PREVENTING AND MANAGING DEBT CRISES:

THE ROLE OF DEBT TRANSPARENCY

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ABSTRACT

Amidst calls for debt relief to mitigate the socioeconomic consequences of COVID-19 in Africa, debt transparency has become an even more pressing issue, in view of the recent wave of debt suspensions under the Debt Service Suspension Initiative (DSSI) and calls for Private Sector Involvement (PSI). This paper assesses the key risks stemming from debt unsustainability in low-income countries (LICs) and lower-middle-income countries *(*LMICs) and the key debt transparency initiatives promoted by international organisations and the private sector. The June 2019 G20 Communiqué on the importance of improving debt transparency for debt sustainability, the April 2020 G20 Communiqué on approving debt relief of the poorest countries and the October 2020 G20 Communiqué have all recognised the need for a global sovereign debt repository. In line with Ayadi and Avgouleas (2020), furthering debt transparency, via the implementation of a global sovereign debt registry, can enhance the quality of debt monitoring and thus help reduce the risk of a messy and costly systemic debt crisis. In the same way it can ensure orderly sovereign debt resolution and reduce the risk of an abrupt loss of market access. Finally, enhanced transparency is key to prudent debt management, thus, limiting endemic corruption in some countries and limiting the potential for destruction of economic value following unmanaged restructuring and defaults.

DEBT UNSUSTAINABILITY, RELIEF AND RESTRUCTURING

In 2019, well before the present Covid-19 crisis, global sovereign debt had increased sharply. According to the IMF GFS Report[1] (2019), the median external debt in emerging markets economies rose to 160% of exports (the highest was up to 300%) as compared to 100% in 2008. This development was largely due to prolonged accommodative monetary policies in developed countries, the growing role of emerging countries in financing low-income countries (LICs) and lower-middle-income countries *(*LMICs*),* and growing capital flows to emerging markets and other LICs, which have supported additional borrowing from a large spectrum of official and non-official sector lenders. International financial institutions, Club of Paris and other creditor countries such as China, and the private sector had all increased their lending to LICs and LMICs. Debt repayment was rapidly limiting the fiscal space of these countries.[2]

However, the risk of debt unsustainability cannot be easily assessed when the debt is not fully disclosed (to) and monitored (by) market participants, especially in good economic times when debt tends to

[1] https://www.imf.org/en/Publications/GFSR/Issues/2019/10/01/global-financial-stability-report-october-2019

[2] This assessment has been confirmed and countries belonging to this category were recommended to implement countercyclical fiscal buffers to withstand shocks. See IMF (2020).

pile up virtually unnoticed. When the debt levels are fully transparent and creditors known, restructuring state liabilities becomes less costly for national economies and their wider societies as well as for the creditors themselves.

By 2020 it had become clear that debt service in LICs was a structural issue (G20 2020a). Some African economies have already shown that the magnitude of the economic shocks they suffer from is very significant, including sharply reduced economic output and a severe reduction in income from migrant worker remittances. Initiatives are underway to alleviate the burden of interest repayments, particularly in Africa (G20 2020a).

The COVID-19 pandemic has exacerbated the situation by accelerating debt distress. According to the IMF[3] (2020), debt levels have now reached new, unprecedented highs. Compared to end-2019, debt ratios are projected to increase by 20% of GDP in advanced economies, 10% of GDP in emerging market economies and about 7% in low- income countries.

Rising external debt in advanced economies, with their relatively greater capacity to borrow, thanks to low interest rates and risk, can turn risky in the upcoming years, placing further strain on future generations. But this increase in debt in emerging economies and LICs, with their reduced capacity to carry and service this additional debt, has resulted in increasing vulnerabilities, increased the probability of default and ensuing risks to economic growth and financial system stability.

But the lack of debt transparency is a major obstacle to restructuring efforts. The longer vital debt restructuring is delayed, the greater the adverse economic impact on these countries, exacerbating the economic and human consequences of the pandemic. The dual advent of a public health and a severe economic crises may destabilise the internal order in the more vulnerable countries and lead to civil unrest, violence between different racial and religious groups and even external wars. The costs of a development would be incalculable.

As part of asset of initiatives to mitigate the consequences of the COVID-19 pandemic, the G20 issued a communiqué[4] in April 2020 to address debt vulnerability in the poorest countries, to enable the freeing up of some fiscal space to combat the health crisis. A Debt Service Suspension Initiative[5] (DSSI) was endorsed by the World Bank's Development Committee and the G20 Finance Ministers to respond to a call by the World Bank and the International Monetary Fund (IMF) to grant debt-service suspension to the poorest countries, in order to mitigate and manage the severe consequences of the COVID-19 pandemic until the end of 2020. The main objective of the DSSI is to allow poor countries to

[3] https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020
[4] https://g20.org/en/media/Documents/G20_FMCBG_Communiqu%C3%A9_EN%20(2).pdf
[5] https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

allocate their resources towards health and social spending in order to fight the pandemic and to save the lives and livelihoods of millions of vulnerable people.

The implementation of the DSSI was accompanied by the monitoring of spending, promoting public debt transparency and ensuring prudent borrowing, mainly through a commitment to limit non-concessional borrowing, as supported by ceilings within the IMF programmes and the World Bank's non-concessional borrowing policies. As of late August 2020, 43 countries had participated in the DSSI and benefited from an estimated USD 5 Billion in debt service suspension from official bilateral creditors. On 14 October, the G20[6] and Paris Club members[7] agreed to extend the DSSI for another six months (from 01 January 2021 to the end of June 2021).

There have been calls by the official sector and others for private sector involvement (PSI) in the DSSI. However, rescheduling debt service on DSSI- comparable terms would result in losses to a diverse base of private creditors because of widening risks at the time of distress. In May 2020, the Institute of International Finance (IIF) issued a framework[8] for voluntary participation in the DSSI, which included a toolkit for DSSI- eligible sovereign borrowers that request forbearance from their private creditors. The initiative was perceived to be "net-present value (NPV) neutral" and was marketed as such. Namely, that is there would be no reduction in the nominal amount of the debt principal or interest and that the contractual rate of interest would be paid on deferred amounts. Since its publication, this framework has not been used by either the creditors or the debtors concerned due to the lack of incentives from both sides. From the creditors' side, rescheduling debt service on comparable terms, using the NPV neutrality principle, would have implied extended maturities at below market interest rates. From the debtors' side, there was a concern of downgrades, loss of market access and, potentially, other legal complex ramifications that would have dire economic and social consequences.

What further drives sovereign debt default complexity is the absence of a credible International sovereign bankruptcy mechanism and generally the market has relied on a contractual approach for resolution – mainly with the use of Collective Action Clauses (CACs). However, as emphasised by the 2020 IMF paper[9] that evaluated the international architecture for resolving sovereign debt involving

[6] https://g20.org/en/media/Documents/FMCBG%20Communiqu%C3%A9_English_14October2020_700pm.pdf

[7] The 22 members of the Paris Club are: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, Korea, the Netherlands, Norway, Russian Federation, Spain, Sweden, Switzerland, the United Kingdom and the United States of America.

[8] https://www.iif.com/Portals/0/Files/content/Regulatory/Voluntary%20Private%20Sector%20Terms%20of%20Reference%20for%20DSSI_vf.pdf

[9] https://www.imf.org/en/Publications/Policy-Papers/Issues/2020/09/30/The-International-Architecture-for-Resolving-Sovereign-Debt-Involving-Private-Sector-49796

private sector creditors, several sovereign debt restructurings in LICs prove to be unnecessarily protracted, incomplete and non-transparent. The same IMF paper highlighted the urgent need to reform international debt architecture. IMF's reform proposal is centred on the expansion of the CAC mechanism to all newly issued debt, the wider use of targeted anti-vulture fund legislation, more involvement of the IMF in debt restructurings, and enhancement of debt transparency and debt management.

Whilst the COVID-19 pandemic continues its second wave worldwide, countries will continue borrowing and pushing debt levels globally to further heights as the only way to, first, alleviate the social cost of the pandemic, and, secondly to jump-start the recovery phase. In the absence of a comprehensive resolution framework, a COVID-19 related systemic debt crisis is neither very far nor can be expected to be effectively managed. The costs will be dire for the countries that will have to restructure or default on their debts. A recent paper[10] shows that post-default restructurings are associated with larger declines in GDP, investment, private sector credit and capital inflows than pre-emptive restructurings.

DEBT UNSUSTAINABILITY AND OPAQUENESS

In April 2019, the Jubilee Debt Campaign, a UK-based charity which is part of a global movement of civil society organisations, called for new mandatory rules that would require lenders to disclose information on loans granted to governments. Several examples of debt cases with little to no disclosure were mentioned. A characteristic example was from Mozambique. In 2013, the country borrowed USD 2 Billion via state-owned companies, guaranteed by the country's Ministry of Finance, to buy tuna fishing ships and military patrol boats and to upgrade the fishing sector. The loans were not fully approved by the Mozambican Parliament, despite the requirement from within the Mozambique Constitution. Several international banks and investors were involved in a structured deal. In 2017, an investigation mandated by the Embassy of Sweden in Maputo, unveiled a scandal of misconduct, incompetence, secrecy, corruption and misuse of funds. Beyond this specific case, which turned into an international scandal, the public sector and local entities in several countries have been able to borrow funds for special purposes that are guaranteed by the government, as part of private-private partnership schemes. Many of these deals are neither registered nor disclosed.

In a 2019 article, Axel Weber, Chairman of UBS and the IIF, emphasised the growing danger of unreported debt. He noted that "more low-income countries borrow on commercial terms from private groups, rather than primarily from multilateral institutions such as the IMF or the World Bank

[10] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3557035

Group, some forms of debt are often not being reported and thus not counted when investors judge a borrower's debt capacity. That makes it hard to help countries avoid falling into the same trap we saw in previous economic cycles: unsustainable debt saps potential growth and robs vulnerable populations of their right to a decent life by tying governments' hands through heavy interest burdens." (Weber, 2019). He also stressed the importance of the Voluntary Principles of Debt Transparency and recognised that greater debt transparency facilitates good governance, fights corruption, supports debt sustainability and ensures the better allocation of funds in the real economy. However, to make these principles work, support is required from the public sector and official and private lenders, to set-up a repository (G20 2020b) where all relevant debt transactions are reported and made publicly accessible.

Augmented governance and monitoring mechanisms will prompt private creditors to exercise discipline, allow for adjustments to the IIF principles as sound practices develop and for pragmatic solutions to emerge in case of debt distress. Debt transparency enhances the accountability of LIC and LMIC governments vis-a-vis their citizens and country creditors. When the issued debt is registered and recorded in a way that is publicly accessible and identified, then it is more efficiently managed in case of default or restructuring and is potentially less costly for all.

INTERNATIONAL EFFORTS TOWARDS ENHANCING DEBT TRANSPARENCY

In a joint WBG-IMF paper (2018), three key observations were highlighted:

1. "Strengthening public debt recording, monitoring and reporting is critical to debt transparency" via capacity-building;
2. "The primary responsibility for reporting accurate and comprehensive public debt data lies with the sovereign borrower";
3. There are gaps in "the recording, monitoring, and reporting of reliable and comprehensive public debt data in LICs and LMICs".

These observations stress the importance of relying on data recorded by the borrowers. There are, however, prerequisites to effectively record, monitor and report public debt consistently. There should be a strong governance framework, effective organisational structure, adequate staff capacity and a functional recording system. The IMF-WBG paper outlines, in detail, the steps necessary to achieve this objective.

Nevertheless, there are significant gaps[11] in debt recording, monitoring and reporting by LICs and LMICs. The key problems in debt management governance range from weak legal frameworks and lack of audits (e.g. debt management performance audit and annual audits) to poor data administration, internal controls, and low staff capacity. The International Organisation of Supreme Audit Institutions (INTOSAI) reaches similar conclusions.[12]

According to the WBG and the IMF, the main drivers of weaknesses in debt recording, monitoring and reporting include:

a) Weak incentives to produce reliable data—linked to the lack of senior public manager demand, limited public scrutiny and non-regular audits, leading to debt data not being recorded or updated accurately or consistently;

b) Weak procedures, which contribute to low-quality data and data administration; weaknesses in infrastructure for debt recording and outdated software and;

c) Insufficient human resources.

Other weaknesses stem from the broader institutional and governance framework. These include fragmented responsibilities and uncoordinated institutional arrangements; limited mandate, where the legal framework for the coverage of public debt is narrow; and weak audit capacity.[13] Overall, there is a fundamental gap in the debt recording and monitoring capacity that can be exacerbated by multiple data requests from different stakeholders (including international financial institutions, rating agencies and investors) demanding different pieces of information in varying formats.

The WBG, the IMF and other Technical Assistance (TA) providers have delivered sustained and

[11] "The World Bank's Country Policy and Institutional Assessment (CPIA) indicates that the average quality of debt management policy and institutions are broadly comparable with the overall assessments of policy and institutions and they both fall short of the 3.5 rating for which countries are considered to have "adequate" capacity." (WBG-IMF 2018).

[12] INTOSAI's "Audit of Lending Borrowing Frameworks, 2013 - 2017" concludes that, "where legislation was not clear on the allocated authority, front, middle and back office activities were uncoordinated and spread across a number of entities, creating inefficiencies in the debt management function, and information to departments and auditors was limited. Lack of clear segregation of duties led to lack of transparency in reporting, weak quality control, and a lack of accountability." The auditors also found that record-keeping was often not accurate or complete, delays in updating of information led to discrepancies between payment schedules and orders, debt reporting often did not comply with legislative requirements and there was little integration of debt statistics into policy-making decisions. They noted that, in some cases, whilst the data was regularly published, it was not useful for decision-makers as it lacked relevant details and they also pointed to significant inconsistencies amongst different sources (INTOSAI Development Initiative 2018a).

[13] According to the findings of the WBG and IMF report, "the lack of trained internal and external auditors can result in weak audits and lack of follow-up on audit recommendations. Where responses are weak, or recommendations are ignored, audits have limited impact. Lack of publication of external audit reports also contributes to a lack of effectiveness, as there is then no public scrutiny." (WBG-IMF 2018).

extensive TA on debt management related issues in LICs and LMICs—from institutional and governance arrangements to the preparation of medium-term debt management strategies. However, the gap has not been filled because of a lack of incentives that would prompt and motivate decision-makers to improve debt management - an essential condition for debt sustainability. Moreover, as we have already illustrated, debt management cannot be effective without debt transparency. Capacity reinforcement can be part of the framework, but if there is no political will locally, little can be credibly and decisively achieved.

As recommended by the WBG and IMF, TA should continue and be expanded to include the revision of the legal and regulatory framework. This will allow the central government to obtain information from sub-central governments and State-Owned Enterprises and provide central oversight on their borrowing activities, including private-public partnership (PPP) financing schemes.

To achieve this, more resources are necessary to support integrating debt management activities into wider public financial management frameworks and processes. More training is required - at all levels of the relevant institutions and international events - to promote activities such as benchmarking, best practices and success stories. Additionally, there should be more campaigns to raise awareness at the highest political level (e.g., politicians, public servants, civil society and academics). Accessible platforms can be set-up as a coordinated effort between all the institutions involved, which, via these platforms, can provide technical assistance and training materials to key officials and others who might require them. Benchmarking and performance assessments should also be encouraged and made public.

Despite the weaknesses mentioned above, the WBG and the IMF have taken fundamental steps towards debt transparency. In a note for the G20 published jointly, in June 2018 (G20 2018), the role of the WBG and the IMF in this field was reviewed and summarised as follows:

a) Collection and dissemination of debt (WBG n.d.) statistics[14] reported officially by the relevant country authorities;

b) Production of analyses of public debt data via debt sustainability analyses (DSAS) and;

c) Support of country efforts to produce medium-term debt management strategies.

Both organisations publish information on a country's borrowing capacity and directly liaise with multilateral, bilateral and private creditors.

These efforts provide important support for borrowers and lenders in their decision-making and so

[14] In October 2020, the WBG published aggregated debt data with an unprecedented level of granularity: https://openknowledge.worldbank.org/handle/10986/34588

that other stakeholders can use this information. Beyond this, the statistics collected provide a wealth of information for civil society organisations and academics to analyse the data and enhance scrutiny. However, the data collected is aggregated by country and not by the counterparty, whilst there are gaps in the debt transactions that are difficult to access from countries, such as loans with the private sector and other over-the-counter transactions.

The private sector (acting as lenders), represented by the IIF, has also been very active in debt transparency, particularly in LICs and LMICs. Since the launch of the Principles for Stable Capital Flows and Fair Debt Restructuring (Principles; ICMA Group 2004) in 2004, under the auspices of the Group of Trustees of the Principles, the IIF has been increasingly active in advancing good practices in sovereign investor relations (IR) and data dissemination in emerging markets and has published the rankings of such practices since 2005. Many countries have made progress in enhancing IR and data dissemination practices, helping develop the investor base and build capital markets.

A new set of voluntary **Principles for Debt Transparency** (IIF n.d.)—conceived within the framework of the 2004 Principles mentioned above and subject to the same governance—relate to financial transactions with both sovereigns and sub-sovereigns. The Principles for Debt Transparency recognised that greater transparency across all debt transactions improves the flow of information and reduces the risk of adverse shocks arising, as a result of undisclosed public liabilities appearing in central government liabilities. Greater transparency assists borrowers, creditors and the official sector in the ongoing assessment of debt dynamics and debt sustainability. In this respect, these Principles also complement the WBG and IMF multi-pronged approach for addressing emerging debt vulnerabilities.

There is also a firm recognition by private sector lenders about the importance of debt sustainability for the evaluation of creditworthiness. Private lenders use and regularly refer to the data, analysis and guidelines of the IMF and the International Development Association's (IDA) Non-Concessional Borrowing Policy, including IMF Article IV consultation reports (which benefit from greater disclosure of debt coverage), the Debt Sustainability Framework and the medium-term debt management strategy recommended by G20 Guidelines. This publicly available data and analysis are valued as important source of information and are taken into account in the decision-making process for credit extension, together with other third-party sources and in-house credit risk assessments.

The voluntary Principles for Debt Transparency acknowledge the role private lenders can play in supporting transparency and official sector debt sustainability objectives and, hence, the stability of the global financial system. The role requires public disclosure by private sector lenders of certain commercial terms of underlying transactions to a reporting entity, hosted by an appropriate international organisation.

Whilst it is certain that the private sector can play a major role in disciplining the sovereign borrowers via registering and sharing key information on individual debt transactions, this would be much easier if data from the largest private lenders and creditors was registered, pooled, recorded and stored in an independent global repository, in the form of an online platform that can be accessible, not only to international financial institutions (e.g., the WBG and the IMF) but also to civil society organisations, donors, debt charities and universities and think tanks.

In its communiqué from a meeting in June 2019, the G20 Finance Ministers and Central Bank Governors, "reiterated the importance of the joint efforts undertaken by both borrowers and creditors, official and private, to improve debt transparency and secure debt sustainability, called on the IMF and WBG to continue their efforts to strengthen borrowers' capacity in the areas of debt recording, monitoring, and reporting, debt management, public financial management, and domestic resource mobilization." (G20 2019).

FURTHERING DEBT TRANSPARENCY TO MANAGE DEBT CRISES

In their recent G20/T20 paper, Ayadi and Avgouleas[15] (2020) called for a sovereign debt registration repository that would be publicly accessible following re-authorisation and would complement the ongoing efforts of international organisations. The repository will be called the Debt Transparency Platform[16] (DTP), powered by blockchain technology, where all bilateral, multilateral and private sector players can register sovereign debt transactions. It will help reduce information asymmetries, deal with the moral hazard of large-scale debt forgiveness programmes under the DSSI, and aid sovereign debt restructuring for LICs and LMICs from a legal and practical viewpoint. This will bring order to sovereign debt restructuring and resolution and it will make the process less costly and less time-consuming. It will reduce uncertainty and opaqueness and will facilitate private sector involvement in large restructurings and participation in coordinated debt relief efforts. For the authorities and those who manage the restructuring process, it will be easier to aggregate investors in different bond issues and limbs per bond issue and, thus, manage the process more effectively once they have the full picture, in terms of the size of the debt and the nature of the investors.[17] It will also

[15] https://t20saudiarabia.org.sa/en/briefs/Pages/Policy-Brief.aspx?pb=TF8_PB6

[16] The platform is originally developed by the Euro-Mediterranean Economists Association to serve as a pilot project to show the data needed to effective enhancement of transparency. The link to the platform: www.DTransparency.org

[17] In the process of drafting this paper, we noticed that several other works also raise the importance of a digital repository for debt transparency. See Mustapha and Olivares-Caminal (2020).

be easier to monitor the implementation of Collective Action Clauses, creditor ranking and subordination arrangements across the spectrum of a country's issued debt, as well as contingent claims such as sovereign guarantees.

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