Economic and Social Survey of Asia and the Pacific 2023

Rethinking Public Debt for the Sustainable Development Goals

ESCAP 75
MOVING FORWARD TOGETHER

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The Economic and Social Commission for Asia and the Pacific (ESCAP) is the most inclusive intergovernmental platform in the Asia-Pacific region. The Commission promotes cooperation among its 53 member States and 9 associate members in pursuit of solutions to sustainable development challenges. ESCAP is one of the five regional commissions of the United Nations.

The ESCAP secretariat supports inclusive, resilient and sustainable development in the region by generating action-oriented knowledge, and by providing technical assistance and capacity -building services in support of national development objectives, regional agreements and the implementation of the 2030 Agenda for Sustainable Development.

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FOREWORD

António Guterres

Secretary-General of
the United Nations

Our world is facing a rising tide of trouble.

The continuing war in Ukraine and a cost-of-living crisis have increased poverty and inequality, and deepened the socioeconomic scars left behind by the COVID-19 pandemic. Historically high inflation is undermining economic stability, while rising interest rates are adding to the fiscal and debt stress of developing economies at precisely the moment when they should be stepping up investments in the Sustainable Development Goals.

For Asia and the Pacific - home to 4.3 billion people, or three out of every five people on Earth - these crises are threatening to reverse years of development gains and hindering investments in an inclusive and sustainable future.

Growing post-pandemic public debt, together with weaker economic growth prospects and higher interest rates, have considerably increased the risk of public debt distress across the region.

The Economic and Social Survey of Asia and the Pacific 2023 highlights a fundamental truth: recovery and development depend on equitably and sustainably managing debt, massive investments in the Sustainable Development Goals, and transforming the international financial system to make it fairer and more resilient.

This is why I have called for a fundamental reform of the international financial architecture and an SDG Stimulus to increase financing at the scale required to deliver on the 2030 Agenda for Sustainable Development.

Throughout, the United Nations will continue standing with countries across Asia and the Pacific to help them invest in a sustainable, inclusive and resilient future for their people.

PREFACE

Armida Salsiah Alisjahbana

Under-Secretary-General of United Nations
and Executive Secretary of ESCAP

Post-pandemic economic growth in developing Asian and Pacific countries weakened considerably in 2022 and is expected to remain weak in 2023, amid the global economic slowdown, unprecedented inflation and uncertainty brought about by the war in Ukraine. These setbacks to past development gains have also been worsened by a food and fuel price crisis, which has increased poverty and inequality across the region. Thus, restoring price stability has become a priority and a critical factor for implementing the 2030 Agenda for Sustainable Development in the region.

Not surprisingly, monetary tightening has gathered pace in many economies. As both demand and supply factors are responsible for high inflation in most economies, the conduct of monetary policy has become increasingly complex. Higher interest rates have implications for the fiscal and debt positions of developing economies and thus their ability to pursue sustainable development and tackle climate challenges.

Indeed, fiscal policy management in support of the Sustainable Development Goals has become ever more challenging. To shield poor households from high food prices, fiscal resources are needed to complement monetary policy and abate the rising cost of living through targeted subsidies or cash transfers. Fiscal space is also needed for countercyclical stimulus packages, amid the risk of a sharp global economic slowdown in 2023. Large financing needs to effectively pursue the Sustainable Development Goals, in the backdrop of limited progress in achieving these Goals, should not be forgotten either. At the same time, climate-related financing needs for mitigation and adaptation and for dealing with climate-induced disasters and loss and damage are also weighing on public finances.

Yet, rising government debt levels, higher financing costs and uncertain economic outlook mean that the risk of public debt distress would be considerable in coming years. This implies that the scale of fiscal responses needed for investing in the Sustainable Development Goals and for climate action is likely to remain limited.

In this context, the Economic and Social Survey of Asia and the Pacific 2023 calls for a significant shift in thinking about leveraging public debt for development gains. The Survey offers new perspectives on fiscal and public debt analysis to help developing countries in the region continue their investments aimed at achieving the Goals and maintaining public debt sustainability over a longer-term horizon.

The Survey argues that a higher debt level does not necessarily mean a higher risk of debt distress. Nor is higher debt necessarily detrimental to economic growth. Rather, deploying public debt as an investment in people and the planet offers sizeable medium- and long-term economic, social and environmental returns. While there is no consensus on optimum public debt levels, fiscal consolidation undertaken to restore public debt sustainability and sovereign debt defaults is known to cause significant and long-lasting adverse socioeconomic impacts. Thus, there is a need to revisit conventional debt assessment tools and associated policies.

The Survey proposes an innovative approach to public debt sustainability analysis that augments the conventional short- to medium-term methodologies of international financial institutions and credit rating agencies. This augmented approach considers a country's Sustainable Development Goal financing needs and Goal financing strategies along with the Governments' structural development policies in determining the sustainability of public debt. Using different policy scenarios, the approach shows that public debt goes down over the long term when the socioeconomic and environmental benefits of public investments are incorporated.

The Survey also offers guidance to Governments for achieving a balance between investing in the Sustainable Development Goals and reducing fiscal and debt distress. Increasing fiscal revenues and improving public spending effectiveness and efficiency are key to expand the fiscal space and reduce debt distress. Better management of public debt can also reduce fiscal risks and government borrowing costs. Similarly, developing domestic capital markets not only supports public debt financing but also increases financial inclusion and reduces exchange rate risks. The Survey discusses several policy options that countries can consider while pursuing these broad objectives.

For countries already facing elevated debt distress, the Survey also recommends sovereign debt restructuring. It highlights that successful sovereign debt restructuring depends on three conditions. First, pre-emptive, swift and adequate sovereign debt restructuring, informed by reliable debt sustainability assessments. Second, strong political commitment, along with a credible strategy for complementary reforms aimed at addressing the root causes of debt distress, which addresses potentially strong resistance from powerful vested interest groups, especially with regard to domestic debt restructuring. Third, fair treatment of all stakeholders that reasonably balances the concerns of debtor countries and creditors.

The international development community, including multilateral and bilateral creditors, can also step up its efforts to accelerate progress towards common international debt resolution mechanisms and restructuring frameworks.

Asia and the Pacific must respond to the call by the Commission last year to pursue a common agenda for sustainable development in the region. Effective pursuit of such an agenda requires fiscal and financial investments, among other policy considerations. Providing such investments is challenging when countries are faced with difficult economic conditions and debt distress. I am confident that member States will find the analytical assessment and policy recommendations in this edition of the Survey, which revolves around debt-related issues, helpful in their journey towards an inclusive, resilient and sustainable future.

EXECUTIVE SUMMARY

Economic activity in Asia and the Pacific is expected to remain weak, amid high inflation, fiscal stress and rising geopolitical risks

Post-pandemic economic performance in developing countries in Asia and the Pacific was considerably weak in 2022. Average output growth is estimated at 3.3 per cent, which is much lower than the pre-pandemic averages. The sluggish economic activity is mainly driven by historically high inflation, which not only undermined economic stability but has also increased poverty and inequality, thus worsening the deep socioeconomic scarring resulting from the COVID-19 pandemic. Restoring price stability and safeguarding the vulnerable are thus not just macroeconomic issues, but critical prerequisites for implementing the 2030 Agenda for Sustainable Development in the region.

The end of 2022 witnessed a global economic slowdown amid a rising cost of living, tighter financial conditions and the continuing war in Ukraine. Without further worsening of the geopolitical risks or a deeper global economic recession, average GDP growth in developing countries in Asia and the Pacific is expected to rise moderately to 4.2 per cent in 2023. However, this outlook remains fraught with uncertainty and is uneven across the region. In addition to declining exports, the growth prospects are clouded by the extent of expected monetary policy tightening in the major developed economies.

In responding to high inflation in the region and rising interest rates in advanced economies, monetary tightening in several developing Asia-Pacific economies gathered pace in the second half of 2022. The average rate of inflation in developing countries in the region is estimated to have been 7.6 per cent in 2022, the highest rate since 1998, compared with 3.4 per cent in 2021. Inflation is expected to remain at the elevated level of 5.9 per cent in 2023. Although both demand and supply factors are responsible for high inflation in most economies, it is difficult to pin down their relative contribution. Likely upward pressure on wages due to high inflation, and thus inflationary expectations, cannot be ignored either. This makes the conduct of monetary policy increasingly complex. Central banks in the region need to balance management of expectations about inflation amid supply-driven factors while they minimize the adverse impacts of higher interest rates on the prospects for economic recovery.

Fiscal policy can and must complement monetary policy in tempering high inflation. Limited fiscal resources should be used for abating the rising cost of living through targeted subsidies or cash transfers to shield poor households from high food prices amid the risk of social unrest. Other longer-term solutions are needed to ensure food security, such as improved agricultural productivity, reduced food waste and fewer trade barriers for food items.

In addition to food price surges, the leap in global energy prices in 2022 also has long-term implications for Asia and the Pacific in addition to an immediate impact on driving inflation. To reduce heavy reliance on fossil fuels and meet targets for carbon reduction, the region needs to accelerate the transition towards clean and renewable energy. This also will help reduce the region's vulnerability to climate shocks in the form of increased frequency and intensity of natural disasters.

In going forward, fiscal policy management in support of the Sustainable Development Goals is a significant challenge. Critical spending needs for health care, education and social protection are substantial. Fiscal space would also be needed for countercyclical stimulus packages amid the risk of a sharp global economic slowdown in 2023. Yet, rising government debt levels in post-pandemic years, higher financing costs and an uncertain economic outlook mean that the risk of public debt distress would be considerable in coming years. Against this background, the Survey for 2023 examines how new perspectives on fiscal and public debt analyses and policies can help countries in Asia and the Pacific to effectively pursue not only the Sustainable Development Goals by 2030 but also improve their long-term sustainable development prospects.

There is a need to rethink the public debt-development nexus to effectively pursue sustainable development under current difficult economic conditions

According to ESCAP estimates made in 2019, to implement the 2030 Agenda Asia-Pacific developing countries would require an average annual investment of $1.5 trillion, an additional 5 per cent of the region's 2018 GDP. The bulk of this would have to come from public resources. The requirements have certainly increased since then, especially for least developed countries. Climate-related financing needs will also put significant strain on public finances in the region. Importantly, countries most vulnerable to climate change and with the highest development deficits have the most limited fiscal space.

As fiscal firepower is shrinking in the Asia-Pacific region, it is time to rethink the relationship between public debt and development financing. The view that high debt levels are necessarily detrimental to economic growth has been challenged in recent years. On the other hand, development deficits and climate risks, if left unaddressed, will have serious implications for growth and the sustainability of public finance.

The Survey for 2023 is based on the premise that public debt can be a powerful sustainable development tool if used judiciously and with a long-term horizon. Public borrowing decisions to finance development can be effective, if expected broader socioeconomic and financial returns are incorporated into debt assessments. More recently, potential environmental benefits have also been assigned a high weight in assessing the impact of debt issuance. Most development expenditures offer clear financial co-benefits, such as enhanced economic growth prospects due to an improvement in education or job creation resulting from investment in renewable energy. It has been well documented that fiscal consolidation episodes, in trying to achieve debt sustainability in the short term, and sovereign debt defaults can result in significant and long-lasting increases in inequality and poverty. Thus, developing a better understanding of the link between public debt and inequality is another good example of the important role of debt in development.

The argument analysed in the Survey for 2023 is that the quantity and quality of debt-funded spending for development can be enhanced. In this regard, it is worth highlighting that there is no consensus on the optimum level of public debt, and thresholds used for developing countries, which do not account for Sustainable Development Goal financing needs, are often quite low. This has led to suboptimum development outcomes for many developing economies. Transparency of debt management is key for ensuring effective development outcomes and increasing national debt carrying-capacity. Functioning domestic debt markets are a powerful tool for financing development while improving financial inclusion and limiting exposure to foreign exchange risk. International debt markets can also be leveraged in tandem with domestic markets to meet large financing needs, but they need to be accompanied by measures to limit the macroeconomic risks of international borrowing.

A better understanding of the public debt profile along with its main drivers and objectives should be a main consideration while undertaking debt sustainability analysis

Prior to the pandemic, the average government debt-to-GDP ratio in developing countries in the Asian and Pacific region was already at an 11-year high of 40.6 per cent in 2019. This jumped to 49.5 per cent in 2021 with two thirds of Asia-Pacific economies reaching the highest level since 2008. Rising interest rates in 2022 have added further pressure to the debt service payments, which are expected to increase in many countries in the region in coming years.

Along with rising public debt and debt servicing costs, the number of countries rated at high risk of debt distress has been increasing. Currently, 19 countries are rated at high risk of debt distress based on the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries or equivalent credit ratings assessed by credit rating agencies. However, not all of them have high levels of debt. In fact, six of these countries have experienced stable or even decreasing trends in their debt levels in the last decade, and their government debt-to-GDP ratios were all below 20 per cent in 2021. In contrast, public debt levels of a few other countries are extraordinarily high but their credit ratings are also high.

Indeed, the Survey for 2023 demonstrates that a low debt level does not automatically prevent a country from facing high risk of debt distress while a higher debt level does not necessarily translate into higher risk. A thorough examination from multiple perspectives of the public debt profile of countries reveals that this situation depends on several factors.

First, strong macroeconomic fundamentals, certain structural, governance and institutional aspects, most critically political stability, which has impacts on every aspect of economic performance, are considered prerequisites for a high credit rating.

Second, understanding the main drivers and purpose of increasing debt is critical. For countries facing a high risk of debt distress, primary deficit is the key factor in driving up their public debt. In contrast, a negative interest rate-growth differential has helped limit debt surge, thanks to the unprecedented low interest environment globally and rapid economic growth in the region in the past decade. However, these two factors may not continue to work in favour of the developing countries in the region. Interest rates have risen and are expected to continue rising, and the region may no longer sustain higher levels of economic growth. This implies that stemming rising debt levels will be challenging in the near future, indicating the risk posed by rising debt vulnerabilities.

Third, composition of public debt portfolios and of creditors matters. Half of the developing Asia-Pacific economies rely heavily on external debt. At the same time, several small island developing States and landlocked developing countries have witnessed the sharpest increases in debt owed to China. Beyond official creditors, the role of government bondholders, such as institutional and individual investors, is increasing in the region's sovereign creditor landscape. The rise of unconventional creditors opens the door to new sources of public financing, but their inherent shorter maturities and higher costs imply a higher interest rate and rollover risks. Moreover, the evolution of the creditor landscape makes debt resolution discussions more difficult, as there is no existing framework that can facilitate effective coordination among unconventional creditors. On the other hand, several Asia-Pacific countries with larger levels of domestic debt have issued more local currency government bonds in domestic markets, especially in 2020 and 2021 to fund pandemic-stimulus packages. Yet, as foreign holdings of these bonds have also increased since 2008, Governments need to be wary of the increasing risk of sudden capital outflows.

A country's Sustainable Development Goal investment needs, its Government's structural development policies and national Goal financing strategies need to be incorporated into "augmented" conventional debt sustainability analysis

Given the urgency of investing in the Sustainable Development Goals and climate action, it is time for policymakers in Asia and the Pacific and the international development community to rethink public debt assessments. The Survey for 2023 proposes an "augmented" approach to analyse public debt sustainability in the long term that supplements the short- to medium-term debt sustainability methodologies used by international financial institutions and credit rating agencies. A long-term approach can supplement the current exclusive focus on reducing near-term debt distress, which can compromise efforts to promote inclusive, resilient and sustainable development.

The augmented approach takes into account a country's additional spending needs to achieve the Sustainable Development Goals by 2030, government structural development policies that go beyond financial investments and national Goal financing strategies. It also integrates climate change issues through various channels, such as investments in climate adaptation and mitigation, government transfers for disaster-affected households and fiscal support for commercial banks burdened with stranded asset values in carbon-heavy industries. By illustrating different trajectories of government debt under different scenarios of public policies and adverse shocks, this approach helps to inform policy choices for balancing reasonable fiscal risks in the near term with long-term development ambitions.

Implementing this new augmented approach to conduct a debt sustainability analysis for Mongolia shows that investing in a package of development policies to promote a greener, more diversified Mongolian economy, in addition to Sustainable Development Goal investments, can boost socioeconomic and environmental gains. Not surprisingly, these investments also result in much higher government debt. Yet, the analysis shows that financing strategies to enhance fiscal resources and mobilize more private finance for development can reduce government debt significantly. Indeed, it is estimated that, by 2040, the government debt level would eventually converge to the same level as under the baseline scenario, which assumes fiscal consolidation. The key difference is that the people and the environment are much better off under the proposed alternative scenario. This analysis emphasizes the importance for all stakeholders to consider public debt sustainability from both short- and long-run perspectives.

Besides providing a longer, more holistic view on public debt sustainability, the quantitative analysis has other policy implications. First, Governments should aim to strike a balance between achieving the Sustainable Development Goals and public debt sustainability. Attempts to meet statutory fiscal rules should be mindful of the broader economic situation and its social impact. The analysis for Mongolia shows that, while controlling government debt, strict fiscal deficit rules push up poverty to a notable extent. Second, international financial institutions and credit rating agencies can play an important role in supporting debtor countries to navigate this balancing act. For example, when public debt sustainability is also assessed by public investment quality and potential returns, and not just the government's debt repayment ability in the near term, the sovereign risk premium should become less sensitive to government debt levels. In such a case, the analysis reveals that government debt declines along with poverty amid lower interest rates and higher employment.

While efficient fiscal and debt management can help ease debt distress, timely debt restructuring and effective debt resolution mechanisms are also needed

While prudence requires Asia-Pacific countries to take precautionary measures to manage sudden or chronic sovereign debt increases and, in some cases, prepare for potential debt distress, precaution should not be misinterpreted as fiscal conservatism. Instead, policies should seek to enhance the efficiency and risk management gains through improvements in fiscal institutions and transparency, productivity of debt-financed public investments and resource mobilization. Preparation for swift and smooth debt restructuring under the worst-case scenario can also help mitigate economic and social shocks from sovereign defaults.

Ensuring productivity of debt-financed public investment to support long-term development remains the first defence against sovereign debt distress. However, it should be recognized that essential public spending, such as for pandemic and natural disaster relief or climate adaptation, may not immediately or adequately yield revenue flows. While Governments' efforts on revenue mobilization will be critical, the scale of financing needs may substantially exceed the fiscal capacity of many poor and vulnerable Asia-Pacific countries. To this end, the international community needs to live up to its development commitments and adopt much bolder ambitions for cross-border development transfers.

Sound fiscal management and improved debt transparency can reduce fiscal distress risks associated with sovereign debt. Transparency is essential for early detection of debt sustainability risks and early debt restructuring, which have historically been much less costly than delayed actions. Debt transparency also reduces information asymmetry barriers for effective restructuring design and coordination.

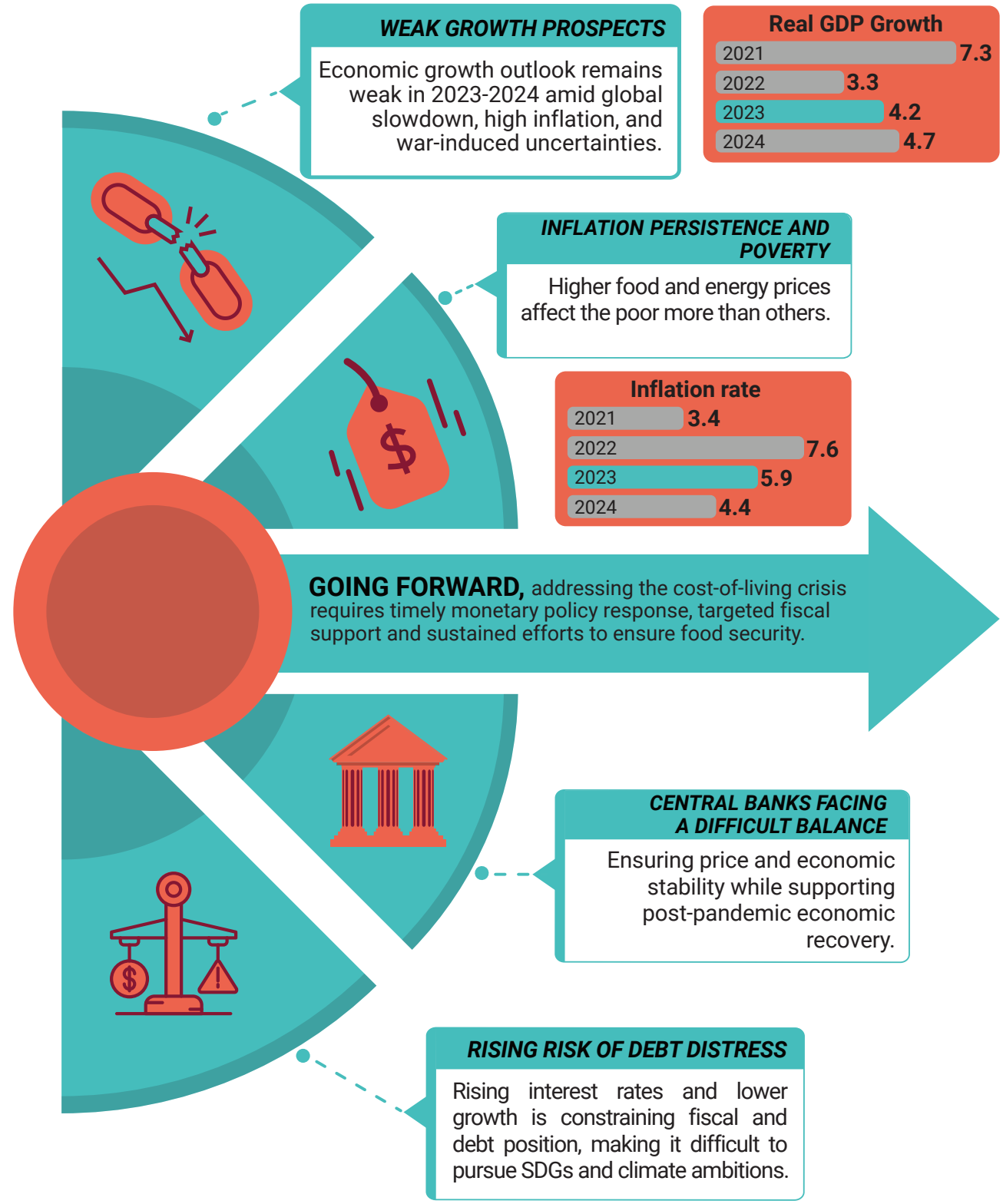
Preemptive, swift and adequate sovereign debt restructuring and relief can serve as the last resort to control damage in the event of serious debt distress. Yet, debt restructuring is often hampered by concerns over domestic political and financial stability as well as fears of capital market denials and creditor holdouts in restructuring negotiations. This tends to result in protracted negotiations, prolonged debt overhang and repeated debt restructuring needs with significant socioeconomic loss. This "too little, too late" challenge has been aggravated by the recent increase in non-traditional official creditors, semi-official creditors and large numbers of small or individual sovereign bond investors. Such fragmentation renders traditional debt resolution mechanisms

ineffective and has significantly increased coordination costs in negotiated restructuring. A significant increase in litigation against sovereign debt restructuring by holdout creditors and vulture funds for unwarranted preferential treatment has also caused additional disruptions and delays.

Debtor countries need to expedite the adoption of the latest collective action clauses and, potentially, state-contingent clauses in their sovereign borrowing contracts to better hedge against uncertainties and risks in debt restructuring. At the same time, the international community needs to improve the international architecture of sovereign debt restructuring by (a) strengthening its commitments and efforts to set up expanded umbrella frameworks to facilitate broad-based creditor coordination; (b) promoting the adoption of contract and market-based solutions in order to reduce creditor holdouts; and (c) exploring pragmatic multilateral frameworks for sovereign debt resolution.

INFOGRAPHICS

MACROECONOMIC PERFORMANCE AND OUTLOOK FOR ASIA AND THE PACIFIC



REVISITING THE NEXUS BETWEEN PUBLIC DEBT AND DEVELOPMENT

1 Conventional Thinking

- High public debt level **undermines economic growth and stability**.
- There is a **common optimum public debt level** for different countries.
- Bold **fiscal consolidation** is needed to reduce near-term fiscal risks.

2 Changing context in Asia and the Pacific

- **Huge spending needs** to attain SDGs and climate goals.
- **Limited progress** towards achieving the SDGs.
- **Rising climate risks** weigh on public finances.
- **Rising public debt level** amid weak economic prospects.

3 Revisiting the debt-development nexus

- **Public debt can be a powerful tool** for development, if used judiciously.
- Appropriate **public debt level is country-specific**, keeping in view the SDGs.
- The optimal **public debt thresholds** advocated by international financial institutions **are too low**.
- Need to **revamp conventional debt assessment tools** that have short-term horizon.

PUBLIC DEBT PROFILE OF ASIA-PACIFIC ECONOMIES

Public debt in **2/3 of economies reached its highest level** since 2008.

The number of countries rated at **high risk** of debt distress **is increasing**.

19 countries are currently rated at **high risk of debt distress**,* but level of public debt is not the sole factor impacting public debt sustainability.

PUBLIC DEBT DISTRESS DEPENDS ON SEVERAL FACTORS:

MAIN DRIVERS AND PURPOSE

- Primary deficit
- Interest rate-growth differential
- Exchange rate

COMPOSITION

- External vs domestic debt
- Creditor profiles
- Foreign currency exposure
- Concessionality

OTHER FACTORS

- Political stability
- Debt carrying capacity and fiscal position
- Macroeconomic strength
- Structural features
- Institutions and governance strength

Half of developing Asia-Pacific economies rely heavily on external debt

Rise of unconventional creditors

**Based on the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries or equivalent credit ratings assessed by credit rating agencies.*

RETHINKING PUBLIC DEBT SUSTAINABILITY ANALYSIS FOR THE SUSTAINABLE DEVELOPMENT GOALS

WHERE WE STAND

Current approaches on public debt sustainability analysis focus on reducing near-term debt distress risks, thus undermining Governments' access to financial resources.

TIME TO RETHINK

Amid shrinking fiscal space and large spending needs to attain the SDGs and climate ambitions, it is time to revisit how public debt sustainability should be analysed.

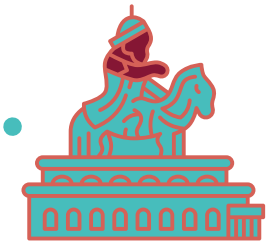
Economic and Social Survey of Asia and the Pacific 2023

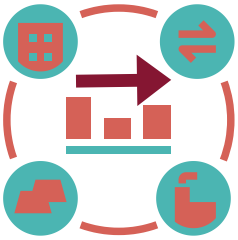
OUR PROPOSAL

ESCAP proposes an **augmented** approach that duly incorporates a country's SDG spending needs and financing strategies and structural development policies.

PROMISING EVIDENCE FOR MONGOLIA AS A PILOT COUNTRY

Government debt would eventually converge to the baseline level that assumes fiscal consolidation, but people and the environment are much better off here.

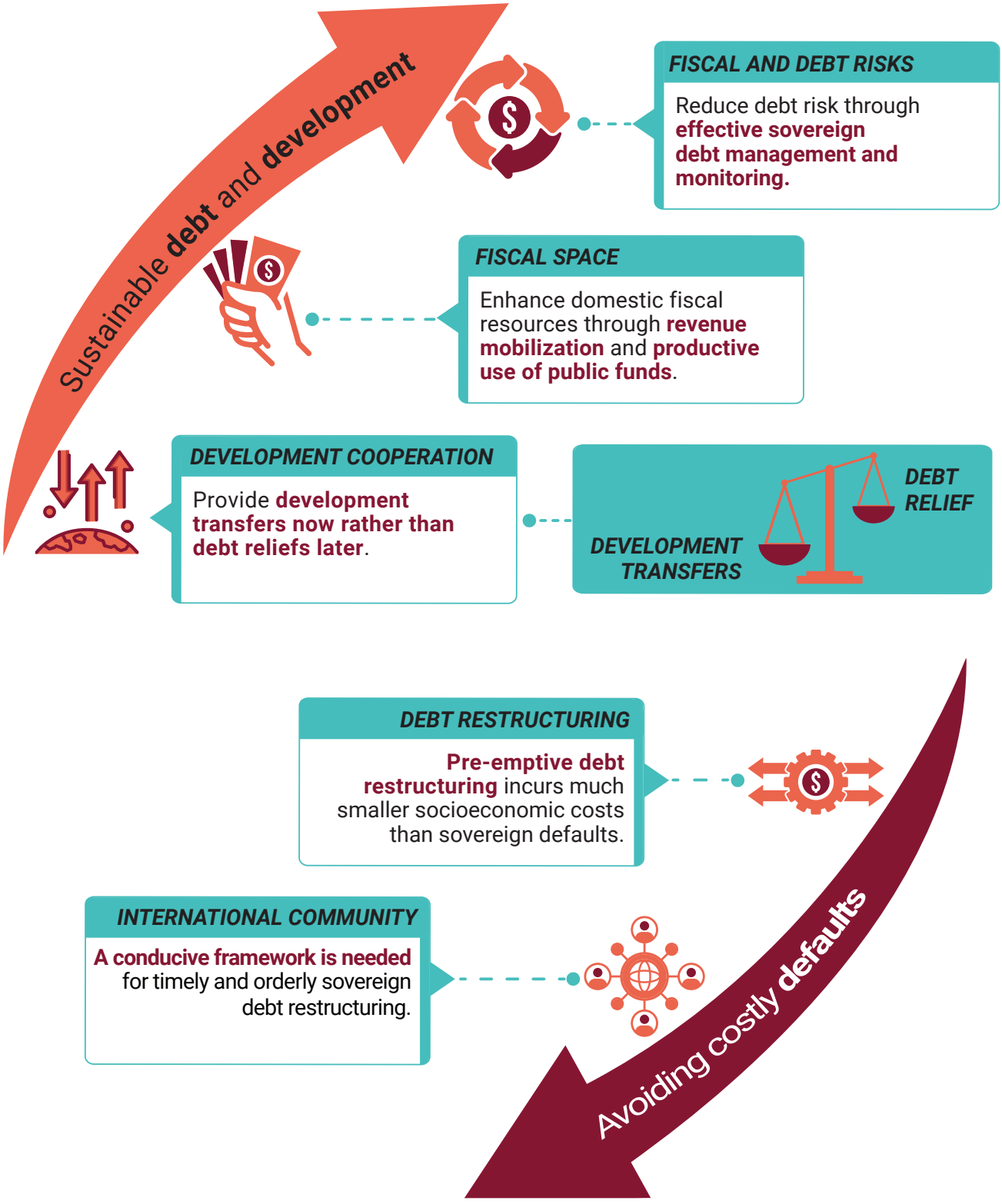




WHAT DOES THIS MEAN FOR ALL STAKEHOLDERS?

Creditors, credit rating agencies and markets should consider not only short-term perspectives. Debtors should strike a balance between the SDGs and debt sustainability.

POLICY OPTIONS FOR MANAGING PUBLIC DEBT SURGE



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The Survey is produced under the overall guidance of Armida Alisjahbana, Under-Secretary-General and Executive Secretary of ESCAP, and Kaveh Zahedi, Deputy Executive Secretary of ESCAP, with support from the Editorial Board of ESCAP. It draws on expertise available in ESCAP substantive divisions and subregional offices and from across the United Nations system.

Hamza Ali Malik, Director of the Macroeconomic Policy and Financing for Development Division, provides overall leadership and management, and shares valuable feedback, comments and suggestions at various stages of preparation of this flagship publication.

This 2023 edition of the Survey was prepared by a core team initially led by Shuvojit Banerjee and then by Vatcharin Sirimaneetham, including Nixie Abarquez, Zheng Jian, Michał Podolski, Kiatkanid Pongpanich and Lin Zhuo of the Macroeconomic Policy and Financing for Development Division.

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EXPLANATORY NOTES

Analyses in the Economic and Social Survey of Asia and the Pacific 2023 are based on data and information available up to 15 February 2023.

Groupings of countries and territories/areas referred to in the present issue of the Survey are defined as follows:

- ESCAP region: Afghanistan; American Samoa; Armenia; Australia; Azerbaijan; Bangladesh; Bhutan; Brunei Darussalam; Cambodia; China; Cook Islands; Democratic People's Republic of Korea; Fiji; France; French Polynesia; Georgia; Guam; Hong Kong, China; India; Indonesia; Iran (Islamic Republic of); Japan; Kazakhstan; Kiribati; Kyrgyzstan; Lao People's Democratic Republic; Macao, China; Malaysia; Maldives; Marshall Islands; Micronesia (Federated States of); Mongolia; Myanmar; Nauru; Nepal; Netherlands; New Caledonia; New Zealand; Niue; Northern Mariana Islands; Pakistan; Palau; Papua New Guinea; Philippines; Republic of Korea; Russian Federation; Samoa; Singapore; Solomon Islands; Sri Lanka; Tajikistan; Thailand; Timor-Leste; Tonga; Türkiye; Turkmenistan; Tuvalu; Uzbekistan; Vanuatu; and Viet Nam.

- Developing ESCAP region: ESCAP region excluding Australia, Japan and New Zealand.
- Developed ESCAP region: Australia, Japan and New Zealand.
- East and North-East Asia: China; Democratic People's Republic of Korea; Hong Kong, China; Japan; Macao, China; Mongolia; and the Republic of Korea.
- North and Central Asia: Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Russian Federation, Tajikistan, Turkmenistan and Uzbekistan.
- Pacific: American Samoa, Australia, Cook Islands, Fiji, French Polynesia, Guam, Kiribati, Marshall Islands, Micronesia (Federated States of), Nauru, New Caledonia, New Zealand, Niue, Northern Mariana Islands, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu.
- Pacific island developing economies: All those listed above under "Pacific" except for Australia and New Zealand.
- South and South-West Asia: Afghanistan, Bangladesh, Bhutan, India, Iran (Islamic Republic of),Maldives, Nepal, Pakistan, Sri Lanka and Türkiye.
- South-East Asia: Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Timor-Leste and Viet Nam.
- Least developed countries: Afghanistan, Bangladesh, Bhutan, Cambodia, Kiribati, Lao People's Democratic Republic, Myanmar, Nepal, Solomon Islands, Timor-Leste, Tuvalu. Samoa and Vanuatu were part of the least developed countries prior to their graduation in 2014 and 2020, respectively.
- Landlocked developing countries: Afghanistan, Armenia, Azerbaijan, Bhutan, Kazakhstan, Kyrgyzstan, Lao People's Democratic Republic, Mongolia, Nepal, Tajikistan, Turkmenistan and Uzbekistan.
- Small island developing States: American Samoa, Cook Islands, Fiji, French Polynesia, Guam, Kiribati, Maldives, Marshall Islands, Micronesia (Federated States of), Nauru, New Caledonia, Niue, Northern Mariana Islands, Palau, Papua New Guinea, Samoa, Singapore, Solomon Islands, Timor-Leste, Tonga, Tuvalu and Vanuatu.

Owing to the limited availability of data, selected small island developing States are excluded from the analysis. For the purpose of this Survey, Singapore is not considered to be a small island developing State due to its high level of development and high-income status.

Bibliographical and other references have not been verified. The United Nations bears no responsibility for the availability or functioning of URLs.

Many figures used in the Survey are on a fiscal year basis and are assigned to the calendar year which covers the major part or second half of the fiscal year.

Growth rates are on an annual basis, except where indicated otherwise.

References to dollars ($) are to United States dollars, unless otherwise stated.

The term “billion” signifies a thousand million. The term “trillion” signifies a million million.

In the tables, two dots (..) indicate that data are not available or are not separately reported; a dash (–) indicates that the amount is nil or negligible; and a blank indicates that the item is not applicable.

In dates, a hyphen (-) is used to signify the full period involved, including the beginning and end years, and a stroke (/) indicates a crop year, fiscal year or plan year.

ACRONYMS

ADB	Asian Development Bank
ADBI	Asian Development Bank Institute
ASEAN	Association of Southeast Asian Nations
ASEAN+3	ASEAN countries plus China, Japan and the Republic of Korea
BIS	Bank for International Settlements
CAC	collective action clauses
CDS	credit default swaps
CEIC	CEIC Data, part of ISI Emerging Markets Group
COP	Conference of the Parties to the United Nations Framework Convention on Climate Change
COP27	27th session of the Conference of the Parties
COVID-19	coronavirus disease 2019
CRA	credit rating agency
DAC	Development Assistance Committee
DBM	Development Bank of Mongolia
DDR	domestic debt restructuring
DfCS	debt-for-climate swaps
DSA	debt sustainability analysis
DSSI	Debt Service Suspension Initiative
EDR	external debt restructuring
ESCAP	United Nations Economic and Social Commission for Asia and the Pacific
ESG	environmental, social and governance
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
G20	Group of Twenty
GDP	gross domestic product
GNI	gross national income
HIPC	heavily indebted poor countries
IFI	international financial institutions
ILO	International Labour Organization
IMF	International Monetary Fund
JETPs	Just Energy Transition Partnerships
LCY	local currency
LIC-DSF	joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries

MDRI	Multilateral Debt Relief Initiative
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC+	Organization of the Petroleum Exporting Countries Plus[1]
$PM_{2.5}$	particulate matter that has a diameter of 2.5 micrometres or smaller
PMI	purchasing managers' index
PPG	public and publicly guaranteed debt
PPP	public-private partnership
R&D	research and development
SCDI	state-contingent debt instruments
SDGs	Sustainable Development Goals
SEEA	System of Environmental-Economic Accounting
SNA	System of National Accounts
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
V20	Vulnerable Twenty Group of Ministers of Finance
WFP	United Nations World Food Programme
WHO	World Health Organization
WTO	World Trade Organization

1 A group of 23 oil-exporting countries which meets every month in Vienna to decide how much crude oil to sell on the global market; created in 2016, when the Organization of the Petroleum Exporting Countries (OPEC) joined forces with 10 non-OPEC oil producers: Azerbaijan, Bahrain, Brunei Darussalam, Kazakhstan, Malaysia, Mexico, Oman, Russian Federation, South Sudan and Sudan.

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CHAPTER 1

CHAPTER 1

Macroeconomic performance and outlook for Asia and the Pacific

1. Introduction

Developing economies in Asia and the Pacific experienced strong economic momentum at the beginning of 2022, driven by increases in regional and global economic activity from border re-openings and a pickup in domestic consumption and growth in external trade. This positive start to the year, however, was soon derailed by the war in Ukraine which triggered global economic turmoil through trade disruptions and the breaking of supply chains, which triggered a shock to food and energy prices. The resulting economic slowdown towards the end of 2022 is expected to continue in 2023. The average GDP growth rate in Asia and the Pacific in 2022 is estimated to have been 3.3 per cent; it is forecasted to increase moderately to 4.2 per cent in 2023. This outlook remains fraught with uncertainty, however. In addition to declining exports, the growth prospects are clouded by the extent of expected monetary policy tightening in the major developed economies.

Against the backdrop of ultra-accommodative fiscal and monetary policies of 2020/21, the disrupted global supply of goods and the war-induced shock to food and energy prices, these conditions have unleashed a wave of global inflation and have led to a considerable increase in inflation in the Asia-Pacific region. The substantial increase in

the cost of living and the plunging purchasing power of disposable incomes has pushed – again – millions of people into poverty amid growing inequalities. The average rate of inflation in developing countries in Asia and the Pacific is estimated to have been 7.6 per cent in 2022 compared with 3.4 per cent in 2021. Inflation is expected to remain at an elevated level of 5.9 per cent in 2023.

Responding to rising inflationary pressures, monetary tightening in developing Asia-Pacific economies gathered pace in the second half of 2022. At the same time, higher interest rates in developed economies have led to accelerated currency depreciations among many developing Asia-Pacific countries, producing further adverse impacts on their import costs and thus domestic inflation, as well as their foreign currency debt obligations. This situation serves as an additional reason for interest rate increases in the region. The impact of higher interest rates in controlling the elevated rate of inflation is not expected to materialize fully in 2023. Furthermore, positive economic developments, such as the opening of the Chinese economy in 2023, are likely to keep inflation under pressure; increases in pent-up demand, however, may in turn lead to surges in commodity and energy prices.

Although both demand and supply factors are responsible for high inflation in most economies, it is difficult to pin down their relative contributions. Likely upward pressure on wages due to high inflation and thus inflation expectations cannot be ignored either. This makes the conduct of monetary policy increasingly complex. Central banks in the region need to balance managing inflation expectations amid supply-driven factors while minimizing the adverse impacts of higher interest rates on the prospects for economic recovery. Overall, policymakers are advised to follow a cautionary approach despite a recent decline in inflation.

With rising inflation and interest rates, the risk of public debt distress has increased, and policymakers are facing potential fiscal consolidation. This may make it difficult to support economic recovery and sustainable development. Nevertheless, fiscal policy can and must complement monetary policy in tempering high inflation. Limited fiscal resources should be used for abating the rising cost of living and shielding poor households through targeted subsidies or cash transfers. It is uncertain whether debt will become unsustainable for more economies in 2023; however, it is apparent that fiscal resources have been mostly depleted. It is also clear that addressing fiscal deficits will require changing current fiscal management paths to follow the much more challenging road of fiscal efficiency, smart spending and increases in fiscal revenues – a continuation of the key messages contained in last year's Survey. Other longer-term solutions are needed to ensure food and energy security, such as improved agricultural productivity, reduced food waste and fewer trade barriers for food items.

2. Global economic developments and prospects

The global economy experienced a broad-based slowdown in 2022

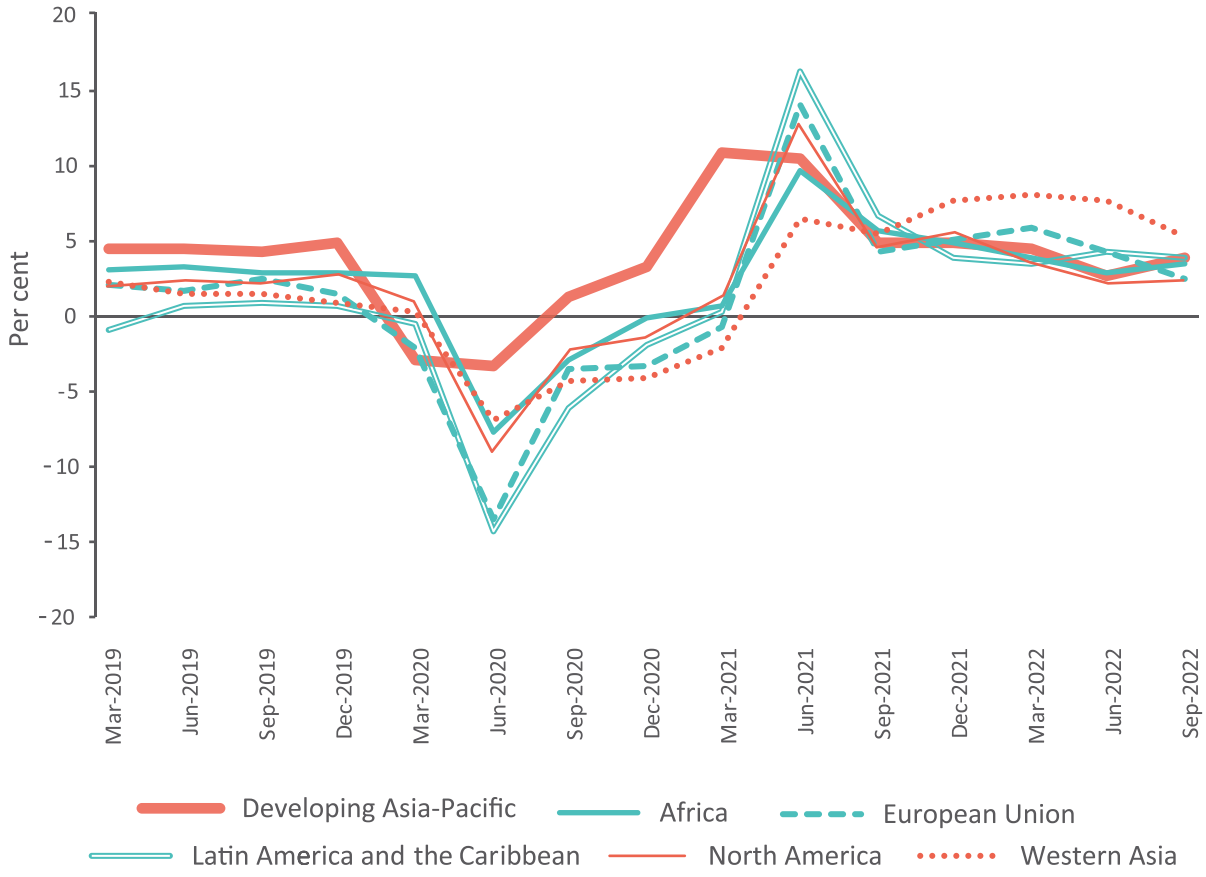
As the impact of the COVID-19 pandemic gradually receded and national borders reopened, economic activities across the globe experienced a resurgence in 2021 and at the beginning of 2022 (ESCAP, 2022a). However, the war in Ukraine, starting towards the end of February 2022, has resulted in numerous setbacks, leading to a simultaneous global economic slowdown in 2022 (United Nations, 2023a). The substantial supply disruptions drove up global food and energy prices, resulting in multi-decade high inflation across the globe, escalating food insecurity and malnutrition in many parts of the Asia-Pacific region (FAO and others, 2022). This triggered rapid monetary policy tightening, led by the United States of America, and thus a rise in borrowing costs, which weighed on economic activities across the globe.

Tightening financing conditions amid high levels of debt and higher debt servicing costs have increased the risk of sovereign defaults and amplified the pressure to expedite fiscal consolidation.

At the same time, climate change and such natural disasters as heat waves, drought, cyclones, floods and earthquakes have resulted in massive economic and humanitarian damage, requiring emergency responses and recovery at a time when fiscal resources have become increasingly limited (ESCAP, 2023b).

Among developed economies, the United States fell into a technical recession in the first half of the year and rebounded thereafter to register an economic growth at 2.1 per cent for 2022.[1] The European Union, responsible for importing about 30 per cent of exports from the Asia-Pacific region (United Nations, 2023c), was on a strong GDP growth path of 5.6 per cent in the first quarter of 2022. However, after the onset of the war in Ukraine, quarterly GDP steadily declined to an annual growth rate of 3.6 per cent for 2022 due to the consequent energy crisis and dampened demand caused by rising inflation (Eurostat, 2023). Against this background, the global economic growth rate is estimated to have dropped to 3 per cent in 2022, from 5.8 per cent in 2021 (United Nations, 2023a). Importantly, the risk of a global recession in 2023 has risen considerably, and economic growth is projected to moderate further in 2023 to 1.9 per cent before slightly picking up in 2024 to 2.7 per cent (United Nations, 2023a). This is driven by output declines in the Euro zone and expected growth moderation in the United States in 2023 and 2024.

Figure 1.1
Global quarterly GDP growth, 2019-2022



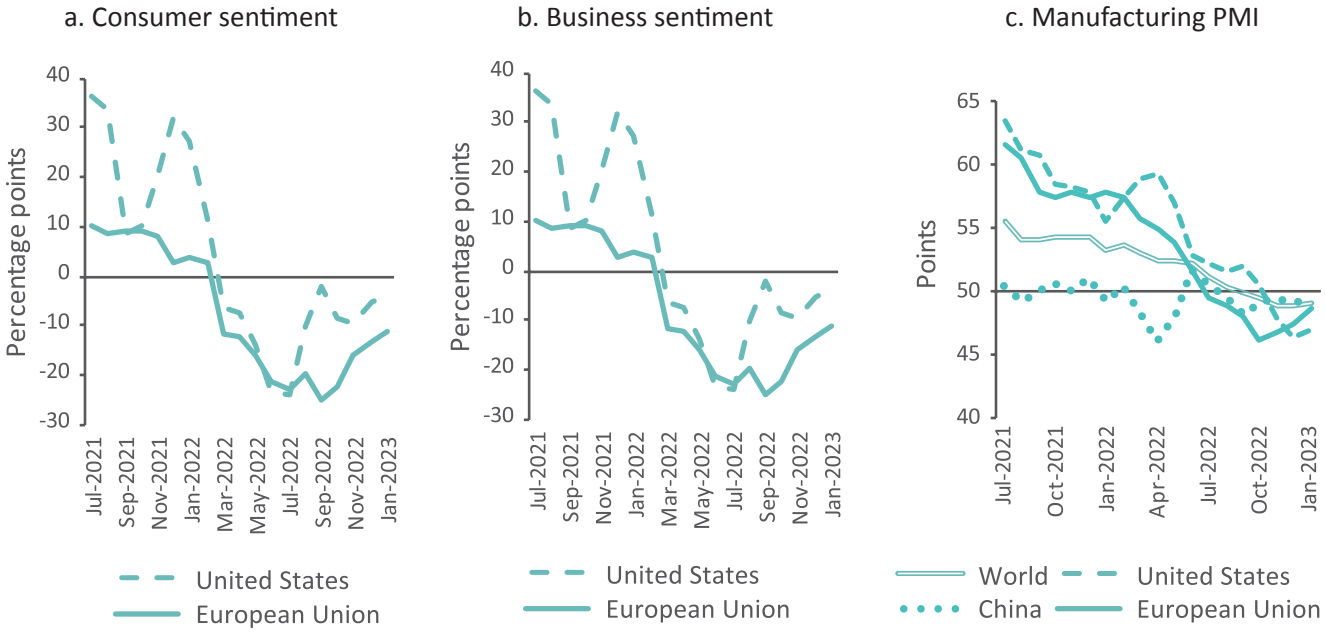
Source: CEIC, accessed on 15 February 2023.

The economic slowdown is visible in several economic indicators

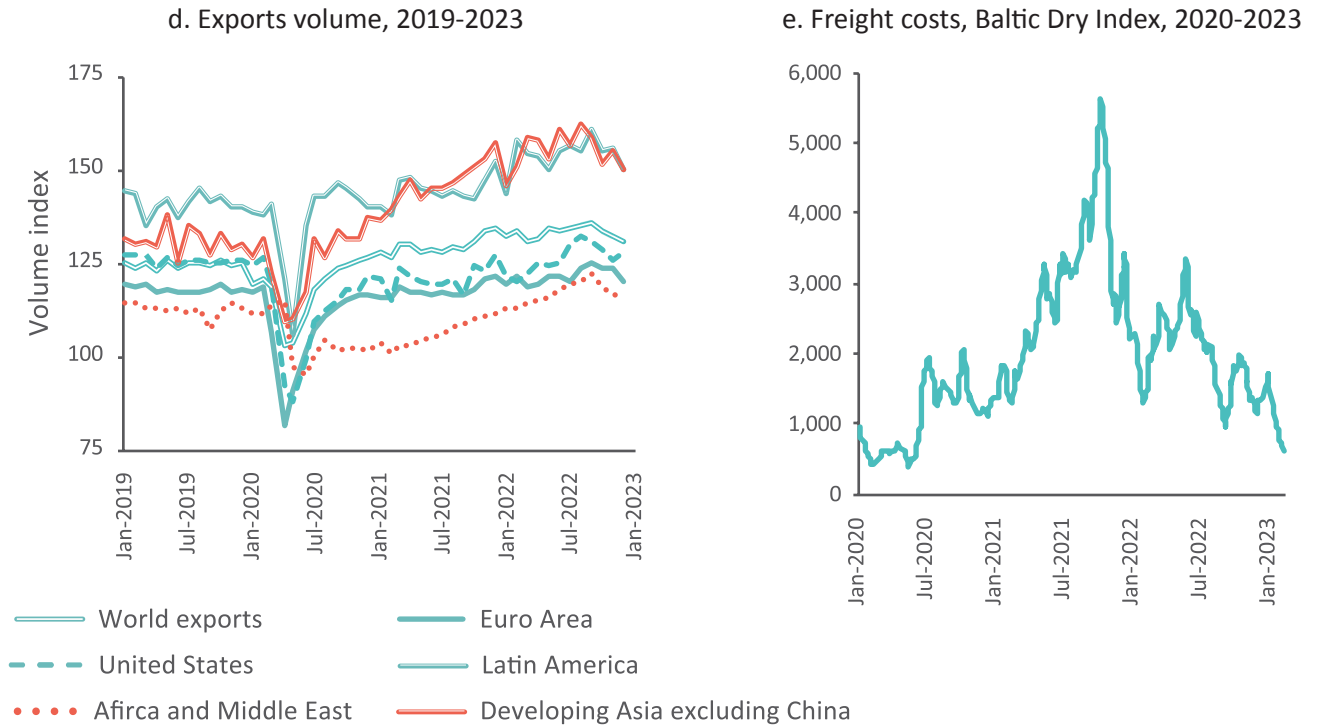
Signs of weakening sentiments and demand are seen in declining consumer and business sentiment (figures 1.2a and 1.2b), moderating manufacturing and export volumes (figures 1.2c and 1.2d) and lower demand for raw materials towards the end of 2022 (figure 1.2e). Trade prospects for 2023 are likely to be shaped by sluggish economic growth, relatively high interest rates, winding down of post-COVID stimuli, high inflationary pressures and rising debt concerns.

1 Recession is defined as two consecutive quarters of negative annualized GDP growth – at negative 1.6 and 0.6 per cent in the first and second quarters of 2022 (United States Bureau of Economic Analysis, 2023). There is no consensus on whether the United States economy had indeed fallen into recession in 2022, due to the relatively strong performance of its other economic indicators, such as labour market data.

Figure 1.2
Signs of slowdown driven by weakening demand from monetary tightening



Source: CEIC, accessed on 15 February 2023.
Note: Change in business and consumer confidence is calculated by CEIC based on data from national statistical institutes, central banks and government agencies of respective countries; Purchasing Managers Index (PMI) readings above 50 indicate expansion; readings below 50 indicate contraction; and a reading at 50 indicates no change.



Source: World Trade Monitor December 2022, CPB Netherlands Bureau for Economic Policy Analysis.

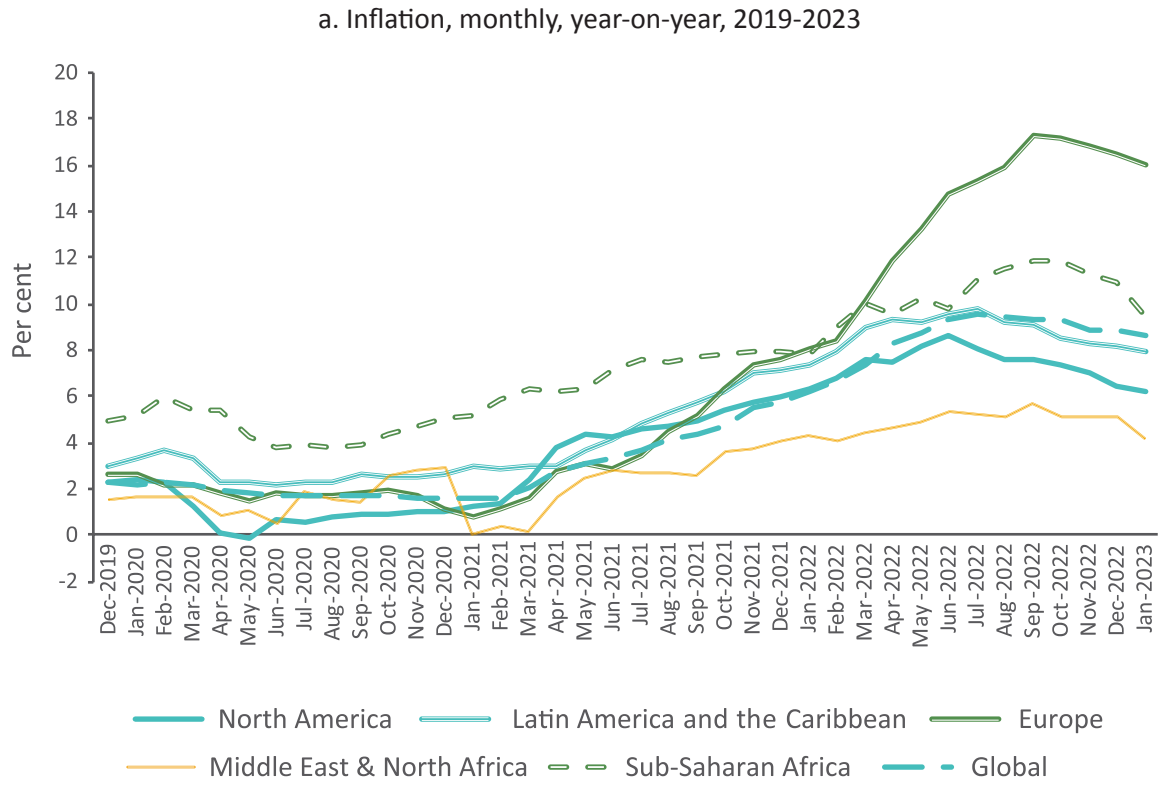
Source: Investing.com.

Inflation has emerged as a top global macroeconomic challenge

Global inflation reached historic levels in 2022 driven by food and energy supply shocks, pandemic-related expansionary fiscal and monetary measures in 2020/21, strained global trade routes and tight labour markets in developed economies (figure 1.3a). The price growth peaked at 9.1 per cent in the United States in June 2022 – the highest level in 40 years, and at 10.6 per cent in the Euro area in October 2022 (Eurostat, 2023). The rise in core inflation across the globe indicates that current high inflation is not just a supply-side phenomenon. It also seems that inflation expectations have been unhinged.

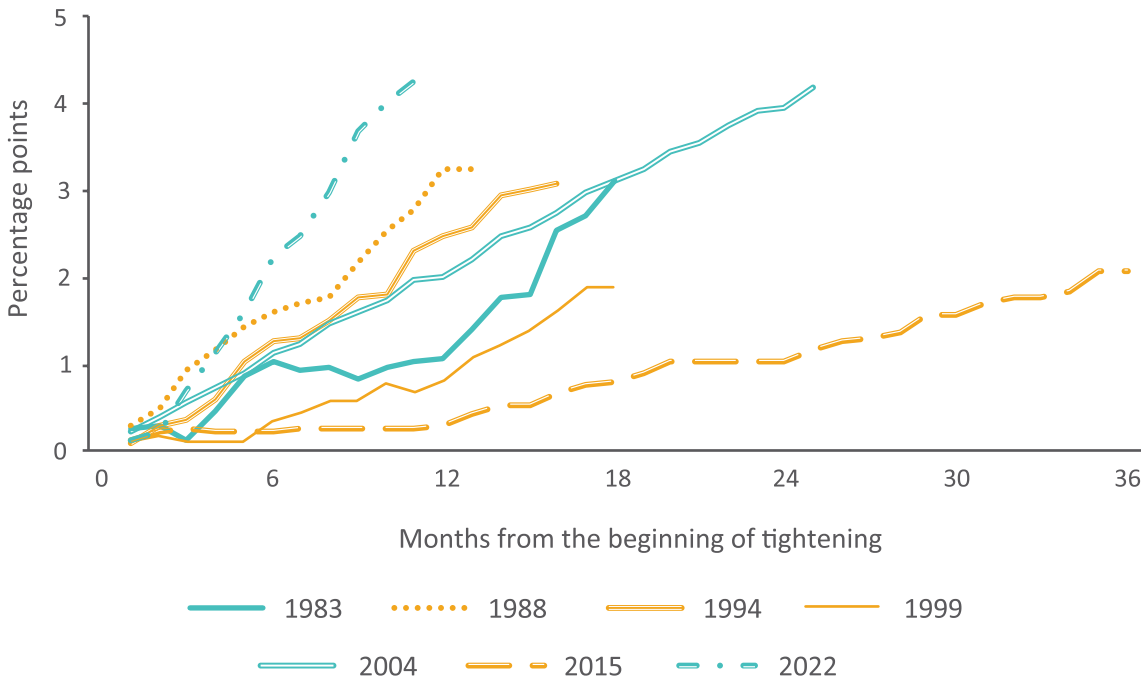
Persistent inflationary pressures have resulted in a rapid monetary tightening (figure 1.3b). Since the start of 2022, the United States has increased its policy interest rate by 475 basis points up to January 2023, and the European Central Bank by 300 basis points. As inflation remains considerably high in the United States and Euro zone, further monetary tightening should be expected, with the likelihood of developing countries, including those from the Asia-Pacific region, following suit.

Figure 1.3
Persistent inflationary pressures have resulted in rapid monetary tightening



Source: ESCAP based on CEIC, accessed on 15 February 2023.

b. Changes in effective Federal Funds Rate during past tightening cycles



Source: CEIC, accessed on 15 February 2023.

3. Economic performance in developing Asia-Pacific economies in 2022

Before discussing the economic performance of the Asia-Pacific region, it is worth highlighting that policymakers' primary focus on economic growth has not shielded their economies from experiencing the negative impact of recent multiple crises. Neither has it translated into improved well-being of people or health of the planet. Measuring progress solely in terms of economic growth does not adequately capture the well-being of people and environmental sustainability. Thus, there is a growing need to complement measurement and assessment of GDP growth with measures that go "Beyond GDP"(box 1.1)

Box 1.1
Beyond GDP – an alternative measurement of progress and well-being

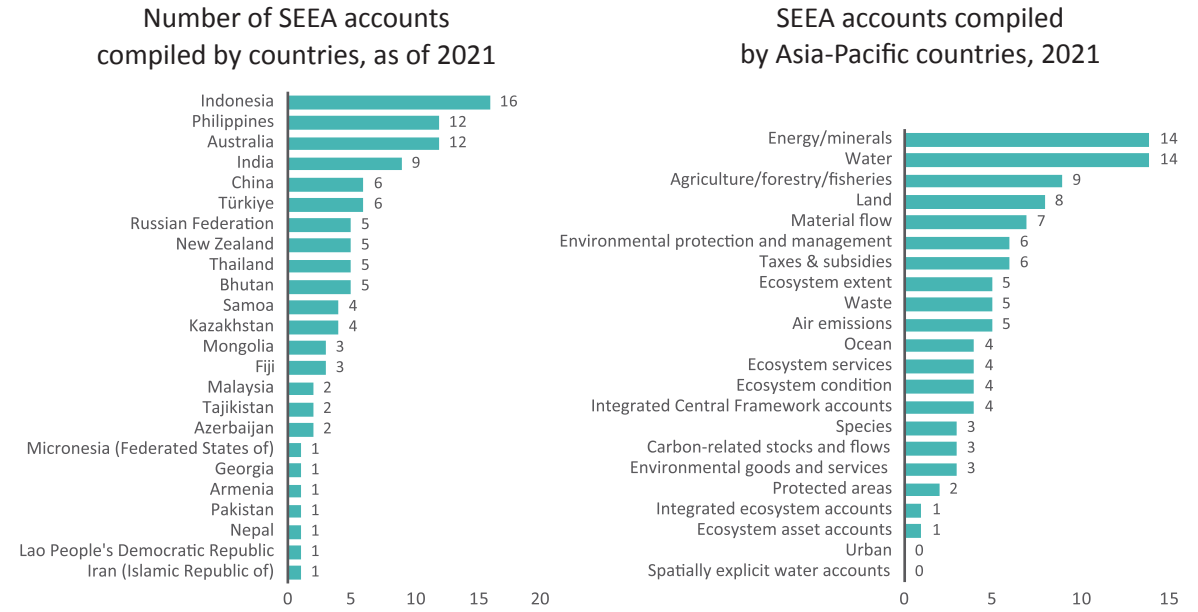
GDP has long been a universally comparable measurement of economic progress based on an agreed set of international standards and accounting framework firmly rooted in economic theory.[a]

One approach to move beyond GDP is to improve existing statistical frameworks, such as the System of National Accounts (SNA). The 2025 SNA revision is one example where more disaggregate information will be included to enable analysis of distributions and inclusiveness aspects, such as digitalization, globalization, well-being, sustainability, informal economy and unpaid work (United Nations, 2023b). The System of Environmental-Economic Accounting (SEEA) Central Framework is another example which builds on SNA and provides a measure linking economic activity and the environment.

Within Asia and the Pacific, 24 countries have compiled SEEA-based accounts either in physical or monetary terms (SEEA, 2022). Indonesia topped the list with 16 accounts, followed by Australia and the Philippines with 12 each, some examples being water, air emissions, energy/minerals, material flow and waste (figure A). Compilation of SEEA-based accounts does not cover an extended time period, and therefore does not permit usage in assessments or reporting.

The lack of sustained partnerships and coordination among government agencies and lack of common understanding on the uses of these accounts have had impacts on the consistent implementation of SEEA. Moreover, knowledge-building on how to generate the data is lacking.

Figure A
SEEA progress in the Asia-Pacific region



Source: ESCAP, based on SEEA 2022.

Other approaches to developing "Beyond GDP" metrics include composite indices or multidimensional indices summarizing well-being, sustainability and inclusivity aspects, or highlighting such priority areas as poverty or human development as in the Human Development Index developed by UNDP. In 2019, approximately 500 global initiatives where indicators of well-being and/or sustainability had been developed were identified (United Nations, 2022).

In the Asia-Pacific region, Bhutan's Gross National Happiness, and New Zealand's Living Standards Framework are some of the best-known examples of the "Beyond GDP" initiative. New Zealand was the first country to embed well-being and sustainable development into budgetary decisions.[b]

To move "Beyond GDP", there is still a need for common understanding on what it is, the need for improved awareness of measurements, construction of new measures and usage of indicators. Similarly, understanding policy constraints and why countries are unable to produce measurements on a continual basis or why they are not fully embedded into national accounting needs more discussion. A recent United Nations report prepared by the High-Level Committee on Programmes on Valuing What Counts proposed a framework to guide national, regional and global efforts, including criteria for identifying the metrics and technical reforms needed (United Nations, 2022) (figure B).

Figure B
Foundational dimensions of a framework for Beyond GDP

Source: United Nations (2022).

a SNA are international standards and an accounting framework on how to compile information about economic activities. It continues to evolve and is maintained by the United Nations, IMF, World Bank, OECD and Eurostat.
b Other initiatives undertaken in the region: Australia: National Development Index; China: Gross Ecosystem Approach; India: Gross Domestic Knowledge; Indonesia: SEEA & Inclusive Growth Index; Japan: Well-Being Dashboard; Philippines: Quality of Life Index; Republic of Korea: National Quality of Life Index; Thailand: SEEA, Bio-Circular Green Economy & Human Achievement Index.

3.1. GDP Dynamics and employment trends

Overall, economic growth in developing Asia-Pacific countries moderated to 3.3 per cent in 2022, which is considerably lower than the 4.5 per cent growth rate that had been projected in 2022 for that year (ESCAP, 2022a). This is a stark slowdown compared with the strong growth rate of 7.3 per cent in 2021 and the average growth rate of 5.5 per cent in the five years prior to the start of the pandemic. China's deeper than expected deceleration due to its zero-COVID policy and instability in the property sector contributed to the region's weak economic performance in 2022. Nevertheless, economic performance varied considerably across the subregions (figure 1.4, box 1.2), with tourism-dependent economies benefiting from border reopenings, commodity - dependent economies benefiting from higher global commodity prices, North and Central Asian countries proving to be resilient to adverse impacts from the war while many economies suffered from balance of payment crisis and impacts of high inflation weighing on sentiments and domestic demand.

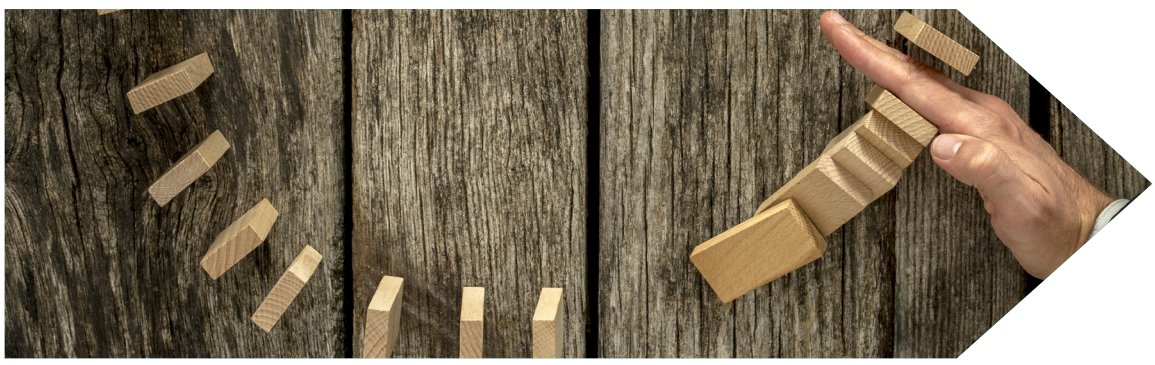
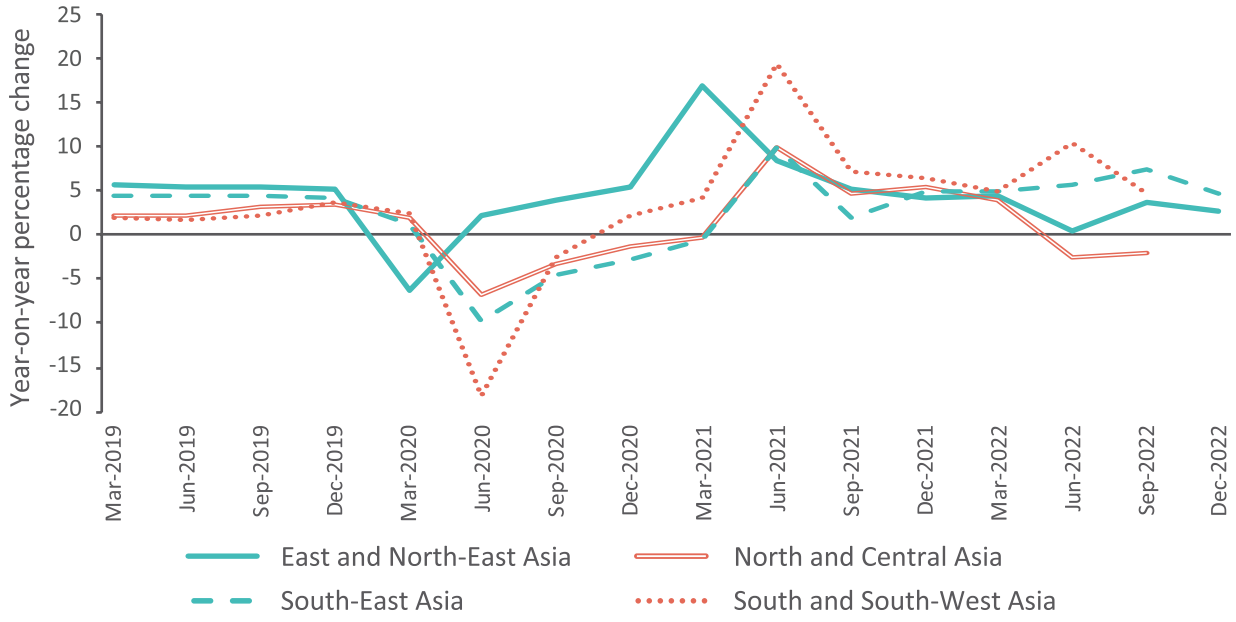


Figure 1.4
Quarterly real GDP growth in developing Asia-Pacific subregions



Source: ESCAP, based on CEIC, accessed on 15 February 2023.
Note: Subregional aggregates are weighted averages based on 28 economies in Asia and the Pacific for which quarterly GDP data are available.

Trade and manufacturing

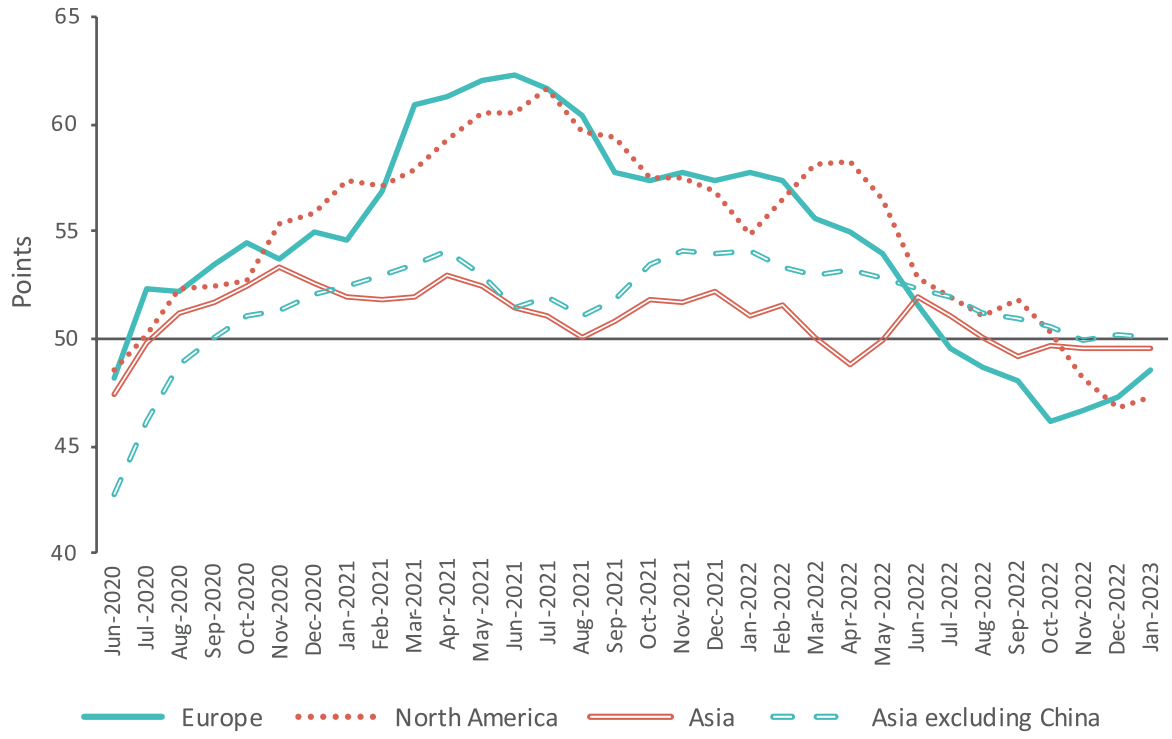
Global demand for goods and services produced by economies in the Asia-Pacific region declined considerably in terms of value as the global economy decelerated in 2022. Asia-Pacific merchandise export volume grew at a moderate pace of 2.9 per cent in 2022, compared with 13.3 per cent in 2021 (WTO, 2022) (figure 1.5). However, export growth was strong in value terms due to rising prices of commodities. Among the key beneficiaries of high commodity prices were Azerbaijan, Indonesia, Kazakhstan, Malaysia, Papua New Guinea and Turkmenistan. Exporters of wheat in Kazakhstan, palm oil in Indonesia and rice in Thailand also benefited from higher food prices (FAO, 2023). Tourism gradually recovered in 2022 as travel restrictions were lifted but tourism remained below pre-pandemic levels.

Figure 1.5
Exports continued to expand in 2022 but at a slower pace than in the previous year

Source: ESCAP, based on World Trade Monitor December 2022 CPB Netherlands Bureau for Economic Policy Analysis.
Note: Developing countries in Asia include 11 developing economies in Asia and the Pacific.

Similar to the situation with regard to trade, manufacturing activities remained subdued, with few exceptions, due to higher cost of inputs and tighter financial conditions. Manufacturing PMI for most economies has been on a declining trend since mid-2022 (figure 1.6). Nevertheless, PMIs for India, the Republic of Korea and South-East Asian economies remained above the 50-point threshold, indicating some expansion. Declines in the second half of 2022 are indicative of muted global demand.

Figure 1.6
PMI trends indicate a slowdown in economic activity



Source: CEIC, accessed on 15 February 2023.
Note: PMI readings above 50 indicate expansion; readings below 50 indicate contraction; and readings at 50 indicate no change.

Box 1.2
Subregional perspectives

East and North-East Asia

Subdued growth in the subregion was attributed mainly to China's lockdown throughout 2022 in response to the pandemic. Within **China**, growth was driven mainly by government spending on infrastructure while the slowing property sector, which fell by 5.1 per cent in 2022, was a drag on growth (China NBS, 2023). Economic activities in **Hong Kong, China**; and **Macao, China**; were similarly constrained by China's zero-COVID policies in 2022. Inflation was more subdued in China but on the other hand, inflation in the **Republic of Korea** accelerated further despite the central bank having raised interest rates by 275 basis points since July 2021, mainly driven by high food and oil prices. Moreover, export growth has suffered severe impacts due to the war in Ukraine and the slowing global economy. **Mongolia**'s inflation also rose rapidly due to import constraints from prolonged border closure with China. China's border reopening will likely provide positive spillover effects, particularly through increased tourism in the Asia-Pacific region.

North and Central Asia

The impacts of the war in Ukraine on countries in North and Central Asia were more benign than anticipated. Growth in the subregion was driven mainly by higher commodity prices, which benefited commodity exporters, along with inflows of Russian citizens, tourists and migrant workers. Economies in North and Central Asia have also seen gains in trade with the Russian Federation (EBRD, 2023). Economic growth in the **Russian Federation** contracted by 3.5 per cent in 2022 as investments were dampened by international sanctions and the withdrawal of foreign businesses while oil production and exports were higher than expected through diverted exports at discounted prices. **Armenia, Georgia and Kyrgyzstan** expanded on the back of strong private consumption, inflows of workers and firms from the Russian Federation and tourist arrivals. **Azerbaijan**'s growth has been driven by rising oil and gas prices and high growth in construction and manufacturing. **Kazakhstan's** economy grew modestly due to reduced capacity in oil production from ongoing repairs to its oil pipeline. **Tajikistan**'s economy was driven by increased industrial production. **Turkmenistan**'s economy benefited from buoyant gas exports. Inflation in North and Central Asia was driven by high food prices and robust domestic demand.

South and South-West Asia

Growth in South and South-West Asia is attributed to strong growth in exports and the services sector in **India**. The Indian economy was not spared the impact of high commodity prices, inflation and higher interest rates but is still expected to remain one of the world's fastest-growing economies. Growth for the subregion declined in mid-2022 reflecting external imbalances and high inflation in **Bangladesh** and the heavy floods in **Pakistan** on top of an economy struggling to regain macroeconomic stability amid a balance of payments crisis. **Sri Lanka**'s growth was also estimated to have contracted for the whole of 2022 due to a balance of payments crisis leading to widespread shortages of food, medicine and raw materials. The situation has since stabilized but remains fragile and requires international support. Tourist arrivals and construction supported growth in **Maldives**. In **Bhutan**, improved agricultural outputs, construction of large projects and hydropower exports contributed to growth, but the tripling of the daily visitor tariff fee will dampen the recovery of tourism. Growth in **Nepal** in FY2022 (ended 16 July 2022) was supported by electricity generation, expansion in construction and rebound in tourism, but domestic demand is being hampered by monetary tightening. **Afghanistan** remains in deep economic depression since 2021 as a result of reduced public revenues, remittance inflows and international aid limited to basic human needs, such as education, health care and nutrition. The **Islamic Republic of Iran** faced inflation reaching up to 50 per cent and strong currency depreciation. The country remains challenged by global geopolitical headwinds. Despite high inflation, **Türkiye** recorded modest economic growth on the back of expanding domestic demand and tourism. However, the earthquake which struck in early February 2023 will likely have adverse impacts on infrastructure and supply chains and could result in a loss of up to 1 per cent of GDP (EBRD, 2023).

South-East Asia

The majority of South-East Asian economies performed better in 2022 than a year earlier on the back of strong consumption, exports and rebound of tourism. In **Indonesia** a surge in exports of commodities supported growth along with a pickup in private consumption and investments. Likewise, in **Malaysia** domestic demand was supported by an increase in the minimum wage and improved labour market conditions. In the **Philippines** growth was driven by robust private consumption, investments and public infrastructure spending along with tourism recovery. The return of migrant workers helped to accelerate growth in construction in **Singapore** while global inflation and tightened financial conditions weighed on demand for financial services. In **Cambodia, Thailand** and **Viet Nam**, growth was driven by the return of international tourists, robust exports, private consumption and investments.

Oil and gas output from **Brunei Darussalam** decreased due to maintenance work on its production facilities. Most central banks in South-East Asia have raised policy rates in response to rising global interest rates, which have led to capital outflows and currency depreciation; those higher policy rates were also aimed at taming domestic inflationary pressures due to higher global food and energy prices. The **Lao People's Democratic Republic** suffered from high commodity prices, as its rapidly depreciating currency and depletion of foreign exchange reserves led to shortages of fuel, resulting in social unrest. The situation has since improved but the economy's high foreign currency-denominated debt exposes it to debt sustainability risks. The global economic slowdown will translate into lower demand for exports from the subregion.

Pacific islands

The Pacific small island States remain extremely vulnerable to global economic shocks, largely due to their high dependence on imports particularly of food. Tourism dependent economies – **Cook Islands, Fiji, Palau, Samoa and Vanuatu** – recovered in 2022 albeit by varying degrees. Fiji's tourism industry recovered more strongly than expected, while growth in Palau and Vanuatu was also supported by agriculture, fishing and construction. **Papua New Guinea**'s economic recovery has been supported by higher export volumes of tea, palm oil and copra, as well as benefiting from higher liquefied natural gas prices. **Solomon Islands** has been affected by multiple shocks – social unrest and a significant COVID-19 outbreak in early 2022 led to an economic contraction for the third year. High inflation is having adverse impacts on growth recovery prospects in **Tonga** and **Marshall Islands** although positive signs have emerged since the border reopening in September 2022.

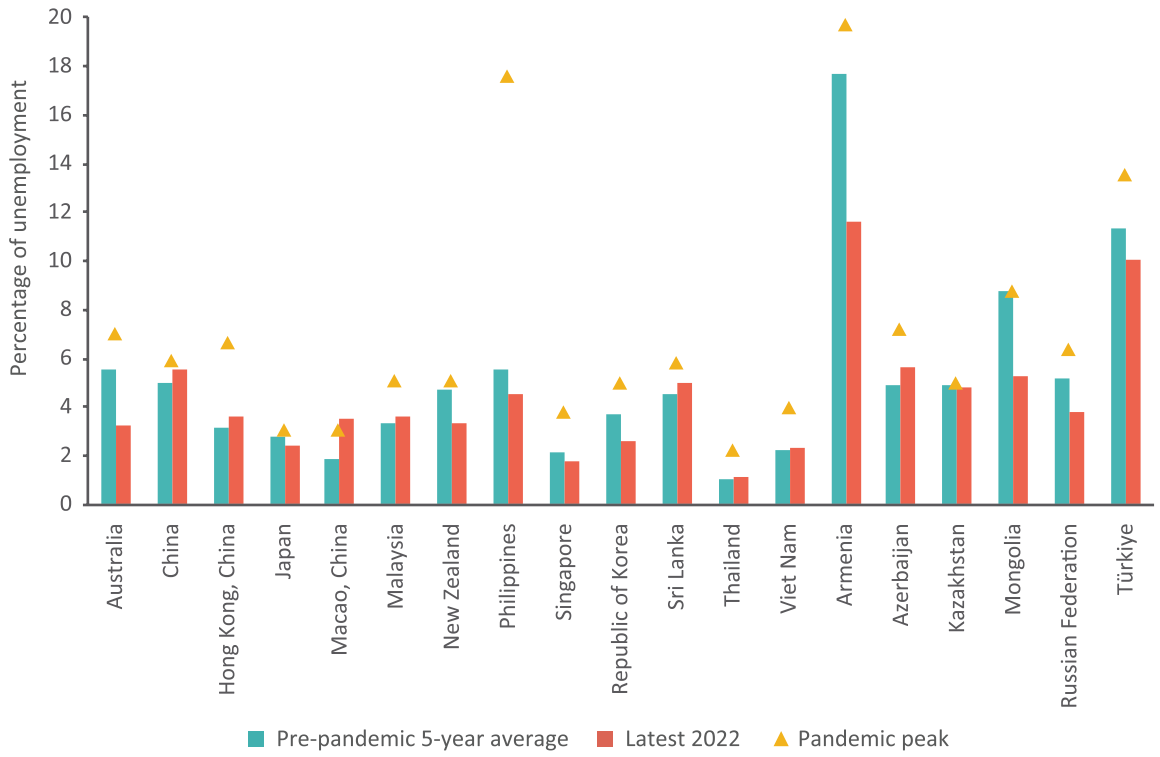
Developed economies

The **Australian** economy expanded robustly over 2022 due to reopening and increases in private consumption. Labour demand was strong and was met by the return of international migrants; nevertheless, the labour market remains tight. Rising living costs and interest rates have reduced spending power, and declines in housing prices are affecting consumer sentiment and demand for new homes. Consumption growth slowed towards the end of 2022. **Japan**'s economy remained resilient amid the global slowdown and high inflation, yet private consumption managed to pick up. High import costs weighed on growth but inbound travel after reopening in September 2022 alleviated trade balances. **New Zealand** registered moderate growth in 2022, supported by household spending and construction, government spending and recovery in tourism. Labour shortages have limited economic activity to some extent. Recent signs of slowing consumption reflects lower house prices, high inflation and rising interest rates.

Employment

Labour market conditions improved somewhat in 2022 as pandemic-related restrictions were gradually lifted but conditions remain uneven. Unemployment rates declined significantly from the pandemic peaks and were close to pre-pandemic levels across the region by 2022 (figure 1.7). Working hours recovered as pandemic restrictions were lifted but mostly remain below pre-pandemic levels. According to ILO, working hours in the Asia-Pacific region registered a decline of 1.2 percentage points in the second quarter of 2022 due to the lockdown in China and dampening effects from the war in Ukraine (ILO, 2022a). Migrant worker shortages were also a factor inhibiting full recovery in some sectors. For example, international migrant workers account for nearly 40 per cent of the employed population in Singapore mainly concentrated in the construction and processing sectors.

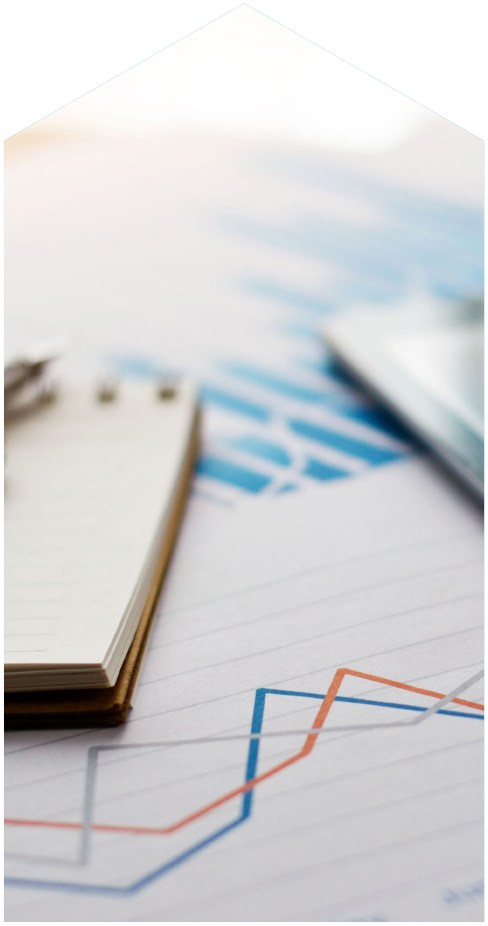
Figure 1.7
Economies where unemployment declined in 2022



Source: ESCAP, based on CEIC and ILO data (2023).

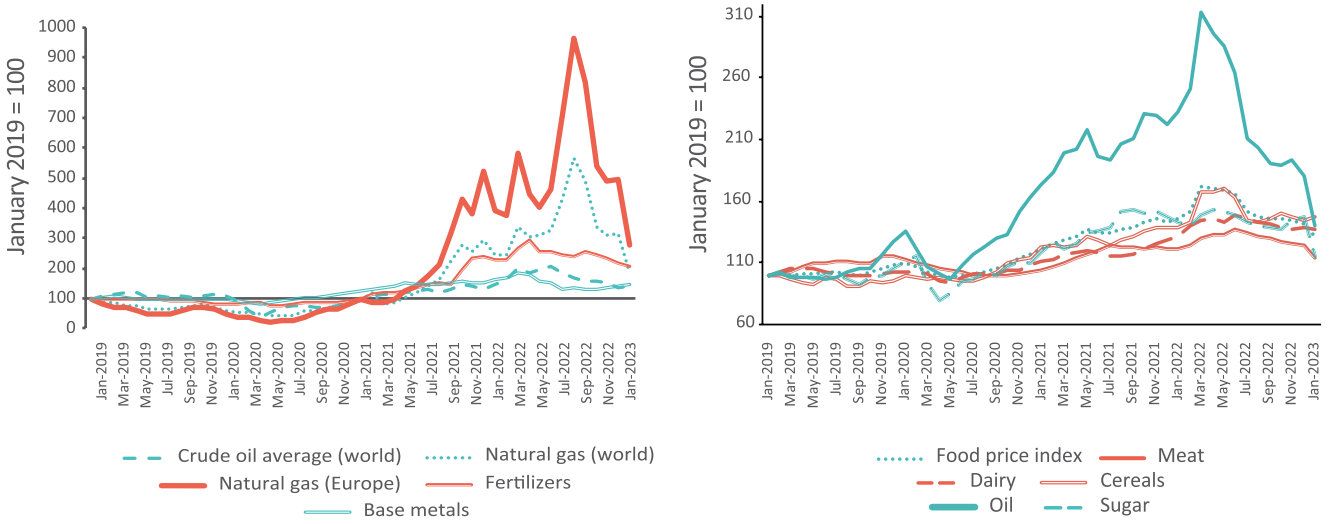
3.2. Inflation and monetary policy

Rapid rise in inflation was driven by both supply and demand factors



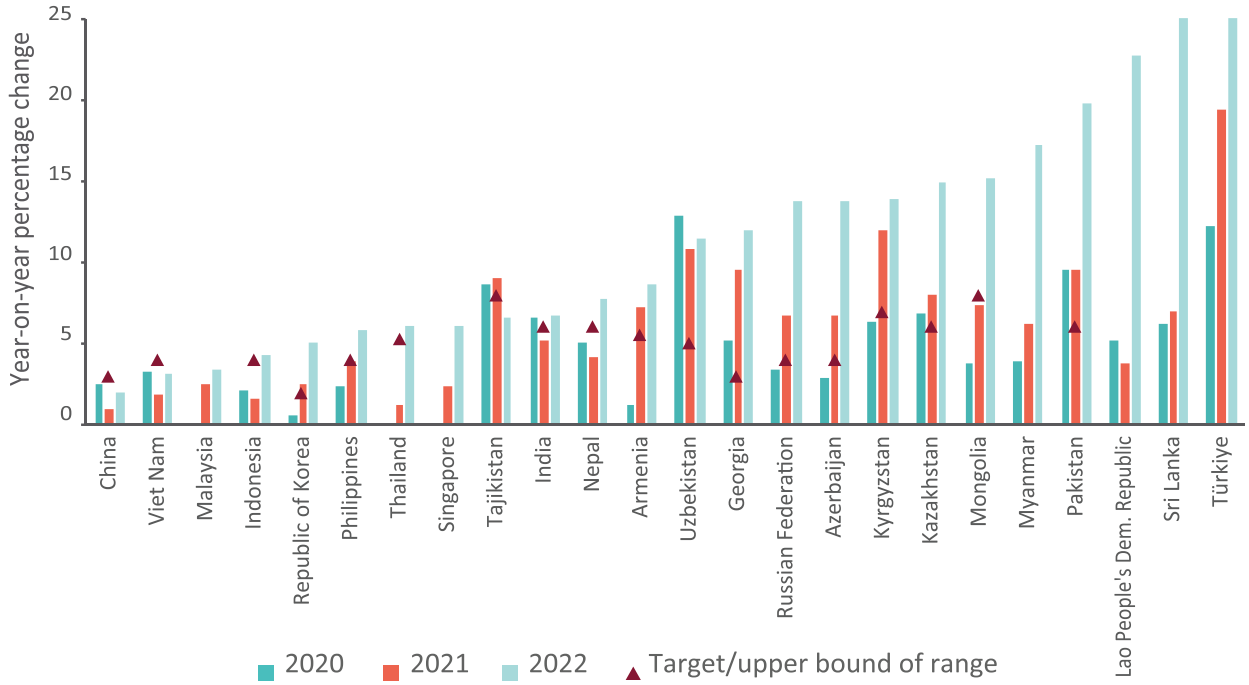
Inflation in Asia and the Pacific in 2022 reached historically high levels in many economies. Average inflation in developing Asia-Pacific economies reached 12.8 per cent in 2022, which was 8.4 percentage points higher than the pre-pandemic average. Rising price levels are driven by both supply and demand factors, including pandemic-related supply chain disruptions, the lagged effects of pandemic-related expansionary fiscal and monetary measures and the war-related supply chain disruptions which led to rapid increases in the prices for food, fuel and key commodities (figure 1.8). Expectations of inflation remaining low and stable seems to have been unhinged as inflation remains persistently above central bank targets in many economies (figure 1.9).

Figure 1.8
Prices of key commodities have risen considerably since mid-2021
Prices of key commodities have risen considerably since mid-2021



Source: Based on CEIC, accessed on 15 February 2023, and World Bank pink sheets (January 2023).

Figure 1.9
Inflation remains higher in many economies than central bank targets



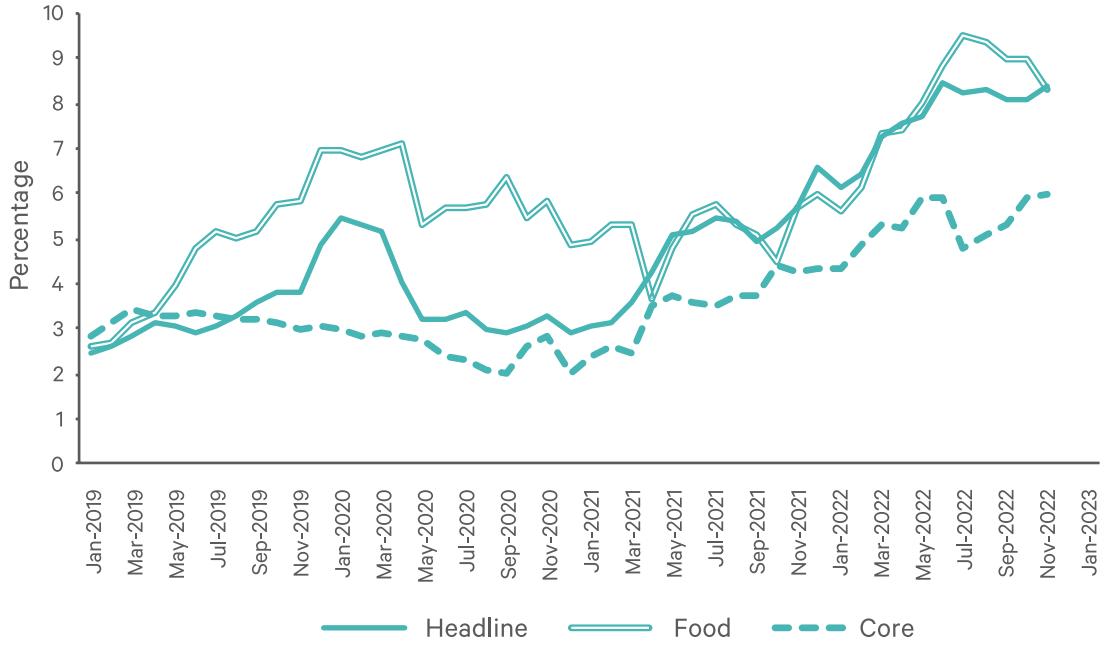
Source: ESCAP, based on CEIC, accessed on 15 February 2023.

High food price inflation is a major concern for low-income households and thus poverty reduction efforts.

Towards the latter half of 2022, food and energy prices moderated somewhat due to softening global demand and better food crop expectations. Nevertheless, both headline and core inflation remained well above pre-pandemic levels across the region (figure 1.10).

Such persistence of inflation has increased the cost of living and reduced people's purchasing power considerably. Food price inflation affects low-income households most as they spend a higher share of disposable income on food consumption. This is likely to push many more people into poverty and delay achievement of food security and malnutrition objectives (box 1.3).

Figure 1.10
Headline, core and food price inflation remain on a rising trend since mid-2021



Source: ESCAP, based on CEIC, accessed on 15 February 2023.

Figure 1.11
Food and energy components represent the main drivers of inflation

Source: ESCAP, based on CEIC, accessed on 15 February 2023.

The main driver of inflation is the pass-through of higher international food and energy prices to domestic inflation. Owing to the lack of data disaggregation for many countries, energy price-related components are reflected through data on housing and transport (figure 1.11). According to ADB (2022), the pass-through effects of a percentage point increase in international food prices raises the average domestic price level by 0.28 percentage points and fuel prices by 0.03 percentage points in developing Asian countries. As most developing Asia-Pacific economies are net importers of food and fuel, and the share of food and oil account for up to 40 per cent of the consumer price index basket in many economies, the impact of the global price shocks has contributed considerably to domestic inflation. The higher cost of living will erode purchasing power and will likely dampen consumption and investments.

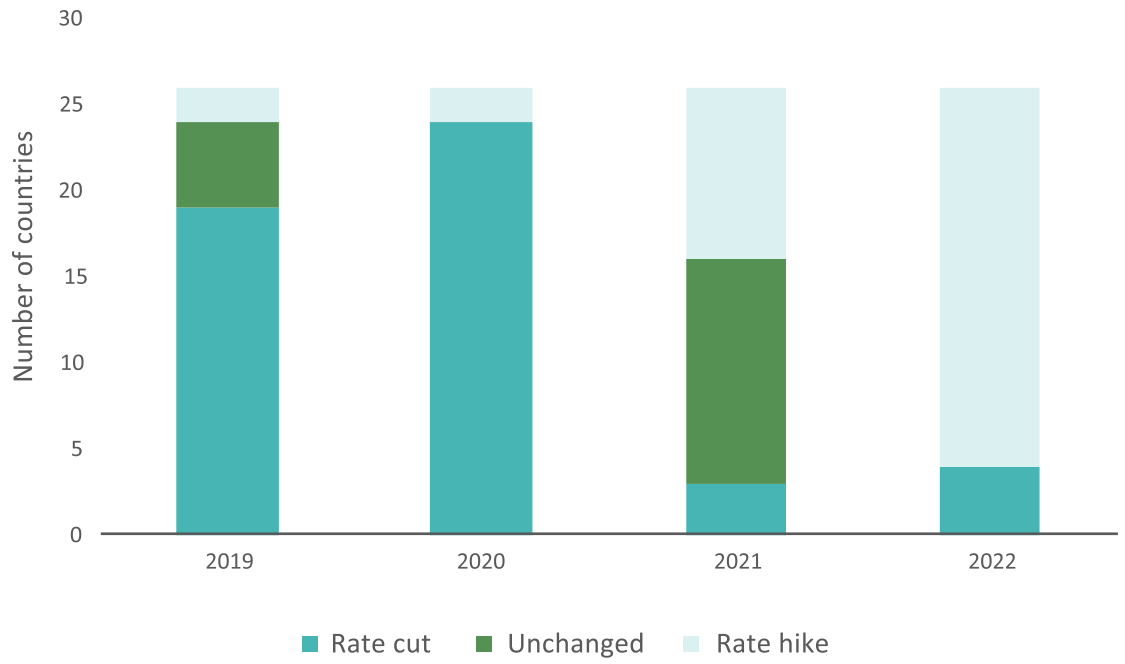
Weakened currencies, higher import costs, country-specific factors and revival of domestic demand also contributed to rising inflationary pressures in 2022. Aggressive interest rate increases in the United States and Europe led to sharp appreciation of the United States dollar and thus depreciating currencies of developing countries. This pushed up prices in local currencies through imported inflation. To safeguard the domestic supply of certain food products, export protectionist measures, such as the export ban on chicken from Malaysia and palm oil from Indonesia, among others, contributed to raising prices of these products. Natural disasters, such as the flood in Pakistan, typhoon in the Philippines and earthquake in Türkiye, pushed food prices even higher. For example, the affected region in Türkiye accounts for approximately 15 per cent of the country's agricultural output, a decline in which could further add to Türkiye's food price inflation, which stood at 71 per cent in January 2023 (Aksoy and others, 2023). In small Pacific island economies, fishing activities were shortened due higher fuel costs while crop production was reduced due to higher fertilizer prices, thus contributing to high food prices. Moreover, the lagged effects of expansionary fiscal and monetary measures introduced since 2020 as a response to the pandemic and increases in demand from reopening also added to upward price pressures.

Central banks are faced with a dilemma of calibrating monetary policy to maintain price and macroeconomic stability without stalling economic recovery.

Appropriate monetary policy response depends on the source (demand versus supply) and nature (temporary versus permanent) of the price shock, as well as the credibility of a central bank in managing expectations of low and stable inflation. Aggressive tightening to offset a temporary supply side shock dampens consumption and investments but may not sufficiently abate price increases of inputs. On the other hand, persistence of inflation at a higher level creates self-fulfilling inflationary expectations and will also dampen economic growth. Not surprisingly, central banks in the Asia-Pacific region started to tighten monetary policy only gradually.

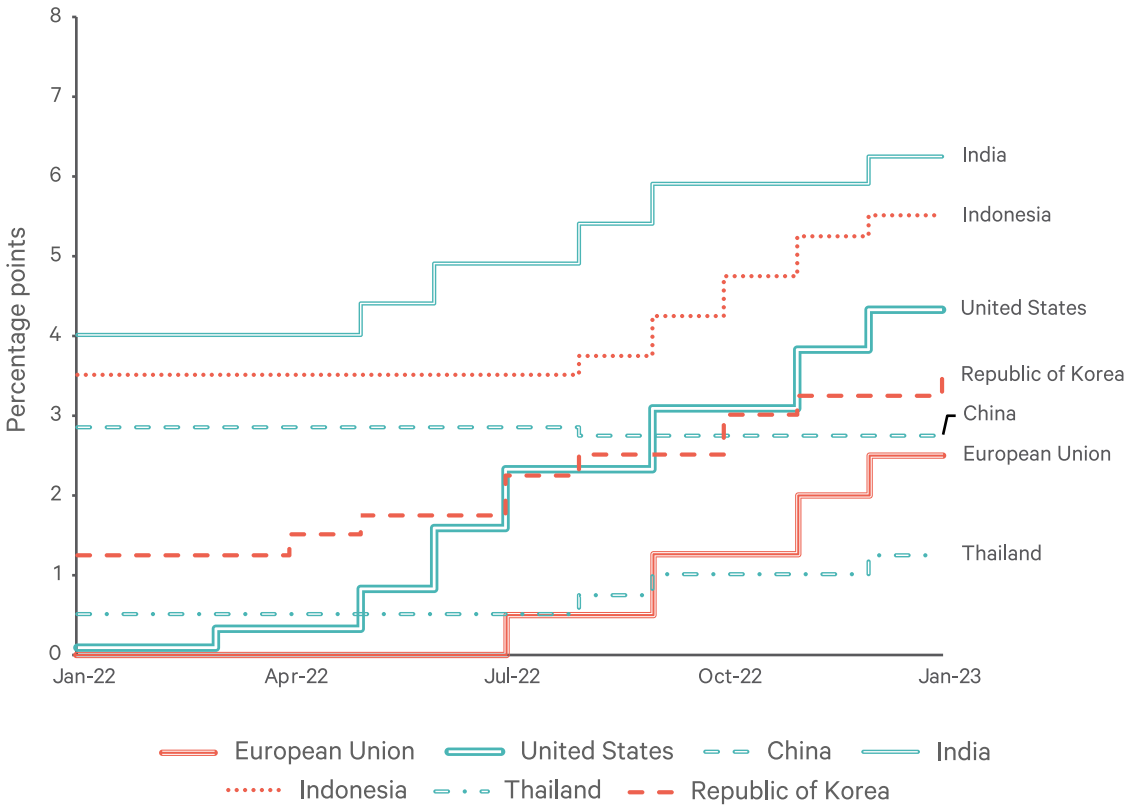
Monetary tightening gathered pace in developing Asia-Pacific countries in the latter half of 2022 as inflation persisted. By the end of 2022, of 26 developing Asia-Pacific economies for which policy interest rate data are available, 22 had raised interest rates by an average of more than 300 basis points (figures 1.12 and 1.13). Because there is a lag of 9-12 months between a change in monetary policy stance and its impact on inflation, central banks will have to wait until at least the middle of 2023 to start seeing some decline in inflation. In the meantime, higher interest rates will raise debt servicing costs for Governments, firms and households and limit public and private investments. For economies with high household debt (Malaysia, Republic of Korea and Thailand), there may be an impact on poverty as well.

Figure 1.12
Central bank interest rate decisions in developing Asia-Pacific economies



Source: ESCAP, based on CEIC, accessed on 15 February 2023.
Note: Central bank interest rate decisions are based on policy rate data for 26 developing countries in the Asia-Pacific region.

Figure 1.13
Interest rates in Asia-Pacific economies follow monetary tightening in major developed economies



Source: ESCAP, based on CEIC (accessed 15 February 2023).

Loss in purchasing power is having an impact on poverty. Based on ILO (2022a), global average monthly wages were estimated to have declined in real terms by 0.9 per cent in the first half of 2022 – the first time in this century that real global wage growth has been negative. In Asia and the Pacific, average real wage growth in 2021 was 3.5 per cent, which slowed to 1.3 per cent in the first half of 2022. Excluding China, average real wage growth for the region was much less at 0.3 per cent in 2021 and 0.7 per cent in the first half of 2022. For countries with data available on spending across the income distribution, it is estimated that the increase in prices in the last two years has increased the cost of living at the bottom income deciles by a greater amount than at the top income deciles. This cost-of-living crisis is in addition to the wage losses seen during the pandemic years.

In terms of impact on poverty, the World Bank (2022a) estimated that the bottom 20 per cent of the population in Indonesia experienced inflation that is 0.8 percentage points higher than the top 20 per cent of the population.[2] Furthermore, household purchasing power has declined on average by 5.5 per cent in the six countries studied with variations across the countries.[3] In the same study, it was estimated that poverty could have increased by 0.2 to 3.4 percentage points using the lower-middle-income poverty line of $3.65 per day and by 0.9 to 8.3 percentage points based on the upper-middle-income poverty line of $6.85 per day.

2 However, some exceptions might occur. For example, in the Lao People's Democratic Republic, the richest quintile experienced inflation at 2.6 percentage points higher than the poorest quintile as the poor relied more on their own food production while the rich were more exposed to the price of transport (World Bank, 2022a).

3 Indonesia, Lao People's Democratic Republic, Mongolia, Philippines, Thailand and Viet Nam.

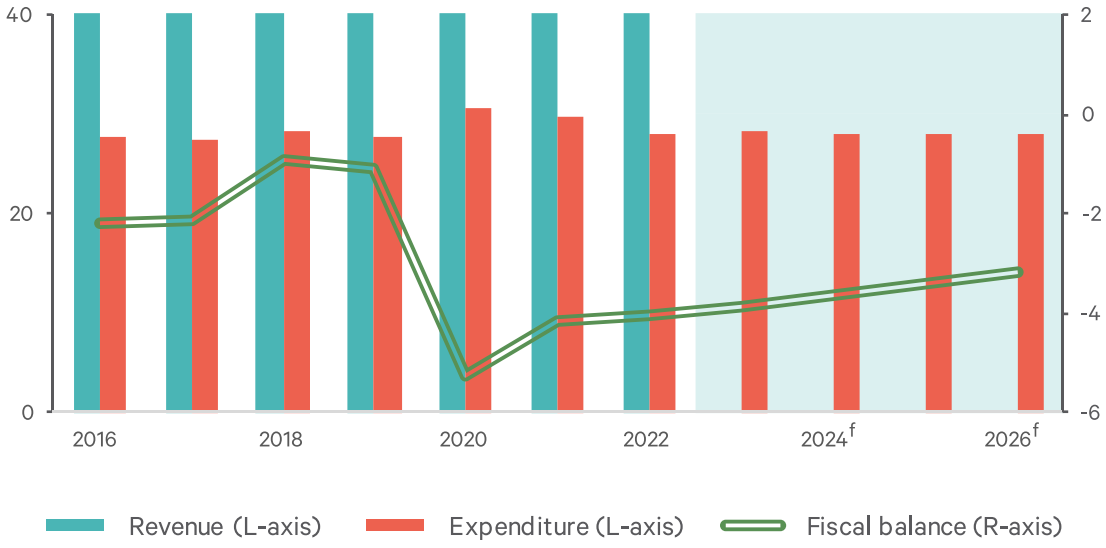
3.3. Fiscal assessment and debt position

Most Asia-Pacific economies entered 2022 with constrained fiscal space and rising public debt levels. The immense fiscal needs generated by the COVID-19 pandemic and the subsequent economic downturn drained fiscal resources considerably in recent years. Fiscal deficits in the region jumped from merely 1 per cent of GDP in pre-pandemic years to about 4-5 per cent of GDP in 2020 and 2021 (figure 1.14a). Similar deficit levels are expected in 2022 and 2023, as government revenues are set to recover only gradually while pandemic-related fiscal expenditures are slowly phased out (figure 1.14a).[4] In 2022, the fiscal shortfalls shrank in several Asia-Pacific economies, partly reflecting the effort on fiscal consolidations (figure 1.14b).

4 In addition to these assumptions on fiscal policy directions, the IMF projections are also based on assessments of economic outlook and an assumption that countries follow IMF policy advice, including on fiscal consolidation.

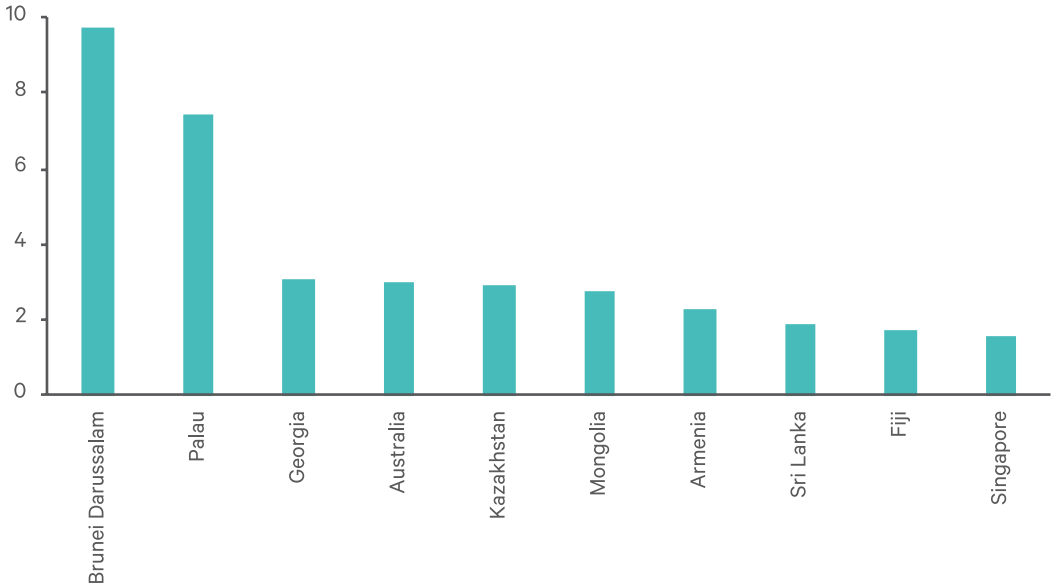
Figure 1.14
Fiscal space in Asia-Pacific economies

a. Developing Asia-Pacific countries, median values, percentage of GDP



Source: ESCAP estimates based on IMF data.
Note: f – forecasts, shaded.

b. Top 10 fiscal consolidations in the Asia-Pacific region, 2022, percentage of GDP



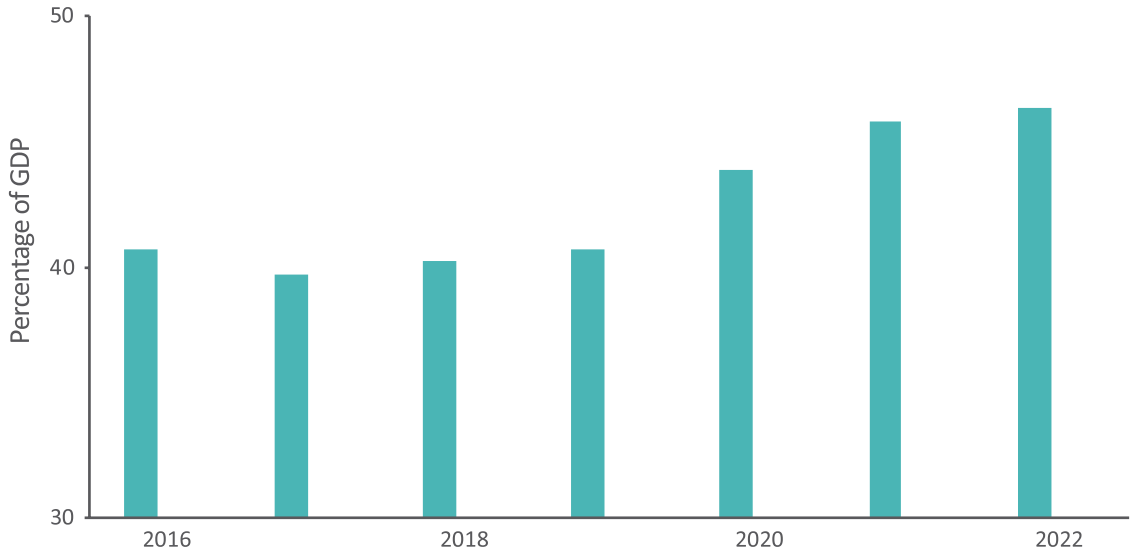
Note: Based on data of 37 countries with fiscal deficit in 2021 (11 Asia-Pacific countries with fiscal surplus in 2021 are excluded).

Rapidly growing fiscal deficits have their mirror reflection in swiftly growing debt. The average government debt-to-GDP ratio in developing Asia-Pacific countries hovered around 40 per cent of GDP during the period 2016-2019 but jumped drastically to 49.5 per cent in 2021 with government debt in two thirds of Asia-Pacific economies reaching its highest level since 2008 (figure 1.15a). Not surprisingly, several economies are and will be facing rising public debt sustainability challenge in the years to come (see chapter 3), especially as rising interest rates push up debt servicing costs amid already tight fiscal space and weak economic growth prospects (figure 1.15b).

Figure 1.15
Debt positions and servicing costs in Asia and the Pacific, 2016-2022

Debt levels rose rapidly since the beginning of COVID-19 crisis, while the negative global inflationary outlook points to further monetary tightening and debt service challenges.

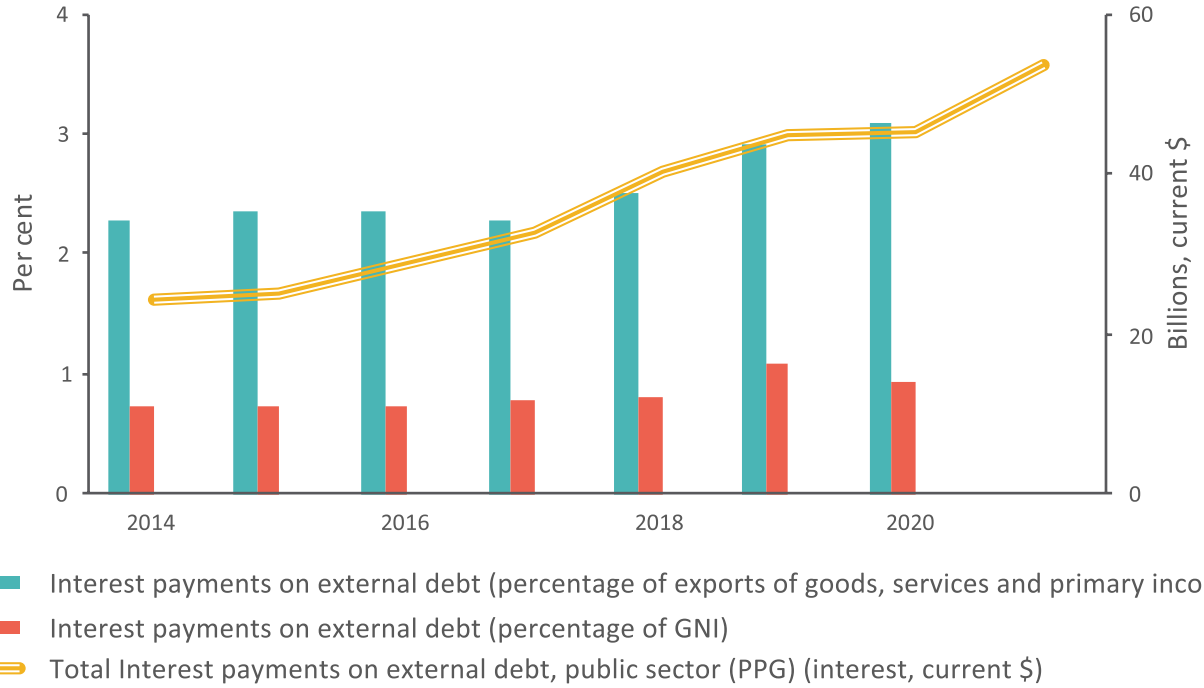
a. Average debt-to-GDP ratio, developing Asia-Pacific economies



Source: ESCAP estimates based on IMF World Economic Outlook data.

Interest payments on external debt have been on the rise, both relative to the size of the economy and in total terms, narrowing fiscal policy options.

b. Interest payments on external debt in developing Asia-Pacific economies



Source: ESCAP estimates based on World Bank data.

Fiscal priorities are changing from responding to the pandemic to being concerned with food security amid weak fiscal revenues

The *Survey* for 2022 stressed the importance of "Spend Smart" and "Tax Fair" policies. Public spending in the areas of education, health care and social protection generate the largest benefits when fiscal resources are limited. Amid relatively low tax-to-GDP ratios in Asia and the Pacific (United Nations, 2022), policy recommendations point to the urgent need to increase tax revenue given elevated public debt levels, largely through tax base expansion, formalization of informal economy and enforcement of already existing regulations, all backed by the immense yet still untapped potential of digital technology. More broadly, longer-term issues, such as demographic shifts and climate change, will have implications on the design and implementation of taxation and public spending policies.

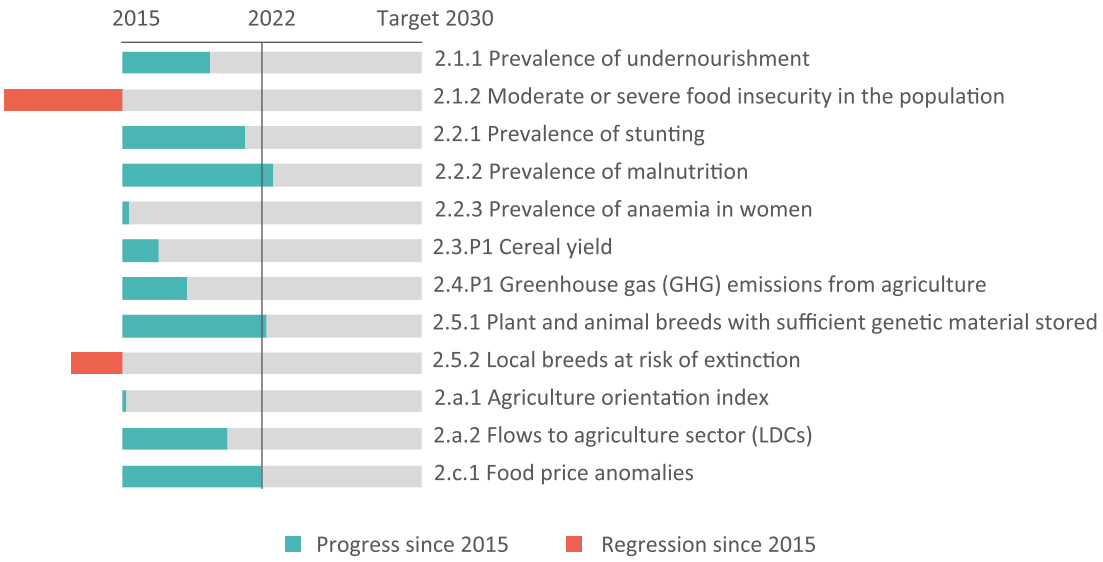
While the need for social spending remains, there is an additional short-term fiscal priority to address food security concerns. Such concerns have been rising globally since early 2022; they require fiscal interventions to ease the burden on poor and vulnerable households. WFP and others (2022) also painted a grim picture of food security for 2023 for many Asia-Pacific economies. Supply of agricultural products and fertilizer to global markets dropped in 2022, while prices increased significantly, driven largely by the war in Ukraine (WFP, 2023). The resultant shortage of fertilizer, amplified by global fertilizer trade restrictions (World Bank, 2022a), has directly decreased the agricultural production in the region for crops in 2022 and 2023. Beyond the headwinds created by geopolitical tensions, food insecurity has been long driven by climate change and biodiversity loss, drawing attention to the lack of resilience and permanent underinvestment in agriculture (box 1.3).

Box 1.3
Food security in Asia-Pacific economies

The state of food security[a] in the region is a fragile one. Recent shocks, such as soaring food and energy prices, unprecedented interest rate hikes and the disruption of supply chains caused by the war in Ukraine further aggravated food insecurity in the region. Even well before this multiple crisis, food insecurity in Asia and the Pacific has long been driven by systemic issues – low production, poor distribution and access, political conflicts and instability, natural disasters, extreme weather conditions due to climate change and biodiversity loss.

A recent progress report on the Sustainable Development Goals revealed that the region's moderate or severe food insecurity further deteriorated and noted that the region will not meet the Goal 2 target on food security unless efforts are multiplied over the next seven years (ESCAP, 2023a) (figure A).

Figure A
Progress in achieving Sustainable Development Goal 2



Source: Asia-Pacific SDG Gateway (ESCAP, 2023a).

Hotspots within the region include Afghanistan, which is of the "highest concern" of food insecurity according to the World Food Programme methodology; Pakistan is of a "very high concern" and Sri Lanka is of "high concern" (WFP and others, 2022). Latest estimates in 2021 indicate that 460 million people in the region suffered from severe food insecurity and an additional 586 million suffered moderate food insecurity. This sums to more than a billion people, implying that half the people in the world who are experiencing moderate or severe food insecurity are from Asia (FAO and others, 2023).

What lies beneath the food insecurity figures is the state of malnutrition, particularly the number of children under 5 stunted and wasted. Recent data point to approximately 396 million undernourished people in Asia where a large proportion are from South and South-West Asia (FAO and others, 2023).

Near-term fiscal interventions are necessary to ease the burden of the vulnerable, but on a long-term basis, increased investment in climate-resilient agriculture is also crucial.[b,c] In recognizing the impact of food production on the environment, it is clear that investment is also needed to shift from fossil fuels to clean renewable energy sources (ESCAP, 2019). Such investments look after the environment by reducing air pollution and protecting biodiversity, thus ensuring food security in a sustainable manner.

a Food security "exists when all people, at all times, have physical and economic access to sufficient, safe and nutritious food that meets their dietary needs and food preferences for an active and healthy life" FAO (1996).
b For further information, see https://www.wfp.org/global-hunger-crisis.
c Climate-resilient agriculture (CRA) is an approach that includes sustainably using existing natural resources through crop and livestock production systems to achieve long-term higher productivity and farm incomes under climate variabilities. This practice reduces hunger and poverty in the face of climate change for forthcoming generations. CRA practices can alter the current situation and sustain agricultural production from the local to the global level, especially in a sustainable manner.

4. Economic outlook for developing Asia-Pacific economies, 2023-2024

Near-term economic prospects seem weakened for developing Asia-Pacific economies.

Average GDP growth in developing economies in Asia and the Pacific is forecast at 4.2 per cent in 2023 and 4.7 per cent in 2024. This assessment is influenced by elevated price levels and expected further monetary tightening, which will hold back economic activities. The projected slowdown in developed economies can translate into a slowdown in demand for exports, a major growth driver for the region. Global trade volume growth is projected to moderate to 1 per cent in 2023 from 3.5 per cent in 2022 (WTO, 2022).

China's abandonment of strict pandemic restrictions and reopening presents an upside potential for the region. After three years of isolation, the pent-up demand for foreign travel will see outbound tourism from China contributing a significant share to tourism receipts of many developing Asia-Pacific economies. This will be particularly beneficial for China's neighbours and economies in South-East Asia that are highly dependent on tourist arrivals from China. In turn, this will help boost tourism and related sectors, which are important for women, youth and migrant workers, many of whom are low-skilled.

Debt levels are becoming increasingly unsustainable for many developing economies, casting a shadow on the near-term economic outlook for Asia and the Pacific. Indebted Governments can hardly expect any relief given weak growth prospects for 2023 and the high interest rate environment. Likely depreciation of currencies in many developing economies could also push their debt situation towards more unsustainable levels in the coming years. Under this scenario, with already elevated debt levels, Governments' fiscal space to try to boost economies would remain severely limited.

The challenging macroeconomic environment will have impacts on job creation and may likely increase unemployment. The war in Ukraine and associated inflationary pressures means that people will struggle to maintain purchasing power, further exacerbating rising inequality and poverty trends. Higher uncertainty, rising interest rates, increased debt burdens and increasing risk of recession in 2023 will dampen investments by businesses, reduce demand by households and thus have adverse impacts on job creation and may likely lead to increases in unemployment.

The prospects for reducing poverty and implementing the 2030 Agenda seem ever more daunting as many more people are pushed into poverty, and progress towards more sustainable and low-carbon development is stalled. Moreover, with food prices expected to remain elevated, the risks associated with food insecurity and malnutrition need urgent attention. Governments are also faced with constrained fiscal space with limited resources to alleviate and protect workers and enterprises in times of downturn or to support a more sustainable and inclusive economy.

Inflation remains elevated in the near term, keeping the cost of living high and domestic demand restrained. Average inflation in Asia and the Pacific is projected to moderate slightly to 5.9 per cent in 2023 from 7.6 per cent in 2022. It is projected to decline further to 4.4 per cent in 2024. The expected gradual decline in inflation in the next two years is on the back of moderating commodity prices, softening global demand and monetary tightening responses by central banks. Core inflation is still on the rise while growth is weakening, and central banks are expected to continue their course in raising interest rates. The United States and the European Union have signalled moderate interest rate increases, which will have implications for monetary policy stances of Asia-Pacific economies (Smith and others, 2023).

Table 1.1
Real GDP growth and consumer price inflation, percentage, 2021-2024

	Real GDP growth				Inflation[a]			
	2021	2022	2023[b]	2024[c]	2021	2022	2023[b]	2024[c]
Total ESCAP region	**6.3**	**3.0**	**3.6**	**4.0**	**2.8**	**6.8**	**5.2**	**3.8**
Developing ESCAP economies[d]	**7.3**	**3.3**	**4.2**	**4.7**	**3.4**	**7.6**	**5.9**	**4.4**
Developed ESCAP economies[e]	**2.5**	**1.7**	**1.3**	**1.1**	**0.7**	**3.6**	**2.4**	**1.5**
Developing ESCAP economies								
East and North-East Asia[f]	**6.6**	**2.4**	**3.7**	**3.9**	**0.8**	**2.4**	**2.2**	**2.0**
East and North-East Asia (excluding Japan)[f]	**7.9**	**2.7**	**4.5**	**4.8**	**1.1**	**2.3**	**2.4**	**2.3**
China	8.4	3.0	4.8	5.0	0.9	2.0	2.3	2.3
Democratic People's Republic of Korea	..	..	..	..	..	..	..	..
Hong Kong, China	6.4	-3.5	3.0	3.1	1.6	1.9	2.3	2.3
Japan	1.7	1.0	1.0	0.7	-0.2	2.5	1.5	1.0
Macao, China	18.0	-26.7	20.5	28.0	0.0	1.0	1.5	1.7
Mongolia	1.4	4.3	5.3	6.0	7.1	15.2	12.0	9.5
Republic of Korea	4.0	2.6	1.6	2.4	2.5	5.1	3.5	2.6
North and Central Asia[f]	**4.9**	**-1.5**	**-1.2**	**2.4**	**6.6**	**13.5**	**8.7**	**5.3**
North and Central Asia (excluding Russian Federation)[f]	**5.5**	**4.7**	**4.6**	**4.8**	**6.3**	**12.5**	**9.4**	**6.3**
Armenia	5.7	12.0	4.2	4.5	7.2	8.6	4.5	4.0
Azerbaijan	5.6	5.0	3.0	3.0	6.7	13.8	8.1	5.5
Georgia	10.1	10.0	5.0	5.3	9.6	11.9	8.4	3.5
Kazakhstan	4.0	2.7	3.5	4.0	8.0	14.9	12.0	8.0
Kyrgyzstan	3.6	7.0	6.0	3.5	11.9	13.9	12.0	7.8
Russian Federation	4.7	-3.5	-3.0	1.6	6.7	13.8	8.5	5.0
Tajikistan	6.0	7.3	8.0	8.0	8.0	6.6	7.0	7.0
Turkmenistan	6.2	6.0	5.6	4.8	8.1	5.2	6.1	3.9
Uzbekistan	7.4	5.7	6.5	7.0	0.7	11.4	7.0	5.1
Pacific[f]	**4.5**	**3.5**	**2.0**	**2.0**	**3.0**	**6.7**	**4.9**	**3.0**
Pacific island developing economies[f]	**-1.6**	**4.6**	**4.9**	**3.2**	**3.2**	**5.8**	**5.0**	**4.0**
Cook Islands	-29.1	10.5	11.2	11.0	2.2	4.2	7.7	7.7
Fiji	-5.1	15.6	6.0	3.8	0.2	4.8	4.2	3.6
Kiribati	1.5	1.8	2.3	3.0	1.0	5.0	3.7	3.3
Marshall Islands	-2.5	1.5	2.2	2.5	1.0	3.5	5.5	3.0
Micronesia (Federated States of)	-1.2	2.2	4.1	4.0	2.0	8.8	4.1	3.0
Nauru	1.6	1.2	2.2	2.4	1.2	2.3	2.5	2.5
Palau	-17.1	-1.0	4.3	3.0	0.5	10.2	5.0	3.0
Papua New Guinea	-0.2	3.5	4.9	3.0	4.5	6.0	5.0	4.0
Samoa	-7.1	-6.0	2.0	2.5	-3.0	8.8	10.6	8.0

	Real GDP growth				Inflation[a]			
	2021	2022	2023[b]	2024[c]	2021	2022	2023[b]	2024[c]
Tonga	-2.7	-2.2	2.5	3.2	1.4	8.5	9.4	4.5
Tuvalu	1.5	2.5	2.7	3.2	6.7	7.6	3.3	3.0
Vanuatu	1.0	2.0	4.0	4.4	2.3	4.8	3.2	2.5
Developed countries in the Pacific subregion[f]	**4.7**	**3.4**	**2.0**	**2.0**	**3.0**	**6.7**	**4.9**	**3.0**
Australia	4.7	3.5	2.0	2.0	2.9	6.6	5.0	3.0
New Zealand	4.4	2.2	1.9	2.0	3.9	7.2	4.0	3.1
South and South-West Asia[f,g]	**8.5**	**5.9**	**4.9**	**5.3**	**10.5**	**24.7**	**17.3**	**11.9**
Afghanistan	-20.7	-10.4	-6.6	2.0	5.2	7.4	9.6	14.1
Bangladesh	6.9	7.2	6.0	6.2	5.6	6.2	5.8	6.2
Bhutan	4.1	4.6	4.3	4.8	7.4	5.7	4.5	4.0
India	8.7	6.8	6.6	6.8	5.5	6.7	5.8	5.0
Iran (Islamic Republic of)	4.7	2.8	2.3	2.3	29.1	47.3	38.1	28.5
Maldives	41.7	12.4	7.4	7.5	0.6	2.3	4.1	3.0
Nepal	4.0	5.8	4.7	5.1	3.6	5.9	7.5	7.0
Pakistan	6.5	6.0	2.0	4.0	8.9	12.1	20.0	10.1
Sri Lanka	3.5	-7.9	-3.7	1.7	7.0	50.0	25.0	12.0
Türkiye	11.0	5.8	3.0	3.0	19.4	72.0	42.5	26.5
South-East Asia[f]	**3.3**	**5.5**	**4.5**	**4.8**	**2.3**	**5.2**	**4.4**	**3.0**
Brunei Darussalam	-1.6	-1.8	3.4	3.2	1.7	3.7	2.0	1.0
Cambodia	3.0	4.8	5.5	6.3	2.9	5.4	3.2	3.0
Indonesia	3.7	5.3	5.0	5.3	1.6	4.2	5.0	3.2
Lao People's Democratic Republic	2.5	2.1	3.0	4.0	3.7	22.7	12.0	9.0
Malaysia	3.1	8.8	4.0	4.5	2.5	3.4	2.5	2.0
Myanmar	-18.0	3.0	3.0	3.3	6.2	16.8	13.3	7.8
Philippines	5.7	7.6	5.5	5.7	4.5	5.8	4.3	3.0
Singapore	7.6	3.7	2.0	2.5	2.3	6.1	5.0	3.0
Thailand	1.6	2.6	3.8	4.0	1.2	6.1	2.7	1.8
Timor-Leste	1.5	3.3	4.2	2.6	3.8	7.0	4.0	2.5
Viet Nam	2.6	8.1	6.3	6.5	1.8	3.2	3.9	3.6
Memorandum items:								
Least developed countries	1.2	5.6	4.9	5.2	5.0	8.5	7.1	6.2
Landlocked developing countries	4.8	4.3	4.3	4.6	5.7	12.1	9.1	6.4
Small island developing States	4.1	5.5	5.2	3.7	2.9	5.4	4.8	3.8

Source: ESCAP estimates and projections.

Notes:

a Changes in the consumer price index.
b Estimates.
c Forecasts.
d Developing Asia-Pacific economies consist of all countries and areas listed in the table, excluding Australia, Japan and New Zealand.
e The group of developed Asia-Pacific economies consists of Australia, Japan and New Zealand.
f Aggregate growth rate was calculated using GDP in 2015 United States dollars as weights.
g The estimates and forecasts for countries relate to fiscal years. These are defined as follows: 2022 refers to the fiscal year spanning the period from 1 April 2021 to 31 March 2022 in India; from 21 March 2021 to 20 March 2022 in Afghanistan and the Islamic Republic of Iran; from 1 July 2021 to 30 June 2022 in Bangladesh, Bhutan and Pakistan; and from 16 July 2021 to 15 July 2022 in Nepal.

4.1. Risk to the outlook

Despite inflation having receded somewhat from alarming levels, several downside risks remain and will have an impact on growth prospects and in some cases may further add to inflation.

An escalation of the war in Ukraine may cause further disruptions to food and energy supplies and keep inflation elevated. Energy prices, particularly for gas, have receded. However, the market remains volatile and any potential disruption to the supply of gas may cause prices to increase again. Pickup in energy demand by China may also keep energy prices elevated. Likewise for food, any disruption to supply channels, such as the Black Sea Grain Initiative,[6] would mean a possible increase in food prices. For low-income countries, this would lead to additional pressure on food insecurity and raise malnutrition concerns. Elevated food and energy prices can also increase the risk of social unrest. Moreover, intensifying geopolitical uncertainties would lower business and consumer confidence and weigh on global demand.

Persisting inflation could de-anchor inflation expectations and lead to further monetary tightening. Risks related to renewed disruptions to food and fuel supplies or a strong rebound in China's growth could keep inflation elevated for longer than expected. Persistently high inflation will prolong the cost of living crisis and will lead to continuation of monetary tightening. Tighter financial conditions increase the vulnerability of economies to debt distress and defaults and limit Governments' ability to support and shield the vulnerable from price shocks. A sharper than expected tightening of monetary policy by developed economies in the event of unexpected persistence of inflation could trigger excessive capital outflows from the region and put pressure on currencies and further exacerbate inflation.

Risks associated with policy missteps on the timing and frequency of monetary tightening can erode central bank credibility and result in market volatility. If inflation is not tamed in time and brought within central bank targets, there is a risk of inflation becoming entrenched. This could lead to a wage-price spiral and eventually unemployment and low economic growth. On the other hand, sharper than expected monetary tightening risks pushing economies into a considerable slowdown. A misjudgment on under or overtightening could erode central bank credibility. As there are lags between the implementation of monetary policy decisions and their impacts, it is often uncertain and difficult to assess the effects of interest rate increases. Clear communication by central banks can reinforce policy objectives and is imperative to keep inflation expectations anchored and avert financial market volatility.

6 The Black Sea Grain Initiative is officially referred to as the Initiative on the Safe Transportation of Grain and Foodstuffs from Ukrainian Ports – an agreement between the Russian Federation and Ukraine, made with Türkiye and the United Nations in July 2022 to safely transport grain from certain ports in an attempt to address the food crisis.

A deeper than expected global economic slowdown and a slower than anticipated recovery in China would further depress demand for the region's goods and stall recovery in tourism. Weak economic prospects can lead to unemployment. Uncertain economic prospects and less availability of credit reduce incentives to invest (in capital and research and development), resulting in lower productivity and lower job creation. Prolonged economic downturns and multiple crises would reinforce the scarring effects since the start of the pandemic. Extended disruptions to labour markets erode workers' skills and reduce the chances of workers returning to the workforce. Many workers would fall into poverty, further exacerbating pre-existing inequalities and reducing future economic growth prospects.

Finally, there is increasing pressure on domestic financial stability. Even before the pandemic, non-financial corporate indebtedness has been on the rise in some Asia-Pacific economies. A sudden and substantial rise in interest rates, devaluation of local currencies and weaker business sentiments can pose a threat to financial stability in these countries. A growing number of highly leveraged companies are struggling to meet their debt obligations, while not all underlying risks on debt sustainability may be known to both investors and Governments (IMF, 2022a; OCC, 2021). To ensure financial stability, macroprudential policies as well as initiatives to improve the transparency and reporting standards by the private sector need to be in place.

5. Policy Considerations

Deploy targeted fiscal measures to cushion households from higher cost of living. Monetary tightening, although necessary, may prove insufficient to tackle inflation and deal with the cost of living crisis. Targeted fiscal approaches, such as cash transfers to eligible households, can be deployed to cushion

the impact of rising food and energy prices. In economies where social safety nets are in place, unemployment insurance can provide the most vulnerable people with rapid buffers. Cutting consumption tax and import tariffs on food items would also bring down food prices.

On the other hand, supply bottlenecks drive prices up but can be alleviated through strengthened trade networks, international cooperation and guarding against protectionism. Export bans on food items can hurt local farmers who should benefit from higher prices, while price controls can discourage firms from investing and hurt future productive capacity. Subsidies can act against bringing down demand.

In the immediate term, tackling food security concerns through fiscal support can help provide basic nutrition and prevent hunger and malnourishment. Some measures to ensure food security in the long term include more diversified production, sustainable methods of increasing agricultural productivity, supply resilience through better risk assessment, early warning and building reliance reserves.

The COVID-19 pandemic and the rapid rise in cost of living highlights the importance of financial inclusion and financial resilience in times of economic hardship, where sufficient financial buffers can provide a means to combat poverty and income inequality (box 1.4).

Box 1.4
From financial inclusion to financial resilience

Financial inclusion of citizens is a prerequisite for poverty reduction and a priority for Asia-Pacific developing economies. However, merely having a bank account or access to financial products does not ensure financial resilience. Individuals should be capable of building financial resilience through savings, developing assets through savings, borrowing when needed and protecting themselves from shocks through insurance or other means of obtaining emergency funds (Gash and Gray, 2016).

The COVID-19 pandemic has pushed an estimated 85 million people in the region back into extreme poverty, and the cost of living crisis in 2022 has provided a clear case for the importance of financial resilience (ESCAP, 2022a). Based on data on 23 countries[a] in Asia and the Pacific surveyed in the World Bank Global Findex Database 2021, more than 50 per cent of the respondents in half the countries were very worried and continued to experience severe financial hardship from the disruption caused by the spread of COVID-19. In two thirds of the Asia-Pacific countries surveyed, more than 70 per cent of the respondents found it difficult or impossible to obtain emergency funding.[b] Among these countries, their adult account ownership ratios were sometimes as high as 96 per cent in Thailand and higher than 80 per cent in the Islamic Republic of Iran and Sri Lanka, deeming them to be highly financially inclusive but not financially resilient.

To increase the financial resilience of financially included citizens, it is critical to improve their financial capability (World Bank, 2013), a concept broader than financial literacy. Financial capability to become resilient and be able to possess emergency savings requires encompassing the need to have an account (be financially included); know about (knowledge) available financial products and be able to make the relevant calculations (skills). They also need to recognize the importance of savings for emergencies (attitude) and spend less than their income to accumulate savings in good times (behaviours).

The global financial inclusion community has been pursuing access to, and to a lesser extent, usage of financial services as a means for combating poverty and income inequality (Omar and Inaba, 2020). Great progress has been made but evidence shows that while financial inclusion from the supply side is the first step to financial resilience, policymakers should also focus on improving individuals' financial capabilities from the demand side.

a A total of 36 Asian and Pacific countries were surveyed but data were available for only 23 of them.
b Emergency funding is defined as 1/20th of GNI per capita in local currency.

Timely interest rate adjustments are important to restore price stability and anchor inflation expectations.

If policymakers underestimate the impact and duration of current high inflation, this can result in inflation becoming entrenched. If core inflation within the region remains high and continues to rise in most economies, central banks will likely continue to raise policy interest rates until underlying inflation declines. A timely monetary response can help avoid a wage-price spiral and medium-term adverse impacts on economic growth and employment.

Effective monetary and fiscal policy coordination is also imperative with the central bank and the finance ministry working in the same direction to safeguard price stability, aggregate demand and employment. As central banks are raising policy interest rates to safeguard price stability, fiscal policy can be used to provide a buffer to lower the impact of the resulting higher cost of living and ensure fiscal support does not add to inflationary pressures.

Ensuring domestic economic and financial stability through clear policy communications by central banks and macroprudential measures.

Under tighter financial conditions, higher interest rates and thus higher debt servicing costs, the possibility of defaults or inability to extend credit lines increases. Several measures can be put into place to avert such macroeconomic instabilities. With rising interest rates and the cost of debt servicing, such measures as debt rescheduling can help alleviate the burden of debt repayments. External positions can be strengthened by building up reserves and guarding against dwindling foreign exchange reserves that may be needed to support economies in times of higher import costs, to defend against rapid currency depreciation and to service external debt.

Other measures to prevent financial volatility include rebuilding capital buffers, borrower-based measures and capital flow management. Central banks should clearly communicate their monetary policy decisions to ensure their credibility and avert volatility.

Continued efforts towards green, resilient and fairer growth. As the pandemic and the war in Ukraine have shown, more resilient supply chains and less dependency on oil and fossil fuels are important policies to reduce exposure to global volatility and disruption. Countries should accelerate the transition to low-carbon energy sources and introduce measures to reduce energy consumption and enhance energy efficiency, promote investments and affordable access to finance in order to accelerate green energy transition to low-carbon energy sources and technologies.

6. Conclusion

Reopening of borders provided a positive backdrop to the start of 2022 with post-pandemic recovery continuing until it was suddenly disrupted by the impacts of the war in Ukraine. The Asia-Pacific region, having to contend with high inflation and intensifying monetary tightening, was still able to maintain positive growth in 2022 albeit at a more moderate pace than previously. Headwinds loom as the war continues and global demand weakens amid the highly inflationary environment. The outlook for 2023 is fairly dim, with China's reopening offering a beacon of light to support growth in the region and beyond. The prospects for reducing poverty and implementing the 2030 Agenda seem even more daunting as inflation continues to be the main risk eroding purchasing power and posing major policy dilemmas on the monetary and fiscal fronts. Apart from the immediate need to restore price stability and protect vulnerable people, countries must also be vigilant in averting macroeconomic instability arising from tighter financial conditions and in dealing with the looming economic slowdown. With the current challenges of widening fiscal deficits, rising borrowing costs, weaker exchange rates amid larger current account deficits and lower economic growth, the region has fallen further behind in achieving the Sustainable Development Goals. With additional investments needed in the midst of constrained fiscal positions, it is time to rethink public debt assessment and how the quantity and quality of public debt can be enhanced to adequately account for Sustainable Development Goal financing needs – concepts that are further explored throughout the rest of this report.

CHAPTER 2

CHAPTER 2

Revisiting the public debt-development nexus

1. Introduction

Eight years into implementing the 2030 Agenda for Sustainable Development, the Asia-Pacific region is not on track to achieve any of the Sustainable Development Goals (ESCAP, 2023a). Urgent action is therefore needed if countries are to come even close to achieving these Goals. While several behavioural and policy changes could help, financial investments are a critical requirement to accelerate progress. In 2019, ESCAP estimated that Asia-Pacific developing economies would require, on average, $1.5 trillion per year to achieve the SDGs by 2030: an additional 5 per cent of the average 2018 GDP of the region (ESCAP, 2019). The bulk of these investment requirements were expected to be fulfilled by public resources, impacting fiscal dynamics. These requirements have most likely increased since then given substantial unexpected setbacks, such as the COVID-19 pandemic and more recently the war in Ukraine.

In parallel with the Sustainable Development Goals, climate-related financing needs are expected to put significant strains on countries' public finances, both ex-ante for adaptation and mitigation efforts, as well as ex-post to deal with the losses and damage caused by ever more frequent climate-related extreme weather events. Discussion on such losses and damage was on the agenda of the twenty-seventh session of the Conference of the Parties to the United Nations Framework Convention on Climate Change (COP27), which was held at Sharm El Sheikh, Egypt, from 6 to 20 November 2022. Participating countries reached an agreement on the creation of a fund dedicated to covering the cost of such losses and damage, to be operationalized in 2023. Similarly, Egypt proposed a global coalition of the willing on sustainable debt at COP27, including both sovereign debtor and creditor nations.

This coalition is expected to support initiatives to increase access to affordable green finance and to facilitate refinancing of existing debt or issuance of new debt, aligned with key climate performance indicators.

The impending materialization of climate risks and sustainable development needs on public finances comes during a period of heightened debt vulnerabilities, especially across developing countries. It has been estimated for instance that globally more than half of low-income countries are currently in debt distress or at high risk of it (Chabert, Cerisola and Hak, 2022). More specifically in Asia-Pacific, 11 countries are rated at high risk of debt distress based on the Joint World Bank-IMF Debt Sustainability Framework for Low Income Countries (IMF, 2023).[1] Furthermore, 21 developing countries in the region qualified for the G20 Debt Service Suspension Initiative in the period 2020-2021.

Importantly, countries most exposed to climate change and facing the highest sustainable development needs are also those with the most limited fiscal space. Under these circumstances, there have been renewed calls for major debt relief efforts to help such countries tackle the "twin" debt and climate crises. These calls include notably the proposal for "debt relief for a green and inclusive recovery", which envisions a mechanism for debt to be reduced in exchange for a commitment to dedicate the freed up fiscal space in order to tackle the climate emergency (Volz and others, 2020).

Indeed, many countries are facing a virtual perfect storm. The lingering effects of the COVID-19 pandemic are now compounded with a looming recession in the developed world together with inflationary pressures and sustained food and energy price shocks in the wake of geopolitical tensions. These intertwined challenges are further reducing the fiscal space available for countries to implement the 2030 Agenda.

Additionally, central banks in advanced economies – notably the United States Federal Reserve and the European Central Bank – have significantly tightened their monetary policies with a combination of interest rate hikes and balance sheet measures. Consequently, the United States dollar has strengthened considerably. This leaves the rest of the world dealing with higher interest rates and borrowing costs, in addition to risks of capital flight and pressures on exchange rates.

Since fiscal firepower will be key for countries to advance the 2030 Agenda, this complex and challenging situation calls for a rethink on the interaction between public indebtedness and development financing.

2. Public debt as a powerful tool for financing sustainable development

When thinking about issuing debt in order to finance sustainable development, Governments face a policy trade-off between the risk of accumulating too much public debt, which can potentially threaten macroeconomic stability, and the hazard of being too prudent with borrowing, which when compounded with limited tax revenues can result in too little public spending and investment for sustainable development to occur.

Assessing the role of public debt as a tool for financing sustainable development first requires understanding the various motives for borrowing. These usually fall under the definition of tax-smoothing, that is, when it is socially or politically unacceptable to finance certain expenditures solely by raising taxes or when the distortionary effect is too high. Barro (1979) argued that Governments should aim at stabilizing the marginal cost of taxes over time, which implies an aversion to changes in tax rates (keeping the tax base constant). The issuance of public debt is justified by the ability to limit swings in tax rates, which are deemed to have distortionary effects in an economy.

Debt is a powerful tool for development

Issuance of public debt therefore enables Governments to implement countercyclical policies or cope with unanticipated shocks as well as help finance large upfront expenditures. Financing sustainable development typically requires significant upfront

1 Latest data available.

expenditures for most countries, especially those that are severely exposed to climate change. The decision to undertake public borrowings to finance development-oriented investments is thus assessed based on the expected social and financial returns of the investment. More recently, potential environmental benefits are also given a high value. Finally, most development expenditures provide clear financial co-benefits, such as enhanced economic growth prospects due to improvements in education, or job creation in the field of renewable energy.

Box 2.1
Public debt and inequality

Looking at the two-way link between public debt and inequality is a good example for understanding the difficult policy trade-off faced by Governments when considering whether or not to issue debt. The COVID-19 pandemic triggered renewed momentum for fiscal spending either to reduce inequalities or to prevent them from increasing, which resulted in the issuance of fresh debt. As debt levels increased drastically, some fiscal consolidation was understandable. However, fiscal consolidation usually comes at the cost of increasing inequalities. Thus, while the initial policy of expansionary fiscal measures, supported by the issuance of debt, could address inequalities, the eventual fiscal consolidation ended up increasing inequalities.

Fiscal consolidation episodes were looked at by Furceri and others (2021) in the wake of pandemics; they found that the increase in inequality, as measured by the evolution of the Gini coefficient, as three times higher when a pandemic was followed by austerity than when it was followed by supportive fiscal policies. The IMF Fiscal Monitor (2022d) found that poverty and income inequality were reduced in Brazil as a result of direct fiscal support provided to the population during the COVID-19 pandemic.

Similarly, ESCAP (2022b) found that Governments should focus on health care, education and social protection as spending in these areas mitigates inequalities, limits the lasting scars from the pandemic as well as generates long-lasting returns. The analysis used expenditure data from 39 countries for the years between 1990 and 2020; it found that periods of fiscal consolidation were associated with a persisting rise in intracountry inequalities. This means that the fiscal consolidation approach tended to be at odds with the achievement of Sustainable Development Goal 10, and thus required credible alternatives.

It is key for Governments to deploy expansionary fiscal measures rapidly as soon as a disaster occurs. However, the associated economic contraction makes it unrealistic to finance additional needed fiscal spending through revenues alone; issuance of debt becomes a must. Rajan (2010) underlined the importance of the provision of public goods by the Government, irrespective of disasters, and shed light on the role of rising income inequality as a major cause of the 2008 global financial and economic crisis. These examples highlight a strong case for the issuance of public debt.

On the other hand, Piketty (2015) pointed out that the management of high public debt levels can lead to a worsening of inequalities, notably due to the distributional effects of public policies implemented to reduce the stock of debt. For instance, financial repression (artificially keeping interest rates low) and periods of high inflation, while effective in reducing public debt levels, disproportionately adversely affect the poorer and more vulnerable groups of the population.

Similarly, by looking at several proxy variables Farah-Yacoub and others (2022) found that sovereign debt defaults have significant and long-felt social costs. The poverty head count appeared to increase by 30 per cent shortly after a default, an effect which may persist for a decade. The study also found similar results for various proxy variables related to, for example, nutrition, energy and health. A decade after the default, there were 13 per cent more infant deaths per year than the hypothetical counterfactual, with surviving infants also expected to have shorter lives.

Thus, while a clear case can be made for issuing debt to deal with inequalities, sustained high levels of debt can, in turn, exacerbate inequalities. A fine balancing act is needed to avoid accumulating "excessive" debt and tackling inequalities through the issuance of debt. There are no magic numbers or thresholds of debt levels and inequalities to ascertain when this balance has been achieved. Rather, such balance depends on country-specific features, the quality and effectiveness of fiscal spending, and the ability to issue fresh debt at relatively low cost, among a host of other considerations.

Moreover, it is also clear that specific sustainable development investments are required to deal with major negative externalities for which no clear immediate financial return can be expected. This is especially true for climate mitigation investments, for which economic and financial returns are highly uncertain. Such investments raise questions about additional considerations regarding taxes and the issuance of debt, such as the loss and damage mechanisms related to climate change.

There have been gradual shifts over time in the view of debt as a tool for development. For instance, it was postulated by Krugman (1988) and Sachs (1989) that large stocks of external debt contribute to a debt overhang, resulting in lower economic growth due to low- and poor-quality investments. Furthermore, lenders' willingness to advance loans becomes further restricted, resulting in severe damage to economic development prospects and society's general well-being because of significant reductions in public investment. High levels of debt make the achievement of sustainable development especially difficult because critical government functions are reduced, ultimately having negative impacts on society and possibly creating social unrest (Cecchetti, Mohanty and Zampolli, 2011).

As early as 2005, the then United Nations Secretary-General Kofi Annan proposed defining debt sustainability as "the level of debt that allows a country to achieve the Millennium Development Goals and reach 2015 without an increase in debt ratios" (United Nations, 2005). This view gained little traction at that time, yet there appears to have been a shift recently towards more differentiation to assess the relevance of public debt for financing sustainable development.

For instance, Pedercini and others (2018) showed in a study on Ivory Coast that it makes sense to increase public debt to achieve the SDGs through a coordinated spending approach in different sectors. Maldonado and Gallagher (2022) showed in Colombia and Peru that factoring in essential climate change-related expenditures in the IMF Debt Sustainability Analysis leads to significantly higher levels of debt, implicitly calling for higher debt thresholds. Additionally, Madan (2020) questioned the existence of a trade-off between infrastructure financing needs and debt sustainability, arguing that the trade-off can be limited by selecting higher-quality projects that can be financed with private financing sources, including through PPPs.

Nevertheless, despite this shift in the narrative regarding a higher tolerable level of debt among policy circles, more empirical work is needed to understand the positive impact of debt on sustainable development, and to better explain the specific factors that support this relationship in terms of financial and institutional structure.

Indeed, besides the intrinsic economic and financial return of public spending, the impact of debt on sustainable development depends strongly on the strength of governance and transparency surrounding the process of debt issuance. Development projects entail significant risks linked to the difficulty of implementation and/or levels of corruption. Naz and Yasmin (2021), for instance, showed that the prevalence of corruption leads to an undue increase in public debt. Similarly, Mohsin and others (2021) mentioned the importance of the institutional framework in offsetting the negative effects of debt accumulation. However, with strong institutional and governance frameworks, it appears that higher and sustainable levels of public debt could finance sustainable development ambitions and generate returns offsetting debt service costs.

3. Public debt and climate change

In parallel with SDGs, climate-related financing needs are expected to put a significant strain on countries' public finances and debt positions. The "superflood" which occurred in Pakistan in the summer of 2022 is a stark reminder of how such events can rapidly push countries to the brink of default.

Climate-related challenges are closely intertwined with the SDGs, as vulnerable populations are expected to be disproportionately affected by the knock-on effects on food supply, health-care systems and housing infrastructure. Climate adaptation will hence require a holistic development perspective, and the design of efficient social safety nets.

Many estimates of climate-related financing needs are available, but it is certain that these financing needs far outweigh the current fiscal firepower of all developing economies - even with theoretical pledges from developed economies. UNEP (2021) indicated in its adaptation gap report that developing economies would need to spend $300 billion a year by 2030 and $500 billion a year by 2050 for various projects, such as the construction of dams to prevent floods and irrigation systems to limit the impact of droughts on crop yields. Meeting these requirements is simply not possible without increasing public debt. The policy issue then becomes how to ensure the sustainability of debt at higher levels.

On the other hand, climate risks are already threatening the sustainability of public debt in many developing countries. Beirne, Renzhi and Volz (2020) studied the impact of the exposure to climate risk on the borrowing costs of sovereigns. They found a climate-related premium of 275 basis points for the group of countries most vulnerable to climate change,[2] and 113 basis points for other emerging economies. The average measured premium for ASEAN countries is a significant 155 basis points.

Cevik and Jalles (2020a; 2020b; 2020c) conducted a systematic analysis of the link between exposure to climate risk or resilience to climate change and borrowing costs, credit ratings and sovereign defaults.

Along these three dimensions they found that (a) climate risk has a significant negative impact on the considered metric; (b) this negative impact is stronger for emerging economies; and (c) the implementation of climate adaptation measures reduces the negative impact.

These findings support the need for policy measures to increase the fiscal space of climate-vulnerable economies, enabling them to finance the most pressing adaptation expenditure through a mix of debt and non-debt financing flows.

2 According to the authors' definition, this high-risk group comprises India, Indonesia, Japan, the Kingdom of the Netherlands, the Philippines, the Republic of Korea, Singapore, Sri Lanka, Thailand and Viet Nam.

4. Is there a single "optimal" level of public debt for assessing the debt sustainability of developing economies?

Views and evidence on the relationship between debt and economic growth in general and whether there exists an "optimal" level of public debt beyond which economic growth is hampered in particular are mixed. The view that high debt levels are necessarily detrimental to economic growth has been challenged in recent years. For instance, Panizza and Presbitero (2013) conducted a broad survey of the literature related to this topic; they found no sustained evidence of a negative link between indebtedness and GDP growth dynamics, nor evidence of the presence of debt thresholds above which economic growth is hampered.

In focusing on the Asia-Pacific region, Pham (2018) demonstrated empirical evidence of a significant and positive impact of public debt on real GDP growth in six ASEAN countries during the period 1995-2015, specifically in Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam.

Looking at data for 1980-2012 Asteriou, Pilbeam and Pratiwi (2021) found a negative impact of public debt on economic growth in 14 ESCAP member countries. They also identified an asymmetric relationship in the short term, meaning that, while an increase in debt hampers economic growth, a decrease in public debt does not significantly improve short-term economic growth.

Focusing on developing countries in Asia and the Pacific, Lau, Moll de Alba and Liew (2022) also found a negative and significant relationship between debt levels and economic growth. Their data cover 16 developing Asia-Pacific countries for the years from 1980 to 2016. By focusing on

debt-to-GDP threshold construction,[3] their results are supportive of fiscal policies targeting a specific debt-to-GDP threshold, which would be flexible enough to allow for a prompt response to unanticipated shocks.

The debate regarding an "optimal" level of public debt or a debt "threshold" is important because in recent years debt levels have increased significantly. There are examples, including in Italy and Japan, of countries sustaining extremely high levels of debt. No model could predict this phenomenon, which is explained by several factors related to the confidence in and credibility of monetary and fiscal policies, sound, prudent and transparent macroeconomic policymaking and implementation, the level and extent of financial market development and the presence of a wider investor base.

Japan has benefited from persistently low interest rates. In fact, the increase in its debt stock has been associated with a decrease in debt service costs. Cohen-Stetton and Oikawa (2022) showed that in the past four decades the debt-to-GDP ratio in Japan rose from 50 to 250 per cent, while interest payments diminished by 50 per cent as a share of GDP and 80 per cent as a share of government revenues.

The characteristics of the creditors can also have a significant impact, reflecting the choice of certain countries to "nationalize" their debt by increasing the share held by the central bank (in Japan) or by domestic creditors (Italy). Emerging and low-income economies face more constraints: for instance, increasing the exposure of domestic entities to foreign-currency debt can result in foreign exchange risks, financial stability concerns or increases of the socioeconomic impact of a devaluation. Similarly for local-currency instruments, low-income economies and developing countries remain constrained by low levels of financial market development and financial intermediation.

Despite these examples of high but sustainable debt levels, debt thresholds remain a critical consideration in economic policymaking partly because they are convenient for cross-country comparison and standardized assessments. This is especially the case for debt sustainability analyses conducted by the IMF. Therefore, it is essential to understand the unintended impact that they might have on the ability of countries to pursue their development objectives.

3 The authors built on the recent literature on debt thresholds, which studied whether relevant thresholds exist for countries above which debt becomes detrimental to growth. Here the authors built country-specific thresholds for every country in the sample.

There is no consensus on the optimal level of public debt

Conventional debt sustainability analyses and the related literature refer to various optimal levels. For example, the fiscal rules of the European Union on deficit and debt limits require countries to keep their public debt below 60 per cent of GDP. In contrast, a review by Daniel (2003) argued that the best way to ensure that public finances are sustainable is a public debt level in emerging economies of 25 per cent of GDP. However, this threshold appears particularly low. Mohsin and others (2021) found a much higher threshold level at 58 per cent when looking specifically at South Asian countries.

In its assessment of debt sustainability, the IMF factors in a judgement-based "debt carrying capacity", encompassing a broad range of indicators: "historical performance and outlook for real GDP growth, international reserves coverage, remittance inflows, and the state of the global environment, in addition to the World Bank's Country Policy and Institutional Assessment (CPIA) index".[4] The IMF sets the threshold for the debt-to-GDP ratio in low-income countries at 70 per cent for countries with strong debt-carrying capacity; 55 per cent for medium capacity; and 35 per cent for low capacity (Kang, 2021).

Current policy debates seem to miss the idea that the achievement of development goals or the mitigation of climate risks have a positive economic impact which in turn increases the capacity of a country to issue public

4 For details, see Joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries, Factsheet. Available at www.imf.org/en/About/Factsheets/Sheets/2023/imf-world-bank-debt-sustainability-framework-for-low-income-countries.

debt. Bua, Pradelli and Presbitero (2014) criticized conventional criteria and argued that increasing the debt thresholds by considering non-financial variables related to the SDGs can be more effective. Azzimonti, Francisco and Quadrini (2014) stated that an increase in financial stability allows the level of public debt to increase too, a feedback loop mechanism rarely taken into account.

It is hence important to complement debt sustainability analyses with realistic tools that incorporate investment needs to achieve the SDGs. Also, incorporating the impact of achieving the SDGs on economic growth and prosperity can support higher levels of debt which would otherwise not be sustainable. These considerations are the focus of chapter 4, which presents an "augmented" DSA approach.

5. Navigating a changing creditor and debt landscape to meet financing needs

Until recently, there was a clear demarcation in the sovereign creditor landscape between multilateral institutions, traditional bilateral creditors and commercial lenders. The previous decade has seen a major shift with the emergence of so-called non-traditional creditors, such as China, India and Gulf countries, and the rise of commercial creditors. In parallel, the difference between official and commercial creditors has been blurred by the emergence of policy banks controlled by Governments. Additionally, the IMF has sought to clarify which multilateral institutions would be subject to the non-toleration policy for arrears (IMF, 2022c).

These changes have created risks and opportunities for sovereign issuers. For instance, the emergence of non-Paris Club lenders has opened new sources to finance infrastructure projects, enabling countries to diversify their creditor landscape or obtain more attractive financing conditions.

The emergence of these alternative lenders requires a rethink of the international debt resolution mechanisms and frameworks, which for decades have centred around the IMF and Paris Club. Non-traditional lenders might be interested in rewriting some implicit rules with regard to the timing of the debt restructuring process, the macroeconomic assumptions underpinning the restructuring parameters and the definition of comparability of treatment.

A gap was also identified by ESCAP (2021b) in the international financial architecture for countries ineligible for participating in the global debt relief initiatives (G20 Debt Service Suspension Initiative, and the G20 Common Framework) and those having little or no access to global capital markets. This group of countries comprise some of those with the highest debt-service-to-export ratios.

In parallel, the lines between different definitions of domestic and external debt are becoming increasingly blurred. The development of domestic debt markets, together with financial globalization and the growth of global investors, has led to significant foreign investments in domestic currency debt across emerging markets. This type of foreign portfolio investment, while reducing foreign exchange risk for issuers, has led to a focus by investors on short-term instruments highly susceptible to capital flight when global financing conditions tighten.

The development of local currency debt markets has also helped countries partly escape a concept known as the "original sin" (Eichengreen and others, 2002), which theorizes why emerging countries are prevented from issuing debt in their own currency. For instance, Beirne, Renzhi and Volz (2021) conducted a cross-country study on emerging economies in Asia and the Pacific which showed that the development of local currency debt capital markets has had positive effects in reducing capital flow volatility. However, according to their findings this effect is partly reversed by foreign investors' participation in the domestic market, illustrating the new challenges faced by countries.

Box 2.2
What falls under the definition of public debt?

The definition and value of public debt varies according to the following main criteria: institutional coverage, instrument coverage and valuation method. Variations in these criteria can lead to huge discrepancies between debt estimates; they often make cross-country comparison difficult (Fatás and others, 2019).

First, what can be considered as "public" in assessing public debt varies greatly depending on the various institutional arrangements observed across countries. This can be narrowed down to "central Government", consisting mostly of budgetary units; "general government", adding the liabilities of local and state governments; and "public sector", which broadens the general government scope by adding liabilities of State-owned enterprises or the central bank.

Further to institutional coverage, many instruments can be included or not within the scope of public debt. These comprise debt securities – understood most of the time as debt instruments tradeable in some sort of a secondary market – loans, currency and deposits, accounts payable, pensions and financial derivatives as well as contingent liabilities (Arslanalp and others, 2019).

Contingent liabilities are liabilities that can potentially materialize on the sovereign balance sheet due to an unknown trigger, for instance a financial crisis or a default. They can be explicit or implicit. Natural disasters, pandemics and their knock-on effects on vital functions of the State fit the definition of contingent liabilities: they have a huge financial impact that Governments need to address through increased fiscal spending, while at the same time the Governments face decreasing revenues due to curtailed economic activities.

Thus, understanding the definition and perimeter of public debt is key to account for the ability of Governments to organize their balance sheets in a way that will enable them to tackle development objectives.

6. The potential of domestic and international capital markets

There is growing consensus that grants and concessional loans will not be sufficient to meet the unprecedented financing needs required to bridge climate and development gaps in the decades to come. Therefore, the role of domestic and international capital markets in pursuing these objectives has become a centerpiece of recent policy debates.

The importance of domestic debt markets for financing sustainable development

There are clear advantages to relying on the issuance of domestic debt as opposed to foreign loans, an obvious one being a reduction in foreign exchange risk. More broadly, well-developed, deep and liquid domestic debt markets offer considerable policy flexibility for Governments, enabling financing at longer maturities, reducing rollover risk and risks stemming from external debt servicing due to currency depreciation.

Abbas and Christensen (2007) built a data set of domestic debt stocks for 93 low-income and emerging economies covering the period 1975-2004. They find a positive effect of public domestic debt on GDP growth, as long as it remains non-inflationary and modest as a share of bank deposits and GDP. Similarly, for 36 low-income countries, Bua, Pradelli and Presbitero (2014) showed that issuance of domestic debt enables Governments to increase the share of long-term debt instruments and reduce borrowing costs.

In addition, a sovereign yield curve facilitates the development of capital markets that can increase the availability and lower the cost of long-term capital for local issuers. It requires a basic

market infrastructure: an expanded local yield curve, settlement and clearing houses, transparent taxation, and legislation on the issuance and trading of capital market instruments.

However, the magnitude of development-related financing needs could lead to an overreliance on domestic debt markets, which can be dealt with through inflation and financial repression, with adverse impacts on social outcomes and inequality. Higher levels of domestic debt can put strains on domestic banks' balance sheets. Domestic debt in this case can crowd-out private investment, reducing the ability of banks to lend to domestic corporates. In turn, this tends to hamper economic growth (Abbas and Christensen, 2007). IMF (2022b) noted that issuance of domestic debt had been mostly absorbed by domestic banks in the wake of the COVID-19 pandemic, putting them in a difficult position vis-à-vis financing private investments.

In cases of debt overhang, restructuring of domestic debt entails significant fiscal and economic costs, and can threaten financial stability (IMF, 2022c); it can also increase inequalities, affecting the vulnerable particularly severely as they are often associated with episodes of high inflation and financial repression. Further, such restructuring can cause the loss of part of a retail bank's deposits.

Maximizing the contribution of international debt capital markets towards sustainable development

The limits of domestic debt markets in terms of potential inflationary pressures, financial stability or difficult restructuring build a strong case for complementary use by Governments of international debt capital markets to finance development-related investments.

Access of emerging economies to international capital markets, mostly through the issuance of Eurobonds, unlocks financing at scale and enables Governments to mobilize funds for development objectives among other endeavors. The issuance of Eurobonds also creates a benchmark for country risk, enabling access to international markets for corporates as well as supporting foreign direct investments. However, it also exposes Governments to sudden changes in market sentiment arising from exogeneous reasons. These changes can translate into a sudden stop of financial inflows and loss of market access preventing the refinancing of maturing Eurobonds and draining foreign exchange reserves.

Hard-earned market access for many emerging and developing economies is currently being jeopardized due to global tightening of financing conditions and a rise in interest rates across the globe. As a result, issuance of sovereign Eurobonds in the Asia-Pacific region, excluding Japan, dropped by more than 60 per cent, from $40.5 billion in 2021 to $15.6 billion in 2022.[5]

In this context, it is important to note that international investors are highly dependent on the credit ratings of public debt securities. Griffith-Jones and Kraemer (2022) looked at the role of credit rating agencies for developing economies and presented new evidence underpinning the idea that such agencies suffer from an inherent bias against emerging markets and developing economies. They noted that advanced economies suffered much greater economic and fiscal shocks during the 2008 global financial and economic crisis and yet experienced little adverse effects in terms of rating downgrades.

In addition to reforming the credit ratings architecture, the creation of a new data paradigm is required in order to align international debt markets with development and climate issues. Market participants lack the relevant data to properly integrate non-financial issues into investment decisions. Many investors, for instance, rely on the World Bank's data to develop ESG scores. Gratcheva, Emery and Wang (2020) found that the average lag for environmental data in this database is five years. The lag for the social and governance pillars stands at two years. The quality of the data is often questionable, and even for the most basic climate-related indicators, such as carbon dioxide emissions, there is a high variability across methodologies.

The improvement of data is likely to come from two different evolutions. First, there are many developments around the use of unstructured data, such as satellite images. Second, renewed dialogue between investors and issuers is expected to lead to improvement in data reliability. Debt management offices are increasingly aware of the need to provide accurate and timely ESG data to

5 These data were obtained on 23 January 2023 from the Bond Radar real-time capital markets news service.

potential investors, especially with regard to environmental policies. Investors themselves are asking an increasing number of ESG-related questions during investor calls and both deal and non-deal roadshows.

All this will require capacity-building not only for debt management offices but more broadly for all the line ministries needed to produce and gather relevant data. Such capacity-building can be facilitated especially by the creation of such formal processes as green budgeting, with clear governance and ownership structures across ministries.

Finally, the contribution of international markets to development goals would require a deeper rethink of the mandate of asset managers and their fiduciary duty. This duty usually prevents them from seeking any goal other than higher financial returns for their end-clients. However, the pursuit of short-term returns can be at odds with long-term development goals, including a mismatch between these goals and the investment horizon – the so-called tragedy of the horizon (Carney, 2015).

7. The role of international cooperation in dealing with debt vulnerabilities and supporting sustainable development

Achievement of sustainable development and climate goals requires deep international cooperation as many sustainable development and climate change challenges are global challenges and have impacts on societies on a vast scale, not only in those countries where the affected population and economic activities are located. This is especially true for the ongoing climate emergency as global warming does not depend on where a ton of carbon is emitted.

Zettelmeyer and others (2022) found two main reasons to justify cross-country transfers to finance climate adaptation and mitigation. The first reason is global externalities: countries in the Global South are responsible for a meagre share of overall greenhouse gas emissions. However, if they were to grow by using the same carbon-intensive approach as their richer counterparts, then this would hamper the global fight against climate change. Thus, there are clear benefits to helping developing countries in the Global South leapfrog towards a cleaner economic growth model. The second argument is that of fairness: despite having a smaller responsibility in historical emissions, countries in the Global South face the most impacts from climate change. It is a crisis not of their making, and fairness requires that they receive outside support.

Owing to pre-existing debt vulnerabilities and the size of financing needs in countries furthest from achieving the SDGs, issuing more debt will not be a sufficient solution. The most efficient way to address the twin development and debt crises is to implement comprehensive debt restructuring and provide new money in the form of grants, but such operations can be politically and financially difficult. In this vein, innovative financing mechanisms, such as debt-for-climate swaps, can be a relevant tool, although they need to be streamlined and scaled up from current practices, which are often of rather limited size, labour intensive and entail high costs (Chamon and others, 2022).

The international community should also step up its role in coordinated debt forgiveness efforts targeting vulnerable countries. This remains the only way to free up sufficient fiscal space in many situations and should build on the experience of the past Heavily Indebted Poor Countries Initiative, which enabled a sharp reduction in the debt burden of low-income countries and a reallocation of resources towards social expenditures and poverty reduction. A new initiative of coordinated debt forgiveness should place the sustainable development agenda front and centre both to calibrate the relief needed and to ensure that resources are used optimally towards the implementation of the 2030 Agenda.

In parallel, more effort is also needed to streamline the process for restructuring sovereign debt, which is often protracted and delivers too little, too late for debtors that are left in a precarious situation. This is best illustrated by the slow roll-out of the G20 Common Framework, which left beneficiary countries hanging for months. Improvements in the current financial architecture for sovereign debt restructuring are urgently needed, such as through debt standstills for the duration of the process and a clearer

timeline. Owing to the concentration of emerging market issuance of sovereign overseas debt in a reduced number of financial centres, such as New York and London, targeted legislative changes in these locations could also be a powerful tool to reduce the ability of recalcitrant creditors to derail restructuring processes.

Such discussions are especially important because, from a development point of view, the most vulnerable countries are often also low-income countries with low debt-carrying capacity and high financing costs, which reduce the relevance of additional debt in the short-term as a tool for financing sustainable development. A recent example of a combination of various financing channels to help countries adapt to and mitigate climate change is the Just Energy Transition Partnerships (JETPs), announced in South Africa, Indonesia and Viet Nam. The idea behind JETPs is to build a coalition of donors providing significant financing for the climate transition with grants and loans, expected to spur further contributions from the private sector. In turn, beneficiary Governments are expected to present a comprehensive investment plan aimed at steering the transition, with emphasis on the social aspects, such as the retraining of workers. JETPs are an interesting tool since they are more agile than comprehensive climate talks. However, depending on the financing mix between the various instruments it should be noted that there remains a risk that JETPs could increase the debt burden of beneficiary countries.

The need for more financing to help climate-vulnerable countries has been made clear in recent months at different forums by leaders in the Global South. The Vulnerable Twenty (V20) Group of Ministers of Finance of the Climate Vulnerable Forum has notably advocated that coordinated debt relief is needed for them to cope with climate-related financing needs.

8. Concluding remarks

No matter what new approaches are pursued, it is clear that, without breaking away from conventional thinking on the debt-development nexus and policy frameworks informed by such thinking, it is highly unlikely that they will trigger the transformation that is required to create a just and new sustainable global socioeconomic-environmental order.

Sustainable debt requires a carefully designed strategy

A number of key policy messages for rethinking the debt-development nexus emerge from the present chapter's discussion of the changing context of public debt:

- If used judiciously, high public debt levels are not necessarily detrimental to economic growth, whereas failing to tackle development deficits and climate risks can hurt growth and public debt sustainability
- The "optimal" public debt thresholds suggested by key multilateral financial institutions are too low, contributing to suboptimal development outcomes
- The conventional debt sustainability assessment tools need a revamping to incorporate the impact of climate change and SDG investments on public finances and how this should impact debt assessments
- Domestic capital market development can support government debt financing, while improving financial inclusion and reducing exchange rate risk
- Debt restructuring by multilateral and bilateral creditors is needed for countries that cannot further increase their debts or raise revenues to finance sustainable development and tackle climate change

The ensuing chapters of the Survey for 2023 are designed to support this rethink and paradigm shift. They highlight concrete policy proposals for countries and the international community that can support sustainable development without necessarily leading to unsustainable debt burdens in the long run.

Chapter 3 presents an overview of public debt profiles in Asia-Pacific economies, looking at debt dynamics and current vulnerability levels across various indicators. Chapter 4 presents a rethinking of public debt sustainability through an augmented approach that explicitly accounts for SDG investments. Finally, chapter 5 contains a discussion of domestic and international policy measures to address debt surges and distress, thus supporting the provision of adequate financing to meet sustainable development needs.

CHAPTER 3

CHAPTER 3

Public debt profiles of Asia-Pacific economies

1. Introduction

Even before the COVID-19 pandemic, the Asia-Pacific region was lagging in its progress towards achieving the Sustainable Development Goals while at the same time facing rising levels of government debt. The average government debt-to-GDP ratio in developing countries in Asia and the Pacific was at an 11-year high of 40.6 per cent in 2019. Driven by large stimulus packages and declining government revenues, the pandemic pushed the region's average level of government debt up to 49.5 per cent of GDP in 2021, with two thirds of regional economies reaching the highest level of such debt since 2008.[1] Several economies are still struggling with double or triple the size of their recent average external debt servicing, as high as 10 per cent of GDP in 2022.

An increasing number of countries in the region have been rated as facing a high risk of debt distress. The war in Ukraine and tighter financial conditions in 2022 have added further to public debt pressures (see chapter 1), putting at risk the sustainability of the public debt of some economies and jeopardizing the prospects of meeting ambitious investment needs for achieving the Sustainable Development Goals. **19 countries are rated at high risk of debt distress based on the joint World Bank-IMF Debt Sustainability Framework for Low-income Countries or equivalent credit rating scores, thus limiting their development investment capacities.**

1 Some countries reached the highest level in 2020; others, in 2021.

It is worth highlighting that a higher debt level does not necessarily translate into higher risk of debt distress. Countries with low levels of debt can still face a high risk of debt distress while countries with high levels of debt may yet enjoy a high credit rating and thus lower borrowing costs from capital markets. Other factors going beyond the scope of this chapter, such as overall macroeconomic conditions, structural features, institutions and strength of governance, also play a critical role in influencing debt vulnerability. Regardless, it is crucial to develop a clear understanding of debt profiles (section 2) and analyse their key drivers (section 3) and composition (section 4).

The present chapter finds that primary deficit is the key driver contributing to higher public debt in Asia and the Pacific. Currency depreciation also accounts for a large proportion of increases in public debt in several countries. Moreover, half of developing Asia-Pacific economies rely heavily on external debt but the composition of creditors has changed over time. This creates both risks and opportunities for sovereign borrowers and needs to be considered in order to navigate more effectively through rising debt levels (see chapter 2). While borrowing more from multilateral and bilateral creditors, developing economies in the region received a lower share of concessional loans, which in coming years will contribute to higher debt service payments on public and publicly guaranteed debt. On the other hand, countries with higher domestic debt have increased issuance of local currency government bonds in the domestic market and have seen increasing participation of foreign investors in the domestic government bond market.

The chapter takes stock of the public debt profile of the region and is organized as follows. Section 2 describes recent and projected trends of the general government debt in the region. Section 3 discusses the drivers of these trends. Section 4 analyses the composition of public debt, first by analysing domestic and external debt and further breaking it down by instruments, creditors, currencies and concessionality, among other considerations. Section 5 assesses public debt sustainability from the perspective of IMF debt sustainability analysis and sovereign credit ratings. This section includes a discussion on the relationships between the characteristics of public debt, including debt level, and debt sustainability to better understand why some economies are rated at higher risk of debt distress than others.

2. Government debt profile of Asia and the Pacific: where do we stand?

Most Asia-Pacific economies have experienced an increase in their general government gross debt since 2008, particularly between 2019 and 2021, caused by pandemic-induced fiscal expenditures and economic contractions. In looking forward, further increases in the general government gross debt are expected to moderate in most developing economies in the region.

Box 3.1
Definitions of terminology discussed in the present chapter

Central government debt: According to Eurostat, this consists of the sum of the debt of administrative departments of the State and other central agencies, the responsibilities of which cover the whole economic territory of a country, except for the administration of social security funds.

Current account deficit: The current account can be expressed as the difference between the value of the export of goods and services and the value of the import of goods and services. A deficit then means that a country is importing more goods and services than it is exporting - although the current account also includes net income (such as interest and dividends) and transfers from abroad (such as foreign aid), which are usually a small fraction of the total.

Concessional loan: Lending extended by creditors at below market terms. A concessional loan is defined as containing an original grant element of 35 per cent or more, according to the World Bank's International Debt Statistics.

Debt distress: A country is in debt distress when it is unable to fulfil its financial obligations, and debt restructuring may be required.

Debt service: Involves both the ongoing meeting of obligations - that is, payments of interest and principal - and the final payment of principal at maturity on total long-term debt.

General government debt: General government debt consists of central, state, and local governments' debt.

Gross debt: All liabilities that require future payment of interest and/or principal by the debtor to the creditor.

Gross external debt: is the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to non-residents by residents of an economy, according to the World Bank. In the context of chapter 3, external debt refers to external public and publicly guaranteed debt.

Gross financing needs: Overall new borrowing requirement plus debt maturing during the year.

Joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries: A framework developed by IMF and the World Bank to help guide countries and donors in assessing the debt sustainability of low-income countries. There is a different framework for market-access countries.

Primary balance: The primary balance is the difference between a Government's revenues and its non-interest expenditures. A **primary deficit** would mean that a Government's revenue is lower than its expenditure, and **primary surplus** would mean that a Government's revenue is higher than its expenditure.

Public and publicly guaranteed debt: Public and publicly guaranteed debt comprises the long-term obligations of public debtors and long-term private obligations guaranteed by a public entity, according to the World Bank's International Debt Statistics.

Public debt: is an external obligation of a public debtor, including all levels of Government, the central bank, State-owned enterprises, public corporations, development banks and any other autonomous public bodies of a Government, according to the World Bank's International Debt Statistics.

Public debt sustainability analysis: An analysis of whether a Government's public debt can meet all its current and future payment obligations without exceptional financial assistance or going into default.

General government debt[2] has reached the highest level in two thirds of Asia-Pacific economies since 2008[3]

(figure 3.1). Five countries had general government gross debt of more than 100 per cent of GDP in 2021 — Japan (262 per cent), Singapore (160 per cent), Bhutan (132 per cent), Maldives (125 per cent) and Sri Lanka (103 per cent). General government gross debt in Fiji, India, the Lao People's Democratic Republic and Mongolia is also significantly high at more than 80 per cent of GDP.

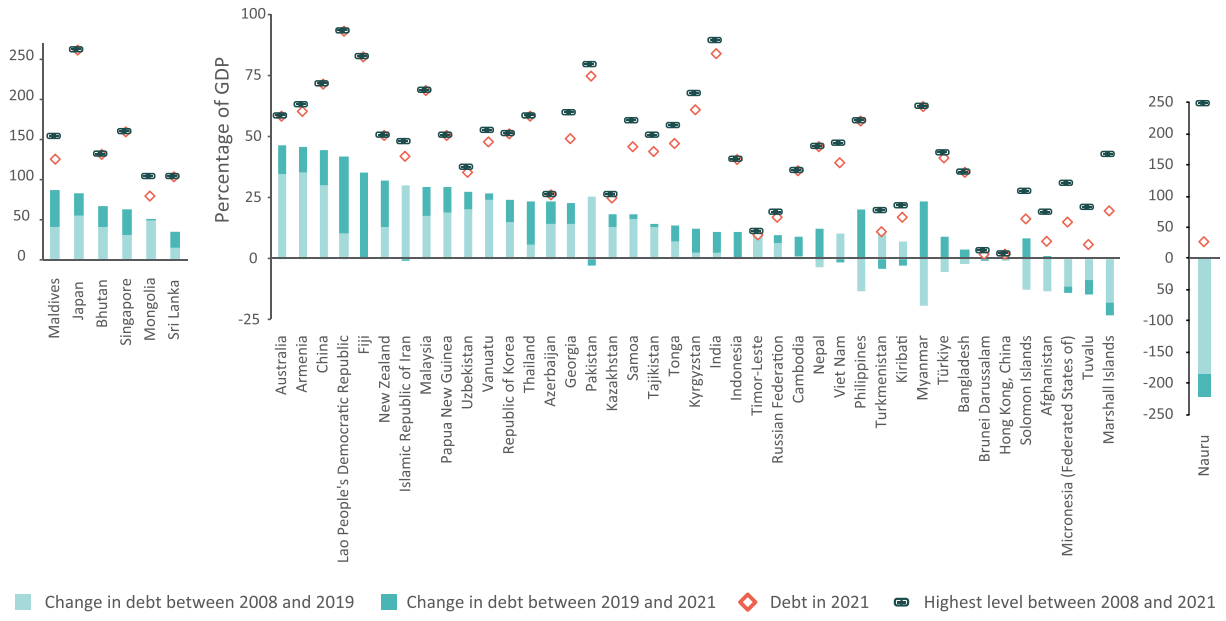
Nearly two thirds of the Asia-Pacific economies have experienced an increase of more than 10 percentage points in their general government debt ratios since 2008, including Bhutan, Japan, Maldives and Singapore, the general government gross debt-to-GDP ratio which was already higher than 100 per cent (figure 3.1).

In particular, pandemic-induced fiscal responses and economic contractions have led to a sharp rise in general government debt in many economies between 2019 and 2021, with significant variations. On average, government debt increased by more than 8 percentage points.[4] The general government gross debt-to-GDP ratio rose by up to 46 percentage points in Maldives, 34 percentage points in Fiji and 32 percentage points each in the Lao People's Democratic Republic and Singapore, but was negligible in the Islamic Republic of Iran, Mongolia, Timor-Leste and Viet Nam. The reason behind the slight change in the latter countries is related to their more rapid economic recovery leading to higher revenues in 2021. This can be explained by the impact of rising commodity prices for the Islamic Republic of Iran, Mongolia and Timor-Leste as well as a strong export performance in Viet Nam.

While most economies experienced an increase in general government debt since 2008, there were a few exceptions (figure 3.1), namely Afghanistan, Marshall Islands, Federated States of Micronesia, Nauru, Tuvalu and Solomon Islands. Apart from Afghanistan, which had been in a state of conflict for decades, the other economies are small island developing States, which are highly reliant on concessional grants from bilateral donors and international financial institutions. Volatile fiscal revenues due to structural limitations amplify their need to maintain fiscal buffers and limit their ability to take on more debt.

2 See definition in box 3.1.
3 Some countries reached the highest level in 2020; others, in 2021.
4 Excluding three developed countries: Australia, Japan and New Zealand.

Figure 3.1
More than two thirds of economies faced an increase of more than 10 percentage points in general government gross debt since 2008



Source: IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: The blue bars indicate changes in general government gross debt from 2008 to 2021. Red lozenge shapes denote general government gross debt in 2021 and the blue dashes denote the highest general government gross debt between 2008 and 2021. Data on Cook Islands, the Democratic People's Republic of Korea and Palau are not available in the World Economic Outlook.

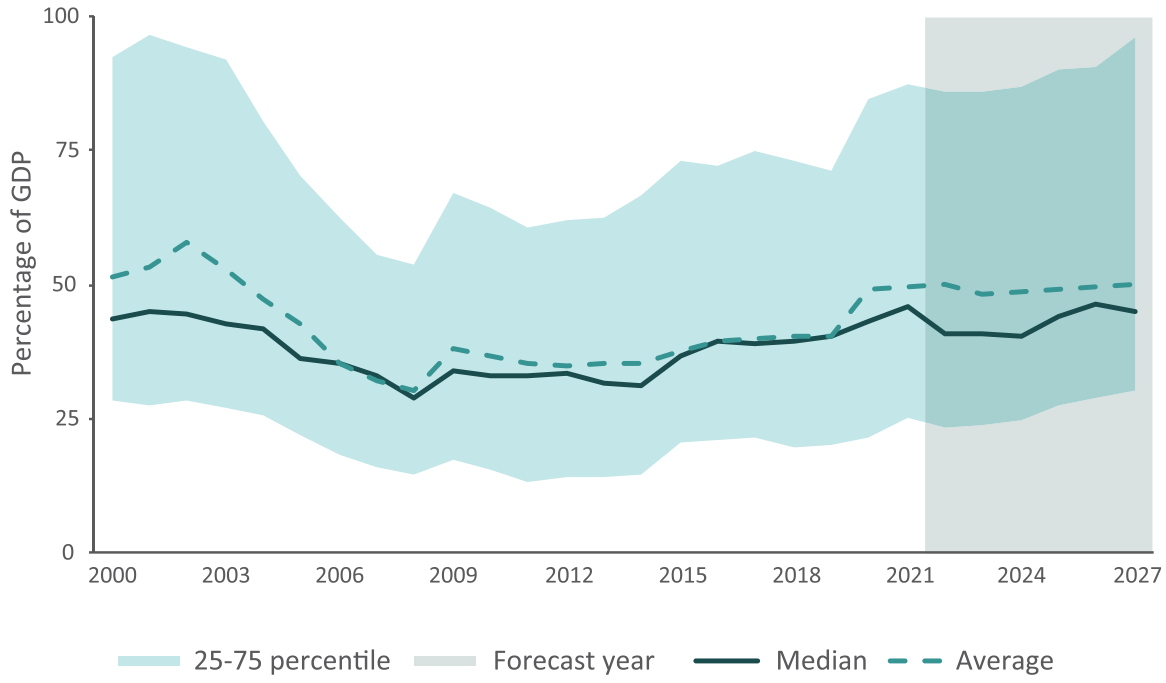
General government debt levels vary significantly among Asia-Pacific economies (figure 3.2.a). Overall, the general government debt level has been concentrated below 60 per cent over the past 20 years, with only a few countries exceeding 100 per cent in some years (figure 3.2.c). As a result, the average general government debt in the region has been consistently higher than the median[5] (figure 3.2.a).

A notable pattern of the general government debt level in Asia and the Pacific and all subregions, except for East and North-East Asia, can be described as following a sort of U-shaped curve since 2000 (figure 3.2.b). This U-curve trend can be attributed to three major events: the 1997 Asian financial crisis, which had adverse impacts on most of the East and North-East Asian and South-East Asian subregions; the 2008 global financial crisis, which led to expansionary monetary policies paired with a low-interest-rate environment; and the COVID-19 pandemic, which required unprecedented stimulus packages that created the sharpest jump in general government debt in most economies.

5 When the distribution is skewed to the right with few very large data points, the mean (average) is usually higher than the median.

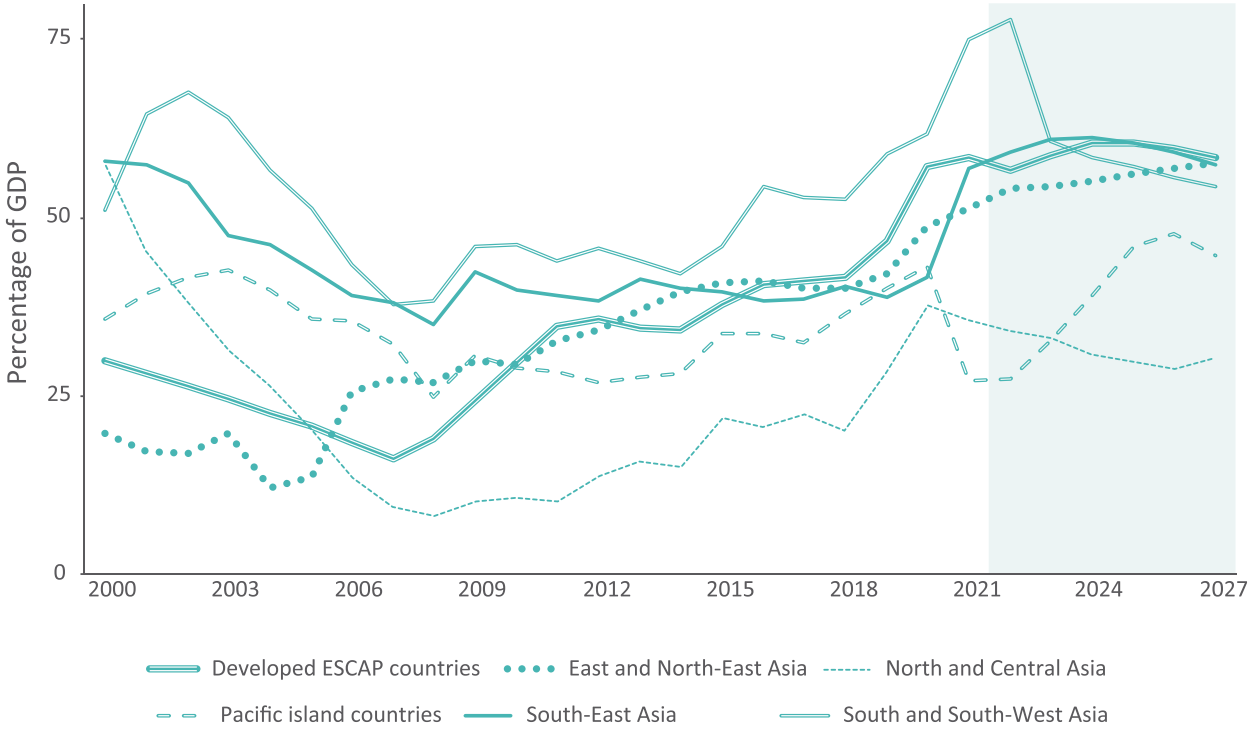
Figure 3.2
General government gross debt

a. The U-shaped curve in Asia-Pacific developing economies, 2000-2027



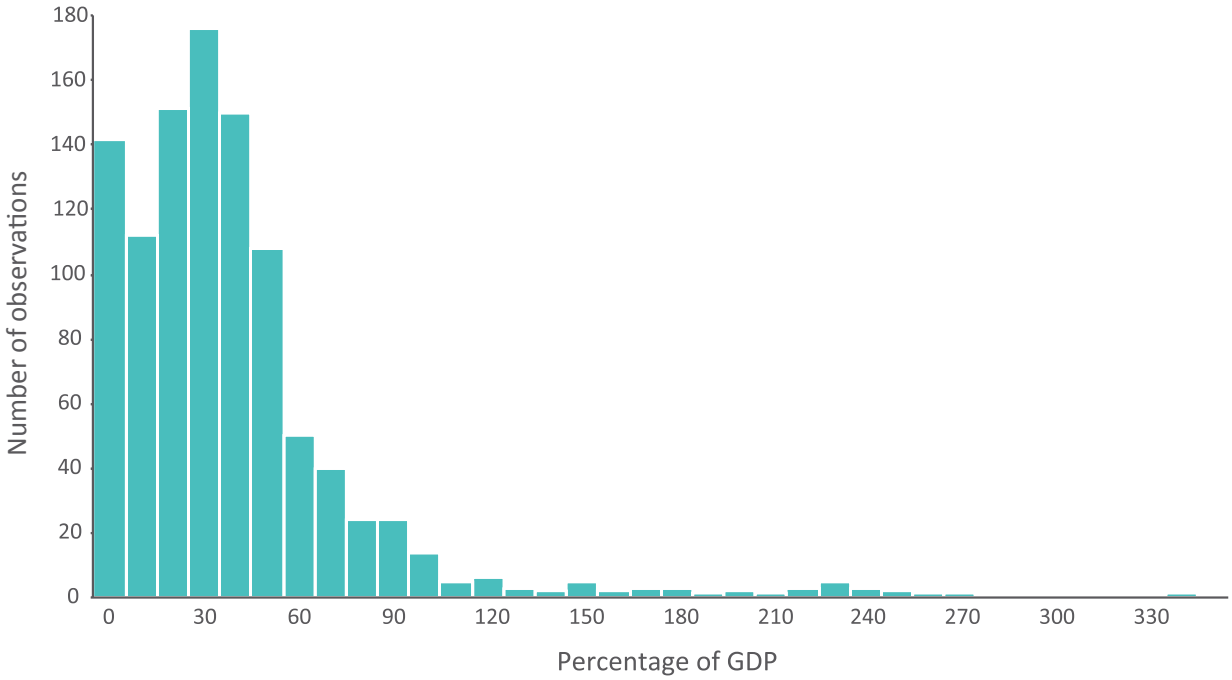
Source: IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: The (solid) line is the median debt level of ESCAP economies excluding developed economies, along with the average (dashed line), the 75th (upper), and 25th (lower) percentile were shown in green shadow. Data on Cook Islands, Palau, and the Democratic People's Republic of Korea are not available.

b. The U-shaped general government gross debt trajectory, by subregion, 2000-2027



Source: IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: The lines are the median values for each subregion.

c. General government gross debt-to-GDP ratio is concentrated mostly below 60 per cent, with only a few countries exceeding 100 per cent in some years



Source: IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: The developed countries of Australia, Japan and New Zealand are included.

Several highly indebted economies also had high gross financing needs[6] in 2022 due to large primary deficits[6] and debt service[6] requirements (figure 3.3). Notably, Japan, Singapore and Timor-Leste are off the charts in figure 3.3 due to their exceptionally high financing needs.[7] Thailand had high financing needs due to large amounts of maturing domestic debt. Bhutan and Maldives had large maturing external debt and primary deficits.[8] Pakistan and Sri Lanka needed to make significant domestic and external principal repayments.

6 See definition in box 3.1.

7 Japan and Singapore always have the highest financing needs due to the extraordinary size of their general government debt and their need to roll over continuously the maturing short-term debt. Timor-Leste also has large financing needs because its high fiscal deficit is funded by its petroleum fund.

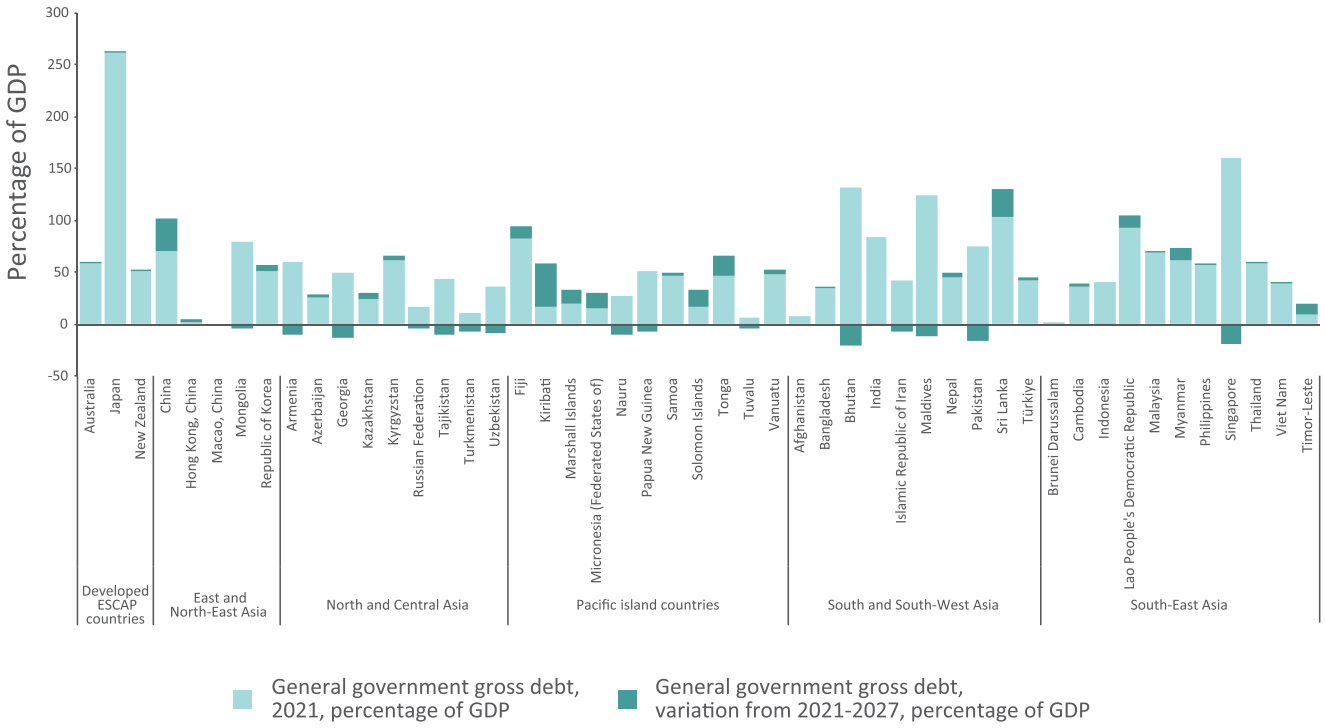
8 The Government of Bhutan tries to maximize concessional borrowing to meet its financing requirements. However, the external borrowing from multilateral development banks was expected to be inadequate to meet its financing needs. A higher share of financing needs was expected to be met from domestic resources. At the same time, borrowing domestically is also in the Government's plan to facilitate the development of its domestic capital market.

Figure 3.3
Gross government financing needs in 2022

Source: ESCAP staff calculation based on IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October; World Bank Cross-country Database of Fiscal Space; and World Bank International Debt Statistics. last updated on 6 December 2022. Note: Because the values for the countries listed in in the boxes are off the chart, the exact values are given as follows: Singapore (56.7; 159.9); Japan (54.8; 262.5); and Timor-Leste (42.29; 10.04). Data on Afghanistan; Cook Islands; the Democratic People's Republic of Korea; Hong Kong, China; Macao, China; Nauru; and Palau are not available. Abbreviations: ARM = Armenia; AUS = Australia; AZE = Azerbaijan; BGD = Bangladesh; BRN = Brunei Darussalam; BTN = Bhutan; CHN = China; FJI = Fiji; FSM = Federated States of Micronesia; GEO = Georgia; HKG = Hong Kong, China; IDN = Indonesia; IND = India; IRN = Islamic Republic of Iran; JPN = Japan; KAZ = Kazakhstan; KGZ = Kyrgyzstan; KHM = Cambodia; KIR = Kiribati; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; LKA = Sri Lanka; MAC = Macao, China; MDV = Maldives; MHL = Marshall Islands; MMR = Myanmar; MNG = Mongolia; MYS = Malaysia; NPL = Nepal; NRU = Nauru; NZL = New Zealand; PAK = Pakistan; PHL = Philippines; PLW = Palau; PNG = Papua New Guinea; RUS = Russian Federation; SGP = Singapore; SLB = Solomon Islands; THA = Thailand; TJK = Tajikistan; TKM = Turkmenistan; TLS = Timor-Leste; TON = Tonga; TUR = Türkiye; TUV = Tuvalu; UZB = Uzbekistan; VNM = Viet Nam; VUT = Vanuatu; WSM = Samoa.

According to the latest IMF projections, most developing economies in the region are expected to stabilize their general government gross debt ratios at current levels by 2027, except China and a few Pacific island developing States (figure 3.4). The IMF projections are based on public information, such as government budget plans and information gathered by IMF country desk offices during their missions to IMF member countries. They assume that announced policies of national authorities will be maintained. It is worth noting that, for highly indebted countries, IMF recommendations often point to fiscal consolidation to reduce debt vulnerabilities. Thus, such recommendations might be incorporated into the government budgeting process, particularly for countries that received funding under certain IMF programmes in turn feeding into IMF projections. However, whether countries actually go through IMF -recommended fiscal consolidation is a different matter. Moreover, Governments might be contemplating additional spending to meet investment requirements for achieving the Sustainable Development Goals and to address climate change. For most developing economies, such information is usually not available in a systematic manner and thus may not be reflected in IMF projections.

Figure 3.4
General government gross debt is expected to stabilize in most developing economies



Source: IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: Sri Lanka has only projections of general government gross debt until 2022; thus, the variation shown in the figure is for the time between 2021 and 2022. Afghanistan data are as of the year 2020; because data for 2021 and subsequent years are not available, no variation is shown.

3. Changes in public debt: what are the key drivers?

The increase in public debt in the region was predominantly driven by primary deficit in the past decade.[9] The interest rate-growth differential is the important contributing factor after primary deficit, but mostly in limiting the debt surge. For a few economies, local currency depreciation also explained a large proportion of increasing government debt levels.

9 The definitions of public debt discussed in this section vary by country due to data availability.

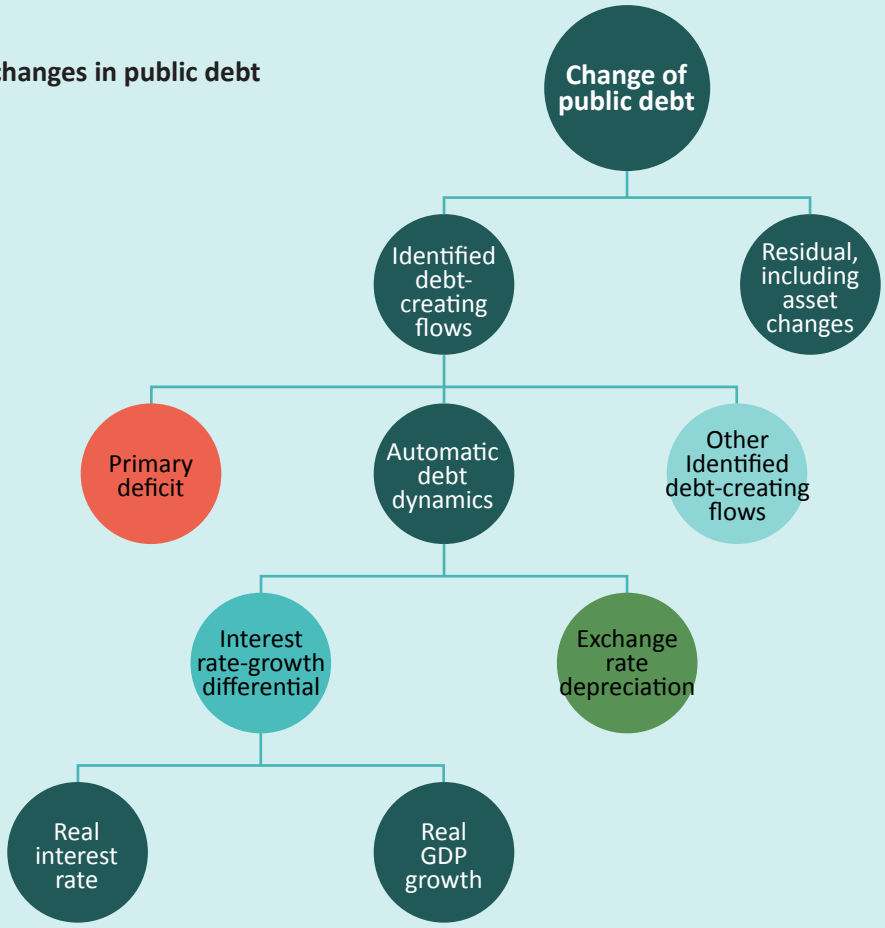
Box 3.2
Key drivers that contribute to the change in the level of public debt

Primary balance, defined as the difference between government revenue and non-interest expenditure, determines a Government's fundamental need to take on new debt. When a Government's primary balance is negative, or when it incurs a budget deficit, the Government can either borrow, which results in an increase/change in debt, or seek funding from other non-debt sources, such as liquidating its assets, for example from its sovereign wealth fund.

The public debt-to-GDP ratio could fluctuate even without issuing new debt due to **two key automatic debt dynamics contributors: the interest rate-growth differential and exchange rate.** The interest rate-growth differential is defined as the sum of the contribution from the real interest rate (that increases debt) and real GDP growth (that reduces debt). **Exchange rate depreciation** is another factor having impacts on the change in public debt.

Large other identified debt-creating flows can arise from privatization receipts, recognition of contingent liabilities,[a] such as bank recapitalization and debt relief. Finally, there are several other remaining residual items, such as extrabudgetary expenditures and other statistical discrepancies.

Figure
Key drivers to changes in public debt



Source: Graphic produced by ESCAP staff.
Note: The terminology used is based on IMF Article IV Public Debt Sustainability Analysis.

a Contingent liabilities are obligations that do not arise unless particular discrete events occur in the future. As such, they differ from direct liabilities where the settlement date is fixed at the time when the nominal obligation is set (Public Sector Debt Statistics: Guide for Compilers and Users. Washington, D.C.: International Monetary Fund. Available at www.elibrary.imf.org/downloadpdf/book/9781484349762/9781484349762.xml).

The increase in level of government debt in Asia and the Pacific between 2008 and 2021 was mainly driven by primary deficits.[10] In contrast, a negative interest rate-growth differential [11] has helped limit the debt surge in the region

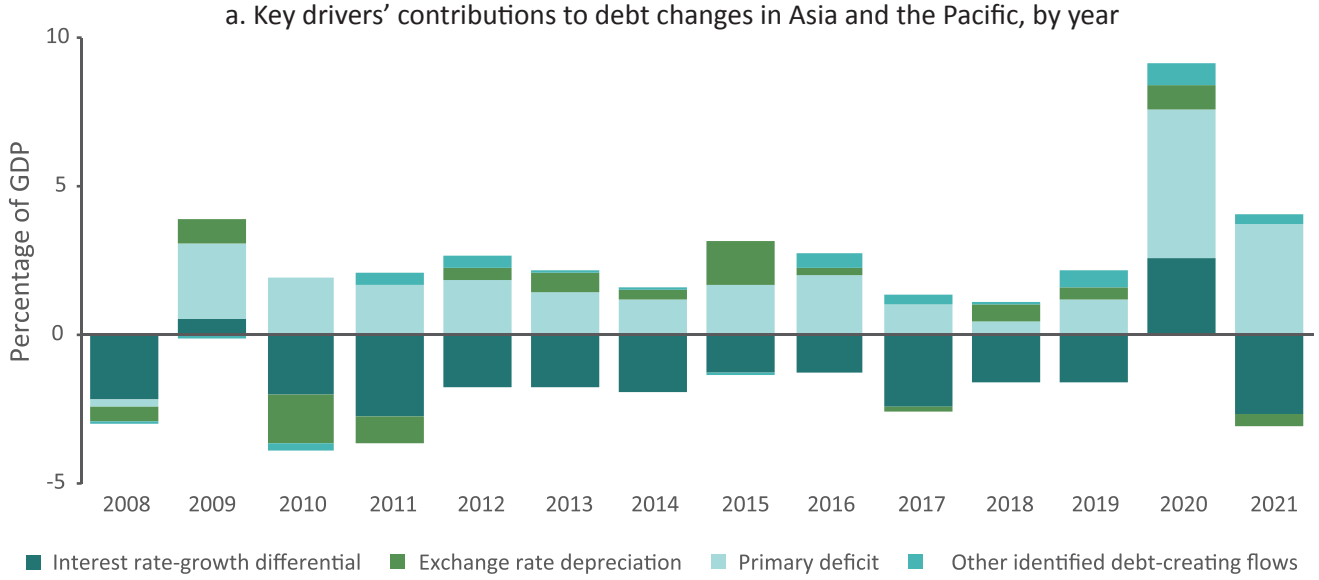
(figure 3.5.a). This is very much in line with the common understanding that Governments borrow to fund the primary deficit, which results in increasing debt, while a higher economic growth rate compared with debt interest costs pays off in the long run and reduces the debt-to -GDP ratio. Larger primary deficits can be observed in 2009 and 2010 after the 2008 global financial crisis and in 2020 and 2021 after the COVID-19 pandemic. Also, the scale of primary deficits was significantly higher after the COVID-19 pandemic. Overall, economic growth rates have been higher than interest rates for most Asia-Pacific economies, which helped moderate debt growth in the region. It is also worth noting that the interest rate-growth differential increased public debt in 2009 and 2020 due to the contraction in GDP in the wake of the 2008 global financial crisis and the COVID-19 pandemic, respectively.

In contrast to the general trend, primary surpluses as well as positive interest rate-growth differentials can also be seen in a few countries with increasing debts. Primary surplus[12] is usually accompanied by a noticeable increase in other identified debt-creating flows[13] or residual items, which explains the increase in debt (figure 3.5.b[14]). For instance, in the case of Singapore, the public debt increase is unrelated to the primary balance. The Government of Singapore issues debt (mainly domestic) to deepen the domestic debt market, meet the investment needs of the Central Provident Fund, and provide individual investors with long-term saving options that offer safe returns. Borrowing proceeds are not used to fund government expenditures but rather for investment, which generates returns that can cover debt servicing costs.[15] On the other hand, the interest rate was higher than economic growth in Fiji[16] and Japan,[17]resulting in a positive contribution of the interest rate-growth differential to the increasing debt level.

10 Including three developed countries: Australia, Japan and New Zealand.
11 Defined in box 3.2.
12 Defined in box 3.1.
13 Defined in box 3.2.
14 Positive primary balance is shown as a negative contribution to the change in debt in figure 3.5.b.
15 Singapore, Ministry of Finance.
16 In Fiji, the effective interest rate was 6.7 per cent between 2010 and 2020 while its real GDP growth rate was only 1.56 per cent. In 2020, Fiji's GDP suffered severe impacts due to the COVID-19 pandemic and recorded a double-digit drop (-16 percentage points) while the real interest rate remained high at 6.2 per cent (IMF, 2021a).
17 The positive change in Japan's public debt from its interest rate-growth differential was minimal because it took place only after the 2008 global financial crisis and the COVID-19 pandemic.

Figure 3.5
In general, the primary deficit pushes up the debt level while the interest rate-growth differential reduces debt

a. Key drivers' contributions to debt changes in Asia and the Pacific, by year



Source: ESCAP staff calculations based on the World Bank Debt Management Monitor and IMF Article IV reports.
Note: Residuals are not shown in the figure. Countries with decreasing debt between 2008 and 2021 or whose increase in debt is lower than 10 per cent and the current debt-to-GDP ratio is lower than 20 per cent are excluded from the calculation. County coverage is lower in 2021 as data of some countries are not available yet. Developed countries are included.

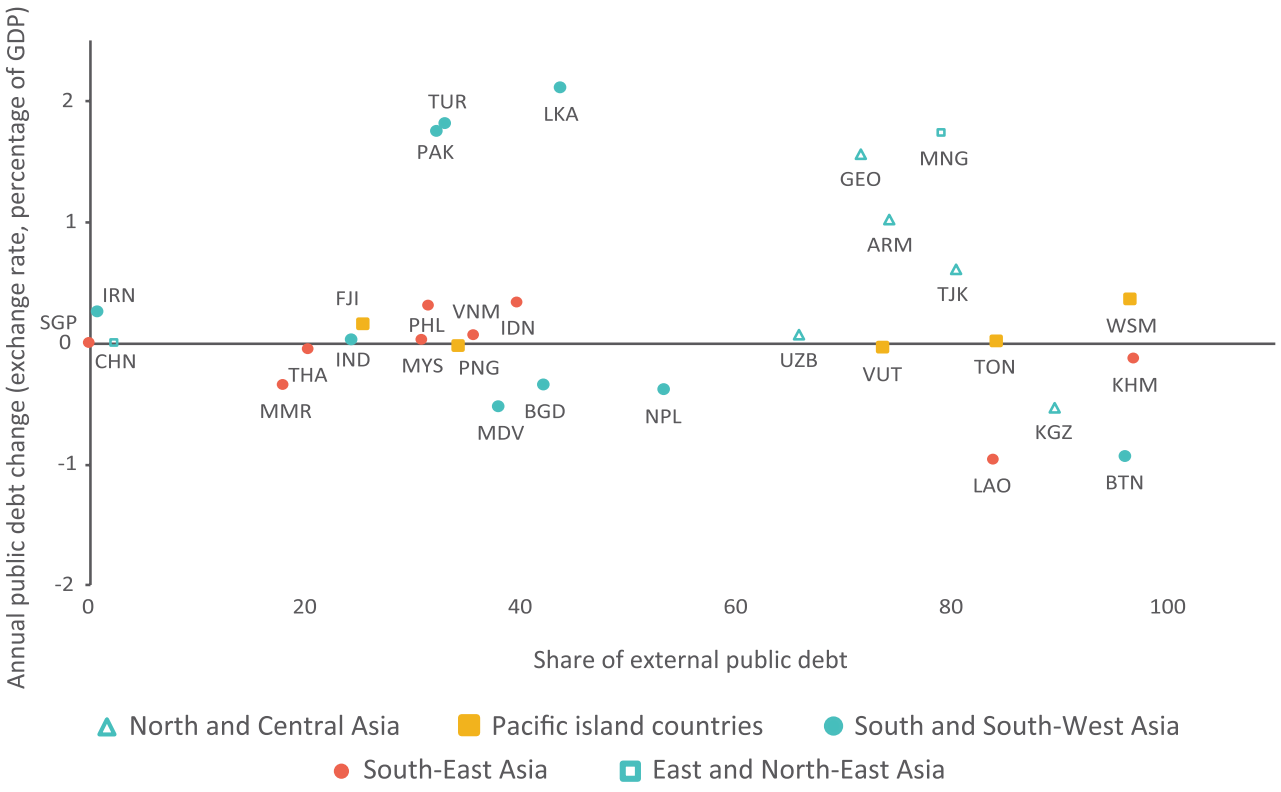
b. Key drivers' contributions to debt changes in Asia and the Pacific, by country

Source: ESCAP staff calculation based on the World Bank Debt Management Monitor and IMF Article IV reports.
Note: Countries with decreasing debt between 2008 and 2021 or whose increase in debt is lower than 10 per cent and the current debt-to-GDP ratio is lower than 20 per cent are excluded. Fewer countries were available in 2021. In some countries, data are not available for all years between 2008 and 2021.

Although primary deficit and interest rate-growth differential are the two main contributors to the change in public debt, exchange rate changes can also lead to large fluctuations in public debt in the short term, and have had significant impacts on even the debt level over a longer period for certain countries. For instance, exchange rate depreciation contributed about 50 per cent of the increase in public debt in Sri Lanka and Türkiye. The extent to which the exchange rate can play a role in change in the public debt is influenced by several factors: the share of external debt in the total public debt portfolio, the currency composition of external debt and the change in exchange rate. In countries where external debt is close to zero, the contribution from the exchange rate is also close to zero, such as China and Singapore (figure 3.6). In contrast, the fluctuation in public debt level caused by the exchange rate is usually higher in economies that rely more on external debt, except for Cambodia where the riel is pegged[18] to the United States dollar, and Pacific island developing economies, which usually do not have their own currency and share a currency with a more developed country (Bowman, 2004). The largest impact from the exchange rate usually takes place in countries which see persistent and significant currency depreciation due to sustained current account deficits[19] or persistently high domestic inflation, as is in the case of Pakistan, Sri Lanka and Türkiye.

18 According to IMF, a country (formally or de facto) pegs its currency at a fixed rate to another currency or a basket of currencies, where the basket is formed from the currencies of major trading or financial partners and the weights used reflect the geographical distribution of trade, services and capital flows.
19 See definition in box 3.1.

Figure 3.6
Average contribution to public debt changes from exchange rate versus share of external debt, 2008–2021



Source: ESCAP staff calculation based on World Bank International Debt Statistics, last updated on 6 December 2022; Debt Management Monitor; IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.; and IMF Article IV reports.Abbreviations: ARM = Armenia; AZE = Azerbaijan; BGD = Bangladesh; BTN = Bhutan; CHN = China; FJI = Fiji; FSM = Federated States of Micronesia; GEO = Georgia; IDN = Indonesia; IND = India; IRN = Islamic Republic of Iran; KAZ = Kazakhstan; KGZ = Kyrgyzstan; KHM = Cambodia; LAO = Lao People's Democratic Republic; LKA = Sri Lanka; MDV = Maldives; MHL = Marshall Islands; MMR = Myanmar; MNG = Mongolia; MYS = Malaysia; NPL = Nepal; PAK = Pakistan; PHL = Philippines; PNG = Papua New Guinea; RUS = Russian Federation; SGP = Singapore; SLB = Solomon Islands; THA = Thailand; TJK = Tajikistan; TLS = Timor-Leste; TON = Tonga; TUR = Türkiye; UZB = Uzbekistan; VNM = Viet Nam; VUT = Vanuatu; WSM = Samoa.

4. Composition of Asia-Pacific public debt: how are Governments borrowing?

Half of Asia-Pacific developing economies are heavily reliant on external debt owed to multilateral and bilateral creditors (section 4.1). Yet, countries with a higher share of domestic debt have seen increasing issuances of local currency government bonds in the domestic market (section 4.2).

4.1. External public and publicly guaranteed debt: half of the Asia-Pacific developing economies rely heavily on external debt

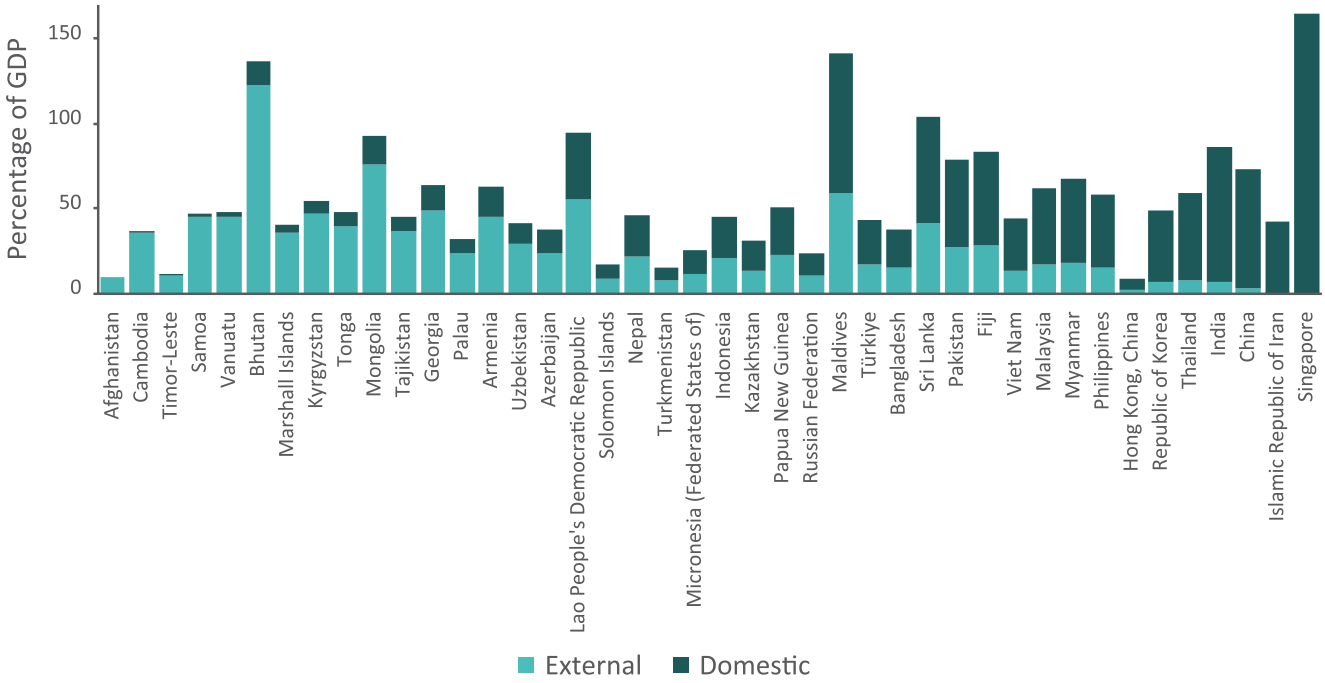
Depending on the development status of the domestic financial market, some countries have no choice but to rely on external borrowings from bilateral and multilateral creditors. By definition, external debt[20] is held by foreign investors, making economies with large external debts vulnerable to global events, such as financial crises and deep recessions. When such events do take place, capital flows out of the borrowing countries, exacerbating their debt vulnerabilities.[21] Moreover, as external public debt is mostly denominated in foreign currencies and domestic central banks cannot print foreign currency to repay external debt, external debt is again associated with greater vulnerabilities that may lead to debt crises. The primary scope of discussion in this section is on public and publicly guaranteed debt[22] and is focused on (a) creditors; (b) currencies; (c) concessionality; and (d) debt service and the interrelationship among all four components.

20 See definition in box 3.1.

21 In practice, most developing countries report figures for external and domestic debt by using information on the place of issuance and jurisdiction that regulates the debt contract.

22 See definition in box 3.1.

Figure 3.7
Half of Asia-Pacific developing economies still rely heavily on external debt



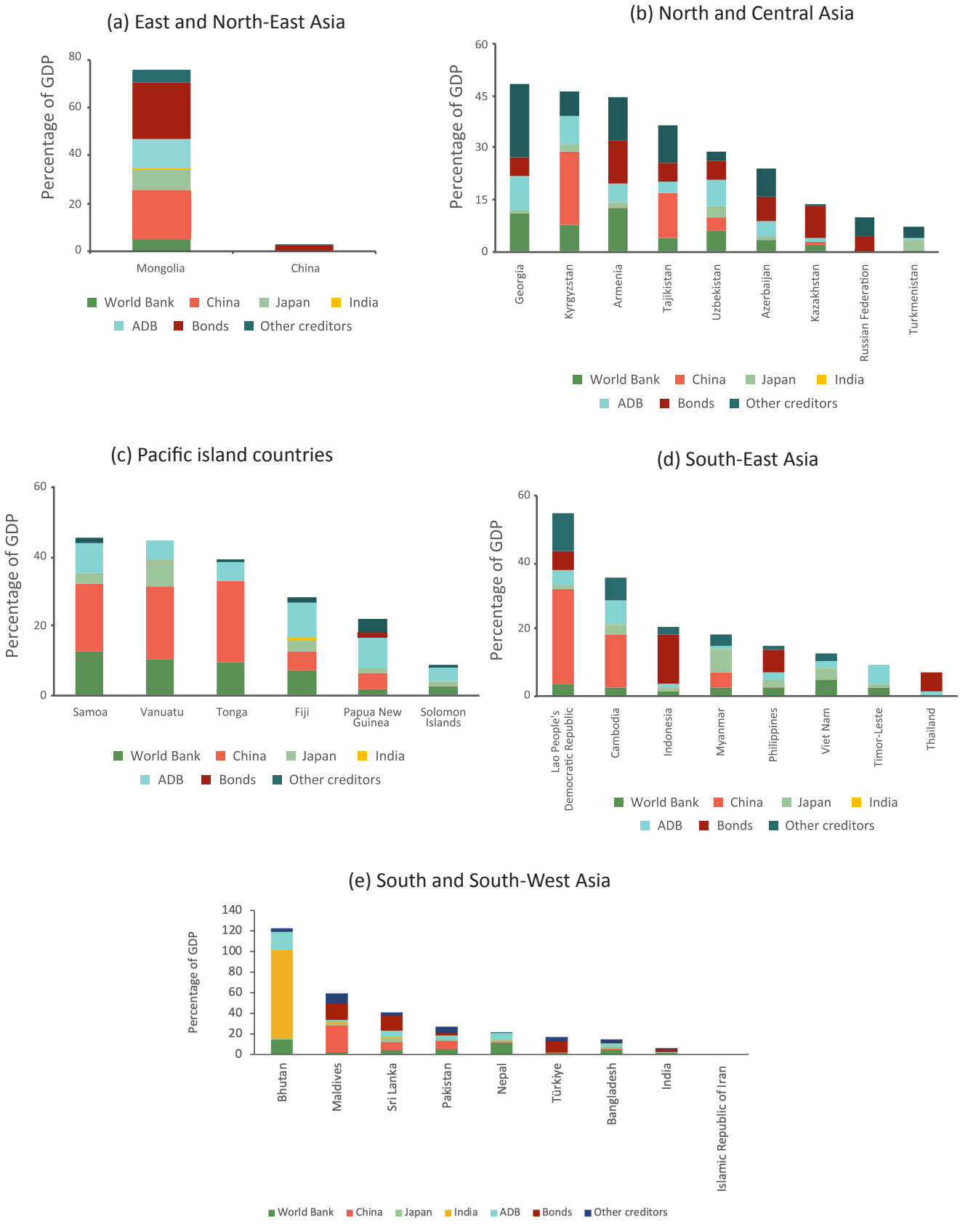
Source: ESCAP staff calculation based on World Bank International Debt Statistics, last updated on 6 December 2022; Debt Management Monitor; IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.; and Government Financial Statistics.
Note: Data of latest year is shown in the figure. Latest year is either 2021 or 2020.

4.1.1. Creditors: The role of unconventional creditors, such as China, and bondholders has increased recently

A diversified sovereign creditor landscape opens more financing channels and avoids the rollover risk of not being able to continue borrowing from only a few creditors. On the other hand, different types of creditors – bilateral and multilateral institutions, such as IMF and the World Bank, and commercial lenders, such as banks and bondholders – have different priorities and thus offer different borrowing terms and behave differently in times of crisis.

Currently, bilateral and multilateral creditors are the two largest creditor groups in the external borrowing portfolio of most developing countries in the region (figure 3.8). Overall, the Asian Development Bank (ADB) and the World Bank continue to be the largest multilateral creditors in the region (figure 3.8).

Figure 3.8
Bilateral and multilateral loans constitute the major sources of external borrowing for most developing countries in all subregions, 2021



Source: World Bank International Debt Statistics, last updated on 6 December 2022.

In the past decade, non-traditional bilateral creditors, particularly China, have gained greater influence and expanded their footprint in every subregion in Asia and the Pacific. Several small island developing States and landlocked developing countries have seen the sharpest increases in Chinese debt, predominantly in infrastructure development through the Belt and Road Initiative (figure 3.9). Over the past decade China has become the top creditor in Cambodia, Kyrgyzstan, the Lao People's Democratic Republic, Maldives, Pakistan, Samoa, Tajikistan, Tonga and Vanuatu; it accounts for more than 20 per cent of total external public debt in another five countries: Fiji, Mongolia, Myanmar, Papua New Guinea and Sri Lanka. In nominal terms, China's lending to the region surged 11-fold from $6 billion in 2008 to $71 billion in 2021.

Figure 3.9
China has become one of the major bilateral creditors in the region

Source: World Bank International Debt Statistics, last updated on 6 December 2022.
Note: Countries selected based on the following criteria: bilateral debt owed to China was higher than 1 per cent of GDP and China's bilateral loans took up more than 10 per cent of total external public debt in 2008 or 2021.

Beyond official creditors, the role of government bond holders, such as institutional investors, has increased in the region's sovereign creditor landscape.

The share of government bond holders in total external public and publicly guaranteed debt has jumped drastically in 16 countries (figure 3.10). However, this has been more the case for countries with a lower share of external debt, such as China, Indonesia and Thailand. Earlier, bond holders were not contributing at all to the external public debt for 10 countries. This is because their international sovereign bonds were first issued after 2007, including five North and Central Asian countries and two small island developing States (figure 3.11).

Figure 3.10
The share of government bond holders in total external public and publicly guaranteed debt has increased considerably in many countries

Source: World Bank International Debt Statistics, last updated on 6 December 2022
Note: Countries selected with bond debt exceeding 1 per cent of GDP and bonds' share in total debt more than 10 per cent in 2008 or 2021.

Figure 3.11
Ten countries have issued their first international sovereign bonds since 2007

Country	Year	Currency	Notional in USD	Maturity	Interest rate
Sri Lanka	2007	United States Dollar	$500 million	5 Years	8.25%
Kazakhstan	2012	United States Dollar	$500 million	10 Years	N/A
Mongolia	2012	United States Dollar	$1.5 billion	10 Years 5 Years	5.125% - 5.25% 4.125% - 4.25%
Azerbaijan	2012	United States Dollar	$4.6 billion	5 Years	5.45%
Lao People's Democratic Republic	2013	Thai Baht	$50 million	3 Years	4.5%
Armenia	2013	United States Dollar	$700 million	7 Years	6.00%
Maldives	2017	United States Dollar	$200 million	5 Years	7.00%
Tajikistan	2017	United States Dollar	$500 million	10 Years	7.125%
Papua New Guinea	2018	United States Dollar	$500 million	10 Years	8.375%
Uzbekistan	2019	United States Dollar	$500 million	5 Years	5.00%

Source: ESCAP staff compilation using national sources.

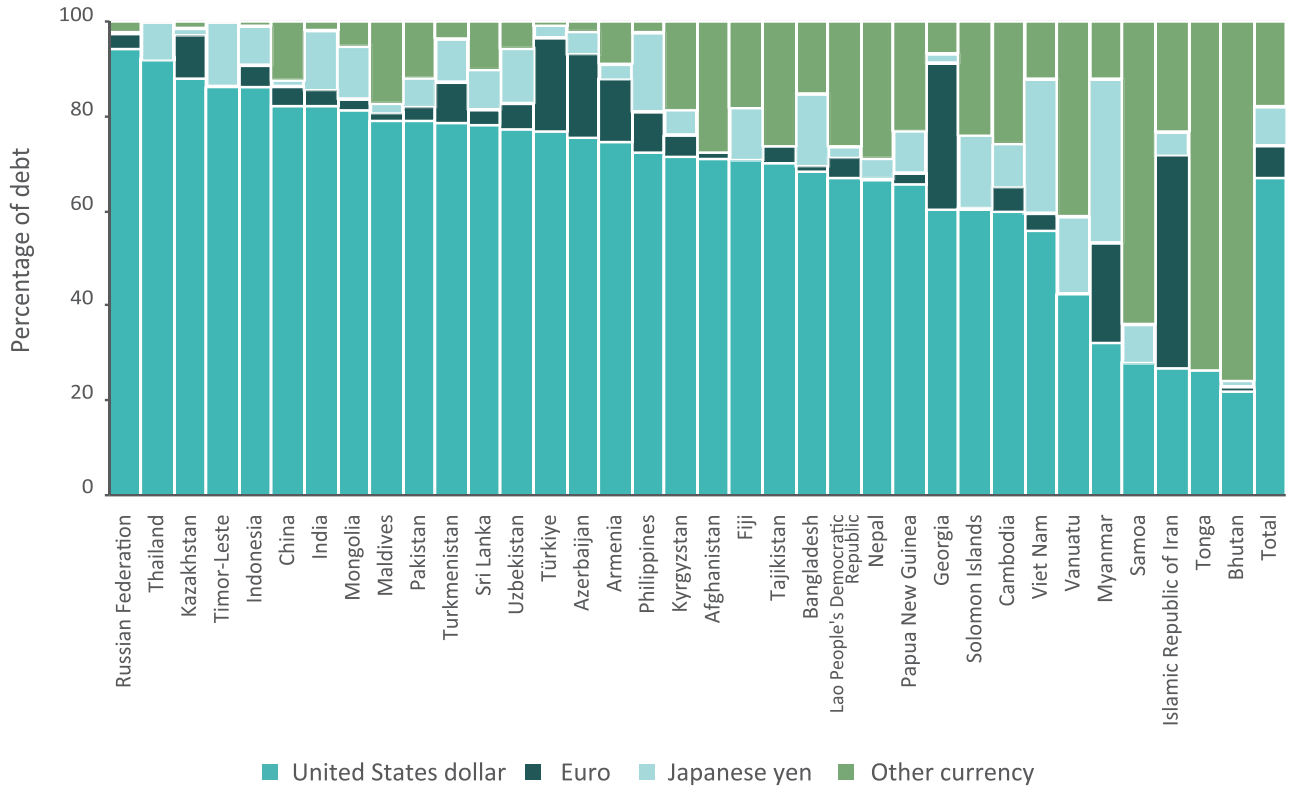
4.1.2. Currencies: United States dollar is still the dominant currency

As discussed in section 3, one of the drivers increasing the public debt level is exchange rate depreciation. Sizable external debt denominated in a foreign currency, particularly with undiversified currency exposure, makes developing countries vulnerable to swings in exchange rates and interest rates, volatile capital flows and even speculative currency attacks, as witnessed during the Asian financial crisis that started in mid-1997. Nevertheless, the low-interest-rate environment in advanced economies might have made United States dollar borrowings more attractive in the past decade, although the situation may have changed more recently.

External public debt is mostly denominated in United States dollars, followed by the euro and Japanese yen. In economies where the external public and publicly guaranteed debt-to-GDP ratio is more than 10 per cent, the share of United States dollar-denominated debt is larger than 70 per cent in about two thirds of the economies (figure 3.12). Moreover, such dollar-denominated debt is larger than 20 per cent of GDP in 12 economies. Most of the countries which have a sizable debt in the euro are North and Central Asian countries, such as Georgia, Kazakhstan and Turkmenistan, due to their geographical proximity and closer economic ties with Europe.

Some countries continue to experience an increasing share of United States dollar-denominated debt. More recently, the choice of currencies for external borrowings has often been driven by a desire to reap the immediate financial benefits of borrowing in currencies with low coupon rates. This is visible in the increasing share of United States dollar-denominated debt, partially resulting from Governments' choice to issue international sovereign bonds to tap into global funding and benefit from lower United States dollar interest rates. However, the rapid hike of interest rates in the United States and subsequent United States dollar appreciation may make domestic borrowing more attractive to countries with access to domestic capital markets and trigger a rebalancing of government debt portfolios.

Figure 3.12
The share of United States dollar-denominated debt in external debt was larger than 70 per cent in two thirds of the economies shown in the figure in 2021



Source: World Bank International Debt Statistics, last updated on 6 December 2022.
Note: Only countries are included if they have more than 10 per cent of external debt to GDP.

4.1.3. Concessionality: the proportion of concessional loans has dropped

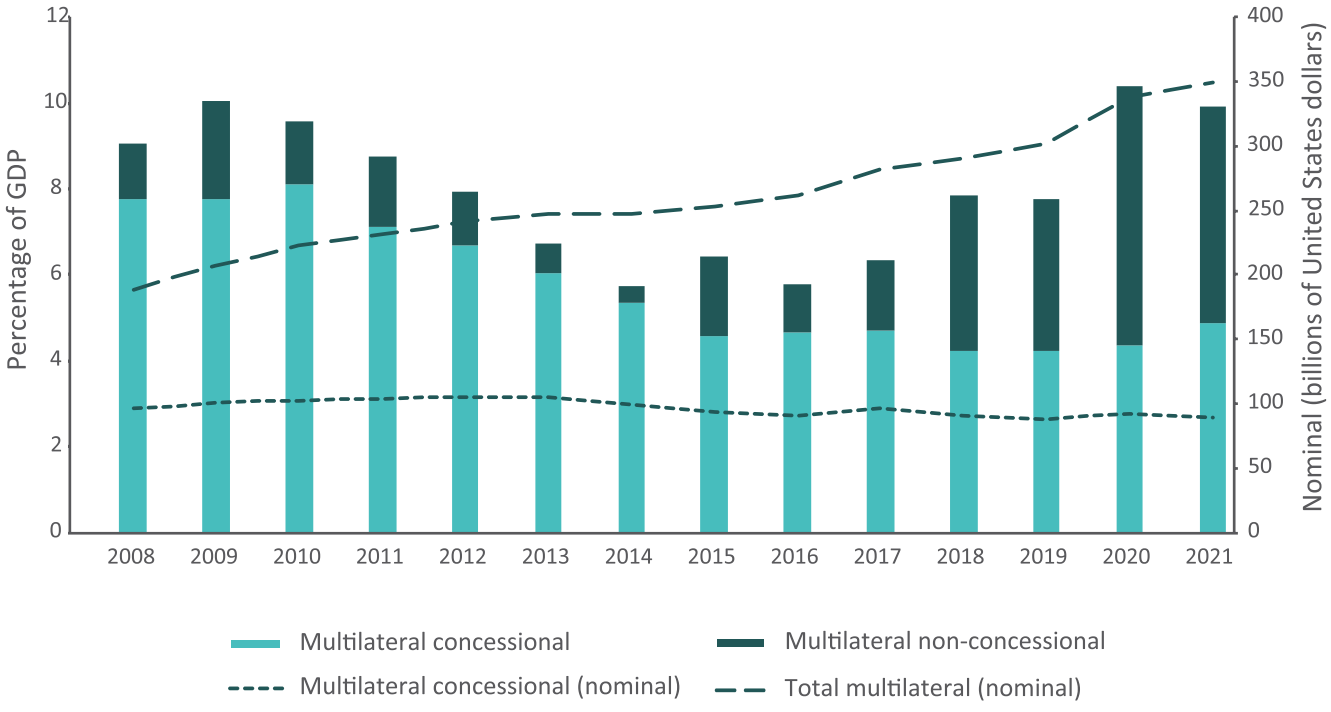
Despite being aware of the risk of currency mismatches, developing countries, especially countries in special situations, still rely on external debt as bilateral and multilateral creditors are more likely to offer concessional terms or below-market-rate interest rates.

The proportion of concessional loans in multilateral public and publicly guaranteed debt has dropped drastically from 51 per cent in 2008 to 26 per cent in 2021. While the total amount of multilateral loans provided to Asian and Pacific developing countries increased by 85 per cent from 2008 to 2021, all the growth was non-concessional (figure 3.13).

China has emerged as one of the largest bilateral creditors in the region although the terms of its loans are less concessional than the traditional bilateral creditors, such as the OECD Development Assistance Committee (DAC) countries. China's loans to the economies in the region (box 3.3) have surged 11-fold, from $6 billion in 2008 to $71 billion in 2021. However, the share of concessional loans[23] by China is low at a mere 4 per cent of total loans, compared with 84 per cent for Japan, 57 per cent for the Republic of Korea, 33 per cent for France, 11 per cent for the United States and 0.1 per cent for the United Kingdom (figure 3.14). It is also worth noting that the concessional portions of bilateral loans by DAC countries are counted in the calculation of official development assistance (ODA); thus, some DAC countries may choose to take a higher share of their ODA commitments in the form of concessional loans (OECD, 2022). Indeed, Japan (55 per cent), the Republic of Korea (36 per cent) and France (23 per cent) are also the countries that provided the highest shares of bilateral ODA as sovereign loans among all DAC countries (OECD, 2022).

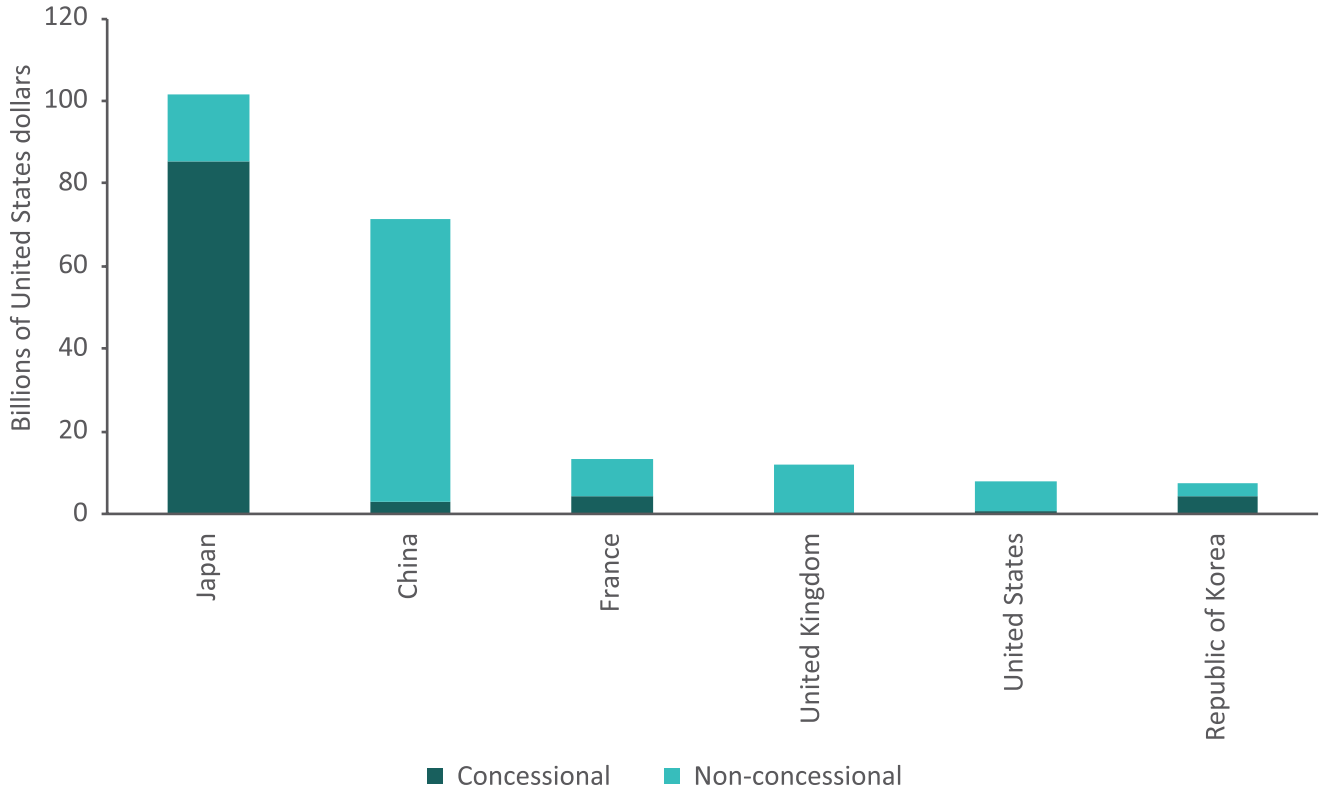
23 Calculated as bilateral concessional loans owed to country A divided by total external public and publicly guaranteed debt owed to country A. Because loans from China's State-owned commercial banks are included in the bilateral loans, to make data comparable among all creditors, total external public and publicly guaranteed debt, including that of commercial banks and other private creditors, is used as the denominator in the calculation.

Figure 3.13
The proportion of concessional loans in multilateral public and publicly guaranteed debt has dropped



Source: World Bank International Debt Statistics, last updated on 6 December 2022.
Note: Bars are the regional median in percentage of GDP, and the trendlines are the total amounts. The number of countries available vary slightly each year due to data availability.

Figure 3.14
Chinese loans, although in less concessional terms, make new funding source possible for developing countries in Asia and the Pacific

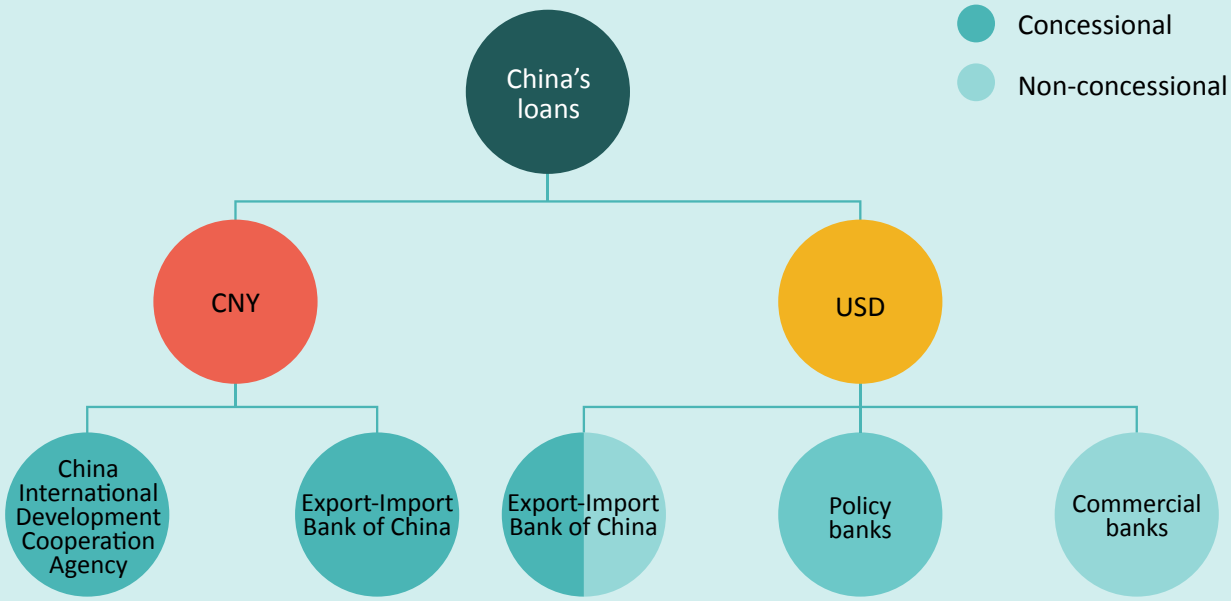


Source: World Bank International Debt Statistics, last updated on 6 December 2022.
Note: Because loans from China's State-owned commercial banks are included in the bilateral loans, to make data comparable among all creditors, non-concessional external public and publicly guaranteed debt, including that of commercial banks and other private creditors, are presented.

Box 3.3
Types of loans extended by China

China's loans are extended and managed by different institutions and can be denominated in United States dollars or Chinese yuan. There are four main types of loans from China. The first type is concessional loans extended by the Government of China. These loans are denominated in Chinese yuan and managed by the China International Development Cooperation Agency. The second type is concessional loans from the Export–Import Bank of China: (a) concessional loans denominated in Chinese yuan; and (b) in United States dollars. The third and largest type is non-concessional loans extended by policy banks, EXIM, the China Development Bank and the Agricultural Development Bank of China, in United States dollars and at market interest rates. The fourth type is loans from Chinese commercial banks and suppliers insured by China's official export credit agency, SINOSURE.

Figure.
Creditors, currencies and concessionality of China's loan



Source: World Bank (2022g).
Abbreviations: CNY = Chinese yuan; USD = United States dollars.

4.1.4. Debt service: surges are expected in many countries

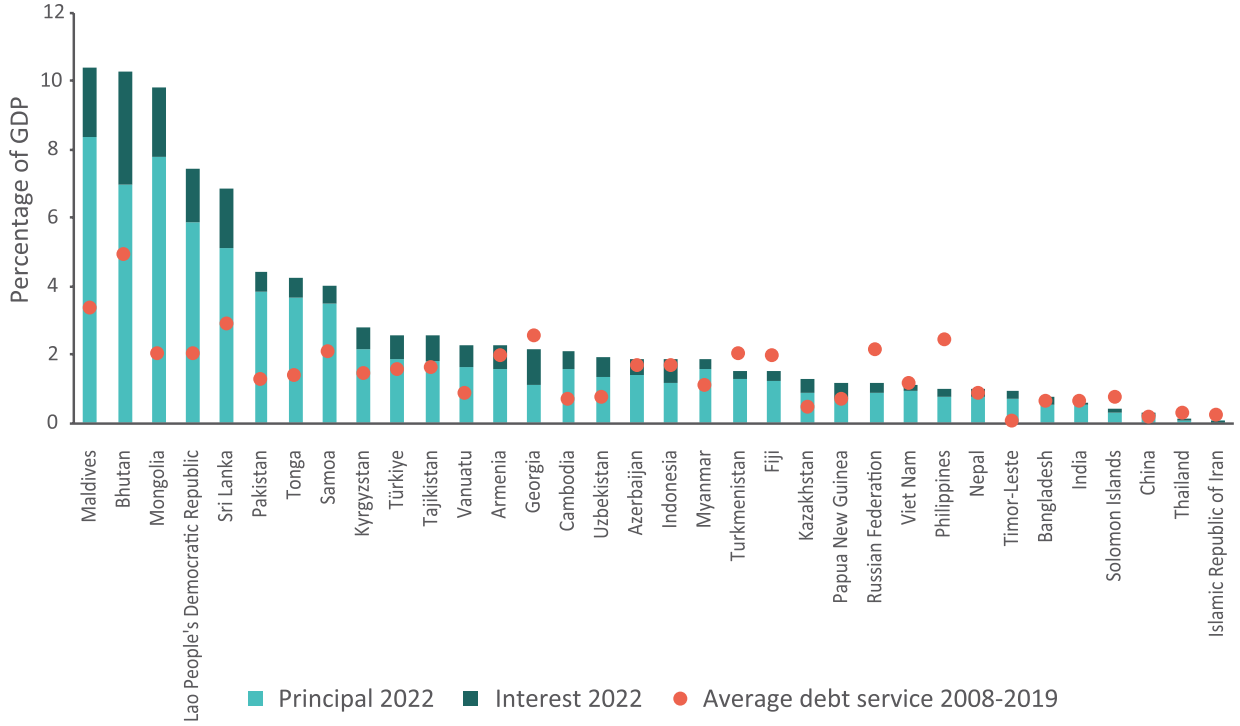
External debt service payments on public and publicly guaranteed debt are expected to surge in most countries in the coming years, putting at risk public debt sustainability of some economies. The average external public and publicly guaranteed debt-service -to-GDP ratio in the region is expected to have been as high as 2.8 per cent in 2022, as compared with 1.3 per cent in 2008 and 2.1 per cent in 2019. Moreover, in 2022, the ratio of external debt service to GDP is expected to have almost tripled compared with the historical average (2008-2021) in the Lao People's Democratic Republic, Maldives, Mongolia, Pakistan and Tonga.

In the next five years (2023-2027), the average external public and publicly guaranteed debt-service-to-GDP ratio in the region is expected to remain above 2 per cent. The external public and publicly guaranteed debt service payments are estimated to be higher in Bhutan, followed by the Lao People's Democratic Republic, Maldives and Mongolia[24] (figure 3.16).

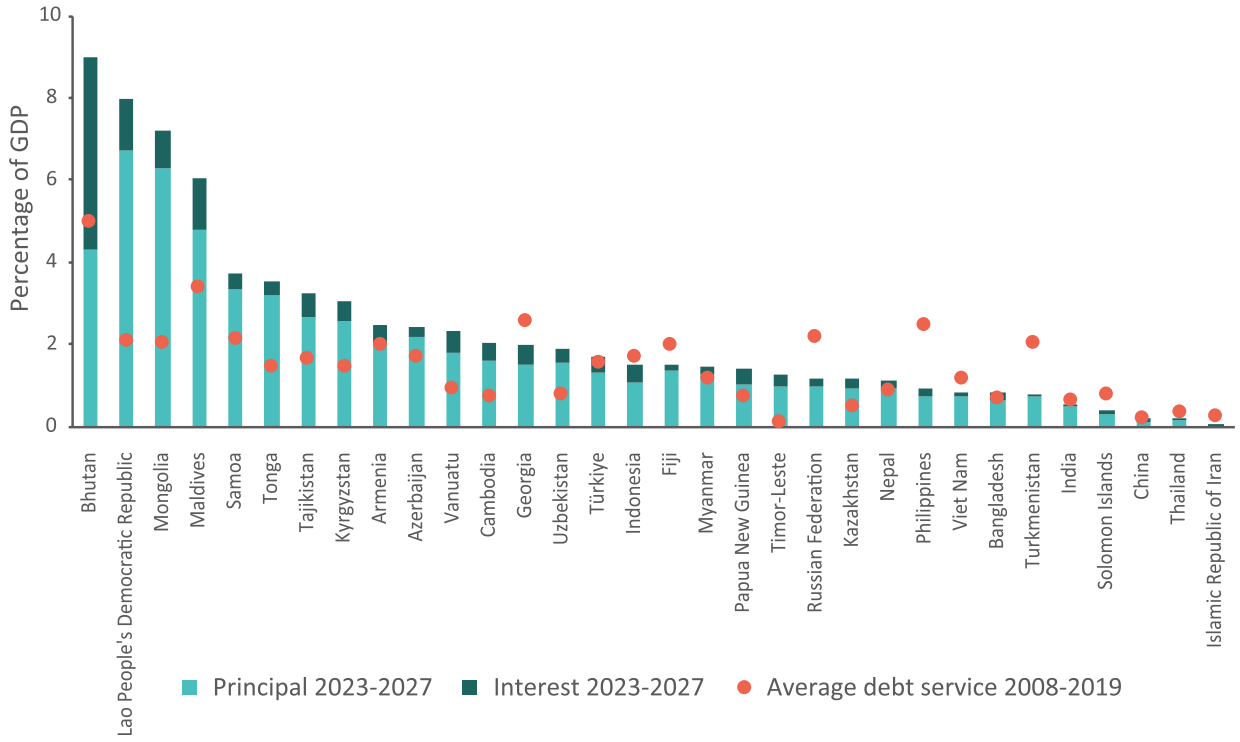
24 Pakistan and Sri Lanka are excluded from the discussion here because their 2023-2027 GDP forecasts are not available.

Figure 3.15
External public and publicly guaranteed debt service payments are expected to surge in most countries, 2022 -2027

a. External public and publicly guaranteed debt service payments in 2022



b. . Average external public and publicly guaranteed debt service payments between 2023 and 2027



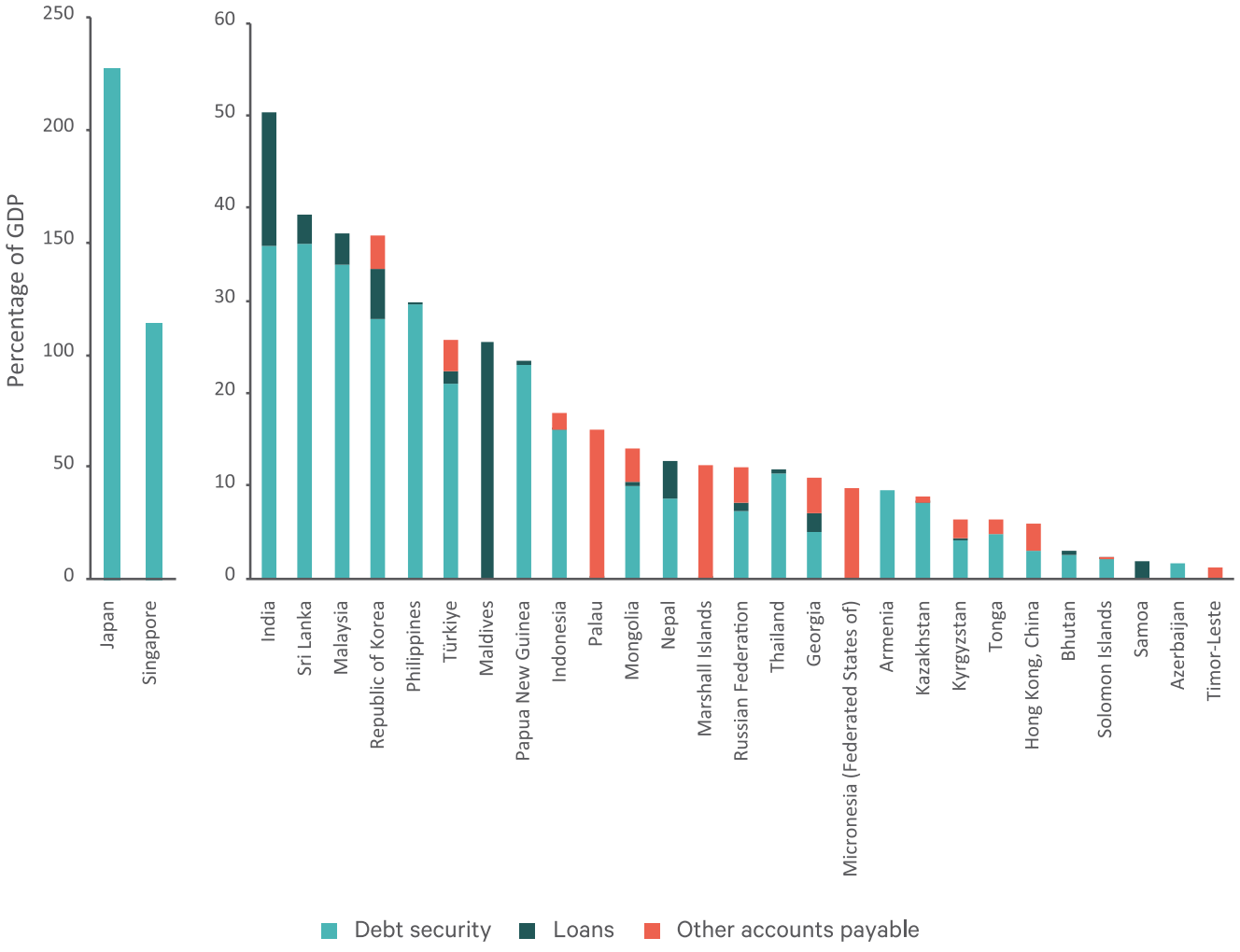
Source: World Bank International Debt Statistics, last updated on 6 December 2022; and IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: Pakistan and Sri Lanka are off the chart in figure 3.15.b because their 2023-2027 GDP forecasts are not available.

4.2. Domestic debt: share of local currency government bonds has increased

Debt securities are the most prevalent instrument for countries with higher domestic debt. Loans and other accounts payable are the two other common instruments of domestic debt. Debt securities include such securities as treasury bills, bonds, and some other securities that are unique to each country. In particular, the ASEAN countries have successfully grown their domestic debt securities market since the 1997 Asian financial crisis. Debt securities account for more than 90 per cent of total domestic government debt in Indonesia, Malaysia, the Philippines and Thailand[25] (figure 3.16). Other accounts payable are usually short term and used in economies with limited domestic financial markets, such as the Pacific island developing States. For instance, other accounts payable of the Federated States of Micronesia were essentially lines of credit from the government-owned company, Petrocorp, which was backed by the company's assets (Micronesia, 2021).

25 Data for other ASEAN countries are not available in this chart from IMF Government Financial Statistics.

Figure 3.16
Debt securities account for the largest share of domestic debt



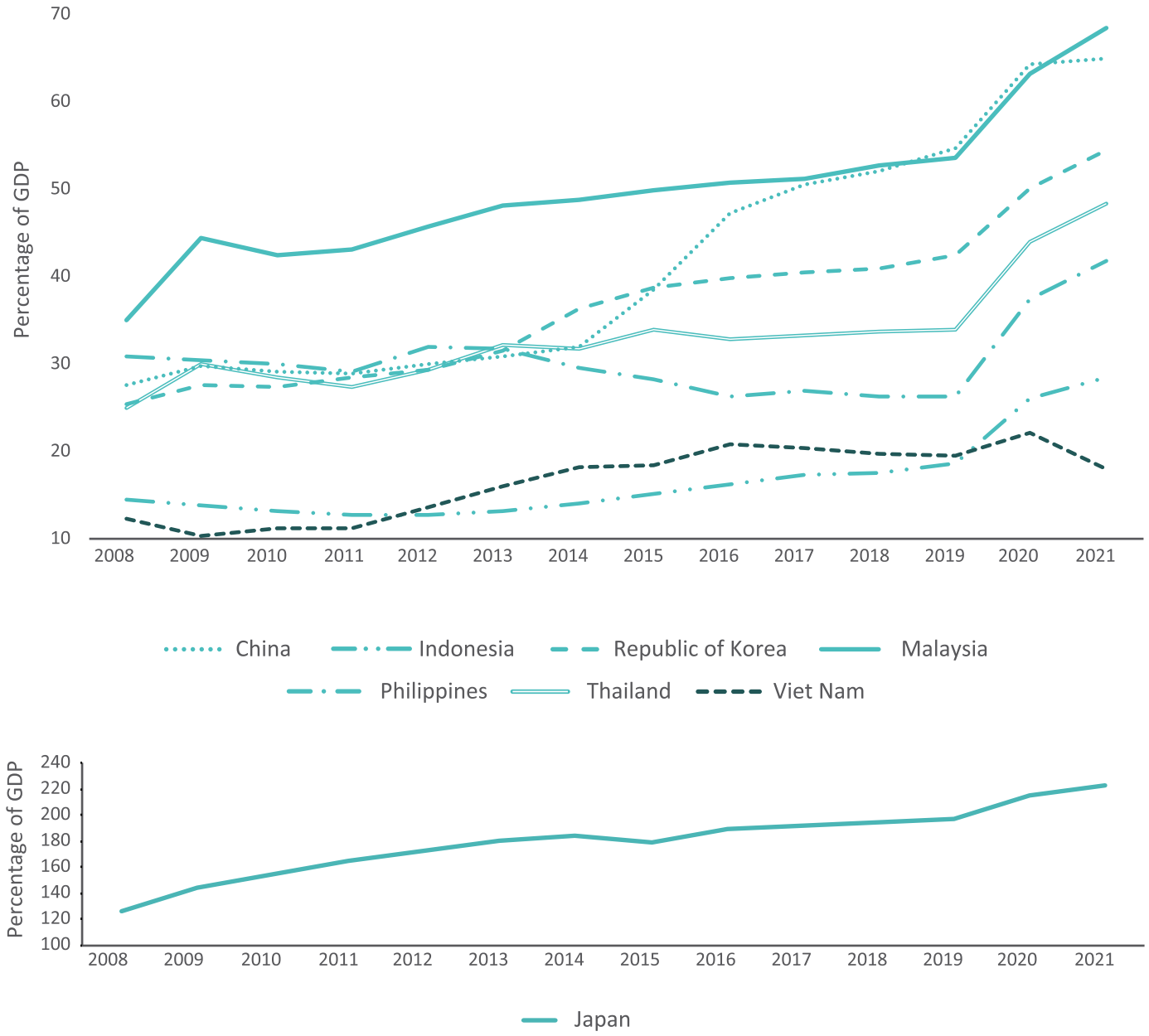
Source: IMF Government Finance Statistics.
Note: If general government debt was not available, central government debt was used instead. Local currency bonds are used for Japan.

As comparable data on domestic debt are scarce in international databases, information on local currency bonds[26] is used as a proxy for discussion, especially for the ASEAN countries, plus China, Japan and the Republic of Korea (ASEAN+3). This is because a striking proportion of their domestic debt is composed of local currency (LCY) government bonds; they account for 73 per cent of GDP of the region. Investor profiles, particularly foreign holdings, and maturity structure are analysed as well.

26 From ADB Asian Bonds Online.

The outstanding stock of LCY government bonds has been on a rising trend in the ASEAN+3 countries. The development of local currency bond markets became a policy priority for many Asian economies following the 1997 Asian financial crisis. A recent jump was recorded in 2020 and 2021, as Governments sought more funding to launch stimulus packages during the COVID-19 pandemic.

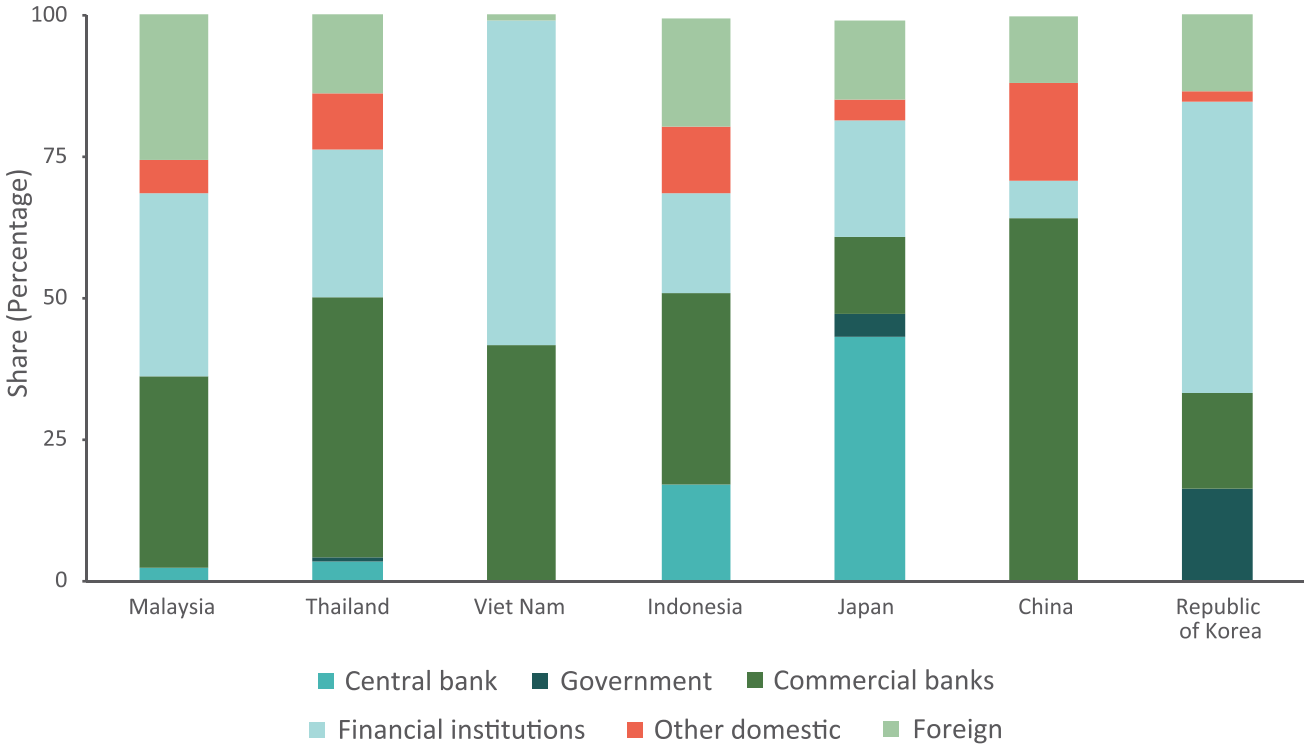
Figure 3.17
ASEAN+3 has seen increasing issuances of local currency government bonds in the domestic market



Source: asiabondsonline.com.

The domestic investors of government LCY bonds are mainly commercial banks, financial institutions[27] and central banks (figure 3.18). The creditor landscape matters. For domestic borrowing, a significantly higher share of commercial banks in government borrowing can crowd out credit to private businesses. Commercial banks' holdings of LCY government bonds were particularly significant in China. Commercial banks hold a similar amount of bonds as do financial institutions in Malaysia, Thailand and Viet Nam. In Viet Nam, more than 50 per cent of LCY government bonds are held by financial companies, which include pension funds and insurance companies, thanks to the Government's strategy to encourage higher participation of pension funds and insurance companies in the long-term government bond market (ADB, 2018).

Figure 3.18
Investor profiles of local currency government bonds in ASEAN+3 countries, 2021

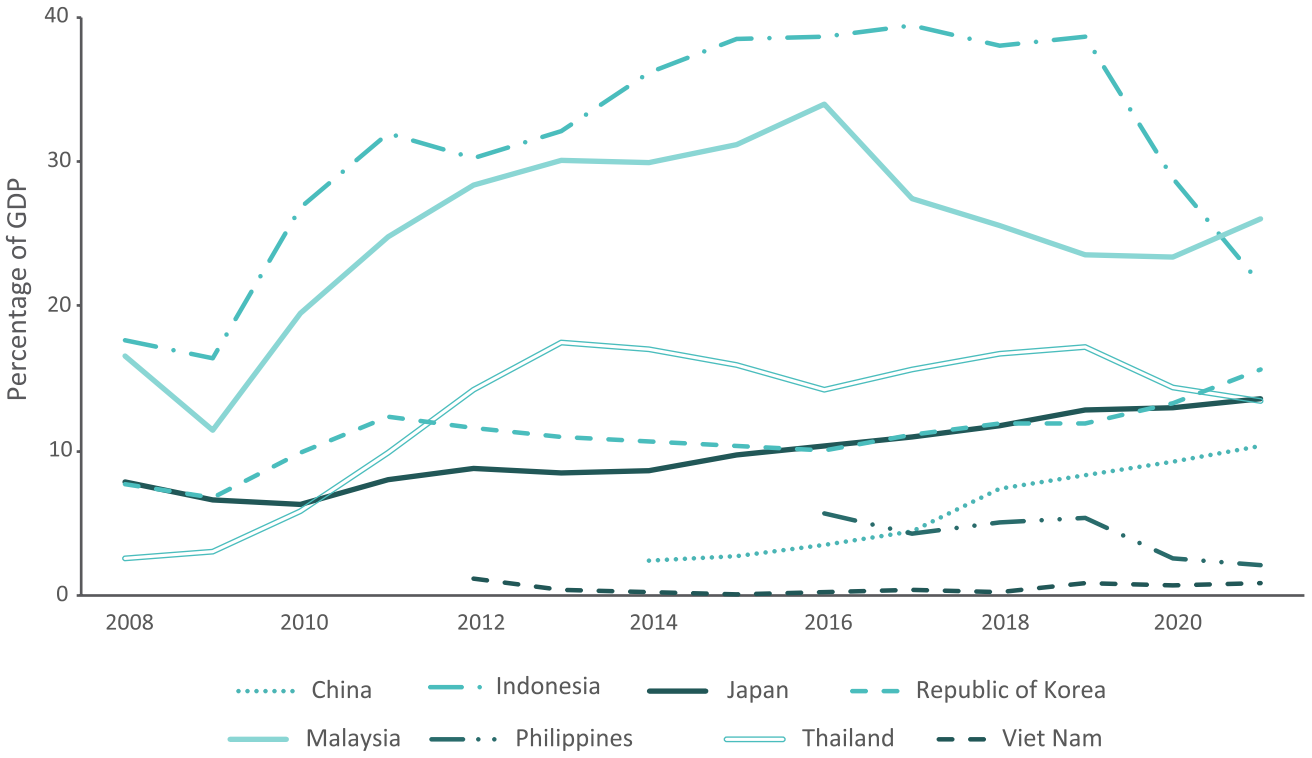


Source: ESCAP calculation based on data and information obtained from asiabondsonline.com.
Note: Financial institutions include insurance companies, pension funds, mutual funds, securities companies and social security institutions.

The foreign holdings of LCY government bonds have been on an upward trend generally after 2008, but have also experienced fluctuations over the years (figure 3.19). Foreign investors' participation in the LCY government bond market can generate significant benefits, such as greater diversity of investors, a broader investor base, greater depth and liquidity for the domestic debt market (Peiris, 2010).[28] The enhanced liquidity and additional demand could also help to reduce borrowing costs. However, greater participation of non-residents in government bond markets also means an increase in the risk exposure to sudden capital outflows (Silva and others, 2020). Specifically, until 2020 Indonesia had seen the highest foreign participation in the LCY government bond market. Malaysia now has the highest holding of LCY government bonds by foreign investors, according to Asian Bonds Online, despite a declining trend since 2016. Foreign holdings of Thai government bonds have also increased remarkably, especially after the 2008 global financial crisis.

27 Financial institutions are composed of insurance companies, pension funds, mutual funds and social security funds.
28 In his Working Paper (p. 3), Peiris stated: "Foreign investors could act as catalysts for the development of local bond markets, particularly by diversifying the institutional investor base and creating greater demand for local EM [emerging market] debt securities".

Figure 3.19
Historical foreign holdings of LCY government bonds in selected ASEAN+3 countries



Source: asiabondsonline.com
Note: Data on Hong Kong, China; and Singapore are not available.

5. Assessing debt distress in the Asia-Pacific region: whose public debt is at a higher risk?

A higher debt level does not necessarily translate into higher risk of debt distress and is only one of the contributing factors.

An examination of public debt distress risk needs to be undertaken from various perspectives to fully ascertain this aspect.

5.1. Risk of debt distress: the number of countries at high risk is rising

This subsection first presents the World Bank and the IMF Debt Sustainability Analysis (DSA)[29] that is commonly used to measure the risk of public debt distress. This is followed by a discussion of sovereign credit ratings for economies with market access, as provided by Moody's Investors Service, Standard & Poor's Global Ratings and Fitch Ratings.[30]

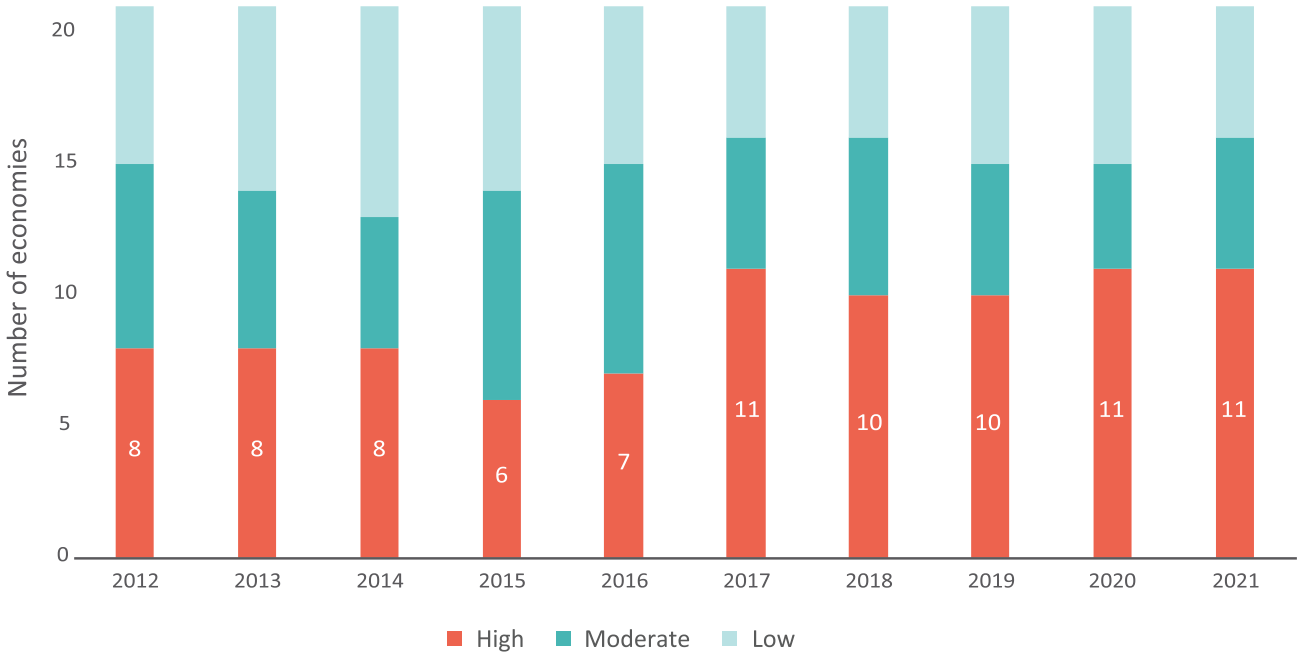
An increasing number of countries have been deemed as facing a high risk of debt distress in the past decade, according to the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries (LIC-DSF)[31] (figure 3.20). The greatest change was between 2016 and 2017 and was partly caused by a change in the DSA methodology to include climate change and disaster-related spending in the case of Samoa and Tonga.

29 The joint World Bank-IMF Debt Sustainability Framework consists of two complementary components: analysis of the sustainability of total public debt and that of total external debt. It is a model-based assessment, but other non-model considerations are also considered before the final risk ratings are given.

30 The term market access means access to capital markets. It should be noted that certain countries assessed by the joint World Bank-IMF Debt Sustainability Framework for Low-In come Countries are also assessed by credit rating agencies; examples of such countries are the Lao People's Democratic Republic, Maldives, Papua New Guinea and Tajikistan.

31 See definition in box 3.1.

Figure 3.20
Risk of overall debt distress in Asia and the Pacific, 2012-2021



Source: Data from joint IMF-World Bank Debt Sustainability Analysis, 2012-2021.
Note: Debt Sustainability Analysis may not be published every year; some economies (such as the Federated States of Micronesia) started as late as 2015. Gap years are filled with assumptions, i.e. that the rating remains the same as in prior years.

The risk of public debt distress is rated as high in 11 countries in the region, based on the latest DSA for low-income countries (table 3.1). Of these countries, eight are small island developing States. The remaining three countries with high risk of debt distress are all landlocked developing countries. In this framework, certain macroeconomic assumptions are used to calculate debt burden indicators, such as present value of the total public and publicly guaranteed debt-to-GDP ratio, under baseline and various risk scenarios. The results are compared with country thresholds, which are established based on three debt-carrying capacity[32] categories (strong, medium and weak). After this, the risks of debt distress are classified into four categories: low risk (when there are no breaches of thresholds); moderate risk (when thresholds are breached in risk scenarios); high risk (when thresholds are breached in the baseline scenario); and in debt distress (when a distress event, such as arrears or restructuring, has occurred or is considered imminent) (IMF, 2018a).

32 Debt-carrying capacity is defined as the threshold for debt service, beyond which a country cannot handle its debt burden (Hakura, 2020).

Table 3.1
Latest Debt Sustainability Analyses under the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries

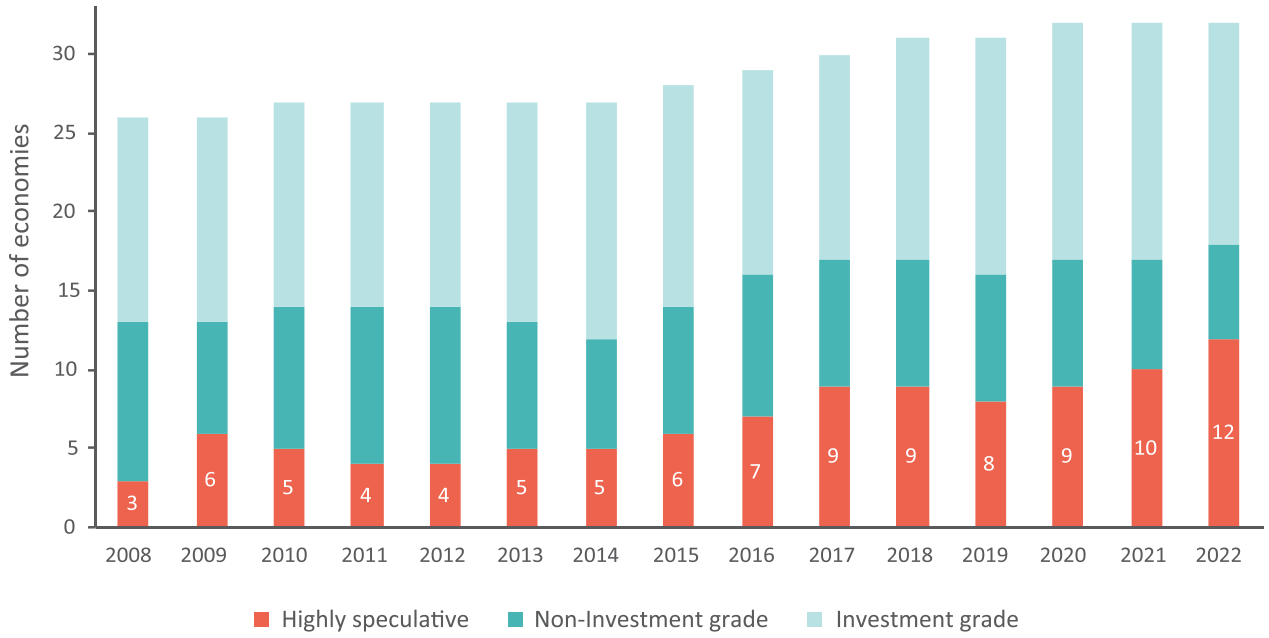
Risk of overall debt distress	Countries	Year of Assessment
High	Afghanistan	2020
	Kiribati	2018
	Lao People's Democratic Republic	2017
	Maldives	2019
	Marshall Islands	2019
	Micronesia (Federated States of)	2020
	Papua New Guinea	2021
	Samoa	2020
	Tajikistan	2020
	Tonga	2021
	Tuvalu	2020
Moderate	Bhutan	2021
	Kyrgyzstan	2020
	Solomon Islands	2020
	Timor-Leste	2021
	Vanuatu	2020
Low	Bangladesh	2021
	Cambodia	2020
	Myanmar	2019
	Nepal	2020
	Uzbekistan	2021

Source: Data from joint IMF-World Bank Debt Sustainability Analysis. Available at www.worldbank.org/en/programs/debt-toolkit/dsa, accessed on 15 February 2023.
Note: In addition to low-income countries, the LIC-DSF framework is also used for countries that are eligible for the IMF Poverty Reduction and Growth Trust and the World Bank's International Development Association grants regardless of their income level; an example is Maldives.

An increasing number of Asia-Pacific countries with market access and available credit rating scores have also been deemed as facing high risk of debt distress,[33] (figure 3.21). Of a total of 32 countries for which credit rating information is available, 18 have a rating of non-investment grade (table 3.2), and of these 18 countries, 12 (highly speculative and below) are further classified as facing high risk of public debt distress. For economies with market access, sovereign credit ratings assessed by credit rating agencies are critical and can have direct impacts on the cost of borrowing in capital markets. Unlike the World Bank-IMF DSA, which covers public debt due to all creditors, the sovereign credit rating relates only to the probability of default on debt owed to private creditors.[34] If official creditors provide debt relief,[35] this would not be viewed as constituting a sovereign default[36] (S&P, 2019). However, the need for such relief tends to initially exert a negative influence on sovereign credit worthiness and potentially on the rating itself in the short-to-medium term as it will be treated as a restructuring event.[37] This explains why countries tend to be reluctant to take up debt relief, as it has implications for their credit ratings and thus access to capital markets.

33 Countries with credit rating of B+ (S&P's assessment) or highly speculative and below are considered as facing high risk of debt distress. This threshold is chosen based on the IMF's Market Access Debt Sustainability Analysis for Fiji. Fiji's risk is assessed high by IMF Market Access DSA and its credit rating is also available. The next country in the list with both DSA and credit ratings is Uzbekistan. But its risk of distress is deemed low based on IMF's DSA. As a result, the credit rating of Fiji, B+ is chosen as the cutoff rating for the classification of high risk.
34 Fitch Ratings Sovereign Rating Criteria.
35 Debt relief is any form of debt reorganization which relieves the overall burden of debt (IMF, 2014a).
36 Sovereign default refers to the failure of a national Government to repay its debt (interest or principal).
37 Fitch Ratings Sovereign Rating Criteria.

Figure 3.21
Trend of sovereign credit ratings in Asia and the Pacific, 2008-2022



Source: countryeconomy.com, Moody's Investors Service, Fitch Ratings, Standard & Poor's Global Ratings, and World Bank: A Cross-Country Database of Fiscal Space, Fall 2022 Version
Note: "Investment grade" is defined as a credit rating of Baa3 (Moody's) or BBB- (Fitch and S&P) or better. "Non-investment grade" is defined as a credit rating of Ba1 (Moody's) or BB+ (Fitch and Standard & Poor's) or lower. "Highly speculative" is considered as a subcategory of non-investment grade and is defined as a credit rating of B1 (Moody's) or B+ (Fitch and Standard & Poor's) or lower.

Table 3.2
Summary of sovereign credit rating actions, January 2022 – February 2023

Grade		Moody's		S&P		Fitch	
		2022.1.1	Current	2022.1.1	Current	2022.1.1	Current
Investment	Australia	Aaa		AAA		AAA	
	Singapore	Aaa		AAA		AAA	
	New Zealand	Aaa		AA+		AA	AA+
	Macao, China	Aa3				AA	
	Hong Kong, China	Aa3		AA+		AA-	
	Republic of Korea	Aa2		AA		AA-	
	China	A1		A+		A+	
	Japan	A1		A+		A	
	Malaysia	A3		A-		BBB+	
	Thailand	Baa1		BBB+		BBB+	
	Philippines	Baa2		BBB+		BBB	
	Indonesia	Baa2		BBB		BBB	
	Kazakhstan	Baa2		BBB-		BBB	
	India	Baa3		BBB-		BBB-	
Non-Investment	Azerbaijan	Ba2	Ba1	BB+		BB+	
	Georgia	Ba2		BB		BB	
	Viet Nam	Ba3	Ba2	BB	BB+	BB	
	Bangladesh	Ba3		BB-		BB-	
	Uzbekistan	B1	Ba3	BB-		BB-	
	Armenia	Ba3		B+		B+	
	B+ or Highly Speculative						
	Fiji	B1		B+			
	Papua New Guinea	B2		B-		B+	
	Cambodia	B2		B			
	Tajikistan	B3		B-			
	Mongolia	B3		B		B	
	Kyrgyzstan	B3		Rating Withdrawn		Rating Withdrawn	
	Türkiye	B2	B3	B+	B	BB-	B
	Maldives	Caa1		B-		B-	
	Pakistan	B3	Caa1	B-	CCC+	B-	CCC-
	Lao People's Democratic Republic	Caa2	Caa3			CCC	Rating Withdrawn
	Sri Lanka	Caa2	Ca	CCC+	SD	CC	RD
	Russian Federation	Baa3	Rating Withdrawn	BBB-	Rating Withdrawn	BBB	Rating Withdrawn

Source: countryeconomy.com, updated on 15 February 2023.

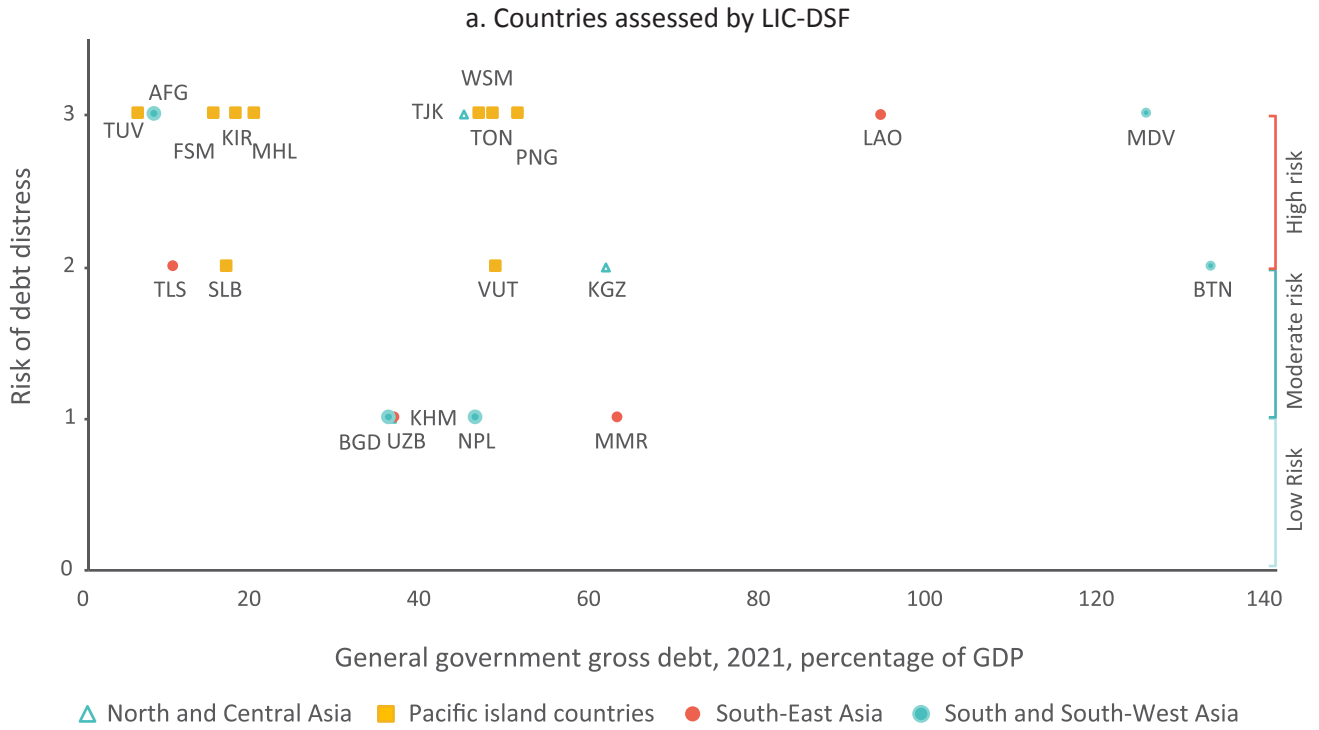
5.2. Public debt profiles of high-risk countries: what are their common characteristics?

As the preceding discussion shows, there are 19 countries in total that are rated at high risk of debt distress based on the Joint World Bank-IMF Debt Sustainability Framework for Low-In -come Countries or equivalent credit ratings assessed by credit rating agencies. These 19 economies are: Afghanistan, Cambodia, Federated States of Micronesia, Fiji, Kiribati, Kyrgyzstan, Lao People's Democratic Republic, Maldives, Marshall Islands, Mongolia, Pakistan, Papua New Guinea, Russian Federation, Samoa, Sri Lanka, Tajikistan, Tonga, Türkiye and Tuvalu. To develop a clearer understanding of why debt is deemed more vulnerable in some economies than others, this subsection contains an analysis of the public debt profiles from different dimensions of countries rated at high risk of debt distress.

A higher debt level does not necessarily translate into higher risk of debt distress, while some countries with low levels of debt can still face a high risk of debt distress.

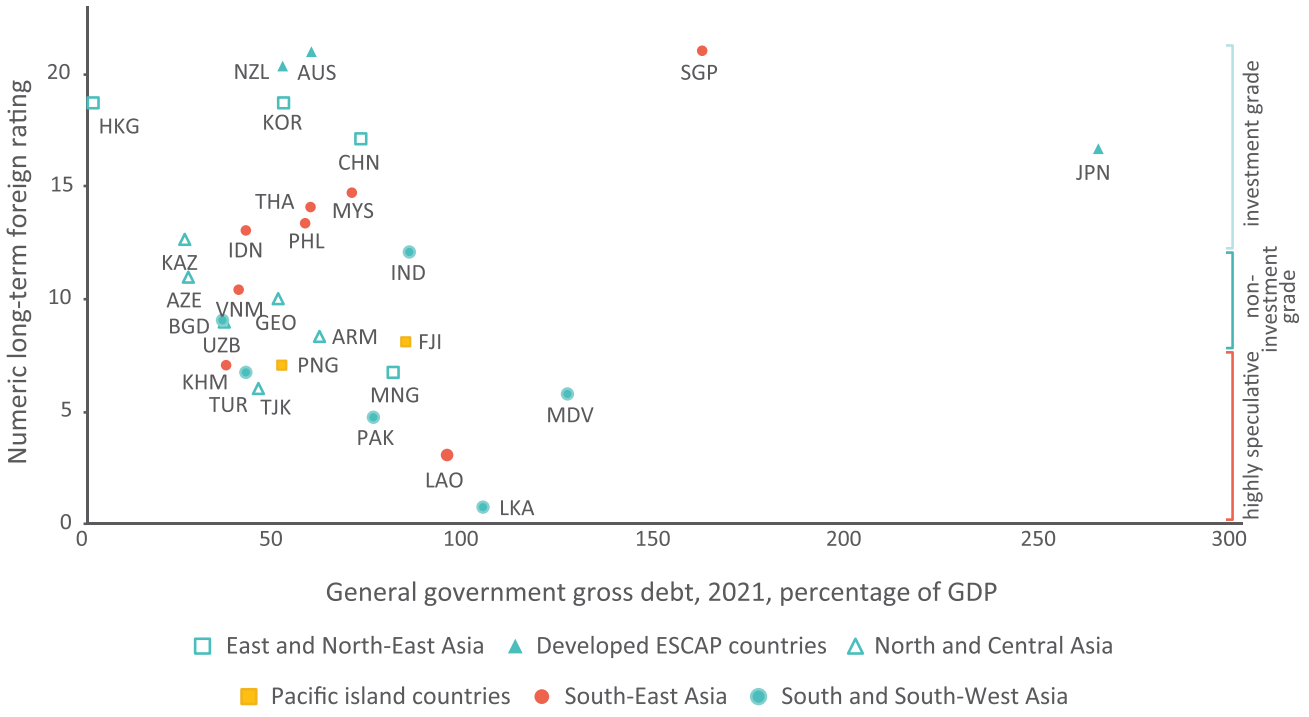
In Asia and the Pacific, six countries with stable and/or low levels of public debt are still rated as facing a high risk of debt distress (figure 3.22.a). These six countries are four Pacific island developing States, Kiribati, Marshall Islands, the Federated States of Micronesia, Tuvalu as well as Afghanistan and the Russian Federation. On the other hand, the general government debt of Japan and Singapore are extraordinarily high, exceeding 150 per cent for both countries, but their credit ratings are high (figure 3.22.b). The level of public debt is only one of the factors having an impact on public debt sustainability; there are other factors as well.

Figure 3.22
General government gross debt level versus risk of debt distress



Source: Data from joint IMF-World Bank Debt Sustainability Analysis. Available at www.worldbank.org/en/programs/debt-toolkit/dsa, updated on 15 February 2023; and IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: 1= low risk; 2 = moderate risk; and 3 = high risk.
Abbreviations: AFG = Afghanistan; BGD = Bangladesh; BTN = Bhutan; FJI = Fiji; FSM = Federated States of Micronesia; KGZ = Kyrgyzstan; KHM = Cambodia; KIR = Kiribati; LAO = Lao People's Democratic Republic; MDV = Maldives; MHL = Marshall Islands; MMR = Myanmar; NPL = Nepal; PNG = Papua New Guinea; SLB = Solomon Islands; TJK = Tajikistan; TLS = Timor-Leste; TON = Tonga; TUV = Tuvalu; UZB = Uzbekistan; VUT = Vanuatu; WSM = Samoa.

b. Countries with credit ratings available



Source: countryeconomy.com, updated on 15 February 2023, Moody's Investors Service, Fitch Ratings, Standard & Poor's Global Ratings; and IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: The numerical credit rating is the average of long-term foreign rating from Moody's Investors Service, Standard & Poor's Global Ratings, Fitch Ratings and are based on a scale of 0-21, with 0 corresponding to any form of default; 21 represents the highest rating, namely Aaa (Moody's) or AAA (Standard & Poor's and Fitch). "Ratings withdrawn" is not assigned any value.
Abbreviations: ARM = Armenia; AUS = Australia; AZE = Azerbaijan; BGD = Bangladesh; CHN = China; FJI = Fiji; GEO = Georgia; HKG = Hong Kong, China; IDN = Indonesia; IND = India; JPN = Japan; KAZ = Kazakhstan; KHM = Cambodia; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; LKA = Sri Lanka; MDV = Maldives; MNG = Mongolia; MYS = Malaysia; NZL = New Zealand; PAK = Pakistan; PHL = Philippines; PNG = Papua New Guinea; SGP = Singapore; THA = Thailand; TJK = Tajikistan; TUR = Türkiye; UZB = Uzbekistan; VNM = Viet Nam.

First, political stability is key. Since the war in Ukraine, the Russian Federation's credit was downgraded twice by Fitch Ratings and three times by Moody's Investors Service, and Standard & Poor's Global Ratings in 2022. It was downgraded from investment grade to only one notch above default by Moody's Investors Service and Fitch Ratings and two notches above default by Standard & Poor's Global Ratings. Since then, the European Union has banned credit rating agencies from rating Russian entities because of the war and consequently, Russian ratings were withdrawn by all three firms. Afghanistan has been in a state of conflict for decades, mired in political instability that has destroyed every aspect of its economy.

Second, debt-carrying capacity and fiscal position play an important role. Debt-carrying capacity is defined as the threshold for debt service beyond which a country cannot handle its debt burden (Hakura, 2020). Factors affecting or determining a country's debt-carrying capacity or threshold include its real GDP growth, fiscal position, remittances, international reserves and the World Bank's Country Policy and Institutional Assessment score[38] (World Bank, 2010). When measuring the risk of debt distress, DSA uses different thresholds based on the debt-carrying capacity of a country. Countries with weaker capacity are subject to lower thresholds, which is the case for four Pacific island developing States. Moreover, the (in)stability of fiscal revenues adds to the challenge of determining a country's debt-carrying capacity. The unique challenges faced by Pacific island developing States makes them extremely vulnerable to

38 The World Bank's Country Policy and Institutional Assessment assesses the conduciveness of a country's policy and institutional framework to poverty reduction, sustainable growth and effective use of development assistance.

climate change and natural disasters and volatile revenues from fishing and tourism. Their fishing license fees are volatile and can easily suffer from a possible reversal of favourable weather or global market conditions. Most are highly reliant on grants and concessional financing. Even for Pacific island developing States with low public debt, containing the risk of debt distress requires the continuation of grants to support their development and the implementation of fiscal and structural reforms which would promote fiscal sustainability and sustainable growth.

Third, drivers and purpose of increasing debt are critical. Despite an exceptionally high level of general government debt, Singapore's credit rating is at AAA. This is because Singapore's debt is not used to fund government expenditures, but rather for investments which generate returns that can cover debt servicing costs. Singapore's long-term budgetary objective is to maintain a balanced budget over a term of the Government. The Government of Singapore issues debt (mainly domestic) to deepen the domestic debt market, meet the investment needs of the Central Provident Fund and provide individual investors with long-term saving options that offer safe returns.

Fourth, the composition of debt matters. Japan's general government debt-to-GDP ratio has been above 200 per cent since 2010, but its credit rating is still considered investment grade. The high credit rating is largely contributed by its important domestic investor base and an advanced, well-developed capital market. Moreover, the Bank of Japan holds more than half of the LCY government bonds and is continuing to purchase more today even when the United States Federal Reserve and the European Central Bank moved to reduce their holdings. In contrast, the previously mentioned four Pacific island developing States with low debt but high risk rely almost exclusively on external debt.

Lastly, the conventional public debt sustainability analysis goes beyond debt and fiscal assessment. A credit rating is evaluated not only based on fiscal conditions and debt level but also many other factors, such as overall macroeconomic strength, structural features, and institutional and governance strength (table 3.3). Japan and Singapore are both advanced economies with strong economic fundamentals.

Table 3.3
Summary of key areas used to determine sovereign credit ratings

Moody's	S&P	Fitch
Economic Strength	Economic assessment	Structural Features
Institutions and Governance Strength	Institutional assessment	Macroeconomic Performance, Policies, and Prospects
Fiscal Strength	Fiscal assessment	Public Finances
Susceptibility to Event Risk	External assessment	External Finances
	Monetary assessment	

Source: Moody's Investors Service, Standard & Poor's Global Ratings and Fitch Ratings.

The other 13 Asia-Pacific countries that are rated at high risk of debt distress based on the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries or equivalent credit rating scores[39] have experienced mostly rising public debt in the last few years (table 3.4).They are: Fiji, Papua New Guinea, Samoa and Tonga (Pacific island developing States); the Lao People's Democratic Republic, Kyrgyzstan, Mongolia and Tajikistan (landlocked countries); Maldives, Pakistan, Sri Lanka and Türkiye (South and South-West Asian countries); and Cambodia (South-East Asian country).

39 B1/B+ and lower.

Primary deficit is the key factor in driving up public debt in these countries, while exchange rate depreciation has also played a noticeable role. All these countries except Tonga ran primary deficits in the past decade.[40] Primary deficits pushed up the public debt level by an average of 7 per cent every year in Maldives. Exchange rate depreciation was the dominant driver of public debt increase in Sri Lanka and Türkiye. The Turkish lira has depreciated about 90 per cent against the United States dollar since 2008 and the Sri Lankan rupee depreciated about 70 per cent against the United States dollar. Exchange rate depreciation also played a noticeable role in driving up the public debt of the Lao People's Democratic Republic, Mongolia and Pakistan.

Table 3.4
The list of countries faced a high risk of distress

		Group 1						Group 2											
		AFG	RUS	FSM	KIR	MHL	TUV	FJI	KGZ	KHM	LAO	LKA	MDV	MNG	PAK	PNG	TJK	TON	TUR	WSM
Source of risk measurement	World Bank-IMF LIC-DSF	X		X	X	X	X				X		X			X	X	X		X
	Credit rating agencies		X					X	X	X	X	X	X	X	X	X	X		X	
Trend of risk	World Bank-IMF LIC-DSF 2012-2021	↔		↔	↔	↔	↔				↑		↘			↗	↔	↘		↗
	Credit Rating 2008-2022		↗					↗	↔	↔	↔	↗	↔	↑	↔	↔	↔		↑	
General government gross debt	Change between 2008 - 2021	↓	↔	↓	↔	↓	↓	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑	↑	↔	↑
	Debt level in 2021																			
Debt composition	domestic ● versus external ●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
External debt service	Level of average debt service between 2022 and 2027																			

Source: Graphics by ESCAP staff.
Abbreviations: AFG = Afghanistan; FJI = Fiji; FSM = Federated States of Micronesia; KGZ = Kyrgyzstan; KHM = Cambodia; KIR = Kiribati; LAO = Lao People's Democratic Republic; LIC DSF = Low-Income Country Debt Sustainability Framework; LKA = Sri Lanka; MDV = Maldives; MHL = Marshall Islands; MNG = Mongolia; PAK = Pakistan; PNG = Papua New Guinea; RUS = Russian Federation; TJK = Tajikistan; TON = Tonga; TUR = Türkiye; TUV = Tuvalu; WSM = Samoa.

Of the 13 countries highlighted above, 7 are highly reliant on external debt. China became the top single creditor (bilateral or multilateral) in almost all 7 countries, but Chinese loans were mostly non-concessional thus adding debt-servicing costs to these countries. At the same time, the Lao People's Democratic Republic, Mongolia and Tajikistan issued their first international sovereign bond in the same period; 30 per cent and 15 per cent of external debt was owed to private creditors in Mongolia and Tajikistan respectively, at market rates that are usually higher than even non-concessional multilateral and bilateral loans. Increasing external debt stocks and higher cost of debt made their external debt service exceptionally high – well above the recent average. In particular, the external debt service obligations in the Lao People's Democratic Republic, Mongolia and Sri Lanka in 2022 are expected to be above 6 per cent of their respective GDP. In addition to high external debt, the share of domestic debt in the six other countries is sizable. The debt-servicing payments are high in these countries due to large domestic debt stocks and rising interest rates.

40 The primary surplus of Tonga starting in 2016 was due to consolidation with the help of donor support (notwithstanding the COVID-19 pandemic), as well as strong revenue collection from fishing, and effective controls on current spending.

6. Policy implications

A low debt level does not automatically prevent a country from facing high risk of debt distress while a higher debt level does not necessarily translate into higher debt risk. A thorough examination from multiple perspectives of the public debt profile of countries reveals that this depends on several factors, such as strength of the fiscal position and debt-servicing capacity, drivers and purpose of increasing debt, composition (domestic versus external) of debt, creditor profile, foreign currency exposure, borrowing costs and certain structural, governance and institutional aspects. For countries with low debt but high risk ratings (group 1 in table 3.4), it is essential to (a) ensure and maintain political stability; (b) address structural limitations and enhance broader fiscal stability, among other macroeconomic fundamentals; and (c) foster effective and efficient public governance, administration and services.

For countries rated at high risk and with increasing debt (group 2 in table 3.4), reducing primary deficits is unavoidable when stabilizing debt-to-GDP ratios. However, Governments must "spend smart" to ensure that public spending is people-centric and that reducing primary deficits does not come at a cost to people and the planet (see chapter 1, section 3.3). For countries with large shares of external debt, prudent macro policies are critical to avoid large-scale local currency depreciation. Diversification of foreign currency exposures should also be considered. Developing a domestic debt market is another key policy option (see also chapter 2, section 6). It is worth noting that a growing share of LCY government bonds reduces foreign currency exposure but not necessarily foreign investor exposure. Governments should strike a balance between a broader investor base, greater depth and liquidity for the domestic debt market benefiting from higher foreign holdings of LCY government bonds and increasing risk exposure to sudden capital outflows. In looking forward, a rising interest rate and moderate economic growth scenario will add to the challenges of developing countries as they strive to deal with debt vulnerabilities.

The rise of unconventional creditors opens a door to new sources of public financing but Governments should also be mindful of potential higher debt-servicing costs and cautiously manage the associated interest rate and roll-over risks, as these new creditors tend to lend in less concessional terms compared with traditional multilateral and bilateral creditors. Moreover, the evolution of the creditor landscape makes any debt negotiation more complex than ever as no effective coordination platform has been established to engage unconventional creditors, particularly private bond holders.

7. Concluding remarks

The number of countries the public debt of which is at high risk of distress has grown steadily at the global level, and the Asia-Pacific region is no exception. Prior to the COVID-19 pandemic, the average government debt-to-GDP ratio in developing countries of Asia and the Pacific was already at an 11-year high of 40.6 per cent in 2019 and jumped further to 49.5 per cent in 2021. While the level of public debt is not the only factor having impacts on public debt sustainability, as discussed in the next chapter, the urgent need for enormous Sustainable Development Goal investments is a source of concern in the context of an already high public debt burden. Currently, 19 countries are considered at high risk of debt distress by the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries or equivalent credit rating scores. For the policymakers in countries in the region, ensuring public debt sustainability while investing in people and tackling climate change simultaneously has emerged as one of the most pressing and significant policy challenges. In the short term, Asia-Pacific countries should take precautionary measures to manage sudden or chronic sovereign debt increases and, in some instances, prepare for potential debt restructuring (see chapter 5).

In this chapter, the answer to the question, "whose public debt is at a higher risk?" was provided based on the conventional debt assessments carried out by IMF, the World Bank and credit rating agencies. The current approach is focused heavily on maintaining debt at sustainable levels in the short term. However, this excessive short-term focus comes at the cost of achieving inclusive and sustainable development. Because the level of public debt is only one of the factors considered in the public debt assessment matrix, long-term environmental and social gains of sustainable investment funded by public debt can and should be considered as well. Such inclusions may become a game changer in assessing the debt sustainability of a country. To analyse public debt sustainability in the long term, chapter 4 proposes an "augmented" approach to supplement the short- to medium-term debt sustainability methodologies used by international financial institutions and credit rating agencies.

CHAPTER 4

CHAPTER 4

Rethinking public debt sustainability analysis for achieving the Sustainable Development Goals

1. Introduction

Assessments on the risk of public debt distress, typically carried out by international financial institutions (IFIs) and credit rating agencies (CRAs), have served various purposes for different stakeholders. For debtor countries, the analysis helps guide the urgency, size and pace of fiscal adjustments that may be needed to maintain public debt sustainability (see chapter 5). For official creditors and IFIs, such assessment informs which debtor countries would benefit from liquidity support and debt relief in order to avoid debt default. For private creditors and financial markets in general, the results of public debt sustainability analysis supplement other criteria used to make investment decisions, including those on government securities. Amid rising government debt levels in Asia and the Pacific (see chapter 3), more attention is being paid to the results of public debt sustainability analysis.

While public debt sustainability analysis has generally contributed to fiscal stability in developing countries, it is time for policymakers and the international development community to rethink how this analysis should be undertaken in the face of an urgent need to pursue implementation of the 2030 Agenda for Sustainable Development and the rapidly changing global economic context. In Asia and the Pacific, limited progress towards achieving the Sustainable Development Goals (ESCAP, 2022b) and concomitant large investment needs (ESCAP, 2019) mean that Governments of countries in the region need to mobilize more fiscal resources to realize the 2030 Agenda. Yet, the average government debt level in Asia-Pacific economies was already at a 14-year high in 2019; moreover, both the COVID-19 pandemic and the war in Ukraine have further weakened fiscal positions in the region (see chapter 1). As the current approach of public debt sustainability analysis is heavily focused on maintaining sustainable debt in the short term, it undermines Governments' ability to access financial resources and is inconsistent with the long-term journey towards inclusive and sustainable development.

Given the lack of a long-term, holistic approach to assess public debt sustainability, this chapter proposes an "augmented" approach, which duly incorporates a country's Sustainable Development Goal investment needs, Governments' structural development policies that go beyond financial investments and national Goal financing strategies. As the aim of this augmented approach is to analyse public debt sustainability in the long term, it supplements the short- to medium-term approaches currently adopted by IFIs and CRAs.[1] This is important because, without a complementary long-term analysis, there is a risk that too much emphasis will be put on reducing near-term debt distress risk at the cost of achieving inclusive and sustainable development.

Based on a quantitative analysis for Mongolia as a pilot country, this chapter contains three evidence-based policy implications.

- First, all stakeholders (official and private creditors, CRAs and financial markets in general) should consider public debt sustainability from both short- and long-term perspectives. After taking into account Sustainable Development Goal spending needs, development policies and financing strategies, the Government's debt-to-GDP ratio in Mongolia in 2040 is estimated to converge to the baseline level that assumes fiscal consolidation, but the difference is that people and the environment would be much better off under the scenarios examined in this chapter.

- Second, Governments should aim to strike a balance between achieving the Sustainable Development Goals and maintaining public debt sustainability. The analysis for Mongolia shows that, while strict fiscal rules that cap the size of the fiscal deficit help control government debt, they require a steep increase in corporate and personal income tax rates, which pushes up poverty significantly.

- Third, IFIs and CRAs can play an important role in supporting debtor countries to navigate such a balancing act. The analysis in this chapter shows that, when the sovereign risk premium becomes less sensitive to an increase in government debt, this not only relieves the government debt burden but also reduces poverty amid a lower interest rate environment and higher employment. The weaker sensitivity between risk premium and debt level can be achieved when public debt sustainability is determined by the potential socioeconomic and environmental benefits public investment would produce, and not just a Government's ability to repay debt in the near term.

1 This chapter does not argue that all public debt sustainability analyses should be long term in nature. On the contrary, when an assessment does not timely detect rising risk of public debt distress, efforts to avoid default may come too late, thus causing unnecessary economic costs to both creditors and debtor countries.

This chapter is organized as follows. Section 2 outlines the conceptual framework of the augmented public debt sustainability analysis. Section 3 demonstrates how this approach can be applied in the case of Mongolia as a pilot country by reviewing the country's major development challenges and policy priorities, highlighting key policy scenarios and discussing the main results of the simulation. Section 4 notes broader policy implications as informed by the quantitative analysis, while section 5 provides concluding remarks.

2. Rethinking public debt sustainability analysis for the Sustainable Development Goals: an augmented approach

This section proposes an augmented debt sustainability analysis approach that seeks to address some of the shortcomings of the current methods used in public debt sustainability analysis (box 4.1). The overall aim is to provide a more holistic and long-term picture of future government debt trajectories as countries embark on their journey towards more inclusive, resilient and sustainable development.

Box 4.1
Review of IMF and World Bank approaches to debt sustainability analysis

IMF and the World Bank have carried out assessments on public and external debt sustainability analysis through two frameworks: one is for low-income countries, which is jointly conducted by both institutions; the other is for market-access economies (typically those that have issued international government bonds) conducted by IMF. These frameworks have undergone periodic internal reviews in the past several years. The latest frameworks for low-income countries and market-access economies were introduced in 2018 and 2022, respectively.

The 2018 framework for low-income countries incorporates several adjustments recommended by an internal review (IMF, 2017a; 2018b). Among others, these include: (a) country classification into three groups (weak/medium/strong debt-carrying capacity) that is based not only on the World Bank's Country Policy and Institutional Assessment but also on domestic economic growth, foreign exchange reserve and personal remittances; (b) assessment of potential risks that go beyond domestic debt vulnerabilities; (c) inclusion of more country-specific variables within the debt distress model; (d) introduction of tailored stress tests; and (e) allowing greater application of staff judgement.

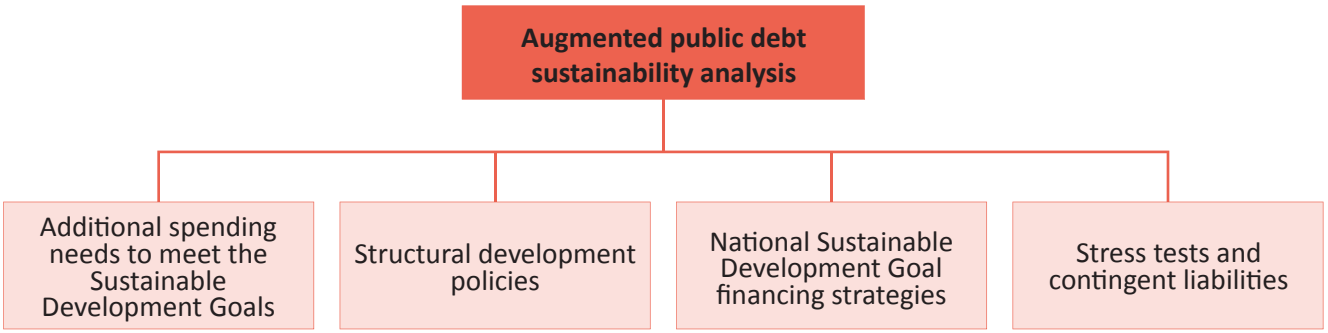
Similarly, the 2022 debt sustainability framework for market-access economies reflects proposals made by IMF (2021b; 2022e). Some of the key changes include: (a) introducing risk assessments that are based on different time horizons; (b) considering a broader set of country-specific characteristics that help gauge a Government's ability to meet its debt obligations; and (c) more explicit application of staff judgement in assessing fiscal risks at each time horizon as well as the overall risk. With regard to time horizon-based assessments, the analysis would indicate a specific risk level (low/moderate/high) for near-term (1-2 years ahead), medium-term (up to 5 years) and long-term (more than 5 years) horizons. The "optional" long-term modules are aimed at analysing the impacts of such issues as population ageing, natural resource depletion and climate change on fiscal risks.

Despite these adjustments, analysts have suggested several areas where such an analysis can be improved further.[a] For example, Pinto (2018) noted that the assessments for low-income countries should pay closer attention to the drivers of changes in debt level as well as the composition and quality of government spending. This would help differentiate countries where a high government debt level is driven by misuse of fiscal resources from those with that have invested, through government borrowing, in productive development projects. Other studies highlight the importance of incorporating Sustainable Development Goal spending needs and climate issues into debt sustainability analysis. For example, the World Bank (2022b) emphasized the need to accurately corporate Goal costs as part of the assumption on fiscal expenditure. Volz and others (2020) argued that the analysis should account for both physical and transition climate risks because these risks could push up fiscal risks significantly. Relatedly, it is important to consider large investment needs to support climate resilience and the transition to a green economy.

[a] See also Akyüz (2007); Wyplosz (2007); Guzman and Heymann (2015); and Cassimon, Essers and Verbeke (2016).

Augmented public debt sustainability analysis comprises four main components. These include Sustainable Development Goal spending needs, structural development policies, Goal financing strategies and stress tests (figure 4.1). These components reflect the issues typically considered by most developing countries as they assess their fiscal and debt positions in pursuit of the 2030 Agenda for Sustainable Development. As countries seek to pursue the Sustainable Development Goals by stepping up public investments and attracting private financial resources in various areas of development, they also formulate national Goal financing strategies and implement structural development policies aimed at boosting economic competitiveness and fostering equitable and green development. Over the years, developing countries are likely to face adverse economic and non-economic shocks, which could increase their fiscal risks notably.

Figure 4.1
Four key components of augmented debt sustainability analysis



Source: ESCAP.

- The first component is additional public and private spending (current and capital expenditures) required to achieve a country's Sustainable Development Goals by 2030. The augmented approach also considers associated long-term economic, social and environmental gains from increased investment in the Goals (such as higher levels of potential output, labour productivity and energy efficiency), which influence future public debt trajectory.

- The second component is a Government's structural development policies that go beyond investing in the Sustainable Development Goals, as typically envisioned in long-term national development planning documents. While this set of policies tends to vary notably across Asia -Pacific developing countries, examples include regulatory and institutional reforms to enhance productive capacity, broaden the economic base and promote innovation.

- The third component is national Sustainable Development Goal financing strategies, which comprise mainly a Government's resource mobilization strategies and initiative to attract more private capital for development. In this context, the Government's resource mobilization strategies include: (a) tax revenue policies, such as improving tax administration and introducing new taxes that promote social and environmental outcomes; (b) non-tax revenue policies, such as leveraging government assets and benefiting from more grants and concessional loans; (c) government spending policies, such as removing carbon subsidies and reallocating non-developmental spending; and (d) public debt management policies, such as exploring debt relief measures and adopting good practices on public debt management.

- Finally, the fourth component is stress tests and realization of fiscal contingent liabilities. Stress tests may reflect sudden changes in economic conditions that result in higher interest rates, weaker exchange rates and higher/lower global commodity prices than those assumed under the baseline assumptions. Fiscal contingent liabilities reflect country-specific risks, such as government bailouts for major commercial banks, loss-making State-owned enterprises, or large-scale investment projects under a public-private partnership modality. Such liabilities may also include support to meet financial obligations of subnational governments and fiscal cost arising from damage and losses in the event of natural disasters.

Based on these components, the augmented debt sustainability analysis also integrates climate risks and action through at least three channels. The first channel is public and private investments in climate adaptation and mitigation, as informed by estimated Sustainable Development Goal spending needs. The second channel is fiscal cost to provide financial assistance to affected households and businesses and rebuild public infrastructure in the aftermath of catastrophes. Finally, the third channel is realization of fiscal contingent liabilities, such as stranded asset values in traditional mining and power generation industries as countries pursue net-zero emission goals, which may require government financial support for commercial banks and State-owned enterprises. Financial bailouts for private banks and insurance companies may also be needed in the event of natural disasters if bank loan defaults and climate insurance payments surge to the extent that domestic financial stability could be compromised.

The quantitative analysis in this chapter is based on the ESCAP Macroeconomic Model (ESCAP, 2021a). This is a global model comprising 46 individual Asia-Pacific country models and other blocs that represent other major global economies. In the short run, GDP in country models is driven by aggregate demand. In the long term, each country's potential output level is driven by its labour force, capital stock, energy use, energy efficiency, trend productivity growth related to labour productivity and damage incurred as a result of climate shocks. In addition to economic relationships, the model also captures interactions with key social and environmental variables, such as poverty and carbon emissions. The individual country models are linked together via trade, remittances, financial markets and global energy markets. (Online annex I provides more information on the model structure.)

The next section demonstrates how to implement the augmented debt sustainability analysis approach in the case of Mongolia. Mongolia was selected as a pilot country for this analysis for various reasons. From an operational perspective, Mongolia is one of only a few Asia-Pacific countries where both detailed estimates on Sustainable Development Goal spending needs and information on national Goal financing strategies are available.[2] From a policy perspective, as Mongolia is currently rated as having a high risk of public debt distress in the short term, it is worthwhile to examine whether its government debt path would trend downward in the long term once the potential socioeconomic and environmental gains from Sustainable Development Goal spending and a wide range of Goal financing options are properly considered. Such a case-study-based augmented approach to debt sustainability analysis provides useful policy insights even for countries at low risk of public debt distress because their risk level could be much higher when large Sustainable Development Goal spending needs are taken into account. In this regard, in coming years ESCAP aims to translate this policy research work into technical assistance projects for selected Asia-Pacific countries. (Online annex III provides some operational considerations for implementing this framework in other Asia-Pacific economies.)

3. Applying the augmented debt sustainability analysis approach in the case of Mongolia

This section first reviews the country's major development challenges and identifies selected policy priorities (section 3.1). It then highlights a key set of assumptions on policy scenarios, financing strategies and stress tests made in this analysis (section 3.2 and online annex II) and discusses the results on public debt sustainability as well as socioeconomic and environmental outcomes in the long run (section 3.3).

2 According to the Integrated National Financing Frameworks dashboard (https://inff.org/dashboard), country-level estimates on Sustainable Development Goal spending needs are also available for Cambodia, Kazakhstan, Samoa, Uzbekistan and Viet Nam.

3.1. Country context: selected development challenges and policy options

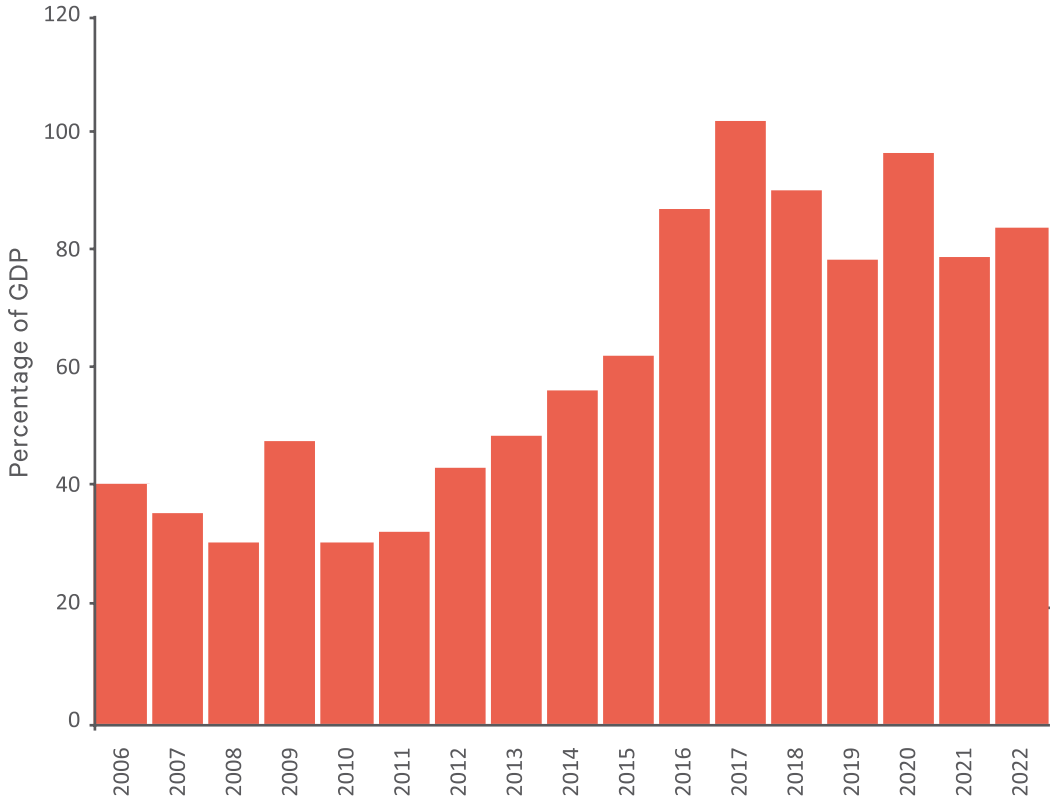
This subsection notes that the Mongolian economy continues to rely on mineral activities, faces a high risk of public debt distress amid a relatively high poverty rate and exhibits limited or reversing progress in environmentally related Sustainable Development Goals. It also highlights policy options aimed at diversifying the economy and reducing fiscal risks and maintaining public debt sustainability.

3.1.1. Development challenges from the economic, social and environmental perspectives

The Mongolian economy has increasingly relied on mineral activities. The share of the mineral sector in GDP has risen from 13 per cent in 1990 to 24 per cent in 2019 (World Bank, 2020d). In 2019, the mineral sector accounted for 89 and 73 per cent of total exports and FDI, respectively. As China accounts for 90 per cent of Mongolia's mineral exports, the Mongolian economy is also closely tied to economic conditions in China. In going forward, the reliance on mineral activities could increase further with the completion of a copper and gold mine that, when it is at full operating scale, is expected to account for up to 30 per cent of the country's GDP (World Bank, 2020c).

According to IMF, Mongolia's risk of public debt distress is high. The COVID-19 pandemic pushed up Mongolia's general government debt level from 79.2 per cent of GDP in 2019 to 97.4 per cent in 2020 (figure 4.2). Over the long term, the government debt level has trended upward from about 41 per cent of GDP in 2006 to an estimated 84 per cent in 2022. Given the underdeveloped state of domestic capital markets, about 96 per cent of total government debt is external debt, mostly with official creditors and on concessional terms. In going forward, IMF had deemed that the public debt distress risk remains elevated (see box 4.2).

Figure 4.2
Gross general government debt in Mongolia, 2006-2022



Source: ESCAP, based on IMF, World Economic Outlook database (October 2022). Available at www.imf.org/en/Publications/WEO/weo-database/2022/October.
Note: The percentage for 2022 is an estimate.

Box 4.2
IMF public debt sustainability analysis for Mongolia

According to the latest public debt sustainability analysis for Mongolia (IMF, 2021c), public indebtedness is expected to decline in the medium term. Such a declining trend is based on several assumptions, including improved fiscal conditions, high economic growth and low effective interest rates given Mongolia's large share of concessional debt. Meanwhile, assumed improvement in fiscal conditions is based on the expiration of pandemic-related policy support measures, forgoing planned savings in the Future Heritage Fund to finance social protection programmes, increased government revenues from higher commodity prices and a one-off tax transfer from a copper mine.

Despite the downward trend of the public debt level, Mongolia's risk of public debt distress is still perceived as high amid its narrow economic base, history of procyclical macroeconomic policies and dominance of foreign exchange-denominated debt. In the light of these aspects, IMF noted that strong fiscal consolidation is urgently needed[a] (IMF, 2022f). Among other aspects, IMF recommended a number of fiscal consolidation measures: (a) more targeted social assistance programmes, including the Child Money Programme and utility subsidies; (b) reductions of the State subsidy to the social insurance fund; (c) more progressive personal income taxation; (d) substantial cuts in public investment, including reprioritization of investment projects by State-owned enterprises; and (e) elimination of import duty exemptions for non-food items.

[a] For example, IMF noted that the scale of the Government's planned fiscal consolidation in 2023 (at 0.50 per cent of GDP) is far from adequate.

Poverty rates and socioeconomic inequality remain high. While the incidence of poverty declined notably from 38.8 per cent in 2010 to 21.6 per cent in 2014, the pace of poverty reduction slowed after the economic recession in 2016. Between 2016 and 2020, poverty declined only marginally from 29.6 per cent to 27.8 per cent as the growth in consumption of poorer households lagged that of the total population (World Bank, 2020a). Access to the Internet, improved water and sanitation and reliable heating sources remain challenges for many households, especially among *ger* dwellers.

Better targeting of social protection schemes would support inclusive societies. Overall, Mongolia's taxes and transfers are progressive and help reduce poverty and inequality (Freije and Yang, 2018). Yet, the Child Money Programme, Mongolia's largest social protection scheme, has little impact on income equality. In 2020, about 1 in 5 households in the bottom 40 per cent income group did not receive Child Money Programme benefits while nearly half of households in the top 60 per cent income group did (World Bank, 2020a).

The Government has launched various climate policies amid the country's limited progress on environment-related Sustainable Development Goals. Affordable and clean energy (Goal 7), sustainable cities and communities (Goal 11) and responsible consumption and production (Goal 12) remain major challenges with stagnating progress (Sachs and others, 2022). More worryingly, Goal 13 on climate action exhibits a regressing trend. As part of Mongolia's climate ambitions, the Government announced its nationally determined contribut ion target in 2021 of reducing the country's greenhouse gas emissions by 27.2 per cent by 2030. The overall policy effort is focused on developing renewable energy sources and promoting afforestation.

Climate change poses large economic and social costs. Between 1990 and 2018, the value added per livestock unit is estimated to decline by about 30 per cent as Mongolia has warmed much faster than the rest of the world (IMF, 2019). From a social perspective, there is evidence that a rise in air pollution reduced school attendance of kindergarten children in Mongolia (Altansukh and others, 2021). Past climate shocks, particularly harsh winters or dzuds, have also diminished the livelihoods of many herders and forced them to migrate to Ulaanbaatar.

3.1.2. Policy priority: diversifying the economy

To widen the economic base, four areas of policy actions should be pursued. First, enhancing the business regulatory environment. According to the World Bank (2020b), of 190 economies worldwide Mongolia ranked 81 on ease of doing business. Areas that ranked less favourably are the following: starting a business, getting electricity, trading across borders and resolving insolvency. Moreover, political instability, tax rates and access to finance are often cited as the most binding obstacles to doing business (World Bank, 2022d).

Second, reducing trade and transport costs. Geographically, the country's vast territorial area and low population density lead to low economic return on infrastructure projects. This is compounded by a relatively small government budget for infrastructure development and governance issues in selecting and implementing infrastructure projects (World Bank, 2020c). In this regard, the selection of a project should be based on its potential contribution to the development of such industries as livestock, tourism and renewable energy. There is also a need to mobilize private investment for infrastructure. In addition to better transport infrastructure, Mongolia can reduce trade costs by participating in regional trade agreements, which has been shown to help boost exports (Batdelger and others, 2018).

Third, foster financial sector development. The financial sector is dominated by commercial banks, with domestic credit extended to the private sector standing at a modest 49.6 per cent of GDP in 2019. While most banks meet capital adequacy requirements under an adverse shock scenario, there are capital-deficient banks and the financial bailout, if needed, would amount to at least 1.3 per cent of GDP (IMF, 2021c). Meanwhile, the development of domestic capital markets is constrained by a long and costly issuance process, absence of centralized information on market volume and yield curve, and lack of institutional investors and CRAs (Batdelger, Manlaibaatar and Dulguun, 2019). Finally, while Mongolia is making some progress on promoting sustainable finance with its national Sustainable Finance Roadmap, which was launched in 2022, the size of green loans remains small.

Fourth, increasing the trade competitiveness of non-mineral sectors, especially the livestock industry. The livestock subsector dominates Mongolia's agricultural sector, which altogether employs about 30 per cent of the labour force. The number of livestock units has jumped from 33.1 million in 2010 to 71.8 million in 2019, while the carrying capacity of Mongolia's land is about 30 million (World Bank, 2022c). Such rapid growth has damaged the environment through degradation of pastureland amid overgrazing and rising methane emissions. The livestock sector continues to face various challenges, such as inadequate feed and poor animal health during weather shocks, outdated meat-processing facilities and limited extension and veterinary services (Miller, 2021; World Bank, 2019; 2022c). To further develop the livestock industry, the Government could seek to enhance food safety standards, ensure a more organized marketing system, streamline the certification process and encourage greater private investments in market infrastructure.

3.1.3. Policy priority: reducing fiscal risks and maintaining public debt sustainability

Mongolia has introduced several fiscal rules to manage high fiscal volatility, although these have not yet been fully implemented. Fiscal volatility in Mongolia, driven by swings in public investment that are closely linked with commodity prices, has exceeded that of other resource-based economies in past decades (IMF, 2019). To reduce such volatility, the Fiscal Stability Law, adopted in 2010, introduced various fiscal rules. Among others, these fiscal rules cap the fiscal deficit at 2 per cent of GDP and the net present value of public debt at 60 per cent of GDP. While these rules were planned to go into effect in 2013, they have been postponed to 2024 or 2025, partly due to unexpected adverse economic shocks (World Bank, 2021a). During the period 2015-2017, amendments to the fiscal deficit and debt limits were also introduced, including raising the original debt target of 40 per cent of GDP.

Mongolia has also established sovereign wealth funds to address fiscal volatility. Established in 2011, the Fiscal Stabilization Fund retains part of the mining revenue in order to reduce fiscal and budget volatility due to unpredictable commodity prices; it also serves as a fiscal buffer during revenue shortfalls. In addition, the Future Heritage Fund was set up in 2017 to ensure fair distribution of mineral wealth across generations. In general, these extrabudgetary funds would benefit from transparent public disclosure and an independent supervisory council tasked with assessing government budget assumptions (IMF, 2019; World Bank, 2021a).

In going forward, maintaining Mongolia's public debt sustainability would benefit from a wide range of policy reforms.[3] First, boosting government revenue. Efforts have been made to enhance tax revenue, such as the introduction of excise taxes in 2017 in the aftermath of the 2016 economic crisis (UNDP, 2018) and the ongoing effort to expand the tax base by addressing the informal economy (IMF, 2021c). Domestic revenue mobilization strategies may be focused on increasing non-mineral government revenue, such as by making the personal income tax rate more progressive and increasing low statutory tax rates. The quality of tax administration could also be enhanced through adopting e-invoicing and taking a risk management approach.

Second, redesigning the pension insurance scheme. Various studies have suggested that the present generous scheme is fiscally unsustainable given its current contribution rates and retirement benefits, and unfavourable demographic trends. The World Bank (2022e) estimated that the current scheme requires government subsidies of 2.8 per cent of GDP and this could rise to 6.8 per cent of GDP in 2030 and 11.3 per cent of GDP in 2050 if no adjustments are made in the design of the scheme. To make the scheme more financially sustainable, the Government could adopt automatic indexation of pension benefits to inflation, gradually increase the contribution rate and raise the retirement age to 65.

Third, improving public financial and investment management.[4] Mongolia generally performs well in such areas as public access to fiscal information and financial data integrity. Yet, various challenges remain, including incentives for line ministries to identify ambitious new projects, ineffective project appraisal techniques and inadequate funding for maintenance costs. To address these challenges, Mongolia should seek to institute a central public investment management unit, improve medium-term budgeting and revenue forecasting, carry out more analysis

3 For further information, see IMF (2021c ; 2022f) and World Bank (2021a).

4 For details, see World Bank (2018); IMF (2019); and PEFA (2021).

on budget execution performance and fiscal risks, including contingent liabilities, and ensure prudent procurement rules by having an independent procurement agency.

Fourth, improving the management of State-owned enterprises to reduce contingent liabilities. The Development Bank of Mongolia (DBM) is the major quasi-fiscal entity that does not fall under fiscal rules. Founded in 2011, most of its loans are large scale and allocated to industrial sectors, such as mining, energy and transport. The main source of funding is foreign borrowing, often at a relatively high cost. In recent years, DBM has faced a net loss due to loan defaults, which are as high as 58 per cent of total loans, while contingent liabilities for its financial support is estimated at about 5 per cent of GDP (World Bank, 2022e). Among other factors, stronger corporate governance and improvements in risk management would help enhance the financial performance of DBM (IMF, 2019).

Fifth, exploring debt relief modalities. The Government is considering debt restructuring to reduce debt repayment costs (UNDP, 2021). Among more innovative modalities, debt-for-climate swaps have been put forward as an option for Mongolia. For official bilateral creditors, UNDP (2022c) identified Germany as a potential creditor given its track record and national legislation supporting debt swaps. For trilateral debt swap modalities, funds such as the Nature Conservancy and the Green Climate Fund have been identified as possible third parties.

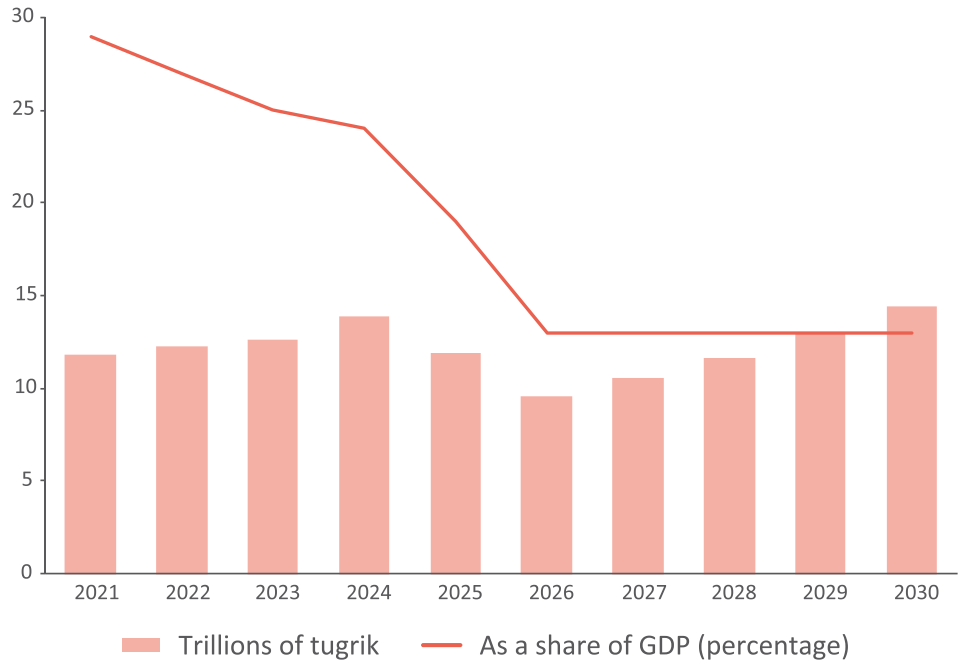
3.2. Policy scenarios and key assumptions

This subsection provides details on policy scenarios and stress tests examined in this chapter. After discussing the size and composition of Sustainable Development Goal spending needs, it notes that structural development policies are focused on securing a green and inclusive economy in Mongolia while national Goal financing strategies are aimed at enhancing fiscal resources and mobilizing private finance for development. Finally, the stress tests cover domestic and global economic and non-economic shocks.

3.2.1. Additional Sustainable Development Goal spending needs

Achieving the Sustainable Development Goals by 2030 would require sizeable additional spending in Mongolia. Based on UNDP (2022a), additional Goal spending needs in Mongolia are estimated at about 17 per cent of GDP per year on average during the period 2021-2030. Spending in the initial years could be as extensive as 27 per cent of GDP in 2021 before trending down to 24 per cent of GDP by 2024 and stabilizing at approximately 13 per cent of GDP from 2026 onward (figure 4.3).

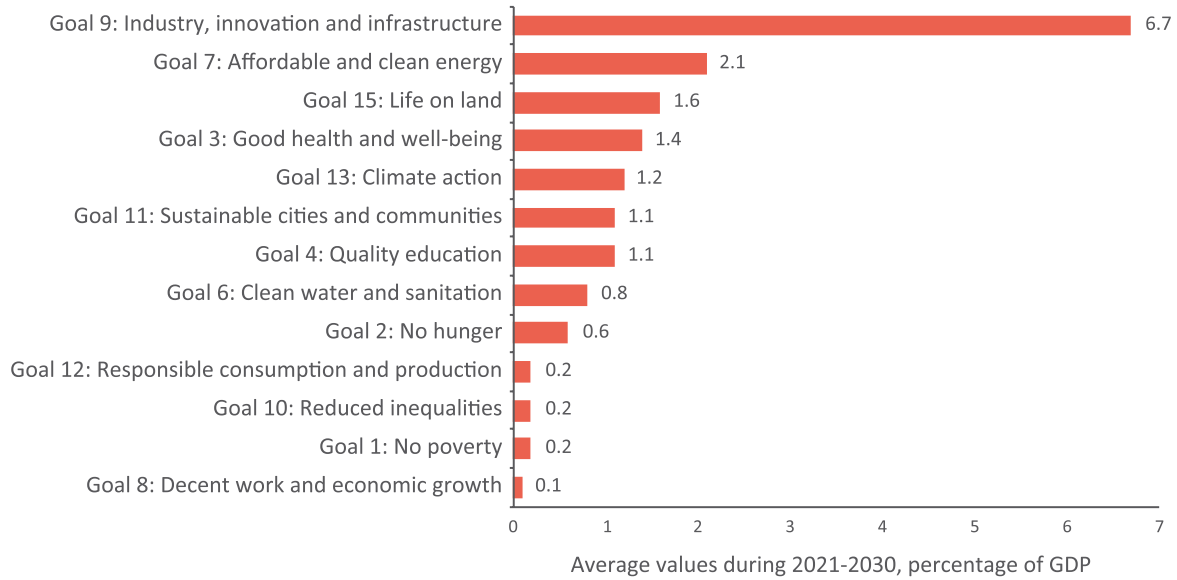
Figure 4.3
Mongolia's additional Sustainable Development Goal spending needs per year



Source: UNDP (2022a).

A large part of the total Sustainable Development Goal cost in Mongolia is for expanding transportation networks and protecting the environment. About 39 per cent of the total Sustainable Development Goal cost is for Goal 9 (figure 4.4), which in this context includes such items as construction costs on road and railway networks and increased national spending on R&D activities (to 3 per cent of GDP). Taken together, environment-oriented Sustainable Development Goals (Goals 7, 11, 12, 13 and 15) account for another 36 per cent of the total cost. Among other actions, these include climate mitigation measures to improve energy efficiency and increase renewable energy sources; spending to provide wastewater treatment, sewage networks and waste recycling; and climate adaptation measures to increase the productivity of the animal husbandry sector and build resilience to natural disasters.

Figure 4.4
Mongolia's additional Sustainable Development Goal spending needs, by Goal



Source: UNDP (2022a).

3.2.2. Structural development policies

In this context, the overall development ambition is to transform Mongolia into a greener and more diversified economy (figure 4.5). A set of long-term structural development policies here is largely informed by the discussion on major development challenges and policy options in section 3.1.

Figure 4.5
Scenarios on structural development policies for Mongolia

Green economy		Diversified economy	
Pricing carbon emissions	**Improving livestock management**	**Enhancing business environment**	**Participating in free trade agreements**
• Removing energy-related subsidies • Introducing a carbon tax • Spending of carbon subsidy saving and carbon tax revenue	• Pasture restoration subsidies • Intensive farming techniques	• Competitive and predictable business climate • Adopting cross-border trade and transport facilitation measures • Formalizing the informal economy	• Realizing potential free trade agreements

Source: ESCAP.

With regard to green economy, the policy scenarios are aimed at pricing carbon emissions and improving livestock management. In addition to removing energy-related subsidies, the analysis assumes that Mongolia introduces a carbon tax as part of its approved laws to align tax revenue measures with climate action. Fiscal savings from subsidy cancellation and additional carbon tax revenue are spent on social protection schemes to mitigate the impact of higher domestic energy prices on consumption by poorer households, as well as on environmental projects to enhance energy efficiency and preserve biodiversity loss. To make livestock management more sustainable, the analysis assumes that the Government provides subsidies to herders to encourage rotational use of summer pastures and a reduction in livestock units per hectare and furnish seeds and fertilizers to improve soil fertility.

In respect of economic diversification, the policy scenarios are focused on improving the business environment and further benefiting from free trade agreements. Policy measures include: (a) creating a more competitive and predictable business environment, which results in lower business risks and operating costs; (b) adopting cross-border trade and transport facilitation measures, such as through single-window services and streamlined border inspections; and (c) formalization of business activities in the informal economy. Moreover, economic diversification can also benefit from reduced trade taxes under proposed free trade agreements with China, the Republic of Korea and the Eurasian Economic Union.[5] Table A.II.1 in online annex II provides more details on the key assumptions of all scenarios on structural development policies.

3.2.3. National Sustainable Development Goal financing strategies

In this context, Mongolia's Sustainable Development Goal financing strategies seek to enhance fiscal space and mobilize private capital for development (figure 4.6). This is in line with UNDP (2018), which recommended a diversified financing strategy that, among other aspects, manages volatile commodity revenues, explores environmental taxes and boosts private investment in non-mineral industries. A well-designed Sustainable Development Goal financing strategy is especially important for Mongolia considering that the country's total financial flows (at about the same size as GDP) are small relative to its additional Goal investment needs.

Figure 4.6
Selected scenarios on Sustainable Development Goal financing strategies: Mongolia

Public finance		Private finance
Boosting fiscal resources	**Reducing public debt burden**	**Mobilizing private finance for development**
• Improving tax administration • Rationalizing subsidies to pension insurance system • Increasing public spending efficiency	• Ensuring prudent public financial and debt management • Engaging with debt-for-climate swaps	• Improving policy framework of public-private partnership modality • Aligning bank loans with green development swaps

Source: ESCAP.

To enhance the fiscal space, the policy scenarios are focused on boosting fiscal resources and reducing public debt burden. Policy measures include improving the quality of tax administration to reduce tax avoidance, rationalizing generous State subsidies to the pension insurance system and increasing public spending efficiency, especially in the social and infrastructure areas. Together with addressing the informal economy, enhancing tax administration is already part of the government plan to increase non-mineral tax revenue (IMF, 2021c). To relieve public debt burden, the analysis assumes better public financial and debt management, which reflects the plan under the Debt Management Strategy (2023-2025). Finally, the assumption includes engaging with debt-for-climate swaps with selected official bilateral creditors (UNDP, 2022c).

5 For further information, see https://aric.adb.org/fta-country

Policy scenarios on attracting private finance for development are aimed at promoting the public-private partnership modality and green loans. Mongolia's legal and regulatory framework for PPP remains underdeveloped, especially on the roles and risk-sharing mechanisms for relevant parties. The analysis assumes a more enabling framework, which benefits from a new PPP law that is under preparation as well as other policy initiatives that could be implemented, such as developing a pipeline of viable projects (UNDP, 2021). The analysis also assumes that a small portion of bank loans, which are currently short-term and concentrated in the consumer and trade sectors, are allocated to green projects. Table A.II.2 in online annex II provides more details on the key assumptions of all scenarios on Sustainable Development Goal financing strategies.

3.2.4. Stress tests and contingent liabilities

The stress test reflects Mongolia's exposure to various economic shocks and contingent liability risks (figure 4.7). With sizeable coal exports, Mongolia will be hampered by a global shift towards greener development, including the pace of the green transition in China. Beyond standard economic shocks, such as higher interest rates and currency depreciation, the stress tests here also examine the fiscal impacts of lower import demand from China. On contingent liability relating to natural disasters, the Government will likely play a leading role in supporting the economy as the penetration rate of private property insurance remains very low. Meanwhile, fiscal support may also be needed to ensure the capital adequacy of commercial banks affected by climate transition risk. The analysis also covers financial support for the State-owned Development Bank of Mongolia, which accounted for about a quarter of public investment in 2020. Table A.II.3 in online annex II provides more details on key assumptions on stress tests.

Figure 4.7
Stress tests and contingent liabilities: Mongolia

Commodity market	Macroeconomic shocks	Contingent liabilities
• Diminished global demand for and lower prices of coal	• Slower output growth in China • Higher global interest rates • Weaker exchange rate	• Natural disaster shocks • Financial support for commercial banks amid climate transition risk • Financial support for a State-owned development bank

Source: ESCAP.

3.3. Results of the augmented debt sustainability analysis

This subsection discusses the simulation results under various scenarios. The first scenario assumes Sustainable Development Goal spending only, the second scenario combines Goal spending and structural development policies, while the final or combined scenario considers together Goal spending, structural development policies and Goal financing strategies. The stress tests are applied to the results of the combined scenario.

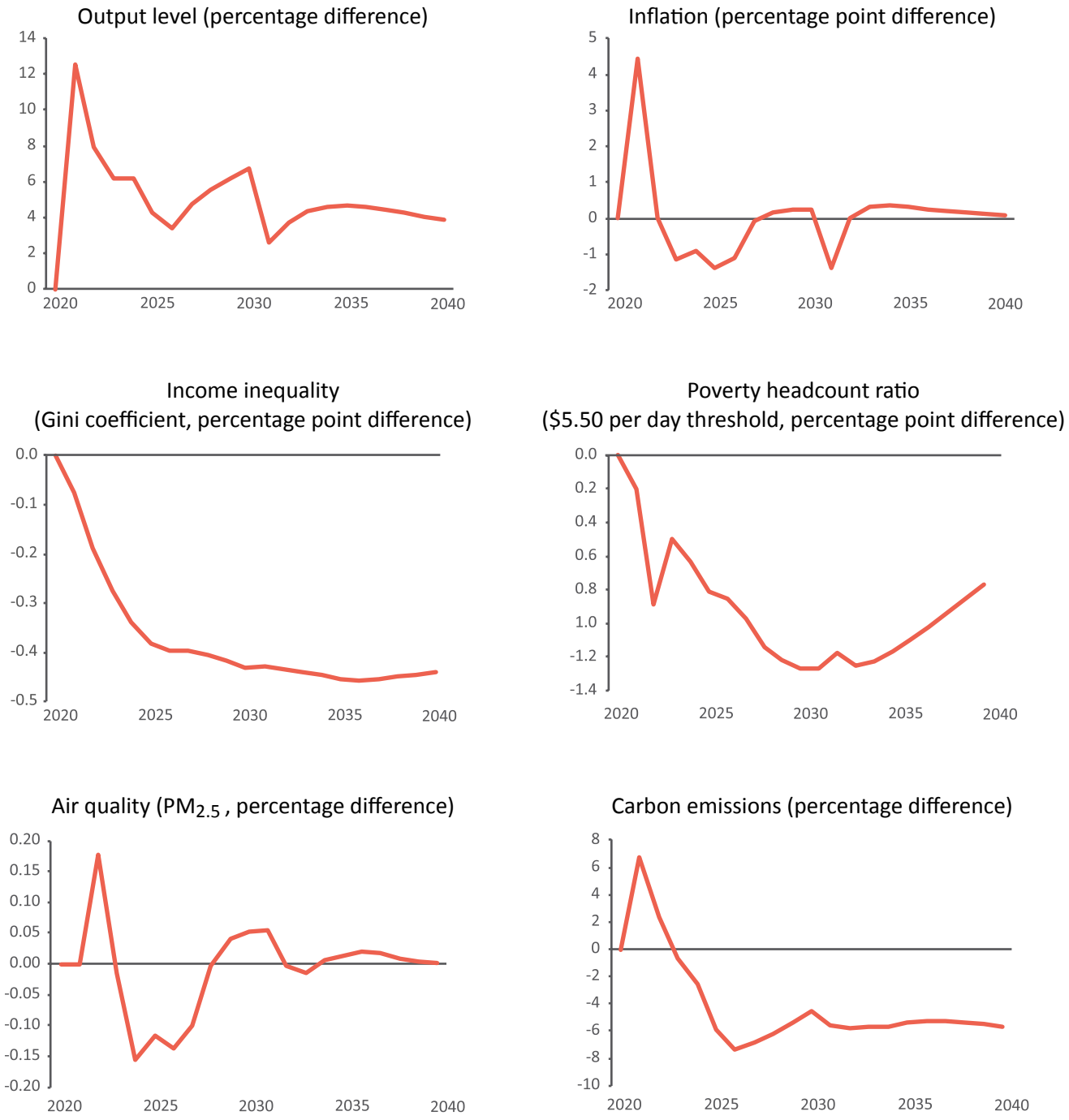
3.3.1. Sustainable Development Goal spending scenario

Investing in the Sustainable Development Goals would offer sizeable socioeconomic and environmental benefits in Mongolia. Relative to the baseline scenario, the annual output level is expected to be between 4 and 13 per cent higher under the Sustainable Development Goal spending scenario during the period 2021-2040 (figure 4.8). This is underpinned by public consumption and public and private investments to achieve the Goals as well as the positive spillovers that these investments have on household consumption. On the social front, both the incidence of poverty and income inequality decrease as employment and real personal disposable incomes rise amid higher social spending and labour productivity.

On the environmental front, carbon emissions initially increase given the expected surge in economic activities, but the emission level in the long run is almost 6 per cent below the baseline because of improved energy efficiency and reduced biodiversity loss. Reduced carbon emissions also benefit the economy through a lower depreciation rate of capital, such as reduced loss of production facilities due to natural disasters. Driven by reduced carbon emissions, air quality improves slightly[6] and raises labour productivity.

6 In the model, air quality is measured according to the level of fine particulate matter (PM2.5) in the atmosphere and mainly determined by the share of coal and oil consumption in primary energy consumption. Under this scenario, air quality improves only marginally because there is no assumption that directly changes the relative prices of coal and oil.

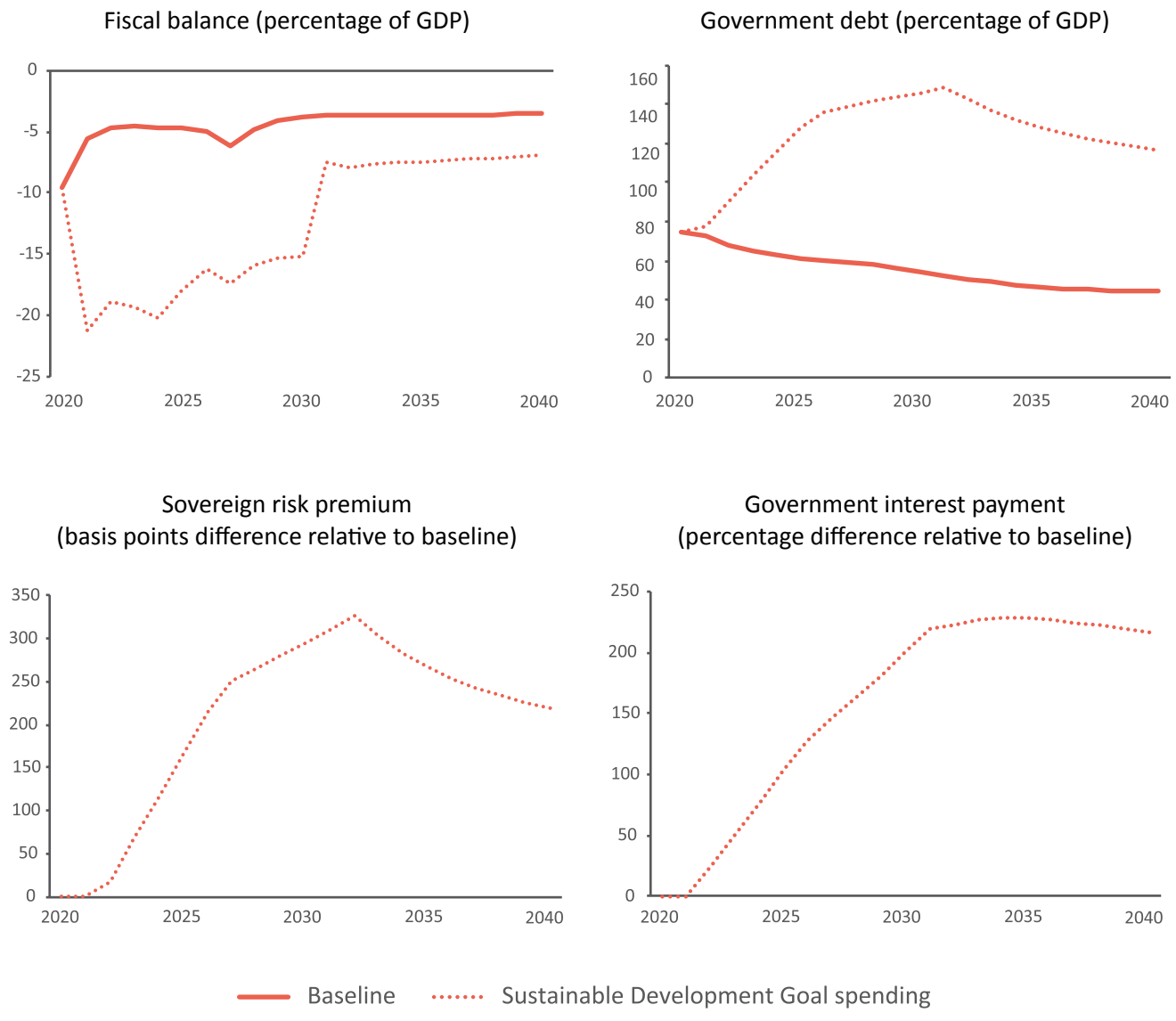
Figure 4.8
Impacts of Sustainable Development Goal spending on selected economic, social and environmental variables



Source: ESCAP.
Note: All results are shown relative to their corresponding values under the baseline scenario.

Not surprisingly, investing in the Sustainable Development Goals would result in a much higher government debt level in Mongolia. Given large additional Goal spending needs, the government debt-to-GDP ratio is estimated to rise sharply to about 146 per cent by 2030 (relative to 54 per cent in the baseline scenario) before trending downward to about 116 per cent by 2040 (figure 4.9). This would likely be deemed as an unsustainable debt path according to conventional public debt sustainability analysis. In addition to larger public spending, a higher government debt level is also driven by rising government borrowing costs because the sovereign risk premium is assumed to rise as the debt level increases (box 4.3). This leads to much larger government interest payments. Greater indebtedness also occurs because corporate and personal income tax rates are assumed to remain largely unchanged (box 4.4).

Figure 4.9
Impacts of Sustainable Development Goal spending on selected fiscal variables



Source: ESCAP.

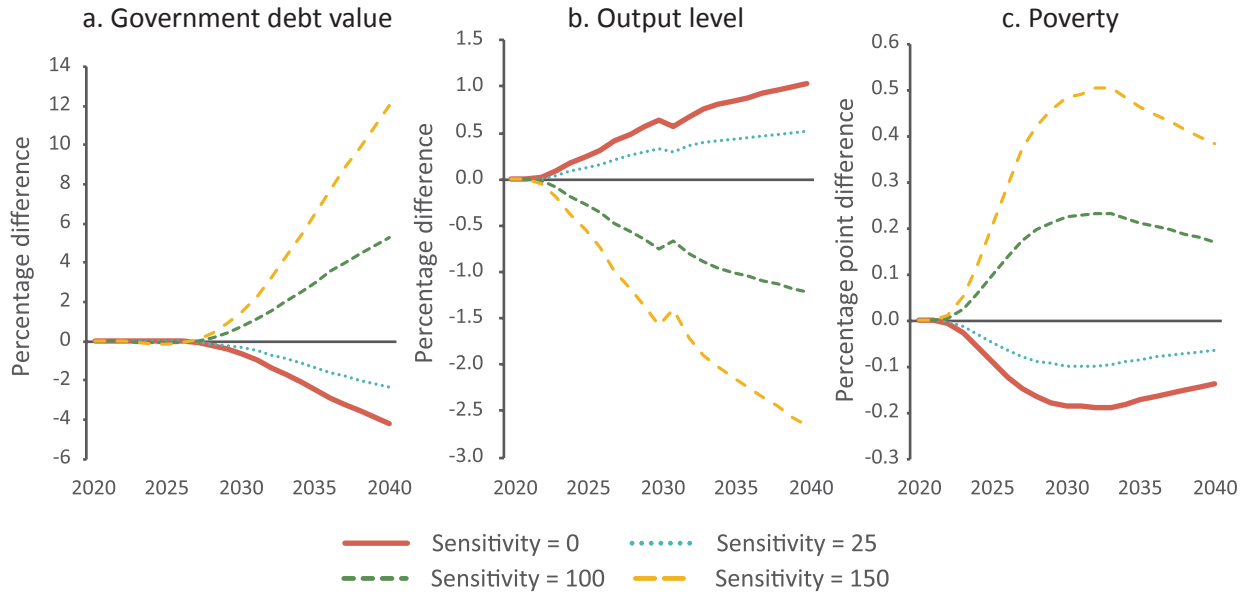
Box 4.3
Impact of varying sensitivity between sovereign risk premium and government debt level

As in the real world, the ESCAP Macroeconomic Model assumes that the sovereign risk premium on borrowing rises with the level of government debt. Yet, how closely these two variables are linked depends on several factors, such as the level and composition of government debt, the perceived quality of public investments and how the financial markets assess the strength of the Government's effort to maintain public debt sustainability. Thus, the sensitivity of the risk premium to government debt level is specific to each country and time period.

The analysis in this box assumes different levels of sensitivity between the sovereign risk premium and government debt level. Such sensitivity could be stronger when the global economy faces unexpected shocks that hamper market confidence and trigger capital flows to safe havens. In contrast, the risk premium could become less sensitive to an increase in the government debt level if financial markets also assess debt sustainability based on the quality of public investment plans and their potential returns, and not just the Government's ability to repay debt in the near term. In such a case, a lower "penalty" should be placed on additional government borrowing when it has been demonstrated that investing in the Sustainable Development Goals leads to sizeable socioeconomic and environmental gains, which would help relieve the government debt burden in the future.

Weaker sensitivity between risk premium and government debt would help reduce the government debt burden and poverty. For Mongolia, the default in the model assumes that the risk premium rises by 50 basis points for every 1 percentage point increase in the government debt ratio. Under the scenarios where the sensitivity is set at the lower values of 0 and 25 basis points, government debt values are estimated to be 4.2 and 2.4 per cent lower by 2040 than that under the Sustainable Development Goal spending scenario, respectively (see panel a in the figure).[a] In contrast, when the sensitivity is much stronger at 150 basis points, the government debt value would be up to 12 per cent higher in the long run. Amid a lower risk premium and thus a lower interest rate environment, stronger business investment would further push up the output level (panel b) and reduce poverty (panel c).

Figure
The impacts of varying risk premium sensitivity



Source: ESCAP.
Note: The differences are relative to their respective values under the Sustainable Development Goal spending scenario.

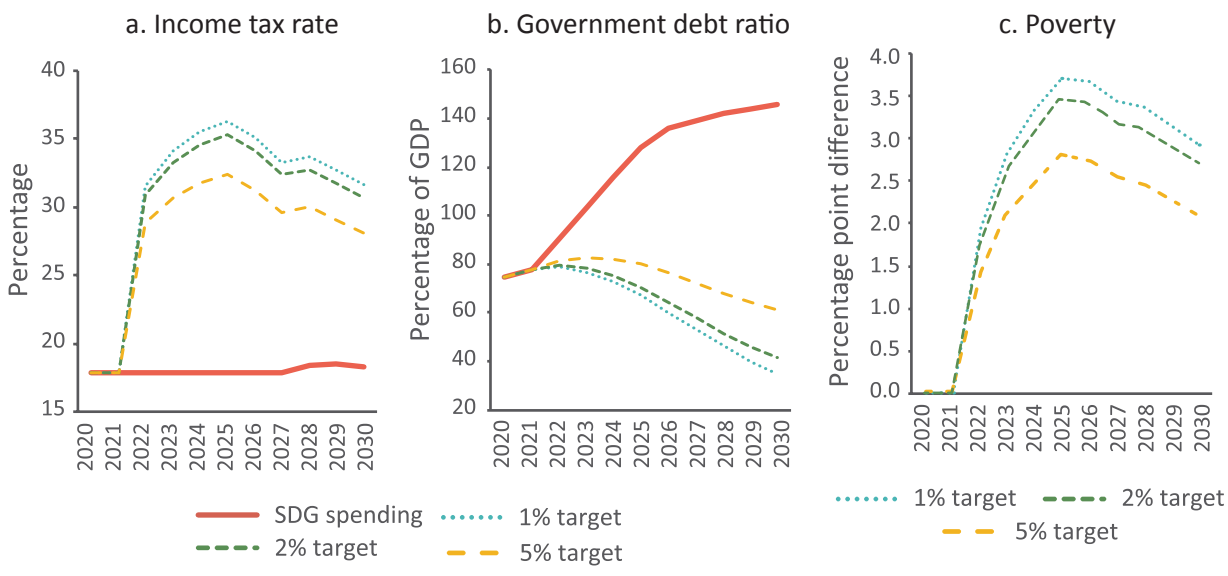
a As the chart illustrates, it would take some years for the government debt value to decline. This is due to a generally slow transmission from a higher sovereign risk premium to higher interest payments by Governments in view of the long-term nature of government borrowing.

Box 4.4
Impact of fiscal rule adjustments on government debt

The ESCAP Macroeconomic Model has an optional, built-in feature that automatically adjusts corporate and personal income tax rates to bring the fiscal deficit-to-GDP ratio to a targeted or pre-determined level that is consistent with a stable government debt trajectory. So far, the analysis on the Sustainable Development Goal spending scenario does not assume that fiscal rules are in place. This partly reflects the current situation in Mongolia (see section 3.1) and allows the model to freely estimate the future trajectory of government debt. Based on this model feature, this box highlights the likely impacts of fiscal deficit rules on government debt and poverty ratios. The analysis assumes fiscal rules that cap fiscal deficit-to-GDP ratios at 1, 2 and 5 per cent, noting that the 2 per cent rule is in line with the Government's plan.

When fiscal rules are enforced, government indebtedness declines significantly but at the cost of higher poverty. To achieve the fiscal deficit target of 1 per cent of GDP, the effective corporate and personal income tax rate needs to increase from about 18 per cent under the Sustainable Development Goal spending scenario (no fiscal rules) to 36 per cent (see panel a in the figure below). As expected, this surge in the income tax rate helps bring down the government debt ratio (panel b), but business investment, employment and household consumption all plunge. Under this scenario, the poverty ratio can be up to 3.7 percentage points higher than that under the Sustainable Development Goal spending scenario. This is indeed much larger than the magnitude of poverty reduction that is brought about by Goal spending.

Figure
Impacts of varying fiscal deficit rules



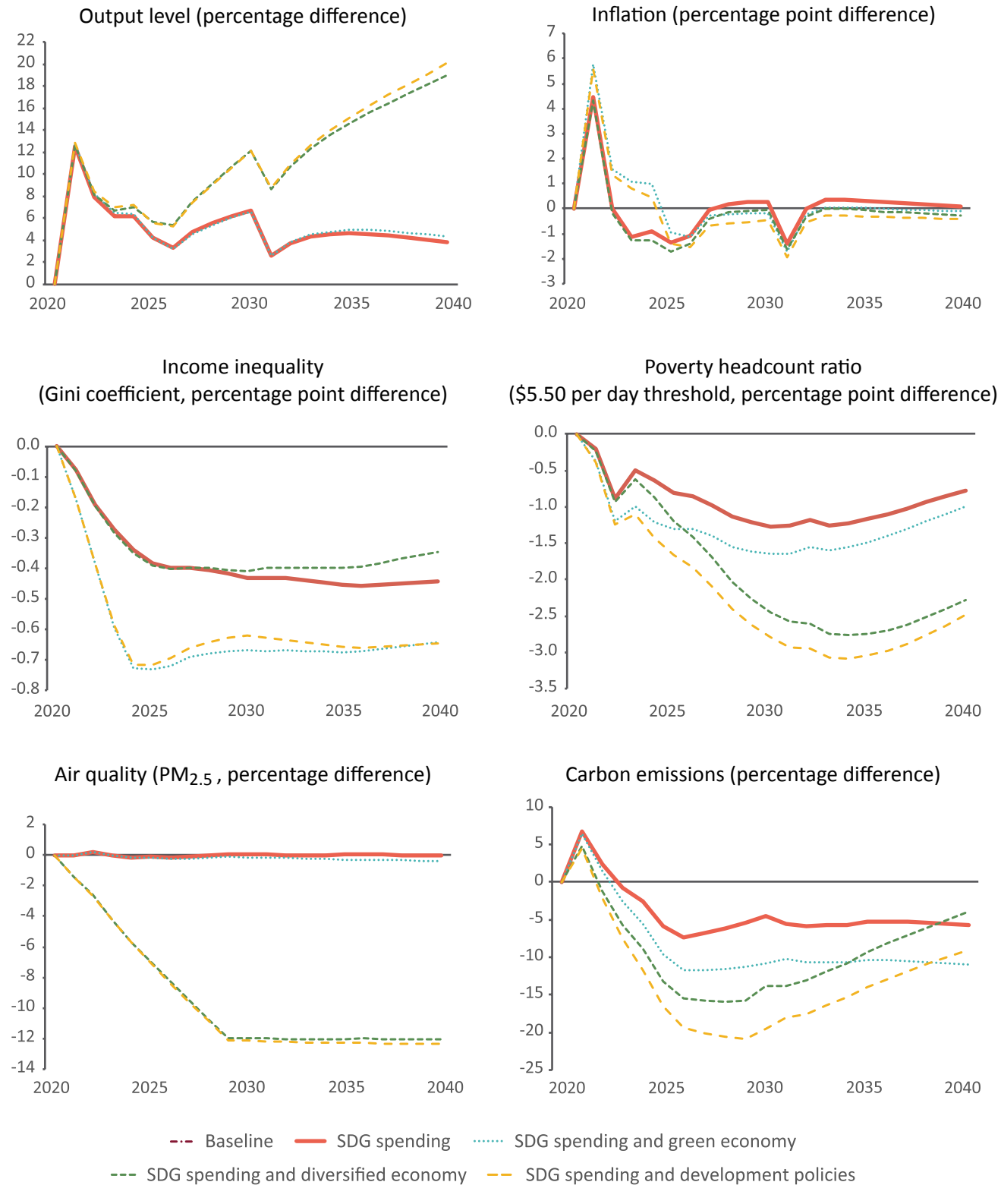
Source: ESCAP.
Note: Income tax rates and government debt ratios are presented in level terms. The poverty impacts are depicted as the differences relative to the Sustainable Development Goal (SDG) spending scenario.

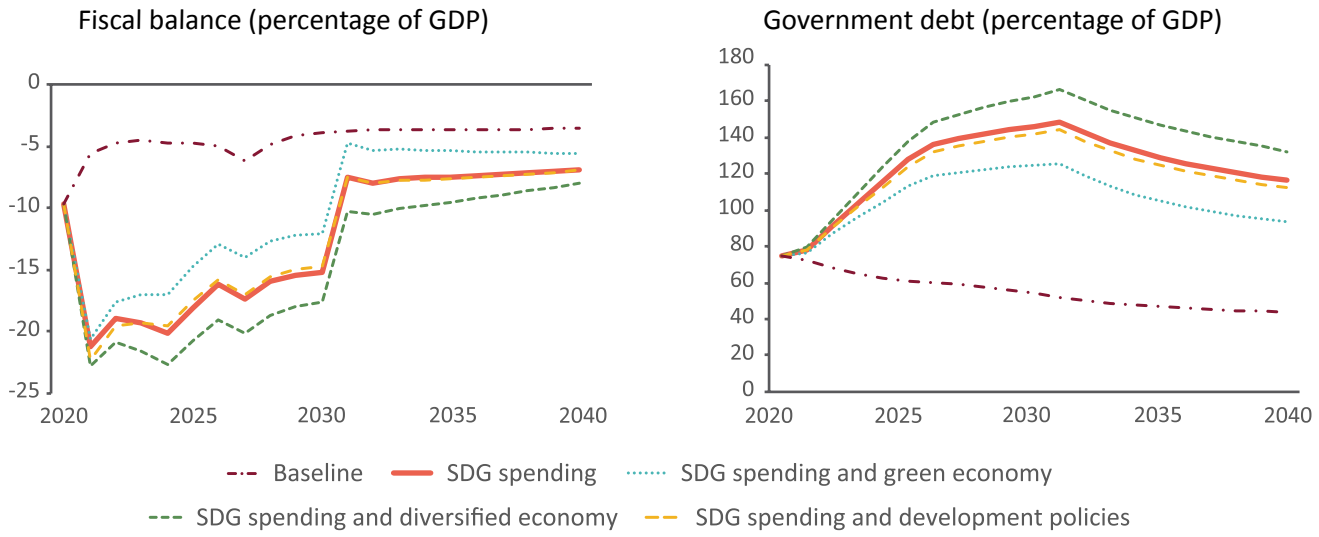
3.3.2. Sustainable Development Goal spending and structural development policies

Implementing green policies in addition to Sustainable Development Goal spending would result in larger social, environmental and fiscal gains. Under the green economy scenario, the estimated output gain is slightly smaller than that under the Sustainable Development Goal spending scenario alone as higher domestic energy prices dampen household consumption and business investment (figure 4.10). Yet, poverty falls more notably, which suggests that the positive impacts of pasture subsidies, higher livestock productivity and additional government spending on social protection (funded by carbon tax revenue) on household consumption are larger than the negative impacts of higher

energy prices. As expected, a reduction in carbon emissions here is larger than that under the Sustainable Development Goal spending scenario amid higher costs of fossil fuel and a higher share of renewable energy in the energy mix. Finally, greener development also contributes to a lower government debt ratio. As this policy scenario assumes that all additional fiscal resources from carbon subsidy cancellation and carbon tax revenue are used to fund additional government spending on social and environmental protection, the improved fiscal condition is not due to higher government income, but rather reduced government health-care spending owing to better air quality and health conditions of people.

Figure 4.10
Impacts of Sustainable Development Goal spending and structural development policies





Source: ESCAP.
Note: Except for the fiscal balance and government debt ratios, all other results are shown relative to their corresponding values under the baseline scenario; SDG = Sustainable Development Goal.

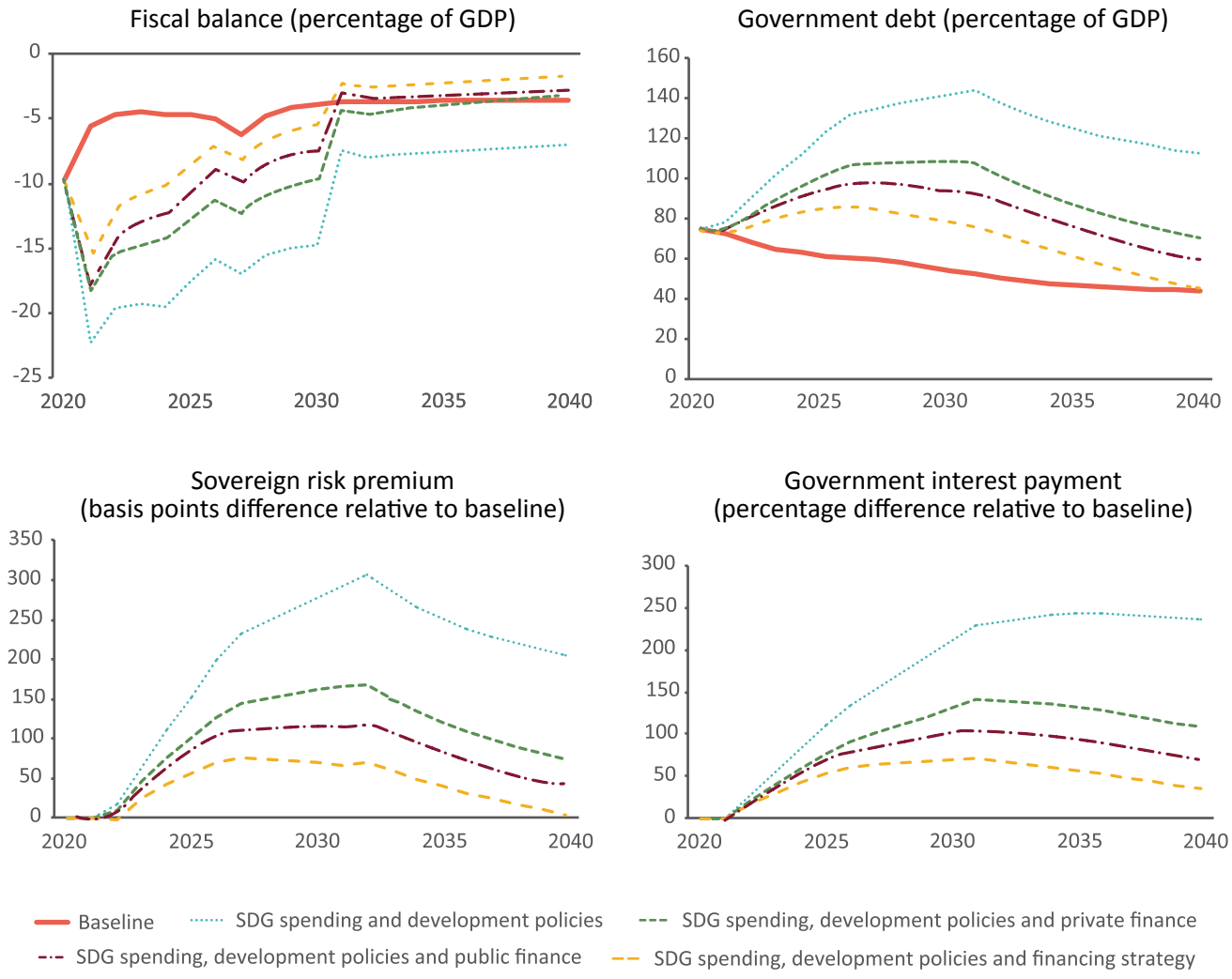
A more diversified economy boosts the level of output, although its distributional and fiscal impacts are less favourable relative to the green economy scenario. A notable increase in the level of output under the diversified economy scenario is driven mainly by higher private investment amid a more friendly business climate and lower cost of capital, as well as higher merchandise exports due to lower trade taxes and better transport facilities (figure 4.10). With higher levels of employment and household incomes, poverty also decreases notably. Yet, the expected decrease in income inequality under this scenario is less than that under the green economy scenario where policy measures directly target the livestock industry, which employs lower-income workers. Meanwhile, a more diversified economy is also good for the environment as the lower trade and transport costs assumed here help improve energy efficiency. For example, extensive and high-quality road networks and faster customs procedures reduce the use of fuel for land transportation. Finally, despite larger output gains under this scenario, the government debt ratio rises further relative to the Sustainable Development Goal spending scenario due to a decrease in trade tax revenue as Mongolia participates in more multilateral free trade agreements.

Pursuing the package of structural development policies on top of Sustainable Development Goal spending offers further socioeconomic and environmental benefits, although the government debt level remains high. Under the structural development policies scenario which combines the green and diversified economy scenarios, the level of output is expected to be about 20 per cent higher than the baseline by 2040 (figure 4.10). Although higher energy prices would push up inflation in the initial years, the poverty ratio (based on the $5.50 per day threshold) is still expected to fall from almost 29 per cent in 2020 to about 8 per cent by 2030. Lower incidence of poverty and targeted policy supports for the livestock industry also reduce income inequality. By 2030, carbon emissions would be about 20 per cent lower than that of the baseline, although the gain shrinks to about 9 per cent by 2040 due to lower spending on infrastructure and associated gains in energy efficiency. From a fiscal perspective, policy measures under this combined scenario help reduce government health-care spending, although international trade tax revenue would decrease. Taken together, the government debt ratio is estimated at about 142 and 112 per cent by 2030 and 2040, respectively, which is only about 4 percentage points lower than the figures under the Sustainable Development Goal spending scenario alone. This suggests that, while pursuing structural development policies helps to somewhat relieve public indebtedness, a well-designed Sustainable Development Goal financing strategy is also needed to reduce government debt in Mongolia. This is explored below.

3.3.3. The combined scenario: Sustainable Development Goal spending, structural development policies and Goal financing strategy

Policy measures to support fiscal resources reduce government debt level notably in the long run. Under the public finance scenario, the fiscal deficit-to-GDP ratio is expected to be about 8 per cent by 2030 compared with about 15 per cent in the scenario that combines Sustainable Development Goal spending with structural development policies (figure 4.11). When investment in the Sustainable Development Goals moderates afterwards, the fiscal deficit ratio decreases further to less than 3 per cent by 2040. As a result, government debt exhibits a decreasing trend after some initial increase and is estimated to reach 60 per cent of GDP by 2040. Such improved fiscal conditions benefit from a wide range of factors, including: (a) higher tax revenue amid the introduction of carbon tax and reduced tax avoidance; (b) fiscal savings from cancellation of carbon subsidy, redesigned pension insurance system and better public spending efficiency in the social and infrastructure sectors; and (c) lower financing costs due to greater debt transparency and lower fiscal risks.

Figure 4.11
Impacts of Sustainable Development Goal spending, structural development policies and Goal financing strategy



Source: ESCAP.
Note: SDG = Sustainable Development Goal.

Reorienting private finance towards development projects further relieves fiscal pressure. Under the private finance scenario, the business sector steps up its contribution to Mongolia's Sustainable Development Goal spending needs in the social, infrastructure and environmental sectors. In this case, the fiscal deficit ratio over the period 2021-2040 would be, on average, about 4 percentage points below the scenario that contains Sustainable Development Goal spending and structural development policies (figure 4.11). This is due not only to lower government spending but also larger output gains as it is assumed that private investment has stronger positive impacts on economy-wide productivity and energy efficiency gains than public investment.

In the long run, a mix of public and private financing policies helps bring government debt to the same level as the baseline scenario, but here people and the environment are much better off. Under this combined scenario (Sustainable Development Goal spending, development policies and financing strategies), the government debt ratio is expected to fall to about 46 per cent by 2040 (figure 4.11). This is much lower than the estimated 112 per cent under the scenario that contains Sustainable Development Goal spending and development policies but not financing strategies. Indeed, the government debt ratio under this combined scenario is comparable to that under the baseline scenario, which is primarily based on IMF estimates and the assumption that Mongolia follows IMF policy advice, including pursuing fiscal consolidation in the short term. While government debt under these two scenarios eventually converges to the same level after 20 years, the debt paths are different. Under the baseline scenario, the government debt level is projected to fall steadily over the period 2022-2040 amid fiscal consolidation while that under the combined scenario rises in the first several years due to investment in the Sustainable Development Goals but subsequently trending downward as socioeconomic and environmental benefits gain momentum. Relative to the baseline scenario, the annual output level under this combined scenario can be up to 24 per cent higher in a given year, while carbon emissions and air pollution would be about 18 and 12 per cent lower, respectively. The poverty ratio is also almost 3 percentage points lower, which is sizeable considering that the poverty ratio by 2030 is estimated to be about 11 per cent.

3.3.4. Stress tests of the combined scenario

Given Mongolia's reliance on mineral activities, its economy and public debt sustainability would be dampened by the world's transition towards clean energy. Under the scenario where global coal demand and prices are assumed to fall by 30 and 10 per cent respectively by 2030, the government debt ratio would reach 89 per cent in 2030 relative to 78 per cent under the combined scenario (figure 4.12). The analysis also suggests that, without Mongolia's policy initiative to promote clean energy locally, lower global coal prices would increase domestic demand for coal relative to other energy items, thus resulting in higher carbon emissions and air pollution.

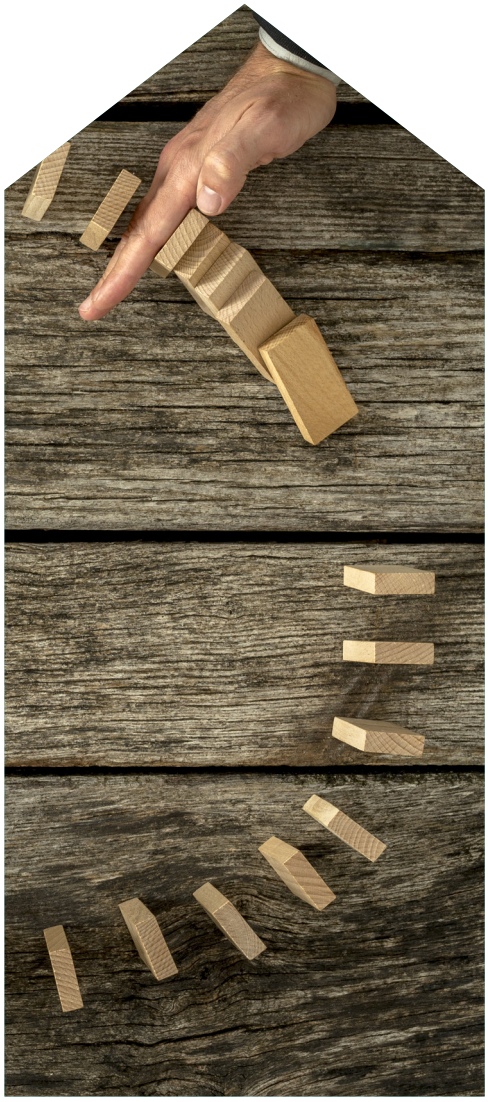
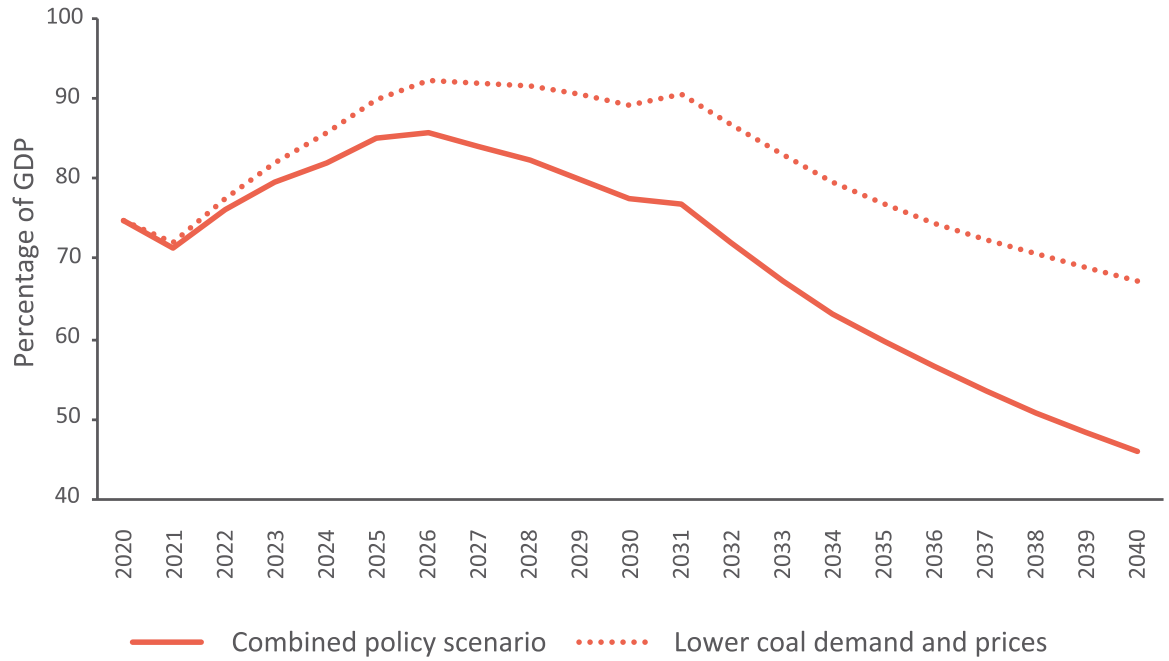


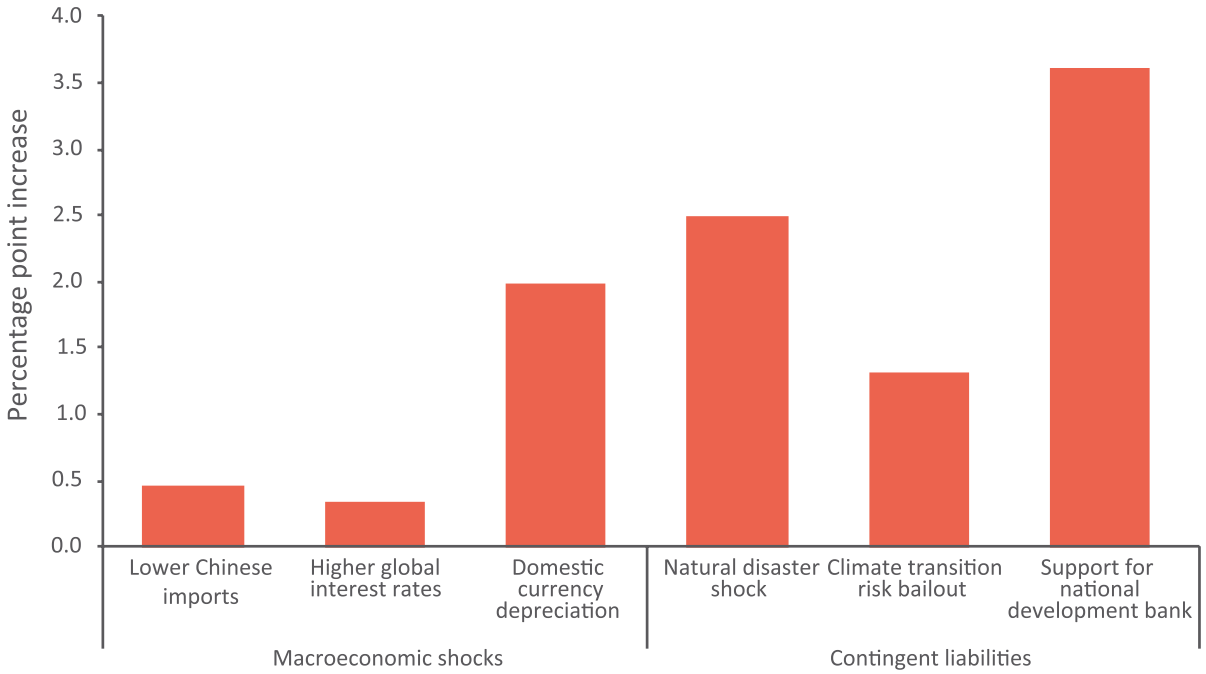
Figure 4.12
Impacts of lower global coal demand and prices on the government debt ratio



Source: ESCAP.

A sudden, large domestic currency depreciation could result in a much higher government debt level. Given that virtually all of Mongolia's government debt is denominated in foreign currencies, the impact of weaker currency (20 per cent in nominal terms for period of one year) on government debt is estimated to be sizeable. In the first year of shock, the government debt ratio could be almost 11 percentage points higher relative to the combined scenario while the average impact over the first three years would be about 2 percentage points (figure 4.13). Lower import demand from China (by 20 per cent for period of two years) and higher global interest rates (by 200 basis points for period of one year) are estimated to have lesser impacts. The small impact of higher interest rates is somewhat expected given that about one third of government external debt is on concessional terms.

Figure 4.13
Impacts of selected macroeconomic shocks and contingent liabilities on the government debt ratio



Source: ESCAP.
Note: The results are presented as differences from the combined scenario. For all shocks, the impacts shown are average values over the first three years since the shocks take effect.

Realization of major fiscal contingent liabilities would add further pressure on government debt. In the event of natural disaster shocks, a combination of output losses, which reduce government revenue collection, and government transfers to people could push up the government debt ratio by 3 percentage points (figure 4.13). On realization of climate transition risk, when assuming that 30 per cent of bank loans for the mining sector are affected by stranded assets, fiscal support for commercial banks could increase the government debt ratio by 1.3 percentage points. Finally, fiscal support to boost financial liquidity of the Development Bank of Mongolia, which is facing a high default loan ratio, could increase the government debt ratio by about 3.6 percentage points.

4. Broader policy implications

Governments should aim to strike a balance between achieving the Sustainable Development Goals and maintaining public debt sustainability. Resource mobilization strategies should be designed in a way that also generates social and/or environmental benefits. For example, instead of raising consumption taxes, which disproportionately affect poorer households, Governments can make taxation of personal income more progressive. Similarly, any attempt to meet the statutory fiscal rules should be mindful of the broader economic situation and development context. An example would be the relaxation of fiscal rules by several Asia-Pacific economies during the COVID-19 pandemic, which unexpectedly increased fiscal burdens. Indeed, a prevailing government debt level that satisfies the fiscal rules or stays below the common threshold suggested by international financial institutions but comes at a significant human or environmental cost should not be regarded as sustainable debt. At the same time, while Governments should not feel deterred from borrowing in order to finance essential, high-impact development projects, they need to ensure that the funds are spent efficiently and effectively.

International financial institutions and credit rating agencies can play an important role in supporting debtor countries to navigate such a balancing act. As entities that conduct assessments on short- to medium-term public debt sustainability, IFIs and CRAs should

avoid penalizing Governments for bold fiscal plans that support people and the environment. For instance, when a Government announces an ambitious plan to realize national climate ambitions or introduce universal health coverage, this should not mechanically trigger a sovereign credit downgrade even if this plan would lead to larger fiscal shortfalls in the near term. Instead, an assessment should go beyond gauging the Government's near-term debt repayment ability by evaluating whether such a fiscal plan would help boost an economy's potential output and bring down government debt in the future. Likewise, CRAs should view a Government's effort to engage in debt relief as a way to help ease its debt burden and improve the fiscal outlook, rather than as a sign of a forthcoming debt default that may trigger a rating downgrade.

All current creditors and potential lenders should consider public debt sustainability analysis from both short- and long-run perspectives while making lending/investment decisions. When the risk of public debt distress is judged solely by a debt assessment that has a short-time horizon and does not adequately consider available Sustainable Development Goal financing options and socioeconomic and environmental gains of Goal investments, the risk may be rated as higher than it actually is. This is harmful to debtor countries because they would be unnecessarily subject to higher borrowing rates and reduced access to international financial markets. As prospects of debt refinancing become expensive and limited, there are fears of debt default, which in turn increase the risk of an actual default. While the need to view debt sustainability from a longer-term perspective should be applied to all lenders, official creditors and private institutional investors could lead by example.

5. Concluding remarks

This chapter makes a case for policymakers in Asia and the Pacific and the international development community to rethink how public debt assessment should be undertaken, especially keeping in view the 2030 Agenda. It does so by proposing an augmented approach to analyse public debt sustainability in the long term. By considering a country's Sustainable Development Goal investment needs, structural development policies and Goal financing strategies, the aim of this more holistic approach is to supplement current approaches adopted by IFIs and CRAs, which are heavily focused on short- to medium-term debt sustainability.

As demonstrated in this chapter, the goal of the augmented approach is not to assign a specific level of public debt distress risk. Rather, the analysis is based on macroeconomic modelling and illustrates different trajectories of government debt level under different policy scenarios and adverse shocks. This helps policymakers make informed choices on how to strike a balance between maintaining public debt sustainability and achieving more inclusive, resilient and sustainable development in the long term.

The analysis on Mongolia as a pilot country shows that investing in the Sustainable Development Goals would likely result in a surging government debt level due to large Goal spending needs. As in reality, this chapter assumes that the Government also introduces a wide range of structural development policies to foster a green and diversified economy as well as Sustainable Development Goal financing strategies to mobilize fiscal resources and attract private finance for development. After considering all these policy initiatives, the government debt level is expected to fall in the long run. Indeed, the estimated debt level by 2040 is comparable to that under the baseline scenario that assumes fiscal consolidation but the socioeconomic and environmental gains of the policy scenarios assumed in this chapter are much larger.

While it is illustrated here that the benefits of Sustainable Development Goal investment and economic reforms would help bring government debt down in the long run, a critical issue is whether relevant stakeholders (official and private creditors, CRAs and financial markets in general) would be willing to understand and accept the transition period of a higher government debt level. To this end, the quantitative evidence presented in this chapter should help create such a buy-in from all stakeholders to rethink how public debt sustainability analysis should be undertaken and how its results can be used to guide decisions on lending to Governments, as well as fiscal policy conduct and the pursuit of the Sustainable Development Goals and climate ambitions.

CHAPTER 5

CHAPTER 5

Managing sovereign debt surges: policy considerations and options

1. Introduction

Since the Asian financial crisis that began in mid-1997, Asia-Pacific developing countries have relied primarily on a three-pronged strategy of strong economic fundamentals, large fiscal and foreign exchange buffers and timely countercyclical interventions for achieving debt prudence and macroeconomic resilience (Posen and Rhee, 2013). This strategy proved highly successful during the 2007-2008 global financial crisis, wherein Asia and the Pacific weathered the storm relatively smoothly and became the first region in the world to regain economic growth momentum (Park, Ramayandi and Shin, 2013).

The robustness of this strategy is now being tested. The considerable sovereign debt build-up since the global financial crisis and further debt surges during the COVID-19 pandemic have pushed up the average government debt-to-GDP ratio in developing Asia-Pacific economies by about 19 percentage points between 2008 and 2021 (chapter 3). Government debt-to-GDP ratios in the region are back to the high levels witnessed immediately after the Asian financial crisis; however, unlike the period after that crisis, when strong regional economic growth and favourable external conditions enabled the region to bounce back swiftly and reduce its average government debt level by two fifths in less than a decade, the outlook for post-COVID pandemic recovery remains beset with headwinds and uncertainties (chapter 1). Amid historically high inflation and rising interest rates, government financing costs are also much higher than those during the decade of low-interest rates in the 2010s. This combination of higher debt levels and debt service burdens, less robust economic fundamentals and reduced manoeuvering space for future countercyclical spending has increased the exposure of Asia-Pacific countries to debt distress challenges.

However, precaution should not be misinterpreted as fiscal conservatism. Fiscal consolidation to reduce sovereign debt levels and the past approach of relying on buffers for fiscal resilience may no longer be the most desirable response to today's challenges. Fiscal consolidation is often ill-conceived and hastily implemented at the cost of development and social spending, leading to negative impacts on economic potentials[1] and inequality[2] in the long term. Meanwhile, chronic fiscal austerity, especially in countries where sizable sustainable development gaps remain, would inevitably jeopardize their ability to finance much-needed investments in poverty reduction, human development and environmental actions. As noted in chapters 3 and 4, sovereign debt levels are not the only yardstick for assessing debt sustainability; a balance between development financing needs and debt sustainability is also needed.

In this context, this chapter explores policy options that do not involve an outright trade-off between development financing and sovereign debt sustainability. It zooms into two policy areas: policies to reduce sovereign debt risks without compromising on investments in sustainable development, and policies to mitigate the socioeconomic damage in worst-case scenarios of severe sovereign debt distress or default. The remainder of this chapter is organized as follows. Section 2 discusses three policy options for improving sovereign debt sustainability keeping in view sustainable development, namely enhanced sovereign debt management and monitoring, greater public spending efficiency and public resource mobilization. Section 3 discusses the current major modalities and primary challenges of sovereign debt restructuring and sheds light on how to make the existing debt restructuring frameworks more timely, orderly and effective. Second 4 concludes with a summary of policy recommendations.

2. Managing sovereign debt risks without sacrificing development

2.1. Sovereign debt management and monitoring

Effective sovereign debt management and monitoring help reduce debt sustainability risks regardless of public debt levels. On one hand, ex ante risk assessment of the sovereign borrowing strategy and appropriate debt portfolio can better align Governments' debt servicing with payment capacities and help reduce refinancing and exchange rate risks. On the other, greater transparency and accountability of government debt operations encourage responsible borrowing as a Government's decisions are subject to broader scrutiny. Data transparency on outstanding and potential debt claims on the Government is particularly important for early detection of debt sustainability challenges and early action to contain the risks and mitigate potential damage. When such risk-reduction effects of high-quality and accountable sovereign debt management and monitoring are factored in by the financial market, risk premiums and borrowing costs on the sovereign debt can also be lowered.

Developing Asia-Pacific countries can consider actions on four fronts to improve their sovereign debt management and monitoring (Singh and Sirimaneetham, 2021). First, clear debt management objectives and legal frameworks should be established, to set up clear boundaries and evaluation yardsticks for a Government's debt operations. They not only provide an important anchor for responsible sovereign borrowing but also reduce uncertainties in a country's debt outlook. It is desirable that such a legal framework grant the authority of public borrowing or guarantees to a dedicated debt management agency in order to centralize decision-making.

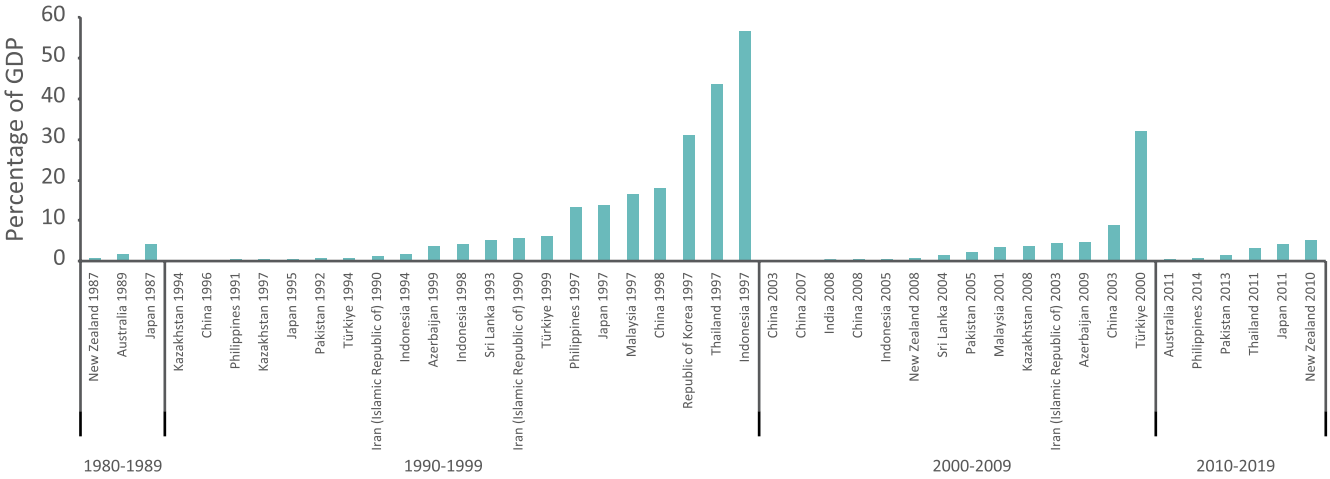
Second, independent and accountable public debt management offices can be created to shield debt management considerations from excessive influence of conflicting policy objectives. For most developing countries, enforcing an appropriate level of discipline on sovereign borrowing is crucial for maintaining sovereign debt sustainability; however, such discipline can often be eroded by both socioeconomic and political pressures for additional public spending funded with debt. Having dedicated debt management offices and preserving their independence are thus factors of great importance for the credibility and accountability of any sovereign debt management strategy. For these offices to function effectively, their responsibilities should be publicly disclosed and their operations should be audited regularly (IMF and World Bank, 2018).

Third, timely collection, monitoring and reporting of sovereign debt data should be ensured. Obscurity on sovereign debt

1 For further information, see Fatás (2019) and DeLong and Summers (2012).
2 For further information, see Forster and others (2019) and Stubbs and others (2022).

profiles erodes the foundation of sound public debt management where informed decisions and accountability depend on timely, accurate and comprehensive data. Asia-Pacific developing countries should aim at adopting international standards in the reporting on sovereign debt data even when confronted with institutional and capacity constraints, as consistent effort towards this objective can be an effective catalyser for overall improvements in sovereign debt management. **One area where urgent and significant effort is needed is the monitoring of sovereign contingent liabilities,** such as undisclosed sovereign debt obligations, public guarantees on debt issued by state-owned enterprises, government bailouts of domestic financial institutions, or additional emergency spending in response to natural disasters or pandemics. In Asia and the Pacific, estimated fiscal costs to Governments if various contingent liability events are to be realized are about 7 per cent of GDP and, under several scenarios of banking sector bailouts, this figure exceeds 30 per cent of GDP (figure 5.1). In addition, for countries with high risks of sovereign debt distress, collection and compilation of contractual details of their outstanding debt would also be important in preparation for potential debt restructuring.

Figure 5.1
Estimated fiscal cost of contingent liability realization in Asia-Pacific countries, 1980-2019



Source: ESCAP, based on estimates by Bova and others (2016).

Fourth, a prudent sovereign debt portfolio can significantly reduce associated risk. In addition to long-term insolvency,[3] sovereign debt distress can also be triggered by temporary liquidity risks, including debt-refinancing bottlenecks, surges in borrowing costs and exchange rate fluctuations. Sovereign debt of short maturities, denominated in foreign currencies, held by foreign investors under foreign law and subject to commercial or floating interest rates generally exhibits higher liquidity risks compared with domestic long-term debt with fixed interest rates or concessional loans from official creditors. A high proportion of these risky elements in the sovereign debt portfolio is often the main source of debt sustainability risks; countries should seek to replace them if better options are available at comparable borrowing costs.

2.2. Enhancing spending efficiency and productivity of public investment

Efficient and productive use of public funds is a first guarantee for sovereign debt sustainability

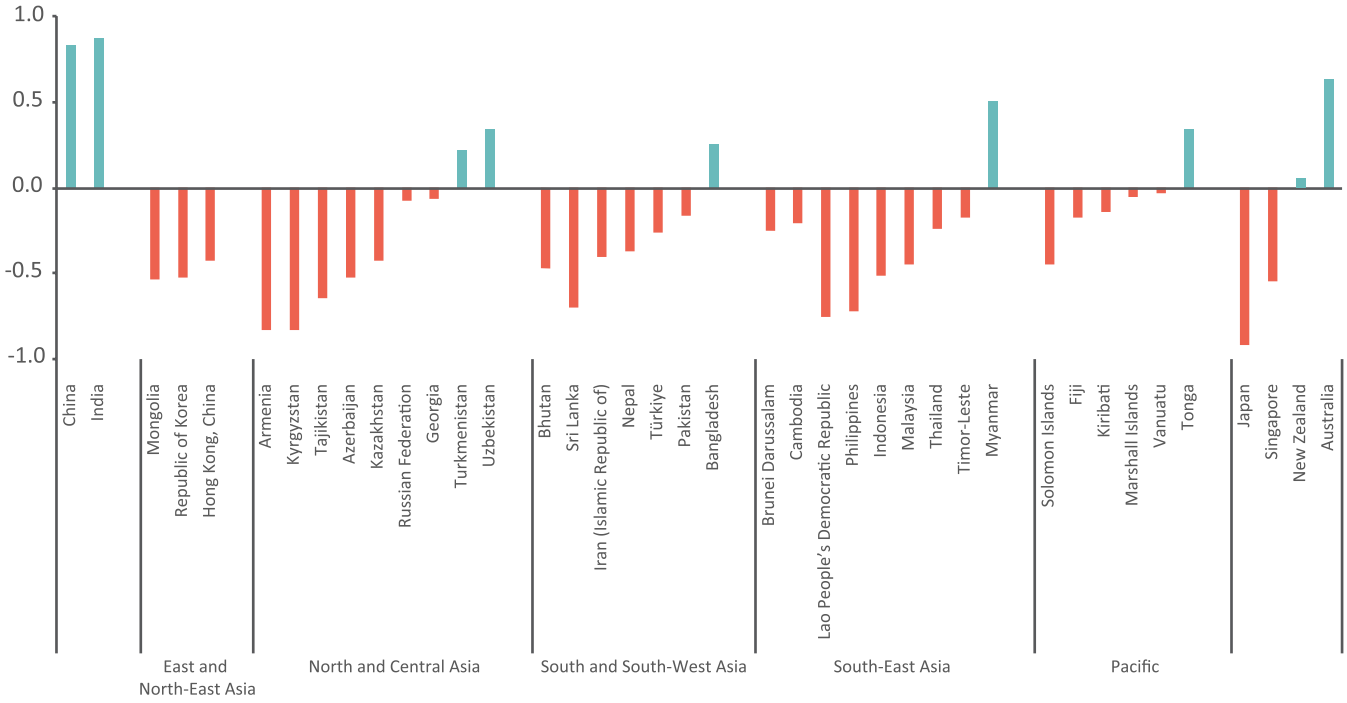
Efficient public spending and productive use of public funds enhance government payment capacity and provide countries with an option to grow out of sovereign debt vulnerabilities. One example is the Republic of Korea during its economic take-off in the 1960s and 1970s. As a typical low-income developing country at the time, the Republic of Korea faced persistent and high current account deficits and fast-accumulating foreign debt. However, unlike its contemporary peers, the country managed to keep its fiscal deficits under control despite a relatively low tax-to-GDP ratio, and it survived the 1979/80 sovereign debt crisis without losing access to the international capital market or suffering acute or prolonged economic damage (Park, 2005). A central policy lesson from the Republic of Korea's success was its relentless emphasis on the productive use of public and private funds (Fertig, 1983). A host of policies and institutions were deployed to enforce the efficiency criterion on its public and private investments, most notably through **centralized approval of external borrowing, close alignment of fund usage with national development priorities, and high-quality debt statistics** to inform debt operations and policy interventions (Collins and Park, 1989). As a result of these policies, debt-financed public funds primarily supported investments in infrastructure and in productive assets of strategic economic sectors, such as heavy and chemical industries, rather than private capital flight as seen in Latin America.

There is still substantial space for Asia-Pacific developing countries to better align public expenditure with sustainable development priorities and to further enhance spending efficiency. For instance, a correlation analysis reveals that increases in public debt were neither associated with higher gross fixed capital formation nor higher education and health-care spending in most Asia-Pacific economies in the past (figure 5.2). In addition, military spending as a share of GDP exceeded the global average in about a third of Asia-Pacific economies in 2021 (figure 5.3). Both figures indicate that there is space for better allocation of public funds for greater sustainable development and economic growth pay-offs. Meanwhile, ESCAP (2019) estimated that fiscal savings of up to 30 per cent could be achieved in public expenditure on health care and education. Potential savings on infrastructure investments could be even higher with better project preparation, selection and implementation. With more efficient public spending, these potential savings could then be redirected either to be used to finance additional investments in sustainable development or to reduce sovereign debt.

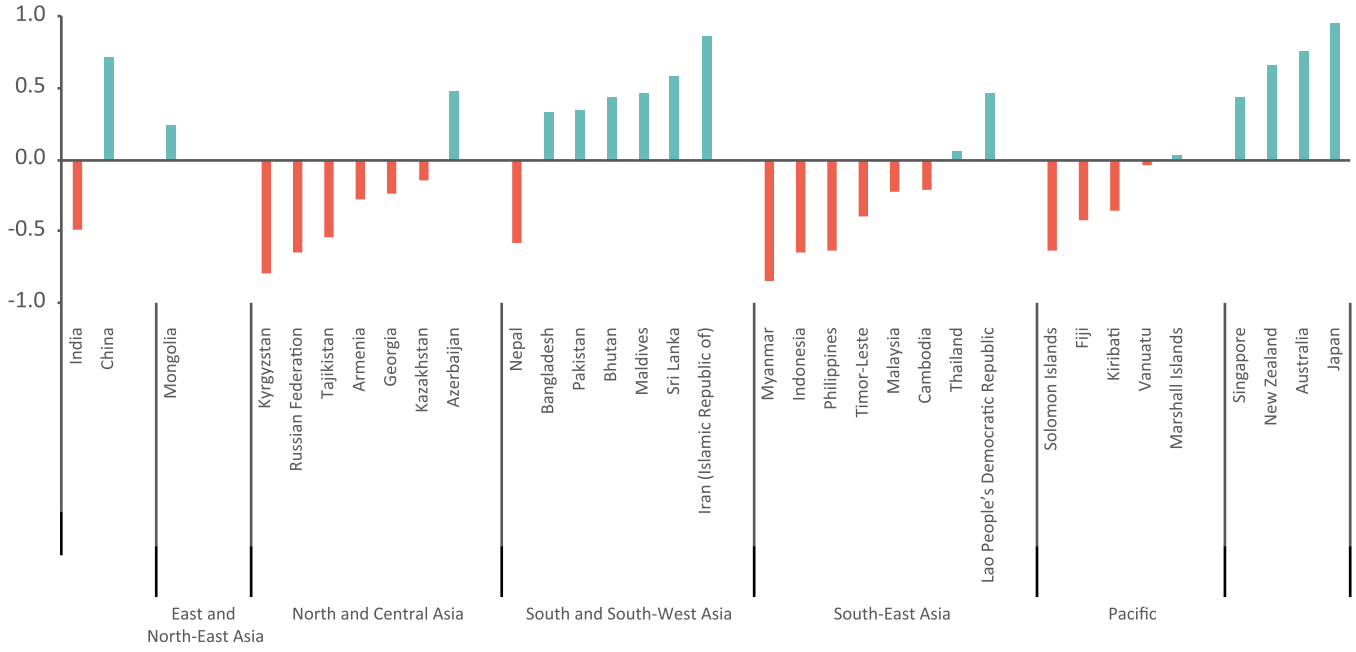
3 This situation occurs when the debt level and debt service burdens exceed the debtor country's long-term financial capacity to pay.

Figure 5.2
Correlation between sovereign debt level and gross capital formation and social-education spending in Asia-Pacific economies

a. Sovereign debt is negatively correlated with gross fixed capital formation in most Asia-Pacific economies, with the notable exceptions of China and India

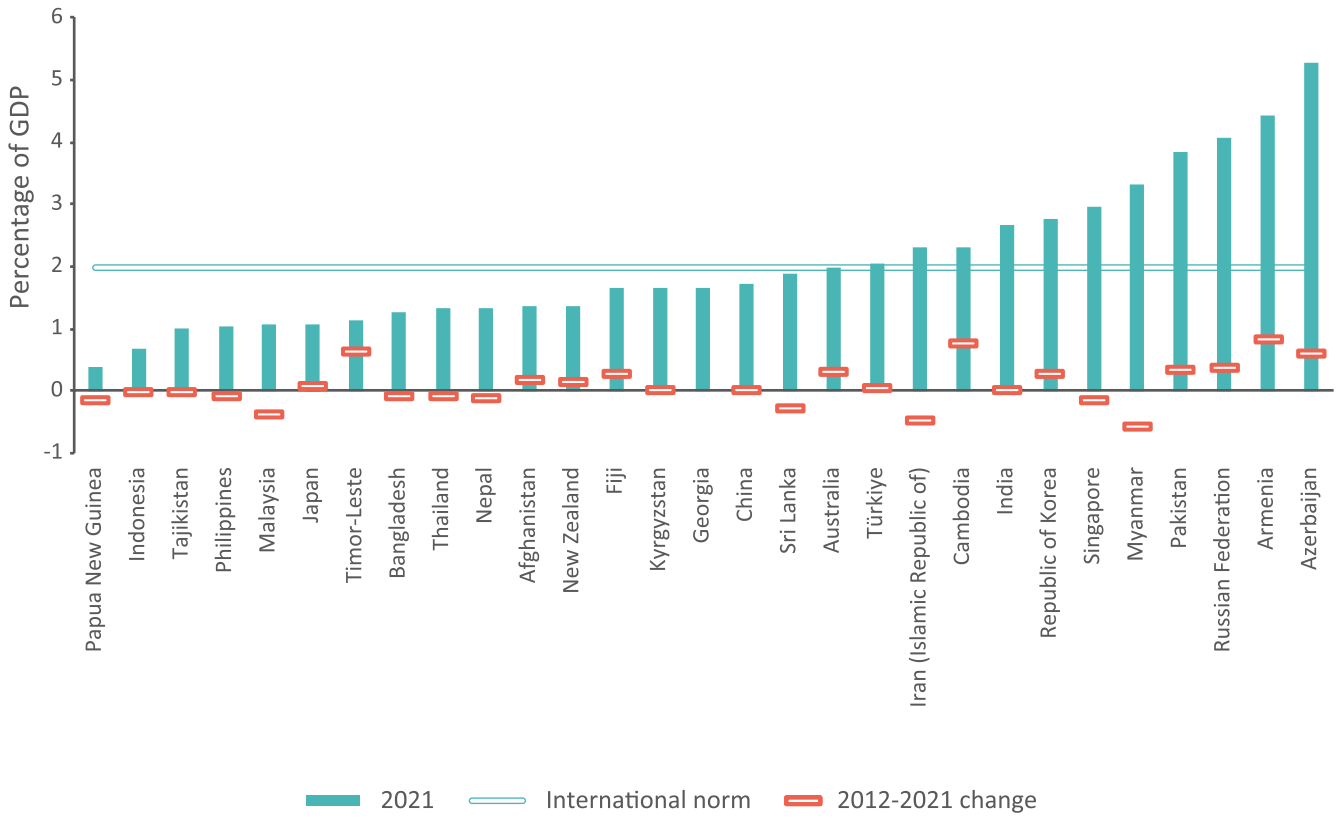


b. Sovereign debt is negatively correlated with health and education spending in most Asia-Pacific developing economies, with a notable exception of South and South-West Asia



Source: ESCAP calculations based on IMF Global Debt Database and World Bank World Development Indicators Database. Accessed on 27 December 2022.

Figure 5.3
Annual military spending as percentage of GDP in Asia-Pacific countries

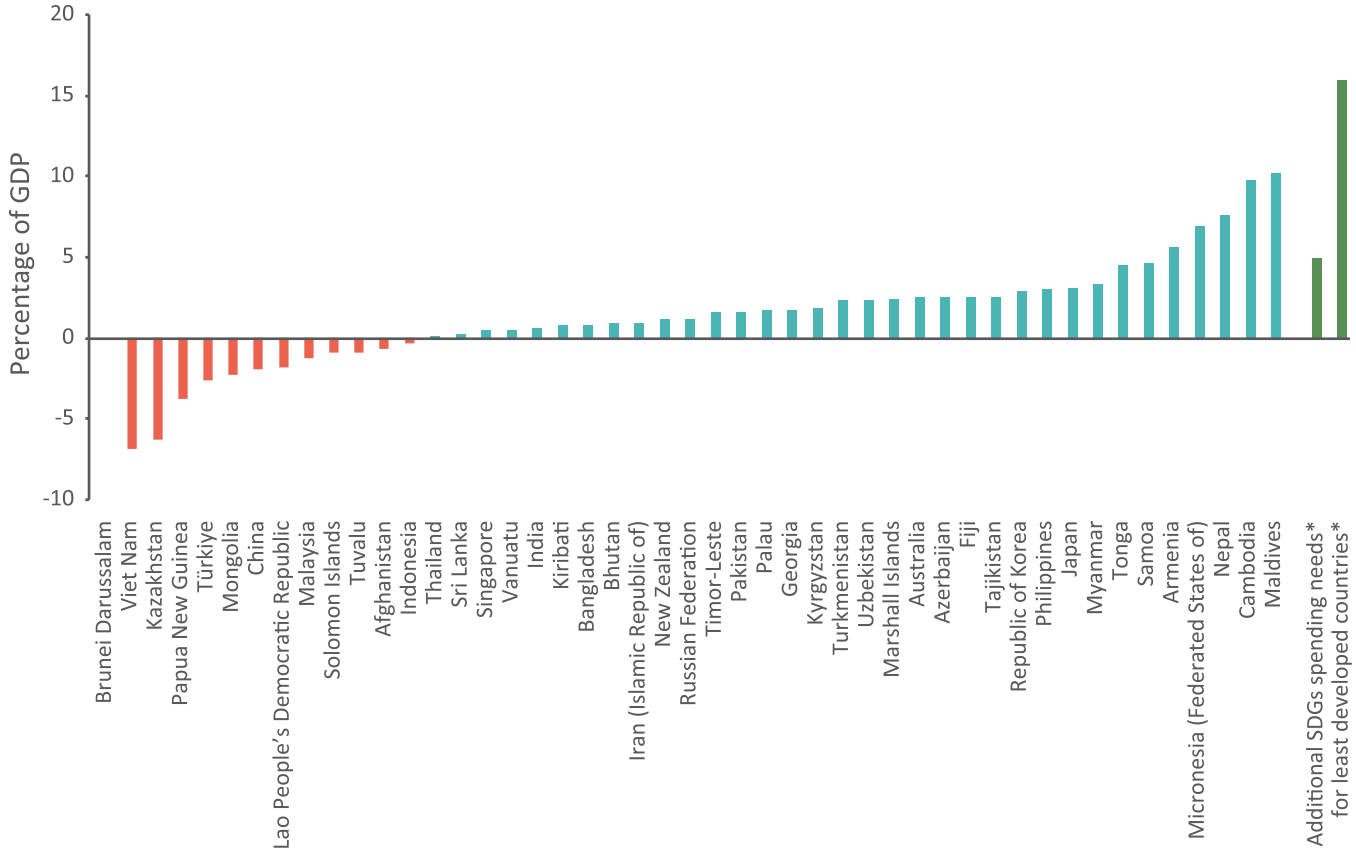


Source: ESCAP, based on Stockholm International Peace Research Institute data. Accessed on 26 February

2.3. Revenue mobilization and international development transfers

Low levels of tax revenue remain a major development bottleneck in Asia-Pacific developing countries, when the tax-to-GDP ratios still remain below 15 per cent in a third of them. On the bright side, however, tax revenue mobilization in the region improved substantially in some economies in the decade prior to the COVID-19 pandemic. While the average region-wide tax-to-GDP ratio increased by 1.1 percentage points between 2010 and 2019, such an increase exceeded 3 percentage points in 10 countries, including in Armenia, Cambodia, Maldives, the Federated States of Micronesia and Nepal, where the increase was more than 5 percentage points (figure 5.4). This encouraging progress suggests that **significant increases in tax revenue collection are not beyond the grasp of many Asia-Pacific developing countries.**

Figure 5.4
Changes in tax-to-GDP ratio, 2010-2019



Source: ESCAP calculation based on IMF World Revenue Longitudinal Data set. Accessed on 10 January 2023.
Note: These are region-wide average additional Sustainable Development Goal spending needs (5 per cent of GDP) and the average Goal spending needs for Asia-Pacific least developed countries (16 per cent of GDP). SDGs = Sustainable Development Goals.

As noted by ESCAP (2018), **sizable revenue potentials can be realized through the broadening of the tax base and overall improvements in tax administration.** Indeed, modernizing and rationalizing tax systems (Cambodia, Maldives, Myanmar, Nepal, the Philippines), introducing new broad-based taxes (Maldives, Myanmar, Samoa, Tonga), incorporating the informal sector and small and medium-sized enterprises into the formal tax regime (Cambodia), improving tax and customs administration (Armenia, Cambodia, Myanmar, Nepal, the Philippines) and removing excessive tax exemptions (the Philippines) were among the major drivers behind the most impressive country-level revenue increases in recent years. This momentum is likely to continue.

Opportunities also exist with progressive direct taxes (Jian and Lee, 2018). Strengthened tax administration capacities, improved transparency on income and wealth of both corporations and individuals and the proliferation of digital technology have significantly reduced the barriers and costs of enforcing progressive direct taxes. Growing public concerns over economic inequality have also injected political impetus for this agenda. Japan and the Republic of Korea already lead the world in revenue collection from inheritance taxes; broader adoption of personal income taxes, property taxes and other wealth taxes can become more common in the region in coming years.

Non-tax revenues should not be overlooked either. In particular, revenues from the booming local real estate market have large potential in some Asia-Pacific economies. In China, revenues from land-lease (an auction of development rights to real estate developers) mobilized about 5.5 per cent of GDP annually in the 2010s, providing a fiscal backbone for China's subnational governments that was equivalent to the bulk of the country's total infrastructure investment. While this model is difficult to replicate in other countries, new revenue tools, such as the sale of development rights (especially when it is connected to urban zoning) and betterment charges, can serve similar purposes and co-exist with property taxes (Germán and Bernstein, 2020).

Debt overhang in poor and vulnerable countries is closely linked to development deficits and shortfalls in development financing

However, domestic revenue mobilization alone will still fall far short of Sustainable Development Goal financing needs in the least developed countries in the region. For these countries, the estimated average additional investment needs amount to 16 per cent of GDP annually (ESCAP, 2019), exceeding total tax revenues in many of them. Such development financing gaps may result in chronic debt overhang, when Governments struggle to meet the basic development needs of their people and resort to high-cost borrowing to bridge the gaps. In recognizing such fundamental challenges, the SDG stimulus to deliver the 2030 Agenda[4] called for drastically scaling up external development finance for developing countries to at least $500 billion annually. Meanwhile, essential sustainable development spending, such as for pandemic and natural disaster relief or climate adaptation, may not immediately or adequately yield revenue flows. Thus, a significant proportion of this funding should come in the form of direct development transfers or long-term concessional loans, so that the development deficit of developing countries would not simply be turned into persistent fiscal deficits and debt burdens.

Scaling up ex ante development transfers as an alternative to ex post and painful debt relief and restructuring is not without precedent. The NextGenerationEU programme[5] in 2021, for instance, benefited from lessons of the 2009/10 European debt crisis and preempted foreseeable fiscal shortfalls in the European Union's vulnerable members with generous grants amounting to €390 billion and 52 per cent of the total funding of the programme. The benefits of such a model are obvious and it should be promoted worldwide as a modality for addressing sovereign debt and development financing challenges in the poorest and most vulnerable countries.

4 For further information on this initiative of the United Nations Secretary-General, see www.un.org sustainabledevelopment/wp-content/uploads/2023/02/SDG-Stimulus-to-Deliver-Agenda-2030.pdf.

5 For more details on this programme, see https://commission.europa.eu/strategy-and-policy/recovery-plan-europe_en.

3. Mitigating sovereign debt distress damage through debt restructuring

3.1. Desirability of preemptive, adequate and collaborative sovereign debt restructuring

Sovereign debt default can cause significant economic and social damage in debtor countries due to a significant increase in borrowing costs, loss of access to capital markets, reputational spillovers[6] and worsening of domestic financial and socioeconomic conditions, as well as domestic political challenges for the incumbent Government. Estimated economic output losses in debtor countries range between 1 and 4 per cent of GDP annually in the short to medium term (Kuvshinov and Zimmermann, 2019; Marchesi and Masi, 2021; Farah-Yacoub and others, 2022), accompanied by sizeable deterioration in poverty and social indicators (Farah-Yacoub and others, 2022).

Debt restructuring is essential for mitigating adverse socioeconomic impacts in such a scenario. Restructuring can take three forms: maturity extensions, also known as rescheduling or reprofiling; coupon adjustments; and principal haircuts[7] or combinations of these. Restructuring provides much-needed fiscal breathing space for debtor countries; they help them regain access to financial markets and reduce their debt burdens for restoring sovereign debt sustainability and financial resilience in the longer term. In past restructuring episodes, debt maturity was on average extended by 3.4 years (Dvorkin and others, 2021 and principal haircuts measured in present value terms averaged 44 per cent (Meyer, Reinhart and Trebesch, 2022).

6 When sovereign default is perceived as an indication of poor governance and economic weakness in general.

7 Maturity extensions refer to extensions in the due dates of interest payments or principal repayment and the introduction of a grace period. Such extensions can incur or not incur a present value reduction of the concerned debt depending on its specific design. Coupon adjustments refer to reductions in interest rates on the debt concerned, while principal haircuts refer to reductions in the principal amount of the debt. Both coupon adjustments and principal haircuts reduce the present value of the debt.

Preemptive debt restructuring with sufficient debt reduction helps reduce socioeconomic damage

Preemptive restructuring can significantly shorten the durations of sovereign debt distress. Restructuring initiated after an actual miss on debt payment on average takes up to five years to complete. In contrast, restructuring initiated before a payment default requires an average of only 12 months to conclude (Asonuma and Trebesch, 2016). Protracted restructuring results in larger declines in GDP, fixed investment and total credit, as well as a higher risk of a banking crisis (Asonuma and Joo, 2020a). Public investment is particularly affected during delayed debt restructuring (Asonuma and Joo, 2020b).

Avoiding inadequate (or "shallow") debt restructuring is important for decisive results and lasting benefits. While debt restructuring with milder impact on creditors will generally cause a smaller dent in the debtor country's credit reputation,[8] a restructuring that does not generate enough reduction in debt burdens to achieve its primary objective of restoring long-term fiscal sustainability tends to cause much more harm. Such shallow restructuring often leads to a series of subsequent inconclusive restructurings, incurring prolonged economic drags and financial instability (Meyer, Reinhart and Trebesch, 2019). A typical example is the so-called "lost decade" from the early 1980s to the early 1990s, when a wave of unsustainable sovereign debts in developing countries was repeatedly rolled over with little reduction in the debt burden and rising interest rates in some cases.[9] This prolonged debt overhang resulted in collapses in investment, rampant capital flight and immense economic and social suffering in debtor countries (Buchheit and Gulati, 2021). Recent evidence also suggests that ambitious debt relief, such as debt write-offs in contrast to rescheduling, lead to improved economic growth outlook in debt distressed countries (Reinhart and Trebesch, 2016).

8 For instance, haircuts are typically smaller in pre-emptive debt restructurings (18 per cent) than in post-default restructurings (48 per cent), which contributes to better performance by pre-emptive restructuring (Asonuma and Trebesch, 2016).

9 This reluctance of providing meaningful debt relief was partly motivated by the concern of the United States over the interest and balance sheets of its own banking sector, which had large risk exposure to these unsustainable debts (Buchheit and Gulati, 2021).

Box 5.1
General steps of sovereign debt restructuring[a]

In the absence of a sovereign bankruptcy law and formal institutions, debtor countries have to follow a decentralized and negotiation-based approach to restructure their debt. This usually involves the following steps.

First, carry out debt sustainability analysis (DSA). A comprehensive and realistic DSA is the starting point of sovereign debt restructuring. Normally, debtor countries conduct this analysis with extensive external support, primarily from IMF and the World Bank.

Second, determine the scope of restructuring. Fair treatment is generally expected for all creditors, with the exceptions of multilateral creditors, namely IMF and other international financial institutions, the credits of which are not subject to restructuring given their lender-of-last-resort role.[b] However, countries can decide on whether to restrict the restructuring to domestic or external debt only or to conduct a comprehensive restructuring that covers both domestic and external debt (see section 3.3).

Third, prepare restructuring proposals. The debtor country is generally responsible for preparing restructuring proposals to approach different creditors, which lay out the terms that the country intends to seek. The proposals serve to prepare the creditors and mark the beginning of a formal negotiation process. Professional financial or legal advisors are often hired by the debtor country in this process to facilitate the proposal preparation and subsequent negotiations with various creditors.

Fourth, negotiate with official bilateral creditors. Debtor countries often first approach bilateral creditors, namely other sovereigns or their official entities. With bilateral creditors, the restructuring negotiation is generally easier and faster given their greater concern over broader public welfare and economic linkages with debtor countries. Existing bilateral creditor coordination platforms, such as the Paris Club and the G20 Common Framework (see section 3.4), also help expedite and simplify the process. In theory, bilateral creditors are expected to receive terms at least as comparable as private creditors receive. In reality, however, they tend to get paid later than private creditors and provide much higher principal haircuts (Schlegl, Trebesch and Wright, 2019).

Fifth, negotiate with private creditors. There is no established platform or mechanism on which the debtor country can rely to reach out to the diverse pool of private creditors for sovereign debt restructuring. The country can take an informal approach of consulting individual or small groups of creditors privately to circumvent less-cooperative creditors and avoid deadlocks, or take a more formal approach and negotiate through creditor committees.

Sixth and finally, manage implementation and litigation risks. Successfully reaching a restructuring agreement with a broad-based majority of private creditors may not be the end of the process when litigation is increasingly employed by creditors as a new holdout[c] tactic (Schumacher, Trebesch and Enderlein, 2021). The risk of litigation is greater for external debt restructuring, where the debt is issued under foreign law and the debtor country has no control over it.

a The information contained in this box is based mainly on Buchheit and others (2018).
b Preferential treatment can also be extended to trade credits or other senior or collateralized debt obligations.
c "Holdout" refers to creditors being determined to turn down restructuring proposals.

3.2. Unique challenges of sovereign debt restructuring

Despite the desirability of pre-emptive restructurings, this is often not the case. Asonuma and Trebesch (2016) documented that only 38 per cent of debt restructurings between 1978 and 2010 were pre-emptive. Concerns over domestic political costs and domestic financial instability were among the main causes of this pattern of being "too late" in initiating restructuring (IMF, 2014b; Guzman and Stiglitz, 2016). International capital markets also tend to fall short in adequately recognizing unsustainable debt situations, a situation which contributes to the problem. Indeed, debtor countries are often able to borrow heavily just before default (Reinhart and Rogoff, 2009), which creates space for opportunistic gambles on a swift economic resurrection (Yeyati and Panizza, 2011). Moreover, such shortcomings of the international capital markets prompt credit rating agencies to become more dependent on debtor countries' policy decisions in assessing their creditworthiness and thus treat a restructuring offer as a de facto sovereign default that can trigger a downgrade in a credit rating. Concerns regarding rating downgrades were one main factor that dissuaded eligible countries to participate in the G20-led Debt Service Suspension Initiative in 2020 (IMF and World Bank, 2020).

In addition to being "too late", sovereign debt restructuring is also often "too little". Experience shows that the overwhelming majority of first restructuring efforts tend to be inadequate. For example, the ratio of debtor countries seeking repeated debt restructuring among those which had at least one restructuring between 1980 and 2012 is very high at 86 per cent (IMF, 2014c). Incentives for shallow restructuring exist on both sides, as acknowledging policy and decision failures and financial losses incur significant costs for debtors and creditors alike (Buchheit and Gulati, 2020).

This "too little, too late" challenge is related to the uniqueness of sovereign debt defaults and restructuring efforts. First, there is no bankruptcy law that sovereigns can invoke to be legally discharged of their debt obligation. Unlike private debtors, a sovereign is deprived of the choice of an orderly debt resolution and a new start by declaring bankruptcy and resorting to legal processes when it is no longer able to make debt service payments on schedule. It is left with the choice between default and suffering its

harmful consequences or embarking on the challenging task of seeking creditors' cooperation and consent for negotiated debt restructuring. In addition, despite the fact that sovereigns have no protection from bankruptcy law, they are still treated as commercial actors in international capital markets. This makes them prone to litigation of creditors in foreign capital markets governed by foreign laws, which can significantly delay the debt restructuring process (Guzman and Stiglitz, 2016).

Second, sovereign debt obligations pertain to the debtor country and its people rather than the Government which actually made the borrowing decision and negotiated the terms. The international public law doctrine, known as state succession, requires Governments to recognize and honour debts incurred by predecessor regimes in that country regardless of differences in their political ideologies or policies (Buchheit and others, 2018). This leads to a moral debate on whether the debtor country and its people should be held accountable for borrowing decisions made not in their interest or on their behalf. International law does provide partial protection of the country and the people in such cases through the concept of "odious" debt, which exempts a country from debt obligations that had been incurred by tyrannical predecessor regimes when the proceedings did not benefit the State or its people.[10]

Third, and probably most importantly, a sovereign's ability to honour its debt (that is, its fiscal solvency) is subject to considerable debate. Unlike a private debtor whose debt repayment capacity and boundaries are clearly defined under bankruptcy law, a sovereign can expand the resources available for honouring its debt obligation given its taxing power, which in theory is constrained only by economic and political impracticalities if the regime were to stay in power. Also, unlike private debtors who can be forced to exhaust all reasonable means, including liquidating their assets for paying back their debt under bankruptcy law, sovereigns normally cannot be forced to do the same. This lack of a clear boundary of solvency and the circumstance of sovereign immunity in debt enforcement complicates debt sustainability assessments. This also makes debt restructuring negotiations difficult, as the necessity and terms of debt restructuring hinge upon judgements on the sovereign's capability and willingness to squeeze revenues from the domestic economy and a moral call on the fine balance between debtor and creditor interests.

10 For a comprehensive discussion on debt defences available to successor regimes, see Buchheit, Gulati and Thompson (2007).

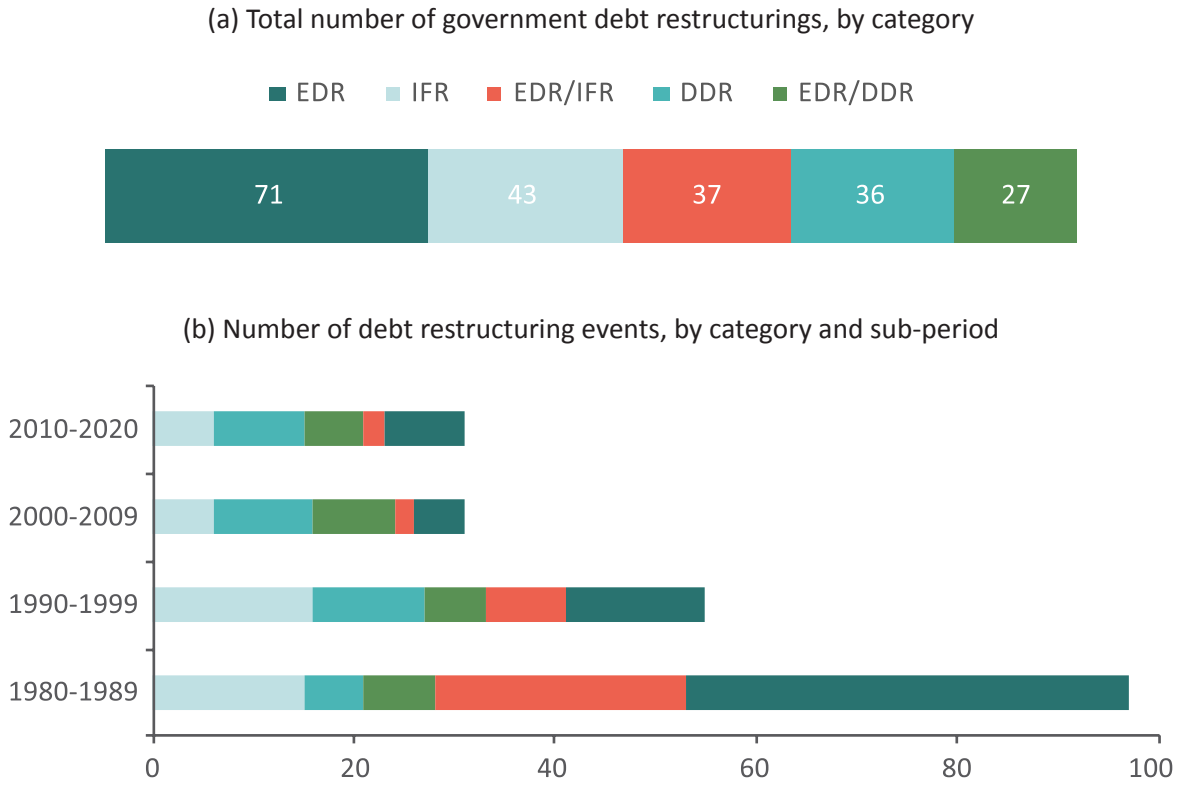
3.3. Domestic debt restructuring

Domestic debt restructuring (DDR) has several advantages over external debt restructuring (EDR). In general, DDR provides debtor countries with much greater flexibility in designing the restructuring plan, limiting creditor holdout and preventing potential litigation, when the Government can unilaterally change the terms of sovereign debt and domestic laws that govern debt issuance and the restructuring process.[11] Moreover, the potential threat of the Government resorting to unorthodox options, such as inflating away the debt or outright default, further adds to the persuasion in restructuring negotiations. Domestic debt restructurings that leave external debt untouched may also help reduce the reputational cost of the debtor country in international capital markets through its signalling effect. One example is the default in 1998 by the Russian Federation where the restructuring of its sovereign debt excluded foreign bonds issued by the country (Buchheit and others, 2018).

DDR, especially standalone DDR, has become increasingly common since 2000. Between 1980 and 1999, the number of standalone EDRs more than tripled the number of standalone DDRs, while high inflation was the preferred option for reducing domestic debt during this period (figure 5.5). Between 2000 and 2019, however, the number of standalone DDRs surpassed the number of standalone EDRs, and "inflating away" domestic debt had become less common compared with DDRs. The adoption of inflation targeting and overall improvements in monetary management have contributed to this trend. The growing stock of marketable domestic public debt also added to the necessity and desirability of DDRs (IMF, 2021d).

11 Examples include unilateral suspension or postponement of payments, unilateral reduction in coupon rates and principal, unilateral conversion of the debt into stocks and compulsory currency conversions in order to preserve foreign exchange reserves at the cost of domestic bond holders (Reinhart and Rogoff, 2011).

Figure 5.5
Total number of government debt restructuring events during the period 1980-2020



Source: IMF (2021d, p. 7).
Abbreviations: IFR = high inflation/financial repression episodes; EDR = external debt restructuring events; DDR = domestic debt restructuring events; EDR/IFR = external debt restructuring accompanied by high inflation/financial repression; and EDR/DDR = external debt restructuring accompanied by domestic debt restructuring.

Stand-alone DDR is generally more common in debtor countries with larger domestic public debt. As noted in chapter 3, the share of domestic public debt in total public debt is sizeable in many Asia-Pacific economies. One such example is Pakistan, where domestic debt accounted for 65 per cent of total sovereign borrowing in 2021 and a dominating share of total debt service burdens due to high borrowing costs. While Pakistan has relied on mostly external debt restructuring for short-term fiscal breathing space, domestic debt restructuring took place for its 1999 uncollateralized Eurobond in which 45 per cent of those bonds were held by local residents and banks (Zaman, forthcoming). Meanwhile, DDR could play an important role in resolving the ongoing public debt crisis in Sri Lanka. Peiris (2022) estimated that even a 50 per cent haircut in the country's external private debt plus a 25 per cent haircut in multilateral and bilateral loans would not be sufficient to restore debt sustainability due to the extremely high interest rates on its new domestic borrowing.[12] In contrast, an extension of domestic debt maturity by 10 years could deliver a greater reduction in future debt levels.

12 As of late 2022, the three-year yield on government bonds denominated in Sri Lankan rupees was about 25 per cent (Peiris, 2022).

A key consideration for DDR is its potential impacts on domestic financial stability and the broader economy. Domestic commercial banks and non-bank financial institutions often have significant risk exposure to default on domestic sovereign debt (Gennaioli, Martin and Rossi, 2018). An ill-planned or poorly executed DDR may cause significant erosion in their balance sheets, threatening to trigger a serious credit crunch and undesirable spillovers to other sectors of the economy. Such economic difficulties will add to resistance to any DDR plan, when the interests of the general public become more aligned with that of domestic bondholder groups. This challenge would be greater in countries where there is already substantial financial deepening and the private sector is more dependent on domestic bank credits (IMF, 2021d).

A careful ex ante evaluation of the potential impacts of DDR is necessary to achieve debt relief while managing possible risks and costs to the domestic economy. For example, stress tests are helpful for determining the scale and depth of the restructuring that avoids serious implications on domestic financial and economic stability. In cases where the central bank is the main holder of sovereign debt, it would be necessary to ensure that the restructuring will not jeopardize the central bank's essential operations as lender of last resort and as the operator of payments and foreign exchange systems. To safeguard the health of the central bank's balance sheet, milder restructuring, such as maturity extensions or coupon reductions, as opposed to a sizeable principal haircut, is generally preferable.

3.4. External debt restructuring

3.4.1. Problems with the current external debt restructuring framework

A conducive international architecture for external sovereign debt restructuring is needed

In the absence of international sovereign bankruptcy procedures, **the current EDR framework, dependent on voluntary negotiations between the debtor country and its creditors, is inherently flawed.** Compared with the clear, unbiased and enforceable guidelines and standardized practices that govern private debt resolution within countries, EDR is hampered by its complicated creditor coordination processes. Negotiations can be unnecessarily protracted and costly when information asymmetry causes friction; unaligned interests and demands of stakeholders lead to deadlocks, or a debtor country's lack of capacity and experience to steer the negotiation stalls progress. Meanwhile, negotiation outcomes are often shaped by differences in the power of the negotiating parties rather than by a fair balance reflecting everyone's interests.

Additional concerns regarding erosion to the efficiency and equity of EDR can also be highlighted. For instance, advantages of foreign creditors in the negotiation-based EDR framework may give debtor country Governments an extra incentive to delay seeking debt restructuring and gamble on economic resurrection through additional borrowings, as they are likely to benefit less and assume greater burdens in EDR than they should have otherwise. The significant uncertainties associated with restructuring negotiations may further block debtor country's access to finance and pause its development spending. Moreover, the interests of stakeholders unrepresented in restructuring negotiations can be sacrificed with both efficiency and equity losses. One example is domestic informal creditors, such as pensioners and social spending beneficiaries, whose claims on the debtor sovereign are not protected by formal debt contracts under foreign laws (Guzman and Stiglitz, 2016).

This creditor coordination challenge of EDR is also aggravated by three recent developments. First, a significant shift in the creditor landscape has added additional layers of complexity. In the 1980s, the international sovereign lending market was dominated by a small group of developed countries and their large commercial banks. Creditor coordination was relatively easy and umbrella platforms and some common practices for EDR also emerged.[13] Since then, the role of private bond investors, new official creditors, particularly China and other emerging market countries, and semi-official creditors, such as policy banks or state-owned enterprises operating as commercial creditors, has increased. The growing prominence of these non-traditional creditors implies that debtor countries will need to engage with larger and more diverse groups of foreign creditors in potential EDRs. Similarly, existing coordination mechanisms among traditional creditors will need to be expanded and updated to accommodate them. Meanwhile, the emergence of novel sovereign lending modalities, such as credit-for-resource contracts,[14] also poses new questions for sovereign external debt monitoring and workouts.

Second, the proliferation of litigation against debtor sovereigns threatens to cause more disruptions to EDRs. The frequency of restructuring-related litigation experienced surges in the 1990s and early 2000s; about half of all sovereign debt restructuring cases between 2005 and 2010 involved litigation (Schumacher, Trebesch and Enderlein, 2021).

13 This does not mean that EDR was performing better in the 1980s, which was plagued by similar "too little, too late" problems rooted in the negotiation-based EDR framework and excessive protection of powerful foreign creditors as well.

14 Such arrangements are not uncommon in foreign lending by China. In these cases, debt repayments are made in resource deliveries or with resource deliveries as collateral. Existing sovereign debt tracking systems and EDR frameworks often fail to capture such new forms of lending. For additional discussion on external lending by China, see Horn, Reinhart and Trebesch (2021; 2022) and Gelpern and others (2021).

Two factors may have contributed to this trend. First is the entry of "vulture capitals" in the international sovereign bond market, who follow a business model of "legal arbitrage" that is centred around buying stranded sovereign debt at deeply discounted prices with the intention to sue debtor countries for full payment and who are often determined to deny and derail EDR proposals for their own interests. Second, disruptive behaviours of vulture capitals and other holdout creditors were significantly emboldened by two United States court rulings: one against Peru in 1998 and the other against Argentina in 2014. The first ruling allowed vulture capitals to pursue litigation against Peru and effectively forbade the "champerty defense"[15] for debtor sovereigns against ill-motivated debt purchases and lawsuits. The second ruling prevented Argentina from making payments to cooperative creators, who agreed to debt restructuring terms, before paying vulture capitals in full. These two rulings are de facto validations of vulture capitals business model and create much stronger incentives for holdouts in EDR negotiations.

Third, non-transparent use of credit default swaps (CDSs) has further complicated representation mismatches in EDR negotiations. CDSs are widely used as an insurance instrument for hedging against default risks. In the EDR setting, current creditors may have purchased CDSs to shift their risk exposure to sovereign defaults to CDS underwriters. This may result in a complete mismatch in representation in EDR negotiations, when parties participating based on their creditor identity may have little interest in the success of the EDR or may even benefit from EDR failures as defaults will increase the value of the CDSs that they hold. In contrast, CDS underwriters who have real stakes in EDR success may have no chance to be represented in the negotiations.

3.4.2. Existing umbrella initiatives for external debt restructuring

Umbrella initiatives play an important role in addressing some of the creditor coordination challenges associated with the current EDR framework based on voluntary negotiations.

Paris Club. Created in 1956, the Paris Club is the oldest umbrella platform for coordination among 22 developed country creditors (with the exception of Brazil). It has been active in almost all international EDR initiatives, having concluded more than 470 debt-restructuring agreements with 101 debtor countries by the end of 2020 (World Bank 2022f). The evolution of its debt restructuring terms demonstrates a growing emphasis on offering debt relief in contrast to its early focus on maturity extensions. The Club's debt restructuring offers are generally conditional on IMF debt sustainability analysis and lending programmes and on comparable treatment from private sector creditors.

London Club. In parallel with the Paris Club, the London Club was created in 1976 as an informal coordination body of major commercial bank creditors. As commercial banks' relative importance has decreased in the external sovereign creditor landscape, this group's role in EDR has also declined.

Brady Plan. The Brady Plan was launched in 1989 to resolve the accumulation of unsustainable debt owed by developing debtor countries to primarily United States-based commercial banks. It was preceded by a number of unsuccessful debt workout attempts, such as the 1985 Baker Plan, which failed to recognize the insolvency reality in debtor countries and refrained from providing meaningful relief. The result was persistent debt overhang and economic difficulties in the debtor countries, causing financial stability concerns in the United States due to the sizeable risk exposure of United States financial institutions in these developing debtor countries.

In this context, the Brady Plan had from the start three important components for success. First, it enjoyed strong political and policy support from the United States Government. Second, the small group of private creditors concerned shared a common United States background, which significantly simplified negotiations. Third, past failures helped to remove the usual obstacles preventing ambitious debt reduction, and years of failure encouraged urgent and decisive actions.

In leveraging these advantages, the Brady Plan adopted an innovative and effective restructuring solution (figure 5.6), in which debtor countries were offered significant debt reductions, and the remainder of the eligible debt was converted into Brady bonds backed by United States Treasury bills as collateral for repayment.

15 Champerty defense is an English common law doctrine that prohibits the purchase of debt with the intent of bringing a lawsuit against the debtor; it has been adopted also by state legislatures in the United States (Blackman and Mukhi,2010).

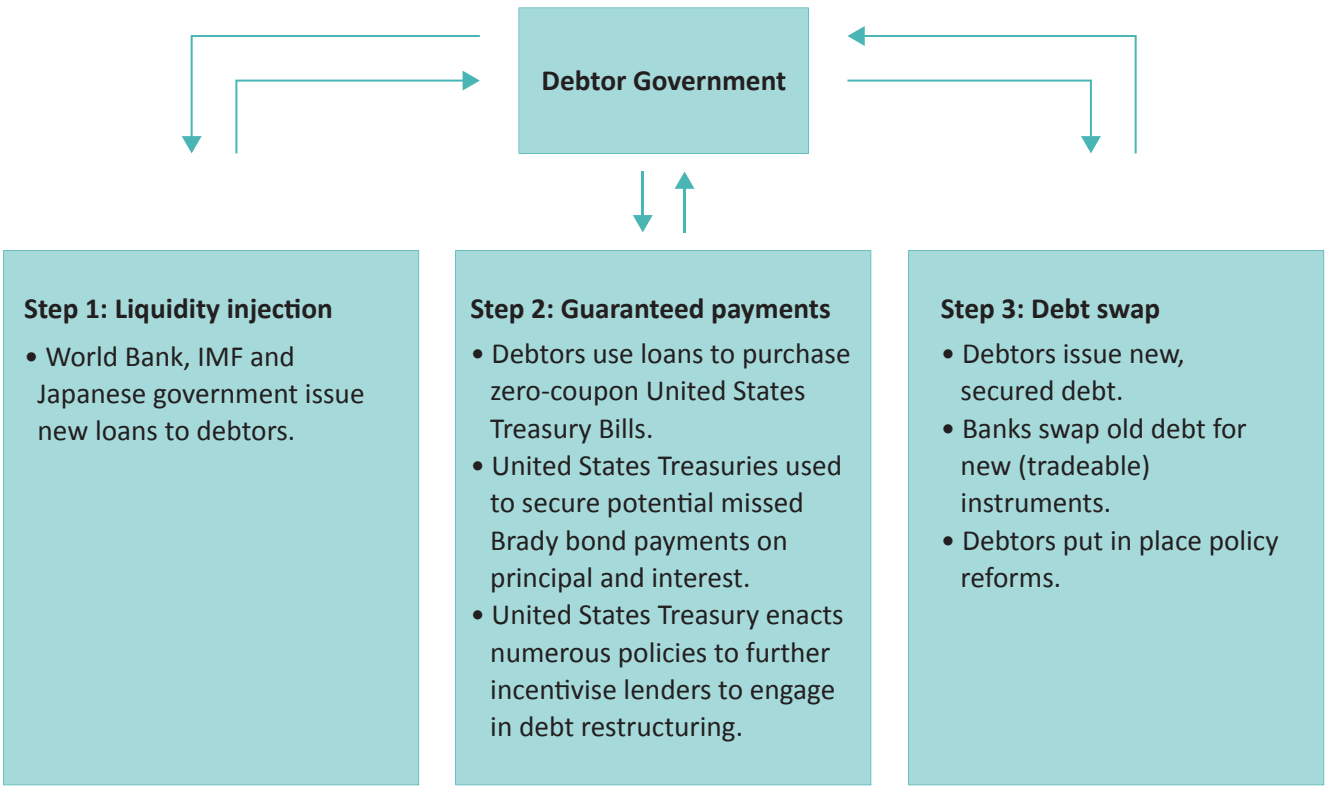
These collateral assets were purchased and owned by debtor countries but were mostly kept by the Federal Reserve of New York (Griffith-Jones, Gallagher and Volz, 2021), and the purchase was funded by new loans extended to the debtor countries by IMF and the World Bank. Brady Plan outcomes proved highly successful. Restructuring agreements were reached with 17 debtor countries with significant debt reduction in net value (37 per cent on average), and 3 countries managed to conclude restructuring agreements within the first year of the Plan.

With the benefit of hindsight, several key design features of the Brady Plan contributed to its success. First, Brady bond conversion, which drew ideas from Mexico's Aztec bond in 1987, appealed to both debtors and creditors when debt reduction, increased tradability and repayment guarantees were simultaneously incorporated into its design. Second, the "flexible menu" approach, which offered different but standardized solutions[16] for creditors, exhibited a fine balance between flexibility and simplicity. Third, new loans by IMF and the World Bank[17] played a central role in addressing the immediate liquidity bottlenecks, which could have blocked the whole plan. Fourth, private creditor participation was encouraged through a combination of tax and regulatory incentives and pressures from the United States Government.

16 For example, creditors were offered three standardized options in the Mexico case: exchanging existing debt with discount bonds involving a 35 per cent haircut; exchanging existing debt with the same face value but bearing a reduced and fixed interest rate; and providing new loans to the debtor country in the period 1989-1992 in an amount equivalent to a quarter of existing debt not committed for restructuring.

17 The Government of Japan also provides loans to facilitate the Brady Plan. While the United States Government did not directly finance the programme, it provided implicit liquidity support through IMF and the World Bank.

Figure 5.6
Brady Plan debt restructuring in a nutshell



Source: Griffith-Jones, Gallagher and Volz (2021).

Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI). HIPC was launched in 1996 as a joint effort by multilateral and bilateral creditors in offering more systematic and decisive solutions to the protracted sovereign debt overhang in the world's poorest countries. It is aimed at providing substantial debt relief in exchange for structural and social development reforms from the beginning; it was enhanced in 1999 to accelerate debt relief provisions under additional conditionalities on poverty reduction spending. In 2005, MDRI was launched as a supplement programme to offer full relief on debt owed to four multilateral creditors, including IMF, the World Bank, the Inter-American Development Bank and the African Development Bank. In addition, private creditor participation was facilitated through the Debt Reduction Facility of the International Development Association.

These two initiatives managed to provide significant debt relief at an average of about 60 per cent and appeared to have created space for investment and social spending in beneficiary countries, although with uncertain economic growth impact (World Bank 2022f). Moreover, this level of debt relief was still below some expectations considering the large development gaps and extremely weak financing capacity in HIPC-eligible countries. The relief was also delayed by slow decisions and implementation. Actual delivery took on average 3.5 years after a decision was made and this lag exceeded 5 years in a fifth of the beneficiary countries (World Bank, 2022f). Finally, HIPC and MDRI debt relief efforts did not seem to generate a long-lasting impact, as debt distress risks re-emerged in many of the beneficiary countries (World Bank, 2021b).

G20 Common Framework for Debt Treatments beyond the Debt Service Suspension Initiative. The introduction of the Framework in November 2020 as a successor and expansion of the Debt Service Suspension Initiative (DSSI) received broad attention, as it is the first and the only regular[18] international framework that brings together traditional (Paris Club) and non-traditional bilateral creditors for coordination on sovereign debt restructuring worldwide. If supported with sufficient political backing from its Member States, the Framework has the potential to evolve into a broad-based and authoritative umbrella platform that may not only play a central role in coordinating creditor actions for timely debt resolution in the short term, but also promote broad-based consensus among creditors on principles, general norms and common practices for orderly and effective sovereign debt restructuring in the future.

Despite its seemingly substantial promise, the Framework remains a modest follow-up of DSSI. It has made limited progress towards high-hanging fruits, such as streamlined and accelerated creditor coordination, consensus-building on greater ideas, or general guidelines for its own operational efficiency. On more reachable fronts, such as extending eligibility to heavily indebted middle-income countries, making more ambitious debt relief efforts, or developing mechanisms to facilitate, incentivize and compel private creditor participation, the Framework also made limited progress. For instance, it continues to consider debt restructuring beyond rescheduling as an exception, and the process leading to relief agreement is still protracted. As of February 2023, only four countries, namely Chad, Ethiopia, Ghana and Zambia, requested debt relief under the Framework, with only Chad concluding a restructuring agreement.

3.4.3. Market-based approaches to improve external debt restructuring

Collective action clauses

Collective action clauses (CAC) play an important role in protecting debtor countries against holdout creditors for orderly sovereign debt restructuring. They allow a supermajority of creditors (or bondholders) to agree on debt restructuring terms which would be binding on minority holdout creditors. First introduced in sovereign bonds issued under English law in the 1990s, they were adopted by sovereign bonds issued under New York law in 2003 following Argentina's default, and they quickly proliferated. In 2014, CACs received another boost in response to problems observed in Argentina and Greece debt restructuring and were upgraded to the second-generation level, which introduced further protection and flexibility for debtor countries.

18 In comparison, DSSI was only a temporary initiative in response to the COVID-19 pandemic shock.

Compared with first-generation CACs, which allow only supermajority voting on a single series of sovereign bond, second-generation, or enhanced, CACs promoted by the International Capital Market Association, provided debtors with three options (Buchheit and Gulati, 2020):

- Option 1: Series-by-series voting requiring a 75 per cent supermajority
- Option 2: Aggregated all-series voting requiring a 75 per cent supermajority, if and only if the proposed restructuring terms are uniformly applicable to all affected bond series
- Option 3: Hybrid "two-limb" voting requiring a 66.6 per cent majority at the aggregated all-series level and a 50 per cent majority for each series in the aggregated pool

The introduction of aggregated voting is aimed at addressing the holdout strategy of acquiring a critical share in a single or limited number of bond series. This strategy could allow the holdout creditor to veto any restructuring proposal concerning these particular bond series under first-generation CACs, but aggregated voting enabled by enhanced CACs may dilute the holdout creditor's veto power in the much larger all-series voting pool. Correspondingly, the non-discrimination condition in option 2 and the simple majority requirement for each bond series in option 3 are deliberately included to ensure fair treatment of creditors across different bond series.

The effectiveness of CACs in promoting timely and smooth debt restructuring is evident, especially for enhanced CACs when aggregated voting is activated. For example, Greece passed legislation in 2012 that retroactively introduced enhanced CACs into its domestic sovereign bonds. As a result, 100 per cent of these domestic sovereign bonds were restructured with steep haircuts while in contrast less than half of Greece's English bonds, still governed by first-generation CACs, were successfully restructured. IMF (2020) noted that pre-emptive sovereign debt restructuring significantly increased after the introduction of enhanced CACs in 2014 and the average duration of restructurings of privately held external debt was reduced by about two thirds. In addition, CACs are found to also reduce debtor countries' borrowing costs, implying a market recognition that credible debt workout plans facilitated by CACs can be an indication of debtor prudence and reduced risks for creditors (Chung and Papaioannou, 2021).

Despite the above-mentioned merits, **CACs as a systematic solution to ill-motivated creditor holdouts are still confronted with several challenges.** For example, the adoption of CACs in sovereign borrowing contracts is a gradual process; a substantial proportion of outstanding international sovereign bonds remain underprotected by only first-generation CACs or have no CAC protection at all.[19]

Moreover, the adoption of CACs is still a voluntary choice by debtor countries, and there is no guarantee that they will not deviate away from the right track under pressure from creditors or in challenging circumstances. It is therefore the task of the international development community to consolidate CAC adoption as the norm in sovereign borrowing, which could help speed up the adoption of second-generation CACs under a reasonably optimistic scenario (table 5.1).

In addition, legislative patchworks to address the vulture capital challenge would be a much-needed complement, as in the case of Belgium, France and the United Kingdom of Great Britain and Northern Ireland, which introduced "anti-vulture laws" in the 2010s to limit the payment that vulture funds can get through litigation.

19 For a discussion on this challenge, see IMF (2014b) and Guzman and Stiglitz (2016).

Table 5.1
Outlook for introduction of collective action clauses (CACs) in international sovereign bonds

	Pre-2003	2003-2014	2014-September 2017	2024 Projected	2034 Projected
New issues under New York law	No CAC	Single-series CACs	Enhanced CACs	Enhanced CACs	Enhanced CACs
New issues under English law	Single-series CACs	Single-series CACs	Enhanced CACs	Enhanced CACs	Enhanced CACs
Aggregate stock of international bonds at the end of the period	Majority have no CACs	Most bonds have single-series CACs	27 per cent have enhanced CACs 73 per cent have single-series CACs	70 per cent have enhanced CACs 30 per cent have single-series CACs	85 per cent have enhanced CACs 15 per cent have single-series CACs

Source: Makoff (2018), based on the assumption that all maturing debt will be rolled into new bonds with second-generation (enhanced) CACs.

State-contingent debt instruments can provide automatic debt relief to vulnerable countries

State-contingent debt instruments

State-contingent debt instruments (SCDIs) are designed to alleviate debt pressure on sovereigns in difficult economic situations or those experiencing negative shocks. By linking contractual debt service obligations with predefined state variables, such as economic performance or natural disasters, SCDIs allow debtor countries to shift some risks and cashflow pressure onto creditors in difficult times, partially smoothing out debt service burdens according to their abilities to pay. This countercyclical feature can deliver multiple benefits for debtors, including risk-hedging and fiscal space preservation. Compared with alternatives, such as self-insurance through high fiscal and foreign exchange buffers, conventional debt management or multilateral financial safety nets, the built-in mechanisms of SCDIs can be more cost-efficient and less susceptible to policy missteps (IMF, 2017b). For creditors, SCDIs help reduce the chance of pushing debtor countries into sovereign debt crises, thus also the incidence of debt restructuring. This, in essence, allows creditors to replace risks of highly disruptive debt restructuring with risks of smaller, rule-based but more frequent state-contingent debt service adjustments. In addition, the state-contingent cash flows generated by SCDIs can broaden the space for risk diversification and risk hedging by creditors. For example, GDP-indexed SCDIs can provide investors with partial hedging against inflation in the debtor country.

Although the economic case for SCDIs is clear, the adoption of SCDIs in practice has been hampered by a few complications (IMF, 2017b). For instance, investors tend to demand high risk premiums on SCDIs due to several factors, such as their complexity and lack of tradability in a nascent market, unclear risk profiles of underlying contingent indicators and investors' inexperience with such instruments. Information asymmetry also triggers investor concerns over data manipulation as well as adverse selection and moral hazards that debtor countries offer SCDIs in anticipation of future negative events, or make a weaker effort in managing vulnerabilities as they already have access to automatic debt relief through SCDIs. Moreover, while SCDIs are designed for shifting risk from debtor countries to creditors, creditors, especially in the private sector, can be ill-prepared to bear such risks.

As a result, **SCDIs are limited in normal times but leveraged more often in debt restructuring deals** (IMF, 2017b; Cohen and others, 2020). SCDI issuance in normal times tends to target specific investor groups. For example, since 2015 India has offered bonds with payments to retail investors linked to the price of gold given its vibrant gold trade and jewelry sector, while Türkiye offered revenue indexed bonds with coupons linked to income from state-owned enterprises to banks with Sharia-compliant investment needs (IMF, 2017b). In sovereign debt restructurings, upward payment revisions contingent on favourable economic conditions have often been incorporated within restructuring terms to improve the terms for private creditors. The Brady Plan, for example, included such bond design options in its loan-to-bond conversion menu (IMF, 2017b).

An inspiring recent development was the incorporation of natural disaster clauses in sovereign debt restructurings of Grenada (2013-2015) and Barbados (2018/19). These clauses were included in the restructured debts held by both domestic and external commercial creditors, which allow deferrals of payments for one to two years following the occurrence of major natural disaster events. The Eastern Caribbean Central Bank is exploring the introduction of similar features into its debt instruments, while a draft term sheet[20] for natural disaster clauses has been prepared by the International Capital Market Association (IMF, 2020).

Debt-for-climate swaps

The use of debt-for-climate swaps (DfCSs) remains limited. These swaps are unique debt restructuring options where the sovereign debt concerned is reduced in exchange for a verifiable commitment to investing in climate mitigation or adaptation measures. Although they evolved from the debt-for-nature swaps in the 1980s and 1990s and have been incorporated into recent debt restructurings in Seychelles (2015), Belize (2021) and Barbados (2022), DfCSs have yet to become a common and effective instrument of sovereign debt restructuring in climate-vulnerable developing countries due to such factors as high transaction costs, time-consuming negotiations and low actual debt relief.

Nonetheless, DfCSs can offer a valuable option for Asia-Pacific small island developing States. These economies experienced some of the largest sovereign debt surges during the COVID-19 pandemic and are among the countries most vulnerable to climate change, especially when the conventional sources of climate finance continue to be insufficient. The Pacific Resilience Facility, in particular, can serve as a suitable independent facility for implementing DfCSs, which can provide both technical oversight and fund management service in view of its mandate and technical expertise (Grigoryan and others, 2022).

20 For further information, see www.icmagroup.org/resources-2/Sovereign-Debt-Information/.

3.4.4. Proposed improvements in the international debt restructuring architecture

Enforcing collective actions and fair treatment of creditors remains a complex and contentious task in the decentralized market-based approach. For example, sovereign debt contracts and their CACs are not entirely standardized and various unique terms exist in different series of sovereign bonds. This leaves space for disputes and lawsuits when broad coordination across these different contracts and respective creditors is needed. Enforcing CACs across bonds issued in different currencies is another practical challenge as the voting share of different creditors for collective action hinges upon the exchange rate, which can fluctuate significantly in a sovereign debt distress scenario (Guzman and Stiglitz, 2016).

In addition to leaving the creditor coordination challenge only partially resolved, the current approach also falls short in other important aspects. For example, automatic suspension of debt payments and a stay on litigation during sovereign debt restructuring are not yet common practices. Ensuring that insolvent debtors can still have access to finance for continuation in essential operations is also important for preserving the debtor's debt repayment capacity and serves the interests of both the debtor and creditors. However, for sovereign debt restructuring, incentives for private creditors to do so is often lacking. Other issues include enhancing debt transparency for early detection of and action on debt sustainability problems and ensuring that DSAs capture financing needs to pursue long-term sustainable development (chapter 4).

In this context, several improvements to the international sovereign debt restructuring architecture have been proposed. IMF (2003) and Guzman and Stiglitz (2016), for example, advocated for an institutionalized approach, where sovereign debt restructuring is governed by an international legal framework that incorporates various desirable features of private bankruptcy practices applicable to sovereigns and is centralized under a single overseeing body that helps coordinate the process, verify claims and adjudicate disputes. However, this idea was confronted with strong objections from developed countries, which have been able to block any meaningful progress in this direction (Gelpern, 2016; Guzman and Stiglitz, 2016). Meanwhile, the United Nations in 2015 outlined nine "Basic Principles on Sovereign Debt Restructuring Processes", which stress the importance of sovereignty, good faith, transparency, impartiality, equitable treatment of creditors, sovereign immunity, legitimacy, sustainability and majority restructuring.[21] A continued discussion on these principles can contribute to global consensus-building on a common set of norms and standards governing sovereign debt restructuring processes. To this end, a proposal by the United Nations (2021) on establishing a global forum for sovereign debt resolution and coordination is highly relevant.

4. Conclusion and policy recommendations

Post-pandemic macroeconomic realities put Asia-Pacific countries in a policy dilemma of mounting sovereign borrowing costs and debt sustainability concerns on one hand and persistent demand for public investment to foster economic recovery and sustainable development in the long run on the other. As this chapter notes, opportunities for a better balance between fiscal prudence and long-term development considerations do exist.

This chapter discussed three policy actions that can enhance sovereign debt sustainability without sacrificing essential public spending and sustainable development investment. First, effective sovereign debt management and monitoring can reduce both debt distress risk and sovereign borrowing costs. Clearly articulated policy objectives and legal frameworks, procedural and institutional transparency and accountability, and strengthened debt statistics can all improve the quality and credibility of public debt management strategies. A sovereign debt portfolio that comprises more long-term debt, local-currency denominated debt and concessional loans also would help.

Second, productive public investment and efficient public spending can boost debt sustainability and deliver additional developmental pay-offs. Productive public investments would enable countries to outpace the debt build-up in economic growth and provide them with an option to "grow out of debt vulnerability" instead of resorting to austerity. Significant efficiency gains can also be achieved through better alignment of public expenditure with sustainable development objectives and better preparation, selection and execution of public projects.

Third, strengthened domestic public revenue mobilization and significant increases in international development transfers can play a key role in addressing chronic debt overhang that is triggered by development deficits. It is important for the international development community to realize that debt sustainability challenges in poor and vulnerable developing countries are closely linked to the fact that their own resources fall far short of their spending needs for sustainable development. Moreover, much of these spending needs, including on emergency responses to health and natural disasters and climate actions, will not be able to generate economic returns that are high enough to cover government borrowing costs. In these cases, the international community is confronted with a choice between ex ante and constructive development transfers and ex post and painful debt relief and restructuring. The previously mentioned SDG stimulus to deliver the 2030 Agenda supports the former.

In parallel, preparation for timely and orderly sovereign debt restructuring is needed for worst-case scenarios. On the part of debtor countries, they need to overcome domestic political incentives to delay seeking debt restructuring and merely hope for economic revival. At the same time, more would be required from the international community to improve the international architecture for sovereign debt restructuring, which is currently fragmented, inefficient and plagued by the "too little, too late" problem.

21 General Assembly resolution 69/319.

In this regard, policy efforts can be strengthened on three fronts. First, the G20 Common Framework for Debt Treatments, as the only umbrella platform for international sovereign debt restructuring that brings together traditional and emerging market official creditors, should live up to its expectations. An immediate and low-hanging objective is to streamline and improve its operations, expand eligibility to debt-distressed middle-income countries and develop mechanisms to engage private creditors early and effectively. For the long term, this Framework could evolve into an effective coordination platform for consensus-building on essential guiding principles and standard practices for international sovereign debt restructuring and, more importantly, for operationalizing the international consensus once reached. Undoubtedly, stronger commitment of the Framework's members is required to resolve their differences and work collectively towards these objectives.

Second, universal adoption of enhanced collective actions clauses in sovereign borrowing contracts can be accelerated, while recent innovations, such as "anti-vulture laws", state-contingent debt instruments or debt for climate swaps, should be promoted. The international community should ensure universal adoption of enhanced collective action clauses in all new sovereign borrowing contracts to reinforce the good progress achieved and explore the chances for introducing it retroactively into outstanding debt contracts. Meanwhile, anti-vulture laws can prove highly effective for reining in current abuses by vulture capitals if they can be adopted by the New York market. While both state-contingent debt instruments and debt-for-climate swaps face difficulties for comprehensive adoption, they can serve well when debtor countries are highly exposed to natural or climate risks.

Third, international consensus-building on a common set of guidelines and standard practices for sovereign debt restructuring should be accelerated. The United Nations has made progress in rallying broad-based support for the previously mentioned nine guiding principles on sovereign debt restructuring, and it will continue to serve as a leading platform for inclusive discussions on this issue. However, how to translate these principles into widely adopted practices and norms and operationalize them in actual debt restructuring negotiations remain an open question. Dialogues and cooperation among United Nations Member States, the G20 Common Framework, expert organizations and other stakeholders would help expedite this process.

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Post-pandemic recovery in developing Asia-Pacific economies in 2022 suffered severe impacts from the war in Ukraine and the global economic slowdown later in the year. Economic growth in 2023 is expected to remain weighed down by continuing geopolitical risks, recession fears and record-high inflation, although China's reopening is a positive development.

The region's growing public debt burden is likely to worsen with higher financing costs and slowing economies, making it difficult to step up public investment to power Asian and Pacific progress towards achieving the Sustainable Development Goals. Public debt can be a powerful development tool; the Economic and Social Survey of Asia and the Pacific 2023 argues and calls for rethinking debt sustainability. A large public debt is not necessarily detrimental to economic growth while fiscal consolidation and debt defaults can cause long-lasting damage to economic productivity.

The Survey proposes an "augmented" debt sustainability assessment approach to supplement the focus of international financial institutions and credit rating agencies on reducing near-term debt distress. National financing needs and structural development policies to achieve the Goals should be taken into account in determining a country's public debt sustainability. Inclusion of the socioeconomic and environmental benefits of public investment has been found to result in public debt reduction over the long term.

Sovereign debt restructuring is recommended for countries with elevated debt distress; accelerated progress is needed towards establishing common international debt restructuring frameworks, involving official and private creditors.

"...recovery and development depend on equitably and sustainably managing debt, massive investments in the Sustainable Development Goals and transforming the international financial system to make it fairer and more resilient."

António Guterres
Secretary-General of the United Nations

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