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Rethinking public debt for achieving the SDGs

Chapter 4. Managing and resolving debt distress: policy considerations and options

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Chapter 4. Managing and resolving debt distress: policy considerations and options

This chapter discusses policy options for countries to **effectively manage the risk of debt distress** during normal times and policy options to **respond to debt distress and mitigate related socioeconomic damages** when a country is already in such a difficult situation.

It aims to address three main questions:

1. What is the main policy objective of managing sovereign debt distress?
2. What are the main causes of sovereign debt distress?
3. What can be done by debtor countries and the international community to reduce the risk and damages of sovereign debt distress while keeping in mind the development financing needs?

This presentation is to share **three potential highlights** of the chapter...






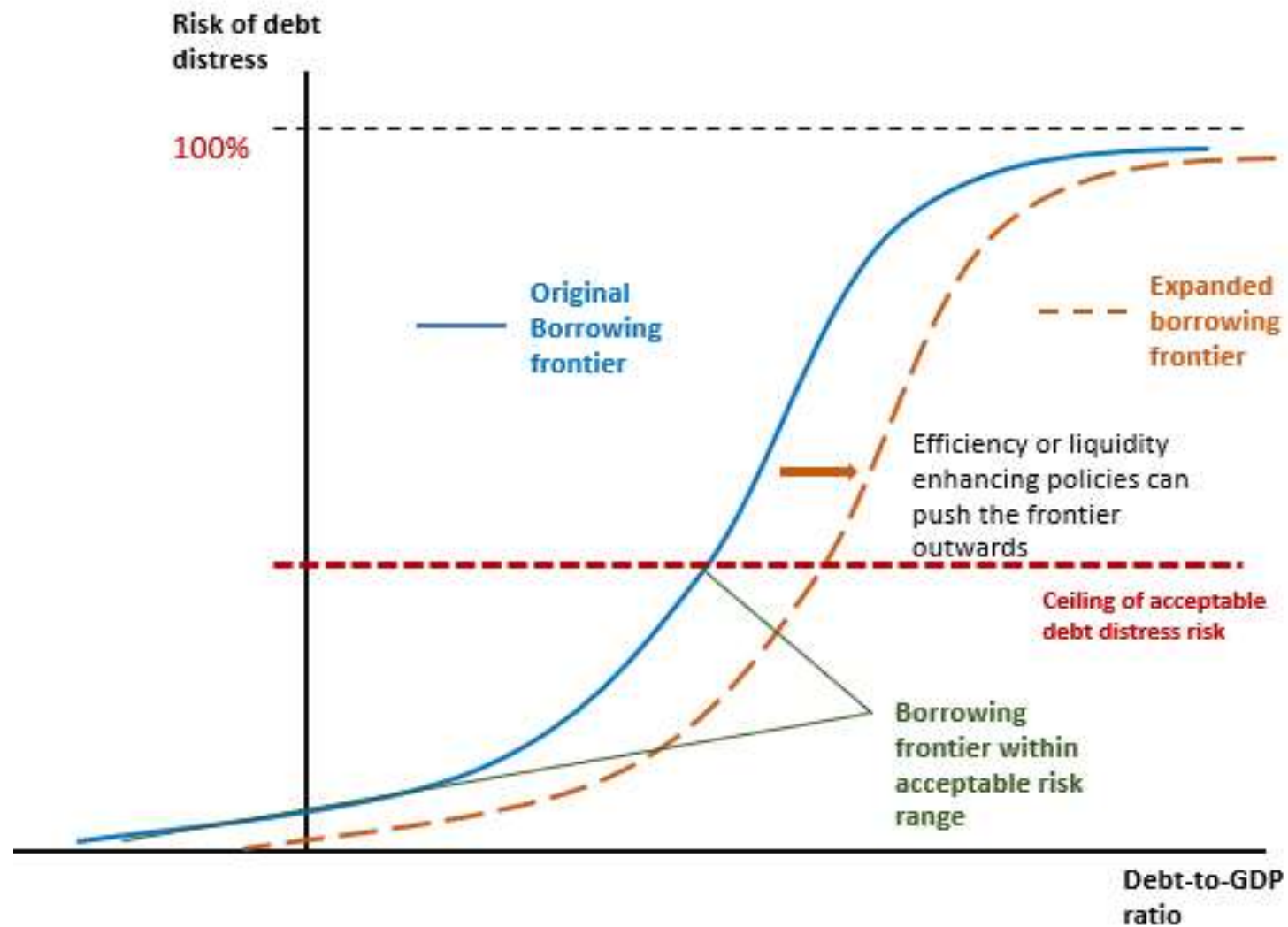
Highlight 1. Managing debt distress is a delicate balance with four objectives

Debt distress is often a result of **fiscal mismanagement**, but it can also be caused by and amplified by **tail-risk development shocks** and **long-term developmental deficits**.

Reducing debt distress risk without considering the development financing dimension simultaneously won't solve the problem. Managing debt distress is a **delicate balance between the level of risks and the need for development financing**.

More specifically, **the objectives of debt distress management** should include the following:

1. To ensure that the risk of debt distress stays within an acceptable range for a given sovereign borrowing frontier;
 2. To increase the maximum level of public borrowing without increasing the risk of debt distress;
 3. To reduce the threat of temporary liquidity bottlenecks (in addition to the long-term solvency risk);
 4. To reduce the damages, severity and duration of debt distress, in case it does happen.
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	Keep debt distress risk within acceptable range at normal times	Enable higher borrowing without increasing debt distress risk	Reduce liquidity bottlenecks	Reduce damages, duration & severity of debt distress	Most suitable countries
Fiscal rules	OOO			O	Countries prone to fiscal mismanagement
Transparent & accountable budgetary institutions	OOO	O		O	All
Fiscal consolidation	OO			OO	Countries with current or looming debt distress
Revenue mobilization		OO	O	OO	All
Enhancing expenditure efficiency		OOO		OO	All
Growth enhancement measures		OOO		OO	All, especially for countries with potentials for an economic takeoff
Encouraging domestic savings & financial market development		OOO	OOO		All
Cross country transfers (ODA, south-south, climate ODA etc.)		OO	OO	OO	All, especially those with high SDG deficits & climate vulnerability
Multilateral liquidity financing mechanisms			OOO	OO	All
Debt restructuring mechanisms			OOO	OO	Countries in debt distress or with high risk of debt distress
Debt monetization		OO	O	O	Only as a last resort option
Unexpected inflation		OO	O	O	
Financial repression		OO	O	O	

Matrix of existing policy options for managing debt distress

Note:

 This matrix is only illustrative to demonstrate the type of eventual analysis to be presented by the Chapter

- Highly effective

OOO
- Effective

OO
- Somewhat effective

O
- No effect



Highlight 2. Economic dividend of public spending as the key for reducing debt distress risk

A central principle for sovereign debt sustainability is to ensure that **economic dividend of public spending financed by the debt is greater than the interest payable**.

Therefore,

- The allocation of public funding (whether to finance consumption or to invest in development) is critical for debt stationarity;
- Ensuring that public investments are productive is equally important.

A **focus on economic productivity of debt-financed public investment and expenditure** can kick start a virtuous circle:

high productivity of investment -> growing capital formation -> sustained high economic growth -> ability to save more, borrow more and invest more




Highlight 2. The example of Republic of Korea

During its economic take-off between the 1960s and 1980s, the Republic of Korea encountered a same set of development financing challenges that confronted other developing countries.

- Persistently and sizable current account deficits;
- Increasing dependence on external debt

But RoK managed to avoid debt distress, in sharp contrast to other developing countries at the time


The most important lesson is ROK's **emphasis on the efficiency criterion of external borrowing**: a country can only remain credit worthy if the marginal economic productivity of its foreign borrowing is higher than the real interest rate payable on it.

- Very high marginal capital productivity
 - Public debt primarily financed investments and foreign exchange reserves, rather than consumption or private capital flight
 - Overall domestic capital formation more than tripled between 1950s and 1970s, contributing an averaging GDP growth of 8.3% between 1961 and 1980
 - Domestic savings also surged, complementing foreign borrowing
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Highlight 2. The example of Republic of Korea

The Republic of Korea employed a **host of policies and institutions to enforce the efficiency criterion.**

- Centralized monitoring and approval of loans and external borrowing at the MOF.
 - Economic Planning Board (EPB) appraisal of creditworthiness and usage of funds.
 - Excellent debt statistics for informed decision making and transparency.
 - Requirement of repayment guarantees on external debt.
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Highlight 3. Debt restructuring: past & existing frameworks, limitations, & future possibilities.

Past & existing debt resolution mechanisms


	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
Paris Club (1956 - date)	<ul style="list-style-type: none">- Established in 1956 to coordinate debt restructuring among traditional bilateral creditors	<ul style="list-style-type: none">- Traditional bilateral creditors only	<ul style="list-style-type: none">- HIPC countries- Case-by-case for middle-income countries	<ul style="list-style-type: none">- IMF program for restoring debt solvency is needed- Comparability in treatment from private creditors- Debt reduction averaged 65 per cent for HIPC countries	<ul style="list-style-type: none">- Strong creditor coordination within the group- Limited creditor and debtor coverage- Assistance for middle-income countries can be time-consuming and limited

	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
Brady Plan (1989-1990s)	<ul style="list-style-type: none"> - Created in 1989 to resolve unsustainable debt of debtor countries to U.S. private creditors (banks) - Syndicated bank loans & other debts were replaced with long-term Brady bonds (25-30 years) - Private creditors are incentivized to provide debt reduction in exchange for secure and liquid Brady bonds collateralized with U.S. treasury bonds - The collateral asset was paid for by debtor countries but financed by IMF/WBG loans - Private creditors are also incentivized by U.S. regulatory changes - IMF lending into arrears policy also reduced the hijacking of debt restructuring effort by hold-out creditors 	<ul style="list-style-type: none"> - U.S. private creditors 	<ul style="list-style-type: none"> - Mainly Latin American countries, but also countries from Africa, Asia (the Philippines, Russia, Viet Nam, and the Europe, (including middle-income) - The majority are middle-income countries 	<ul style="list-style-type: none"> - IMF/WBG lending to finance Brady bond collateral is needed, with DSA & reform requirements - Net debt present value reduction averaged to 37 per cent 	<ul style="list-style-type: none"> - Recognition of the solvency challenge (thus also the need for debt reduction beyond rescheduling and refinancing) - Enabled quick resolution of debt distress & risk diversification - A common menu of options with flexibility - Highly dependent on backing by the creditor & jurisdiction country - Despite significant improvement in access & liquidity, the much more diversified portfolio of investors poses challenges to creditor coordination in future debt reliefs

	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
HIPC Initiative (1996- date)	<ul style="list-style-type: none"> - To provide a clean start for the poorest heavily-indebted countries - Strengthened in 1999, with most remainder debt written off - Supplemented by MDRI in 2005, offering full debt relief on multilateral debt (IMF, WBG, IADB, AfDB) 	<ul style="list-style-type: none"> - Traditional bilateral and multilateral creditors - Non-Paris Club bilateral creditors - Private creditor participation facilitated by the IDA Debt Reduction Facility (financing debt buy-back at a discount) 	<ul style="list-style-type: none"> - 37 poorest countries (1 Asia: Afghanistan) - An exception of Albania 	<ul style="list-style-type: none"> - Key structural and social development reforms - Spend fiscal savings on poverty reduction - On average 60 per cent of the eligible debt stock 	<ul style="list-style-type: none"> - Highly standardized programs and terms - Allowed beneficiary countries to raise investment and social spending - Slow processing: average 3.5 years from decision to delivery (5 years or more for one in five countries) - By 2019 around half of IDA-eligible countries were in debt distress or at high risk of debt distress, with a shift towards more expensive and riskier borrowing (WB 2021) - Weak participation by small and private creditors, with also litigation against HIPC by private creditors



	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
G20 Common Framework for debt treatment (2020)	<ul style="list-style-type: none"> - Bring traditional and new bilateral creditors to a same framework - Focus primarily on debt service reliefs (maturity extensions, interest rate reductions) - Debt face value reduction is subject to DSA and collective assessment by participating creditors 	<ul style="list-style-type: none"> - Both Paris Club members and non-Paris Club G20 members 	<ul style="list-style-type: none"> - DSSI eligible countries (mainly low-income) 	<ul style="list-style-type: none"> - Comparability in treatment from other creditors - [in case of debt reduction] IMF/WB DSA and programs - Only three countries have sought for debt relief under this framework 	<ul style="list-style-type: none"> - Bring together traditional and new bilateral creditors - Exclusion of many heavily indebted middle-income countries - Limited ambition in debt reduction (similar to Baker plan in early 1980s) - No mechanism for private creditor engagement



Highlight 3. Debt restructuring: past & existing frameworks, limitations, & future possibilities.


Failed initiatives

	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
Sovereign Debt Restructuring Mechanism proposal by IMF (2002)	<ul style="list-style-type: none">- Majority restructuring: qualified majority agreement on debt restructuring is binding for the minority- Temporary stay on creditor litigation before a restructuring agreement is reached- Safeguards of creditor interests during restructuring- Prioritizing continuous financing	-	-	-	-


Highlight 3. Debt restructuring: past & existing frameworks, limitations, & future possibilities.


Future possibilities

	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
G20 Common Framework expansion	<ul style="list-style-type: none">- Expand debtor coverage to include also heavily indebted middle-income countries- If possible, create mechanisms for private sector participation- Explore innovative options such as debt for climate swaps				-





	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
“Brady-like” debt relief	<ul style="list-style-type: none"> - Replace problematic debt with more secure and liquid new debt, but with longer maturity and adequate reduction in value - Mechanisms for improving risk and liquidity profiles of the new debt, probably involving a broader group of creditor countries, are needed - Credit-enhancement facilities and policy expertise of IFIs would remain central 	<ul style="list-style-type: none"> - Potentially traditional and new creditor countries 	<ul style="list-style-type: none"> - All countries with debt overhang 	<ul style="list-style-type: none"> - IFI involvement and credible plans to restore debt sustainability 	<ul style="list-style-type: none"> - IFI credit-enhancement facilities have been significantly expanded and can be leveraged to finance a “Brady-like” debt relief - Debtor countries are confronted with a much larger and more diversified group of private creditors - Hold-out investors, especially vulture funds, remain a hurdle for creditor coordination






	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
State-contingent debt instruments (SCDIs)	<ul style="list-style-type: none"> - Payouts to creditors is contingent on the country's economic and financial health (GDP, exports, commodity prices etc.) - Debt or debt service burden is countercyclical for debtor countries - 	-	-	-	<ul style="list-style-type: none"> - An automatic hedge against negative shocks, thus also lower risk of default - More risk-profile choices in sovereign debt assets for investors, thus improving liquidity - Can provide an alternative/better option for debt restructuring - Potential complexity in design (e.g. what level of hedge to seek, how to price the hedge)





	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
Aggregate collective action clauses (CACs)	<ul style="list-style-type: none"> - CACs now cover most new debt, but legacy stock of debt still accounts for about 50 percent of outstanding international debt - Aggregated collective action clause to cover all creditors and apply to both outstanding debt and new debt 	-	-	-	- Address the holdout creditor challenge





	Features	Creditor coverage	Debtor coverage	Conditionalities & extent of debt reduction	Successful lessons & limitations/side effects
International sovereign debt restructuring mechanism	<ul style="list-style-type: none"> - Based on the 9 UN principles for debt restructuring - Multilateral soft law forum to renegotiate debt (no judicial or treaty-based institution) 	-	-	-	<ul style="list-style-type: none"> - Facilitate broader coordination and reduce the risk of holdout and litigation

