The Challenge of LDC Debt

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A challenge set by the COVID-19-induced economic crisis that would be difficult to address is the external debt crisis engulfing developing countries. While the G-20 with its Debt Service Suspension Initiative appeared to recognise the problem, the evidence indicates that the international community is unwilling to do what is needed. There are enough proposals on the table, but inadequate commitment among those sitting around it.

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As governments begin to vaccinate their populations against COVID-19 to win herd immunity, attention would turn to addressing the multiple crises that are the legacy of the pandemic. One such only partially recognised and half-heartedly addressed so far is the burden of debt that developing countries, especially low-income countries (LICs), have accumulated. The January 2021 issue of the World Bank's flagship publication *Global Economic Prospects* (GEP) estimates that, during the pandemic year 2020, the ratio of government debt to gross domestic product (GDP) in emerging market and developing economies (EMDEs) rose by more than 8 percentage points from 52.1% to 60.8% (World Bank 2021).[1] This compares with a 4 percentage point increase over the two years 2018–19. Figures on how much private debt, driven by difficult economic conditions and global monetary easing, rose from its pre-existing level of 123.1% is not yet known. But that rise is likely to be steeper if past trends are any indication. Over the five years ending 2019, while government debt as a ratio to GDP rose by 12 percentage points from 40% to 52%, private debt rose by 21 percentage points from 102% to 123%. In LICs, while the public debt to GDP ratio was stable at 59.7% over 2018–19, it is estimated to rise to 67.7% in 2020.

One problem is that a substantial and rising share of this debt is external. According to the International Monetary Fund (IMF) economists (Kose et al 2020), the proportion of government debt in EMDEs held by non-resident investors had touched 43% in 2018, and foreign-currency-denominated corporate debt had risen from 19% of GDP in 2010 to 26% of GDP in 2018. This tendency was visible even before the pandemic and even in low-income countries, which, having benefited from the debt reduction provided by the Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) of 1996 and 2005, once again accumulated new debt. The stock of external debt of low-income countries rose from $80 billion in 2006 to $90 billion in 2010, $124 billion in 2015 and $160 billion in 2019. Private players have contributed to this spike. The share of private non-guaranteed debt in total external debt stocks of LICs increased from 3.2% in 2010 to 8.5% in 2015 and 10% in 2019.[2] These figures are likely to have spiralled over the last year. The Institute of International Finance estimates that borrowings by all emerging market governments from international bond markets rose by $100 billion between April and August 2020 (Jack and Wheatley 2020).

But the problem is not restricted to the LICs. External debt stocks in the "lower middle" income countries rose from $565 billion in 2006 to $926 billion in 2010, $1,381 billion in 2015 and $1,803 billion in 2019. These countries too have been hit badly by the COVID-19-induced crisis.

Double Burden

External debt places a double burden since debt would not have to be just serviced but serviced in foreign exchange. When the pandemic was still in its early stages, in April 2020, the United Nations Conference on Trade and Development (UNCTAD) had estimated that in 2020 and 2021, repayments due on just the public external debt of developing countries was around $3.4 trillion, of which $666 billion and $1.06 trillion was on account of foreign debt incurred by middle- and low-income countries (UNCTAD 2020). Debt service burdens due to past debt combined with the effects of the COVID-19 crisis have resulted in heightened debt distress in the developing world. GEP estimates based on a sample of 69 poor countries indicate that 43% of HIPCs and 59% of non-HIPCs face a high risk of debt distress.

The COVID-19 crisis has resulted in debt distress for multiple reasons. First, the sheer weight of the aggregate public debt service payment burden in a period when the sudden stop in economic activity and subsequent recession led to a huge fall in government revenues. Thus,

a larger share of public resources would be diverted to servicing debt, at a time when the need for spending to address the health emergency and counter the economic collapse is rising (Watkins 2020). In September 2020, David Malpass, in statements urging commercial creditors to adopt a long-run perspective and join developing country debt-reduction initiatives, noted:

> There is a direct connection between debt service, which takes money away from countries, and the urgent need for resources to address health, education and investment in human capital. (Jack and Wheatley 2020)

Second, the COVID-19 crisis has reduced foreign exchange earnings from commodity exports, tourism and remittances, making the task of servicing foreign debt that much more difficult. This requires borrowing more in foreign currency to service past debts. Third, the surge in domestic and foreign indebtedness has meant that interest rates in the EMDEs have not fallen like they have in the advanced economies. Lenders are unlikely to be forthcoming unless spreads relative to safer, advanced economy markets are not high. Between early 2019 and April 2020, policy rates in the advanced economies fell from a low of 1.4% to 0.2%, whereas those in the EMDEs came down from 5.2% to 4.2%. Finally, much of the increased borrowing is being used to finance current expenditures, whereas using debt to finance capital expenditures by expanding capacity and possibly supporting increased exports would strengthen the capacity to repay debt.

Debt Distress

To mitigate the devastating impact the growing debt distress would have on the response to the COVID-19 crisis in the poorest countries, the role of the international community is crucial. Unfortunately, the support on offer thus far has been minimal, in the form of the Debt Service Suspension Initiative (DSSI), which offered a six-month freeze (from May to December 2020) in debt service payments for 73 countries eligible for International Development Association (IDA) support. It has since been extended for a further six months till June 2021. This is not a write-off but a rescheduling, with payments to be made over three years after a one-year grace period. It does not include multilateral agencies and private creditors, who accounted for $7 billion and $18 billion of the $49 billion of payments that was due from eligible countries over May to December 2020 (Ramaphosa 2020). This does not even begin to resolve the problem. Moreover, it makes it difficult for countries availing of the DSSI to access other sources of international borrowing. According to the GEP, only 44 of the 73 eligible countries opted for the DSSI. Others have held back since a DSSI-recipient tag would reduce the sovereign credit rating of the country concerned and limit access to additional credit, especially from private markets whose role, as noted, has increased in recent years. In October 2020, the European Network on Debt and Development (Eurodad) reported that just 24% of debt payments due between May and December 2020 were covered by the DSSI, since the multilateral agencies and private creditors did not participate (Fresnillo 2020). The extension till June 2021 would potentially cover only 44% of debt payments by the 46 countries expected to participate in the initiative as of now.

The presence of private bondholders unwilling to participate in debt-reduction initiatives among providers of developing country debt also makes restructuring difficult, because of the obstructive role that hold-out bondholders and vulture funds can play in any debt rescheduling and forgiveness exercise. Vulture funds acquire EMDE debt at a discount and then sue to obtain full payout, as happened in the case of Argentina. Collective action clauses can help but are often inadequate or absent. According to the IMF (2020), about 50% of outstanding foreign debt does not include such clauses.

Addressing the problem of an excessive debt burden requires a range of measures, from those that ease the terms of debt service to those that wipe out past debt in part or full. But it is also important to ensure access to cheap liquidity and the continued flow of reasonable volumes of credit, especially from the hard currency holding North to the South. Even if, in the long run, countries must rely more on mobilising domestic resources and on borrowing at home rather than on external debt, dependence on borrowing abroad will decline gradually at best, especially in developing countries that require foreign exchange.

Ideas to resolve the crisis are not wanting. One is to immediately provide developing countries with foreign currency liquidity by issuing an additional $1 trillion of Special Drawing Rights, which would provide extremely low-cost reserves to each country depending on their share in allocation. The other is to bring private creditors and multilateral creditors into the rescheduling framework that must involve debt reduction and not just temporary payments suspension. There are many more proposals that have been mooted. What is needed is a recognition that a debt reduction and rescheduling effort benefits all countries (not just poor, indebted ones) in the medium and long term and a commitment to address the problem with seriousness.

NOTES

1 Unless otherwise stated, figures quoted are from the GEP.

2 Figures from the World Bank, *World Development Indicators* database.

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