development. To do so, many will need access to increased multilateral finance. In order to provide sufficient investment capital, the World Bank and regional development banks will need recapitalization or other measures to stretch their balance sheets to expand lending significantly beyond their current investment programs.

Though it is important to expand the pool of potentially available multilateral finance over the next 1-2 years, it is equally important to balance access to multilateral finance with careful targeting of new investments by governments emerging from debt distress. Even concessional multilateral lending can exacerbate risks of future debt distress if the investments do not contribute to sustained increases in growth and productivity.

A balance is also needed in the share of multilateral finance in total debt stocks. MDBs have a "preferred creditor status" by remaining outside the restructuring envelope, a status they need to maintain as global custodians of development and liquidity funds and in order to defend their own ratings and calls on their shareholders. To protect this status and to mitigate concerns of official bilateral and private creditors that the reprofiling/restructuring risk falling on them is too large, MDBs must keep their share of financing within appropriate limits.

While taking these concerns seriously, a significant number of governments may need access to multilateral finance in order to increase growth rates while meeting poverty reduction, social and environmental goals. The multilateral financing system has a critical role to play in working with sovereign debtors to design lending programs that bridge from crisis recovery to sustainable investment, without creating new problems for debt sustainability and without crowding out private investment.

Recommendations for supporting investment in sustainable development while managing the risks of debt distress

1. **After restructuring, MDBs should provide additional funding to help countries maintain key investments for sustainable development.** The MDBs already have the policies and instruments needed to develop lending programs that meet this goal, but need additional capital and balance sheet optimization to provide sufficient resources to meet borrower needs. In the COVID recovery context, they should seek to integrate short-term debt restructuring with medium-term investment programs. To the extent possible, they should use their own investments to leverage new private investment on terms that are viable for debt sustainability.

2. **The IMF program negotiated with the debtor country should continue to set the macroeconomic parameters for a return to debt sustainability**, particularly the path of the primary fiscal surplus, the new finance necessary to fill the interim finance gap, and the implied resource envelope available to service restructured debt. The path of fiscal balance should recognize the need to support vulnerable households and the public investment requirements to support recovery of the economy wherever long-run returns exceed the cost of funds.

3. **Debtor governments and their national development banks, partnering with MDBs and bilateral credit agencies, should construct platforms to mobilize private and official finance for sustainable investments.** Such platforms could reduce transaction costs in a variety of ways (e.g. technology platforms, portfolio construction, standardized provision of guarantees, contract standardization with clear enforcement provisions, standardized PPPs) and provide other collective action services in project origination, planning, monitoring, and trouble-shooting.

4. **As the demand for new lending exceeds current multilateral lending capacity, the IMF and MDBs should consider ways to leverage and/or expand their resources to sustain investments for development,** through reallocating IMF Special Drawing Rights (SDRs), and recapitalization and balance sheet optimization for the MDBs. The IMF is actively planning on new SDR issuance in the second half of 2021, and the World Bank's International Development Association (its on-granting/lending window for LICs) is planning an accelerated capital replenishment. Other MDBs should also consider ways to accelerate the investment of their existing capital, and seek additional capital from their members as needed.

5. **Sovereign debtors emerging from debt distress should give serious consideration to issuing state-contingent bonds** (e.g. GDP or commodity price-linked bonds, sovereign contingent convertible bonds (COCOs) that convert foreign currency debt into domestic currency debt if a high debt-to-GDP trigger is breached) if they can do so on viable terms. Debtor governments that face substantial volatility in key drivers of growth can use state-contingent bonds to manage risk. There is a growing body of technical advice available to help governments with the structuring, risk valuation, pricing, and marketing components of these bonds. In a global environment where volatility may be high at least for the next several years, and potentially for decades to come, these instruments may become essential for sustainable public finance.

6. **Sovereign debtors should continue strengthening their capacities for public financial management.** Many sovereign debtors, especially LICs, currently lack these capacities. **The IMF and the MDBs should significantly scale up their support** to such countries to help strengthen the pillars of sound public debt management.

7. **International financial institutions should accelerate work on their existing commitments to help develop domestic capital markets in LICs and MICs, particularly long-term bond and insurance markets**. Consistently low domestic resource mobilization, left unaddressed, will perpetuate the existing huge structural gaps between government expenditures and revenues and the heavy reliance on and vulnerability to external financing. Further, the MDBs should significantly scale up

their support to client countries to enhance the management of their natural resources and to stem illicit financial flows. The MDBs should review their institutional frameworks and policies to even better incentivize countries that show improvements in these areas.

Conclusion

Roundtable participants see many opportunities to build on existing commitments, policies, and tools for managing the risks of debt distress, including those established in response to COVID by the G20, Paris Club IMF, and MDBs, in order to minimize the risk of widespread debt distress. The most important challenges to meet are 1) ensuring that debt restructuring by vulnerable low- and middle-income countries on the basis of comparable treatment is sufficiently timely and inclusive to enable sovereign creditors to maintain public services and investments; and 2) providing additional public and private finance to meet the very substantial needs for investment in recovery and sustainable development.

Using the recommendations offered here (as well as other, complementary proposals and options that are under discussion in a variety of global forums), multilateral, bilateral and private creditors and sovereign debtors can work together to minimize losses and seize new opportunities. If well designed, actions to avoid and remedy debt distress can produce positive public and private returns on investment. We urge public and private stakeholders to maximize the benefits of collaboration by integrating actions to manage debt distress with actions to support longer term investments in sustainable development.