An Updated Bridge Proposal: Towards A Solution to the Current Sovereign Debt Crises and to Restore Growth

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Table of Contents

Executive summary

1. **Climate change and the increasing debt crisis in developing countries are intertwined**. The collision of these two issues is hindering progress on both fronts, underscoring the need to find a comprehensive solution. Due to their limited capital markets and currency movements that follow economic cycles, developing countries' financial situations are closely linked to their balance of payments. Given the current economic downturn, they have few options available, particularly as existing official financing mechanisms fall short.

2. **The funds from international finance institutions are leaking out,** meaning they are being used to pay off debts, primarily to private creditors and non-Paris Club lenders, and therefore significant amounts of money are not reaching the intended recipients in developing countries. Currently, the global debate has centered on two alternative strategies to address this issue.
    - Accept that multilateral funding will bail out creditors until, eventually, the monetary cycle reverses and funds start flowing back into developing countries – which is de facto the current practice.
    - Engage in debt relief to create room for increased lending to support recovery and green growth. This proposal is ambitious but differs significantly from current practices.

3. **A third strategy is desirable for a large group of countries:** Debt relief can take different forms. It can be temporary, through extending maturities, or structural, through reducing the principal. The third alternative strategy, also known as the "Bridge Proposal", focuses on countries that do not have a problem with the level of debt stocks but are experiencing difficulties in servicing their debt today due to creditors' refusal to roll over debt, leading to negative net transfers, austerity, and a development crisis. Our proposal is to launch a structured Bridge Program, led by the IFIs, that organizes a three-way agreement whereby debtor countries develop an ambitious national investment push, multilaterals scale up their support, and all other creditors refrain from withdrawing capital prematurely. This proposal is applicable only to countries that face liquidity problems but, with access to financing at reasonable rates, could grow out of the debt problem. It is needed to promote the climate transition and avoid a future systemic debt crisis. Additionally, some countries still require debt restructurings with principal haircuts—particularly those for which reasonable trajectories of refinancing and economic growth rates would lead to unsustainable primary fiscal surpluses for debt stabilization.

4. **A successful Bridge Program would rest on four key pillars**:
    a. Developing country-led, credible multi-year programs for recovery and green growth.
    b. Improved coordination between the World Bank and the IMF to scale up financing for developing countries in ways that foster inclusion and sustainability without compromising access to multilateral financing for middle-income countries.
    c. Support by bilateral lenders in the form of debt restructuring as needed.
    d. Revision of private creditors' incentives to participate in debt operations, including principal reduction for countries unable to meet their financial obligations, and reasonable rollovers for countries capable of meeting their obligations.

Introduction

The climate agenda is now on a collision course with the rising debt crisis in developing countries. Although they have largely been treated as separate problems so far, the debt crisis is now becoming a significant obstacle in addressing climate change. Leaders of developing countries are being urged to commit to ambitious long-term climate plans, while their houses are on fire.

Although good intentions are motivating current efforts to increase liquidity injections for the climate transition through the multilateral system, there is a high risk that these efforts may prove to be inefficient. When debt service is high, the injected liquidity may end up being used to pay off existing creditors, rather than being effectively utilized for climate goals. In the next five years, debt repayments are expected to be high, even though the overall debt levels for most developing countries remain below distress risk levels, provided they can refinance at reasonable rates.

For many countries, establishing a sizable liquidity that combines new financing with an extension of the maturity of debt at suitable interest rates would offer the needed financial flexibility for investing in climate initiatives while simultaneously reducing debt.

This note expands on a previous proposal by the Finance for Development Lab 2014 (Diwan et al, 2024). New analysis, supported in part by comments and reactions to Diwan et al. (2024)'s initial proposal and by the discussion held at the workshop "Addressing the Debt Crisis in the Global South" held at the Pontifical Academy of Social Sciences at the Vatican (June 2024), have enriched the analysis and main arguments and allowed us to update the proposal. The first part outlines the primary issue for many countries: leakages from multilateral funding to other existing creditors, and macroeconomic vulnerability to shocks. The second section discusses the two main strategies that have been either promoted or adopted to address these issues: debt relief and refinancing by multilateral institutions. While both strategies are useful under certain circumstances, they also have limitations. Therefore, in the third section, we propose a new approach applicable to countries that would be solvent under sustainable refinancing conditions but are currently illiquid. We also provide details on how this new approach could work.

The Leakage Problem

In the wake of the COVID-19 crisis and the subsequent war in Ukraine, International Financial Institutions (IFIs) significantly increased their support for developing countries. However, those funds have been massively leaking out as debt service to the private sector and to China. Net transfers in long-term debt to the group of (68) low-and-lower middle-income countries (LLMICs), which are the focus of this paper, were negative in 2022. Estimates suggest that 2023 was worse, as rising interest rates made floating-rate debt and new borrowing more expensive. While IFIs and some bilateral creditors accounted for roughly $42 billion in net-positive inflows to LLMICs in 2022**,** these contributions were more than offset by large debt payments to private lenders (-$52.15 billion) and China (-$6.3 billion) – see Table 1. Firm figures for 2023 and projections for 2024 are not yet available. But preliminary evidence indicates a further deterioration, given that bond markets for LLMICs have been closing mostly since 2022, and that interest rates sharply rose, making both new debt and flexible interest rate debt more expensive (Kharas and Rivard, 2024).

Table 1. Net transfers on Long-Term External Debt to LLMICs, by different creditors

	Total NT on LT external debt	IFIs	Bilateral creditors	China loans	Private lenders
2019	84.4	28.9	1.7	4.6	54.3
2020	55.2	68.3	8.6	0.9	3.0
2021	45.4	27.3	6.4	3.5	11.0
2022	-15.7	32.2	9.8	-6.1	-51.2

Source: World Bank Debt Indicators. Notes: Net transfers on long term debt are new long-term loans (more than a year) minus debt service on past loans; "Bilateral creditors" exclude Chinese creditors; "China" includes public and private loans.

These figures demonstrate that developing countries are not only suffering a development crisis, but also that increasing the flows of IFIs has not been effective, since funds have largely leaked out to their creditors. Some voices skeptical of IFIs might reasonably claim that they are simply bailing out private and bilateral creditors who now want their money back.

The Macroeconomics of Sovereign Debt Distress

LMICs generally have relatively thin local capital markets and weak currencies. Their macroeconomic cycle is strongly connected to the dynamic of the balance of payment. Countercyclical macroeconomic policy depends to a large extent on their access to foreign exchange, unlike advanced economies with deep capital markets and strong currencies, in which the capacity for countercyclical macroeconomic policy is mainly linked to fiscal and domestic credit conditions. Indeed, the sudden stop has resulted in heavy pressures on the Balance of Payments (BoP), which has led to depreciations larger than 10% for currencies of 36 LLMICs in 2022, and 24 in 2023, according to the IMF World Economic Outlook.

Access to capital markets has been challenging for the world's poorest borrowers in recent times. In the immediate aftermath of the COVID-19 pandemic, easy monetary policy in the US and euro-area largely kept the spigots of the bond markets open: LLMICs raised $36 billion in 2021, an unprecedented record. The shift came in 2022 when rising global inflation led to global monetary tightening. By 2023, the spigots had become a dribble. The "safe" interest rate, the 10-year US Treasury yield, rose from 1.5% in December 2021 to 4.6% at the end of September 2023. Risk spreads increased in every asset class, but "frontier market" economies were cut off primary issuance altogether. While12 LLMICs issued bonds in 2021, the figure fell to 5 in 2023 (raising about $10 billion), and none after March. The market closed down, in a "sudden stop (Properzi, 2023)." The market has only started to reopen, very selectively, by mid-2024.

A developing country facing a sudden stop has three main options to enhance its current account:

- **Contracting imports.** This is typically achieved through an exchange rate depreciation and contractionary fiscal policies that help reduce aggregate demand, leading to a decrease in imports. While this approach may have immediate negative social impacts, it can also harm the economy's future productive capacity, especially in the tradable sector.
- **Expanding exports.** This can be challenging in the short term due to the short-term inelasticity of tradable production. Even a significant depreciation of the real exchange rate might not result in a substantial increase in exports immediately[1], as global demand may also be inelastic in the short term.
- **Depleting reserves.** This is what is happening in developing countries, with an average loss of 20% in 2023. Once the reserve buffer is exhausted, the country stops servicing its debt in foreign currency.

To navigate such a situation effectively, a country experiencing a sudden stop could benefit from external assistance in the form of financing, grants, or by suspending principal payments on foreign currency debt.

Capital Flows: Countercyclical for Advanced Economies and Procyclical for LMICs

Planet Earth is a closed economy. The sum of capital accounts across all countries must be equal to zero[2], as we cannot move capital in and out of the planet. Consequently, for the world as a whole, capital flows are a-cyclical.

However, the dynamics differ when considering groups of countries. When a negative shock hits the global economy, capital tends to flow towards advanced economies, which are known for their safe assets. There is a flight to safety that has pushed the interest rate premia required from developing countries to historic heights (Properzi, 2023). On the other hand, in the positive stage of the global economic cycle, characterized by increased liquidity, capital tends to flow towards developing economies.

This creates a countercyclical pattern of capital flows for advanced economies. The logic here is straightforward: if capital flows are a-cyclical globally but countercyclical for the safest economies, they have to be procyclical for other countries. This is indeed how the international financial system works. Regrettably, the current international financial system places the burden of shocks, even those originating in advanced nations, on developing countries that are least equipped to withstand them (Songwe, 2023). This inherent flaw should be recognized as a foundational issue within the architecture of the global financial system.

Paths to Addressing Debt Challenges

There are three potential strategies to consider:

[1] See the analysis of Guzman, Ocampo, and Stiglitz (2018).

[2] With the existence of tax havens, the statistics feature a net transfer of capital from the global economy to somewhere else – rather than to another planet, to offshore accounts (Zucman, 2013, 2015).

A. **Prioritize debt reduction** to create room for a fresh wave of sustainable financing, particularly aimed at green initiatives.
B. **Accept that IFI funding will bail-out creditors**, while hoping for a swift reversal of the macroeconomic cycle and a prompt reopening of frontier and emerging capital markets. However, this strategy entails significant risks and relies on the assumption that IFI policymakers possess superior insights compared to the market regarding the potential for reestablishing access to global credit markets.
C. **Explore a collaborative approach** involving new IFI funding to facilitate a mutually beneficial agreement that supports domestic investment initiatives. This strategy involves all creditors refraining from premature capital withdrawal and adjusting interest rates for delayed payments to reflect the low-risk nature of sustainable debt restructuring, thereby creating a three-way win-win scenario.

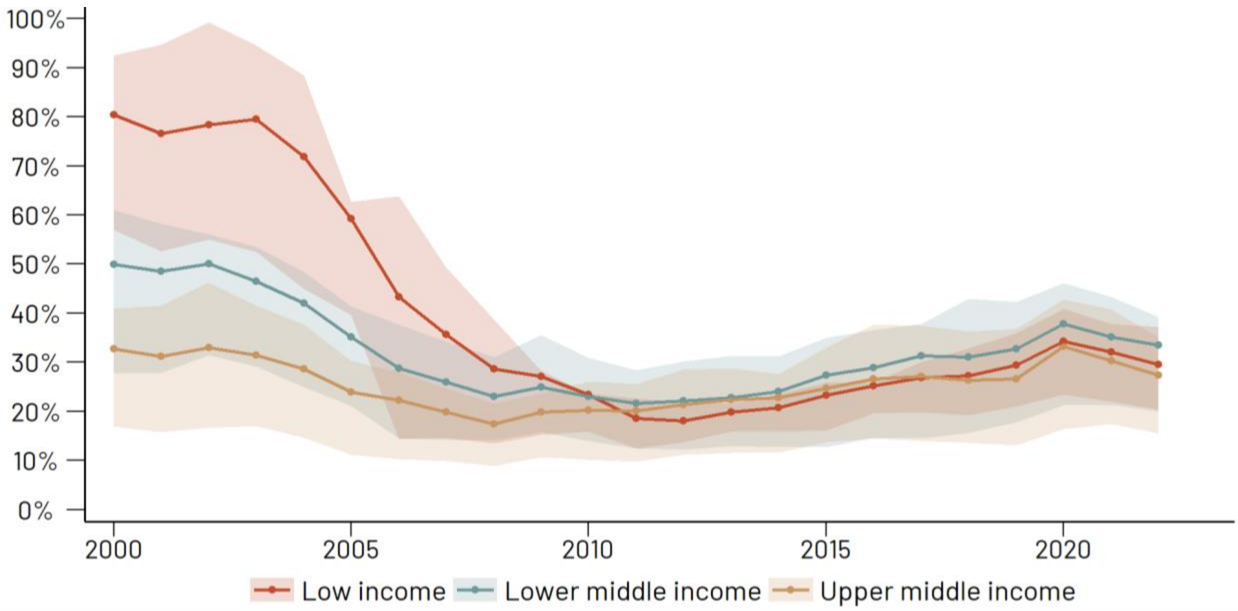
Debt Reduction

For insolvent countries, debt operations that include reduction of principal and/or coupon payments - strategy A – is necessary. Debt restructurings remain difficult, as they involve dealing with a significant heterogeneity of creditors without a formal mechanism like the equivalent of a bankruptcy law. There is a well-recognized need to improve the architecture for sovereign debt restructurings (Guzman and Stiglitz, 2016; Guzman, Ocampo, and Stiglitz, 2016). And there is urgency: recognizing the current state of affairs, at a meeting on "Addressing the Debt Crises in the Global South" held at the Vatican, Pope Francis called for the creation of a multinational mechanism for the resolution of sovereign debt crises (Pope Francis, 2024). In the short term, improving and accelerating the Common Framework becomes urgent.

The fact that only a handful of LLMICs defaulted in 2022, with only Ethiopia defaulting in 2023, can be partially explained by the ineffectiveness in the application of the Common Framework and the positive net flows countries are receiving from IFIs. However, it is also apparent that many LLMICs still highly value the relationship they developed with their creditors. When evaluating the cost and benefit of default, they still find defaulting unattractive, although this comparison does not properly account for the long-term implications, and how short-term political incentives may take precedence.

Debtor countries' reluctance to default is demonstrated by the fact that in most low and lower-middle-income countries (LLMICs), despite high debt service, debt stocks are still relatively low compared to their pre-HIPC levels (see Figure 1). According to our estimates, the number of defaults can be reduced if we take action now to promote growth.

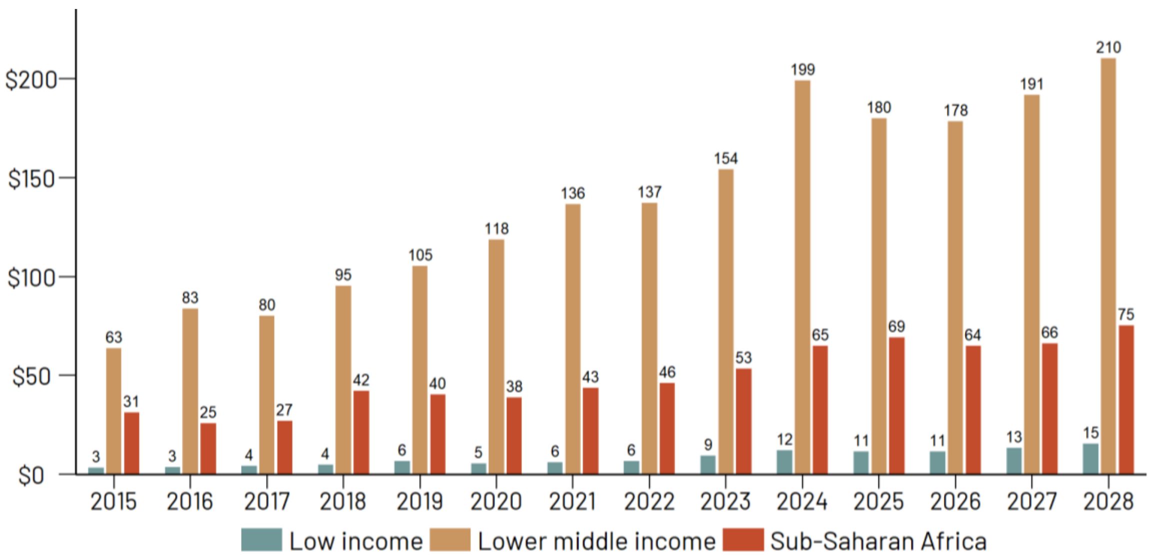
Figure 1. Mean external debt in LLMICs (as a share of GDP)



Source: World Bank Debt Indicators

The borrowing boom in LLMICs started in the early 2000s with the rise of loans from China. It expanded further in the late 2000s after the global financial crisis and the QE policy in the advanced economies, which in turn, led to a massive increase in global liquidity and hence more private-sector financing. However, both cycles have now reversed. As a result, many LLMICs are currently facing a bunching of repayments that are due in the short term, with very high risks of being unable to roll over these debts (see Figure 2).

Figure 2. External debt service - $ billion



Source: World Bank Debt Indicators, 2024, and FDL projections.

Diwan et al. (2024)'s debt sustainability analysis finds that most LLMICs' governments remain solvent, but suffer from illiquidity, with their public debt service above 15% of their tax revenue. Smoothed over time, these countries could bear their debt obligations, if refinanced at a "reasonable rate". The problem arises when the quantity of refinancing available falls steeply, and/or becomes much more expensive due to a spike in interest rates.

Still, even if most countries' debt stocks are manageable under reasonable refinancing conditions, profound debt reduction would help create the headroom they need to be able to absorb the large future green funding that they need to receive to address the climate challenge they face (as estimated for example by Songwe and Stern, 2023). While most LLMICs would not want to jeopardize future access to lending by defaulting on debt obligations, future access (at least in the near term) is dubious under the new global circumstances of tighter liquidity, in the view of some analysts (Guzman et al., 2024). But even if countries did default with the hope of creating a debt headroom, it is unrealistic to hope to convince their creditors to deliver profound debt reduction today to make space for *future* lending by MDBs. This had been possible in the past with HIPC, when most external debt was due to IFIs and Paris Club official creditors. However, LLMICs current external debt is dominated by more commercially minded creditors - see Table 2 for the relative shares of the creditors among different groups of borrowers.

Table 2. Composition of LLMICs external debt ($ billions, and shares of total)

	2022 PPG debt stock, total and creditor share			
	UMICs (ex-China)	**LMICs (ex-Ukraine)**	**LICs**	**Sub-Saharan Africa**
Total US$ billion	1636.8	1466.9	165.4	547.9
IFIs share	28.3	40.1	57.0	41.7
Bilateral share (ex-China)	4.2	13.7	16.5	8.0
China share (public and private)	1.9	8.5	15.0	14.6
Private share (ex-China)	65.7	37.6	11.5	35.6

Source: World Bank Debt Indicators, 2023

Today, convincing creditors to engage in early action to prevent predictable defaults is challenging. This is especially the case because the benefit of "waiting" with a defaulted bond is high: one of the multiple factors that contribute to delay is that the compensatory rate for securities in default is 9% pre-judgment under the law of New York, where roughly 50% of developing countries' bond issuances occur.

Thus, for countries with low enough debt stocks, it is worth exploring other paths to deal with their current liquidity challenges.

Current Strategy

Under strategy B, which is currently followed, IFIs support countries in fully meeting their liquidity obligations. In our view, this strategy is likely to be very costly, fostering a destabilizing debt spiral, undermining the mobilization of green finance, and risking ending IFIs' ongoing attempt to increase their capital base.

Conceptually, it would be desirable for IFIs to support solvent but illiquid developing countries in smoothing the global macro-economic cycle by refinancing the debt service coming due of the illiquid LLMICs, at least until capital markets access reopens—although the IFIs have more knowledge about the fundamentals of the economy than the market participants that doubt about the payment capacity of the country. Regardless of whether such a strategy would be desirable or not, IFIs do not have the power to carry it forward. While this strategy may be conceivable in isolated cases, it has become unfeasible globally for LLMICs as a whole, given the expansion of private and commercial credit to LLMICs, and the relative stagnation of the size of the IFI system. We estimate that given the size of debt service due to private lenders and to China by countries that the FDL analysis deems illiquid, refinancing the debt service would cost about $40b per year in 2024 (rising slightly in the next few years). If IFIs were to refinance these amounts, they would need to nearly double their flows to these countries, before even starting to scale up financing to smooth the impact of other external shocks and to support an increase in investments.[3]

There are several other problems with the current IFIs refinancing strategy.

First, as IFIs loans come to dominate LLMICs external debt, they become less flexible in the face of future shocks, as IFIs do not typically restructure their debts, preferring to share the burden by providing new lending. It is important to note that IFIs provide financing at lower rates than private creditors, which charge risk premia that recognize that debt restructurings are part of the economic environment.

A second more costly problem is that, because IFI funds are scarce, refinancing commercial creditors means less financing for LLMICs domestic expenditures. This constrains IFIs to push a significant part of the adjustment burden on the debtor, by insisting, in some cases, on substantial fiscal and external adjustments to quickly generate the surpluses needed to repay part of debt servicing not refinanced by the IFIs, even at the cost of austerity. As a result, we have seen a slowing down of investment and growth in LLMICs, devaluations, higher taxes, and lower spending on social services, leading to lowering growth, regressing on the SDGs, and increasing risk of social instability (World Bank, 2024).

Finally, because refinancing debt service uses scarce development funds to service developing countries' debt, this is likely to be perceived as bailing out private creditors at the expense of development spending, thus weakening political support for increasing IFIs capital case in the future, even though this is necessary given the rising costs of achieving the SDGs in a warmer world, and the challenge of financing the transition to a green growth path.

[3] More precisely, IFIs' disbursement to the 20 LLMICs that we deem illiquid but solvent in 2023 amounted to $32billion, while their debt service due in 2024 to private and Chinese lenders amount to $44billion.

These tensions are exacerbated by the fact that the leakage problem is concentrated in the countries we deem solvent under reasonable financing conditions but currently illiquid. As seen in Table 3 below, where Net Transfers on external debt are expressed as shares of GDP, it is in illiquid countries that IFIs flows leak out most dramatically, with the median country receiving inflows of 1.3% GDP in 2022 from IFIs and Paris Club bilateral creditors, and losing as much to private and Chinese creditors, in sharp contrast to the 2019 situation. In comparison, IFIs now refrain from lending to countries perceived as insolvent. In particular, the concessional arm of the World Bank provides grants to countries it considers at high risk of debt distress, while IBRD reduces lending when country risks rise. For both illiquid and insolvent countries, there is a sharp difference between their 2019 and 2022 financial situation. However, there is little leakage in countries with no assessed debt risk, and overall Net Transfers on debt remain positive, only slightly lower in 2022 compared to 2022.

Table 3. Median Net Transfers on External Debt, by different creditors, to debtors with different risk groups, 2019, vs 2022, among LLMICs (shares of GDP)

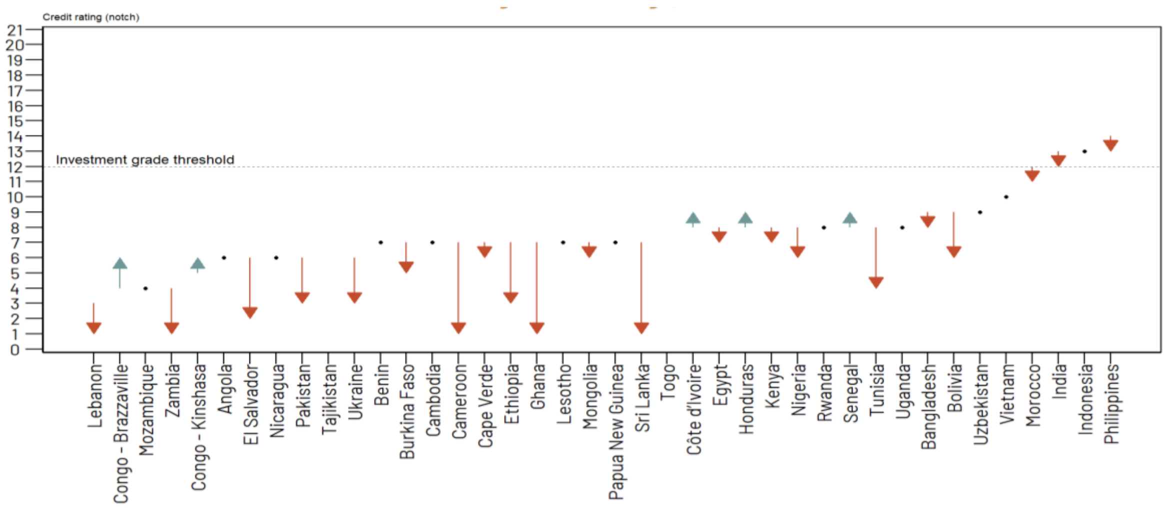
Debtor Risk group	Year	Total NT/GDP	IFIs NT/GDP	Bilat NT/GDP	China NT/GDP	Private NT/GDP
Illiquid	2019	2.1	1.2	0.3	0.4	-0.5
Illiquid	2022	-0.0	1.1	0.2	-0.1	-1.2
Insolvent	2019	5.4	1.5	0.3	0.6	6.3
Insolvent	2022	-1.3	0.2	-0.1	-0.0	-0.2
No Risk	2019	1.6	0.9	0.2	0.1	-0.0
No Risk	2022	1.3	1.1	0.1	-0.1	0.0

Source: World Bank and FDL. Debt classification according to FDL projections

The question for private sector debt is how quickly the current macro-cycle will last until the market reopens to allow for the rollover of maturing debts and the possibility of new borrowings—which will depend on perceptions about debt sustainability. There are two levels of uncertainty. Global interest rates might remain high for another few years, and global liquidity tight. More importantly, risk ratings for developing countries have recently deteriorated, which means that the borrowing costs could remain high for many countries for many years even after the global cycle reverses (see Figure 3).

As for debts from China, the resumption of net financing is unlikely in the medium term. The best that can be expected is to slow down repayments and hope that FDI will gradually rise to compensate over time.

Figure 3. LLMICs credit ratings 2014 vs 2019



Source: countryeconomy.com

A Coordinated Three-Way Solution

For the many illiquid countries with debt stocks that otherwise would be manageable, option C is in our view the best solution. When debt service is high (for example, above 15% of tax revenues) but external debts are relatively low (for example, below 40% of GDP), rescheduling repayments at a reasonably low cost can both create fiscal space and produce a sustainable financing position.

This is the strategy supported by the African Union's Nairobi Declaration for Climate Change (African Unions, 2023): it recommends that countries pursuing green growth receive assistance in rescheduling their debts, to free up space for new investments, which can be financed by the IFIs. Recently, the US Treasury has also supported a similar strategy, recommending that countries with ambitious green transition plans receive generous IFIs support, with bilateral and private creditors committing not to withdraw funding during an adjustment period (Shambaugh, 2024).

To achieve the goal of these proposals, there is a need for a three-way deal to create value through coordination in a new compact that engages and benefits all parties: the country, which would be able to restore economic growth; the IFIs, which would increase lending in a sustainable fashion; and the bilateral and private creditors, which would do better than if the debt problem is not resolved (Bakir et al, 2023). The presumption is that a country can grow out of a debt problem if it is provided with sufficient liquidity, which it uses for pro-sustainable-growth policies, while adopting supportive reforms. Such an effort needs to be anchored in a national renewal program that incorporates measures to move onto a new growth path, in a manner that is sustainable socially and environmentally. These countries would be the first to benefit from a scaling-up of IFI funding, the justification being that this would prevent the development of a systemic debt crisis down the road that would hurt all actors.

It should be possible to reschedule bilateral debts, when needed, at reasonable terms, commensurate with the reduced risk associated with sustainable debt – with interest rates lower than countries' expected growth rates. Paris Club creditors have a history of doing so (e.g. Evian terms). Chinese lenders too have an objective interest in coordinating relief with other creditors (Diwan and Wei 2022), and indeed they have provided liquidity relief in the past, relatively frequently, and for large amounts (Brautigam et al, 2020). However, as in the case of Ecuador in 2020, for instance (Cueva and Chekir, 2024), this requires a high level of political commitment, and tends to be negotiated separately from other creditors. While such opacity would create difficulties, the level of information sharing necessary for a liquidity treatment is less onerous than in debt treatments with principal haircuts. Full comparability of treatment would not necessarily apply, as long as creditors would commit to maintaining non-negative net flows—or alternatively, the commitment to maintain non-negative net flows could be defined as comparable to creditors that provide relief through maturity extensions at sustainable interest rates.

A second difficulty is China's lack of trust in the possibility of obtaining voluntary participation from the private sector. The experience of the DSSI, where Chinese institutions have provided a large majority of liquidity relief, has led to justified misgivings on the willingness and the ability of the G20 to force a rescheduling. This tension is incredibly costly for countries whose debt still trades in the market at high yields, say above 10%. The interest rate should be low enough to prevent the debt situation from worsening and reflect the principle that should guide debt operations—namely, ensuring sustainable debts. Our simulations suggest that at such high rates, repayment obligations will keep growing, increasing the risk of not being able to roll over debts in the future, with the consequence being that the risk of default down the line will also grow (see Figure 4).

To encourage private creditor participation in this strategy, changes in legislation for sovereign debt in the major jurisdictions for sovereign bond issuances, namely New York and the UK, that affect the incentives of bondholders to cooperate would be helpful, and indeed are almost certainly necessary if there is to be the cooperation of the private sector necessary for this plan to work. Such reforms need to include at least three elements: (i) comparability of treatment—no private sector creditor will get more favorable treatment to a public sector body, and comparability of treatment has to take into account interest rates charged on debt (prior to restructuring); (ii) the reenactment of the champerty law, eliminated in 2004 from the NY legislation, that prohibited the purchase of defaulted securities with the intention to litigate against the issuer; not surprisingly, this repeal led to a proliferation of the vulture funds business (Blackman and Mukhi (2010), Guzman (2020), Schumacher, Trebesch, and Enderlein, 2021); and (iii) the reduction of the 9% pre-judgment rate for securities in default under the New York law.

We propose three options to resolve the question of private creditors, and we believe that if adopted transparently by the G20, they could be convincing enough to lead all non-Paris Club creditors to participate in such liquidity treatments.

First and more fundamentally, to produce credible expectations of higher growth rates through sound national programs,[4] backed by credible multi-year IFIs' commitments to finance the programs.

[4] International rules for trade should also be adapted for the kind of approach to the debt crisis that we propose here. See Guzman and Stiglitz (2024).

However, markets may exhibit "irrational pessimism," so even countries that pursue good policies may not be rewarded with sufficient lowering of interest needs.

Second, IFI partial guarantees should be added to the rescheduled debt to signal IFI's commitment to supporting the country program even more credibly. IFI partial guarantees entail a transfer of risk from private creditors to international taxpayers. Private creditors receiving the guarantee would have to lend at a rate close to the World Bank's borrowing rate. Indeed, this should become an explicit condition of the guarantee, since otherwise, it would amount, de facto, to just a transfer from the public underwriting the IFIs to private creditors. However, it would be important for these guarantees not to use up much of the scarce capital of the IFIs. More broadly, distributional considerations of IFI financing among low-income and middle-income countries should be carefully managed, as implementing this proposal should not create debt or development distress in middle-income economies.

Figure 4. Debt service and debt stock for illiquid countries under various interest rate scenarios

Source: FDL, 2024. The scenarios correspond to interest rates used to reschedule private and China debts at varying levels.

If both of these approaches do not reduce the rescheduling cost sufficiently to ensure debt sustainability, then the country would need to restructure its debts through a negotiated approach. Indeed, if a push on growth, plus some partial guarantees, are unable to bring down the market yield, this then means that the country is insolvent and requires debt relief in the form of principal and coupon reductions and possibly maturity extensions. It is hoped that improvement in the Common Framework would allow for a faster treatment of countries that require mainly debt rescheduling.

Overcoming the Main Constraints

For the first time in two years, some LLMICs can access the bond markets. However, as long as interest rates remain high in advanced economies, frontier markets will face volatile and expensive markets, and a collaborative solution remains necessary.

Kenya's recent liquidity injection, with a bond issuance at 10.375% yield, and a domestic program heavily focused on austerity measures, is not an example of a sustainable path. While Kenya has engaged with internal reforms and in deals with the IFIs and its creditors, there is a need for major improvements on each of the three pillars of a three-way deal to produce a bridge to growth that works: debt rollovers should be cheaper and more comprehensive, IFIs need to increase their financing at a faster rate and not to be used for debt amortizations with other creditors, and the country program needs to be growth-focused. A better program could have avoided the tragic social unrest currently gripping the country, which has also thrown its financing program up in the air again.

Beyond Kenya, three priorities must be addressed to put in place a credible and effective Bridge Program that can pull illiquid countries back into a sustainable growth path:

- **First, the starting point to scale up climate action is the development of consistent country platforms** that have enough social and political support to be credible. It is at the level of countries that burden sharing among creditors needs to occur. To make this appealing would require a credible and effective offer of multi-year support from MDBs - say five years - unlike the short-term support offered by the Debt Service Suspension Initiative (DSSI). These country programs must be ambitious enough to reduce country risk in ways that facilitate the refinancing of old debts—and if this is not achieved, recoveries will not occur, and the debts of distressed countries will need to be restructured.
- **Second, the IFIs need to take the lead in supporting a recognizable program**, developed by the country that will adopt it but accepted by the international community that provides the support, to bridge illiquid countries into a new (green) growth path. This requires leadership, ownership, more effective coordination between the World Bank and the IMF, and more financing. Talks about IFI reforms have been advancing, especially during the India G20. Still, while the results in terms of scaling up have been encouraging (more leverage at the World Bank, the use of hybrid capital at the AfDB), they remain modest. There is an urgent need for much more financial firepower to avoid a systemic debt crisis.
- **Third, creditors should not reduce their exposure in countries with ambitious development plans**. China would be more likely to support such an initiative if there was comparable burden sharing with private lenders, if others act likewise. If developing countries can come up with a reliable strategy for growth, the risk and cost of rolling over private debt is more likely to decrease. If models for credit risk assessment were sensible (they are not), the private sector and credit rating agencies should positively respond to a robust credible green growth plan, allowing for cheaper market access with significant compression in spreads. The extent to which spreads fall will determine the sustainability of the debts.[5]

Conclusion

The proposals laid out in this paper ultimately seek to address the pro-cyclical nature of capital flows for LMICs and developing countries more generally. At its root, this brief proposes a countercyclical response for the official sector, including for multilateral official institutions and bilateral creditors, to neutralize the procyclical behavior of the international private sector in a global environment, where there is a marked difference between the safety of assets issued by advanced economies and those of

[5] Debt sustainability assessments depend on expectations that are generally heterogenous across different stakeholders. Private creditors may have different views than the IFIs or analysts, and debt sustainability will ultimately depend on market expectations if there is a sufficiently large fraction of market debt (Calvo, 1988; Guzman and Heymann, 2015).

developing economy states. If there is not to be a bail-out of private creditors, they must cooperate by lowering interest rates to levels commensurate with the risks associated with debt sustainability.

The main task ahead is to move from a design phase to actual blueprints that can be applied to individual countries. Ideally, Brazil's G20 would push for a handful of countries to initiate pilots, which the South African G20 could then scale up.

If nothing is done to help countries facing liquidity or sustainability crises, a wave of destabilizing debt defaults will end up severely undermining progress on the green transition, with catastrophic implications for the entire world.

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