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An Unprecedented Opportunity to Boost Finance for Development

The Upcoming Special Drawing Rights Allocation

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The IMF's upcoming Special Drawing Rights (SDR) allocation will provide urgently-needed liquidity for countries struggling to meet their crisis-related spending needs and boost resilience against global financial volatility. But, under current quotas and with severe fiscal and financial constraints in many countries, it will not be enough. A voluntary channeling of SDRs to the benefit of vulnerable countries is needed. The potential large size of such also presents an opportunity to move beyond the urgent provision of liquidity toward dealing more systematically and effectively with interlinked debt and development challenges. This will be necessary to safeguard development prospects in the large number of countries that are highly debt-vulnerable, face huge future spending gaps, and are heavily exposed to external shocks, such as from climate change. To deal more effectively with future liquidity risk, an SDR-funded or backed mechanism could offer a range of state-contingent debt instruments that automatically reduce the debt-service burden and refinancing risk based on pre-determined "triggers" tied to external factors or key economic variables. To deal more effectively with solvency problems, SDRs could be channeled toward concessional funding support for countries coming out of debt-restructuring conditional on sufficient treatment of debt, full transparency, and fair burden-sharing between creditors. Finally, as a development objective, SDRs could be channeled to target climate vulnerabilities. This would make sense not only because it would adhere to a global fairness principle, but also because debt- and climate-vulnerabilities are highly correlated, climate change will intensify in the future, and because of the transmission channels from climate risk to financial and economic stability risk.

1. Introduction

Underlying this year's Spring Meetings of the World Bank Group and the International Monetary Fund (IMF) was a sense of optimism, helped on by an updated global growth forecast of 6 percent.[2] However, it was mentioned on several occasions that we are witnessing a multispeed recovery with several low- (LICs) and middle-income (MICs) countries being left behind due to a lack of access to vaccines, mounting debt problems, and severe fiscal and monetary policy constraints. Unlike the financial crisis in 2008-2009, GDP per capita losses under the current crisis will be much higher in developing regions while they also face a higher risk of further setbacks.[3] Despite such acknowledgments there is a real risk that international efforts aimed at helping countries deal with these challenges will fall short.

At the meetings, an extension was announced of the Debt Service Suspension Initiative (DSSI) until the end of 2021 and the G20 and others endorsed the Common Framework (CF).[4] Important as these measures are, they cover only about two-thirds of the highly debt-vulnerable developing economies and one-third of the estimated external public debt service payments at risk. For a variety of reasons, countries have been reluctant to make use of them.[5] One major announcement has been a new general Special Drawing Rights (SDR) allocation worth $650 billion for which the IMF was urged to quickly deliver a proposal that is expected to be approved by the end of June or early July of 2021.[6] The proposal is also expected to include a voluntary option, or set of options, to allow countries with excess SDRs to donate or on-lend (channel) SDRs to vulnerable countries.

An SDR general allocation followed by a channeling to countries in need will for many developing economies be necessary to free up resources for urgent crisis-related spending and to build resilience towards global financial volatility. But looking beyond the short-term provision of much-needed liquidity it is also an unprecedented opportunity to explore alternative uses of SDRs that could lead to a significant boost for finance for sustainable development. This policy brief contributes to this discussion. Section 2 provides a quick overview of the public debt situation in developing economies. Section 3 discusses the distribution and relative size of the $650 billion general SDR allocation. Section 4 discusses the potential size and objectives of an SDR-funded mechanism. Some concluding remarks are offered in Section 5.

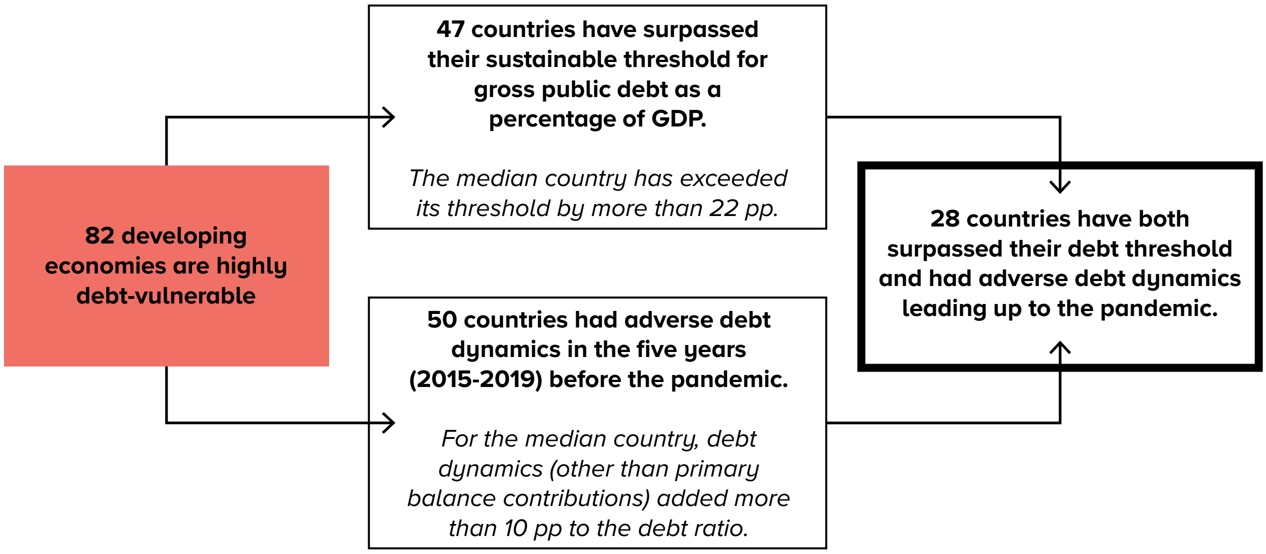
2. More than half of developing economies are highly debt-vulnerable

Earlier this year, UNDP published a paper on sovereign debt vulnerabilities in developing economies in which we identified and ranked 72 highly debt-vulnerable countries for which we have access to external debt data.[7] One of the main conclusions of the study was that close to one-third of these countries — accounting for more than two-thirds of total estimated external debt service payments at risk — are not covered by either the DSSI or the CF. Another 10 fragile and conflict-affected countries (with less data coverage) can be added to the 72 countries based on either their credit or Debt Sustainability Assessment (DSA) risk rating, bringing the total number of highly debt-vulnerable developing countries to 82.[8]

It is important to draw a distinction between debt liquidity issues, on the one hand, and solvency issues on the other. In simple terms, liquidity problems are short-term phenomena where a country has problems accessing markets at affordable rates and in rolling over its debt, for example, because of external factors that do not reflect the country's fundamental risk, or other short-term shocks. Left unaddressed, liquidity problems can turn into solvency problems. On the other hand, a country can be said to have solvency problems if it has surpassed, or is expected to surpass, its thresholds for debt considered sustainable (relative to its debt carrying capacity) and at the same time has an adverse debt dynamics outlook, i.e., its debt trajectory is considered unsustainable.

Before the pandemic in 2019, 40 of the 82 highly debt-vulnerable developing countries had already surpassed their threshold of gross debt that was deemed to be sustainable as a percentage of their GDP. This year, the number is expected to have grown to 47 countries, with the median country exceeding its debt threshold by 22.4 percentage points (pp).[9] Assessed over the five years preceding the pandemic (2015-2019), 50 of the 82 countries (61 percent) had adverse debt dynamics — here understood as additions to their debt-to-GDP ratio not coming from primary balance contributions.[10] For this group of 50, debt dynamics other than primary balance contributions added 10.3 pp to gross public debt as a percentage of GDP for the median country over the five-year period.[11] Little more than one third of the highly debt-vulnerable economies have both surpassed their debt-to-GDP threshold and had adverse debt-dynamics during the five years preceding the pandemic. See Figure 1.

Figure 1: Gross debt and debt-dynamics — 82 highly debt-vulnerable economies



Note: *Debt-vulnerability is determined based on either credit or DSA risk rating. All developing economies (LICs and MICs) with a credit rating of "highly speculative" (B1 for Moody's, B+ for FITCH and S&P) or worse are included. So are all countries with a DSA risk rating of "high risk of debt distress" or "in debt distress" except for Eritrea and Yemen, which have neither a credit rating nor a recent DSA risk rating, but both of which have high public debt levels. Both countries are assigned a public gross debt threshold of 35 percent (as for LIC-DSA countries with weak debt-carrying capacity). Debt-ratio thresholds are taken from the most recent DSAs. Adverse debt dynamics refer to debt-generating flows other than primary balance contributions. Data is from the World Economic Outlook database, April 2021. Libya and Syria are not included due to missing data.*

Bringing down their high debt burdens will, for many countries, depend on their ability to generate and sustain growth rates that far exceed recent pre-COVID rates. Coupled with this is the concern that a growing number of countries are now going through a third or fourth wave of COVID, followed by new lockdowns at the same time as inadequate vaccine access and new virus strains continue to threaten recoveries for all. For many developing economies, the recovery will also depend crucially on the continued stability of and access to financial markets at affordable rates. We have already witnessed how precarious global financial flows can be with the large outflows from developing markets in March and April last year, and how little influence developing economies themselves have over the factors that affect flows. The general SDR allocation will help mitigate such risk. But will it be enough?

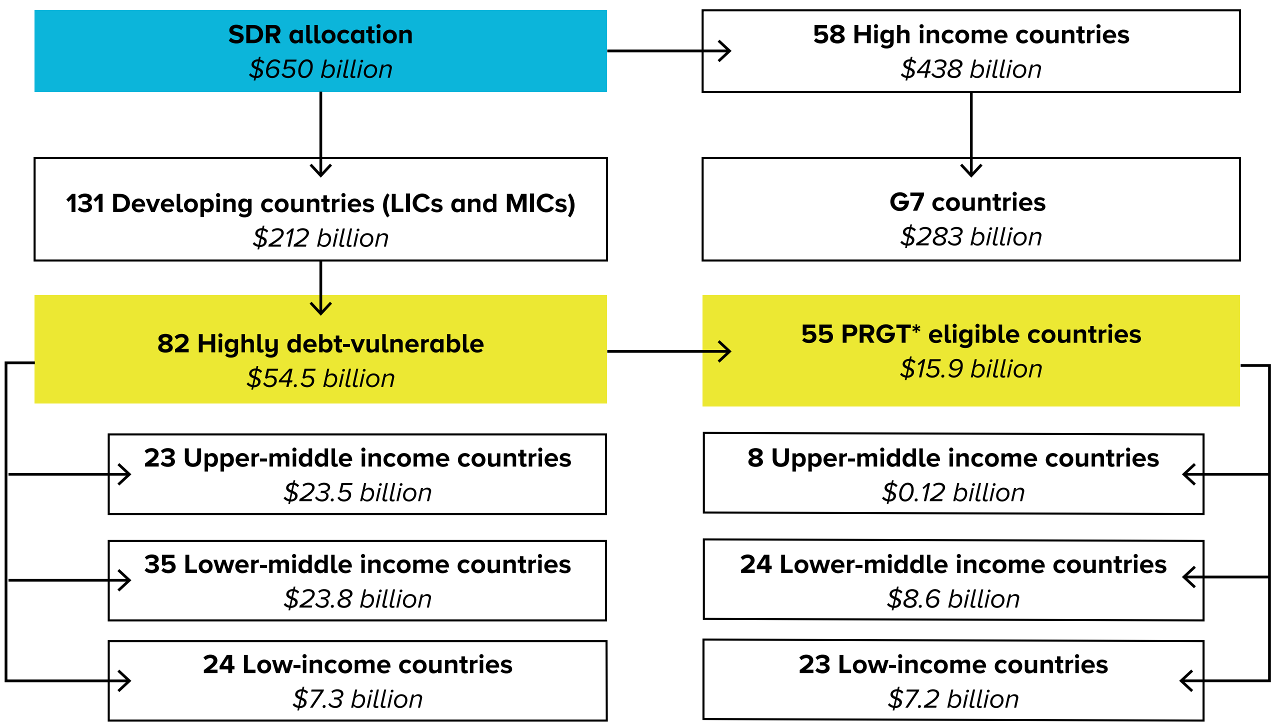
3. A $650 billion SDR allocation

SDR is an international supplementary reserve asset that countries can swap among each other for freely usable hard currency and is meant to aid countries with short-term balance of payment disequilibria. In the current context of widespread health and socioeconomic crises, severe fiscal constraints, and high debt, SDRs can help free up fiscal resources for crisis-related expenditures. This is because the SDR allocation can be thought of as a perpetual loan priced at the same rate as short-term debt for some of the most creditworthy governments.[12]

Thus, for countries that are solvent, and have adequate reserves, SDRs could cheaply fund additional spending. SDRs could also be used to pay off creditors and bring down the debt service burden by, for instance, refinancing higher-interest debt. As an example, with the objective of freeing up short-term cashflows Ghana recently became the first sub-Saharan African (SSA) country to issue a foreign currency denominated zero-coupon bond. In a 4-year tranche, the country issued $525 million, raising $409.5 million, which was then used to refinance local currency debt with an average interest rate of more than 18 percent. This will save the country about $184 million in interest payments over the next four years in exchange for a higher debt exposure to exchange rate movements.[13] Ghana was able to raise funding from the market to undertake this refinancing, and at an annual interest rate equivalent of little more than 7 percent. Many other countries cannot do the same. Had Ghana instead been able to use $409.5 million of its upcoming general SDR allocation, it would have had to pay only $819,000 resulting in a net interest saving of almost US$300 million.[14]

The general SDR allocation of $650 billion would immediately send $212 billion to 131 developing economies defined as LICs ($8.5 billion) and MICs ($203 billion).[15] Of this allocation, $54.5 billion would go to the group of 82 highly debt-vulnerable economies that include 24 LICs and 58 MICs, the latter of which can be further split into 35 lower-middle income countries (LMICs) and 23 upper-middle income countries (UMICs). Figure 2 shows the allocation for the subgroup of 55 of the 82 highly debt-vulnerable countries that are eligible for facilities under the IMF's Poverty Reduction and Growth Trust (PRGT). These 55 countries will receive close to $16 billion.[16] The PRGT is expected to play a central role in the IMF's upcoming proposal on voluntary options for channeling more SDRs to vulnerable countries. For example, 38 SSA countries make up the majority of the 69 PRGT-eligible countries, and the 55 PRGT-eligible countries that are highly debt-vulnerable include among them 31 SSA countries.

Figure 2: Distribution of the general $650 billion SDR allocation



Source: Author's own calculations based on SDR quotas. *Note:* *PRGT is the IMF's Poverty Reduction and Growth Trust, the facilities of which are open to 69 eligible countries. For a definition of debt vulnerability, see Figure 1 note.

For the group of 82 highly debt-vulnerable countries, $54.5 billion is at the most equal to 5 percent of their total external public and publicly-guaranteed (PPG) debt stock (based on the latest datapoints available from 2019) or 1.8 percent of the total gross public debt stock in 2021.[17] In other words, the amount is far short of even covering a years' worth of interest payments for most. But the variation within the group is large. For the Democratic Republic of the Congo, the SDR allocation would equal approximately 20 percent of its total gross public debt (or about one-third of its total external PPG debt). For Egypt, Eritrea, Kenya, Laos, Maldives, Sri Lanka, and Sudan, it would be not even 1 percent of total gross public debt.

Another issue is that using SDRs to provide liquidity support to countries with solvency problems is no guarantee that countries will spend more on combatting the crisis. Instead, there is a real risk that support will be used to allow private creditors to continue to free-ride while the underlying solvency issues persist.[18] It is therefore worth thinking about how voluntary options for channeling SDRs beyond the short term could help developing economies deal more effectively with both liquidity and solvency problems and help safeguard their sustainable development prospects.

4. Channeling SDRs to vulnerable countries

Discussions on the possible SDR channeling options, size and objectives have begun, and it is expected that the PRGT will play a central role.[19] One of the main benefits of using the PRGT is the speed with which the extra liquidity could be provided as it is already operational and can handle SDR on-lending.[20] One of the main drawbacks is that it is not open to all developing countries in need. Currently, 69 countries are PRGT-eligible, including 55 of the 82 highly debt-vulnerable countries identified above. Ideally, all vulnerable developing economies should be able to benefit.

The combination of widespread high debt-vulnerabilities and massive future estimated spending needs in developing economies call for more ambition on mobilizing finance for development on all fronts. The potentially large size of an SDR channeling provides an opportunity to look beyond the provision of urgent liquidity and address some of the interlinked debt and development challenges. The IMF has recently estimated the scale of developing countries' spending needs. Based on four case studies, it concludes that countries, on average, will have to spend (public and private) 14 percent of GDP annually to make significant progress on only a subset of the Sustainable Development Goals (SDGs) by 2030.[21] Even under a scenario of comprehensive and successful domestic reforms they will not make it without substantial additional external support. Another IMF study has assessed the pandemic recovery spending needed for the group of 69 PRGT-eligible countries by 2025 which amounts to no less than $450 billion, plus an additional $100 billion projected in an adverse growth scenario.[22]

How large could a redirection of SDRs be?

Of the $650 billion allocation, the G7 alone will receive $283 billion which is more than the total amount the IMF is currently making available to member countries.[23] In total, all high income countries would receive as much as $438 billon. That is equivalent to about 47% of the amount of total excess gross public debt for the 82 highly debt-vulnerable developing economies.[24] Another comparison could be the total amount of global Official Development Assistance (ODA) of $167.8 billion in 2019.[25] Yet another comparison could be the Green Climate Fund, established in 2014 as the world's largest climate fund mandated to support developing countries raise and realize their Nationally Determined Contributions (NDC).[26] As of April 2021, total cumulative confirmed pledges to the fund were only $17.6 billion.[27]

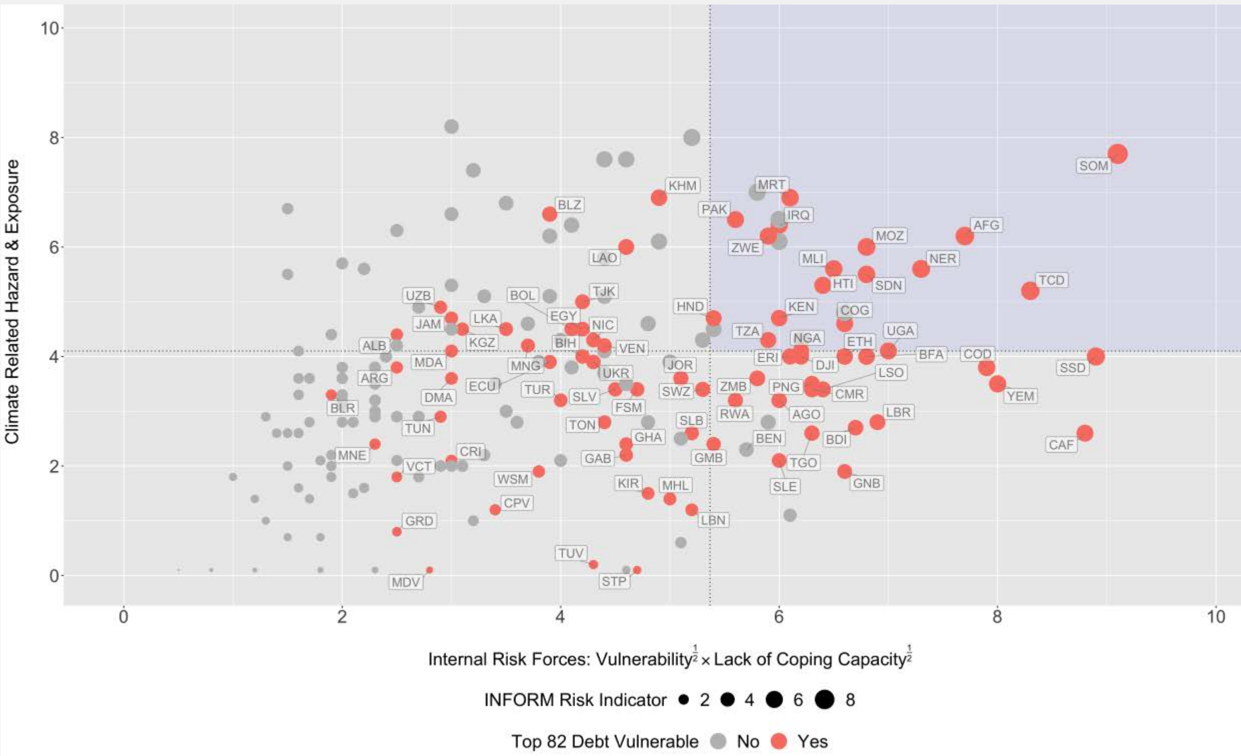
SDRs could also be leveraged in capital markets to increase funding capacity and mobilize private capital to developing economies. As an example, the European Stability Mechanism (ESM), which was preceded by the European Financial Stability Facility as a response to the 2008-2009 financial crisis, has paid-in capital from members states of $98 (€80) billion and a lending capacity of $612 (€500) billion.[28] The capitalization from strong member states ensures that the ESM has a strong credit rating which allows it to issue debt at low funding costs which it passes on to member states experiencing, or threatened by, severe financing problems.[29]

What could be the objectives of channeling SDRs?

Beyond the provision of urgently needed liquidity support, an SDR funded or backed mechanism could directly target development objectives with global implications and which are closely linked to future debt dynamics. One option would be to provide concessional funding for countries to deal with climate vulnerabilities. The rationale and justification would be straightforward. First, developing countries have contributed the least to the global climate crisis but will disproportionately bear the costs associated with climate change, while they also have the fewest financial and institutional resources to cope. Second, there is a high correlation between being debt- and climate-vulnerable. Nine of the top 10 most climate-vulnerable countries in the world are highly debt-vulnerable developing economies, and more than three-quarters of countries that score high on the IMF's climate vulnerability index are highly debt-vulnerable. See Box 1 for details.

Box 1: Climate- and debt-vulnerabilities

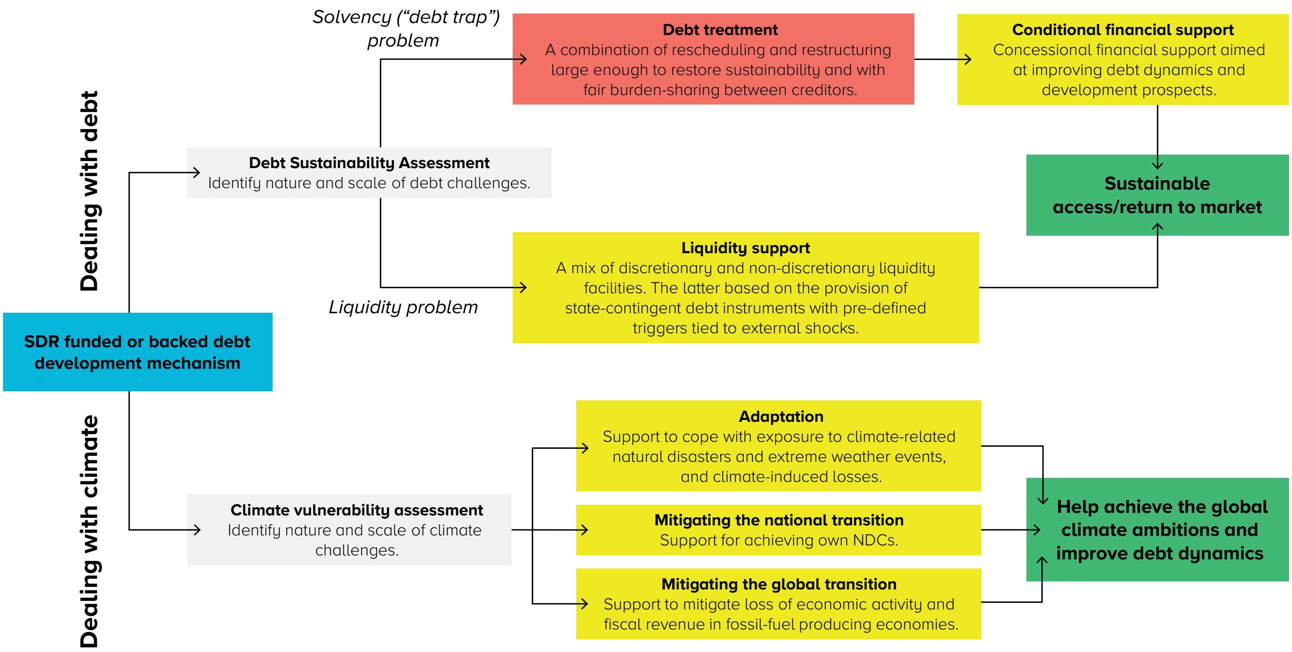
The Figure below uses data from IMF's recently published climate change indicators dashboard.[40] More specifically, the figure shows how vulnerable 191 countries are to climate change. The x-axis captures countries' internal risk forces that determine whether they have the capacity to deal with climate-related hazards and the y-axis indicates how exposed countries are to climate-related hazards. A higher score indicates higher vulnerability, and the vertical and horizontal lines represent the average scores on each of the two dimensions. In the figure, the 82 highly debt-vulnerable countries are colored, and the size of the dots indicates countries' overall score on the aggregate climate-vulnerability index. The picture is striking: 16 of the 22 most climate-vulnerable countries (upper-right quadrant) are highly debt-vulnerable; 9 of the top 10 most climate-vulnerable countries are highly debt-vulnerable; 76 percent of countries that score high, a value of 5 or above on the aggregate climate-vulnerability index ('INFORM Risk indicator'), are highly debt-vulnerable; 80 percent of countries that score higher than the country average on internal risk forces (x-axis) are highly debt-vulnerable; and, finally, 48 percent of countries that score above average on exposure to climate-related hazards (y-axis) are highly debt-vulnerable.



Source: Author's own calculations based on the IMF's climate-change indicators dashboard. Note: The IMF has adjusted the INFORM Risk Index by taking out hazards and exposures that are not linked to climate change, e.g., earthquakes.

Based on DSAs, part of an SDR channeling could be used to offer differentiated debt-relief support to countries depending on whether problems are issues of solvency or liquidity — see upper part of Figure 3. The support measures should be systematic, targeted, and preventative, and importantly, open to all vulnerable countries. Similarly, eligibility for financial support for dealing with climate vulnerabilities could be granted based on a climate vulnerability assessment — see lower part of Figure 3.

Figure 3: Possible uses of an SDR channeling to vulnerable countries



Support for countries with solvency problems should be made conditional on adequate, orderly, and fully transparent debt treatment with fair burden-sharing between official and private creditors. The CF has provided a first step for such a framework and, as called on by the UN Secretary-General, the CF should be used as a steppingstone toward a more universal and permanent framework for sovereign debt-resolution.[30] Post restructuring, inflation in advanced economies, in particular the US. Part of the logic behind the proposed SDR allocation is that it will mitigate the upward pressure on countries' funding costs by giving reserves a boost. But there are a range of alternative options that could help deal more effectively with liquidity risks and help stabilize economies after being hit by shocks.