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External debt sustainability and development

Report of the Secretary-General

Summary

The present report, submitted pursuant to General Assembly resolution 68/202, analyses the evolution of debt indicators of developing countries and transition economies. It provides an assessment of progress under international debt relief initiatives and the reform of credit rating agencies. The report discusses emerging and existing challenges of developing countries in maintaining debt sustainability and the renewed debate surrounding a sovereign debt workout mechanism.

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I. Introduction

1. The General Assembly, in its resolution 68/202, requested the Secretary-General to submit a report to the Assembly at its sixty-ninth session on the implementation of the resolution and to include in that report a comprehensive and substantive analysis of the external debt situation of developing countries and options for enhanced approaches to debt restructuring and resolution mechanisms that take into account the multiple dimensions of debt sustainability. In compliance with that request, the present report examines recent developments in the external debt and debt service situation of developing countries and transition economies and discusses emerging and existing challenges faced by developing countries in maintaining debt sustainability. The report examines recent developments and the renewed debate surrounding a sovereign debt workout mechanism and concludes with policy recommendations.

II. Overview and trends

2. The total external debt stocks of developing countries and transition economies (henceforth "developing countries") reached $6 trillion in 2013, indicating an 8.7 per cent increase over 2012 stocks (see annex).[1] This marks the fourth consecutive year that the external debt growth of developing countries has exceeded the average growth rate of approximately 7 per cent that persisted for nearly a decade prior to 2010.

3. Long-term debt represented approximately 72 per cent of total debt stocks in 2013, as in 2012, and was mainly owed to private creditors. The share of official long-term lending to developing countries continued to decline in 2013, as in 2012. However, the share of short-term debt increased from $1.26 trillion in 2011 to $1.35 trillion in 2012, reaching $1.5 trillion in 2013.

4. The average real gross domestic product (GDP) of the group grew by 5 per cent in 2012 and slowed to 4.7 per cent in 2013. Exports continued to grow by 4.2 per cent in 2012 and by 4.4 per cent in 2013. In spite of the slight improvement in export growth, debt ratios for the group continued to worsen in 2013. Total debt to GDP increased to 22.7 per cent in 2013, following increases in ratios in 2011 and 2012 to 20.9 and 21.7 per cent, respectively. Debt service to exports rose from 7.9 to 8.3 per cent, and total debt to exports increased from 72.8 per cent to 75.9 per cent from 2012 to 2013.

5. International reserves for developing countries increased to $6.8 trillion in 2013, from nearly $6.3 trillion in 2012. This represents a major improvement in the growth rate of reserves from 4.5 per cent in 2012, the lowest rate in more than a decade, to 8.5 per cent in 2013. The stock of international reserves continues to exceed the stock of total debt for developing countries as a whole. While the growth in international reserves in developing countries has been unprecedented since 2000, the faster growth of debt than reserves since 2008 is a concern. Ninety out of 93 countries, for which 2012 short-term debt data was available, have international reserves that cover more than 100 per cent of their short-term debt, making a

[1] United Nations Conference on Trade and Development (UNCTAD) secretariat calculations based on the World Bank 2014 International Debt Statistics online database.

liquidity crisis in developing countries a low probability. Since 2000, international reserves in developing countries have further grown at an unprecedented rate, although a significant part of this growth may be due to borrowed reserves given that non-residents may increase their holdings of liabilities such as equity investment or debt. One unintended consequence of the expansionary quantitative easing programmes of the United States of America and the United Kingdom of Great Britain and Northern Ireland has been a surge of capital inflows from 2009 to 2013 to developing countries. Emerging market countries have in part converted the inflowing capital into exchange reserves.

Regional trends

6. Total debt stocks in Eastern Europe and Central Asia continued to grow by 6 per cent from 2012 to 2013, marking a slight increase from the previous year's growth of 5 per cent. The region's total debt to GDP ratio has remained steady since 2012 but was the highest (40.8 per cent) among all the regions in 2013. Short-term debt as a share of total debt stocks was stable at approximately 18 per cent, close to the average for the previous decade (17 per cent). Other debt ratios have increased slightly, with debt service to GDP and total debt to GDP increasing by less than 1 per cent and debt service to exports increasing by 1.5 per cent. The region's international reserves remained constant from 2012 to 2013 following a 7 per cent increase in 2011.

7. The growth of total debt stocks in sub-Saharan Africa slowed to 4 per cent in 2013, down from 11 per cent in 2012 and 2011. The share of short-term debt in total debt stocks remained relatively constant at 15 per cent in 2013, registering just a 1 per cent decrease from 2012. The region's debt service to exports and debt service to GDP ratios increased by less than half a per cent, while the total debt to exports increased by 3 per cent from 2012 to 2013. In 2013, the region grew by about 5 per cent. International reserves for the region increased by 1 per cent in 2013 following an increase of 12 per cent in 2012. However, downside risks posed to the region's future growth include a prolonged period of slow global growth, a contraction of investment in emerging market countries in addition to challenges faced by internal conflicts and adverse climate developments. While the debt ratios of many countries in the region have improved, thanks to international debt relief initiatives, many countries remain vulnerable to economic downturns as their capacity to finance larger deficits is constrained by the size of domestic financial markets. The increased ability of some countries in the region to issue international sovereign bonds is due to favourable global conditions. This has contributed to a shift in the composition of the region's debt, increasing the region's currency exposure, bringing new challenges for countries to monitor and manage.

8. In Latin America and the Caribbean, the growth of total debt stocks slowed in 2013 to 7 per cent, down from 12 and 13 per cent in 2012 and 2011, respectively. The share of short-term debt remained constant at 14 per cent from 2011 to 2013. The region's debt ratios have increased incrementally over recent years. The growth in international reserves also slowed to 3 per cent in 2013, down from 8 and 17 per cent in 2012 and 2011. Growth in the region is low and below the average of the past decade, which has been attributed to sluggish external and moderating domestic demand. Increases in United States interest rates have triggered sell-offs in the region's emerging markets and the resulting capital market volatility has had an

impact on, inter alia, exchange rates, stock markets, sovereign spreads and bond yields. As a result of moderate debt levels, countries in the region have thus far managed to navigate the turbulence owing in part to Government buffers, official reserves and flexible exchange rates; yet downside risks persist.[2]

9. Within the region, the Caribbean continues to face increasing public debt difficulties, where debt reduction remains a key policy priority. Growth in the Caribbean remains weak owing to subdued construction and tourism sectors, tourism being the main economic activity. Except for commodity exporting economies, this has made the Caribbean countries highly susceptible to external shocks.

10. The total debt stocks in the Middle East and North Africa continued to grow at 9 per cent in 2013, as in 2012. The share of short-term debt rose slightly from 21 to 23 per cent from 2012 to 2013, a higher share than the 17 per cent average from 2000 to 2009. The increase in debt stocks is reflected in incremental increases in the region's debt ratios, including debt service to exports, total debt to exports and debt service to GDP. International reserves increased by 3 per cent in 2013 after contracting by 4 per cent in 2012. Growth in the region is expected to improve in the short term, though the outlook has weakened partly owing to the ongoing uncertainties associated with political instability, sanctions and conflicts in the region. Concern remains that improvements in growth will be insufficient to reduce the high levels of unemployment.

11. Growth of total debt stocks in East Asia and the Pacific amounted to 15 per cent in 2013, following increases of 10 and 19 per cent in 2012 and 2011, respectively. Owing to stronger growth in the region, total debt to GDP increased by less than 1 per cent in 2013 to 14.6 per cent. From 2012 to 2013, other debt ratios, namely debt service to exports and debt service to GDP, remained constant, while the total debt to exports ratio increased from 42.2 to 44.3 per cent. The international reserves increased by 13 per cent, marking the largest increase of all the regions surveyed. Short-term debt continues to represent a large share of the region's debt (48 per cent in 2013), which is relatively constant at 2012 and 2011 levels.

12. Emerging market economies in South Asia and East Asia and the Pacific have also been subject to volatile capital flows that were driven by the increased attractiveness of investments in developed economies owing to changes in monetary policy in the United States. The improved economic outlook in developed economies is expected to boost export sectors in the region. Moreover, growth in both regions relies heavily on China's economic performance, leaving them exposed to unexpected changes in economic activity. Growth rates in both regions are forecast to be between 5 and 6 per cent, despite the uncertainties surrounding global growth prospects.

III. Least developed countries

13. In 2013, the total external debt of the 48 least developed countries increased by $16.8 billion or 9.5 per cent compared with 2012 as a group. Most of the increase in the debt stock was in long-term private debt, whereas short-term debt decreased.

[2] International Monetary Fund (IMF), *Regional Economic Outlook: Western Hemisphere — Rising Challenges*, World Economic and Financial Surveys (Washington, D.C., April 2014).

The increase in debt stock from 2012 to 2013 resulted in an increase of debt to GDP from 25.5 to 26.5 per cent and the ratio of total debt as a percentage of exports also increased from 87.1 to 89.4 per cent.

14. The ratio of debt service to GDP and exports for the least developed countries remained low at 1.2 per cent and 4.2 per cent, respectively, in 2013. This is the result of the highly concessional terms of the majority of external debt for least developed countries, which is primarily long-term debt (83 per cent). Short-term debt totalled $15.7 billion in 2013, a reduction of $1.4 billion compared with 2012. The total amount of foreign currency reserves increased from $63.3 billion in 2012 to $71.8 billion in 2013, which covered nearly six times the amount of short-term debt of these countries.

15. As at March 2014,[3] there was one least developed country in debt distress (Sudan) and nine least developed countries at a high risk of debt distress (Afghanistan, Burundi, Chad, Comoros, Democratic Republic of the Congo, Djibouti, Haiti, Kiribati and Sao Tome and Principe). Myanmar's status changed from being classified as in debt distress in 2012 to having a low risk of debt distress in 2013, following debt cancellation of nearly $6 billion at the Paris Club in January 2013.[4]

16. On average, the performance of the least developed countries improved slightly in 2013, with average GDP growth of 4.5 per cent, compared with 4.3 per cent in 2012.[5]

17. In 2013, the current account balances of 27 least developed countries worsened, while the fiscal deficits widened in 30 least developed countries. Seventeen least developed countries ran double-digit current account deficits in 2013. In particular, Liberia and Mozambique continued to run high current account deficits of over 30 per cent of their GDP in 2013, as in 2012. Imports of goods and services are projected to increase in least developed countries that continue to expand their production capacity, while exports as a percentage of GDP are projected to decline in a number of countries. This partly reflects lower demand for commodities from emerging markets. By contrast, exports as a percentage of GDP are projected to increase in a number of least developed countries that have recently expanded their mining production capacity. The large current account deficits require careful monitoring as countries with large fiscal deficits and high debt burdens will have less policy space to adopt expansionary policies.

18. The magnitude of recent sovereign bond flows to sub-Saharan Africa reached $5 billion in 2013, marking the highest level to date. This level is equivalent to 20 per cent of aid and 12 per cent of foreign direct investment (FDI) for the region.[6] A number of least developed countries such as Rwanda, the United Republic of Tanzania and Zambia have diversified from the traditional concessional loans and joined the international financial market to borrow on commercial terms. Many of these countries are motivated to access finance on the international market because

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[3] IMF list of low-income countries' debt sustainability analyses for Poverty Reduction and Growth Trust-eligible countries as at 4 April 2013 (available from www.imf.org).

[4] Paris Club press release. Available from www.clubdeparis.org/sections/communication/archives-2013/myanmar-20130128.

[5] UNCTAD staff calculations based on IMF World Economic Outlook data.

[6] Overseas Development Institute briefing No. 87, "Sovereign bonds in sub-Saharan Africa: good for growth or ahead of time?" (April 2014).

they can issue bonds at a lower interest rate compared with borrowing from domestic markets. The yields on four out of eight rated sub-Saharan African eurobond issuers were lower than 5 per cent in 2013.[7]

19. Greater access to the international financial market could help least developed countries to mobilize resources to meet their long-term infrastructure needs for economic growth. However, the least developed countries should pursue active debt management to mitigate the risks associated with these new financial instruments, including rollover risk, currency risk and greater macroeconomic volatility from large capital inflows. For instance, there could be peaks in the debt redemption profiles at maturity of the bonds owing to large principal payments, which may become difficult to roll over if a need arises. In the event of a sharp depreciation of domestic currency, not only could the interest payments on the Eurobond become more expensive than the interest payments on an equivalent domestic bond, but the principal payments in terms of domestic currency may rise significantly, increasing the risk of default and/or rollover risk at maturity. This could undo the benefits of lower interest rates on Eurobonds than on domestic bonds. Moreover, large short-term capital inflows may lead to undue appreciation of the domestic currency, credit booms and inflation, creating problems for monetary policy. It is therefore crucial that countries are able to manage such capital inflows and volatility while taking advantage of the favourable conditions in international financial markets.

IV. International debt relief initiatives

A. Progress of the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative

20. Since the previous report (A/68/203), there has been no change in the status of countries eligible to benefit under the Heavily Indebted Poor Countries (HIPC) Initiative, as it winds down. Thus far, of the 39 eligible countries, 35 have completed the HIPC Initiative. One country (Chad) remains in the interim phase between decision and completion points, and three countries (Eritrea, Somalia and Sudan) have yet to reach the decision point.

21. In addition to those HIPCs, Myanmar, Nepal and Zimbabwe are countries that have been identified as being potentially eligible for debt relief under the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI).[8] After meeting with Myanmar in January 2013, the Paris Club cleared $10 billion of its arrears, cancelling nearly $6 billion and rescheduling the remainder. Zimbabwe remains in debt distress. The country has been in the process of normalizing its relations with international financial institutions and established its first staff-monitored programme with IMF in June 2013. Zimbabwe’s eligibility for assistance under the HIPC Initiative is uncertain and will depend on whether it meets end-2004 and end-2010 indebtedness criteria and clears its arrears owed to the Poverty Reduction and Growth Trust.

[7] Standard & Poor’s, “The growing allures of eurobonds for African sovereigns” (May 2013).

[8] IMF, “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) — statistical update” (Washington, D.C., December 2013).

22. Debt relief provided under the HIPC Initiative and MDRI have redirected resources to increase poverty-reducing expenditures. While the increase in poverty-reducing revenue is welcome, it is a concern that most HIPCs remain off-track for achieving many of the targets of the Millennium Development Goals, albeit with variations across countries. HIPCs have made some progress and, relative to other country groups, were faced with the challenge of making the largest absolute changes to meet their Goal targets.[9] Debt relief alone is not a panacea to the development challenges confronting HIPCs; it is a necessary but insufficient solution and must be accompanied by additional assistance, both in terms of development financing and capacity-building.

23. While there have been marked improvements in numerous debt indicators of HIPCs, many continue to be at risk of debt distress despite completing the Initiative. Of the 36 HIPCs that have actively engaged under the HIPC Initiative, 7 are classified as being at high risk of debt distress, 16 are classified as being at moderate risk of debt distress and 13 are classified as being at low risk of debt distress.[10] For the countries that have yet to start under the Initiative, Sudan remains in debt distress and debt distress levels for Eritrea and Somalia have not been reported. Eritrea's previous reported debt sustainability analysis was completed in 2009 and Somalia's Article IV consultation has been delayed for more than 20 years, owing to a lack of adequate information.[11]

24. Unfortunately, the end of the HIPC Initiative and MDRI debt relief will not bring an end to debt crises. The international community must reflect on the strengths and weaknesses of the framework to carry forward lessons learned into the future. The international community must also respond to new challenges that have emerged since the launch of the HIPC Initiative, as non-HIPCs facing insurmountable debt difficulties need assistance from the international community. Countries in debt distress that have yet to benefit from debt relief mechanisms should be afforded the same opportunity.

B. Paris Club activities

25. Since the last report, only one Paris Club meeting has been held. In May 2014, Argentina reached a deal with Paris Club creditors to clear its $9.7 billion arrears over a five-year period. The agreement gives Argentina some flexibility to adjust the level of its yearly payments to creditors, as only a minimum of $1.15 billion needs to be paid in the first year. De facto, Argentina has obtained a deal under which it has an imbedded one-year option on the level of payments contingent on the level of economic performance. This gives the country breathing space to continue with its reforms, while the Paris Club deal opens the door for the reinstatement of export credits and normalizes Argentina's relations with the international financial community. Furthermore, the 2001 Argentine default is widely viewed as a success because although the country's economy shrank for one quarter after the default, a rapid-growth recovery followed, allowing the country to realize annual average

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[9] Ibid.

[10] IMF list of low-income countries' debt sustainability analyses for Poverty Reduction and Growth Trust-eligible countries as at 1 May 2014. Available from www.imf.org.

[11] IMF, "Delayed Article IV consultation with Somalia", press release No. 13/293 (August 2013).

GDP growth of 8.7 per cent and annual poverty reduction of almost 34 per cent by the end of 2011.[12]

V. Official development assistance

26. In 2013, net official development assistance (ODA) from the Development Assistance Committee donors of the Organization for Economic Cooperation and Development (OECD) totalled $134.9 billion, an increase of 6.1 per cent in real terms compared with 2012.[13] This marks a rebound in ODA after two consecutive years of decreasing aid volumes. The increase is the result of a number of Governments stepping up their ODA spending to meet the target of 0.7 per cent of gross national income (GNI). Thus far, only five advanced countries of the Committee have met or surpassed this target, namely, Denmark, Luxemburg, Norway, Sweden and the United Kingdom. The international community has consistently fallen short of that target, with net ODA as a percentage of GNI averaging 0.3 in 2013.

27. Even though the total nominal amount of ODA to developing countries increased in 2013, the geographical breakdown of aid flows shows an uneven picture. In 2013, aid to the African continent fell by 5.6 per cent and bilateral aid to sub-Saharan Africa decreased by 4 per cent in real terms compared with the previous year. This downward trend in programmed aid to least developed countries and low-income countries, particularly in Africa, is likely to continue, based on the results from the survey conducted by the Development Assistance Committee in 2014 on donors' future spending plans. The shift in ODA allocations away from the poorest countries towards selective middle-income countries is also a concern as countries that are affected by the reduction in programmed aid are the ones heavily relying on aid to achieve the Millennium Development Goals and reduce poverty levels.

28. ODA is an important source of financing for developing countries in times of crisis as it provides them with a crucial cushion to pursue the objectives outlined under internationally agreed development goals. The survey on donors' future spending plans projected the country programmable aid to increase slightly by 2.4 per cent in real terms in 2014 and to remain unchanged from 2014 to 2017. It is likely that this stagnation is associated with the uncertainty that continues to hang over the global economic climate. The uncertain global economic outlook is likely to continue to affect aid budgets, raising concerns about the predictability of planned aid in the years to come. For developing countries, uncertainty about future resources complicates government decision-making on resource allocations and can stand in the way of implementing longer-term programmes and reforms. Aid predictability is, therefore, crucial for developing countries to design and implement their national development strategies.

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[12] Economic Commission for Latin America and the Caribbean, "Social panorama of Latin America" (2012). Available from www.cepal.org/publicaciones/xml/4/48454/SocialPanorama2012DocI.pdf.

[13] OECD, "Aid to developing countries rebounds in 2013 to reach an all-time high" (April 2014). Available from www.oecd.org/newsroom/aid-to-developing-countries-rebounds-in-2013-to-reach-an-all-time-high.htm.

29. It is important for donors to continue to deliver on their aid commitments and reduce aid volatility. There is a need to secure more stable and predictable, and less procyclical aid flows for the poorest countries. The international community should ensure that aid targets those who need it the most and that the declining trend in ODA to least developed countries and low-income countries, particularly Africa, does not damage the efforts achieved so far in development, growth and poverty reduction.

VI. Credit rating agencies: recent developments

30. Credit rating agencies contributed to the 2007-2009 global financial crisis, which began with problems in the United States sub-prime mortgage market and engulfed financial markets globally. Agencies failed to accurately assess the risks inherent in more complicated financial instruments, issuing incorrect ratings that proved to be disastrous to the financial system. Thus far, consensus has not been reached on the types of reforms that need to be undertaken. The current debate on how to reform credit rating agencies is divided between two extremes: (a) subjecting the agencies to tighter regulation in order to purge conflicts of interest and downsizing the agencies; and (b) deregulating the agencies to solve the current market failures such as conflicts of interest, lack of transparency and competition, lack of accountability and over-reliance on ratings. There may be a need for both types of reforms.[14]

31. At the 2009 London Summit, the Group of 20 leaders agreed to a stricter regulatory oversight of credit rating agencies,[15] consistent with the 2008 Code of Conduct Fundamentals for Credit Rating Agencies established by the International Organization of Securities Commissions.[16] As a result, national, regional and international initiatives have been under way to strengthen the oversight of the agencies while some measures had been initiated before the crisis. Since the outbreak of the global crisis, the United States, Europe and various international financial institutions have taken steps to regulate the agencies and ensure more transparency and competitiveness; the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States is one example. The European Union established an independent authority known as the European Securities and Markets Authority, tasked with regulating the activities of rating agencies in accordance with European Union standards. At the same time, the European Union recommended the gradual removal of references to external credit assessment. These new rules are also in line with the policies developed by other international institutions, the Financial Stability Board and the Basel Committee. In October 2010, the Financial Stability Board endorsed principles to reduce the overreliance of authorities and financial institutions on agency ratings. The Seoul Summit of the Group of 20 held in 2010 approved the Board's principles on reducing reliance on external credit ratings.

[14] Marwan Elkhoury, "Reforming the credit rating industry. What more needs to be done?", UNCTAD background paper (March 2014).

[15] In their Global Plan for Recovery and Reform, the Group of 20 leaders agreed to "extend regulatory oversight and registration of credit rating agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest". Available from www.g20.utoronto.ca/2009/2009communique0402.html.

[16] See www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf.

32. New legislation in place internationally has addressed important issues with respect to conflicts of interest, transparency and competition. However, despite these positive changes, some room for improvement remains. For instance, there is still an absence of meaningful competition within the oligopolistic industry, an inability to resolve the inherent conflict of interest of issuers choosing their rating agency and a lack of solutions to engaging in rating shopping for the highest ratings and credible alternatives to the issuer-pay model. Moreover, the current regulations have not fundamentally altered the market structure for credit rating agencies, as far as the oligopoly structure of the market is concerned, the potential conflict of interest with the issuer-pay model and the privatization of the public good nature of credit risk rating.

33. However, positions taken by some economists are radically opposite to the international reform efforts. They advocate less regulation, less reliance on credit rating agency ratings and more prudential regulation of bond portfolio managers' and investors' own assessments of bond creditworthiness. Instead of delegating safety judgements to the rating agencies, prudential regulators would rather place the burden for safe bond portfolios directly on the regulated financial institutions and allow them to seek advice about the creditworthiness of bonds as they see fit, subject to prudential oversight.[17]

34. To date, regulators, market participants and scholars may have identified credible complements to credit ratings, such as market-implied ratings in credit default swaps but no certain substitutes to the issuer-pay model of credit ratings have been agreed upon. It is clear, however, that regulators should develop independent standards of credit worthiness and eliminate registered agency ratings for regulatory purposes. However, investors should increasingly develop internal models to assess the credit worthiness of their portfolio and use agency ratings as one element among many in their internal assessment of credit worthiness of their portfolio assets.

35. Ultimately, the correct incentives have to be created by regulators to reduce potential conflicts of interest, be it an investor-pay model, an issuer-pay model, a performance-pay model or a clearing house model, to promote competition and transparency. Accountability and civil liability of credit rating agencies should be imposed, should agencies fail to properly assess debt instruments or possible abuse of investors by lack of due diligence or the search for gaining market shares at the cost of providing accurate ratings. If incentives are right, much less regulation is required. Conversely, if incentives are wrong, market failures may have very large repercussions on financial markets, even with stronger regulations in place, as has been witnessed in the global financial crisis.

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[17] Lawrence J. White, "Credit-rating agencies and the financial crisis: less regulation of CRAs is a better response", *Journal of International Banking Law and Regulation*, vol. 25, No. 4 (2010).

VII. Emerging and existing challenges

A. Increasing public commercial debt[18]

36. The past decade has seen important structural changes in public debt in most developing and transition economies. Locally and internationally issued securities have continued to account for the bulk of it while bank loans have remained a small proportion of the total.[19] However, there has been a rapid shift from international to domestic debt markets. The share of the public sector debt issued in domestic debt markets of some developing and transition economies is now higher than the share in international securities issued by financial and non-financial corporations. For all developing economies,[20] this share of public sector debt in external commercial debt securities in 2013 was close to 43 per cent. This has been associated with a concomitant increase in foreign participation in domestic markets for government debt for a number of large developing countries, and a rapid increase in corporate issues abroad. At the end of 2013, for a number of developing countries, foreign investors held more than one third of government bonds in local debt markets. Almost all these foreign holdings are denominated in local currencies.

37. There are several factors driving this trend. First, increased foreign holdings resulting from a search-for-yield triggered by exceptionally low United States Treasury yields have no doubt played a central role in the increase of foreign participants in domestic financial markets.[21] Second, countries issuing local-currency bonds on average have higher credit ratings than those relying mainly on United States dollar bonds, and this tends to narrow the margin between local-currency and United States dollar-denominated bonds. Third, success in bringing inflation under control, together with improvements in current account and reserves positions in many developing and transition economies, has helped decrease currency risk. Finally, as a result of the surge in capital inflows, the currencies of most countries have come under appreciation pressures, raising the return on local bonds. Particularly after the eurozone crisis, returns on these bonds started to move more closely with those on international assets regarded as “safe”.[22]

38. At the end of 2013, the average share of foreign holdings in total government local-currency securities for a selected number of developing economies, including internationally issued local-currency bonds and notes, was close to 30 per cent.[23] The increase in the share of foreign holdings in local-currency bonds since the onset of the crisis has been accompanied by reduced exposure of domestic banks to sovereign debt as a percentage of total assets, notably in Asia and Latin America.

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[18] Yilmaz Akyuz, “Internationalization of finance and changing vulnerabilities in emerging and developing economies,” UNCTAD background paper (forthcoming).

[19] A notable exception is China, where less than 30 per cent of general Government debt is in securities.

[20] Classification by the Bank for International Settlements international financial statistics.

[21] Philip Turner, “The global long-term interest rate, financial risks and policy choices in EMEs”, Bank for International Settlements Working Paper, No. 441 (February 2014).

[22] Ken Miyajima, M. S. Mohanty and Tracy Chan, “Emerging market local currency bonds: diversification and stability”, Bank for International Settlements Working Paper, No. 391 (November 2012).

[23] Namely, Indonesia, Malaysia, Mexico, South Africa and Turkey.

39. An important implication of increased foreign access to domestic debt markets is a sizeable shift in the holder profile of government debt towards non-residents, particularly in securities. It is estimated that foreigners now hold $1 trillion of government debt of developing and transition economies, excluding foreign official loans. About half of this was incurred in the period between 2010 and 2012, mostly through inflows from foreign asset managers, attracted by large interest rate differentials with advanced economies.[24] The increase in foreign holdings is much more widespread and visible for public securities than for total gross public debt.

40. More significantly, the externally-held local-currency government debt of developing and transition economies is not in the hands of foreign central banks and other official bodies, but mostly in the portfolios of short-horizon investors in advanced economies, notably foreign asset managers. It is estimated that, as at end 2012, foreign central banks held only between $40 billion and $80 billion of government debt of developing and transition economies out of about $1 trillion held by foreigners.[25] And out of a total of 24 countries, government debt of only 7 countries is included in central bank reserve assets. Except for a few countries with large official debts, foreign official holdings, including central bank holdings as reserve assets and foreign official loans, fall far short of private holdings, both by foreign banks and non-banks.[26]

41. While the shift from foreign to domestic currency denominated debt has some advantages for issuers, the observed trend of increased foreign participation in domestic debt markets in a number of developing countries has a number of implications for policymakers. The increased investment in local bonds and notes from non-residents increases the depth and liquidity of the domestic debt market, leading to both improved price discovery and extension of maturities owing to increased overall demand for debt instruments. However, foreign holdings of domestic debt tend to be less stable than those held by domestic institutional investors, as the former have no obligation to hold a certain percentage of their assets in local debt instruments. For example, domestic banks of many countries are required to hold part of their reserves in local currency debt instruments and, therefore, cannot reduce their holdings below the required levels even at times of crisis. Foreign asset managers, on the other hand, can in principle unload an entire position they hold and exit the market. In instances when sharp changes in international interest rate differentials occur and foreign investors account for an important part of the local debt market, they might rapidly reduce their holdings of local currency debt, producing both a sharp rise in domestic interest rates and downward pressure on the domestic currency.[27] Such effects resulting from sharp changes in investor sentiment can be significant for countries in which the capital account is liberalized and no capital account management techniques are used. For those countries in which there are capital controls or capital account management techniques are employed, ways to circumvent swift capital outflows can be found. Further, since all foreign investors in domestic debt instruments of developing

[24] Serkan Arslanalp and Takahiro Tsuda, "Tracking global demand for emerging market sovereign debt", IMF Working Paper, No. 14/39 (March 2014).

[25] Ibid.

[26] Ibid.

[27] Christian Ebeke and Yinqiu Lu, "Emerging market local currency bond yields and foreign holdings in the post-Lehman period — a fortune or misfortune?", IMF Working Paper, No. 14/29 (February 2014).

countries are private creditors, the multitude of private creditors in domestic debt becomes larger. In the event of a default, this makes debt restructuring difficult, especially in the absence of an ex ante debt restructuring mechanism.

B. Setback for debt restructuring

42. The recent debt crises and the protracted holdout bondholder litigations against Argentina have led to intensified international debate on the need for a sovereign debt restructuring mechanism to improve efficiency, fairness and coordination in sovereign debt restructuring. The recent debt crises demonstrated again that disorderly debt restructuring can lead in many cases, through procrastination and the costly bailout of creditors, to socializing private debt and to human suffering. The litigations against Argentina further highlighted the problem of the existing legal forum fragmentation, which entails different courts having very different interpretations of the same contractual clause and hence imposing a wide array of rulings. The end result is greater incoherence and unpredictability in debt restructuring.

43. The United States Supreme Court rulings of 16 June 2014 (*Republic of Argentina v. NML Capital Ltd.*) concerning the debt swaps that took place in Argentina in 2005 and 2010 in the wake of its catastrophic 2001-2002 default on $100 billion bonds mostly governed by New York law are a resounding victory for the specific hedge funds that have not participated in Argentine debt swaps. They also represent a setback for orderly sovereign debt restructuring, the consequences of which will likely resonate well beyond the borders of the United States and Argentina.

44. The first restructuring attempt by Argentina was made in 2005 subsequent to its 2001 default, followed by the second debt swap in 2010. More than half of the holdouts of the 2005 swap accepted the terms under the 2010 offer, which resulted in a 93 per cent creditor participation in the two debt swaps. Some hedge funds purchased the defaulted bonds from holdout creditors at a deep discount and have subsequently demanded full payment of the original face value of the bonds. This is characterized as predatory behaviour by many. Led by NML Capital, a few holdout hedge funds collectively sued Argentina in the United States District Court of the Southern District of New York.

45. The court’s interpretation of the pari passu clause (equal treatment clause) led the court to rule that any future payments on restructured bonds would be tied to payment in full of holdout bondholders. This unusual interpretation of the pari passu clause surprised even veterans in the debt restructuring world. However, on 18 November 2013, the United States Second Circuit Court of Appeals ruled in favour of NML. Argentina appealed the ruling to the United States Supreme Court, which subsequently left the lower court rulings intact in its decisions of 16 June 2014. The rulings have effectively created a precedent for rewarding holdout creditors while penalizing creditors who participated in debt restructuring.

46. The Second Circuit Court ruling also carried important implications for third parties (banks in this case) that make payments on behalf of the Government of Argentina to those bondholders who participated in the two debt swaps. The Court ruled that such third parties would be viewed and treated as being in contempt of law if they continued to make payments before the holdouts are paid in full. In

addition, the second ruling of the Supreme Court confirmed the request made by NML that banks involved in handling the payment of Argentina bondholders must turn over information of Argentina's worldwide assets to holdout bondholders. Obliging financial institutions not to pay participating exchange bondholders and to provide information about assets of the sovereign borrowers' assets worldwide may have significant impact on the international financial system as the financial service providers would be requested to facilitate the enforcement of debt contracts for the creditors.

47. The case of the *Republic of Argentina v. NML Capital Ltd.* set important new legal precedents that could have profound consequences for the international financial system and represents a significant setback for international sovereign debt restructuring. The rulings remove financial incentives for creditors to participate in orderly debt workouts and will make future debt restructuring more difficult, particularly for outstanding bonds without a collective action clause, which aim at reducing the likelihood of a small number of creditors holding out on debt restructuring. The outstanding amount is unknown but is likely to be large. While the prevalence of the introduction of collective action clauses in bond contracts has grown since the Argentine default and particularly since the global financial crisis of 2007-2009, the expiry of existing bonds without collective action clauses will take years. Moreover, obliging third-party financial institutions to provide information about assets of sovereign borrowers will have a significant impact on the international financial system as the enforcement of debt contracts for the creditors would be becoming part of the services obligations of financial service providers involved in debt restructuring.

C. International debate on a debt workout mechanism

48. The case of the *Republic of Argentina v. NML Capital Ltd.* highlights the immediate need to improve the efficiency and coordination in debt restructuring at the international level to reduce the obstacles to wider participation in restructuring in the absence of clear sovereign insolvency procedures. The existing procedures are ad hoc and lack consistency. Following the global financial crisis and the lengthy litigation of Argentine debt swaps, there has been a shift of sentiment in favour of a debt workout mechanism. Five years into the crisis, procrastination or "too little too late" has been acknowledged as a problem that needs to be resolved to reduce economic costs and human suffering caused by debt overhang. In several resolutions on debt, including resolutions 65/144, 66/189 and 67/198, the General Assembly has recognized the design of a debt workout mechanism as a tool for debt crisis prevention and resolution and called for consideration of enhanced approaches to sovereign debt restructuring and debt resolution mechanisms.

49. Various international forums, including UNCTAD, IMF, the Department of Economic and Social Affairs of the Secretariat, the Commonwealth Secretariat, non-governmental organizations, think tanks and academic institutions have been organizing meetings and conducting research to explore the feasibility and configuration of a potential debt workout mechanism. IMF proposed a sovereign debt restructuring mechanism in 2003 and revisited the issue of debt restructuring in a 2014 policy paper entitled "The Fund's lending framework and sovereign debt — preliminary considerations" and its annexes. However, with respect to possible directions for reform, the latest proposal by IMF is to maintain a market-based

approach centred on debt contracts, accompanied by debt reprofiling. Reprofiling would be employed in circumstances in which the IMF member country has lost market access and IMF judges debt to be sustainable but not with high probability. This is achieved by extending debt maturity, normally without any reduction of principal or interest.

50. Yet, without collective, inclusive and transparent ex ante discussions on the desired characteristics of a restructuring mechanism, the legitimacy and economic effectiveness of proposed debt workout mechanism designs would be compromised. At the beginning of 2013, UNCTAD initiated a process of broad-based consultations with legal and economic experts on a proposed design of a mechanism that is framed, structured and anchored by a unifying set of internationally accepted general principles and procedures. The process underlying the formulation of the debt workout mechanism benefits from an inclusive approach that will also confer substantive legitimacy to any existing proposal in line with the normative characteristics identified by the process. These procedural premises will make a big difference in terms of the legal, political and institutional outcome of the design of the debt workout mechanism. Given that the provision of global public goods necessarily entails the coordination of authorities at the international level, such procedural premises will ensure its effectiveness in dealing with global debt crises, defaults and disputes in the future.

D. Importance of establishing internationally agreed norms and principles

51. The adoption of sound practices in the management and governance of sovereign debt by both lenders and borrowers is the first line of defence against debt fragility and crises, and is crucial to the promotion of economic growth and development through sustainable and good-quality finance. The global sovereign debt system is in dire need of harmonization as sovereign debt crisis resolution is governed by loose networks and ad hoc arrangements. This patchwork arrangement could benefit from the establishment of common standards applicable to all stakeholders and compliance to norms that promote co-responsibility between lenders and borrowers at the international level.

52. The Draft Principles on Promoting Responsible Sovereign Lending and Borrowing established by UNCTAD in 2012 aim to fill the legal and institutional void in three ways to benefit both sovereign lenders and borrowers. First, the principles systematize and generalize the law and practices of sovereign debt to propose a unified normative framework that can be read by sovereign States and international adjudication bodies. Second, they diffuse knowledge and contribute to the global consensus on responsible sovereign financing practices. Third, they engage diverse stakeholders to create constituencies for responsible behaviour and contribute to its successful implementation at various institutional levels. These principles do not claim to establish new legislation, but rather to harness and elaborate existing sound practices and general principles. Successful implementation of the principles should therefore result in a durable change of behaviour among sovereign borrowers and their lenders at a low political cost. The resulting adoption of common standards will further send a clear and reinforcing signal that States are committed to work together on the path to preserve financial stability.

VIII. Conclusions and policy recommendations

53. Developing countries continued to experience a worsening of their debt indicators in 2013 in terms of increasing debt stocks, including increasing short-term debt, which has contributed to a worsening of overall debt ratios. This has occurred in an environment of slow global economic growth, making developing countries vulnerable to economic downturns and external shocks. They should be cautious and pursue active risk and debt management strategies to maintain sustainable debt levels.

54. Moreover, the increasing trend by least developed countries of floating bonds on international markets to take advantage of low interest rates has helped countries access sources of finance for infrastructure needs. This increases the importance of managing the risk of using new financial instruments, including the bunching of maturities, rollover risk and currency risk, and the challenges relating to absorption capacity and macroeconomic volatility associated with large capital inflows.

55. Although the increase in ODA in 2013 after two consecutive years of decreasing aid volumes is welcome, the shift in allocations away from the poorest countries towards middle-income countries is a concern. Countries affected by the reduction in programmed aid are most dependent on aid to achieve the Millennium Development Goals and reduce poverty levels. Moreover, the declining trend in programmed aid to least developed countries and low-income countries, particularly in Africa, is worrisome as highly concessional financing is crucial to debt sustainability. The international community must reinvigorate its ODA commitments as part of the post-2015 agenda.

56. Even though the increased foreign participation in domestic debt markets in a number of developing countries offers some benefits, issuers should be fully aware of the trade-offs, in particular the possible reversal of capital flows at times of internal and external shocks, possibly resulting in sharp increases in domestic interest rates and downward pressure on the domestic currency or both. Thus, an important equilibrium should be found by policymakers in balancing foreign participation in local debt markets with the need to continue promoting large holdings of local currency debt by domestic institutions.

57. The case of the *Republic of Argentina v. NML Capital Ltd.* has demonstrated the complications that may arise in the absence of an international debt workout mechanism. The international ad hoc arrangements for debt crisis resolution have created incoherence and unpredictability. Different courts have very different interpretations of the same contractual clause and can impose a wide array of rulings. Politics and interest groups can impact on the outcome of the rulings and debt restructuring, compromising consistency and fairness. The *Republic of Argentina v. NML Capital Ltd.* rulings have made future debt restructuring more difficult as debtors are left with only moral suasion and foreign relations as incentives to encourage creditor coordination.

Annex

External debt of developing countries[a,b]

(Billions of United States dollars)

	All developing countries and countries with economies in transition					*Sub-Saharan Africa*				
	2000-2009	*2010*	*2011*	*2012*	*2013*	*2000-2009*	*2010*	*2011*	*2012*	*2013*
Total debt stocks	2 855.8	4 575.6	5 072.6	5 517.1	5 996.4	221.9	268.0	296.5	330.2	343.0
Long-term debt	2 232.7	3 332.4	3 646.7	4 013.1	4 311.8	176.3	204.3	232.1	256.5	267.3
Private (share)	67.1	74.8	76.2	77.0	76.5	29.9	48.7	51.2	53.8	51.7
Private non-guaranteed (share)	37.7	48.2	50.1	50.0	49.8	10.0	21.3	22.2	22.5	20.8
Short-term debt	530.7	1 075.1	1 257.9	1 348.1	1 513.5	36.6	44.3	43.7	52.1	51.8
Arrears	91.2	61.4	59.5	64.4	65.0	38.6	28.6	26.8	28.2	29.2
Debt service	409.3	606.7	670.5	678.4	745.9	14.2	13.2	15.4	19.5	21.3
International reserves	2 206.2	5 451.4	5 967.7	6 239.1	6 766.2	79.9	138.5	146.5	164.3	166.5
Debt indicators (percentage)										
Debt service/exports[c]	11.6	8.7	7.8	7.9	8.3	6.4	3.4	3.3	4.2	4.5
Total debt/exports	84.6	75.1	69.0	72.8	75.9	98.0	67.5	62.4	70.7	71.7
Debt service/GDP	3.7	2.5	2.4	2.3	2.5	2.3	1.2	1.2	1.5	1.6
Total debt/GDP	27.1	21.9	20.9	21.7	22.7	35.7	23.7	23.6	25.3	25.9
Reserves/short-term debt	436.2	527.3	489.2	473.2	457.1	239.6	336.6	354.6	328.0	336.1
Reserves/M2	29.3	30.1	28.3	26.1	25.3	34.4	30.3	31.9	32.9	32.4

	Middle East and North Africa					*Latin America and the Caribbean*				
	2000-2009	*2010*	*2011*	*2012*	*2013*	*2000-2009*	*2010*	*2011*	*2012*	*2013*
Total debt stocks	153.0	166.6	162.9	177.1	192.3	810.6	1 096.3	1 244.1	1 389.2	1 484.5
Long-term debt	123.3	121.1	120.0	129.8	136.5	669.8	888.6	1 039.8	1 168.6	1 251.7
Private (share)	32.2	35.5	34.4	36.5	37.2	79.5	80.8	83.2	84.1	79.8
Private non-guaranteed (share)	4.8	5.8	6.1	6.6	6.3	35.9	43.4	48.3	48.2	43.3
Short-term debt	26.7	37.2	34.7	38.7	44.0	118.0	182.4	178.8	194.3	205.3
Arrears	7.0	0.8	0.8	1.4		23.1	16.3	21.4	21.4	21.3
Debt service	18.8	16.5	18.2	15.6	15.4	137.3	136.5	162.5	191.3	203.7
International reserves	192.2	374.6	374.1	359.1	368.7	287.6	618.2	723.0	781.9	802.0
Debt indicators (percentage)										
Debt service/exports[c]	8.7	4.7	4.5	4.5	5.1	21.1	13.4	13.0	15.0	15.9
Total debt/exports	70.9	47.2	40.4	51.1	63.8	124.6	107.6	99.5	109.0	115.8
Debt service/GNI	3.1	1.5	1.4	1.2	1.3	4.9	2.7	2.9	3.4	3.6
Total debt/GNI	25.3	15.1	13.0	13.5	16.4	29.1	22.0	22.2	24.9	25.9
Reserves/short-term debt	719.2	1 006.2	1 079.0	926.9	837.2	245.4	341.5	407.6	405.7	393.9
Reserves/M2	50.3	63.3	59.8	54.0	57.2	29.2	30.5	33.7	32.5	32.3

	East Asia and the Pacific					South Asia				
	2000-2009	*2010*	*2011*	*2012*	*2013*	*2000-2009*	*2010*	*2011*	*2012*	*2013*
Total debt stocks	634.4	1 078.1	1 284.1	1 407.3	1 619.6	226.5	407.4	459.2	498.8	537.8
Long-term debt	436.4	580.2	641.1	708.6	817.4	199.0	323.6	352.7	380.4	411.2
Private (share)	59.2	64.0	66.7	70.9	72.4	41.5	52.0	53.5	56.5	58.8
Private non-guaranteed (share)	37.4	42.0	47.1	50.4	51.0	31.5	41.9	42.8	43.9	46.0
Short-term debt	187.3	477.7	622.9	678.7	782.2	22.0	63.8	86.5	100.0	106.8
Arrears	11.9	6.2	6.4	2.2	2.2	0.1	0.0	0.0	0.0	0.0
Debt service	80.5	100.0	110.4	112.0	122.7	24.7	30.2	33.9	34.9	48.5
International reserves	1 153.0	3 312.6	3 705.5	3 866.2	4 352.7	164.0	312.3	306.5	306.0	312.5
Debt indicators (percentage)										
Debt service/exports[c]	5.9	3.8	3.6	3.4	3.4	12.3	7.1	6.3	6.5	8.6
Total debt/exports	46.6	41.5	41.4	42.2	44.3	112.5	96.0	85.8	93.1	95.1
Debt service/GNI	2.4	1.3	1.2	1.1	1.1	2.3	1.5	1.5	1.5	2.2
Total debt/GNI	18.6	14.2	13.9	13.7	14.6	21.5	19.8	20.1	22.0	24.3
Reserves/short-term debt	616.3	693.8	595.4	570.6	557.3	744.8	489.6	354.1	306.0	292.7
Reserves/M2	24.3	27.0	24.8	22.6	22.0	24.7	21.1	21.0	19.3	19.6

	Europe and Central Asia				
	2000-2009	*2010*	*2011*	*2012*	*2013*
Total debt stocks	809.3	1 559.1	1 625.8	1 714.5	1 819.2
Long-term debt	627.8	1 214.6	1 261.0	1 369.3	1 427.9
Private (share)	84.9	90.0	90.1	87.9	89.5
Private non-guaranteed (share)	55.9	65.0	64.5	62.4	65.6
Short-term debt	140.0	269.7	291.3	284.3	323.4
Arrears	10.6	9.5	3.9	11.1	8.1
Debt service	133.8	310.4	330.1	305.0	334.3
International reserves	329.4	695.2	712.1	761.6	763.8
Debt indicators (percentage)					
Debt service/exports[c]	17.4	21.1	16.8	15.3	16.9
Total debt/exports	120.2	134.9	111.6	114.3	121.7
Debt service/GNI	6.0	6.8	5.8	5.3	5.5
Total debt/GNI	42.5	44.5	39.5	40.5	40.8
Reserves/short-term debt	275.1	297.6	276.1	293.1	258.3
Reserves/M2	62.6	53.0	50.1	45.9	42.9

Source: United Nations Conference on Trade and Development calculations based on the World Bank International Debt Statistics 2014 online database.

Abbreviations: GDP, gross domestic product; GNI, gross national income.

[a] As defined in the Global Development Finance publication.

[b] 2013 estimates.

[c] Exports comprise exports of goods, services and primary income.