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Assessing the impacts of investments in the Sustainable Development**Goals on public debt sustainability: a new approach****Assessing the impacts of investments in the Sustainable
Development Goals on public debt sustainability: a new
approach****Note by the secretariat***Summary*

Amid a rising risk of public debt distress in developing Asia-Pacific countries, the key policy challenge is how to accelerate investments in efforts to achieve the Sustainable Development Goals while maintaining public debt sustainability in the long term. At present, the approaches commonly used to assess public debt sustainability are focused on the short term. Thus, too much emphasis could be placed on reducing the risk of near-term debt distress instead of investing in sustainable development.

In the present document, the secretariat presents a new, long-term approach to assessing public debt sustainability that augments the conventional short-term analysis by taking into consideration the impacts of investments in the Goals, along with associated financing strategies and government structural development policies, on future public debt trajectories.

The results of a pilot study on Mongolia have revealed that, while investing in the Goals would increase the government debt level in the short term, a policy package that is aimed at making the economy of Mongolia greener and more diversified would boost fiscal resources and mobilize private capital for development, which would help cut government indebtedness, notably in the long term.

The results of the analysis have several policy implications for all countries. For instance, Governments should aim to strike a balance between achieving the Goals and maintaining public debt sustainability, and international financial institutions and credit rating agencies can play an important role in supporting debtor countries to navigate such a balancing act. Moreover, all current creditors and potential lenders should carry out public debt sustainability analyses from both a short- and a long-term perspective when making lending and investment decisions. Thus, a bold fiscal plan to support people or the environment should not

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mechanically trigger a sovereign credit downgrade, even if it would lead to larger fiscal shortfalls in the near term.

The Committee on Macroeconomic Policy, Poverty Reduction and Financing for Development is invited to review and discuss the policy issues regarding the new, long-term public debt sustainability assessment approach set out in the document, in the context of increasing investments in the Sustainable Development Goals. The Committee is encouraged to share country-specific experiences and initiatives and to provide feedback and guidance on these issues to help the secretariat in its forthcoming analytical work and technical assistance.

I. Introduction

1. The levels of public and sovereign debt distress have risen in Asia and the Pacific. Even before the coronavirus disease (COVID-19) pandemic, the average government debt as a share of gross domestic product (GDP) in developing countries in Asia and the Pacific was already at an 11-year high, measuring 40.6 per cent in 2019.¹ Driven by large fiscal stimulus packages and declining government revenues, the pandemic caused the average government debt level in the region to increase to 49.5 per cent of GDP in 2021, with two thirds of regional economies reaching the highest level of such debt since 2008. At present, 19 Asia-Pacific countries are rated as having a high risk of debt distress,² thus limiting their capacity to invest in efforts to achieve the Sustainable Development Goals.

2. As a result of the continued rise in government debt levels since the pandemic, higher financing costs and an uncertain economic outlook, the risk of public debt distress is likely to remain considerable in coming years. The post-pandemic resumption of economic activities and the war in Ukraine, which has led to trade and transport disruptions and international trade sanctions, have caused inflation to increase globally. Interest rate hikes to address high levels of inflation have added further pressure on public debt servicing costs. Moreover, continued geopolitical uncertainty, rising geoeconomic fragmentation and the risk of an economic slowdown, especially in developed economies, have increased economic uncertainty in Asia and the Pacific, with direct impacts on the fiscal position of countries in the region.

3. At the same time, developing countries in the Asia-Pacific region require significant financing to accelerate progress towards the Sustainable Development Goals. The region has thus far made limited progress in achieving the Goals,³ partly because of its financing needs. According to a pre-pandemic estimate, the Asia-Pacific region needs to spend an additional \$1.5 trillion – or approximately 5 per cent of GDP in 2018, per year, on average – to achieve the Goals by 2030.⁴ Such spending needs in the region's least developed countries are estimated to be much higher, at almost 20 per cent of GDP. According to a post-pandemic estimate, Goal-related financing gaps worldwide have widened from \$2.5 trillion to \$4.2 trillion, owing to the large

¹ *Economic and Social Survey of Asia and the Pacific 2023: Rethinking Public Debt for the Sustainable Development Goals* (United Nations publication, 2023), p. 43.

² *Ibid.*

³ *Asia and the Pacific SDG Progress Report 2023: Championing Sustainability Despite Adversities* (United Nations publication, 2023).

⁴ *Economic and Social Survey of Asia and the Pacific 2019: Ambitions beyond Growth* (United Nations publication, 2019).

fiscal costs associated with reducing the adverse socioeconomic impacts of the pandemic and a decline in external private finance.⁵

4. The key policy challenge is determining how developing countries can increase their investments towards achieving the Goals while maintaining public debt sustainability in the long term. Governments have a wide range of policy options to consider in order to increase government revenues, improve public spending effectiveness and efficiency, and enhance public debt management. The international community can also provide support by making existing multilateral debt relief initiatives more accessible and effective and by promoting common multilateral debt resolution frameworks and mechanisms to streamline debt negotiation processes.

5. In addition to these policy actions by debtor countries and the international community, one critical way forward is to rethink the concept of public debt sustainability itself and the means of assessing it. This is important because, at present, the approaches commonly used often place an excessive focus on reducing fiscal risks in the near term, which is inconsistent with a country's long-term development ambitions towards inclusive, resilient and sustainable development.

6. Outlined in the present document is a new, long-term approach to assessing public debt sustainability that takes into consideration the impacts of investments in the Sustainable Development Goals on future public debt trajectories. The document also contains information on (a) the need to rethink public debt sustainability assessments for achieving the Goals; (b) the conceptual framework of the long-term oriented public debt sustainability analysis proposed by the secretariat; and (c) how the new approach can be applied in the case of Mongolia, as a pilot country. In addition, the document includes an examination of broader policy implications, as informed by the analysis, and issues for consideration by the Committee on Macroeconomic Policy, Poverty Reduction and Financing for Development.

II. Rethinking public debt sustainability assessments for achieving the Sustainable Development Goals

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

⁵ Organisation for Economic Co-operation and Development and United Nations Development Programme, "Closing the SDG financing gap in the COVID-19 era: scoping note for the G20 Development Working Group", October 2021. Available at www.oecd.org/dev/OECD-UNDP-Scoping-Note-Closing-SDG-Financing-Gap-COVID-19-era.pdf.

8. While the conventional public debt sustainability analysis has generally contributed to fiscal stability in developing countries, policymakers and the international community need to rethink how public debt assessments should be undertaken, given the urgent need to increase investments in the Sustainable Development Goals. In Asia and the Pacific, the limited progress made towards achieving the Goals together with large investment needs mean that Governments need to mobilize more fiscal resources to realize the 2030 Agenda for Sustainable Development. The current approaches used to assess public debt sustainability analyses are heavily focused on ensuring sustainable debt in the short term. There is a risk that too much emphasis will be placed on reducing near-term debt distress risk, thus undermining the ability of Governments to increase investments in sustainable development.

9. Existing approaches to public debt sustainability analyses by international financial institutions have undergone several adjustments.⁶ For example, the frameworks of the International Monetary Fund (IMF) and the World Bank take into consideration a broad set of country-specific characteristics that help to gauge the ability of Governments to meet their debt obligations and allow a greater application of staff judgment in assessing fiscal risks.

10. Nonetheless, there are several areas where public debt sustainability assessments can be improved further. For example, in carrying out an analysis, closer attention should be paid to the drivers of changes in debt levels and the composition and quality of government spending.⁷ Studies also highlight the importance of incorporating spending needs and climate issues related to the Goals into debt sustainability analyses.⁸ More recently, the Secretary-General presented the Sustainable Development Goal stimulus, in which he noted that an improved understanding of long-term debt sustainability was needed to assess debt risks more accurately. Conducting a review of debt sustainability assessments could help to better reflect both a country's needs related to the Goals and the long-term benefits of productive investment in sustainability and resilience.

III. Augmented approach to assess public debt sustainability

11. The secretariat has proposed a long-term, holistic approach to assessing public debt sustainability as part of the analysis contained in the 2023 edition of its flagship publication, *Economic and Social Survey of Asia and the Pacific*. With a long-term focus, the approach augments the conventional short-term public debt sustainability analysis used by international financial institutions and credit rating agencies.

⁶ IMF, *Review of the Debt Sustainability Framework for Low-income Countries: Proposed Reforms*, IMF Policy Paper (Washington, D.C., 2017); and IMF, *Review of the Debt Sustainability Framework for Market Access Countries*, IMF Policy Paper, No. 2021/003 (Washington, D.C., 2021).

⁷ Brian Pinto, "The distressing debt sustainability framework of the IMF and World Bank", The Brookings Institution, 3 July 2018.

⁸ World Bank, *World Development Report 2022: Finance for an Equitable Recovery* (Washington, D.C., 2022); and Ulrich Volz and others, *Debt Relief for a Green and Inclusive Recovery: A Proposal* (Berlin, Heinrich Böll Foundation; London, Centre for Sustainable Finance, School of Oriental and African Studies, University of London; Boston, Massachusetts, Global Development Policy Center, Boston University, 2020). Available at <https://drgr.org/files/2021/01/DRGR-report.pdf>.

12. The augmented public debt sustainability analysis proposed by the secretariat comprises four main components (see figure I), which reflect the issues typically considered by most developing countries as they assess their fiscal and debt positions in the implementation of the 2030 Agenda. The components are the following:

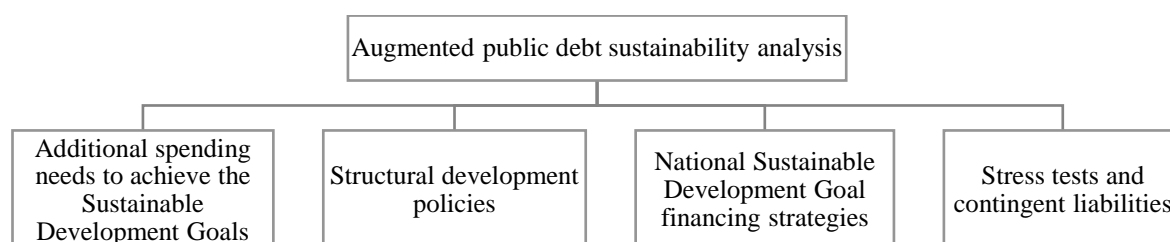
(a) Additional spending required to achieve the Sustainable Development Goals by 2030. This includes the public and private spending necessary, covering both current expenditures and long-term capital expenditures. In applying an augmented approach, it is also necessary to take into consideration any associated long-term economic, social and environmental gains from increased investment in the Goals (such as increased labour productivity and energy efficiency), which would likely have an influence on the future public debt trajectory;

(b) Government structural development policies that go beyond financial investments in the Goals, as often envisioned in long-term national development planning documents. Examples include regulatory and institutional reforms aimed at enhancing productive capacity and broadening the economic base;

(c) National Sustainable Development Goal financing strategies, which mainly comprise government resource mobilization strategies and initiatives to attract more private capital for development;

(d) Stress tests and the realization of fiscal contingent liabilities, which may reflect sudden changes in economic conditions that result in higher interest rates, weaker exchange rates and global commodity prices that are higher or lower than those assumed under the baseline scenario. Examples of fiscal contingent liabilities are fiscal costs arising from damage and losses in the event of natural disasters and government bailouts for commercial banks, loss-making State-owned enterprises or large-scale investment projects under a public-private partnership modality.

Figure I
Four key components of augmented debt sustainability analysis



13. Based on these components, the augmented debt sustainability analysis integrates climate risks and actions through 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 comprises the costs associated with providing financial assistance to affected households and businesses and rebuilding public infrastructure in the aftermath of catastrophes resulting from climate change. The third channel is the realization of fiscal contingent liabilities, such as stranded asset values in traditional mining and power generation industries, as countries pursue net-zero emissions goals, which may require government financial support for commercial banks and State-owned enterprises.

IV. Applying the augmented approach in the case of Mongolia

14. Mongolia was selected as a pilot country for an augmented public debt sustainability analysis for various reasons. From an operational perspective, Mongolia is one of the few Asia-Pacific countries for which both detailed estimates on Sustainable Development Goal spending needs and information on national financing strategies are available. 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-to-GDP ratio would diminish in the long term once the potential socioeconomic and environmental gains from Sustainable Development Goal spending and a wide range of financing options are properly considered. The quantitative analysis here is based on the macroeconomic model of the Economic and Social Commission for Asia and the Pacific.⁹

A. Policy scenarios

15. Achieving the Sustainable Development Goals by 2030 would require considerable additional spending in Mongolia that is estimated at about 17 per cent of GDP per year on average during the period 2021–2030. It was estimated that spending could be as high as 27 per cent of GDP in 2021, diminishing to 24 per cent of GDP by 2024 and stabilizing at approximately 13 per cent of GDP from 2026 onward. A large part of the total expenditures related to the Goals in Mongolia is aimed at expanding transportation networks and protecting the environment.

16. In this context, the overall development ambition is to transform Mongolia into a greener and more diversified economy. With regard to the green economy, the policy scenarios are aimed at removing energy-related subsidies; introducing a carbon tax; spending subsidy savings and additional carbon tax revenue on social protection schemes; providing subsidies to herders with a view to encouraging a reduction in livestock units per hectare and furnishing seeds and fertilizers to improve soil fertility. In respect of economic diversification, the policy scenarios are aimed at creating a more competitive and predictable business environment, adopting cross-border trade and transport facilitation measures, formalizing informal business activities and engaging with more free trade agreements.

17. In order to pursue these ambitions, the Sustainable Development Goal financing strategies of Mongolia are aimed at enhancing the fiscal space and mobilizing private capital. In order to enhance the fiscal space, the policy scenarios are focused on improving the quality of tax administration to reduce tax avoidance; rationalizing generous State subsidies to the pension insurance system; increasing public spending efficiency in the social and infrastructure areas; and engaging in debt-for-climate swaps with selected official bilateral creditors. Policy scenarios on attracting private finance for development are aimed at promoting a more enabling framework for the public-private partnership modality and increasing the share of bank loans to green projects.

18. The stress test reflects the exposure of Mongolia to various economic shocks and contingent liability risks. With sizeable coal exports, Mongolia will be hampered by a global shift towards greener development and international coal prices. With regard to contingent liability relating to natural disasters, the Government will likely play a leading role in supporting the economy as the

⁹ *Economic and Social Survey of Asia and the Pacific 2021: Towards Post-COVID-19 Resilient Economies* (United Nations publication, 2021).

penetration rate of private property insurance remains very low. The analysis also takes into consideration financial support for the State-owned Development Bank of Mongolia.

19. This set of policy scenarios is illustrative and similar to policy initiatives that can be considered for other countries, after making appropriate adjustments. For example, scenarios for the least developed countries could explore the fiscal impacts of larger amounts of official development assistance received, including assistance earmarked for climate purposes; and different degrees of concessionality of such assistance, such as grant-loan compositions and lending rates. More broadly, scenarios could compare the fiscal impacts of different deficit-financing options, such as tax rate increases versus government bond issuances.

B. Simulation results

20. Simulation results based on the above policy scenarios are presented below. The first scenario contains spending towards the Sustainable Development Goals only. The second scenario incorporates spending towards the Goals with structural development policies aimed at promoting a green and diversified economy. The third scenario combines spending towards the Goals and structural development policies with Goal financing strategies. The impacts of selected stress tests on the government debt level under the third (combined) scenario are also examined.

21. Investing in the Goals would offer significant socioeconomic and environmental benefits in Mongolia. Relative to the baseline scenario, the annual output level under the first scenario (spending towards the Goals only) would be expected to increase by between 4 per cent and 13 per cent during the period 2021–2040. That increase would be underpinned by increases in public consumption and public and private investments to achieve the Goals, as well as the positive spillovers that those investments would have on household consumption. On the social front, both the incidence of poverty and income inequality would decrease as levels of employment and personal disposable incomes would rise amid higher social spending and labour productivity. On the environmental front, carbon emissions would initially increase, given the expected surge in economic activities, but the emissions level in the long run would be almost 6 per cent below the baseline because of improved energy efficiency and reduced biodiversity loss. Driven by reduced carbon emissions, air quality would improve slightly and labour productivity would increase.

22. As expected, however, investing in the Goals would result in a much higher government debt level in Mongolia. Given the substantial additional spending required for the Goals, the government debt-to-GDP ratio would be expected to rise sharply, to about 146 per cent by 2030 (relative to 54 per cent in the baseline scenario) before diminishing to about 116 per cent by 2040. If analysed using a conventional public debt sustainability approach, the first scenario would likely be deemed to be unsustainable. In addition to higher levels of public spending, a higher government debt level is also characterised by rising government borrowing costs because the sovereign risk premium would be expected to rise as the debt level increased, leading to a substantial increase in government spending on interest payments.

23. Pursuing the second scenario, which incorporates spending towards the Goals with structural development policies aimed at promoting a green and diversified economy, would offer further socioeconomic and environmental benefits. The government debt level, however, would remain high. Under the

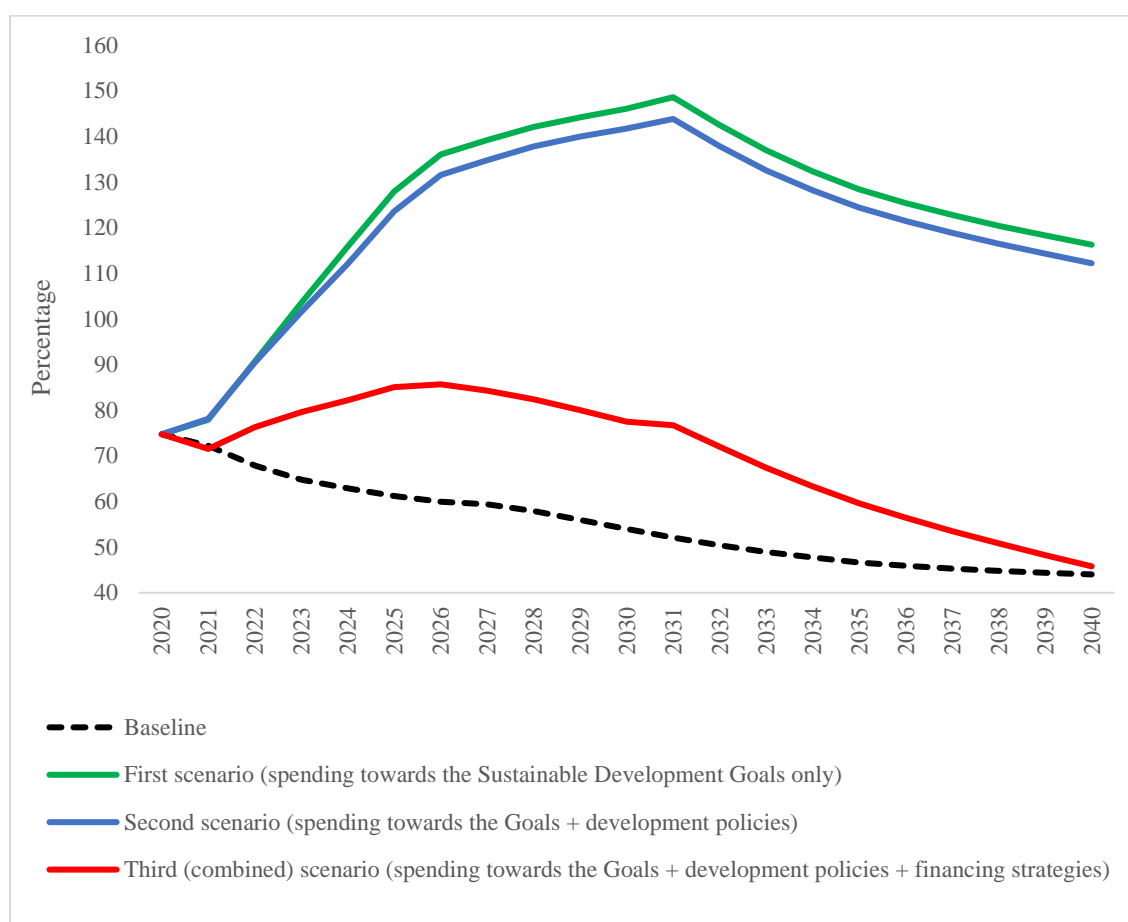
second scenario, by 2040, the level of output would be expected to be about 20 per cent higher than the baseline scenario. This would help to cut the poverty ratio (based on the \$5.50 per day threshold) from almost 29 per cent in 2020 to about 8 per cent by 2030. A lower incidence of poverty and the provision of targeted policy supports for the livestock industry would also help to reduce income inequality. By 2030, carbon emissions would be about 20 per cent lower compared with the baseline scenario. From a fiscal perspective, policy measures under the second scenario would help to reduce government health-care spending, although international trade tax revenue would decrease. As a result, the government debt-to-GDP ratio would be expected to reach 112 per cent by 2040, which is only about 4 percentage points lower than the figure under the first scenario. This suggests that, while pursuing structural development policies would help to relieve public indebtedness to some degree, a well-designed Goal financing strategy is also needed to reduce government debt in Mongolia.

24. Policy measures to support fiscal resources can reduce government debt level, notably in the long run. In a third scenario, which combines investing in the Goals, structural development policies and policy measures to enhance the fiscal space, a fiscal deficit-to-GDP ratio of about 8 per cent by 2030 would be expected, compared with about 15 per cent under the second scenario. When investment in the Goals is reduced in the period from 2030 to 2040, the fiscal deficit ratio would decrease further, to less than 3 per cent by 2040. As a result, government debt-to-GDP would diminish, reaching 60 per cent by 2040, owing to higher tax revenues, fiscal savings and lower financing costs amid lower fiscal risks.

25. Reorienting private finance towards development projects further relieves fiscal pressure. If the business sector were to increase its contribution to the country's spending towards the Goals in the social, infrastructure and environmental sectors, the fiscal deficit-to-GDP ratio of Mongolia over the period 2021–2040 would be, on average, about 4 percentage points below the level expected under the second scenario. This is due not only to lower government spending but also to larger output gains as it is assumed that private investment has greater positive impacts than public investment does on economy-wide productivity and energy efficiency gains.

26. In the long run, a mix of public and private financing policies can help to reduce government debt to the same level as the baseline scenario, but with greater benefits to people and the environment. Under the third (combined) scenario, the government debt-to-GDP ratio would be expected to fall to about 46 per cent by 2040 (see figure II), which is much lower than the 112 per cent expected under the second scenario. Indeed, the government debt-to-GDP ratio under the third 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 with regard to pursuing fiscal consolidation in the short term.

Figure II
Estimated government debt-to-GDP ratio in Mongolia under different policy scenarios



27. While levels of government debt under the third (combined) and second scenarios eventually converge after 20 years, the trajectories would be different. Under the baseline scenario, the government debt level is projected to fall steadily over the period 2022–2040 amid fiscal consolidation. In contrast, under the third (combined) scenario, it would rise for several years owing to investment in the Sustainable Development Goals; however, the debt level would subsequently diminish as socioeconomic and environmental benefits gained momentum. Relative to the baseline scenario, the annual output level under the third (combined) scenario could be up to 24 per cent higher in a given year, while carbon emissions and air pollution would be about 18 per cent and 12 per cent lower, respectively. The poverty ratio would also be almost 3 percentage points lower in the combined scenario, which is significant, considering that the poverty ratio by 2030 is estimated to be about 11 per cent.

28. Given the reliance of Mongolia on mineral activities, its economy and public debt sustainability would be dampened by a global transition towards clean energy. If global coal demand and prices were to fall by 30 per cent and 10 per cent, respectively, the government debt-to-GDP ratio would reach 89 per cent in 2030 compared with 78 per cent under the third (combined) scenario. Moreover, a sudden, large depreciation in the national currency and the realization of major fiscal contingent liabilities could also result in a much higher government debt level.

V. Policy relevance for other countries

29. The pilot analysis for Mongolia contains three evidence-based policy implications that are of relevance for all countries. First, 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.

30. Similarly, any attempt to meet the statutory fiscal rules should be mindful of the broader economic situation and development context. For instance, while strict fiscal rules that cap the size of the fiscal deficit can help to control government debt, they may require a steep increase in corporate and personal income tax rates, which could increase poverty rates significantly. Indeed, although a prevailing government debt level might satisfy the fiscal rules or stay below the common threshold suggested by international financial institutions, if it comes at a significant human or environmental cost, it should not be regarded as sustainable debt.

31. Another consideration is that international financial institutions and credit rating agencies can play an important role in supporting debtor countries in navigating such a balancing act. As entities that conduct assessments on short- to medium-term public debt sustainability, international financial institutions and credit rating agencies 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 automatically trigger a sovereign credit downgrade, even if the plan would lead to larger fiscal deficits in the near term. Instead, an assessment should go beyond gauging the ability of the Government to maintain debt repayment in the near term by evaluating whether such a fiscal plan would help to boost an economy's potential output and reduce government debt in the future. Likewise, credit rating agencies should view a government effort to engage in debt relief as a way to help ease a debt burden and improve the fiscal outlook, rather than as a sign of a forthcoming debt default that might trigger a rating downgrade.

32. Furthermore, all current creditors and potential lenders should consider public debt sustainability analyses from both a short- and a long-term perspective when making lending and investment decisions. When the risk of public debt distress is judged solely by a debt assessment that (a) only covers the short term and (b) does not adequately consider available Sustainable Development Goal financing options and the socioeconomic and environmental gains of Goal investments, the level of risk may be overestimated. This is harmful to debtor countries because they would be unnecessarily subjected to higher borrowing costs and reduced access to international financial markets. As prospects of debt refinancing become expensive and limited, fears of debt default grow, 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.

VI. Issues for consideration by the Committee

33. In the present document, the secretariat has presented a new, long-term approach to assessing public debt sustainability that duly considers a country's Sustainable Development Goal investment needs and financing strategies, as well as its structural development policies. The approach augments conventional public debt sustainability analyses, which are focused on the short term. By illustrating different trajectories of government debt levels under different policy scenarios and taking adverse shocks into consideration, the analysis is aimed at helping policymakers to 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.

34. The Committee is invited to review and discuss the policy issues regarding the new, long-term public debt sustainability assessment approach set out in the present document, in the context of increasing investments in the Sustainable Development Goals. The Committee is encouraged to share country-specific experiences and initiatives and to provide feedback and guidance on these issues to help the secretariat in its forthcoming analytical work and technical assistance.
