Sovereign debt vulnerabilities in developing countries

A report produced for the Brazilian G20 under the auspices of the International Financial Architecture Working Group (IFA WG)

July 2024

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Executive Summary

1. UN Trade and Development has highlighted that rising external (and public) debt service is draining resources away from the 2030 Agenda and the Paris Agreement ambitions in developing countries. This development crisis means that progress on the SDGs is significantly behind schedule, with only 15 per cent of them expected to be achieved by 2030.

2. In this context, the report aims to provide more detail of the vulnerabilities of developing countries based on their profile of global financial integration. Three groups of countries are identified: Emerging-Market Economies (EMEs), mostly upper-middle-income developing countries that have integrated into the international capital markets since the 1990s, Frontier-Market Economies (FMEs), defined here as the group of developing countries with mainly low- or lower-middle-income levels that began to tap this market after the Global Financial Crisis of 2008 (GFC), and Other Developing Economies (ODEs), which are associated with low degrees of integration into the international capital markets and rely mainly on external public financing and ODA.

3. The sovereign debt life cycle is introduced to the analysis as a conceptual device to identify the differential experience of these three profiles of developing countries (EMEs, FMEs and ODEs), especially as they relate to debt acquisition and access to markets, debt servicing, repayment and resilience.

4. The relative external creditor composition between the three country profiles reflects their relative financial integration and exposure to private creditors. ODEs are mainly exposed to multilateral and bilateral creditors, with private creditors making up only 17 per cent of Public and Publicly Guaranteed (PPG) debt in 2022 (latest available). The private sector exposure of FMEs has virtually doubled since 2010, making up 32 per cent of their PPG Debt in 2022. By contrast, for the EMEs, which have had the longest exposure to financial markets, the private creditors account for 67 per cent of the PPG debt.

5. The implications of this differential exposure can be seen in data by creditor group on net transfers on the PPG debt. For example, in 2022 when positive net transfers by official creditors (US$ 43 billion) were insufficient to compensate the negative net transfers by private creditors (US$ 67 billion), developing countries faced a negative net transfer on the PPG debt of US$ 25 billion in 2022. But the results were mixed: EMEs faced the largest total negative transfer of U$S 32 billion, FMEs had a total net negative transfer of U$S 2.2 billion, and the ODE group recorded positive total net transfers in 2022 (of US$ 10.2 billion).

6. FMEs, which issue speculative grade sovereign bonds, face greater spread volatility and access the global capital market at higher costs than EMEs. The surge in bond issuance since 2010 was at the core of the three-fold increase in the accumulation of external PPG debt in FMEs, which made up 56 per cent of total FME debt in 2023. PPG debt accounted for 36 per cent of total debt of EMEs in 2023, and 23.5 per cent of ODEs.

7. Both FMEs and ODEs experienced sharp increases in external interest payments in 2023 associated with the significant monetary tightening in developed countries. The external interest costs of FMEs increased on average by 15.5 per cent a year between 2010 and

2023, twice as fast as the rate of increase for both EMEs and ODEs. Similarly, the principal repayments of FMEs rose much more than that of ODEs and EMEs over the same period.

8. The ratio of debt service on PPG debt relative to government revenues for FMEs surged from almost 6.3 to 14.7 per cent between 2010 and 2023. In contrast, for EMEs, this figure stood at around 3 per cent throughout the period. The ratio also grew in ODEs, but it reached 7.9 per cent in 2023 – a little more than half that of FMEs.

9. Increased external public debt with high costs has contributed to the deterioration of the external solvency of FMEs. The ratio of external debt service to exports in this group rose from about 6 to 18.7 per cent between 2010 and 2023 compared to 12 per cent for EMEs and 10 per cent for ODEs in 2023. While all three profiles of developing country have experienced growing public and external debt over the last decade, the asymmetry across them in accessing external finance has resulted in different costs of servicing sovereign external debt, which has critically influenced each group's relative external debt solvency.

10. Two primary factors can derail a country's capacity to service its debt. The first one is the ability to withstand external shocks, including those related to climate. In this case, access to the Global Financial Safety Net (GFSN) is critical to ensuring resilience to these shocks since addressing a temporary liquidity crisis quickly and comprehensively can prevent a solvency crisis. The second factor is if the growth rate of the debt service costs is higher than the growth rate of the revenues generated for servicing the debt

11. While the IMF resourced the GFSN exclusively after World War II, after the GFC, the GFSN expanded rapidly: A rising number of regional financial arrangements (RFAs) have been established, and central banks have mobilized huge volumes of bilateral temporary liquidity injections through currency swap agreements. One key differential in the provision of GFSN is whether a country has access to unlimited US Fed swaps, which are provided to a select group of central banks that issue international currencies which have systemic importance. Another is access to one or more well-funded regional funds.

12. The provision of crisis finance by the GSFN is unevenly distributed across the three developing groups. While none have current access to the Fed swap lines, some cannot access RFAs either (notably Africa countries). The access of EMEs to limited swaps, such as those with the PBOC (Public Bank of China), and central bank swaps between other EMEs, provides them with greater access and more options in terms alternative emergency lines than the other two groups. For the two other developing country profiles, the predominant element of the GFSN remains IMF conditional lines.

13. If a country's external debt service costs are increasing at a faster rate than its exports and remittances, its external financial sustainability will be deteriorating – even if current obligations can easily be covered. Examining the three profiles of developing countries through this lens reveals a deterioration in the external financial sustainability for most FMEs and ODEs, but not for EMEs, between 2017 and 2023, although data for all countries was not available. The median rate of annual increase in external debt service costs of EMEs for this period was significantly lower (2.4 per cent) than either FMEs (11.8 per cent) or ODEs (16.3 per cent), while growth in exports plus remittances was slightly higher (6.4 per cent) compared with 6.1 per cent for FMEs and 5 per cent for ODEs.

14. In the case of public sector financial sustainability, growth in interest costs outgrew public sector revenues for the majority of all three country profiles: EMEs, FMEs and ODEs. The

median annual increase in public sector revenues for EMEs between 2017 and 2023 was 8.1 per cent, while interest costs rose by 11.6 per cent over the same period, for FMEs it was 14.5 per cent and 9.9 per cent, respectively, and for ODEs 8.1 per cent and 13.6 per cent.

15. Between 2017 and 2023, over 4.1 billion people were living in countries with improving external financial sustainability, while 2.1 billion were in countries that experienced deteriorating sustainability. However, there was a dramatic shift in the number of people residing in countries with deteriorating public sector financial sustainability, due largely to the fact that the two countries will the largest populations (India and China) had improving external financial sustainability but deteriorating public sector sustainability. As a result, close to 5.6 billion people lived in countries with deteriorating public sector financial sustainability in 2023.

16. The financial sustainability analysis highlights a divergence between EMEs on the one hand, and FMEs and ODEs on the other, with respect to their external positions, but a convergence with respect to their public sector finances. The external integration profile of EMEs into the international capital market and global trade resulted in a general – but not universal – improvement in their external financial sustainability, underpinned by much lower increases in debt service costs and slightly higher export plus remittance growth.

17. As a group, FMEs performed better than ODEs, but external debt service costs rose at twice the rate of increase of exports plus remittances, and at a much faster rate than that of EMEs. However, the deterioration in external financial sustainability of almost three quarters of FMEs and ODEs points to limited capacity to take on new external debt to finance climate and development priorities.

18. For two-thirds of developing countries analyzed, both external and public sector financial sustainability worsened between 2017 and 2023, as external debt servicing costs rose more quickly than foreign exchange earnings and interest cost growth outstripped that of government revenues. Taken together, this raises concerns about the ongoing sustainability of both external and public debt for developing countries, and the extent to which the servicing of such debt drains resources from development in the context of the vast financing gap for achieving the goals of the 2030 Agenda and the Paris Agreement.

19. Policy recommendations for transformation are provided based on the life cycle of sovereign debt. These include proposals relating to the prevailing architecture and operations of the global financial system to reduce the costs of financing development over time. It is, however, important to note that many of these initiatives may only influence terms of new borrowing and will therefore be slow to change the overall debt dynamics currently facing developing countries.

I. Introduction

The cascading crises of recent years – the pandemic, the war in Ukraine, a deepening climate crisis, a cost-of-living crisis and escalating geopolitical tensions and conflicts – along with the most aggressive monetary tightening in developed countries since the 1970s have intensified what was already an unsustainable position for many developing countries. In 2019, the IMF estimated that 48 of the LIC DSA countries were in or at high risk of debt distress; by 2021 this had risen to 56 countries, but by the end of 2023, 52 countries were similarly classified, with current IMF estimates that this will fall back to 50 by 2024.

UN Trade and Development has highlighted that while this metric suggests relative resilience, and while a systemic external debt crisis – where a growing number of countries move simultaneously from distress to default has not eventuated - a development crisis is underway. Rising external (and public) debt service is draining resources away from the 2030 Agenda and the Paris Agreement ambitions. Progress on the SDGs is significantly behind schedule, with only 15 per cent of them expected to be achieved by 2030.

The current debt challenges and consequent development crisis are taking place against the backdrop of the hierarchical international monetary and financial system (IMFS). The cost and risks arising from volatile and high-cost external private financing, insufficient external public financing (bilateral and multilateral loans, and official development assistance), unequal access to the global financial safety net, currency vulnerabilities and the lack of an inclusive multilateral framework for sovereign debt workout, suggest a disconnect from development priorities. Moreover, a fractured multilateral trade system with asymmetries in trade benefits, speculative price movements and market instability in commodity markets[1], as well as subordinated positions in global value chains, undermine the capacity of developing countries to generate export earnings to service their external debt.

Different degrees of integration with the global financial system means that the IMFS does not impact all developing countries uniformly. Typically, the literature on external debt provides analysis across developing regions or income groups[2]. In this paper, we classify developing countries based on their profile of external financial integration into three distinct groups. The first group comprises the Emerging-Market Economies (EMEs), mostly upper-middle-income developing countries that have integrated into the international capital market since the 1990s. The second group includes the Frontier-Market Economies (FMEs), defined here as the group of developing countries with mainly low- or lower-middle-income levels that began to tap this market mainly during the capital flows boom after the Global Financial Crisis of 2008 (GFC). The third group relies mainly on external public financing and ODA as they have low degrees of integration into the international capital markets, and many are unrated by credit rating agencies. We group them here as Other Developing Economies (ODE).

In the next sections, we will focus on the external sovereign debt vulnerabilities of developing countries in general and of these three groups. Following UNCTAD (2023, ch. V), the analysis will use as a conceptual device the sovereign debt life cycle to consider the way in which debt is incurred, how debt instruments are issued, how debt management is structured and debt sustainability is tracked, and the options for debt workout. The arguments are organized as follows. Section II summarizes our conceptual approach. Section III addresses the differential access of the three profiles of developing countries to external finance and their consequence for

[1] See UNCTAD (2023), ch. II (sections A to C) and ch. III.
[2] See, for example, United Nations (2023) and World Bank (2023).

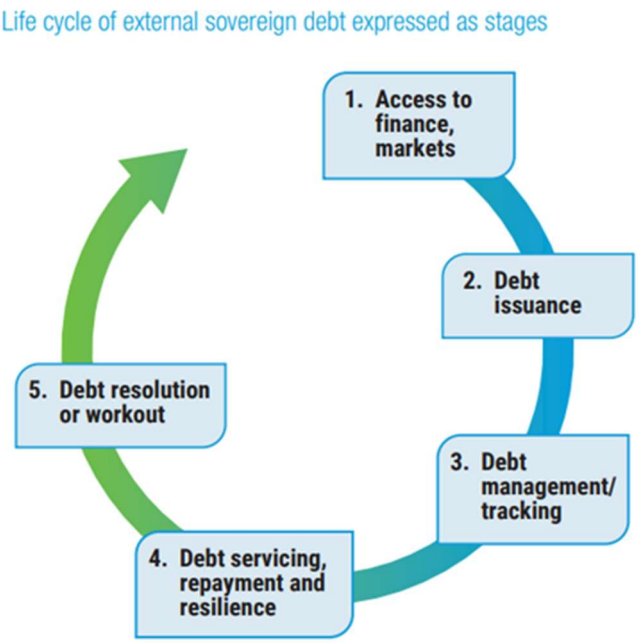
external sovereign debt vulnerability in the medium and long run (i.e., external solvency). Section IV explores how the three different profiles experience debt servicing and resilience. Section V presents transformational proposals.

II. The life stages of the sovereign debt cycle and three profiles of developing countries

This section is based on the UNCTAD Trade and Development Report 2023 (Chapter V), which analyses sovereign debt through a life cycle framework comprising five stages. The life cycle acts as a conceptual device to identify challenges and failures, but also transformational policy recommendations, at each stage. We use these five stages here to show how different profiles of developing countries (EMEs, FMEs and ODEs) impact debt outcomes, as there are differences in terms of conditions and costs of debt, the kind of debt instruments issued, the sophistication of debt management, the comprehensiveness of debt data, and the options for liquidity and solvency relief.

This section provides a brief introduction to the life cycle and its stages and relates this to our three profiles of country. In subsequent sections, we focus primarily on Stage 1 (Access to financial markets) and Stage 4 (debt servicing, repayments and resilience).

Figure 1
Unpacking the debt black box



Source: UNCTAD (2023), chapter V.

a. Stage 1: Access to financial markets

The critical issue in the first phase relates to the shortage of both concessional finance and affordable long-term capital. The differential access to external finance and to the global capital market, as well as the insufficiency of grants and concessional finance, shape the financial integration profile of developing countries. In stage 1 of the sovereign debt life cycle, the profile, depth and duration of global financial integration all matter and have a critical influence on the impact of the failures of the following stages on these countries' external debt challenges.

As mentioned in the Introduction, we distinguish three groups of developing countries with distinct financial integration profiles: the EMEs, the FMEs, and ODEs. Not only does their access to financial markets differ, but the terms and pricing of that access is crucially affected.

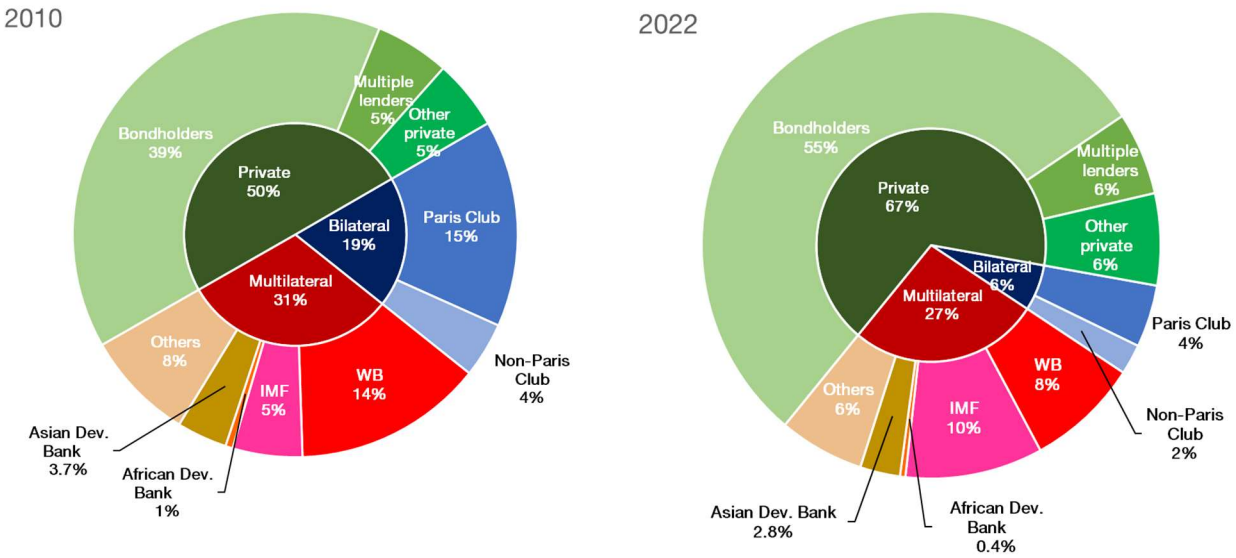
There are several definitions of EMEs and FMEs. As the critical issue in our approach is the differentiated access of countries to the global capital markets, we employ a classification based on global investment benchmarks to differentiate countries.

Since the integration of EMEs in the 1990s, global investors have relied increasingly on passively managed or benchmarked-driven funds that track a benchmark index with a predefined list of countries and securities with specific weights. Moreover, the influence of these indexes goes beyond the passive funds, as managers of actively managed funds also tend to allocate their portfolios according to the share of each country's bonds in the indexes.[3] Our samples of EMEs and FMEs refer to the country composition of the leading benchmark index for sovereign bonds, the JP Morgan indices for EMEs and FMEs in May 2024. The third group, ODEs, comprises the developing countries that are not included in these indices and, consequently, in global investors' portfolios (or have a minor share in them)[4].

The uneven access to external finance between the two financially integrated groups (EMEs and FMEs) and the group of ODEs is apparent when considering change in the relative creditor composition over time (Figures 2, 3 and 4). The figures show the different creditor compositions in 2010 and then in 2022 (the latest for which data is available). Figure 2 refers to the EMEs – in 2010 private creditors accounted for half of the external debt exposure of these countries, with multilaterals accounting for almost a third of their exposure. By 2022, private credit exposure had risen to two-thirds for EMEs, on average, with multilateral exposure shrinking to just over a quarter. Bilateral credit shrunk from 17 per cent in 2010 to 6 per cent in 2022.

[3] See Goldberg and Krogstrup (2018).
[4] For the list of EMEs and FMEs, see Annex.

Figure 2
Public and publicly guaranteed debt: creditor's composition of EMEs
(Percentage of total)



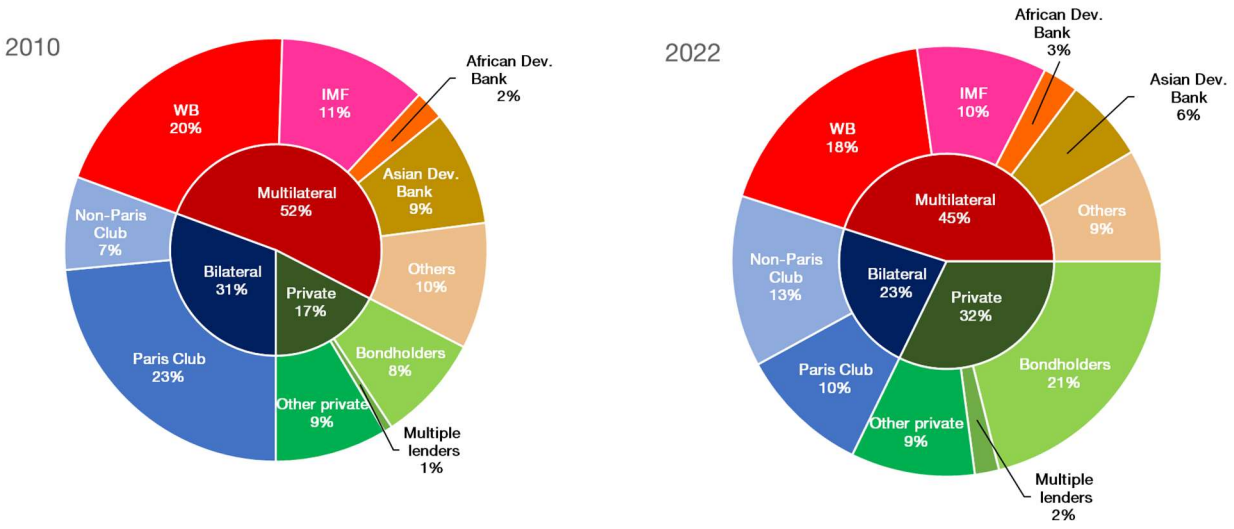
Source: UNCTAD calculations based on World Bank *International Debt Statistics*.

FMEs were included in the benchmark-driven investment strategies in 2011 when the JP Morgan index for FMEs (the Next Generation (NEXGEN) index) was launched. The inclusion in the index has stimulated the issuance of new foreign sovereign bonds by FMEs since the benchmark-driven funds have to allocate a share of their portfolios in these bonds. FMEs' bond issuance reached a record value of around US$22 billion in 2018 and 2019, on the eve of the COVID-19 pandemic (UNCTAD, 2023). The number of developing countries in this index increased from 17 in 2011 to 35 by May 2024.

In Figure 3, the change in creditor composition for FMEs is represented. Since the inclusion of countries in the NEXGEN index, there has been a virtual doubling (17 per cent to 32 per cent) of exposure from 2010 to 2022 to private capital sources (bonds, loans and other).

Exposure to both multilateral and official bilateral creditors has fallen commensurately, with a shrinking of Paris Club bilateral exposure and simultaneously growth in non-Paris Club official exposure. This is partially explained by dwindling access to external official development finance that has increasingly led to the reliance of lower middle and low-income (LICs and LMICs) FMEs on private external finance. This is especially the case of FMEs that upgraded from LICs to LMICs just before or in the aftermath of the GFC (Angola, Mongolia, Nigeria, Pakistan and Viet Nam) as this graduation is associated with loss of access to low-cost concessional external finance whose main eligibility criteria is income level (see BOX 1).

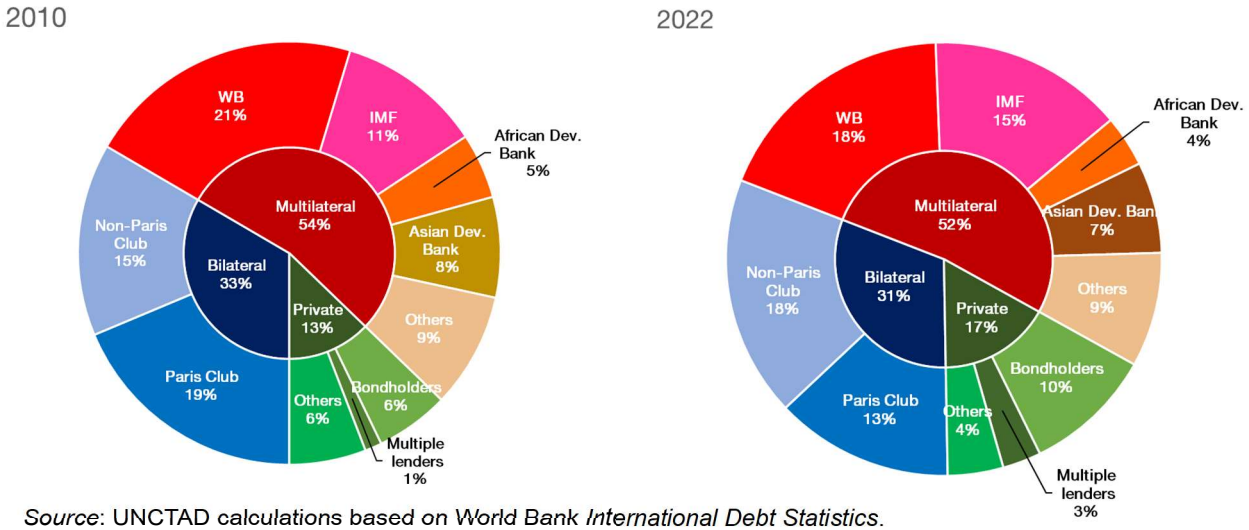
Figure 3
Public and publicly guaranteed debt: creditor's composition of FMEs
(Percentage of total)



Source: UNCTAD calculations based on World Bank *International Debt Statistics*.

In Figure 4, the creditor composition for ODEs is shown. ODEs include LMICs and LIC that rely mainly on official creditors and Official Development Assistance (ODA) for external financing to close the foreign exchange and development finance gaps (BOX 2). Therefore, they have remained relatively unaffected by private capital flows volatility (see Section III). There have been relatively small shifts over time, with a mild growth of exposure to private capital markets from 13 per cent to 17 per cent between 2010 and 2022.

Figure 4
Public and publicly guaranteed debt: creditor's composition of Other Developing Economies
(Percentage of total)



Source: UNCTAD calculations based on World Bank *International Debt Statistics*.

BOX 1 – Eligibility criteria and access to official external finance

The COVID-19 crisis has starkly exposed the multidimensional nature of developing countries' vulnerabilities. Climate change is exacerbating structural, trade, and financing barriers to development. This situation has underscored the need to move beyond income thresholds as the primary eligibility yardstick for concessional loans and grants. Similar GDP levels can mask vastly different development realities and vulnerabilities among countries (United Nations, 2023a).

Among developing countries, Small Island Developing States (SIDS) are particularly exposed to climate and other external shocks due to their characteristics, which include geographical remoteness, small size, external economic dependence and greater exposure to adverse impacts of climate change (United Nations, 2020). Only a few institutions currently consider climate-related vulnerabilities as a criterion in lending allocation (United Nations, 2022), which results in the non-eligibility of many SIDS to concessional finance and grants due to their high or middle-income levels[5]. As a result, most of them depend on private capital flows to meet their financing requirements, having an above-average sensitivity to shifts in capital flows compared to EMEs (United Nations 2020a). Exposure to climate change compounds this by increasing the cost of borrowing (United Nations Environment Programme, Imperial College Business School and SOAS, 2018).

In recognition of these challenges and echoing SIDS's call for criteria based on vulnerabilities to guide concessional lending and grants since 1994, the UN General Assembly called for the development of a multidimensional vulnerability index (MVI) that captures all dimensions of vulnerability—economic, social, and environmental—and countries' resilience to external shocks (United Nations, 2020b). A representative high-level panel of experts was established in February of 2021 to develop this index. The panel concluded its work in September 2023 and the final report was published in February 2024 (United Nations, 2024)[6]. In December 2023, the UN General Assembly requested the UN Secretary-Genera to (i) launch an intergovernmental process to consider the recommendations presented in this report, its applicability, scope, custodianship and governance, and ways to improve it further to allow for its implementation; (ii) assess the current consideration of multidimensional vulnerability within the United Nations system, explore the potential uses and applications of the MVI, and inform the intergovernmental process (United Nations, 2023b). Among other UN entities, the UN Trade and Development (UNCTAD) has initially explored the potential uses of the MVI, demonstrating its application and identifying associated challenges (i.e., data availability) and shortcomings in the current MVI design proposed by the panel (especially the non-inclusion of indicators of financial external vulnerability and debt sustainability).

While the MVI was initially requested by SIDS, developing countries generally stand to benefit from a vulnerability index that considers all dimensions of vulnerability and the degree of resilience to external shocks. Therefore, if such an index is adopted as an eligibility criterion in the lending policies of multilateral and regional development banks, developing financial

institutions, and Official Development Assistance (ODA), it can improve inclusivity and fairness in access to official external finance. Moreover, its universal application is crucial to ensure comparability between SIDS and other country groups, further enhancing its potential to promote equity in development finance.

[5] For example, only 11 out of 38 SIDS are eligible for the World Bank's IDA. Moreover, an income threshold is also the eligibility criteria for the IMF's Resilience and Stability Trust (RST), which was established to help low-income and vulnerable middle-income countries build resilience to balance-of-payments shocks—including those related to long-term challenges, such as climate change—and ensure a sustainable recovery from the COVID-19 pandemic. See (IMF, n.d.)

[6] For more information on the MVI, see (United Nations, n.d.)

Within the two financially integrated groups, the terms on which private external finance can be accessed differ widely. All FMEs' sovereigns are non-investment (or speculative grade) issuers, which have filled the void in the high-yield segment left by most EMEs during the capital flows boom after the GFC. In that context, global investors sought out FMEs' sovereign bonds in search of higher yields as returns on EMEs' sovereign bonds decreased due to a fall in the country-risk premium in the global bond market. This fall was associated with the strategy of some EME sovereigns after the financial crisis of the 1990s of decreasing the currency mismatch in their balance sheets - and, consequently, the vulnerability to external shocks - through pre-emptively building up foreign currency reserves and repurchasing external sovereign bonds. This trend, along with the adoption of market-friendly macroeconomic policies[7] that improved the country's macroeconomic fundamentals in the view of CRA, contributed to the upgrade to the investment grade of many EMEs' sovereigns[8]. CRAs have also a critical role in the integration of FMEs into the global capital market as acquiring a credit rating is a prerequisite for a debt issuer to participate fully in this market[9].

The relevance of the exposure of different profiles of developing countries to different classes of creditors can be seen in the data on the net transfers on the Public and Publicly guaranteed (PPG) of developing countries.

For example, in 2020, multilateral flows soared to US$51.5 billion due to the countercyclical role of multilateral and regional development banks amid the COVID-19 pandemic, but this level was not sustained in the following years, falling to a range of US$ 35-40 billion in 2021-2022. Bilateral flows also increased in 2020, reaching US$ 6.4 billion compared to a negative net transfer of US$ 3 billion in 2019, but decreased to U$S 4.8 billion in 2021 and US$ 2.6 billion in 2022. As the positive net transfers by official creditors (US$ 43 billion) were insufficient to compensate the negative net transfers by private creditors (US$ 67 billion), developing countries faced a negative net transfer on the PPG debt of US$ 25 billion in 2022 (Figure 5.1).

However, there were significant variations across the three country groups due to the different depth and profile of financial integration (Figure 5.2). As expected, EMEs faced a greater withdrawal of resources by private creditors that resulted in a total negative transfer of U$S 32 billion. FMEs were very vulnerable to the deteriorating global financial conditions with many of them losing market access in 2022 (UNCTAD, 2023). Consequently, they also faced a net negative transfer by private creditors that was compounded by net negative transfers from bilateral creditors. Multilateral creditors provided resources for this group, but it was insufficient to compensate for the withdrawal from the other classes of creditors, resulting in a total net negative transfer of U$S 2.2 billion. The ODE group recorded positive total net transfers in 2022 (of US$ 10.2 billion) because the positive net transfers by bilateral and multilateral creditors were greater than the withdrawal of resources by private creditors (US$ 3.2 billion).

As idiosyncratic factors may influence one year's performance, the net transfers on PPG debt in the three-years before the COVID-19 pandemic (2017-2019) and the three first years of the cascading crises (2020-2022) are compared. Considering the 3-year averages for the 3 groups of creditors, the net positive transfers of US$ 57 billion from private creditors in the pre-pandemic years turned into a net negative transfer of US$ 33 billion in the following period. By contrast, the total official net transfers increased by 58 per cent - from US$ 29.6 billion to US$ 47 billion

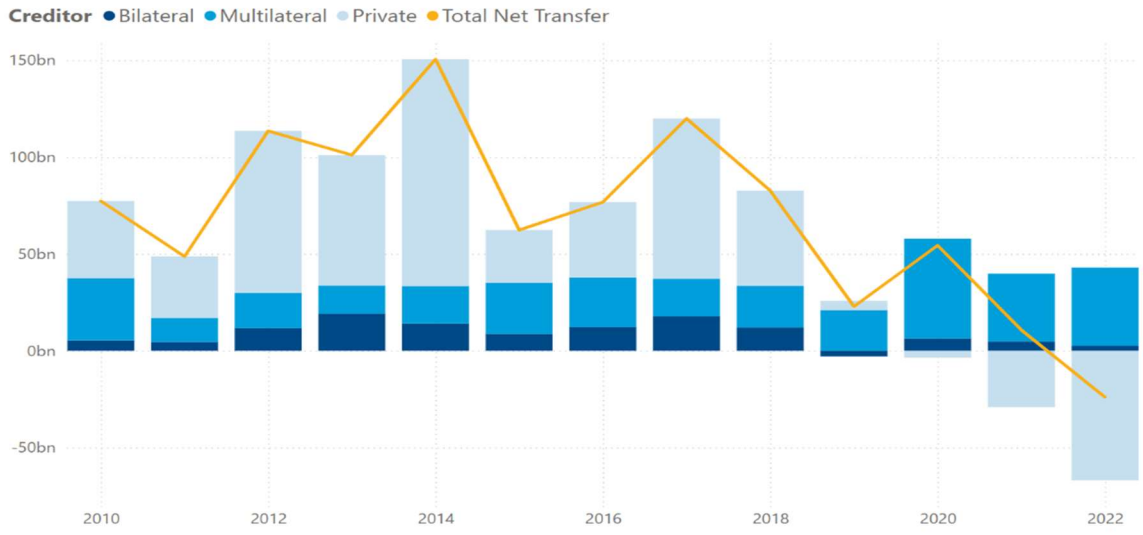
[7] These policies are inflation targeting, flexible exchange rates and fiscal austerity, the so-called macroeconomic tripod adopted by most EMEs after the financial crises of the 1990s.
[8] UNCTAD (2024) analysis found that market movements sometimes lead and sometimes follow ratings decisions and that the causality between the two is unclear.
[9] Some 54 developing countries remain unrated (UNCTAD, 2024).

between the two periods - because of a significant rise in multilateral creditors' net transfers – which more than doubled, from US$ 20.6 billion to US$ 42.3 billion - while bilateral transfers fell by almost 50 per cent (from US$ 9 billion to US$ 4.6 billion).

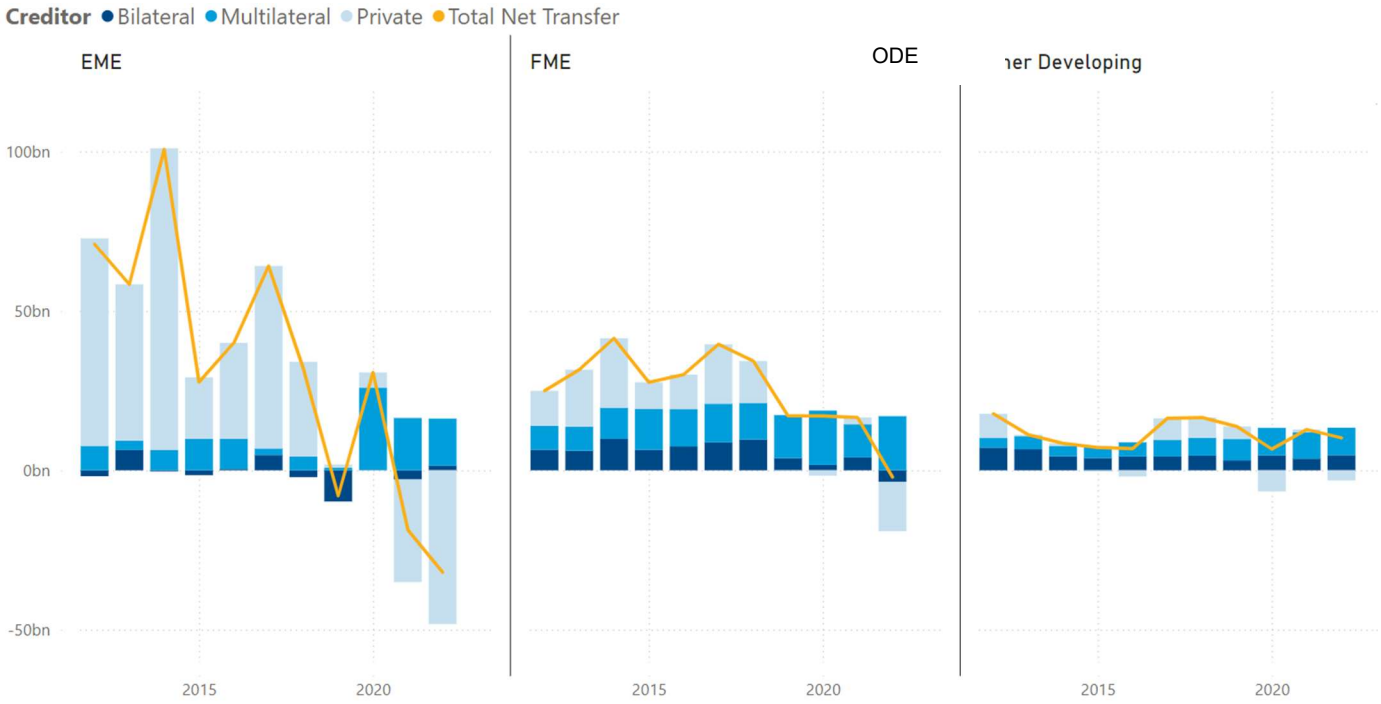
As a result, the share of multilateral flows in the total official flows grew from 70 per cent to 90 per cent between the two periods. Therefore, the two classes of official creditors had opposite behaviors during the cascading crises: bilateral creditors behaved pro-cyclically, as did private creditors, while multilateral creditors performed a counter-cyclical role. However, this was insufficient to compensate for the withdrawal of resources by private creditors and the dwindling net transfers by bilateral creditors. The total net transfers on the PPG debt shrunk from US$ 86.5 billion in the pre-pandemic period to US$ 13.7 billion during the cascading crises. This stemmed from the behavior of total net transfers for the three groups of countries. Even the least integrated ODE group that depends more on official transfers received less resources in the second period (US$ 15.5 billion and US$ 9.9 billion, a fall of 37 per cent). But, as expected, the deterioration was greater for the more financially integrated groups. For EMEs, total net transfers changed from an inflow of US$ 29.3 billion in the pre-pandemic period to an outflow of US$ 6.67 billion amid the cascading crises. For FMEs, the total net transfers remained positive, but decreased by 65.4 per cent (from US$ 30.3 billion to US$ 10.5 billion).

Figure 5
Net transfers on PPG debt by creditor
(Billions of US Dollars)

5.1 All developing countries excluding China



5.2 Country groups



Source: UNCTAD calculations based on World Bank *International Debt Statistics*
Note: Net transfers refer to new disbursements minus debt service.

BOX 2 – International Development Cooperation

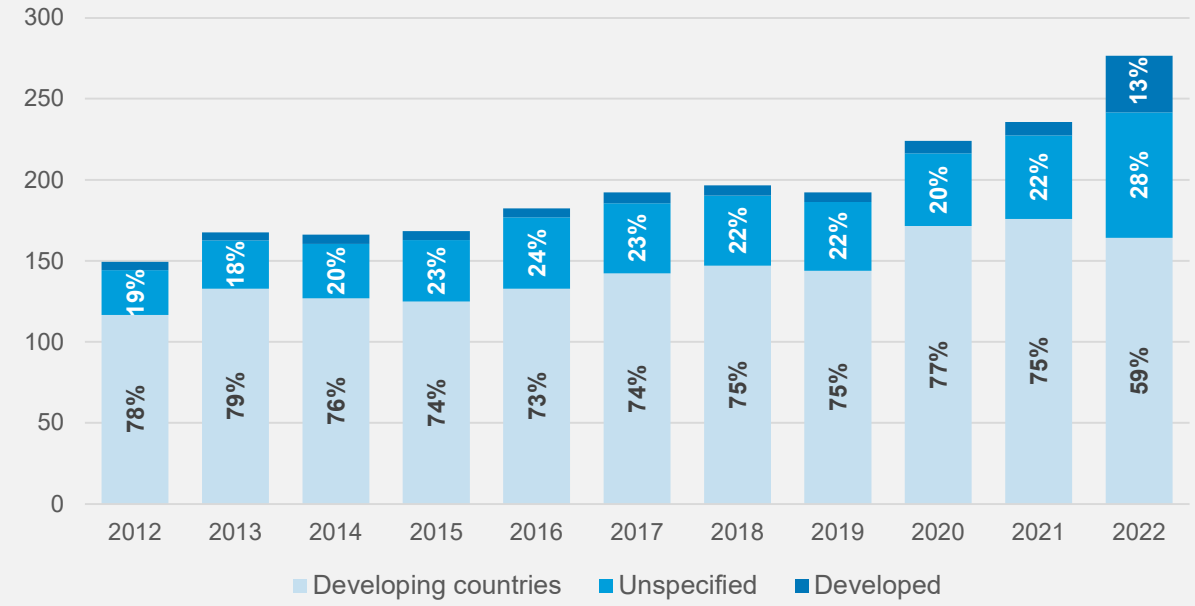
International financial cooperation plays an important role in providing affordable and long-term official external finance and complementing developing countries' efforts to mobilize public resources domestically, especially in the poorest and most vulnerable countries with limited domestic resources. The main instruments of this cooperation are official bilateral and multilateral credit flows and official development assistance (ODA). However, they fall short of developing countries' financing needs to meet their development and climate challenges.

Recent trends in ODA show that while total ODA reached a record level of US$ 277 billion in 2022 it remained short of the SDG 17 aid target of 0.7 of Developing Assistance Committee (DAC) countries' gross national income[10]. Only four DAC countries (Luxembourg, Sweden, Norway and Germany) achieved this target in 2022. Moreover, aid flows to developing countries amounted to US$ 164 billion in 2022, a fall of 7 per cent from 2021 (or US$ 12 billion), the greatest decline since 2012. By contrast, ODA towards developed countries and "unspecified" recipients (including spending on asylum seekers and refugees in donor countries) increased 88 per cent, in response to the war in Ukraine. Consequently, the share of total ODA flowing to

[10] In 1969, the Pearson Commission proposed a target of 0.7 per cent of donor GNP to be reached "by 1975 and in no case later than 1980." This suggestion was taken up in a UN resolution on 24 October 1970. The target built on the DAC's 1969 definition of ODA. With the revised System of National Accounts in 1993, gross national product was replaced by gross national income (GNI), an equivalent concept. DAC members' performance against the 0.7% target is therefore now shown in terms of ODA/GNI ratios. See (OECD, n.d.).

developing countries decreased from 75 per cent to 59 per cent in 2022, a record low in the past decade (Figure 6.1)[11].

Figure 6.1
Total ODA disbursements by status
(Billions of US Dollars)

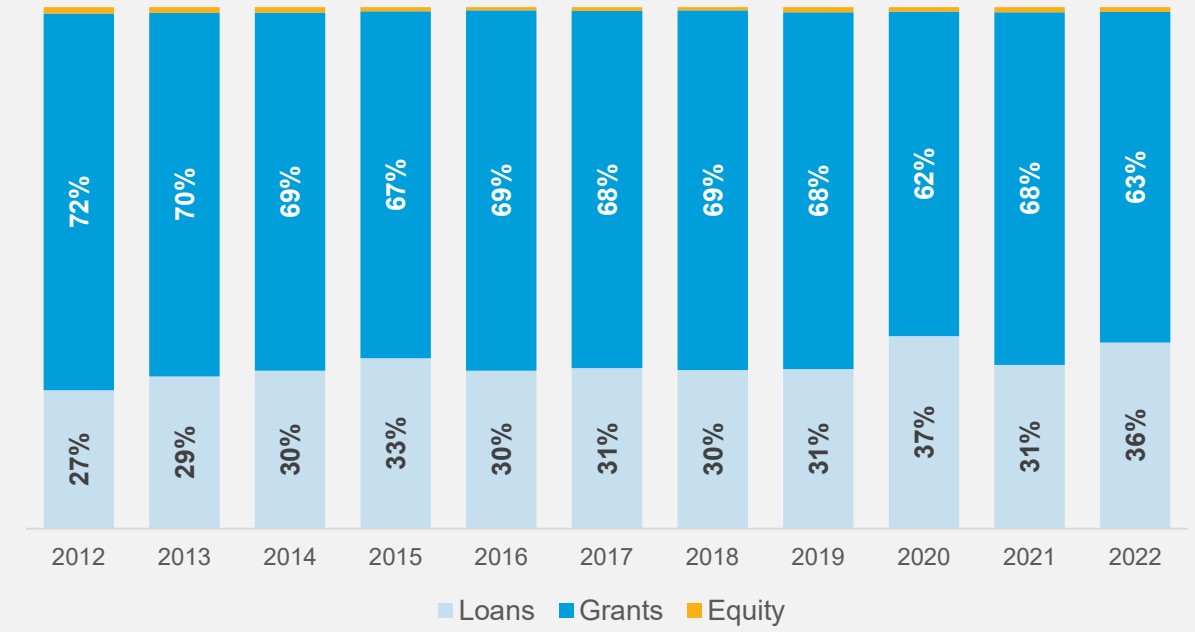


Source: UN Global Crisis Research Group (GCRG) based on OECD (Dec. 2023)

The ODA landscape has undergone shifts that are detrimental to the development prospects of eligible developing countries. First, a growing share of ODA is now provided through concessional loans rather than grants. The share of loans in aid for developing countries increased from 27 per cent in 2012 to 36 per cent in 2022 while the share of grants declined from 72 per cent to 63 per cent in the same period (Figure 6.2). Second, resources allocated to actions related to debt, including debt relief, swaps, restructuring and others, hit a historical low of US$ 316 billion or 0.2 per cent of total ODA in 2022 (compared 3.5 per cent and US$ 4.1 billion in 2012).[12]

[11] ODA data presented in this BOX include ODA flows in the forms of grants, loans and equity investments reported to the OECD-DAC by DAC and non-DAC bilateral and multilateral donors. Hence, many development partners that do not report to the OECD-DAC (e.g. China and India) are not covered in the analysis.
[12] For a detail analysis of ODA recent trends, see United Nations (2024).

Figure 6.2
ODA by instrument
(Percentage of total)



Source: UN Global Crisis Research Group (GCRG) based on OECD (Dec. 2023)

b. Stage 2: Debt issuance

Crucial to this phase is the transparency of cost and contractual terms which govern the relationship between borrowing countries and creditors. Although there have been innovative improvements in related financial instruments (such as State-contingent clauses), there is still room for improvement.

There is a steep learning curve for countries newly integrated into financial markets, and those that have been relatively integrated for decades are more likely to have the technical capacities to deal with the complexities of debt issuance and all that follows.

A general adoption of the UNCTAD Principles for Responsible Sovereign Lending and Borrowing (2012) would be a useful first step in guiding integration in global financial markets. A borrower's club where sovereigns could share experiences and expertise would also be useful.

c. Stage 3: Debt management and tracking

While countries have been increasingly empowered to upskill and resource debt management offices to record, report and manage their debt (including through the technical assistance provided by the UNCTAD Debt Management Financial Analysis System, DMFAS) – which is essentially a global public good - technical barriers remain. In the same way that the debt landscape of creditors and instruments are dynamic, skills and systems also need to be dynamic, and continually upgraded. Moreover, countries that are intending to undertake debt issuance –

whether domestic or foreign – need to have well-structured and resourced debt management offices in place.

Increasingly, debt management systems can provide sensitivity analysis and identify foreign exchange risks, but the quality and comprehensiveness of data – including for subnational government and State-owned and parastatal enterprises – remains crucial to better assess their vulnerabilities and evaluate the debt sustainability analysis required by IMF. This is especially critical for FMEs and ODEs.

d. Stage 4: Debt servicing, repayment and resilience

Ideally, debt servicing should go smoothly but the frequency of external shocks, including those that are climate-related, can derail the process.

Creating innovative financial instruments - such as hurricane or disaster clauses - can be helpful for managing debt, but even the most effective of tools need improving to ensure resilience. Moreover, these innovations are not invoked in all new contracts, and the vast majority of existing contracts have been designed without them. In addition, limited access to the global financial safety net (GFSN) may hinder rather than improve resilience in countries heavily affected by climate change. Section IV further explores the differential access to the GFSN.

e. Stage 5: Debt resolution or workout

In the best-case scenario within the life cycle, debt is repaid or easily and affordably rolled over. This is referred to as resolution. If not, the country may have to seek a debt workout, which could involve suspending the debt servicing agreement, extending the maturity, reducing interest rates and/or cancelling the debt outright (i.e. a haircut or a reduction in the value of the collateral).

While the G20 Common Framework has evolved during the four cases where countries sought relief through this mechanism, it is common cause that the process has been heuristic for borrowers and creditors alike. It is noted that the G20 IFA WG, under the Brazilian Presidency, are completing a note on *Lessons from the Common Framework*, and we do not consider this further here, except to mention that three of the countries, Ethiopia, Ghana, and Zambia that applied for the Common Framework are part of the FME profile. Chad is classified as an ODE.

BOX 3 – New York Sovereign Debt Stability Act

In the absence of a sovereign debt workout mechanism, mounting debt difficulties and restructurings across countries has increased the need for practical solutions. According to the World Bank, over the past three years alone, 18 sovereign defaults have occurred in 10 developing countries, surpassing the total of the previous two decades (World Bank, 2023). For this reason alone, proposed legislation in New York State Legislature entitled the "Sovereign Debt Stability Act" has attracted much attention. It aims to facilitate sovereign debt restructurings that would apply to claims governed by New York Law. Almost half of all outstanding sovereign bonds are governed by New York law,

The Act is currently under deliberation for the 2024 legislative session closing in June 2024 and combines aspects of two previous proposals that were advanced in 2021 and 2023. If the Act is entered into force, it would become Article 8 of the New York Banking law. This would have widespread implications given that New York state laws currently govern an estimated US$800 billion in global sovereign bonds which constitutes about 52 per cent (IMF, 2020a) of the market, and sovereign bonds are by far the largest category of sovereign debt whose terms are governed or enforced by New York law (White & Case, 2024).

The Act aims to create a greater degree of predictability and efficiency by facilitating sovereign debt restructurings via:

1. Establishment of a comprehensive mechanism to restructure sovereign debt.
2. Enforce comparable treatment of creditors by setting the maximum judicial recovery threshold to be equal to what is agreed by official bilateral lenders. This would impede private creditors from obtaining a better deal than that of the US government should they be party to an agreement.

Legal opinion (White & Case, 2024) suggests that the Act, among others, will:

- Permit the sovereign to self-certify that the debt is unsustainable as opposed to current practice whereby the IMF makes that determination based on its debt sustainability analysis.
- Allow for retroactive application of the law may impede creditor rights and may invite challenges under the US Constitution "contract clauses".
- Regulate the grouping of claims, where: i) official cannot be classed with private; ii) New York law cannot be grouped with other claims; iii) only non-New York claims can be subject to restructuring if the creditor opts in; and
- Introduce a new level of ambiguity and uncertainty as details as to what burden sharing standards will translate in practice (Lee and Gill, 2024), which may prompt moves to other jurisdictions where contractual rights are more easily enforced.

Critiques of the potential legislation also include concerns that the new legislation might disrupt sovereign debt markets and contribute to increased cost of financing for sovereign issuers as well to reduce liquidity in sovereign debt markets (ICMA, 2024). Others have suggested the legislation will serve to add yet another layer of complexity to an already complicated debt landscape (Fieser and Song, 2024) and that if existing investor provisions in New York law become undone, competitive shifts to other jurisdictions would jeopardize New York's role as the gold standard for debt legislation (ICMA, 2024).

Proponents of the proposed Act have pointed out that similar concerns around the increased cost of finance were raised when Collective Action clauses (CACs) were introduced, however, an IMF report found “that market participants do not associate the use of CACs and enhanced CACs with borrowers’ moral hazard, but instead consider their implied benefits of an orderly and efficient debt resolution process in case of restructuring.” (IMF, 2020b). However, differences already exist between jurisdictions; for example, the UK, Belgium and France have already adopted various provisions to target hold out creditors.

As the largest market of sovereign bond issuance, the NY State legislature is acting to address a gap in their legislation that exposes other aspects of their financial markets, namely bond holders and investment funds, to risk and drawn-out financial losses in the absence of a debt resolution mechanism. It is the responsibility of State legislators to appropriately regulate the financial transactions within their jurisdiction and the current system at the national and international level fails to address sovereign borrowers. Outlining predictable rules for restructuring is likely to *reduce* uncertainty in moments of debt distress and facilitate faster resolution, thus lowering the cost of delayed restructurings. It is possible that further refinement of the language may clear up some of these ambiguities.

Importantly, this Act would also enable middle-income countries to benefit from debt treatment who are otherwise ineligible to benefit under the G20 Common Framework or past debt relief initiatives such as HIPC (Buchheit and Gill, 2024).

In conclusion, considering the size of the sovereign bond market in the NY it is in the interest of both issuers and investors to have a comprehensive and robust legal framework that is equipped to resolve issues more efficiently to minimize loss of value in times of debt difficulty. Moreover, from a development perspective, facilitating orderly and timely debt restructuring minimizes social and economic costs and reduces the period of economic dislocation. However, like other measures, it constitutes a partial solution. Finally, from a global perspective, while international coherence is ideal, state-level action is necessary in the absence of a global mechanism. The Act alone will not constitute a comprehensive solution for a sovereign debt restructuring, but it may provide certain advantages of clarity during uncertain times.

The following two sections will delve into two stages of the sovereign debt life cycle. Section III addresses *Stage 1*, examining the differential access of the three profiles of developing countries to external finance and their consequence for external sovereign debt vulnerability in the medium and long run (i.e., external solvency). Section IV analyses *Stage 4* that refers to debt servicing, repayment, and resilience, focusing on the inequities in the access to the Global Financial Safety Net (GFSN) across the three country groups and their differential capacity to service and repay debt. These two stages are closely interlinked: on the one hand, the type of access to external finance determines its cost and maturity and, consequently, has a critical influence in the country’s capacity to service and repay its debt; on the other hand, resilience to external shocks through access to the GFSN may prevent a temporary liquidity crisis transforming into an external solvency crisis.

III. Developing country profiles and access to markets

The cascading crises laid bare the asymmetry between the two financially integrated country profiles (EMEs and FMEs) in accessing external finance. FMEs issue speculative-grade sovereign bonds that offer high-yield assets for global investors, but also have greater spread volatility since they are the first to be sold off during global financial shocks. Given that many pension funds are precluded from investing in non-investment grade debt instruments, more speculative asset managers and investors (such as hedge funds) predominate in the case of ownership of FME securities. Speculative securities are also more prone to being re-graded more frequently by credit rating agencies.[13]

Consequently, FMEs' external sovereign bonds faced greater repricing and sharper spread swings than EMEs. Gradually, more FMEs joined the group of distressed issuers. Most countries that lost market access (indicated by spreads above 1.000 basis points) between 2019 and mid-2023 were FMEs. These sharper swings also took place when global financial conditions improved between the last quarter of 2023 and the first quarter of 2024, driven by expectations of interest rate cuts in the United States. As FMEs' sovereign bond prices reached record lows, global investors again bought in, resulting in compression of their spreads closer to those of EMEs[14] (Figure 7).

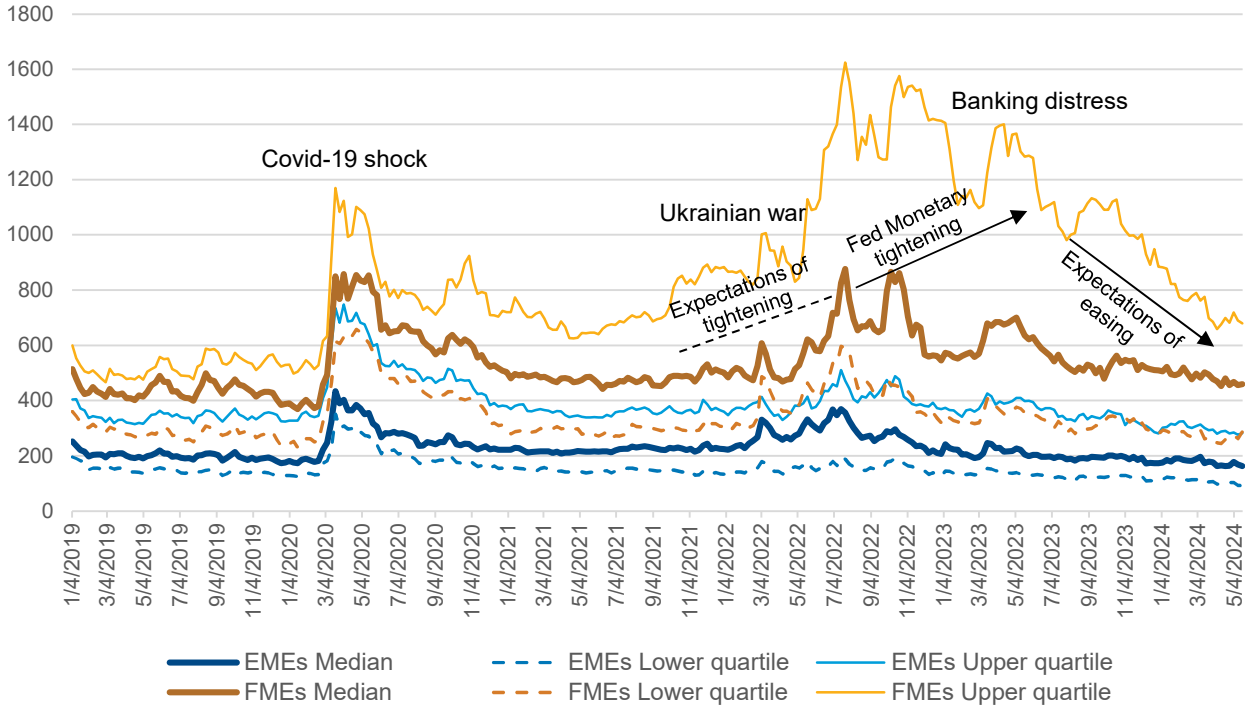
Therefore, FMEs' sovereigns have gained access to the global capital market at a high cost. The surge in bond issuance over the past decade was at the core of these countries' massive accumulation of external public and publicly guaranteed (PPG)[15].

In 2023, FMEs' PPG debt reached an estimated US$ 684 billion in 2023, marking a threefold increase since 2010 compared to 2.4 times for EMEs and 1.8 times for the third country group. As a share of FMEs' total debt in 2023, the PPG debt responded to 56 per cent, respectively. These shares were much lower in the other two groups (36 per cent for EMEs and 23.5 per cent for ODEs).[16]

[13] See Rossi and Kraemer (2024).
[14] See Cotterill (2024).
[15] For a detail analysis of the drivers of FMEs integration into international capital markets, see UNCTAD (2023), ch. II.D. (UNCTAD, 2024).
[16] UNCTAD Secretariat calculations based on World Bank International Debt Statistics.

Figure 7
Spreads with respect to the Treasuries of the United States, selected country groups
(Basis points)

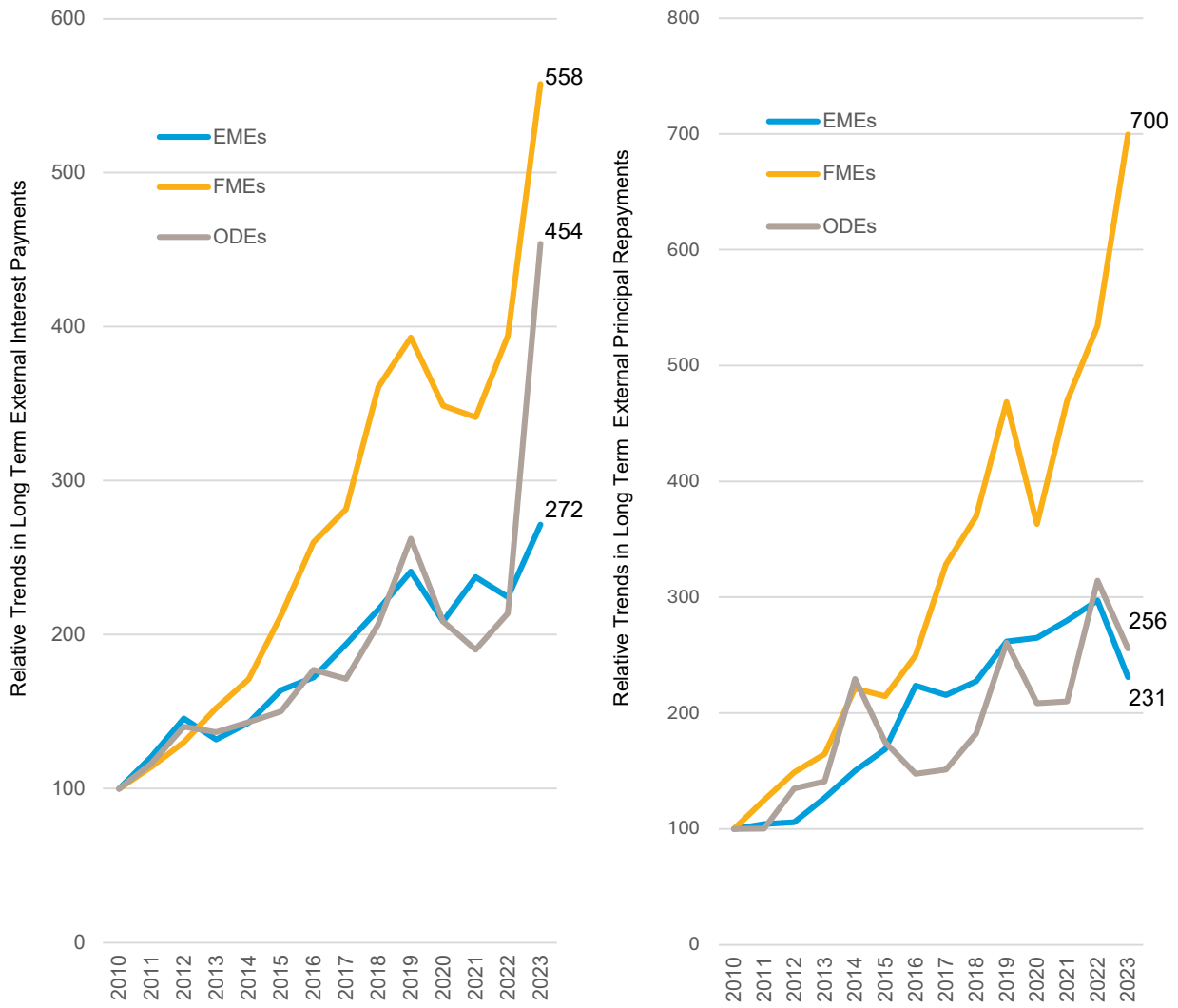
Source: UNCTAD calculations based on JP Morgan Emerging Market Bond Index (EMBI) data.



Note: Medians and quartiles are based on the country-level data available in JP Morgan EMBI–Global Diversified.

The vulnerability of FMEs to global capital market developments over the past decade is illustrated in Figure 8. Both FMEs and ODEs experienced sharp increases in external interest payments in 2023 in response to significant monetary tightening, with the former rising by 42 per cent and the latter by 112 per cent. However, the external interest costs of FMEs consistently increased at a faster rate than both EMEs and ODEs between 2010 and 2023, rising by almost 300 per cent compared with increases of around 110 per cent for the other two groups over this period – see Figure 8 (left).

Figure 8
Relative trends in long-term external interest payments (left) and long-term external principal repayments (right) of EMEs, FMEs and ODEs
(Index: 2010 = 100)



Source: UNCTAD calculations based on World Bank *International Debt Statistics*

While both EMEs and ODEs were able to offset higher external interest costs in 2023 by reducing their principal repayments, FMEs were unable to do so. Their principal external debt repayments rose by 31 per cent compared with reductions of around 20 per cent for the other two groups – see Figure 8 (right). Between 2010 and 2023, the principal repayments of FMEs rose by 600 per cent, compared with 156 per cent for ODEs and 131 per cent for EMEs.

The development classification of FMEs and their access to global capital markets means that they are generally unable to source capital at concessional rates and are forced to borrow at market rates that embody higher risk perceptions. The term of their long-term external lending is also generally shorter, averaging 7 years in 2023, compared with over 10 years for EMEs and almost 26 years for ODEs. Table 1 shows the recent trends in external borrowing terms of the

three groups of developing countries. Whereas both EMEs and ODEs were able to extend the term of their long-term external debt in 2023 in the face of higher interest costs, FMEs' borrowing term consistently decreased between 2020 and 2023.

Table 1
Average term of long-term debt in years

Developing Country Group	2020	2021	2022	2023e
Emerging Market Economies	8.41	8.19	7.49	10.13
Frontier Market Economies	12.83	10.32	9.11	7.00
Other Developing Economies	30.29	30.13	19.93	25.73

Source: UNCTAD calculations based on World Bank *International Debt Statistics*

The net result of these developments was that the total external debt service costs of FMEs increased by 548 per cent between 2010 and 2023 (an average of 15.5 per cent a year), compared with 174 per cent (8.1 per cent per year) and 121 per cent (6.3 per cent a year) for ODEs and EMEs respectively.

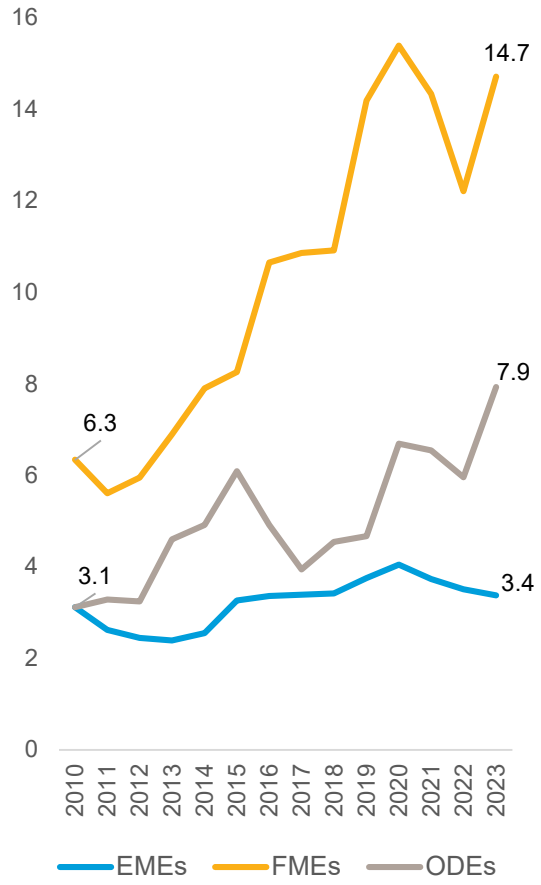
Consequently, FME's sovereign external debt build-up has been accompanied by an increasing sovereign debt service that shrinks available resources for crucial public expenditures. Debt service on PPG debt relative to government revenues surged from almost 6.3 to 14.7 per cent between 2010 and 2023. In contrast, for EMEs, this figure stood at around 3 per cent. The indicator also grew in the third group, but it reached 7.9 per cent in 2023 – a little more than half the FMEs' figure (Figure 9.1).

However, group averages conceal differences across countries. Considering the top 25 developing countries with the highest PPG debt service to government revenue ratio in 2023, two were EMEs, 10 were FMEs, and 13 were in the ODE group. This means that sovereigns from this last group are also facing high debt vulnerabilities, particularly those with lower-middle and low-income levels. Among these 13 countries, only two are upper-middle income (Belize and Mauritius)[17] (Figure 9.2).

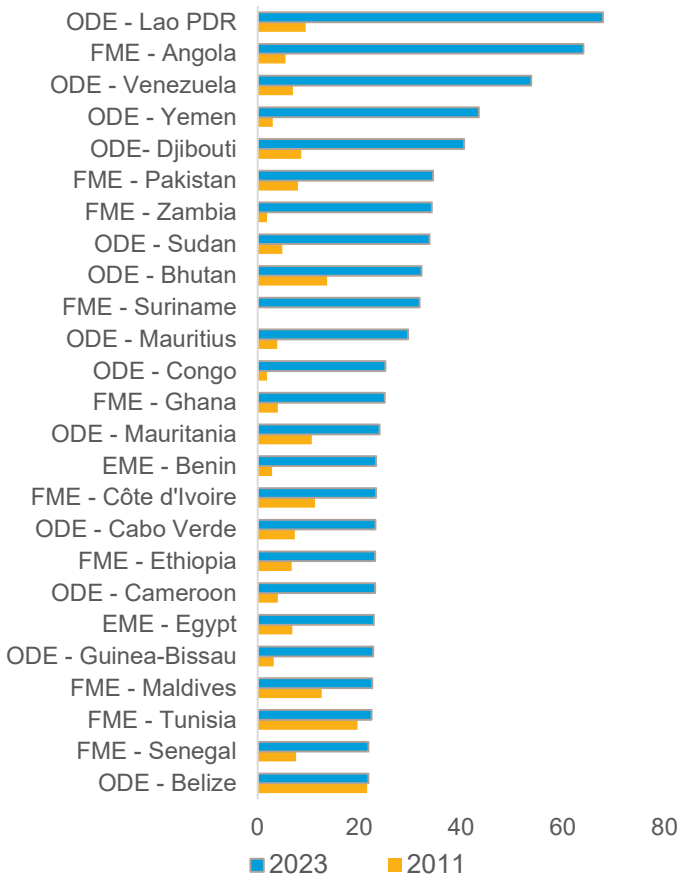
[17] Belize was an FME until its default in 2021, when it was excluded from the JP NEXGEN Index.

Figure 9
Public and publicly guaranteed external debt service relative to government revenue
(Percentage)

9.1 Selected country groups



9.2 Top 25 within all developing countries in 2023



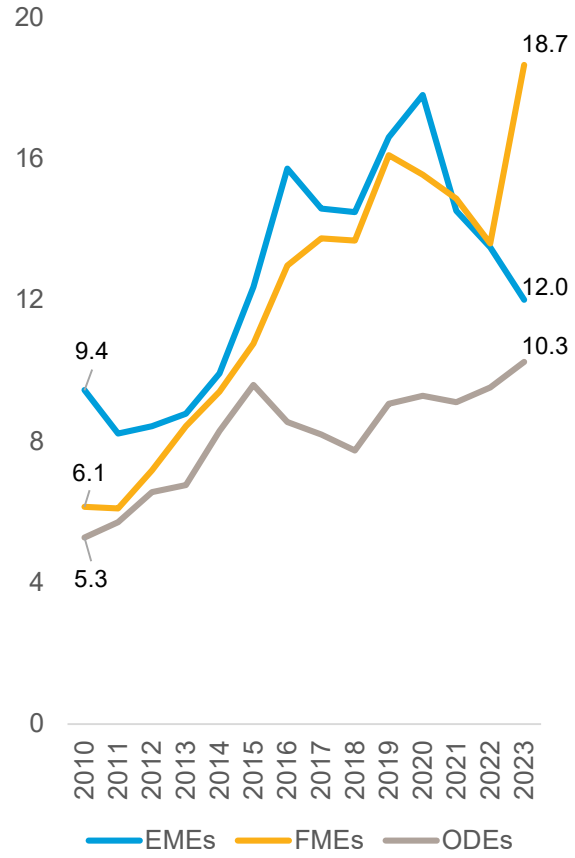
Source: UNCTAD calculations based on World Bank *International Debt Statistics* and IMF *World Economic Outlook*.
Note: In panel B, 'EME, 'FME', and 'ODE' refer to, respectively, emerging market economy, frontier market economy and Other Developing Economies.

Increased external public debt with high costs has contributed to the deterioration of the external solvency of FMEs. The ratio of external debt service to exports in this group rose from about 6 to 18.7 per cent between 2010 and 2023 compared to 12 per cent for EMEs and 10 per cent for ODEs in 2023 (Figure 10.1). To provide context, these aggregate figures are double or even triple the threshold established by the 1953 London Agreement on restructuring Germany's war debts[18]. Furthermore, among the 25 countries with the highest proportion of export earnings allocated to total external debt service in 2023, almost half (12 countries) were FMEs, 7 were ODEs (only one upper- middle income) and 5 were EMEs (Figure 10.2).

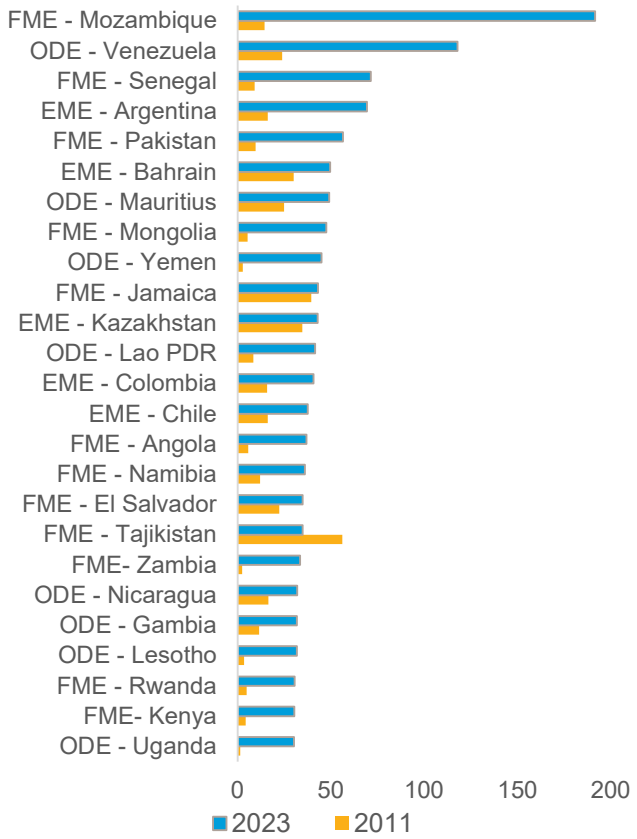
[18] This agreement limited the portion of export revenues that could be allocated to external debt servicing to 5 per cent of the total with the aim of ensuring the post-war recovery of West Germany (UNCTAD, 2015).

Figure 10
External debt service relative to export revenues
(Percentage)

10.1 Selected country groups



10.2 Top 25 within all developing countries in 2023



Source: UNCTAD calculations based on World Bank *International Debt Statistics* and IMF *World Economic Outlook*.
Note: In panel B, 'EME, 'FME', and 'ODE' refer to, respectively, Emerging Market Economies, Frontier Market Economies and Other Developing Economies.

Summing up, the asymmetry across the three profiles of developing countries in accessing external finance in *Stage 1* has resulted in different costs of servicing sovereign external debt, which has critically influenced each group's external debt solvency. These costs will have crucial spill overs on *Stage 4* where debt servicing, repayment, and resilience come into play. This will be analysed in the following section.

IV. Developing country profiles and their debt servicing, repayment, and resilience

Two primary factors can derail a country's capacity to service smoothly its debt. The first one, examined in section IV.a, is the frequency of external shocks, including those related to climate. In this case, access to the Global Financial Safety Net (GFSN) is critical to ensuring resilience to these shocks since addressing a temporary liquidity crisis quickly and comprehensively can prevent it from transforming into a solvency crisis. The second factor is if the growth rate of the debt service costs is higher than the growth rate of the revenues generated for servicing the debt (discussed in Section IV.b).

a. Resilience to external shocks: access to the Global Financial Safety Net

The GFSN comprises a set of institutions and arrangements on global, regional and bilateral levels that provide a temporary balance of payments finance to countries in financial distress during external financial shocks. In particular, this includes: the IMF conditional and unconditional emergency lending, the regional financial arrangements (RFAs) and the bilateral currency swaps between central banks.[19] While the IMF resourced the GFSN exclusively after World War II, after the 2008/2009 global financial crisis (GFC) the GFSN has expanded rapidly: A rising number of regional financial arrangements (RFAs) have been established, and central banks have mobilized huge volumes of bilateral temporary liquidity injections through currency swap agreements (Mühlich et al., 2022). Although the growing relative importance of such bilateral and regional elements has boosted the GFSN lending capacity, it has led to a more decentralized provision and has not necessarily enhanced its predictability. Indeed, a lack of coordination across all GFSN elements has resulted in fragmentation (IMF, 2016).

The lending capacity of the GFSN reached US$ 12 billion in 2023[20], with clear access differences between developed and developing countries and across developing country groups, particularly in terms of the range of alternative sources of liquidity and of access to disbursement of timely emergency liquidity without policy conditionalities (Figures 11 and 12)[21].

One key differential in access to the GFSN is whether a country has access to unlimited US Fed swaps, which are provided to a select group of central banks in developed countries that issue international currencies[22]. The Fed access was provided during the onset of COVID-19 because "intensification of stresses in [these countries' financial markets] could trigger unwelcome spillovers for both the U.S. economy and the international economy more generally" (Steil, Della Rocca and Walker, 2024)[23]. Countries that are in this group have the richest choice and provision of the GFSN: besides being (notionally) unlimited, Fed swaps are readily accessible and without

[19] On the contrary to the literature (e.g., IMF 2016), following the GFSN tracker methodology, we do not include international reserves – that is a national liquidity buffer - as an element of the GFSN. For details on this methodology, see Mühlich et al. (2022)

[20] UNCTAD secretariat calculations based on the GFSN tracker database. The term "lending capacity" is used to approximate available third-party crisis finance from the GFSN per country (see Zucker-Marques, Mühlich, and Fritz (2023).

[21] Zucker-Marques, Mühlich, and Fritz (2023) elaborate a composite index to analyze the GFSN's preparedness for shielding countries from financial crises and to identify a hierarchy in access to the GFSN. For a comparison of the different elements of the GFSN in terms of predictability, speed, reliability, and costs, see IMF (2016).

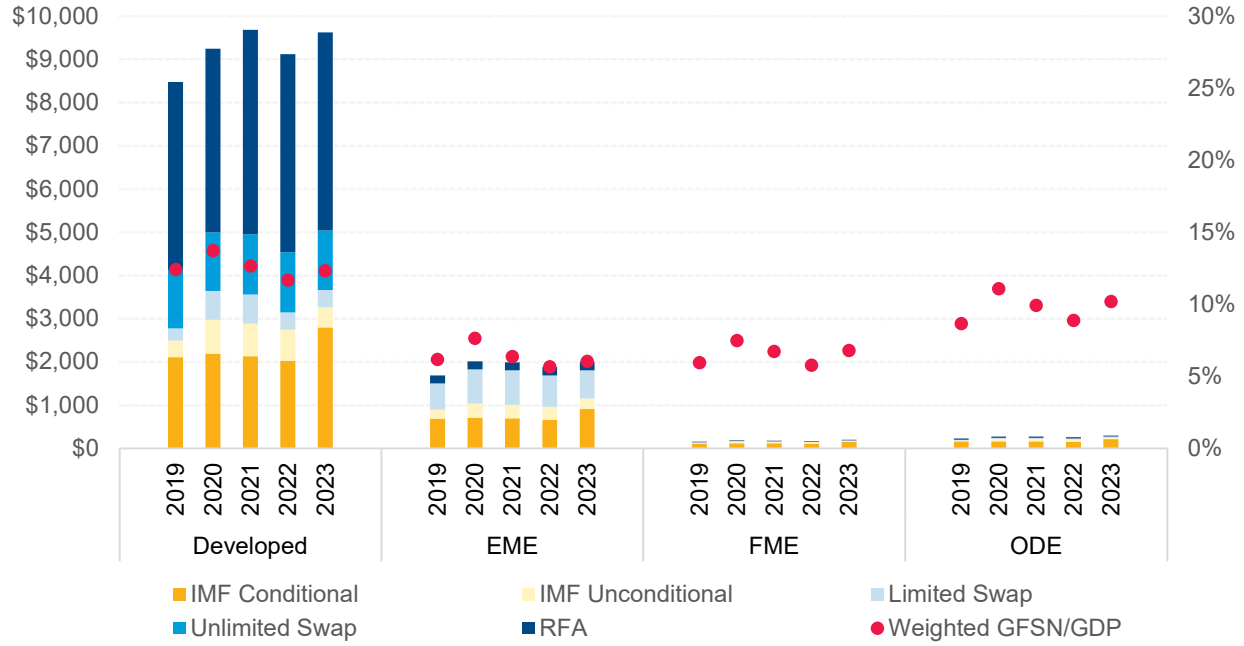
[22] During the GFC, the Fed established unlimited currency swaps lines with the key central banks of developed countries, i.e., Bank of Canada (BoC), Bank of England (BoE), Bank of Japan (BoJ), European Central Bank (ECB) and Swiss National Bank (SNB). In 2013, these became standing currency swap lines.

[23] On the reasons underlying the Fed swaps, see Aizenman, Ito and Pasricha (2021).

policy conditionalities or market stigma. Although only five countries had access to these swaps between 2020-2023, this source made up 15% of the total lending capacity of the GFSN for all developed countries during the period 2020-2023 (Figure 12).

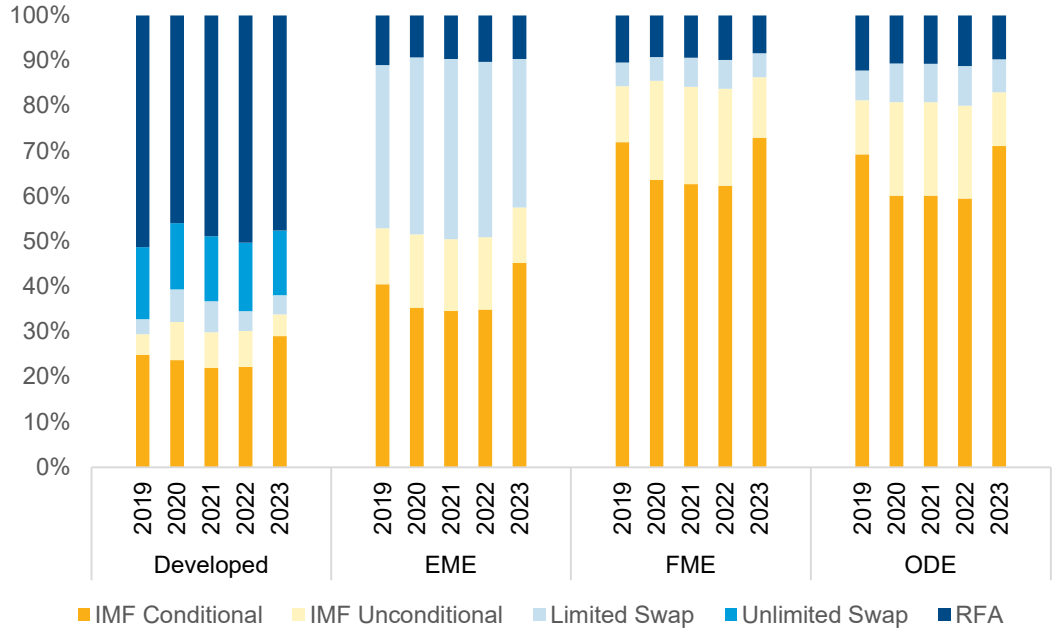
The second source of difference in access is whether a country has access to well-equipped regional funds. In the case of developed countries, the European Stability Mechanism (ESM) and other RFAs accounted for an annual average of 50 per cent of the total GFSN lending capacity for developed countries between 2020-2023.

Figure 11
Lending capacity of the GFSN
(left scale: US$ billion; right scale: as a share of GDP



Source: UNCTAD calculations based on GFSN Tracker and IMF *World Economic Outlook* (2024) databases.
Note: Weighted GFSN/GDP is the sum of group GFSN lending capacity divided by group GDP.

Figure 12
Lending capacity of the GFSN - composition
(Percentage of total)



Source: UNCTAD calculations based on GFSN Tracker

The provision of crisis finance by the GSFN is also unequally distributed across the three developing groups, who typically do not have access to the Fed swap lines (Figure 12). The access of EMEs to limited swaps, such as those with the PBOC (Public Bank of China), and central bank swaps between EMEs, provides them with greater access to emergency lines than the other two groups. These lines, while limited, are not linked to ex-post policy conditionalities, such as the IMF conditional lines and some RFA lending lines[24], and accounted for an annual average of 38 per cent of this group's total GFSN lending capacity during 2020-2023 compared to only 6 per cent for FMEs and 8 per cent for those in the ODEs category. Among EMEs, only the central banks of Mexico and Brazil had access to limited Fed swaps during the COVID-19 crisis (with a cap of US$ 60 billion)[25]. As in the case of the developed central banks, the explanation was the potential for international spillovers. For the two other developing country profiles, the main element of the GFSN was the IMF conditional lines that accounted for 65 per cent and 63 per cent of the total in this period, respectively.[26]

Following the IMF (2016), we compare lending capacity to the gross external financing needs (GEFN), which is the sum of a country's current account deficit (or surplus), the external debt service in the next 12 months and the short-term debt stock (Figure 13). Considering the average ratio of the lending capacity of GFSN to the GEFN during 2020-2023 (excluding unlimited swaps), no developing country group[27] had a coverage higher than 50 per cent. However, ODEs had the

[24]For example, drawing on more than 40 per cent of the country's maximum allocation in the Chiang Mai Initiative Multilateralization (CMIM) requires the agreement on an IMF program (Mühlich et al., 2022).
[25] For information by country of the central bank bilateral swaps and the other elements of the GFSN, see: https://www.bu.edu/gdp/global-financial-safety-net-tracker/.
[26] For a detailed analysis of the GFSN inequalities across the different World Bank income groups during the Covid-19 crisis, see Mühlich et al. (2023).
[27] Because of many data gaps, it was not possible to calculate this indicator for developed countries.

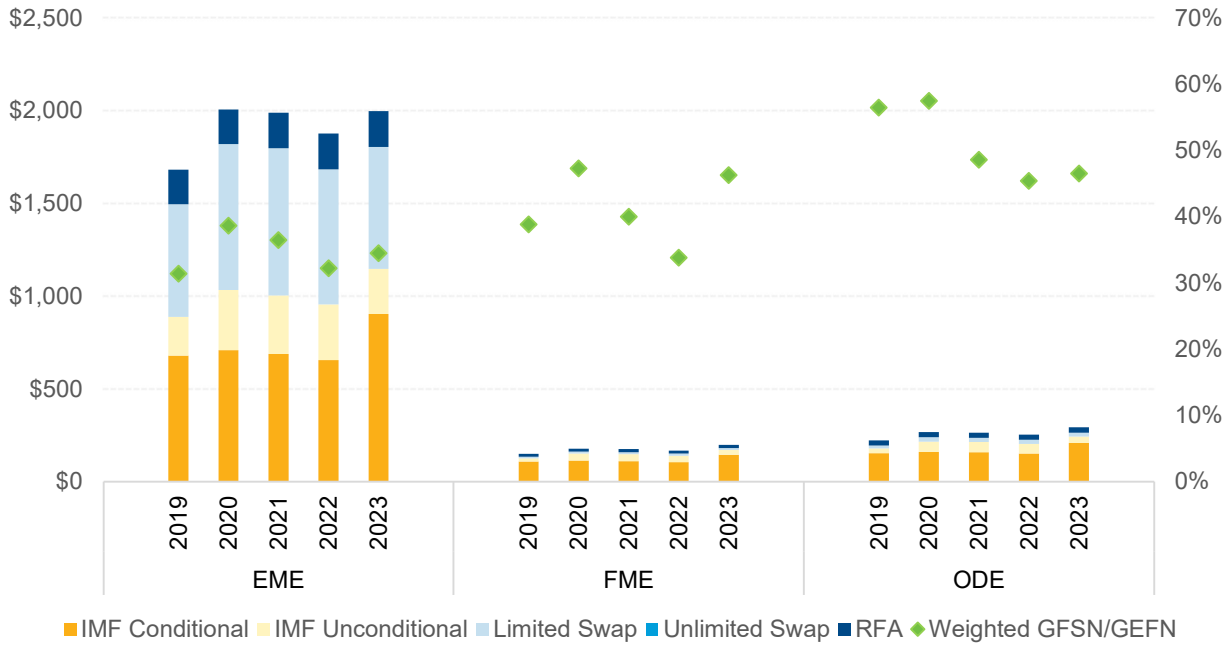
highest coverage, followed by FMEs and EMEs (48 per cent, 42 per cent, and 36 per cent, respectively). One can imply by this that in the case of an external shock, the readily available third-party finance would cover less than half of the countries' external payment obligations in the short run.

Notable in the case of average GFSN coverage of ODEs and FMEs between 2020 and 2021 was the boost provided by greater provision of unconditional IMF lines during the COVID-19 crisis in particular to the Rapid Financial Instrument (RFI) and Rapid Credit Facility (RCF) (from 50 per cent to up to 100 per cent of a country's quota per disbursement) of many developing countries. The goal of the IMF was to allow easy access to liquidity for member countries that could not access unconditional lending through facilities that require prequalification, such as the Flexible Liquidity Line (FCL) or the Precautionary Credit Line (PCL), available to some EMEs (Zucker-Marques and Mühlich, 2023). Consequently, the share of IMF unconditional lines in the total lending capacity of these groups increased from around 12 per cent in 2019 to around 21 per cent in 2020-2021. The return to the standard annual access limit means that country groups now have to rely much more on traditional IMF credit lines[28].

Although EMEs had the lowest relative GFSN coverage among the developing country groups, EMES have more options compared to FMEs and ODEs due to the greater share of limited swaps in the lending capacity provided by the GFSN. The availability of a wider choice of sources of emergency finance implies a better quality of access. Conversely, for FMEs and ODEs, IMF lines which include conditionalities, continue to predominate, making up 63 per cent of the GFSN for FMEs and 60 per cent for ODEs, even although access to unconditional lines has improved. However, this last group had a slightly higher quality of access due to the greater shares of RFAs and limited swaps in the total lending capacity (on average, 11 per cent and 8 per cent, respectively) compared to the FMEs (9 per cent and 6 per cent, respectively). In conclusion, then, FMEs not only faced the greatest debt vulnerability but also had the poorest quality of access to the GFSN during the period of cascading crises.

[28] The cumulative access limit has been extended to at least the end of June 2024 and stands at 150 per cent of the quota (IMF, 2023).

Figure 13
Lending capacity of the GFSN by developing country profile
(left scale: US$ billion; right scale: as share of GEFN)



Source: UNCTAD calculations based on GFSN Tracker and IMF *World Economic Outlook* (2024) databases.
Note: Weighted GFSN/GEFN is the sum of group GFSN lending capacity divided by group GEFN.

b. Debt servicing and repayment

The financial sustainability of a particular stock of debt will be threatened if the costs of servicing that debt increase at a faster rate over time than the rate at which the resources available for servicing it are generated. In the context of external debt, the capacity to service debt is earned through inflows on the various sub-accounts that make up a country's balance of payments. However, some of these inflows – such as inward investments through the financial account – carry servicing costs in the form of interest, dividends and royalties that give rise to subsequent outflows through the primary income account.

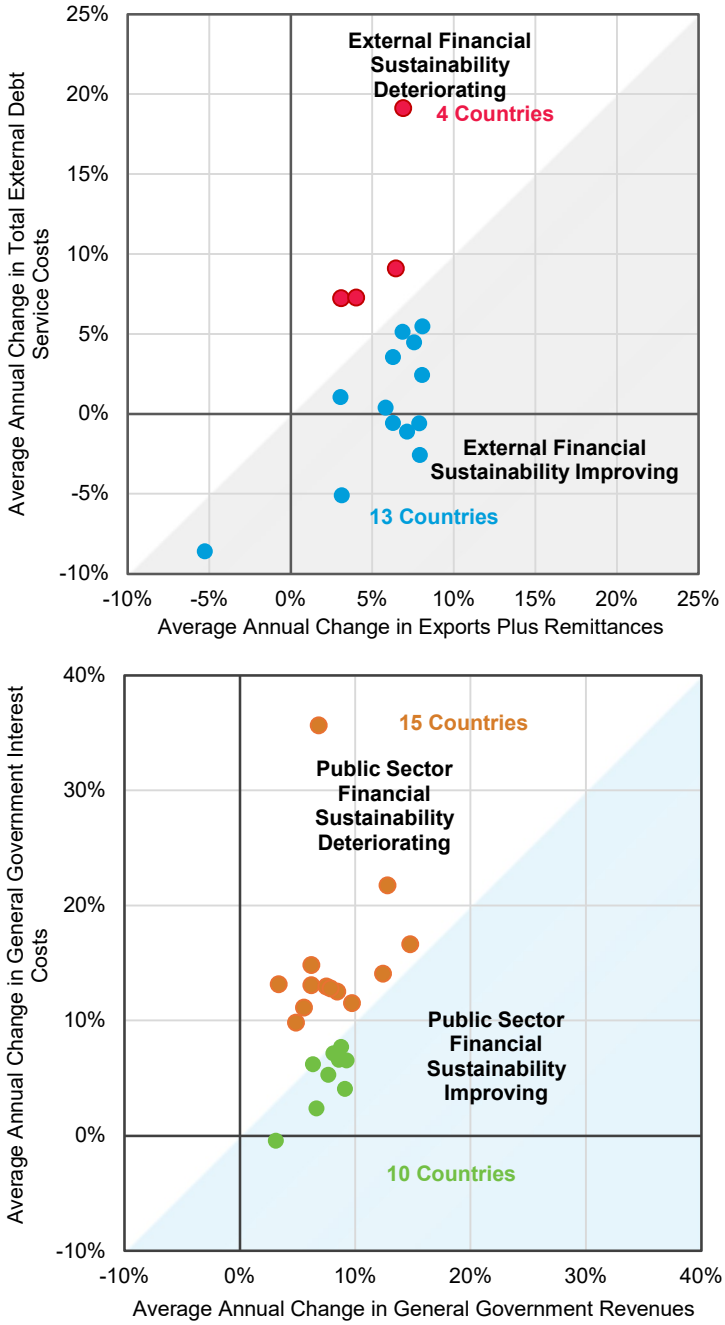
UN Trade and Development (UNCTAD) considers exports of goods and services and remittance inflows as the only sources of foreign exchange that are essentially free of cost and that can reliably and consistently be used to service external debts. So, if a country's external debt service costs are increasing at a faster rate than its exports and remittances, its external financial sustainability will be deteriorating – even if current obligations can easily be covered. Conversely, if its exports and remittances are expanding at a faster rate than its debt service costs, its external financial sustainability will be improving.

Similarly, in respect of public sector financial sustainability, if the interest and associated costs of servicing the public debt stock are increasing at a faster rate than tax and other revenues, public sector financial sustainability will be deteriorating.

Figure 14

Trends in the external (top) and public sector (bottom) financial sustainability of Emerging Market Economies

2017–2023



Source: World Bank IDS, IMF WEO, IMF GFS, UNCTAD estimates

Figure 14 reflects trends in the external (top) and public sector (bottom) financial sustainability of EMEs between 2017 and 2023. In relation to external financial sustainability, countries that experienced faster average growth in exports plus remittances than external debt service costs over this period are represented by blue dots in the shaded area, while those that experienced relatively higher average increases in debt service costs are represented by red dots in the unshaded area. Thirteen EMEs (76 per cent) – home to more than 3.8 billion people in 2023 -

experienced improving external financial sustainability over this period, while 4 EMEs – home to 200 million people - deteriorated. The median change in exports plus remittances of this group was 6.4 per cent per year, while the median change in external debt service costs was 2.4 per cent.

The analysis of EME public sector financial sustainability over the same period indicates that 15 countries (60 per cent) – represented by the orange dots in the unshaded area – experienced deteriorating sustainability, while 10 countries – represented by the green dots in the shaded area - experienced a relative improvement. The median annual increase in public sector revenues for this group between 2017 and 2023 was 8.1 per cent, while interest costs rose by 11.6 per cent per annum over the same period. The countries that experienced a deterioration in public sector financial sustainability had a combined population of over 3.8 billion people at the end of 2023, while those that experienced an improvement were home to around 325 million people.

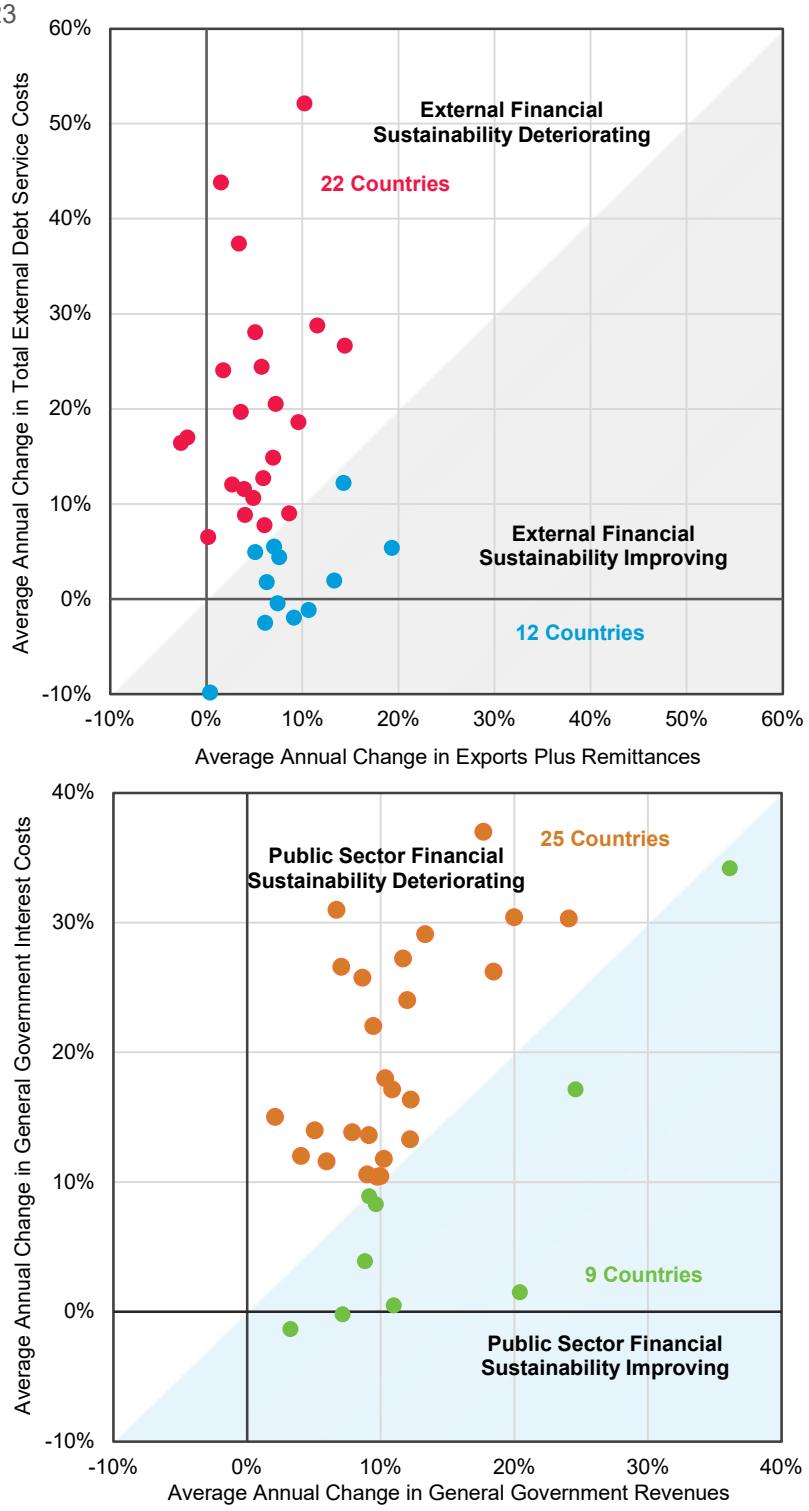
Figure 15 reflects a similar analysis for FMEs. In contrast to EMEs, most countries in this group (65 per cent) experienced a deterioration in the external financial sustainability between 2017 and 2023. In 12 of the 22 countries that deteriorated, average annual increases in debt service costs exceeded changes in exports plus remittances by 10 percentage points or more and in three cases the difference was above 30 percentage points. The median annual increase in exports plus remittances of this group was 6.1 per cent, while external debt service costs rose by 11.8 per cent per year over the same period. Almost 1 billion people resided in FMEs with deteriorating external financial positions in 2023, while only 125 million people were in countries with improving positions.

The deterioration in public sector financial sustainability of this group was more pronounced. Twenty-five of the 34 FMEs (74 per cent) for which data was available experienced larger average increases in public sector interest costs than in public sector revenues between 2017 and 2023, with a median rate of increase of the former of 14.5 per cent per annum, and 9.9 per cent for the latter. The combined population of FMEs with deteriorating public sector financial sustainability stood at around 890 million people in 2023, compared with only 205 million with improving public sector financial positions.

An analysis of ODEs (Figure 16) indicates that 46 of the 57 countries (81 per cent) experienced a deterioration in their external financial sustainability between 2017 and 2023, with a median annual increase in debt service costs of 16.3 per cent far outstripping growth in exports plus remittances of 5 per cent. Twenty-seven countries with deteriorating positions were in Africa, 14 were in Asia and 5 in Latin America and the Caribbean. In 28 countries the average annual increase in external debt service costs was more than 10 percentage points higher than the increase in export plus remittance earnings. In 2023, 900 million people resided in countries of this group with deteriorating external financial positions, and only 175 million people in countries with improving positions.

Analysis of the public sector financial sustainability of ODEs reveals a similar number of countries (46) with deteriorating positions. However, an increase in the number of countries for which the required data is available means that the proportion of this sample that experienced a deterioration was lower, at 69 per cent. The median annual increase in external debt service costs of this group of developing countries between 2017 and 2023 was 16.2 per cent – more than three times the 5 per cent average increase in exports plus remittances over the same period.

Figure 15
Trends in the external (top) and public sector (bottom) financial sustainability of Frontier Market Economies
2017–2023

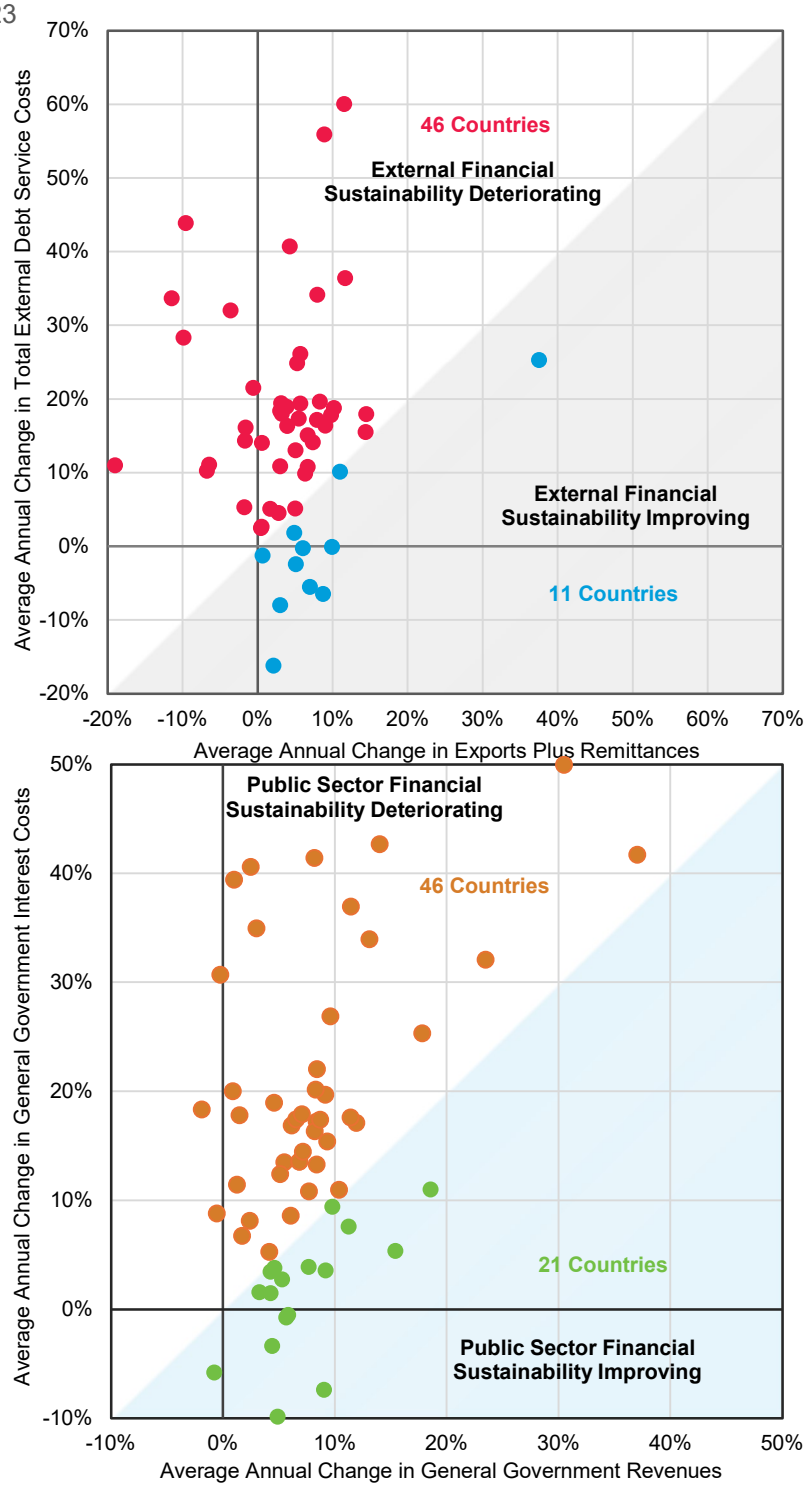


Source: World Bank IDS, IMF WEO, IMF GFS, UNCTAD estimates

Figure 16

Trends in the external (top) and public sector (bottom) financial sustainability of Other Developing Economies

2017–2023

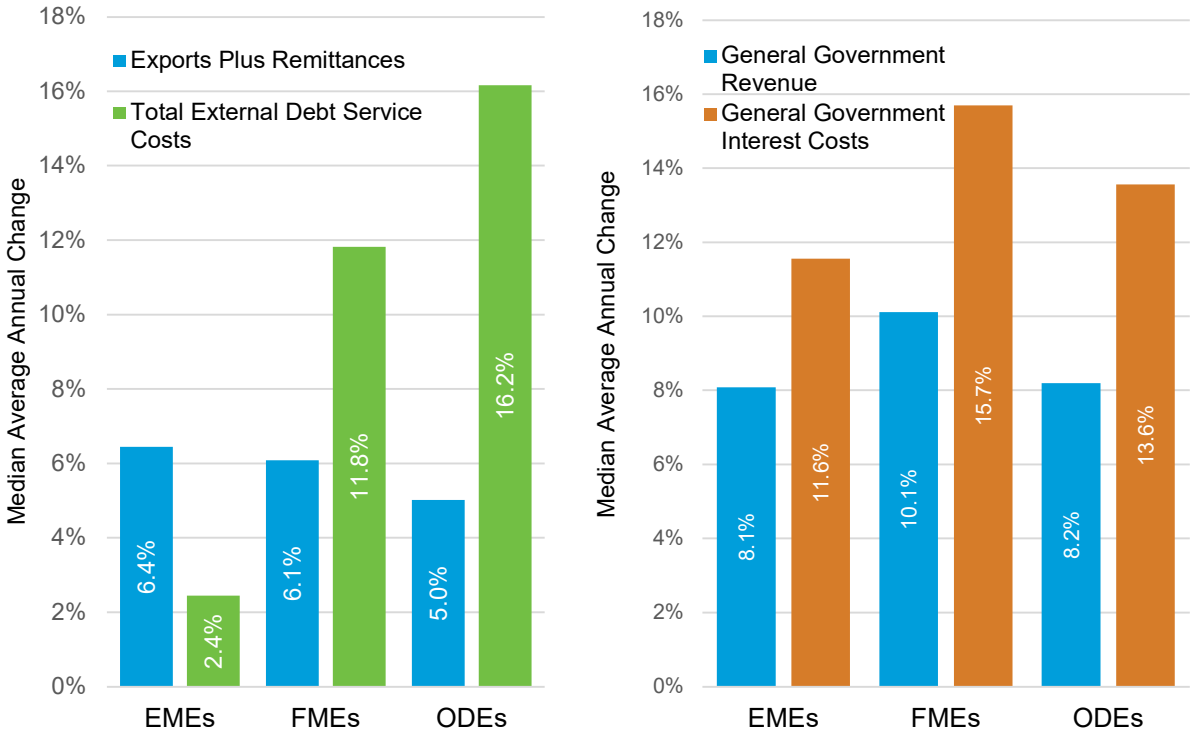


Source: World Bank IDS, IMF WEO, IMF GFS, UNCTAD estimates

The relatively better profile of external integration of EMEs into the international capital market and global trade is reflected in Figure 17 (left). The median rate of annual increase in external debt service costs of this group between 2017 and 2023 was significantly lower (2.4 per cent) than either FMEs (11.8 per cent) or ODEs (16.3 per cent), while growth in exports plus remittances was slightly higher (6.4 per cent) compared with 6.1 per cent for FMEs and 5 per cent for ODEs.

However, while general government revenues of FMEs expanded at a faster rate (10.1 per cent) than EMEs (8.1 per cent), interest costs increased more rapidly (15.7 per cent compared with 11.6 per cent for EMEs). ODEs experienced similar revenue growth rates of EMEs, but higher rates of increase in interest costs (13.6 per cent).

Figure 17
Median changes in external financial sustainability components (left) and public sector financial sustainability components (right)
2017–2023



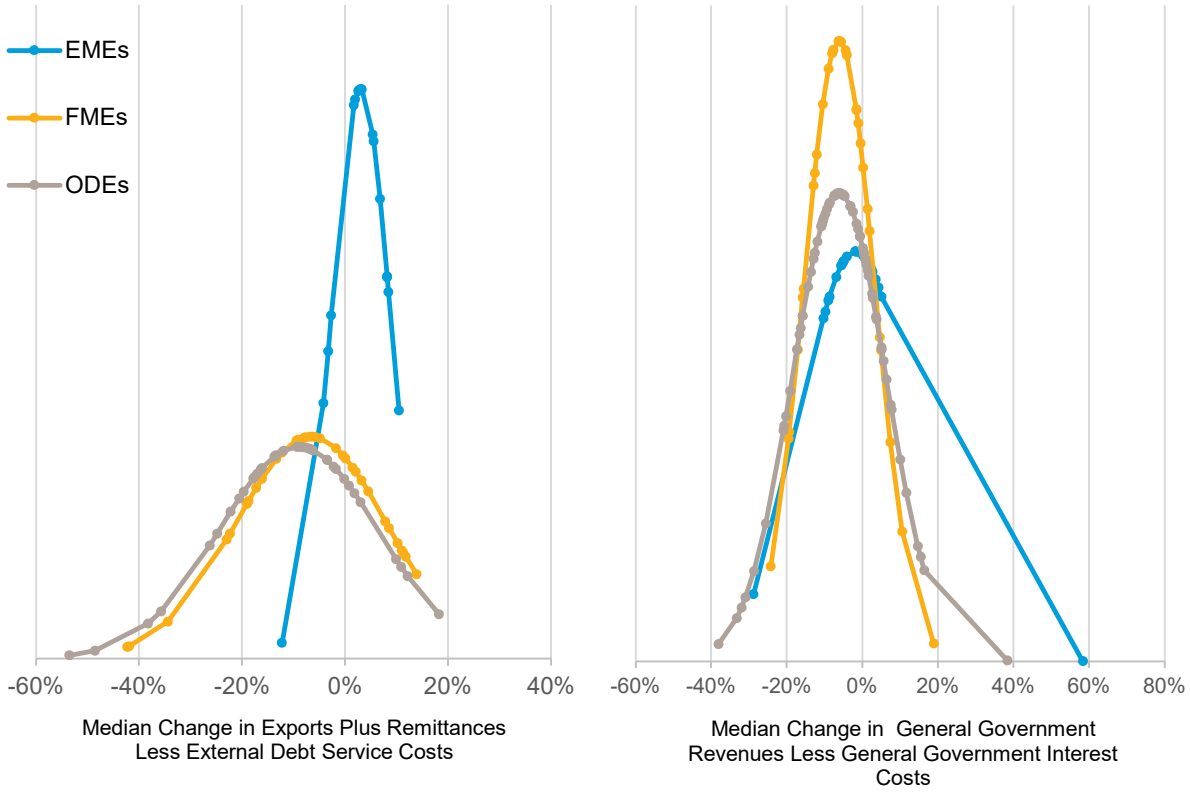
Source: World Bank IDS, IMF WEO, IMF GFS, UNCTAD estimates

The respective changes in the elements that determine the external financial sustainability of the three groups of developing countries results in differences between the average annual change in exports plus remittances and the average annual change in external debt service costs ranging from +3.1 per cent in the case of EMEs, to -6.6 per cent in the case of FMEs and -9 per cent for ODEs. The distribution of developing countries in each group around their respective sample medians is displayed in Figure 18 (left). There is a significant gap between the performance of EMEs and the other two groups.

The changes in general government revenues and general government interest costs result in differences of -1.8 per cent for EMEs, and -6.1 per cent for both FMEs and ODEs. Figure 18 (right) displays the distribution of countries in each group around their respective medians. There are relatively smaller differences between the median values of the three groups.

Figure 18

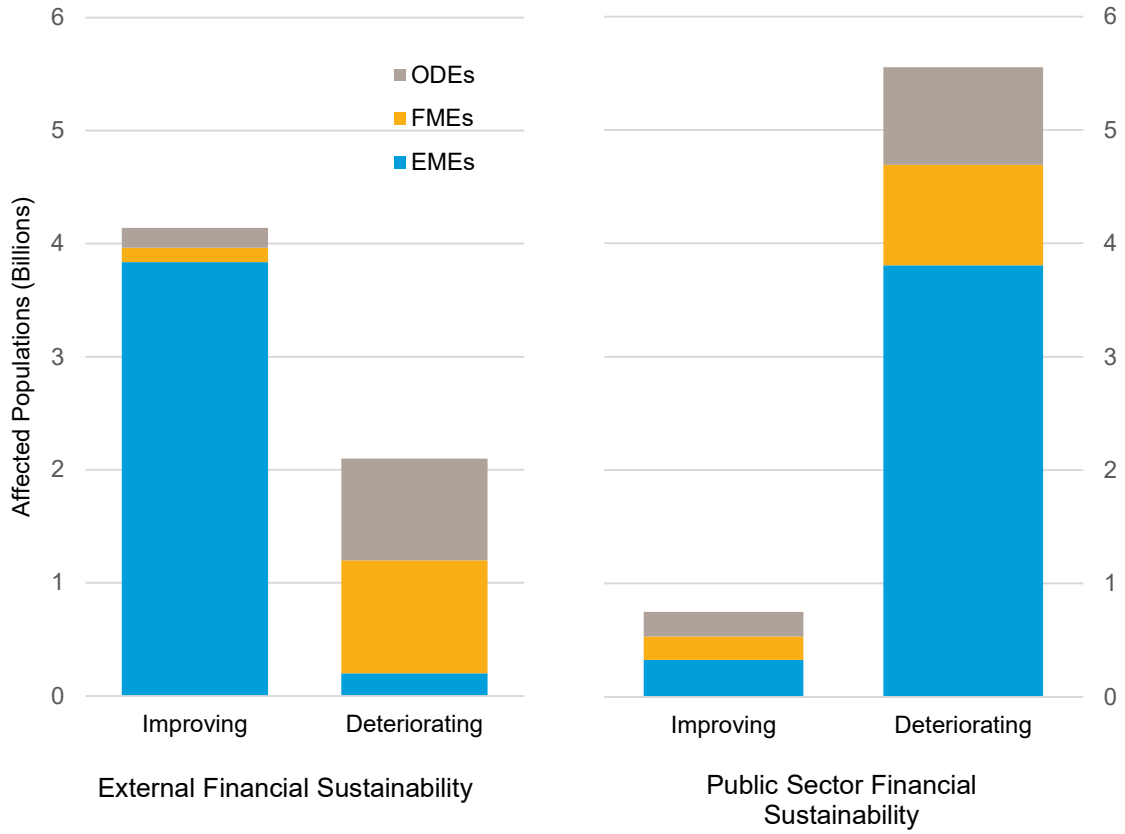
Distribution of developing countries around sample medians for external financial sustainability (left) and public sector financial sustainability (right)
2017–2023



Source: World Bank IDS, IMF WEO, IMF GFS, UNCTAD estimates

Figure 19 indicates the aggregate 2023 populations of developing countries that experienced improving and deteriorating external (left) and public sector (right) financial sustainability between 2017 and 2023. Over 4.1 billion people were in countries with improving external financial sustainability, while 2.1 billion were in countries that experienced deteriorating sustainability. However, there was a dramatic shift in the number of people residing in countries with deteriorating public sector financial sustainability, due largely to the fact that the two countries will the largest populations (India and China) had improving external financial sustainability but deteriorating public sector sustainability. As a result, close to 5.6 billion people lived in countries with deteriorating public sector financial sustainability in 2023.

Figure 19
Developing country populations in 2023 affected by improving and deteriorating external (left) and public sector (right) financial sustainability
2017–2023



Source: World Bank IDS, IMF WEO, IMF GFS, UNCTAD estimates

The financial sustainability analysis highlights a divergence between EMEs on the one hand, and FMEs and ODEs on the other, with respect to their external positions, but a convergence with respect to their public sector finances. The external integration profile of EMEs into the international capital market and global trade resulted in a general – but not universal – improvement in their external financial sustainability, underpinned by much lower increases in debt service costs and slightly higher export plus remittance growth. There are, however, at least four EMEs for which this improving position did not hold.

As a group, FMEs performed better than ODEs, but external debt service costs rose at a much faster rate than EMEs and at almost twice the rate of increase of the group's exports plus remittances. The performance of FMEs and ODEs was also significantly more dispersed around their respective medians. The deterioration in external financial sustainability of 74 per cent of the countries in these two groups suggests limited capacity to take on new external debt to finance climate and development priorities.

Taken together with the deteriorating public sector financial sustainability of over 68 per cent of all developing countries (EMEs, FMEs, and ODEs), there is little reason to expect that most developing countries can realize the twin challenges of meeting SDGs and climate-related commitments within the prevailing global financial architecture.

V. Conclusion and Proposals for Transformation

Addressing external and public sector debt sustainability

The analysis presented here shows the explicit resource and access unevenness between developing countries, as viewed from the perspective of their global financial integration. The lack of viable alternatives for securing concessional development financing has set the stage for expensive sources of debt financing for development. The experience of FMEs is testament to the fact that access to private capital flows may expand the quantum of capital available, but it can come at a high price. Moreover, for both FMEs and ODEs, curtailed access to concessional finance and grants from official sources has increased the cost of debt financing.

Our analysis of external debt sustainability in Section IV finds that 67 per cent of developing countries experienced deteriorating external financial sustainability between 2017 and 2023 because the costs of servicing the stock of external debt were increasing at a faster rate than the resources available to service that debt. Debt service costs were rising faster than exports of goods and services plus remittances. Similarly, over 68 percent of developing countries experienced a deterioration in public sector financial sustainability between 2017 and 2023 because the interest costs on their public debt stocks rose at a faster rate, on average, than government tax and other revenues. Taken together, this raises concerns about the ongoing sustainability of both external and public debt, and the extent to which the servicing of such debt drains resources from development in the context of the vast financing gap for achieving the 2030 Agenda and Paris Agreement.

In terms of high costs of external sources of financing there are two broad non-exclusive ways to address this situation without curtailing economic growth and jeopardizing sustainable development.

The first is to reduce a country's net external liabilities by diminishing the need for imports and/or expanding and diversifying exports and participation in global value chains over time. This would require the adoption of trade, industrial and technological policies that bring about structural changes in the import and export propensities of the economy. Moreover, this would need to be enabled by a truly multilateral and healthy trade system[29].

The second is to reduce the average cost of servicing external liabilities which is associated with the ability of countries to access private and official finance at reasonable terms.

Pitfalls along all stages of the sovereign life cycle contribute to the high costs developing countries incur when they borrow externally. These range from differential, and in some cases limited, access to global capital markets, to currency risk, to contractual terms that limit disclosure and transparency relating to debt agreements, to the poor-quality data systems and limited capacity of many developing countries to manage their debt, to global crises and the availability of an appropriate and accessible Global Financial Safety Net, and the limitations of available measures for debt restructuring.

Transformational proposals along the entire sovereign debt cycle are therefore needed to make up a development-centred global debt architecture. Although each proposal may have specific relevance to a particular stage, the stages and their outcomes are interdependent. The process also contains path dependencies; for example, weak transparency and a high cost of debt at the

[29] See UNCTAD (2023), ch.II.

“access to finance” stage hinder the entire process. Moreover, some proposals are fundamental to every stage of the cycle, such as ensuring debt transparency (Table 2).

Table 2
A summary of main stages, critical issues and transformational proposals in the life cycle of external sovereign debt

Stages	Pitfalls	Transformational proposals
Stage 1: Access to finance & markets	Shortage of both concessional finance and grants. Countries may face extortionate spreads which imply loss of market access or unexpectedly high borrowing costs as a result of external financial shocks leading to capital outflows. Asymmetries in market access across developing countries	Increased mobilization of concessional finance and grants, including by creating mechanism to reduce foreign currency risk and changing in eligibility criteria Enhanced transparency of terms and conditions around how financing is used. Improve the credit rating system. Implementing integrated national financing frameworks
Stage 2: Debt issuance	A lack of transparency hinders responsible lending and borrowing. Contractual and cost terms are obscure, particularly if they contain potentially harmful clauses such as resource-backed collateral. A global consensus on principles for responsible lending and borrowing remains elusive.	Full disclosure and transparency are required regarding the contractual terms to ensure that borrowers and lenders can usefully integrate these tools into their financial assessments. Financial instruments and collective action clauses can be enhanced. Effective regulation can help improve transparency and prevent harmful practices including collateralization and exploitative sovereign syndicated loans. To revisit UNCTAD Principles for Responsible Sovereign Lending and Borrowing to align them with broader development financing needs, innovative financial instruments and the new creditor landscape Legal frameworks for public debt management can help address key problems, including clear authorization mechanisms for the issuance of debt.

Stage 3: Debt management	Countries need to be empowered to track their debt sustainability to be better able to assess their vulnerabilities and evaluate the debt sustainability analysis required by IMF. Technical barriers remain in debt management.	Enhance debt transparency. Improved debt sustainability analysis and tracking to empower country negotiators with improved data on their potential for growth and fiscal consolidation. An International Loans Repository can improve debt management by digitizing loan transactions, ensuring consistent financial terms and providing reliable statistics
Stage 4: Debt servicing, repayment & resilience	Frequency of external shocks, including those that are climate-related, can derail the debt servicing process. Creating innovative financial instruments can be helpful for managing debt, but even the most effective of tools needs improving to ensure resilience. Limited access to the GFSN and the inability to address loss and damage hinders rather than improves resilience.	Access to a truly global financial safety net would greatly benefit developing countries. Countries need to be able to exploit the innovative financial instruments that best serve their needs. International and domestic rules for a standstill on debtors' obligations in case of climate, health and other external crises. Ensure a well-equipped Loss and Damage Fund to all climate-vulnerable developing countries.
Stage 5: Debt workout	The institutions and mechanisms dealing with debt workouts have become increasingly disconnected from the realities and complexities of sovereign debt distress. The composition of institutions like the Paris Club are outdated and processes such as the Common Framework are inadequate. The ongoing absence of an automatic standstill mechanism during negotiations, incomplete creditor participation and delays in the process are among the underlying weaknesses.	Establishing a multilateral sovereign debt workout mechanism with statutory authority. Establishing a borrower's club to discuss technical issues and innovation as well as sharing experience and advice. Establishing an automatic standstill for countries declaring distress, to concentrate the minds of creditors in the workout process. Establishing international and domestic rules for a standstill on debtors' obligations in case of climate, health and other external crises are needed.

Source: Summary Chapter V, TDR, 2023.

Set out below are proposals related to Stages 1 and 4, which were the focus of this paper.

Stage 1: Access to finance and markets

1. Transforming sovereign debt requires increased mobilization of affordable concessional finance and grants. The G20 Capital Adequacy Framework (CAF) reforms are critical but insufficient to fill the current development finance gap. This also requires greater capitalization by multilateral and regional development bank (MDBs and RDBs) shareholders and rechanneled unused special drawing rights (SDRs) through these banks.

2. Concessionality is not only about finance with lower costs and longer maturities compared to market finance. One critical source of risk for developing countries when they borrow abroad is currency risk. Therefore, dealing with foreign exchange risk needs to be part of the overall discussion on concessional finance as it can reduce risk and volatility for longer-term investments, including on climate adaptation and mitigation. MDBs and RDBs could bear partially or entirely this risk through different mechanisms that could include: (i) Increasing the share of lending to governments in local currencies; (ii) strengthening financial cooperation with National Public Development Banks using on-lending, co-financing and risk-sharing mechanisms; (iii) creating an FX-guarantee mechanism individually or jointly with other MDBs and RDBs[30].

3. New eligibility criteria that go beyond the income level (such as the UN Multidimensional Vulnerability Index) for access to MDBs and RDBs' loans and ODA need to be adopted so that more developing countries can benefit from affordable sources of development finance. This will reduce the asymmetries across the three groups of developing countries in this first stage and, consequently, in the others.

4. The lack of viable alternatives for securing concessional development financing leads to opaque and expensive sources of debt financing. The presence of confidentiality clauses limiting disclosure by sovereign borrowers and the use of collateralized loans or borrowing on commercial terms that are incompatible with long-term development requirements highlight these power asymmetries. Therefore, greater access to financing should be guided by improved transparency of terms and conditions around how financing is used. Digitalizing loan contracts would significantly improve the automation and accuracy of this information. Rules regarding collateralized sovereign bonds would also protect developing countries.

5. The impact of multilateral efforts to strengthen development financing must be mediated by efforts at the national level to ensure that resources are deployed towards the SDGs. Implementing integrated national financing frameworks at the country level can play a key role in developing comprehensive financing strategies that explicitly link sources and uses of financing in a transparent way for all relevant stakeholders[31].

6. Regarding Credit Rating Agencies and their role[32], several initiatives could improve the sovereign ratings process and limit its negative impacts on developing countries, including:

- Provision of enhanced technical assistance targeted at the 54 developing countries that do not currently have sovereign ratings so as to enhance their access to financial markets in an incremental, and developmentally supportive manner;

[30] Persaud (2023) proposes the creation of a joint agency of multilateral development banks and the IMF to provide foreign exchange guarantee for green transformation projects.
[31] For more details, see UNDP (2023).
[32] UNCTAD, 2024, Forthcoming,

- Adoption of regulatory changes that address potential conflicts of interest by rating agencies (e.g., by divesting from non-rating activities), to reduce the importance of sovereign ratings in investment decisions;

- Development of a supportive rating approach for countries that choose to engage in debt restructuring, including under the G20 Common Framework, so that the "Credit Rating Impasse" does not discourage debt distressed countries to restructure their debt using the Common Framework or similar approaches.

Stage 4: Debt servicing, repayment and resilience

7. Access to a truly universal GFSN would not only increase the resilience of developing countries to external shocks, but also allow them to reduce their costly foreign exchange reserves and contribute to lowering the premium they pay for external financing. Providing central bank swaps is a decision of each country, subject to domestic and geopolitical interests, but initiatives at the multilateral and regional level could make the GFSN more effective, accessible and predictable for developing countries, as detail below:

- Boosting the IMF lending capacity, lowering the cost of IMF lending including by increasing the access limit of the lending facilities with low conditionality (e.g., RST) and ex-post conditionalities; suspend IMF surcharges during external shocks and create corridors for their application; increase concessional finance through the PRGT; revise the existing skewed and outdated IMF quota limits in the 17th review, which will also contribute to increasing IMF resources; and abolish the tiered interest rates on the IMF Resilience and Sustainability Trust (RST) to support climate-related projects.
- African countries should join efforts to set up an RFA so that all developing countries have access to a regional source of short-term external financing.

8. To achieve the SDGs, countries need to be able to exploit the innovative financial instruments that best serve their needs. More work needs to be done to empower countries in this regard. Rules are needed regarding sustainable development bonds, resilience bonds and automatic restructurings and guarantees.

9. An external shock can undermine a country's ability to remain resilient while servicing its debt. International and domestic rules for a standstill on debtors' obligations in case of climate, health and other external crises, such as climate-resilient debt clauses (CRDC) and the approach spearheaded by the World Bank, are initial steps that could benefit all sovereign borrowers. This should be coupled with a general acceptance that use of capital flows regulation is a legitimate policy tool to manage inflows and outflows.

10. The Loss and Damage Fund (LDF) established by the Conference of the Parties (COP) in COP28, will be a World Bank hosted financial intermediary fund (FIF) for an interim period of four years[33]. Its operationalization is still pending but a well-funded and inclusive LDF can enhance resilience and provide relief during climate-related emergencies[34].

[33] See: Fund for Responding to Loss and Damage (worldbank.org).
[34] For more details, see: First Meeting of the Board of the Fund for responding to loss and damage | UNFCCC.

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Annex

Table 1

List of EME's and FMEs and WB Income Classifications

EMEs	
UNCTAD Country Name	**WB income classification**
Argentina	Upper middle income
Bahrain	High income
Benin	Lower middle income
Brazil	Upper middle income
Chile	High income
China	Upper middle income
Colombia	Upper middle income
Dominican Republic	Upper middle income
Ecuador	Upper middle income
Egypt	Lower middle income
India	Lower middle income
Indonesia	Upper middle income
Kazakhstan	Upper middle income
Kuwait	High income
Lebanon	Lower middle income
Malaysia	Upper middle income
Mexico	Upper middle income
Morocco	Lower middle income
Oman	High income
Panama	High income
Peru	Upper middle income
Philippines	Lower middle income
Qatar	High income
Saudi Arabia	High income
South Africa	Upper middle income
Trinidad and Tobago	High income
Türkiye	Upper middle income
United Arab Emirates	High income
Uruguay	High income

FMEs	
UNCTAD Country Name	**WB income classification**
Angola	Lower middle income
Armenia	Upper middle income
Azerbaijan	Upper middle income
Barbados	High income
Bolivia	Lower middle income
Costa Rica	Upper middle income
Côte d'Ivoire	Lower middle income
El Salvador	Upper middle income
Ethiopia	Low income
Gabon	Upper middle income
Georgia	Upper middle income
Ghana	Lower middle income
Guatemala	Upper middle income
Honduras	Lower middle income
Iraq	Upper middle income
Jamaica	Upper middle income
Jordan	Lower middle income
Kenya	Lower middle income
Maldives	Upper middle income
Mongolia	Lower middle income
Mozambique	Low income
Namibia	Upper middle income
Nigeria	Lower middle income
Pakistan	Lower middle income
Papua New Guinea	Lower middle income
Paraguay	Upper middle income
Rwanda	Low income
Senegal	Lower middle income
Sri Lanka	Lower middle income
Suriname	Upper middle income
Tajikistan	Lower middle income
Tunisia	Lower middle income
Uzbekistan	Lower middle income
Viet Nam	Lower middle income
Zambia	Lower middle income