October 2024

IMF-World Bank Non-Paper on Actions to Support Countries Faced with Liquidity Challenges

Improved creditor processes have helped streamline sovereign debt restructurings and shorten timelines in the past 12 months. Further progress is needed to make the resolution of the cases of unsustainable debt faster and more predictable. At the same time, there is also a need for urgent action to address liquidity challenges, which are of a different nature and require different solutions. If left unaddressed, these liquidity challenges could morph into a debt crisis. This joint IMF-World Bank note proposes to mobilize existing and new tools available to all countries into a comprehensive package to support low-income and vulnerable emerging market countries as they work to address liquidity challenges. The approach includes three pillars: 1) structural reforms and domestic resource mobilization; 2) external financial support, including from the IFIs; and 3) where relevant, actions to reduce debt servicing burdens.

Debt vulnerabilities remain elevated in many low-income countries (LICs) and some emerging markets (EMs). Higher interest costs and refinancing needs are aggravating financing challenges at a time when countries need critical investment to progress on the Sustainable Development Goals (SDGs), including adapting to climate change. Progress has been made on debt restructuring processes, in particular under the Common Framework, leading to shorter restructuring timelines and thus accelerating the resolution of situations of unsustainable debt. While further progress is needed to make these processes faster and more predictable, there is also a need for urgent action to address liquidity challenges, which are of a different nature and require different solutions. In many countries, increasing interest payments and high debt redemptions are squeezing the capacity to finance essential spending such as education, health, and infrastructure investment. If unaddressed, these liquidity challenges could morph into a debt crisis.

Accelerated domestic policy action and strong international support will thus be critical to support vulnerable countries address liquidity challenges**.** This entails mobilizing fiscal revenues to meet priority needs and developing domestic financial markets to improve access to financing, undertaking structural reforms to boost potential growth, ensuring adequate external financial support, including from the IFIs, and, where relevant, actions to reduce debt servicing burdens.

A THREE-PILLAR APPROACH

The IMF and World Bank propose a three-pillar approach to help low-income countries and vulnerable emerging markets address current liquidity challenges. Countries, whose debt is sustainable, have adequate macroeconomic policies, are undertaking or committed to growth enabling and fiscal reforms, but are experiencing temporary liquidity pressures, as assessed through debt sustainability analysis, could make use of this three-pillar approach. While the policies and instruments under each of these pillars are available to all countries, the approach would activate a country-specific package, tailored to the country's unique circumstances and needs, including for the use of pillar 3, for those countries meeting the abovementioned circumstances. The Pillars would include:

- **Pillar I: Structural reforms and domestic resource mobilization, supported by technical assistance, capacity development and policy advice.** Governments themselves must be willing to tackle underlying imbalances exacerbating debt challenges. This pillar thus entails mobilizing fiscal revenues to meet priority needs, improving the efficiency and effectiveness of public spending, strengthening the business environment to foster the domestic private sector as well as foreign direct investment, and developing domestic financial markets to enhance access to financing. The joint IMF-World Bank Domestic Resource Mobilization Initiative (see June 2024 note for the G20) has been launched to help country authorities implement these reforms. Moreover, both institutions will support members prioritize and sequence structural reforms to accelerate growth and create jobs, improve governance and tackle corruption including through strengthening public financial management and accountability mechanisms, alleviate policy trade-offs, and support the green and digital transitions, while softening the impact on vulnerable population and maintaining political feasibility.

- **Pillar II: External financial support, including from IFIs.** Structural reforms and resource mobilization will take some time to deliver on their potential. In the meantime, mobilizing sufficient international support will be needed to help countries meet their financing needs and provide net positive flows, particularly in low-income countries. Support from bilateral and multilateral development partners will be needed, including through the provision of concessional loans and grants. This support should be consistent with the strength and ambition of the domestic reform agenda, and the needs of the country. The IMF and World Bank are important parts of this collective effort, including through their catalytic role. 2024 is a "mission critical" year to ensure successful completion of the IMF's Poverty Reduction and Growth Trust (PRGT) review and twenty-first replenishment of the International Development Association (IDA). The results of both the PRGT Review and IDA replenishment, adjustments to the Bank's Capital Adequacy Framework, which created additional headroom for IBRD, reforms to the IMF's charges, surcharges, and access limits policies will help both institutions deploy the financial support necessary to support their most vulnerable members. For countries engaged in a Fund-supported program, official bilateral creditors could contribute to the collective effort to address the liquidity challenges by aiming at maintaining, where possible, their exposures over the program period.
- **Pillar III: Reducing debt servicing burdens where relevant.** New solutions are needed to support countries that do not have solvency problems but need to manage high debt servicing burdens. This could include greater use of risk-sharing instruments by bilateral and multilateral partners to incentivize new or higher inflows from private creditors. The new World Bank Group guarantee platform can support these efforts.

ACCELERATING ONGOING ACTIONS AND MOBILIZING NEW TOOLS WHERE APPROPRIATE

A number of actions are already well-advanced on Pillar 1 (growth-enhancing reforms and domestic resources mobilization) and Pillar 2 (bilateral and multilateral financial support). Progressing further on these actions, including through helping countries implement reforms and finalizing successfully the PRGT review and IDA21 replenishment, will be essential in the coming months. On debt, in parallel to ongoing efforts to make debt restructuring processes faster and more predictable (including under the Common Framework), specific actions to reduce debt servicing costs could include:

1. **Mobilizing new/higher inflows from private creditors including through incentives such as credit enhancements where appropriate.** The set of domestic reforms proposed under Pillar I would facilitate new or higher inflows from private creditors. In addition, multilateral or bilateral credit enhancement could be used to share risks and lower interest expense, including to refinance existing debt, where appropriate.

2. **Liability management operations (e.g., debt for development swaps and debt buy backs).** Bilateral debt for development swaps and commercial debt buybacks, including through debt for development swaps, can deliver debt service savings and face value reductions. Debt-for-development swaps can be used to replace high-cost sovereign debt with one or more lower-cost liabilities that entail a spending commitment over time towards development goals in exchange for debt relief. However, they raise some important questions, including the potential need for financial support from an external partner to make the operation viable and rating implications, among others, and need to be carefully designed to ensure benefits to all parties involved (See August 2024 Bank-Fund note).

While the proposed actions to reduce debt servicing burdens would primarily aim at mobilizing private creditors, support from official bilateral creditors (e.g., through debt service reprofiling) could also be considered, where necessary, and on a case-by-case and as appropriate basis.

The IMF and World Bank propose to build by the time of the 2024 Annual Meetings a consensus on the "conceptual approach" that could frame the support to countries faced with liquidity challenges. In parallel, the two institutions are advancing their operationalization work, including under the new DRM Initiative and potential use of credit enhancement. Following the Annual Meetings, the work could further progress, including by building on the early lessons of implementation in the first cases. This work would complement the parallel work on efforts to further improve debt restructuring processes, including under the Common Framework, for those countries that need a debt restructuring.