A Framework to Evaluate Economic Adjustment-cum-Debt Restructuring Packages

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1. Introduction

Badly hurt by a series of negative shocks since 2019, and increasingly shut-off from capital markets, many developing countries (DCs) are at risk of falling into a debt crisis.[1] The current global financial architecture reacts to debt crises through the negotiation of complex packages that include the debtor country, international financial institutions (IFIs), and external creditors. The debtor must promise to "adjust;" the IFIs must put up new loans and enforce conditionality; and creditors must accept some amount of debt and debt service reduction. Domestic parties also matter: bondholders or labor unions for example try to protect their interests. The bargaining process among these stakeholders can be lengthy, involving domestic and global gaming, each trying to push the costs of adjustment onto others.

In this paper we discuss how the diverse aspects of such adjustment-cum-debt restructuring packages can be evaluated in a coherent fashion. A unified treatment of such packages allows us to highlight important questions that tend to be less evident when studying them in isolation, such as: Why do DCs need conditionality to implement reforms that are good for them? What convinces the old creditors to provide debt relief? How does the size of new lending relate to the depth of debt reduction? Under what circumstances can the IFIs arrange such deals, and what burden sharing would they demand? What does the present global context imply for the design of debt relief-cum-growth packages?

In an earlier paper, two of us developed a framework that clarifies how debt workouts, new loans, conditionality, reforms, and burden sharing relate to each other (Diwan and Rodrik 1992). New growth opportunities play a central role in that framework to facilitate deals among the many stakeholders involved. Taking advantage of these new opportunities requires new funding, but also conditionality, debt reduction, and fair burden sharing. As we embark on a new wave of debt workouts, it is necessary to update some of the elements of such grand-deals and adapt them to the new global realities. This relates in part to the nature of growth opportunities, which now include centrally adaptation to climate change but also other developments such as deglobalization, digitalization, nd the likely demise of the export-oriented growth model.

The required reforms require large amounts of new funding. In the current context, new flows must come early on from the IFIs, but the private sector should be able to provide flows soon afterwards, with an enabling and backstop role played by IFIs. The nature of conditionality will need to be adjusted to the longer-term nature of the reforms under consideration as well as the reduced growth opportunities. Because the existing debt overhang constrains new lending, it will be necessary to remove it by reducing debt. Creditor heterogeneity raises further new issues on how to share the burden of debt restructuring in a fair manner. These considerations also bring to the fore some of the ongoing discussions on how to enhance the DCs' growth process, make the G20's initiated Common Framework for debt overhang resolution work, scale up green finance, and improve the performance of the IFIs.

[1] For a review, see World Bank 2021, IMF 2020, United Nations 2021, Kose, et al 2021.

In the rest of this paper, we describe a broad model of the three-ways deals among a debtor country, the IFIs, and old creditors; consider what type of efficiency gains can facilitate deal-making in the current environment; discuss the nature and limitations of growth possibilities; examine the challenges of the management of conditionality in such an environment; discuss the implications for IFIs financial resources; and end up with considerations of burden sharing. A short conclusion sums up the main policy implications of the analysis.

2. Adjustment-cum-debt restructuring as three-way deals

When serious debt difficulties arose in the 1980s, a "lost decade" of low growth, rising poverty, and political instability ensued. There is a risk that the coming debt crisis will be similarly bogged down by difficulties, with even worse consequences. The current environment is different, and in many ways more challenging than that of the 1980s, when most external debts were owed to international banks and Paris Club creditors. Instead, as seen in Table 1, the current debt overhang for poor and lower middle-income countries is caused by large public debts owed largely to multilateral institutions (51% and 33% for LICs and LMICs respectively), private creditors (11% and 41%), and Chinese institutions (15% and 9%).[2] In upper MICs, the share of private lenders dominates at nearly 80%.

This changed creditor landscape brings into the picture several complicated issues. First, is the reluctance of multilateral institutions to participate in any debt reduction. Second, new emerging market creditors such as China, India, Saudi Arabia and others have not historically participated in coordinated official creditor mechanisms, often preferring bilateral discussions, and current geo-political divergences make this coordination even more difficult.[3] Finally, private creditors tend to be reluctant to provide debt reduction when they see that official creditors are slow in moving.

Debt outstanding provides a static picture after a decade and a half of rapid changes. In recent years, new lending has started to decrease, most notably from market sources and from China. In 2019 and 2020, new disbursed flows were flat. At the same time, debt service was rising, leading to declining net transfers (NT), which is the difference between new loans and debt service (see Table 3). This change especially affected SSA countries and LMICs. In SSA, NT on debt collapsed from $20.8 to $1.7b between 2019-20. In LMICs, NT fell from $55b to $33b. Most of this evolution stemmed from private creditors. Private NTs were negative in 2020 for the first time since 2000, with a large net transfer of -$10.5b from SSA countries to their creditors. For LMICs, this amount was $11.5 billion. Flows from China were also lower, partly linked to “push factors” (lower GDP growth and current account surplus), but also because of a deterioration in the perceived creditworthiness of developing countries (Diwan and Wei 2022).

Besides complicating coordination, this creditor landscape brings into the picture more destructive processes led by self-fulfilling expectations, such as sudden stops and banking crises. Country crises that blow up are thus both more difficult to resolve, and more urgent to address rapidly when they erupt. Indeed, the current dynamics are worrisome. In recent weeks, more and more DCs have been losing market access – most spectacularly, low and lower middle-income

[2] A prominent study by Horn, Reinhart, and Trebesch (2019) finds that when accounting for non-guaranteed debt, debts owed to China are 50 to 80% larger.

[3] For both multilaterals and several bilaterals, the strong preference is for new concessional lending to refinance existing obligations without marking down principal. Depending on the extent of the concessionality or grant element this can result in considerably smaller debt burdens in present value terms. But historically, the concessionality of new lending has been marginally greater than that of the debt being refinanced.

countries (see figures 1 to 4). This is related to the flight for quality occasioned by the rise of interest rates in the US and the EU. In these circumstances, both private and Chinese lenders seem to be reducing their lending out of fear of financing debt service to other creditors. In this way, a liquidity crisis risks turning into a solvency one, if official loans do not provide a cushion (Albinet and Kessler 2022).

The mechanisms needed to respond to upcoming crises will be in part fashioned by precedents, but they also must adjust further to the new realities to become effective. This process however remains in its infancy. The mechanism created by the G20 to deal with the crises arising in poor countries (Zambia, Ethiopia, Chad) is experiencing difficulties taking off. Debt problems that have arisen in middle income countries (Lebanon, Sri Lanka) are also not being resolved in a timely manner. It does not help that the world is more preoccupied with post-Covid recovery, geo-political competition, the war in Ukraine, and stagflation, than with the challenge of development and the ticking bomb of climate change. Nevertheless, with progress on Zambia, and ongoing discussion on Sri-Lanka, "deals" are seemingly starting to trickle down.

In current circumstances, the cost of arriving at debt deals risks being perceived by creditors as higher than the benefits of timely resolutions. Creditors have an interest to wait for better opportunities to open up before considering writing down their loans. Private creditors can also exit by selling their claims, with minimal transaction costs. So, unless debt reduction generates important efficiency gains, paying large transaction costs to reach a complex deal is not an attractive option. Conversely, the existence of large efficiency gains would facilitate the discovery of a win-win opportunity for all the parties involved. Presently, discussions on how to improve the workings of the Common Framework (CF), or on how to reform bond covenants, have focused more on how to reduce the transaction costs of reaching a debt deal than on the gains that can be reaped by doing so. Indeed, most discussions about workouts seem to assume implicitly that the renegotiation game is zero-sum. Instead, it would be more productive to turn negotiations into a positive-sum game.

So what could be the benefits of a debt workout? At a minimum, a debt deal avoids the economic difficulties associated with the status-quo, where each creditor refrains from supporting the debtor country for fear of financing debt service to another creditor. It also avoids the consequence of such a situation, which leads sooner or later to a costly hard default. A debt deal can save on such deadweight costs and can divide these gains among debtor and creditors. These costs have been estimated in the literature to be around 5% GDP (Trebesch and Zabel 2017).[4] The costs include a temporary loss of access to the capital market (Cruces and Trebesch 2013; Lang et al 2022).

But such small magnitudes are unlikely to convince creditors to write down their claims, especially if they believe that the option value of waiting is large. More broadly, it is generally accepted that a debt overhang tends to reduce growth. Presbitero (2010) shows that higher debt is associated with lower growth, and that this is especially the case in countries with good governance, where other constraints to growth are not binding. Recent research continues to find a negative relationship between public debt and growth (Mitchener and Trebesch 2022). But unlike the literature of the 1980s, these studies do not claim that over-indebted countries are likely to sit on the "wrong side of their Laffer curve", and that consequently, debt reduction is in the interest of creditors. Indeed, the importance of the overhang-as-a-tax argument has been in

[4] Trebesch and Zabel 2017 distinguish between "hard" and "soft" defaults and find that the former is associated with a steeper drop in GDP (up to 10%), compared to the latter (3 to 4%) - where hard default include high haircuts, long negotiation delays, and "coercive" government measures, such as a unilateral payment suspension.

doubt empirically, as the tax rates implied by debt service are small, with the net transfers to creditors rarely exceeding 5 percent of GNP.

Two of us have argued in the context of the Latin debt crisis that a more convincing reason why debt reduction can produce gains are the inefficiencies connected to illiquidity (Diwan and Rodrik 1992). We believe that this is still the case, and that illiquidity provides the most compelling justification for debt deals, which is to regain market access. The inefficiency connected to illiquidity is that it prevents over-indebted countries from taking advantage of positive NPV opportunities to increase economic growth. The liquidity constraint is a natural consequence of the overhang, because (1) new creditors are deterred from lending as they expect to be "taxed" by the old creditors, who stand to gain disproportionately, and (2) even if some new money is available, debtor governments are unable to commit credibly not to spend the additional resources on consumption. The result is that investments that are profitable at the world interest rate go unexploited. Financing these good projects is however not sufficient in this environment. Conditionality is also needed to prevent the debtor country from squandering the new loans on consumption. In the absence of debt reduction, however, new lending by IFIs would lead them to make losses, as they would have to join the long list of debt claimants. The role of debt reduction is thus to create the "headroom" needed for the IFIs to lend without subsidizing the old creditors.

The presence of the overhang therefore necessitates a three-sided bargain: The debtor government can afford to undertake adjustment policies – i.e., invest in growth opportunities that pay in the future -- only if additional resources are provided. The IFIs can safely lend those resources only if the old creditors undertake debt (and debt-service) reduction. The old creditors, in turn, will provide debt reduction only if the IFIs can apply effective conditionality to debtor governments to ensure appropriate growth policies are in place. The gains that such a package unleashes can be shared among all parties involved.

But would an overindebted country not be better off avoiding to share its upside with the old creditors – by first presenting a sorry state in order to get deep debt reduction, and in a second stage, focusing on growth opportunities to attract new money? There are several reasons why this strategy is unlikely to work. First, the country can get bogged down early on in a deep recession that further worsens its situation. Second, creditors would be unwilling to negotiate, since they do know about the upside, even if not in great detail, and so keeping their claims hanging would represent the best option. Indeed, historically, deals have tended to be over-ambitious, containing too little debt reduction, not too much -- this also why we tend to observe a sequence of small deals followed by crisis relapse (Kose et al forthcoming). From a political economy perspective, governments tend to try to push debt reduction to future governments as long as they can. But when it becomes unavoidable, they tend to use the crisis as an opportunity to convince citizens that big reforms are inescapable, the IFIs that generous financing is required, and creditors that deep debt reduction is necessary.

3. Growth opportunities and constraints

Once we focus on the role of growth in helping to resolve a debt overhang, it becomes clear that the resolution of the debt crisis of the 1980s in Latin America was facilitated not only by the strengthening of the U.S. banking system, but also, by the Baker plan that stressed moving away from policies (such as import substitution) that had run their course, and towards more market-friendly approaches, at a time when globalization was on the rise (Chari et al 2021). Beside stabilization efforts, the key structural conditions fueling debt reduction deals were market and trade liberalization reforms. In LAC in particular, typical adjustment programs foresaw medium term growth of about 5%, after a lost decade of negative growth in the 1980s (Goldfajn et al

2021). The HIPC supported reforms, especially in Sub-Saharan Africa, were more focused on improvements in governance. Here too, these programs led to a sharp rise in growth rates (Ndulu and O'Connell 2021). In retrospect, for both cases, the promise of higher growth potential was crucial in allowing these programs to be constructed – even though in most cases, lofty projections ended up not being fully realized.

This brings us to question if the growth opportunities that exist in the current environment can be unleashed in the absence of debt reduction. To be sure, development economists have in recent years developed a more pessimistic outlook on the potential for growth in poor countries, due to the loss of comparative advantage of labor relative to capital and robots (Rodrik, 2022). There is also evidence of an important drag on growth coming from climate change. This implies that debt reduction bargains should not exaggerate the role of future growth, and consequently, that the cost of the loss of growth opportunity will have to be deeper debt reduction. But more importantly for our concerns, future growth would be even lower in the absence of new investments that adjust the growth path to new realities. New gains on growth require however new loans. If these new growth opportunities are profitable and if they are funded, they can result in a reduction of the need for debt reduction, counteracting at least in part the effect of the trade-related decline in growth opportunities.

Growth policies

Prior to the COVID-19 pandemic, developing countries appeared to be generally on a converging path with income levels in the wealthiest countries. Many nations in South Asia, Latin America, and, notably, Sub-Saharan Africa witnessed growth spurts in the 1990s or early 2000s. The World Bank now expects developing country-growth rates to fall behind advanced-economy growth rates in the years ahead (that is, convergence to turn into divergence), with the lowest-income countries suffering the most severe blows (World Bank 2021). While the effects of COVID-19 are undeniable, there are reasons to believe that the pre-pandemic growth performance of the developing world was fragile and unsustainable. Growth rates were already beginning to sag prior to the pandemic.

The key point is that the growth strategy around which policies had converged since the 1980s – export-oriented industrialization – appears to have lost its efficacy.[5] There are three key factors that traditionally made manufacturing special and turned it into a powerful growth escalator. First, formal modern manufacturing activities tend to absorb state-of-the art technology relatively easily and hence exhibit rapid unconditional convergence in labor productivity (Rodrik, 2013). Second, manufactured goods are tradable and can be exported, so there are few demand-side constraints – arising from low productivity and incomes in the home market – that constrain scaling up. Third, large segments of manufacturing have tended to be intensive in low-educated labor, which means that manufacturing can absorb significant amounts of a developing country's labor force and faces few constraints on the supply side either. These three characteristics are key to understanding why industrialization has historically avoided the pitfalls of diminishing returns and has been able to foster self-sustaining growth.

Manufacturing has not played a growth-driving role recently, largely because the third of these factors is no longer operative. Historically, rapidly growing countries could move a third or more

[5] This section draws heavily on Dani Rodrik, "Prospects for Global Economic Convergence Under New Technologies," in David Autor et al., An Inclusive Future? Technology, New Dynamics, and Policy Challenges, Brookings Institution, Washington, D.C., May 2022.

of their labor force from farming into manufacturing, reaping the benefits of significant economy-wide productivity gains. Since 1990, practically no country outside of East and Southeast Asia has managed to reach or sustain employment levels in manufacturing exceeding 20 percent of the labor force, with most developing nations falling far short of this threshold. The phenomenon of "premature de-industrialization" seems to have taken over the developing world. Middle-income countries are experiencing declines in manufacturing employment shares at much lower levels of industrialization and of per-capita GDP, while low-income countries are finding it virtually impossible to replicate the experience of previous generations of manufacturing success stories (Rodrik 2016). Moreover, in the few low-income countries where industrialization seems not to have run out of steam, its quality is very poor. Employment growth in these "success" stories (such as Ethiopia, Ghana, and Kenya) seems limited to unregistered/informal parts of manufacturing, with formal manufacturing still in the grasp of premature de-industrialization (see Kruse et al., 2021, Table 6).

The most important reason latecomers outside of East and Southeast Asia are finding it difficult to ride the industrialization bandwagon is technological change. Since the 1980s, innovation in advanced economies' manufacturing sectors has taken a predominantly labor-saving form. Developing countries that want to compete by adopting the latest technologies need to import them from abroad. That means that production techniques – and the relative demand for low-skill labor -- in the most advanced sectors of developing countries will be determined largely by innovation trends beyond their borders. There may be some substitutability between low-educated workers, on the one hand, and skilled workers and capital, on the other. But in practice there will be limited room to deploy production techniques that are significantly more intensive in low-skill labor.

This leaves manufacturing firms in low-income countries with a Sophie's choice: either they adopt new technologies to compete internationally, but at the cost of creating few local jobs; or they absorb labor, at the cost of remaining unproductive and uncompetitive (Diao et al., 2021). Contemporary discussions of industrialization policy in low-income countries emphasize the imperative of upgrading technology and skills – though the implied tradeoff between competitiveness on world markets, on the one hand, and employment generation in formal economic activities, on the other, is rarely noted.

The post-pandemic growth prospects of developing nations do not rest solely on industrialization. Growth "fundamentals" such as education, skills, improved institutions and governance also matter. These fundamentals are the classic drivers of (conditional) convergence. But they do not produce rapid growth of the sort that was getting built into growth projections prior to the pandemic. Even in the most favorable scenario, growth is likely to be slower than in the past, when rapid, labor-absorbing industrialization was still possible (Rodrik, 2014).

The fundamental question facing low- and middle-income countries in the years ahead will be no different from that confronted by advanced economies: where will the good, productive jobs come from? Within agriculture, low-income countries retain considerable potential for productivity improvement and diversification into cash or export crops. But it is difficult to envisage a future world in which agriculture will absorb more, rather than less, of the economy's labor force. Likely, a more productive agriculture will mean a greater outmigration of labor from the countryside, as it has traditionally. So, agriculture will not provide the needed good jobs.

As for services, they come essentially in two varieties. There is first the high-productivity, tradable type of services such as ICT services, business services, finance, etc. These are generally intensive in skills (which are in short supply) and cannot absorb much labor. Even in economies

that have done well in ICT and business services, such as India and the Philippines, there has been little labor absorption into these sectors. Then there is the low-productivity, non-tradable type made up of petty, largely informal activities. This is the part of the economy that currently absorbs the bulk of the urban labor supply. But unlike manufacturing or tradable activities in general, these services cannot individually act as growth poles since they cannot deliver the structural transformation and productivity increases needed for robust, long-term growth. Nor can they expand without turning their terms of trade against themselves. Given the limits of the home market, continued expansion in one segment relies on the expansion of all the others, resulting in limited gains from sectoral "winners."

New growth opportunities

The traditional model of export-oriented industrialization was based on nurturing productive manufacturing firms that act as growth leaders. Future growth policies will need to have different priorities. Instead of focusing on the most productive segment of firms, the next generation of growth strategies will have to target small- and medium-sized firms with the potential to enhance both productivity and employment and which are mostly in services. Economic growth will be possible only by raising productivity in smaller, informal firms that employ the bulk of the poor and lower-middle classes. At the same time, sustainable poverty reduction and enhanced economic security will remain possible only by creating more productive, better jobs for workers at the bottom of the skill distribution. In short, the growth policies of the future will need to look more like social policy, albeit with a much more productivist, firm-oriented bent. While these new services-oriented policies have resource implications and do require public investment, the main policy adjustments needed are in the overall regulatory and governance domain.

The investment needs are clearer and more substantial with respect to the green transition. In the coming decade, growth opportunities will be increasingly of the green growth type. This is paradoxical, given that climate change is hurting growth prospects in DCs most, partly because of their geographical location, and partly because of their population's greater vulnerability and inability to mitigate climate risks. The explanation is that green growth is largely about public policy to offset these negative forces. But it is also about taking advantage of new opportunities.

The negative effects of global warming are estimated (in the range of +1.5°C to +2.5°C) to generate a median loss of 1.5 percent of annual global GDP in 2030, compared to its level without climate change. These costs at much higher in the more exposed countries - some small islands are at risk of disappearing due to sea-level rise (IPCC 2022). Already, climate change has lowered country growth potential, but also their creditworthiness (Bolton et al 2022).[6]

To neutralize this drag on growth would require important investments in adaptation to climate change. Adaptation includes projects to build defenses against sea-level rising, reduce the salinity intrusion and floods, make resilient road and bridge infrastructure, and increase water conservation. Since global food prices are expected to vary much more, it also includes improving food security. Because most adaptation efforts provide public goods, they require scare public funds, and as a result, remain underprovided, even as rates of return are estimated to be very high, including in better resilience to climate disasters.

In addition, although mitigation will remain in the near future a rich country responsibility, the generation of clean energy has become much cheaper in recent years. This is because generating

[6] Bolton et al 2022 find that higher climate risk is associated with higher spreads on external debt, with the spread rising over time to 65 basis points for countries more at risk.

power in clean ways, using solar and wind technologies, has become cost effective compared to fossil technologies, but only when interest rates are low enough (and fossil fuels expensive enough). This is because these investments are front-loaded.

According to the recent COP26 report (Songwe et al 2022), annual investment in adaptation is expected to rise over current levels by about 2% GDP/year by 2025, and by 4% GDP by 2030 for the average DCs. Estimate by the IMF (2021) are slightly lower but of similar magnitude. [7]

In sum

We can take away several conclusions from these considerations. First, the prospective growth ceiling of developing countries is lower, requiring more conservative best-case projections for the future. But relative to that baseline, there are still significant growth benefits from pursuing appropriate growth strategies, focused on cleaner activities such as services and green industries rather than manufacturing. Importantly, a green transition offers important potential gains but over longer time horizons than typical investments: by neutralizing some of the growth drag caused by global warming, saving foreign exchange for oil-importers, and exporting carbon offsets. As a result, credible, realistic programs of adjustment will require new funding, and they will also have to adjust the amount of debt reductions to the emerging new growth realities.

To give a sense of dimensions, if the gains amount to a pushback of the climate drag of around 2%, plus a 1% gain in productivity due to digitalization, debt reduction and new financing can unleash gains whose value is in the magnitude of 60% GDP (at a discount factor of 5%). The possibility for the debtor of capturing some of this value can act as a powerful incentive to arrive at cooperative debt deal. Such deals would need to incentivize sufficient external capital flows to support a rise in domestic investment of the order of 5% GDP in the medium term.

4. The changing role of IFIs

IFIs are the central brokers of these multi-party deals. But to adjust to the new needs, there are several types of adjustments in the way they work that will be needed. First, the design and management of conditionality needs to be adapted to the new types of development challenges. Second, IFIs' financing role has become more central and more onerous than in the past, requiring both a large increase in their financial muscle, and in the way they coordinate among themselves. And third, the disciplinarian role of IFIs has also become more complex given the changed nature of the creditors. Let's explore each of these issues in turn.

Conditionality

Conditionality remains at the heart of adjustment packages as this is the commitment mechanism that allows the debtor to promise to invest the forthcoming funds, which is a necessary condition for the new creditors to make these funds available (the other requirement is debt reduction). The nature and application of conditionality needs to evolve however to meet the new conditions.

[7] IMF (2021) finds that short term mitigation costs (i.e by 2025) are highest in EMs (because they have a lot of assets to protect), at about 2.5% GDP/year, followed by small developing countries (at 1.8% /year) and the LICs (at 1.6%.per year), which are more hit by global warming. They are lowest in the advanced countries (at about 1% a year), where construction costs are cheapest, and climate exposure lowest. In terms of regions, adaptation costs in sub-Saharan Africa are estimated at between 2–3 percent of regional GDP/year, and in some Middle East countries at over 3 percent of GDP/year.

First, the content of conditionality needs to change, particularly in the context of IMF-supported programs. It is critical that IFI programs considered in the context of debt reductions do justice to the growth agenda. Otherwise, the premise of higher future growth, that underlies the value of such deals, disappears. This means that the balance must shift from a primary emphasis on meeting macroeconomic targets to that of achieving the relevant reforms and undertaking the investments needed to push growth. In large, complicated programs where reviews are often delayed and domestic political pressures acute, there is a tendency on the part of both the IMF and the authorities to prioritize meeting of the macro targets (e.g. budget deficit, net international reserves levels, interest rates) and turn a more flexible eye towards delays in achieving reform milestones which may turn out to be politically inopportune.[8] Moreover, the distribution of costs and benefits in the case of growth-oriented reforms is often more concentrated than in the case of macroeconomic measures. For example, raising fuel excises to meet a deficit target hits a broad base of people and therefore there is less incentive on the part of any one group to lobby hard against it. Other reforms, such as reducing subsidies or restructuring/privatization of state-owned enterprises, can hit particular interest groups that over the years have benefited from such inefficiencies. Being fewer in number and often better organized such groups can galvanize more effectively against such measures.

Second, even more than in the past, governments will need to ensure that the conditionality they commit to is socially acceptable -- its role is to be a commitment mechanism that improves welfare, and not a form of tyranny from abroad. This is especially the case because these commitments need to be of a long-term nature to be able to unleash financing for long-term investments. For this to work, the nature of the upside – sustainable, inclusive economic growth -- must be the centerpiece of adjustment programs. Greater effort need to be deployed by governments to encourage national debates within civil society leading to national plans, so that conditionality becomes a commitment internalized by the main social forces. The experience of the Comprehensive Development Framework, which has served as a basis for strengthening country ownership of its reforms by insisting on social participation in shaping these reforms constitutes a valuable basis to build on (Stiglitz 2002).

Third, the mechanisms needed to enforce conditionality also need to be adjusted to the gradual and longer-term nature of the underlying commitments necessary to make progress on adjustments to climate change in particular. In the Latin America programs of the 1980s, "structural reforms" were largely of the strike-of-the-pen type, and so they could be implemented during the short duration of IMF programs. In contrast, the new types of investments in adaptation and mitigation to climate change require a much longer period of implementation, and thus, conditionality needs to be spread over a longer period. In this, there are similarities with the HIPC reforms programs, which provided debt reduction in tranches, governed in a first phase by IMF conditionality at an "inception point," and then at a later phase ending with a "completion point," according to broader reforms spelled out in nationally owned "poverty reduction strategies." In the current situation, HIPC-like mechanisms would need to be considered, including the possibility of providing debt reduction in tranches and over time, as opposed to in one short at the outset, as in the traditional MIC model.[9] Moreover, debt reduction would need to

[8] For example, in the IMF's 2019 EFF program with Pakistan, most of the structural reform agenda defined at the outset of the program remains incomplete – for example, the tax to GDP ratio remains low, and untargeted subsidy remain large.

[9] There is a new literature on debt-for-nature swaps that suggests that private loans can be made contingent on climate investment and monitored by an independent agent. Expanding IFIs' conditionality to green policies would seem easier to institute. See Bolton et al 2022, Chamon et al 2022.

create headroom for future investment, and this headroom would need to be guarded over time, and used solely for the required purposes. [10]

Fourth, more than in the past, coordination between the IMF, the World Bank, and regional development banks will need to improve considerably, to accommodate further the longer duration reforms. While IFI leadership on the structural reform agenda should logically come from the World Bank, coordination between the two institutions is often a challenge. The new IMF instrument, the Resilience and Sustainability Trust can help in setting up the fiscal structure for such engagement. The IMF would also need to offer more often higher conditionality programs with larger funding (several times quota). But it would also need to operate jointly with MDBs, who would ideally initiate from the outset a longer-term budget support and sector operations in support of transformation programs. This cooperation needs to find its way in the analysis of debt sustainability (DSAs) that determines how much lending and how much debt reduction are needed. Even a loose commitment by World Bank for medium-term reform programs can allow for projections of more capital flows over time, higher investments, and higher growth rates. Moreover, new skills are required in IFIs to support this new type of reforms.

New loans

In theory, IFIs could simply put their imprimatur on adjustment programs and monitor program implementation, without lending money. Under the Baker plan in the 1980s, the IFIs had some "skin in the game" through their own lending, but they could still count on some level of "forced lending" by old creditors (Cline 1989). But back then, creditors were mainly a handful of commercial banks that could coordinate their actions around a table. During HIPC, IFIs could count on bilateral support, which increasingly came to the LICs in the form of grants. In the current situation where market finance dominates, an exchange of old bonds for bonds with a lower debt service will provide some flow relief, but this is unlikely to make a big dent, given that total debt service to GDP ratios for LMICs is around 3%, while required additional investment requirements are more than that. But it seems impossible to require uncoordinated bondholders to provide new money, as even the most advanced collective action clauses (CACs) that help coordinate bondholders can allow at best for the exchange of securities (and thus debt service reduction), but not for new money calls.[11] This means that more than in the past, new finance will need to be provided early on by the IFIs, until debtor countries re-establish a track record of creditworthiness and market access, once they have managed to transition to a new growth path.

Moreover, as seen above, the new type of growth programs is costly as it needs to improve investment ratios by about 5 pps by 2030. This seems higher than the old-style reforms of the 1980s, which shifted investment from the public to the private sector to concentrate on a narrower set of public expenditures. Because IFIs will be at least for the next period the main intermediary between markets and DCs, new debates on how to improve their financing power – whether it will be new capital increase, issuance of SDRs, more leverage, or a combination of these mechanisms. It will be hard to expect a quick resolution of debt difficulties before the source of additional new financing for IFIs is clarified.

An important note here is that the size of IFIs loans, and the amount of debt reduction needed, should be negatively correlated. Even though, mechanically, one would think that larger IFIs

[10] Despite all the effort to prevent "excessive" borrowing, it proved difficult to enforce discipline in the face of a fast-rising supply of capital by the private market and by China.
[11] Because CACs are not included in all bonds, Bolton, Gulati and Panizza (2021) have suggested that a UN resolution is needed to declare a moratorium on debt service payment during emergencies.

loans require larger DR, to create sufficient room, this should not be the case in the presence of valuable growth opportunities. An ambitious lending program that financed an ambitious reform program should lead to high growth rates and thus require *less* debt reduction. More precisely, as long as the "return to adjustment" is expected to be larger than the IFIs' cost of lending, mutually beneficial deals exist, where the IFIs are repaid, and the debtor and creditors end up better off.

To fully unlock the growth returns from countries in debt distress, it is also important for the IFIs to prioritize the leveraging of private sector financing. First, the nature of several growth enhancing type investments requires flows that are so large as to be above the level of sovereign debt that countries can carry. As a result, as much as possible of the financing should come in the form of FDI, especially in areas that traditionally attract the private sector, such as energy generation or green agriculture. These investments however may require risk reduction to encourage larger flows, and in some cases, some level of subsidy. Enhancements could be also needed for the provision of country debt by the capital market as just after having given debt relief, there is likely to be less appetite among private lenders to follow up with new loans.[12] Moreover, there is also a risk-management angle for diversifying public and private debts. Multilateral loans are senior to official bilateral loans which in turn are typically senior to private sector lending. Loading up on senior debt makes it difficult for a debtor to access private capital markets and to restructure debt in the future should the need arise. By contrast growing the share of private creditors gives the debtor a more flexible balance sheet.[13]

Burden sharing

A third function that IFIs fulfill, in addition to funding and the management of conditionality, is to coordinate burden sharing amongst creditors when a debt reduction is needed. The IFIs need to make sure that the old debts are reduced sufficiently to make their lending if not risk-free, then at least of acceptable risk (IMF 2020). This also is not a new goal, but its application in the current crisis is more complex than in the past due to the growth of debt to the private market and to the BRICs and Middle East official creditors.

Historically, the frameworks for debt restructuring have been developed by international financial institutions led by the IMF and the World Bank. They have generally worked in the past because the countries that are well-represented in the Boards of the IMF and the World Bank—primarily advanced Western economies—were also the major bilateral creditors to the DCs. These countries had organized themselves in the Paris Club to coordinate their interactions with debtor countries. Thus, as the major creditors, they had ownership in the debt resolution frameworks developed by the IMF, which allowed the framework to work as well as it did.

Over the past two decades the landscape of bilateral official creditors has changed significantly. As noted above, for the typical low-income country only a small share of its total official bilateral obligations is to Paris Club creditors; the rest are to China and other countries. But while the creditor landscape has changed significantly, the representation of these new creditors at the boards of the IFIs has not. These new official creditors are not the major decision-makers in these

[12] A Center for Global Development study finds that the use of MDB policy-based guarantees has allowed countries with marginal market access to regain market access, to reduce the cost of borrowing (Landers and Aboneaaj 2022).
[13] Equally, there is also a debt management angle at diversifying between domestic and foreign debts, with the latter reducing the incentives to inflate the domestic currency, which lowers the cost of the former (Panizza 2008).

institutions. As such they have little ownership in the principles for debt restructuring developed by these institutions. From their perspective, if they are going to be taking major losses in their claims, they should have a major say in how these principles are developed. In other words, they don't want others to be generous with their money. To be workable, the debt resolution framework needs to give more say in its design to the existing creditors.

Given the nature of IFIs and the nature of debt issues, fundamental changes to address these considerations are unlikely to arise rapidly. In the meantime, the main instrument that the IMF has available to achieve coordination of official bilateral creditors is its lending into official arrears policy (LIOA). Under this policy that was introduced in 2015, so long as certain conditions—that are meant primarily as safeguards—are satisfied, the IMF can proceed with a lending program despite concerns from any holdout official bilateral creditors. Prior to the introduction of this policy, the IMF could not lend to a country if it were to run arrears to any bilateral official creditor. Thus, any bilateral official creditor could hold up an IMF program unless it was satisfied with the debt restructuring terms being offered to it. When this policy was introduced in 2015, it was intended as a major step forward in the architecture of resolving debt crises by overcoming such potential holdout problems, under appropriate safeguards.[14]

However, it has proven difficult to use this policy to produce more timely creditor coordination. For Zambia it took more than two years before the first meeting of its creditor committee took place. At one level, using a stick against bilateral agencies is complicated since they are owners of the IMF. At another and conceptual level, it is not clear if allowing the IMF to tolerate arrears towards a non-cooperating official bilateral creditor country would fundamentally address the debt sustainability situation if the creditor country could, exercising its influence, get its arrears cleared on preferential basis after the end of the IMF program.

Moving forward on this issue remains a challenge. Meanwhile the IMF continues to do important outreach to new creditors to participate in the creditor committees. The case of Ghana will test whether debt discussions can go faster when China is not a large creditor, but where domestic debt is dominant. While Chad and Ethiopia seem to have unique circumstances that is slowing their pace of reaching a deal, there has been some progress in Zambia and Sri Lanka recently. What will be of critical importance will be whether official bilateral creditors provide debt reduction as opposed to rollovers or rescheduling of existing debts.

A related concern is over IFIs' own exposure. Private creditors often complain that at the time of the restructuring they don't have good visibility on the IMF's debt sustainability analysis (DSA). This tool determines the envelope of resources that would be available to service any claims on other creditors. Since the IMF has most preferred creditor status, private creditors express the concern that the IMF has incentives to present a DSA that calls for a sharper than needed debt restructuring. The deeper the restructuring the greater post-deal debt sustainability and greater the prospects that the IMF will be repaid. Moreover, and somewhat paradoxically, a restructuring deal that imposes greater pain on current private bondholders has a greater chance of being seen as a success at restoring sustainability and thereby inviting more "buy" orders from new private sector funds—one person's loss is another person's gain. The extent to which exchanged bonds rally in the secondary market after an exchange has been concluded is often a metric of the success of the restructuring.

[14] As a historical footnote, this policy change was introduced in the backdrop of the then Russia-Ukraine conflict when one of the concerns of several members of the international financial community was to not let Russia hold up IMF assistance to Ukraine.

Conclusion: Key Policy implications

We have outlined a framework that allows thinking coherently about many of the hot issues in the field of development finance that tend to be treated separately: the nature of adjustment programs, IFIs' loans to finance reforms, the possibility of a new growth path, and the type of debt workout needed to support such arrangements. The framework is useful in highlighting how efforts devoted to several reform of the international financial architecture relates to each other.

- First, we argued that growth is an essential ingredient of debt relief-cum-adjustment packages. This is especially the case this debt crisis around because of the predominance of official debt to both multilateral and non-Paris Club creditors.
- Second, growth is likely to be lower and more domestically oriented, even in the best of circumstances, requiring a combination of deeper debt reduction and longer time horizons.
- Third, new growth opportunities exist, but unlike the past, they will be largely shaped by investments in adaptation to digitalization and to climate change.
- Fourth, to be realized, these investment opportunities require new funding and new forms of conditionality. New loans will have to come early on largely from the IFIs, until DCs embark credibly on new growth paths. This will require efforts to increase their financial muscle.
- Fifth, there are several areas where IFIs will have to reform the way they work: conditionality needs to focus on new types of reforms; coordination among themselves will have to improve; and debt sustainability analysis needs to account for medium-term reforms.
- Finally, for countries that do not have a debt overhang but are experiencing illiquidity, and for countries emerging from a debt overhang, commitment of public funding to loan enhancement will be important in raising their creditworthiness sufficiently so that they can regain market access rapidly.

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Figure 1. Number of developing countries with Eurobond yields above and below 10%: All developing countries

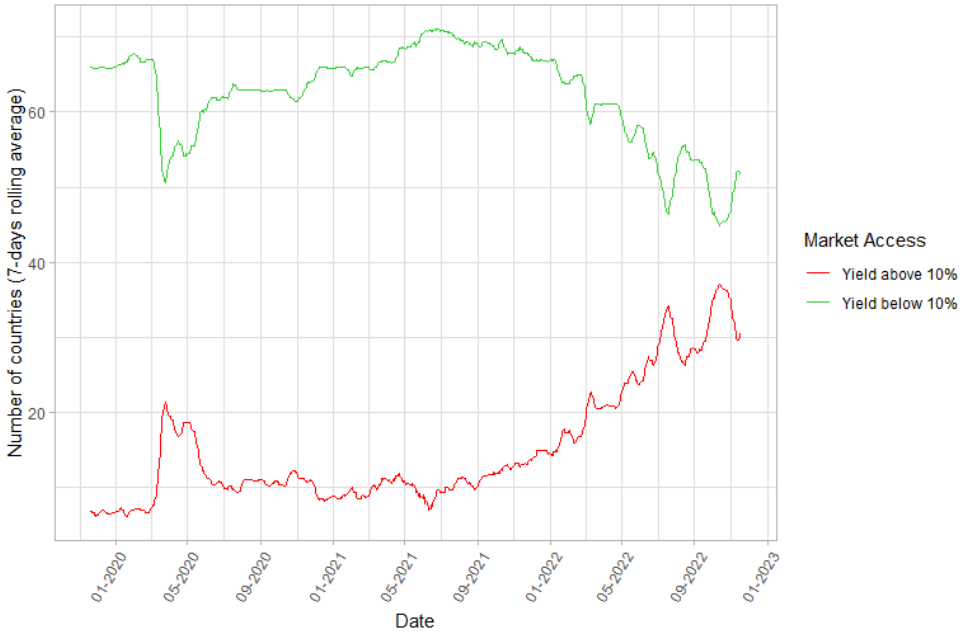

Figure 2. Number of developing countries with Eurobond yields above and below 10%: Low Income countries

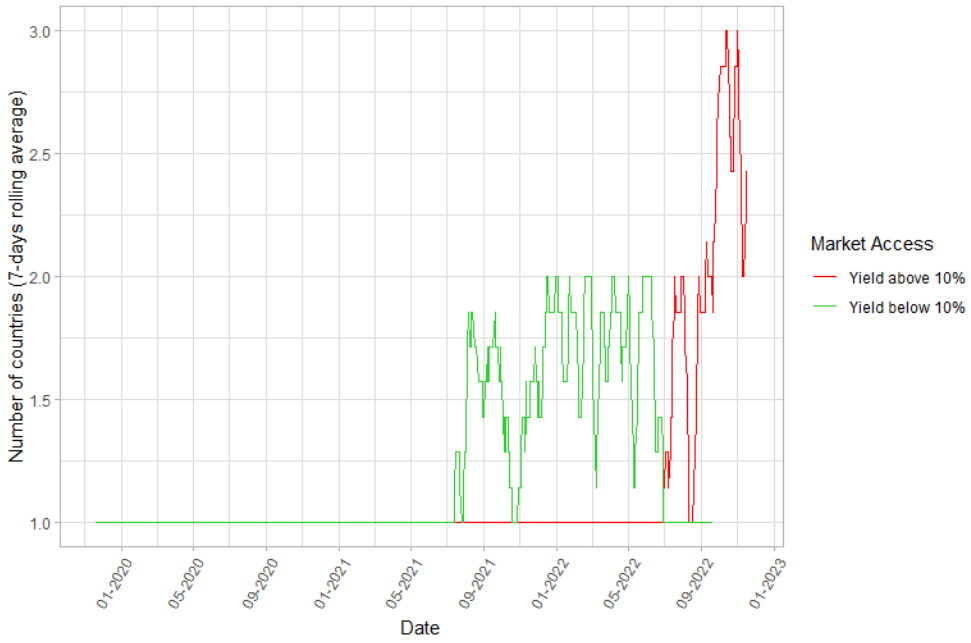

Figure 3. Number of developing countries with Eurobond yields above and below 10%: Lower middle-income countries

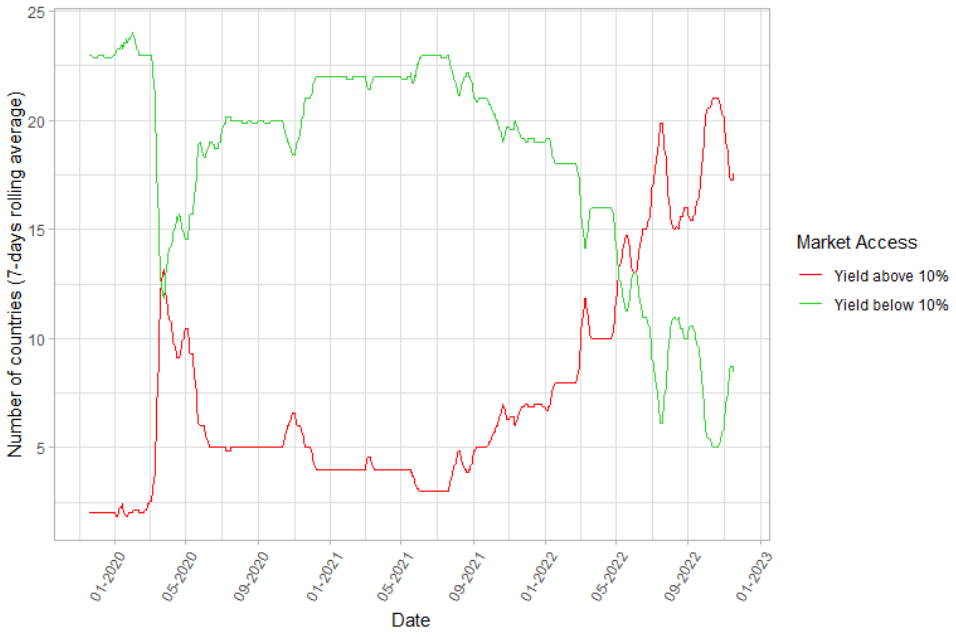

Figure 4. Number of developing countries with Eurobond yields above and below 10%: Upper middle-income countries

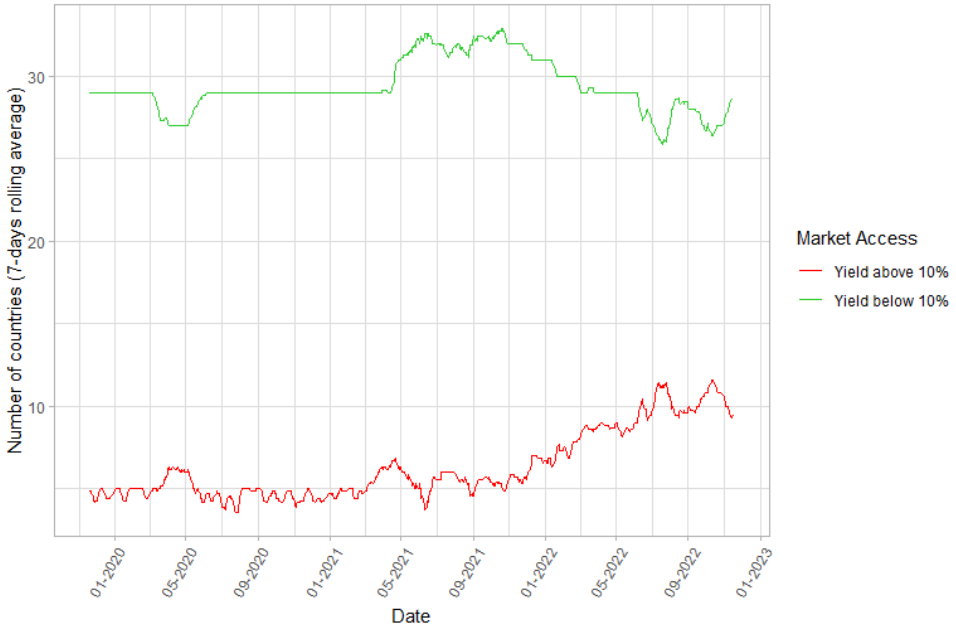

Table 1: Total Long Term external debt stocks (Public and Publicly Guaranteed), end 2020

	SSA	LICs	LMICs	UMICs
PPG external debt stock ($mil)	453,946	123,812	1,283,672	2,037,191
China debt stock ($mil)	76,951	18,721	120,201	31,532
China (%)	17.0%	15.1%	9.4%	1.5%
Multilateral (%)	31.6%	51.1%	32.7%	15.1%
Bilateral ex-China (%)	10.3%	22.3%	16.5%	3.9%
Private creditors (ex-China) (%)	41.1%	11.4%	41.4%	79.5%

Source: IDS, WB, 2022. PPG is public and publicly guaranteed debt. SSA excludes high-income countries.

Table 2. Total (net) Capital Flows on external debt

Avg. 2018-2020	SSA	LICs	LMICs	MICs
Total (net) flows ($m)	79,204	54,603	228,162	725,710
FDI (net) flows ($m)	20,227	9,370	121,448	468,129
Total grants* ($m)	29,804	39,001	23,720	37,362
Debt (net) debt flows ($m)	29,173	6,232	82,994	220,219
From China (%)	12.60%	7.30%	12.20%	3.70%
From Multilateral (%)	42.50%	75.60%	36.30%	18.70%
From bilateral (ex-China) (%)	5.60%	11.70%	8.40%	2.50%
From private creditors (ex-China) (%)	39.20%	5.50%	43.10%	75.20%

Source: IDS, WB, 2022

Table 3. Net Transfers on external debt (PPG)

	SSA		LICs		LMICs		MICs	
	2019	2020	2019	2020	2019	2020	2019	2020
Total NT	20,833	1,760	4,016	4,978	55,002	33,864	78,659	141,281
China	799	-1,040	-477	337	4,747	-1,015	-1,704	-4,038
Multilaterals	11,385	11,770	3,811	4,459	18,886	37,509	13,819	50,707
Bilaterals	1,054	1,530	897	434	1,378	8,808	-3,496	5,615
Private	7,596	-10,499	-215	-253	29,992	-11,438	70,040	88,996

Source: World Bank, IDS, 2022