Working paper 577

The role of debtors and creditors in preventing debt crises in low-income countries

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March 2020

This paper was commissioned to brief the Commonwealth senior-level meeting at the World Bank/ International Monetary Fund (IMF) Annual Meetings in October 2019 and reflects evidence and research up to that date.

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Acknowledgements

The author would like to thank the following people for helpful advice and reviews of drafts of this report: Annalisa Prizzon and Samantha Attridge (ODI), Matthew Martin (Development Finance International), Sanjay Kumar and Motselisi Matsela (Commonwealth Secretariat), and Tim Jones (Jubilee debt Campaign). We gratefully acknowledge the financial support of the Commonwealth secretariat who funded this report, and the Bill and Melinda Gates Foundation who funded some of the background research that fed into this report. The views expressed are those of the author alone and do not necessarily represent the views of funders.

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Acronyms

DSA	debt sustainability analyses
GDP	gross domestic product
GNI	gross national income
HIPC	Highly Indebted Poor Countries
IMF	International Monetary Fund
LDC	least developed country (UN classification)
LIC	low-income country (World Bank classification)
LIDC	low-income developing country (IMF classification)
MDRI	Multilateral Debt Relief Initiative
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
PPP	public–private partnership
PRGT	Poverty Reduction and Growth Trust
SCDI	state-contingent debt instrument
SDGs	Sustainable Development Goals
SDRM	sovereign debt- resolution mechanism
UN	United Nations
UN DESA	United Nations Department of Economic and Social Affairs
UNCTAD	United Nations Conference on Trade and Development
VAT	value added tax

Executive summary

In recent years, debt has been rising across the world and has reached worrying levels in a large number of low-income countries, which are most vulnerable to the damaging impact of debt crises. Finding ways to reduce the likelihood of debt crises in these countries should be at the top of policy-makers' agenda at the national, regional and international level.

This paper contributes to this policy discussion by providing an overview of the current debt situation, globally and in low-income countries, and setting out the imperative for action. It makes policy recommendations to debtors, creditors and international institutions.

Providing alternatives to borrowing

There is room to improve domestic tax and revenue collection in low-income countries to reduce the need for borrowing. However, this is often a significant challenge as low-income countries tend to have a significantly lower tax potential than other countries. In addition, the trend of offering tax incentives to increase investment, driven in part by international tax competition, is eroding the tax base in many developing countries.

Creditor countries and the international system play an important role in determining how easy it is to raise taxes in low-income countries, particularly taxes on wealthy individuals, multinational corporations and extractive industries. Financial secrecy and the use of offshore financial centres, and intra-company operations within multinational corporations allows tax avoidance and evasion in developing countries. In addition, 'spillover' effects mean tax policies in developed countries can erode the tax base in many developing countries.

However, as a recent ODI study showed, even if developing countries improved their tax collection to the maximum extent, 48 would still face public spending gaps to end extreme poverty (Manuel et al., 2018). To meet financing gaps that cannot be filled from domestic taxation or continued economic growth would require all donors to meet the 0.7% official development assistance (ODA) target (ODA as a share of gross national income, GNI) and direct half the money to least developed countries (LDCs), which is why failure to meet these ODA targets remains a major problem (ibid).

Managing the borrowing options that are available

It is critical for low-income borrowing countries to carefully understand and manage the opportunities, costs and risks of different sources of borrowing. However, the diversification of external borrowing leads to greater risks, which are complex to manage and often involve trade-offs. Unfortunately, capacity for debt management remains weak in many low-income countries, fuelled by lack of demand, accountability and political commitment.

It is important to recognise that lenders also have responsibilities in improving the borrowing options available to low-income countries. Creditors could offer state-contingent debt instruments (SCDIs), whereby repayments are paused if the borrower faces a difficulty in repayment and support changes to debt contracts to make restructuring easier, mandate 'standstills' on debt repayments during restructuring so that debtors can have additional fiscal space during a difficult period; and provide for independent mediation or arbitration mechanisms.

Improving lending and borrowing behaviour

There is considerable room for improvement in debt transparency at the country level, and increased transparency will enable domestic citizens and parliaments to provide incentives for governments to improve debt contraction, use and management. Data on public debt levels is incomplete, and the terms and conditions of the debt may not always be well understood by or available to key stakeholders. In addition, levels of contingent liabilities are high in many countries, meaning that without greater transparency, the real debt risks that low-income countries are facing remain hidden.

Transparency is a theme that international initiatives have taken up only to a limited extent. Good proposals include creating a mandatory public register of lending and requiring both multilateral actors and private-sector actors to use the register. The public disclosure of lending contracts would allow parliaments, journalists and civil society organisations to examine them, and would also allow other lenders to have the full information before making further loans.

There are various codes of conduct that attempt to bind creditors to a common set of lending principles. These codes make clear that the lender has a responsibility of due diligence to provide full information to borrowers, and ensure that this information is understood, and to estimate the likely impacts of project financing, including social and environmental impacts. Lenders also have a responsibility to consider the wider debt situation of the countries to which they are lending, including the broader financing situation and contingent liabilities. One common problem is that existing principles remain voluntary and there are no mechanisms to ensure that they have traction.

Dealing with shocks and crises

Ensuring debt is managed in relation to potential shocks is an important, but difficult, element of low-income countries' debt management. Increasing resilience to shocks should also be a part of a country's national development strategy. It is important to recognise, however, that there are limits to how much individual countries can be expected to insulate themselves from shocks. This is why the role of creditors and the international system is important.

The evidence shows that restructuring is a common feature of sovereign debt markets, suggesting that the focus should be on how to do this better. The starting point for debt restructuring processes is that the debtor state should take the lead. The development of a permanent mechanism for resolving sovereign debt problems has long been on the international agenda and should be revived. The key feature of such an institution is that it would be impartial, drawing upon expertise, with a legal basis that would make its decisions binding. In addition, fast-disbursing international finance to help low-income countries deal with temporary shocks should be promoted.

1 Background and current context

Debt crises can cause major economic disruption, set back development, and have long-term negative consequences, with defaults taking as long as 15 years to resolve in some cases (Trebesch, 2019: 421). Borrowing is an important source of government finance to invest in productive activities, to smooth expenditure and to fund government programmes. However, unsustainable debt can place a burden on countries – reducing revenues for other expenditures and affecting macroeconomic performance by, for example, causing balance of payments crises or influencing investment decisions.

In recent years, debt levels have been rising across the world and have reached worrying levels in a large number of low-income countries, which are most vulnerable to the damaging impact of debt crises. (For a note on the terminology used for low-income countries, see Box 1.) Finding ways to reduce the likelihood of debt crises in these countries should be at the top of policy-makers' agenda at national, regional and international level. This paper, which was commissioned to brief the Commonwealth senior-level meeting at the World Bank/International Monetary Fund (IMF) Annual Meetings in 2019, contributes to this policy discussion by setting out the range of options for debtors and creditors to reduce the risks of debt crises in low-income developing countries, making specific suggestions for the Commonwealth.

This chapter summarises briefly the global debt situation, before focusing on the public debt situation in low-income countries. The following chapter summarises the historical evidence on potential causes of debt crises and efforts to resolve them, after which chapters 3 and 4 examine the roles that debtors, creditors and the international system could play in efforts to reduce the likelihood of debt crises. The final chapter provides policy recommendations.

Box 1 Low-income countries: a note on terminology

There are several different ways of classifying low-income countries, including the World Bank's low-income country (LIC) grouping,[i] the IMF's low-income developing country (LIDC) grouping[ii] and the United Nations least developed country (LDC). Different sources used in this paper use different groupings, principally LIDC and LIC. The main difference is that the LIDC group has a higher income cut-off level ($2,700 per capita) compared with the LIC group ($1,025 per capita), resulting in a larger set of countries. For ease of understanding, this paper uses the term 'low-income countries' throughout but each time the source is an IMF source, the reader should be aware that it refers to LIDCs. Of the 53 Commonwealth countries, seven are classified as LICs and 16 as LIDCs, meaning that a significant proportion of the Commonwealth are low-income countries.

[i] World Bank (n.d.); [ii] IMF (2018).

1.1 The global debt situation

Global debt – both public and private – reached an all-time high of $184 trillion in 2017, equivalent to 225% of gross domestic product (GDP) (IMF, 2019a: 3). This is part of a long-term trend of increasing debt levels driven by increases in private debt, which has tripled since 1950. High levels of private debt represent risks not just for overall economic performance, but also for future levels of public debt, as we shall see in chapter 2.

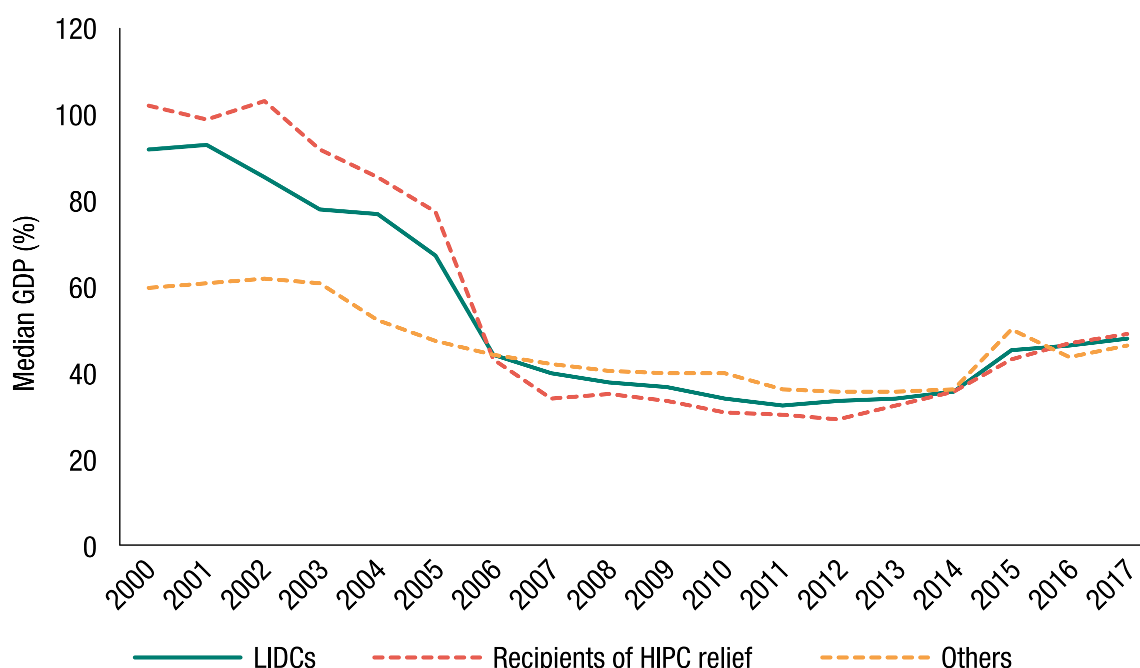
Public debt-to-GDP ratios have risen for all categories of countries over the past 10 years. They remain highest in high-income countries but have been rising most rapidly in low-income countries. High-income countries experienced a dramatic increase in public debt in response to the global financial crisis of 2007–2008, with average debt-to-GDP ratios rising to above 100% of GDP by 2011 before stabilising. In contrast, debt-to-GDP ratios only began to rise in middle-income countries in 2013 and reached 51% of GDP by 2018, while low-income countries have seen a major increase in debt to GDP since around 2014, though it was rising before this (IMF, 2019a: 77).

1.2 The public debt situation of low-income countries

Public external debt in low-income countries has been rising since around 2013 (Figure 1). As a percentage of GDP, low-income countries' median public debt rose to 47% in 2017, up from 33% in 2013. Only eight countries did not see an increase in public debt levels during this period (IMF, 2018).

The number of low-income countries facing serious debt problems is rising rapidly, with 42% at high risk of or already in debt distress – a number that has almost doubled since 2013 (Figure 2). As of July 2019, the IMF classified seven countries as being in debt distress,[1] of

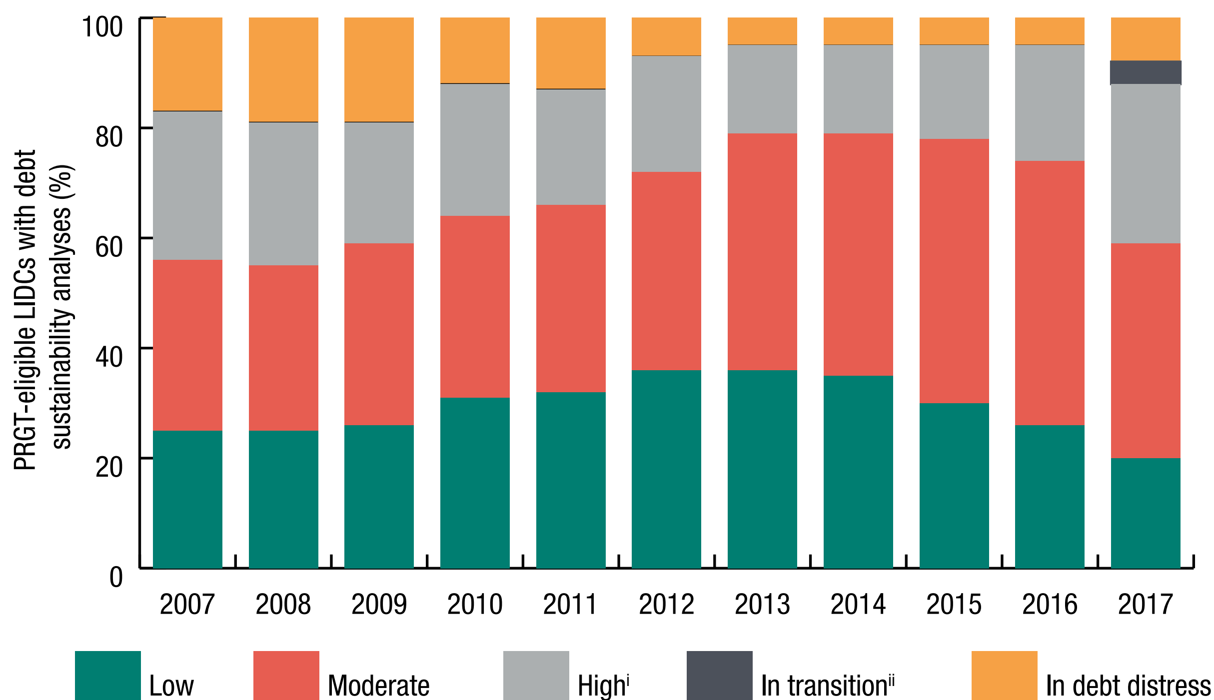
Figure 1 Public debt in low-income countries, 2000–2017



Source: Adapted from IMF (2018: 35) (data from the IMF World Economic Outlook database, 2001–2017).

1 The Gambia, Grenada, Mozambique, São Tomé and Príncipe, South Sudan, Sudan and Zimbabwe.

Figure 2 Debt distress levels in LIDCs



Notes: PRGT, Poverty Reduction and Growth Trust

[i] Ethiopia was assessed as high risk in its latest DSA, which was approved in January 2018. [ii] In-transition countries are not yet formally rated in the DSA but moving towards distress.

Source: Adapted from IMF (2018: 42) (data from the LIC Debt Sustainability Analysis (DSA) database).

which three were Commonwealth countries[2] and two were Commonwealth low-income countries (the Gambia and Mozambique). The IMF judged 24 countries to be at high risk of debt distress,[3] of which 10 were Commonwealth countries, including five Commonwealth low-income countries (Cameroon, Ghana, Kiribati, Sierra Leone and Zambia), underlining why this is such an important issue for the Commonwealth.

The composition of low-income country public debt has changed dramatically over recent years, with declining concessionality and increased borrowing from private lenders, non-traditional official lenders, and domestic lenders (Table 1). While the share of low-income country debt owed to private creditors more than doubled to nearly 6% of GDP, the share of debt owed to bilateral creditors that are members of the Paris Club (a group of creditor nations) stood at just above 2% of GDP in 2016. This is compared with nearly 14% of GDP that was owed to non-Paris Club creditors, of which China's share amounted to just over 4% of GDP. Domestic borrowing has been increasing, and has reached 15% of GDP, a similar level to that borrowed from external multilateral creditors.

The changing nature of public debt has meant that it has become more expensive in low-income countries, thanks mainly to the increase owed to the private sector and a rise in domestic debt as a share of the total. As a result, debt service is absorbing a growing share of public expenditure (IMF, 2018: 50). Private debt tends to be significantly more expensive than alternative public international bilateral or multilateral sources. One analysis using IMF and World Bank

2 The Gambia, Grenada and Mozambique.

3 Afghanistan, Burundi, Cameroon, Cabo Verde, Central African Republic, Chad, Djibouti, Dominica, Ethiopia, Ghana, Haiti, Kiribati, Lao PDR, Maldives, Marshall Islands, Mauritania, Micronesia, Samoa, Sierra Leone, St Vincent and the Grenadines, Tajikistan, Tonga, Tuvalu and Zambia.

Table 1 Total public and publicly guaranteed debt

Creditor	Percentage of GDP		
	2007	2013	2016
Total	**47.1**	**39.8**	**52.7**
External	**36.5**	**28.7**	**37.3**
Multilateral	19.6	14.4	15.7
World Bank, International Development Bank, IMF, African Development Bank, Asian Development Bank	16.8	9.4	9.9
Other	2.8	5.1	5.8
Bilateral	14.2	11.4	16.0
Paris Club	7.4	2.3	2.2
Non-Paris Club	6.8	9.1	13.8
China	0.3	2.5	4.2
Commercial	2.7	2.9	5.6
Bonds	0.5	0.6	1.4
Commercial banks	1.1	0.8	1.1
Other	1.1	1.5	3.2
Domestic	**10.5**	**11.1**	**15.3**
Central bank claim (net)	–0.8	0.3	2.8
Deposit money banks	0.6	2.6	6.2
Non-banks	10.7	8.2	6.3
Memorandum			
Domestic, by instrument			
Marketable	3.1	5.9	7.0
Non-marketable	7.4	5.2	8.3

Note: Based on 37 LIDCs where continuous data is available from 2007 to 2016. These figures are simple (mean) averages, which means that countries with high levels of debt pull up the average, which is why the median figures are given in Figure 1.
Source: IMF (2018: 51).

data suggests that the mean average for the 124 developing countries for which data is available was 12.2% of government revenue in 2018, up from 6.6% in 2010 (Jubilee Debt Campaign, 2019). A total of 29 developing countries devoted more than 15% of government revenues to debt service in 2017, up from 21 countries in 2014 (UNCTAD, 2018: 7). For low-income countries as a whole, the IMF calculates that interest repayments accounted for a median average of 5.3% of government revenues in 2017, up two percentage points since 2013 (IMF, 2018: 38).

Domestic debt levels have also increased significantly in low-income countries. Although it can be nominally more expensive than alternative sources, domestic debt has significant advantages as it reduces exchange rate and other risks and can therefore be cheaper than external debt. Data on domestic debt is harder to find than that on external debt, but IMF surveys suggest is represented about half the debt stock of low-income countries between 2007 and 2014 (IMF, 2015: 12).

Many low-income countries have made significant strides in developing their domestic debt markets in recent years. Domestic debt reduces risks associated with exchange rates, capital flow reversals, may allow countercyclical borrowing in response to shocks, and – if done well – can help to develop the domestic financial

system (Bua et al., 2014). However, there is a wide variation between countries, as not all low-income countries are able to issue domestic debt and some can only do so on expensive terms due lenders' lack of trust in their macroeconomic and fiscal frameworks or concerns about the quality of their institutions (ibid: 2).

Although the IMF has estimated that the average nominal interest rate for domestic debt is four times that of concessional external debt (8% interest versus 2% interest) (IMF, 2015: 13), this is likely to be a misleading comparison in many countries. First, the interest rates for private external debt are higher than for concessional debt, so the real difference between private domestic and private external debt will be lower. Second, because many low-income countries are likely to find their currency depreciating against the dollar over time, the real interest rate can end up being cheaper than external borrowing (Panizza, 2008). Domestic debt tends to be shorter-term debt than external debt, but this may be driven by government preferences (Bua et al., 2014: 9).

It is likely that official figures underestimate the scale of borrowing from some creditors, particularly China, which does not report on its lending to many multilateral bodies (Horn et al., 2019: 7). As indicated, the IMF estimates that low-income countries owed debts equivalent to 4% of GDP to China in 2016. A more recent academic analysis estimates that the 2017 figure was closer to 11% of GDP (Horn et al., 2019: 13).

The changed mix of lenders means that risks associated with debt have increased and restructurings cannot, as they have in the past, be focused on the Paris Club and multilateral lenders. For example, previous ODI research has detailed the risks associated with the increased use of private bond-market borrowing in sub-Saharan Africa, which include exchange rate risks and the potential to feed financial market instability (Tyson, 2015). The increased range of different lenders means that coordinating restructuring efforts will be more complicated.

Low-income countries are now more integrated into the global economy than before, and more exposed to market risks because of their greater reliance on private borrowing (IMF, 2015). The increased availability of private borrowing has been driven partly by the economic performance of low-income countries, but also because of international factors, particularly investors searching for yield during an era of low interest rates in developed economies (IMF, 2015). Foreign currency bonds ('eurobonds') are also more likely to have bullet payments that lead to spikes in financing needs (IMF, 2015), increasing risks and potentially refinancing costs.

Low-income country debt levels are particularly sensitive to shocks, whether these arise internally or externally. Debt sustainability analyses (DSAs) confirm that the majority of low-income countries are vulnerable to exchange rate changes, as well as to shocks arising from contingent liabilities (IMF, 2015) and many are vulnerable to changes in commodity prices, with, for example, sharp increases in fiscal deficits following the 2015 commodity price shock (IMF, 2018: 39). Conflict, disasters related to natural hazards or epidemics can also have dramatic impacts on debt levels, which rose by an average of 22% of GDP in Liberia and Sierra Leone following the West African Ebola virus epidemic, for example (IMF, 2018: 39).

The rise of foreign participation in domestic capital markets means that the risks associated with changes in investor sentiment have grown (Cornford, 2018). Sudden capital outflows caused by external investors withdrawing from domestic debt markets could lead to both sudden changes in exchange rates and to funding shortfalls for actors that rely on these markets (IMF, 2018: 50).

2 Overview of potential causes of debt crisis

2.1 Historical experience

The most comprehensive analysis of several centuries of data on debt crises shows that international waves of defaults on external sovereign debts are a common occurrence throughout history, though such waves are normally many years, sometimes decades, apart (Reinhart and Rogoff, 2009).

The causes of each individual crisis are, of course, complex, but historical analysis shows a high correlation with three factors (Reinhart and Rogoff, 2009):

- **Global banking crises.** These can lead to falls in growth and commodity prices, cause credit to dry up around the world, and have tended to be 'contagious', affecting both the financial system and economies of countries outside the initial centre of the crises. While developing countries largely escaped the last global banking crisis, as we have noted, the impacts of that crisis has helped to create the conditions for the increase in indebtedness of low-income countries.
- **Global economic factors, including commodity prices and interest rates in global financial centres.** In effect this has tended to mean that global economic conditions make borrowing by developing countries highly pro-cyclical: when commodity prices are high and interest rates low in major financial centres, borrowing increases, but when global conditions worsen, borrowing shrinks and defaults increase.
- **Large capital inflows.** Surges in capital inflows have often been followed by external debt crises at national, regional and international levels.

Each country may, due to its own particular circumstances and decisions, be vulnerable to an external sovereign debt crisis. However, it is global business and financial cycles that tend to be the underlying causes of vulnerability to crises and which drive 'waves' of crises such as the one that low-income countries may now be facing.

Much less is known about the history of domestic debt defaults and crises. Available data suggests that domestic debt can typically be a large percentage of the total. It is often presumed that defaults on domestic debt are rare as governments can more easily restructure debt owed to domestic creditors or deflate away the value of the debt during periods of higher inflation. However the most comprehensive review of the available data suggests that, although rarer than external defaults, domestic defaults are not rare occurrences in general (Reinhart and Rogoff, 2009). This suggests that the lack of information about the domestic debt situation of low-income countries should be of concern.

While several high-income countries faced serious debt problems in the wake of the global financial crisis of 2007–2008, the last major wave of developing country debt crises began during the 1980s and peaked in the 1990s, before it was largely resolved by the Highly Indebted

Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). These initiatives, together with related debt relief from Paris Club creditors, relieved the 36 participating countries of $120 billion in debt (IMF, 2017),[4] reducing the debt of participating countries by 90% (Staffs of IDA & IMF, 2011: 10). This reduction in debt freed up HIPC countries to increase government expenditure in other poverty-reducing areas, with the IMF concluding that lower debt servicing costs post-HIPC resulted in a rise in capital spending and an increase in spending targeted towards poverty reduction (IMF, 2015: 8).

Although the HIPC and MDRI initiatives were successful in reducing debt problems, they did not apply to all countries or all debtors and took a very long time to implement due to the conditions attached. The HIPC initiative began in 1996 following several years of Paris Club debt-relief negotiations. However, it was not until the launch of the MDRI in 2006 that the debt-relief process entered completion stage, meaning that the full cycle took well over a decade – or closer to two decades if the initial debt build-up is included. Now that 36 of the 39 HIPC eligible countries have passed through the mechanism, there are currently no remaining mechanisms to help the increasing number of low-income countries that are facing severe debt problems, meaning that any future wave of debt crises could face a similarly long and damaging road to resolution.

2.1.1 A framework for understanding debt crises causes and prevention in low-income countries

The remainder of this paper will focus on the different roles of debtors and lenders, and of the overall system, in preventing debt crises. To facilitate comparative understanding of the roles of different actors, and to help to move towards solutions, the following two chapters are organised in the same way, looking at what role debtors, lenders and the international system have in:

1. **providing alternatives to borrowing** as sources of public finance in low-income countries, particularly tax, revenues and international aid
2. **managing the available borrowing options**, and their characteristics – in particular their costs and risks
3. **improving the behaviour of actors** through adopting responsible financing standards and increasing accountability and transparency
4. **determining how easy it is to rollover or restructure debt** to deal with shocks and prevent or resolve crises that do arise.

4 In 2015 present-value terms.

3 The role of debtors

3.1 Finding alternatives to borrowing

3.1.1 Boosting domestic revenue mobilisation

There is room to improve domestic tax and revenue collection in low-income countries to reduce the need for borrowing. However, this is often a significant challenge as low-income countries tend to have a significantly lower tax potential than other countries. Taxation had reached a median average of 13% of GDP for low-income countries in 2016, which is substantially lower than in middle-income countries, where the median average was 18% of GDP (IATF, 2018: 41). The other main revenue sources for low-income countries principally include royalties paid for the extraction of natural resources. Social contributions – payments paid by individuals to governments for social protection – are virtually non-existent in low-income countries.

Structural factors, including the extent of the country's industrialisation, its population's education level and the size of its imports, reduce the tax potential of low-income countries (Langford and Ohlenburg, 2016). Fragile states in particular have found it hard to improve their tax take (Drummond et al., 2012). In addition to structural factors that affect the size of the tax base – and hence the tax potential of countries – raising more tax also requires improved efficiency of tax administration. Improving the efficiency of tax collection depends on the state's administrative capacity and fight against corruption, but also critically on increasing its accountability to its citizens, making it primarily a domestic political enterprise (Langford and Ohlenburg, 2016).

Low-income countries have a very different tax structure to that of developed economies: goods and services taxes, which are likely to be regressive, provide more than 40% of all tax revenue, and corporate and trade taxes are far more important and personal income tax much less important. The revenue that resource-rich low-income countries raise from extractive industries varies greatly but is in general far lower than it could be. IMF research estimates that developing country governments retain only around one-third of the resource income in mining, but 65%–85% in petroleum (IMF, 2012: 6). This means that there is a significant additional share of the resource rent that could be captured by governments, if they can improve tax collection, and prevent tax evasion or avoidance by mining companies.

In addition, the trend of offering tax incentives to increase investment, driven in part by international tax competition, is eroding the tax base in many developing countries. One study estimates that statutory corporate tax exemptions alone cost developing countries $138 billion per year (ActionAid, 2013). Yet a joint report by the IMF, Organisation for Economic Co-operation and Development (OECD), World Bank and United Nations (UN) found that such incentives generally rank low in surveys of what attracts investment to low-income countries and there are many examples of where investment would have happened without them (IMF et al., 2015).

As a recent ODI study showed, even if developing countries improved their tax collection to the maximum extent judged possible by the IMF and World Bank and if their economies continued to grow, they would still face significant public spending gaps (Manuel et al., 2018). In total, 48 countries would be unable to meet the full costs of ending extreme poverty and delivering health and education to all – and 29 would only be able to afford half the costs (ibid). This shows that many countries face a binding financing constraint that prevents them from achieving

the outcomes that their electorates demand, and which all countries have signed up to through the Sustainable Development Goals (SDGs). In this context, if low-income country governments are to be supported in avoiding using borrowing to pay for basic expenditure then additional sources of revenue will need to be found, which we will examine in chapter 4.

3.1.2 Boosting sustainable economic growth

Sustainable economic growth can boost tax revenues and help to keep down debt-to-GDP ratios. This means that macroeconomic policy and performance tend to be of greater importance for avoiding debt crises than debt management alone. Obviously, debt crises can have a major negative impact on sustainable economic growth, which can in some cases last for many years. Public domestic borrowing also has a macroeconomic effect through its impact on the financial sector, which may be positive – helping to develop and deepen the sector – or it may be negative – crowding out borrowing for private actors (IMF, 2015: 13). However, it is important to remember that debt can have a positive impact on macroeconomic performance if borrowed funds allow investment that increases the productive capacity of the economy, boosting long-term growth.

There is a significant body of literature that attempts to estimate the effects of such public capital investment; however, it can be very difficult to establish the economic rates of return (Nautet and Meensel, 2011) and so estimates should be treated with caution. For example, a study of 52 countries found that investment in public capital – that is, physical infrastructure assets – made a contribution to economic growth, but that the effect was driven by the quality of the investment, in particular how well projects were selected and implemented (Gupta et al., 2014). The same study also found the effects to be larger in low-income countries because of the lower existing stock of capital.

The second key channel is through public investment in education, health, sanitation and other services that contribute to what the World Bank has called the 'human capital' of the economy. For example, one study of 46 developing countries suggested that significantly increasing the educational outcomes of 15-year-olds could boost long-run growth by more than 2% over the baseline trend (UNESCO, 2012).[5]

3.2 Managing borrowing options

It is critical that low-income country borrowers carefully understand and manage the opportunities, costs and risks of different sources of borrowing – domestic and international, concessional and market rate. The diversification and growth of financing options is perceived as beneficial by borrowing governments, given their huge financing needs and the decline in concessional lending from traditional creditors (Prizzon et al., 2016). However, as noted, this diversification of external borrowing leads to greater risks, which are complex to manage and often involve trade-offs. Low-income countries can develop their domestic debt markets to provide a potentially lower-risk alternative to international foreign currency borrowing – though this needs to be done with care.

Effective policies, systems, procedures and capacity to manage debt in low-income countries are needed, but according to various international assessments, their capacity to manage debt is often weak (Mustapha and Prizzon, 2018).[6] The Medium-Term Debt Management Strategy is the major tool for doing this, as is establishing a clear legal and organisational framework and transparent reporting policies, and good systems and procedures (ibid). However, while there is considerable guidance and technical assistance devoted to debt management, including by the

5 Ensuring that an extra 75% of 15-year-olds reach the minimum mathematics benchmark in the OECD's Programme for International Student Assessment (PISA) test at the end of a 10-year period.

6 These assessments are the World Bank's Country Policy and Institutional Assessment, Debt Management Performance Assessment and Public Expenditure and Financial Accountability.

Commonwealth Secretariat, there is relatively little empirical evidence on which reforms work best in which contexts (ibid). One key area in which greater attention could be paid is improving the capacity and incentives for low-income countries to negotiate well when taking on new debt.

The reasons for the limited improvement in debt management, despite many years of technical assistance are related in part to institutional issues, but also to lack of demand, accountability and political commitment (Mustapha and Prizzon, 2018). Recognising that improving the debt-management capacity in low-income countries means dealing with more than just technical solutions is one reason why an emphasis on accountability and transparency is so important, which we cover in the next section.

Careful understanding and management of contingent liabilities and collateralised debt are becoming an issue of increased importance, as we will see in the next section.

3.3 Improving behaviour and institutional accountability

Data on public debt levels are inconsistent, incomplete and may significantly understate the problem. As such, it is important to improve the production and publication of data. A major IMF survey of low-income country debt notes, for example, that there are significant data gaps in many countries and that results largely reflect only central government debt (IMF, 2015). Key issues are how to improve coverage, by including all public-sector entities – including state-owned enterprises and both local and national governments – and how to include public guarantees and liabilities that are currently not included in debt estimates (IMF, 2018).[7] One important proposal is that debtor states should ensure that an independent debt stability report is published regularly to provide an early warning sign should debt problems be building, signalling to both debtors and creditors that they need to change their behaviour (UNCTAD, 2015a). This would go further than provisions to regularly publish the medium-term debt strategy and disaggregated statistics, which are often standard provisions of public debt laws, as it would offer an independent view more likely to influence creditors' behaviour.

In addition, levels of contingent liabilities – debts that may arise depending on the outcome of an uncertain future event[8] – are high in many countries. This means that without greater transparency, the real debt risks facing low-income countries remain hidden. The IMF defines contingent liabilities as relating to:

> Debt guarantees, agreements linked to public-private partnerships (PPPs), pension funds, debts from state-owned enterprises and sub-national entities, as well as bailouts of nonpublic entities and natural disasters. (IMF, 2015: 23)

Overall, the fiscal cost of losses that incur contingent liabilities can be substantial, with a survey of eastern and southern African countries finding contingent liabilities of between 4% and 31% of GDP (Mauro et al., 2015). There are some countries where a shock related to a public–private partnership (PPP) could lead to a fiscal impact of more than 10% of GDP (IMF, 2018: 54).

It is also very important for stakeholders to know the terms and conditions of the debt, which may not always be well understood by or available to key stakeholders. For commercially contracted debt, IMF teams found the terms and conditions to be clear or fairly clear in fewer than half of the cases. In the case of PPPs, the IMF notes that the contractual implications for public liabilities are not normally taken into account,

7 The scale of the problem has been well summarised by the IMF, noting that IMF staff and Finance Ministry officials are lacking key data: 'Three-quarters of LIDCs report only debts of the central rather than the general government; one-third of countries do not report guaranteed debt; and fewer than one in ten countries report non-guaranteed debt of public corporations that lie outside the general government' (IMF, 2018: 52).

8 Such as, for example, the failure of a project that has a government guarantee, triggering a payment by the government.

nor is the extent to which they are collateralised (i.e. a public asset is involved) (IMF, 2018).

Concerns have been raised about increasing levels of collateralised debt, which although small overall may be significant for some countries; however, relatively little analysis has been conducted of this issue.[9] The main concern that is often raised is the fact that Chinese lending sometimes contains collateral clauses that mean that repayment is made through the proceeds of commodity exports, particularly oil (Horn et al., 2019: 4). This represents an effort by China to raise its seniority as a creditor – in other words, China is trying to ensure that, in the event of default problems, it is more likely to be repaid than other creditors without such clauses. A recent study of the seniority structure of sovereign debt found that, in practice, bond holders and multilateral creditors tend to be senior lenders and private creditors tend to be more senior than official creditors who are, in effect, junior creditors (Schlegl et al., 2019). This may help to explain why some bilateral creditors are keen to raise their seniority through collateralisation.

There is considerable room for improvement in debt transparency at the country level. Greater transparency would enable domestic citizens and parliaments to provide incentives for governments to improve debt contraction, use and management. Strengthening public debt laws to improve transparency and accountability in debt-management operations is an important step in this direction. In addition, as we have already seen, though improving debt management has a technical aspect, many of the problems are linked to political economy issues, which will only be resolved with improved accountability. This means, for example, upholding the role of parliament to debate and approve borrowing plans, preferably set out in loan-by-loan detail, and the role of audit institutions to scrutinise spending after approval. Putting this information into the public sphere is vitally important as it allows for further scrutiny by the media and civil society.

3.4 Dealing with shocks and preventing or resolving crises

Ensuring debt is managed in relation to potential shocks is an important, but difficult, element of low-income countries' debt management. Low-income countries, like other developing countries, have been building their reserves over the past 20 years to help protect themselves, but the small size of their economies means this policy may have a limited usefulness for protecting against larger shocks. A shorter-term response may be efforts to manage commodity price volatility through stabilisation funds, which save money when commodity prices are high to be released when they fall below certain thresholds.

Increasing resilience to shocks should also be a part of a country's national development strategy by, for example, reducing reliance on commodity exports that are frequently subject to price volatility. Other tools to reduce the likelihood of financial shocks include capital account management techniques and the use of public development banks and other institutions to try to direct national savings towards longer-term productive investment.

It is important to recognise, however, that there are limits to how much individual countries can be expected to insulate themselves from shocks – particularly those caused by extreme weather events, increasingly linked to climate change, and those caused by external economic factors. This is why the role of creditors and the international system is important, as we shall see in the following chapter.

9 Reports of collateralised debt problems are often in reality linked to other debt issues, as Moramudali (2019) details.

4 The role of creditors and the international system

4.1 Supporting alternatives to borrowing

Creditor countries and the international system play an important role in determining how easy it is to raise taxes in low-income countries, particularly taxes on wealthy individuals, multinational corporations and extractive industries. The use of offshore financial centres, intra-company operations within multinational corporations and financial secrecy allows tax avoidance and evasion in developing countries. The scale of the problem of tax evasion and avoidance is, by its nature, impossible to quantify precisely, but all available figures suggest there is a significant loss of resources for developing countries. This is the case in terms of both lost resources for investment or consumption expenditure in developing countries and lost tax revenues. For example the United Nations Conference on Trade and Development (UNCTAD) estimated that $100 billion is lost in tax annually by developing countries is related to the use of inward investment stocks linked to offshore investment hubs (UNCTAD, 2015b: 200). Tax losses to money already transferred to offshore financial centres have been estimated at $190 billion per year (Zucman, 2014).

In addition, international competition over tax incentives and other 'spillover' effects mean tax policies in high-income countries can erode the tax base in many developing countries. IMF research estimates that around $200 billion in revenue is lost to developing countries annually because of the spillover effects of tax policies in other countries (Crivelli et al., 2015).

International institutions and treaties also affect the ability of low-income countries to raise taxes, as the example of the shift from trade taxes to value added tax (VAT) shows. Low-income countries tended to rely more on trade taxes because they are relatively easy to collect and because of the structural problems that reduce their tax base, as noted. However, a significant shift away from trade taxes in favour of VAT during the 1990s, promoted by conditionalities of the IMF and World Bank (Emran and Stiglitz, 2005), has reduced their contribution to revenues.

Low-income countries face a significant financing gap in achieving the SDGs, one that they will not be able to fill by increasing domestic revenues, which is why ODA remains a vitally important resource. ODA as a percentage of GNI rose from 0.22% of GNI among OECD Development Assistance Committee (DAC) members to 0.31% between 2000 and 2018, but is still less than half of the UN's 0.7% of GNI target, and volumes of public climate-finance transfers have proved far lower than promised. ODA to the least developed countries fell in 2018 and remained well below the international target of 0.2% of GNI (OECD, 2019).

Moreover, the OECD DAC definition of ODA allows a significant portion of ODA to be spent in the donor country itself, with more than 10% of current ODA being spent on in-donor

refugee costs in 2016, for example (OECD, 2018a). Promises to provide $100 billion annually in new and additional climate finance also appear to have resulted in little additional public finance transfer.[10] The OECD estimated that bilateral public climate finance was around $56 billion in 2017 (OECD, 2018b). However, previous versions of this study have shown that the majority of these figures are likely to be accounted for by ODA (OECD and Climate Finance Initiative, 2015: 22).

ODI research has estimated that to meet financing gaps that cannot be filled by domestic taxation or continued economic growth, all donors would need to meet the 0.7% ODA target and direct half the money to LDCs (Manuel et al., 2018).

4.2 Supporting the management of borrowing options

It is important to recognise that lenders also have responsibilities in improving the borrowing options available to low-income countries. Perhaps the most useful step that lenders can take is by adopting and supporting the use of state-contingent debt instruments (SCDIs), whereby repayments are paused if the borrower faces a difficulty in repayment caused by, for example, a disaster related to natural hazards or an economic recession. This allows countries to increase their fiscal space to respond to shocks, giving countercyclical opportunities to boost expenditure during difficult times.

The case for SDCIs has been made for many years and the Commonwealth has done important work in this area (Robinson, 2016; Zoheir and Tavakoli, 2016). However, there have been, as yet, limited examples of implementation such as hurricane clauses in loans to Grenada. Proposals are being developed for a model contract for private-sector lenders; others have suggested that multilateral actors could be first movers in this area (Mustapha and Prizzon, 2018).

There are a number of other reforms whose inclusion debtors could demand, and creditors could support, in particular:

- restructurings on the basis of a majority vote of creditors[11]
- ‘standstills’ on debt repayments during restructuring so that debtors can have additional fiscal space during a difficult period
- mediation or arbitration mechanisms.

It is also important to recognise that international actors have been promoting mechanisms such as PPPs, which have significant contingent liabilities concerns. Because PPPs can be used to keep government expenditures off-budget, they have result in hidden debts. The World Bank, in particular, has played a major role in promoting the use of PPPs across developing countries (Romero, 2015) which has in effect meant an increase in debt risks.

International lenders have also recently been increasing the number of collateralised loans in circulation. In some cases, this has meant that loan terms which were favourable in normal circumstances become less so in difficult times, with for example a requirement to sell commodities to the lender at below market prices. They have also complicated restructurings in some cases such as Chad (Mustapha and Prizzon, 2018).

10 In 2009, at the Copenhagen United Nations Framework Convention on Climate Change summit, developed countries committed ‘... to a goal of mobilising jointly $100 billion dollars a year by 2020 to address the needs of developing countries’ from a mix of sources.

11 One initiative that has come to the fore in recent years has been the effort to amend bond contracts to ensure that effective Collective Action Clauses are included to prevent situations where a small minority of creditors can block debt restructuring. However, this only covers a portion of relevant debt – that portion of private debt owed to bond holders.

4.3 Improving behaviour

4.3.1 Principles of responsible lending

There are various codes of conduct that attempt to bind creditors to a common set of lending principles, including UNCTAD's *Principles on Responsible Lending and Borrowing* (UNCTAD, 2012), and the G20's *Operational Guidelines for Sustainable Financing* (G20, 2017). The UNCTAD principles are the most complete and detailed guide to the responsibilities of both lenders and borrowers.

The UNCTAD principles make clear that the lender has a due diligence responsibility to provide full information to borrowers, and ensure that it is understood, and to estimate the likely impacts of project financing, including social and environmental impacts. This means that the lender should accept its fair share of responsibility for cases of loans being made for bad or fraudulent projects, or where borrowers were not fully informed of the implications of the terms and conditions of the loan.

The UNCTAD principles highlight that lenders also have a responsibility to consider the wider debt situation of the countries to which they are lending, including the broader financing situation and contingent liabilities. This is a duty they owe to the borrower, but also to other lenders that will be affected if debt becomes unsustainable.

However, not all countries have formally endorsed the UNCTAD principles, and one common problem is that they remain voluntary and there are no mechanisms to ensure that they have traction. In addition, not all countries have formally endorsed them.

4.3.2 Debt transparency and accountability

Transparency is a theme that has been taken up in international initiative only to a limited extent. In 2017, the G20 agreed *Operational Guidelines for Sustainable Financing* but these only have two paragraphs on transparency (G20, 2017). Their major proposal is that 'as a general policy, information on past debt restructurings from official and private creditors should be made public,' though there is no plan for how this might be implemented. This proposal would have some incentive effects but it would not be as powerful as transparency measures related to current and future lending and borrowing.

G20 leaders recently recognised the importance of improving transparency by both lenders and borrowers, referring to the work of the Institute of International Finance on the Voluntary Principles for Debt Transparency. These principles are only intended to apply to the private sector and, at least to start with, only to PRGT-eligible countries (IMF, 2019b) and to external lending. The principles request that lenders disclose a list of relevant facts about each loan, guarantee or other debt instrument, including amounts involved and the costs. The intention is to make this information public; however, it has not yet been agreed what entity will collect and collate this information. It is worth noting that if private-sector actors do begin to sign up to these principles and report on their lending publicly, they would become significantly more transparent than public-sector lenders.

Other proposals include creating a mandatory public register of lending to governments by G20 governments (Spelman, 2019), and requiring both multilateral actors and private-sector actors to use the register. The public disclosure of lending contracts would allow parliaments, journalists and civil society organisations to examine them, and would also allow other lenders to have the full information before making further loans.

4.4 Restructuring to deal with shocks and prevent or resolve crises

It is important to remember that restructuring is a common feature of sovereign debt markets (Schlegl et al., 2019); rather than pretending that restructurings – whether caused by external shocks or other factors – can be avoided, the focus should be on how to do these better. One important way to prevent debt crisis is to make restructuring easier before low-income countries reach crisis point.

Debt restructuring is a broad term that encompasses any efforts to change the scale or terms of debt to make it easier for the lender to repay. This can include debt forgiveness,

where the debt is reduced or eliminated;[12] debt rescheduling, where the terms and conditions are changed – for example by reducing the interest rate or extending the maturity; and debt conversions or swaps, where the debt is exchanged for something of equal value.

In 2015 the UN General Assembly passed a resolution setting out internationally agreed principles for sovereign debt restructuring (UNGA, 2015). Although this resolution was very high level, it did set out important principles, including:

- the need for transparency in order to enhance accountability
- the need for a sustainable end point where the debtor's situation is stable including the consideration of human rights and social and environmental impacts
- the stipulation that a minority of creditors should not be allowed to hold up restructuring if a majority of creditors are in agreement.

A more detailed set of proposals on how to improve restructuring was provided in UNCTAD's Roadmap and Guide on Sovereign Debt Workouts. The starting point for the proposed process is that the debtor state should take the lead. In practice, this has proved difficult, in part because of political economy problems in indebted countries (Trebesch, 2019) and because debtors are aware of the ramifications of signalling that they are having problems. However, There are some examples – particularly the case of Indonesia which, in 1969, called in an independent mediator to negotiate a restructuring with all creditors; the restructuring was accepted by all parties (Kaiser and Wittmann, 2018).

The Roadmap proposes the formation of a debt workout institution to deal with the fact that restructurings can be very lengthy and damaging. The development of a permanent mechanism for resolving sovereign debt problems – also known as a sovereign debt-resolution mechanism (SDRM) or sovereign debt workout mechanism – has long been on the international agenda. There are various ideas about how such a mechanism could work (Das et al., 2012) but the Roadmap is the most recent major attempt by an international institution to set out practical steps. The key feature of such a debt-resolution mechanism is that it would be impartial, drawing upon expertise, with a legal basis that would make its decisions binding. It would aim to ensure that debt crises were resolved rapidly and fairly, but should also help to reduce the number of such crises, as creditors in particular would moderate their behaviour knowing that in any future crisis a binding mechanism existed. Such a mechanism would require political support from UN member states and a revival of previous attempts to get international agreement on this.

In the absence of a debt workout institution, it is hard to see how existing forums for debt restructuring can be made to work in the current context. The Paris Club group of bilateral creditors have played an important role in previous restructuring of low-income country debts, but is currently hamstrung by the fact that it does not represent a large number of bilateral creditors or private-sector creditors and therefore holds a very low percentage of total low-income country debt. In addition, Paris Club restructurings have often been lengthy and damaging to borrowers. The rise of collateralised debt, non-traditional borrowers, and private-sector lenders makes debt restructuring processes potentially more complex in the future, reinforcing the need for forums where all debt can be treated together.

In practice, the IMF is the main institution that mediates debt restructuring in low-income countries, but it has seldom proved able in the past to do this in a way that ensures that indebted countries emerge with sustainable debt levels. The IMF plays a key role in debt restructuring though there are concerns with its track record – especially over many countries becoming 'repeat borrowers' and the impacts of policy reforms agreed to in return for lending (Stubbs et al., 2017).

12 Including transferring the liability to another entity.

In particular, there is an absence of fast-disbursing international finance to help developing countries deal with temporary shocks such as balance of payments problems. The IMF was, in theory, established in part to provide such financing, but its facilities take considerable time to agree and are designed with conditionalities aiming to help restructure the economy, rather than to help countries through temporary shocks. In practice, as we have noted, developing countries have been building their own reserves to do this, which comes with a cost as reserves are built in effect by lending money at low interest rates to high-income countries, in particular the United States.[13]

Finally, a case can be made for treating debt that is 'odious' or 'illegitimate' differently, emphasising that lenders bear some responsibility for the outcomes of their decisions beyond purely financial terms.

13 The United Nations Department of Economic and Social Affairs (UN DESA) has proposed that to reduce the need for tying up much-needed development finance in reserves, annual allocations of new Special Drawing Rights could be created – in effect to create new reserve assets for developing countries that could free up their existing reserves for development expenditure. UN DESA suggests annual allocations to yield between $100 billion and $167 billion annually (UN DESA, 2012).

5 Policy recommendations

This paper has given an overview of the current public debt situation in low-income countries, which has worsened significantly in recent years. Given the damage that debt crises can cause, and their frequent occurrence, this paper has attempted to set out key issues for debtors and creditors if future damaging debt crises are to be prevented in the poorest countries. This section sets out a range of policy options for all governments and a recommendation on the key role the Commonwealth could play.

The following policy recommendations set out a range of options that governments – both debtor and creditor – and international institutions and cooperation mechanisms could push forward in order to prevent future debt crises and to create more stable future for low-income countries. The recommendations are grouped under four key issues that will have to be tackled.

5.1 Providing alternatives to borrowing

Low-income countries face a significant financing gap if they are to meet the SDGs: unless alternative sources of finance are developed, these countries face a choice between failing to reach the SDG targets and taking on unsustainable debt burdens. It is beyond the scope of this paper to set out in detail actions that could be taken in to boost public financial resources for low-income countries, but it is clear that much more needs to be done, such as the following:

- **Low-income countries can:**
  - improve their tax-collection rates, even though they face structural barriers that mean they cannot raise the same levels of tax to GDP as other categories of country
  - improve their macroeconomic strategy and fiscal framework and improve the efficiency of public spending to promote sustainable economic growth and to ensure that borrowing is used for productive investment
  - strengthen public debt laws to improve transparency and accountability in debt management.

- **Creditor countries and international institutions can:**
  - deliver 0.7% of GNI in aid and make sure at least half of this goes to LDCs
  - support and improve international efforts to prevent international tax avoidance and evasion and ensure that low-income countries have a seat at the table when international rules and agreements on tax are negotiated.

5.2 Better managing borrowing options

Both debtors and creditors can help to build better borrowing options for low-income countries, which can help to manage the costs and risks of debt.

- **Low income countries can:**
  - carefully build their domestic debt markets as a lower-risk alternative to international borrowing
  - strengthen their debt management capacity, medium-term debt management strategy, legal and organisational framework and systems for debt management
  - improve their focus on negotiating well when taking on new debt and coordinate with and learn from each other to help get better deals
  - conduct audits to examine contingent liabilities and avoid taking on 'hidden' liabilities through instruments such as PPPs if they are off budget.

- **Creditor countries and international institutions can:**
  - help to develop far greater use of state-contingent debt instruments, by, for example, aiming to make them standard practice in multilateral and bilateral lending
  - support low-income country governments to negotiate better terms and conditions in loan contracts, including by supporting clauses that allow for restructurings by a majority of creditors, standstills during temporary liquidity shocks and mediation and arbitration mechanisms
  - stop promoting the spread of off-budget contingent liabilities in instruments that they support, such as PPPs, and reduce demands for collateralised debt.

5.3 Improving behaviour

Adopting standards of responsible lending and borrowing, and greatly improving transparency and accountability of lending and borrowing could help to significantly reduce the risks of future debt crises.

- **Low income countries can:**
  - put all key details and terms and conditions of public borrowing into the public domain on a loan-by-loan basis, to allow parliaments, the media, civil society organisations and others to scrutinise and hold governments accountable for responsible borrowing
  - adhere to principles of responsible borrowing such as those set out by UNCTAD.

- **Creditor countries and international institutions can:**
  - endorse and adhere to UNCTAD's principles of responsible lending and borrowing and begin a process to determine how to improve adherence and enforcement
  - Create a mandatory public register of lending to governments and requiring both multilateral actors and private sector actors to use the register. This can be done at the national level as a step towards an international register.

5.4 Improving debt refinancing and restructuring

If another wave of low-income country debt crises is to be avoided, it will be important to improve the way that temporary shocks are dealt with in order to avert crises and to make restructuring easier before low-income countries reach crisis point.

- **Low income countries can:**
  - take a lead in negotiating restructurings in advance of serious problems
  - adopt other tools to reduce the likelihood of financial shocks include capital account management techniques and the use of public development banks and other institutions to try to direct national savings towards longer term productive investment.

- **Creditor countries and international institutions can:**
  - revive efforts to create a more permanent mechanism for dealing with unsustainable debts, such as a debt workout institution
  - develop new proposals for fast-disbursing mechanisms to deal with temporary shocks and consider ways that low-income

country reserves can be supplemented, for example by the creation of new special drawing rights.

The Commonwealth has a strong track record of working on debt issues, and the Commonwealth Secretariat is known for its work on supporting debt management. However, there is clearly much more that could be done, given the increasing importance and urgency of the issue. A reinvigorated Commonwealth work programme on preventing and resolving debt crises, based on analysing and sharing experience and undertaking advocacy could be a major contribution to tackling this pressing issue. Examples of work that could be done include:

- A review of Commonwealth experience of the HIPC initative and MDRI, given the Commonwealth's active engagement with these initiatives, with recommendations on new mechanisms to take on the work of rapid and fair restructuring of unsustainable low-income country debt
- Continuing the Commonwealth's excellent leadership on countercyclical financial instruments that automatically reduce debt-service costs when countries get into trouble and producing recommendations for how multilateral lenders can roll these out so that they become common practice.

By reinvigorating a Commonwealth work programme on preventing and resolving debt crises, and by focusing on key issues, acting together, its members can exert international influence, and the Commonwealth could play a vital role in helping to avoid the threat of a new wave of developing country debt crises.

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