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TRADE AND DEVELOPMENT REPORT UPDATE

From the Great Lockdown to the Great Meltdown:

Developing Country Debt in the Time of Covid-19

EMBARGO

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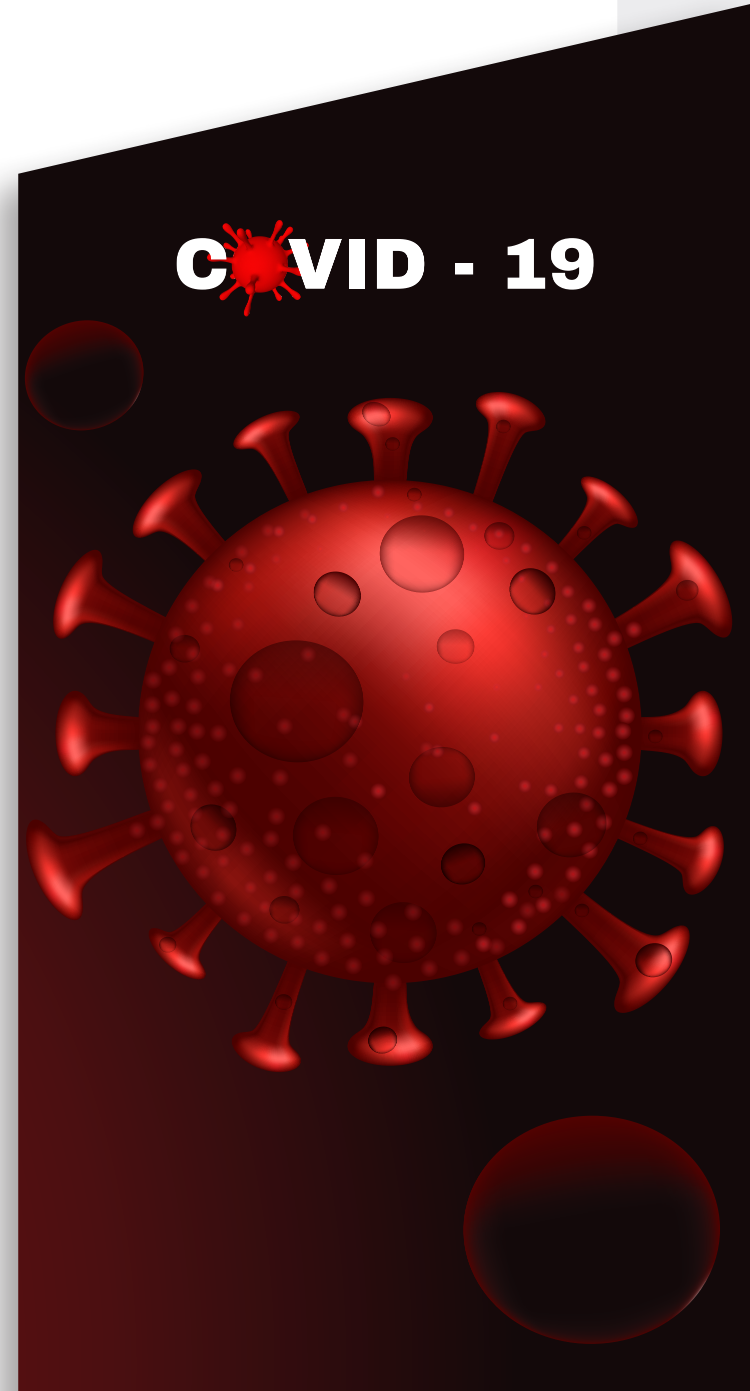

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Introduction

The Covid-19 shock is posing unprecedented challenges to advanced country governments. As most have come to recognize, the economic crisis entailed by the pandemic is unique in that it combines a deep supply shock - arising from wide-ranging and prolonged lockdowns of entire economies – with consequent demand shocks – arising from a collapse in corporate investment plans, retrenchment of household spending, rapidly increasing unemployment and patchy social welfare systems reduced to their bare bones after decades of rentier capitalism – as well as radical uncertainty and heightened fragility in financial markets. As a consequence, policy makers have focused on the provision of massive stabilisation packages, designed to flatten both, the contagion curve of the pandemic as well as the curve of economic meltdown and financial panic, through a raft of cash transfers, credit lines and guarantees from governments to households and firms. Doing so depends on the ability of governments to borrow from their central banks – or for central banks to revert to their original role as bankers to their governments[1] – on the required scale, a concept often referred to as 'fiscal space'. How to deal with this necessary accumulation of government debt in response to the crisis, and in particular, how to avoid the mistake of turning to austerity to make adjustments once the crisis has passed, is already beginning to tax the minds of policymakers in the advanced economies.[2]

If the challenges are huge in advanced economies, they are enormously more daunting in developing economies. While advanced country governments struggle to revamp administrative and regulatory frameworks and to break ideological taboos, developing countries cannot easily flatten the contagion curve by closing down their largely informal economies without facing the prospect of more people dying from starvation than from the Covid-19 illness. Moreover, even the most advanced high-income developing countries with relatively deep financial and banking systems do not have anywhere near the fiscal space that advanced economies can, in principle, unlock.

The vast majority of developing countries are heavily reliant on access to the 'hard currencies' of advanced countries – earned primarily through commodity and service exports, such as food, oil and tourism, and received through remittances from their diasporas as well as from access to concessional and market-based borrowing –to pay for imports and to meet external debt obligations. Their central banks cannot act as lenders of last resort to their governments at the required scale without risking catastrophic depreciations of their local against hard currencies, and therefore also steep increases in the value of their foreign-currency denominated debt as well as unleashing, potentially, destructive inflationary pressures.

This situation is all the more critical where developing countries already face high debt burdens. The Covid-19 shock has put a glaring spotlight on the difficulties arising from high and rising developing country indebtedness since it is set to turn what was already a dire situation into serial sovereign defaults across the developing world. It has, therefore, turbo charged the need to move from discussion to action on debt matters in developing countries.

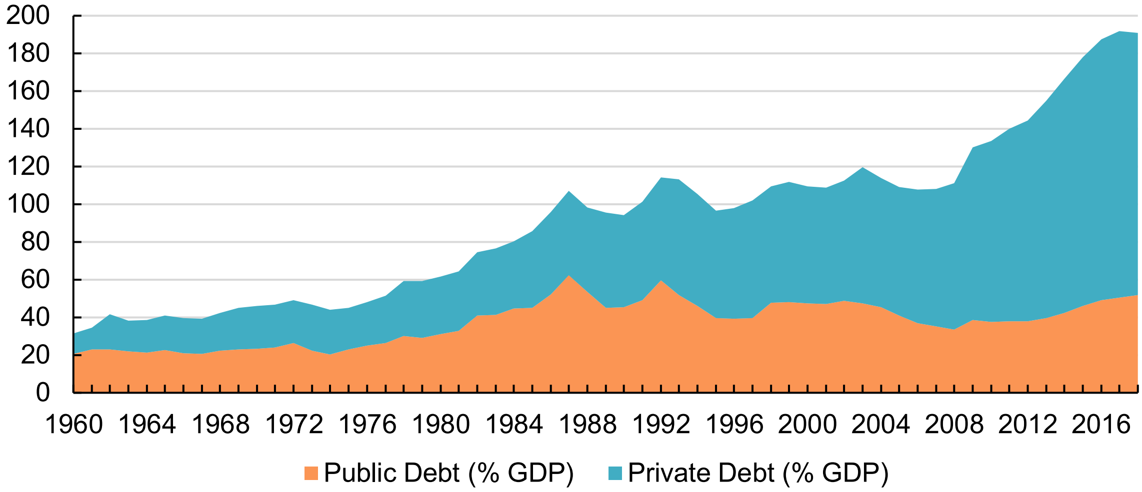
Following a brief discussion of current debt vulnerabilities in developing countries, this update of UNCTAD's Trade and Development Report 2019 lays out a series of steps that the international community will need to take if there is to be any hope of salvaging the Agenda 2030 and moving to a more resilient and sustainable future for all countries.

[1] See S Kapoor and W. Buiter (2020) To fight the COVID pandemic, policymakers must move fast and break taboos, Vox Cepr Policy Portal, 6th April.
[2] See Emma Dawson (2020) We do not have to worry about paying off the coronavirus debt for generations, The Guardian, 22nd April.

Developing country debt pre-Covid-19: Rising vulnerabilities and a looming wall of debt repayments

Covid-19 hits developing economies at a time when they had already been struggling with unsustainable debt burdens for many years.

Figure 1 **Total Debt Stocks, all developing countries, 1960–2018**
(Percentage of GDP)



Source: UNCTAD secretariat calculations based on IMF Global Debt Database.

As Figure 1 shows, at end-2018[3] the total debt stocks of developing countries – external and domestic, private and public – stood at 191 per cent (or almost double) their combined GDP, the highest level on record. A developing country debt crisis, already under way prior to the Covid-19 shock, had many facets[4], but two are worthwhile putting upfront in the context of ongoing debates about debt relief for the developing world in the aftermath of the Covid-19 shock. First, the unfolding debt crisis was not limited to the poorest of developing countries but affected developing economies of all income categories.[5] Second, it has, by and large, not been caused by economic mismanagement at home, but by economic and financial mismanagement at the global level. Over the past decade, developing countries have witnessed a rapid and often premature integration into heavily underregulated international financial markets, including the so-called shadow-banking sectors, estimated to be in control of around half of the world's financial assets. [6]

In this context, developing countries became highly vulnerable to massive but volatile flows of high-risk yet relatively cheap short-term private credit, on offer from financial speculators in search of higher yields on their investments than available to them in the near-zero interest monetary policy environment

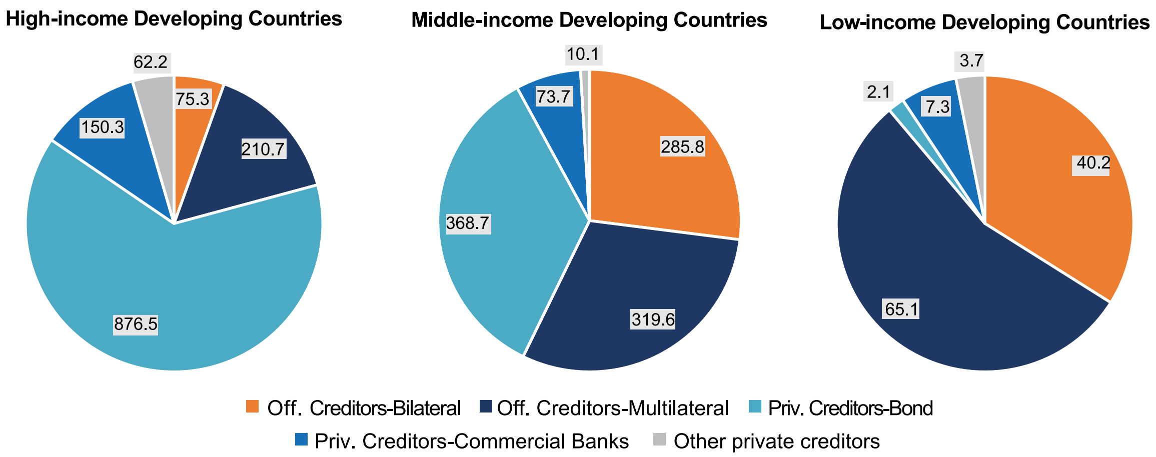
[3] Last date for which this data is available at present.
[4] For more detail, see UNCTAD Trade and Development Report 2019: Financing a Global Green New Deal, chapter IV: Making debt work for development. UN Publication, Geneva.
[5] See e.g. M. A. Kose, P. Nagle, F. Ohnsorge and N. Sugawara 2020. *Global Waves of Debt. Causes and Consequences.* World Bank Group. Washington DC, p. 12.
[6] Financial Stability Report (2019). *Global Monitoring Report on non-Bank financial intermediation 2018*, February.

of their advanced home countries. This 'push factor', and the volatility of private capital inflows in combination with wide open capital accounts, has affected developing countries *whether or not* they had so-called strong economic fundamentals, such as relatively low public debt, small budget deficits, low inflation rates and high reserve holdings.[7] An essential 'pull factor' leading developing countries to borrow at high risk in international financial markets was their dwindling access to concessional multilateral finance and a shift of Official Development Assistance (ODA) away from central budget support towards wider goals, such as climate change mitigation, migration management, good governance and post-conflict support, oftentimes determined by donor interests.

As a result, developing countries have seen a rapid build-up in private sector indebtedness, in particular since the Global Financial Crisis of 2008-09, accounting for 139 per cent of their combined GDP at end-2018 (see Figure 1). This trend has been most pronounced in high-income developing countries with relatively deeper domestic financial and banking sectors but has also and substantively affected middle- and low-income developing economies. It represents the largest contingent liability on public balance sheet in the event of a full-blown debt and financial crisis, not least in the shape of fledgling public-private partnerships, widely promoted throughout the developing world, but that may now quickly unravel in the wake of 'sudden stops' to their refinancing due to the Covid-19 crisis.

The fragility of developing country debt positions prior to the Covid-19 crisis was further increased by concomitant changes to the ownership and currency-denomination of their private and public debt. Thus, domestic bond markets were increasingly penetrated by non-resident investors and sovereign external debt held to a much larger extent than in previous episodes of developing country debt distress by private rather than official creditors, in particular in high- and middle-income developing economies (see Figure 2).

Figure 2 **Long-term public and publicly guaranteed external (PPG) debt by creditor, all developing countries, debt stocks at end 2018**
(Billions of current US dollars)

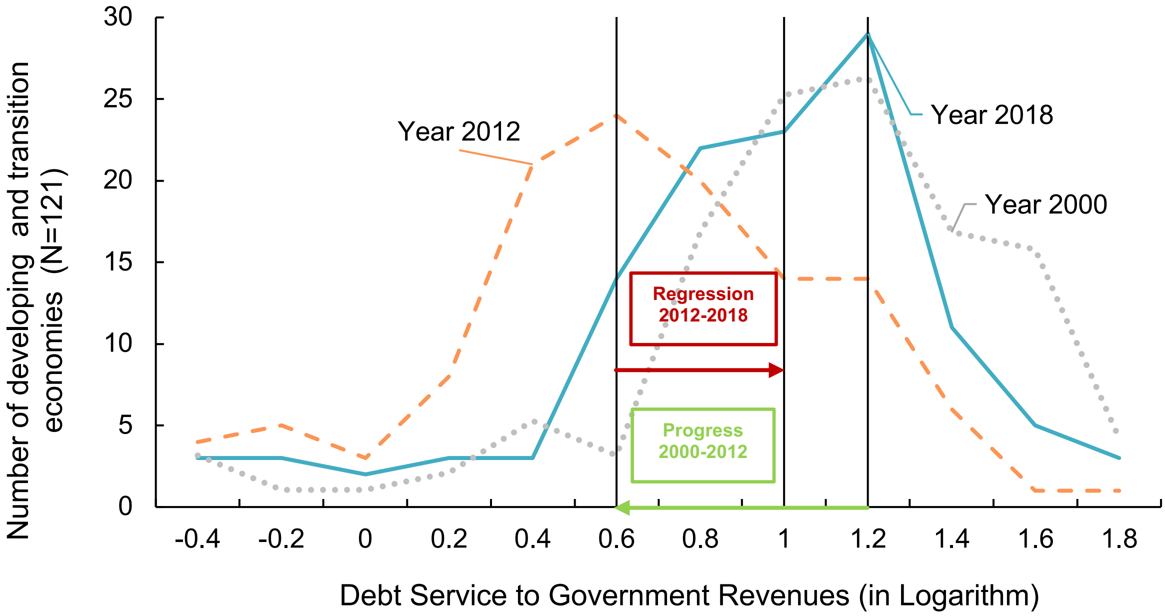


Source: UNCTAD secretariat calculations based on World Bank International Debt Statistics.

[7] See e.g. Eichengreen, B. et al. 2017. *Are capital flows fickle? Increasingly? And does the answer still depend on type?* World Bank Group Policy Research Working Paper 7972. February. Washington DC.; Eichengreen, B. and P. Gupta. 2016. *Managing Sudden Stops*. World Bank Group Policy Research Working Paper 7639. April. Washington DC.

In the wake of these developments, much of the higher-risk borrowing by sovereigns has been accompanied by rising debt servicing costs with a negative impact on the fiscal space of many countries, compounded by a slowdown in growth relative to the period before the Global Financial Crisis of 2008-09 as well as by commodity price slumps.

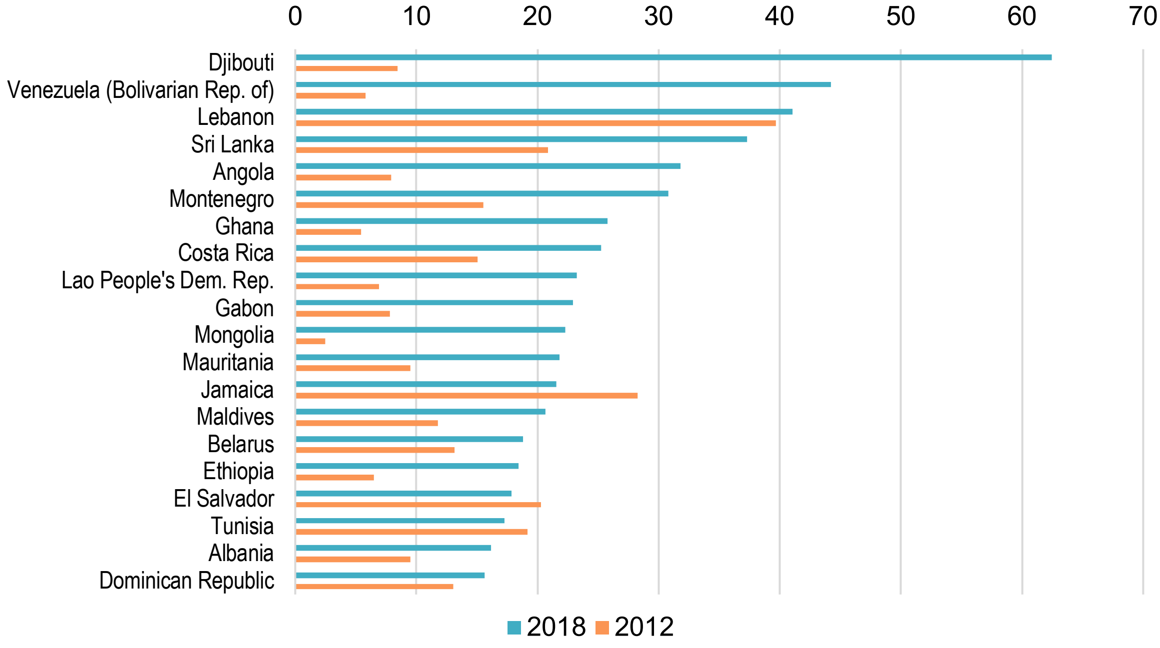
Figure 3 **Ratio of debt service on long-term public and publicly guaranteed external debt to government revenues, 2000, 2012 and 2018**
(in logarithm)



Source: UNCTAD secretariat calculations based on World Development Indicators (WDI), IMF World Economic Outlook (WEO), Economic Intelligence Unit database (EUI) and World Bank Quarterly External Debt Statistics (QEDS).

Figure 3 depicts the distribution of debt service burdens, as a share of government revenues, across developing countries in 2000, 2012 and 2018. While these had declined substantively between 2000 and 2012 (as indicated by the leftward shift of the distributions for 2000 to those for 2012 and by the fall in the distributions' median value depicted by the green arrow), this progress has largely been reversed since then (as indicated by the rightward shift of the distributions for 2012 to those of 2018 and the by increase in these distributions' median value depicted by the red arrow). Thus, servicing their external long-term public and publicly guaranteed debt cost developing country governments on average 6.5 per cent of their government revenues in 2012, but 10.3 per cent in 2018.

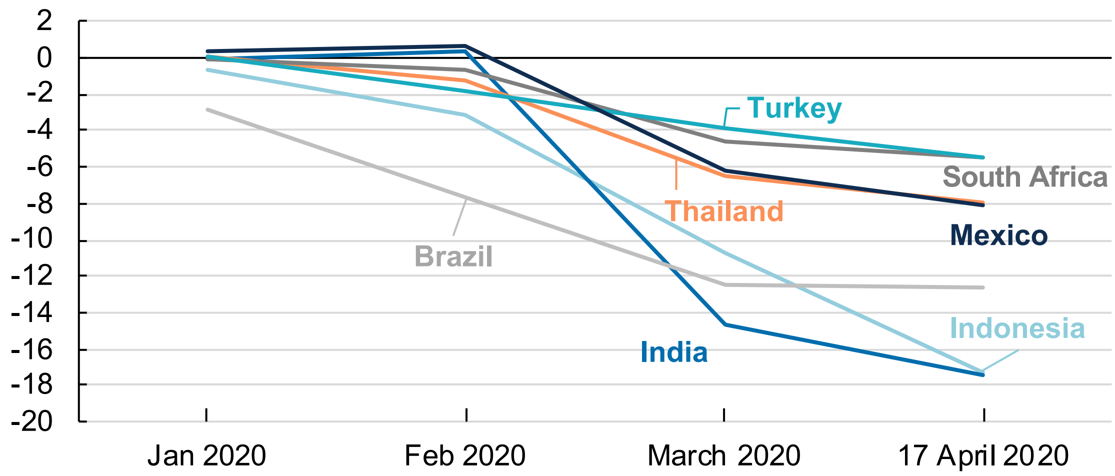
Figure 4 **Ratio of debt service on long-term public and publicly guaranteed external debt to government revenues, top 20 developing and transition economies in 2018 (%)**



Source: UNCTAD secretariat calculations based on *World Development Indicators* (WDI) and IMF *World Economic Outlook* (WEO).

However, the situation is much more severe in many developing countries where more than a quarter of revenues are absorbed by debt servicing (Figure 4). This includes a number of oil exporters, facing a particularly difficult moment given the collapse in oil prices, as well as middle-income economies that have witnessed a sharp outflow of portfolio capital since the start of the crisis (Figure 5).

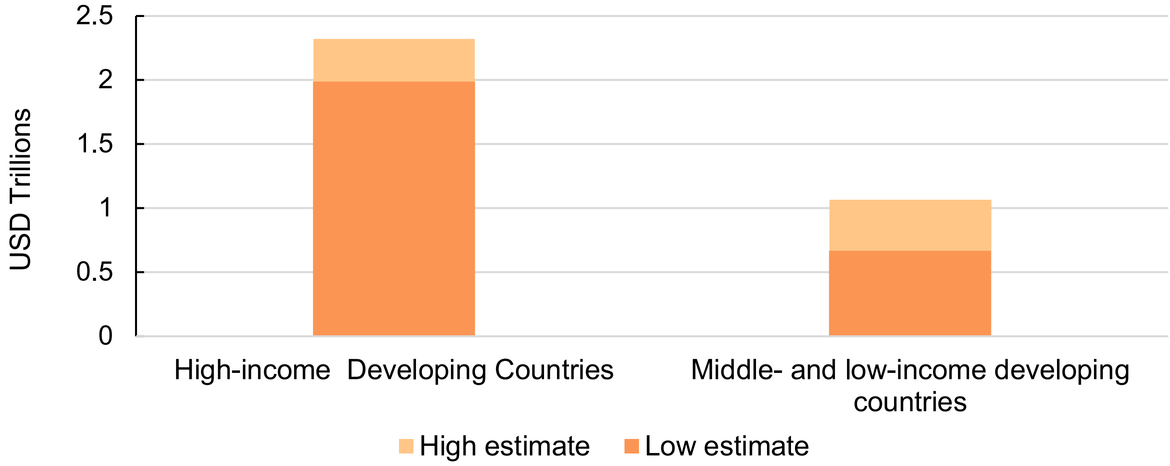
Figure 5 **Cumulative net non-resident portfolio capital outflows from selected developing countries, 24 January to 17 April,** (Billions of current US dollars)



Source: UNCTAD secretariat calculations based on IIF *Daily Emerging Market Portfolio* database.
Note: Data for Brazil includes equity flows only; and for Mexico and Turkey debt flows only.

Predictably, developing countries will be facing a wall of debt service repayments throughout the 2020s, and in the context of deeply distressed economic circumstances. In 2020 and 2021 alone, these amount to between $2 to $2.3 trillion in high-income developing countries, and to between $700 billion to $1.1 trillion in middle-and low-income countries (see Figure 6).[8]

Figure 6 **Redemption schedules for public external debt, all developing countries, 2020 and 2021**
(Trillions of current US dollars)



Source: UNCTAD secretariat calculations based on World Bank *QEDS and World Development Indicators* , IIF *Global Debt Monitor and* IMF *Global Debt Database.*
Note: Data refer to sovereign debt for HICs and to public external debt for MICs and LICs.

Charlie Brown goes to Washington: [9] The promise of relieving developing countries' debt burdens in response to the Covid-19 shock …

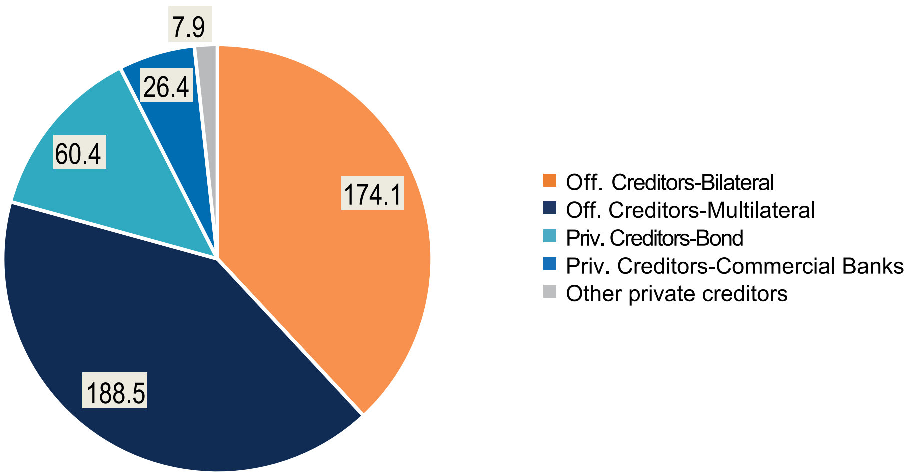
On 13 April, the IMF cancelled debt repayments due to it by the 25 poorest developing economies for the next six months. This debt cancellation is estimated to amount to around $215 million.[10] Moreover, on 15 April, G20 leaders announced their "Debt Service Suspension Initiative for Poorest Countries".[11] This suspension of debt service payments (including principals and interest) from 01 May to the end of 2020 applies to 73 primarily low-income developing countries that are either eligible to borrow from the International Development Association (IDA) or are classified as least developed countries (LDCs) by the United Nations (UN LDCs).[12] For now, the initiative applies to all official bilateral creditors, with calls on private creditors to join on comparable terms, and on multilateral banks to consider joining should such a step be compatible with maintaining their current high credit ratings and low-cost lending capacities. Qualifying developing countries must make a formal request for forbearance to their creditor

[8] The range estimates for redemption schedules for public external debt in 2020 and 2021 for all developing countries results from the combination of observed redemptions schedules for 44 developing countries, including major developing economies, and estimated redemptions for all others, considering their income group. Developing countries, especially within the same income group, show some degree of synchronization in their external debt redemption schedules, which is mostly shaped by the financial conditions prevailing in international financial markets. This explains why, as a whole, they periodically face "walls of maturity": the bonds and the loans that they contract in international markets often come to maturity in the same time period. The estimation therefore consists in applying the distribution of redemption schedules relatively to public debt stocks from the 44 observed countries. The low and high estimates refer to the lower and higher bounds of the distribution, respectively, defined as the 10th and 90th percentiles.
[9] Recalling one of the cartoon character Charlie Browns' best known comments "I have been repeating the same mistakes in life for so long now I may as well call them traditions"
[10] See e.g. https://jubileedebt.org.uk/press-release/reaction-to-215-million-of-debt-cancellation-by-imf
[11] G20 Finance Ministers and Central Bank Governors Meeting. Communiqué. 15 April 2020. Annex II, p. 12-13.
[12] Of the 76 IDA-eligible developing countries, 4 (Eritrea, Sudan, Syria and Zimbabwe) are excluded due to protracted non-accrual status. Of the UN LDCs, only Angola is not also an IDA-eligible country and therefore included.

countries and their eligibility for the initiative is conditional on a number of factors, including an active borrowing status with the IMF (or a request for financing from the IMF), the use of the temporarily freed-up resources for increased health and economic spending in response to the Covid-19 crisis, and full disclosure of all public sector debt obligations (with the exception of commercially sensitive information).

Current estimates suggest that this initiative covers around $20 billion of public debt owed to official bilateral creditors in the eligible countries in 2020. An additional $8 billions of such debt payments might be included, if all private creditors joined the initiative, and a further $12 billion if the same was the case for all multilateral creditors[13] However, this amounts to a relatively small part of the long term public and publicly guaranteed external debt stocks these countries had accumulated at the end of 2018, as Figure 7 shows.

Figure 7 **Long-term public and publicly guaranteed external (PPG) debt by creditor in developing countries benefiting from the G20 debt service payment suspension initiative, 2018**
(Billions of current US dollars)



Source: See Figure 2 above.

Initiatives such as these are welcome since they provide urgently needed fiscal “breathing space” to crisis-ridden developing countries, but they do not constitute debt relief of any kind. Quite the contrary, by linking eligibility to new or ongoing borrowing, even if on concessional terms, the initiative