Blog

The COVID-19 crisis built up indebtedness and increased external financing needs in low-income countries

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The shock of the COVID-19 pandemic and the associated deterioration in the economic outlook has exacerbated solvency concerns and increased the risks of debt restructurings in low-income countries (LICs). Financing conditions for many LICs still remain tight while the external financing needs are increasing. The International Monetary Fund (IMF) estimates that LICs would need a total of $450 billion in investments in the medium-term to respond the COVID-19 crisis and to accelerate growth to reach the pre-pandemic convergence path with advanced economies. How to fill the vast financing gap in LICs is a central on-going discussion in the international fora. A solution will require a combination of international and domestic measures to increase the availability of external financing, enhance domestic revenue mobilization and address debt sustainability issues.

The pandemic has increased indebtedness and risks of debt restructurings in low-income countries

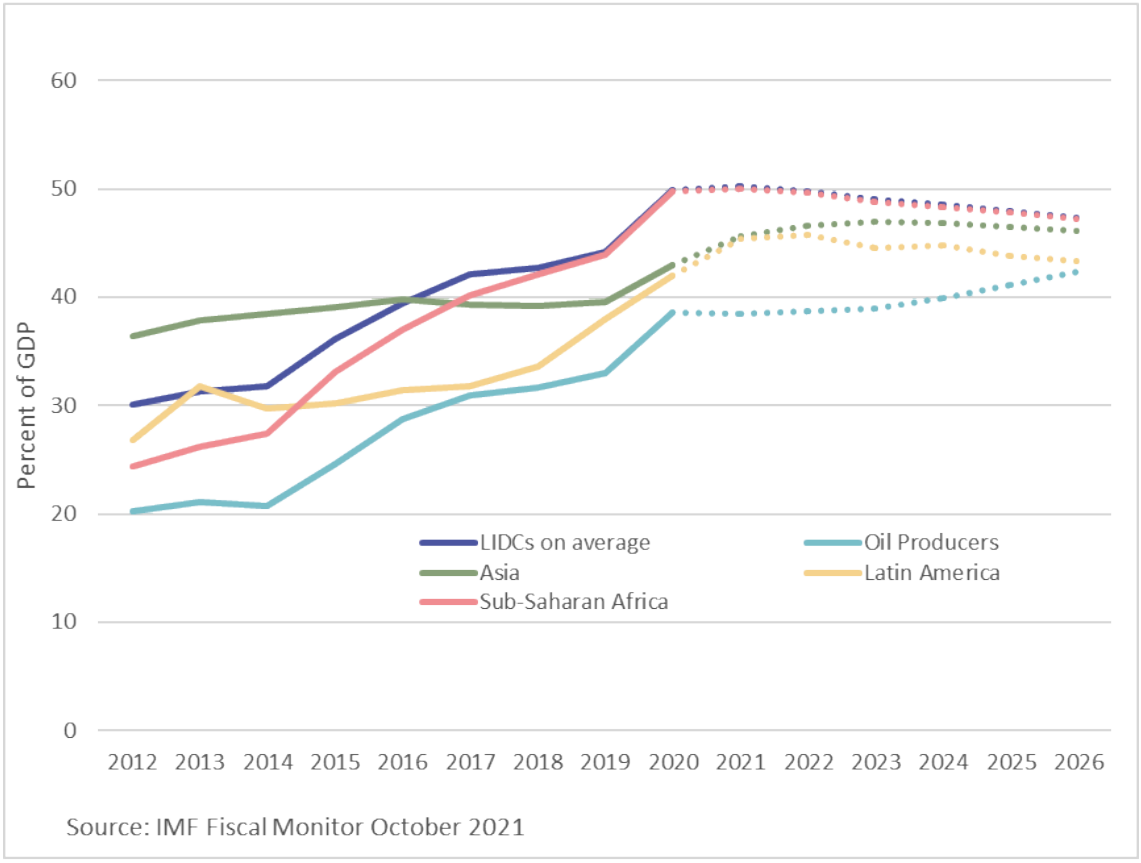
As recently as in the 1990s – less than 30 years ago – a large share of low-income countries (LICs)[1] faced considerable debt distress. In response, the IMF and the World Bank Group (WBG) initiated the Debt Relief under the Heavily Indebted Poor Countries (HIPC) Initiative in 1996. During the following decade, a total of 36 countries concluded the process and emerged with lower external debt while the process is still ongoing for three remaining countries. The HIPC Initiative was considered a new paradigm of international action with its rules-based approach to debt relief. The total amount of debt relief under HIPC is estimated to have been $76 billion. Overall, the

HIPC initiative is considered to have been successful in reducing the debt overhang and diverting funds to poverty-reducing expenditure.[2]

After debt relief under HIPC, general government gross debt overall decreased in LICs. However, already in 2010, the trend changed, and debt to GDP ratios of LICs started growing again. The COVID-19 crisis has further hastened this development as countries have been trying to mitigate the health and economic effects of the crisis amidst lower growth and falling revenues. Growth in debt levels has been relatively fast, especially in tourism dependent countries that were hit hard by the pandemic. According to IMF projections (Chart 1), the sovereign debt to GDP ratio should begin to decrease in 2022 in most low-income developing countries mostly owing to recovering GDP growth. However, oil producers continue on a path of increasing debt to GDP ratios.

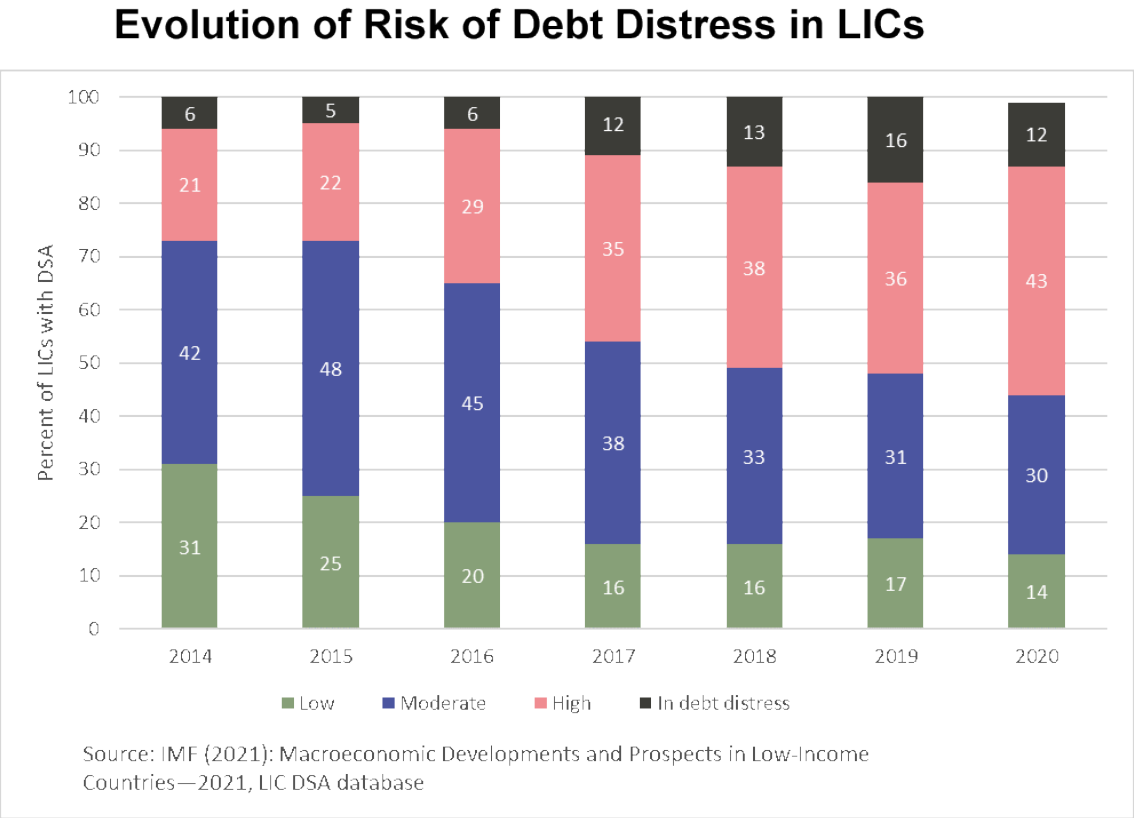
Chart 1.

General Government Gross Debt in Low-Income Developing Countries



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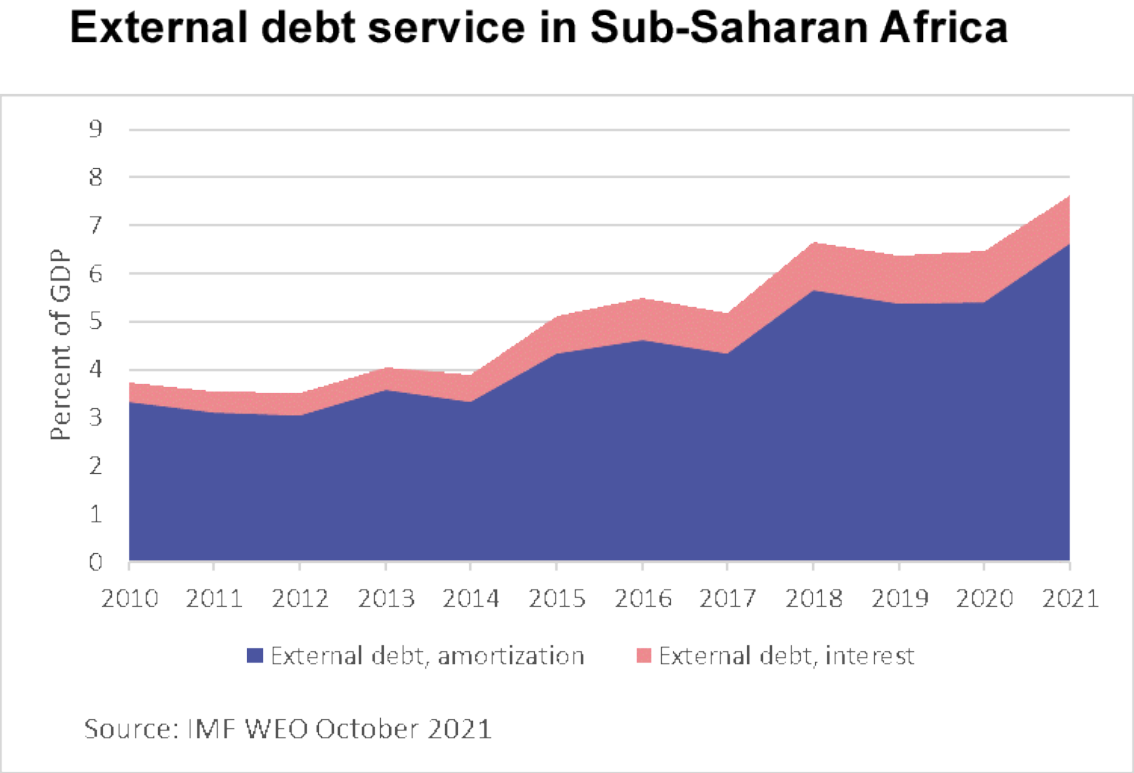
Chart 2.



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The exacerbated trend of debt accumulation coupled with deteriorated growth prospects, has increased the likelihood of solvency problems in LICs. In 2020, already 12 percent of LICs were in debt distress, and up to 43 percent in high risk of debt distress (see Chart 2). Increased debt risks reduce the availability of external financing and increase the price for it. Along with elevated indebtedness, debt service payments are growing in many LICs (see Chart 3 for Sub-Saharan Africa's external debt services). Increasing interest payments shift LICs' scarce resources away from investments for growth and development. Hence, avoiding the recurrence of the situation in the 90's where a large debt overhang stifled development is a key priority to ensure a sustainable recovery from the crisis.

Chart 3.



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Financing conditions for many LICs remain tight while financing needs are increasing

Financing conditions tightened globally at the onset of the pandemic. While they eased relatively rapidly for advanced economies (AEs) and emerging market economies (EMEs), financing conditions for LICs did not return to pre-pandemic levels despite the very large global crisis response. Emergency financing and debt service suspension provided under the G20 and Paris Club Debt Service Suspension Initiative (DSSI)[3] have allowed breathing space and built a bridge over the initial shock. In addition, IMF's and other multilateral institutions' lending turned out to be vital for LICs to reduce the impact of the pandemic. Multilateral lending increased significantly during 2020 and IMF's lending alone rose to $13,4 billion from the usual annual lending of $1,7 billion. Collectively multilaterals committed $75 billion of new financing between April 2020 and mid-2021.[4]

Chart 4.

Remittances, foreign direct investment, and official development assistance flows to low- and middle-income countries, excluding China



Source: World Bank, World Development Indicators, Migration and Development Brief 34

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Due to the tightened financing conditions private financing flows declined and total capital inflows to low and middle income countries decreased by around 13 percent in 2020.[5] The decline in foreign direct investments was especially pronounced with World Bank projections showing a 30% drop in low and middle-income countries excluding China. Instead, remittances decreased only by 1,6% which is much less than forecasted at the onset of the pandemic. One reason behind the lower than expected decline is the extensive policy support especially in advanced economies protecting migrants' livelihoods and ability to transfer money.[6]

Overall, the pandemic has significantly increased financing needs in LICs. The IMF projects external financing needs to increase from $101 bn in 2019 to over $166 bn in 2025. However, this estimation does not include spending on COVID-19 related costs. Most of the increase comes from higher external debt amortization but also current account deficits are expected to grow. IMF assumes that this need can be financed through official lending and private financing. Yet, the financing needs estimation is based on WEO growth projections, that are subject to more than

usual uncertainty due to the pandemic.[7]

A vast financing gap emerges when considering the additional resources required for COVID-19 response and addressing the scars of the pandemic. The IMF estimates additional financing needs of at least $180 billion during 2021–25 for COVID-19 crisis response and $20 billion to rebuild buffers. An additional $250 billion would be needed in increased investment spending to accelerate growth to reach the pre-pandemic convergence path with AEs. However, it should be noted that these assumptions are very fragile, and uncertainty remains high.[8]

Debt sustainability risks limit the borrowing space of LICs. The IMF estimates that of the aggregate increased spending needs, only a third could be financed through new borrowing [9]. The rest should be financed through other sources. Presumably no country wants to lend even the maximum third as it would put them close to the debt sustainability limit. Overall, to increase the capacity to borrow, many LICs should implement necessary domestic economic policy and governance reforms to boost growth, competitiveness and domestic revenue collection. Also, addressing the debt overhang gains importance and necessary debt restructurings could free up additional resources to cover spending needs. Yet, private sector financing and investments that are not debt-increasing are needed to cover financing needs.

Multilateral institutions play a key role in catalysing private financing. Also, ensuring a supportive environment for resolving debt related challenges will be central in helping LICs to sustainably recover from the crisis. Attracting official and private capital is an essential element in the path for recovery and to avoid further divergence from AEs.

The pace of economic recovery is tied tothe recovery from the pandemic, which can only fully happen through global access to vaccines. Hence, improving the availability of vaccines at affordable prices globally, and especially in LICs, is the most important policy priority for the global community in the near term. Here, multilateral institutions and the global community have done important work in supporting LICs through the COVAX-facility[10] to finance the purchase and distribution of COVID-19 vaccines, tests, and treatment.

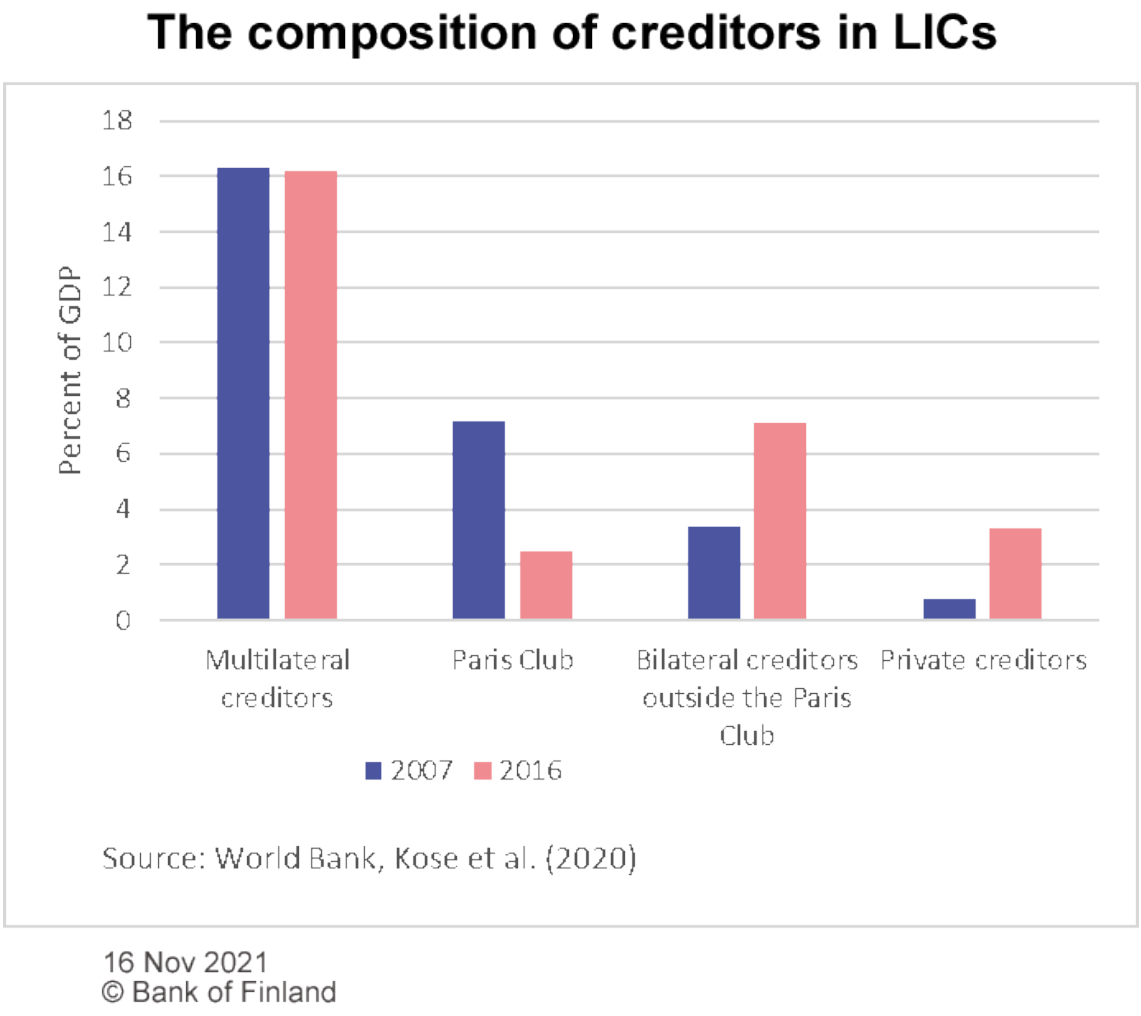
In addition to economic scarring, the COVID-19 pandemic has caused severe humanitarian scars hitting particularly women, children, and low-skilled workers. The impact on education is much more severe in LICs than in developed countries. This may leave long-lasting effects through increased school dropouts and decreased educational outcomes. The pandemic might also undermine the progress made in reducing inequality. The World Bank estimates that 97 million people fell into extreme poverty in 2020 [11]. There is a large risk that the humanitarian outcomes could end up much worse if the global community fails to end the pandemic, there is not sufficient

financing available to address the scars of the pandemic and/or debt issues cannot be solved and a debt overhang stifles development in the longer run.

How to meet the large financing needs of LICs?

A challenging question is how to meet the large post-pandemic financing needs of LICs. The main financing sources for LICs are multilateral organizations such as the IMF, World Bank and other development banks, Paris Club creditors [12], bilateral creditors outside the Paris Club and private creditors. A significant change in the composition of LICs' creditors took place in the 2010's. The share of traditional Paris Club creditors has decreased, while the shares of private creditors and non-Paris Club official creditors, especially China, have increased (see Chart 5).

Chart 5.



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In addition to new borrowing, there are other options to improve liquidity position of LICs. For example, the IMF's SDR-allocation provided additional liquidity for all member countries. Moreover, debt restructuring or reprofiling is a central option to enhance liquidity for example through renegotiating the loan maturities. If debt sustainability is at risk, sovereign debt restructurings should be done promptly and in a scale that restores sustainability.

Many LICs have limited absorption capacity to efficiently scale up investment spending due to often weak institutional and governance capacities. For example, the IMF estimates that on average LICs waste more than half of their infrastructure spending on inefficiencies.[13] This highlights the importance of complementing increased financing by strong domestic reform efforts for example in public financial management and infrastructure governance.

How much of the LICs' debt can be multilateral?

When discussing the future of multilateral financing and increasing its share of the overall debt stock, it is especially interesting to investigate the effects on the multilateral's preferred creditor status (PCS). The preferred creditor status implies that borrowing countries are expected to give priority to meeting their obligations to the multilateral lenders (e.g. the IMF) with PCS over other creditors [14]. When the share of multilateral financing grows, in a restructuring situation private and other "non-preferred" creditors will have to agree to more debt relief, which will complicate the restructuring. This may compromise the IMF's and other multilaterals' catalytic role and change the risk-diminishing effect of an IMF program, to a risk-increasing role arising from the subordination of private obligations to the IMF's preferred credit.

Assessing the composition of sovereign debt is always ultimately a country specific question. However, when discussing a significant global increase in the IMF and other multilateral financing it is also useful to look at the overall picture. The IMF's empirical analysis, that is based on historical evidence, defines indicative boundaries that can help to form a rough assessment on an overall upper bound of the super senior debt in LICs [15]. According to this analysis, 75 percent of LICs are estimated not to be able to borrow if their ratio of multilateral debt to total public debt increases above 56 percent [16]. According to the latest available data, the IMF and multilateral debt stock was already at 48 percent of the total aggregate public debt of LICs at the end of 2019 [17].

The shares of IMF and multilateral debt have grown since 2019 due to large emergency lending, where IMF's lending alone rose $13,4 billion and collectively the multilaterals have committed

$75 billion.[18] At the same time the growth of bilateral and private lending has been more sluggish.

As discussed earlier, the IMF estimates that LICs' financing needs sum up to $450 billion of which a maximum of one third, $136 billion, could be financed through new borrowing, without compromising debt sustainability. Moreover, IMF finds that the high share of multilateral debt of total debt limits the LICs' ability to borrow from multilaterals already in 48 percent of the countries. At the same time, the IMF is aiming to scale up its lending to LICs by SDR 25–57 billion during the pandemic period and its immediate aftermath (2020–24).[19]

This surge in lending would significantly increase the Fund's country-level exposures, underscoring the need to scrutinize capacity-to-repay in individual cases. Especially, reaching the upper bound of the lending projections would likely push the share of IMF lending in some countries to a level where it may compromise the Fund's catalytic role.

The new general allocation of SDRs improved liquidity

As a part of the global response to COVID-19, the IMF boosted its member reserve assets through a new general allocation of Special Drawing Rights (SDRs) of US$ 650 billion. This allocation was distributed in August 2021 to all IMF members according to their quota shares. The allocation sent a strong signal of continued global support to crisis response, boosting confidence and facilitating a more broadly shared global recovery from the pandemic.

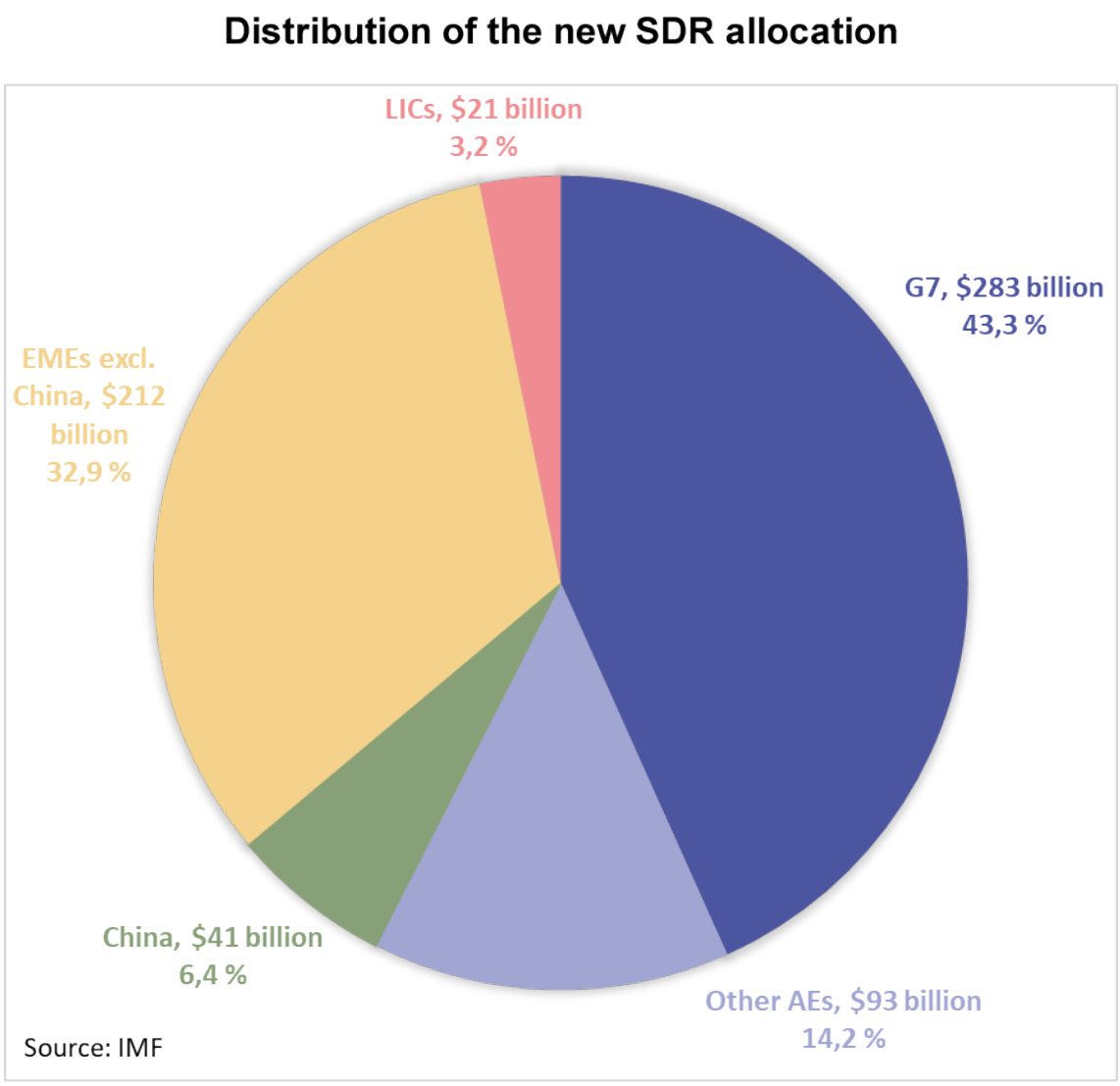
The SDR is an unconditional and fully fungible reserve asset that IMF members can exchange to freely usable currencies, which can be used without restrictions. Most countries keep them in their reserves, boosting buffers. However, members can also sell their SDRs for freely usable currencies (USD, EUR, JPY, GBP, RNB) to adjust the composition of their international reserves or alternatively use them to finance additional spending or meet other balance of payment needs. In addition, members may use SDRs to meet their obligations due to the IMF.[20]

The previous SDR allocation, worth US$ 250 billion, was made in conjunction with the Global Financial Crisis (GFC) in 2009. At that time, the sales of SDRs ended up significantly lower than expected, peaking at the first year after the allocation, when 21 members sold 3,4 billion SDRs.[21]

This time, even more acutely than after the GFC, the strongest argument for the allocation arose from the need to support emerging and low-income economies, where the IMF estimates gross external financing needs of over US$ 3 trillion in 2021-2025. 36 percent of the SDR allocation was allocated to emerging economies (excluding China), providing an important boost of US$ 233

billion to their reserves. Whereas LICs, where the financing needs are the most acute, received 3,2 percent of the total allocation, increasing their reserve assets by US$21 billion.[22]

Chart 6.



By boosting reserves, the allocation helps to smooth the needed adjustment and support especially more vulnerable countries in meeting their financing needs without overly contractionary or distortionary macroeconomic policies. Moreover, it provides a welcome boost to EMEs' buffers, in the face of possible volatility associated with unwinding accommodative policies in advanced economies.

The increase in reserve assets is particularly important for LICs, where the allocation represents on average of over 2 percent of their GDP and many of whose reserve adequacy is low.[23] However, the IMF estimates that even the SDR allocation will not bring reserves to adequate level in many LICs. Thus, while the allocation offers a very welcome one-off boost for vulnerable countries' buffers, it does not solve the financing challenges LICs are facing. The SDR allocation complements other international efforts to narrow the large financing gap in LICs caused by the pandemic, including the IMF's Poverty Reduction and Growth Trust (PRGT), the Debt Service Suspension Initiative and multilateral support.

Considerations of channelling SDRs to vulnerable countries

Most of the new SDRs were allocated to advanced economies with little need for extra reserves. Thus, the option of using these "excess" SDRs by channeling them for the benefit of more vulnerable countries, notably LICs, but also middle-income countries (MICs), is heatedly discussed at the global arena. The idea of countries in stronger positions on-lending their SDRs or reserve assets denominated in other currencies to the benefit of LICs is not new and is already used to finance the IMF's Poverty Reduction and Growth Trust (PRGT). [24]

Most countries hold their SDRs at the central bank as part of their international reserve assets, which may limit the ability to simply donate the SDRs for a certain purpose. Generally, the SDRs can be on-lent in a way that their reserve asset status at the central banks' balance sheet remains intact. Overall, this requires sufficient safeguards[25] to limit the risks of on-lending and an arrangement that ensures liquidity of the assets. There is variation in the country level legal frameworks, which affect the IMF members ability to use their SDRs.

The IMF's PRGT framework has the necessary features built in to be able to use loans from member countries' central banks as reserve assets. Thus, the most advanced idea of channelling SDRs to the benefit of LICs is significantly expanding IMF's concessional lending provided under the PRGT.

In addition, to broaden the group of eligible countries and focus on longer-term resilience building the IMF is considering establishing a new Sustainability and Resilience Trust (RST) by using SDR's channeled by members in stronger BoP positions. The new trust would support policy reforms for economic resilience and sustainability in low-income countries, small states and vulnerable middle-income countries that cannot access the PRGT and do not have market access. The new trust is envisioned to supplement Fund programs, with longer term loans addressing longer-term structural challenges notably climate change (mitigation, adaptation, and transition) and pandemic

preparedness.[26]

The opinions expressed in this article are those of the authors and do not necessarily represent the views of the Bank of Finland.

Keywords

COVID-19, COVID-19 crisis, financing, IMF, indebtedness, low-income countries, SDR