STRATEGY, POLICY AND REVIEW

June 24, 2021

The Common Framework: Utilizing its Flexibility to Support Developing Countries' Recovery

By Craig Beaumont and Dalia Hakura

The COVID-19 pandemic has exacerbated debt vulnerabilities in many developing countries around the world. The G20 and Paris Club have endorsed a Common Framework for coordinating official creditors to provide debt treatments when they are needed by the developing countries eligible for the Debt Service Suspension Initiative (DSSI). The Common Framework can be an important step to strengthen the architecture for sovereign debt resolution even beyond the pandemic. This note discusses the key features of the Common Framework and how it can be used to support DSSI-eligible countries' recovery. It explains the conditions under which debtors can request a debt treatment and the steps that need to be taken to implement the treatment. It also highlights that a critical element of the Common Framework is the expectation that private creditors participate in the debt treatment on terms comparable to official creditors.

I. BACKGROUND

In one of its most important decisions in 2020, the G20 adopted the Common Framework (CF) for Debt Treatments, which has also been endorsed by the Paris Club.[1] A total of 73 developing countries are eligible to request a debt treatment under the CF, comprising all International Development Association-eligible countries and UN Least Developed Countries current on their debt service to the IMF and World Bank. Three countries have made requests for CF debt treatments to date (Chad, Ethiopia, and Zambia), with Chad's request for a debt treatment recently receiving support from its Creditor Committee, thereby providing official financing assurances to the IMF.

But some countries and creditors still have questions about the role of the CF and how it works. This note aims to share our understanding of the CF drawing on our experience in supporting its implementation for the IMF.

[1] A debt treatment covers both liquidity relief through the reprofiling or rescheduling of debt service payments over a longer period, or solvency relief including through reductions in the principal due to be repaid.

We would highlight that the CF has great potential to support the recovery of eligible countries from the COVID-19 crisis if its flexibility to provide case-by-case debt treatments is fully utilized. Debtor country authorities should deal with their debt challenges sooner rather than later as timely and efficient debt resolutions can minimize the costs to both the debtor and its creditors. As the CF is a new initiative, periodic reporting to the G20 on its implementation is envisaged, with the potential to refine processes as experience is gained.

II. ORIGINS OF THE COMMON FRAMEWORK AND ITS KEY FEATURES

The CF builds on the G20 and Paris Club's Debt Service Suspension Initiative (DSSI) which, starting from May 2020, has provided liquidity relief to more than 40 of the 73 eligible countries, which are mostly low-income countries (LICs). The DSSI was unprecedented in part owing to its speedy implementation, but also because this liquidity relief is a multilateral initiative bringing important new creditors such as China, India, Saudi Arabia, South Africa, and Turkey together with the traditional official creditors participating in the Paris Club.

At the outset of the COVID-19 crisis, when prospects were highly uncertain, the DSSI coordinated a suspension of debt service payments to the official creditors of the G20 and Paris Club, with a one-year grace period and repayments over three years for the debt service falling due in May–December 2020 (later extended to five years for the debt service due in 2021).[2]

Even as it was adopted in April 2020, it was understood that DSSI was a rapid emergency response that would be temporary. Although the generic DSSI treatment provided valuable breathing space, it would not be enough for those countries with more prolonged financing needs or with unsustainable debt. Moreover, the lack of private participation in DSSI put the full burden on the official creditors, which was not consistent with the large increase in eligible country reliance on private external debt financing over the past decade.

By establishing the CF in November 2020, this broad group of official bilateral creditors stands ready to provide debt treatments tailored to the specific needs of the same countries eligible for DSSI, along the lines of the role played by the Paris Club. The coverage of these treatments would be more comprehensive than DSSI, as the CF includes a comparability of treatment requirement to ensure participation by other bilateral creditors and by private creditors. Moreover, the G20 has required that countries making requests for a debt treatment under the CF must also have or be seeking an IMF-supported program, which supports policies to underpin sustained economic recovery.

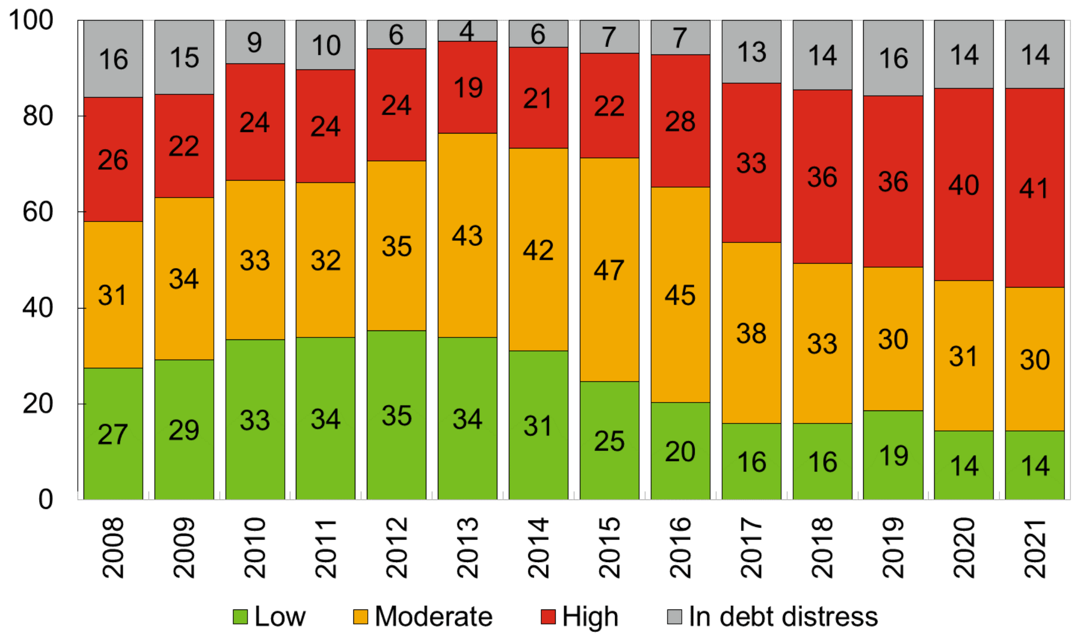
III. DIVERSE NEEDS REQUIRE TAILORED DEBT TREATMENTS

Figure 1 shows the debt distress ratings of LICs. The most striking feature is the near doubling since 2015 of the share of countries either in debt distress or at high risk of debt distress, to reach 56 percent of LICs by end-April 2021. Many of these countries face prolonged high debt and debt service burdens that increase their vulnerability to falling into arrears and distress. In some cases, their debts may become unsustainable. These high-risk countries, together with those already in debt distress, are the most likely to need a debt treatment under the CF.

[2] To preserve market access of eligible countries and support these countries' participation in DSSI, an exception was made to the "comparable treatment" requirement of the Paris Club: namely, that the countries seek comparable debt treatments from their other creditors, including private creditors. Private creditor participation in DSSI was encouraged but voluntary. In the end, there was essentially no private participation in practice as few countries requested it, including in some cases because of concerns over possible loss of market access.

FIGURE 1. Evolution of Risk of External Debt Distress

(Percent)



Source: LIC DSA database as of end-April 2021.
Note: Share of countries with a LIC DSA. 66 out of 73 DSSI-eligible countries apply the LIC DSA.

But countries requiring debt relief do not all need the same debt treatment! The debt relief needs of LICs and other eligible countries vary considerably because they entered the crisis with different debt vulnerabilities and because the crisis has impacted some countries much more than others, depending on their reliance on commodity exports, tourism, and remittances among other factors. Even among the first three countries that have made requests for a CF debt treatment, the nature and depth of their debt challenges vary widely.

The CF can address the diverse needs of countries facing large debt (service) burdens. These can be grouped as follows:

- ***Liquidity relief***: as with the Paris Club, CF debt treatments can be provided to countries with sustainable debt if their financing needs exceed the financing that can be mobilized by the IMF and World Bank and other sources. A suitable treatment would reduce the debt service payments due during the years of the IMF-supported program, with additional debt repayments spread out over a longer period, but there need not be a reduction in the debt in present value terms.

- ***Restoring debt sustainability***: some countries face a combination of debt build up and economic shocks that make their debts unsustainable (Box 1). Even with sound policies, these countries are not likely to be able to service their debts, and a reduction in debt in present value terms is often necessary as part of a broader package to restore sustainable growth. The amount of debt reduction needed can vary widely, depending on how far debt and debt service is from sustainable levels. In some cases, the needed reduction can be achieved while still repaying the original principal over a longer period, while in others, an upfront “haircut” or principal reduction is necessary.

Box 1. Debt Sustainability Definition and Concepts in the LIC DSF

In general, overall public debt and public external debt can be regarded as sustainable when there is a high likelihood that a country will be able to meet all its current and future financial obligations. In practice, sustainability would imply that the debt level and debt service profile are such that the policies needed for debt stabilization under both the baseline and realistic shock scenarios are politically feasible, socially acceptable, and consistent with preserving growth at a satisfactory level while making adequate progress toward the authorities' development goals.

A debt treatment becomes necessary if feasible fiscal adjustment is not sufficient to restore debt sustainability. An IMF-supported program will aim to ensure that the envisaged fiscal adjustment underlying the macroeconomic framework is politically feasible and socially acceptable, while also supporting investment and social spending aimed at reaching the development goals of the country requesting the debt treatment, including spending needs in response to COVID-19. Debt sustainability is assessed on the basis of implementing such a feasible fiscal adjustment, and if the debt and debt service prospects are not improved sufficiently to restore debt sustainability, there is a need to resort to requesting a debt treatment to ensure sustainability. (Debt treatments can also be needed to provide liquidity relief as noted above.)

The questions of (1) whether a country needs a debt treatment and (2) the nature and depth of the treatment required are assessed during the country authorities' discussions on an IMF-supported program. The program request will trigger the preparation of (1) an analysis of financing needs and sources and (2) a joint IMF-World Bank Debt Sustainability Analysis (DSA). These analyses are based on a macroeconomic framework that is consistent with IMF policies for Board approval of the arrangement, including on fiscal adjustment and on mobilizing external financing from the World Bank and other international lenders and donors. Findings from these analyses guide the appropriate debt treatment in each country case:

- *No debt treatment needed*: If the DSA finds debt to be sustainable and if the available financing sources are sufficient to meet the country's needs.

- *Liquidity relief*: If the DSA finds debt to be sustainable, but financing sources are not sufficient to meet the country's needs, a debt treatment is needed. The gap between financing needs and financing available defines the "envelope" for the reductions in debt service payments that will ensure the country's program is fully financed. Looking further ahead, the rescheduled payments must remain manageable for the country, which is ensured by limiting the risk of debt distress to moderate in the medium term in cases of IMF lending within normal access limits, and by the end of the IMF-supported program for countries with exceptional access to IMF resources as an added safeguard.[3] In order to be able to absorb potential shocks, buffers in the envelope for the debt treatment are determined case by case, taking relevant economic risks into account.[4]

- *Solvency relief*: If the DSA finds debt to be unsustainable, there would be a need for a deeper debt treatment, and there is also typically a need for that treatment to help close financing gaps during the program. In addition to analyzing those financing gaps, there is a need to assess the debt service and debt levels that the debt treatment would need to achieve over time to ensure that debt is made sustainable. This envelope for debt and debt service will generally be sufficient to place countries at least into the category of moderate risk of debt distress over the medium term (or by the end of the IMF program period in IMF exceptional access cases) and, as above, the appropriate buffers to be built into the envelope are determined case by case.

[3] The assessment of the risk of debt distress is discussed in the LIC DSF guidance note.

[4] World Bank Group and International Monetary Fund Support for Debt Relief under the Common Framework and Beyond.

DEBT TREATMENTS ENTAIL COLLABORATIVE WORK BY ALL STAKEHOLDERS

The key parties to a debt treatment are naturally the debtor and creditors. Once a debtor has made a request for a CF debt treatment to each of its official bilateral creditors and has requested an IMF-supported program (if there is not an existing program), the work begins toward a key milestone in the CF debt treatment process, which is reaching agreement between the G20/Paris Club bilateral creditors and the debtor country on a memorandum of understanding (MOU) that sets out the key parameters of the treatment. This MOU also guides the comparable treatment to be provided by other bilateral creditors and by private creditors.

The steps toward concluding the CF debt treatment rely on close collaboration between debtors and creditors supported by the IMF and World Bank:

- ***IMF-supported program***. The country authorities and the IMF together develop a set of policies that will restore medium-term external viability, including by supporting sustained inclusive growth. Financing is a key element of the program. The IMF must assess the financing needs of the country and whether available financing is sufficient to support the policy program; if not, a country may need relief under the CF.

- ***Assessment of debt sustainability and distress risks.*** When a country requests an IMF-supported program, the sustainability of its debt must be assessed. For LICs, the assessment is done jointly with the World Bank using the Debt Sustainability Framework for Low Income Countries (LIC DSF), which also assesses the risk of debt distress.

- ***Provision of financing assurances***. Once IMF staff has reached staff-level agreement on an IMF-supported program (or on a review under an existing program) it is the turn of G20 and Paris Club official bilateral creditors to form a Creditor Committee to discuss the debt treatment.[5] This treatment must be sufficient to ensure the IMF can proceed with financing. Accordingly, the IMF provides official and private creditors with an aggregate "envelope" for the debt service and debt consistent with closing the program financing gaps, reducing debt risks, and, if needed, restoring debt sustainability. The official bilateral creditors participating in the Creditor Committee provide assurances that they support a debt treatment consistent with that envelope.

- ***Finalizing and implementing the debt treatment***. Once the official bilateral creditors have provided the above financing assurances, the IMF will assess whether the country (with its financial and legal advisors) has a credible process in train for private debt resolution when this is necessary, and that all the safeguards are in place for the IMF Executive Board to approve financing. After IMF program approval, the official bilateral creditors and the debtor discuss and agree the MOU for the debt treatment, in terms of (1) the reduction in debt service during the determined period; (2) the extension of the duration of payments and, where needed; (3) the reduction in the present value of payments. These latter parameters guide the implementation of relief by other official bilateral creditors and by private creditors through bilateral agreements with the debtor.

- ***Program monitoring***. Following the approval of financing, the IMF Executive Board will monitor program implementation. This monitoring includes following the implementation of the debt treatment by the participating G20 and Paris Club creditors as agreed in the MOU, and also by the other official creditors and by private creditors which are subject to the comparability of treatment clause in the MOU.

---

[5] It they are willing, official bilateral creditors that are not G20 or Paris Club members, but that have claims on the country, can also participate in the Creditor Committee.

COMPARABLE TREATMENT OF PRIVATE CREDITORS

A critical element in the collaboration for a debt treatment is the discussions between the debtor country and its private creditors. The stakes are high because comparability of treatment is a key condition that is closely monitored by the official bilateral creditors that have the possibility to withdraw their debt treatment. Moreover, shortfalls in private creditor and other (non-G20 and non-Paris Club) official creditors participation can undermine financing adequacy and debt sustainability, which may preclude the IMF from disbursing financing.

Unlike the DSSI, countries using the CF must seek a treatment from private creditors at least as favorable to the debtor as that agreed in the MOU with official creditors. In a case where official creditors provide a reprofiling of debt service falling due within a certain period of years, private sector creditors would generally be expected to provide a comparable reduction in nominal debt service during that period along with an extension in the duration of those payments. If, instead, the MOU specifies a cut in the present value of debt, private creditors would generally be expected to provide at least that reduction. According to Paris Club practice, comparability of treatment is in practice assessed at the level of private creditors as a whole, rather than to each private creditor.

Debtor countries generally hire financial and legal advisors with expertise in engaging with private creditors to assist them in restructuring sovereign debt. In the case of bonds, advisors will be familiar with collective action clauses and other options to promote participation by private creditors. Support for hiring advisors from the World Bank's Debt Reduction Facility (subject to DRF guidelines) and the African Legal Support Facility could be available for some countries.

Historical experience indicates that private creditors will generally agree to provide a comparable treatment, as they understand that the debtor country is not able to offer a better treatment to them. Creditors may also recognize that the IMF is not precluded from lending to a country in arrears to private creditors when certain conditions are met.

HOW TO USE THE COMMON FRAMEWORK TO SUPPORT DEVELOPING COUNTRIES' RECOVERY

On top of its role in addressing unsustainable debt burdens, the CF can replace the DSSI in providing liquidity relief, and it can do so over the longer horizon that some countries may need as they recover from the COVID crisis. A key concern is that some countries with unsustainable debt or very large financing needs will not utilize or will delay utilizing this instrument. This could exacerbate the scarring effects from the crisis on their long-term development and make an eventual debt workout more painful.

(1) Unsustainable debts must be resolved in a timely and durable manner

When a country is facing an unsustainable debt burden, its creditors have often already reassessed credit risks, limiting the countries' access to financing and reducing its capacity to address the crisis. Knock-on effects often include pressures on monetary and financial stability and lower investment. It is important to approach the IMF for a package of support that also restores debt sustainability, as only by tackling the debt problem forcefully can the country return to a path of sustained growth.

Depending on their circumstances, LICs facing unsustainable debt should consider utilizing the CF, as it will coordinate relief from the most important official bilateral creditors, and by comparability of treatment, it will also bring in other creditors including the private sector. Such a broad-based treatment helps address creditor concerns about fair burden sharing, which could otherwise result in delays. Timely treatments are needed but they should also be durable, and this is a key goal of the Common Framework.

(2) Debt reprofiling would support fiscal space for recovery in other cases

As countries seek to recover from the current crisis, even those with sustainable debts often face difficult trade-offs. Domestic financing may be unduly costly, curtailing future growth by crowding out lending to the private sector and leading to a buildup of financial stability risks, including through an intensification of the sovereign-bank nexus. Meeting the health and other costs of the crisis may then require cutbacks elsewhere, such as investment, with the potential to undermine their recovery and future growth.

An IMF-supported program is a traditional financing tool for countries in these circumstances. But, in the current deep crisis, financing provided by the IMF and other donors may not always be sufficient. By reducing debt service during the program period, a reprofiling of debt service from the CF would enhance fiscal space and smooth fiscal adjustment over time, helping the country recover while protecting its long-term growth prospects.

Although countries could benefit from an IMF-supported program coupled with a debt reprofiling under the CF, some may be deterred by concerns about their credit standing and access to financing. This is less of a concern for most DSSI eligible countries which have not issued international sovereign bonds or do not have imminent plans to do so. Where such bonds are outstanding, it should be noted that official bilateral creditors and the country have a mutual interest to utilize debt reprofiling modalities that limit creditworthiness impacts as these may undermine the repayment capacity of a country.

CONCLUSION

Building confidence in the CF among the full range of countries that require debt treatments should be a priority to promote debtor country participation in the initiative and maximize its contribution to recovery in eligible countries. The CF provides an important new opportunity to take a coordinated approach aimed at delivering more comprehensive, timely, fairer, and more durable debt restructurings. Successful conclusion of a case with a deep debt treatment will be important for eligible countries facing severe debt challenges, by giving confidence that creditor coordination under the CF, together with an IMF-supported program, can enable them to return to sustained growth. Moreover, the international community should consider supporting reprofiling of debt using the CF for those countries with sustainable debt but insufficient financing to maintain high-priority social and investment spending. Failing to deliver debt treatments via the CF risks impeding countries' recovery or requiring reliance on costly and unstable sources of financing, which may ultimately require more debt relief.