International financial architecture

Commonwealth Seminar on Fiscal Policy Options for Sustainable and Resilient Development

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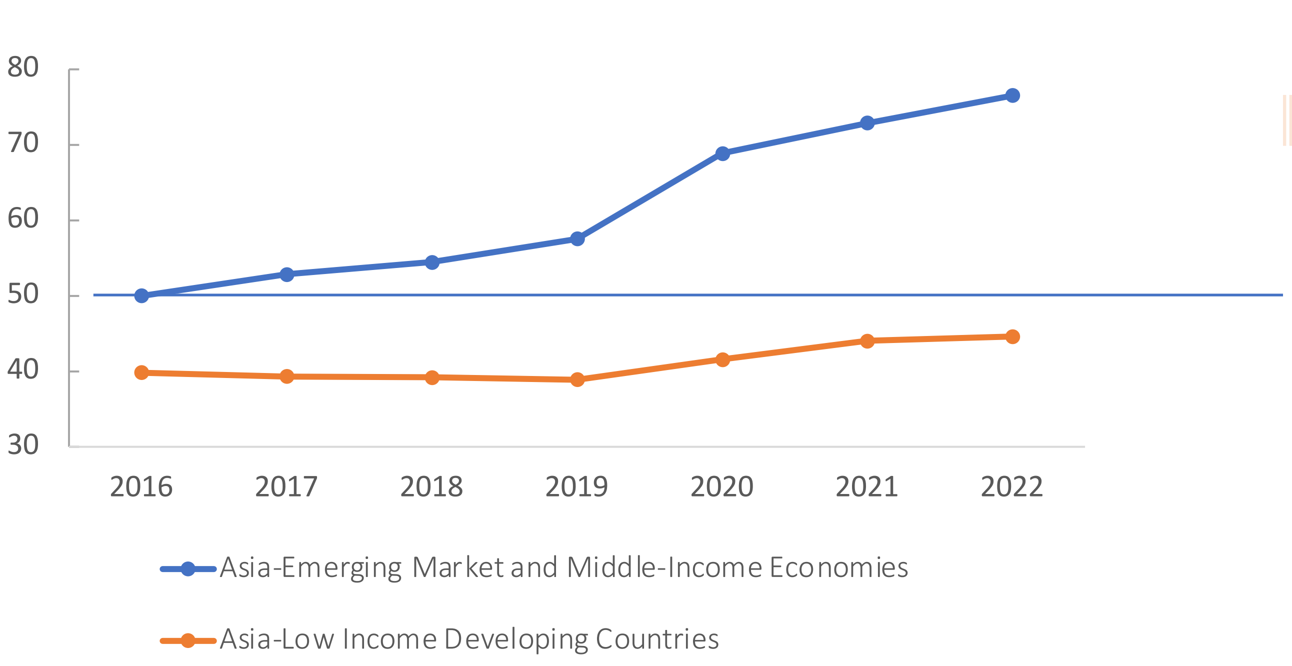
Present Challenges: Countries Are Facing High Debt

Figure 1: Debt-to-GDP, 2016-2022



Source: IMF Fiscal Monitor April 2022

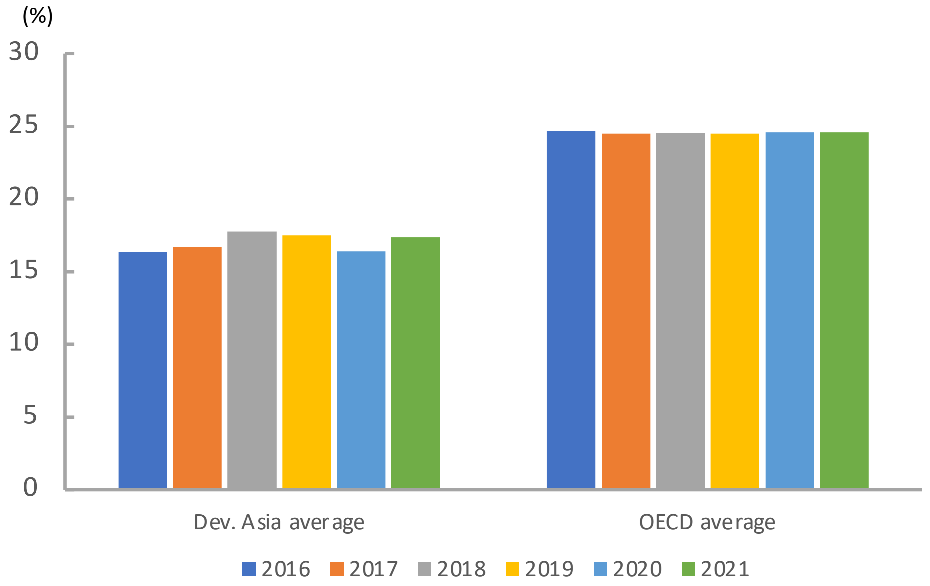
High and rising debt-to-GDP ratios and **low tax-to-GDP ratios** over the years.

The Challenge – How to strengthen [SDGs] (particularly [climate change]) and raise developmental expenditures without risking debt sustainability.

Urgent Need to Improve Revenue Efforts

- ➢ **Domestic Resource Mobilization (DRM)**

Figure 2: Tax-to-GDP ratios, 2016-2021

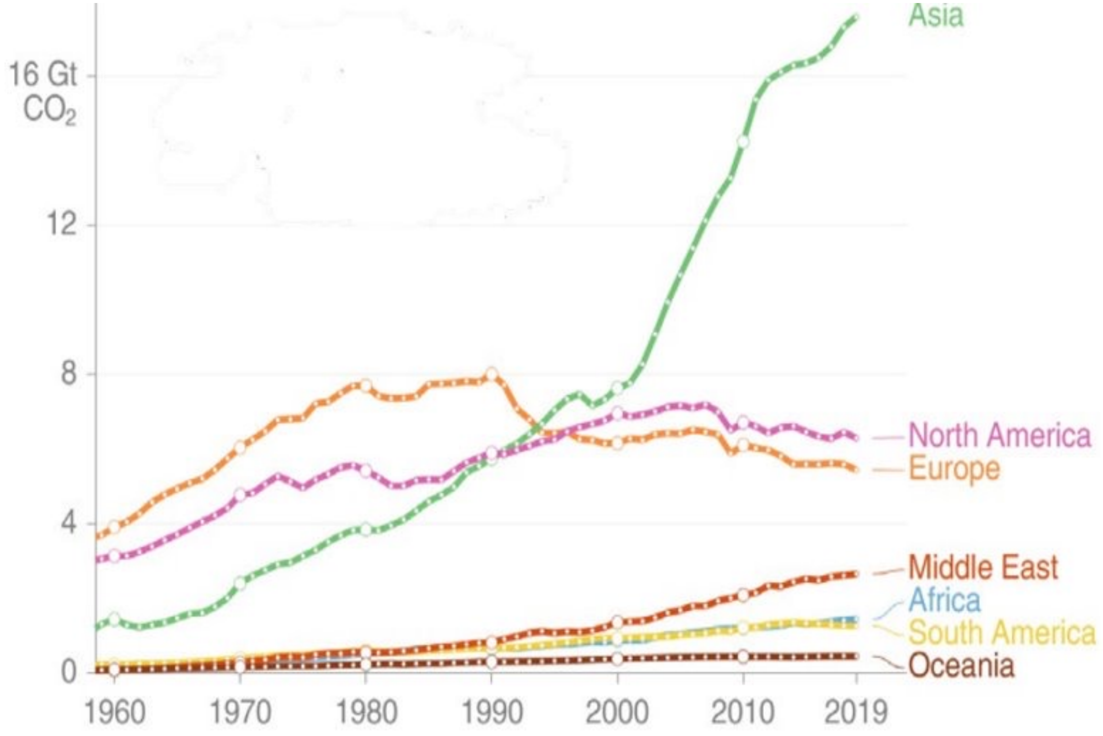


Note: In terms of OECD average, FY 2020 data is used for FY 2021 due to the data unavailability. Data do not include Social Security Contribution.
Source: ADB staff estimates based on *ADB Key Indicators Database, OECD Revenue Statistics 2022, IMF Government Finance Statistics, Government Statistics, and World Bank Open Data,*

Present Challenges: Addressing Climate Change

- Discouraging the use of fossil fuels and promoting renewable sources of energy is crucial.
- Carbon pricing can help achieve climate objectives and substantial revenues at the end.
- Carbon pricing comprises three pathways:
  - ✓ Emission Trading Systems (ETS)
  - ✓ Carbon Taxes
  - ✓Fossil Fuel Subsidy Reduction (FFSR)

Figure 3: Annual Fossil CO2 Emission by Continent



Source: ADB support for Action on Climate Change, 2011-2020; Global Carbon Project.

back

ADB

Sufficiently reducing excessive debt burdens will eventually require debt restructurings

- In the mid-nineties of last century, the failure of repeated rescheduling interventions to address the high indebtedness of developing countries led eventually to the adoption of a more structured approach, through the **Highly Indebted Poor Countries Initiative** (HIPIC, 1996), later supplemented by the **Multilateral Debt Relief Initiative** (MDRI, 2005).
- Among bilateral lenders, the decline of G7 lending has been partly offset by the impressive increase of China, which is now by far **the biggest official bilateral creditor**. China's claims are 3.5 times bigger than those of the second most important bilateral creditor (Japan).
- Since then, while the largest part of developing countries debt is still by official creditors and the share of **multilateral creditors has remained relatively stable around 45%,** the share of bilateral creditors has fallen having been offset by private creditors (banks and increasingly bondholders).

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The role of MDBs in debt restructuring

Many issues (transparency, private sector involvement, comparability of treatment, etc.). Focus on:

1. Burden sharing

2. What should accompany debt relief

Burden sharing?

- The Common Framework (CF) does not require MDBs to participate in debt restructurings. The participation of MDBs, without cost coverage by donors, would impinge their (de facto) **Preferred Creditor Status** (PCS) eroding the capacity to support their members.
- MDBs had and have a crucial role in debt restructuring by providing financial support of an adequate size but also at appropriate financial conditions, providing an implicit **"ex-ante" debt relief**.
- MDBs' participation in debt restructurings would facilitate a fair burden sharing among all creditors and would reduce total losses for main bilateral creditor.
- Multilateral creditors (IDA, IMF, AfDB and IADB, but not ADB, although two of its member countries, Cambodia and Tajikistan, were involved) participated in 2005 in the MDRI, preserving their PCS and their rating by financing the cost of the debt relief trough special trust funds, funded by **internal resources and mostly by bilateral contributions**.
- The financing of new special trust funds can be an element in the negotiation of the burden sharing of the debt restructuring between MDBs shareholders and bilateral lenders. A small share would be borne by the MDBs (internal resources).
- Alternatively, MDBs may **scale up concessional** finance, particularly for climate change (G20 IP Recommendations)

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The previous two debt relief initiatives have not been a fully-fledged success

- Apart from reducing the debt providing beneficiaries a fresh start, the debt reduction was **not** associate with **tangible improvement in macroeconomic performance**
  - **Highly concentrated export structure** has remained a key structural economic feature of lower income countries,
  - the **impact on institutional quality quite limited**. At the end of November 2022, over half of the beneficiaries of the previous debt relief initiatives were assessed in debt distress or at high risk of debt distress

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Debt relief is a necessary but not sufficient condition for lasting debt sustainability

Actions to promote sustainable growth, income and ultimately capacity to repay are needed.

- These actions involve **technical assistance** (TA) and **financing to support growth enhancing reforms** and promote sustainable debt dynamics.
- The solutions to it should not only focus on debt relief, but also **work more on the capacity-building** of the developing countries in economic recovery and sustainable development.
- However, ADB TA on projects that failed to deliver their planned outcomes were generally in public expenditure and financial management, integration of planning and budgeting. Beyond capacity building, introduce **inclusive institutional reforms for quality governance** (**including intergovernmental and international responsibilities and transfers**) to promote economic growth.
- These reforms may include **fiscal rules** (including constitutional constraints, like several EU member countries have done in recent years) that constraint politicians in making and pursuing unsustainable promises. Fiscal rules may not have been adequately well defined so far, but their role in enhancing fiscal discipline should not be underestimated.

Back up

1) The involvement of private creditors I

The involvement of private creditors faces three main difficulties:

a) heterogeneity of creditors, financing instruments and contract provisions.

b) forbearance may trigger an event of default and lead to rating downgrades on the debtor.

c) bondholders may find strategic to obstruct the debt restructuring process with the implicit support of their governments, particularly if these are not bilateral creditors of the country.

1) The involvement of private creditors II

- The International Institute of Finance (IIF) is in the process of updating its Terms of Reference for Voluntary Participation in the G20/Paris Club Initiatives.

- Official creditors participating in the CF should cooperate to leverage participation of commercial creditors, possibly introducing incentives or credit enhancements that could be needed to achieve the NPV neutrality.