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Questioni di Economia e Finanza

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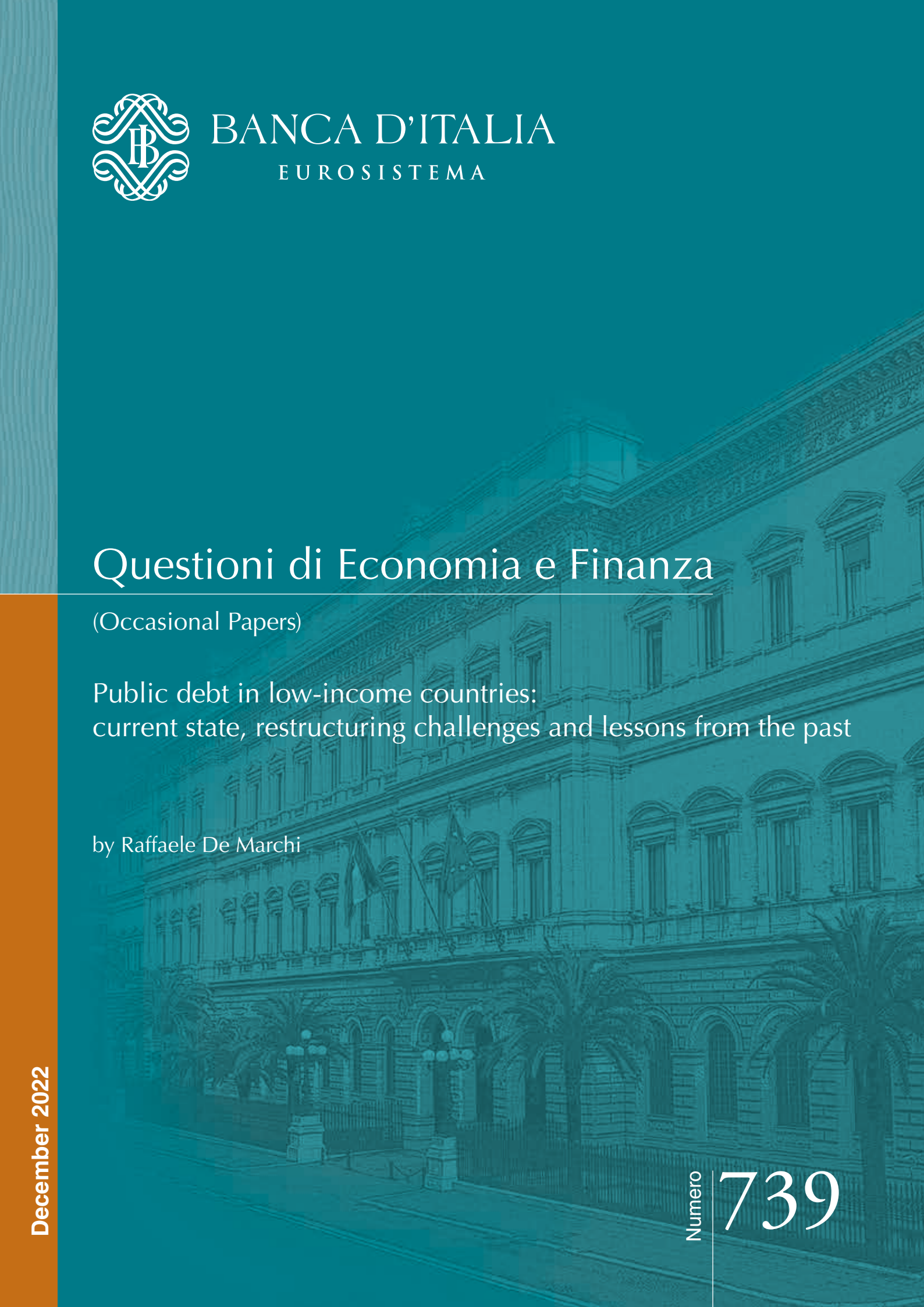
by Raffaele De Marchi



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The series is available online at www.bancaditalia.it .

ISSN 1972-6643 (online)

Designed by the Printing and Publishing Division of the Bank of Italy

PUBLIC DEBT IN LOW-INCOME COUNTRIES: CURRENT STATE, RESTRUCTURING CHALLENGES AND LESSONS FROM THE PAST

by Raffaele De Marchi*

Abstract

In the face of high and rising debt vulnerabilities in low-income countries (LICs), the G20 Common Framework for Debt Treatments provides an important tool to facilitate debt restructurings, but its implementation has so far been hampered by delays and difficulties. Drawing also from a comparison with past debt relief initiatives (HIPC and MDRI), this paper analyses the main challenges for successful debt restructurings in the current environment characterized by a greater complexity of debt structures in terms of instruments and creditors. The presence of a dominant bilateral lender and the increased role of private creditors make it hard to replicate the solutions applied in the past to reduce LICs' debt. The current challenges also reflect a distributional conflict between advanced economies and China as to the allocation of the losses deriving from debt relief, which also involves a different approach regarding the role to be played by Multilateral Development Banks in support of the countries in need of debt restructurings.

JEL Classification: F34, H63, O19.
Keywords: public debt, debt relief, G20 Common Framework, low-income countries, international organizations.
DOI: 10.32057/0.QEF.2022.0739

Contents

* Bank of Italy, International Relations and Economics Directorate.

1. The evolution of LICs' debt in the last decade and the recent G20 relief initiatives[1]

After having benefited in previous years from the debt cancellations granted by the international community (HIPC and MDRI; see paragraph 2), starting from 2010 public debt to GDP ratios in low-income countries[2] (LICs) have recorded a steadily increasing trend, with an acceleration since 2013 (Fig. 1). From a level slightly below 30 percent in 2010, the average public debt to GDP ratio almost doubled in a decade, to over 50 percent in 2020 and 2021. This average value conceals significant differences at the country level, with around a quarter of LICs currently having a public debt to GDP ratio over 75 percent.[3]

The upward shift in public debt has been a generalized feature among LICs. More than 80 per cent of them (corresponding to 59 countries) have recorded an increase in the debt to GDP ratio during the last decade; two thirds of countries have experienced a rise of more than 10 p.p. of GDP, and in one third of them the increase has exceeded 30 p.p. of GDP (Fig. 2). The trend has been fairly generalized also from a geographical point of view (Fig. 3), although it has been more prominent in Sub-Saharan Africa than in other regions.

While significantly lower than the average levels in advanced economies, public debt ratios in LICs and their rising trend had raised concerns already well before the Covid-19 pandemic, which has further exacerbated debt vulnerabilities. Around 55 percent of the countries subject to the Debt Sustainability Framework for Low-Income Countries (LIC-DSF), jointly developed by the International Monetary Fund (IMF) and the World Bank, are currently assessed as being "in debt distress" or "at high risk of debt distress" (Fig. 4).

Fig. 1

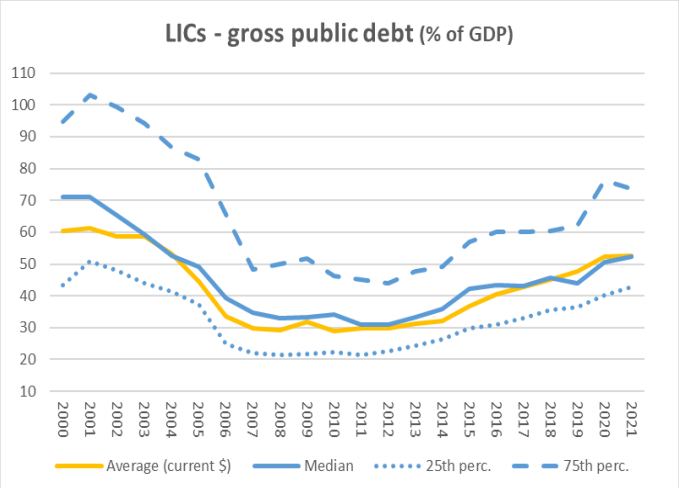
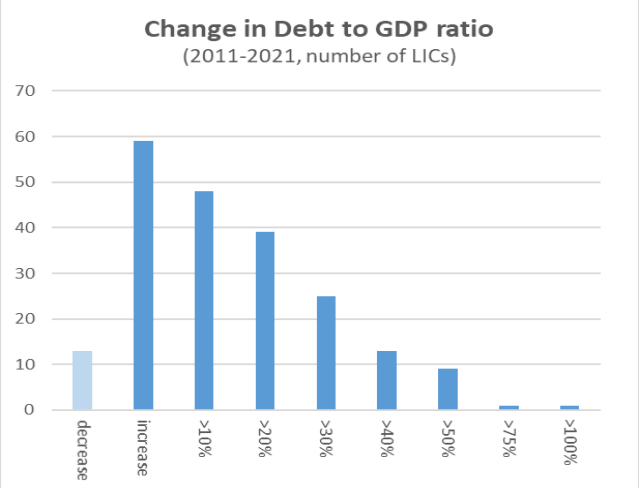


Fig. 2



Source: IMF World Economic Outlook (WEO) database. The series "average" in Fig. 1 (yellow line) is calculated as the weighted average of individual-country data, with weights given by the annual nominal GDP converted to U.S. dollars at market exchange rates.

[1] The opinions expressed in the paper are those of the author and do not necessarily reflect the views of the Bank of Italy. I thank Pietro Catte, Leone Gianturco, Francesco Paternò and Riccardo Settimo for very helpful comments and discussions.

[2] In this paper, the term "LICs" refers to, and is used interchangeably with, the group of DSSI-eligible countries. The motivation of this choice is twofold. First, it is a relatively large aggregate (compared to other classifications), comprising 73 countries with a share in world GDP of 5 percent at purchasing power parity and 2.6 percent at current prices and exchange rates (see Annex I). Moreover, this group is the target of the G20 debt relief initiatives launched in the aftermath of the pandemic.

[3] In the Debt Sustainability Framework for Low-Income Countries (LIC-DSF), developed jointly by the IMF and the World Bank, an indicative benchmark for the ratio of public debt (in present value terms) to GDP ranges between 35 and 70 percent, depending on the specific debt-carrying capacity of the country (defined through a set of indicators including the quality of policies and institutions). Ratios above these values provide a signal of higher risk (IMF, 2018).

Fig. 3

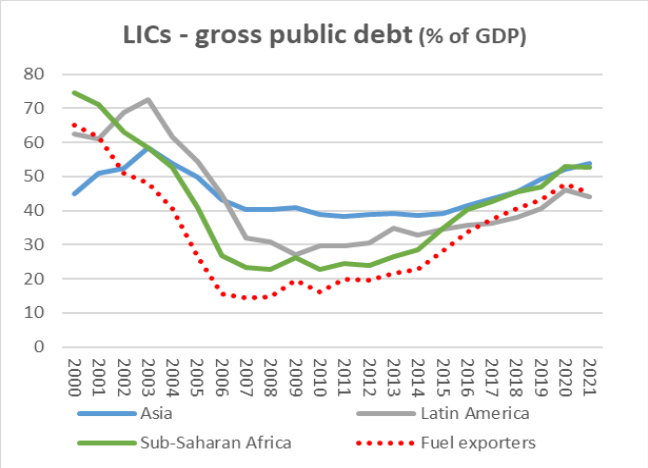
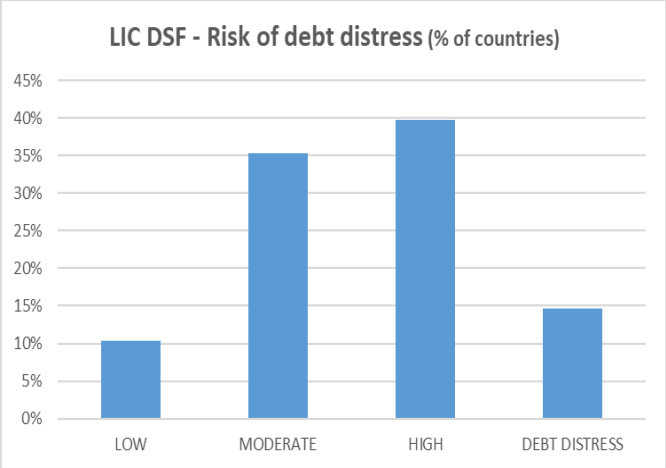


Fig. 4



Source: IMF World Economic Outlook (WEO), Fiscal Monitor and LIC-DSF. Fig. 4 is as of November 30, 2022.

An important factor behind these developments has been the deterioration of fiscal balances. From the mid-2000s, persistent negative balances have been driving up public debt, and the situation deteriorated further in 2020 following the outbreak of the pandemic, even if the increase in deficits was relatively small compared to emerging and (especially) advanced economies due to a limited space for countercyclical policies (Fig. 5 and 6). Deficits may have been encouraged also by an increased capacity to borrow following the past debt relief initiatives launched in the 1990s, coupled with greater opportunities to access international financial markets in a context of accommodative global monetary conditions and an intensified lending activity by commercial and non-Paris Club bilateral creditors (see infra). The growing gap between primary and overall balances indicate an increase in interest costs, driven by the rising debt levels and a shift towards borrowing on more expensive and non-concessional terms.

Fig. 5

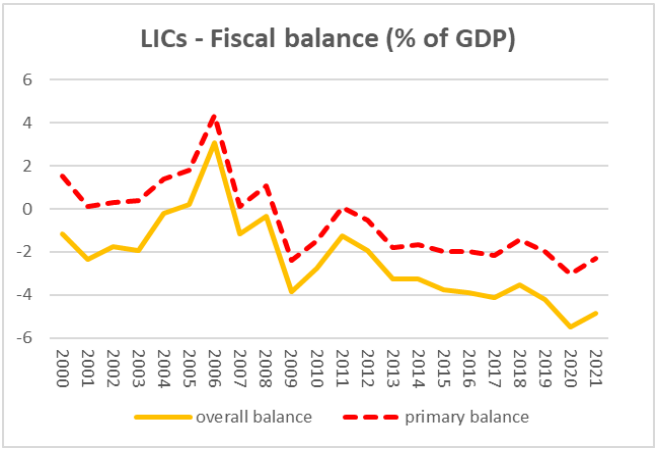
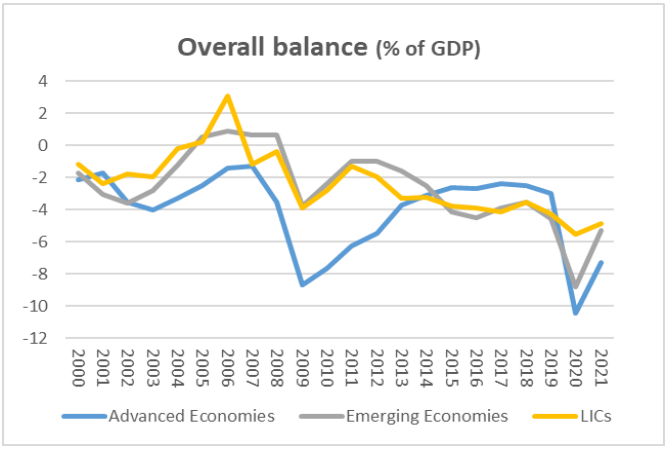


Fig. 6



Source: IMF WEO and Fiscal Monitor.

Primary deficits cumulatively contributed more than 20 percentage points to the increase in the average debt to GDP ratio recorded since 2008. Together with other factors outside the budget balance (such as the emergence of contingent liabilities and currency depreciation increasing the local currency value of debt denominated in foreign currencies), primary deficits have been a key driver of the rise in public debt, more than offsetting the impact exerted by a negative interest rate-growth differential (see Annex II for a description of the main drivers of debt accumulation).

World Bank data show that the public and publicly guaranteed (PPG) long-term external debt of LICs[4] has increased from a low of around US$ 180 billion in 2006 to US$ 670 billion in 2021 (Fig. 7). The biggest part (75 percent of the total) is held by official creditors, comprising multilateral institutions and bilateral lenders such as foreign governments and their agencies. The share of official creditors was even larger in the past, exceeding 90 percent in the early 2000s. The increase in total PPG external debt has in fact been associated with some significant shifts in its composition by type of creditor.

Between 2000 and 2021, the share of official bilateral creditors has fallen from 46 to 30 percent. The declining share of bilateral creditors has been offset by a steadily rising relevance of private creditors (mostly commercial banks and bondholders), whose weight has grown from 9 to 25 percent during the same period. The portion accounted for by multilateral creditors has been relatively more stable and currently stands at 45 percent, making these institutions the most important category of lenders to LICs' governments.[5]

Noteworthy changes have also been observed in the distribution of debt holdings within the main categories of creditors. Regarding private creditors, their growing share has been boosted predominantly by a rapid increase of debt held by bondholders, as a number of LICs have progressively gained access to international capital markets amid favorable global financing conditions. In 2021, bonds accounted for 13 percent of total PPG external debt, from just 2 percent in 2000; bonds' share in debt held by private creditors has thus increased from 25 percent to over 50 per cent (Fig. 8).

The shrinking share of official bilateral creditors also reflects a remarkable shift in its composition. In particular, an impressive increase in the debt held by China has offset a declining share of the more traditional lenders, such as official creditors from G7 countries (Fig. 9). Almost non-existent in the early 2000s, the stock of PPG external bilateral debt owed by LICs to China exceeded US$ 100 billion in 2021, making China by far their biggest official bilateral creditor (Fig. 10). Chinese official bilateral lending includes credits provided by a large variety of state-owned entities, among which a prominent role is played by China Export-Import Bank and China Development Bank[6]. The increasing weight of China (in 2021 accounting for over half of total official bilateral debt) has been mirrored by a sharp drop in the share of G7 countries, from 48 to 25 percent between 2000 and 2021.

[4] PPG long-term external debt comprises public debt (an obligation of a public debtor, such as the national government or agency, a political subdivision or agency, or an autonomous public body) and publicly guaranteed debt (an obligation of a private debtor that is guaranteed for repayment by a public entity), owed to non-residents and with an original or extended maturity of more than 1 year. World Bank data (International Debt Statistics) provide information on PPG long-term external debt (including its composition by creditor), which is the main focus of international debt relief initiatives.
PPG external debt is a component of total public debt, with the main difference being that the latter includes also debt owed to domestic creditors (while it generally does not include publicly guaranteed debt). External debt has traditionally represented the largest part of total public debt in developing countries; while this is still the case today, during the last decade domestic debt has gained more importance and increased its share in total public debt, following also the development and deepening of local capital markets in some countries. In 2021, aggregate total public debt of LICs amounted to around US$ 1,340 billion.
It must be reminded that, in this paper, the term "LICs" corresponds to the group of "DSSI-eligible countries" (see footnote 2).
[5] The share of multilateral creditors includes loans provided by the multilateral development banks and the IMF (the allocations of Special Drawing Rights are excluded, as they do not contribute to the net indebtedness of countries). Following the pandemic, these institutions have launched various financing packages to support developing countries. Reflecting also a widespread use of fast disbursing emergency financing in the immediate aftermath of the pandemic, since the end of 2019 the share of the IMF in total multilateral claims has risen from 9 to 15 percent (corresponding to 6 percent of total LICs' PPG external debt).
[6] The precise magnitude of China's lending is nevertheless a debated issue. Based on data covering a very large number of Chinese overseas loans since 1950, gathered from various sources, Horn et al. (2019) estimate that around 50% of China's lending to developing countries is not reported in the most widely used official debt statistics, such as the World Bank's International Debt Statistics (IDS). These findings have been disputed by the IMF and the World Bank, on the ground of methodological issues associated with the approach used by the authors, which would tend to overestimate the outstanding stock of debt to China (IMF, 2020a).

Fig. 7

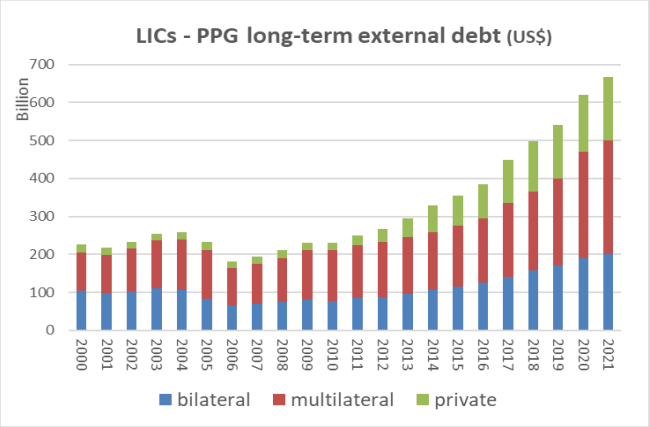


Fig. 8

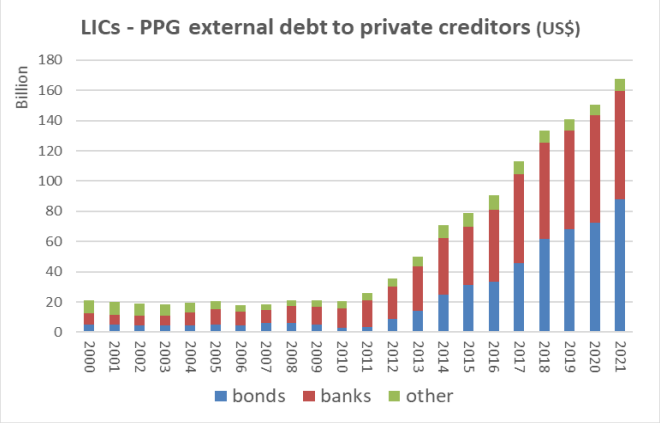


Fig. 9

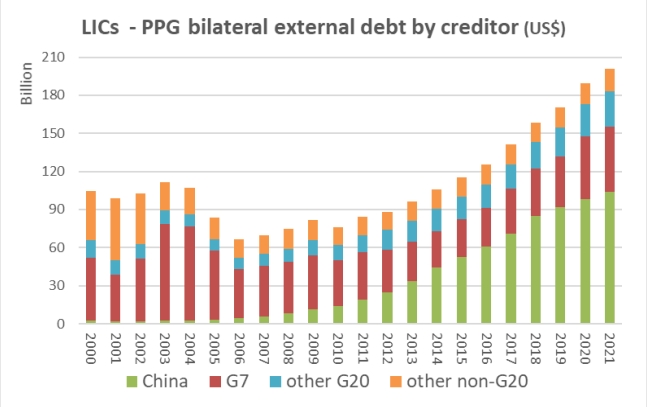
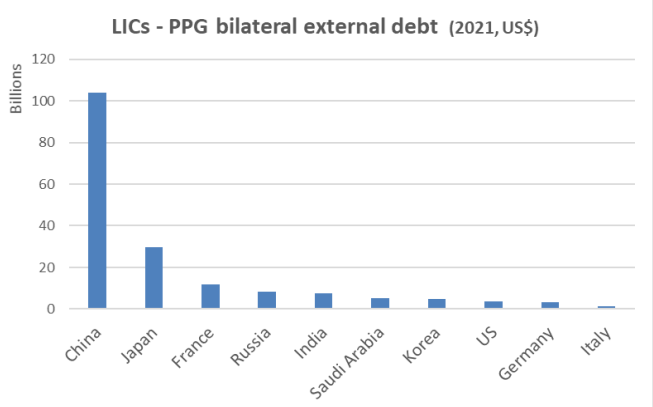


Fig. 10



Source: World Bank International Debt Statistics (IDS).

The international community has adopted several initiatives to support poorer countries in dealing with the pandemic crisis and the worsening debt vulnerabilities. These actions fall in 4 broad categories:

1) Additional financing by the International Financial Institutions (IFIs);
2) A boost to global reserves and liquidity via a new Special Drawing Rights (SDR) general allocation;
3) Temporary cash flow relief through the G20 Debt Service Suspension Initiative (DSSI);
4) Debt relief / restructuring with the G20 Common Framework beyond the DSSI.

The last 2 categories highlight that debt relief is a key component of the international support to vulnerable countries. The DSSI, launched in April 2020, granted beneficiary countries a (net present value neutral) suspension of debt service payments owed to G20 official bilateral creditors. The initiative, which run from May 2020 to December 2021, allowed a total debt service deferral of US$ 12.9 billion, providing around 50 participating countries with liquidity support of about 0.5 percent of GDP, against an average Covid-related spending of 1.6 percent of GDP (IMF and World Bank, 2021).

The DSSI was a tool for rapid emergency response, to improve countries' liquidity conditions and provide them with temporary breathing space to fight the immediate health and economic consequences of the pandemic, with the size of savings linked to each country's specific debt maturity profile and unrelated to the impact suffered from the crisis. The deferral of debt service payments left unaltered the present value of bilateral creditors' claims. However, the severity of debt vulnerabilities in many LICs required a shift from addressing liquidity problems to dealing with solvency issues, with debt treatments tailored to the specific needs of the same countries eligible for the DSSI.

To this end, in November 2020 the G20 endorsed the *Common Framework for debt treatments beyond the DSSI* [7] (CF), which points to a shared approach to facilitate appropriate restructurings in cases of unsustainable debt situations. Key aspects of the CF are the existence of an IMF program with strong conditionality and the principle of comparability of treatment, which implies that debtor countries benefiting from debt relief are required to seek from their other creditors (official bilateral and private creditors) a treatment at least as favorable as the one agreed with G20 official bilateral creditors[8].

2. A precedent: the debt crisis of the 1980s - 1990s and the HIPC-MDRI initiatives

2.1 The crisis and the response from the international community

The 1970s and 1980s saw a sharp increase in external borrowing by low-income countries, mainly from official sources (Fig. 11). Debt stocks and debt service costs of the so-called "Highly Indebted Poor Countries" (HIPCs) skyrocketed and peaked in the mid-1990s at clearly unsustainable levels.[9]

The initial reaction of the international community was what has been described by some authors as a "defensive lending strategy" (Ferry and Raffinot, 2019). This strategy involved non-concessional, i.e. net-present value (NPV) neutral, "flow rescheduling" by the Paris Club (implying the deferral of payments falling due during the period of an IMF economic program), combined with new concessional lending from the IFIs. The underlying logic was therefore to provide cash flow relief to treat a liquidity problem. This initial strategy shows some similarities with the immediate response of the international community after the pandemic, through the DSSI and the expansion of financing by the IFIs.

This approach was later reinforced by the introduction, from 1988, of concessional rescheduling methods (i.e. the postponement of debt service payments involving an NPV reduction). Set in motion by the 1987 Venice G7 summit and by an increased awareness of the seriousness of the problem, a main feature of this phase (which lasted until 1996) was also the application of progressively more favorable terms and conditions. These terms, which generally took their name from the city of the G7 summit where they were discussed or approved, provided for increasing relief in NPV terms (Table 1).

Table 1

PARIS CLUB DEBT TREATMENTS (1975-1996)

TERMS	*NPV reduction*	*Dates*	*n. of deals*	*n. of countries*	*Amounts ($ mill.)*
Non- concessionnal		Before October 1988	81	27	22,803
Toronto terms	33%	Oct. 1988- June 1991	28	20	5,994
London terms	50%	Dec. 1991 - Dec. 1994	26	23	8,857
Naples terms	67%	Since January 1995	34	26	14,664

Source: IMF. Amounts refer to consolidated debt, i.e. debt payments subject to a rescheduling agreement.

The high frequency of repeated rescheduling interventions (as well as the large number of countries involved) is a signal of the inadequacy of this type of measures to tackle the problem. Several reasons can explain this initial response and the slow progress in concretely addressing the heavy debt burden of the HIPCs. One factor, at least in the early period, was the misinterpretation of a solvency crisis for a

[7] https://clubdeparis.org/sites/default/files/annex_common_framework_for_debt_treatments_beyond_the_dssi.pdf .
[8] This highlights a difference with the DSSI, where the involvement of private creditors was on a voluntary basis. In the end, private creditors did not participate in the DSSI, due in part also to a reluctance of debtor countries to ask for a rescheduling of payments on private sector-held claims, out of concerns for the potential implications in terms of ratings and market access.
[9] For a description of the origins and evolution of the crisis, see (among others): Daseking and Powell (1999); Easterly (2002); Ferry and Raffinot (2019); Kose et al. (2020); World Bank (2022).

temporary liquidity problem. Moreover, the rescheduling approach was convenient for and supported by both creditors and debtor countries, at least in the short term. For creditors, it reduced the immediate pressure to find other, potentially costlier solutions, considering also that some official lending agencies' accounting practices allowed them to report rescheduled claims at their full contractual value, without the need to make loss provisions. For debtor countries, it avoided the emergence of arrears and payment defaults, and facilitated new flows of official financing, especially from multilateral institutions. Finally, the slow-moving approach also reflected the necessary time to build consensus, among all the major creditors involved, for more long-lasting solutions.

In the end, the "defensive lending strategy", by delaying payments to the future and fostering additional borrowing from the IFIs, led to a further increase in debt stocks, coupled with a substitution of private debt with official debt, as private creditors – essentially commercial banks – progressively reduced their exposures (Fig. 11 and 12).

Fig. 11

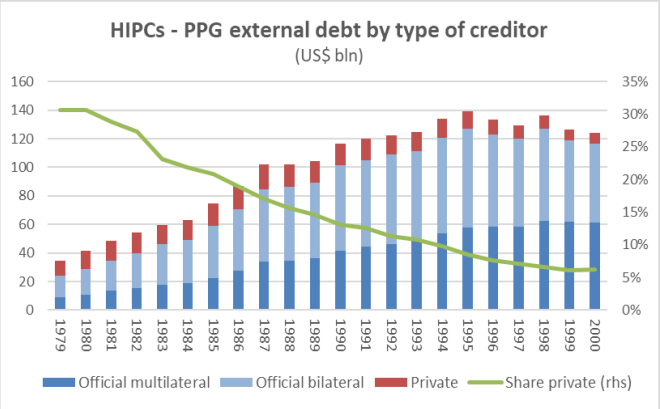
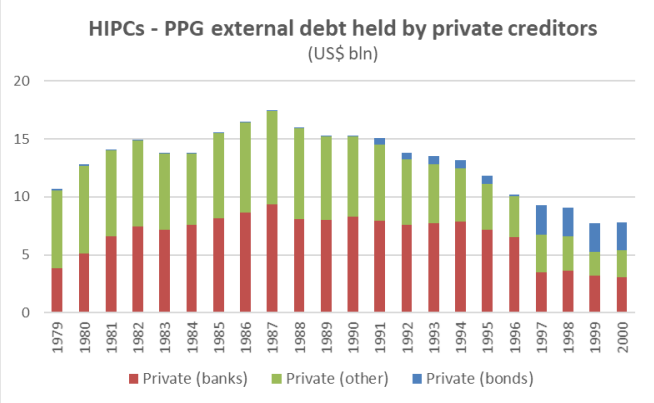


Fig. 12



Source: IDS. PPG: Public and publicly-guaranteed. HIPCs: Highly Indebted Poor Countries.

The failure of these programs to address effectively the crisis led eventually to the adoption of a more structured multilateral approach, through the Highly Indebted Poor Countries Initiative (HIPC), later supplemented by the Multilateral Debt Relief Initiative (MDRI).

The HIPC, launched in 1996, was a notable innovation in the development finance landscape. The various actions taken until then by the international community, aimed at providing some form of debt payments' relief, show that the issue of poor countries' debt had been on the G7 agenda since the early 1980s. The HIPC, however, was innovative on several fronts. First, it established a more coordinated approach by all major creditors, based on well-defined rules, which represented a break from the mainly ad-hoc interventions previously undertaken. Moreover, it embodied a clear strategy shift, with a more explicit recognition of the situation as a severe and widespread solvency problem.

The main goal of the initiative was to reduce the excessive debt burden ("debt overhang") of the qualifying countries, thus removing an important obstacle to growth and poverty reduction. With the revision of the initiative in 1999 ("Enhanced HIPC"), the objectives were expanded to include also the goal of releasing resources for social expenditures targeted at poverty reduction. The initiative, still ongoing for three countries (Somalia, Sudan and Eritrea), includes a two-stage process: the first step is the "decision point", where a country is declared eligible to receive debt relief by the boards of the IMF and the World Bank (WB), having made sufficient progress on a set of specific conditions. The second step is the "completion point", where the country receives full and irrevocable debt relief, after it has established a further record of good performance under IMF-WB programs and implemented a set of key country-specific reforms agreed at the decision point (see Annex III for more details on the HIPC Initiative).

Another important innovation of the HIPC was that, for the first time, it also involved the claims held by multilateral creditors. One of the guiding principles of the initiative, however, was the need to preserve the financial integrity and the preferred creditor status (PCS) of the IFIs. This principle, which was later applied also in the MDRI (see infra), was mainly achieved by financing the cost of IFIs' debt relief through the establishment of special trusts, funded by a mix of transfers of internal resources and (mostly) bilateral contributions from donors. By drawing on these funds to meet the debt service payments owed to them by beneficiary debtor countries, the IFIs were fully compensated for the losses incurred on their exposures.[10]

The debt relief provided through the HIPC Initiative was reinforced in 2005 with the adoption of the Multilateral Debt Relief Initiative (MDRI). Its main goal was to provide additional resources and free up fiscal space to support the achievement of the Millennium Development Goals, set by the international community in 2000 (and replaced in 2015 by the Sustainable Development Goals). The MDRI involved only multilateral creditors (IDA, IMF, African Development Fund and IADB), and allowed the full cancellation of these institutions' remaining claims on countries having reached HIPC's completion point. There is no MDRI-specific conditionality in addition to the one already required by the HIPC initiative.

To date, 36 of the 39 potentially eligible countries have passed the completion point of the HIPC and received full and irrevocable debt relief, while two countries (Somalia and Sudan) are in the interim phase, between the decision point and the completion point. Eritrea is the only remaining pre-decision point country. The overall costs of the HIPC, estimated by the IMF and World Bank (IMF, 2019), amount to US$ 76 billion, expressed in end-2017 present value terms (Fig. 13). The biggest burden was borne by official (multilateral and bilateral) creditors, in line with the debt structure of the beneficiary countries. The total costs of the MDRI, entirely borne by the four IFIs involved (and largely offset through external resources provided by major donors, as in the case of the HIPC), amount to approximately US$ 43 billion. Overall, the debt relief granted through these initiatives is therefore estimated at around US$ 120 billion (in end-2017 present value terms).

Fig. 13

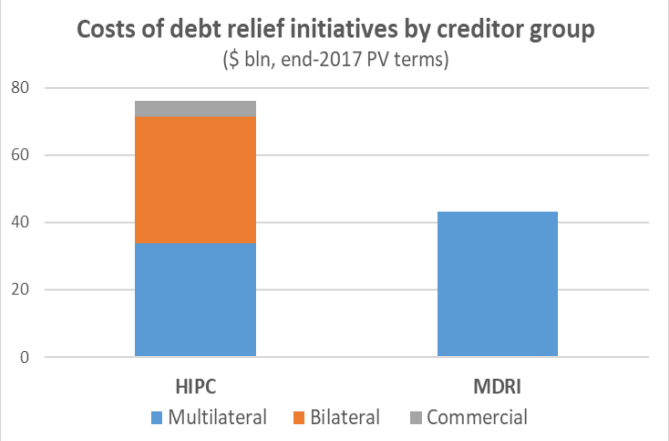
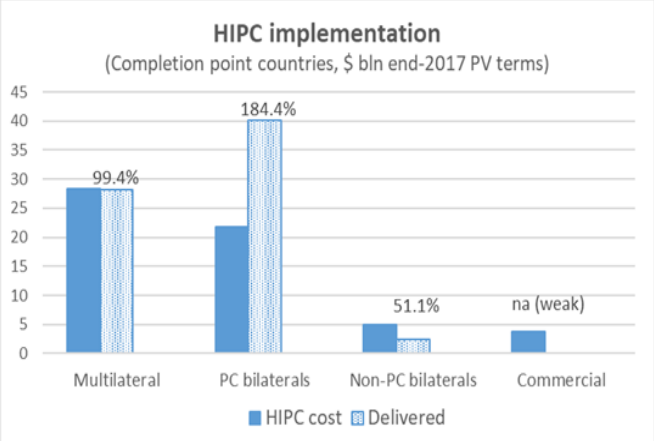


Fig. 14



Source: IMF. PC: Paris Club.

A main challenge of the HIPC initiative has been the achievement of full creditor participation to debt relief, especially with regard to private creditors and official bilateral creditors not members of the

[10] In the case of IDA, the institution of the World Bank supporting low-income countries, total debt relief costs amounting to around US$50 billion were financed predominantly (over 90 percent) by contributions from donors, supplemented by income transfers from the International Bank for Reconstruction and Development (the non-concessional window of the World Bank). Regarding the IMF, debt relief costs of around US$ 7 billion were covered in almost equal parts by donors' contributions and by internal resources, the latter being generated mainly by profits from the sale of gold holdings.

Paris Club, a situation evoking some similarities with the implementation issues emerged in the DSSI and in the first cases of the Common Framework.

The participation of multilateral and Paris Club bilateral creditors, which together account for 85 percent of the total cost of the HIPC for post-completion point countries, has been very strong (Fig. 14). Over 99 percent of multilateral lenders, estimated by their share in the cost of debt relief, have committed to participate[11]. Paris Club official bilateral members have gone beyond the commitments made under the initiative, and many of them have voluntarily provided additional relief to that required by the HIPC (so-called "topping up", generally granted at completion point in cases where exogenous factors had led to a significant and unexpected deterioration of the economic situation of the beneficiary country).

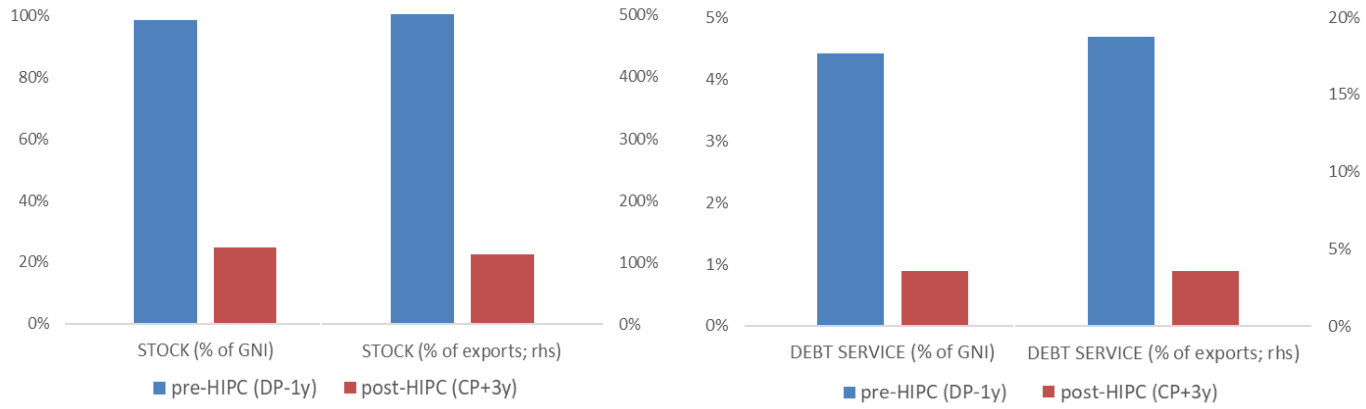
Although increasing in recent years, the delivery of debt relief by non-Paris Club official bilateral creditors stands at around 50 percent. While precise data are not available, the participation by private creditors has been problematic, despite the support of the IDA Debt Reduction Facility, created by the World Bank in 1989 to provide low-income debtor countries with grants to buy back external debt to private creditors at a discount[12]. Several lawsuits against HIPCs for the recovery of their claims have also been launched by commercial creditors, including by so-called “vulture funds” which purchased the debt at bargain prices on the secondary market[13].

2.2 Were the HIPC Initiative and the MDRI a success?

These initiatives were undoubtedly successful in reaching their main goal of reducing debt stocks and debt service payments, thus providing beneficiary countries with a “fresh start”. This is confirmed by the sizeable fall recorded in the average values of some main debt burden indicators (Fig. 15).

Fig. 15

PPG external debt in HIPCs



Source: calculations from IDS. PPG: public and publicly guaranteed. The bars show the average levels of the HIPCs’ debt burden indicators measured 1 year before the decision point (DP-1y) and 3 years after the competion point (CP+3y). Dates are different for the various countries, depending on the year they reached decision and competion points.

[11] Only a few minor institutions are missing, all of them having a small size and a limited geographical activity.
[12] Financed by a mix of transfers from the IBRD and bilateral contributions from donors, since its inception the Debt Reduction Facility has supported 25 buy-back operations in 22 IDA-only countries, extinguishing about US$10.3 billion of external commercial debt. The debt structure of low-income countries was significantly different from that of several Latin American countries involved in a debt crisis during the same period. In the latter case, the crisis involved primarily middle-income countries, with a large share of debt held by private banks, and was managed mainly through the Brady Plan (securitization of loans, involving a substantial present value reduction and supported by collateralization with risk-free US securities).
[13] IMF (2019), “Heavily Indebted Poor Countries (HIPC) initiative and Multilateral Debt Relief Initiative (MDRI) - Statistical update”, IMF Policy Paper, August 2019.

The remarkable fall in debt stocks and debt service burdens, however, was not associated with a tangible improvement in macroeconomic performance, at least according to a number of empirical studies that have tried to shed some light on the impact of the HIPC and/or the MDRI, looking at several dimensions.[14] In general, the literature does not provide a clear and irrefutable evidence that debt relief granted through the HIPC, by removing excessive debt and enhancing investment prospects, has promoted growth. This result can reflect methodological issues, including the difficulty of properly isolating the effect of debt relief on economic growth because of the different channels through which its positive contribution may operate[15]. But it could also point to the fact that promoting growth required additional actions (by debtor governments, donors and IFIs) beyond the scope and means of the HIPC initiative. In this context, growth is likely to have been constrained by the lack of meaningful improvements observed in some factors usually considered as key drivers of sustainable growth, such as (among others) economic diversification and the quality of governance and institutions.

Figure 16 shows the export product concentration index published by UNCTAD for the 36 HIPCs having reached the completion point, comparing their latest values in 2021 to the levels just before the launch of the HIPC Initiative (in 1995)[16]. As the countries are almost equally distributed above and below the 45-degree line, there is no evidence of a generalized reduction in the degree of export concentration among HIPCs, with the number of countries displaying a decrease of the index (which reflects an increased product diversification of their exports) basically matching the number of those with a rising index. A highly concentrated export structure and a strong dependence from a limited number of commodities have thus remained a key structural economic feature of HIPCs (Fig. 17).

Fig. 16

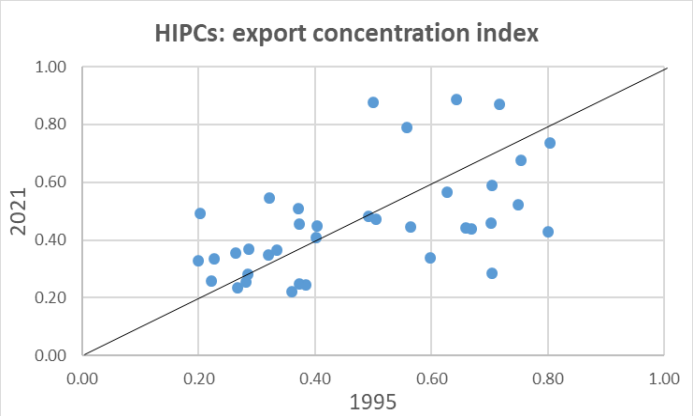
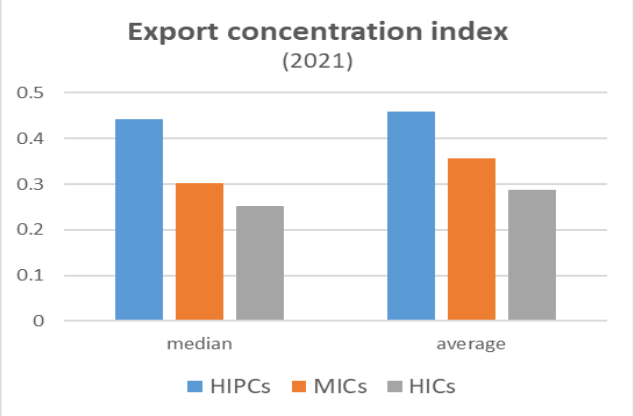


Fig. 17



Source: UNCTAD. MICs: Middle Income Countries. HICs: High Income Countries.

Moreover, some widely used World Bank indicators show a limited progress also in the areas of governance and institutional quality. The average value of the overall score of the Country Policy and Institutional Assessment (CPIA) does not pinpoint an improvement over time and, if anything, a slight deterioration seems to have occurred in the most recent years (Fig. 18). This is confirmed at the level of CPIA's main sub-components, with some improvements only in the category "policy for social

[14] On fiscal space and development spending, the literature highlights some positive effects (Cassimon and Van Campenhout, 2008; Cassimon et al., 2015; Dessy and Vencatachellum, 2007). The impact found on institutional quality is instead quite limited, with few and mostly non-significant positive effects, which do not identify a robust causal relationship from debt relief to the quality of institutions (Depetris and Kraay, 2005; Djimeu, 2018; Domeland and Kharas, 2009; Presbitero, 2009). A number of studies do not show any positive, robust contribution by these debt cancellations to the GDP growth rate (Depetris and Kraay, 2005; Johansson, 2010; Marcelino and Hakobyan, 2014).

[15] From 2002 to 2007, many post-completion point HIPCs experienced strong rates of economic expansion. However, this was also a period of rapid global economic growth and acceleration in international trade.

[16] The indicator is defined as a normalized Herfindahl-Hirshmann index of the product concentration of goods exported. Its value ranges from 0 to 1, with higher values indicating a higher degree of export concentration.

inclusion/equity", along with an apparent worsening in the areas of "economic management" and "structural policies" (Fig. 19). Similar results emerge from the evolution of the index concerning the rule of law[17] (from the World Governance Indicators - WGI) (Fig. 20 and 21).

Fig. 18

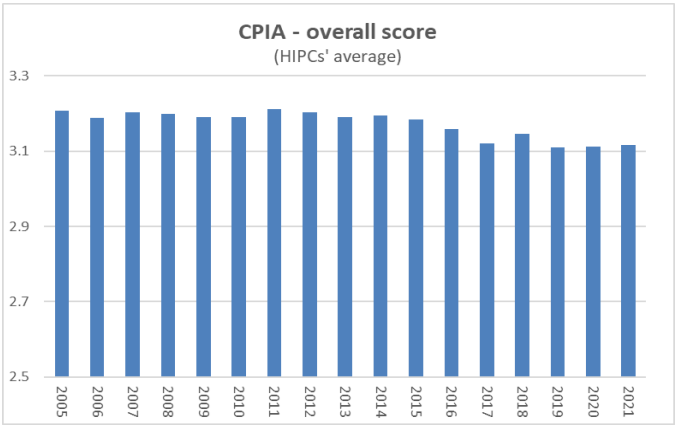


Fig. 19

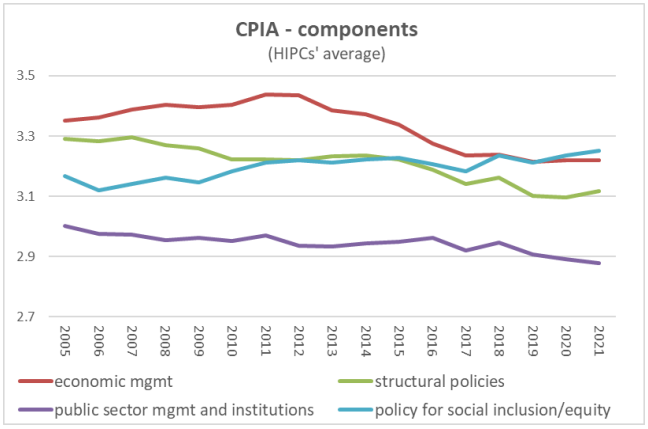


Fig. 20

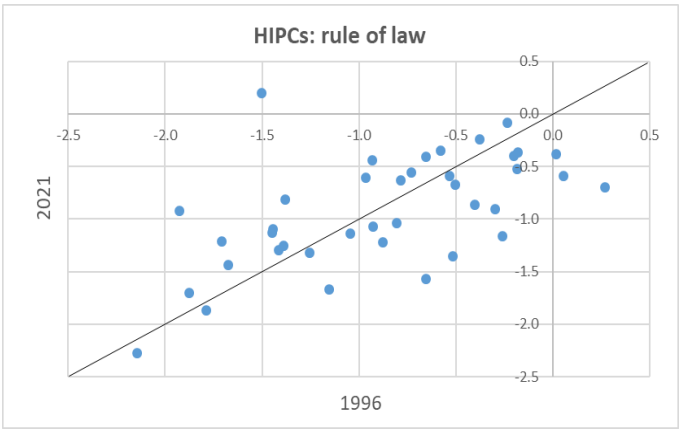
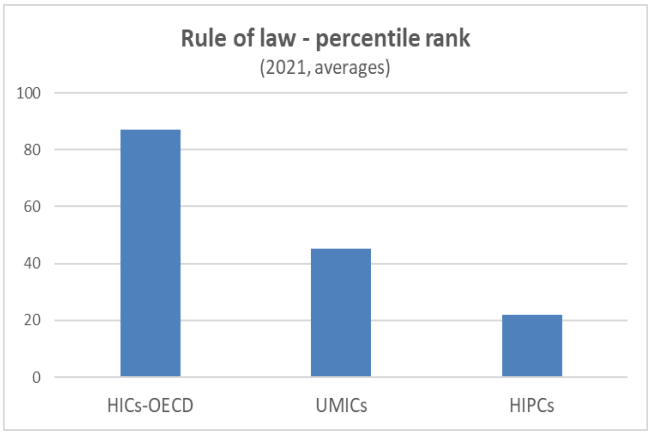


Fig. 21



Source: World Bank. HICs-OECD: High Income Countries members of the OECD. UMICs: Upper-Middle Income Countries.

Finally, financial developments over the more recent years (described in paragraph 1) suggest that debt relief has paved the way for new funding opportunities, from both domestic and external sources. The enlarged funding possibilities, with an increased recourse to international financial markets (more volatile and more expensive than official credit) and a growing lending activity by some new official bilateral creditors, have enabled the financing of development projects but also a new process of rapid growth in public debt, raising once again concerns about its sustainability. At the end of November 2022, over half of the HIPCs having reached completion point and being subject to the IMF-WB LIC-DSF were assessed as in debt distress or at high risk of debt distress.

[17] Analogous findings (not shown here) are obtained by looking at other WGI, such as "government effectiveness", "regulatory quality", "control of corruption" and "political stability and violence".

3. A comparison between the HIPCs' debt crisis and the current LICs' debt situation

This paragraph focuses on a comparison between the HIPCs' debt crisis and the current public debt situation in LICs, with the aim of identifying the main similarities and differences. The comparison is performed looking at various dimensions, such as the origins of the crisis, the level of some key debt burden indicators, the nominal amounts involved, the debt structure and the initiatives undertaken by the international community. The results are summarized in Table 2.

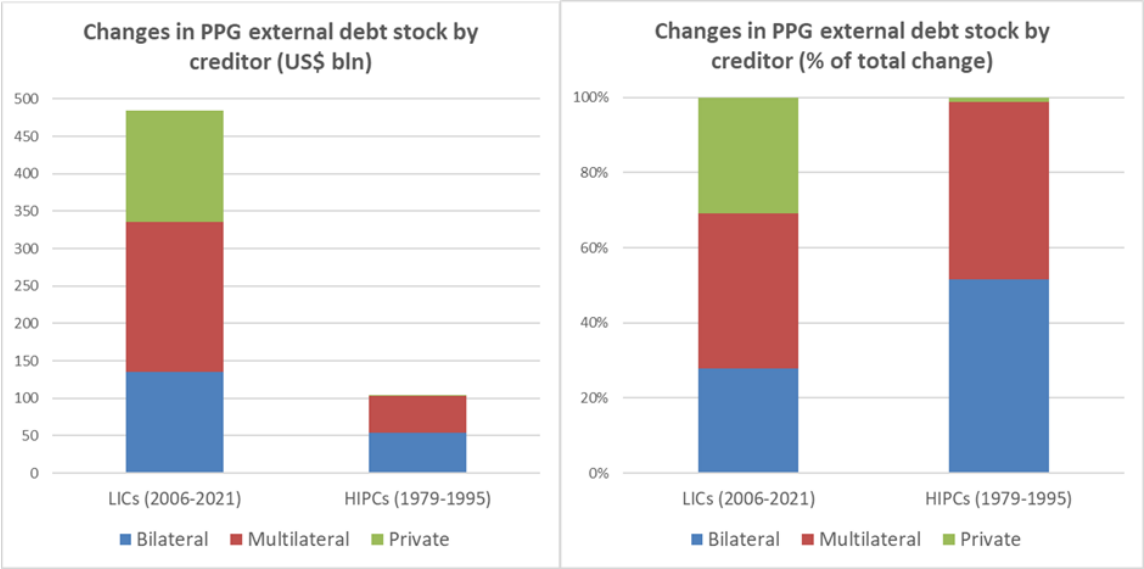
Table 2

Current LICs debt situation and HIPCs debt crisis: a comparison	
Origins	**HIPCs**: period of rapid external borrowing (primarily from official sources) followed by economic shock **LICs**: persistent public deficits and build-up of debt financed from various sources (key role of new official lenders and private creditors). Aggravated by pandemic
External debt burden indicators	Current LICs' levels lower than HIPCs' peak levels (but higher role of domestic debt)
Nominal amounts	Current stock of LICs' debt higher than HIPCs at decision point
Debt structure	Mainly official financing, but currently bigger role of private creditors (especially bondholders)
Reaction from international community	• Initial reaction: some analogy DSSI+IFIs' financing with *defensive lending strategy* before HIPC-MDRI • Quicker recognition of need to deal with solvency problems (G20 Common Framework vs HIPC Initiative)

The rapid debt build-up in the HIPCs during the 1980s and early 1990s was driven in large part by borrowing from official sources, firstly from bilateral creditors (and their export credit agencies) and then from multilateral institutions. Therefore, the growth in HIPCs' PPG external debt recorded between 1979 (first year when data are available in the World Bank International Debt Statistics) and 1995 (the year when debt peaked, and which immediately preceded the launch of the HIPC Initiative) is almost entirely accounted for by a rise in official debt, split more or less equally between bilateral and multilateral creditors (Fig. 22). On the contrary, the rise in LICs' public debt from its low in 2006 to 2021 is much more diversified by category of lenders, as it reflects broadly similar increases in the claims held by bilateral, multilateral and private creditors[18].

[18] These broadly similar increases in nominal exposures imply a much higher percentage growth of debt held by private creditors, due to its lower share. Since 2006, nominal debt towards both bilateral and multilateral lenders has tripled, while private sector exposures to LICs have recorded a ninefold increase.

Fig. 22

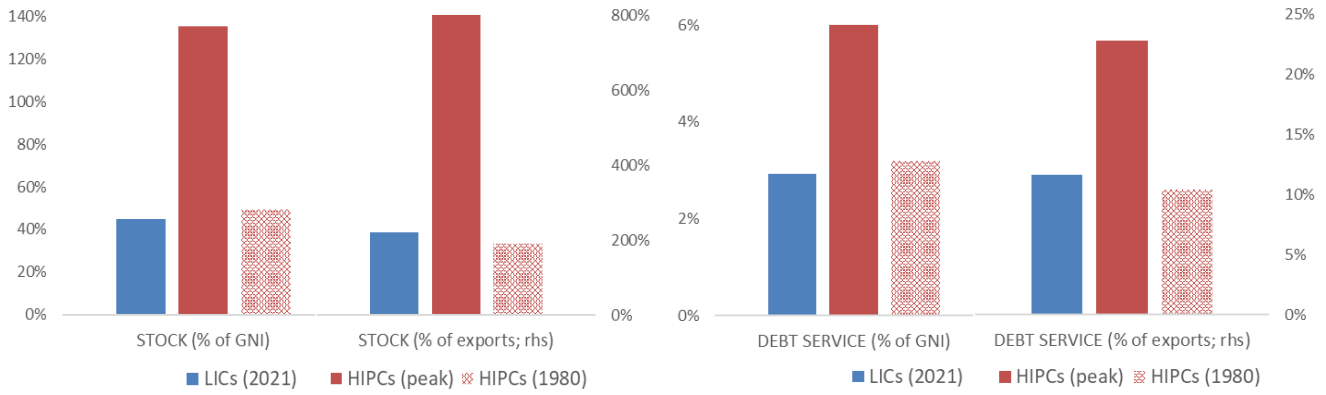


Source: IDS.

Some widely used debt burden indicators show that the current external debt stocks and debt service payments (as a ratio of GNI and exports) are noticeably lower than the maximum levels reached by the HIPCs (Fig. 23). This is true for both types of indicators, even if the gap is narrower in the case of debt service payments, reflecting today's higher share of more expensive sources of borrowing in LICs' debt structure (such as bonds issued in international financial markets). Currently, LICs' average public external debt burden indicators are broadly similar to the levels recorded by the HIPCs in 1980 (light shaded red bars in Fig. 23), a year which was followed by more than a decade of non-decisive debt reschedulings and by a considerable further debt build-up before the establishment of the HIPC Initiative.

Fig. 23

PPG external debt burden indicators



Source: IDS. PPG: public and publicly guaranteed. Average values. The peak level for HIPCs is the maximun average level reached by the various indicators. LICs' data (2021 or latest available) refer to 34 vulnerable countries, i.e. countries assessed at high risk of debt distress or in debt distress according to the IMF-WB LIC-DSF analyses (as of November 30, 2022), or having a public debt to GDP ratio higher than 70 percent for the countries not subject to the LIC-DSF.

In this context, while the initial reaction to the current crisis (DSSI and expansion of IFIs' financing) displays some similarities with the so-called "defensive lending strategy" followed during the first stages of the HIPCs' debt crisis, the endorsement of the *Common Framework* can be seen, in

comparison, as a quicker recognition of the need to deal with severe solvency problems. At the same time, it must be noted that the lower and less worrisome external debt burden indicators are associated with a much more sizeable domestic public debt. According to IMF figures, since 2007 domestic debt (by residency of holders) in LICs has doubled from just under 10 percent to roughly 20 percent of GDP, and the average share of domestic debt in total public debt is currently around one third[19] (while in the case of the HIPCs public debt was almost entirely accounted for by external debt).

Despite lower debt burden indicators, the current debt stocks are considerably larger in nominal terms. The volume of PPG external debt in LICs at end-2021, at around US$ 670 billion, is almost 3 times bigger than the total debt stock of all HIPCs at their respective decision point (in 2021 present value terms; Fig. 24). Regarding total public debt, the overall stock for all LICs, amounting to about US$ 1,340 billion in 2021, is almost 4 times larger. When restricting the analysis to a group of more vulnerable countries (defined as those being at high risk of debt distress or in debt distress as per IMF-WB analysis), the gap narrows but the level of debt "at risk" (red bars in Fig. 24) is still larger than the total debt of HIPCs.

Figure 25 compares the external debt stocks to the combined GDP of the advanced economies plus China (i.e. the main creditor countries). At around 1 percent, the incidence of LICs' total current stock of public external debt is around twice the weight of the HIPCs in 1996. When considering only the most vulnerable LICs, on the other hand, the situation looks rather similar in the two cases.

Fig. 24

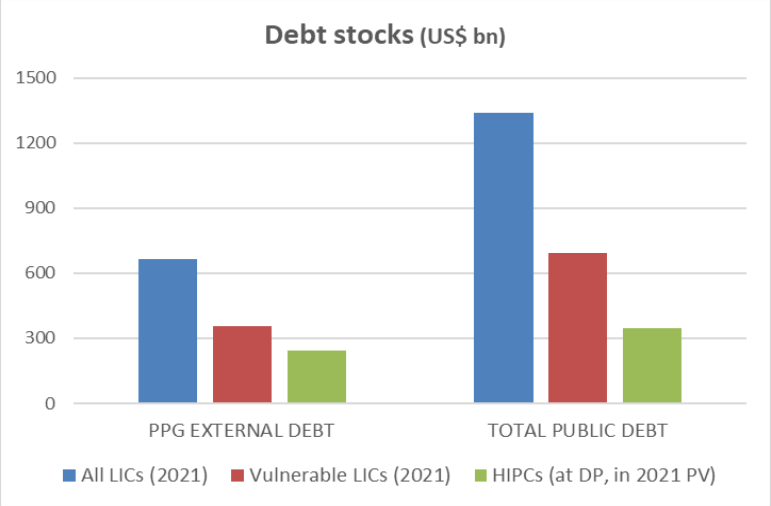
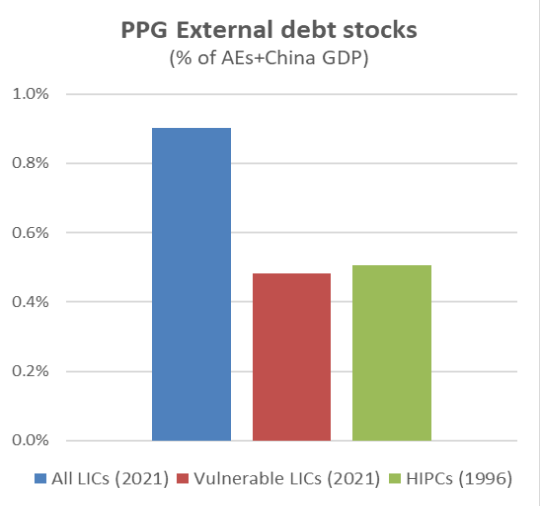


Fig. 25



Source: WB IDS and IMF WEO. AEs: advanced economies. Vulnerable LICs are 34 countries assessed as at high risk of debt distress or in debt distress according to the IMF-WB LIC-DSF (as of November 30, 2022), or having a public debt to GDP ratio higher than 70 percent for the countries not subject to the LIC-DSF. The total for HIPCs is calculated by aggregating the stock of debt recorded at their respective decision point. The year varies from country to country, depending on the timing of their decision point. The figures are then translated in 2021 value terms by applying a 3 percent interest rate (the average interest rate on the 5-year US Treasury bond from 1996 to 2021).

[19] IMF (2021). Publicly available granular data on the composition of domestic public debt in LICs are limited, and at present there is no comprehensive cross-country comparable dataset concerning low and middle-income countries. The World Bank has launched a project aimed at closing this gap and extending its reporting requirements (in the context of the Debtor Reporting System) to domestic public sector liabilities.
By looking at the figures included in the latest debt sustainability analysis performed by the IMF and the WB for each country eligible to the Common Framework, the situation seems quite heterogeneous, with around half of the countries having a share of domestic debt in total public debt over 30 percent. In 9 – out of 67 - countries the share of domestic debt is null or negligible (below 10 percent), while in 15 countries it exceeds 50 percent. The share of domestic debt is high in some countries with a very large size of public debt (such as Pakistan, Nigeria and Bangladesh): this makes the simple average of countries' shares lower than the share of domestic debt calculated for the whole aggregate of LICs. In the countries with the highest shares of domestic debt, the data (when available) show a prevalence of Treasury Bonds and Bills, predominantly held by the banking system, and in a number of cases a substantial reliance on borrowing from the central bank.

A common feature of both episodes is a debt structure largely dominated by official financing. The limited possibilities of market access have traditionally made LICs highly dependent on borrowing from official sources to meet their external financing requirements. However, the role played by private creditors is comparatively higher today, as a number of LICs have gained access to international capital markets.[20] The share of LICs' public external debt held by commercial creditors currently stands at 25 percent, against below 10 percent for the HIPCs in 1996 (Fig. 26). Among official creditors, a key difference is that bilateral lenders were the biggest creditors for the HIPCs (with claims held in large part by G7 countries, against a dominant role played by China today), while multilateral institutions currently hold the biggest share and account for almost half of LICs' external public debt.

As the importance of private creditors has increased, its internal composition has also evolved. In 1996, the limited volume of debt towards private creditors was mainly in the form of bank loans (especially syndicated loans). Conversely, bonds now represent over 50 percent of LICs' commercial debt (Fig. 27).

Fig. 26

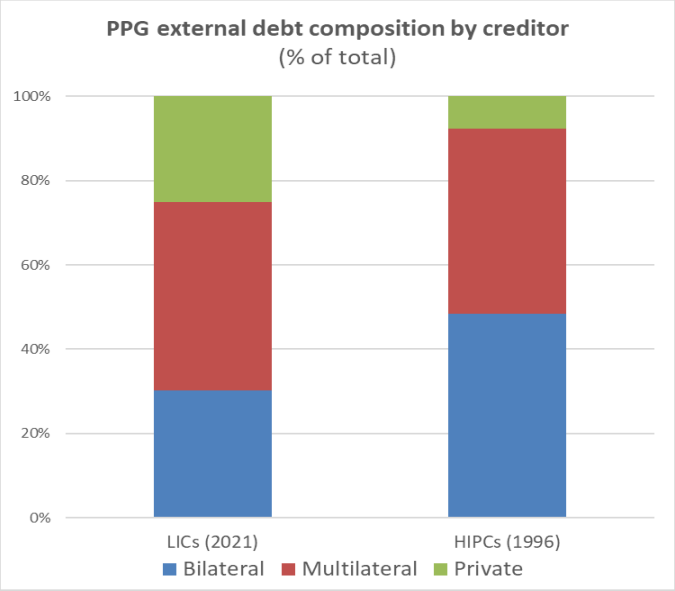
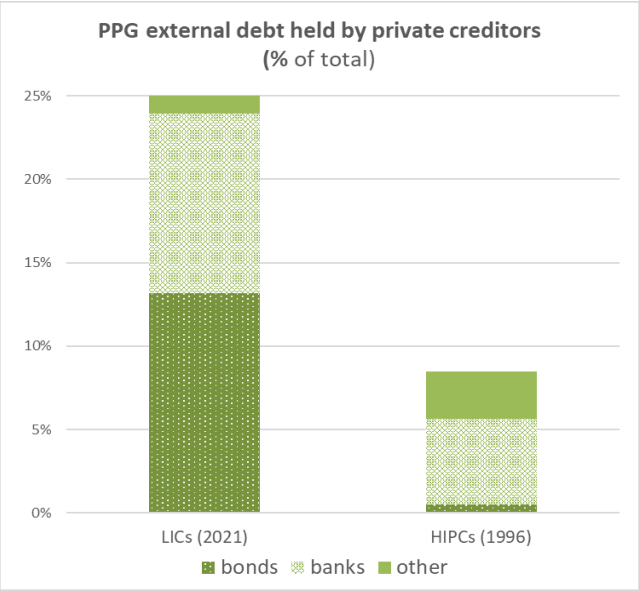


Fig. 27



Source: IDS.

4. Debt restructurings in the current context: main challenges and lessons from the past

The severe economic and financial situation in several LICs has not yet translated in a wave of sovereign debt crises. This probably also reflects the support provided by the increase in IFIs' financing, the DSSI and the August 2021 SDR general allocation[21]. However, the high public debt levels, coupled with LICs' uncertain economic prospects (further aggravated by the consequences of the Russia's war of aggression against Ukraine) and the ongoing tightening of global financing conditions, increase the likelihood that sufficiently reducing excessive debt burdens will eventually require debt restructurings.

[20] Public liabilities towards private creditors are highly concentrated among LICs, with a sizeable share held by commodity exporters. In nominal value, the first 5 countries (Angola, Pakistan, Ghana, Nigeria and Cote d'Ivoire) account for 62 percent of the total public external debt owed by LICs to private creditors, and the first 10 countries account for 80 percent. In only one-fifth of the countries (14 out of 68), the share of private creditors in total public external debt exceeds 25 percent (with Angola, Ghana, Cote d'Ivoire and Zambia being the most prominent examples, with a private creditors' weight higher than or close to 50 percent). At the end of 2021, almost 60 percent of countries had no external bonds outstanding; however, the number of countries with outstanding external bonds has increased from less than 10 to 29 during the last decade.

[21] LICs as a whole received the equivalent of US$ 26 billion in new SDRs (around 1 percent of their combined GDP).

A major feature of the current global financial architecture is the lack of an international statutory framework for resolving sovereign debt. Therefore, crises are usually handled through established practices and workouts are implemented on a case-by-case basis[22]. Official bilateral claims are mostly treated via the Paris Club, while the restructuring of liabilities towards private creditors is typically implemented through market-led processes. The involvement of private creditors mainly relies on the so-called contractual approach, through the use of Collective Action Clauses (CACs) in sovereign debt contracts allowing a qualified majority of creditors to change the terms of the debt agreement.

Moreover, restructurings are more challenging now than in the past, due to the increased complexity of debt structures in terms of instruments and lenders, which makes an effective coordination of all creditors more difficult to achieve. Another key feature of the current debt landscape is the presence of a very large and dominant bilateral creditor, which is not a permanent member of the Paris Club.

4.1 The presence of a very large official bilateral creditor

China holds 52 percent of total official bilateral debt of all CF-eligible countries, and 16 percent of their total public external debt. China's claims are 3.5 times bigger than those of the second most important bilateral creditor (Japan). By contrast, in the mid-1990s the share of the biggest bilateral lender did not exceed 20 percent of HIPCs' total bilateral debt and 10 percent of their total external debt (Fig. 28). Following a reduction in private creditors' exposures during the first half of the 1990s[23], the debt of the HIPCs in 1996 was mostly official and a large majority of it widely distributed among a group of like-minded and mainly advanced countries, directly through their bilateral exposures or indirectly through the IFIs, of which they were the main shareholders (Fig. 29). This situation is likely to have finally facilitated the attainment – although not without difficulties and substantial delays – of an agreement on debt restructurings.

Fig. 28

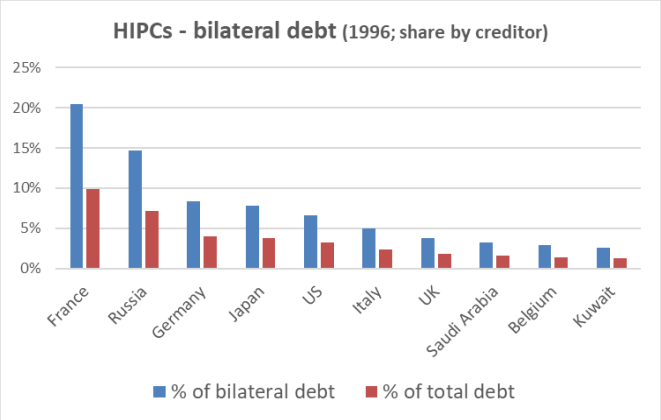
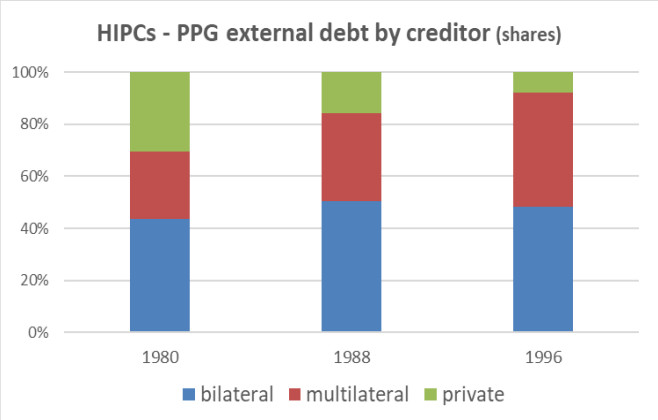


Fig. 29



Source: IDS.

A settlement among creditors must be reached today in a very different situation, where G20 emerging economies hold over 60 percent of LICs' external bilateral debt, while G20 advanced economies (which remain the dominant shareholders in the IFIs) account for less than 30 percent.

[22] On sovereign debt restructuring processes, see: Buchheit et al. (2019) and Hagan (2020).

[23] From 1988 (when the debt problems emerged more clearly and the international community started to provide debt reschedulings involving net present value reductions) and 1996 (year of the official agreement on the HIPC Initiative), private creditors' nominal claims towards HIPCs fell by almost 40 percent, and their share in HIPCs' total public external debt halved from 16 to 8 percent.

In this context, the CF is an important milestone, as it brings together Paris Club and non-Paris Club official bilateral creditors in a coordinated process to deliver jointly on debt treatments. The CF represents a sort of an augmented format of the Paris Club, in an attempt to bring to the creditors' table some key actors who are not permanent members of the Paris Club (China in the first place), with procedures largely based on similar working modalities.

The CF presents some similarities as well as differences with the HIPC initiative. Both have a restricted eligibility, with beneficiary countries selected mainly through an income per capita criterion (while there is a strong overlapping, the number of countries eligible to the CF is larger as the criteria are relatively less restrictive[24]). Another common feature is the link to various policies, procedures and principles of the Paris Club, which can be seen in the requirement of an IMF program, the technical support provided by the IMF and the World Bank, and the reliance on the principle of comparability of treatment.

One of the main differences is that the HIPC established standardized, common terms of debt restructurings, while the CF entails a more flexible, case-by-case approach, aimed at providing debt treatments tailored to the specific circumstances of each requesting debtor country. The more flexible approach of the CF is justified by the increased complexity of the debt landscape and the greater heterogeneity of today's debt structures. Another important difference concerns the direct involvement of multilateral creditors in debt restructurings, which is not expected in the CF (see infra par. 4.4).

Compared to the long process that led to the establishment of the HIPC Initiative, the CF can be seen as a quicker recognition by the international community of the need to have appropriate tools to deal with the problem (see paragraph 3). However, the delays and implementation issues experienced in the first cases of its application[25] have raised concerns about the ability of this mechanism to deliver on its intended goals.

Since the CF is currently the only coordinated multilateral mechanism to provide needed debt relief, G20 cooperation is essential to translate this agreement into tangible results through its effective operationalization. Some measures have been proposed to improve the framework and facilitate the achievement of timely and orderly debt restructurings[26], but they have not yet gathered the full consensus of all stakeholders, including China.

Streamlining and accelerating the process with greater clarity on its different steps and timelines, while maintaining the case-by-case approach of the CF, could help mitigate the "too late" part of the "too little, too late" problem of sovereign debt restructurings[27]. It would also accelerate the engagement of the country with the IFIs and its commitment to the necessary reform program. At the same time, faster processes need to preserve the "quality" of restructuring operations, minimizing the risk of too hasty workouts leading to a lowering of standards (e.g. in terms of policies), or to "too little" (i.e. too shallow) restructurings. The goal should be to achieve - within a reasonable time - deep enough treatments to restore debt sustainability.

[24] IDA-eligible and Least-Developed countries for the CF (same as for the DSSI), against IDA-only highly indebted countries for the HIPC Initiative. This results in 73 countries potentially eligible to the CF, against 39 for the HIPC Initiative. On key similarities and differences between HIPC and current initiatives, see also Essers and Cassimon (2021).

[25] These delays and implantation challenges are also believed to have engendered a low confidence in the mechanism by eligible countries. Despite the existence of widespread debt vulnerabilities, only three requests of debt treatment (from Chad, Ethiopia and Zambia) have been made in the first two years since the launch of the CF.

[26] Georgieva K. and Pazarbasioglu C. (2021), "The G20 Common Framework for Debt Treatments Must Be Stepped Up", IMF Blog, 2 December 2021.

[27] IMF (2013), "Sovereign Debt Restructuring: Recent Developments and Implications for the Fund's Legal and Policy Framework", 26 April 2013; Graf von Luckner et al. (2021), "External sovereign debt restructurings: Delay and replay", VoxEU.org, 30 March 2021. The "too little, too late" problem is the observed tendency to avoid large restructuring exercises, which often leads to a sequence of several interim restructurings before a crisis is brought to an end.

Moreover, the framework could benefit from more clarity on the concrete application of the principle of comparability of treatment, which is key to promote a fair burden sharing among all creditors (including private lenders) and increase the prospects for positive outcomes. Currently, the principle is assessed on the basis of three broad parameters (changes in nominal debt service, debt stock in net present value terms and duration of the treated claims), leaving a high degree of uncertainty and discretion in its application. Enhanced methodological clarity, in particular through the use of a single and transparent indicator in terms of net present value reduction, could facilitate the enforcement of the principle[28].

The presence of a dominant bilateral creditor, which is not familiar with the traditional procedures used by the Paris Club, can slow down decisions and require time for all actors to gain comfort with the restructuring processes. At the same time, it also implies that reaching a consensus on some adjustments to the CF, and getting all the main creditor countries fully engaged in the process, could substantially enhance its implementation and accelerate debt restructurings. In light of the serious and rising debt problems in LICs, finding effective and lasting solutions is certainly in the interest of all actors involved.

4.2 The involvement of private creditors

Past experience highlights that it is challenging to secure private sector involvement in debt restructurings. The weak participation of private creditors to the HIPC Initiative did not have significant repercussions, due to the limited share of debt held by commercial lenders at the time[29]. In the current context, this issue is more relevant, considering the comparatively higher weight of private creditors in LICs' debt structure.

But the involvement of private creditors is now also more difficult to achieve. This reflects the changes occurred in the nature of private creditors' claims, with a shift from primarily bank loans in the case of the HIPCs to a more diversified funding mix, including a higher reliance on bond issues. The fragmentation of holdings among a large number of creditors, with different preferences, interests and accounting practices, makes it more difficult to coordinate all creditors and reach an agreement. While contractual innovations, such as enhanced CACs, mitigate these collective action problems by reducing (but not eliminating) the risk of holdout creditors blocking a restructuring operation, there is still a significant outstanding legacy stock of international sovereign bonds without enhanced CACs[30]. Moreover, syndicated loans and sub-sovereign debt often lack similar provisions allowing a qualified majority of lenders to agree an amendment of payment terms.

Official debt relief through the CF entails an obligation of the beneficiary country to seek comparable debt treatments from all its private creditors (as well as non-G20 official bilateral creditors). Leaving apart the already mentioned technical difficulties in assessing the comparability of treatment among a plethora of very heterogeneous creditors and instruments, there are no legal means of enforcing this obligation[31]. Some indirect means have been used by the Paris Club to incentivize comparable treatment, such as the frequent practice of offering "flow-based" debt relief instead of upfront write-offs

[28] Rivetti D. (2022), "Achieving Comparability of Treatment under the G20's Common Framework", Equitable Growth, Finance and Institutions Notes, Washington, D.C.: World Bank Group.

[29] As already mentioned in the main text, the low share of private creditors at the start of the HIPC was also a consequence of the progressive reduction in exposures that they carried out in the years preceding the launch of the initiative. It must be noted that, on the other hand, the involvement of private creditors – mainly commercial banks – was at the center of the resolution of the middle-income countries' debt crises in the 1990s (through the Brady Plan; see footnote 12).

[30] IMF (2020b), "The International Architecture for Resolving Sovereign Debt Involving Private Sector Creditors - Recent Developments, Challenges, and Reform Options", Policy Paper 2020/043. Despite the progress recorded in the uptake of these clauses in new bond issuances, there is still a legacy debt without enhanced CACs accounting for around half of the total outstanding stock of international sovereign bonds.

[31] The data on creditor participation to the HIPC debt relief presented in paragraph 2.1 highlight that comparable treatment by private creditors and by non-Paris Club creditors has indeed fallen short of expectations.

(i.e. changes in the profile of debt service repayments that leave nominal debt unaffected but reduce its present value), which facilitates the possibility of reversing the relief if the comparability of treatment is ultimately violated[32]. The enforcement of the principle can also be supported by the application of the IMF lending into arrears policy, which allows the Fund (under certain conditions) to extend financial assistance to countries even in the presence of payment arrears to uncooperative external creditors.

4.3 The issue of debt transparency

An additional obstacle to effective restructurings is the lack of full transparency regarding debt amounts and lending terms. As highlighted by a 2021 World Bank's study[33], several LICs had not published or updated any sovereign debt data in the previous two years. When available, the coverage of statistics tends to be quite partial, often limited to central government loans and securities while omitting other public sector entities, as well as non-standard debt instruments and contingent liabilities (such as those arising from guarantees and public-private partnerships).

Transparency challenges are particularly acute for some debt instruments and operations. Domestic debt markets, towards which developing countries have increasingly turned to in recent years to meet their financing needs, tend to be opaque, with only a minority of LICs using market-based auctions as the main issuance mechanism. External loans can also be a source of non-transparent operations, as they are not traded in official markets and are more likely to include confidentiality clauses. Collateralized loans, especially those backed by natural resources or unrelated revenue streams, are a source of specific concern: these operations are often not reported in debt statistics (being frequently contracted by state-owned enterprises or special purpose vehicles outside the coverage of public debt data), and collateralization details are very rarely disclosed (due also to the large use of confidentiality clauses in these contracts).

The international community has promoted several initiatives in recent years to improve debt transparency. On the debtors' side, the IMF and the World Bank are carrying out a range of programs to enhance debt transparency as part of their Multipronged Approach for Addressing Emerging Debt Vulnerabilities. On official creditors' side, G20 Finance Ministers and Central Bank Governors endorsed in 2017 the Operational Guidelines for Sustainable Financing (OGSF), which cover 5 areas including information sharing and transparency. Regarding private creditors, the Institute of International Finance (IIF) delivered in 2019 a set of voluntary Principles for Debt Transparency, with the goal of promoting consistent and timely disclosure of private sector financial exposures to low-income countries.

Despite some positive results obtained through these initiatives, further progress is needed and a transparency agenda remains of critical importance. Some G20 countries have not participated to the self-assessment exercises aimed at gauging the degree of compliance with the best practices recommended by the OGSF. Following up on the IIF initiative, the OECD has launched a repository portal to host and disseminate the transaction-specific data voluntarily submitted by participating financial institutions, but adherence to the initiative has so far been limited.

4.4 The role of Multilateral Development Banks

A further issue concerns the role of multilateral creditors. The CF does not require these institutions to participate in debt restructurings. This could seem in contrast with the principle that successful

[32] ECB (2021), "The IMF's role in sovereign debt restructurings", Occasional Paper Series No. 262. In theory, non-compliance with the commitment of seeking comparable treatment could be sanctioned by a suspension of the agreement. However, this is very difficult to implement in practice and the Paris Club seems to have never withdrawn a debt treatment on comparability grounds (G30, 2021, "Sovereign Debt and Financing for Recovery after the COVID-19 Shock: Next Steps to Build a Better Architecture", G30 Working Group on Sovereign Debt and COVID-19).

[33] Rivetti D. (2021), "Debt Transparency in Developing Economies", World Bank Group.

restructurings are facilitated by the full participation and a fair burden sharing among all creditors, considering the large share of LICs' debt currently held by multilaterals. This preferential treatment (so-called Preferred Creditor Status or PCS) reflects primarily the idea that these institutions perform the special role of providing sovereigns with low cost financing in times of financial stress, when funding from capital markets usually dries up. The IMF performs this role in the context of its key "lender of last resort" function, and the Multilateral Development Banks (MDBs) as trusted development partners, supporting borrowing countries not only with financial resources, but also technical assistance and an external anchor to push through development policies.

The PCS is a de-facto status: while having no legal foundation, it has been validated empirically by the behavior of borrowers in distress (which have rarely accumulated arrears to multilateral institutions even when defaulting on private obligations), and is also supported by Paris Club's practices, regularly exempting IFIs from its restructuring operations. As seen in paragraph 2, the main multilateral institutions were involved in the HIPC Initiative and the MDRI, but in order to protect their finances and the PCS, the costs of debt relief were fully covered through special trusts funded in large part by bilateral contributions from their wealthy members.

The participation of multilaterals to the CF, without the direct coverage by donors of the related costs, would impinge on their PCS and have negative consequences on their business and financial models, eroding their lending firepower and ultimately the capacity to support their members.[34] This would be particularly damaging for developing countries, at a time when financing needs to bridge their development gaps are expected to be very sizeable. This position is rejected by China, which has repeatedly called for the involvement of MDBs in restructuring operations.

From a purely financial point of view, MDBs' participation in debt restructurings could reduce total losses for China as an official creditor. A more widespread creditor involvement in debt relief efforts would in fact decrease the shares of the costs to be borne directly by official bilateral creditors (as well as private creditors). For China, being the dominant bilateral creditor, these benefits would be substantial, while the losses that it would bear as a member of the MDBs participating to the debt restructurings would be rather limited, reflecting the relatively low shares of China in the capital of these institutions.

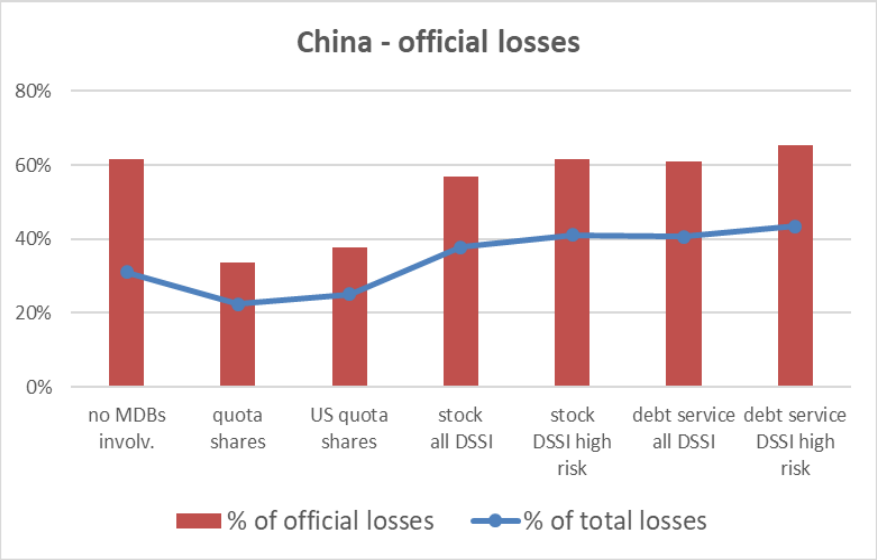
Back-of-the envelope calculations, based on a fully hypothetical scenario of a 25 percent overall haircut on the external debt of all DSSI-eligible countries assessed as in debt distress or at high risk of debt distress, suggest that China's official losses (on direct bilateral exposures plus its share of multilateral losses) could be 30 percent lower compared to a situation without the MDBs' involvement[35]. As a share of total official losses, the burden for China would go down from over 60 percent to below 40 percent[36] (Fig. 30). These estimates assume that MDBs' losses would be covered by their member shareholders, according to the respective capital quotas.

[34] De Marchi R. & Settimo R., (2021), "Will multilateral development banks weather the Covid-19 crisis?", Bank of Italy Occasional Paper 598.

[35] The calculations are performed using World Bank figures (at end-2021) on the size of individual exposures held by the main MDBs and bilateral creditors, complemented by data on each MDB's shareholding structure. For the World Bank (IBRD and IDA), the shareholding structure of the IBRD is used (qualitatively similar results are obtained by calculating IDA shares using its members' percentages of voting power).

[36] Without the MDBs' involvement, a hypothetical 25 percent debt reduction would need to be covered entirely by official bilateral and private creditors, implying a loss of 40 percent on their exposures. The participation of the MDBs would reduce the haircut applied to each creditor to 26.6 percent (slightly higher than the 25 percent overall debt reduction due to the exclusion of IMF claims from debt restructurings). China's estimated losses reflect also its especially large exposures towards riskier debtors: China's share in total official bilateral debt of DSSI-eligible countries in debt distress or at high risk of debt distress is 62 percent, higher than its share calculated with respect to all DSSI-eligible countries (52 percent).

Fig. 30



Source: calculations based on IDS data and MDBs' shareholdings. Fully hypothetical assumption of a 25 percent overall haircut on the external debt of all DSSI-eligible countries assessed as in debt distress or at high risk of debt distress. Official losses are the sum of the direct losses on bilateral claims and the share of MDBs' costs. In the scenario "no MDBs involv.", MDBs are excluded from debt restructurings. The other scenarios imply the involment of MDBs and differ on how the related costs are covered among official bilateral creditors:

- *quota shares*: in proportion to MDBs' current capital shares;
- *US quota shares*: in proportion to MDBs' capital shares and by assuming China's shares rising to US levels;
- *stock all DSSI*: in proportion to the weights in PPG external bilateral debt stock of all DSSI-eligible countries;
- *stock DSSI high risk*: in proportion to the weights in PPG external bilateral debt stock of DSSI-eligible countries in debt distress or at high risk of debt distress;
- *debt service all DSSI*: in proportion to the weights in PPG external bilateral debt service (2021-2024 period) of all DSSI-eligible countries;
- *debt service DSSI high risk*: in proportion to the weights in PPG external bilateral debt service (2021-2024 period) of DSSI-eligible countries in debt distress or at high risk of debt distress.

As a merely theoretical exercise, it is also possible to estimate what would happen in a scenario where China's shareholding quotas in each of the various MDBs are increased to the levels of the United States. In this case, China's total official losses would obviously increase compared to the scenario with current MDBs' quota shares, due to the need to absorb a higher relative burden of MDBs' costs. However, this increase would be quite moderate and China's total official losses would remain significantly below than in the case without MDBs' involvement, confirming the key dilution effect produced on the losses related to China's large bilateral claims.

Another possibility of financing MDBs' involvement, which would safeguard their PCS and credit rating, is for the related costs to be fully compensated by contributions from bilateral creditors, calculated in proportion to their relative weights as creditors to DSSI-eligible countries. There are several modalities through which these weights could be calculated, by relying on debt stocks or debt service payments, and with reference to all DSSI-eligible countries or only to the subset represented by the countries assessed as in debt distress or at high risk of debt distress. While some minor differences among them exist, all these modalities lead to approximately similar outcomes, and in particular to a common result: the financial benefits for China stemming from MDBs' involvement in debt restructurings would in essence disappear if MDBs' losses were to be covered by bilateral creditors according to their respective debt holdings, instead of their MDBs' shareholding quotas. In some scenarios, China's official losses could even be slightly higher than in the case without MDBs' involvement[37].

[37] This would be the case if the burden sharing of MDBs' losses among bilateral creditors were based on their respective shares in the total debt service of DSSI-eligible countries in debt distress or at high risk of debt distress. This reflects the relatively higher share of China in the debt service (rather than debt stock) of riskier countries (rather than all DSSI-eligible countries).

It is important to reiterate that these estimates are very rough approximations, based only on publicly available aggregated data and with a set of strong assumptions and simplifications. They nevertheless provide some qualitative insights that can be useful in framing these issues.

Irrespective of the question of their involvement in debt treatments, multilateral institutions (with the backing of their membership) will have a crucial role to play in supporting LICs, by providing them with financial support not only of an adequate size but also at appropriate financing conditions, with due consideration to the already high debt levels and limited space to accumulate further liabilities. By providing resources at favorable terms, through grants and concessional loans, multilateral institutions provide an implicit "ex-ante" debt relief, without endangering their PCS and business model[38].

4.5 The issue of domestic debt and the importance of the use of resources

The relatively higher share of domestic debt in LICs' total public debt, compared to the HIPCs whose debt was mostly external, suggests that domestic liabilities could have a potential role to contribute to future restructurings. However, restructuring debt issued under domestic law brings specific challenges and implications. While it can be relatively easier to accomplish as sovereigns have considerable flexibility to change the terms of debt contracts, it can have adverse effects especially in terms of financial stability and economic activity. In a recent paper[39], the IMF therefore suggests to "handle with care" sovereign domestic debt restructuring, with an accurate assessment of its net benefits, that is, the benefits of a lower debt burden against the associated financial and economic costs.

Finally, the experience of the HIPCs' debt crisis shows that debt relief is a necessary but not sufficient condition for lasting debt sustainability. It is an instrument to reduce unsustainable debt stocks and to remove a key obstacle to growth and poverty reduction, but long-term debt sustainability requires complementary actions to promote sustainable growth, income and ultimately capacity to repay. These actions involve not only debtor countries, but also development partners, through technical assistance and financing to support growth-enhancing reforms and promote sustainable debt dynamics.

The "use of resources" freed up by debt relief is therefore a crucial aspect and calls for appropriate conditionality standards, paying due attention to targeting both social spending and structural reforms.[40] On this latter front, the list of reforms is long and should include (as seen in previous paragraphs) measures aimed at improving governance and institutional quality, as well as promoting a higher degree of economic diversification. Considering the high exposure of several LICs to the effects of climate change, investments in mitigation and adaptation are also a priority, and can encourage donors to provide more substantial debt relief due to the global public good nature of this issue.

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[38] Following the previous international debt relief initiatives, in 2002 IDA (the biggest multilateral lender to low-income countries) introduced a framework allowing it to provide support also through grants, in addition to loans. The only criterion for grant eligibility is countries' risk of debt distress (according to the IMF-WB Debt Sustainability Framework for LICs). The IDA grant allocation framework translates the debt distress risk ratings into a traffic light system to determine the share of IDA grants and highly concessional IDA credits for each country: high risk or in debt distress ("red" light) is associated with 100 percent grants, medium risk ("yellow" light) with 50 percent grants and 50 percent credits, while low risk ("green" light) is associated with 100 percent credits and zero grants. The allocation of grants could therefore be considered a form of "ex-ante" debt relief, which supports debt sustainability of countries with higher risk of debt distress.
Since the introduction of the framework, IDA's grants to all DSSI-eligible countries have amounted to US$ 43 billion (in the period from 2002 to 2021), representing 22 per cent of all IDA commitments to the same countries.

[39] IMF (2021), "Issues in Restructuring of Sovereign Domestic Debt", IMF Policy Paper, November 2021.

[40] With regard to the HIPC, a World Bank's independent evaluation raised an issue related to the conditionality mix attached to the initiative. Noting that growth is critical for both debt sustainability and poverty reduction, the evaluation observed that "the initiative places a heavy emphasis on social expenditures as the primary means of poverty reduction. The initiative's performance criteria should be better balanced between growth-enhancing and social expenditure priorities, and tailored to the individual country circumstances" (World Bank, 2003).

5. Conclusions

Past debt relief initiatives illustrate the difficulties involved in achieving comprehensive debt restructurings. Moreover, today's significantly changed creditor composition precludes the possibility of relying on solutions similar to those applied to reduce LICs' debt in the past. In this context, the extent of the current debt problems and the strong creditor coordination challenges make it urgent to substantially enhance the implementation of the Common Framework.

In addition to the time naturally needed for all actors to get familiar with a new process, the weak performance of the framework so far reflects also sharp disagreements on some of its key features. Advanced economies, while holding a relatively limited share of total LICs' debt, are showing a united stance aimed at steering G20 discussions towards procedural improvements, such as greater clarity on the various restructuring steps and the introduction of a debt service standstill during the negotiations. China, on the other hand, calls for the direct involvement of MDBs in debt restructurings, and simultaneously pushes for extending the scope of G20 negotiations by calling for capital increases at these institutions.

The distributional conflict between advanced economies and China regarding the allocation of the losses deriving from debt restructurings appears difficult to solve at this stage. This conflict could develop in the medium term depending on China's ability to contain the losses associated with its large bilateral exposures. It could also be affected by any possible differential impact exerted on advanced economies and China by a prolongation of LICs' debt crisis, as well as by the growing relevance of MDBs' credits towards LICs in a scenario where MDBs are called on to provide LICs with large net positive financial flows.

Against the background of this distributional conflict, the achievement of an agreement on the allocation of the losses stemming from debt restructurings requires an overall bargain among all the main creditors. One possible avenue, among others, could be for the advanced economies to consent to MDBs' capital increases coupled with a rise of China's shares, in exchange for the exclusion of MDBs from restructuring operations. Another possibility could be to include MDBs' claims in debt restructurings but fully offset MDBs of the related losses, with contributions calculated through a system based on a mix (with appropriate shares to be decided) of shareholding quotas and official bilateral exposures. While not yet discussed and therefore still purely theoretical at this stage, the aforementioned hypotheses could add further elements to the debate on how to overcome the current stalemate and accelerate debt restructuring processes.

Annex I

The classification of low-income countries

The expression "low-income countries" (LICs) is often used to generally refer to a group of countries with low GDP per capita and a limited degree of economic development. There are, however, several classifications, formulated by various institutions and differing in terms of purposes, identification criteria, number of countries included and their share in world GDP[41] (see table and charts).

Some classifications (LIC of the World Bank, LDC of the United Nations and LIDC of the IMF) are mainly employed for analysis, while others also have operational purposes as they are used to identify the countries eligible for IFIs' concessional financing or specific debt relief initiatives[42]. The main common identification criterion is the per capita income, but the thresholds are different and in some cases other complementary criteria are used. The different criteria lead to some divergence in terms of number of countries included (varying from 28 to 74) and their combined weight on world GDP (between 0.9 to 5 percent based on purchasing power parity (PPP), and from 0.5 to 2.6 percent at current prices and exchange rates).

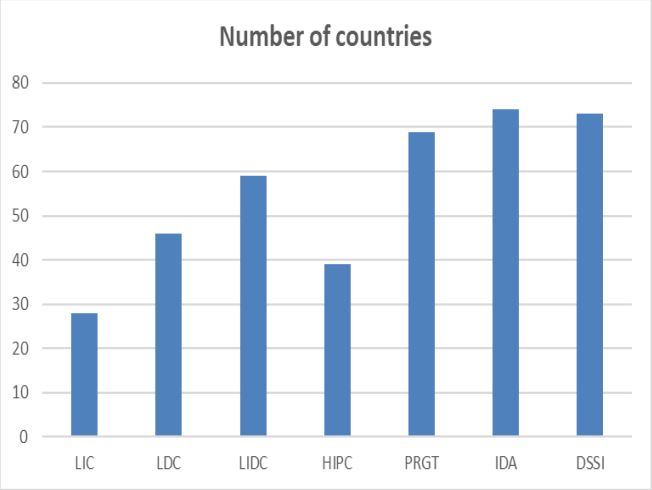
In this paper, the term "LICs" is used to refer to the group of DSSI-eligible countries. This choice is motivated by two main reasons. First, it is one of the largest aggregates, comprising 73 countries with a share in world GDP of 5 percent based on PPP and 2.6 percent at current prices and exchange rates. Moreover, this group is of interest as it is the target of the G20 debt relief initiatives launched in the aftermath of the pandemic (Debt Service Suspension Initiative and Common Framework).

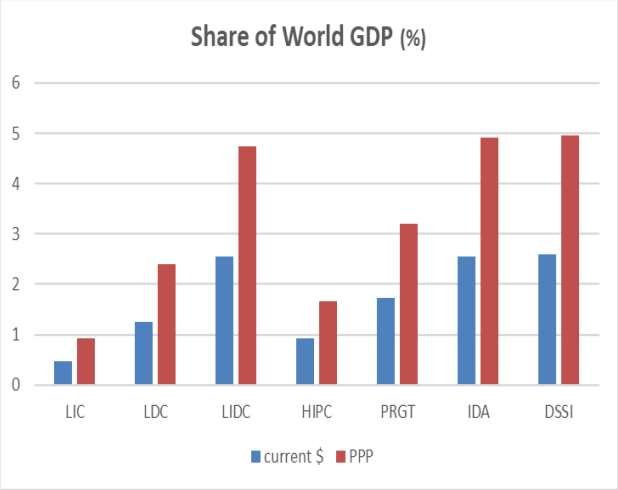
DEFINITION	NUMBER of COUNTRIES	SHARE OF WORLD GDP (2021)		MAIN CRITERIA
		PPP	CURRENT $	
Low Income Country - LIC (WB)	28	0.9%	0.5%	GNI per capita
Least Developed Country - LDC (UN)	46	2.4%	1.3%	GNI per capita + others
Low Income Developing Country - LIDC (IMF)	59	4.7%	2.6%	GNI per capita
HIPC	39	1.7%	0.9%	Debt situation
PRGT-eligible (IMF)	69	3.2%	1.7%	GNI per capita
IDA eligible (WB)	74	4.9%	2.6%	GNI per capita
DSSI eligible	73	5.0%	2.6%	IDA+LDC

[41] For all classifications, the data reported refer to the latest composition (as of September 2022), which may vary over time as the relevant parameters change (HIPC and DSSI have a stable composition, as they have determined, at a given time, the eligibility of a country to benefit from a specific debt relief initiative).

[42] The classification of HIPC (Highly Indebted Poor Countries) was actually coined initially for purposes of analysis, and was later employed also to identify the countries eligible to the homonymous debt relief initiative.

LIC (WB)	GNI per capita < $ 1,085
LDC (UN)	Countries confronting severe structural impediments to sustainable development. 3 criteria: GNI per capita <= $1018 ; Human Assets Index (HAI); Economic and Environmental Vulnerability Index (EVI)
LICD (IMF)	Per capita income below a certain threshold ($2,700 in 2016), structural features consistent with limited development and structural transformation, and insufficiently close external financial linkages
HIPC	Unsustainable debt situation and eligible for highly concessional financing from WB and IMF
PRGT (IMF)	GNI per capita below IDA operational cutoff (currently $1,255) and no capacity to access international financial markets on a durable and substantial basis
IDA (WB)	GNI per capita below threshold updated annually (currently $1,255)
DSSI	IDA + LDC (current on debt service to IMF and WB)





Annex II

The main drivers of the recent debt accumulation in LICs

This annex uses a simple accounting framework to decompose into 3 main drivers the change in the average public debt to GDP ratio recorded in LICs since 2008.[43]

One of the key factors behind the debt dynamics is represented by persistent primary deficits, which have cumulatively contributed more than 20 percentage points to the increase in the average debt to GDP ratio (see charts A and B, blue bars).

A considerable influence (in the opposite direction) has been exerted by the so-called "snowball effect", which is directly related to the difference between the average nominal interest rate paid on the stock of debt and the nominal GDP growth rate (interest rate-growth differential, i-g)[44] . The "snowball effect" has pushed down substantially the average debt to GDP ratio, as a result of a persistently negative interest rate-growth differential (charts A and B, yellow bars).

Chart A

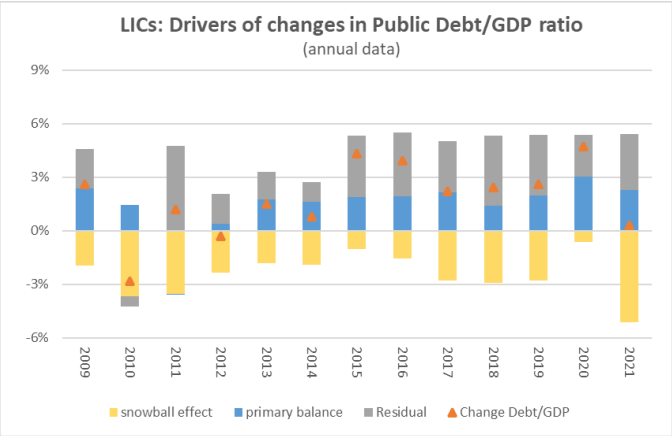
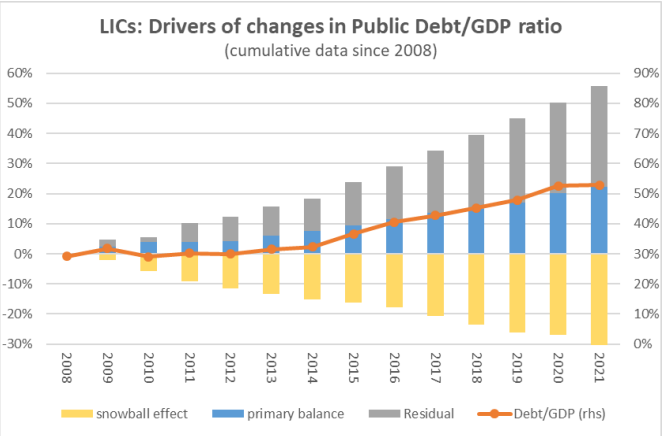


Chart B



Source: calculations based on IMF WEO and Fiscal Monitor.

As highlighted by IMF analysis[45], a low and negative differential is a common feature among non-advanced economies, and particularly low-income countries. This phenomenon, which constitutes a powerful debt-stabilizing force, stems primarily from levels of interest rates on government debt well

[43] The analysis is based on the typical debt accumulation equation (see also ECB, 2019):

$$\Delta b_t = \frac{(i_t - g_t)}{(1+g_t)} b_{t-1} - pb_t + dda_t$$

where Δb_t is the change in the debt to GDP ratio, i_t is the average nominal interest rate paid on debt, g_t is the nominal GDP growth rate, pb_t is the primary balance (as a share of GDP) and dda_t is the deficit-debt adjustment (or stock-flow adjustment) as a share of GDP. Leaving aside the last factor, the dynamics of the debt to GDP ratio is then mainly determined by the primary balance and the difference $(i_t - g_t)$. If the interest rate paid on the stock of debt is higher than the nominal growth rate $(i_t > g_t)$, stabilizing or reducing the ratio requires a primary surplus (the higher the initial level of debt, the higher the required primary surplus). Conversely, if the difference is negative, a country can stabilise or reduce the debt ratio even while running a primary deficit (as long as the impact of the primary deficit is equal to or lower than the effect induced by the interest rate-growth differential).

[44] The snowball effect is equal to the interest rate-growth differential (i-g) multiplied by the debt to GDP ratio in the previous period (and divided by 1+g). The average interest rate i is not a market rate, but represents an average of the cost of debt, obtained by dividing interest expenses in a certain year by the average stock of debt during the same year. Equivalent results are obtained by using real instead of nominal figures for both interest rate and growth.

[45] Escolano J., Shabunina A. and Woo J. (2011), "The Puzzle of Persistently Negative Interest Rate-Growth Differentials: Financial Repression or Income Catch-Up?", IMF WP/11/260.

below what would prevail in a competitive financial market, due to domestic market distortions and financial repression, as well as (especially in the case of low-income countries) highly concessional terms on external borrowing from official bilateral and multilateral lenders. A cursory look at the data shows, for example, that the interest rate–growth differential is negatively correlated with the degree of restrictions on capital outflows, which can be considered an important dimension of financial repression as they allow governments to maintain a captive market by limiting alternative investment opportunities to domestic savers[46]. LICs, in particular, exhibit on average more intrusive restrictions on capital outflows and a lower differential than emerging markets or advanced economies (chart C).

In LICs, the median interest rate-growth differential has averaged around minus 7 percent during the last 20 years. However, excluding the very large fluctuations observed in 2020 and 2021 as a result of the exceptional fall in economic activity and the subsequent recovery following the pandemic crisis, the differential has shown a clearly worsening trend in the last decade (chart D), reflecting both a rising average cost of debt and a slowdown in the pace of economic growth. In perspective, the economic outlook in LICs is surrounded by several risks, which could affect the level of the differential. The possibility of long-term scarring effects from the pandemic, coupled with the uncertainties related to the economic implications of the war in Ukraine, could hold back growth in several countries. Borrowing costs can be impacted by a stronger than anticipated rise in interest rates and risk premiums driven by the global tightening of monetary policies to mitigate inflationary pressures. Moreover, as both interest rates and growth rates in LICs tend to be highly volatile, a negative interest rate-growth differential can quickly turn positive and large.

Finally, another important driver has been the "stock-flow adjustment", a residual comprising all the other factors affecting the debt to GDP ratio and not included in the budget balance. The positive residuals (charts A and B, grey bars) suggest the existence of other factors pushing up the debt to GDP ratio in LICs during the last decade, such as the emergence of contingent liabilities and foreign exchange depreciation increasing the local currency value of debt denominated in foreign currencies.

Chart C

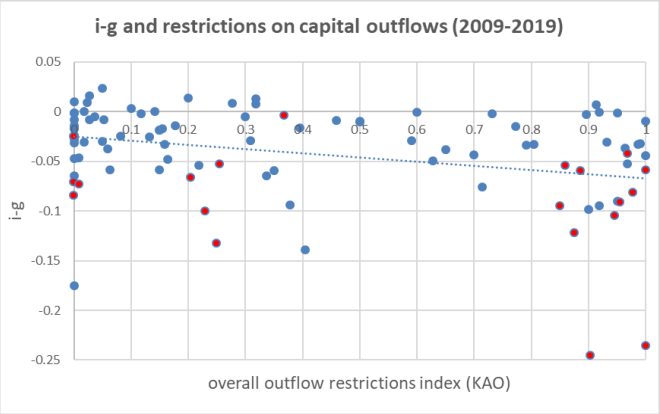
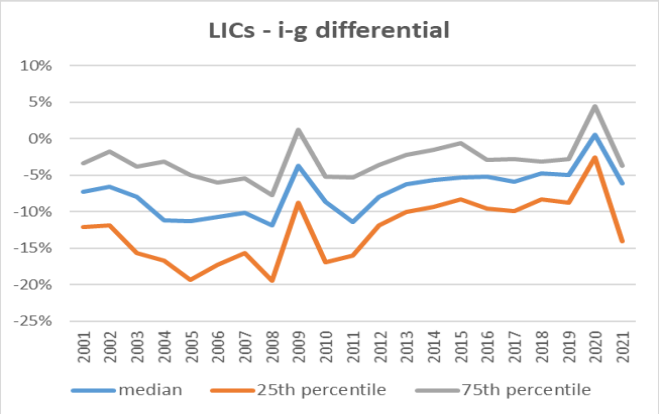


Chart D



Source: calculations based on IMF WEO; IMF Fiscal Monitor and Fernandez et al. (2016). In Chart C, the data points are averages per country during 2009-2019 and red points are LICs. A higher KAO implies a higher degree of restrictions on capital outflows.

[46] Through a formal econometric analysis, based on an annual panel data set of 128 advanced and non-advanced countries for the period 1999–2008, Escolano et al. (2011) show that various indicators of financial repression or lack of financial development are found to be significantly associated with lower real effective interest rates.

Annex III

The HIPC Initiative and the MDRI

The Highly Indebted Poor Countries (HIPC) Initiative was launched in 1996 with the main goal of reducing the excessive debt burden of the qualifying countries, thus removing an important obstacle to growth and poverty reduction in line with the logic of the "debt overhang theory"[47]. Later, with the revision of the initiative ("Enhanced HIPC"; see infra), the objectives were expanded, to include also the goal of releasing resources for social expenditures targeted at poverty reduction.

To be eligible for the HIPC, a country had to fulfill the following conditions:

1) face an unsustainable debt situation, identified by some external debt burden indicators being above specific thresholds (present value of debt higher than 150 percent of exports or 250 percent of government revenues);
2) be eligible for highly concessional assistance from the WB and the IMF;
3) having established a track record of reform under WB and IMF supported programs, and developed a Poverty Reduction Strategy Paper (PRSP) with broad-based participation by civil society.

The eligibility criteria indicate that the focus of the initiative was on debt sustainability, poverty and policy performance. The initiative includes a two-stage process. The first step is the "decision point", where the boards of the IMF and the WB, having judged that a country has met or made enough progress on the conditions listed above, formally decide that it is eligible to receive debt relief. This decision also implies the determination of the amount of debt relief, which is calculated by considering the relief effort needed to bring the debt burden indicators below their specific thresholds.[48] The second step is the "completion point", where countries receive full and irrevocable debt relief, after they have established a further record of good performance under IMF-World Bank programs, conditional upon the implementation of a set of key country-specific reforms agreed at decision point (so-called "completion point triggers").

In 1999, following the slow and limited progress recorded during the first years of the initiative, the HIPC was modified, as a response also to the pressure arising from the growing influence exerted by civil society organizations[49] (such as the "Jubilee 2000" campaign). The main changes introduced by the "Enhanced HIPC" were: i) the reduction of the thresholds for the debt burden indicators, which widened country eligibility and increased the amount of maximum debt relief; ii) the possibility of providing some interim debt relief between the decision and completion points; and iii) the introduction of a "floating completion point" (upon reaching the reform targets agreed at decision point), instead of the previous fixed three-year interim period between decision and completion points, with the aim of promoting country ownership and providing incentives to accelerate the reform process.

The HIPC Initiative was supplemented in 2005 with the adoption of the Multilateral Debt Relief Initiative (MDRI), whose main goal was to provide additional resources and free up fiscal space to support the achievement of the Millennium Development Goals set by the international community in 2000. The MDRI involved only multilateral creditors and allowed the full cancellation of these institutions' remaining claims towards countries having reached the completion point of the HIPC.

[47] The "debt overhang theory" was developed in some works of Krugman (1988), Sachs (1989) and Sachs (1990).
[48] The Common Reduction factor is the percentage reduction of debt applied to all creditors to bring the debt burden indicators below the thresholds.
[49] From 1996 to 1999, only 7 countries became eligible for debt relief. Following the revision of the initiative and an intensification of efforts by the World Bank and the IMF, by the end of 2000 22 countries had reached decision point.

The HIPC and MDRI are coming to their end. To date, 36 of the 39 potentially eligible countries have passed the completion point of the HIPC and received full and irrevocable debt relief (see Table). Two countries are in the interim phase, between the decision point (reached by Somalia in 2020 and Sudan in 2021) and the completion point. Eritrea is the only remaining pre-decision point country.

HIPC POST-COMPLETION POINT (36)			
Afghanistan	Congo, Dem. Rep.	Haiti	Niger
Benin	Congo, Rep.	Honduras	Rwanda
Bolivia	Cote d'Ivoire	Liberia	Sao Tome and Principe
Burkina Faso	Ethiopia	Madagascar	Senegal
Burundi	Gambia, The	Malawi	Sierra Leone
Cameroon	Ghana	Mali	Tanzania
Central African Rep.	Guinea	Mauritania	Togo
Chad	Guinea-Bissau	Mozambique	Uganda
Comoros	Guyana	Nicaragua	Zambia
HIPC POST-DECISION POINT (2)			
Somalia	Sudan		
HIPC PRE-DECISION POINT (1)			
Eritrea			

Source: IMF.

A debate exists about the "additional" character of these initiatives. The concept of additionality revolves around the question of whether debt relief provided supplementary resources to debtor countries, or it merely replaced other forms of aid from donors. In other words, were other (non-debt relief) transfers from donors at the same levels as they would have been in the absence of debt relief? Or did donors, on the contrary, cut back on other non-debt relief transfers in order to provide debt relief? Absence of additionality is a situation where donors simply reduce other flows, dollar for dollar, against the debt relief provided. On the opposite side, there is full additionality when donors preserve the same (non-debt relief) transfers they would have provided in the absence of debt relief. Intermediate situations between these two extremes are of course possible, as full additionality is likely to be hindered by the budgetary constraints of donor countries.

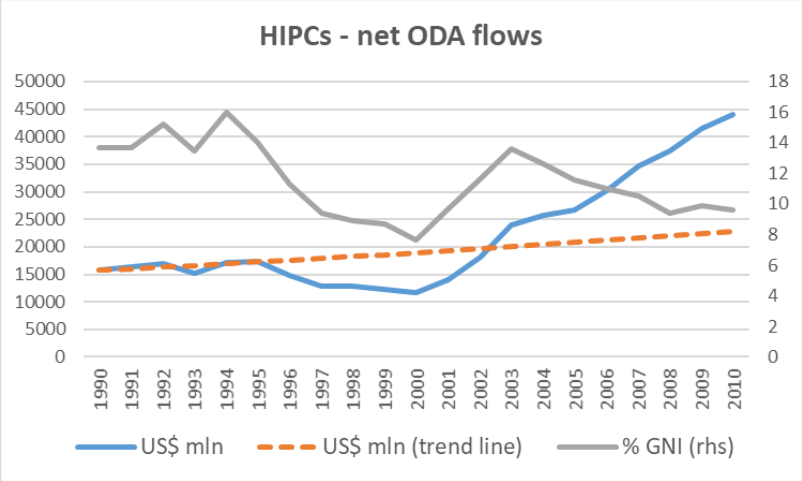
Assessing additionality is a difficult task, because it requires a judgment about the counterfactual, that is, the estimation of what resource transfers would have been without debt relief. A further complication is that, in principle, the assessment should also estimate how much of the forgiven payments would have actually been paid by the debtors, or would have instead entered into arrears and eventually turned into default (in this latter case, there would be no additional resources provided by debt relief).

Despite these difficulties, a rough assessment can be performed by projecting over time the same trend of net Official Development Assistance (ODA) flows towards HIPCs recorded in the 5 years immediately preceding the HIPC Initiative (from 1990 to 1995), and comparing this counterfactual with the flows actually observed. This simple exercise shows that, following a slowdown during the first years after the launch of the initiative, net ODA flows subsequently grew at a rapid pace (see Chart). This seems to

suggest that debt relief was (at least partially) additional in the aggregate, even if aid flows trended downwards as a share of HIPCs' gross national income[50].

It must be noted, moreover, that according to the "debt overhang theory", debt relief could bring benefits even in the absence of additionality, through incentive effects exerted on governments' reform efforts as well as public and private investment. Incentive effects refer to the fact that, in the presence of large indebtedness, the debtor's incentives to pursue the needed adjustment and meet its debt service payments might be distorted. This happens when the debt burden is so high that all the resources that a debtor country can generate through its maximum feasible adjustment effort will end up being spent in debt repayments. In this case, as the rewards would go entirely to the creditors, there is no clear motivation for the country to make the adjustment effort.

By reducing debt repayments to a level where the debtor can partly benefit from the outcome of its adjustment effort, debt relief can therefore provide the debtor country with an incentive to make the adjustment, and partially refrain from current consumption in favor of public investment that will pay out in the future. In addition, debt relief can also mitigate the negative effects that an elevated level of public debt has on private investment, due to the expectation of a future rise in taxation and a higher probability of a fiscal crisis.



Source: OECD. ODA: official development assistance. The trend line is constructed by linerly projecting the compound annual growth rate of net ODA flows recorded in the five-year period between 1990 and 1995.

[50] The period of HIPCs' strong economic growth that started in the early 2000s was a factor in driving the declining share of net ODA to recipient countries' GNI. On the issue of additionality, see also World Bank (2006).

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