



**FORUM:** Economic and Financial Committee (GA2)

**TOPIC:** Strengthening of the Domestic Financial Institutions to Address Debt Vulnerability in LEDCS

**STUDENT OFFICER:** Stavros Panoutsopoulos

**POSITION:** Co-Chair

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## PERSONALINTRODUCTION

Dear delegates,

My name is Stavros Panoutsopoulos and it is my pleasure and honor to serve as your Co-Chair for the GA2, the Economic and Financial Committee (ECOFIN). I will be attending 12th grade, as I am 17 years old, at Anavryta Model Lyceum. This year's agenda includes many pressing macroeconomic issues of our time. The organizing and structural integrity of financial systems is often the only barrier between the growth of a nation and its total collapse. I am looking forward to hearing your opinions and innovative solutions and combining them to reach a rigorous and fruitful debate. My goal was to explain as much as possible to the best of my ability but please feel free to reach out to me with any questions before and during the conference.

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## TOPIC INTRODUCTION

In recent years, the global economy has been destabilized severely by cascading crises, including geopolitical fragmentation, climate change and the reduction of concessional financing. Those events are only a small part of the reasons behind the intensification of an already unsustainable debt burden for Less Economically Developed Countries (LEDs).

When a developing nation is forced to choose between servicing high-interest external debts and funding public services, its sustainable development path is severely slowed. Elevated debt vulnerabilities carry broader social implications. As debt service absorbs an increasing share of scarce revenues, fiscal space for investment in education, health, and infrastructure is squeezed, constraining the ability of governments to create jobs. This is particularly concerning given Low-Income Countries' (LICs) demographic profile: large and growing youth populations whose prospects depend on sustained investment in human capital and growth-enhancing infrastructure. In 2024, 88 million

young people lived in LICs simultaneously facing the triple challenge of low revenues, high debt service, and elevated risks of debt distress.<sup>1</sup>

Many low-income countries have increasingly turned to domestic debt issuance to meet their expanding financing needs after being barred from international financial markets in the wake of COVID-19 and an increase in global interest rates. The development of efficient and liquid domestic markets is crucial, as this trend emphasizes. Although there have been prior international interventions, the resilience of domestic financial institutions (DFIs) has frequently been disregarded. The majority of these interventions have been centered on foreign aid and external debt restructuring. In order to mobilize domestic resources, mitigate currency risks through local-currency lending, and increase fiscal capacity, DFIs must be strengthened and supported. This topic calls on the delegates to look within the borders of LEDCs to build financial infrastructures so robust that they are capable of handling exogenous macroeconomic shifts.

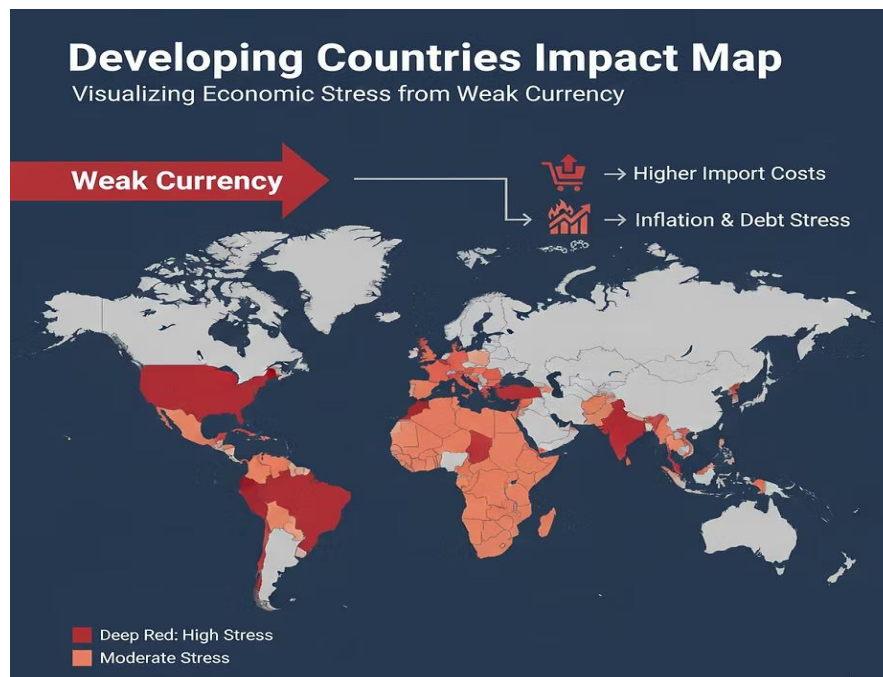


**Figure 1:** Explaining the Global Ripple Effect of Currency Devaluation<sup>2</sup>

<sup>1</sup> United Nations Department of Economic and Social Affairs. Financing for Sustainable Development Report 2026. United Nations, 2026, [financing.desa.un.org/sites/default/files/ffd4-documents/2025/2024\\_FSDR%202025%29.pdf](https://financing.desa.un.org/sites/default/files/ffd4-documents/2025/2024_FSDR%202025%29.pdf).

<sup>2</sup> Team, Tech. "Exchange Rate Impact on International Trade: Insights from Academio." Academio, 1 Dec. 2025, [www.academio.co.in/post/how-currency-exchange-rates-affect-international-trade](https://www.academio.co.in/post/how-currency-exchange-rates-affect-international-trade). Accessed 4 Aug. 2026.

## DEFINITION OF KEY TERMS

### Debt vulnerability

“Debt vulnerability refers to a borrower's susceptibility to financial distress, default, or an inability to service their obligations when unexpected economic or personal shocks occur. Meaning the risk that a person, business, or country will struggle to pay back what they owe if something unexpected happens.”<sup>3</sup>

### Less Economically Developed Countries (LEDCs)

“Less Economically Developed Countries refers to nations with lower per-capita Gross Domestic Product (GDP), limited industrialization, and lower standards of living compared to More Economically Developed Countries (MEDCs). Meaning a country with a lower average income, less industry, and a lower standard of living compared to wealthier nations.”<sup>4</sup>

### Gross Domestic Product (GDP)

“Gross domestic product or GDP refers to the total value of all final goods and services produced within a country during a specific time period, such as a year or a quarter.”<sup>5</sup>

### More Economically Developed Countries (MEDCS)

“More Economically Developed Countries refers to highly industrialized, wealthy nations with advanced economies, strong infrastructures, and high standards of living.”<sup>6</sup>

### Domestic Financial Institutions (DFIs)

“Domestic Financial Institutions refers to government-backed entities that provide long-term risk capital, loans, and guarantees for economic development projects. Meaning

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<sup>3</sup>World Bank. Debt Vulnerability Analysis: A Multi-Angle Approach. World Bank, [documents1.worldbank.org/curated/en/514551644261687296/pdf/Debt-Vulnerability-Analysis-A-Multi-Angle.pdf](https://documents1.worldbank.org/curated/en/514551644261687296/pdf/Debt-Vulnerability-Analysis-A-Multi-Angle.pdf).

<sup>4</sup> World Bank. Financial Institutions. World Bank, [documents.worldbank.org/pt/publication/documents-reports/documentdetail/837241468142484678](https://documents.worldbank.org/pt/publication/documents-reports/documentdetail/837241468142484678).

<sup>5</sup> Global Concessional Financing Facility (GCFF) <https://www.globalcff.org/about-us/>

<sup>6</sup> UNCTAD LDC Recognition Framework <https://unctad.org/topic/least-developed-countries/recognition>

government-supported banks or organizations that provide long-term money for projects that help the country grow.”<sup>7</sup>

### **Concessional Financing**

“Concessional Financing or soft financing refers to funding provided on terms significantly more generous than standard market loans. It achieves this through below-market interest rates, extended repayment periods, and extended grace periods.”<sup>8</sup>

### **Financial Repression**

“Financial Repression refers to the measures implemented by governments to channel funds to themselves that would otherwise go to other borrowers, often leading to domestic financial institutions absorbing government securities at below-market returns.”<sup>9</sup>

### **Local-Currency Lending**

“Local-currency lending refers to the practice of issuing debt in the currency of the borrower's operations and revenue. Meaning it eliminates currency mismatch risks.”<sup>10</sup>

### **International Monetary Fund**

“International Monetary Fund refers to a major global organization with 191 member countries based in Washington, D.C. Its main job is to help keep the global economy stable, encourage trade between countries, and give loans to nations in deep financial trouble.”<sup>11</sup>

## **BACKGROUND INFORMATION**

### **The Escalation of Debt Vulnerabilities in LEDCs**

#### **The Shift to High-Risk Borrowing**

Over the past ten years, debt vulnerabilities in Low-Income Countries (LICs) and Less Economically Developed Countries (LEDCs) have significantly increased. The World Bank estimates that since 2013, these countries' median government debt has increased by about 20 percentage points of GDP.<sup>12</sup> Importantly, instead

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<sup>7</sup> Bank for International Settlements. Local Debt Expansion and Vulnerability Reduction. BIS, [www.bis.org/publ/bppdf/bispap36f.pdf](http://www.bis.org/publ/bppdf/bispap36f.pdf).

<sup>8</sup> International Monetary Fund. “Concessional Financing.” IMF Glossary, [www.imf.org/external/np/glossary/index.htm](http://www.imf.org/external/np/glossary/index.htm).

<sup>9</sup> Concessional Financing. *International Monetary Fund Glossary*, IMF, [www.imf.org/external/np/glossary/index.htm](http://www.imf.org/external/np/glossary/index.htm).

<sup>10</sup> Bank for International Settlements. Local Debt Expansion and Vulnerability Reduction. BIS, [www.bis.org/publ/bppdf/bispap36f.pdf](http://www.bis.org/publ/bppdf/bispap36f.pdf).

<sup>11</sup> [wikipedia.org/ International Monetary Fund](https://en.wikipedia.org/wiki/International_Monetary_Fund), [https://en.wikipedia.org/wiki/International\\_Monetary\\_Fund](https://en.wikipedia.org/wiki/International_Monetary_Fund)

<sup>12</sup> World Bank Group. Debt in Low-Income Countries: Evolution, Implications, and Remedies. World Bank, 2019,

of conventional, low-interest loans from international organizations, this new financing increasingly originates from non-concessional and private sector sources. Although this made it possible for developing countries to meet their immediate needs, their growing proportion of market-based debt exposes them to risky refinancing and interest rate swings.

### **Actual Crises and Reversals of Capital Flow**

Countries that depend on private, foreign-sourced debt sometimes find it difficult to refinance in the event of a sudden decline in global market conditions. As international investors grew wary of these fiscal weaknesses post-pandemic, governments' access to external market financing diminished and reliance on the domestic financial sector increased, leading to sharp capital flow reversals as global borrowing costs escalated. For instance, Sri Lanka's default on its foreign sovereign debt in 2022 was the first in its history, where the run-up to the sovereign default was marked by a tide of economic adversity and a financial sector heavily exposed to the sovereign through rising holdings of government securities. Similarly, Ghana slipped into default after its domestic debt market could not absorb the government's increased domestic bond issuance and it entered a spiral of higher rates and growing deficits.

### **Impact on Sustainable Growth**

#### **Reduction in Public Capital Investment**

There is a challenge in the ability of governments to finance viable public expenditures because a significant proportion of the available domestic resources is being allocated to the service of debts. According to data from foreign research reports, by 2022, several countries in the developing world had already started spending more on paying off debts than what was being received as loans. This implies that the governments of these countries have reduced their rate of investment in areas such as health, education, and infrastructural development in favor of paying off their debts.

#### **Long Term Economic Implications**

The implication of the situation described previously is that the ability of these governments to clear their debts in the future will be compromised. This has adverse long-term economic implications as it will be a challenge to provide sufficient employment opportunities for the huge number of young people in these countries, who are in need of jobs. As such, it is important to mitigate the risks associated with the development mentioned above.

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[documents1.worldbank.org/curated/en/378031553539256399/pdf/Debt-in-Low-Income-Countries-Evolution-Implications-and-Remedies.pdf](https://documents1.worldbank.org/curated/en/378031553539256399/pdf/Debt-in-Low-Income-Countries-Evolution-Implications-and-Remedies.pdf).

## The Shift Towards Domestic Debt Financing

### Defining Domestic Debt Financing

Governments traditionally classify as external debt all debt issued on the international market and classify as domestic debt all debt issued in the domestic market. Domestic debt financing happens when a government relies on its own local financial markets instead of foreign investors, utilizing its own currency and legal frameworks.

### Market Trends and Resource Mobilization in LEDCs

Since the 1990s, developing governments have increasingly turned to domestic debt issuance, which is a shift from their traditional reliance on external borrowing that was driven by underdeveloped local markets and restrictions on foreign investment. Over the past decade, this shift has helped mobilize resources during shocks and reduced exchange rate risks. By 2024, 80 percent of LEDCs issued domestic debt through local markets, with marketable instruments accounting for around 60 percent of domestic issuance.<sup>13</sup>

### Examples of Countries Utilizing Local Markets

The ability to use these markets heavily depends on established frameworks, as institutional strength often compensates for lower income. Countries like Egypt and South Africa maintain credible central banks and robust legal frameworks, supporting local bond markets that allow them to successfully fund themselves internally.

### New Vulnerabilities from Domestic Debt

#### The Impact of COVID-19 on Frontier Economies

Despite the benefits of local currency lending, domestic debt vulnerabilities have grown, especially after COVID-19. An unanticipated need for funding and limited access to international markets meant that limited external financing and high fiscal needs drove up domestic debt burdens and service costs, particularly in frontier economies. Specifically, COVID-19 forced governments to spend more on emergency health systems, cash transfers, food subsidies and business support, while lockdowns cut tax revenue from trade, tourism and informal work. At the same time, foreign investors sold local bonds and new external loans became more expensive. Because LEDCs still needed to pay wages, hospitals and stimulus packages, they issued more Treasury bills and bonds

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<sup>13</sup> International Monetary Fund. “Debt Vulnerabilities in Low-Income Countries: Recent Developments and Trends.” IMF eLibrary, 2025, [www.elibrary.imf.org/view/journals/007/2025/002/article-A001-en.xml](http://www.elibrary.imf.org/view/journals/007/2025/002/article-A001-en.xml).

to their own banks. That is why domestic debt and domestic interest costs rose so sharply after 2020.

### **Fiscal Discipline and Revenue Challenges**

Today, countries with low tax revenue and high domestic debt levels face acute challenges. Because domestic interest rates are often higher, these rising burdens heavily emphasize the need for continued fiscal discipline and greater domestic resource mobilization efforts to keep their economies stable.

## **The Role and Challenges of Domestic Financial Institutions**

### **The Sovereign-Bank Nexus**

The heavy reliance on domestic borrowing creates a dangerous interdependency known as the "sovereign-bank nexus." When a government borrows predominantly from its own local banks, pension funds, and households, any sovereign debt distress immediately threatens the domestic economy. Unlike international defaults where foreign investors take the hit, domestic debt restructuring inflicts direct financial losses on the citizens and institutions within the country.

### **Capital Suffocation and Private Credit**

Because banking regulations frequently assign a zero-risk weight to government debt, domestic financial institutions rarely hold adequate safety provisions against sovereign defaults. If a government is forced to restructure, local banks suffer massive balance sheet losses, which can devastate their capital adequacy. Furthermore, when governments absorb the majority of available domestic capital to fund their deficits, they inadvertently crowd out private credit. This starves local businesses of the loans they need to operate, stifling broader economic growth.

## **Mechanisms and Examples of Local Borrowing**

Understanding that domestic debt financing includes all domestic public debt instruments issued in domestic markets is necessary to appreciate this change. According to the World Bank (2025), it includes commercial paper, Treasury bills, and long-term bonds and notes. This domestic burden often consists of government-issued debt instruments owned by commercial banks, local investors, or the central bank. Although domestically manufactured debt lowers exchange rate risks and aids in resource mobilization, a greater adoption of domestic debt sometimes leads to higher borrowing costs than anticipated because these instruments are typically issued at higher rates and shorter maturities.

### **Examples of Countries Using Domestic Debt Financing**

Several frontier economies vividly illustrate these growing vulnerabilities:

For example, Ghana. Following a sudden loss of international capital market access and difficulties in rolling over domestic debt, the government was forced to rely increasingly on monetary financing by the Bank of Ghana. This triggered a severe crisis, ultimately leading authorities to execute a comprehensive domestic debt restructuring program completed in 2023 (IMF, 2025). Another example is Kenya. In Kenya, domestic debt is issued mostly in the form of Treasury bonds and bills. Consequently, there are growing official concerns about the pace of increase in domestic debt to unsustainable levels. Multilateral reviews emphasize that excessive domestic debt should not crowd out the private sector in the credit market, which remains an essential engine of economic growth and development (World Bank, 2010; IMF, 2023). The final example is Sierra Leone and Zambia. In highly vulnerable nations like Sierra Leone, the domestic debt service to revenues ratio is very high, directly reflecting the short tenor of the debt and associated rollover needs (IMF, 2026). This dynamic forces governments to prioritize short-term obligations over development, highlighting the acute challenges faced by countries with low tax revenue and high domestic debt levels when external financing remains limited.

### Key Indicators of Debt Vulnerability

To better evaluate the growing domestic risks and sovereign-bank pressures outlined in previous sections, delegates should examine these key benchmarks: The estimated, rounded values of two standards are: 17 percent for the average domestic public debt-to-GDP ratio and 22 percent for the average domestic public debt service-to-revenue ratio. The comparison to the middle values is intended only to provide a starting point of the analysis of domestic public debt risks and, as such, should not be interpreted as showing any target level, which would be completely unique to each country. Domestic debt to GDP ratio in LICs more than doubled from 8 percent of GDP in 2014 to over 17 percent of GDP in 2024, with over one-fifth of LICs now having more domestic than outside debt. By 2024, 80 percent of LICs issued domestic debt through local markets, with tradeable financial tools accounting for around 60 percent of domestic borrowing.<sup>14</sup> Building on these trends, the standard of 17 percent for the average domestic public debt-to-GDP ratio and 22 percent for the average domestic public debt service-to-revenue ratio is showing domestic debt risk and offers an additional analytical lens through which we can focus more on evolving risks.

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<sup>14</sup> International Monetary Fund. "Debt Vulnerabilities in Low-Income Countries: Recent Developments and Trends." IMF eLibrary, 2025, [www.elibrary.imf.org/view/journals/007/2025/002/article-A001-en.xml](http://www.elibrary.imf.org/view/journals/007/2025/002/article-A001-en.xml).

## MAJOR COUNTRIES AND ORGANIZATIONS INVOLVED

### Ghana

Ghana adopted a Domestic Debt Exchange Program (DDEP) in 2023 in response to a significant macroeconomic crisis. This is highly relevant to the GA2 agenda because of the substantial restructuring burden on its domestic financial institutions. It is a prime example of DFIs' shortcomings in handling shocks associated with the national debt.

### Sri Lanka

After using up all of its foreign exchange reserves, Sri Lanka fell behind on its external debt in 2022. Its ensured economic collapse, which resulted in hyperinflation and necessitated a huge IMF rescue along with local debt restructuring, demonstrated how vulnerable domestic financial institutions become when sovereign debt becomes unsustainable.

### Zambia

During the COVID-19 pandemic in 2020, Zambia became the first nation in Africa to experience a sovereign debt default. Its subsequent and drawn-out battle to restructure debt under the G20 Common Framework emphasizes how difficult and slow international debt resolution is, putting a great deal of continuous strain on its domestic financial stability.

### World Bank Group (WBG) & International Monetary Fund (IMF)

The primary global financial institutions responsible for monitoring debt vulnerability and assisting countries with liability management operations, policy guidance, and restructuring efforts. The IMF runs the Debt Sustainability Framework for Low-Income Countries and can lend through programmes such as the Extended Credit Facility when a state cannot pay. The World Bank, through the International Development Association (IDA), provides concessional loans and technical help to debt-management offices. Together they collect debt data, advise on local-currency markets, and sit in restructuring talks under the G20 Common Framework. Their limit is that they cannot force private creditors to accept the same terms, so domestic banks in LEDCs are often left holding the remaining risk.

### African Development Bank (AfDB)

Key player in mobilizing resources across the African continent and pushing for the transition toward systemic sustainable financing to mitigate reliance on burdensome external debts. The AfDB finances African governments and local banks through the African Development Fund and helps countries issue local-currency bonds so they depend less on dollar debt. It also supports public financial-management reforms and works with the IMF and World Bank on African cases under the Common Framework. For this topic, its value is practical: it can strengthen African DFIs directly, rather than only writing off old external loans.

## Low-Income Countries (LICs) and LEDCs

Nations heavily burdened by borrowing costs, dedicating high percentages of tax revenue just to pay interest, placing them at significant risk of debt distress.

## TIMELINE OF EVENTS

| DATE          | EVENT                                                                                                                                                                                                                                                                                                                                                           |
|---------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1996          | The Heavily Indebted Poor Countries (HIPC) program was started by the World Bank and the International Monetary Fund (IMF) to lower unsustainable debt in developing nations.                                                                                                                                                                                   |
| 2005          | Execution of the Multilateral Debt Relief Initiative (MDRI), which offers 100% cancellation of qualifying debts <sup>15</sup> owing to the World Bank (IDA), IMF, and African Development Fund in order to free up funds for the fight against poverty. It is put into practice for poor nations with high levels of debt when they finish the HIPC Initiative. |
| March 2020    | The World Health Organization declares COVID-19 a pandemic. Lockdowns and emergency spending push LIC debt-to-GDP ratios up quickly.                                                                                                                                                                                                                            |
| November 2020 | The G20 and the Paris Club launch the Common Framework for debt treatments beyond the Debt Service Suspension Initiative (DSSI).                                                                                                                                                                                                                                |
| 2022          | The United Nations General Assembly adopts Resolution 77/153 on external debt sustainability and development. It warns that heavy borrowing from local                                                                                                                                                                                                          |

<sup>15</sup> World Bank. "5 Lessons from Past Episodes of Debt Relief." World Bank Blogs, 2022, [blogs.worldbank.org/en/developmenttalk/5-lessons-past-episodes-debt-relief](https://blogs.worldbank.org/en/developmenttalk/5-lessons-past-episodes-debt-relief).

|            |                                                                                                                                                                                     |
|------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|            | banks can worsen the sovereign-bank nexus.                                                                                                                                          |
| 5 May 2023 | The World Health Organization declares that COVID-19 is no longer a global health emergency. Debt ratios in many LEDCs nevertheless stay above their pre-pandemic level.            |
| 2024       | By the end of 2024, debt levels were still higher than their pre-pandemic peak of 49% of GDP <sup>16</sup> , making it more urgent to strengthen domestic institutional resilience. |

## RELEVANT UN TREATIES, CONVENTIONS AND RESOLUTIONS

### Addis Ababa Action Agenda (2015)<sup>17</sup>

A comprehensive framework emphasizing the necessity of domestic resource mobilization and the development of robust domestic financial sectors as the foundation for financing sustainable development.

### UN Department of Economic and Social Affairs (DESA) Institutional Proposals

In ongoing discussions regarding sovereign debt restructuring, UN DESA has proposed systemic improvements, including "the creation of a neutral Sovereign Debt Forum, which would help assuage the information and analytical issues associated with the question of debt sustainability, as well as provide a permanent space for negotiations and consultations" (UN DESA, Sovereign Debt Restructuring).

<sup>16</sup> International Monetary Fund. Macroeconomic Developments and Prospects in Low-Income Countries—2026. IMF, 2026, [www.imf.org/-/media/files/publications/pp/2026/english/ppea2026005.pdf](http://www.imf.org/-/media/files/publications/pp/2026/english/ppea2026005.pdf).

<sup>17</sup> General, UN. "Addis Ababa Action Agenda of the 3Rd International Conference on Financing for Development (Addis Ababa Action Agenda) :: Resolution /: Adopted by the General Assembly." *United Nations Digital Library System*, UN, 17 Aug. 2015, [digitallibrary.un.org/record/801013?ln=en&v=pdf](http://digitallibrary.un.org/record/801013?ln=en&v=pdf). Accessed 16 Oct. 2026.

## **SDG Target 17.4**

Assist developing countries in attaining long-term debt sustainability through coordinated policies aimed at fostering debt financing, debt relief, and debt restructuring, as appropriate.

### **General Assembly Resolution 68/304 (2014)**

A/RES/68/304 focuses on "Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes." This resolution recognizes "sustainable debt financing... as an important element for mobilizing resources for public and private investment" (UN, 2014).<sup>18</sup>

### **General Assembly Resolution 77/153 (2022)**

In A/RES/77/153, titled "External debt sustainability and development," the UN General Assembly acknowledges that "debt crises are costly and disruptive... affecting the poor and vulnerable in particular." Vitally, it addresses modern shifts by noting "that excessive borrowing from the domestic banking system could also exacerbate vulnerabilities through the sovereign-bank nexus, in the event of a crisis" (UN, 2022).<sup>19</sup>

## **PREVIOUS ATTEMPTS TO SOLVE THE ISSUE**

### **Initiative for Heavily Indebted Poor Countries (HIPC) (1996)**

This initiative, which was jointly started by the World Bank and the International Monetary Fund, sought to guarantee that no impoverished nation had an unmanageable debt load. For qualified LDCs, it offered substantial, all-encompassing debt relief to reduce their external debt to levels that could be sustained.

### **Initiative for Multilateral Debt Relief (MDRI) (2005)**

Building on the HIPC, the MDRI provided countries that finished the Heavily Indebted Poor Countries (HIPC) process with a 100% cancellation of eligible debts owed to the World Bank, African Development Fund, and International Monetary Fund.<sup>20</sup> In order to assist nations in achieving the Millennium Development Goals, this was intended to free up domestic resources.

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<sup>18</sup> A/RES/68/304 General Assembly 68/304. Towards the Establishment of a Multilateral Legal Framework for Sovereign Debt Restructuring Processes. 2014.

<sup>19</sup> Seventy-Seventh Session Agenda Item 16 (C) Macroeconomic Policy Questions: External Debt Sustainability and Development Resolution Adopted by the General Assembly on 14 December 2022. 2022.

<sup>20</sup> World Bank. "5 Lessons from Past Episodes of Debt Relief." World Bank Blogs, 2022, [blogs.worldbank.org/en/developmenttalk/5-lessons-past-episodes-debt-relief](https://blogs.worldbank.org/en/developmenttalk/5-lessons-past-episodes-debt-relief).

### **Common Structure for Treating Debt Outside of the DSSI (2020–Present)**

The G20 and the Paris Club launched this continuing project to coordinate individual debt treatments for nations that qualify for the Debt Service Suspension Initiative. Importantly, it mandates that all creditors, including those in the private sector, participate on the same conditions, although complicated international talks have often impeded its advancement.

### **POSSIBLE SOLUTIONS**

#### **Boosting domestic reforms and expanding domestic capital markets**

To support countries struggling to meet debt payments, delegates should focus on boosting domestic reforms, including resource mobilization, increasing financing from international finance institutions, and making use of liability management operations. Expanding domestic capital markets helps mitigate currency risks through local-currency lending, ensuring institutions are not exposed to rapid foreign exchange rate changes. Additionally, increasing support to debt management offices is critical. This includes helping countries design sound debt policies with proper parliamentary oversight, and improve public disclosure of debt data.

#### **Strengthening financial institutions through capacity-building and strategic partnerships**

Financing for Development should emphasize the importance of strengthening domestic financial institutions in developing countries. This can be done through capacity-building efforts aimed at enhancing the project appraisal and risk-management capabilities of national development banks as well as encouraging international financial institutions to form strategic partnerships with local banks to transfer knowledge and expertise. Establishing regulations that move away from financial repression towards positive real rates will also prevent the crowding out of private sector credit and ensure domestic banks remain resilient against sovereign risk defaults.

#### **Mitigating the adverse effects of the sovereign-bank nexus**

To minimize the adverse effects of the sovereign-bank nexus, efforts should be focused on maintaining fiscal and bank buffers, strengthening surveillance and supervision of the banking system, improving transparency and data quality of bank-sovereign linkages, and better addressing the regulatory treatment of the sovereign. Larger fiscal buffers and better management of public debt improve debt sustainability and reduce the risk of sovereign-related bank distress. Larger capital buffers and better prudential frameworks strengthen banks and reduce the risk of bank-induced sovereign distress. Higher capital requirements can mitigate risk-shifting incentives of banks. By reducing their leverage, banks become safer and their funding costs become lower. The introduction of positive risk weights on sovereign exposures reduces banks' endogenous exposure to sovereign risk and makes them effectively safer.

## Safeguarding financial stability during domestic debt restructuring

To safeguard financial stability following a domestic debt restructuring, policy responses may include liquidity and solvency support to financial institutions affected by the restructuring, as well as temporary capital flow management measures and other central bank interventions to support orderly market functioning. Mitigating the impact on non-bank institutional investors and households may require tailored policies. A domestic debt restructuring can be designed to limit bank losses, but those losses should not be hidden. For example, the impact of a sovereign domestic debt restructuring on banks' balance sheet has in some cases been limited when the restructuring did not involve any principal haircut but was designed as reprofiling.

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