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Policy brief

DEBT RELIEF FOR SUSTAINABLE RECOVERY IN LOW- AND MIDDLE-INCOME COUNTRIES: PROPOSAL FOR NEW FUNDING MECHANISMS TO COMPLEMENT THE DSSI

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ABSTRACT

Whilst the COVID-19 pandemic continues its successive waves worldwide and amidst the uncertainty about the timing and the effectiveness of the vaccine coupled with virus mutation, continuous lockdowns and social distancing measures, countries and particularly low-income countries (LICs) and lower-middle-income countries *(*LMICs) will continue borrowing and pushing debt levels to further heights to alleviate the social cost of the pandemic and to jump-start the recovery phase. The costs will be dire for countries that will have to restructure or default on their sovereign debts. The recovery of these countries must be aligned with the 2030 Agenda for Sustainable Development. We propose a **public-private financing fund/plan,** as part of global economic recovery plan post-COVID-19, fully aligned with the 2030 Agenda, to complement the Debt Service Suspension Initiative (DSSI) that should be extended to LICs and LMICs. This mechanism can be used to restructure the existing piles of sovereign debt and interest and to finance a sustainable recovery. The mechanism would reduce uncertainty, economic hardship and sovereign debt opaqueness. Further, it would facilitate private-sector involvement in large restructurings and participation in coordinated debt relief and post-COVID-19 recovery efforts aligned with the 2030 Agenda, while fully committing to sovereign debt transparency and monitoring and placing these countries in a post-COVID-19 recovery and sustainable path for development.

CHALLENGE

DEBT UNSUSTAINABILITY AND DEBT RELIEF VIA DSSI DURING THE COVID-19 PANDEMIC

In 2019, well before the COVID-19 crisis, global sovereign debt had increased sharply. According to the IMF GFS Report (IMF, 2019), the median external debt in emerging markets economies rose to 160 per cent of exports (the highest was up to 300 per cent) as compared to 100 per cent in 2008. This development was largely due to prolonged accommodative monetary policies in developed countries, the growing role of emerging countries in financing low-income countries (LICs) and lower-middle-income countries *(*LMICs), and growing capital flows to emerging markets and other LICs, which have supported additional borrowing from a large spectrum of official and non-official sector lenders. International financial institutions, the Club of Paris and other creditor countries such as China, and the private sector had all increased their lending to LICs and LMICs. Debt repayment was rapidly limiting the fiscal space of these countries.[1]

By 2020 it had become clear that debt service in LICs was a structural issue (G20, 2020a). Some African economies have already shown that the magnitude of the economic shocks they suffer from is very significant, including sharply reduced economic output and a severe reduction in income from migrant worker remittances. Initiatives multiplied to alleviate the burden of interest repayments, particularly in Africa (G20, 2020a).

The COVID-19 pandemic has exacerbated the situation by accelerating debt distress. According to the IMF (2020b), debt levels have now reached unprecedented highs. Compared to end-2019, debt ratios are projected to increase by 20 per cent of GDP in advanced economies, 10 per cent of GDP in emerging market economies and about 7 per cent in low-income countries.

Rising external debt in advanced economies, with their relatively greater capacity to borrow thanks to low interest rates and risk, can turn risky in the upcoming years, placing further strain on future generations. But this increase in debt in emerging economies and LICs, with their reduced capacity to carry and service additional debt, has resulted in increasing vulnerabilities, upping the probability of default and ensuing risks to economic growth and financial system stability.

As part of a number of initiatives to mitigate the consequences of the COVID-19 pandemic, the G20 issued a communiqué[2] in April 2020 to address debt vulnerability in the poorest countries by freeing up some fiscal space to combat the health crisis. A Debt Service Suspension Initiative (DSSI) was endorsed by the World Bank's Development Committee and the G20 Finance Ministers to respond to a call by the World Bank and the International Monetary Fund (IMF) to grant bilateral debt-service suspension to the poorest countries, in order to mitigate and manage the severe consequences of the COVID-19 pandemic until the end of 2020 (World Bank, 2021). The main objective of the DSSI is to allow poor countries to allocate their resources towards health and social spending in order to fight the pandemic and to save the lives and livelihoods of millions of vulnerable people.

Implementation of the DSSI was accompanied by the monitoring of spending, promoting public debt transparency and ensuring prudent borrowing, mainly through a commitment to limit non-concessional borrowing, as supported by ceilings within the IMF programmes and the World Bank's non-concessional borrowing policies. As of late August 2020, 43 countries had participated in the DSSI and benefited from an estimated USD 5 billion in debt service suspension from official bilateral creditors. On 14 October 2020, the G20 and Paris Club members[3] agreed to extend the DSSI for another six months (from 1 January 2021 to the end of June 2021). In 2021, further extension was granted till end-December 2021 and a more comprehensive framework called "the Common Framework for Debt Treatment beyond the DSSI" was agreed between the G20 and Paris Club countries to co-ordinate and cooperate on debt treatments for up to 73-low income countries that are eligible for the DSSI (World Bank, 2021). The debt treatments under the Common Framework are initiated at the request of a debtor country on a case-by-case basis. The framework intends to ensure broad participation of creditors with fair burden sharing. Importantly, it includes not only members of the Paris Club but also G20 official bilateral creditors such as China, India, Turkey or Saudi Arabia that are not members of the Paris Club.

The pandemic is causing severe economic stress for these countries, overwhelming weak health systems, heavily impacting their fiscal positions and exacerbating an already challenging public debt situation, while increasing the risk of social unrest and fragility.[4] Financing from the IMF, the World Bank Group and Multilateral Development Banks alone will not be sufficient to enable these countries to manage the severe health, economic and social impacts of the pandemic. In this context, the DSSI plays an important role to help eligible countries meet their increased needs for financing to respond effectively to the crisis. The DSSI is being implemented as many developing countries face major adverse spillovers from the impact of the pandemic on the global economy. The global economic impacts of the pandemic are channelled to DSSI-eligible countries via lower exports and commodity prices, especially oil prices, and through tourism (almost one-third of countries are heavily dependent on tourism, and flight arrivals have dropped by more than 75 per cent). The COVID-19 pandemic is crippling the economies of rich and poor countries alike. Yet for many low-income and fragile states, the economic shock will be magnified by the loss of remittances – money sent home by migrant and guest workers employed in foreign countries. The pandemic will deliver a blow to remittance flows that may be even worse than during the financial crisis of 2008, and it will come just as poor countries are grappling with the impact of COVID-19 on their own economies. Migrant workers who lose their employment are likely to reduce remittances to their families back home. Recipient countries will lose an important source of income and tax revenue just when they need it most (Abdih et al., 2012). In fact, according to the World Bank[5], remittance flows are expected to drop by about $100 billion in 2020, which represents roughly a 20 per cent drop from their 2019 level. Fiscal and trade balances would be affected, and countries' ability to finance and service their debt would be reduced. Overall, the economies of DSSI-eligible countries are expected to contract by about 2.8 per cent in 2020 according to the latest WEO projections, compared with average growth of 3.6 per cent in the previous five years. Importantly, a permanent loss of productive capacity, or "scarring", is expected, with a drawn-out recovery rather than a rapid rebound. The world's poorest have been hit especially hard by the pandemic. World Bank estimates indicate that the crisis could push 100 million people into extreme poverty, with about one-third of the new poor expected in Sub-Saharan Africa. As a result, 2020 marks the first net rise in global poverty in more than 20 years, with large increases in Internal Development Association-eligible and fragile countries. Poverty outcomes could further worsen in the absence of measures to protect the poorest and most vulnerable, limit increases in inequality and alleviate a more prolonged impact of the COVID-19 pandemic. It is expected that the development challenges will deepen and become even more severe over the next year (World Bank, 2020).

PROPOSAL

COMPLEMENTING THE DSSI WITH A PRIVATE-PUBLIC FUNDING MECHANISM FOR SUSTAINABLE RECOVERY

There have been calls by the official sector and others for private sector involvement in the DSSI. However, rescheduling debt service on DSSI-comparable terms would result in losses to a diverse base of private creditors because of widening risks at the time of distress. In May 2020, the Institute of International Finance (IIF) issued a framework for voluntary participation in the DSSI, which included a toolkit for DSSI-eligible sovereign borrowers that request forbearance from their private creditors (IIF, 2020). The initiative was perceived to be "net-present value (NPV) neutral" and was marketed as such: namely, there would be no reduction in the nominal amount of the debt principal or interest and the contractual rate of interest would be paid on deferred amounts. Since its publication, this framework has not been used by either the creditors or the debtors concerned due to the lack of incentives from both sides. From the creditors' side, rescheduling debt service on comparable terms, using the NPV neutrality principle, would have implied extended maturities at below market interest rates. From the debtors' side, there was a concern of downgrades, loss of market access and, potentially, other legal complex ramifications that would have dire economic and social consequences. Further feedback on the Common Framework was published by the IIF in April 2021, mainly requesting to build a meaningful and regular public-private sector dialogue and consultation on its implementation, the importance of a case-by-case approach, assessment of debt sustainability and preserving market access and new financing; taking the right steps to improve the sovereign debt restructuring process; promoting transparency around all types of sovereign obligations for all creditors; and supporting green sustainable capital flows to emerging and developing economies (IIF, 2021).

What further drives sovereign debt default complexity is the absence of a credible International sovereign bankruptcy mechanism, and generally the market has relied on a contractual approach for resolution – mainly with the use of Collective Action Clauses (CACs). However, as emphasised by the 2020 IMF paper that evaluated the international architecture for resolving sovereign debt involving private-sector creditors, several sovereign debt restructurings in LICs prove to be unnecessarily protracted, incomplete and non-transparent (IMF, 2020c). The same IMF paper highlighted the urgent need to reform international debt architecture. The IMF's reform proposal is centred on the expansion of the CAC mechanism to all newly issued debt, the wider use of targeted anti-vulture fund legislation, more involvement of the IMF in debt restructurings and enhancement of debt transparency and debt management.

Whilst the COVID-19 pandemic continues its successive waves worldwide, countries are expected to continue borrowing and pushing debt levels globally to further heights as the only way to, firstly, alleviate the social cost of the pandemic and, secondly, to jump-start the recovery phase. In the absence of a comprehensive resolution framework, a COVID-19-related systemic debt crisis is neither very far off nor likely to be effectively managed. The costs will be dire for countries that will have to restructure or default on their debts. A recent paper shows that post-default restructurings are associated with larger declines in

GDP, investment, private sector credit and capital inflows than pre-emptive restructurings (Asanuma et al., 2020).

At this juncture and while the uncertainty of the COVID-19 pandemic is looming amidst unequal global access to vaccines, there must be further financial firepower to meet the LIC and LMIC debt servicing needs, while establishing a transparent debt tracker to monitor the use of borrowed funds under this facility.

Our proposal is to complement the DSSI with **a public-private recovery fund/plan – hereafter the recovery plan (RP),** as part of the global economic recovery plan post-COVID-19. This mechanism can be used to restructure the existing piles of debt and interest and to finance a sustainable recovery in line with the 2030 Agenda.

This fund/financing plan could take the form of a partial guarantee (between 40 per cent and 60 per cent) issued by the International Monetary Fund (IMF) and the World Bank Group (WBG), using their leverage capability via the special drawing rights system and including other development aid providers (e.g., the EU and others) or a newly set-up fund under the auspices of the G20 supported by the IMF/WBG[6] and other donors (e.g., the European Union and other bilateral donors) who wish to participate to support LICs and LMICs by issuing long-term maturity (up to 50 years) COVID-19 Recovery Bonds (CR Bonds) in line with the key indicators of the SDGs of the United Nations and complying with full transparency principles, with lower interest rates (no more than 1 per cent based on current rate levels on the USD). Such an effort would exceptionally transform the existing unpaid debt of developing countries and help finance their post-COVID-19 recovery plans. The private sector (e.g., IIF) members) would contribute with a firm written commitment to provide affordable liquidity for these countries within a period of time. The countries issuing CR Bonds must justify they are using resources for sustainable recovery post-COVID-19 and must fully comply with the SDGs.

To design the plan, the G20 is recommended to call on the relevant Taskforce to work on key details (such as eligibility criteria, size, structure and implementation roadmap) in close consultation with public and private stakeholders. Countries that have accessed the DSSI and are willing to fund their post-COVID-19 recovery sustainably and access to the capital markets under these conditions should comply with the terms of the plan. In the long run, this plan will allow more countries to access capital markets and will enhance the transparency of the productive use of funds and hence would reduce the incidence of corruption, enhance accountability and improve public governance. International financial institutions such as the World Bank already have experience in using partial guarantee to facilitate the financial access of countries to the capital markets (World Bank, 2015). This proposed plan will build on these experiences with a specific objective of accelerating a sustainable post-pandemic recovery, while establishing a systematic monitoring mechanism to track the use of funds, via establishing a systematic external audit and complementing it with targeted capacity-building tools to achieve better debt management and adequate use of funds for sustainable development. Such a funding plan would encourage investors to step in with the necessary affordable liquidity for countries that need to strengthen their essential infrastructure and whose budgets are weakened by COVID-19-related disruptions.

Focusing on African countries and considering that their cost of borrowing is much higher than for other countries due to perceived risks mainly driven by the lack of transparency, operational backlogs/inefficiencies and shallow local financial infrastructure, this financing plan can go hand in hand with a recent proposal by UNECA (March 2021). The UNECA proposal is articulated around the Liquidity and Sustainability Facility (LSF). The LSF is suggested to be set up as a special purpose lending vehicle designed to support LIC and LMIC sovereigns in advancing sustainable development initiatives and, more immediately, facilitate access to liquidity, lending and investment in these countries, leveraging a wider use of special drawing rights (UNECA, 2021). While the developed countries have long enjoyed the existence of large "repo" (repurchase) markets for their government bonds, facilitating access for a wide range of investors and the creation of stable and additional funding sources, the LSF will replicate this dynamic for LIC and LMIC market sovereign bonds, providing investors with competitive funding through repurchase agreements. The proposed recovery funding plan and the LSF (which might have a wider scope than the recovery financing plan for the DSSI countries) will provide the participating countries the much needed financial dynamic that will allow them to access cheaper funds and more liquidity, which is essential to build greater depth in frontier debt markets.

The countries accessing both or either funding/liquidity mechanism must be committed to full transparency on previous and future sovereign debt and use of proceeds from this bond, and this will have to be monitored, audited by the IMF and WBG and reported to the public to enhance accountability. In line with the proposal[7] in Ayadi and Avgouleas 's (2020) to credibly enhance transparency in the debt markets particularly for LICs and LMICs, it is important to accelerate the set-up of a sovereign debt registration repository that would be publicly accessible following re-authorisation, and would complement the efforts of international organisations. The paper recommended the repository to be powered by blockchain technology, where all bilateral, multilateral and private-sector players can register sovereign debt transactions. It will help reduce information asymmetries, deal with the moral hazard of large-scale debt forgiveness programmes, and aid sovereign debt restructuring for LICs and LMICs from a legal and practical viewpoint. This will bring order to sovereign debt restructuring and resolution, and will make the process less costly and less time-consuming. It will reduce uncertainty and opaqueness and will facilitate private-sector involvement in large restructurings and participation in coordinated debt relief efforts. For the authorities and those who manage the restructuring process, it will be easier to aggregate investors in different bond issues and limbs per bond issue, and thereby manage the process more effectively once they have the full picture, in terms of the size of the debt and the nature of the investors. It will also be easier to monitor the implementation of Collective Action Clauses, creditor ranking and subordination arrangements across the spectrum of a country's issued debt, as well as contingent claims such as sovereign guarantees. In 2021, the OECD launched the debt transparency initiative to enhance debt transparency for LICs (OECD, 2021). This is a step in the right direction but more needs to be done to ensure that all creditors and debtors in both LICs and LMICs would engage and register debt data with a verification mechanism. Debt transparency is a prerequisite for the screening and monitoring of the use of debt proceeds, particularly for uses that are compliant with SDGs. With the establishment of the proposed recovery fund and LSF, and to accelerate the Paris Agreement targets and more generally the SDGs, in the absence of sufficient data mapping SDGs investments and budgetary classifications, we recommend for the G20 to request the IMF and OECD in collaboration with the UN's Classification of the Functions of Government to develop a standardised approach between budget codes and SDGs. This will accelerate the transition towards the objectives of the 2030 Sustainable Development Agenda.[8]

To conclude, this paper proposes to complement the DSSI with a private-public recovery plan that would support the DSSI-eligible countries to embark on a sustainable post-COVID-19 recovery, while also being complementary to other proposals such as the LSF put forward by UNECA. One essential eligibility criterion to access the RP is to register the newly issued debt in a global registry that could be powered by a blockchain technology aimed ultimately at monitoring the use of proceeds and tracking their compliance with SDGs criteria.

ANNEX

HOW HAS THE DSS INITIATIVE BENEFITTED COUNTRIES?

As of 18 September 2020, 43 DSSI-eligible countries had formally requested to join the initiative, as confirmed by G20 creditors and information provided by beneficiary countries. This brings the participation rate of the 73 countries eligible for the DSSI to around 60 per cent. With the total debt service benefitting from suspension of US$5.0 billion, these 43 countries account for more than 75 per cent of potentially eligible official bilateral debt service under the DSSI for the period May to December 2020 based on World Bank estimates. As of 14 September 2020, the Paris Club had received 39 formal requests and had approved 31 Memoranda of Understanding.

2020 saw a record number of sovereign bond defaults from emerging markets and low-income countries, including Argentina, Belize, Ecuador, Lebanon, Zambia and Suriname. While COVID-19 was certainly an important contributing factor, in many of these cases the pandemic simply exacerbated pre-existing debt problems. Fortunately, debt strain has remained generally contained even for low-income countries, as the great majority continue to roll over their debt. We include below some details about Niger as a case in point.

NIGER[9]

The updated outlook for the Nigerien economy is close to the projections of October 2020. Real GDP growth for 2020 is estimated to be somewhat higher at 1.2 per cent, while activity this year is projected to increase by 6.9 per cent, driven by the removal of containment measures, acceleration of the implementation of large-scale projects and the reopening of the border with Nigeria. This compares to pre-pandemic projections of 6.0 per cent for 2020 and 5.6 per cent for 2021. Niger's limited exposure to international value chains and a large informal agricultural sector afford a degree of protection. The COVID-19 crisis adds to numerous pressing challenges – including the security crisis across the Sahel, climate change and the recent massive floods – thus worsening the incidence of poverty in the country with one of the lowest Human Development Index rankings in the world. Budgetary savings in non-priority areas and stepped-up budget support notwithstanding, the fiscal deficit is set to widen in 2020 and 2021 from pre-pandemic projections of 2.7 and 1.9 per cent of GDP, respectively, to 5.8 and 4.4 per cent of GDP. This reflects revenue shortfalls related to the economic slowdown and difficulties in collecting taxes under pandemic conditions. The current account deficit is estimated at 13.3 per cent of GDP in 2020 and projected at 16.7 per cent in 2021, below pre-pandemic projections, due to lower imports stemming from delays in large-scale projects. However, external financing needs will remain high in the short-to-medium term, reflecting the difficult fiscal situation. In terms of public health and macroeconomic policy response, most containment and restriction measures adopted early after the outbreak of the pandemic in the context of declaration of a state of emergency were gradually lifted from mid-May to August 2020. Only the closure of land borders and the obligation to wear masks in public remain in place. With the resurgence of new cases, the authorities decided on 5 January 5 2021 to extend the state of emergency for a further period of three months, and renewed the measure to close entertainment venues. Overall, the government devised a comprehensive response plan to tackle the health, social and economic aspects of the COVID-19 pandemic. Niger has made progress in recent years with strengthening its governance framework more generally, including the establishment and strengthening of the anti-corruption agency, Haute Autorité de Lutte contre la Corruption et les Infractions Assimilées. A judicial process is currently investigating alleged procurement irregularities at the Ministry of Defence, and the government has committed to undertake all necessary measures to review and strengthen procurement procedures once the process is complete.

NOTES

[1] This assessment has been confirmed and countries belonging to this category were recommended to implement countercyclical fiscal buffers to withstand shocks. See IMF (2020a).

[2] http://www.g20.utoronto.ca/2020/2020-g20-finance-0415.html.

[3] The 22 members of the Paris Club are: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, Korea, the Netherlands, Norway, the Russian Federation, Spain, Sweden, Switzerland, the United Kingdom and the United States of America.

[4] Public debt vulnerabilities in lower-income countries before the onset of the pandemic were analysed in IMF and World Bank (2020).

[5] https://www.worldbank.org/en/news/press-release/2020/04/22/world-bank-predicts-sharpest-decline-of-remittances-in-recent-history.

[6] The set-up of a new fund and the negotiation of its design, co-founders and funding will take more time.

[7] A pilot platform was developed in 2020 by the Euro-Mediterranean Economists Association to collect debt transactions data and to accelerate research on the topic (Debt Transparency Platform, 2021).

[8] This is also in line with the UN's adoption of ecosystem accounting, see System of Environmental Economic Accounting (2021).

[9] Most recent Staff Report and DSA: https://www.imf.org/en/Publications/CR/Issues/2020/11/03/Niger-Sixth-ReviewUnder-the-Extended-Credit-Facility-and-Request-for-Waiver-for-49862.

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