T20 SAUDI ARABIA 2020 THINK

POLICY BRIEF

COVID-19 CRISIS: HOW SHOULD THE G20 SUPPORT HEAVILY INDEBTED LOW-INCOME COUNTRIES?

Task Force 8

INTERNATIONAL FINANCIAL ARCHITECTURE

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موجز السياسة

أزمة كوفيد-١٩: كيف تقدم مجموعة العشرين دعمًا كثيفًا للبلدان المدينة منخفضة الدخل؟

فريق العمل الثامن

الهيكل المالي العالمي

المؤلفون

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ABSTRACT

As low-income countries (LICs) need assistance to manage the effects of the COVID-19 crisis, the G20 can play an important role in providing short-term liquidity with a suspension of debt service payments and debt relief. However, debt relief should be bound to reforms, and LICs bear part of the responsibility for coping with the crisis. To prevent a debt crisis in the long term, the G20 could implement measures to promote responsible lending and borrowing among LICs. Two instruments are particularly important: (i) guidelines for responsible lending and borrowing, and (ii) effective debt management.

بينما تحتاج البلدان منخفضة الدخل إلى مساعدة لإدارة آثار أزمة كوفيد- ١٩، فإن مجموعة العشرين يمكنها أن تلعب دورًا مهمًا في تقديم سيولة قصيرة المدى، مع تعليق مدفوعات خدمات الديون وتخفيف أعبائها. إلا أن تخفيف أعباء الديون ينبغي أن يكون مرتبطًا بإصلاحات، وتتحمّل البلدان ذات الدخل المُنخفض مسؤولية مواكبة الأزمة. ولمنع حدوث أزمة ديون على المدى البعيد، يمكن أن تطبق مجموعة العشرين تدابير لتعزيز الإقراض والاقتراض الحكيم بين البلدان منخفضة الدخل. وهناك أداتان ذواتا أهمية على نحوٍ خاص: ١ـ مبادئ توجيهية للإقراض والاقتراض الحكيم. ٢ـ إدارة فعَّالة للديون.

CHALLENGE

The COVID-19 crisis exacerbates the debt situation in LICs

Even before the COVID-19 crisis, the International Monetary Fund (IMF) and the World Bank estimated that about half of LICs were at a high risk of debt or in debt distress (IMF 2020a). The COVID-19 pandemic will further deteriorate the debt situation in LICs.

One reason for the increased debt levels has been a change in the composition of debt from concessional to market-based loans from private and public creditors. According to IMF estimates, public loans made to LICs at market conditions comprised 46% of total public debt, doubling between 2007 and 2016 (IMF 2018). Similarly, in LICs, the share of external public and publicly guaranteed debt provided by private creditors as a percentage of the total increased from about 40% in 2000 to about 60% in 2017 (UNCTAD 2018). The higher interest rates of the non-concessional loans increased the debt burden of LICs. Additionally, public debt went up. For example, in sub-Saharan Africa (SSA), public debt as a percentage of a country's gross domestic product rose from an average of 33.1% between 2010 and 2016 to 50.1% in 2019 (IMF 2020b).

Heavily indebted countries are obliged to use scarce financial resources to service their debts, although these resources are required for education, health, and social security systems. High levels of foreign indebtedness may also affect poverty levels by redirecting finances away from investment to debt service payments. High debt service payments prevent countries from making investments in economic development that are necessary to support growth (Loko et al. 2003). Additionally, debt distress in LICs has limited the financial resources available for achieving the Sustainable Development Goals.

The COVID-19 pandemic will further exacerbate the debt situation in LICs. On the one hand, public revenues will decline significantly. As a result of the pandemic, it is estimated that public revenues in SSA will be 12 percent lower in 2020 than they would otherwise have been, and the budget deficit as a percentage of gross domestic product will be 2.7 percent higher (Zeufack et al. 2020, 59). On the other hand, export earnings in LICs will decrease substantially, not only because of falling international trade levels but also because they primarily export raw materials. For 2020 alone, the World Bank expects an average decrease of 40 percent in energy prices compared to prices from the previous year (World Bank 2020). The World Bank estimates a recession of -2.1 to -5.1 percent for SSA countries in 2020, the first in more than 25 years, due to the impact of the pandemic (Zeufack et al. 2020).

Without financial resources, many LICs, particularly those in SSA, will experience severe recessions alongside social and health crises. If several LICs collapse economically, this would lead to social unrest in these countries and affect international trade and finance linkages.

Although the international community—including the G20—should also take responsibility for LICs, LICs bear part of the responsibility for coping with the COVID-19 crisis, for example, by improving their tax and debt management systems. Against this background, the central question of this paper is as follows: How can the G20 contribute to preventing and dealing with an evolving debt crisis in LICs?

PROPOSAL

G20 measures to address debt crises in LICs

As LICs will find it difficult to respond effectively to the pandemic without assistance, the international community has a shared responsibility to engage with these countries. The G20 can play an important role in providing short-term liquidity using various instruments, including loans at market conditions, concessional loans, debt restructuring, suspension of debt service payments, and debt relief. However, in this precarious financial situation, loans at market conditions are no longer an option. The concessional loans made available by the international community are extensive, and the World Bank Group will provide approximately USD 160 billion (Zeufack et al. 2020) to LICs over the next 15 months. The IMF provides interest-free loans of around USD 10 billion to the poorest countries via the Rapid Credit Facility (IMF 2020c). However, the loans provided by international financial institutions—even concessional loans—further increase debt levels (Berensmann 2020a, 2020b). Additionally, the IMF has provided debt service relief to LICs through the Catastrophe Containment and Relief Trust (CCRT; IMF 2020d). In the G20 Action Plan, the G20 calls for more countries to contribute to this fund (G20 2020). The G20 countries should assume a frontrunner role in contributing to the replenishment of this fund. Although the G20 and Paris Club members have already offered a moratorium of seven months, a longer moratorium would be required. Despite this enormous level of financial support, some heavily indebted LICs will require more comprehensive debt relief.

To prevent a looming debt crisis in LICs in the long term, the G20 should also support any measures that promote responsible debt in LICs. In this regard, the G20 should support the following instruments specifically: guidelines for responsible lending and borrowing, and effective debt management.

Immediate liquidity support for LICs

Given the poor fiscal positions and increased debt vulnerability of LICs, these countries require immediate liquidity. The G20 countries should provide this liquidity by offering a longer debt moratorium than offered in April this year and comprehensive debt relief to highly indebted LICs. Additionally, the G20 should contribute to replenishing the CCRT.

Debt moratorium

To provide immediate liquidity to the poorest countries, all creditors should offer a debt moratorium for LICs. All bilateral public creditors agreed to suspend debt service payments for the poorest countries from May to December 2020 (G20 and Paris Club

2020; IMF and World Bank 2020). During a moratorium, the debtors suspend their payments for a given period. The main aim of the debt moratorium is to improve the debtors' liquidity positions and provide them with time to recover.

The African Finance Ministers and the World Bank have estimated that about USD 100 billion would be required immediately to stimulate African economies. All interest payments to multilateral, bilateral, and private creditors for 2020 would amount to about USD 44 billion. Subsequently, a suspension of debt service payments would provide immediate fiscal space for these economies (African Finance Ministers 2020; Zeufack et al. 2020).

The G20 has taken on an important signaling role among other bilateral public and private creditors in granting a debt moratorium to the poorest countries. The G20 has called upon private creditors to also suspend debt service payments (G20 2020). This would ease the risk of some creditors taking advantage of the moratoriums granted by others by encouraging collective action. In this way, the number of collective action problems in terms of free-rider problems decreases. Additionally, the G20 has asked multilateral development banks to increase the suspension period beyond the agreed seven months (G20 2020). Nevertheless, a moratorium is an instrument that should only be adopted in emergency cases, such as the current pandemic (Berensmann 2020a). The credit ratings of debtor countries could deteriorate because creditors might fear that debtors may demand debt moratoriums in the future, thereby requiring higher risk premiums (Berensmann 2003).

Debt relief

The G20 countries should provide comprehensive debt relief to highly indebted LICs and contribute to replenishing the CCRT, which provides debt service relief to LICs. Generally, the CCRT enables the IMF to provide debt relief when LICs face catastrophic natural disasters or public health crises, as in the case of the COVID-19 pandemic. The IMF has recently enacted reforms of established enhancements to the CCRT to offer debt service relief to LICs that are impacted by the COVID-19 crisis because the previous design of the CCRT was associated with the following problems: (i) The health crisis window would address regional epidemics instead of global pandemics; (ii) there was the risk of limited resources being bundled for only a small number of countries; and (iii) donors faced an opportunity cost by prefunding the CCRT (IMF 2020d).

The reforms of the CCRT include expanding qualification criteria to better address global health crises by including a specific test for what qualifies as a public health disaster (for example, when a life-threatening global pandemic occurs and generates significant economic disruptions across IMF member countries). Two further reforms prevent the concentration of funding to only a few countries. First, the IMF approves debt service relief in tranches, providing relief for a specified shorter period, starting for example, with a period of six months. Second, the duration of debt service relief is capped at two years and is no longer limited to a 20% quota. As some eligible countries do not have to pay much debt service in the coming two years, the funds of the CCRT could be used for countries that have immediate needs. One prerequisite for providing this debt relief would be that the money is spent on health-related measures.

To address donors' opportunity costs in prefunding the CCRT, the IMF has offered donors the possibility of contingent grants: Donors would commit to providing a specific amount of funds that would only be disbursed if specified triggers occur. The United Kingdom, for example, has already pledged to fund USD 183 million in two tranches—one tranche would be contingent on such conditions (IMF 2020d).

The IMF has started fundraising for the CCRT to offer about USD 1 billion for the current COVID-19 crisis, and it has asked economically stronger member countries to provide financial support to replenish this fund (IMF 2020d). The G20 member countries could assume a frontrunner role and offer such financial support for this fund, as called for in the G20 Action Plan (G20 2020).

However, the IMF's debt service waiver through the CCRT is not sufficient for some highly indebted LICs. Subsequently, more extensive debt relief is required. Germany's Federal Minister for Economic Cooperation and Development, Gerd Müller, also supports debt relief for the poorest countries in his "Emergency Covid-19 support program" (BMZ 2020).

To ensure that individual creditors do not benefit from the remissions of other creditors (avoidance of free-rider behavior), there are at least two necessary prerequisites for debt relief: (i) All public and private creditors should participate equally in debt relief; and (ii) all public creditors and public debtors should disclose their loan agreements. There should be a case-by-case analysis, and only highly indebted countries should receive debt relief. Debt limits could be agreed on for this, and the levels should be in line with the Debt Sustainability Framework (DSF) of the IMF and World Bank (IMF 2020e). The DSF should be used as an instrument for determining the extent of the relief and the threshold values for debt. Public debt should be relieved until "moderate debt risk" has been established within the DSF (i.e., none of the debt indicators under the DSF should exceed their respective thresholds in the basic test or the stress test; Berensmann 2020a, 2020c).

However, debt relief alone only works on the symptoms and not the causes of high levels of debt. Therefore, debt relief should be subject to conditions such as using funds to reduce poverty, building infrastructure, or improving debt management. Additionally, LICs should provide transparency on their debt situation. Additionally, creditors should pursue responsible lending. The international community should agree on uniform principles for responsible lending and borrowing.

Promote responsible debt in LICs

To prevent a debt crisis in LICs, the G20 could further measures to promote responsible debt in LICs. Two instruments are particularly important: (i) guidelines for such lending and borrowing; and (ii) effective debt management policy and capacity.

Guidelines for responsible lending and borrowing

Guidelines or principles for responsible LICs set out voluntary rules for creditors and debtors in the period before and during a debt crisis, such as transparency on the debt situation, timely dialogue between creditors and debtors, cooperative negotiations, and equal treatment of all creditors (Berensmann 2018).

Under the German presidency in 2017, the G20 established the "Operational Guidelines for Sustainable Financing" (henceforth referred to as the G20 Guidelines), which include five dimensions: (i) adequate financing for sustainable development, (ii) information-sharing and transparency, (iii) consistency of financial support, (iv) coordination of stakeholders, and (v) the promotion of contractual and new financial instruments and minimizing litigation issues to strengthen resilience (G20 2017).
One objection to these Guidelines is that various other guidelines have been proposed, and some of them have been implemented, such as those from the Institute

of International Finance (a global association of private financial institutions), the United Nations, and the Organisation for Economic Co-operation and Development.[1] To resolve this, the G20 could promote dialogue on this type of instrument and further the development of a set of uniform guidelines for responsible lending and borrowing based on the G20 Guidelines. A further main objection to these Guidelines is that they are voluntary, making it difficult for them to be applied effectively. The World Bank and the IMF have addressed this problem by developing a standardized diagnostic tool, including several practices for each of the five key dimensions named in the Guidelines. This tool provides bilateral creditors and their agencies with the opportunity to assess whether they meet the Guidelines (IMF and IDA 2019).

Promote debt management

Debt management takes on an essential role in managing the risks of the increasingly diversified creditor structure more effectively (Berensmann 2018). Debt management includes measures to promote sustainable debt structures for LICs, taking into account adequate loan maturities, interest rates, and ratios of domestic and foreign currency. In this way, low debt servicing costs at an adequate degree of risk can be ensured, and domestic securities markets can be developed. Moreover, through effective monitoring and reporting, effective debt management can contribute to lower fiscal risks generated by contingent liabilities, including guarantees or on-lending to state-owned enterprises (Essl et al. 2019, 11).

Regardless of higher public debt levels and riskier debt portfolios, debt management capacities in LICs have been weak. According to the World Bank's Country Policy and Institutional Assessment, around half of the International Development Association (IDA) countries do not reach a rating of 3.5, for which countries are assessed to have "adequate" debt management policy and institutions capacity (IDA 2019). The main problems are inadequate coordination with fiscal policy, the low quality of debt data, inadequate staff capacity in debt management offices, deficient debt management governance, and weaknesses in public financial management and regulatory frameworks (IDA 2019; IMF and IDA 2020).

1. The following actors have proposed or put in place the following guidelines: (i) Institute of International Finance (2019): "Principles for Stable Capital Flows and Fair Debt Restructuring"; (ii) Organisation for Economic Co-operation and Development (2016): "Principles and Guidelines to Promote Sustainable Lending in the Provision of Official Export Credits to Low-Income Countries"; (iii) UNCTAD (2015): "Sovereign Debt Workouts"; and (iv) United Nations General Assembly (2015): "Basic Principles on Sovereign Debt Restructuring Processes."

To address these weaknesses, international institutions have established debt management measures, including the Debt Management Facility of the World Bank and the IMF, and the Debt Management and Financial Analysis System of the United Nations Conference on Trade and Development. These instruments need to be improved and further enlarged.

The G20 countries could promote debt management by enhancing their funding for the debt management tools of the international financial institutions. However, only four G20 countries (Germany, Japan, Russia, and the United Kingdom) provide funding for the well-established Debt Management Facility (IMF and World Bank 2019). As one obstacle to effective debt management is the lack of transparency on debt, the G20 countries should increase transparency on their lending to LICs (Berensmann 2020a).

CONCLUSION

To conclude, the G20 should support LICs in dealing with their severe debt vulnerability by providing immediate liquidity. The G20 countries should replenish the CCRT and offer a moratorium for LICs' debt service payments for a period longer than seven months. If the G20 assumes a frontrunner role, other public and private creditors might offer a moratorium for LICs' debt service. Additionally, more comprehensive debt relief for highly indebted LICs is necessary.

Further measures for debt relief and restructuring should be discussed at the G20, including an insolvency procedure for LICs. Such an international insolvency procedure would be a useful permanent tool for dealing with debt crises. This procedure would restructure debt according to defined guidelines, established through a majority decision by creditors, with a binding effect on minorities. This would ensure orderly, transparent, and predictable processes (Berensmann and Herzberg 2009).

Long-term measures that improve responsible debt in LICs should be promoted by the G20, in particular, internationally unified guidelines on responsible debt, and effective debt management policies and capacity.

Similarly, LICs should enact appropriate economic policies to achieve long-term debt sustainability. Countries should take several measures to strengthen their fiscal and external repayment abilities. The mobilization of domestic resources should be improved. This includes reforming government revenue policies, such as developing a more efficient tax system. Effective governance reforms are particularly important in this area.

Additionally, to reduce foreign debt, more domestic financial resources in the national currency should be mobilized on local financial markets. The debtor countries should also improve their debt management so that the funds are used productively. Diversifying exports is the only reasonable strategy to mitigate exogenous shocks, which are a major cause of debt crises in LICs. As countries would have to expand their range of exported goods and therefore change their economic structure, export diversification is more of a long-term strategy.

Disclaimer

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