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RESOLVING THE WORST EVER GLOBAL DEBT CRISIS

TIME FOR A NORDIC INITIATIVE?

There is an almost universal consensus that the new developing country debt crisis is very serious: this briefing paper, drawing on a new ***Debt Service Watch*** database[1], proposes a Nordic Initiative to resolve it.

Measured by the burden of debt service on budgets, this is the worst global debt crisis ever. In 2023, debt service is absorbing 38% of budget revenues, 29.5% of spending, and 7.6% of GDP: figures much higher than those before relief was provided to Latin America in the 1980s and HIPCs from 1996. Most important, service equals all social spending, and is 2.5 times education spending, 3.7 times health, 11 times social protection, and 13 times climate adaptation. The crisis is also widespread – affecting 109 countries - and concentrated in those which have accessed capital markets (rather than those previously receiving relief). The creditors to whom the debt is owed are so diversified that meaningful relief will require external and domestic bondholders, and for some countries multilateral creditors, to participate.

To find the best solutions, the paper learns lessons from all debt relief initiatives since World War II. On the most recent, it finds that debt relief through the current "Common Framework" is falling way short of expectations in terms of timeliness, participation by all creditors, and transparency and accountability. Most important, countries will be paying 48% of their budget revenue on service ***after relief, freeing up virtually no money for spending on the SDGs***. Progress on mobilizing additional new financing – including via the World Bank RoadMap, Bridgetown Initiative and Paris Summit - has also been very disappointing compared to the original expectations generated of US$500 billion extra a year for SDG Stimulus; and such money will come mostly in loans, adding to the debt burden. It should also not be forgotten that debt relief has major advantages over new financing in terms of rapid delivery, long-term predictability, country ownership, sustained increases in social and environmental spending, and accountability. The paper makes 10 recommendations for comprehensive debt relief and new finance to

[1] "For a more detailed briefing on the Debt Service Watch database, and the detailed numbers for 139 countries, see https://www.development-finance.org/en/news/831-11-october-the-worst-debt-crisis-ever-shocking-new-debt-service-numbers.

support the SDGs, and reduce dramatically the risk of future debt crises. Its key suggestions are that relief should be:

- available to countries of all income levels and regions, tailored to their needs;
- provided in ways which reduce service rapidly to less than 15% of budget revenue;
- provided rapidly and with immediate standstills of payments when a country applies for relief;
- including all creditors by drawing on legal and regulatory tools used successfully in the past, and;
- especially legal protections for debtors against holdouts and lawsuits in all major financial centres.

To reduce the risk of future debt crises, it recommends:

- making debt relief and new lending (including PPPs) fully transparent and accountable to parliaments, citizens and audit offices in developing countries, as well in creditor countries.
- passing an amendment to the UN Convention Against Corruption to prevent corrupt or predatory lending or debt restructuring, giving legal action against such acts teeth in all countries.
- dramatically enhancing efforts to build developing country capacity to negotiate debt relief and new lending, and to make development financing more transparent and accountable to stakeholders.
- accompanying relief with extra concessional multilateral and bilateral funds, measures to reduce market borrowing costs for countries, and greater efforts to mobilise progressive tax revenues.
- establishing a permanent legitimate supporting architecture led by the United Nations.

Nordic governments have a remarkable history of leading initiatives to reduce developing country debt. The report therefore proposes a new initiative for Nordic governments, building on the consensus views of 40 governments, international organisations, CSOs and independent experts. It would build on current debt relief mechanisms, and provide comprehensive, effective and just debt relief – as well as more rapid financing – allowing countries to accelerate progress to the Sustainable Development Goals.

EXECUTIVE SUMMARY[2]

There is an almost universal consensus that there is a new developing country debt crisis. Norway and the Nordic countries have long been at the forefront of advocating and implementing measures to resolve previous debt crises. This report therefore describes a potential new Nordic initiative, which builds on current debt relief mechanisms, declared policy intentions by the Norwegian and German governments, and a remarkable degree of consensus among 40 governments, international organisations, CSOs and independent experts interviewed for the study. It suggests how to provide comprehensive, effective and just debt relief to resolve the current - and prevent future - debt crisis.

The context of the report is that COVID-19 and high global inflation have dramatically set back prospects of reaching the Sustainable Development Goals, and of citizens accessing their rights to basic public services. The global crisis of extreme inequality and poverty has also dramatically worsened in 2020-22, and without strong remedial action the world will not eliminate poverty by 2030. The climate emergency is becoming ever more urgent and must be fought by spending much more on adaptation – and in ways which reduce poverty and inequality. Confronting all these crises will require huge extra funding to avoid widespread post-COVID austerity and a "lost decade" for development. So the report asks: *what contribution can debt relief make to financing post-COVID recovery and the SDGs ?*

[2] This briefing is the executive summary of a longer report due to be released in early December 2023. It was commissioned by Norwegian Church Aid, managed by Kjetil Abildsnes, and written by Matthew Martin and David Waddock of Development Finance International. The authors also thank 51 interviewees for giving their time generously, and Iolanda Fresnillo (EURODAD) and Jurgen Kaiser (Erlassjahr) for reviewing the report.

1) THE SCALE OF THE CRISIS

The new debt crisis is the most severe developing countries have ever faced. Looking at **key indicators of "economic" sustainability**, In terms of ***debt compared to country GDP***, the new crisis has been building for a decade, pushed up by the global financial crisis in 2008-09, and commodity price falls in 2014-16. The COVID-19 pandemic has worsened the crisis so at end 2022, ***countries in all developing regions (except Europe), income groups and special situations face excessive average debt burdens***. This is not a temporary problem: IMF analyses indicate that without drastic action to cut spending and/or increase taxes, high debt/GDP would persist in most countries through the 2020s. In addition, many countries face huge actual and potential liabilities from US$1 trillion of public-private partnerships.

The debt service burden is the worst ever faced. We have compiled a new ***Debt Service Watch*** database for this report, which covers external and domestic debt service for 139 developing countries. It finds that service currently averages 38% of budget revenue, 57.5% for low-income countries (LICs) and 53% for Africa. However, it is not confined to LICs: lower-middle income countries (LMICs) average 45%, and all regions exceed 30%. Debt service is also an average of 7.6% of GDP. The former Heavily Indebted Poor Countries (HIPCs) are paying 8.2%, more than twice the level they were paying before they received relief from 1996. Even Latin American countries are paying more on average than they were in the 1980s.

FIGURE 1: DEBT SERVICE TO REVENUE (by Income group, %, 2023)

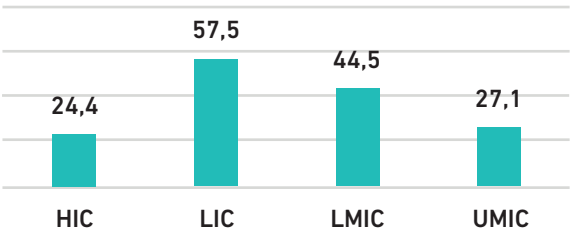
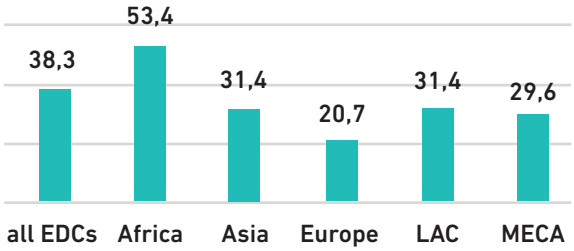


FIGURE 2: DEBT SERVICE TO REVENUE (by Regional group, %, 2023)



Most vital for confronting global crises and reaching the SDGs, service averages 29.5% of total spending, and reaches 39% in Africa and LICs, and 33% in LMICs, least developed and landlocked countries. ***Debt service matches total social spending (education + health + social protection) on average across all countries***, and exceeds it by half in Africa, by 62% in LICs and by 14% in LMICs. For countries currently in default or seeking debt relief, it is twice as high as social spending. ***Debt service is 2.5 times education spending across all countries, 3.7 times health spending, and 11 times social protection spending***. For 47 countries reporting climate spend in their UNFCCC Nationally Determined Contributions (NDCs), ***debt service is 13 times climate adaptation spending***.[3]

[3] Source: Debt Service Crowding Out Climate Spending, forthcoming briefing by Development Finance International for COP 28.

FIGURE 3: DEBT SERVICE AS % OF SPENDING
(by Regional group, 2023)

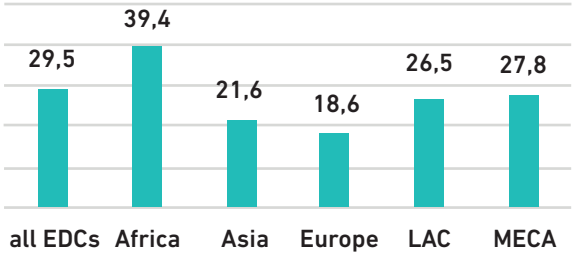


FIGURE 4: DEBT SERVICE AS % OF SPENDING
(by Income group, %, 2023)

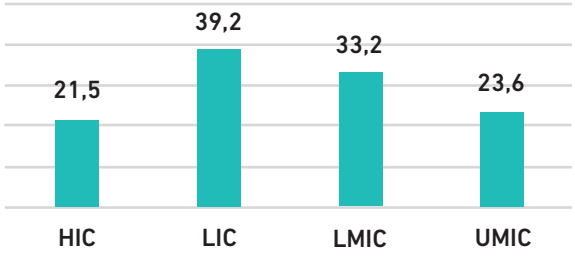


FIGURE 5: DEBT SERVICE vs SOCIAL SPENDING
(by Income group, 2023)

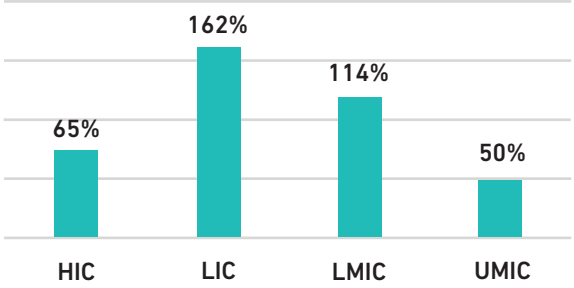


FIGURE 6: DEBT SERVICE vs EDUCATION SPEND
(by Regional group, 2023, in %)

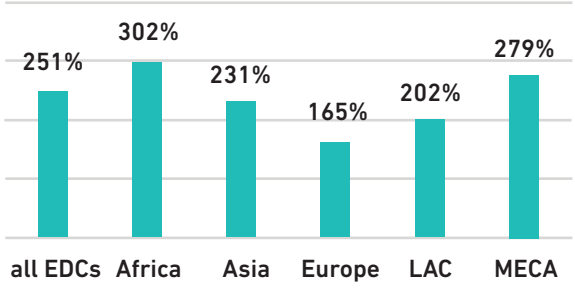


FIGURE 7: DEBT SERVICE vs HEALTH SPENDING
(by Regional group, 2023, in %)

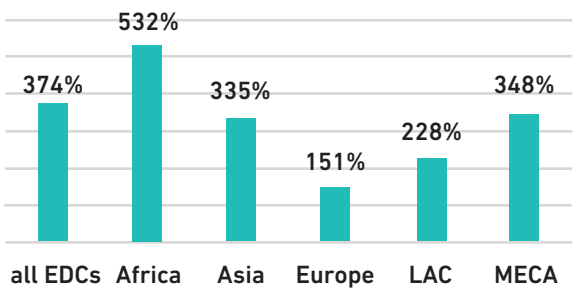
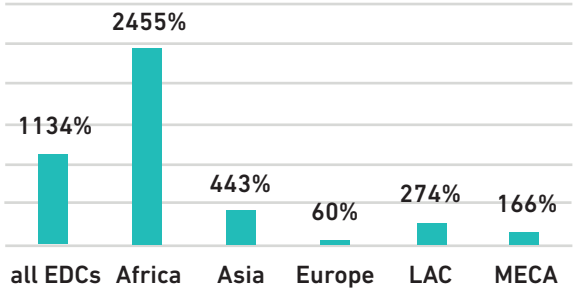
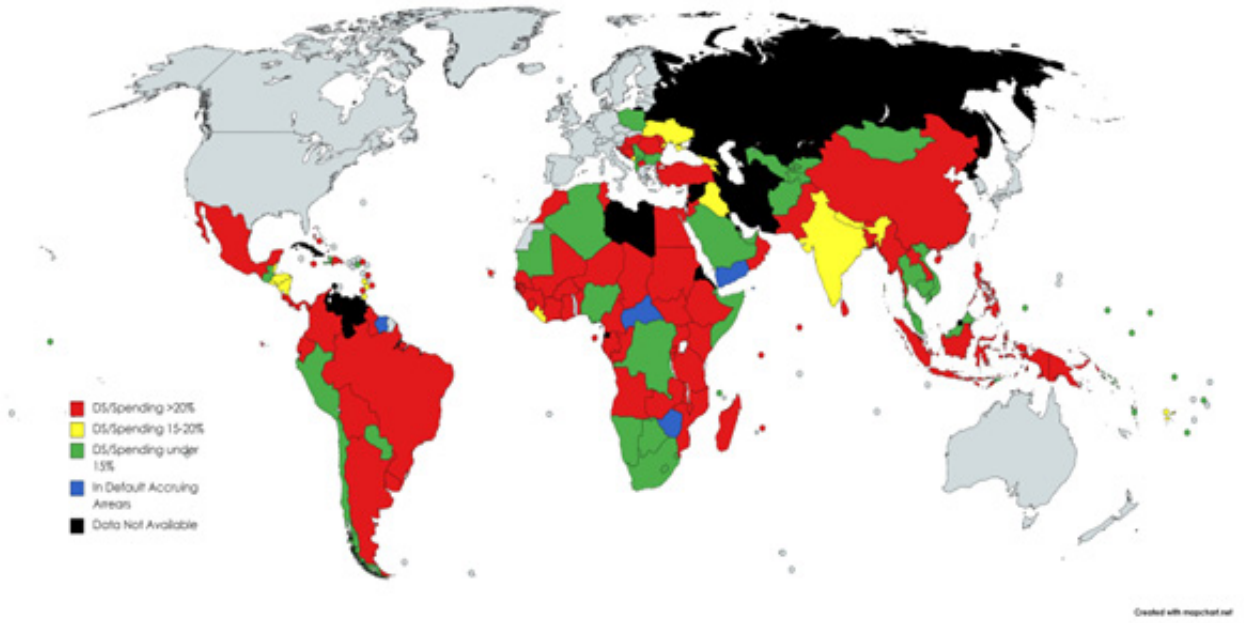


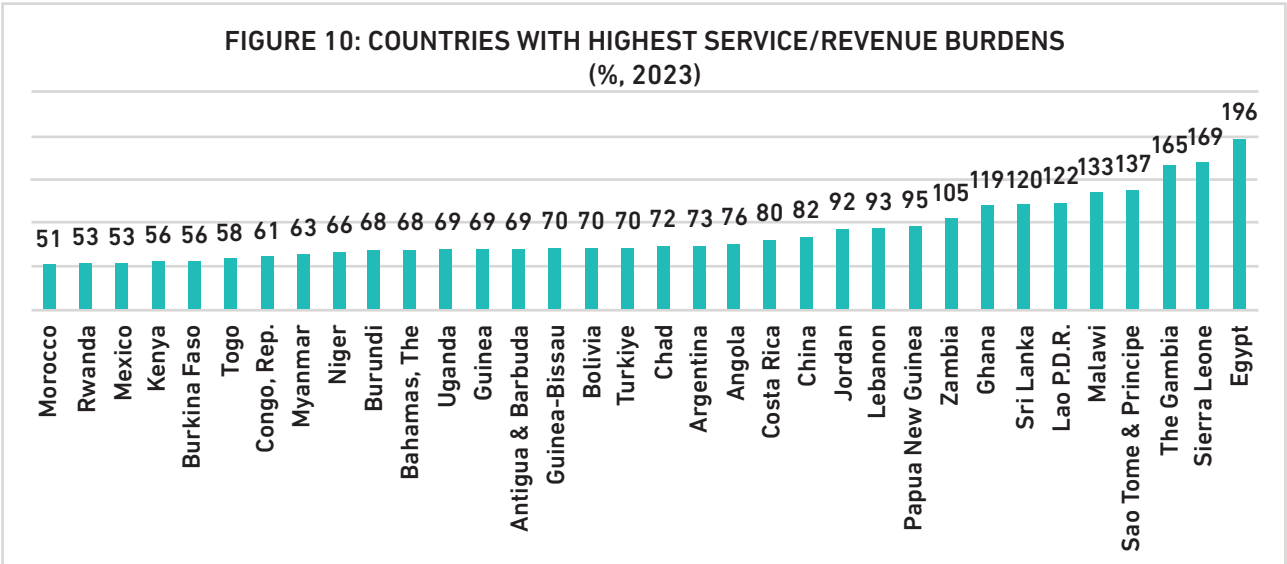
FIGURE 8: DEBT SERVICE vs SOCIAL PROTECTION
(by Regional group, 2023, in %)



The crisis is also very widespread. The worst affected countries are not those which received debt relief before, but those which accessed global and national capital markets excessively post-2010. Overall, only 30 of 139 developing countries do not have any debt problem: ***60 have excessive service/revenue (>15%); 13 excessive stock/GDP (>60%), and 41 both***. Service exceeds 33% of revenue in 63 countries, and 20% of spending in 79 countries. It exceeds total social spending in 33 countries, education spending in 104 countries, health in 116, social protection in 107 and climate in 45 of 47 countries.

Figure 9: Countries Worst Affected by the Debt Service Burden





One other key finding is that **creditors have changed considerably since 2000**: domestic debt has risen sharply, and because of higher interest rates domestic service is higher than external in 80% of countries. Shares of debt to China and global bond markets have also risen fast, but in LICs and LMICs multilateral creditors (notably the World Bank) are the most important creditors, owed 46% of debt. Two-thirds of these countries are paying most service to multilateral creditors. ***This means that debt relief can cut service enough, only if commercial and domestic and in many cases multilateral creditors participate***.

2) WHAT CAN BE DONE: THE LESSONS OF HISTORY

What can be done about this crisis ? To answer this question, the report examines key lessons from debt reduction initiatives since World War II, focusing on the post-war settlement of German debt; the gradual move to debt reduction for LICs and MICs during 1988-2010; and responses since the 2008-09 crisis. It finds that the best relief:

1. Is provided to all different types of debtors (by income, special situation, and with/without market access), but has worked best when tailored to their needs;
2. Is based above all on assessing country financing and liquidity needs, with a particular focus on growth, poverty reduction and (more recently) the MDGs/SDGs;
3. is provided rapidly and in a virtually automatic or orderly way, to avoid huge extra costs caused by lengthy defaults and delays in restructuring;
4. includes all significant creditors in order to maximise relief and ensure genuine burden-sharing;
5. provides protection against holdouts and lawsuits by non-participating creditors;
6. maximises transparency and accountability, especially to domestic stakeholders, on lending, debt restructuring and the spending of their proceeds;
7. ensures the introduction of laws and procedures for responsible borrowing and lending, and to protect against corrupt, predatory and odious debts;
8. has a sustainable and comprehensive supporting architecture involving all stakeholders;
9. builds capacity of developing countries to negotiate debt relief and improve future borrowings; and
10. is accompanied by high-quality development finance to ensure all countries can reach their development goals – even those which do not have heavy debt burdens.

Compared to these objectives, the current Common Framework for debt relief, and ad hoc arrangements for other countries, fall far short. There has been marginal progress in agreeing deals, and improving participation by creditor governments, and technical discussions are continuing in the Global Sovereign Debt Round Table. Several creditors have also agreed to put contingency clauses in their new loans, suspending service payments if countries are hit by natural disasters. Less positively, relief is still being provided only to a very small number of countries, with long delays after default. Commercial, multilateral and often domestic creditors are not participating. There continue to be major problems with transparency and accountability of debt relief and new borrowing, and many new corrupt, predatory and odious loans. There is no comprehensive legitimate supporting architecture involving all stakeholders, and capacity-building support to countries to negotiate debt relief and new financing is inadequate.

Most tellingly, relief is not based on any target for reducing debt service rapidly to sustainable levels. After their relief deals, according to IMF forecasts, Chad, Ghana, Sri Lanka, Suriname and Zambia will still pay an overall average of 48% of their budget revenue on debt service in the next 3 years, compared to the 11% average reached after HIPC/MDRI deals. In addition, the Suriname and Zambia agreements include clauses saying countries will pay even higher service to creditors if their economic outcomes improve. Because of this inadequate relief, these countries will have to cut their spending by 4% of GDP in the next 5 years, leaving no room to raise spending to confront the polycrises, or reach the Sustainable Development Goals by 2030. Given these failings, it is no surprise that a large number of countries which desperately need debt relief are not applying for it.

On the other hand, there has been some progress in mobilising additional new finance to support the SDGs. This is currently falling trillions of dollars short every year, as highlighted by the UN Secretary General in his SDG Stimulus proposal for US$500 billion more a year[4]. In the last 3 years:

- the IMF issued US$230 billion of SDRs[5] to developing countries in 2021 and, with the multilateral development banks, could channel a further 60 billion of reallocated SDRs to

[4] See https://www.un.org/sustainabledevelopment/wp-content/uploads/2023/02/SDG-Stimulus-to-Deliver-Agenda-2030.pdf

[5] https://repositorio.cepal.org/server/api/core/bitstreams/a4d76467-4802-421e-bb51-207cdb91bccf/content

developing countries in future years. However, proposals to issue SDRs on a regular (eg biannual) basis have gone nowhere.

- the new Evolution Roadmap for the World Bank has so far agreed to allow it to lend up to US$10 billion more a year[6]. Similar measures by the other MDBs could double this amount to US$20 billion, but this is well short of the US$400 billion a year envisaged from such initiatives for SDG Stimulus.
- as a result of the Bridgetown Initiative, Paris Summit for People and Planet and preparations for COP 28, new climate finance commitments have accelerated slightly. Agreement has been reached on creating a Loss and Damage Fund, and slightly faster progress is being made to the long overdue OECD target of US$100 billion of climate finance a year. However, some of this is relabelling or rechannelling of existing commitments rather than new money. In a context where ODA is rising much more slowly, and much is being diverted to Ukraine or spending on refugees in OECD countries, increases in climate ODA also risk reducing ODA for education, health or social protection.
- proposals by many developing countries (for example by the Bridgetown Initiative and UNECA) to reduce bond market borrowing costs for countries by using MDB and other DFI finance to guarantee their bonds, have so far met little enthusiasm, while rising global interest rates raise costs higher.

However, there are two major problems with this new funding: i) with the exception of the SDRs issued directly to developing countries, it will take several years to disburse; and ii) insofar as it consists of (especially non-concessional) loans, it risks increasing country debt burdens further.
In addition, there are multiple reasons why "one dollar of debt relief is better than one dollar of aid". The best debt relief disburses immediately (rather than taking years as aid does); provides long-term predictable financing over the life of the cancelled loans; promotes country ownership by funding programmes included in the country's development plan and budget; can be targeted to key social and environmental spending; and, as delivered in the HIPC and MDRI Initiatives, is transparent and accountable to domestic stakeholders.
Nor surprisingly, therefore, global civil society organisations meeting in Bogota on 20-21 September 2023, have issued a statement calling for much more comprehensive debt relief (supplemented by new concessional financing) to achieve the Sustainable Development Goals.[7]

3) RECOMMENDATIONS

Based on these lessons, and on stakeholder consensus, Chapter 5 of the report makes a proposal for more effective and just debt relief. It turns the lessons into a set of 10 principles which combine to build a debt relief initiative and mechanism; and then proposes detailed measures to make debt relief:

1. **open to all countries which need relief** based on the weight of their debt burden, regardless of their income level or special situation, and tailored to maximise access to affordable financial markets, so that most countries which need relief will also want it (see Section 5.2.1).
2. **maximise its contribution to the SDG and climate adaptation financing needs** of debtor countries, by basing the assessments of debt sustainability and relief needs on bringing debt service to revenue levels down to below 15% of budget revenue, while ensuring that the spending itself is highly "productive" in terms of SDG results (see Section 5.2.2).
3. **rapid in order to avoid delay, and automatic or "orderly" to minimise uncertainty**, by identifying unsustainability clearly as soon as it emerges, and following this with immediate formal standstills of debt service payments (see Section 5.2.3).
4. **including all creditors** (ie commercial, multilateral, domestic and non-Paris Club governments), by providing them with menus of different modalities to fit with their national legal and regulatory frameworks, and offering them multiple "carrots and sticks" to encourage

[6] See https://consultations.worldbank.org/content/dam/sites/consultations/doc/2023/Development-Committee-paper-2023.pdf
[7] https://assets.nationbuilder.com/eurodad/pages/3194/attachments/original/1696845336/BOGOTA_DECLARATION_07.10.pdf?1696845336

participation (5.2.4).

5. **providing legal protection against holdouts** and lawsuits, preferably through laws similar to the vulture fund law introduced by the UK in 2010 forcing all creditors to provide comparable treatment, as well as laws to protect payments systems from seizure of assets (5.2.5).
6. **maximising transparency and accountability** before and after lending and restructuring, especially of debtors to their key domestic stakeholders (parliaments, citizens and independent audit offices), and of creditors to global bodies through compulsory registers of loans and other liabilities (5.2.6).
7. **ensuring future borrowing and lending are made much more "responsible"**, by passing an amendment to the UN Convention Against Corruption which would prevent corrupt and predatory lending or debt restructuring, and give legal action teeth in all jurisdictions (5.2.7)
8. **providing a comprehensive supporting architecture**, building on the Common Framework, which would consist of an Inter-Agency Task Force of UN and other agencies, each bringing to the table its own comparative advantages, and consulting all stakeholders through participation (5.2.8)
9. **enhancing capacity-building efforts** to promote debtor country leadership and skills in debt negotiations and renegotiations, transparency and accountability to domestic stakeholders, and ability to analyse SDG-related debt sustainability (5.2.9)
10. **accompanying debt relief with high-quality new finance**, including extra concessional external funds from multilateral and bilateral sources, measures to reduce market borrowing costs such as suggested under the Bridgetown Initiative, and greater efforts to mobilise progressive tax revenues through global taxes on methane emissions, bunker fuels, financial transactions and global wealth, which could mobilise trillions of dollars a year. Only these measures will ensure that all countries can fund their needs beyond what can be provided by debt relief, and spend them on **SDG Acceleration Compacts as part of the SDG Stimulus programme** (5.2.10)

Among these recommendations, the most urgent and crucial for successful debt relief are the first five. However, the last five are also essential, to minimize future debt crises and ensure the SDGs are better funded in all countries. At the recent IMF and World Bank Annual Meetings, there was near-universal consensus that current debt relief mechanisms require comprehensive reinforcement: at the same time, participants lamented the lack of political will to move forward comprehensively on debt relief. It is this political will which – as they have so many times in the past - Nordic and other like-minded governments could once again provide

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