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The Impacts of the Covid-19 Crisis in Developing Countries

There is broad agreement that the global economy will contract sharply this year given the sudden stop to large swathes of activity from the Covid-19 pandemic and the resulting income loss in the manufacturing and services sectors across the world. The contraction will be compounded by persistent fragilities surrounding speculative financial positions, and, in particular, the already unsustainable debt burdens associated with highly leveraged corporate loans. These have been built up over the last decade of easy money and sluggish growth against a backdrop of deeply ingrained inequalities.

The avalanche of cheap credit since 2008 has also spilled over to developing countries, creating new financial vulnerabilities and undermining their debt sustainability. There has been a rapid build-up of private debt in reserve currencies and increased penetration of their markets by non-resident investors, foreign banks, and other financial institutions, as well as allowing their own residents to invest more freely abroad. There has also been a strong shift in the ownership of central government debt, including public external debt, from official to private creditors and shadow-banking actors. The greater presence of foreigners in bond and equity markets has increased the potential instability of exchange rates and further exposed domestic financial markets to the unpredictability of global risk appetite and liquidity conditions.

In response to the initial shock, the major developed economies and China have announced stimulus packages to extenuate the mounting economic damage and respond to the health crisis. Aside from financial injections to keep the banking and corporate balance sheets on relatively stable footing, the critical measures to attenuate contractions of economic activity include government spending (particularly on health care), extended unemployment benefits and cash transfers.

Developing countries, however, face distinct pressures and constraints which make it significantly harder for them to enact effective stimulus without facing binding foreign exchange constraints. These countries do not issue international reserve currencies, and they can only obtain them through exports or sales of their reserves. Exports themselves require significant imports of equipment, intermediate goods, know-how and financial business services. Finally, the financial turmoil from this crisis has already triggered sharp currency devaluations in developing countries, which makes servicing their debts and paying for necessary imports for their industrial activity far more onerous.

The Covid-19 shock can be expected to increase financial pressures on developing economies over the coming months, through three main transmission channels.

The first channel is the pressure on government budgets from the public health crisis. Tariff revenues are falling as a result of the collapse in international trade and with employment conditions deteriorating in both the formal and informal sectors, and incomes contracting, fiscal revenues will be squeezed. Tighter fiscal space and weaker healthcare and social protection systems expose developing countries to higher human and financial toll while limiting their ability to respond.

The second channel is international trade. Lower demand for exports and the sharp falls in energy and commodity prices will hit developing countries hard and cause a loss of export revenue in 2020 which UNCTAD has estimated to be at least $800bn. Moreover, other items on the current account, such as remittances, royalty payments and profit outflows, are likely to add to the financing difficulties facing many developing countries over the course of the coming year.

The third channel is through financial flows. A flight to safety has already caused record capital outflows from emerging economies, triggering large currency depreciations against the dollar and widened spreads. This comes against a background of a systematic build-up of financial and debt vulnerabilities in many developing countries over the past decade. Total developing country debt stocks stood at 193 per cent of their combined GDP already at the end of 2018, the highest on record, with close to $3 trillion in repayments due on foreign-currency denominated public debt over this year and the next, including from many G24 member states. In “normal” times, much of this debt would be rolled over, adding to future debt burdens but providing vital breathing space to honour overall obligations. But with sudden stops to external refinancing possibilities this is no longer possible.

It is therefore a matter of immediate urgency that the international community co-ordinates appropriate economic rescue programmes to address the looming financing gap which many developing countries are now facing. These would have to include at least the following measures:

First, a coordinated global response to liquidity shortages to address immediate financing needs. The IMF has signalled that it is willing to fully deploy its current $1 trillion lending capacity, but current lending facilities and financing instruments are complex, tied to inappropriate conditionalities under the circumstances and therefore difficult to access quickly. But the IMF is not only a multilateral creditor. It is, *de facto*, a global lender of last resort. In this regard, an additional and faster avenue to address current liquidity shortfalls is through a much more expansive use of ***Special Drawing Rights***, or the IMF's *own* money. While SDRs remain, broadly, linked to real reserve accumulation in its constituent national currencies, it has, within these (fairly loose) limits a relatively free hand in making use of its money-creating powers to allocate much needed liquidity to where this is most needed. There is little excuse for failing to do so. A serious first step in this direction would be to ensure that around 730 billion SDRs ($1 trillion at the current exchange rate) reaches the international reserve accounts of developing countries fast, which could be achieved through a new allocation of SDRs and an IMF "designated" reallocation of current and new but unused SDRs from advanced countries to poorer developing economies. The required new allocation of SDRs would, no doubt, have to be multiple times that agreed in 2009 (the equivalent of $287 billion at the time).

Second, ***capital controls*** should be endorsed by the IMF as a necessary, permanent and fully legitimate part of any member country's policy regime and wherever appropriate introduced to curtail the surge in outflows, to reduce illiquidity driven by sell-offs in developing country markets, and to arrest declines in currency and asset prices. Implementation should be coordinated by the IMF to avoid stigma and prevent contagion, and who, in cooperation with other appropriate international bodies, should also be tasked with lending the technical support needed to ensure their effectiveness and extending advice on complementary measures needed to deal with related disruptions.

Third, it will be important to ensure that the medium-to-longer term economic fallout from this global crisis does not result in destructive and widespread developing country debt crises. One such measure are ***temporary standstills*** on debt service payments, or a formal or informal agreement between a debtor and one or more of its creditors to suspend these payments for a given period of time to allow debtors to propose restructuring plans. During this time creditors cannot seek legal remedies, a critical provision to keep non-cooperative and litigious creditors (or so-called vulture funds) in check.

Fourth, in addition to temporary standstills, new ***debt relief programmes*** need to be agreed on. On 25 March, the World Bank and the IMF called on all official bilateral creditors to suspend debt payments from the world's 76 poorest economies, currently in receipt of support from the International Development Association (IDA). While a first tentative step in the right direction, more systematic, transparent and co-ordinated steps towards writing off developing country debt across the board, and to advance international consensus-building on how to co-ordinate and advance an international framework to promote inclusive, fair and effective sovereign debt restructurings is long overdue. This will require close and productive collaboration, whether in the context of immediate agreements on short-term debt relief and cancellation, or in regard to longer-term sovereign debt restructurings, between bilateral, multilateral and private creditors with their debtor countries.

Fifth, Official Development Assistance (ODA) must be ring-fenced in all donor countries. Despite a majority of donors having routinely missed agreed ODA targets in the past, and despite ODA flows being spread ever more thinly across additional donor-determined objectives, ODA remains a vital source of external financing for the poorest of developing countries. Over the decade since the financial crisis an additional $2 trillion would have reached developing countries had the 0.7 per cent (of global national income) ODA target been met by DAC members. This, therefore, is the time, for donor countries to, finally, honour their collective commitment and deliver ODA to developing countries in full and unconditionally.

As the health pandemic is brought under control and economic shocks dissipate, a more profound re-evaluation of the multilateral system – promised but not delivered in 2009 – will also be needed to ensure that resilience and fairness become integral characteristics of our more interdependent world.