Reforming the global debt architecture

BY PATRICIA MIRANDA

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Debt distress, defaults and the increasing debt burden on the budgets of countries in the Global South are a threat in the current context of multiple crises, putting in evidence the fragility of the current financial architecture and taking the world backwards in the elimination of inequalities and poverty. At the same time, we are witnessing a lack of timely and efficient measures to deal with current debt problems but also to prevent debt deterioration in many countries. The impacts of pursuing conventional mechanisms that don't fit the need for a long-term debt resolution are regrettably borne by the people that are more exposed to economic, social and climate vulnerabilities.

The experiences and failures of debt restructuring efforts reflect the fact that there is a "non-system" in place for an ordered debt restructuring mechanism and this is why in the middle of a polycrisis with no precedents, with debt trends increasing while debt service is prioritized at the expenses of people, the international financial community needs to start urgently taking the right steps towards debt architecture reform, as part of a new financial architecture that finds a fair balance of power between developed and developing countries.

Alarms are not loud enough to start a transformation?

With one crisis stalling after the other, one of the impacts of the polycrisis is the steep increase in debt levels in developing countries. While the global "solutions" implemented since the beginning of the pandemic were primarily focused on low-income countries (LICs), the impact has imminently reached at the same time to middle-income countries (MICs). The crises are global but not all countries have the same chance to recover.

Despite the warnings from several stakeholders including civil society organizations, global decision-makers were not able to address, in a timely manner, liquidity and solvency problems with a middle and long-term sustainability approach. The G20 had offered debt suspension to LICs during the COVID-19 crisis, but because this did not include actual debt reduction, it could not provide the debt resolution needed by eligible countries. The G20´s "Common Framework" that was adopted later failed to include private creditors in debt relief, so it is not able to provide fair and speedy solutions to debt crises either. In the case of MICs, the issuance of Special Drawing Rights (SDRs) was the main measure that benefited them after the pandemic.

Some countries were already in debt distress when COVID-19 arrived, and the situation of many others deteriorated due to the pandemic and rapidly turned into debt distress. Global debt increased more in 2020 than in any other year in the last 50 years.[1] The last wave of debt started in 2010, and has already seen

1 Gaspar/Medas/Perrelli (2021)

the largest, fastest, and most broad-based increase in debt in emerging market and developing economies in the past 50 years.[2] Debt levels in emerging economies and developing countries remained high during 2021, reaching close to 65 percent of GDP – considering only gross public debt– and the upward trend is expected to continue over the next years until it reaches or exceeds 75 percent. This implies that in the following years the debt service burden is expected to increase and countries will have to use more fiscal resources for debt repayment, with the caveat that tax revenues might not increase in the same proportion to guarantee a path of debt sustainability and achieve fiscal rules.

Debt problems and risks vary from one country to another in terms of creditors composition and financial conditions. However, what is not different are the debt impacts over the people that are more exposed to vulnerabilities in a context of unequal recovery and unresolved crises. A unique, agile and ordered debt resolution mechanism for a group of countries in debt distress, instead of on a case-by-case process, would have been more effective.

For countries in distress and even for those labelled as “having sustainable debt”, the prioritization of debt service payments in this context of multiple crises is fulfilled at the expense of health, social protection, education, climate action and resilience and other basic needs, in other words, at the expense of people and nature. States cannot provide needed resources to combat multiple crises, where they do not have equal access or equal terms of access to needed finance, and where they are being forced to redirect funds and shrink needed socioeconomic expenditures to repay creditors.[3]

The new risks such as interest rates increases,[4] higher inflation, collateralized debt, hidden debts, to name a few, are, worrisomely, a dangerous combination that already signals that the world is on its way to a new global financial crisis. Unfortunately, alarms are not sounding as loud as they should, to allow for urgent measures and prevention policies.

After the experience of several “mechanisms” to coordinate debt renegotiation in the past, there should be lessons learned to feed into a new debt architecture. However, the fact that traditional processes with the same key actors in charge remain still at the core in a “non-system” of debt restructuring, with made-up changes but no deep structural transformations towards a long-term and sustainable resolution, demonstrates that the world needs now, more than ever, a reform of the debt architecture.

Why the current global debt architecture is not fit for purpose

- The IMF is a creditor that plays a key role in debt management, debt sustainability, debt renegotiation and debt restructuring in a non-independent process. It is an institution based on a quota vote system that keeps the power in the hands of a few advanced economies.

- Other traditional groups of creditors such as the Paris Club are still relevant, although western bilateral creditors are not the main group of creditors in the current debt landscape. Bringing new creditors around the debt negotiation table is not ideal when the need is for a different, independent and non-asymmetric process.

- Existing practice for debt crisis resolution is fragmented, uncoordinated, unfair and characterized by too little relief that comes too late, leaving countries unable to address debt problems comprehensively and caught in a process driven mostly by creditors’ needs.[5] As a recent Atlantic Council analysis of debt restructuring in Zambia stated: “The current approach to sovereign debt restructuring is still plagued with many deficiencies.”[6]

2 Kose/Nagle/Ohnsorge/ Sugawara (2020)

3 UN General Assembly (2021)

4 The Federal Reserve has raised interest rates to the range of 4.5% to 4.75% (in February 2023), while the European Central Bank has raised the interest rate on the marginal lending facility to 3.25% (in February 2023) and the Bank of England has raised rates to 4% (in February 2023). In all three cases, rates are expected to continue rising in 2023.

5 UN General Assembly (2021)

6 Tran (2022)

- Liquidity problems have been addressed through the G20 Debt Service Suspension Initiative (DSSI), but a suspension instead of a debt service cancellation only postponed the fiscal problem of repaying debt obligations during the pandemic.

- Solvency problems and the need for debt renegotiation have not been addressed by the G20's Common Framework for debt treatments (CF), which in two years has not led to successful results in the four African countries that applied for it. The experience of Chad, the only country which has completed the Common Framework process "took two years to get to a deal with its creditors after which it did not receive any debt reduction".[7] Now Ghana has applied for debt treatment under the CF and is expecting a more agile process. Under the current trends, there will be more countries in need of a debt resolution process. What will happen if all countries in need would ask to be part of the CF? The non-system of debt restructuring would probably collapse. A case-by-case basis in a context of polycrisis is part of the too little-too late approach. Paris Club creditors have been putting China on the spot as the reason why the CF does not work efficiently. Despite the importance of China as a creditor for the African countries that have requested CF debt treatments, a global sovereign debt workout mechanism needs more than China for debt resolution, when in general the main creditors in developing countries are multilaterals and the private sector. Bilateral renegotiations with the private sector have taken place in some countries in Latin America and Africa, but they are complex, inefficient and long processes.

- Measures as Collective Action Clauses (CACs) in bond contracts – which aim to prevent litigation by vulture funds in case a sovereign debtor needs to restructure its debts – are important and need to be included in all sovereign bonds' issuance, but are not a silver bullet. In any case, bonds with CACs are not currently a significant portion of the debt portfolio.

7 Tamale (2023)

- The current methodologies for Debt Sustainability Analysis (DSA) that the IMF has developed do not sufficiently incorporate a gender approach, SDG financing needs and the Climate Agenda. While DSAs should help countries adopt a sustainable financing strategy by calculating how concessional the loans need to be in order to prevent debt crises, they only allow an estimate of country capacity for debt payment with some dangerous degree of overoptimism in its projections.

- Another problem is related to Credit Rating Agencies (CRA). When the pandemic hit, CRAs downgraded the credit rating of the majority of Latin American countries and other developing countries, which makes credit even more expensive in a context of urgent concessional financing needs. The same could happen in the aftermath of extreme climate events, considering that credit rating agencies tend to penalize climate vulnerable countries, downgrading their credit rating. There is a conflict of interest when an oligopoly of private agencies rates the financial situation of countries.

Unequal burden sharing of restructuring costs

In a context of debt crisis and power imbalances, impacts are not equal for all, but all parties should bear the burden of the solutions. Borrower countries are subject to external shocks, they didn't have a role in deploying the worst crises in more than 100 years. In a "non-system" where creditors lead the debt treatment processes, the unequal relationship and burden most of the time fall mainly on borrower countries, which ultimately carry the higher costs of restructuring. This implies that borrower countries' people are the ones that carry these costs, with expenditure cuts, fiscal consolidation and other medium-term adjustments resulting from austerity measures.

What is needed: A fair system, a new debt architecture

The need for a fair debt architecture system has been characterized over time by identifying the needs and negative impacts of the current "non-system" in place.

A new debt architecture is needed to contribute to:

- Achieving the Sustainable Development Goals (SDGs).
- Implementing the climate agenda, in particular to finance climate adaptation with non-reimbursable financing in the Global South.
- Fulfilling human rights.
- Eliminating the vicious circle of debt for countries in need, which bear more pressure to accelerate the extraction of non-renewable resources to repay debts.
- Achieving a fair economic and financial system where debt is not a geopolitical mechanism to enable creditors power to prevail against debtors.

Among key measures needed to reform the current debt architecture are the following:

- Establish a **debt restructuring process under a multilateral framework,** under the auspices of the United Nations, guaranteeing the elimination of any asymmetries between creditors and debtors in terms of access to comprehensive information and with an independent technical support to the country team in charge of the renegotiation process. An important achievement to build on are the UN´s Basic Principles on Sovereign Debt Restructuring Processes which were adopted by the General Assembly in 2015.[8]
- Establish an **automatic stay on debt payments** when borrowing countries are close to a debt crisis and at the initiation of a sovereign debt restructuring process, to truly look after the short- and long-term sustainability.
- Implement a **comprehensive debt sustainability evaluation** that allows for timely identification of the debt cancellation and the debt restructuring needs before a country falls into debt distress and defaults. These criteria should be comprehensive, including ratios of debt service to fiscal revenues and debt service to social expenditures, considering domestic debt burden and other risks. This assessment should not be run only by one institution, such as the IMF, but by other multilateral institutions such as UNCTAD. In addition, realistic projections considering the assessment of other national stakeholders can prevent the over-optimism that leads to bad decisions.
- Establish **a binding approach in any debt treatment process**, with the participation of all creditors, multilateral, bilateral and private; but also including domestic bondholders (so as to avoid the experience for example of Argentina). Countries that led a renegotiation process with private creditors in a bilateral approach have managed to reach agreements, in a long and asymmetric process. More initiatives on national laws on private creditors will contribute to a binding approach.
- Implement **national legislation in creditor countries** to prevent private creditors, particularly vulture funds, from undermining multilateral debt restructuring agreements.
- Consider **economic, social and climate vulnerabilities criteria** beyond only debt sustainability ratios and the income level of the country. Developing countries are exposed to several vulnerabilities (e.g., the recent health crisis, the current food and climate crisis), where women are disproportionately affected. A catastrophe clause that allows for automatic stay on payments should be included in all loan contracts.
- Ensure access to **concessional finance** for developing countries in need, regardless of its income level, not only by accomplishing the official development assistance (ODA) and climate finance targets that developed countries have committed to, but also with other innovative sources of financing, including no debt mechanisms such as the allocation of Special Drawing Rights (SDRs).
- Ensure transparency and accountability from several angles: 1) transparency from creditors, with a

8 UN DESA (2015)

global registry of private creditors, 2) transparency from borrower countries to their citizenship, 3) transparency of the debt sustainability analysis for different stakeholders in the country, such as parliamentarians.

- Apply **responsible lending** criteria in terms of eliminating conditionalities such as austerity and negative impacts, and **responsible borrowing** on the efficient use of resources for the benefit of people.
- Create a **multilateral credit rating agency** to balance the credit rating assessment of countries' economies.

Finally, the financial architecture is interconnected. It is important that conditions are given for a **mobilization of domestic resources** through progressive taxation systems and the elimination of illicit financial flows and tax dodging. Debt and tax justice policies need to take place at the same time, otherwise the increase on tax collection will be used to repay debts; an integrated debt treatment process will bring a degree of liquidity but will not be a long-term resolution if countries need to increase debt again.

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