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How to Deal with the Current Debt Crisis of Developing Countries?

Jürgen K. Zattler

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Dr Jürgen Karl Zattler is currently distinguished non-resident fellow at the Center for Global Development in Washington as well as non-resident research fellow at IDOS. Until October 2023, he was Director General at the German Ministry for Economic Co-operation and Development. Prior to that, he served as the Executive Director representing Germany at the World Bank.

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Email: publications@idos-research.de
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Abbreviations

ADB	Asian Development Bank
CF	Common Framework for Debt Treatment
DSA	debt sustainability assessment
DSSI	Debt Service Suspension Initiative
G7	Group of 7 countries
G20	Group of 20 countries
HIPC	heavily indebted poor country
IDB	Inter-American Development Bank
IMF	International Monetary Fund
JGTP	Just Green Transition Programme
LIC	low-income country
LMIC	lower-middle-income country
MDB	multilateral development bank
MIC	middle-income country
ODA	official development assistance
SDG	Sustainable Development Goal
UK	United Kingdom
UMIC	upper-middle-income country
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
USD	United States dollar

Executive summary

Many countries are still struggling with high and rising debt levels. The economic impact of the pandemic, as well as some longer-term structural factors, explain this situation. The key problem is the high level of debt service relative to government revenues, which makes it difficult to address growing development, social and climate challenges. As this is a particular problem for low-income countries (LICs) and lower-middle-income countries (LMICs), the focus should be on these countries. But even within this group, the situation is not uniform. A differentiated approach with different components is therefore needed, depending on countries' individual situations and their own priorities and choices. There have been many contributions to this debate and proposals on how to address the current problems. This paper builds on some of those contributions presenting a practical and coherent approach to address the current debt crisis which focuses as far as possible on incentives for debtor countries and private creditors.

Importantly, a distinction should be made between countries with high debt levels that are at risk of debt distress and those with liquidity problems. Therefore, debt sustainability assessments (DSAs) are needed to decide which countries (a) are not in debt distress, (b) have an insolvency problem, and (c) have a liquidity problem. The International Monetary Fund (IMF) and World Bank should be asked to classify all LICs and LMICs accordingly, based on updated DSAs, using a prudent approach with conservative projections. These DSAs must emphasise debt service indicators. For countries with liquidity problems, they need to identify those countries where the problem is of a longer-term nature, with a risk that the liquidity squeeze will turn into acute debt distress.

All LICs and LMICs facing insolvency or liquidity problems should be offered a moratorium similar to the Debt Service Suspension Initiative (DSSI) to give them breathing space (of 2-3 years). The expectation is that this would help countries with liquidity problems to maintain basic social and economic services until market conditions improve or debt relief is implemented. In cases where debt service remains high after the moratorium expires, the country would be expected to request debt relief. Countries at risk of default would be expected to use the period of the moratorium to engage promptly in restructuring discussions and to prepare negotiations with creditors on a debt relief programme.

The IMF would make its resources conditional on a suspension of debt service payments. The question is whether private creditors, including sovereign bondholders, should be required to participate. It is suggested that a distinction be made between two categories of countries. For countries at risk of insolvency, including those with longer-term liquidity problems, the moratorium should be conditional on private participation on comparable terms, as their creditworthiness is likely to be affected anyway. In contrast, with countries facing short-term liquidity problems the approach should be more flexible. While pressure on private creditors to join a standstill should be maximised, this should be complemented by strong incentives.

Countries with unsustainable debt would request treatment under a reformed G20 Common Framework for Debt Treatment (CF) with the option of a more comprehensive debt relief arrangement ("CF+"), including the following enhanced or new components:

- At the beginning of the process, countries would have to present a "Just Green Transition Programme" (JGTP), monitored by the IMF and the World Bank.
- The CF+ would be accompanied by more comprehensive debt relief, thus creating more fiscal space to allow the country to finance transformational and social investments. Debt service after rescheduling should be based on DSAs, which pay greater attention to Sustainable Development Goal (SDG) investments and countries' particular circumstances, leaving countries with substantial room to absorb shocks. The objective would be to limit the

debt burden to external creditors as a share of revenue after rescheduling to around 10-15 per cent.

- For those countries where a large part of the debt service will be due to multilateral creditors, the involvement of multilateral institutions should be considered. This should be the case for those multilateral creditors which are not willing, or able, to provide positive net flows at highly concessional terms.
- The issuance of "Brady-like" bonds could be considered for specific country cases. The issuance of Brady-like bonds could be an incentive to maximise private creditor participation in exchanging old debt for new bonds with a significant discount or "haircut".

1 We have a situation: a debt service crisis!

High and rising debt levels continue to plague many countries. In addition to the economic impact of the pandemic, longer-term structural factors also explain this situation. The climate crisis is already leaving its mark: climate-related extreme weather events and the gradual effects of global warming are exacerbating the debt situation in many countries. The rise in interest rates has added to the debt burden and made refinancing more difficult. The depreciation of local currencies against the dollar has significantly increased the repayment burden. A major concern is the long-term trend towards lower economic growth rates. According to the World Bank (2023), the increase in the external debt stock of low- and middle-income countries has outpaced economic growth over the past decade. The problem is most acute for African countries.

International capital markets have recently reopened to most emerging market borrowers, albeit at high interest rates that appear unsustainable for some. Moreover, further rate cuts are on the horizon. The onset of a monetary easing cycle could support a further pick-up in Eurobond issuance and a broader revival of capital flows to emerging markets and developing countries.

But many countries, especially many low-income countries (LICs) and lower-middle-income countries (LMICs), are still in trouble. According to Holland and Pazarbasioglu (2024) from the IMF, around 52 per cent of LICs are “in debt distress” or “at high risk of debt distress”. Higher debt levels, combined with global interest rate hikes in 2022 and 2023, have increased debt servicing costs, especially for LICs. The IMF estimates that the median LIC spends more than twice as much on debt service to foreign creditors as a share of revenue than it did a decade ago – about 14 per cent at the end of 2023, up from 6 per cent a decade earlier. UNCTAD (2024b) points out that 54 developing countries spend more than 10 per cent of their revenues on net interest payments alone, almost half of them in Africa.

There are different views on the nature of this debt service crisis, in particular whether it is longer-term and structural, or more short-term. According to Albinet and Kessler (2022), debt service will peak in the period 2024-2025. But more recent estimates cast doubt on these optimistic projections. According to Development Finance International (DFI, 2024a), the debt service burden will continue for almost all affected countries over the next decade. Pazarbasioglu and Saavedra (2024) warn that these liquidity pressures, if left unaddressed, could lead to solvency problems for many vulnerable countries. Reprofiling and refinancing this debt would also exacerbate the situation.

According to UNCTAD (United Nations Conference on Trade and Development) (2024b), net transfers to developing countries, excluding China, have turned negative, meaning that debt service costs exceed new disbursements. A total of 52 countries experienced net outflows in 2022, up from 32 in 2010. LICs and LMICs in particular are finding it difficult to tap external sources of finance: official development assistance (ODA) is stagnating; private investors are wary of risk; and China has reduced its lending to most developing countries. Although some of these countries have regained access to international credit markets, the cost of financing is much higher than before the pandemic.

At the same time, developing countries face huge and growing financing needs. The World Bank (2023) estimates that the total expenditure needed to address climate, pandemic and conflict challenges in developing countries will be around USD 2.4 trillion annually by 2030. The International Energy Agency calculates that developing countries (excluding China) will need to invest between USD 1.4 trillion and USD 1.9 trillion per year over the next decade (up from USD 260 billion per year today) to meet their Paris Agreement commitments. They must also urgently prepare to adapt to the new normal of higher temperatures and their impacts. To put these financing needs into perspective, the World Bank provided USD 128 billion in loans, grants and investments last year.

Crucially, debt is crowding out important spending on social and environmental challenges. Debt service as a proportion of total budget expenditure is a major concern in many countries. According to DFI (2024a), it averages 41.6 per cent for all developing countries, with the highest rate in Africa (55 per cent). Debt service is now equal to total social spending (education, health and social protection) on average across countries. It exceeds such spending by two-thirds in Africa and LICs, and by 25 per cent in LMICs.

2 Creditor structure and the Common Framework for Debt Treatment

The pool of creditors has become much more diverse. According to *Erlassjahr* 2023, private creditors held 47 per cent of developing countries' public debt in 2021, with bondholders being the most important private lenders. For LICs, the share of private debt has risen to 14 per cent. This is a growing concern, especially regarding bondholders. Tradable bonds represent the fastest growing share of private debt for low-income countries. Private debt, including bonds, dominates short-term payment obligations and short-term debt. Multilateral creditors also play a relatively important role. At 26 per cent, debt held by multilateral institutions is particularly important for LICs, most of which are in Africa. Bilateral official creditors hold 13 per cent of the debt of developing countries and 34 per cent of the debt of LICs. China is the largest bilateral official creditor, holding about 30 per cent of bilateral official debt, followed by Japan, while the G7 together hold 40 per cent. For countries facing debt distress, a particularly important aspect of the debt burden is the expected value of near-term debt service payments. According to Ray and Simmons (2024) of the Boston University Global Development Policy Center, half of these countries (31 countries) owe their debt service mainly to multilateral development banks (MDBs), another 13 countries to China, 8 countries to bondholders, and 5 countries to Paris Club creditors.

The complexity of the debt structure and the need to coordinate traditional official lenders organised in the Paris Club, Chinese institutions and private lenders pose new difficulties. China has sought to minimise the burden of debt relief by insisting that multilateral institutions and commercial creditors must participate. Beijing argues that, if it accepts a haircut on its loans, then private creditors and international institutions such as the IMF and World Bank should also forgive some of their loans. The IMF and World Bank have not provided debt relief, saying that doing so would damage their preferred creditor status, which allows them to lend to troubled countries at preferential rates. Non-Chinese lenders, including private bondholders, are reluctant to participate in debt relief talks where not all the terms and conditions attached to Chinese loans are disclosed, fearing that Chinese lenders could be given preferential treatment.

There have been efforts to address the debt problems of poor countries, notably the Debt Service Suspension Initiative (DSSI) and the Common Framework (CF) for Debt Treatment, both supported by the G20 and the Paris Club. While the DSSI provided a welcome pause in debt service during the COVID period, it ended up increasing countries' debt burdens. The CF, adopted in 2020, is an approach designed to speed up and simplify the debt relief process. It is supported by China and is seen as a major step forward. However, debt relief under the CF has been slow, and limited to very few countries. Moreover, as DFI (2024b) points out, it has not led to a significant reduction in debt service. In general, the CF requires debtor countries to ensure that all creditors, including private creditors, participate in debt relief on comparable terms ("comparability of treatment"). In practice, however, this has proved difficult. In the case of Zambia, for example, an initial deal with bondholders was rejected by the Official Creditor Committee, as not providing comparable relief. This caused further delay in the process.

The Paris Club has preferred to maintain much wiggle room by keeping three criteria to assess "Comparability of Treatment". However, under current conditions, a more precise approach is required. Chinese lenders face high scrutiny at home. If they agree to a restructuring, a more precise definition of “Comparability of Treatment” – focusing on one clear criterion, net present value reductions – would be helpful. Similarly, if private sector creditors are to know what kind of deal lives up to “Comparability of Treatment” considerations, clarity is required.

3 An incentive-based and differentiated approach to debt treatment

In particular, adverse financing conditions and high debt levels are of almost existential importance for the countries affected. Debt relief should be part of a package of new liquidity, grants and concessional financing, as well as improvements in the global financial architecture. The aim must be to improve financing conditions in a comprehensive way, allowing for more fiscal space and investment. Given that many upper-middle-income countries (UMICs) have relatively good and improving market access, the focus should be on providing credit enhancements, that is, measures to reduce countries’ borrowing costs. This paper focuses on these countries as current financing conditions and prospects, particularly debt service obligations, are particularly problematic for LICs and LMICs. But even within this group, the situation is not uniform. A differentiated approach with different components is therefore needed, depending on countries’ individual situations and their own priorities and choices.

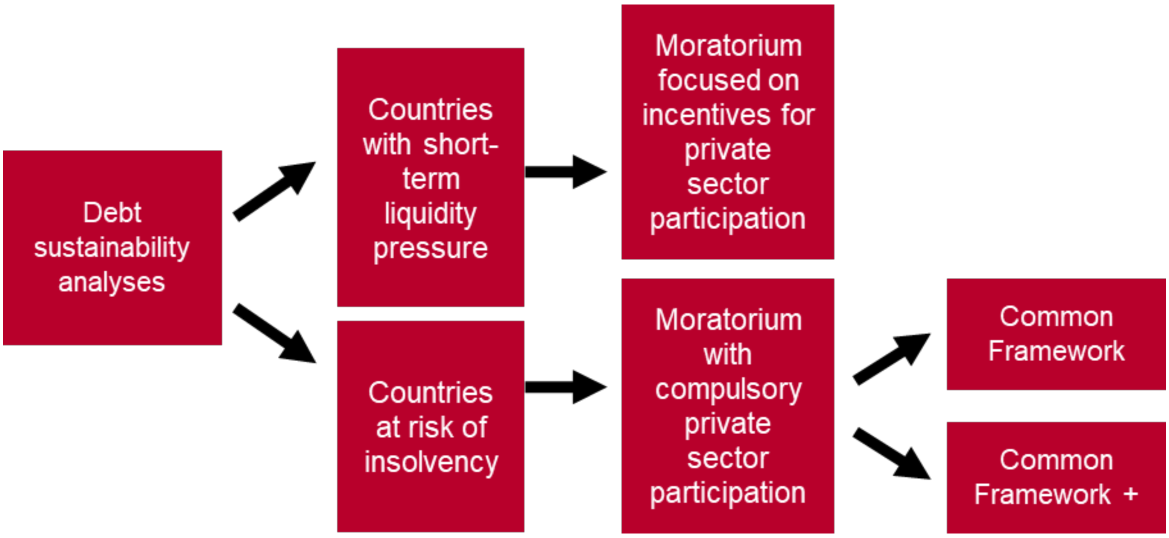
Most importantly, a distinction should be made between countries with high debt levels and the risk of debt distress, and those with liquidity problems. This aligns with recent proposals by the Finance for Development Lab (see Albinet & Kessler, 2022) and Songwe and Diwan (2024). Both have suggested a kind of bridging programme with credit enhancement provided by international financial institutions for countries not in debt distress but facing illiquidity. Therefore, debt sustainability assessments are needed to decide which countries (a) are not in debt distress, (b) have an insolvency problem and (c) have a short-term liquidity problem. The IMF and the World Bank should be asked to classify all LICs and LMICs accordingly on the basis of updated DSAs. In doing that, a prudent approach should be applied acknowledging that, if liquidity problems are of longer-term nature, they can easily make debt unsustainable and the country insolvent.

3.1 A moratorium for LICs and LMICs

Both countries with unsustainable debt and those at risk of illiquidity should be offered a moratorium similar to the DSSI to give them breathing space (of 2-3 years). The expectation is that this would help countries facing liquidity problems to maintain basic social and economic services until market conditions improve or debt relief is implemented. In cases where debt service remains high (above 20 per cent of revenues) after the moratorium expires, the country would be expected to request debt relief. Countries at risk of default would be expected to use the moratorium period to promptly engage in restructuring discussions and prepare negotiations with creditors on a debt relief programme.

The IMF would make its resources conditional on the standstill of debt service payments, whereby creditors agree not to enforce their security or demand payment of their debts for a period of time with the aim of enabling a consensual restructuring to be negotiated. The standstill would involve a deferral of interest and principal payments due during the standstill/moratorium period and would not involve a significant net present value reduction in creditors’ claims. However, private sector creditors are unlikely to offer debt suspension voluntarily, as seen during the DSSI. Also, creditors are reluctant to force private sector participation. Rating agencies could assess a negotiated reprofiling as a forced exchange, leading to credit downgrades. In practice, debtor countries often try to avoid such a scenario as long as possible, even paying a high cost. Kenya, for instance, incurred double-digit interest costs on its refinancing, in order to avoid a reprofiling. If liquidity problems threaten to lead to solvency problems, due to high refinancing costs, the IMF may need to play its cards more forcefully in order to enable reprofilings. Against that backdrop, it is suggested that a distinction be made between the two categories of countries mentioned above. The sketch below shows the proposed debt treatment for the two categories of countries.

Figure 1: Suggested debt treatment for LICs and LMICs



Source: Author

For countries with unsustainable debt that are on the verge of insolvency, the moratorium should be conditional on private participation on comparable terms, as their creditworthiness is likely to be affected in any case. The implementation of this standstill would also be made a condition for the use of IMF resources. The standstill would ensure that private creditors would continue to have claims eligible for debt relief. As Hagan (2020) points out, this changes the incentives and improves the chances of implementation.

By contrast, for countries with problems of short-term illiquidity, the approach should be more flexible. While pressure should be maximised on private creditors to join a standstill, this should be complemented by strong incentives. For example, if a debtor country succeeds in bringing private creditors on board, the IMF and the donor community could commit to providing extra-concessional lending to facilitate a smoother adjustment and a more comprehensive reform programme. Besides, it would be important to engage with credit rating agencies to avoid downgrades.

3.2 Debt restructuring for LICs and LMICs with unsustainable debt

Countries with unsustainable debts could use the moratorium period to prepare negotiations with creditors on a debt relief programme. They would have two options: to request treatment under a (slightly reformed) CF or a more comprehensive debt relief arrangement ("CF+"). These options could also be used by countries currently facing illiquidity and whose debt situation does not improve after the end of the moratorium.

3.2.1 Option A: Rescheduling under a reformed Common Framework for Debt Treatment (CF)

As mentioned above, the CF has so far failed to deliver the expected results in terms of timeliness (it has proved slow and cumbersome), creditor participation and the amount of debt relief granted.

The CF rules therefore need to be refined in several respects:

- The various steps to be taken should be formalised – with clear deadlines and a specification of the particular categories of debt to be included.
- The IMF should strengthen its policy on private sector participation on comparable terms, in line with the proposals above and below. It should establish a “comparability of treatment” formula to minimise technical disputes. An important point here is that commercial debt relief also needs to be frontloaded to create fiscal space for development needs.
- To effectively enforce comparability of treatment and to reduce the leverage of holdout creditors, the IMF should use its “lending into arrears policies” more systematically.
- Bondholders and other private creditors should be involved in the restructuring process at an early stage. One option is to form enhanced creditor committees with private sector creditors to address coordination challenges, as proposed by a group of African finance ministers (UNGA [UN General Assembly], 2023). Hagan and Setser (2024) have proposed simultaneous negotiations of debtors with official and private creditors, where appropriate.
- All creditors, including China, must be required to disclose the terms of their loans.

3.2.2 Option B: A comprehensive debt relief option (CF+)

Countries seeking debt relief should be offered an alternative to the standard CF described above. This enhanced CF+ would be based on the CF framework outlined above but would be more ambitious both in terms of policies and the degree of debt relief. The CF+ would have the following new components:

(a) At the beginning of the process, countries would have to present a “Just Green Transition Programme” (JGTP), monitored by the IMF and the World Bank. The focus should be on measures that green the economy at minimal or no fiscal cost, or even generate fiscal revenues. For example, programmes could focus on “green” fiscal and regulatory policies with a positive social impact, such as redirecting fossil fuel subsidies to additional social spending.

(b) The CF+ would be accompanied by more comprehensive debt relief, thus creating more fiscal space to allow the country to finance transformational and social investments. At the outset of the CF, the G20 could not agree on a level of ambition, leaving open the question of how much room to absorb shocks countries should have after debt relief. Now, the ambition should be to ensure that debt service after rescheduling leaves countries with substantial room to absorb shocks and invest in SDGs. Debt service to external creditors as a share of revenue after rescheduling should be limited to around 10-15 per cent.[1] This should be based on DSAs that take greater account of countries’ specific circumstances, such as their debt service capacity and the share of interest payments, as well as the size of domestic debt.

1 The Heavily Indebted Poor Countries (HIPC) Initiative debt relief, launched in 1996, aimed to limit debt to 10 per cent of government revenues. At that time, poor countries had very little domestic debt. This has since changed.

(c) For those countries where a large part of the debt service will be due to multilateral creditors, the involvement of multilateral institutions should be considered. This should be the case for those multilateral creditors which are not willing, or able, to provide positive net flows at highly concessional terms.

(d) The issuance of "Brady-like" bonds could be considered for specific country cases. Brady bonds are sovereign debt securities, denominated in US dollars, issued by developing countries and backed by US Treasury bonds. They were first announced in 1989 as part of the Brady plan, named after then-US Treasury Secretary Nicholas Brady, which was introduced to help restructure the debt of developing countries. Today, most Brady bond debt has been matured or has been retired.

The issuance of Brady-like bonds could be an incentive to maximise private creditor participation in exchanging old debt for new bonds with a significant haircut. As suggested by Zucker-Marques and Volz (2023), debt repayments would be backed by a guarantee facility. In the event of default, the guarantor would step in to service the debt in the first instance and would later be repaid by the sovereign. The advantage of the credit enhancement mechanism would be that it would help countries to maintain access to international capital markets. Some authors, such as Gallagher and Zucker-Marques (2024) have suggested that China would be a candidate to lead such an approach, given the growing importance of Chinese state-controlled banks. However, China's retrenchment from lending to developing countries and Chinese policy banks' lack of AAA or near AAA credit ratings may prove a challenge. Traditional bilateral donors with high ratings could step in. MDBs could step in as well, particularly where they have low exposure and only make up a minor part of claims on debtors. Some MDBs such as the Asian Development Bank (ADB) have significant headroom, however for most MDBs the opportunity costs are high.

4 Supporting steps

4.1 Bankruptcy proceedings for sovereign default

One of the key reasons current debt relief efforts, including the G20 CF, are failing is the lack of mechanisms to compel private lenders to participate. In addition to the above approach, the participation of private creditors could be greatly facilitated by an improved regulation of bankruptcy proceedings for sovereign default. It is currently not looking likely that negotiations will be initiated within the IMF aimed at an international agreement. However, it would be instrumental that individual countries review their national legal provisions with a view to placing greater obligations on private creditors in the event of sovereign default. This would include an automatic stay of court proceedings for the duration of good faith restructuring negotiations and the limitation of enforcement actions in accordance with comparability of treatment. A successful precedent can be found in the UK Debt Relief Act 2010, which limits recovery of qualifying debt to the quota prescribed by the Heavily Indebted Poor Countries (HIPC) initiative. As suggested by Hinrichsen, Reichert-Facilides, Waibel and Wiedenbrüg (2024), similar legislation could be encouraged by the G7 with regard to the G20 Common Framework for Debt Treatment and other international debt relief initiatives. This would be relevant for all jurisdictions where debt contracts might be enforced, notably the United Kingdom, the United States and other major trading nations. For Germany, such a "safe harbour law" would be the best way to achieve the goal set out in the coalition agreement of 24 November 2021.

4.2 Rolling-out climate-resilient debt clauses

Climate-resilient debt clauses in bond and loan contracts across official and private creditors could provide for necessary debt service suspensions in the future, at least for the natural disasters covered by such clauses. MDBs, such as the World Bank, have introduced such clauses, and bilateral and commercial creditors should follow suit. Some development banks, such as the Inter-American Development Bank (IDB), even allow for changes in the amortisation schedule independent of natural disasters, as long as the average maturity of loans is unaffected.

4.3 Mobilising more resources for increased lending

The objective is not just to reduce debt pressures. Debt has to be seen in a broader context. The broader objective is to reverse negative external flows and relieve fiscal pressure to allow investment in basic economic and social services. The debt issue is therefore part of the broader challenge of improving the international financial system and mobilising more resources for developing countries. Three promising avenues are outlined below.

First, the G20 has put forward comprehensive proposals that focus on the ongoing process of reforming the MDBs. These include better use of their existing capital, the provision of additional resources by shareholders (mainly in the form of callable capital and guarantees) and ambitious replenishments of their “soft windows” and also, in the medium to long term, general capital increases. The international community should strongly encourage these reforms.

Second, attention turns to the IMF. The IMF has increased its financial capacity and created new facilities to support developing countries facing structural challenges. However, the IMF does not have the expertise or mandate to design and implement complex reforms with member countries, for example, in the area of climate change mitigation, adaptation, and pandemic prevention and control. The MDBs and the IMF must, therefore, step up their cooperation. IMF funding, particularly from the Resilience and Sustainability Trust, needs to be more closely dovetailed with the MDBs. The proposal under discussion for industrialised countries to redirect “their” special drawing rights to the MDBs in the form of hybrid capital instruments should be pursued.

Finally, a relatively simple way to increase the fiscal space of indebted countries is to allocate a larger share of MDB lending to budget support. Unlike investment lending, budget support (or programme-based lending such as development policy operations or programmes-for-results) does not involve additional spending. The funds going to the budget are intended to be used to implement smooth policy reforms. These reforms need not be costly. On the contrary, they can even mobilise additional resources, for example in the case of fossil fuel subsidy reforms. MDBs could therefore be asked to increase the share of budget support in their lending portfolio. Such programme-based lending should then focus on climate-related policy reforms, particularly in the area of fiscal and regulatory policy.

5 The broader context: elements to facilitate progress

The above proposals seek to take into account the different positions and interests of the various stakeholders, both debtors and creditors, including the G7 and non-Paris Club lenders, in particular China. They, therefore, represent a kind of balanced package. Nevertheless, there are other “neighbouring” issues that could facilitate progress.

One important “side issue” is a possible capital increase for the World Bank. Usually, such a capital increase would be accompanied by an alignment of voting rights. However, given China’s growing economic power, this would increase China’s influence, which could be problematic for the G7 and the United States.

Another issue is the long-standing practice of having a European managing director of the IMF and a US president of the World Bank. Many parties have called for a more competitive process. This could take several forms. A relatively pragmatic step could be to require successful candidates to be supported not only by a majority of shares but also by a majority of shares from developing country members (“double majority”). Progress on both issues – the alignment of shares and the election of the President of the World Bank and the Managing Director of the IMF – could facilitate agreement on a package of reforms to ease financial conditions for developing countries, including debt treatment.

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