

## 4. Asia's lower-income countries: concessional public debt, concessional rescues

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### 1. INTRODUCTION

Debt fragility in Asian lower-income countries has over the past decade been increasing.<sup>2</sup> By the time the coronavirus disease (COVID-19) broke out in 2019, these countries needed help from their creditors. And so, 21 of them qualified for the G20's Debt Service Suspension Initiative (DSSI). This chapter focuses on these 21 countries. In their 2015 International Monetary Fund (IMF) Article IV statements, nine reported a moderate risk of debt distress and six reported a high risk. By 2019, before COVID-19 triggered the beginning of the global crisis, the IMF reassessed the debt distress risk for these 21 countries and put four at moderate risk and 12 at high risk. But in most of the countries with limited access to financial markets to begin with, debt distress risk was low.

Periods of increasing debt fragility are not new and have been associated with different debt waves. Before the COVID-19 pandemic, developing economies had experienced three debt waves in the last 50 years (Kose et al. 2020a). During the 1970s, a combination of low real interest rates and a rapidly growing loan market encouraged governments in Latin America and sub-Saharan Africa to borrow heavily. This debt wave ended with an increase in the interest rate and a series of financial crises in the early 1980s, which led to several debt restructuring and debt relief programs. During the 1990s, the liberalization of financial and capital markets enabled banks and businesses in East Asia and the Pacific to borrow heavily, leading to a series of crises between 1997 and 2001, which required large-scale bailouts of banks and companies. Finally, from 2002 and for five years thereafter, regulatory easing allowed for a rise in private sector borrowing, particularly in Europe and Central Asia. This wave was interrupted by the 2007–2009 financial crisis, which once again required bank bailouts and international assistance.

At the start of the COVID-19-induced global crisis, the world was already experiencing the conclusion of a new debt wave that began in 2010. As in past debt waves, global interest rates were very low, and in this case, this was also due to central bank stimuli following the great recession. As a result, the search for better yields contributed to narrowing spreads for developing economies. At the same time, a rise in regional banks, growing appetite for local currency bonds, and increased demand for developing economies' debt from the expanding nonbank financial sector contributed to an escalation in borrowing (Kose et al. 2020a). A correction in commodity prices in 2014–2015 and a slowdown in the economy amid global

trade disputes reduced growth perspectives and triggered concerns about the capacity of many developing countries to serve and refinance their debt obligations.

The concerns about debt distress in developing countries became a reality when the COVID-19 pandemic hit in early 2020. While the end of the other debt waves was the result of a once-in-a-decade event, the current borrowing cycle is caused by a once-in-a-century global event. Moreover, the level of total indebtedness in the early 2020s was larger than that observed in the beginning of other debt crises. These high levels of indebtedness are combined with a riskier debt profile: shorter-term, higher proportion of non-concessional debt, larger proportion of nonresident investors, and greater proportion of foreign-currency-denominated corporate debt. For developing countries, the current crisis is a perfect storm as the reduction of revenues and the need to increase expenditures to support their economies put them in the difficult position of having to still service their debt and access credit markets.

This chapter revives the question of how to finance governments in developing countries, focusing on the DSSI 21 lower-income countries. The next section provides an overview of their debt and macroeconomic dynamics since 2000 and describes their current situation of potential financial distress. Section 3 reviews the lessons from past debt crises and debt relief initiatives in terms of short- and medium-term solutions. In every new debt and financial crisis, global financial institutions and governments must first work out solutions to resolve the crisis, and then design policies and regulations to prevent a new crisis. Large defaults as a solution to the crisis are always an option but are clearly suboptimal. A better potential solution is to restructure the debt to make it sustainable and compatible with the development plans of the country. This often involves debt reductions, which require lenders to coordinate the allocation of public and private resources and agree on how to distribute losses. In addition, policies and regulations often involve addressing structural problems, including weak fiscal regimes and poor debt management systems.

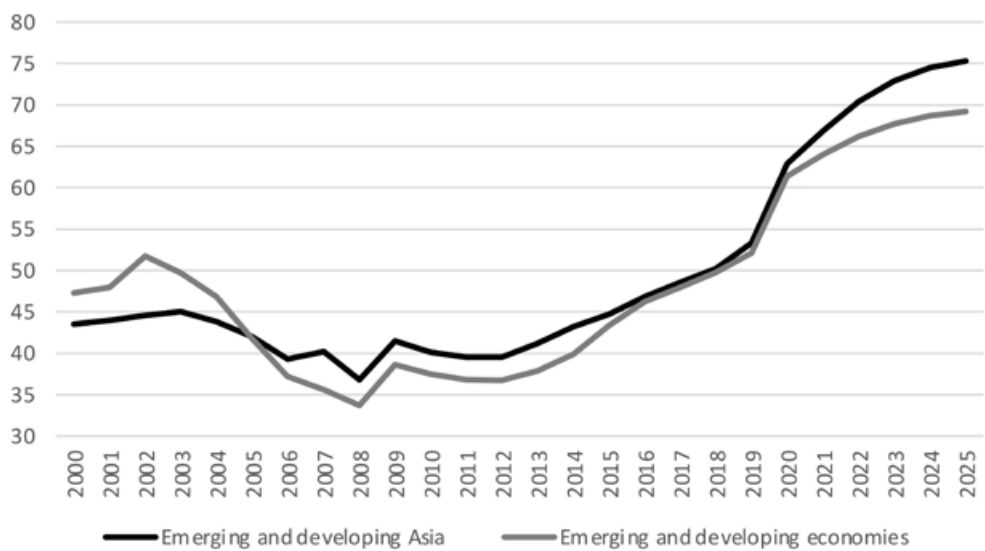
An effective development financing must reconcile the twin objectives of meeting the large needs of developing countries and maintaining their debt at sustainable levels. However, crisis after crisis have shown how difficult it has been for most developing countries to deal with this trade-off in practice. Section 4 revisits this trade-off, considering the current situation in the developing Asian countries as discussed in section 2 and the lessons from past debt crisis and debt relief initiatives presented in section 3. This section will also review the current policy proposals and emphasize that the potential solution will need to be fully integrated into a framework that considers medium- and long-term sustainability issues.

Section 5 concludes the analysis, highlighting the priorities for the policy agenda.

## 2. DEBT VULNERABILITY IN ASIAN LOWER-INCOME COUNTRIES

Debt vulnerability in the developing world has increased substantially in recent years. Since 2010, median government debt has risen by about 20 percentage points of gross domestic product (GDP) in emerging and developing economies (Figure 4.1). The IMF projections show levels of indebtedness that are expected to increase further during the next five years, and the increase will be greater in emerging and developing Asian economies than in the average developing economies. This type of dynamics should not necessarily be considered a source of concern. Developing countries in general, and Asia in particular, have used debt to finance

their growth. The relevant questions are whether the level of indebtedness is compatible with future growth prospects and how to deal with eventual bumps in that trajectory. Figure 4.1 includes not only developing but also emerging Asian countries, where the People's Republic of China (PRC) plays a major role. While debt levels have increased across many Asian countries, the mechanisms of debt accumulation and potential consequences vary widely; thus, we need to define carefully the target countries we will consider in our analysis.



Notes:  
GDP = gross domestic product.  
Data for 2020–2025 are estimates as of October 2020.  
Source: World Economic Outlook.

Figure 4.1 General Government Gross Debt (% of GDP)

The DSSI is a global effort to help developing economies that are in or at risk of pandemic-driven debt distress. The DSSI countries typically have more severe structural problems and fewer sources of development finance, which makes them more fragile in the event of domestic and external shocks. But they have in the past been able to manage their debt obligations successfully. Myanmar was the last Asian country to default on its sovereign debt in 2002.<sup>3</sup>

To narrow down the focus of our analysis and provide a more accurate picture, from now on we will work with a sample of the 21 Asian countries that qualified for assistance under the DSSI. In 14 of the 21 DSSI countries, public indebtedness levels have increased significantly (Table 4.1). On average, public debt-to-GDP ratio in 2020 was almost 12 percentage points higher than 10 years ago. However, this average ratio masks a greater degree of heterogeneity. In countries like Bhutan, Maldives, Papua New Guinea (PNG), and Vanuatu, debt-to-GDP ratios have increased significantly, often doubling or tripling in a short time, while they have remained relatively stable in others (such as

Table 4.1 *Indebtedness levels and risk of debt distress for Asian DSSI countries*

Developing Member Country	General Government Gross Debt (% of GDP)			Risk of Debt Distress		
	2010	2015	2020	2015	2019	June 2020
Afghanistan	7.7	9.2	7.8	High	High	High
Bangladesh	35.5	33.7	39.6	Low	Low	Low
Bhutan	61.0	98.6	121.3	Moderate	Moderate	Moderate
Cambodia	28.7	31.2	31.5	Low	Low	Low
Kiribati	8.5	19.9	17.7	High	High	High
Kyrgyz Republic	59.7	67.1	68.1	Moderate	Moderate	Moderate
Lao PDR	49.3	53.1	70.9	Moderate	High	High
Maldives	52.7	53.4	118.3	Moderate	High	High
Marshall Islands	38.6	33.7	27.4	High	High	High
Micronesia, Fed. States of	28.8	25.6	16.5	High	High	High
Myanmar	52.2	36.3	42.4	Low	Low	Low
Nepal	34.0	25.6	39.2	Low	Low	Low
Pakistan	60.7	63.3	87.2	Moderate	High	High
Papua New Guinea	17.3	29.9	46.7	Low	Moderate	High
Samoa	39.7	58.9	55.6	Moderate	High	High
Solomon Islands	22.9	9.0	15.3	Moderate	Moderate	Moderate
Tajikistan	36.6	34.7	47.8	High	High	High
Timor-Leste	0.0	2.8	11.7	Low	Low	Low
Tonga	44.7	51.2	41.9	Moderate	High	High
Tuvalu	27.6	57.6	16.0	High	High	High
Vanuatu	19.4	36.0	47.7	Moderate	Moderate	Moderate

Note: DSSI = Debt Service Suspension Initiative; GDP = gross domestic product; Lao PDR = Lao People's Democratic Republic.

Data for Afghanistan and Myanmar were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting both countries.

Sources: Various IMF/World Bank Debt Sustainability Analysis and country reports.

Afghanistan, Bangladesh, and Cambodia) or even decreased (such as the Marshall Islands, Myanmar, and Solomon Islands).<sup>4</sup> On the other hand, the sample countries share some commonalities. For example, the risk of debt distress has not improved in any of them during the last five years.<sup>5</sup> In fact, the number of countries where debt distress was considered high has increased from six in 2015 to 12 in June 2020 and is likely to increase further in the context of the current pandemic.

To understand the fragility of these countries' debt position, two indicators are noteworthy: much of their public debt is external (Table 4.2), and almost all of it is denominated in foreign currency. Obviously, claims held internationally can be more volatile. Borrowing in foreign currency removes the incentive to reduce ex post the real value of government debt through unexpected inflation. However, it exposes the domestic currency value of government liabilities to fluctuations in the exchange rate. In 2019, 76 percent of public debt for the developing countries in our sample was external and 79 percent was denominated in foreign currency (US dollars in most cases)—in particular, 15 of them had more than 75 percent as external debt

**Table 4.2** *Public external debt as % of total public debt for Asian DSSI countries*

Country	2010	2015	2019
Afghanistan	30	100	100
Bangladesh	57	39	35
Bhutan	97	100	93
Cambodia	90	98	90
Kiribati	91	100	100
Kyrgyz Republic	98	99	86
Lao PDR	95	86	79
Maldives	46	35	29
Marshall Islands	100	100	94
Micronesia, Fed. States of	100	100	100
Myanmar	0	27	23
Nepal	66	73	55
Pakistan	51	32	33
Papua New Guinea	49	28	36
Samoa	100	100	100
Solomon Islands	77	86	79
Tajikistan	98	97	87
Timor-Leste	n/a	100	100
Tonga	n/a	95	94
Tuvalu	100	98	100
Vanuatu	90	81	83

*Note:* DSSI = Debt Service Suspension Initiative; Lao PDR = Lao People's Democratic Republic.

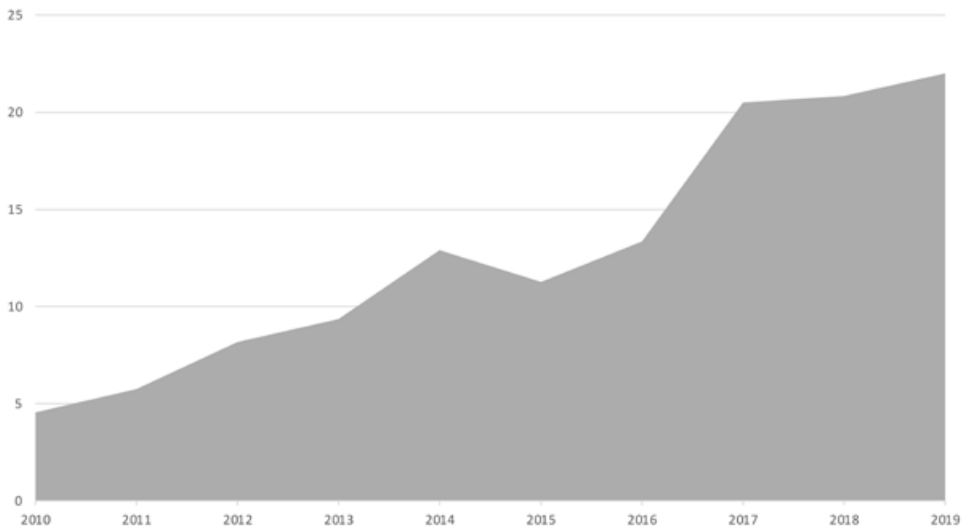
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*Sources:* Various IMF/World Bank Debt Sustainability Analysis and country reports.

and denominated in US dollars. This is a stark contrast from most emerging Asian countries that have been able to develop debt markets in domestic currency. Notable exceptions were Bangladesh, Maldives, Myanmar, Nepal, Pakistan, and PNG—of these six countries, three were assessed at low risk of debt distress.

The external debt buildup can be better observed in Figure 4.2. Debt flows into most Asian DSSI countries have been on the rise in the last five years. The total corresponds to 17 of the 21 countries in our sample for which data were available during this period.<sup>6</sup> During 2015–2019, external debt disbursements in these countries have doubled. However, the total once again hides some important heterogeneity. Flows have decreased for Bhutan, the Kyrgyz Republic, the Lao People's Democratic Republic (Lao PDR), Samoa, Tajikistan, and Vanuatu and increased for all the other countries. In Maldives, Myanmar, and PNG disbursements increased four or five times over 2015. In Bangladesh and Pakistan, the largest economies in our sample, public external debt disbursement increased by over 170 percent and 95 percent, respectively.

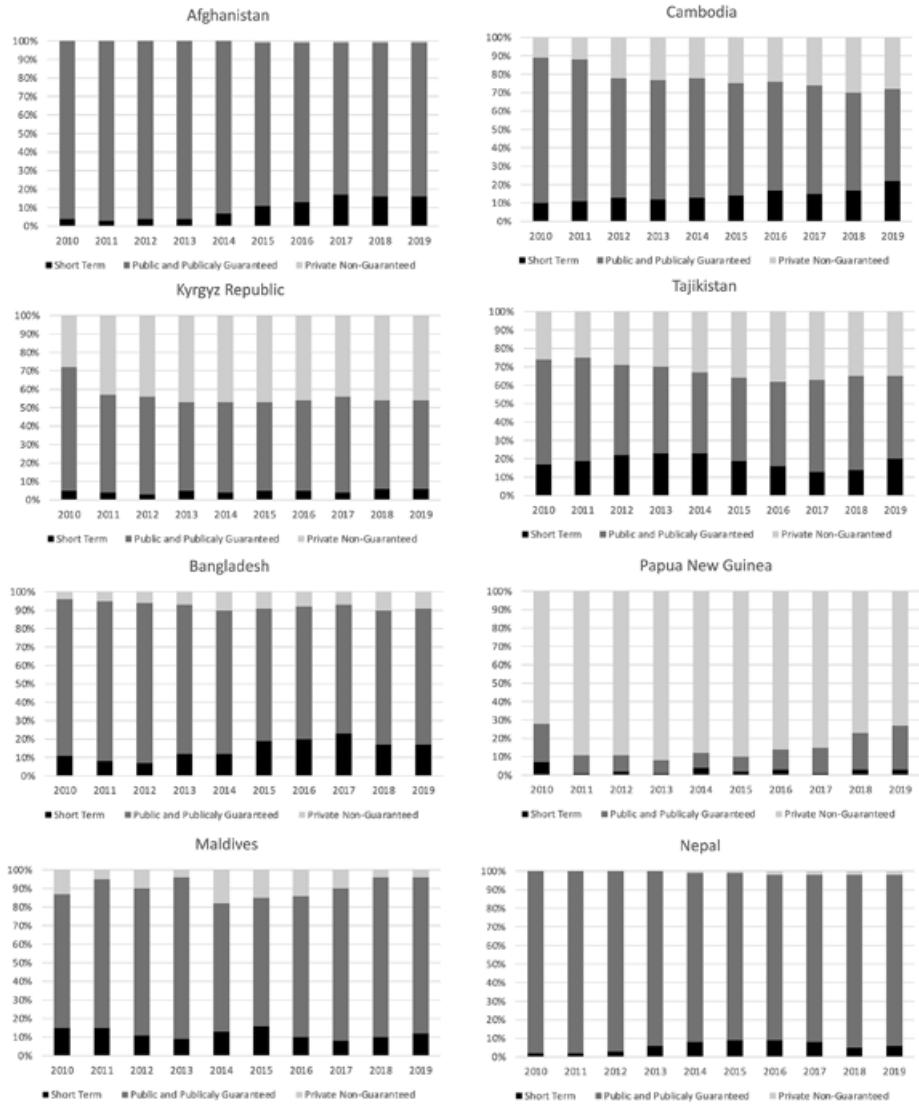
The recent increase in total debt in Asian DSSI countries is only one indicator of potential vulnerability. Past global financial crises have shown that a number of indicators can signal rapidly rising stress and domestic problems. Many of these countries have not only seen changes in their indebtedness levels but also in the composition and risk of their debt portfolio.



Source: World Bank.

**Figure 4.2** *Disbursements on external debt, general government sector, sample of Asian DSSI countries (current \$ billion)*

In particular, non-concessional, non-guaranteed, and private sources of lending have increased, and the percentage of short-term debt in total debt has more than doubled in the last decade. As before, the dynamics is somehow heterogeneous across countries. Figure 4.3 presents the total external debt composition in 2010–2019 for eight of the 21 sample countries using data from the World Bank's Debtor Reporting System. Reporting countries submit detailed reports on the annual status, transactions, and terms of the long-term external debt of public agencies and that of private debt guaranteed by a public agency in the debtor country. In 1973, the World Bank expanded the coverage of the Debtor Reporting System to include private sector non-guaranteed borrowing, but for this debt category, data are provided by borrowers in aggregate rather than loan by loan, making it impossible to assess the maturity of this debt. However, anecdotal evidence shows that this type of debt tends to have a much shorter maturity than public and publicly guaranteed debt. Therefore, when we combine the short-term and the private non-guaranteed debt, we see that, except for Nepal, the Asian DSSI countries for which data are available have a higher share of short-term maturities than 10 years ago, which raises rollover risk, especially in periods of stress and heightened risk aversion. The level of debt concessionality (measured as a percentage of concessional debt over total external debt) has also declined on average for these countries. In 2010, on average, 42.1 percent of the external debt was concessional. In 2019, the share of concessional debt declined to 30.1 percent. Decreases were noted in Cambodia (from 62.3 percent in 2010 to 29.4 percent in 2019), the Kyrgyz Republic (from 42 percent to 20.5 percent), Bangladesh (from 67.8 percent to 47.1 percent), Pakistan (42.3 percent to 20.2 percent), and Bhutan (from 36.8 percent to 17.9 percent). On the other hand, increases were seen in Myanmar



Source: World Bank Debt Reporting System.  
Data for Afghanistan were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting the country.

Figure 4.3 Total external debt composition, selected developing Asian countries

(from 22.3 percent in 2010 to 49.8 percent in 2019), and Vanuatu (from 23.5 percent to 43.7 percent). Obviously, ex ante, these reductions in the level of concessionality can be interpreted in two different ways. On the one hand, they may be the result of growth and public sector reforms that have allowed some countries in the region to access other sources of financing,

increasing the envelope of resources to sustain economic and social development. On the other hand, increased reliance on funding in commercial or near-commercial terms raised the exposure to interest rate, exchange rate, and rollover risks. Recent experience also indicates that the increasingly diverse creditor base and types of debt instruments used can complicate and lengthen the process of debt restructuring, whenever such restructuring is needed (IMF 2020b).

The composition of public and publicly guaranteed official debt stock varies across Asian DSSI countries (Table 4.3). In 2015, official multilateral loans comprised most of the debt stocks of Timor-Leste (96 percent), Nepal (91 percent), Solomon Islands (89 percent), and Bangladesh (83 percent). On the other hand, the share of official bilateral loans in total official debt stocks was larger in Myanmar (82 percent), Bhutan (75 percent), the Lao PDR (72 percent), and Cambodia (69 percent). Between 2015 and 2019, the share of multilateral loans declined slightly in favor of bilateral official loans. The table highlights the important role played in the region by the Asian Development Bank (ADB) and bilateral official lenders that do not belong to the Paris Club, in particular the PRC and to some extent India. In 2015, on average, 43.6 percent of all multilateral debt stocks in our sample countries consisted of ADB loans. This share decreased to an average of 41.7 percent in 2019. An important feature of these Asian countries when compared with African and Latin American ones, is the importance of bilateral loans from countries that do not belong to the Paris Club. On average, more than two-thirds of bilateral outstanding debt was with countries like the PRC, India, and the United Arab Emirates. The advantage of groups of major creditors like the Paris Club is, of course, that it reduces uncertainty by establishing rules and practices for sovereign debt relief and provides a coordinated answer among creditors. Historically, coordination issues were fine-tuned through an arrangement in which the largest bilateral creditors worked on a consensus basis through the Paris Club, which in turn coordinated with the IMF and other major multilateral creditors (Gardner et al. 2020). The emergence of the PRC as an international creditor has provided very-much-needed financial resources to Asian countries, but creates a challenge in the resolution of debt restructuring when more than one debtor and creditor are involved. The PRC has restructured its debt on a case-by-case basis (Gardner et al. 2020 gives two examples) involving only the debtor government, while the Paris Club governments, the World Bank, the IMF, and private investors have taken part in coordinated and comparatively well-documented debt relief initiatives (Horn et al. 2020).

The significance of the PRC as a source of financial resources for lower-income Asia and Pacific countries goes beyond the official loan data presented in Table 4.3. The PRC's Belt and Road Initiative hopes to deliver trillions of dollars in infrastructure financing to Asia, Europe, and Africa. This initiative has led some analysts to raise important questions about the risk of debt sustainability problems in less-developed countries (Hurley et al. 2018; and Rajah et al. 2019). That risk could be potentially acute for the small and fragile economies of the Asia and Pacific regions. There is currently no hard evidence to evaluate these potential effects. However, the current debt problems faced by the Lao PDR signal that countries and donors need to monitor the situation carefully, as various Belt and Road Initiative-related projects have made the PRC the Lao PDR's biggest creditor and the latter has faced problems in meeting its obligations. A study published in 2019 by the Sydney-based Lowy Institute estimated the Lao PDR's debt to the PRC at 45 percent of the Lao PDR's GDP (Rajah et al. 2019).



*Table 4.3 Composition of public and publicly guaranteed official debt stock of Asian DSSI countries*

Country	2015				2019			
	% Multilateral	of which % ADB	% Bilateral	of which % Non Paris Club	% Multilateral	of which % ADB	% Bilateral	of which % Non Paris Club
Afghanistan	58%	46%	42%	12%	55%	47%	45%	12%
Bangladesh	83%	35%	17%	38%	67%	35%	33%	36%
Bhutan	25%	52%	75%	94%	25%	50%	75%	97%
Cambodia	31%	59%	69%	78%	29%	63%	71%	75%
Kiribati	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Kyrgyz Republic	44%	35%	56%	69%	43%	33%	57%	85%
Lao PDR	28%	53%	72%	90%	21%	50%	79%	93%
Maldives	44%	35%	56%	88%	27%	20%	73%	97%
Marshall Islands	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Micronesia, Fed. States of	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Myanmar	18%	30%	82%	61%	23%	24%	77%	46%
Nepal	91%	42%	9%	61%	87%	38%	13%	62%
Pakistan	63%	31%	37%	39%	54%	32%	46%	67%
Papua New Guinea	75%	63%	25%	73%	61%	67%	39%	65%
Samoa	56%	44%	44%	86%	56%	37%	44%	82%
Solomon Islands	89%	35%	11%	n/a	93%	45%	7%	n/a
Tajikistan	50%	25%	50%	98%	48%	24%	52%	98%
Timor-Leste	96%	62%	4%	0%	88%	70%	12%	0.0
Tonga	36%	41%	64%	100%	46%	34%	54%	100%
Tuvalu	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Vanuatu	43%	41%	57%	89%	46%	30%	54%	65%
<b>Average</b>	<b>54.8%</b>	<b>42.8%</b>	<b>45.2%</b>	<b>67.3%</b>	<b>51.1%</b>	<b>41.2%</b>	<b>48.9%</b>	<b>67.5%</b>
<b>Median</b>	<b>49.8%</b>	<b>41.1%</b>	<b>50.2%</b>	<b>75.2%</b>	<b>48.2%</b>	<b>37.4%</b>	<b>51.8%</b>	<b>71.0%</b>

*Note:* ADB = Asian Development Bank; DSSI = Debt Service Suspension Initiative; Lao PDR = Lao People's Democratic Republic; n/a = not available.

Data for Afghanistan and Myanmar were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting both countries.

*Source:* World Bank Debtor Reporting System.

The fragile debt position observed in most of the Asian DSSI countries in 2019 was coupled with deteriorating macroeconomic performance. While these economies enjoyed high growth for most of the last 10 years, critical imbalances accumulated during the same period. Most economies fueled growth with large fiscal and current account imbalances (Table 4.4).

Table 4.4 Macroeconomic performance for Asian DSSI countries

Country	Real GDP Growth				General Government Net Lending/Borrowing (% of GDP)				Current Account Balance (% of GDP)			
	2010	2015	2019	2020	2010	2015	2019	2020	2010	2015	2019	2020
Afghanistan	8.4	1.0	3.9	-5.0	0.9	-1.4	-1.1	-2.8	29.4	3.8	11.7	9.5
Bangladesh	5.6	6.6	8.2	3.8	-2.7	-4.0	-5.4	-6.8	2.8	1.8	-1.7	-1.5
Bhutan	9.5	6.2	3.8	0.6	7.9	-0.2	-1.1	-5.5	-22.8	-27.9	-22.5	-21.4
Cambodia	6.0	7.0	7.0	-2.8	-3.8	-0.6	3.2	-2.4	-8.8	-8.7	-15.8	-25.4
Kiribati	-0.9	10.4	2.3	-1.1	-8.3	47.4	15.0	-13.2	0.1	32.8	32.0	-1.6
Kyrgyz Republic	-0.5	3.9	4.5	-12.0	-5.9	-2.5	-0.1	-7.3	-6.6	-15.9	-5.6	-13.4
Lao PDR	8.0	7.3	5.2	0.2	-1.5	-5.6	-5.0	-6.4	-16.5	-22.4	-6.4	-8.7
Maldives	7.3	2.9	5.7	-18.6	-13.5	-6.8	-6.4	-21.9	-7.3	-7.5	-26.0	-31.8
Marshall Islands	7.6	1.6	5.3	-4.5	3.5	2.8	0.3	-3.5	-14.8	17.2	8.0	1.6
Micronesia, Fed. States of	2.3	4.6	1.2	-3.8	0.5	10.3	16.4	-1.7	-17.5	4.5	16.0	1.6
Myanmar	5.2	7.5	6.5	2.0	-0.8	-2.8	-3.9	-6.0	4.7	-3.5	-2.6	-3.5
Nepal	4.8	3.3	7.1	0.0	-0.8	0.7	-4.6	-7.9	-2.4	5.0	-7.7	-2.5
Pakistan	2.6	4.1	1.9	-0.4	-6.0	-5.3	-9.0	-8.0	-2.2	-1.0	-4.9	-1.1
Papua New Guinea	10.1	9.5	4.9	-3.3	3.1	-4.5	-5.0	-6.3	-19.7	25.6	22.2	14.7
Samoa	2.6	4.3	3.5	-5.0	-5.6	-4.0	2.7	-7.3	-6.4	-2.8	2.3	-7.1
Solomon Islands	8.6	1.4	1.2	-5.0	5.0	0.0	-1.7	-5.6	-26.4	-2.7	-9.6	-11.3
Tajikistan	6.5	6.0	7.5	1.0	-3.0	-2.0	-2.1	-6.0	-10.3	-6.1	-2.3	-7.1
Timor-Leste	9.5	3.1	3.1	-6.8	-19.8	-33.1	-32.1	-17.5	180.2	12.8	8.2	-13.7
Tonga	0.8	1.2	0.7	-2.5	-1.2	-2.8	3.2	5.1	-23.8	-10.1	-4.8	-4.6
Tuvalu	-3.3	9.2	6.0	-0.5	-24.1	15.3	-8.6	-12.3	-12.1	-53.5	12.4	17.0
Vanuatu	1.6	0.2	3.3	-8.3	-2.5	-9.3	4.6	-7.6	-5.9	-1.6	13.1	-0.3
<b>Average</b>	<b>4.9</b>	<b>4.8</b>	<b>4.4</b>	<b>-3.4</b>	<b>-3.7</b>	<b>-0.4</b>	<b>-1.9</b>	<b>-7.2</b>	<b>0.7</b>	<b>-2.9</b>	<b>0.8</b>	<b>-5.3</b>
<b>Median</b>	<b>5.6</b>	<b>4.3</b>	<b>4.5</b>	<b>-2.8</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-1.7</b>	<b>-6.4</b>	<b>-7.3</b>	<b>-2.7</b>	<b>-2.3</b>	<b>-3.5</b>

Note: ADB = Asian Development Bank; DSSI = Debt Service Suspension Initiative; Lao PDR = Lao People's Democratic Republic.

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Source: World Economic Outlook, data for 2020 are estimates as of October 2020.

Rising debt servicing costs, now at multiyear highs, were diminishing the already constricted fiscal space of some of these countries. Chapter 1 in this book shows that economic growth and fiscal balances are expected to deteriorate relative to historical trends in several DSSI countries during 2021–2024.

The external debt-to-export ratio, which is typically considered an indicator of debt repayment capacity, was in the Asian DSSI countries above the average of the developing world in recent years. Bhutan's present value of external debt-to-export ratio at 247 percent in 2019

was one of the highest in the world. Also, during 2019, this ratio was 119.5 percent in the Lao PDR, 113.9 percent in Nepal, 104.4 percent in Afghanistan, and 103.3 percent in the Kyrgyz Republic.<sup>7</sup> Growing debt-to-export ratios have in fact become a trend for many developing Asian countries in recent times.

Weakening trade and global financial conditions, high levels of external debt, lack of fiscal space, and undiversified exports had all indicated that a correction was likely to happen in these countries. And then, the COVID-19 pandemic caught these economies by surprise, almost overnight disrupting many economic activities, sharply decreasing trade and growth, reducing government revenues, and increasing unemployment and poverty. Governments found it necessary urgently to increase expenditures to sustain economic activities and provide a social safety net in the course of increasing external debt service and addressing very limited access to debt markets.

This perfect storm created once again the need for a coordinated response by international financial institutions, private creditors, and governments.

### 3. LESSONS FROM PAST DEBT CRISES AND DEBT RELIEF INITIATIVES

Periods of debt accumulation followed by crises and macroeconomic adjustments seem to be a recurrent feature of the global economy. Kose et al. (2020a) identified four waves of debt accumulation during the last 50 years. The first wave of debt came in the form of low interest rates and a rapidly growing market for syndicated loans, which encouraged Latin American and African governments to borrow heavily, culminating in a series of debt crises that started in the 1980s. The second wave started around 1990 when financial and capital markets liberalization enabled banks and businesses in East Asia and the Pacific to borrow heavily in foreign currency. This period of expansive credit came to an end with the 1997 Asian financial crisis. The third wave started around 2002, once again bringing a period of low interest rates, this time triggered by a sharp increase in private sector borrowing from emerging and developing economies particularly in Europe and Central Asia. The source of these funds was mostly banks headquartered in the United States (US) and the European Union (EU). The global financial crisis of 2008 and the global recession of 2009 brought the third wave to an end. The fourth and current wave of debt accumulation began in 2010, once again prompted by low interest rates and important changes in financial markets. Even if we exclude the PRC from the analysis, the current wave has seen the fastest and largest accumulation of debt in emerging and developing countries, albeit in a more resilient global financial system.

These debt waves had some points in common, such as that (1) real interest rates were low; (2) financial innovations and investors' appetite for higher yields promoted lending; and (3) they all ended abruptly, triggered by shocks that increased risks premium or borrowing costs, which led to sudden stops of capital inflows. In all cases, the widespread financial crises coincided with global recessions or downturns (Kose et al. 2020a).

The waves were also distinctive in the financial instruments used for borrowing, the economic agents involved, how the international financial architecture reacted, and the reforms that followed to strengthen policy frameworks. Each of these crises provided useful lessons to consider in the current debate on how to deal with increasing debt distress in lower-income economies, including those in Asia. For this reason, we briefly summarize the particularities of each debt wave.

### 3.1 1980s Debt Crisis and the Adverse Economic Consequences of Delaying External Debt Reduction

The first wave in the 1970s and 1980s saw rapid debt accumulation of sovereign debt in Latin American and sub-Saharan African countries. The sharp increases in interest rates in the early 1980s made the debt dynamics of these countries unsustainable, leading to suspension of payments and requests for IMF support.

The most salient feature of this crisis is that output losses were particularly large and protracted. Its consequences lasted until the early 1990s in Latin America and until the 2000s in sub-Saharan Africa. Many authors, including Eichengreen (2020) and Stiglitz and Rashid (2020), have noted that the 1980s debt crisis highlighted the adverse economic consequences of delaying external debt reductions, a lesson that needs to be seriously considered in the current situation. This delay can be partially attributed to the complexity of the negotiation process. As noted by Truman (2020, pp. 2–3) “four groups were centrally involved in managing the crisis: the borrowing countries, their foreign bank creditors, the authorities of the countries in which those banks were chartered, and the international financial institutions”. Within those four groups there was a lot of heterogeneity in terms of opinions on how the crisis should be solved.

In the case of Latin America, the process evolved over different phases which did not include the possibility of debt relief in terms of write-offs. This was due in part to concerns about the potential disruptive impact on the global financial system but also on the expectation that borrowing countries could soon return to financial markets. It took almost a decade of disappointing growth performance for countries to switch focus to debt reduction and produce a coordinated solution among the main actors. This was possible because of leadership in Mexico and the US and followed later by several Latin American governments that decided to sign the Brady Plan. Brady bonds allowed the commercial banks holding developing countries debt to swap it into tradable instruments, reducing their balance sheets' exposure to sovereign debt. The main innovation of the plan was to provide a “menu” of options to restructure, which allow heterogeneous creditors to tailor the debt restructuring to their preferences. The menu approach also favored debtors as they were able to reduce the cost of debt restructuring. Finally, this flexible approach significantly reduced the risk that creditors would refuse to participate in a debt restructuring, the so-called holdout problem.

The debt situation in sub-Saharan Africa shared some characteristics with the dynamic observed in Latin America. The African government first relied on IMF macroeconomic adjustment programs to resolve macroeconomic disequilibrium with the hope to regain access to international financial markets. Once again, debt relief was not considered initially as an option as it could damage the prospect of future borrowing. However, for low-income countries, ad hoc partial solutions in the form of perennial macroeconomic adjustment programs perpetuated the problem and created bad equilibria.

As was the case in Latin America, the solution in sub-Saharan Africa required coordination among all parts involved and the leadership of key individuals, which led to the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). These initiatives primarily aimed to cancel debt down to the level necessary to restore debt sustainability in a number of low-income countries. The debt reduction would eliminate the so-called “debt overhang”, where a high debt burden depresses investment, reform willing-

ness, and hence, future economic growth. Furthermore, debt relief, if additional to official development assistance (ODA) flows, would increase resource availability in the recipient country (the so-called “fiscal space”) to increase poverty reduction-targeted spending (health and education). In theory, appropriate donor conditionality attached to receiving the debt relief should have in principle strengthened the probability of reaching the desired goals (Cassimon et al. 2017).

What were the effects of these initiatives in practice? In terms of economic growth, the evidence shows that it is not possible to prove that debt relief has increased growth in recipient countries. Much of the growth following debt relief was concentrated in commodity producers and lower middle-income countries. There is only weak evidence of increased expenditure in health and education as conditionality was weakly enforced (Depetris-Chauvin and Kraay 2005). There is some evidence of positive impact on the total domestic revenue and public investment. Another issue often discussed, which is relevant for some of the DSSI Asian countries, is whether debt relief was additional to ODA. The evidence shows some crowding out of ODA but probably not to the extent predicted by some analysts. In any case, additionality is hard to measure as the relevant comparison is between the present value of debt services versus the present value of ODA flows, which is not measurable without assuming how ODA would behave in the future.

Overall, the main effect of these initiatives was to reduce debt. Debt relief under the HIPC Initiative and the MDRI helped to reduce public debt among lower-income countries from a median debt-to-GDP ratio of close to 100 percent in the early 2000s to a median of just over 30 percent in 2013. However, since 2013, deficits and the increased borrowing allowed by space created by debt relief have increased indebtedness among debt relief recipient countries. Clearly, the initiatives did not solve the countries’ dependence on foreign debt, as a significant share of their new funding came from nontraditional creditors and commercial loans. While some countries used this new debt to finance productive investments, many others used it to finance current consumption. Even before the COVID-19 crisis, many African countries were already in debt distress by 2019, which highlights their ability to carry debt sustainably. According to Leo (2009, p. 1) “taken together, these findings suggest that donor countries should reexamine the issue of debt sustainability in lower-income countries and the system for determining the appropriate grant/loan mix”.

### **3.2 The 1997 Asian Crisis: Financial Imbalances and Liquidity Shortfalls Can Lead to Insolvency**

While the first wave saw rapid debt accumulation by government, the second wave was mostly about borrowing by the private sector (although during the Asian crisis many companies were closely related to the state). This financial crisis was largely unanticipated by market participants, but there were a few warning signs such as growing balance-of-payment deficits, a seemingly unsustainable rise in domestic asset prices, and rapid growth in credit from the banking system (Crockett 2007). In the buildup of external financial fragility, overinvestment in manufacturing, speculative investment in real estate, and excessive short-term borrowing in foreign currencies played a crucial role (Akyüz 2017). These vulnerabilities had arisen as a result of several policy failings, including inadequate prudential regulation and supervision of banks, implicit government guarantees for foreign borrowing (including pegged exchange

rates), and structural changes in global financial markets. These developments made these countries increasingly vulnerable to sudden stops (Corsetti et al. 1998; World Bank 1998).

As documented by Akyüz (2017), the crisis broke out in Thailand when its reserves dropped rapidly as net capital inflows fell short of the funds needed to meet the widening current account deficits. Other economies in the region with better balance-of-payment fundamentals suffered primarily from contagion through the exchange rate. As exchange rates came under pressure, markets soon became aware of the similarities in financial vulnerability and inadequacy of reserves. Foreign speculators selling domestic currencies were joined by domestic financial and nonfinancial firms seeking to escape the squeeze on their balance sheets caused by rising domestic cash needs to service foreign debt and falling cash flows to meet them. As a result of this dynamic, the East Asian economies experienced simultaneous sharp falls in asset prices and currency values (Chowdhry and Goyal 2000).

How the Asian crisis was resolved has been the subject of much study. In late 1997, the IMF committed more than \$110 billion in short-term loans to Thailand, Indonesia, and the Republic of Korea to help stabilize their economies. Some \$35 billion of IMF financial support was provided for adjustment and reform programs, and some \$85 billion of financing was committed from other multilateral and bilateral sources, although not all of this financing actually materialized. In exchange for the funding, the IMF required countries to adhere to strict conditions, including higher taxes, reduced public spending, privatization of state-owned businesses, and higher interest rates, designed to cool the overheated economies. Some other measures required countries to close illiquid financial institutions, recapitalize potentially viable financial institutions often with government assistance, close central bank supervision of weak financial institutions, and strengthen financial supervision and regulation, all to prevent a recurrence of the fragilities that led to the crisis (IMF 2000).

The Asian crisis reflected two phenomena. First, the unstable financial equilibrium depended on agents' expectations. As long as economic agents were confident, the pre-crisis exchange rate could be sustained with little or no official intervention. However, once confidence vanished, a vicious cycle took hold—selling provoked declines in value, which in turn led to more selling. As a result, leveraged companies saw their values plummet and their access to additional credit dry up. Second, the foreign exchange regime was closely linked to the health of the financial sector. Each downward movement in the currency exacerbated the banks' liquidity and solvency problems. In addition, the growing weakness of the domestic financial sector contributed, in turn, to further pressures on the currency (Crockett 2007).

The Asian crisis also showcased that when capital inflows surge, vulnerabilities can emerge in at least four areas: (1) currency and maturity mismatches in private balance sheets; (2) domestic credit, asset and spending bubbles; (3) unsustainable currency appreciations and external deficits; and (4) reliance on IMF assistance and policy advice rather than self-insurance against sudden stops and reversals of capital flows (Akyüz 2017). To avoid these potential vulnerabilities, countries need to strengthen their domestic financial systems and introduce macroeconomic prudential policies, including exchange rate and reserve management policies.

### 3.3 The Coordinated Responses in 2008–2012 Made the Crisis Short-Lived

After the second wave, global borrowing resumed at a faster pace. This coincided with a period of rapid expansion of US- and EU-headquartered banks following financial deregulation (Arteta and Kasyanenko 2019). In the US, barriers between commercial and investment banking were removed, which opened the way for the formation of “mega-banks” and encouraged the rapid growth of corporate bond markets (Kroszner and Strahan 2014; Sherman 2009). In Europe, the Financial Services Action Plan in 1999 encouraged cross-border connections between banks and their rapid expansion (Goddard et al. 2015).

External debt rose sharply in Europe and Central Asia between 2000 and 2007, matched by rapid rates of GDP growth and aided by many countries’ growing ties with the EU. When the crisis hit, the deterioration in financial conditions resulted in sharp recessions in Europe and Central Asia. The deterioration in the real economy resulted in rising nonperforming loans, primarily attributable to households, rather than corporates as in the Asian crisis (Kose et al. 2020a).

The crisis in Europe and Central Asia was short-lived, thanks partly to the G20’s coordinated response to the global financial crisis and the unprecedented monetary and fiscal stimulus in 2009 and 2010 (Kose et al. 2020a). Due in part to the European Bank Coordination Initiative (Vienna Initiative) in 2009, major foreign banking groups maintained support for their subsidiaries in Europe and Central Asia, which also helped to contain the financial crisis and limit its damage to the region (Berglöf et al. 2009; Pistor 2011). According to Kose et al. (2020b, p. 41), “in many economies, better policy frameworks after the first two debt waves helped mitigate the damage of the global financial crisis that marked the end of the third wave”.

An important lesson from this crisis is that interdependent financial systems require coordinated governance regimes. As presented in Pistor (2011, p. 7), “governing interdependent financial markets requires mechanisms for managing last-resort public and private financial responsibility during a crisis as well as principles for regulating and supervising financial markets *ex ante* in a manner that is consistent with the expected *ex post* allocation of costs associated with a financial crisis”. The Vienna Initiative played this role and helped to solve the collective action problems of the different stakeholders involved in the resolution of the crisis.

The analysis of the different debt waves provides several useful lessons for Asian DSSI countries. The first set of lessons relates to minimizing the likelihood of this type of crisis:

- Sound macroeconomic policies, particularly in response to exogenous shocks, are crucial in limiting the financing needs of the public sector. Fiscal consolidation imperatives, however, have proven challenging for several developing countries. These policies should be extended also to the regulation of the financial sector, as half of the debt crisis was associated with the financial crisis. Inadequate regulatory and supervisory regimes can encourage excessive risky lending and debt buildups (Claessens 2015).
- Debt should be used efficiently. Borrowing for low-return spending at real interest rates that exceed longer-term economic growth, with repayments that spike in a given time period, is poor economic management and has led several economies to insolvency and liquidity crises as market sentiment turns against them. Conversely, borrowing at low cost to finance high-return growth-enhancing investments in physical and human capital is sound macroeconomics.

- Debt should be accumulated with care. As countries borrow, they need the capacity and analytical tools to design strategies to manage sovereign debt and contain its risks. In particular, careful choice of projects and increasing absorptive capacity and investment efficiency are critical. To minimize the risk of imprudent lending, various analytical tools have been developed to inform borrowing decisions, and policy frameworks introduced to promote fiscal discipline and prevent a buildup of debt and contingent liabilities.
- Potential sources of external shocks should be monitored, particularly in a country with substantial domestic vulnerabilities, including reliance on external and short-term debt in conjunction with a fixed exchange rate and low levels of reserves (Bordo et al. 2010; Claessens et al. 1999; Mishkin 1999). The evidence shows that countries with higher international reserve levels are significantly more resilient to these types of shocks (Gourinchas and Obstfeld 2012).
- Most defaults and restructuring episodes are triggered by one or more of the following factors: a worsening of the terms of trade; an increase in international borrowing costs; consistently poor macroeconomic policies, leading to a buildup of vulnerabilities; or a crisis in a systemically important country that causes contagion across goods and financial markets. Additional factors include macroeconomic volatility, banking crises and related contingent liabilities, and political and institutional factors.

The second set of lessons pertains to the resolution of the debt crises and the final outcome:

- Default is a costly solution. Policy makers avoid, as much as possible, declarations of default and debt restructuring. Defaults are costly especially in political terms, and even more so if the exposure of the domestic banking system is significant. Incentives to gamble for resurrection are high and the costs are typically even higher for all involved when the bet eventually does not pay off (UN DESA 2013). In the case of default, the economic costs in terms of GDP are exacerbated by prolonged uncertainty. A framework for sovereign debt restructuring could provide incentives to avoid these additional costs. Once default is declared, protracted debt renegotiations can erode confidence even more. Even in cases where negotiations facilitated voluntary debt exchanges, the associated economic and social costs have been high.
- A mechanism for sovereign debt restructuring could help improve coordination and provide fair representation of the debtor and all dispersed creditors; establish priority rules for the whole range of official and private creditors; provide an early response to debt distress, allowing time to find a solution and protect from litigation; and provide space and establish procedures for dispute resolution.
- We note several stylized facts from the last 20 years of debt restructuring. Since 1998, sovereign bond restructuring in emerging markets has been implemented relatively quickly. The extent of creditor losses (haircuts) shows a large variation, ranging from an estimated 5 percent (the Dominican Republic in 2005) to a nearly 90 percent (Iraq in 2006) reduction in net present value. The number of debt restructuring episodes with face value reduction (nominal debt write-downs) has increased notably since the late 1980s. Post-default restructuring cases on average show a higher net present value haircut than preemptive restructuring cases. The restructuring cases varied in complexity (Claessens et al. 1999).
- The negotiation process and the basic restructuring mechanics are very similar between domestic debt restructuring and external debt restructuring (Sturzenegger and Zettelmeyer



2006). However, a significant difference is that domestic debt is adjudicated domestically, often leaving litigation in domestic courts as the only recourse available to investors. Another difference is that investors in domestic instruments are often mostly residents, in which case a restructuring of domestic debt instruments will directly affect the balance sheets of domestic financial institutions and can affect the country's overall financial stability. Finally, exchange rate considerations and currency mismatches play a smaller role in domestic debt than in external debt restructurings (Claessens et al. 1999).

- The problem of creditor holdouts and litigation is widely seen as the main reason for delayed and inefficient debt restructuring. This type of free-riding behavior and other forms of creditor coordination failures are seen increasingly as critical stumbling blocks, mainly due to the shift from bank to bond financing (Das et al. 2012). However, as shown above, bond restructuring since the 1990s has been implemented more quickly than the bank debt exchanges of the 1980s.

#### 4. HOW BEST SHOULD ASIAN DSSI COUNTRIES BE FINANCED?

Many developed and emerging Asian countries have borrowed extensively to support the development of their economies. It is therefore natural for lower-income Asian countries to follow the same strategy. In practice, however, the relationship between debt, development, and growth is rarely smooth. To be effective, financing for development must reconcile the objective of meeting the large needs of developing countries with that of maintaining their debt at sustainable levels. This often requires a trade-off, and the choice of financial instruments is not neutral: while grants reduce the likelihood of future debt problems, loans provide more upfront financing.

This trade-off needs to be revisited in light of three new developments. First, the analysis of the trade-off is even more relevant in light of the COVID-19 crisis, which will require measures to be adopted at an unprecedented scale. The different policy proposals currently being considered to deal with this crisis must be evaluated in terms of the scale, conditions and efficient use of financial resources and different financial instruments. Second, new financial instruments to finance developing countries have emerged in recent years. The so-called family of “innovative finance” instruments emphasizes the achievement of outcomes and often includes the participation of the private sector both as a source and user of funds. Third, over the last decade, debt has increased substantially in most low-income countries and its composition has changed. As Asian countries develop, they will require new financing sources and financing instruments but also policies and debt management systems that reduce the likelihood of disruptive debt crises.

How best then should governments of Asian DSSI countries be financed? Our answer looks at two different horizons. We first assess the immediate impact of the COVID-19 crisis and the current debt relief proposals. We then discuss how these countries should balance the increased need for development financing while maintaining long-term debt sustainability.

##### 4.1 Debt of Asian DSSI Countries and the COVID-19 Crisis

Several Asian DSSI countries were already at a high risk of debt distress even before the first case of COVID-19 was diagnosed in late 2019 (see section 2 for details). The pandemic has

exponentially increased the problems of these countries to serve their debt. Drastic reductions in growth, trade, and fiscal revenue, coupled with massive and unplanned expenditures to support the health system and the livelihood of millions of individuals and companies, made an already complex starting point even more challenging. Some vulnerable countries are also facing higher financing costs or have very limited access to external financing. As a result, both solvency and liquidity indicators have deteriorated.

A number of proposals and initiatives from the international financial community have been launched or are being considered to mitigate these problems. In general, these proposals aim to provide liquidity, reduce likelihood of default, make available the needed resources to key sectors (such as health, social protection, and economic activity), and delay macroeconomic adjustment that would lead to a bad equilibrium.

On 15 April 2020, the G20 announced the DSSI, which is an eight-month official bilateral sovereign debt payment suspension if requested by International Development Association (IDA) member countries and least-developed countries that are current on their IMF and World Bank obligations. The DSSI allowed 76 IDA countries and Angola to suspend principal or interest payments on their debts to G20 members from 1 May 2020 through the end of 2020. The eligible countries include the 21 ADB developing member countries in our sample. For these countries, the potential DSSI savings as a percentage of 2019 GDP range from 0 percent in Timor-Leste up to 5.8 percent in Bhutan. In most cases, the savings are less than 1 percent of GDP.

After the moratorium period (the initial eight months have now been extended until June 2021), countries will have to pay the deferred principal and interest over the three years following a one-year grace period. This deferral is net present value neutral and therefore does not reduce the total payment debtors will make to participating creditors (Nye and Rhee 2020). Bilateral official creditors under the Paris Club have endorsed the DSSI. Though not a formal member of the Paris Club, the PRC is implementing the DSSI based on the same term sheet as its members. This is crucial as the PRC is the most important bilateral creditor for Asian DSSI countries. One question about the PRC's implementation of the program is whether the China Development Bank should participate. The G20 does not define the scope of "bilateral official creditors". The China Development Bank considers itself a "commercial lender"- its operational model is similar to that of the World Bank, relying heavily on funding from the financial market and acting very conservatively. This is an issue to solve as the G20 has also urged private sector creditors to participate in this initiative on comparable terms. However, an agreement has yet to be reached.

While welcome, the DSSI has several shortcomings. First, the DSSI has difficulty extending participation to other creditors. The negotiations with private creditors are likely conducted on a case-by-case basis, and the possibility of holdouts may complicate any restructuring plan. Enforcing a blanket standstill on the other hand could cause credit rating downgrades, shutting these countries out of international capital markets (Nye and Rhee 2020). Second, this proposal will not provide the fiscal space these countries will need to deal with the consequences of the pandemic. Finally, most of these countries already have important debt service commitments from 2022 onward to which they will need to add to these the debt service that was due in 2020–2021. Some of the alternative or complementary policy proposals highlight these shortcomings. The United Nations makes a number of policy recommendations to expand the DSSI, crucially to cover all highly indebted countries that request debt relief including

middle-income countries, and to encourage the participation of multilateral and commercial creditors. The United Nations Conference on Trade and Development (UNCTAD) (2020) proposed “comprehensive and automatic temporary standstills on debt repayments, including all external creditors and with possible annual renewals based on debt sustainability assessments”. In addition, UNCTAD called for an immediate stay on all creditor enforcement actions, and for jurisdictions that govern sovereign bond documentation for most emerging markets to deter lawsuits against debtor countries. UNCTAD proposed the creation of an International Developing Country Debt Authority to oversee the implementation of debt standstills and debt sustainability assessments in the longer term. Our assessment is that this ambitious proposal is very unlikely to find support in the current political and economic environment.

The uncertain nature of the COVID-19 crisis means that it is difficult to determine whether the countries' current sovereign debts are sustainable. Ultimately, the extent of debt distress will depend on how deep and prolonged the impact of the pandemic will be, which will vary from country to country depending on the importance of commodity and oil exports, tourism, and remittances. Countries with higher debt burdens will face an even more difficult trade-off between scaling up much-needed health and social safety net spending and public investment to meet ambitious development objectives while containing debt vulnerabilities.

The extent of debt distress will also depend on the extent of international support to countries through debt service relief, concessional financing, and when needed, support for debt restructuring. Although the IMF and the World Bank, as well as ADB and other regional development banks and concessional lenders have helped countries through such temporary crises, they do not have enough resources to deal with the problem alone. The real question then is what to expect beyond the life of the DSSI. Obviously, default would be a possibility for some of the lower-income countries. But history shows that this is a suboptimal solution and efforts should be made to avoid it. The extent of the problem will be better understood after the end of the pandemic. What is the level of indebtedness and how fast can Asian DSSI countries recover post-COVID-19 will be good indicators for the potential depth of any debt restructuring needed.

The capacity of the international financial system to resolve this issue would also depend on the extent of the problem. Will the need for restructuring and potential debt relief be limited to lower-income countries or should it also apply to emerging economies? The magnitude of the problem clearly would be very different. We know that in the case of lower-income countries, the level of resources needed is within the scope of what the international community deems possible, although the situation is different from in the early 2000s as donors' budgets are tighter and domestic demands are higher. The geopolitics is also different due to the rise of the PRC as the largest bilateral creditor. Debt portfolios are different, too; any solution now will require participation of nontraditional and commercial lenders. For most of the lower-income Asian countries, the implicit level of bailout of private creditors would be relatively small compared with emerging Asian countries but the available data are a bit opaque to provide an accurate assessment. In all likelihood, concessional financing will need to be increased for lower-income Asian countries in its many forms, and a blend of concessional finance and investments will need to be provided to avoid drastic reductions in economic growth.

While we still do not know the extent of debt restructuring and debt write-offs that will be needed, international expert groups are working on designing a mechanism to run multiple sovereign debt workouts simultaneously. In November 2020, the G20 approved the Common

Framework for Debt Treatments beyond the DSSI, which is available to the same set of countries that are eligible for the DSSI and involves the same group of 39 official creditors from the G20 and the Paris Club. In its current stage, the common framework provides a set of loose parameters, using a modified version of the Paris Club's classic debt treatment (Evian terms) for how the negotiations could be carried out. The document states that the negotiations would be done on a country-by-country basis and all countries would receive similar treatment. This could imply lengthy and costly negotiations if a standard mechanism is not properly developed. It also suggests that low-income countries will not be provided special treatment on standardized terms similar to those of the HIPC Initiative. We know from our review of previous debt crises that political commitment is paramount to reach a successful debt restructuring agreement. In the context of Asia, for debt relief to be effective, it must be closely coordinated with the PRC because of its increasing importance as a lender in the region. The recent historical evidence on the PRC's debt relief shows that the country has successfully restructured or refinanced approximately \$15 billion of African debt in the last 20 years (Acker et al. 2020). In none of these episodes was there evidence of asset seizures, the use of courts to enforce payments, or the application of penalty interest rates.

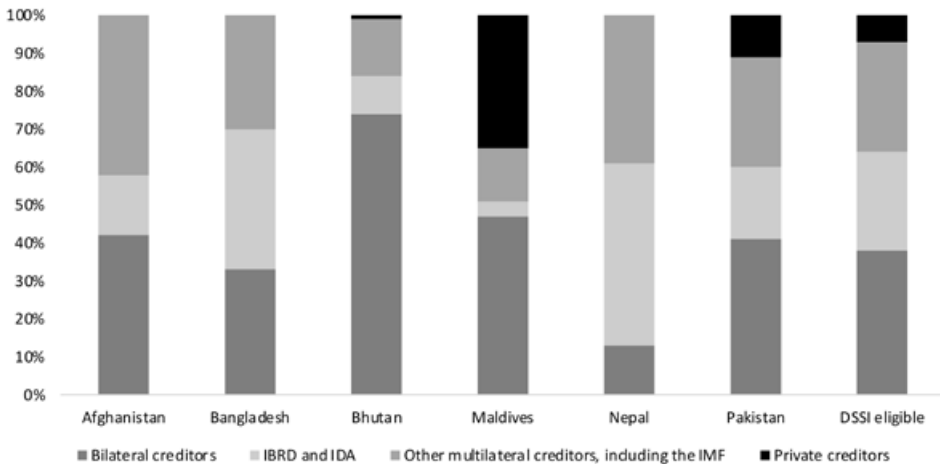
The creation of the Common Framework for Debt Treatments beyond the DSSI is in itself good news—the international community recognizes the fact that post-COVID-19, temporary debt service relief would not be enough. Maturity extensions should be prioritized, while haircuts are reserved for exceptional cases, according to the document. Our analysis indicates that the need for haircuts may become more the norm for several DSSI Asian countries. The common framework explicitly requires debtor countries to seek comparable treatment from other external creditors, including the private sector. However, this problem is not simple to resolve. Many lower-income countries have a poor debt management system and the official level of debts may underestimate the problem faced by Asian DSSI countries.<sup>8</sup> Hidden debts distort policy surveillance, risk pricing, and debt sustainability analyses. The need for transparency is at a premium, as governments and private creditors demand assurance that the debt relief will be channeled to confront the COVID-19 pandemic and not to repay preexisting debts to other creditors (Horn et al. 2020).

In this context, the main issue remains unsolved: how to distribute the losses between creditors and debtors and among creditors—especially the private ones. The diversification of the creditor base and the type of debt instruments used have only increased the complexity of these processes. The IMF has suggested two mechanisms to solve this problem: an agreement on a common approach to debt restructuring between the Paris Club and others, and the use of debt sustainability assessment risk ratings to limit eligibility for debt relief. Besides the fact that it would be hard to get private creditors to agree to that, the approach poses two problems in practice. First, available information on public debt is often incomplete and inconsistent, making it difficult to gain a comprehensive understanding of creditor composition. Therefore, it is almost impossible to do a fair distribution of losses among creditors. Second, if debt treatments are considered on a case-by-case basis, countries with a similar debt burden may end up with different debt relief deals depending on the creditors' interest. Even if Paris Club members are able to enforce comparable treatment, private creditors will refuse to agree to debt write-offs unless commercial creditors from nonmember countries participate on similar terms, further complicating the process. This could be a serious problem if other lenders prefer

to address restructuring on a bilateral basis, tailoring programs to each situation and often on a loan-by-loan basis rather than for the entire portfolio.

These debates need to be put in the context of the debt stock composition of Asian DSSI countries. If the focus is only on public external debt, the problem of (registered) private creditors should not be overestimated. Because of the nature of these countries, much of the external debt of these governments is with official creditors. Figure 4.4 shows external debt composition for selected Asian DSSI countries. Except for Maldives (31 percent) and Pakistan (11 percent), the incidence of private creditors is very low in most countries (7 percent on average for DSSI eligible countries).

In the absence of a game-changing event that helps to align the incentives of the different creditors or of an innovative market-based mechanism to improve debt restructuring as in the case with the Plan Brady,<sup>9</sup> a political and economic agreement may be lengthy and costly for developing countries. This needs to be avoided to prevent a repeat of the costly mistakes of the past. Ongoing discussions of potential debt relief mechanisms are considering different options to include private creditors—from legal and legislative strategies to more market-friendly mechanisms such as the creation of a voluntary credit facility, buy backs, and debt swaps. A successful coordination with non-Paris Club official creditors remains one of the main challenges in designing an effective debt relief initiative.



*Note:* DSSI = Debt Service Suspension Initiative; IBRD = International Bank for Reconstruction and Development; IDA = International Development Association; IMF = International Monetary Fund.

Data for Afghanistan were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting the country.

*Source:* World Bank Debtor Reporting System.

*Figure 4.4 External public debt composition for selected countries (end of 2019)*

## 4.2 Debt Sustainability and Development: Beyond COVID-19

Debt crises in developing countries recur, with each crisis eventually ending up with a more or less efficient resolution and the promise of implementing policy measures to avoid a new crisis. To build a more robust system, short-term debt distress solutions must be linked to medium- and long-term debt sustainability to avoid the pitfalls from the previous debt crises, while providing predictable sources of financing for sustainable development. However, developing countries and creditors have so far failed to achieve this in most cases. From the HIPC and MDRI debt relief initiatives, we learn that solutions should be integral, otherwise they would not be sustainable in the long run. Urgency and limited capacity to negotiate may work against an integrated approach, which may later open the door to accumulating new debt.

Despite earlier efforts, improving debt transparency and strengthening debt management practices remain a challenge for many developing countries. Figure 4.5 shows debt reporting heat maps for our 21 Asian countries as of June 2020. Prepared by the World Bank, the heat map presents an assessment based on the availability, completeness and timelessness of public debt statistics and debt management documents posted on the websites of national authorities. Unsurprisingly, most countries in our sample fail in all or most of the categories. On average, the countries at high risk of debt distress perform worse in the heat map than those with low- and medium-debt distress risks.

Country	Data Accessibility	Instrument Coverage	Sectorial Coverage	Info on Last Loans Contracted	Periodicity	Time Lag	Debt Management Strategy	Annual Borrowing Plan	Contingent Liabilities
Afghanistan									
Bangladesh									
Bhutan									
Cambodia									
Kiribati									
Kyrgyz Republic									
Lao PDR									
Maldives									
Marshall Islands									
Micronesia, Fed. States of									
Myanmar									
Nepal									
Pakistan									
Papua New Guinea									
Samoa									
Solomon Islands									
Tajikistan									
Timor-Leste									
Tonga									
Tuvalu									
Vanuatu									
	N/A	Limited			Partial		Full		

*Note:* DSSI = Debt Service Suspension Initiative; Lao PDR = Lao People's Democratic Republic; N/A = not applicable.

Data for Afghanistan and Myanmar were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting both countries.

*Source:* World Bank.

*Figure 4.5 Debt reporting heat map for selected Asian DSSI countries (June 2020)*

It is impossible not to overemphasize the importance of a debt management system and an active debt management strategy. Strengthening debt management is critical because it can free up resources for investment and also reduce the risk of debt crises. Debtors and creditors cannot make informed decisions without a full picture of a government's outstanding debt and

contingent liabilities. In such a situation, it is not possible to ensure that debt remains sustainable, and the lack of public information on public debt weakens accountability. Clearly, debt transparency is not easy to fix and depends on a multitude of factors, such as a country's institutional capacity, legal framework, governance, and civil service organizations more broadly. Investment in developing debt management and reporting capabilities must be pursued in parallel with complementarity policies to strengthen fiscal frameworks, improve the efficiency of public expenditures and public investment management, and develop domestic financial systems. ADB can play a key role in this area by providing technical assistance to its developing member countries as well as by issuing the right incentives through its lending policies.

A well-functioning debt management system plays two other important roles. First, in debt restructuring negotiations, transparent debt data facilitates agreements by providing clear information about who the creditors are. This helps prevent free-riding behavior that could delay agreements. Second, debt management systems help to reconcile the objective of meeting the large needs of developing countries with that of maintaining their debt at sustainable levels. Without these systems, most low-income countries are constrained to rely only on grants and highly concessional finance. A transparent system and good debt management practice would allow them to borrow from other sources without having to pay much higher costs, if the borrowing is done responsibly.

There is an extensive body of literature on the sources of development financing for low-income countries. Most of this literature focuses on two aspects: domestic resource mobilization (DRM) versus external financing and the form external financing should take.

The case for DRM is clear: in the long run, countries should raise and spend their own funds to finance most of the domestic investment and social programs that are essential for economic development. DRM is founded mainly on the development of the tax system through improvements in tax administration and tax policy. Following the pandemic, increased public- and private financing from the developed to the developing world would probably be hard to achieve. In this context, developing Asian countries will face pressure to progress on DRM. However, DRM is a process with often modest year-to-year improvements, while drastic tax reforms fail in many cases because of political and economic constraints. The immediate post-pandemic scenario does not seem conducive to such reforms. There is a role here for multilateral development banks like ADB. They can intensify the work they do with their members and establish a common understanding of what constitutes "good" DRM, identify the structural and political constraints, and determine the effectivity of policy advice, financial support, and technical assistance. This is also an area ripe for innovative solutions. For example, Lee (2018) pointed out that with this type of reform, paying for outcomes makes a lot of sense. A multilateral bank could use concessional lending to match half of a one percentage point actual increase in the tax revenue-to-GDP ratio. The additional concessional lending would strengthen instead of weaken a country's long-term debt sustainability. (A key issue would be to provide the right incentives for countries not to rely exclusively on indirect taxes, which are easier to administer but will put the poor at risk of becoming net payers if redistributive tax and spending policies are not in place.)

The development of domestic debt markets is also emphasized as a potential tool for using domestic resources to finance development. As in the case of DRM through higher tax revenue, the development of domestic debt markets should not be considered a short-term solution, but a continuous process with a long-term goal. In the case of low-income countries, there is no

trade-off between issuing safer and cheaper debt, as external debt tends to have concessional rates and longer maturity. Therefore, even if external borrowing carries a potential currency mismatch, it tends to be cheaper than domestic borrowing. Given the limited domestic savings, however, there is potential for direct crowding out as governments and corporate bonds would compete in the portfolio of local institutional investors. The role of domestic debt markets in financing governments in lower-income countries in Asia may remain modest in the years to come.

Official multilateral and bilateral grants and loans will remain the main source of development financing for Asian DSSI countries in the short- and medium term. A central question in this context is what form financial aid should take. The debate has rightly centered in the choice between pure grants or concessional loans. There is a clear trade-off between the two: for a given cost to donors, loans provide more upfront financing while grants avoid the risk of future debt problems. In the case of low-income countries, the debate has settled more in favor of grants than loans, because of the history of pervasive “lend-and-forgive” cycles. However, this historical evidence is highly biased because of the negative experience of low-income countries in Africa and, to a lesser extent, in Latin America. There is no systematic evidence, at least until now, that this has been the case for low-income countries in Asia. On the other hand, as noted earlier, many of these countries were already at high risk of debt distress even before the COVID-19 pandemic. Was this due to excessive lending, particularly from new sources of financing, or the result of unexpected worsening of global economic conditions? While the answer to this question would require a country-by-country analysis, we note that most of these countries have poor debt management systems. Improving them should be a condition to have access to conditional lending, instead of being limited to using only grants.

Another potential problem of using loans to finance low-income countries is the need to produce tradable goods and services (the transfer problem) to be able to repay a loan. Many projects, particularly in the social area, may not have an immediate tradable output, making them unsuitable candidates for loans. While funds are fungible up to some point, multilateral banks could use a mixed grant-and-concessional loan strategy to finance governments in low-income countries, but rebalancing the mix according to the likelihood that the funds would create the resources to repay the loan. Even then, for the lending part of that mix, it would be advisable to emphasize the use of the so-called “innovative finance” instruments that focus more on outcomes than on inputs. This family of instruments include (1) development impact bonds and social impact bonds; (2) blended impact investment funds; and (3) outcome-based funds.

## 5. CONCLUSIONS

This chapter analyzed the current sovereign debt problems of several developing Asian countries, focusing in particular on the countries that qualified for the DSSI, the debt relief mechanism put in place by the G20 in the wake of the pandemic. It explored short-term solutions to those problems and determined the key elements of a strategy to provide sustainable development financing for these governments.

We find that debt distress risk has been increasing for most of the Asian DSSI countries in the last decade, even before the pandemic, due to a number of domestic and international factors. Most of these countries have seen an increase in the level and risk profile of their debts. In



most cases, debt is external and denominated in foreign currency, short-term commercial debt has increased, and countries' fiscal and current account positions have deteriorated. Following the global shock created by the pandemic, most of these indicators have deteriorated further. Because of reduced revenues and the need to increase expenditures to support their economies, these countries have difficulty servicing their debt and accessing credit markets.

In this context, many of them, including the Asian countries, face a greater possibility of being in debt distress. Based on historic evidence, we draw the following lessons that should be useful in case a debt workout proves necessary:

- Policy makers should avoid, as much as possible, declarations of default and debt restructuring that end up increasing cost. A framework for sovereign debt restructuring could provide incentives to avoid these additional costs.
- A mechanism for sovereign debt restructuring could help, by improving coordination and providing fair representation of the debtor and all dispersed creditors, establishing priority rules among the whole range of official and private creditors, responding early to debt distress, allowing time to find a solution and protect from litigation, and creating space and establishing dispute resolution procedures.
- Creditor holdouts and litigation are widely seen as the main reasons for delayed and inefficient debt restructuring.

Acting on these lessons, the international community is actively seeking to provide immediate temporary debt relief and to develop a framework to deal with the potential debt restructuring in several countries. In April 2020 the G20 introduced the DSSI, which provides short-term relief by suspending payments on official bilateral sovereign debt for a number of developing countries. No doubt, for a few DSSI countries, long-term debt sustainability is not a major concern and the payment suspensions will serve their short-term purpose. But for the majority of DSSI countries, some degree of debt forgiveness from creditors will probably need to be on the table. For that reason, in November 2020, this initiative was upgraded to include a framework for debt negotiations based on a modified version of the Paris Club's classic debt treatment. However, there are several problems with this initiative, including the difficulty of making private creditors agree to participate. Our analysis shows instances in the past where multicountry debt relief initiatives have been possible. However, the evidence shows that the debt restructuring process is often complex and time-consuming, typically taking years to resolve and at great cost to all parties. Moreover, there is little evidence of how such negotiations would work in a context like the one created by the pandemic. A quick and efficient solution to debt restructuring will depend on a political deal and the development of flexible and innovative instruments that can accommodate the preferences of the different actors involved.

Once a solution is reached, it is essential to ensure that it avoids the pitfalls of other major debt relief initiatives. In this sense, in many developing Asian countries ensuring debt transparency and strengthening debt management practices remain a challenge. Addressing these challenges should be a priority for both creditors and debtors not only to reduce the likelihood of future crises but also to allow for better resolution if they happen. Without a proper debt management system, many countries would only be able to attract grants and a limited amount of concessional lending.

Multilateral and regional development lenders should keep working with their member countries to strengthen domestic resource mobilization and develop domestic debt markets.

However, for most governments in Asian DSSI countries, official multilateral and bilateral grants and loans will remain the main source of funding in the short- and medium-term. International financial institutions should emphasize the use of the so-called “innovative finance” instruments that tie financing to measurable results.

## NOTES

1. The views expressed therein are those of the authors and do not necessarily reflect the views and policies of ADB, its Board of Governors or the governments they represent.
2. For a recent overview of the evolution of public vulnerabilities in lower-income countries see IMF (2020a). The appendix of this report provides a useful classification of lower-income countries.
3. In this chapter, data for Myanmar were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting the country.
4. Data for Afghanistan and Myanmar were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting the countries.
5. IMF (2020b) provides information on how risk of debt distress is estimated. A country is considered to be in debt distress if it is experiencing difficulties in servicing its debt, as evidenced, for example, by the existence of arrears, ongoing or impending debt restructuring, or if there are indications that a future debt distress event is probable.
6. Afghanistan, Bangladesh, Bhutan, Cambodia, the Kyrgyz Republic, the Lao PDR, Maldives, Myanmar, Nepal, Pakistan, PNG, Samoa, Solomon Islands, Tajikistan, Timor-Leste, Tonga, and Vanuatu.
7. Data for Afghanistan were valid as of 14 December 2020 and may have changed thereafter because of major recent events affecting the country.
8. There are indications that reporting on state-owned enterprise debt in the World Bank's International Debt Statistics database is likely to be incomplete (IMF 2020b). This raises significant concerns of hidden direct and contingent liabilities which may further exacerbate the debt position of Asian DSSI countries.
9. Willems (2020) proposed the use of an auction-based mechanism to deal with sovereign debt restructurings.

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