T20 Policy Brief

G20 BRASIL 2024

T20 Brasil 2024 Let's rethink the world

Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Breaking the Vicious Cycle of Debt and Climate Crisis: Debt Relief for a Green and Inclusive Recovery

Marina Zucker-Marques, Senior Academic Researcher, Boston University Global Development Policy Center (USA)

Maria Fernanda Espinosa, Chief Executive Officer, GWL Voices (Spain)

Joerg Hass, Head of the Globalization and Transformation Division, Henrich Boell Stiftung (Germany)

TF03

Abstract

In a decade where Emerging Market Developing Economies (excluding China) need to mobilize additional US$3 trillion – being US$1 trillion just in external resources - annually for sustainable development and climate goals, they are also disproportionately bearing the brunt of the climate crisis while absorbing the financial impact of monetary tightening in developed countries. With the Brazilian G20 presidency, there is a crucial opportunity to reshape the system to better serve the needs of developing countries. Brazil's agenda for the G20 prioritizes social inclusion, sustainable development and combating hunger and poverty. Central to achieving these goals and mitigating global inequalities is the G20 discussion on debt relief.

Within the G20, the Common Framework for Debt Treatments has been criticized as slow and ineffective. This policy brief proposes significant reforms to make it more efficient, inclusive and oriented towards climate and development goals. As a first step, the policy brief recommends that the G20 advocates for a reformed Debt Sustainability Assessment (DSA), requesting the International Monetary Fund (IMF) and World Bank to include development investment needs and climate shocks in the analysis. Moreover, it highlights the need for comprehensive debt relief from all creditor classes (public, private and multilateral). It recommends that the G20 create incentives for the participation of all creditor classes. For private bondholders and commercial creditors in particular, the G20 could consider an updated take on the Brady bonds of the 1980s – when private creditors provided debt relief in exchange for bonds with greater assurance of collectability – which helped to ease the Latin American debt crisis. Finally, for countries that are not in debt distress but lack fiscal space, the G20 could consider credit enhancement to lower the cost of capital for a green and inclusive recovery.

This comprehensive approach could resolve the debt crisis in Emerging Market and Developing Economies (EMDEs) while forging a fairer global financial system. The G20 has a critical role in implementing these solutions, to help avoid a potential lost decade and enable a Decade of Action.

Diagnosis of the Issue

Debt relief today for tomorrow's development and financial stability

It is now widely recognized (Songwe et. al 2022, G20 Independent Expert Group 2023) that EMDE (excluding China) need to mobilize $3 trillion annually - $1 trillion from external sources and $2 trillion domestically – by 2030 to meet shared climate and development goals. These investments are not only essential to avoiding the relative catastrophic economic, social and environmental costs of inaction, but can also transform the world economy into one that is low-carbon and more equitable and resilient.

But on the opposite trend, EMDEs are currently slashing essential basic services and forgoing investments in education, health and climate resilience to meet record levels of external public debt service. According to the WB, in terms of debt service payments, 2024 is the costliest debt service year yet this century (WB 2023). Currently, at least 3.3 billion people live in countries that spend more paying interest rates than on investing in health and education (UNCTAD, 2023). In Africa, unmet climate finance needs alone are roughly the same amount as external debt service (Gallagher et al. 2023). These are some examples of how the current debt burdens are competing with social-economic investment needs.

Apart from squeezing government's fiscal space, many EMDE are already facing a debt-overhang, where much needed new investments are averted by their high debt burdens. According to the World Bank International Debt Statistics published in December 2023, external sovereign debt in EMDEs (excluding China) increased close to 2.5 times in 2022 relative to the levels during the 2008 global financial crisis – from $1.27 trillion in 2008 to $3.1 trillion in 2022, as seen in Figure 1. Not only has the level of debt increased, the composition of external creditors has widened to include not just commercial banks and multilateral development banks (MDBs) as in the last century, but also private bondholders from across the world and emerging market public and private creditors from countries such as China and Saudi Arabia.

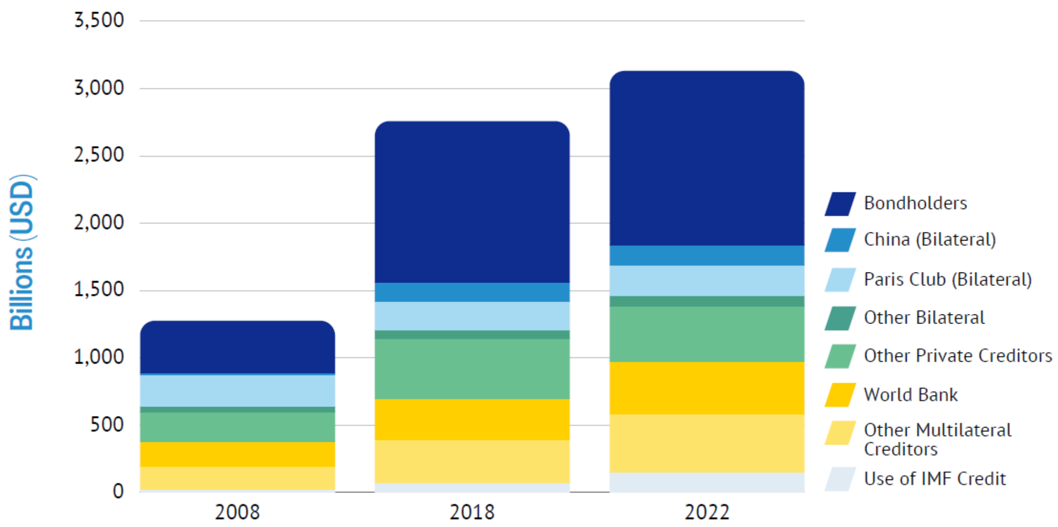

FIGURE 1. EMDE (excluding China) public external debt composition by creditor, 2008-2022, in USD billions. *Source:* Compiled by authors using World Bank (2023).

What is more, given the high interest rates, mobilizing much needed investments at high costs could quickly build up debt vulnerabilities and deepen a debt crisis. As Figure 2 shows, if EMDEs were to rely on current bond market conditions to borrow, 40 countries would face this unsustainable situation where available interest rates are higher than nominal growth rates. Even excluding countries whose bonds are trading 1,000 basis points over Federal Funds rates – and hence are excluded from issuing new bonds – the interest rates are higher than projected economic growth rates for much of the Global South. Even countries with seemingly 'accessible' spreads of 600 and 700 basis points face the same predicament. In 2024, although some African countries have returned to financial markets- including Kenya, Côte d'Ivoire, Benin –the double-digits costs are likely to exacerbate current vulnerabilities.

Although EMDEs do not borrow solely from bond markets and it is important to assess a weighted cost of borrowing, bond markets have become an increasingly important source of finance for EMDEs (WB 2023), pushing up the overall cost of capital.

Bearing the current challenges in mind and analytically following studies on external debt sustainability (Albinet et. al 2023, Kessler and Albinet 2022) and IMF debt sustainability framework for Low-Income countries (IMF 2018), Zucker- Marques et al (2024) perform an enhanced global debt sustainability analysis to estimate the extent to which EMDEs can mobilize the G20 Independent Expert Group recommended levels of external financing without jeopardizing debt sustainability. The study focuses on 66 of 73 economically vulnerable countries eligible for the LIC DSF, excluding seven countries due to data constraints.

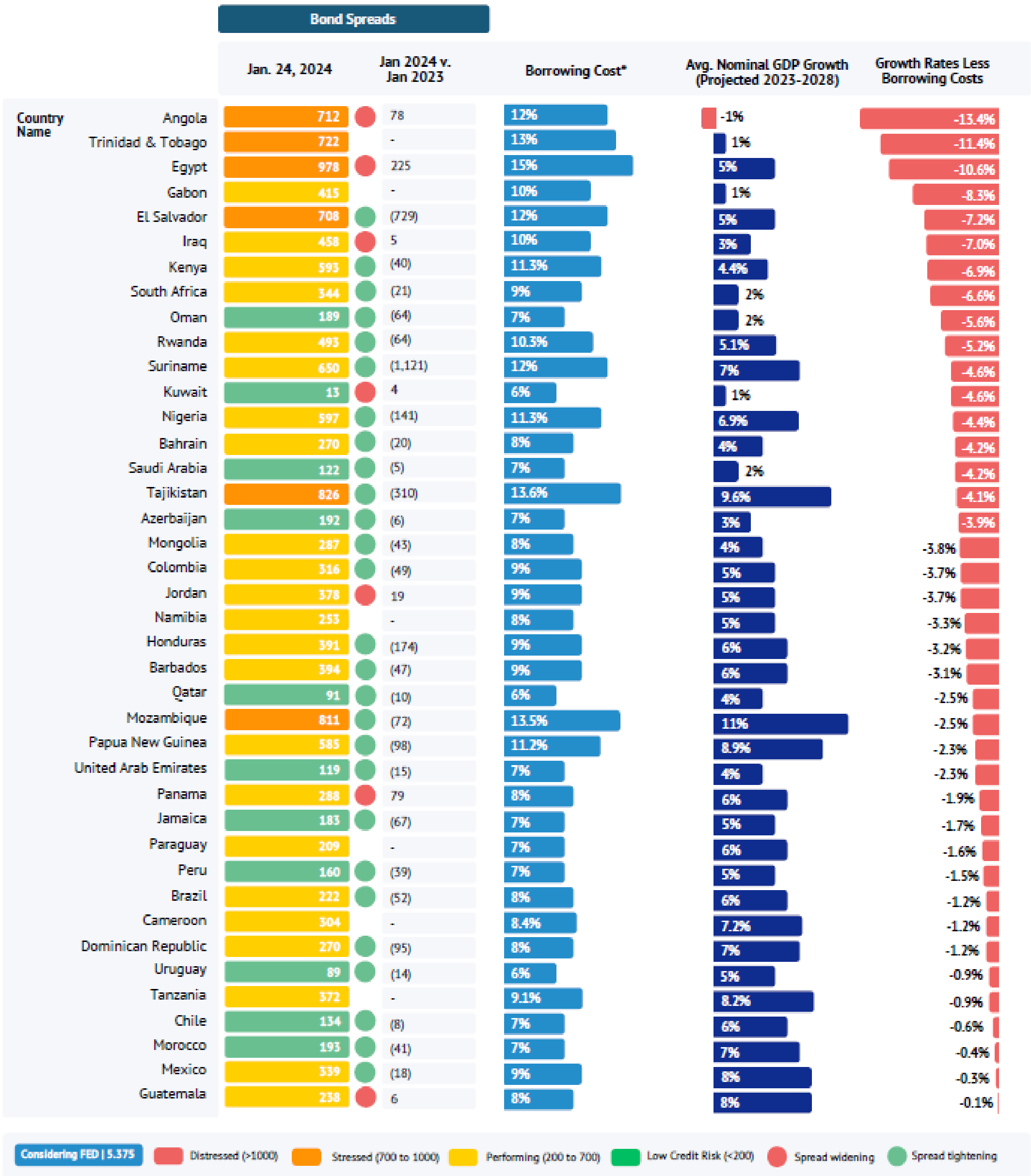

FIGURE 2. Selected countries - Sovereign bond spreads (change between Jan 2023-Jan 2024), borrowing costs and nominal GDP growth projections. *Source:* Authors' calculation based on JPMorgan Emerging Market Bond Index Global, IMF World Economic Outlook (2023). *Note:* Comparison of financial spreads from January 24, 2024, to January 24, 2023. Positive values (signed in red) account for increase in spreads, while negative values (signed in green), represent reduced spreads. Borrowing costs for individual countries factor their respective spreads in addition to the Federal Reserve's average rate of 5.375 percent. This average rate is derived from the current Federal

Reserve target range of 5.25 percent to 5.50 percent. FED rates are a reference for the cost of risk-free assets, which are the parameter for investment decisions regarding different maturities and assets.

The study incorporates external financing needs following estimates by the G20 independent Expert group (2023), it then compares these present value amounts to the projected GDP and export growth rates of each country to provide a PPG external debt sustainability analysis. GDP and export projections rely on the IMF World Economic Outlook (2023), with upward revisions in GDP growth to account for a multiplier effect of new investments in SDGs and climate, given that these can be expected to stimulate economic activity. These revised projections assume that the new investments will be climate-oriented. Following the approach of Batini et al. (2022), the study incorporates a "green" fiscal multiplier of 1.2, surpassing the multiplier for non-green-related investments. Hence, in our model's assumptions, 1 percent of GDP spending results in a 1.2 percent of GDP response in the first year of disbursement.

As Figure 3 shows, 42 of 66 countries eligible for the IMF and World Bank Debt Sustainability Framework for Low-Income Countries (LIC DSF) would surpass external debt solvency thresholds in the next five years (by 2028) for trying to mobilize financing for climate and development. An additional five countries could surpass thresholds if unexpected climate shocks or prolonged high base interest rates occur. Altogether, 47 countries are identified as in need of debt relief. While the collective GDP of these 47 countries is equivalent to less than 2 percent of the world economy ($1.6 trillion as of 2022), they are home to 1.11 billion people.

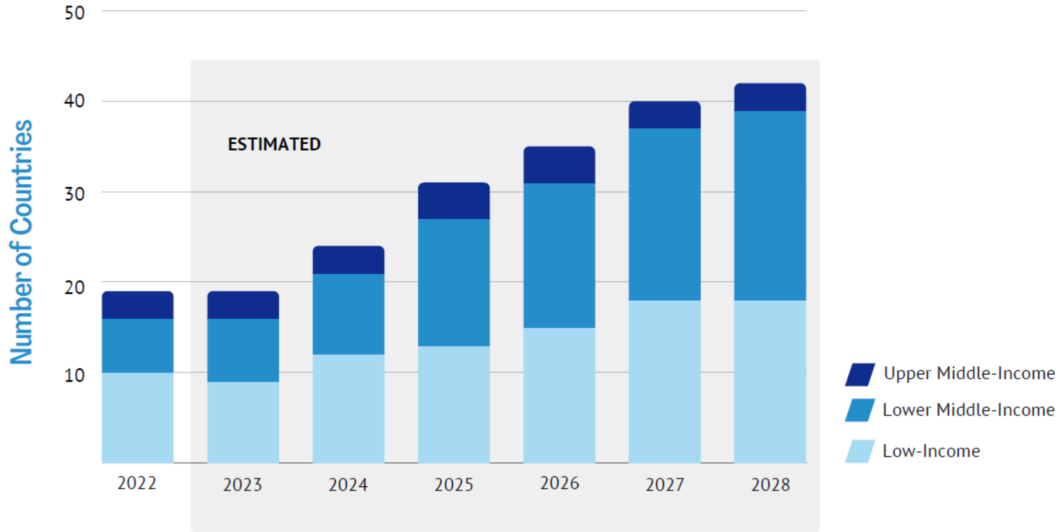

FIGURE 3. Number of countries breaching solvency indicators of external debt sustainability, 2022-2028*, by income group. *Source:* Authors' elaboration.

Recommendations

Forging a comprehensive approach to debt relief

The Relief for a Green and Inclusive Recovery (DRGR) Project, initiated in 2020, proposes a reform of the G20 Common Framework towards a comprehensive approach to alleviate debt burdens in heavily indebted developing countries, enabling them to transition to low-carbon, socially inclusive, and resilient economies. The proposal comprises three main pillars, as illustrated in Figure 4.

1. Public and multilateral creditors should grant significant debt reductions that not only bring a distressed country back to debt sustainability but put the country on a path to achieving development and climate goals – in a manner that preserves the in a manner that preserve the financial health of multilateral institutions.

2. Private and commercial creditors should grant commensurate debt reductions alongside public creditors with a fair comparability of treatment. These creditors must be compelled to enter negotiations through a combination of carrot and stick incentives.

3. Credit enhancement should be provided for countries not in debt distress, but that lack fiscal space, alongside a temporary debt service suspension to lower the cost of capital and increase fiscal space for investing in a green and inclusive recovery.

FIGURE 4. DEBT Relief for a Green and Inclusive Recovery Proposal

Source: DRGR Project, 2024.

The prerequisite for properly assessing which countries need debt relief or liquidity support – balancing debt sustainability and development – is reforming DSAs. The Low-income countries Debt Sustainability Framework carried out by the IMF/WB is currently being revised. The G20 could request the WB and IMF – with consultation to other organizations – to include the investment needs of a country as a baseline, as well as scenarios whereby a country may experience various traditional and climate- or nature-related shocks (Maldonado and Gallagher, 2022; Kraemer and Volz, 2022). Enhanced DSAs will give a more realistic picture of the amount of external debt necessary to finance investment needs, and the relative cost of capital necessary to mobilize such investment. In the case of debt restructuring, an enhanced DSA will also provide a more realistic envelope for the level and nature of the needed debt reduction.

If a DSA asserts that the sovereign debt of a country is of significant concern, an official creditor committee should coordinate all bilateral and multilateral official creditors. The G20, by reforming the common framework, could play a key role incentivizing the participation of all creditor classes but taking into account their particularities. Regarding participation of MDBs, it could take place in distinct formats (provision of new financial flows or direct haircuts), it is fundamental that their claims are not excluded preemptively from debt relief efforts, as such policy could dissuade countries with high debt to MDBs from pursuing debt relief altogether. Moreover, excluding MDBs from debt relief risks realizing an insufficient debt reduction to restore debt sustainability, especially in the case of LICs. Finally, MDBs will need to provide debt relief in a manner that maintains their financial health and/or provide grants and concessional financing to bring the country to solvency (Zucker-Marques et al., 2023). Countries with outstanding IMF debt should resort to the Catastrophe Containment and Relief Trust.

Moreover, the G20 could design incentives for private and commercial creditors to participate in debt relief and bear a fair share of the burden. Incentives should be made for Brady-type credit enhancements for new bonds that would be swapped with a significant haircut for old debt. Such a mechanism may have particular appeal to Chinese commercial creditors, where debt obligations are in the form of long-term bank loans that could be swapped for new bonds at a haircut and partially guaranteed, therefore not only providing fiscal space to borrowing countries but allowing Chinese commercial banks to sell the new bonds and alleviate balance sheet pressure. To this end, we propose the creation of a Guarantee Facility for Green and Inclusive Recovery, as illustrated in Figure 5, managed by the World Bank in close cooperation with regional development banks. If a country misses a debt service payment on the new bonds, the Facility would be activated and cover the missed payments, which the sovereign would then repay to the Facility.

FIGURE 5. Design of the Guarantee Facility for Green and Inclusive Recovery

Source: DRGR Project, 2024.

In addition to these 'carrots' to bring private and commercial creditors to the negotiating table, history shows that 'sticks' will also be necessary. As proposed in previous DRGR Project reports, the IMF should use its lending in arrears policy, and threaten to withhold emergency financing until a restructuring is underway and to be the first to disburse upon a successful restructuring. This move provides an incentive for holdout private creditors to participate in the restructuring process. Moreover, lawmakers and regulators in key jurisdictions – New York and London, in particular – can put pressure and use 'moral suasion' to convince private and commercial creditors to partake in debt restructuring.

Finally, what most important is that the outcome of a restructuring is linked to investment in climate and development goals. The G20 could support, governments participating in debt restructuring to develop a Green and Inclusive Recovery Strategy, in which they identify actions the country would undertake to advance their development and climate goals.

TF03

Scenarios

The future of EMDEs is at crosswords. If current economic and policy trajectories persist, the international community will see a default on the 2030 Agenda. Moreover, the repercussions of inaction would result in devastating social, economic and environmental costs that could become irreversible. However, another pathway exists. If countries can accelerate investments on climate and development goals, the world economy can evolve into one that is low-carbon, more equitable, resilient and conducive to growth.

However, many EMDE are already facing debt overhang, where current debt burdens are preventing the mobilization of new investments. What is more, given monetary tightening at the Global North, raising new capital or refinancing debt positions is likely to build up further vulnerabilities, possibly leading to an acute debt crisis within a few years.

Hence, for many of the most vulnerable countries, debt relief today would enable these countries to forge a high-growth, inclusive and sustainable path. But the current debt architecture is not adequate to enable a smooth, speedy, fair, and efficient debt restructuring. In that sense, the G2O should urgently reform the common framework in four main areas. First, underpin debt relief needs on on an enhanced and calibrated DSA to account for critical development investment needs, as well as the potential of climate and other shocks. With an enhanced DSA, the adequate haircut is accounted as to ensure indebted countries can forge a new development path. Second, the G20 should support productivity and growth-enhanced programs, instead of fiscal austerity programs often implemented during debt restructuring. Third, given the broad creditor based for EMDE, G20 should rely on tools to compel all creditors to provide debt relief. And finally, it must rely on a comparability of treatment rule that is fair for all creditors as to ensure that concessional lenders subsidize high-cost creditors.

TF03

References

ECLAC. 1990. Latin America and the Caribbean: Options to Reduce the Debt Burden. United Nations Economic Commission for Latin America and the Caribbean.

G20 Independent Experts Group. 2023. The Triple Agenda: A Roadmap for Better, Bolder and Bigger MDBs. Retrieved from https://www.cgdev.org/publication/triple-agenda-roadmap-better-bolder-and-bigger-mdbs.

Gallagher, Kevin, Liliana Ramos, Whitney Ansetze, and Mariana Zucker-Marques. 2023. "Debt Relief for a Green and Inclusive Recovery Writing Paper." Available at: https://drgr.org/research-2/working-papers/africas-inconvenient-truth-debt-distress-and-climate-resilient-development-in-sub-saharan-africa/.

Griffith-Jones, Stephany, Kevin P. Gallagher, and Ulrich Volz. 2021. Debt Relief by Private Creditors: Lessons from the Brady Plan. Background Paper to the Debt Relief for Green and Inclusive Recovery Project. Berlin, London, and Boston: Heinrich Böll Stiftung; SOAS, University of London; and Boston University. Retrieved from https://drgr.org/research-2/background-papers/debt-relief-by-private-creditors-background-paper-7/.

International Monetary Fund. 2018. Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries. Retrieved from https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf.

Kessler, Martin, and Céline Albinet. 2022. The Coming Debt Crisis. Finance for Development Lab, Working Paper 1. Retrieved from https://findevlab.org/the-coming-debt-crisis/.

Maldonado, Felipe, and Kevin P. Gallagher. 2022. Climate Change and IMF Debt Sustainability Analysis. Task Force on Climate, Development, and the IMF. Retrieved from https://www.bu.edu/gdp/2022/02/10/climate-change-and-imf-debt-sustainability-analysis/.

Munevar, Daniel, and Georgi Pustovit. 2020. Back to the Future: A Sovereign Debt Standstill Mechanism IMF Article VIII, Section 2 (b). SAFE Working Paper No. 282. Retrieved from https://ssrn.com/abstract=3596926.

Qian, Yuge. 2021. Brady Bonds and the Potential for Debt Restructuring in the Post-Pandemic Era. GCI Working Paper 09/2021. Boston University Global Development Center. Retrieved from https://www.bu.edu/gdp/files/2021/09/GCI_WP_018_FIN.pdf.

Ramos, Liliana, Rebecca Ray, Rishikesh Ram Bhandary, Kevin P. Gallagher, and William 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. https://drgr.org/our-proposal/report-guaranteeing-sustainable-development/.

Songwe, Vera, Nicholas Stern, and Amar Bhattacharya. 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.

UNCTAD. 2023. The World of Debt. Available at: https://unctad.org/world-of-debt.

World Bank. 2023. International Debt Report. World Bank. Available at: https://www.worldbank.org/en/programs/debt-statistics/idr/products.

World Bank. 2024. Global Economic Prospects. World Bank.

Zucker-Marques, Mariana, Kevin Gallagher, and Ulrich Volz. 2024. Defaulting on Development and Climate: Debt Sustainability in the Race for the 2030 Agenda and Paris Agreement. Debt Relief for a Green and Inclusive Recovery.

https://drgr.org/research/report-defaulting-on-development-and-climate-debt-sustainability-and-the-race-for-the-2030-agenda-and-paris-agreement/.

G20 BRASIL 2024
BUILDING A JUST WORLD AND A SUSTAINABLE PLANET

T20 Brasil 2024
Let's rethink the world

Let's rethink the world

CEBRI
Rethink Tank

FUNDAÇÃO ALEXANDRE DE GUSMÃO

ipea
Instituto de Pesquisa Econômica Aplicada