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External debt sustainability and development

Report of the Secretary-General

Summary

The present report, prepared by the secretariat of the United Nations Conference on Trade and Development pursuant to General Assembly resolution 69/207, reviews the recent evolution of debt indicators of developing countries and countries with economies in transition. It provides an assessment of trends in debt relief and official development assistance. The report analyses the growing challenges faced by developing countries in maintaining and managing debt sustainability as a result of changes in the global economic environment, shifts in the composition of their external debt and increased incidences of natural disasters.

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I. Overview and trends

1. The total external debt stocks of developing countries and countries with economies in transition (henceforth "developing countries") reached $6.7 trillion in 2014 (see annex), an increase of 5.2 per cent compared with 2013 stocks.[1] Long-term debt constituted nearly three-quarters of total debt stocks and was mainly owed to private creditors (78.8 per cent). Official lending to developing countries, which accounted for 21.2 per cent of total long-term external debt, has been on a downward trend following the global crisis. Meanwhile, the stock of short-term debt has been increasing rapidly, totalling $1.8 trillion in 2014, an increase of 60 per cent compared with 2010.

2. The gross domestic product (GDP) of the developing countries grew by 4.4 per cent in 2014, which was lower than the growth rate of total debt stocks. Consequently, the ratio of total debt to GDP increased slightly, from 23.3 per cent in 2013 to 23.5 per cent in 2014. Owing to a slowdown in export growth from 4.4 per cent in 2013 to 1.8 per cent in 2014, the ratios of debt to exports and debt service to exports rose from 81.1 to 84.0 per cent and from 8.8 to 9.2 per cent, respectively.

3. International reserves for developing countries as a group are estimated to have decreased slightly, from $6.8 trillion in 2013 to $6.7 trillion in 2014, with China accounting for more than half the stock of total reserves. The decrease, which resulted from a fall in the reserves of China in the last quarter of 2014, marks the first time that international reserves have declined after more than a decade of rapid growth. Total reserves now just barely cover the stocks of total external debt for all developing countries. The ratio of total reserves to short-term debt also fell, from 424.6 per cent in 2013 to 382.5 per cent in 2014. Of 117 countries for which short-term debt data was available for 2014, 108 countries had international reserves that covered more than 100 per cent of short-term debt. The nine countries with international reserves lower than the amount of short-term debt were Belarus, Guyana, the Lao People's Democratic Republic, Seychelles, the Sudan, Turkey, Ukraine, Venezuela (Bolivarian Republic of) and Zimbabwe.

Regional trends

4. Total debt stocks in Europe and Central Asia fell by 3.9 per cent, from $1.93 trillion in 2013 to $1.86 trillion in 2014, after increasing by nearly 10 per cent in 2013. A high share (90 per cent) of the region's private debt is in long-term debt. The amount of short-term debt fell by 11.2 per cent in 2014, while international reserves fell significantly, by nearly 20 per cent, from $762 billion in 2013 to $612 billion in 2014, resulting in the further deterioration of the ratio of reserves to short-term debt. All other debt indicators for the region also worsened in 2014. Although total debt stocks declined, the region's total debt to GDP ratio increased from 44 per cent to 45.7 per cent as a result of major GDP contractions in some countries (Kazakhstan, the Russian Federation and Ukraine). Europe and Central Asia region, among all regions, continues to have the highest ratio of debt to GDP.

5. Total external debt stocks in sub-Saharan Africa increased by 7.6 per cent in 2014, to reach $395 billion. The majority of long-term debt in that region is public

[1] United Nations Conference on Trade and Development (UNCTAD) secretariat calculations based on the World Bank 2015 International Debt Statistics online database (the database does not include debt data for Chile, the Russian Federation or Uruguay).

and publicly guaranteed debt (81.3 per cent). International reserves fell by 5 per cent in 2014 compared with 2013 but still covered around three times the level of short-term debt. The GDP growth rate of the region slowed to 4.3 per cent in 2014, from 5 per cent in 2013, owing to such factors as declining commodity prices, the Ebola epidemic in some countries (Guinea, Liberia and Sierra Leone) and lower oil prices that severely affected the region's oil exporters (e.g., Chad and Nigeria). The total value of exports for the region also declined by 3 per cent in 2014. As a result, the ratio of debt to GDP increased from 26.1 per cent to 27 per cent and that of debt to exports increased from 76.8 per cent to 85.2 per cent. The favourable global financing conditions in 2014 enabled the continuation of the recent surge in sovereign bond issuance, which increased from $6.5 billion in 2013 to $8.7 billion in 2014 for the region,[2] with maiden issuances by Côte d'Ivoire, Ethiopia and Kenya. However, yields on the region's bonds have been trending up, especially in Gabon, Ghana and Nigeria, as a result of high fiscal deficits or lower oil prices.

6. In Latin America and the Caribbean, total external debt stocks rose by 11 per cent to $1.8 trillion in 2014, giving the region the second-highest debt level. Most of the debt is long-term and the majority of long-term debt (82.4 per cent) is owed to private creditors. Short-term debt increased by 20 per cent in 2014, while international reserves increased by only 3 per cent, resulting in a deterioration of the ratio of reserves to short-term debt from 336.9 per cent in 2013 to 288.5 per cent in 2014. Growth in the region declined for the fourth consecutive year, to 1.3 per cent in 2014, owing to subdued external demand and worsening terms of trade. Falling commodity prices resulted in a loss of 1.8 per cent in export value and further widened external current account deficits in most commodity-exporting economies. Both sluggish growth and falling exports in 2014 contributed to a worsening of all debt indicators for the region, with the ratio of total debt to GDP increasing from 27.8 per cent to 30.2 per cent and that of total debt to exports from 128.3 per cent to 145.1 per cent.

7. Total debt stocks in the Middle East and North Africa continued to grow at a rate of 5 per cent in 2014 to reach $200 billion. The long-term debt consisted mainly of public and publicly guaranteed debt (93 per cent). In 2014, short-term debt increased by 2 per cent while international reserves declined by 2.5 per cent. Nevertheless, international reserves still covered more than 11 times the amount of short-term debt, making it the highest ratio among all the regions. Debt-to-GDP ratios increased from 14.8 per cent in 2013 to 16.2 per cent in 2014, owing to slower growth in the region as a result of declining oil prices, ongoing conflicts and political instability. Many of the region's oil exporting countries (e.g., Iran (Islamic Republic of), Iraq, Saudi Arabia and the United Arab Emirates) have seen substantial downward revisions to their growth forecasts. Exports were also hit by declining oil prices and high volatility, with a fall of 2.5 per cent in the value of exports. As a result, the ratio of debt to exports rose from 58.7 per cent to 63.2 per cent.

8. The growth of total debt stocks in East Asia and the Pacific slowed to 7.6 per cent in 2014 after a period of, on average, more than 10 per cent annual growth. Private debt accounted for a large share of long-term debt (77.2 per cent) and continued on an upward trend. The region experienced strong growth in 2014

[2] International Monetary Fund (IMF), *World Economic Outlook*, World Economic and Financial Surveys (Washington, D.C., April 2015).

despite slowdowns in several large economies, including those of China, Indonesia and Japan, helping to lower the total debt-to-GDP ratio from 14.6 per cent to 14.2 per cent, the lowest debt-to-GDP ratio of all regions. In 2014, the share of short-term debt of total external debt continued to increase and surpassed long-term debt to reach more than half of the region's total debt stocks. By contrast, international reserves remained unchanged in 2014, slowing down, owing to a fall in the reserves of China in the last quarter of 2014, after a period of rapid accumulation and a 12.5 per cent increase in 2013. Consequently, the ratio of reserves to short-term debt deteriorated from 505.8 per cent in 2013 to 445.5 per cent in 2014. Since the region is a net oil importer, the drop in oil prices in 2014 benefited many oil-importing countries, generating a windfall and improving current accounts. However, the region remains vulnerable to capital outflows, slower corporate debt issuance (especially in emerging Asia), and rising short-term market interest rates since the last quarter of 2014, in line with global trends and expectations of higher policy rates in the United States of America.

9. The group of small island developing States had total external debt stocks of $87.7 billion in 2014, an increase of 4.2 per cent compared with 2013. The group had the highest ratio of debt to GDP (63.6 per cent), nearly 3 times higher than the ratio of all developing countries. Long-term debt accounted for the majority of total external debt (85.4 per cent), which is evenly distributed between public and publicly guaranteed debt and private non-guaranteed debt. Short-term debt has been stable, at around 12 per cent of total debt, for the past few years. Meanwhile, the ratio of reserves to short-term debt has been declining and the total amount of reserves covered less than twice the amount of short-term debt in 2014, the lowest ratio compared with all other regions. In 2014, a number of countries in the group were either in debt distress (Grenada) or at high risk of debt distress (Haiti, Kiribati, the Marshall Islands, Micronesia (Federated States of), Samoa, Sao Tome and Principe and Tuvalu). Many countries in the group are highly vulnerable to natural disasters. In 2015, for example, Cyclone Pam, which was centred in Vanuatu, devastated a number of small economies. In the Caribbean region, which is highly dependent on tourism and susceptible to a slowdown in external global demand, some small countries are facing stagnant growth and high debt levels (Antigua and Barbuda, Jamaica and Saint Kitts and Nevis).

II. Least developed countries

10. In 2014, the total external debt of the 48 countries belonging to the group of least developed countries amounted to $217 billion, an increase of 8.8 per cent compared with 2013. Most of total debt is long-term (85 per cent) and the majority of long-term debt is public and publicly guaranteed (94.4 per cent). Short-term debt accounted for only 5 per cent of total debt and increased by 3.7 per cent to $16.8 billion in 2014. International reserves increased by 6.1 per cent to $76.3 billion, helping to raise the coverage of reserves to short-term debt from 539.5 per cent to 550.2 per cent.

11. Despite the increase in total debt stock, the ratio of debt to GDP remained stable at 24.7 per cent in 2014 as it did in 2013, owing to strong growth in the group. On the other hand, the ratio of total debt as a percentage of exports increased from 82.6 to 88.8 per cent, owing to a slowdown in export growth resulting from declining commodity prices. The ratio of debt service as a percentage of GDP and of

exports for the group remained low in 2014, at 1.6 per cent and 5.7 per cent, respectively, owing to highly concessional terms (long maturity, low interest rates) of most of the external debt of the least developed countries.

12. As of May 2015,[3] one least developed country was in debt distress (the Sudan) and ten least developed countries were at high risk of debt distress (Afghanistan, Burundi, the Central African Republic, Chad, Djibouti, Haiti, Kiribati, Mauritania, Sao Tome and Principe and Tuvalu). Mauritania and Tuvalu joined the list of least developed countries at high risk of debt distress in 2014, while the Comoros and the Democratic Republic of the Congo got off the list by reducing their risk of debt distress from high to moderate.

13. The GDP growth for the group of least developed countries, at an estimated at 5.2 per cent in 2014, was the second highest globally, just below that of East Asia and the Pacific. Within the group, performance varied markedly, with some countries achieving a growth rate of more than 7 per cent (Cambodia, Chad, the Democratic Republic of the Congo, the Lao People's Democratic Republic, Mozambique and the United Republic of Tanzania), while others, especially oil-exporting countries, experienced a negative GDP growth rate (Equatorial Guinea and South Sudan) owing to declining oil prices.[4]

14. A total of 20 countries in the group of least developed countries ran double-digit current account deficits in 2014 compared with 17 countries in 2013.[5] Among those countries, Liberia and Mozambique continued to run persistently high current account deficits of more than 30 per cent of GDP for the third consecutive year. Djibouti and Kiribati also had high current account deficits; the current account deficit of Kiribati is more than half of its GDP (53 per cent). The widening current account deficit is due mainly to lower exports as a result of declining commodity prices. Meanwhile, imports of goods and services are projected to increase in least developed countries that continue to expand their production capacity. Countries running both large current account deficits and large fiscal deficits (Kiribati, Liberia and Mozambique) require careful monitoring, as those countries will have less space to adopt expansionary policies and Kiribati was already at high risk of debt distress.

15. In 2014, a number of least developed countries continued to tap the international market through the issuance of sovereign international bonds. Ethiopia successfully issued $1 billion of 10-year Eurobonds at a yield of 6.625 per cent. Senegal raised $500 million of 10-year bonds at a yield of 6.25 per cent and Zambia launched $1 billion of 10-year bonds at 8.625 per cent.[6] Those activities reflect a continuing trend for some least developed countries to diversify away from such traditional sources of finance as concessional loans and to take advantage of the current favourable financing conditions in the international financial market to borrow on commercial terms.

16. While greater access to international financial markets could help least developed countries to mobilize resources to meet their long-term infrastructure

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[3] IMF list of debt sustainability assessments for low-income countries that are eligible for the Poverty Reduction and Growth Trust as at 7 May 2015 (available from www.imf.org).

[4] Estimates from IMF World Economic Outlook and *The Economist* Economic Intelligence Unit.

[5] World Economic Outlook, April 2015.

[6] Bloomberg data.

needs, it is important that they manage the market risk exposure associated with such instruments, including refinancing risk, currency risk and greater macroeconomic volatility owing to large capital inflows. Moreover, taking into account the risks of excessive private-sector borrowing and the inevitable limitations of the credit assessments of private lenders, least developed countries should carefully weigh the risks of such borrowing and pursue active debt management, especially in the case of significant mismatches between the exchange rate and maturity.

17. Nine countries belong to both the group of least developed countries and that of small island developing States (the Comoros, Guinea-Bissau, Haiti, Kiribati, Sao Tome and Principe, Solomon Islands, Timor-Leste, Tuvalu and Vanuatu). These countries are small, open economies that are particularly vulnerable to external economic shocks and natural disasters. Among them, four (Kiribati, Haiti, Tuvalu and Sao Tome and Principe) were already at high risk of debt distress in 2014. Natural disasters pose threats and additional risks to the economies of the small island and least developed States.

III. Debt relief initiatives

Heavily Indebted Poor Countries Initiative and Multilateral Debt Relief Initiative

18. Since the enhanced Heavily Indebted Poor Countries (HIPC) Initiative was launched in 1999, 36 of the eligible 39 heavily indebted poor countries have reached the completion point and benefited from debt relief under that initiative and the Multilateral Debt Relief Initiative.[7] Progress under the HIPC Initiative has slowed tremendously as it comes to an end. The only country to reach the completion point since 2012 is Chad, which reached it in April 2015, marking the end of a long process for the country from its arrival at the decision point in 2001. Three eligible heavily indebted poor countries have yet to reach the decision point: Eritrea, Somalia and the Sudan. In addition, Myanmar and Zimbabwe may potentially benefit from both initiatives' debt relief, depending upon whether they meet indebtedness and income criteria and can clear the arrears they owe to the Paris Club and multilateral creditors. To be eligible for debt relief, countries are also required to demonstrate the ability to implement policy reforms and establish a strong track record under an IMF staff-monitored programme. In the case of Zimbabwe, it is uncertain whether an exception to the income criteria will be required.

19. To date, the total cost of debt relief delivered under the HIPC Initiative is estimated at $75 billion. That of the Multilateral Debt Relief Initiative was $41.1 billion in present value terms, at the end of 2013. As a result of that assistance, the 36 post-decision point heavily indebted poor countries have witnessed an improvement in debt ratios. The debt service-to-exports ratios for those countries declined from 15.7 per cent to an estimated 5.5 per cent between 2001 and 2015, and their debt service-to-GDP ratios from 3 per cent to an estimated 1.5 per cent during the same period. In addition, the ratio of poverty-reducing expenditure to GDP increased from 6.8 per cent to an estimated 9.3 per cent from

[7] See IMF, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) — statistical update" (Washington, D.C., December 2014).

2001 to 2015. The ratio of poverty-reducing expenditure to government revenues, however, has remained relatively stable, at 49.7 per cent in 2001 compared with an estimated 49.3 per cent in 2015. It peaked at 56.2 per cent in 2009.[8]

20. While the improvement of debt ratios is encouraging, a number of completion point heavily indebted poor countries continue to face debt difficulties. As of May 2015, the Sudan was classified as being in debt distress and 7 other heavily indebted poor countries were classified as being at high risk of debt distress (Afghanistan, Burundi, the Central African Republic, Ghana, Haiti, Mauritania and Sao Tome and Principe), 17 at moderate risk of debt distress and 11 at low risk of debt distress.

21. Of concern is the lack of progress of heavily indebted poor countries towards achieving the Millennium Development Goals. Despite the increase in poverty-reducing expenditure, many of those countries, particularly in sub-Saharan Africa, are seriously off-track in terms of meeting their targets,[9] in particular in the areas of health and education. To date, no heavily indebted poor country has met the objectives for reducing infant mortality rates or combating HIV/AIDS and other diseases. The funds provided under the HIPC Initiative were designed to supplement existing development assistance programmes under the principle of additionality.

22. Securing the participation of commercial creditors in debt relief initiatives has been a challenge in delivering full debt relief to heavily indebted poor countries. Debt relief is provided with a clause of "comparability of treatment", which aims to ensure balanced treatment among all external creditors of the debtor country. Under Paris Club agreements, the debtor country commits itself to seeking rescheduling on comparable terms from non-multilateral creditors (non-Paris Club and private creditors). Litigation by non-cooperative creditors, in addition to the lack of participation by some creditors, has compounded that negative effect and led to inequitable burden-sharing among creditors. While the number has diminished, at present 11 commercial creditor lawsuits are being pursued against six heavily indebted poor countries,[10] threatening to undermine the debt relief and consequent policy space for pursuing development goals.

23. As the international community embarks on a new international development agenda and the pursuit of the sustainable development goals, it is important to take stock of the strengths and disadvantages of the HIPC and Multilateral Debt Relief initiatives in order to improve international efforts going forward. A multidimensional approach is necessary for securing debt sustainability and attaining internationally agreed development goals in heavily indebted poor countries. Debt relief must be complemented by stable and predictable funds and sound management and planning. In the absence of debt relief, reliable aid flows or good debt management, the ability of the poorest countries to succeed is greatly diminished.

[8] Ibid., table AIII1.

[9] See UNCTAD, *Least Developed Countries Report 2014 — Growth with Structural Transformation: A Post-2015 Development Agenda*.

[10] See IMF, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) — statistical update" (Washington, D.C., December 2014), table AIII16.

Paris Club

24. The structural shift in the composition of the debt of developing countries away from official bilateral lending to bond financing over the past 15 years, coupled with the continued progress of the HIPC and Multilateral Debt Relief initiatives, is reflected in a drastic drop in the number of Paris Club meetings. In the last 12 months, there have been only two Paris Club meetings, compared with a yearly average of 14 meetings in the 1980s.

25. While a reduced number of restructuring meetings in the Paris Club is a positive development, the shift towards bonds as the primary sovereign borrowing instrument and the lack of an appropriate forum for restructuring that type of debt has probably decreased the overall efficiency of the restructuring process. As an example, Paris Club creditors were historically quick to respond to the restructuring needs of a country following a natural disaster. It is questionable whether such a quick response, with traditionally fairly generous terms, will be obtained in the context of a bond restructuring following a default linked to an unforeseen event of nature.

26. There have been some positive advances, however. Although the amounts involved are not very large, with the volume of affected debt at around $30 million, on 25 February 2015 Seychelles and Paris Club creditors reached an extremely innovative debt restructuring agreement aimed at supporting the environment. The deal consists of a buyback by Seychelles of its debt at a discount, which both reduces the country's external debt and releases funds previously committed to servicing the debt to be used for marine conservation and adaptation to climate change. As climate change poses increasing challenges to developing countries, such types of deals should receive the full support of the international community and be expanded to a wide range of developing countries.

27. An additional Paris Club meeting was convened in June 2015 to consider the case of Chad after the country reached the completion point under the HIPC Initiative in April 2015. Paris Club creditors met their debt commitments in line with the HIPC Initiative and, on a bilateral basis, agreed to further debt write-offs. The totality of the agreement amounted to a full cancellation of the country's eligible debt.

IV. Official development assistance

28. The total net official development assistance[11] flows remained stable in 2014 at $135.2 billion, on par with the 2013 level of $135.1 billion, although the 2014 level marked a 0.5 per cent decline in real terms. Of concern is the decline in aid to the poorest countries. In aggregate terms, official development assistance is at an historical high, with steady increases delivered since 2000 when Member States committed to achieving the Millennium Development Goals. The stability of official development assistance is encouraging in light of the global recession and the austerity measures taken by some donors.

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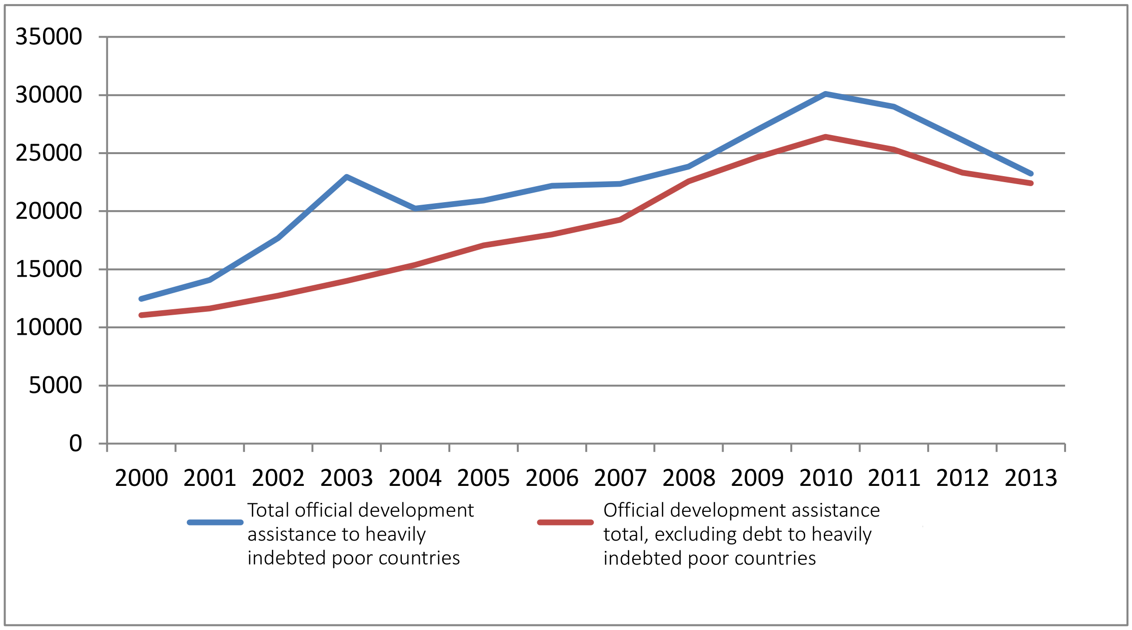
[11] Organization for Economic Cooperation and Development (OECD), "Development aid stable in 2014 but flows to poorest countries still falling", 8 April 2015 (available from www.oecd.org/dac/stats/documentupload/ODA%202014%20Technical%20Note.pdf).

29. While official development assistance has been increasing overall, such assistance to heavily indebted poor countries began to sharply contract in 2010 (see figure I). This was also the case for official development assistance that excluded debt relief.

Figure I
Total official development assistance to heavily indebted poor countries
(Constant price, millions of United States dollars 2013)



Source: Organization for Economic Cooperation and Development, *International Development Statistics online database*.

30. In addition, there is some concern about the contraction of official development assistance to least developed countries of 16 per cent in real terms in 2014, which is estimated to be a decline of 8 per cent when debt relief is excluded. This contraction is of particular concern as official development assistance constitutes more than two-thirds of external financing for least developed countries.

31. The current international dialogue around the new sustainable development goals has brought the topic of development finance to the fore, as the awareness of donors and recipients of the considerable costs of attaining those goals grows and discussions about climate change mitigation and adaptation imply a significant increase in the price tag attached to internationally agreed development goals. The World Bank and IMF spring meetings included calls for a paradigm shift to consider mobilizing more and different forms of finance, with a particular emphasis on more private sector investment in the poorest economies, along with more innovative financing instruments. There is some concern, however, that unless the principle of the additionality of official development assistance is preserved, that approach might not only shift the burden of financing the new development goals to developing countries as a whole, but also seriously distract attention from the importance of international public finance for development cooperation.

32. The meetings highlighted the need to increase development financing from $100 billion per year in official development assistance to trillions per year in overall financing. It remains to be seen whether such an increase is feasible, but it is still important to emphasize that such forms of financing should be additional to existing official development assistance and that donors must redouble their efforts to deliver on their aid commitments. At present, alternative instruments and funds, including innovative sources of financing, constitute only a small fraction of the resources mobilized annually through official development assistance.

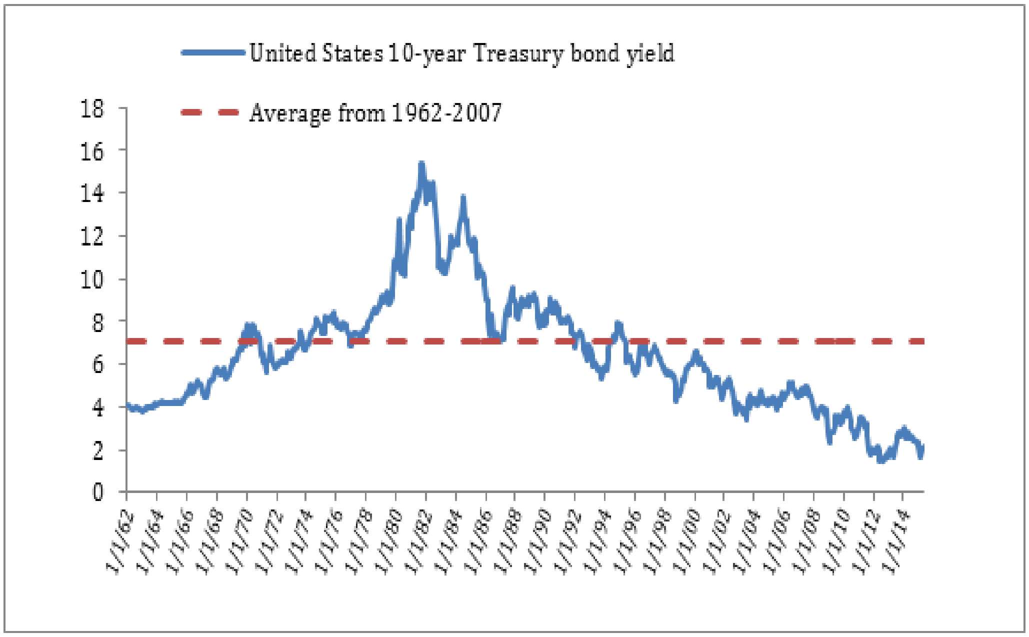
V. Challenges to debt sustainability in developing countries

Risks posed by the global macroeconomic environment

33. Following the implosion of an increasingly fragile international financial system in the 2008 global financial crisis, levels of indebtedness, mainly public, have continued to grow in advanced economies. By contrast, the sovereign debt indicators of developing countries have improved owing to a more rapid rebound in economic growth, a favourable interest rate environment and ongoing international debt relief initiatives since 2002. However, such a broadly beneficial environment, from the perspective of developing countries' overall debt sustainability, is unlikely to last as a number of supporting factors appear set to change.

34. To stimulate their domestic economies in the aftermath of the global financial crisis, central banks in major developed economies adopted policies that combined low interest rates with quantitative easing, resulting in a multiyear period of historically low borrowing costs across the maturity curve (see figure II).

Figure II
United States 10-year treasury bond yield



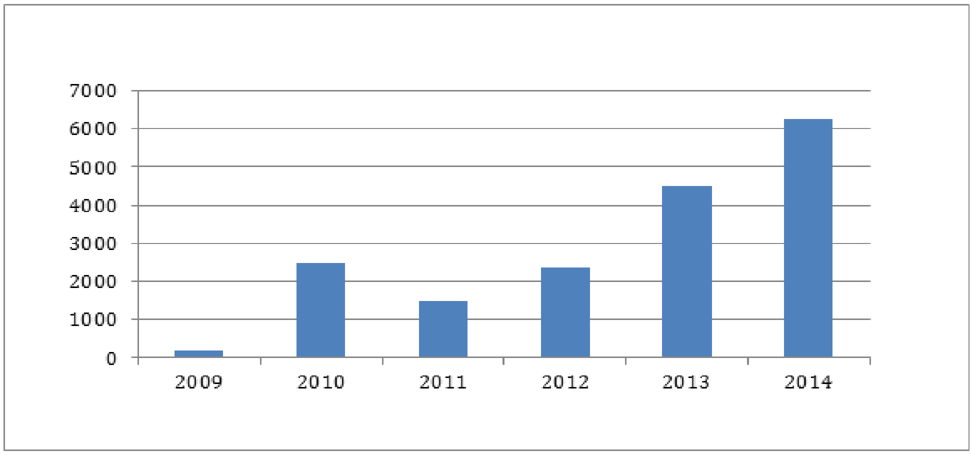
Source: Thomson Reuters Datastream.

35. By now, there are clear indications of a normalization of United States interest rates in the near future, however, presenting emerging markets with the possibility of a rapid reversal of capital inflows, as well as refinancing risks, as already witnessed during the 2013 so-called “taper tantrum” episode. While there are well-known links between interest rates in the developed economies and borrowing costs for developing countries, the past 30 years have profoundly changed the transmission mechanisms between monetary policy in advanced economies and debt sustainability in developing countries.

36. The change in the composition of developing country debt from predominantly syndicated bank lending to bond financing entails a significant increase in exposure to financial risk and instabilities. Generally speaking, highly marketable securities can change hands much faster, making herd behaviour both more prevalent and more damaging. Bond financing of external debt also substantially increases the complexity of debt workouts once financial or debt crises happen. Specifically, when developing countries borrowed mostly from banks, provided that most of their external debt was contracted on fixed rates, they were essentially insulated from changes in global interest rates, except for refinancing costs and exchange rate movements. Indeed, as long as the maturity of their debt portfolio was staggered over time, they could benefit from fairly stable average interest payments on their debt, making currency risks the only important risk to debt sustainability. The increased prevalence of bond financing, and in particular the shift in the composition of some developing country sovereign debt towards local currency bonds observed from the mid-1990s, has seemingly reduced the risk of exchange rate shocks to debt sustainability in those countries. In reality, while the currency risk might be lower for sovereign borrowers, new challenges for policymakers have emerged in countries that rely heavily on bond financing. The significant increase of non-residents holding local currency debt over the past 20 years has substantially increased the risk of capital outflows in response to small interest rate differentials emerging across countries.

37. Newcomers to the international bond market, such as sub-Saharan Africa, are particularly vulnerable. Some of them are former heavily indebted poor countries and countries that depend heavily on commodity export revenues for foreign exchange income. Questions about the future price path of commodities, potential rollover risk at expiration and the capacity of their debt management offices to anticipate refinancing costs and design strategies to mitigate such risks, create concerns that some of those countries might face debt servicing difficulties in a less benign international financial environment.

Figure III
Sub-Saharan Africa sovereign bond issues
(Millions of United States dollars)



Source: Bloomberg, Dealogic and *Financial Times*.

38. Such potential risk to developing country debt sustainability over the next few years is compounded by the fact that although sovereign borrowers have reduced their currency risk by issuing heavily in their domestic debt markets, that has not been the case for private borrowers. Companies have borrowed heavily, often in United States dollars, exposing themselves to currency risk, both from dollar appreciations relative to the domestic currency and from any sudden reversal of capital flows. There are particular vulnerabilities among companies in the commodity sector that might have borrowed aggressively against future revenue streams under the assumption of relatively stable commodity prices. Following major adjustments of commodity prices over the last 12 months, in particular oil prices, such assumptions may turn out to have been mistaken. That could raise problems of contingent liabilities, as many of the companies concerned benefit from explicit or implicit government guarantees, and their failure would pose a systemic risk to the domestic financial sector and to the growth prospects of the countries in which they are domiciled. The rapid rise of external private debt repeats a pattern seen prior to the Latin American crisis of the 1980s and the Asian crisis of the 1990s. Solvency problems of large domestic companies in key sectors of the economy can rapidly become public debt, as evidenced by the current public finance crises in the eurozone.[12]

39. Over the coming years, the speed and magnitude of the increase in the United States federal funds rate could have major implications for international bond markets. It is hard to predict the level of volatility that will affect bonds with longer maturities and the spread between United States Treasury securities and emerging market bonds. Because of the new transmission channels created by the higher integration of developing countries in the global financial system, the impact of the readjustment of monetary policy in developed countries needs to be closely monitored by policymakers in both developed and developing countries.

[12] See UNCTAD, *Trade and Development Report, 2015*, chap. V.

40. The recent drop in commodities prices also has important implications for lower income countries that are not directly exposed to a potential rout in global bond markets but rely heavily on commodities for their export earnings. The secular boom in commodity prices that has been driven mainly by the rapid growth in emerging markets over the last 20 years may have come to an end. The recent weakness in the growth rates of some major developing countries might worsen with continued lacklustre growth in developed countries and a new episode of global financial turbulence. Falling commodity prices and increased exchange rate volatility is likely to create a challenging economic environment for a growing number of developing countries.

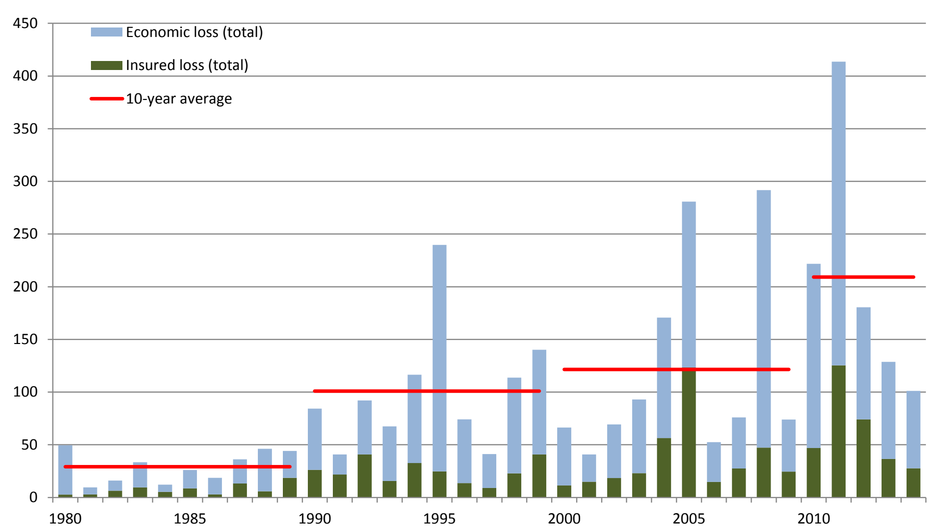
Climate change and debt instruments to mitigate risk

41. The increased frequency of natural disasters owing to climate change will pose further sustainability problems in affected countries (see figure IV).

Figure IV

Total and insured global economic losses from natural catastrophes and man-made disasters, 1980-2014, 2014 prices

(Billions of United States dollars)



Source: Swiss Re, *Sigma World Insurance Database*.

42. Natural catastrophes and extreme climate events are negative income shocks associated with an immediate contraction in economic output and a rise in borrowing needs to replace physical capital losses. As was evidenced by the 2007 tsunami, natural disasters can cause immediate insolvency in countries by devastating key economic sectors.

43. A number of market-based instruments are currently available to mitigate the impact of natural disasters. Catastrophe bonds are securities issued by special purpose vehicles that transfer risk from a financial sponsor, usually a reinsurance company or an investment bank, to capital market investors. There are two main advantages over the alternative of issuing plain vanilla bonds plus buying an insurance contract, especially for emerging market countries. First, increasing

liquidity and a maturing market should reduce the cost of the bundled contract (bond plus insurance) with respect to the alternative, in particular in countries with poorly rated and little traded bonds or those in which insurance premiums are likely to be higher because of their past catastrophe record. Second, insurance contracts determined on the basis of parametric indexes remove all sources of moral hazard. As a further advantage, catastrophe bonds also alleviate counter-party credit risk as they are collateralized.

44. Another option is to use contingent capital as a risk transfer instrument. This is securitized capital that makes funds available under pre-negotiated terms through an options contract if a specific event (e.g., a natural catastrophe) occurs or a threshold (e.g., a certain earthquake magnitude) is crossed. A debt management office underwriting a contingent capital contract would pay a fee to a second party that agrees to extend a loan or purchase debt if the trigger event occurs. With contingent capital, no risk is actually transferred from one party to the other, and the underlying option is exercisable if both counterparties agree that a pre-defined trigger has occurred.

45. The World Bank Group has developed a broad range of financing solutions to help countries prepare to respond to natural disasters. The catastrophe deferred drawdown option provides a committed line of credit that can be drawn upon if a major natural disaster occurs.

46. The introduction of GDP-indexed bonds, which pay an interest coupon based on the issuing country's rate of growth, could have a number of positive effects, not only in the context of natural disaster risk management but also for the broader goal of exogenous shock mitigation (see A/62/151). By issuing GDP-indexed bonds, borrowing countries would benefit from the stabilization of overall government spending and limit the pro-cyclicality of fiscal pressures. Moreover, allowing debt-service ratios to fall in times of slow or negative growth would reduce the likelihood of costly defaults and debt crises. The main benefits arise from the possibility of taking a position on countries' future growth and from lowering the frequency of defaults and debt crises by stabilizing the overall budget. Issuing GDP-indexed bonds might naturally create a constituency in favour of growth that will back the reform efforts of Governments. Finally, at a broader level, GDP-indexed bonds can be viewed as desirable vehicles for international risk-sharing and as a way of avoiding the disruptions arising from formal default.

47. A potential downside is that markets for new complex instruments may be illiquid and it might be difficult for investors to price such instruments. This poses the challenge to the international financial community to engage in a coordinated effort to achieve and maintain a critical mass of GDP-indexed bonds to attain market liquidity. However, for low income countries with limited capacities to use market-based instruments, in particular, and for the most vulnerable nations, global measures to assist such economies directly to mitigate climate change impacts will remain highly relevant. It is extremely important that these new international commitments be additional to the already agreed level of official development assistance of 0.7 per cent of gross national income.

VI. Debt management capacities

Developments since 2000

48. Changes since 2000 in the size and composition of public debt in developing countries have reinforced the need for effective debt management. Developing countries have generally strengthened their capacity to analyse their debt portfolios over the period, although the rate of progress differs greatly among countries. The most notable improvements have been in relation to debt recording and reporting, debt sustainability analysis and debt strategies. Increased capacity in debt recording and reporting is evident from the results of Public Expenditure and Financial Accountability framework assessments. These indicate that, on average, since 2006, the quality of debt recording and reporting and of public debt management systems for contracting loans and issuing guarantees has improved significantly. The increasing number of countries reporting to the various debt databases developed by the World Bank in collaboration with IMF also attest to the improved capacity. Although the quality of debt data of low-income countries, in general, is still slightly lower than that of other income categories, those countries have shown the fastest rate of improvement.

49. There is broad consensus that technical assistance has been a major contributing factor in improving debt management capacity. The support available to countries has evolved in line with their changing needs since 2000, with an increased number of organizations providing technical assistance, including a broadening range of support services. The de facto organization of technical assistance in debt management into "downstream" and "upstream" activities has been an important development. Downstream activities include the maintenance of debt databases, debt-data validation, debt operations, internal and external debt reporting, debt statistics and basic debt analysis. The main providers of technical assistance in that area are the UNCTAD Debt Management and Financial Analysis System and the Commonwealth Secretariat. The downstream activities complement the upstream activities, which include diagnosis, designing reform plans, medium-term debt strategy formulation and debt sustainability analysis. The main providers of the upstream activities are the World Bank and IMF, in partnership with other international and regional organizations, through the Debt Management Facility.

Challenges post-2015

50. While much progress has been made in strengthening debt management capacity, countries still need to improve in many areas. Debt management requires a higher level of sophistication than in the past owing to the increased complexity of portfolios. Many countries have yet to reach the minimum standards in some key areas and high staff turnover continues to be a common and recurrent problem. Recent studies have concluded that the weakest performance indicators are debt management strategy, audit, cash flow forecasting and cash balance management, the segregation of duties, staff capacity and business continuity planning and debt administration and data security.

51. The post-2015 environment can also be expected to present countries with new challenges. Increased access to international capital markets, public-private partnerships, sub-national debt, blended and climate finance, development finance from emerging or re-emerging sovereign donors and domestic debt will require new

capacities. Operational and financial risk management, the development of effective borrowing strategies and the full integration of debt within the public finance framework will become increasingly important for debt crisis prevention. Improving the coverage of debt data will also be critical, particularly in relation to domestic, short-term and private non-guaranteed debt and contingent liabilities. An important issue is that there is evidence that the lack of a mechanism to help low-income countries to identify resources to implement downstream reforms represents a significant risk for the sustainability of improvements.

52. For debt management to be effective in meeting those challenges, countries will need to invest in building adequate capacity and implementing sustainable reforms. This will require financial resources and technical assistance. Building sustainable capacity in debt management necessitates a long-term, continuous, iterative process of learning and adapting to change. Assistance should be provided to strengthen recipients' capacities to monitor their debt profiles and reduce vulnerabilities from the excessive build-up of debt and increased market exposure. Technical assistance providers, particularly UNCTAD, IMF and the World Bank, must ensure that the products and services offered are public goods that are continuously updated in line with the new requirements of countries and best practices. Providers must also maximize coordination and complementarity to minimize duplication and adopt a cooperative, holistic approach that covers both upstream and downstream activities, thus ensuring that the full spectrum of country needs is met. Similarly, the international community must ensure that adequate financing is provided to support the implementation of national reforms and the provision of technical assistance for public debt management as an effective tool for debt crisis prevention. Donor support for downstream activities in low-income countries will be particularly important.

53. It is critical for effective crisis management that debt management offices have the staffing, skills and systems needed to meet those challenges. Debt strategy, financial and operational risk management and debt management systems will require particular attention. The international community should continue to support the provision of financial and technical assistance for institutional capacity-building for public debt management to assist countries in implementing the required reforms and ensure that both the upstream and downstream activities are adequately supported, with specific consideration given to financing downstream activities. Priority should be given to fragile countries in sub-Saharan Africa. It is critical to ensure the availability of comprehensive, reliable debt databases that cover all aspects of the evolving debt portfolio and adequate support for debt statistical capacity and reporting. Providers of technical assistance in debt management should give precedence to coordination and cooperation.

VII. Conclusions and policy recommendations

54. The trend since 2010 of a gradual, albeit mild, deterioration of the external debt indicators of developing countries persisted in 2014. Total external debt stocks, in particular the stock of short-term debt, continued to rise and key debt ratios to worsen. The total international reserves of developing countries also fell for the first time after more than a decade of rapid growth, owing mainly to a decline in the reserves of China at the end of 2014. While the group of least developed countries experienced a year of relatively strong GDP growth, thus maintaining a stable ratio

of total debt to GDP, its export growth declined as a result of falling prices in some commodities markets, leading to an increase in that group's total debt-to-export ratio. Least developed countries also continued to diversify away from traditional sources of financing, favouring in particular the issuance of sovereign bonds on international markets.

55. After declines in 2011 and 2012, official development assistance maintained its 2013 level of approximately $135 billion in 2014. Although this is high by historical standards, the renewed decline, in 2014, of official development assistance to the poorest developing economies is of concern, especially since the enhanced HIPC Initiative is fast approaching its end. For vulnerable countries, including small island developing States, post-HIPC Initiative assistance is urgently needed and should be considered swiftly. For developing countries overall, it is important to ensure that future official development assistance terms and modalities preserve the principle of its additionality. This is especially relevant in the context of the ambitious post-2015 development agenda and support for climate change adaptation measures. Policymakers in developing countries should be wary of blending concessional assistance with complementary funds from non-concessional public or private sources. While such blended finance can provide opportunities to meet additional financing needs, recipient Governments of aid packages funded in part by official development assistance should be aware of their overall financial obligations and contingent liabilities. The danger of undermining the principle of official development assistance additionality is not only the shift of much of the burden of financing the new development goals to developing economies, but the serious erosion of the contribution of international public finance to development cooperation.

56. Although the external debt of developing countries and countries with emerging economies declined markedly as a share of their GDP between 2000 (37.2 per cent) and 2011 (21.3 per cent) and has risen only gradually since, regional performances have differed and developing countries now face considerable challenges to the future sustainability of their external debt. These challenges emanate from a combination of factors, including slower global growth since 2008, the expected normalization of United States interest rates in the near future, increased volatility in some commodity markets and the impact of climate change and the increased incidence of natural disasters. Such continuing changes in the composition of the debt of developing countries as a large and growing share of commercial debt relative to official debt, the shift from international bank claims to debt securities issues and heightened foreign participation in growing domestic debt markets are a double-edged sword. As highlighted in earlier reports, while greater access to international financial markets can facilitate resource mobilization for growth and development, it also results in much higher market risk exposure and more complex transmission mechanisms between monetary policies in advanced economies and developing country debt sustainability. Consequently, the external debt of developing countries is considerably more vulnerable today to economic policy changes in advanced economies and to the vagaries of decision-making in international financial markets than even a few years ago.

57. International support to ensure the effective management of day-to-day public liabilities, through financial and technical assistance and institutional capacity-building for public debt management, is critical to equipping developing countries with the means to manage and assess the market-based risks to debt sustainability.

Some innovative financing mechanisms, such as GDP-indexed and catastrophe bonds, also merit further attention and may prove helpful in mitigating the growing vulnerability of the external debt positions of developing countries. In the current global economic environment, however, debt crises are highly likely to recur. The ability of the international community to resolve such crises in a timely, predictable, fair and transparent manner therefore remains of the utmost importance. The present fragmented and ad hoc arrangements for debt resolution are unsatisfactory in that regard, as well as excessively slow and costly. Recent IMF initiatives to improve collective action clauses with a view to minimizing interference by non-cooperative creditors are a step in the right direction, but are not designed to address the lack of early crisis diagnosis and prevention. It is therefore of vital importance, in order to achieve both greater global financial stability and sustainable long-term development, that the international community continue its efforts to reform current debt resolution mechanisms.

Annex

External debt of developing countries[a]

	All developing countries and countries with economies in transition					Sub-Saharan Africa				
	2000-2010	2011	2012	2013	2014[b]	2000-2010	2011	2012	2013	2014[b]
Debt indicators (billions of United States dollars)										
Total debt stocks[c]	3 045.2	5 197.6	5 763.0	6 324.8	6 655.6	227.4	302.4	342.1	366.6	394.6
Long-term debt	2 358.5	3 726.7	4 163.3	4 563.0	4 735.1	179.9	239.1	269.5	290.7	314.8
Public and publicly guaranteed	1 435.2	1 847.9	2 105.9	2 311.9	2 327.6	157.9	180.2	203.8	227.2	256.0
Private non-guaranteed	923.3	1 878.8	2 057.3	2 251.1	2 407.4	22.0	58.9	65.7	63.5	58.7
Short-term debt	586.7	1 301.3	1 440.7	1 627.0	1 777.1	37.6	42.5	50.9	53.9	53.2
Arrears	88.3	59.8	69.5	63.6	64.8	37.7	26.8	28.3	29.8	30.9
Debt service	428.7	683.5	693.4	789.4	831.5	14.3	18.1	22.4	27.6	31.2
International reserves	2 508.7	5 998.9	6 296.4	6 793.1	6 701.5	85.2	146.4	164.1	166.3	158.3
Debt indicators (percentage)[d]										
Debt service/exports[e]	11.3	8.0	8.1	8.8	9.2	6.8	3.8	4.8	5.8	6.8
Total debt/exports	85.0	70.7	75.9	81.1	84.0	105.7	63.0	72.4	76.8	85.2
Debt service/GDP	3.5	2.4	2.4	2.6	2.6	2.1	1.4	1.7	2.0	2.2
Total debt/GDP	26.4	21.3	22.5	23.3	23.5	32.8	23.0	25.2	26.1	27.0
Reserves/short-term debt	447.4	474.0	445.3	424.6	382.5	246.6	348.3	321.8	309.4	300.7
Reserves/money and near money	29.5	28.4	26.3	25.3	22.9	33.7	31.7	32.9	32.3	27.8

	Middle East and North Africa					Latin America and the Caribbean				
	2000-2010	2011	2012	2013	2014[b]	2000-2010	2011	2012	2013	2014[b]
Debt indicators (billions of United States dollars)										
Total debt stocks[c]	154.4	164.0	172.9	190.6	199.9	848.5	1 316.7	1 481.7	1 641.1	1 823.0
Long-term debt	123.2	120.6	130.7	147.1	157.1	699.5	1 087.5	1 230.0	1 376.0	1 509.6
Public and publicly guaranteed	117.1	112.5	121.3	136.8	146.5	436.1	537.8	613.2	669.5	718.8
Private non-guaranteed	6.1	8.0	9.5	10.2	10.6	263.4	549.7	616.8	706.4	790.8
Short-term debt	27.7	35.2	33.5	34.0	34.7	126.0	203.7	225.2	239.7	288.8
Arrears	6.4	0.8	1.4	2.1	2.2	22.5	21.3	21.3	21.7	21.9
Debt service	18.6	18.2	15.6	16.1	18.0	139.6	177.8	209.6	209.9	224.6
International reserves	208.4	382.5	389.7	400.5	390.4	325.4	743.4	804.1	802.0	827.4
Debt indicators (percentage)[d]										
Debt service/exports[e]	9.1	4.5	4.5	5.0	5.7	22.4	14.2	16.4	16.4	17.9
Total debt/exports	75.3	40.5	50.1	58.7	63.2	135.9	105.1	115.9	128.3	145.1
Debt service/GDP	2.9	1.4	1.2	1.2	1.5	4.6	3.1	3.7	3.5	3.7

	Middle East and North Africa					Latin America and the Caribbean				
	2000-2010	2011	2012	2013	2014[b]	2000-2010	2011	2012	2013	2014[b]
Total debt/GDP	23.8	13.0	13.2	14.8	16.2	28.1	23.0	25.9	27.8	30.2
Reserves/short-term debt	751.5	1 086.9	1 163.6	1 177.3	1 123.7	260.1	367.4	359.8	336.9	288.5
Reserves/money and near money	52.0	61.1	58.6	61.6	57.8	30.1	34.6	33.6	32.4	33.5

	East Asia and the Pacific					South Asia				
	2000-2010	2011	2012	2013	2014[b]	2000-2010	2011	2012	2013	2014[b]
Debt indicators (billions of United States dollars)										
Total debt stocks[c]	693.4	1 334.7	1 492.7	1 654.0	1 780.0	242.5	456.0	511.8	543.1	603.7
Long-term debt	462.8	668.3	746.6	772.9	775.3	210.2	351.5	395.4	431.3	470.5
Public and publicly guaranteed	293.0	368.7	385.4	397.9	402.3	141.1	201.8	229.5	228.4	234.5
Private non-guaranteed	169.8	299.6	361.2	375.0	372.9	69.1	149.7	165.9	202.8	236.0
Short-term debt	219.1	646.2	726.0	861.0	980.0	25.6	84.6	98.0	96.2	116.6
Arrears	11.2	6.8	6.8	5.5	5.6	0.1	0.0	0.0	0.1	0.1
Debt service	80.9	105.4	107.1	116.5	137.8	25.2	33.8	35.0	47.4	49.0
International reserves	1 349.4	3 705.5	3 866.2	4 348.3	4 359.8	177.5	306.5	305.9	313.6	353.9
Debt indicators (percentage)[d]										
Debt service/exports[e]	6.5	3.4	3.2	3.3	3.6	13.2	6.3	6.6	8.4	8.4
Total debt/exports	55.5	43.0	44.4	46.3	47.1	127.3	85.0	96.0	96.6	103.5
Debt service/GDP	2.1	1.1	1.0	1.0	1.1	2.2	1.5	1.5	2.0	1.9
Total debt/GDP	18.3	14.4	14.5	14.6	14.2	21.1	20.1	22.5	23.1	23.4
Reserves/short-term debt	616.5	573.8	533.3	505.8	445.5	694.3	362.2	312.2	326.0	303.5
Reserves/money and near money	24.9	24.8	22.6	22.0	20.0	24.0	20.9	19.3	19.2	19.5

	Europe and Central Asia				
	2000-2010	2011	2012	2013	2014[b]
Debt indicators (billions of United States dollars)					
Total debt stocks[c]	879.0	1 623.8	1 761.8	1 929.4	1 854.4
Long-term debt	683.0	1 259.7	1 391.1	1 545.0	1 508.0
Public and publicly guaranteed	290.1	446.8	552.7	651.9	569.6
Private non-guaranteed	392.9	812.8	838.4	893.1	938.4
Short-term debt	150.8	289.0	307.0	342.2	303.8
Arrears	10.4	3.9	11.5	4.4	4.1
Debt service	150.1	330.1	303.7	371.9	370.8
International reserves	362.8	714.6	766.3	762.3	611.7

	Europe and Central Asia				
	2000-2010	*2011*	*2012*	*2013*	*2014*[b]
Debt indicators (percentage)[d]					
Debt service/exports[e]	20.4	16.8	15.3	18.9	19.5
Total debt/exports	139.0	111.5	118.2	130.9	130.1
Debt service/GDP	6.2	5.9	5.4	6.4	6.9
Total debt/GDP	42.9	39.4	41.7	44.0	45.7
Reserves/short-term debt	280.8	279.1	270.5	239.3	216.3
Reserves/money and near money	60.7	49.9	46.2	43.1	31.9

Source: United Nations Conference on Trade and Development calculations based on the World Bank International Debt Statistics 2015 online database.

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

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

[b] 2014 estimates.

[c] Total debt stocks include long-term debt, short-term debt and use of IMF credit.

[d] Data used for ratio calculation has been adjusted according to country data availability.

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