ODUMUNC 2023 Issue Brief
Second Committee: Economic and Financial Committee

Protecting developing economies from the effects of external debt

Old Dominion University Model United Nations Society

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The Economist

The 53 fragile emerging economies

The contours of a debt crisis are starting to become clear

20 July 2022 | WASHINGTON, DC

For a fleeting moment, the protesters seemed to be having a good time. On July 9th some of the thousands of Sri Lankans who had taken to the streets to express frustration at the country’s economic crisis stormed into the president’s residence, where they cooked, took selfies and swam in the pool. Not long after, word came that the president, Gotabaya Rajapaksa, had fled and would resign. His successor, Ranil Wickremesinghe, until recently the prime minister, inherits a mess. In April Sri Lanka declared that it could no longer service its foreign debt. Its government has sought aid from India and Russia to pay for essential imports. The economy is likely to shrink dramatically this year. In June annual inflation climbed to 55%. If the government is unable to stabilise the situation, the country may yet succumb to hyperinflation and further political chaos.

The scenes in Sri Lanka may be a sign of things to come elsewhere. Debt loads across poorer countries stand at the highest levels in decades. Squeezed by the high cost of food and energy, a slowing global economy and a sharp increase in interest rates around the world, emerging economies are entering an era of intense macroeconomic pain. Some countries face years of difficult budget choices and weak growth. Others may sink into economic and political crisis. All told, 53 countries look most vulnerable: they either are judged by the imf to have unsustainable debts (or to be at high risk of having them); have defaulted on some debts already; or have bonds trading at distressed levels.

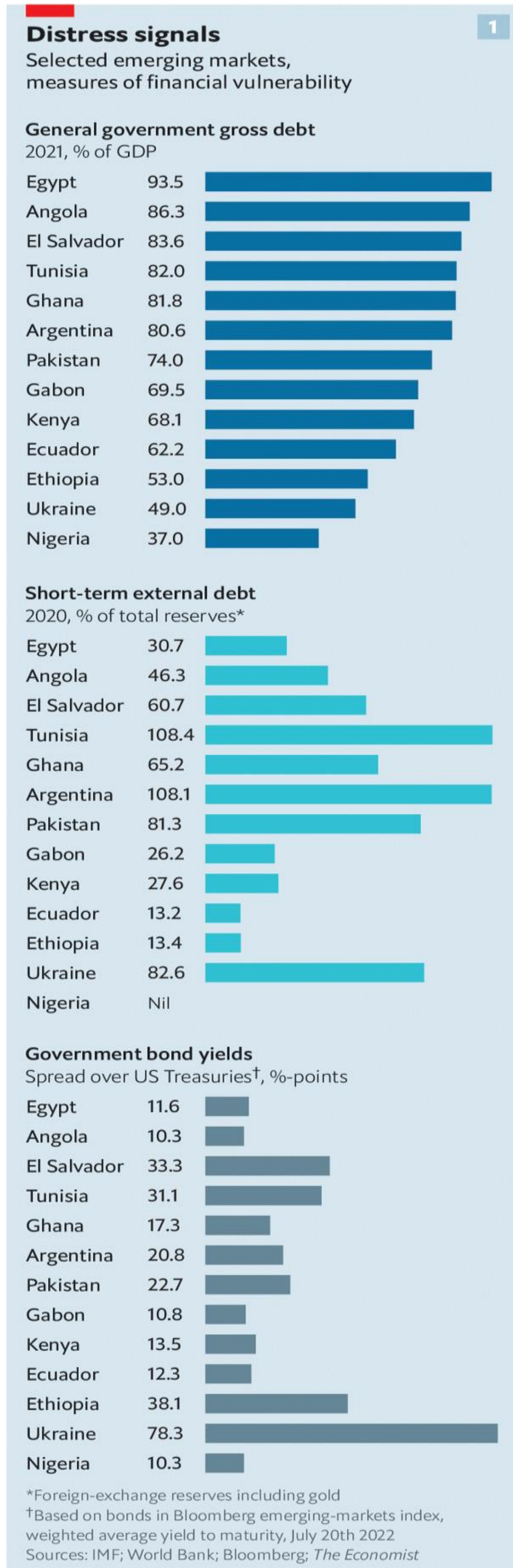
Today’s bleak situation has an analogue in the desperate years of the 1980s and 1990s. Then, as now, a long period of robust growth and easy financial conditions was followed by leaner times and rising debt burdens. Macroeconomic shocks, rising inflation and, eventually, soaring interest rates in the rich world pushed many heavily indebted poor economies over the fiscal cliff. In August 1982 Mexico’s government announced that it could no longer service its foreign debt. More than three dozen countries had fallen behind on their debts before the year was out. By 1990 roughly 6% of the world's public debt was in default.

Much has changed since. Many governments opened up to trade, liberalised their economies and pursued more disciplined macroeconomic policy. Faster growth and better policy led to broad improvements in the fiscal health of emerging economies. By 2008, as rich countries sank into an intense financial crisis of their own, the level of public debt across poorer economies stood at just 33% of GDP.

This allowed them to engage with the global financial system in a manner more like the rich world. Most emerging-market governments hoping to tap global capital used to have little choice but to borrow in a foreign currency, a risky step that could quickly transform home-currency depreciation into a full-blown crisis. Around the turn of the millennium, about 85% of new debt issued outside America, Europe and Japan was not denominated in the borrower's currency. But by 2019 roughly 80% of outstanding bonds across the emerging world were denominated in local currency.

As emerging economies' financial systems matured, their governments became better able to tap domestic capital markets. The crises of the 1980s and 1990s also taught them the value of stockpiling foreign-exchange reserves; global reserves rose from less than 10% of world GDP in 2005 to 15% in 2020. It was thanks largely to these adjustments that most emerging markets weathered the slow growth of the 2010s and the shock of the pandemic. Only six governments defaulted in 2020—including Argentina (for the ninth time), Ecuador and Lebanon—equivalent to just 0.5% of outstanding global public debt.

But this greater resilience also allowed governments to rack up more borrowing. In 2019 public debt stood at 54% of GDP across the emerging world. The pandemic then led to an explosion in borrowing. In 2020 emerging economies ran an average budget deficit of 9.3% of GDP, not far off the 10.5% run by rich economies.



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Borrowing stabilised in 2021 as economies rebounded. But the picture has grown darker this year. The jump in food and energy prices that followed Russia's invasion of Ukraine is depressing growth across most of the world, increasing debt burdens. Rising import bills have drained hard currency from many vulnerable places—including Sri Lanka—eroding their capacity to service foreign debts. Conditions will probably deteriorate as rich-world central banks continue to raise interest rates. Hawkish turns by the Federal Reserve tend to diminish risk appetite and draw capital out of emerging markets, leaving overextended borrowers high and dry.

And Fed policy has not been this hawkish for some time. The federal-funds rate is expected to approach 3.5% by the end of this year, which, along with the unwinding of some recent asset purchases, would constitute the Fed's sharpest tightening since the early 1980s. The emerging world has thus experienced net capital outflows every month since March, according to the Institute of International Finance, an industry group. The dollar has risen by over 12% against a basket of currencies since the start of the year, and is up by far more against many emerging-market currencies. As funding conditions have worsened, borrowing costs for some governments have soared. About a quarter of the low- and middle-income issuers of debt face yield spreads over American Treasuries of ten percentage points or more—a level considered distressed (see chart 1).

The combination of heavy debt burdens, slowing global growth and tightening financial conditions will be more than some governments can bear. One set of potential victims comprises the poorest economies, which have been less able to borrow in relatively safe ways—in their own currencies, for example—and which, because of the pandemic, were already vulnerable. Among 73 low-income countries eligible for debt relief under a g20 initiative, eight carry public-debt loads which the imf has deemed to be unsustainable, and another 30 are at high risk of falling into such a situation. Debt problems in these countries pose little threat to the global economy; together, their gdp is roughly equivalent to that of Belgium. Yet they are home to nearly 500m people, whose fates depend on whether their governments can afford to invest in basic infrastructure and public services.

Then there are the troubled middle-income economies in the mould of Sri Lanka, which are more integrated into the global financial system, and which through policy missteps and bad luck have found themselves exposed. Overall, 15 countries are either in default or have sovereign bonds trading at distressed levels. They include Egypt, El Salvador, Pakistan and Tunisia.

Home discomforts

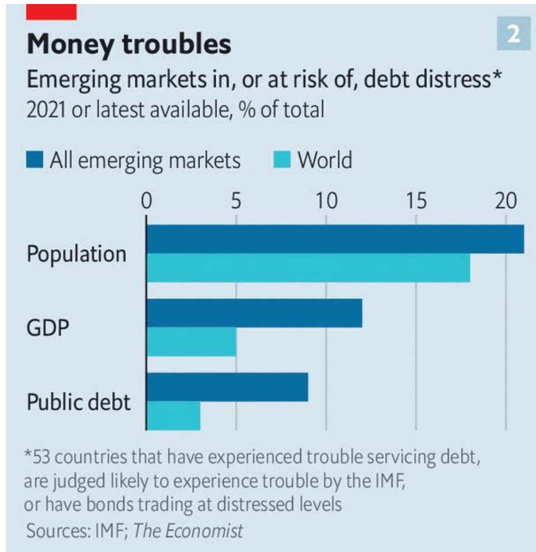
More middle-income countries may be better insulated against deteriorating global conditions than they were in the past. Still, the imf reckons that about 16% of emerging-market public debt is denominated in foreign currencies. And the places that are more insulated have in many cases become so by funding borrowing through local banks. That, however, raises the possibility that any credit stress experienced by a government also feeds through to its banking system, which could in turn impair lending or even lead to outright crisis. Across the emerging world, reckons the imf, the share of public debt held by domestic banks has climbed over the past two decades to about 17% of GDP, more than twice the level in rich economies. Sovereign-debt holdings as a share of total bank assets stand at 26% in Brazil and 29% in India, and above 40% in Egypt and Pakistan.

Just how big this group eventually gets, and how serious the spillovers are to the rest of the world, depends on whether bigger economies, like Brazil and Turkey, are ensnared by crisis. Both have muddled through so far, despite some vulnerabilities, but poor policy could push them towards the brink.

As a commodity exporter, Brazil has benefited from higher food and energy prices. Its hefty pile of foreign-exchange reserves has so far reassured markets. The president, Jair Bolsonaro, trails in the polls ahead of an election due in October, though, and has loosened the country's purse strings in an attempt to win support, adding to the country's heavy debt load. He has also suggested that he may not obey voters should they decide to toss him out. If he spooks markets, an outflow of capital could at the very least leave the economy facing a severe fiscal crunch and recession.

Turkey has a dynamic economy and a modest level of public debt. But it owes a lot to foreigners relative to its available currency reserves. And its president, Recep Tayyip Erdogan, insists that the central bank keeps interest rates unduly low in the face of soaring inflation—which has climbed to near 80%. The lira has crashed in value over the past four years. Without a policy change, the government could face a balance-of-payments crisis.

Neither of the world's largest emerging markets, China and India, is at high risk of an external crisis. Both have intimidating piles of foreign-exchange reserves. China's government wields close control over both capital flows and the domestic financial system, which should allow it to contain panic, while India's is only minimally reliant on foreign funding. Both, however, carry enormous public-debt loads by historical standards. And both matter enough to the global economy that a period of deleveraging that depressed growth and investment could have big knock-on effects.



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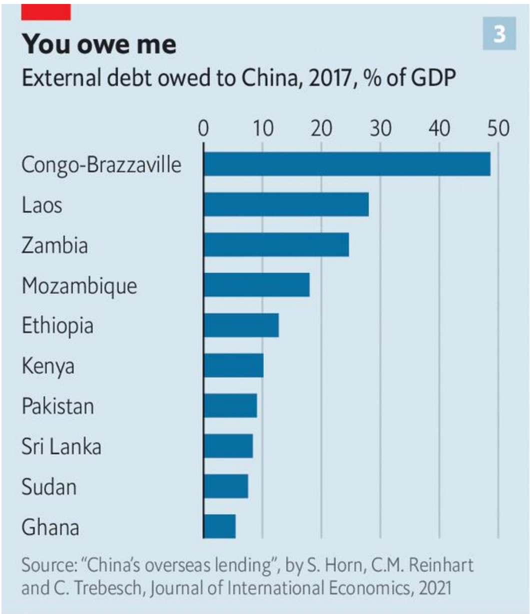
Taken together, then, 53 low- and middle-income countries are already experiencing debt troubles, or are at high risk of doing so. Their economic size is modest—their combined output amounts to 5% of world GDP—but they are home to 1.4bn people, or 18% of the world's population (see Chart 2). And worryingly, there are few options available to ward off crisis. An end to the war in Ukraine seems a distant prospect. A growth rebound in China or elsewhere could be a double-edged sword: it would boost growth but also contribute to inflation, leading to further rate rises in the rich world.

Debt relief would help. Roughly a third of the massive debts owed by middle-income economies in the 1980s was forgiven under a plan put together by Nicholas Brady, then America's Treasury secretary, in 1989. Additional relief was provided to 37 very poor countries through an initiative organised by the imf and World Bank in 1996. The G20 took similar steps during the pandemic, first with the Debt Service Suspension Initiative, through which more than 70 countries were eligible to defer debt payments, and then through the Common Framework, which was intended to provide a blueprint for broader relief.

Yet the framework has failed to gain traction. Only three countries have so far sought help under it, and none has completed the process. Prospects for improving the scheme, or for reaching agreement on debt relief, have been dimmed by the fact that lending by Paris Club countries—rich economies that have agreed to co-operate in dealing with unsustainable debts—has become less important, while loans from private creditors and big emerging markets, China in particular, have become more so. In 2006 Paris Club economies and multilateral bodies accounted for more than 80% of poor countries' foreign obligations. Today they account for less than 60% of poor-country debt. Nearly a fifth is owed to China alone.

Indeed, work by Sebastian Horn and Christoph Trebesch of the Kiel Institute and Carmen Reinhart of Harvard University helps illustrate how massive and murky a force Chinese lending has become. They reckon that almost half of China's lending abroad is unreported, such that their estimates of China's claims on foreign governments probably understate the true figures. Even so, they reckon that from 1998 to 2018 China's foreign lending, the bulk of which has gone to low- and middle-income economies, rose from almost nothing to the equivalent of nearly 2% of world GDP. And among the 50 economies most in hock to China, obligations to Chinese institutions amount to 15% of GDP on average, or about 40% of external debt.



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More than a third of the world's most debt-distressed countries also number among those most indebted to Chinese lenders. As of 2017, the debt owed to China by Kenya amounted to 10% of the latter's gdp, and by Laos a staggering 28%. China is also a big creditor of Sri Lanka (which owed it the equivalent of 8% of GDP in 2017) and Pakistan (9%). Many indebted economies are loth to ask for debt relief from China, fearing the wrath of its leadership or a loss of access to future funding, and Chinese institutions have tended to prefer reprofiling debts to outright relief. Deteriorating relations between China and the West, meanwhile, have reduced the scope for co-operation in handling debt problems.

In the 1980s, emerging-market defaults on loans owed to American banks pushed some financial institutions to the brink of insolvency. Residents of rich economies may take some comfort from the fact that their lenders are less exposed today. But for the billion or more people living in countries at risk of distress, the pain will be only too drawn out, both as fiscal woes infect local banks and as negotiations over external debt prove intractable. ■

Debt repayment costs are rising fast for many African countries

They are unlikely to default this year, but face trouble by 2024

30 April 2022 | PARIS

AFRICAN FINANCE ministers trying to manage debt must be cursing their luck. First the pandemic slammed their finances. In December a pandemic-inspired scheme to suspend interest payments to bilateral creditors ended. It had delayed debt problems but did not fix them. In February Russian tanks rolled into Ukraine and jumpy investors began to ditch African government bonds. In March the Federal Reserve began to raise interest rates, which will make financing pricier everywhere. Meanwhile, China, a big economic partner for the continent, is struggling because of a rumbling property-debt problem of its own and lockdowns to slow covid-19.

All this has taken a toll. In 2015 the IMF judged that eight countries in sub-Saharan Africa were in debt distress or at high risk of it. Zambia defaulted in 2020. By March the IMF's list had grown to 23 countries. African governments owe money not only to rich countries and multilateral banks but also to China and bondholders.

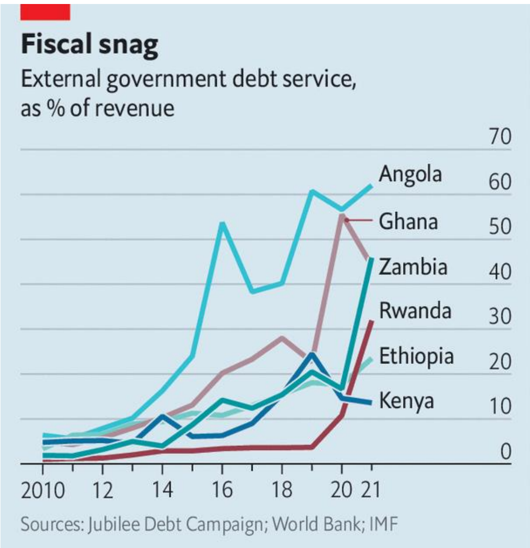
The good news is that few countries in sub-Saharan Africa need to make big principal repayments to private creditors this year. It is therefore unlikely that there will be bond defaults in sub-Saharan Africa in 2022, even as countries elsewhere miss payments, says Gregory Smith, an economist and fund manager. In Sri Lanka, for example, protesters are occupying the entrance to the president's office and the government has cancelled exams for millions of schoolchildren because it could not afford the paper to print them on. The bad news is that African countries have some of the world's highest interest bills relative to revenues. That leaves less for spending on education and health. It could also foreshadow bigger trouble in 2024, when big loan payments are due.

In 2010, amid a commodity boom and after a big debt write-off for many poor countries, African governments were on average spending less than 5% of revenues servicing foreign loans. By 2021 this had jumped to 16.5%, says the Jubilee Debt Campaign, an NGO. This is higher than the 12.5% average of other emerging markets. In Ghana external debt costs consume 44% of government revenues, reckons the IMF. Cameroon, Ethiopia and Malawi all shelled out about a quarter of revenues.

For oil exporters such as Angola and Gabon, higher crude prices help. In Angola the local currency has soared along with oil. Nigeria, paradoxically, may find itself in deeper trouble as oil prices rise.

Although it exports the stuff, it also burns cash on fuel subsidies, which increase as the oil price does. It issued a $1.25bn seven-year bond in March, though at an expensive interest rate of 8.4%.

The war in Ukraine has jolted metal and mineral prices upwards, helping exporters. Yet this will be offset if dearer fuel drains their currency reserves, which are scant for many. On average about 60% of debt owed by sub-Saharan countries is in foreign currencies. Mozambique's foreign-currency borrowing stands at 113% of GDP. There and in Angola, Rwanda and Zambia every 10% fall in their currency increases debt-to-GDP by six to 11 points, says Capital Economics, a consultancy.



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These problems stem from a stubborn fact. Debt-funded spending by African governments has not generated enough economic growth, tax revenue or export earnings to pay back the debt comfortably.

The pandemic bears much of the blame but plenty of spending was inefficient. In Ghana, for example, it soars in election years and much goes on salaries and handouts.

Few remedies appeal. Egypt, Ghana and Tunisia may need IMF bail-outs. These are unpopular, especially in Ghana, where the government has staked its reputation on sound financial management.

Governments could try to restructure their debts. When Africa's debt costs were previously this high, rich countries agreed to big write-offs. Last year the G20, a group of large economies, set up the Common Framework to help countries at risk of default. In theory the scheme requires private creditors to take the same hit as government lenders, which may explain why they want nothing to do with it. The result is stasis. Only Chad, Ethiopia and Zambia have applied—and none has got beyond talks. Ethiopia had its credit rating cut after applying, putting others off trying.

Some hope to fix their problems without outside help. That will be painful. To stabilise its debt Ghana needs to find savings or taxes worth 6% of GDP, reckons Capital Economics. Ghana has promised to slash discretionary spending by almost a third and has ignored street protests to ram through a tax on electronic payments. The cedi, the local currency, has fallen by about a fifth against the dollar this year. To try to stop the slide the central bank recently raised interest rates by 2.5 percentage points to 17%, its biggest-ever jump. Most countries in sub-Saharan Africa need to cut spending or raise more taxes to avoid debt trouble, says the IMF.

Many governments would rather bet on economic growth and the debt-fuelled spending they hope would spur it. Yet if that does not work, the fallout will be brutal. Just ask Sri Lankans. ■

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How China should handle its bad loans to poor countries

Time to work with Western creditors

25 August 2022

How big is China's Belt and Road Initiative? It is hard to pin down a number. The programme has been running for nearly a decade, during which time China has financed hundreds of infrastructure projects in dozens of countries. These include railways in Africa, ports in Asia and roads in Latin America. President Xi Jinping has called it the "project of the century". The lofty rhetoric and opaque numbers fuelled fears that China was trying to reshape the world, by putting itself at the centre.

In one sense, it succeeded. The developing world is suffering a sovereign-debt crisis and China is at the heart of it. Buffeted by the pandemic, inflation and the war in Ukraine, dozens of countries involved in the Belt and Road Initiative are struggling to pay back loans from China and other creditors. Ethiopia and Zambia are among those restructuring their debts; Sri Lanka needs China's co-operation to do the same; in time, Cambodia, Kenya and Laos may follow. China's ruthlessly self-interested lending policies share some of the blame. The country must work with other creditors to resolve the crisis.

Such teamwork does not come naturally to China. An early test is Sri Lanka, where it has provided cash for ambitious projects. Some of these endeavours, such as big roads and expressways, seem to be worthwhile. But others have been costly flops. A new international airport in Hambantota, in the south, built with a $190m loan from China, has at times struggled to keep the lights on. A Chinese-funded seaport nearby also looks like a dud. Struggling to service its debts, Sri Lanka's government handed control of the port, on a 99-year lease, to a state-backed Chinese firm in 2017.

White elephants alone did not cause the debt crisis. The blame lies mostly with Sri Lanka's government for slashing taxes in 2019 and with covid-19 for crushing tourism. But China provided a shovel to burrow deeper into debt. Early in the pandemic, as the island's debt woes mounted, some officials wanted to approach the imf for a bail-out. But China stepped in, offering emergency loans to boost liquidity. That strategy failed spectacularly this year, when Sri Lanka ran out of dollars to pay for basic imports. By the time it approached the fund in April, its economy was in free-fall. Three months later big protests forced the president to flee.

The hope is that China learns the lesson Western creditors were taught in the 1980s and 1990s, when they repeatedly rescheduled loans, instead of writing them down, prolonging the economic pain in several developing countries. Better still if China learned to work with Western and other rich creditors, which are grouped together in the Paris Club and tend to co-ordinate sovereign-debt restructurings, often in tandem with the imf. China has long resisted such efforts, resenting America's leading role in those organisations, as well as the club's commitment to consensus, transparency and "comparable treatment" for all creditors.

However, there are some reasons to be optimistic. China financed a splurge on infrastructure in Zambia similar to the one in Sri Lanka. And it frustrated debt-restructuring efforts after Zambia, too, ran into financial trouble. In 2020, though, it backed the "Common Framework" agreement between the g20 and the Paris Club to co-operate on debt treatments for poor countries. In July, after months of talks, China and other government creditors agreed to provide debt relief to Zambia in the first such deal under the framework. Now comes talk of China co-chairing a creditor committee with Japan and perhaps India to resolve Sri Lanka's debt.

China's stress test

That would be welcome, as more tests are coming. China has scaled back the Belt and Road Initiative. But it is still not clear if the crisis has prompted a serious rethink in Beijing. In the past China has claimed to offer a better model of development finance, free of the conditions that Western and multilateral lenders impose. It is true that those lenders need to improve their own practices. America, in particular, should not let geopolitical tensions hamper co-operation on debt relief. The onus, however, is now on China as the world's biggest official lender to take a more responsible approach to dispensing loans abroad—and to work with other creditors when things go bad. ■

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General Assembly

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77/153. External debt sustainability and development

Seventy-seventh session
Agenda item 16 (c)
Macroeconomic policy questions: external debt sustainability and development

Emphasizing that debt sustainability is essential for underpinning growth, underlining the importance of debt sustainability, debt transparency and effective debt management to the efforts to achieve the Sustainable Development Goals, and acknowledging that debt crises are costly and disruptive, including for employment and productive investment, and tend to be followed by cuts in public spending, including on health and education, affecting the poor and vulnerable in particular,

Reaffirming that each country has primary responsibility for its own development, including through maintaining its own debt sustainability, and that the role of national policies and development strategies, including in the area of debt management, is central to the achievement of sustainable development, and recognizing that national efforts, including to achieve development goals and to maintain debt sustainability, should be complemented by supportive global programmes, measures and policies aimed at expanding the development opportunities of developing countries, while taking into account national conditions and ensuring respect for national ownership, strategies and sovereignty,

Noting the increasing share of domestic borrowing, and acknowledging that the development of domestic bond markets can contribute to fiscal and financial resilience and mitigate exchange rate risks in times of financial turbulence, while noting that excessive borrowing from the domestic banking system could also exacerbate vulnerabilities through the sovereign-bank nexus, in the event of a crisis, *Recognizing with concern* that, in 2021, the external debt positions of many developing countries had continued to deteriorate, with external debt stocks of developing countries growing by 600 billion United States dollars in 2021 to reach a new record level of 11.9 trillion dollars, and that, for low-income and middle-income countries, the debt stock reached 9.7 trillion dollars in 2021, an increase of 8.1 per cent as compared with 2020,

Recognizing with concern also that small island developing States saw their external debt position deteriorate further in 2021, reaching new record levels of 66.1 billion dollars and raising the ratio of debt service costs to export revenues from 37 per cent in 2019 to 41.1 per cent in 2021,

Recognizing with concern further that total external debt stocks in lower-middle-income countries grew in 2021 to 2.5 trillion dollars, or 30.4 per cent of their gross domestic product, 118.3 per cent of their export earnings, while those of upper-middle-income countries rose to 7.1 trillion dollars, amounting to 26.1 per cent of their gross domestic product and to 104 per cent of their export earnings in 2021 and that the debt of middle-income countries has not only been growing at a faster pace than anticipated over recent years but is a more costly debt with a shorter maturity,

Recognizing the importance of debt sustainability for the smooth transition of countries graduating from least developed country status, as well as those that have already graduated,

Emphasizing that international support, in the form of official development assistance and a coordinated multilateral effort to provide low-cost, long-term development financing, as well as enhanced domestic resource mobilization, which is the primary source of financing for development across all country classifications, are needed to address the growing challenges to developing countries' debt sustainability,

Taking note of the operational guidelines for sustainable financing promoted by the Group of 20, while urging the Group to continue to engage in an inclusive and transparent manner with other States Members of the United Nations in its work, in order to ensure that the initiatives of the Group complement or strengthen the United Nations system, and noting the progress achieved in the implementation of the operational guidelines,

Noting the need for coordinated efforts by the International Monetary Fund and the World Bank to promote responsible, transparent and sustainable lending and borrowing,

Noting with concern that countries around the world continue to grapple with multiple crises, including COVID-19, climate change and geopolitical tensions and conflicts which have accentuated food, energy and financial challenges and undermined inclusive recovery and eradication of poverty, while rising risk aversion has triggered capital outflows from emerging market economies, causing adverse effects on the debt sustainability efforts of developing countries,

1. *Takes note* of the report of the United Nations Conference on Trade and Development;[6]

2. *Emphasizes* the special importance of timely, effective, comprehensive and durable solutions to the debt problems of developing countries to promote their economic growth and development;

3. *Recognizes* the importance, in particular, of new and emerging challenges and vulnerabilities in regard to developing country external debt sustainability arising from structural changes to overall debt composition, the rapid growth of private sector debt in many emerging and developing countries and the growing use of new debt financing instruments and approaches;

4. *Notes* the growing concerns about fast-rising corporate debt, high-risk exposure to volatile international financial markets and fast-growing debt servicing burdens as potential triggers of financial and debt crises and the consequent need for coordinated policy responses;

5. *Stresses* the need to continue to assist developing countries in avoiding a build-up of unsustainable debt and in implementing resilience measures so as to reduce the risk of relapsing into another debt crisis, taking into account the challenges posed by the global economic environment and risks for debt sustainability in a growing number of developing countries;

12. *Notes with concern* that some low- and middle-income developing countries that were not part of the existing debt relief initiatives now have large debt burdens that may create constraints on mobilizing the resources needed to achieve the Sustainable Development Goals, indicating a need to consider, as appropriate, stronger debt management initiatives for those countries, and stresses the importance of medium- and long-term debt sustainability to deal with debt, including non-Paris Club debt;

13. *Underlines* the fact that heavily indebted poor countries eligible for debt relief will not be able to enjoy the full benefits unless all creditors, both public and private, contribute to debt workouts, as appropriate, in order to ensure the debt sustainability of those countries, and invites creditors, both private and public, that are not yet fully participating in debt relief initiatives to substantially increase their participation, including by providing comparable treatment to debtor countries that have concluded sustainable debt relief agreements with creditors;

25. *Calls for* the intensification of efforts to prevent and mitigate the prevalence and cost of debt crises by enhancing international financial mechanisms for crisis prevention and resolution, encourages the private sector to cooperate in this regard, and invites creditors and debtors to further explore, where appropriate and on a mutually agreed, transparent and case-by-case basis, the use of new and improved debt instruments such as debt swaps, including debt for equity in Sustainable Development Goal projects, as well as debt indexation instruments;

33. *Encourages* Member States, the United Nations system, the World Bank Group, the International Monetary Fund and other relevant stakeholders, and international financial institutions, to scale up technical assistance in debt management, including debt data recording and reporting, and debt transparency and to provide greater coordination of advice, for the delivery of such technical assistance upon request, and to ensure synergies with the full spectrum of debt management mechanisms;

34. *Invites* donor countries, taking into account country-specific debt sustainability analyses, to continue their provision of concessional and grant-based financing to developing countries, which could contribute to debt sustainability in the medium to long term, and notes the provision by the International Monetary Fund of interest relief to eligible developing countries in the form of zero-interest loans;