

Debt and COVID-19: A Global Response in Solidarity

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Table of Contents

INTRODUCTION	4
COVID-19 AND DEVELOPING COUNTRIES.....	5
POLICY RESPONSES	6
PRINCIPLES FOR GLOBAL SOLIDARITY	7
PROPOSALS TO ADDRESS COUNTRIES' VULNERABILITY	8
RECOMMENDED ACTIONS	13

Introduction

Since the global financial crisis of 2008, public external debt in many developing countries has increased. The increasing indebtedness reflected the funding required to finance domestic investment-savings gaps. It was also encouraged by the long period of unusually low international interest rates and unprecedented levels of global liquidity associated with quantitative easing. Developing countries, including least developed countries (LDCs), increased access to commercial financing. Lending by non-Paris Club official creditors also increased.

Yet rates of economic growth have not been as high as in the 2000s in most countries, partly due to the decline in commodity prices that reduced the capacity of many countries to pay. By January 2020, the debt of forty-four per cent of least developed and other low-income developing countries was already at high risk or in distress.

The creditor landscape change has affected developing countries debt-service burden and their exposure to interest rate, exchange rate and rollover risks. Funding from international and domestic capital markets also embodies higher cost of financing, lower average maturities and greater risk and vulnerabilities¹ than traditional official financing.

In this context, the global COVID-19-induced contraction in economic activity is having disastrous consequences, including in debt sustainability. Legally binding contracts with different maturities, creditors, interest rates and financial structures that could have been easily honored are now looming, while countries grapple with the need to fight the virus and address the development emergency it has unleashed.

This is not limited to low-income countries. Middle-income countries, home to 75% of the world's population and 62% of the world's poor², are highly vulnerable to a debt crisis, lost market access and capital outflows.

¹ For example, in the form of volatile capital flows when investors have short-term horizons and global risk perceptions change.

² World Bank, <https://www.worldbank.org/en/country/mic>

Covid-19 and developing countries

While in the best case scenario recovery in developed countries' economies may start by the end of 2020 and reverberate to developing countries, it is also possible that this may be the start of the worst economic downturn since the Great Depression.³ According to the ILO, the crisis could wipe out the equivalent to 195 million full-time jobs globally in just the second quarter of 2020.⁴ This has fed into financial markets volatility.

Most developing countries are already experiencing a significant shock. Entire sectors have come to a sudden stop, supply chains have collapsed, and commodity prices have fallen sharply, with oil prices for example hitting an 18-year low of \$22 per barrel last month. The negative economic, social and financial impacts will likely outlast the pandemic and hit hardest poor, developing and highly indebted countries.

Global financial markets are coming to a standstill as investors race to pull funds out of emerging-markets and other high-risk sectors, and into safe havens. Capital outflows from emerging markets have been unprecedented, at over USD 90 billion⁵. While some positive market reaction was observed amidst

the intervention of the US Federal Reserve, the European Central Bank and other central banks, many middle-income countries that until weeks ago enjoyed access to international capital markets have been cut adrift from refinancing⁶ maturing loans or raising new funds without paying exorbitant yields.

At the same time, the pandemic is straining budgets, as countries struggle to meet the health needs of their population, respond to growing unemployment and support their economies. All countries will need to use all the fiscal space available. This will require mobilizing domestic resources, including by reorienting current fiscal expenditures and showing flexibility in using available budgetary resources. Most developing countries will also need external resources, and many will need concessional finance, to help combat the spread of the virus (health and emergency logistics and infrastructure).

Beyond dealing with the immediate pandemic, additional resources will also be needed to stimulate demand, regenerate jobs and restore supply capacity to pre-crisis levels, let alone to achieve the SDGs.

³ <https://www.imf.org/en/News/Articles/2020/04/07/sp040920-SMs2020-Curtain-Raiser>.

⁴ https://www.ilo.org/global/about-the-ilo/newsroom/news/WCMS_740893/lang--en/index.htm

⁵ https://www.iif.com/Portals/0/Files/content/1_EV_040920.pdf

⁶ Over USD 4.3 trillion of emerging markets bonds and loans come due through end-2020 and emerging markets will need to refinance USD730 billion in foreign exchange debt through end-2020. This includes public and private debt. See https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor_April2020.pdf

Policy responses

While this remains, for now, a liquidity crisis in most countries, it may quickly become a solvency issue. It is unclear whether or when developing countries will return to the same level of exports and terms of trade as before the pandemic. Countries might be on a lower economic growth trajectory going forward, affecting access to financial markets for years to come, through no fault of their own. **Initial estimates indicate that Africa may be in its first recession in the last 25 years, while Latin America and the Caribbean is facing the worst recession ever. Similar decelerations are affecting many countries in the world, including in Asia and the Arab Region.**

We must do all we can to prevent what could be a devastating debt crisis with disorderly defaults. This would damage the trust that developing countries have developed through years of careful reform and sound economic management. Achieving the SDGs could become a pipedream if this development emergency is not addressed.

As we strive to address the health emergency, debt relief must be an important part of the response to the associated development emergency.

Policy makers are deeply concerned. A consortium of African ministers has requested financial support⁷, including a “debt holiday waiver”⁸ of \$44 billion. In an emergency meeting on March 26th, the G20 committed itself to addressing debt vulnerabilities. The World Bank and International Monetary Fund (IMF) have called for a suspension of debt repayments for the poorest countries.

On April 13th, the IMF Executive Board approved immediate debt service relief to 25 IDA countries⁹ under its Catastrophe Containment and Relief Trust. The Organisation for Economic Cooperation and Development has urged leaders to consider a “highly indebted poor countries initiative on steroids”¹⁰. The International Institute of Finance¹¹ and private sector representatives¹² have joined such calls that have also been echoed by think tanks¹³ and global leaders¹⁴.

7 <https://www.reuters.com/article/us-health-coronavirus-africa/african-finance-ministers-call-for-100-billion-stimulus-debt-holiday-idUSKBN21A2GK>.

8 Interest payment waiver.

9 Five of them Small Island Developing States (SIDS).

10 https://read.oecd-ilibrary.org/view/?ref=126_126445-5ofyod1xpv&title=SecretaryGeneralAngelGurriaStatementforthe20_VideoconferenceSummitonCOVID19.

11 www.iif.com/Portals/0/Files/content/Regulatory/IIF%20Letter%20Debt%20LICs%20April%202020.pdf.

12 The International Chamber of Commerce (ICC), the International Trade Union Confederation (ITUC), and Global Citizen <https://iccwbo.org/media-wall/news-speeches/global-business-workers-and-civil-society-unite-in-call-for-emergency-debt-relief-to-save-lives-and-livelihoods/>

13 These include the Brookings Institution and the Peterson Institute for International Economics.

14 <https://www.theguardian.com/world/2020/apr/07/coronavirus-global-leaders-urge-g20-to-tackle-twin-health-and-economic-crises>.

We commend the IMF, the World Bank, the G20 and others for responding to developing countries needs in these extraordinary times.

These initiatives are as welcome as they are necessary. However, focusing on the poorest countries alone will not suffice to address the global scale of the challenge. This crisis has been indiscriminate in its impacts, slamming hard all countries alike. Developing countries are calling for additional support¹⁵.

Debt relief should not be based on level of income but on vulnerability.

In many countries, including both low and middle-income countries, it is becoming clear that unless sizeable debt relief is provided, private and public creditors may face multiple unilateral defaults. The choice is no longer between default and continued debt-service payments, but between a wave of disorderly defaults, and orderly payments agreed to between debtor countries and their lenders, once the economic situation improves. It is in the interest of all, and especially creditors, to safeguard international capital markets, at risk over a potential wave of defaults.

Principles for global solidarity

To effectively halt a debt crisis, we need to move quickly. We propose a framework that aims to ensure debt relief, while accounting for heterogeneous debt situations across countries and the need for tailored policy responses.

This approach builds on principles for debt sustainability discussed and agreed at the United Nations and laid out most recently in the Addis Ababa Action Agenda. Most principles also reflect best practices underlying debt resolution at the IMF and the World Bank.

These include:

- I. Debtors and creditors must share responsibility for preventing and resolving unsustainable debt situations
- II. Debt restructurings should be timely, orderly, effective, fair and negotiated in good faith
- III. Debt workouts should aim to restore public debt sustainability, while enhancing the ability of countries to achieve sustainable development, growth with greater equality and the sustainable development goals.

¹⁵ The G24 in the Communiqué issued April 14th, 2020, expressed support to discussions with multilateral and bilateral creditors on ways to alleviate the debt burden of developing countries that request forbearance during these exceptional circumstances. They call for support for other emerging and developing countries (EMDCs) as debt vulnerabilities build up due to the economic shock. In some cases, fair and comprehensive debt restructuring will be needed to restore debt sustainability. Private creditors should share the burden of alleviating debt distress. The Group calls on the IMF and World Bank to provide continued support to strengthen borrowers' debt management capacity. They also call Credit Rating Agencies to avoid downgrading countries that are restructuring their debts to manage the impact of the pandemic.

Proposals to address countries' vulnerability

The proposal starts from the following premises:

- An urgent priority is a moratorium, providing “breathing space” for all that need it to focus on crisis response.
 - The approach will need to be comprehensive, involving all relevant creditors, acknowledging how challenging this will be.
 - All countries facing liquidity and solvency issues due to the crisis, and unable to finance the response to the epidemic should be given relief where this is requested – not just IDA eligible countries.
 - It should allow flexibility. Debt situations are heterogeneous across countries and require specific policy responses. Countries with good credit still have access to international financial markets and can issue bonds. Countries that can service debt should continue to do so.
 - While it is difficult to assess magnitudes right now in a volatile situation, it is already clear that some countries will need debt relief beyond temporary suspensions of debt service, so the framework will need to aim for orderly, timely, fair solutions.
- Any crisis response should thus be formulated in a way that creates space for consideration of solutions to prevent a recurrence and facilitate fiscal space for recovery and SDG investments while maintaining debt sustainability¹⁶. Conditionalities that make it difficult for countries to recover in a resilient manner should be avoided.
 - The crisis response should be part of a holistic approach, including capital account management as needed, to ensure that financing provided through debt relief helps stabilize the financial situation.

A three-phase approach¹⁷ should be considered:

- **PHASE 1:** Standstill to give immediate “breathing space” for all countries that need it through an agreed mechanism (perhaps through certification by the IMF), as well as support to countries that still have market access. A moratorium will provide a pause until the depth of the crisis has passed, and the extent to which countries have been affected by it is better understood.

¹⁶ Debt sustainability assessment methodology and framework may need to be adapted.

¹⁷ Acknowledging that different countries will be at different stages in dealing with matters related with debt management and vulnerability, we organize the framework in three phases with options for countries and their partners to consider.

- **PHASE 2:** Beyond the immediate crisis response and the debt moratorium, targeted debt relief will likely be needed, as the impact of COVID-19 has compounded high debt levels and unmet financing needs for the SDGs even before the pandemic hit.
- **PHASE 3:** Addressing structural issues in the international debt architecture to prevent defaults leading to prolonged financial and economic crises.

PHASE 1: STANDSTILLS

The proposal calls for an across-the-board debt stand still for all developing countries that have no access to financial markets and cannot service their debt.

What many countries need in the very near term is the ability to redirect their financial resources away from debt obligations and towards fighting the consequences of the pandemic. Standstills with creditors, i.e., agreements to postpone principal and interest payments until the crisis has subsided, would free up resources to address the health and economic effects of COVID 19. Another purpose is to avoid costly sovereign defaults¹⁸ that could turn a temporary shock into a protracted crisis causing permanent economic damage.

The IMF and World Bank have recommended, and G20 countries negotiated, a suspension of debt service payments for IDA-eligible countries, for their bilateral debts.

The IMF Executive Board agreed on April 13th 2020 to provide grants to cover IMF debt obligations for an initial phase over the next six months to 25 IDA countries, and to help them channel more of their scarce financial resources towards vital emergency medical and other relief efforts.

While these are welcome steps, they do not address several of the aforementioned points. The standstill should:

1. Include other creditors (private creditors as well as multilaterals)
2. Extend beyond IDA countries to include other low-income and those heavily indebted middle-income countries that request relief.
3. Include principal and interest payments, as well as associated fees and charges
4. Set a cut-off date, after which new financing is excluded from future debt restructurings, in order to facilitate access to financing after this date.
5. Allow for repayment schedules that ensure ability of countries to implement the 2030 Agenda for Sustainable Development.

A proposal that includes official and private creditors and low and middle-income countries would offer developing countries a chance to survive the pandemic with their creditworthiness weakened but intact. Unilateral defaults, on the other hand, could turn a temporary shock into an extended economic slump for these countries.

¹⁸ While not the focus of this piece, the growth of private sector debt remains a major driver of total debt growth in developing countries. At the end of 2018, it accounted for 139 per cent of their GDP. Lending to non-financial corporations in emerging markets and China accounts for the bulk of this increase. But even in low-income countries with shallow financial systems, private sector debt now stands at over 27 per cent of GDP, up from around 12 per cent just before the start of the global financial crisis. Growing private sector debt raises debt sustainability concerns. As noted above, low global interest rates and a search for yield by international investors facilitated the growth in private credit. Outside of China, where corporate bonds are primarily domestically owned, large developing countries corporate debt is predominantly held by external creditors (around one third of non-financial sector corporate debt, or around USD 1.8 trillion, in 26 emerging market countries, excluding China). The build-up in external foreign currency borrowing makes countries vulnerable to capital flow reversals and currency crises and could endanger financial stability and ultimately public debt sustainability.

Coordination will be more important now than ever, especially given the increased exposure of developing countries to non-traditional bilateral creditors and to private creditors and international capital markets.

In this comprehensive approach covering bilateral, multilateral and commercial debt, the granting of forbearance to countries that request relief would imply an immediate stay on all creditor enforcement actions.

Official bilateral creditors would immediately institute an emergency debt payment (interest and principal) moratorium on sovereign debt for LDCs, other low-income countries, and highly indebted middle-income countries **that request** forbearance.

Debt to international financial institutions (IFIs) should also be included, though IFIs will likely need support from their shareholders to do so, in order not to threaten their AAA ratings and curtail their ability to provide fresh financing during the crisis. Multilateral lenders should relax restrictions on lending-into-arrears to continue to channel funding to countries in need.

Private creditors should join this debt moratorium on comparable terms to avoid the public sector bailing out private creditors. There is no established mechanism, at the international level, to guarantee such private sector participation in a fair and effective manner, but creative steps can be taken, beyond appealing to what would ultimately be in commercial creditors' best collective interest.

For example, creditors should not be able to seize assets¹⁹ or initiate court proceedings against any sovereign creditor that fails to

make debt service payments during the pandemic. While acknowledging the difficult legal and contractual issues involved, solidarity and shared interests should facilitate the process.

This could include jurisdictions that govern most emerging market sovereign bonds halting lawsuits by non-cooperative creditors against countries where debt payment suspensions have been agreed and certified by the IMF. Halting existing legal procedures, as well as refraining from initiating fresh litigation, for a specified period is an effective safeguard against non-cooperative creditors exploiting the crisis by benefiting from developing country bond debt trading at highly distressed levels. This would require full cooperation and understanding of the related constitutional aspects and contractual arrangements.

Countries that can service debt should continue to do so. Otherwise there is a risk of paralyzing the credit markets that are still functioning. Countries with good credit that still have access to international financial markets can and would still issue bonds. Asset purchases could be used to maintain market access of countries that choose to continue servicing their debts. For example, a global asset purchase program funded with the issuance of additional Special Drawing Rights by the IMF could be used to maintain an adequate supply of liquidity. Other options could be explored to support countries in accessing markets, such as partial guarantees.

As the crisis subsides, forbearance should give way to debt relief and restructurings in some cases.

¹⁹ A precedent for this exists in UNSC resolution 1483 which barred all types of attachment, garnishment or seizures of Iraqi assets after the Second Gulf War.

PHASE 2: DEBT RELIEF

An initial debt moratorium should be a starting point for discussions of more comprehensive options towards debt sustainability and SDG achievement.

Although not a solution for countries with unsustainable debt situations, debt swaps can release resources for the COVID-19 response in developing countries. Official creditors should consider debt swaps to enhance social investments and address the impact of COVID-19, as was the case for debt swaps to support the fight against AIDS, tuberculosis and malaria.

The UN has put forward initiatives to free resources for SDG investments, which should be implemented now. Debt-to-health swaps target additional funds to health systems through debt relief, which instead of repaying debt owed in the future require countries to invest in health systems. ECLAC has proposed to swap Caribbean external debt for annual payments into a resilience fund, which can be a source of funding for investments for the crisis response and the SDGs. ESCWA is currently exploring a similar initiative for the Arab region. ESCAP has also highlighted the need for coordinated debt relief and/or deferral of debt repayments. Given the scope of the current crisis, such programs need not be regional programs, and could be scaled up globally.

A mechanism for the SDGs, with a focus on creating fiscal space for recovery and SDG achievement could be considered. Historical precedents, most notably the enhanced Heavily Indebted Poor Countries (HIPC) initiative or the Multilateral Debt Relief Initiative (MDRI), which many consider as a success in expanding fiscal space in countries most in need, can provide some guidance in this regard²⁰.

It is also worth noting that the HIPC required countries to spend fiscal savings from debt relief on increases in poverty-reducing programs such as health and education. This time, it could focus on SDG related spending. Integrated National Financing Frameworks (INFFs) may provide guidance on spending on country-specific SDG priorities.

PHASE 3: INTERNATIONAL DEBT ARCHITECTURE

As we develop a process to deal with the immediate debt crisis stemming from COVID-19, the international community can use this as a platform to address long outstanding issues in the international debt architecture, which should be cast as a third phase given the urgency and immediacy of the need to act in the face of COVID.

A new international debt architecture is required, one that ensures sustainability and provides incentives to institutional and large financial markets to invest in sustainable ways going forward.

²⁰ For instance, creditors initially responded to the 1980s debt crisis with debt rescheduling but eventually moved on to debt relief. A total of 36 countries were granted debt relief under the HIPC and MDRI initiatives between 1996 and 2015, and this helped reduce the median public debt-to-GDP ratio among LICs from close to 100 percent of GDP in the early 2000s to a trough of just over 30 percent of GDP in 2013. The total cost of the HIPC program was some USD77 billion (including USD22 billion by Paris Club) and the MDRI USD42 billion.

As noted by the UN Inter-Agency Task Force (IATF) on Financing for Sustainable Development in its recent report²¹, existing mechanisms for debt workouts need to be revisited²². A revitalized framework for debt restructuring should be based on the Principles established in the Addis Agenda of timely, orderly, effective, fair resolutions, with the aim of preventing defaults from turning into prolonged financial and economic crises, restoring public debt sustainability, and enhancing the ability of countries to achieve sustainable development, particularly the SDGs.

Such a framework could include:

1. Continued improvements to contractual terms of market-based debt instruments, such as aggregation clauses in collective action clauses, the wider use of state-contingent debt instruments (e.g. disaster-linked and/or GDP-linked bonds); and the introduction of standardized majority restructuring into commercial loans.
2. The extension of national legislation to limit litigation by uncooperative creditors, as well as consistent application of sovereign immunities against enforcement.

3. Further development of soft law principles based in international norms. Existing soft law initiatives include, in the realm of responsible borrowing and lending and crisis prevention, the Group of Twenty (G20) Operational Guidelines for Sustainable Financing, and the UNCTAD principles on promoting responsible sovereign lending and borrowing. The UN's Basic Principles on Sovereign Debt Restructurings²³ is an effort to spell out basic principles that can guide restructuring processes.

At the national level, developing countries should use all policy tools, including capital account management, to address capital flight triggered by the crisis. Integrated national financing frameworks (INFFs) provide a framework to bring together all policy tools, including a better assessment and incorporation of financial and non-financial risks in financing policies. The UN system will strengthen coordination to provide support to debt management to meet the SDGs.

²¹ <https://developmentfinance.un.org/fsdr2020>

²² The coming cases of defaults will highlight the shortcomings of international financial architecture, at least when compared to well-developed domestic bankruptcy regimes (i.e., Chapter 9 and Chapter 11 in the US), where courts can encourage creditors to collaborate with each other and negotiate new terms with a borrower, and if there is an agreed restructuring plan, to preclude otherwise recalcitrant creditors from holding out for better terms. The Sovereign Debt Restructuring Mechanism (SDRM), an international analogue of a domestic bankruptcy regime, or a push towards expanding the breadth of collective action clauses (CACs) may come back to the table. Experience in recent years has shown that the new creditor landscape has further complicated and lengthened the process of debt restructuring, greatly increasing its economic and social costs. The urgency of the current situation will not allow for seeking a comprehensive solution at this moment, but further underlines the costliness of this gap in the international financial architecture. Existing proposals like the SDRM are not designed with shocks like a pandemic in mind. At the same time, CACs are not ubiquitous enough to be useful under the circumstances, and bondholders are unlikely to agree to expand the breadth of existing CACs or introduce them into legacy debt without CACs to make it easier for governments to change the terms of their bonds. Also, CACs do not address debt to other kinds of lenders (i.e. commercial banks).

²³ UN General Assembly Resolution on Basic Principles on Sovereign Debt Restructuring Processes" (A/69/L.84), July 2015.

Recommended Actions

A comprehensive approach across three phases, involving all relevant creditors and all countries facing liquidity and solvency issues due to the crisis is required.

PHASE 1

An across-the-board debt standstill for all developing countries that have no access to financial markets and cannot service their debt.

To start, official bilateral creditors should immediately institute an emergency debt payment moratorium on sovereign debt.

The standstill should also:

- Include other creditors (private creditors as well as multilaterals). Coordination is of the essence.
- Extend beyond IDA countries to include other low-income and those heavily indebted middle-income countries that request relief.
- Include principal and interest payments, as well as associated fees and charges
- Set a cut-off date, after which new financing is excluded from future debt restructurings, in order to facilitate access to financing after this date.
- Allow for repayment schedules that ensure ability of countries to implement the 2030 Agenda for Sustainable Development.

PHASE 2

A second phase should consider a more comprehensive assessment and options towards debt sustainability.

Debt swaps can release resources for the COVID-19 response in developing countries, although they may not adequately solve unsustainable debt situations.

A debt mechanism for the SDGs, with a focus on creating fiscal space for recovery in a resilient manner and SDG achievement could be considered.

PHASE 3

Addressing structural issues in the international debt architecture to prevent defaults leading to prolonged financial and economic crises should be cast as a third phase given the urgency and immediacy of the need to act in the face of COVID.

This new international debt architecture should build upon the Principles established in the Financing for Sustainable Development Agenda of timely, orderly, effective, fair resolutions.

It should aim at preventing defaults from turning into prolonged financial and economic crises, restoring public debt sustainability, and enhancing the ability of countries to achieve the sustainable development goals.